



The Association of Investment Companies

# Supporting enterprise and growth: the role of Venture Capital Trusts

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## 1. Executive summary

Supporting small businesses which can enhance the UK's rate of economic growth should be a priority for the next government, whatever its political hue. Venture Capital Trusts (VCTs) provide capital and management expertise to growing companies to assist their development, a role which is particularly valuable in the current fragile economic environment. This paper highlights the results of a survey by The Association of Investment Companies (AIC) which demonstrates the impact of this involvement.

- VCTs invest in many commercial sectors, including those identified as particularly important for future growth. These include 'industry' (manufacturing, engineering and electronics), environmental (including renewables), healthcare and telecoms.
- Despite their small size, many VCT-backed firms are often undertaking research and development and/or are seeking and successfully developing export markets.
- As they grow, VCT investee companies create jobs. Of 303 investee companies who provided data in this area, the net employment impact since VCT investment was a 47% increase of the total workforce.
- The VCT scheme operates nationwide and relies on a complex infrastructure that would be very difficult to replicate through an alternative scheme.
- The amounts invested by VCTs fall within the well documented equity gap of £2m to £10m. The average amount invested by VCTs in any single company was £2.5m. In the past VCT investment has also been important in helping secure bank financing. However, recent market developments are expected to increase the VCT sector's focus on stand-alone investment and acting as a substitute for lending where banks have withdrawn from the small business sector.
- 87% of VCT investee companies had a VCT representative join their board. This additional management skill provides invaluable support for growing businesses.
- The public policy cost of VCT investment is offset, and eclipsed, by the tax returns generated by VCT backed companies. In the medium and long term the scheme provides significant opportunities to enhance government tax revenues.

The AIC **recommends** that continued support for the VCT scheme should be part of any future government's plans to support innovation and growth in the UK's small business community.

As we approach the General Election, policymakers on all sides of the political spectrum should make a public commitment to sustaining the VCT scheme to provide certainty and continued confidence in the scheme.

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## 2. Context

Stimulating enterprise will be an important component in restoring the UK's fiscal and economic health. The development of growing businesses, able to provide tax revenues to support public spending and help pay off government debt, as well as creating jobs, will be a priority for the next government, whatever its political hue.

Venture Capital Trusts (VCTs) invest in smaller companies to secure enhanced growth. (See Box 1. for an overview of the VCT structure.) They provide capital and management expertise to businesses which otherwise might struggle to raise development funding. This assistance is particularly important in the current fragile economic environment.

### Box 1. Overview of the VCT Structure

VCTs were launched in 1995 as vehicles to encourage private investors to invest in small higher-risk UK unlisted companies which need start-up, early stage or expansion capital. They pool this money and employ a professional fund manager to make the day-to-day investment decisions. A small number of VCTs are 'self-managed' by their directors. All VCTs are specialist investment vehicles which aim to invest in companies that have the potential for good growth. VCTs commonly fall into three broad sectors: generalist, AIM, and specialist sectors e.g. technology.

VCTs themselves are listed on the London Stock Exchange and subject to tax law, company law and the UK Listing Rules. Each VCT has a board of directors which monitors its performance and has a legal duty to uphold the interests of its shareholders.

VCTs offer investors certain income tax and capital gains tax reliefs to compensate for investing in an inherently risky asset class. These include:

- income tax relief on the initial investment when subscribing to new VCT share issues (providing the shares are held for a minimum period of time)
- tax-free dividends
- tax-free capital gains

VCTs access a unique source of capital as they rely on funds provided by private investors. They therefore supplement the funds available from other sources, such as banks. Over £3bn has been raised under the scheme so far and VCTs have proven to be a sustainable mechanism – without a single fund failure over the lifetime of the scheme.

Their experience of investing in smaller companies will be invaluable in delivering growth in the current challenging economic environment and beyond. While new initiatives have inherent political attractions, policymakers should not ignore the potential of the VCT sector and should commit to maintaining its role.

## Case Study



### Accelerating early drug development

#### The business

Founded in 1996, Xceleron is a leading expert in providing analysis for early drug development. It was spun out of the University of York to commercialise the medical application of its Accelerator Mass Spectrometer (AMS). Since then, it has established itself as the world's leader in Microdosing, an innovative new method of testing drugs in humans prior to full clinical trials, and related services.

#### The investment

Albion Ventures' VCTs invested £1.5m in Xceleron in April 2005 when the University of York still held over 80% of the company. At this point, Xceleron required substantial working capital to support its growth. Albion Ventures helped to recapitalise the business, providing essential growth funding, while ensuring that staff would benefit from Xceleron's future success through the provision of a 20% option pool.

Albion Ventures' VCTs provided additional funding of £2.7m over the following years as the company sought to increase its growth rate.

#### Business developments

VCT funding was used to purchase essential capital equipment and support short term losses. In addition, Albion Ventures helped Xceleron develop its strategic direction and, in particular, oversaw the company's successful expansion into the key US market. It also assisted with the recruitment of a chairman, chief executive and finance director, and the implementation of a structured staff bonus scheme. In the years following VCT investment, staff numbers increased from 14 to over 50.

Xceleron is now the world leader in its field and attracts business from leading pharmaceutical and biotechnology companies in Europe, North America and Asia. The company continues to pioneer new developments in this rapidly growing field and enjoys substantial market share.

#### Results

In the year of investment, turnover was £1.4m and the business was making a small loss. The company now has a global presence, with sites in two continents, turnover has increased almost fourfold and the company is profitable.

Xceleron's Chairman commented: *"Over the four and a half years since Albion Ventures first invested in Xceleron, the cash invested has always been secondary to the skills...., experience.... and networks ....of the Albion executives. They understand young, entrepreneurial, genuinely high technology companies..."*

The Association of Investment Companies (AIC) has 93 VCT members which hold some £1.9bn of assets (88% of the sector by assets). It recently surveyed 15 managers employed by 61 VCTs to explore the impact of VCT investment. The surveyed funds held assets of £1.4bn on the survey date, which represented 62% of the sector's total assets, and 73% of those focused on unquoted investments.

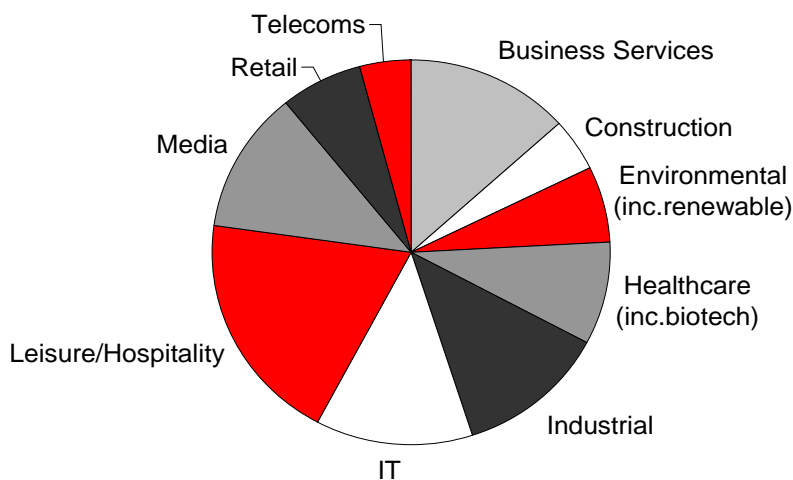
In the five years between April 2004 and April 2009 these 61 VCTs invested £973m in 384 smaller unquoted UK companies. The survey's focus on these businesses reflects the attention being given by policymakers to the particular difficulties being faced by these companies.

It is also worth noting that VCTs also invest in companies which trade their shares on the Alternative Investment Market (AIM). Issuing shares on AIM is often a stepping stone from a purely private context and an important aspect of corporate development. Overall, we estimate that some 20%, or approximately £450m, of VCTs assets are invested in AIM traded shares. Nevertheless, this paper's sole focus is on the impact of VCT investment in unquoted companies.

### 3. Supporting key growth sectors

The survey illustrates the diverse range of sectors in which VCTs invest.

**Fig 1: Sectors receiving VCT investment**



The main beneficiary of VCT investment over the period was the leisure and hospitality industry, which received just under 20% of capital invested. Business services providers were the next largest recipient of capital and received 13% of the total. The popularity of these sectors reflects the broader dynamics of the UK economy, which includes a very high focus on these commercial activities.

## Case Study



### Rapid expansion of active lifestyle wear brand

#### The business

Fat Face is a brand of active lifestyle wear launched in 1989 as a way of financing the founders' extended skiing trips. The first shop was opened in Fulham in 1993, starting a period of exponential growth.

#### The investment

In mid-1999, the two founders decided to sell the business. ISIS, the investment managers of the Baronsmead VCTs, originally considered a management buy-in but concluded that the founders were essential to the business until a second tier of management could succeed them. In 2000, the first two Baronsmead VCTs were two of the ISIS clients that paid £3.5m for 40% of the business, with the founders retaining 51% and the remaining 9% reserved to provide options to the current and future senior managers. A further £1.5m was provided by bank debt.

#### Business developments

The investment by ISIS clients combined with the depth of experience in professionalising a growth business at ISIS enabled the business to grow rapidly. The multi-channel approach of high street shops, direct mail and website sales continued to be developed. The brand skills of the founders were retained and they moved gradually towards non-executive roles.

ISIS introduced a new chairman and two ISIS executives attended board meetings (one of whom became a non-executive director) so as to meet the governance standards required for such a fast growth business that was doubling in size every two years. A new Chief Executive Officer and Finance Director together with a full cadre of second tier management were put in place to meet the challenges of the increasing complexity and size of the company.

Innovation was a recurring theme for Fat Face. It was one of the very first truly integrated 'multi channel' retailers (store, catalogue and web) with all the operational challenges that posed. It defined a brand position that has proved sustainable and scalable as well as stretching its brands from a menswear core into dressing the whole family. Management professionalisation alongside investment in the IT and logistics base permitted rapid growth. UK outlets grew from 28 to 100 and employees rose from 191 to 1,316 over the five year period of investment.

#### Results

In 1999, the company's turnover was £7m. During the period of VCT investment, annual turnover grew to £60m and profits to over £8m in the year to May 2006. The acquisition of the business by Advent International in 2005 generated a return of nearly 12 times the initial investment.

However, VCTs also targeted less prominent sectors which have been the subject of recent political interest. The third largest recipient of VCT capital, 12% (or £120m), were industrial sectors, which include manufacturing, engineering and electronics companies. Another sector identified as a political priority also supported by VCTs were environmental businesses, including renewable energy, which secured 6% (or £62m) of the total. Healthcare, including biotech, was also targeted by VCTs as an area with growth potential, and received nearly 9% (£84m) of the capital invested.

VCTs have the potential to stimulate growth in commercial sectors which have been identified by policymakers as important sources of future economic activity for the UK.

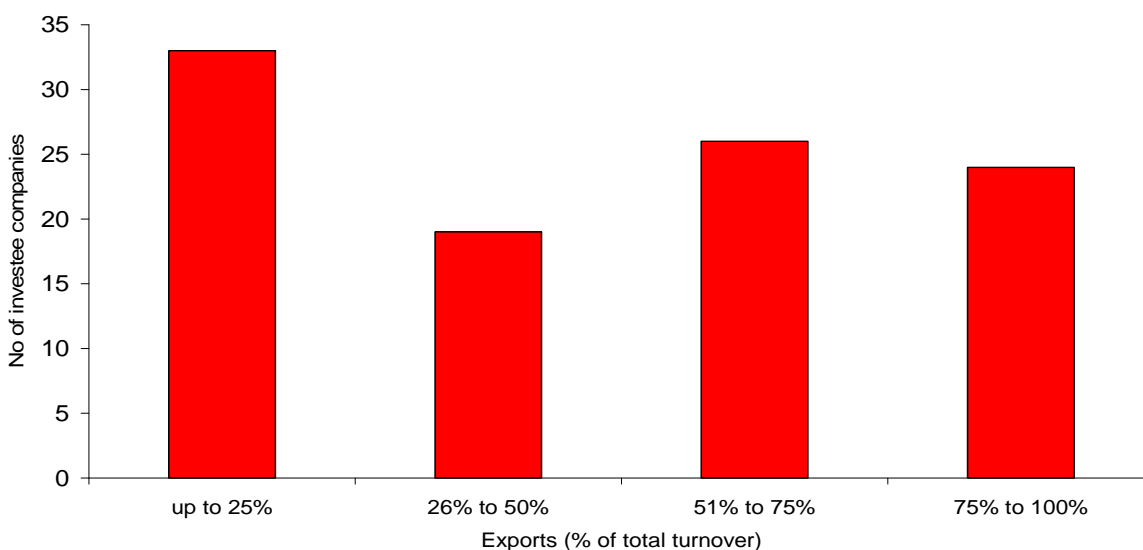
## 4. Focus on R&D and exports

Companies supported by VCTs also have ambitions for development not universally shared by other smaller UK companies. This is illustrated by their focus on R&D and ambition to secure export markets.

88 investee companies disclosed dedicated R&D spending totalling £55.4m. We anticipate that this represents a significant level of activity in this area in comparison with other smaller companies. The average amount spent in the last year of the survey was £630,000. 21 of the 88 companies devoted over £1m to R&D activities.

102 investee companies provided data on the level of their turnover derived from exports. Their total exports were £303m (from a total turnover of £920.7m), averaging nearly £3m per company. 62 of these companies reported exports of over £1m. The percentage of turnover these companies earned outside the UK is shown below.

**Fig 2: Proportion of turnover earned outside the UK**



## Case Study

# ANTIC

### Replacing bank financing

#### The business

Antic had successfully owned and operated a number of South London public houses for 10 years, most of which were leasehold properties although it also wanted to extend its portfolio to freeholds. Freehold properties provide far greater opportunities to develop an individual and sustainable brand either individually or as part of a wider group.

#### The investment

In early 2009, an opportunity arose for Antic to acquire the freehold interest of three existing and successful leasehold units from Punch Taverns plc. It approached its bank, which originally indicated a willingness to lend, but this source of finance eventually fell through.

Although it was late in the process, Downing VCTs were able to invest £4.2m to complete the deal within extremely tight deadlines and allow Antic to take advantage of this important commercial opportunity.

#### Business developments

Having bought out the freeholds, Antic is now operating the pubs without the restrictions typical of tied leases. This is expected to result in increased profitability and employment, particularly once the range of services have been extended to include a full food offering in each location.

One of the recently purchased units, The East Dulwich Tavern, the first to benefit from an upgrade to food provision, has been called by Time Out 'one of the best things going on in the neighbourhood'.

Anthony Thomas, Antic's founder, commented: *"Downing VCTs were brilliant. They stepped up to the plate extremely quickly and have since left us to get on with running the business. When we do need them they are always there to give us the benefit of their experience. They made the whole process run far smoother than I could have possibly imagined."*

#### Results

The businesses are operating to plan and Downing looks forward to developing a long term relationship with Antic.

Of those companies which disclosed export earnings, half of them generated more than 50% of their turnover outside the UK. Again, we anticipate that this statistic compares favourably with other similarly sized UK companies and that the provision of capital and management expertise by VCTs makes a significant contribution to this performance.

### 5. Supporting and creating employment

VCT investment often supports job creation. The survey received data on employment levels from 303 investee companies. Their total workforce at the time an investment was made was 17,219. The total at the survey date (April 2009) or, if a divestment had been made, at the time of exit, was 25,402.

These companies therefore created just over 8,000 more jobs, a rise in the workforce of 47%.

The increase in employment was not evenly distributed. 46 of the investee companies saw a decline in numbers employed (from 4,636 at the time of investment down to 3,076 at the time of the survey/divestment date). This reflects the fact that some investee companies need reorganisation to secure a healthy business model and the potential for further growth.

While any job losses are unfortunate, we anticipate that these jobs will be more sustainable than they would otherwise be because the company has received the capital it requires and is now subject to the professional standards required by VCT managers as a condition for investment. Without these benefits the company may be less able to sustain its business model and employment capacity. This threat will have been greater during the difficult trading conditions covered by the survey period. Also, while these businesses may have seen an initial reduction in their workforce, they should now be in a better position to grow and hopefully create more jobs in the future. VCT involvement in a small company is a dynamic process, and jobs created to date are not the end of the story.

The overall impact of VCT investment on employment is positive and significant. We anticipate that even the strong record shown by this data understates the full picture as VCT-backed companies will also support other jobs up and down their supply chain.

### 6. An established national network

A critical advantage of the VCT scheme is that it operates across the UK. This makes it uniquely able to support developing companies facing a funding gap wherever they are located.

The 125 VCTs which comprised the sector at the survey date employed 36 specialist fund managers to run their portfolio. As much as half of a VCT manager's time is devoted to identifying suitable investment opportunities and selecting the most attractive. Significant effort is also devoted to running the portfolio and providing input into investee companies. To fulfil these tasks VCT managers employ some 200 investment professionals with extensive experience of the sector as well as around 150 support staff.

## Case Study



### Developing green technology

#### **The business**

Silvigen is a biomass fuel supplier specialising in eucalyptus energy crops and waste wood. It arranges the establishment of eucalyptus plantations, and processes the biomass into pellets that are then used as fuel by power generators.

Silvigen was formed in 2005 to advise Drax Power (which generates some 10% of the UK's electricity) on using biomass within its coal-fired power station. Power generators' use of biomass reduces their CO2 emissions and liability under the EU Emissions Trading Scheme. In 2008, Silvigen started supplying power generators with waste-wood biomass fuel. It then sought to expand its business beyond fuel supply and into the provision of heat, through long-term heat supply contracts. This would allow schools and hospitals to reduce their reliance on imported fossil fuels and help them meet responsibilities under various environmental legislation.

#### **The investment**

In early 2008, Silvigen approached several banks to raise £1.75m of finance for its fuel processing operation. Ultimately, no banks were prepared to invest and Foresight had to fund the whole project, £1.5m of which came from its VCTs. A Foresight manager joined the board and helped to instill a more professional ethos into the business, for example by introducing new reporting mechanisms. Foresight also restructured the management team towards securing a wider base of customers.

#### **Business developments**

Foresight invested a further £1.2m in 2009 to provide working capital to deal with operational delays, with just over £1m coming from its VCTs. This allowed the completion of a processing plant in Goole, with capacity to annually produce 40,000 tonnes of wood pellets and sales of around £4m. When fully operational, it will employ 12 operatives in addition to the management team of 6. More staff will also be needed for the heat and eucalyptus divisions, the latter of which will be developing a whole new market sector. Silvigen is discussing supply contracts with several large power generators and expects to develop at least two further processing plants. It has also received significant interest for its heat supply contracts, particularly from local authorities.

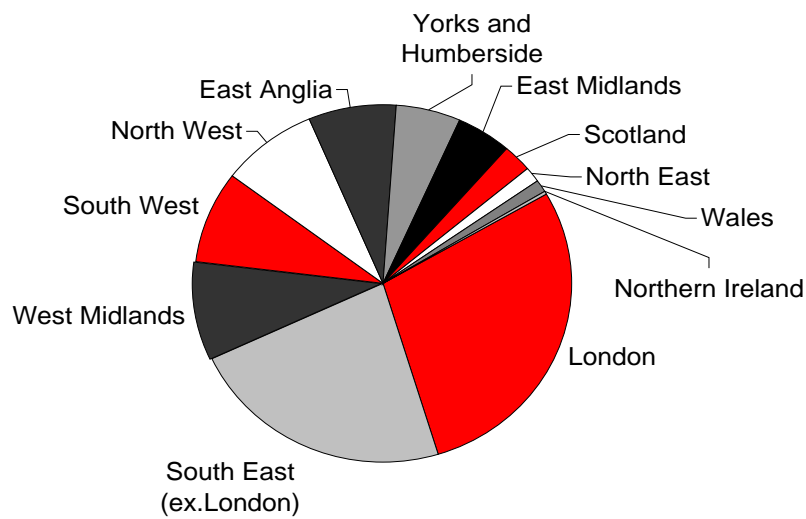
#### **Results**

Silvigen is expected to generate revenue from early 2010. The investment is currently valued at cost.

In addition to these dedicated managers, an extensive professional network surrounds the sector and creates a flow of investment propositions for consideration by VCTs. This resource has evolved through the ongoing contacts developed and sustained by VCT investment managers. Professional advisors (lawyers, accountants etc), many of whom are experienced in working with smaller companies, advise on VCT deals and help link VCTs into small business networks. VCTs also have relationships with business angels and academic institutions which provide further reach for the sector.

VCT managers are dispersed across the UK and have offices in cities including Aberdeen, Birmingham, Bristol, Edinburgh, Glasgow, Leeds, Liverpool, London, Manchester, Newcastle and Oxford. The geographical distribution of investee companies is similarly broad.

**Fig 3: Distribution of investee companies**



London and the South East take the lion's share of investment, reflecting the overall balance of economic activity within the UK. Nevertheless, other parts of the UK also capture significant investment and the VCT sector has a truly national reach.

The value of this network should not be underestimated. It has been created over the duration of the VCT scheme and would be very difficult for a competing financing process to replicate.

## Case Study



### Delivering success in facilities management

#### The business

Covion provides facilities management services in the office and industrial sectors. Its services include providing maintenance, cleaning, security and reception staff. Its goal is to allow customers to focus on achieving their business goals, rather than being concerned with infrastructure matters. Covion forms a unique and close partnership with its customers by setting up a Joint Executive Board, with its clients, to which one of its managers, based at the customer's site, reports. The business was formed in 2000 with backing from a group of business angels.

#### The investment

Covion approached Foresight and another VCT investor, Octopus Private Equity, in February 2005 for funding to buy out the original business angels and to provide a partial exit for the company's founders. Only £2.75m of the required £8.4m could be met through bank borrowings. Foresight was impressed by the management team's track record and the performance of the business to date. The Foresight VCTs provided £2.5m of investment and the Octopus VCTs a further £1.3m. Foresight and Octopus recruited an experienced chartered accountant as a mentor to the company's young finance director. Executives from Foresight and Octopus joined the Covion board.

#### Business developments

Covion's revenue increased to £10m in 2004 and to £25m in 2006. Employee numbers during the period of VCT investment increased from 287 to 600. In 2007 the business was sold to Balfour Beatty for £33m.

#### Results

As a result of the acquisition by Balfour Betty, the VCTs achieved a return of 4.4 times their original investment and an 84% IRR. David Steventon, one of Covion's founders, commented: *"Our VCTs were brilliant. They left us to get on with running the business, but were always there to give us the benefit of their experience when we needed it. Foresight contributed significantly when we were going through the sale process and [their] attention to detail helped us to make sure that we went to market with an excellent Information Memorandum."*

Covion continues to trade successfully within the Balfour Beatty group. Foresight has since invested in another company set up by Frank Rodriguez, Covion's other founder.

## 7. Tackling the equity gap

The amounts invested by VCTs closely match the requirements of smaller companies facing an equity gap. The Rowlands Growth Capital Review, for example, found that businesses seeking to raise between £2m and £10m faced particular difficulties in securing financing. Across all sectors the average amount invested by VCTs in each company was £2.5m (see Fig 4).

**Fig 4: Level of VCT investment**

Amount invested	Number of investee companies
Up to £1m	82
£1m to £2m	110
£2m to £5m	158
£5m to £10m	32
Over £10m	2
<b>Average investment</b>	<b>£2.5m</b>

Around half of the investee companies in the sample received more than one round of financing. The provision of ongoing support is a particularly valuable aspect of VCT investment. Further top-ups of capital help impose commercial discipline on investee companies as well as providing money required to deliver their business objectives. (See Box 2. for further discussion of the structure of VCT investment.)

### Box 2. Approach to investment

The precise nature of VCT investment will vary in different situations.

- **VCT investment may be 'stand alone'**, where VCTs, alone or in partnership with other VCTs, are the only providers of development capital to the investee businesses. This is expected to become increasingly important as other sources of finance become more difficult to secure and banks withdraw from lending to small business, widening the traditional finance gap. VCT investment may also involve follow-on funding for companies which they supported earlier in the economic cycle. This protects current investments and helps businesses trade through testing market conditions.
- **VCT investment can be deployed alongside other sources of funding**, notably bank financing. This customarily arises where the company's management perceives greater opportunities for growth than its current owners and invests (with support from a bank) alongside the VCT. The VCT often helps the co-investors hone their business plan (including establishing rigorous financial and other internal controls) and increases the company's credibility with lenders.
- **VCT backing supports 'operational' financing to portfolio companies.** VCT managers have reported cases where the presence of VCT investment has reassured lenders about a company's financial controls, and that this mitigates their risk. Also, small businesses have found leasing arrangements easier to secure where they have a VCT investor. Most significantly, VCTs have provided 'follow on' operational financing as a substitute for bank lending. Anecdotal evidence suggests that support of this nature has become a more common requirement in current market conditions.



## Case Study

### Maintaining the UK's Strategic Highways Network

#### The business

Carnell was formed in 1992 to provide maintenance services to the major service providers who manage the technology and infrastructure of the UK Highways Network. Its ultimate customers include The Highways Agency, Transport Scotland, Transport Wales, Transport for London and some local authorities, Carnell also works in partnership with a range of private sector support services businesses to deliver its services.

Carnell provides expert advice for planning, project management, implementation and installation services covering the drainage, water management, road maintenance and communication equipment on the Network such as the telecoms infrastructure and electronic message signs. It has developed a patented on-site process to refurbish road side drains in an environmentally friendly and cost effective way.

#### The investment

The founder sought an investment partner who could help continue to innovate, grow and develop the business. After a dialogue spanning two years, the Baronsmead VCTs managed by ISIS invested £6m in Carnell in 2008 taking a 37.5% shareholding.

#### Business developments

ISIS introduced a chairman with whom they had worked at two earlier investments (where he had been CEO) and one ISIS executive became a non-executive director. The board has subsequently worked to strengthen the senior management team and invested to improve the operating infrastructure. The founding Chief Executive summed up the experience as: *"Entering a private equity partnership has been very challenging for me in a positive way. I like that it has given me a focus and the tools to drive the business through a formalised process that I have never had before.."*

Since formation, Carnell has provided cost effective and sustained innovations to help their customers keep strategic roads operating smoothly. Increasingly technology solutions are required to power the sophisticated electronic signage. See [www.carnellgroup.co.uk](http://www.carnellgroup.co.uk) for the full range of services.

#### Results

Turnover for the main operating company has grown from £13m in the year to 30 September 2007 to more than £30m in 2009.

Early stage or start up companies were significant recipients of VCT support over the period, with 110 of the 384 companies falling into this bracket. Each received, on average, investment of £2m. The rest of the sample, 274 companies, received development capital. As would be expected, the amount of financing provided for these companies was slightly higher, at £2.7m per company.

A significant proportion of VCT investment was made alongside bank finance. Most of these deals involved management buy-ins or buy-outs, a process which has traditionally been an important stage in the development of smaller unquoted companies where the individuals committed to the purchase have greater ambition or a clearer view of how the company can be developed than its existing owners.

119 of the deals undertaken by the VCTs in the sample were made alongside bank finance. They provided some £360m of capital with a further £540m provided by banks. VCT investment averaged £3m per deal with banks providing an additional £4.6m. The total investment of £7.6m per deal sits clearly within the gap identified by the Rowlands review.

The ability of VCTs to help secure loans will remain significant as conditions for acquiring debt finance are currently more challenging than in the past. Nevertheless, in the immediate future at least, we anticipate that VCTs are more likely to be investing without any accompanying bank finance. This is a consequence of the lower availability of bank finance. It may also be influenced by more difficult trading conditions, which could make equity financing more attractive than loans requiring regular interest payments.

## 8. Capital plus expertise

VCTs also help enhance the general viability of the investee company by providing additional management resources. This aspect of VCT investment should not be underestimated. 87% of the companies included in the survey had a representative of the VCT join their board of directors. These businesses were able to gain from their experience and insight as well as securing an additional resource dedicated to their commercial development.

VCT investors also often seek to influence management by analysing the company's current skills and identifying possible gaps which need to be filled to ensure it is best placed to deliver its commercial goals. A common example might be the appointment of specialist finance or marketing directors to provide skills the original team may not possess.



## Case Study

### Delivering rapid growth in care services

#### **The business**

Careforce provides care for the elderly and infirm in their own homes. Its services are delivered principally with local authorities.

#### **The investment**

Albion Ventures' VCTs backed the company virtually from its inception. The state-funded domiciliary market was experiencing rapid growth due to demographic changes and an increased desire to provide care for the elderly in their own homes. In addition, local authorities were starting to outsource the provision of care to the private sector. Venture capital funding was an attractive option for Careforce because it provided access to fast and flexible investment suitable for its size and level of risk. Albion Ventures' VCTs invested £4.5m between 2000 and 2004 through a mixture of loan stock and equity. Albion Ventures appointed directors to the board, including one of its own partners, and recruited a new chairman.

#### **Business development**

Albion Ventures helped to build Careforce's strategy. In particular, it supported its expansion programme by establishing suitable acquisition criteria. As a result, Careforce acquired many other domiciliary care businesses and now operates from branches across Lancashire, Yorkshire, East Anglia, the Midlands and the South East of England. By 2008, employee numbers had risen from 20 to 1,584.

In November 2004, Careforce floated on London's AIM Market and became Careforce Group plc. In 2008, it was acquired by Mears Group PLC for £22m, at which point the Albion Ventures' VCTs sold their entire investment. The business is a now core part of Mears and continues to expand.

#### **Results**

Revenue grew from £0.4m at initial investment to £20m just prior to the float on AIM. At this point the amount originally invested by the VCTs was returned and they continued to retain 20% of the company. Revenue increased to £29m in 2006. As a result of the acquisition by Mears Group, the VCTs received £4.7m, doubling their cash return and generating an IRR of 24%.

## 9. Growing government tax receipts

Current fiscal conditions make it especially important that policy interventions to support the UK's enterprise economy are cost effective. While the VCT structure is inherently cost effective (see Box 3.), evidence also indicates that VCT investment supports significant tax revenues in its own right.

### Box 3. An efficient investment process

The structure of VCTs is inherently suited to delivering targeted and cost effective investment in small and growing companies because:

- Government costs are offset by private investors putting their own capital at risk. This enhances the attraction of using the VCT route in comparison with alternatives which rely entirely on public resources.
- They utilise established market mechanisms. Expert investors evaluate companies in an effort to secure a good return for their clients. They have commercial incentives to seek out the most viable investment opportunities from the pool of opportunities allowed by the scheme rules. This targets the intervention and reduces the risk of investment in 'lame ducks'. Successful investment attracts future investment capital for small businesses which face a finance gap but nevertheless offer prospects of creating economic growth.
- The fund model is predicated on recycling the proceeds from divestment. This means that VCT money may be recycled when an interest in a small business is sold. Some older VCTs have already invested their capital nearly twice-over as exit proceeds have been circulated back into new investments.
- VCT managers provide additional assistance to investee companies to foster the development of the business and secure its ongoing success.
- The conditions which govern VCT investment mean that they support companies which are otherwise unlikely to thrive without assistance from a scheme dedicated to promoting enterprise. These companies have low levels of internal resources to support their business models and owners without collateral to secure financing from other sources. At the same time, they offer sufficient promise for a VCT manager to devote capital and time to supporting their growth.

247 investee companies provided details of the tax they had paid in the previous full year (see Fig 5).

## Case Study



### Supporting manufacturing through economic hard times

#### **The business**

TFC is one of Europe's leading suppliers of technical fasteners. It aims to be a single source supplier and has a large range of standard and bespoke products. It supplies a wide range of industries, including aerospace, automotive, hydraulics and petrochemicals. It is also an exclusive distributor in the UK for a leading US manufacturer. Since its establishment in 1960, TFC has developed internationally with over 45% of its sales being exported to 24 countries worldwide. TFC operates from a number of sites in and outside Europe.

#### **The investment**

In 2007, the Foresight VCTs funded the transfer of the business from the retiring founding director to a team comprising an external individual with fifteen years' experience in the sector and four senior long-serving employees of the company. Foresight was attracted by plans to expand fastener sales through the provision of 'just in time' service centres in key geographic areas of the UK. The total funds required were £5.5m. The Foresight VCTs invested £1.5m for a 37% shareholding in the business. An executive from Foresight joined the board.

#### **Business developments**

TFC acquired another fasteners company in April 2008 which was funded through bank debt. Trading at both businesses was satisfactory in the months thereafter, but the effects of the recession started to become apparent in the final quarter of 2008. The company's bankers were asked to revise covenants, which resulted in a significant increase in the cost of financing the company's debt. The Foresight VCTs committed a further £750,000 between February and May 2009. In the meantime, TFC had to cut staff numbers of 54 by around 40% to save £1.3m in annual running costs. A phased repayment of corporation tax liabilities and PAYE was agreed with HMRC. The Foresight VCTs had to increase their exposure to the business by 50%.

#### **Results**

Since VCT investment in 2007, turnover has increased from nearly £8m to £11m. The business is trading profitably on a monthly basis, although the effects of the recession are still apparent.

**Fig 5: Taxes paid by VCT investee businesses**

Type of tax	Number of companies providing information <sup>1</sup>	Aggregate revenues (£ millions)
PAYE and social security contributions	247	169.8
Corporation tax	86	21.6
Net VAT paid over	95	47.2
Business rates	146	9.5
<b>Total</b>		<b>248.1</b>

<sup>1</sup> Some of the 247 may be paying additional tax which has not been disclosed in this survey as information was not available when the data was compiled.

These 247 investee companies received aggregate VCT investments of £696.1m. The “tax cost” of those investments can be calculated at £371.3m. This assumes that the VCTs involved invest 75 % of the funds available to them i.e. it “grosses up” the aggregate amount of investments by 100/75. It also assumes that the aggregate figure costs the maximum rate of initial income tax relief possible i.e. 40%. This is therefore a conservative estimate which maximises the possible cost to the taxpayer for the purposes of this analysis.

Nevertheless, in a single year, the surveyed companies returned some 67%of the estimated tax cost. On the basis that VCT investments are held (on average) for at least five years the tax cost is repaid three times over the period of the investment.

While some of these tax revenues would have been accrued without VCT investment, we are confident that the tax revenues are stronger than they would otherwise have been. VCT investment secured growth (including increased employment) and sustained companies which may not have otherwise been in a position to pay tax. This strongly indicates that in a relatively short period the direct costs of the VCT scheme are certainly recouped and are very likely to deliver increased tax receipts over the medium term.

## 10. Policy conclusions

This survey data does not cover all VCT investments but we believe that it is indicative of the overall impact of the scheme.

Even where companies do not provide the same level of benefits (e.g. employment creation and tax receipts) VCT successes offset these and provide the broader public policy benefits the scheme is intended to deliver.

Particularly striking is that the level of VCT investment precisely targets the identified funding gap of between £2m and £10m – a gap which is likely to become even more pronounced given current conditions in the banking sector.

VCTs are successfully playing the role they were designed for and doing so at a small or no cost to the Exchequer. The evidence suggests that over the medium term VCT investee companies not only pay back the cost of supporting the scheme, they will even surpass it. Potentially the cost is therefore only one of timing. Overall the VCT scheme has a net positive impact on Exchequer receipts and it is an investment which will secure higher tax receipts for the Government in the future.

The ongoing debate over the best way to stimulate the small business sector is a welcome one. However, recent months have seen a wide variety of new approaches and structures mooted. The difficulty is that these schemes will take time to become established, not least because of the potential need for approval from the European Commission, but also because of the practical considerations involved, for example, where will the funding come from and how will a new initiative be staffed? There is no guarantee that an alternative scheme will be able to replicate the track record, skills base and extensive network already achieved by the VCT initiative.

VCTs are a unique private/public partnership which draw upon private investors' savings to create funds targeted on entrepreneurial, innovative companies. Without VCTs pooling these funds, these resources would lie untapped. VCTs operate in a competitive market. This weeds out lame-duck investment propositions, helps identify the companies most likely to provide future growth and employment and ensures that public funds are utilised as effectively as possible.

The AIC **recommends** that continued support for the VCT scheme should be part of any future government's plans to support innovation and growth in the UK's small business community.

Policymakers on all sides of the political spectrum should make a public commitment to sustaining VCTs to provide certainty and continued confidence in the scheme.

## Annex: Survey of VCT qualifying investments

This survey explores the type of companies which VCTs have invested in, the sectors they are involved in, how much capital was provided and the contributions those companies make to the UK economy through tax payments and employment.

It covers 15 managers employed by 61 VCTs which held assets of £1.4bn on the survey date. This represented 62% of the sector's total assets and 73% of all those focused on unquoted investments.

In the five years between April 2004 and April 2009 these 61 VCTs invested £973m in 384 smaller unquoted UK companies. (Unless otherwise stated all figures are based on all 384 investee companies in the sample.)

### A. General characteristics of VCT qualifying investments

Stage of investment	Number of investee companies	Total invested	Average investment
Early stage/start up	110	£220.9m	£2.0m
Development capital (MBOs and MBIs)	274	£752.4m	£2.7m

Amount Invested	Number of Investee Companies
Up to £1m	82
£1m to £2m	110
£2m to £5m	158
£5m to £10m	32
Over £10m	2
Average investment	£2.5m

Investments by VCTs alongside bank finance	
Number of investee companies	119
Total invested	£909.7m
Amount invested by VCTs	£363.0m
Amount invested by banks	£546.7m
Average investment by VCT	£3.0m
Average investment by bank	£4.6m
Average total investment	£7.6m

Investments by VCTs without bank finance	
Number of investee companies	265
Amount invested by VCTs	£610.3m
Average investment	£2.3m

## B. Sector spread of VCT investments

Sector	Number of Companies	Total Invested	Average Investment
Business (support) services	54	£129.4m	£2.4m
Construction	16	£43.2m	£2.7m
Environment (inc. Renewables)	35	£62.3m	£1.8m
Healthcare (biotech)	11	£13m	£1.2m
Healthcare (other)	37	£71.1m	£1.9m
Industrial <sup>1</sup>	47	£119.8m	£2.5m
IT and related services	51	£124.2m	£2.4m
Leisure (incl hospitality)	56	£188.1m	£3.3m
Media (inc. marketing and Publishing)	36	£117.8m	£3.3m
Retail and distribution	20	£64.2m	£3.2m
Telecommunications	21	£40.2m	£1.9m

<sup>1</sup>: Includes manufacturing, engineering and electronics

## C. Research and development

88 companies included in the survey provided details of their latest (annual) figures for their research and development (R&D) expenditure.

The figures can be summarised as follows:

- 88 investee companies made aggregate R&D expenditure of £55.4m
- The average R&D expenditure per investee company was £630,000
- 21 of the 88 investee companies made R&D expenditure in excess of £1m

## D. Export turnover compared with total turnover (102 responses)

Exports (% of total turnover)	No of investee companies
up to 25%	33
26% to 50%	19
51% to 75%	26
76% to 100%	24

## E. Employment creation

303 investee companies provided details of employee numbers

	Number of employees at time of the VCT investment	Number of employees at the time of the survey or when VCTs realised their investments
Companies that have increased the number of employees or maintained the number of employees at the time of the investment (257 companies)	12,583	22,326
Companies that have seen a reduction in the number of employees from the date of the investment (46 companies)	4,636	3,076
<b>Total (for 303 companies)</b>	<b>17,219</b>	<b>25,402</b>

## F. Geographical spread of investments

Region	No of companies	Total investment	Average investment
London	107	£277.2m	£2.6m
South East (ex London)	94	£223.9m	£2.4m
West Midlands	27	£85.2m	£3.1m
South West	28	£81.1m	£2.9m
North West	25	£80.7m	£3.2m
East Anglia	33	£73.2m	£2.2m
Yorkshire and Humberside	22	£55.3m	£2.5m
East Midlands	18	£44.5m	£2.5m
Scotland	18	£24.8m	£1.4m
North East	7	£14.7m	£2.1m
Wales	4	£10.8m	£2.7m
Northern Ireland	1	£1.9m	£1.9m

**G. Tax attributable to VCT investments (based on 247 companies which provided relevant information)**

Type of tax	Number of companies providing information	Aggregate revenues (£ millions)
PAYE and social security contributions	247	169.8
Corporation tax	86	21.6
Net VAT paid over	95	47.2
Business rates	146	9.5
Total	247	248.1

Some of the 247 may be paying additional tax which has not been disclosed in this survey as information was not available when the data was compiled.

The 247 investee companies in this part of the survey received aggregate VCT investments of £696.1m.

The “tax cost” of those investments (assuming that the VCTs invest 75% of the funds available to them i.e. need to “gross up” the aggregate amount of investments by 100/75 and then assume that aggregate figure costs the maximum rate of initial income tax relief of 40 % which will be the maximum rate to apply) is £371.3m.

On that basis in a single year the surveyed companies returned some 67 per cent of the “tax cost”. On the basis that VCT investments are held (on average) for at least five years the “tax cost” is repaid over three times.



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## For further information

### Visit our website

Our website is a good place to start if you want to learn more about VCTs or other investment companies. You can find it at [www.theaic.co.uk](http://www.theaic.co.uk).



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