

# **Bridging the finance gap: next steps in improving access to growth capital for small businesses**

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December 2003



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**Bridging the finance gap:  
next steps in improving  
access to growth capital for  
small businesses**

December 2003

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### **HM Treasury contacts**

This document can be accessed from the Treasury Internet site at:

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For further information on the Treasury and its work, contact:

Correspondence and Enquiry Unit  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4574

E-mail: [public.enquiries@hm-treasury.gov.uk](mailto:public.enquiries@hm-treasury.gov.uk)

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### **Small Business Service contacts**

You can also find SBS on the Internet at:

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For enquiries about this publication or to obtain further copies, contact:

*Bridging the Finance Gap*  
SBS Enquiry Line  
Small Business Service  
St Mary's House  
c/o Moorfoot  
Sheffield  
S1 4PQ

Tel: 0845 001 0031

Fax: 0114 279 4458

E-mail: [enterprise@sbs.gsi.gov.uk](mailto:enterprise@sbs.gsi.gov.uk)

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# FOREWORD

Over the past six years, this Government's priority has been to ensure and entrench macroeconomic stability. As a result, for the first time in fifty years, Britain – usually the country first in, worst hit and last out of a downturn – has not only avoided recession but continued to grow in every quarter since 1997.

And now that a British consensus has been achieved on the fundamentals of economic stability, it is the right time to forge a deeper British consensus on support and enthusiasm for enterprise. Building on our hard won platform of stability, we must break away from a past in which enterprise opportunity was too often seen as a closed circle for a privileged few, and ensure that the opportunities and benefits of enterprise can be shared by all.

Our aim as a Government has been to change attitudes to enterprise in every region and community of the UK, and to tackle the barriers that we know entrepreneurs can face when starting and growing their businesses. We have put in place the foundations for success – cutting taxes for small business, building a world-leading competition regime and providing funding to ensure that, in the future, every child will gain real-life experience of enterprise during their school career.

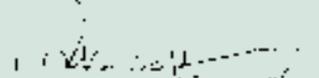
Finance is a vital ingredient in the growth of any successful business, and the vast majority of British businesses are well served by our dynamic and flexible financial markets. Even so, as we listen to businesses across the country, we hear that some are still unable to access the finance they need to innovate, invest and grow. These lost opportunities represent both an economic cost – through reduced job creation and lower productivity growth – and a social cost to the communities in which they trade.

We are already taking targeted action to help markets overcome the specific barriers that lead to a finance gap, through measures such as the Small Firms Loan Guarantee, Regional Venture Capital Funds, the Enterprise Investment Scheme and Venture Capital Trusts. And through our new Enterprise Areas, we are taking extra steps in our most disadvantaged communities – where finance often presents the greatest barrier to enterprise opportunity – to help bring jobs and prosperity to areas left behind for too long.

In Budget 2003, we launched *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*, to explore these issues in more detail. We have listened to the views of business men and women, innovators, investors and advisors from across the country, and this paper sets out the actions we will take to help ensure that talented entrepreneurs can access the finance they need to convert their ideas and creativity into thriving businesses. These steps, together with other measures announced in this year's Pre-Budget Report, will help to build a Britain where enterprise is truly open to all.



The Chancellor of the Exchequer  
Rt Hon GORDON BROWN MP



The Secretary of State for Trade and Industry  
Rt Hon PATRICIA HEWITT MP



# EXECUTIVE SUMMARY

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**E1** Financial markets are key to the proper allocation of resources within the economy, ensuring that viable enterprises can access the finance needed to achieve their full potential. The UK is widely acknowledged as possessing one of the most efficient financial markets in the world, meeting the financing needs of the vast majority of businesses. Nevertheless, a small but important minority of innovative, growth-oriented businesses continue to face difficulties in attracting funding, providing a case for targeted government intervention to assist markets where these difficulties create a significant barrier to enterprise and innovation, and hence to productivity growth.

**E2** *Bridging the finance gap: a consultation on improving access to growth capital for small businesses* explored the underlying causes of the finance gap, and presented evidence of where it is most severe. The consultation paper set out the range of targeted measures the Government is already taking to encourage private investment within the gap, and invited views on how to ensure they remain appropriate for a dynamic, ever-changing market. The consultation also described the Small Business Investment Company (SBIC) model that has operated in the USA for 45 years, and illustrated how a variant of this approach could be adopted in the UK.

**E3** The Government, in partnership with the Regional Development Agencies and the Devolved Administrations, has held a series of consultation events across the country, and has discussed its proposals with a wide variety of interested parties. It has received over 150 written responses to the consultation, from entrepreneurs, the finance industry, individual investors, the business advisory community, trade associations and others. This document provides an overview of those responses, and describes the steps the Government proposes to take in the light of the findings of the consultation.

## THE FINANCE GAP

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**E4** Most businesses seeking to finance investment, innovation and growth are well served by a variety of private-sector sources of external finance. Debt finance and asset-backed lending together account for the majority of external finance supplied to small and medium-sized enterprises (SMEs), but are not suitable in all circumstances. In particular, equity finance may be more appropriate where a business is seeking risk capital to generate rapid growth, or is not yet generating sufficient cash flow to service regular repayments.

**Debt finance E5** The availability of debt finance has improved significantly over the past decade, as a result of increasing economic stability and the development of the business banking market. Despite these developments, lenders continue to face uncertainty in assessing credit risk when lending to SMEs, and often rely on collateral provided by the borrower to reduce their risk exposure. This approach generally works well, but can create difficulties for entrepreneurs who do not have suitable assets to offer as security.

**Equity finance E6** The UK private equity industry is the largest and most developed in Europe, accounting for over a third of total European private equity investment in 2002. Growth of the UK market has been accompanied by an increasing concentration on larger investments in well-established businesses, for example to finance management buy-out (MBO) activities. These investments make an important contribution to UK productivity and output growth. However, structural features of the market result in an ongoing shortage of venture capital funds to support smaller-scale investments, creating a barrier to business formation and growth.

**E7** Individual investors, including friends, family and business angels, are an alternative source of capital, but are limited by the extent of their personal wealth. This leaves an equity gap for investments that are beyond the financial means of most informal investors, but too small to attract venture capital funding. The gap appears to be most acute for investments between £250,000 and £1 million, but is also severe for businesses seeking up to £2 million – and, for some businesses, it may extend even higher. This equity gap is a barrier to productivity growth, as it can stifle the development of innovative start-up and early-stage businesses, and can constrain the supply of capital for some established businesses that are seeking to modernise or diversify their activities.

**Demand for growth capital E8** Alongside these constraints on the supply of finance, it is equally important to consider the factors that limit demand. Not all SMEs are fully aware of the various financing options available to them, and many lack the skills needed to develop a business proposal to a stage where it is ready to attract external investors. There is also evidence that, for some entrepreneurs, the fear of losing control and management freedom is a significant deterrent to seeking equity finance.

## EXISTING MEASURES TO BRIDGE THE FINANCE GAP

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**E9** The Government is already taking targeted action to help commercial investors to increase their activity within the finance gap, and is working with various partners to help enable businesses to identify and attract finance from appropriate external sources.

**Small Firms Loan Guarantee E10** The Small Firms Loan Guarantee (SFLG), operated in partnership between government and 23 lending institutions, plays an important role in enabling loans to be made to SMEs that are unable to offer collateral. In April 2003, the Government introduced a package of measures to enhance SFLG, leading to a 40 per cent increase in take-up of the scheme.

**E11** Respondents to the consultation welcomed these changes, and suggested some further potential enhancements to the scheme. In the light of these suggestions, the Government will:

- seek to raise awareness and understanding of SFLG among SMEs and their advisors, by improving the clarity and availability of guidance;
- continue to work with partner lenders to encourage consistent application of SFLG, for example by simplifying the administrative requirements of the scheme wherever possible;
- publish details of how new lenders wishing to participate in SFLG can apply to do so; and
- undertake a review of SFLG to ensure that, in the light of changing debt market conditions, the Government continues effectively to help small businesses to overcome barriers to raising debt finance.

**Tax incentives E12** Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) offer a number of tax reliefs to encourage private investors to invest in small companies affected by the equity gap, either indirectly through a mediated fund (a VCT) or by investing directly in the small company (through EIS).

**Venture Capital Trusts E13** The Government is mindful of the recent relative weakness in the VCT market, and is in favour of providing a less cyclically-sensitive set of incentives for investors. To help relieve the cyclical nature of fundraising, the Government will consider withdrawing, from 6 April 2004, the ability to defer liability for capital gains tax (CGT) by investing in VCT shares. It proposes that, in the long term, the incentive effect of withdrawing CGT relief should be offset by an enhancement, of equivalent value, to the level of income tax relief for new subscriptions to VCT shares. To provide a boost to fundraising, the Government proposes to increase the upper limit for eligibility for income tax relief from £100,000 to £200,000 in any single tax year.

**E14** In the short term, and subject to consultation, the Government intends to provide a stimulus to VCT fundraising through an additional temporary improvement to income tax relief for a period of two years from 6 April 2004. The Government will discuss with business the most appropriate form for this temporary improvement to take, but its favoured option is to increase the effective rate of income tax relief from 20 per cent to 40 per cent, with the additional relief paid directly into the VCT for investment in companies seeking finance.

**Enterprise Investment Scheme E15** The level of investment through EIS has held up relatively well. The Government will therefore continue to assess options for incremental changes to improve the commercial operation of the scheme, drawing on suggestions made in response to the consultation. In line with the proposed increase in the upper investment limit for VCTs, the Government proposes to increase the upper limit for eligibility for 20 per cent income tax relief through EIS from £150,000 to £200,000 in any single tax year, with effect from 6 April 2004.

**Demand for growth capital E16** The Government is taking forward a series of measures to help ensure that these supply-side measures are backed by more effective demand for growth capital from SMEs. These measures will include:

- working with Regional Development Agencies to build on the findings of the recent 'investment readiness' demonstration projects at the local level;
- with the accountancy profession and other business bodies, developing the proposals of the Accountancy Working Group, which has been considering how best to enhance the role of business advisors in providing financial advice to firms;
- launching a *no-nonsense guide* to finance for SMEs; and
- asking the Small Business Investment Taskforce to examine the scope for a review of demand-related issues, looking in particular at barriers to the growth of affordable financial intermediation focused on small-scale equity finance.

## ENTERPRISE CAPITAL FUNDS

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**E17** Notwithstanding the contribution of existing measures, most respondents to the *Bridging the finance gap* consultation believed that a small but important minority of growth companies will continue to be constrained by the equity gap. Respondents supported the objectives put forward for a new approach based on the US SBIC programme, and suggested ways in which the model could be adapted to maximise its impact in the UK market.

**E18** The Government therefore believes that a suitably designed variant of the SBIC programme could play an important role in supporting increased private-sector investment in the equity gap. It recognises that the design of such a programme would need to take full account of the differences between the US and UK markets, and the lessons that have been learned from the 45-year history of the US programme.

**E19** The Government therefore intends to explore further the scope for such a programme, by:

- inviting bids for a round of ‘pathfinder’ funds based on the SBIC model, to be known as Enterprise Capital Funds (ECFs); and
- using the lessons learned in establishing the pathfinder round to determine whether and how to develop a longer-term ECF programme.

**ECF pathfinder round** **E20** The Government intends to allocate leverage to pathfinder ECFs through a competitive bidding process and, subject to receiving the necessary European state aids clearance, will publish detailed bidding guidance in spring 2004. In the pathfinder round, prospective ECF managers will be allowed some flexibility to specify in their bids how the proceeds of their successful investments would be allocated between private investors and the Government. This will allow more equal risk-sharing between the Government and private investors, compared with the model proposed in the consultation paper. The Government is seeking state aids clearance on the basis that pathfinder ECFs would be allowed to invest in financing rounds of up to £2 million, with additional flexibility for follow-on rounds.

**Delivering an ECF programme** **E21** The Government believes that, should it decide to proceed with a longer-term ECF programme, this would most effectively be delivered through a company set up specifically for that purpose. Such a company would operate at arm’s length from government, and would be given the operational freedom needed to adapt its approach in the light of its experience and in response to changes in the market for SME finance.

# INTRODUCTION

**A thriving small and medium-sized enterprise (SME) sector makes a vital contribution to the productivity of the UK economy. The Government remains committed to playing its part in creating the conditions in which SMEs flourish, providing a supportive business environment and tackling barriers to SME formation and growth. The Government launched *Bridging the finance gap: a consultation on improving access to growth capital for small businesses* in April 2003. This paper looks at the responses to that consultation, and sets out the further steps the Government will take to help increase the availability of growth capital to SMEs, targeting specific areas where market outcomes present a barrier to successful enterprise.**

## ENTERPRISE AND PRODUCTIVITY

**1.1** Small and medium-sized enterprises (SMEs) form a major part of our economy, employing over half the private-sector workforce and generating more than £1,000 billion of private-sector turnover each year. Recent research has focused on the role of SMEs as ‘agents of change’ within a dynamic economy, and there is increasing evidence that an active SME sector can play a significant role in driving productivity and output growth throughout the economy.<sup>1</sup>

**1.2** *Enterprise Britain*<sup>2</sup>, published by the Government in November 2002, described the central role of enterprise in the modern economy, and described the Government’s approach to boosting levels of entrepreneurship in the UK. This approach is based around building a more enterprising culture, creating the best possible environment in which to start and grow a business, and tackling specific barriers to successful SME formation and growth.

**1.3** *Enterprise Britain* identified access to finance as a potential barrier for start-ups and smaller businesses. While there is strong evidence that the availability of external funding for SMEs has improved over the past decade or two, finance remains a problem for an important minority of the SME population. The greatest difficulties are typically faced by start-ups and by small businesses with significant growth potential seeking relatively modest sums of risk capital, but can also affect established businesses seeking development capital to modernise or diversify their activities.

## BRIDGING THE FINANCE GAP

**1.4** Building on the evidence set out in *Enterprise Britain*, the Government launched *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*<sup>3</sup> in April 2003. This showed that the UK’s dynamic and flexible financial markets meet the needs of most businesses, but that a small but important minority of firms still face difficulties accessing finance for innovation, investment and growth.

**1.5** The publication of the consultation paper was followed up with a series of roadshows across the UK, organised in partnership with the Regional Development Agencies and the Devolved Administrations. At these events, stakeholders were invited to explore the Government’s view of the market for SME growth capital in the UK, and its proposals for tackling impediments to the supply of, and demand for, growth capital.

<sup>1</sup> See, for example, Organisation for Economic Co-operation and Development, *Drivers of growth: information technology, innovation and entrepreneurship*, 2001.

<sup>2</sup> HM Treasury/Small Business Service, *Enterprise Britain: A modern approach to meeting the enterprise challenge*, November 2002, [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

<sup>3</sup> Available at [www.sbs.gov.uk/financegap](http://www.sbs.gov.uk/financegap).

**Supply of debt finance** **I.6** SME debt markets have developed substantially over the past 20 years, but not all SMEs are able to provide the collateral that is often required by lenders. The Small Firms Loan Guarantee (SFLG), operated in partnership between government and commercial lending institutions, is available in cases where the absence of collateral is the only obstacle to making a loan. In the first six months of this financial year, SFLG supported commercial loans to 3,000 small businesses.

**Supply of equity finance** **I.7** There is an ongoing shortage of risk capital for businesses seeking relatively modest amounts of external funding through raising equity. The *Bridging the finance gap* consultation paper described the underlying causes of this 'equity gap', which affects not just the UK but equity markets worldwide. The equity gap results from rational investor behaviour in the face of information costs and other transaction costs that are disproportionately large for smaller investments, but creates a barrier to enterprise. This gap is most acute for businesses seeking between £250,000 and £1 million of equity finance, and is also severe for some seeking up to £2 million.

**I.8** The Government is already working to stimulate private sector investment within this equity gap. Over £3 billion of private capital has been invested through the Enterprise Investment Scheme in the past five years, and Venture Capital Trusts have raised over £1 billion in the same period. The Regional Venture Capital Funds, the UK High Technology Fund and the Early Growth Funding programme will collectively invest around £400 million in businesses otherwise affected by the equity gap. The Government has also introduced specific measures to improve access to finance in the UK's least prosperous communities, including the Phoenix Fund and Community Investment Tax Relief, and has supported the Bridges Community Development Venture Fund.

**Demand for growth capital** **I.9** Alongside these measures to boost the supply of growth capital, steps to stimulate effective demand for risk capital are equally important. Many entrepreneurs are not fully informed about the different finance options available to them, and lack the skills necessary to develop their businesses to a stage where they are ready to make best use of external finance. SME representative bodies have also voiced concerns about the quality and consistency of financial advice made available to some businesses by their advisors. The Government is currently evaluating the impact of six 'investment readiness' demonstration projects, and further steps to help address the barriers to increased demand for risk capital are set out later in this document.

**Government proposals** **I.10** *Bridging the finance gap* invited views on the Government's assessment of the finance gap, and on a range of proposals that could help to enhance the effectiveness of existing programmes that are designed to alleviate this gap. It also described the Small Business Investment Company (SBIC) model, which has played an important role in the development of the US early-stage venture capital market over the past 45 years. The consultation asked whether a variant of this programme could make a similar contribution in the UK and, if so, how the model would need to be modified to suit the UK market.

## CONSULTATION RESPONSES AND NEXT STEPS

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**Consultation responses** **I.11** The Government received 153 written responses to the consultation document from a broad spectrum of interested parties. The responses indicated widespread support for the range of existing government activities, and provided valuable suggestions as to how their effectiveness could be further enhanced. Nevertheless, over 95 per cent of respondents agreed that small businesses continue to face a significant equity gap, with many respondents arguing that this gap is substantially wider than suggested in the consultation paper.

**Next steps** **I.12** The remainder of this paper sets out the conclusions the Government has drawn from the consultation process. The responses are assessed in more detail in Appendix A. Copies of those consultation responses where the respondent did not specifically request confidentiality are available at [www.sbs.gov.uk/financegap](http://www.sbs.gov.uk/financegap).

**I.13** Chapter 2 describes the factors that limit the supply of finance to SMEs, and presents evidence on the resulting equity gap and its extension over time. Chapter 3 outlines the steps the Government will take to enhance the effectiveness of existing measures to alleviate this equity gap, taking account of the evidence collected during the consultation process. It concludes that these steps will help to address both the supply of and demand for equity, but that the equity gap will continue to affect a minority of ambitious, growth-oriented firms.

**I.14** The Government therefore intends to proceed with a ‘pathfinder’ round of Enterprise Capital Funds (ECFs) in the UK, based on the US Small Business Investment Company programme, in order to explore whether and how a longer-term ECF programme might be established. Chapter 4 describes how the pathfinder round of ECFs will work, taking account of the views expressed in response to *Bridging the finance gap*.



# 2

## ASSESSING THE FINANCE GAP

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Access to finance for the majority of small firms has been improving since the mid 1990s, driven in part by greater economic stability and by easier access to bank finance. The Small Firms Loan Guarantee (SFLG) is helping to support debt financing for those small firms that would otherwise be prevented from accessing debt finance by a lack of collateral.

The consultation responses to *Bridging the finance gap* made it clear that there remains a key group of small and medium-sized enterprises (SMEs) which are not suited to debt finance, and which are currently not able to access the equity capital that they need to thrive. Respondents agreed that there was an equity gap, pointing to a shortfall in growth funding in amounts of between £250,000 and £2 million.

The firms affected by the equity gap are often those with a key role in generating productivity growth, particularly SMEs with high growth potential and in innovative or high-technology sectors. Businesses seeking modest sums of investment to modernise or diversify their activities are also affected.

The success of the UK private equity industry has resulted in a movement away from venture funds investing in early-stage businesses. This trend will continue to constrain enterprise unless action is taken to address the market imperfections in this sector of the economy.

### INTRODUCTION

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**2.1** The UK has dynamic and flexible financial markets that are acknowledged to be among the most efficient in the world, but there remain market imperfections that prevent some entrepreneurs and businesses accessing the finance they need. In many cases these market imperfections reflect rational behaviour by investors and businesses in response to information failures in the market (see Boxes 2.1 and 2.2), but these imperfections mean that some viable businesses are unable to access the external finance they need.

**2.2** Consistent with this view, research shows that levels of income<sup>1</sup>, increases in personal wealth<sup>2</sup> and receipt of an inheritance or other windfall payment<sup>3</sup> are all significant drivers of entrepreneurial activity. Tackling barriers that entrepreneurs face when seeking to attract external finance will therefore help to increase enterprise opportunity, including in the UK's less prosperous communities.

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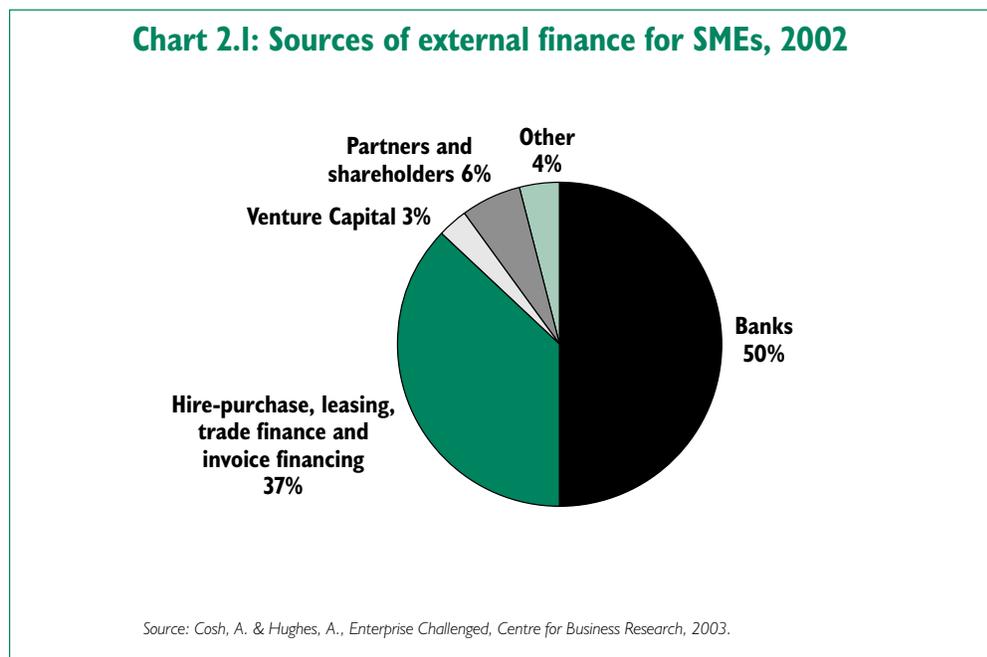
<sup>1</sup> *Global Entrepreneurship Monitor*, 2002.

<sup>2</sup> Robson, M., *The Rise in Self-Employment amongst UK Males*, Small Business Economics, Vol. 10, pp. 199-212, 1998.

<sup>3</sup> Blanchflower, D. and Oswald, A., *What makes an entrepreneur?*, Journal of Labor Economics, Vol. 16, pp. 26-60, 1998.

## SOURCES OF FINANCE

**2.3** Many businesses can meet their financial needs from capital invested by their owners or, in the case of established firms, from retained profits. As the macroeconomic environment has become more stable since the mid 1990s, SME performance has improved and businesses have been increasingly able to make use of internal funds to finance investment and growth.<sup>4</sup> For businesses that are unable to draw upon internal funds, various different sources of finance are available, illustrated in Chart 2.1. Survey evidence shows that around 87 per cent of businesses are able to access the finance they need.<sup>5</sup>



### Debt finance

**2.4** The most important single source of external finance is bank debt, principally in the form of overdrafts and fixed-term loans, which together account for around half of all external finance.<sup>6</sup> Bank debt is most suitable where businesses are generating sufficient cash flow to service interest payments.

**2.5** The availability of debt finance has improved significantly over the past decade, reflecting increasing economic stability and the development of the business banking market. Research by the Bank of England has emphasised the importance of credit scoring systems in helping to improve the supply of debt finance. The Bank concluded last year that there was “no real evidence of firms having difficulties accessing bank finance”.<sup>7</sup>

<sup>4</sup> Cosh, A. and Hughes, A., *Enterprise Challenged*, Centre for Business Research, Cambridge University, 2003.

<sup>5</sup> Small Business Service, *SME Omnibus survey*, [www.sbs.gov.uk](http://www.sbs.gov.uk).

<sup>6</sup> Bank of England, *Finance for Small Firms – A Tenth Report*, 2003.

<sup>7</sup> *ibid.*

**2.6** Nevertheless, lenders can still face considerable uncertainty when assessing the prospects of individual businesses. As explained in Box 2.1, they often rely on collateral to support SME lending, especially where the borrower lacks an established track record in business. Not all business owners are able to offer suitable security, and in such cases the Small Firms Loan Guarantee (SFLG) can play an important role.

**Box 2.1: The role of collateral in the SME debt market**

Market imperfections in the debt market arise from ‘information asymmetries’, whereby the lender is only partially informed about the prospects of a business. Information asymmetries mean that lenders are unable to quantify the level of risk involved in a particular SME. It is therefore difficult to assess the quality of investment propositions, and even harder to charge an interest rate that accurately reflects the level of risk involved.

Many lenders have developed ‘credit scoring’ techniques that help them to assess loan and overdraft applications from SMEs. Bank of England research shows that banks typically make lending decisions on the basis of criteria such as credit history, past bank account management, the applicant’s track record in business and willingness to invest their own money in the business, and evidence of repayment capability based on a business plan.<sup>1</sup>

However, an individual may not have a previous track record and may have no personal capital to invest in the business. As a result, lenders also place significant emphasis on the entrepreneur’s willingness to provide collateral to underwrite the loan, though some are becoming increasingly willing to provide small start-up loans even where collateral is unavailable.<sup>2</sup> Collateral may perform a number of important functions, including:

- reducing the level of risk to which the lender is exposed;
- signalling to the lender the entrepreneur’s confidence that the business will succeed; and
- ensuring that the borrower is strongly incentivised to repay the loan, and not to take undue risks with the lender’s capital.

While lenders’ reliance on collateral enables many businesses to secure debt finance, this approach to SME lending can create difficulties for entrepreneurs who lack suitable assets to offer as security. In cases where a business is unable to secure a loan solely because of a lack of collateral, the SFLG offers a government guarantee to support loans of up to £250,000. Chapter 3 describes the SFLG in more detail, and summarises the Government’s recent and forthcoming steps to enhance the scheme.

<sup>1</sup> Bank of England, *Finance for Small Firms – A Tenth Report*, 2003.

<sup>2</sup> A recent study suggests that lending up to £35,000 is likely to be unsecured (except for start-ups) (Ram, M., Smallbone, D. and Deakins, D., *Ethnic minority businesses in the UK: access to finance and business support*, British Bankers Association, 2002). Barclays has commented that 85 per cent of borrowing applications from its small business customers are now determined irrespective of whether security is available (Bank of England, *Finance for Small Firms – A Tenth Report*, 2003).

## Asset-backed finance

**2.7** Chart 2.1 illustrates that leasing and hire-purchase are other important sources of capital for SMEs. Like debt finance, these depend upon the business having sufficient cash flow to service regular repayments, and are only appropriate where it has tangible assets. Invoice factoring and discounting have also increased in importance in recent years, but are typically used as sources of working capital rather than to finance investment. Again, they are only suitable where a business is already generating revenues and has existing creditors.

## Equity finance

**2.8** While debt and asset-based finance are sufficient to meet the needs of most firms, an important minority require equity finance. Equity investors inject capital in exchange for shares in the business, enabling them to receive a proportion of its future profits. This form of financing is most appropriate when:

- the business is at an early stage of development, and is not yet generating a sufficient stream of revenue to service debt interest repayments; and/or
- the business is developing new technologies, products or markets with the potential to achieve substantial rates of growth, but also with significant risk of failure.

### Sources of equity finance

**2.9** Venture capital investors provide a substantial amount of equity finance to businesses. Members of the British Venture Capital Association (BVCA) have invested some £33 billion in up to 7,000 unquoted businesses over the past 5 years. ‘Informal’ investors also provide a substantial amount of equity capital, typically for smaller, younger ventures than provided for by institutional venture capitalists. According to one recent estimate, as much as £12.8 billion was invested in UK small businesses between 1999 and 2000 by friends and family of the business owners, or by individual investors previously unconnected with the entrepreneur (commonly known as ‘business angels’).<sup>8</sup>

**2.10** Equity finance accounts for only 8 per cent of all external finance for SMEs<sup>9</sup>, but this statistic understates its importance in a modern, enterprising economy. Businesses that are most likely to need equity finance are often highly innovative, and have the potential to make an important contribution to UK productivity growth. In addition, the finance provided by venture capital and business angel investors is sometimes accompanied by management support, advice and other expertise. The Government is keen to encourage this active mentoring role, which can significantly enhance the performance of the recipient businesses.<sup>10</sup>

### The ‘equity gap’

**2.11** While equity finance is an important driver of growth of individual businesses, and more widely across the economy, there is a strong body of evidence that structural features of the private equity market give rise to a significant and growing ‘equity gap’ facing businesses seeking modest amounts of growth capital. These structural causes relate to both the supply and demand sides of the market, and are outlined in Box 2.2. Evidence of the existence of a gap is presented in the following section of this chapter.

<sup>8</sup> Cowling, M., Harding, R. and Murray, G., *The “Virtuous Circle” of Informal Investment Activity: Evidence from the UK*, July 2003.

<sup>9</sup> Centre for Business Research, average for period 2000-2002.

<sup>10</sup> British Venture Capital Association, *The economic impact of private equity in the UK*, 2002.

**Box 2.2: Structural causes of the equity gap**

The information problems highlighted in Box 2.1 are also applicable to the equity market. At the same time as seeking to enable market participants to overcome these supply-side constraints, it is equally important to tackle the factors that restrict the demand for growth capital.

*Supply-side issues***(i) Information problems**

Information asymmetries mean that equity investors can face significant costs in identifying suitable investment opportunities. These information problems are typically greatest for smaller, younger firms and especially innovative businesses seeking to develop unproven technologies, products and markets. Information difficulties present a significant impediment to smaller-scale equity investments, because the costs of investment do not vary proportionally with the size of investment. These costs include:

- **search costs.** In comparison to large companies that are quoted on public stock markets, the flow of information about small, unquoted companies seeking investment is much more limited. Investors can therefore incur significant search costs when seeking out suitable opportunities;
- **due diligence costs.** It is often difficult to assess the prospects of a business, especially where the management team, product or technology is unproven. Before equity investors can make informed investment choices, they must therefore undertake a process of due diligence. These information gathering costs do not vary proportionally with the size of the investment and, for smaller investments, can be prohibitively large relative to the potential financial rewards from making the investment; and
- **monitoring costs.** Having invested in a business, equity investors need to monitor the ongoing performance of their investment. They will often do this by taking a seat on the board, and may contribute significant time and effort to providing management support, especially where a business' management team is relatively inexperienced. This can make an important contribution to the performance of the investee business but, again, these costs do not vary proportionally with investment size.

**(ii) Transaction costs**

There are significant fixed costs involved in making equity investments, for example in negotiating the terms of investment and putting in place the necessary legal agreements. As with other fixed costs, these transaction costs tend to militate against investing in smaller sums.

**(iii) Perception of risk and reward**

Investment decisions will be driven by perceptions of risk and likely financial returns. If investors have incorrect expectations, this will result in a sub-optimal allocation of capital. Evidence from the BVCA<sup>1</sup> shows that this is the case, at least for institutional investors. This research showed that UK institutions that did not invest in venture capital believed that the returns achieved by the asset class were considerably below the reality. Those institutions that did invest in venture capital generally had more accurate perceptions, but many still underestimated actual historic returns.

<sup>1</sup> British Venture Capital Association, *Institutional Investor Attitudes to Venture Capital in the UK*, 1999.

### **Demand-side issues**

**Demand-side constraints are equally significant in limiting the flow of equity finance from investors to SMEs. Research has highlighted a number of issues that deter small businesses from seeking equity capital. Loss of control and restricted management freedom are the concerns most commonly cited by SMEs, but the costs of securing equity finance and a lack of knowledge of external sources of finance are also common obstacles.<sup>2</sup>**

**Many of those businesses that do actively seek equity investment are also constrained by a lack of ‘investment readiness’. SMEs may be hampered by a limited awareness and understanding of the various forms of risk finance available and how to access it, and by insufficiently developed or poorly presented business plans. Inadequate business preparation and planning will deter potential investors, not least by increasing the information and due diligence costs involved**

2 Poutziouris, P., Chittenden, F., and Michaelas, N., The Financial Development of Smaller Private and Public SMEs, Manchester Business School, Working Paper 378, 1999.

## ASSESSING THE EQUITY GAP

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**2.12** An equity gap arises where viable businesses are unable to attract investment from either informal investors or venture capitalists, which are the principal sources of equity finance for SMEs.

**2.13** As noted in paragraph 2.9, business angels and other informal investors form a vital part of the private equity market, but informal investors have access to limited financial resources and therefore generally invest relatively small amounts of equity. By giving up some of their own time to carry out due diligence and perhaps by investing partly on ‘instinct’, informal investors are able to keep the costs of investment to a minimum. By contrast, formal venture capital investors typically incur far greater costs in evaluating potential investments. For the reasons set out in Box 2.2, these costs are often prohibitive where a business is seeking only a modest amount of equity finance.

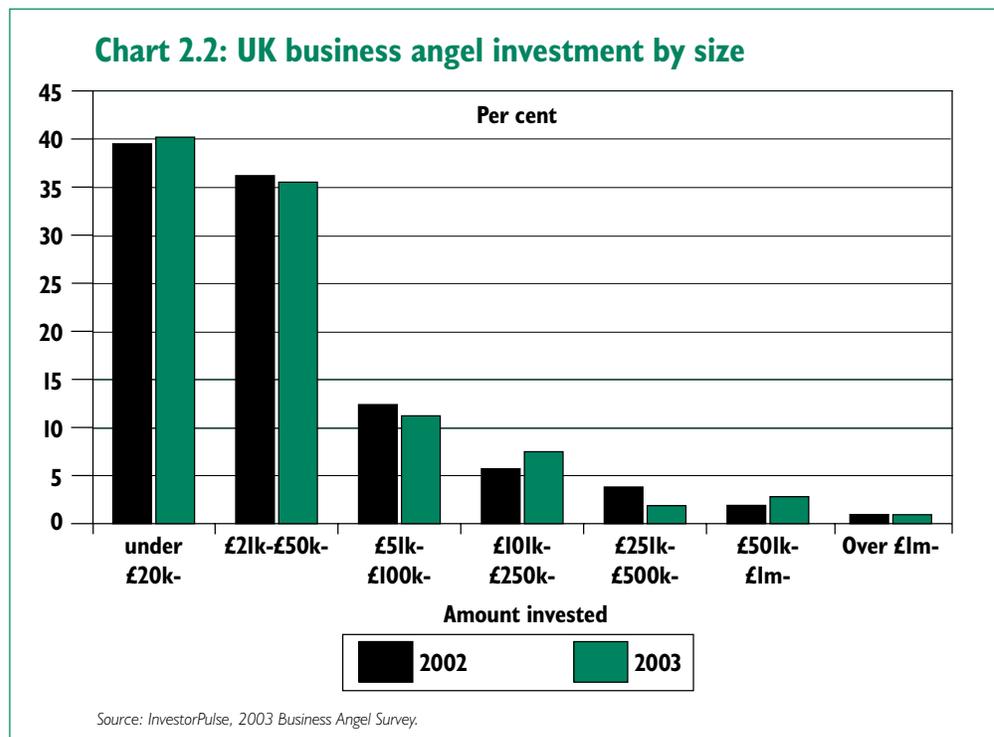
**2.14** An equity gap therefore affects businesses that are seeking a sum of money that is beyond the financial means of most informal investors, but below the level at which it is viable for venture capitalists to invest. The following section of this chapter presents evidence that an equity gap affects businesses seeking to raise between approximately £250,000 and £2 million of equity finance, and that this gap is most severe for sub-£1 million investments and for innovative businesses at an early stage of their development.

**2.15** This is consistent with the view of respondents to the *Bridging the finance gap* consultation, of whom 97 per cent agreed that SMEs continue to face a significant equity gap. Many also argued that the severity of the gap varies according to the size, sector and stage of development of the business. However, it is difficult to measure the equity gap with certainty, because it requires an assessment of which businesses would have attracted investment if there had been no equity gap.

## Boundaries of the equity gap: business angels and other informal investors

**2.16** Over 60 per cent of consultation respondents agreed that the lower bound of the equity gap is at around £250,000, with the remaining responses split broadly evenly between higher and lower estimates. The overwhelming majority of business angel and other informal investment occurs below £250,000, and this is also the upper investment limit for the government-supported Regional Venture Capital Funds (RCVFs).

**2.17** Formal quantification of the typical size of business angel investment can be difficult because of its informal nature. A recent InvestorPulse survey showed that, in 2002, three quarters of business angels made investments averaging less than £50,000, and 40 per cent averaged less than £20,000 per investment.<sup>11</sup> Chart 2.2 illustrates that business angel investment activity is heavily concentrated on businesses seeking less than £250,000 of equity finance.



**2.18** Other survey work confirms this picture. Cowling, Murray and Harding found that the median level of investment was £35,000 over a three-year period.<sup>12</sup> In 2000, Mason and Harrison estimated that there were between 20,000 and 40,000 business angels in the UK who invested between £500 million and £1 billion per annum in around 3,000 to 6,000 businesses, suggesting that average business angel investment was approximately £167,000.<sup>13</sup> This study was based on the investment activity of members of business angel networks, for whom the average investment size may be higher than for the informal investment community as a whole.

<sup>11</sup> C2 Ventures, *InvestorPulse UK Angel Attitude Survey*, 2003.

<sup>12</sup> Cowling, M., Murray, G. & Harding, R., *The "virtuous circle" of informal investment activity: evidence from the UK*, 2003.

<sup>13</sup> Mason, C. and Harrison, R., *The size of the informal venture capital market in the UK*, *Small Business Economics*, 2000.

### Boundaries of the equity gap: formal venture capital

**2.19** The extent of the equity gap is difficult to estimate, not least because it is likely to differ according to the sector and stage of development of the business. The majority of respondents believed that the equity gap extended higher than £1 million, and some felt that, in certain business sectors, the gap could extend as high as £5 million.

**2.20** Academic evidence suggests that the equity gap is severe for investments of up to around £2 million. For example:

- a recent study based on 1999 data showed that the gap reached as high as £1.5 million at that time.<sup>14</sup> Given that the average size of new venture capital funds has increased since then,<sup>15</sup> this estimate is likely to understate the current extent of the gap;
- a recent study of private equity providers found that a £250,000 to £2 million equity gap has been “created post-1999/2000 as venture capital moved on to larger deals”;<sup>16</sup> and
- the same study concluded that the equity gap ranges between £250,000 and £2 million in the West Midlands region.

#### Venture capital investment in the equity gap

**2.21** Throughout the UK, investment in the sub-£2 million range is relatively limited in extent. Although there has been an average of 1,000 investments a year (2000 to 2002) in the sub-£2 million range, this greatly overstates the number of businesses in the equity gap that are receiving new investment. This is because many businesses have received several investments, either simultaneously from a number of members of a syndicate or in a number of separate funding rounds.

**2.22** Using BVCA data, it is estimated that more than 70 per cent of investments in this range were follow-on, rather than initial, investments, and fewer than one in four are initial, unsyndicated investments.<sup>17</sup> Paragraphs 2.36 to 2.39 suggest that this is only a small fraction of the potential demand for equity finance.

#### The equity gap for early-stage businesses

**2.23** The equity gap is especially severe for start-up and other early-stage businesses: between 2000 and 2002, these businesses received just 11 per cent of all sub-£2 million investments (by number) and 12 per cent (by value).<sup>18</sup> Only 3 per cent of all private equity funds raised in 2002 were expected to be invested in early-stage businesses, according to the BVCA.

**2.24** Although the UK has the largest private equity market in Europe, the proportion of total private equity investment targeted at early-stage businesses in the UK is among the lowest in the OECD. As a share of GDP, early-stage investment in the UK is broadly on a par with the European average but, at just 0.05 per cent of GDP, is less than half the US and Canadian levels.<sup>19</sup>

<sup>14</sup> Harding, R. Cowling, M. and Murray, G., *Assessing the Scale of the Equity Gap: Report to H.M. Treasury and SBS*, November 2003.

<sup>15</sup> Funds raised by BVCA members rose from £5,813 million in 1999 to £7,827 million in 2002.

<sup>16</sup> Ecotec, *Advantage Enterprise and Innovation Fund: Analysis of Market Demand*, a final report to Advantage West Midlands, 2003.

<sup>17</sup> BVCA Investment Activity Surveys conducted by PricewaterhouseCoopers, 2003.

<sup>18</sup> British Venture Capital Association, *Report on Investment Activity*, 2003.

<sup>19</sup> OECD Venture Capital Database, 2002. Data are for 1998–2001.

## Dynamics of the equity gap

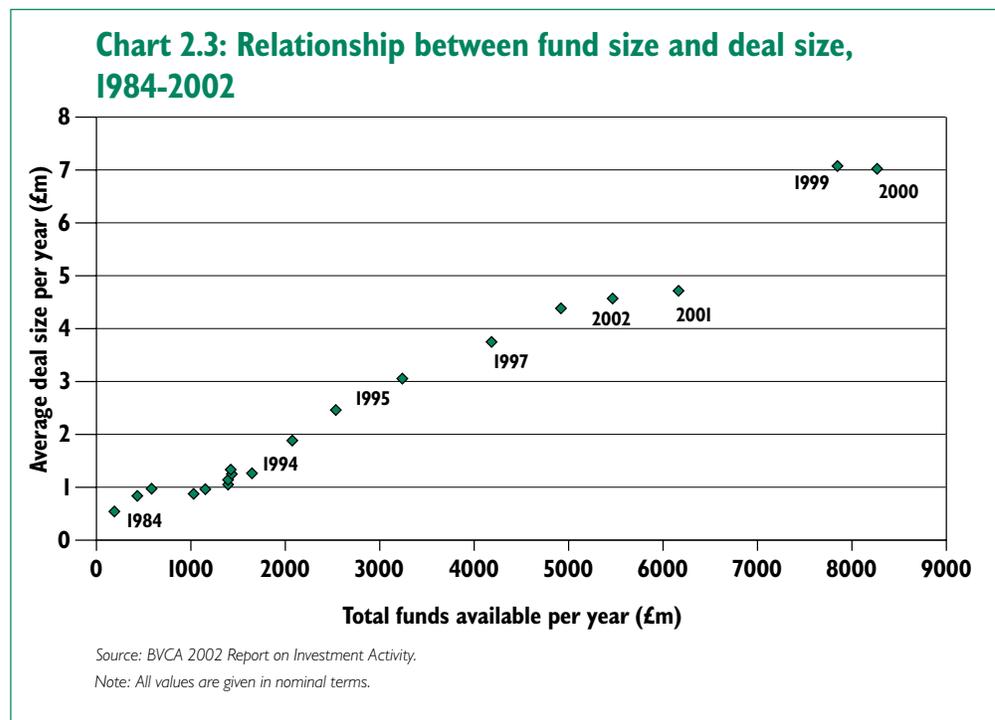
**2.25** There are particular funding problems faced by early-stage high-technology firms, highlighted in a recent report on the biotech industry.<sup>20</sup> This was also noted by consultation respondents who cited higher due diligence costs driven by the need for specialist knowledge as a factor hampering the supply of equity finance to high-technology SMEs.

**2.26** The persistence of the equity gap reflects a combination of two factors. First, market forces are encouraging most established venture capitalists to gravitate towards larger deals in later-stage businesses. Secondly, the importance of reputation and track record in the venture capital sector presents a significant barrier to entry for new fund management teams. This restricts the flow of new venture funds into the market to replace those who have moved upscale. These two factors are discussed below.

### Size of funds and individual investments

**2.27** The UK private equity market is the largest and most developed in Europe and second in the world only to the US. Average fund size is rising as a consequence of this success. In the past ten years, funds invested by BVCA members in UK firms have risen from £1,251 million (1992) to £4,480 million (2002), following a peak of £6,371 million in 2000.<sup>21</sup>

**2.28** Growing experience and fund size encourage incumbent venture capital firms and their institutional investors to move toward larger and less risky deals. Although total funds invested rose by more than 200 per cent from 1992 to 2002, the number of UK firms invested in barely increased, rising by just 49, from 1,147 to 1,196.<sup>22</sup> As the number of firms receiving venture finance has remained broadly static, the average deal size has risen substantially, allowing venture capital firms to benefit from economies of scale (see Chart 2.3).

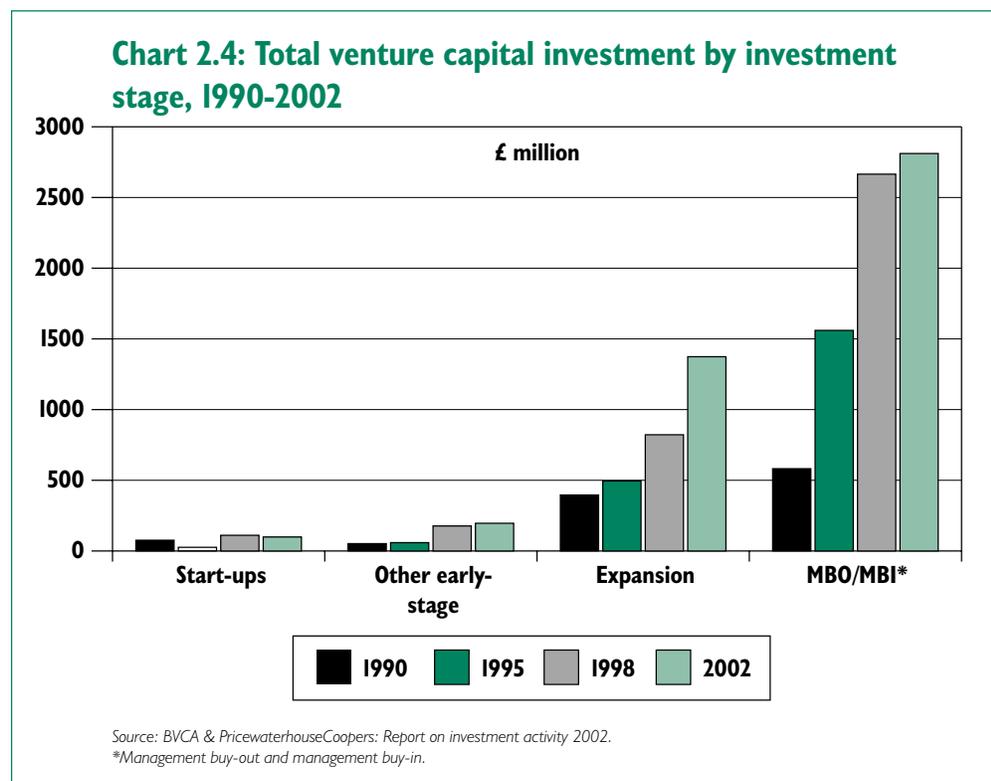


<sup>20</sup> Bioscience 2015: Improving National Health, Increasing National Wealth, a report to Government by the Bioscience Innovation and Growth Team, BioIndustry Association, DTI and Department of Health, 2003.

<sup>21</sup> British Venture Capital Association, Report on investment activity, 2003.

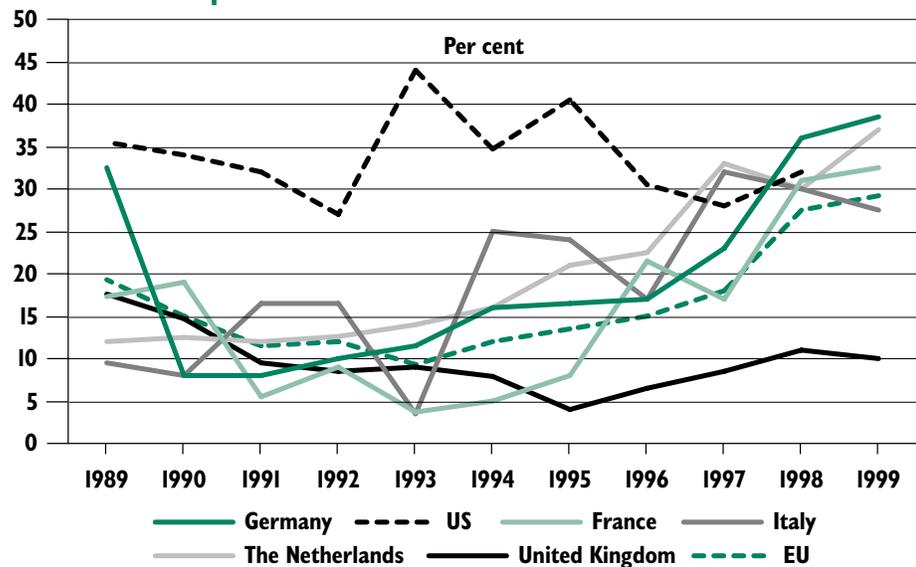
<sup>22</sup> *ibid.*

**2.29** Part of this increase in average deal size is due to an increasing emphasis on later-stage and, in particular, management buy-out (MBO) and buy-in (MBI) investments, as illustrated in Chart 2.4. A recent report by the European Investment Bank notes that the UK experience contrasts strikingly with the trend throughout the rest of the EU towards “greater proportional involvement in early-stage and hence technology-based investments”, illustrated in Chart 2.5.<sup>23</sup> This trend has exacerbated the equity gap for early-stage and smaller-scale investments. In addition, there is evidence that the average size of UK early-stage investments has risen over time. For example, the average size of early-stage investments more than doubled in the last ten years, reaching a peak of £1.7 million in 2000. This might reflect an increase in the extent of the equity gap as investors migrate towards larger-scale and lower-risk deals.



<sup>23</sup> Christofidis, C. and Debande, O., *Financing Innovative Firms Through Venture Capital*, February 2001, European Investment Bank Sector Papers.

**Chart 2.5: Early-stage investment as a proportion of all venture capital investment**



Source: Christofidis, C. and Debande, O., *Financing Innovative Firms Through Venture Capital*, Feb 2001, EIB Sector Papers.

**Barriers to entry 2.30** While the evidence shows that many established venture capitalists are migrating towards larger fund and deal sizes, there is little evidence of a sustainable flow of venture capital investment teams into the lower end of the market. Keuschnigg<sup>24</sup> notes that “the supply of experienced financiers... is a scarce resource that is not easily accumulated in short order and may become a considerable bottleneck in the development of a healthy venture capital sector”.

**2.31** In explaining the limited extent of entry into the venture market, Fenn, Liang and Prowse<sup>25</sup> focus on the importance of reputation in the venture capital sector. Gathering information on the quality of venture fund managers is a costly process, and reputation and track record are typically used as a proxy for quality and as a guide to likely future performance. This is, of course, a rational approach for investors to take, but it creates a significant entry hurdle for prospective new fund management teams seeking to compete in the venture market.

<sup>24</sup> Keuschnigg, C., *Public policy and venture capital backed innovation*, paper presented to the 59th Congress of the International Institute of Public Finance, 2003.

<sup>25</sup> Fenn, G., Liang, N. and Prowse, S., *The economics of the private equity market*, Federal Reserve staff paper, December 1995.

**Conclusion on venture capital activity** **2.32** The consultation responses, disaggregated BVCA data, academic literature and examination of the longer-term trends point to an equity gap in the UK currently between £250,000 and £2 million. High transaction costs and the proportionally higher costs of obtaining information about smaller firms create the scope to exploit economies of scale by focusing more on fewer, larger investments in more established businesses. There is therefore a structural, not cyclical, constraint on the provision of funds and venture capital expertise to smaller and riskier companies. As more funds flow into the private equity market, without changes to address the market imperfections, this suggests that deal size will continue to increase and venture capital investors will shift their focus further towards larger, later-stage deals. However, there are significant barriers that prevent new venture investors from entering the market to fill the gap, and there is little sign that new investors are entering this section of the market. Left unchecked, this trend is likely to result in a shortage of talent and experience in the equity gap that will become increasingly hard to replace as time progresses.

### Existing interventions

**2.33** Existing UK Government interventions make important contributions to addressing different parts of the equity gap, and are covered in more detail in Chapter 3. However, these interventions only meet part of the equity gap identified in the consultation responses. Venture Capital Trusts (VCTs) tend to invest in larger, more mature businesses with established track records and positive cash flow, often in sums around the top of the equity gap. Investee businesses raised an average of £1.5 million through VCTs.

**2.34** The Enterprise Investment Scheme (EIS) provides support for investment in smaller, younger businesses through tax reliefs to individuals investing directly in EIS-eligible firms. Half of all EIS investee companies have raised less than £100,000 through the scheme.

**2.35** RVCFs also support smaller investments around the lower end of the equity gap, providing finance in the range of £100,000 to £500,000, with an upper investment limit of £250,000 per funding round. An early evaluation of the RVCF programme indicates a significant level of demand for equity investments greater than £250,000, with over 40 per cent of all applications for RVCF investment seeking more than that amount.<sup>26</sup>

### ESTIMATING DEMAND FOR EQUITY FINANCE

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**2.36** The level of unmet demand for equity finance is impossible to estimate with any certainty. The number of firms that are refused equity finance is a poor proxy, as some will have been turned down because they were not commercially viable investment propositions. Moreover, the very existence of any equity gap is likely to suppress observable demand: rational firms will not incur the costs of seeking equity finance if they know they have little chance of receiving investment.

**Estimating potential demand** **2.37** It is possible to make a very approximate estimate of the latent demand for equity finance by applying estimates of the proportion of small firms that have the potential for high growth to the UK business population.

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<sup>26</sup>Small Business Service, *Early evaluation of the Regional Venture Capital Funds: Summary of findings*, 2003.

**2.38** The US Small Business Administration argues that between 5 and 10 per cent of start-ups will require equity financing.<sup>27</sup> Applying this to UK data gives the results in Table 2.1. The estimate it provides of high growth firms is broadly in line with that of the UK Small Business Service, which defines high growth as having at least £1 million turnover and/or 10 or more employees by the fourth year of trading. 12,400 of 1998 start-ups were considered to be high growth by 2002. The Cruickshank review of banking services suggested that 20,000 to 50,000 of UK SMEs would need risk finance at any time.<sup>28</sup>

**Table 2.1: Estimating demand for equity finance for start-ups**

	Average (1998–2002)	
Number of start-ups <sup>1</sup>		180,668
Estimated number of firms requiring equity finance <sup>2</sup>	Low	9,033
	High	18,067
Number of start-up companies that received equity funding <sup>3</sup>		135

Sources:

<sup>1</sup> *Business start-ups and closures: VAT registrations and deregistrations in 2002 - News Release, SBS, October 2003.*

<sup>2</sup> *Assuming that 5-10 per cent of start-ups will require equity funding.*

<sup>3</sup> *BVCA Investment Activity Surveys conducted by PricewaterhouseCoopers, 2003.*

**2.39** Another useful source of comparison is the number of investments each year by business angels. The National Business Angel Network estimates that angels invest in 3,500 companies each year, while Mason and Harrison suggest the figure is between 3,000 and 6,000 annually.<sup>29</sup> Even if angel investment is a perfect substitute for formal VC this would still leave substantial unmet demand for equity finance even under the conservative assumption of approximately 9,000 firms suitable for equity investments a year.

## CONCLUSION

**2.40** Access to finance, particularly debt finance, has improved for the majority of businesses in Britain, driven by improvements in macroeconomic stability, the financial health of small and medium-sized firms, and the growing sophistication of bank lending.

**2.41** Nevertheless, small businesses with the potential for high growth still have problems in attracting equity capital. They can fall between the scope of individual business angels to provide sufficient financial backing and the desire of formal venture capitalists to incur the relatively higher costs of investing in smaller amounts.

**2.42** The evidence indicates that this equity gap has the greatest impact for firms wishing to attract initial investments between approximately £250,000 and £2 million. The evidence also points to a gap that has been growing over time, driven in part by the success of the UK private equity industry in moving to larger size investments. The evidence on the extent of the equity gap is backed strongly by the responses to the *Bridging the finance gap* consultation paper.

<sup>27</sup> SBA, *Creating new capital markets for emerging ventures*, 1996.

<sup>28</sup> Cruickshank, D., *Competition in UK banking: a report to the Chancellor of the Exchequer*, March 2000, [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

<sup>29</sup> Mason, C. and Harrison, R., *The size of the informal venture capital market in the UK*, Small Business Economics, Vol. 15, 2000.

**2.43** Market imperfections are pushing venture capital firms up the stage and size hierarchy in search of economies of scale and perceived lower risk as fund sizes increase. This reflects the operation of market forces, but the resulting gap acts as a constraint on innovation, investment and growth within businesses that are unable to attract finance. In these circumstances, the Government is prepared to undertake carefully targeted interventions to help the market to overcome the structural features that lead to a finance gap. Chapter 3 describes existing measures that are designed to help achieve this.

# 3

## ENHANCING THE IMPACT OF EXISTING INTERVENTIONS

Chapter 2 examined the evidence for a continuing finance gap facing small and medium-sized enterprises (SMEs) looking to raise relatively small sums of risk capital. This chapter sets out the steps the Government is taking to support private-sector investors trying to overcome that gap, and considers both the supply of and demand for finance. It describes how existing interventions complement each other and describes what actions the Government will take to enhance them further.

The Government's Small Firms Loan Guarantee continues to play a significant role in supporting the provision of debt finance for businesses that lack suitable collateral. The Enterprise Investment Scheme and Venture Capital Trusts offer tax incentives to investors in early stage businesses. Regional Venture Capital Funds (RVCFs) and other targeted public-private funds have also been developed to give SMEs with high growth potential access to equity finance. These funds are all aimed at increasing the supply of finance available at modest levels of funding, in amounts of up to £250,000 in the case of RVCFs.

In addition to supply-side causes of the finance gap, responses to *Bridging the finance gap* highlighted the importance of demand-side issues such as improving the general quality of investment proposals. In this chapter, the Government puts forward a range of measures designed to help businesses with high growth potential to raise their understanding of the financing options available to them and to access good quality advice.

**3.1** Chapter 2 concluded that, although access to finance has improved for the majority of UK businesses, problems remain. The commercial debt market in which banks operate has changed considerably since the Small Firms Loan Guarantee (SFLG) was first introduced as a partnership between the Government and lending institutions, but the rationale for it remains valid. The factors that make smaller equity-based deals less attractive to potential investors than larger deals continue to mean that some businesses with high growth potential face problems accessing growth capital in sums that are too large for most informal investors, but are too small to appeal to most commercial venture capital funds.

**3.2** This chapter describes the targeted measures the Government is already taking to help to improve access to finance for these businesses. It also describes how these measures will be further enhanced in the light of responses to *Bridging the finance gap*.

### DEBT FINANCE

#### Small Firms Loan Guarantee

**3.3** As illustrated in Chapter 2, a large proportion of small businesses needing external finance rely on debt. Access to debt finance has traditionally depended not just on the quality of the individual business case and track record, but also on the lender's common requirement for collateral. As well as reducing the lender's risk exposure, collateral provides a signal of the borrower's confidence in the viability of their business and ensures borrower and lender interests are more closely aligned. However, lenders' reliance on collateral can be a problem for new and growing businesses unable to provide sufficient security. For the past 22 years, the SFLG has been successfully enabling lenders to lend to firms with good business proposals that lack the necessary security.

**3.4** In April 2003, the Government enhanced the SFLG by:

- simplifying the eligibility criteria and the terms and conditions of participation, making SFLG available to businesses in a number of previously excluded sectors including retail, catering and motor repairs;
- initiating efforts to improve understanding of SFLG in a number of ways including through a revitalised website<sup>1</sup> and guidance booklet; and
- permitting re-eligibility under the scheme for borrowers who had been granted an SFLG over ten years ago. SFLG use has increased by around 40 per cent since the introduction of these changes.

**Respondents' views on SFLG**

**3.5** *Bridging the finance gap* raised a number of questions about how the Government might build on these reforms to meet the evolving needs of both lenders and borrowers. Typically respondents welcomed the recent changes to SFLG, and put forward a number of suggestions on how it might further be improved. These included:

- raising awareness and understanding of SFLG among businesses and their advisors;
- ensuring that SFLG is made available as widely and as consistently as possible to eligible businesses; and
- further simplifying the administration of SFLG.

**Government response**

**3.6** The Government is keen to build on the success of the changes introduced in April 2003 and is taking a three-pronged approach. First, **the Government will work to raise awareness of SFLG and to ensure that it is as easy as possible to understand**. The *no-nonsense guide*, described in paragraph 3.46, will raise awareness of SFLG and other forms of support available to businesses seeking to raise external finance. **The Government will also make further improvements to the clarity and availability of SFLG guidance**, including brochures and online links. **The Government will continue to work with its partner lenders to simplify the administrative requirements** of SFLG wherever possible, to encourage consistent application of SFLG.

**3.7** Second, the Government has been approached by a number of lenders interested in providing SFLG cover for their customers. The Government is keen to encourage access to SFLG from a wide lender base, including community development finance institutions (CDFIs). Therefore, **lenders who wish to operate SFLG will now be able to apply at any time to become an approved SFLG lender**. The Government will shortly publish details of how to apply, and will be approaching interested parties.

**3.8** Third, **the Government intends to review SFLG in light of the changing debt market in the UK**, to examine how to maximise the effectiveness of SFLG and other public sector interventions.

**3.9** The market in which businesses raise debt finance has become more sophisticated since SFLG was first introduced in 1981. Equity finance is making a more significant contribution to SME financing today, and new forms of financing are coming to the market. In particular, the structure within which financial intermediaries operate has changed and the way in which small firms and start-ups are assessed for loans is more sophisticated. For instance, the Bank of England, in its latest report on finance for small firms<sup>2</sup>, said that the “development of scoring systems may be reducing banks’ reliance on collateral. However, some concerns have been voiced that scoring systems can work against some firms, because ‘non-standard’ information that may support their case cannot be taken into account in automated systems.”

<sup>1</sup> [www.businesslink.gov.uk/sflg](http://www.businesslink.gov.uk/sflg)

<sup>2</sup> Bank of England, *Finance for Small Firms – A Tenth Report*, April 2003.

**3.10** This changing market environment will inevitably affect the way in which public sector interventions such as SFLG are applied and the impact that they have on the market. The use by banks of centralised scoring systems should make smaller loan amounts more easily accessible for firms with good behavioural records, reducing the traditional reliance upon collateral. However, as the Bank of England notes, some concerns have been raised that reliance on scoring systems alone could work against some firms who have non-standard loan applications. They may also work against serial entrepreneurs who have been associated in the past with failed enterprises. In such an environment the importance of SFLG is potentially enhanced for start-ups who lack a track record and where larger loan amounts are concerned.

**3.11** The Government believes that SFLG continues to play a valuable role, but wishes to review its effectiveness in this changing market environment. It will undertake a review to ensure that, through SFLG and other interventions, the Government is doing all that it can to help start-ups and small firms overcome the obstacles that they face when raising debt finance. The review will work closely with the main SFLG lenders and will examine, and if appropriate make recommendations regarding:

- the structure and rules of SFLG and their appropriateness to the scheme's effective operation; and
- whether SFLG, as the Government's principal intervention in the supply of debt finance to SMEs, is sufficient to tackle the barriers faced by start-ups and small businesses in the current market.

## EQUITY FINANCE

**3.12** The UK has one of the most developed private equity markets in the world. However, as described in Chapter 2, the venture capital sector has gravitated over time towards larger deal sizes, leaving a shortfall both in the supply of modest sums of risk capital, and in the number of professionals with the specific skills needed to make investing in SMEs a success. Government interventions have hitherto concentrated on increasing the availability of finance for businesses. The Government is also developing a package of actions to raise the level of effective demand for risk capital that are set out in paragraphs 3.36 to 3.51. The Government's objective to increase the number of professionals with the skills to manage a portfolio of SME investments is a key part of the proposals for Enterprise Capital Funds, described below in Chapter 4.

**3.13** The Government is already taking a series of targeted steps to help the market address the equity gap. These can broadly be divided into two types: tax incentives and cornerstone investments in 'equity gap' venture funds. *Bridging the finance gap* illustrated how these interventions are each effective in targeting particular segments of the equity gap.

**3.14** It is important to ensure that the financial services regulatory regime does not impose any unnecessary restrictions on the marketing of equity investments to investors who are sufficiently sophisticated not to need the consumer protection afforded by this regime. This was recognised in the Financial Services and Markets Act 2000, where the promotion of certain types of investments to certified high net worth or sophisticated investors was exempted from the financial promotion restriction in that Act. Recognising that take-up of these provisions has been slow, the Government has announced that it will consult publicly in January 2004 on whether further steps can be taken to improve the operation of the certification process.

## Tax incentives

**VCTs and EIS 3.15** Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) provide tax relief to encourage private investors to invest in small companies affected by the equity gap. VCTs are mediated funds that appeal to retail investors seeking exposure to private equity as an asset class but who wish to diversify their risk by investing in a portfolio of SMEs chosen by professional fund managers. EIS is targeted at individuals making investments directly in SMEs.

**3.16** Independent research commissioned by the Inland Revenue<sup>3</sup> showed that VCTs and EIS are successful in targeting distinct areas of the equity gap. Drawing on this and other evidence, *Bridging the finance gap* argued that:

- VCTs attract retail investors seeking exposure to a diverse portfolio of venture investments. VCT activity is mainly in the upper range of the equity gap, with investee businesses raising an average of £1.5 million through VCTs. This is consistent with a recent British Venture Capital Association (BVCA) study, which found that over 30 per cent of VCT investee businesses have raised more than £2 million; whereas
- EIS appeals principally to informal investors – for example friends, family and business angels. Three quarters of EIS companies have raised less than £250,000 through the scheme, with about half raising less than £100,000.

**3.17** Consultation respondents concurred with this broad characterisation of the usage of VCTs and EIS, and were very positive about the contribution these schemes have made to the availability of capital in the equity gap.

**3.18** Many respondents expressed reservations about proposals designed to refocus the targeting of either of the schemes. For VCTs in particular, it was widely felt that refocusing the scheme to target a lower part of the equity gap would exacerbate the difficulties in the upper range of the equity gap, and could undermine the investor appeal of some VCTs by restricting their ability diversify risk.

**3.19** Accordingly, the Government does not intend fundamentally to alter the focus of either EIS or VCT, but will take further steps to enhance their effectiveness in their current areas of activity. These steps are described in the paragraphs that follow, but the Government accepts that this approach will leave an ongoing need for further action to tackle the part of the equity gap that remains. The Government's proposals for Enterprise Capital Funds (ECFs), discussed in Chapter 4, are designed to meet this need.

## Enhancements to tax interventions

**VCTs 3.20** The Government recognises the difficulties that VCTs have faced as a result of the global downturn in equity markets. Table 3.1 shows that there has been a sharp reduction in the sums invested in VCTs since 2000-01. It is clear that the VCT sector, like the private equity market as a whole, is not immune to developments in the global economy. However, many consultation respondents believed that the downturn in the VCT sector could undermine the long-term sustainability of the scheme.

<sup>3</sup> *Research into the Enterprise Investment Scheme and Venture Capital Trusts*, a report prepared by PACEC on behalf of the Inland Revenue, 2003, [www.inlandrevenue.gov.uk/research/index.htm](http://www.inlandrevenue.gov.uk/research/index.htm).

**Table 3.1: Sums invested through EIS and in VCTs (£ million)**

	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	01-02	02-03	Total
<b>EIS</b>	4	41	53	94	113	296	611	1,045	728	480	<b>3,466</b>
<b>VCT</b>	-	-	160	170	190	165	270	450	155	65	<b>1,625</b>

Source: Inland Revenue (EIS); PricewaterhouseCoopers and Allenbridge (VCT).

**VCT fundraising 3.21** Accordingly, the Government is considering options to enhance the VCT scheme, targeting structural factors that contribute to volatility in fundraising. These would take effect from 6 April 2004, and are detailed below.

**3.22** *Bridging the finance gap* noted that the design of VCT tax incentives may have contributed to the cyclicity of VCT fundraising. In particular, the opportunity to defer liability for capital gains tax (CGT) makes investment in VCTs very sensitive to the level of capital gains being realised across the economy. The consultation therefore invited views on whether the Government should rebalance the VCT incentives from capital gains tax deferral towards up-front income tax relief.

**3.23** Consultation respondents expressed a range of views, but the balance of responses supported a move to enhanced income tax relief. Several respondents noted that, as well as helping to reduce the cyclicity of VCT fundraising, a rebalancing would also increase the attractiveness of VCTs to a more diverse investor base. For example it could attract more investors who do not have capital gains to defer, but who are keen to gain some exposure to venture capital investments and who are ready to adopt the high level of risk inherent in VCT investments. A number of respondents noted that, while enhancements to business assets taper relief have created an extremely favourable regime for the taxation of business assets, they have also reduced the benefits of CGT deferral.

**Income tax relief 3.24** The Government is mindful of the recent relative weakness in the VCT market and is in favour of a less cyclically sensitive set of incentives for investors. To help to relieve the cyclicity of fundraising, the Government will consider withdrawing, from 6 April 2004, the ability to defer liability for CGT by investing in VCT shares. It proposes that, in the long term, the incentive effect of withdrawing CGT relief should be offset by an **enhancement, of equivalent value, to the incentives to invest through income tax relief** for new subscriptions to VCT shares.

**Proposal for temporary additional stimulus 3.25** In the short term, however, it is the Government’s intention, subject to consultation with the industry, to provide a stimulus to VCT fundraising through an **additional temporary improvement in income tax relief for a period of two years** from 6 April 2004. The intention would be to reinforce the stability of the scheme following the downturn in VCT fundraising illustrated in Table 3.1, and to ensure that VCT fundraising is sufficient to finance the available investment opportunities in qualifying high-growth small businesses.

**3.26** The Government will discuss with business the most appropriate form for this temporary improvement in income tax relief. Its favoured option would be for a temporary increase in the effective rate of income tax relief from 20 per cent to 40 per cent, where government would pay the value of the additional 20 per cent relief directly to the VCT. This would have the advantage of delivering the additional relief directly into the fund to be invested in companies seeking finance. It would also provide investors with enhanced incentives to demand that VCT managers manage the additional funds effectively over the whole of the investment period.

**Upper investment limit for tax relief** **3.27** Although the average VCT investor subscribes for only £25,000 of VCT shares, a minority of VCT investors are constrained by the upper investment limit of £100,000 in any financial year. To provide a further boost to VCT fundraising, **the Government proposes to increase this limit to £200,000**, with effect from 6 April 2004.

**EIS** **3.28** The evidence in Table 3.1 suggests that, despite the general downturn in global market conditions, the level of current investment through EIS appears to be holding up well. The Government will therefore continue to offer EIS relief on broadly similar terms as present, but remains committed to considering evolutionary changes to ensure that EIS remains effective in meeting its core objectives. **Consequently the Government proposes, from 6 April 2004, to increase the limit on the size of investment eligible for 20 per cent income tax relief through EIS to £200,000 in any one tax year.**

**Continued dialogue on Approved Investment Funds** **3.29** The Government acknowledged in *Bridging the finance gap* that the collective vehicle for EIS, Approved Investment Funds (AIFs), do not fit well with the investment needs of many potential beneficiaries. Consultation responses supported the Government's view that the flexibility and light regulation available to AIFs gives them an important potential role in developing the structured business angel syndicate market that has been so important in the US. However, there was no consensus on the best way to achieve this consistent with the need to protect the scheme from abuse. Therefore the Government intends to return to the issue of how AIF provisions might be improved, and will continue its dialogue with the informal investing sector over the coming 12 months, taking into account the early progress of the pathfinder Enterprise Capital Funds outlined in Chapter 4.

**3.30** Notwithstanding these improvements, it is clear that VCTs and EIS will not provide a complete solution to the financing difficulties in the equity gap:

- informal investors are limited by their financial means, generally constraining them to participation in the sub-£250,000 range; and
- the arguments put forward in Chapter 2 – that the economics of venture capital favour larger individual investments – apply equally to VCTs. Most investments by VCTs are therefore likely to remain clustered towards the upper end of the equity gap.

## Fund-based interventions

**Public-private funds** **3.31** Nine Regional Venture Capital Funds (RVCFs) have now been established across England, and by the end of October 2003 had made 77 investments into 63 companies totalling £15.5 million. Over £250 million will be available for investment via RVCFs into businesses with high growth potential. Initial investments are restricted to amounts of up to £250,000, with an opportunity for a follow-on investment of up to £250,000 after six months.

**3.32** The Early Growth Funding (EGF) programme complements the regional funds by providing smaller amounts of risk capital, averaging around £50,000, for start-up and early-stage businesses. The EGF programme, which is designed to run for ten years, is in its early stages but has, to date, funded 13 projects to the sum of just over £1.2 million. This has been invested alongside at least a matching contribution from the private sector.

**UK High-Technology Fund** **3.33** The UK High-Technology Fund (UKHTF) is a 'fund of funds' supporting early-stage high-technology businesses and uses the Government's £20 million cornerstone investment to leverage over £100 million of additional private sector investment. To date, £123 million has been committed to nine specialist venture capital funds. These venture capital funds have in turn made investments in over 110 technology-based companies throughout the UK.

**University Challenge Fund 3.34** The University Challenge Fund (UCF) complements this with capital for early-stage financing to enable universities to develop business proposals and spin-out companies. The UCF has invested £36 million in 186 university spin-outs over the last three years and led to the development of 102 patents and 15 licences. The UCF will be incorporated into the second round of funding for the Higher Education Innovation Fund.

**3.35** These fund-based interventions play a valuable role in targeting specific parts of the equity gap. But, as *Bridging the finance gap* made clear, the Government does not believe it would be appropriate to change the investment limits on existing funds where the terms were fixed in a competitive bidding process, particularly where doing so would risk diverting funds away from sub-£500,000 investments.

## DEMAND SIDE MEASURES

**3.36** *Bridging the finance gap* reiterated the Government's view that demand for finance is at least as important as the supply of finance in increasing the flow of growth capital to SMEs. This was confirmed by a significant number of responses highlighting the importance of improving businesses' understanding of the benefits of equity capital, and the way to go about raising it.

**3.37** Investor readiness problems stem from deficiencies in management, finance and marketing skills within the businesses seeking equity finance:

- businesses that lack awareness of sources of finance are not in a position properly to explore the options offered by equity-based investment;<sup>4</sup>
- a large proportion of business proposals submitted to potential investors are of low quality;<sup>5</sup> and
- information asymmetries between the business and investor result in increased incidental costs for both. The level of effort required to find good investments at this level can act as a disincentive for many investors. A survey of business angels registered with the National Business Angel Network recorded that 90 per cent of business angels would be keen to make more investments but for the difficulties in finding proposals that meet their investment criteria.<sup>6</sup>

## Next steps

**3.38** There is evidence that businesses that receive good quality mentoring and advice have higher survival and growth rates.<sup>7</sup> Oxford Innovation attributes the high survival rate of the 250 innovative businesses it works with (89 per cent over a two year period from December 2000) to the high level of quality support given to the businesses. The Government therefore is keen to ensure that businesses operate in an environment where they are able to access the quality of business advice that will help them flourish.

<sup>4</sup> The Institute of Chartered Accountants England and Wales supported this view in *SME Finance and Regulation: a survey from the ICAEW enterprise group*, 1999.

<sup>5</sup> *Investor Pulse*, the UK Business Angel attitude survey produced by C2 Ventures (2003) perceived that there is a problem of quality and not just quantity of business plans. 'Almost 80 per cent of plans received by the Angel community are related as average or poor...not one of the respondents rated a business plan as excellent.' 2 per cent of business plans submitted to business angels succeed in raising finance.

<sup>6</sup> Mason C. and Harrison R., *Designing an 'Investment Readiness' Programme: Some considerations; a report to the Small Business Service*, 2001.

<sup>7</sup> Gompers, P. and Lerner, J., *Venture Capital and the Creation of Public Companies: Do Venture Capitalists Really Bring More than Money?* Journal of Private Equity, Fall 1997.

Cortun, S. and Lester, J., *Does Venture Capital Spur Innovation?* Harvard Business School Working Paper 99078, 1999.

**3.39** The Government is working with a number of partners to take forward a package of measures, which together will help businesses to identify and attract finance from appropriate external sources. The elements of this package, which are outlined in greater detail below, include:

- working with Regional Development Agencies (RDAs) to build on the findings of the investment readiness demonstration projects at a local level (paragraph 3.40);
- with the accountancy profession and other business bodies, developing the proposals of the Accountancy Working Group, which is considering how best to enhance the role of business advisors in providing financial advice to firms (paragraph 3.43);
- launching a *no-nonsense guide* to finance for small, growing businesses (paragraph 3.46); and
- working with the Small Business Investment Taskforce<sup>8</sup> (SBIT) to examine barriers to the growth of affordable financial intermediation focused on small-scale equity finance (paragraph 3.50).

**Investor readiness demonstration projects**

**3.40** The Government consultation paper, *Investment Readiness: helping enterprises access equity finance for growth*, published in March 2001, set out a number of issues surrounding the provision of an investment readiness service. The responses from that, along with the evidence from an academic review that was commissioned from Professors Mason and Harrison<sup>9</sup>, led to the launch of a programme of demonstration projects.

**3.41** Following a competitive bidding process, six investment readiness demonstration projects were launched in autumn 2002. The Small Business Service (SBS) is now evaluating the impact of these projects with results due in the new year. Information gained will be shared with the RDAs as they develop regionally based interventions with local partners that meet the specific needs of their regions. The SBS will continue to play an important role in helping the RDAs drive forward this agenda, sharing best practice across the country, and ensuring that the RDAs are well placed to learn from each other's experiences.

**3.42** The Government will conduct a programme of continuing research to improve understanding of investor readiness issues. This research will look at ways to join up existing EU and UK measures dealing with the demand for finance to ensure maximum impact.

**Improving the quality of business advice**

**3.43** The Accountancy Working Group, announced in Budget 2003 and chaired by Michael Snyder, has been examining the role that accountants and other business advisors play in helping businesses to access the external finance they need to realise their growth potential. Many accountants already play an important role in advising their clients about the financing options available to them. However, not all fully meet the needs of their clients, and there is scope for more to develop the expertise required to provide high quality advice about sources of external finance for firms. The Government expects the Working Group to report shortly, and will, in the light of the Group's recommendations, consider how it might encourage the professional bodies actively to develop the role of their members in the field of financial advice for businesses, in the mutual interest of both the accountancy industry and the businesses they serve.

<sup>8</sup> The Small Business Investment Taskforce, chaired by Sir David Cooksey, is an expert group set up, following Budget 2000, to advise the Government on issues relating to access to finance for SMEs.

<sup>9</sup> Mason C. and Harrison R., *Designing an 'Investment Readiness' Programme: Some considerations; a report to the Small Business Service*, 2001.

**Banks' role in improving SME skills** **3.44** Other intermediaries also have a role to play in providing the appropriate advice and support to firms seeking to raise finance. As announced in Budget 2003, the Government/Banks Working Group, chaired by Sue Brownson, is advising the Government on how to establish a new one-stop online package of training and support for SMEs that will be promoted through the banks' existing communication networks. From spring 2004 the banks will be actively referring customers to information diagnostics and a training directory available on the national Business Link website<sup>10</sup>. One of the most important aspects of the training and support that SMEs can benefit from concerns improved financial planning and management. Better access to the appropriate training and skills will play an important role in improving SMEs' awareness of financial issues and their ability to plan accordingly.

**Business Links** **3.45** The national network of Business Link operators already provides guidance to firms seeking finance. The penetration of Business Link amongst small firms is markedly improving with over 330,000 customers so far this year, equivalent to a market penetration of 18.5 per cent. Business customer use of Business Link services has increased by 55 per cent since the same period last year and enquiries about starting up a business have increased by 43 per cent. This growth is set to continue with Business Link's development of a core national start-up offer, which will be launched in spring 2004 and will be available through Business Links and the national Business Link website. It will provide people interested in starting up a business with information, advice and support on all aspects of starting a business including financial management issues, the provision of better diagnostics and access to providers of training. The 2002 Spending Review announced that RDAs would be invited to pilot new approaches to managing business support in the regions. Two pilots were launched in April 2003, with the East Midlands Development Agency and North West Development Agency becoming responsible for the management of their regions' Business Links. A third pilot will see Advantage West Midlands taking on the same responsibilities in April 2004.

**No-nonsense guide** **3.46** Following the positive response to *The no-nonsense guide to government rules and regulations for setting up your business*, the Government will develop a *no-nonsense guide* to raising finance, to be published on the new [www.businesslink.gov.uk](http://www.businesslink.gov.uk) website at its formal launch in April 2004. The guide will explore the benefits and drawbacks of each of the various types of investment available and will be developed in conjunction with industry specialists. The guide will provide a useful first information point on where to seek specialist advice.

**National Business Angel Network** **3.47** The SBS has recently announced a further term of support for the National Business Angel Network (NBAN). Part of the service that NBAN will provide will be aimed at potential users of business angel finance. By reducing the gap between the expectations of SMEs and the business angels this work has the potential to reduce the failure rate of investment proposals and subsequently have an effect on the operating costs of the angels and networks. Mason and Harrison (2001) found that this gap in expectations was top of a list of deficiencies in investment opportunities encountered by angels registered with NBAN.

**Model contracts** **3.48** *Bridging the finance gap* suggested that there may be a range of benefits if entrepreneurs were able to access model contracts that could form the basis of negotiations with equity investors. Although a majority of respondents supported the provision of model contracts between small businesses and investment managers, the Government recognises that there are a number of technical and legal issues that could only be properly resolved by circumstance-specific legal advice. The Government will, however, provide guidance in the *no-nonsense guide* to finance on what small businesses should expect from equity finance, and an explanation of the common features and legal terms used across the industry. The Government has asked the BVCA to explore the scope for issuing further guidance and education to entrepreneurs in this area.

<sup>10</sup> [www.businesslink.gov.uk](http://www.businesslink.gov.uk)

**Incidental costs of raising equity** **3.49** In the light of the limited impact on the intended target SMEs that consultation respondents suggested would result from allowing the incidental costs of raising equity to be tax deductible, the Government will not, at this stage, take this proposal further. However, it was clear from responses that cost is only one barrier facing firms considering whether or not to seek equity funding. Some of these barriers are due to the complexities of the process involved, and so the Government is committed to examining the scope to reduce these barriers.

**Other barriers to intermediation** **3.50** The Government also wishes to understand the reasons why there appear to be proportionally fewer firms in the UK than in the US specialising in matching small businesses with potential equity investors. This is a particular problem where smaller deal sizes are involved. There could be a number of reasons for this, some of which may be unintended consequences of regulation or other legal constraints.

**3.51** **The Government will ask the Small Business Investment Taskforce (SBIT) to consider these issues in advance of Budget 2004.** In particular the Government will ask the SBIT to consider a number of issues facing small high-growth SMEs that could benefit from early-stage equity or mezzanine finance, including:

- whether there are barriers that inhibit new entrants to the private sector intermediary market, or that raise the costs of raising small amounts of equity or mezzanine finance; and
- the barriers facing small high-growth SMEs when raising early-stage and second round finance.

## Conclusion

**3.52** The changes to existing Government interventions announced in this chapter will contribute to their effectiveness in helping SMEs to access the external risk capital they need to finance their growth, and will contribute to enhanced quantity and quality of deal flow to finance providers:

- improvements to SFLG will further improve small firms' access to debt finance;
- changes being considered to the EIS and VCT tax incentives are likely to boost the supply of equity capital in the lower and upper segments of the equity gap respectively;
- existing fund-based interventions will continue to play a valuable role in targeting equity investments in specific areas of the equity gap; and
- the Government will take forward a package of actions to help tackle the demand-side problems highlighted in the course of the consultation.

**3.53** However, the Government believes that structural features of the market will continue to constrain the supply of risk capital for businesses with high growth potential, which cannot be filled by reforms to the Government's existing interventions alone. The model for Enterprise Capital Funds described in the next chapter will complement the existing supply side measures by:

- encouraging an increased supply of private capital for equity investments in businesses that are affected by the equity gap;
- lowering the barriers to entry for new risk capital managers to enter the market in 'equity gap' investing, thereby ensuring a cadre of skilled risk capital managers is available to channel finance and mentoring to SMEs with growth potential; and
- targeting different investors, so raising the overall supply of finance while minimising the effect on flows through EIS and VCT.

The changes outlined in Chapter 3 will help to improve the operation of existing measures designed to increase private-sector investment in the equity gap. However, consultation responses and other evidence presented in earlier chapters indicate that some businesses will continue to be affected by a shortage of equity capital, and that market capacity is likely to be constrained by the limited flow of new skilled fund managers entering the market.

The Government believes that a suitably designed variant of the US Small Business Investment Company (SBIC) model could play an important role in supporting greater private-sector investment activity in the equity gap. The Government therefore intends to explore this possibility further by inviting bids for a round of 'pathfinder' funds, to be known as Enterprise Capital Funds (ECFs). The Government would use the lessons learned from these pathfinder funds in considering whether and, if appropriate, how to develop a longer-term programme.

This chapter sets out the broad conclusions that the Government has drawn from the consultation process, and which it will seek to test further through the pathfinder funds. The Government believes that, should it decide to proceed with any longer-term ECF programme, this would most effectively be delivered through an arm's length company set up specifically for that purpose. Such a company would need to be given the operational freedom needed to adapt its approach in the light of experience and in response to changes in the market for SME finance.

This chapter also provides an overview of how the pathfinder ECFs will operate. The Government will invite interested parties to submit bids to participate in this pathfinder round of ECFs and, subject to receiving the necessary European state aids clearance, will publish detailed bidding guidance in spring 2004. The design of the pathfinder will incorporate a number of modifications to the original SBIC proposals, taking account of the responses to the consultation. In particular, prospective pathfinder ECF managers will be allowed some flexibility to specify in their bids how the proceeds of successful ECF investments will be allocated between private investors and the Government.

## INTRODUCTION

### Consultation proposals

**4.1** The *Bridging the finance gap* consultation paper described the Small Business Investment Company (SBIC) model that has operated in the USA for the past 45 years. It outlined a possible variant of this model that could be introduced in the UK, and sought views on whether this would be appropriate and, if so, how the proposals might need to be further adapted to suit the UK market. The proposals set out in the consultation paper are briefly summarised in Box 4.1.

**Box 4.1 Summary of proposals for a possible UK SBIC programme**

In *Bridging the finance gap*, published in April 2003, the Government described a possible UK SBIC model. This initial model would see government offering debt (or ‘leverage’) at a favourable interest rate to privately owned and managed SBIC funds. An SBIC would be entitled to draw down public leverage up to a maximum of twice the private capital in that fund. The pooled public and private funds would be invested by the SBIC in UK SMEs. As the investment grew and the SBIC made a profit, the SBIC would repay government leverage and interest (charged at or close to UK gilt rate), then repay private investors’ capital, before sharing any remaining profits between government and the private investors.

Government would allow SBICs to defer repayment of interest until the SBIC had generated sufficient cash flow to service the debt, thereby allowing SBICs to invest in pre-revenue and other early-stage businesses where they chose so to do. Government’s profit share would be set so as to offset losses on SBICs that did not recoup enough on their investments to repay government-backed leverage. This would allow the programme to be self-financing over the medium term. In this model, where an SBIC did lose money, government funding would be senior to the private investors’ capital - i.e. the risk of ‘first loss’ would rest with the private investor.

**Objectives 4.2** The consultation paper described the objectives that the Government would hope to achieve if it introduced a variant of the SBIC programme in the UK. The overall aim would be to increase the availability of growth capital to SMEs affected by the equity gap, so helping to alleviate what would otherwise remain a significant barrier to enterprise and to productivity growth. This would be achieved by:

- providing government funding for a new investment product that encouraged an increased flow of private capital into the equity gap by adjusting the risk-reward profile of such investment; and
- lowering the barriers to entry for entrepreneurial risk capital managers seeking to channel finance and mentoring to SMEs affected by the equity gap, by reducing the amount of private capital needed to establish a viable venture fund.

**4.3** Consultation responses showed an encouraging level of support for these objectives, and many respondents highlighted ways in which the proposed model could be adapted to maximise its impact in the UK market. The Government believes that the SBIC programme has made a significant contribution to the development of the early-stage venture capital sector in the USA, but also recognises that the design of any similar programme in the UK would need to take full account of:

- the significant differences between the UK and US in the cultural, financial, regulatory and legal environments; and
- the lessons that have been learned from the 45-year history of the US SBIC programme.

**Enterprise Capital Funds 4.4** The Government believes that a variant of the SBIC approach could improve the operation of the SME finance market in the UK, and intends to explore this possibility further, by:

- **inviting bids for a round of ‘pathfinder’ Enterprise Capital Funds, based broadly on the US SBIC model.** Subject to receiving the necessary European state aids clearance, the Government will publish detailed bidding guidance in spring 2004; and
- using the lessons learned in establishing the pathfinder round to determine whether and, if appropriate, how to **develop a longer-term Enterprise Capital Fund programme.**

**Implementing a long-term ECF programme 4.5** The Government believes that, if it decides to introduce a long-term ECF programme, it would need to incorporate a significant degree of flexibility to adapt the programme in the light of experience and in response to changing market conditions. It would need to be designed and managed in a way that recognised the commercial realities of venture capital investment, while also delivering maximum value for taxpayers’ money in meeting the Government’s objectives. The Government would also wish to ensure that any new programme complemented existing public interventions in the risk capital market.

**4.6** In the light of these considerations, the Government believes that any long-term ECF programme would be most effectively delivered through an organisation that operated at arm’s length from government itself. If the Government decided to proceed with a longer-term programme, it would therefore act as soon as was practicable to establish a company to oversee the programme. The Government would set the over-arching objectives for this company, which would operate within an agreed spending envelope and risk management framework. The company would otherwise have the operational freedom to determine how best to achieve the programme objectives, in the context of a dynamic SME finance market.

**4.7** However, the Government recognises that it would only be appropriate to establish such a delivery body once it had become clear that a long-term ECF programme could operate successfully. This will be assessed in the light of the early progress of the pathfinder funds.

## CONSULTATION FINDINGS

**4.8** The Government has drawn a number of broad conclusions from the consultation<sup>1</sup>, which it believes could inform the design of any longer-term ECF programme. The following paragraphs describe these conclusions, which the Government will test further through the pathfinder process. The remainder of this chapter, from paragraph 4.20 onwards, provides an overview of how this pathfinder round will operate.

**Investor appetite for an ECF product 4.9** Consultation responses indicated that the most likely target investor groups for the proposed product would be institutional and wealthy individual investors, but many respondents questioned the degree of investor appetite for a product in which repayment of public leverage and interest took priority over private capital. The Government therefore recognises that an ECF programme might also need to allow some flexibility for alternative repayment structures that would spread risk more equally between public and private capital. However, it remains of the view that such a programme should avoid exposing public funds to greater risk than private investors’ capital.

<sup>1</sup> Appendix A provides a summary of the consultation responses.

**4.10** Responses indicated that the proposed model could provide a vehicle for business angel groups who were willing to pool funds and expertise in a fund-based structure, and more than two thirds of respondents believed that leverage could be attractive to structured business angel syndicates. However, the Government also recognises that many business angels prefer to select investments independently, on a deal-by-deal basis. For these investors, government support provided through the Enterprise Investment Scheme (EIS) and the Early Growth Funding programme, described in Chapter 3, may be more appropriate than any ECF model.

**Targeting the equity gap**

**4.11** The objective of any ECF programme would be to encourage an increase in the flow of private capital to SMEs affected by the equity gap. Consultation respondents generally acknowledged that some restrictions would be needed to ensure that any ECF programme targeted this gap, and so avoided crowding out existing venture capital activity. At the same time, most respondents felt that any programme should be commercial in its focus, and the government should therefore avoid imposing more restrictions on the investment strategies of individual funds than necessary to target the equity gap.

**4.12** Almost two thirds believed that it would be practicable to require funds to invest a minimum proportion of their capital in early-stage businesses, but not all of these respondents believed it would be desirable. Many respondents argued that the equity gap affects not just early-stage businesses but also more established businesses seeking modest sums of development capital, and that the programme should allow for investment strategies that focus on the latter group of businesses. Over four fifths of respondents who expressed a view felt that mezzanine funding instruments, which would be more suitable for established businesses seeking development capital, should be allowed under any new programme.

**Commercial flexibility**

**4.13** The Government would prefer any long-term ECF programme to allow fund operators as much commercial flexibility as possible. It would therefore prefer to minimise the use of specific rules on how a fund's portfolio should be allocated between different types of company, and on the types of deal structures a fund could adopt. The Government believes that this could be achieved without compromising its objectives by setting the broad parameters within which an ECF programme should operate, together with an approval process that took account of the extent to which proposed funds would target the most severe part of the equity gap.

**Selecting fund managers**

**4.14** The Government would wish to ensure that public funds were invested on a fully commercial basis, and recognises that the success of an ECF programme would depend upon the quality of the fund management teams. Taking account of the history of the US SBIC programme, the Government believes that it would be crucial to strike the right balance between ensuring that:

- leverage was provided only to funds with good prospects of implementing successful investment strategies; and
- the approval process did not itself present an unnecessary barrier for new fund management teams that possessed the competencies needed to stand a good chance of commercial success, but that lacked a demonstrable track record in the sector.

**4.15** This highlights the need for an approval process to be carried out by individuals who have the necessary expertise to evaluate the prospects of potential fund management teams, and to assess their likely contribution to meeting the Government's objectives.

**Legal structure 4.16** In line with the views of consultation respondents, the Government believes that a limited partnership structure would be attractive for the majority of participants in any ECF programme. However, half of respondents who expressed a view suggested that any programme should maintain sufficient flexibility to accommodate business models where an alternative fund structure was most appropriate. For example, a syndicate of business angels or other wealthy individuals might prefer to manage their own funds through a corporate vehicle, because this would not constitute a regulated activity in the context of the Financial Services and Markets Act 2000.

**4.17** The Government therefore believes that an ECF programme would need to incorporate the greatest possible flexibility for different fund structures. Moreover, the Government would be keen to ensure that investments in any ECFs were not disadvantaged relative to investments made directly in the underlying asset, irrespective of the legal structure chosen for ECFs.

**Taxation 4.18** Many respondents suggested that the success of any ECF programme would depend upon specific tax incentives to encourage private investment, perhaps on a similar basis to the reliefs offered through EIS and Venture Capital Trusts (VCTs) (described in Chapter 3). However, it would be impossible to target the full range of possible investor groups, for example non-taxpaying institutions, by means of tax reliefs alone. The Government also believes that leverage would itself provide a substantial benefit to private investors in successful funds, and would wish to maintain a clear distinction between any ECF programme and the existing tax incentive-based schemes.

**4.19** The Government does not therefore believe that an ECF programme should offer specific EIS- and VCT-style tax reliefs to investors. It is envisaged that, where commercially appropriate, investment through an ECF would otherwise broadly receive parity of tax treatment with direct investment in unquoted equities, irrespective of the legal structure of the ECF. More details on how this tax treatment will be achieved for the pathfinders will be published alongside full bidding guidance in Spring 2004, and legislation will be brought forward at the appropriate time.

## OVERVIEW OF ECF PATHFINDER FUNDS

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**4.20** The key features of the ECF pathfinder funds take account of the conclusions drawn from the consultation. The Government believes that these features could underpin a longer-term ECF programme, but will take decisions on whether and how to develop such a programme in the light of the lessons learned in establishing the pathfinder funds. These key features, which are covered in more detail below, will be:

- **applying for ECF leverage.** Potential ECF managers will be invited to submit their business plans in a competitive bidding process. They will need to demonstrate that they possess the competencies needed to select and manage a portfolio of venture capital investments successfully, and that they will be able to raise capital from private sources;
- **drawing down leverage.** Once an ECF has secured capital commitments from private investors, the ECF will be entitled to draw down leverage from government. The maximum leverage entitlement will be agreed as part of the application process, but will be no greater than £2 of leverage for every £1 of capital drawn down from private investors. Interest on outstanding leverage will be charged at, or close to, gilt rate, but repayment of that interest will be deferred until the ECF has the necessary cash flow;
- **investing in SMEs.** ECFs will invest their funds in eligible SMEs. The Government has applied for state aids approval for a possible programme that targets the equity gap by allowing ECFs to participate in initial financing rounds of no more than £2 million, but that allows flexibility for funds to participate in larger follow-on funding rounds where necessary to protect their equity stake from dilution; and
- **realising successful investments.** When an ECF generates income from dividends and from the sale of its successful investments, it will distribute the proceeds to government and private investors. The consultation document proposed that repayment of public leverage and interest should take priority over private capital, but the pathfinder will offer some flexibility for prospective ECF managers to propose alternative repayment structures. However, the Government will not allow public capital to be exposed to greater risk than private investors’.

## Applying for ECF leverage

**Application criteria** **4.21** Full details of the application criteria and process will be set out when the bidding round is launched. Applicants are likely to be judged on their capacity to manage a portfolio of investments successfully and to deliver value for public money in the context of the ECF programme objectives. It is envisaged that prospective ECF managers will be asked to submit a full business plan that, among other things, includes details of:

- the proposed management team, their relevant experience and evidence that they possess the competencies necessary to run an ECF effectively;
- the proposed fund's investment strategy (e.g. sector and stage of development of target investee companies, intended deal structures and any sectoral or geographical focus);
- the amount of private capital to be raised, the intended sources of capital, and evidence of investor appetite for the proposed ECF business plan; and
- the priority of repayment of public leverage and interest, private capital and subsequent profits.

**4.22** Applicants will be judged in a manner that is consistent with the Government's objective to reduce the barriers facing new fund management teams seeking to enter the equity gap segment of the market. The application process will not require a proven track record in all aspects of equity gap investing, but will expect each applicant to demonstrate that its business plan is viable and its objectives likely to be successfully achieved, given the skills and experience of the proposed management team.

**Minimum fund size** **4.23** The *Bridging the finance gap* consultation paper invited views on whether the Government should specify a minimum fund size. In the US, participating securities type SBICs are required to secure commitments for a minimum amount of private capital (usually \$10 million). However, the consultation paper argued that adopting this approach in the UK would risk excluding viable, small-scale funds, such as those managed by business angel groups.

**4.24** Two thirds of consultation respondents who expressed a view favoured imposing a strict minimum fund size, though a significant minority encouraged the Government to let private investors determine the limits on a viable fund. Respondents who took the latter view were often those who believed the proposed model would be attractive for business angel groups.

**4.25** In practice, the minimum viable fund size will vary according to the business model of the individual fund, and the Government wishes, at the pathfinder stage, to preserve flexibility to cater for the widest possible range of potential ECF business models. The application process will therefore assess the overall viability of each proposed fund, and its proposed size will form part of that assessment. By not adopting a fixed minimum across the board, the Government remains open to the possibility of receiving proposals from a range of potential ECF managers with innovative business models.

## Drawing down leverage

**Interest 4.26** Once an ECF has secured commitments for the agreed level of private capital, it will be entitled to draw down public leverage. Interest will be charged at or close to gilt rate, but repayment of interest will be deferred until the ECF has generated the necessary cash flow from its investments

**Leverage limits 4.27** Each ECF will be free to draw down as little or as much leverage as it wishes, subject to the overall constraint imposed by the maximum leverage ratio agreed when approval is granted. At any point in time, the maximum leverage entitlement will be determined by applying this ratio to the amount of private capital already drawn down into the fund. In the light of the consultation responses, the Government intends to apply a maximum leverage ratio of 2:1 for any pathfinder ECF. Experience from the US suggests that some prospective ECFs may opt to bid for a smaller leverage entitlement.

## Investing in SMEs

**Targeting the equity gap 4.28** As described in paragraphs 4.11 to 4.13 above, the Government intends that any long-term ECF programme would allow funds as much commercial flexibility as possible, while ensuring that they target businesses affected by the equity gap. In line with this principle, the Government does not intend pathfinder ECFs to face specific requirements in relation to the stage of development of investee companies.

**4.29** Instead, the Government is seeking state aids approval on the basis of an overarching limit that pathfinder ECFs will be allowed to participate in funding rounds of up to £2 million, reflecting the current position of the equity gap. Where an ECF invests as part of a syndicate, other investors' contributions will also count towards this £2 million upper limit.

**4.30** However, the Government recognises that, within the sub-£2 million range, the severity of the equity gap varies according to a company's stage of development and business sector. Subject to the overall £2 million size limit, the process for assessing ECF applications will therefore take account of the extent to which prospective ECFs are likely to benefit those companies that are most severely affected by the equity gap.

**Geographic focus 4.31** ECFs will otherwise be free to invest in any eligible SME, so long as the purpose of the investment is predominantly related to, or for the benefit of, the United Kingdom. The approval process will not adopt any preference in relation to an ECF's geographical focus, unless this affects the commercial viability of the proposed fund. It is envisaged that pathfinder ECFs would be allowed to invest throughout the UK, but it would be a matter for the Devolved Administrations to decide whether their respective countries will participate in any longer-term programme.

**Flexibility for follow-on investments 4.32** Consultation respondents highlighted the need for flexibility within the scheme's rules to allow funds to protect their investments from dilution in subsequent funding rounds. The Government therefore intends to allow pathfinder ECFs to participate in larger follow-on investments in these circumstances. In such cases, the ECF would be constrained only by an upper limit on the proportion of its total fund size that may be invested in any single portfolio company. This limit would be set in line with normal commercial practice.

**Deal structures 4.33** Pathfinder ECFs will be free to structure investments in the most appropriate manner for each deal, subject to an overarching requirement that each investment must include some equity or equity-related instruments. This would not preclude the use of debt instruments with options to convert to equity.

**Other restrictions** **4.34** As with the Regional Venture Capital Funds, a limited number of business sectors will be ineligible for investment from ECF pathfinder funds. These restrictions will ensure compliance with European law, and will ensure that public investment is not directed towards activities (such as property investment) that are well served by existing finance markets.

**4.35** It is not envisaged that companies quoted on public markets, including the Alternative Investment Market and other non-recognised investment exchanges (NRIEs), will be eligible for ECF investments in the pathfinder. However, companies quoted on NRIEs continue to qualify for investment through EIS, VCTs and the Corporate Venturing Scheme, so long as they meet the relevant conditions for those schemes.

## Making repayments

**Distributing repayments** **4.36** The Government will allow some flexibility in the pathfinder round for applicants to specify in their bids how the proceeds of successful investments will be distributed between government and private investors. This will provide flexibility for prospective pathfinder ECFs to appeal to a wider range of potential investors, while also testing the appetite for a model where repayment of public leverage takes priority over private capital. Where an applicant exposes public funds to a higher level of risk than proposed in the consultation paper, the Government will expect this to be reflected in other features of the bid, for example, a higher government profit share.

**4.37** Further details will be provided in detailed guidance when the application process is launched, but the Government will not consider applications that place public funds at greater risk than private capital. This overriding principle means that, although up to two thirds of a pathfinder ECF's capital will be provided by the Government, ECFs will face strong incentives to maintain a fully commercial focus.

## NEXT STEPS

**4.38** The Government has notified the European Commission of its intention to proceed with a round of pathfinder ECFs. It will now develop detailed bidding guidance, in discussion with the SME finance community and other relevant parties, to enable a competitive bidding round to be launched in spring 2004 if the necessary state aid approval is received by that time. Alongside the bidding guidance, the Government will provide more details on how the tax treatment described in paragraph 4.19 above will be achieved for the pathfinder funds.

**4.39** The Government will, in any case, provide an update of progress in the spring.



# A

## APPENDIX A: SUMMARY OF CONSULTATION RESPONSES

### EXECUTIVE SUMMARY

**AI** The Government received 153 written responses to the *Bridging the finance gap* consultation paper, representing a wide range of interest groups across the small business and finance communities. The key response themes, analysed by individual consultation question, are set out below. Many respondents chose to respond only to particular parts of the consultation. Unless otherwise stated, all percentages in the subsequent analysis refer to proportions of those responding to a given question, not to the proportion of responses as a whole.

**Equity gap A2** Around two thirds of respondents commented on the equity gap and, of these, 97 per cent agreed that an equity gap exists. 93 per cent believed that the upper limit was £1 million or greater, with over 50 per cent suggesting a figure of more than £1 million. Several responses indicated that the gap could be as high as £5 million. Over 60 per cent agreed that the lower bound was £250,000, with roughly equal numbers suggesting higher or lower figures.

**A3** Many respondents argued that the finance gap was not only a function of size of investment sought, but also the stage of the firm involved. Early-stage funding was seen as more difficult to obtain than later-stage finance, and a clear majority of respondents agreed that high-technology firms face more severe issues in accessing equity finance.

**SFLG A4** Many respondents were very positive about the Small Firms Loan Guarantee (SFLG), although some felt that the scheme is not always applied consistently by the major banks. Some respondents said that the Government could promote SFLG more effectively, and many felt that there was scope to reduce further the administrative requirements of the scheme.

**A5** Some argued that SFLG could be adapted to provide quasi-equity finance, for instance by allowing for interest repayment holidays alongside existing capital repayment holidays, which would allow firms to defer repayment until an investment started to generate positive returns. There was also clear support for amending the 'ten-year' rule, which was seen as having the potential to discourage serial entrepreneurs from using the scheme. Alternative suggestions included replacing the ten-year cutoff rule with a cap on total borrowing outstanding at any one time, or reducing the it to a three-year rule.

**VCT A6** Respondents generally opposed new restrictions on Venture Capital Trusts (VCTs) such as limiting syndication or requiring all VCTs to invest a proportion of their funds in early-stage companies. The suggested two-tier system was generally seen as unduly complex, though a minority favoured this approach. Overall there was enthusiasm for greater simplicity, though practical suggestions as to how this might be achieved were limited.

**A7** Many respondents called for enhanced tax reliefs to ease current fundraising difficulties, while others argued that the perceived problems with the scheme were structural not cyclical. A small majority favoured enhanced income tax relief over capital gains tax (CGT) deferral relief, as income tax relief was seen as less cyclical and more attractive to younger investors.

**EIS A8** In general, respondents felt that the Enterprise Investment Scheme (EIS) has weathered the downturn much better than VCTs, and few called for enhanced EIS reliefs. There was support for encouraging business angel syndication, though some noted that many informal investors prefer to maintain day-to-day control over individual investment decisions, and some raised concerns about the impact of the Financial Services and Markets Act (FSMA) on business angel syndicates. Some respondents also expressed interest in extending the provisions of the EIS Approved Investment Fund (AIF) to limited partnerships.

- Incidental costs of equity** **A9** Most who responded felt that tax relief for the incidental costs of raising equity finance would remove a potential obstacle to equity fundraising, though few believed it would have a decisive impact on behaviour. Some noted that relief would benefit only profitable small and medium-sized enterprises (SMEs), particularly established businesses rather than start-up and other early-stage firms. There was also some concern that the benefit of tax relief could ultimately flow to advisors and lawyers rather than to the SMEs themselves.
- SBICs** **A10** The proposals for a variant of the US Small Business Investment Company (SBIC) scheme were positively received by more than 60 per cent of respondents. Some respondents argued that UK investors would require tax incentives before considering putting money into SBICs. Some also questioned the success of the US scheme over the past three years since the downturn in the private equity market.
- A11** The most common suggested alternatives to SBICs were extended Regional Venture Capital Funds (RVCFs), and a Government co-investment approach along the lines of the Scottish Co-investment Fund and the projects supported as part of the Early Growth Funding programme.
- Private investors** **A12** Respondents were divided over the most likely sources of private investment for any SBIC programme. The greatest appetite for investment was expected to come from high net worth individuals (HNWIs) and institutions. There was also broad support for the idea that the SBIC model might appeal to structured angel syndicates (nearly 70 per cent of respondents commented that this was likely).
- Minimum fund size** **A13** Two thirds of respondents who commented on the issue said there should be a minimum fund size for SBICs. Responses divided roughly equally between those who thought the minimum fund size should be greater than, less than, or equal to the £10 million limit suggested in the consultation document. The general consensus was that a mediated fund would have to be larger than £10 million in order to be commercially sustainable. Most respondents argued against placing an upper limit on the value or number of funds that could be controlled by a particular fund manager.
- Borrowing from government** **A14** In response to questions on appropriate limits that might be imposed on government funding, most respondents favoured either a monetary limit (frequently £50 million), or a leverage ratio (most commonly 2:1 or 3:1). These were broadly consistent with the current US approach. Over 60 per cent of those who commented suggested that the Government should adopt a tiered leverage approach, with the Government giving a higher proportion of leverage to smaller SBICs. Many argued that this would help attract capital to the lower end of the equity gap, although other respondents emphasised the need to keep the rules of the scheme as simple as possible.
- Investing in SMEs** **A15** Respondents broadly supported limiting total investments in any one SME to £2 million, with no more than £1 million in any single financing round. However, several argued for minimal limits on follow-on funding, to limit the risk of successful investments being diluted by larger subsequent funding rounds.
- A16** 60 per cent of those who commented believed that it would be practicable to require SBICs to invest a minimum proportion of their fund in early-stage SMEs, though there was no consensus on how these might be defined. More broadly, ensuring that a certain proportion of the fund was invested in the target SME sector was seen as an acceptable way of meeting the Government's objectives. Proposals to restrict syndication were generally unpopular. Similarly, more than 80 per cent of respondents argued that SBICs should be allowed to offer mezzanine financing.

**Model contracts A17** More than 70 per cent of responses supported optional model contracts. Those against claimed that one size would not fit all, and individual contracts would inevitably have to be written for each deal.

**Profits and losses A18** Over 40 per cent of those who commented suggested that the Government’s profit share should depend on the leverage offered. Other suggestions were that the Government should take a fixed premium interest rate, and that the Government should receive profits on the same terms as private investors. Over 60 per cent suggested that private investors would have little appetite for a model in which full repayment of public leverage took priority over repayment of private capital.

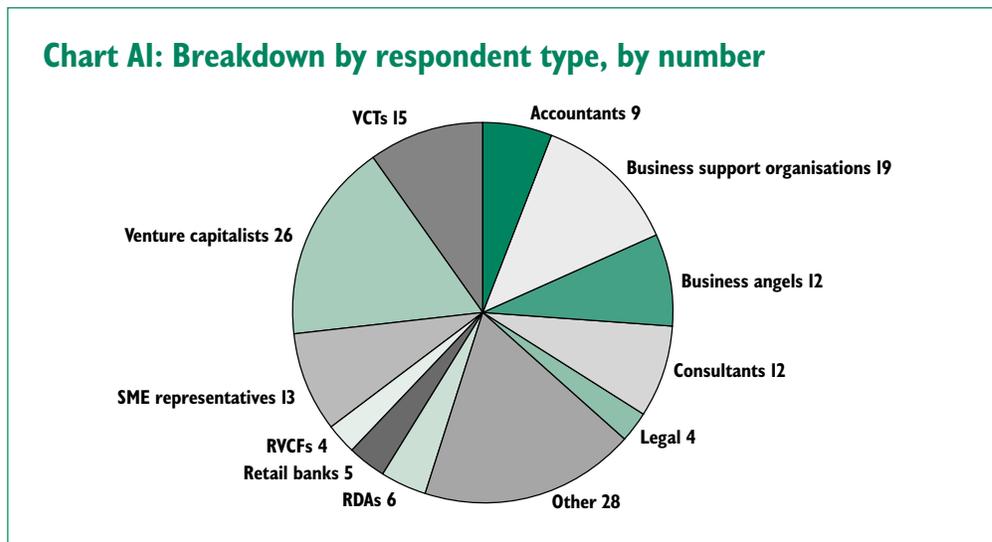
**A19** There was some concern about the monitoring of SBICs and the possibility of the Government liquidating under-performing funds. A number of responses argued that the capital impairment ratio at a particular point in time might not be a good indicator of the actual and potential performance of an SBIC. Most respondents agreed that liquidation should be a last resort, and some suggested that even the threat of liquidation could deter investors from SBICs.

**Other issues A20** Half the respondents who commented on the issue favoured minimal restrictions on allowable legal structure for an SBIC, agreeing with the Government’s view that the structure of an SBIC should, as far as possible, be determined by commercial considerations. More than 60 per cent believed that the SBIC scheme should be monitored and regulated by the Financial Services Authority (FSA).

## SUMMARY OF RESPONSES BY QUESTION

### Overview

**A21** The Government received 153 written responses to *Bridging the finance gap*, covering a wide cross-section of interested parties as shown in Chart A1. These written responses were complemented by views expressed at ‘roadshows’ held by HM Treasury, the Small Business Service (SBS) and the Inland Revenue in collaboration with the Regional Development Agencies and Devolved Administrations at venues across the UK. This appendix only considers the written responses, although the comments made at the roadshows have been taken into account in the policy development process.



**A22** Where responses are broken down by respondent type in the subsequent analysis, the respondents are grouped under the following categories:

- **business support groups:** business support organisations (BSOs), Regional Development Agencies (RDAs) and SME representatives;
- **services:** accountants, consultants and legal services;
- **venture capital funds:** venture capital firms, including VCTs and RVCFs;
- **business angels;** and
- **others:** retail banks, institutional investors, community development finance institutions (CDFIs) and all others.

**A23** Many respondents chose to respond only to parts of the consultation (see Table A1). All percentages in the subsequent analysis refer to proportions of those responding to a given question, not to the proportion of responses as a whole.

**Table A1: Number of respondents to the questions posed in *Bridging the finance gap***

Question in <i>Bridging the finance gap</i>	Number of respondents	Question in <i>Bridging the finance gap</i>	Number of respondents
2.1	106	4.4	38
2.2	89	4.5	56
2.3	72	4.6	53
3.1	45	4.7	40
3.2	71	4.8	43
3.3	32	4.9	33
3.4	43	4.10	51
3.5	42	4.11	48
3.6	68	4.12	43
3.7	58	4.13	28
3.8	74	4.14	51
3.9	54	4.15	31
3.10	14	4.16	56
3.11	54	4.17	41
3.12	65	4.18	16
3.13	48	4.19	29
4.1	27	4.20	32
4.2	36	4.21	17
4.3	49		

**A24** Although Chapter 4 introduces a UK Enterprise Capital Fund (ECF) programme, this appendix refers to SBICs throughout to avoid confusion and to remain consistent with consultation responses. Also, all references to chapters or paragraphs in questions refer to those in the *Bridging the finance gap* consultation document.<sup>1</sup>

<sup>1</sup> Available at [www.sbs.gov.uk/financegap](http://www.sbs.gov.uk/financegap)

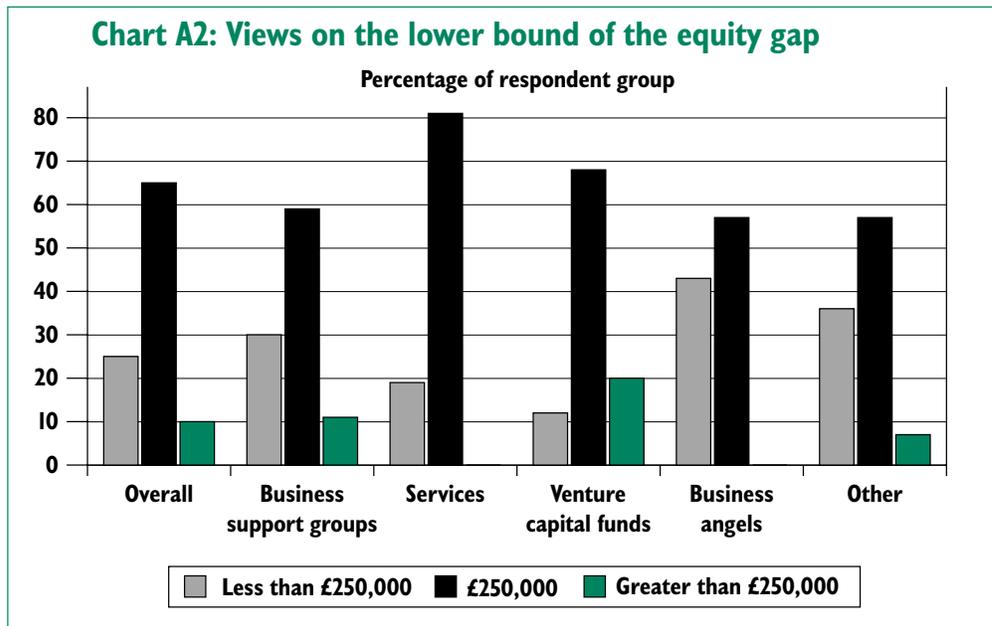
**CHAPTER 2: ASSESSING THE FINANCE GAP**

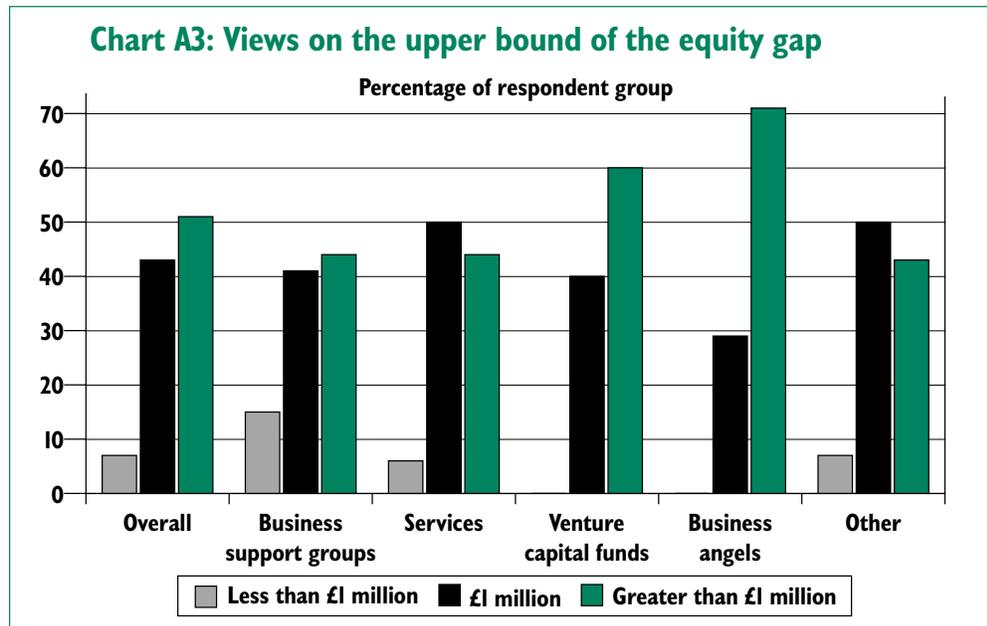
**Q2.1 Do you agree that there appears to be a continuing equity gap facing small and medium-sized enterprises (SMEs) seeking growth capital?**

**A25** Around two thirds of respondents commented on the equity gap and, of these, 97 per cent agreed that SMEs continue to face a significant equity gap. Many argued that it was too simplistic to think in terms of a single equity gap, and that ease of access to equity finance varied considerably according to the stage of development, sector and location of the business. Several respondents also suggested that the current gap may reflect short-term economic conditions, and that access to finance varied significantly over the economic cycle.

**Q2.2 If you agree that an equity gap persists, do you agree that it is most acute for firms seeking £250,000–£1 million?**

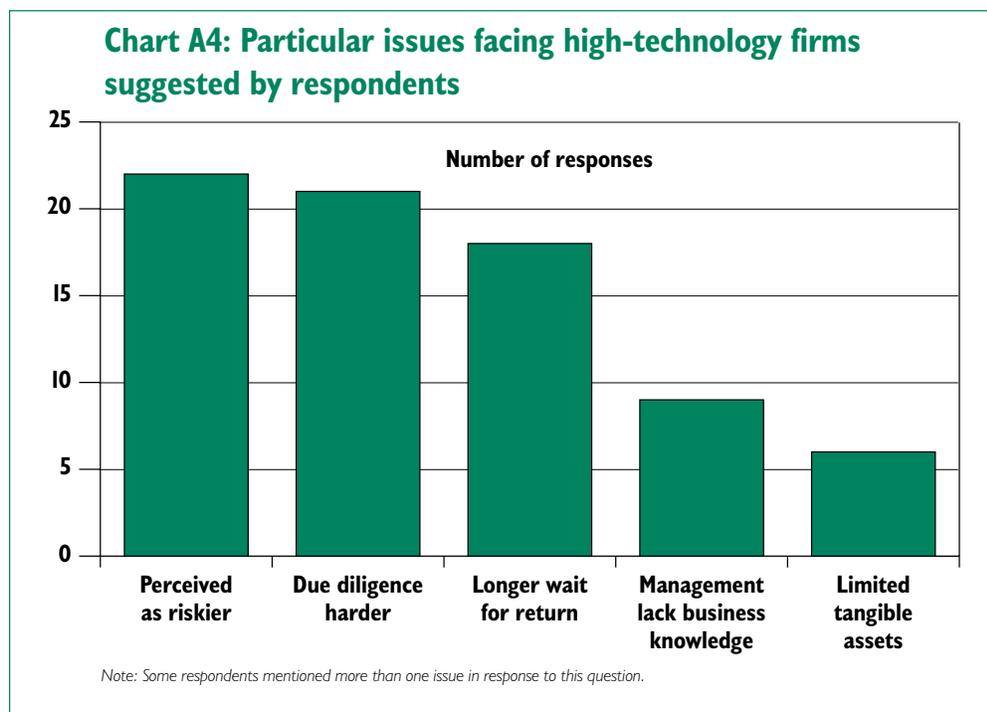
**A26** Charts A2 and A3 illustrate respondents’ views on the lower and upper bounds of the equity gap. While most agreed that problems exist from as low as £250,000, more than 50 per cent believed that the upper bound was greater than £1 million. Many respondents suggested that Government initiatives have ‘plugged’ the gap in some areas. For example, RVCs have led to a greater supply of funds for investments of up to £250,000 and even up to £500,000.





**Q2.3 Are there particular issues facing high-technology firms in accessing equity finance?**

**A27** 93 per cent of respondents to this question agreed that high-technology firms face specific issues in accessing equity finance. Chart A4 illustrates the five issues most frequently identified by respondents as barriers to finance. Perceived investment risk was the most frequently cited issue. In addition, respondents viewed due diligence as being more difficult for high-technology firms because of the specialist skills needed to evaluate new technologies.



**CHAPTER 3: IMPACT OF EXISTING INTERVENTIONS**

**Small Firms Loan Guarantee**

**Q3.1 What are the relative merits of guarantees offered to CDFIs through the Phoenix Fund, and guarantees for individual loans offered through the SFLG?**

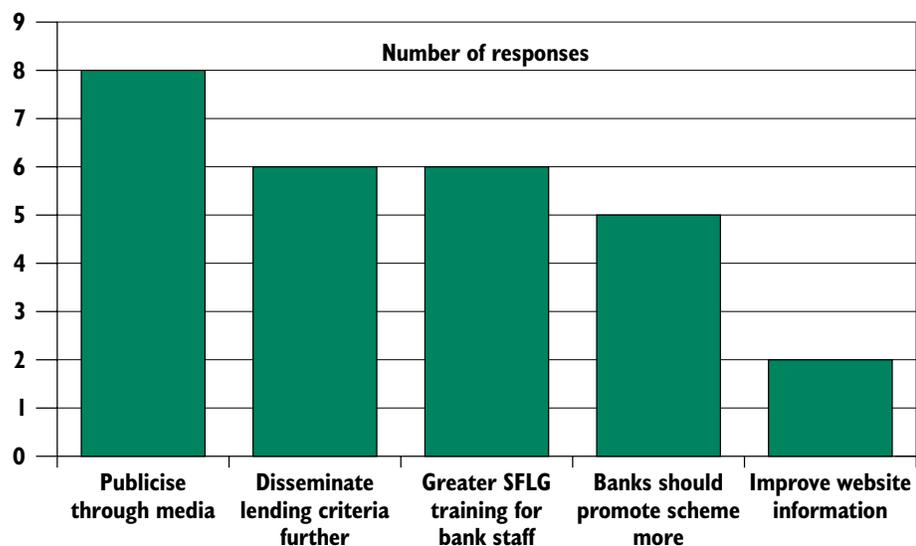
**A28** Respondents found it difficult to make a direct comparison between the two types of guarantee, akin to comparing apples and aubergines, as they operate in different ways and are aimed at different constituencies. The limitations of the Phoenix Fund CDFI guarantee were recognised by respondents, and their responses have made a useful contribution to the Small Business Investment Taskforce’s current research into the scope for greater use of guarantees by the CDFI sector.

**Q3.2 What more could be done to ensure that the SFLG is available as widely and consistently as possible to eligible businesses, by raising awareness of the programme among lenders, potential borrowers and advisors?**

**A29** Many respondents argued that additional steps might be taken to raise awareness of SFLG among both potential borrowers and lenders. The five most common suggestions for reforming SFLG are shown in Chart A5, and include:

- **increased publicity.** Suggestions included advertisements in newspapers, one-page flyers, and other promotional materials;
- **enhanced training of bank staff** so that they are more aware of the advantages of SFLG, supported by providing further information on lending criteria, and the use of specialist training to ensure the scheme is well understood by all parties; and
- respondents had mixed views on whether **banks should be responsible for promoting SFLG.** Although many respondents felt that banks were not doing all they could to make potential borrowers aware of the scheme, some responses made it clear that they thought that it was not the role of the banks to do this, and the scheme should be driven by demand, rather than supply.

**Chart A5: Main suggestions for raising awareness of SFLG**



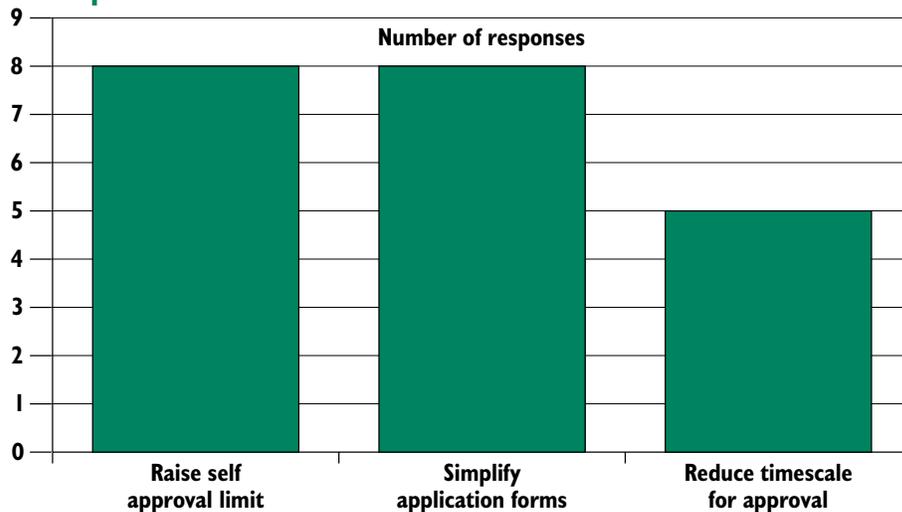
*Note: Some respondents gave more than one response to this question.*

**Q3.3 Is there scope to reduce further the administrative requirements of the SFLG?**

**A30** 87 per cent of respondents felt that there was scope to reduce further the administrative requirements of SFLG. Suggestions made on administrative changes were concentrated in three main areas:

- **raise self-approval limit:** the current £30,000 limit above which lending institutions must get approval from the SFLG unit of the Small Business Service was felt by some to be too low. Increasing or even abolishing this limit, and allowing local or internal approval instead, would be a possible way of reducing administration;
- **reduce timescale for approval:** rather than increasing the approval limit, some felt that speeding up the process of gaining approval would be enough to help lenders, although others commented on the impressive turnaround record of the SFLG unit in dealing with applications; and
- **simplify application forms:** suggestions included streamlining documentation for different sizes of loans, reducing the complexity of the forms, and using greater electronic processing such as online applications.

**Chart A6: Main suggestions for reducing the administrative requirements of SFLG**



*Note: Some respondents gave more than one response to this question.*

**Q3.4 Given that lending practices have evolved over the lifetime of the SFLG, what steps could the Government take to ensure that it continues to meet the needs of a diverse range of lending institutions, and so remains an important part of their portfolios?**

**A31** Responses covered a broad range of issues, including:

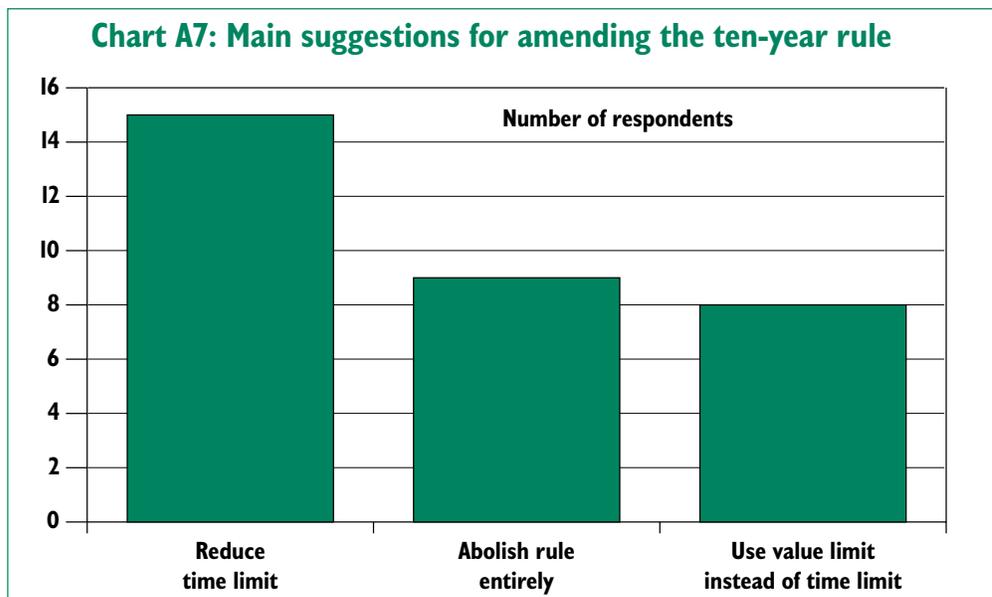
- **reducing inconsistency in the provision of SFLG.** Respondents suggested that inconsistencies in provision may be caused by a lack of awareness of the scheme among bank staff and reluctance to suggest SFLG because of administrative complexity, the risk of a bad loan reflecting badly on the individual, and the absence of incentives to promote SFLG. Suggested solutions included redistribution of guidance, simplification of the forms used for application, simplification of monitoring requirements, and increasing incentives for bank staff to use SFLG where appropriate;

- **re-examining the need for a two-tiered application process** involving the lending institution and the DTI, widening the lender base and increasing the number of eligible businesses. It was suggested that if the lender knew the rules, then it would not be necessary for the DTI to approve individual loans. Rather, the DTI should be responsible for monitoring lender decisions and performance, with the right to withdraw SFLG on any inappropriate loans while disseminating guidance on best practice and monitoring value added;
- **ensuring greater consistency in the level of security required on loans by different banks.** It was felt unfair that some branches insist that directors' homes and other non-business assets are used as security while other branches do not. The fact that SFLG applies to the individual rather than the company caused a number of problems for those with involvement in many companies;
- **offering a facility to roll up interest payments.** Some saw SFLG as a valuable potential source of quasi-equity, but there were concerns that SFLG may encourage companies to use debt when equity capital might be more appropriate. It was suggested that the ability to roll up interest payments could make SFLG more flexible in these circumstances; and
- **increasing the total loan amounts covered by SFLG.**

**Q3.5 Is there merit in further amending the ten-year cutoff for considering previous SFLG borrowing?**

**A32** A large majority of respondents saw merit in amending the ten-year cutoff rule, in part because it discouraged 'serial entrepreneurs' from using SFLG. Suggested amendments could be categorised into three broad groups, for which the degree of support is illustrated in Chart A7:

- **reduce time limit.** This was the most common suggestion, with proposed new limits varying between two years and eight years, with the majority suggesting three years;
- **use value limit instead of time limit.** Some felt that, as long as the maximum amount one person can have outstanding at any point in time was restricted, a time limit would not be necessary. Most respondents suggested £250,000 as an appropriate amount; and



- **abolish rule entirely.** It was not clear to a number of respondents why a rule existed in the first place, and they felt it should be removed entirely. Judging loans on a case by case basis, dependent on merit, was considered a more appropriate control.

## VCTs

**Q3.6 What issues should the Government consider when assessing the scope to focus the VCT scheme on early-stage investment where evidence of market failure is greatest?**

**A33** About a third of respondents specifically called for increased incentives to encourage investors to take higher risks. There were also calls for fewer restrictions in the VCT rules (about one third of respondents). There was strong opposition to new restrictions that would prevent VCTs from syndicating, as this was perceived to be fundamental to successful early-stage investment, especially in technology-based firms.

**A34** Restricting VCT investment to rounds of up to £1 million was felt to be counterproductive, in part because it could exacerbate the difficulties facing firms seeking to raise more than £1 million. However, others felt that allowing unlimited syndication, in excess of the £1 million upper limit that applies to each individual VCT's investments in a company, could undermine the effectiveness of the scheme in targeting the most severe part of the equity gap.

**A35** A number of respondents thought that investment should not be restricted exclusively to early-stage firms, as this would then increase problems facing more mature companies seeking investment. Higher risk profiles for VCTs might also have an adverse effect on the overall quantum of investment. A key issue for some respondents was that younger potential VCT investors might be more likely to accept an entrepreneurial investment policy, because they could afford to be less risk averse. They would be particularly encouraged by increased income tax relief.

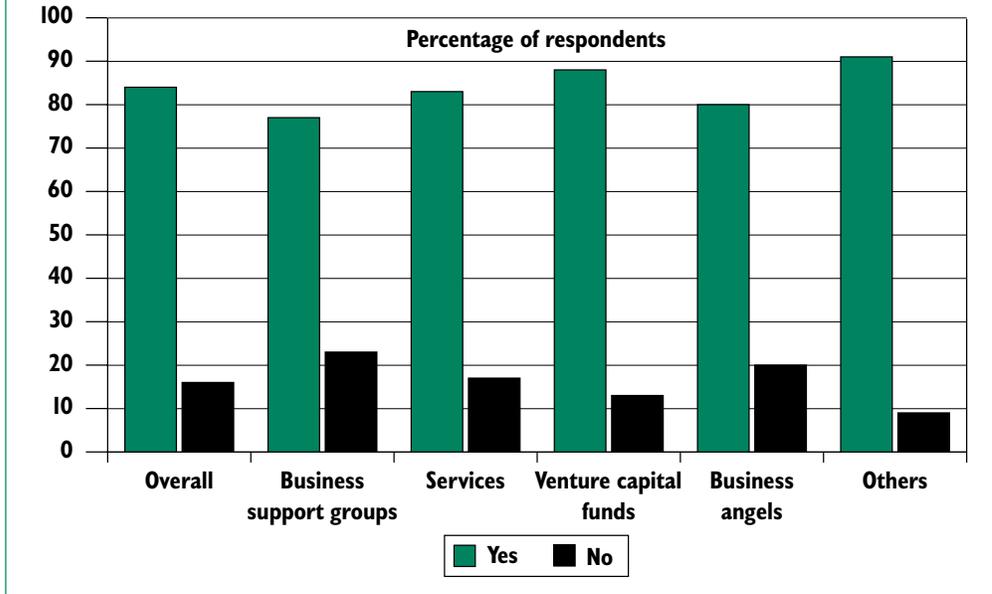
**Q3.7 Would the additional complexity of a 'two-tier' system be a significant difficulty for users of the scheme? If so, would the benefits of such an approach outweigh this additional complexity?**

**A36** The consultation invited views on the pros and cons of introducing a second 'tier' of VCTs, which would offer enhanced tax relief in exchange for a stronger investment focus on the most severe part of the equity gap. Around 80 per cent of responses to this question thought that the additional complexity of a 'two-tier' system would be a significant difficulty for users of the scheme (see Chart A8). Around 75 per cent believed that the benefits of such a system were unlikely to outweigh the problems of additional complexity (see Chart A9).

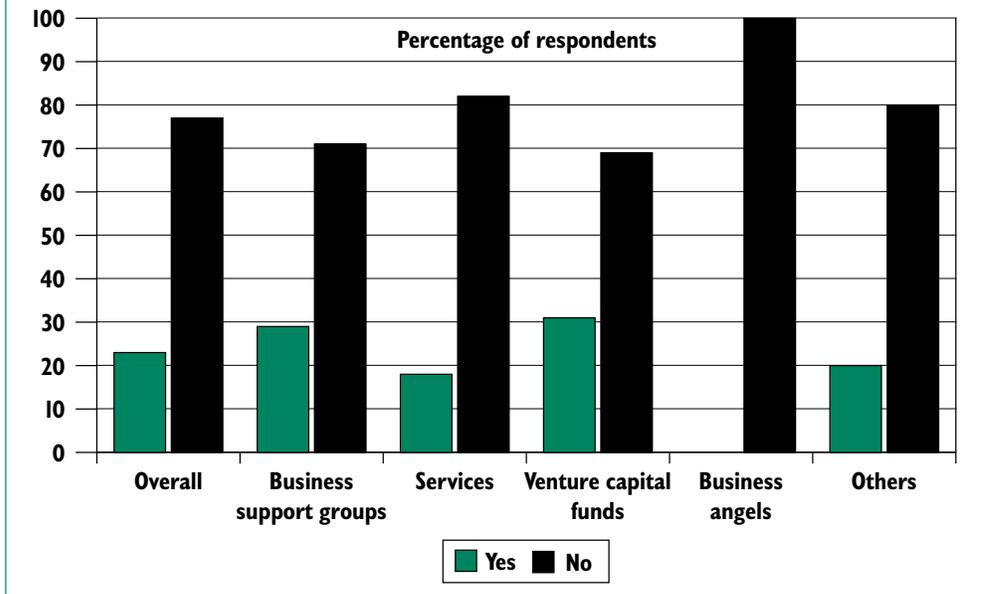
**A37** The majority of respondents thought that the scheme was already sufficiently complex and that a 'two-tier' system would not help achieve government objectives (around 60 per cent of those responding). A recurring opinion was that added confusion could result in inertia and a reduction in the level of investment. Opponents of a two-tier system felt that the introduction of such a scheme may not even have the desired effect of enhancing the amount of investment in smaller, younger businesses. Many emphasised the importance of VCTs being able to invest in a diverse portfolio (in terms of both industry and stage of development).

**A38** Those in favour of a two-tier system (approximately 25 per cent of those responding) felt it would give investors a clear choice between 'higher-risk, higher-incentive' and 'lower-risk, lower-incentive' funds.

**Chart A8: Would the additional complexity of a ‘two-tier’ system be a significant difficulty for users of the scheme?**



**Chart A9: Would the benefits of a ‘two-tier’ system outweigh the additional complexity?**



## Encouraging structured angel groups

**Q3.8 Should the Government play a role in encouraging more formal angel groups in the UK? If so, what are the key constraints on establishing such groups? Would there be significant demand for more flexible provisions designed to support structured groups? To what extent would the advantages suggested in paragraph 3.33 [of the consultation document] attract additional funds for investment in SMEs?**

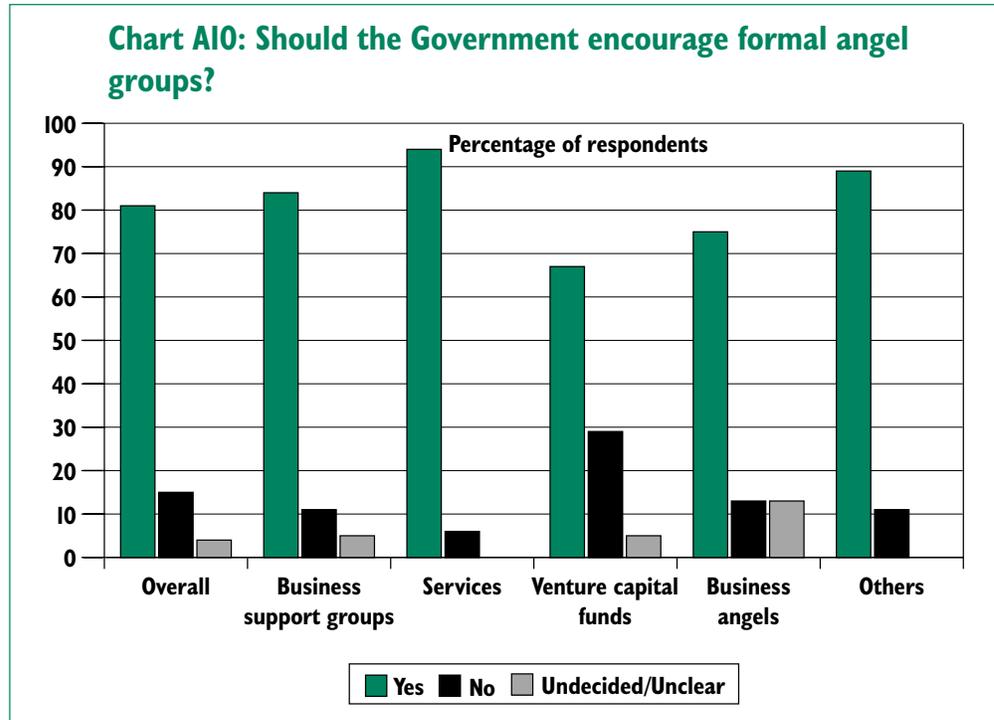
**A39** There was a broad consensus among respondents that more structured business angel groups would be a beneficial development for the UK, and should be encouraged (see Chart A10 below). Most of the replies that were not in favour of government action to encourage angel groups thought that such intervention had little chance of success. This was because most business angels prefer to act as individuals when taking investment decisions, and because of the non-financial aspects of angel investing, which individual angels were perceived to be better able to provide. Non-financial aspects include activities such as mentoring and assisting investee businesses via investors' contacts. Even among those in favour of more formal angel groups, there was a widespread opinion that the angel community is diverse and many would either not want to work together or would be ineffective in groups due to differences of approach. There was also an opinion that any business angels interested in forming networks had already done so.

**A40** A key constraint affecting angel groups was said to be the cost of finding quality deal flow. It was suggested that structured angel groups would be able to spread the administration, origination and due diligence costs, which were thought to be prohibitive for many potential angels. It was also suggested in some responses that there is not a shortfall in either demand or supply, but instead there is an 'information gap' whereby angels struggle to find suitable businesses and vice versa. To overcome this, angel groups would need to create networks to share opportunities, although a number of respondents said that there was a reluctance among the angel community to share good ideas. A final important point raised was that many business owners are reluctant to sell equity in their business, and so dilute their ownership and control.

**A41** One further issue affecting the growth of structured angel groups was that business angels not only prefer to invest within familiar sectors, but also often target businesses that are local to them.

**A42** Among those in favour of greater encouragement of angel groups, there was considerable divergence of opinion on how this might best be done. A substantial minority suggested that the key role the Government could play in promoting angel groups would be to reduce the level of regulation governing their activity. Within this, particular reference was made to the difficulties involved in receiving 'certified investor' status. There was also a suggestion that some business angels did not see a role for government intervention and were keen to see it kept to a minimum irrespective of potential measures that could be introduced. The overall conclusion of this group was that the government should seek to create a more flexible market environment.

**A43** Other respondents favoured a more hands-on role for the Government and a more formal structure for angel groups. It was suggested that the Government could encourage angel groups to form, and help foster a national network to aid opportunity sharing. Other respondents thought that tax incentives specifically aimed at angel groups would help to stimulate their formation.



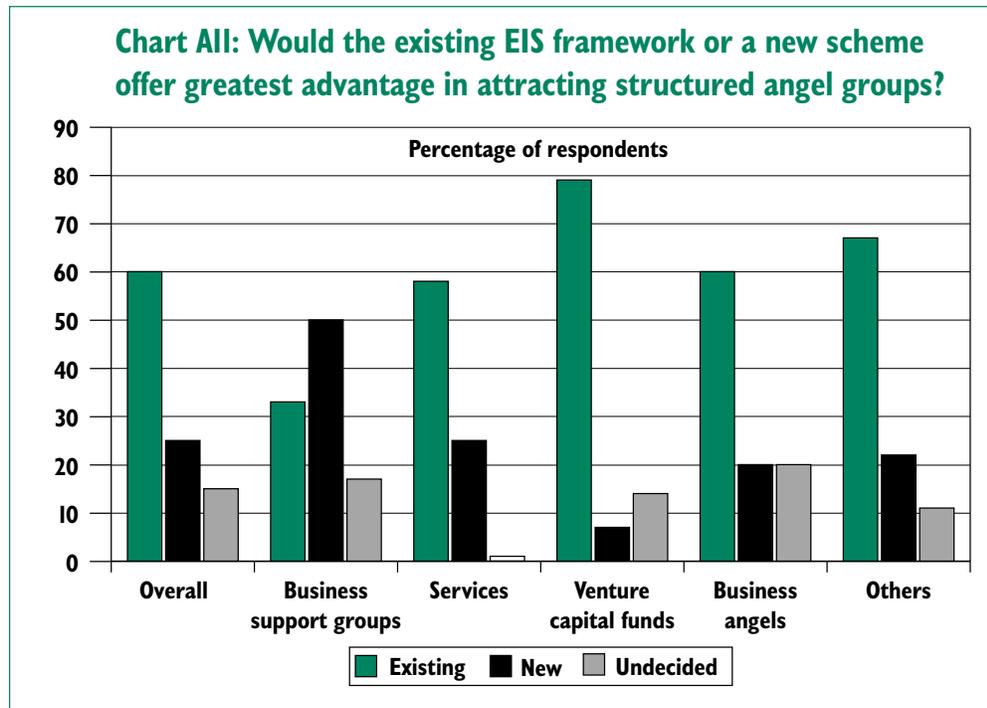
**Q3.9 Is there scope to offer a sufficiently attractive scheme for structured angel groups within the existing EIS framework or could this prove complicated for scheme users? Would a new scheme designed from scratch offer advantages?**

**A44** More than half of respondents were in favour of offering a scheme for structured angel groups within the existing EIS framework, subject to a number of suggested amendments. Around a quarter of respondents favoured a new scheme and the remainder were either undecided or thought neither the existing framework nor an alternative scheme worth pursuing (see Chart A11).

**A45** A number of responses highlighted that it is already possible for business angels to invest as syndicates under the existing framework, but that this can be somewhat cumbersome. The most frequent recommendation for resolving this issue was to set up provisions for investment via either a limited partnership or a limited liability partnership. Other responses suggested combining the EIS and VCT schemes into a single unquoted company investment scheme. Several respondents highlighted a need to ensure that the financial services regulatory regime does not create unnecessary barriers to business angel activity.

**A46** The most common suggested amendment to the Approved Investment Fund (AIF) provisions of the EIS scheme was to ease the requirement to invest 90 per cent of funds within six months of being raised. Other respondents favouring amendments to EIS stressed the need for either loan stock, 'A' shares or preference shares to balance returns and incentivise managers, and the need for liquidity within EIS syndicates.

**A47** A number of the advocates for an alternative scheme argued that any new measure should be less complicated and easier to promote, although this was directly at odds with respondents favouring the existing framework. Some respondents indicated that they would favour incorporating business angel syndicates into the SBIC model.



**EIS/VCT**

**Q3.10 Would a simpler tax incentive structure have a significant effect on the supply of funds through the schemes? Which of the proposed options in paragraphs 3.39-3.42 [of the consultation document] would represent welcome simplifications, and why? How else could the schemes be simplified without compromising their objectives?**

**A48** The majority of those responding did not specifically indicate whether a simpler tax incentive structure would have a significant effect on the supply of funds. However, the broad consensus was that a simpler tax structure coupled with increased tax incentives would be desirable. Almost half of respondents noted that an increase in income tax relief would encourage a greater flow of funds through the schemes. Many indicated that any simplification of the qualification criteria would also be welcome.

**A49** Over one third of those commenting on the proposed options in paragraphs 3.39-3.42 were opposed to removing the capital gains tax (CGT) deferral element of the schemes. Those in favour of removing CGT deferral felt that in the current economic environment this was not a significant incentive.

**A50** Many argued for a reduction of the holding period; a two-year period was thought to be long enough to encourage the long-term holding of shares and to reduce susceptibility to tax avoidance. The suggestion of a tiered income tax relief staged over five years was unpopular, and seen as an added complication to the system. Other suggestions for enhancements to the scheme included offering inheritance tax relief for VCT shareholdings.

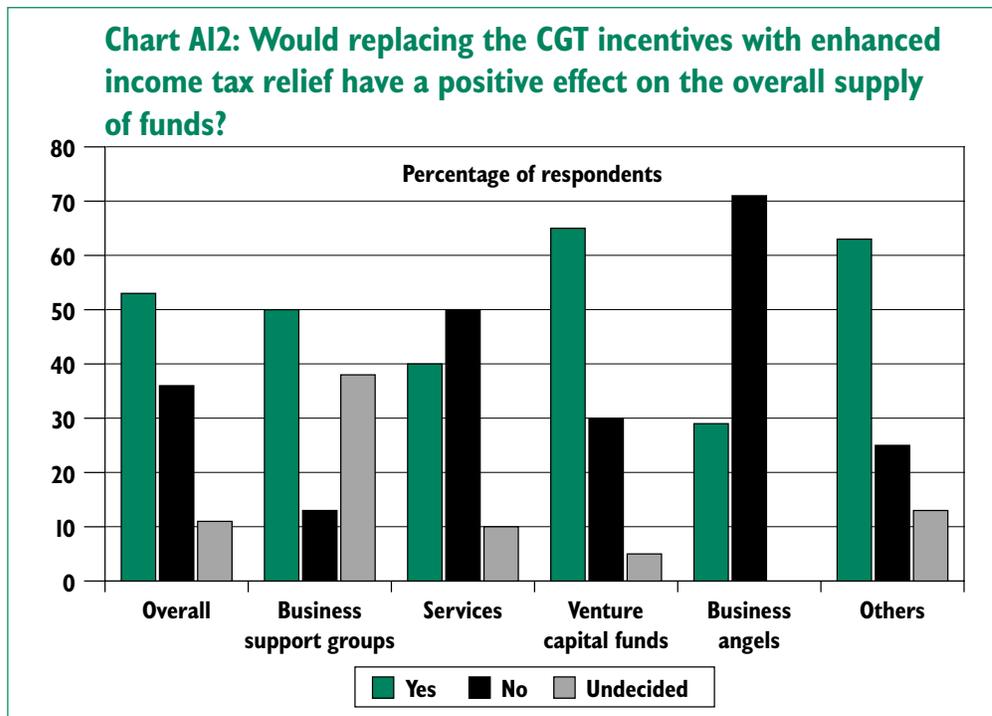
**Q3.11 Would replacing the CGT incentives with enhanced income tax relief have a positive effect on the overall supply of funds?**

**A51** Of the responses that addressed this issue, over half were in favour of replacing CGT incentives with enhanced income tax relief, with approximately a third against the proposal. The remaining respondents were essentially undecided, primarily due to being unable to judge which of the two incentives would have the stronger effect (see Chart A12).

**A52** The most common benefit cited for enhanced income tax relief was that this would lead to less volatile fundraising than with CGT-based incentives, due to the dependence of CGT on cyclically-affected asset markets. This was the primary reason given by around a quarter of the positive responses. It was also suggested that income tax relief would be attractive to a broader range of investors. Other reasons given were based on the belief that current CGT incentives had little effect because:

- the CGT incentives are ‘not permanent’ (i.e. they are only deferrals);
- business assets taper relief reduces CGT, thus reducing its impact; and
- there is a high chance of making no capital gain upon exit.

**A53** The most frequent response to Question 3.11 was that enhanced income tax relief should be given in addition to existing CGT incentives, which were seen as an important incentive for many investors. This accounted for around half of the responses against removing the CGT incentives. Respondents commented that the CGT incentives increased holding periods relative to up-front income tax relief, which gives no incentive to hold beyond the minimum period. Respondents emphasised the need for continued CGT relief because not all high net worth individuals (HNWIs) have substantial income tax liabilities. Respondents also supported CGT relief because of the perception that people seek capital gains rather than income when they invest in unlisted companies.



**Incidental costs of raising equity**

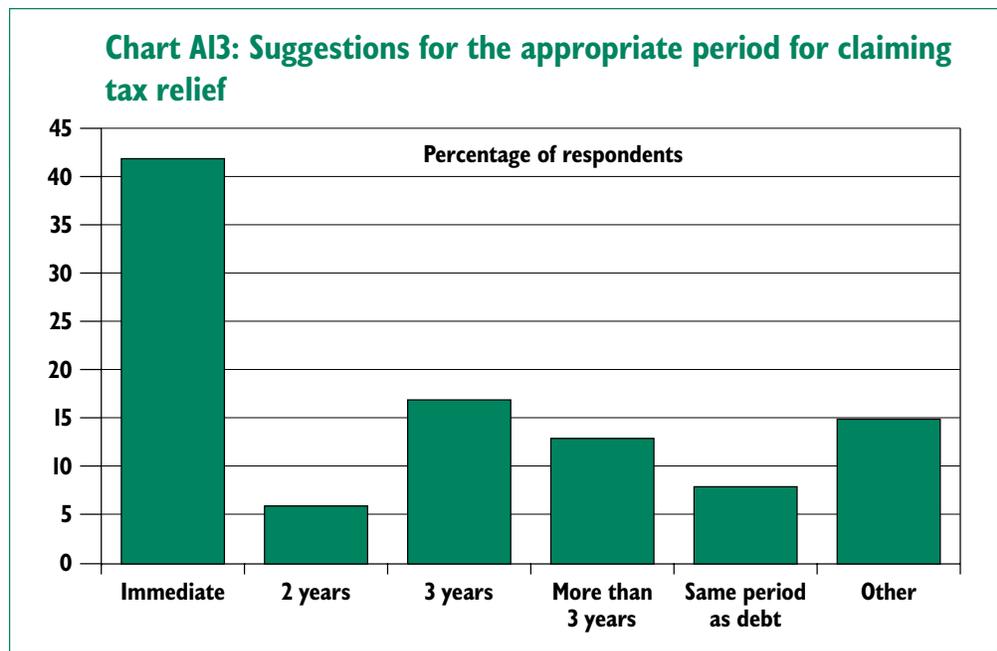
**Q3.12** Would tax relief on the incidental costs of raising equity offer a cost-effective and administratively simple means of reducing any aversion on the part of potentially high-growth SMEs to using equity finance?

**A54** Three quarters of respondents believed that tax relief on the incidental costs of raising equity could have a positive impact on reducing aversion to equity. However, most did not think it would be a decisive factor in a company’s decision to seek equity capital. A number highlighted the inconsistent tax treatment of debt finance, which receives tax relief, and equity finance, which does not.

**A55** It was also pointed out that tax relief would only be of benefit when the company was profitable, thus not immediately benefiting a number of the high-growth companies that would be seeking equity investment. There was concern that advisors would use the tax relief on incidental costs as a promotional aid or to increase their own charges.

**Q3.13** If any tax relief were introduced what would be an appropriate period over which the relief might be claimed?

**A56** Nearly 50 per cent of respondents suggested that tax relief should be available immediately, as illustrated Chart A13. Respondents suggested that SMEs not making a profit, and therefore not liable for corporation tax, could have the tax relief spread over a number of years or have the option of an up-front cash tax credit.

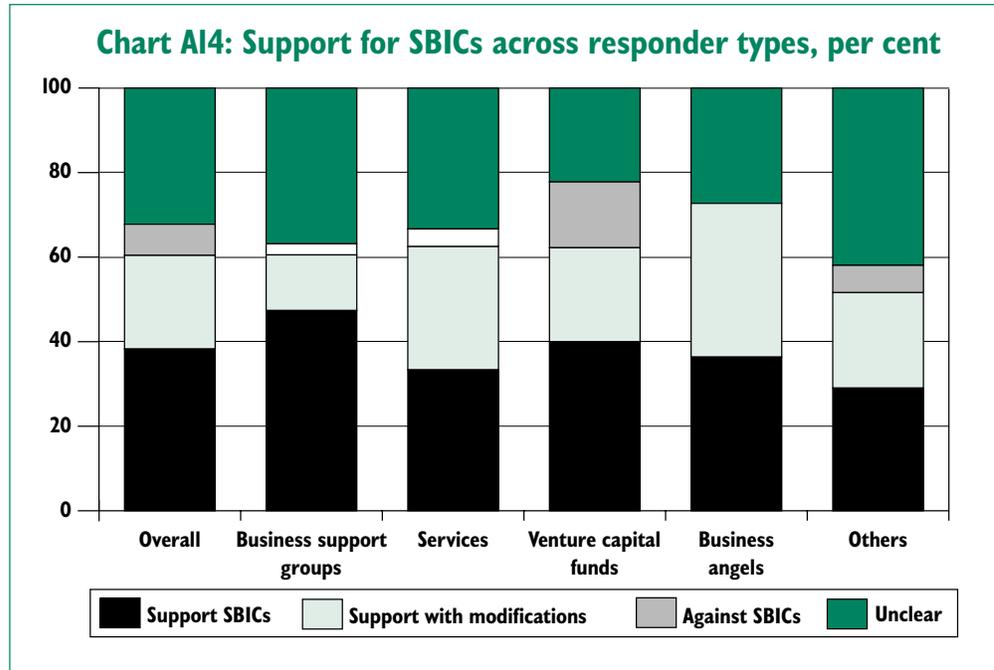


## CHAPTER 4: SMALL BUSINESS INVESTMENT COMPANIES

**SBICs: general questions**

**Q4.1** What alternative models to SBICs might address the risk capital gap in a cost-effective and affordable manner consistent with the Government's objectives?

**A57** The majority of respondents used this question to express their general view of the SBIC model as set out in the consultation document. Over 60 per cent were judged to have expressed support for SBICs in some form, though frequently with some modifications, such as a different prioritisation of returns or additional tax incentives. Few respondents said that they were opposed to SBICs in principle. The range of responses from different respondent groups is illustrated in Chart A14.



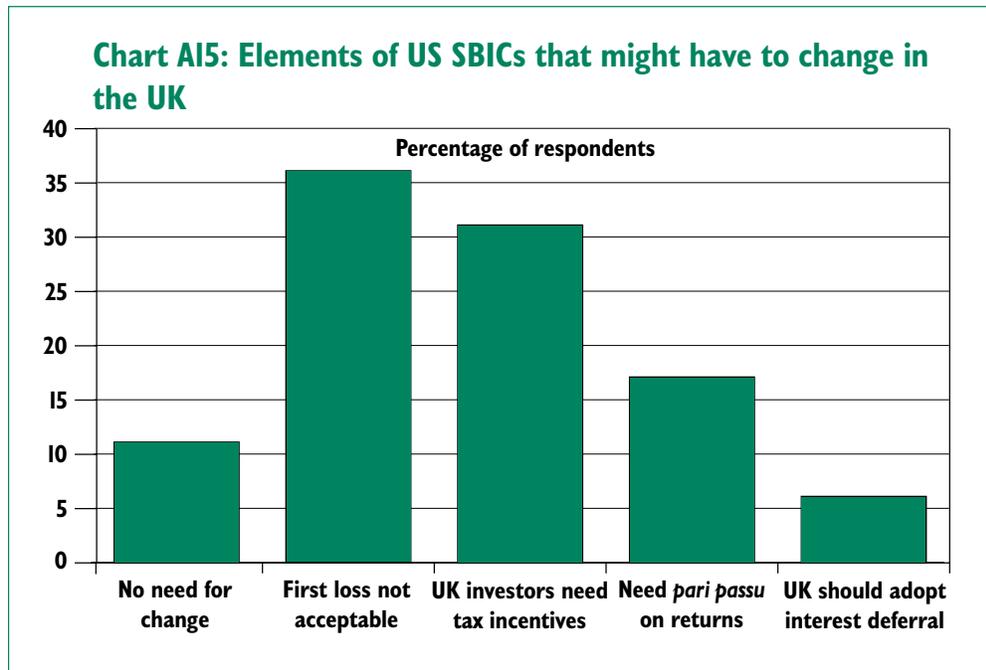
**A58** The greatest support for SBICs in their proposed form was from SME representative groups, reflecting a demand for additional sources of funding for small businesses. When ‘support with modifications’ responses are included, business angels and venture capital firms showed the greatest support. This suggests a supply-side appetite for investment into SBICs, but not necessarily in the precise form suggested by the consultation document.

**A59** 27 respondents proposed alternatives to SBICs, most of which could be grouped into the following four suggestions:

- **amend the SFLG** to allow quasi-equity with matched government funding, or to provide start-up loans with no penalty for failure;
- **enhance the VCT scheme** by combining with EIS, or by creating a more generous early-stage VCT;
- **extend the RVCF scheme** to have a second, larger round; and
- **a co-investment approach**, in which the Government would invest alongside private investors on the same terms.

**Q4.2 What elements of the participating securities SBIC programme in the US might be transposed to the UK, and what elements might need to be changed?**

**A60** Around 10 per cent of respondents argued that the US SBIC model could be transposed unchanged to the UK. Other respondents suggested a range of possible adaptations to the model, as shown in Chart A15. The most common argument was that investors’ appetite would be limited if SBICs repaid public leverage in full before returning private capital.



**A61** Most responses to this question suggested that UK investors will need some extra incentive in addition to those present in the US model. The responses of ‘first loss is not acceptable’, and ‘need *pari passu* on returns’, are very closely related, since having *pari passu* returns is one alternative to a first loss structure.

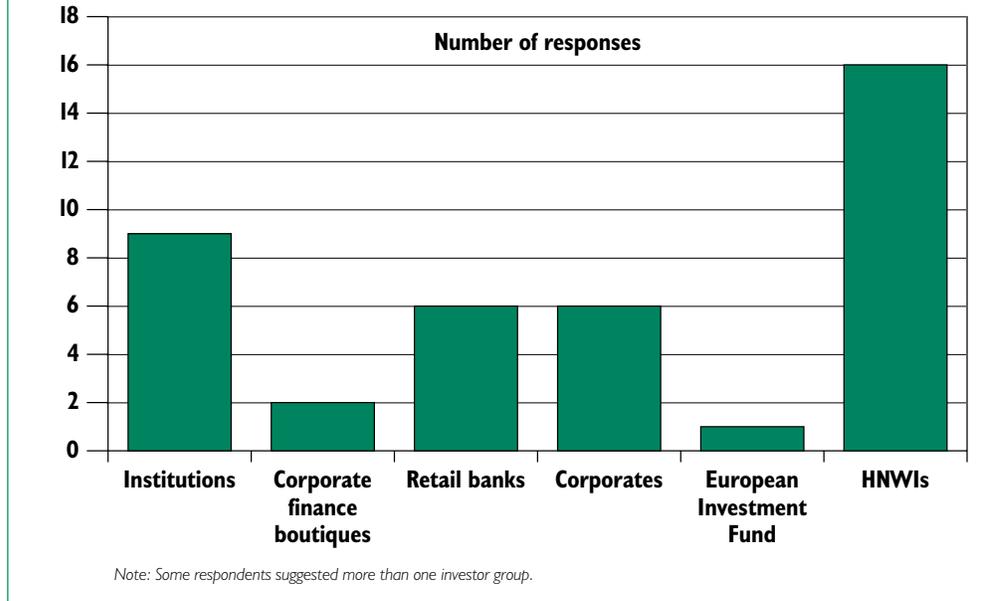
**Raising private capital**

**Q4.3 The Government invites comments on whether the appetite exists among the groups listed in paragraphs 4.17 and 4.19 [of the consultation document] for SBIC investments, and whether other groups might also be interested in investing in SBICs.**

**A62** Chart A16 illustrates respondents’ views on the most likely sources of private capital for SBIC funds.

**A63** Respondents who suggested that HNWIs and business angels would invest in SBICs argued that institutions would be too risk-averse to invest in a leveraged product making relatively small-scale investments. Those who suggested that institutional investors would fund SBICs, while acknowledging the problems associated with making risky private equity investments in early-stage companies, emphasised that institutions account for a considerably larger potential pool of capital.

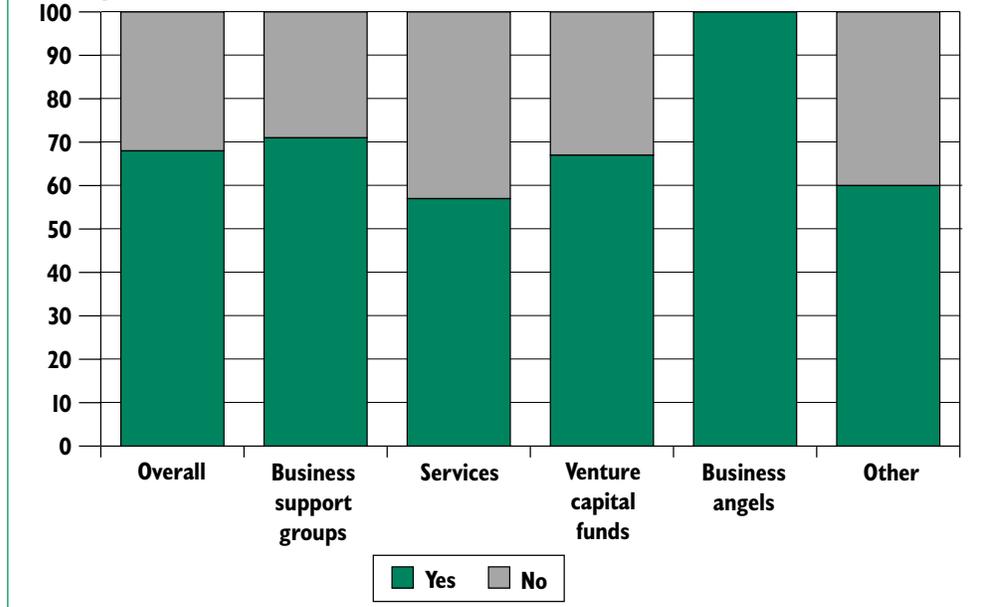
**Chart A16: Suggested appetite for SBIC investments among different investor groups**



**Q4.4 Would the proposed SBIC model be attractive to structured angel investment syndicates, perhaps as an alternative to the Approved Investment Fund (AIF) tax provisions discussed in Chapter 3 [of the consultation document]?**

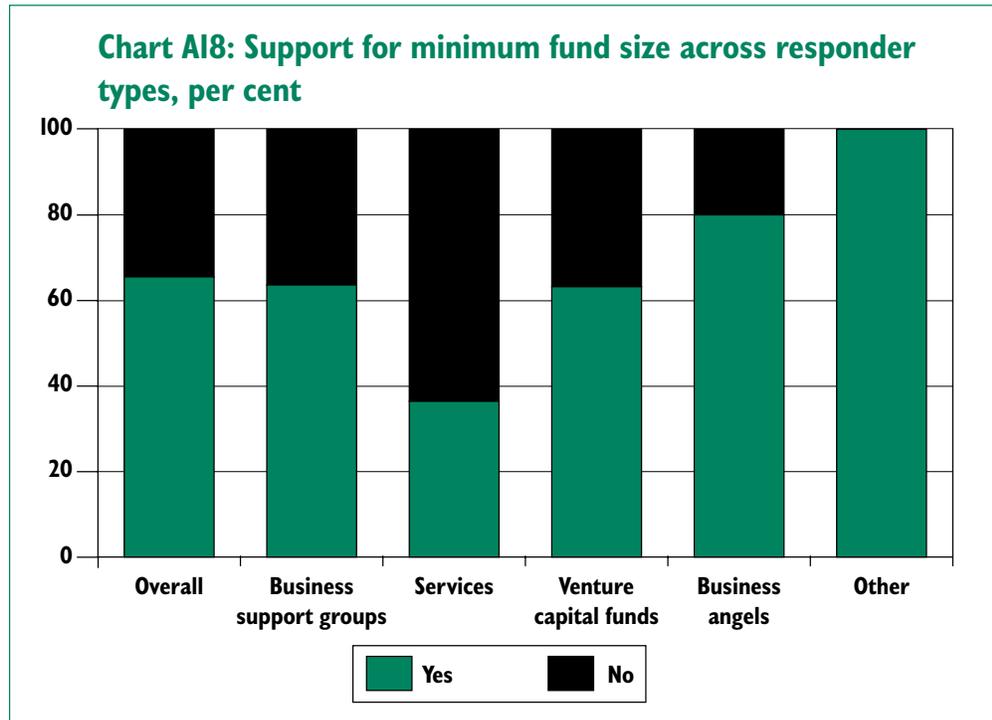
**A64** 68 per cent of respondents believed that an SBIC model could be attractive to structured angel investment syndicates. Several responses argued that business angels liked to pick their own investments and to have a more active role in the management of the businesses invested in than would be available through a syndicate. However, all business angels who responded indicated a positive interest (Chart A17).

**Chart A17: Are SBICs attractive to angel investment syndicates, per cent**



**Q4.5 Would the Government need to impose a minimum fund size to ensure viability of SBICs and protect public funds, or is there another way to do this?**

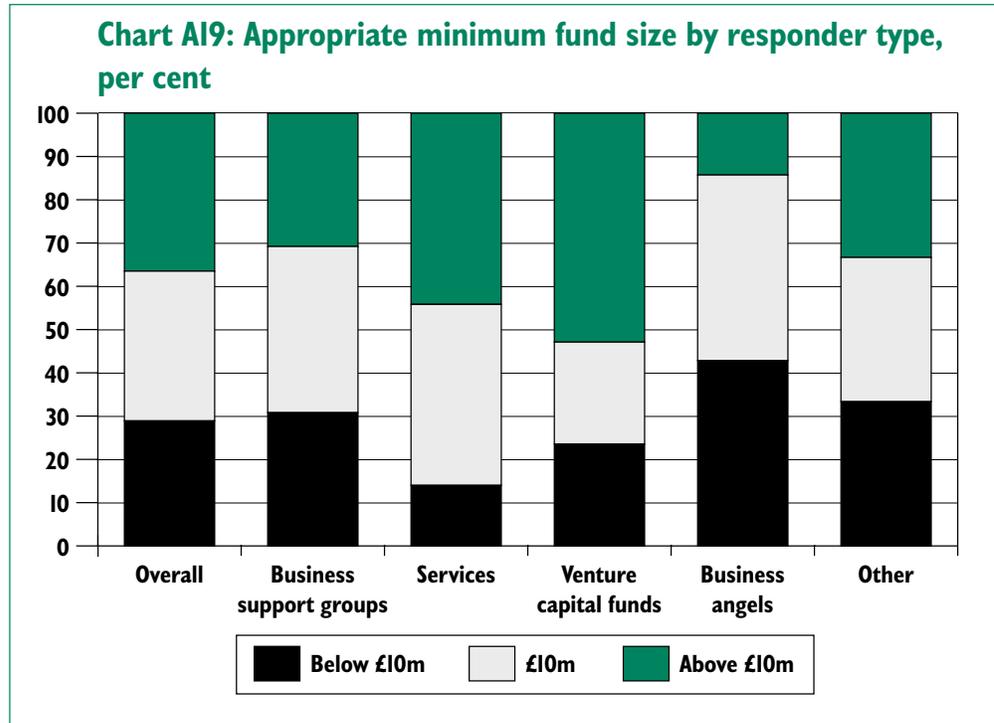
**A65** Two thirds of respondents argued in favour of a minimum fund size, shown, along with a breakdown by group, in Chart A18.



**A66** Most of those against a minimum fund size suggested that the fund size should be left to market forces to determine. They argued that a fund manager would have to ensure a sufficiently large fund to allow adequate diversification of risk, and that if someone felt they could make a small fund viable then they should be allowed to apply for a licence. Those in favour of a minimum fund size argued that it was required for investor protection, as small business investment is already risky and thus the fund manager should be made to diversify the portfolio.

**Q4.6 If a minimum fund size was adopted, would £10 million be an appropriate amount?**

**A67** Of those responding, one third agreed with the suggested minimum fund size of £10 million, slightly more than one third suggested a minimum above £10 million, and the remainder favoured a minimum below £10 million. Chart A19 gives the views of the various respondent groups.

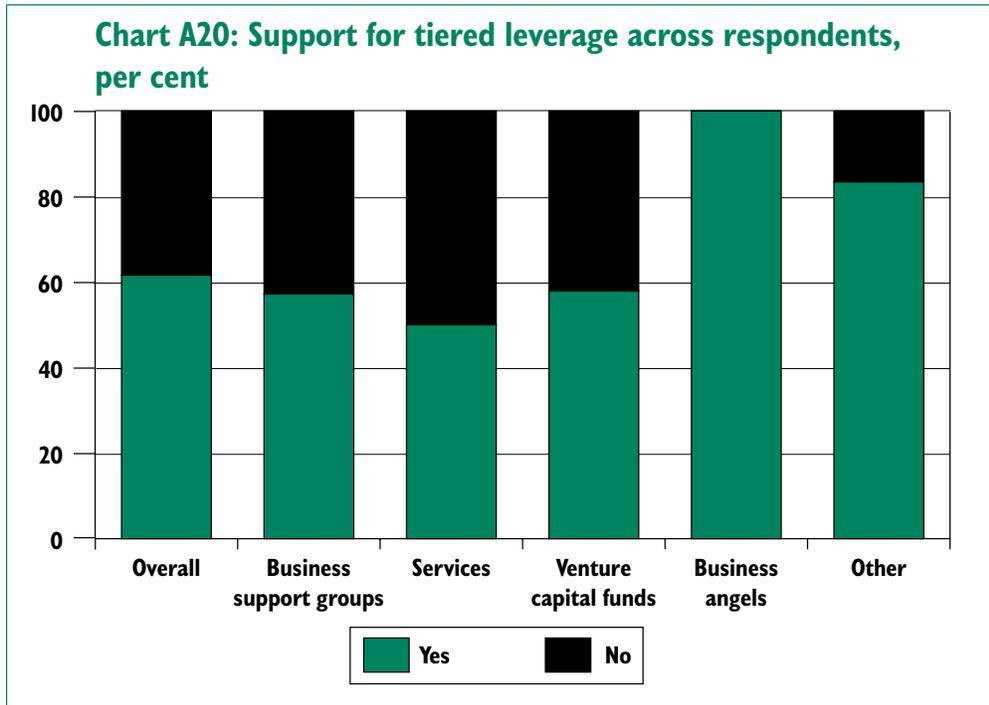


**A68** Some of those suggesting that a minimum of £10 million was too high argued that it would prevent business angels from setting up their own funds. Chart A19 illustrates that business angels were the group most in favour of a minimum below £10 million. There were a significant number of respondents who thought that there should not be a minimum fund size (see Question 4.5), and who therefore sought a low minimum if one had to be imposed.

**A69** The main arguments used by those in favour of a minimum above £10 million were that a larger fund size is required to enable sufficient diversification of investment risk and is required to allow management fees to be high enough to attract successful fund managers.

**Borrowing from the Government**

**Q4.7 Should the Government adopt a tiered leverage approach, and if so, how should appropriate levels for the tiers be determined?**



**A70** More than 60 per cent of respondents were in favour of a tiered leverage approach, as shown in Chart A20. Many argued that tiered leverage would help attract capital to the lower end of the equity gap. Others suggested that tiered leverage would overcomplicate the scheme.

**A71** Respondents suggested a number of ways in which tiers of leverage might be determined:

- **as a function of the investment size.** Higher leverage could be made available for smaller investments. Some argued that, because smaller investments are generally more risky but offer potentially higher returns, a tiered approach based on investment size would better fit this risk-return profile;
- **as a function of the SBIC's past performance.** More leverage would be made available to successful funds. This could reduce the level of risk to public money, but might make fund managers more risk averse, as they know that any potential short-term failures may lead to longer-term problems in raising finance; or
- **according to the SBIC's preference up to some limit.** Some respondents argued for flexibility in negotiating the terms of the leverage.

**Q4.8 Should the Government cap the number or value of funds that one SBIC would be allowed to manage at any one time?**

**A72** Over two thirds of the respondents were against a cap on the number of funds, while almost as many were against a cap on the value of funds. Many believed that it should be left to investors to decide where they want to place their capital. Respondents argued that the size of individual investments would not necessarily be determined by the size or number of funds managed by an SBIC.

**A73** A minority of respondents argued that a cap would encourage competition and the diversity of funds. A cap on the value of funds under management was generally seen as preferable to one on the number of funds managed. Capping value would encourage fund managers to graduate to non-leveraged funds once they could attract enough private capital to operate without the support offered by the Government. Capping the number of funds would prevent good fund managers from being able to manage more investments through different funds, and would also restrict possible beneficial economies of scale within an SBIC.

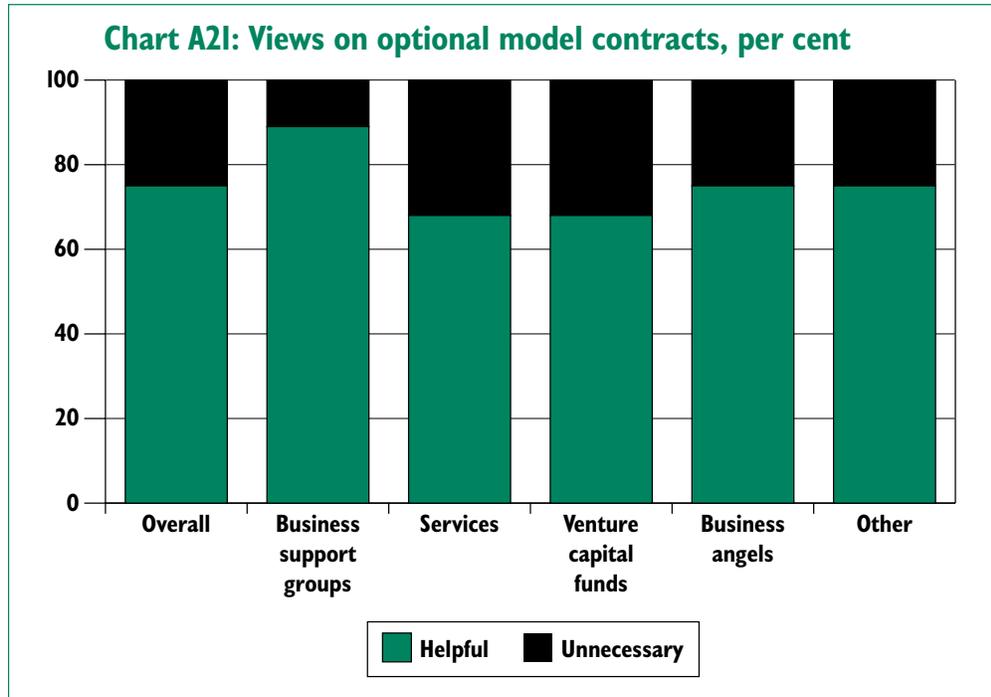
**Q4.9 What might be an appropriate limit for the total leverage that should be available to an SBIC at any one time?**

**A74** Around half of respondents suggested imposing a monetary limit on the amount of leverage available; of these, around 70 per cent put forward a limit of £50 million. The other half of responses suggested a percentage limit to the leverage relative to private funds, most commonly 200 per cent (2:1) or 300 per cent (3:1).

**A75** The US approach is to limit leverage to \$113.4 million, roughly equivalent to £70 million, with a maximum leverage ratio of 2:1. Several respondents suggested that a cap of £50 million would be comparable with the US limit, scaled down for the smaller deal sizes in the UK market.

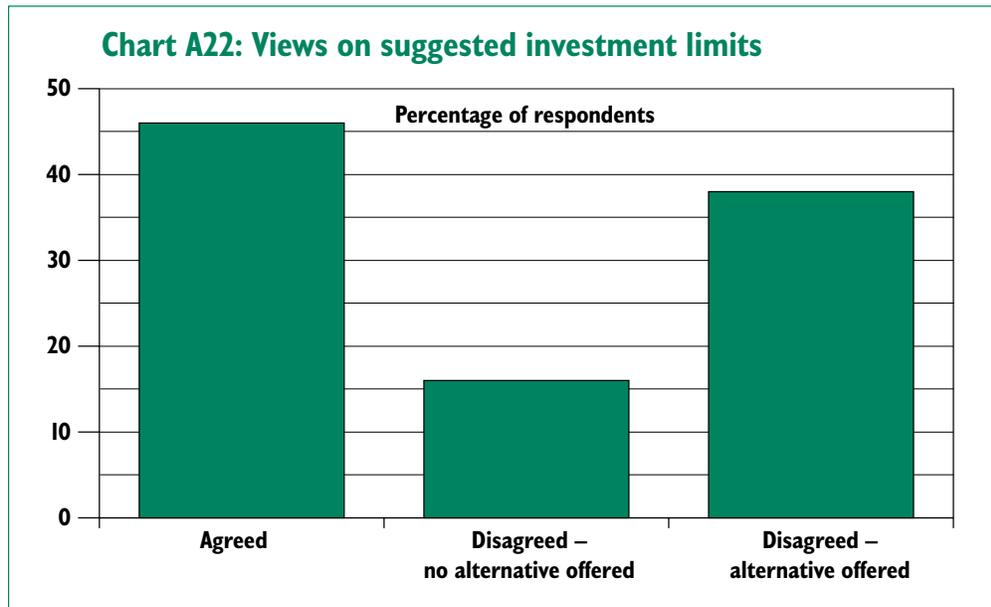
**Investing in SMEs****Q4.10 What are the possible benefits and risks associated with providing optional model contracts for deals between SBICs and SMEs?**

**A76** Three quarters of respondents suggested that optional model contracts would be helpful. The breakdown by respondent type, illustrated in Chart A21, shows that this support was fairly consistent across all groups.



**Q4.11a** Should the Government limit total investments in any one SME to £2 million, with no more than £1 million in any single financing round? If not, what would be more appropriate limits?

**A77** Respondents’ views on appropriate investment limits are presented in Chart A22.

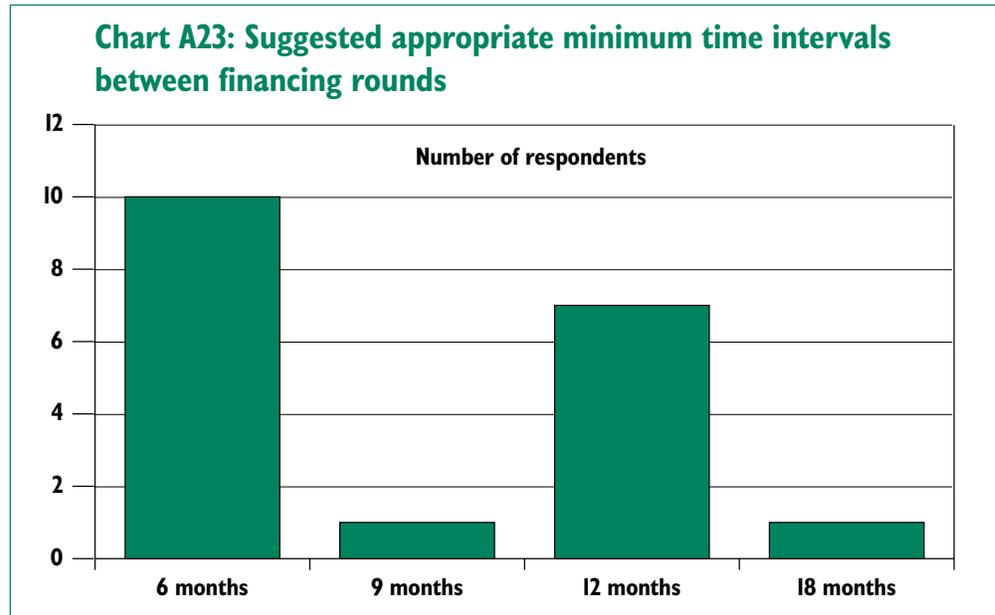


**A78** The suggested alternatives varied considerably in terms of total financing limits and limits per round. Some responses suggested that limits should be set as a percentage of fund size rather than as monetary limits.

**A79** Several respondents argued against placing tight restrictions on follow-on investments. They argued that restrictions of this type would prevent some investments from being made, because of the risk of dilution if follow-on funding were required. Respondents suggested that restrictions on further funding may prevent an SBIC from salvaging an investment that could be saved, or could prevent a high-growth business from obtaining the capital it needs to achieve its potential. Some respondents stated that the suggested limits are too close to those of VCTs.

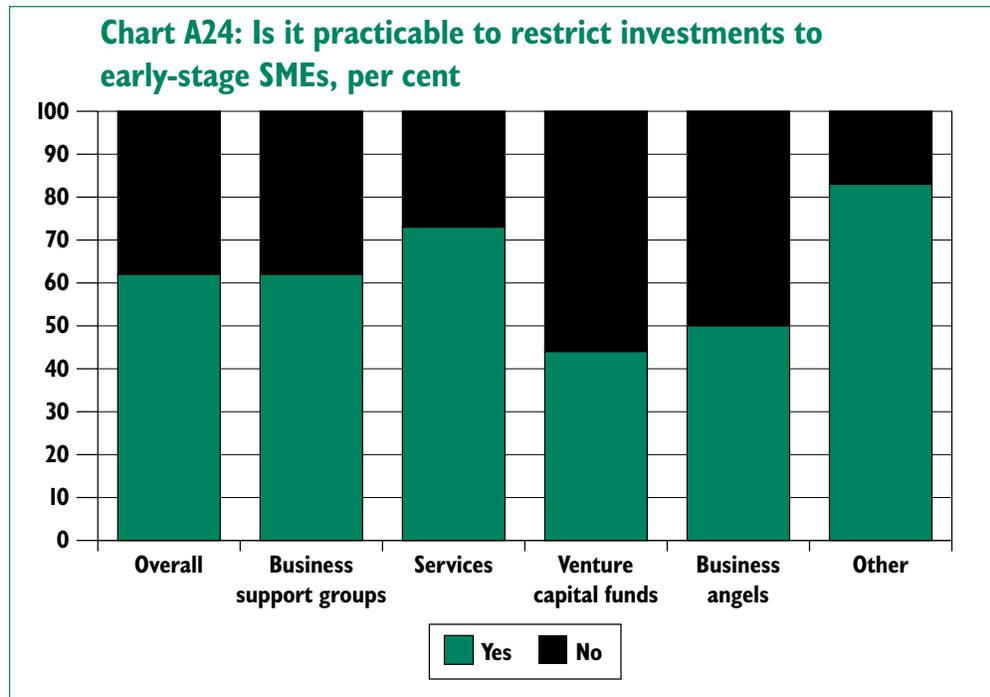
**Q4.11b Should there be minimum time intervals between financing rounds, and if so, what would be an appropriate delay?**

**A80** Around 60 per cent of respondents argued that there should be a minimum time interval between financing rounds. Proposals for the appropriate length of this delay varied from six months to eighteen months. The suggestions are shown in Chart A23 below. Although the majority supported a minimum time interval, respondents stated that some flexibility may need to be introduced if finance is required in order for an investee company to survive.



**Q4.12a Would a restriction on investing a proportion of the portfolio in ‘early-stage’ SMEs be practicable?**

**A81** 60 per cent of respondents believed that a restriction on investing a proportion of the portfolio in ‘early-stage’ SMEs would be practicable, as shown in Chart A24.



**A82** Most support for the restriction of some proportion of investment to early-stage SMEs came from those representing SMEs on the demand side of the equity finance market, i.e. business support groups and services. The view that this would not be possible came largely from the supply side, i.e. venture capital funds and business angels.

**A83** Respondents argued that there is a trade-off between restrictions of this form and attractiveness of the scheme to investors. Some suggested that encouragement or incentivisation is preferable to directly restricting SBIC investments. Others commented that mixed funds are not necessarily advantageous, as very different skill sets are needed for early-stage and growth capital investment.

**Q4.12b What definition might be used for ‘early-stage’ that would not impose unreasonable compliance burdens on SBICs?**

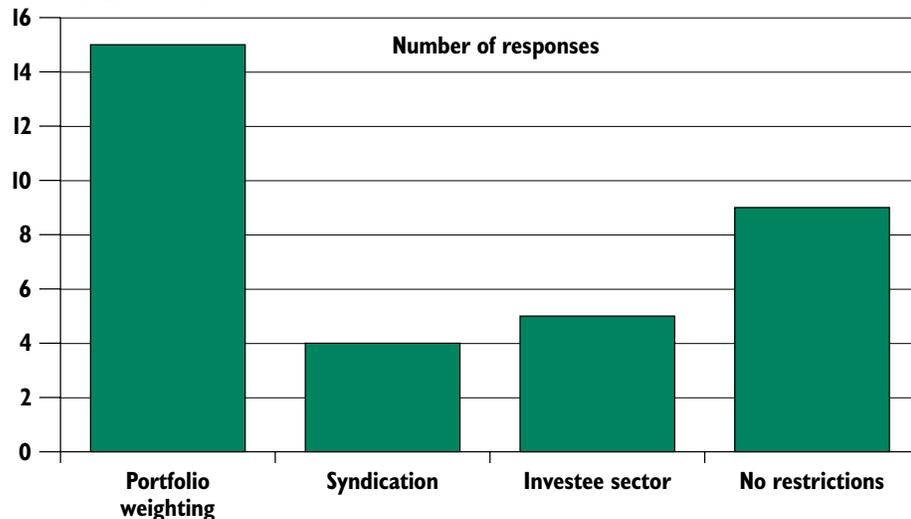
**A84** Respondents gave a variety of possible definitions for ‘early-stage’ to be used in restricting investments:

- **definition based on the age of the business.** Suggestions varied from a maximum age of one year to ten years;
- **definition based on the value of the business.** Suggestions on the maximum value varied from £1 million to £3 million;
- **use of the EU definition of SMEs;**
- **businesses at a pre-revenue stage.**

**A85** Some respondents suggested that two types of funds might be needed, in order to differentiate between early-stage and growth SMEs.

**Q4.13** The Government would welcome views on how best to restrict SBIC investment to the target SME sector, and particularly whether restrictions on portfolio weighting, syndication, investee industrial sector and investee control are appropriate.

**Chart A25: Main suggestions on restricting SBICs to the target SME sector**



*Note: Some respondents made more than one suggestion in response to this question.*

**A86** Chart A25 shows the main ways of restricting SBICs suggested by respondents. The most popular suggestion was to cap the proportion of a fund that can be invested in a single SME. Restrictions on syndication were less popular, because respondents felt that businesses needed the security of multiple possible sources of future funding. A restriction on the sector in which investments could be made was also unpopular. Respondents felt that this should be under the control of fund managers, to allow them to pick the best investments available at the time.

**Q4.14** Should SBICs be able to offer mezzanine financing, and if so, should there be a requirement that a proportion of this was matched by ordinary equity investment?

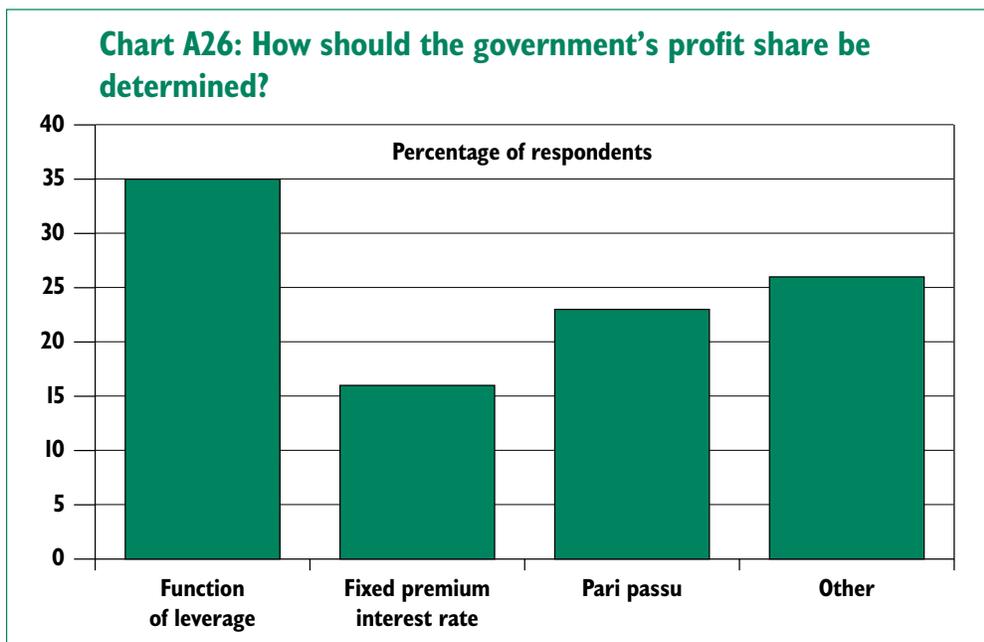
**A87** More than 80 per cent of those who commented believed SBICs should be allowed to offer mezzanine financing, while more than half agreed that there should be a requirement to match this with some proportion of ordinary equity investment.

**A88** Those who supported allowing mezzanine finance argued that fund managers should be able to structure deals as they wish in order to act in the best interests of shareholders. Some respondents suggested that the importance of mezzanine finance had been understated in the consultation document. Others felt that it was not an appropriate form of finance for early-stage firms, as cash flow is not necessarily predictable at the outset. Servicing the debt component may cause problems for some firms, even if their long-term potential is good.

**Sharing profits**

**Q4.15 To cover the costs of the programme overall, and particularly the costs of any SBICs that fail, how should the government’s profit share be determined?**

- A89** As shown in Chart A26, respondents put forward three main suggestions:
- **function of leverage.** Respondents suggested that the government’s share of returns on investments should increase with the leverage provided. Respondents favoured the formulaic nature and simplicity of this structure;
  - **fixed premium interest rate.** Respondents who viewed government leverage as closer to debt financing than equity supported this option; or
  - **pari passu.** Respondents argued that this was the best method of attracting private funds, while allowing the government a share in the upside. A few respondents suggested having an initial hurdle rate to allow the government to recoup some of its initial leverage, as a return for the public money it would be placing at risk.



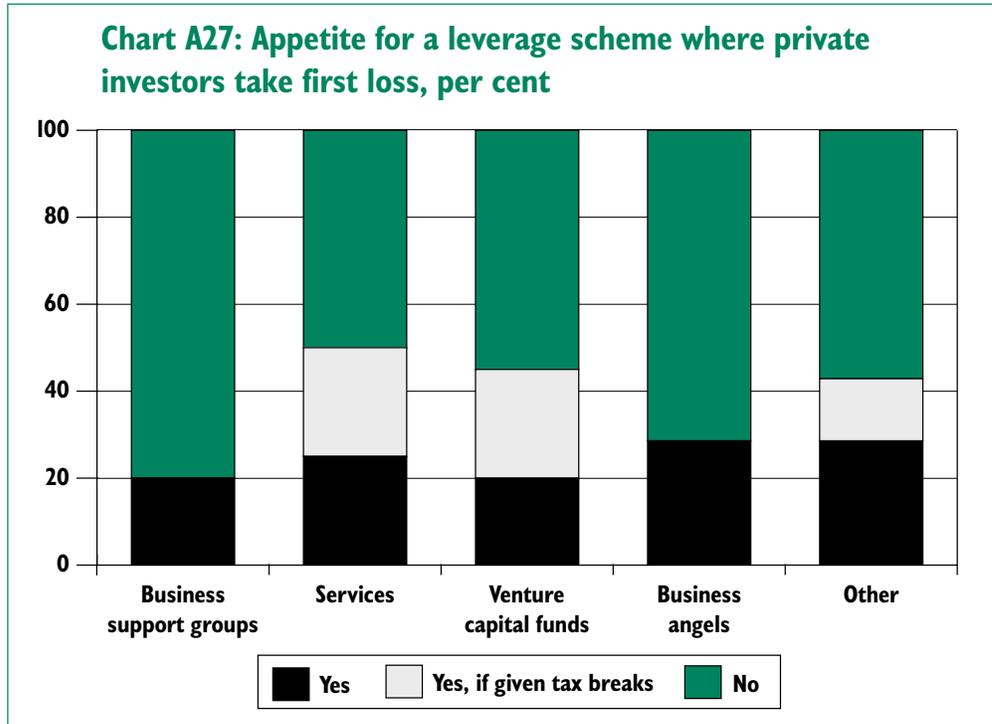
**A90** Respondents expressed a range of different attitudes on whether the scheme should be self-financing over the medium term. Although some believed that this was a vital part of the scheme, others felt that cost neutrality should not be a driving issue. Instead, they argued that the scheme should focus on encouraging investments in the equity gap. Some respondents mentioned that indirect benefits should be taken into account when determining cost neutrality, such as increased tax revenue and greater employment.

**A91** A further suggestion was that the government share should reflect variables such as SBIC investment strategy, track record and market environment. Several respondents argued that the Government should be willing to take a subordinated downside position, as with the RVCFs.

**Covering losses**

**Q4.16 Is there the appetite among private sources of funding for a leveraged investment scheme where private investors take first loss?**

**A92** Around 60 per cent of those responding to this question felt that there was little appetite among private investors for leveraged investment under a first loss structure. Chart A27 shows that this view was held fairly consistently across all the respondent types. Some respondents emphasised that it was current market conditions that made investors averse to a scheme with first loss, while others believed that incentives such as tax breaks could help change attitudes.



**A93** Several respondents thought that business angels might be more willing to accept a high risk-return structure than other investors. Respondents also mentioned that corporate investors may be willing to invest in order to access innovation, despite the first loss structure.

**Liquidation**

**Q4.17 Monitoring and the possibility of liquidation once a certain capital impairment ratio had been reached would be, in the Government’s view, the most appropriate way to avoid moral hazard among capital impaired SBICs. Respondents are asked to comment on this point, and to propose any alternative control regimes.**

**A94** Many responses highlighted the fact that the capital impairment ratio at a particular point in time might not actually reflect the potential performance of an SBIC, due to the ‘J-curve’ profile of returns to venture capital investment. Since returns are frequently not realised until several years after an initial investment has been made, often an SBIC will have a high capital impairment ratio in its early years, even if it is ultimately successful.

**A95** Respondents suggested that monitoring could be problematic due to the difficulties of measuring the value of an SBIC's unrealised investments. Respondents generally accepted that SBICs would have to undertake some sort of regular reporting of their solvency. However, many were reluctant to allow the government to liquidate failing SBICs. Alternative suggestions were:

- to leave the situation to market forces and existing insolvency laws;
- to try replacing the fund manager before liquidation;
- to transfer the failing SBIC's investments to another, better-performing SBIC; and
- to prevent any new investments by the SBIC, and allow time for remedial action before liquidation.

**A96** Respondents suggested that the 'moral hazard' problem, which leads to less than optimal private sector monitoring of SBICs, could be solved by making returns *pari passu*. Private investors would then face the same profit-loss pay-offs as the government.

**Q4.18 The Government would like to hear from respondents on the principles that should guide a licensing authority when taking a decision on whether or not to liquidate a failing SBIC, bearing in mind the competing interests of the taxpayer and the private investors.**

**A97** Most responses emphasised that liquidation should only be used as a final measure, and that other options such as transferring the SBIC and replacing the fund manager should be attempted first. Some argued that private investors should have some say in the decision to liquidate, and that liquidation must be used carefully, as it may deter investors from any future investments in this area.

**A98** Respondents commonly suggested that the liquidation decision should be based on some set level or measure, which had been clearly presented at the outset of the scheme. Having these set parameters would prevent allegations of unfairness. However, some respondents felt that, ultimately, discretion might still be required.

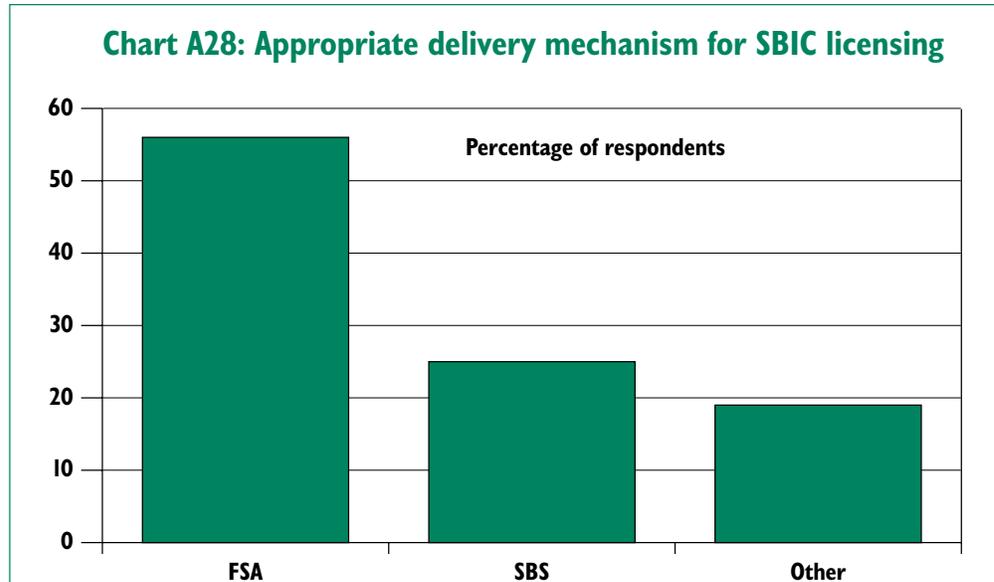
### Licensing

**Q4.19 What issues should the Government consider when deciding any restrictions on allowable legal structures?**

**A99** Around half of responses recommended minimal restrictions on legal structure, arguing that the SBIC should be allowed to decide on the optimal structure to suit its investors. This reflects the importance that was placed on simplicity and flexibility in general. Many of the respondents stated that the structure should be tax efficient and transparent to ensure that investors are willing to invest in SBICs. Some respondents also argued that the SBIC should have tradable secondary shares (as VCTs have), to give investors greater liquidity.

**Q4.20** The Government invites respondents' views on the appropriate delivery mechanism for the licensing process that would combine the necessary skills and competencies with the flexibility necessary to deliver the Government's policy objectives in a dynamic, light-touch way.

**A100** 62 per cent of respondents suggested that the FSA would be the most appropriate delivery body for SBIC licensing, while 28 per cent suggested the SBS, or a division of it. These responses are illustrated in Chart A28.



#### Other issues

**Q4.21** As well as affordability and value for money, are there other considerations the Government should take into account when deciding whether to develop an SBIC scheme further?

**A101** Respondents put forward a number of considerations that can be divided into three main groups:

- any new scheme that is developed should be simple and flexible;
- if a UK version of SBICs is developed it should complement, rather than compete with, current government interventions; and
- demand-side issues, including the need for mentoring and support, are important factors when dealing with the problems of businesses with the potential for high growth.



# B

## APPENDIX B: DEFINITIONS

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- Business angels** Informal investors who invest in growing businesses, and who often have prior relevant business experience that they use to support a company's management and development, often through taking a position on the board.
- Business angel networks** Networks providing a matching service between potential investors and companies seeking investment. In more sophisticated networks, members are presented with screened propositions that have already been through a degree of due diligence.
- Due diligence** Research to corroborate and verify the content of a business plan.
- Investment readiness** SMEs need to be 'investment ready' in order to attract private equity. Businesses with growth potential are prevented from raising the finance they need if they are not able to put a coherent investment proposition to potential funders. SMEs may also not be 'investment ready' if the management team is incomplete or is unwilling to have an equity partner.
- MBOs, MBIs** Management buy-outs and management buy-ins provide funding to enable current or new management to acquire an existing product line or business.
- Mezzanine finance** A financial instrument that ranks between equity shares and loans for repayments of capital and income. Mezzanine finance is invested in the form of a loan together with an entitlement to an equity participation in the future.
- Pari passu*** All investors participate on the same terms.
- Private equity** Equity capital for companies not quoted on a stock market. Private equity usually refers to a broader set of investments than just venture capital, as private equity includes activities such as MBOs and MBIs.
- Small and medium-sized enterprises** The EU definition of small and medium-sized enterprises (SMEs) is as follows:
- |                |                            |
|----------------|----------------------------|
| Turnover:      | less than 50 million euros |
| Balance sheet: | less than 43 million euros |
| Employees:     | fewer than 250             |
| Independence:  | 25 per cent                |
- To qualify as a SME, both the employee and the independence criteria must be satisfied, and either the turnover or the balance sheet criterion. The independence criterion refers to the maximum percentage of the enterprise that may be owned by one, or jointly owned by several, enterprises not satisfying the same criteria. Venture capital companies may, however, own up to 50 per cent of a SME without affecting the status of the enterprise.
- Venture capital** Equity investments in early-stage SMEs with strong growth potential. Venture capital includes start-up, early-stage and expansion financing. Managerial and technical expertise are often provided along with the finance.



# C

## APPENDIX C: LIST OF ACRONYMS

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<b>AIF</b>	Approved Investment Fund
<b>AIM</b>	Alternative Investment Market
<b>BVCA</b>	British Venture Capital Association
<b>CDFI</b>	Community Development Finance Institution
<b>CGT</b>	Capital Gains Tax
<b>ECF</b>	Enterprise Capital Fund
<b>EGF</b>	Early Growth Funding
<b>EIB</b>	European Investment Bank
<b>EIS</b>	Enterprise Investment Scheme
<b>FSA</b>	Financial Services Authority
<b>GDP</b>	Gross Domestic Product
<b>HNWI</b>	High net worth individual
<b>MBI</b>	Management buy-in
<b>MBO</b>	Management buy-out
<b>NBAN</b>	National Business Angel Network
<b>NRIE</b>	Non-recognised investment exchange
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>RDA</b>	Regional Development Agency
<b>RVCF</b>	Regional Venture Capital Fund
<b>SBA</b>	Small Business Administration
<b>SBIC</b>	Small Business Investment Company
<b>SBS</b>	Small Business Service
<b>SFLG</b>	Small Firms Loan Guarantee
<b>SME</b>	Small and medium-sized enterprise
<b>UCF</b>	University Challenge Fund
<b>UKHTF</b>	UK High Technology Fund
<b>VCT</b>	Venture Capital Trust



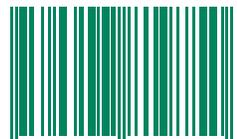








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