Bridging the finance gap: a consultation on improving access to growth capital for small businesses

April 2003

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FOREWORD

Small businesses are the lifeblood of our economy – boosting productivity, creating employment and prosperity, and revitalising our communities. Our aim as a Government has been to change attitudes to enterprise and tackle the difficulties that we know entrepreneurs can face in starting and growing their businesses, including access to finance.

The UK has one of the most dynamic and flexible financial markets in the world, meeting the funding needs of hundreds of thousands of small businesses every year. And sustained economic growth and historically low and stable interest rates since 1997 have helped ease the financial constraints affecting small businesses and allowed them to invest for the long term with greater confidence.

Over the last six years, the Government has also played an important role in ensuring that markets work effectively and that any gaps or weaknesses are addressed. We have created the Regional Venture Capital Funds to support small growing companies, with £80 million of Government investment attracting a further £155 million from private sector investors. And we have supported the Bridges Community Development Venture Fund which is boosting investment and helping foster a spirit of entrepreneurship in our most disadvantaged communities.

But many small businesses with high-growth potential still find it difficult to access the risk capital, and particularly the equity, they need to realise their ambitions. These lost opportunities represent both an economic cost through reduced productivity growth and job creation, and a social cost to the communities within which they trade.

So this paper sets out what more could be done to ensure that entrepreneurs have access to the finance they need to turn their ideas into thriving businesses – and we encourage all interested parties to respond to the consultation. The issues are complex and the questions raised difficult but our aim is that, by working together, we can create a country 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

E.1 In *Enterprise Britain*[1], the Government set out the enterprise challenge faced by the UK. Levels of entrepreneurship in the UK are half those of the US, and variations between UK regions and communities are even greater. The Government is working to create a fertile environment for business start-up and growth, and to address specific market failures that prevent small and medium-sized enterprises (SMEs) from realising their full growth potential.

E.2 This consultation paper focuses on how to ensure that young and growing small businesses have efficient access to capital. It summarises the main sources of finance for small businesses, then concentrates on the causes of market failure and the resulting finance gap that is particularly acute for potential high-growth small businesses. The paper goes on to consider how new measures and improvements to existing measures might help resolve this. In particular, it considers the scope for introducing in the UK a variant of the Small Business Investment Company programme, which has been a key driver behind the growth of US early-stage equity finance.

Sources of finance

E.3 The Government recognises that the sharpest slowdown in the global economy for 30 years has made market conditions for small businesses difficult, but business failure rates remain significantly below levels prevailing in the early 1990s. However, private equity, which is inherently riskier than other asset classes, has witnessed a particularly sharp decline as investors have moved towards more cautious investment strategies.

Debt finance

E.4 Overall, firms now find it easier to access the debt finance they need than they did ten years ago. The lowest interest rates for over 40 years have been made possible through macroeconomic stability and sustained low inflation, with operational independence of the Bank of England's Monetary Policy Committee and tough rules on Government borrowing and public sector debt.

Small Firms Loan Guarantee

E.5 Where SMEs do not possess a track record or sufficient collateral to access debt finance, the Government continues to offer the Small Firms Loan Guarantee (SFLG). A package of enhancements to the SFLG took effect from 1 April 2003, including opening the scheme up to new sectors including retail and catering. The Government will shortly be inviting applications from new lenders wishing to participate in the SFLG, particularly those serving disadvantaged groups, and is seeking views on how it could be further enhanced to meet the needs of eligible businesses more effectively.

Risk capital

E.6 Although surveys have found an improving overall financing environment for SMEs over recent years, they mask a more complex underlying picture. For a minority of SMEs, especially young or potentially risky SMEs with high growth aspirations, debt finance alone is inappropriate, and risk capital in the form of equity finance is more suitable. Evidence indicates there may be problems for such firms accessing relatively modest amounts of equity or other forms of risk capital.

[1] *Enterprise Britain: A modern approach to meeting the enterprise challenge*, HM Treasury/Small Business Service, 2002, http://www.hm-treasury.gov.uk/

E.7 SMEs seeking equity pass through different stages in the funding life-cycle, typically starting with personal capital, often supplemented with bank debt and equity from friends, family and other private investors including 'business angels'[2]. Only a small minority raise equity in amounts over £250,000 from these sources. Above this threshold, SMEs must generally look to the formal venture capital sector to meet their equity funding requirements.

The equity gap

E.8 Many commercial venture capitalists are reluctant to invest in small amounts (a £1 million threshold is often cited) for a variety of reasons, principally high fixed transaction costs, shortage of available exit options, and a perceived greater risk in investing in early-stage companies. Although the UK has one of the most developed private equity markets in the world, it has increasingly focused on later-stage deals. While the overall number of private equity investments has increased by 17 per cent since 1997, the number in the £500,000 – £1 million range has declined by 10 per cent.

E.9 The Government has taken a number of steps to ease the problems associated with the equity gap, including: one of the most favourable capital gains tax (CGT) regimes in the industrialised world; enhancing a range of tax measures to stimulate venture capital investment, including the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs); setting up Regional Venture Capital Funds (RVCFs); and creating a series of 'investment readiness' demonstration projects. The Government has also announced a review of the operation of the Financial Promotion Order 2001 as it applies to high net worth and sophisticated investors, and has set up a working group with representatives of the accountancy profession and small business to consider how to drive up the quality of advice on access to growth capital available to SMEs.

E.10 The Government recently commissioned independent research[3] into the effectiveness of the EIS and VCT schemes. The schemes were found to have a valid rationale and to play a significant and growing role in the supply of private equity funds in the UK. Nevertheless, there may be scope to enhance their effectiveness in meeting the needs of smaller businesses affected by the equity gap. The Government therefore wishes to consult on whether there may be scope for enhancement, and particularly on three options for reform:

- enhancing the focus of the VCT scheme to meet its policy objectives;
- encouraging business angel syndication[4]; and
- simplifying and enhancing the flexibility of both schemes.

E.11 As well as consulting on possible changes to the EIS and VCT schemes, this paper invites views on whether there may be advantages from changing the tax treatment of the incidental costs to SMEs of raising equity finance.

[2] Business angels are wealthy individuals who invest in growing businesses, and who often have prior business experience that they use to support a company's management, perhaps through a board position.

[3] *Research into the Enterprise Investment Scheme and Venture Capital Trusts*, A report prepared by PACEC on behalf of the Inland Revenue, 2003, available at www.inlandrevenue.gov.uk/research/index.htm

[4] Syndication is the process by which several investors might group together to invest in a company, sometimes sharing the costs of due diligence that precedes such investments.

E.12 Despite the potential benefits from these changes, a need for additional support is likely to persist for start-up and early-stage businesses that are caught in the equity gap. One possible approach to meeting this need might be a variant of the US Small Business Investment Company (SBIC) programme.

SMALL BUSINESS INVESTMENT COMPANIES

E.13 SBICs were introduced in the US in 1958, and were refocused in 1994 on equity-based investment in early-stage small companies. The programme has been instrumental in the development of the US venture capital industry, and in 2002 SBICs represented 58 per cent of venture capital investments by number in US small companies.

E.14 A UK SBIC programme would aim to improve the availability of risk capital to SMEs facing the equity gap, by: bringing more 'entrepreneurial investors' into the management of funds which specialise in making small, early-stage deals; offering incentives to make these investments; and enhancing the impact of business angel networks.[5] An SBIC programme, if implemented in the UK, would be designed to be self-financing over the meduim term, would complement existing schemes, and its demand-led design would reinforce rather than displace existing private sources of finance.

E.15 The Government wishes to consult on the overall suitability of the model in the UK context, as well as on more specific questions concerning the applicability of different aspects of the model to the UK market. The role that fast-growing SMEs play in raising productivity means that there are enormous potential rewards for the UK economy from ensuring they are able to access efficiently the capital they need to achieve their potential.

[5] Business angel networks provide a 'matching' service between potential investors and companies seeking investment.

1 Enterprise and Productivity

Small and medium-sized enterprises (SMEs) make an important contribution to the output, employment and productivity of the UK. Levels of entrepreneurship in the UK remain moderate by international standards. The Government's approach is to create a supportive business environment and to address market imperfections that act as barriers to business growth. One such market failure is the shortage of equity funding for growing SMEs.

1.1 Raising productivity growth is central to improving the UK's standard of living. There exists a significant and long-standing productivity gap[1] between the UK and many of its major competitors. While progress in reducing the gap has been made over recent years, a substantial gap still remains.

Key productivity drivers

1.2 The Government has a clear strategy to narrow further the productivity gap over the longer term, comprising two elements. The first is the macroeconomic framework, which has delivered a sustained period of stable economic growth, kept interest rates at their lowest level for over 30 years, and achieved the longest period of low and stable inflation since the 1960s; the second is a series of microeconomic reforms based around the five key drivers of productivity:

- competition;
- enterprise;
- innovation / research and development;
- human capital (skills); and
- physical capital (investment).

1.3 This consultation paper focuses on part of the Government's strategy to raise levels of enterprise in the UK. Ensuring that young and growing small businesses have efficient access to finance is critical if they are to realise their growth and productive potential. Recognising this, 'improving access to finance for small businesses' is one of the seven core themes of the Government's policy framework for small businesses.[2]

1.4 The role of enterprise in driving productivity growth was set out in *Enterprise Britain: a modern approach to meeting the enterprise challenge.*[3] Among major industrialised economies, the level of entrepreneurship is positively correlated with both the level of per capita GDP and the rate of GDP growth. The creation and growth of new entrepreneurial firms contributes to a beneficial process of 'productive churn', by which more productive growing businesses increase their market share at the expense of less productive incumbents. The aggregate effect of this market-driven process is a net increase in the productivity of the economy. Entrepreneurial SMEs are also an important source of competition and innovation within the economy, driving productivity growth both within the SME sector and among other larger businesses.

[1] Fully described in *Productivity in the UK: the Evidence and the Government's Approach*, HM Treasury, November 2000, *www.hm-treasury.gov.uk/*

[2] *Small Business and Government: The way forward*, Small Business Service, December 2002, *www.sbs.gov.uk/*

[3] *Enterprise Britain: a modern approach to meeting the enterprise challenge*, HM Treasury/Small Business Service, November 2002, *www.hm-treasury.gov.uk/*

The enterprise challenge

1.5 Despite the rapid growth of the SME sector since the 1970s, rates of entrepreneurial activity in the UK remain only moderate by international standards. It is estimated that around 5½ per cent of working-age adults are engaged either in starting a new business or in running a young business in the UK.[4] This figure is close to the European average, but is only around half that of the US. Moreover, the UK appears to lag behind the US in terms of high-growth start-ups: new firms in the US typically expand more rapidly than those in Europe.[5] If the UK is to close the productivity gap with its major competitors, then it is important that levels of enterprise are increased and barriers to business growth removed. Two objectives underlie the Government's approach to enterprise and investment:

- building a supportive business environment which encourages people to start and grow businesses, investing for the long-term; and
- correcting market failures that create obstacles to successful enterprise, investment and business growth.

A supportive business environment

1.6 The business environment is vital for the success of small businesses. The Government has reformed the tax system to promote enterprise and growth. With corporation tax now cut to its lowest-ever level, and a 10 per cent rate of capital gains tax (CGT) for business assets held over two years, the UK now has one of the most favourable CGT regimes in the world. As a result of macroeconomic stability, company insolvency rates are now running at less than half the level reached during the early 1990s, reducing a key risk in starting up and expanding a business.

Market failure

1.7 A supportive business environment, which aids market-driven processes such as productive churn and efficient investment allocation, is essential for the vast majority of businesses. However, left to themselves, markets cannot always be relied upon to deliver the best economic or social outcomes, leading to market failures. Government sometimes has a role to play in correcting market failure.

1.8 One market failure, identified as early as 1931[6], concerns the ability of firms to access relatively modest amounts of finance; this is often referred to as the 'finance gap'. Although studies since then have shown the gap identified by the Macmillan report has declined significantly, this consultation paper examines evidence for the continuing existence of a gap, considers the impact of existing Government interventions to tackle it, and seeks views on the scope for further action.

[4] *Global Entrepreneurship Monitor 2002 Executive Report*, 2002, Reynolds, Bygrave, Autio, Cox & Hay, Babson College/London Business School/Ewing Marion Kauffman Foundation.

[5] Scarpetta, S., Hemmings, P., Tressel, T. & Woo, J., *The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data*, OECD Working Paper 329, 2002.

[6] Macmillan Committee on Finance and Industry, 1931.

2 Assessing the Finance Gap

The UK has well-developed capital markets in comparison to other European countries, and the majority of UK businesses have few problems in accessing finance to operate their business. Nevertheless, market imperfections mean that a minority face difficulties in raising the finance they need to support the early stages of growth.

Potentially high-growth small businesses seeking equity investment suffer most from these market failures, yet these firms contribute disproportionately to productivity growth. This chapter sets out how market failures may arise in the provision of finance and explores the evidence on where they appear most acute.

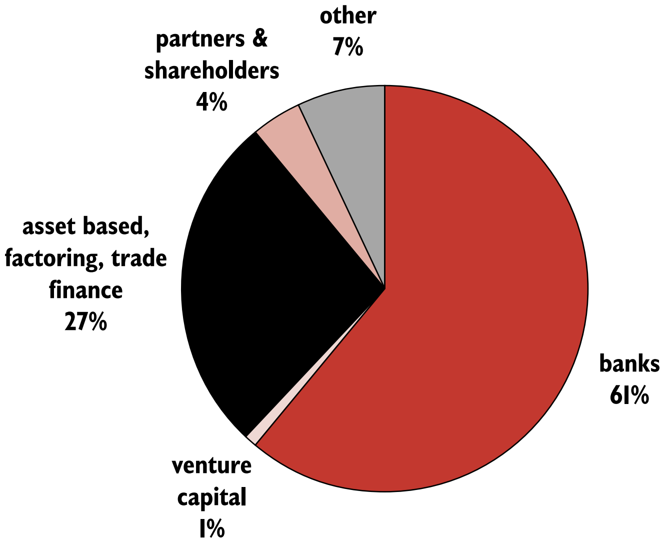
INTRODUCTION

2.1 Efficient access to finance is an essential ingredient if firms are to achieve their growth objectives. External sources of finance are particularly important for start-up and small businesses, which often lack retained profits to re-invest to support their own growth.

Sources of finance

2.2 SMEs access finance from a variety of external sources. At one end of the spectrum is equity, where the investor buys a proportion of a company with the aim of making a capital gain by selling that share later on, and possibly taking a share of the profits in the meantime through dividends. Equity encompasses different forms of investment, ranging from informal finance from friends and family to publicly listed shares. At the other end of the spectrum is traditional debt, where a fixed amount is borrowed and paid back in a given time-frame, with interest payable at fixed intervals irrespective of business performance and whether or not the business generates sufficient cash-flow to meet the repayments. In practice it is bank debt which constitutes the majority of external financing for established SMEs, as Chart 2.1 illustrates.

Chart 2.1: Sources of external finance for SMEs, 1997-1999



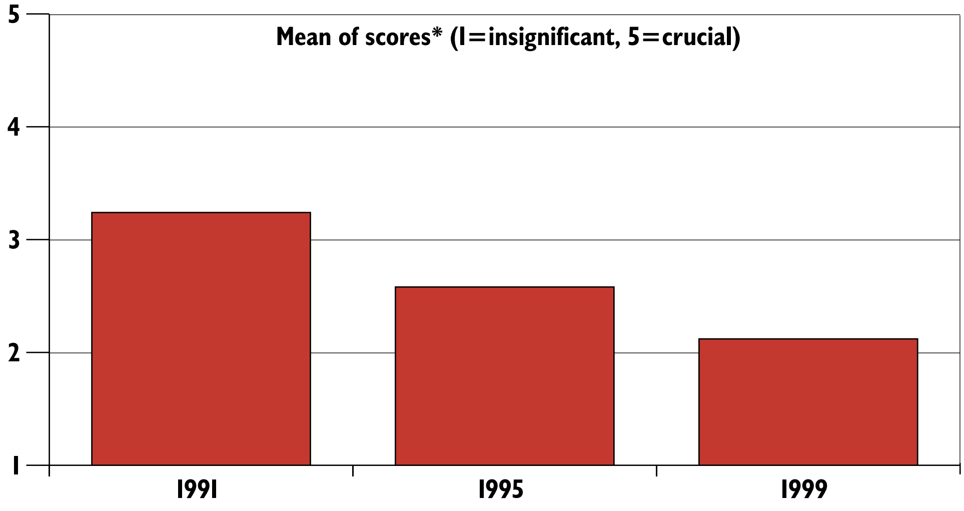
Source: ESRC Centre for Business Research: British Enterprise in Transition, 1994-1999, Cosh, A. & Hughes, A. (eds.), 2000.

Access to finance

2.3 The bulk of available evidence points to an improvement in the general financing conditions for SMEs, and especially access to bank finance, since the early 1990s. For example:

- the Bank of England has found that 'small business organisations have not reported their members indicating notable problems with access to, or the cost of, bank finance';[1]
- the CBI's quarterly *SME Trends* surveys show that credit or finance is rarely mentioned as a key problem likely to limit output for smaller manufacturers;[2]
- a recent survey by the Forum of Private Business found that, out of the 39 per cent of small firms applying for a loan in the previous six months, 94 per cent had received the full amount sought, and only 9 per cent said the terms and conditions were worse than before;[3] and
- surveys conducted by the Centre for Business Research since 1991 illustrate the declining importance of finance as a constraint in meeting business objectives (Chart 2.2).

Chart 2.2: The declining significance of finance as a barrier to growth



** Responses from firms asked to grade the significance of availability or cost of finance as a barrier to growth.*
Source: ESRC Centre for Business Research: British Enterprise in Transition, 1994-1999, Cosh, A., & Hughes, A. (eds), 2000.

2.4 Although SMEs are reporting decreased problems in assessing bank finance, a recent Competition Commission investigation[4] into the SME banking market, prompted by the Cruickshank report,[5] found that competition was not working in this market. The lack of competition was leading to problems of excess prices being charged by the four largest clearing banks in England and Wales. The Commission recommended a package of remedies to improve competition, which the eight largest UK banks have now accepted. But these measures will take time to have the desired effect so, as an interim measure, the Office of Fair Trading also secured the four largest banks' agreement to offer their SME customers in England and Wales either interest on their current accounts or an account free of money transmission charges from the start of 2003.

[1] *Finance for Small Firms, A Ninth Report*, Bank of England, April 2002.

[2] *Quarterly SME Trends Survey*, CBI, various editition s.

[3] *Quarterly Survey of Private Business*, Forum of Private Business, March 2002.

[4] *The supply of banking services by clearing banks to small and medium-sized enterprises*, Competition Commission, 2002, Cm 5319, www.competition-commission.org.uk.

[5] *Competition in UK Banking – A report to the Chancellor of the Exchequer*, Don Cruickshank, March 2000, www.hm-treasury.gov.uk.

2.5 The improvement in the overall availability of finance is due in part to a reduced dependence on external finance, and also to improved macroeconomic stability. The Government recognises that the sharpest slowdown in the global economy for 30 years has made market conditions for small businesses difficult. Nevertheless business failure rates remain well below levels prevailing in the early 1990s. However, private equity, which is inherently riskier than other asset classes, has witnessed a particularly sharp decline as investors have moved towards more cautious investment strategies.

2.6 The generally positive overall picture masks some underlying problems for certain businesses. Start-up businesses and those lacking a track record sometimes face difficulties in accessing debt finance, and SMEs with high growth potential are often unable to raise the relatively modest amounts of equity finance required to meet their growth ambitions. The Government believes that some SMEs that fail to raise this investment may be victims of structural market failures that give rise to 'finance gaps'. This chapter explores both the theory and the evidence for these finance gaps.

Debt finance

2.7 In the case of debt, the information needed by lenders to make judgements on individual loan applications may be expensive, or even impossible, to obtain. In situations where lenders are unable to access relevant information that is known to the borrower, they may protect their exposure by rationing lending by quantity rather than through the price mechanism.[6] Moreover, they are more likely to confine their activities to relatively low-risk, low-return segments of the market.

2.8 Many banks have developed sophisticated systems to assess credit risk by placing significant emphasis on information gained through past relationships with potential borrowers or on a track record of business success. Problems of information asymmetry and moral hazard may be further alleviated if the business manager can demonstrate a significant personal stake in the success of the business, by offering collateral to the lender or by taking a significant personal equity stake in the business.[7]

2.9 Barriers resulting from a lack of information remain acute for enterprises that lack an established track record, most obviously new and fledgling firms, and consequently they face greater difficulty accessing debt finance.[8] Moreover, entrepreneurs with a viable business proposition may be unable to offer collateral or to inject personal capital into their business. And particular difficulties may be faced by entrepreneurs located in disadvantaged communities.[9] Chapter 3 considers how the Small Firms Loan Guarantee (SFLG) and government support for community development finance institutions are helping address these issues.

[6] Stiglitz, J.E. and Weiss, A. *Credit Rationing in Markets with Imperfect Information*, American Economic Review, Vol. 73, 1981.

[7] *Finance for Small Firms, A Ninth Report*, Bank of England, April 2002.

[8] *SBS Household Survey*, Small Business Service, 2001.

[9] *Finance for Small Firms*, *A Ninth Report*, Bank of England, April 2002.

Equity finance

2.10 For a small subset of SMEs, growth is often best financed using private equity based investment, either alongside or instead of debt finance, particularly when:

- the firm is young, and does not have sufficient cash-flow to service debt or interest repayments at the outset;
- the investment is perceived as risky, and the investor requires a share in the firm's profits to compensate; and
- the business is seeking the substantial rates of growth sought by equity investors, who generally make their returns through capital appreciation of their investment.

Economic benefits of private equity

2.11 Although only a small proportion of SMEs meet these criteria, private equity-backed firms make an important contribution to UK productivity. As well as financial support, private equity investors typically offer active management support, advice and mentoring. As a result, firms that are backed by venture capital before their initial public offering tend to perform better once floated than other businesses not backed by venture capital funding.[10] There is also evidence that venture capital backing increases rates of innovation as measured by numbers of patents.[11]

2.12 Despite the benefits of venture capital as a catalyst for growth and innovation, it remains under-utilised as a source of small business finance.[12] In line with the rest of Europe, UK SMEs are failing to grow as fast as their US counterparts[13] and are not reaching their full productive potential.[14] This suggests that reducing barriers to growth and ensuring SMEs have efficient access to, and make efficient use of, equity finance could yield substantial economic benefits.

Business angels

2.13 At seed and start-up stages, many SMEs will use informal sources of funding alongside bank finance, including family and friends. In some cases, start-up businesses are also able to attract informal venture capital funding from individuals (or groups) known as business angels. Business angels are an important source of funding during the seed, start-up and early growth stages of a company. Quantifying the supply of finance from business angels is difficult, but broad estimates suggest that their collective annual investments may lie in the range of £$^1/_2$ billion to £1 billion.[15] An estimated 75 per cent of investments recorded by business angel networks are below £100,000 and only 8 per cent are above £250,000, illustrated in Chart 2.3.[16]

[10] Gompers, P. & Lerner, J., *Venture Capital and the Creation of Public Companies: Do Venture Capitalists Really Bring more than Money?* Journal of Private Equity, Fall 1997.

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

[12] Harding, R., *Venture Capital and Regional Development*, Venture Capital, November 2000.

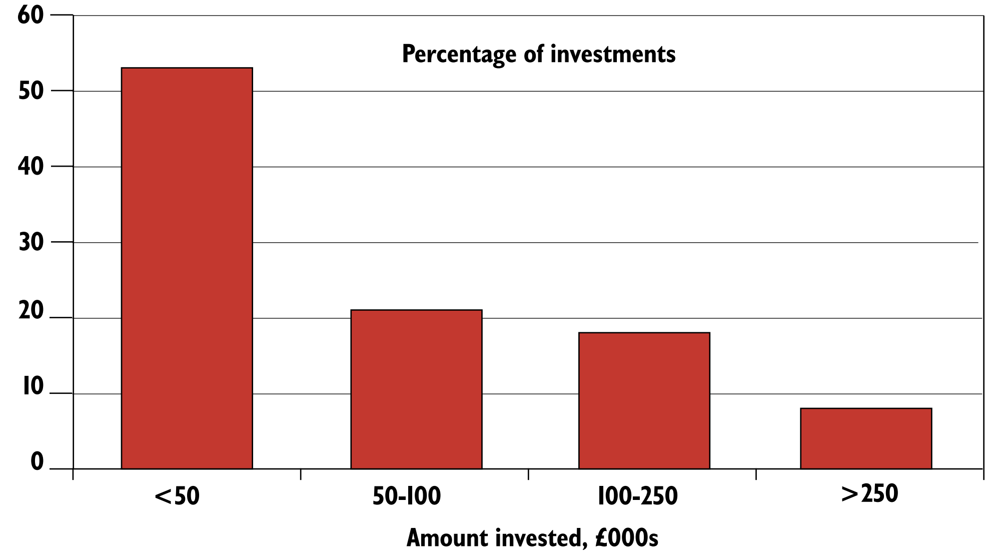
[13] Scarpetta, S., Hemmings, P., Tressel, T. & Woo, J., *The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data*, OECD Working Paper 329, 2002.

[14] Westall, A. and Cowling, M., *Agenda for Growth*, IPPR, 1999.

[15] Mason, C. & Harrison, R., *The size of the informal venture capital market in the UK*, Small Business Economics, Vol. 15, 2000.

[16] Mason, C. (2002) *Report on Business Angel investment activity 2000-2001*.

Chart 2.3: UK business angel investments by size*, 2000-2001



*Measured business angel activity only.
Source: Report on Business Angel Investment Activity 2000-2001, Mason, C., 2002.

2.14 Business angels sometimes invest in syndicates of two or more, but even when total amount per deal is considered (i.e. the amount invested at any given funding round by all business angels involved), only 11 per cent of deals were above £250,000. Unmeasured deals are likely to be even smaller, so it is clear that informal equity from business angels over £250,000 is relatively difficult to access. In regions with fewer wealthy individuals, even accessing much smaller amounts can be problematic.

THE EQUITY GAP

Reasons for a gap

2.15 Beyond the £250,000 upper threshold of most UK business angel investment, firms generally need to look to formal venture capital providers to meet their risk capital needs; all but the most exceptional propositions are likely to face difficulties raising small amounts. The effect of the 'equity gap' only begins to ameliorate for deals over £1 million.

2.16 There are a number of reasons why commercial investors tend to avoid smaller deals:

- **high transaction costs** reduce the viability of smaller venture capital investments. To overcome information asymmetries, investments are made only after due diligence: a rigorous examination of the investee company by venture capitalists to protect the interests of their investors. This process can involve the costly employment of accountants, lawyers and industry specialists, especially if a new product or technology is involved. The costs involved are largely fixed, so they represent a larger proportion of lower value deals. Potential investors can also face significant 'search costs' when seeking out opportunities; in sum, there is a financial advantage to any fund manager in making a few larger investments rather than a larger number of smaller ones;

- largely fixed **ongoing running costs** may also reduce the viability of smaller investments. Young companies might have less experienced management teams, and investors will often contribute significant time and effort to mentoring and providing management support, for instance through taking a seat on the board. The time involved can add significantly to the investor's costs;

- **risk is perceived to be higher** for early-stage (and particularly pre-revenue) companies because the management team or the SME's product and market may be unproven. Uncertainties may be even greater where the SME is promoting innovative technologies or processes; and

- **lack of exit options** can be problematic for business angels and venture capitalists. When investors want to realise the capital gain on their investments, they need to sell their share on. Trade sales are cyclical, and the public markets for trading in smaller-firm shares are sometimes illiquid.

Demand side factors

2.17 Equally important as supply-side obstacles are factors which can reduce the attractiveness of formal equity to potentially high growth SMEs and their ability to access it. Lack of investment readiness includes factors such as limited understanding of equity instruments, poor quality and presentation of business plans, and reluctance to cede control.[17] The Government is taking a number of initial steps to make businesses more 'investment ready', complementing supply-side measures, but recognises this is an area where further government intervention may yield continued benefits. These issues are explored in more detail in Chapter 3.

EVIDENCE FOR THE EQUITY GAP

2.18 The extent of the equity gap cannot be measured precisely, since it is not possible to know with certainty which growing businesses 'ought' to have received funding in an efficient market. The level of difficulty in raising equity, and therefore the finance gap itself, also varies by region, industry sector, round of funding and stage of development. Three things can, however, be measured:

- the distribution of UK private equity investments by value and financing stage;

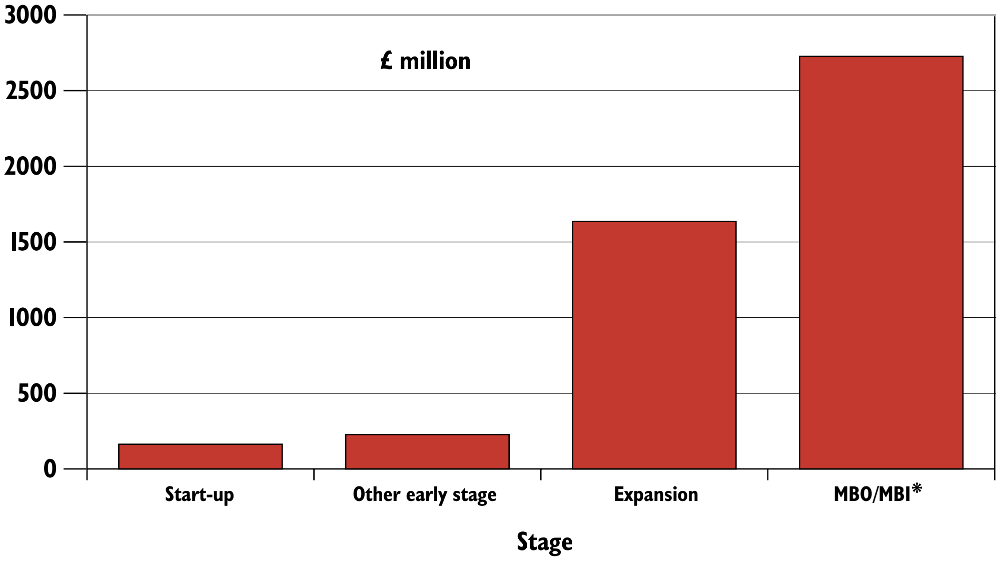
- patterns of private equity investment in the UK relative to other countries; and

- changes in the pattern of UK early-stage investment over time.

2.19 Chart 2.4 shows that only 3 per cent of total private equity investment was invested at the start-up stage in 2001, and only a further 5 per cent in other early-stage investments. In comparison, MBOs and MBIs accounted for nearly 60 per cent of investment. Chart 2.5 shows that in recent years, the average investment size has increased by almost 50 per cent for early-stage deals, and is now around £1.3 million. The comparative figures for later-stage deals are disproportionately higher.

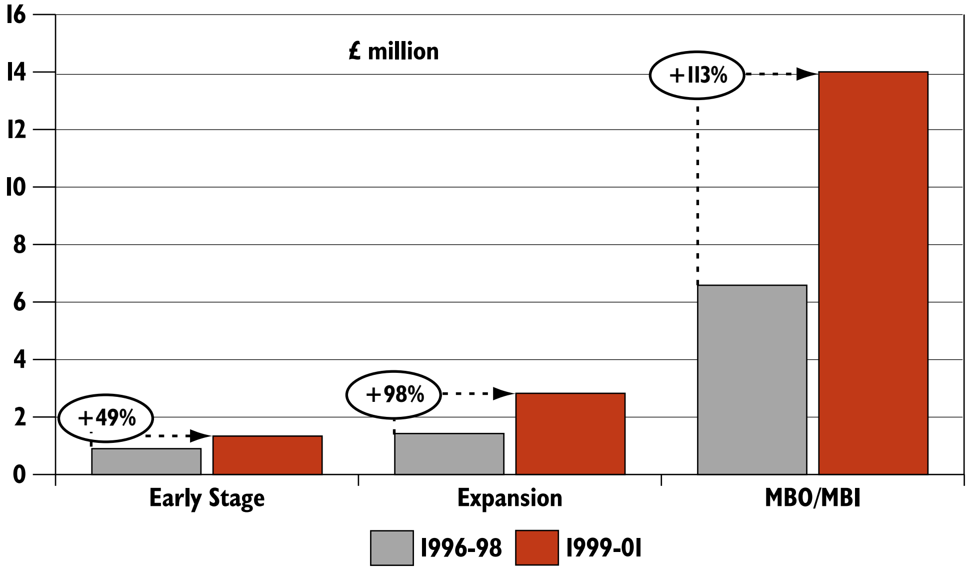
[17] Mason and Harrison, 2001, *Designing an Investment Readiness Programme: Some Considerations*, Report to the SBS.

Chart 2.4: Total venture capital investment by investment stage, 2001



Source: BVCA & PricewaterhouseCoopers: Report on investment activity 2001.
** Management Buy-out and Management Buy-in.*

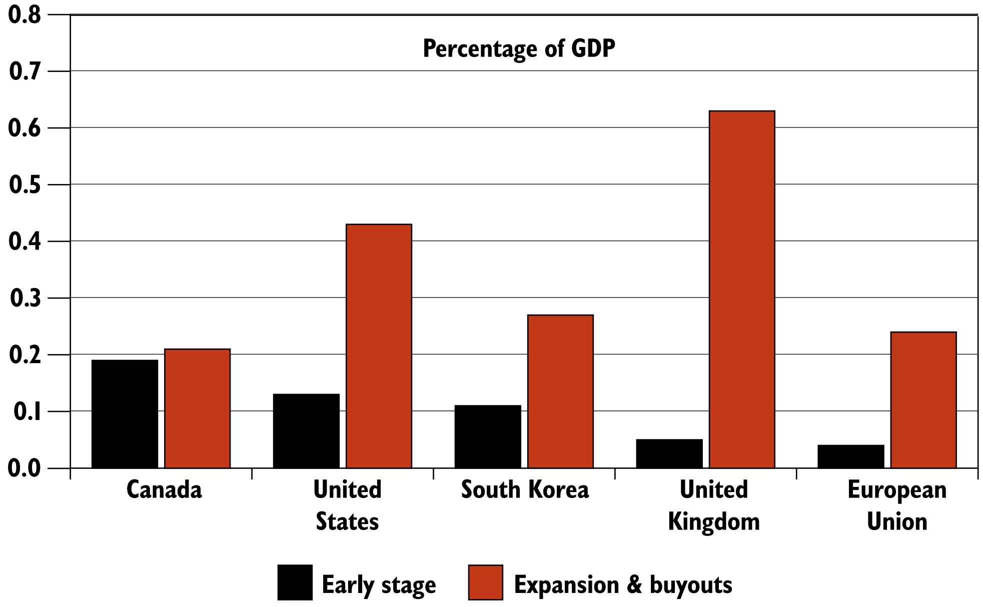
Chart 2.5: Change in average venture capital investment size by investment stage



Source: BVCA & PricewaterhouseCoopers: Report on investment activity 2001.

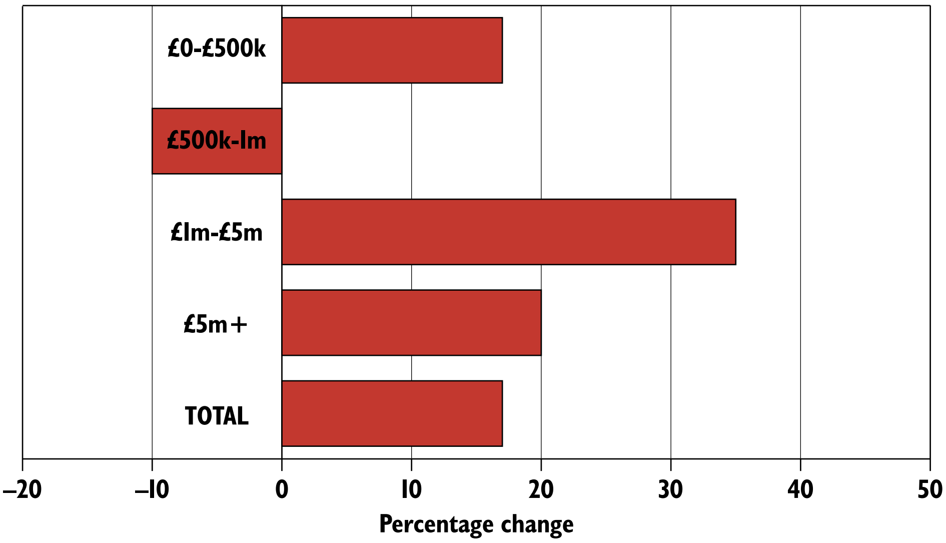
2.20 Chart 2.6 shows that despite having a much larger private equity industry in total, UK private equity investment in early-stage companies as a proportion of GDP is relatively low compared to other countries. Chart 2.7 goes on to show that against a backdrop of strong growth in private equity investment as a whole, the number of investments in the £500,000 - £1 million range is now 10 per cent lower than in 1997.

Chart 2.6: Venture capital by stage as proportion of GDP, 1998-2001



Source: OECD Venture capital database, 2002.

Chart 2.7: Change in number of investments by deal size, 1997-2001



Source: BVCA & PricewaterhouseCoopers: Report on investment activity 2001.

Qualitative evidence

2.21 The quantitative evidence above is backed by interview-based research conducted in 2000, which suggested that the UK is unique in the nature of its equity gap, with a tendency for investment sizes to increase over time.[18] The equity gap was estimated to be particularly acute in the range between £375,000 and £900,000 in the UK. Relative to other countries surveyed, the evidence for an equity gap was seen to be stronger and its estimated size greater.

2.22 Even in areas of the country where funding sources are more numerous, problems remain in accessing small amounts of equity or mezzanine funding. As many as 90 per cent of businesses that had sought advice from the St John's Innovation Centre in Cambridge were unable to attract equity investors.[19] Of those firms it identified as seeking equity, it estimated that 45 per cent had viable business propositions.

2.23 Many of these firms offered good growth potential, but were unable to realise that potential because investors either needed even greater growth prospects to offset the transaction costs associated with the deal, or were unable properly to assess the firms' technologies. For a number of these firms, mezzanine finance[20] might have been appropriate, but they were unable to structure deals in that way.

2.24 More generally, capital market imperfections may affect firms in high-technology sectors more acutely due to the skewed nature of returns,[21] greater informational asymmetries for investments that embody new knowledge[22] and their limited collateral value. Despite these difficulties, innovative high-technology firms as potential pioneers in new markets offer the prospect of very high returns to investors.

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

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?

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

[18] Harding, *Plugging the Knowledge Gap: an international comparison of the role for policy on the venture capital market, policy in enabling entrepreneurship*, Venture Capital, Vol. 4, No. 1, 2002.

[19] St John's Innovation Centre, *Funding problems Facing Early Stage Businesses in the Cambridge Sub Region*, (unpublished)

[20] Mezzanine finance is a term used to refer to certain forms of junior debt finance. The lender will frequently retain a right to share in the success of the firm through equity participation, and the debt is senior to common equity in the event of business failure.

[21] Harhoff, D, *Are there financing constraints for innovation and investment in German manufacturing firms?* Annales d'Economie et de Statistique, no 49/50, June 1998.

[22] Carpenter, R. & Petersen, B. *Capital Market Imperfections, High-Tech Investment, and New Equity Financing*, The Economic Journal Vol. 112, 2002.

CONCLUSIONS

2.25 Access to finance, in particular bank finance, has improved for the majority of businesses, in large part reflecting the improved macroeconomic environment. For the small subset of small businesses looking for finance to support fast growth, equity finance is often needed alongside, or instead of, debt. While informal sources of finance are an increasingly important source of smaller sums of risk capital, evidence of an equity gap, estimated at being between £250,000 and £1 million, remains; its exact size depending on sector, stage of development, region and round of funding. The factors deterring small equity investments, such as the largely fixed costs of due diligence, continue to apply during periods of buoyant equity markets, suggesting that this is a structural rather than a cyclical problem.

3 Impact of Existing Interventions

The Government has implemented a range of targeted measures, each designed to tackle a specific part of the funding gap identified in Chapter 2. The Small Firms Loan Guarantee provides support for debt finance where businesses lack the necessary collateral or track record to obtain a loan. The Enterprise Investment Scheme and Venture Capital Trusts offer tax incentives to support investment in early-stage businesses affected by the finance gap, and Regional Venture Capital Funds and other specialist venture capital funds provide further support for smaller-scale equity investments. The Government is also exploring ways to raise levels of awareness of, and effective demand for, the various financing options available to new and growing SMEs.

Each of these schemes plays an important role in bridging the finance gap, and this chapter examines the scope to enhance further their efficiency and effectiveness. It concludes that there may be a need for additional steps to ensure an adequate flow of funds to start-up and early-stage businesses seeking sums of equity finance that are too large for most individual business angels, but too small to attract interest from mainstream venture capital investors.

OVERVIEW OF EXISTING GOVERNMENT INTERVENTIONS

3.1 The previous chapter concluded that, although finance markets in the UK are well developed and generally function effectively, problems in accessing risk capital in amounts below £1 million appear to persist. This chapter shows how the Government is working to address the finance gap through a number of targeted measures, but concludes that existing interventions may be insufficient to address the gap fully.

3.2 The Government's approach to ensuring an adequate supply of finance is based on targeted action to correct or compensate for market failures. Specific measures are designed to harness rather than stifle market forces, for example by working through private-sector intermediaries that operate using commercial criteria. The resulting incentive structures direct government support towards those business propositions with real prospects of success, and help to ensure that government support complements, rather than competes with, private sector provision.

Debt finance

3.3 The **Small Firms Loan Guarantee (SFLG)** is targeted at new and established firms throughout the UK which have viable business propositions but are unable to obtain debt finance due to a lack of collateral or track record. The SFLG is operated by commercial lenders alongside their existing products, and provides guarantees for over 4,000 business loans every year.

Tax measures

3.4 The **Enterprise Investment Scheme (EIS)** provides tax incentives for individuals, including business angels, to invest directly in higher-risk small trading companies. The **Venture Capital Trust (VCT)** scheme offers tax incentives to individuals investing in professionally-managed portfolios, known as VCTs, which can invest sums of up to £1 million a year in qualifying businesses. VCTs can supply funds alongside other investors, so the overall amount of capital raised by each investee company can be much higher than the £1 million upper limit that applies to an individual VCT. The **Corporate Venturing Scheme** provides incentives for non-financial companies to invest in small trading businesses.

3.5 Evidence from the US shows that reductions in capital gains tax (CGT) encourage entrepreneurship and increase the demand for venture capital assets.[1] In the UK, the Government has introduced **CGT taper relief** to promote investment in business assets. A higher-rate taxpayer realising the gains on shares in an unlisted trading company held for at least two years now pays CGT at an effective rate of just 10 per cent, making the UK CGT regime one of the most favourable in the industrialised world.

Public-private funds

3.6 **Regional Venture Capital Funds** have been set up across England. These will invest a total of up to £270 million in SMEs with growth potential, backed by up to £80 million of government funding. 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. The **Early-Growth Funding Programme** complements the regional funds by providing smaller amounts of risk capital, averaging around £50,000, for start-up and early-stage businesses.

Technology funds

3.7 Recognising that the long lead times and uncertainties associated with investment in technology-based firms may lead to particular problems in accessing funding, the Government also supports the **UK High-Technology Fund** – a 'fund of funds' supporting early-stage high-technology businesses across the UK. The Government acts as 'cornerstone' investor, leveraging over £100 million of additional private sector investment. Complementing this fund, the **University Challenge Fund** provides capital for early-stage financing to enable universities to develop business proposals and spin-off companies. It aims to strengthen public-private partnerships by supporting the transfer of science, engineering and technology research to commercial application.

Access to finance in disadvantaged areas

3.8 The Government is taking further targeted action to improve access to finance for small businesses in disadvantaged communities. This approach recognises the additional barriers that these businesses often face in raising funds from external sources, and the potential for increased levels of business activity to make an important contribution to providing greater opportunity and prosperity within these communities. The Government has therefore invested £20 million in the **Bridges Community Development Venture Fund**, which will invest in businesses in the most deprived wards across England. In addition, Budget 2003 confirm that the first eleven community development finance institutions have been accredited for **community investment tax relief**, enabling them to raise around £35.5 million of new capital for onward lending to small businesses and social enterprises in disadvantaged communities across the UK.

[1] Gompers, P. & Lerner, J., *What drives venture capital fundraising?* National Bureau of Economic Research working paper 6906, 1999.

The remaining challenge

3.9 Each of the existing measures outlined above makes an important contribution to addressing different elements of the funding gap, and this chapter explores the potential for further improving the effectiveness of some of these schemes. As outlined later in this chapter, these supply-side measures are being complemented by steps to raise awareness of and effective demand for risk capital. The chapter concludes that there may be a remaining need for an innovative, demand-led approach to meeting the shortage of smaller-scale, early-stage risk capital identified in Chapter 2.

SMALL FIRMS LOAN GUARANTEE

3.10 Small businesses use traditional debt finance for a number of reasons, notably to finance working capital and investment expenditure.

3.11 Evidence presented in Chapter 2 suggests that the availability of debt finance for SMEs has improved since the early 1990s. For small start-ups, banks appear increasingly willing to issue loans below £25,000 without security.[2] Improved financing conditions can in large part be attributed to a more stable macroeconomic environment and lower interest rates. At the same time, significant increases in the value of deposits held in SME bank accounts may have helped reduce their dependence on external finance.

3.12 Accessing debt finance remains problematic for new and existing businesses which lack an established track record or suitable security, but which need to invest for future growth. As set out in Chapter 2, information asymmetries between the bank and the business customer may lead to an under-supply of debt finance. Recognising that not all business owners are able to offer security to help overcome these information problems, the Government offers guarantees for loans to viable business propositions that cannot offer collateral through the Small Firms Loan Guarantee (SFLG). Since the scheme's launch, over 83,000 loans have been guaranteed, worth approximately £3 billion in total.

Independent evaluation of SFLG

3.13 Since its introduction in 1981, four value-for-money evaluations have been undertaken, the last by KPMG in 1998. This evaluation study included: an econometric analysis of the SFLG database, including data on over 60,000 loans; large-scale telephone surveys of borrowers and branch lenders; and in-depth interviews with experts in the field of small business finance.

3.14 The evaluation[3] found that firms offered loans through the scheme face interest rate margins that do not move proportionately in line with base rates. This meets an accepted test for credit rationing, and the evaluation supports the findings of representative bodies that collateral is required for the majority of lending by banks, and that track record continues to be an important factor for bank lending decisions. The evaluation also found that the majority of SFLG loans were additional to those which would have been available without the guarantees, 86 per cent of the firms using the SFLG were growth-orientated, and over half of recipients were using SFLG finance to develop a new product or service.

[2] *Finance for Small Firms, A Ninth Report*, Bank of England, 2002.

[3] *Evaluation of the small firms loan guarantee scheme*, KPMG, 1999, www.dti.gov.uk/about/evaluation.

3.15 The evaluation recommended a number of improvements to the SFLG, including:

- equalising the guarantee level between start-ups and established businesses;
- opening up the scheme to new lenders;
- developing new publicity material to increase awareness of the scheme among target groups; and
- operational and administrative changes to enhance efficient delivery of the scheme.

3.16 Separately, the Small Business Investment Taskforce (SBIT), the Ethnic Minority Business Forum (EMBF) and the Cross-cutting review of government services for small business4 all recommended that the scheme be expanded to remove sector exclusions where possible.

Recent enhancements to SFLG

3.17 In response to the KPMG evaluation and recommendations by the SBIT and the EMBF, the 2002 Pre-Budget Report announced a package of enhancements to the SFLG. On 1 April 2003, it was expanded to a number of additional business sectors, including retailing, catering and vehicle repair; a single guarantee level was introduced; and the maximum turnover limit for service sector businesses was raised to £3 million per year.

3.18 The changes made to the SFLG were one of the first outputs of the Department of Trade and Industry's review of business support. The Government believes that, in line with practice across the industrialised world, a guarantee mechanism for loan finance should continue to be a key part of government support to promote enterprise. As outlined in Chapter 2, however, debt finance is not always suitable as the only source of finance for businesses seeking to grow rapidly, particularly if returns on investment are not expected for some time. In these cases, equity or quasi-equity finance may often be more appropriate, not simply because of the opportunity for the investor to balance downside risk with a share in the upside potential, but also because equity providers are more likely to provide hands-on support to the businesses in which they invest.

3.19 While the commercial lenders operating the SFLG are an essential part of the business support framework, they are often unable to offer specialist expertise and may lack the skills needed to assess the higher risks and returns associated with equity investments. For these reasons, the Government does not believe that extending the SFLG to provide quasi-risk capital in larger amounts than at present would be the best means of meeting what is essentially an equity gap for high-growth SMEs.

[4] *Cross-cutting review of government services for small business*, Small Business Service/HM Treasury, 2002, www.sbs.gov.uk/crosscutting.

Potential further enhancements to SFLG

3.20 The SFLG continues to play an important role in supporting over 4,000 businesses every year, though its basic structure remains the same as when it was first launched in 1981. The Government recognises that there may be scope for further improvements, building on the package of changes that took effect from 1 April.

New lenders

3.21 The Small Business Service has already announced that it will shortly be inviting applications from new lenders interested in operating the SFLG. The Government is keen to encourage applications from community development finance institutions (CDFIs) and other lenders serving disadvantaged groups. It would therefore particularly welcome views from CDFIs, including those which are already SFLG lenders, on the relative merits of guarantees offered to them at the institutional level through the Phoenix Fund, and guarantees for individual loans offered through the SFLG.

Accessibility, awareness and usage

3.22 The Government is keen to ensure that the SFLG remains as accessible as possible to eligible businesses and lending institutions, and that it continues to form an important part of lenders' portfolios. Smaller or newer SFLG lenders may face different issues to the larger banks when using the guarantee, and the Government is keen to ensure that the SFLG is as responsive as possible to the needs of lenders of all sizes. It would therefore welcome views on how to ensure that the SFLG is available as widely and consistently as possible to eligible businesses, for example by raising awareness of the SFLG or by reducing further its administrative requirements.

3.23 The Government recently moved to allow previous beneficiaries of the scheme to requalify for support, with loans prior to April 1993 no longer counting towards the maximum loan amount. This cut-off date will, in the future, be moved forward one year on an annual basis. A fixed date was chosen rather than alternatives such as a continuously rolling loan limit since, after consultation by the Small Business Service (SBS), the complexities of the latter approach were felt to outweigh its benefits. Nevertheless, the Government recognises that the average business has a lifespan of only four years, and that these 'business churning' effects can play an important role in driving productivity growth. Accordingly, the Government invites views on whether the current cut-off arrangements are appropriate.

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?

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

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

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?

Q3.5 Is there merit in further amending the 10-year cut-off for considering previous SFLG borrowing?

ENTERPRISE INVESTMENT SCHEME AND VENTURE CAPITAL TRUSTS

Overview of the schemes

3.24 The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) provide tax incentives to encourage the supply of equity finance by individuals to smaller, higher-risk, unlisted trading companies.[5] The EIS provides tax reliefs to investors in respect of direct equity holdings in qualifying companies, while the VCT scheme offers incentives for indirect portfolio investments administered by professional fund management companies. Both schemes benefit businesses by encouraging the supply of risk capital that they might otherwise have been unable to obtain. The schemes complement the Small Firms Loan Guarantee by supporting investments in SMEs where, for reasons outlined in Chapter 2, equity-based investment is more suitable than debt lending. The principal features of the two schemes are outlined in Box 3.1.

[5] As well as unquoted companies, trading companies quoted on the Alternative Investment Market (AIM) and 'off exchange' (OFEX) attract EIS and VCT reliefs. The trustees of certain trusts are also eligible for EIS deferral relief.

Box 3.1: Key features of EIS and VCT[1]

	Enterprise Investment Scheme	Venture Capital Trusts
Summary of schemes	• Individual investors subscribe directly for shares in an EIS-eligible company	• Individual investors subscribe for shares in a VCT - a quoted, professionally-managed company which invests in qualifying companies
Tax reliefs	• 20 per cent 'front-end' income tax relief on investments in EIS shares • exemption from capital gains tax (CGT) on disposal of EIS shares • unlimited CGT deferral where chargeable gains on other assets are invested in EIS companies	• 20 per cent 'front-end' income tax relief on investments in VCT shares • exemption from capital gains tax (CGT) on disposal of VCT shares • CGT deferral where chargeable gains on other assets are invested in new VCT shares up to £100,000 in any tax year
Limits and restrictions[2]	• income tax relief on most losses on EIS shares • shares must generally be held for at least 3 years for EIS income tax relief to be retained • EIS income tax relief limited to investments of up to £150,000 per tax year • the investee company's gross assets must be no more than £15 million before the investment, and no more than £16 million afterwards • funds must be employed by the investee company within 12 months	• VCT dividend payments exempt from income tax • shares must be held for at least 3 years for VCT income tax relief to be retained • all VCT reliefs limited to investments of up to £100,000 per tax year • the investee company's gross assets must be no more than £15 million before the investment, and no more than £16 million afterwards • 70 per cent of investments by the VCT must be in newly-issued securities in eligible companies • a VCT may invest no more than £1 million per year in any company • companies issuing shares to a VCT must be unlisted (companies quoted on AIM and OFEX are eligible) • the VCT may not hold more than 15 per cent of its investments in any single company

[1] Full details of the schemes may be found at www.ir.gov.uk.

[2] Investee companies must also satisfy certain qualifying conditions throughout a three-year period in order for most EIS and VCT reliefs to be retained.

Sums invested through EIS and VCT (£ million)

	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	Total
EIS	4	41	53	94	113	290	559	1,039	**2,193**
VCT	-	-	160	170	190	165	271	451	**1,407**

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

Independent research into the schemes

3.25 The results of independent research into the operation of the EIS and VCT schemes are being published alongside Budget 2003, and details can be found on the Inland Revenue website.[6] The research endorses the schemes, finding that:

- the rationale for the schemes was valid during the period considered by the research;
- the schemes play a significant and growing role in the supply of private equity funds in the UK;
- the schemes appear to be reasonably effective in targeting the companies for which they were intended;
- the schemes are associated with important supply-side gains, a substantial proportion of which would not have arisen in the absence of the schemes; and
- the substitution and displacement effects associated with the schemes appear to be moderate.

3.26 The research also demonstrates that, while both schemes are successful in targeting companies with significant growth ambitions, the EIS and VCT provisions mainly support two separate segments of the market. It finds that:

- EIS investee companies are typically younger, smaller businesses seeking start-up or early-stage finance, with half of all EIS companies raising less than £100,000 through the scheme; and
- VCT investee companies are typically larger, more mature businesses, raising much larger amounts of capital. They have raised an average of over £1.5 million (or a median of £900,000) through the scheme. Almost a third of investee companies are quoted on the Alternative Investment Market (AIM) or 'off exchange' (OFEX), and around a fifth used the scheme primarily to finance a management buy-out (MBO) or buy-in (MBI). This is consistent with the view that VCTs, being marketed to the retail investor community, tend to adopt more conservative investment strategies than EIS investors, preferring companies with an established track record and positive cash-flow.

3.27 Having considered the report, the Government believes that there may be opportunities to improve the cost-effectiveness of the schemes while continuing to meet their objectives. The following section therefore considers a range of potential options for reform to the EIS and VCT schemes.

[6] *www.inlandrevenue.gov.uk/research/index.htm.*

Options for reform to EIS and VCT

THEME 1: Enhancing the focus of the VCT scheme to meet policy objectives

3.28 At present, there is no constraint (other than the gross assets test) on a VCT investing alongside other VCTs, or other private investors. This means that VCT funds can be used to support investments that, in total, exceed the £1 million upper limit on the amount an individual VCT can invest in a single company each year. Indeed, according to one survey, over 30 per cent of VCT investee companies have raised more than £2 million in private equity, and around 9 per cent have raised more than £5 million.[7] In some cases these funds will have been raised through a number of funding rounds, but some investment deals in which VCTs participate still appear to lie beyond the waterfront of the equity gap.

Enhancing the focus of the scheme

3.29 The targeting of the VCT scheme towards smaller, early-stage investments could be enhanced in a number of ways. For example, the scheme rules could place restrictions on VCTs forming part of an investment syndicate that collectively invests beyond the £1 million upper investment limit. Alternatively, VCT investments in more mature companies, or in businesses seeking to finance MBOs and MBIs, could be restricted. While the Government recognises the economic benefits that these activities provide, it is less clear that there is a market failure in the flow of finance to such deals.

3.30 These measures might have little effect on the companies excluded, as it is likely they would be able to obtain the finance from alternative sources, but could alter the risk-return profile of VCTs. If there were clear evidence that this would reduce the attractiveness of investment in VCTs, there might be a case for enhancing the tax reliefs at the same time as tightening the scheme's focus.

A 'two-tier' incentive structure

3.31 Another approach might be to adopt a 'two-tier' incentive structure, in which investments in VCTs that supply capital to larger or more mature companies would attract less tax relief than those investing only in smaller or younger businesses, better reflecting the lesser market failure. This could provide an alternative to withdrawing all relief for larger, later-stage investments, but would introduce a significant additional layer of complexity to the scheme and could risk confusing potential investors. Problems might arise if a VCT started out with ambitions to obtain the higher tier of tax relief but ended up having to settle for the more modest tier.

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?

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?

[7] *The economic impact of VCTs in the UK*, British Venture Capital Association, 2003.

THEME 2: Encouraging business angel syndication

3.32 Chapter 2 noted the important contribution of business angel investors in supplying small sums of early-stage risk capital. Nevertheless, the UK angel sector remains significantly less developed than that in the US, with individual angels typically investing less frequently and in smaller sums.

3.33 Evidence suggests that a large proportion of UK business angels would be willing to invest additional funds in smaller growth businesses, but are constrained by the time required and by the difficulties identifying suitable deals.[8] Business angel networks, including the government supported National Business Angel Network, play an important role in matching investors with businesses. More widespread angel syndication in the UK would allow business angels to make larger investments, helping to narrow the equity gap. It would also permit an increase in *overall* business angel investment, by:

- allowing individual investors to reduce their risk exposure by spreading investments across a more diverse portfolio of companies;
- allowing syndicate members to share expertise, information and contacts. When investing alone, many business angels prefer to invest only in activities or sectors with which they are familiar. Participation in a syndicate would enable angels to invest with greater confidence in a wider range of businesses; and
- providing an entry route for new or inexperienced business angels. There is a significant learning curve associated with appraising and managing investment opportunities, and angel syndication provides a means for novice angels to gain investment experience while taking on less risk than if investing alone.

Structured angel groups

3.34 The Government is keen to explore ways to support the development of structured angel groups, which have aided the development of more efficient and effective markets for business angel capital in the US in recent years (see Box 3.2). The structured angel group model captures the benefits of syndication, while still allowing individual angels to play an active role in selecting and managing specific investments – a strong motivation for many angels.

3.35 A key feature of structured angel groups in the US is their limited liability company structure, which offers significant administrative advantages for investors and businesses. In the UK, the EIS provides tax incentives for collective investment through Approved Investment Funds (AIF).[9] However, the AIF provisions have not been widely used, largely because they cannot accommodate a limited liability partnership structure.

[8] *Barriers to investment in the informal venture capital sector*, Mason, C.M. & Harrison, R.T., paper presented to the 21st Babson-Kauffman Foundation Entrepreneurship Research Conference, Jönköping International Business School, Sweden, 13-16 June 2001.

[9] AIFs offer greater administrative simplicity to investors claiming tax reliefs in respect of multiple investments. In addition, income tax relief may be carried back to the tax year in which the Fund closes, rather than the tax year in which individual investments are made, if 90 per cent of the Fund is invested in qualifying companies within six months of closing.

Box 3.2: Structured angel groups in the US[1]

The emergence of structured business angel groups in the US has contributed to greater efficiency and increased investment activity in the US angel sector. Prior to the emergence of structured groups, even the most sophisticated business angels would typically learn of investment opportunities by word of mouth, with no regular stream of business proposals to assess. Structured groups have therefore provided a more formal framework for novice and experienced angel investors alike.

A typical structure in the US is a limited liability company (LLC) managed by a general partner, with individual business angels as members of the LLC. The LLC typically employs one or more individuals, who are responsible for pre-screening applications from investee companies, for arranging presentations and for enforcing the group's policy on admission of new investors. Most groups insist that their investors meet the US Securities and Exchange Commission's requirements for an accredited investor.[2] Group members play a key role in assessing the quality of applications for investment, in carrying out due diligence, and in monitoring and mentoring businesses once investments have been made.

This approach provides the various advantages of angel syndication set out in paragraph 3.33. It is more flexible than a VCT, as the angel groups do not need to be quoted on public markets, and offers advantages over the current EIS Approved Investment Fund provisions by allowing an LLC framework. The approach complements business angel networks, which aim to match angels with suitable businesses, but goes a step further by providing a structure for collective investment.

[1] This Box is based on May, J., *Structured angel groups in the USA: the Dinner Club experience*, Venture Capital, Vol. 4, No. 4, pp. 337-342, 2002.

[2] Accredited investors in the US must meet specific criteria in relation to liquid net worth (greater than $1 million) or annual income ($200,000 for at least two years running, or $300,000 if married).

3.36 The Government recognises that building a sufficiently flexible provision for syndicated angel investments within the constraints of the existing EIS framework could effectively amount to an entirely new scheme, but also recognises that a more accommodating facility to support syndicated investment may help increase activity in this area. Chapter 4 explores the scope for a variant of the US Small Business Investment Company model to provide such a structure in the UK.

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 attract additional funds for investment in SMEs?

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?

[10] *The Enterprise Investment Scheme*, CBI/BDO Stoy Hayward, 2000.

THEME 3: options for simplification and enhanced flexibility

3.37 Following a report issued by the CBI in December 2000,[10] the Government has sought to improve the operation of the EIS and VCT provisions. It has established specialist EIS and VCT units within the Inland Revenue, and has made a number of improvements to the schemes. The Government remains keen, however, to receive further proposals that would make the EIS and VCT schemes easier to use and administer, while ensuring that they remained true to their objectives of making additional risk capital available to smaller businesses that would otherwise face the greatest difficulties in accessing funds.

Simplifying the tax incentives

3.38 The EIS and VCT provisions currently incorporate a number of tax incentives, including front-end income tax relief and the opportunity to defer capital gains tax (CGT) liabilities arising from other assets. It is envisaged that, by virtue of the variety of tax incentives available, the schemes should appeal to as many potential investors as possible.

3.39 A simpler approach to both schemes might actually be more attractive to a wider range of investors. Options might include removal of the CGT deferral element of the schemes, or replacement of the exemptions for gains on EIS and VCT shares by business assets taper relief. At the same time, the level of front-end income tax relief could be enhanced to maintain the overall level of incentive provided by the schemes. Removing the CGT deferral element could also reduce the volatility of the flow of funds into the schemes, since the importance of CGT deferral to investors clearly varies according to whether they have significant capital gains to defer.

3.40 A potential drawback of this approach is that some investors are primarily attracted by the CGT deferral element of the schemes. It is unclear whether enhanced front-end income tax relief would be sufficient to maintain the attractiveness of the schemes to these investors in place of CGT deferral.

The minimum investment period

3.41 A further option might be to reconsider the requirement that shares should be held for a minimum of three years in order to qualify for front-end income tax relief. While a strong incentive for longer holding periods is desirable, not least to minimise the scope to use the schemes for tax avoidance purposes, a strict three-year rule may be overly restrictive. As an alternative to the current approach, the income tax relief mechanism could be structured in a similar way to community investment tax relief, which offers income tax relief of 5 per cent a year for up to five years (i.e. a total of up to 25 per cent, providing the investment has been held for the full term).

3.41 If it adopted this approach, the Government would need to strike a balance between investors' appetite for 'front-end' tax relief, and the need to preserve a strong incentive for longer-term holding. Different levels of relief might be offered in successive years to achieve this. However, the Government recognises that spreading the income tax relief over a number of years might reduce the simplicity of the schemes for its users.

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 would represent welcome simplifications, and why? How else could the schemes be simplified without compromising their objectives?

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

REGIONAL VENTURE CAPITAL FUNDS

3.43 Regional Venture Capital Funds (RVCFs) were introduced to improve the supply of sums of risk capital that were beyond the usual scope of informal investors. RVCFs may invest up to £250,000 in the first round, with the option of a further round of £250,000 after six months. The Government welcomes the progress that the Funds have made to date, and the role they will play in helping to fill the lower end of the finance gap over the next three to five years.

3.44 While the Funds have only recently begun to make their first investments, they are time-limited by design. One of the key objectives for the Funds is to demonstrate the potential returns that can be made on smaller-scale equity investments, and so to encourage private sector investment into that part of the market.

3.45 Building on this demonstrative effect, the Government is keen that any future interventions should be put on a sustainable, demand-led footing, by creating incentives for private-sector investors to generate their own funds to meet the finance gap. Nevertheless, there may be an ongoing need for action on the supply side in areas where early-stage finance is scarce. The strength of the case for future RVCF-type funds is likely to vary from region to region, and needs will best be assessed by Regional Development Agencies as part of their Regional Economic Strategies.

3.46 Regional Funds do not tackle the finance gap between £500,000 and £1 million. The Government does not believe that it would be appropriate to relax the investment limit for these existing funds, as this would risk diverting funds away from sub-£500,000 investments, where problems in accessing risk capital are also acute. As the next chapter outlines, the Government is interested in views on the benefits of introducing a variant of the US Small Business Investment Company programme, which could provide a source of follow-on funding for investments made by the Regional Funds, and an exit route for these Funds to realise the gains on their investments.

DEMAND-SIDE MEASURES

Investment readiness

3.47 As important as obstacles to equity finance on the supply-side are factors restricting effective demand for risk capital. A key problem is that smaller businesses in the UK are less aware of the possibilities of different forms of risk finance than their US counterparts, and are sometimes unable to prepare a sufficiently well-presented and persuasive business plan to attract funding.[11] The Government is concerned that many business advisors are also unaware of the options open to their clients, and are not qualified or able to help SMEs take full advantage of the options available to them. Some small business owners are put off seeking equity finance because, despite the potential growth benefits, they fear it will mean giving up control of the business to the investor. While this is a legitimate factor to consider, it needs to be set against the range of benefits, not least management and mentoring support, that equity finance can bring.

[11] Mason, C.M. & Harrison, R.T., *Barriers to investment in the informal venture capital sector,* paper presented to the 21st Babson - Kauffman Foundation Entrepreneurship Research Conference, Jönköping International Business School, Sweden, 13 - 16 June 2001.

3.48 The Government is currently running six 'investment readiness' demonstration projects providing intensive education to SMEs, to raise their awareness and understanding of the various financing options available and how best to access them. The Government will consider the results of these projects carefully in determining how best to move forward in this area. Business advisors, accountants and other intermediaries play a key long-term role in making businesses 'investment ready'. Recognising this, the Government will be working together with the accountancy profession and small business representative groups to consider what more could be done to drive up the quality of financial advice available to SMEs.

Incidental costs of equity finance

3.49 As well as needing to consider the pros and cons of equity finance and the difficulties in accessing it, businesses also need to take account of the up-front costs of raising finance. At present, the incidental costs of raising debt finance (such as professional fees) are tax deductible, whereas this is not the case for equity finance. Informal consultation in 2001 showed that this is unlikely to be a decisive factor in most cases, but the Government would be interested in wider views on whether current tax treatment represents a further obstacle to SMEs seeking equity finance.

3.50 If relief were to be offered, the Government would want to limit it to SMEs which face particular difficulties in raising equity finance, so meeting the twin aims of simplicity and the cost-effective targeting of any relief.

3.51 For accounting purposes, the incidental costs incurred in raising debt finance are spread over the lifetime of the loan, and the tax relief is received over the same period. However, equity does not have a predetermined lifetime, and the incidental costs of raising equity finance are not written off for accounting purposes. Giving full relief for the incidental costs of equity in the year of issue would be inconsistent with the treatment for debt. If a relief was introduced, the Government would want to spread it over a fixed period, and would welcome views on what an appropriate period would be.

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?

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

CONCLUSIONS

3.52 Existing government measures each play an important role in addressing different parts of the finance gap. The Government believes there may be scope to make them more effective, and a number of possible options have been raised in this chapter. Nevertheless, as suggested by the evidence presented in Chapter 2, there may be a need for additional support for start-up and early-stage businesses that are seeking risk capital in sums that are too large for most individual business angels, but too small to be of interest to mainstream venture capitalists. Existing provisions may be insufficient for these businesses, because:

- the businesses are seeking equity finance, so the SFLG scheme is not appropriate;
- most business angels do not invest at these levels through EIS, unless as part of a syndicate alongside other investors, and the extent of collective angel investment in the UK may be constrained by existing tax and regulatory rules;
- a large proportion of VCT funds are invested in more mature companies with an established track record and positive cash-flow; and
- RVCFs are time limited, and are targeted towards smaller investments.

3.53 While proposed enhancements to existing schemes have the potential to improve their effectiveness in meeting their individual objectives, the Government believes that a more wide-reaching and flexible structure may be needed, alongside existing initiatives, to attract a range of investors with an appetite for smaller-scale early-stage investment. Chapter 4 outlines the US Small Business Investment Company model, and examines the scope to introduce a variant of this approach in the UK, recognising that the legal, cultural, financial and regulatory environments in the two countries are very different.

4 Small Business Investment Companies

Small Business Investment Companies (SBICs) have played a central role in stimulating the development of private sector venture capital activity in the US, and are an important part of the US Federal Government's strategy for tackling the equity gap. Under the programme, government guarantees allow SBICs to borrow money at low rates on the capital markets, which they use alongside privately raised capital to invest in US small companies. The borrowed money increases the return private investors are potentially able to make.

This chapter seeks views on whether a variant of the SBIC programme might similarly help UK small and medium-sized enterprises (SMEs) achieve their growth potential by improving the availability of and access to risk capital.

INTRODUCTION

4.1 The Government is considering whether to adopt a variant of the US Small Business Investment Company (SBIC) programme, which has been very successful in addressing the equity gap in the US. SBICs could potentially improve the availability of risk capital to UK SMEs, by:

- **offering investors enhanced returns** through favourably priced loans, or 'leverage', to invest alongside their private capital, so helping to offset the factors that reduce the attractiveness of small investments to commercial venture capital providers;
- increasing the **supply of risk capital managers** that specialise in smaller investments, by reducing the minimum amount of private capital needed for a viable fund;
- **enhancing the impact of business angels** on a demand-led, market-driven basis; and
- offering a flexible framework within which **local and regional networks** can match public and private capital with their investment expertise in a cost-effective manner.

Summary of how US SBICs work

4.2 In the US, participating security SBICs are private companies that combine privately raised capital with government-guaranteed leverage and invest the funds in small US companies. As the investments grow, and the SBIC makes a profit, the SBIC repays the leverage and interest, then repays the private investors' capital, before sharing any remaining profits between the Government and the investors. The Government's profit share is designed to offset losses on SBICs that do not recoup enough on their investments to repay the Government-backed leverage. This allows the programme to be self-financing over the medium term. Where an SBIC does lose money, it is the private capital that is at risk of first loss.

Success in the US

4.3 The SBIC programme has been credited with being one of the key drivers of the development of a robust venture capital industry in the US. As Box 4.1 shows, the programme has been particularly successful since 1994, when the participating securities SBIC model was launched.

Box 4.1: The impact of the SBIC programme in the US

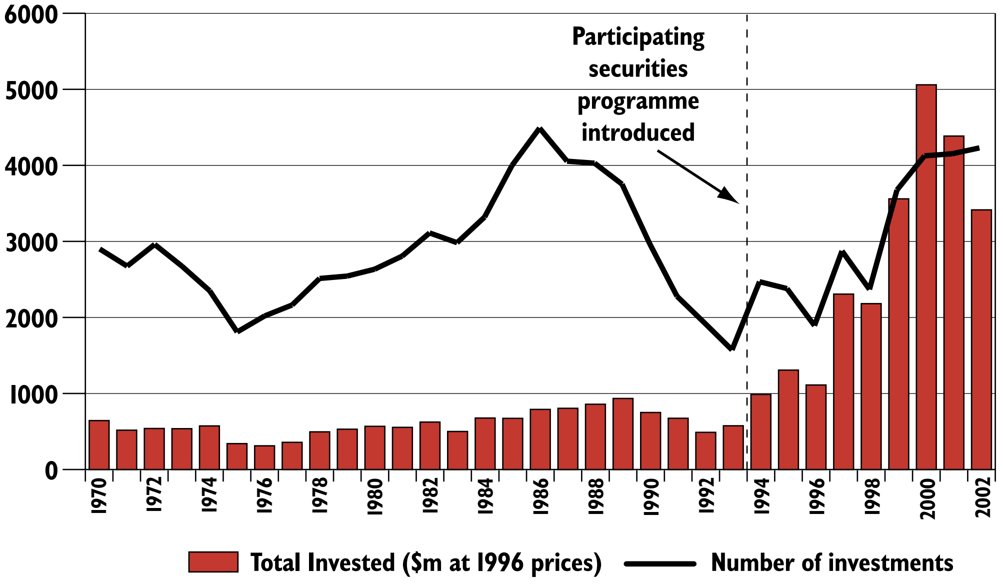
The US SBIC programme was launched with the passing of the Small Business Investment Act of 1958, to provide financing and management assistance to small entrepreneurial companies in the US. SBICs rapidly established themselves as a key source of risk capital for small businesses.

In 1992, new legislation introduced a new 'participating securities' SBIC model, which allowed SBICs to defer repayment of the interest and capital until they had generated sufficient cash-flow to service the debt. Deferral allows SBICs to focus on making equity investments in younger, pre-revenue companies, where there may be no prospect of an immediate cash return on the investment, but where the longer term prospects are good. In return, SBICs using this model were required to share some of their eventual profits with the SBA.

This change is perceived to have been a major success. By 2002, SBICs represented 58 per cent of venture capital investments to SMEs[1] and, in comparison with the rest of the US venture capital industry, were investing comparatively small amounts in small companies: the type of investment most constrained by the equity gap in the UK.

The impact of the scheme is illustrated in the following three charts. Chart A illustrates the number and size of SBIC financings over the past thirty years:

Chart A: SBIC investments in US small businesses since 1970



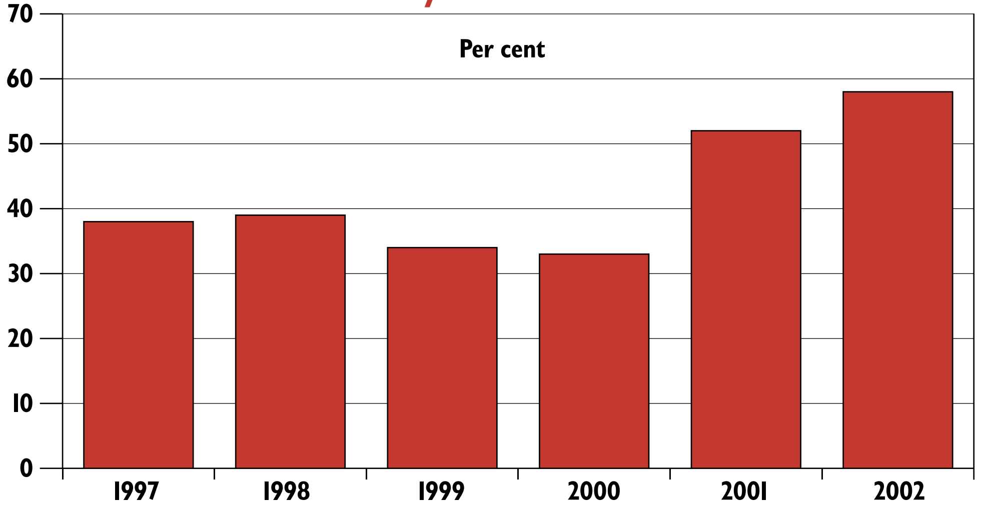
Source: SBIC statistical package 2003, Small Business Administration.

[1] Investments by number. In 2002, SBICs represented 11 per cent of the dollar amount of venture capital financing to small businesses.

Source: Small Business Administration.

Chart B illustrates the importance of the SBIC programme in the provision of venture capital to US small businesses, particularly during the recent economic downturn:

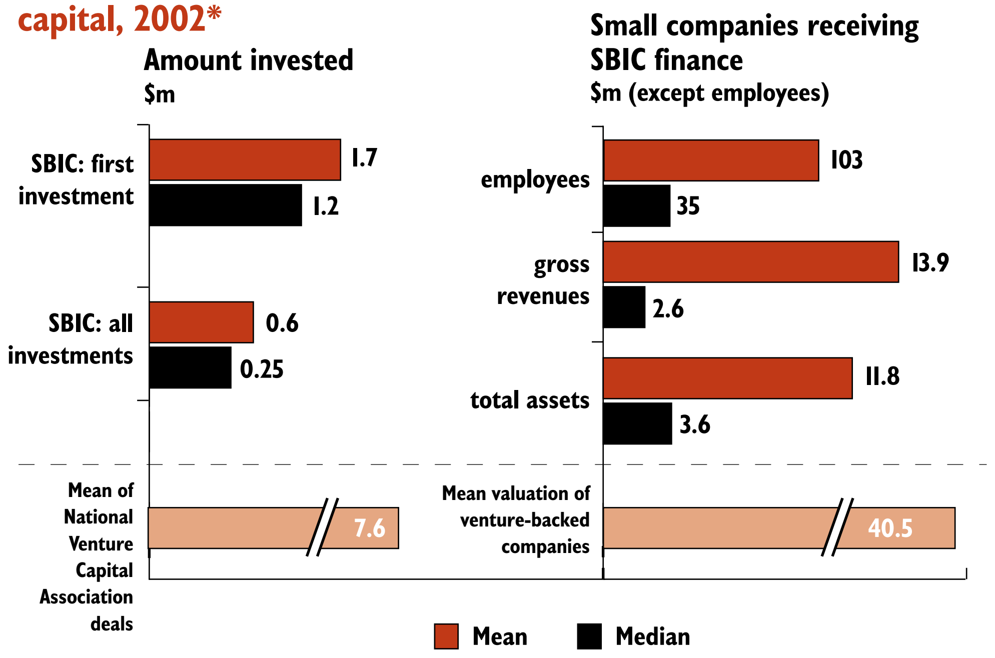
Chart B: Proportion of total venture capital investments in small businesses made by SBICs*



*Number of investments. In 2002, SBICs represented 11 per cent of the dollar amount of investment in small companies. Excludes debt-only SBIC investments.
Source: SBIC Statistical Package 2003.

Comparing the amount invested and the profile of recipient SMEs to the pattern of investments by the US venture capital industry as a whole, Chart C shows that the SBIC programme has succeeded in targeting smaller companies needing more modest amounts of equity:

Chart C: Comparison of SBICs with mainstream US venture capital, 2002*



* Participating security SBICs only; fiscal year 2002 (Oct 2001 – Sept 2002).
Source: SBIC Statistical Package 2003, NVCA deals (average for fiscal year 2002) from www.nvca.org; valuations from PricewaterhouseCoopers Moneytree Survey 2002.

4.4 Clearly, the US model could not be introduced in the UK without taking into account the legal, cultural, financial and regulatory differences between the two countries. The Government is therefore keen to consult on what aspects of the US model would be appropriate to the UK market, and whether there may be other mechanisms to achieve the objectives set out in paragraph 4.5. The results of this consultation, along with affordability considerations, will help to inform any Government decision on whether to develop an SBIC programme.

OBJECTIVES AND PRINCIPLES

SBIC objectives

4.5 The overall aim of a UK SBIC programme would be to improve access to appropriate risk capital for new and early-growth SMEs. To achieve this, it would have the following objectives:

- **self-finance** over the medium term;
- support an increased flow of **new fund managers** entering the early-stage venture capital market;
- attract more '**entrepreneurial investors**' to this section of the market, for example by promoting business angel syndication;
- provide **flexibility** to invest both equity and mezzanine financing;
- put in place a **demand-driven model**, with the scope to be rolled out on a **national basis** and to be targeted at disadvantaged areas or groups once established; and
- increase **mentoring and support** provided to SMEs.

4.6 In designing a strategy to achieve these objectives, the Government believes it should adhere to the following principles:

- **minimise impact on existing private sources of finance**, by targeting subsidies proportionately at areas of identified market failure and ensuring uptake is demand-led;
- **provide value for money and protection of taxpayer interests**, by ensuring that investment decisions are taken on a commercial basis, and that any government support is the least necessary to encourage private capital into the area affected by market failure; and
- **complement existing government measures** to tackle the finance gap.

Local networks

4.7 When looking at ways to develop the market for smaller equity investments, the Government recognises the importance of local networks in providing sustainable sources of risk capital and expertise to SMEs. Local networks of business angels, both formal and informal, have played an essential role in closing the finance gap in the US. Drawing on this experience, leverage provided to an SBIC would directly support a local network of 'entrepreneurial investors', and so would maximise the impact of successful investment strategies.

Devolved countries

4.8 For the purposes of this paper, the Government refers to a possible UK SBIC programme. Aspects of the market failures outlined in earlier chapters affect all parts of the UK, including Scotland, Wales and Northern Ireland. However, it will be for the devolved administrations to decide what policies they wish to pursue, reflecting their own circumstances and priorities. If implemented, an SBIC programme could be rolled out on a UK-wide basis, or restricted to England with the devolved administrations choosing to address specific market failures in their countries through alternative measures. In taking forward any proposals from this consultation, the Government would consult the devolved administrations in the normal way.

Fit with existing schemes

4.9 Although the existing interventions outlined in Chapter 3 are successful in their target segments of the equity gap, the Government believes SBICs would complement them by addressing the remaining affected area:

- Small Firms Loan Guarantee (SFLG): there would be minimal overlap as the SFLG supports debt lending (sometimes as part of a funding round involving equity) rather than equity or mezzanine investment;
- Regional Venture Capital Funds (RVCFs): SBICs could provide an exit route for RVCF investments; and
- Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs): as set out in Chapter 3, an SBIC programme would complement these schemes – it would stimulate investment in different companies. The EIS is used by individual investors making investments that are generally below £250,000, and often less than £100,000. VCTs can syndicate to invest in amounts in excess of £1 million. SBICs would be targeted at the equity gap in between, and would not raise funds from retail investors who are the predominant users of VCTs.

Increasing the pool of fund managers

4.10 An efficient capital market requires not only a proper supply of finance, but a sufficient pool of fund managers who are able to find, select, negotiate, support and mentor, and finally exit investments. The obstacles to making smaller investments (described in Chapter 2) have resulted in an increase in the typical investment size that fund managers target, and a reduced pool of fund managers actively seeking to make smaller investments in early-stage companies. The Government is keen to increase the flow of fund managers specialising in smaller investments, in order to:

- **promote competition** between funds for the best deals, ensuring a good geographical spread of sources of funding and driving down the cost of risk capital to SMEs; and
- ensure that as managers become more successful, raise larger funds and move on to invest in larger companies, there is a **flow of new entrants** to replace them at the lower end.

4.11 New fund managers, lacking a track record, may be able to raise only a relatively small fund, for example drawing on their own money and personal connections. The Government would aim to attract such entrepreneurial investors to the smaller end of the venture capital market by offering support (in the form of leverage) to increase the viability of their funds. If their first fund proved successful, the fund managers would then find it easier to raise a larger second fund on the basis of their newly aquired track record, reducing the need for government support. With a client base and strong track record, venture capitalists could then raise capital without government support, and would no longer need to use the SBIC framework.

Sources of new SBIC managers

4.12 The Government believes there are several possible sources of future SBIC managers who might possess the right skills, including:

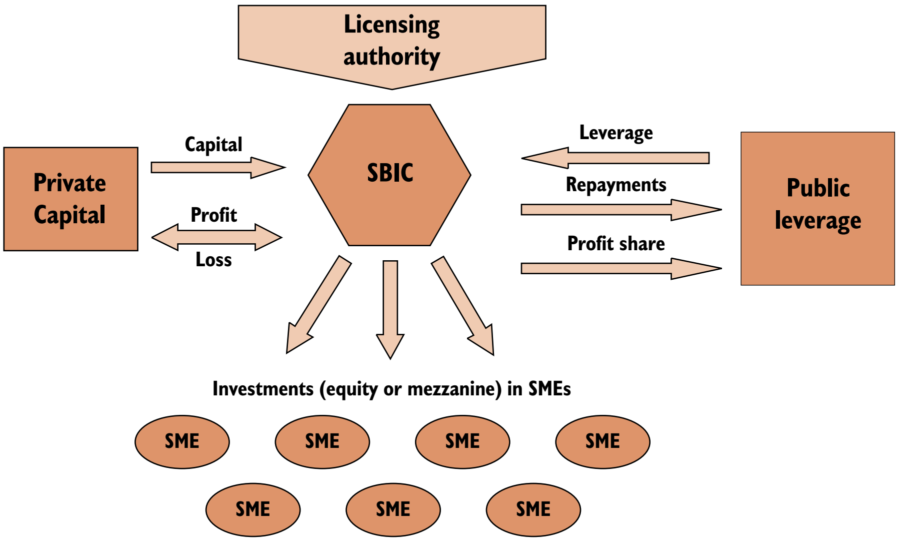
- business angels, particularly those already operating on a quasi-professional basis, managing serial investments, perhaps in a semi-structured syndicate;
- managers of early-stage investment funds overseas who might be looking for new opportunities in the UK, as well as existing UK fund managers (such as junior partners and employees of more established VC firms) who are seeking new opportunities to invest in start-up and early growth businesses;
- corporate finance boutiques: organisations that specialise in advising and putting together finance packages for small growing businesses;
- entrepreneurs who are keen to set up new early-stage funds, but who may not possess the track record to raise sufficient funds from private investors to make a new fund viable;
- business incubators with experienced management and a track record of providing value-added support to client SMEs; and
- community development finance institutions, which are particularly well placed to serve disadvantaged groups.

Outline of possible UK SBIC model

4.13 The key features of a possible SBIC model in the UK, shown in Figure 4.1 and covered in more depth under the "detailed issues" section, might be:

- **Raising private capital** (for example from high net worth individuals, institutional investors): once a prospective SBIC had raised, or had secured commitments for, the minimum level of private capital, it could apply for an SBIC licence.
- **Borrowing:** when licensed, an SBIC would be eligible to apply for leverage from the Government. The loan would be committed at the time of licensing, but drawn down on a 'just-in-time' basis. The Government would charge interest on the loan at, or close to, gilt rate (i.e. below the rate the SBIC would pay on the commercial markets).
- **Investing:** the SBIC would invest borrowed funds alongside private capital in equity (or as mezzanine financing) in SMEs.
- **Repaying the loan and interest:** SBICs would be able to defer repayments of capital and interest until cash-flow (normally achieved from exiting investments) allowed repayment.
- **Sharing profits:** in return for the Government bearing the increased risk deferral brings, the SBIC would share a proportion of its eventual profits with the Government. The programme would be designed to be self-financing over the medium term, i.e. the Government would offset any losses from unsuccessful SBICs that default against the profit shares received from successful SBICs.
- **Making a loss:** where an SBIC lost money over its portfolio, private capital would bear first loss, before the leverage. Such an approach would mean the private investors had powerful incentives to monitor the SBIC managers, minimising the need for ongoing government monitoring and regulation.

Figure 4.1: How SBICs might work in the UK



4.14 Set against these key features, the Government acknowledges that if SBICs were launched, the incentives they offered would have to be sufficiently attractive to interest private investors. The Government would need to consider the balance between rewarding entrepreneurial behaviour among risk capital providers and managers, and making sure the programme as a whole met the Government's objectives while providing the least support necessary to address the market failure effectively.

4.15 The SBIC model assumes that, in the pursuit of its wider economic objectives, the Government would be willing to bear a level of risk associated with the provision of leverage for equity investments that the market would not be able to assume. This tolerance for risk would be reflected in the 'price' at which the Government could make leverage available to SBICs; the Government would not need to achieve the same level of return on its share as a commercial lender would. The Government's attitude towards risk would also be reflected in its tolerance for capital impairment (where the value of an SBIC's assets is lower than its outstanding debts): the Government would be willing to wait for a longer period than a commercial leverage provider for the SBIC to correct any impairment. An SBIC scheme would therefore allow leveraged funds to be invested in more early-stage companies than would otherwise have been possible.

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?

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?

Targeting disadvantage

4.16 Should the model be found to work successfully, there may be scope for offering additional support to SBICs that target specific disadvantaged areas or groups, for instance by improving the terms of government leverage, or by providing grants to support training or operational assistance. This has been tried with some success in the US, originally with Specialised SBICs and, latterly, the New Markets Venture Capital programme. There may be scope to target SBIC support towards areas where access to risk capital is most difficult, such as the 2,000 Enterprise Areas.[1]

DETAILED ISSUES

Raising private capital

Sources of private capital

4.17 The Government would expect SBICs to seek to raise private capital from:

- pension funds and other institutional investors;
- corporate finance boutiques
- retail banks;
- corporate investors;
- the European Investment Fund;
- non-bank financial institutions (e.g. community development finance institutions); and
- individuals who are certified as either 'high net-worth' or 'sophisticated investors' under the Financial Promotion Order 2001.

[1] The 2,000 most deprived areas across the UK, where the Government is taking extra steps to break down the barriers to successful enterprise.

4.18 The Government has received a number of representations on the need to improve the operation of the 'high net worth' and 'sophisticated investor' certification systems. The Government will review the effectiveness of these systems shortly, and the results would be taken into account in the design of any SBIC model in the UK.

4.19 SBICs might also be established by public bodies, such as university business development offices. The Government believes it would be appropriate to restrict this to instances where the public body had raised the initial capital from non-public sources. It would not be appropriate to offer public leverage on public funds. Trades unions may also wish to invest in SBICs, building on the experience of Canadian Labour Sponsored Venture Capital Companies, which account for around one fifth of all venture capital under management in Canada.[2]

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

Q4.4 Would the proposed SBIC model be attractive to structured angel investment syndicates, perhaps as an alternative to the Approved Investment Fund tax provisions discussed in Chapter 3?

Minimum fund size

4.20 When considering the appropriate minimum size of an SBIC, the Government would want to strike a balance between making sure a fund was viable, and making sure the public funds were not exposed to unacceptable risks. Two factors need to be considered:

- **viability:** the Government would seek to ensure that any funds raised (private capital plus leverage) would be sufficiently large so as to be viable, allowing both diversification of the investment portfolio (which reduces risk) and follow-on investments; and

- **barriers to entry:** the Government would not want to impose an unnecessarily high minimum fund size in an attempt to dictate commercial viability, as this would raise barriers to entry for setting up new funds, which would be contrary to one of its objectives.

4.21 In the UK, research carried out in the context of developing the Regional Venture Capital Funds in 1998 indicated that the optimal size of a venture capital fund was at least £10 million. Assuming leverage available was up to twice the private capital offered, a £10 million fund would require at least £3.3 million of private capital. This contrasts with the minimum private capital required in the US under the participating securities scheme of $10 million (approximately £6 million), implying a minimum fund of $30 million (£20 million) when fully leveraged. The Government believes that differences in attitudes to risk, as well as the relative inexperience of UK SBIC managers, would justify a lower UK minimum at the start of any programme.

[2] The first LSVCC was introduced in Quebec in 1984. Currently, there are about 21 LSVCCs across Canada. Source: *Venture Capital Policy Review: Canada*, Baygan, G., STI Working Paper 2003/4, OECD, 2003.

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?

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

Borrowing from the Government

4.22 Once licensed, an SBIC would be entitled to apply to borrow money ('leverage') from the Government at an interest rate at, or close to, the gilt rate. This would be committed at the outset, but drawn down on a 'just-in-time' basis, to be invested alongside private capital in SMEs.

Funding the leverage

4.23 In the US, the Government provides guarantees for debentures (bonds) that SBICs issue to raise their leverage on the open capital markets. The Government does not finance the leverage directly. The cost of the capital to the SBICs is higher than that available directly to the Government through government-issued bonds. This additional cost in part reflects the fact that the SBIC-issued securities issued in the US are callable by the issuer (i.e. they are not fixed-term, and may be repaid early). There are also costs associated with the management of the central pool of SBIC securities that are borne by the SBICs, and ultimately passed on to the SMEs themselves.

4.24 If the Government were to develop an SBIC scheme in the UK, it would be better value for money for the Government to provide the leverage to the SBIC itself, rather than provide a guarantee for monies raised indirectly. This reflects the better price gilt issues achieve because they offer a more liquid market than would be possible with bespoke SBIC bonds. The Government would still charge SBICs to cover the administrative costs of operating the SBIC scheme, but these fees would be lower than if the SBICs were raising capital directly themselves on the back of government guarantees.

4.25 Whether the leverage is provided directly by loans, or indirectly by guarantees, the Government would be exposing public money to risk. A licensing authority would therefore need to ensure that appropriate controls were exercised over the SBICs to whom the leverage was made available. A balance would need to be struck between this need for control, and the benefits of expanding the programme on a demand-driven basis. In striking this balance, a licensing authority would need to exercise controls in a light touch way. These controls are expanded on below, but would essentially relate to ensuring an SBIC did not breach the terms of its licence, invested only in qualifying small businesses, and did not expose the leverage to unacceptable risks when 'capital impaired'. The licensing authority would not be involved in the day-to-day activities of an SBIC where it took commercial decisions consistent with its business plan.

Leverage ratios

4.26 Three factors need consideration when determining the leverage ratio (how much leverage can be raised on the back of private capital):

- **risk-return profile.** A higher leverage ratio would offer a higher risk-return profile to private investors. The risk to the leverage would also increase unless it was compensated for by a tougher capital impairment regime. The amount invested would be larger, so the potential upside would be higher; but since private capital would still take first loss, a lower percentage loss would lead to the private investors losing everything;

- **effect on investment strategy.** A higher risk-return profile could lead to a more conservative investment strategy (e.g. favouring more established enterprises with a track record and/or cash-flow) if investors sought greater downside protection; and
- **effect on size of investments.** A larger total fund size could encourage larger investments (although still subject to the investment limits discussed below).

4.27 The Government believes that it might be appropriate to adopt a tiered approach, similar to that used in the US, thereby targeting more generous assistance on the smallest funds. As a *quid pro quo* for the additional risk associated with higher leverage ratios, the Government also believes that it might be appropriate to increase its profit participation rate in line with the leveraged capital ratio actually drawn down. This is discussed further from paragraph 4.42.

Maximum leverage amount

4.28 The Government believes there would need to be a cap on the total leverage available to each SBIC. Such a cap would encourage experienced SBIC managers to 'graduate' to non-leveraged funds. The US imposes a limit of $113.4 million on total leverage that one SBIC can have under management at any one time, no matter how many individual funds that SBIC manages. If a UK SBIC were to be allowed to manage more than one fund at any time, then the cap would need to be set appropriately.

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

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

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

Investing in SMEs

Model contracts

4.29 In order to ensure that SMEs are not discouraged from seeking equity by the complexity of the transaction, the Government believes that there may be advantages in providing a standard 'model' contract for deals between SBICs and SMEs. No standard contract would be able to cater for the inevitable variations that will occur between deals, and legal advice to the parties would still be necessary. But by starting from the basic model, variations would be clearly visible, and SMEs may be in a better position to seek justification for each variation. The Government would be interested in views on whether providing such a model contract might lower transaction costs and increase confidence by providing a starting place for negotiations.

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

4.30 In order to target the leverage to the worst affected part of the equity gap, SBICs would be constrained in their investments, possibly along the lines set out below. Should the Government decide to take forward an SBIC programme, the exact nature of any restrictions would be developed in market testing before any roll-out and refined as the programme developed. Market testing and roll-out would be likely to involve a bidding process for first round applicants to ensure that the support being offered was the least necessary to achieve the Government's objective of correcting the market failure in the provision of risk capital to SMEs. However, to aid the process of consultation, some possible restrictions are outlined below.

Maximum investment size

4.31 It is not possible to quantify precisely the investment range affected by the funding gap, because of the difficulties involved in measuring the number of potentially viable SMEs that fail as a consequence of funding problems. Chapter 2 suggested that firms seeking equity injections of between £250,000 and £1 million are likely to encounter the greatest difficulty in raising finance. An upper limit on investment size would be necessary to limit any 'crowding out' effect of SBICs on commercial sources of risk capital, but should not act as a significant disincentive to private investors.

4.32 The Government invites comments on limiting the initial size of an SBIC investment to £1 million, with scope for additional investments after twelve to eighteen months, to a maximum of £2 million in any single SME. Under exceptional circumstances, and only where necessary to protect the SBIC's interests, there could be scope for 'over-line' investments above this threshold. Such over-line investments would require advance approval from a licensing authority, and would need to be accompanied by a restructuring or exit strategy.

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

Investment restrictions

4.33 The Government would wish to restrict SBIC investments so that they would only be permitted to invest in enterprises that fall within the EU definition of SMEs. This definition is set out at Appendix A. The Government also believes that SBICs might be further obliged to hold a proportion of their investments in early-stage SMEs, where evidence of the equity gap is strongest. This would prevent SBICs adopting a risk-averse strategy of only investing in mature SMEs. The Government welcomes views on this proposal, and where any restrictions might be set.

Q4.12 Would a restriction on investing a proportion of the portfolio in 'early-stage' SMEs be practicable? What definition might be used for 'early-stage' that would not impose unreasonable compliance burdens on SBICs?

4.34 The Government is minded, in the event that an SBIC programme was launched, not to allow an individual SBIC to invest more than 20 per cent of its private capital in one concern. This rule would be intended to ensure a minimum level of diversification of investments by the SBIC, thereby reducing the risk exposure of the portfolio overall, and of the public leverage invested in that portfolio.

4.35 To maintain the focus on smaller deals, no SBIC would be permitted to invest in a syndicate that included either another SBIC fund or a VCT. The Government believes that the VCT scheme, which has been successful in its own right in attracting a new class of investor into the risk capital market, should continue independently of SBICs, where the Government's objectives are different. Allowing SBICs to syndicate would run the risk of limits on maximum investment sizes being breached.

4.36 Eligibility for support would be similar to the criteria for assistance under the Regional Venture Capital Funds: an SBIC established in the UK (wherever it may be incorporated) might obtain Government support and the SBIC might invest in any business meeting the EU SME definition set out in Appendix A which had its head office or a material part of its business established in the UK, and where the purpose of the relevant investment was predominantly related to, or for the benefit of, the UK (or a region of the UK).

4.37 European State Aids rules mean certain SME sectors would not be eligible investments for SBICs, for instance agricultural SMEs. The Government is also keen to focus any aid on sectors where the evidence of market failure is greatest. The Government would therefore welcome views on prohibiting investments in at least:

- other SBICs;
- finance and investment companies, or finance-type leasing companies;
- publicly-quoted companies;
- land and property deals; and
- businesses that are not actively trading.

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.

Mezzanine financing

4.38 The Government believes that if an SBIC programme were adopted, it should be open both to SBICs that invested in high-growth SMEs yielding high returns, and to SBICs that specialised in mezzanine investments in medium-growth SMEs. This latter group often includes businesses that require finance with equity features but which cannot offer the kinds of returns that are traditionally associated with venture capital investments. This middle market, where quasi-equity debt instruments might be appropriate, appears poorly served by existing lenders and may involve complex deal structures which some SMEs may find off-putting. In such cases, the Government is concerned that viable businesses may face a funding gap, unable to promise the returns needed to attract equity investors, but too high-risk for traditional lenders.

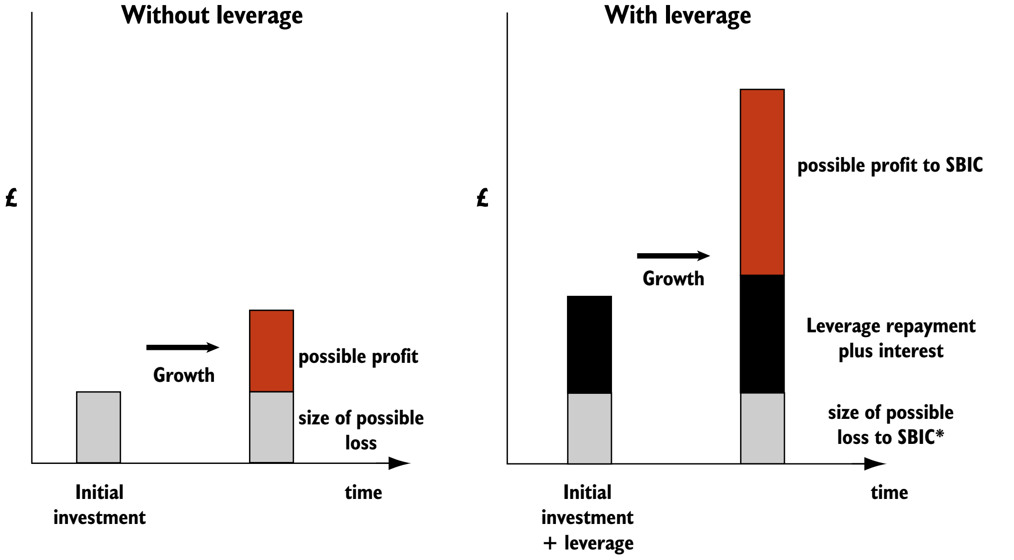
4.39 The Government would welcome comments on whether SBIC provision of mezzanine finance would crowd out existing private sector provision, and whether it might be appropriate to require mezzanine financing to be alongside investments in common equity, to ensure an appropriate risk mix in SBIC investments.

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?

Making repayments

4.40 In a UK SBIC programme, interest would be charged on the leverage at, or close to, the gilt rate. Like a conventional venture capital fund, the SBIC would make money by investing in SMEs, helping them grow rapidly, and then realising a capital gain on exit (for example, a trade sale or flotation). As a shareholder, it might take a dividend from retained earnings before exiting its investments. As Figure 4.2 shows, the provision of leverage boosts the potential return to private capital, making smaller investments economic and allowing SBICs to invest in younger companies that are perceived as riskier. SBICs would be allowed to defer repayments of both capital and interest until cash-flow allowed it, with interest accumulating during the interim period.

Figure 4.2: The effect of leverage


Without leverage
£
Growth
possible profit
size of possible loss
Initial investment
time
With leverage
£
Growth
possible profit to SBIC
Leverage repayment plus interest
size of possible loss to SBIC*
Initial investment + leverage
time

** The maximum possible loss to the SBIC is the same with or without leverage but the probability of loss may be higher with the leverage, as a smaller percentage loss to the overall fund is needed to lose all private capital under the 'first loss' principle.*

Prioritisation of repayments

4.41 The prioritisation of repayments envisaged would be:

- interest that has accumulated on the leverage finance;
- leverage finance itself;
- private capital; and then
- profit, shared between the private investors and the Government.

Sharing profits

4.42 The Government would take a share of SBICs' profits so as to cover losses from those SBICs that made a loss; as in the US, any UK programme would be designed to be self-financing over the medium term.

4.43 In the US, the amount of profit shared with the Government is determined by the leverage ratio drawn down by the SBIC - where an SBIC borrows a higher multiple, the Government's share of the profit increases. This reflects the fact that where greater leverage is made available to the SBIC, the Government is assuming a greater level of risk. To compensate for this additional risk, the Government charges a higher 'price' by taking an enhanced share of profits.

Profit sharing models

4.44 In the UK, there could be three possible profit sharing models:

- profit share as a function of leverage ratio (as in the US model outlined above);
- profit share determined at the time of licensing according to an assessment of the risk profile of the investment strategy the SBIC sets out in its business plan. This would require each SBIC to negotiate terms for its leverage with the licensing authority, which could add to the complexity of the licensing process; and
- the Government takes a fixed equity stake in all SBICs, with a corresponding proportion of the profits. Though administratively simple, a more exposed SBIC would pay a similar proportion of eventual profits as a 'safer' SBIC, which could lead to investment strategies being adopted that did not fulfil the Government's objectives.

4.45 The Government seeks views on the appropriate mechanism for the profit share given its desire that the programme should be self-funding over medium term. In particular, the Government would welcome views on whether the Government's share should be capped, or uncapped if this allowed it to fund more SBICs overall.

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?

Covering losses, ongoing monitoring and liquidation

Private capital at risk of first loss

4.46 The US SBIC programme is founded on the principle that should the SBIC lose money, the private investors' stakes are at risk before the leverage. Private investors accept this risk because that leverage enhances potential returns.

4.47 The Government believes that the principle of the private sector taking first loss, as outlined in paragraph 4.13, is central to the potential viability of an SBIC model:

- the first loss principle means that private investors' natural protection of their own interests safeguards the interests of the taxpayer, with the need only for light-touch ongoing regulation focusing on compliance rather than commercial issues (although there would still be a need for some controls to counter the risk of moral hazard in cases of capital impairment); and
- using incentives rather than active government controls to ensure an appropriate investment strategy avoids the problem of information asymmetry that would otherwise make government control unnecessarily burdensome. The private sector investors would have all the incentives to ensure the fund managers are performing, so protecting taxpayers' interests.

4.48 Previous government-backed venture capital interventions have attracted limited interest where the government stake was not subordinated. However, the SBIC model would offer investors much greater leverage and a considerably greater potential upside than previous schemes, and the success of the scheme in the US demonstrates that the model is viable. But given the differences between the US and the UK markets, the Government would welcome views on the feasibility of setting up the scheme on this first loss basis.

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

Liquidation

4.49 For the SBIC programme to self-fund over the medium term, the extent of upside benefits (profit sharing) to the Government would be intrinsically linked to downside liability in the event of losses. Once an SBIC reached a certain level of capital impairment - the exact level would be open to consultation - the Government would seek the liquidation of the SBIC, with funds first repaying the leverage and interest, before returning any remaining funds to private capital holders. Liquidation following capital impairment could be necessary to counter the risk of moral hazard: if the fund managers thought that the private capital was at serious risk, they would have incentives to take unacceptable risks with the leverage, in order to try to recoup the original investment.

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.

4.50 The Government is aware that in any decision to liquidate, there would be an element of subjectivity. An SBIC's investors, managers and a licensing authority are unlikely to agree on whether the SBIC is going to recover and get back on track. The Government is therefore keen to hear views on steps that might be taken to formalise the arrangements to remove as much of the subjectivity as possible from the final decision on whether to liquidate.

Q4.18 The Government would like to hear views 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.

Licensing

4.51 Having raised the initial private capital, an SBIC would seek a licence. This section focuses on licensing restrictions for SBICs; paragraph 4.57 onwards discuss possible regulatory and licensing bodies.

Legal structure

4.52 The Government believes that subject to adequate protection of its interests, and particularly its economic interests as lender, SBICs should be free to choose the legal structure that suited them best (i.e. whether an SBIC was formed as a corporate body such as a company or limited liability partnership, or whether the SBIC was founded on a limited partnership agreement). Some of the implications of this choice are outlined below. The Government believes this flexibility is essential to attracting new entrants to the SBIC market.

FSA authorisation

4.53 The issues of legal constitution and managerial organisation may have consequences for the SBIC's interaction with the financial services regulatory system. If an SBIC was itself a legal personality – i.e. if it was a company or a limited liability partnership – and managed its own investments, then it would be unlikely to have any interaction with the regulatory system. If, however, it chose to contract out its investment management to a third party, European and domestic regulation would require these investment mangers to be authorised by the Financial Services Authority (FSA). Similarly, if an SBIC was not a legal personality – for example if it was a partnership – then its investment manager would be acting as a third party on behalf of the partners, which again would require FSA authorisation.

4.54 Whatever the form chosen, the Government believes that certain constraints would be necessary to ensure consistency with wider regulatory policies. For example, the SBIC would need to be closed-ended with no secondary market in the instruments of ownership (i.e. in the case of SBICs based on corporate structures, it would be a licensing condition that the shares in the SBIC should not be tradable).

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

Licensing criteria

4.55 Licences would be issued based on an assessment of the quality of the prospective SBIC management team and the quality of their business plan. Applicants' business plans would be required to present proposed types and stages of investments, any proposed sectoral or geographic focus, and other factors relevant to proposed investment activities. The licensing body would also expect the management team to demonstrate that it possessed the capacity and competencies necessary to run an SBIC effectively, including the ability to:

- generate good deal-flow;
- perform effective due diligence and analysis of small private companies of the type that the SBIC intends to invest in;
- implement the types of private equity deal structures that the SBIC intends to use;
- mentor and support early-stage businesses in their target sectors;
- oversee investments over a period of several years;
- turn around failing companies and liquidate investment positions when necessary; and
- effectively exit an investment.

4.56 The Government understands that a requirement to satisfy all of these criteria in full may conflict with its objective to increase the numbers of new entrepreneurial SBIC managers. Fitness and properness would be the only absolute criterion to be satisfied; the licensing body would need to take a judgement on the other criteria in the round. The burden of proof would fall on the applicants to demonstrate that they were a viable proposition.

Licensing authority

4.57 The licensing body would be responsible for ensuring ongoing compliance with the rules of the scheme, and have the power to withhold leverage from, and ultimately liquidate, the SBIC for capital impairment and regulatory violations.

4.58 In the US, the Small Business Administration (SBA) has developed the skills and capacity to exercise a regulatory function over the 40 years that the SBIC programme has been operating. The UK has no public body with an equivalent capability.

4.59 The Government is aware that in delivering the programme, the licensing authority would need to combine the competencies and flexibility necessary to assess applicants against the criteria set out in paragraph 4.55 with the capacity to make judgements to meet the Government's policy objectives. These objectives include promoting the interests of SMEs and the SBIC programme, protecting public money from excessive risk, encouraging new fund managers and, in time, seeking to deliver other policy objectives such as targeting the programme at regional inequalities or disadvantaged communities. The Government would want to ensure that any licensing authority combined the appropriate competencies with the flexibility to implement the programme in a dynamic and light-touch way.

4.60 There would be several possible candidates for the role of licensing body, including:

- the FSA, which is experienced at authorising investment managers, but the wider role in licensing and supervising SBICs would not sit well with its core statutory objectives;
- direct involvement by a government agency such as the Small Business Service (SBS) which could ensure the taxpayer interest was preserved. But the SBS does not presently possess the resources and capabilities needed to run the programme, and direct delivery would not fit easily with their new enhanced role of raising the standard of services to SMEs provided across government; and
- a private contractor who could be appointed to act as licensing body, although it is not clear what private sector organisations possess the necessary skills, and it might be difficult to cater in contract at the outset for the capacity to make judgements to meet Government objectives that would be needed.

4.61 The Government believes in order to achieve the right balance between the incentives to make the programme a success, and the need to deliver the Government's policy objectives, there may be scope to deliver an SBIC programme through a partnership between the public and private sectors. The Government invites views from respondents on the best means of delivering any possible SBIC programme.

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.

Other issues

4.62 This consultation paper has covered a wide range of issues on which the government is seeking views, but there may be a number of additional areas on which respondants have comments. The Government invites interested parties to raise these in their consultation responses so that they can be taken into account in an assessment of whether an SBIC programme might be appropriate in the context of improving the access of SMEs to growth capital.

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?

5 Summary of Consultation Questions

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 seeking growth capital?

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?

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

Chapter 3: Impact of existing interventions

SFLG

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?

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

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

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?

Q3.5 Is there merit in further amending the 10-year cut-off for considering previous SFLG borrowing?

VCTs

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

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?

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 attract additional funds for investment in SMEs?

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?

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 would represent welcome simplifications, and why? How else could the schemes be simplified without compromising their objectives?

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

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?

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

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?

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?

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 for SBIC investments, and whether other groups might also be interested in investing in SBICs.

Q4.4 Would the proposed SBIC model be attractive to structured angel investment syndicates, perhaps as an alternative to the Approved Investment Fund tax provisions discussed in Chapter 3?

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?

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

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?

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

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

Investing in SMEs

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

Q4.11 Should the Government limit total financings 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? Should there be minimum time intervals between financing rounds, and if so, what would be an appropriate delay?

Q4.12 Would a restriction on investing a proportion of the portfolio in 'early-stage' SMEs be practicable? What definition might be used for 'early-stage' that would not impose unreasonable compliance burdens on SBICs?

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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?

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?

Covering losses

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

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.

Q4.18 The Government would like to hear views 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.

Licensing

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

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.

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?

6 Next Steps

The Government welcomes responses to the issues and questions raised in this paper by 25th July 2003.

All responses received may be made public unless specifically requested otherwise. In the case of electronic responses, general confidentiality disclaimers that often appear at the end of e-mails will be disregarded for the purposes of publishing responses unless an explicit request otherwise is made in the body of the response.

Responses should be sent to:

Bridging the Finance Gap Consultation Responses
Investment and SME Finance Directorate
Small Business Service
St Mary's House
c/o Moorfoot
Sheffield
S1 4PQ

E-mail: enterprise@sbs.gsi.gov.uk

Tel: 0114 259 7325
Fax: 0114 259 5197

Enquiries or comments about the consultation process should be sent to the same address.

AI Appendix: EU Definition of Small and Medium-Sized Enterprises

Turnover	under €40 million
Balance Sheet	under €27 million
Employees	fewer than 250
Independence*	25 per cent

From Spring 2003, the definition is expected to change, with member States having up to two years to transpose the changes to national law. The new definition is likely to be:

Turnover	under €50 million
Balance Sheet	under €43 million
Employees	fewer than 250
Independence*	25 per cent

In both definitions, to qualify as an SME, both the employee and the independence criteria must be satisfied, and either the turnover or the balance sheet criteria.

* The independence criterion refers to the maximum percentage 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 an SME without affecting the status of the enterprise.