

Economic impact of AIM and the role of fiscal incentives

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The London Stock Exchange has commissioned Grant Thornton to analyse the contribution of AIM to the UK economy and the role of fiscal incentives in attracting investors to smaller companies on the market. The study provides new evidence about the progression of UK companies after joining AIM and the value they add to the economy in terms of turnover and employment. It discusses the importance of existing incentives such as the Venture Capital Trust scheme in helping SMEs raise the capital they need to achieve their growth potential.

However, recent changes to incentives that have historically been critical to the development of the investor community around AIM, are severely constricting the flow of equity capital to businesses that need it the most. The report asks the Government to recognise the importance of the existing package of measures and recommends targeted changes to increase their effectiveness. The aim of these recommendations is to reduce the cost of capital for SMEs by attracting a wider set of investors to the market. This will help to ensure a robust and vibrant funding environment for SMEs, which are essential to future growth and economic recovery.

Marcus Stuttard, Head of AIM

1 Executive summary

The credit crunch, financial crisis and recession have made it successively more difficult for small and medium sized companies to raise external finance. This report quantifies the importance of AIM, the London Stock Exchange's growth market, to the UK economy, examines the extent to which the market facilitates and improves access to finance, and assesses the role of fiscal incentives in supporting and strengthening access to equity capital.

Policy suggestions

Although there are a range of well targeted fiscal incentives to address genuine market failures, there has been a gradual erosion in their strength and effectiveness in recent years due to increasing restrictions. This is putting at risk the substantial economic benefits delivered by AIM companies.

This report highlights that action is needed now to ensure that smaller companies can raise finance for growth and AIM can continue to play its part in fostering a dynamic and entrepreneurial SME sector, a vital ingredient if the private sector is to lead the UK recovery. We understand the fiscal pressures facing the Government. This report outlines that investing in high growth companies provides the Exchequer with increased tax revenues as well as significant contribution to Gross Domestic Product (GDP).

A call to action

This report demonstrates that AIM companies are genuine drivers of growth, creating significant levels of employment growth and enhancing GDP. At a time when access to capital and finance is constrained, AIM's role in the UK economy is now even more important in ensuring that current Government policies are a success. A vibrant AIM is also particularly well placed to:

- provide an exit route for investments made through the UK Innovation Investment Fund and the Growth Capital Fund
- provide a platform for companies supporting the UK's transition to a low carbon economy and can have an important role in the success of the proposed Green Investment Bank
- contribute to growth and employment creation.

Delivery of these substantial economic benefits is, however, at risk from reform of the fiscal incentive regime.

We recommend that the Government acts urgently to reinforce the fiscal incentive regime to attract investment

that will enable the private sector and SMEs in particular to lead the UK economic recovery.

There is a delicate balancing act between encouraging entrepreneurial behaviour and carefully managing the economy. However, we believe consideration should be given to further encouraging investment in AIM as part of the Government's commitment to making the UK a more competitive place to do business and in helping entrepreneurial businesses to thrive. The Government has already shown commitment in this area by enhancing the quantity of entrepreneurs' relief for capital gains tax purposes for those who meet the qualifying conditions. Further steps to consider could include enlarging access to the relief, eg a lower required percentage shareholding in specified circumstances.

Our specific proposals centre on the following five areas to support and enhance capital raising, investment, and liquidity on AIM:

1 Allow VCT participation in the secondary market, which will not only provide urgently needed liquidity for the secondary market but also indirectly stimulate investor appetite for smaller companies in the primary market.

2 Increase the gross asset test for VCTs to £15 million and to 250 employees, which will allow VCTs to invest in a wider pool of SMEs and make VCTs more attractive to investors.

3 Provide a favourable capital gains tax regime for investing in SMEs to attract investors to such companies and therefore boost liquidity.

4 Protect the liquidity and investment benefits resulting from the VCTs, EIS and IHT Business Property Relief schemes and improve certainty by making a commitment that existing incentives will stay in place for at least five years.

5 Consider whether AIM securities should be eligible for inclusion within ISAs, to enhance market liquidity and broaden the investor base.

Economic contribution of AIM

In 2009, AIM made a substantial contribution to the UK economy of around £21 billion and supported around 570,000 full-time equivalent (FTE) jobs through direct, supply chain and multiplier effects.

UK incorporated AIM companies directly contributed around £12 billion in GDP in 2009 and supported around 250,000 FTE jobs, larger than the level of employment in either the UK pharmaceuticals or UK defence industries.

Direct economic contribution of UK incorporated AIM companies

Economic indicator	Direct contribution in 2009
GDP	£12 billion
Tax contribution	£1.8 billion
Direct employment	250,000

Source: Grant Thornton estimates

A further 320,000 jobs and £9.4 billion of GDP are supported indirectly through the supply chain and multiplier effects.

Since its inception in 1995, AIM has supported the growth of more than 3,100 companies, allowing them to raise over £68 billion of capital from initial flotation or through further capital raisings.

The growth dividend

AIM's importance is based on its role within the funding ladder, enabling growth companies to raise external finance so they can make a step change in their performance.

- Companies admitting to AIM experience an immediate growth spurt, with turnover increasing by an average of 37% and 25% in the first and second years respectively. Longer-term prospects are also enhanced with growth of 15% per annum still seen some five years after listing.
- AIM stimulates innovation, enterprise and productivity. SMEs are twice as likely to innovate, account for 40% of live patents and are often owned by entrepreneurs. Such innovation and enterprise creates spillover benefits as new knowledge, technology and skills are transferred to other industries, raising the level of productivity across the UK economy.

Value of fiscal incentives

Fiscal incentives including Venture Capital Trusts (VCTs), the Enterprise Investment Scheme (EIS) and Business Property Relief (BPR) for Inheritance (IHT) Tax underpin the economic contribution of AIM, as they:

- address persistent market failures and barriers which restrict access to capital, such as asymmetric and imperfect information, illiquidity of assets and transaction costs
- encourage new investment in the primary market (ie new share issues) to address the 'equity gap' where SMEs and growth businesses can struggle to attract equity investment of up to £10 million
- improve liquidity in the secondary market (ie the trading of AIM shares) which supports investor appetite in the primary market, as increasing liquidity lowers the cost of capital, permitting greater levels of investment which in turn enhances productivity
- have a 'leverage effect' whereby amounts invested significantly exceed cost to the Exchequer (eg VCT ratio of funds raised to cost is 2.3).

The fiscal incentives act as a package of measures to address market failure in both the primary and secondary markets. Without a well functioning secondary market, incentives to address the equity gap alone will be inefficient. The fiscal incentives have led to funds raised of over £4.6 billion over the past five years and are eligible to investors in 35% of AIM companies.

Without such incentives, many AIM companies would suffer reduced investment or would not have been able to raise capital on AIM in the first place. In the absence of the incentives, liquidity would be lower, and delivery of the economic benefits would be put at risk.

2 Economic impact

Key points

AIM has supported the growth of over 3,100 companies since its inception in 1995 and enabled over £68 billion of capital to be raised. This has delivered significant economic benefits to the UK economy. In 2009, UK incorporated AIM companies:

- employed over 250,000 full-time equivalent employees
- contributed £12 billion in GDP to the UK economy
- contributed £1.8 billion of tax revenues to the Exchequer.

From additional supply chain and wider multiplier impacts, a further 320,000 jobs FTE and £9.4 billion of GDP are indirectly supported.

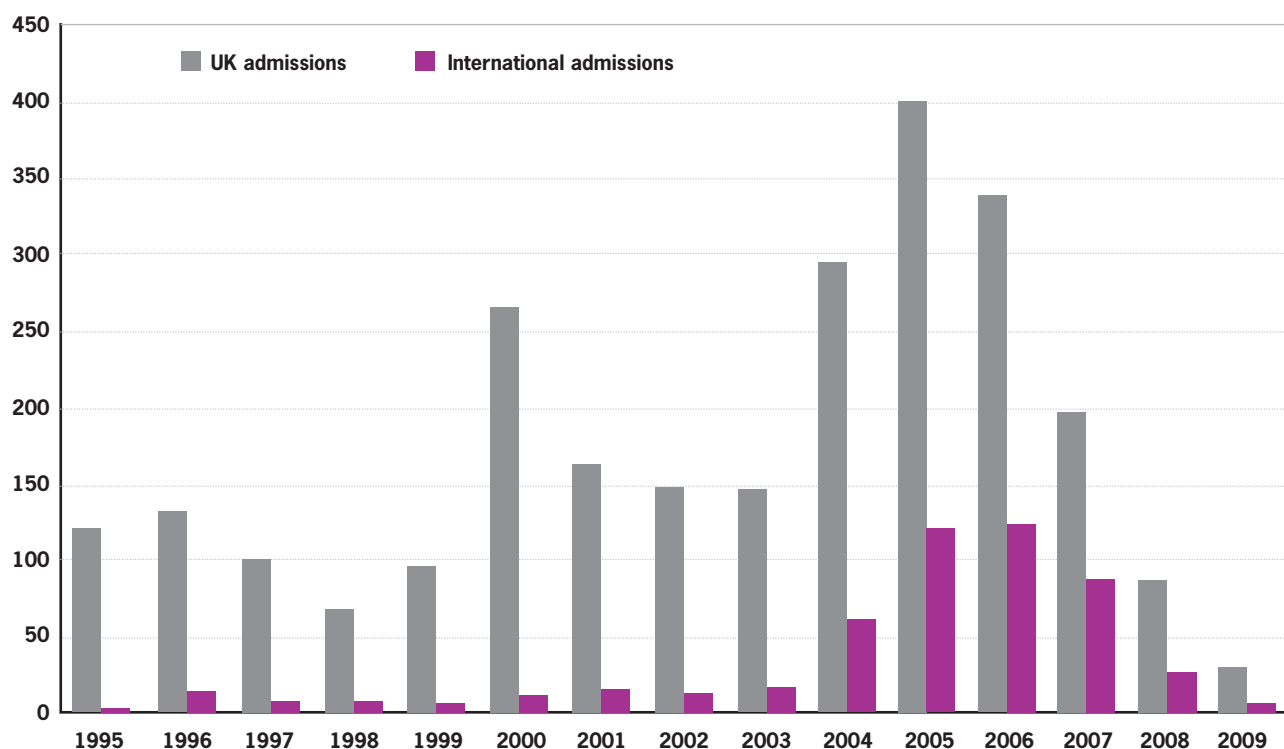
AIM companies are fast growing, increasing turnover by 37% in the first year after admission.

AIM has a key role within the funding ladder, allowing smaller companies to raise external finance at different stages in their lifecycle.

2.1 Characteristics of AIM

AIM companies have raised £33.5 billion of capital at admission and followed this with further fund raising amounting to £35.2 billion, demonstrating the important role of AIM in supporting growth after admission to market. The chart below details the number of companies admitting to AIM since its inception in 1995, incorporated both in the UK and internationally. At the end of 2009, UK incorporated companies represented 83% of new admissions to AIM and 81% of the total stock of companies.

Figure 1: Number of admissions to AIM, 1995 to 2009



Source: London Stock Exchange

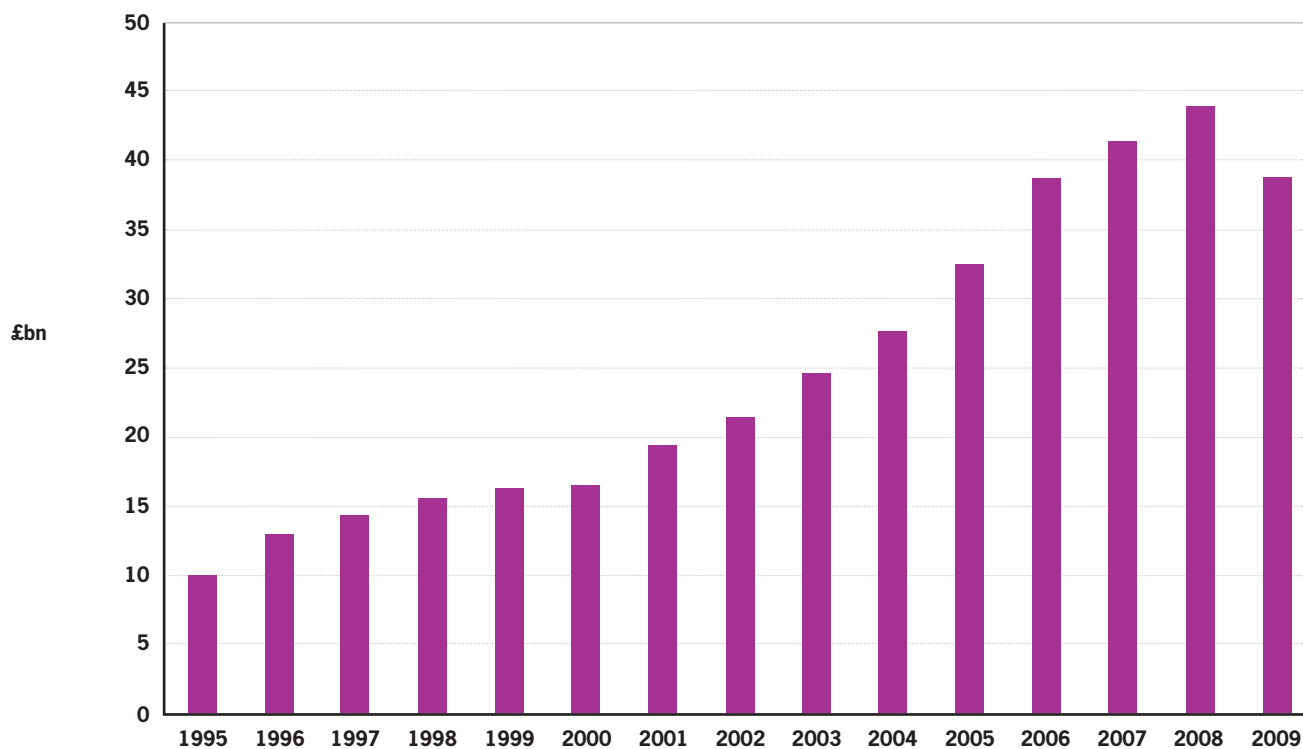
Since 1995, the total turnover of AIM companies has increased from under £10 billion to over £38 billion – an increase of over 10% per annum. Growth was particularly rapid over the 2000 to 2006 period, although there was a slight decline in 2009 as a result of the financial crisis and global recession.

The growth reflects not only the increase in the size of AIM as new companies join, but also the growth of existing companies as they expand operations. For example, in 2000 AIM companies had average annual sales of under £25 million, whereas in 2009 this had risen to over £45 million.

The economic downturn has presented significant challenges for AIM businesses, with substantial falls in valuations. Value traded in AIM securities (after excluding the change in company numbers) dropped by 33% in 2008 and 47% in 2009 when compared to the 2007 level. This has led to an increasing number of companies evaluating

whether being on a public market was still appropriate for them and subsequently choosing to leave market, accounting for 39% of cancellations in 2009 compared to 21% in 2008 and 8% in 2007. There has also been a decline in the number of AIM companies as some have exited the market following trade sales and mergers and acquisitions activity. Nevertheless, with 1,293 companies and a market capitalisation of £56.6 billion at the end of 2009, AIM continues to make a substantial contribution to the UK economy. In the period 2008 and 2009, companies already on the market raised £8 billion through further fundraisings.

Figure 2: Turnover of (UK incorporated) AIM companies, 1995 to 2009



Source: Thomson Reuters

2.2 AIM supports small and growing companies

SMEs have a critical role to play in the economy, and access to appropriate financing options is key to facilitating their growth.

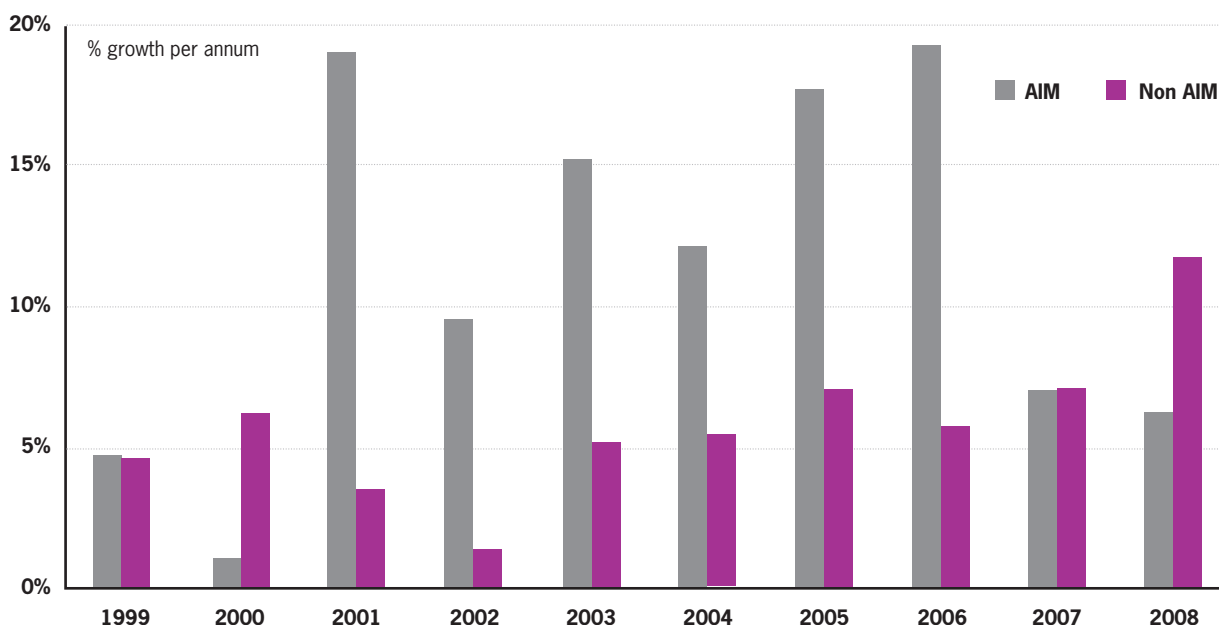
Equity finance is essential for such companies as bank finance may often be unsuitable, for example for younger companies with no immediate revenue streams and limited cash flows. For technology firms and fast growing companies needing to make upfront investment¹, equity is also the most suitable form of capital. AIM plays a key role in the UK's SME funding environment, allowing companies to raise external finance at different stages in their lifecycle and providing an exit route for early stage investors (such as for the company founder(s), 'friends and family' and angel investors). AIM offers a regulatory framework designed specifically for smaller, growing companies, proving less burdensome than for companies listing on the London Stock Exchange's Main Market. As companies continue to grow, they also benefit from the advisory and investor support network that has developed around AIM over the last 15 years; they can return to the market to raise further funds.

For some companies, admission to AIM is a long-term proposition, whereas for others it serves shorter-term growth plans including the aspiration to eventually progress to the Main Market. Over 70% of current AIM companies have been on the market for five years or less. It is often the case that companies leaving AIM do so following a takeover (or reverse takeover), but a significant number progress onto the Main Market. Since 1995, over 140 companies have transferred onto the Main Market.

2.3 The growth dividend

AIM companies have outperformed the broader business population in terms of employment and turnover growth. Figure 3 highlights the performance of AIM companies in terms of employment and turnover growth compared to the broader business population. However, 2008 saw a reversal in the trend as the aggregate turnover of AIM companies was outstripped by the broader business population.

Figure 3: Comparison of turnover growth across AIM and non-AIM² companies, 1999 to 2008



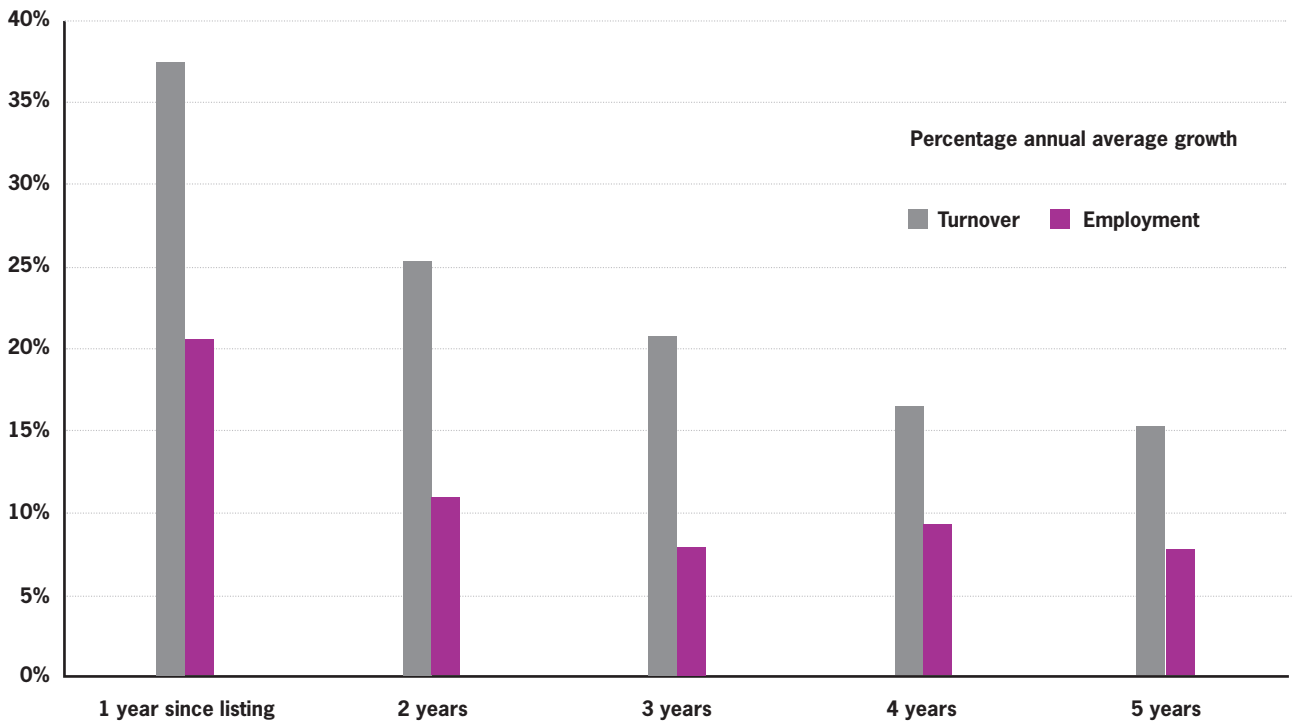
Source: Thomson Reuters and Grant Thornton analysis

¹ For more analysis on these issues, see for example 'The City's Role in Providing Equity Financing Needs of UK SMEs', City of London, March 2010.

² By 'non-AIM' companies we are referring to the broader business population, with data taken from the Annual Business Inquiry.

Further analysis of turnover of AIM companies in the first five years post admission shows that growth is especially strong in the years immediately after admission – see Figure 4 below.

Figure 4: Turnover and employment growth in AIM companies, by period since admission

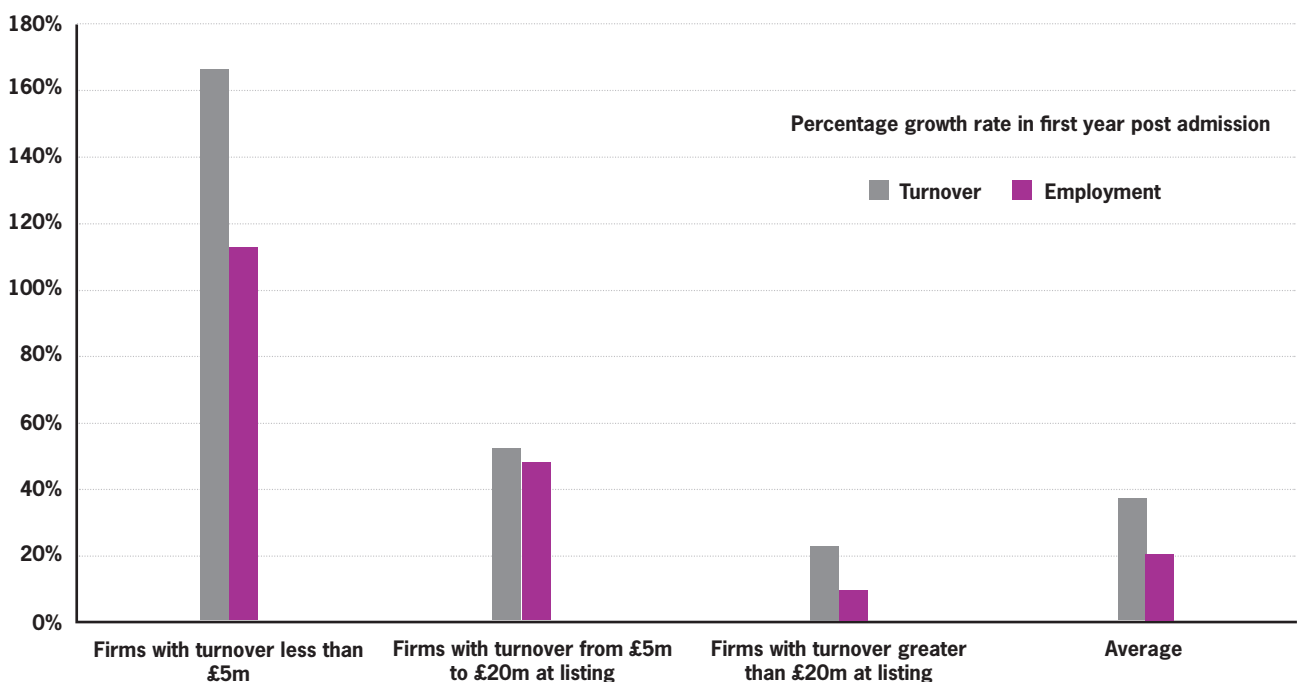


Source: Thomson Reuters and Grant Thornton analysis³

Note: weighted by size of company

Smaller companies in particular see especially rapid growth in turnover in the first year post admission.

Figure 5: Turnover and employment growth in AIM companies, by size of company



Source: Thomson Reuters and Grant Thornton analysis

Note: weighted by size of company

³ These figures are compound annual growth rates.

Although the analysis illustrated in Figures 4 and 5 focuses on the growth of companies after admission, our interviews have also indicated a 'pre listing' impact whereby firms expand as they strengthen their business prior to joining the market. Other 'pre listing' impacts include strengthening corporate governance and systems to ensure a smooth progression from being private to becoming a public company.

Companies also demonstrate significant growth in the years immediately prior to admission, suggesting a 'pull' effect whereby the intention to float supports increased growth, perhaps in part to provide investor confidence in the future success of the company. An AIM company we spoke to emphasised the importance of this, saying "the listing process itself is beneficial as it forces the company to enhance performance in the run up to ensure a smooth listing."

2.4 Acting as a spur to innovation and enterprise

Growth markets such as AIM and PLUS-quoted stimulate the level of innovation and enterprise, acting as a spur to productivity and economic growth:

- **Innovation** – SMEs and growth companies influence the level of innovation and are at the heart of technological changes. SMEs account for 40% of live patents⁴, are twice as likely to innovate⁵ and are often run by the founding entrepreneur
- **Enterprise** – AIM companies are typically growth and smaller businesses created by entrepreneurs. Entrepreneurship is a key driver of the economy, based on the value of knowledge and ideas being translated into new products and services
- **Productivity** – both innovation and enterprise create spillover benefits in the wider economy as new products, technologies, knowledge and skills created by SMEs and entrepreneurs are transferred over time to other industries and sectors, raising the level of productivity.

Access to adequate funding allows new and existing companies to make the investment needed to turn ideas, patents and knowledge into marketable products and services. Venture capital is particularly important to small and growth companies as it directly stimulates innovation in the economy⁶, increasing productivity as a result.

2.5 Benefits to companies from joining AIM

There are a broad range of benefits resulting from an AIM admission. AIM provides access to capital and knowledge, facilitates growth, allows easier ownership transition and enhances the status and credibility of the company – see Box 1 for more detail.

Box 1: Benefits for companies joining AIM

Companies join AIM for a variety of reasons. Important benefits include:

- **access to capital** – the opportunity to raise finance for short or long-term growth and development
- **access to ongoing finance** – the ability to raise additional funds at an efficient market price
- **access to knowledge** – external investment often plays a significant role in accelerating the improvement of systems and practices
- **productivity improvements** – delivered through consolidation of businesses or from the introduction of more efficient practices across a group of companies
- **attraction and retention of staff** – through the use of share options and other financial incentives
- **increased growth** – publicly traded shares support and encourage expansion through acquisition
- **status and credibility** – the confidence that the association with the London Stock Exchange instills in business partners and key stakeholders, which also results from the impetus to strengthen corporate governance
- **public profile** – the AIM admission and associated press coverage fulfils an important marketing role
- **control** – greater control for the company than would be the case with other forms of external investment (such as venture capital)
- **ownership transition and exit strategy** – a change of ownership from early stage investors to new companies can often bring the impetus and opportunity a company needs to move it to the next stage
- **expert adviser network** – access to a large and experienced community of advisers that help companies prepare for admission to AIM and continue to support them after admission.

⁴ Office for National Statistics.

⁵ Importance of small firms to the UK economy. (A Briefing paper by the Performance and Innovation Unit and Small Business Service).

⁶ Does Venture Capital Spur Innovation, Harvard Business School (1998).

2.6 Creating substantial economic benefits to UK Plc

In addition to their contribution to innovation and entrepreneurship, AIM companies support increasing levels of employment and greater levels of economic contribution over time. In 2009 AIM companies contributed £12 billion to UK GDP and directly supported more than 250,000 jobs, greater than either the UK pharmaceuticals industry or the UK defence industry⁷. AIM companies also made a significant contribution of £1.8 billion in 2009 to the Exchequer⁸.

Figure 6: Direct economic contribution of UK incorporated AIM companies

	2009
GDP	£12 billion
Tax contribution	£1.8 billion
Direct employment	250,000

Source: Grant Thornton analysis

The supply chain of AIM companies supports a further 150,000 FTE jobs and GDP worth £5.1 billion. This indirect impact includes suppliers to AIM companies, which provide financial services (nominated advisers, tax, corporate finance), business services (PR, marketing, legal, accountancy) and wider goods and services.

Directly and indirectly, employees spend their wages on goods and services supplied by UK businesses, generating further employment and GDP through the so-called multiplier effects. This induced or multiplier impact is estimated to lead to a further 170,000 FTE jobs supported and GDP contribution of £4.3 billion.

The total direct, indirect and induced economic impact therefore amounts to £21 billion in GDP impacts and some 570,000 FTE jobs as summarised below.

Figure 7: Total direct, indirect and induced impact of UK AIM companies

Economic impact	GDP (£billion)	Employment
Direct	12.0	250,000
Indirect	5.1	150,000
Induced	4.3	170,000
Total	21.4	570,000

Source: Grant Thornton analysis

⁷ Table 3-1 UK sector size 2006, The economic case for investing in the UK defence industry (September 2009).

⁸ The estimated tax take (£1.8 billion in 2009) associated with AIM companies is based on an analysis of profitability. It is calculated using data on profitability of AIM companies and calculating the Corporation Tax due, including rate relief for companies with profits below £300k.

2.7 Maintaining the economic contribution of AIM

The continued importance of AIM in the SME funding environment and the wider UK economy is dependent on economic, financial and wider factors such as:

- ✓ the health of the UK economy – a prosperous economy with strong growth increases potential returns for investors and the demand for equity in SMEs and start up companies
- ✓ financial returns – the absolute and relative risk and return for investments in AIM companies, compared to other asset classes
- ✓ investor appetite – sentiment about the direction of the market is derived from a mixture of fundamentals and perceived factors, but is crucial to the overall health of the market
- ✓ the supply of bank finance – in the current economic climate, finance from banks remains limited, placing added importance on other mechanisms for raising capital, such as AIM
- ✓ an appropriate level of regulation – balancing the benefits from maintaining the integrity of the market with the direct economic and financial costs of regulation
- ✓ levels of liquidity – the ability for buyers and sellers of investments to quickly find each other and transact at low marginal costs
- ✓ fiscal incentives – government support in the form of fiscal incentives is to address market failures in the provision of equity funding to SMEs and growth companies.

All of these linked and overlapping factors are fundamental to the continuing success of AIM, but the role of fiscal incentives is particularly important for AIM and more generally for attracting investors to SMEs.

Fiscal incentives such as EIS, VCTs and BPR have played an important role in the development of AIM. Pump-priming has helped enable the critical mass of investment and financial infrastructure to be developed around AIM. Without such government intervention, the level of equity investment would be considerably less than the optimal levels, reducing economic benefit to the UK. However, over the years changes to available incentives, such as the abolition of Business Asset Taper Relief and reduced VCT investment criteria have diminished the effectiveness of the schemes and reduced investor confidence. These changes

have constrained investment in smaller companies and reduced the benefits that AIM delivers.

AIM has had a critical part to play in the funding ladder, and in the current climate when access to business finance remains delicate this role is amplified even further. It is all the more important that fiscal incentives which underpin AIM are preserved, to ensure that one of the few methods by which SMEs can currently access capital and ongoing finance is not harmed.

Government support in this area is justified by the presence of persistent market failures around equity investment for SMEs and growth companies.



3 Rationale for intervention

Key points

- Well functioning capital markets support the efficient allocation of resources in the economy. But genuine market failures around information asymmetries restrict SMEs' access to capital. An equity gap clearly exists for deals up to £10 million, although this could be as much as £25million.
- Government has a role to play in helping to bridge this gap, through specific incentives and more generally by fostering a culture of investment and entrepreneurship.

3.1 Introduction

This section sets out the rationale for public sector intervention in enabling access to finance for SMEs. The analysis is based on the principle of 'market failure' which states that government should intervene to address market failures which are delivering sub optimal outcomes. An 'equity gap' exists for deals up to £10 million due to disproportionate information and transaction costs associated with raising external finance.

While the debate is relevant for a wide range of smaller companies, we focus on specific issues pertaining to AIM. Analysis of other aspects such as exit routes for external investors is well covered in the broader literature.

3.2 Market failures and barriers associated with capital markets

Well functioning capital markets support the efficient allocation of resources in the economy and lower the cost of capital for businesses. Although the UK has highly effective capital markets, smaller growth businesses can struggle to attract investment. Reasons for this market failure include asymmetric information and illiquidity of assets.

Imperfect information means that it is harder for investors to obtain reliable information about potential investment opportunities; this may be due to lower visibility of smaller businesses and/or unproven business models that have no direct peer comparison. As a result, investors may not have all the information to enable accurate assessment of risks and to make optimal investment decisions. This leads to a sub optimal supply of growth capital for SMEs in general.

One reason investors prefer to invest in large companies is that due diligence costs disproportionately affect small investments or investments in small companies. As the Rowlands Review highlights: *'The costs of researching information are similar for small and large businesses. Investors therefore tend to prefer larger deals involving larger businesses where the transaction costs are a smaller proportion of the investment made. There is little performance measurement data, in other words track record, on investing in SME growth capital. This may make investors more risk averse and can result in higher levels of return being required or lower levels of investment being committed.'*

The efficiency of the market is also reduced due to infrequent trading of assets. Illiquidity of assets means that the prices of those assets may not always reflect true fundamental value, creating exit risks to investors. This makes it particularly difficult for young high growth firms to attract investment, because there are only a limited number of suitable investors and entrepreneurial growth firms in the economy⁹. Such market inefficiency means that search costs between investors and firms are higher than they would otherwise be, and the equity valuation lower due to a built-in risk premium.

⁹ British Venture Capital Association and NESTA.

3.3 The value of the equity gap

These market failures and barriers result in a shortage of available capital for companies seeking to raise funds. A lack of resources typically exists for deals of value up to £10 million, and are particularly scarce for businesses seeking to raise equity up to £2 million. The equity gap is a long-standing issue, as identified by the following studies:

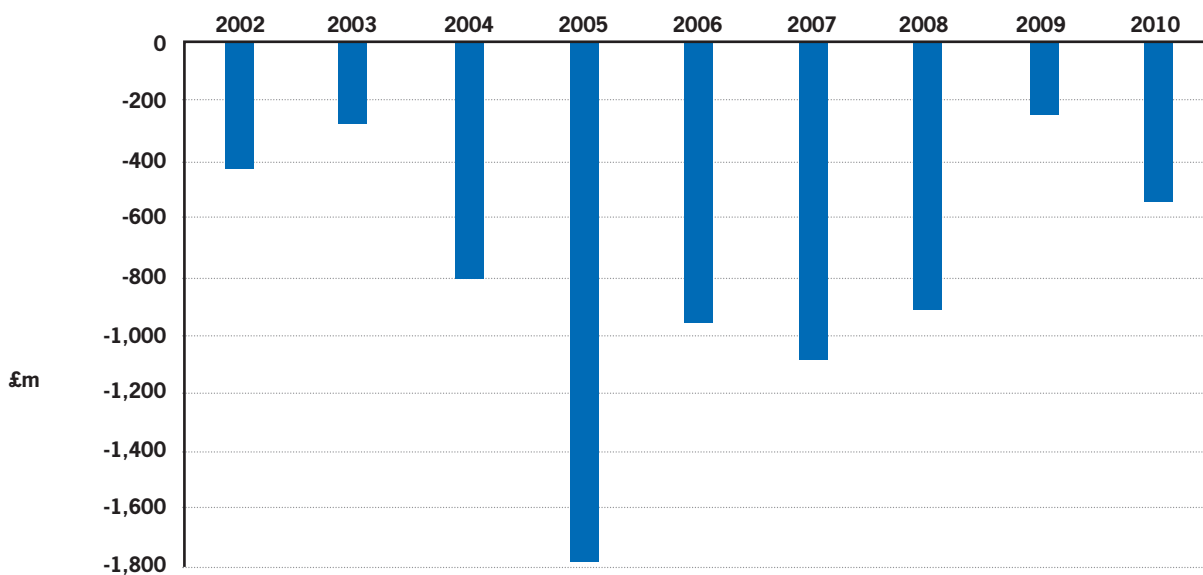
- HM Treasury identified in 2003 an ‘acute gap’ for equity financing between £250,000 and £1 million, but also ‘extending up to £2 million’¹⁰
- A study for BIS reinforced these findings, concluding that the gap could even stretch up ‘to a ceiling of £5 million’ and extending ‘to £15 million for sectors requiring complex R&D or large capital expenditure’¹¹
- The Rowlands Review¹² concluded that it is ‘possible to locate a gap at between £2 million and £10 million’, reflecting that fiscal incentives have had a positive impact in the market for capital up to £2 million.

Each of these research studies concluded that government intervention is required to reduce the equity gap.

Our research and consultation with the private equity and venture capital community suggests that in light of the credit crunch and global recession the reality of this equity gap has become more serious in the past few years, as evidenced by the increase in the average size of venture capital deals. Tighter bank lending practices and lower interest from equity investors have significantly reduced the range and supply of funds available.

With continuing uncertainty regarding the economic outlook, retail and institutional investors are choosing to invest in securities that have a lower short-term risk and higher ease of exit, ie greater liquidity, such as bonds. In fact investment trends since 2002 show consistent net outflows from the UK small cap sector (Figure 8).

Figure 8: Outflow of funds from small cap stocks



Source: IMA

¹⁰ Bridging the finance gap: next steps in improving access to growth capital for small businesses, December 2003.

¹¹ The Supply of Equity Finance to SMEs: Revisiting the ‘Equity Gap’, SQW Consulting. 2009.

¹² The Provision of Growth Capital to UK Small and Medium Sized Enterprises, 23 November 2009.

This depresses valuations, reduces liquidity and raises the cost of capital. In turn this limits the amount of investment going into smaller cap shares and hence constrains their growth. In such a constrained market, there is an enhanced role for fiscal incentives to reduce the acuteness of the equity gap.

3.4 Addressing market failures associated with the equity gap

In addition to the market failures discussed in section 3.2, companies on AIM may have low levels of assets and uncertain cash flow and will typically not be able to borrow

at attractive rates, hence the importance of access to equity finance.

Fiscal incentives have a significant role in addressing the persistent market failures associated with equity investment for smaller companies. By adjusting the risk reward profiles of investment in small companies and addressing genuine market failures, the incentives support the growth of AIM companies, boosting entrepreneurship, innovation and hence support productivity and economic growth. Box 2 below sets out some of the key principles around the design of an effective and efficient fiscal incentive.

Box 2: What makes a good fiscal incentive

Fiscal incentives have a key role in addressing a market failure – in this case relating to the supply of finance to SMEs affected by the persistent equity gap. The range of incentives applicable to unquoted securities are critical to ensuring the continued success of AIM and protecting the delivery of the significant economic benefits that AIM companies generate. It is important that any fiscal incentive is efficient and effective to ensure value for money. A good fiscal incentive should:

- address a clear market failure and have a strong rationale
- support the delivery of Government policy and strategy
- be transparent, simple and automatic in order to reduce administration costs
- deliver genuine additionality (ie not just replace what would have occurred in the absence of intervention)
- be targeted to minimise deadweight and displacement
- correct market distortions
- provide continuity and certainty
- be cost effective and deliver value for money outputs
- produce economic benefits which are significantly in excess of economic costs.

In this case, success is measured by the economic benefits which flow from the additional investment in AIM companies that would not otherwise be taking place, balanced against the financial costs to the Exchequer plus the costs of administering the incentive. The incentives are well targeted, supporting investment into AIM companies. The incentives have a clear role to play in directing investment towards growth companies.

Source: Grant Thornton analysis based on HM Treasury Green Book Principles

4 Role of fiscal incentives

Key points

- Over £3.6 billion of funds have been raised through Venture Capital Trusts since inception in 1995. The Enterprise Investment Scheme has directed over £7 billion to eligible companies (including those admitted to AIM) since the start of the scheme in 1993/1994 through to 2007/08
- The package of incentives supporting AIM securities tackles genuine market failures associated with access to finance for small firms, and have an important role in supporting market liquidity, thereby lowering the cost of capital

4.1 Relevant fiscal incentives

This section sets out the role and impact of specific incentives as they relate to AIM and outlines how they support the delivery of the benefits as we have outlined above. Fiscal incentives which have a positive impact on AIM are:

Venture Capital Trust Scheme

Venture Capital Trusts (VCTs) are collective investment vehicles listed on the Main Market of the London Stock Exchange. They are run by investment managers with experience of working with smaller companies and raise funds from private investors. VCTs encourage individuals to invest indirectly in a range of small higher-risk companies, by spreading the investment risk over a number of companies. This allows investors (through VCTs) access to a wider range of investment opportunities. The incentives, including capital gains, income tax and dividend relief, go some way to offset the higher potential level of risk associated with investment in smaller cap growth stocks. To ensure their ongoing eligibility, VCTs have to invest at least 70% of the funds raised in new issues of unlisted shares (including AIM company shares).

Over £3.6 billion of capital has been raised through the VCT scheme since its inception in 1995/1996, of which over £800 million has been raised by AIM VCTs, enhancing access to capital for smaller cap stocks. In addition to capital, companies that received VCT investment benefit from the expertise and detailed industry knowledge provided by VCT managers.

Our interviews also highlighted the beneficial role and impact that the VCT fund management companies and process can offer to the investee companies to help improve business performance and enhance growth. The tax efficient status of investment in AIM shares also supports the effectiveness of share option schemes in attracting and retaining key staff within AIM companies.

VCTs have a key role to play in bridging the equity gap, but the attractiveness of the schemes is dependent on the incentives available. Further tightening or restrictions on the incentives could therefore put at risk delivery of the significant economic benefits that AIM companies, including the VCTs themselves, generate.



The increasing restrictions on VCTs have had a detrimental impact in terms of funds raised and performance, and there has been a reduction in the number of investee companies benefiting from the scheme.

The value of qualifying investments in AIM companies held by AIM VCTs is over £200 million. Generalist VCTs also hold an additional £100 million in AIM companies.

Enterprise Investment Scheme

The EIS provides a range of income tax and capital gains tax reliefs to encourage equity investment directly from individual investors in smaller cap stocks. The reliefs are applicable to investment in new shares only.

These investments are designed to be used by small higher-risk companies to grow their businesses. By increasing the incentive to invest in SMEs the EIS also helps bridge the equity gap.

In the 15 years since being established to 2007/08, over 15,000 companies raised funds for the first time through the EIS. In total across the period since 1993/1994, over £7 billion of investment has been made through EIS. In 2008 EIS investment levels were around £700 million per year and represented a significant source of finance for SMEs.

Along with VCTs, EIS has been an important driver of capital bringing investment into smaller cap stocks with genuine additionality. This was identified in a number of our case study and stakeholder discussions.

Business Property Relief for Inheritance Tax

BPR allows transfers of eligible business assets to reduce inheritance tax liability, subject to a range of restrictions. Transfers of AIM securities are eligible for inheritance tax relief (after a two-year holding period).

BPR provides longer term liquidity due to the two-year minimum holding period. The relief plays a significant role in allowing founders and seed investors to exit by minimising the tax burden on transfer. It also encourages high net worth individuals to allocate a proportion of their investment portfolio to SMEs.

In 2007, the leading IHT funds alone held £530 million in AIM companies. Analysis of HMRC data indicates that in a typical year, there are over 800 cases of IHT relief against unquoted shares with the value of the relief applied ranging from £300 million to £600 million, although not all of these are AIM companies.

These fiscal incentives have a key role to play in bridging the equity gap and addressing market failure relating to equity investment for growth companies. The aims and objectives of each fiscal incentive together with an overview of their uptake and effectiveness are detailed in Table A1 on page 26.

This package of incentives helps to address the problems associated with the equity gap and improve the attractiveness of SMEs to investors by stimulating additional liquidity in the secondary market.



4.2 Economic impact of fiscal incentives

The fiscal incentives have a key role to play in enabling AIM companies to access finance, provide jobs and support economic growth. They do this both through initial injections of capital (through the EIS and VCT schemes) and through the provision of liquidity in the secondary market (BPR).

However, over time changes to VCT legislation have made the scheme more restrictive. These changes are summarised in

Figure 9 below. The changes in the VCT investment criteria have made a significant contribution to the reduction in the average funds raised at admission by AIM companies.

The changes have also increased the complexity and management costs of the scheme (eg the requirement to ring fence funds raised under each set of criteria as the requirements tightened), reducing the incentive for AIM VCT managers to raise further funds.

Figure 9: Trends in AIM VCTs

Tax year	AIM admissions	Admissions of UK companies operating in qualifying sectors	AIM VCT funds raised	Max gross asset limit	EU restriction
2005/06	509	143	£196m	£15m	
2006/07	391	132	£29m	£7m	
2007/08	262	108	£9m	£7m	£2m max VCT EIS per company; <50 employees
2008/09	83	38	£6m	£7m	£2m max VCT EIS per company; <50 employees

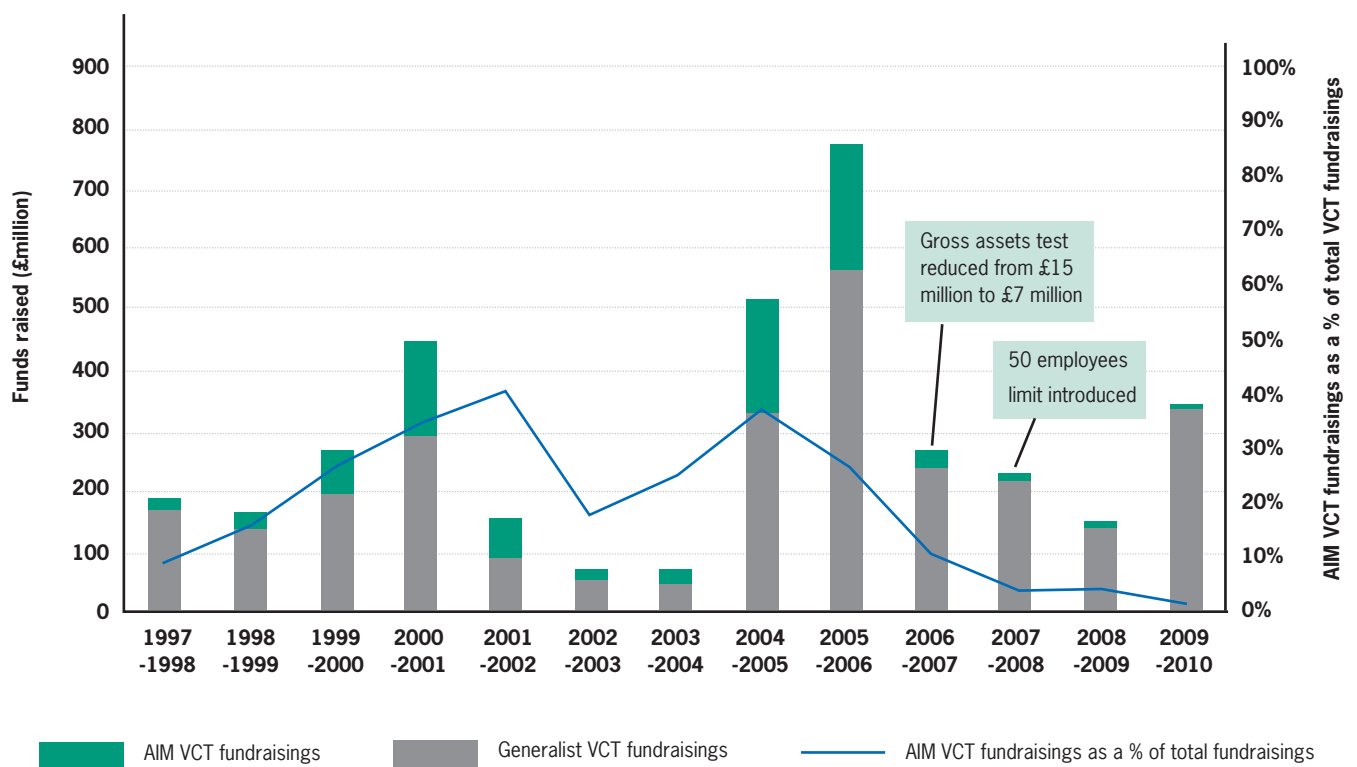
Source: HMRC and Office of National Statistics

Bridging the equity gap

These fiscal incentives help to increase the sources of finance available for smaller companies. VCTs have been a major source of finance for growth companies since inception in 1995, having raised over £3.6 billion by 2008/09. The amount raised (by AIM VCTs) has fallen sharply since 2005/06 however, constraining a key source of SME finance.

This is important because VCTs focus on the smaller end of the AIM companies (for example in 2009, 35% of AIM companies would pass the VCT eligibility requirement for maximum number of employees). Figure 10 below indicates the amounts raised.

Figure 10: AIM VCT fundraisings as a proportion of total VCT fundraisings



Source: HMRC, London Stock Exchange

Our interviews highlighted the problem of VCTs being restricted to new equity issuances as presenting a barrier to them being able to fully support their investee companies. VCT investment in the secondary market would provide much needed additional liquidity to eligible AIM securities and help alleviate the high cost of capital experienced by these companies. Over time this will allow companies to raise further funds at a lower cost. With a decrease in the number of new AIM admissions, it was suggested by interviewees that this presented a constraint to the potential positive impact of the VCTs.

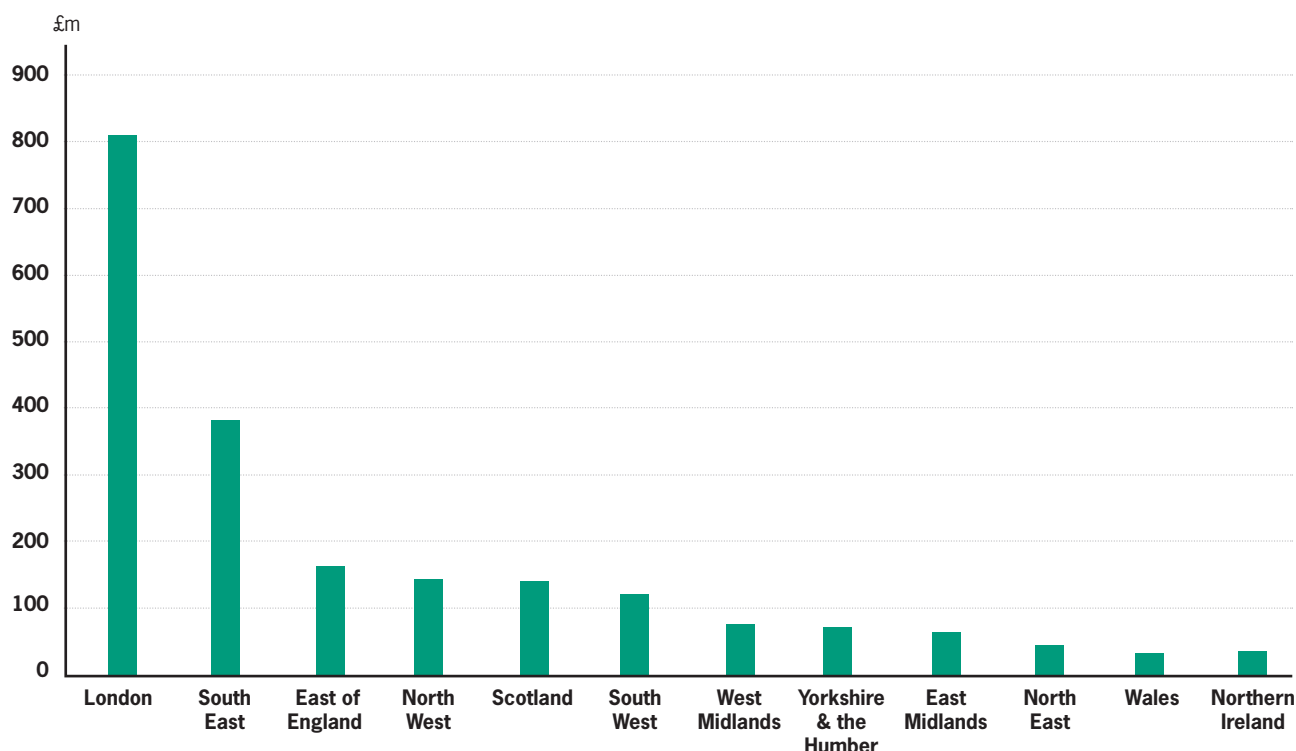
AIM VCTs are required to invest at least 70% of their funds within eligible companies within three years, of launch. With limited new subscriptions, this could present significant risks to AIM's attractiveness as a platform for SMEs raising capital in the coming years while reduced levels of liquidity across the market make investing in SMEs less attractive for the wider investor community.

HMRC figures on the amounts of funds raised by companies demonstrate the significant impact the EIS scheme has had across all regions. The majority of companies raise up to £300,000. In 2007/08, 26% (568) of companies are described as 'high tech' companies. From the start of the scheme in 1993/1994 to 2007/08, the EIS has directed over £7 billion to eligible companies (including AIM companies).

Since inception, 25,000 companies have benefited from investment through EIS. Over £2 billion was raised between 2005/06 and 2007/08, and over a quarter of beneficiaries are high tech companies. Over 60% of funds raised through the EIS are for companies accessing external investment for the first time – indicating significant additionality.

Earlier research for the HMRC¹³ indicated that between 52% and 87% of the funding provided through the EIS and VCT schemes would not have been invested in small, unquoted companies in the absence of the schemes.

Figure 11: Enterprise Investment Scheme – funds raised by nations and region 2005/06 to 2007/08

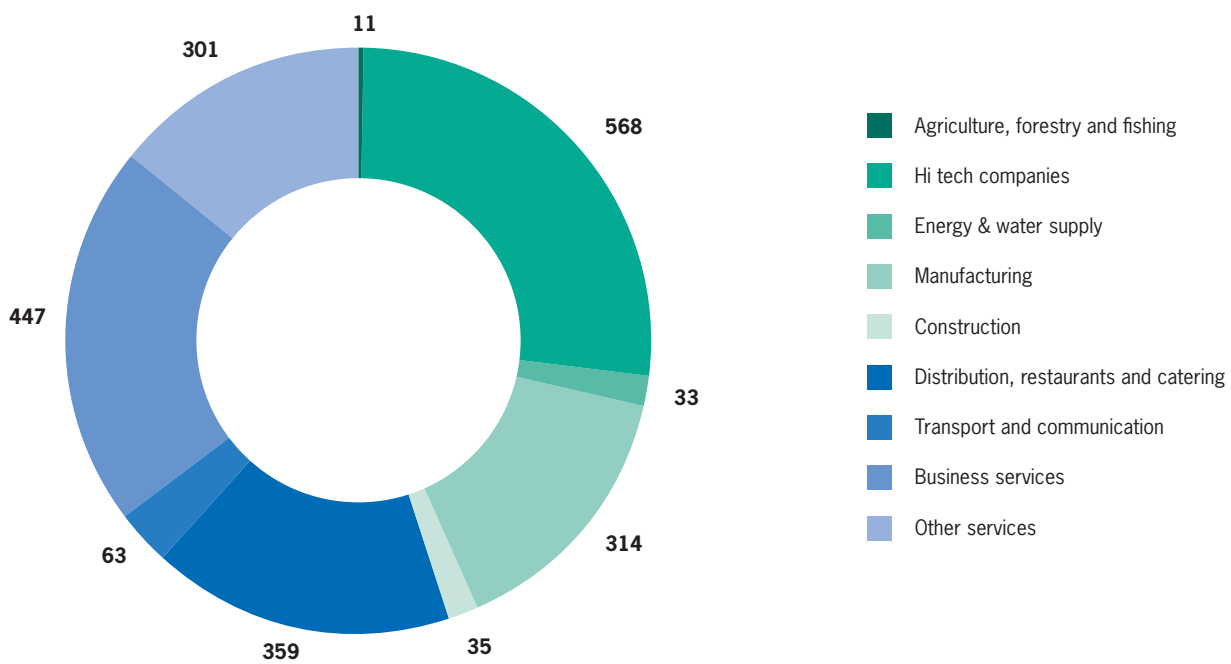


Source: HMRC

¹³ Financing a private sector recovery, HM Treasury & BIS (July 2010).

EIS has benefited a wide range of businesses, with the largest beneficiaries being high tech businesses followed by companies in the business services sector. Figure 12 below indicates the breadth of companies receiving investment under EIS.

Figure 12: Enterprise Investment Scheme – funds raised by sector 2005/06 to 2007/08



Source: HMRC

Improving liquidity on AIM

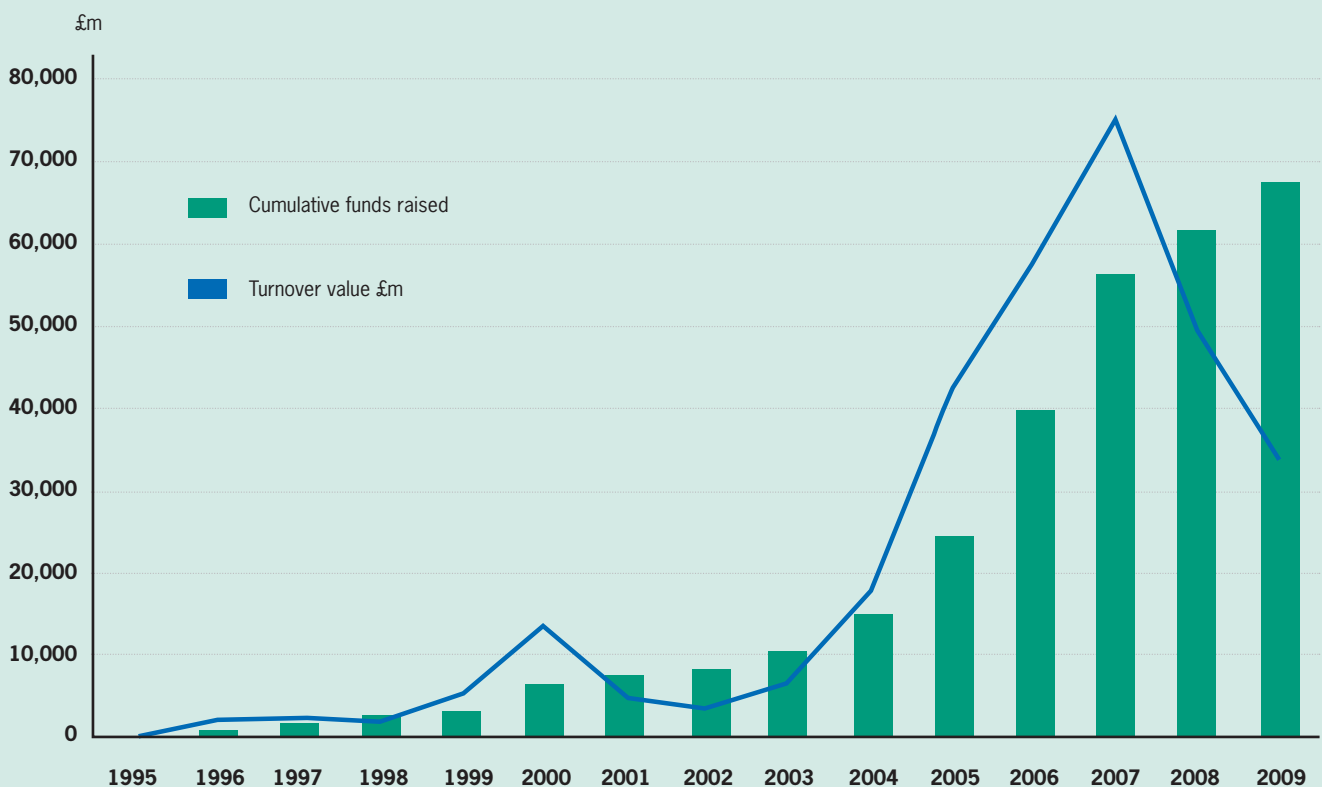
Research suggests that lower liquidity results in investors requiring higher predicted returns to compensate for greater uncertainty over their exit options, and this translates to a higher cost of raising equity capital. As smaller cap stocks

tend to have lower liquidity, this implies a higher cost of capital which in turn suggests constraints in the availability of funds for productive investment. Further evidence of the link between the liquidity and cost of capital is given in Box 3.

Box 3: The link between liquidity and the cost of capital

Research indicates a direct causal link between liquidity and the cost of capital. Improving the level of liquidity in a market appears to lower the cost of capital. There is an extensive and widespread body of evidence, influenced by the original work conducted by Amihud and Mendelson which identified that increases in liquidity directly contributed to lowering of the cost of capital for a company. The chart below indicates how liquidity on AIM has evolved since its inception. It can be seen that the last few years have seen significant reductions in the value of shares traded.

Turnover value of AIM trading and cumulative funds raised since launch



Source: London Stock Exchange and Thomson Reuters

The authors considered a number of potential options for managers to increase their liquidity, including measures such as stock splits, appropriate trading venues and taking advantage of new technologies. Asset liquidity appears to be very valuable with respect to the cost of capital. An Oxera report on the costs of capital also reviewed the academic literature on the subject, concluding that the academic literature shows that any differences in trading costs also have an impact on share valuations and the cost of capital. Domowitz and Steil (2001), estimates a 10% increase in transaction costs increases the cost of capital (as measured by the post-tax cost of equity) by between 1.4% and 1.7%.

Further secondary research by Oxera indicated a 'small firm' effect which makes small firms' stock more vulnerable to market illiquidity. It highlights research by Amihud (2002) which highlights that in times of dire liquidity there is a 'flight to liquidity' making large stocks relatively more attractive, as witnessed in recent market conditions.

Source: Journal of Financial Economics, Journal of Applied Corporate Finance, National Bureau of Economic Research and OXERA.

Although the incentives have different eligibility requirements and differ substantially in terms of scale and focus, the range of fiscal incentives available to investors in AIM tackle well defined market failures across the primary (ie new share issues) and secondary markets (ie in the trading of AIM securities).

Both the EIS and VCT schemes direct investment to new share issues and therefore address failure in the primary market relating to the equity gap. Whereas, Business Property Relief and Entrepreneurs' relief (and the previous CGT taper relief) contribute towards improved liquidity in the secondary market by providing incentives for investors to allocate a greater proportion of their investments to small cap stocks.

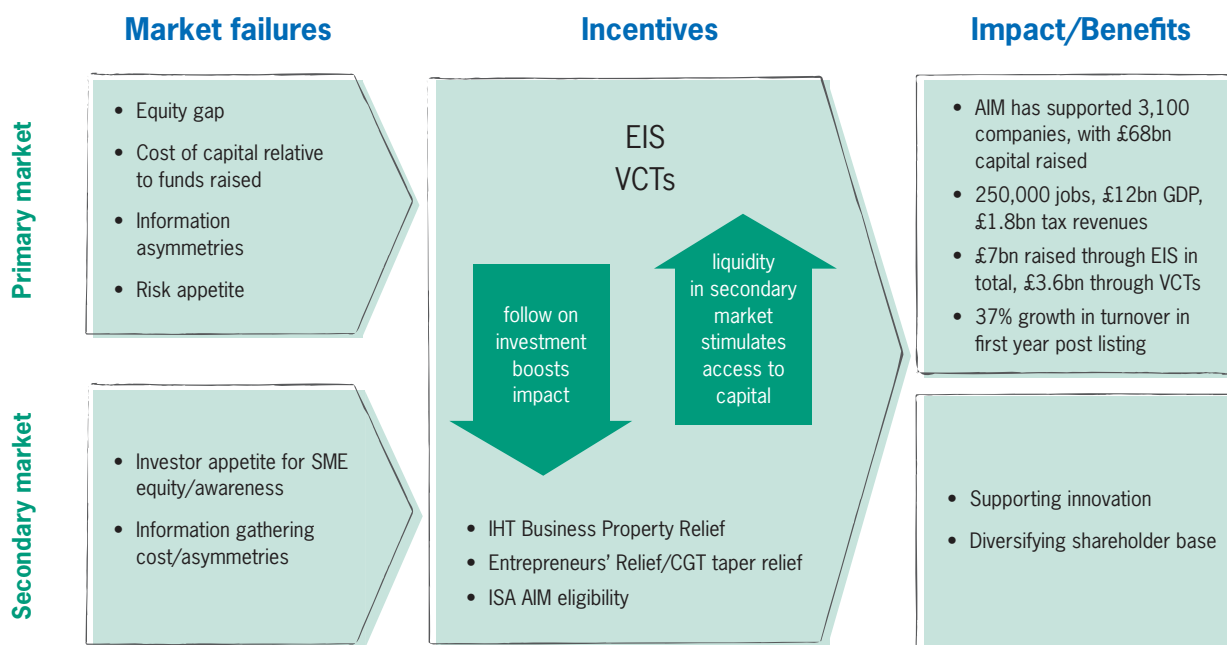
Liquidity in the secondary market is closely linked to the investment in the primary market. Without well functioning secondary markets, efforts to attract investment in the primary market are likely to struggle as investors need confidence that there is sufficient liquidity in the secondary market to support current valuation levels or future exit decisions.

Put simply, investors will not provide funding or invest in new shares if the secondary market does not support sufficient levels of liquidity or a suitable valuation of the security.

Low liquidity and poor valuations are key threats to AIM, with negative consequences across the funding ladder. Liquidity in the secondary market for SMEs is inherently lower due to the supply and demand forces in SME shares. This lack of liquidity raises the costs of capital for SMEs, constraining their investment and expansion plans, ultimately limiting their potential contribution to economic growth and job creation.

The overarching rationale is consolidated in the diagram below. The incentives supporting investment in the primary and secondary markets need to be seen as a package of measures to address dual market failure. An active secondary market is a pre-requisite for a successful primary market.

Figure 13: How fiscal incentives work together to address liquidity and the equity gap



Fiscal incentives have a key role to play in improving liquidity and addressing this dual market failure across the primary and secondary market for small cap shares.

Augmenting liquidity and trading in the secondary market is key to revitalising the success and impact of VCTs and EIS and their role in supporting access to capital. The fiscal incentives support companies at different stages of their lifecycle and in relation to the scale of investment. VCT investment tends to be for larger funding amounts than EIS and at a later stage in the company's lifecycle. The BPR/IHT incentive, with a different focus on encouraging high net worth investors to allocate a proportion of their portfolio to SMEs, is more likely to be applicable to more developed companies often paying dividends, although these may still be small businesses with founders seeking to realise value.

AIM also provides an exit for private equity and other early stage (pre-AIM) investors. Most early stage investors are only willing to provide funding because of the viable exit through the public market. Declining levels of liquidity on AIM therefore have a ripple effect whereby earlier stage companies will find it more difficult to access external investment. Earlier funders will avoid the risk associated with exiting at a time of poor liquidity and valuation levels.

4.3 Exchequer cost of reliefs

Figure 14 below indicates the estimated cost of the VCT scheme and EIS to the Exchequer compared with the amounts of funding directed to small companies. It can be seen that there is a significant 'leverage effect' whereby the amounts invested significantly exceed the cost to the Exchequer.

Figure 14: Funds raised and cost to Exchequer¹⁴ of specified tax reliefs

	2004/05 to 2007/08
EIS cost to Exchequer	£670m
EIS funds raised	£2,676m
EIS ratio of funds raised to cost	4
	2004/05 to 2008/09
VCT cost to Exchequer	£855m
VCT funds raised	£1,950m
VCT ratio of funds raised to cost	2.3

¹⁴ EIS and VCT figures include the cost associated with capital gains and income tax. Relief for trading loss cost is presented separately (at £10m per annum). These figures take into account the subsequent effect on income tax liability of the earlier use of trading losses against capital gains.

4.4 Potential additional incentives for AIM

Enabling AIM company shares to become eligible for ISA investments could provide a further source of liquidity, protecting the economic benefits delivered. It would be necessary to ensure an appropriate balance of investor protection was maintained for retail customers. AIM shares are regarded as unlisted, therefore shares in these companies do not currently qualify for inclusion of a share in an ISA (except those with dual listing on a recognised exchange).

Additional incentives that promote liquidity could also be introduced. For example, reducing the tax rate on capital gains made on investment in AIM securities from the existing 28% would attract a wider set of investors as investment costs are reduced. In a more limited manner, enabling AIM company shares to be eligible for ISA investments could also provide a further source of liquidity, protecting the economic benefits delivered. It would of course be necessary to ensure retail investors were aware of the potential downside of investing in smaller, earlier stage companies.

Furthermore, to direct capital flows to businesses that need them most, incentives could focus on the innovative 'three tech' sectors: high, clean and bio.

4.5 Importance of continued support for fiscal incentives

As stock market conditions have deteriorated globally, the aggregate amounts raised by companies admitting to AIM has fallen from £6.5 billion in 2006 to £740 million in 2009. This suggests risks to the impact and benefit that admission to AIM can deliver for companies in future years.

It is imperative to not risk the economic benefits delivered by AIM by restricting existing incentives. Instead, fiscal policy should recognise and promote a package of incentives that seeks to address the funding gap and lower the cost of capital for companies by bringing a wider set of investors to smaller companies in the primary and secondary markets.

5 Going forward

5.1 The need to reshape the UK economy

There are signs that the worst of the economic recession may be over, but significant and serious challenges still remain. The large UK Government deficit, weak prospects for the Euro area and the ever present level of unemployment will hold back any growth of the UK economy for years to come. The path back to normality will indeed be rocky, but the financial and economic crisis should hopefully continue to dissipate.

The new coalition government has quite rightly focused its attention on tackling the large public deficit, without doubt the most serious problem facing the long-term health of the economy. We urge it not to underestimate the importance of reshaping and rebalancing the economy over the medium term. Going forward, the financial and business services sector will still be vital, particularly to London, but greater economic balance will be required. Productivity, investment and employment growth will need to come from other industries and sectors.



5.2 AIM has a critical part to play

AIM has a critical part to play in helping to rebalance the economy, encouraging investment and economic growth. AIM companies are typically fast growing and innovative, and consistently outperform the wider business population in terms of employment and turnover growth. But the market experiences some genuine market failures which are partly corrected by fiscal incentives such as Enterprise Investment Schemes, Venture Capital Trusts and Business Property Relief. These fiscal incentives have a key role to play in ensuring the success of the market and thereby protecting the delivery of the significant economic benefits that AIM companies generate.

5.3 Recommendations

The strength and effectiveness of the fiscal incentives to encourage investment to SMEs securities has been eroded in recent years, particularly with the removal of CGT business asset taper relief in the 2008 Budget and the tightening of eligibility requirements for VCTs which have severely restricted the flow of funds to SMEs, particularly those admitted to AIM. This has not only made AIM less attractive for entrepreneurs and investors, but also created a perception of a reducing public sector commitment to smaller quoted companies.

The UK government is seeking to finance a private sector recovery¹⁵. We believe therefore that action is needed now to address the erosion of the effectiveness of fiscal incentives such as VCTs, EIS, IHT BPR in order to support the role of AIM and the private sector in particular. A healthy and entrepreneurial SMEs sector will help drive the recovery of the UK economy.

The following five proposals are designed to help lower the cost of capital for smaller companies by attracting a varied set of investors to provide upfront investment and to enhance liquidity.

¹⁵ Financing a private sector recovery, HM Treasury & BIS (July 2010).

1. Allow VCT participation in the secondary market

This would ensure the potential of the VCT infrastructure is maximised and stimulate appetite in the primary market, enhancing the success of the scheme.

VCT investment in AIM's secondary market would provide an immediate source of liquidity through already raised funds (hence at minimal cost to the Treasury). This would alleviate some pressure on downward valuations experienced by many smaller AIM companies.

As VCT fund managers offer their expertise and ongoing support to the companies they invest in, their further investment would restore confidence in the market and attract other investors. This would further boost liquidity and help lower the cost of capital in the longer term.

A restriction on the level of funds that can be invested in the secondary market can help address any concerns that such a change may result in a change in focus of VCT activities.

2. Increase the gross assets and employees test limits for VCTs

It is proposed that the gross asset test should be increased from £7 million to up to £15 million and the employee test limit from 50 to 250 employees.

The increased limits, while remaining within the SME definition under EU State Aid Rules, would seek to alleviate the funding gap as a larger population of SMEs could benefit from VCT investment. The changes would also allow VCTs to balance their portfolios, ultimately making them more attractive to end investors and thus helping companies raise additional funds.

3 Reduce capital gains tax for smaller companies

Introducing a reduced CGT rate for investment in smaller companies to boost investor interest and help reduce the cost of capital for such companies.

Any further increases to capital gains tax would diminish investor return and interest in smaller companies. This in turn would reduce liquidity.

4. Protect the liquidity benefits and economic impact derived from the IHT Business Property Relief

BPR provides a valuable source of longer-term liquidity for SMEs as a result of the two-year holding period, providing confidence to the wider investment community. The support provided for SMEs through this incentive is significant, with IHT funds holding £530 million in AIM shares as of September 2007. Without this incentive, a lower proportion of individuals' portfolios would be allocated to SME stocks.

5. Further consideration for AIM security eligibility within ISAs

Inclusion of AIM securities in ISAs would attract a broader set of investors and enhance liquidity in these securities. This would directly impact on companies' ability to raise further capital at a reasonable cost. Inclusion of AIM shares in ISAs would therefore help to make incentives such as the VCT scheme more effective.

AIM is clearly positioned as a market for smaller companies at an earlier stage in their development, and therefore retail investors would be aware of the higher potential risks of including AIM securities in their portfolios.

However, this recommendation should not be implemented at the expense of existing schemes, which remain key to SME access to capital at the time of admission to AIM.

AIM shares have historically been excluded from ISAs on the grounds that for AIM shares to be included would require their unlisted status for tax purposes to be removed. This would potentially make them ineligible for inclusion in VCTs and EIS or for IHT BPR relief. This argument is inconsistent with the fact that AIM shares are eligible for inclusion in SIPPs along with fully listed shares.

5.4 A call to action

The UK economy is in need of rebalancing. The financial and business services sector, the powerhouse of the previous economic boom, will be important in the future but is unlikely to have such a strong influence. Productivity, investment and employment growth will need to come from other new industries and sectors, if the private sector is to lead the UK recovery.

So where will this new growth come from? We should not try to pick winners. Governments, practitioners and various commentators have been notoriously bad at predicting the industries of tomorrow. Instead, successful entrepreneurs and new businesses will identify the industries and services of the 21st century, such as biotech and green industries.

In an environment where finance is restricted, AIM plays an important role helping SMEs in these sectors to secure finance and grow. Government should support and encourage a culture of innovation, investment and enterprise, which will be critical to delivering sustainable and high economic growth over the coming years.

A) Fiscal incentives available to AIM companies

This appendix provides further detail on fiscal incentives currently available to AIM companies as well as the additional proposed incentives.

A.1 Eligibility for the Enterprise Investment Scheme

The tax reliefs include:

- 20% income tax relief. This relief takes the form of a credit against an individual's personal tax liability. It is given at 20% of the sum invested subject to there being sufficient tax liability to absorb the relief. The maximum tax credit available to an individual is £100,000 in each tax year resulting from a £500,000 investment threshold.
- No capital gains tax on disposal. If a qualifying individual holds eligible shares for more than three years from the date of issue (or from the date of commencement of trading, if later), then any capital gain on the disposal of the EIS shares after that period will be tax-free, subject to any withdrawal of the relief as mentioned below. Further, if a loss arises on the disposal of EIS shares then, subject to adjusting for the income tax relief previously claimed, that loss will be available to the investor. This relief can either be claimed as a capital loss or as a loss for income tax purposes.
- Deferral of tax on other capital gains. CGT on a gain from the disposal of any asset can be deferred against an EIS share subscription. The tax on any gain rolled over in this way only becomes due on disposal of the EIS shares (provided the conditions are met through the three-year period referred to above) or if the individual ceases to be UK resident within three years of issue of the shares.

The EIS has benefited a wide range of businesses, with the largest beneficiaries being hi tech businesses followed by companies in the business services sector.

The tax reliefs are available to 'qualifying individuals' who subscribe for 'eligible shares' in 'qualifying companies' undertaking 'a qualifying business activity'. We provide a summary definition of each of these below:

- **Qualifying individuals:** This is any individual who has subscribed for eligible shares wholly in cash in the company. The individual cannot be connected with the company. The connection can be by way of employment, partnership, or by being an associate (eg a spouse or child,

but not a brother or sister) of such a person. They cannot however be a director in some circumstances.

The individual will also be connected if they own or are entitled to acquire, directly or indirectly, more than 30% of the issued ordinary share capital, loan capital, issued share capital or voting power of the company or a subsidiary. They must also be a qualifying individual for the two years prior to the share issue and three years after the share issue date or the date on which trading commences, if later.

- **Eligible shares:** Are any new ordinary shares issued in the EIS company for bona fide commercial reasons, which, throughout the period of three years beginning with the date on which they are issued, carry no preferential rights to dividends or assets on liquidation of the company. The shares must be fully paid up at the time of issue and they cannot be redeemable.
- **Qualifying companies:** A qualifying company need not be resident in the UK for tax purposes but it must be unquoted and the funds raised must be used by the issuing company or by a qualifying 90% subsidiary in carrying out qualifying activities. Companies listed on AIM are treated as unquoted for the purpose of this relief. The gross assets of a non-group company, or aggregate gross assets of the group, must not exceed £7 million prior to investment or £8 million post investment (£15 million and £16 million respectively for shares subscribed for before 22 March 2006 or issued before 6 April 2006).
- **Qualifying business activity:** Broadly speaking, the business activity for which the money is being raised should be conducting a qualifying trade wholly or mainly in the UK during the three years from when the shares are issued or, if later, three years from when the company commences to trade. Research and development undertaken with the intention of starting to trade is also treated as a qualifying business activity.
- **Qualifying trades** encompass all forms of trading except for certain prohibited businesses including dealing in land, financial activities, legal/accountancy services, property backed activities, shipbuilding, as well as coal and steel production.

In addition, funds raised through EIS must be applied within two years and the shares must be held for a minimum of three years to be eligible for the tax incentives. The EIS company or group cannot, at the time of issue of the shares, have more than 50 employees, or have raised more than £2 million in the last year under EIS, VCT or the Corporate Venturing Scheme (see VCT comments below).

A.2 Eligibility of VCTs

There are a range of requirements on investments made by VCTs intended to support the policy objective of directing equity to smaller growth companies which would not otherwise be able to access such capital.

These constraints include:

- No more than £1 million can be invested each year in an unquoted trading company and any holding in a single company must not exceed 15% of the value of the VCT's total investments at cost
- The VCT cannot invest in any company whose gross assets exceed £7 million immediately before the investment in it or £8 million afterwards (this is reduced from the limits of £15 million immediately before the investment and £16 million afterwards that applied prior to 6 April 2006)
- The VCT cannot invest in a company or group of qualifying companies with 50 or more employees from 6 April 2007
- Funds raised by VCTs must be applied within two years.

From 6 April 2007, the VCT cannot invest in a company that has raised more than £2 million in the past year through VCTs, the EIS or the Corporate Venturing Scheme (however, shares issued to VCTs on or before 5 April 2007, shares issued to VCTs for money raised on or before 5 April 2007, and shares issued under the Corporate Venturing Scheme and EIS prior to 19 July 2007, are ignored for these purposes).

A.3 Business Property Relief for Inheritance Tax

On death, transfers or gifts made in the previous seven years are added to the value of assets then held by the deceased and tax is assessed by reference to this total and certain transfers made in the previous seven years. Similarly, the total value of chargeable transfers made in the last seven years determines the tax payable on the last transfer. Once seven years have elapsed since the making of a gift, it can generally be ignored. It is not then taken into account for the calculation of tax on later lifetime transfers, and is not added to the rest of the estate on death.

There are two principal reliefs from IHT, namely: business property relief and agricultural property relief. Both types, subject to certain ownership conditions, operate by reducing the chargeable value of qualifying assets. The reduction relating to business property relief is: 100% for business interests and, with effect from 6 April 1996, all shareholdings in qualifying unquoted companies (including those traded on AIM).

Table A1: Incentives currently available to investors in AIM companies

Incentive	Policy aims	Details	Key benefits	Eligibility	Uptake/Effectiveness
Venture Capital Trusts	VCTs encourage individuals to invest indirectly in a range of small higher-risk companies, by spreading the investment risk over a number of companies. Through this system, investors in VCTs can gain access indirectly to a professionally managed portfolio of unquoted investments, including shares in qualifying AIM companies.	VCTs are collective investment vehicles. Investors acquire shares in a VCT which then invests in trading companies. VCTs gain an equity stake in the business in return for their investment, therefore becoming shareholders in these companies. Their return is dependant on the profitability and growth of investee companies, and will be gained when the VCT sells its shareholding to another owner.	Investors into VCTs may be entitled to various forms of tax relief. These include: Dividend relief: exemption from income tax on dividends from ordinary shares in VCTs. Income tax relief: for shares in VCTs for which were subscribed to a maximum of £200,000 issued in that year. At 30% of the amount subscribed for shares issued provided the shares are held for five years. Capital gains tax (CGT) relief or disposal relief, where investors do not have to pay CGT on gains made when they dispose of their VCT shares.	VCTs must be approved by HMRC, for which they must meet certain conditions. A VCT's investments must, after three years, be at least 70% in qualifying unquoted trading companies.	In 2009 there were 29 AIM VCTs with net assets of £330 million ¹⁶ . Since 1994, AIM VCTs have raised over £800 million, contributing significantly to the supply of long-term finance to support SME growth. The value of qualifying investments in AIM companies is £205 million – representing ~20% of the value of the relevant population of companies. Generalist VCTs also hold investments in AIM companies, representing ~10% of the value of the relevant population of companies. However, the changes in VCT investment criteria introduced in 2006 and 2007 have disproportionately impacted on AIM VCTs in comparison to Generalist VCTs.
Enterprise Investment Scheme	This scheme was designed to attract individual investors to small higher risk companies to grow their businesses.	A range of tax reliefs for investors. Investments can be made either directly or through EIS funds.	Income tax relief: 20% relief on the investment leading to a maximum of £100,000 reduction on income tax liabilities. CGT exemption: relief on gains arising on disposal of EIS qualifying shares. CGT deferral relief : deferral of the capital gains tax charge on a capital gain that is reinvested in an EIS qualifying company. Loss relief: if the shares are disposed of at a loss, that can be set against income of that year, instead of being set off against any capital gains.	All must be qualifying investments up to £500,000. For income tax relief and CGT deferral, the investment must be held for three years.	Over 1,000 new companies have obtained EIS funding each year. In 2008 EIS investment levels were around £600 million per year. Companies receiving investment through EIS and VCTs exhibit enhanced growth indicators.
Business Property Relief	Provides longer-term liquidity for companies and improves investor confidence.	Relief from an individual's IHT liability.	100 per cent relief from inheritance tax (IHT) on investments in qualifying AIM companies.	Investment must be held for a minimum of two years. Qualifying AIM stocks must be 'trading companies' to qualify.	Promotes longer-term liquidity due to the two-year minimum holding period. In 2007, the leading IHT funds alone held £530 million in AIM companies.

¹⁶ Based on latest audited annual financial statements of each AIM VCT.

Table A2: Incentives previously available for investment in AIM companies

Incentive	Policy aims	Details	Key benefits	Eligibility	Uptake/Effectiveness
Capital gains tax – Business Asset Taper Relief (BATR).	Targeted at attracting a wider set of investors to smaller companies, boosting medium to longer-term liquidity.	Taper relief available to individual investors and trustees to reduce CGT liability. Shares in qualifying AIM companies were classed as 'business' assets.	50% or 75% BATR available for capital gains on sale of AIM shares depending on number of years an investment was held.	AIM shares could be purchased in the primary or secondary market. Qualifying AIM shares had to be 'trading companies' to qualify.	This relief, previously available for holdings in AIM securities, was abolished in the Finance Act 2008. Prior to abolition an estimated 680 AIM companies with a combined value of £30 billion qualified as business assets for the purposes of taper relief. As ~50% of shares were estimated to be held by institutions at the time, over £16 billion of AIM securities (24% of the total market value) potentially qualified for BATR. A London Stock Exchange survey at the time revealed that 90% of retail investors considered the CGT BATR to be a significant factor in their decision to buy AIM shares. Over two-thirds planned on selling all or part of their qualifying AIM shares before April 2008.

Table A3: Additional incentives proposed by AIM

Incentive	Policy aims	Details	Key benefits	Eligibility	Uptake/Effectiveness
Eligibility for inclusion in ISAs.	To give investors the ability to invest in AIM company shares through ISAs.	AIM shares are regarded as unlisted, therefore shares in these companies do not currently qualify for inclusion of a share in an ISA (except those with dual listing).	Open more paths to investment into AIM companies.	Not yet implemented.	Not yet implemented.

B) Case studies

As part of our research we analysed a number of companies in terms of their experience of AIM, and undertook interviews to understand the benefits brought by admission to AIM. The case studies are drawn from a range of sectors and provide an indication of the breadth of drivers for seeking admission to AIM and the benefits delivered.

Case study 1 – Andor Technology plc

Andor Technology is based in Belfast, Northern Ireland and operates at the high-value end of the global scientific digital camera market. The company was set up in 1989, and now employs over 260 people in 16 offices worldwide and distributes its products to 10,000 customers in 55 countries. This represents significant growth – in 2002 the company employed 91 people.

Established as a spin out from Queen's University, Belfast, the company had previously received venture capital investment through an organisation linked to Belfast University.

The original objectives of the company included plans to list the company, with the current CEO originally having been brought in as finance director with responsibility for seeking to list. The owners did not want to exit via a trade sale and did not want to partner with a larger venture capital firm. They believed that listing provided 'more control and flexibility'. The company was not seeking to raise large amounts of capital, and a key driver for the company to join AIM was the enhanced public profile that it delivers.

Another key benefit of joining AIM was that it enabled the company to provide strong incentives for employees through the issuance of share options. These have played a major role in supporting staff retention and in attracting new staff into the business. Since its admission to AIM, the company has seen impressive growth with an especially strong performance in terms of profitability over the past two years, which is in part attributed to the strength of incentives provided through the employee share programme. A further benefit of being on AIM, compared to other possible forms of external finance, was identified as the ability to raise further funds at a market price without risk of significant impact on operational activity that could exist with the other forms.

Further benefits were identified as:

- flexibility – being on AIM allows the company to set its own objectives rather than being determined by external investors
- the public profile of being on AIM helps develop investor appetite
- simplicity of the listing process
- quoted shares 'provide currency' for the company when seeking to make acquisitions.

Case Study 2 – Mears Group plc

Mears is the leading social housing repairs and maintenance provider in the UK and a growing presence in the domiciliary care market. Mears also has a subsidiary mechanical and engineering division. The company joined AIM in 1996, with 83 staff and turnover of £12 million. By 2006 the company had over 2,500 employees and was in the top 20 in its sector in Europe for employment growth. In 2008 Mears transferred to the Main Market of the London Stock Exchange and subsequently won the PLC award for new company of the year on the Main Market. It currently employs over 8,000 staff.

Overall, the company's experience of AIM was described as 'very favourable'. The benefit was not only seen once admitted to the market, but the company experienced a pre-admission impact as it enhanced its performance to ensure a smooth admission and early trading activity.

The tax advantages of AIM were identified as a major draw at the time of listing, but have become of less importance as the scale of the benefit has been reduced.

A major driver for Mears Group seeking to join a public market was the 'currency for growth' it would have from its publicly traded shares, eg when seeking to make

acquisitions. Joining AIM also raised the company's profile and received the acceptance and understanding from the market of the growth nature of businesses which can lead to inconsistency of results. On the Main Market, a lack of stable performance would lead to major falls in share prices, whereas on AIM there is a greater recognition and tolerance of the uncertainty.

Case study 3 – Murgitroyd Group plc

Murgitroyd is a firm of European patent and trade mark attorneys which assists organisations to protect their intellectual property rights.

AIM was the right fit for the company given the scale of operations and the amount of funding being sought. At the time of its admission to AIM in 2001, Murgitroyd had an annual turnover in the region of £8 million to £10 million based solely in the UK, whereas it is now a £30 million business with 15 offices internationally.

The company was seeking to balance a range of objectives for listing, which included:

- founders were looking for partial exit
- to re-structure the capital base balance (from debt to equity)
- to raise the profile of the company
- to enhance staff retention through enabling use of share options.

Their proposition to investors was described as the delivery of sustainable growth, and they have undertaken four acquisitions since the initial listing – this was not an objective of coming to market per se, but being public made it easier to undertake acquisitions. Murgitroyd has not sought to raise further funds since its admission.

As part of its admission process, the company strengthened its corporate governance arrangements with the introduction of two non-executive directors and forming of an audit committee and the remuneration committee.

Case study 4 – Tikit Group plc

Established in 1994, Tikit is a leading independent provider of IT consultancy, services and technology to legal and accountancy firms, with operations in the UK, US, France and Spain. In 2000 the company employed 63 staff, which has grown to over 200 since its admission to AIM in 2001.

Joining AIM has helped raised the company's profile and supported its international growth. Today, the firm has over 1,000 clients, including over 90 of the UK's top 100 law firms, 20 of the top 50 US law firms and 18 of the top 50 UK accountancy firms.

Financial performance has seen significant revenue growth in recent years, with turnover of £25 million in 2009.

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