

Citizens' Innovation Funds

The case for unlocking the patriotic potential of the public



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BTG

"Alongside good ideas, talent and strong business plans, funding is critical to building successful innovative companies. The Citizens' Innovation Funds (CIFs) would create an additional source of funding for developing businesses, while providing incentives to individual investors to support sectors that are important for our future economic growth."

Louise Makin, Chief Executive, BTG plc

"CIFs could be an effective way to attract investment into high technology businesses, particularly small and medium-sized enterprises. Access to capital is critical to the success of UK high technology industries, including the games industry. Policy makers should give serious consideration to the establishment of CIFs."

Richard Wilson, Chief Executive, TIGA

"Access to long-term, growth capital is vital for innovative gazelle firms to realise their potential. CIFs could assist in diversifying the finance market for these businesses."

Hayley Conboy Principal Policy Advisor, CBI

"UK medical technology companies are operating at the forefront of developing innovative devices to help and treat patients' worldwide. Funding for such activities, particularly in the early stages, is vital and CIFs offer the opportunity to unlock public support for innovative UK companies like our members"

Peter Ellingworth, Chief Executive, ABHI

"The CIFs concept has been implemented in other European countries with great effect and would provide a return for investors, while stimulating the life science sector and helping to maintain the UK as a leading provider of cutting-edge therapeutics. Apposite Capital wholly supports this exciting initiative"

Allan Marchington, Partner, Apposite Capital

"The kind of innovative companies we see across London could really benefit from an additional source of equity finance and CIFs offers the potential to deliver that by providing the public the chance to support UK innovation"

Dr. Olalla Linares Segade, Head of Research, London Chamber of Commerce and Industry

"Raising money through the FCPI scheme has enabled Seventure Partners to back promising companies and helps provide another source of capital to support innovation. The introduction of CIFs could build on the successful French FCPI model that clearly shows the potential benefits of the scheme to the UK."

Iain Wilcock, Investment Advisor, Seventure Partners, a venture capital company that has run FCPI funds

"The FCPI investment Syntaxin has received has provided another source of funding to support our innovative research and development for new treatments for patients. Having a similar scheme in the UK would benefit companies like Syntaxin, provide a boost to innovation and bring a understanding of science closer to the public."

Dr. Melanie Lee, Chief Executive Officer at Syntaxin, a company that has received FCPI funding

FOREWORD



Since we launched the BIA's campaign to engage the British public with UK innovation last year we have been delighted by the enthusiastic response we have received to our Citizens' Innovation Funds (CIFs) proposals.

Policymakers, financiers, parliamentarians and the media have all seen the benefit of unlocking the patriotic potential of the British public to support emerging innovative businesses which are essential for the jobs and growth vital to Britain's economic future.

We have been heartened, and learnt much from, our in-depth discussions with the retailers of financial products; high street banks, and independent financial advisors. Fund managers and providers have suggested improvements and companies that have utilised the similar French FCPI scheme have shared their experiences.

Most importantly we are encouraged by our initial discussions with HM Treasury about the benefit of targeting tax relief to this vital engine of economic growth with a catalytic effect of enabling thousands of British savers to play their part in our

economic recovery. CIFs compliment and support other government measures being taken to stimulate the economy. At a time when returns from traditional savings methods are low, CIFs provide an opportunity for investors to support UK innovation by investing up to £15,000 a year with the potential for attractive returns.

These are not investments without risk, but the risk is in the challenge of the discovery and development of things vital for our society in the coming century – like new treatments for disease, cleaner sources of energy or new communications tools.

The pool of capital unlocked by the creation of CIFs can be directed into the most productive companies, not by government diktat, but by knowledgeable investment professionals with a track record of building and selling innovative companies.

Underwriting this scheme via a fixed tax incentive, which we estimate could be revenue neutral in three years, would be effectively using public funds to leverage additional private sector capital into the most productive sectors of the economy.

For entrepreneurial companies, the ability to

access new capital would enable them to grow faster, employ more people and pay tax sooner than otherwise possible.

It would potentially enable them to grow to a size where long term independence could be a viable possibility, through an IPO, as recent French companies who have raised investment in similar schemes have shown.

Although the BIA is the trade association for innovative bioscience companies, this policy proposal is equally applicable to other innovative sectors that will fuel the British economy in the 21st century.

This report not only explains the concept of CIFs but also gives an update on recent developments to make them a practical reality and answer the questions that have come up along the way. I hope everyone will see the value of this cost effective, practical and timely scheme.

A handwritten signature in blue ink, appearing to read 'Steve Bates'. The signature is stylized and somewhat abstract, with overlapping loops and lines.

Steve Bates
Chief Executive
Biotechnology Industry Association

January 2013

THE CASE FOR UNLOCKING THE PATRIOTIC POTENTIAL OF THE PUBLIC

Since the publication of the original Citizens' Innovation funds (CIFs) report in September 2012, the BIA has had positive discussions with a number of interested stakeholders to further develop the policy potential. The following

four pages outline some key themes that have emerged from those discussions. Following from page eight is the original detailed report which remains unchanged.

Unlocking the patriotic potential of the UK Public

The popularity of the French scheme upon which CIFs are based is clear, with an average of €500m raised per year.

However, the BIA was keen to examine UK public interest further. Representative research, conducted independently by YouGov, demonstrates the general public want the opportunity to invest in innovation.ⁱ

As Figure A highlights, **just over nine out of ten people who expressed a preference agree that where bank lending is not an option, the government should seek to incentivise such investment.**

Figure B emphasises the public's appetite in this area further still. **Again almost nine out of ten who expressed a preference agree that the public should be given the opportunity to invest in innovation.**

This independent representative survey provides compelling reasons for government to implement a product like CIFs.

The BIA believes individuals would like the opportunity to invest in innovation. The rise of crowdfunding platforms such as Seedrs and Funding Circle for example, while different from the CIFs offering, perhaps highlights the interest a new generation of investors have in supporting something more tangible. The introduction of a tax incentive would only serve to further unlock such investments. The government has made some moves in this area recently, such as announcing £55m worth of co-investments alongside some of these platforms.

Further encouragement for the introduction of CIFs can be found by examination of Individual Savings Account (ISA) subscriptions. In 2009/10, 40 per cent who subscribed to a cash ISA invested the full amount suggesting they would invest more if allowed. If only 2 per cent of this group invested the same into a CIF, over £300m would be raised.

- i. All figures, unless otherwise stated, are from YouGov Plc. Total sample size was 2214 adults. Fieldwork was undertaken between 21st-23rd November 2012. The survey was carried out online. The figures have been weighted and are representative of all UK adults (aged 18+). <http://y-g.co/UhmFGo>

Figure A. Survey question: The Government should consider new funding policies that support innovative companies in the UK where bank lending is not an option.

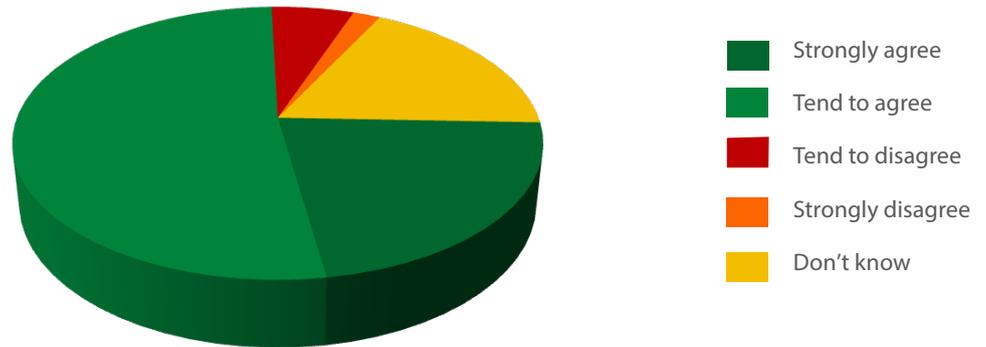


Figure B. Survey question: The general public should be provided with the opportunity to invest modest sums of money, if they wish to, into funds that will be targeted towards innovative companies,



- For every euro spent by the French Exchequer on income tax relief through the FCPI scheme, five euros of additional private investment was raised.
- 500m euros - the amount raised annually by the FCPI scheme since 1998.
- £300m - amount estimated to be raised yearly by CIFs in the UK.

Protecting the patriotic – consumer regulation

The BIA is aware that CIFs are being proposed at a time of heightened interest in consumer protection. Regulation is, of course, an important feature of any financial product and CIFs should be introduced in such a way as to satisfy Financial Services Authority (FSA) rules and efforts made to afford such protection. That is why, for example, the BIA suggests a cap on individual investments of £15,000 per annum.

However, it is vitally important that individual investors are not smothered by a dated approach that suggests they are unable to make informed decisions about their own investment. Recent moves to limit promotion of financial products to 'sophisticated investors' appears divorced from the wider government growth agenda.

It may often be the case that CIFs are discussed between an individual investor and an advisor when investment decisions are being made. However, the banking sector – with its large retail footprint – should also be considered as a viable avenue for CIFs.

Overly complex regulation cannot be allowed to stifle novel funding mechanisms that afford the wider public the opportunity to invest in UK innovation. Any investment should be aligned

to the individuals' interest and it must be clear that CIFs represent a longer term, more illiquid investment option. But the BIA agrees with Vince Cable that markets are for customers, as are financial products, judged not solely on economic efficiency but on their ability to create jobs, help companies succeed and generate returns for saversⁱⁱ

Put simply, as it currently stands, the tax breaks on offer to incentivise investment in UK businesses are aimed squarely at higher income individuals with large amounts of investable capital at their disposal.ⁱⁱⁱ The BIA does not argue against current schemes and recognises their contribution to UK companies. However, what is inequitable is the lack of opportunity afforded to other wage earners to make similar decisions should they wish to.

With this in mind, the Chancellor's announcement in December 2012 that there will be a consultation into the possibility of allowing stocks and shares ISAs to invest directly into AIM listed companies is a welcome step. The BIA believes this is a move in the right direction as it signals a step change in what retail deposits can be targeted towards and the BIA would strongly suggest CIFs forms a part of this.

Why innovation?

In a time of financial constraint and economic austerity some may ask whether innovation should be the focus of government resources. The answer must be unequivocally yes.

Innovation will drive a large proportion of future UK growth, bringing economic benefits and job creation in biosciences, engineering, medical technology, software, clean tech or gaming sectors for example.

Figures show that between 2000 and 2009 innovation delivered 63% of the UK's economic growth and that product innovation in particular delivered faster growth for innovators vs non innovators.^{iv} However, traditional sources of innovation financing, such as venture capital,

continues to be in short supply while traditional forms of bank lending are often simply not an option.

Considering the French experience, data shows that for every euro spent by the French state in foregone income tax revenue, five times as much private finance has been leveraged. This represents an economical way of backing innovative companies and is a wise use of government resource.

The leveraging affect does not stop there. One of the key strengths of the French regime has been the de-risking effect of Fonds Commun de Placement dans L'Innovation (FCPI) funds which helps to draw in significant additional private capital. Quality fund managers are required to

- ii. <http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-1188-equity-markets-support-growth-response-to-kay-review>
- iii. Such as through the Enterprise Investment Scheme and Venture Capital Trusts – discussed in more detail in part II of this report
- iv. <http://www.nesta.org.uk/library/documents/PlanIwebv3.pdf>

drive forward such investment and support a company's growth.

The need for action is compelling – UK growth depends on innovation. Moreover, beyond the simple economic analysis, it is important to remember that such innovation will lead to the new products and technologies that, all of us, in

the UK and worldwide, stand to benefit from. These could be new software developments improving ease of business and connectivity, clean technology, new consumer products or medical therapeutics for areas of unmet need such as cancer, diabetes or dementia.

Working with other emerging ideas

The BIA recognises there are a number of proposals from various stakeholders with the aim of boosting UK growth. Analysts, financial commentators, representative bodies and others stress the need for companies to have access to a diversified source of capital. Bank lending has, in the words of the Confederation of British Industry, entered a 'new normal' and senior policymakers now recognise the potential of a more diverse financing eco-system.^v

Beyond this, there is a growing acceptance that financial products should have some sort of social impact, that individuals want to invest in something more tangible than a deposit which can bring benefit to the wider society and align with their own aims.

CIFs offer a convincing policy option to do just that. Perhaps in future this could be aligned to the government's Business Bank if that institution were to consider playing a

supportive role to companies which require equity support.

It may be possible also to achieve support for innovative companies through aligning CIFs with pension contributions for example, providing a source of patient capital that aligns itself to the development timelines innovation requires. Or, perhaps, CIFs could be achieved through amendments to existing legislation.

However, such approaches are only worthwhile if they truly offer a new approach to finance that enables the diversification of funding sources and has a focus on innovation at its core. To this end two sides of the same coin should be met – 1) 60% of the funds targeted towards innovative companies; and 2) offering to the wider public to unlock additional finance.

FINANCIAL TIMES

September 3, 2012 12:07 am

Tax-exempt funds sought for sector

By Andrew Jack in London

Individual investors would be able to place up to £15 million in tax-exempt funds, under proposals submitted to the industry trade body.

The BioIndustry Association (BIA) called for the UK for mid net-worth taxpayers, totalling £15 million, to be able to place up to £15 million in tax-exempt funds, under proposals submitted to the industry trade body.

BIA: funds could keep firms in UK ownership

By James Hurley

RETAIL INVESTORS should be encouraged to back innovative companies to close an "equity gap" that is forcing British businesses into the arms of overseas buyers, according to a new report.

The BioIndustry Association has called for the creation of "citizens' innovation funds" to allow the public to invest in UK science and technology. The BIA said the funds would be used to support UK start-ups and early-stage companies, but not those that are already established.

A French scheme that could boost British innovation

TODAY the UK government will lay before Parliament its future strategy for UK life sciences. It will rightly highlight the success of the Biocatalyst Fund, an initiative which is already helping bioscience small businesses to accelerate the development of future therapies. But existing government support is not enough. That is why we are calling for the introduction of a further scheme. Citizen Innovation Funds (CIFs), a new investment product that will give the public the chance to be more actively involved in future innovative companies, but also operate in a global business. If we fail to support our world-leading companies, we risk losing the start-up phase of the life sciences industry, which is the most important for the future of the UK.



STEVE BATES

ogy products – and Parrot, a manufacturer of wireless devices for mobile phones.

And the results are clear: While the UK hasn't seen a biotech company listing in quite some time, in France the public markets remain an option. Nanobiotix, which is developing a therapeutic approach to local cancer treatment, was 20 per cent funded by FCPI before its listing on the

v. http://www.cbi.org.uk/media/1673105/cbi_financing_for_growth.pdf

EXECUTIVE SUMMARY

The future of UK growth rests, in large part, on the industries that design and produce the innovative products of tomorrow, the so-called "knowledge economy". When adequately

supported, such companies often experience rapid growth and employ highly skilled individuals.

What do Citizens' Innovation Funds (CIFs) offer?

CIFs are a tax-advantaged investment product aimed at mid-net worth individuals. It would offer an income tax break on up to £15,000 of investment which is then pooled and used to support innovative, research-intensive companies.

CIFs offer a new source of funding for the knowledge economy in the UK, with benefits for all of the stakeholders.

For government, CIFs offer the ability for private finance to fund UK innovation and generate the right kind of sustainable, skills based investment into UK innovation.

For the private investor with a philanthropic or patriotic motivation and for those charities which seek involvement, they offer funds for some of the most worthwhile causes in society.

For fund managers and financially motivated private investors, CIFs offer fees and returns in an underinvested sector of the UK economy with huge growth potential.

For high street banks, CIFs are an opportunity to offer lending products to benefit UK innovation which are part of their repositioning within society.

How would CIFs work?

Individuals would invest up to £15,000 annually and receive a tax deduction at 40% of the amount invested. A CIF investment would be made for a minimum of five years and the return would be tax free for the investor.

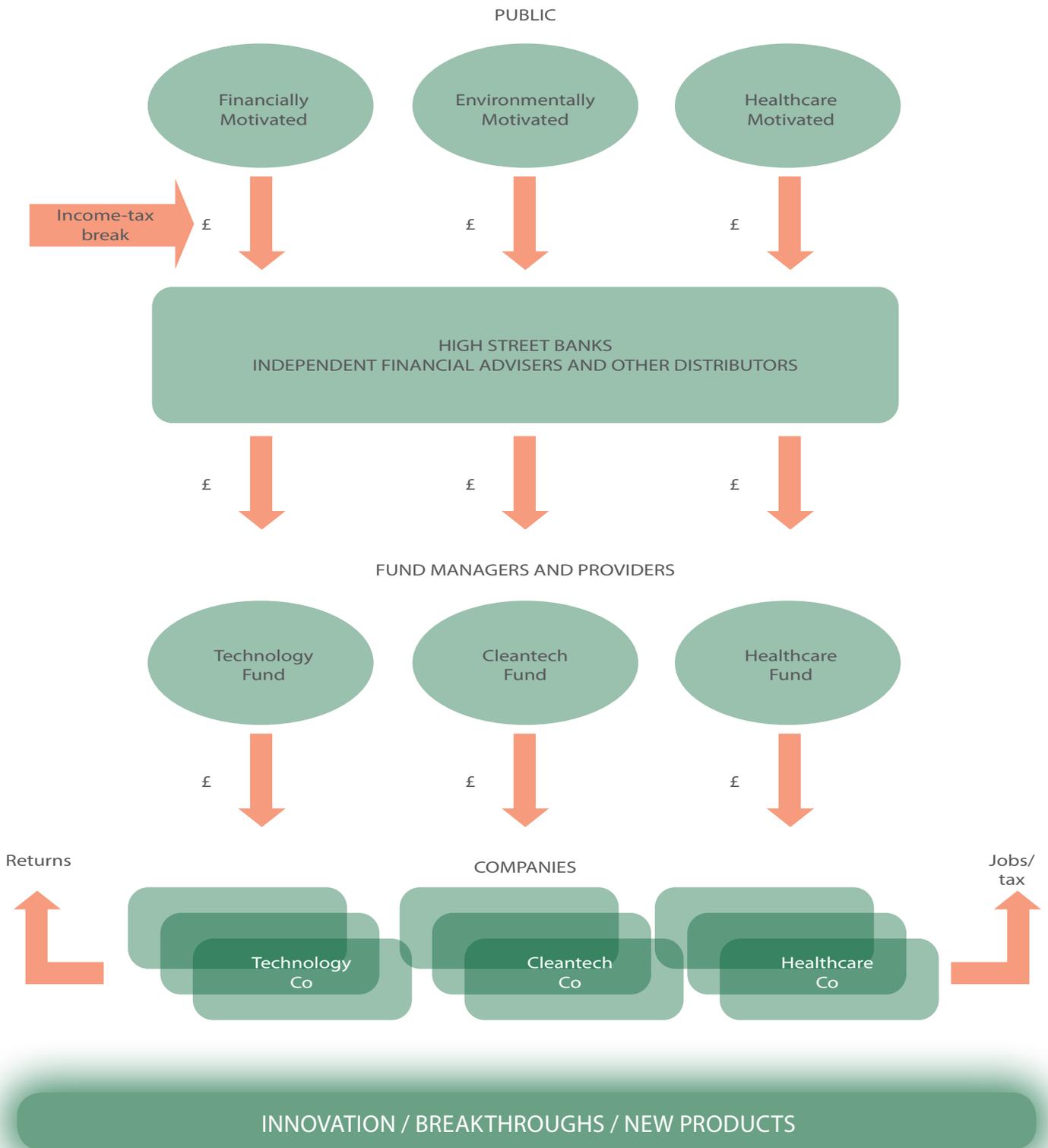
The investor would be able to specify the fund they wished to invest in, which satisfied their own criteria. This could be a fund focused on medical research, a fund dedicated to low carbon technology, or a generalist technology fund for example.

CIFs would be sold online, through the high street branches of retail banks and through other distribution mechanisms and would involve a range of organisations – from financial institutions offering the potential for high returns through to charities providing their expertise in identifying the most disruptive technologies in their sector.

In order to ensure that the investment reaches deserving companies, the funds would be required to invest a minimum of 60% of CIF monies in innovative companies, for example those which are Small and Medium sized Enterprises (SMEs) carrying on Research and Development (R&D) as defined for tax purposes. The funds would make equity investments in the SME companies and would therefore be a much-needed additional source of finance. It is estimated that such a policy could be revenue neutral within three years.



CIF MODEL



INTRODUCTION

Access to finance remains the key issue for small and emerging innovative companies across various high-tech sectors in the UK. The need to provide diversified sources of funding for such companies is perhaps now more acute given the continuing uncertain global financial climate. But the need to do so is clear if the UK is to continue to have a leading edge in producing innovative products and technologies and support the growth of such companies.

The government funds a world class science base that produces many of the ideas that go on to be pioneering technologies used throughout the world. However, a constrained funding climate continues to impact upon the likelihood of such technologies being taken forward at all or, as is increasingly the case, being translated and commercialised in other countries where finance is more readily available.

This report will highlight a successful French scheme, which has raised over six billion to date, that offers the opportunity to address this issue and place UK innovation on a firmer and more sustainable footing. The report is presented in two parts:

- Part I, Analysis of the Fonds Commun de Placement dans l'Innovation (FCPI) scheme, will provide an overview of the tax-advantaged scheme in France and examine the available performance data. This will include a review of FCPIs impact on innovative companies and their investors.
- Part II, Citizens' Innovation Funds in the UK, will then outline the applicability of the FCPI scheme to the UK, consider the existing tax-advantaged landscape, and outline a prospective blueprint for its operation.

PART I

ANALYSIS OF THE FCPI SCHEME

In order to demonstrate the appropriateness of the French FCPI scheme to the UK market there is a need to analyse the structure and design of FCPI's and examine their performance to date in; 1) achieving support of high-growth innovative companies, and; 2) their investment performance. Further detailed information on the FCPI can be found in the appendix.

Part I of this report therefore focuses upon a detailed analysis of FCPI's outlining their record in relation to both points above. Where appropriate, this includes a direct comparison to funding mechanisms used in the UK particularly in so far as it relates to measuring investment performance. This has been done to benchmark the FCPI performance and provide a degree of context.

The analysis provided in this section draws upon the experience of those who have managed such funds in France and in large part on a number of detailed studies already undertaken into FCPI's. In particular, two recent studies have compared the growth of companies receiving their first FCPI investment with those not receiving any FCPI funding.

The first, "Activité d'investissement des FCPI dans les entreprises innovantes 1997 – 2008"¹, published in May 2010 and referred to here as "Study 1" analyses data from 1,121 companies certified by OSEO² as "innovative", over 60% of which had revenue and/or employment data available, and, of which, roughly half had received FCPI investment between 1998 and 2006.

1. "Investment activity of FCPIs in innovative companies", <http://www.afic.asso.fr/Images/Upload/DOCUMENTS/Etude-FCPI-AFIC-mai-2010.pdf>
2. OSEO is the French equivalent of the Technology Strategy Board (TSB). It was established in 2005 bringing together the French innovation agency ANVAR and the SME development bank BDPME.

The second, "Performance des entreprises innovantes investies par les FCPI³", published in January 2012 and referred to here as "Study 2", focuses on data from 1,434 "innovative" companies, comparing 146 that received their first FCPI investment between 1997 and 2007 with an equal number not receiving FCPI

investment during this period. In this study the two groups of companies were carefully matched to ensure that each group had similar characteristics including company age, revenues, employees, cash and debt levels and patents published in the year prior to any FCPI investment being received.

THE IMPACT OF FCPI INVESTMENT ON THE FRENCH ECONOMY

FCPIs have been characterised by their success in raising significant sums of money from large numbers of retail investors to finance a generation of innovative technology companies both in France and beyond.

- Over **€6 billion** raised for investment by 2011.
- By the end of 2010, FCPIs had invested in over **1,150 companies**, 88% of which were less than four years old at the time of investment.
- Over **300 Funds** run by nearly 40 asset management companies.

FCPI funds have had a demonstrably positive effect on their target market of innovative SMEs according to the comprehensive data compiled between 1997 and 2008 in the studies highlighted above and others.

The specific aspects of economic performance measured have showed that there are clear benefits to innovative companies receiving

FCPI backing compared to similar, innovative companies not receiving such funding, including:

- Increased revenues
- Increased job creation and higher spending on personnel
- Greater propensity to export and increased proportion of sales derived from exports
- Enhanced access to credit
- Greater likelihood of publishing patents and a higher number of patents subsequently published
- Greater probability of listing on a stock market

The performance indicators of the FCPIs, outlined in detail below, demonstrate all the necessary ingredients of a successful government intervention to spur real growth and innovation within an economy.

SUMMARY OF ECONOMIC DATA AND ANALYSIS

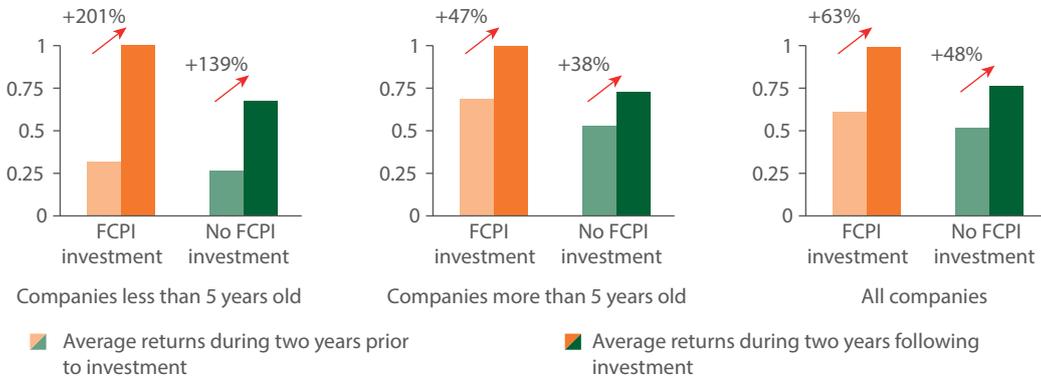
Revenue data

FCPIs have demonstrated their ability to aid a company's revenue performance, clearly a key factor for any government growth policy. Both Study 1 and Study 2 show markedly higher revenues for FCPI-backed companies as opposed to those which did not receive FCPI investment.

As can be seen in figure 1 below, Study 1 indicates that companies less than five years old see the greatest benefit, with FCPI-backed companies growing revenues by 201% following investment.

3. "Performance of innovative companies invested in by FCPI", http://www.afic.asso.fr/Images/Upload/Etudes/2012/Performance_des_entreprises_innovantes_investies_par_les_FCPI_2010.pdf

Figure 1. Growth of revenues following first FCPI investment



Likewise Study 2 illustrates a significant increase in revenues post-investment with FCPI-backed companies experiencing an increase of revenues of 150% in just two years.

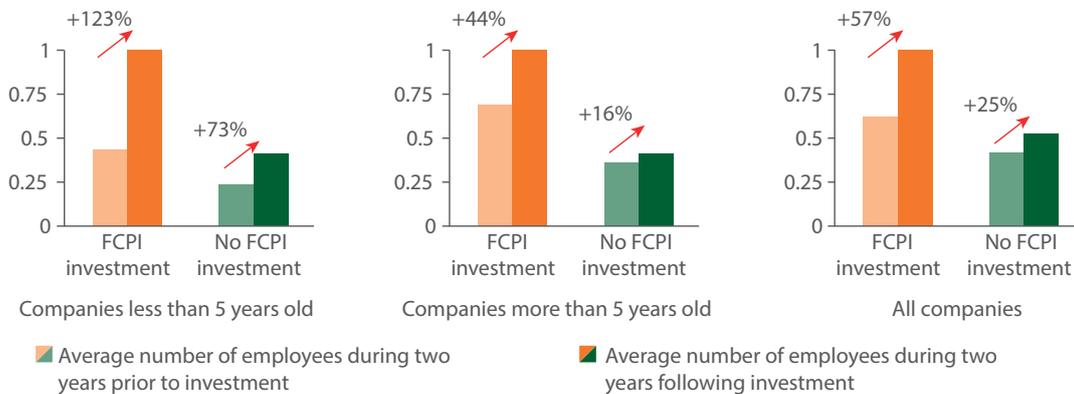
Employment data

Any growth promoting policy such as the FCPI must also contribute to employment in innovative, high growth companies. Such jobs, often in research intensive and creative sectors, are likely to be highly skilled, well remunerated and contribute to the knowledge economy.

Job creation is also important given the impact it has on the overall cost of the scheme to the government. Increased employment, and with it increased revenue from personal-taxation, go some way to bringing the costs of the scheme down, ultimately, to a revenue-neutral position.

In the case of FCPIs, both studies show significantly greater job creation at those companies with FCPI backing as opposed to those without. Study 2 also highlights greater levels of remuneration. Figure 2 below shows that FCPI-backed companies under five years old grow staff numbers by 123% post-investment as compared to 73% in the comparator group. With employment, this relative difference is even greater for companies over five years old.

Figure 2. Growth of number of employees following first FCPI investment



Detailed analysis provided in Study 2 indicates that the greatest impact of FCPI funding is seen in the first year post investment, with the gap in staff numbers continuing to grow thereafter, but more modestly in the following two years (see figure 5).

investment and 149% in the third year, but that remuneration levels are 150% and 157% higher respectively. This could indicate either that more senior or more qualified staff have been hired or that FCPI-backed companies pay more competitive salaries.

Importantly, Study 2 also captures information regarding remuneration and shows that not only are staff numbers at FCPI-backed companies 120% higher two years post

Export data

A key value driver for many innovative companies is their ability to increase their export base.

As highlighted in the graphs below, drawn from detailed analysis contained within Study 1, FCPIs have a high impact on a company's ability to penetrate other markets and drive up exports, increasing that company's value and revenues. FCPI-backed companies under five years old have a markedly higher tendency to begin exporting (61%) post investment than non-backed companies (38%) during the same period, with this advantage slightly less pronounced in companies older than five years.

Figure 3. Growth of number of companies exporting following first FCPI investment

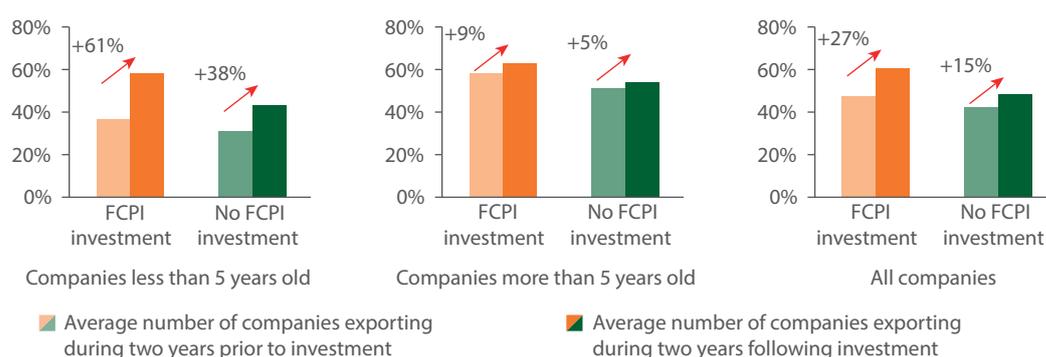
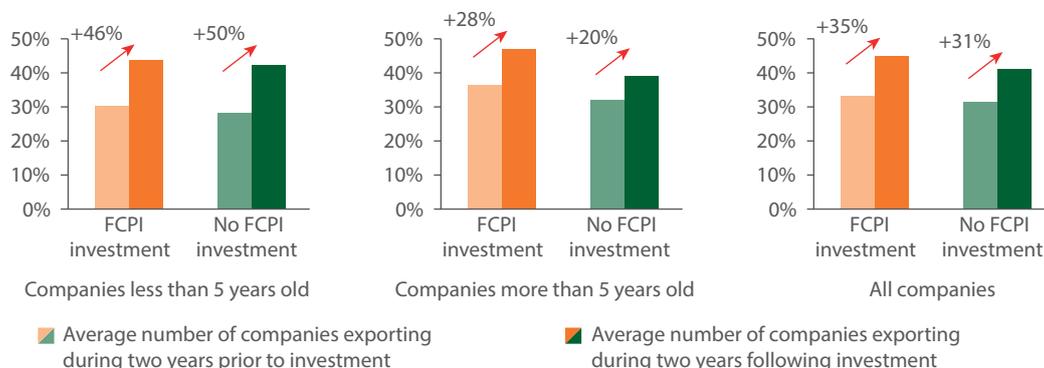


Figure 4 indicates that although younger FCPI-backed companies export marginally less as a percentage of sales (46% compared to 50%), companies more than five years old that have received FCPI funding outstrip their non-backed counterparts.

Figure 4. Growth of exports as percentage of company sales following first FCPI investment



Corporate investment data and cash/capital raising data

Study 2 has been able to illustrate that internal investment levels, meaning here product development and investment in assets, are 323% higher at FCPI backed companies two years following investment, and still 257% higher three years after.

The same study also indicates, perhaps unsurprisingly, that FCPI-backed companies increase their capital bases significantly in the year of receipt of funding and in the two

years following compared to the comparator group. More importantly, the cash levels of FCPI-backed companies then remain correspondingly greater, being 444% higher two years following investment and 303% three years after.

Intellectual property data

Intellectual property represents a key indicator of research and development within companies and of the level of innovation more broadly. In the UK patent applications for example are often cited as a sign of innovation and regularly scrutinised in government reports.

Intellectual property is a value generator in itself and a vital factor in the ability of research-intensive SMEs to attract finance, particularly those at a pre-revenue stage. Bioscience companies, for example, rely heavily upon a robust and enforceable intellectual property

development of products and technologies to treat patients. Patents provide the external verification of a company's scientific research and development.

Data provided by Study 2 shows that companies more than double their probability of publishing at least one patent once they have received FCPI-funding. Furthermore, following investment, FCPI-backed companies publish three times as many patents.

portfolio, usually in the form of patents, to protect their research and attract the private investment that is crucial to continuing the

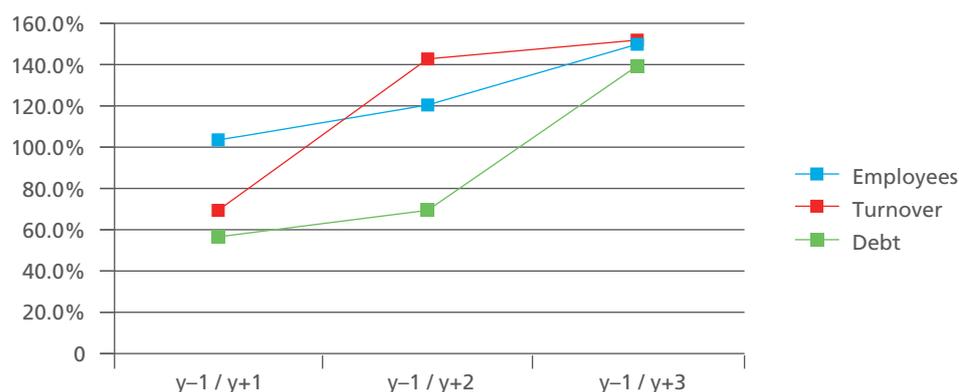
Investor liquidity data

Further information contained within Study 2 states that FCPI investment increases the probability of an investee company listing on a stock exchange fourfold.

There could be a number of possible reasons for this. Firstly, FCPI-backed companies have access to experienced fund managers who are able to provide guidance, expertise and networking to support their growth. Such managers will often have a track record of helping guide a company to a listing and will be in frequent dialogue with investment banks to gauge the right moment for a listing should that be the desired strategy of the company.

As discussed, FCPI-backed companies are more likely to be better capitalised also. This means such companies will have longer post-IPO “cash runways” than non FCPI-backed equivalents which will, in turn, reduce their risk profile to potential IPO investors. Such risk is reduced further when considering that FCPI funds are able to buy shares in a public offering, providing support to a company that is seeking to list and putting FCPI-backed companies at an advantage in marketing to institutional IPO investors.

Figure 5. Key performance indicators from Study 2



SUCCESSFUL FCPI-BACKED COMPANIES

The data described in the preceding pages highlight a strong performance of FCPI-backed companies in key target areas of revenue generation, employee numbers and exports for example. FCPIs are designed to support innovative companies and to that end have demonstrably had a positive impact benefiting those companies which have received investment substantially over those which have not.

Beyond the data however it is useful to examine individual case studies to ascertain whether any particular successes have emerged from the FCPI scheme. It has been commented that FCPIs have spawned a generation of new technology companies but what range of value can be achieved following investment?

Listed below is an overview of selected successful FCPI-backed companies, further examples can be found in the appendix.

Parrot: French based Parrot, a manufacturer of wireless devices for mobile phones, was backed by FCPI funds from Seventure and CM-CIC and was generating 87.7% of its sales from exports by the time of the company's IPO on Euronext in 2006. In 2011, Parrot had revenues of €247.7m and 694 employees.

Vistaprint: The online provider of marketing products and services, Vistaprint was founded in Paris and backed by the FCPI fund of Seventure. It completed its IPO on Nasdaq in 2005 and forecasts revenues of over \$1 billion for its financial year ending June 2012 and has 3,100 employees.

Fovea Pharmaceuticals: Founded in Paris in 2005 and backed by FCPIs managed by CAPE, Fovea rapidly created a portfolio of three ophthalmology products prior to its sale to the French pharmaceutical company Sanofi Aventis in 2009 for up to €370 million.

Carmat: A leading medical technology company in the development of artificial hearts, Carmat was backed by FCPIs managed by Truffle and achieved its IPO on Alternext in 2010. The company continues to develop its lead products for the treatment of patients worldwide.

The FCPI does not stipulate that investments must go only to French based companies. While in practice around 88% of funding has backed and supported innovative French SMEs there are also a number of successful stories to be found elsewhere, including the UK.

gate5: Founded in Berlin in 2003, gate5 had FCPI manager Innoven as its lead investor through multiple investment rounds until its sale to Nokia in 2006 for €150 million.

BioVex: A lead developer in cancer therapeutics originally based in the UK prior to relocating to the US, BioVex had long-term support from FCPI managers Innoven and CAPE, which together controlled close to 30% of the company prior to the entry of a number of US venture capital firms into its shareholder base. BioVex was acquired by US biopharmaceutical company Amgen for an upfront payment of \$400 million in 2011 with a further \$600 million of potential milestone payments, in what constituted one of Europe's most successful biotech trade sales exits to date.



THE INVESTMENT PERFORMANCE

It is clear from the detailed analysis and data reviewed above that the FCPI mechanisms have been hugely successful in providing much needed finance to small and emerging technology companies. They have led to the funding and support of a wave of innovative companies that have provided for increased revenues, exports and employment.

However, it is of course also important to review the performance of such funding vehicles for the investors. In order to remain successful and continue generating funds for investment into innovation such a product must demonstrate its attractiveness to the investor community.

As explained above this product is targeted towards, and largely taken up by, the retail market with French banks being among the major distributors. It is clear that the tax incentives on offer for such investors provide a clear benefit. Indeed, any changes to the tax benefits offered have had a demonstrable impact on the levels of investment into FCPIs. This would be an important consideration for any similar product in the UK.

It is also commented by those who have managed such funds and are familiar with the scheme that a number of investors engage with the scheme to support French companies and to be involved in supporting innovation,



research and development. An element of “patriotic” investment has certainly been seen.

As this is a retail product, which involves investing a proportion of funds in companies considered higher risk, any government examining the possibility of introducing a similar scheme will want to ensure investors have adequate information and protection.

As above, there are a number of studies and reports that have evaluated the investment performance of both FCPI and Fonds d’investissement de proximité (FIP) (further information can be found on the FIP product in the appendix) vehicles and other forms of venture capital investment. There is also UK data which enables a comparison. Two studies in particular have been used here, both of which base their performance analysis on net Internal Rate of Return (IRR):

- “Performance nette des acteurs français du Capital Investissement à fin 2010⁴”, published in June 2011 by AFIC and Ernst & Young⁵; and
- “BVCA Private Equity and Venture Capital Performance Measurement Survey 2010⁶”, published in August 2011, produced by PwC and Capital Dynamics.

In summary, the comprehensive AFIC study demonstrates that FCPI and FIP vehicles have performed similarly to French venture capital funds since inception, displaying an average IRR of approximately -3% to 2010.

The BVCA study shows that technology funds in the UK, perhaps the closest in terms of strategy to FCPI funds, have generated an average IRR of 0.6% from inception to 2010. However, UK venture capital funds have performed only slightly better than their French counterparts since 1996, with an average IRR to 2010 of -0.3%. Data would suggest that FCPIs tend to follow the traditional venture capital “J curve” with an initial drop post investment before a levelling out and steady increase in the subsequent years as investee companies begin to realise potential. As companies exit through trade sales and IPOs for example the capital gains released begin to cover fund management costs and overall performance improves.

4. Net performance of French private equity investors to 2010, <http://www.afic.asso.fr/Images/Upload/DOCUMENTS/CP%20-%20Performance%20nette%20du%20CI%202010%20-%2001.06.11.pdf>

5. Association Française des Investisseurs en Capital is the French private equity association.

6. http://admin.bvca.co.uk/library/documents/Performance_Measurement_Survey_2010.pdf

The role of tax incentives in FCPI investment

The detailed data obtained regarding FCPI/FIP performance would suggest that positive returns enjoyed by retail investors have been derived in large part from tax incentives built into the product. Such incentives are clearly important in encouraging mid-net worth retail investors to consider investment in an FCPI.

This goes some way to explaining the attraction of such investment vehicles to French retail investors who may feel more comfortable parting with modest sums of money into vehicles that offer a tax incentive and the potential to achieve reasonable returns without needing to be a

knowledgeable or engaged investor capable of “picking wins”. Such investors may not have considered the direct backing of small innovative companies within their reach otherwise.

The risk profile of FCPIs

As explained the risk profile for such a retail market product is important to ensure the protection of less knowledgeable or less engaged investors is considered. Higher risk investments, as early stage innovative companies clearly are, require the appropriate risk labels to ensure awareness.

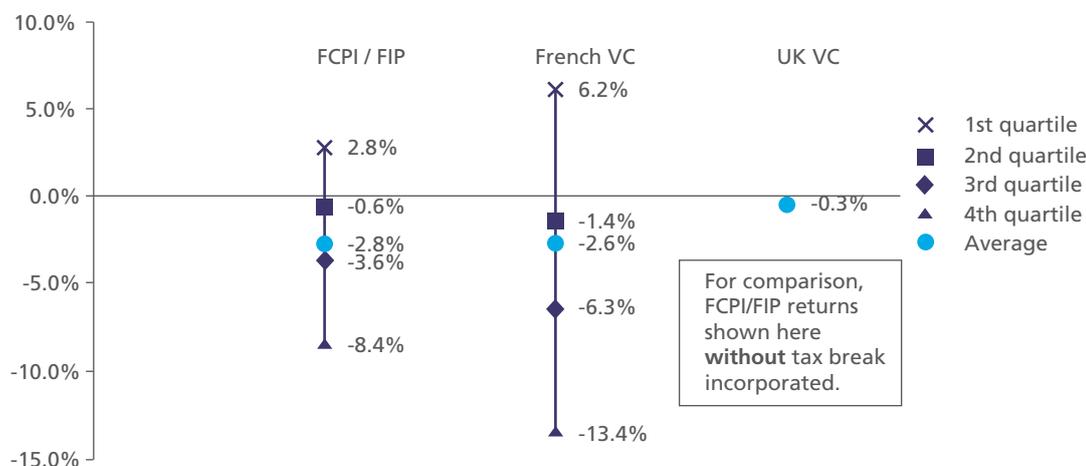
It is interesting at this stage therefore to examine the risk profile of FCPIs as compared to other forms of equity financing and venture capital in France and the UK. In particular, has there been any characteristic specific to the FCPIs that has enabled the potential risk for the investor to be mitigated?

Figure 6 below shows that the divergence between the top and bottom quartiles of FCPI/ FIP funds, 2.8% compared to -8.4%, is less great than the divergence between the

top and bottom quartiles of venture capital funds, at 6.2% compared to -13.4%. This would indicate that FCPI / FIP funds occupy a relatively narrow risk band appropriate for the type of investor targeted.

This may be explained by the fact that FCPI and FIP vehicles draw down all their funds on inception and can invest up to 40% of their assets from the outset in money market instruments or blue chip equities for example with comparatively limited volatility or risk. Experience in France has shown a sliding scale of FCPIs emerging with some investing a smaller percentage in 'safer' assets to those that invest the full 40% and which as a result have a lower risk profile.

Figure 6. IRR by quartile to 2010 for FCPI/FIP, French venture capital and UK venture capital⁷



The fund manager perspective

An FCPI fund manager must ensure that 60% of assets are invested in qualifying innovative companies. The choice of where and how to invest the remaining 40% is then at their discretion and will depend upon how the manager wishes to position the FCPI offering along the 'risk' scale.

FCPIs are well regulated and managers are naturally required to follow the necessary reporting requirements. Further information regarding the detail of such requirements can be found in Part II of this report.

7. UK VC captures data from 1996 fund vintages onwards. All return data shown is net.

The fund raising dynamics of an FCPI fund are also subtly different to other traditional venture capital funds. Due to the distribution model and because FCPIs provide a yearly tax advantage for tens of thousands of investors, managers typically raise new funds each year.

Given the impact that legislation can have on the attractiveness of a scheme such as FCPIs, regular interaction between managers,

distributors and government is required to avoid any unintended consequences of legislative changes. For example, changes to the duration allowed for a fund to invest its assets, from 24 months to 16, can affect the quality of investee company selection.

CONCLUSION

Part I of this report has provided a detailed analysis of the FCPI scheme operating in France and measured its performance. As the available data shows the scheme has been hugely successful in generating large sums of money, over €6 billion to date, to invest in high growth, research-intensive companies across a number of innovative sectors, at least half of which were under five years old.

The analysis has shown the positive effect of FCPI investment with those companies able to increase revenues, exports and staff numbers amongst a number of other successful indicators. Case studies have been highlighted to demonstrate the impact such investment can have.

The FCPI vehicle has also proved hugely popular with investors and continues to raise hundreds of millions for continued investment

each year. FCPI funds follow a broadly similar investment and performance pattern to other French venture capital funds both in France and the UK. As FCPIs have been closely linked to venture capital performance in France, a UK version could arguably track the performance of venture capital in the UK.

When the tax incentive, applied to the relatively modest investment cap, is taken into account a clearer picture is shown of the attractive nature of such investments for the retail market and individuals looking to more directly support innovation and technology which also hold out the prospect of delivering returns. The narrow upper to lower quartile performance bands of FCPIs to date highlight a potentially more favourable risk profile than other forms of private equity which is arguably a result of the funds design.



PART II

CITIZENS' INNOVATION FUNDS IN THE UK

The first part of this report has demonstrated the success and attractiveness of the FCPI scheme and highlighted that it is a government-led policy worth exploring for potential use in the UK.

The costs to the Exchequer can be partially or fully offset by the success of the scheme in later years as companies begin to pay increased levels of corporation tax and hire more staff. In such a way the policy holds the potential to be revenue neutral..

It is clear that a large part of future UK growth will be based on innovative industries and the UK is fortunate to be amongst the world leaders in many such sectors including the biosciences, medical technology and diagnostics, information technology, electronics and the video games industry for example.

However, this position cannot be taken for granted. While the UK continues to fund a world class and productive research and science base a continued lack of equity and venture funding will damage the long term prospects of translating such ideas into products. There have been cases where

companies have relocated overseas to continue their development due not to a lack of quality but to a lack of available funding.

Recent government commissioned reports, along with the overarching Plan for Growth, have highlighted the importance of funding innovation and research and recognised the difficulty for SMEs to obtain funding to continue their development and growth. This is particularly the case as many such companies cannot secure bank lending.

The previous section has demonstrated the attractiveness and success of the FCPI policy and Part II will therefore highlight its applicability to the UK market. Specifically, the following will provide information as to: how Citizens' Innovation Funds will fit with and complement existing tax-based measures; the ideal blueprint and design of such a scheme; and, the possible cost of such a proposal in the UK and how to measure its success.

HOW CITIZENS' INNOVATION FUNDS FIT WITH, AND COMPLEMENT, EXISTING TAX-BASED SME FUNDING SCHEMES

If Citizens' Innovation Funds (CIFs) are to be introduced in the UK it must be shown that the proposal fits within existing tax-based SME funding schemes already available so as not to duplicate, disrupt or dilute such existing mechanisms to the detriment of investee companies or investors.

A careful examination of how CIFs can complement the existing framework is therefore required to demonstrate to government the market case and market position for their introduction.

Firstly, it is necessary to demonstrate that CIFs will not simply result in displacement of funds from other tax-driven SME funding products (meaning either displacement of the investor community or to the investee company); and secondly, that other schemes, such as R&D tax credits, do not already provide sufficient capital to the type of companies targeted by CIFs.

The principal schemes currently providing funding for SMEs via tax relief are the Venture Capital Trusts (VCTs), Enterprise Investment Schemes (EIS) and the R&D tax credit programmes. More recently, in Budget

2012, the government introduced the Seed Enterprise Investment Scheme (SEIS) which slightly expanded the criteria available for EIS investment. However, due to the cap on the amounts of funding the SEIS scheme can provide to any one company and a lack of available data the introduction of the SEIS is extremely unlikely to affect the positioning of CIFs in the current tax framework as outlined below.

As the following explanation will show, to answer the first concern outlined above, an assessment of the publicly available data on the VCT scheme and the EIS suggests that neither of the initiatives tap into the “mass affluent”, mid-net worth retail investor targeted by FCPIs in France and to be

Existing tax-based schemes

Before providing more detailed explanation and data analysis to address the concerns highlighted above a note on how to view the proposal as compared to existing mechanisms. The purpose of this section is to demonstrate that the introduction of CIFs, based on the success of FCPIs, would complement existing mechanisms in the UK. It is argued that it will allow for significant additional funding for innovative UK companies, particularly SMEs.

A comparison with the EIS and VCTs is not to detract from these mechanisms ability to fund a certain level of company growth. Clearly the continued importance of existing successful UK schemes should be emphasised. It is also accurate to comment that there are a range of VCTs on offer, such as tech-focused or more generalist, with a varying appetite for higher risk investments.

Moreover, the R&D tax credit has provided tangible government support to research intensive companies for a number of years and is a key pillar of assistance provided to innovative companies performing R&D in the UK. However, given that the R&D tax credit rewards funding which has already been spent on research it is clearly not targeted towards the initial pump-priming of innovative

targeted by CIFs in the UK. The relatively modest sums of money involved and the distribution model has led to large numbers of retail investors in France.

The second concern, that existing tax relief adequately targets innovative SMEs, can also be convincingly answered by highlighting that (a) only 20% to 25% of VCT and EIS funding has historically been directed at R&D-focused SMEs, and that both UK schemes have delivered less “innovation” funding overall than the FCPI programme; and (b) the R&D tax credit programme provides, on average, around 5% of the amount of funding per company that would be expected from CIFs, based on what has been observed with the FCPI scheme.

development nor providing the scale of financing required.

CIFs provide an opportunity to improve overall investment into companies and promise support for more innovative companies. It is not a zero sum, either/or, game as far as existing policies are concerned and should therefore be considered in conjunction with them. The underlying principle remains that additional funding sources are required for innovative UK companies and should be a priority of government.



Profile of retail investors targeted by CIFs

A key concern for the government when considering the introduction of CIFs will likely be whether it will simply benefit investors who would already be likely to invest through other existing mechanisms such as EIS. This would serve to confuse the marketplace and dilute the performance of both mechanisms and is therefore a valid concern.

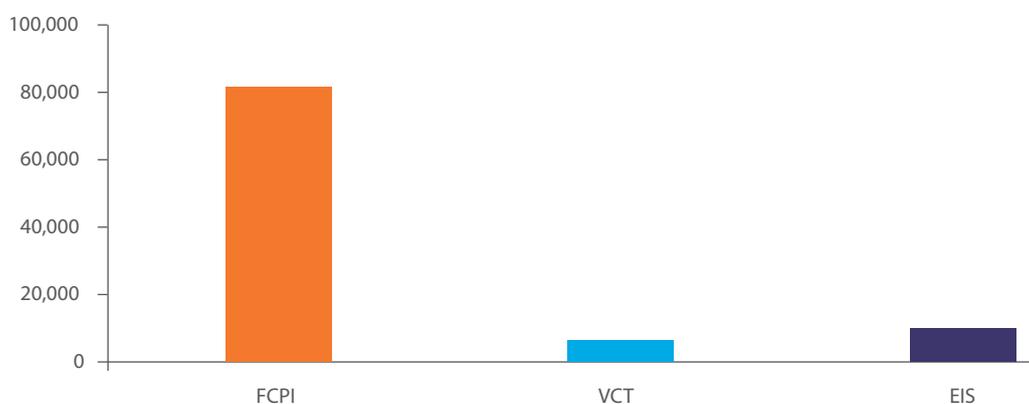
However, an examination of the available data and a consideration of the target market for the different mechanisms clearly demonstrates this should not be a concern here. CIFs are designed to target the same profile of investor as the FCPI scheme does in France. Typically this is the “mid-net worth” investor.

While it is true that the EIS, with a minimum investment of £500, should be accessible for non-institutional investors this is not generally the case in practice. The administration, evidence and tax return disclosure required by

individuals to obtain EIS and VCT tax benefits makes the schemes more appropriate for large investment sums by high-net worth individuals but unworkable as a retail investment product.

This view is supported by the available statistics which show that FCPI products address a far broader market than VCTs and the EIS scheme. The number of FCPI subscribers in 2008 for example, at 80,000, far outstrips VCT subscribers by over eight times and the number of VCT and EIS subscribers combined by almost five times (as shown in figure 7). FCPIs have consistently attracted similar large numbers of subscribers (for example over 60,000 in 2009 and 2010).

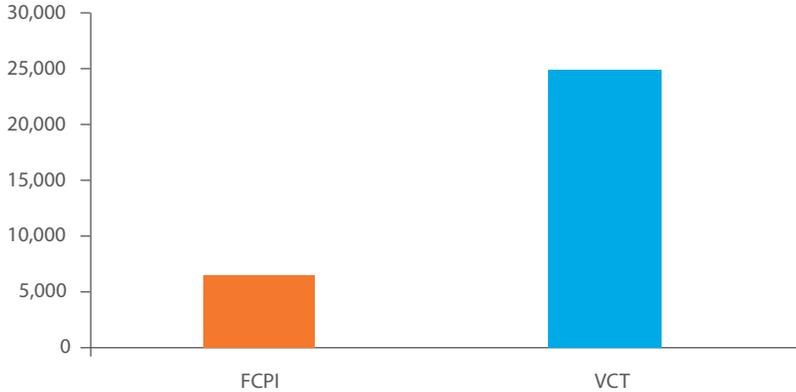
Figure 7. Number of subscriptions in FCPI funds in 2008 and VCT and EIS funds in 2008/09



As might be expected with a more mass-market product, and given the lower investment cap available, individual FCPI subscribers invest considerably less than VCT subscribers, committing an average of £6,454 in 2009, just 26% of the average

£24,767 invested by VCT subscribers in the tax year to April 2009. In the same year, EIS investors on average committed over £50,000, over nine times higher than the comparable FCPI average.

Figure 8. Average amount subscribed for FCPI funds in 2008 and VCT funds in 2008/09⁸

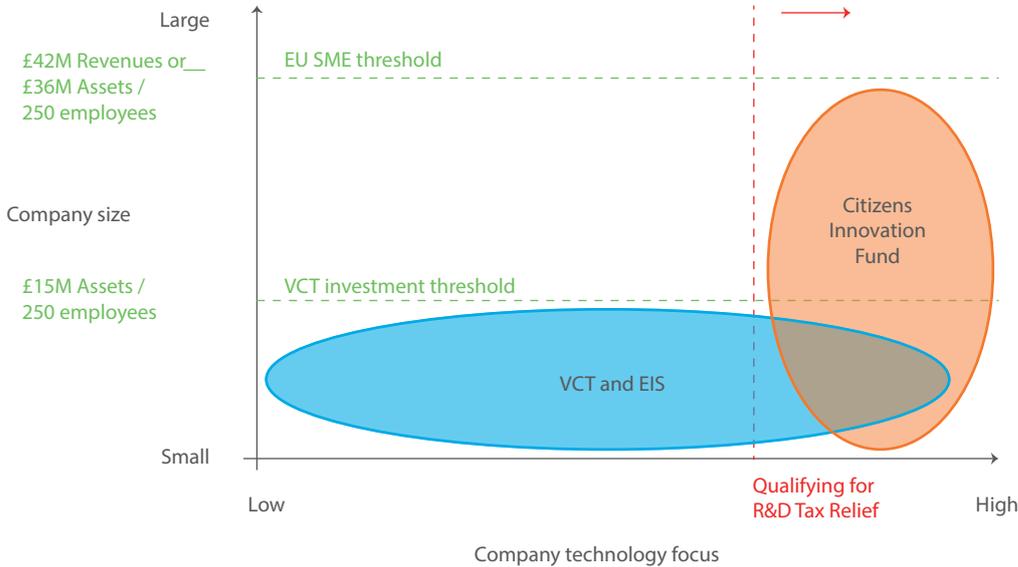


Potential investment focus of Citizens’ Innovation Funds

Figure 9 suggests how CIFs fit into the current UK landscape of tax-driven SME funding programmes. While the proposed coverage coincides with the full definition of an SME

according to the European Commission, in practice, CIFs, like their French counterparts, will primarily focus on companies with lower revenues than those backed by VCTs.

Figure 9. Potential focus of Citizens’ Innovation Funds compared to VCTs, EIS and R&D Tax Credits



8. “Levées de capitaux par les FCPI et FIP en 2011”, AFIC / AFG, February 2011; and “Enterprise Investment Scheme and Venture Capital Trusts: Better Focus”, HMRC, 2012

The suggested footprint in terms of company size is to allow investment in some larger R&D focused companies unable to attract sufficient equity finance and to allow some balance in

CIF portfolios in terms of stage of development of investee companies, an important factor when considering the risk profile of such funds.

While there is a small overlap in the type of companies funded, allowing for a diversified funding base and additional source of finance for innovative companies, the FCPI record of investing in technology and research intensive companies is important to note. Experience

Positioning compared to R&D tax credits

CIFs are designed to focus on high technology companies which would ordinarily be eligible for R&D tax credits. However, there are essential differences in where the impact of each scheme is felt and several reasons why CIFs complement the R&D tax credit and contribute to its overall success:

- i) R&D tax credits are limited to the amount of actual historical R&D costs, and while they enable increased spending on future product innovation and development and reward research intensive sectors through tangible government support, they do depend on prior capital investment or cashflow. As such, R&D tax credits do not kick-start significant corporate innovation programmes for early stage companies with limited revenues or limited prior capital injections. CIFs would therefore complement and interact with the credit by providing a major “shot in the arm” for eligible companies.
- ii) The R&D tax credit regime provides cashflow benefits and does not have as an aim the supply of additional governance and networking capability that technology funds such as FCPIs provide and which have been shown to boost the growth of R&D-focused companies materially. Again, this demonstrates how CIFs would complement the tax credit regime.

shows that the type of investee company is unlikely to significantly overlap with VCTs and EIS as shown by the focus of CIFs on high technology focused companies.

- iii) Historical data suggests that CIFs would target only a small proportion of companies claiming tax Credits (approximately 1 in 20) but would make far more capital available per company invested to provide the scale required to support innovative product development and complement the availability of the R&D tax credit. This would reduce large scale duplicative support albeit that points (i) and (ii) demonstrate even where this exists it is to the benefit of both schemes.

The UK R&D tax credit scheme assists a substantially larger number of companies. In the year to April 2010, there were 7,410 claims by SMEs under the R&D tax credit scheme, some 20 times higher than the number of companies receiving FCPI investment in 2010. However, the average R&D tax credit claim in 2009/10 was for just £43,185 compared to the average FCPI investment per company of £1.1m in 2010.

These figures suggest that CIFs would provide a far greater financial impact per company but would affect only a small annual number of SMEs likely to claim R&D tax credit relief, limiting the amount of “doubling-up” by eligible companies under both schemes.



Figure 10: Number of companies receiving FCPI investment in 2010 compared to number of SME R&D tax credits in 2009/10, and average size of FCPI investment per company compared to average size of SME R&D tax credits in the same years⁹



Positioning compared to VCTs

It is clear from the information provided above that the investor profile of CIFs will be different to that of VCTs. This answers any concerns that the introduction of CIFs would dilute the funding base of VCTs. However, it is also important to view any potential impact or duplication that may be caused on the investment side also.

To address this, it should be stressed that CIFs will be required to invest at least 60% of their assets in qualifying innovative companies, whereas there is no statutory minimum technology quota for VCTs. For example, data published by the Association of Investment Companies (AIC) in its April 2012 report "Delivering Growth: The Role of VCTs", indicates that less than one third of qualifying investee companies disclosed R&D expenditure in the latest financial year. The AIC surveyed 13 VCT managers representing 75% of the VCT industry's assets under management, reviewing data from 311 qualifying companies between 1997 and 2010, and 31%, disclosed R&D expenditure.

VCTs clearly play an important funding role. However, without a statutory duty to invest in innovative companies clearly many VCT funds are free to invest the majority of assets under

management in non-innovative companies. CIFs will be targeted, in large part, at a different cohort of companies.

The rationale for having a larger upper threshold for qualifying companies for FCPIs (figure 9) is twofold: firstly, to ensure there is sufficient innovation-focused capital in the UK across the entire SME spectrum given the limited amount of technology venture capital raised during the last five years; and, secondly, to enable CIFs to balance their portfolios with more mature businesses to create a potentially lower risk overall profile for the investor whilst maintaining significant support for innovation.

These differences are illustrated again by reference to figure 9 which show the small potential overlap that CIFs will have with VCTs if delivered in the proposed way. CIFs will be able to diversify their portfolio whilst having a duty to focus on higher tech, innovative companies.

9. Source: "Activité d'investissement des FCPI dans les entreprises innovantes, Tableau de Bord 1997-2010", AFIC / OSEO, February 2012; "Research and Development Tax Credits: Tables RD1 and RD2", HMRC, October 2011

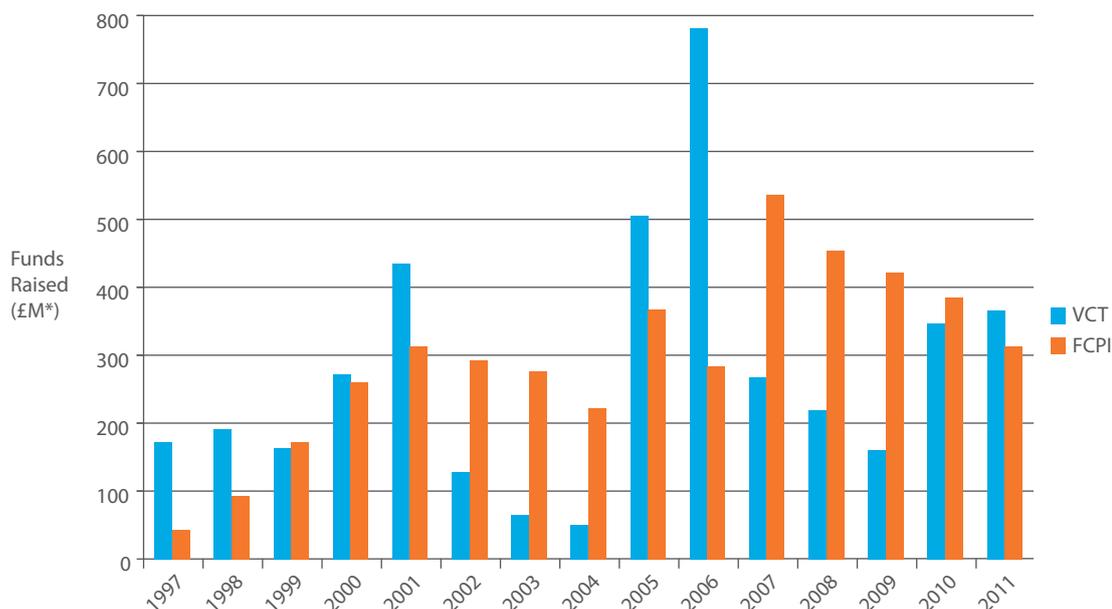
Comparative size of the FCPI and VCT schemes

Figure 11 provides a comparison of the funds raised by FCPI and VCTs between 1997 and 2011 with the latter raising slightly less overall. Both schemes have seen fundraising levels fluctuate according to changes in applicable tax reliefs and investment criteria, which demonstrates the importance of introducing CIFs with a suitable tax incentive to encourage investment.

For example, VCT subscriptions increased dramatically in the tax years to April 2005 and 2006 when relief climbed from 20% to 40%, then declined in the following three years as relief fell back down to 30%, the required holding period increased to five years and the gross assets limit of qualifying companies was reduced to £7 million.

FCPI fundraising increased significantly in 2007 as France's "IMP o de Solidarité sur la Fortune" became eligible for relief through FCPI investment. FCPI subscriptions have declined when modifications with the scheme, such as reducing the time available for managers to achieve their funds' qualifying ratios from twenty four to sixteen months, have impacted the attractiveness of the scheme and increased its perceived risk profile.

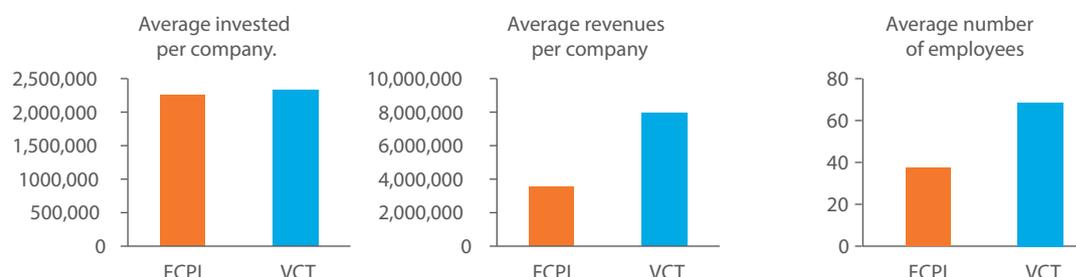
Figure 11. Comparison of funds raised by FCPI and VCTs, 1997 - 2011¹⁰



There is also comparable data available to demonstrate other characteristics of the FCPI and VCT schemes. It can be seen that FCPIs and VCTs have made almost identical sizes of investment per company since inception, with FCPIs investing on average £2.2 million compared to £2.3 million for VCTs.

10. Source: Various AFIC, AIC, PwC studies. Average annual exchange rates have been used for each calendar year.

Figure 12. Average amount invested per company by FCPI and VCT funds since 1997, average revenue per company and average number of employees per company¹¹



Despite the ability of FCPIs to invest in far larger companies the average size of a VCT-backed company at investment is approximately twice as large. The average revenues of VCT companies pre-investment

is £7.9 million compared to £3.4 million for an FCPI-backed company, while the average number of employees at a VCT-backed company is 68 compared to 37 for an FCPI investee company.

Positioning compared to EIS

Since the changes announced in the 2012 Budget, EIS funding now targets very similar companies to VCTs. Historically, the EIS has, like VCTs, focused less than a third of its cash on innovative companies. In 2006/07, for example, 564, or 27%, of the 2062 companies raising capital through the EIS were deemed “high tech” according to the Office for National Statistics, and accounted for £177 million, or 25%, of the total £699 million EIS funding raised.

CIFs would therefore overlap with the EIS in a similar limited way to how they will overlap with VCTs. However, the requirement for the EIS to invest only in ordinary shares tends to make it more suitable for relatively stable businesses that are unlikely to take on dilutive venture capital funding at a later stage as EIS investors will not want to be disadvantaged.

BLUEPRINT FOR CITIZENS’ INNOVATION FUNDS

The purpose of this section is to introduce a recommended blueprint for the introduction of CIFs in the UK drawing from the design of the successful FCPI scheme, with some modifications required to make it suitable for the UK framework and to optimise the balance between fund performance and economic stimulus.

As in France, the primary focus of CIFs in the UK should be in the support of innovative companies and technology. Their successful introduction would serve to diversify the funding base for such innovative companies seeking finance and bring the many benefits outlined in Part I to investee companies. The

product will also be designed in a way which instills confidence to investors above and beyond the attraction of a tax break. Through this, the public will be engaged in supporting UK growth and the knowledge economy.

Innovative companies, characterised by their propensity for R&D investment, are perceived to involve a higher degree of risk than companies with little or no technology component. However, they have demonstrated their ability for rapid growth and job creation with the benefits of their innovation being felt by private and corporate consumers worldwide.

11. Source: “Activite d’investissement des FCPI dans les entreprises innovantes, Tableau de Bord 1997-2010”, AFIC / OSEO, February 2012; “Delivering Growth: The Role of VCTs”, AIC, April, 2012. Period for FCPI data is 1997 – 2007, period for VCTs is 1998 – 2010.

Bearing this in mind, when creating a venture capital product with a relatively narrow innovation focus, it is appropriate to ensure that product managers have the tools available, through the design of the product, to deliver an attractive long-term return to investors. For this reason, it is argued that CIFs should enjoy a 40% tax break to encourage investment. This will be capped at a relatively low level of £15,000 per annum reducing its affect on the cost of the scheme but increasing its attractiveness to the individual investor.

It is also proposed that higher investee company gross asset limits be applicable than for VCTs, and that eligible investments be able to be made with a broader range of securities to avoid being disadvantaged when co-investing with institutional venture capital funds, a key issue for existing government tax-advantaged schemes. The remaining 40% of funds will not have any limit on investment and

could be used to buy shares in publicly listed companies or in retail bonds for example.

The distribution strategy for the product will be a crucial part of the success of CIFs and requires careful consideration. With CIFs being more of a 'mass-market' retail product, differentiated from VCTs or the EIS and with a largely separate target audience of investors, the involvement of major product platforms is required. FCPIs are distributed by banks and insurance companies as well as by Independent Financial Advisers and wealth management firms for example. Close dialogue will be necessary with financial advisers to optimise distribution and ensure the product is well regulated whilst being easily understandable and accessible by the public. It is envisaged banks with a large retail footprint will play a significant role here.

Product features

Figure 13 outlines the proposed features of the CIFs product in the UK and compares it to the

features of other tax-advantaged schemes that have been explored in this paper.



Figure 13. Comparison of principal features of existing tax-efficient products*

	FCPI	Citizens' innovation Fund	VCT	EIS
Vehicle	None used	Limited partnership	Listed PLC	None used
Fund duration	10 years (8 + 2)	12 years (10 + 2)	No limit	No limit
Fund governance	Manager	Manager	NED Board	Manager
Income tax relief	22% for IR funds 50% for ISF funds	40%	30%	30%
Maximum amount relief applies to	€12,000 (IR) €50,000 (ISF)	£15,000	£200,000	£1,000,000
Capital Gains Tax (CGT) relief	0% CGT No deferral	0% CGT Deferral	0% CGT No deferral	0% CGT Deferral
Treatment of dividend income	No distributions permitted pre-liquidation	Tax free	Tax free	Taxable
Minimum investment holding period	5 years	5 years	5 years	3 years
Geographical focus	EU	EU	EU, requires permanent UK establishment	EU, requires permanent UK establishment
Maximum employees per company	2,000 (IR) 250 (ISF)	250	250	250
Maximum assets per company	No asset limit (IR); €50m revenues or €43m assets (ISF)	£42m revenues or £36m assets	£15m pre £16m post	£15m pre £16m post
Securities eligible for qualifying investments	Minimum of 40% in equity or quasi equity (ords, prefs, convertible bonds)	Minimum of 40% in equity or quasi equity (ords, prefs, convertible bonds)	70% must be in ordinary shares	100% must be in ordinary shares
Period to satisfy qualifying ratio	16 months	24 months	36 months	12 months (for approved funds)
Maximum investment per company	€2.5m / 12 months	£5m / 12 months	£5m / 12 months	£5m / 12 months
Maximum single company allocation	10%	10%	15%	25% (for approved funds)
Fund reporting	NAV every 6 months, sometimes quarterly	NAV every 6 months	NAV every 6 months, often more frequent	NAV every 6 months
Initial fees	Approx 5% average	Up to 5%	Approx 5% average	Up to 5%
Annual charges	Range up to 6%	2.5% to 3.5%	Usually capped at approx. 3.5%	Usually capped at approx. 3.5%
Redemption of fund shares	At NAV, at manager's discretion, exit fee often applied	At NAV, at manager's discretion	At discount to NAV, at manager's discretion	At NAV, upon exit of holding(s)

*IR & ISF are the French income tax and wealth tax respectively. NAV refers to Net Asset Value.

Measuring the cost and success of Citizens' Innovation Funds

The success of the FCPI scheme and its applicability to the UK market have been outlined in this report. The opportunity clearly exists for a well designed CIF product to support a new generation of high tech innovative companies and support growth in the UK. However, it is also important to understand the potential cost of CIFs to the taxpayer and then effectively measure their success.

While the AFIC FCPI studies previously cited provide a solid and workable template for assessing the impact of CIFs, accurately assessing their likely cost in the UK is not a straightforward exercise.

Extensive modelling can be conducted on any finalised and agreed criteria, possibly considering the potential cost on a sliding scale of tax relief, at 30% through to 40% for example.

However, some sense of net cost/benefit may be derived from some interpretation of the AFIC/OSEO FCPI studies referred to earlier and applying them to a UK scheme. These estimates, based just on corporation and employment related tax receipts suggest that tax relief could be repaid within thirty six months.

Estimating the cost to the Treasury of CIFs

Assessing the cost to the taxpayer of a product such as a CIFs involves calculating: (a) the amount of tax relief generated for subscribers in each fiscal year that funds are raised; and subtracting (b) any incremental tax receipts resulting from deployment of such funds.

Tax receipts should include: corporation tax, employee income tax, VAT, employer and employee national insurance and capital gains tax paid on share disposals by employees and shareholders at exit.

- a) Calculating the cost of tax relief - assuming that £300 million is raised annually by CIFs, and that all fund subscriptions are tax deductible, the amount of tax relief with a blanket 40% relief would be £120 million per annum.
- b) Calculating the level of incremental tax receipts - incremental tax receipts are defined here as the increase in tax receipts in any given year following investment by a CIF. It is an imprecise science to calculate certain receipts such as corporation tax without P&L and balance sheet data, or VAT without product information.

However, by applying revenue and employment growth data from the AFIC/OSEO studies cited, and by using a uniform assumed level of profitability, it is possible to gain

rough estimates of the potential corporation tax, employee income tax and employer and employee national insurance tax receipts that may result from CIFs if modelled on the FCPI programme.

It is recognised that this calculation makes assumptions in the absence of available data and should serve as an estimate only. However, it does go some way to demonstrating the potential costs involved.

Our analysis suggests that tax relief could be repaid within 3 years without factoring in any VAT receipts or employment costs post-investment. It should be noted, however, that employment related tax receipts are based on the assumption that new jobs have been created. Further information can be found in Appendix C.

In order to best measure the impact of CIFs, it is necessary to collect financial and operating data on investee companies pre and post-investment, and to compare growth rates with similar companies which have not benefited from capital injections during the same period. Perhaps the most suitable cohort of companies with which to find comparator companies would be those eligible for R&D tax credits.

The cohort of comparator companies should be refined to include companies with similar financial and operating statistics as those backed by CIFs. The comparator group should exclude companies receiving any capital injection during the period of measurement.

Data to be gathered should ideally include:

- Revenues
- Employee numbers
- Employment cost
- Corporation tax paid
- Employee income tax paid
- Employer and employee NI paid
- Proportion and value of sales exported
- Financial debt
- Amount of R&D expenditure
- Number of patents published

CONCLUSION

Part II of this report has sought to demonstrate the appropriateness of CIFs, based closely on the FCPI model, to the UK market. As such, it has been demonstrated that CIFs can be very effectively positioned within the current UK tax-advantaged framework.

It has been demonstrated that CIFs will not disrupt existing schemes, either in the investor group targeted or the investee companies supported. Regarding the R&D tax credit the product will actually be complementary to the benefit of continued research and development in the UK.

Regarding investors, the evidence highlights the difference in target markets with existing tax-advantaged schemes in practice being attractive only to high-net worth individuals who are able to invest large amounts of money. The CIFs by contrast will be offered to the retail market, mid-net worth individuals, and seek to raise large amounts of funding through relatively small individual subscriptions. The available data indicates this.

CIFs will provide support to higher technology companies and in practice will most likely follow the FCPI experience where half of such funds are invested in companies less than four years old. CIFs will have a higher technology focus, given the 60% mandatory requirement, than VCTs or EIS. However, as proposed, CIFs should also be allowed to invest in some larger companies should they chose to, still of a high technology nature, in order to help balance the portfolio and produce returns for investors whilst support cutting edge and pioneering innovation.

Part II has also provided a detailed blueprint for consideration by government based closely on the French FCPI experience whilst making the necessary changes to ensure applicability to the UK market. CIFs must be attractive to the retail investor community through an adequate tax incentive to ensure it can deliver success. This blueprint has also enabled the estimation as to the possible costs to Treasury and have shown that such a scheme could be revenue neutral within three years.



APPENDIX

Appendix A

WHAT ARE FCPI?

Fonds Commun de Placement dans l'innovation (FCPI) were launched in France by the Finance Act in 1997 in order to raise funds to support the development of innovative SMEs. It is a form of venture capital in which individuals can invest modest sums of money, through a retail product. Such a product is obtainable through a number of sources be it from Independent Financial Advisors (IFAs), diversified asset managers or, as has largely been the case in France, through high street banks.

These funds are then pooled together for investments to be made by experienced fund managers. 60% of these pooled funds must be invested in securities of non-listed companies that have the following characteristics:

- Innovative
- Established in the European Economic Area
- Subject to corporate income tax
- Fewer than 2,000 employees
- One or more legal entities do not hold a majority shareholding.

The remaining 40% of assets can then be invested freely in other assets. In practice different FCPI Funds have emerged offering different levels of investment risk with some, for example, investing more than the 60% required into innovative SMEs.

With regards to the nature of those SMEs which qualify for investment, a company is considered innovative if it meets one of the following criteria:

- Have had cumulated R&D expenditure in the course of the three previous financial years, equalling at least a third of the highest turnover figure during those three years.
- Be able to provide evidence for the creation of innovative products, processes or techniques which has demonstrated economic development potential.

For the investor an income tax deduction of 22% of the amount invested in an FCPI is currently available. This deduction was reduced from 25% from 2011. The amount of investment is limited to €12,000 per person, or €24,000 per household. There is a further exemption from capital gains tax for all FCPI fund shares held for more than five years.

In addition to FCPIs, FIPs¹ were created in 2003 to help finance regional SMEs in France. In the case of this mechanism, 60% of the funds raised must be invested in unquoted innovative French regional SMEs with the remainder, as with FCPIs, able to be invested freely.

1. Fonds d'investissement de proximité, Regional Investment Funds

Appendix B: Examples of successful FCPI backed companies

Non-French FCPI-backed life science companies

Company	Activity	Selected FCPI investors	Comment
Biovex	Cancer therapeutics	Innoven, CAPE (Credit Agricole Private Equity, now known as Omnes Capital)	Sale to Amgen for up to \$1B in 2011
CMC	Contract biologics manufacturing	Innoven	Partial sale to Monitor Clipper, 2008, valuing the company at approximately €100M
OctoPlus	Drug delivery	Innoven	IPO: Euronext, 2006
PanGenetics	Therapeutic antibody development	CAPE, EDRIP	Sale of main asset for up to \$190M to Abbott in 2009
Santaris	Development of RNA-silencing drugs	Seventure	Still private, but collaborative deals with Pfizer, GSK
Syntaxin	Development of targeted secretion inhibitors	Seventure	Still private, but collaborative deals with Allergan, Ipsen

French FCPI-backed life science companies

Company	Activity	Selected FCPI investors	Comment
Carmat	Development of artificial hearts	Truffle	IPO: Alternext, 2010
Fovea Pharmaceuticals	Ophthalmology	CAPE	Sale to Sanofi Aventis for €370M in 2009
Innate Pharma	Immunotherapy	Viveris	IPO: Euronext, 2006
METabolic Explorer	Production of chemical intermediates	CAPE, Seventure	IPO: Euronext, 2007
Novagali Pharma	Ophthalmology	Idinvest – 123 Venture	IPO: Euronext, 2010 ; Sale to Santen Pharmaceutical for €102M in 2011
Opi	Orphan drug development	Viveris, Seventure	Sale to EUSA Pharma for €110M in 2007

Non-French FCPI-backed ICT companies

Company	Activity	Selected FCPI investors	Comment
gate5	Mobile navigation software	Innoven	Sale to Nokia for €150M in 2006
NovaLED	OLED technology development	123Venture, CAPE	Filing for Nasdaq IPO, export-led

French FCPI-backed ICT companies

Company	Activity	Selected FCPI investors	Comment
Criteo	Pay-per-click advertising platform	Idinvest, 123Venture	Still private but \$200M revenues in 2011, over 500 employees
Dailymotion	Video hosting site	Idinvest, CM-CIC	Sale of 49% to Orange valuing company at €120M in 2011
Kelkoo	Price comparison service	Turenne Capital	Sale to Yahoo for €475M in 2004
Meetic	Online dating platform	Idinvest	IPO: Euronext, 2005
Netbooster	Digital marketing agency group	Truffle	IPO: Alternext, 2006
Parrot	Manufacture of wireless devices for mobile phones	Seventure, CM-CIC	IPO: Euronext, 2006
Talend	Open source software provider	Idinvest	Still private but has raised \$62M mainly from international follow-on investors (Balderton, Silver Lake), export-led
Viadeo	Business-oriented online social networking platform	Idinvest	Still private but had an estimated \$40M of revenues in 2009 and has 45M members
Vistaprint	Online provider of marketing products and services	Seventure	IPO: Nasdaq, 2005

Appendix C: Further detail and explanation on the proposed CIFs blueprint

The below table outlines an estimate of the potential tax receipts that could be generated per qualifying company, based solely on corporation and employee-related tax, assuming an average salary of £50,000 per company. The

proportion of qualifying investments has been modelled at 70% of funds raised as well as at 60% to reflect the expected actual amount of qualifying investment that will be made.

Calculation of estimated potential tax receipts*

	Pre-Investment	Post-investment	Increase
Fund assumptions:			
Total funds raised	£300,000,000		
Qualifying investments (60% of funds)	£180,000,000		
Qualifying investments (70% of funds)	£210,000,000		
Average investment per company	£2,154,370		
Implied number of investments (60%)	84		
Implied number of investments (70%)	97		
Assumptions used per company:			
Revenues	£3,376,556	£5,503,786	£2,127,230
Growth rate*		63%	
Number of employees	37	58	21
Growth rate*		58%	
Pretax margin	10%	10%	
Pretax profit	£337,656	£550,379	£212,723
Average salary	£50,000	£50,000	
Total salary cost	£1,850,000	£2,923,000	£1,073,000
Implied tax receipts per company:			
Total employer NI	£217,066	£342,965	£125,898
Total employee NI	£155,027	£244,943	£89,916
Total income tax	£365,708	£577,819	£212,111
Corporation tax	£74,284	£121,083	£46,799
Total tax receipts per company	£812,086	£1,286,810	£474,724
Implied taxpayer cost / benefit:			
Total cost of tax relief	£120,000,000		
Cost of tax relief per company (60%)	£1,436,247		
Cost of tax relief per company (70%)	£1,231,068		
Number of years to repay relief (60%)	3.0		
Number of years to repay relief (70%)	2.6		

*As per ASFIC / OSEO Study 1, in Part I of this document, increase in revenues and employee numbers post-investment is based on the average per company during the two year period pre-investment compared to the two year period post-investment.

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