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High growth companies and how to fund them – a real driver of economic growth?

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The working session in Prague is entitled "*High-growth companies and how to fund them – a real driver of economic growth?*" In the working session we plan to address funding alternatives for high-growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high-growth companies. This questionnaire mainly concentrates on these two topics in relation to high-growth companies, but will also cover commercial and regulatory opportunities and constraints.

1. CORPORATE FINANCE – FUNDING ALTERNATIVES

1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

This will depend on the profile of the investee vehicle but the most common financial instruments are preferred **ordinary shares, convertible loan notes and preference shares.**

Exceptionally hybrid instruments (eg **Mezzanine Finance**) are used but these are usually expensive to document and only used for larger investments. The main cost is the need to get detailed advice on the tax implications of the hybrid structure. At the moment debt is either too expensive or too burdensome. In the early days as rolling up interest or capital holdings can create issues for the exit.

While debt financing is the most commonly used form of external finance for SMEs, straight debt financing poses challenges to firms and may be ill-suited at specific stages in the firm life cycle. Usually a company borrows from a bank, rather than from a venture capital firm. But some firms can provide loans, leasing and hire purchase as well as equity finance. There are limits in the sustainability of the financial leverage, usually defined as ratio of the sum of short and long term debt over total equity. Highly leveraged firms find it difficult to obtain further credits and often rely on private investors and pre-IPO funding when on an expansion phase.

The financial crisis has exacerbated the issue of debt financing as banks and institutional investors generally tightened credit standards.

Seed capital can be distinguished from venture capital in that venture capital investments tend to come from institutional investors and tend to involve significantly more money, an arm's length transactions, and much greater complexity in the contracts and corporate structure that accompany the investment. Seed funding involves a higher risk than normal venture capital funding since the investor does not see any existing projects to evaluate for funding.

Private investors and business angels will prefer simple equity investments due to the tax breaks they can get for EIS qualifying investments[1] in the UK and other tax breaks which can be lost if loans are included in the mix.

[1] EIS qualifying investments: The Enterprise Investment Scheme (EIS) was introduced in 1994 to help smaller higher-risk trading companies to raise finance by offering a range of tax relief (in particular in relation to income tax and capital gain tax) to investors who purchase new shares in those companies. The scheme supposes that certain conditions are met by both investors and companies for a period of time.

1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above)

(Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

The institutional investors and venture capitalists (VC) firms will usually prefer loan notes to preference shares for tax purposes and because interest is payable out of cashflow not distributable profits.

Institutional investors will also consider "Mezzanine finance" to complement rather than replaces other forms of finance. It can be used in conjunction with various forms of equity finance, such as private equity, venture capital, business angels, or listing on an exchange or similar trading platform.

Virtually all documents relating to the financing of a private limited company not listed on an exchange or similar trading platform other than the articles of association (constitutional documents of companies incorporated in the UK) or charges are totally private (if drafted correctly) and not electronically registered instrument.

The main types of investment made by VC firms and business angels are as follows:

1.2.1 Ordinary shares

Ordinary shares give the venture capital investor ownership of an agreed proportion of the company, and each of the investor's ordinary shares will carry the same rights as each of your ordinary shares. The return is made up of a combination of dividends (if any) paid out, and the increase in the capital value of the shares.

Ordinary shares are cheap for a company to finance in the short term, and the company only has to pay out dividends if the company has profits available to fund them.

Negotiations over the proportion of ordinary shares that the VC firm or business angel receives for an investment can be long and difficult. The founding members will tend to value their company more highly than outsiders will.

1.2.2 Preference shares

Preference shares usually entitle the venture capital investor to a fixed dividend each year, such as 10p per £1 preference share (provided there are profits available to pay it from), before any dividend can be paid on the ordinary shares.

If there are no profits to pay the preferential dividend in a particular year, the dividend is usually cumulative, ie arrears are carried forward and paid to the investor in subsequent years when there are profits.

The terms of issue of redeemable shares usually provide that the shares are to be repaid ('redeemed') on specified dates, or if the company fails to meet its performance targets. On redemption, the investor usually receives at least the

amount he originally paid for his preference shares plus any arrears of the preferential dividend.

Preference shares have presentational advantages in that they give the company at least the appearance of being less leveraged, improving its balance sheet. This may be relevant depending upon the business or regulatory environment in which the company operates.

1.2.3 Loan notes

Loans are sometimes made pursuant to the terms of the investment agreement rather than in a separate instrument. Where investors prefer loan notes, the documentation will need to include a loan note instrument. Loan notes may require a subordination agreement (or deed of priorities) between the holders and the providers of senior debts. If the loan notes are to be secured, this may be achieved through stand-alone security documentation or by the investor accepting that the lead debt provider acts as a security agent for all lenders and loan note holders. Consideration should be given to the repayment provisions, in particular, should the loan notes be repaid automatically on a sale or quotation and as to how these provisions interrelate with a ratchet and internal rates of return which investors are looking for.

Loan notes give the investor a preferred right to income generally and to capital on a winding-up and so are preferable to ordinary share capital.

The payment of interest on loan notes (in contrast to the payment of dividends on preference shares) is made before tax. This amounts to a tax saving of approximately 24% of the interest payment (23% from April 2013, 21% from April 2014 and 20% from April 2015). Loan notes can be secured over the assets of the Company. Loan notes can be repaid irrespective of the company's available distributable profits which is unlike the rules applicable to distribution of profits.

1.2.4 Mezzanine finance

Mezzanine finance differs from "straight debt" finance, in that it implies greater sharing of risk and reward between the user of capital and the investor. However, the risk and the expected return are lower than for "pure" equity. In the event of bankruptcy, mezzanine investors have lower rankings than other creditors, but higher rankings than "pure" equity investors. In as much as recourse to mezzanine finance requires the firm to pay interest, mezzanine finance is most relevant in a later (expansion) phase of the firm, usually when a firm with positive cash flow is approaching a turning point in its development. For companies looking for an injection of capital to grow an already successful business without giving up control, mezzanine financing can be an appropriate solution.

1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

The main regulations applicable to high growth companies will be the Companies Act 2006 and the Financial Services and Markets Act 2000 (FSMA) in relation to

financial promotion and the Prospectus Rules applicable in the UK (implementing the EU prospectus directive). Under the Prospectus Rules, high growth company may have to issue a prospectus and have it approved by an authorised person, unless an exemption applies. The Prospectus Rules applies to a UK high growth company whenever there is either an offer of transferable securities to the public in the UK or a request for the admission to trading of transferable securities on a regulated market in the UK or abroad.

There are several exemptions to the Prospectus Rules in relation to wither the size of the transaction or where the securities which are to be offered, are so offered either qualified investors (which would include VC firms here) or less than 100 people. Particular care should be taken in relation to private investors and business angels who must qualify under the Prospectus Rules and the FSMA to be able to be marketed and offered securities within the UK regulatory framework.

In addition, since 22 July 2013 the Alternative Investment Fund Managers Regulations 2013 (UK Regulation) transposed most of the provisions of the European Directive of the same name which introduced a harmonised regulatory framework across the EU for EU-established managers (AIFMs) of alternative investment funds (AIFs). The UK Regulation requires AIFMs to be authorised, and contains provisions about how AIFMs should conduct their business, transparency and marketing. The Financial Control Authority (**FCA**) is responsible for supervising and enforcing the UK Regulation. With regard to private equity managers, Part 5 of the UK Regulation contains provisions applicable to AIF managed by an AIFM subject to full authorisation when they hold a significant proportion of the shares in, or acquires control of, a private company or an issuer of traded securities. Part 5 imposes requirements about the provision of information to the company or issuer, shareholders, employees and employees and contains restrictions on distributions, capital reductions, share redemptions and acquisitions by companies or issuers of their own shares for 2 years after the AIF acquires control.

The Directive contains provisions that apply to non-EU AIFMs marketing AIFs within the EU. Its impact on US managers who market their funds to European investors is a particularly controversial aspect of the Directive.

Private equity managers are usually part of a bank or financial services group or, as have become more common in recent years, an independent, owned and managed by the venture capitalists themselves. Investors capable of being caught by the UK Regulation comprise hedge funds. private equity funds, venture capital funds, property funds and investment trusts. It also covers real estate investment trusts (REITs), FCA-authorised non-UCITS funds (including non-UCITS retail schemes (NURS), funds of alternative investment funds (FAIFs) and qualified investor schemes (QIS)), charity funds, commodity funds and infrastructure funds.

1.4 Is crowdfunding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.

Crowd funding is one alternative to provide either debt or equity finance to a small, but growing number of businesses. It is starting to gain ground in the UK with many start-ups and small firms as a realistic alternative to bank lending and VC funding.

As with many investment project, financial review, selection of suitable finance strategy and protection of assets and intellectual property are some of the key aspects to consider before opening the business to external investors. For example, disclosing the details of a business plan to the public at large can leave a business vulnerable to competitors using ideas of the business and perhaps infringing IP rights at possibly the weakest time for the business.

Crowd funding is new and the regulation is a grey area. Hardly any crowdfunding platforms are FCA regulated and the FCA observes that many crowdfunding opportunities are high risk and complex. Not many uses the protection afforded by the FCA and the financial promotion regulation under the FSMA in UK.

Ideally, the provider of the services should be authorised by the FCA and/or the Office of Fair Trading in the UK. If a company obtained finance from a lender or investor that was not registered by the FCA, the company will not be eligible for compensation in the event the proposed finance proves to be a scam or if the provider is forced to close down.

For investors, one has to assume that the risk of investing money in businesses which may have already been turned down by their bank is high. Crowdfunding is a complex area when it comes to the rights of minority shareholders. These rights sometimes may turn out to be toothless in real-life.

The UK Crowdfunding Association (UKCFA), was set up as a self-regulatory trade body by several UK crowdfunding businesses. For more information on the UKCFA see its website http://www.ukcfa.org.uk/.

Crowd funding is still in its early days. Time will tell if it is to become a serious alternative to a bank loan in particular.

2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

2.1 Who are typical investors into a high growth company in your jurisdiction? Sources of funding (i.e founders-family-friends, angel investments, venture capital investments, private equity)

Private Equity rarely invests at this stage so the typical investors into high growth companies in the UK are founders-family-friends, angel investments, venture capital investments plus investors using crowdfunding.

Otherwise venture capital funds source equity from a wide range of investors, both public and private. Private investors can include:

- High net-worth individuals;
- Family offices;
- Pension and insurance funds;
- Funds of funds;
- Sovereign wealth funds; or
- Corporate investors.

Public investors can include:

- Local and central government pension schemes;
- Charities. These are becoming increasingly important sources of funds, particularly for venture capital funds that have a wider social purpose; or
- A range of quasi-governmental institutions and public sector-backed venture capital investors, including regional venture capital funds and enterprise capital funds; or
- At a European level, significant investment in venture capital funds is also available from a number of supra-national organisations, including the European Investment Bank (EIB) and its venture capital/private equity focused arm, the European Investment Fund (EIF), both of which are active market participants.

2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?

Venture investment can range from tens of thousands of pounds from a business angel in a seed round to tens of millions of pounds from institutional investors in a later round (the term seed suggests this is an early investment, meant to support the business until it can generate cash of its own, or until it is ready for further investment). Broadly, early stage/seed investment are common around the £1m mark and early stage “with revenues” seed investment are likely to be around the £3m mark.

An institutional investment will typically be between GB£500,000 and GB£5 million. In recent years, the pace of traditional venture investing has slowed, and there has been an increase in the use of venture funds to finance small scale infrastructure projects (particularly solar photovoltaic projects) in a tax-efficient way.

2.3 Describe the process of documenting the investment

The main documentation usually associated with an investment includes:

2.3.1 <u>Shareholders/Investment Agreement</u> or a subscription and shareholders

agreement. This will contain:

a. the terms on which the investor makes its investment, what it gets for its cash and how the investment will be made (for example, in a single drawdown or series of tranches);

b. warranties provided by the target company and founders as to the position of the company, and to a limited extent, the founders other business interests;

c. restrictive covenants to be provided by the founders;

d. a series of obligations as to the management and governance of the company and matters which specifically require investor consent.

2.3.2 Articles of association. These deal with the rights attaching to shares, the new share issues and transfers, the the operation of the board and general constitutional matters.

Note: rights affecting shareholders should be in Articles of Association of the Company primarily for tax rather than enforcement reasons e.g. unless all vote for or are issued new shares with the restriction attached then good/bad leaver and tag and drag rights can be resisted. However if privacy is an issue they can be included as a contractual right in the Investment Agreement.

2.3.3 Ancillaries including service contracts and debt instruments.

2.4 Are there incentive schemes for investing into high growth companies

There are a few incentive schemes for investing into high growth companies in the company. These schemes are both tax schemes and governmental grants.

2.4.1 **Governmental grants**:

a. Big Society Capital Limited (BSC). BSC is a UK social investment bank which started in 2011 to help finance project under the UK Government banner of the "Big Society" and launched a GBP£600 million investment fund on 4 April 2012.

b. Seed funding **-** Government funds may be targeted toward youth, with the age of the founder a determinant. Often, these programmes can be targeted towards adolescent self-employment during the summer vacation. Depending on the political system, municipal government may be in charge of small disbursements. The European Commission also runs microfinance programmes (loans under €25 000) for self-employed people and businesses with fewer than 10 employees. European SMEs can often benefit from the Eureka programme, which federates SMEs and research organisations, such as universities. Government programmes are often tied to political initiatives, for example greentrustwind.co.uk, a

means by which the UK place subsidies in the green sector, or the Energy Saving Trust, designed to draw attention to energy conservation.

2.4.2 Tax schemes:

a. Enterprise Investment Scheme (EIS)

The EIS is designed to encourage entrepreneurship and assist small and medium-sized trading companies to raise finance by offering tax relief to investors who purchase ordinary shares. The EIS offers the following benefits on the subscription for shares in a qualifying company:

Income tax relief of 30% of the amount subscribed (subject to a maximum subscription of GB£1 million) provided the shares are held for at least three years.

Capital gains tax exemption on sale after three years provided that the income tax relief has not been withdrawn within those three years.

These benefits are referred to as Investment Relief in this Report. In addition, EIS relief allows a taxpayer to defer capital gains made on the disposal of assets, by reinvesting the gain into the subscription for shares in an EIS qualifying company. The shares must be issued at any time beginning one year before and ending three years after the disposal of the asset. This is referred to as Reinvestment Relief and there is no maximum limit for this.

There are some significant restrictions for Investment Relief and it is more likely to be available to an outside investor than to someone who works in the business.

The rules for directors are complex. Careful planning and timing is critical, but it could allow a seed investor to be a director.

There are strict conditions that apply to the target company as well. Their description is beyond the scope of this Report.

b. Seed Enterprise Investment Scheme (SEIS)

The SEIS was introduced on 6 April 2012. This is similar to EIS, save that it is focused on smaller- early stage companies.

The main benefits are:

- Income tax relief will be available at 50%, but the individual threshold will be limited to GB£100,000 and the company level threshold to GB£150,000.
- Any gain made on the SEIS shares is free from capital gains tax on sale provided the shares are held for at least three years and the income tax relief has not been withdrawn (Disposal Relief).

- Any gain made on the disposal of an asset in the 2012/13 or 2013/14 tax year that is reinvested in SEIS qualifying shares within the same or following tax year, will be exempt from capital gains tax (Reinvestment Relief).

An investor must meet certain criteria to qualify for SEIS relief, as with EIS and VCT relief. An investor cannot be an employee of the company, but can be a director.

There are strict conditions that apply to the target company as well. Their description is beyond the scope of this Report.

c. Venture capital trust (VCT)

VCTs are also designed to encourage investment in small- medium-sized and start-up trading companies. The individual invests in the VCT and the VCT invests in the company.

An individual making an investment in a VCT is entitled to income tax relief of 30% of the amount subscribed (maximum subscription GB£200,000) provided the shares are held for at least five years. Dividends are exempt from income tax and any gain made on disposal is free from capital gains tax, provided the VCT continues to be approved.

The VCT must be approved by HM Revenue & Customs (HMRC). There are a number of conditions which apply, including that it must be listed on the Official List of the London Stock Exchange or an EU regulated market.

There are strict conditions that apply to the target company as well. Their description is beyond the scope of this Report.

2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?

Private investors and business angels will prefer simple equity investments due to the tax breaks they can get for EIS qualifying investments in the UK and other tax breaks which can be lost if loans are included in the mix.

The institutional investors and venture capitalists (VC) firms will usually prefer loan notes to preference shares for tax purposes and because interest is payable out of cashflow not distributable profits.

The tax reliefs referred to above are unlikely to apply to foreign investments by UK ordinarily residents.

3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

3.1 Which company form is most popular?

Most young trading businesses or high growth enterprises seeking finance will be incorporated as private companies limited by shares in the UK. Certain businesses may opt for tax reason for the form of a Limited Liability Partnership. To an extent, a private limited company might make the business more credible to potential customers, partners or investors. We have summarised below the key features of private companies limited by shares:

- Separate legal personality. A company limited by shares is a body corporate and has a separate legal personality from that of its owners/shareholders. A company holds its own assets and can grant charges over them. A company enters into contracts in its own right, and can sue and be sued on those contracts.
- Limited liability of participators. A company limited by shares is responsible for its own debts and liabilities. The liability of each shareholder for the company's debt and other liabilities is generally limited to the amount which remains unpaid on that shareholder's shares.
- Number of participators. There is no statutory upper limit on the number of shareholders in a limited company. A company limited by shares can be formed with a single member.
- Separation of management and ownership. There is separation between the management of and ownership in a limited company. The owners of the company are its shareholders. Responsibility for the management of a company generally falls to its directors. Although the directors of a company will often be shareholders as well, this is not a legal requirement.
- Share capital. A company limited by shares must have an issued share capital comprising at least one share. Each issued share must have a fixed nominal value. The ways in which a company can alter its share capital is strictly controlled by the Companies Act 2006. There are also strict statutory controls on a company's ability to make returns of value to its shareholders. **Shares cannot be offered to the public**. A private company is prohibited from offering its shares to the public.
- No minimum issued share capital. The nominal value of a private limited company does not have to exceed a specified amount. So, for example, it is possible (and common in practice) to incorporate a private company with a share capital made up of just one £1 share.
- No restriction on amount paid up on shares on issue. Unless its articles of association provide otherwise, a private company can issue shares on terms

that the subscription price for the shares will be partly paid or nil paid on issue.

- Constitutional documents. All companies must have articles of association which set out the basic management and administrative structure of the company. The articles of association are a public document. A copy of a company's articles must be filed with Companies House on incorporation and the company must notify Companies House of any changes that are made to its articles during the life cycle of the company.
- Ongoing administration and filing requirements. Companies are subject to extensive ongoing filing and disclosure obligations. These include both obligations that occur on an annual basis (such as the requirement to file an annual return and annual accounts with Companies House) and event driving filing obligations (such as notifying and changes to its share capital, directors or other registered particulars). A fee is payable in relation to some of these ongoing filing obligations.
- Officers. A private limited company must have at least one director. A private company is not required to have a company secretary, although it may choose to do so.
- Shareholder meetings and decisions. A private company not admitted on a market, is not required to hold an annual general meeting, unless its articles of association provide otherwise. Decisions of the shareholders in a private company can be taken by way of a written resolution.
- Capital reductions, redemptions and share buybacks. Private companies have more flexibility in terms of procedure and source of funds for carrying out a reduction of capital, redemption of shares or share buyback. A private company can provide financial assistance for the purchase of its own shares.

3.2 What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?

In the UK, the private investors invest by owning equity in the companies with a high potential for exponential growth. The current sectors concerned have a novel technology or business model in high technology industries, such as IT and digital business, biotechnology, clean tech and life sciences, renewable energies and business natural resources. Areas with low growth and/or very high capital costs will generally not be suited to venture investment although there are always exceptions.

3.3 Are there incentive schemes for entrepreneurs incentivising high growth companies

The two main tax incentive scheme of entrepreneurs in the UK are:

3.3.1 The entrepreneurs' relief is available to individuals (and in certain cases, trustees) who realise qualifying gains. This is a relief from capital gains tax for individuals

and trustees which applies to the first £10 million of gains on the disposal of a business or certain shares or securities of a trading company. Subject to certain conditions being met, it operates so as to apply a rate of capital gains tax of 10% to qualifying gains up to a lifetime limit (£10 million). In the absence of entrepreneurs' relief, gains are taxed at 18% to the extent that the individual's taxable income for the year falls below the basic rate band upper limit, and 28% on the balance. Although gains benefiting from entrepreneurs' relief are taxed at 10%, they are, nevertheless, deemed to use up any remaining part of an individual's basic rate band in priority to other gains. This increases the likelihood that other gains will be taxed at 28%.

3.3.2 The enterprise management incentives (EMI) scheme is a tax-favoured share option scheme, designed to assist smaller and/or entrepreneurial companies to recruit, incentivise and retain employees at a key time, e.g. the pre-sale of the company. This is done through the offering of tax-advantaged share options in the company as an alternative to cash rewards such as bonuses.

Note: If an employee acquires the shares at less than the market value, there can be an immediate charge to income tax (currently up to 50%, but reducing to 45% from April 2013) and possibly national insurance contributions (a payroll tax on the employee and the employer).

Further charges may apply in the future, particularly at the point of disposal. Careful planning can mitigate the income tax risk and it is important to consider making tax elections on acquisition.

3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?

Ordinary shares are cheap for company to finance in the short term, and the trading company only has to pay out dividends if it has profits available to fund them.

4. CORPORATE GOVERNANCE – CONTROL ISSUES

4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:

No investor would invest in any company without certain controlling arrangements which will be of particular importance to an entrepreneur, such as:

4.1.1 Anti-dilution measures

Investor will want to participate equally on any new issues of shares (so as to maintain their shareholding stake in the investee company). In addition to this, it is very common for the investment agreement to contain a contractual restriction

on the investee company from issuing new shares without investor consent, except for agreed actions to satisfy employee share options.

4.1.2 Rights of first refusal, pre-emption rights, drag and tag along

Share transfers are restricted to ensure that all shareholders in an investee company stand together and exit together to maximise shareholder value. The rights of first refusal, pre-emption rights, drag and tag along are commonly used as well as co-sale and agreed exit strategy provisions.

4.1.3 Protective provisions and information rights

The investment documentation will normally include undertakings on the part of the company and the management not to do various things without the consent of the investors. These will generally be non-ordinary course matters such as the acquisition or disposal of significant assets. Regular supervision will be effected through the investors' monitoring of the board, either from its ability to appoint a director or an observer.

Shareholders in the investee company will typically agree an exit plan in the investment agreement to record who does what and the timing of an exit.

Investors will seek to address issues through provision relating to Dead-lock resolution. They may ask to be appointed at the board or have observer rights.

They will insist to have good / bad leaver provisions and restrictive covenants on the exit of the key managers/shareholders.

4.1.4 Information rights

Private equity funds are likely to require information rights in addition to any rights its board nominee(s) may have. This often includes information on the company's performance against projections and the likely achievement of banking covenants. This sits alongside the fund's right to appoint external advisers to examine the company's books and records.

Private equity funds may require consent rights in respect of a number of actions and/or inactions of their portfolio company including:

- changes in its business;
- acquisitions and disposals;
- issues of shares, options or rights to acquire shares or the redemption of shares;
- undertaking or defending litigation;
- increasing the remuneration or benefits available to senior employees;
- increasing indebtedness;
- changes to constitutional documents;
- capital commitments.

5. EXIT STRATEGIES AND TIME HORIZON

5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?

At the moment trade sales are more common than secondary MBO's and other exits and then IPO's. Failures were one of the most common 'exits', at the start of the recession. However, this is starting to slow down.

We have subdivided the question into two.

5.1.1 The forms of exit typically used to realise an investment in an unsuccessful company?

- Sale to a specialist acquirer/ investor. There are investors and trade buyers who specialise in buying distressed assets. This is a risky market, so the purchase price will be low (often based on the underlying value of the investee company's assets) rather than any profit valuation (as this can be too uncertain).
- Solvent (voluntary) liquidation. The shareholders can decide to close down the business in an orderly fashion by putting the investee company into voluntary liquidation. Once the investee company has paid off its creditors, any remaining assets, which the liquidator will more than likely have converted into cash by that stage, would be distributed to shareholders.
- Insolvent liquidation. Sometimes shareholders do not have time to carry out a business sale or a solvent liquidation and, if the investee company becomes insolvent, the fate of the investee company is taken out of their hands. The process of distributing assets is the same as for a solvent liquation, save that there is an increasing risk that there will not be any proceeds left to return to shareholders, as the investee company' creditors are likely to outweigh the value of its assets.

  Liquidation processes can provide stakeholders with the opportunity to take control of the core assets of the business and seek to exploit them in the context of a new business. These "pre-pack" schemes can be controversial as they will generally leave creditors of the original business out of pocket.
- Redemption. Finally, an investor may have the right in the articles of association to demand that the investee company redeems its shares at a pre-agreed valuation. Clearly this is only useful if the investee company has money to fund the redemption.

5.1.2 The most common forms of exit typically used to realise an investment in an successful company?

- Trade sale. The main advantage of a trade sale is control, particularly if there is interest from competing buyers, as the sellers will be able to take advantage of the competitive tension involved. The process also provides a

fair degree of certainty of execution. The main disadvantage is that management shareholders might lose their jobs and/or influence if the investee company is being acquired by a larger company who plans to assimilate the investee company into its own business. Care also needs to be taken to manage secret "business critical" information during the sale process in case the transaction aborts, particularly if the buyer is a competitor, or could become so.

- Buyout. As well as having the advantages of a trade sale, buyouts can also be great events for management shareholders, as they get the chance to realise some cash, retain their position within the business and reinvest into attractive equity instruments in the new company. However, there is likely to be more uncertainty around execution. This is because private equity firms usually undertake a much more thorough due diligence process, particularly about the market in which the investee company operates, as private equity firms might know less about this than a trade buyer. In the current market, it is extremely difficult to raise bank debt to support larger buyouts because of the reduction in availability of acquisition finance.
- IPO. The main advantages of an IPO are that management shareholders will retain their position within the business. There is also a degree of profile raising/feel good factor for any business that is listed on a major stock market. However, an IPO is not really an exit at all, but is more like a partial refinancing of the shareholder base. Investors and management shareholders are often required to agree that they will not sell their shares for an agreed period. In addition, in terms of execution, IPOs are still risky, depending on whether the investee company can secure sufficient interest from initial investors. This will often only become clear late in the process once the marketing phase has begun. IPOs are also expensive to do and are very consumptive of management time.

5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?

New documentation is used in all cases except for simple follow up on investments by all or some of the original Investors.

6. REGULATORY ISSUES

6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?

They need to take note of various thresholds (both group and single companies) for VAT, filing full accounts, pensions etc

6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.

In UK more sector restrictions than growth potential – local issues only arise if local incentives grants or geographically based investment funds have been awarded. The biggest constraint is lack of investment funding for less than £1m.

7. OTHER

7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high growth companies which have not been discussed in responses to earlier questions (if any).

For this sort of investment activity UK jurisdiction is commonly used where there is a jurisdictional issue amongst investors and investees, e.g. US Investors in a European Investment Vehicle.