Northern 3 VCT PLC

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To shareholders in Northern 3 VCT PLC 22 January 2016

Dear Shareholder

NORTHERN 3 VCT PLC – FUTURE INVESTMENT STRATEGY

Over recent months, your directors have been carrying out a review of the company's investment strategy, in the light of the Chancellor's Summer Budget announcement in July 2015 which became law following Royal Assent on 18 November 2015. The new legislation contains fundamental and retrospective changes to the rules governing qualifying investments by VCTs. I am now writing to explain the implications of these changes and to update you on our thinking about the way forward. In the course of our review we have liaised with the boards of Northern Venture Trust and Northern 2 VCT, our sister VCTs managed by NVM Private Equity (NVM), and the chairmen of those companies are writing to their shareholders in similar terms.

Background

The main provisions of the new VCT legislation that affect our company may be summarised as follows:

- It will no longer be permissible for companies to use funds invested by VCTs to acquire existing shares or businesses – in future such funds may be used by investee companies only for "growth and development" purposes.
- In order to be eligible for VCT investment, companies will normally have to have made their first commercial sale within the past seven years (ten years in the case of "knowledge-intensive" businesses, as defined by the legislation).
- In addition to the existing £5 million annual limit on the amount that companies can raise from State aided sources such as VCTs, there will be a new £12 million lifetime limit (£20 million for knowledge-intensive businesses).

These are significant changes, and the impact is heightened by the fact that they apply to new investments made using any VCT funds, whenever raised – by contrast with previous rule changes which have generally applied only to new funds raised by VCTs after the relevant legislative date. HM Treasury has stated that the new legislation is designed to ensure that the VCT scheme complies with the European Commission's State aid rules, and has made it clear that there is no scope for further discussion or transitional measures. However we were pleased to learn that, following representations by a broad range of interested parties including NVM, and subject to European Commission approval, the Government intends in due course to introduce secondary legislation which will allow investments by VCTs to include an element of replacement capital. This should give VCTs greater flexibility to facilitate an exit by minority shareholders whose objectives and time horizon may be significantly different from those of the VCTs.

Northern 3 VCT's investment strategy

The three Northern VCTs have traditionally followed a "generalist" approach, investing in unquoted and AIM-quoted companies covering a wide range of industry sectors and at various stages of the corporate life cycle. Within these broad parameters, we have tended to focus mainly on relatively mature companies, where in many cases the investment opportunity is created by a change of ownership such as a management buy-out (MBO).

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In future it appears that investments to facilitate MBOs will no longer be open to us, and the focus will therefore shift in the direction indicated by the new legislation, with the emphasis on growth capital investment in companies less than seven years old (or ten years in the case of knowledge-intensive companies). In some cases this will involve investing in early-stage opportunities. We have a good track record in this type of investment, including notable past successes such as Alaric Systems as well as current portfolio holdings It's All Good and Lineup Systems. NVM has already taken steps to recruit additional experienced executives to augment its capability in this area.

Our existing portfolio of VCT-qualifying investments is not affected by the new legislation, except to the extent that it will no longer be possible for us to make follow-on investments in many of the companies, and these holdings will continue to be managed with a view to providing a strong investment return in the form of income yield and capital growth.

As older investments are sold and new investments are added under the revised investment approach, we expect that over a period of time the composition of the portfolio will gradually change and that future investment returns may become more volatile, with potentially a greater emphasis on capital returns rather than income yield. This may have implications for the company's future dividend policy, and your directors will be considering this further over the period leading up to the announcement of our annual results and final dividend in May 2016.

Published investment policy

Northern 3 VCT's current investment policy is set out on page 6 of the annual report for the year ended 31 March 2015. Your directors are satisfied that in the short term the change in approach set out above can be implemented within the terms of the existing policy, but we intend to review its wording in the coming months with a view to submitting an updated version for approval by shareholders at the annual general meeting in July 2016.

Future fund-raising

Our company currently has ample funds available for future investment, as a result of the strong cash generation from the investment portfolio in recent years. We have already stated that we do not intend to raise new funds from shareholders in the 2015/16 tax year, and we will keep future capital requirements under review in the light of new investment activity and portfolio exits.

On a related point, I am pleased to report that the dividend investment scheme (DRIS), which was suspended in July 2015 pending our review of the effects of the new VCT legislation, will now be reinstated with effect from 1 February 2016, enabling shareholders to have future dividends invested in new ordinary shares in the company with the benefit of the normal VCT tax reliefs on investment. We expect that the next dividend payment for which the DRIS will be applicable will be the final dividend for the year ending 31 March 2016, which is scheduled to be paid in July 2016.

Conclusion

Whilst the recent changes to the VCT legislation are fundamental in nature, our company has achieved consistently strong performance over a long period during which there have been frequent changes in the VCT legislation, as well as peaks and troughs in the state of the UK economy and financial markets. This record of adaptability gives us confidence that our manager, NVM, will be able to identify attractive new investment opportunities within the new parameters laid down by the Government. We are grateful for the support and encouragement which we continue to receive from shareholders.

Yours sincerely

James Ferguson

James Ferguson
Chairman