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Acuity

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The good, the bad and the ugly of VCTs and EISs

> There's some serious wealth destruction there that at worst could have left you with less than 20p in the pound. You'd have more fun setting fire to £50 notes.

Monevator - 'The Investor' on VCTs[1]

Is the tax tail of VCT and EIS investment wagging the investment dog?

When it comes to considering the role of Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EISs), this is the question that needs to be asked and answered. Tax breaks need to be very carefully weighed against the material risks of owning minority stakes in small, unquoted company investments. Are they ever appropriate for investors?

VCTs and EISs represent tax-advantaged opportunities to invest equity capital into very small and often very early stage – or even start-up - privately held businesses[2]. The words 'equity', 'privately held', 'small' and 'early stage' immediately point out some of the risks, which we cover in more detail later.

There is a certain human appeal towards potentially investing in the next Google or similar tech start-up, or owning a share of a biotech firm commercialising some aspect of research for the good of mankind. Intuitively, one knows that this is a risky, dice-rolling business and that for every winner there are bound to be some losers and some also-rans. But the tax breaks afforded by HM Government, for both of these schemes, risk clouding the due diligence that these investments deserve.

It is a mistake to think that these tax breaks are altruistic in nature. Their purpose is to encourage the supply of capital to these companies in the hope that they will employ more people - who will pay income tax, make NI contributions (individual and company) and pay VAT on goods bought with their wages – and that they will generate higher corporate earnings on which corporation tax can be charged. The tax breaks are provided to improve the risk-return relationship that potential investors in these companies face. It is estimated that somewhere in the region of 35% to 50% of money invested in early stage businesses would not have been invested in the absence of EIS[3].

Capital raising metrics

By way of background, it is worth noting that there are over 5 million SMEs (companies with fewer than 250 employees) in the UK, accounting for 99% of businesses and around 50% of total private sector turnover. Companies with fewer than 10 employees account for 95% of all UK businesses[4].

EISs were launched in 1993-1994 as an evolution of the Business Expansion Scheme that went before them. Since they began, they have raised over £10.7bn for 21,000 small companies, with an estimated £1 billion raised in 2013/2014 for around 2,400 companies[5]. This compares to around £22bn of retail investments into UK mutual funds[6] in the 12 months to October 2014. The peak of EIS capital raising was in 2000/1 at the height of the technology boom. Today's level of fund raising is almost comparable to the previous high. Since 2006, around 60% of all investment has been made into companies operating in London and the South East.

EIS investors have the opportunity to invest either directly into share issues of qualifying firms or via a pooled arrangement - somewhat erroneously described as a fund - which tends to be a collection of investments held by the manager and managed on behalf of the pool of investors. The investments are held in a nominee name with the individual investors remaining as the beneficial owners. This makes access to the tax reliefs easier.

The VCT scheme was first introduced in 1995. VCTs are similar to investment trusts, raising capital by the sale of shares in the trust, which is then invested into qualifying trading companies. VCTs must be listed on a UK stock exchange and will trade at a premium (rare) or discount to the Net Asset Value (NAV) of the underlying portfolio companies. They are managed by professional fund managers. Total funds raised from 1995-6 to 2013-4 were £5.5 billion, with record funds raised in 2000-1 of £450 million. In 2013-14, funds raised were £440 million, via 66 funds, out of 97 funds in existence[7]. This is around half of the funds raised for EIS in 2012/13.

Tax Issue	EIS	VCT
Maximum annual investment	£1,000,000	£200,000
Income Tax relief on subscriptions	30% of subscription amount. (Providing sufficient tax liability).	30% of subscription amount in new ordinary shares. (Providing sufficient tax liability).
Claiming income tax relief	Company sends form EIS3 (when it meets EIS qualifying requirements) or fund manager sends EIS5 if invested via an EIS fund.	Claim relief via tax return for the year in which the 'eligible shares' were issued.
One year carry back	Yes (all or part of the cost of shares acquired).	No. Based on year in which 'eligible shares' were issued.
Qualifying holding period	3 years from the time shares are issued (or qualifying trade starts).	5 years.
Dividends	Taxed at the investor's marginal rate.	Exempt on both new and second-hand shares acquired.
Capital Gains Tax	Exempt after 3 years (if no Income Tax relief is sought, then no CGT exemption is available).	Exempt. Otherwise known as disposal relief.
Loss offset	Yes. Loss less Income Tax relief can be set against Income Tax in year of disposal or income in previous year.	No allowable losses.
Capital Gains tax deferral relief	Yes - unlimited. Capital gains can be deferred by investing gains in new EIS investment.	No
Inheritance Tax Relief	Hold for 2 years to take outside of the estate.	No

Table 1: General tax parameters of EIS and VCT investments[8]
Data source: HMRC[9]

There is a dichotomy between the drivers for investors and advisers

Recent research[10] provides some useful insights into the differences between advisers and investors when considering tax-advantaged, early stage equity investments in small unquoted companies.

From the advisers' perspective

In terms of advisers advising on EISs, the research points out that around three quarters of advisers recommend EIS investments (recommending both single company and discretionary managed funds), and over 90% of advisers stated that tax benefits were one of the main reasons why they recommended EISs to clients. Surprisingly, around 60% thought that they provided diversification. Their key concerns are the complex investment process and poor quality investment literature. The forecast timing of exit from the EIS is, surprisingly, a very low concern. Only 30% think that EISs are only appropriate once ISA and pension allowances have been maximised.

These findings are surprising – even alarming – to us. The tax tail seems to be wagging the investment dog, particularly the fact that 70% of advisers believe that these investments should be considered before other more mainstream tax breaks (ISA and pension) have been fully utilised. The fact that 60% of advisers thought that they provide diversification is a sad reflection on the knowledge of investing that many advisers must hold. The one thing that we can be certain of is that when equity markets fall, the value of microcap companies will fall too. The artificial smoothing of the pricing of unquoted companies – managers have the scope to value the underlying portfolio as they wish - is a diversification illusion.

From the investors' perspective

The same piece of research also polled 6,000 private investors (the database of 'Angel News'), who classified themselves as sophisticated or reasonably experienced investors. 61% held EIS investments and 93% had considered them. When choosing an investment, 92% stated that the expected level of return was one of the most important criteria. Three quarters preferred direct investment in companies to a fund/portfolio structure.

These findings also alarm us. Even self-selected 'sophisticated' investors are probably taking far higher risks than they are aware of, not least the risk of real disappointment that returns are poor (or their capital is lost entirely, before the tax breaks they receive). Direct investment in a single company EIS is a game of Russian roulette with a tax beak on your funeral costs! Investors may well be seduced by the high target rates of return that are illustrated in the glossy marketing literature, which may or may not include the tax beaks received. The table below provides an insight into the levels of target returns being touted.

	Low end	High end	Average
Single company	3%	84%	23%
EIS fund	6%	60%	18%

Table 2: Direct and 'fund' EIS target returns
Data source: AIR (see footnote 10)

There is a dichotomy between expectations and reality

Return promises of 20% or so, on average, for an EIS fund sound attractive. After all, that is more than double the rate of return on UK publicly listed equities since 1900[11]. The reality of how poorly the reality matches up to the expectation is illustrated below. The data captured looks at internal rates of return (IRR) based on the cashflows of the investment portfolio - not accounting for tax breaks - of funds that have been in existence for long enough so that the IRR is meaningful. It also includes funds that have disappeared because they have been merged and have a new manager (a frequent event) or closed.

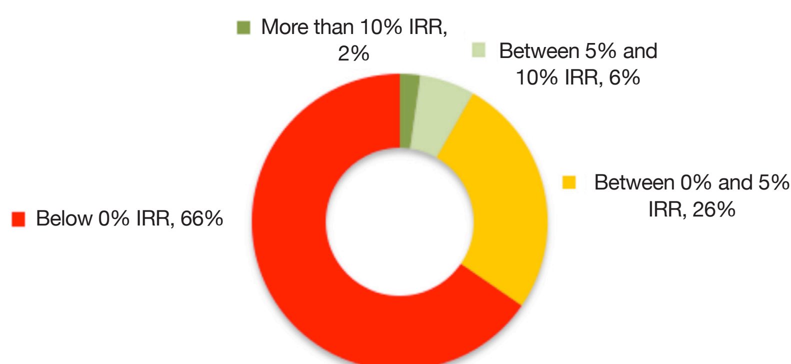

Figure 1: Return outcomes of existing, merged and closed funds
Data source: Allenbridge[12]

It is evident that the history of VCT investing is littered with disappointment. Public data for EISs is virtually non-existent. Some firms may provide top-line performance to investors, but that is rarely publicly available. Investee company level information is scarce. The use of case studies (obviously favourable ones) and tempting target rates of return seem to be common practice in the sales process, which make the EIS investment proposition a leap of faith.

The costs of investing are high

The fees on EIS and VCT funds are, as one might expect, exorbitantly high in comparison to passive funds. Every £1 of costs that spills from a portfolio in intermediary fees is £1 of investors' money that cannot compound and grow over time.

	Initial Fee	AMC	Performance Fees
Low	1%	0.5%	10% above 105p
High	6.5%	3.0%	25% of all profits
Average	4.3%	1.8%	20% of all profits

Table 3: EIS fund fees (indication)
Data source: Air Report 2014

Only annual management fees (AMCs) have been shown above, but it is likely that other ongoing fund charges that can be offset against performance are likely to be significant, which will raise the overall cost of investing. VCT fees are broadly comparable, with initial fees of 5% not unusual (although these may be discounted, depending on the distribution channel). Total ongoing costs are estimated at around 3.5% per year[13]. Arrangement fees, representing around 2% of each transaction, may also be charged when portfolio companies are acquired. In the end, investors only receive returns net of costs. When costs are high, as they are in this case, intermediaries take, in our opinion, an unjustified share of the upside. The proof of the pudding is in the eating, as Figure 1 clearly illustrates.

Risks are material

The risks of VCT and EIS investments are varied and considerable. They both invest in very small, unquoted companies. It is our belief that many investors do not have a clear insight into the risk they are taking on. These are summarised in the table below:

Risk	Explanation
Minority stake	Investing in minority stakes of small businesses is problematic. The company has the investor's money, but the investor has little, if any, control over the workings of the company.
Exit strategy	It is easy enough to get invested in an EIS or VCT investment, but very much less easy to predict the exit strategy and the timing of the exit from the fund. Exit from either EIS or VCT investments is dependent on the sale of the underlying companies, which could take years to achieve.
Company failure	According to a recently published report[14], 55% of SMEs fail to survive the first five years of their lives.
Concentration risks	To construct a portfolio with 95% confidence that a '10 times cost' investment is selected – assuming 1-in-10 deliver such returns – a portfolio of 30 stocks is required. The risks of concentrated portfolios (or single company EIS investments) are obvious.
Loss of qualifying status	There is a risk that EIS-qualifying companies or VCT funds lose their status. In this case, all tax reliefs are at risk.
Changes in tax	The tax reliefs available to EIS and VCT investors can and do change over time, as does legislation in other areas that could affect the attractiveness of EIS and VCT reliefs. Less favourable reliefs may skew the risk-return equation away from these assets. The new pension regime may well also reduce the value of the IHT benefits available, for example.
Fraud and mismanagement	There is obvious scope for both fraud and mismanagement. Using a fund may mitigate this to some extent, but this risk also applies at the fund level.
High costs	The high costs (set out above) risk negating a material proportion of the initial income tax reliefs, when looked at over a 5-year time frame. Performance fees with low hurdle rates will further damage the risk-return equation.
Manager selection	This is not a straightforward task, given the wide number of providers, opacity in performance and the onerous due diligence surrounding both the manager and the underlying portfolio strategy.
Lack of liquidity	For VCT investments, despite being listed, discounts tend to be well below NAV and any attempt to sell the shares will most likely lead to a decline in the share price of the NAV, even in small quantities. For EIS there is no secondary market whatsoever, and extracting assets will depend on a liquidity event at the firm (a trade sale or listing) or as these occur in an EIS fund's portfolio. Exit could be far further away than first envisaged, which is why it is a crucial question in any due diligence.
Tail risk	Within a VCT or EIS portfolio, considerable tail risk (i.e. large, bad outcomes) exists, given that there is a high likelihood of very poor performance or even liquidation of portfolio companies.

Table 4: VCT and EIS risks

Should you invest?

It would be extremely rare for us to recommend EIS and VCT investments in the event that a client's other tax reliefs (e.g. pension, ISA, CGT) have not yet been maximised. These products should only be offered in very client-specific circumstances where all other avenues have been explored, and only for those clients who meet stringent net worth and investor sophistication criteria.

Does the tax tail wag the investment dog? On balance, and on the evidence, yes.

End notes

1. Monevator (2010), The risks of Venture Capital Trusts (VCTs) by The Investor on March 22, 2010 www.monevator.com
2. A small number invest in AIM listed companies, but that tends to be the minority.
3. Pierrakis, Yannis, Incentivising the Supply of Finance for Early Stage Business Through Tax Schemes: A Preliminary Analysis of the Impact of EIS, VCT and CVS (February 3, 2011). Available at SSRN: http://ssrn.com/abstract=1754379
4. Rhodes, C., (2014), House of Commons, Business Statistics – standard note SN/EP/6152, 28 Nov 2014.
5. HMRC (2014), Enterprise Investment Scheme and Seed Enterprise Investment Scheme – Commentary Note, Released 12th December 2014
6. The Investment Association website: Retail sales http://www.theinvestmentassociation.org/investment-industry-information/fund-statistics
7. UK Government (2014), Venture Capital Trusts: Introduction to National and Official Statistics.
8. Note that this table represents our understanding of the tax regime as at 31/12/2014. However it should not be relied on. Professional tax advice should be sought prior to making any investment in any EIS or VCT scheme.
9. HMRC – About Venture Capital Trusts, Gov.UK – Enterprise Investment Scheme. www.HMRC.gov.uk
10. Intelligent Partnership (2014) AIR – Alternative Investments Report 2014, EIS Industry Report.
11. Barclays Equity Gilt Study 2013.
12. Raw data sourced from Allenbridge (website). This data includes all funds for which IRR figures have been calculated and includes open funds, closed funds and funds that have merged or have new managers.
13. Merryn Somerset Webb (2014) Money for nothing among VCT managers. Financial Times, 14th Feb 2014.
14. RSA (2014), Growing Pains; How the UK became a nation of "micropreneurs", October 2014"

Other notes and risk warnings

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