NOTHING VENTURED NOTHING GAINED

Simon Dobson[1]

Similar to daffodils, Venture Capital Trusts (VCTs) seem to be common in the spring. Then, when the climate warms up they seem to fade away, only to start reappearing again at the end of the next winter. Whether funds held in Venture Capital Trusts will also show green shoots of growth, is a matter for conjecture. These investments may bloom seasonally but do they really have long term appeal?

1. What are VCTs?

Venture Capital Trusts were invented in 1995 by the then Chancellor of the Exchequer Ken Clarke. They were developed so as to encourage investment in young British companies. Unlike their Enterprise Investment Scheme (EIS) counterparts, VCTs offer an element of diversification, as the person putting the trust together, the fund manager, will attempt to offer a broad number of small companies, in order to spread risk. In essence therefore, the Venture Capital Trust is a collection of EISs.

In order to qualify to be a VCT, the companies within the trust must meet a number of criteria. Primarily, the gross assets of a qualifying company must not exceed £7million immediately before the issue of the shares and £8 million thereafter. In addition, it must be an unquoted trading company.

VCTs are generally established in a ‘closed end’ format. This means that there is a fixed amount of capital within the trust. The value of the shares within the trust will rise and fall in keeping with supply and demand. This in itself, offers an additional element of risk which will be considered later in this piece. Nevertheless, it could be argued that the element of diversification reduces risk, even though the fund is exposed to young, small companies with little or no track record. Generous tax reliefs are available for taking these risks, however.

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2. Tax Reliefs

So why would anyone wish to put their money into small untried and untested companies: even though diversification will manage some risk? One may argue that investing in more than one small company without a track record merely increases the chance of discovering one that will fail!

The trade-offs for the risk are some relatively generous tax breaks. These have been adjusted quite considerably since 1995 but at the moment investors can enjoy an income tax reduction in the year of investment of 30% of the amount contributed. The proviso is however, that these shares have to be held for 5 years so this is no 'quick buck'. It is also important to note that investors will only benefit from the 30% income tax relief if they are earning sufficient to actually pay the income tax against which the relief can be gained. There is also an overriding maximum allowance of £200,000 per person in any one tax year.

In addition to the income tax relief, any capital gain on the investments within the maximum allowance are also free of capital gains tax to UK tax payers. This may appear very generous on behalf of Her Majesty's Revenue & Customs (HMRC) but when one examines the track record of the VCTs that had been issued over the years, it is not always the case that capital gains are made. Consequently, this benefit may appear generous but it is usually the income tax relief that generates the most interest.

Dividends emanating from VCT shares acquired within the permitted maximum are free of income tax. Once again, this may appear very generous however, it is not always the case that fresh, new, small companies are in a position to pay any dividends. These are often the companies struggling to have their business idea off the ground. Most entrepreneurs will admit that it can take time before the business plan matures to such an extent that profits can be paid out. It can often be engineered so that capital gains can be liberated from within the trust and paid out as dividends, thereby giving rise to some tax free income. Even though a 5 year qualifying period is required to maintain the income tax relief, it may take longer than that for a fledgling company to be in a position to give anything back to investors.

3. How Have They Done?

Determining how successful VCTs have been is not an exact science. One could examine how they have performed and subsequently, how much investors have committed. Some conclusions could possibly be drawn from this information.

Downing Corporate Finance Ltd have been involved in the VCT market since 1997. They were established in 1986 and were involved in VCTs' predecessors the Business Enterprise Scheme (BES). Besides offering their own trusts, Downing promote a number of schemes for other providers including Rathbones and Northern Venture Management (NVM) Private Equity Ltd. They have therefore gleaned some considerable knowledge of the market and report that the VCT market raised £50million to the end of January 2010. At the same point in 2009 it had raised £30million and in 2008, £36million. It would appear therefore, that this year is looking like a bumper year for these specialised and risky investments.

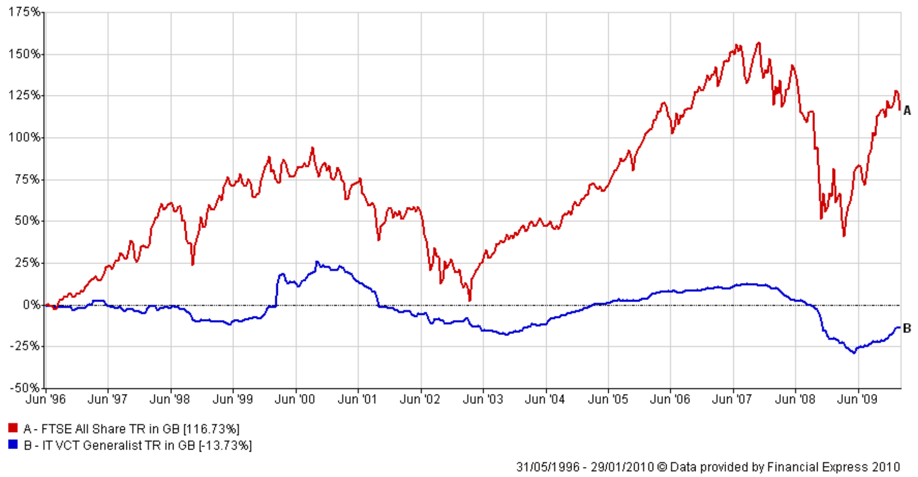
More broad information is provided by Downing Corporate Finance Ltd for the total 2008/2009 tax year, where they state that the VCT market size was £135million. In contrast, the VCT market was £209million in the 2007/2008 tax year. They state the following split by sectors.

	2008/2009	**2007/2008**
Planned Exit VCTs	47%	50%
Generalist VCTs	40%	39%
Specialist	13%	8%
AIM	0%	3%

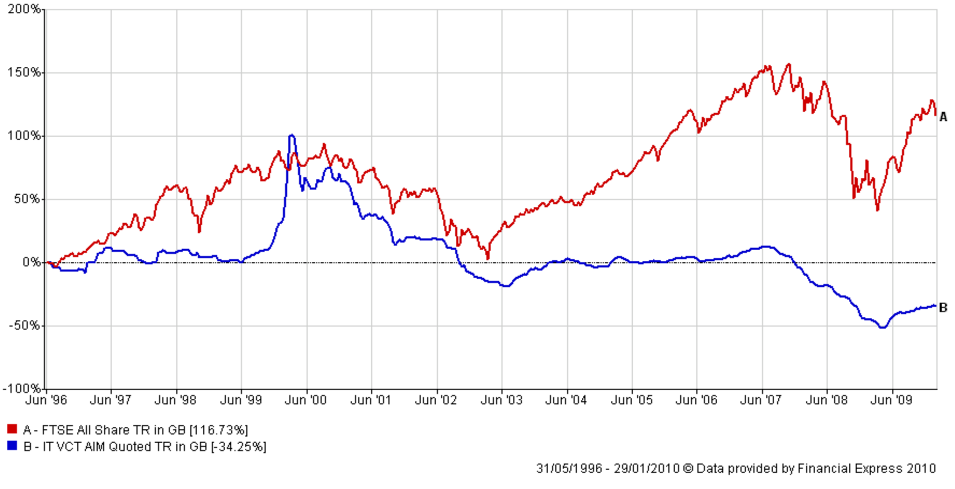
Some patterns can be drawn from this information. Firstly, it would appear as if appetite for risk was very much more great when global stock markets were being successful in 2007 and 2008. The market nearly halved in 2008/2009 and there would appear to be some indication of a recovery in interest this year.

Other patterns would indicate that the majority of investors prefer planned exit VCTs. In these cases, a fixed wind up date is offered to investors so that the directors running the trust have a fixed time span to conclude their project and return value to their investors.

Performance of VCTs is more difficult to determine as each one will be very different to its brothers and sisters. The Association of Investment Companies (AIC) is the trade organisation for closed end investment companies, such as VCTs. They do their best to generate indices for the various investment trusts available in the market place. Similarly, they separate out various VCT types and likewise, attempt to generate an index to give investors an idea as to how they have performed. Using information provided by Financial Express the investment analysis software provider, it is possible to compare two of the more common indices. The following charts should give some idea as to the relative success and volatility of the indices selected.



The VCT generalist sector has provided a total return of -13.73% since June 1996. The purpose of using such a long time frame here is to give investors an opportunity to see what has happened to VCTs since near their inception.



AIM quoted VCTs were more successful in the technology boom of the millennium but faded particularly during the credit crunch. They have returned a total of -34.25% over the same period. The FTSE all share index is used to provide some form of comparison. It is not a truthful like for like comparison as VCTs are so specialised. Hopefully it gives some contrast, if nothing else.

In fairness, it is rare that investors with the speculative nature that would encourage investment in such trusts, would hold onto an investment for as long as the period in the charts. This type of investor is more likely to attempt to sell when things are going well, as capital is often required to fund other projects. Timing in the market is however notoriously difficult. Consequently, most equity oriented investors will seek to buy their funds and hold for the long term. Of course, the five year qualifying period cannot be ignored.

The performance results should not, however, be viewed in isolation. To consider the simple total return would ignore the tax breaks that the investments have provided. For example taking into account the current 30% income tax relief upfront would mean that the generalist VCT sector would have still provided a positive return to investors if held over the time span of the chart. The AIM VCT investor however, would not have been so well off. It is possible however, that the AIM VCT investor may have received slightly more in terms of income dividends that were tax free, as time went by.

A warning should be given to investors tired of awaiting their anticipation gains. Up to April 5 2004 individual investors could claim CGT deferral relief in respect of VCT holdings. Consequently, checks should be made before encashing old VCT shares in case some previously deferred CGT comes into charge.

Taking part in an investment purely for the tax breaks is often a mistake, however. 'Never let the tax tail wag the investment dog' is a common warning. If making recommendations purely on investment grounds therefore, many advisors may suggest that their clients avoid these sectors given the evidence of these charts. This would however, be ignoring the tax relief. When clients are looking for a tax break, and there is the possibility of a planned exit after the qualifying five year period, then VCTs may indeed, offer value for money to those investors prepared to accept the risks.

4. A Perfect Storm

The current investment climate would appear to offer a number of benefits to this particular sector. The credit crunch causes bank managers to tend to avoid lending into adventurous projects. Consequently, successful and experienced entrepreneurs often have few other places to turn to for funding their new enterprises. In this environment, therefore, private equity and funding from the directors of a venture capital trust end up coming higher up the list of remaining choices open to entrepreneurs and better deals come in to the sights of the VCT directors.

It might be common for an entrepreneur to seek private equity involvement in his project as a last resort, as he is effectively, giving up some of his potential profit to other investors. In the current market however, there is less choice for funding so the venture capital companies are finding more and more projects offering better value. These would usually have gone to the banks. Because of this, VCT directors are able to encourage greater involvement from the entrepreneur themselves, whilst also enjoying a larger share of the potential profits. This may therefore, be seen as an opportunity to investors as they can participate in potentially greater returns in the current climate. The current recessionary climate would however, give rise to potentially more risk so this also needs to be taken into account.

A second point encouraging Venture Capital Trusts at this time is the fact that the type of investors generally content to leave their funds in the bank, are receiving little or nothing in terms of interest. The opportunity for a quick income tax rebate of 30%, plus the potential for tax free profits and tax free dividend looks very much more appealing than cash in the bank. One would have to warn traditional cash based investors however, that VCTs behave in no way like traditionally safe cash deposits. Should they be happy to accept the risks however, there may be some value for them in VCTs.

5. Triple Whammy

In contrast to a seemingly more benign investment background, many high earners are now faced with three tax hits. Those earning over £150,000 will see their pension tax relief restricted to only 20%. Secondly, those earning over £150,000 will also see their income tax rate increase to 50% and finally, those earning over £100,000 will start to see their personal allowance being eroded. With this background, the relatively easy tax relief at 30% on VCTs looks very attractive.

Those faced with significant tax hikes will be looking for alternatives to claw something back and keep them within the thresholds. Furthermore, VCTs have a relatively short qualification period, only five years, Conversely investors in the more common tax relief generator of pensions, have to wait until they are at least 55 before being able to access any of their capital once again. Indeed, accessing the pension's capital is rather complex, as only 25% can be withdrawn in many cases, albeit free of tax. The remaining 75% however, has to be used to purchase a pension which is in itself, taxed as earned income and forsakes the capital sum.

These factors all further increase the attraction of VCTs where all capital can be accessed free of tax after the five year qualification period. In addition, should investors chose to leave the VCT in place, there may be the possibility for a tax free income in the form of dividends long into the future.

6. Risks and Risk Management

No matter how attractive VCTs may appear, they are high risk and potentially illiquid investments. They should only be considered by investors deemed to be adventurous. These investors must be able to afford the potential to lose their entire capital invested. The Financial Services Authority (FSA) treats VCTs as a specialist investment category and causes FSA registered advisers to carry out additional vetting procedures as part of their advice process to clients. There are however, ways to manage these obvious and real risks.

A simple starting point is to commit a smaller amount to a wider number of VCTs at one time. Consequently, investors could accumulate a portfolio of VCTs with varying maturity dates, fund managers and strategies. Some VCTs will accept as little as £3,000 as an initial investment so investors should consider this when committing to these arrangements. Maybe a selection of five VCTs of £10,000 would be better than one of £50,000, for instance.

One point often ignored by investors is that only 70% of the VCT capital has to be invested in risky enterprises. The VCT company has three years to invest all their clients' money into the qualifying investments. The remaining 30% can be held in much more secure investments such as cash, gilts and loan stock. Some VCT fund managers will seek to exploit this, in order to manage risk. Others will prefer to commit all clients' funds to qualifying companies in order to benefit, as far as they are concerned, from the opportunities they have identified in the smaller enterprise sector. Analysis of this strategy is important before investing.

A number of companies who establish VCTs have a fixed termination date after the qualifying period on their offers. A number of providers, currently offer a planned exit VCT fund for example. Their literature stresses 'lower risk' and 'capital preservation' as investment themes. Investors need to be very careful how they interpret these sentiments, given the comments made previously with regards to the overall view of the FSA in relation to VCT investments. Indeed, one particular VCT provider used to market their risk managed approach as 'protected'. They have since amended their literature to describe their offerings as 'planned exit' so as to not imply any protection when there is none.

A popular strategy to manage risk is to invest in companies that have exposure to bricks and mortar as a constituent part of the enterprise in which they are investing. As a for instance, health clubs, nurseries and wedding and conference centres are common benefactors of this approach. This type of scheme may also insist upon the assets being unencumbered with bank debt allowing investors in their VCTs first recourse to the property in the event of the enterprise not succeeding. Whilst it is true that the property market has struggled recently, at least investors in this type of arrangement could expect to see something in the event of the enterprise's wind up. It can also be possible to further insist upon a significant contribution by the entrepreneur sponsoring the enterprise so that they are convinced they have complete 'buy-in' by the person committed to the project. In doing so, investors are being placed in companies with someone truly committed driving the project, as well as the chance of something solid should things not go so well.

Investor risk is also heightened in the case of VCTs, purely because of the fact that VCTs are 'closed end'. Section 1 refers to this and whilst it can often be seen as being a bad thing for investors, as is often the case, risk can also be a good thing for investors. Many advisors prefer to avoid closed end investments as there can be a variation in the share price, owing to how attractive or otherwise the market perceives that particular company. This can often have little to do with the success or good organisation of the company. As an example, during this banking crisis, many stocks in the financials' sector suffered in price, even though they have a large number of customers, clients and decent revenue streams. These companies could be other financials such as life assurance and insurance companies. This type of institution tends to do very well in recessionary times but because people had a bad view of the financial sector, life assurance companies were pulled down in value, simply because they fell in the wrong sector. The same often occurs with investment trusts. Although the board of directors may successfully invest in good companies and make profits for their companies, the share price may fall, simply because that sector has gained a poor reputation for some reason or another.

The zero dividend preference share issue was a case in point. Many investors bought investment trusts in successful companies having nothing to do with zero dividend preference shares. Nevertheless, once the issue became public notice, the whole investment trust sector suffered. This means that even though the net asset value (NAV) of the investment trust is 100p, the shares were being sold for as little as 80p, in many cases. Sometimes it was even less. Consequently, investors who are being advised to buy into an investment trust investing in small company shares may be very disappointed to find that they have lost money through no fault of their chosen investment trust board of directors. Furthermore, advisors will often avoid recommending this type of investment, simply because dissatisfied clients can result as a consequence of effects in the share price beyond the advisors' control. It is true to say that investors can take advantage of this differential between the NAV and the share price. In our example quoted previously, investors should be able to pick up 100p worth of assets for only

80p. This should give an opportunity for 20p return should the share price eventually match the NAV, which one would argue it should at some point.

Taking advantage of a discount in share price rarely occurs with VCTs however, as there is a limited secondary market. Investing in a company that buys and sells small, fledgling companies is a risky business, as has been described previously. The full effect of this risk however, is tempered by the generous tax reliefs available which can make them an attractive proposition. The fact is tax reliefs are only available on initial offering meaning that those buying VCT shares on the secondary market will be subjecting themselves to all the risk, but without the tax reliefs. They may of course, be able to pick up a bargain but savvy investors would probably wish to see a very wide discount to the NAV before committing themselves to the risky venture without the tax relief sweetener.

One way of eliminating the risk incurred by the variation in the NAV and the share price can be to agree to formally wind up the VCT at a fixed point in future and dish out all the assets to shareholders. Some schemes are currently available that offer such a fund where the assets within the VCT will be distributed to shareholders after a five year period. This should therefore, eliminate the risk that the share price never meets the NAV. If investors in the company know that they are going to receive their share of all the company assets at a fixed point, then the share price should rise to meet the NAV at the distribution point. It also happens that this particular offer plans to have a targeted dividend issued over the lifespan of the VCT. The trust in question will invest in environmental issues, hoping to make money on the back of the side effects of the world attempting to hit climate change targets.

These aims are indeed laudable but there is little that providers can do to guarantee these terms up front. There is much that can occur in the five year lifespan of a venture capital trust and as all investors know, shares can fall as well as rise. Companies offering planned exits such as this, cannot offer cast iron guarantees that they will be able to meet their targets. Clearly investors would therefore be better advised to aim for a VCT provider that has a good track record of meeting these aims and this will require an element of research and advice.

Whilst access to capital after five years may appear attractive, there is never any telling what may occur to an investors’ circumstances during that five year time span. Investors can suffer additional risks in investing in VCTs as they may not be able to extract their money when they most need it. As has previously been stated, there is a limited secondary market in VCTs. Who would wish to subject themselves to such a risk without the sweetener of tax relief? Nevertheless, clients may need to have their money out in order to meet some desperate emergency or unforeseen circumstances.

It is becoming more common for VCT providers to offer a share buy back policy. A variety of current arrangements have a buy back policy on their current issue where clients can have their money back, subject to a discount to net asset value of between 10% and 15%. This may appear rather costly however, the discount on the open market may indeed be very much more. As one would imagine that a new investor into an existing VCT would want a discount of at least 30% in order to make up for the 30% income tax relief he has lost by buying the second-hand shares.

As can be seen, there are many risks to VCTs, some more obvious than others. Hopefully investors can assess all of these risks, as long as they can find adequate information in order to make a judgement.

7. Where Can I Find Out More?

This article should demonstrate that investing in VCTs is not a straightforward issue. There is much to think about, bear in mind and weigh up. Consequently, advice in this sector is not likely to be cheap. It is possible however, to discover some information by accessing a number of websites that offer useful information. One of the most well known providers of independent information in this sector is Martin Churchill's tax efficient review. This can be found at www.taxefficientreview.com. This website offers information on VCTs as well as a number of other tax efficient investments. As is often the case with the websites of many providers and independent pundits, they summarise the tax reliefs available and give details of many of the offers open to subscription.

Another well known source of information is the Allenbridge tax shelter report at www.taxshelterreport.co.uk. There are also a number of companies that have established themselves to market VCT issues to qualified advisors including stockbrokers and IFAs. RAM Capital Partners LLP are one such organisation. Their site www.ramcapital.co.uk offers brochures and prospectuses on a number of offers currently open to subscription and their representatives are always willing to help give guidance. In fairness, they are unable to provide advice to the general public, but they can provide generic information on the offers they are supporting.

It is also possible to go directly to those companies putting VCTs together like Downing Corporate Finance Ltd. Not only do they put their own offers together but they also promote VCTs run by other fund managers. They can be found at www.downingcf.co.uk. The site offers a variety of brochures, prospectuses and background information to the sector.

Investors would generally speaking, be better off receiving some advice as there is much to consider. If one is to manage risk, a portfolio of VCTs may be advisable and many investors may find this complex to establish and keep track of as time goes by. Most IFAs will offer advice and guidance in these matters. The FSA is pushing the IFA market into one of more of a professional nature and consequently, investors may wish to seek advisors who are already set up to act in this manner. Solicitors for Independent Financial Advice (SIFA) have a professional advisors' website where the general public can gain access to a list of independent financial advisors which is endorsed by the Law Society. Their site at www.sifa.co.uk has a directory of professional financial advisors. www.unbaised.co.uk also offers investors the opportunity to search for an IFA in their area.

Her Majesty's Revenue and Customs (HMRC) have a good manual for more technical detail and all the necessary chapters and verses. This can be found at their website www.mhrc.gov.uk/manuals/vcmmanual/vcm60000.htm

8. How Much Do They Cost?

Charges within a VCT can mount up. Many VCTs may be accused of allowing their charges to run away with themselves as the tax reliefs provide all the value for money that the client is looking for. It is important therefore, to make sure that the VCT the investor is selecting does not have a board of directors that is extracting too much from the NAV in terms of their costs.

Establishing a VCT will not be inexpensive. So the VCT board will need to raise a number of fees for setting the arrangement up, a 5% initial cost is not out of the question. There will also be ongoing fees within the trust. As an example, one such scheme quotes a basic rate of management fee of 2.06% of the VCT's net assets per annum. In addition, there is a performance related the fee of up to an additional 1% of net assets per annum if financial year targets are exceeded. Whether this is deemed excessive is up to investors however, an element of incentivisation can be beneficial to investors in the end. At least the providers of this particular scheme appear to be keen to cap annual running costs at 3.5% of its net assets. The current prospectus, gives an indication that their current total running costs are 2.9% of net assets in the year ending 31 March 2009.

These costs may appear high but the providers in this case are only seeking to raise just over £2million in this issue so there is little room for economies of scale in this particular enterprise. Nevertheless, the fund managers have a great deal of responsibility, many qualifying criteria to meet as well as a reputation to keep and this will come at a cost.

Besides the cost of actually running the trust itself, it is quite possible that investors will have advice to pay for. Commission is often available on VCTs and this can vary from between 3% to 1%. It is often also quite common to see an element of a share of the on going annual management charge to the tune of 0.5% per annum, for example. This should remunerate the advisor for remaining in touch with their client for ongoing reviews.

Owing to the complexity of these investments, an advisor is taking significant risk in recommending them to clients. Consequently, the advisor will seek to charge a premium fee and this can hopefully be covered by the commission being paid. It may not always be the case and depending on the size of the investment, there may even be surplus commission available to be returned to the client. Nevertheless, investors should make sure that they are aware of the costs they are suffering both within the VCT and for the advice and on going reviews.

9. What Next For VCTs?

This article has already mentioned how the world is suffering from a credit crunch and general recession. The UK is not alone in having to replenish its coffers and whilst the Chancellor of the Exchequer may wish to encourage investors to invest in small enterprises, he also has a duty to make sure that the balance of payments are right and the UK's reputation around the world is maintained. With this backdrop therefore, the generous tax reliefs available through VCTs may not be available for very much longer. An election in the UK has to take place before 2 June 2010, which means that a budget may be brought forward to the end of February or even early in March. Removing tax reliefs from tax privileged products has already proved to be popular for this current chancellor. If investors are currently using VCTs instead of pensions to get their tax relief already, there is a risk that the chancellor will identify this trend and prevent any further loss of tax revenue by reducing the reliefs available.

Complexities, risk and costs are common themes throughout the world of VCTs. Investors and advisors alike should take them seriously and be careful when they are being recommended. Governments of all colours however, will be keen to continue to encourage the small and medium sized enterprise (SME) sector so VCTs, in some form, could be around for a long time.

The current market would appear to be flourishing, at least. Indeed the market may even be seen as being crowded, not unlike, perhaps, a host of golden daffodils.
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