Lifting the bonnet on VCT & EIS

Making an informed choice

Scott Longley,
Clear Concise Media

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Table of Contents

01 — Introduction

02 — Executive summary

03 — Part 1: The tax-advantaged landscape

07 — Part 2: Lifting the bonnet

13 — Part 3: What the future holds

Introduction

Governments of every stripe are in agreement that the SME sector is the engine room of the British economy. The challenge is helping them in a meaningful way, particularly when it comes to the innovators and the entrepreneurs. The means chosen is what this report is all about, the tax-advantaged investment schemes designed to encourage investment in Britain's future prosperity.

Specifically, in this report we delve into VCT and EIS investment schemes. Tied as they are to the political weather, the landscape for both forms of investment changes more than most. But their central proposition always stays the same; that investors should derive benefits from investing in growth companies.

Within that framework, we also discuss provider's differences in approach and, ultimately, outcome. Tax-advantaged investment is designed to be a win/win for both investors and the UK economy. With darkening economic clouds on the horizon, the need for innovation is as important as ever.

This is all vital for adviser. They may not receive too many queries about what the government of the day might mean for their investments; but questions around tax and financial planning are evergreen and will always be top of mind for their clients. Given that EIS and VCT investments come with a range of tax reliefs including 30% income tax reliefs on initial investments, CGT exemptions on gains and also IHT reliefs, it means they will need to be aware of the choices that they can put before them.

So, for the government, investors and their financial advisers, the case for both VCTs and EIS has never been stronger.

Executive Summary

- Recent government reassurances around the regulatory backdrop for tax-advantaged investments should see investment in VCTs and EIS continue their growth path despite the economic headwinds. The most recent data shows that via EIS schemes, 3,755 companies raised a total of £1.66bn in the financial year to March 2021 while in VCTs, a total of £668m, was raised in 2021, up 4% on the previous year. Third party data suggests that VCTs went on to raise £1.13bn in the year to March 2022, an increase of 65%.

- The differences between EIS and VCTs are vital for investors to know. Issues around investment time horizons, diversification, investor involvement and liquidity all have to be understood by both the investor and their adviser.

- Equally important are the clear differences in approach on the part of providers. From questions about investment process through to the nuances around valuations, exits, AIM investment and fees, investors and advisers need to be aware of the many aspects of what any given provider offers before making an informed decision.

- The future looks bright for tax-advantaged investment as the need to encourage innovation and entrepreneurship in the British economy is as vital as ever. Against this backdrop, those looking to put their money to work within the tax-advantaged space need to find a provider that is closely aligned with the drive for economic growth.

- For reason of space, this white paper does not deal with two other areas of tax-advantaged investment, IHT tax efficient planning and Seed EIS.

Part 1: The tax-advantaged landscape

The politics of tax-advantaged investment

Whichever way you cut it, politics is thoroughly entwined with the tax-advantaged investment sector. More than any other area of the investment map, perhaps, what the politicians think, say and do has a profound impact on the areas of EIS and VCTs. Their very existence can be ascribed almost entirely to a long-standing interest from governments of all stripes in fostering innovation and growth in British business. What governments and ministers say about venture capital matters to the sector more, perhaps, than any other area of investment.

Hence, even amidst the chaos caused by Kwasi Kwarteng's mini-budget in September 2022 the tax-advantaged sector was able to grab a crumb of comfort from his comments to the House of Commons. The then Chancellor announced that the sunset clause – which would have seen both EIS and VCT schemes shut down in 2025 – was to be extended, adding "we want to become an entrepreneurial nation".

Richard Manley, CEO at Seneca Partners, welcomed Kwarteng's words and suggested they removed at least one uncertainty surrounding the future. "For the industry as a whole, the sunset clause has been hanging over the sector for a while now," he says. "The scheme itself was due to run out in 2025 as it was historic EU regulation. That meant it could potentially dry up."

While Manley notes the details of how the government will proceed beyond 2025 have not yet been fully disclosed, Manley is in no doubt that it gives the sector license to now "push on with supporting these businesses and continuing investment activity".

"It aligns with the whole Brexit rationale of self-sufficiency for the country, Manley adds. "From our perspective, EIS and VCTs are pivotal in attracting the funds to support those early stage investments into businesses which we hope will be the powerhouses of the future UK economy."

The success of VCTs and EIS

The proof of the importance of both EIS and VCTs to both investors and British business can be seen from the recent success both schemes have had in attracting money. The most recent data from the government shows both areas to be booming despite the impact of the pandemic in the reporting period.

In the financial year 2020-21, 3,755 companies raised a total of £1.66bn of funds under the EIS scheme, a 12% decrease from the Covid-unaffected 2019 to 2020, when 4,165 companies raised £1.89bn, according to government statistics.[1]

Also, according to the most recent government statistics with VCTs, meanwhile, the amount of funds raised rose to £668m, up 4%, with 40 out of 57 existing VCTs raising money, a slight drop on the 43 figure the year previous.[2]

Accepting that the growth in investment in both schemes is not linear, it can still be seen that the schemes have helped a huge amount of businesses in their near 30-year existence.

It was an idea that was central to the Patient Capital Review that the government undertook six years ago which again was an attempt to further direct the tax-advantaged space towards the funding of start-up and scale-up businesses and, ultimately, job creation.

"The outcome was a change in the rules which refined where the money could end up," says Manley who noted that the rules on investee companies having to be under seven years old. "The government wanted to force money into genuine growth companies, so some managers had to adapt their investment policies."

Sources:

[1] *Enterprise Investment Scheme, Seed Enterprise Investment Scheme and Social Investment Tax Relief: May 2022*

[2] *Venture Capital Trusts: 2021*

Peter Steele, retail operations director at Seneca Partners, is keen to add that the tax benefits of both EIS and VCTs are far from being a one-way street. "For the government, there should be more PAYE and corporation tax as a result of the increased employment and hopefully longer term profitability of investee companies," he points out. "As long as this is the case, it would not be a sensible strategy for the government to give this up."

The tax advantages of 'tax advantaged' investment

	EIS	VCT
Annual investment limit	£1,000,000*	£200,000
Income Tax relief on investment	30%	30%
Minimum hold period	3 years	5 years
Carry back relief to previous tax year?	Yes	-
Defer the CGT due to a gain already made?	Yes	-
Tax free dividends?	-	Yes
Tax free capital gains?	Yes (after 3 years)	Yes
Income Tax relief for losses?	Yes	-
IHT Relief via Business Relief?	Yes	-

The differences between EIS and VCT

It is important to note, at this point, the key differences between EIS and VCTs; differences that will have an impact on how investors chose between them.

Consideration	EIS	VCT
Time to obtain tax relief	Shares normally allotted over a longer period of time (say 6 to 12 months). EIS 3 certificates usually received 3 to 6 months later	Shares normally allotted within 3 months. Tax certificates produced on or shortly after allotment
Administration and documentation	Each investment in an EIS Fund will involve multiple investments and multiple tax certificates	Only one investment to manage per VCT
Diversification	Can be less than 10 underlying investments	Usually 20 or more underlying investments
Predictability of realising investment	Unpredictable as reliant on the individual sales of multiple underlying investments	Usually after 5 years (if VCT offers a buy back facility)
Availability of dividends	Unlikely	Can be available immediately if there are distributable reserves
Minimum investment period in underlying companies	3 years for each company (and the company must have been trading for a minimum of 3 years)	N/A. Manager can sell investments and secure gains as and when the opportunity arises

Richard Manley, CEO, Seneca Parnters: "These differences are important when it comes to the time it takes to obtain tax relief"

"These differences are important when it comes to the time it takes to obtain tax relief," says Manley. "From an investor's perspective EIS typically ends up with a portfolio of direct investments in growth companies and it can take time to invest and create this portfolio. There can also be a duplication in paperwork as each individual investment results in its own EIS tax certificates. In comparison, a VCT is a singular investment and has the structured diversification built into it. Whilst the tax reliefs associated with EIS investments are generally considered to be more attractive, some may consider a VCT investment to be an easier route in terms of certainty of timing and reduction in paperwork."

The diversification within a VCT will often stretch to more than 25 companies whereas an EIS will often result in six or seven investee companies contained within an investor's portfolio. "But some people prefer that direct investment and the ability to say, 'I backed this company'," Manley adds. "Some like that direct ownership which differs from investing in VCTs, which are more blended."

Part 2: Lifting the bonnet

The investment process

Broadly, when investors put their cash into either an EIS or a VCT, they are investing in early-stage companies. Yet, within that there are nuances.

Such companies will either be:

- Seed
- Pre-revenue
- Post-revenue, pre-profit
- Profitable

As Manley says, it stands to reason that investors would want to be putting their money to work as far down that maturity line as is possible "but it is often the earlier-stage companies that are the ones that need the money".

"But if there is a sweet spot, then for us that is in the post-revenue, pre-profit stage," he adds. "This is where we think we can get the best balance between attractive growth prospects and risk".

For Seneca, there are then further investment parameters layered on top. Although it is a generalist investment house, it has avoided film and media schemes, for instance, and ESG considerations are becoming increasingly important. It also avoids aggressive consumer growth plans, particularly in the food and beverage sector.

"We see that as an area that specialist funds are really good at" says Matt Currie, investment director at Seneca Partners. "But we find that management teams in that space are very good at spending money quickly and the failure rate is high. It is not a business model we particularly like as we consider the risks are just too high."

Instead, Seneca likes to back companies whose business model is built on an asset, whether that be a tech platform or a suite of IP. "That gives us confidence that, if things don't go to plan and the companies miss a few metrics, there will still be some good value created to fall back on" Currie adds.

He adds that Seneca takes an active part in the strategic development of the companies in which it invests. "We will be close to the management team and will be working with them toward exits," he says. "We like to play a key role in that. We don't just sit back; we like to be on the front foot."

That work of strategic involvement and challenge is arguably becoming more important. Going back to the question of what stage of a company's lifecycle a fund might invest, Manley adds that investment timelines are becoming more stretched.

"By definition, if you invest in a younger company, your investment in it will take longer to mature and that is why we try to invest further down this development pathway – it reduces risk but also helps shorten our time to an exit."

What you see might not be what you get

One area which often causes a stumble – both for investors and for the providers – is that of the valuation of companies within a portfolio. When dealing with companies listed on AIM, this is a simple enough task with the share prices for those companies quoted on a daily basis. But when it comes to the valuation of unquoted companies, there will be differences in approach across the market.

For unquoted companies held in a VCT, the risk of material misstatement in the valuation is reduced by the rigours and challenge of an audit process and independent board who have to sign off VCT valuations. Private company valuations held in EIS portfolios, however, are not subject to the same independent checks and balances and so investors must carefully consider the valuation approaches of different EIS managers.

"It would be highly unusual for the value of an EIS investment to remain stable or to increase in a linear fashion over its life cycle so investors should look very carefully at investments showing these characteristics and do not be afraid to challenge managers on their valuation rationale – indeed we speak regularly with our investor bases about our valuation methodology." Manley added.

Exit issues

As Manley says, any business has a price and "from our perspective, we are always open to selling an investment as long as that is at the right price and we are lucky enough to have a strong track record of delivering exits for our investors". But that is not necessarily the same across all managers and investors should thoroughly investigate a manager's exit track record as part of their due diligence. Manley adds "it is one thing indicating stable or even increasing valuations on paper but the only true measure of the quality of a manager is the cash that is successfully returned to investors".

There is also the need for a setting of investor expectations and this is particularly the case when it comes to dealing with investments which fail. "Those that fail tend to go wrong earlier than those that succeed," notes Manley. "Unfortunately, it is the nature of EIS and VCT investments that not all will succeed – so investors should be prepared for that.

"If a business is failing to deliver on its business plan, it is sometimes the braver yet correct decision to say that you will no longer support it with follow on funding, even though that decision may result in the failure of that business if it cannot access funds elsewhere" he adds. "Following your money is not always the right decision and each investment decision must stand up on its own."

AIM high

Issues around valuation are less prevalent when it comes to investments in EIS and VCT qualifying AIM companies. Currie says Seneca is keen on AIM companies as a means of deploying capital and notes that they have a broadly 50/50 split within their existing portfolio of AIM-listed versus unquoted companies.

"One of the main attractions of investing on AIM is liquidity," he says. "The average size and scale of businesses on AIM is also typically larger and they often raise additional capital compared to private companies, which mean that they have a longer cash runway on which to execute their business plan.

The benefits of AIM do also come with some drawbacks. "Some advisers in the space don't like AIM stocks because of the volatility that comes with it and the fact that the investors have real time visibility of that." Currie says.

But Manley also identifies another reason for the reticence of some managers to invest in AIM stocks and touches on the issue of fees. “Clearly for managers like us, there is the potential to earn fees when you deploy capital,” he says. “When you put money into a private company there might be an arrangement fee and a monitoring fee for working with the team and attending board meetings and so on. These fees can be attractive. That same opportunity doesn’t exist when capital is deployed into AIM companies where you tend to be investing on an arm’s length basis.“

These fees can also create additional conflicts. Currie queried “Where these fees are material in the context of the investment, are managers truly aligned with investors in terms of exits and realisations, if they are charging a significant monitoring fee to that investee company? These fees have the potential to reward managers for backing businesses which aren’t and may never be sellable in order to enhance their own P&L over an extended investment period.”

Without that fee incentive associated with backing private companies, it means managers might be dissuaded from investing in AIM quoted businesses. “I think it’s why some management companies don’t invest in AIM companies,” says Manley. “There is a natural conflict there between managers selecting the UK’s best investments for their clients, which you would expect to include AIM quoted companies and managers selecting the best investment for their own fee potential which are typically private only companies – investors should be considering this area very carefully.

Matt Currie, Investment Director, Seneca Partners:

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Fee to pay

Steele has a word to say about the general issue of fees. "Don't always take them at face value," he warns. "This is a complex area; there are a host of fees that can be charged and these will vary by provider with some having stronger fees in one area in order to offer a lower fee elsewhere."

Performance fees, for instance, will often be set at 20% but as Steele says, a key question will be at what point does it get triggered – is there an annual hurdle for example or is the hurdle cumulative and what is the hurdle rate. Meanwhile, the annual management change – the AMC – can also be charged in different ways, particularly for EIS investments. Cash could be retained from an investor's subscription to cover the AMC each year, which reduced the amount an investor gets invested, or it could be charged at the back end once the investors have their capital back, which serves to increase the amount invested in qualifying companies.

"Look at where you are charged and how you are charged," he says. "Fund managers will always show how low their fees are where they can."

Manley added: "Managers tend to be quite tightly grouped on fees but there are nuances that need to be understood."

Assessing track records – a reviewer's verdict

Hugh Rogers from the Tax Efficient Review says that when it comes to the effort to measure how funds are performing, an obvious port of call is the track record, and profitable exits are a part of that. "We put weight on that," he says. "But we also take time to understand what has driven their valuations."

He adds that one of the aspects Tax Efficient Review looks at is whether the management group is "committed enough" and whether the fund manager is "wedded to the area".

"Lastly it will be fees," he adds. "We don't like to see performance aligned to NAV; rather it should be aligned with returns to investors."

On the issue of valuations of the underlying investments, while noting that AIM company valuations are "easy", he adds that with unquoted companies it can be a "minefield".

Hugh Rogers, Director, Tax Efficient Review:

"When it comes to the effort to measure how funds are performing, an obvious port of call is the track record, and profitable exits are a part of that. We put weight on that. But we also take time to understand what has driven their valuations."

"They all say they are valued in line with best practice and are following the rules, but there is scope of interpretation," he says. "Plus, the perennial epithet of past performance not being a guide to future returns."

He also makes a point that needs to be understood by investors when it comes to choosing between VCT and EIS. While the first are structured like an investment trust, meaning getting money out after the minimum holding period can be relatively simple if the VCT Board is good at applying a buyback policy, with EIS "there is no exit route that investors can call upon to get the money back," he adds. "The only route is for when the managers sell the underlying company and give money back to investors."

Part 3: What the future holds

Over to you Mr Hunt

In his autumn statement, Chancellor Jeremy Hunt said the UK had a "genius for innovation". Noting the UK had three of the world's top 10 universities, he said the UK had one of the largest life sciences technology sectors in Europe.

"Twenty-first century economies will be defined by new developments in artificial intelligence, quantum technologies and robotics. But we need to be better at turning world class innovation into world class companies.

"I want to combine our technology and science brilliance with our formidable financial services to turn Britain into the world's next Silicon Valley."

These laudable aims have been central to the arguments in favour of tax-advantaged investment right from their very first days. While the personnel might change – quite often as it turns out – successive government have maintained the tax advantages of EIS and VCTs through thick and thin.

"Given the economic uncertainty, I think it would be absurd for the government to consider withdrawing or reducing the reliefs associated with EIS and VCT investing – and I'm glad they have given no indication that this is the case," says Manley.

"VCT and EIS investing has a key part to play in supporting the growth of the UK's SMEs which is crucial as we seek to return the UK economy to period of sustained economic growth."

This remains the case even in periods, such as we are experiencing right now, of economic distress. Start-ups are difficult regardless of the economic backdrop. New businesses are tough to launch, tough to manage and very tough to make a success. That doesn't change regardless of the macroeconomic backdrop.

Indeed, some would say that forming a business when the economic backdrop is somewhat bleak can actually work to the advantage of a start-up with the thinking being that any company that survives and thrives when the going is difficult will be better set for succeeding in the long-term.

Even the difficulties of raising funding when money is tight itself imposes a discipline on the companies. Start-ups always have to be mindful of how they are spending the money they have received from investors, and the fact that it is hard right now to raise investment means it is all the more important to be making sure that the cash at hand is marshalled appropriately.

Why growth matters

As Manley adds, at Seneca they have always “focused on the provision of growth capital” and many of our investors like to feel that they are in some way supporting the growth of the UK's economy in addition to investing in tax efficient manner.

Much as the government might use the hackneyed phrase about the UK being the next Silicon Valley, the importance of having a vibrant and well-functioning growth capital investment community dedicated to supporting the UK's start-ups and growth companies has never been clearer. Moreover, those in and around the sector know this more than anyone.

The tax-advantaged sector remains one of the most exciting and dynamic from an investment perspective and is a great way for advisers and financial planners to invest in a tax efficient manner in what managers hope will grow to become the UK's leading businesses of tomorrow.

They come with a range of tax breaks which governments over nearly three decades have supported and at time when the UK has one of the highest tax rates of major economies it surely must be a sector that justifies more attention.

Contact

Share Communications

team@sharecomms.co.uk

020 7071 3949