Feature *VCTs*

Nothing ventured, nothing gained

Tax-efficient investment funds are seeing interest surge, raising the question of whether supply can keep up with demand, says Julia Faurschou

Once a relative investment unknown, venture capital trusts (VCTs) and enterprise investment schemes (EIS) have now become a bright spot for tax-efficient investing. But their soaring popularity has resulted in a capacity crisis that could put the products at risk of becoming victims of their own success.

The context for the vehicles' rise to prominence is continued cuts to pensions allowances. The lifetime allowance dropped from £1.8m in the 2011/12 tax year to £1m by 2016/17, while the annual allowance for high earners is also now tapering off following rule changes in April 2016.

These changes have left many savers scrambling to find tax-efficient vehicles in which to stash their savings. But as investors pile into VCTs and EISs, the products have struggled to keep up with the spike in demand.

As **Table 1** shows, more than 15 VCTs alone had already closed to new business as of early March, well before the end of the tax year. That left just seven open for investment at what is traditionally the busiest time of year for the sector, as **Table 2** indicates. Product providers must step back and re-examine this new tax-driven climate, especially as rule changes in 2015 made it more difficult for VCT managers to find qualifying companies.

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That said, although the products are experiencing a boost in popularity, the sustainability of inflows has yet to be determined. Investors will have their eye on future VCT and EIS launches, but also on how well these products perform under the spotlight.

Ian Sayers, chief executive of the Association of Investment Companies (AIC), does not expect investor interest in these products to abate any time soon, particularly as the VCT sector has seen the average share price rise by 82 per cent over the decade to 31 December 2016, with the added benefit of tax-free dividends and capital gains.

"From a VCT perspective, the pension rule changes and reduction in the lifetime allowance have clearly acted as a boost to investor interest, together with the established performance track record as the sector has matured.

"Clearly, there is a strong demand for income and tax-efficient investments, and frankly it is hard to see that going away any time soon," Mr Sayers explains.

Popular products

The first EIS products launched in 1993 as a way for more sophisticated investors to support small UK companies. These products received a boost in the 2012 Budget when George Osborne introduced Seed EIS, which aimed to help entrepreneurs raise funding from start-ups by giving those who invested a tax break.

VCTs got their own start in 1995, when the Conservative government at that time introduced tax breaks to encourage investors to put their money into domestic early stage companies – an area that many tend shy away from, as young companies with no business track record are often perceived as overly risky.

While getting in on a promising new company in the early stages of development can appeal to some, the main draw for VCT investors has proved to be the tax breaks they enjoy. HM Revenue & Customs has stated that shareholders who are over the age of 18 can claim income tax relief at a rate of 30 per cent on annual investments of up to £200,000, as long as the shares are held for at least five years.

Investors also pay no income tax on dividends from ordinary shares, and no capital gains tax is due when individuals decide to sell their ordinary shares in VCTs.

Similarly, EISs are also frequently in focus for tax-efficient investors. They can claim a 30 per cent tax relief on up to £1m worth of shares. Shares are also eligible for a capital gains tax exemption, as well as capital gains tax deferral relief, and investors who sell their shares at a loss can offset this, minus any income tax relief given, against income in either the year in which they were disposed of or the previous year.

Tax benefits

These tax benefits, in combination with the tighter limits on pension tax relief, have

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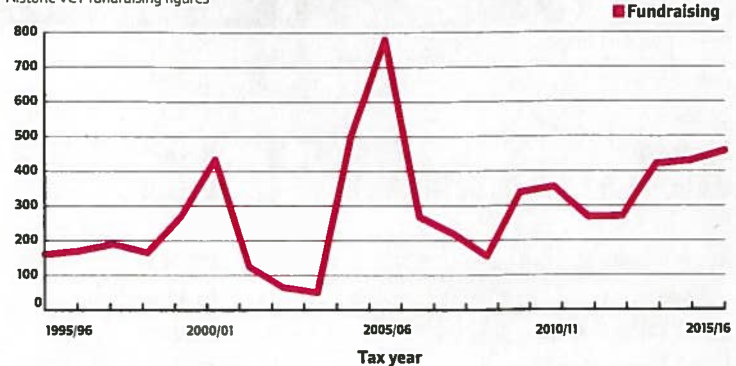
Chart 1
Historic VCT fundraising figures



Source and Copyright: Money Management
Note: Figures include enhanced share buybacks. 2016/17 figures not included

resulted in a surge of inflows into VCTs and EIS.

VCT fundraising in the 2016/17 tax year to the end of February 2017 was £270m, compared to £204.4m during the same period in the previous tax year, according to data from the AIC.

The spike in the 2004/05 and 2005/06 tax years seen in **Chart 1** is due to upfront VCT tax relief being raised to 40 per cent, although it was subsequently reduced back to 30 per cent.

There is however a snag in the recent success. Rule changes from 2015 have made it more difficult for VCTs to find qualifying companies to invest in. Under the new rules, companies will normally have to have made their first commercial sale in the past seven years – or 10 years for companies that are deemed to be knowledge intensive. In addition, money from VCTs cannot be used to fund management buyouts and acquisitions.

High barriers to entry and limitations from the rule changes have hampered prospects for new VCT launches, as have the fact that many investors would rather put their money into more established companies or funds, says Lauren Radford, head of business management for tax-advantaged investments at Allenbridge.

"Unfortunately, there are significant headwinds and a competitive disadvantage for new VCTs coming to market. Even raising new funds for existing VCTs is hampered by the current rules and restrictions," Ms Radford notes.

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Ryan Hughes, head of fund selection at AJ Bell, notes the vehicles can come in a variety of forms, but most tend to have the underlying theme of rapid advancement.

"We see a wide variety of different investment strategies ranging from restaurants, healthcare, fitness and media. All of the focus is on high-growth sectors that reflect the changing attitudes of UK consumers."

Ms Radford says VCT rules have resulted in a focus on venture and growth investments in newer and smaller companies, with a significant focus on technology and consumer brand businesses, along with public houses, hospitality and infrastructure.

VCTs are meant to be long-term holdings, so that shareholders can benefit from the growth of these early stage companies over time as well as hold on to the tax advantages they offer. This means underlying assets will remain fairly consistent over the years.

"Most VCTs will still retain

Table 1: VCTs closed in 2017

VCT	Date closed
British Smaller Companies 2	10-Jan
Proven Growth & Income	31-Jan
Calculus	02-Feb
Unicorn Aim	03-Feb
Maven Income & Growth 6	07-Feb
Northern 1, 2, 3	09-Feb
Albion (various)	9-20 Feb
Octopus Aim	03-Mar
Hargreave Hale Aim 2	04-Mar
British Smaller Companies 1	06-Mar
Amati Aim	06-Mar
Octopus Titan	06-Mar
Octopus Apollo	09-Mar

Source: Wealth Club. **Copyright:** Money Management.

Given that VCT managers want to protect their reputation, they are more likely to ensure they only invest in the highest quality investment opportunities

Table 2: VCTs open as of March

VCT
Downing 4 Healthcare
Downing 4 General
Elderstreet
Foresight
Hargreave Hale Aim 1
Pembroke
Triple Point Income

Source: Wealth Club. **Copyright:** Money Management.

their existing investments, so on aggregate, the majority of holdings would not look vastly different from last year," Ms Radford explains.

Growth and development

The climate is similar in the EIS space, with a focus on growth and development in the underlying companies. Adam Spence, partner at Edition Capital, says that adviser focus has shifted "towards EIS qualifying opportunities that can deliver greater levels of growth in line with the spirit of the EIS legislation".

The First Edition EIS invests in live entertainment and media, while others are investing in a range of activities from public houses and recycling of organic waste. Some even invest in more esoteric underlying businesses such as showjumping horses, microbreweries and classic cars.

Keeping up with demand

All of the recent attention being paid to VCTs and EIS has many wondering if more could come to market, and if providers will be able to reposition the vehicles as year-round products instead of just a consideration for the final few months of the tax year.

Mr Spence is confident that new offerings will be launched to keep up with growing demand for tax-efficient investment vehicles.

"More products will inevitably be launched to try and meet demand. However, advisers and their clients will need to have a greater understanding of where managers are investing their money as well as the track record of managers as new players enter the market," he said.

Tax planning is becoming "more holistic", according to Alan Sheehan, chief investment analyst at Micap Alternative Investment Research. Advisers must be savvy to maximise the shrinking government-backed investment tax reliefs rather than simply putting the majority of their clients' funds into pensions or Isas.

Mr Sheehan has noticed a more evergreen approach from advisers towards VCTs and EIS. Interest used to begin in September and peak just before the end of the tax year, but this has begun to change.

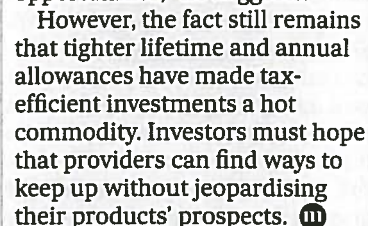
A switch in practices along these lines would also benefit the funds themselves, as steady business allows managers to focus on underlying investments throughout the year, rather than being flooded with cash near the tax year-end.

"It is important to consider that EIS and VCT investments are becoming more focused on the growth and development of more organic, early stage companies. These businesses' funding requirements are driven by all-year-round requirements rather than tax year-ends," Mr Sheehan says.

While demand has certainly picked up, investors should not yet get too excited for new product launches quite yet. There are still relatively few providers of these products, especially compared to the wider funds universe.

Although there may be the potential for existing providers to raise capital, a careful balancing act must be struck if managers want to ensure they are not investing in lower-quality firms, says AJ Bell's Mr Hughes.

"Given that VCT managers want to protect their investment reputation, they are more likely to be prudent with capital raising and ensure they only invest in the highest quality investment opportunities," he suggests.



However, the fact still remains that tighter lifetime and annual allowances have made tax-efficient investments a hot commodity. Investors must hope that providers can find ways to keep up without jeopardising their products' prospects.

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