

Article topic: Corporate Finance

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Venture Capitalist Trusts – a vehicle for growth

Mark Harman, Head of Target Corporate Finance explains the benefits of Venture Capital Trusts and predicts they will play a more important role as a vehicle for funding deals in the future.

Imagine an investor that is willing to consider more risky companies and less popular industries, accept lower returns and commit their money for a fairly long period of time. It may sound too good to be true, but all of these benefits can be found in a Venture Capital Trust (VCT). Essentially, VCTs are given tax incentives by the Government to encourage investment in companies which otherwise may find it hard to attract such funding.

VCTs are ideal for funding businesses enjoying rapid growth but in the earlier stages of development where investors are in limited supply. They are also good for funding smaller MBOs since their structure allows the management team to retain a majority shareholding. VCT fund managers can afford to accept lower yields as the tax relief will boost the returns for investors. So, for example, a 15% return on investment gears up to a 20% return for the initial investor.

So how does it work?

To qualify for tax relief, VCTs must hold the stock for five years so they are longer-term investors. Indeed, some fund managers are also more interested in the yield on loan notes rather than return of capital, as in the traditional private equity model. VCTs offer 30% income tax relief and investors are allowed to put in a minimum of £200,000 per year. All dividends are free from tax, as is any capital growth on VCT shares. There is a minimum five year holding period.

Within three years of raising the funds, a VCT must invest at least 70% in qualifying holdings, which are described as shares, securities, or loans lasting at least five years in companies which are unquoted or listed on the junior markets. VCTs can invest up to £1 million in a qualifying company providing it does not account for more than 15% of its assets and the gross assets of the target company do not exceed £7 or £8 million after the investment. Where a company becomes listed on the Official List it continues to be a qualifying company for up to five years.

There is not normally a secondary market in VCT shares, as the tax reliefs are only available to the first purchaser. Investors, therefore, normally need to rely on a flotation or winding up after five years to crystallise the value. VCTs can be classified as generalist, AIM, or specialist. Generalist VCTs tend to have the majority of their investments in unquoted companies. A generalist VCT manager will act as a true venture capitalist, seeking to invest in unquoted businesses in the hope of making profits when these companies are floated or sold.

Some generalists favour repeat investments in companies. Their knowledge of the companies is greater having worked with them and the company may benefit from further funds at critical times in its development. Other managers prefer to increase the size of their portfolio to reduce risk. AIM VCTs invest almost exclusively in shares quoted on AIM. They may also invest in some PLUS quoted shares or unquoted companies approaching an IPO on AIM.

AIM VCTs are similar to traditional investment trust, unit trust, or OEIC funds in that the manager selects companies in which to buy and sell shares. However, the big difference is that VCTs can only invest in new issue shares. Specialist VCTs pursue a very specific investment strategy, for example, one focused on technology, media or live events. The degree of risk will be dependent upon the underlying structure of the investment. Specialist VCTs can combine investment in quoted and unquoted companies.

As corporate finance advisers, VCTs have enabled us to get deals completed that are of a scale that traditional funds would not be interested in. Their aim was always to fill a funding gap at the smaller entrepreneurial end of the market and, in our experience, they succeed in achieving this. For example, deals on which Target advised and which have relied on VCT funding include the £7 million MBO of Playforce, one of the leading providers of children's play areas to schools, supported by ISIS Equity Partners and HSBC Bank, and the £11.5 million MBO of CableCom Networking, the UK's leading provider of IT and communications services in student and key worker accommodation, backed by ISIS and Royal Bank of Scotland. VCT funding was also used in the £25 million acquisition of surveillance systems specialist SEA (Group) Ltd by Cohort plc, a leading defence technical service provider.

Overall VCTs provide funding and liquidity to both AIM and unquoted transactional markets. Given the current issues of liquidity at the smaller end of the corporate market, I believe we will start to see increased activity from VCTs filling the gap which the banks are leaving behind.

For more information on VCTs, please contact a member of the Corporate Finance team, or visit our website.