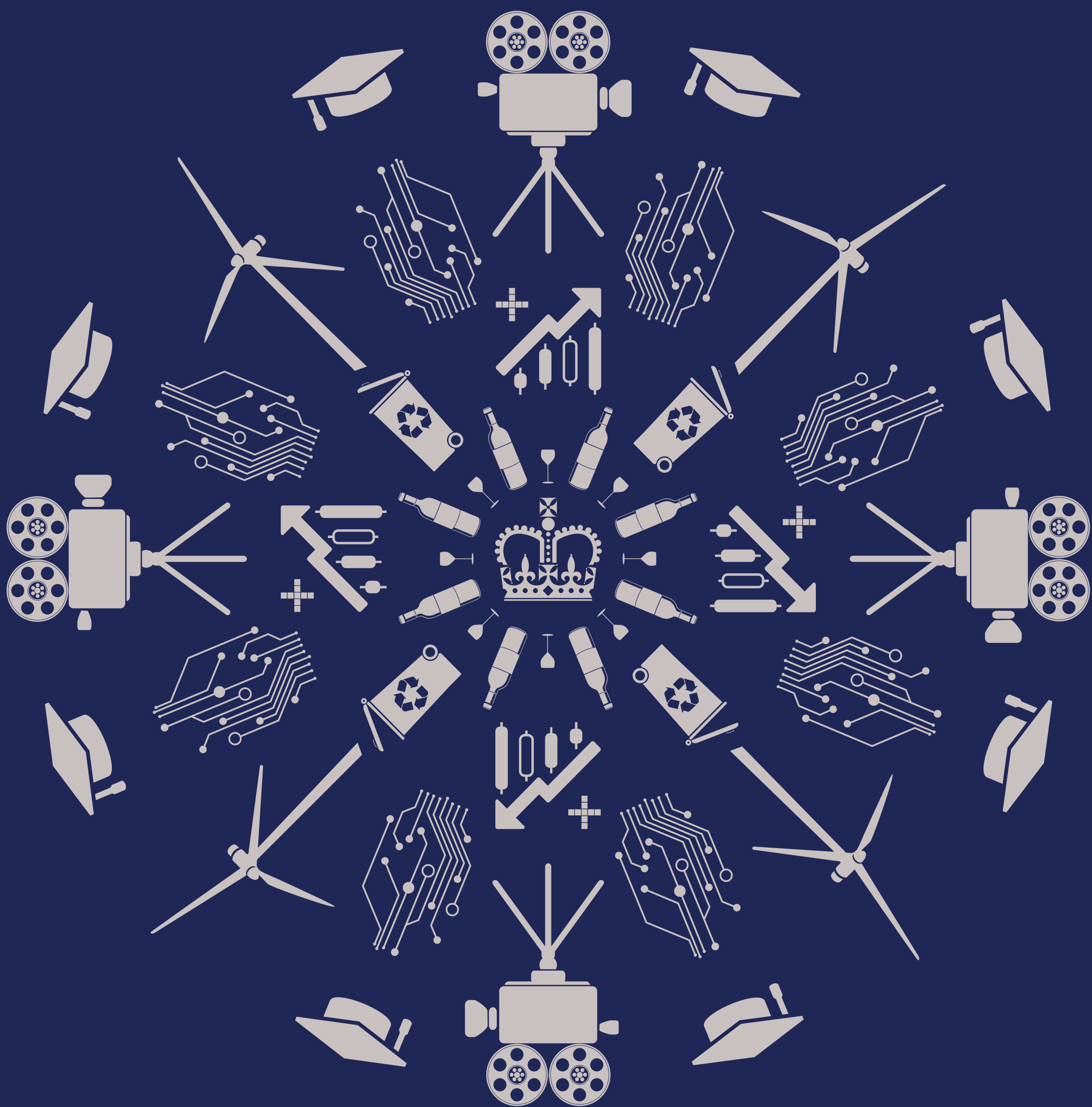
AiR 2014

ALTERNATIVE INVESTMENT REPORT



EIS - INDUSTRY REPORT 2014

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FOREWORD

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Print

Welcome to the first industry report focused purely on the Enterprise Investment Scheme.

Take advantage of legitimate tax allowances and diversify your portfolio – all the while giving a helping hand to small UK businesses. Who wouldn't want to invest in an asset class that does all this? Advisers who can help their clients to access these kinds of opportunities are clearly providing a great service – and adding value for their customers.

Sure, EIS investments won't be for every client and probably won't be for every adviser. But with declining pension allowances, low annual ISA limits and volatile stock markets, EIS feels like an asset class whose time has come.

This report will help advisers get to grips with the EIS sector, whether approaching it for the first time and wanting to understand what it is all about, to those already experienced who just need a refresher on where the market is right now.

We've compiled the report with input and assistance from the EIS Association, compliance consultancy Bovill, EIS review provider Allenbridge Tax Shelter Report and several EIS managers who are credited in the report. We could not have put such a comprehensive and authoritative report together without their input. Of course, any errors or omissions are ours and not theirs.

We also surveyed EIS investors via Angel News, the website for sophisticated private investors, we interviewed some prominent platforms that intermediate in the EIS market and we surveyed our own database of advisers and financial services professionals. This work helped us to develop a qualitative picture of where the market is in 2014 – how the most important people, the people on the 'buy side' of the market, feel about investing in EIS.

Finally, in order to give us a more quantitative view of the market, we undertook a large-scale desktop research project to compile a register of as many EIS investment opportunities as we could find. In short, this work allowed us to identify some emerging trends in the market and provide some analytics that we believe will help guide advisers in their investment decision making.

As far as we know, this is the only place where advisers and experienced investors can access all of this information in one place. Our aim is to make it easier for advisers to use EIS investments within their clients' portfolios – now and in the future.

Guy Tolhurst
Managing Director
Intelligent Partnership

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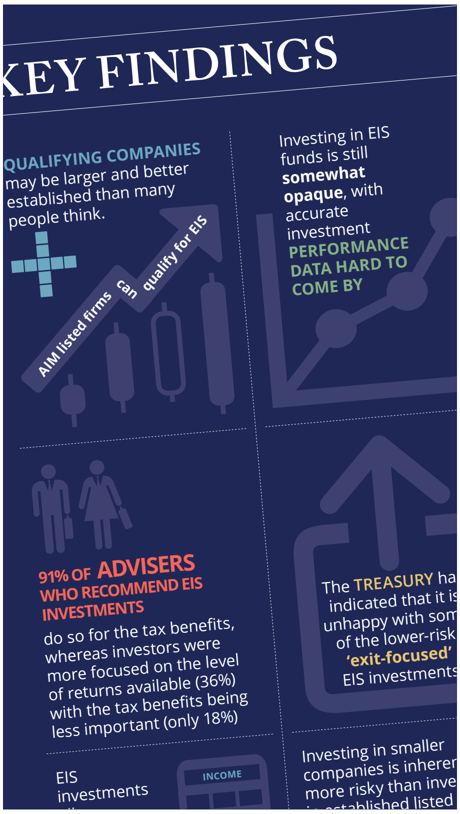


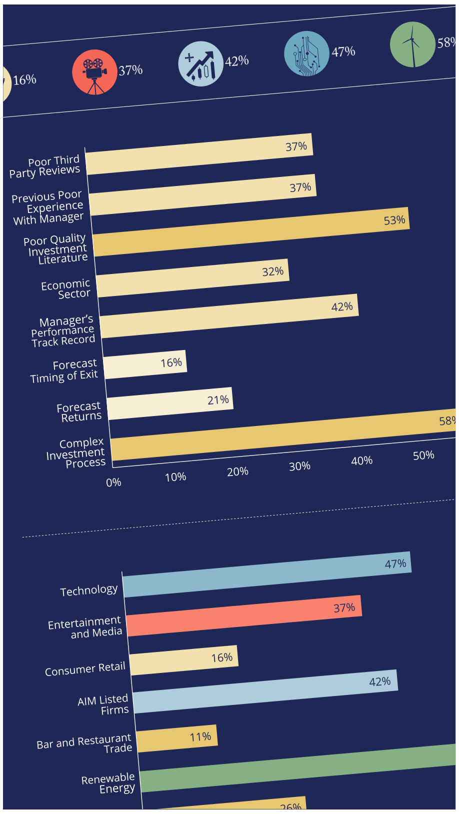
EIS IN FOCUS

ADVISING ON EIS

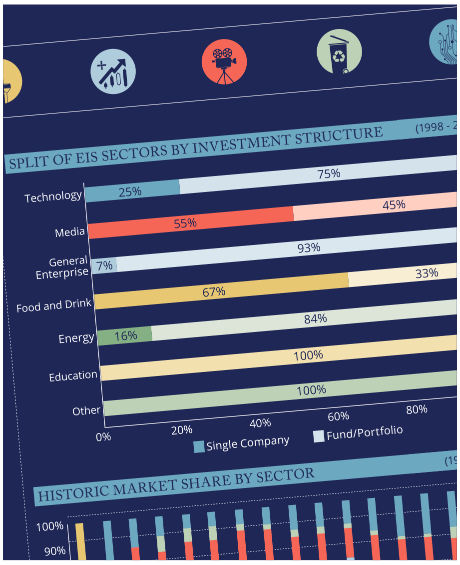
Please note: unless otherwise stated, all charts and graphs have been provided by Intelligent Partnership

Intelligent Partnership is committed to the very highest professional standards as embodied by our accreditation and membership to these industry associations.

MARKET RESEARCH



MARKET ANALYSIS



GLOSSARY

AiR 2014
ALTERNATIVE INVESTMENT REPORT

AMPS AIPP

OPENING STATEMENT

During the seven years I have been chairman of the EIS Association it has been rewarding to see the EIS industry mature and play a growing role in the much needed provision of equity capital for new and small businesses. There are now a significant number of managers (30+) of EIS funds providing a professional approach to the selection and management of EIS qualifying investments as well as looking after the interests of early stage investors as portfolio companies grow.

It was particularly fortunate that David Gauke, Financial Secretary to the Treasury, was persuaded to do battle with the EU and managed to successfully widen the parameters for EIS relief. This supported businesses that had been operating for two or three years who continued to need equity finance to support their growth. Thanks to this intervention:

- The maximum gross assets a qualifying firm can have has risen from £7m to £15m (pre new money)
- The maximum number of employees has risen from 50 to 250
- The annual cap for investment into an EIS company has risen from £2m to £5m

In addition, the EISA Association (EISA) was also able to persuade the Government not to proceed with the proposed £50,000 cap on loss relief applying to EIS, and to increase the Income Tax relief from 20% to 30%.

Thanks to the EIS scheme, businesses requiring early stage and development capital now have a better chance of succeeding and contributing to the growth of the economy. HMRC is also a beneficiary as the Corporation and Income Tax generated as such businesses expand, as well as the VAT on the spending of their employees, leads to increasing tax revenues.

Since these overhauls in April 2012, the interest in EIS by both businesses and investors has increased dramatically. Here are some key statistics:

- EIS backed funding raised £1.02bn in the tax year to March 2012, almost double the £545m raised in the previous year. This level of growth is predicted to have continued throughout the 2013 and 2014 tax years
- The number of businesses using EIS has also increased by some 50% since 2011
- Over 20,000 businesses have raised £11bn since EIS was introduced

And perhaps the ultimate compliment for EIS was a visit by French officials to the UK some 18 months ago, in order to find out why the UK EIS was so much more successful than the then existing French Scheme for incentivising equity investment in small companies.

Finally, one of the most under appreciated attractions of EIS is that (subject to a two year holding rule) EIS investments are potentially free of Inheritance Tax. This is becoming of increasing importance as the 'baby boom' generation grows older and is looking for ways of protecting its family from Inheritance Tax bills.

As a result of the attractive conditions for EIS investing, both Wealth Managers and Financial Advisers are increasing their focus on EIS investing. To assist this, the EISA, in partnership with Tolleys, has launched a Diploma Course on EIS investing – consisting of an online course of some 12 hours followed by an examination. The course will cover an introduction to the EIS territory; the tax rules and incentives; the EIS Fund sector and relevant financial regulation. We would strongly encourage any advisers who are considering EIS investments for their clients to take this diploma to ensure they have the best quality training available on EIS.

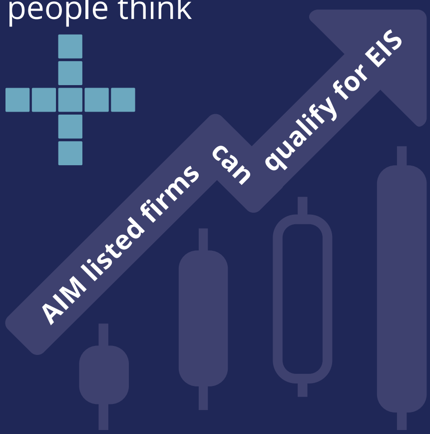
We also welcome the introduction of Intelligent Partnership's annual EIS industry report as another development that will grow awareness and knowledge of our sector and make EIS investing easier for advisers and their clients.

EIS investing is playing an important role in supporting the significant increase in entrepreneurial activity in the UK over the last three years, particularly in new business areas and new technology. Several of these companies will be the giants of tomorrow, driving the growth and success of the British economy. Investment in this sector is to be encouraged and applauded and we hope the positive story of the last seven years continues.

Lord Howard Flight,
Chairman of the EISA

KEY FINDINGS

QUALIFYING COMPANIES may be larger and better established than many people think



Investing in EIS funds is still **somewhat opaque**, with accurate investment **PERFORMANCE DATA HARD TO COME BY**

Driven by the **need for diversification,** tax benefits and strong returns, the EIS market has seen **STELLAR GROWTH** over the last few years

91% OF ADVISERS WHO RECOMMEND EIS INVESTMENTS do so for the tax benefits, whereas investors were more focused on the level of returns available (36%) with the tax benefits being less important (only 18%)

The **TREASURY** has indicated that it is unhappy with some of the lower-risk, **'exit-focused'** EIS investments

The shape of the EIS market has changed dramatically over time

ENERGY is now the largest industry sector with **28% OF THE MARKET**

EIS investments allow **TAX** to be reduced considerably

Investing in smaller companies is inherently more risky than investing in established listed companies, but the tax advantages of the EIS tilt the **RISK/REWARD BALANCE** back in favour of the investor

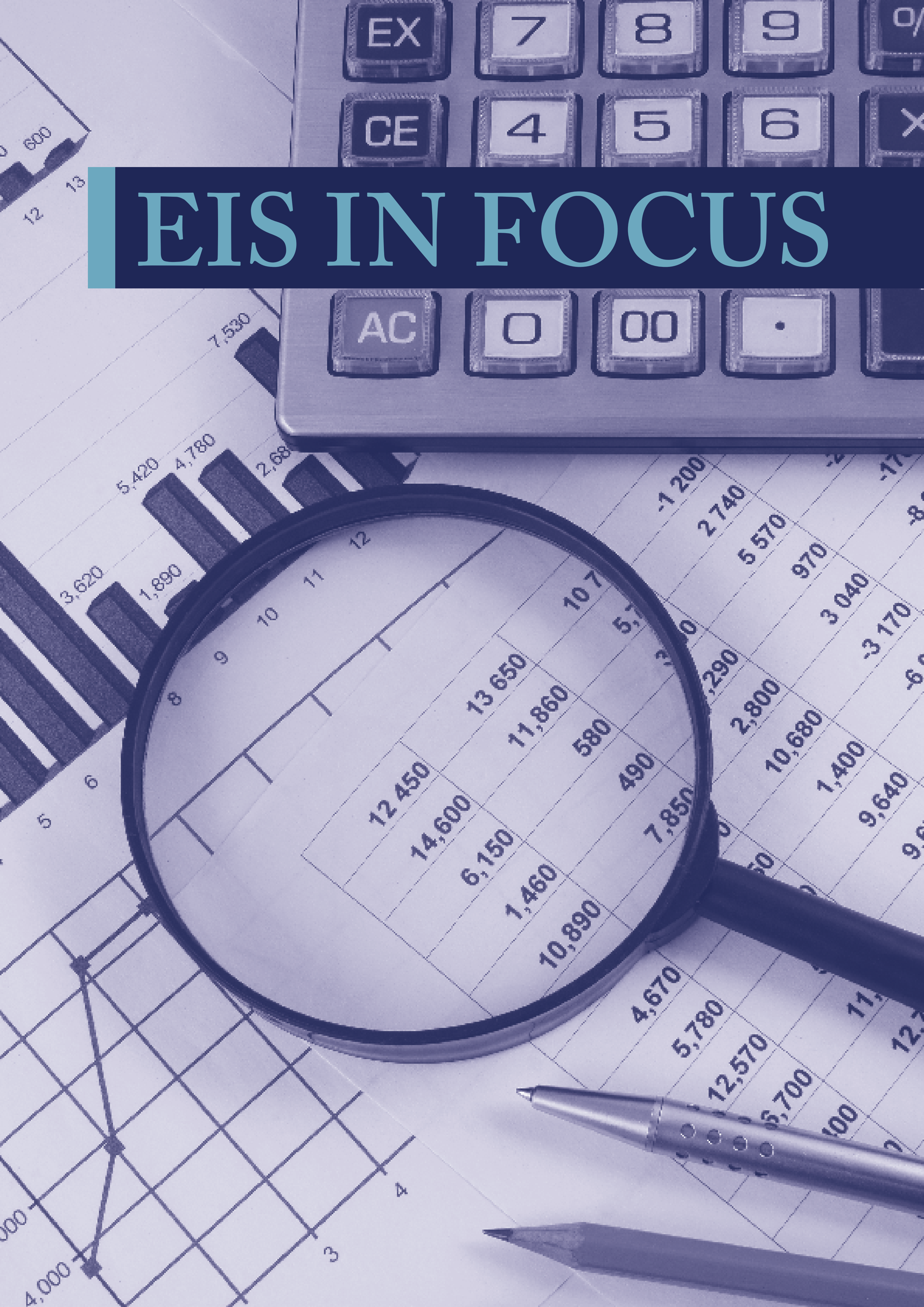
Research indicates that **systematically diversifying** across a portfolio of EIS qualifying companies is the most sensible approach to reducing risk.

A PORTFOLIO OF TEN WOULD BE THE MINIMUM

A PORTFOLIO OF THIRTY WOULD BE OPTIMAL**

*potentially **the administration and management costs of a large portfolio could be significant

EIS IN FOCUS



INTRODUCTION

The intention of this report is to provide the very first comprehensive overview of the EIS investment market.

With tighter limits on annual and lifetime pension allowances, a freeze on the IHT threshold until 2019 and a growing awareness of the need to diversify away from the public markets, increasing numbers of investors and advisers are looking at EIS as an attractive, legitimate tax efficient investment option.

At the same time, the government is keen to encourage investment into this important sector of the economy. EIS is an initiative that has support across all the three major UK political parties. Small and medium sized businesses are the lifeblood of the UK economy and, as Lord Flight points out in this report's opening statement, represent the future giants of tomorrow.

So we have a benign synergy – investors looking for tax efficient investment options and ways to access a section of UK business that will drive growth over the next few decades; and a government that wants to encourage this behaviour. These are some of the factors behind the growth of EIS investment to an estimated £1.5bn in the last tax year; a figure that could be set to rise to £2billion in the foreseeable future.

The EIS industry is gearing up for this influx of investment and this report is part of that process. At present there is no single place where advisers and investors can review all of the various EIS investment options that are available in the marketplace. The investment register that we compiled in conjunction with this report aims to capture as many EIS funds, managed portfolio services and single company EIS investment opportunities as possible, in order to provide a broad view of the market. Advisers who keep a copy of this report on file will be able to demonstrate a detailed knowledge of the EIS sector.

We do not rate or recommend any of the investment opportunities, or single out any particular investment for individual praise or criticism. Our objective is to provide easily understood information on the market to allow meaningful comparisons to be made. By bringing more transparency to the sector, we aim to make it easier for advisers and the investors they represent to consider EIS investments alongside mainstream, listed equity investments.

As well as considering all of the investment opportunities in one place, this report is also an educational resource for advisers and professional investors who are perhaps considering EIS investments for the first time, or want to refresh and extend their current knowledge base. This report will outline the attractive tax breaks, investment benefits and risks associated with the EIS, look at some of the history behind the sector to put it into context and review some potential investment strategies.

We will also delve into some of the recent developments in the marketplace – new market entrants, emerging trends and potential difficulties – as well as looking ahead to consider what the next 12 months might hold.

Finally we have also surveyed both advisers and investors to get a timely temperature check on their perceptions of the market, what is currently working well and what could be improved.

MARKET OVERVIEW

We wanted to start with a brief history of the EIS market to help advisers put it into its historical context and a look at the rules for qualifying companies. Advisers who are already up to speed with this information may want to skip ahead to the 'Why Invest in Smaller Companies?' section on page 14.

EMERGENCE OF EIS

- The first initiative to be taken with a view to encouraging investment in small private trading companies was a facility for capital losses on unquoted shares to be relieved against Income Tax. This was introduced in 1980 and remained substantially unchanged until 1998, when it was aligned with the provisions of the EIS.
- In 1981, a scheme called the Business Start-Up Scheme was introduced.
- This was superseded in 1983 by the Business Expansion Scheme (BES), which provided relief for investment in both new and existing trading companies, designed to encourage private investors to provide venture capital for unquoted companies, initially for a minimum of five years. In 1986, BES was extended to give exemption from CGT in cases where BES relief had been given.

The BES gave upfront tax relief at the investor's marginal rate of Income Tax and allowed a wide range of assets to be invested in, including residential property. This led to some abuses of the scheme as it was used as a tax shelter rather than incentivising investors to place capital at risk.

- BES came to an end at the end of 1993, replaced by the Enterprise Investment Scheme in 1994. This represented a revision and fine tuning of BES, adding Income Tax relief on subscriptions and CGT exemption, as well as CGT deferral relief.
- The next major revision was in 1998, when CGT deferral relief became available whether or not Income Tax relief had been obtained on the new shares. In this way, it effectively replaced a set of CGT provisions known as Reinvestment Relief, which was then abolished.
- In 2012, the Seed Enterprise Investment Scheme (SEIS) was introduced, which was aimed at encouraging investment into even smaller companies, with even more attractive tax benefits. SEIS is outside the scope of this report.

KEY POLICY CHANGES

There have been some policy changes to the scheme since its inception:

1997-98 From 17 March 1998, farming, market gardening, property management, hotels, guest houses and care and nursing homes became 'excluded activities'.

1998-99 From 6 April 1998, Capital Gains Tax deferral relief was extended to include shares that did not qualify for Income Tax relief. In addition, a company's gross assets limit of £15m before investment and £16m after investment was introduced. Prior to this, there was no limit on company size, but a company could only raise up to £2m per tax year through EIS (though certain qualifying shipping activities could raise up to £5m). Also, the maximum amount of investment on which Income Tax relief could be obtained was increased from £100,000 to £150,000.

1998-99 Capital Gains Tax exemption was introduced from 1 January 1999.

2000-01 The period for which shares must be held to retain Income Tax relief was reduced from five years to three.

2001-02 The requirement that all money be employed in qualifying activities within 12 months was changed to 80% (with the remaining 20% to be employed within the next 12 months).

2004-05 The maximum amount of investment on which Income Tax relief could be obtained increased from £150,000 to £200,000.

2006-07 Gross assets limit was reduced to £7m before investment and £8m after investment. Maximum amount of investment on which Income Tax relief could be obtained was increased from £200,000 to £400,000.

2007-08 From 19 July 2007, companies must have raised no more than £2 million per annum under any or all of the tax-based venture capital schemes (Venture Capital Trusts, Enterprise Investment Scheme and, available at the time, Corporate Venturing Scheme).

2008-09 The maximum amount of investment on which Income Tax relief could be obtained increased from £400,000 to £500,000.

2009-10 The time within which monies raised by the share issue must be employed was extended from 80% within 12 months and the remainder within a further 12 months, to 100% within 2 years.

2011-12 The requirement that the trade be carried on wholly or mainly in the UK was removed, and replaced with a requirement that the issuing company have a permanent establishment in the UK. Companies whom it would be reasonable to regard as 'enterprises in difficulty' as defined by the European Commission, were excluded. The EIS rate of relief was increased to 30%.

2012-13 From 6 April 2012, EIS was extended to companies with fewer than 250 full time equivalent employees and gross assets of no more than £15m before investment and £16m after investment. The annual investment limit for companies increased to £5 million: that sum must take account of Venture Capital Trusts (VCT) and SEIS investment, and any other investment received via any measure covered by the European Commission's Guidelines on State Aid to promote Risk Capital Investment in Small and Medium-sized Enterprises. For shares issued on or after 6 April 2012, a company using the funds to acquire shares in another company will not be regarded as using them for a qualifying purpose. The annual investment limit for an individual was increased to £1m, and the £500 minimum investment requirement was removed. Most trades attracting Feed-In Tariffs or overseas equivalents were excluded.

It's not necessary for advisers and investors to remember all of this history, but perhaps the key point to take away from this is that there is a long history of government support for tax incentives that encourage investment into smaller companies. EIS is not a new, untested idea – it is a well-established market that has been around for some time in one form or another.

"Government has done a great job of invigorating early-stage entrepreneurial activity, and the EIS scheme has been particularly effective." **Bruce Macfarlane, MMC Ventures**

GROWTH OF MARKET

The chart opposite shows how both the total amount of funds raised into EIS and the number of companies raising capital increased steadily from 1994 to 1998 and then sharply from 1998 to 2001, in line with the 'tech' boom in the stock market.

Both the amount of investment and the number of companies raising funds via EIS fell after 2001.

We can speculate that the tech boom in the late nineties attracted a lot of investment into smaller, start-up style firms and that encouraged investment into EIS qualifying companies. After 2001, the stock market rallied and a strong bull market existed until 2008 – but this market was not associated with smaller companies in the same way as the previous bull market was and, consequently, we did not witness dramatic increases in EIS fundraising.

This is actually encouraging, as it shows that the EIS market is at least somewhat uncorrelated from mainstream markets – at least when it comes to fundraising success.

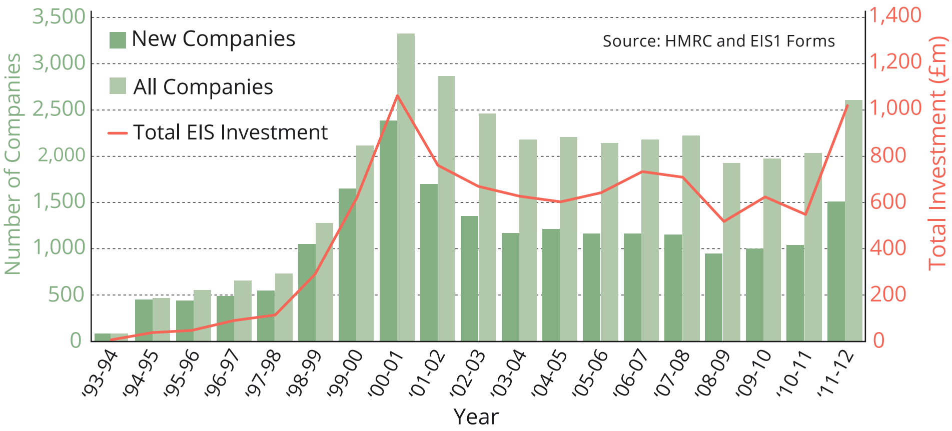
What is also encouraging is that after an initial dip of companies raising funds via EIS, from 2004 – 2011 the numbers have stayed reasonably steady, indicating that there is a strong foundation of engaged investors and successful fundraisers in the market.

In the 2011/12 tax year, there was a dramatic spike in both the amount of funds raised (an increase of 87% to £1.017bn) and the number of companies raising money (including a large influx of new companies accounting for 41% of the total).

This sharp increase can be attributed to the increase in Income Tax relief from 20% to 30% in 2011, historically low interest rates and the introduction of the 50% Income Tax rate for higher earners (over £150,000 and since reduced to 45% again).

We can also speculate that the introduction of Feed-In Tariffs (FITs) in 2010, stimulating investment into renewable energy, also played a part. The combination of the security of revenue that FITs provide combined with a low-risk asset backed investment in a tax efficient EIS was very alluring. Companies benefiting from FITs were excluded from EIS qualification in 2011, and Renewable Obligation Certificates, which provide similar benefits, were excluded in the recent 2014 budget.

COMPANIES RAISING FUNDS AND AMOUNTS RAISED (1993 - 2012)



The announcement in December 2012 that the government would be reducing the annual allowance for pension tax relieved savings from £50,000 to £40,000 and the lifetime allowance from £1.5m to £1.25m may have a similar positive impact on funds raised into EIS over the next few years. We may well see EIS investment used as a form of 'pension substitution'.

Most investments are still relatively small – 49% of investments are below £100,000 and funds are typically raised from a number of smaller investors investing £10,000 – £30,000. Many investors will invest relatively small amounts – perhaps £10,000 – but invest these amounts regularly, perhaps every year.

However, 50% of the amount of funds raised into investments is over £1m. Over 60% of the companies raising money via the EIS are in London and the South East (although this does not necessarily mean that is where all of their activity is based, this statistic is taken from the companies registered address). What is also interesting to note is that, as of 2012, over 70% of investment goes into three categories: Other Services (recreational, medical and educational), High Tech and Business Services.

In total, the Enterprise Investment Scheme has promoted investment of over £11bn since it started. Although there are no official figures to support this, it has been suggested that the Treasury earns more in tax from the success of the companies supported by the EIS than they give away in relief to investors, and the government and politicians from all the major parties are, of course, keen to support the important SME (Small and Medium-sized Enterprises) sector.

As Matt Taylor of Rockpool put it at our 2013 Alternative Investment Summit in London:

"You can judge political support by politicians' willingness to be photographed in connection with the EIS. It does not seem rash to conclude that the EIS will be with us for some time yet."

KEY POINTS

- Launched in 1994, the Enterprise Investment Scheme grew out of previous schemes that used tax incentives to encourage private investment into small and medium sized companies such as the Business Start-Up Scheme and the Business Expansion Scheme. Fundraising via EIS peaked in the tax year 2000-2001 and again in 2011-2012 and is set to continue to rise
- The most recent peak is associated with an increase in Income Tax relief, increase in the additional rate of tax, low interest rates, and the opportunity to invest in EIS opportunities based on revenues supported by FITs (which no longer qualify for inclusion in an EIS)
- Decreasing annual and lifetime pension allowances and an increasing recognition of the need to diversify away from public markets may mean that we see further increases in EIS investment over the next four to five years
- It is believed that the Treasury earns more in tax from the success of the companies that have been supported by the EIS, than they give away in relief to investors
- Historical statistics on the number of EIS managers and opportunities are hard to obtain as there is no central location or list that covers the whole market

QUALIFYING COMPANIES

QUALIFICATION CRITERIA

The full list of rules can be found on the HMRC website, but the qualification criteria are quite simple and actually cover a very broad range of companies from start-ups to well-established firms:

- Must be unquoted, i.e. not listed on the London Stock Exchange. It can be listed on the AIM or PLUS markets, but not the PLUS-listed market. It can subsequently become a quoted company and retain its EIS status, but only if there were no arrangements in place for it to become quoted when the shares were issued
- Must not control or be controlled by another company that is not EIS qualifying. It can have subsidiaries, but they must all be qualifying subsidiaries
- The gross assets of the company must not exceed £15m immediately before any share issue and £16m immediately after that issue
- Must have fewer than 250 full-time employees (the definition of a full-time employee is a standard 35 hour week)
- Can raise up to £5m on a rolling 12 month basis via the EIS (up from £2m previously), but this limit also includes any funds raised via VCTs or any other government backed source of funds
- Funds raised must be deployed within two years of the later of either a) the issue of the shares or b) commencement of the qualifying trade (this does not necessarily mean spending the money – earmarking it for a particular project is acceptable)

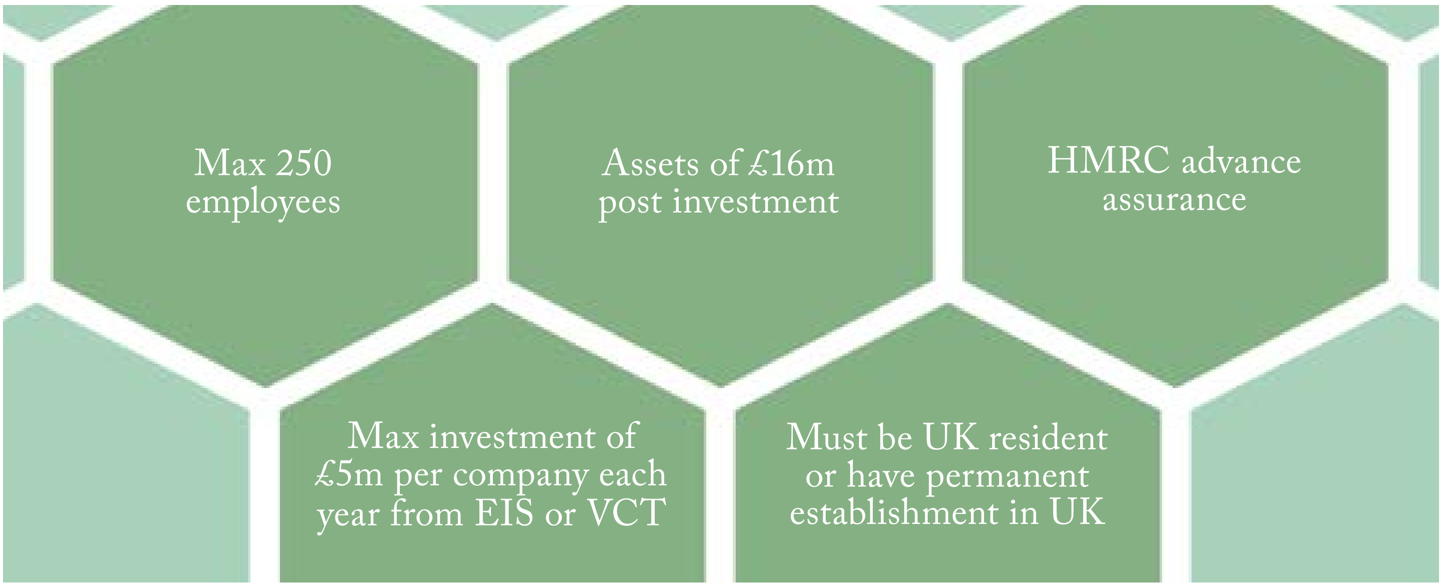
EXCLUDED ACTIVITIES

A number of activities are excluded and have been listed below. For a full list you should again consult the HMRC website.

- Dealing in land, in commodities or futures in shares, securities or other financial instruments
- Dealing in goods, other than in an ordinary trade of retail or wholesale distribution
- Financial activities such as banking, insurance, money-lending, debt-factoring, hire-purchase financing or any other financial activities
- Leasing or letting assets on hire, except in the case of certain ship-chartering activities, receiving royalties or licence fees though if these arise from the exploitation of an intangible asset which the company itself has created, that is not an excluded activity (this is an important consideration for firms in the creative arts or software development)
- Providing legal or accountancy services
- Property development
- Holding, managing or occupying woodlands, any other forestry activities or timber production
- Farming or market gardening
- Shipbuilding
- Coal production
- Steel production
- Operating or managing hotels or comparable establishments, or managing property used as an hotel or comparable establishment
- Operating or managing nursing homes or residential care homes, or managing property used as a nursing home or residential care home
- Generating or exporting electricity which will attract a Feed-In Tariff, unless generated by hydro power or anaerobic digestion, or unless carried on by a community interest company, a co-operative society, a community benefit society or a Northern Irish industrial and provident society
- Providing services to another person where that person's trade consists, to a substantial extent, of excluded activities and the person controlling that trade also controls the company providing the services

There is some flexibility; a company can carry on some excluded activities, but these must not be a 'substantial' part of the company's trade. HM Revenue and Customs take 'substantial' to mean more than 20% of the company's activities.

EIS QUALIFYING CRITERIA



"We look for businesses that have exceptional leadership teams, who show the potential to become the next big UK success stories." **David Mott, Oxford Capital**

EXAMPLES OF QUALIFYING COMPANIES

What the rules on qualifying companies mean in reality is that for a lot of investors, EIS qualifying company investments are not necessarily as risky as they may have thought.

Many people's perception is that EIS investments are only into extremely risky small start-up companies at a pre-revenue stage – the sort of investing normally associated with very early stage fundraising (often from friends and family and in fact the type of investing SEIS is designed to encourage to some extent).

But the qualifying criteria now allow very well established companies with strong and predictable revenue streams and their own assets. Recent changes in the legislation raised the cap on the amount of funds that can be raised from £2m to £5m and raised the limit on the number of full time employees from 50 to 250. This gave a huge boost to the industry, as it opened up much bigger firms for investment via the EIS.

Often companies are seeking the funding to grow into new markets, scale up or deliver new product lines; activities of growth businesses that are admittedly more risky than very large listed companies, but much less risky than start-up companies. Indeed, some AIM listed companies now qualify for EIS status, allowing investors to access EIS benefits without sacrificing the liquidity a listed investment provides.

WHEN DO COMPANIES NEED TO ISSUE AN INVESTMENT PROSPECTUS?

According to European legislation, any company raising more than €5m by offering transferable securities to the public must issue an investment prospectus. This prospectus has to be approved by the relevant listing authority and obviously has a cost in both time and money. Issuing a prospectus would normally take between two to three months. However, there are exceptions: firms who only make the offer to 150 people or fewer, firms who issue non-transferable securities or firms who only market their offer to professional investors.

APPROVING INFORMATION MEMORANDA

Firms that do not issue a prospectus will issue an information memorandum (IM). If the memorandum is approved by an FCA authorised person who has carried out their own due diligence and verified the claims made in the memorandum, then the IM can be freely distributed to retail investors. If the IM has not been approved by an authorised person, then it can only be distributed to high net worth or sophisticated investors (these categories can be self-certified in this instance).

A high-net worth investor is somebody with over £100,000 annual income or over £250,000 in investable assets (excluding residence, pension and life insurance).

A sophisticated investor is somebody who has (for example) been a member of a network of business angels for the last six months or has made one unlisted company investment in the last two years.

A LOOK AT SEED EIS (SEIS)

As noted earlier, Seed Enterprise Investment Schemes are outside of the scope of this report, but it is worth quickly mentioning them here for the sake of completeness.

Benefits and qualifying criteria of SEIS:

- SEIS was introduced in 2012 to encourage investment in higher risk, earlier stage companies
- The maximum a company can raise under SEIS is £150,000
- The average amount of investment raised is £72,000
- Over 1,100 companies have raised money through SEIS
- Companies have raised over £82m of funding through SEIS
- On average, £1.3m of SEIS funding is raised by 19 companies every week
- Investors can receive initial Income Tax relief of 50% on investments up to £100,000 per tax year in qualifying shares issued on or after 6 April 2012
- The individual investor can be a director of the company, but not an employee
- An individual's stake in the company can be no more than 30%
- SEIS tax relief applies only to recently incorporated companies
- The company must have 25 or fewer employees and gross assets of up to £200,000
- For the 2012/13 tax year only, a CGT exemption is offered in respect of gains realised on the disposal of assets that are invested through SEIS in the same year
- In the 2014 budget, SEIS were made a permanent feature of the start-up funding/tax planning landscape (they were originally scheduled to expire in April 2017)

WHY INVEST IN SMALLER COMPANIES?

In this section, we will look at the investment case for purchasing unquoted equities in smaller companies as an asset class without considering the tax advantages – we'll cover those later when we discuss the EIS benefits. The reason for this is most seasoned commentators suggest that the tax benefits should be secondary – the tax tail should not wag the investment dog – so we wanted to start by considering smaller companies as an asset class and then examine how the tax relief tilts the risk/reward ratio.

#1 THE POTENTIAL FOR SUBSTANTIAL CAPITAL GAIN: Smaller companies that do go on to be the giants of tomorrow will, of course make huge capital gains for investors. Around 10% of investments into smaller companies return greater than 10x capital (of course, picking out these investments and avoiding the failures is vital and we discuss some investment strategies that can help with this in later sections). Listed equity investments rarely achieve such high returns, particularly in the mid-cap and large-cap sections of the market.

#2 DIVERSIFICATION: There is no doubt that small companies are somewhat wedded to the business cycle and there are more successes when the economy is doing well. However, as unquoted investments that may be in companies that are at different stages of development or working in non-mainstream activities, smaller company investments are not highly correlated to the stock market and can provide some diversification benefits by offering the prospect of returns that are not correlated to the mainstream markets.

#3 IT'S A BUYERS' MARKET: Venture Capital funds are usually looking to make investments of greater than £2m, and banks are very reluctant to lend to small businesses at the moment. This means that a section of smaller companies are starved of capital. Therefore, for business angels who are prepared to invest, it is very much a buyers' market. Britain is a very entrepreneurial economy (perhaps counter-intuitively, research suggests that entrepreneurial activity has actually increased during the recession) and there are hundreds of thousands of small businesses in the UK. There is no shortage of deal flow and investors can take their pick from a very wide range of opportunities.

#4 IT'S INTERESTING AND EXCITING: Investing in smaller companies can be about more than just financial returns. Certainly for investors who choose to invest directly rather than through a fund manager, supporting new and interesting ventures or companies in sectors where they have a personal interest can be much more engaging and rewarding than the more abstract concept of stock market based investing.

#5 IT SUPPORTS THE UK ECONOMY: Of course all investment should support the economy – one of the theoretical functions of the stock market is to enable the efficient allocation of capital. But in reality stock market investing often supports companies whose activities (and spending) are largely overseas and do not directly benefit the UK economy; or it supports companies who are already very well capitalised. And a significant percentage of the investment may be used to pay for the long chain of intermediaries that sit between investors and the stock market.

Conversely, investing in smaller companies supports a vital and dynamic part of the UK economy. According to the House of Commons, there are some 5,000 SMEs, accounting for over 99% of UK businesses and some 50% of the total turnover in the private sector (approx. £1,578bn). Companies with fewer than 10 employees account for 95% of all UK businesses.

Whereas most investors and advisers think of ethical investing as either screening out 'non-ethical' companies or investing in a social enterprise or environmental business, it can certainly be argued that there is an ethical side to investing in smaller businesses – it's giving something back and supporting an important part of the UK economy.

THE RISKS OF SMALLER COMPANY INVESTING

The most obvious risk when investing in smaller companies is a company failure. According to research by NESTA, whereas one in ten investments return 10x capital, approximately five out of ten return less than capital.

We contacted HMRC to see if they could supply more information on how EIS qualifying companies performed. They confirmed that through research of the Companies House database at least 94% of all companies receiving EIS investment in the tax year 2011/12 were still active in November 2013 – this is, of course, not an indication of performance and too small a sample to be significant, but it does hint that EIS qualifying companies are not here today, gone tomorrow start-ups. However, this statistic shouldn't be surprising; new EIS companies would have received a cash injection during this time period and would be expected to still be in business at this point.

There are two ways to mitigate the risk of total failure. One is by being an outstanding stock picker who rarely backs a loser – this is possible but notoriously difficult! This is one of the main reasons why advisers and investors delegate to investment professionals – for example, a manager with specialist knowledge of start-ups and small companies. The other is to be systematic and diversify investment across a portfolio of smaller companies in the expectation that the returns from the winners will more than offset the losses on the failures.

The other risk is really down to the position of a small shareholder of unquoted equities. This is not a powerful position and investors may have very little influence on matters of great importance to their investment – such as rights issues, the timing of a listing or the sale of the company. For direct investors, this risk can only really be mitigated by carrying out due diligence and developing confidence in the management team. For investors in funds, the expectation is that the fund manager will take a large enough position to exercise some influence over the management and look out for investor interests.

The final risk is one of frustration really – perhaps nothing very interesting will happen and investors will find their capital is 'stuck'. If a company does not manage to reach a stage where a profitable exit from the investment is possible, but does stay in business and investors cannot sell their shares, then the investment is essentially in limbo: not necessarily a bad investment and still holding out the possibility of success one day, but the capital cannot be taken out and recycled into other opportunities. This is a further risk with unquoted, equity investments.

"EIS investment is vital for early stage companies that have no assets or income stream to support bank lending"

Sarah Wadham, EISA

EIS VS VCT

EIS and VCTs are often positioned as competing sectors – after all, they are both focused on small company investing, offer generous tax breaks and managers often operate funds in both the EIS and VCT segments of the market. However, there are significant differences as well, and there is no reason why they can't both be included in a portfolio. VCTs are sometimes focused on larger companies and as a listed vehicle give investors easier access, liquidity (though this can be illusory) and more clarity on overall investment performance. VCTs can also pay tax-free dividends, perhaps making them a more suitable long-term investment vehicle (and perhaps more suitable for pension substitution).

However, the tax breaks on offer are not as generous as those attached to EIS investments. Both sectors have recently come under the microscope for exploiting the tax breaks and not putting capital genuinely at risk – something the government indicated they are concerned about in the 2014 budget.

FEATURES	EIS	VCT
Maximum Annual Investment	£1,000,000	£200,000
Tax Relief	30%	30%
Holding Period	3 years	5 years
One Year Carry Back	Yes	No
Dividends	Taxable	Exempt
Capital Gains Tax	After 3 years	Exempt
Deferral Relief	Yes	No
Inheritance Tax Relief	After 2 years	No

CONCLUSIONS TO THE MARKET OVERVIEW

For over 30 years now there has been a government policy to use tax incentives to encourage private investment into smaller company shares, and EIS has been the preferred scheme for most of that time. Smaller companies play a vital role in the economy but the investment deals available are too small for institutional investors. Therefore, private investment plays an essential role.

And whilst the government will always be keen to ensure that capital is genuinely being put at risk to encourage economic growth, the parameters for EIS qualifying companies are perhaps more generous than many people realise. EIS investment does not have to be about investing in small start-ups (although it can be). Very well established companies with large workforces and significant assets can qualify and can be lower risk investments. Despite all the rules and regulations that are wrapped around EIS qualification and claiming the tax benefits, the underlying investments themselves are actually very simple – it's investing into the share capital of businesses to help them expand.

This kind of smaller company investing holds out the prospects of occasional stellar returns, frequent steady returns and, possibly, some total losses. It can be a much more engaging part of an investment portfolio when compared to plain vanilla, mainstream fund investing.

KEY POINTS

- EIS qualifying companies can have up to 250 staff and assets of up to £15m
- Investing in smaller companies has the potential for high returns, but also increased risk
- Companies with less than 10 employees account for 95% of all UK businesses
- Smaller company shares are more often illiquid
- Investors in unquoted equity can find they lack influence with the underlying companies

POTENTIAL FOR SUBSTANTIAL CAPITAL GAINS

DIVERSIFICATION

IT'S A BUYERS' MARKET

IT'S INTERESTING AND EXCITING

IT SUPPORTS THE UK ECONOMY

EIS BENEFITS AND RISKS

The Enterprise Investment Scheme is designed to encourage private investment in small and medium sized companies. Not necessarily start-ups, but companies that are seeking capital for business activities such as entering new markets, scaling up the business or launching a new product.

Generous tax benefits make investing in smaller companies that are EIS qualifying more attractive and help to tilt the risk profile of the small company sector back in favour of the investor. HMRC has undertaken a lot of anti-avoidance and anti-abuse activities in recent years – this means advisers need to be 100% confident that any tax efficient investment options that they utilise for their clients are legitimate.

SUMMARY OF BENEFITS

- Income Tax relief of 30%
- No Capital Gains Tax
- CGT incurred elsewhere can be deferred
- Losses can be offset against either Income or Capital Gains Tax
- Potential for Inheritance Tax Relief (through business property relief after holding the shares for 2 years)

BENEFITS IN DETAIL

INCOME TAX RELIEF

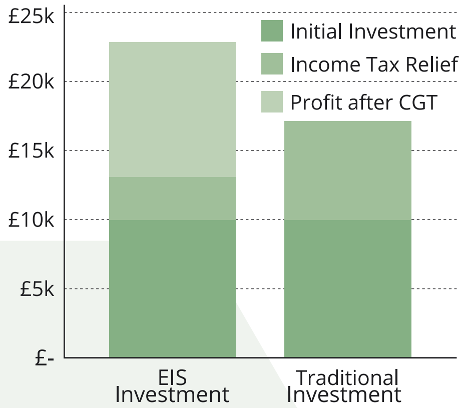
Investors get Income Tax relief of 30%. An investment of £10,000 allows an investor to reduce their Income Tax bill by £3,000. This relief can also be carried back into the previous tax year, which means the cost of the shares is treated as though they had been acquired in the previous year, and relief is given to the Income Tax liability of that year. This can be useful to mitigate an unusually high tax bill from the previous year or simply to access the relief while it's available, as once it's gone it cannot be reclaimed in the future.

Note that any dividend income from EIS qualifying investments will be taxed at the investors' marginal rate, hence profits are usually rolled up and paid as a capital gain.

CAPITAL GAINS TAX RELIEF

There is no Capital Gains Tax on any profits from an EIS investment. An investment profit of £10,000 goes directly to the investor without being taxed, saving at least £1,800 (CGT at 18%) for an ordinary rate tax payer.

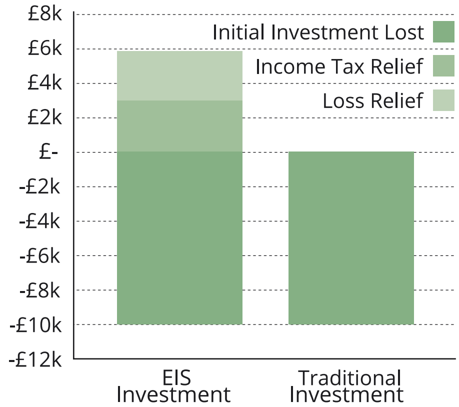
BENEFITS OF TAX RELIEF



CAPITAL GAINS TAX DEFERRAL

Tax on capital gains incurred elsewhere can be deferred if the gain is invested in an EIS qualifying company. There is a four year window to defer the tax – so the tax on any gains made three years prior to the EIS investment or one year after can be deferred. Deferral relief is unlimited, can be rolled over from one investment to the next and can go on indefinitely. However, if and when the investment is realised, the Capital Gains Tax is payable once again. Note that CGT is eliminated if the shares are still held at death. Investors may look to sell their investments over a number of years to take advantage of more than one years' CGT allowance.

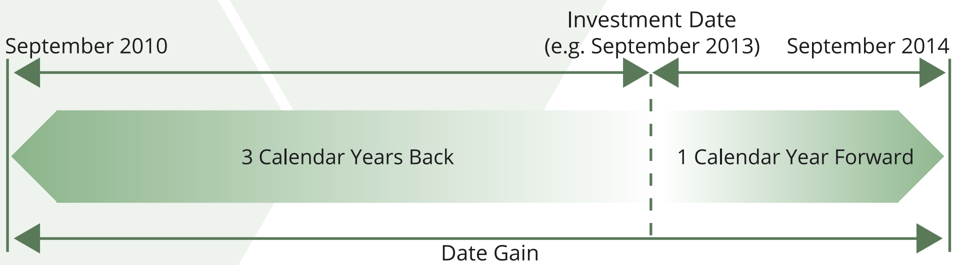
BENEFITS OF LOSS RELIEF



LOSS RELIEF

Investment losses can be offset against either Income or Capital Gains Tax. For a £10,000 investment that was a 100% loss, because of Income Tax relief, the actual loss is only £7,000 (£10,000-£3,000). Forty percent of that loss of £7,000 (for a higher rate taxpayer) can be used to reduce the taxable income for the year in which the shares were disposed, resulting in a saving of £2,800 and a total loss of only £4,200 (42%).

CAPITAL GAINS DEFERRAL RELIEF



TAX BENEFITS (BASED ON A HIGHER RATE TAXPAYER) (2014/15)

	New ISA	SIPP	VCT	EIS	SEIS
Annual Limit	£15,000	£40,000	£200,000	£1,000,000	£100,000
Lifetime Limit		£1,250,000			
Income Tax Relief	0%	40%	30%	30%	50%
Loss Relief	0%	0%	0%	Up to 40%*	Up to 40%*
IHT Rate	40%	55%	40%	0%	0%**
CGT Rate	0%	0%	0%	0%	0%***
Tax Free Lump Sum	100%	25%	100%	100%	100%

*less any income tax relief received **provided shares qualify for BPR ***after minimum three years' holding period

"Retirement and Inheritance Tax planning and the wish to shelter capital gains made on other transactions are increasingly important drivers for EIS investment" **Sarah Wadham, EISA**

INHERITANCE TAX RELIEF

Business Property Relief (BPR) applies after an initial holding period of two years and means that qualifying shares fall outside the estate for IHT purposes. Shares in an unquoted company qualify for 100% BPR, as long as the assets are held at death. (Full details are included in the HMRC guide here: hmrc.gov.uk/cto/customerguide/page16.htm.)

Business property relief can be claimed on the following:

- A business or an interest in a business (such as a partner in a partnership)
- Unquoted shares – including shares traded in the Unlisted Securities Market (USM) or the Alternative Investment Market (AIM)
- A holding of shares or securities owned by the transferor, which are fully listed on a recognised Stock Exchange, which themselves or with other listed shares or securities give control of a company
- Land, buildings, plant or machinery owned by a partner or controlling shareholder and used wholly or mainly in the business of the partnership or company immediately before the transfer (this applies only if the partnership interest or shareholding would itself, if it were transferred, qualify for business relief)
- Any land, or buildings, machinery or plant which was used wholly or mainly for the purpose of a business carried on by the transferor and was settled property in which the transferor was beneficially entitled to an interest in possession and used in the transferor's business

TAX RELIEFS FOR NON-DOMICILED INVESTORS

Resident non-domiciled investors can take advantage of Business Investment Relief (BIR) to bring money into the UK tax free if that money is then invested into a BIR qualifying company within 45 days. (Full details can be found in the HMRC guide here: hmrc.gov.uk/manuals/rdrmmanual.)

This means there is a double benefit of a tax-free remittance into the UK plus the tax reliefs available via EIS investing and often this money will have been untaxed offshore income or gains, so continuing to shelter this wealth from tax makes sense. This is designed to encourage non-domiciled individuals to invest in UK trading companies (note that such companies may also qualify for tier 1 Visa Investment purposes).

On exit from the EIS investment, any profits can be retained onshore, but the principal (less any losses) must be returned offshore within 45 days of the exit.

The conditions for Business Investment Relief are slightly tighter than for EIS:

- Investors must subscribe in cash for new shares (although BIR is also available for loans to qualifying companies)
- The investment must be in a private limited company or an AIM listed company
- It must be a trading company (but companies which invest in eligible trading companies may qualify)
- Property rental companies may qualify
- There are restrictions on receiving 'benefits' (if provided on non-commercial terms for BIR)
- There are penalties if the qualifying conditions are breached. Usually, the asset must be disposed and the proceeds sent offshore
- BIR has its own advance assurance procedure

Not only is this a great benefit for non-domiciled investors, but it is fantastic for the UK economy as well, as it is bringing in new money from overseas that otherwise would not have been invested here. Several EIS managers are now developing BIR products.

Full detail of the available tax benefits can be found in the HMRC manual: hmrc.gov.uk/manuals/vcmmanual

PRINCIPAL RISKS WITH EIS

Although the EIS is designed to mitigate some of the main risks associated with investing in small companies, there are a number of considerations to be aware of which are particular to EIS investments.

FINANCIAL SERVICES COMPENSATION SCHEME (FSCS) STATUS

Whether or not an EIS investment is covered by the FSCS depends upon the structure of the investment. Single company EIS investments and investments that are not held within a traditional fund (where investors' money is pooled and invested collectively) would not be considered to be retail investment products and therefore would not be covered by the FSCS. Note, that this means that a managed portfolio service in *not* covered by FSCS.

However, many EIS funds are now structured so that they are appropriate for Ordinary Retail Investors, and these will be covered by the FSCS. In these cases, if the fund manager was unable to meet its liabilities and the clients lost money as a result of this, then eligible claimants will be covered for up to £50,000. In addition, un-invested cash will be held in a segregated client account that also benefits from FSCS cover. The normal £85,000 per person, per institution rule applies (and therefore it's always best to check which bank holds the cash).

LOSS OF EIS STATUS

If firms make changes to their structure or activities that result in the loss of their EIS status, this will have a dramatic impact on investors' returns. Investors in single companies must assure themselves that the company management are cognisant of this and have their investors' interests in mind when making key business decisions.

RISK	SMALL COMPANY INVESTING	SPECIFIC TO EIS INVESTING
Company Failure	✓	✓
Lack of Influence	✓	✓
Modest Performance	✓	✓
Inexperienced Management	✓	✓
Illiquidity	✓	✓
FSCS Status	✓	✓
Loss of EIS Status	✗	✓
Deal Flow and Cash Drag	✗	✓
Scams and Frauds	✗	✓

"The current enterprise landscape in the UK has led to increased entrepreneurial activity and seed funding, resulting in many fantastic early stage opportunities" **Bruce Macfarlane, MMC Ventures**

Investors in EIS funds obviously delegate this task to the fund manager and it is worth checking that the manager has a good track record of picking firms that do not lose their status (although this is one of the pieces of information that fund managers can be reluctant to disclose – see the section on Measuring Performance).

EIS managers may use the services of an external company (tax experts or accountants) to check and verify the EIS status of their underlying companies and support ongoing monitoring of qualifying status.

Advisers should be aware of this and satisfy themselves that the investments qualify for EIS status as part of their due diligence process. They should consider what effect loss of status would have on a client's financial plan.

ADVANCE ASSURANCE

Companies raising money can get advanced assurance from HMRC that they will meet the necessary criteria and will gain EIS qualifying status.

HMRC can give an opinion as to whether they would be able to authorise the issue of EIS or SEIS certificates in due course.

The assurance is based on information supplied:

- Company statutory details
- Financial statements
- Activities
- Funds to be raised and their use
- Investment documentation

HMRC need to be satisfied that:

- The company will meet the conditions to be a qualifying company structure
- Purpose
- Activities
- The shares will be 'eligible' shares
- The shares are issued to raise money for a qualifying business activity
- The money raised is to be employed in accordance with the requirements

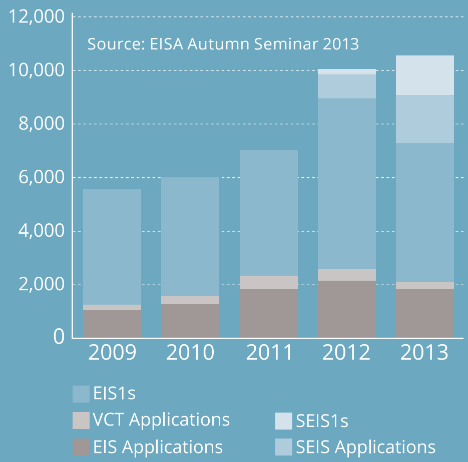
Advance Assurance enables appropriate changes to be made prior to investment. It's not a statutory procedure but can be relied upon, provided matters proceed as described and there are no material differences.

If a company does make material changes, they are obliged to inform HMRC.

However, an advance assurance does not mean:

- That any particular investor will receive tax relief
- That the company will continue to meet the requirements

ADVANCE ASSURANCE STATS



DEAL FLOW AND CASH DRAG

This risk is particular to EIS funds: they should deploy cash relatively quickly to start earning returns. Failure to do so leads to cash drag – a drag on performance.

Speaking with EIS fund managers and the EISA, there appears to be no shortage of deal flow, so this is not a risk right now. However, if the deal flow dries up, we could see instances of cash drag, or if managers start to feel pressure to deploy their cash they could be rushed into poor investment decisions. It is down to the expertise of the manager to ensure that they do not raise too much money that they then cannot allocate. Managers will have foresight over their pipeline of investment opportunities and therefore raise funds accordingly, with a lower and upper fundraising limit.

SCAMS AND FRAUDS

To date, there has not been any major fraud using EIS investments. However, several industry participants have privately acknowledged that fraud is a concern as any incident of fraud would taint the whole sector. Some have expressed a concern that fraudsters who previously targeted the UCIS (unregulated collective investment scheme) market are now focusing on EIS, after the regulators new policy (PS13/03) narrowed the market for the promotion and sale of UCIS.

How could a fraud occur? It could be an outright fraud – setting up a fund, using the EIS status as a marketing tool, collecting investors' money and running off with it.

Alternatively, it could be more sophisticated – a fund could invest in zombie companies that are only just surviving (probably thanks to the low interest rate environment), investors could collect their tax relief and the manager could collect their fees even though the capital had not been invested productively. This sort of fraud could carry on for years without coming to light – and in fact, even if it did it could be hard to prove that it was a fraud and not just a spectacularly bad investment manager. Thorough due diligence on the underlying investments or simply investing through reputable managers with proven track records is the key to avoiding this particular pitfall.

Film Investment Schemes: EIS investments are sometimes used to fund the production of films and provide some of the more glamorous headlines attached to the EIS sector. However, there have been some widely publicised cases of film investment schemes that have been used for tax evasion, by exploiting clauses in section 42 of the Finance (No 2) Act 1992 and section 48 of the Finance (No 2) Act 1997 (designed to encourage the UK film industry) with no intention of putting capital to work in order to produce a film. This has led to a widespread reluctance to invest in any film-related investment scheme even though there have been no frauds exploiting the EIS tax breaks.

In summary, the primary risks around investing in EIS qualifying companies are really the same risks associated with small company investing – smaller companies can and do fail. However, the EIS tax benefits tilt the risks back in favour of the investor somewhat. There are also some additional risks to be mindful of when investing in an EIS opportunity, but these can be mitigated through thorough due diligence. Overall, the risks in EIS investing are not really unique to EIS. At its heart, it is a tried and tested investment proposition – providing capital to companies to help them grow, in exchange for a share of the company profits at a later date.

KEY POINTS

- Tax reliefs tilt the risk/reward ratio back in favour of the investor
- Non-domiciled investors can combine EIS investments with Business Investment Relief
- Many EIS investments will not be covered by the FSCS

INVESTING IN EIS

The demand for EIS investments is increasing. In the past, uncertainty about where this niche range of products sits within the regulatory landscape sometimes limited their appeal to advisers and wealth managers. However, with EIS investments now a firmly established concept, the industry is seeing increasing engagement from intermediaries as well as increased take-up of direct sales.

There are a number of ways of accessing EIS investment opportunities. Whichever of these routes is selected, the result will always be ownership of shares in the company (whether beneficially or directly) so that EIS relief can be claimed. However, the route selected makes a significant difference to how (and if) the regulations apply.

SINGLE COMPANY EIS

In order to be appealing to potential investors, many companies who are looking to raise money by issuing shares seek to be EIS qualifying. Minimum investment levels range from £10,000 – £30,000.

From a regulatory perspective, single company issues are the least complex EIS arrangement. In fact, single company fundraising does not even have to require the involvement of a regulated firm.

As long as the EIS company is willing to limit its target market to certain categories of investor, and undertakes its own distribution, a regulated firm does not need to be involved. Having said that, some companies seeking a wider distribution network will bring on a promoter to source investors for them and this promoter should be regulated by the FCA.

Although it may not be complex, the lack of regulation in such an arrangement provides investors with fewer protections and rights of recourse if something goes wrong. It therefore may not be as appealing to investors as other EIS arrangements. In addition, without a fund or portfolio manager the investor will have to carry out their own due diligence and assessment of the opportunity.

Investors may also find that as a single investor they lack representation and influence on the company board, or alternatively they might be called upon to provide additional capital to unlock the value of the investment – something that may be easier for funds rather than individuals.

Without the economies of scale of collective investing, single company investing also makes it harder for smaller portfolios to diversify. However, for very engaged investors running their own portfolio of single company investments can be fun, exciting and rewarding (as well as very demanding).

In addition, the ban on adviser commission brought in by the Retail Distribution Review (RDR) does not usually apply to a single company raise. In all other EIS arrangements, as with most investment products, the ban applies when a recommendation is made to a retail client to invest in an EIS product and the adviser must agree their charges directly with their client.

EIS FUNDS

Funds pool and manage investors' money on a common basis. The fund manager typically selects EIS qualifying investments according to an investment strategy which determines the profile of the companies that they will invest in, any investment restrictions they impose and their overall approach to investing. Investors sign up to this strategy and the fund will be managed in line with this.

There are a huge number of funds to choose from, some are generalist but many specialise in a particular segment of the market or particular funding stage. Funds can also be 'approved' or 'unapproved'. In an approved fund, for Income Tax relief purposes investors will be treated as having made the EIS investments at the date of the fund's close, which provides certainty for the investor. To qualify as an approved fund, the prospectus must be reviewed by HMRC, and at least 90% of the fund's assets must be invested within 12 months. This usually requires an existing pipeline of deal flow, as making selective investments in such a short time frame is a big challenge. In an unapproved fund, Income Tax relief is available following each investment by the manager. This is often preferred as there is greater flexibility around the Income Tax relief – especially when the ability to carry back tax relief is taken into account.

One important point to be clear on – there is no real difference in the risks with either an approved or unapproved fund and just because a fund is approved, advisers and investors should not assume that it is in some way 'better' than an unapproved one. As noted above, it simply refers to the technical status of the fund in the eyes of HMRC.

Typically the investments are all held in a nominee name, by the fund manager or a custodian, and the investors have beneficial ownership of the shares in order to benefit from the potential tax reliefs.

EIS funds promise the benefits of scale and investment expertise. A fund-based approach means that investors can diversify their risk across a broad portfolio of investments, even if they have a relatively small amount of capital to invest (see the section 'A Portfolio Approach' later for more insight into the importance of diversification in this market).They also benefit from the fund manager's expertise and resources – meaning, in principle, that only the most attractive opportunities are selected for investment and thorough due diligence is undertaken before money is committed.

Unlike an individual investor with a modest contribution, when a fund that makes a significant investment in an EIS qualifying company, the fund manager will often have influence over the board and can therefore look after their investors' interests in an ongoing capacity. This could include making sure that the investors' shareholdings are not diluted, influencing the timing of an exit, ensuring EIS qualifying status is retained and that the company is headed in the right direction.

In order for investors to access the tax relief, EIS funds do not have a typical fund structure and are instead simply a collection of money and shares held by the manager and collectively managed on behalf of the investors in the arrangement.

From a regulatory perspective, EIS funds can be easier to promote and recommend than traditional investment funds. The vast majority of EIS funds are not categorised as UCIS, making distribution easier. This is possible thanks to a dedicated Enterprise Initiative Scheme exemption within the FSMA Collective Investment Schemes Order.

"An EIS Fund allows a portfolio approach to be taken by the investor which in many funds allow losses to offset capital gains before performance fees are charged" **Alastair Kilgour, Parkwalk Advisers**

This exemption means that EIS are not a UCIS where they meet certain criteria, including, but not limited to, having a minimum investment level of £2,000 and no withdrawal rights for investors in the underlying shares for a period of seven years (although they can withdraw cash).

In addition, the FCA recently confirmed EIS funds are not subject to the new ban on promoting funds and other collective vehicles, (referred to as 'non-mainstream pooled investments' or NMPIs), to retail clients so long as they are not structured as a UCIS. As with all products, the FCA would only want promotions to be made where these are suitable for the recipient but this additional flexibility allows advisers to exercise their discretion.

There are also clear standards when it comes to fund management. EIS funds have recently come under European legislation in the form of the Alternative Investment Fund Managers Directive (AIFMD). On the 22nd July 2014, all Alternative Investment Fund Managers (AIFMs) became subject to either the lighter-touch standards for small AIFMs or the more prescriptive regime for full-scope AIFMs. The regime that applies will depend on the manager's total assets under management across all of its alternative investment funds.

Of course, funds, as opposed to single company investments, do introduce another layer of charges, making the investment more expensive. Charges vary but are generally around a 3% initial charge and a 2.5% ongoing annual management charge, and perhaps a performance incentive (fee) of 20% of the exit proceeds once targets are achieved. Minimum investment levels vary greatly from £5,000 to £50,000.

MANAGED PORTFOLIO SERVICES

Portfolios can be an attractive option, especially for investors wanting access to EIS but who are less familiar with typical EIS sectors or early stage company investment. As with a fund investment, investors can benefit from scale and expertise. However, unlike a fund, the investments are made on the investor's behalf on a discretionary basis and the investment manager will build up a bespoke portfolio for each investor based on that particular investor's needs, circumstances and risk appetite.

Providing such a bespoke service comes with a significant increase in the regulatory burden for the portfolio manager and many EIS specialists do not have the resources to undertake the level of suitability analysis required to run such a service. In addition, with the transition to AIFMD, many EIS providers may no longer have the correct MiFID (Markets in Financial Instruments Directive) permissions required to run such a bespoke portfolio service.

Some EIS arrangements are termed portfolios or services but do not offer this bespoke arrangement.

Portfolios where decisions are made in line with an investment strategy set by the manager rather than the investor's circumstances are likely to be viewed as a fund for regulatory purposes.

ADVANTAGES OF A PORTFOLIO

What is particularly attractive about any kind of portfolio of EIS qualifying companies (provided the investment is not a collective), is that investors can offset the losses in individual companies – even if the overall portfolio is performing well in aggregate.

It's worth noting that in the EIS sector, managed portfolio services are often referred to as funds – technically this is incorrect, but it is useful shorthand.

PLATFORMS

Some online investment platforms provide an EIS portfolio-building service and can offer access to both companies and funds. Some services such as Rockpool are geared to investors whereas others such as Kuber are focused on advisers. In some cases, the platform simply facilitates the investments and the investor/adviser stays in control of which investments to make and how much of their capital to commit to each opportunity. In other cases, the platform can provide a discretionary service which selects investment in line with an overall strategy selected by the investor/adviser.

As an online platform arranging investments the recently implemented crowdfunding regulations will apply. Where advice or management services are also supplied, the platform will take on an increasing regulatory burden such as undertaking suitability assessments. In addition the platform may undertake due diligence on the company or fund, or offer information about the manager and investment structure.

In most cases the investor has beneficial ownership of the shares through a nominee account. For more engaged investors, a platform can provide access to a diverse range of opportunities whilst still retaining control over their investments.

Of course, the platform will charge for their services, with charges still in the range of 3% initial and 2.5% ongoing with performance incentives. Minimum investment levels are around £10,000 to take part in the service and around £5,000 for each individual investment which can make diversification across managers, sectors and funding stages easier. Some platforms even offer a regular contribution feature.

CROWDFUNDING

Crowdfunding platforms are a new entrant into the EIS space and have further raised the profile of EIS and Seed EIS. According to the FCA, crowdfunding is:

"A way in which people, organisations and businesses (including business start-ups) can raise money through online portals (crowdfunding platforms) to finance or re-finance their activities and enterprises".

Often this fundraising takes the form of EIS qualifying companies selling unquoted shares.

Prominent examples include Crowdcube, the world's first equity crowdfunding platform and SyndicateRoom, which gives its members the opportunity to invest alongside experienced business angels on a like for like basis.

As with investment platforms, crowdfunding platforms intermediate between the investment opportunity and the investors. The level of due diligence undertaken on investments varies from platform to platform. It is therefore worth assessing how thorough the due diligence has been when identifying what other research and investigation the investor should undertake.

Crowdfunding platforms have much lower minimum investment levels than traditional EIS platforms, making diversification much easier.

Although crowdfunding aims to empower people to make their own investment decisions, the FCA's new rules for crowdfunding platforms seem to favour crowdfunding through intermediaries. The new requirements for platforms, when dealing with ordinary retail investors, requires that investors put no more than 10% of their net assets into non-readily realisable securities (such as unlisted shares) and complete an appropriateness test. However, the requirements do not apply when the investor is in receipt of advice or management services from a regulated firm.

INVESTMENT STRATEGIES

CLASSIFICATION

EIS managers and reviewers have different terms for classifying EIS investments according to their investment objective, risk profile or structure. However, whatever the terms and definitions used, most EIS investments can fit into one of three broad categories:

High Growth: investment in order to support rapid organic growth; perhaps to establish or cement a competitive advantage or to support a management buyout. The objective is to provide the capital to help the business grow, whatever stage it is at. Investors would be targeting 2-3x capital or more and would expect to realise their investment within five to ten years. This is perhaps the riskiest, but also the most common form of EIS investing.

Capital Preservation: investment in lower risk companies, usually asset backed or with strong revenues, with a focus on preserving the real value of capital and achieving the 30% Income Tax relief and saving the 40% Inheritance Tax. The capital is still put at risk but not to the same extent as in more speculative EIS investments, and the expectation is that returns will be much lower, to reflect the lower level of risk.

Exit Focus: investment with a focus on a predictable exit as soon as possible after the three year minimum holding period. Even if there is no growth and the investment simply returns the initial capital invested, the 30% Income Tax relief alone would deliver a >10% compound annual return.

These lower risk strategies can be illegal if the money is not being genuinely invested in business growth. HMRC are very aware of the EU State Aid guidelines and EIS investments need to be seen as having a substantial element of risk, with no defined exit at the time of investment. The issue attracted the attention of the Treasury in the 2014 budget:

"The government is concerned about the growing use of contrived structures to allow investment in low-risk activities that benefit from income guarantees via government subsidies and will therefore explore a more general change to exclude investment into these activities, consulting with stakeholders. The government is also interested in exploring options for venture capital reliefs to apply where investments are in the form of convertible loans, and will be considering this as part of a wider consultation and evidence gathering exercise over summer 2014."

A PORTFOLIO APPROACH

Generally, smaller companies of the sort that qualify for EIS status are more risky. There is a much greater chance of investments returning less than the original investment amount than would be expected with more established companies. The tax breaks are an incentive designed to offset this risk and make investing in smaller companies more attractive, however, based upon the statistics it seems that investors would still be wise to employ systematic diversification strategies.

FINDINGS

Our research suggests that even with the tax breaks to mitigate the risks, it would still be wise to take a portfolio based approach to EIS investing. The returns from business angel investments are generally found to be as follows:

- The average return is 2.2x capital on a portfolio (becomes 1.9x after tax)
- This becomes 3.4x after tax with EIS relief
- 56% of ventures returned less than cost
- 35% return 1-5x cost
- 9% return 10x or more

The Optimum Portfolio Calculation

Based on the available research from NESTA we know that there is a 1 in 10 (0.1) chance of selecting an investment that returns 10x capital.

We would like to construct a portfolio that statistically gives us a 95% (0.95) of including one of these investments.

Target Confidence	0.95
Probability of Win	0.1
Number of Intervals Required	28.4331588
Formula	$0.9N = 0.05$ $\ln(0.9)xN = \ln(0.05)$

#1 A portfolio of ten investments would seem to be the minimum requirement based on the figures for satisfactory returns from 'angel' investing. A portfolio of 30 is conventionally seen as optimal giving 95% confidence of picking an investment that returns over 10x capital. Investors and their advisers should look to diversify across managers, sectors and funding stages (depending on their risk appetite).

There is though the risk that different managers may invest into the same underlying companies, particularly for AIM focused strategies. Diversification should be done systematically following a rational procedure or strategy.

#2 For investors who do not have sufficient scale or who are looking for a less time-consuming way to achieve the level of diversification required, an EIS fund makes sense.

#3 Another strategy to mitigate the risk is to invest in asset backed projects that have lower levels of return, but have reasonably secure and predictable revenue streams. Of course these opportunities are not without risk, but they are perhaps less risky than other EIS qualifying ventures.

RESULTS

We looked at building a portfolio of ten EIS investments and how that portfolio performed under a number of different scenarios: Worst Case, Barely Breaking Even, Evidence Based, Boring and Mediocre, Imagine Wild Success!

The five scenarios have all been based on the same following criteria:

- Initial investment of £100,000
- Investment period of 5 years
- Investor is a Higher Rate tax payer and claims all available reliefs
- We have not included any asset management charges in the calculations
- Annual returns compound

On the following page we look at how each of these different scenarios might play out.

"EIS funds allow the investor to build a portfolio of investments through an experienced fund manager"

1. Worst Case

- All ten investments return -90% annually

Total Return	£58,000.60
Loss	-£41,999.40
Return	-42.00%

This scenario shows us that even if all ten investments perform catastrophically, the tax and loss reliefs limit losses to 42% of the initial investment, far better than a comparable investment in traditional shares.

2. Barely Breaking Even

- 5 investments return -90% annually
- 4 investment return 0% annually
- 1 investment returns 7.5% annually

Total Return	£98,356.59
Loss	-£1,643.41
Return	-1.64%

This scenario shows us that even if five investments perform catastrophically, and four under-perform, it only needs one investment to achieve respectable annual returns to offset the losses on the others.

3. Evidence Based

- 5 investments return -90% annually
- 4 investment return 12% annually
- 1 investment returns 61% annually

Total Return	£222,669.58
Gain	£122,669.58
Return	122.67%

This scenario is based upon the figures for returns from Angel Investing. Loss relief limits losses on the poor performers but has no impact on gains from average performers or the stellar performer. Loss relief limits the downside risk of losses to investors. It suggests that a portfolio based approach means four to five catastrophic investments can be absorbed provided these losses are offset with gains from elsewhere. A portfolio containing less than ten investments increases the chances of only picking the losers and missing the offsetting benefit of a stellar performer.

4. Boring and Mediocre

- All 10 investments return 3% annually

Total Return	£145,927.41
Gain	£45,927.41
Return	45.93%

This scenario is unlikely considering the volatile and unpredictable nature of small company investing, however renewable energy investments with predictable revenue streams may fit this profile. It is worth noting that if all ten companies only achieved less than market rates of return (under-perform the FTSE 100 for example), the tax relief means EIS investors are still likely to receive higher returns than from mainstream opportunities.

5. Imagine Wild Success!

- All 10 investments return 10% annually

Total Return	£191,051.00
Gain	£91,051.00
Return	91.05%

Again, this scenario is unlikely considering the volatile and unpredictable nature of small company investing. However, were you able to consistently pick winners that achieved market levels returns of 10% a year, the overall portfolio would perform even more strongly than that thanks to the tax reliefs. It is worth noting, though, that the returns in this scenario are lower than the returns in the Evidence Based scenario where there was only one stellar performer.

CONCLUSIONS TO A PORTFOLIO APPROACH

The generous tax benefits and loss reliefs reduce some of the risk associated with investing in smaller companies.

The power of the tax and loss reliefs can be exploited further when they are combined with a portfolio approach to investing: the loss relief reduces the impact of losses from under-performing investments, the Income Tax relief provides a huge immediate benefit and the CGT relief maximises gains from out-performers – so even a portfolio that has fewer winners than losers will still provide positive returns.

"The EIS allows individuals to invest in potential world beating companies at very low after-tax cost, and without any obligation to make a multi-year investment commitment. Contrast that with the several million dollar minimums and ten year limited partner structures that are providing the subsequent growth equity funding as these businesses expand across the world"

Bruce Macfarlane, MMC Ventures

RESULTS OF A PORTFOLIO APPROACH

	Worst Case	Barely Breaking Even	Evidence Based	Boring and Mediocre	Imagine Wild Success!
Total Return (£)	£58,000.60	£98,356.59	£222,669.58	£145,927.41	£191,051.00
Gain (Loss)	-£41,999.40	-£1,643.41	£122,669.58	£45,972.41	£91,051.00
Return (%)	-42.00%	-1.64%	122.67%	45.93%	91.05%

PLANNING EXITS FOR INCOME

In this section we examine the possibility of reinvesting the gains from EIS investments in other EIS offers, and using 'exit focused' EIS investments to try and build a tax-free source of annual income for the future. The spreadsheet we used to calculate the returns is available on request from reports@intelligent-partnership.com.

METHODOLOGY

We looked at a hypothetical strategy where the investor has a surplus £10,000 annually and has used (or nearly used) their lifetime allowance within their pension and their annual ISA allowance. Clearly we are thinking about wealthier investors here, perhaps nearing retirement age and mortgage free home owners.

By investing the annual £10,000 surplus into EIS schemes with an exit focus, the capital can be recycled into another investment at exit. In our simple example we have recycled the capital every three years and assumed each investment returns 1.3x capital (equivalent to 10% simple annual growth).

We implemented this strategy with the surplus £10,000 a total of eight times (Pots A–H in the table below). This means that Pot A can be crystallised in year 10 and the total return of £21,970 can be taken as a tax free gain – and the same can be done with all the subsequent pots until year 17, providing a tax free annual income – potentially in the early years of retirement when spending is highest.

PLANNING EXITS FOR INCOME (£ '000s)

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Pot										Taking Profits As Income						
A	10			13			16.9			21.97						
B		10			13			16.9			21.97					
C			10			13			16.9			21.97				
D				10			13			16.9			21.97			
E					10			13			16.9			21.97		
F						10			13			16.9			21.97	
G							10			13			16.9			21.97
H								10			13			16.9		
	Initial Investments								Re-Investing Gains							

MORE COMPLEX SCENARIOS

Of course in reality the initial investment amounts are likely to fluctuate; as client circumstances change the level of returns will vary greatly, EIS managers may take longer to achieve an exit than planned at the outset and advisers and investors may work over differing timeframes.

We carried out similar research with company returns set at levels based upon NESTA research (56% return less than cost, 35% return 1.5x cost and 9% return >10x capital) and randomly distributed through our scenario. As you would expect, the 'income' taken as the investor starts to exit was much more erratic, but still almost always positive each year, with some years providing significant returns in the tens of thousands.

MORE COMPLEX SCENARIOS

			Investment 1		Investment 2		Investment 3		Final Exit	
Pot	Initial	In Year	Return	Timeframe	Return	Timeframe	Return	Timeframe	Total Return	In Year
A	£10k	1	0.5	3 years	1.5	3 years	0.5	3 years	£3.75k	10
B	£10k	2	10	3 years	0.5	3 years	0.5	3 years	£25k	11
C	£10k	3	0.5	3 years	1.3	3 years	0.5	3 years	£3.25k	12
D	£10k	4	1.5	3 years	0.5	3 years	1.5	3 years	£11.25k	13
E	£10k	5	0.5	3 years	1.5	3 years	0.5	3 years	£3.75	14
F	£10k	6	1.5	3 years	0.5	3 years	10	3 years	£75k	15
G	£10k	7	0.5	3 years	1.5	3 years	0.5	3 years	£3.75	16
H	£10k	8	1.5	3 years	0.5	3 years	1.5	3 years	£11.25	17
Totals	£80k								£137k	

CONCLUSIONS

As the NESTA research indicates, small company investing can be risky and therefore a portfolio approach is necessary. If only one in 10 investments is going to be a stellar performer, this suggests that a portfolio of 28 investments would be optimal to give a 95% chance of including the high performer. This level of diversification may be beyond many investors' resources, which leaves advisers with a couple of options: either using a fund or choosing to invest in lower risk, exit focused EIS opportunities. These are often based around established businesses with predictable revenue streams and are very different to the growth focused investments EIS is traditionally associated with.

If the emphasis is on exit focused EIS, they can be combined in a portfolio approach similar to the one we've outlined here and advisers can help clients build a satellite portfolio of tax efficient investments that will provide a regular stream of capital gains in the future.

EIS investments can be suitable for clients for a number of tax planning reasons:

- Defer (potentially indefinitely) the payment of Capital Gains Tax
- Income Tax relief to offset a large Income Tax bill
- Shelter investments from Inheritance Tax
- The potential for tax free capital growth

EXAMPLE OF INVESTING TO OFFSET TAX ON A CAPITAL GAIN

James, a higher rate taxpayer, has made a taxable gain of £20,000 due to the sale of an investment property. With the current CGT tax-free allowance of £11,000 (2014/15), he would be liable for CGT at 28% on £9,000 (£20,000 – £11,000) which is £2,520.

If this £20,000 is invested in an EIS qualifying company within three years of the sale of the property then the CGT can be deferred (saving the client £2,520), and only becomes due when the EIS investment is exited (but there is nothing in the rules to prevent rolling this over again into a new EIS investment). In this way CGT could be deferred indefinitely. In this case the tax bill dies with the investor, which when combined with the potential for Inheritance Tax relief, can make EIS investments very attractive for estate planning.

Advisers with clients who anticipate a large capital gain in the next twelve months, or who have made a large capital gain in the last three years, may consider EIS investments to defer the tax liability.

EXAMPLE OF OFFSETTING A LARGE INCOME TAX BILL

Looking at another scenario. If Stephen had a successful couple of years and incurred annual Income Tax bills of say, £40,000, the total possible claim would be £80,000 (£40,000 x2, remembering that Income Tax relief can be backdated to the previous year). An investment of £266,667 in EIS qualifying companies would mean that the client could claim the entire £80,000 in tax relief (£80,000 x 30%, the rate at which relief is available).

Clearly this is a useful tool for advisers who want to minimise their clients' Income Tax bills.

EXAMPLE OF USING EIS TO POTENTIALLY SHELTER INVESTMENTS FROM INHERITANCE TAX

The mother of our hypothetical client, a widow, has an estate valued at £1m. Her late husband had left the whole of his estate to her, keeping intact his entire tax-free allowance (£325,000) which then passed on to his widow. Her tax-free allowance (nil rate band) increased to £650,000 as a result. She is therefore liable for 40% tax on the assets of her estate above £650,000 on death. £1m – £650,000 = £350,000 x 40% = £140,000. This is a significant tax bill and will reduce the value of the estate being passed to her loved ones.

By investing into an EIS investment with shares that qualify for business property relief, she can potentially reduce her IHT bill (providing that the shares have been held for a minimum of 2 years and she still holds the shares on death). A £100,000 investment would reduce the taxable value of her estate by £100,000 (£1m – £100,000 – £650,000 = £250,000). She would therefore only be liable for IHT on £250,000 (£250,000 x 40% = £100,000), reducing her IHT bill by £40,000.

IHT relief on an EIS investment is not a given. The shares must qualify for BPR and there are a number of conditions that need to be met for this, but it is an added advantage of EIS and is very useful for tax and estate planning.

PREVENTION OF TAX AVOIDANCE

The government has acted to prevent abuse of the tax reliefs before. It introduced two new 'no disqualifying arrangements' tests in section 178 of the taxes act to stop schemes where the primary objective was tax avoidance and there was no commercial purpose, or where another business was indirectly funded by EIS money. The first test was whether more than half of the funds raised via the EIS were going to another party; the second test was to establish if there was another party to the arrangements that could be carrying out the same business the EIS qualifying company is proposing to undertake. This is to prevent service companies interposing EIS between themselves and their customers to give them a route to raise cheaper finance.

One sector that has previously attracted a lot of investment is renewable energy. Renewable energy technology is now very mature and well understood. It performs reliably within known parameters and very reliable predictions can be made for how much wind or solar irradiation can be expected over multi-year periods. Finally, government subsidies to encourage investment in renewable energy infrastructure (such as Feed-in-Tariffs or Renewable Obligation Certificates) mean that revenues from renewable energy can be predicted with a high degree of certainty. The infrastructure is uncomplicated, easy to maintain and profitable for 20+ years, therefore buyers can be lined up to take on the assets once installation has been completed.

Overall this made renewable energy a relatively low risk, asset-backed investment that can be used to structure exit-focus EIS investments. However, the treasury has deemed that structuring investments in this way is not in the spirit of the EIS scheme, and Feed-in-Tariffs were excluded from EIS qualification in 2011 (with the exception of hydro-power or anaerobic digestion plants) and Renewable Obligation Certificates were excluded in the 2014 Budget. The Finance Bill was granted Royal Assent on 17 July and is now effective.

The EIS industry is very keen to retain its close working relationship with HMRC and ensure that EIS investment opportunities are structured in the spirit of the scheme and not simply as tax shelters. This is partly driven by European Legislation. The EIS was given State Aid approval in May 2011, and in paragraph 63 the European Commission noted that 'In light of the forthcoming revision to the RCG (Risk Capital Guidelines), the Commission notes that the UK Government undertakes to modify the EIS and VCT schemes to the extent that would prove necessary to comply with a possible Commission proposal for appropriate measures following the entry into force of revised risk capital guidelines after the end of 2013.'

"The UK EIS scheme gives very generous tax breaks to encourage investment into companies that would otherwise find it difficult to raise capital. It is extremely important that these tax breaks are targeted to support investment into genuine risk capital investments"

Sarah Wadham, EISA

COMPARISONS WITH OTHER ASSETS

In this section, we provide a review of the advantages of EIS investing and some comparisons to other investment options. This is based on simplistic scenarios to aid your understanding of the concepts we're looking at. Real world scenarios would in all likelihood be more complex, with advisers having to build portfolios for their clients over a period of years and exiting over time, with considerations for variables that we cannot predict, such as the performance of individual investments or changes in client circumstances.

The spreadsheet we built to help us to conduct this research is available to subscribers of Intelligent Partnership. Advisers can adjust the investment amount, tax status, timeframes and level of returns used in the calculations to explore alternative scenarios they might be interested in.

METHODOLOGY

In all of the scenarios in the table below, for simplicity's sake, we have assumed the following:

- Initial investment of £10,000
- Investor is a Higher Rate tax payer and claims all available reliefs
- Tax Relief is included as part of the return (i.e. it was not invested)
- We have not included any asset management charges or transaction charges in the calculations
- We have assumed no dividends are paid as they are smaller companies
- This does not include the portfolio effect of variance between underlying investments within an EIS e.g. if one company in the portfolio falls to zero and another increases by 50%

FINDINGS

- Investments held within a Self Invested Personal Pension (SIPP) perform strongly when returns are positive, due to upfront tax relief, but of course SIPP money is not accessible until retirement, which is a big downside for many investors
- In negative scenarios, the loss reliefs mean that SEIS investments are the best performers
- Even relatively low investment returns are boosted by the tax reliefs available through SIPP, VCTs, EIS and SEIS

OTHER BENEFITS

There are four other major investment benefits with EIS:

#1 EIS are potentially Inheritance Tax exempt providing they have been held for more than two years and are still held upon death, which of course makes them an excellent tool for IHT planning. The government has frozen the IHT threshold at £325,000 until 2019, creating the need for new IHT planning solutions.

#2 The payment of tax on a capital gain can be deferred if it is invested in an EIS (the gain can arise from the disposal of any kind of asset, but the investment must be made within three years after the gain arose). There are no minimum or maximum amounts for deferral and no minimum period for which the shares must be held; the deferred capital gain is brought back into charge whenever the shares are disposed of. Gains can be deferred indefinitely if they continue to be reinvested in EIS qualifying companies and, if held upon death, the gain is written off completely.

#3 Tax reliefs apply from the date the investment is made into the EIS company and that company starts trading – which is a minimum of 3 years for EIS compared to 5 years for VCTs.

#4 There is a 'time value' of money consideration: receiving tax back within 12 months of investing is more valuable than receiving it as a return at the end of a much longer holding period, as the money can be reinvested in other opportunities, or used elsewhere.

> *"In uncertain economic times, a high-alpha, low-correlation EIS portfolio can complement a defensive portfolio very well"*
>
> **Alastair Kilgour, Parkwalk Advisors**

COMPARISONS WITH OTHER ASSETS

	TOTAL RETURN								
	-100%	-75%	-50%	-25%	0%	25%	50%	75%	100%
	-£10,000	-£7,500	-£5,000	-£2,500	£-	£2,500	£5,000	£7,500	£10,000
INVESTMENT OPTION	GAIN (LOSS) AFTER TAX AND LOSS RELIEF								
Directly Held Shares	-£10,000	-£7,500	-£5,000	-£2,500	£-	£1,500	£3,000	£4,500	£6,000
Shares ISA	-£10,000	-£7,500	-£5,000	-£2,500	£-	£2,500	£5,000	£7,500	£10,000
Shares within a SIPP	-£6,000	-£3,500	-£1,000	£1,500	£4,000	£6,500	£9,000	£11,500	£14,000
VCT	-£7,000	-£4,500	-£2,000	£500	£3,000	£5,500	£8,000	£10,500	£13,000
EIS	-£4,200	-£2,700	-£1,200	£500	£3,000	£5,500	£8,000	£10,500	£13,000
SEIS	-£3,000	-£1,500	£-	£2,500	£5,000	£7,500	£10,000	£12,500	£15,000

MEASURING PERFORMANCE

One of the biggest obstacles to investment in the EIS sector is the lack of independent, accurate performance information on the underlying activity of EIS funds and portfolios. Managers may release top level performance, but accessing the performance of individual companies held within a portfolio can be challenging. Without this information advisers and investors are putting their money in a blind pool and trusting that the manager will be able to produce the kind of performance they are promising, but with no verifiable track record to assess the veracity of their claims.

At the moment, most managers are prepared to share some top level information: how much money they have under management, how much they have deployed and how many deals they have done. It is also very common to come across case studies of underlying businesses that have been invested in, which bring some life and colour to the abstract investment process – and of course show EIS investing in a very favourable light.

This cherry-picking of information to share does not give investors the accurate picture they need to make systematic, objective judgments.

THE IDEAL

The holy grail of EIS performance measurement would be a full performance look-through for each fund.

- The performance data would list all of the underlying companies that have been invested in, how much was invested, when was it invested and an up-to-date valuation (or price achieved on exit). This would allow calculation of the performance of the underlying companies and allow investors to assess the fund manager's style and see which investments were driving the performance
- It would also capture how much cash was in the fund. This shows if the manager is deploying the capital or if there is a cash drag on performance
- Finally, the manager would need to confirm that each of those underlying investments had retained its EIS qualifying status. Any loss of status would, of course, have a big impact on the final returns to the end investors
- Performance would be calculated gross and net of the manager's charges

Presenting performance information in this way would allow investors to make meaningful comparisons between funds. It is much closer to the way mainstream equity fund performance is presented and we believe that it would invite much more new investment.

THE REALITY

As part of compiling this report we went out to over 40 EIS investment managers asking them what level of performance information they would be prepared to share. Only six managers responded. We asked if they were prepared to share any of the following: fund level valuations; fund level and company level valuations on current investments; fund level and company level valuations on exited investments; or no information at all.

Most managers were reluctant to share any information. However, there are important and understandable reasons why managers are reluctant to share this level of detail. In many cases, the exit from an underlying investment will depend upon a sale: making the internal valuation of the company public would make negotiating the sale and achieving the best deal for investors very difficult.

Depending upon the stage the underlying companies are at, valuations can be esoteric and open to manipulation. Valuation models can be adjusted to give quite different outcomes depending on the assumptions, projections and methodology used.

In addition, EIS funds can have very different investment strategies. A fund with a focus on a particular sector, or that is targeting a particular risk/return profile will obviously have very different performance results – returns, variance in the valuations, timing of exits, deployment of cash – to a fund that has different objectives. This can make some managers hesitate to share information as they fear that their fund might appear to be under-performing, when in fact, it is doing exactly what it should do, based upon the strategy and objectives of the fund. The key is to always make sure that you are comparing apples with apples – the same problem is common in the mainstream fund sector, but can be dealt with by grouping similar funds in IMA sectors (for example).

Another difficulty for managers is that, to date, there have not been that many exits to report on, certainly for some of the newer managers. And indeed, the exits themselves are also more complicated than they look at first glance. Most exits are asset sales rather than company sales, these are quicker and simpler (buying the assets is preferred as a company purchase may mean taking on the company's liabilities as well). However, this process attracts a CGT charge for the company, which obviously reduces profits.

One final note: AIM listed EIS qualifying companies will be obliged to provide a lot more detail than non-listed companies. This is one way advisers and investors can ensure they can have more performance related information on an EIS investment.

THE WAY FORWARD?

There are a couple of possible ways forward from these challenges:

- Carry on as we are. Not really a way forward, but it is clearly satisfactory for a number of participants in the industry – particularly the current incumbents who already have the largest market share and don't have much incentive to support change. However, they run the risk of getting complacent and being disrupted by new entrants
- Report top level fund performance. This would allow advisers and investors to assess and compare fund managers, but without the look through to the underlying investments so that they can see where that performance is coming from. However, it does keep the valuations of the underlying companies out of the public domain, making negotiating sales easier
- Provide a full performance look through, but only to selected parties on a confidential basis. Perhaps organisations that control significant amounts of investment capital such as IFA firms and wealth managers could insist upon access to the full performance look through on the basis that they would keep this information confidential. This would give these firms a competitive edge, which means the playing field is not level for all investors – although these firms may argue this is simply an advantage of their size and scale
- Full performance look through. The EIS managers and underlying companies will have to accept that the valuations will be public knowledge. Any astute buyer of these companies would presumably have a very accurate valuation of what they are about to purchase anyway, so perhaps the argument that putting this information in the public domain makes exits difficult is a smokescreen EIS managers are using to avoid further scrutiny

CONCLUSIONS

We explored this topic with a number of EIS Managers and other parties on this topic. Overall, it seems that most of the operators in this market are hesitant about being first to report on their performance, as understandably nobody wants to unilaterally disclose performance information.

Overall, it will need a concerted effort on behalf of the industry to reach a consensus on this point. There will be an advantage for those managers who do disclose more information though – investors may give preference to a manager who perhaps promised less or had slightly worse track record, but was more transparent about what they have been doing with their investors' money rather than a manager who promised much but had little verifiable evidence to back up their claims.

CONCLUSION TO EIS IN FOCUS

There are some fantastic reasons to invest in EIS qualifying companies and investment can be a rare win-win-win- win-win scenario.

- Win 1: Small and medium sized enterprises can access the capital they need to grow
- Win 2: The government knows an important part of the UK economy is being supported
- Win 3: HMRC may gain more from the taxes these companies pay than it loses from giving investors tax reliefs
- Win 4: Those tax reliefs tilt the risk/reward profile of smaller company investing back in favour of the investor
- Win 5: The same tax reliefs can be very important tax mitigation tools for advisers

These drivers, along with the reduction in annual and lifetime pension allowances, are going to be behind the growth in the EIS market for several years to come. Based on this, we cautiously predict a £2bn market by the end of the 2014/15.

We may see some further regulatory changes as well: the EISA is lobbying HMRC to remove 'anti-dilution' prohibitions. At present, any specific provisions to protect early stage investors from being diluted in the future are outlawed under EIS as they greatly reduce the investment risk. However, the EISA and the rest of the industry would like to see these prohibitions removed.

It's also possible that we'll see a wider variety of investments qualifying for the EIS. Currently only shares (and a narrow category of preference shares) qualify, but we may well see that widened to include loan stock and full preference shares – investments that are commonly used in early stage fundraising.

Some other changes that HMRC might consider bringing in:

- A lifetime company fundraising allowance of £10m
- A maximum age of qualifying company
- Allowing funds raised via the EIS to be used for secondary company purchases (currently prohibited, forcing companies to use other sources of capital to fund acquisitions)

All of these proposed changes would require a consultation period, clearance from the EU and a finance act to bring them into legislation, so the soonest they could be implemented would be on a two to three year time-scale.

No doubt there will also be some growing pains.

The first one has been flagged up by the government in the 2014 budget. Schemes set to exploit the EIS and serve as tax shelters rather than putting money at risk to grow businesses, will come under the microscope.

We are surely going to see some under-performance at some point as well. Not all the fund managers are going to get it right, and while there is more than enough deal flow, the pressure to deploy cash could lead managers into poor investments. The issue will be compounded by the illiquid, hard to value, long term nature of the investments – problems may not come to light for a number of years.

The low interest rate environment also means there are a lot of 'zombie' companies out there – companies who are only just servicing their debts, but not growing – it must be hoped that EIS fund managers will be skilled enough to avoid these.

The growth in the sector could attract unscrupulous elements that will set up 'me-too' opportunistic funds that verge on fraud – with the potential to cause great reputational damage to the sector. Greater levels of disclosure and transparency should help to mitigate this risk.

Overall though, in our opinion, it is hard not to feel positive and optimistic about a sector with so many good points that is enjoying government support.

"The EIS allows investment in a wide range of sectors, but qualifying companies should all have strong management teams, scalable business models, the potential to grow and create jobs and build value for investors"

David Mott, Oxford Capital

EIS CASE STUDIES

EIS investment opportunities can be particularly interesting and exciting – covering a range of innovative sectors and supporting some fantastic companies.

We have included some case studies of EIS investments over the next few pages to help bring to life some of the key points that we have been making throughout this report.

#1 EIS investment is not necessarily about providing seed capital to high-risk start-ups. It can be about investing in well-established companies that have their own assets, a large workforce and long-standing customers.

#2 On the other hand, we've also highlighted the additional risk of investing in smaller companies. They are more risky than large, listed companies and mainstream investment funds, and there is less information available to base investment decisions on.

#3 However, for investors who are prepared to do their own research and due diligence in order to bridge this information gap, it is possible to identify fantastic opportunities where the risk/reward ratio is favourable.

#4 EIS investment managers can give investors access to the skills and experience required to carry out the required level of research and accurately assess these opportunities – for a fee of course.

#5 EIS investment managers can also help solve some of the other problems with small company investing. They can exercise influence over the companies they invest in, adding value by offering guidance at the same time as ensuring that their investors' interests are taken into account.

#6 Finally, successful EIS investments have wider benefits that go beyond the investment return: companies grow, pay more tax and employ more people. These are the reasons why the EIS continues to attract strong levels of support from the government.

PARTICIPATION

At the EISA Fund Manager Forum in June 2014 we invited its members to participate in an initiative to have this, our first industry report on EIS, professionally designed and printed. Four of the EIS managers agreed to participate – they were Oxford Capital, MMC Ventures, Parkwalk Advisers and Octopus Investments. In return they could provide us with case studies and a short company profile for inclusion, as well as some general commentary and these appear as attributed quotes throughout the report.

OXFORD CAPITAL

Oxford Capital makes EIS investments accessible, easy to understand and hassle-free for investors and their financial advisers.

The firm offers clients two distinct EIS investment strategies. One is focused on investment in high growth companies from a range of different industries, whilst the other invests in infrastructure companies.

Oxford Capital has been making EIS investments since 1999 and was a pioneer of discretionary managed EIS portfolios.

Its growth capital EIS portfolio backs well-established businesses to support their expansion. Oxford Capital builds each investor a portfolio of around 8-10 such companies, providing all the tax advantages of the EIS whilst mitigating some of the risk of smaller company investments through portfolio diversification.

Oxford Capital's Infrastructure EIS invests in companies which own and operate infrastructure assets, particularly renewable energy installations. Because the investee companies own physical assets and earn revenues through long-term contracts, the Infrastructure EIS has a lower risk profile than some other EIS investments. Private clients can also access Oxford Capital's infrastructure strategy through its Estate Planning Service, which provides protection from Inheritance Tax.

Oxford Capital was voted Best EIS Fund Manager at the EIS Association awards in both 2013 and 2014, and is the only firm to have won the award four times.

Website	oxcp.com
Email	info@oxcp.com
Telephone	01865 860760

OXFORD CAPITAL

SIRIGEN

Investment Date	2008 and Follow-on
Sector	Life Sciences
Location	Ringwood, Hampshire
Employees	19

sirigen.com

ABOUT SIRIGEN:
Sirigen develops and manufactures light harvesting polymers which have a wide range of applications in research, medical diagnostics and life sciences. Sirigen was successfully acquired by Becton, Dickinson & Company in August 2012 at nearly 90x revenues.

RATIONALE FOR INVESTMENT:
- Clear route to exit, since an acquisition would be possible once Sirigen demonstrated the potential to scale rapidly inside an acquirer
- Commitment from commercial partners was already demonstrated
- The management team was highly experienced in the field
- Extremely scalable business model, selling highly valuable reagents through commercial partners
- Well-aligned investor syndicate

GROWTH IN REVENUES AND EMPLOYMENT:
Since Oxford Capital first invested in 2008 there has been:
- CAGR 180% revenue growth
- 1.7x increase in the number of employees

VALUE ADDED BY EIS MANAGER:
- Active and supportive board member particularly on issues of strategy
- Providing balance to shareholder group and Board
- Built investor syndicates over several rounds
- In 2011, Oxford Capital and its co-investors oversubscribed to fund the company through to exit
- Very active in exit negotiations
- Supportive shareholder, bringing syndicate together

AMOUNT INVESTED AND ANY CO-INVESTORS:
Oxford Capital: £2.3 million
Seraphim, IQ Capital, NESTA, YFM and others: £9 million

CELOXICA

Investment Date	2008 and Follow-on
Sector	Hardware-accelerated trading
Location	London
Employees	36

celoxica.com

ABOUT CELOXICA:
Celoxica sells a combined hardware and software product to institutional investors who require extremely high performance access to financial market data. Data feeds are delivered over high-speed networks to the host computer memory, where it can be processed in a few millionths of a second. This allows Celoxica's clients to respond faster to changing market conditions and ultimately increase profits.

RATIONALE FOR INVESTMENT:
- Celoxica had an attractive business model with high gross margins and long-term recurring revenues
- In the financial technology sector, Celoxica was unique as the only vendor to offer a compact hybrid hardware and software solution, which helps reduce data centre footprint and total cost of ownership

GROWTH IN REVENUES AND EMPLOYMENT:
Since 2008 there has been:
- CAGR 150% revenue growth
- 3x increase in the number of employees

VALUE ADDED BY EIS MANAGER:
- Oxford Capital backed the company as part of a 'take-private' transaction from the AIM market in 2008
- Supported bringing key strategic investors on-board including Credit Suisse and Goldman Sachs
- Helped the company to expand into Asia and the US
- Worked with the company to develop new product launch strategies

AMOUNT INVESTED AND ANY CO-INVESTORS:
Oxford Capital: £1.9 million
Goldman Sachs, Credit Suisse, Spark Ventures, Herald Investment Management and others: £8.9 million

MMC VENTURES

Founded in 2000, MMC Ventures Ltd (MMC) is an active investor and award-winning venture fund manager. MMC is classified as a generalist manager, with an established investment strategy focused on technology-enabled sectors where the UK is a world leader – particularly financial and business services, business software, digital media and e-commerce.

MMC has circa £120m under management and invests around £20 million per annum in a combination of new investments and add-on capital for existing portfolio companies. MMC invests its EIS Funds alongside other money that does not qualify for tax relief, reinforcing their fundamental approach of investing on the commercial merits of each transaction. MMC specialises in fast-growth early-stage UK-based businesses, partnering with entrepreneurs and impressive management teams to achieve substantial scale and profitability.

MMC has an established track record of trade sales and IPOs and its current portfolio of investee companies have seen a significant uplift in valuation from follow-on institutional investors. MMC's EIS Funds are designed for investors seeking long-term capital growth, or for those looking for some significant upside potential as part of a broader portfolio of EIS products.

Website	mmcventures.com
Email	anna.slemmings@mmcventures.com
Telephone	0207 938 2220

BASE79

Investment Date	2010 and Follow-on
Sector	Digital Media
Location	London
Employees	70

base79.com

ABOUT BASE79:
Base79 is a network for Video Creators, Content Owners and Brands. It is the largest YouTube Multi-channel Network (MCN) outside North America and was one of the leading partners in YouTube's Original Programming Initiative. Base79 creates global audiences for video, partnering with video rights holders, producers and brands to build online audiences, claim and protect their intellectual property, sell premium advertising, and generate new revenues on YouTube and other platforms. According to comScore, almost 90 million people watch Base79 content every month.

RATIONALE FOR INVESTMENT:

- Backing an outstanding management team and experienced board
- Investing in a technology and service proposition allowing traditional content owners to address the rapid shift towards online video consumption
- Strong growth and commercial traction in the business itself, combined with online video being the fastest growing subset of the digital media market
- Strong acquirer appetite driven by traditional media businesses

GROWTH IN REVENUES AND EMPLOYMENT:
Since MMC first invested in 2010 there has been:

- CAGR 151% revenue growth
- 10x increase in the number of employees

VALUE ADDED BY EIS MANAGER:
MMC invested in Base79 from an early stage and continued its support over several rounds of funding, alongside existing angel investors in the first instance and latterly alongside a US institutional VC.

MMC worked closely with management in assessing the merit of an offer to acquire the company by Rightser Group PLC. The offer was accepted and the business sold in Q3 2014 for up to £50 million in cash and shares. This represents a return of up to 5.3x investment for MMC investors.

AMOUNT INVESTED AND ANY CO-INVESTORS:
MMC: £3million
The Chernin Group and others: $10million

NEWVOICEMEDIA

Investment Date	2012 and Follow-on
Sector	Business Software
Location	Basingstoke
Employees	170

newvoicemedia.com

ABOUT NEWVOICEMEDIA:
NewVoiceMedia is a leading provider of true cloud contact centre and voice solutions, enabling businesses of all sizes to deliver a personal and unique customer experience, quickly and securely. Service availability and security are critical attributes of the cloud. NewVoiceMedia guarantees 99.999% service availability, and transparently backs that up with a Trust Site, which offers real-time data on how its services are performing.

Established more than 10 years ago, NewVoiceMedia has 200+ customers in 40 countries on five continents covering most industry sectors. Customers include Topcon, PhotoBox, DPD, Lumesse, QlikTech, Cunningham Lyndsey, CEB Group and Parcelforce.

RATIONALE FOR INVESTMENT:

- Strong management team with a track record of growing SaaS businesses
- A disruptive technology and business model in a large and mature market
- A strong growth rate combined with quality recurring revenue, high gross margins and exceptionally low customer churn
- High valuation potential driven by strong public market comparables

GROWTH IN REVENUES AND EMPLOYMENT:
Since MMC first invested in 2012 there has been:

- 217% growth in revenues
- 152% growth in employees

VALUE ADDED BY EIS MANAGER:
MMC backed NewVoiceMedia when the business was starting to see strong commercial traction. MMC provided investment capital at a time when the business still did not meet the requirements of larger growth investors. MMC's funding gave management the confidence to continue executing an aggressive expansion plan and the Company has since gone on to raise two further funding rounds of more than $85m of growth capital from major UK and US investors at a significant uplift in valuation.

AMOUNT INVESTED AND ANY CO-INVESTORS:
MMC: £1.5 million
Co-investors: Eden, Notion Capital, Highland Capital, Bessemer Venture Partners and Technology Crossover Ventures

PARKWALK ADVISORS

Parkwalk is one of the leading Investors in technology and growth early stage companies. The management have a substantial history in investment banking and bring that record to the EIS space.

Parkwalk's Funds have an Investment strategy which seeks to return multiples of original investment or to allow investments to fail in order that EIS tax benefits can be maximised for the investor.

Parkwalk currently publish the performance of their funds online and have already seen substantial returns and uplifts in valuation from some of their investee companies.

Parkwalk invests in UK University spin-outs generally alongside much larger specialist VCs, giving greater certainty of funding further investment rounds. The investments range from start-up to AIM listed companies, thereby giving a spread of maturities in their funds.

Parkwalk have invested in spin-outs from 13 UK Universities and their relationship with University Technology Transfer departments means unique access to potential deal-flow. This is enhanced at Oxford and Cambridge as Parkwalk manage specialist funds for both those Universities.

Website	parkwalkadvisors.com
Email	funds@parkwalkadvisors.com
Telephone	0207 759 2285

PARKWALK Advisors

TRACSIS PLC

Investment Date	2011
Sector	Software
Location	Leeds
Employees	200

tracsis.com

ABOUT TRACSIS PLC:
Tracsis solves a wide variety of resource optimisation, data capture and reporting problems through technology led services and a range of associated professional services.

The company reduces costs, improves efficiency and enhances the operational performance of transport networks.
Tracsis was named Small Cap Company of the year 2013 and recently won the Santander Breakthrough 50 Business Award.

RATIONALE FOR INVESTMENT:
Parkwalk invested in Tracsis in an M&A financing round in June 2011 at 45p per share (31.5p after EIS Relief), alongside Downing.

Parkwalk were very confident of the extremely strong, motivated operational management who had an enviable record of hitting their forecast numbers.

Parkwalk believed the acquisition of MPEC provided an exceptional opportunity which almost doubled the company's sales and provided a new product line with substantial contracted revenues.

Parkwalk expected this to be the beginning of a concerted M&A program by Tracsis and believed diversification would add to recurring revenues.
Since Parkwalk first invested:

- Acquisition of Sky High plc
- Revenues increased 600% in 4 years
- Number of employees increased 550% in 3 years
- Significant interest from Institutional shareholders

Parkwalk exited the investment in June 2014 at 308.5p resulting in a 9.9x return for investors inclusive of EIS Relief over 3 years.

AMOUNT INVESTED AND ANY CO-INVESTORS:
Parkwalk, Downing, IP Group and others: £2million

XEROS LIMITED

Investment Date	2010 to 2013
Sector	Chemicals & Materials
Location	Sheffield
Employees	33

xeroscleaning.com

ABOUT XEROS LIMITED:
Xeros has developed a revolutionary 'virtually waterless' laundry cleaning system, using nylon beads to remove dirt from clothes, which creates a step change reduction in water, energy and detergent use and cuts effluent production compared to aqueous wash cleaning.

Xeros came 2nd in the top 100 '2010 Best Inventions' by TIME Magazine and was cited in the WWF's survey of global 'Green Game-Changers'.

The company has since won numerous accolades, including Rushlight, Climate Week and Edison awards and was named University Spin-Out of the Year in the New Energy & Cleantech Awards 2014.

RATIONALE FOR INVESTMENT:
Parkwalk first invested in Xeros in a Series 'A' round in October 2010 alongside IP Group, Entrepreneurs Fund and Enterprise Ventures.

Parkwalk was convinced by the huge potential savings of a laundry system that used 10% of the water, 25% of the detergent and 50% of the power.

Xeros listed on AIM at 123p per share in a £30m fund-raise in March 2014 at a valuation of £80m. New investors included Baillie Gifford.

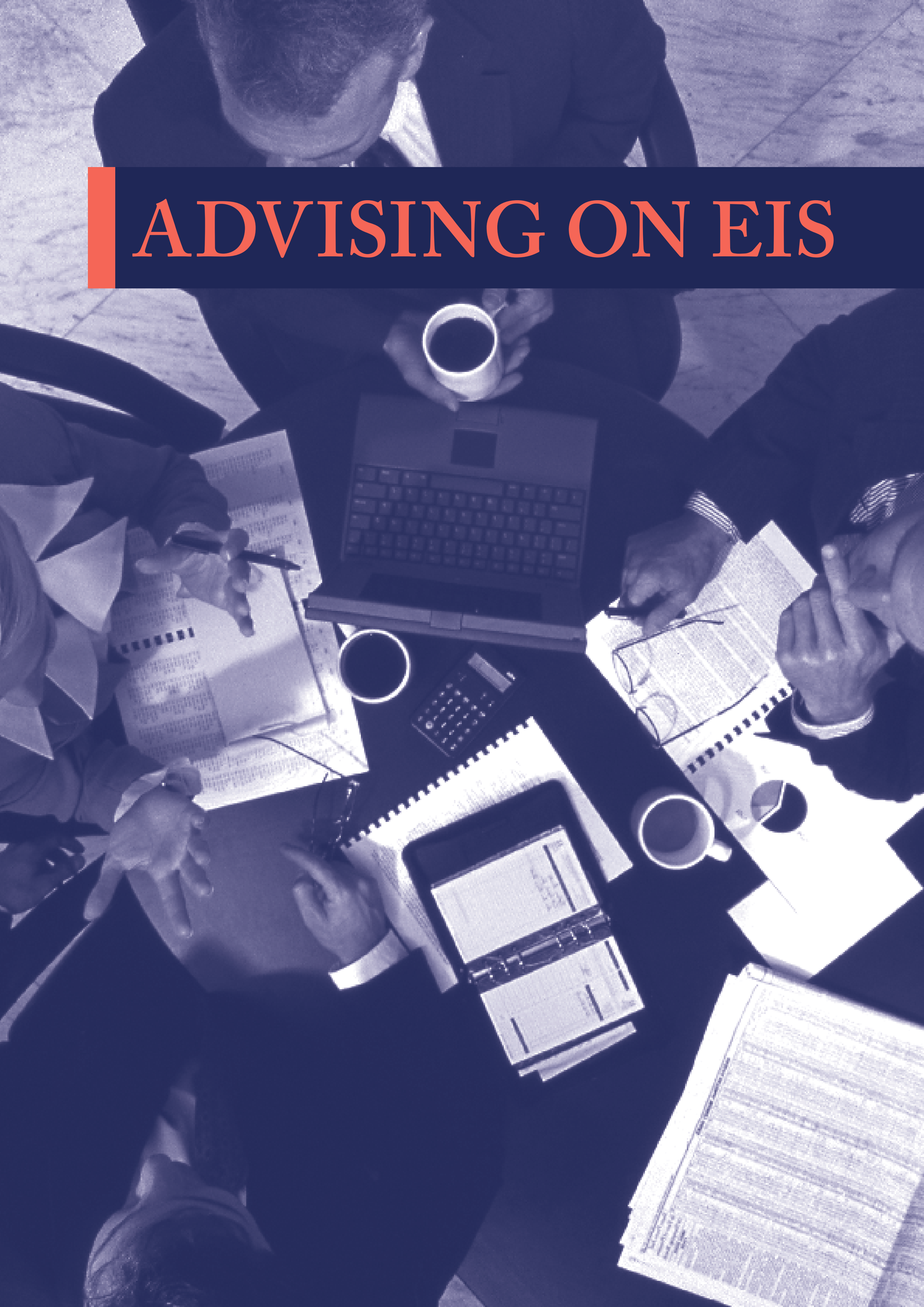
Parkwalk remains convinced that:

- Xeros is showing excellent traction with global multi-nationals and tier-1 equipment manufacturers, chemical companies and end-users
- Water shortage and effluent pollution are key global challenges
- There are multiple revenue streams accessible to Xeros in substantial markets

This represented a 4.7x return for investors inclusive of EIS Relief over 3½ years.

AMOUNT INVESTED AND ANY CO-INVESTORS:
Parkwalk, IP Group, Invesco Perpetual, Entrepreneurs Fund, Enterprise Ventures, Baillie Gifford and others: £45million

ADVISING ON EIS



ADVISER CONSIDERATIONS

As with any investment, the advice process is all about ensuring the product is appropriate and suitable for the client, and that they understand the investment objective and the risks associated with it as well as the investment itself.

First the adviser must understand and assess the client's individual circumstances. This includes documenting their tax and planning needs. Do they earn a level of income or pay sufficient tax to warrant EIS investments?

Then comes the appropriateness test. Does the client have the necessary knowledge and experience to understand the investment? Questions to ascertain this would typically be around the charges, the T&Cs, the liquidity and the risks. The appropriateness test is really designed for non-advised, execution only investments – if an investor is receiving regulated advice then these issues should be covered as part of the wider advice process.

The suitability test centres around whether the investment meets the client's financial objectives – it starts from the premise that the client has a financial plan or some financial objectives and the adviser's role is to ensure that the investment is well-placed to satisfy these.

SELECTION

The process for selecting the correct EIS investment should go through the following steps:

- Look at the clients' entire investment portfolio to see how this currently meets their requirements
- Highlight opportunities or circumstances where EIS investments will be appropriate to their needs
- Select a range of products that fit the investment objectives
- Reviewing the investment manager's track records
- Look at the underlying investments and overall investment strategies
- Obtain and review independent investment reviews where they are available
- Review the costs
- Select the most appropriate product
- Advisers should be conservative when assessing underlying company investments – there is a tendency to overestimate potential revenues and underestimate costs. Check what they are raising funds for and if the funds are really being used to deliver business growth

RISKS

As noted earlier in the report, small company investing is inherently risky – but advisers should not make the mistake of assuming that all EIS investments are equally risky. Well established and AIM listed companies both qualify for EIS status and should be lower risk than start-ups. Funds aiming for capital preservation should, in theory, be lower risk than those aiming for growth – although changes made in the 2014 Budget will impact the type and range of capital preservation opportunities available in the market.

Investors in EIS must have the right attitude to risk – in all likelihood, it will be a more aggressive approach to risk than the catch-all 'balanced'. They must also have some capacity for loss. EIS investing is not necessarily only about risk capital, but investors must be able to absorb losses.

CLIENT DISCOVERY

Picking out the right clients from a client bank should not be too hard – the focus should be on high net worth clients with enough investable assets to allocate to an EIS portfolio. Solutions for the majority of ordinary retail investors will likely focus on ISA's and pensions before EIS really comes into the picture. The FCA has been keen to point out the 'tax tail should not wag the investment dog', however, with tax breaks such a big part of the rationale for EIS investment, it would be difficult to justify extensive use of EIS investments if more mainstream tax solutions have not been implemented first. Overall the EIS benefits are stacked in favour of more wealthy individuals.

ADVISER SUPPORT

ADVISER SUPPORT

What support is available for advisers who want to learn more about investing in EIS and ensure that they have researched the whole of the market?

ENTERPRISE INVESTMENT SCHEME ASSOCIATION (EISA)

The EISA is an independent, not-for-profit organisation, which exists to assist in the flow of capital and resource available to British small and medium-sized enterprises through the Enterprise Investment Scheme and the Seed Enterprise Investment Scheme. The website provides details of the tax reliefs available and information for companies seeking investment, investors and advisers. The EISA runs a number of annual events. Technical seminars update members on regulatory and tax changes and have an industry speaker. The EISA Awards Ceremony takes place at the Chairman's Reception at the House of Lords. The Awards recognise excellence in various categories in the EIS industry. The EISA maintains close relations with the Treasury, HMRC and the FCA to ensure that EIS works in an efficient manner. One of their most important achievements to date was successfully lobbying against a proposed £50,000 cap on loss relief.

Membership is currently £850 per annum, for more information on the EISA or to apply please visit eisa.org.uk

EIS DIPLOMA

Tolley Exam Training has launched an EIS Diploma in conjunction with the EISA. The Enterprise Investment Scheme Diploma is a comprehensive on-line, ten hour self-study course followed by an exam. The syllabus covers all aspects of EIS, including the tax implications, regulatory aspects, EIS funds and portfolios. It demonstrates effective ways to utilise investments efficiently to maximise the benefits in an easy and understandable manner.

The diploma is a comprehensive way for advisers to evidence their knowledge and understanding of the EIS market. The total cost is £335 including VAT.

For more information or to register visit the EISA website at eisa.org.uk

INDEPENDENT REVIEW SITES

There are a small number of independent organisations carrying out investment reviews of EIS opportunities:

Allenbridge provide subscribers with their Allenbridge Tax Shelter Report, a newsletter, an online database of VCT and EIS investment opportunities, listing open single company opportunities, funds and managed portfolios and, where they have been requested, they also provide their investment reviews for subscribers. These give an in-depth view of the investment opportunity covering the sector, the management, the terms of the investment and possible risks and returns.

Martin Churchill operates the Tax Efficient Review.

A new entrant into this space will be MICAP, which proposes to operate a similar business model with higher levels of online functionality and a broader range of reports.

Allenbridge Tax Shelter Report can be found at taxshelterreport.co.uk

Tax Efficient Review can be found at taxefficientreview.com

MICAP can be found at micap.com

Advisers using these services can evidence they have researched the investments they are putting their clients into. These services, in combination with general market research and the EISA diploma, should put advisers in the best possible position to advise on EIS investments.

Although not to be considered independent, some national IFAs and wealth managers do have in-house research teams which identify and review EIS opportunities which can then be recommended by their advisers. The level of due diligence undertaken may vary by firm and they may not cover the whole EIS market. This can, though, aid advisers in identifying and recommending suitable EIS opportunities to their clients.

EVENTS

Like many mainstream investment providers, EIS distributors and EIS investment providers either host or participate in a number of events aimed at promoting their products. These events usually have a combination of educational and promotional elements, so their independence can be questioned, but it is a format all advisers are familiar with.

Some relevant events include, the FT Adviser's Tax Efficient Investing Conference, the VCT and EIS Investor Forum from Angel News, the EIS and Angel Investing Showcase and our own Alternative Investment Summit devoted several sessions to EIS.

Providers that have been active in organising and participating in educational events for advisers include Rockpool, Kuber Ventures and Octopus among others.

Attendance at these events gives advisers the opportunity to refresh their knowledge and learn about new products and developments in the marketplace.

THE EISA TOLLEY'S DIPLOMA

- Comprehensive online, self-study diploma covering EIS
- Designed to give finance professionals an in-depth understanding of EIS, covering tax implications, regulatory aspects and the wider EIS landscape
- Launched in 2014
- Comprehensive study manual, question bank and online package including mock examinations
- Interactive examinations taken at a time to suit participants
- EISA accredited certificate on completion

DISTRIBUTION OF EIS

Distribution of EIS investments has traditionally been a rather low key affair. The biggest EIS investment providers would distribute their products via a network of advisers who they had established a good working relationship with. This worked well for both parties – the providers knew the advisers gave them access to the right category of investors (indeed, many investors were rolled over into similar EIS funds whenever one closed) and the advisers had products from providers that they knew and trusted.

This worked because there was a lot of knowledge and trust throughout the distribution chain, and the majority of EIS investments are still distributed in the same way today. However, it does mean that there are challenges for new investment providers to overcome – they have to earn the support and respect of advisers and this makes it very hard for new market entrants to challenge the status quo. Well established managers know they can distribute through this route, but EIS funds run by new managers or new single company EIS investments looking for distribution through IFAs have to undertake a very large business development task to attract advisers.

To our knowledge there are no firms focused solely on the task of independently distributing EIS investments to advisers (i.e. they are not a provider, an industry body or investment broker). Ram Capital is a pure distributor who focuses on EIS as well as VCTs and other products aimed at tax planning; there are a number of online discount brokers who distribute EIS alongside VCTs and mainstream funds. These organisations would be the closest to pure EIS distribution businesses.

The Allenbridge Tax Shelter Report, Tax Efficient Review and EISA websites all have reasonably comprehensive lists of current open opportunities. When MICAP launches, they plan to offer a facility for advisers to search, compare and build sample portfolios of all the current EIS offers in their online database.

One barrier to the distribution of EIS investments is that they are not held on the large investment platforms such as Transact or Cofunds. These are very popular with both advisers and clients, with over £274bn in assets held on platforms (Platforum), and it is estimated that between 70-80% of all new transactions now take place on a platform. Clearly being able to be held on platforms would be a massive boost to distribution.

To date there have only been tentative moves in that direction, primarily from the EIS platform providers who are seeking to build strategic links. The main consideration with EIS investment through a platform centres on the illiquidity of unlisted companies. The majority of investment platforms focus on mainstream investment opportunities, which are traded and therefore considered lower risk and liquid from a regulatory stand point. Platforms are set up to support listed investments, which can be easily bought and sold and are often considered more suitable to ordinary retail investors. There has been much less demand from advisers and investors to hold more alternative and tax efficient products through investment platforms, and there are also additional costs and regulatory restrictions to be considered. Advisers would have to weigh up the additional platform costs against the flexibility that investment platforms provide.

PS13/03: Restrictions on UCIS and other Non-Mainstream Pooled Investments

EIS (and VCT) investments escaped the restrictions placed on other 'esoteric' or Non-Mainstream Pooled Investments (NMPIs) contained in PS 13/03, which came into force on 1 January 2014.

Initially, the draft policy statement wording had appeared to capture EIS and VCTs. However, after some effective lobbying during the consultation process the regulator was persuaded that EIS and VCTs already have strong corporate governance measures in place and were not as risky as the products it was primarily concerned about, such as Unregulated Collective Investment Schemes and Qualified Investor Schemes.

This means that regulated advisers can still recommend EIS investment to any client who they felt met the appropriateness and suitability tests.

PS14/04: Restrictions on Crowdfunding

However, the new crowdfunding regulations will have an impact on the promotion of EIS investments. These rules impact 'direct offer' financial promotions, where investors receive promotional material and can then respond directly to the product provider – such as a response form. Note that this applies both on and off-line.

Before making a direct offer financial promotion, firms will now need to check that a retail investor is appropriately certified.

In addition to the familiar high net worth and sophisticated investor certificates, a third route of certification has been introduced for retail investors. Individuals who restrict themselves to investing only 10% of their net investable financial assets in 'non-readily realisable securities' can also be promoted to.

Firms will also have to apply an appropriateness test before allowing an investment to be made.

These rules apply to 'non-readily realisable securities' – a bit of a mouthful, referring to illiquid securities where there is only a very limited secondary market.

KEY POINTS

- The EISA, Allenbridge Tax Shelter Report, Tax Efficient Review and MICAP can all provide information on the market that can support advisers, including investment reviews
- Investment performance data is difficult to obtain and it will require an industry-wide consensus to address this issue. The lack of data remains an obstacle to investment
- Advisers need to be careful, but not overly cautious when recommending EIS investments. Generally they are going to be more suitable for wealthier clients who are close to maximising more mainstream tax allowances or have tax liabilities that they wish to offset

MARKET RESEARCH

RATIONALE

We regularly conduct surveys of market participants including financial advisers, wealth managers, professional intermediaries, investment providers and private investors.

The intention is to build a picture of how the market works – how much business is being done, which segments of the market are successful, what activities drive growth and what obstacles stand in the way of progress. Ultimately the results of these surveys help to identify emerging trends, threats and opportunities and inform our readers about the latest developments in the market.

We have undertaken two surveys as part of this report, one focused on advisers and one on private investors. Each survey took participants less than 10 minutes to complete. The questions were straightforward and easy for participants to answer.

METHODOLOGY

All of our surveys are built in-house and hosted online. We primarily collect quantitative data to help identify emerging trends within the market. These are supported by a small number of qualitative questions that allow us to draw conclusions about market sentiment and provide context to current market trends.

CONFIDENTIALITY AND USE OF DATA

All of the survey results are kept completely anonymous and treated in the strictest confidence. We do not share underlying data with any third parties or publish it elsewhere.

ADVISER SURVEY

INTENTION OF THE SURVEY

Our intention was to gain an insight into how advisers perceive EIS investment products – how they use them within client portfolios, what criteria they use to select EIS investments, and what they look for and expect from EIS managers.

The survey sample also included advisers who do not currently use EIS investments. We wanted to find out what factors make them hesitant – is it down to the type of clients they service, their perception of the risks attached to EIS or the difficulty in understanding EIS and ensuring they have whole of market knowledge?

The survey did not ask questions about specific managers, we wanted to establish a general view on EIS managers and investment opportunities. The survey was conducted as an independent exercise solely for inclusion in this report.

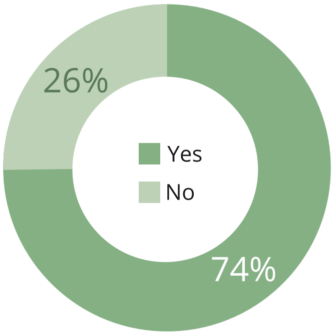
By participating in the survey, we hope that the responses and opinions provided by advisers can help to shape future EIS offerings. These responses allow us to draw out trends and developments within the market, which will ultimately enable EIS managers to develop their propositions and deliver products that best meet the needs of investors.

The survey was sent to a database of advisers (both independent and restricted), financial planners, wealth managers and financial intermediaries. Respondents were provided with an incentive to participate in the survey with the chance to win £250 in shopping vouchers and receive a free hard copy of this report.

The survey included up to a maximum of 20 questions and was dynamic – questions changed depending on the answers given and the route the respondent took. The most interesting and insightful questions have been selected as part of this analysis.

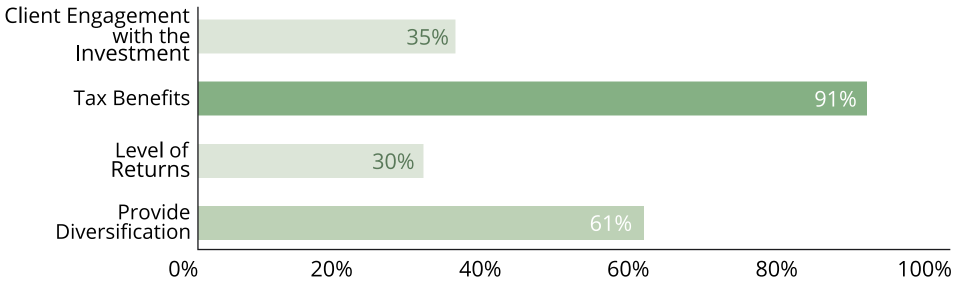
We had 78 respondents to the survey, including a mixture of IFAs, paraplanners, restricted advisers, wealth managers and financial intermediaries.

Q. Do you recommend EIS investments to your clients?



A. EIS investments are often higher risk as they focus on small start-up companies, but in return the investor is given generous tax benefits and is often rewarded with higher returns. We wanted to gauge how financial advisers viewed EIS investments and how they use them with their clients. Almost three quarters (74%) of survey respondents recommend EIS investments to their clients. The remaining 26% do not recommend EIS and the reasons for this have been analysed later.

Q. For what reasons do you recommend EIS investments to your clients?

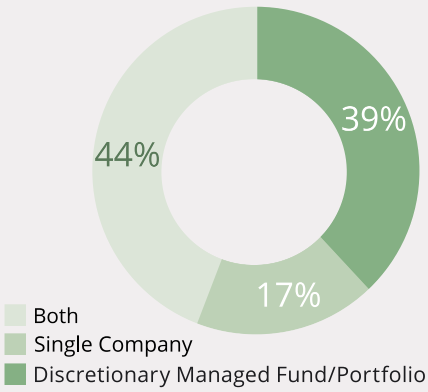


A. Respondents were able to choose more than one answer to this question. Focusing only on the 58 respondents that do recommend EIS investment to their clients – 91% cited tax benefits as one of the main reasons to recommend EIS investments and 61% said that diversification was a key reason for recommending them. The level of returns and client engagement were not seen as particularly important by respondents with 30% and 35% respectively. The tax benefits will often reduce the risk and magnify returns, but they may only really be beneficial for higher rate tax payers or investors looking to offset large capital gains.

Q. What structure of EIS investments do you most commonly recommend to clients?

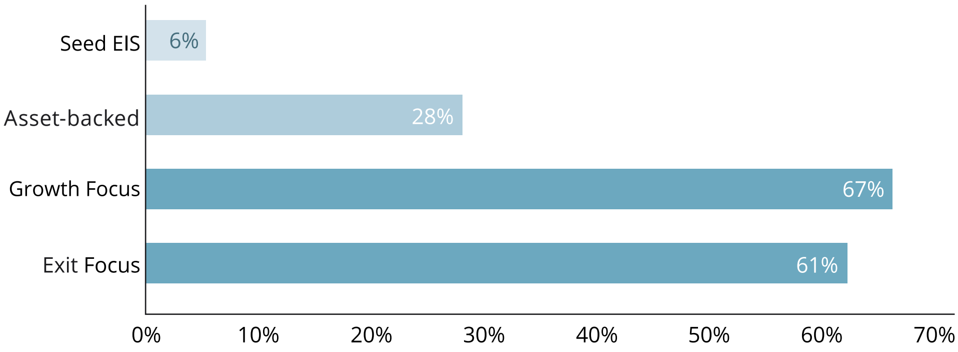
A. Participants were asked whether they recommend a discretionary managed fund (portfolio) of EIS investment companies, single company EIS investments or both to their clients. A discretionary managed fund allows the adviser to benefit from the expertise of an investment manager, rather than having to research each underlying company individually and choose the company that best suits their client – which takes time as well as expert knowledge. Discretionary managed EIS funds also provide diversification as investor's money is spread across a number of underlying companies. This does mean though that the adviser is putting their faith in the knowledge, experience and expertise of the investment manager and that the client has to pay an additional layer of charges.

The majority (44%) of respondents recommend both discretionary managed funds and single company EIS to their clients. 39% only use discretionary managed funds and a small number (17%) solely recommended single company investments to their clients.



The reputation and size of the manager was cited by 63% of the advisers as the most important consideration in their selection process.

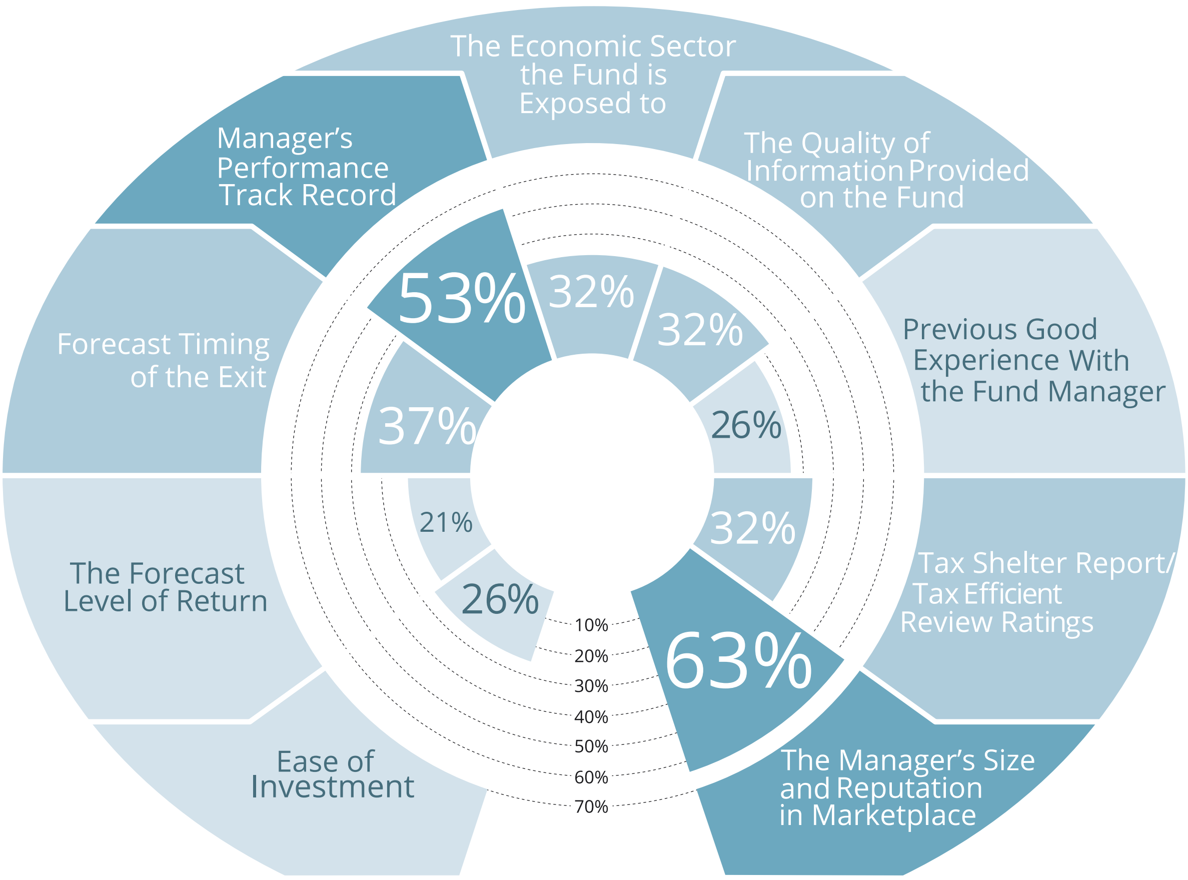
Q. Which EIS fund strategies do you recommend to your clients?*



*The following analysis is based on responses from advisers that recommended discretionary managed funds or both funds and single company investments. This accounted for 48 respondents in total.

A. Again respondents could choose more than one answer. This question highlights the investment strategies that advisers favour, but of course these are only top level strategies. Advisers may favour certain investment managers, sectors or specific types of opportunities The majority of respondents choose investment strategies that have either a growth or exit focus – 67% of advisers recommend growth focused and 61% exit focused strategies. These two options provide for clients looking for high returns (growth) or tax benefits (exit). 28% of advisers recommend asset backed investment opportunities which provide capital preservation and typically include renewable energy, which can achieve steady returns over the medium to long-term. Only 6% of respondents recommend Seed EIS (SEIS) investment strategies which often focus on very small start-up companies that can be significantly more risky.

Q. What are the most important criteria when choosing an EIS fund?

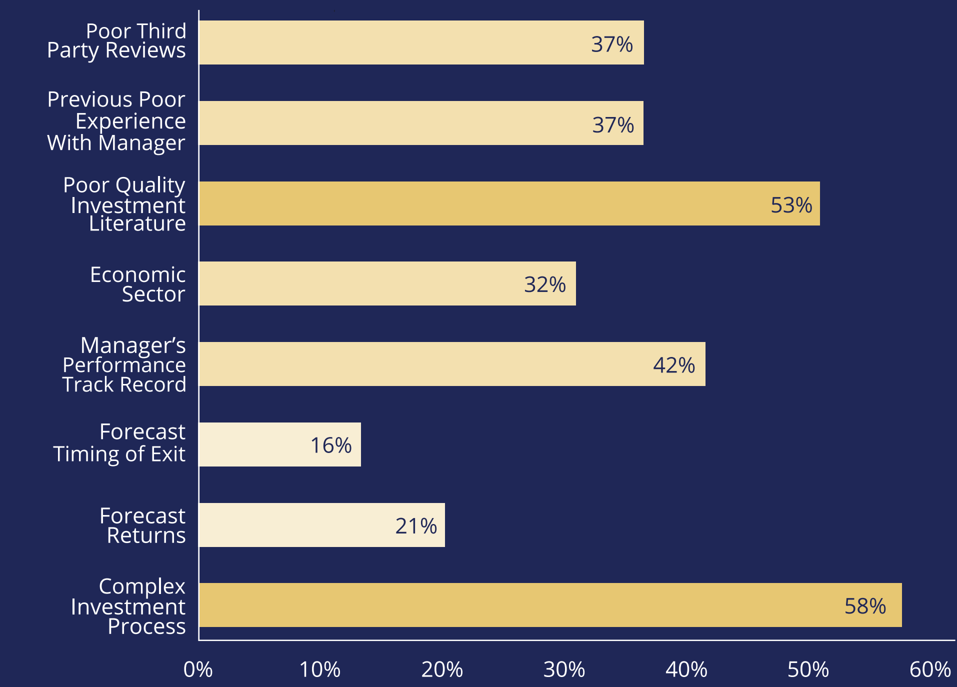


A. Advisers have a number of considerations when choosing an EIS fund. The reputation and size of the investment manager was cited by 63% of the advisers as the most important consideration in their selection process. 53% said that the manager's track record was one of the most important considerations when choosing an EIS fund. Other criteria such as the forecasting timing of the exit, the economic sector of the fund and the quality of information provided by the fund manager were also important considerations. Perhaps rather surprisingly the forecast level of return was seen as the least important consideration, with only 21% of advisers including this.

SECTOR PREFERENCE (ADVISER):

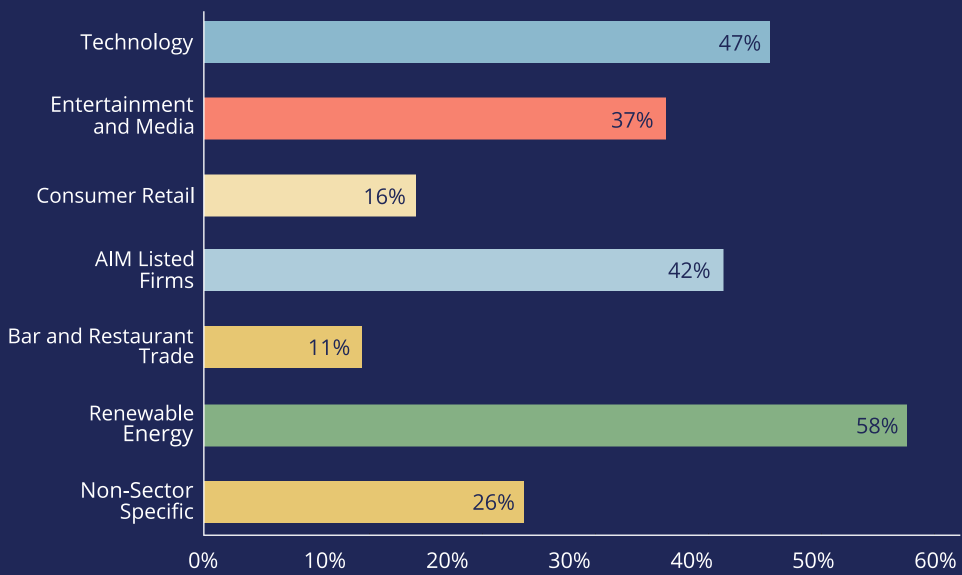
Q. Which factors are most likely to make you hesitant about recommending an EIS fund?

A. The most common reasons cited by advisers as to why they may hesitate before recommending an EIS fund is due to it having a complex investment process, with 58% of respondents selecting this response. Rules and regulations surrounding EIS investments could be seen as complicated involving a large amount of paperwork, which could put advisers off recommending a certain product. The poor quality of information provided on the fund was seen as the second most common reason to hesitate recommending an investment with 53% of advisers considering this to be an issue. Providing regular reporting and detailed information can really add value to the manager's investment proposition. The knowledge, experience and track record of the fund manager is seen as another important consideration for advisers, with 42% citing the manager's track record and 37% a previously poor experience with the fund manager as reasons to hesitate recommending an EIS fund.



Q. What are your preferred sectors for EIS fund investments?

A. Renewable Energy was highlighted by 58% of advisers as being their preferred investment sector. This may be down to the number of energy opportunities available in the market place which provides choice and competition, the government support behind the sector (through renewable obligation certificates) or that energy investments are often asset backed and offer steady returns over a relatively long period of time. They can also appeal to investors as they have a green halo affect and can support local economies and the local community. Other popular investment sectors include Technology with 47% and AIM listed funds. Niche sectors such as Consumer Retail (16%) and Bars and Restaurants (11%) are less popular, which could be attributed to there being a smaller number of investments available, less competition in the market or a perception that they are higher risk.

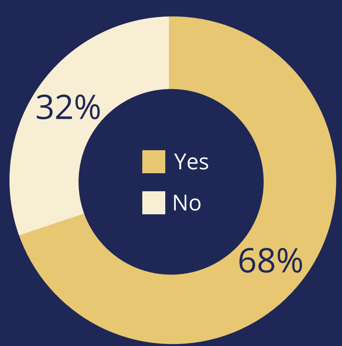


Q. Do you feel that there is enough competition in the EIS market?

A. It is important to identify whether advisers feel they have enough choice and whether there is enough competition in the market. Competition is generally seen as healthy as it lowers costs and improves efficiency.

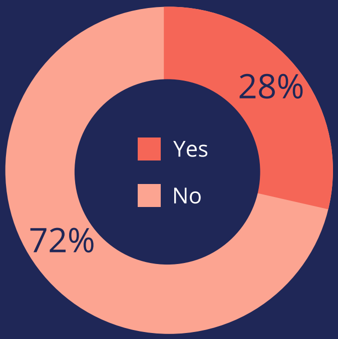
68% of advisers that recommend EIS funds said they are happy with the amount of competition in the market. The remaining 32% said that there is not enough competition in the market which leaves room for new entrants and new investment propositions.

This could also be seen as an opportunity for firms already operating in the space to improve their investment offerings to attract new business.



"Advisers need good quality information covering the nature of EIS, the practical process of investing and the many ways of using EIS as part of a broader financial strategy" **Andrew Sherlock, Oxford Capital**

Q. Do you feel that there are enough resources and information available to enable advisers to achieve whole of the market knowledge of the EIS sector?

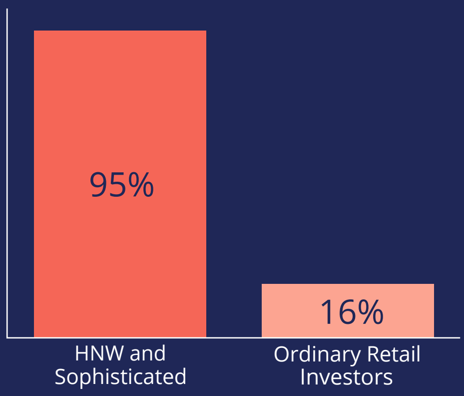


A. Being an education and content provider this is a very interesting question for us. 72% of advisers feel that there are not enough resources and information available on the EIS sector. Although the EIS has been available since 1994 and there are a number of well-established managers in the market, advisers feel that they still do not have enough resources to gain the whole of market knowledge they require to fully understand the sector and recommend these products to their clients. It seems there is definitely scope for more education and training in this space, which should ultimately improve the market for everyone involved.

Q. Which EIS investment managers and platforms have you had dealings with?

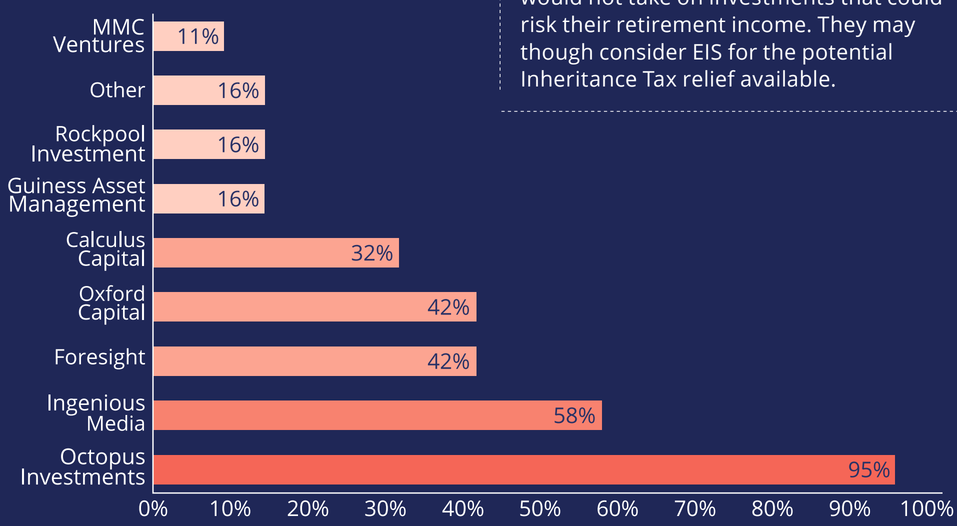
A. Octopus Investments was by far the most widely known EIS manager with 95% of advisers having dealings with them. This is likely due to their track record and existence in the EIS market for a number of years. Other well-known managers include Ingenious Media with 58% and Oxford Capital and Foresight, both with 42%, and managers with a smaller presence including MMC with 11%. It appears advisers stick to managers that they have had previously good experiences with, making it hard for new entrants or competitors to attract these advisers. Many of the advisers questioned had not used a manager that wasn't listed above. Interestingly just over a quarter of advisers use only one EIS manager, but some use as many as nine and a large number use between five and seven managers. On average advisers use between three and four EIS managers. Other EIS managers and platforms that advisers use include Kuber Ventures, RAM Capital, Downing, Motion Picture Capital, Triple Point and Par Equity.

Q. What category of client do you recommend invest in EIS funds?

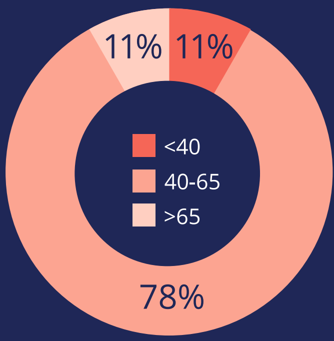


A. Advisers were asked whether they recommend EIS to HNW and sophisticated investors or ordinary retail investors (they could also tick both). Unsurprisingly the vast majority only recommend EIS to HNW and sophisticated investors, with only 16% seeing them as suitable for ordinary retail investors.

EIS investments generally involve a large amount of risk and capital can be tied up for a number of years. The tax reliefs offset some of this risk, but the majority of ordinary retail investors will not be higher rate tax payers and therefore will not receive the maximum benefit from these tax breaks. Therefore HNW and sophisticated individuals are usually considered a better fit for EIS investments as they will take full advantage of the tax relief available, have a greater understanding of both the underlying investment and the risks involved and also have a greater capacity for loss should the investment fail.



Q. What age is your average EIS investor?



A. The typical age of an EIS investor is between 40 and 65 years old. Investors in this age group will usually be at (or approaching) the peak of their working life (and income), may have children that have recently flown the nest and will be focused on building a portfolio of investments to provide for their retirement.

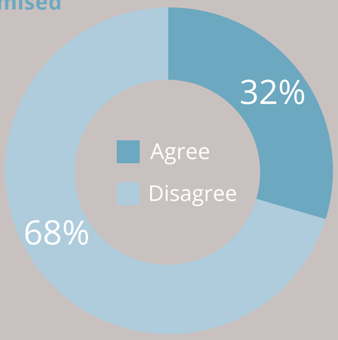
They may also have surplus income which they can afford to allocate to riskier investments such as EIS in the search of higher returns.

Only 11% of advisers recommend EIS investments to investors below the age of 40 or above the age of 65. Younger investors may not have the capital to allocate to these types of investments as they are likely to be focused on buying a property and/or starting a family. However, there is potential for growth from this age group as they pay more attention to saving for retirement, and they may also have a higher capacity for loss, as any losses can be made up through future earnings.

Investors in the over 65 age group are likely to be in retirement and therefore would not take on investments that could risk their retirement income. They may though consider EIS for the potential Inheritance Tax relief available.

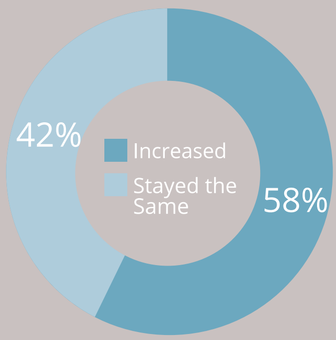
"Increased knowledge of the market, long-term relationships with EIS managers and a strong track record of success should lead to more use of EIS investments by advisers"

Q. EIS are only appropriate when both ISA and pension allowances have been maximised



A. Respondents were asked whether they agree or disagree with this statement. Only 32% believe that EIS investments only become appropriate once other tax efficient saving/investment vehicles have been used up. The majority believe that EIS can sit alongside these other options as they can offer other benefits, such as interesting investment concepts, diversification and high returns, which cannot be found through ISA and pension held investments. EIS are also often used to offset capital gains and for inheritance tax planning, advantages which don't come with ISAs or pensions.

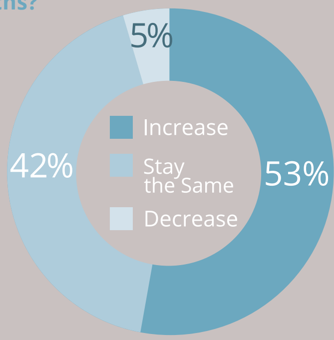
Q. Did your use of EIS in client portfolios change over the last 12 months?



A. 58% of the advisers surveyed said they had increased their use of EIS investment in client portfolios over the last 12 months. This could be attributed to a number of factors including an increase in the size of companies receiving EIS investments, an increase in the amount investors can invest into EIS in a single tax year and also a reduction in annual pension contributions and the lifetime allowance.

There may also have been appetite from investors looking to offset capital gains achieved elsewhere due to the relatively strong performance of property and equities over the last 12 months. Added to this, there has also been an increase in promotion and awareness in the sector and an increase in the number of opportunities available, which could have made EIS more attractive to advisers.

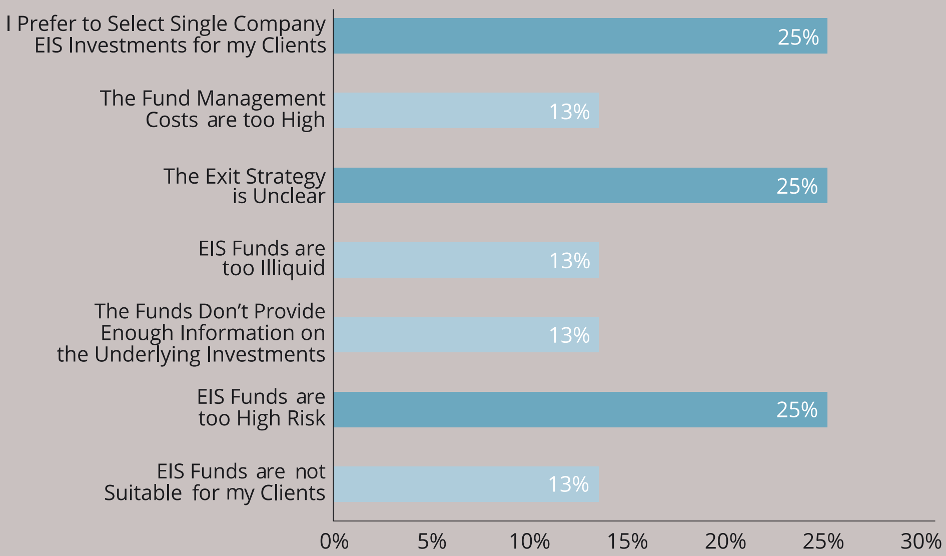
Q. Do you see your use of EIS in client portfolio changing over the next 12 months?



A. When asked whether their use of EIS investments will change over the next 12 months, 53% of advisers believe this will increase, while 42% feel it will stay the same. Only 5% see a decrease, although it is unclear why they think this is likely. As advisers increase their knowledge and understanding of the market, develop long-term relationships with EIS managers and as managers begin to evidence strong track records of success it is likely to lead to more use of EIS investments by advisers. On the other hand, if the government cuts support for the sector, or the UK economy falls back into recession, this picture could change dramatically.

Q. For what reasons do you NOT recommend EIS funds to your clients?*

A. There wasn't a particularly high response rate to this question, but the most common reasons cited by respondents for not recommending EIS funds to their clients include that they are deemed too high risk or the exit strategy is unclear. Respondents also prefer the flexibility and control of picking single company EIS investments, which could result in investments that are more suitable to their clients. As echoed elsewhere, advisers also feel that fund management costs are too high and there is not enough information provided on the underlying investments. These are two areas which need to be addressed by EIS managers.



*Answered by the 10 respondents who only recommend single companies. Respondents could tick more than one answer.

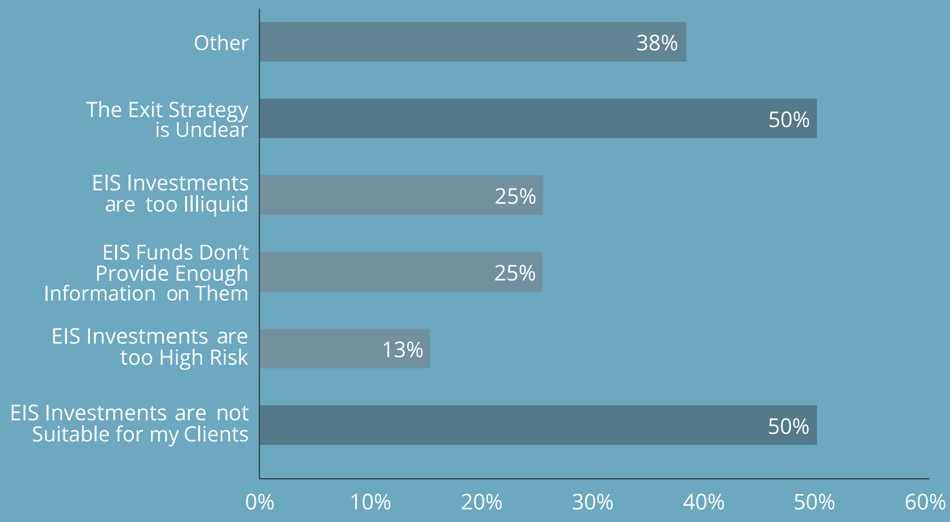
"Fifty eight percent of advisers felt that they will increase their use of EIS investments during the next 12 months"

Q. For what reasons do you NOT recommend EIS investments to your clients?*

A. The main two reasons cited by 50% of advisers for not recommending EIS to their clients are that the investments are not suitable for their clients and that the exit strategy is too unclear.

There is a feeling from advisers that too much control is handed over to the investment manager and investors do not have any influence over when they can exit the investment, even after the initial holding term.

Other reasons given by advisers are that EIS investments are too high risk for their clients and that there is not enough information available to fully understand the sector or the underlying investments themselves.



*This question was answered by the 20 respondents who do not recommend EIS investments.

Q. What single development do you believe would most improve the EIS market?

A. We asked all survey participants what they believe could be done to improve the EIS market. The responses were generally very similar across four key areas:

- Availability on traditional platforms
- Greater transparency on charges
- Historical performance data
- More broker support/roadshows

There is clearly a need for advisers to have more information made available to them, particularly on historical fund performance and charges, which will allow for greater comparisons between EIS funds and investment managers. The traditional investment market has a wide range of tools and resources available, and many advisers are calling for the same level of detail making it easier for them to recommend and facilitate an investment.

KEY FINDINGS FROM SURVEY

- Growth (67%) and exit (61%) focused strategies were the two most common fund strategies recommended by advisers
- Technology and Renewable energy are the two most popular sectors for advisers
- 58% of advisers felt that they will increase their use of EIS investments during the next 12 months
- Although the majority of respondents advise on EIS, the lack of quality information available was cited as a major issue by both those that advise on EIS as well as those who don't
- Advisers felt that HNW investors and those with a larger appetite for risk are more suited to EIS investments, but benefits such as 100% Inheritance Tax relief could also be beneficial to ordinary retail investors
- 63% of advisers cited the fund manager's reputation as one of the most important criteria when selecting a fund
- 26% of advisers who recommend EIS funds stick to only one provider
- On average advisers recommend EIS investments from between three and four different providers
- Access to more information and historical performance data was highlighted by a number of respondents as being essential to help improve the EIS market

PRIVATE INVESTOR SURVEY

The second survey undertaken as part of this report focused on investors, with the aim of identifying their feelings towards EIS managers and investment opportunities. These results will also allow us to see whether advisers' and investors' views support each other and where their views differ.

The survey was sent out by a third party (www.angelnews.co.uk) to their database of 6,000 private investors which included a mixture of HNW and sophisticated individuals and ordinary retail investors. It should be noted that a large number of those surveyed are very knowledgeable investors and are likely to have had some previous knowledge or experience of this sector.

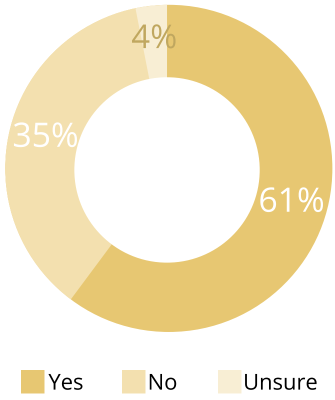
INTENTION OF THE SURVEY

The intention of this survey was to see how investors perceive the EIS sector: do they invest; how do they invest; what opportunities interest them; the types of investment structures and strategies they prefer; the criteria they use when considering a potential investment; their investment objectives and how EIS investments meet these objectives.

As with the adviser survey, this survey did not focus on specific managers and is not aimed to feed information back to managers about their position in the market. The survey has been undertaken independently in order to gather detailed information on the EIS sector to support the adviser survey and for inclusion in this report.

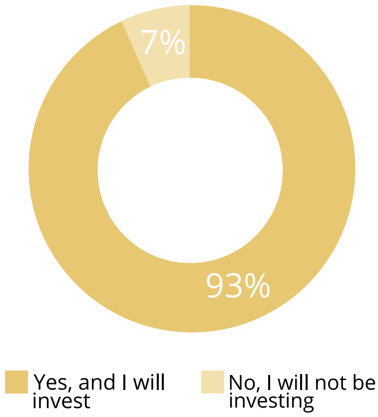
Our hope is that these responses will echo the adviser survey and will help to shape future offerings in the market, helping EIS managers to develop their propositions and deliver products that meet the needs of investors.

The survey included less than 20 questions and was relatively similar in nature to the adviser survey. The most relevant questions have been included in the analysis that follows.



Q. Do you currently hold any Enterprise Investment Schemes (EIS) Investments?

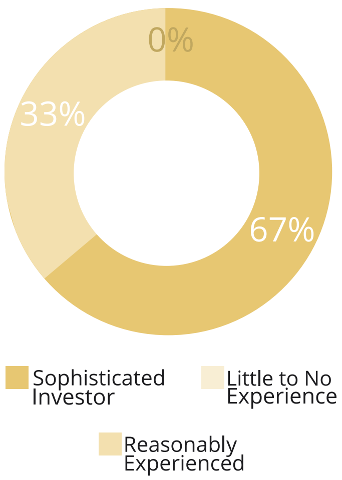
A. The enterprise investment scheme aims to help smaller higher risk companies raise funds from private investors, with investors receiving tax incentives and the possibility of strong returns to somewhat offset the risks involved. We wanted to gauge how many investors surveyed currently hold an EIS qualifying investment. 61% of investors surveyed said that they currently hold an EIS investment, compared to the 35% that do not. These results are not representative of the whole population but they do show that EIS investments are very popular among the sophisticated investor community.



Q. Have you ever considered investing in an EIS?

A. Investors who currently hold an EIS investment were then asked whether they would consider investing in an EIS again in the future. 93% said that they would consider investing again in the future and only 7% said they wouldn't.

We can speculate that this positive response could stem from previously good experience with EIS investments, a good relationship with the investment manager or from the numerous benefits that EIS investments can offer such as portfolio diversification; generous tax reliefs and the potential for high returns which can be hard to come by elsewhere. What it does show is that there is a lot of mileage for providers in returning to current investors with new opportunities, as well as trying to find new investors.



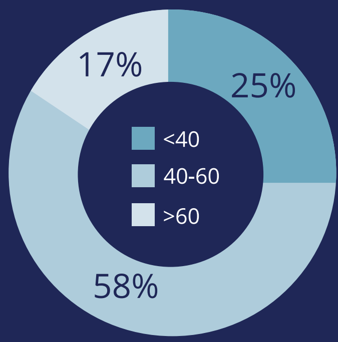
Q. Please state your investment experience.

A. 67% of respondents to the survey classed themselves as sophisticated and the remaining 33% as reasonably experienced. No one who completed the survey classed themselves as having little or no investment experience and therefore it is likely that every respondent has at least a good understanding of the market.

"Private investor respondents view the expected level of return as the primary objective when investing in EIS, with the tax benefits being much less important"

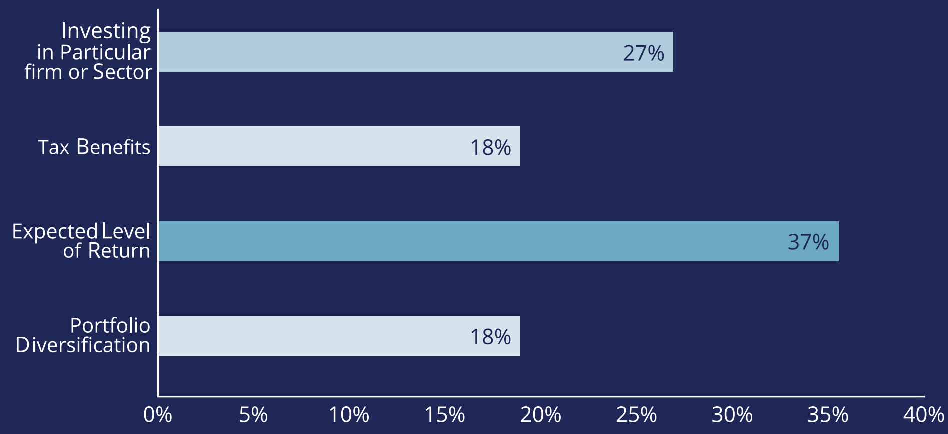
Q. Which age bracket do you come under?

A. The typical age of an EIS investor according to this survey is between 40-60 years old with 58% of respondents falling within this age group. As EIS are generally higher risk investments they are often not suitable for investors much older than the age of 60 who are more focused on capital preservation rather than improved returns – although they may consider EIS for potential Inheritance Tax relief. Younger investors below the age of 40 account for 25% of respondents. They may have more pressing financial goals such as buying a house or starting a family and not have the capital available to allocate to riskier EIS investments, although there are likely to be a number of high earners in this category who can afford to take on the risks as they can supplement any losses with future earnings. These results reflect the response advisers gave to this question.



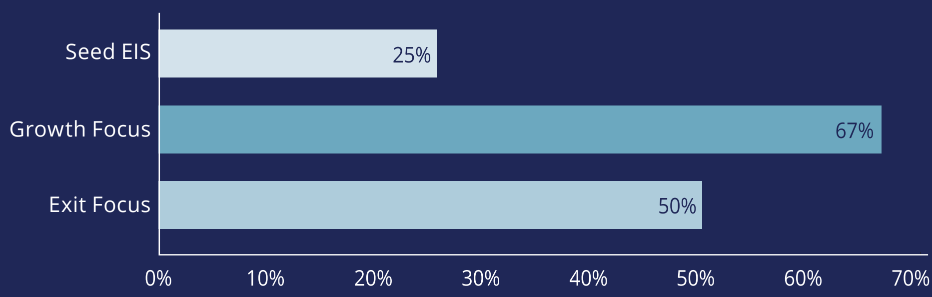
Q. What is your main objective when investing, or considering investing, in an EIS?

A. The expected level of returns was the most popular choice among investors and was cited by 37% as being their main objective when considering an EIS investment. This is in contrast to the adviser survey, where tax benefits were the primary consideration. Investing into a specific firm or sector from an angel point of view was chosen by 27% of respondents as being their main objective when investing. The EIS can provide a more direct way for investors to get involved with certain companies or sectors from a very early stage. The extra benefits that EIS investments can offer such as tax relief and diversification are also seen as important with 18% of respondents citing these.



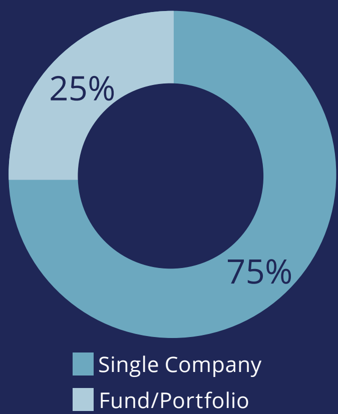
Q. Which are your preferred EIS investment strategies? Please tick all that apply

A. Investors were asked to choose the investment strategies that they prefer and could pick more than one. The two most popular investment strategies were growth focused chosen by 67% of respondents and exit focused chosen by 50%. These results mirrored advisers' responses to the same question.



Q. What is your preferred EIS investment structure?

A. Those who have previously invested through the EIS were asked whether they preferred investing in a discretionary managed fund, a single company EIS investment or both. A discretionary managed fund will spread risk across several underlying EIS companies and relies on the knowledge, experience and skill of the investment manager. Single company investments are likely to require far more research and due diligence on the part of the investor but will enable the investor to have complete control over which companies receive their money. 75% of investors prefer single company EIS compared to only a quarter who choose funds. As evidenced by their main objectives for EIS investing, many investors value the ability to invest in a specific company or sector of their choosing. Investing directly also removes an additional layer of charges.



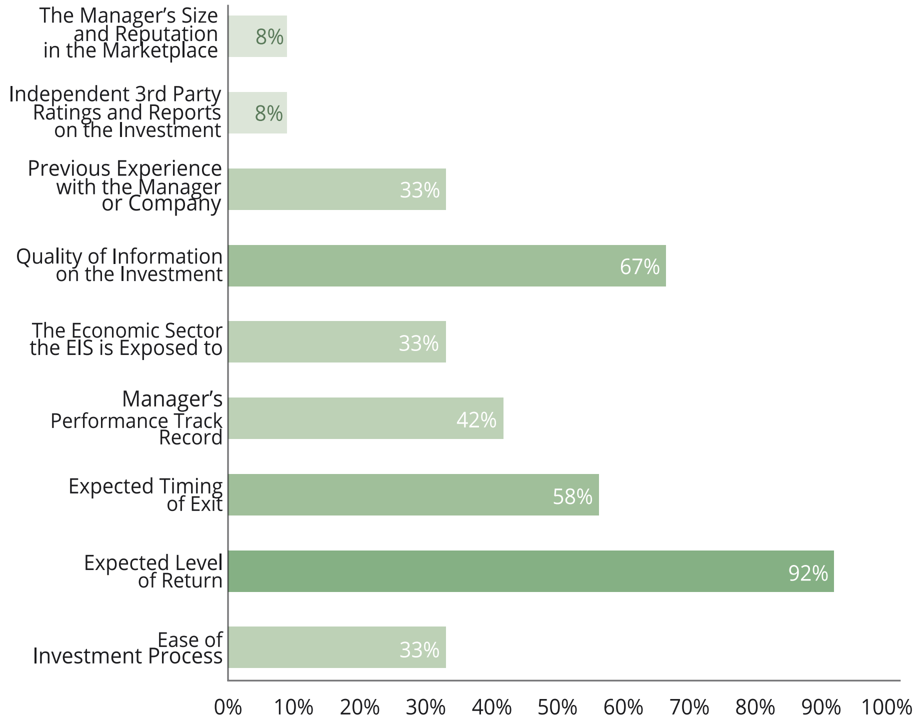
"Increased competition should create a better environment for investors, leading to more openness and transparency and ultimately better quality investment opportunities"

Q. What are your most important criteria when choosing an EIS investment? (Top 3)

A. Investors were asked to pick their top three most important criteria when considering an investment. The vast majority (92%) cited the expected level of return, 67% the quality of information available on the investment and 58% the expected timing of exit as being within their top three most important criteria when considering an investment opportunity.

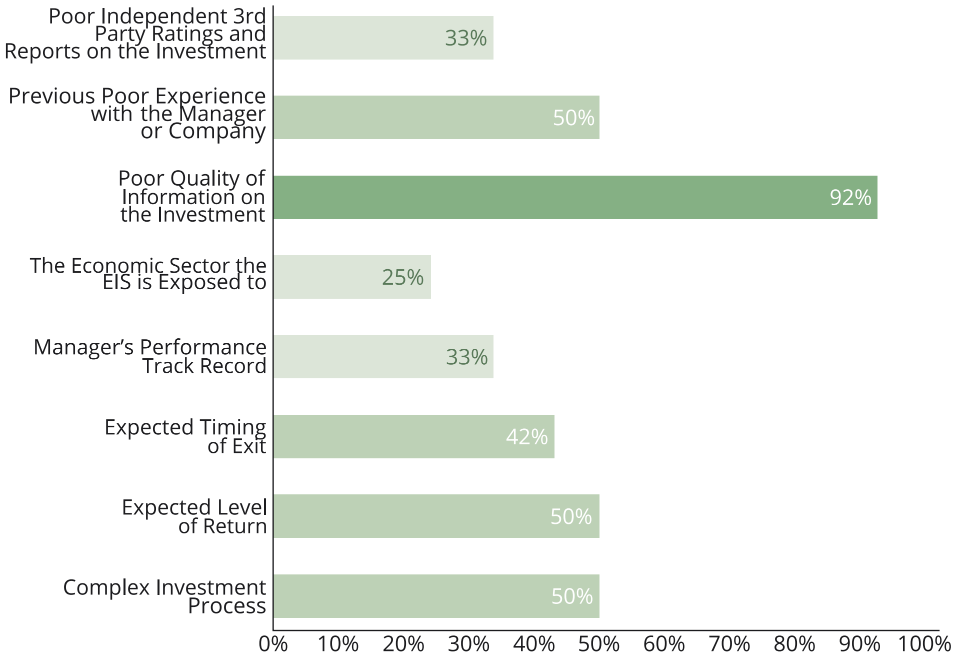
Returns have stood out throughout this survey as being extremely important for investors and as the risks associated to EIS investments are significantly higher than traditional investments it is important for investors to have quality information on the investment so that they can make an educated and informed decision.

Criteria picked by only 8% of respondents included the manager's size and reputation in the market place and 3rd party ratings and reports on the investment – this can be partly attributed to the large number of investors that choose single company EIS investments rather than using the services of an EIS investment manager. Identifying the kind of information that investors value most could help investment providers tailor their pitch more effectively.



Q. Which factors are most likely to make you hesitate about investing in an EIS? (Top 3)

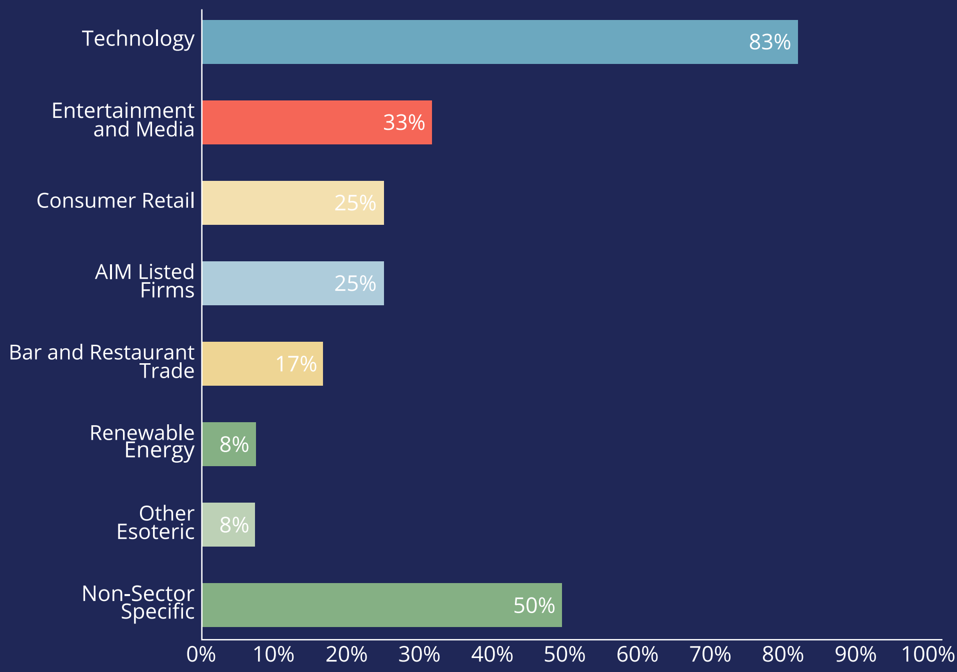
A. Investing into small start-up companies requires a lot of investment knowledge, research and due diligence on the proposition. Once again, the quality of information is important for investors with 92% of respondents saying that poor quality information would cause them to hesitate making an investment. Investment providers should again take note of this as clear, detailed and quality information on the investment could encourage more investors to consider EIS. Other factors that investors are concerned about include the level of return, having a complex investment process and previous poor experiences with the provider or manager (all 50%). The economic sector the investment is exposed to was seen as the least likely factor to make an investor hesitate with only 25% of respondents selecting this in their top three.

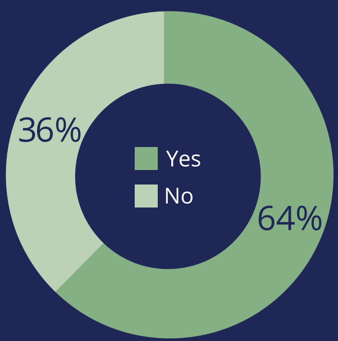


SECTOR PREFERENCE (INVESTOR):

Q. What are your preferred sectors for EIS investment? (Top 3)

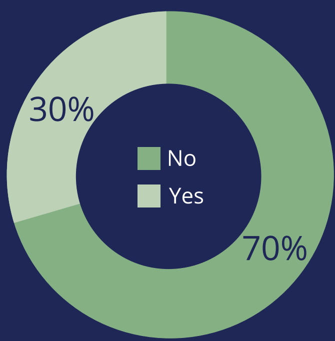
A. 83% of investors surveyed said that Technology was one of their top three preferred sectors for EIS investment, followed by 33% for Entertainment and Media. Technology is one of the best established EIS investment sectors with a huge range of investment opportunities available which can possibly explain why so many investors prefer this sector – and as a sector with many exciting small start-ups, it also presents the prospect of excellent returns if somebody can identify the next Google or Facebook. 50% of investors said that the sector is not as important as the specific investment opportunity. This highlights again how the quality of information and the potential returns on offer has a big influence on the decision making process.





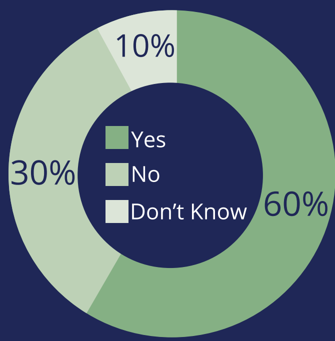
Q. Do you feel there is enough competition in the EIS market?

A. 64% of investors felt that there is currently enough competition in the EIS market, compared to 36% who believe there is not enough competition. These results were very close to the responses advisers gave. Increased competition should create a better environment for investors, leading to more openness and transparency and ultimately better quality investment opportunities. Respondents feel that there is too much dominance by the largest three EIS managers and EIS managers do not always take on enough risk. There is also a feeling that single company investments need more promotion and are often overshadowed by portfolio offerings.



Q. Do you feel EIS managers provide enough historical performance data?

A. Despite the substantial size of the EIS market over two thirds (70%) of investors feel there is not enough historical performance data made available from EIS managers. The quality of available information has been an important theme throughout these survey responses. The lack of coverage in the EIS market is felt by many investors and there is some way to go to create a more open and transparent marketplace. This may explain this groups' preference for single company EIS investments.



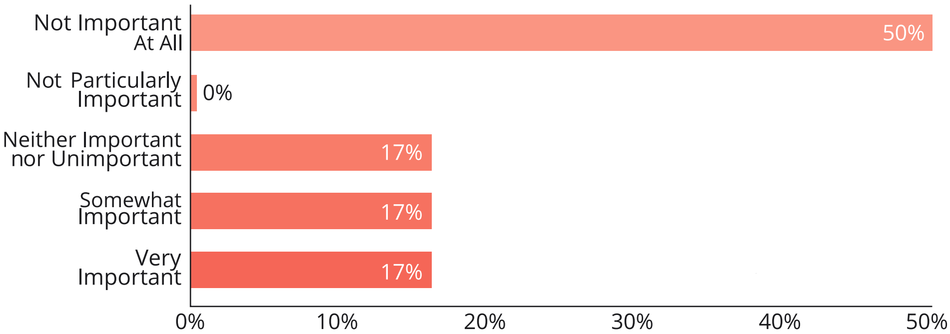
Q. Do you feel that there are enough resources and information available to enable you to understand the EIS market?

A. Along with the need to have specific information on each investment proposition, there is also a need to be educated on the EIS market as a whole. Knowledge is required to understand the tax reliefs available, the risks associated with investing in unlisted companies and the often complex investment process. 60% of investors feel that they have access to enough information to understand the market, while 30% believe there is not enough information available and a further 10% are not sure. There is definitely scope to further educate investors on the EIS market, but interestingly investors felt differently to advisers – 72% of advisers felt that there was NOT enough information available, perhaps reflecting their need for more information in order to comply with regulations.

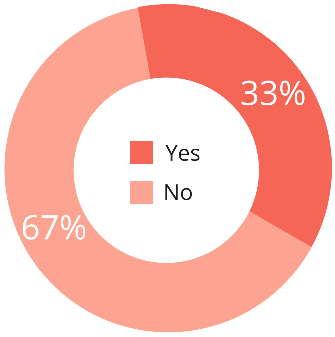
"75% of investors believe EIS should be considered alongside other tax efficient saving/investment vehicles"

Q. How important is independent financial advice when choosing an EIS investment?

A. The complex investment process often involved with EIS can require time and knowledge on the part of the investor. Investors were asked whether they felt taking financial advice was important when considering an EIS investment. 50% feel that it is not important at all, 17% feel it's neither important nor unimportant and a further 17% each feel that it's somewhat important or very important. The requirement to use an IFA is likely to depend on the knowledge and experience of the investor and the quality of information available on the investment – the majority of investors questioned feel they are able to choose an investment without the help of an IFA.

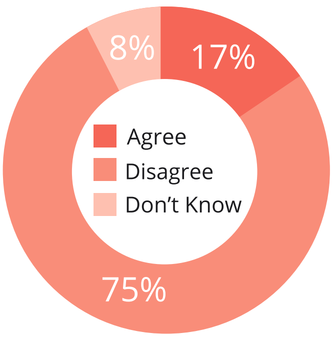


Q. Do you have an IFA?



A. Investors with a keen interest in angel investing, good knowledge of the EIS market and who are able to obtain quality information can possibly sidestep the need to use an IFA to invest in EIS. The remaining 33% do have an IFA who may have expert knowledge of the market and be able to assist with in-depth due diligence that the investor cannot afford to spend time on.

Q. EIS investments are only appropriate when both ISA and pension allowances have been maximised?



A. Respondents were asked if they agreed or disagreed that EIS investments should only be considered once the full ISA and pension allowances have been used up. The tax reliefs available from EIS investments are greater than other tax efficient forms of saving such as pensions or ISAs. They also offer further scope for investing across interesting and exciting sectors as well as offering the potential for very high returns. 75% of respondents disagreed with this statement as they feel that EIS should be considered alongside other tax efficient saving/investment vehicles. Their suitability will depend on the investor's strategy, tax situation and the level of diversification they are seeking. EIS investments also offer opportunities that are not available through the mainstream investment products available within pensions and ISAs.

Q. Please state what single development you would believe would most improve the EIS market?

A. There were several suggestions here that cover many different aspects of market:

- Better research on the sector
- Widely available investment platform
- Larger choice when it comes to low risk funds
- Better process for achieving advanced assurance
- More data on performance and track records

The main development that investors want to see is an improved process for submitting paperwork to HMRC for EIS approved status and advanced assurance to simplify the process for investors and speed up the receipt of tax reliefs.

KEY FINDINGS FROM SURVEY

- 93% of current EIS investors say they plan on investing in EIS again in the future
- The expected level of return was chosen by 92% of respondents as the most important criteria when choosing an investment
- 92% of investors see poor quality of information as a reason to hesitate when considering an EIS investment
- 67% of respondents selected growth as their preferred investment strategy
- 50% of investors feel that it is not important to seek independent financial advice when considering an EIS investment
- 75% of investors believe that EIS investment should be considered alongside other tax efficient investing/ savings vehicles

MARKET RESEARCH CONCLUSIONS

There are a number of conclusions that can be drawn between the EIS adviser survey and EIS investor survey. There were several points where concerns and opinions expressed in both surveys highlight important issues with the EIS market. Below are some similarities and differences that can be drawn between each survey:

Similarities:

- Both growth and exit focused investment strategies were the most popular amongst adviser and investors
- Poor quality of information and the complex investment process where cited by both advisers and investors as factors that make them hesitant about an EIS investment
- Around 70% of the advisers and investors felt there was enough competition in the EIS market
- Increased risks associated with EIS investment often makes them unsuitable for ordinary retail investors. Both advisers' clients and private investors tended to be more sophisticated and in the 40-60 years age group

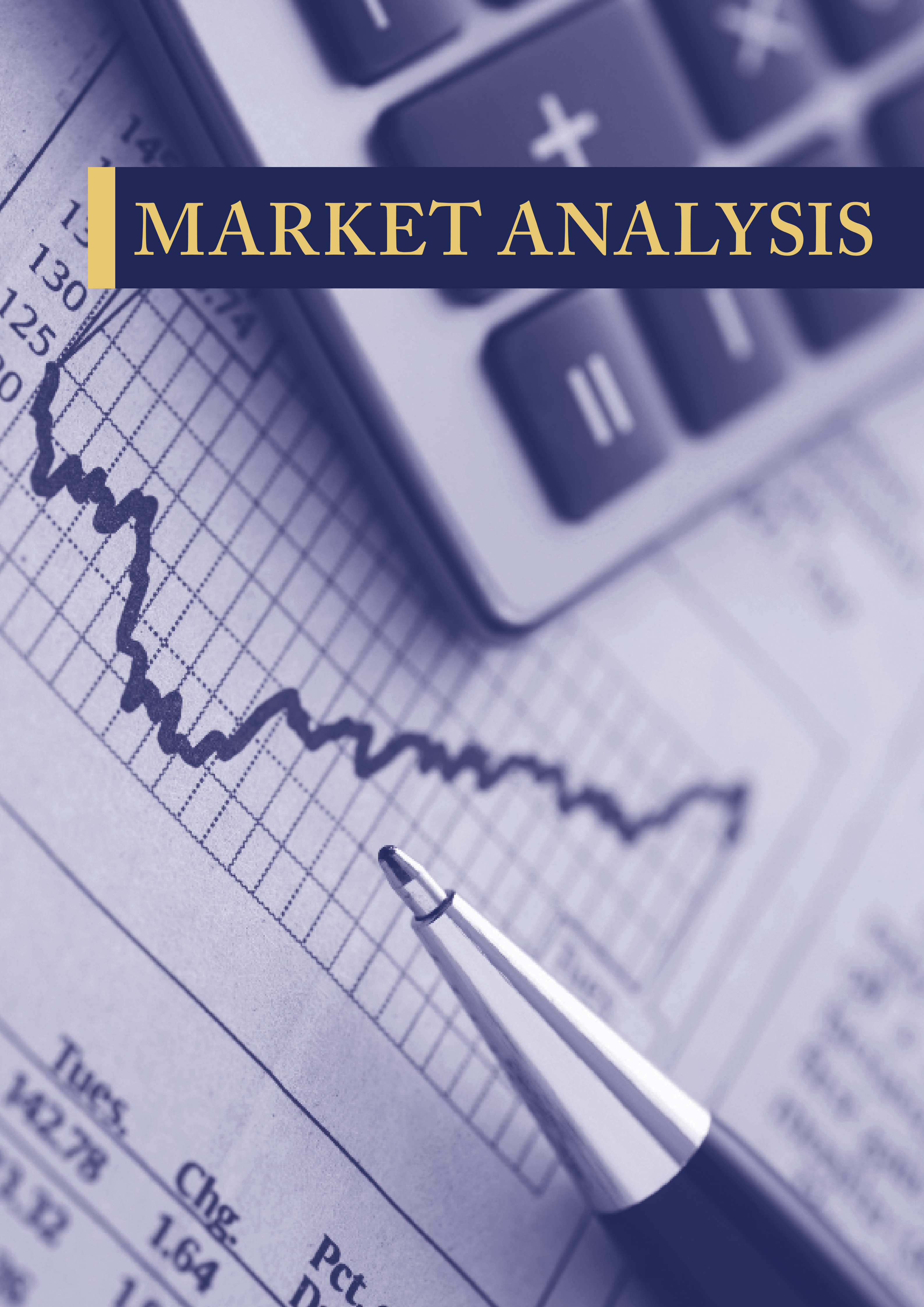
Differences:

- 91% of advisers recommend EIS investments primarily for the tax benefits, whereas investors were more focused on the level of returns available with the tax benefits being less important
- Individual investors favoured single company investments, while advisers most commonly recommend an EIS fund or a mixture of both structures
- Renewable energy was a popular sector among advisers, while being one of the least popular among private investors
- Both advisers and investors felt that the quality and availability of information is extremely important to understand the EIS market, but the majority of advisers feel there is not enough information available whereas investors feel that there is. This could be due to regulatory requirements – advisers are compelled to educate themselves to a higher standard to comply with the rules and evidence due process

We seem to have a situation where advisers are more cautious about investing in EIS than sophisticated investors. As noted, this could be a reflection of advisers' client banks that perhaps do not have the same appetite for risk as the sophisticated investors we surveyed, or it may reflect advisers' concerns around complying with the regulations and evidencing due process to the regulator in the event of a dispute with a client at a later date.

This suggests that advisers' clients are missing out on some of the benefits offered by EIS – and that if EIS investment providers could overcome advisers' concerns there might be a much bigger market of investors out there for them.

MARKET ANALYSIS



RATIONALE

The next section of this report takes a look at the current state of the EIS market based on the data we have been able to collect and include in our EIS investment register.

The register includes data on 244 investments across single EIS companies, discretionary managed services and EIS funds going back as far as 1998. The aim is to build a picture of how the market has developed over time, and with this in mind the register includes historical information on investments that have closed as well as those that are still open to investment.

The overall aim of the investment register and this analysis is to help improve the EIS market and develop a more mature, open and transparent market that investors can have more confidence in.

When compiling the register we collected information on the type of opportunity available, the sectors that investments focus on, the minimum investment requirements, the forecast level of returns, the amount of investment the products are looking for and the strategic focus of the investment.

The information included in this register has been analysed to identify emerging trends within the market. It does not single out individual products for praise or criticism. The objective is to simply provide an overall picture of the EIS market to enable investors and advisers to make their own appraisal.

OBJECTIVES

Our aim in compiling the investment register and carrying out the subsequent analysis is to help readers acquire whole-of-market awareness of the EIS sector. There are many different investment products available through the enterprise investment scheme, covering a range of investment objectives, structures, manager styles and risk and return profiles. Gathering as much of the available information together as we can in one place will help advisers develop their understanding of the opportunities available and decide if EIS investments are right for their clients. The register and analysis aim to:

- Provide a snapshot of the market for EIS investing as of Q2 2014
- Highlight the different investment opportunities, risks and returns available in the market
- Analyse the prominence and growth of the EIS market over time
- Look at the growth and evolution of sectors, structures and investment objectives
- Analyse how fundraising targets and investment sizes have adapted to investor appetite and the size of the market as a whole

The information included in this register forms the basis of unique analysis on the EIS market. To the best of our knowledge, data of this kind has not been collected and analysed in this way before and is not available elsewhere.

As this is the first report we have produced and data is relatively restricted, the following analysis looks at cumulative growth of the EIS market, rather than analysing and comparing statistics year on year. The aim is to analyse the overall growth and evolution of the EIS market, based on the data available. In some sections more in-depth analysis focuses on specific years, and this is clearly marked for the reader. Future editions of this report will build on this analysis, providing year on year comparisons as more information is made available on the market.

DATA COLLECTION

We began the data collection process by assimilating all of the publicly available information, with some assistance and data from some market participants including Allenbridge Tax Shelter Report, MICAP and the EISA. We also scraped product provider websites and on-line marketing materials for data.

For stage two of the data collection process, managers and providers were contacted and asked to verify the details we had on record about their current investment offerings (and provide further supporting information where required). This initiative was well received by the majority of providers and was essential to ensure that the information used in our analysis was as accurate as possible.

OVERALL ANALYSIS

INTRODUCTION

The data we collected on the EIS market can be broken down and analysed in a number of different ways, using a number of different criteria. The following sections of this report provide an overall analysis of the EIS market, looking at how it has grown in recent years, the different economic sectors where investments can be made and the different structures available for investors looking to access the market.

We break the data down by:

- Sector
- Structure
- Focus (investment objective)
- Size of fundraise
- Forecast returns
- Charges

MARKET GROWTH

The first investment included as part of this analysis was launched in 1998. The market saw relatively modest and stable growth between 1998 and 2004 with only a small number of new product launches across both single company investments and managed funds. In 2005 there was a notable increase in the number of new product launches, which can probably be attributed to the total investment amount qualifying for tax relief increasing from £150,000 to £200,000. The period 2010 – 2014 has witnessed the most rapid expansion in the market though: there has been a 229% increase in the number of investments in this time.

This recent rapid growth can be attributed to a number of factors.

Firstly, awareness of the benefits of EIS has been increasing over time, in part due to the marketing efforts of some of the bigger providers and the adviser education provided by the EISA.

Secondly, after seeing conventional assets become quite highly correlated during the 2008 crash and subsequent recession, there has been a recognition that conventional portfolios require additional sources of diversification – something that EIS products can provide as investments into parts of the economy that are not generally covered by mainstream funds.

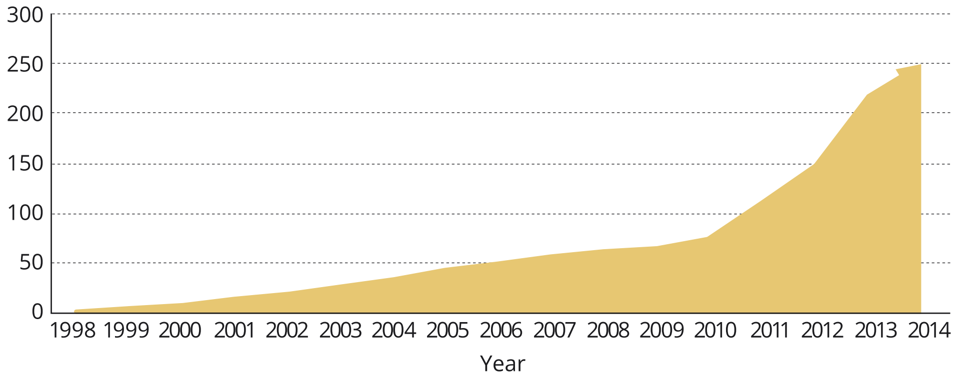
Third, there has been an appetite for higher returns. Low interest rates and low bond yields have depressed the returns on fixed income investments, and many commentators are forecasting that equities will continue to be volatile in the future, with more 2008-style shocks in store. At the same time, investors are realising that they need to save more for their retirement as life expectancy increases. These factors have pushed investors and advisers into searching for assets with higher than average returns, and many EIS investments fit the bill.

Fourth, as mentioned in previous sections of the report, changes in both the annual and lifetime allowances in pension contributions and the increased scope of EIS to cover more, and bigger, companies will also have played a part in this increase in activity.

Finally, the flip-side of the 2008 narrative is that we are now seeing the UK economy starting to recover and improve and many advisers and their clients feel that investing into smaller companies is a good way to participate in and benefit from that recovery.

It is important to note the limitations in the data collection process as detailed at the end of this section – there is an in-built bias towards investments launched more recently, which makes the recent growth appear more dramatic than it has been in reality.

EIS MARKET GROWTH (1998-2014)

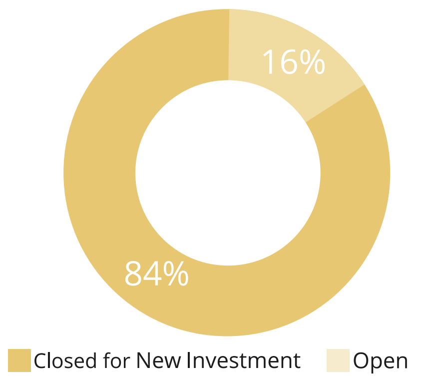


CURRENT OPPORTUNITIES

This analysis covers 244 EIS investment opportunities across single company investments and discretionary funds/ portfolios. Of these, 16% of the products are open to new investment, with 44% of these being evergreen products (always open to new investment). It's worth noting that a large number of investment opportunities closed at the end of the 2013/14 tax year at the start of April.

The vast number of opportunities focus on a single (or sometimes 2) tax year period, so that investors can claim (and offset) tax for a specific period. Investment launches often occur in the final quarter of the year with a large amount of activity ramping up towards the end of the tax year as investors (and their advisers) look to put their tax affairs in order.

OPEN vs CLOSED (1998-2014)



"The enterprise investment scheme has been a very successful programme and has no doubt addressed a significant funding gap in the UK market"

Bruce Macfarlane, MMC Ventures

"Of the 244 investment offers analysed for this report, only 16% of those appear to be open to new investment which typifies the constantly evolving nature of early-stage investing"

EIS STATUS

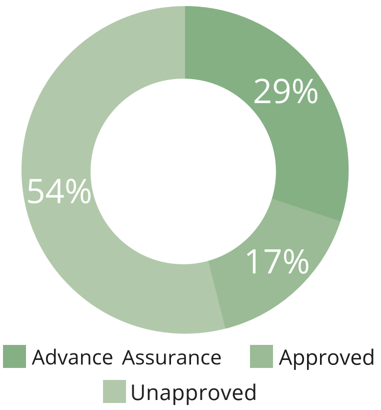
In order to qualify for tax relief the underlying companies must meet certain criteria prescribed by HMRC. EIS investments can either be 'approved' or 'unapproved' or can gain 'advance assurance' from HMRC that the underlying companies will likely meet the set criteria.

29% of the investments included in this analysis have achieved advance assurance status before they were marketed to investors. This is a relatively new innovation and we forecast that this number will increase in the future.

The majority of investments (54%) choose to start their marketing activity while still unapproved. This gives increased flexibility to both the investment manager and investors as it means that there is no HMRC imposed time limit for deploying funds and investors can claim their tax relief as investments are made.

With an approved EIS (only 17% of investments) the investor receives tax reliefs on the closing of the fundraise or once 90% of funds raised have been invested into underlying EIS qualifying companies. This puts more pressure on managers to invest swiftly and also means investors may have to wait a number of months before receiving tax benefits.

EIS STATUS (1998-2014)



CLASSIFICATION OF EIS

APPROVED:

Having EIS approval has certain advantages for investors in respect of Income Tax relief. If the approved fund satisfies the rules in section 251 ITA individual investors will be able to obtain relief on the date the fund closes, rather than the date when the actual underlying investments are made. Instead of receiving an EIS3 certificate for each investment, the managers of approved funds will send a form EIS5 covering all the investments made on the investors behalf – as long as underlying companies meet HMRC criteria for EIS approval and once 90% of the fund capital has been invested (within 12 months of the closing of the fund).

UNAPPROVED:

The EIS is administered in HMRC by the Small Company Enterprise Centre (SCEC). The SCEC decides if a company and a share issue qualifies for the available tax reliefs. Unapproved companies must apply to the SCEC who then takes responsibility for checking the accounts etc. of the company to ensure that it continues to meet the requirements of the Scheme. Investors cannot claim tax reliefs from EIS investments until the underlying company (or manager) sends them an EIS3 form to complete and return to HMRC.

ADVANCE ASSURANCE:

The SCEC also operates an advance assurance scheme, whereby companies can submit their plans to raise money, details of their structure and trade etc. before the shares are issued. The SCEC will advise on whether or not the proposed issue is likely to qualify for EIS relief. Companies are not required to obtain advanced assurance, but it may be prudent, particularly for companies using the EIS for the first time, to do so. This gives them an opportunity to spot any problems before shares are issued, and advanced assurance from the SCEC is also useful for companies to show to potential investors.

INVESTMENT LEVELS

	Min.	Max.	Average
Single Company	£400	£100,000	£13,195
EIS Fund/ Portfolio	£2,000	£50,000	£16,131

Lower minimum investment levels show how accessible a market is for investors. Based on our data, the minimum investment in EIS ranges from as little as £400 to as high as £100,000, with an average of just over £15,000.

Examining single company investments and discretionary managed funds/ portfolios separately gives us more insight. Single companies have lower average minimums at just over £13,000. However, this average is misleading and hides a large number of products that have low minimums: the median entry level is £10,000 and the 1st quartile is just £5,000.

Minimum investment levels for funds and portfolios start between £2,000 and £50,000 and have an average of just over £16,000. Funds generally have higher entry levels as monies are split across a number of underlying companies, and therefore more capital is required to ensure the portfolio is sufficiently diversified. However, there are a number of managed funds/ portfolios that start at £10,000 which makes this a relatively accessible asset class for a wide demographic of investors.

These lower entry levels are closely linked to the size of the fundraise. Single companies typically have lower initial fundraises, with an average fundraising target of £3.79m and several companies aiming to raise less than £1m.

This is logical: single company fundraises are usually targeted at small groups of knowledgeable investors who have some experience or connection with the sector or firm and the amount of investment required is obviously much lower than it would be for a fund making a number of investments across several companies. Funds generally have much higher fundraising targets. The lowest targeted amount is £1.2m, but the average is £12.84m.

	Low	High	Average
Single Company	£175k	£15m	£3.79m
EIS Fund/ Portfolio	£1.2m	£75m	£12.84m

There are also a number of evergreen funds which have no upper limit to their fundraising, but of course they do need to ensure that they have a pipeline of suitable underlying companies to invest in.

"EIS funds allow an investor into a deal-flow that is not generally seen by Angel investors"
Alastair Kilgour, Parkwalk Advisors

THIRD PARTY REVIEWS

Investments often go through a third party review from either Allenbridge Tax Shelter Report or Tax Efficient Review. These companies review both single companies and funds and aim to provide impartial opinions on a number of aspects of the investment such as the track record of the manager, the focus and sector of the investment and the key principles behind the offering. These two reports are often used in the marketing of the product as they provide impartial opinions for investors and advisers to use as part of their own due diligence and investment decision making process.

As reviews are only made available to paying subscribers it is not possible to accurately ascertain which investment offers have or haven't been reviewed: based on our desk research we estimate that 62% of investments (across both single company and funds/portfolios) have been reviewed by either Allenbridge Tax Shelter Report or Tax Efficient Review, with 6% reviewed by both companies. If these estimates are correct it would suggest the remaining 32% have not been reviewed by either company. Going through this review process does not incur a cost for the provider.

The benefits include increased exposure, marketing and enhanced credibility.

KEY POINTS

- 16% of the EIS investments on our investment register are currently open
- EIS providers prefer unapproved funds to provide more flexibility to managers and investors
- Fund/portfolio investments tend to have higher minimum investments than single company investments, averaging around £16,000

SECTOR ANALYSIS

There are seven principal industry sectors within the EIS market which can be broken down into a number of specific sub-sectors. This analysis looks at the sector level only. The sectors are:

- Energy
- Technology
- General Enterprise
- Food and Drink
- Media
- Education
- Other

At present the largest sector is Energy, which accounts for 28% of the market. Investments available within the Energy sector include traditional energy projects, but the bulk of investments are in renewable energy projects such as wind turbines and solar power installations.

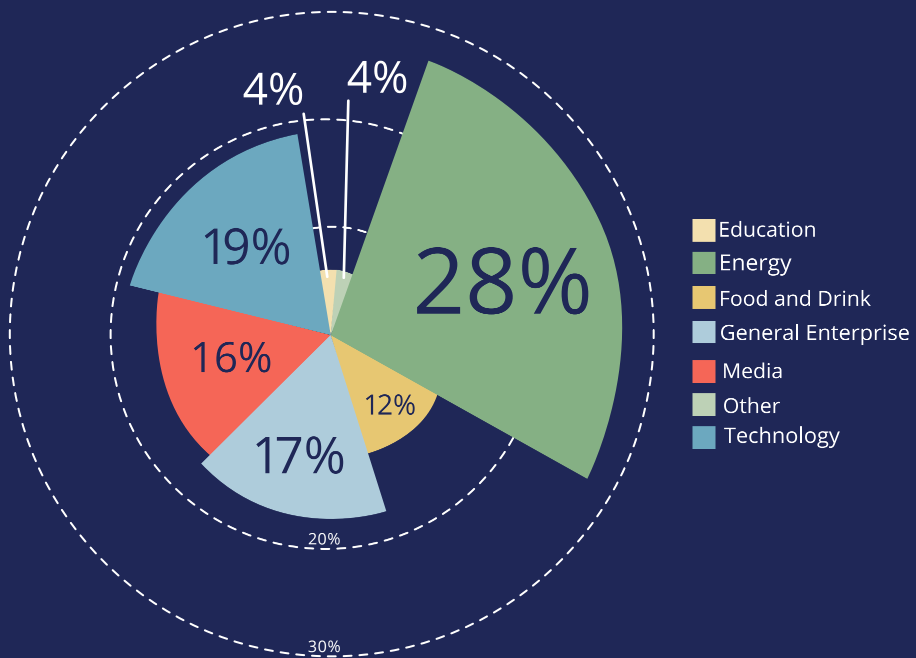
These projects have their revenue streams underpinned by government subsidies such as Feed-in Tariffs (FiTs) and Renewable Obligation Certificates (ROCs), which guarantee a minimum price for the energy produced over a fixed period of time.

The subsidies remove some of the uncertainty from the undertaking, and as the installation, maintenance and performance of renewable energy kit is now well understood and very robust, these investments are very attractive. The treasury has recognised this and has gradually been lowering FIT levels resulting in them now being excluded from inclusion in EIS (with the exception of hydro and biomass installations).

Technology is the next largest sector accounting for 19% of the market, followed closely by General Enterprise with 17% and Media with 16%. These sectors are all relatively well established in the market and include a mix of single company and managed funds. General Enterprise is a bit of a catch-all, but it is no surprise to see Technology and Media capturing so much of the EIS investment market, as they are both sectors that experience a high degree of change and engender themselves to adventurous, smaller start-up companies of the sort that qualify for EIS status.

Smaller niche investment sectors including Construction, Transport and Sport have been grouped together under Other due to the very small number of investments in this space. Education is another very small sector, which together with Other accounts for less than 10% of the overall market.

OPPORTUNITIES BY SECTOR (1998-2014)



SECTOR SPLIT BY STRUCTURE

The industry sectors can be looked at in further detail by analysing the split between single company investments and managed funds/portfolios.

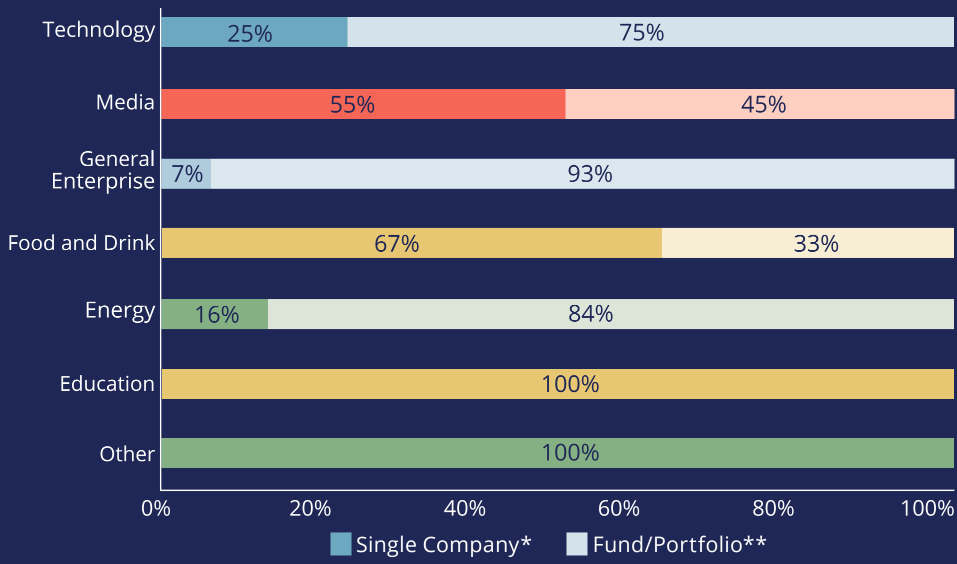
It is interesting to see that the Other (including Transport, Sport and Construction) and Education sectors are all dominated by single company investments. It seems that there are no specialist operators in these sectors as yet, which suggests that there isn't the kind of deal flow required to merit specialist funds.

The larger sectors generally have a good mix of both single company and fund based investments. Funds account for the highest proportion of investments within General Enterprise accounting for 93% of the sector, followed by Energy with 84% of the sector and Technology with 75%. Media has a relatively even split with 55% single companies and 45% funds/portfolios. There are a number of well-established operators in each of these sectors with many having launched more than one investment, which suggests both a healthy amount of deal flow and investor demand – hopefully an indicator of successful investments that have benefited both investors and the companies.

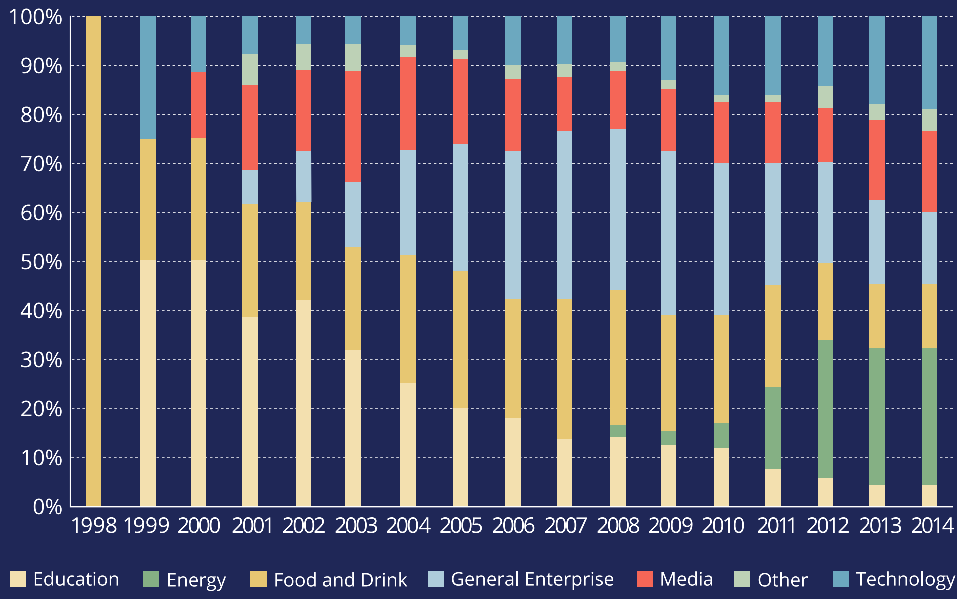
It is also very interesting to see how the different sectors within the EIS market have developed over time. The chart on the right looks at the proportion of the market each sector accounted for over the last 16 years. Over time there has been a reduction in the dominance of sectors such as Food and Drink and Education, and a large amount of growth in Energy, which since 2008 has grown to become the largest sector. Technology was a dominant sector in 1999 leading up to the tech bubble, lost market share between 2002 and 2005 and has since seen strong growth to once again become one of the largest sectors.

Over the last half dozen years, Food and Drink and General Enterprise have seen their market share drop while Technology, Media and Energy have all risen.

SPLIT OF EIS SECTORS BY INVESTMENT STRUCTURE (1998 - 2014)



HISTORIC MARKET SHARE BY SECTOR (1998 - 2014)



KEY POINTS

- There are 7 main sectors in the EIS market with Energy, Technology and General Enterprise accounting for 64% of the market
- The larger, more established sectors tend to be weighted towards fund/portfolio based opportunities as opposed to the smaller niche sectors which focus on single company offerings
- The EIS market has changed vastly over time with Energy now the largest sector with 28% of the market

*the darker shade represents single company **the lighter shade represents fund/portfolio

ANALYSIS BY STRUCTURE

As noted throughout the preceding analysis, the EIS market includes a mix of single company investments and managed funds/portfolios. The following section looks at the split of the market between these two structures and how they have each developed over time.

Based on the investments identified, the EIS market is currently made up of 65% funds and 35% single company investments. 17% of EIS funds and 14% of single companies are currently open for investment.

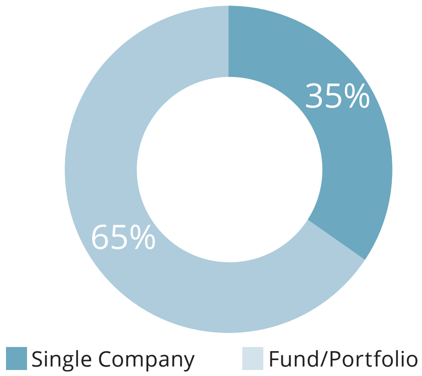
MARKET GROWTH BY STRUCTURE

Splitting the data between these two types of investment structure, we can track the growth in the EIS market and the changes in the landscape over the period since 1998. In the initial stages of the EIS market, single company investments were the most popular. Funds started from a very low base and were only available in very small numbers in the early days of EIS. However, as the EIS concept became more widely understood, funds did begin to enter the market in increasing numbers. The real catalyst for funds however, was the rule changes to allow larger companies to qualify for EIS status. At a stroke the EIS investment universe was both bigger and more investable, and fund structures became more feasible – this is reflected in the steep up-tick in fund launches in 2010.

Both structures saw their highest number of product launches in 2013, which can be attributed to the drivers behind the growth in the market we've discussed earlier – lower pension allowances, improved EIS benefits, an increasing investor appetite for risk/returns and the need for diversification.

We can also speculate that as fund managers become more established and can evidence a track record of success, it becomes easier to launch new funds – also contributing to the increasing number of fund based opportunities in the market.

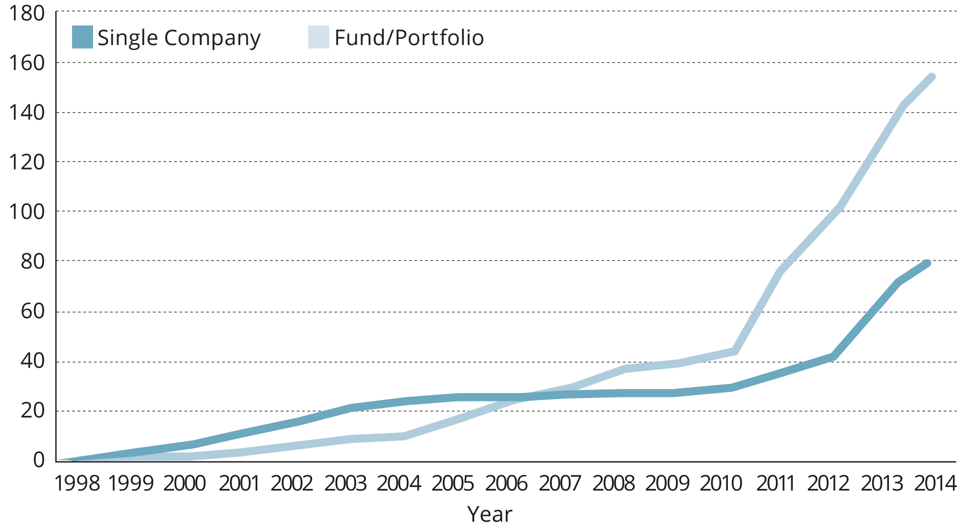
SPLIT BY STRUCTURE (1998-2014)



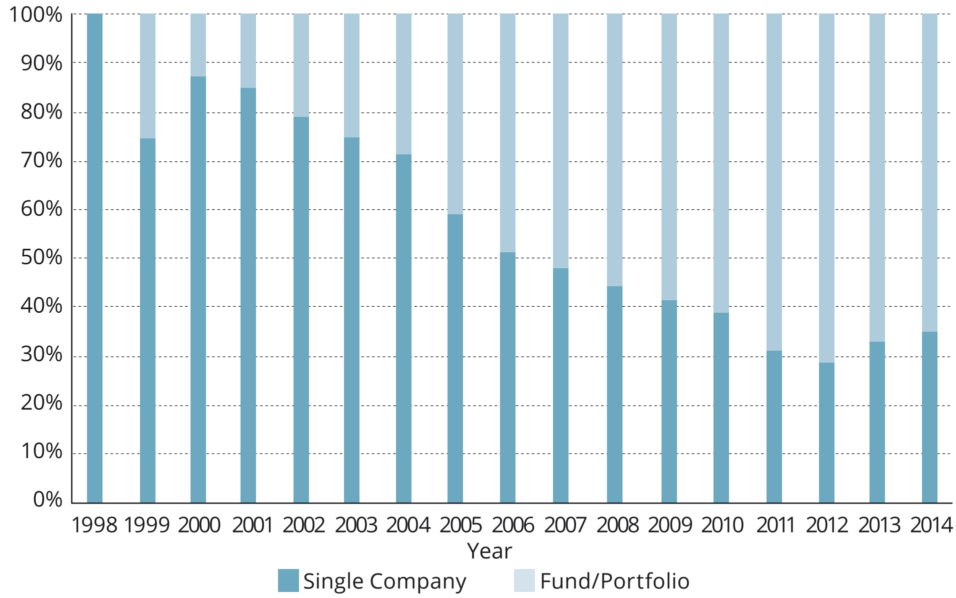
KEY POINTS

- From 1998 to 2005 single company opportunities dominated the market, but since 2007 fund/portfolio investments have grown to account for the largest share of opportunities
- 2013 saw the greatest number of product launches in both structures
- As managers establish strong track records the fund market will continue to grow

HISTORIC GROWTH BY INVESTMENT STRUCTURE (1998 - 2014)



HISTORIC MARKET SHARE BY INVESTMENT STRUCTURE (1998 - 2014)



ANALYSIS BY OBJECTIVE

This is also referred to as the investment focus or investment strategy.

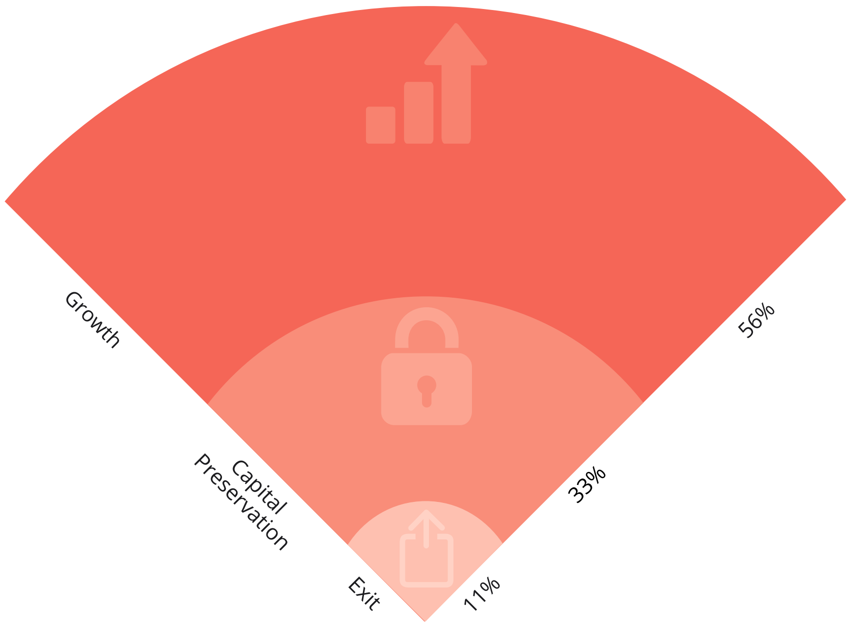
Different providers use different terms for classifying their investment objective and risk profile, but for the purposes of our analysis we have put them all into one of three broad categories: growth, capital preservation or exit focused. Growth is focused on achieving market beating returns, capital preservation on achieving inflation level returns and exit focused on achieving a relatively quick exit from the investment, within 3-5 years.

The following section analyses the EIS market by looking at the stated investment focus of the products.

Looking at the market as a whole just over half (56%) of investment opportunities (single company and funds) are growth focused. This is no real surprise as the underlying aim of the enterprise investment scheme is to stimulate investment into small companies in order to fund their growth.

Capital preservation accounts for 32% of the market and exit focused investments just 11%. Capital preservation investments may be asset backed and are often lower risk than growth focused opportunities. Both capital preservation and exit focused investments have been criticised for not taking on enough risk, and this has led to some scrutiny from HMRC, but it should be noted that there is always going to be some element of risk surrounding the exit whatever the stated investment objective and skill of the manager. Smaller company investing is a risky activity and investors have to accept that exits may not be achieved as intended and their capital could be tied up for quite some time.

OVERALL MARKET SHARE BY INVESTMENT OBJECTIVE (1998-2014)



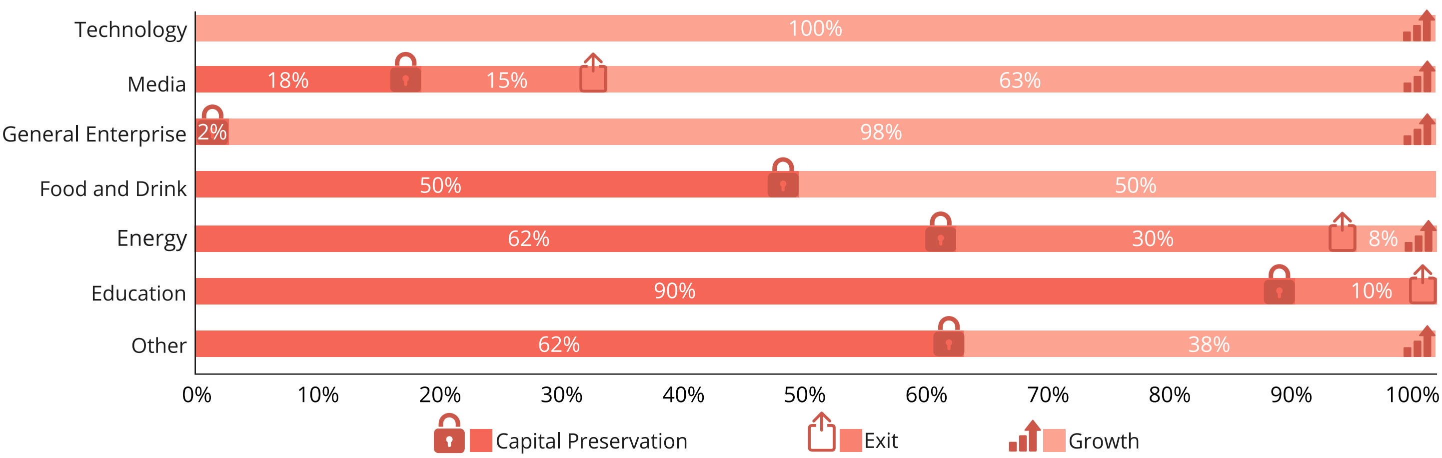
SECTOR SPLIT BY OBJECTIVE

Splitting the market down further we can see the different investment focuses across each sector. At the extremes, the investments focusing on Transport and Construction are 100% focused on capital preservation, while investments in the Technology sector are 100% growth focused.

Again, this is logical: the opportunities available within Other are often asset backed and therefore provide more protection for investors. In Technology, there are fantastic opportunities to invest in new start-up companies, with the hits promising stellar returns and the misses potentially resulting in complete loss of capital (thankfully mitigated by the EIS tax benefits of course).

Media presents a good mix of opportunities covering all three investment focuses. Energy is largely weighted towards capital preservation with a number of asset backed investment opportunities. However, as we should expect, growth is the dominant focus in the majority of sectors within the EIS market.

INVESTMENT SECTORS SPLIT BY INVESTMENT OBJECTIVE (1998-2014)



"Funds and portfolios generally have a higher investment focus on growth and a lower proportion of investments focused on capital preservation"

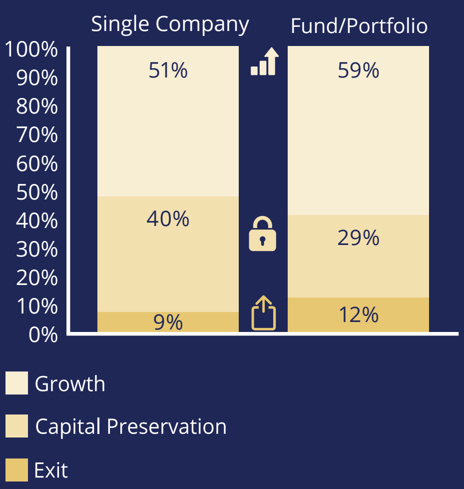
STRUCTURE SPLIT BY FOCUS

Another way to look at the investment focus is to split it by investment structure. The following charts look at how single company investments and funds are split down by investment focus.

51% of single company investments are growth focused, 40% capital preservation and only 9% exit. The higher proportion of investments focused on capital preservation could be due to the high number of investments in the food and drink sector. These often include take-overs of established pubs and restaurants and therefore they are asset backed opportunities with lower levels of risk.

Funds have a higher focus on growth (59% of investments) and a lower proportion of investments focusing on capital preservation. The higher number of growth based investments could be attributed to several funds focused on the Technology sector, which as noted above tends to be higher risk/higher return activity.

SPLIT BY FOCUS (1998-2014)



KEY POINTS

- Growth focused investments account for 56% of the EIS market
- The Technology sector, which favours small start-up companies, has 100% growth focused investments
- The Media sector is the most balanced based on investment focus
- Fund/portfolio structures have a higher focus on growth than single company investments

FUNDRAISING ANALYSIS

The fundraising target is the amount of capital each investment offering (single EIS company or managed fund/portfolio) is looking to raise. It should represent the provider's confidence that they can successfully deploy that amount of capital productively and earn returns. Unfortunately in the mainstream fund universe it can also occasionally represent the provider's confidence that their marketing machine can raise large sums of money that they can take a healthy initial fee and on-going charges from. This is a malaise that thankfully does not seem to have spread to the EIS market to date from what we can tell.

For single company investments, the size of the fundraise is obviously dictated by the activities they are undertaking and their intentions for putting the capital to work. For funds, the number of opportunities available that meet their investment criteria is key.

Being under-capitalised is of course a major problem as firms cannot develop according to their business plans. However, being over-capitalised is also an issue as it can make it hard to generate returns for investors.

The average fundraising target across the EIS market is just under £9.5m, but this ranges from as low as £175,000 to as high as £75m.

FUNDRAISING TARGETS

Low	£175,000
High	£75,000,000
Average	£9,418,000

FUNDRAISING TARGET BY STRUCTURE

As discussed earlier, single company investments are typically much smaller fundraises. The average for companies is £3.79m whilst for funds this is much higher at £12.84m. Funds generally have much higher fundraises due to the fact that they are raising money to invest across a number of underlying companies.

TARGET BY STRUCTURE

	Low	High	Average
Single Companies	£175k	£15m	£3.79m
EIS Fund/ Portfolio	£1.2m	£75m	£12.84m

FUNDRAISING TARGET BY INVESTMENT FOCUS

Exit focused investments had the highest average fund size of £16m. We can speculate that this is down to investor demand, or it could be due to many of these investments being either asset-backed, investments into more established companies or investments into renewable energy installations – all of which are expensive.

Growth focused investments had the lowest average fundraising target of £7.55m. Growth focused opportunities are usually investments into smaller start-up companies that are cheaper to acquire.

TARGET BY FOCUS

	Low	High	Average
Capital Preservation	£250k	£40m	£9.94m
Exit	£250k	£75m	£16.08m
Growth	£175k	£50m	£7.55m

FUNDRAISING TARGETS BY SECTOR (£M):

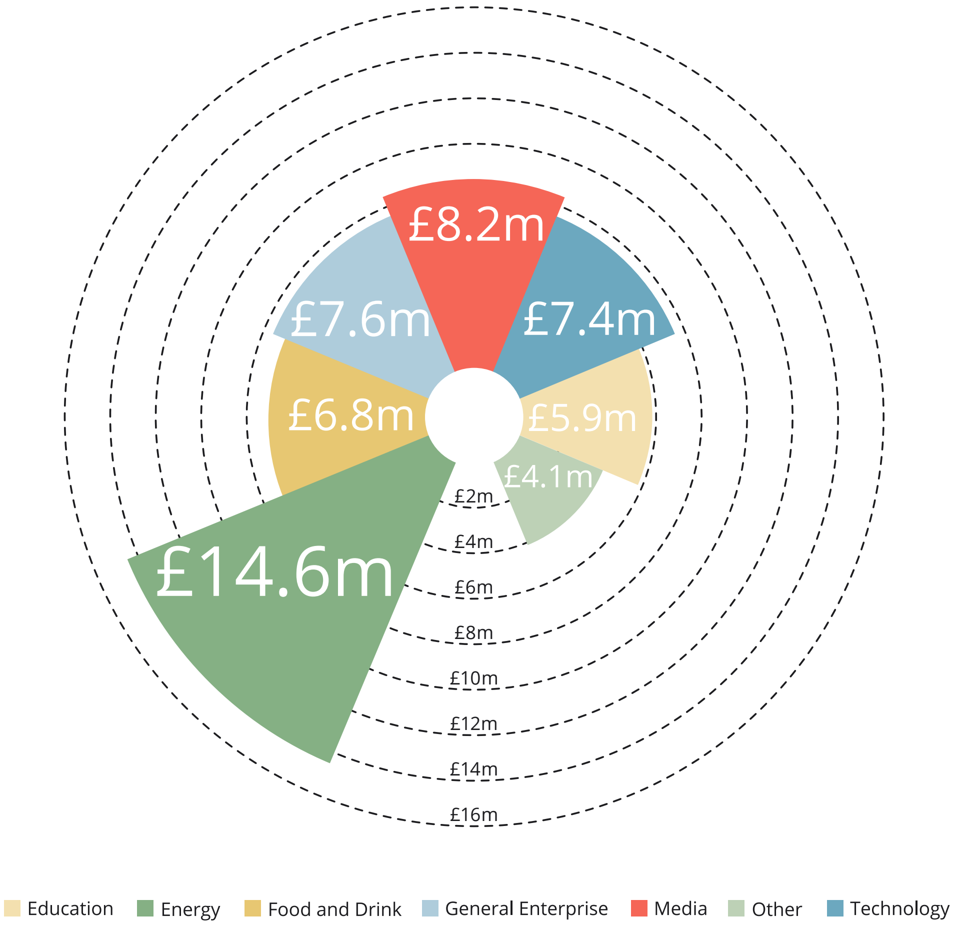
FUNDRAISING TARGETS BY SECTOR

By analysing fundraising targets by industry sector we can pick out some further interesting trends.

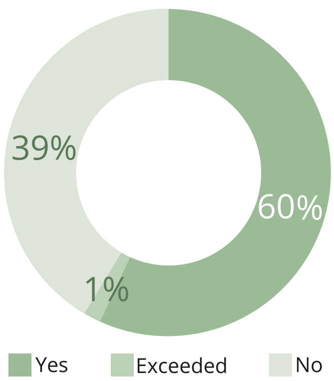
The Energy sector (the largest EIS sector) presents a very wide range of opportunities, which look to raise anything between £250,000 and £75m. This sector has the highest average across the market of £14.67m, which is almost £6m higher than the next highest sector average. This is not really surprising due to the size of the energy sector and the large upfront cost often associated with energy projects.

Media, General Enterprise and Technology are the next largest sectors when it comes to fundraising targets. The smallest fundraises are seen within the Other category, which includes Construction and Sport focused investments. They are relatively specialist sectors which are dominated by single company investments – which have lower fundraising targets as we have noted.

AVERAGE FUNDRAISING TARGET BY INVESTMENT SECTOR (1998-2014)



PROPORTION OF OPPORTUNITIES ACHIEVING FUNDRAISING TARGET (1998-2014)



It is important to note how many investments achieve their fundraising targets. Providers do not always disclose this information and therefore this only represents a sample of the market. Based on information provided by 70% of the market, 60% of opportunities achieved their targets, just over 1% exceeded their fundraising and the remaining 39% were unable to meet their total targets.

Note here that we are looking at the upper cap on total fundraising. Investments will have a minimum hurdle for their fundraising, but we were not able to obtain statistically significant data on the success (or otherwise) of firms meeting minimum investment levels.

FUNDRAISING TARGET GROWTH:

2008	-31%
2009	60%
2010	-11%
2011	14%
2012	28%
2013	14%
2014	7%

AVERAGE ANNUAL FUNDRAISING TARGETS

It is more meaningful to focus specifically on fund/portfolio investment opportunities here as they account for the largest share of the EIS market and have seen the largest amount of growth in recent years. The main aim of looking at the growth in this way is to see whether, on average, investment providers have increased their fundraising each year as investor interest and the number of available opportunities in the market has increased. This will also show whether providers have more confidence in their ability to raise money and have increased their targets each year.

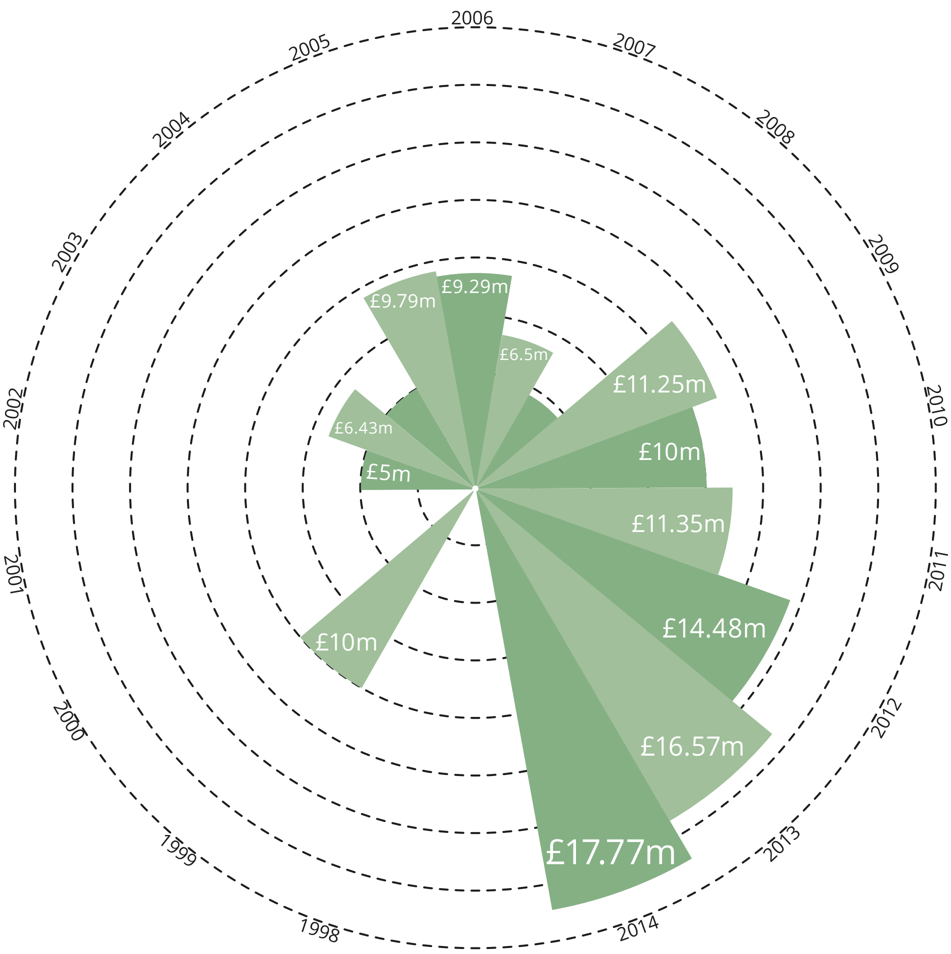
Between 1998 and 2005 there was a lot of variation in the average fundraising target. There were a number of years when there weren't any fund launches recorded or where there were only a very small number.

There was also a noticeable drop in fundraising in 2007 and 2008, which is likely to be down to the performance of the wider financial markets. However there was then a jump in the average fundraising target in 2009, and since then we can identify a pattern of steady increases in the average target over the last four years.

It is also interesting to note how the smallest and largest fundraises have changed over this period. The lowest fundraising amount has generally fallen over the last five years, and at the same time the highest has increased. This could be down to the wide range of opportunities now available in the sector, but perhaps can also be attributed to there being a number of new entrants in recent years with smaller funds.

At the other end of the scale, the increase in the number of large funds could be down to growing investor confidence in and awareness of the sector, and also wider economic confidence stimulating larger scale investment projects. The growth in the energy sector generally is also an important factor here.

AVERAGE ANNUAL TARGETS PER OPPORTUNITY (1998 - 2014)



KEY POINTS

- Single company investments are smaller scale (raising £3.79m on average) compared to managed funds/portfolios (raising £12.84m on average)
- Technology based investments have on average the largest fundraising targets
- Exit focused investment strategies have on average the largest fundraising targets
- 39% of investments did not meet their upper level fundraising target

ANOTHER LOOK AT FUNDRAISING TARGETS

The Tax Efficient Review published some timely data on EIS funds raised in the 2013/14 tax year (see table opposite). In the main this is based upon data provided by the relevant providers. The investment opportunities have been categorised using their own unique methodology.

What the data shows us chimes with the findings from our research. The two biggest areas of investment are funds or portfolios with a track a record – supporting our point that as a track record is established, launching and raising investment into a fund becomes easier. The biggest sector for investment is renewable energy, with 62% of investment during the period. The second biggest sector contained a mixture of growth focused funds, which shows that the tax incentive is working, pushing capital into smaller, growth focused companies.

This also demonstrates that companies without a track record can struggle to establish themselves. Perhaps surprisingly, there were not many AIM focused EIS investments, even though investing in AIM listed companies provides some additional insight into the underlying investments that is not always available with non-listed companies.

EIS FUNDS RAISED – 2013/14

EIS FUNDS RAISED IN TAX YEAR 2013-14				
Fund Name	**EIS Type**	**Raised in 2013-14**	**% of Funds Raised**	**Source if Not Provider**
Guinness AIM 2014	EIS AIM portfolios	£2,300,000		
	Total	**£2,300,000**	**1%**	
City Pub Cos (East & West)	EIS company seeking growth with a track record – single sector	£6,000,000		
City Pub Cos (East & West)		£4,000,000		
	Total	**£10,000,000**	**2%**	
INS Rosehill Enterprises PLC	EIS company seeking growth without a track record – single sector	£1,200,000		
London Shipping Limited		£2,000,000		
Wine Enterprise Investment Scheme Limited		£2,500,000		
	Total	**£5,700,000**	**1%**	
Select Television EIS Service 2013	EIS fund seeking lower risk without a track record – non renewables single sector	£11,100,000		
	Total	**£11,100,000**	**2%**	
Calculus EIS Fund 14	EIS portfolio offerings/funds seeking growth with track record – multi sector	£20,300,000		
Downing Growth EIS Fund 3		£2,000,000		
MMC EIS Fund		£16,100,000		
Octopus Eureka EIS Portfolio Service		£21,200,000		
Oxford Gateway EIS Portfolio		£15,000,000		
Parkwalk Opportunities EIS Portfolio Service		£7,500,000		
Parkwalk UK Technology EIS Fund V		£8,300,000		
	Total	**£90,400,000**	**15%**	
Imbiba London Bar & Restaurant Fund 3	EIS funds seeking growth with track record – single sector	£5,000,000		
	Total	**£5,000,000**	**1%**	
Bestport EIS Fund	EIS portfolio offerings/funds seeking growth without track record – multi sector	£2,000,000		
Boundary Capital Home Run SEIS & EIS Fund 2		£1,000,000		
Mercia Growth Fund 3		£3,000,000		
Rockpool EIS (capital preservation offer)		£18,089,000		
Rockpool EIS (growth offer)		£3,060,000		
Seneca Acceleris EIS Investments		£6,800,000		
Seneca EIS Portfolio Service		£5,700,000		
	Total	**£25,500,000**	**6%**	
Downing Pub EIS Fund 1	EIS funds seeking lower risk with a track record – non renewables single sector	£8,400,000		
Ingenious Broadcasting EIS		£30,000,000		TER Estimate
Ingenious Shelley Media EIS		£30,000,000		TER Estimate
	Total	**£68,400,000**	**11%**	
Downing Renewables EIS	EIS portfolio offerings/funds seeking lower risk renewables	£58,200,000		
Enterprise Solar EIS Fund		£1,000,000		
Foresight Solar EIS 3		£20,000,000		
Foresight Solar EIS 4		£87,500,000		
Guinness EIS		£14,000,000		
Ingenious Renewable Energy EIS 2		£26,000,000		
Octopus EIS tranches		£114,500,000		
Oxford Capital Infrastructure EIS		£40,000,000		
Sustainable Tech Investors App EIS Fund 2		£4,000,000		
TIME:EIS Renewables Tranche 1		£3,400,000		
Triple Point EIS		£18,100,000		
	Total	**£386,700,000**	**62%**	
Puma EIS	EIS funds seeking lower risk without track record – non renewables multi sector	£7,500,000		
	Total	**£7,500,000**	**1%**	
		£626,749,000	**100%**	
M Churchill 04 June 2014				

Source: taxefficientreview.com – data provided to Tax Efficient Review by providers (except where estimated)

ANALYSIS BY RETURNS

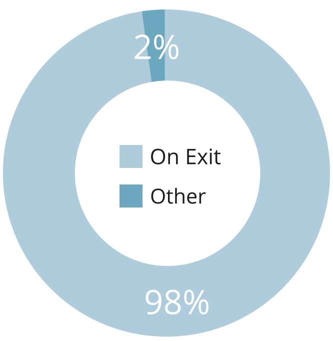
The following section looks at the returns available in the EIS market. There is often a criticism that EIS investments focus too much on the tax benefits rather than the actual investment case for underlying opportunities. This can often skew the returns and make the investment manager's performance appear disproportionally positive.

This also presents a challenge when it comes to assessing the market, as some opportunities are advertised with targeted returns before tax relief, whilst others advertise returns after tax relief.

EIS investments must be held for a minimum of three years in order to qualify for tax relief. The vast majority of EIS investments look to pay returns at the end of the investment term (often variable) in the form of a capital gain which is tax free. Any dividends paid are subject to Income Tax at the investor's marginal rate. Investors therefore have to wait a number of years for returns to be realised. Single company investments can provide the investor with more flexibility as they can sell their shares as and when they wish (but they must of course find a buyer).

A very small number of investment opportunities look to pay annual returns in the form of a dividend or royalties based on the performance of the underlying company, but of course this income is taxable.

FREQUENCY OF RETURNS**



OVERALL RETURNS

Every investment in the EIS market offers variable returns – there are no products offering a fixed rate of return. Returns are usually positioned as a target level of return. It's worth noting that it has not been possible to collect return information on every investment included in this analysis, with 35% of opportunities not quoting their targeted returns in their marketing literature or providing them to us on enquiry.

Investments only quoting total returns range from 100% to as high as 500%. This is often worded in the parlance of angel investors as '5x return of capital'. These returns can look very attractive, but they must be looked at based upon time – a 500% return may not appear as attractive if it's going to take 10-20 years to be realised. As always, the exit is as important as the level of return achieved.

ANNUAL RETURNS* (1998-2014)

Low	3%
High	84%
Average	20%

Whilst overall there is a very wide range of returns available in the market, it is more meaningful to look at the products when split down by structure. Single company EIS investments have the highest range of targeted returns and make up both extremes of the market. A number of the returns on offer are very aggressive, and are therefore likely to present some very high risks to investors. The average targeted return from single company EIS investments is 23% per year.

EIS funds/portfolios have more moderate targeted returns but these still range from a conservative 6% per year to a very aggressive 60%. The average for this structure is lower than the market average at 18%. There are only a very small number of EIS funds/portfolios that offer particularly high returns and these are all found within the Technology sector.

While there are some extremely high returns targeted in the market, it is important to note that returns are often advertised including tax relief (often for a higher rate tax payer) and this therefore skews the actual return achieved by the manager. Ordinary rate tax payers would not benefit from the same sort of returns and investors must be mindful that the tax reliefs on offer could potentially hide poor performance from the company and/or fund manager when the investment is compared to more mainstream investment opportunities (although of course, provided the investor gets the tax reliefs this is somewhat of a moot point).

RETURNS BY STRUCTURE**

	Low	High	Average
Single Company	3%	84%	23%
EIS Fund/ Portfolio	6%	60%	18%

RETURNS BY SECTOR

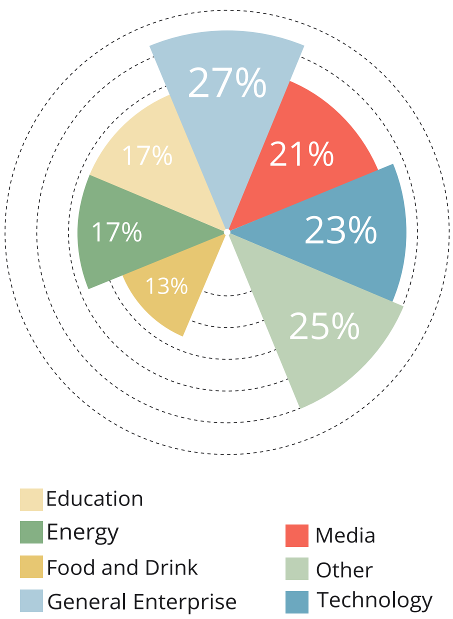
The highest average forecast return comes from the General Enterprise sector at 27%. At the other end of the scale Education offers the lowest targeted return at only 13% per year.

Media, Technology and Other all target average returns of over 20% per year, which would signal that these sectors present a number of high risk/reward opportunities.

The Energy sector offers lower returns of 17% on average, which is still very strong compared to mainstream opportunities. As many of these investments are lower risk, asset backed investments that benefit from long-term revenue streams based on government subsidies, it is easy to see why they have been so attractive to investors.

But even within each sector there is a very wide range of potential returns, offering a large number of opportunities for investors targeting varying risk profiles.

RETURNS BY SECTOR* (1998-2014)



*targeted **1998-2014

"Attractiveness of returns will depend upon the timeframe over which the investment is realised"

AVERAGE ANNUAL RETURNS BY INVESTMENT FOCUS

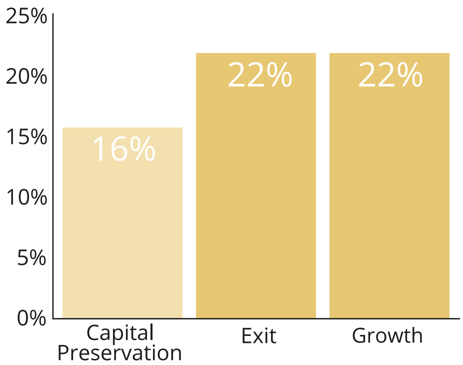
Both growth and exit opportunities have a targeted average return of 22% per year, which is surprising as growth opportunities are likely to take on inherently more risk and often focus on earlier stage start-up companies. This is even more surprising when looking at the range of targeted returns on offer, with exit focused investments ranging from 12-84% per year and growth focused from 6-76% per year. Note though that a small number of exit focused investments targeting very high (speculative) returns has skewed the average to some extent here. Growth focused investments range from 6% to 76% per year.

A number of growth focused investments target an overall total return, rather than splitting this down into a targeted average annual return. The average total return is 271% which is particularly strong, but of course the attractiveness of this return will depend upon the timeframe over which the investment is realised.

Products focused on capital preservation, which are often asset backed and seen as lower risk investment opportunities, still offer strong returns which range from 3-72% per year, with an average of 16%.

Again when considering these investments the impact that tax reliefs have when calculating targeted returns must be taken into account.

RETURNS BY FOCUS (1998-2014)



KEY POINTS

- Returns quoted in investment material often include tax benefits which dramatically increases predictions
- 98% of investments pay returns on exit and 100% are variable
- Each sector has a wide range of returns presenting a number of risk/return options
- Exit and growth focus investment strategies have the highest average returns of 22%

ANALYSIS BY CHARGES

The following section looks at the charges associated with EIS investment opportunities. The focus here is on funds and portfolio services which use the experience and expertise of a specialist investment manager. There have only been five sectors included in this analysis as a number of sectors did not include a sufficient number of fund based investments to undertake meaningful analysis.

High charges are one of the main criticisms associated with EIS investments. There are three main charges that are levied on pretty much every investment in the market: an initial fee; an annual management charge (AMC) and a performance fee. The initial fee is taken upfront when an investor first invests, and this therefore affects the amount of capital that actually reaches the underlying investments. Pre RDR, the initial fee would also cover IFA commissions.

Looking at the market as a whole, the initial fee ranges from 1% to as high as 6.5%. The average is 4.3%.

This is extremely high, particularly when compared to mainstream fund based investment opportunities, and could have a dramatic impact on returns.

However, EIS investments are more specialised and sourcing deals, research and due diligence, and ongoing monitoring (often including taking an active role on the board) all have higher costs associated with them.

The annual management charge is commonly taken as a percentage of the value of the fund on an annual basis. This covers the active management involved with EIS funds and portfolios. Some managers levy this upfront, usually for the first 3 years, and others will take this fee at the end of the investment when underlying investments are sold. Other managers may keep an allocation of cash un-invested in order to cover this charge annually – this again will affect performance as it means less capital is invested from the outset. AMC's range from 0.5% to 3% per year. 0.5% is very competitive and lower than a number of mainstream investment funds.

The average across the market is 1.82%, which again is quite low, but investors must also remember the initial fee and take into account that there is a limited amount of active buying and selling throughout the term of the investment, as most of the investment decisions will have been made at the outset.

Both the initial fee and the AMC are due regardless of the performance of the underlying investment, with managers being paid even when investments perform badly.

The performance fee is charged on exit, as and when underlying companies are sold and profits are realised. The fee is usually set based on a hurdle rate, such as 20% of any profit above 105p for every 100p invested. These fees range widely by investment manager and include a range of combinations of different hurdle returns and different fees. The performance fee incentivises managers' to return a profit as they share in the success, but it could mean that they take on more risks in search of this profit or that they are unfairly rewarded with a high share of profits when they haven't truly earned them.

The lowest performance fee across the market is 10% of profits above 105p, the highest 25% of all profits and the mean 20% of all profits. These fees appear very high, although if an investor is receiving a strong return they may be happy for the manager to take a share of success.

"High charges are one of the main criticisms associated with EIS investments"

MANAGEMENT CHARGES BY INVESTMENT SECTOR

Splitting down the charges by sector, on average Media has the highest initial fee at 4.75% but one of the lowest AMC's at 1.67%, Technology also has a very high initial fee of 4.71% on average, but the lowest AMC at 1.66%.

MANAGED FUND/PORTFOLIO

	Initial Fee	AMC	Performance Fee
Low	1.00%	0.50%	10% above 105p
High	6.50%	3.00%	25% of all profits
Average	4.30%	1.82%	20% of all profits

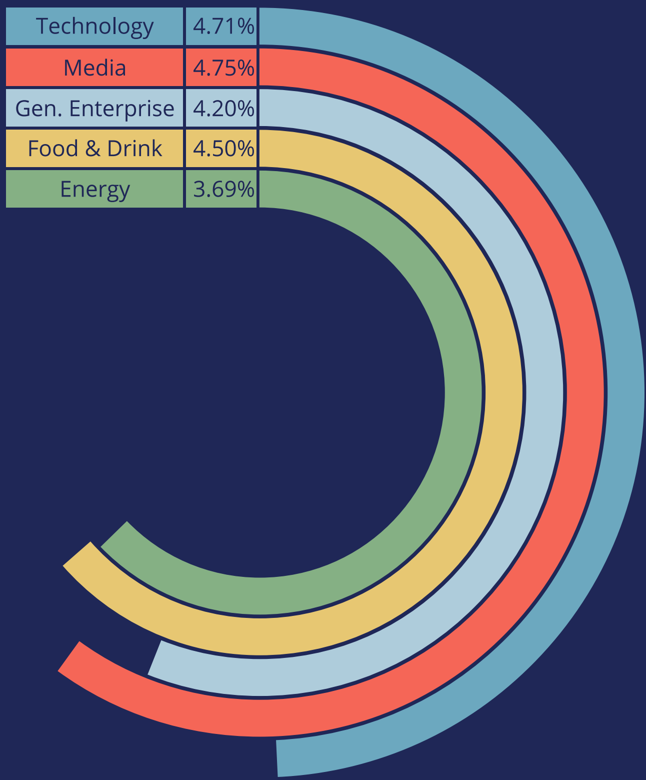
The high initial fees for these two sectors could be due to the large amount of in-depth research and due diligence that is required upfront when searching for and assessing investment opportunities.

On the other hand energy has the lowest initial fees at 3.69% but one of the highest AMC's at 1.95%. Energy projects can often be income producing and therefore managers may look to take their fees through a higher AMC paid for from income rather than taking a large fee upfront.

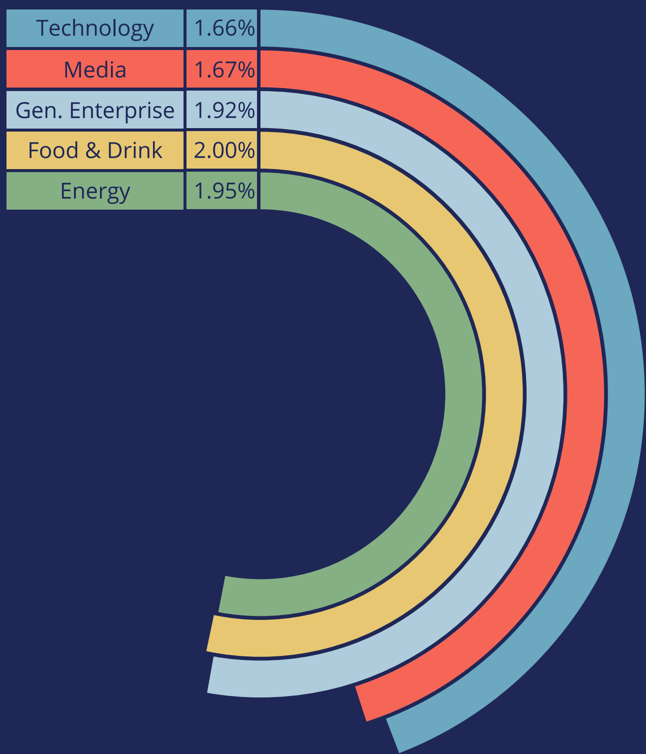
Looking at performance fees, the food and drink sector actually has the highest average performance fee with 25% taken from all profits. The lowest average performance fee is actually seen in the Technology sector, which is surprising as this is a high growth focused sector and therefore it would be envisaged that profits would be highly rewarded. We don't have an explanation for this apparent anomaly!

Across the remaining sectors the average performance fee is 20-22.5% of all profits which is relatively similar to the market average.

INITIAL FEE BY SECTOR (2002-2014)



ANNUAL MANAGEMENT CHARGE BY SECTOR (AMC) (2002-2014)



"The high initial fee for growth focused investment opportunities is likely to be due diligence required"

MANAGEMENT CHARGES BY INVESTMENT FOCUS

Analysing the charges by the investment focus could provide some insight into whether high growth focused opportunities take higher charges in reward for more active management and expertise, or whether capital preservation and exit focused opportunities take higher charges in return for looking after investors' capital whilst providing a modest, lower-risk return.

The high initial fee for growth focused investment opportunities is likely to be down to the large amount of research and due diligence required to find suitable high growth investment opportunities. The majority of investments are likely to be early stage companies in specialist sectors, and therefore information is harder to access and assessment requires more time and resources.

At the other end of the scale, exit focused investments may be into slightly more mature companies which are closer to becoming profitable. They may have been established for a longer period of time and therefore less research and due diligence is required to find suitable investment opportunities.

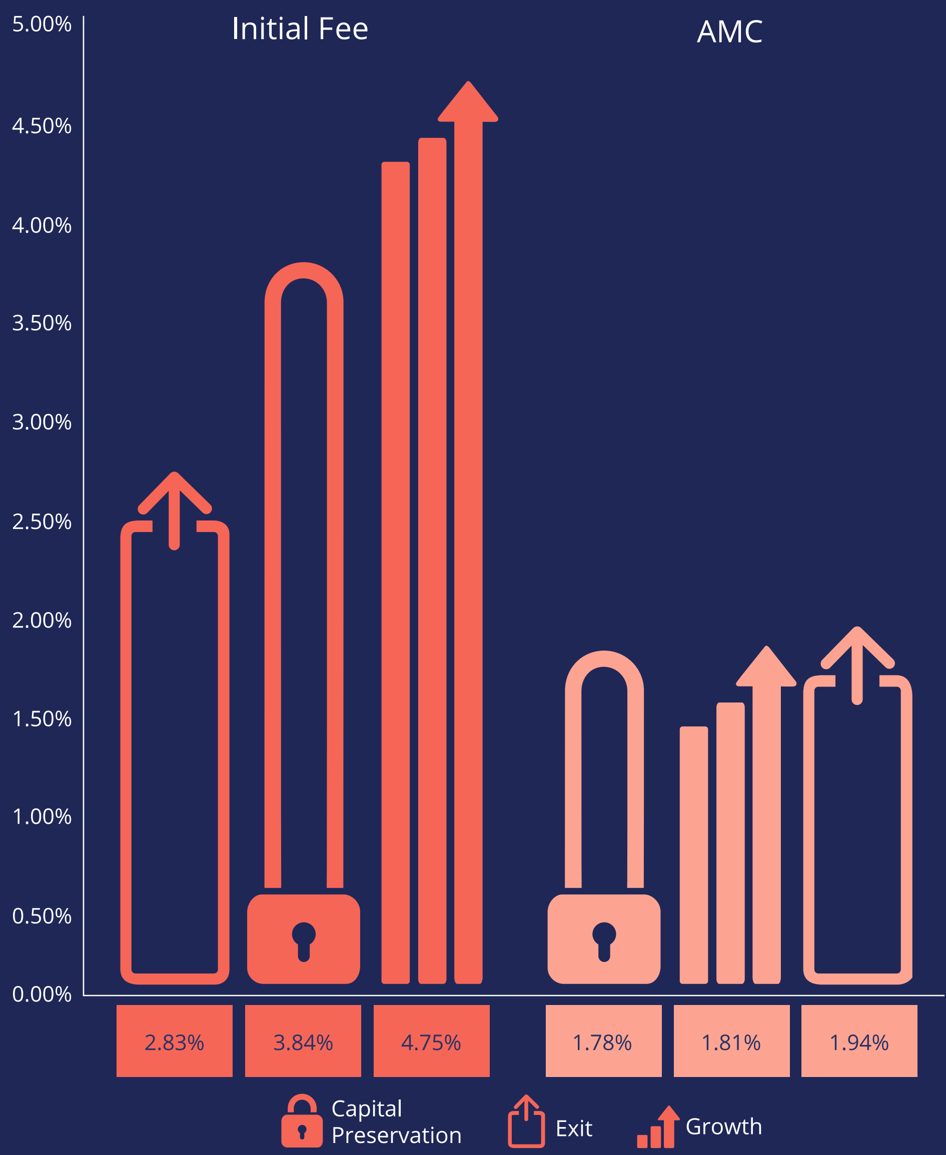
The annual management charges are much closer across the three sectors, ranging on average from 1.78% for capital preservation to 1.94% for exit. The moderate AMC seen from growth focused investment opportunities is likely to be offset by the very high initial fees involved.

The following table provides a snapshot of some of the different fees and charges in the market. This includes examples of some of the highest and lowest initial fees, AMCs and performance fees.

KEY POINTS

- Initial fees within the EIS market are very high with an average of 4.3% of the subscription amount
- Initial fees and AMCs are due regardless of the performance of the fund
- 20% performance fee on all profits is the most common charged on EIS funds
- Technology and Media have the highest initial fees, due to the large amount of research and due diligence required

CHARGES BY FOCUS (2002-2014)



EXAMPLES OF HIGH AND LOW CHARGES

Sector	Name	Initial Fee	AMC	Performance Fee	Focus	Category
Technology	Anglo Scientific EIS Fund 2012	1.25%	1.50%	Variable	Growth	Low Initial Fee
Media	Film Fund One	6.50%	2.50%	None Stated	Growth	High Initial Fee
Media	Prime Time EIS Fund	3.50%	0.50%	25% Above 105p	Capital Preservation	Low AMC
General Enterprise	Jenson Growth EIS Fund	5.50%	3.00%	25% of All Profits	Growth	High AMC
Energy	Elara Renewables EIS Fund II	6.50%	2.75%	10% Above 105p	Capital Preservation	Low Performance Fee
Energy	Ingenious Renewable Energy EIS Fund	6.50%	1.50%	30% Above 105p	Capital Preservation	High Performance Fee

MARKET ANALYSIS CONCLUSIONS

Our analysis of the EIS market reveals a broad range of investment opportunities that cover any number of investment objectives.

As logic would suggest, single company EIS investments tend to have lower minimum levels of investment than funds, and because investment is into just one company there is a higher risk/reward ratio.

Funds cover a broader range of investment objectives. Some offer similar risk/reward profiles to single company investments, but others take a more conservative approach and structure themselves with lower levels of risk, and more certainty around the exit for the investor. These opportunities tend to have higher minimum investments, higher charges and are very often focused in the energy sector where feed-in-tariffs and renewable obligation certificates have provided security. Interestingly though these investments forecast similar levels of return to growth focused EIS investments.

Charges are broadly similar across the investment sectors, with all having relatively high initial fees compared with mainstream funds – to pay for the more detailed work involved in making investments into unlisted companies. Initial fees are between 4-5% across all sectors with the exception of Energy, where the average is 3.8% – perhaps reflecting greater competition for investment in this sector. Ongoing annual management charges are between 1.5 and 2% across all sectors.

When charges are looked at from the perspective of investment focus, charges are somewhat lower for exit focused investments, with an average initial fee almost 1% lower than growth focused, perhaps reflecting that exit focused investments may be based around one or two larger opportunities, rather than 10s or 100s of smaller opportunities that all need to be researched before investment takes place.

The annual average fundraising target for EIS funds previously varied widely from year to year. However since 2009, as more funds have moved into the EIS space and the sector has matured, the average has increased each year – and this is a trend that looks set to continue as funds' reputation, size and confidence grows.

- The EIS market saw 229% growth in opportunities from 2010 to 2014
- 16% of the EIS investments we analysed are currently open to investment, with a number of these being evergreen opportunities
- Growth focused opportunities account for 56% of the whole EIS market
- There are seven main sectors with Energy, Technology and General Enterprise accounting for 64% of the market
- The shape of the EIS market has changed dramatically over time, with energy now the largest industry sector with 28% of the market
- Funds/portfolios have a higher focus on growth than single company investments
- Single company investments are smaller scale, with lower fundraising targets and lower minimum investment levels
- Returns quoted in the investment material provided often include tax benefits that may only be applicable to higher rate tax payers
- 98% of investments on our investment register pay returns on exit
- Initial fees within the EIS market are very high with an average of 4.3% of the subscription amount
- The most common performance fee charged on EIS funds is 20% of all profits

CHALLENGES AND LIMITATIONS

It is also important to note that there are some limitations with our data collection process that have an impact upon the final analysis.

Firstly, the information included in our investment register is limited to those investments that are openly marketed that we were able to identify. There is no central register for EIS investments (we did enquire with HMRC, who are responsible for administering the tax benefits, but they do not publish a central register) so ultimately we simply don't know what we don't know – there could be a number of EIS investments that are not widely marketed that we have not captured as part of our analysis process. However, our view is that although this information is not included, it is not essential – if these opportunities are not widely marketed and available, then there is no need for them to form part of most advisers' and investors' thinking.

Secondly, unfortunately not all of the EIS investment providers engaged with the data verification process. Every EIS manager and provider was given the opportunity to participate, and it was very encouraging to receive a high response rate, but inevitably there were a number that chose not to participate – perhaps due to understandable apprehensions about disclosing commercially sensitive information for inclusion in a new and unfamiliar report. Again, we feel that although in some cases this verification is missing, it is not essential. Provided that those managers' publicly available information was accurate, then the data in the register will be accurate.

Finally, our data collection process means that there is an in-built bias towards the most recent investment opportunities as these are the easiest to identify and collect data on. We're not able to quantify the impact of this, but experience tells us that the more recent the data the more accurate the analysis can be.

Our hope is that as this report becomes better established and can show a track record of helping to grow the EIS market, more managers will participate with the data collection exercise.

Broader participation can only improve the quality and accuracy of our investment register.

REPORT CONCLUSIONS

Imagine enjoying generous tax incentives, diversifying your portfolio, supporting the British economy and having a share in some of the most exciting companies in the UK with the potential to earn very high returns. All by investing in a government backed scheme – not some dubious structure that pushes the limits of the rules but a well-established arrangement that has been around in one form or another for over 20 years.

Sound too good to be true? The proof of the pudding is in the eating, but to date it seems as though EIS investors are enjoying these benefits. Smaller companies can access a vital source of capital and the treasury (it has been suggested) is a net beneficiary from the tax these expanding companies pay. It's a rare case of an incentive working exactly as intended for the benefit of everyone.

A theme running throughout the report is the popular view that this market can only grow from here as investors respond to the lower cap on pension allowances. It certainly feels like the sector is gearing up for more activity as new participants enter the market place, new investment opportunities are launched and new marketing initiatives are finalised.

So why do people hesitate to invest? It might be a reluctance to invest in a riskier part of the economy. As the NESTA evidence confirms, smaller companies are more likely to fail and that alone might be enough to put off some investors with lower levels of wealth or little appetite for risk.

Yet we hope that the report has shown just how these risks can be mitigated against. We have seen how systematic diversification improves the chances of investing in a stellar performer, that investing through EIS managers gives access to specialist expertise and that generous tax benefits tilt the risk/reward balance back towards the investor.

What's more, smaller companies don't have to be risky ones. The recent expansion of the qualifying criteria means that very well established, medium sized businesses with large assets, strong cash flows and long-standing customers, are also open for investment via the EIS. The perception that EIS is about funding start-ups or very small companies is wrong – that is now the role of the SEIS scheme. Advisers who review the analysis in this report will see that, although growth focused investments still form the majority of the opportunities available, there are plenty of asset-backed or exit-focused investments for the more risk averse.

Perhaps another reason people hesitate to invest is the opaque nature of the market. Performance information or precise details about exactly what is being invested in, and how portfolios are being run, can be hard to come by. We talk about this in the report, but in all honesty it is easy to get too hung up on this point. By its very nature, investing in smaller unquoted securities is going to be a murkier activity than investing in listed companies. It's one of the reasons why investing in smaller companies is more difficult and requires more research and expertise. It's also one of the reasons why the EIS scheme exists and why investors are so well rewarded when things go well. Having said that, something is clear from the research we have done: any steps the EIS industry can take to provide more precise information about their investment activity, and performance, will be well received by advisers and investors.

So what does the future hold? As noted above, everybody seems to agree that the market is set for growth. The hope is that this growth can be achieved without attracting the kind of poor quality, "me too", opportunist investment products that tarnished the UCIS market over the last few years. The industry is also keen to ensure that EIS investments continue to place capital in productive, growing companies and that rules are not abused to simply shelter clients from tax risk-free. The EISA and major industry players are constantly on their guard against this, as they know that a failure to play by the rules could lead to government intervention.

Provided the EIS sector manages to successfully navigate around these obstacles, the next 12 to 24 months should see increased levels of investment – and not just from existing customers. We believe that more advisers and investors will engage with EIS and the industry is starting to take steps to reach out and welcome them. The outlook from here?

It's very positive.

GLOSSARY OF TERMS

Term	Description
AIFMD	Alternative Investment Fund Managers Directive. Published in the Official Journal of the European Union on 1 July 2011 and was transposed into UK law on 22 July 2013. Covers the management, administration and marketing of alternative investment funds (AIFs). Its focus is on regulating the Alternative Investment Fund Manager (AIFM) rather than the AIF.
AIM	The Alternative Investment Market, is a sub-market of the London Stock Exchange (LSE) for smaller growing companies. It has a more flexible regulatory system than the main listings market to allow smaller companies to list shares. Businesses include early stage, venture capital backed and more established companies seeking access to growth capital.
CGT	Capital Gains Tax. This is a tax on the gain or profit made when selling or giving away an asset. It applies to assets that you own, such as shares or property. The individual CGT allowance for 2014/15 is £11,000.
FCA	Financial Conduct Authority. Replaced the FSA on 1st April 2013 and took over the regulation of the financial services industry in the UK. Its aim is to protect consumers, promote competition and enforce standards.
FSA	Financial Services Authority. Up to 31st March 2013 regulated the financial services industry in the UK, including financial services markets, exchanges and firms. Set and enforced standards for FSA authorised firms to comply with.
EISA	The EIS Association is an independent, not-for-profit organisation, which exists to assist in the flow of capital and resource available to British small to medium-sized enterprises through the Enterprise Investment Scheme.
EIS	Enterprise Investment Scheme. Government supported initiative designed to help smaller higher-risk trading companies raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies.
HMRC	HM Revenue and Customs. They are the UK's tax authority, responsible for making sure that money is available to fund the UK's public services and for helping families and individuals with financial support. Responsible for Income Tax, Corporation Tax, Capital Gains Tax, Inheritance Tax, Stamp, Land and Petroleum Taxes among others.
IHT	Inheritance Tax. This is a tax due on the value of your estate at death, including any assets held in trust and gifts made within 7 years of death. The current IHT threshold (2014/15) is £325,000, been frozen until 2019. Tax is payable at 40% on any amount above this nil rate threshold.
IM	Investment Memorandum, Offering Memorandum (OM) or Private Placement Memorandum (PPM). A legal document stating the objectives, risks and terms of a private investment. It should provide buyers with information on the offering and protect sellers from the liability associated with selling unregistered securities.
NMPI	Non-Mainstream Pooled Investment. Term coined by the FCA in PS13/03 to include UCIS and other forms of Pooled Investments such as QIS, certain SPVs which have similar attributes and Traded Life Policy Investments.
PLUS	PLUS Markets Group. London based electronic stock exchange for small companies and a rival to AIM. Acquired by ICAP in 2012 and re-branded as ICAP Securities and Derivatives Exchange (ISDX). Providing cash trading, listing, derivatives and technology services.
PS13/03	Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes: Feedback to CP12/19 including final rules. Policy statement issued by the FCA in June 2013 covering UCIS and close substitutes.
Section 42 of the Finance (No. 2) Act 1992	Allowed expenditure on the production or acquisition of British films to be matched against income from the film or written off over three years.
Section 48 of the Finance (No. 2) Act 1997	Allowed expenditure on low budget British films to be written off immediately.
SEIS	Seed Enterprise Investment Scheme. Aims to help small, early-stage companies raise finance by offering tax reliefs to individual investors who purchase new shares in those companies. It complements the EIS and focuses on very early stage companies, offering tax relief at a higher rate than the EIS.
UCIS	Unregulated Collective Investment Scheme. An investment structure which pools investors' funds in order to invest directly in underlying companies or assets. The marketing of UCIS is regulated and subject to complex rules, including restrictions imposed by s. 238 of the Financial Services and Markets Act 2000 and COBS 4.12.
VCT	Venture Capital Trust. Scheme started on 6 April 1995 and is designed to encourage individuals to invest indirectly in small higher-risk trading companies whose shares are not listed on a recognised stock exchange. VCTs are traded on a regulated market and tax reliefs are available to individuals who invest.

CPD AND FEEDBACK

CONTINUING PROFESSIONAL DEVELOPMENT (CPD)

Intelligent Partnership has achieved accredited status for AiR 2014 from the Institute of Financial Planning (IFP), Chartered Insurance Institute (CII) and Personal Finance Society (PFS).

Members of these professional organisations represent the majority of the insurance and financial services industry.

Readers of the industry report can claim one CPD hour towards their scheme for each hour spent on the report, the CPD hours claimed should reflect the length of time spent studying the material.

The review process included an assessment of the technical accuracy and quality of the material against CPD Accreditation standards. Achieving the recognised industry standard afforded by these organisations for this report, and our training, demonstrates our commitment to delivering only balanced, informative and high quality content to the financial services and investment industry.

In order to obtain CPD and meet accreditation standards, readers must complete a short questionnaire and provide feedback on the report. This includes fifteen multiple choice questions to demonstrate learning and a feedback form to assist in the compilation and improvement of future reports.

To claim CPD please create an account and complete the questionnaire by visiting:

EIS2014.AiReport.co.uk

FEEDBACK

Intelligent Partnership actively welcome feedback, thoughts and comments to help shape the development of this industry report, with a particular interest on the topics readers would like to be covered in more detail in both interim and future annual reports.

This report is produced on an annual basis and is compiled through conducting research and surveys with investment providers, financial advisers, wealth managers and private investors within the EIS industry. Greater participation, transparency and fuller disclosure from industry participants should help foster best practice and drive out poor practice.

Feedback can be given by creating an account on the dedicated report website or via email:

EIS2014.AiReport.co.uk

reports@intelligent-partnership.com

Participation and feedback are gratefully received.

DISCLAIMER

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PUBLICATION

The information has been compiled from credible sources believed to be reliable, however it has not been verified and its accuracy and completeness are not guaranteed.

The opinions expressed are those of Intelligent Partnership at the date of publication and are subject to change without notice.

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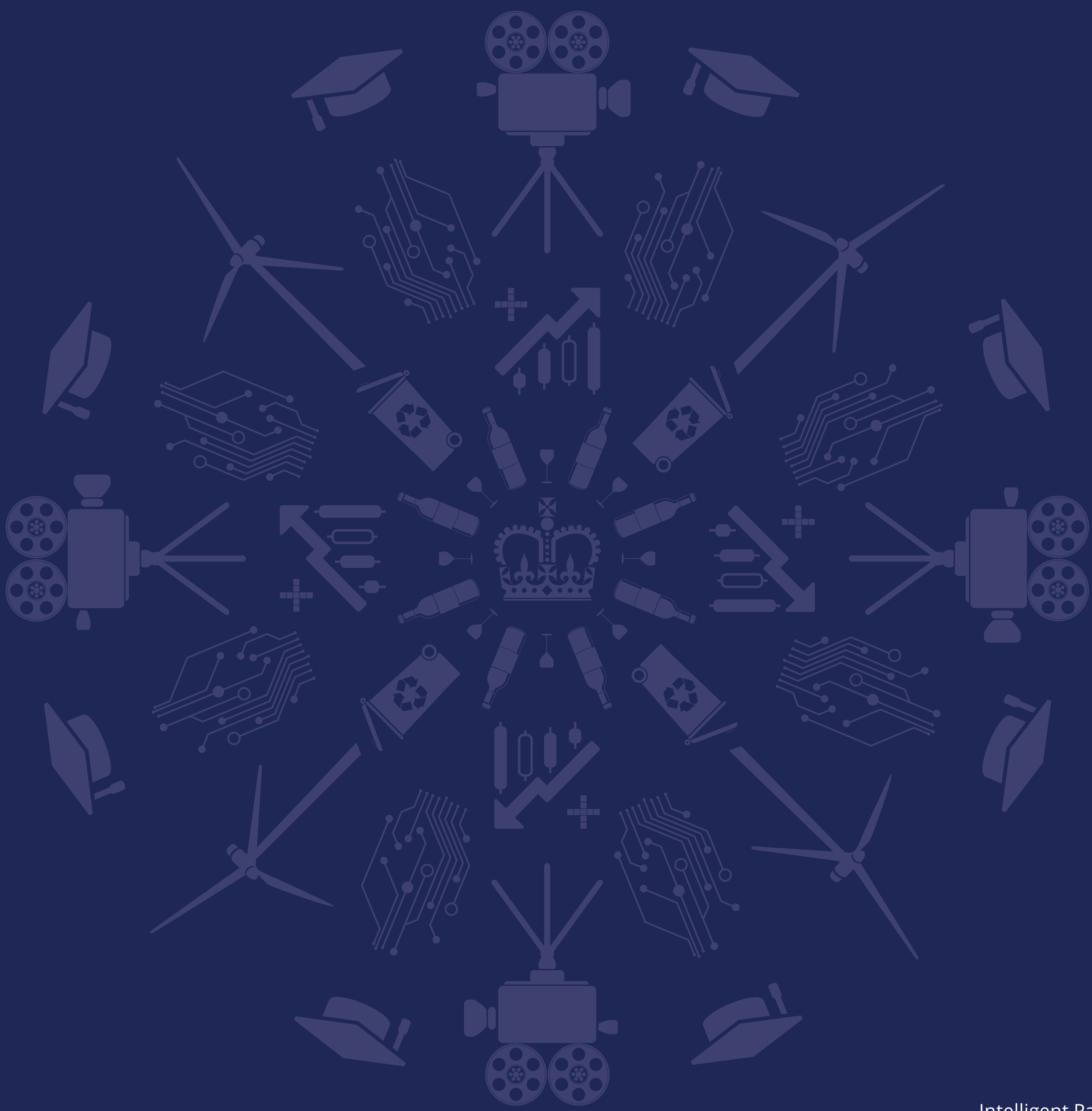
"With tighter pension allowances, a freeze on IHT until 2019 and the need to diversify away from the public markets, investors are increasingly looking to EIS as an attractive, tax-efficient option"



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