

## WING TIPS

### *VCTs – Due Diligence or Bust?*

*With funding having returned to, and surpassed, the highs of 2001, VCTs have seen another boom time. Now, unless the VCT managers, undertake adequate due diligence, the rush to invest £500 million in AIM or unquoted companies could result in poor decision making, argues Philip Marsden, Director, Vantis Corporate Finance Limited.*

#### **Boom Time**

VCTs were established by the last Conservative government to encourage investment in new UK businesses, with subscriptions for new shares in VCTs offering lucrative tax benefits to tempt investors. However, falling stock markets between 2000 and 2003 meant that fewer investors needed to shield capital gains from the taxman. This led to a big fall in VCT demand post 2001, and prompted a change of stance from the Chancellor, who despite scrapping the deferral of capital gains tax, increased the income tax rebate to investors in VCTs from 20% to 40% for the two years to 2005/06. This led to soaring demand, with investment sales in VCTs for the tax year ended 5 April 2005 hitting £500 million.

Despite the Chancellor praising VCTs for the positive influence on growing businesses and confirming his intention to ensure the long-term sustainability of the VCT market, it would appear he intends the margin of relief for 2006/7 and subsequent years to revert to 20%. The venture capital industry is trying to ascertain the potential implications on the VCT market as we speak.

Most VCTs aim to invest the majority of assets in qualifying companies, including those whose shares are traded on AIM and OFEX. New issues on AIM have continued to boom throughout 2004 and 2005 with in excess of 870 admissions to the market (40% of total admissions since the market's launch), so investment opportunities are potentially strong.

Nevertheless, how many companies will be tempted to come to AIM prematurely to take advantage of this one-off opportunity? Certainly, competition between VCTs for good AIM and unquoted company investment opportunities is strong, as funds fight to woo the most promising businesses. This combination of financial boost and the 'three years to invest' time constraint imposed on the VCTs could cause significant problems. Unless they undertake appropriate due diligence the market could become the next bubble attracting the appalling publicity that has dogged the financial services industry for so long. With an upper ceiling of £1 million to invest per company, and accordingly less available to spend on due diligence, the opportunities for rigorous due diligence are limited.

#### **Market Implosion**

VCTs became unfashionable investments when the financial markets imploded in 2001. The combination of a limited requirement for a vehicle for individual investors to roll over disappearing capital gains, and the poor performance of the many VCTs that invested in emerging tech stocks, contributed to the funds falling out of favour.

Yet, according to stockbrokers Charles Stanley, despite widespread belief, VCT fund performance over the past few years has not been bad. Indeed, on average, ignoring any initial tax relief and taking into account the three-year period in which a VCT will invest, the performance has been acceptable in relation to that of the general market.

### **Too Soon?**

With competition between VCTs for investment opportunities fierce, how many will end up making poor decisions simply to find a home for the money?

Of course, for those investing in new AIM stock, it is reasonable to expect that the sponsor has undertaken due diligence prior to putting the prospectus together. However, being realistic, there are many small companies coming to AIM with a very small market capitalisation. They are opting to get investment from VCTs because the money is available now and so few private equity funds work in the sub £5 million investment area. These companies are likely to have no liquidity in their shares, and they face the higher costs associated with being a quoted company – from increased corporate governance to extra auditing. Is AIM really the right place for these organisations? If not, how many AIM VCTs will suffer from their willingness to support this trend?

### **Flexible Due Diligence**

With many VCTs looking to raise funds, the manager's track record will be key. For those VCTs eschewing AIM in favour of private companies, the risks can be higher.

There is, therefore, a clear need for due diligence, particularly for small private equity investments, though with a ceiling of £1 million per investment, VCTs cannot possibly afford to undertake an in depth, all encompassing due diligence process. A typical budget of up to 2% on due diligence does not stretch far. Even for those VCTs opting to work together in a syndicate, while potential funds available for due diligence are larger, there is still pressure to minimise due diligence costs. VCTs need to be smart about targeting investigations, opting for highly focused due diligence which addresses key business drivers.

From a check on working capital assumptions or the sustainability of margins to the validity of forecasts or even the quality of senior management, such targeted due diligence, undertaken by a third party expert, is highly effective.

Due diligence may result in advice not to make an investment, or more often the process will raise concerns or issues with the potential investee's assumptions, or forecasts, that will result in a change in the terms of investment.

The due diligence process also looks at the ongoing support required by the investee company. What support will a company require to meet its objectives and deliver returns to the VCT? From additional management expertise and management controls to raising further funds, both VCT and investee gain a clearer picture of the short to medium term requirements. In addition to making better up-front decisions on investment quality and expected rate of returns, carefully targeted due diligence will enable VCTs to be better prepared to assist the company post-investment to meet its objectives.

**For further information on Vantis plc's due diligence services contact: Philip Marsden or Rebecca Guerin on [philip.marsden@vantisplc.com](mailto:philip.marsden@vantisplc.com) 0207 549 2467 and [rebecca.guerin@vantisplc.com](mailto:rebecca.guerin@vantisplc.com) 020 7549 2441 respectively.**