HOW MUCH SHOULD CLIENTS INVEST IN VENTURE CAPITAL

THE SUMMARY OF A REPORT
BY HARDMAN & CO.

NOVA GROWTH CAPITAL

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The report investigates the effect of adding venture capital to equity/bond portfolios for retail investors.

Our overview is that it makes a compelling addition, significantly improving an investors risk/return profile.

The analysis suggests that venture capital can improve returns by 0.5% to 1.0% without changing portfolio risk for investors with normal risk appetites.

The effect of tax reliefs

The UK is lucky to have venture capital schemes that offer significant tax reliefs to investors: Venture Capital Trusts, Enterprise Investment Scheme and Seed Enterprise Scheme.

We show that these tax reliefs hugely improve expected IRRs: almost doubling them in the case of SEIS.

Unsurprisingly, these make venture capital even more attractive in our analysis. The net result is that clients with an average risk profile should have venture capital exposure in mid- to high teens percentages, depending on which area of venture they have exposure to.

Venture Capital is not homogenous

Although Venture Capital is a distinct asset class, it is far from homogenous. The focus of this analysis is on the UK's tax advantaged schemes, which limit the size of company that can be invested in, and for the purposes of this paper we are using two categories:

Seed: this is early stage funding, usually when companies are in product development or finding their first customers.

Scale-up: once a company achieves product-market fit, it usually invests in distribution to grow revenue quickly.

While seed includes SEIS funding, it covers other early-stage investments too.

Scale-up companies are better developed than seed companies and this should translate into a lower risk of failure and investors should expect an accordingly lower return.

Making reasonable **assumptions**

The analysis suggests that a reasonable return target for venture capital in our areas would be something from mid-teens to low twenties percentages. Earliest stage investments, such as SEIS, may be a bit higher, while scale-ups may be in the lower half of this range. For our purposes we make the following estimates:

Expected return on scale-up investments is 15% p.a.

Expected return on seed investments is 22% p.a.

Although these could be conservative.

It is pretty clear that adding in venture capital has a favourable effect: the portfolios with venture capital are higher, showing that we can improve returns for most levels of risk.

Mathematically, even those with a low risk appetite should still have a small amount of venture capital in their portfolio. And it can be added without increasing the same portfolio risk. If all that happens is that venture is added to an existing portfolio, then we are increasing risk. There is an obvious concern that venture capital investments can and do fail. One of the key ways of addressing this is through diversification.

Diversification

If someone has a portfolio of 5 investments and one fails, that is likely to concern most people. If the portfolio is 100 or 200 strong, then failures are much easier to tolerate.

Syndicate Room shows that in a portfolio of 150 venture capital investments, the probability of an overall capital loss in 5 years is under 5% - about the same as an equity market. The challenge is that no tax advantaged products give this diversification on a standalone basis, so investors need to buy into several funds to diversify properly.

How do tax reliefs change expected return and risk?

Effect of tax reliefs on returns

Scenario	
No tax reliefs	17%
Initial income tax relief of 30% (EIS)	24%
Add loss relief (EIS)	27%
Add CGT deferral	31%
Initial income tax relief of 50% (SEIS)	30%
Add loss relief (SEIS)	32%

Source: Hardman & Co.

Assumed initial income tax relief received after 12 months, loss relief is paid immediately for a 40% tax payer. CGT deferral assumes whole investment from capital gain with 20% tax and no CGT allowance.

It can be seen that the tax reliefs make a huge difference to expected returns.

The initial relief alone adds 7% to EIS returns under this scenario and 13% to SEIS returns. Loss relief is slightly less beneficial for SEIS due to the larger initial relief. In absolute terms, this scenario would give another 12.7% of tax relief for EIS investors (for a total of 42.7%) and 8.2% for SEIS investors (total 58.2%).

IN SUMMARY

Using well-justified assumptions, we have shown that venture capital is a compelling addition to investor portfolios.

Even at a relatively small proportion of portfolios it can make a significant difference.

The addition of tax-reliefs makes it even more compelling. The old rule of thumb of 10% looks more like a minimum for most investors, with mid- to high teens more realistic for those with average risk profiles.

Hardman & Co is a rapidly growing, innovative corporate research & consultancy business, based in London, serving the needs of both public and private companies.

Within the EIS and VCT market, we write reviews of funds and companies to an institutional standard. We also offer panel services, training and consulting to IFAs, supporting them in making the best decisions for their clients.

Nova Growth Capital Ltd.
57 Jordan St
Liverpool
L1 0BW

0151 317 4250
fund@novagrowthcapital.co.uk
novagrowthcapital.co.uk

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