OXFORD CAPITAL

VENTURE CAPITAL
AND EIS

A GUIDE TO INVESTMENT STRATEGY & RISK IN EARLY STAGE INVESTING

CONTINUING PROFESSIONAL DEVELOPMENT - APPROVED MATERIAL - CISI CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

FOR FINANCIAL ADVISERS AND WEALTH MANAGERS

IMPORTANT INFORMATION:

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This document has been designed to provide general information about the risks and strategies associated with Venture Capital and Enterprise Investment Schemes (EISs). It is based on our understanding of the current legislation. Tax reliefs described in the guide are based on our understanding of the current legislation. Note that tax treatment depends on an individual's circumstances and legislation may be subject to change in future.

Information correct as at March 2019.

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LEARNING OUTCOMES: AS EASY AS 1, 2, 3.

This guide is aimed at advisers and industry professionals who may or may not have had some previous experience of venture capital and EIS investing.

After reading this guide, advisers can expect to have an understanding of:

- **Venture Capital (VC) investing and how it works.**
- **EIS investing and how it intersects with VC**
- **The risk management techniques that Venture Capital EIS managers can apply.**

USING THIS GUIDE

Look out for these symbols throughout this document to help you to pass the online CPD test.

Key facts   Case study

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50 PER CENT OF ADVISERS CURRENTLY ADVISING ON EIS BELIEVE THAT INVESTOR INTEREST IN EIS WILL NOW RISE. ***EISA SURVEY DECEMBER 2017.***

Welcome

The purpose of this guide is to help you understand the venture capital investment strategy that can sit behind an EIS portfolio. It looks at how it can be combined with EIS to create an attractive investment proposition complete with effective risk mitigation.

Venture capital (VC) is a type of funding for new or growing firms operating in fast-growing industries, with the potential to increase in value significantly. The funding for these small unquoted businesses is in exchange for equity in the company.

This is remarkably similar to the goals of EIS as restated and brought back to the fore in the Autumn 2017 budget. Low-risk, asset-backed structures focused largely on the tax reliefs for investors – previously a common feature in EIS portfolios – are no longer an option.

Under the requirement for 'risk to capital', the EIS spotlight has shifted back to VC and the exciting opportunities that continue to emerge there. Risk has always been present in VC-focused Enterprise Investment Schemes (EIS). Start-up and early stage companies are simply more prone to failure than larger companies. The tax advantages under the Enterprise investment Scheme are designed to compensate for the associated risks of investing in small unquoted trading businesses. But it is important to note that tax advantages are subject to change and will depend on an individual's circumstances.

The good news is that experienced venture capitalists targeting high growth, such as Oxford Capital, have been offering their propositions within the EIS wrapper for many years.

When you're investing in an early stage business, you want to make sure the quality of its management and the industry it's in give it the greatest chance of success.

When using a venture capital specialist, you can leverage their experience and expertise in unearthing companies that have the potential to grow rapidly and become very valuable.

Investors will be stakeholders in the investee companies and will be able to follow their stories as they develop.

To me, there is nothing more exciting than being part of a company's journey as it grows in size, becomes more valuable, and ultimately produces a profitable return for its investors. Of course, some of the companies will fail or under-perform. that is the nature of venture capital investing.

These journeys can be long and difficult. But they can also be incredibly rewarding.

Enterprise Investment Scheme (EIS) tax reliefs provide a generous incentive to take the risks associated with investing in smaller companies, particularly in the early stages.

As such, before committing to any EIS investment, it is important to understand exactly what you are buying.

Tom Bradley, CEO of Oxford Capital

An introduction to venture capital

An introduction to Venture Capital

Whether this is your first experience of EIS or VC investing, or you're an experienced hand, it's important for you to understand what you're buying into and what role VC can play in your clients' portfolio.

GROWING A SUCCESSFUL BUSINESS COSTS MONEY

In some industries, an entrepreneur can turn an idea into a fledgling business with relatively modest amounts of capital.

To get things started, they might put some of their own cash into the business. They could also raise money from family or friends, or secure a grant from a relevant foundation or government body.

Once the new company is up-and-running, the entrepreneur may need more finance to help it grow and become profitable more quickly. For example, perhaps they want to recruit some employees, improve their product, or invest in marketing to build awareness of their brand.

It can be hard to borrow money for these purposes. Banks usually do not like to take on the risks of lending to small companies, unless the money is being used to buy an asset that can be security for the loan.

This is where venture capital can help. VC investors provide finance by buying shares in small businesses that have the potential to grow quickly. The VC investor's objective is to generate a return by participating in the value growth that stems from rapid expansion.

...BUT IT'S MORE MORE THAN JUST MONEY

An important facet of VC is that many investment managers are not just providing money.

They also play an active role in helping the businesses they invest in to grow, providing expertise and consultancy that would otherwise be out of reach..This might include sitting on the board of directors, to help shape the company's strategy. VC investors also have large networks of useful contacts. They can introduce companies to new potential customers, suppliers or partners. They might also help to recruit new employees, or bring in a respected industry expert to chair the business to increase profile.

Entrepreneurs may choose to work with the VC manager who they think is most capable of helping them grow their business, or who shows most empathy with their challenges. This often hinges on whether the investor has a lot of experience in the relevant industry sector. This is partly why it is common for VC managers to focus on investing in a particular sector.

> **Venture capital is about the search for the extraordinary. Extraordinary breakthroughs, extraordinary change, extraordinary growth.**
>
> *Tom Bradley, Oxford Capital*

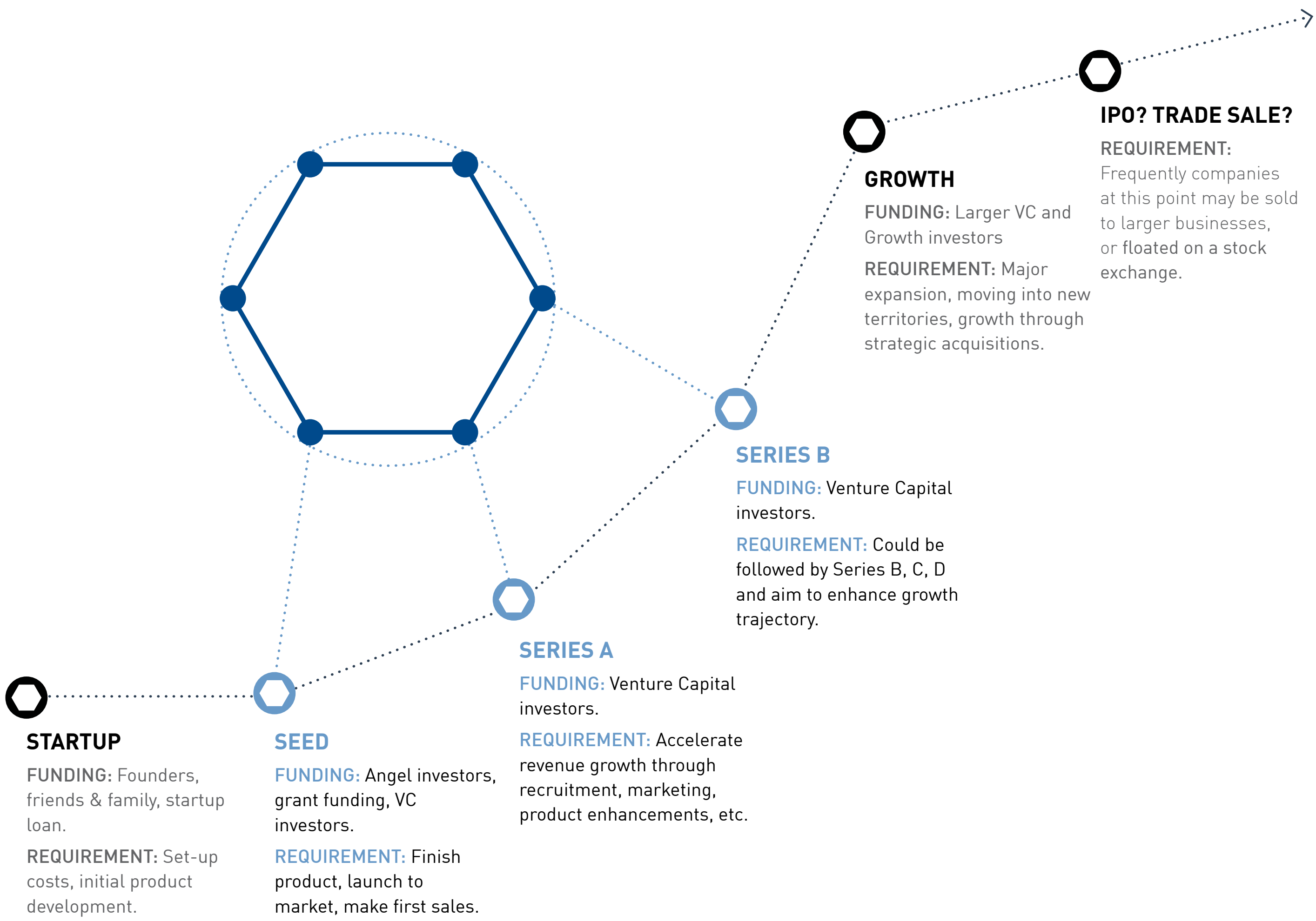
HOW SMALL ARE THESE COMPANIES?

Typically, the first time that a company raises money from institutional investors such as VC investment managers, is in what's known as a 'Seed' round or 'Series A' round.

At this stage, the company may have already started selling a product or service. If so, the investment manager can use the company's performance so far as part of its decision-making process. For example, revenues might already be growing quickly, and the company may have gathered a lot of positive feedback from customers. This helps to demonstrate the potential of their business model and the quality of their product.

If the company has not yet launched a product or service, the investment manager will look for different types of indicators of potential. For example, the company may have achieved a technological breakthrough with obvious value to a large market. Or if the entrepreneur behind the company has already successfully built and sold previous businesses, it could strengthen the case for investing in their newest venture.

Each company's funding requirements and growth plan are different. But the diagram below illustrates the different points in a company's development when funding might be needed.



HOW MUCH DO INVESTMENT MANAGERS INVEST?

VC investment managers might invest from a few hundred thousand pounds to several million. But if they want the investment to be EIS-qualifying there are investment limits that they must be mindful of. They must also take into account their diversification strategy when deciding on the investment amount.

It is not uncommon for managers to invest in a company more than once – with the first investment being fairly small – typically less than £1 million at the 'Seed' stage, so it's only a small part of the overall portfolio.

This will allow them to become a shareholder and to take a board seat early on, working closely with the management team, closely monitoring the company's progress and helping it to achieve its objectives. The unique insight this gives the manager allows them to make a fully informed decision about further funding when the time comes for a Series A round. For Series A and later rounds, the manager could invest up to £2 million or more.

If a company has underperformed between the Seed and Series A rounds, the manager can decide not to commit any further investment to the company.

Case Study: Active Engagement

Operational assistance can be invaluable to early-stage businesses as founders often have little or no experience of actually running a company. Oxford Capital helps investees to prioritise the strategies that will drive value creation.

A good example is Red Sift, an investee company which has a software platform designed to help consumers and businesses turn disparate data into useful information. Oxford Capital supported their drive to develop their own commercial application to credentialise their software development platform. The product they developed, OnDMARC, achieved first revenue in under four months and has attracted business from the Department of Justice and a raft of law firms.

Oxford Capital also runs a quarterly series of events for its portfolio companies to encourage knowledge sharing between companies, and curates the 'OCV Marketplace'. This is a list of products and services that portfolio companies make available to each other, often at a discount to their standard rates.

Contacts are another resource that investment managers can make available to their investees. In the case of Wrisk, which develops smartphone-based insurance products, Oxford Capital was able to introduce an insurance technology veteran. He became an adviser to the Wrisk management team.

TRACK RECORD

A manager's investment record can be useful, although it is important to assess the quality and experience of the team at the time of investment, which may be different to the one in place when earlier exits took place. Consider their strategy and the processes involved in making investments. Failures may be an indicator of proactive management rather than poor management.

Questions to ask:

- Do they have details of past individual exits?
- What is the expertise of the current team?
- Can they articulate their strategy and process? What insights do independent analysts give?

QUALITY OF DEAL FLOW

Having an excellent source of potential deals — or deal flow — is vital and a key criterion for choosing a good manager. Investment Managers in this space rely heavily on contacts, developed over their careers, so reputation can be crucial.

It is important that VC and EIS managers have a good balance between how much investor money they are taking in and how many good-quality opportunities they are finding. Attracting too much money is a risk where there is a temptation to deploy money sub-optimally.

Questions to ask:

- How do the team's background and experience help with deal flow?
- How many deals do they see?
- What proportion of deals that they want to be involved in do they end up securing?

INVESTMENT SELECTION

Filtering the large number of potential investments from the deal flow to the final few that reach the final stage of investment is complex. It requires meticulous and disciplined consideration of numerous elements – from the personalities involved to the market potential. Due diligence in this field requires expertise.

Questions to ask:

- Can they outline their investment process, philosophy and investment selection criteria?
- What proportion of deals from the start of their funnel do they end up investing in?
- What are the key metrics they look at in assessing the likelihood of success?
- What are the signs that a deal should not be pursued further?

> **Venture capitalists are traditionally respected for their quality advice, drawing on personal experiences as well as a network of past portfolio companies and industry contacts.**
>
> *GARY DUSHNITSKY, ASSOCIATE PROFESSOR, LONDON BUSINESS SCHOOL*

Joining forces with other investors allows managers to take part in bigger fundraising rounds, whilst keeping their own level of commitment consistent

WORKING WITH CO-INVESTORS

VC investment managers sometimes invest in companies alongside other investors, including other VC firms, but occasionally investment banks, government funding bodies or the venture arms of major corporations. Working with co-investors can bring both the VC and the investee company significant benefits:

- **Access to bigger deals**
  Joining forces with other investors allows the VC to take part in bigger fundraising rounds, whilst keeping its own level of commitment consistent. For example, some VC managers would prefer to contribute £1m to a £5m fundraising round alongside co-investors, rather than being the sole investor in a company that is only raising £1m.
- **Further verification of investment case**
  Knowing that an investee company has successfully passed through the due diligence processes of other investors can increase a VC manager's confidence in its own investment decision.
- **Greater support for investee company**
  With multiple VC investors backing their company, entrepreneurs have a wealth of knowledge and an extended network to support the growth of their business.

Examples of Oxford Capital's co-investors include:

- Balderton
- Nauta Capital
- IP Group
- Wellington Partners
- Episode 1
- Goldman Sachs
- Credit Suisse
- IP Group
- Open Ocean
- Samos Investments
- Pentech Ventures
- Draper Esprit
- Whitestar Capital
- Forward Partners
- Canvas Ventures
- ADV
- Partech
- Jamjar Investments

KEY FACTS

REGIME CHANGE

EIS rules have been restated to focus on risk-based investing as opposed to asset-backed projects

Things to look for in selecting a VC portfolio manager

- **Pipeline of deals**
  How many deals they see in their specialist sectors
- ***Selectivity***
  Low proportion of deals that they ultimately invest in
- **Guidance**
  Managers who help and guide start-ups on their growth path
- **Track record**
  Strong record of successful investments and exits by the current team

UP NEXT...

In the next chapter, we will find out how vibrant technology companies and innovation in the UK, combined with a thriving VC investment scene, are driving a major growth story for the UK economy.

The age of UK Venture Capital

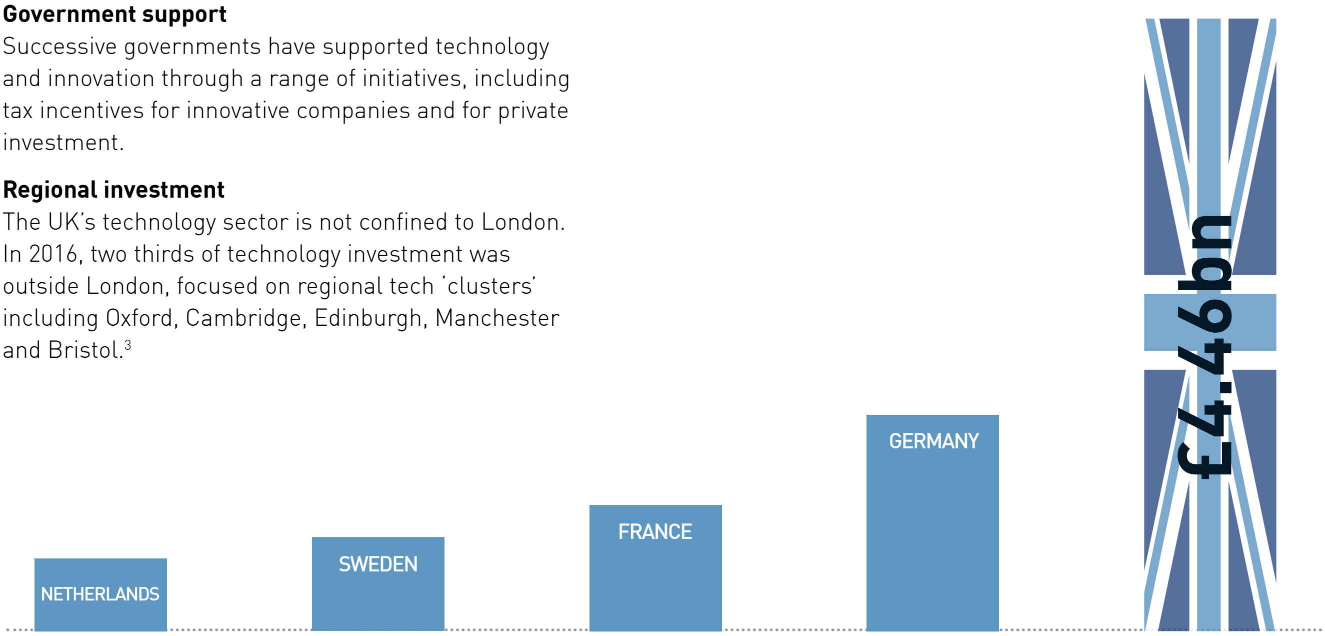
Venture Capital in the UK

The UK is a world leader in technology and innovation. Over the last decade the UK's venture capital sector has become more mature and experienced. Those who invest in a venture capital fund are both enabling and capturing the potential growth of innovative businesses in up-and-coming industries.

The UK's 'unfair advantage'

What makes the UK a good place to start and grow innovative businesses?

- **Academic excellence**
  Universities play a crucial role in the digital economy, creating a skilled workforce, driving innovation and attracting inward investment. The UK has three of the world's top-ranked computer science universities[1] and 4 of the Top 10 universities in the world are in the UK[2].
- **Big talent pool**
  There are now more than 187,000 tech companies in London that employ 1.2 million people and have a combined turnover of £285 billion[3].
- **Government support**
  Successive governments have supported technology and innovation through a range of initiatives, including tax incentives for innovative companies and for private investment.
- **Regional investment**
  The UK's technology sector is not confined to London. In 2016, two thirds of technology investment was outside London, focused on regional tech 'clusters' including Oxford, Cambridge, Edinburgh, Manchester and Bristol.[3]



TOTAL DIGITAL TECH INVESTMENT IN 2017[4]

1 Times Higher Education Global Rankings 2018
2 World Univeristy Rankings 2019
3 Tech London 2018
4 Pitchbook 2018

£184bn

EST. TURNOVER OF THE UK DIGITAL TECH INDUSTRIES IN 2017

2.6x

UK TECH SECTOR GROWING

ALMOST THREE TIMES FASTER THAN THE OVERALL UK ECONOMY

1.64m

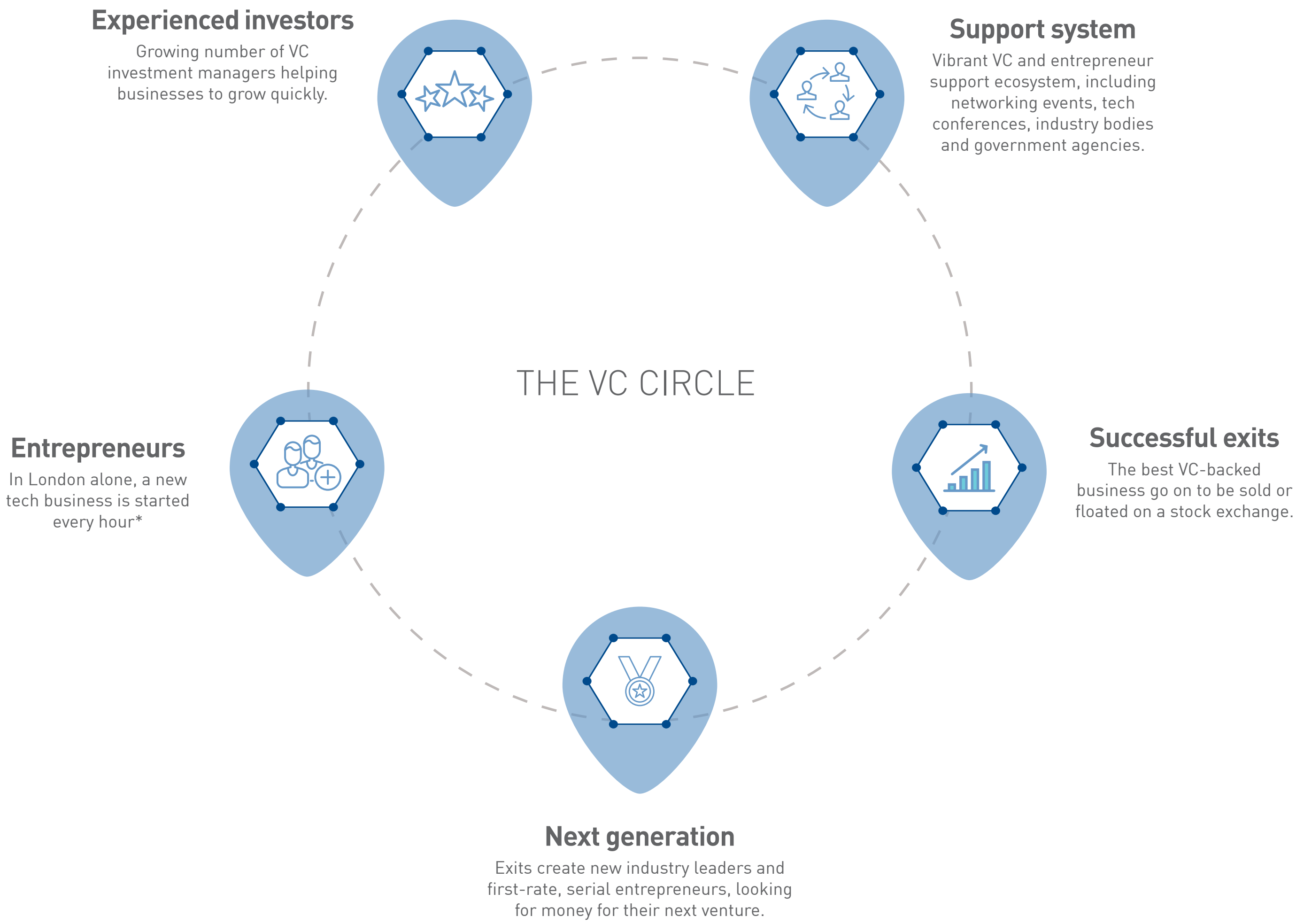
UK DIGITAL TECH JOBS

THE NUMBER OF TECH JOBS HAS GROWN AT MORE THAN TWICE THE RATE OF NON-TECH JOBS[5]

5 Pitchbook, Tech City UK, 2016

Coming of age

The success of UK technology and innovation is intertwined with the development of the country's venture capital investment scene. VC investing has grown and matured considerably over the past 20 years. Entrepreneurs are now able to seek funding and support from many well-respected and experienced VC investment managers. And VC investment managers are increasingly able to back experienced entrepreneurs who have already proved their talents, by growing and selling a previous business.



* Philip Hammond, Spring Statement March 2018

(xihelm)

Xihelm is developing specialised agriculture-applied artificial intelligence and a machine vision algorithm that sees, understands and acts in the indoor farm to enable roboticised indoor harvesting. This represents an opportunity to optimise crop yield and to cut high labour costs. Xihelm's first product is a software solution that uses off-the-shelf industrial robotic arms to automate the harvesting process in greenhouse tomato farms. It is currently undergoing field trials with a large commercial producer in the sector.

Beyond tomatoes, the machine vision technology being developed by Xihelm is generalised enough to be applied to other fields, both within and beyond the glasshouse.

Case Study: Due Diligence

In May 2018, Oxford Capital closed its £1.3m investment in Xihelm.

The company is developing technology in the field of computer vision applied to agriculture, initially within glasshouses. Its software turns off-the-shelf robotic arms into automatic fruit and vegetable harvesting machines. This brings automation to the part of the process which accounts for the highest operating expense within this multi-billion-dollar industry. Xihelm's first product is a tomato picking robot that is undergoing field trials with a large UK commercial producer.

The technology has potentially massive implications for both UK and worldwide food production by securing harvests threatened by workforce issues. The market drivers are undeniably very strong with a global addressable labour spend in greenhouse agriculture of $68bn that is growing at 14% year-on-year.

Success or failure rests on delivering the technology. That's where the importance of bespoke research and access to external expertise comes to the fore.

Bespoke due diligence is a crucial part of the activities undertaken by venture capital investment managers to minimise the risks. For Xihelm, Oxford Capital's due diligence extended well beyond in-depth research in the possible size and scope of the opportunity. We sought expert opinion and external validation on the quality of Xihelm's IP, technical know-how and the viability of their approach. This is crucial to the long-term viability of their equipment and their growth - and therefore to our investment.

moneybox

Moneybox is a mobile service making savings and investments simple and fun. Through its flagship 'round-up' features, it allows users to save the spare change from their everyday purchases by rounding up card transactions to the nearest pound. Users can also make more significant lump sum contributions. Moneybox is one of the UK's fastest-growing asset managers by customer numbers, giving tens of thousands of people access to cost-effective investment products designed to meet their life goals.

Case Study: Moneybox

Oxford Capital's Ventures team initially invested in Moneybox in July 2016. Since that time, it has invested twice more following the growth and development of the company and its attainment of key milestones. Between the first funding round and the second, in April 2017, Moneybox launched their ISA product and performance was strong - surpassing an ambitious budget.

Between the second and third funding rounds, in August 2018, Moneybox continued to make strong operational progress, almost quadrupling its user numbers, launching its Lifetime ISA product and focusing on preparations for the release of a pensions product in late 2018. This was aimed at further broadening Moneybox's addressable market, increasing penetration among the current userbase, and enabling Moneybox to grow with their users over time.

KEY FACTS

UK TECHNOLOGY AND INNOVATION

Technology and innovation-led business are thriving in the UK, with a highly skilled talent pool and strong government support.

The UK technology sector is growing 2.6 times faster than the economy as a whole.

UK start ups are well supported by a thriving investment scene, with many respected and experienced investors backing entrepreneurs and their ideas.

UP NEXT...

In the next chapter, we will find out how the EIS and its tax advantages are designed to encourage investors to support early stage UK companies and – if they choose the right ones – to enjoy the benefits of their success.

EIS: tax-efficient investing to support the grass roots of the UK economy

Where VC and EIS converge.

The EIS and Seed EIS (SEIS) encourage early-stage investment into smaller and younger UK companies that show high promise and growth potential. These companies use investor money to help finance expansion and development.

EISs are high risk investments. While reinforcing this, the Finance Bill 2017-2018 also solidified EIS as a legitimate scheme, giving certainty to everyone involved. The government has again demonstrated its support for the scheme, as well as for emerging innovation and entrepreneurship.

A new principles-based test - the 'risk-to-capital condition' for EIS - was introduced by the Finance Bill 2017-2018. Since then tax-motivated investments, where the tax relief provides a substantial part of the return for an investor with limited risk to the investor's capital, are no longer eligible for relief. An investment should meet the following requirements to be eligible for the scheme:

- The company in which the investment is made must have objectives to grow and develop over the long term
- The investment must carry a significant risk that investors will lose more capital than they gain as a return (including any tax relief).

So, capital preservation strategies no longer qualify for EIS. Companies employing structures where asset backing, such as investors owning a pub's freehold, or contract backing, such as a film-production company with distribution contracts already in place, are now highly unlikely to be eligible for EIS.

Consequently, the door has now closed on the more predictable EIS opportunities. EIS investors now need to focus on venture capital strategies.

VC strategies are often termed *growth* strategies, but it is important to draw a distinction between different types of growth - the linear and the exponential. A good growth investment might be capable of being three times bigger than it is today in your period of ownership. A good VC investment should be capable of being 30, 40, or 100 times bigger.

In most venture capital vintages, delivering three times the money invested on a gross basis will see the manager in the top quartile of institutional VC managers.

EIS: SOME THINGS DON'T CHANGE

There has been no erosion of the generous tax reliefs on offer (subject to investors holding EIS qualifying shares for the required time periods). The rationale is to encourage investment and to compensate for the additional risks and costs of involvement in start-up or SME firms and the downside protection (and upside enhancement) of the reliefs available is still substantial.

EIS and SEIS serve the same essential purpose. Both work with relatively small and young firms in the context of the UK's business and corporate landscape, although SEIS is explicitly targeted at start-ups and earlier-stage companies than EIS.

This guide focuses on EIS.

EIS IN NUMBERS

£18bn

Funds raised and deployed in EIS since launch in 1993/94
(HMRC May 2018)

27,905

Number of companies that have received EIS investment
(HMRC May 2018)

76%

Proportion of EIS investees that attribute an increase of sales to the investment.
(The use and impact of venture capital schemes, HMRC Research Report 355 Feb 2016)

EIS: BEST IN CLASS

- **Top class scheme:** In a European Commission report on the effectiveness of tax incentives to support SMEs and start-ups*, EIS came second behind Seed EIS.
- **Government backing:** In existence over 25 years, through the administrations of various parties in government
- **Important role**: "The schemes appeared on many measures to have a particularly strong impact among the smallest and youngest companies, as well as those aiming to expand, broadly suggesting they are being targeted at those most in need of investment." ((The use and impact of venture capital schemes, HMRC Research Report 355 Feb 2016)
- **Huge potential:** Some very well-known and successful companies received EIS funding in their early stages. They include Innocent Smoothies and Brewdog.

WHICH COMPANIES QUALIFY FOR EIS?

Fewer than 250 employees (or fewer than 500 employees for 'Knowledge Intensive' companies).

Trading for less than seven years (or less than 10 years for 'Knowledge Intensive' companies - typically those with high research and development costs/ requirements).

Gross assets valued at no more then £15m.

Maximum lifetime amount that can be raised under SEIS, EIS and VCTs is £12m (or £20m for 'Knowledge Intensive' companies).

*"Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups", European Commission, 2017, which looked at schemes in 36 countries.

KEY FACTS

EIS IS DESIGNED TO ENCOURAGE INVESTMENT IN EARLY STAGE COMPANIES WITH A SERIES OF ATTRACTIVE TAX RELIEFS:

30% income tax relief
Actual net cash outlay of 70p in the pound

CGT freedom
No Capital Gains Tax to pay on successful exits

CGT deferral
Potential unlimited and indefinite deferral of an existing CGT bill

Loss relief
Maximum exposure of 38.5p in the pound for a 45% income tax payer

Inheritance tax relief
Potential saving of 40p in the pound.

UP NEXT...

In the next chapter, we will see the importance and the techniques investors can use to mitigate risk in a portfolio of early stage companies.

Managing investment risk in early stage investing

Risk and return in venture capital investing

By investing at an early stage in businesses with the potential to grow very rapidly, investors are positioning themselves for the possibility of very high returns. The risks inherent in early stage investments mean that a successful VC manager will need to have some portfolio companies that deliver these outsized returns in order to compensate for the losses that will inevitably occur in some investments.

When executed well, VC strategies offer the potential for high returns. In order to achieve this, however, it is important that the funds are invested in a suitably diverse range of high quality and high potential businesses. The aim of the VC investment manager is to build an operation that gives it the level of access and insight needed to do this.

It is crucial to understand that many companies that receive VC investment will fail, and the investors will lose the money they put in to the business. EIS qualification can, however, limit the extent of the loss.

Only a proportion of VC-backed businesses will go on to be sold at a significant profit, but if done in the right proportions, this can lead to a very attractive portfolio return.

As well as the risk of company failure, there are a number of other risks that investors should be aware of. They include:

- **Management Risk**
  companies of this nature are often dependent on a few key executives. Any changes to the leadership team can have a big impact on the success of the company.
- **Liquidity**
  These companies will be unquoted and there is no liquid market on which to sell the shares. To enjoy the tax benefits associated with EIS, investors need to be invested for three years. It may take much longer than that for some investments to reach a successful exit. It will usually be impossible for an investor to liquidate their investments if they need cash rapidly. So before investing, careful consideration should be given to the likelihood of an investor needing the cash before the investments mature.
- **Past performance**
  The past performance of entrepreneurs or investment managers is not an indication of likely future performance.
- **Systemic risk**
  The risk of the collapse of a whole market or sector (as in the financial crisis of 2008-9). Companies within EIS portfolios tend to have reduced systemic risk. The longer-term nature of the investment and the fact that most are unlisted mean they are often insulated from the sentiment-driven highs and lows of public markets.
- **Specific risk**
  The risk facing an individual company (like its technology being overtaken or failing to find a market). There are mitigation methods covered in this guide.
- **Eligibility**
  In most cases, before considering a company for investment, an investment manager looking to secure tax reliefs for investors, will want evidence that the company is likely to be EIS-qualifying. An investee company may apply to HMRC for 'advance assurance', which is an indication that it appears to meet EIS-qualifying criteria, based on the information provided to HMRC.

> **We all recognise that there is a reason the government provides these benefits – by mitigating some of the risk it encourages investors to direct their capital towards Britain's entrepreneurs, helping fuel economic growth. It's a partnership that can benefit everyone.**
>
> *MARK BROWNDRIDGE, DIRECTOR GENERAL OF EISA*

Risk mitigation

The importance of people, process and strategy.

The choice of investment manager is a significant factor in mitigating risk. A good manager will help ensure investment in the best EIS-qualifying companies at the right time and at the right price, offering expert support to help investee companies grow. They will also help achieve a successful exit. So, what should you look for?

PORTFOLIO DIVERSIFICATION

Because of the risks involved, VC investors like Oxford Capital focus on portfolio diversification. We will invest in a portfolio of companies, making sure that we do not commit too much money to any single business.

Within a portfolio, as mentioned above, performance will be variable. Investors' returns will likely come from selling shares in the small minority of companies that become successful.

Higher numbers of losses in a portfolio do not necessarily reflect poor investment decisions. A higher-risk portfolio (perhaps including more early-stage investments) may have an increased chance of failure but greater potential for superior returns.

If there are significant problems with an investee company, there are circumstances when selling the shares at a loss, even a total loss, or closing the company is the best option. A zombie company languishing in a portfolio is of no benefit to the investor — it may often be more advantageous to realise the loss relief.

There are other ways to diversify beyond just numbers.

GENERALISATION VERSUS SPECIALISATION

EIS and VC portfolios can be specialised in particular areas or provide diversity across multiple sectors and investment types. Specialist funds draw on their managers' in-depth knowledge and contacts, whereas generalist funds can offer greater diversification. An investor should consider which of the opportunities available best suit their needs and objectives.

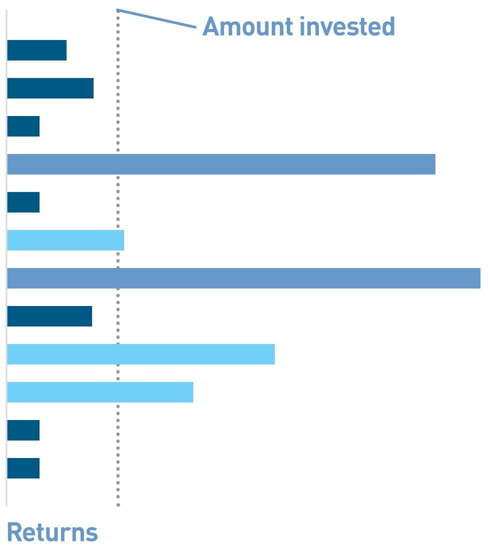
DIVERSIFICATION ACROSS MANAGERS

Further diversification is possible by investment across different managers. This may reduce systemic risk where fund managers have a particular approach, leading them to seek out particular characteristics in the companies in which they invest. It also allows diversification across a greater number of companies than a single manager can actively manage.

DIVERSIFICATION BY STAGE

A portfolio of investments might feature companies at different stages of maturity such as start-ups and more mature, established businesses. This approach balances early-stage investments that have high potential but are higher risk with later-stage investments with a higher valuation but lower risk.

Risk isn't a dirty word. It can supercharge a portfolio.



From a portfolio of 12 companies:

- A minority of companies are sold for a significant profit, generating nearly all of the investor's total return.
- Some companies will grow more slowly than expected, generating only modest gains or breaking even.
- Some companies will fail, resulting in a loss for its investors.

> **Successful venture capital investors avoid putting all of their eggs in one basket. They should instead invest in a portfolio of companies, making sure that they do not commit too much money to any single business.**

KEY FACTS

Risk can be balanced within your EIS portfolio by diversification.

Risk can be mitigated by selecting a good EIS investment manager.

Risk can be mitigated by a well-defined investment strategy.

Risk can give the opportunity for returns.

UP NEXT...

In the next chapter, we discuss the importance of investors' ongoing engagement with early stage companies and the route to successful exits.

Post-investment: The route to exit

ON-GOING INVOLVEMENT

A major part of VC investing is to take an active part in keeping their investee companies and entrepreneurs focused on the ultimate goal of achieving a profitable sale of the business, referred to as an 'exit'.

In simple terms, the eventual buyer of a portfolio company wants to see that the business has grown and created value, and that it has the potential to continue doing so after being acquired.

VC managers can add significant value by helping their investee companies to grow quickly, whilst also building the systems, processes, strategy and management team that will demonstrate to a buyer that the business can achieve even greater scale.

Strategic buyers may be identified by the VC manager many years before an exit is likely, to help improve the chances of a successful outcome when the time comes.

In the meantime, the progress and value of the companies will be closely monitored.

VALUATIONS AND REPORTING

Because there is no ready market for the shares in a venture capital EIS portfolio, there is also no 'market price'. As such, investment managers use alternative ways of determining the value of the shares. Various different methodologies can be applied, some more conservative than others.

External data points can be useful to set unbiased valuations. For example, if a portfolio company has recently raised money from another institutional investor, then the share price used in that round can usually be assumed to be the fair value of shares acquired in previous rounds.

Another common methodology is to value shares using data about similar companies that have already been sold or listed. For example, companies from a certain industry sector may on average be acquired at a price that represents roughly five times their annual revenues. When valuing its own investments in that sector, a VC manager might determine a company's value by applying a 5x multiple to its annual revenues.

THINGS TO CONSIDER WHEN CHOOSING AN EIS MANAGER?

- Do they apply industry-standard principles like the guidelines of the International Venture Capital Association used?
- Are there any external verifications of valuations?
- What reporting is provided on the activity, performance and progress of the portfolio companies?

FURTHER INVESTMENT

Follow-on investing is very common in the EIS sector. It can be a sign that a company is taking root and its ambition is growing with the opportunities that are becoming apparent. It may also be a sign that a company is struggling to gain traction quite as quickly as was hoped and needs money to keep going.

An investment manager will assess how likely it is that further investment may be needed before an exit can happen and what that could mean for the investment. Further rounds of investment will dilute existing shareholders' proportion of ownership but may result in an increase in the overall value of the company, either mitigating or outweighing the dilution. Failure to give follow-on funding might impair a firm's chances of success.

Questions for investors to ask:

- How common is follow-on investment in their portfolio companies?
- Do they have a process for deciding when and how to invest?
- How are follow-on investments valued and are these validated by new third-party investors?

Case Study: Valuations

Spoke is an online men's apparel brand. In June 2016, Oxford Capital led a funding round into the company alongside Forward Capital Partners and various angel investors. The valuation was set by Oxford Capital, but the co-investors, including some experienced fashion investors, reviewed and agreed it. The valuation was also approved by a large international accounting firm.

Over the next 18 months, the company generated 296% revenue growth. But, the valuation remained unchanged in this period. At Oxford Capital, we generally only increases valuations based on further funding rounds. It was only when a new external funder led a new round in January 2018 at an uplift of 1.5x of the original price, that the valuation of the initial shares purchased was increased by this amount.

It's worth remembering that conservative valuations can lead to pleasant surprises, whereas overly optimistic ones can generate disappointment and negativity.

SPOKE

SUCCESSFUL EXITS

When a company in the portfolio is sold to another business or successfully lists on a stock exchange, it allows the investment manager to return capital to its investors who held shares in the company through their portfolio.

This will usually happen through a trade sale (where an acquirer buys all the company's shares from investors, management and any other shareholders) but may be in the form of a buy-out or, more rarely, a stock market listing.

The timing of returns from a venture capital portfolio is unpredictable. The minimum holding period to achieve EIS qualification is three years, but many VC managers target an exit from each company after a greater period. Often, this is around five to seven years after first investing. But some companies will inevitably face a longer journey to a successful exit, whilst others may be sold much more quickly than expected.

The strategy should be to maximise value, rather than seeking to deliver a quick profit. Selling out too soon could lose potential value.

Nevertheless, it is possible that shares may be sold after a holding period of less than three years. This may be the case if an unsolicited and generous acquisition offer is made by a strategic buyer.

KEY FACTS

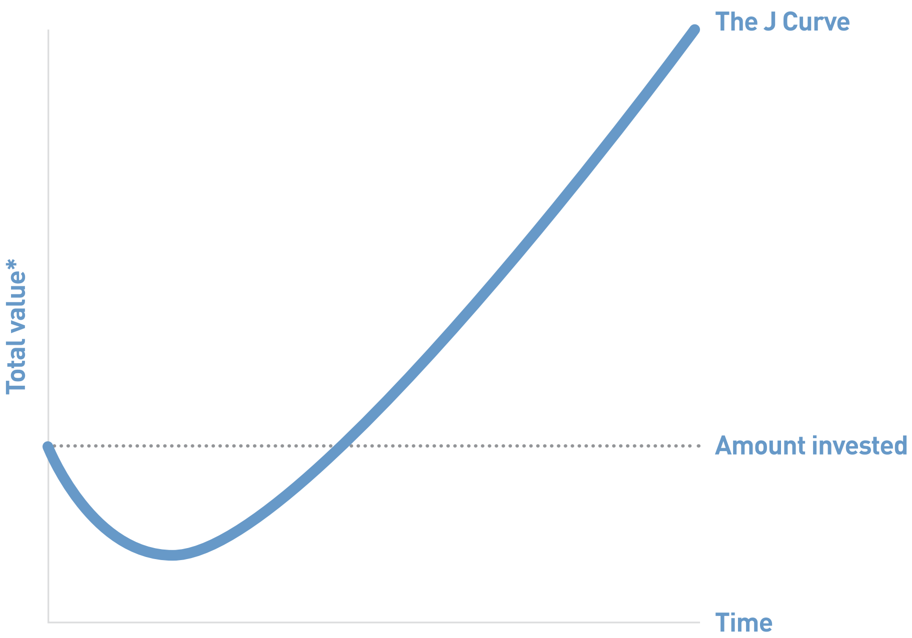
INVESTOR ENGAGEMENT AND EXITS

Successful VC investors play an active role in guiding the growth of investee companies, providing a wealth of experience on strategic direction and implementation, as well as helping to identify eventual buyers.

There is no 'market price' for shares in venture capital investments. Methods to value a company include valuations for other recent investments or industry averages for earnings-based valuations.

Follow-on investments are a useful sign that a company is growing – but they might also it needs more investment to achieve its growth targets.

VC investors in early stage companies get their money back when the company is sold to another business, other investors, or it floats on the stock exchange.



The timing of returns from a venture capital portfolio is sometimes explained using a 'J-curve', like the one in the diagram below. The J-curve is overly simplistic and implies a smoother return than would normally be expected in VC. However, it does neatly make two important points:

1. A negative return in the early years is not unusual. Some companies may struggle or even fail early in the life of the portfolio. This can cause the total value of the portfolio to dip below 100%.
2. By contrast, the successful companies in the portfolio often take longer to maximise their value and achieve successful exits, resulting in a steepening of the returns profile in the later years.

Questions for investors to ask:

What is their average holding period for an EIS investment?

*Total value includes value of shares still held plus value of any distributed.

Conclusions

THE OPPORTUNITY IN EIS-WRAPPED VC

Any investment carries a risk that its value might go down as well as up. With investments focused on younger and smaller companies, the risk is inherently high.

The government is keen to support Britain's most promising entrepreneurs and businesses and that is why it is willing to sacrifice tax income to release private capital to help nurture these companies to success.

The reliefs are generous and mitigate the investment risks significantly. By considering some of the factors highlighted in this guide you can mitigate those risks further and increase your prospects of a successful outcome.

THE OPPORTUNITIES:

- There is risk, but there is also the potential for high returns
- The UK takes 4th place in the Global Innovation Index 2018 – ahead of the US in sixth place
- UK technology, a common component of EIS eligible VC portfolios, is among the best in the world
- It takes time, patience and know-how to identify and nurture an EIS portfolio. But specialist VC managers' experience and expertise can be leveraged to help
- Individual investee company losses in a well-managed EIS VC portfolio are likely and planned for, to be offset by more significant successes that can generate overall growth from a portfolio as a whole
- There is a growing appetite for partnerships and acquisitions of early-stage companies where fresh ideas are available among larger firms (Wall Street Journal)
- EIS downside protections and unlimited upside remain unchanged

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FEEDBACK

If you have feedback on any aspect of this guide, please forward it to news@oxcp.com or call Oxford Capital on 01865 860 760.

NOTES

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