VCTs Made Simple Guide

A Guide to Venture Capital Trusts

MATRIX

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Introduction

This guide provides a brief impartial introduction to Venture Capital Trusts (VCTs). It aims to explain how they work, how profits are made and passed on to investors, what the generous tax reliefs are, what the risks are, how to select the right VCT for you and how to measure performance. This guide is not intended to be comprehensive and you may want to seek the advice of a professional financial adviser before investing in a VCT.

What is venture capital?

Venture capital is a way of financing the growth of unquoted companies, including companies listed on the AiM and PLUS (formerly OFEX) markets. The aim of venture capital is to enable today's "growth" companies to develop into tomorrow's major businesses - thereby providing investors with significant returns on their investment. The venture capital industry in the UK has an excellent record of generating good returns for investors. 2007 results show that UK private equity has continued to outperform the FTSE All-Share index over the medium to long term*.

Annual compound investment returns to 31 December 2007			
	3 Years	5 Years	10 Years
Total Private Equity	**38.8%**	**27.3%**	**20.1%**
FTSE All Share	14.5%	15.4%	6.2%
WM Pension Fund Universe	12.4%	13.1%	7.1%

A significant percentage of venture capital money has traditionally come from institutions such as pension funds and insurance companies. However, since 1995 private investors have played a more significant role in venture capital through VCTs.

*Source BVCA Private Equity and Venture Capital Performance Measurement Survey 2007

What is a VCT?

VCTs were devised in the 1993 Budget and launched in Autumn 1995. They are designed to give private investors an opportunity to back young growth companies while offering generous tax incentives. To date, around £2.4 billion has been invested in over 140 VCTs.

A VCT is managed by a specialist, hands-on venture capital manager who invests the fund's assets in private, unquoted, PLUS (formerly OFEX) and AiM listed companies. These are companies that have many of the same characteristics as the "small companies" that specialist OEICs target, but in the case of the VCT the companies are generally smaller and can be at an earlier stage of development. Many of the arguments for investing in smaller companies apply to VCTs in that small entrepreneurial companies have the opportunity to grow at a much faster rate than larger mature companies. However, with companies that are at an early stage in their development there is an increased risk of failure. That is why VCT managers do very extensive due diligence before making an investment and have a very hands on role in the company's development once the investment has been made.

An advantage of VCTs over other investment companies is that VCTs have three years in which to invest their assets, rather than having to be fully invested from day one. Money is therefore invested only when a venture capital manager finds a company that has passed the rigorous due diligence tests. During the three year investment period most VCTs will keep the uninvested money safe in cash or near cash assets.

Key Features of a VCT

- Specialist venture capital manager
- Invests mostly in small unquoted companies
- Higher growth potential than quoted investments
- Higher risk than quoted investments
- Extensive due diligence undertaken on potential investments
- A VCT manager has three years to invest his money, meanwhile he will hold cash or near cash assets

How are VCT returns generated?

Investors can expect to receive returns on their investment through regular tax free dividend payments. The income which finances these payments is generated from two sources: the **income** that is paid to the VCT by the investee companies or generated by the assets temporarily held in cash or cash-equivalent investments; and from the re-payment of **capital profits** from investments that have been successfully sold.

1) Income Paid by Investee Companies

A VCT manager can invest in three main types of security:

Loan stock
Similar to a bank loan, this type of investment is a loan with terms attached that are negotiated between the venture capital manager and the company. The interest paid on such loans is often very attractive and paid out regularly to the VCT, providing a good stream of income that can be passed on to investors.

Preference shares
These shares aim to pay a fixed dividend which provides a specific income return that is paid out before any dividends are paid to ordinary shareholders. When the investment is realised, preference shares may also offer some capital growth as well.

Ordinary shares
Many small companies choose not to pay out dividends in their early stages of development, instead ploughing any profits back into further growth. However, some more mature companies may start paying dividends on their ordinary shares which can in turn be passed on to VCT investors as an income payment.

2) Realisations (or exiting the investment)

The aim of venture capitalists is to nurture young companies through various stages of growth into becoming the household names of the future. Once a company has grown sufficiently the ordinary and preference shares should be valued higher than the initial cost. At this point the manager will seek to create an opportunity to sell its shares. There are generally four options for selling investments:

Trade sale

Where a competitor business buys the investee company. This is traditionally the preferred exit route for VCTs.

Flotation

Where an investee company becomes listed on a stock market and the VCT can sell its shares.

MBO (Management Buy Out)

Where the managers of the investee company wish to assume full control of their business and buy the VCT's holding.

MBI (Management Buy In)

Where an external management team wishes to buy the company and take over the management of that company as a single transaction.

When the manager sells an investment the profit can be passed on to shareholders as a tax free income payment, enhancing the income that has already been generated from the underlying investments.

The 3 types of VCTs

VCTs can invest in a variety of companies and they broadly fall into one of three brackets: Generalist, AiM, or Specialist.

Generalist VCTs
Invest in a range of companies in different sectors and stages of investment. The usual stages of investment are:

1) management buyout - where a VCT helps the management team of an established company buy other shareholders' shares to take full control of the company. Frequently this is a branch or department of a larger company that the management team believes would be better off standing alone as a separate entity.

2) development capital - where a company that is in an advanced stage of development requires an injection of funds to expand or develop (e.g. to buy a competitor, open new manufacturing premises or enter a foreign market).

3) seed capital - where a company needs funding to get off the ground. Often these companies have good intellectual property that is protected by patents, and require funding to convert the ideas into a fledgling business.

AiM VCTs
Invest in companies that are, or are about to become, AiM (Alternative Investment Market) listed. This provides greater transparency and investors have direct access to information on the companies in the portfolio. Some of the more successful companies listed on the AiM market have experienced astonishing share price growth. However, the investments may be subject to market volatility.

Specialist VCTs
A highly specialised manager investing in only one sector. The manager may invest in a spread of stages of investment, as described under Generalist VCTs above, or may concentrate on earlier or later stage investments in its specific field of expertise.

What are the tax reliefs?

VCTs provide investors with several tax benefits, positioning them as one of the most tax efficient investment products in the UK.
Below is a summary of the current tax reliefs for VCT investments made on or after 6 April 2008.

Up front 30% income tax relief
On investments of up to £200,000 per tax year provided the shares are held for 5 years. For example:

An investor with taxable income of £50,000 invests £10,000 in a VCT

Gross Investment	£10,000
Income Tax Relief @ 30%	£3,000
Net Cash Cost of Investment	£7,000

Note that investors cannot claim back more than their tax liability. Therefore, if the investor in the above example had an income tax liability of £2,000 they would not get a further £1,000 back from their £10,000 VCT investment.

Up front income tax relief only applies on subscription for new VCT shares. If shares are sold within 5 years of being held, the investor will be liable for any income tax relief received and will have to pay it retrospectively. VCTs should therefore not be considered as a short term investment.

Tax-free dividends
All dividends distributed by a VCT are free of income tax. VCTs pay no corporation tax or capital gains tax on realised investment gains and can distribute them following each realisation. These capital profits will be paid as tax-free dividends to shareholders.

VCTs are not obliged to adhere to a policy of distributing realised capital profits, and investors should take note of the existence, or absence, of any such commitment in the prospectus.

No capital gains tax
Any profit from the sale of VCT shares is not subject to capital gains tax however any loss of value is not an allowable loss.

Who qualifies for VCT tax relief?

Investors must be UK taxpayers aged 18 or over investing in the primary VCT market. If shares in a VCT are bought through a stockbroker on the London Stock Exchange (i.e. not in the initial offer period), the initial 30% income tax relief will not apply. However, the investor will still receive tax-free distributions and will not pay capital gains tax when selling the VCT shares.

Comparison of VCT tax benefits with other investments

Tax Benefit	VCT	ISA	OEIC	Investment Trust
Maximum amount to which tax reliefs apply	£200,000	£7,000	-	-
Income tax relief on amount subscribed	up to 30%	✗	✗	✗
All dividends free of income tax	✓	✓	✗	✗
Gains made on sale free of capital gains tax	✓	✓	✓	✓
Capital gains made within the investment free from corporation tax	✓	✓	✓	✓
Ability to distribute realised capital profits tax free	✓	✗	✗	✗

What are the risks?

Capital Risk
Many of the risks associated with VCTs are the same as those of private equity. A portfolio of investments in unquoted companies can offer attractive investment returns but by its nature involves a higher degree of risk than a quoted portfolio. The companies will generally be at an earlier stage than more developed quoted companies and therefore have a higher risk of failing. There is also no capital guarantee and since the value of shares in VCTs can fluctuate you may not get back the amount you originally invested.

Tax Risk
There may be a possibility of a VCT loosing its tax-free status if it fails to meet any of the qualifying requirements (see the “What investments can a VCT make” section, page 10). Should the fund loose its VCT status, you may be required to retrospectively repay the income tax relief you obtained. Furthermore, any future dividends and the disposal of your shares would become subject to tax.

You would also have to retrospectively repay your tax relief if you sold your shares having held them for less than 5 years. As such, VCTs must be seen as a medium to long term investment.

Liquidity Risk
Although VCT shares are listed on the London Stock Exchange the secondary market for VCT shares is extremely illiquid and as such you may find it difficult to realise your investment. Furthermore, because of the illiquid market there is no guarantee that the VCT's share price will reflect the Net Asset Value of the portfolio. Some VCTs offer a Share Buyback Programme that aims to protect shareholders by managing the level of the discount to Net Asset Value at which their shares trade. However, most Buyback Programmes are at the discretion of the Directors and therefore provide no guarantee of the VCT's share price.

What investments can a VCT make?

A VCT must invest at least 70% of its funds in Qualifying Companies within three years of the initial fund-raising. The balance of up to 30% may be invested in non-qualifying investments. Qualifying Companies are unquoted companies,including AiM and PLUS (formerly OFEX) listed companies which must comply with some basic rules:

- they must not be controlled by the VCT or another company.
- they must not carry on certain trades including dealing in land, commodities, futures, shares, securities or other financial investments. Most financial activities are excluded, as are most property-based trades such as property development, hotel management, the operation of nursing homes, farming and forestry enterprises.
- they must carry on a trade that is wholly or mainly in the UK.
- they must have less than 50 full time employees.
- they must have raised less than £2 million via VCTs over the last 12 months.

In addition the VCT must comply with the following:

- a VCT cannot invest more than £1 million in any Qualifying Company, in any single year, and no investment in any single company can exceed more than 15% of a VCT's total portfolio value, at cost.
- a VCT cannot invest in any company whose total assets exceed £8 million immediately after such investment.
- at least 30% by value of the VCT's holdings in Qualifying Companies must comprise of ordinary shares with no preferential rights. The remainder can be debt of at least five years term or other more secure instruments.
- A VCTs holding in each Qualifying Company must comprise at least 10% by value of ordinary shares in that company with no preferential rights.

In practice VCTs will probably hold nearer 80% of the total funds in Qualifying Companies to minimise any risk of falling below the 70% hurdle. If the hurdle were to be breached VCT status could be withdrawn. It is in everyone's interest that the activities of a VCT are continually monitored by the Board of Directors, assisted by external experts.

What charges might I have to pay?

Charges vary widely between VCTs and the managers are obliged to disclose them in the prospectus. Usually, you can expect the following:

- An initial charge of between 5% and 5.5% is used by the manager to fund the set up costs of the company, issue shares and fund IFA commissions.
- An annual management charge to pay the fund manager, usually of between 1.5% and 2.5%.
- As is customary in the private equity industry, managers often have performance related incentive fees to reward exceptional performance. Managers will usually receive a certain percentage on any excesses above a defined level as set out in the prospectus. Usually the performance fee will only be payable if the fund has generated substantial returns to shareholders.
- An additional charge used to pay for other running costs, which include Directors' remuneration, annual trail commission to IFAs and fees for accounting, registration and stockbroking services.
- Charges will often be capped so that regardless of how much money is invested in the fund, shareholders will never have to pay more than the percentage amount outlined in the prospectus.

Selecting the right VCT for you

Not all VCTs are the same and having decided to invest in one you should make sure that it meets your investment needs. The important questions to ask are:

What are my investment objectives?
If your aim is for regular income you should look for VCTs that primarily invest in loan stock and in larger, more established companies as these are more likely to pay out more consistent and regular tax free dividends. If, however, your aim is to look for the potential for higher capital growth over the medium to long term you should look for VCTs that primarily invest in equity and in smaller start-up companies.

How risky do I want my VCT to be?
Not all VCTs are equally risky. If you want to take on less risk in the search for greater capital security look for VCTs that invest primarily in the loan stock of larger companies. If, however, you want to take on more risk in the search for greater reward look for VCTs that invest primarily in the equity of smaller companies.

What is the Manager's track record?
Look for a VCT manager who has verifiable experience investing in unquoted companies and has a successful track record in selecting, managing and realising their existing VCT investments*.

Has the Manager got a good source of potential investment opportunities?
You should look for a VCT that has access to a good selection of investment opportunities. A good indication of the investment opportunities available to the VCT Manager will be to ask how quickly they have made investments for their existing VCTs.

What size of deals would the Manager look at?
If a VCT manager is managing a number of VCTs that have similar objectives, they will have the advantage of being able to look at larger deals than managers who only have one or two VCTs. This is because they can spread an investment in a single company across their range of VCTs.

*past performance is no guarantee of future performance.

How can I measure a VCT's performance?

As a shareholder in a VCT your main measurements of performance will be:

1) The Share Price
This is a measure of how much your capital is worth if you were to sell your VCT shares (note the share price is based on your gross investment, not your investment net of income tax relief). A VCT's share price is loosely linked to its net asset value (the collective value of all the VCT's investments) but is determined by the demand for new shares vs. the supply of shares from sellers.

In the first five years, whilst VCTs are making their investments, investors are discouraged from selling their shares because they will loose their initial income tax relief. This normally results in a quiet market where there are few sellers and so the price is likely to trade just under the net asset value.

In the medium to long term VCTs should be aiming to realise investments and pass on returns to investors. As such, VCT share prices should reflect market perceptions of the performance of the investments held by the VCT and the value of future tax free dividends they might provide. The secondary market is often illiquid and the shares can trade at a discount or, in exceptional circumstances, at a premium.

2) The amount of return received through tax-free dividends
Obviously the higher this is the better. The size and frequency of dividends can be a very important element of your total return, especially in the initial years of a VCT when capital gains are unlikely. It is our view that VCTs committed to paying out all distributable profits arising on realisation of individual investments should maximise the long-term attraction of VCT shares to original subscribers and to secondary market investors alike.

Where can I find VCT performance information?

Share price listings
As VCTs are fully quoted shares, their prices appear daily in papers such as The Financial Times and on other outlets such as websites that provide financial statistics.

Latest Report and Accounts
VCTs provide annual and half yearly interim accounts, which are sent automatically to shareholders and are available to others on request. As well as accounting information such as the net asset value and dividends, these usually provide a report from the Board and/or the fund manager on the market outlook and give details of investments made by the VCT. Some VCTs provide more frequent newsletters by post and email.

VCT websites
Some VCT managers and promoters provide the latest VCT information on their websites. Useful statistics and commentary also appear on a number of independent sites such as www.taxshelterreport.co.uk and www.taxefficientreview.com.

Matrix
For the latest information on Matrix' current range of VCTs visit our website at www.matrixgroup.co.uk/VCTs or contact the Matrix sales team by phone on 020 3206 7222 or via email at sales@matrixgroup.co.uk

Some questions answered

Can I invest in a VCT?
Almost any investor over the age of 18 who has a UK tax liability can invest in a VCT.

Can companies or trusts obtain these reliefs?
No. Companies or trusts can invest in VCTs but only qualifying individuals can obtain these tax benefits.

Are non-residents allowed to invest?
Yes, other than US persons or residents of Canada. All tax reliefs are available to both residents and non-residents, so long as they are paying tax in the UK. You can go abroad at any time and continue to enjoy the above tax reliefs.

How do I invest in a VCT?
A VCT is quoted on the London Stock Exchange, so you can invest in a VCT at any time. If, however, you want to take advantage of the upfront income tax relief of 30% you must invest in new ordinary shares of a VCT. This means that you cannot buy shares from someone else (e.g. on the market) but must buy them from the VCT itself, usually under an offer for subscription.

So, if I invest in a VCT under an offer for subscription do I get income tax relief of up to 30%?
Correct, if you have paid sufficient income tax in the tax year of investment and you retain the VCT shares for five years.

Do non-higher rate taxpayers get 30% income tax relief?
Yes, whatever tax band you are in, the government will reduce your income tax bill for that year by 30% of the amount you invest. The maximum income tax relief you can obtain is the amount you are due to pay in income tax. If you had, say, an income tax bill of £2,000 and invested £10,000 in a VCT, your income tax bill would be reduced to zero, but the government would not also pay you a further £1,000 to make up the full 30%.

How much can I invest in a VCT?
There is no limit but tax relief is limited to £200,000 per tax year.

Can I sell my shares?
Yes, you will get a share certificate and you can sell your VCT shares in the same way that you can sell any other quoted shares you own. However, if you subscribe for new ordinary VCT shares, you will lose the benefits of income tax relief if you dispose of the VCT shares within five years of their acquisition. Transfers between spouses and transfers to beneficiaries on death are not deemed disposals for this purpose.

How do I claim my tax reliefs?
To claim your income tax relief you must enter your aggregate investment in one or more VCTs on your Self-Assessment Tax Return for the relevant year. It may also be possible to effect an immediate re-coding by contacting your tax office.

What happens if I own VCT shares when I die?
VCT shares can be inherited like any other asset. There are no tax reliefs associated with Inheritance Tax but if you die within five years of buying the shares, the inheritor will not suffer any claw-back of the 30% income tax relief. Also, any VCT dividends will continue to be tax-free and the inheritor will benefit from not paying capital gains tax when the shares are sold.

If I invest in a VCT can I also invest in an Enterprise Investment Scheme (EIS) and claim the available upfront reliefs on each investment?
Yes; the two schemes are independent of one another. However, please take professional advice regarding the tax interaction of the two schemes.

How does a VCT fit into my investment Portfolio?
VCTs are only really a consideration for investors with significant investment portfolios who can afford to take a long-term view and are comfortable with the risks of investing in smaller companies. We feel that at most VCTs should be 5% to 10% of your equity portfolio. Whilst not suitable for making up a large part of your portfolio, adding a generalist VCT can help to manage risk and offer growth prospects when traditional equities fail to perform.

About Matrix

Matrix Securities Limited ("Matrix") is a division of Matrix Group Limited, a leading provider of specialist investment products and solutions. Matrix is an independent promoter of VCTs and has been at the forefront of bringing these innovative funds to UK private investors since their introduction in 1995. Matrix runs training seminars around the UK for Financial Advisers who want to find out more about how VCTs work, and any Financial Advisers who would like to participate in future seminars in their area should contact Matrix on 020 3206 7222

For more information on VCTs please contact your financial adviser or Matrix-Securities:
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Adviser's Stamp

Important notice

Taxation

This guide is a short summary which is not intended to be comprehensive. Tax advice should be sought. Tax reliefs referred to are those currently in force. The levels and bases of taxation and of reliefs from taxation may change and the value of reliefs depends upon personal circumstances. If the detailed conditions required for any relief to be given and maintained are not satisfied the relief in question will not be given or may be subsequently withdrawn. Legislation, London Stock Exchange rules and Inland Revenue working practices are subject to addition, amendment and change.

General

This guide is not an invitation, or a solicitation of such an invitation, to subscribe for shares in any Venture Capital Trust (VCT). The price of VCT shares may fluctuate and income generated may fall or rise and investors may not get back the amount invested. The market for VCT shares may be limited and it may be difficult for investors to realise their value.

VCT shares may not be a suitable investment for all recipients of this guide and advice should be sought from an independent financial adviser authorised under the Financial Services and Markets Act 2000. Information contained in this guide is not intended to be and should not be construed as investment advice on the merits of investing in any particular VCT. In relation to transactions, investments and arrangements referred to in this guide, Matrix- Securities Limited acts for the VCTs and no-one else and will not be responsible to anyone other than the VCT for providing the protection afforded to customers of Matrix-Securities Limited nor for providing advice.

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Updated January 2009