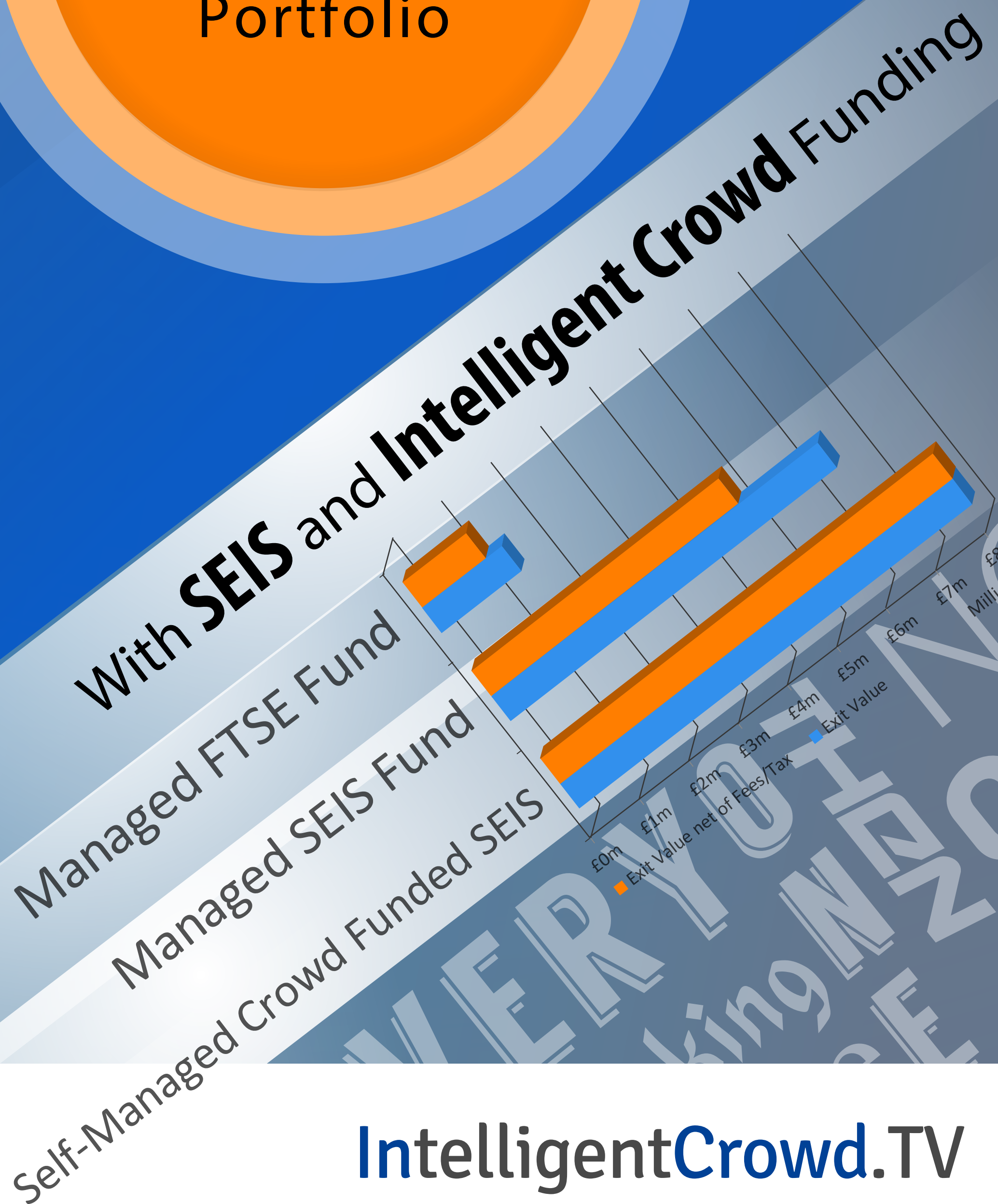
Supercharging

Your Retirement Portfolio

With SEIS and Intelligent Crowd Funding



IntelligentCrowd.TV

The UK Government introduced a scheme in 2012 to incentivize people to invest in early stage companies.

It's still largely unknown, which is a great pity because combined with crowd funding, a recent innovation in how young companies raise money, it has huge potential – both for the UK economy, and for your personal investment planning.

This series of articles has been written by our "dream team" of experts in the field:

Shane Smith, creator of a new TV series to highlight the Best of British start-ups;

Paula Steele, an award winning independent financial advisor; and

Kathryn Robertson, until recently HMRC's policy leader on the tax reliefs that she helped to design.

Prof. Paul Nightingale of the University of Sussex, one of the UK's most prolific hubs for innovation in digital creative industries, also contributed.

They have come together to tell you all about boosting your retirement portfolio with SEIS funds, or better still…

Supercharging your retirement portfolio with SEIS and Intelligent Crowd funding

Shane Smith
Kathryn Robertson
Paula Steele

Executive summary

An innovative tax relief scheme introduced by the Chancellor in 2012 has had modest take-up so far, leaving great potential for the scheme to both boost portfolio returns and have a transformative impact on the UK economy.

In this paper we examine why the take up has been so low, and illustrate one particular context for using the scheme, combined with crowdfunding, to make prudent but productive investments.

This entails a combination of targeted investment, active use of the tax reliefs, and a proportionate level of diligence. For the purpose of the worked example, we have assumed that investors make full use of the annual £100,000 ceiling allowed by HMRC for the framework – and we compare the returns available from comparable investment in a low risk FTSE managed portfolio with a typical fee structure; as well as a managed SEIS fund, again with a typical fee structure. Readers can of course scale back. The results make a compelling argument for embracing this kind of investment.

A great year for the start-up ecosystem, and for Crowdfunding platforms

2014 was a great year for equity crowd funding , with approximately £80 million raised by the UK's combined platforms and the industry bellwether, the FCA regulated platform Crowdcube, recording 264% growth over 2013. But even this strong performance pales in comparison to the potential for further growth. It took years of campaigning by the London Stock Exchange's Alternative Investment Market (AIM) before the shares listed on its board could be included in an ISA. Similar benefits, and more, are available to crowd fund equity investors through the UK's Seed Enterprise Investment Scheme (SEIS). Some 82,000 tax payers in the UK earned enough taxable income in 2014 to benefit from the full £100,000 annual limit on SEIS investment, a notional untapped investment pool of £82bn. Given that 581,000 new companies registered at Companies House in 2014, this notional investment pool would be sufficient to provide £150,000 (the maximum a company is allowed to raise under SEIS) to about 10% of the new start-ups created in the UK each year. Now that would be quite a shot in the arm for UK Plc, as only a small percentage of firms (roughly 4-8%) generate the vast majority of job creation and innovation in an economy. £82bn would represent a transformative level of equity funding for new firms in the UK. So, what's holding us back? The two key roadblocks are risk, and the costs imposed by complexity.

How risky are smaller, start-up companies?

It's a great question, with answers varying widely and depending on how we define success and failure. Most start-ups fail quickly, with roughly half going out of business within 3 years. But most of these firms aren't interested in equity investment and aren't 'investment ready'. Prof. Marc Cowling, a leading economist of small firm financing at the University of Brighton, has shown that conventional wisdom about the risks of equity investment is often incorrect, with the kinds of innovative firms that seek equity funding having very low failure rates. For example,

possibly the longest-established equity Crowd funder, The Australian Small Scale Offerings Board, founded in 2005, has seen 176 listings of which 83% are still in business. By contrast Jeff Lynn of Seedrs, the number two UK platform, says his platform has seen 12 failures out of 170 listings – but prudently warns investors to expect 50-80% to fail.

However, the issue isn't just failure rates. When you put your money into a start-up, it will stay there until the company gets acquired, gets listed, or goes bust. A company can tick along nicely, providing a little income or pleasant lifestyle for its owners – but no hope of exit for investors. Is that a success or a failure? Similarly a company could list on (say) AIM – but without decent earnings, research and liquidity, and hence wouldn't necessarily be much better than if it was unlisted. The key issues for investors are both success and being able to get money out.

FCA risk vs HMRC risk

The FCA's position is that if you invest in a start-up company, you are likely to lose all your money. Yikes. Strictly, the probability may be correct, if Lynn is correct that 50-80% of firms will fail. But hang on a second – doesn't the regulator talk to HMRC about its tax schemes? Or consider portfolio diversification? The answer seems to be, it doesn't.

SEIS helps at different stages in the investment lifecycle. When an investor makes a qualifying investment in a company, she is entitled to deduct 50% of the amount invested from her income tax bill for the tax year of investment or the previous tax year. That means, simply, £50 of every £100 invested is rebated (either netted off against a tax liability or yet more satisfyingly, a cheque arrives through your letterbox!).

If you made the investment out of a gain you realized such as sale of a second home, on which CGT is payable, you would get a further 14% relief – that is, half of the current 28% CGT rate. So now, your entry price for the investment could be reduced to 36p in the £.

Now we assume the company turns out to be a dud. It valiantly tries to do what it said on the tin, but fails. In theory you lose your 36p – except that in most cases you're now able to claim "Share Loss Relief", offsetting the loss against your income tax during the tax year the loss arose, or the previous tax year, so you can claim relief at your marginal tax rate (say 45%), reducing your actual loss from 36p to about 20p. Now, the FCA's headline warning starts to look a tad over-done.

Alternatively, we assume that the company is a roaring success. As it grows, it may well need additional capital so there's a risk that your original stake can be diluted. It's important that you're protected by full pre-emption and voting rights (which need to be carefully drafted, to avoid falling foul of certain SEIS eligibility criteria); and it's ideal if you're financially equipped to follow new investors into additional rounds. At the end of the day (the day can be very, very long) the company floats or exits in a trade sale after the end of the three year qualifying period for the investment, and you get to keep the lot: your original SEIS investment is CGT free - as will be any follow-on rounds provided they qualify for either SEIS or EIS. And if the end of the day is extremely long, by which time you've passed through the pearly gates, you can at least take posthumous comfort that your investment is inheritance tax (IHT)-exempt.

Understanding the real risk

We discussed above the regulators approach to risk warnings and it's really here that common sense needs to prevail. There isn't a risk that you will lose all your investment: HMRC ensures that. Nor is there a risk that you will lose some of it: it's pretty much a certainty, given the failure rate of companies. If all investors embrace this certainty, willingly because of the potential upside, all is well. The real risk lies elsewhere - not in loss thanks to HMRC, but in liquidity. Once you are in, the exit is a long way off. So here we take a page from the gamblers' playbook, with minor variations: do not invest what you cannot afford to lock up for a very long time. In this context, SEIS and intelligent crowd-funding investment could be very usefully deployed as part of retirement planning.

In search of perfection

Given the early-stage of the industry's evolution, crowd-funding inevitably suffers from a few imperfections. Start-up companies are the only asset class where you are invited to invest without the benefit of objective third party research. There's a perfectly good reason for this: the individual amounts being raised simply don't support the fees required for professionals with appropriate expertise to devote time to it. Professionals capable of adding value by accurately assessing the prospects of success of a start-up will be, in probability, applying themselves to earning a living on much bigger deals. If good research is being produced, someone is paying for it. And that someone will be you.

So, investors use a proxy measure for quality: how much is everyone else investing in this company? The weakness in this proxy measure is that early investors tend to be friends and family, typically, who are doing it for love not profit. Relying on this group to do all the incisive, objective thinking for you is plainly dangerous.

Yet their role creates an essential component of every successful crowdfunding campaign: momentum.

Now, there's nothing wrong with momentum or trend trading as a strategy in public markets. You buy because the market is going up, and you use your skill to judge when it's about to stop going up, and you sell at a profit. But in crowdfunding, you can't get out that easily: there's no sell button to hit.

But now consider that only around 20% of pitches on crowdfunding platforms meet their funding targets and consequently close the round successfully. We don't hear about the 80% that fail to reach their target, and consequently we can never know with any certainty what "woulda/coulda/shoulda" happened to some of these bright prospects that withered on the vine. If you are diligently putting in hours of research to find your own "winners", you will find that you're pedaling very hard indeed if the rest of "The Crowd" isn't doing the work to reach the same conclusion. You will be systematically backing pitches that fail to close.

Meanwhile the herd approach of the crowd may lead to sub-par opportunities getting funded, a higher proportion of which will go bust; Investors lose out, snubbed entrepreneurs lose out, and the public purse – through HMRC's share loss relief disbursed – loses out. The problems associated with the 'thin market' connecting investors and investee firms in UK small firm equities is improved by crowd funding platforms, but the

core problem of matching investors to high potential firms remains. As a result, public policy tends to be rather scatter-gun and unfortunately spreads resources more thinly that might be optimal.

Dodging complexity: Making sure that effort, risk and return are proportionate

So we need to improve the investment selection process, but within the constraints of resources appropriate for the returns that are available and the associated levels of risk. This is where SEIS can make such an impact, by reducing both the cost of entry and the cost of failure. That said, no one likes to walk blindly into a dud investment – even if there is a buffer to reduce the pain of loss. What sort of effort is required to become properly informed? A research paper from Nesta concludes that 20 hours of due diligence improves the investment outcome significantly. That's 20 hours for each and every opportunity examined before one in ten, perhaps, is selected. Have you got the time? Individuals earning a high enough salary to benefit significantly from the SEIS reliefs simply don't – so the outcome is that few people, in practice, take advantage of the scheme.

We set out below the pillars of our approach, to reduce your chances of buying into a dud investment, with only modest effort. Will we always get it right? Emphatically, no. Inevitably we will admit some losers. Yet more sadly, we will exclude some winners. But overall we expect to improve the quality of the investment portfolio.

An Orchestra of Angels

We believe that the purpose of the crowd is to act in unison, but not as a herd. Each instrument in the orchestra plays a different part, and collectively the result is harmonious – they are not all playing the same note.

The Pillars of our approach

Intelligent Crowd TV is a weekly showcase of up to four opportunities, which reaches a nationwide – not just London – audience of registered viewers via IPTV at **www.intelligentcrowd.TV** . The first show in the series is due to go in late spring 2015.

Pillar 1: On the show, the audience gets to see how well the entrepreneur presents, hears about the proposition, sees the entrepreneur lightly grilled by the host, hears from Argus Research, one the most long- established equity research firms in the US, for an assessment of how well the the experience and skillset of the founders are matched with the challenges of executing on the business plan; and finally, can ask questions, live.

Pillar 2: But before the entrepreneur makes it to the live show, we've put their proposition through a series of tests and filters. Crowd funding sites in general include any proposition that appears to be viable – in a sense, fulfilling a partly social function. But for Intelligent Crowd, a project could be worthy but just not interesting enough in terms of scalability. All propositions admitted to Intelligent Crowd have a more focused objective: return on investment.

- We are ideally selecting companies that have the potential to dominate their markets;

are scalable with an international, ideally global, opportunity; have some unique, non-derivative quality; strong management credentials (though probably not, at this early stage, a complete management team); are raising enough money for a minimum of six months and to achieve identifiable milestones; have limited additional capital requirements; are offering voting shares with pre-emption rights; and are ambitious – we prefer higher risk with higher potential, so that a binary outcome is likely: companies will fail fast, or succeed (the worst outcome is a zombie company which provides neither exit, nor release of funds back to the investment pool through share loss relief); an identifiable exit route, by reference to the current deal landscape in their sector; a plausible valuation; and where the founders and principals have skin in the game.

- These are companies which must also "pass" the detailed requirements and tests of our nominated crowdfunding platform: 80% of applicants do not pass.

- The credentials of the company's managements are assessed to be up to the challenges ahead by the sector analyst at Argus Research, and the industry itself is considered of interest – in terms of competitive threats, exit opportunities, valuation multiples, M&A culture, and capital intensity. More specifically, Argus applies a 4-point fundamental review to address Industry, management, competitive advantage, risks – the same topics of focus when it produces reports on upcoming IPO's.

Pillar 3: We're building an audience with particular investment/domain expertise. Our experts will be encouraged – anonymously if they wish – to ask searching questions live on air, to add to the pool of information at everyone's disposal. Our Intelligent Crowd can certainly be a source of wisdom, particularly in terms of the competitive landscape – perhaps the hardest field for any individual to keep abreast of. And of course, we all want to see how the entrepreneur performs, under the pressure of live questions, both when she can – and can't – answer the query.

Pillar 4: Investors decide on the basis of information and insight, not on the basis of crowd dynamics. Within our Orchestra of Angels, each is acting independently to decide if the investment case is solid, and sufficient positive opinions deliver an overall positive outcome: only after this book-building is complete, the pitch goes live on the crowdfunding platform, with its Intelligent Crowd "backers" gaining priority access to the deal for 48 hours.

Pillar 5: Investors are encouraged to invest little, regularly. Since we've reduced the effort/cost of finding viable investment opportunities, we can help bring the power of diversification to bear. For example, take a 40-year-old member committing £100,000 per year to an SEIS portfolio over 15 years: from our four weekly pitches, he selects one for a £2,000 investment. After 15 years, the total of 750 portfolio constituents will have diminished through failures (and some exits on the way), and the capital returned to the pool re-invested in follow-on rounds of the emerging success stories. Currently fewer than 2% of investors on Crowdcube invest in more than 20 companies: with the complexity and effort required to make each investment reduced by Intelligent Crowd, we expect this percentage to be significantly higher amongst our members.

Pillar 6: Take full advantage of SEIS provisions, so that tax relief returns to the investment pool and share loss relief on

failures is also made available for follow-on investment in successful companies. This creates a Darwinian selection environment, where the strongest investments emerge from the debris of the weakest investments.

Pillar 7: It's paramount to the interests of both the entrepreneur and the investor that the share register is complete, kept up to date, and that regular updates are available in an easily manageable form through a single dashboard. This helps with further funding rounds, as well as corporate actions. So, Intelligent Crowd plans to integrate tools to help the newly-minted public company entrepreneur to embrace best practice with updates and communication, and to keep investors engaged and informed over the long term. This will help to make sure that when the moment for exit arrives, the mechanical process is not impeded.

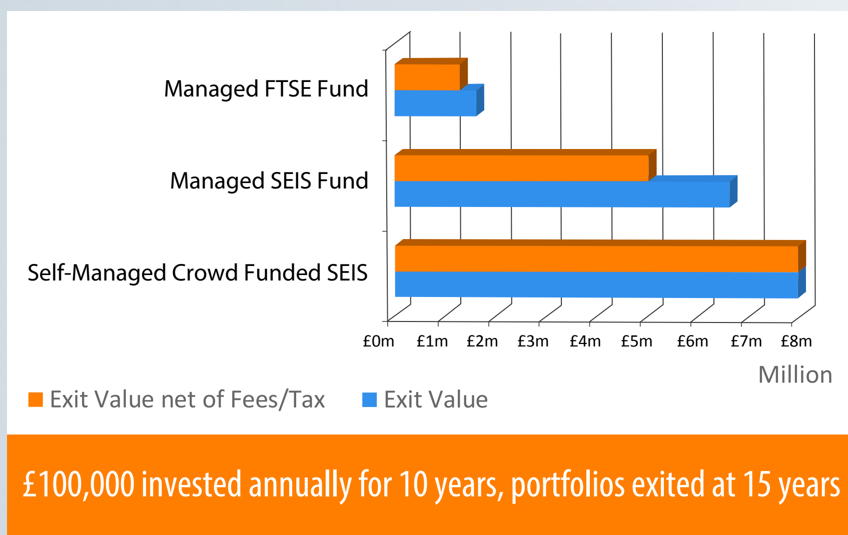
Pillar 8: Knowing what we don't know. Earlier we mentioned proportionality between cost and opportunity. Considering cost, there are elements of the investment case that we simply can't explore. In particular, even in the quoted public company realm, it's hard to find out whether the CEO is a kleptomaniac. Claims about personal histories and experience will go unchecked and yet we have to rely upon them to a great extent – the credibility and experience of the founders of the start-up effectively takes the place of a deep dive into their business plan.

Alternative approaches: investment funds

EIS and SEIS funds take a conventional approach to stock selection. But, the costs of a "deep dive" into research mean that ultimately, such funds have very limited diversification. Add to this the (often) unproven track record of their stock pickers in the notoriously difficult art of crystal ball gazing; and layer on top of this the performance-eroding fees (typically, on initiation, on maintenance, and on exit) that are charged, and such fund frameworks become relatively unappealing in our view.

Our supercharged portfolio

Here we compare two strategies: active management of a FTSE portfolio with typical returns, vs. SEIS buy and hold. For further comparison we have also included the returns expected from a typical SEIS Fund structure, both before and after fees are deducted. We've made assumptions that we consider robust and viable in the model here, but which readers can find and flex at our website (www.intelligentcrowd.tv) Can we unleash the potential impact on the economy of combining SEIS investing by higher earners, and entrepreneurialism? We hope to help light a new fire under the UK start-up ecosystem.



Shane Smith has spent his career in foreign exchange & equity research, connecting institutional investors with listed companies, and now connecting start-up/early stage companies with prospective crowd investors. His technology, investor communications and Intelligent Crowdfunding companies, are based at St Paul's, with offices in the USA and Asia. Shane is always on the lookout for great companies that are thinking of starting a crowdfunding campaign, and are EIS or SEIS eligible. The first show will air later in the Spring.

You can reach him on
shane.smith@intelligentcrowd.tv

or visit the website,
http://www.intelligentcrowd.tv/

to audition or to sign up as a registered viewer.

Paula Steele is Managing Partner, John Lamb LLP, a Financial Planning practice which reached the finals of Financial Adviser Team of the Year 2014 and New Model Advisor Top 100 Advisors 2014.

Kathryn Robertson was previously HMRC's policy lead on EIS, SEIS and the VCT scheme and was responsible for designing the SEIS legislation when it was introduced in 2012. She is now a partner in Robertson Hare LLP, a tax advisory firm specialising in advising companies and investors using, or thinking of using, these Incentive schemes.

Professor Paul Nightingale, Professor of Strategy at the University of Sussex. Paul is an expert on equity funding for innovative SMEs and a successful entrepreneur and investor.

Our Sponsors

IntelligentCrowd.TV