EIS mandates

Characteristics of quoted venture capital

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Once the strategic and diversification benefits of venture investing have been established investors should – before investing – be prepared to lock that money away and accept that values in the intervening years are an approximation. Because these investments tend to be infrequently traded on an exchange, their values are not continuously appraised like listed companies. This is commonly known as the illiquidity premium in exchange for a low-volatility strategy and locking up your money for a long period.

Our approach is differentiated to an expanding range of EIS fund products. We invest in later-stage eligible venture opportunities, i.e. those that are typically profitable and less risky than early-stage start-ups. We ensure we build portfolios across multiple sectors and companies, and all our investments are exchange traded from the outset. EIS eligibility rules mean that new shares have to be purchased directly from companies, leading to a gradual build-up of each client's portfolio.

Patient capital is long duration – in many cases for life – however, many strategies are not capable of being run for decades. Our approach is to provide an evergreen portfolio service where the focus is on sustainable growth and running the winners (keeping them as they become more valuable, rather than cashing in profits early). Holding exchange-traded holdings allows us to top slice these successful opportunities when they start to bump against portfolio limits and recycle that cash into new opportunities. We believe this strategy, over the long term, makes EIS an effective investment.

On one hand, a stock market quotation gives greater access or liquidity: there are more shares to go around and more people you can trade with on any given day. However, this constant valuation appraisal leaves investments exposed to significant swings up and down, often not reflecting the considerable inherent value. In this report we will compare exchange-traded and private (or 'off-market' venture strategies), the challenges of early-stage valuations, the IPO process and our view on values.

Scale capital

Earlier stage EIS-eligible opportunities of today – while ideally revenue generating – largely centre on intangible assets, a serious amount of deep technology knowhow and expertise established to challenge and disrupt. This is the essence of scale capital, investing independent of the market cycle – where a long-term view is taken to focus on supporting innovative companies to become the successes of tomorrow.

Innovation can be difficult to put your arms around

Measuring progress in a traditional approach can be extremely difficult to quantify, value and capture in financial reports. Many opportunities have proven their technology and de-risked their business models, but the financial track records are nascent and generalist investors find it challenging to value the potential when sector specialists couldn't be more enthused. Why is this? Well, in short it's largely tied to a lack of proven financial progress of cashflows and earnings – both dependable metrics for investors that help underpin pricing and gauge risk.

Weak sentiment, whipsaw pricing and funding allocations

In times of market distress, high growth but immediately difficult to value opportunities – like many early-stage challengers – prove difficult to hold in a 'risk-off' environment. This is despite a clear need for life sciences, technology and productivity gains in a world of negative demographics and climate challenge. Investors' path dependency to the reliable, safe-haven comfort zones at the expense of growth opportunities. This approach has major downstream implications, freezing investment at the expense of a better future. However, it also creates a significant value opportunity as sentiment takes little account for that deep technology knowhow and expertise I mentioned earlier and its future potential.

It all begins at IPO

An IPO is a major milestone. The perception, though, is often the opposite: a value-maximising exit and departure for the founders and very early backers. This is not always the case, especially so in EIS-eligible on-exchange opportunities. When the time comes for a business to start scaling up, its demands for money to invest in itself grow rapidly. Often, this requires more money than a fledgling business can deliver from its own operations. Here in the UK, small companies know that EIS tax benefits allow them to seek out that money from investors, supporting this next generation of British businesses.

As a supplier of exchange-traded venture capital we have invested at IPO throughout our two decades in this sector. We like retained founder stakes, encouraging fresh capital rather than simply a cash-out. We also want to see clear capital disciplines for multi-year, slow release commercial delivery that offers more flexibility for adjustment when new buying patterns emerge. And overarching it all is a conservative approach to forecasts: we want companies that make attainable promises.

Once the IPO is complete, public market valuations of intangible-heavy, micro-capitalised business are likely to move at pace and especially so compared to those 'off-market' with stale valuations. Typically, share price oscillations are a function of a number of factors – the macroeconomic picture, sentiment swings, sectoral concerns or stock specifics. Add to these aspects a limited retail and institutional investor audience and an easy disconnection can take place between price and value – well-financed companies in a sustainable growth execution phase offer investors the opportunity to uncover gems.

A convergence with private valuations

Privately held assets are termed lower volatility where asset values are assessed over fixed points in the year – unlike continuous exchange-traded pricing. Pricing between the two will, in time, converge, however the time needed to catch up has been long debated – Narv Narvekar, of Harvard's $51bn endowment, opines that private market funds don't reflect "general market conditions" and warned in October of **"substantial markdowns"** to come.

Prevailing sentiment is bearish and a greater emphasis on balance sheet strength and cash runways – recession resilience – is unfairly weighing on micro-caps. While this is to be expected soon after a major correction, the best investment vintages are typically identified in the two years after that event. The environment isn't presently supportive of innovative, early stages of commercialisation ventures despite the quality of assets – therein lies the opportunity.

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