8 May 2018

Par Syndicate EIS Fund

Par Fund Management Limited

Summary	**The fund's investment strategy is to invest in EIS Qualifying companies involved in the development, commercialisation and sale of innovative technologies or using them to gain a competitive advantage.**	
	Positives	**Issues**
Why Invest	**Strategy:** Exposure to a small portfolio of technology companies co-investing with Business Angels.	**Track record:** Only a small number of exits to date, mostly predating the EIS fund, but the results so far look promising.
The Investment Manager	**Team:** Diverse range of experience in team, with clear strategy and good support from its Angel network.	**Company size:** The team is small, and this may act as a slight constraint, although it has recently expanded and has plans to recruit further.

Nuts & Bolts

- **Duration:** The fund is evergreen, with closings around financial year-end or when sufficient investments are made.
- **Diversification**: The manager expects to provide at least six equal investments for each closing.
- **Valuation:** Usually changes at next financing or on write-down.

Specific Issues

- **Fees:** Combination of direct fees and company charges. Four years of annual fees are deducted upfront.
- **Performance fee:** Charged at 20% on aggregate returns over 120% of subscription, but threshold increased by 40% if exit within three years.

Risks

- **Target returns:** The benchmark average IRR of 15% (roughly doubling the gross investment in five years) suggests a medium- to high-risk investment strategy.
- **Companies:** Supplying risk capital to early-stage technology companies at the start of commercialisation. There will be a spread of company returns as the successful ones will do very well, but those who fail may do so completely.

Analyst	Manager information		Contact details	
Brian Moretta	Scheme assets	£4.5m	Partners:	Paul Atkinson, Andrew Castell, Robert Higginson, Paul Munn
020 7194 7622	Scheme target	£10m		
bm@hardmanandco.com	EIS assets	£30.3m		
	Total FUM	£59.1m	Contact:	Pauline Cassie +44 (0)131 556 0044
	Launch date	2012		info@parequity.com

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Factsheet

Par Syndicate EIS Fund		
Product name		Par Syndicate EIS Fund
Product manager		Par Fund Management Limited (Par Equity)
Tax eligibility		EIS
Target return		IRR of 15% per annum
Target income		None
Type of product		Discretionary portfolio service
Term		Evergreen
Sectors		Technology
Diversification:		
Number of companies		6-8
(Expected) Gini coefficient		0.13-0.17
Fees	**Amount**	**Paid by**
Initial fees:		
Initial charge	1.0% (incl. VAT)	Investor
Arrangement fee	5.0%	Investee company
Annual fees:		
Management charges	0.75% (incl. VAT)	Investor – 4 years deducted upfront
Monitoring fee	Larger of 1.25% of investment or £6,000 (£12,000 if Par Director)	Investee company
Exit fees:		
Performance fee	20%	Investor – aggregate proceeds over 120% of subscription
Dealing fee	Balance of any outstanding management fee plus dealing fee of 0.35%	Investor
Advisor fee facilitation		Yes
Advisor fee amounts		As agreed with investor
HMRC Approved?		No
Advance Assurance		Yes for each investment
Reporting		6-monthly (as of 31st March and 30th Sept)
Minimum investment		£20,000
Current funds raised		£4.1m
Fundraising target		£10m in current financial year
Closing date(s)		At least quarterly
Expected exit method		Mostly trade sale

Source: Par Equity, Hardman & Co research

Fund aims

The Par Syndicate EIS Fund is a discretionary portfolio service, which will provide a portfolio of investments in unquoted technology companies. The manager highlights that it is providing genuine risk capital. The benchmark is an average annualised IRR of 15%, equivalent to doubling capital over a five-year period. Returns will be focused on capital gains, and investors are unlikely to receive any dividends. The fund is evergreen.

Summary of risk areas

Note: There are generic risks from investing in EIS or unquoted companies in addition to the specific ones commented on below. Comments on relative risk refer to other EIS investments and not to wider investments.

Investments

Portfolio risk

Each investment will be providing risk capital to an unquoted early-stage technology company. Par Equity aims to have at least six companies in each portfolio, with roughly equal size positions. Although sector diversification is limited, stock-specific risk should dominate market risk.

The benchmark IRR of 15% per annum suggests medium to high risk and seems appropriate for the strategy.

Sourcing and external oversight

Historically, Par Equity has made six to seven new investments a year. It appears to have a good network, with a strong connection to the Angel investor community generally, and within Scottish institutions in particular. The target of six to eight investments p.a. looks achievable. The Angels in the Par Syndicate co-invest and provide some due diligence input, which Par takes into account alongside its own due diligence.

Ongoing support and monitoring

Support for investee companies comes through a combination of a member of the Par Syndicate being appointed to the board and support from invested members of the Advisory Panel. Both consist primarily of experienced Angel investors. Par Equity's investment team also maintains close contact with investee companies.

Exits

Limited track record, but expects mostly via trade sales. The return profile of individual investments is likely to be skewed, with successful investments probably giving very good returns, while those that do not will give little or nothing back. The fund had its first exit in June 2016.

Manager

Team

The investment part of the Par Equity team consists of the four Directors plus two additional team members. The team brings an interesting mix of experiences. It has recently added to the team and currently does not feel any capacity constraints.

Track record

Since 2009, Par Equity has made 44 investments, with 11 exits. Prior to 2018, these showed an average monetary gain of 78%. An exit in March 2018 boosted this to 408%. The continued improvement in a broad spread of the more mature current investments suggests that the promise that Hardman & Co has noted before is starting to materialise. The right track record seems to be arriving.

Regulation

Product

Advance Assurance is sought for each investment.

Manager

The manager of the fund is Par Fund Management Limited. It is FCA registered (number 485668) with fund management permissions. Submissions to Companies House appear to be up to date.

Risk analysis/commentary

Overall, Par Equity gives the impression of being a well-run company with a credible investment process. The team brings a broad range of backgrounds with experiences in different areas. Those team members that we have met give the impression of being sober assessors of businesses, rather than technology evangelists. The age of the company does mean the track record currently lacks depth, but its returns so far show much promise.

Investors do need to be aware that they will be investing risk capital into early-stage technology companies. The involvement of Business Angels, with experience of the appropriate area, provides an added degree of comfort, although Par's own diligence depends somewhat on these views too. The ongoing support of both Angels and Par Equity partners is also significant. We note the resource constraints that the latter have, but this should improve in the near future as Par Equity recruits.

Diversification is an important consideration for any investor – while the companies that succeed are likely to produce exceedingly good returns, those who do not may return little. Diversification within the fund is limited, although typical for products in this area. This EIS fund should be considered in the context of an investor's entire portfolio.

Investment process

Deeper dig into process

Par Equity looks to provide an EIS investor with a portfolio of technology investments. Although it has managed venture funds since 2010, it is primarily a manager of Business Angel investments, sourcing and managing deals for successful entrepreneurs who are looking to reinvest in new business. It currently has around 120 participants in the Par Syndicate, and they form a key part of its investment process.

The focus is on companies that are at the early stage of commercialisation of their technology. Companies need to be able to not just demonstrate that the technology works, but also that they have managed to earn some revenue from selling it. Par Equity is very aware that it is easy to get distracted by exciting technology that may not lead to a real business. Having said that, Par Equity is clear that it is providing genuine risk capital to these companies.

Although the Par Equity team has a wide range of experience, it understands that it will never have detailed knowledge of all the technologies with which it is presented. This is the first area where the team's Angels get involved – Par Equity gets someone in its network to validate the technology it is looking at. This must include some defensible or unique aspect. The requirement is that the technology must bring an advantage in the marketplace, and this advantage should be defensible in some way.

Par Equity consequently restricts the technology areas that it will look at. The focus is on information technology and communications, clean energy and medical technologies. These are still reasonably broad categories, and previous investments have included e-commerce, social media, technical textiles and more. Par Equity specifically excludes armaments and biotechnology from its categories. The latter distinguishes it from some technology EIS and suggests Par Equity may provide diversification benefits to investors with other EIS investments.

The quality of the management team also matters to Par Equity. The process implicitly tests the team, as, if it can sell the company to the Angel network, then this bodes well for its ability to sell its product to customers.

Sourcing deals

Par Equity gets potential deals from two main sources. Direct approaches are the most frequent but, as for many EIS managers, they are less likely to lead to an investment. Referrals from within its network are more likely to be of interest. As well as the Angels, it has a range of contacts among professional firms such as lawyers and accountants.

Par Equity has been investing in a new IT platform. This has several elements (see also *Governance and monitoring* below), one of which is a facility for companies to apply online for funding. This should lighten administration, by automatically presenting data in a systemised way. It will also help with sharing data with the Syndicate.

In geographical terms, Par Equity looks at companies within the UK, which allows it to continue to provide effective support after investing. Within the UK, it professes to be agnostic, although we note that its connections in Scotland appear to be a little stronger than elsewhere in the UK. It also observes that valuations outside London are often more reasonable than in the capital, which is likely to lead to a corresponding effect on the portfolio.

The current aim is to give EIS investors a portfolio of at least six investments, although Par Equity believes it can increase that number in the future, and it is currently investing to grow its capacity. The recent run rate has been around six to seven new companies p.a., so the portfolio target should be achievable.

Decision-making

In broad terms, Par Equity's decision-making process is similar to that of most mainstream EIS managers, although there are a couple of positive distinctions. Par Equity follows a four-step process.

The triage stage is a very quick internal review to weed out companies in the wrong area or at the wrong stage. This is followed by a preliminary assessment where the company, management and technology are assessed. This is usually the first stage at which the Par Equity investor network is involved. The secondary assessment extends this to the wider market, looking at competition and the business model in more detail.

It is at this stage that the company is valued. Valuations are generally based on a simple DCF model, which is based on an expected rate of progress and comparable companies. Par Equity indicates that this is as much qualitative as quantitative – most investments are at the stage where any detailed model could only be highly speculative.

Par Equity operates a co-investment model, and will only invest if Angels in its network, or in a comparable network, are also investing. As these are experienced entrepreneurs, and often very well placed to understand the technology, this effectively provides an extra layer of diligence. They may be augmented by what Par Equity brands as "First Thursday", where companies can pitch to a large number of the syndicate members. At these events, the members can also network and hear speakers. We understand that this may be changed soon in order to separate the pitching from the other elements.

The final stage is the detailed due diligence. Par Equity is aware that this process can be expensive, but it uses the same panel of lawyers, accountants, etc. in order to keep it as straightforward as possible.

Historically, most companies that received investment had an initial valuation of £1m-£4m. As assets grow and companies mature, Par Equity is making bigger investment rounds, and there are companies with higher valuations. There is no set or typical percentage for the stake that Par Equity investors end up holding.

Often, Par Equity co-invests with other groups or companies, although sometimes they come in at later funding rounds. We note that for investments in Scottish companies the Scottish Investment Bank is often a co-investor. This is an arm of Scottish Enterprise, and in practice tends to be more a supplier of capital than a source of expertise or additional diligence. This still gives more flexibility to Par Equity in terms of the size of deals it can carry out. It also gives Par Equity scope to expand, as it can invest more into its existing deal flow with a lower contribution from other parties.

Investors should be aware that, as the majority of companies are early-stage, it is unlikely that the first investment will see the company through to maturity. Further funding rounds may be dilutive, although Par Equity does try to ensure that they are done fairly and to allow existing investors to participate. Par Equity has recently changed the terms of the fund to allow follow-on investments within it. These will be capped at 10% per company, rather than the 25% limit for new investments. The total proportion of follow-ons is capped at 20% of an investor's investment. Investors should note that, where a follow-on takes place within the EIS fund, those investing in the follow-on will be looking for a minimum three-year holding period from the date of their investment.

Exits

Exits are generally reliant on trade sales. The nature of these businesses is that the date of this has to be uncertain, and exits will often take longer than the minimum three-year period that EIS requires.

Governance and monitoring

Advance Assurance is sought from HMRC on all investments prior to completion.

All client assets, including shares and cash, are held by the Share Centre (FCA registered – no 146768), which is the Administrator for the Fund.

The Fund may invest in SEIS companies, but mostly sticks to EIS investments – Par Equity is generally looking for larger deals than SEIS can offer. Investments may be split between the Fund and other investors, depending on available funds.

The values of investments are reported to investors every six months (31st March and 30th September), along with a brief update on each company. Investments are most likely to be unquoted and hence valuations will generally move at specific events. Positive revisions are most likely to happen when follow-on investments take place, when the latest price is used. Downward revisions are more at Par Equity's discretion, although we note that it has been proactive in doing so historically. For a typical investment, success is usually validated by a further need for capital, while failure tends to happen relatively quickly, as a company runs out of funding.

As indicated above, Par Equity is developing a new online platform. For an EIS investor, this will have two functions of interest. The first, which is already live, is an administrative function. This gives investors basic information on their holdings, such as number of shares and copies of relevant paperwork. The second is more ambitious, and will give investors access to more detailed information on their investee companies. This will allow investors to track progress of investments on a more continual basis. It should be noted that the intention is to have two levels of access, with more sensitive information being restricted to Par Equity staff only. The aim is to have this ready by the end of 2018.

Par Equity also runs regular investor meetings in Edinburgh, which it calls First Thursday. These usually have some investee companies giving brief presentations, and allow investors to meet and get updates from management. This is an unusual format among EIS managers, which many investors will appreciate. It has also started to have occasional meetings in London.

The Advisory Panel

Generally, Par Equity looks to have someone appointed to the board of investee companies. Usually, this will be someone from the Par Syndicate who has invested in the company, although exceptionally it may be a member of staff. His/her main role is to protect investor interests and be a relationship manager with the company.

A large part of ongoing support, however, comes from the Advisory Panel. This is a subgroup of the Angel network, which is willing to take a more active role in helping investee companies. Usually, this is in support of their equity investment – Par Equity is understandably wary of consultants looking to suck out fees from companies. As the investee companies develop, they will have different needs at different times – so the aim is to provide a flexible pool of expertise, rather than having too many specific board appointees.

We understand that, to date, the Panel has been run in a reasonably informal way, but is currently being looked at in conjunction with the pitching events. The new IT system is intended to help with this.

Track record

The Fund has been in existence for just over five years, and had it first exit in June 2016. Par Equity has had exits from investments pre-dating its EIS Funds, of which four were EIS-eligible. The investment process is essentially the same for the non-EIS investments, so we briefly examine Par Equity's entire record as it has more substance.

To the end of 2017/18 tax year, Par Equity had made investments of £50m into 45 companies, of which 12 have led to exits. Three of these have been in the last 12 months. One of these was a small spin-off from another investment, which has been written off and which we discount here as immaterial. Over the 12 investments, two were not meaningful in a portfolio context (one buyback, one write-off). Five have given exits greater than the target multiple, with the other five being written off.

Recently (1Q2018), Par Equity has agreed a stunning exit (although, at the time of writing, this has not completed as it requires regulatory approval). The other exits, although less spectacular, still produced IRRs of 30%-45%. Up to the recent exit, the average return had been 1.84x the aggregate investment. This is now 4.85x, with two possible escrow payments to come, which would take it to almost 5x.

The remaining portfolio of 33 companies is showing a small gain of 3.7% – an improvement from the figure one year ago of 0.4% ex-ICS. Of these, 17 companies show an uplift and six companies a loss. The write-downs on most of the latter are reasonably aggressive, with some residual values based on loan notes, rather than equity. The majority of the unchanged investments have been made in the last year.

The EIS has invested in 22 companies to date. The average unrealised gain on these is 33.5%. With roughly half of the funds having been deployed in the last 12 months, the longer-standing investments are performing in line with the broader portfolio.

For the last couple of years, Hardman & Co has seen the track record as very promising, although lacking some maturity. There are increasing signs that this promise is coming through. While the return on the latest exit cannot be the expectation for all investments, a successful exit rate of 50% is good for venture capital. The improvement in a broad spread of the more mature current investments suggests that existing investors will see some further good returns in due course.

Fees

The fees for the Fund are set out in the table on page 3. Administrator fees are paid from Par Equity's charges other than as noted.

Annual fees

Four years' worth of annual fees are deducted from the subscription at outset. The balance of any Management Charge is paid at the time of exit.

The initial deduction is therefore 4% for management fees (initial fee plus four years of annual fees). The fees deducted at the outset are not eligible for EIS tax relief.

Exit fees

The performance fee has a threshold of 120% of the aggregate subscription. If an exit is achieved within three years, then the threshold is raised by 40% of the subscription applied to that investment. This is an unusual, and welcome, adjustment to make allowance for the loss of tax relief that would occur. The performance fee is based on aggregate capital return over the investor subscription, and is charged after the other fees.

There is also a dealing fee of 0.35% payable to the administrator, plus any outstanding annual fee as indicated above.

Investee company fees

Companies usually pay an arrangement fee of up to 5%. In addition, there is a monitoring fee of the larger of 1.25% of the investment or £6,000 p.a., raised by £12,000 where a staff director is appointed (although, as noted above, this is pretty rare). Par Equity observes that the monitoring fees tend to be negotiated away over time. For an EIS investor, there is a dilutive benefit from these being charged to the company, rather than the Fund.

Fundraising targets

Par Equity's fundraising targets are soft, with an aim of raising £10m in the current financial year, but this is significantly higher than in previous years. Par Equity says it could cope with this level of inflows by taking higher proportions of investments and reducing co-investors' shares.

The minimum subscription is £20,000, with higher amounts in multiples of £1,000.

Investment manager

Par Fund Management Limited has been a source and manager of investments for Angel investors. As well as the £40.2m attributable to the Syndicate and the EIS Fund (including some of the gain from the recent exit), there are £13.4m of other venture capital assets, including from co-investors, and another £26.2m in other asset classes.

People

Paul Atkinson – Partner

Was the founder of Direct Resources, an IT recruitment business, which he sold in 1999, and Recruitment Scotland, which was sold in 2000. He remains the majority shareholder in Head Resourcing, although he stepped down from an executive role to start Par Equity. He is a serial Angel investor.

Andrew Castell – Partner

Started his career at Touche Ross in audit and then management consultancy. After several corporate advisory roles, he became Group Finance Director at Goshawk Insurance Holdings plc. He was also one of the architects of Insurance Capital Partners LP, an innovative underwriting fund.

Robert Higginson – Partner

Started as a programmer in 1980, and joined Reuters as the manager of real-time systems in 1986. Subsequently, he joined Telekurs AG, before moving to strategic roles at ABN AMRO and Royal Bank of Scotland. From 2002, he worked with various universities on start-up technology spin-outs.

Paul Munn – Partner

Brings a corporate management background, having worked with blue-chip companies in consumer goods, manufacturing and healthcare. He was Group Finance Director and then CEO at Dawson International (textiles), where he led a successful restructuring. Before joining Par Equity, he worked for Hermes Fund Managers on corporate governance.

Marcus Henderson – Investment Manager

A chartered accountant with a background in corporate finance and business consulting, gained from working with Deloitte. His background is cosmopolitan, having studied in New Zealand and Vienna.

Graeme McKinstry – Investment Manager

Is also a chartered accountant with experience in corporate finance from working with Deloitte. A relatively recent recruit to Par Equity, he will focus on existing investments, including follow-on funding.

Pauline Cassie – Investor Relations Manager

Formerly with the private bank Adam & Co. She is another recent recruit and will be looking after private clients and intermediaries.

The Investment Committee consists of the Partners, with the other team members in attendance. The team brings an interesting mix of experiences that contrast well those of some other EIS managers. The management acknowledges that, at times in the past, the small size of the team has been a constraint on growth. It has continued to add to its administration team, with a new Financial Controller having arrived in March 2018, and intends to recruit on the investment side ahead of need.

Appendix 1 – due diligence summary

Summary of core due diligence questions		
Manager		**Validated by**
Founded	2008	Hardman & Co
Type	Limited Company	Hardman & Co
Ownership	Par Equity LLP, which is 89% owned by founders	Hardman & Co
FCA Registration	Yes – 485668	Hardman & Co
Solvency	Confirmed	Hardman & Co
EISA member	Yes	Hardman & Co
Administrator		
Company	Share Centre	Information Memorandum
FCA Registration	Yes – 146768	Hardman & Co
Fund Custodian		
Company	Share Centre	
FCA Registration	Yes – 146768	Hardman & Co

Source: Hardman & Co research

The manager of the fund is Par Fund Management Limited. It is FCA registered with fund management permissions. The balance sheet is healthy for a small firm, particularly as it completed a fundraising in 2016. At the last accounts (31st March 2017), it had just under £380,000 of shareholders' funds. We note that the company has plans to grow, but clearly is not constrained by capital.

Par Fund Management Limited is wholly owned by Par Equity Holdings Limited, which, in turn, is 89% owned by Par Equity LLP. The four co-founders (below) are partners in the latter, together with Malcolm MacPherson, Jim Kilcullen, Simon Best and Andy Ley. Malcolm MacPherson and Andy Ley are partners in HBJ Gateley, a law company that is one of the panel law firms used.

Appendix 2 – example fee calculations

These calculate the estimated amount payable to the manager under certain assumptions.

Basic assumptions	
Term	5 years
Investor amount	£100,000
Company investment	£500,000
VAT on company fees is offset against revenue	

Source: Hardman & Co Research

Calculations					
			Hardman & Co Standard		Target
Gross return		**-50%**	**0%**	**50%**	**100%**
Amount (pre-tax relief)		**£100,000**	**£100,000**	**£100,000**	**£100,000**
Initial fees	**Rate**				
Manager	1.00%	£1,000	£1,000	£1,000	£1,000
Company	5.00%	£4,800	£4,800	£4,800	£4,800
Total		£5,800	£5,800	£5,800	£5,800
Annual fees					
Manager	0.75%	£750	£750	£750	£750
Deduction upfront (4 years)		£3,000	£3,000	£3,000	£3,000
Net investment		£96,000	£96,000	£96,000	£96,000
Annual fees – from company					
Monitoring fee	1.25% pa	£6,000	£6,000	£6,000	£6,000
Gross fund after investment return		£48,000	£96,000	£144,000	£192,000
Exit fees					
Administrator	0.35%	£168	£336	£504	£672
Balance of annual fee (1 year)	0.75%	£750	£750	£750	£750
Performance	20%	£0	£0	£4,549	£14,116
Net amount to investor		£47,082	£94,914	£138,197	£176,462
Gain (pre-tax relief)		-£52,918	-£5,086	£38,197	£76,462
Gain (post-tax relief)		-£24,118	£23,714	£66,997	£105,262
Total fees to manager		£15,718	£15,886	£20,603	£30,338

Source: Hardman & Co research

Notes: post-tax relief figures assume initial income tax relief only. Other reliefs may be available to investors.

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Some professional investors, who are subject to the new MiFID II rules from 3rd January, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies and legal entities about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'

The fact that we are commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.

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