Governance in the world of business relief

By Brian Moretta, Head of Tax Enhanced Research

Governance in business relief

Advisers need to look at the quality of governance behind business relief products

When advisers first start looking at business relief (BR) products, there is much to look at: the rules governing such products, investment strategies that are being used and what the investment risk is. It is easy to lose sight that for non-AIM products, the investment is being made directly into a company or partnership rather than a fund. This means it is essential that governance is part of the diligence process.

Independent directors

In the investment trust/company industry, the concept of independent directors is not only well known, but an argument that has long been settled. For the vast majority of investment trusts, the fund manager is a separate entity from the company that investors own shares in. The manager supplies services in return for a fee. The board has discretion as to how much the fee might be, or whether the manager should remain in that role. Once upon a time, investment trust boards consisted primarily of people connected to the manager, with all the potential for conflicts of interest that that brought. Over time, it was realised that this was a 'bad thing' and it was deemed that a majority of the board should be independent of the manager.

Most non-AIM BR products have much in common with investment trusts. Most of the companies have no employees, with managers being paid a fee or having expenses covered for both fund management and company management.

What is surprising then, is that over half the products in our database invest into companies with no independent directors.

Independent directors in business relief products

Source: Hardman & Co Research

This would seem to be important - in private companies, transparency is usually more limited than for quoted companies. From the research we have undertaken, over a quarter of products invest in companies that publish abbreviated accounts rather than full accounts. This is not restricted to the smaller companies: the smallest company publishes full accounts, while some of those with abbreviated accounts are among the larger in the sector. When information is limited, it is hard for investors to validate that companies are doing what they say they are.

Potential conflicts of interest

There are more concrete areas in which potential issues manifest. Many advisers are aware that potential conflicts can arise. At its simplest, these are the same issues as for investment trusts, such as whether the fees or expenses are appropriate. However, the potential for conflicts in BR runs deeper.

For investment trusts, independent directors have a key role to play in ensuring that investors are treated fairly. In the BR area, matters are less clear

Many companies have participated in related party transactions, which take one of two forms. The first is buying assets that were previously under the management or control of the fund manager. Mostly these have been renewable energy assets, such as solar or wind farms that were previously in companies funded through EIS schemes. These can create a potential asymmetry of incentives for the fund manager, who may be due a performance fee for the sale or could lose market credibility for a poor outcome. And while some transactions have been small, others have been significant.

The second transaction is lending to related parties. Typically, this is making loans to other companies run by the fund manager, for example to fund the construction of renewable energy projects. Again, there is the potential for inappropriate pricing, though generally Hardman & Co view this as being less concerning than for asset transfers. Not only are the loans usually asset backed, but the connection can make diligence both easier and more comprehensive, so there are offsetting benefits.

If a company were quoted, then the independent directors would have a key role to play in ensuring that shareholders are being treated fairly. In the Business Relief area, matters are less clear. While the managers we have spoken to have outlined their process for assessing the transaction price, and made these sound reasonable, independent oversight of this process would give some reassurance.

Setting share prices

Another area that is worth highlighting is the share prices used for transactions. Most of the trades generate revenues from assets that they hold or lend using assets as security. Consequently, share prices are asset based. Over half of products use the net asset value (NAV) from the audited accounts, or the same basis between year ends.

However, a substantial minority, all of which invest in renewable energy assets, are using a distinct share price. The rationale is understandable: market values of these assets have moved in a way their accounting does not reflect. Where a company has constructed a project then, if it is successful, the market value should exceed the book value of the investment. However, using valuations that are outside the audit process raises governance questions.

From a governance perspective, the manager that has perhaps the clearest approach uses a named external consultant for the valuation and specifies the key assumptions, most notably the discount rate used. The latter is particularly useful for an external analyst, helping with assessments of whether the company will achieve its target returns and allowing easier comparisons with others in the market.

Unfortunately, they are the exception. Most managers are happy to outline the process they use but, while these seem reasonable, the lack of external validation has to be a serious concern for advisers. While the price of electricity has shown some volatility over recent years, the market for the assets appears to have remained solid. This suggests that in the current market, market evidence should converge on a clear valuation basis. If circumstances become less benign, this may become more difficult and an external audit will have more value.

This is not to say that there are no issues in the market at present. Given the comments above, it is not surprising that the growth in NAV per share has lagged the share price growth from these companies. In a strong market for the underlying assets, the premium to NAV may be justified. However, having a rising share price when the NAV per share is falling should require further investigation. An adviser should probably be sure that the premium is justified before recommending such products to clients.

In the world of quoted investments, governance is a topic that has been getting increased attention. It is probably time that it got the same attention in the unquoted world too.

About the author

Brian Moretta is the Head of Tax Enhanced Research at Hardman & Co, and also covers Financials stocks and Investment Funds.

In addition to his role with Hardman & Co, Brian has lectured on actuarial science and financial economics at Heriot-Watt University, is an examiner for the Faculty & Institute of Actuaries, and is on the Bankers without Borders Financial Modelling Reserve Corp.

Brian has had a 20-year career in Financial Services, including more than a decade as a fund manager. He specialised in analysing Financial Services companies at SVM Asset Management, as well as managing two traded endowment funds, an equity fund and working on hedge funds.

Brian joined Hardman & Co in February 2013. He holds a PhD in Applied Probability and a BSc in Actuarial Maths and Statistics from Herriot Watt University.

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