HARDMAN & CO.
TAX ENHANCED

BUSINESS RELIEF PRODUCTS

The truth about what's underneath

By Brian Moretta & Nigel Hawkins

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Introduction

This report has been written to coincide with the launch of the Hardman & Co panel service for Business Relief (BR) products. Hardman & Co has been providing high quality investment research for more than 20 years. Its pool of analysts is highly experienced, having examined their specialist markets for decades. The co-authors of this report include: Brian Moretta, who has headed Hardman & Co research in the BR space and Nigel Hawkins, who has been analysing the renewables sector since the 1980s.

Although BR has been available for decades, its popularity has surged in the past few years as increasing numbers of people accrue estates that may be subject to inheritance tax. Both the value of assets invested, and the number of products, has grown very quickly. The lack of transparency means that specialist support can add significant value to businesses, both in terms of saving time and avoiding potentially problematic investments.

In this report, we give a brief overview of the strategy options and their prospects, and give insights into some of the potential issues. If you want to know more about BR products and how Hardman & Co can help you to give better advice, then contact us on 0207 194 7622 (see page 16 for full contact details).

Business Relief background

What is Business Relief?

Business Relief (BR) was introduced into inheritance tax legislation in 1976, although at the time it was known as Business Property Relief. The concept was to allow owners of small businesses to pass the relief on to their beneficiaries without the latter having to break it up to pay tax.

The key premise of BR is that it allows the owners of shares in unquoted businesses, subject to specified conditions, to be exempt from inheritance tax. The shares have to be held for a minimum of two years at the time of death. There are also restrictions on what sorts of businesses are eligible. The following do not meet the criteria (source: HMRC):

- businesses mainly dealing with securities, stocks or shares, land or buildings, or in making or holding investments;
- not-for-profit organisations;
- businesses being sold, unless the sale is to a company that will carry on the business and the estate will be paid mainly in shares of that company; and
- businesses that are being wound up, unless this is part of a process to allow the business of the company to carry on.

Any other business should be eligible, although it should be noted that simply holding cash in a company falls under the 'holding investments' restriction and so would not be eligible.

For the purposes of BR, 'unquoted' also includes AIM-listed stocks. There is also a category of relief which allows 50% relief for certain other business assets, although this is not of relevance to this report. Full details can be found on the HMRC website https://www.gov.uk/business-relief-inheritance-tax.

For investors, this has an obvious appeal, in that, if they can invest assets into an appropriate business then, after two years, those assets will be exempt from inheritance tax. There are a variety of products, schemes and services which offer this possibility. In broad terms, they can be divided into two groups: AIM portfolio services and non-AIM products.

Overview of the BR market

Inheritance tax planning has long been an established part of financial advice for the wealthy. However, a long bull market for many assets, including residential property, stock and bond markets, has meant that the number of people whose estates may incur significant inheritance tax liabilities has been rising.

The topic of preparing for death can be a difficult one for many people and families. Preparing assets to optimise an estate is often deferred for as long as possible. It has not helped that the solutions available are not widely known and many of them, such as trusts, require specialist knowledge and advice to implement and attract significant costs.

In that context, BR can seem like an attractive option. It is straightforward to implement, with the recent review from the Office of Tax Simplification making no recommendations for change. Additionally, the assets can remain accessible if required or be used to generate an income. The key decision for most investors is the trade-off between capital preservation and future returns. In broad terms, the shorter the future life expectancy of an individual the more likely there will be a greater emphasis on capital preservation. Investors who can expect to live longer can, and should, place more emphasis on returns.

Most non-AIM BR products are more orientated to capital preservation than AIM portfolios, although there are exceptions. Some advisers use retirement age or something similar as a cut-off date to switch between the two: this is conceptually useful, but far too simplistic in practice. The typical non-AIM BR investor is aged 70- to 80-something, often coming to terms with their own mortality and has finally got around to looking at their estate and doing something about it.

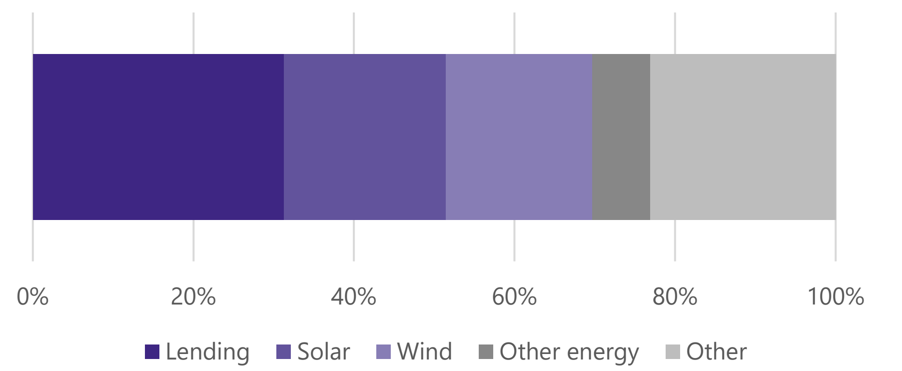
Given the simplicity of implementation and claiming, it should be no surprise that BR products have grown in popularity in the past few years. Assets in the non-AIM BR sector are now well over £4bn and increasing rapidly, although most of the products in the market are less than five years old.

Non-AIM BR products

The non-AIM BR product market employs two broad classes of strategy:

- Secured lending: The most common objective for lending is for the development of residential property but there are many others, including commercial real estate, media projects and infrastructure.
- Holding assets: These are usually business assets that generate an income – most commonly renewable energy assets such as solar panels or wind turbines but may also include others such as forestry or leasing.

Sector exposure to different strategies



Source: Hardman & Co Research

While almost a third of products employ a single strategy, the majority are multi-strategy and may include exposure to different lending strategies and/or different asset classes.

For multi-strategy products, diversification may be achieved in one of two ways. The most common way is that investors buy shares in a single parent company. This in turn invests in various subsidiaries, either directly or indirectly, each of which deploy the cash into a single strategy. Other products are discretionary portfolio services, with the investor receiving shares in two or more companies, each of which is usually a single-strategy company. For these, the product provider may give options to have different asset mixes.

It should be noted that these businesses are run somewhat unconventionally; most have more in common with investment funds than listed companies. Many of them have no direct employees, with services being supplied by the product manager. Some of these are done on a cost (or cost plus) basis while others may be covered by a service or management fee that the product manager receives (or hopes to receive).

There are products aimed at three target markets:

- standard product for individuals;
- bespoke product for individuals; and
- existing small businesses, so cash inside the business can be deployed in business activities and keep the business eligible for BR.

All the providers we examined have an offer for the first category; the others are less common. The lines between the products for all these categories are often blurred, with options for the second and third categories varying from customised asset allocation for the existing product to strategies that are distinct from the other offerings.

So, what's the issue?

Looking from a high level, these products sound straightforward. Yet, the area is fraught with difficulties. For many advisers and their clients, these are related to the challenges of estate planning. Often an adviser is only writing a small amount of business in this area, and so doesn't have time to probe deeply into the products. Generally, clients only go through this process once and are usually in no position to become experts themselves.

In support of advisers, some of the providers have done an excellent job in providing education for advisers and clients. Octopus, in particular, even gets credit from several of its competitors for growing the market, which has led to it becoming by far the largest provider in this space.

However, this support cannot be considered unbiased and many of the advisers that we have spoken with feel the existing research providers are not filling the gap. This report marks the start of Hardman & Co providing a more informed opinion.

We have identified many issues, some small, some very significant, that advisers and clients need to consider in their decision making. Some of the key ones are:

- Strategy analysis: What are the businesses actually doing and what risks are they taking?

- Lack of transparency: Six managers publish only abbreviated accounts for their products. This is a choice, and it makes it difficult for external analysts to confirm what is going on in a business. Furthermore, particularly for the larger schemes, the nesting of subsidiaries and sometimes inconsistent consolidations only serve to obscure matters further.

- Poor disclosure: Fees are the most noticeable area but there are others. Key Information Documents (KIDs) have helped but many products are exempt. In many cases, indirect fees are still obscure and other costs can be substantial. For example, in the past three years, listed renewable energy funds have outperformed comparable BR products by several percentage points a year. A large part of this gap is a relative cost disadvantage.

- Weak governance: Only three managers have products with a board in which the majority of directors are independent of the product manager. Six companies have products with no non-executive directors.

Many of these are not standalone issues. While hardly any products suffered from every issue, there were very few products for which we did not have any concerns. Governance, in particular, has been largely ignored to date but is likely to come more to the fore.

Oxford Capital Estate Planning Service, for example, had only one independent director, didn't publish income statements (only balance sheets) and used a valuation process that was outside the audit. While we cannot directly link its issues to these, greater external scrutiny may have made the problems less likely.

One observation that we might make is that, of the 19 product providers in our survey, we are only aware of two that have significant numbers of investors that have done so purely for investment reasons. That these products are not attractive to investors who are not looking for BR is telling, although we note that some providers are attracting investments into similar strategies in other products.

Analysing investments

Investments into non-AIM BR products means investing directly into one or more unquoted companies or limited partnerships. Many of these have 'Trading' in the name, as if to emphasise that they are real businesses. From an analysis perspective, this naturally suggests that the primary information to be used is the company accounts.

The benefit of this approach is that it should allow analysts to look at what the products are really doing, rather than relying on what the glossy brochures say. There are some challenges, which we alluded to above.

The first is that most activities take place in subsidiaries. These can be numerous and, on occasions, four or five layers deep. The consolidation of these subsidiaries is inconsistent across the sector, with many using net figures that do not reflect the underlying activity. Others fund through loans, which may or may not pay interest to parent companies at probably undisclosed rates. At least one manager uses a transaction price of an NAV based on a different consolidation basis to that used in the published accounts.

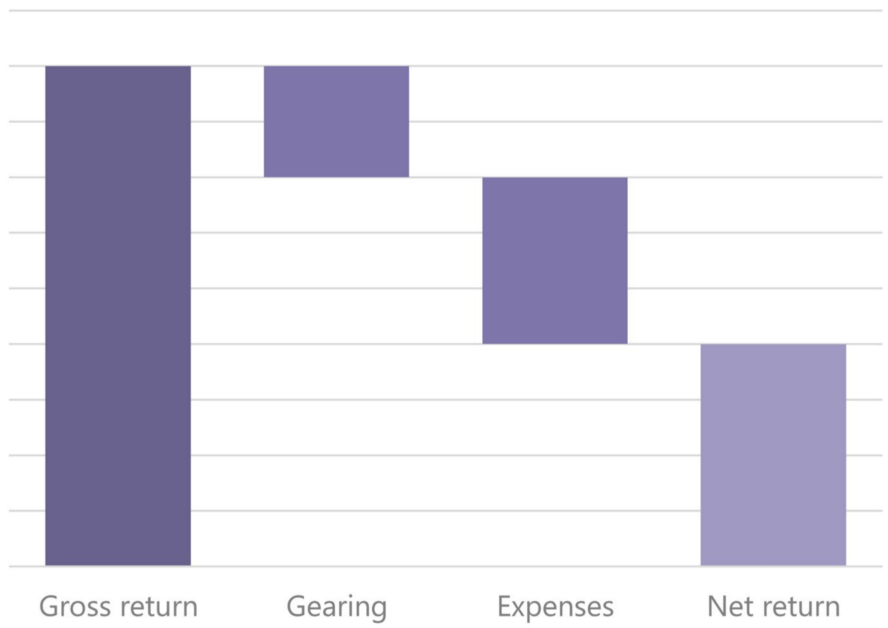
The second challenge is the use of abbreviated accounts. As we mentioned before, a third of managers use these throughout the operations. Even where full accounts are given for the investee companies, subsidiaries often have abbreviated accounts. This includes some larger managers, as well as smaller ones.

The final challenge is a lack of timeliness. The only restriction on production of accounts is the deadline that Companies House imposes, which is nine months after the financial year-end. We regard this as a relatively minor inconvenience, although we know there is at least one manager that has significantly restructured its product since the latest accounts and, as yet, we have no meaningful information on how the companies are structured now.

Providing a coherent framework

Hardman & Co provides a coherent intellectual framework for analysing and comparing BR companies. This can be summarised in the waterfall figure below.

Methodology



Source: Hardman & Co Research

Many products are producing a low net return; most target something around 3%-5%. However, the gross return required on the underlying assets to achieve that is usually substantially higher. Given that risk is the flip side of return, the starting point for assessing relative risk is this gross return.

That is not to say the underlying assets are ignored: both cross-strategy and in-strategy diversification are considered, as well as the managers' processes for managing the underlying assets. The latter allows Hardman & Co to use its vast experience to make proper comparisons of what managers are doing and how effectively they are managing risk.

The strategies

Power generation

As indicated above, a high degree of stability and low commercial and regulatory risks are among the most desirable characteristics. For many years, energy stocks had met these criteria. Prior to the 2008/09 financial crisis, they were widely regarded as defensive investments. This long-standing market view was subsequently, and dramatically, disproved by the share price falls of many large energy stocks – and especially those with heavy exposure to generation.

The background is complicated by environmental factors, which are driving major changes in the UK energy sector, with all coal-fired plant – central to powering the nation's economy throughout the 20th century – due to close by 2025.

Despite the challenges faced by many large energy players, as the generation element of the electricity supply industry undergoes a sea-change, the sector has given rise to the arrival of many comparatively small energy businesses, a few of which are quoted. For the most part, however, they operate under the aegis of private equity, as infrastructure funds within a trust, as closely held private companies, or simply through a power project shareholding.

Renewable energy

The majority of BR investment is focused on UK renewable energy, which has grown strongly in the past decade as generous subsidies have been on offer. Of course, potential investors have also declined to invest in many other renewable projects, especially if the risk/return ratio seems unattractive.

In reality, there are seven technologies – excluding nuclear power where the renewable power claim is controversial – which can be genuinely categorized as generating renewable power. These seven technologies are: hydro; wind; marine/wave; biomass; geothermal; solar; and fuel cells.

Generous subsidies are available through the Renewables Obligation Certificates (ROCs) regime or through the complex Feed-in Tariff (FIT) mechanisms; the latter are different not only for each renewable technology but also for variations within that technology grouping, especially in respect of biomass plants.

Importantly, since 2017, new renewable power plants, with a few exceptions, do not qualify for renewable subsidies.

Hydro-power plants have been operational for generations – and still contribute a sizeable proportion of Scotland's electricity production.

However, in recent years, the focus has moved to the wind sector – both on-shore and off-shore – and increasingly to solar power.

The remaining four renewable technologies, in the UK at least, have faced many challenges. Aside from the partly converted Drax coal-powered plant, biomass continues to struggle at large scale, although some BR products invest in smaller-scale projects. None of the marine/wave, geothermal or fuel cell projects have so far produced meaningful output. From a BR perspective, the largest exposure is to solar and wind power.

Solar power

Despite the UK's unpredictable climate, BR products are increasingly focusing on solar power. While roof-top conversions provide the technology with a high profile, it is the photo-voltaic solar farms in rural areas, perhaps with a capacity of 10MW, that are attracting most new investments.

For solar power operators, their revenues are underpinned by long-term ROC/FIT payments.

The leading sector companies have assembled a portfolio of solar farms thereby minimising the climate risk. Nevertheless, there is – not surprisingly – a noted bias in favour of solar investment in the southern part of England, where irradiation levels are appreciably higher, rather than in Scotland. Consequently, electricity generation figures should be reasonably predictable on a year-to-year basis.

However, there are risks, on several fronts, that investors need to address.

In particular, there is no guarantee that ROC/FIT payments will necessarily endure: in Spain, major cuts in solar power subsidies were hastily implemented after the financial crisis of 2008/09. Also, other adverse developments on either regulation or irradiation levels could materially affect the revenue line – and consequently expected returns.

Furthermore, prevailing market electricity prices can fluctuate quite sharply. Although the existence of Power Purchase Agreements (PPAs) can substantially mitigate the pricing risk, these are not always long-term in nature.

The solar sector is also subject to risks arising from construction, the arrival of new competition and higher interest rates.

Wind power

Investment in UK wind power has also been undertaken by BR companies. To date, most of their activity has been in the on-shore wind generation market.

For many years, particularly through the ROCs regime, generous subsidies have been available. Combined with the relatively straightforward technology involved, on-shore wind investment has proved popular. But, as is the case with solar power development, it is not risk-free. The issue of ongoing subsidy provision and trends in the price of electricity are crucial to the revenue line and, in consequence, to overall returns.

In recent years, on-shore wind development in England, as opposed to Scotland where it continues to thrive, has stalled. Planning issues have been pivotal to this trend, along with the removal of subsidies for new on-shore wind plants.

Instead, the wind generation focus has moved off-shore, encouraged by the Government, which has been delighted – and surprised – that bidding prices in recent off-shore auctions have fallen dramatically. As such, subsidies for future North Sea off-shore wind developments through Contracts for Differences (CfDs) will be far lower than anticipated previously.

Off-shore wind, though, necessitates much larger turbines – and therefore construction risks – compared with the on-shore equivalent. Consequently, it is less obviously appealing at present to BR products than some other potential investments.

Of course, these lower subsidies raise serious questions about the potential returns for investors. This may explain why, although it is still early days, investor interest has been less apparent than might be expected; currently, BR investors remain focused on on-shore wind.

In time, other renewable technologies, especially wind and solar, may become more suitable for BR-related investment: to do so, they would need to prove their capability to generate secure, long-term earnings.

Summary

In summary, UK renewable energy offers good prospects but the risks need to be properly – and regularly – assessed, something that Hardman & Co is well-qualified to do.

Lending

The majority of lending within BR companies is in two areas: residential property and infrastructure, primarily energy-related projects.

Since the financial crisis, the big banks have cut back or withdrawn from lending to residential property developers. Some smaller specialists have remained in the market and some smaller challenger banks and peer-to-peer lenders have increased their presence. Anecdotally, the aggregate supply of lending remains lower than it was previously and many BR companies are seeking to fill the gap.

Nevertheless, this is still a competitive market. Most business is sourced through brokers and, consequently, is subject to competing bids. While most of the companies outline criteria by which they set their pricing, this is less scientific than for consumer loan pricing and the risk of 'winner's curse' is present.

In most of the managers, specialist teams have been built up by bringing in staff who are experienced in the area, mostly from the big banks. While expert knowledge is critical in this area, it has to be noted that the track record of the banks is, at best, mixed. It is impossible to apportion credit or blame to individuals, other than to note that expertise does not guarantee good outcomes.

The managers generally articulate very sensible and reasonably conservative criteria, getting first charges on properties and using moderate loan-to-value (LTVs). There are some differences in how these are applied; however, most appear to be lending towards the safer end of the development spectrum.

Having said that, development lending is riskier than mortgage lending. If a developer goes bust and a site is not completed, then the residual value is usually significantly less than the expenditure incurred. In these circumstances, the lender may prefer to get a new developer to finish the job as the best way to maximise value.

Risks of economic downturns

While this is a good strategy under normal economic circumstances, it may be less effective in a downturn. While many of the experienced staff worked through the economic crisis, very few of the current product managers and teams have been lending and collecting through an economic downturn. Most managers would have the option of renting the property once completed; however, this extends the commitment and there is no certainty as the ultimate realisable value.

When asked what the expected cross-cycle default rate is, the most common response from managers was that they have not incurred any losses yet. This is not entirely reassuring. While they do make a good case for having lent sensibly, so far most have not been tested through a full economic cycle.

From an investment perspective, Hardman & Co's other main concern is the lack of diversification in portfolios. Many are geographically concentrated (and could see much larger falls in value than national house prices) as well as having limited numbers of properties. When there are only 20 loans in a portfolio, the loss on one can more than wipe out the expected return for a year. With most companies growing their assets, we would expect that to improve over time. However, there are very few companies that currently have a good level of diversification on a standalone basis.

Other areas

As well as residential property, BR companies have been, inter alia, lending to infrastructure projects, doing factoring for companies, leasing and media finance. Each area has its own characteristics, risks and expected returns.

We note on infrastructure lending that, in many cases, the BR company is lending to a project that is linked to the manager, either being another company that it manages or a project that it has an interest in. This can have advantages, as it makes underwriting easier and could, potentially, reduce fees. However, there is clearly a potential conflict of interest and investors should reassure themselves that the terms are on a normal commercial basis.

Summary

In summary, to date, this has been a good area for BR companies to invest in, producing stable returns and few credit losses. Risks remain, though, and it will be interesting to see how robust the processes are to a downturn in the credit cycle.

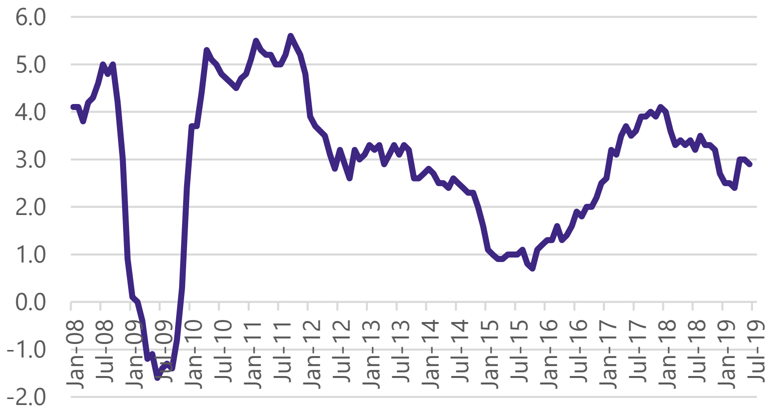
Outlook

Although the risks for lending and holding assets are different, there are some common themes, of which interest rates is the clearest.

The UK appears to be back into a rising interest rate environment. While Brexit introduces an element of unpredictability, short-term interest rates are probably going to start rising slowly over the next year or so.

For solar and wind assets, it is not clear what effect this will have. Valuations and returns depend on three factors: the discount rate; the inflation rate; and electricity prices (including subsidies). Rising short-term interest rates do not necessarily imply that long-term rates will also rise. General monetary tightening, though, is unlikely to be supportive of prices for most assets. If discount rates rise, with everything else being equal, then asset values will fall but future returns should be higher. Given the shorter-term perspective of most non-AIM BR investors, the former may be more significant than the latter.

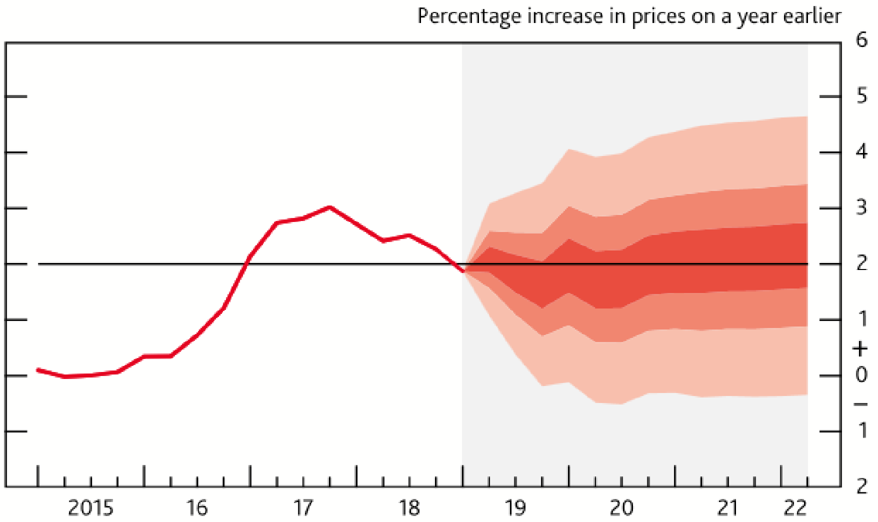
RPI Index



Source: Hardman & Co Research

Inflation is currently above the usual assumptions of 2.5% for RPI and 2% for CPI. If this continues, then it should be a positive for returns. The difference relative to assumptions over the 12 months to April was 90bps. This is expected to fall back. However, with rising oil prices and volatile currency movements, this is not something we can say with confidence. With most target returns in the 3%-5% range, this may remain a useful uplift in the short run, although as the above chart shows, periods where RPI is below the assumed rate are possible too.

CPI inflation projection based on market interest rate expectations, other policy measures as announced



Source: Bank of England Inflation Report, May 2019

The chart below shows fluctuations in UK power prices over the last decade.

ICIS Power Index (IPI) value £/MWh

Source: ICIS

Unlike inflation, there is no real consensus about how energy prices will move in the future (although there are forecasters whose predictions are typically used in valuation assumptions). For a long time, electricity prices were considered to be stable and defensive in investment terms, but events have shown this may no longer be correct. The IPI, shown above, gives an average for forward prices over the next year and the volatility can be seen. In the past couple of years, the IPI has varied between £40 and £60 per KWh. Given many asset valuations use longer-term forward curves, there can be significant leverage to price changes if long-term PPAs are not in place.

For lending, in the near term, any increases in short-term rates should be a positive as the interest rates chargeable would seem likely to rise. The concern would be if rates rise enough to affect affordability for owners or drive the economy into a recession. Given the expected slow pace of increase, neither of these risks look likely to appear any time soon.

Overall, there are good reasons to suppose that rising rates should increase returns in the underlying strategies. However, not all investors will see their returns increase, or not significantly at least! There are several products in which annual fees are conditional upon achieving a minimum return, but that return is not currently being achieved. In most of these cases, the shortfall is small and the expected increase in returns is not that big, so the increase in return may mostly go to paying the fee. In some others, much of the return above the target is simply captured by the provider rather than investor, so the former would receive the benefit rather than the latter.

Value of a Hardman & Co panel

Benefits of our panel services:

- Thoroughly compliant solution.
- Confidence to recommend suitable and appropriate products: Our research capabilities are unrivalled in the industry. Our analysts have an average of 25 years sectoral expertise, providing insight and knowledge on the products' complex characteristics.
- Tailored to the profile of your clients.
- Up-to-date market information: We will review and update the panel as necessary during the year, to reflect company and product changes.
- Education and training: We will help to educate and train you in the nuances of the BR market.
- Saving your time and money.

If you are interested in growing your IHT business, please contact us below.

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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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Nigel is responsible for analysing the UK Utility companies, including those privatised in the 1980s and 1990s, as well as newer arrivals in the sector. He has been involved in the Utilities sector since the late 1980s, as a feature writer at Utility Week magazine and as an analyst at Libertas Capital. Prior to that, he was the Telecoms analyst at Williams de Broë. Between 1989 and 1995, he worked at Hoare Govett as the Water and Electricity analyst.

Between 1984 and 1987, Nigel was the Political Correspondence Secretary to Lady Thatcher at 10 Downing Street.

Nigel joined Hardman & Co in February 2016. He holds a BA (Hons) in Law, Economics and Politics from the University of Buckingham. He is an associate of the Institute of Chartered Secretaries and Administration and a senior fellow of the Adam Smith Institute.

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