Downing TWO VCT K-Share

VCT type:	Limited Life	Charges:	
Issue details:	New Share Class	Annual Management Charge	2%
Max sought:	£15m	Standard Initial Charge	4%
Min investment:	£5,000	EQ Investors Discount	2.25%
Offer Closes:	5 April 2016 29 April 2016		

EXECUTIVE SUMMARY

Downing is seeking to raise £15 million into a newly launched "K-share" class within the existing Downing TWO VCT. The capital raised within this offer will remain a separate pool of capital within Downing TWO VCT, albeit it will follow a comparable investment strategy. Downing have regularly issued limited life VCTs, raising varying amounts of capital. The most successful fund raise within Downing TWO was G Share class, launched in January 2012 after raising £22.6 million.

The K-share class is targeting a return of £1.10 over its limited life, by investing predominantly in asset backed companies trading from freehold premises, or those offering predictable revenue streams.

Limited life VCTs are deemed to be at the lower end of the VCT risk spectrum, more conservative in nature than a generalist VCT due to the requirement to return capital following the compulsory five year holding period under HMRC regulations. In addition to this, the strategy attempts to further mitigate risk by its focus on asset-backed opportunities and use of loan note investment structures.

BACKGROUND

The Downing TWO K share class is a new share class, and as such has no track record. However, this is the sixth fund raise into the Downing TWO VCT, the first of which launched in 2005. Therefore, there is a track record with regards to the investment strategy, portfolio construction and performance track record that we make reference to throughout this report. In addition, Downing have launched a further 13 planned exit VCTs, gradually merging them over time.

While the investment strategy will remain unchanged compared to other Downing TWO share-classes, investors should appreciate that changes to the VCT qualifying rules introduced by the HMRC in recent years excludes a number of asset classes from their investable universe, such as renewable energy companies.

The Downing TWO has net assets of approximately £42 million, split between the share classes as follows:

VCT	Launch date	Size (Millions)*
Downing TWO O shares	January 2005	Wound up
Downing TWO C & A Shares	September 2008	£3.7
Downing TWO D & E Shares	November 2009	£7.6
Downing TWO F Shares	October 2011	£7.9
Downing TWO G Shares	January 2012	£22.6

Please note: Previously named Downing TWO Planned Exit

The C & D share pool, which includes the A & E shares, have both passed their five year anniversary. The C (&A) share pool is at the advanced stages of a full exit, while the D share class is less so, with a substantial exit transaction of all solar holdings falling through at its latter stages.

Pros	Cons
Investment in asset-backed opportunities through the use of loan notes reduces the overall risk characteristics	The Downing TWO K share class will not pay a dividend, and therefore this is not appropriate for clients requiring an income
Downing have substantial resources available and in addition have a long track record in the limited life VCT space	This share class is more constrained with respect to qualifying asset classes, and therefore has a narrower investable universe
As a limited life VCT, investors should be able to exit at a zero discount to net asset value	The only Downing TWO share class to date that has fully returned capital to investors underperformed, returning 90.4p.

Impact of latest regulations

While the investment strategy followed by Downing TWO VCT has not been materially impacted by the most recent changes in VCT regulations, there are a number of investments, such as those in renewable energy opportunities, which are no longer deemed VCT qualifying. The implication of this is that the investment universe in which the VCT can invest has been narrowed. However, Downing have stated that "*although changes to the VCT rules introduced in the July 2015 summer budget restrict the range of investments the VCT can undertake, we believe that an attractive portfolio can be built to deliver the target returns*".

ORGANISATION & MANAGEMENT

Downing was founded in 1986, and now has over £700 million of assets under management across VCTs, a number of EIS schemes, an estate planning services and investments within renewable energy and the Alternative Investment Market (AIM).

Downing launched its first VCT, Downing Absolute Income VCT 1 in 1997, following the introduction of the scheme in 1995. It has therefore built up an 18 year track record in VCT investing, and now manages approximately £231 million of assets within these structures.

The Downing TWO VCT is managed by the wider investment team at Downing, which is comprised of over 25 individuals, four of which share a greater responsibility for the ongoing management of this VCT, detailed below.

Chris Allner, Head of the Investment team, has over 30 years of venture capital and private equity experience. Prior to joining Downing, Chris was head of Private Equity at Octopus Investments. The other key members are Colin Corbally, Head of the Renewable Energy team, Jonathan Boss, Head of the Asset Backed team and Martin Robertson, who oversees the ongoing monitoring of the portfolio

The Downing TWO Board comprises three non-executive directors, Hugh Gillespie (Chairman), Dennis Hales and Christopher McGann, all with relevant experience in the VCT sector, private equity and banking and financial services.

INVESTMENT STRATEGY

The funds raised in the Downing TWO K share class will be deployed in a comparable investment strategy to that of the other share classes within Downing TWO, albeit capital will remain held in a separate pool for the duration.

This strategy is solely focused on investing in unquoted companies with significant asset-backing, either in the form of bricks and mortar real estate, or predictable income streams with similar characteristics, over which first charge is taken. The implication of this is that if an investment were to fail to perform in line with expectations, the assets that have secured the investment will be taken by the VCT, and potentially liquidated to generate a return. These investments will be made with a high proportion structured as loan notes, reducing the overall risk albeit also reducing the upside participation in successes.

The VCT will co-invest in deals, although will typically be the majority investor, investing up to 85% of the investments value. The co-investors will include third parties or entrepreneurs, who will generally be more junior in the capital structure.

The majority of funds raised within this share class will initially be invested in non-qualifying investments, predominantly secured loans and other fixed income securities. These loans will typically be secured on property or other assets, while the fixed income securities will consist of bonds issued by the UK government, or major companies or institutions.

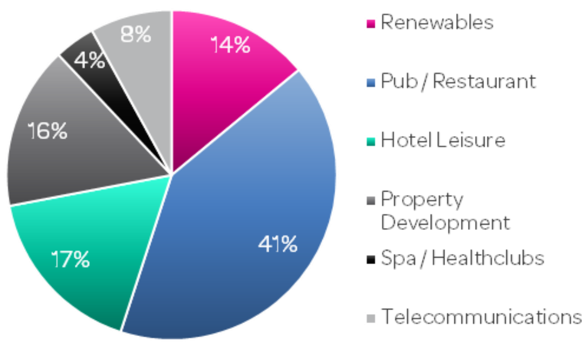
The Downing literature states that the VCT "*plans to start selling its investments five years from the close of the offer, and to commence distributing the proceeds to investors within six months thereafter. It may take up to two years after this date to exit all investments*". We expect that Downing will exit investments made in the K-share through a sale to third party or refinancing, most likely bank financing.

PORTFOLIO CONSTRUCTION & ACTIVITY

Downing TWO K-Share is a new share class within an existing VCT, with funds raised to remain a separate pool of assets for the duration of its limited life. Given this, a portfolio does not currently exist, but given it is following a comparable investment strategy to other Downing TWO share classes, we have highlighted some of the recent activity and current portfolio positioning in **Figure 1** below.

In the 2015 calendar year, Downing TWO (includes all share classes) deployed £14.03 million across 14 investments, of which 6 were into new underlying investee companies, and the remaining 8 were follow-on investments.

Figure 1: The combined portfolio of the Downing TWO VCT share classes (October 2015)



Downing have invested the majority of funds raised by the share classes within Downing TWO VCT, with the exception of the G share which has £3.3 million of capital to be deployed.

DISCOUNT CONTROL MECHANISM

The Downing TWO VCT K Share class is structured as a limited life, and as such is launched with the intention to wind-up soon after the required holding period. Downing state an intended realisation plan to exit "*within approximately five and a half to seven and a half years from the close of the offer*". This will provide the shareholder with an exit at full value, at no discount to NAV, a key benefit of limited life VCTs.

Within their prospectus, Downing also state the intention to "*buy back K shares in the first five years from launch at nil discount to net asset value, subject to regulations and having sufficient liquidity within the Company*". Following this period, it will be at the discretion of board to provide a share buyback between the end of the five year holding period and the full realisation.

HISTORIC RETURNS

An important consideration of limited life VCTs is their ability to make successful and timely exits following the five year holding period. Total shareholder returns from previous Downing TWO share classes are illustrated in **Figure 2**. The Downing TWO VCT Ordinary share, previously named the Downing Planned Exit 2 VCT, launched in 2005, targeting a return of £1 per share within six years, with a minimum IRR of 10% per annum. The O share fell short of this target, returning 90.4p. However, 89.4p of this was returned to shareholders approximately four years after launch, therefore providing an IRR of 11.2% per annum.

The most successful share class pool to date is the C (&A), which is in the latter stages of returning capital to investors, having returned 75p to date. The remaining NAV is expected to be returned to shareholders on 24 March, albeit this will be net of a 7p performance incentive fee.

The D (&E) share class pool has now passed its required five year holding period, and is in the process of exiting the final underlying investments. Within the latest Reports & Accounts it states that a "*proposed transaction to dispose of a number of solar investments earlier in the year fell through, although a new process has now commenced with a different purchaser*". Therefore we expect the remainder of the NAV to be paid out to investors in due course.

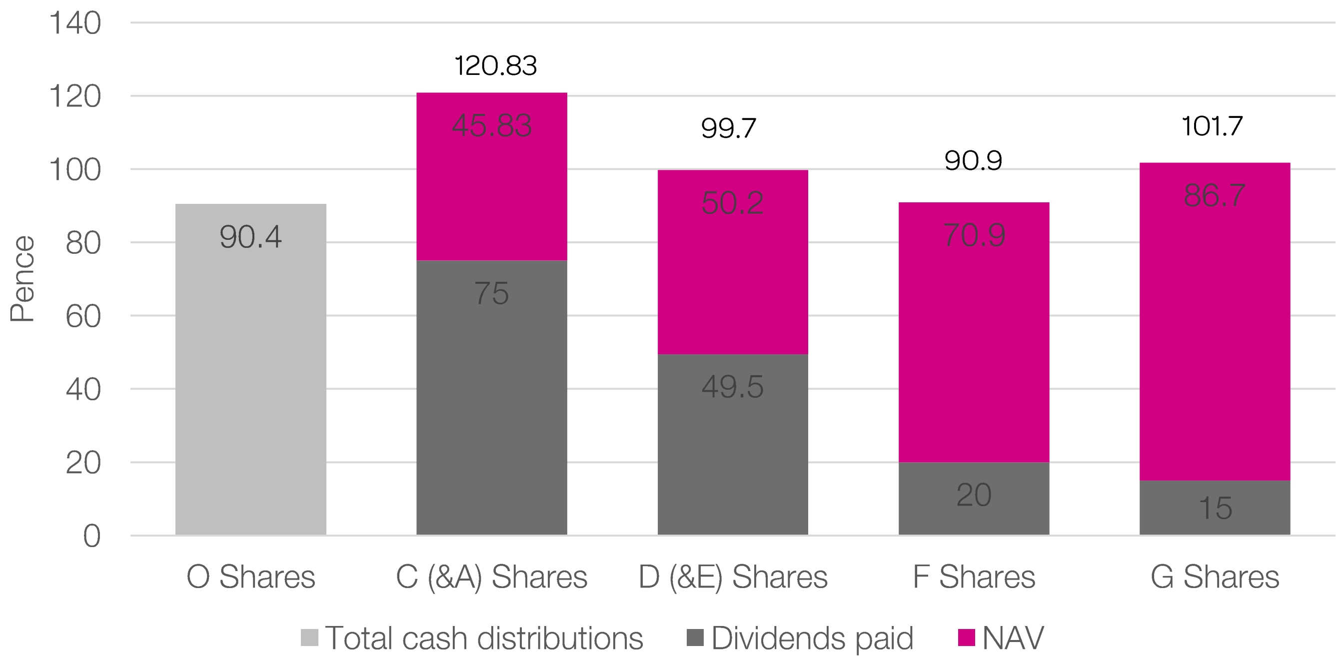
The F & G share classes launched in 2011 and 2012 respectively, and therefore have to yet reached there five year holding periods. However, to date they have paid out dividends of 20p and 15p respectively.

FUTURE RETURNS

The Downing TWO VCT K Share will not pay a dividend, following the recent changes in regulations regarding the distribution of reserves. Therefore, the total return will be delivered when the limited life K-share realises investments, likely to be between five and a half and seven and a half years from launch.

The K Share is targeting a total return of £1.10 per £1 invested, not including any initial tax relief received.

Figure 2: Total Shareholder returns from previous Downing TWO share classes (C (&A) share class NAV data as of 28 January 2016, while remaining share class NAV data as of 31 Oct 2015)



Risk Warning

The value of investments, and the income derived from them, can go down as well as up and you can get back less than you originally invested. Past performance is not a guide to future performance. This report does not constitute personal advice. VCTs should be regarded as higher risk investments, suitable only for experienced investors who are able to withstand losses. If you are in any doubt as to whether this is a suitable product for you, you should seek professional advice.

VCTs are only suitable for UK resident taxpayers who can tolerate higher risk and have a time horizon of greater than five years. Owing to the nature of their underlying assets, VCTs are highly illiquid. Investors should be aware that they may have difficulty, or be unable to realise their shares at levels close to those that reflect the value of the underlying assets. Tax levels and reliefs may change and the availability of tax reliefs will depend on individual circumstances. You should only subscribe for new VCT shares on the basis of the relevant prospectus and must carefully consider the risk warnings contained in that prospectus.

Next steps:

To download an application form please visit:

eqinvestors.co.uk/vct/offers

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