



Split Capital Investment Companies

Split Capital Investment Companies (Splits) are companies with a portfolio of investments just like conventional investment companies. However, unlike conventional investment companies which issue one main class of equity share capital, splits issue two or more different classes of share. These share classes have specific rights and entitlements to participate in the income and/or capital returns of the portfolio. At least one share class of a split is likely to have a limited life with a fixed wind-up date.

What are investment companies?

In a nutshell, investment companies are companies that invest in a diversified portfolio of assets to make money for their shareholders. Investment companies can be investment trusts, venture capital trusts, and offshore and AIM traded investment companies. Investment companies pool investors' money and employ a professional fund manager to invest in a wider range of assets than most people could practically invest in themselves. This way even people with small amounts of money can gain exposure, at low cost, to a diversified and professionally run portfolio, spreading the risk of their investment. Investment companies are listed on a stock exchange and there are over 400 investment companies in the UK responsible for the management of billions of pounds worth of assets on behalf of investors. For more information on investment companies please read our factsheet 'An introduction to investment companies'.

An overview of the structure and features of splits

Splits were first introduced in 1965. The original split structure had a limited life with a fixed wind-up date and issued two classes of share, namely income shares and capital shares. Income shareholders were entitled to all the income generated from the investments held by the company during its life, whilst capital shareholders received, at wind-up, the capital value of the company including any capital growth achieved by the company over its life. This enabled investors to concentrate on either capital growth or income exclusively and receive a potentially greater level of return from the larger pooled amount. This is a form of gearing known as structural gearing, and is explained further in this factsheet.

Over time, a much wider range of split structures and share types has developed, catering for a variety of investor needs in terms of both risk and return.

Each type of share within a split structure has a predetermined order of entitlement during the life of the company and repayment at wind-up. Although there is an order of entitlement, investors should be aware of the rights and entitlements of any prior charges, such as bank loans, and all share classes within the split structure.

Splits also vary in overall investment policy, objective and strategy; therefore each company portfolio will be exposed to different potential returns and risk. This in turn affects the potential return and risk characteristics of the share classes within each structure.

Splits can be complex investment vehicles and investors need to ensure they fully understand the split capital structure before investing. If investors have any doubts about whether splits are appropriate for them, or require further information, they should seek professional financial advice before investing.

Features of splits

Limited life

An important concept to understand is limited life. At least one class of share in a split is likely to have a limited life. This means that at a specified date the company will need to realise a specified value from the underlying investments to distribute to the shareholders of the limited life shares. If the whole company has a limited life this triggers the termination of the company or the wind-up procedure. This involves realising its assets, paying off prior charges, such as bank loans (if any) and other creditors, and distributing the remaining assets to shareholders according to the correct order of priority and the various share class entitlements.

Limited life is also important in that the length of life of the company affects the ability of the company to generate growth both in terms of income and capital.

What happens at wind-up?

At a predetermined date, shareholders with voting rights are asked to agree to wind-up the company according to the procedure laid down in its constitution, thereby enabling them to receive the predetermined entitlement of their investment, provided sufficient assets are available.

They may, however, be given the option of continuing the life of the company, by rolling their investment over into a new or existing vehicle or taking a cash exit. If the investment is rolled over, this may have important tax implications for an investor as this will normally be structured in such a way as to avoid any charge to Capital Gains Tax. If the investment is realised in cash, then a capital gain may arise on which you may have to pay Capital Gains Tax depending on your personal tax position.

If the company winds-up, the shareholders are repaid in order of priority out of the assets available after any prior charges and expenses have been deducted.

Although some split shares have a limited life, the shareholders are not obliged to hold their shares until the final wind-up date. They can be sold on the secondary market at the prevailing market price during the life of the company.

Share Classes, investor needs and order of priority

The table that follows provides details on the different classes of shares that may exist in a split structure, information about the shares' order of priority and entitlement, as well as some information about the tax implications of investing in the different share classes. The structure of a split provides investors with the ability to invest in different share classes to fulfil different financial needs.

Share/ security	Investor need	Brief description	Order of priority	Tax
Prior charges		In general terms, a prior charge should be seen as an amount which must be paid before any other claims on the assets and income of the company can be met. This may be a result of bank debt, loan stock or higher ranking share classes. The higher the proportion of prior charges the higher the risk as explained in the following section about gearing.	First	
Zero dividend preference shares (Zeros)	Predetermined capital return at a specific date. No income.	<p>Zeros are a class of share with a limited life that offer a capital return from the assets of the split in the form of a predetermined redemption value at wind-up.</p> <p>The asset value attributable to each zero is structured to rise at a predetermined rate from their issued value to their final redemption value.</p> <p>They have no right to receive a dividend, hence their name.</p> <p>The predetermined capital return is not guaranteed and is dependent on sufficient assets being available at wind-up.</p> <p>If there are prior charges and/or if the capital value of the underlying assets of the company perform poorly, or do not perform at all, the capital attributable to these shares could decline or, in extreme cases, fall to zero.</p>	Zeros are preference shares and, as such, usually (but not invariably) rank ahead of income, ordinary income and capital shares for capital repayment.	They have no entitlement to income and are therefore not subject to income tax. The gain arising on the sale or redemption of a zero is taxable as a capital gain. This makes them tax efficient for shareholders who pay income tax, especially at the higher rate, but who do not make full use of their annual Capital Gains Tax allowance.
Income shares	An income stream, with an entitlement to a predetermined capital return on wind-up.	<p>Income shares aim to provide income generated from a company's underlying investments, paid in the form of dividends.</p> <p>There are several types of income share classes which vary in their entitlements to income and offer various capital entitlements on wind-up. The entitlements vary between each split structure.</p> <p>The range of income entitlements of income share classes includes;</p> <ul style="list-style-type: none"> • a target fixed dividend entitlement • a share in the revenue with other shares in the structure • entitlement to receive all the distributable income generated by the company. <p>Income share classes have predetermined capital entitlements, which could be the issue price or a value below.</p> <p>Some very high yielding income share classes pay back only a fraction of the issue price at wind-up. These are referred to as annuity income shares, which are</p>	<p>Income share entitlements to income depend on the structure of the company.</p> <p>Distributable income will depend on the entitlements of any prior ranking charges.</p> <p>Any predetermined capital entitlement ranks after payment of any prior ranking charges.</p>	<p>The dividends on such shares will be taxed like any other UK dividend and are therefore subject to income tax.</p> <p>As the characteristic of an 'annuity' income share is that its issue price is far higher than its redemption price, a capital loss will arise. Whether this is an allowable loss for tax purposes is uncertain and professional advice should be taken.</p>

typically entitled to all the income from a company's portfolio, but only to a nominal capital repayment value at redemption. Annuity income shares aim to offer a high yield at the expense of capital. The term 'annuity' is colloquial in this context and should not be confused with life assurance or pension annuities.

If there are prior charges and/or if the capital value of the underlying assets of the company performs poorly, or does not perform at all, the returns attributable to these shares will decline, possibly providing no income or capital return at all.

Ordinary income shares	A combination of potential high and rising income and potential capital growth at a higher risk relative to other classes of share.	<p>Shares which offer a potential for rising income with prospects for capital growth.</p> <p>Ordinary income shares are also sometimes known as highly geared ordinary shares or income and residual capital shares.</p> <p>Depending on the structure of the company in which the ordinary income share is issued their entitlement to income may vary from:</p> <ul style="list-style-type: none"> • all distributable income generated by the company • income following the predetermined dividend payment to any prior income share class • a share of the revenue with other income receiving shares. <p>They have no predetermined capital value but are entitled to all surplus assets on wind-up of the company after prior ranking charges.</p> <p>They are geared by the existence of prior ranking charges and if the capital value of the underlying assets of the company performs poorly, or does not perform at all, the returns attributable to these shares will decline, possibly providing no return at all.</p>	<p>Distributable income will depend on the entitlements of any prior ranking charges.</p> <p>These shares rank last in the company's repayment order for capital.</p>	<p>The dividends on such shares will be taxed like any other UK dividend and are therefore subject to income tax. Any gains or losses made on the sale or redemption of the shares will be taxable as a capital gain/loss.</p>
Capital shares	Potential for capital growth at a higher risk relative to other classes of share.	<p>Capital shares have no predetermined capital value but are entitled to all of the surplus assets on wind-up of the company after prior ranking charges.</p> <p>They are geared by the existence of prior ranking charges and if the capital value of the underlying assets of the company performs poorly, or does not perform at all, the returns attributable to these shares will decline, possibly providing no return at all.</p>	<p>These shares rank last in the company's repayment order for capital.</p>	<p>Any gains or losses made on the sale or redemption of the shares will be taxable as a capital gain/loss.</p> <p>Capital shares receive no income, so therefore returns are not subject to income tax.</p>

Units

Some splits arrange for a combination of their share classes to be traded together in what is known as a 'unit'. The combination of shares which make up a unit varies from company to company. Units which are structured in the same ratio as the component share classes of the company may be considered and analysed as the reconstituted ordinary share of a conventional company.

Summary

As detailed in the above table, each class of share in a split follows a particular order of entitlement to capital and right to income earned by the company during its life, and at wind-up to capital paid from the assets of the company. If the company has prior charges such as bank loans, these rank ahead of equity shareholders. In other words, for every split, there is a set sequence in which the various classes of share returns are paid.

Each split is unique and it is important to be aware of the rights and entitlements of any prior charges and of each of the share classes within the split structure. For shares where the income entitlement and/or redemption value is predetermined, this is not a guaranteed return and depends on the assets and revenue available within the company. Depending on the underlying investment portfolio and the complexity of the structure, the further down the chain of entitlement the greater the effect on the potential return and risk of each share class.

Warrants and subscription shares

Investment companies can issue warrants and/or subscription shares, which are a type of security, which give the holder the right, but not the obligation, to buy the company's shares at a predetermined price (the 'exercise price') on a predetermined date or between a range of predetermined dates in the future.

Gearing

Splits may be financially geared but they will also be geared as a result of their capital structure. This is called structural gearing.

Structural gearing

Splits may be financially geared (see below) but they will also provide gearing to their share classes through their capital structure called structural gearing. This type of gearing is due to the predetermined entitlement and order of priority within the structure. The returns to each class of share are governed by the effects of the entitlements of the securities and other share classes. The number of share classes and the proportionate entitlement of each determine the level of gearing involved.

Shares in splits with high levels of financial gearing in addition to their structural gearing will be higher risk. Shares further down the order of entitlement are subject to greater gearing and higher risk within the structure.

Financial gearing

Investment companies are able to borrow money to invest in further investments in the expectation that the returns on the additional investments will exceed the costs of borrowing. This is known as financial gearing.

If a company 'gears up' and the underlying portfolio rises in value and the returns outstrip the costs of borrowing, the return to the investor will be enhanced. However, if performance of the assets is poor, then losses suffered by the investor will be magnified due to the effect of gearing, and the costs of borrowing.

Investment companies have great flexibility in the ways that they may implement financial gearing. They may issue long-term debentures or preference stock, arrange bank loans with various coupon rates set for the short or long term, or issue specialised types of securities such as convertibles. If a company has financial gearing it is important to establish what the characteristics of the borrowings are such as the costs and the type of borrowing.

What is net asset value (NAV) per share?

Simply NAV per share is the available shareholders funds divided by the number of shares in issue. The shareholders' funds are the net value of all the company's assets having deducted liabilities.

Measurement of gearing

Gearing is expressed as a ratio of total assets to shareholders' funds (NAV) multiplied by 100. It provides an indication of the level of a company's/share's financial and/or structural gearing. A figure of 100 means that there is no gearing. Normally, the higher the gearing factor the more sensitive the shares underlying value will be to the movement, both up and down, of the investment portfolio.

A simple example

If a company has £100 million of total assets and £13 million of borrowings, shareholders' funds are worth £87 million. If the total assets grow or fall by 10% to £110 million or £90 million, and the prior charges remain the same at £13 million, the shareholders' funds grow to £97 million or fall to £77 million. This is an increase or decrease in the shareholders' funds of 11.5%, which in both cases is 15% more than the 10% increase or decrease in total assets. This means the shareholders' funds are 15% geared.

You should be aware that if there is no published gearing figure this does not mean that the share classes within the company are not geared.

Levels of gearing vary considerably from company to company and from share class to share class. These gearing levels change as the company's underlying assets change and the entitlements of the share classes within the company change.

Although the term gearing when applied to investment companies is usually used to describe the effect on the asset value, it also affects the company's revenue and dividend potential.

How to invest

Investing with advice

You can go to a professional financial adviser, who will give you advice on what to invest in. Together you can work through all the factors that affect your decision, including your needs and available funds, the performance figures for different companies, and the outlook for different sectors. Your adviser can then advise you on whether investment companies are a suitable investment for you and how to make your investment.

The AIC website www.theaic.co.uk has further information about getting financial advice or you can find a Certified Financial Planner by calling the Institute of Financial Planning on 0117 945 2470 or by going to www.financialplanning.org.uk.

Investing without advice

If you are prepared to select your own investment company you can choose whether to go direct to a stockbroker or an execution only dealing service to buy shares for you. Or you can approach a fund management group to invest via a wrapper product.

Wrapper products are a way of purchasing shares in investment companies. You can put your money into an ISA, a savings and investment scheme or a pension scheme. You can invest monthly or make a lump sum investment or a combination of both. Most investment company shares are available through these schemes which are usually run by the management companies of the relevant investment company. The AIC website www.theaic.co.uk has further information on wrapper schemes.

Key things to remember

Splits are worth considering if you are looking for cost effective access to a diversified portfolio of shares, and would like income and/or capital growth. They can provide the potential for income and/or capital growth within one investment company by issuing different types of shares with different rights to income and capital growth, each with different exposures to risk.

The most important thing is to make sure you know exactly what it is that you expect from your investment – that way you are more likely to choose one that can most appropriately fulfil your needs. Knowledge and understanding of the split structure, share types, underlying portfolio and investment objectives, performance record and risk characteristics is vital. Assessment of splits needs in-depth and careful research.

Remember, share prices may go down as well as up and you may not get back the full amount invested. Past performance is not necessarily a guide to the future.

For further information

For more information on splits, please refer to the information provided by Management Groups and the individual company report and accounts.

AIC Stats

You can also access the AIC Stats which is a monthly publication on every member investment company and downloadable from the AIC website. The publication also contains a wide range of information and statistics specific to splits. An interactive version of AIC Stats is also available and can be found at www.aicstats.co.uk.

Visit our website

Our website is a good place to start if you want to learn more about investment companies and find detailed information on all our member companies. You can find it at www.theaic.co.uk.

Information factsheets

The AIC publishes a range of factsheets which are available free of charge by calling 0800 085 8520 or can be downloaded from our website.



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Disclaimer

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