Mini-Bonds: Risk and Reward?

Carmel King explains why mini-bonds are not nearly as secure as the bank or your mattress...

What are mini-bonds?

Mini-bonds are an increasingly popular way for companies to raise funds by borrowing money directly from individuals. Companies can issue mini-bonds via crowdfunding platforms or market directly to individuals, thereby raising capital for their business. Mini-bonds typically have terms of three to five years, with investors earning regular interest payments for the duration, as well as their initial investment and an interest lump sum at the end of the term. Interest rates on offer can be between 6% and 8% a year, or even higher where investors are given the choice of store credit or other benefits.

Who holds the cards?

Although not without their attractions to investors, it could be said that mini-bonds benefit the issuing company, with the risks entirely passed to the investor. The global financial crisis has left many small and start-up companies unable to qualify for bank loans; mini-bonds offer an easier way to raise funds, with the added benefit of engaging with customers and encouraging customer loyalty. Significantly, mini-bonds are not subject to the same degree of regulation as other products to which they might be compared; there is the potential for real cost savings to the company in relation to compliance issues, including when it comes to the provision of information at issue stage, and throughout the term of the mini-bond.

There are a number of significant risks to investors. Primarily, there is a lack of investor protection in the event of insolvency or the failure of the specific scheme. In the UK, mini-bonds are not protected by the Financial Services Compensation Scheme. Market commentators have observed that funds raised are often secured by charges held against the value of the assets being developed. In the event the company issuing the bond becomes insolvent, investors may find that their security is over assets that are overseas, or assets that are partially completed or not yet in development, depending on the stage at which insolvency occurs. Investors will find themselves with few or no prospects of seeing their investment again. Any identified recovery actions by an insolvency practitioner could take years to complete, and there is no guarantee that they will result in a dividend payment to creditors.

Mini-bonds are predominantly used by small or start-up companies, targeted at individuals as larger funds are unlikely to be attracted to such uncertain opportunities. Start-up businesses have a higher risk of failure.

Mini-bonds are fundamentally risky investments. They cannot be traded, meaning that investors will not be able to cash in early, and will not be able to access their funds until maturity. The mini-bonds can, however, be bought back by the issuing company at parity, for example, in the event the company obtains finance at a more competitive rate. This is not the case with institutional bonds, where the company must pay a premium to buy back the bonds, thereby giving the investor a degree of compensation.

The risk of fraud in an unregulated sector which

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traditionally promises high returns to investors is significant. Online fundraising platforms which connect investors with companies looking to raise funds may well be regulated by the Financial Conduct Authority ("FCA") but are highly unlikely to be held responsible should investors end up victims of a determined fraudster using the platform.

So for all of these risks and downsides, what is the attraction for an investor? The interest rates, for the most part. In these times where savings accounts offer similar rates to stashing your cash under the mattress, mini-bonds offer a return that we haven't seen for some years from banks or building societies. Mini-bonds are, on the face of it, accessible and approachable. Crowdfunding platforms allow investment from the comfort of your own laptop. Mini-bonds also offer an interesting way to invest in a hobby or support a particular theme. They can offer higher rates of returns through innovative pay-out schemes. The coffee shop chain Taylor St Baristas offered a choice of an 8% cash return, or 12% in the form of store credit. The Jockey Club offered a 7.75% return, divided into 4.75% cash, and 3% in points that could be used for tickets, food, drink, hospitality and membership at the Club's race courses. It's easy to see the attraction to a coffee or racing enthusiast in being able to visit the issuing company and obtain benefits that, whilst paid for through their investment, have that psychological feeling of being complimentary, or in appreciation of their patronage.

The Regulator

The FCA has expressed concern about the increasing popularity of mini-bonds, citing a number of reasons why investors should be cautious.. The FCA is concerned that companies issuing bonds have failed to make clear that mini-bond investments place investors' capital at risk. Mini-bonds are not deposit-based or capital-protected products. The FCA has highlighted that mini-bonds are not in reality comparable to savings accounts, where, although the return offered may be significantly lower, investors' capital is not at risk. The FCA is also concerned that mini-bonds are not comparable to institutional bonds or other retail bonds, due to the inability to trade mini-bonds, meaning that investors are locked-in for the full term. A requirement highlighted by the FCA is that the lack of FSCS-cover must be highlighted in the mini-bond promotional material. The promotional material must furthermore be fair, clear and not misleading.

The FCA introduced a number of protection rules which apply to crowdfunding and the promotion of non-readily realisable securities (including mini-bonds) by other media, with a view to ensuring that consumers have access to clear information. From October 2014, companies can only make direct offer promotions to individuals who meet certain criteria:

- those who take regulated advice;
- those who qualify as high net-worth or sophisticated investors, and
- those who confirm they will invest less than 10% of their net assets in this type of security.

Companies are also required to check whether individuals understand the risks if they do not take regulated advice. This effort to take largely unregulated activities into the regulated sphere should offer a degree of protection, however investors should be under no illusion, the fundamental risks of investing in mini-bonds remain.

Mitigating the risk

Is there any way to mitigate the risk of investing in mini-bonds? Don't underestimate the risk, for starters. Consider the nature of mini-bonds as being more suited to forming a small part of a wider investment portfolio, perhaps in a cause, hobby or product of particular interest. Mini-bonds are certainly not the answer to the less-than satisfactory rates of return offered by banks and building societies.

It might be possible to spread risk by buying a bond fund, which covers a number of mini-bonds, rather than tying up funds in one company or organisation.

In the case of established larger companies, a detailed review of the filed financials can assist in understanding the

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company's position before investing. Given that mini-bonds are predominantly used by start-ups and small companies, the amount of information publicly available might be limited. The risk could be higher where no historical financial information is available, in comparison to a company that has been trading for a number of years. Cash flow forecasts and business plans should be available to give some idea of anticipated performance. A degree of scepticism is required with future projections, as companies are going to look to paint as positive a picture as possible whilst staying within FCA rules.

The frequent use of words such as "security" and "guarantee" within the invitation document should elicit a degree of wariness in the potential investor. What sort of security is on offer? Do these assets exist yet or is their development part of the investment scheme? Are they controlled by the company directly? Is the security shared with any other party, for example, a bank, which might rank ahead and snaffle up any equity ahead of investors in the event of insolvency? Who is offering a guarantee, and are they likely to be able to pay? Is the guarantee straightforward to enforce? There is a multitude of questions that must be answered before an investor should be handing over his or her hard-earned cash.

Reward

The website *crowdcube.com* has in the past listed as many as 33 mini-bond investment opportunities at the same time, ranging from mouldable glue to a mobile payment app to emergency shelters for the disaster relief market. These opportunities have had fund raising targets of anything ranging from £50,000, to £1,500,000. Mini-bonds are an exciting way to invest money in a variety of products and ventures that are intended to provide a good rate of return to investors. A seasoned investor willing to place funds in a high-risk venture of personal interest might enjoy the gamble, and not be overly upset out if the exercise fails.

Those who are less experienced should exercise extreme caution and carry out as much due diligence as possible before investing in mini-bonds. They should not be dazzled by the impressive rates on offer or the peppering of comforting words such as "security" and "guarantee" because there is no recourse to the FCA or FSCS. Investors need to consider from the outset their ability to be philosophical and "take the hit" if that wine bar, on-demand music-streaming service or pet-beauty competition app fails to capture the imagination of the wider market and insolvency looms. ■

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