A level field for the UK equity market

SQCs are finding it increasingly difficult to access capital. Yet, what affects them affects the economy as a whole. Tim Waterstone of HMV Media Group explains.

All businesses, big or small, public or private, require access to capital if they are to grow. Corporate growth is a prerequisite of the health and vibrancy of a nation's economy. All companies have an interdependent relationship with each other. This means that the difficulties that smaller quoted companies (SQCs) now experience here in the accessing of capital affect not just them, but the economy as a whole.

Historically, institutional investors have provided an efficient and easy means for SQCs to raise development capital. In recent years, however, this has not been the case. Institutions, for reasons of benchmarking and consolidation and increasing Europeanisation, are allocating capital primarily to larger stocks. The listings of demutualised companies, plus the recent mega mergers, have substantially increased the market capitalisation of these.

We have reached the position whereby an index portfolio of all quoted equities assembled five years ago would have become by now progressively overweight in SQCs and underweight in larger businesses. So the institutions have made their adjustments in accordance with this. As a group they have reacted to the changing balance either by concentrating new cash flows into larger stocks or by withdrawing capital from SQCs, or both (see *Figure 1*).

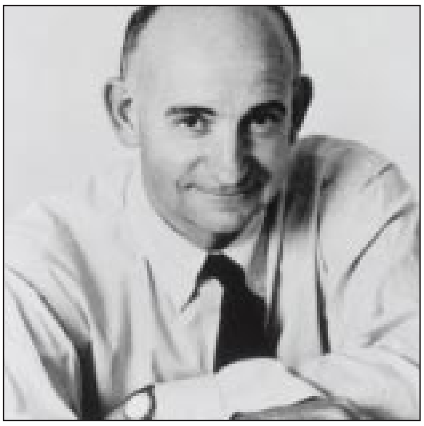
Market dysfunctionality

It is true that the capital liberated by the trend of public to private transactions has helped the share prices of SQCs to rise this year. But it is the underlying dysfunctionality of the market that has fed the trend in the first place, and that trend looks well entrenched. Wearying of achieving what they consider a reasonable market value for their companies and faced by institutional inertia, (the large institutions are not investing in them so the brokers are not earning commission and so stop paying for research, so there is little or no analysis available for any investor, large or small), smaller companies are deserting the market in droves. A recent DTI report 'Creating Quality Dialogue' estimated that this year as many as 800 out of 2,400 companies on the London Stock Exchange (LSE) might leave the public market. By doing so they flock back into the arms of venture capital, private equity players, who will themselves get the gains from the mergers and acquisitions that follow – from which the public equity shareholders have been disbarred by the market's dysfunctionality. The trend is extreme. (See *Figure 2*.) Delistings in 1999 will exceed those at the height of the last recession.

Striking too is the fact that there has been a dramatic fall in new equity being raised by SQCs with a market value of below £250m. In the first nine months of 1999 just £1.1bn was raised by them. In 1996, the figure was £4.3bn.

SQCs matter

SQCs are too important to the economy to be allowed to suffer too long in this situation. The latest figures indicate that, as a sector, SQCs provide about 1m jobs (10% of the private sector working population). It is from the ranks of the SQCs that the next generation of British global players will be found. Furthermore, they are the manifestation of the entrepreneurial society that the government is at such pains to encourage.



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But what is happening is that not only the founding entrepreneurs but the employee shareholders as well – loyal investors in some cases from the birth or very early stage of their company's development – are being deprived of the rewards they had every right to expect and that the public market should be there to provide.

What is to be done?

The Treasury can help of course, and it is most important that it does. The current UK tax system serves to encourage investment through institutions and to discourage direct investment by private individuals. What is needed now is a level playing field between private and institutional investors, incorporated into general rationalisation and simplification of tax reliefs. This review of tax reliefs (capital and income taxes and stamp duty) should address the mass market, enabling 'the man in the street' to understand the options available to him in the making of informed equity investments without tax penalties.

Two factors that have contributed to giving private individuals equal tax status with institutions in the US are the IRAs and 401k plans. It's vital that they and similar measures are studied for UK application. For it is the private investor who holds the key to unlocking the proper market value and acceptable liquidity for SQCs. Wider and deeper share ownership provides just that: proper liquidity and proper value.

In the US, NASDAQ provides in its listing rules a requirement that when a company comes to the market it must have on its share register a minimum of

FIGURE 1

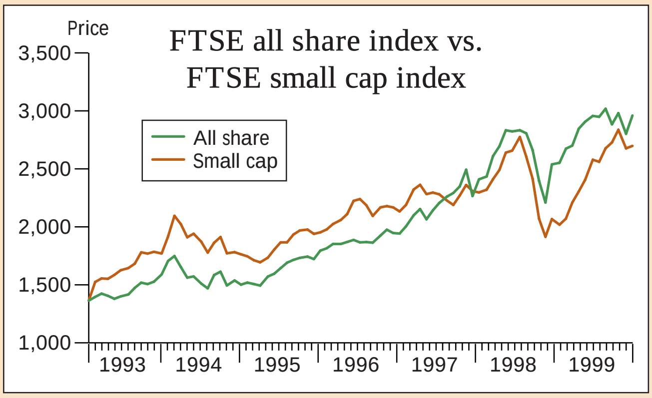
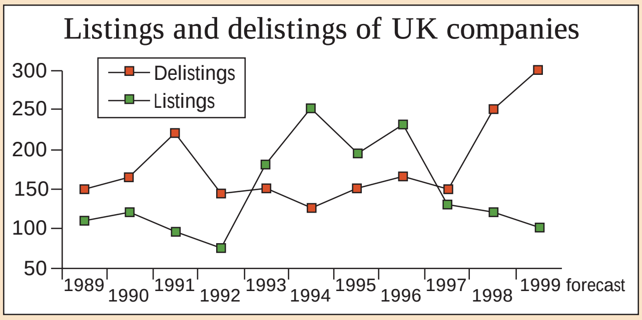


FIGURE 2



400 shareholders. This provides the near certainty of decent liquidity in the secondary market. NASDAQ has been a shining light in its proactive encouragement of private shareholders. The SEC too has been active. Regulation has been streamlined and there has been an insistence on the provision of equality of access to company information for private and institutional investors, both in content and timeliness (and incidentally provided on the internet free of charge).

The US market has a considerably greater active involvement of private investors than has the market in the UK. The vibrant SQC market in the US is supported almost entirely by private investors. Some 42% of the US market overall is represented by private investors, in contrast to only 20% in the UK. There are many reasons for this of course.

The booming US economy means that people have more disposable income; there is, famously, a culture of self-dependency and enterprise; and the US has relatively low levels of state benefits. But the guts of it is that, in contrast to the US, the UK government has, historically, been more comfortable in steering private investors into unit trusts and the other collectives than in encouraging them to invest directly.

Times have changed. We now have a huge army in the US of the most financially sophisticated people with large war chests of available funds (Merrill Lynch recently put the figure at four million individuals who have investments of over £50,000, amounting to £680bn in total, which will grow to the staggering figure of £2trn by 2005.) These people are well able to look after themselves. They would like to do so. The dramatic growth in the use of execution-only broking services, especially internet brokers, is the proof of that. There is an ever-increasing number of investment clubs. All people need is a levelled tax environment, so that their direct investments are not penalised. There is a distinct hint in the air now that the present chancellor at least understands the opportunity we are missing out on and intends to do something about it.

Liquidity

The fact that direct retail investors create liquidity is not in dispute. Indeed one could go so far as to say that the liquidity of the market as a whole is driven by private shareholders. Statistics recently released by the LSE reveal that private shareholders are responsible for no less than 56% of all bargains (but only 7% of the value of all transactions) and UK institutions account for just 25% of bargains (but 52% of value traded).

The Treasury appears to understand that fact as well as anyone else. Oddly enough though, it's the City itself that has a tendency to hang back. Too many SQCs have been underbriefed by their advisers at the point of their IPO. It seems that the City is run by institutions, for institutions. Retail investors on the other hand, come to AGMs, they write letters, they want information. Worse, they create a churn by buying and selling their shares. They create a market. How much easier it is then, to do an institutional placing.

Self-help

SQCs can and should help themselves. They should challenge their advisers to find ways of attracting private investors both at flotation and in the secondary market. Their corporate brokers should respond to this, by recognising that private shareholders provide liquidity and by recognising too that without that liquidity the small companies that they advise are never going to be properly valued. The FSA has work to do as well. Suitability rules should not be there to inhibit investment in SQCs by private client brokers on behalf of their private investors. And the LSE could and should do even more to encourage companies and their advisers to consider long-term liquidity when coming to market. The UK government, mindful of the need to encourage and enable a true enterprise culture in its economy, can consider as expeditiously as possible the tipping of the balance of the tax and legislative framework towards the encouragement of the direct investor.

One must try to be confident that all these things will come to pass. Internet-based services are developing at a dramatic pace and are not only empowering the private individual but providing the opportunity for all companies, big and small, to communicate as effectively as possible with a greatly extended shareholder base. The equity market does need to work. At the moment one side of it – and a vital side to the economy as a whole – has become dysfunctional. That dysfunctionality will surely be repaired.

Within a remarkably short period of time – four or five years perhaps – we could have an equity market for all companies, both large and small, which would be as vibrant and as all-embracing as in the US. For the City, the chancellor, the DTI, the LSE, the FSA, but most of all for listed companies and all their shareholders, private and institutional, that would be a huge achievement. ■

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