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The City's Role in Providing for the Public Equity Financing Needs of UK SMEs



URS

with

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The City's Role in Providing for the Public Equity Financing Needs of UK SMEs

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Foreword

Stuart Fraser
Chairman, Policy and Resources Committee
City of London

Support for small and medium-sized enterprises and an acknowledgement of the role they play in the wider economy is something of a political catchphrase. All of us believe in SMEs and support measures to encourage them.

Those expressions, however, are too often as far as it goes. This study, commissioned by the City of London and undertaken by URS Corporation Ltd, has many useful recommendations and conclusions. It highlights how vital SMEs are in terms of job creation and growth, their geographical spread across the UK, their flexibility and capacity for innovation. Most massive national and international businesses were once SMEs: a modern economy needs therefore to have in place mechanisms to support SMEs of many different types and sizes with different financing needs throughout their life cycles which encourage those with growth potential to enlarge and evolve, while accepting that for others the target should be the maintenance of an economic size.

This study is timely as an election approaches and politicians face the challenge of encouraging business growth. Whatever the differences in approach between the parties, there is agreement on the central role of business in recovering from the recession – by creating new jobs, by taking on and training new entrants to the workplace, by innovating, by exporting and of course by generating profits on which taxes are paid.

Whilst it has long been recognised that seeking equity capital will be more appropriate for some SMEs than others, the difficulties in obtaining bank finance – whether real or perceived – highlight the need for other structures, including family and other informal sources, business angels and venture capital. Equity capital is perhaps regarded too often as a route for the large company rather than for those on the 'escalator' from small to medium, and medium to large. Equity investors differ from bank lenders in their expectations of return and their view of risk. Both forms of finance have an essential role, but equity can be better suited to a business environment which itself is more fluid and challenging than ever before. Public equity also provides the reassurance of an 'exit route' for venture capital funds.

This study identifies challenges as well as successes. It examines in detail the many sources of SME funding and particularly the role of AIM and PLUS Markets at the public equity end of the spectrum. There is much to applaud but equally much for policy-makers, regulators and the markets themselves to note, especially liquidity issues, flotation costs and the impact of EU Prospectus, Transparency and Market Abuse directives.

It underlines too the role of City institutions in supporting and developing SMEs and demonstrates again that the wholesale financial services sector – for which 'the City' is convenient shorthand – is an essential part of the real economy.

A healthy and growing smaller business sector is not a luxury but a necessity in a challenging national and global economy. I believe that this study and its recommendations will be the basis of a much-needed and urgent debate.

Stuart Fraser
London
March 2010

EXECUTIVE SUMMARY

Introduction

The City of London recognises the important contribution made by small and medium sized enterprises (SMEs) to the UK economy and the critical role played by UK financial services in providing equity finance to facilitate their growth. As a result the City of London has commissioned research to assess the role and contribution made by UK financial services in terms of supporting the provision of and access to equity finance for UK SMEs. This commission is timely given the Government's concerns over gaps in the SME funding escalator and the recent economic downturn, which has led to a withdrawal of venture capital funds and a loss of investor confidence.

The primary objective of this research is to assess the role and contribution of public equity markets in providing for the equity finance needs of UK SMEs. The UK's two main growth markets - the London Stock Exchange's AIM and PLUS Markets' PLUS-quoted (PLUS) - act as platforms for SMEs to raise equity finance for business growth. This research study investigates the benefits, shortcomings and efficacy of these markets in supporting SMEs access to equity finance. This includes an assessment of the characteristics and recent performance of the markets, and an understanding of how regulatory regimes, operation and taxation impact on the provision of and access to equity finance through public markets.

We also consider whether issues impacting on the provision of and access to equity finance along the funding escalator and via public equity markets are the result of the economic downturn or are longer term issues that reflect structural change.

The report recommends actions to support and build on the potential of the UK's public equity markets that will help SMEs access equity finance in both the short and longer term.

Key Findings

Key messages and conclusions arising from the research are:

1. Entrepreneurship and small firm formation are important drivers of the UK's economy. SMEs contribute significantly to UK employment, prosperity, innovation, productivity and provide a number of other benefits to society.
2. High growth SMEs have the potential to generate substantial economic benefits. Though they represent a small minority of all SMEs, it is these high growth SMEs, which deserve the greatest access to appropriate forms and levels of equity finance.
3. The funding escalator model is supported which suggests high growth SMEs need different sources of finance at different stages in their development. The escalator as an inter-dependent system of funding supply and release means that any gaps in the provision of finance have knock-on effects, forward and backward, on other parts of the escalator. The demand for public market listings is therefore dependent on the provision of and access to equity finance lower

down the escalator, in particular from public sector venture capital, business angels and venture capital investors.

4. At present, the operation of the SME funding escalator could be improved. Several parts of the escalator appear to be operating sub-optimally due to:
 - The reduction in the supply of early stage venture capital funds (£2m to £10m), which means that SMEs are becoming more reliant on business angels to meet their equity finance needs.
 - An investment relationship disconnection between business angels and venture capital firms, which means that business angels are now tending to fund SMEs for an exit, as opposed to seek ongoing investment or a market listing.
 - A depressed Initial public offering (IPO) market, which means that business angels and venture capital funds are unable to exit from investments to raise funds.
5. The economic downturn has made it harder for SMEs to raise external finance. Rejection rates have risen, with term loans more affected than overdrafts but the banks have not stopped lending. Firms most affected are those with low assets (lack of collateral), high credit demands, poor credit ratings and low business experience (start-ups).
6. AIM is the largest small caps public equity market in the world. The operation of AIM has enhanced the position of the London Stock Exchange among the world's principal stock exchanges. Success factors include the favourable regulatory rules; comparatively low costs for admission, fundraising and transactions; access to the wider UK financial and business community; and its positioning as an aspirational brand that SMEs would actively seek to list on.
7. AIM and PLUS have together substantially increased the variety of capital-raising and investing opportunities for UK financial services in SMEs. These opportunities have reinforced the value of the cluster of experience, resources and management skills which are concentrated in the City.
8. AIM and PLUS provide the platform for SMEs to raise equity to finance growth. Though a substantial proportion of the UK's financial services are based in London, the markets support SMEs from all regions of the UK. Both AIM and PLUS have also been successful in attracting foreign based SMEs.
9. Levels of daily liquidity are a major and recurrent issue for markets with large volumes of small capitalisation stocks. This is true for both AIM and PLUS. Low daily liquidity can act as a deterrent to investment in small cap stocks, making it harder for investors to access funds.
10. Though AIM tends to attract early-stage businesses and businesses from high-risk sectors, the risk profile of the overall market is not considered to be too high.
11. 2010 brings new opportunities for both AIM and PLUS to support high growth SMEs in accessing equity finance. Mergers and acquisitions are expected to pick up in early 2010, which could lead to consolidation of small cap stock and enhanced

levels of liquidity among smaller stock bands. In particular, the trends in fundraising on AIM through rights issues are rebounding following the effects of the global economic downturn.

Recommendations

We make the following recommendations to enhance the effectiveness of the SME funding escalator and role of the public equity markets in meeting the equity financing needs of UK SMEs

- Investigation into the financial requirements of technology firms, particularly at the commercialisation, start-up and early growth stages
- Enhanced Government support for the business angel market through increasing financial input and tax incentives, supporting business angel networks, retaining the Enterprise Investment Scheme and amending investment rules
- Enterprise Investment Scheme rules are amended to address the investment disconnect between business angels and venture capital firms
- Research to be undertaken to examine why the UK venture capital industry is segmented by stage and how funds investing through the whole cycle from start-up to IPO might be encouraged
- Research into the economic cost/benefit to the UK economy of SMEs undertaking trade sales
- Raising awareness amongst SMES and their advisors of good practice/methods in operating as a publicly quoted company on AIM/PLUS
- Research to be undertaken that considers how issues around low levels of liquidity should be tackled
- AIM continues to monitor Nomads and an annual survey to be conducted to assess the performance of Nomads operating on AIM
- The City of London, AIM and PLUS to ensure that they remain central to the debates on changes to EU legislation which may affect the ability of SMEs to raise capital cost-effectively.
- To bring together a consortium of interested partners to make the case for or commission an annual 'state of SME finance' report.

1. INTRODUCTION

1.1. Research Brief

The City of London recognises the important contribution made by SMEs to the UK economy and the critical role played by UK Financial Services in providing equity finance to facilitate their growth. As a result the City of London has commissioned research to assess the role and contribution made by UK financial services in terms of supporting the provision of and access to equity finance for UK SMEs. This commission is timely given the Government's concerns about gaps in the SME funding escalator and the recent economic downturn, which has led to a withdrawal of venture capital funds and a loss of investor confidence.

The primary objective of this research is to assess the role and contribution of public equity markets in providing for the equity finance needs of UK SMEs. The UK's two main growth markets – the London Stock Exchange's AIM and PLUS Markets' PLUS-quoted (PLUS) - act as platforms for SMEs to raise equity finance for business growth. This research study investigates the benefits, shortcomings and efficacy of these markets in supporting SMEs' access to equity finance. This includes an assessment of the characteristics and recent performance of the markets, and an understanding of how regulation regimes, operation and taxation impact on the provision of and access to equity finance through public markets.

We also consider whether issues impacting on the provision of and access to equity finance along the funding escalator and via public equity markets are the result of the economic downturn or are longer term issues that require structural change.

In this context, the report recommendations provide action-focused solutions to support and build on the potential of the UK's public equity markets that will help SMEs access equity finance in both the short and longer term.

1.2. Background

Entrepreneurship and the growth of small firms are recognised to be essential drivers for the UK's economic prosperity and quality of life. Indeed, high growth SMEs represent a small proportion of all SMEs but make a significant contribution to the UK economy particularly in terms of job creation and increasing employment. This contribution will be highlighted as part of this study.

High growth SMEs however usually require access to external finance in order to realise their growth potential. Access to finance is often a critical factor in the growth of an SME. Finance for business growth is generally acquired through a number of different sources (reviewed as part of this study), the primary source being bank finance. However banks tend to place restrictions on the amount of finance and the types of businesses they lend finance to. SMEs with the potential to generate high levels of growth and return are often considered by banks as too risky and not viable investment propositions.

Equity finance provides both a viable and important alternative to bank finance for SMEs at different stages of business development. High growth SMEs may seek equity investment from public sector funds, business angels, venture capital firms and

ultimately the public equity markets. Given that demand for admission to the public market by SMEs is dependent on an 'escalator of pre-market finance', this study assesses its effectiveness and the relationship between business angels, venture capital firms and the public equity markets. A key part of this assessment determines whether there is an adequate supply of equity finance for high growth SMEs or whether gaps exist in this supply chain. This is a particularly relevant subject to investigate given the recent shift in private equity supply from venture capital investments to increasing leveraged buy-out activity to facilitate ownership change and restructuring of companies. Also, this is further emphasised by recent Government commissioned reports, such as the Rowland's Review, *The Provision of Growth Capital to UK Small and Medium Sized Enterprises* which have highlighted Government concerns regarding the impact of economic downturn on the provision of risk finance and the re-emergence of gaps in early stage finance.

The public stock markets play a fundamental role in supporting the development of growing SMEs and offering a viable alternative to bank finance by providing a platform for raising equity finance and increasing the visibility of SMEs amongst their peers and stakeholders. The City of London acts as a global financial hub and conduit for international market listings and fundraisings, and is home to the London Stock Exchange and two growth markets - AIM and PLUS. The regulatory regimes of these growth markets promote a tailored and dynamic operation of business infrastructure, allowing them to fulfil a vital role in the SME financing ladder. They provide smaller businesses with an opportunity to raise significant additional funds for growth; allow original investors an opportunity to realise a return on their initial investment; and compel SMEs to start running their affairs in accordance with recognised standards relating to governance, which in turn gives added confidence to potential investors. The existence of effective, efficient and liquid public markets is an essential component in the evolution of fast growth SMEs and the long-term strength of the UK economy. This study assesses the benefits and efficacy in the provision of equity finance to SMEs but also identifies the areas through which public markets and policy makers can assist further with supporting the business development and growth of this target group.

1.3. Methodology

The research programme was designed to gain an understanding of the role and efficacy of the markets, within the context of the wider funding ladder providing equity finance to SMEs. The programme involved a number of activities:

- A literature review gathering and analysing in detail reports and research on the importance of SMEs to the UK economy and the SME funding ladder.
- Analysis of data and information relating to the characteristics and performance of public equity markets AIM and PLUS.
- To the extent possible within the scope of the research, a review of regulatory regimes which impact upon market operation and taxation rules regarding investment and SMEs.
- To understand the efficacy of the funding ladder and markets in raising equity finance for SMEs, interviews were held with senior representatives and knowledgeable experts of organisations and businesses involved in the provision of equity finance. Interviews were held with 19 different organisations in total, including the markets (AIM and PLUS) and the wider

advisory community (investment banks, nominated advisers, brokers, lawyers and accountants), the British Business Angel Association (BBAA), the British Venture Capital Association (BVCA) and other venture capital providers. Discussion topics were tailored according to the interviewee.

For the public markets and its advisory community, topics of discussion included:

- The benefits and costs of raising capital;
- Liquidity of the SME public equity markets;
- Appropriateness of regulation and how regulation at the UK and European level impacts efficiency and operation of the markets;
- The importance of peer groups and networks of professional business services supporting the markets;
- Geographical differences in the ease of access to equity finance; and
- How the operation of the markets can be improved to meet SME equity financing needs.

Topics of discussion with business angels and venture capitalists specifically focused on:

- The effectiveness of the SME funding escalator, whether there are deficiencies/gaps in the funding escalator, the reasons for deficiencies/gaps and how to overcome them
- Reasons why an SME/investor seeks trade sale over admission to a public market
- Reasons for seeking a quotation on AIM or PLUS instead of the other markets; and
- Experience of preparing for flotation and being a quoted company.

These interviews provide a strong evidence base from a range of informed stakeholders, often speaking on behalf of a broader client base (i.e. SMEs) or peer group (other business angels or venture capital firms).

- Discussions with businesses to gather views on the growth funding story of businesses, their experiences of accessing finance and achieving an Initial Public Offering (IPO) on AIM or PLUS and/or raising funds through further issues; and the reasons for and implications of a business seeking a trade sale over IPO. In total 14 businesses spread across the UK¹ were interviewed.
- Research findings from the literature review, data analysis and consultation, which have been interwoven into chapters and presented in such a way to highlight key issues.
- Research into good practice to identify how provision of and access to equity finance by SMEs could be potentially improved. Good practice was identified in pre-market equity finance as well as for equity markets operation. A workshop with stakeholders was held to test findings and develop recommendations.

¹ Of 14 businesses consulted six were based in London, three in the South of England, two in the North, one in the Midlands, one in the West and one from Wales.

Our findings enabled us to set out a series of actionable recommendations in terms of how the City can improve and increase the provision of equity finance for SMEs.

1.4. Report Structure

Following this introduction, the first two chapters provide context to the research questions:

- Chapter 2 sets the context to the research by identifying the importance of the SME sector to the UK economy; and
- Chapter 3 illustrates the workings of the SME funding escalator and the role of the public equity markets within this mechanism.

Chapters 4 and 5 present the research analysis. They are based around key issues identified from the literature review, data analysis and consultation work as well as drawing upon the expertise and experience of our consultancy team:

- Chapter 4 looks at deficiencies and gaps in the provision of and access to equity finance in the pre-market funding escalator and the implications these have for the public markets; and
- Chapter 5 assesses the characteristics, role and effectiveness of the public markets in providing equity finance to UK SMEs.

The last two chapters draw together findings, reflecting back to the research questions and suggest recommendations:

- Chapter 6 draws together the key conclusions; and
- Chapter 7 sets out recommendations, aimed at policy makers and growth markets.

2. IMPORTANCE OF SMEs TO THE UK ECONOMY

2.1. Introduction

This chapter provides the context for the detailed discussion of the financing of SMEs which follows in Chapter 3. Its aims are threefold. First we set the current recognition of the economic significance of SMEs in historical context. Small businesses were seen as being of marginal economic significance until the 1970s and it is only in the past two to three decades that their importance has been recognised and valued. This change in attitude has been reflected in increasing government support for the SME sector. The first section therefore traces this revival and discusses the reasons for the 'revival' of the SME sector. Second, we briefly examine the current size and characteristics of the SME sector. Third, we review the economic significance of SMEs in terms of employment, innovation, economic development and societal contribution. Finally, we briefly review government support for the SME sector.

2.2. The Revival of the SME Sector

UK SMEs make a significant contribution to the economy particularly in terms of enterprise, innovation and growth. However the SME sector has not always been so important to the UK economy. It is widely accepted that the economies of developed countries, including the UK, have undergone a significant structural shift since the 1970s, which has set in place conditions that have promoted the growth of the SME sector. The 1960s and early 1970s were the apogee of what has been termed *bureaucratic capitalism*.² It was an era of growing consumer demand, fostered by growing affluence. Meeting this demand involved the production of large volumes of standardised products using mass production, assembly-line technology with economies of scale critical. This favoured the emergence of massive, hierarchically organised corporations. Meanwhile, small business and entrepreneurship were marginalised. Indeed, the Labour Government of the time became sufficiently concerned about the future of the small business sector that it set up *An Inquiry on Small Firms*, chaired by John Bolton, to enquire into 'the place of small firms in a modern economy' and to recommend on future policy. The Committee's report, published in November 1971, has been hugely influential on several counts – assembling a body of research which established the significant role of small firms in the economy, shaping subsequent policy interventions, and stimulating scholarly interest in the small business sector.³

Since the mid-1970s, SMEs as a proportion of the UK economy have been growing in importance. This revival and resurgence of small firms can be attributed to a variety of trends. Cultural attitudes towards self-employment have become more positive.⁴ The social contract between business and labour, in which large companies provided lifelong employment, steady pay increases with seniority and generous pensions in exchange for employee loyalty and commitment, started to break down

² C J Schramm (2006) *The Entrepreneurial Imperative: How America's Economic Miracle will Reshape the World (and change your life)* New York: Collins.

³ For example, see J.Stanworth and C.Gray (eds.) (1991) *Bolton 20 years on: the small firm in the 1990s*. London: Paul Chapman Publishing.

⁴ An OECD report commented that 'a near unanimous view held by analysts is that culture plays a critical role in determining the level of entrepreneurship' (OECD, *Fostering Entrepreneurship*, 1998).

in the 1980s. Relatively few large companies now offer long-term job security. Pension schemes have been curtailed or closed, seniority systems have given way to performance pay, workloads have increased and work schedules are increasingly long and inflexible. As a consequence, working in the corporate sector has become less attractive and rewarding, especially for Generation X (the post-baby boomers born between 1965 and 1980) who have become increasingly willing to leverage their skills and professional networks to work for themselves.⁵ Generation Y or 'Millennials', (born between 1978 and 2001) are intensive users of technology, having been raised on computers and the internet, are also less likely to be attracted by corporate careers. Wanting to maintain their independence and 'own' their careers, they are also much more likely to work for themselves compared with previous generations.⁶

Meanwhile, economic, cultural and technological changes have opened up opportunities for small businesses. There are a number of reasons for this:

- First, economies of scale have become less important. In the era of mass production, economies of scale favoured large-scale production, so large firms were able to produce goods more cheaply than small firms. However, technological changes in methods of production (e.g. CNC machines) and materials (e.g. plastics replacing steel) have lowered the minimum efficient scale of production and enabled short productions at no cost penalty. Related to this, the costs of doing business are becoming variable rather than fixed on account of increasing opportunities to outsource (e.g. distribution and shipping). ICT technology in the form of cheap and powerful personal computers and software, and other innovations (e.g. express parcel delivery, printing and copying) have provided small businesses with the power, scope and access of large companies but without sacrificing the independence and flexibility of being small. More recently, the internet, along with money transfer mechanisms (notably PayPal), have been particularly important in enabling small businesses to cost-effectively serve small, geographically dispersed, market niches (the 'long tail' phenomenon). At the same time, consumers have become more comfortable buying online.⁷
- Second, the mass market has fragmented and has been replaced by numerous niche markets which favour small scale production. This has been driven by growing affluence which has created demands for customised, tailored and natural products and services tailored to their specific needs.⁸
- Third, the process of sectoral shift, involving the decline in manufacturing and the growth of business and personal services, has also been a key driver. This is due to the absence of scale economies in many parts of the service sector, the consequent lower barriers to entry, and growing demand for specialised and personalised services.

⁵ Institute for the Future/Intuit (2007a) *Intuit Future of Small Business Report. First Instalment: Demographic Trends and Small Business*, The Intuit Future of Small Business Series, www.intuit.com/futureofsmallbusiness

⁶ Ibid

⁷ Institute for the Future/Intuit (2008) *Intuit Future of Small Business Report. Third Instalment: The New Artisan Economy*, The Intuit Future of Small Business Series, www.intuit.com/futureofsmallbusiness

⁸ The growth of real ale, or boutique, breweries is often cited as an example of this trend. For example see: Mason, C M and McNally, K N (1997) 'Market change, distribution and new firm formation and growth: the case of real ale breweries in the UK', *Environment and Planning A*, 29, 405-417.

- Fourth, restructuring, downsizing and the development of new ways of organising work by large organisations in efforts to reduce costs and increase flexibility, such as project based working, have led to a reduction in the number of permanent workers they directly employ and an increase in their use of independent contractors, freelancers and outsourcing to smaller businesses.⁹ The reliance of larger organisations on external sources of specialist expertise has been of particular importance in driving the growth of small business services firms. However, these trends have prompted some commentators to argue that at least part of the small firm revival is merely a transfer of activity from large to small firms and thus a statistical artefact.¹⁰ Fifth, proponents of long wave theory¹¹ have noted that the 1980s and 1990s were characterised by the emergence of a cluster of new technologies, notably ICT, which formed the basis for new industries. Studies of the evolution of technology-based industries note that small firms play the leading role in the commercialisation of new scientific discoveries at the early stages but large firms become relatively more important once the technologies begin to mature.¹²
- Finally, privatisation and de-regulation, which have ended government monopolies in particular industries, opening them up to private sector businesses, and increased contracting out by government departments and public sector agencies have provided opportunities for SMEs, some of which have been able to expand into large enterprises (e.g. Stagecoach, First Group and Easyjet in transport, Carphone Warehouse in mobile phones).

Many of these factors that have driven the revival and resurgence of the SME sector over the past few decades will continue to create the positive conditions for SME start up. As such it is important to recognise that the UK SME sector will continue to play an important role for the UK economy. To gauge the economic importance of the sector for the UK economy we next look at the employment contribution of the SME sector to the UK economy.

2.3. Economic Significance: Number, Location and Sector

There were an estimated 4.8 million enterprises in the UK at the start of 2008 (latest available estimate). Almost all of these businesses (97.0%) were micro or small (0-49 employees); only 2.5% were medium sized (50-249 employees); and just 0.6% were considered large (250+)¹³ (see Table 2.1).

⁹ For examples of types of workers who have been 'converted' from employees to self-employed, see: (i) Granger, B, Stanworth, J and Stanworth, C (1995) Self-employed career dynamics: the case of 'unemployment push' in UK book publishing', *Work, Employment and Society*, 9, 499-516; (ii) Stanworth, J, Stanworth, C, Watson, A, Purdy, D and Healeas, S (2004) Franchising as a small business growth strategy: a resource-based view of organizational development, *International Small Business Journal*, 22, 539 - 559.

¹⁰ Harrison, B (1994) *Lean and Mean: the Changing Landscapes of Corporate Power in the Age of Flexibility*, Basic Books: New York

¹¹ Alternatively known as Kondratieff cycles

¹² Rothwell, R (1984) The role of small firms in the emergence of new technologies, *Omega*, 12, 19-29

¹³ The Companies Act 1985 definitions for an SME in relation to compulsory audit thresholds defines SMEs as organisations that employ fewer than 250 persons and which have an annual turnover not exceeding £22.8 million net, and/or an annual balance sheet total not exceeding £11.4 million net. These criteria and thresholds are similar to The European Commission definition as per Recommendation 2003/361/EC.

The majority of small businesses, some 74%, have no employees¹⁴. Nevertheless, their self-employed owners, partners and employee-directors totalled 3.9million. Even though most SMEs are either one-person businesses or micro businesses, their sheer quantity translates into a significant number of jobs. SMEs with employees – which number 1.2 million - have a total combined workforce of just under 10 million. SMEs account for 59.4% of total private sector employment (including sole traders and proprietors of businesses with no employees) and generate 50.1% of private sector turnover. Micro and small enterprises (0-49 employees) account for 47.9% of employment and 36.5% of employment respectively. Older businesses (over 5 years old) provide most of the jobs (8 in 10).

Table 2.1: Number of Enterprises, Employment and Turnover by Number of Employees, Start of 2008

Size Definition	Enterprises (/'000)	Employment (/'000)	Turnover (/£million)
All enterprises	4,783	23,128	2,994,978
All employers	1,238	19,239	2,763,280
With no employees ¹ (Micro)	3,546	3,888	231,698
1-9 (Micro)	1,033	3,857	420,282
10-49 (Small)	17	3,332	442,396
50-249 (Medium)	27	2,665	406,450
250+ (Large)	6	9,386	1,494,152

Source: BERR, 2008

Note 1: Sole proprietorships and partnerships comprising only the self-employed owner-manager(s), and companies comprising only an employee director

Behind this profile is a dynamic process of start-ups and closures, expansions and contractions. For example, there were 1.97 million businesses registered for VAT at the start of 2007. By the end of the year 148,000 existing businesses had deregistered (7.5%) while 206,000 new businesses had registered (10.4%). High churn rates appear to be beneficial to the economy, with growing regions characterised both by lower survival rates and higher rates of job losses but also by high rates of business start-ups and superior job creation. A plausible interpretation is that this process is shifting resources from declining activities to new activities. So, whereas business births will inevitably lead to business deaths because of the high closure rate amongst new businesses, it would also appear to be the case that business deaths are a signal of a culture of business experimentation.

To analyse the distribution of SMEs by geography or sector, we can use the Office of National Statistics (ONS) Inter Departmental Business Register (IDBR). However, this records only VAT and/or PAYE based enterprises with a turnover of £68,000 over a 12 month period. In 2008 ONS recorded 2,152,400 businesses of which 99% were SMEs. By region, London and the South East are home to the largest numbers of SMEs - a direct reflection of population and economic activity. These two regions account for 31% of UK SMEs. High numbers of SMEs are also present in the North West and South West across all size groups.

¹⁴ No employees means sole proprietorships and partnerships comprising only the self-employed owner-manager(s), and companies comprising only an employee director.

Table 2.2: VAT and/or PAYE Based Enterprises by Size and Location, UK

Region	Number of Enterprises	Micro	Small	Medium	Large
London	339,185	304,405	27,735	5,280	1,765
South East	337,380	302,015	29,180	4,850	1,335
East England	217,925	195,160	18,840	3,095	830
North West	211,915	186,170	21,365	3,455	925
South West	202,550	180,670	18,640	2,635	605
West Midlands	177,195	156,540	17,160	2,765	730
East Midlands	147,980	130,505	14,475	2,425	575
Yorkshire/Humber	152,475	132,980	16,165	2,695	635
Scotland	145,745	127,275	15,180	2,630	660
Wales	92,005	82,340	8,095	1,300	270
Northern Ireland	70,620	61,970	7,350	1,100	200
North East	57,425	49,415	6,590	1,115	305
Total	2,152,400	1,909,445	200,775	33,345	8,835

Source: Inter Departmental Business Register, UK Business, Size and Location, 2009

In terms of sector focus, micro businesses are concentrated in wholesale, retail and repair (20% of all micro-sized businesses). A large group of micro enterprises are also active in professional, scientific and technical, and construction sectors (15.6% and 14.0% respectively). Small enterprises are concentrated in health (25%), with a further 18% operating in accommodation and food services. Medium enterprises are also concentrated in the health sector (27%), business administration and support services (24%) and accommodation and food services (16%).

Table 2.3: VAT and/or PAYE Based Enterprises by Size and Sector, UK

Employment Size Band	Number of Enterprises	Micro	Small	Medium	Large
Agriculture, forestry & fishing	139,100	135,075	3,760	240	25
Production	140,580	106,920	25,455	6,650	1,555
Construction	289,085	267,645	18,795	2,310	335
Wholesale, retail; repair	367,535	327,490	34,400	4,580	1,065
Transport & storage	71,180	62,355	7,185	1,290	350
Accomm & food services	134,220	109,615	21,960	2,255	390
Info & communication	148,690	140,065	7,040	1,255	330
Finance & insurance	43,015	38,475	3,425	760	355
Property	75,730	70,810	4,125	600	195
Prof, scientific & technical	321,825	298,490	19,810	2,940	585
Business admin & support	154,800	137,020	13,260	3,525	995
Public admin & defence	2,790	2,020	225	115	430
Education	30,550	23,295	4,485	1,855	915
Health	78,405	49,900	24,140	3,430	935
Arts, entertainmt, recreatn	154,895	140,270	12,710	1,540	375
Total (%)	2,152,400	1,909,445	200,775	33,345	8,835

Source: Inter Departmental Business Register, UK Business, Size and Location, 2009. Based on SIC 2007.

SMEs are important to all regions of the UK and are well represented across many sectors of the economy. As we will see in the next section, their economic contribution is more than just employment benefits – they are symptomatic of entrepreneurship, they underpin innovation and they bring societal benefits.

2.4. Benefits of SMEs to the UK Economy

2.4.1 Job Creation

There is now a large volume of evidence which indicates that SMEs – small firms in particular - make a disproportionate contribution to the creation of new jobs. This feature was first identified by David Birch for the US in his classic study *The Job Generation Process*¹⁵ but has been confirmed in a number of other studies in various countries, including the UK.¹⁶ Moreover, the contribution of small firms to job creation is fairly steady across the business cycle whereas the contribution of large firms is much more volatile, creating jobs in economic upswings but shedding jobs in recession. Thus, the relative importance of small firms to job creation becomes even more significant in periods of economic crisis.

It is important to note that most small firms do not create many new jobs – they typically start small and remain small. The main contribution to job creation comes from a small number of fast growing companies. Whereas Birch argued that fast growing firms were young, labelling them *gazelles*, a later synthesis of research by OECD¹⁷ suggested that fast growth firms comprise both young and old firms, as well as small and large firms. Moreover, younger and smaller firms tend to expand organically whereas larger and older firms are more likely to grow through acquisition. The key point in this context is that fast growth firms – especially young fast growth firms - are likely to have the greatest need for external finance. A stock market listing is likely to assist in growth through acquisition.

A new report on high growth firms, published by NESTA and based on an analysis of the IDBR, provides new insights into firm growth in the UK.¹⁸ Following the OECD, a high growth firm (HGF) is defined as a firm with an average employment growth rate of 20% per annum over a three year period and with 10 or more employees at the start of the period. Four-fifths of HGFs had fewer than 50 employees in the base year. Young firms are more likely to be HGFs but the majority (70%) of HGFs were at least 5 years old. Finally, HGFs can be found in all sectors of the economy – there is no bias to high tech sectors.

In the 2002 to 2005 period HGFs accounted for 6.4% of all firms employing 10 or more people at the base year. In the 2005 to 2008 period the proportion was 5.8%. The proportion of HGFs increases if a turnover definition is used (13% and 9%,

¹⁵ Birch, D L (1979) *The Job Generation Process*, MIT Program on Neighbourhood and Regional Change: Cambridge: MA

¹⁶ Gallagher, C, Daly, M and Thomason, J (1990) The growth of UK companies 1985-87 and their contribution to job generation, *Employment Gazette*, February, 92-98. Anyadike-Danes, M, Bonner, K, Hart, M and Mason, C (2009) *Mapping Firm Growth in the UK: The Economic Impact of High Growth Firms*, NESTA: London.

¹⁷ EUROSTAT-OECD (2007) *Business Demography Manual*. Paris: EUROSTAT-OECD

¹⁸ Anyadike-Danes, M, Bonner, K, Hart, M and Mason, C (2009) *Measuring Business Growth: High Growth Firms and their contribution to employment in the UK*, London, NESTA

respectively).¹⁹ These HGFs created 1.9million jobs between 2002 and 2005 out of the 3million new jobs created in this period, while in the period 2005-8 they created 1.3million out of the 2.4million new jobs created.

The types of HGFs responsible for creating the most new jobs are those employing more 250 people and those at least five years old.²⁰

The second part of the NESTA study involved a 10 year longitudinal study of the 1998 cohort of new businesses. Here again it was found that instances of high growth are rare, with only 3.1% of businesses growing by more than 20% per annum after they reached 10 employees. Cases of firms growing at this rate on more than one occasion are extremely rare. Over half of the firms with one employee at start-up did not increase employment and almost half of the firms which grew added just one employee. Finally, growth does reduce the risk of closure. The overall closure rate of the cohort is 60% whereas only 18% of HGFs closed.

Comparison with the US suggests that the US has a higher proportion of high growth enterprises than the UK, whereas the UK has a much higher proportion of very small businesses.²¹ One suggestion for these contrasts is that financial markets are more developed in the US than the UK, enabling new entrants in the US to access the capital they require to support business development.²² This study will test whether there are gaps in the UK SME funding escalator that are restricting business development opportunities.

2.4.2 Quality of Jobs

Rather less attention has been given to the nature of the jobs provided by SMEs and who fills these jobs. After allowing for the heterogeneity of the small firm sector, the available evidence is fairly consistent on both topics. Regarding the nature of the jobs the SME sector as a whole provides a different range of jobs compared to that of large firms. Small firms pay lower wages and salaries, and provide fewer fringe benefits, and although they provide considerable on-the-job training they are less likely to provide formal training to their staff. On the other hand, small firms appear to provide more job satisfaction and have more harmonious employment relations than large firms. The SME workforce also differs from that of large firms in several key respects. Small firms are more likely to employ younger workers (16-21 years) who have fewer educational qualifications, are more likely to have been unemployed prior to obtaining their present job, and are more likely to be employed on a part-time basis. SMEs are therefore important not just in terms of the number of jobs they provide but also because they are more likely to employ people who have disadvantages in the labour market. Moreover, fast growth firms are reported to be distinctive, with human resource management practices which emphasise

¹⁹ However, high growth firms are a very small proportion of *all* firms (0.94% in the 2002-5 period and 0.61% in the 2005-8 period)

²⁰ The analysis does not distinguish between organic growth and growth through acquisition. However, there is evidence (Deschryvere, M (2008) *High growth firms and job creation in Finland*, Working Paper 1144, Research Institute of the Finnish Economy, Helsinki) which suggests that larger and older firms are more likely to expand through acquisition

²¹ Kingston University (Small Business Research Centre) and Babson College (2008) *Growth Challenges for Small and Medium Sized Enterprises: A UK-US Comparative Study*, A report for HM Treasury and BERR.

²² Ibid

employee training, employee development and a remuneration system that gives employees financial incentives,²³ as well as provide opportunities for rapid career advancement.

2.4.3 Innovation

SMEs also play a disproportionate role in the generation and dissemination of innovative ideas in the economy and so expand the boundaries of economic activity. Research²⁴ shows that despite their lack of formal R&D activity, SMEs produce more innovations per employee than large firms, although there are variations across industries. This is generally attributed to the lack of bureaucratic constraints in small firms. Large firms, on the other hand, even if they are well-managed market leaders, are often slow to recognise and respond to new technological and market developments, especially if such changes are disruptive. This shortcoming can result in lost market position and even threaten the continued survival of the company.²⁵ Indeed, entrepreneurs and small businesses have been responsible for many of the most significant innovations. Moreover, innovation by SMEs is not confined to 'high-tech' sectors. Innovations in business functions and business models can also transform industries and create new opportunities, (e.g. budget airlines, express parcel delivery, direct sale of insurance).

However, three important caveats are in order. First, innovative small firms are often based on knowledge and discoveries generated in large firms and laboratories which fail to see their commercial application. This knowledge is typically transferred as a result of the departure of employees who can see the commercial applications and leave to start their own businesses or to join smaller firms. Second, because of resource constraints in SMEs the widespread commercialisation of innovations that they have pioneered may require the managerial and financial resources and distribution channels of larger businesses if they are to expand from their initial customer base to the mass market.²⁶ The decision to sell out to a large business is a common response to such challenges. Third, SMEs in the US have been much more likely to be responsible for generating disruptive technologies that lead to the creation of new industries than their counterparts in the UK, or indeed, Europe. This is attributable to a variety of factors, including the size of the US domestic market, the scale of government spending on research and development (much of it military- and space-related), its venture capital industry and the range of active programmes to promote commercialisation.

²³ Barringer, B R, Jones, F F and Lewis, P S (1998) A qualitative study of the management practices of rapid-growth firms and how rapid-growth firms mitigate the managerial capacity problem, *Journal of Developmental Entrepreneurship*, 3, 97-132.

²⁴ Acs, Z J and Audretsch, D B (1988) Innovation in large and small firms: an empirical analysis, *American Economic Review*, 78, 678-90 and Rothwell, R (1989) Small firms, innovation and industrial change. *Small Business Economics*, 1, 51-64.

²⁵ The most cited example of this situation is computing. IBM dominated the mainframe computer market but missed the emergence of mini-computers which were exploited by Digital, Data General, Prime, Wang, Hewlett-Packard and Nixdorf. However, all of these companies missed the development of the personal computer which was led by Apple, Commodore and Tandy (C M Christensen: *The Innovator's Dilemma*)

²⁶ Moore, G (1999) *Crossing the Chasm, Marketing and Selling High-Tech Products to Mainstream Customer* (revised edition), HarperCollins Publishers, New York, 1999

2.4.4 Entrepreneurship and Economic Growth

There is considerable evidence to support the claim that entrepreneurship is positively associated with economic growth.²⁷ Indeed, Michael Porter regards entrepreneurship as 'being at the heart of national advantage'. Entrepreneurship's impact on economic growth arises in three ways. First, entrepreneurship is a mechanism for knowledge spillovers. Most new firms – especially in technology sectors – arise from the departure of individuals or groups of people from an existing enterprise to start a new business that is based on exploiting the knowledge that they gained as employees in their previous business(es). In other words, such individuals take knowledge from the source where it was created to a new business where it is commercialised. Second, by increasing the number of enterprises new firms result in increased competition which generates efficiency gains. Third, new firms contribute to diversity. Not only do they result in new firms but they also create variety. A process of competition between these various new ideas and initiatives takes place, continually leading to the selection of the most viable firms and industries. Variety, competition, selection and also imitation expand and transform the productive potential of regional and national economies by displacing obsolete firms, increasing productivity and expanding new niches and industries.²⁸

2.4.5 Societal Contribution

SMEs also make a wide variety of societal contributions that are less amenable to statistical quantification, but are no less important. First, SMEs are the bedrock of their communities and provide localities with a source of uniqueness. Second, entrepreneurship is arguably the most important source of social and economic mobility. As Timmons observes: it 'rewards only for talent and performance and could not care less about religion, sex, skin colour, social class, national origin and the like'²⁹. Indeed, a number of the UK's successful entrepreneurs, such as Lord Alan Sugar, had humble origins. And third, a significant proportion of SMEs are involved in community engagement of various types (e.g. supporting local charities and sporting activities). Meanwhile, successful entrepreneurs have a high propensity to engage in philanthropic activities, giving not just their money but often also their time and expertise to support local, national and international causes. More than two-thirds of the people on the 2008 Top 100 Giving List are self-made men and women (including entrepreneurs, entertainers and sports people).

2.5. Government and the SME Sector

Virtually all governments have a range of programmes designed to support small firms. In many cases these policies were first introduced after World War Two. However, the main growth in such initiatives occurred in the 1980s, prompted by a combination of high levels of unemployment, weak economic performance and research by Birch and others on the role of small firms in job creation. Cross-country

²⁷ Audretsch, D and Keilbach, M (2004) Does entrepreneurship matter? *Entrepreneurship Theory and Practice*, 28, 419-429; Audretsch, D (2005) Entrepreneurship capital and regional growth, *Annals of Regional Science*, 39, 457-469; Audretsch, D (2007) Entrepreneurship capital and economic growth, *Oxford Economic Papers*, 23, 63-78.

²⁸ Carree, M A and Thurik, A R (2006) The impact of entrepreneurship on economic growth. In S C Parker (ed) *Handbook of Entrepreneurship Research*. Kluwer: Dordrecht), pp 437-471.

²⁹ Timmons, J A. (2009). *New Venture Creation*, Irwin McGraw Hill, p 5

comparison reveals a high degree of similarity in these programmes. In the UK the Bolton Report provided an early impetus to small business policy, with several of their recommendations implemented by the 1974-79 Labour Government. The post-1979 Thatcher Government introduced a plethora of schemes to encourage business start up and growth. Subsequent Governments have maintained a pro-SME stance. For example, the present Government's enterprise policy objective is to 'make the UK the most enterprising economy in the world and the best place to start and grow a business' so that more people will have the ambition to start and grow a business.³⁰ The policy focuses on so-called enterprise enablers:

- Culture – develop a culture where people are aware of the rewards available from enterprise and have the motivation to act upon aspirations;
- Knowledge and skills – fostering and supporting the development of enterprise skills and knowledge across the education system and enabling people running businesses to access the support and skills they need;
- Access to finance – ensuring that businesses that are starting up and seeking to grow are not constrained by a lack of finance;
- Regulatory framework – reducing regulatory burdens on small firms; and
- Innovation – to support the role of innovation as a driver of enterprise.

These policy themes have a strong continuity with the approaches of previous Governments.

The rationale for small business policy is based on two lines of argument. The argument from principle rests on the proposition that small businesses are at an economic disadvantage to large firms because of various 'market failures' which impose greater costs on small firms. The argument from practice is that small firms are desirable on account of their economic and social contributions such as employment, innovation and flexible labour markets. Government intervention to promote the SME sector has, however, attracted a range of criticisms. First, the market failure case has not been convincingly demonstrated. This is a particular criticism of interventions intended to increase the supply of finance to SMEs. Moreover, it is argued that even if market failure could be demonstrated, this is not a sufficient condition for government intervention. The case for intervention must establish that post-intervention welfare improvements can be demonstrated after taking account of the costs of the intervention. Second, and more problematic, many of the interventions have little explicit rationale for their introduction. Third, the impact of many of the interventions has been questionable. This is not simply because of vague and opaque objectives but also because the assessment has focused on 'evaluation' rather than 'impact'. In other words the assessment has focused on the recipients of the scheme (take-up rates, characteristics of recipients, opinions of recipients) rather than comparing the performance of assisted firms with that of a sample of matched firms, taking account of selection bias in the assisted firms.³¹

³⁰ HM Treasury and BERR (2008) *Enterprise: unlocking the UK's talent*

³¹ D Storey (2000) Six steps to heaven: evaluating the impact of public policies to support small businesses in developed countries. In D L Sexton and H Landström (eds) *The Blackwell Handbook of Entrepreneurship* (Oxford: Blackwell) pp 176-193.

Graham Bannock - a key analyst and commentator on the SME sector for many years (and secretary of the Bolton Commission) - argues that no matter what way the assessment of policy is done the results are generally unimpressive. He attributes this to two factors. First, the SME sector is so large that any realistic scale of intervention can only be marginal, with resources too widely dispersed and diluted over a proliferation of small interventions. Second, there is a mismatch between the constraints that owners of SMEs face and the types of intervention provided by government. Small business owners have in general shown little interest in loans and management assistance. Rather the problems which most exercise SME owners are related to taxation and regulatory burdens. Bannock's conclusion, therefore, is that it would be more productive for government to focus on improving the framework conditions for all enterprise. This will benefit SMEs disproportionately because regulatory burdens impose a greater burden on them.³² Professor David Storey – another influential commentator on small business policy – is critical of the emphasis of policy on increasing the numbers of small firms, arguing that a high proportion fail and few exhibit growth. He argues that there needs to be more emphasis on quality.³³

2.6. Summary

SMEs, by number, dominate the economy in the UK as in other advanced economies and in aggregate make a significant contribution to employment, innovation and economic development. The SME sector is highly skewed in terms of proportion towards one-person businesses and micro firms. The main economic impact of the SME sector derives from the small minority of firms which achieve rapid growth over a relatively short time period, generally on the back of technological or other types of innovation which have created new market opportunities.

The link to finance is twofold. First, high growth firms are likely to need access to finance – especially equity finance – to support their growth. Second, compared to the US, the UK has been less successful in generating high growth firms and has a higher proportion of micro firms, features which have been attributed to the more efficient financial markets in the US. When set in this context the availability of finance for SMEs becomes a key factor in the UK's ability to emerge from recession and promote economic growth.

³² Bannock op. cit.

³³ Greene, F J, Mole, K F and Storey, D J (2004) Does more mean worse? Three decades of enterprise policy in the Tees Valley, *Urban Studies*, 41 (7), 1207-1228

3. THE SME FUNDING ESCALATOR

3.1. Introduction

The purpose of this chapter is to put equity into context as a source of finance for SMEs. In context, the vast majority of SMEs do not seek equity finance and most would not meet the investment criteria of funders even if they did. Indeed, many SMEs are self-funded, through choice or necessity, and amongst those that do seek external finance the preference, after family and friends and bootstrapping, is bank overdraft followed by bank debt. Equity finance, in contrast, accounts for a very small proportion of SME funding, and it is only a very small proportion of the SMEs population which seeks and successfully obtains equity finance. Nevertheless, equity finance is critical in an entrepreneurial economy because it is a much more appropriate source of finance upon which to grow a business than debt finance, and is essential in situations where business success is based on significant up-front investment as in the case of new technology-based firms. As we noted in Chapter 2, it is fast-growing firms – which will often be reliant upon external sources of equity finance – which have a disproportionate economic impact, in terms of employment, exporting, innovation and competitiveness.

The chapter goes on to develop the concept of the funding escalator as a means of illustrating the different sources of equity finance that a firm might access as it grows.

3.2. Sources of Finance Used by SMEs: an Overview

Contrary to the prevailing view, the majority of SMEs are self-financed, either through personal savings or retained profits. For example, the Warwick Business School study for the Small Business Investment Taskforce³⁴ reported that only 44% of SMEs had sought new finance in the previous three years. The Annual Survey of Small Businesses for 2007-8 reported an even smaller proportion of firms - just 23% - had tried to obtain finance, mainly in the form of bank loans and overdrafts. Most start-ups and a significant proportion of established small firms are funded through a combination of '3F' money (founder, family, friends) and 'bootstrapping' - that is, creative ways of acquiring resources without the use of financial resources.

This pattern of financing – with a heavy reliance on self-financing, followed by bank overdraft and then bank debt, and very little use of equity – has been explained in terms of the *pecking order hypothesis*³⁵ which argues that the financing preferences of small business owners are based on their fear of loss of control. Thus, their preference will be for types of finance that minimise external interference and ownership dilution. Hence they will prefer internal over external financing, debt over equity finance. When seeking debt finance, they will prefer short-term debt which does not involve security and covenants over term loans. The least preferable option is to raise equity finance which most SME owners regard as financing of the last resort. However, Amar Bhidé suggests an alternative view. He argues that “most start-ups ... don't have the assets that an objective investor would consider

³⁴ S Fraser (2005) *Finance for Small and Medium Sized Enterprises: A report on the 2004 UK survey of SME Finances*, Warwick Business School

³⁵ Myers, S C (1984) The capital structure puzzle, *Journal of Finance*, 39 (3), 575-92.

valuable. They have little to offer investors besides their hopes and dreams. The founders, therefore, have to rely on their own resources or raise funds from their relatives and friends who are willing to overlook the founder's me-too strategies and inexperience."³⁶ There is mixed evidence regarding provision of bank finance for SMEs. In the Warwick survey, 11% were rejected outright and 19% received less finance than they needed.³⁷ In a survey on behalf of the Federation of Small Business (FSB), 9% were rejected. The overdraft rejection rate is nearly twice as high as for business loans (16% compared to 9%).³⁸ The Annual Small Business Survey (SBS) reported that 14% were unable to obtain finance,³⁹ with rejection mainly associated with lack of security and track record. The most frequently cited reasons for difficulties in obtaining finance were insufficient security, no credit history/not in business long enough, business sector too risky, and poor business performance/profit margins.⁴⁰ However, other SMEs do not seek external finance because they fear that they will be rejected by funders. These 'discouraged borrowers' represented 8% of firms in the Warwick survey⁴¹ and 10% in the FSB survey⁴².

More recent research however has found that the rate of rejection of SMEs seeking bank finance has increased. Research by the Institute of Directors (IoD), published in February 2010, found that difficulties in accessing bank finance have intensified. In a survey of more than 1,000 company directors, a quarter said they had tried to access finance from their banks. Of these, 57% said their application had been rejected. By contrast the Treasury has said that government data showed approval rates for loans and overdrafts were running at about 66% for businesses with a turnover of up to £1m and close to 90% for companies with a turnover of £1m to £25m.⁴³ As with the UK, Eurozone SMEs have experienced difficulties in accessing bank finance. A European Central Bank survey of SMEs in February 2010 found that rejections of bank loan applications rose significantly in the second half of 2009 compared with the previous six months. In the first half of 2009, 77% of SMEs had received in full or part the bank loans they had sought; however, in the final six months of 2009, this figure fell slightly to 75%. Moreover, the share of SMEs saying bank loans had been rejected rose from 12% to 18%.⁴⁴

A final reason for the reliance on internal sources of finance is that many businesses are too small to need to raise external finance. The Warwick survey found that by far, the main reason for firms not to seek external finance was because "they did not need it". Home-based businesses – which account for nearly 60% of all SMEs⁴⁵ – are a significant category of businesses that make limited use of external finance, with

³⁶ Bhidé, A (2000) *The Origin and Evolution of New Businesses*, New York: Oxford University Press., quotes from pages 37 and 39.

³⁷ Fraser, op. cit.

³⁸ Carter, S, Mason, C and Tagg, S (2006) *Lifting The Barriers to Growth in UK Small Businesses*. Federation of Small Business, London.

³⁹ Williams, M and Cowling, M (2009) *Annual Review Small Business Survey 2007/8*, Institute of Employment Studies, University of Sussex, for BERR

⁴⁰ Fraser, op. cit.

⁴¹ Carter et al, op. cit.

⁴² Fraser, op. cit.

⁴³ See 'Banks shun half of companies'; *Financial Times*, February 15 2010

⁴⁴ Europe's SMEs face funding difficulties; *Financial Times*, February 16 2010

⁴⁵ Levie, J and Mason, C (2009) *Global Entrepreneurship Monitor: Scotland 2007/8*. Hunter Centre for Entrepreneurship, University of Strathclyde.

cost-minimisation' being the biggest single reason for locating the business in the home.⁴⁶

The financial crisis has clearly made it harder for SMEs to raise external finance. A follow-up survey by Warwick Business School of their 2004 respondents found that rejection rates have risen, with term loans more affected than overdrafts, but the banks have not stopped lending. Firms most affected are those with low assets (lack of collateral), high credit demands, poor credit ratings and low business experience (start-ups).⁴⁷ The Department for Business, Innovation and Skills' SME Business Barometer⁴⁸ – a longitudinal survey of 500 businesses with employees – reported in their June 2009 survey that 33% of firms were unable to raise any finance, compared with 14% in July 2008. Bank overdrafts were the most problematic source of funding to obtain.

Looking at sources of external finance used, the Warwick Business School study⁴⁹ noted that the most commonly used sources in the previous three years were credit cards (both business and personal⁵⁰) and bank overdraft, both used by just over half of the firms in the survey. Asset financing (hire purchase) and term loans were each used by around one-quarter of firms. External sources of equity finance – in contrast – were used by a small proportion of SMEs (3%) (Table 3.1). This pattern of financing is corroborated by other studies. For example, a survey of the members of the FSB highlighted bank overdraft, bank loans, personal credit cards and company credit cards as the most frequently used external sources of finance, with very little use of external equity investment from friends, business angels and venture capital funds (see Table 3.2). The Annual Survey of Small Businesses for 2007-8 reported the main demand for finance was for bank loans and overdrafts with 25% seeking finance in the £10,000 to £25,000 range.⁵¹ The BIS SME Business Barometer⁵² for June 2009 reported that bank loans (40%) and bank overdrafts (27%) were the most common types of finance sought. Only 1% sought equity. In all of these surveys the larger and older firms made the greatest use of external sources of finance.

Table 3.1: Types of External Finance Used in the Previous Three Years

Overdraft	Grants	Term loans	Asset finance	Asset-based	Credit cards	Equity finance
52.9%	6.4%	24.3%	26.9%	3.0%	55.3%	2.9%

Note: Excluding friends and family

Source: S Fraser (2005). Finance for Small and Medium Sized Enterprises: a report on the 2004 UK survey of SME finances, Warwick Business School

⁴⁶ Mason, C M, Carter, S and Tagg, S K (2011) Invisible businesses: the characteristics of home based businesses in the United Kingdom, *Regional Studies*, forthcoming.

⁴⁷ Fraser, S (2009) *How have SME finances been affected by the credit crisis*, SME Centre, Warwick Business School

⁴⁸ Department for Business, Innovation and Skills (2009) *SME Business Barometer: June 2009*. URN09/P75D

⁴⁹ S Fraser (2005) *Finance for Small and Medium Sized Enterprises: A report on the 2004 UK survey of SME Finances*, Warwick Business School

⁵⁰ The latter can be regarded as a type of financial bootstrapping

⁵¹ Williams, M and Cowling, M (2009) Annual Review Small Business Survey 2007/8, Institute of Employment Studies, University of Sussex, for BERR.

⁵² Department for Business, Innovation and Skills (2009) *SME Business Barometer: June 2009*. URN09/P75D

Table 3.2: Typical Sources of Finance by SMEs

Source	Number of businesses	%
Bank overdraft	8,267	49.2
Own savings	6,977	41.2
Retained profit	5,963	35.5
Bank loan	5,068	30.2
Personal credit card	3,596	21.4
Company credit card	3,153	18.8
Supplier credit	2,351	14.0
Family	2,204	13.1
Leasing	1,253	7.5
Second mortgage	1,158	6.9
Grants	954	5.7
Pension	621	3.7
Inheritance	620	3.7
Other business/ employment	608	3.6
Factoring	582	3.5
Friends	490	2.9
Redundancy payment	436	2.6
Small firm loan guarantee	367	2.2
Business angel/ private investor	168	1.0
Enhanced capital allowances	85	0.5
Public sector low interest loan	75	0.4
Venture capital	58	0.3
Total Responding	16,776	-
Non respondents	2,163	-

Source: Carter, S, Mason, C and Tagg, S (2006) *Lifting The Barriers to Growth in UK Small Businesses* (Federation of Small Business, London)

The purpose of this brief overview of SME financing is to make three very simple, but often overlooked, points. First, a significant proportion of SMEs, particularly new and recent start-ups and micro businesses, do not seek formal sources of external funding, either through choice or necessity. Second, bank financing is the primary form of external finance for SMEs, commonly in the form of overdrafts and term loans. Third, firms which seek and successfully raise equity finance are very much the exception rather than the norm. However, as we noted in Chapter 2, these SMEs are significant for the economy on account of their entrepreneurial qualities, innovation and fast growth. Accordingly, we focus for the remainder of this report on sources of equity finance for the growing firm.

3.3 Finance and the Growing Firm – The Funding Escalator

Equity finance is generally regarded as a more appropriate form of finance for growing firms than bank finance for several reasons. On the one hand, the bank lending decision is a credit decision not an investment decision.⁵³ The bank needs to

⁵³ Rowlands Committee (2009) *The Provision of Growth Capital to UK Small and Medium Sized Enterprises*, Stationery Office.

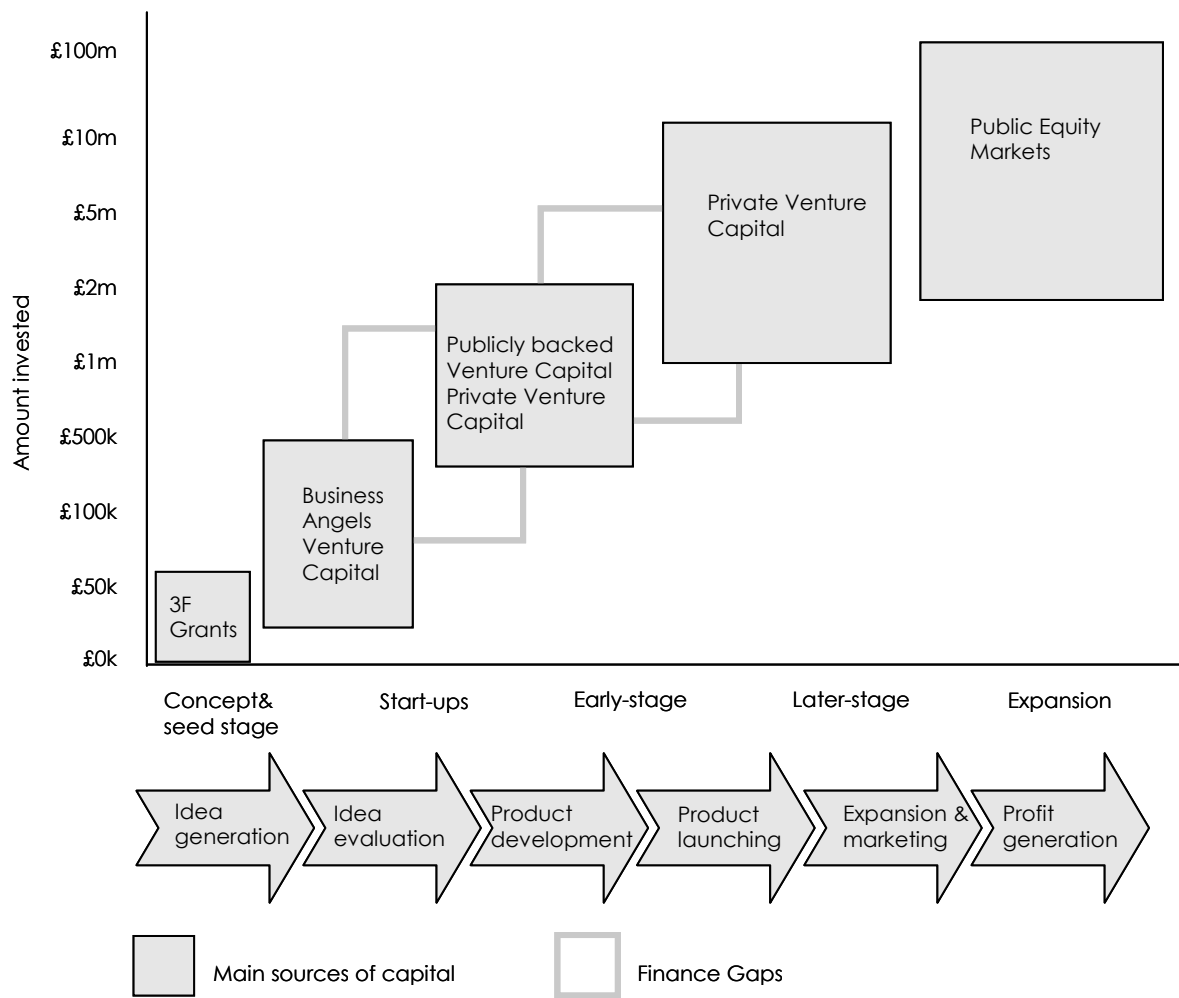
be reassured that the business can generate the cash to service the loan and can offer security that can repay the lender in the event of a default. However, growth businesses are likely to have few, if any, tangible assets against which to secure a loan so their borrowing potential is limited. Furthermore, growth potential businesses - especially if they are based on the development or application of new technology - are likely to have irregular revenue streams in their early stages and need to invest ahead of revenue generation, making it difficult if not impossible to service a loan. Moreover, bank lending yields only a small margin over the Bank of England base rate to the lender who will therefore normally only lend where it is judged that the risk of capital loss is very low.⁵⁴ Banks will therefore be unwilling to finance businesses which they judge to involve high risk because they do not share in the upside.

The advantage of equity finance is that it provides a permanent injection of finance into a business in exchange for a share in its ownership. In the event that the business performs well, equity holders will get a share of that return. However, shareholders are in a subordinate position to debt holders in the event that the business fails and so are likely to lose their investment. For this reason equity investors in SMEs seek a high return. A further benefit of at least some types of equity investors is that they offer 'smart money'. Business angels and venture capital funds are typically 'hands on' investors who make various value-added contributions, notably advice, strategic insight and networking to their investee companies, while raising finance from a corporate investor brings access to its tangible and intangible assets.

There are various sources of finance available to growing firms. However, they are differentiated in terms of amounts, rate of return sought, terms, conditions and obligations and value-added contribution. These different sources of equity finance are also appropriate at different stages in a firm's growth. This so-called *funding escalator* is shown in Chart 3.1. A good example of the funding escalator in practice is Amazon.com (Table 3.3).

⁵⁴ Ibid.

Chart 3.1: The SME Equity Funding Escalator



Source: Amended Figure 1 of 'Reshaping the UK economy: The role of public investment in financing growth' (NESTA, June 2009)

Table 3.3: A Financial Chronology of Amazon.com, 1994-1999

Date (m/yr)	Price per share	Source of funds
7/94 to 11/94	\$0.001	Founder: Jeff Bezos starts Amazon.com with \$10,000 of his own money and borrows a further \$44,000
2/95 to 7/95	\$0.1717	Family: father and mother invest a combined \$245,000
8/95 to 12/95	\$0.1287- \$0.3333	Business angels: two angels invest a total of \$54,408
12/95 to 5/96	\$0.3333	Angel syndicate: twenty angels invest \$46,850 each on average for a total of \$937,000
5/96	\$0.333	Family: siblings invest \$20,000
6/96	\$2.3417	Venture capitalists: two venture capital funds invest \$8 million
5/97	\$18	Initial Public Offering: three million shares are offered on the equity market raising \$49.1 million
12/97 to 5/98	\$52.11	Loan and bond issue: \$326 million bond issue is used to retire \$75 million in loan debt and to finance operations

Source: Van Osnbrugge and Robinson (2000), p 59

3.3. Sources of Equity Finance for High Growth Firms

The main sources of equity funding available to finance new businesses through stages of growth and development are as follows:

- Personal savings of the entrepreneur
- Family and friends
- Business angels
- Venture Capital Firms
- Public Stock Markets

We introduce each of these in turn.

3.3.1 Personal Savings of the Entrepreneur or Team

This is typically the primary source of initial funding. Even though the amounts involved are typically quite small, this funding is important for two reasons. First, subsequent investors will expect to see that the entrepreneurs have committed themselves financially to the business. Second, the effect of raising outside capital will be to dilute the proportion of the business owned by the original entrepreneurs. Thus, the larger the amount they are able to invest, and the longer they can survive on this and other non-equity sources of funding and bootstrapping, the less dilution they will experience when they come to raise external capital. The entrepreneur is also likely to contribute 'sweat equity' by working for no salary or at a level below what could be obtained by working for someone else until the business is on a solid financial footing.

3.3.2 Family and Friends

Recent research by the Global Entrepreneurship Monitor (GEM) consortium, an international association of more than 40 countries which collect data on entrepreneurial activity on a consistent basis by means of large scale household surveys, reports that close family members, friends and neighbours are by far the biggest source of start-up capital after the founders themselves. A study of 29 countries reported that some three-quarters of all informal investments were provided by a close family member, other relative or friend/neighbour.⁵⁵ Such investments typically take the form of short-term loans which may be converted into equity at a later stage. This form of finance is relatively easy to get, although the amounts involved are relatively small. The providers are unlikely to regard their investment as a commercial one and, indeed, may not expect it to be repaid. However, entrepreneurs may be reluctant to 'take advantage' of kinship and friendship ties and may feel under emotional pressure not to lose the money.

3.3.3 Business Angels

Business angels are conventionally defined as "high net worth individuals who invest their own money directly in unquoted companies in which they have no family connection in the hope of financial gain and typically play a hands-on role in the businesses in which they invest."⁵⁶ They typically have a business background and often are cashed out entrepreneurs.

Their investments are typically at, or soon after, start-up. Business angels rarely invest at the seed stage. The amounts they invest range from under £10,000 to over £250,000, although the norm is £50,000 to £100,000. However, there is a trend for business angels to increasingly invest as part of an angel group, rather than on their own, enabling firms to raise larger amounts from this source. A key feature of angel investing is their hands on involvement in supporting their investee businesses through a variety of hands-on roles, including mentoring, the provision of strategic advice, networking and in some cases direct involvement in a specific functional capacity. This has prompted the description of informal venture capital as "capital and consulting".

Business angels are investing in the hope of achieving a financial return, typically in the form of a capital gain that is accomplished through some form of harvest event such as an acquisition of the investee company or an IPO. The psychological rewards are also an important motivation however. Studies are consistent in identifying that the fun and enjoyment derived from such investments is an important subsidiary reason for becoming a business angel. This links back to the point that business angels are also characterised as being hands-on investors. Some angels also express altruistic motives.⁵⁷ US evidence indicates that most business

⁵⁵ Bygrave, W.D., Hay, M., Reynolds, P.D. (2003), Executive forum: a study of informal investing in 29 nations composing the Global Entrepreneurship Monitor", *Venture Capital*, 5 (2),101-16.

⁵⁶ Mason, C.M. (2006) 'Informal sources of venture finance', in S C Parker (ed) *The Life Cycle of Entrepreneurial Ventures*, New York: Springer: New York, pp. 259-299.

⁵⁷ One study quotes a Scottish angel as follows: "don't get me wrong, I want to make money. But I've done well out of Scotland and I'd like to help others to do the same." Source: Paul, S., Whittam, G. and Johnston, J. B., 2003, The Operation Of The Informal Venture Capital Market In Scotland. *Venture Capital: An International Journal of Entrepreneurial Finance*, 5: 313-335.

angels would be willing to forego some financial return either to invest in businesses that were seen as socially beneficial⁵⁸ or simply to support new entrepreneurs.⁵⁹

The strong desire amongst angels for anonymity and the private nature of the process means there are no accurate statistics on the number of business angels, the number of investments they make and the amount they invest.⁶⁰ Some evidence is available from ad hoc academic and other studies. There is also evidence from that part of the market that is visible: (i) business angel groups and (ii) business angel networks – private and public sector organisations that have been established to facilitate business angel investments.⁶¹ Studies in the US and UK have both sought to extrapolate from this visible market to estimate the overall amount invested by business angels.⁶² The UK study estimated that in the late 1990s there were between 20,000 and 40,000 business angels investing between £0.5bn and £1bn per annum in between 3,000 and 6,000 businesses. The study further suggested that business angels financed eight times as many early stage businesses as venture capital funds although because of differences in the size of investments the overall amounts invested were similar. This confirms earlier US research which found that business angels are much more prominent than venture capital funds in funding the start up and early growth stages of businesses.⁶³

3.3.4 Venture Capital Firms

Venture capital firms are financial intermediaries which attract investments from financial institutions (banks, pension funds, insurance companies), large companies, wealthy families and endowments into fixed life investment vehicles ('funds') with a specific investment focus (location, technology, stage of business development) which are then invested in young, growing businesses which offer the prospects of high reward. The function of the fund managers (the general partners) is to identify promising investment opportunities, support them through the provision of advice, information and networking and ultimately exit from the investment. The proceeds from the exit are returned to the investors (the limited partners). Most venture capital firms are independent organisations. Some are subsidiaries of financial institutions (termed 'captives'). A few large non-financial companies, particularly technology companies, have their own venture capital subsidiaries which invest for strategic

⁵⁸ Sullivan, M.K., 1994, Altruism And Entrepreneurship. In *Frontiers of Entrepreneurship Research*, edited by W.D. Bygrave, S. Birley, N.C. Churchill, E. Gatewood, F. Hoy, R.H. Keeley and W.E. Wetzel jr., pp. 373-380. Babson College: Babson Park, MA.

⁵⁹ Wetzel, W.E., 1981, Informal Risk Capital In New England. In *Frontiers of Entrepreneurship Research 1981*, edited by K.H. Vesper, pp. 217-245. Babson College, Wellesley, MA.

⁶⁰ For a review of potential ways to measure business angel activity see Mason C M and Harrison, R T (2008) Measuring business angel investment activity in the United Kingdom: a review of potential data sources, *Venture Capital: an international journal of entrepreneurial finance*, 10, 309-330.

⁶¹ Mason, C M (2006) 'The informal venture capital market in the United Kingdom: adding the time dimension', in J E Butler, A Lockett and D Ucbasaran (eds) *Venture Capital and the Changing World of Entrepreneurship*, Information Age Publishing, Greenwich: CT., pp 137-171.

⁶² US estimates are produced by Prof Jeffrey Sohl at the Center for Venture Research, University of New Hampshire (<http://wsbe2.unh.edu/cvr>). For an estimate of the UK market see Mason, C M and Harrison, R T (2000) The size of the informal venture capital market in the UK, *Small Business Economics*, 15, 137-148. Colin Mason and Richard Harrison are currently undertaking a project on the angel market for the Department of Business, Innovation and Skills, one of the objectives being to estimate the size of angel investment activity in the UK on an annual basis.

⁶³ Freear, J and Wetzel, W E (1990) Who bankrolls high-tech entrepreneurs? *Journal of Business Venturing*, 9, 109-123.

reasons to complement their own internal R&D activities (corporate venture capital). Venture capital investments are typically in the range of £2m to £10m.

The government has become much more significant in recent years as a source of early stage venture capital in response to concerns about an 'equity gap' which has arisen on account of the withdrawal of many private sector venture capital funds from the early stage market for a combination of the high transaction costs involved in making small investments and low returns.⁶⁴ The form of intervention has varied over time. Current government intervention has taken the form of hybrid funds which involve a combination of public and private investment, with incentives which enhance the returns or lower the risk to attract private sector institutions to invest, and are managed by private sector fund managers.⁶⁵ Examples include the Early Growth Funds, University Challenge Funds; Regional Venture Capital Funds. Many of these funds are regionally focussed. Both the English Regional Development Agencies and the development agencies in Scotland and Wales have also created their own funds. Most of the public sector funds have an upper investment threshold of £500,000.

Venture capital funds are highly selective as to the businesses in which they invest. The need to generate a large return on their investment in a five to seven year time frame through an IPO or acquisition means that only certain types of start-ups are candidates for this type of funding. Management needs to be capable of rapidly building an enterprise. Venture capitalists normally avoid businesses that are trying to create a market. Rather, they tend to wait for evidence of sizeable sales in conjunction with a large number of potential users who have not yet become customers".⁶⁶ Venture capitalists tend to avoid investing in mature markets and generally prefer businesses that offer a durable competitive advantage. Typically this means a business that has technological foundations in the form of their own or someone else's patents (usually obtained prior to raising venture capital) and an incipient technological advantage. However, venture capitalists avoid companies that are developing ground-level technologies. Rather, they seek to build on, or combine, the high level knowledge that the business has already secured. Finally, venture capitalists look to invest in businesses where rapid expansion has significant payoffs. That said, they will make a range of trade-offs amongst these criteria. For example, exceptionally credible founders may lead Venture Capitalists to suspend their normal criteria for evaluating potential markets or competitive advantages.^{67 68}

⁶⁴ Pierrakis, Y and Mason, C (2008) *Shifting Sands: The Changing Nature of the Early Stage Venture Capital Market in the UK*, Research Report, NESTA, London.

⁶⁵ Murray, G C (2007) Venture capital and government policy, in H Landström (ed) *Handbook of Research on Venture Capital*, Cheltenham: Edward Elgar, pp 113-151.

⁶⁶ Bhidé, A (2007) *The Venturesome Economy*, Princeton University Press: Princeton.

⁶⁷ *ibid*

⁶⁸ See the following for reviews of how venture capital fund managers make their investment decisions: Mason, C M (2006) 'Venture capital and the small business' in S Carter and D Jones-Evans (eds) *Enterprise and Small Business: Principles, Practice and Policy*, 2nd edition, FT-Prentice Hall, pp 357-384; Zacharakis, A and Shepherd, D (2007) The pre-investment process: venture capitalists' decision policies. In H Landström (ed) *Handbook of Research on Venture Capital*, (Edward Elgar: Cheltenham), pp 177-192.

3.3.5 Public Stock Markets

Acquiring a listing on a public stock market – often termed an Initial Public Offering (IPO) - may be the logical final step for a fast growing company which can offer a good track record of profitability and good prospects of further growth. Recent US research underlines that the majority of firms making an IPO will have previously raised finance from business angels and/or venture capital funds (unfortunately, there is no equivalent evidence for the UK). The US study, which covered the 2001-2007 period, discovered that 13% of the firms making an IPO had business angel investors, 33% had venture capital fund investors and 16% had both business angel and venture capital fund investors. The remaining 38% had neither business angel nor venture capital investors.⁶⁹ This underlines the strong inter-dependence between venture capital and the stock market. Indeed, there is considerable academic evidence⁷⁰ that active stock markets significantly stimulate venture capital activity because they enable venture capital firms to exit faster and more profitably, although the effect is stronger on later stage Venture Capital than early stage Venture Capital.

There are three financial markets in the UK on which a company can be floated.

The **London Stock Market's Main Market** is an international market for large, established companies with high standards of regulation and disclosure. It currently has 1,600 companies from 60 countries. The majority of its companies (70%) have a market capitalisation of over £50m (40% of these are over £250 million).

AIM, which is part of the London Stock Exchange, was launched in 1995 (replacing the Unlisted Securities Market) as a market specifically for smaller growing firms seeking to raise capital. Various observers also emphasise its importance as a stepping stone to the Main Market.⁷¹ Compared with the Main Market, AIM has simplified admission requirements and regulatory framework tailored for SMEs. Central to AIM are the Nominated Advisers (Nomads), approved by the London Stock Exchange to act in such a capacity. Nomads are responsible for ensuring companies are appropriate to admit to the market and continue to remain appropriate thereafter.

AIM has attracted over 3,000 companies since its launch. However, in the economic downturn companies seeking a market quotation have fallen back. AIM currently has fewer than 1300 companies quoted of which 19% are incorporated outside of the UK. Most AIM-quoted companies have small market values - approximately 25% of companies have a value under £5m and 78% have a market value of less than £50m⁷².

⁶⁹ W C Johnson and J E Sohl (2009) *Initial Public Offerings and Pre-IPO Shareholders: Angels Versus Venture Capitalists*. Working Paper, Center for Venture Research, Whittemore School of Business and Economics, University of New Hampshire

⁷⁰ Black, B S and Gilson, R J (1998) Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets, *Journal of Financial Economics*, 47, 243-277

⁷¹ Institutions stand by London's junior market despite difficult year, *Financial Times*, 18 December 2009, p. 20.

⁷² AIM Statistics September 2009

PLUS (previously known as OFEX) is a smaller market, with around 200 companies⁷³, mostly with a market cap of around £5m. The cost of joining via an IPO and maintaining a quotation is lower on PLUS than on AIM.⁷⁴

Regulation is also said to be lighter than on AIM. However, in contrast to AIM, PLUS attracts higher levels of private rather than institutional investors, which means there is less liquidity on PLUS than on AIM.

Becoming quoted on a public market has two main purposes. First, it is a means of funding ongoing growth. Finance can be raised both at the IPO and subsequently through secondary issues. Raising debt finance also becomes easier with a public listing. Public companies can also use their shares to make acquisitions. Indeed, businesses quoted on AIM report that the primary benefit of a quotation is the ability to raise money in their early stages of growth.⁷⁵ Second, a stock market listing is an important way in which existing shareholders – notably the founders and their families, business angels and venture capital funds – can realise their capital gains.

However, the costs involved in both obtaining and maintaining a stock market listing, in the form of lawyer, accountant and broker fees and commissions, joining fees and an annual charge, and ongoing compliance regulations and disclosure requirements mean that a stock market listing is likely to be unsuitable for small, early stage firms. Moreover, if the purpose of an IPO is to raise additional finance it is only worthwhile for companies seeking to raise significant amounts otherwise the costs will absorb too high a proportion of the funds raised.

Other aspects of the stock market may also discourage some owners from seeking a listing. First, shareholders who are insiders in the business (entrepreneurs and investors) are often subject to a 'lock-in' period after the IPO before they are allowed to sell their shares. Clearly, if inside investors sold their shares immediately after the IPO this would drive the share price down. However, this exposes them to risk that the share price will fall during this lock-in period.

Our consultations with the venture capital community respondents were consistent in stating that a trade sale was their preferred means of exit. Moreover, they could not remain as long-term shareholders in companies that had achieved an IPO because their Limited Partners wanted the cash to be recycled back to them after an exit. Some respondents went further, saying that it is mistaken to see an IPO as an exit; rather, it should be seen as representing a further round of capital raising. Second, there is a weight of academic evidence that the short-term performance of IPOs is positive, relative to the market as a whole, meaning that they are under-priced and so 'leave money on the table', while their longer term performance is worse than the market as a whole because of a lack of liquidity in their shares.⁷⁶ The amount of under-pricing is related to the extent of information asymmetry. There is,

⁷³ PLUS provides a market for two types of companies: PLUS-listed companies which trade on a quote-driven basis with market makers and PLUS-traded companies which trade on an order driven, matched bargain (trade) basis. Shares in any public companies can be traded on PLUS.

⁷⁴ The cost of a listing on the PLUS Market is typically around £100,000-£150,000 compared with £350,000-£1m on AIM

⁷⁵ Arbutnot Securities (2009) AIM Investor Survey: The Road to Recovery

⁷⁶ Ritter, J R and Welch, I (2002) A review of IPO activity, pricing and allocation, *Journal of Finance*, 53, 1795-1828,

however, evidence that venture capital-backed IPOs are less likely to suffer either problem.⁷⁷ There are a number of potential explanations for this. The companies they bring to market may be of better quality because of their skills in selecting companies to invest in and the value-added that they contribute. It may also reflect a certification effect. Venture capital firms repeatedly bring companies to the market so have reputational capital to protect. They also have strong relationships with underwriters to sell the shares. All of this reduces information asymmetry. Third, some entrepreneurs may also be deterred from seeking a stock market listing because of the exposure to greater outside scrutiny and the governance arrangements required (e.g. non executive directors) and the associated dilution of control and decision-making.

3.3.6 Sources of Finance and Stages of Growth

These various sources of equity finance come into play at different stages in a firm's growth. At the *seed stage* the business is in the process of being established. It may therefore be undertaking R&D, solving key product or service development issues and moving to an operating demonstration prototype of the initial product or service. This phase may occur in the founder's home and the founder may even continue to work full-time. Financial needs are likely to be fairly minimal and will be met by a combination of the founder's own personal savings, family and friends (the 3 Fs) and 'bootstrapping' techniques. Commercial investors will regard such 'pre-ventures' as being too high risk. However, government support may be available in the form of R&D and proof-of-concept grants for technology-based firms.

The *start-up stage* begins with the founding of the company, demonstration of commercial applicability, securing of initial sales and seeking new sales channels. The financial needs increase as the company invests in capital equipment and infrastructure, begins to employ staff and has growing working capital requirements. Investment in businesses at this early stage is very high risk – the management is unproven and the product or service has yet to demonstrate widespread acceptance - and any return may not materialise for several years. Thus, businesses are likely to continue to rely upon a combination of founder, family and friends (3Fs) money, bootstrapping⁷⁸ and government support, although those with growth prospects may be able to raise finance from business angels. Importantly, business angels will typically mentor such businesses, providing expert advice and guidance. Venture capital funds are unlikely to be interested in investing at such an early stage unless the fund has been established with an economic development mandate (i.e. set up by a government agency such as a Regional Development Agency).

Companies which come through the start-up stage with a product or service which is in demand enter *the initial growth stage*. The business will be seeking to improve product quality, lower its unit costs and develop new products. The business may be reaching profitability but this is insufficient to fund the expansion of plants and equipment, bigger premises, additional staff to fill out each of the functional areas

⁷⁷ Megginson, W L and Weiss, K (1991) Venture capital certification in Initial Public Offerings, *Journal of Finance*, 46, 879-903.

⁷⁸ Defined as "a range of highly creative ways of acquiring the use of resources without borrowing money or raising equity financing from traditional sources". Harrison, R T, Mason, C M and Girling, P (2004) 'Financial bootstrapping and venture development in the software industry', *Entrepreneurship and Regional Development*, 16, 307-333.

and larger working capital requirements. Risk and uncertainty have declined. By this stage the business will no longer be reliant on 3F money. The main source of external funding will be a combination of equity investment from business angels and bank finance. However, larger funding requirements and follow-on financing are likely to be met by venture capital funds.

Companies that continue to grow enter the *sustained growth stage*. Profits and cash flow are sufficient to meet the majority of their capital requirements but additional finance may be required to grasp new growth possibilities (including acquisitions). Such companies will look to venture capital funds specialising in development capital and even to more esoteric financing instruments and ultimately to a stock market listing.

It is, however, important to emphasise that this model is not deterministic. By no means will every growing business access finance from all of these sources. Some may go from 3F money to venture capital without raising angel finance. Others might raise finance from business angels but not venture capital firms. Relatively few firms achieve an IPO. Indeed, some firms can achieve high growth without recourse to external sources of equity finance, particularly if the business is in a cash-generative sector (e.g. retail) or is dependent on human, rather than physical, capital.

Moreover, the takeover option is ever-present, particularly as an alternative to an IPO for businesses whose investors are seeking an exit. Indeed, rightly or wrongly, a trade sale is often seen by both entrepreneurs and investors as an easier, quicker and more appropriate means of achieving a harvest event. There is evidence that a trade sale is likely to have less information asymmetry than an IPO because the potential purchaser has the opportunity, inclination and ability to carry out due diligence. This, in turn, should reduce under-pricing.⁷⁹ However, the benefits of a trade sale vis-à-vis an IPO are based on the assumption that, as noted above, investors are locked in for a period of time after an IPO whereas they immediately gain cash following a trade sale. In reality, investors may be paid in part or fully in paper and so incur the risk that the acquirer's shares may have gone down in price by the time they want to sell (although it is also possible that they will have gone up!). From the perspective of the growing business a trade sale is also a means of accessing further resources for growth. The non-financial resources that a strategic purchaser can bring to an acquisition, for example, in terms of management talent and distribution channels, are likely to be particularly valuable. This example is illustrated in Chapter 4 by the DXS case study where the trade sale was motivated by a combination of price and strategic benefits. There is also evidence in the literature that venture capital firms derive higher returns from IPOs than from trade sales⁸⁰, but this is likely to reflect a selection effect because their better performing firms are more likely to be taken public than sold to another company. But whether trade sales are in the best long-term interests of the company or UK economy remains a matter for debate.⁸¹ It is certainly one plausible reason why there is an

⁷⁹ Cumming, D and Johan, S (2008) Information asymmetries, agency costs and venture capital exit outcomes, *Venture Capital: an international journal of entrepreneurial finance*, 10 (3), 197-231.

⁸⁰ Gompers, P and Lerner, J (2001) *The Money of Invention: How Venture Capital Creates New Wealth*, Cambridge: MA, Harvard Business School Press.

⁸¹ Mason, C M and Harrison, R T (2006) After the exit: acquisitions, entrepreneurial recycling and regional economic development, *Regional Studies*, 40, 55-73.

absence of American style 'gorilla' firms in the UK – firms like Cisco and Microsoft which grow very fast over a sustained period to become major global companies.⁸²

3.4. Summary

In well-developed entrepreneurial economies, various sources of equity finance will be present. The concept of the funding escalator suggests that growing SMEs will use these different sources of finance at different stages in their development. In simple form the funding escalator is as follows: 3Fs to business angels to venture capital and finally listing on a public market. However, the model is not deterministic. It is also clear from the funding escalator model that it is an inter-dependent system, with gaps in one part of the ladder having potential knock-on effects, either forward or backward, on other parts of the ladder. We further noted that government has had to intervene where there was perceived to be a gap in the provision of finance, typically at the bottom of the escalator.

The funding escalator is impacted by changes in the economic and financial environment and is therefore in a constant state of evolution. Government periodically intervenes when it sees gaps appearing in the funding escalator. The next chapter therefore moves on from this static perspective to examine the current effectiveness of the funding escalator in the UK in the context of recent and longer-term changes in the financial environment. Specifically it examines the effectiveness of recent government interventions to 'fix' problems in the availability of finance for growing businesses and to highlight emerging aspects of the funding escalator where further intervention might be required.

⁸² Owen, G (2004) Where Are The Big Gorillas: High technology entrepreneurship in the UK and the role of public policy. The Diebold Project UK. www.dieboldinstitute.org/papers.htm

4. EQUITY GAPS

4.1. Introduction

The funding escalator is an idealised model of the various sources of finance that firms might access at different stages in their growth. It assumes a seamless progression from one funding source to another. The reality is different: the escalator is continually evolving in response to the wider economic environment, creating funding gaps and frictions between different funding sources. Government intervenes to 'fix' these issues but the complex and dynamic nature of the system often means that solutions are ineffective. The aim of this chapter and the following chapter is therefore to consider the current effectiveness of the UK SME funding escalator in providing growing SMEs with the equity finance that they need to grow. This chapter considers the funding of companies up to an IPO. Chapter 5 considers issues associated with the public markets.

Our review and consultations identify the several parts of the pre-IPO funding ladder that appear to be operating sub-optimally:

- The lack of commercial seed capital, which hinders the process of commercialising scientific and engineering discoveries and the growth of university spin-off companies;
- A reduction in the supply of early stage venture capital, which has had knock-on effects for the business angel market, notably the emergence of business angels groups which have the capability to make bigger investments before exiting;
- The business angel – venture capital disconnect; and
- A depressed Initial Public Offering (IPO) market⁸³.

Meanwhile the effectiveness of Government interventions has been mixed.

We look at each of these issues in turn.

4.2. Lack of Seed Capital

New technology-based firms – firms that are seeking to develop and exploit new technologies - occupy the very bottom of the funding escalator. They are likely to need seed funding to cover what may be a lengthy period of negative earnings as they turn their intellectual assets into products in advance of sales. Further substantial funding is also likely to be needed to bridge the gap between early adoption and mainstream customer use. However, all the available evidence suggests that seed investing on a commercial basis is unlikely to be achievable.⁸⁴ Certainly, the venture capital industry does not provide seed capital and even business angels tend to

⁸³ An initial public stock offering can also be referred to as an offering, flotation or listing.

⁸⁴ Mason, C (2004) *The Financing Of Early Stage Technology Businesses In The UK: A Review*. Hunter Centre for Entrepreneurship, University of Strathclyde, for NESTA.

avoid investing in pre-commercial, pre-revenue businesses, with seed investments consistently accounting for no more than 2% or 3% of all their investments.⁸⁵

The main source of seed capital has been government sponsored micro venture funds. These operate on the hybrid principle of using public money to leverage in additional private investment. The funds are managed by private venture capital fund managers. The performance of these funds to date indicates that “they do not appear to be on track to meet the commercial expectations of investors ...”⁸⁶ There are several reasons for this. First, seed investments are very high risk and there is a very long time to wait for any returns. Second, these schemes have a maximum investment size which limits their ability to make follow-on investments. But without the ability to do their own follow-on investing the seed fund’s position will be severely diluted because of the greater bargaining power of later stage investors. Third, funds have to be large to be able to selectively follow-on investments and to be able to keep investing until the returns from the initial investments start to appear (if they ever do). Fourth, evidence from a Scottish study of university spin-offs indicates that the commercially successful businesses have typically taken more than 10 years to realise their potential⁸⁷. This suggests that the typical 10 year partnership structure of venture capital funds is inappropriate for making seed capital investments. Finally, there are high management costs because of the need for post-investment support. University spin-out companies have a particular need for ‘smart’ investors who are able to add value. The academic management team may have limited commercial awareness and the technologies more often than not have a wide range of potential applications and it can be difficult to work out which is the best market. Indeed, even some of the most successful Scottish university spin-out companies changed their business model substantially before they succeeded.⁸⁸

Indeed, there are strong arguments for suggesting that equity is an inappropriate source of finance at this initial stage in the funding escalator. First, it is very difficult to value a seed investment. The availability of data is limited and so it is problematic to apply formal valuation tools. Only as a company moves to the revenue generation stage is there sufficient quantifiable data available to perform a more rigorous valuation. The high degree of uncertainty inherent in the seed and early stage translates into low pre-money valuations. For these reasons it may be better to avoid equity at the seed stage and use alternative financial instruments. Second, the Lambert Review of Business-University Collaboration noted that the availability of equity finance in the form of University Challenge Funding led to the creation of too many unsustainable spinouts which were unable to attract follow-on equity finance because the funding had run out before the technology was proven.⁸⁹ The Committee advocated proof-of-concepts funds as a more appropriate form of funding at this stage in the funding escalator.

⁸⁵ Mason, C M (2006) ‘The informal venture capital market in the United Kingdom: adding the time dimension’, in J E Butler, A Lockett and D Ucbasaran (eds) *Venture Capital and the Changing World of Entrepreneurship*, Information Age Publishing, Greenwich: CT., pp 137-171.

⁸⁶ Sharpe, S, Cosh, A, Connell, D and Parnell, H (2009) *Start-up Finance: The role of micro funds in the financing of new technology-based firms*. London: NESTA

⁸⁷ Targeting Innovation (2008) *Scottish Spin-out Study*. Glasgow

⁸⁸ Ibid

⁸⁹ *Lambert Review of Business-University Collaboration: Final Report*. London: HMSO, 2003.

The consequence of this inadequate funding regime is that most university spin-outs are small and do not grow significantly⁹⁰. For example, a study of 200 spin-offs from Scottish universities reported that 30% were no longer trading, 55% employed fewer than 10 people and only 15% employed more than 15 people. Just 17 spin-outs employed more than 50 people and just six are substantial businesses.⁹¹

4.3. Decline in the Supply of Early Stage Venture Capital

Trends over the past decade show a reduction in the supply of early stage equity finance from venture capital firms. This has had two significant consequences. First, it has meant that business angels are now increasingly important as the only source of early stage venture capital. Second, it has prompted government intervention with a range of hybrid funds in an effort to fill the gap created by the withdrawal of private venture capital funds. We address these points below.

4.3.1 Withdrawal of Venture Capital Funding

More than 70% of the amount invested by the 200+ members of the British Venture Capital Association in 2008 comprised private equity rather than venture capital. Private equity can be defined as investments in established businesses to facilitate enhanced performance through a mixture of financial engineering, turnaround management skills and ownership change. Typically this involves management buyouts and buy-ins of family-owned businesses and divisions of corporate groups although in terms of deal sizes the public-to-private deals in listed companies dominate.⁹² Venture capital, by contrast, is the injection of additional finance into a business in the form of equity finance to enable it to grow.

In 2008, BVCA members invested over £20bn in companies of which investment in the UK was £8.5bn, a figure significantly down from 2007 reflecting the negative economic climate but still considerably higher than previous figures (see Chart 4.1). The UK share of total BVCA member investment has fallen sharply since 2000 - prior to 2000 around 80% of investment was in the UK but this has since declined to about 40%.

Private equity accounted for 72% of total investment by value in 2008 with venture capital accounting for the remainder. However, in terms of the number of investments, the same proportions applied but in reverse, with 72% in venture capital and 28% in private equity, reflecting the much larger size of private equity investments.⁹³ This focus on late stage investments is in line with other major European countries. However, in comparison to the US, Europe is much more heavily involved in later stage activity.

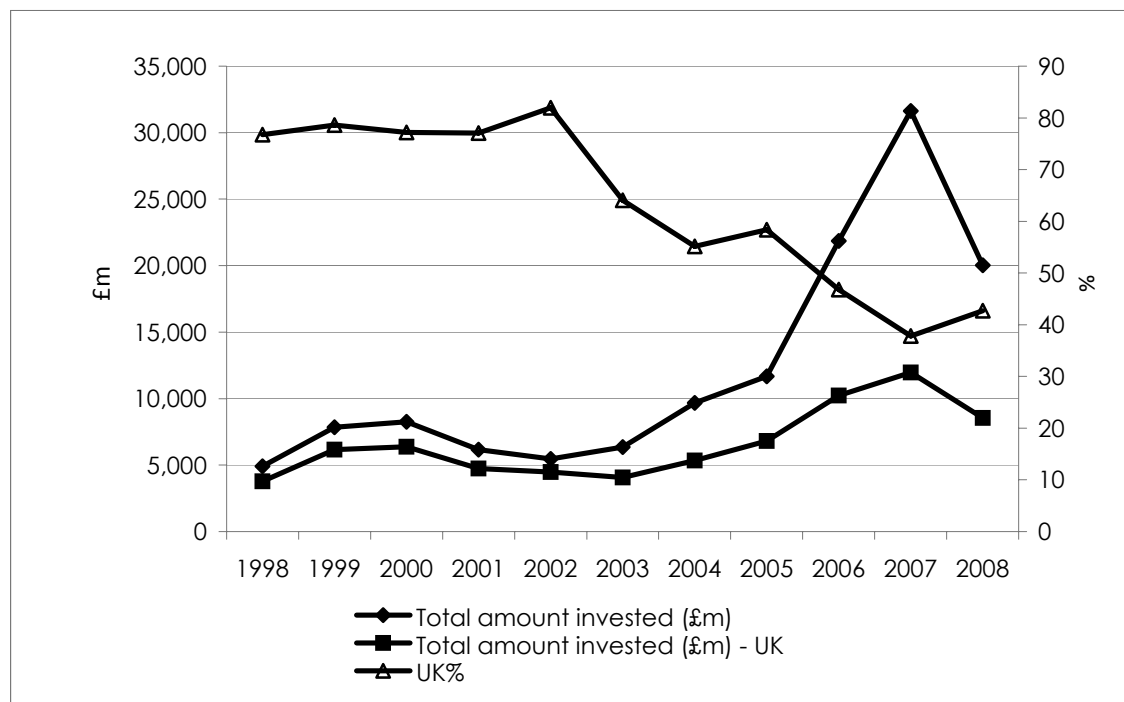
⁹⁰ It should be noted limited growth is not just a direct consequence of the funding regime. In several cases the product ideas are simply not viable in the first place.

⁹¹ See Targeting Innovation (2008) *op cit*, and Harrison and Leitch, C *op. cit*.

⁹² For a review of private equity see M Wright, J Gilligan and K Amess (2009) The economic impact of private equity: what we know and what we would like to know, *Venture Capital: an international journal of entrepreneurial finance*, 11, 1-12.

⁹³ BVCA (2009) *Private Equity and Venture Capital Report on Investment Activity 2008*. London: British Venture Capital Association.

Chart 4.1: Funds Invested by BVCA Members



Source: BVCA

The amount invested by BVCA members in early stage deals has fallen since 2000, albeit irregularly, from £703m to £359m in 2008. In proportional terms this represents a decline from 11.0% to 4.1%. However, the actual number of early stage investments has actually increased slightly from just over 400 investments at the start of the decade to 455 in 2008, while the proportion of all investments has remained fairly constant at just over one-third (Table 4.1 and 4.2). The obvious explanation from these two trends is that the average size of early stage investment has declined since 2000.

Table 4.1: UK Early Stage Investments 2001-8: Amount invested (£m)

Finance stage	2000	2001	2002	2003	2004	2005	2006	2007	2008
Start-up	175	163	99	73	96	160	531	190	172
Other early stage	528	227	196	190	188	222	415	244	187
Total early stage	703	390	295	263	284	382	946	434	359
Early stage as a % of total investment	11.0	8.2	6.6	6.5	4.2	5.6	9.3	3.6	4.1

Source: BVCA Report on Investment Activity (various years)

Table 4.2: UK Early Stage Investments 2001-8: Number of Companies

Finance stage	2000	2001	2002	2003	2004	2005	2006	2007	2008
Start-up	153	190	165	185	190	208	245	207	170
Other early stage	256	218	233	242	264	285	255	295	285
Total early stage	409	408	398	427	454	493	500	502	455
Early stage as a % of total investment	35%	31%	33%	34%	35%	38%	38%	38%	36%

Source: BVCA Report on Investment Activity (various years)

What these tables do not reveal is the significant change in the supply of early stage venture capital from private to public venture capital funds.⁹⁴ This has been driven by three main factors. First, early stage investments involve higher risk. These risks are not compensated with higher returns. Poor investment returns since the post-technology bubble period have reduced the attraction of venture capital as an asset class for institutional investors, making it difficult for existing venture capital firms to raise new funds and for new venture capitalists to enter the industry (Table 4.3). In the UK the average size of funds has fallen continuously since 2004, and just seven new funds were created in 2008 compared with two or three times that number in previous years. Second, existing fund managers have sought to conserve their cash to meet the financial needs of their existing investments and have largely stopped making new investments. This has been reinforced by the lack of exit opportunities which has forced investors to stay involved with their existing businesses for longer, further constraining their ability to make new investments. Third, the personal remuneration of fund managers is related to fund size. Fund managers with a track record have therefore had an incentive to shift to later stage and private equity where larger funds are the norm.

The recent publication of the Rowland's Review of Growth Capital highlights equity gaps not just in the sub £2million but also in the provision of growth capital in the £2m-£10m range. This is being driven by the same factors of risk, returns and remuneration.⁹⁵

⁹⁴ Pierrakis, Y and Mason, C (2008) *Shifting Sands: The Changing Nature of the Early Stage Venture Capital Market in the United Kingdom*. London: NESTA.

⁹⁵ Rowlands, C (2009) *The Provision of Growth Capital to UK Small and Medium Sized Enterprises*. London: The Stationary Office.

Table 4.3: Venture Capital Funds Established 1996-2004: Returns since Inception to December 2008

	Venture Capital	Small MBO	Mid MBO	Large MBO	Total
IRR	-1.8	6.5	14.9	21.5	17.2

Source: BVCA

4.3.2 The Growing Importance of Public Sector Venture Capital Funds

Increased intervention by government explains why the decline in early stage venture capital investment has not been more dramatic. The Labour Government has established a range of 'hybrid' funds in which the state invests as a special limited partner alongside private investors in a fund that is managed by a commercial fund manager. In such schemes the private investors are offered some kind of downside protection against losses or upside leverage to offset the low returns typically associated with early stage investment.⁹⁶ This contrasts with previous approaches in which government has been the only source to provide the investment funds. It should be noted that the objectives of these hybrid funds were not only to fill the gap in early stage funding but also to provide a demonstration effect that it was possible to make good returns from early stage investments. Examples of hybrid funds include the Early Growth Funds, University Challenge Funds; Regional Venture Capital Funds (see Table 4.4). Many of these funds are regionally focussed. Both the English Regional Development Agencies and the development agencies in Scotland and Wales have also created their own funds.

⁹⁶ Murray, G (2007)

Table 4.4: Publicly Backed Venture Capital Funds

Fund Type	Total funds available ¹	Investment size range	End of investment period	Scope
Regional Venture Capital Funds	£241m	Up to £660k	2007 - 2008	Regional
RDA VC Funds ²	£220m	£50k - £2.5m	2008 - 2012	Regional
Early Growth Funds (EGFs)	£36.5m	Up to £200k	2014 - 2016	Regional
University Challenge Seed Funds (UCSFs)	£60m	£25k - £250k	Evergreen	National
UK High Technology Fund	£126m	Up to £2m	2006	National
Community Development Venture Fund ³	£40m	£100k - £2m	May-09	National
Enterprise Capital Funds (ECFs)	£185m	£500k - £2m	2011 - 2013	National
Carbon Trust Funds	£27m	£250k - £3m	Still open to investments	National
NESTA fund	£50m	£250k - £1m	Evergreen	National

Source: SQW Consulting (2009) The Supply of Equity Finance to SMEs: Revisiting the Equity Gap. Department of Business, Innovation and Skills, URN 09/1573.

1: During investment period

2: Data does not include figures from the North West and South East Venture Capital Funds

3 Also known as Bridges fund

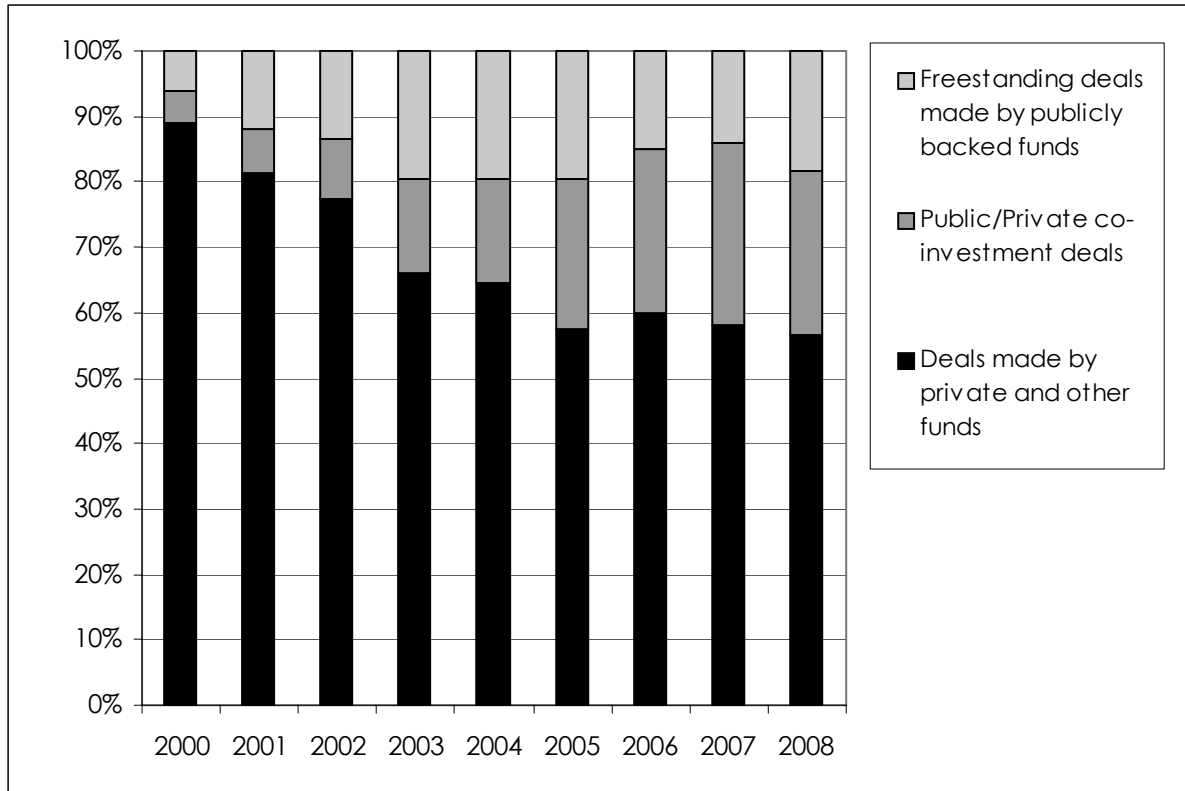
A variant on the hybrid funds model are **co-investment funds** which provide public money to match investments made by private early stage investors. However, they differ in terms of how they operate. One model is the passive fund, such as the Scottish Co-Investment Fund, which follows the lead of its private sector partners who have been approved to invest under the scheme. It does not undertake its own due diligence and plays no part in the investment. Any investment that the investor makes and which meets the scheme's criteria will automatically qualify for co-investment. The Co-Investment fund invests on identical terms and conditions to those of the private investors. This feature removes any uncertainty for the investor, and reduces the operating costs of the scheme to a minimum. Another model of co-investment schemes involves more active management, inviting investors to bring deals to them (or approve deals from particular sources, such as business angel networks) but make their own investment decisions and possibly invest on different terms and conditions to those of the business angel group.⁹⁷ Because of the maximum investment size under the scheme (£500,000) the partners are almost exclusively business angel groups – that is, organised and managed groups of business angels who invest together rather than as individuals.

The early stage venture capital market is therefore increasingly underpinned by public sector and hybrid funds. In 2001, public sector funds were involved in 36% of investments. By 2003, as the various funds established by the Labour Government came on stream, this had risen to 51% and by 2008 it accounted for 68% of all

⁹⁷ For example, London Seed Capital co-invests with the London Business Angels Network and the Great Eastern Investment Forum (GEIF) has a co-investment fund that only invests in companies which receive investments from GEIF business angels.

investments. This reflects the growth of co-investment schemes which have risen from 10% of all investments in 2001 to more than 30% since 2005 (Chart 4.2).⁹⁸ Several of these funds have now reached the end of their investment phase⁹⁹, suggesting that early stage investments will have declined in 2009.

Chart 4.2: Proportion of Investments by Type of Investor, 2000-2008



Source: Mason, C and Pierrakis, Y (2009) Venture capital, the regions and public policy: the United Kingdom since the post-2000 technology crash, Working Paper, Hunter Centre for Entrepreneurship, University of Strathclyde.

Emerging evidence suggests that these hybrid funds have not been effective. First, a NESTA/BVCA study found that investee companies performed only marginally better than a control sample.¹⁰⁰ Second, a National Audit report noted that both the RVCs and the UK High Technology Funds have produced negative returns to date.¹⁰¹ This is largely attributed to deficiencies in the design of these funds. First, the funds had

⁹⁸ Mason, C and Pierrakis, Y (2009) Venture capital, the regions and public policy: the United Kingdom since the post-2000 technology crash, Working Paper, Hunter Centre for Entrepreneurship, University of Strathclyde. Note that these proportions exclude investments made under the Enterprise Investment Scheme and by Venture Capital Trusts (see next section) so under-estimates government's effect in underpinning early stage venture capital.

⁹⁹ SQW Consulting (2009) *The Supply of Equity Finance to SMEs: Revisiting the Equity Gap*. Department for Business, Innovation and Skills, URN 09/1573. Pierrakis, Y and Mason, C (2008) *Shifting Sands: The Changing Nature of the Early Stage Venture Capital Market in the UK*, Research Report (NESTA, London)

¹⁰⁰ Nightingale, P, Murray, G, Cowling, M, Baden-Fuller C, Mason, C, Siepel J, Hopkins M and Dannreuther C (2009) *From funding gaps to thin markets: UK Government support for early-stage venture capital*, NESTA and BVCA. London

¹⁰¹ Comptroller and Auditor General (2009) *Venture Capital Support to Small Businesses*, National Audit Office. London: The Stationary Office.

multiple objectives, seeking both a commercial return and encouraging economic development. Second, for the laudable reason of preventing 'mission drift' the funds had an upper size of investment, generally £500,000 and in some schemes much smaller. However, this has typically been too small to meet the funding needs of high-growth firms. In addition, the funds are generally too small to have the capacity to make significant follow-on investments. The consequence for the management teams of the investee businesses is that they are forced to spend a disproportionate amount of their time seeking further finance. If follow-on investment is not found, this may necessitate the premature sale the company, or even its closure. Moreover, because the public fund has not been allowed to make follow-on investments beyond its investment limit, its original investment has been diluted thereby reducing its eventual return. Third, the restricted geographical focus of the regional funds limited their deal flow, reducing their prospects of making good investments. Fourth, the funds were not set up, either in terms of their size or rules, to support companies in the number of funding rounds or time required to achieve an exit. There is evidence that these lessons have been taken on board by government and its new approach is to favour a UK fund-of-funds model in which government sets up a scheme to match public with private money in a fund which is then invested in a variety of early stage private sector funds. This will include both those with an established track record and also new funds led by a management team comprising investment managers with credible early stage investment skills and experience. Whilst an upper limit to the size of the initial investment is appropriate, the funds need to be able to make larger follow-on investments in order to support their investee companies across several stages of the funding escalator. This also means that the funds themselves must be fairly large. Murray (1999)¹⁰² has argued for a minimum size of £20m. More recently Pierrakis and Westlake (2009)¹⁰³ have argued for a minimum of £40m.

There are two alternative interpretations for the lack of effectiveness of these funds. First, public sector venture capital funds may not be as 'smart' as private sector venture capital in terms of deal selection and adding value. Second, it may indicate that the UK does not have a large stock of high potential firms that are only being held back by a simple lack of equity funding.

Co-investment schemes, in contrast, appear to have been very successful in significantly increasing the volume of investment activity in the early stage venture capital market. However, the only scheme to have been the subject of evaluation is the Scottish Co-Investment Scheme.¹⁰⁴ This highlights business angel groups as being the main beneficiary, accounting for 82% of the co-investments. By providing matched funding it has enabled these groups not only to make more investments but also to make investments that in the absence of the co-investment fund they would not have made, notably larger investments that require significant follow-on funding.

¹⁰² Murray, G. (1999). Early stage venture capital funds, scale economics and public support, *Venture Capital: an international journal of entrepreneurial finance*, 1, 351-384.

¹⁰³ Pierrakis, Y., Westlake, S. (2009). *Reshaping the UK Economy: the role of public investment in financing growth*. Research Report 91, NESTA, London.

¹⁰⁴ Hayton, K., Thorn, G., Percy, V., Boyd, C. and Latimer, K. (2008) *Evaluation of the Scottish Co-Investment Fund: A Report to Scottish Enterprise*. Glasgow: Hayton Consulting/GEN.

4.3.3 Implications for Business Angels

Evidence on business angel investment activity (from academic studies and consultations with angel groups and networks) indicate that business angels make significantly more investments than venture capital funds, especially at the start-up and early growth stages. However, because business angels make smaller investments the overall amount that they invest is lower than that of venture capital funds.

The reduction in the supply of early stage venture capital has had three consequences on the business angel community:

- Increased demand;
- the need to make bigger investments; and
- the need to make more follow-on investments

First, as they are increasingly 'the only game in town', business angels have experienced an increase in demand from businesses seeking finance for the first time. At the same time they are seeing more opportunities as a consequence of banks making fewer loans. Second, business angels are now seeing much larger investment opportunities from companies that in the past would have approached venture capital funds. A third consequence is that business angels are having to support their existing investee companies through more funding rounds instead of handing them on to venture capitalists. One of the knock-on effects of business angels having to provide larger sums of investment and make more rounds of follow-on funding before exiting – which has been well documented and is also supported through consultations with business angels and venture capital fund managers – is a reduction in their capability to make new investments.

The ability of business angels to fill at least some of the gaps left by the withdrawal of venture capital funds can be attributed to two main factors. The first factor is that the business angel community has responded to this changed investment environment by organising themselves into semi-formal angel groups. The obvious benefit of forming angel groups is that they have much deeper pockets than solo angels and ad hoc angel groups and so are therefore able to make bigger investments and make more rounds of finance, even taking firms to an exit without the need to involve other providers of finance such as venture capitalists. Advantages for the individual investor from working together include better deal flow, superior evaluation and due diligence of investment opportunities, and the ability to diversify their investments and to participate in bigger investments, as well as social attractions. Indeed, there is clear evidence, particularly in Scotland, that business angels groups now provide longer-term commitment, with five rounds of investments across seven years, before exiting, being typical (see Table 4.5).

Table 4.5: Archangel Informal Investment Group

Current Portfolio	
Average age investment	5 yrs
Average amount	£1.5m
Scottish Enterprise Co-Investment	18 out of 23
Venture Capital investment	4 out of 23
Average new deals per year	3
Average number of rounds	5
Average number of angels	22
5 profitable companies	5
Sectors:	27% IT; 27% High-Tech; 36% Life sciences
Outcomes	
Total invested	£57m
Total with others	£94m
New deals in 2008	1
Follow-ons in 2008	16
Scottish Enterprise	27
VC Investment	11
Scottish jobs created	600+
Companies seeded	63
Active	23
Failed/Moribund	29
Flotations	3
Profitable Sales	3 (5 trade sales in total)
Dividend paying companies	3

Source: Presentation by Barry Sealy on 'Angel investing in Scotland', Edinburgh University Business School, 8 October 2009

The second factor which has enabled business angels to go some way towards filling the funding gap has been the creation of co-investment funds which provide public sector funding to match private investments. Given the upper investment threshold on co-investment funds (£500,000) the main partners have been business angel groups. In most schemes, the co-investment fund invests on a pound-for-pound basis and on the same terms and conditions as the investment partner. As noted earlier, an evaluation of the Scottish Co-Investment Fund has been shown to stimulate investment and is strongly supported by business angels as they enable angels to fund larger investments. Hybrid funds have also been important co-investment partners for business angels. Nevertheless, even with the availability of co-investment schemes, evidence from the more mature Scottish market suggests that there is a natural tendency for angel groups to make fewer new investments as they mature. The implication is the need to continually create new angel groups able to invest in new growth opportunities.

A concern is that co-investment funds are overly dependent on European Investment Bank (EIB) and European Regional Development Fund (ERDF) funding, which is linked (typically) to economic deprivation and is patchy across the UK regions. Better coordination and extension of co-investment funds is supported by the business angel network BBAA who highlight the need for '[a] UK framework to support and promote angel co-investment fund development across the UK regions

[which would be] ...established by government (BERR), using both the ERDF and EIB framework, and centrally through Capital for Enterprise Ltd'.¹⁰⁵

Two other factors have been critical in maintaining a vibrant angel market. The first concerns tax-based measures to encourage high net worth individuals to invest in unquoted businesses. This approach was introduced in 1981 with the Business Start-up Scheme, which was extended to the Business Expansion Scheme (BES) in 1983. Under this scheme private individuals could reclaim tax at their highest marginal rate on investments in 'qualifying' companies. However, the operation of the scheme was deemed to be largely ineffective in meeting its original objectives of channelling funds to small companies, particularly in high technology sectors, as a result of being institutionalised by the financial services community which created investment vehicles to make large investments in asset backed companies.¹⁰⁶ The BES was replaced in 1993 by two new schemes. The Enterprise Investment Scheme (EIS) provides both front-end and capital gains tax relief on investments made directly in qualifying unquoted companies, and which therefore appeal mainly to business angels. Venture Capital Trusts (VCT) are collective investment vehicles which appeal largely to passive, retail investors. Funds raised by VCTs peaked at £780m in 2005-6 but fell back to less than £300m in 2006-7 and 2007-8 following a tightening up of the rules (see Table 4.6).

¹⁰⁵ 'Siding with the Angels' (p 9. NESTA and BBAA, May 2009)

¹⁰⁶ Mason, C.M., Harrison, J., Harrison, R.T. (1988), *Closing the Equity Gap? An Assessment of the Business Expansion Scheme*, Small Business Research Trust, London

Table 4.6: Venture Capital Trusts¹: Number (actual) of Trusts and Amount of Funds Raised (£ million)

Year	Funds raised ² (Amount)	VCTs raising funds in the year ³ (Number)	VCTs managing funds ⁴ (Number)	Rate of income tax relief (%) ⁵
1995 - 96	160	12	12	20
1996 - 97	170	13	18	20
1997 - 98	190	16	26	20
1998 - 99	165	11	34	20
1999 - 00	270	20	43	20
2000 - 01	450	38	61	20
2001 - 02	155	45	70	20
2002 - 03	70	32	71	20
2003 - 04	70	31	71	20
2004 - 05	520	58	98	40
2005 - 06	780	82	108	40
2006 - 07	270	32	121	30
2007 - 08	230	54	131	30
2008 - 09	150	46	129	30
Total	3,650	**	**	

Source: HMRC

1. The data sources are outside the managerial control of HM Revenue & Customs (HMRC) and therefore we cannot ensure their completeness and quality; hence, this table falls outside the scope of National Statistics.

2. The amount of funds raised by VCTs raising funds in each tax year, rounded to the nearest £5 million.

3. The number of VCTs raising funds in each tax year, consisting of both new VCTs raising funds for the first time and existing ones raising further funds.

4. The number of VCTs in existence in each tax year.

5. The rate of investors' income tax relief in each tax year; capital gains tax deferral relief was available until 5 April 2004.

** The totals are not given to avoid duplication of number of VCTs as VCTs can raise funds in multiple tax-years.

The Enterprise Investment Scheme covers qualifying investments made by private investors directly in small businesses and is designed to offset the high risks involved in making such investments. This risk is highlighted by research which indicates that at least half of all investment fails to return the capital invested¹⁰⁷. In recent years over 2,000 companies per annum have raised finance through the EIS, involving some £600m-£700m. This is down from the level at the peak of the dot.com boom in 2000-1 when over £1 billion was invested in over 3,330 companies. Informed comment suggests that the onset of the financial crisis will have resulted in a lower figure in 2008-9 (see Table 4.7). Evaluations of the economic impact of both schemes have been fairly positive. A 2003 evaluation noted that between 52% and 87% of the finance invested through the two schemes was additional (i.e. would not have been invested in SMEs in the absence of the schemes) and that the investment has a

¹⁰⁷ Mason, C M and Harrison, R T (2002) Is it worth it? The rates of return from informal venture capital investments, *Journal of Business Venturing*, 17, 211-236.

Wiltbank, R (2008) *Siding with the Angels: business angel investing – promising outcomes and effective strategies*. London: NESTA

positive impact on the growth of the investee companies.¹⁰⁸ A 2008 evaluation, which just focused on company performance, again found that investments made under the schemes had positive effects on the investee companies.¹⁰⁹ Consultations with members of the business angel community confirm that tax incentives play a critical role in stimulating angel investment activity.¹¹⁰ However, as angels are investing larger amounts in their investee companies so they risk being hit by two restrictions of the scheme: (i) its limitation to companies with 50 employees or less; (ii) 30% maximum shareholding per company.

Table 4.7: Enterprise Investment Scheme: Number (actual) of Companies Raising Funds, Number of Subscriptions and Amounts Raised (£ million). Claims Received by November 2008¹

Year	Companies raising funds for first time (Number)	All companies raising funds (Number)	Subscriptions ² (Number)	Amount
1993-94	77	77	482	4
1994-95	399	427	4,969	41
1995-96	439	550	5,142	53
1996-97	474	651	11,819	94
1997-98	532	725	11,396	113
1998-99	1,036	1,267	15,341	294
1999-00	1,641	2,106	29,349	614
2000-01	2,378	3,314	45,765	1,061
2001-02	1,685	2,856	25,483	759
2002-03	1,338	2,455	27,639	667
2003-04	1,147	2,172	28,139	627
2004-05	1,204	2,184	32,323	605
2005-06	1,143	2,126	31,476	645
2006-07p	1,057	2,062	39,039	699
All Years	14,550	n/a ³	308,362	6,276

Source: HMRC, EIS1 forms

1. At most, companies have up to three years after shares are issued to submit an EIS1 compliance statement. Therefore, with the likelihood of sizeable revisions due to claims not yet received

2. The number of subscriptions is not equal to the number of investors as an individual can invest in more than one company

3. The total is not given as companies may raise funds in more than one year

The second factor that has been critical in maintaining a vibrant angel market is the support that the public sector has provided towards the costs of operating **Business Angel Networks** (BANs). These are organisations which have sought to provide a superior channel of information between business angels seeking investment

¹⁰⁸ Boyns, N, Cox, M, Spires, R and Hughes, A (2003) *Research into the Enterprise Investment Scheme and Venture Capital Trusts*, PACEC, for Inland Revenue.

¹⁰⁹ Cowling M, Bates P, Jagger N, Murray G (2008) *Study of the Impact of Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT) on Company Performance*. HM Revenue & Customs, Research Report 44.

¹¹⁰ Also confirmed by Wiltbank, op cit

opportunities and entrepreneurs seeking finance in order to stimulate investment activity. Both business angel networks and economic development agencies have also supported capacity building programmes which help entrepreneurs to become investment ready and to raise the competence of investors.¹¹¹

It is clear, however, that despite this support business angels are unable to meet the scale of the demand for finance. An illustration of this mismatch from one of our consultees is that the London Business Angels estimates that they receive 1,000 'serious' enquiries a year but only 5% go forward for presentation to investors. This is not atypical. With the emphasis of business angel markets on 'investment pitches' there are a finite number of slots available. Business angel investing is considered interpersonal and not amenable to being replaced by internet matching.¹¹² Research by NESTA and BBAA recognised the issue of business angel supply, and proposed a national awareness raising campaign and capacity building actions, which are both in the process of being undertaken.¹¹³

Comparison of the support that countries across Europe give to business angels (through tax breaks, financial support, co-investment funds, etc.) that is collected by EBAN (European Business Angels Network) suggests that other countries have caught up with the UK in terms of business angel support and in some cases, for example France, are now ahead. Indeed, one leading angel support organisation in the UK felt that on balance, other countries, such as France, were giving more financial support to the angel market, for instance large co-investment funds and better support networks, which were better equipped to engage business angels and entrepreneurs in investment ready training. In the UK most networks have to attract paying customers to deliver training and support, hence the current climate has reputedly seen London Business Angels (LBA) stop its angel training activities.

4.4. Business Angels – Venture Capital Disconnect

In the funding escalator model, business angels and venture capital funds have often been described as complementing one another.¹¹⁴ Indeed, the early stage venture capital market has often been described as a relay race in which "angel investment runs the critical first leg of the race, passing the baton to [the] venture capital [fund] only after the company has begun to find its stride". However, this model appears to have broken down. An indication of the growing disconnect between angel groups and venture capitalists is exemplified by the trend that angel groups are increasingly only investing in deals that they can fund themselves to an exit. This has repercussions for the growth markets' role in the funding ladder.

There are three factors driving this disconnect. First, there are differing investment practices and philosophies between angels and venture capitalists (some venture

¹¹¹ For a review of interventions to support the informal venture capital market, see C M Mason (2009) Public policy support for the informal venture capital market in Europe, *International Small Business Journal*, 27 (5) 536-556.

¹¹² The BBAA were not supportive of businesses signing up to private angel matching web-sites

¹¹³ See Policy Measure 4, page 9 from 'Siding with the Angels', NESTA and BBAA, May 2009.

¹¹⁴ Harrison, R T and Mason, C M (2000) 'Venture capital market complementarities: the links between business angels and venture capital funds in the UK', *Venture Capital: An International Journal of Entrepreneurial Finance*, 2, 223-242.

capitalists would also add 'professionalism'¹¹⁵). Angels provide not only financial support but also mentoring and advice. As such, the business angel invests not only finance but intellectual and emotional capital, guiding the SME through the early phases of growth. The result is that angels often have a stronger affiliation to the entrepreneur, whereas venture capitalists tend to be driven by a financial return. Angels are also more patient investors (prepared to work alongside the business for longer periods of time – up to 10 years) than venture capitalists (three to five years). Consultations with both groups indicate what appears to be an increasing divergence in philosophies and practices. Second, there is a lack of venture capitalists to undertake follow-on investing – as previously discussed. Third, the design of the Enterprise Investment Scheme (EIS) requires angels to invest using ordinary shares¹¹⁶ to qualify for tax relief, whereas venture capitalists almost typically use preference shares and convertible loans¹¹⁷. This disadvantages Angels when negotiating joint investments or when a company with existing angel investment seeks further investment from venture capitalists. It also forces the premature valuation of a company.

One implication of the disconnect is that the emergence of global businesses, which might require in excess of £20m in investment, will be compromised if they are unable to access the deep financial resources of venture capital funds. Instead, business angel investors might feel the need to seek a premature exit either via a trade sale or an IPO.¹¹⁸ In both cases the consequences for the company may be negative.

The current rules for how to qualify for EIS tax relief, as mentioned above, are considered to be particularly negative to business angels, and merit further attention. Consultations with the BBAA and LINC Scotland corroborate recent research findings¹¹⁹ that the EIS stimulates investments in higher risk, early stage companies but that EIS rules disadvantage the business angel community in relation to venture capitalists. LINC Scotland has produced a note on the EIS tax structure and how it impacts upon informal investing.¹²⁰ Text from the note, supported by consultations findings, underpins the following two paragraphs.

LINC Scotland suggests that the current structure of EIS may 'restrict the number of individuals committing to be serial entrepreneurs, reduce the amount of capital available for business angel investing (by locking it up in low growth companies),

¹¹⁵ Though venture capitalists consulted agree that angels now undertake more thorough valuation and due diligence research than previously.

¹¹⁶ The most common form of share in the UK - also known as equity shares.

¹¹⁷ Preference shares (prefs) are legally shares, but they are very different from ordinary shares. The economic effect of prefs is more like that of bonds. They are regarded as hybrids of debt and equity. By comparison, American and many European business angels invest through Cumulative Convertible Preference shares (CCPs), which are also favoured by venture capitalists, and indeed this is considered good practice.

¹¹⁸ Consultations suggest that the public markets are typically perceived to have little relevance for angel groups as an exit route. The few examples of angel backed companies which were floated, that stakeholders consultations identified, indicated that angels sell immediately post flotation as price falls have been the norm.

¹¹⁹ 'Siding with the Angels' (NESTA and BBAA research, May 2009) states that 82% of angel investors surveyed had used the EIS.

¹²⁰ 'Note on UK tax structure and informal investing': A response to the HMRC consultation on EIS (Nelson Gray of LINC Scotland, 2008)

and encourage angels to seek exits for their investee companies rather than seeking further development capital from venture capitalists. The result is that angels often suffer cram down by venture capitalists. Although the business angel may have supported the company through the earliest, and most risky, period of its development, the terms imposed by the venture capitalists mean that the angel receives a substantially reduced return as a result of the venture capitalists slicing off the majority of any early return. This may act as a disincentive for the business angel to encourage the company to seek venture capitalists development capital' (p.1). The implication is that the EIS structure acts as a disincentive for the Angels who may favour an early exit rather than seek venture capitalists follow on financing. The proposition put forward by consultees is that business angel investors should be able to invest using preference shares and the EIS investment rules needs to be realigned to allow this.

LINC Scotland also sets out how the current arrangements of EIS disadvantage very early stage investment by business angels. There is a wealth of evidence which illustrates the contribution business angel investors make to very early stage businesses through hands on personal assistance and guidance (e.g. development of viable business plans), as well as financial support (say up to £50,000).¹²¹ Over time, if it becomes apparent that the company is incapable of generating the level of return required to attract further investment, the angels' initial investment will be locked in to a company and unable to provide a return on investment. The current structure of the EIS can therefore discourage angels from becoming involved in early stage companies and should be changed. Our research also supports the NESTA and BBAA proposed policy measure to increase EIS tax relief for business angel investors making very early stage investments in micro SMEs, in recognition of the significantly higher investment risks borne¹²².

One consultation highlighted the success of a French annual tax on wealth, which allows investors to obtain an exemption if they invest in unquoted companies. According to a leading practitioner from the business angel sector, this tax has reportedly raised more than the UK's Enterprise Investment Scheme in just a few years. To avoid issues of state aid rules, these investments are applicable to any location across Europe. Given the success of this tax, an assessment should be undertaken to consider the benefits of applying a similar tax in the UK.

4.5. 'Closed' IPO Markets and Trade Sales

The markets themselves actively influence the provision of pre-market equity finance. The performance of the markets impacts on the liquidity of listed companies and their capacity to undertake merger and acquisitions (M&A) activity. Markets also affect the wealth and psyche of business angels (if angels are getting cash and dividends from their stock market investments this raises morale, giving them disposable money to invest in angel deals).

¹²¹ Mason, C.M. (2006) Informal sources of venture finance, in S C Parker (ed) *The Life Cycle of Entrepreneurial Ventures*, New York: Springer: New York, pp.259-299.

¹²² 'Siding with the Angels' (NESTA and BBAA research, May 2009) states that 82% of angel investors surveyed had used the EIS.

The decision whether or not to seek an IPO is influenced by both generic and time-specific considerations. There are two key generic influences. First, as noted in Chapter 3, because of the costs involved in obtaining and maintaining a listing it will be uneconomic for smaller businesses to seek an IPO. Second, investors may prefer a trade sale instead of an IPO because they are able to get cash immediately and so are not subject to a 'lock-in' or to the risk that the share price might fall (however, this only applies in the case of an all-cash purchase, and by no means all acquisitions of SMEs take this form). In addition, strategic buyers might be willing to pay a price premium. A case study in point is the recent decision by Venture Capital investors to sell Manchester-based biotechnology company DXS to Qiagen, a Dutch biotechnology company (see Case Study A).¹²³

Once an SME has floated on the market, the ease by which an investor can access their money is influenced by liquidity – that is the ease with which it is possible to trade. Markets with a large number of small and mid cap companies typically face an ongoing challenge to maintain appropriate levels of liquidity, and AIM and PLUS are no exception. The implication is that if there are low levels of liquidity, investors (business angels and venture capitalists) will find it harder to sell their shares. Consultations highlighted liquidity as a major concern which can deter investors from floating companies on the market. As such, low levels of liquidity can add to the view of a closed IPO market. We address the issue of liquidity further in Chapter 5.

In 2008 and 2009 the number of IPO and volume of further fundraising on AIM and PLUS fell significantly. The depressed nature of the IPO and further fund raising, with its knock-on effects on the M&A market, means that business angels and venture capital funds are unable to exit. This is a further factor which has required investors to reserve a higher proportion of their funds for follow-on investments and which, in turn, reduces their ability to make new investments. It also prevents them from returning funds to their limited partners. This discourages limited partners from making new investments in the venture capital asset class, which in turn reduces the number of new venture capital funds. More generally, if the negative aspects of flotation (such as risk of overvaluation leaving the investor company 'locked-in' due to share value falls post flotation) are perceived to outweigh the benefits then this will discourage companies and their backers from seeking a stock market listing.¹²⁴ One AIM company commented that for its first rights issue after listing it had to give a discount on share prices to attract investors. One consequence may be to favour a trade sale over an IPO as a means of achieving an exit.

One venture capital firm invested in UK SMEs with the specific intention of grooming the businesses for sale to American companies (such as Cisco or Microsoft, which have distribution channels and global market reach already in place). The implication here is that once sold, there will be great pressure for the business to become a US resident company. Trade sale to a foreign company may therefore translate as a loss to the UK economy in terms of economic opportunity (enterprise,

¹²³ Case study sources: Interview with Fidelity Ventures, YFM and media reports

¹²⁴ However, it should be noted that despite the fall in share prices the majority of companies on AIM have no regrets. This suggests that AIM is fulfilling its function of providing companies with access to capital, liquidity, an exit for investors and facilitating acquisitions (AIM Annual Survey 2009)

employment, management training, innovation, productivity, taxation). It may also inhibit innovation potential of a firm as it is sucked into a larger organisation.

Case study A: Venture Capital exit via M&A driven by strategic benefits

Investors in venture capital backed DXS had considered both trade sale and IPO options as exit routes. The decision to exit through a sale to Qiagen was made because the buyer was able to offer a better valuation because of its strategic significance.

Manchester-based biotechnology company DXS, which calls itself 'the personalised medicine company', was bought by the Dutch biotechnology company Qiagen in a deal that could be worth \$130m, generating a 13 fold return and IRR of 39% to NVM Private Equity which provided DXS with start-up capital of £1.25m in 2001 and led two further rounds in 2004 and 2006, which raised its total investment to £3m, and brought in YFM and Hygea as co-investors. The deal generated an 11-fold return for YFM which invested through its North West Investment Scheme and British Smaller Technology Companies VCT2. Qiagen will pay approximately \$95m in cash to acquire the entire outstanding share capital of DXS and an additional \$35m if specified commercial milestones are met. Qiagen, whose shares are traded on Nasdaq and Frankfurt, and has spent almost \$1m on acquisitions since 2004, is issuing new shares to help fund the acquisition and for potential other acquisitions. Qiagen's sales may pass \$1 billion this year for the first time as a result of this expansion, one of just a handful of diagnostics companies with this level of sales.

YFM originally invested in 2004 when the company had 13 staff, sales of £400,000 and operated exclusively in North West England. It now employs 80 staff, forecasts sales of £20m and has operations across the USA. The deal was completed in September 2009.

With this acquisition Qiagen has taken a strong leadership position in the new era of personalised healthcare. DXS brings to Qiagen a portfolio of molecular diagnostic assays that allow oncologists to predict patients' responses to certain cancer treatments in order to make them more effective and safer, intellectual property, and a pipeline of active or planned companion diagnostic partnerships in oncology with several pharmaceutical companies. These assets complement Qiagen's existing strong portfolio of personalised healthcare diagnostic solutions. All of DXS's assays are suitable for use with Qiagen's existing suite of instruments. Qiagen's CEO Peer Schatz said that "the acquisition of DXS is strategically a highly important transaction for Qiagen. It is a key element in our strategy to lead in molecular diagnostic-based prevention, profiling and personalised healthcare." In a statement to its shareholders Qiagen went on to say that "the acquisition creates an un-matched portfolio for personalised healthcare and builds a strong foundation for diagnostic solutions ... By merging our two operations, we create an independent companion diagnostics provider with a full set of global functions and expertise in molecular diagnostics, assay design and development, intellectual property, global and regional regulatory compliance and customer reach through strong, well established sales and marketing channels." DXS's founder and CEO, Stephen Little, commented that "Qiagen is the ideal partner for DXS to globally roll out our assays, to take our partnerships to the next level and to take a leadership position in companion diagnosis." Continued overleaf...

Continued...

DXS's senior management will join Qiagen in leading roles in the company's rapidly expanding personalised healthcare focus area, facilitating rapid integration and focus on further expansion of this key segment. To achieve this objective, Qiagen proposes to establish a Centre for Excellence in Pharma Partnering at DXS's Manchester HQ which should, as a consequence, grow in size.

Source: interview with BVCA, Yorkshire Fund Managers and media reports

The argument for and against putting a company up for sale are complex. Venture capitalists tended to argue the negative case – that trade sale prompts a loss in the potential UK headquartered global companies, loss of management training ground, loss of future acquiring companies. While acquisition provides access to finance, management and distribution channels, the longer term economic impact is often negative. The new owners may not understand the business they have acquired as well as the entrepreneur and so do not exploit fully its real potential; the acquired company may be integrated into its new parent company in a way which limits its growth; the entrepreneurial flair and creativity of such companies is often stifled as part of a big organisation¹²⁵; and where the acquiring company is foreign, it may seek to relocate the intellectual assets to its home country. In many cases the outcome in the medium to longer term is that the acquired company gets shut down (see Mason and Harrison for examples¹²⁶).¹²⁷ The contrary view to this argument is that of entrepreneurial recycling: entrepreneurs whose companies are sold will use the trade sale money to instigate other entrepreneurial activity, become serial entrepreneurs, act as business angels or even set up venture capital funds¹²⁸ - that is, they recycle their entrepreneurial skills which benefits the UK economy. Moreover, if all the owner-managers act in this way these impacts are multiplied. In addition, it can be argued that if entrepreneurs are financially secure then they may be more ambitious with their next business venture. The biggest risks probably arise when a sale is premature. From the perspective of the SME business angel or venture capital investor, a trade sale provides liquidity to re-invest.¹²⁹

Whether a trade sale brings about economic loss or a gain, a complete funding escalator (without equity gaps) would provide more choice to investors and

¹²⁵ ACOST (1990) *The Enterprise Challenge: Overcoming Barriers To Growth in Small Firms*, HMSO.

¹²⁶ Mason, C M and Harrison, R T (2006) 'After the exit: acquisitions, entrepreneurial recycling and regional economic development', *Regional Studies*. 40, 55-73.

¹²⁷ One very topical example is the case of Award Ltd in Livingstone, Scotland. This company, which was formed in 1993, was based on an innovative process of manufacturing contact lenses so cheaply that they could be disposable. Having grown the company to 100 employees the founders sold out to the US healthcare company Bausch & Lomb in 1998. Under its new ownership the company quickly expanded to 1,400 employees. However, two years ago its workforce was reduced to 500 and in early September 2009 it was announced that the plant would be closed and production switched to one of the company's other plants in Ireland.

¹²⁸ There are also a number of specialist early stage venture capital funds which have been established by former entrepreneurs, such as Pond, Celtic House, Passion Capital, Profounder.

¹²⁹ For a study of the entrepreneurial recycling process see Mason, C M and Harrison, R T (2006) 'After the exit: acquisitions, entrepreneurial recycling and regional economic development', *Regional Studies*. 40, 55-73.

entrepreneurs in growing their businesses, and bring more opportunities to the City and the financial and business services which support the markets.

4.6. Summary

Chapter 3 set out the funding escalator model to describe the idealised way in which growing businesses are financed at various stages in their development. This Chapter has introduced a reality check by highlighting several ways in which the funding escalator is operating inefficiently as a consequence of changes in the financial environment.

First, new technology based firms, which need access to finance at the pre-revenue stage, often have difficulty proceeding onto the funding escalator because of the lack of seed capital, or are able to get onto the escalator by accessing public sector seed capital but are then unable to progress or even fall-off because they cannot raise follow-on finance.

Second, the decline in the availability of early stage venture capital has put pressure on business angels to make more investments, bigger investments and more funding rounds. Co-investment funds and investing alongside hybrid funds has given them the liquidity to do so. Tax incentives available under the EIS have also been critical. However, EIS has not caught up with the significant changes in the nature of angel investing. Rules that were appropriate to the 1990s, when angels typically invested on their own and made small, one-off investments in new or early stage businesses, are now becoming restrictive as angles make bigger investments and follow-on investments.

There are limits to the capacity of business angels to make bigger investments so they still need to be able to pass on their larger investments to venture capital funds. This is compromised by the requirement to invest in ordinary shares to qualify for EIS tax relief which puts angels at a disadvantage to venture capital funds in terms of valuation and returns.

Government interventions have generally proved inadequate to fill the gaps in the funding escalator, mainly because of design flaws. The small size of funds and maximum limits on the amount they could invest in individual businesses meant that firms which raised funding from these funds often had to seek further funding from other sources to continue their growth.

Finally, there is a disconnect between angel and venture capital investors and the public market. These investors typically seek an IPO as an exit route but as significant shareholders they are likely to be subject to a 'lock in' period during which time there is a risk that the share price might fall. Instead they often opt for a trade sale. This represents a potential loss to the public markets as well as having potentially negative effects for both the business and economy. The operation of the public market is discussed in more detail in Chapter 5.

The overall criticism that can be made is that the system of equity funding of SMEs prior to IPO is too fragmented. The small scale of public sector funds and restrictions on their size of investments limits their ability to make follow-on investments. The limited financial resources of business angels, notwithstanding the emergence of

business angel groups, and the structure of venture capital funds which focus on particular stages, rather than providing funding from 'cradle to grave' (or, more appropriately, from start-up to IPO), in contrast to the US, combine to create a system which 'drip feeds' finance to growing businesses. This wastes the time of management who have to engage in repeated searches for finance, taking their attention off their business, and reduces the potential returns of the investors in the earliest rounds who get diluted if they do not, or cannot, follow-on their initial investment. Enterprise Capital Funds (ECFs), a variant of the US Small Business Investment Company (SBIC) model, are an initial attempt to meet this need for 'seamless' investment. ECFs, which are able to make investments up to £2 million are privately managed funds that leverage private investment with public funds, ten funds have been launched since 2006.¹³⁰

These various disconnects are having consequences for the funding escalator. First, the lack of seed capital is creating difficulties for start-ups at the pre-revenue stage, preventing them from getting on, and then staying on the funding escalator. Second, it is changing the behaviour of some angel investors in favour of fast exits.¹³¹ This takes advantage of the smaller amounts of money needed to start and grow a technology company so it can reach critical milestones quicker and with less investment. Meanwhile there are plenty of large technology companies with buy-to-build strategies looking to buy young technology businesses with products that they can 'bolt-on' to their existing offerings (as illustrated in the DXS – Qiagen case study). This makes it possible for angels to fund a company to an exit without needing to raise follow-on funding from venture capital firms. It also encourages growing businesses to exit the funding ladder in favour of a trade sale.

Third, for many companies the funding ladder is likely to end with a takeover rather than an IPO. This is likely to be increasingly typical not just of business angel investments but also venture capital backed companies. The acquisition of growing companies by larger companies raises the question whether it is desirable from the perspective of the UK economy.

¹³⁰ We understand that there has been no evaluation yet undertaken on the ECF.

¹³¹ See Peters, B (2009), *Early Exits* (First Choice Books, Canada) and <http://www.basilpeters.com>. Also "Super angels shake up venture capital", *Business Week*, 21 May 2009.

5. THE ROLE AND EFFECTIVENESS OF PUBLIC MARKETS

5.1. Introduction

This chapter is concerned with the role and effectiveness of AIM and PLUS as platforms for UK SMEs to raise equity finance. We first look at the characteristics of the markets, including the geographical and sector spread of businesses accessing AIM, trends in IPO and fundraising activity, and the impact of the recent economic downturn. Outside the UK, the fortunes of growth markets have been varied and we reflect briefly upon the factors that have contributed to the success of the UK growth markets. We discuss too the key challenges which face the markets, which impact upon their effectiveness, such as liquidity and regulation regimes, including the implications of wider EU legislation.

As a more established market, we have been able to access more information pertaining to AIM than PLUS, and this is reflected in the discussion.¹³²

5.2. Market Characteristics

Below we set out the characteristics of the markets by describing the distribution of SMEs quoted, by size, location and fund-raising activity. Through our analysis we highlight the role and effectiveness of the markets in supporting SMEs' access to growth finance.

5.2.1 Geographical Reach of AIM¹³³

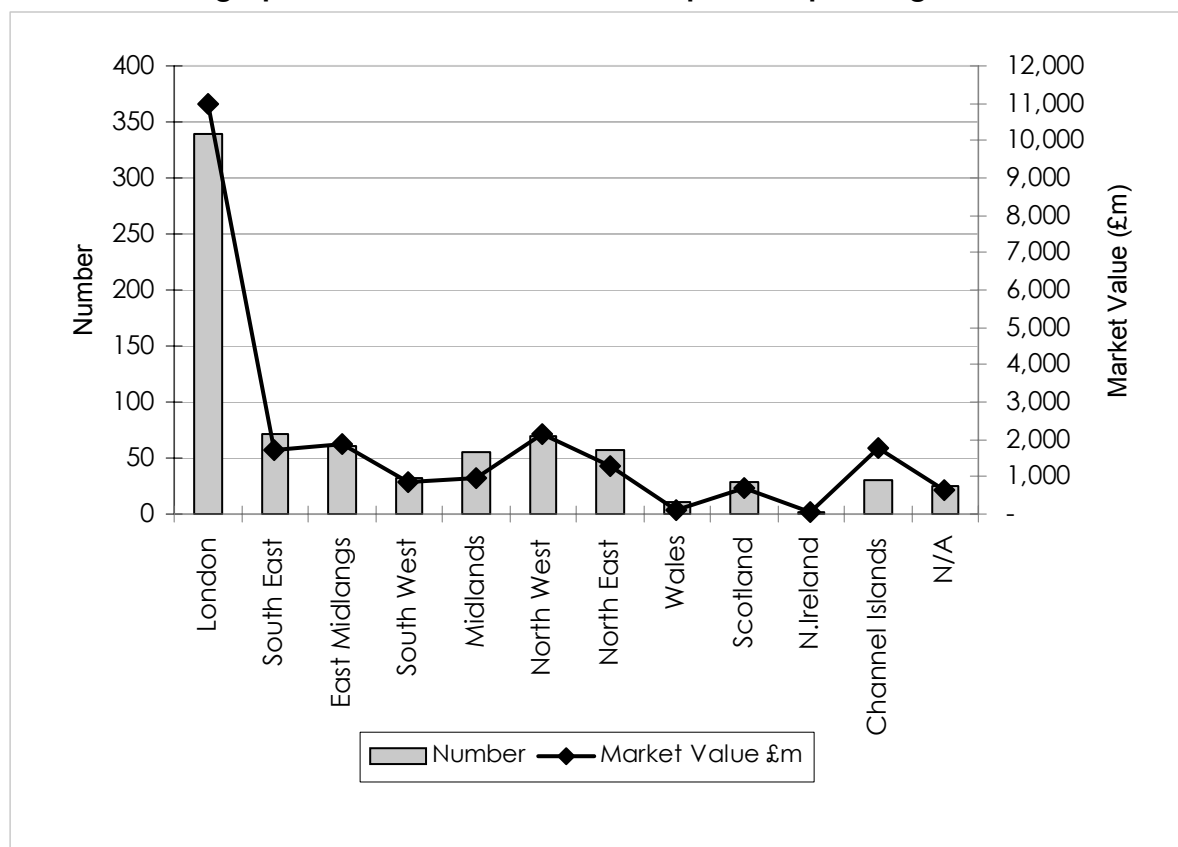
To maximise their role as platforms for raising equity finance, growth markets need to attract all SMEs, irrespective of location, to list and raise funds. At the end of January 2010 of the 1,277 companies on AIM, 1,038 were incorporated in the UK and 239 overseas. Twenty-five per cent of the UK incorporated companies had their main operations overseas – and a small number of overseas incorporated AIM companies had their main operations in the UK. In all, 783 AIM companies had their main operations in the UK. Chart 5.1 shows the number of companies and the total market value of these UK companies by region. There are caveats to note however - the stated location of head office and operation can be different. For example, companies which have their head office in London and their operating facilities outside London may well be counted as London companies. Indeed many of the companies, such as pub chains, will have nationwide operations.

London aside, the proportion of SMEs by region on AIM is broadly reflective of the proportion of SMEs per region, though the representation of companies from Scotland, Wales and Northern Ireland (which given the local financial hub in each region might be thought less likely to opt for a London head quarter) is low – a mere 40 companies (5%) of the total.

¹³² During this study ongoing liaison took place with the London Stock Exchange with regards to obtaining relevant market data. Detailed discussions with senior members of both AIM and PLUS were held and, alongside a range of other market practitioners, have informed this Chapter.

¹³³ Geographical analysis of AIM companies is based on monthly statistics published by the London Stock Exchange. The statistics only provide detail of the regional location of each UK company's head office and are therefore a limited representation of AIM's geographical reach.

Chart 5.1: Geographical distribution of AIM companies operating in the UK.



Source: London Stock Exchange published statistics

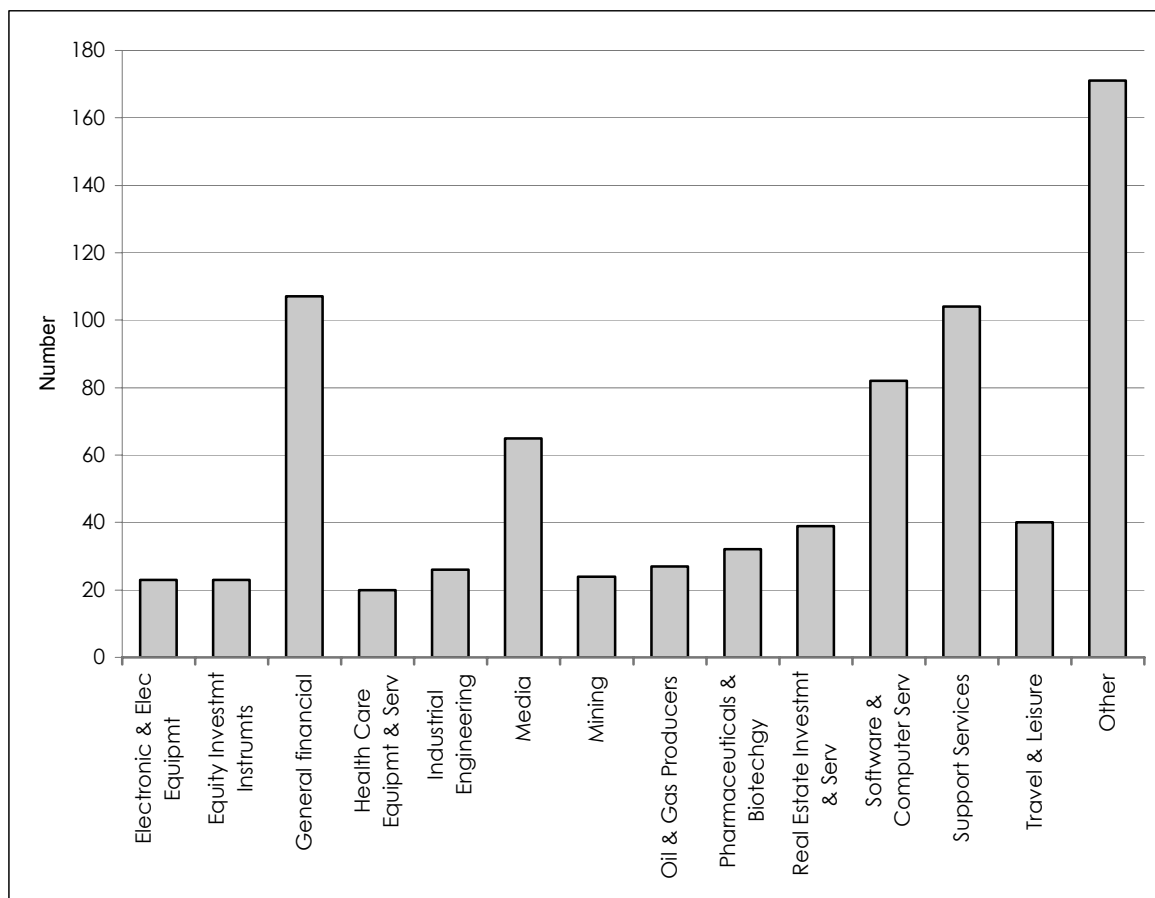
The high proportion of London based SMEs is likely to be due to the large number of SMEs located in London (though as Chart 5.1 shows the number is in line with that of the South East, which is comparatively under-represented) and the strength of the UK financial community, which will positively influence access to the markets. Anecdotal evidence suggests that some advisers based outside London are reluctant to see their client companies floated on AIM / PLUS for fear of losing them to a London-based adviser.

AIM demonstrates geographical coverage across the UK although in the future this could be enhanced to increase SME representation in certain UK regions. This highlights the need for markets to ensure marketing activities and awareness rising extend throughout the UK, and for particular effort to tackle any misperceptions held by the financial community and SMEs located outside London.

5.2.2 Sector Distribution of AIM

Growth markets are often seen as the forums for companies in newer industries, higher risk sectors and sectors where smaller companies are the norm. A sector analysis of AIM companies with UK operations is shown in Chart 5.2, which details the industry sectors with more than 20 constituent companies.

Chart 5.2: Industry distribution of AIM companies with UK operations



Note: The 'other' category includes over 20 sectors which have less than 20 companies represented on AIM. Sectors include, amongst others: aerospace and defence (2); alternative energy (10); beverages (4); chemicals (10); construction and materials (19); electricity (12) food producers (16); and mobile telecommunications (11).

Source: London Stock Exchange published statistics

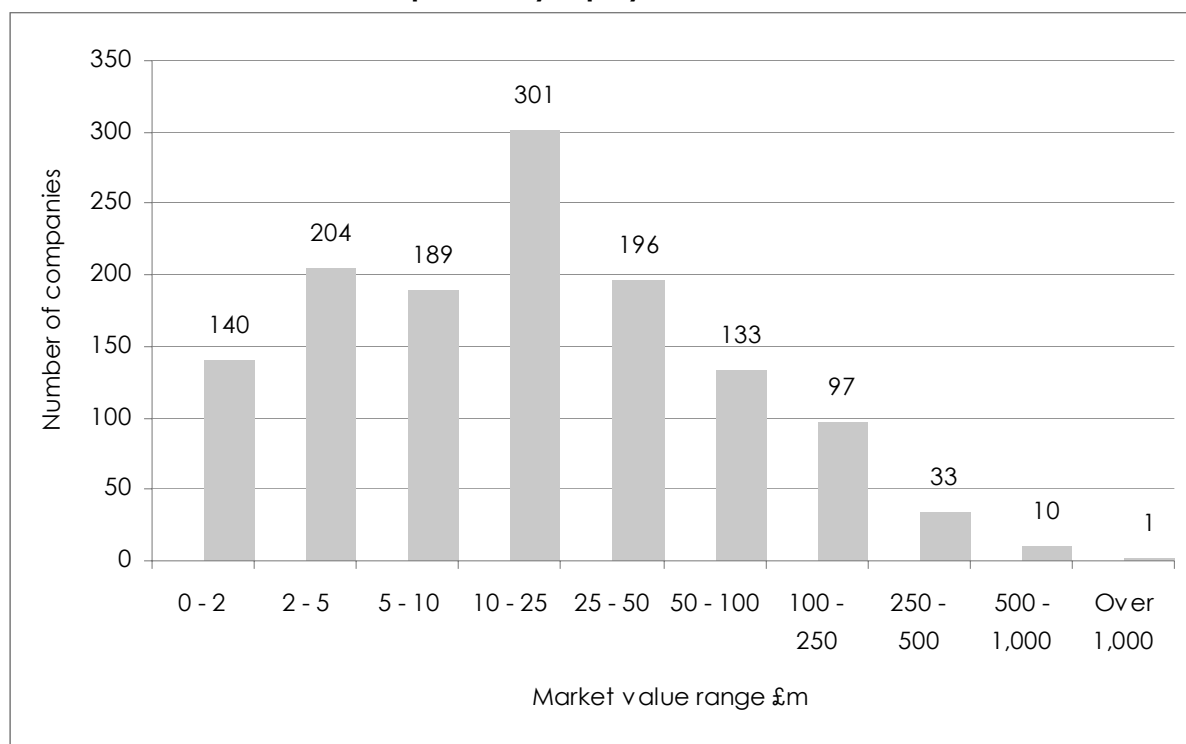
AIM has been successful in providing a platform for companies from a range of sectors to raise finance, adding to the market's cyclical resilience. Particularly well represented are Support Services (driven by the large number of start-ups consequent upon out-sourcing of functions) and Software and Computer Services companies. Media companies are also well-represented as are General Finance companies (including a large number of investment companies).

5.2.3 Market Size¹³⁴

AIM has been a considerable success for the London Stock Exchange. Since opening in 1995, AIM has grown steadily to the current position of 1,277 companies (1,038 of which are UK incorporated companies) with a market value exceeding £58bn. While the early 2000s saw tough trading conditions for growth markets which led to some closing (for example both the German and French growth markets have been abandoned – though subsequently reopening in different forms), AIM has grown¹³⁵. Contributing to this success has been the regulatory framework, marketing activities of AIM successfully targeting a wide range of companies, rather than focusing on particular sectors such as high-technology (a sector that has suffered since the dotcom crash in 2000) and the London Stock Exchange brand.

By size, companies trading on AIM are spread across a range of market values with the main concentration being in the band £10m - £25m. There are 140 companies trading on AIM with an equity market value of less than £2million (see Chart 5.3).

Chart 5.3: Distribution of Companies by Equity Market Value



Source: London Stock Exchange, October 2009 Fact sheet

There has been a growth in the admission of micro-caps on AIM and PLUS.¹³⁶ Due to the disconnects in the funding escalator, according to market operators the likelihood of a business angel bringing an SME to float on the growth markets is now

¹³⁴ Data as of October 2009

¹³⁵ AIM saw positive growth up to 2007, but then negative as the economic downturn took hold.

¹³⁶ There is no official definition for the market value of micro-caps. In this instance we refer to a company with a market value of under £10million.

stronger than at any other time.¹³⁷ Growth markets are said to be playing the role of venture capitalists. Consultations with SMEs highlighted the benefits of the wider pool of capital that growth markets offer as well as the ability to raise further funds via issues post flotation, whereas venture capitalists may offer a staged payment tied to earn-out.¹³⁸ It could be said that AIM is acting as 'venture capital with a quote'.¹³⁹

PLUS-quoted is one of the capital market offerings of PLUS Markets, an independent small and mid-cap stock exchange which gained Recognised Investment Exchange status in 2007, giving it the same regulated status as the London Stock Exchange. PLUS's SME entry criteria is described as clear, transparent and unequivocal – factors which have proved a positive in attracting SMEs to seek a listing with PLUS. PLUS has 194 companies on its market with a total market value of £2,525m. The total market value is dominated by the top five companies which represent 62% of the total (these include RAK Real Estate, a UAE company developing a new financial centre, and Arsenal FC). More PLUS companies are smaller than most of those on AIM – a significant number of PLUS companies are worth less than £1m. The average quantity of money raised through IPO or further issues is very much smaller than the norm on AIM (see Table 5.1). It should be noted that PLUS does not position itself as a feeder market to AIM or the London Stock Exchange Main Market.

Table 5. 1. AIM and PLUS Market Value, IPO and Further Issue Comparisons

	AIM	PLUS
Average market value of admissions	£42.9m	All companies: £13m If top 5 largest excluded: £5m
Average IPO value (Jan 2006 - Oct 2009)	£26.4m	£0.82m
Average further issue value (Jan 2006 -Oct 2009)	£6.7m	£0.28m

Source: London Stock Exchange, PLUS Markets

5.2.4 Fundraising

Since its inception in 1995 AIM has raised a significant amount of equity finance £65.9bn, of which £33bn was at admission. Of the total, £47.4bn was for UK incorporated companies, of which £24bn was at admission and £23.4bn through further issues. Of the companies admitted to AIM, 60% have been UK companies with an initial value of less than £25m. Of the companies that raised money through an IPO on AIM (many companies join by introduction i.e. not raising money) 40% have a market value at the time of the IPO of below £10m, and 84% had a value below £50m.

¹³⁷ Admission to AIM typically costs upwards of £400,000. It is therefore only economically viable for SMEs with the ability to raise a certain size of investment to undertake an IPO.

¹³⁸ The acquiring company typically pays 60–80% of the purchase price up front with the remaining 20–40% structured as an 'earn-out', paid out over time as the acquired company achieves certain levels of sales or profitability.

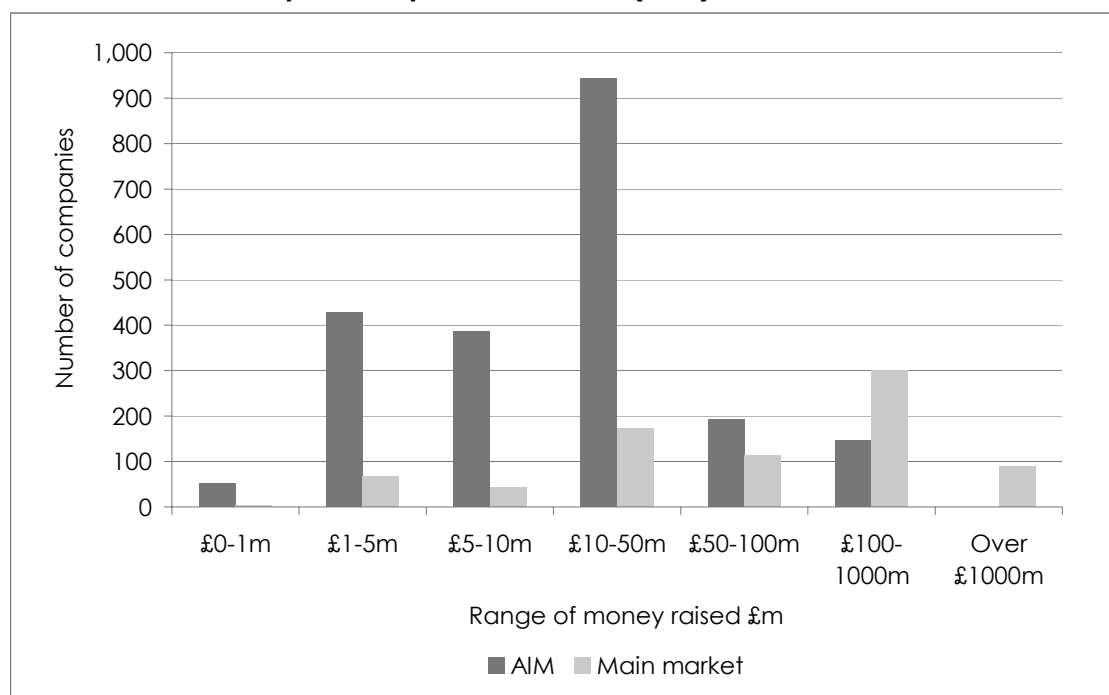
¹³⁹ Institutions stand by London's junior market despite difficult year, *Financial Times*, 18 December 2009

PLUS has been in existence for a shorter time period but has still been very successful. In the period January 2006 to September 2009 PLUS issues raised a total of £88.6m, of which £23.9m was through 29 IPOs and £64.7m through 230 secondary offerings.¹⁴⁰

The size of companies joining AIM clearly marks out the domain of AIM in comparison to the London Stock Exchange's Main Market. Valuation at admission and market choice are strongly linked: companies valued up to £10m market at admission are almost certain to join AIM; companies valued between £10-50m are likely to join AIM; larger companies are most likely to opt for the Main Market, as illustrated in Chart 5.4. This is also reflected in the current valuation of companies on both markets. The median market value of an AIM company at 31 January 2010 was £14m compared to median market value of around £95m on the Main Market.

In addition to a company's size, a variety of factors impact a company's choice of market, including its trading history, investor demand and ability to cover costs of being on a public market. Smaller companies are more likely to join AIM as it provides a regulatory framework tailored to them and a platform to increase their profile and visibility amongst similar-sized peers. Over time, as companies progress through their development cycle they may choose to move to the Main Market.

Chart 5.4: New Companies by Market Value (AIM)



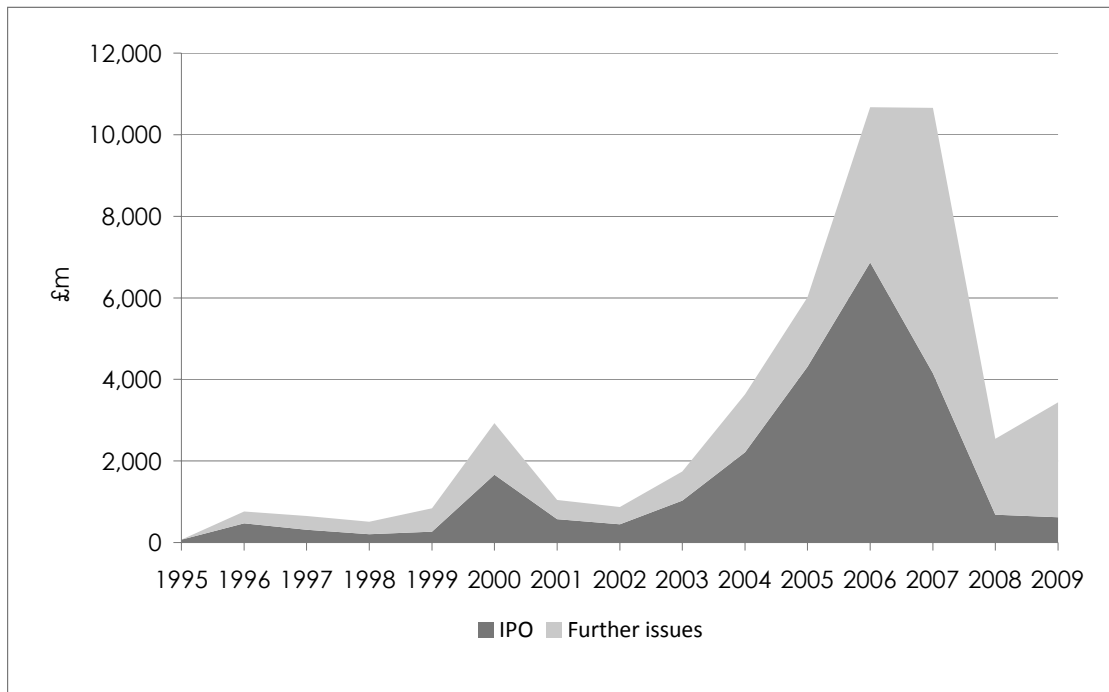
Source: London Stock Exchange statistics, author

The following chart (5.5) shows the money raised for UK companies through AIM split between IPOs and further issues. The impact of the global economic downturn is clearly shown, but at over £2.5bn in 2008 the amount of equity raised remains substantial with some recovery to £3.4bn in the first 10 months of 2009. The Chart

¹⁴⁰ Prior to 2006 PLUS was a different entity, operating under a different name and was not a full exchange so comparative data is not available

provides evidence that more recently further fundraisings on AIM have been much more buoyant than IPOs, suggesting that investors are keen to back AIM companies with which they are familiar.¹⁴¹

Chart 5.5: Money Raised (Total Equity Value) by UK AIM Companies

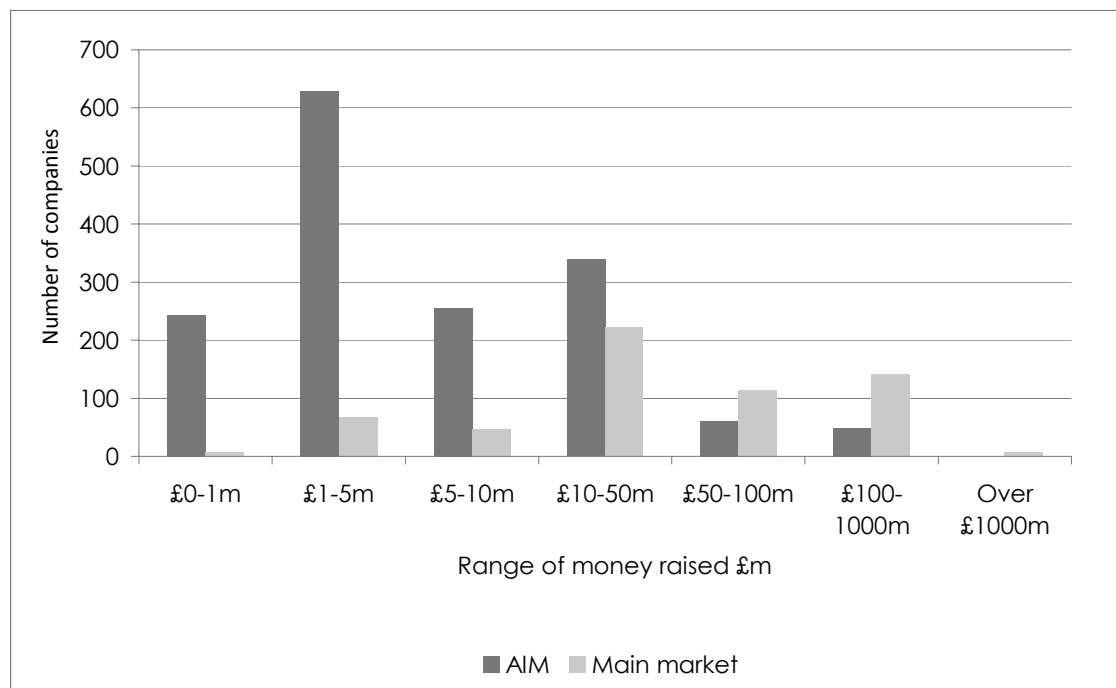


Source: London Stock Exchange statistics

A breakdown of IPOs by value on AIM and the Main Market, illustrated by Chart 5.6, re-emphasises the key role of AIM as a market for smaller companies. The vast majority of IPOs on AIM raise less than £10m while 55% of them have raised less than £5m. London Stock Exchange Main Market IPOs tend to be much larger with 80% of them being over £10m and 435 over £50m.

¹⁴¹ Signs of recovery seen after years of famine, *Financial Times*, 16 December 2009,

Chart 5.6: Money Raised by IPOs by Band for AIM and Main Market

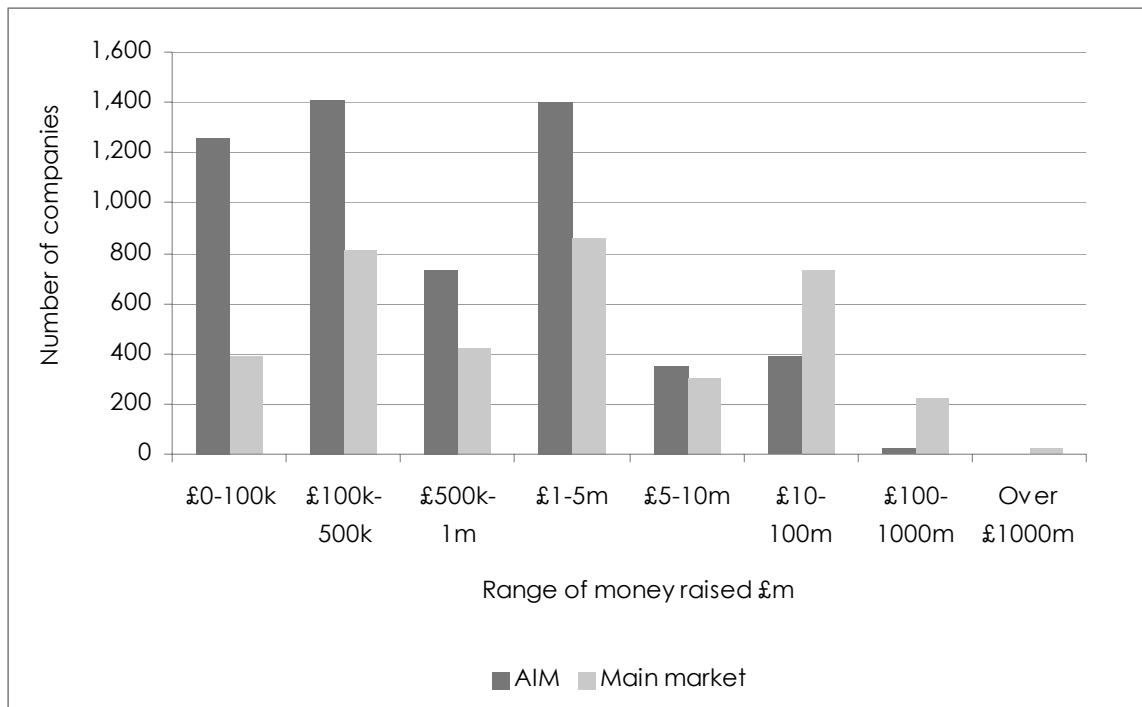


Source: London Stock Exchange statistics, author

Many of the smallest issues on both AIM and the Main Market tend to be related to share option schemes and similar arrangements¹⁴². As AIM companies are smaller and have fewer shareholders the size of their share option schemes is also smaller. The conclusion, therefore, is that while the issues by Main Market companies in the smaller bands are mainly share-option related with any money raised being incidental, for AIM companies many of these smaller issues are deliberately intended to raise money. The ability to issue small amounts of stock and raise small amounts of money is a key feature of AIM (see Chart 5.7).

¹⁴² Any kind of share incentive programme, which means there are a large number of small issues which are not primarily aimed at money raising.

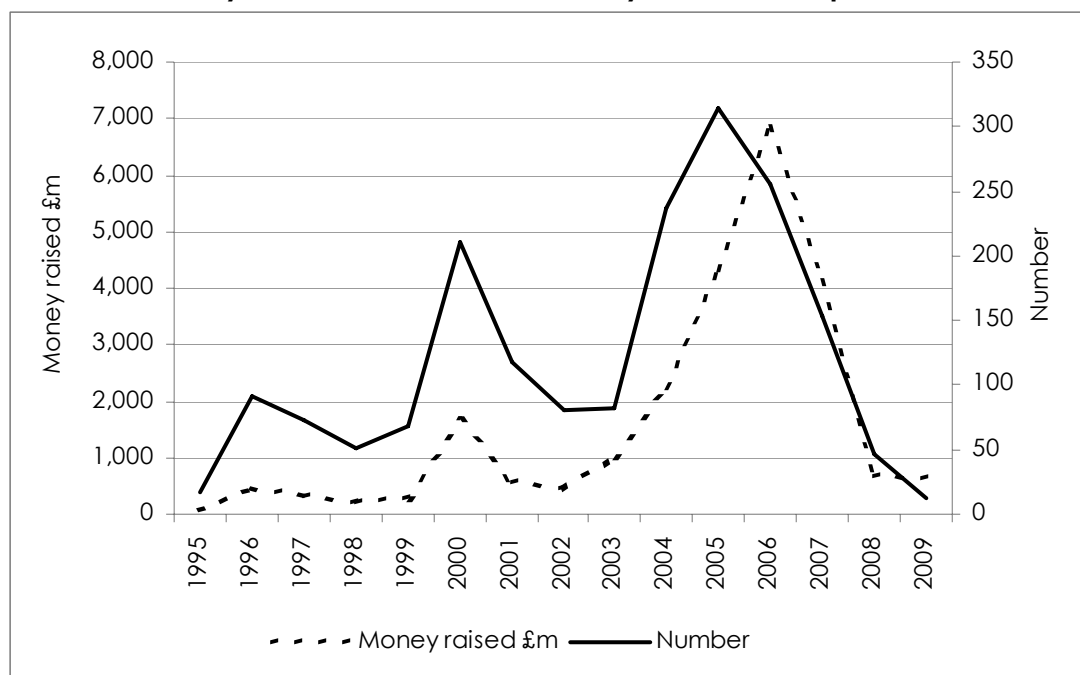
Chart 5.7: Further Issues by Bank for AIM and Main Market



Source: AIM, author

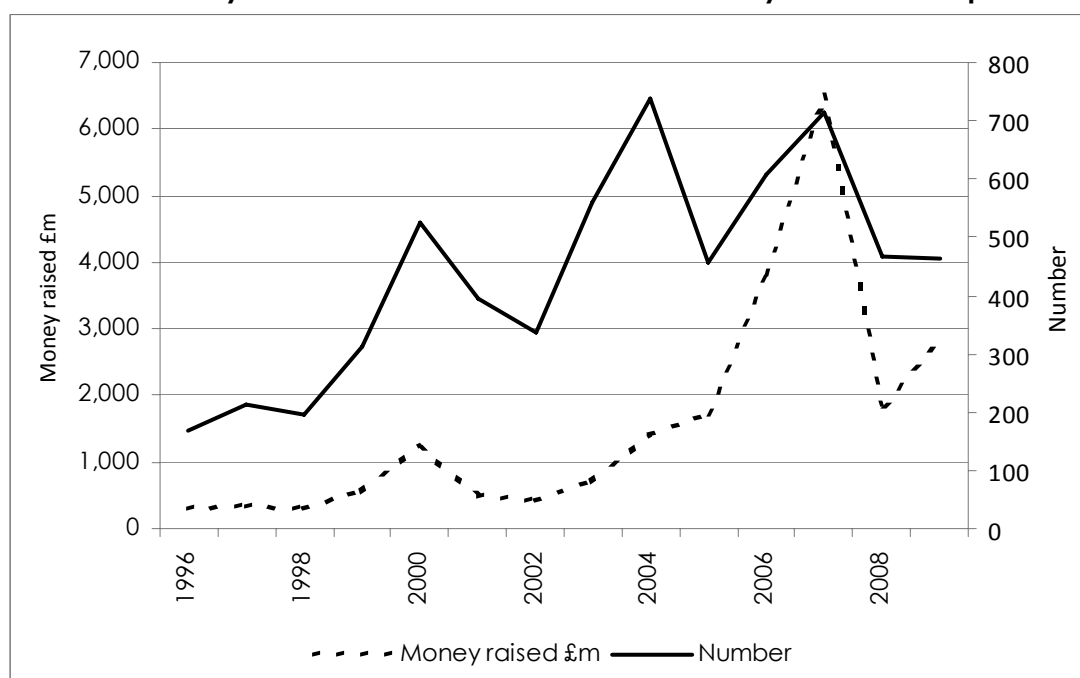
A more detailed analysis shows the sharp rise in money raising activity since 2002, after the effects of the tech crash. IPOs peaked in 2006 and further issues peaked in 2007. The number of IPOs has since slumped along with the value but the number of money raising further issues has fallen much less indicating a shift towards smaller issues in difficult economic times (see Chart 5.8 and Chart 5.9).

Chart 5.8: Money Raised and Number: IPO by UK AIM Companies



Source: London Stock Exchange

Chart 5.9: Money Raised and Number: Further Issues by UK AIM Companies

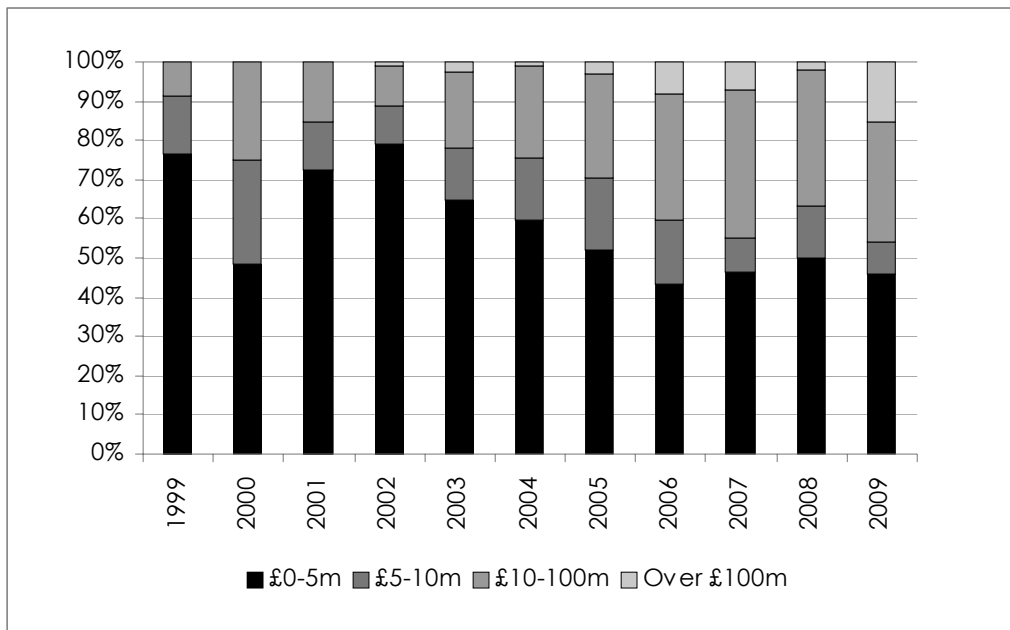


Source: London Stock Exchange

Over time the shift has been towards larger issues. In 2000, 75% of AIM IPOs by UK companies raised less than £10m but by 2007 this had fallen to 55% with 11 IPOs raising over £100m. The trend in further issues was similar until 2007 with the proportion of further issues raising less than £1m falling from over 70% in 1999 to just over 40% in 2007. Since then, the trend in further issues has reversed – though the number of

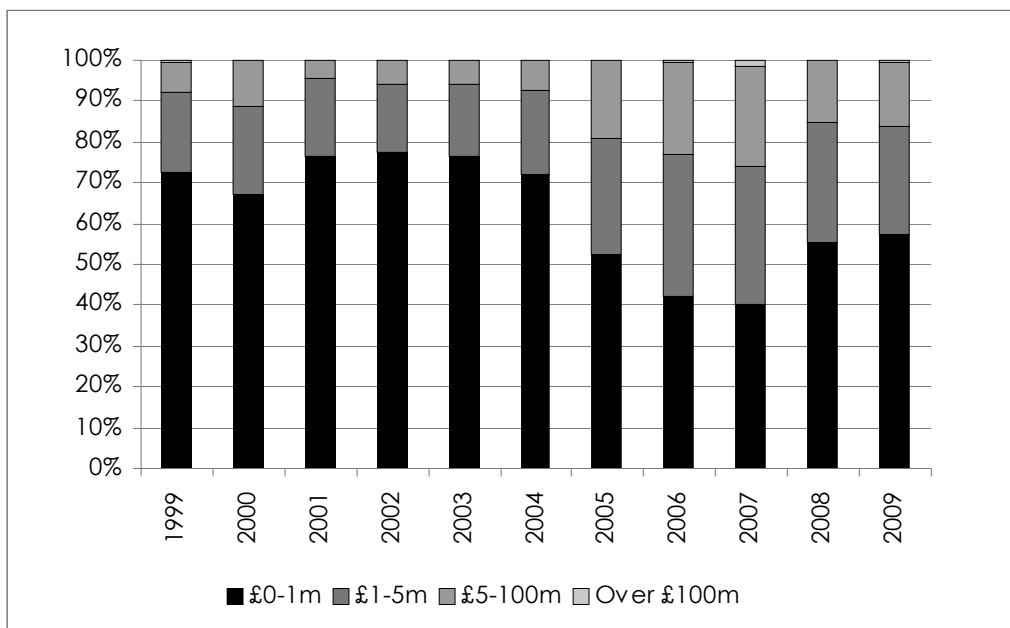
issues is so much smaller that it may not represent a true shift (see Chart 5.10 and Chart 5.11).

Chart 5.10: Money Raised by AIM Companies through IPO, by Band



Source: London Stock Exchange

Chart 5.11: Money Raised by AIM Companies through Further Issues, by Band



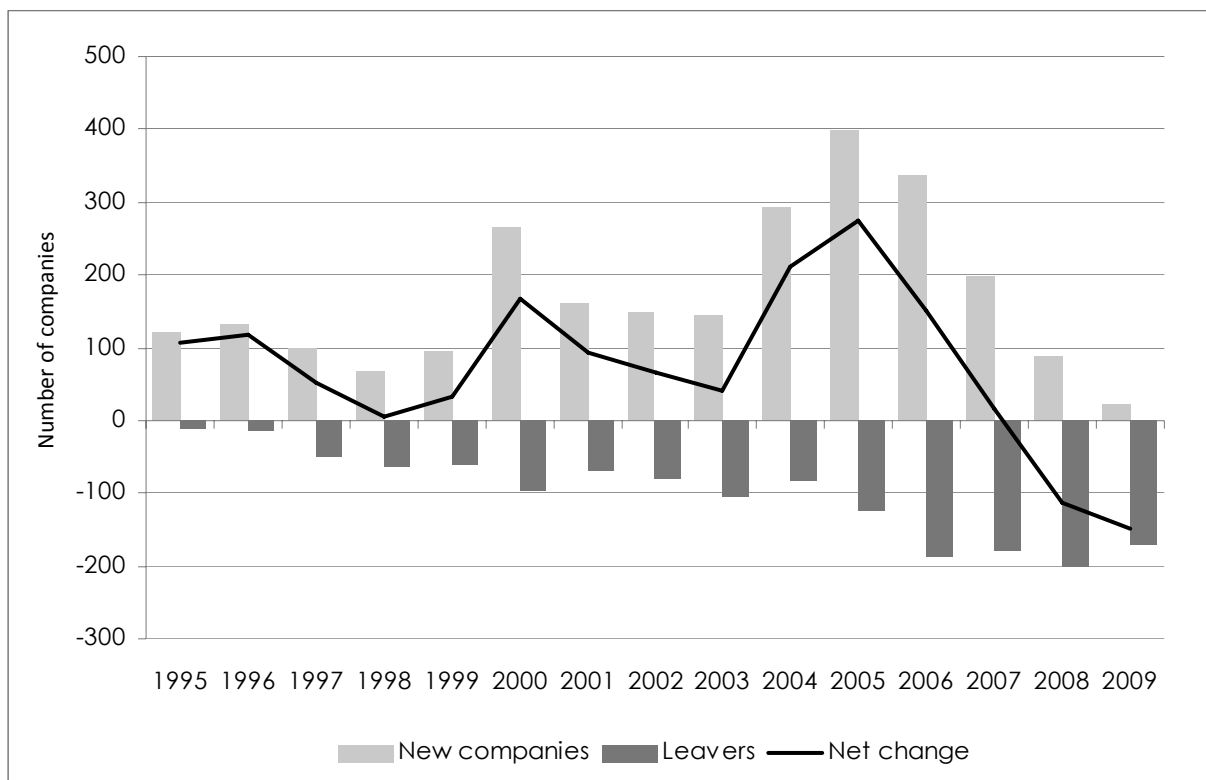
Source: London Stock Exchange

5.2.5 Leavers

Since its inception, AIM has admitted 3,098 companies, of which 2,580 have been UK companies. Chart 5.12 compares the number of joiners and leavers since the start of the market in 1995. The net inflow peaked in 2005 and since then the market has

seen a declining net inflow with almost no growth in 2007 and significant net attrition in 2008 and 2009. It is expected that the market will resume its upward growth when economic conditions improve. However, this will depend on the reasons for the high level of leavers (both recently and more generally). Companies have left the market for a number of reasons including takeovers and promotion to the Main Market¹⁴³ as well as through financial difficulty and choosing to leave the market. Whilst some companies might leave AIM to join the Main Market, the movement has historically been the other way from the London Stock Exchange's Main Market to AIM. It is important if AIM is to continue to fulfil the vital role in the SME financing ladder that companies leave AIM for positive rather than negative reasons – i.e. takeovers rather than failure.

Chart 5.12: Number of UK Companies Joining and Leaving AIM



Source: London Stock Exchange, author

The reasons for AIM companies leaving the market are many and complex and related to positive and negative factors. There is often a combination of reasons for a company cancelling from market, and it will typically state the one that is 'least damaging' for its ongoing business. In the boom years of 2006/7 about two thirds of AIM cancellations were due to positive M&A activity including reverse takeovers. In 2009 about 41% of cancellations from AIM were due to companies choosing to leave the market compared to only 8% in 2007. Around 20% of these were international companies with dual listings in their home market. In the current climate an increased number of companies have left the market citing low valuations; in

¹⁴³ A key function of AIM is to act as a platform for early-stage growth companies from which companies can then progress to the London Stock Exchange Main Market.

fact, of the 113 companies that chose to leave AIM in 2009 over 75% had a market value of under £10m immediately prior to cancellation. As investor preference has moved towards larger companies due to the lower perceived risk of ownership, SMEs on AIM have experienced depressed share prices and lower levels of liquidity.

Research into delistings by Trowers & Hamblins LLP and UHY Hacker Young published in July 2009 found that AIM delistings hit a peak of 81 in the fourth quarter of 2008, with fewer delistings in 2009. They suggest that improvements in the AIM index in 2009 may have dissuaded some companies that were suffering from a very low market capitalisation from cancellation¹⁴⁴. They find that the number of AIM companies that have cancelled because of financial stress or insolvency increased substantially in 2009. The number of companies that cancelled because of the costs and expenses of maintaining an AIM listing fell significantly. The number of companies that said they are delisting because they do not have a Nomad also fell significantly during the first two quarters of 2009 (from 27 to 5). In a previous press release from the same team, Charles Wilson, Partner of Trowers & Hamblins stated that 'There is the worry that Nomads may be deciding to resign because they see the legal, regulatory and reputational risks involved in continuing to advise that company as being too high. They worry that if a company they advise goes under, they may face the regulator's and investors' wrath' ... and that 'The regulatory capital requirements and levies on small and medium sized Nomads also need to be kept at a sensible level so that firms are not driven out of the market.' An alternative view to this could be that the 'Engagement Responsibilities' introduced in the Nomad Rules in 2007 have resulted in more due diligence being undertaken by an incoming Nomad who is required to make an assessment of the appropriateness of a company for AIM on take-on – resulting in fewer companies regularly moving between Nomads. A small proportion of companies specifically blamed their delisting on their inability to raise new funds, though the number of companies which identified this as a issue increased in quarter two of 2009. As a result one commentator stated the need for tax breaks to be reintroduced for investing in AIM and other smaller companies (Laurence Sacker, Partner of UHY Hacker Young).

However, while AIM focuses on potentially more risky stocks, insofar as the market attracts early-stage businesses and because it attracts companies in potentially more risky sectors, results suggests that risks are not disproportionately high. Research by the London School of Economics found that that the failure rate 'is low, running at less than three per cent in the last four years'.¹⁴⁵ Earlier research by the ICMA Centre at the University of Reading found that the perception of higher risk of AIM stocks compared to Main Market stocks was incorrect: 'The main conclusion that comes out of this analysis is that the perception that AIM has higher volatility than the [Main Market] is perfectly understandable, but incorrect. Our simpler analyses generally found a large difference between volatility of AIM and Main Market stocks. However as we moved to more complex analyses differences in volatility between AIM and the Main Market are very small, usually not significant statistically and tend, if anything, to indicate a slightly lower volatility when on AIM.'¹⁴⁶

¹⁴⁴ AIM delistings driven by financial stress and insolvency up 183% (Trowers & Hamblins LLP and UHY Hacker Young; 14th July 2009)

¹⁴⁵ From Local to Global – The rise of AIM as a stock market for growing companies. By Sridhar Arcot, Julia Black and Geoffrey Owen London School of Economics, Sept 2007

¹⁴⁶ A False Perception? The relative riskiness of AIM and listed stocks; John board, Alfonso Dufour, Charles Sutcliffe, Stephen Wells, ICMA Centre, Univ. of Reading, Oct 2005

5.2.6 Impact of the Economic Downturn

The growth markets have suffered heavily during 2008-9 with fundraisings falling sharply from the peak of the previous two years. Public markets throughout the world all experienced declines in fund-raising as market prices fell sharply and investors shifted to lower risk portfolios. The subsequent recovery of prices has, in the past, led to a flurry of money raising activity among existing listed companies on stock markets as companies seek to rebuild their balance sheets and investors seek opportunities to invest in value offers to offset their recent losses. Typically therefore the pattern has been for existing companies to make further issues followed some time later by new IPOs as recovery gains momentum. AIM figures for 2009 are consistent with this; 2009 saw some recovery of further issues as £4.8bn was raised with IPOs remaining depressed (£0.74bn raised). Whether this pattern will continue into 2010 will, of course, depend largely on the progress of the UK economy more generally. However, the wide sectoral distribution of companies on AIM has previously meant that it escaped the collapses that affected technology focussed exchanges overseas.

The economy will not be the only factor, and whether AIM fully recovers and its role in capital-raising will depend upon structural factors in the market:

- The data suggest that AIM companies are more likely to be in the London/Southeast region than elsewhere in the country. They are also highly likely to be engaged in business support services and finance related activities. Many companies in the southeast region and in these sectors have been directly or indirectly dependent upon the substantial finance sector in the UK economy. Any 'rebalancing' towards a smaller finance sector may affect the current constituency of AIM. Were this to happen it would be important – both for AIM and the economy generally – that the Nomads are able to change their focus to support the new growth sectors such as the alternative energy sector¹⁴⁷.
- Data also suggests that the size of capital-raising on AIM and new companies joining AIM has been rising over the long term. Small cap institutions such as VCTs play a vital role in the provision of capital to SMEs. However, as previously illustrated in Table 4.6, the availability of this source of finance has significantly declined as a result of increasingly restrictive rules, which is a growing concern.

5.3. Attributes of a Successful Market

Many stock exchanges around the world have at various times set up markets for growth companies. Typically, these markets have been set up because small companies cannot, or find it difficult to, meet the main market's entry standards – for instance, regulatory standards are set too high for smaller or newer companies (e.g. the requirement to have a minimum free float) or the costs of compliance with the regulatory standards of the main market being too expensive for smaller companies.

¹⁴⁷ There are 102 Cleantech companies on AIM and 66 of the FTSE AIM Environmental Opportunities Index launched in conjunction with FTSE in June 2009.

Many small cap markets were set up, like AIM, in the 1990s but most did not long survive the collapse of tech stocks in 2000 – e.g. the German Neuer Markt and the French Nouveau Marche. The 2000s saw a re-awakening of interest in growth markets and most of the 54 major exchanges that are members of the World Federation of Exchanges (WFE) have set up such markets. In Europe, growth markets have been set up like AIM as exchange regulated markets rather than EU regulated markets allowing them to set regulatory standards that are appropriate to the local needs of the companies and investors. AIM is the largest growth market by a significant margin and arguably one of the most successful. Comparisons between AIM or PLUS and other international growth markets comparisons are difficult to make.

It is worth considering the possible success factors underpinning growth markets. The key challenge faced by a growth market is to offer a structure that is sufficiently different to the main market to make it attractive to small companies without so compromising the regulation of the market that investors are deterred from buying the shares. A study by the ICMA Centre¹⁴⁸ in 2006 identified key factors in the success of a growth market and assessed the features of AIM against those factors. The ICMA Centre paper suggests these key factors include:

- The aspirational brand of the London Stock Exchange and attractiveness of the Main Market. AIM has been portrayed as the better market for growth companies compared to the Main Market – as demonstrated by the tendency to attract companies from the Main Market.
- Regulatory requirements, which are favourable for SMEs. AIM has no size, track record or prescribed free float requirements; has lower shareholder approval requirements for major transactions; and, has no pre-vetting of documents. AIM delegates screening of companies for IPO to Nomads who suffer reputational risk if do not screen out weak companies.
- Costs of IPO and fund raising on AIM are comparatively low. The Nomad system is designed to reduce the costs of admission for issuers. Costs tend to be fixed irrespective of amount raised, which benefit SMEs.
- A lock-in period for directors gives confidence to investors that the shares are not being dumped in the IPO. AIM restricts sales by directors etc in companies without a revenue track record.

AIM has many attributes which can be considered to be good practice. AIM was created with the vision for it to be an 'aspirational brand' that SMEs would want to belong to rather than, for example, a second division home for companies that could not make the Main Market. The success of AIM has seen the brand and model of London Stock Exchange AIM exported to Italy in the form of AIM Italia and Japan where Tokyo AIM - a joint venture partnership between the Tokyo Stock Exchange and the London Stock Exchange – opened in June 2009, to provide a new market for growing companies.

¹⁴⁸ International Capital Market Association, University of Reading

5.4. Liquidity

A former Director of Policy at the London Stock Exchange, when asked what were the three most important attributes that it took to make a stock exchange successful, replied 'Liquidity, liquidity and liquidity'. He was not mistaken. Liquidity is what drives the growth of stock markets. Liquidity can loosely be described as the ease with which it is possible to trade any given product. The Nasdaq Stock Market used to operate a mathematical formula that quantified the liquidity of any given stock. It was based on the number of securities that could be traded before the price of that security changed. If one trade in a stock moved the price then that stock was highly illiquid. Typically blue chip stocks (stock of a well-established company having stable earnings and no extensive liabilities) that are listed on a major stock exchange will have many thousands if not hundreds of thousands of their securities traded every day. Prices will rise or fall to a greater or lesser extent based upon a variety of factors, including the performance of that company's business and probably the overall performance of the economy. However, it is rare that the price of a blue chip company will change more than a few percentage points on any given day.

On a growth market however, totally different circumstances apply. Firstly it is likely that there will be a much smaller percentage of the stock of an SME in public hands, as the founders of the company will probably want to hold on to a significant stake in the ownership of the company. Secondly, once an SME has floated on a growth exchange it is quite likely that much of the initial tranche of shares floated will be held for a period of time by the initial investors (some of whom will be institutions) in the hope that there will be an appreciable growth in the price of those shares. Consequently, if the 'free float' (the percentage of a company's shares that are tradable) is small then there are quite simply not many shares to buy, and if the company is performing well, why would those investors who own some shares want to sell? Therefore, almost by definition, shares of an SME traded on a growth market will almost certainly be considerably less liquid than those of blue chip companies traded on the main market.

An issue to underline here relates to the size of the company. AIM has a relatively broad range of companies ranging from small UK start-ups to larger foreign companies.¹⁴⁹ Similarly, there are smaller companies on the London Stock Exchange's Main Market that have levels of liquidity comparable to some of the less liquid stocks on AIM. The liquidity of a stock is therefore related to the company rather than its exchange. The issue that a market like AIM faces is that if it has a large number of illiquid small cap stocks that will lead to a perception that the market itself is illiquid.

The question is sometimes asked, often by the companies whose shares are traded on a growth market, 'So what if my shares are illiquid? I only wanted to have a listing in order to raise some money. I have done that. I no longer care that it is difficult to trade my shares.' In fact, they should care. The prices of severely illiquid stocks will

¹⁴⁹ Many of these foreign issuers are either of a size where they would fall under the radar of many Main Market investors or are in sectors where AIM has a stronger peer group of both UK and international issuers.

tend to stagnate and eventually fall. No entrepreneur likes to see his or her venture sink in value. In some cases the value of a company measured by the share price can drop below its net asset value. When the time comes to raise additional capital the cost of raising that capital increases proportionately. In the worst cases the original owners of the company have to envisage a severe dilution of ownership because of the performance of their stock price.

Exchanges the world over have wrestled with this issue over the decades, and they have come up with different solutions. In London, before the Big Bang, liquidity was encouraged by the existence of jobbers. Brokers seeking to buy or sell stocks would physically approach two or three and ask for a quote on a particular stock. He would be given a two-way price, usually in a certain size. (In other words the jobber would limit the size of the risk he was taking.) The broker would then choose the jobber who offered the best price and trade with him on behalf of his client.

After Big Bang, the London Stock Exchange adopted the Nasdaq model, whereby jobbers on the floor of the exchange were replaced by market makers on a screen. These market makers would effectively fulfil the same role as the jobbers by quoting a two-way price in the stock. Exchanges were able to use this system to enhance liquidity by requiring all stocks to have at least two market makers. Therefore every stock listed on an exchange would always have at least two prices quoted. Clearly the more market makers there were (and the biggest companies would attract a large number of market makers) the more chance the stock would have of enhanced liquidity.

The New York Stock Exchange operated a different system. It relied instead on Specialists. Specialists were firms that stood on the floor of the NYSE and handled trades in designated stocks. Each stock listed on the exchange had one designated Specialist and every morning it was the job of that monopoly specialist to assess the supply and demand for each of the stocks for which it was responsible and set an opening price based on that supply/demand equation. It was the contention of the NYSE that by giving the Specialist a monopoly in a particular stock it was obliging it to always make a market in that stock. Other exchanges encouraged liquidity by other means; commodity and derivatives exchanges tended to rely upon 'locals'. These were individual traders who stood between orders coming into an exchange from brokers' clients. Continental European exchanges usually operated systems whereby client orders matched other client orders, and where there were no matches the orders simply sat in the queue until a matching order came along.

There is no magic solution to this problem. The simple fact is that some stocks are more highly desirable than others, and will always be so. The common function of an exchange is put into place a system that encourages as far as possible the trading of all the stocks listed on that exchange. The issue in relation to SMEs is whether the public markets in the UK have done enough to achieve that ambition.

5.4.1 Challenges in Liquidity Provision for Small Cap Stocks

So, how have AIM and PLUS responded to this challenge? As noted, running a trading facility designed to enhance the liquidity of smaller stocks is always a challenging task for a stock exchange and there is plenty of evidence that the illiquidity encountered by AIM and PLUS stocks, is very common in other markets.

Small cap stocks tend to be difficult to trade and relatively illiquid for a number of reasons including:

- Their small size means there is less stock available to trade
- Small size also means institutional holdings tend to be large, relative to the total stock available; and
- Often the free-float¹⁵⁰ is limited because of family, strategic and other non-tradable holdings.

The focus of this report is on stocks which are outside the large group where order driven trading is all that is required. At the other extreme a bulletin board is generally seen as a rather poor option by exchanges and companies – since it does not offer very much in the way of liquidity enhancement nor does it offer any regular price for benchmarking portfolios etc. For AIM and PLUS to tackle liquidity issues there is a need to focus on enhancing market making.

AIM and its predecessors have continuously grappled with the challenge of liquidity – and AIM has largely been successful in ensuring market maker commitment in its stocks. However it has not been easy – a look down the list of market makers on AIM (and PLUS) demonstrates that there are a relatively small number of firms that are willing to take on the role of market maker in illiquid stocks. This has made the exchanges vulnerable to the possibility of withdrawal of one or more of those market makers and has, on occasions, made it difficult to get the right balance of privileges and obligations.

Evidence of liquidity issues was illustrated by a company that floated on AIM several years ago. Following its IPO, the share price moved steadily over a period of a few years from £1 to a high of nearly £6. This increase in share price was driven in part by strong organic growth in the company's sales and operating profit, and a number of successful acquisitions. However, over time the stock became largely illiquid. To tackle this, the company employed an additional broker with the aim of accessing a new set of investors. This did not help and the share price fell to its current levels of between 80p and £2. Institutional investors have indicated they might be prepared to invest in the company but only at a heavy discount to the existing share price. The company concluded that the combination of reduced debt finance from the banking sector and the structure of the markets, which should enable them to raise additional capital, was simply not working, and their future growth was seriously inhibited (see case study B).

City stakeholders highlight concerns about the illiquidity levels of smaller cap stocks on both AIM and PLUS, although they recognise that this is a factor inherent to small cap markets. They noted that when an SME comes to market its main objective is to raise money but in many cases this money comes in the first instance from institutional investors whose objective is to hold on to that stock and see it generate significant capital gains. Buy and hold is a recipe for illiquidity. It considerably reduces the available free float. Stocks will only become liquid when there is a significant retail base and there is sufficient news in the market about developments within the company (hence the need for the company to keep the market informed

¹⁵⁰ Free float is the percentage of stock that can be freely traded. It is often less than 20% on AIM.

of progress). The general view in the market place is that the market will become more liquid when there is more confidence in the economy as a whole. A number of consultees also remarked that the growth markets were much more liquid when there was venture capital trust activity.

Stakeholders suggested that the creation of tax breaks for investing in SMEs was a way to enhance liquidity. This could be brought about by a recreation of Venture Capital Trust (VCT) schemes¹⁵¹, or by allowing AIM/PLUS stocks to be used for ISAs. There is a perception that no government will be able to afford these tax breaks in the short to medium term, but it is at least arguable that the government will generate more tax revenues from encouraging the stronger growth of SMEs by introducing these tax breaks than it will lose by allowing them in the first place. Furthermore, as stocks become more liquid the cost of capital for the SMEs becomes more manageable, which in turn encourages the further growth of SMEs. It is important to add that any tax incentive for investors on PLUS does not siphon off money that would otherwise be invested in EIS.

The liberalisation of the markets brought on by MiFID¹⁵² gives exchanges the ability to compete with each other by trading the same stock. In the SME sector this has led to competition between AIM and PLUS for the trading of AIM stocks. Brokers are required by MiFID to trade 'at best'. This means they have to be sure that if they trade a particular company's stock on AIM, for example, there is not a better price to be had on PLUS. The lack of a single screen containing all the prices available for any given stock (known in the US as a 'consolidated tape') makes this process more complicated and has the potential to reduce liquidity. The Securities and Exchange Commission in the United States has imposed a requirement that a consolidated tape should exist in order to give investors the best information leading to them investing in the market that offers them the best price. Could such a mechanism exist in the UK? In fact with the attempt by MiFID to make the market in shares more truly European it could be argued that we need a European consolidated tape.

Finally there is the question of what the listed companies themselves should do about enhancing the liquidity of their own stock. We spend a lot of time asking questions about whether or not the infrastructure that surrounds the capital raising needs of SMEs is fit for purpose, but we spend less time asking whether SMEs themselves are doing enough to harness the systems.

It is by no means clear that the considerable effort that has been made by the public markets themselves to educate the listed companies on how they should manage their listing has had as great an impact as might have been expected. This is borne out by the views of those to whom we spoke in the market, many of whom felt that yet more needs to be done to educate SMEs in the processes that exist to assist them. For example SMEs coming to market for the first time put a great effort

¹⁵¹ Venture Capital Trust (VCT) scheme started on 6 April 1995 is designed to encourage individuals to invest indirectly in a range of small higher-risk trading companies whose shares and securities are not listed on a recognised stock exchange, by investing through VCTs.

¹⁵² MiFID (Markets in Financial Instruments Directive) is a European Union law that provides harmonised regulation for investment services. The main objectives of the Directive are to increase competition and consumer protection in investment services. It became effective as of 1st November 2007, replacing the Investment Services Directive. Venture Capital Trust (VCT) investors benefit from income tax and capital gains tax reliefs.

into the capital raising exercise but some of them spend less time thinking about what needs doing after their stock has been listed on AIM or PLUS. Being a public company requires an ongoing commitment to keeping the market informed beyond the regulatory requirements. There is also a responsibility for Nomads to assist with this process. The evidence suggests that while a number of Nomads do indeed assist with this process, others are less proactive. Some Nomads suggest that the frequent efforts they make to try and persuade companies of the need to keep a steady information flow to the market fall on deaf ears. All parties associated with a company's listing on one of the public markets, whether brokers, Nomads, lawyers, accountants, non-executive directors, managing directors, have a responsibility to ensure that investors have regular access to news flows about the company. The stock exchanges can assist in this process by increasing their existing efforts to educate directors on how to be a public company.

It is worth pointing out that there is another side to the argument. One AIM-listed company that we consulted accepted that after-listing activity was a necessary part of its responsibilities (see Case Study B). Its CEO had a background in running a bigger company, understood the needs of investors, and had devoted time to a very active marketing programme to shareholders. Notwithstanding these extensive efforts on his part there had been little impact on the overall liquidity of the company's stock. This example illustrates that liquidity problems are not capable of an easy solution. They comprise a number of interconnected and fundamental issues. However, taking account of the specific issue relating to the efforts that should be undertaken by the companies themselves, we recommend that the exchanges should step up their efforts to educate company executive directors in the management of their listing. There can be little doubt that the more companies that make this effort, the more likely it will be that the many other steps that are taken to enhance liquidity will begin to have an effect.

Case Study B: Liquidity Issues on AIM

Company B has been listed on AIM since 2005. Becoming quoted on AIM has enabled the company to raise equity finance to pursue strong organic growth and fund acquisition activity to complement its existing market.

When Company B (the company wished to remain anonymous) first listed on AIM it did so with a CEO who had previously been CEO of a much larger company. Consequently he knew the market well and had good contacts with the main institutional investors. During the listing process he spent a lot of time talking to these institutions and felt that they had a good understanding of what he was trying to achieve.

At the same time as the company was raising money on AIM it also looked to raise debt capital. This latter exercise was less successful as the bank they were initially using was less than helpful. Six months later they switched banks, and have since then establish a better banking relationship.

The initial listing process on AIM was considered to be a success. They were able to raise the money they needed and the share price moved encouragingly in the first few months. After listing at £1 the share price moved to a high of nearly £6. However, then AIM started to seize up as a result of which the company decided to take on an additional broker to see whether it would be possible to increase the liquidity of the stock. They had no major problems with their existing Nomads but they felt that by tapping into a new set of brokers contacts it might be possible to access a new set of investors.

In fact this did not happen. The stock has now become largely illiquid. The share price has oscillated between 80p and £2. Institutional investors indicated they might be prepared to invest but only at a heavy discount to the existing share price. Company B has therefore failed to entice any new institutions into their market for at least the last two and a half years. From their perspective AIM is 'broken' and they are now seriously considering their options.

With regard to the support they have received from the market and their advisers, their view is that there has been very little assistance they have received. While they did not want specifically to criticise their Nomads they were of the view that there was nothing the Nomads could have done to help. There is simply no interest in their stock because of the small size of the company. They were of the view that institutions today were only interested in companies with a market cap of at least £100m. The only incentive for institutions to invest in companies like theirs would be if they were to see a rapid rise in the share price, to reflect the growth of the business. (In fact, Company B was growing well and a fair valuation would be nearer £60m than their existing £20m or so).

Some companies listed on AIM had been criticised because of the lack of after-listing activity. The company accepted that this was a necessary part of their responsibilities but their CEO said that coming from his background in running a bigger company he well understood the need for this and had devoted time to a very active marketing programme to shareholders. These efforts had little effect upon the liquidity of their stock, however. Continued overleaf...

In discussion of the possibility of more government assistance for this sector the company expressed the view that it was not the job of the government to intervene artificially in this sector. There needs to be a free market in this sector just as in any other sector. It just so happened that the particular market they were involved with - AIM – was, from their perspective, broken. The company would have to make a decision within the next few months as to whether they should stay on AIM or try a different tack. As to what that might be, remained to be seen. From the company's perspective, there was no question of moving to PLUS as that seemed to be in an even worse state than AIM and it had no track record of successfully raising capital.

As far as the debt markets were concerned the company was unhappy with the way in which the government's attempts to get the banks to increase their lending had failed to work. On the one hand the government was imploring banks to lend more, but on the other hand they were imposing higher capital adequacy standards on the banks which had the effect of reducing the money available for lending.

In the short term the company had given up on the idea of using AIM to raise more capital. They needed to raise funds to generate growth on a 3 - 5 year basis. In present circumstances their only option was to use the debt markets, and for the reasons given here these were not particularly helpful for them at the moment. Their conclusion was that despite being in a position where they have successfully weathered the recent financial storm and have good growth prospects, the structure of the markets, which should enable them to raise additional capital, is simply not working, and this could seriously inhibit their future

5.4.2 Differentiation between Small and Micro Cap Stocks

A view that became crystallised through the consultation process was that there were effectively two kinds of companies whose shares were traded on growth markets. There were the 'true growth' companies - those with a market cap of £10m upwards - whose home was quite clearly AIM; and there were the micro-cap stocks, with a market cap below £10m - and often down as low as £1m - whose home might be on a lower tier of AIM¹⁵³ or on PLUS. Some stakeholders believe there ought to be a clear dividing line between the small cap and the micro cap stocks. As commercial enterprises, AIM and PLUS, together or in competition, will judge what is most appropriate for them. However, for the purposes of this study we have reached the following conclusions.

- There is not a clear economic benefit to the UK economy for there to be two market places competing for the business of SMEs. Counter intuitive though it may sound, stock exchanges tend to thrive when they have a monopoly on the trading of a particular stock, because the liquidity of that stock is concentrated in one place. This may not be true at the level of highly liquid stocks where competition between exchanges tends to drive down the cost of trading but at the level of illiquid growth market stocks it is certainly true.

¹⁵³ Some consultees suggested that lower tier smaller companies were damaging the brand of the London Stock Exchange.

- PLUS has cast its target market in the same realm as AIM both in the listing of small and micro cap stocks as well as larger foreign listings (the latest restructuring at PLUS would suggest that foreign listings will take on even greater importance at PLUS).

Market participants also wonder whether it is appropriate for very small companies to admit to a public market. Regulatory rules and low costs on Aim and PLUS have allowed smaller companies to list and retail investors have been enthusiastic about exploiting the possibility of the high capital growth that these very small companies are capable of generating (at least in the earlier years of the growth of these markets). Though micro cap stocks impact on the perceived overall liquidity of the market, stakeholders agreed that there was no reason to reduce the choice of funding sources that is now available to SMEs: if companies do not perform well, the cost of being on the market will become too high and they will delist. This is reflected in recent trends in AIM cancellations. Seventy per cent of AIM companies that have chosen to leave market in the last two years had a market capitalisation of under £10m¹⁵⁴.

Stakeholders argued that it is difficult to agree on action on the issue. The Quoted Companies Alliance has resolved to prepare a guide for SMEs, indicating the likely profile of a listed company; this should support SMEs in understanding whether they are suitable for listing.

It was also agreed that more education for SMEs management teams would help ensure that expectations of the market and the ongoing requirements of the market are clearly stated and used to inform a decision of whether to list or not.

5.5. Regulation

One of the most important issues regarding the operation of growth markets, designed in particular to appeal to SMEs seeking additional funding, is the regulation of those markets. Regulation in this context covers company legislation, taxation issues, investor protection legislation as well as the listing standards and ongoing regulations operated by the exchanges themselves. In the case of AIM, the effective compliance with the requirements of the regulation of the companies listed is delegated to Nomads.

The level of regulation that is appropriate for blue chip mature companies is often not appropriate for small start-up companies. If the standards to be imposed on SMEs were similar to those on the Main Market then very few SMEs would be able to afford either the time or the resources to comply. Governments have an in-built and fully justified desire to ensure that the public who invest in shares do not lose money as a result of misdemeanours by the companies in which they are investing because of poor or ineffective regulation. By their very nature SMEs are perceived to be a riskier investment than blue chip companies –the majority of SMEs do not survive or

¹⁵⁴ With any mature market, including the Main Market and the NASDAQ, there will be a tail of smaller companies (last June NYSE permanently reduced its minimum market cap requirement to £15m) and it is for market users to decide whether the cost of being on the market is justified.

realise their full market potential. However, for investors, SMEs represent an opportunity to derive greater returns – it is possible to double your money or better by investing in a successful SME far more easily than by investing in a mature blue chip company. The issue therefore is to strike the right balance between regulation and investor protection.

We spoke to a range of practitioners - market operators, fund managers, nominated advisors/brokers, lawyers, accountants, and a leading financial journalist – about whether the balance is operating efficiently. Consultees focused on the role and effectiveness of Nomads on AIM, and the wider regulatory burden SMEs face. The markets operate within the wider EU regulatory and legislative context, and we discuss below the implications relating to the EU listings directives and legislation.

5.5.1 Investor Protection and Regulation

There is a strong view amongst practitioners that the regulations that surround the whole SME public market are still far too onerous. Consultees expressed concerns about the quantity of 'red tape' that SMEs endure in order to get a listing. What was less easy to define was whether this red tape was caused by UK company law, taxation issues, FSA (Financial Service Authority) legislation, EU legislation or rules of the market operators. When asked to specify the actual red tape that caused problems the answer was usually non-specific - 'It's the sheer amount that turns off the SMEs'. The perception of the responsibilities of a public company is burdensome for entrepreneurs, experts in their respective fields but with limited financial markets experience.

Following admission, SMEs suddenly find that going public entails a raft of responsibilities that they have not been exposed to while they remained private companies. These responsibilities extend far beyond the rules and regulations of the exchange itself and into the realm of government regulation as a whole. There is limited evidence that in drawing up company law successive governments have paid enough attention to the very special needs of SMEs. Yet, notwithstanding this level of burdensome regulation the fact remains that SMEs can raise capital on secondary markets. Indeed AIM companies raised £5.5 bn in 2009.

However, the volume of criticism of the level of red tape faced by SMEs coming to the market cannot be ignored. Even if significant amounts of capital are raised on AIM we have to be conscious of the fact that there may be a real possibility of raising considerably more if a more efficient balance of regulation were struck.

We therefore recommend that a detailed study be commissioned into the overall level of regulation that falls on the SMEs, the first time they come to market¹⁵⁵. Such a study should take a holistic approach: rather than looking simply at the individual rules and regulations of the exchange the study should instead look at the overall objectives of company law, taxation issues, investor protection as well as the rules and regulations of the exchange, what these are trying to achieve and then draw up a much pared down version of what is actually essential rather than simply

¹⁵⁵ On 12 October 2009, Christine Lagarde, the Economic Minister for France, announced a fifteen point plan to improve SME access to finance in France. She has also called for the need of a Small Business Act for the benefit of all European SMEs.

desirable. In doing this more attention should be paid to the needs of the overall economic desirability of encouraging the growth of SMEs than to protecting investors from investing in what is by definition a higher risk investment. The notion of Caveat Emptor ('let the buyer beware') may be more appropriate in a market of this nature.

5.5.2 Regulation of Companies on AIM by Nomads

The role of the Nomad on AIM is crucial and it has a number of differing responsibilities. Firstly it introduces the company to the market. Secondly it acts as the company's adviser for the time it is admitted to the market (although a number of companies have chosen to have a broker who is different from their Nomad). Thirdly it acts as the regulator of the company for the duration of its listing. The partial delegation of the regulatory role to these Nomads has always been one of the more controversial characteristics of AIM (no such delegation takes place on PLUS). The London Stock Exchange first introduced the principle of delegating key aspects of regulation to a broker when it created its short-lived Third Market in the mid 1980s. This experiment failed in large part because of the reluctance of brokers to take on this responsibility. However, on balance the Nomad structure has worked quite well on AIM over the years. Criticism grew in 2005 and 2006 over the poor performance of some of the Nomads, which led to AIM introducing the Nomad Rules in 2007.

The implementation of the Nomad rules in 2007 was the result of an internal review undertaken by the Exchange into the operation and regulation of AIM. The review provided positive confirmation that AIM's regulatory structure and the Nomad system were key factors in AIM's success. The changes included the publication of a new rulebook for Nominated Advisers and an enhanced disclosure regime for AIM companies. The rulebook provides guidance on the level of due diligence the Exchange expects Nomads to undertake in order to confirm the appropriateness of a company to AIM, and ensure it is able to comply with the AIM rules on an ongoing basis. The new rules of 2007 have certainly had an impact on the quality of companies coming to market. There has also been a reduction in the number of Nomads as a result of consolidation of firms, particularly in the current depressed IPO market, and resignations from the Nomad register.

However, notwithstanding these improvements there continue to be mixed views about the efficiency of the current Nomad system that operates on AIM. The larger Nomads and lawyers consulted were generally satisfied with the way the system operates. However the quality of the Nomads is undoubtedly still variable. Larger firms usually have formal procedures to help fulfil their responsibilities under AIM rules. They may also have dedicated risk management teams to ensure the executives understand any reputational risks to the firm. Hence such Nomads take their role very seriously and conduct their relationships with their clients conscientiously. Some of the smaller Nomads are equally efficient. However, some small Nomads are perceived to be weak and provide little effective support or advice to their clients. A key reason to the introduction of AIM rules for Nomads in 2007 was to help AIM companies better understand the role of the Nomad. However, on the basis of conversations with some of the SMEs it is clear that they still have an imperfect grasp of the role of a Nomad. In their view they are paying out large sums of money (in relative terms for an SME) on an annual basis with very little in return. They often

seem to believe that the job of a Nomad is solely to provide the company with financial advice and they do not fully appreciate the regulatory role of the Nomad.

In the current uncertain environment, SMEs are also concerned about changes in the wider regulatory environment that may bring additional costs and burden. One company complained that in the current climate with financial services regulation being so heavily in the spotlight they have found that all financial advisers no longer come to the company proffering advice. Instead they wait for the company to come to them seeking advice on compliance, tax and regulatory issues(see case study C).

Any belief that the Nomad model is broken is an extreme view which we do not concur with. There is, however, some evidence that the very mixed qualities of the Nomads do generate an impression that the system is in need of further tightening up. There would be considerable benefit from a continued review of the way that Nomads are appointed in the first place and then supervised by the London Stock Exchange with a view to aligning the behaviour of Nomads to the standards that investors and SMEs expect, and to remove Nomads that are unable to meet these expectations. A programme of continuous training could be introduced for individual executives at Nomad firms responsible for interfacing with clients. This could complement the current activity AIM has regarding the appointment, monitoring or supervision of Nomads.

Case Study C: Listing on AIM to Gain Credibility

Company C (the company wished to remain anonymous) operates in a highly priced competitive sector and has been listed on AIM since 2004.

Company C had a very specific objective from a listing on AIM. As a franchising operation they were not looking to raise money for growth purposes but rather to protect their profits. In order to generate more franchises, specifically in France, New Zealand and the United States, Company C had to create credibility. Having a listing on AIM, achieved this. The operations of AIM, therefore, have not really been of major concern.

Since becoming quoted, Company C had little need to spend time with their Nomads. Their view is that the job of the Nomad is to make sure that they complied with the rules of AIM and were generally perceived to be run according to the best standards of the market. Achieving this would demonstrate to their franchisees that they were dealing with a good quality company.

The company confirmed that their share price is illiquid and that they have very few institutional investors. Their major investors are now private client brokers and they see no prospect of any major new institutional investors. They doubt whether the Nomads could have improved the illiquidity of their stock, which they consider to be down to the fact that they are a very small company.

As the company has been cash positive they have really paid little attention to the share performance. They pay regular dividends and they see the growth of the company coming organically rather than by needing to raise money for purposes of further investing in the growth of the company. With the creation of every new international subsidiary they generate increasing income from the new franchisees coming on board.

The sector in which Company C works is hugely competitive. Due to the economic downturn a number of companies in this sector will have fallen by the wayside over the last 12 months. However, Company C feel they are well positioned to take advantage of the upturn in the economy to come. There is one business opportunity which might require the raising of additional capital and that is if they were to enter into joint ventures in new or expanding markets such as the US or France. This might require the addition of a further £5m - £10m. Plans are not advanced for such a move and they have not so far given any real consideration as to how they might raise this money, should it be required. They might use the debt markets or AIM.

In terms of the support they received from their advisers they complained that in the current rather fraught atmosphere for financial services regulation they find that the advisers no longer come to the company proffering advice. Instead they wait for the company to come to them seeking advice on compliance, tax and regulatory issues. Advisers are very nervous indeed about regulation and are therefore tending to hang back. Continued overleaf...

In conclusion the company feels that what they sought from an AIM listing was a 'seal of approval' which would enable them to sell themselves to their potential clients. Notwithstanding the performance of their stock, AIM has helped them to achieve this target.

5.5.3 EU Listing Directive: Premium/Standard listings

The EU Prospectus Directive introduced in 2003, sets out the minimum disclosure standards for companies seeking to list on an EU regulated market. The UK Listing Authority (UKLA), a division of the Financial Services Authority (FSA), has a set of 'super-equivalent' standards for UK companies listing on a UK regulated market such as the Main Market i.e. higher than the minimum set in the Prospectus Directive. This resulted in no provision under the UKLA rules for a standard EU minimum listing - the standards for the Main Market were higher and AIM and PLUS rules were lower. Following changes to the UKLA's rules in October 2009, companies incorporated in the UK are now able to seek admission to the FSA's Official List and the London Stock Exchange's Main Market via a Standard Listing, i.e. in compliance with EU minimum listing standards.

Given the reduced requirements under the Standard listing regime there is some concern that the introduction of the new regime will create confusion about the different standards and levels of investor protection applicable to companies listed in the UK. There seems at least a reasonable chance that the introduction of the Standard listing regime will indeed attract some companies from AIM, or result in some new companies coming to the market choosing a Standard listing rather than an AIM or PLUS quotation. What is less clear is what effect this will have on the overall positioning of AIM and PLUS. It might result in AIM becoming more clearly identified as a market for UK SMEs rather than for large foreign companies seeking a London listing at a lower level of regulation than the Premium market. The London Stock Exchange would probably argue that large foreign companies could always have chosen to use the Main Market had they so wished. If therefore AIM were to become more exclusively a market for SMEs then this might actually benefit the SMEs. On the other hand if it were to result in a reduction in the differentiation between the Main Market and AIM, then this would clearly not be to the advantage of SMEs. The London Stock Exchange will continue to monitor the impact of the regulation, so that it can respond appropriately should there be any negative effects.

However, for the purposes of this study we wish to make some recommendations for the UK Listing Authority at the FSA. The various EU listing directives have been aimed at standardising the quality of companies entering the respective main markets of the EU member states. Little detailed thought has so far been given to the public market needs of SMEs. Without doubt these companies need a totally different regime from blue chip companies. The use by large blue chip companies from outside the EU of growth markets within the EU in order to gain a listing on a 'respectable' market is really not what growth markets were set up to provide. The real danger of this trend is that markets like AIM, and to a lesser extent PLUS, as well as their advisers, become preoccupied by the large amounts of capital raised on these small markets by large companies (and concomitant fees for advisers) to the detriment of the needs of SMEs. London has always been an international market

and there is no need to suggest that markets like AIM should be confined to UK SMEs. But there is an argument that large foreign companies simply seeking a lower level entry to a respectable market should not use these growth markets. We therefore recommend that the UK Listing Authority take steps to encourage large foreign companies that are perfectly capable of listing on the Main Market to be encouraged to do just that.

5.5.4 EU Legislation

In addition to the consequences of introducing Standard Listing on the FSA's Official List and the impediments in the way of allowing investments in AIM and PLUS stocks to be used for ISAs, there is a third major issue, relating to ensuring any regulatory changes at the European level do not adversely impact SMEs.

EU changes that have taken place in the past have been handled relatively painlessly. For example AIM responded successfully to the move in 2004 to make it an exchange regulated market. Nevertheless, we conclude that any changes to EU directives need to take EU growth markets like AIM and PLUS into account in order to avoid damaging any steps taken in the UK alone to improve the environment for stimulating the growth of smaller companies. We would therefore endorse the approach taken by the QCA for the EU Commission to bring forward its reviews of the relevant directives and we hope that this approach will be endorsed by the British Government.

5.6. Markets Support Other Financial and Business Services¹⁵⁶

To function, markets require the support of a range of financial and business services. Research by the London School of Economics charting the rise of the AIM identifies the importance of the market in providing 'a considerable boost for the London-based investment banks and brokers which specialise in small-capitalisation stocks'¹⁵⁷.

The research states that AIM's growth has 'reinforced the cluster of experience, resources and management skills which underpins the dynamism of the City. Our interviews with SMEs found evidence to suggest that there are strong, established links between finance professionals within London and also between London and other UK cities such as Manchester and Edinburgh who are very familiar with the growth markets operations. The strength of the London financial sector does mean that advisors located elsewhere can be sceptical about the benefits of AIM for their business: one Scottish-based entrepreneur stated that he felt that Scottish advisers were reluctant to recommend AIM to their clients for fear that they might lose them to London advisors. Markets must work with the financial community across all parts of the UK to ensure that any misconceptions which may exist, in particular any view that the markets are biased towards the financial community based in London, are tackled.

¹⁵⁶ This section draws heavily upon work by the London School of Economics - 'From local to global: the rise of AIM as a stock market for growing companies' (London School of Economics, Sept. 2007)

¹⁵⁷ *ibid*

The London School of Economics research also argues that AIM has contributed to the internalisation of a part of the financial community which traditionally had been geared to UK clients. As such AIM has brought in significant fees arising from IPOs and further equity issues, which together with payments made to accountants, lawyers and other advisers, which in 2007 was estimated at approximately £1bn a year.

An annual estimate of income generated by AIM is provided by the AIM Investor Survey. The survey definition of income includes listings, secondary fundraisings and fees for brokers and Nomads, and different to the London School of Economics research (so direction comparisons across research should not be made). The 2009 survey illustrates how the economic downturn has impacted on commissions with total fees in 2008 are estimated at £268m down almost two thirds on 2007 levels (£746m) and 2009 commission levels expected to be similarly depressed. This is due to significant reductions in issues (new and further) and trading activity (institutional and retail).¹⁵⁸

The London School of Economics highlights the importance of AIM in widening the opportunities the City has in capital-raising opportunities and enhanced the position of the London Stock Exchange among the world's principal stock exchanges (AIM having grown at New York Stock Exchange's expense – attributed to a regulatory system which is less prescriptive¹⁵⁹). AIM has also been valuable in linking the London capital markets to fast-growing emerging markets such as India, China and Russia. It can be surmised that for companies based in countries whose stock markets are under-developed or poorly equipped to service smaller enterprises, AIM has proved to be a useful capital-raising mechanism.

Some market participants are concerned that AIM and AIM intermediaries are too focused on attracting large foreign listings from China, Russia and elsewhere with too little time spent attracting UK SMEs and helping them access the market. One interlocutor said that AIM had become a market for large foreign companies that wanted a prestigious listing on a major international exchange without having to comply with onerous listing standards. Another consultee pointed to how foreign companies promoted their listing as 'a London Stock Exchange market', rarely referring to AIM. Despite these views, the consensus view was that foreign listings on AIM are welcome; indeed it has long been a tradition of the London Stock Exchange to welcome foreign listings.

Diversity on AIM has in fact has contributed to its success, differentiating the market from other growth markets across Europe. Foreign companies coming to AIM have also attracted a wider pool of investors and analysts to the market and provided UK companies the opportunity to be compared to sector peers on an international basis. The problem is essentially not that AIM has attracted too many foreign listings but rather too many large companies (many of which are foreign), thus undermining the *raison d'être* of AIM as a market for small cap stocks. Market participants feel that the main objective for AIM should continue to be to provide SMEs with an efficient public market place. If the size of the market was increased by the

¹⁵⁸ Arbuthnot Securities AIM Investor Survey 2009: The road to recovery (Arbuthnot Securities)

¹⁵⁹ The Sarbanes-Oxley Act of 2002 increased the costs and complexity of public flotations, and accentuated the differences in between London and New York's philosophy of regulation.

presence of other foreign SMEs, so much the better. But growing the market with large foreign companies clearly capable of listing on the main market tends to distort the perception of AIM. We have recommended that the UK Listing Authority should encourage large foreign companies capable of listing on the main market to do just that (section 5.5.4). We also recommend that the London Stock Exchange and all those advisers associated with AIM should be careful to ensure a better balance of devoting their resources between SMEs and large foreign listings. There is no reason to stop promoting AIM abroad, but more should be done to ensure that AIM remains primarily a market for SMEs.

As with AIM, by pitching themselves as direct competitors to AIM, PLUS has ended up seeking foreign listings, some would suggest to the detriment of the market they offer to UK SMEs. Recent changes at the top of PLUS suggest that this trend is likely to increase. Whilst the direction PLUS takes will be guided by business strategy, one way to differentiate themselves from AIM would be by concentrating on smaller UK SMEs (see section 5.4.3). Foreign companies seeking a listing in London are more likely to choose AIM because of the link with the London Stock Exchange brand although other factors will play a key part, such as transaction costs and liquidity. It might be easier to sell the PLUS offering to the smaller UK SMEs than to foreign companies and they would then provide SMEs with a stronger alternative to AIM than is currently the case.

5.7. Summary

AIM and PLUS play a critical role in enabling UK SMEs to access early stage equity finance. AIM has successfully attracted SMEs from across the UK and from a broad spread of sectors, though there is bias towards London and South East companies and the finance and professional business services. There are clearly still opportunities for AIM (and PLUS also) to attract companies from other parts of the UK and broaden SME sector interest in floating on AIM.

Both geography and sector have contributed to a more diverse base of quoted companies, and have added to the economic resilience of the market. That is not to say AIM has been spared from the economic downturn. The number of and volume of money raising through IPO saw a substantial fall in 2008 with little or no return in 2009. However, there was more resilience in the volume of money raised via further issues on AIM. Clearly 2010 will be an important year for the market as the UK economy picks up, business confidence returns, lending from banks is relaxed and restructuring of companies takes place. AIM and PLUS has attracted micro businesses over the past few years.

AIM's regulatory structure, the Nomad system and the relatively low costs of flotation and maintaining a listing are key factors in the markets success. AIM took steps in 2007 to build on the quality and integrity of the market through the publication of a rulebook for Nomads and an enhanced disclosure regime for AIM companies. It is imperative that AIM continues to assess the appointment and supervision of Nomads to ensure appropriate standards are maintained.

AIM and PLUS have attracted micro stock caps. This has been driven by the favourable regulation and admission costs, which compared to the Main Market do not impose regulatory or financial barriers to entry for SMEs, and the withdrawal of

venture capital investment from early stage funding which has exacerbated a finance gap of £2m to £10m (as discussed in Chapter 4) and meant that growing companies are more likely to seek admission to the growth markets earlier. In this respect, growth markets are taking the place of venture capital investment on the funding escalator. There is evidence too of a direct relationship being between business angels and growth markets. SMEs seeking access to growth market earlier in their business growth will typically raise smaller amounts of equity finance – that is they are micro stock caps. Micro stock caps can impact negatively on perceived liquidity of the market and higher rates of delisting (as the cost of maintaining a listing are comparatively large). However, there is no reason to reduce the choice of funding sources that is now available to SMEs by discouraging micro stock caps, and instead the debate among the financial community should be whether there ought to be a clearer dividing line between the small cap and the micro cap stocks in terms of AIM and PLUS operations.

The ongoing success of AIM and PLUS, and their relationship with the wider funding ladder (upwards and downwards), is dependent on how they respond to the particular challenges they both face: the outcome of the debate on EU legislation and the recent FSA listing authority decision on premium/standard listings; illiquidity levels, which impact on the perception and willingness of business angels and venture capitalists to take SMEs to IPO, and the ability of SMEs to fund-raise; enhancements required to internal market regulation (i.e. Nomads on AIM); and awareness raising amongst the SMEs community of how the markets can best serve their needs.

6. CONCLUSIONS

6.1. Introduction

This Chapter considers the key findings of the research and their implications, and sets out a number of key messages. Recommendations arising from the findings are set out in the next chapter.

6.2. Conclusions

Entrepreneurship and small firm formation are important drivers of the UK's economy. The SME sector has become increasingly important since the 1970's, driven by socio-economic factors, such as cultural attitudes toward entrepreneurship, ICT technology, and the privatisation and deregulation of markets so that, arguably, the sector is now more important to the UK than ever before. Many of the conditions which brought about the revival and resurgence of the SME sector still underpin the sector today. The strength of the SME sector will therefore continue to be a vital component of the UK economy.

The UK SME sector has grown since the early 1970s so that by number the vast majority of businesses in the UK are SMEs. Of the 4.8 million enterprises in the UK, 99.5% are micro, small or medium in size. The majority of these are one person businesses and micro firms (less than 10 employees). SMEs are shown to be important to all regions of the UK and are well represented across many sectors of the economy. They contribute significantly to the UK employment profile, drive innovation and productivity, and bring wider societal benefits to the UK. There is strong evidence that economic growth is positively associated with entrepreneurship and in expanding and transforming the productive potential of regional economies. The Government has recognised the importance of SMEs, but the impact of small business policy intervention has been somewhat limited. One comment suggests that not all SMEs have the same growth potential (in fact a high proportion of SMEs fail and few exhibit growth), so rather than distributing SME support resources widely with interventions small in scale, support needs to be focused on those SMEs with high growth potential.

The main economic impact of the SME sector in fact derives from firms which achieve rapid growth over a relatively short time period. However, though the UK has a higher proportion of micro firms than in the US, the UK has been less successful than the US in generating high growth firms. The reason for this has been attributed to less efficient financial markets.

Public markets are only one component of the SME funding escalator, however. The funding escalator concept suggests that growing SMEs will use these different sources of finance at different stages in their development. The model is an inter-dependent system, so that gaps in one part of the ladder have potential knock-on effects, either forward or backward. The funding escalator is impacted by changes in the economic and financial environment and is therefore in a constant state of evolution. As such the effectiveness of the public markets is not only determined by the financial and economic climate, but also by the provision and access to pre-market equity finance. Understanding SME funding requirements therefore demands a holistic view of the funding escalator.

Our research finds that the equity funding escalator is operating sub-optimally at a number of points. There is a lack of seed capital funding preventing new technology based firms from accessing the escalator, and also a lack of follow on funding. As a result SMEs cannot raise the right levels of equity finance. The inability to access seed capital and raise early stage follow funding has implications for the growth of high technology enterprises in the UK, which rely upon equity funding to bridge the gap between early adoption and mainstream market, and through pre-revenue generation. This implication could have knock-on effects on UK innovation and productivity gains.

A second issue is the re-emergence of an equity gap in early stage venture capital between £2m and £10m. This is primarily due to the preference of venture capital investors to later stage, larger transactions, which carry lower risks. The decline in the availability of early stage venture capital has put pressure on business angels to make more investments, bigger investments and more funding rounds. Early stage equity gaps mean that fewer SMEs are able to access the appropriate type and volume of funds required for growth and their economic potential remains unfulfilled. The economic downturn of 2008, which saw poor stock market performance, exacerbated the lack of early stage equity finance for business angels, and venture capital investors had less equity to fund SME growth.

There is also evidence of growing disconnects between business angel, venture capital investors and the public market. The funding escalator model suggests high growth SMEs will ultimately seek to raise equity finance via a public market listing. However, investors (business angels and venture capital investors) have concerns that their stock value will fall during the lock-in period following IPO and hold negative views on perceived liquidity levels of growth markets. The growth of micro stocks caps on AIM and PLUS has added to this view of perceived liquidity issues. There is evidence too of how the EIS investment rules require business angels to invest in ordinary shares to qualify for EIS tax relief, which puts angels at a disadvantage to venture capital funds in terms of valuation and returns. The EIS therefore adds to the angel – venture capital disconnect.

The implication of these disconnects is that some investors are favouring fast exits over IPO – that is they are encouraging growing businesses to exit the funding ladder before IPO in favour of a trade sale. Trade sales are often made to larger companies that have established channel for distribution, often to foreign companies. The debate of who trade sale benefits is complex, as captured in the discussion between entrepreneurial recycling vis-à-vis the loss of high growth SMEs, and with it knowledge, skills, etc. from the UK economy. Trade sale also means that the public markets themselves lose a potential opportunity to support and SME through admission and fund raising.

Despite these finance gaps and disconnects, AIM and PLUS, in their own right, are successful platforms for growing SMEs to raise equity finance. Both markets have grown in size during a period when many other growth markets from other European did not survive. AIM has attracted a broad geographical and sectoral spread of SMEs which has provided a certain resilience to the economic downturn. Both markets too have been able to attracting SME listings from foreign countries. As successful markets, it can be said that AIM and PLUS display many characteristics

which can be considered good practice. Key factors in AIM's success have been regulatory structure, the Nomad system and the relatively low costs of flotation and maintaining a listing. AIM is acutely aware of the importance of maintaining the quality and integrity of the market and took steps in 2007 to strength the market operations further through the publication of a rulebook for Nomads and an enhanced disclosure regime for AIM companies. These have proved to be beneficial to enhancing regulation, but there are indications that more needs to be done. However, the favourable regulatory conditions and low costs of market admission also means that some SMEs may have prematurely sought a listing on the public markets. This has contributed to perceived liquidity issues and some members of the financial community feel that micro stock caps are damaging the performance and brand of AIM.

The success of AIM and PLUS has had a positive influence on the wider UK financial community. The services associated with SME and foreign companies listings and fundraising, has strengthened the UK financial and business services, by reinforcing the cluster of experience, resources and management skills, and bringing jobs creation, fees and income for HM Treasury.

There are challenges for the AIM and PLUS in the year ahead, as the UK emerges from recession. The economic downturn has impacted on performance, and as businesses both markets will be looking to attract IPOs, raise levels of further issues and retain stock, in order to generate fees. There are the ongoing issues of raising liquidity among small caps stock, which lowers the performance of the market and lead to companies delisting following IPO, if they cannot raise further funds. Year 2010 is likely to see M&A activity pick up and consolidations of micro cap stock, which could be beneficial for the market's daily liquidity. The debates on the Prospectus Directive, Market Abuse and Transparency Directive reviews could impact on the environment for stimulating the growth of smaller companies.

Through the right provision of support for SMEs, the UK economy can continue to harness significant economic gains from the SME sector. We suggest that, in recognition of the importance of the funding escalator, and specifically the interrelationships between angels, venture capitalist firms and the growth markets in supporting SME growth, policy responses takes a holistic view. That is, it is imperative that policy measures are based on the funding escalator and take a joined up approach, involving policy makers at all stages of the ladder.

6.3. Key Research Messages

There are a number of key messages arising from the research:

1. Entrepreneurship and small firm formation are important drivers of the UK's economy. SMEs contribute significantly to UK employment, prosperity, innovation, productivity and provide a number of benefits to society.
2. High growth SMEs have the propensity to generate significant economic benefits. Though they represent a small minority of all SMEs, they make a large contribution to the UK economy. It is these high growth SMEs, which require access to appropriate sources and levels of equity finance.

3. The funding escalator model suggests high growth SMEs will use different sources of finance at various stages of their development. The escalator is an inter-dependent system so that any gaps in the provision of finance will have potential knock-on effects, either forward or backward, on other parts of the escalator. The demand for public market listings is therefore dependent on the provision of and access to equity finance lower down the escalator, in particular public sector venture capital, business angels and venture capital investors.
4. At present, the operation of the SME funding escalator could be improved. Several parts of the escalator appear to be operating sub-optimally due to:
 - The reduction in the supply of early stage venture capital funds (£2m to £10m), which means that SMEs are becoming more reliant on business angels to meet their equity finance needs.
 - An investment relationship disconnection between business angels and venture capital firms, which means that business angels are now tending to fund SMEs for an exit, as opposed to seek ongoing investment or a market listing.
 - A depressed Initial Public Offering (IPO) market, which means that business angels and venture capital funds are unable to exit from investments to raise funds.
5. AIM is the largest growth market in the world. Success factors include the favourable regulatory rules; comparatively low costs for admission, fundraising and transactions; the strong wider UK financial and business community; and its positioning as an aspirational brand.
6. AIM and PLUS have enhanced the capital-raising opportunities of UK financial services. These opportunities have reinforced the cluster of experience, resources and management skills which underpins the dynamism of the City. The operation of AIM has enhanced the position of the London Stock Exchange among the world's principal stock exchanges.
7. AIM and PLUS provide the platform for SMEs to raise equity to finance growth. Though a substantial proportion of the UK's financial services are based in London, the markets support SMEs from all regions of the UK. Both AIM and PLUS have also been successful in attracting foreign based SMEs.
8. Levels of daily liquidity are a major and recurrent issue for markets with large volumes of small capitalisation stocks. This is true for both AIM and PLUS. Low daily liquidity can act as a deterrent to investment in small cap stocks, making it harder for investors to access funds.
9. The economic downturn has made it harder for SMEs to raise external finance. Rejection rates have risen, with term loans more affected than overdrafts but the banks have not stopped lending. Firms most affected are those with low assets (lack of collateral), high credit demands, poor credit ratings and low business experience (start-ups).

10. Though AIM tends to attract early-stage businesses and businesses from high-risk sectors, the risks are not considered too high.
11. 2010 brings new opportunities for both AIM and PLUS to support high growth SMEs in accessing equity finance. Mergers and acquisitions are expected to pick up in early 2010, which could lead to consolidation of small cap stock and enhanced levels of liquidity among smaller stock bands. In particular, the trends in fundraising on AIM through rights issues are rebounding following the effects of the global economic downturn.

7. RECOMMENDATIONS

7.1. Introduction

Our research has identified a number of recommendations designed to enhance the effectiveness of the SME funding escalator and the public equity markets in meeting the equity financing needs of UK SMEs. These recommendations address the key research questions by proposing action focused solutions to: enhance the operation of the SME funding ladder by addressing equity finance gaps; improve the effectiveness and contribution of the public equity growth markets in catering for the needs of SMEs across the UK SMEs.

7.2. Recommendations: The Pre-Market Funding Escalator

7.2.1 Seed Capital

Issue: Lack of seed capital to fund the pre-start up phase in technology companies, which is a constraint on the emergence and growth of university spin-out companies and other new technology based firms.

Recommendation: An investigation into the financial requirements of technology firms, particularly at the commercialisation, start-up and early growth stages which will (i) identify and work-up new investment mechanisms, investment instruments and investment models to provide seed capital and other forms of support and (ii) assess how the business environment can be made more conducive for the emergence and growth of technology-based firms.

Our research indicates that companies seeking to commercialise scientific and technology knowledge often find difficulties in either getting onto the funding escalator or quickly falling off. For example, there has been a disappointing lack of success in the number of high growth university spin-off companies that have been created. Such companies are of critical importance to the UK economy on account of their contribution to innovation and potential for growth. It has proved difficult to obtain commercial returns from seed capital investments hence most of the funding for commercialisation is provided through the public sector. However, these schemes have proved to be ineffective. The 'Innovation Nation' White Paper proposes "an escalator of financial support for innovative businesses at different stages of their growth". However, it may be that a venture capital based approach is inappropriate for funding the commercialisation stage of technology based firms as some commentators have recently suggested,¹⁶⁰ and that a mix of different financial instruments is required. A more holistic approach might also include adoption of the US SBIR (Small Business Innovation Research Program) and public procurement-based innovation contracts.

We therefore note the need for an investigation into the financial requirements of technology firms particularly at the commercialisation, start-up and growth stages.

¹⁶⁰ Sharpe, S, Cosh, A, Connell, D and Parnell, H (2009) *Start-up Finance: The role of Micro Funds in the financing of new technology-based firms*, NESTA: London.

7.2.2 The Business Angel Market

Issue: The focus of venture capital firms is moving to providing later stage funding to businesses. As a consequence business angels are being relied upon to a greater extent for provision of larger volumes of equity finance over longer periods of time and greater levels of more business support to SMEs.

Recommendation: Government needs to enhance its support for the business angel market, by increasing the financial support, to support business angel networks, extending coverage of co-investment funds, retaining the Enterprise Investment Scheme and increasing the tax incentives, and changing various rules which have become restrictive as angels have been required to make larger investments and support their investee businesses for longer.

There has been a long term trend for private venture capital funds to withdraw from making small scale early stage investments. The minimum venture capital investment has risen from around £250,000 in the 1980s to around £2m now, with the Rowlands Commission even suggesting a funding gap from £2m to £10m. The consequence is that business angels have become much more significant in the lower part of the funding escalator. The demand for angel funding has fundamentally changed in two key respects. First there are more companies seeking angel finance as they become the only funding option. Second, with businesses now having to be significantly larger before they approach venture capital funds, business angels have to make larger amounts available to their investee companies and finance them through a series of funding rounds over a longer time period. Many business angels have responded by forming syndicates which have the financial strength to meet this changing demand.

Government therefore needs to take a series of measures to support and expand the business angel market. First, it needs to provide more generous core financial support, to fund business angel networks which have significant positive effects on market efficiency (enabling investors and entrepreneurs seeking finance to more easily locate one another), capacity building (through training and education activities focused on raising the competence of novice and inexperienced angels, and enabling entrepreneur to become investment ready) and building angel syndicates. The UK's Business Angel Network system is static at best whereas it is growing in many other European countries. Second, Co-Investment Funds have been critical in increasing the investment capacity of business angels. However, their availability is patchy across the UK. Moreover, there is no consensus on the most appropriate model for such funds. Government therefore need to ensure that investors and businesses across the country have access to co-investment funds. There is also need for research to evaluate the effectiveness of the various forms of co-investment schemes that currently exist across the UK. Third, tax is the biggest influence on the amount that they allocate from their investment portfolio for investment in unquoted companies. Government must therefore appreciate that raising the top marginal rate of tax and capital gains tax is likely to depress levels of angel investment. Given this sensitivity of tax it is not surprising that the angel community values the Enterprise Investment Scheme (EIS), which has played a critical role in stimulating angel investment in early stage, growth oriented businesses. As a *minimum* this must be retained in its present form. However, given

the particular funding issues in the seed capital market there is a strong case for raising the tax relief on such investments. This would also have the advantage of discouraging 'investment drift' in the angel market. In addition, there is a strong case for raising the tax write off from 20% to 30% for seed investments (this change needs to be accompanied by the change in ordinary shares discussed below). In addition, because of the way in which angel investing has changed in recent years some of the Scheme's rules need to be modified:

- The trend towards larger investments by angels means that the 30% maximum shareholding is becoming a constraint
- For similar reasons the restriction of investment relief to companies with less than 50 employees is becoming restrictive
- The requirement to invest in Ordinary shares runs against good practice in angel investing which advocates convertible instruments. Ordinary shares are particularly inappropriate for seed funding and forces the premature valuation of businesses which often proves to be inappropriate and as a result may deter subsequent investors or be unfair to the entrepreneur. It would be more appropriate to allow angel investors to provide convertible loan funding to a company which becomes convertible to equity at a more appropriate point in a company's development, without losing EIS relief. Relief would start from the conversion from loan to equity which would have to occur within a time limit – perhaps 24 months.

We therefore recommend the emphasis to government of the critical and growing importance that business angels play in financing growing business, lobbies BIS for increased core funding for Business Angel Networks, and lobbies The Treasury and HMRC to amend rules of the EIS which have become a constraint to investment on account of the changing nature of angel investing.

7.2.3 The Business Angel-Venture Capital Disconnect

Issue: The Enterprise Investment Scheme is contributing to an investment disconnect between business angels and venture capital firms.

Recommendation: Enterprise Investment Scheme rules are amended to enable business angel investors to convert their investment to the same terms as venture capitalists without losing their tax relief.

The funding escalator model sees business angels and venture capital funds as being complementary to one another. In early stage equity financing fast growing SME companies tend to be initially supported by business angel who provide finance, guidance and mentoring and then by venture capital firms which enable growing SMEs to access larger volumes of equity finance (to a point where they may be in a position to access the stock market). Our research suggests this model is in a danger of being compromised with a growing disconnect between the investment relationship of business angels and venture capitalists. The main driving force is the increase in the minimum size of investment by venture capital funds, which is forcing business angel groups increasingly to only invest in deals that they are able to fund themselves for an exit. However, there are also differences in investment philosophies and objectives between angels and venture capital funds. A further reason for this disconnect is the design of the Enterprise Investment Scheme (EIS)

which misaligns the interests of business angels and venture capital funds because of the requirement that business angels to invest using ordinary shares with no preferential rights to qualify for tax relief. Venture capitalists on the other hand typically invest using convertible instruments, such as a loan with conversion rights which are only exercised if the company is successful. This requirement misaligns the interests of business angels and venture capitalists when negotiating joint investments or when a company with existing angel investment seeks further investment from venture capital firms. One consequence is that angels often suffer 'cram down' by venture capitalists. Even though the angel may have supported the company from the it's early, and most risky, stage in its development the terms imposed by the venture capital fund mean that the angel receives a substantially reduced return. This may act as a disincentive for angels to encourage their investee companies to raise venture capital, and either limit the firm's further growth or seek an early exit.

We therefore recommend representation to HMRC to make this change to the Enterprise Investment Scheme rules.

7.2.4 The Pre-Market Funding Escalator

Issue: The system of equity funding of SMEs prior to IPO is too fragmented.

Recommendation: That research is undertaken to examine why the UK venture capital industry is segmented by stage and how start-up to IPO funds might be encouraged.

The funding escalator has created too fragmented a system of funding for growing SMEs. It starts with the small scale of public sector funds and restrictions on their size of investments which combine to limit their ability to make follow-on investments. Business angels have limited financial resources, notwithstanding the emergence of angel groups, and have upper limits on the amounts that they can commit to a single business. Venture capital funds are set up to focus on particular stages, rather than funding a company from start-up through to an IPO. The consequence of this series of vertical markets is a system which 'drip feeds' finance to growing businesses. This requires management time to engage in repeated searches for finance which may detract from their business, and reduces the potential returns of the investors in the earliest rounds who get diluted if they do not, or cannot, follow-on their initial investment. This, in turn, makes early stage investing unattractive. This contrasts with the situation in the US where venture capital funds invest across all stages and do follow-on the investments that they make in start-up companies.

We recommend research to investigate how the UK venture capital system might become less fragmented and move closer towards the US model. Government accepts that the funds that it has created have been too small and the current discussion about the UK Innovation Investment Fund¹⁶¹ appears to recognise the

¹⁶¹ The UK Innovation Investment Fund was announced by Government on 29 June to drive economic growth and create highly skilled jobs by investing in businesses where there are significant global opportunities. The Government has committed £150m with the aim of attracting significant private sector investment into a fund of funds, to invest into underlying specialist technology venture capital funds.

need to create funds of scale. This research should also assess the likelihood that this outcome will be achieved.

7.2.5 Trade sales amongst growing SMEs

Issue: Clarifying the benefits and costs to the UK economy of an SME trade sale on the public equity markets.

Recommendation: Research into the economic cost / benefit to the UK economy of SMEs undertaking trade sales.

We have noted that many growing firms opt to sell to another, usually larger, company rather than complete the funding escalator with an IPO. This is often instigated by venture capital funds that prefer a trade sale to an IPO as an exit route. Whether an SME trade sale is beneficial to the company – and hence to the UK economy – is complex. On the one hand, the acquired company may gain access to financial, managerial and strategic resources to enable it to continue to grow. In addition, the entrepreneurs who sell off their companies typically use the funds from the trade sale to instigate other entrepreneurial activity, act as business angels or even set up venture capital funds. This process of recycling their experience and finance clearly benefits the UK economy. On the other hand, it prevents fast growing firms – ‘gazelles’ – from becoming ‘gorillas’ – globally significant companies and so reduces the management pool with experience of growing global companies. Moreover, there is evidence that trade sales can be detrimental to the growth of an SME as the acquired company may be integrated into its new parent company in a way which limits its growth and limits entrepreneurial flair and innovation. In some cases the acquisition is mismanaged, resulting in the destruction of value. In addition, where the sale of a growing SME is to a foreign company the consequence may be that economic benefits to the UK economy, such as intellectual property, skills, the creation of UK headquartered global companies and future acquiring companies, may be lost.

We make two recommendations. First, further research would be valuable on the economic benefits and costs of trade sales of growing SMEs to the UK economy, and if found to be detrimental to make appropriate recommendations which reduce or remove the factors which encourage growing SMEs to seek a trade sale rather than an IPO. Second, we recommend that further research be undertaken which involves the London Stock Exchange and also engages in wider dialogue with the BVCA and its members and the venture capital community at large to explore what changes could be made to reverse the current preference for exit through trade sale, rather than an IPO, and to make appropriate recommendations to the relevant parties.

7.3. Recommendations: Operation of Growth Markets

7.3.1 Responsibilities of a Company Quoted on the Public Markets

Issue: Understanding the responsibilities of being a listed company.

Recommendation: Raising awareness amongst SMES and their advisors of good practice / methods in operating as a publicly quoted company on AIM / PLUS.

Following the success of an SME being admitted to AIM or PLUS, our research suggests businesses tend to underestimate the required commitment to investor relations associated with being a quoted company. Once part of a public market it is important that an SME provides company news and related price sensitive information on an ongoing basis to the market, investors and other stakeholders to keep all aware of the progress of the company. Without a regular flow of such information the inherent illiquidity of the market will be deepened to the detriment of the company.

Raising awareness among SMEs and advisors of good practice in operating on an exchange is important. We suggest the following could be undertaken to achieve this, building on the existing mechanisms in place:

- Literature highlighting examples of good practice in operating as an SME on the markets provided on AIM and PLUS websites; and
- Provision of training seminars to SMEs which have been admitted to the AIM and PLUS, and their advisors. SMEs currently operating on the exchange could be invited to help facilitate these seminars and share their experiences.

7.3.2 Improving Daily Liquidity

Issue: Low levels of daily liquidity on AIM and PLUS are impacting on SME valuations and fundraising activity.

Recommendation: Research is undertaken that considers how issues around low levels of liquidity should be tackled.

Levels of daily liquidity, particularly at the lower end of the market, are a major and recurrent issue for both AIM and PLUS. An illiquid share impacts the cost of capital of an SME and hence its ability to grow and fundraise. In particular it:

- Results in an unrealistic share price (often lower than Net Asset Value of the company) and in turn
- Implies a serious dilution of ownership in subsequent fund raising exercises
- Dissuades both retail and institutional investors from making further investments in the company;

Our research suggested there are methods through which liquidity could be enhanced, for example:

- Use of tax breaks for people investing in SMEs through an enhancement of the Venture Capital Trust (VCT) schemes; and

- increasing the retail investor base by, for instance, allowing AIM/PLUS stocks to be used for ISAs.

We recommend further research is undertaken that looks at how issues around low levels of liquidity can be tackled. This research would include further investigation of the ideas referred to above. The research should involve liaison with SMEs, the markets and wider investment community to establish the reasons for low daily liquidity and potential ways in which these problems could be mitigated.

7.3.3 Improving Further the Quality of Nomads

Issue: Importance of maintaining ongoing monitoring of Nomads.

Recommendation: AIM continues to monitor Nomads and an annual survey should be conducted to assess the performance of Nomads operating on AIM.

Nomads are used by SMEs to advise on the admission process to AIM and the rules and regulations regarding its operation. As such Nomads are a key pillar of the AIM regulatory framework. AIM recognises the importance of thorough procedures in the appointment and supervision of Nomad activity. Since 2007, AIM has undertaken an enhanced programme of ongoing monitoring of both the appointment and activities of Nomads with a view to improving standards and, where necessary disciplining those whose performance is not up to sufficient standards required by investors and SMEs.

Notwithstanding this increased surveillance of Nomads it remains the case that there are some Nomads of mixed quality. It is important that the ongoing monitoring of Nomads is maintained to ensure a high level of service is provided to clients. We recommend that ongoing monitoring of Nomads continues but that this is supplemented by an annual SME survey that assesses the performance of Nomads operating on AIM. This survey could be undertaken by a reputable research organisation or a major financial newspaper/journal on an annual basis and is likely to include covering areas such as satisfaction levels of working with Nomads, strengths, gaps in provision and areas for improvement.

7.3.4 Potential Impact of UK and EU legislation

Issue: Changes in EU legislation when implemented in the UK market may adversely impact UK SMEs. For example, the recent introduction by the FSA of the EU minimum listing route could have an impact on other UK market offerings including AIM and PLUS.

Recommendation: The City of London, AIM and PLUS to ensure that they remain central to the debates on changes to EU legislation which may affect the ability of SMEs to raise capital cost-effectively. The UK Treasury and UKLA take steps to encourage as far as possible the use of growth markets in the UK to genuine SMEs and feed into policy decisions at the European level to improve SME access to finance. .

The EU is currently holding debates on the Prospectus Directive, Market Abuse and Transparency Directive reviews. The extension of these existing EU directives to

smaller companies could have the potential to impact on the UK's aim to improve the environment for stimulating the growth of smaller companies.

We endorse the approach taken by the Quoted Companies Alliance (QCA) for the EU Commission to bring forward its reviews of the relevant directives and recommend that the City of London, AIM and PLUS continue to participate energetically in these debates, and also monitor any future changes to these Directives to establish if there could be potential impacts that will affect AIM and PLUS. This is an area worthy of further in-depth analysis and we recommend that a detailed piece of research be undertaken into the potential impact these proposed legislative measures may have upon growth markets.

For example, there are concerns in the market that the new Standard listing route introduced by the UKLA may confuse investors and companies and erode the differences between the different market offerings in the UK.

We recommend the London Stock Exchange continues to monitor the impact of this decision by the FSA so to respond appropriately should there be an adverse impact on the different market offerings. To mitigate the risks of differentiation of the UK market offerings, the UKLA should ensure that investors, companies and market participants fully understand the benefits of each available route to a public quotation in the UK.

7.4. Recommendations: Understanding SME Funding Issues

7.4.1 SME Funding Needs

Issue: A regular publication is required providing information and a greater understanding of SME funding issues.

Recommendation: To bring together a consortium of interested partners to make the case for or commission an annual 'state of SME finance' report.

Issue: There is a gap in information and understanding of SME financing issues since the Bank of England ceased publication of its annual publication Finance for Small Firms which stopped in 2004, following the decision of the Bank to step back from work on small firms. However, the commissioning of this report and the recent publication of other reports on SME finance (e.g. 'Shifting Sands: The Changing Nature of the Early-Stage Venture Capital Market in the UK', 'From Funding Gaps to Thin Markets' and others reports by NESTA, the 'Provision of Growth Capital to UK Small and Medium Sized Enterprises' by Chris Rowlands) underlines the need for a regular, comprehensive and authoritative report on SME finance which provides a commentary and interpretation of the available statistics and other information.

Contact with former Bank staff previously involved in the annual publication Finance for Small Firms, estimated that it would have involved three to four person months (for someone familiar with SME financing issues) which could equate to £50-£60k per.

We suggest that a consortium of interested partners (for example, BBAA, BBA, BVCA, BIS, HMT, HMRC) commission an annual 'state of SME finance' report.¹⁶²

¹⁶² Contact with former Bank of England staff involved in the Finance for Small Firms report indicates that the time input was in the order of three to four months, excluding special topics which were undertaken separately.

ACRONYMS

3 F	Founder, family, friends
AIM	Alternative Investment Market
BBAA	British Business Angel Association
BES	Business Expansion Scheme
BVCA	British Venture Capital Association
EBAN	European Business Angel Network
ECF	Enterprise Capital Funds
EFG	Enterprise Finance Guarantee
EGF	Early Growth Funds
EIB	European Investment Bank
EIS	Enterprise Investment Scheme
ERDF	European Regional Development Fund
FSA	Financial Services Authority
GEM	Global Entrepreneurship Monitor
HGF	High Growth Firms
HMRC	HM Revenue & Customs
IDBR	Inter Departmental Business Register
IPO	Initial Public Offering
IRR	Internal rate of return
JEREMIE	Joint European Resources for Micro to Medium Enterprises
M&A	Merger and acquisition
MBI	Management buy-in
MBO	Management buy-out
MiFID	Markets in Financial Instruments Directive
NESTA	National Endowment for Science, Technology and the Arts
Nomad	Nominated Advisor
OECD	Organisation for Economic Co-operation and Development
ONS	Office of National Statistics
PLUS	PLUS Markets
QCA	Quoted Companies Alliance
R&D	Research and Development
RDA	Regional Development Agency
RVCF	Regional Venture Capital Fund
SBIC	Small Business Investment Company
SBS	Small Business Survey
SFLGS	Small Firm Loan Guarantee Scheme
SME	Small and Medium-sized Enterprise
SPI	Swiss Performance Index
UCSF	University Challenge Seed Funds
VC	Venture Capital
VCT	Venture Capital Trust

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