



**London**  
Stock Exchange Group

**London Stock Exchange Group plc**  
**Response to the**  
**Rowlands Growth Capital Review**  
**17 July 2009**

*The London Stock Exchange is Europe's largest and most liquid equity market. Since 2007, London Stock Exchange Group also operates the Italian equity market and, through its subsidiaries, offers post-trade services and has a majority interest in MTS, Europe's leading market for trading government debt.*

## **1.0 Introduction**

The London Stock Exchange welcomes the opportunity to respond to the Rowlands Growth Capital Review. We believe that the Government should look to complement action taken to date to increase access to debt finance with policies that increase access to equity finance. This approach will be vital to ensuring a sustainable recovery.

## **2.0 AIM - providing access to growth capital**

Through the operation of AIM, our stock market for smaller, growing companies, the Exchange plays a specific role in financing UK SMEs. AIM is an important fund raising mechanism for early stage companies seeking access to growth capital.

As at 30 June 2009, there were 1,413 companies on AIM with a market value of £47bn, operating across 40 different industry sectors. Over 800 of these companies are UK SMEs providing around 150,000 jobs.

Since 1995, over 3000 companies have raised £61bn on AIM. Last year over £4bn was raised by AIM companies (£1bn of new funds raised and over £3billion of further fundraisings). Over the years, private equity and other early stage backers have successfully used AIM as an exit; indeed, most early stage backers are only willing to provide funding to companies because there is a viable exit route in the public equity markets.

In addition to providing a valuable source of finance for smaller companies, AIM has enabled a wide range of companies to significantly improve their international profile and visibility with key stakeholders. This is an important benefit of a vibrant public equity market and often translates into companies being able to attract and retain key employees and secure contracts that were often not available to them as private businesses.

## **3.0 Importance of public equity finance to growth companies**

Companies seeking to raise finance on AIM are often seeking large capital injections to fund innovation or growth strategies. These companies often have low levels of assets and cash flow and are usually unable to borrow money on commercially attractive terms.

Indeed, for some companies there is no realistic alternative to equity finance.

For example, high-tech, early stage companies may not produce revenues during the product development stage, and so will be unable to fund debt repayments. Similarly, smaller companies operating in traditional sectors seeking growth want to focus resource and capital on the core business without the added pressure of debt repayments.

Equity investment allows an investor to look closely at an innovation or business model, and fund the development of a company in expectation of a future return.

Public equity capital is therefore vital to driving the enterprise and innovation needed for sustainable recovery and ensuring the UK's position as a major knowledge economy exporter.

## **4.0 London Stock Exchange - response to the Rowlands Review**

### Scope of the Review

We would like to suggest that any discussion on the demand for, and availability of, long term finance to fund growth for SMEs in the UK should be in the context of all SMEs rather than only those that are cash generating. Not every growing company will go through each stage of the business life cycle in sequence - as SMEs are continually evolving they often compromise financial return for further development and/or change in business direction. In the Exchange's view, it is therefore more appropriate to discuss growth capital requirements in the context of SMEs that have robust plans and good growth prospects (but may or may not be 'cash generating').

We note that the scope of the review excludes financing of higher risk investments such as start-ups, spin-outs or venture capital ("VC") appropriate business. We agree that completely new business ideas (often funded by founder capital) may not be appropriate for discussion in the context of this review. However, it is important to recognise that as start-ups evolve into growing SMEs they often go back to the venture capital market for further funding to continue their product development efforts. We believe it is vital to consider the robustness of the entire SME finance ecosystem and not simply focus on particular rungs of the funding ladder.

In the context of the above comments, our response to the review relates to the wider universe of UK SMEs, including those with good growth potential that may not necessarily be cash generating or backed by venture capital type funding.

**Q1: Is there is a failure in the supply of long term finance to support the growth of SMEs? Does the suitability of different types of finance vary for different categories of business growth?**

**Please outline your definition of 'SME' in this context.**

We define SME as a company with a market capitalisation of less than £25m.

**Q2: If there is a failure, what is its scale and nature and which type of SMEs does it affect?**

We believe there is a failure in the supply of long term finance to support the growth of SMEs. And, this has only worsened in current economic conditions.

Some larger SMEs often struggle to raise funds for growth as they are considered too large for business angels and do not have the risk-reward profile desired by traditional institutional investors. And, equity finance remains more appropriate for SMEs seeking growth to enable them to focus resource on their business without pressure to re-pay debt finance.

Since AIM's inception in 1995, over 1800 UK incorporated SMEs have joined the market. The Venture Capital Trust (VCT) regime has helped these companies raise funds, contributing significantly to the supply of long term finance to support their growth. However, in recent years the reduction in VCT investment criteria, lower income tax relief and abolition of business asset taper relief have severely impacted the supply of VCT funding for SMEs (as evidenced in Table 1 included within the response to Questions 8 and 9).

In addition the combination of difficult market and economic conditions has had a disproportionately negative impact on many smaller companies. Many are struggling to raise finance during the downturn and the equity gap appears to be widening. These smaller businesses need support during the downturn as not only will they be important to the recovery, but they are also significant employers. UK incorporated AIM quoted companies employ over 260,000 people and around 150,000 of these jobs are provided by over 800 quoted SMEs.

The current market turmoil has reduced the supply of equity in AIM's primary market; for example there was £917 million raised via IPO during 2008 compared to £6.3 billion in 2007.

Market conditions have also severely impacted the value of trading (or liquidity) of all AIM securities as it fell by 66 per cent in the first three months of 2009 compared to the same period in 2008. As secondary market liquidity has fallen, the cost of trading has increased, further reducing investors' willingness to participate in the market and thus increasing the cost of capital to SMEs<sup>1</sup>.

The negative impact of falling liquidity is not limited to quoted SMEs needing to raise equity finance. Falling share prices are also undermining the confidence of customers, suppliers, employees and banks.

While we are very keen to explore ways in which the public equity markets can potentially be enhanced through public policy for the benefit of SMEs over the medium term, our immediate concern, is to look at short term measures to:

- increase the level of capital investors are able to provide to companies in the primary market
- stimulate trading in the secondary market – a liquid secondary market being a pre-requisite for the long term success of the primary market.

**Q3: What is the level of demand amongst SMEs for additional long term capital for growth, as opposed to shorter term, flexible and available capital?**

**If there is demand, what are acceptable costs of raising such capital and the appropriate return i.e. is dilution of equity acceptable?**

**What evidence would you cite in support of this view?**

There is clearly a strong demand for capital for growth amongst SMEs. As mentioned above, we believe that equity finance is more appropriate for supporting SME growth.

However companies are often forced to raise equity capital on less than favourable terms, even if they have a compelling business proposition. This is because of information asymmetries that exist around investing in smaller companies and associated higher perceived risk.

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<sup>1</sup> There is extensive research demonstrating the relationship between secondary market liquidity and a company's cost of capital. In order to compensate for the increased difficulty and cost associated with trading in a thinly traded stock, investors require higher net returns i.e., other things being equal, lower liquidity implies higher required returns and hence a higher cost of raising equity capital.

As a result of this, investors are in a stronger bargaining position. Whilst dilution of equity is not preferable, often companies have little choice in the matter as their original investor is unlikely to offer further funding and companies are forced to look elsewhere. This was the case even when the economy was growing and funds were plentiful.

This is where VCTs have been crucial to easing SME access to finance. The VCT regime has created an infrastructure of VCT fund managers who have the expertise to provide valuable support to smaller companies. We believe it is important for steps to be taken to encourage greater and more efficient investment through the VCT regime.

**Q4: If a financing gap exists, is there a range in the size of investments or risk:return profile of investment that is particularly difficult to obtain; at what level is this and why?**

Based on our experience, we believe that there are in fact a number of different equity gaps in the UK as different groups of investors focus on the different rungs of the SME funding ladder. Any measures to improve SME access to growth capital need to consider the SME funding ecosystem as a whole to ensure SMEs have continuing access to finance at all stages of their development.

The first gap exists between seed funding and venture capital funding in the £500k – £2m range. A gap exists at this level because many venture capital funds are not prepared to invest less than £2m due to the costs which arise out of doing a transaction – such as the necessary due diligence. We note that this is not the focus of the Rowlands Review.

The second gap exists at the £5m to £25m level. This is the level at which companies are too large to attract seed/venture capital funding, but are also not usually able to attract traditional institutional investors because of their risk-reward profile.

On AIM this has been evidenced by the average level of funds raised by companies with a value of £5m to £25m at admission falling from £15m to £4m. Please refer to Appendix 1 for further detail.

**Q5: Is there a difference across regions in the ease with which SMEs can access the appropriate type of long term growth capital, and if so why?**

Companies with a quotation on AIM originate from a wide range of locations around the UK. Of the total 1134 UK companies on AIM, around 50 per cent are based outside of London and the South East. The Exchange is committed to ensuring that companies from around the country can access the growth capital that they need. We run Investor Roadshows, bringing together companies and investors from different regions in the UK. Our CEO was recently in the North East of England promoting AIM and meeting with local companies and advisors.

We believe that any measures to improve SME access to growth capital must help bring together companies and investors to deepen the available capital pool for SMEs and improve overall liquidity.

**Q6: Is private capital available and willing to be invested in SME Growth Capital asset class? What would the minimum return expectations be?**

Whilst private capital is available and willing to be invested, measures could be taken to increase the amount which is invested in SMEs.

In particular, the tax system currently distorts investment away from equity investment and needs to be fundamentally redesigned to incentivise greater levels of equity investment.

Equity is taxed at purchase, dividend and sale whilst other asset classes such as bonds and cash are subject only to income tax. This means that debt finance is encouraged over equity which is often not appropriate for SMEs or the long term health of the UK economy. Stamp duty in particular is one area where we think there would be substantial benefits to the economy by removing it.

The Exchange has taken action itself to stimulate private capital investment in SMEs. Immediate actions have focussed on the need to stimulate liquidity and have included:

- Reduced trading fees for SME stocks – the Exchange has reduced fees and increased incentives for market makers
- Launched a research service for SMEs to alleviate the information asymmetries associated with smaller companies
- Growing Company Investor Days – providing opportunity for directors to meet new investors

**Q7: Should Government seek to intervene in this market, and if so, what are the policy options and measures for doing so?**

**Q8: What would be the appropriate approach to the delivery of any Government interventions for meeting this objective?**

### **Policy Measures**

The London Stock Exchange believes that the quickest way to boost equity investment in quoted SMEs would be through changes to existing tax legislation, specifically:

1. Enable VCT participation in secondary market trading
2. Increase gross asset and employee limits tests:
  - a. Increase the gross asset limit of qualifying companies so that VCTs may invest in businesses with gross assets of up to £25 million
  - b. Increase the employee limit so that VCTs may invest in businesses with up to 200 employees.

### **Further Information**

The Government should seek to stimulate private capital to boost investment in growth companies as this will be key to the recovery. As highlighted above, the Exchange has taken measures to encourage investment and increase liquidity in growth companies quoted on AIM.

Given that the funding landscape for companies seeking equity capital has severely contracted, the Exchange believes that the quickest way to boost investment would

be through changes to existing tax legislation. The changes proposed in this response relate to the current Venture Capital Trust (VCT) regime. Other interventions would be to make the costs of raising equity tax deductible. It is anomalous that the costs of raising loans are tax deductible but the costs of raising equity is not.

The availability of new VCT funds to SMEs on AIM has all but dried up (refer to Table 1 for VCT funds raised in recent years), leaving VCT fund managers and associated investment infrastructure under-used at present. The recommendations in this submission consider how VCTs could be used to inject much needed capital into SMEs and liquidity into their shares.

**Table 1.**

<b>Year</b>	<b>Total VCT funds raised</b>	<b>AIM VCT funds raised</b>	<b>Max Gross Assets</b>	<b>Investor Income Tax Relief</b>	<b>EU State Aid Restriction</b>
2005 / 6	£790m	£196m	£15m	40%	
2006 / 7	£267m	£29m	£7m	30%	
2007 / 8	£219m	£9m	£7m	30%	£2m max VCT/EIS per company; < 50 employees
2008 / 9	£30m to date	£6m to date	£7m	30%	£2m max VCT/EIS per company; < 50 employees

### **Recommendations to reform of Venture Capital Trust legislation**

As mentioned already, we believe the expertise of the VCT fund managers should be harnessed in the downturn to target equity funding at SMEs that are struggling to access finance. The fund managers have a good knowledge of which companies have sustainable business models but short-term financing requirements and the expertise to provide hands on support to the companies they invest in. This is particularly important in current conditions.

The following recommendations are designed to underpin the existing funds already raised by AIM focused VCTs and to support new fundraisings, thus assisting in creating a sustainable financing environment for quoted SMEs.

These measures will improve liquidity and thus increase the attractiveness of SMEs to other investors. This in turn will improve the prospects for SMEs to obtain equity funding at a reasonable price.

### **Recommendation One: Enabling VCT participation in secondary market trading**

Under current restrictions, VCTs are only able to invest in new shares issued by companies in the primary market and are unable to buy shares in the secondary market.

This restriction has the effect of reducing potential secondary market liquidity and makes it difficult for VCTs to re-orientate their portfolios towards those companies with better prospects thus hampering their own performance and attractiveness to end investors. Lifting this restriction would increase the liquidity and reduce the cost of capital for SME's desperately seeking funds.

The AIM VCT investment management community estimates that there is currently around £50 million of un-invested funds in AIM VCTs. If AIM VCTs were allowed to invest in the secondary market it would provide urgently needed liquidity and help alleviate the current downward pressure on share prices which has made it extremely difficult and costly for companies to raise further equity capital.

### **Recommendation Two: Increase gross asset and employee limits tests**

The current restrictions on VCT investment limit a VCT from investing in a company which has more than 50 employees and £7 million in assets.

As at 31 December 2008, we estimate that there were 170 AIM companies with qualifying UK operations, employing up to 200 people each with gross assets between £7 million and £25 million. However, due to current restrictions newly raised VCT funds are unable to invest in these companies.

### **Suggested action**

- Increase the gross asset limit of qualifying companies so that VCTs may invest in businesses with gross assets of up to £25 million
- Increase the employee limit so that VCTs may invest in businesses with up to 200 employees.

In the short-term, increasing these limits will make available existing funds to a wider pool of SMEs. In the medium term, increasing the limits will make AIM VCTs more attractive to their ultimate investors and help restore the ability of VCTs to raise funds. This will have a tax impact to the Treasury. However, we believe that, in the medium term, some fiscal assistance will be required to ensure the sustainability of a positive funding environment for quoted SMEs to prevent business failure, unemployment and loss of future tax revenue.

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### **Appendix 1**

The graph below shows that a company with a value between £5m - £10m at the time of admission to AIM in 2006 raised £7m on average compared to only £1m in 2008. Similarly, a company with a value of £10m - £25m at admission raised an average of £8m in 2006 compared to under £3m in 2008. We believe this shift is a result of current economic conditions as well as the changes in VCT legislation.

