QUOTED COMPANIES ALLIANCE

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SMALL AND MID-CAP INVESTORS SURVEY 2015

INSIGHTS FOR COMPANIES SEEKING EQUITY INVESTMENT

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INTRODUCTION

This is the second QCA/Baker Tilly Small and Mid-Cap Investor Survey, conducted by YouGov. We are delighted to be building on last year's report to provide insights into how the investor community have viewed the market in 2014 and how they view prospects for 2015. We also provide some useful tips for aspiring and existing quoted companies.

You will detect throughout this survey an aura of uncertainty when it comes to future markets; much of this is based on the behaviours of 2014. The IPO market started well, yet was overpriced, and then in the second half fell back even though valuations became more realistic. Our investors pointed to several contributory factors: the behaviour of bulge bracket banks, valuation-greed by selling shareholders, advisers seeing IPOs as a transaction rather than the start of a long-term relationship and the ever-changing economy and international scene.

Much of what is relayed in this report may seem to be obvious to many readers. However, we stress again that it is the investors who are consistently pointing out that they want to see clear evidence and action from companies when they talk to them and when they read their admission documents and annual reports. It is no good thinking that you do something; it is only good if you actually do it.

We have set out the positive signals that investors are looking for at the time of IPO and thereafter. We have also highlighted the mistakes that they told us many companies make and which frustrate them hugely. Glossing over bad issues is a major factor.

We have covered areas such as accounting standards, tax changes and reporting, but the key one which we have looked at, and which exercised our investors the most, was the interaction of investors with companies at the time of IPO and beyond. Face-to-face meetings count for so much.

It strikes us that any company worth its salt must start from scratch every time it conducts any investor relations. It should evaluate who should be on its share register; it should demand names of potential shareholders from its broker; it should ask why these names should merit their interest; and it should find out how each fund manager differs in terms of investment strategy and specialism. These helpful tips and more are highlighted throughout this report.

The Quoted Companies Alliance and Baker Tilly believe that this report will help every quoted company (and aspiring quoted company) understand how equity markets work so that they can use them better to raise finance and grow. By raising expectations, there is also the requirement that the companies themselves go to the next level so that their own performance demands more attention from investors. It should become a virtuous circle.

We would like to thank the 16 investors who gave up their time to be interviewed by YouGov. We very much appreciate their input and thought on this project.

Chilton Taylor
Head of Capital Markets
Baker Tilly

Tim Ward
Chief Executive
Quoted Companies Alliance

KEY FINDINGS

2014 was characterised by volatility, most likely as a result of the continued impact of macroeconomic effects on the UK's small and mid-cap sector. Generally, fund managers were slightly disappointed at how the market performed over the year, especially as the market showed signs of improvement at the end of 2013.

A VOLATILE MARKET AND MIXED BAG OF IPOS IN 2014

The first half of the year saw strong gains for small and mid-cap quoted companies and also a strong IPO market. However, this reversed in the second half of the year, with failed listings and then a sell-off of small and mid-cap cap stocks in the autumn.

The IPOs of 2014 were considered to be a mixed bag. While Venture Capital Trusts (VCTs) and Enterprise Investment Scheme (EIS) funds took part in many new floats, other small and mid-cap funds found the valuations either too rich, the quality of the businesses too poor, or they were given insufficient time to complete due diligence for many of the opportunities they saw. Secondary fundraisings, always a lower risk option, remained as popular as ever.

Investors we spoke to strongly criticised the performance of some advisers through the IPO boom earlier in the year, with major international banks being singled out. Small and mid-cap fund managers value the trust they have built up with specialist brokers and advisers within the sector and feel that this approach not only works better for them, but also for small and mid-cap quoted companies over the long-term.

While the decision to invest in either an IPO or secondary fundraising is difficult, few fund managers publicly regret any of the offers they had taken part in. They are also positive about most of the process involved, barring the odd gripe about the accounts (specifically the disclosure of cash flow and having too much hidden in the notes) and Admission Documents/ Prospectuses (such as, companies having generic risk factors – rather than company-specific ones).

PICK YOUR ADVISERS CAREFULLY AND WORK WITH INVESTORS EARLY-ON

Fund managers have many tips for companies looking to appoint advisers, as well as general tips about what they themselves are looking for from a business seeking investment. The most important takeaway from these tips is that companies should look to work with investors as early as possible and be open to a two-way conversation, which can include important advice from fund managers.

TURBULENT TIMES FOR 2015?

Prospects for 2015 are unclear and that in itself is worrying fund managers. The macroeconomic and political environment looks unsettled with geopolitical uncertainty, eurozone weakness, and the UK facing a general election in May. Such uncertainty always destabilises markets. Fund managers remain encouraged about the longer-term performance of their funds due to the quality of the businesses they are already invested in and the underlying earnings that they are delivering. However, some are clearly aligning themselves to minimise their downside risk.

ABOUT THE FUND MANAGERS INTERVIEWED

The Quoted Companies Alliance and Baker Tilly commissioned YouGov to undertake research into the current attitudes of UK small and mid-cap institutional investors towards the companies in which they choose to invest.

Respondents were recruited from a pre-selected database of the UK's leading small and mid-cap institutional fund managers. 16 telephone interviews took place during October and November 2014 with the following senior UK small and mid-cap investors:

David Stevenson
Amati Global Investors

Mark Niznik
Artemis Investment Management

Judith MacKenzie
Downing LLP

Catherine Stanley
F&C Investments

Jim Maun
Fidelity Investments

Guy Feld
Hargreave Hale Limited

Adam McConkey
Henderson Global Investors

Katie Potts
Herald Investment Trust

Robin West
Invesco Perpetual

Ken Wotton
Living Bridge

Richard Penny
Legal & General Investment Management

Daniel Nickols
Old Mutual Global Investors

Gervais Williams
Miton Group

Andrew Buchanan
Octopus Investments

Richard Power
Octopus Investments

James Thorne
Threadneedle Investments

The funds managed include VCTs, EIS funds, growth funds, retail unit trusts and pension funds. All of the funds invest in UK and/or European small and mid-cap quoted companies and many of the funds benchmark against the Numis Smaller Companies Index.

The fund managers we interviewed have varying definitions of a 'small and mid-cap quoted company.' These usually are dependent upon the investment mandate that their fund has. The range varied from a small and mid-cap quoted company being one with a market capitalisation below £30m to those with a market capitalisation up to £1.6bn. Those who operate VCTs tend to define a small and mid-cap quoted company at the smaller end of the spectrum, versus those that run larger retail unit trusts or pension funds, who tend to say that an average market capitalisation of a small and mid-cap quoted company would be anywhere between £300m and £500m.

THE MARKET

The past 12 months saw the markets challenged by volatile swings in sentiment. The UK's small and mid-cap sector began the year brightly, but then was struck by a flight towards larger cap stocks. Fund managers saw retail investors (thanks in part to AIM and ISDX shares being able to be held in ISAs) and non-traditional small and mid-cap investors (such as international hedge funds) come into the sector. However, both, especially the international hedge funds, were perceived to leave as sentiment fell. Coming off the back of a strong run over the last five years or so, there is a view that, in many cases, valuations are now becoming more realistic in the small and mid-cap quoted company sector.

REVIEW OF 2014
– THE YEAR OF VOLATILE SWINGS

Early 2014 has been described by what one fund manager called "a big IPO frenzy," when it became a seller's market. This is in contrast to the position in the latter part of the year, which another respondent has called "show-me mode" – where benefit of the doubt and risk appetite for all companies has been removed.

Fund managers felt trading performance and growth were looking good for companies at the start of the year and that view has not actually changed for most. Despite the wider market's malaise as a result of macroeconomic issues, specifically the performance of sterling, emerging markets and the Eurozone, fund managers' longer-term perspective has allowed them to maintain their confidence in existing investments. Benchmarks for sector performance are down or level for the year, following several years of growth, so things have not been easy.

"We are still in quite a fragile worldwide economy."

KEY MARKET STATISTICS FOR 2014:

48
IPOs on the UK Main Market

72
IPOs on AIM

£9.3bn
raised by IPOs on the UK Main Market

£2.1bn
raised by IPOs on AIM

7012
Number at which the Numis Smaller Companies Index peaks at in February and then steadily declines

FUND PERFORMANCE

The Numis Smaller Companies Index shows that the small and mid-cap sector has fallen from its gains at the start of the year. This reflects the position of most of the fund managers interviewed, except those running VCTs, who generally had more substantial gains over the year.

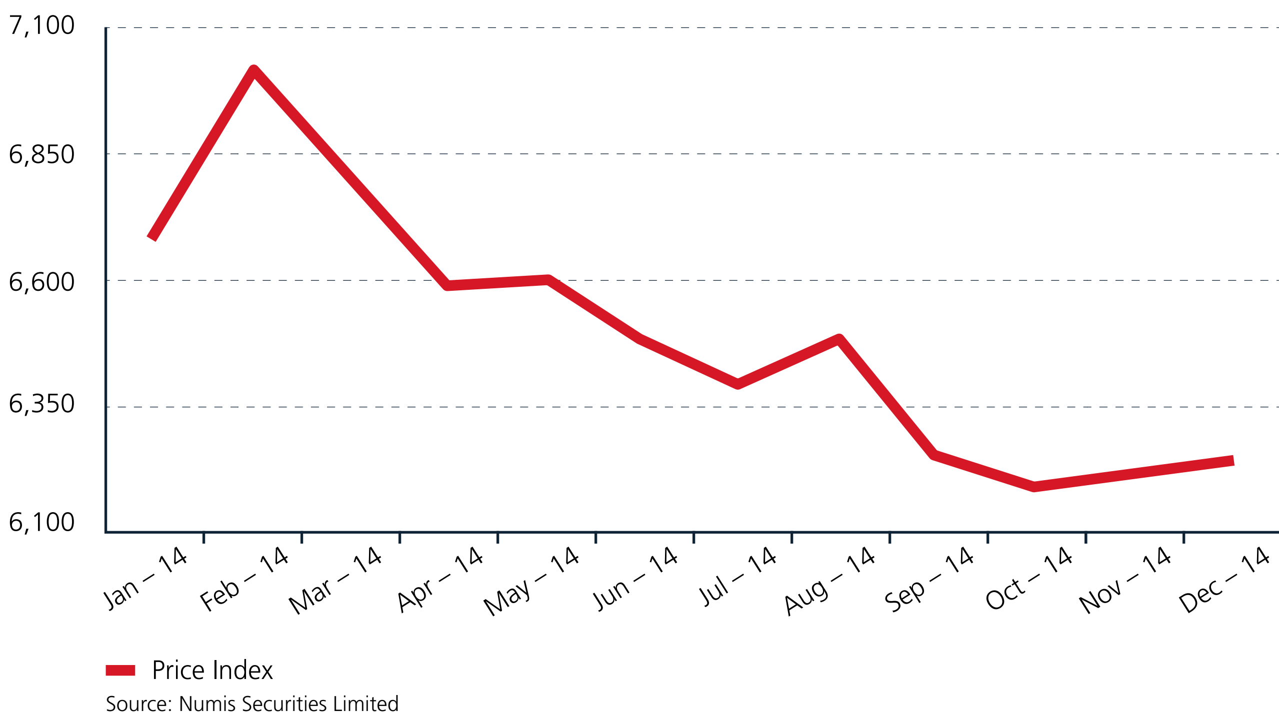
Despite this, none of the fund managers spoken to had particularly altered their approach over the previous 12 months nor did they intend to change it through 2015. Underlying quality of their investments remained sound in their eyes and any preferences for specific sectors or type of business showed no sign of being amended.

Most fund managers felt their fund had performed well in light of the market. However, most had hoped 2014 would be a stronger year of growth than it turned out to be, with growth being affected by negative headwinds from outside the small and mid-cap sector. As one fund manager put it "we were thrown by the gate-crashing of international events."

There is a sense though that some fund managers are becoming slightly more protective toward downside risk, but fundamentally their approach is not changing. Their view is that what makes a good business remains the same.

Inevitably, most fund managers have benefitted from a certain amount of activity around mergers and acquisitions during the year. It is interesting to note that those who then found themselves with cash in their portfolios (either through M&A or new inflows) were happy to be able to take advantage of the opportunity to reinvest when prices pulled back in the second half of the year.

Numis Smaller Companies Index (Excl Investment Trusts) – 2014



Source: Numis Securities Limited

> "Share prices do not match earnings growth over short periods, but they do, eventually, over longer periods. They continue to grow their profits and their dividends, so it will be reflected in the share prices in due course."

ENCOURAGING MORE INVESTMENT IN SMALL AND MID-CAP COMPANIES

Nearly all the fund managers we spoke to were pleased with the changes they had seen in the market over the previous year, specifically around the abolition of stamp duty on growth market shares and allowing AIM and ISDX shares into ISAs. The view was generally that "we're living in, at the moment, quite a supportive environment for smaller companies" and there were few serious concerns.

However, there remain a few gripes and regulatory changes that some would like to see, such as:

- Addressing the unintended consequences of a recent proposal to ban the use of dealing commissions to pay for investment research;
- Allowing VCTs to buy shares in the secondary market;
- Creating an additional ISA allowance just for investing in small and mid-cap quoted companies;
- Providing corporation tax benefits to companies employing at a faster rate;
- Allowing VCT investments to qualify for Capital Gains Tax Deferral Relief, as EIS investments do;
- Addressing EU State Aid restrictions on VCTs and EIS (such as increasing the annual investment limit for VCTs and EIS and the size of companies that can be invested in); and
- Creating a fund that can specifically invest in companies that qualify for Inheritance Tax (IHT) Relief (for example, AIM and ISDX securities).

In general, fund managers do not think that legislators understand that small and mid-cap companies can perform better than large cap companies over the long-term. Therefore, there was a feeling that there should be greater encouragement from both policymakers and regulators to back these growth companies and grow liquidity.

One respondent simply asked for the regulator to stop tinkering completely, as a period of stability would help the market make the necessary adjustments. Another picked out the "interesting dichotomy" between the risk aversion coming out of the Financial Conduct Authority (FCA) and the Chancellor's tax incentives for investing in small and mid-cap companies. The idea of tax breaks for investing in the small and mid-cap market, despite any self-interest, just seems logical to many.

> "UK small companies are one of the engines for growth in the UK economy, so if you can encourage more capital to be applied to the sector that should be a win-win scenario."

QCA VIEWPOINT:

THE DANGER OF BANNING DEALING COMMISSIONS FOR PAYING FOR RESEARCH

Europe and the UK's Financial Conduct Authority (FCA) are having a close look at how investment research is paid for. Research is seen as an inducement provided by brokers to encourage fund managers to trade in particular stocks. There is a desire to make paying for these inducements more transparent. At the moment, it is often bundled up in dealing commissions and fund managers allocate a proportion of the commission they pay for dealing in shares to the brokers that have provided them with the research. They have the benefit of hindsight and they pay for what they deem to be research that has helped them.

All that will change if Europe and the FCA are successful in banning the use of dealing commissions to pay for investment research, which is what has been proposed. Fund managers will have to be clear about who they think will provide them with valued research. We may see a move towards a subscription service where fund managers pay in advance for a research service. As a result, we could see research gravitating towards the larger brokers and investment banks, which can afford to pay for a larger group of researchers.

The consequences of this could be that there is less research devoted to small and mid-size quoted companies. Funds and brokers that concentrate on small and mid-cap quoted companies will have even less spending money.

This could have a profound effect on small and mid-size quoted companies' ability to raise finance on public equity markets and grow. It could lead to a reduction in the number of research pieces on small and mid-size quoted companies (which is already low) and a drop in liquidity (undoing hard won battles such as getting AIM and ISDX shares into ISAs).

Regulatory and Tax Changes Wanted by Fund Managers

Greater government encouragement of investment in small and mid-caps

- Address unintended consequences of not allowing funds to pay research commission from client funds
- Allow VCTs to buy in a secondary market
- Allow VCT investments to attract Capital Gains Tax Deferral relief
- Offer IHT benefits through a fund management structure
- Address EU state aid restrictions on VCT s and EIS
- Provide corporation tax benefits for 'faster' employers
- Create a small-cap-only ISA allowance

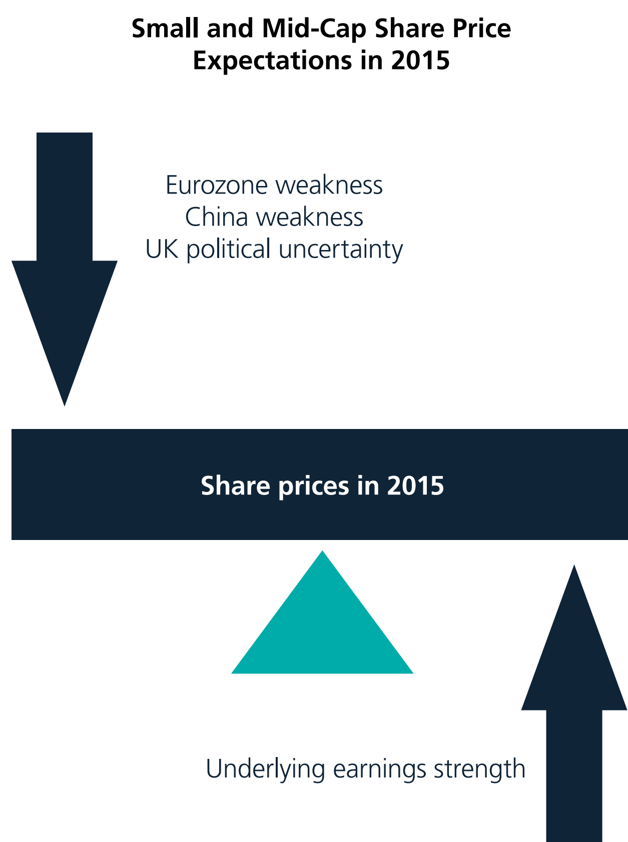
UNCERTAIN OUTLOOK FOR 2015

The fund managers we spoke to were reluctant to provide too much of a forward-looking perspective. Nonetheless, there was almost universal fear that the forthcoming general election would add uncertainty to proceedings, which the market invariably dislikes.

There was also a general concern that, for small and mid-cap quoted companies to pick up, there will need to be positive cash inflows and questions remain about where these might come from. However, fund managers of VCTs and EIS and IHT 'funds' in particular do expect net inflows over the coming year.

Overall, the view was summarised by one who said "I say this every year but, I'm still quite pessimistic." Despite the worry, fund managers expect small and mid-cap companies to perform well in 2015. General views swing from the bullish ("Small companies, I suspect, are set for a promising future, in general share price terms") through to the bearish ("It's a hard graft across the piste from here"). Most lean towards reasonable, if unspectacular performance through 2015.

Small and Mid-Cap Share Price Expectations in 2015



"I don't make predictions over short-term periods – it's a mug's game."

"People will be pretty apprehensive ahead of the election."

"We are confident that companies continue to deliver pretty good earnings growth and we are still seeing earnings upgrades out there – but whether that is going to be reflected in share prices over the next 12 months…?"

PRIORITIES FOR SMALL AND MID-CAP COMPANIES IN 2015

There are clear concerns amongst fund managers for market performance in 2015 and so the view is that small and mid-cap quoted companies may find life quite hard this year. As a result, investors are particularly concerned that small and mid-caps deliver what they say they will. By inference, this means that they hope businesses will be conservative in their expectations going forward. Any businesses that have faced foreign exchange problems or issues regarding exporting are expected to continue to be hampered by these.

One other area mentioned is the view that many investors, particularly larger ones, are becoming increasingly risk averse as a result of the attitude and action of regulators. Many felt that investors are being discouraged from investing in small and mid-cap companies due to the perception that they are 'risky' investments. This means that some investors may continue to manoeuvre their way out of the small and mid-cap space altogether, making funding and liquidity even harder to gain as the year progresses.

This squeeze is perceived to be in direct opposition to what the policymakers are trying to achieve for the market and is perhaps merely an unintended consequence. Regardless, it could be very problematic as it could diminish the value of being listed.

The key issue for companies, as outlined by one fund manager, is that "[Companies] all think that if they present well, they will get in a portfolio. The reality is, there are way more good businesses than there are slots in a portfolio." This may increasingly become the case if the number of small and mid-cap investors decreases.

"Don't disappoint on expectations – deliver what you say you are going to deliver and get noticed for the right reasons. Those are the businesses which will continue to have investor support."

"If [companies] don't make the numbers in the market set by consensus estimates from their broker and other brokers, they get ruthlessly punished, and it is hard to come back from that. I think the environment [of 2015] – one where there are a lot of question marks, a lot of uncertainties, and where it's not easy to run a business – is going to be key."

"I think that [companies] need to be realistic in a tough growth environment about what they can achieve and the timescales they can achieve it in, and the degree to which they are going to be cash hungry as a consequence. The last thing you want to be in is a company which does not have growth visibility and is going to run out of money fairly soon. Therefore, its ambitions are going to be curtailed massively by its ability to raise that money."

TOP THREE TIPS FOR QUOTED COMPANIES IN 2015

1. **Recognise that 2015 may be a difficult year due to macroeconomic and political uncertainty**
2. **Be realistic about what you can achieve and don't overpromise**
3. **Manage expectations and deliver what you promise**

IPOs

Just as the wider market was seen as being "a game of two halves" through 2014, the IPO market was considered to be the most obvious example of this. One fund manager referred to it as a "phase full of paradoxes." Valuations in the first half of the year were generally viewed as too high and yet many large IPOs got away. A withering in confidence followed when share prices slipped and so valuations retrenched into what was viewed as a more acceptable position.

QUALITY VS PRICE – REVIEWING THE 2014 IPOs

Between them, the fund managers we spoke to took part in well over 100 IPOs throughout the year (there were 120 IPOs in total in 2014 on the UK Main Market (excluding international companies) and AIM). In general, the view of most equity fund managers could be summarised by one respondent: "There were a few [IPOs] that were very good quality but were very highly priced. There were very few that I thought were high quality and the right price which I wanted to invest in." Fund managers describe the quality of businesses that came to market as "a mixed bag" or "I think there were a few chancers." Another said "there have been quite a few businesses which are perfectly decent businesses, but they have come at the wrong price."

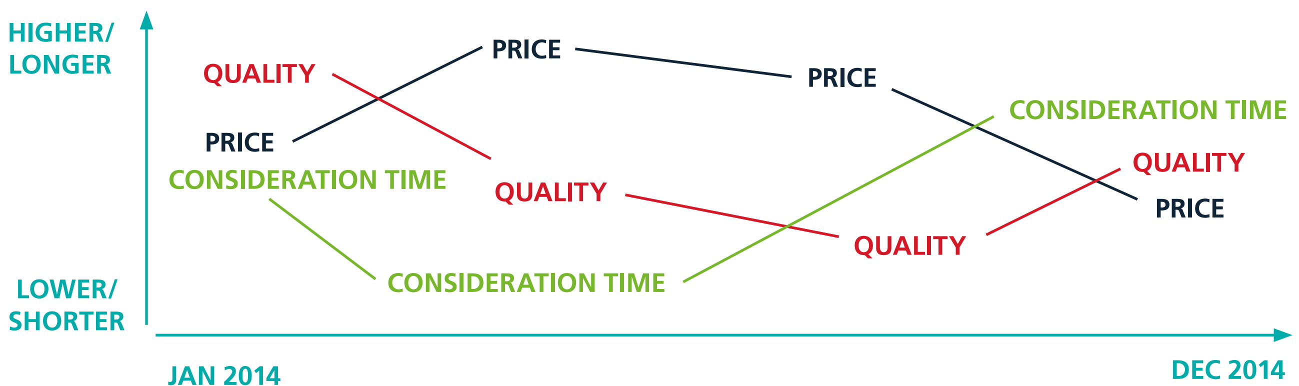
At the end of 2013, the view was that prices were about right, as people saw this as the start of a new cycle. The start of 2014 was described as being a little "frothy," with one respondent describing Q1 and Q2 as a time when some institutions were less price-conscious and panicked to get involved. The fact that some of the larger IPOs in the early part of the year were underwater relatively quickly was the key aspect noted as bringing more caution to the market. The second half of the year then saw more volatility, with some IPOs abandoned and prices sinking back down.

As prices have become more realistic, fund managers' interest in IPOs has risen again. As one fund manager put it: "My own slightly cynical view is actually, I think, just given the sheer scale of IPO supply, people on the buy-side have become much more discriminating about what they will pay."

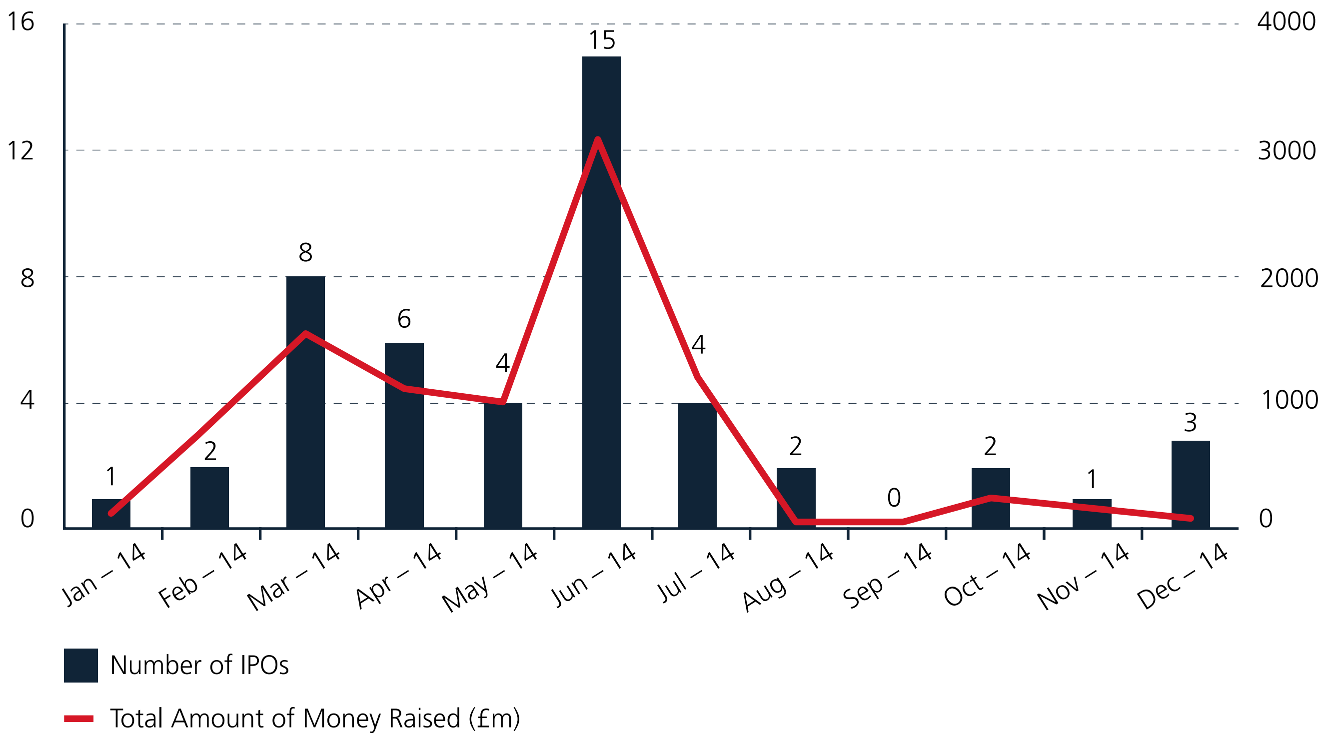
One fund manager also made the point that some businesses that came to market earlier in the year were businesses that were similar to existing quoted companies. As such, funds were not willing to risk money to pay a valuation for a less well known business that was similar to one already quoted. Fund managers stated that the risk level demands there will be a discount to existing similar opportunities.

Similar to the results of this survey last year, fund managers complained that they did not have enough time to make investment decisions, especially in the earlier part of 2014, and so some did not take part in IPOs.

2014 IPOs – Fund Managers' Perspective of Price, Value and Consideration Time

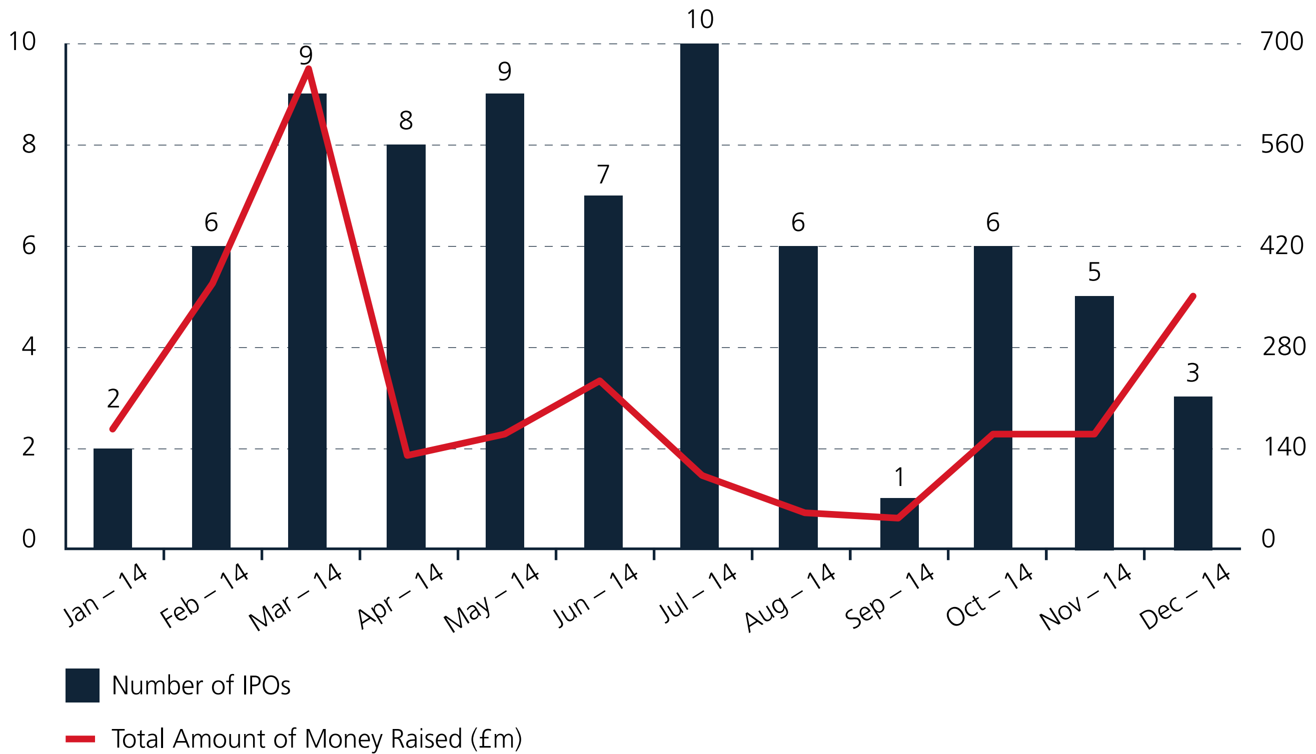


IPOs and Amount of Money Raised on the UK Main Market in 2014 by Month



Source: London Stock Exchange

IPOs and Amount of Money Raised on AIM in 2014 by Month



Source: London Stock Exchange

"At the height of the IPO frenzy, we had to make decisions within a very, very short period of time, which did not allow us to do the diligence that we would want to do."

"You roll forward into February and we seemed to move fairly quickly into a much more aggressive valuation environment, but still some attractive businesses to look at. Then, if you rolled that forward into the second calendar quarter, we were beginning to see some of the worst signs of very fledgling, less attractive business opportunities, and valuations that were too high. So I think we were disappointed. There was an element of greed. We felt there should have been another six months of fairly-valued, compelling businesses."

"We have avoided some of the bigger [IPOs]. I think there is more value at the small end where the companies are still loss making – where people need capital. That is where we find more value."

PRIVATE EQUITY AND EXITS

While private equity (PE) owners were mentioned almost universally as being responsible for some of the excessive valuations of the 2014 IPOs, there is no suggestion that PE owners exiting a business via an IPO is always a negative. In fact, the view is that, without PE backers, there would not be many IPOs left. Fund managers are realistic enough to say that PE can form a useful function of recycling businesses back into the market. In cases where a PE owner does not exit completely at the point of bringing a company to market, there remains the opportunity for the PE owner to remain an important part of the business's joint ownership going forward.

PE owners are often credited with adding discipline to these companies and getting them well prepared for public life. However, there are occasions where the management team is perhaps forced to float by their PE owners or are just unprepared (or inexperienced) for a public listing.

"…If [PE owners] are completely selling out, then that is something that weighs on our calculations."

"Having a temporary owner in the form of private equity is not going to put us off if we think there is a quality business with good growth potential."

"I always have quite a pretty cynical view of private equity there. They obviously want to make the most profit they can and, if they are selling out, there is no incentive for them to give anything to the next guy. So I am even more wary of the majority of totally-owned venture capital companies that [come to market]."

OUTLOOK FOR THE IPO MARKET IN 2015

Most fund managers expect there to be a decline in 2015 of companies coming to market – perhaps a continuation of the lower level of IPOs in the second half of 2014. The view is that the tap of new money has been turned off to some extent, even if the number of businesses trying to IPO does remain consistent. As mentioned earlier, the uncertainties around macroeconomic and political issues are thought to be primarily the cause of lower expectations for the IPO market in 2015.

Nonetheless, fund managers have commented that the quality of IPOs has actually improved recently, partly because pricing is more realistic. The prevailing belief is that businesses that can generate value and provide returns will continue to attract investment.

So, fund managers will not be pulling down the shutters on all IPOs. "Some funds, such as VCTs, essentially have to take part in IPOs so there will continue to be some appetite, but the quality of opportunities is unclear.

"There is going to be less money around so people are going to be more selective."

"It is tougher to get things away, but good stuff is absolutely still getting away. We will look at things. If they look like proper businesses, with proper commitment to the quoted market and what we need to see, then that's fine. There just won't be that many of them."

"There could easily be, in this environment, some very interesting, much more sensibly valued propositions."

FUNDRAISINGS

Most of the fund managers we spoke to do not feel any pressure to take part in IPOs, except those running VCTs and EIS funds. So the ideal attributes for an IPO investment are no different to the ideal attributes for any investment that an institutional fund manager may wish to make.

THE IDEAL ATTRIBUTES

At the heart of the decision of whether or not to invest is the opportunity to fund a business that will deliver above average growth. Tied to that, there is the likelihood that the business will significantly outperform the wider market within the average three to five year holding period of a fund manager. This will deliver the sort of gains that funds need to return to their investors.

When looking to invest, fund managers want to see financial integrity, clear prospects and quality management. Tied into that simple formula is a series of key points below.

☑ **Pre-marketing and/or longer relationship prior to IPO**
Ideally, the fund manager will have met management well before an IPO is considered. This allows the business to gain feedback and make changes ahead of the IPO process and allows potential investors to see if targets set in the year before IPO are met.

☑ **Valued properly and at a good price**
Like any decision, price will ultimately decide whether a fund invests or not – especially following some of the IPOs of 2014.

☑ **Strong management team**
Fund managers want to see a management team that is focused on the business and hungry to succeed, preferably with a track record of success or relevant previous experience. Suitable non-executive director (NED) support is important, and NEDs should be in place well before an IPO.

☑ **Clear business plan and strategy**
Fund managers are keen to understand how the business will develop in coming years, preferably over a five-year time span. Companies should be prepared to articulate clearly their strategy and plans for growth.

☑ **Genuine reason to raise funds**
Funding should be sought to drive growth. It should not be sought simply as a way for management or private equity to exit in the case of an IPO or to pay back debt in the case of secondary fundraisings.

☑ **Partnership**
The business should be looking for institutional investors who will be treated as partners. Ideally, there should not be a single shareholder who will retain majority ownership.

☑ **Uniqueness**
While the business does not have to be completely unique, a defendable proposition or first-mover advantage, often within a niche market (so it does not attract competition from major players), will offer a certain security for future growth and earnings.

☑ **Openness**
The business must be able to establish trust with the fund manager through transparency, open dialogue and clarity in its accounts (particularly around its cash flow).

☑ **Track record**
The accounts should show growth going back over a number of years. Ideally, companies should strive for a debt-free balance sheet.

☑ **Corporate governance**
Corporate governance is seen as a way of establishing greater trust with potential investors. NEDs have an important and valuable role to play in helping a company to develop its governance processes and behaviour. Investors do not expect companies to tick all the boxes at the point of IPO, but want to see them taking governance seriously and it evolving over time. Fund managers told us that they are particularly keen to check the specifics around directors' remuneration and related party transactions.

☑ Commitment to public ownership
Companies should have a management team, which understands what it means to be quoted and is committed to the constraints, but also to the benefits, of being a public company.

☑ Early-stage news
In the case of IPOs, fund managers would like a strong news-flow post-listing, particularly as markets are so sensitive to delays and deferments. They want to see early wins. In the case of secondary fundraisings, ongoing communication with your investors is key to developing a mutually beneficial relationship.

"Anyone who can do double-digit growth is going to pretty much get an interview with me."

"I like to see people maybe who have made it before. I like to see hungry people – people who are not necessarily too rich, who are really motivated and who want to go and make their next fortune."

"We are working on the basis that, if the stock market shut tomorrow and we came back in three years, it needs to be a bigger, better company with a better valuation. This is the opportunity to get involved, but we do not expect any immediate instant gratification."

"[I look for] a management team that seems to know what they are doing. [I look for] enough evidence that the business model looks like it is working and that the valuation makes sense, seeing a reasonable growth rate."

"I'm very price-conscious at the moment."

"We have three things that we would look for. First, a personal 'raison d'être'. Second, could or should [the company list], and third, value. If you are not ticking at least two of those three boxes (because value is always a conversation at the end of the day), we are not going to play."

> "Three basic questions we ask ourselves: a) does it have the ability to give a sustained above average earnings growth, a unique feature or niche exposure; b) can we identify the opportunity for this company to surprise the market positively (and that very much goes to or is driven by our analysis); and c) do we think this company for whatever reason can be re-rated relative to the market."

> "The first thing we look for is a completely open dialogue and flow of information so that we can build a model or a view of the business over a reasonable time period to date. Then we look for businesses where we think they have a sustainable business model within its market and a competitive position. [We also want to see] a corporate structure, which means that institutional equity holders effectively have as much control over the board as anyone else, and that the corporate governance is strong."

> "I suppose, if you boil it down, what I want is a stream of growing cash flows into the future and for that stream to be relatively predictable. There is hopefully a low chance of any diminution, and in order to generate those cash-flows, you do not need a lot of capital. That is the essence of a good investment."

RED FLAGS

Fund managers are pretty clear on the major issues that make them uneasy about a potential investment. Many of the concerns represent the reverse of the ideal position and cover perceived problems with management, business sustainability, the balance sheet and obviously the price or value.

☒ Toppy prices
Fund managers want value. If the price goes beyond what fund managers have signalled that they expect, then they will pull out.

☒ Challenging forecasts
One fund manager described excessively optimistic or challenging targets as being "toxic," with the greatest sin being a warning post-IPO.

☒ Cash out
In general, investors do not want to see private equity or management exiting.

☒ Lack of experience and track record
Fund managers are sceptical of a poor or sketchy management track record and lack of trading history.

☒ Inappropriate deal structure
Investors are likely to get cold feet if there is a lack of free float or a large owner retaining majority ownership.

☒ Wrong sector
Most of the fund managers in this survey avoid capital intensive, heavily specialist and/or early stage businesses, though the latter is more relevant for VCTs and EIS funds.

☒ Unbalanced management
Investors have concerns over a dominant CEO who has built 'his' business coupled with a subservient CFO.

☒ The wrong brokers and advisors
Your advisers matter. The broker and banks on the ticket can be an instant turn-off, with several fund managers saying that big banks in particular would be a major warning sign, particularly if there is more than one. A second layer of intermediaries is also concerning.

☒ Inconsistent performance
A company's track record of positive performance should have no gaps.

☒ Acquisitive companies
Companies that are bulking up the business through acquisitions or that are using a fundraising to build a war chest are viewed sceptically by many fund managers.

☒ Speed and rushing a decision
If a fund manager feels rushed into a decision, that is an instant a red flag. Lack of time to properly assess the business, no piloting or test-marketing, and late access to documentation will all count against a possible IPO or fundraising.

"I do not like management teams that have parachuted in just to conduct an IPO."

"Duration of management and ownership of management in the equity is an important factor for me as well."

"There is a second leg of advisers in this process, which we are very, very uncomfortable with. We do not like the advisers to companies who help them do a beauty parade and choose investment banks. In fact, if we see them, we're almost 100% likely not to invest."

SECONDARY FUNDRAISINGS VS IPOs

There is unanimity amongst fund managers we spoke to that they mostly would want to, wherever possible, participate in secondary fundraisings. Generally, they all prefer secondary fundraisings to IPOs because they know so much more about the business. The track record takes away much of the risk felt towards IPOs.

However, there will be little discount on a secondary fundraising as the risks are better understood. So, sometimes the value might not be there as much as with an IPO. Nonetheless, investors are keen to reward a management team that is delivering and also retain the percentage they hold in the business.

> "Hopefully, we will have much, much more historical information to base our decision on [in a secondary fundraising], which makes me much more comfortable than doing an IPO."

> "We like to do as much of that as possible. This is not a stranger knocking on your door, and that is why IPOs have to come at a discount usually."

CHOOSING ADVISERS

It was clear from our discussions with fund managers that choosing your advisers wisely is important in terms of attracting investors. While many fund managers mentioned that some of the over-valuations that characterised the first tranche of the IPO market in 2014 were driven by hopeful business owners and private equity owners in particular, it was the advisory firms that bore the brunt of the negative comments, in particular the big banks.

ADVISERS AND THE IPOs OF 2014

Many fund managers said that seeing certain big banks involved in an IPO would put them off, as they would perceive it as being transactionally-driven and a "sausage machine" approach. Amongst a number of respondents, there was certainly a spontaneous and general "suspicion of bulge bracket banks operating in gaggles."

Fund managers also cited concerns that, when more advisers are involved in an IPO, more mouths need to be fed. This extra number of advisors also caused an obscuring of the real position and an "artificial price tension." One fund manager was left with a feeling that there may have been a "divide and rule" exercise going on through use of syndicates, possibly caused by high levels of competition amongst banks to get on the ticket. Earlier in 2014, there was also a feeling that some of the placings were taken up by purchasers who are not necessarily the natural holders of UK small and mid-cap stocks and may, therefore, not hold for the long-term, potentially to the detriment of the company.

The so-called froth in the market, mixed with the distaste for some advisers, came through in stories, such as:

> *There was one instance where we were asked by a broker to send an email giving the reasons why almost we should be allowed to invest in this fantastic opportunity, which, when it gets to that point, I think it is time to move on really.*

Another said:

> *I have five pieces of research on my desk from five different banks on one stock. We won't even see the company. There are five pieces of research. It is too many. It is being set-up for a sale. It will be over-broked. It will be overpriced. All the banks are doing it – the big banks, not the specialist [ones]. The big investment banks' behaviours have deteriorated very rapidly.*

"Normally, the seller is taking money out. He is paying the investment banks, brokers and fees in commissions for getting the shares shifted, so I am rather cynical about the whole thing."

"I have no time for the big boys."

"The vendors of the cycle, the big banks, just want to pump these up and take the fee and forget about it. That is where we have been in the last six months."

CHARACTERISTICS OF A GOOD ADVISER

Fund managers seem to be far more comfortable dealing with smaller, specialist brokers with whom they have a more trusted and personal relationship, where valuations are generally more realistic and feedback from the fund managers is listened to. Nonetheless, some small and mid-cap brokers are viewed with scepticism. Fund managers are looking for long-term relationships with businesses and are concerned that big banks are rarely looking to establish the same in their part of the market.

Some fund managers noted that, rather than preferring certain brokers/banks, it is instead down to the individuals who are coming to them and whether the fund manager can trust them. Others took a more pragmatic approach and said that it is all about the quality of the house and how dependent on fees they are.

Central to choosing advisers is the need to establish trust between the two sides. Investors are cynical of how trust can be genuine when advisers are often incentivised in a way that will not benefit the company in the long-term. Fund managers suggest that companies should focus on the following areas when choosing a broker/NOMAD/bank:

- a track record of strong after-sales service;
- ability to provide proper research;
- ability to provide market making; and
- those that are willing to contact shareholders when a significant RNS comes out.

Companies need to find advisers who will listen and work for their benefit. This requires establishing a genuine rapport.

"I don't think the City is a particularly nice place; it is full of charlatans, scoundrels and people that can't be trusted. When people are paid commissions and big fees for doing deals, that lends itself to poor advice."

"If you see a local accountant in there that you have not heard of, that raises eyebrows."

"You can form a stockbroker tomorrow. Then you can have a couple of good [IPOs]. You are everyone's friend, but actually, you get greedy. You take a lot of fees; you lower the quality threshold; you push as much through the sausage machine as possible and then you blow up. This happens time and time again, particularly in the world of small cap broking."

"I think the biggest thing is probably to find an adviser that you think can give you the coverage in the market, and listens and wants to understand your business, rather than telling you what they think they can achieve."

Small and Mid-Cap Fund Managers' Views of Advisers

Small and Mid-Cap Specialists

- More likely to be looking for a long-term investor base
- More trusted relationships, though scepticism remains
- Can be prone to chasing fees
- Better understanding of small and mid-cap fund managers
- Likely to try to establish deeper client relationships

International Banks

- Lower trust as higher turnover of sell-side staff
- Can be immediate turn off
- Prone to pressure selling
- "Sausage-machine", transactional approach
- Fear they will fail to build long-term, committed shareholder base

TEN QUESTIONS TO ASK POTENTIAL ADVISERS BEFORE APPOINTMENT

Fund managers recommend a series of questions that companies should ask their advisers (mainly aimed at brokers/NOMADs) either before or during appointment:

1. **Who is going to buy my company's stock and why?**
You should ask for specific names of potential shareholders and make sure you get a list that is fit for purpose with relevant investors.

2. **What do I need to know about each of the fund managers and their funds that I am going to see?**
All funds have different strategies and specialisms. If the broker does not know the funds well enough, then pick another. Nobody wants to waste time at meetings that will not go anywhere. Also, your broker should be able to tell you the major likes and dislikes of all the funds you meet. Brokers should help companies understand the sorts of questions investors are likely to ask them and how to answer them.

3. **How will you show fund managers that my company is different and perhaps better than existing investment opportunities?**
It is key that your advisers really get to know your business and can reiterate your growth story to potential investors. They should be excited about your potential and reflect the same enthusiasm that you have for your company.

4. **Do you have a track record in my sector?**
Do your research – your broker should have a track record in your sector.

5. **What services are you going to provide post-listing?**
Your broker should remain actively involved after an IPO or fundraising, providing access to your company and information. You do not want someone around only when the news is good.

6. **What are the relevant market rules and the ongoing disclosures that our company will have to make?**
Your advisers should be able to advise you on what needs to be disclosed to the market and how other similar companies handle their disclosures.

7. **Tell me about your view of the market. What type of advice do you provide on managing our news cycle?**
Brokers should provide support to companies on how the market will interpret information released, particularly at different points in the cycle.

8. **How will the price of a potential fundraising affect the make-up of my shareholders?**
Your advisers should help you to understand how different pricing levels, especially at IPO, impact the likely make-up of the shareholder list and how that will impact relationships post-float and long-term. It is also important to establish whether your broker will conduct test-marketing to robustly check the price and model.

9. **How many other clients do you have?**
It is important to establish whether the potential adviser has the space and time to take on your firm. Your company does not want to end up being a small fish in a large pond, and not get enough support.

10. **Tell me about your analysts. Can you give me some examples of their research on other similar companies?**
You should find out if the analysts of any potential broker write good research on competing businesses and understand the challenges and opportunities that you face.

COMMUNICATING WITH INVESTORS

Developing a relationship with your investors is important in helping to grow your company. Continuous, open communication is a key ingredient in this. The fund managers we spoke to all placed great value in face-to-face meetings, but recognised the important role that documents, such as prospectuses, admission documents and annual reports and accounts, play in providing an in-depth picture and story of the company.

MEETINGS WITH INVESTORS

The general view is that fund managers are only going to get a real understanding of what the motivations and ambitions of the management team are from face time. For many, the face-to-face meeting or presentation is where the deal is either going to be won or lost.

Investors need to be sure that they can trust management. Meetings are the only way to establish such trust. Small things, such as not leaving behind copies of the presentation or designing them in solid colour backgrounds so the investor cannot make notes on the page, can undermine this. The presentation also offers a chance to cross-reference what is in the prospectus or admission document to ensure that it is factually correct. Investors want to see the CFO answering the numeric questions, while the CEO talks about the business model and strategy.

THE ADMISSION DOCUMENT AND PROSPECTUS

The Prospectus or Admission Document is never going to be the only document that induces an investment from the fund managers we interviewed. However, its existence is certainly valued when used alongside other sources of information, such as face-to-face meetings. The disclosure requirements of the Admission Document/Prospectus make them a valuable and complementary part of the process.

Most suggest that the Admission Document/ Prospectus is important to go through, specifically looking out for:

- customer concentration or IP issues in the risk factors;
- information about the management and their own background; and
- information on advisers' fees (it was even suggested that these could be broken down more).

However, there are mixed views amongst fund managers about the usefulness of the risk factors set out in an Admission Document/Prospectus. Some say they find them useful. They accept that the majority of what is in there tends to be generic and bland, but there are sometimes additional dimensions worth following up with management. Others dismiss the risk factors completely, saying that it is their own job to find and assess the risks and believe that "they do not really tell you anything that a five year old child probably couldn't work out."

When asked if there was any other information that should be in the document, most felt that there was nothing else that is particularly necessary. Fund managers seem to feel slightly put out by the idea that so much information should need to be spoon fed to them when they feel perfectly able to implement their own processes and do their own due diligence.

The only area where there was any appetite for greater information was extending the length of financial track record shown in the Admission Document/Prospectus, particularly where a business has been trading for many years before coming to market.

Looking back at 2014's IPOs, none of the managers felt any great concern in hindsight about the IPOs they took part in, particularly around information that had not been declared. Where problems had occurred post-listing, respondents felt there was little or nothing that greater disclosure could have done to help.

In actual fact, the biggest gripe about the Admission Document/Prospectus was not its content, but the timing of its publication. Getting the Prospectus too late was a major bugbear for many who, in fact, feel it should be ready at the start of the process.

"All history and life is there in a Prospectus and it is definitely worth spending time on it."

"The Prospectus is really the last sense check to hopefully make sure that things like fraud, integrity of directors – those kinds of things – have been properly checked by the NOMAD. You would hope."

"It is less about what is in the document; it is more about when the document is available."

"It is [about] seeing the whites of the eyes and interrogating the business model."

THE ANNUAL REPORT AND ACCOUNTS

Respondents are generally positive about the amount of disclosure in the Annual Reports and Accounts, with praise given to guidance issued by third parties for small and mid-cap quoted companies who have generally followed it. Some complain about the disclosures being too boilerplate and, more generally, a box-ticking exercise. It is those sections that refer to the company directly which are of most interest, such as the Chairman's Statement.

With regard to the accounts, cross-referencing of the P&L and cash flow statements was mentioned as important. In addition, the note on costs which have been capitalised on the balance sheet, working capital movements, and deferred income and tax relief were highlighted as of interest. As one fund manager stated "they are all the typical areas for naughtiness."

One specific area mentioned several times was that of remuneration, with some wanting greater disclosure about salaries and incentives (especially on Long-Term Incentive Plans (LTIPs)). However, this was also mentioned as an area where communication, particularly between NEDs and shareholders, has improved in recent times. Some felt that remuneration issues were now being flagged in advance of AGMs, which is good news.

In general, respondents are keen on the disclosures they currently see in the Audit Report and the Notes to Accounts, such as accounting judgements and estimates, and often mention specific cases where this has been critical to understanding what is going on at a company.

In terms of the Audit Report specifically, the issues at Tesco were fresh in several respondents' minds. Most people feel that adding more reporting requirements here will never be able to completely cover all eventualities. Instead, it is down to auditors and investors to ask the right questions.

Generally though, the Audit Report and, more generally, the auditor were recognised as bringing an element of professional attention to the business. However, most felt that the Audit Report was nothing to get too agitated about and that they did tend to include boilerplate disclosure.

"A company I read this morning [had its] entire operational cash flow coming from paying their creditors slower and chasing their debtors, which is not really a sustainable way of generating cash going forward."

"The Audit Report is so anodyne that it would have to be an extreme breach before the auditor would actually say anything negative."

"A cash figure in a bank account is very difficult to fiddle on a consistent basis over time, whereas your profit is a judgmental assessment with the finance director, the auditor and whoever else."

ACCOUNTING STANDARDS

The view is that, over the years, accounts and financial statements have become increasingly complex and the role of the fund manager in analysing them has become increasingly forensic. Fund managers say they have to spend more time cross-referencing the P&L with the cash flow statements when really what they are most interested in, with early stage investments, is the cash flow. The starting point for accounts should be making them as simple and transparent as possible, and failing to do this will put off investors.

Specific points mentioned by respondents include:

- Several concerns about which costs have been capitalised on the balance sheet and amortization of goodwill versus R&D (which just adds confusion for some investors);
- A desire for more disclosure around revenue recognition and cost recognition policies;
- A greater focus in the accounts of what is going on in the 'real world' in terms of revenues;
- A desire for less general noise;
- A view that accounts have become less helpful and many of the changes in recent years have been of academic rather than practical value; and
- A dislike of constant changes to calculations, such as pension fund accounting, which then impacts all the numbers.

In terms of IFRS, there is an understanding that trying to bring accounting standards together is sensible, but that IFRS itself has not particularly helped achieve greater transparency. Greater uniformity is generally welcomed (where it is possible), but there is little enthusiasm for IFRS, with some readjusting accounts back to UK GAAP or complaining about the prescription of standards.

"We are in danger of not being able to see the wood for the trees."

"Accounts are becoming more and more of a dog's breakfast."

"Over time, pre-tax profits have diverged more and more from cash, which is what matters."

AVOIDING THE MISTAKES

Fund managers recognise that small and mid-cap quoted companies are not as developed as large cap companies and that things are a work in progress. However, there are a number of mistakes that companies can make, which can damage relationships with potential and existing investors. Companies looking for investment seem to sometimes forget that investors will probably have a raft of other potential competing investments from firms they may have known much longer and so getting investment is not easy.

TOP FIVE TIPS FOR BUILDING GOOD RELATIONSHIPS WITH FUND MANAGERS

1 **Don't overpromise and then fail to deliver**
The result of failing to deliver, particularly if it is still in the halo of an IPO, is that the price will get hammered and any fledgling trust between the company and its investors will be shattered. Post-listing, the frequency and tone of announcements need to be right, so that expectations are clearly managed, again not over-promising on timescales or future performance.

2 **Don't overprice**
Top-end price estimates can have a negative impact on the business in the long-term and decrease the likelihood of developing a sustainable track record. Also, top-end prices can bring in short-term investors looking for faster growth, which may not suit the management or company. The problem is then that the company is run by market requirements and not by its own strategy.

3 **Raise the right amount of money**
Fund managers stress that companies should be raising an appropriate amount of money to build their businesses, rather than raising less than required and hedging their bets on raising the rest when the market is higher. If the market does not go the right way, your company may not have enough cash to achieve its stated aims and then you end up with disappointed investors.

4 **Give straight answers**
The quickest way to wind up a fund manager is to avoid a difficult question or give a generic answer during a roadshow or meeting. Nobody will make an investment without absolute clarity of what they are getting into.

5 **Don't gloss over the problems**
As mentioned earlier, fund managers acknowledge that no company is perfect. Highlight your company's challenges and you will build trust with investors more quickly.

"Don't be a public company if you don't want to disclose basic information about yourself. You are in the wrong room and doing the wrong thing."

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