BAKER TILLY

Small and mid-cap investors survey:

Insights for companies seeking equity investment

January 2014

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Contents

Foreword – Chilton Taylor, Baker Tilly, and Tim Ward, Quoted Companies Alliance

Introduction	**4**
General fund-related considerations	**5**
Size of fund and preferred stake	6
Sector bias	8
Length of investment	9
Ideal investment cycle	10
Tax incentives	11
Gut instinct	11
Corporate characteristics	**12**
Corporate governance	12
Ethical policies and level of transparency	13
Dividend policy	13
Accounting standards and disclosures	14
Personality of the CEO	14
Fundraisings	**15**
Secondary fundraisings vs. IPOs	15
IPO likes and dislikes	16
Meetings with fund managers	**17**
The do’s and don’ts of meetings	17
Top 10 tips	19
Appendix: Methodology and full interview details	**20**

Foreword

One of the most important ingredients for a successful equity market is the availability of new funds. For small and mid-cap quoted companies, such finance is principally provided by dedicated small and mid-cap funds, which in recent years have generally suffered both a reduced allocation of overall institutional funding and withdrawals in favour of safer havens. This has led to a decrease in the availability of new equity funding for small and mid-cap companies and a paucity of IPOs in particular.

As the UK is at last showing positive signs of emerging from recession, the IPO market is opening up. As quality small and mid-cap stocks are likely to have the potential to attain higher growth than large, blue chip companies, it is an appropriate time to explore the current appetite amongst the small and mid-cap institutional investor base.

Through semi-structured in-depth interviews, we analysed the ways in which small and mid-cap fund managers approach investment decisions. These conversations covered:

- General fund-related considerations, such as the size of stakes which they like to take, their favourite industry sectors, and average length of investment;
- Corporate characteristics, including how important certain aspects of a company are to them;
- Fundraisings, covering the attitudes towards IPOs versus secondary fundraisings and how they perceive the IPO market today; and
- Meetings with fund managers, covering the do's and don'ts of meetings which companies need to be aware of when seeking to attract institutional investors.

We are delighted that this research provides an essential guide for companies when presenting to institutional investors together with a deeper understanding about how the "money" thinks and operates. Whilst some of the views expressed may seem common sense, they importantly highlight how individual funds may, for example, have different – often divergent – investment criteria – something that is important for companies to recognise when presenting their investment case.

Understanding this mindset allows directors of quoted companies to do their jobs better. It helps them understand that investors tend to invest in a larger proportion of a smaller company and hold investments for a longer period than in larger cap stocks. But, as a consequence, they may take longer to make up their mind about whether to invest.

The message is simple – view fund managers as potential investment partners; listen to what they have to say; and learn from their considerable experience. They are a valuable resource for any intelligent company that wants to create long-term value for its shareholders by delivering a coherent strategy via a well developed business model. Companies create market impact through the way they influence and utilise their shareholders.

We would like to thank each of the 16 fund managers that participated in this YouGov study.

We would welcome your views and challenge on the findings of this report.

Tim Ward
Chief Executive
Quoted Companies Alliance

Chilton Taylor
Head of Capital Markets
Baker Tilly

Introduction

Our survey reveals that small and mid-cap fund managers have a large degree of unanimity when they consider the attributes of an attractive company to invest in.

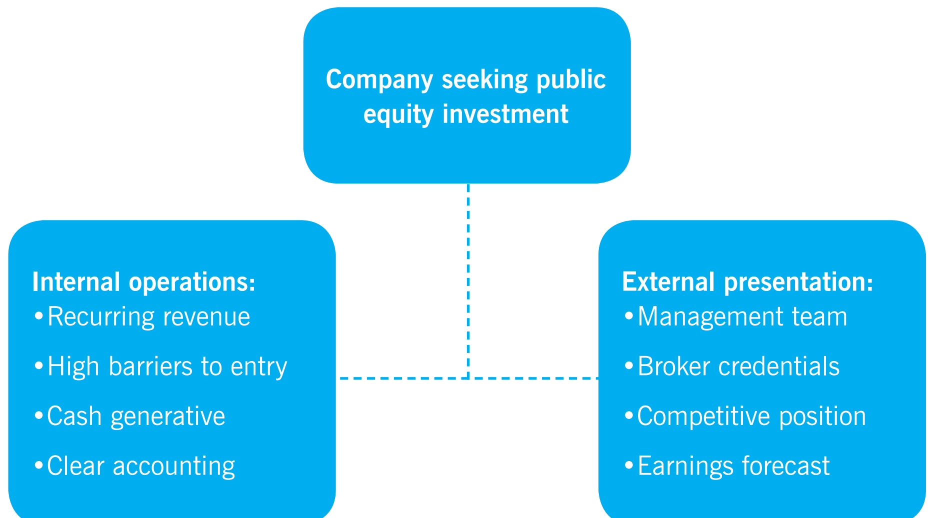
All of our respondents are looking for under-valued companies with good fundamentals, recurring revenues, a good management team and sustainable competitive position. Within this ambit, the investors divulged a number of insights, which are useful for companies to consider.

Most importantly, companies need to view fund managers as potential investment partners who can help to develop and grow their business and operations, rather than just as a source of funds. In exchange, the fund managers are keen to offer advice and support to help the company mature and expand. In doing so, areas like dividend policy and corporate governance are bound to be considered. But these are non-core to the original investment decision and are considered as ways of cementing the company's long-term development.

The most important consideration for any putative growth stock is to make sure they concentrate on both the internal and external aspects of the listing or fundraising process.

The clear feedback from investors is that, if a company is able to demonstrate that its internal operations are aligned with what fund managers are looking for and the external presentation of these operations is clear and credible, then this will give the best chance of success for the company. Bearing in mind that the fund managers we surveyed tend to invest in less than 1 in 10 of the companies they meet, it is essential that companies take this advice on board if they are to attract the attention of institutional investors who are constantly in demand.

Internal operations and external presentation



General fund-related considerations

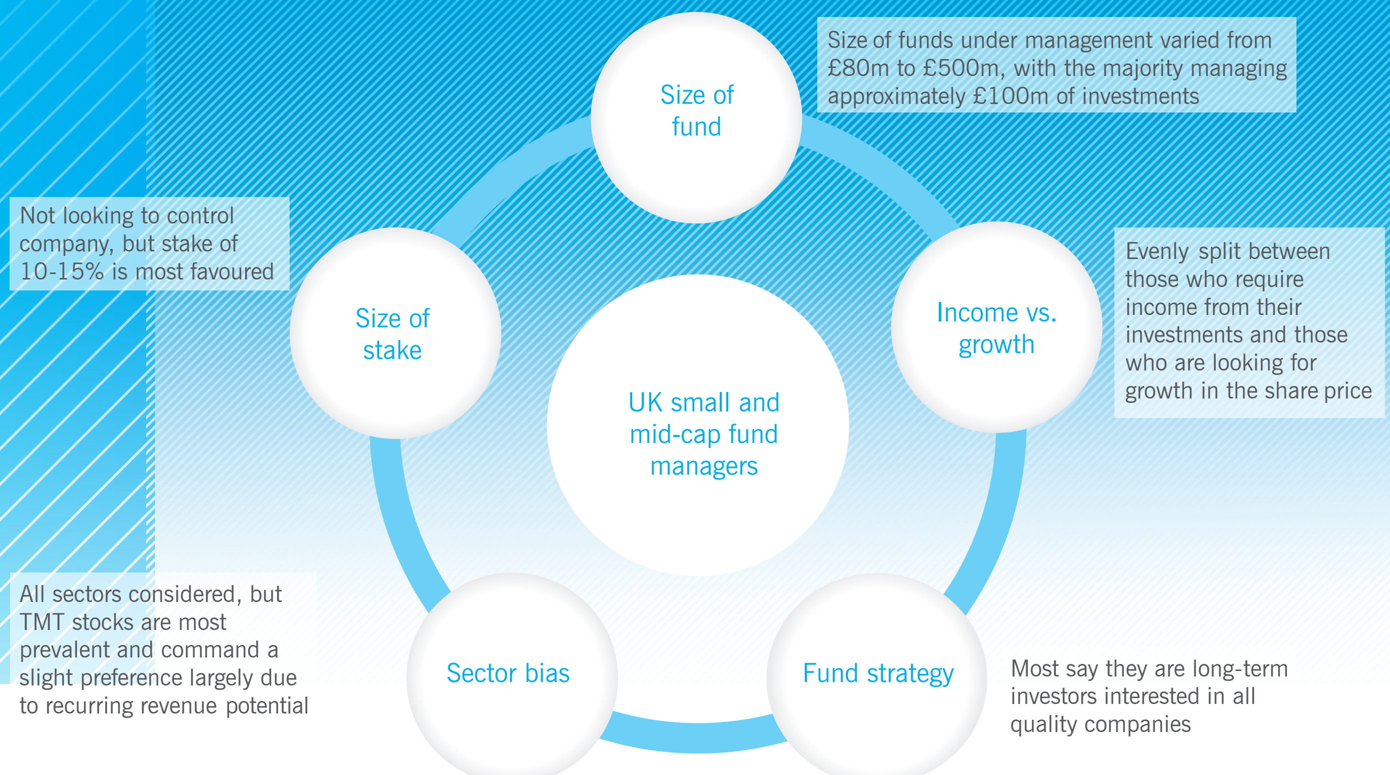
- Most investors are not looking to take very large stakes in companies; they do, however, seek to have a stake that gives them an element of influence over the company's operations and to enable them to share in the upside of a successful company.
- Investors are evenly split between those seeking income and growth – it is important for companies to have researched the investment criteria sought from individual funds and recognise these when presenting to fund managers.
- No one business model or sector is favoured; however most funds express a preference for recurring revenue, which can result in more interest in subscription-based service companies.
- The fund managers we surveyed tend to see themselves as long-term investors, and are happy to remain invested in successful companies for at least 3-5 years on average.
- As companies build up a track record as a public company and demonstrate adequate returns in the short term, existing institutional investors can help provide more finance and grow the company.
- On the whole, investors did not identify any particular tax incentives as being critical for their investment objectives; however, meeting the qualifying criteria to attract venture capital trust (VCT) investment can importantly widen the range of available investment and the inclusion of AIM and ISDX shares in ISAs is seen as a positive step.
- The gut instinct of the fund manager is a key deciding factor about whether to invest in a company.

Size of fund and preferred stake

All respondents are fund managers who invest primarily in UK small and mid-cap companies. The size of funds under management varied from £80 million to £500 million, with the majority managing approximately £100 million of investments. The respondents were split evenly between those who require income from their investments and those who are looking for growth in the share price.

Nearly half of the respondents are managers of Venture Capital Trusts, 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. Therefore these respondents are used to dealing with the smallest companies in the UK by market cap.

In terms of percentage stake, most managers like to take a stake of 10-15%, with some going as high as 20%, but no one willing to go beyond 29.9%. For some, but not all, investors, the level of free float stock available is very important.



We aim to look for the smallest companies possible.

We are heavily income biased, but we're open-minded about where the gain is going to be.

We are a generalist fund with a quality bias.

We are an institutional house with a long-term investing outlook focussed on good quality fundamentals.

We have a narrow focus of TMT – a lot of emerging companies adapt to new technologies quicker than large companies.

We have no minimum stake; the free float is the critical element for us.

As a house we hold beyond 10% in some stocks and have approached 20% in some. We like to look at it in terms of our conviction of the business and the risk/reward involved with that holding.

Sector bias

Nearly all investors we interviewed manage small and mid-cap funds that are generalist, meaning they have freedom to invest in any sector within the small and mid-cap universe. Therefore, it is important for companies to tailor the business plan and any contact with the fund manager to ensure that the strategy and business model is as clear as possible.

Despite the generalist sentiment, Technology, Media and Telecoms (TMT) stocks are slightly more favoured, but this is also a function of the larger numbers of new smaller firms emerging in this sector in recent years. In the interviews, technology companies were mentioned frequently as being of interest to fund managers, alongside support services and media companies, as these firms are most likely to have subscription-based business models which produce recurring revenue.

However, rather than being particularly focused on a sector, fund managers are most concerned with recurring revenue and strong cash flow – if your company can demonstrate both then you will be more in favour, regardless of your company's sector.

What is clear is that in the small and mid-cap end of the market there is little appetite to invest in cash consumptive businesses which have a long investment cycle.

Sector bias: 'Cash is king'

We like computer software, as it produces recurring rental stream and cash flow, and similarly media companies with subscriptions for databases. We don't like loss-making early stage companies, and we don't like capital intensive businesses like housing, as these tend to be cash consumptive.

We favour tech and business support services. We avoid mining and oil and gas, as they are outside our investment mandate.

We invest in companies that can drive high returns on capital in industries that have high barriers to entry, such as aerospace, media, support services, defence and subscription datasets.

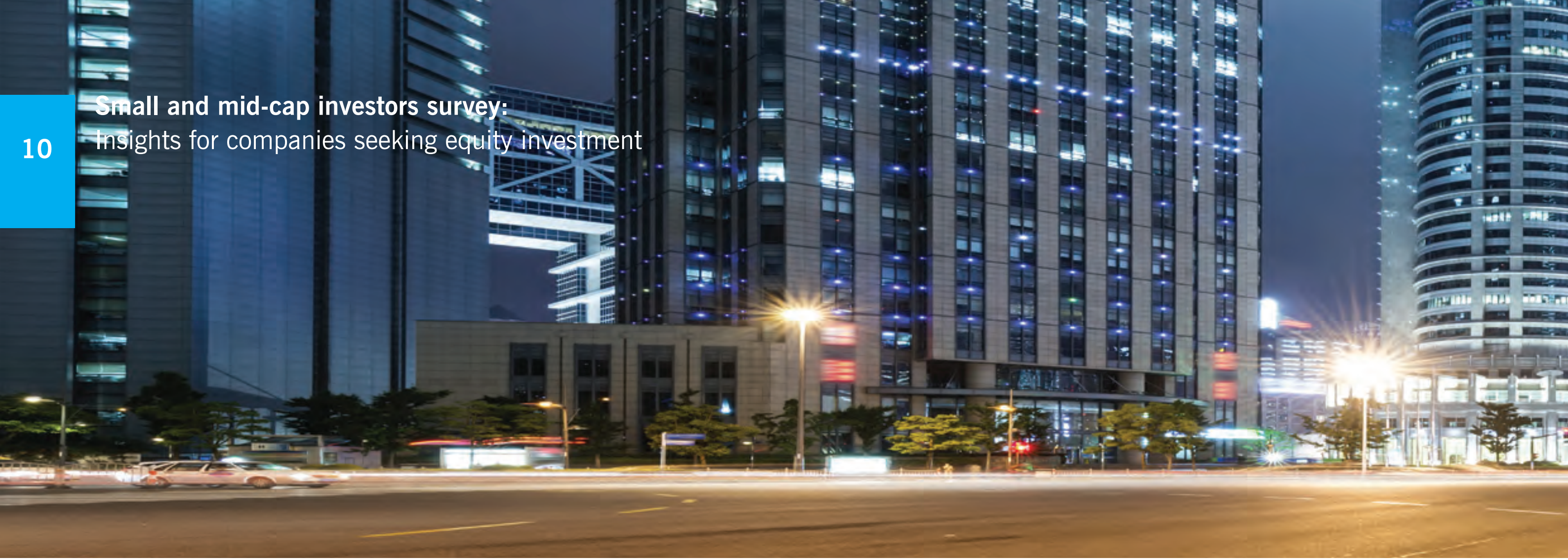
It hasn't been this buoyant since 2008 for tech – I'm seeing a lot of activity, although some of it is overpriced.

Length of investment

The majority of fund managers see themselves as long-term investors, and like to remain invested for three to five years. Having said this, most managers also stated that they expected to see significant improvement in the company's performance within the first year of investing. Therefore, it is vital that companies manage expectations and deliver on promises.

> I'd like to see something happen within six months. If after a year nothing's happening I need a return. I'm not a trader; I'm a long-term investor.

> Our industry is guilty of saying we are long-term investors. Tax relief on VCTs applies for holding up to five years, so we're investing for a 3-5 year time scale; the shares are not the most liquid so you can't trade aggressively.



Ideal investment cycle

The vast majority of respondents said that they would rather invest in a company that they already have a stake in because there is more available information and a track record. Therefore, the opportunities to grow the business once the initial investment is made are considerable. By demonstrating adequate returns in the short term, companies can benefit from a long-term partnership with an institutional investor, who can help the company to mature and grow by offering best practice advice on areas, such as dividend policy and corporate governance. IPO companies should be aware of the opportunity to attract further institutional investment in the years after joining the market, as they build up a track record as a public company.

Chart: Ideal Investment Cycle

Tax incentives

The overarching sentiment is that tax incentives in isolation are not the primary aspect driving investment decisions. Fund managers feel that the underlying operations and company fundamentals are what should guide investment decisions and not just specific tax incentives.

Having said this, there was an overwhelming feeling that Government should be encouraging capital investment in small and mid-cap UK companies, as these companies are the drivers of overall growth in the economy.

Building on this, the inclusion of growth company shares, such as those on AIM and ISDX, in ISAs is seen as a positive step for the sector. Fund managers thought that a separate ISA allowance just for the purpose of investing in AIM and ISDX shares would be a good next step in order to encourage even further investment in these companies, especially from private investors.

Managers of VCTs already benefit from tax advantages, and so this area does not apply to them.

Gut instinct

Regardless of the size of the fund or any other criteria, we found that the gut instinct of the fund manager is a key deciding factor about whether or not to invest in a company. While fund managers carry out detailed quantitative analysis of company fundamentals before making investments, their gut feel is as relevant and is derived from their overall experience in the small and mid-cap quoted company sector. They rely on it heavily to support any quantitative analysis already performed.

At this end of the market, the job is as much art as science – you get exposed to very enthusiastic entrepreneurs, but you can't invest on that basis alone. It's very dangerous to fall in love with a concept of a fledgling company. You can be excited by a concept, but you have to understand how they get to market and can grow.

We prefer to pick on the fundamentals of the company.

Reducing corporation tax for all businesses would make companies more attractive. I worry that if you mix tax incentives with investment, it affects valuation. It's better to invest on the basis that a company is high value.

We don't like investing on the basis of tax incentives which can be removed. We prefer good quality companies, which have sustainable returns on their capital base, and are in markets where they can grow. Tax incentives encourage people to invest just for the sake of it – if there are tax changes we would like them for the long-term.

Very specifically it would be advantageous to have an AIM fund. The inclusion of AIM stocks in ISAs has created a level playing field. Any kind of incentive is good; if people are being encouraged to buy AIM stocks then the governance will need to be improved. People should get tax breaks but shouldn't be encouraged to invest in markets that haven't performed.

Corporate characteristics

- While gut instinct is the key deciding factor about whether to invest, other determining factors include a company's corporate governance, ethical policies and transparency, dividend policy, accounting disclosures, and, least important, the personality of the CEO.
- Investors want to ensure that, when dividends are paid, there are no better alternatives for the cash to be applied internally – rather than just focusing on whether a company pays one or not.
- Investors are wary of the over-zealous use of certain IFRS accounting techniques, such as capitalising expenditure, and tend to rely on the cash flow statement as the most accurate barometer of a company's overall health.

Corporate governance

Small and mid-cap fund managers rate corporate governance as a key factor in whether or not they will invest. They recognise the importance of embedding effective corporate governance procedures within their target companies. While small and mid-cap quoted companies should not be expected to necessarily have the same corporate governance structures and processes as large companies, most fund managers agree that it is a vital part of a company's overall maturity if it can demonstrate attention to good corporate governance principles.

> Corporate governance matters more in small caps in fact – independence and alignment of the board is very important. It's important that smaller companies abide by principles and, as they grow, move in the right direction.

> Typically they don't have ideal corporate governance so this isn't essential, but we work with them to try to improve it.

Ethical policies and level of transparency

Fund managers deem how ethical and transparent a company is as slightly less important than whether they have good governance structures. They wish to be associated with companies that consider and manage these issues in a responsible manner.

> This is very important – there is the issue of wanting to associate with companies complying with the law. It also makes good business sense for the long-term.

> It's part of the bigger picture; we favour companies which are disciplined with all the pressures that a modern business faces.

Dividend policy

Companies that pay a dividend are generally seen as preferable as it is a sign of capital discipline within the business. However, it is not deemed to be an essential factor when a fund manager is making an investment decision.

If a company is trying to attract investment from an income fund, then often those fund managers will require a dividend payment. If it is a growth fund, the dividend is less important.

But, most fund managers view paying a dividend as an overall sign of a business maturing – and so it can be a useful tool in attracting investment.

> [Paying a dividend] is not particularly important. It's a useful messaging tool, but not a valuation tool.

> [Dividends] are something we encourage as a sign of maturity; our style is growth-oriented so we look for longer capital growth. But dividend payments can form a material part of the total return and a signal of management's confidence in the business. However, if management has good alternative uses for the cash, then we encourage that.

> [Dividends] remind management that there's a cost to the equity, but it all depends on what alternative use of funds the management has.

> I expect dividend payments after a certain period. I asked companies during the dotcom boom what their dividend policy was. They didn't understand question.

> We're not an income fund and therefore have no particular requirements for a level of dividend. We would rather see a business reinvest its profits than pay it out as dividend. Dividends are widely seen as a badge of a more grown up company. It marks out a more developed, better quality stock.

Accounting standards and disclosures

A key message from fund managers in terms of accounting and disclosures is to tell it like it is. They do not like the use of accounting techniques to obscure or infer a story that the financials do not really reflect.

The cash flow statement is the disclosure of most interest to fund managers, as it is the hardest statement to manipulate and offers a clear picture of the company's cash position. Revenue recognition is another key factor and fund managers are careful to scrutinise the quality of earnings which a company puts forward.

There is some concern at the complexity of IFRS standards, especially on mark-to-market valuations for pension liabilities and stock holdings. Furthermore, the ability of firms to capitalise their IT or other development costs via IFRS is viewed unfavourably.

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The good thing about IFRS is comparability, but the most difficult thing to cope with is constantly changing standards. Capitalisation of IT investment is dangerous, as it is generally being used to bolster profit. You now have to adjust it out as it is misleading.”

“[The] obsession [with] mark-to-market of various factors, including mark-to-market book adjustments, clouds people's views of a business. Quarterly updates are also unhelpful. I'm increasingly of the view that less is more.”

“The IT sector has a history of being creative in recognising sales, so revenue recognition is important. Generally we try to find companies with potential to become cash generative, so we spend a lot of time going through cash flow statements. Profits can be very different to underlying cash flow, which leads us to question about development expenditure being capitalised as window dressing. Pension and other liabilities also are really important – we can't get involved in a company borrowing to grow. The treatment of pension and leases and related party transactions are the first places we look – we look for commitments that are not arm's length.”

Lots of standards are irritating – for example, in IFRS, such as the various treatments of valuations of assets. The modern treatment of share-based payments is stretching credibility. The headline profit figure is affected but it's accounting nonsense.

Personality of the CEO

The aspect that matters least to fund managers when making investment decisions is the personality of the CEO. Fund managers are not concerned with getting on with the CEO of a potential investee company. They are far more interested in that individual's expertise and whether he or she has a track record of running successful businesses.

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We're not interested in whether he's a nice guy, but track record and expertise is important.”

“We've invested with people who you wouldn't want to go and have a beer with – in terms of management expertise is a priority.

Fundraisings

- Fund managers typically favour secondary fundraisings over IPOs – there is a view that secondary fundraisings tend to offer better value for money for investors, particularly if they are already invested in the company.
- Many of the investors raised significant concerns over the value for money during the IPO process – fund managers often feel unable to get the best price or volume due to the amount of competition for the stock and feel restricted by the window of time they have to make the investment decision.
- Most fund managers say they invest in roughly 1 in 10 of the companies that are brought to them via IPOs.
- Management exiting during the IPO process is a major red flag for investors – they also look unfavourably at related party transactions and lots of capitalised costs.

Secondary fundraisings vs. IPOs

The majority of fund managers we surveyed were minded to concentrate on secondary fundraisings as they provide better value than IPOs. Most voiced concerns with the IPO process, citing the lack of time to scrutinise the financials and the amount of competition for the stock, which usually means that the fund managers end up with smaller holdings than they would like. Most fund managers said that they invest in roughly 1 in 10 of the companies that are brought to them via IPOs.

Investors who managed VCTs were more skewed towards IPO investments. This is mainly because under the VCT legislation they are unable to purchase shares in the secondary market as qualifying holdings.

While most fund managers felt that the volume of IPO activity had definitely increased in 2013 with improved economic activity, they still remain sceptical about investing in IPOs and say their interest in them is relatively unchanged.

IPOs are timed to benefit the seller not the buyer, as you can end up with massive over-demand. The way the City works is you have to make a decision on the basis of a 40 minute presentation. We take long-term decisions so we like to see companies several times before making an investment.

We tend to look for cheap shares – some people have an axe to grind with IPOs, but we've made some fabulous money from IPOs – each case as it comes is my view.

Generally we have a preference for businesses which we have known and followed for a while. IPOs usually lack a track record so we're usually more cautious.

We're more interested [in IPOs] than five years ago. In terms of the quality of businesses, the AIM market has improved.

IPO likes and dislikes

While most fund managers prefer secondary fundraisings, we wanted to find out what helped drive their investment decisions during the IPO process. Most fund managers are primarily interested in looking at each business and assessing the market in which it operates and the sustainability of its market position going forward.

Unsurprisingly, the most important factors cited by fund managers are the quality of the management team and the soundness of the business itself. As mentioned earlier, fund managers want to know that the management team has the correct expertise to grow the business and has a proven track record. In addition to this, they want to ensure that the company is in a competitive position – fund managers want to see what the inputs and outputs are and be able to quickly understand its offering. Lastly, investors want to work with brokers who they trust and who bring them interesting and appropriate companies.

Common red flags cited by the respondents include:

- **Overvalued IPOs** – this is the number one red flag. If investors feel that a company's shares are overvalued, then investment is unlikely. As mentioned before, this is one of the key reasons why fund managers favour secondary fundraisings over IPOs.
- **Management track record** – fund managers will be far less likely to back a company where management does not have a track record of success and of making credible forecasts.
- **Management attempting to exit the business** – this is viewed very suspiciously, especially in the context of private equity. Institutional investors do not want to be an exit route for private equity. More generally, there is a market consensus that companies backed by private equity can be overleveraged and overvalued.
- **Related party transactions and any recent acquisitions made by the company** - these are generally viewed unfavourably, especially if the debt generated by these activities is the reason for the IPO. Any recent acquisitions made by a company ahead of an IPO need to be clearly explained (e.g. the transaction should not just be used to bulk up the business).
- **Investment/debt** – Merely raising funds to plug extant underinvestment is also discouraged.
- **Competitive position** – If the company cannot convince the investor of the sustainability of its competitive position, it will not be successful at an IPO.

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If they're just trying to pay people back, or if a stakeholder wants out and that's the reason they are coming to the market, I become a bit suspicious. We want to put the capital to good use; we want to invest it. We don't want it just to be given back as dividends. It is more about getting a proper return on the investment. [An IPO] should be used to grow the business rather than bail people out. I get suspicious if it's used to pay down debt. I very rarely get involved in a heavily indebted company without a management change.

Related party transactions, bad corporate governance, a high price, a company taking out a loan to buy a subsidiary, lack of growth prospects, sales by board members and minority holdings – these are all bad signs. If the Board has a majority, then you have an issue.

Meetings with fund managers

- At meetings, companies have to convince fund managers that they have a sustainable and competitive market position, as this is at the heart of a fund manager's investment decision.
- The company must ensure that it can communicate the nature of its operations and growth plans in a clear and concise way when meeting fund managers.

The do's and don'ts of meetings

Most fund managers try to meet the companies they invest in at least once a year if not more often.

As has been highlighted throughout the results of this survey, a clear explanation of the source of the company's competitive position is what most fund managers value most from meetings. Fund managers also want directors to have realistic targets – it is vital that companies do not oversell and that companies spend time explaining the bad news, as well as the good.

Investors expect companies to have a firm grip on the financials and to be able to talk through them at the meetings without necessarily needing their finance director present.

In order to make the meetings more valuable, most fund managers advocate a partnership approach whereby both sides do their homework prior to the meeting. This means that companies should have an idea of the fund that they are pitching to, what the manager's motivations are and where his or her expertise lies.

Treat us like partners in business rather than someone you are selling to. We want to hear bad news first; many companies are too paranoid about upsetting their shareholders.

[We value] the ability not to stick to the script – put the presentation to one side and talk about the business. Brokers need to understand what our investment criteria are. The other bugbear is we don't just want 45 minutes – the worst thing of all is the broker sitting there looking at his watch during a presentation.

Where companies have something amenable to product demos, it can be useful. One hour is a limited commodity so they need to get bang for their buck. They need to hit the right level to pitch at – technical companies are meeting laymen so it can go over the fund manager's head.

They need to know their audience and need a good broker to advise on who they're seeing. Some companies bring passengers who don't say anything – I don't like meeting a 5-a-side football team.

Top 10 tips for investor meetings

1. **Demonstrate competitive position**
   Sustainability of that position is most important
2. **Do not oversell**
   Treat investors as allies from the start of the process
3. **Be on top of the numbers**
   A knowledgeable finance director is an asset
4. **Do not use accounting 'tricks'**
   Investors are interested in underlying operations
5. **Know who you are meeting**
   Be aware of how you fit the fund's investment criteria
6. **Give case studies**
   Show how the products are used by the customers
7. **Engage with investors**
   Be prepared to respond to a broad range of requests
8. **Get to the point**
   Time is limited so be honest about the business up front
9. **Don't bring passengers to the meeting**
   Everyone at the meeting should add value
10. **Show why you want productive investment**
    Too many companies are unable to show this

Appendix – Methodology and full interview details

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.

16 phone interviews took place during August and September 2013 with the following senior UK small and mid-cap investors:

- **David Stevenson** – Amati Global Investors
- **Mark Niznik** – Artemis Investment Management
- **Toby Belsom** – Aviva Investors
- **Robin West** – Aviva Investors
- **Judith Mackenzie** – Downing LLP
- **Catherine Stanley** – F&C Investments
- **Guy Feld** – Hargreave Hale Limited
- **Adam McConkey** – Henderson Global Investors
- **Katie Potts** – Herald Investment Trust
- **Henrietta Marsh** – ISIS Equity Partners
- **Ken Wotton** – ISIS Equity Partners
- **Richard Penny** – Legal & General Investment Management
- **Gervais Williams** – Miton Group
- **Andrew Buchanan** – Octopus Investments
- **Marina Bond** – Rathbone Investment Management
- **James Thorne** – Threadneedle Investments

Respondents were recruited from a pre-selected database of the UK's leading small and mid-cap institutional fund managers, with investors from the above organisations supplying their feedback for this project.

This report relies on data, conclusions, and recommendations from primary and secondary sources (including third parties) that were gathered in good faith. Although believed to be accurate, this information is not guaranteed and, as such, The Quoted Companies Alliance, YouGov and Baker Tilly can accept no liability for action taken based on any information in this report.

The Quoted Companies Alliance is the independent membership organisation that champions the interests of small to mid-size quoted companies. It is a company limited by guarantee registered in England under number 4025281.

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