PEEL HUNT

QUOTED COMPANIES ALLIANCE

To be or not to be... a public company

The growing de-equitisation crisis

QCA/Peel Hunt Mid and Small Cap Survey

February 2020

YouGov

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AN INTRODUCTION FROM PEEL HUNT

As one decade draws to a close and another begins, the public markets find themselves in a state of flux, on a scale we haven't seen since the years directly following the financial crash of 2008.

Though the outlook for 2020 is more optimistic, with a majority Government now in place and a definitive conclusion to Brexit seemingly imminent, the challenges on the horizon are no less significant. After years of political instability, consistently low interest rates, major regulatory change and sustained Brexit uncertainty, 2019 marked a worrying turning point for the UK capital markets, which in many ways ceased functioning as they were designed to.

The IPO market ground to a halt, as the London Stock Exchange endured its quietest year since 2009 with just 36 companies listing their shares last year. Investor appetite in the UK dried up, as declining valuations, Brexit extension after Brexit extension, the high-profile Woodford scandal and the unintended consequences of MiFID II knocked investor confidence and made many small to medium sized businesses question their rationale for being listed at all.

2019 also saw huge sums of private capital flood the market, as venture capital and private equity firms went on the acquisition trail. Fund ownership horizons grew longer, as their returns softened. Persistently low interest rates made debt financing ever more appealing. While swathes of companies bought back stock, removing shares from the public markets (or taking the decision to come off the market altogether), as the trend towards de-equitisation gathered momentum. Indeed, during 2019 more companies left the main market than joined it, while the number of companies on AIM ended the year at a 15-year low.

It's for this reason that we asked YouGov to conduct a refreshed investor sentiment survey to kick off the new decade. Not focused entirely on MiFID II as our previous three reports have been (although it inevitably does feature), but rather to identify the scale and causes of the accelerating de-equitisation threat to the UK stock markets, while exploring its impact on both corporates and investors, and the potential remedies that could reverse or at least, assist this escalating trend.

Because efficient, liquid and well-stocked public markets have never been more important for Britain as they are today. To drive economic growth, enable companies to efficiently raise capital, provide investors with access to companies to invest in, ensure proper regulation of corporates and, ultimately, maintain the UK's standing as a global financial centre in a post-Brexit world.

Steven Fine
Chief Executive
Peel Hunt

THE QCA VIEW

The sun set on the UK's world-leading public equity markets in 2019 and action is needed from the Government to halt the decline. The number of IPOs and companies leaving the markets in 2019 was stark and we need to focus the minds of our policymakers and regulators to see how we can improve the situation in 2020.

In particular, the lack of liquidity in smaller company stocks is a long-standing issue that deteriorated further last year. Ideas proposed in this survey could help, including a reweighting of pensions away from bonds to equities; encouraging pension funds to take small stakes in growth companies; taking a proportionate approach to regulation; and providing tax incentives for equity investment.

It's clear from these survey results that, in the eyes of both companies and investors, the MiFID II set of regulations has continued to have a negative (and worsening) impact on mid and small-cap markets. Action is therefore needed, perhaps in the shape of exempting smaller quoted companies from some of the requirements relating to the distribution of investment research.

The decline in smaller companies coming to the public markets has wide implications for the country, including reducing the options of financing for companies, in driving too large a proportion of companies to be reliant on bank financing, and reducing opportunities for people's pensions to be invested for growth in the future.

The QCA emphasises the need for proportionality in policy and regulation for smaller quoted companies. There is a huge disparity in size on the UK's public equity markets with the largest company in the FTSE 100 having a market capitalisation of over £188 billion, and the smallest company in the FTSE All-Share having a market cap of £42 million - that is just 0.02% of the size. Both companies are required to follow the same rules - this does not make sense at all. Small and mid-caps in the UK employ over 3 million people (around 11% of UK private sector employment) and contribute over £26 billion in tax (about 5% of UK tax take). This is all at risk if we allow investors and regulators to demand a one-size-fits-all approach.

What is encouraging is that we see that 97% of respondent companies are taking action in one form or another to increase visibility to investors. Most commonly, they are investing in their corporate websites, seeking media coverage, and releasing more information to the market through less-used channels (like social media). Company directors should note though that the majority of investors recommend that companies hold a capital markets day to improve their visibility.

Also included in here are the questions that companies should be asking their brokers. We hope that QCA member companies can get practical use from this to help them flourish in these tough times.

It's always darkest before dawn and there are glimmers of hope that we will see an upturn in equity market activity in 2020. However this should not give policymakers cause to step back from addressing the long-term trend of de-equitisation that pervades this report.

Tim Ward
Chief Executive
Quoted Companies Alliance (QCA)

Executive Summary

The growing de-equitisation crisis in the UK

In 2019 there were just 10 IPOs on the AIM Market and the number of companies on the market shrunk from 923 to 863. The Main Market of the London Stock Exchange also reduced in size and saw just 26 IPOs.

The reasons for this de-equitisation trend are varied and UK political uncertainty and global trade tensions are a part of it, but much lies in the hands of UK policymakers and regulators to resolve. Regulations, such as MiFID II, have worked to reduce liquidity in small and mid-caps in recent years. This is something that previous editions of this survey anticipated and now the impact is being more clearly felt, with the inevitable consequence that the regulations have had a negative impact on smaller quoted company liquidity.

The findings of this report are based on surveys with 155 UK-based fund managers, and 110 mid or small-sized quoted companies. They tell us that both the investors and companies on UK markets are worried about de-equitisation and that action needs to be taken to reverse this trend and protect the UK world-leading public markets for small and mid-sized companies.

Actions are proposed in this report that the UK's policymakers should pay attention to, including encouraging pension funds to take small stakes in growth companies and providing tax incentives for equity investment. In the long-term, a proportionate approach needs to be taken to all regulation in order to avoid situations like we have with MiFID II.

KEY FINDINGS

75%

of companies & investors are concerned over the de-equitisation of UK stock markets.

60%

of companies say burdensome listing requirements and excessive scrutiny is the main driver of the shrinking UK public markets.

79%

of investors think MiFID II has had a negative impact on small & mid cap liquidity. This perception has significantly increased since 2017.

Investors views on how the UK Government can help increase the flow of private companies to list on UK markets.

41% reducing costs

34% simplifying corporate tax rates

41% allowing dividends to be tax deductible

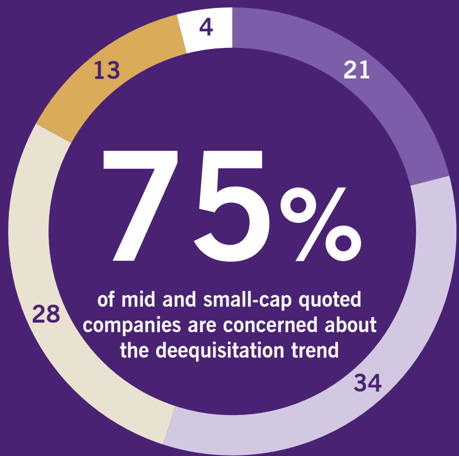
UK public markets in decline

75% of investors & companies are concerned over the de-equitisation of UK stock markets.

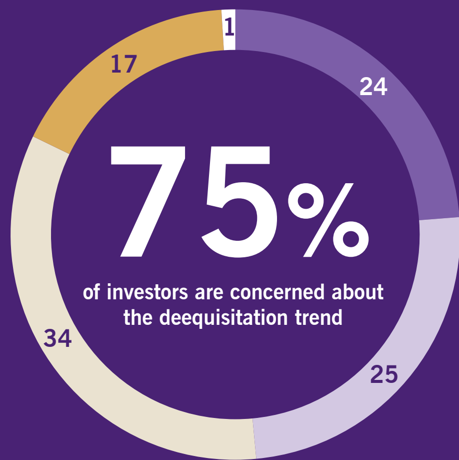
Q1. How concerned or unconcerned are you about the de-equitisation of the UK's stock markets due to factors such as share buy-backs, acquisitions and reduced numbers of IPOs?

- Not at all concerned
- Slightly concerned
- Moderately concerned
- Extremely concerned
- Don't know

COMPANIES



INVESTORS



"Companies are frequently being acquired by private equity (PE) firms which look to maximise returns often over a very short period of time. Also, any reduction in the overall market cap of the stock market reduces liquidity and concentrates risk in an ever decreasing number of securities."

"I am more concerned about the reduced numbers of IPOs. Large amounts of private capital means the next generation of disrupters will probably not be public companies."

"I am not concerned about buy backs or acquisitions as that is a capital market functioning properly. The lack of IPOs however is a concern as that is a capital market not functioning properly."

"I am extremely concerned that being listed is no longer seen as something to aspire to. This rather obviously reduces the available investment opportunities but has wider negative implications:

(i) reduces the ability of companies to efficiently raise capital
(ii) reduces the ability of investors to access companies to invest in
(iii) reduces price discovery
(iv) reduces the ability to regulate companies
(v) reduces efficient capital allocation and therefore value creation.

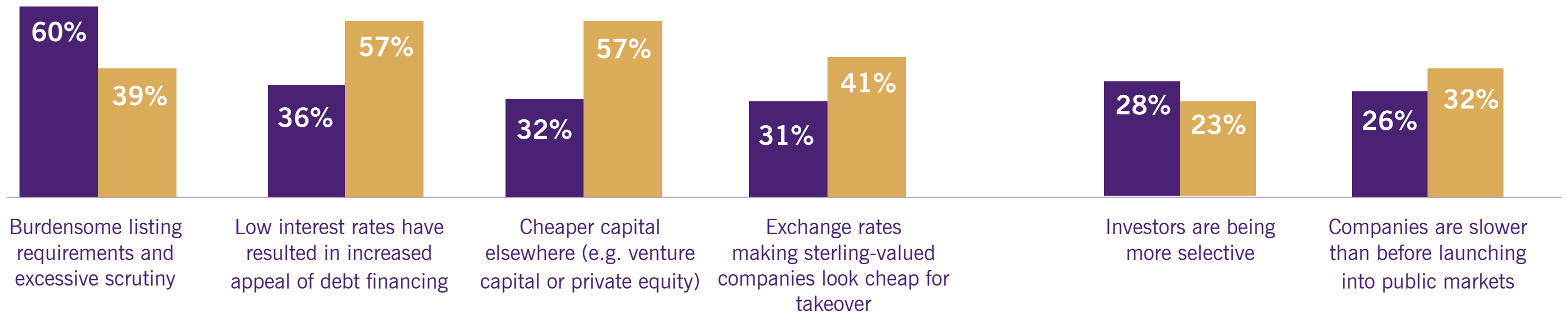
I could go on - stock markets are good things and de-equitisation is very worrying."

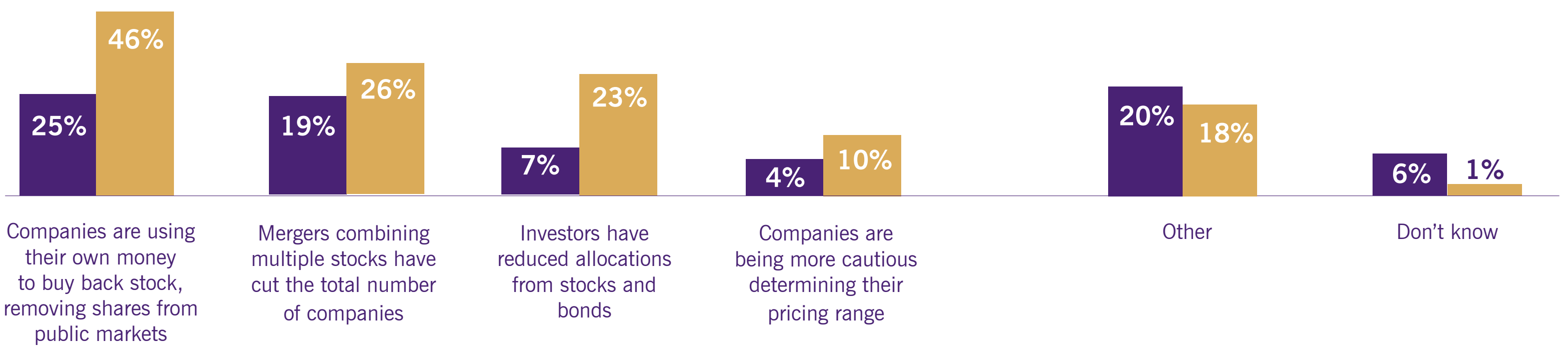
Why is this happening?

Q2. What do you think are the main drivers of the shrinking of the UK public markets?

Companies

Investors





Main drivers of shrinking UK public markets

60%

of companies say burdensome listing requirements

57%

of investors blame the availability of private capital and low interest rates

Regulation and MiFID II

The following topics are covered in this section:

a. Less liquidity

b. Less research on UK Mid and Small Cap Companies

c. Fewer broking houses

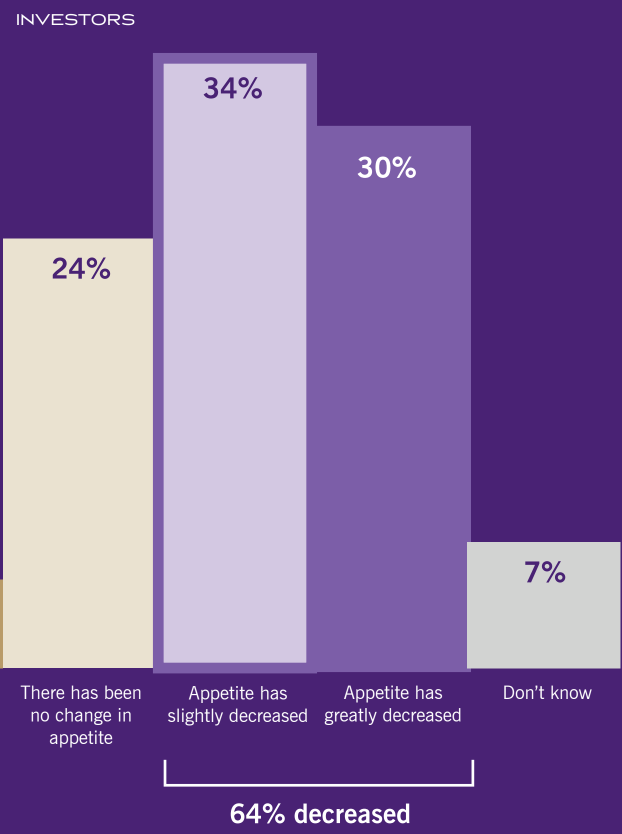
The percentage of investors that believe that MiFID II has had a negative impact on the liquidity of mid and small-cap stocks has increased from 54% in 2017, to 63% in 2018, and now reaching 79% in 2019.

MiFID II is blamed for reducing both the quantity and quality of coverage and research produced on mid and small-caps.

The view is that this has had a direct effect of reducing appetite for private companies to list on UK public equity markets.

64% of investors believe that appetite for private companies to list on the UK public markets has decreased as a result of MiFID II

Q3. What impact, if any, do you think MiFID II has had on the appetite for private companies to list on the UK public markets?



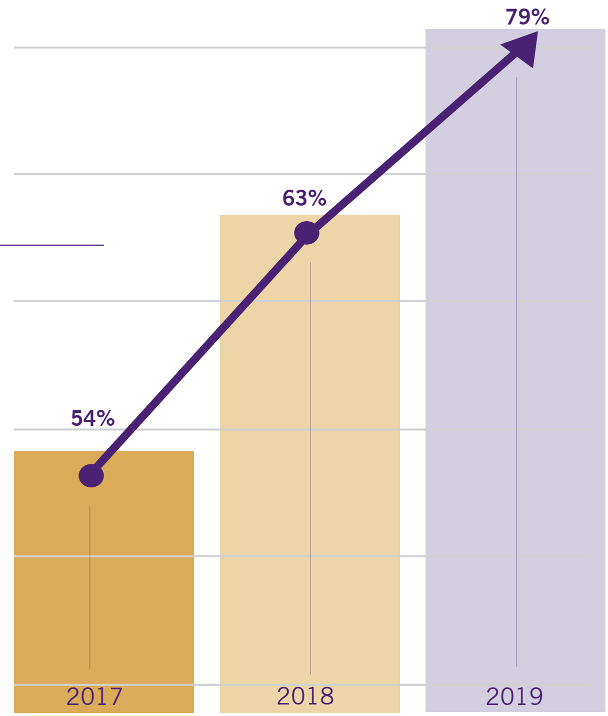
Less liquidity

Perception of negative impact of MiFID II on liquidity increases each year.

Q4. What impact, if any, do you think MiFID II has had on the liquidity of UK mid and small-cap stocks?

**In the last 3 years we have asked the same question*

This graph shows the total of 'quite negative impact', and 'very negative impact' over the last 3 years

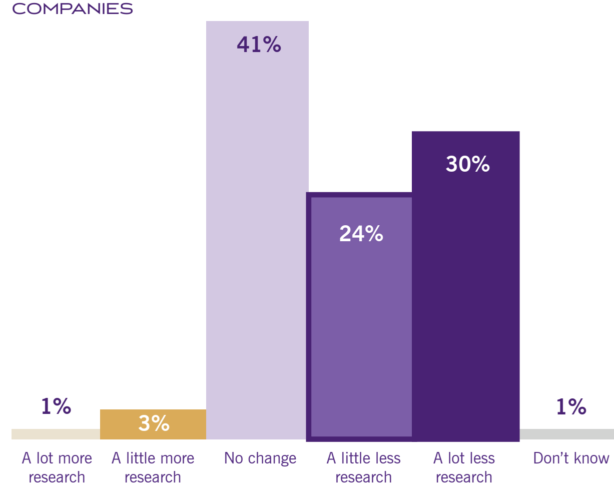


All results	2019	2018	2017
Very positive impact	-	-	2%
Quite positive impact	1%	4%	14%
No impact	17%	20%	17%
Quite negative impact	49%	48%	31%
Very negative impact	30%	15%	23%
Don't know	2%	14%	13%
Net: Negative	**79%**	**63%**	**54%**

Less research on UK Mid and Small-Cap Companies

Q5. Since MiFID II came into effect, have you noticed a change in the amount of research that is being produced within your own company?

COMPANIES

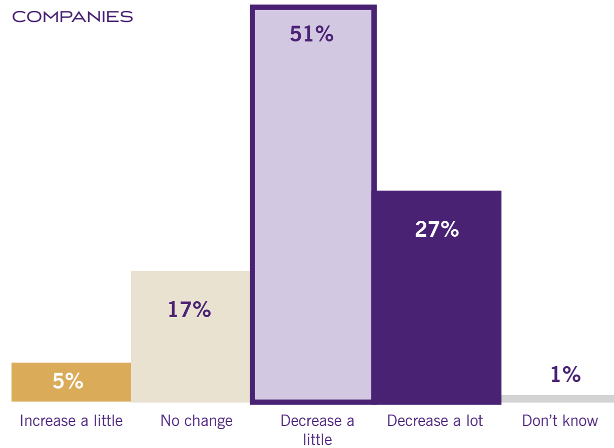


54% say less research

Q6. In the next 12 months, how do you think the volume of research on mid and small cap quoted companies will change, if at all?

*(0%)
say increase a lot*

COMPANIES



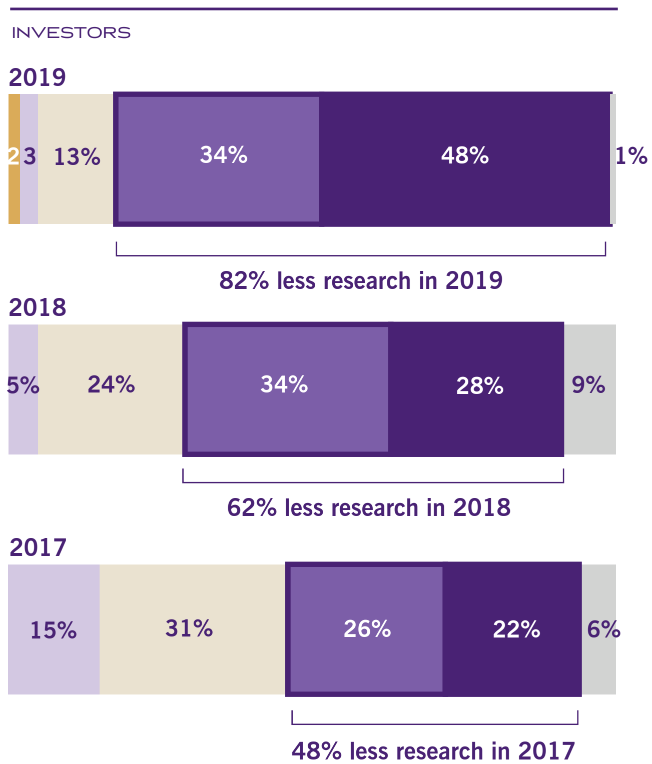
78% say it will decrease

82%
investors report less and less research is being produced each year on mid and small-caps.

77%
of investors believe that the volume will continue to decrease over the next 12 months

Q7. Since MiFID II came into effect, have you noticed a change in the amount of research that is being produced on mid and small-cap companies? There has been…

- No change
- A lot more
- A little more
- A little less research
- A lot less research
- Don't know

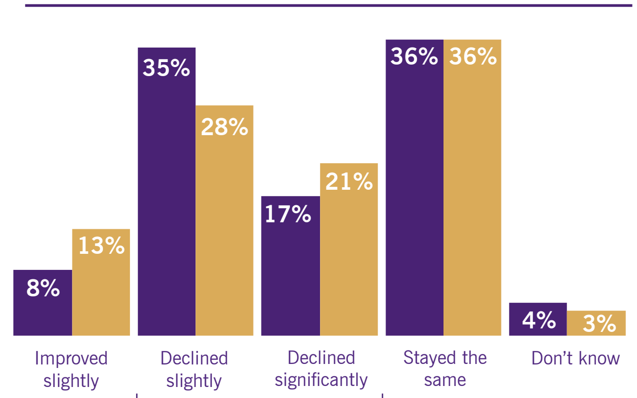


Lower quality research

Q8. Thinking about the general quality of mid & small cap research over the last 12 months, do you feel this has…

- Companies
- Investors

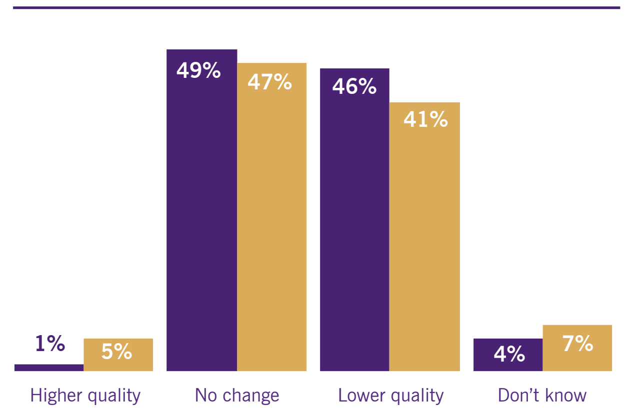
*(0%)
say improved significantly*



52% of companies & 48% of investors believe quality of mid and small-cap research has

Q9. Looking ahead to the next 12 months, do you expect a change in the quality of research that is available on mid and small-cap companies?

- Companies
- Investors



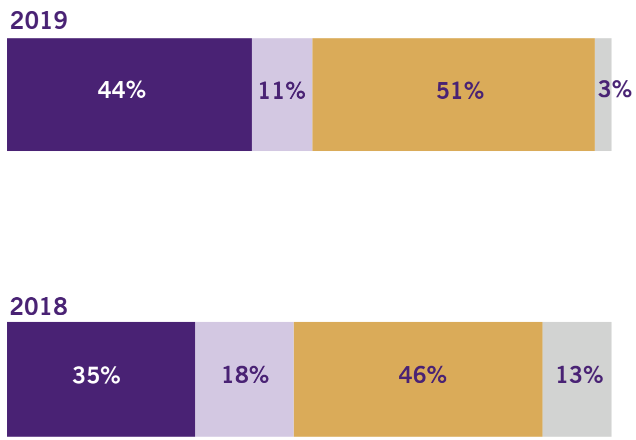
The expectation is that the quality of the research available will continue to worsen.

More risks in the market

Q10. If there is less research on mid & small cap companies in the market as a result of MiFID II changes, do you think this predominantly provides more opportunities or more risks in the market for you?

Opportunities
Risks
No real impact
Don't know

INVESTORS



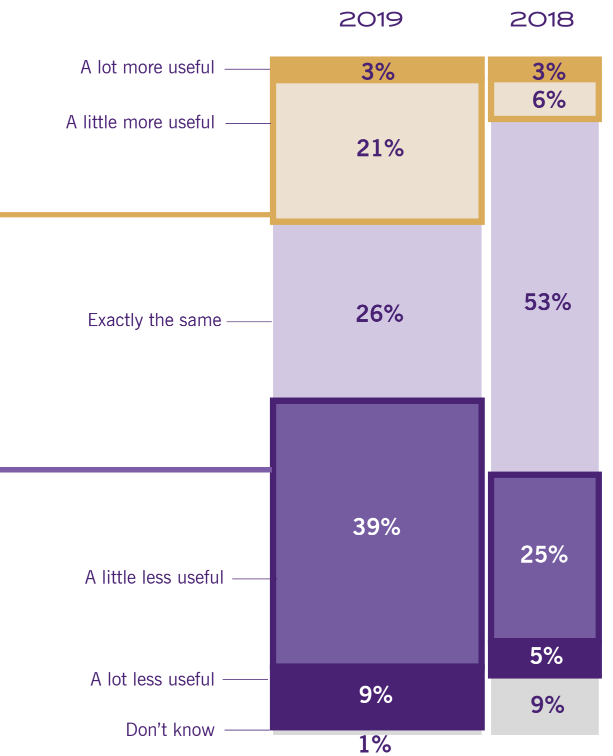
*Note: Respondents could select both opportunities and risks therefore the totals add up to more than 100%

Many mention the risks regarding a decline in research, however for larger firms with significant in-house analysts, it could be an opportunity.

Research on a corporate written by its house broker has become less useful than that produced by an independent source.

Q11. Compared to research from an independent source, how useful do you find research on a corporate written by its house broker?

INVESTORS



Increase from 9% to 24% in those who say more useful

Increase from 30% to 48% in those that say less useful

OPPORTUNITIES

INVESTORS

"Finding undercovered and therefore undervalued opportunities. A benefit for large scale fund managers with significant analytical resource, increasing barriers to entry on the buy side."

"In the right circumstances it can provide larger rewards for those investors prepared to do their own research."

RISKS

"With less research being undertaken there are greater unknowns with a stock which could easily be overlooked. Also, access to company management is likely to be less which means that investors are not necessarily being able to ask management the right questions."

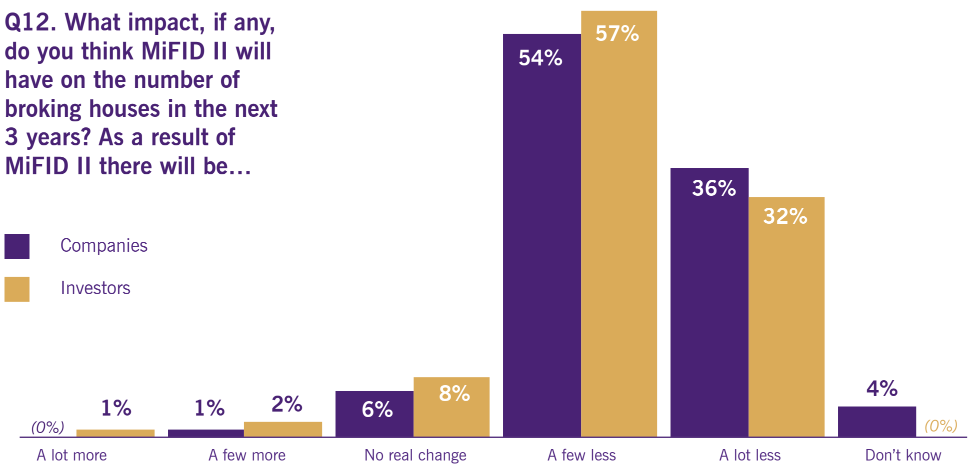
"Rogue promoters will rip off the unsuspecting public. We are currently on a journey back to the 1800's. It has all happened before. Remember the South Sea bubble. It is unbelievable to be honest."

Fewer broking houses

Less support for UK Mid and Small-Cap Companies

For the second year running, 9 in 10 investors say that MiFID II will result in fewer broking houses in the next 3 years.

Q12. What impact, if any, do you think MiFID II will have on the number of broking houses in the next 3 years? As a result of MiFID II there will be...

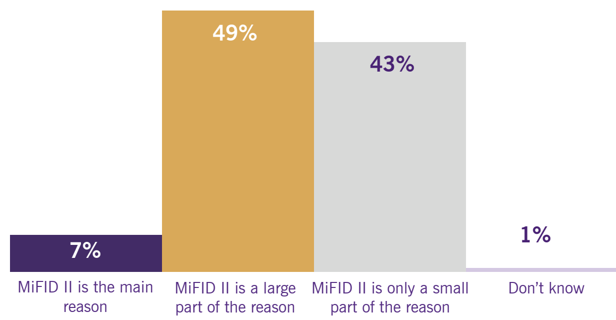


90% of companies and 89% of investors think there will be fewer brokers in the next 3 years

Q13. You said you expected the number of broking houses to change in the next 12 months. How much of that change is going to be caused by MiFID II rules?

*(0%)
say MiFID II is not a contributing factor*

COMPANIES



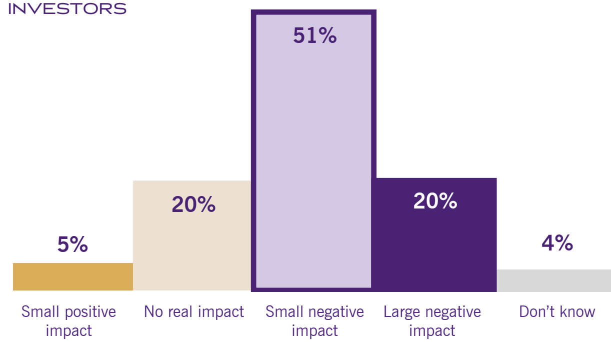
99% believe MiFID II will be part of the cause of fewer brokers

Overall, MiFID II is negatively impacting on investment firms.

Q14. After two years since it came into force, how has your firm been impacted, if at all, by the introduction of MiFID II rules on the market?

*(0%)
say large positive impact*

INVESTORS



71% negative

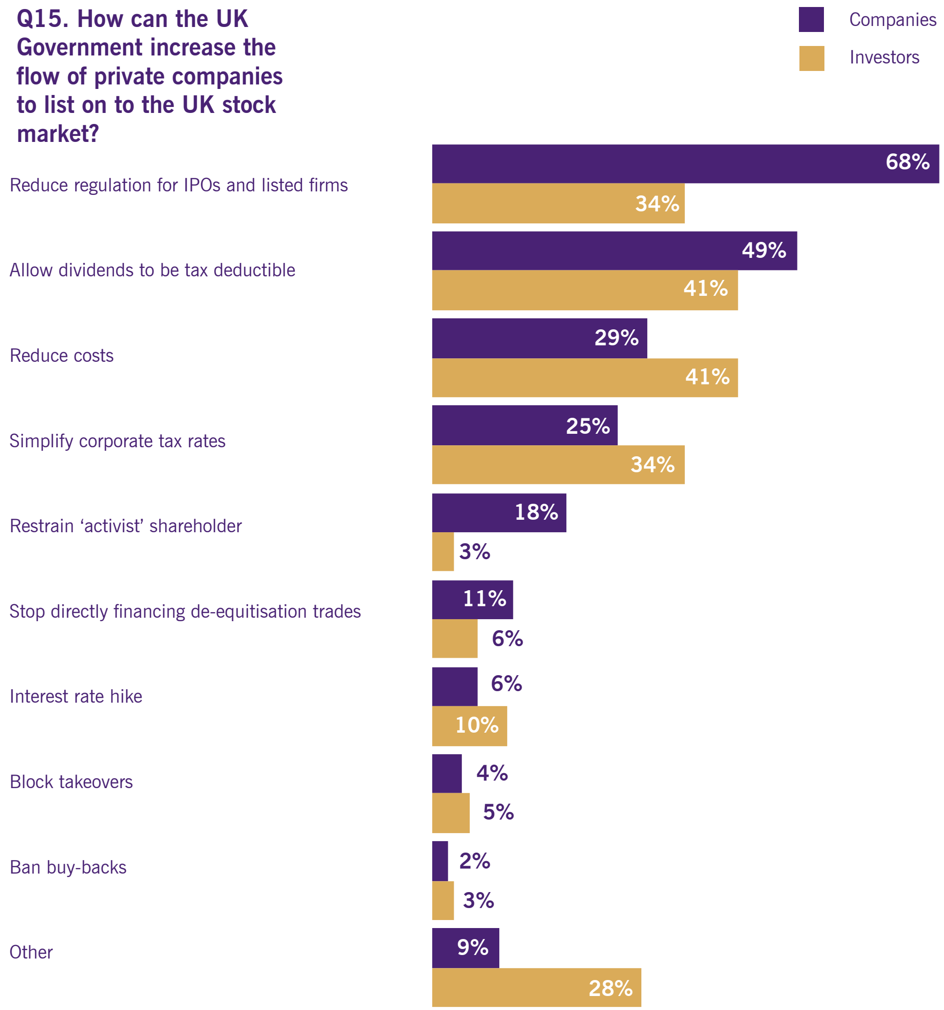
What can be done about de-equitisation?

68% of companies call for reduced regulation for IPOs and maintaining listings

Investors say the UK Government can help increase the flow of private companies to list on UK markets by reducing costs, allowing dividends to be tax deductible, reducing costs (41%), and simplifying corporate tax rates (34%).

Investors say the UK Government should reduce costs, allow dividends to be tax deductible and simplify corporate tax to increase the flow of private companies listing on the UK stock market.

Q15. How can the UK Government increase the flow of private companies to list on to the UK stock market?



Q16. What, if anything, should the UK Government do to improve smaller companies' access to and benefits from UK capital markets?

INVESTORS

"UK Govt should simplify the tax structure, increase liquidity by enabling banks to increase the availability of lending and spend money on infrastructure."

"Revoke Mifid II. This does nothing to protect investors only increases regulatory costs which either have to be passed onto the investor or force the investor to limited choice of only dealing with the larger players as the regulatory burden/costs is too high. Slightly different sector but as an example a number of houses have stopped / outsourced monthly savings schemes into investment trust as the administration burden is now too costly. Regulation does not prevent mis-selling (Woodford) but merely reduces choice and costs investors more."

"UK government needs to engage with buyers of such stock a bit more to understand why and how some of their policies might be unhelpful or even uneconomic in the long run."

COMPANIES

"The lengthy Brexit uncertainty has impacted investor appetite in the UK market, domestic and international. Scandals such as Woodford have compounded the situation. Very significant incentives to investors (tax, dividend and otherwise) required to open up the market for listed small caps."

"Increase the tax benefits of investing so that private investors are attracted to the product, reform is needed of so that the pool of potential investments is larger."

"Improving the capital markets for SMEs is not linked to leaving the EU. Actions to improve the markets need to be taken irrespective. MAR regulations have not helped for smaller less liquid stocks."

"Turbo charge VCT and EIS for tech/healthcare. This area needs urgent attention. Get patient capital funding from the BBB to new equity fund managers investing in the smaller tech and healthcare businesses."

"Make the capital markets easier to access via lower cost, better education and ensure there is less fear when private companies are looking to access these markets. Education and understanding is the key."

Pension Reweighting

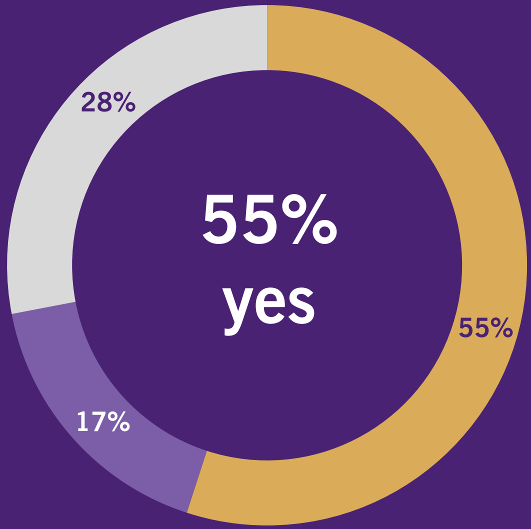
55% of companies think the UK Government should encourage a US-style re-weighting of pensions toward equities and away from bonds

62% of investors favour a re-weighting of pensions in a fashion similar to the US, with a variety of different ways to do so offered.

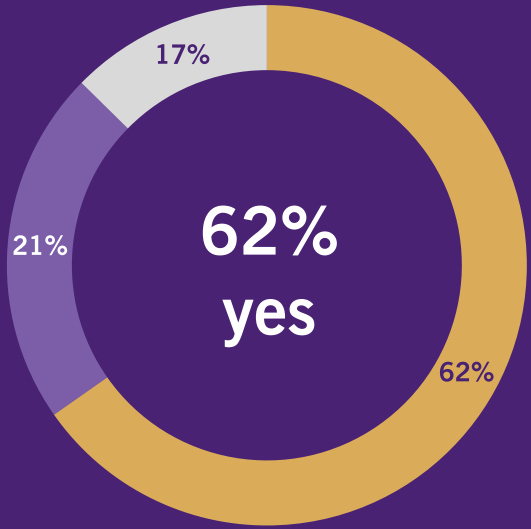
Q17. Should the UK Government encourage a pension 're-weighting' back to equities away from bonds as the US has done?

- Yes
- No
- Don't know

COMPANIES



INVESTORS



PENSION
REWEIGHTING

Q18. How should pension reweighting be done in your view?

"Equities should have higher tax relief and more weighting to sub £300m market cap"

"Pension funds and other institutional investors should be required to hold a certain percentage of their portfolio (say 3%) in SME Growth stocks"

"The Australian superannuation funding retirement system and 401K planning is worth examining in depth. This would provide ongoing capital for the corporate sector while helping to build pensions and reduce state dependency in retirement"

"Improve tax advantages and reduce costs for equity investment/trading"

"Main issue being accounting standards requiring unrealistic positions for trustees towards bonds where they have to (for benefit of pensioners) have a far longer perspective and equities would/should provide more growth long term"

"Provide tax relief for dividends for small company investments"

"Regulation in pensions must be changed to allow growth within schemes with out them being taxed if they go over lifetime allowances. For existing personal pensions that are already over the lifetime allowances there is no incentive to take any risk as the growth is taxed very heavily. Also, with reduced amounts now being allowed each year into pension schemes younger savers will need investment growth to get their pension to a size that might support them in their retirement as the allowances alone will not be enough. This is creating a problem for future generations that will otherwise fall back onto the government's books."

"Pension funds should be incentivised to invest in growth companies. Long term statistics indicate these provide a better return than mature companies."

"By abandoning the idea that everything in life must be 'risk free'. A good start would be to encourage, or even mandate that, pension funds should have 5-10 in earlier stage investments."

"Tax benefits on dividends/ penalties on bond interest"

How to increase liquidity?

What would be a real stimulus to create greater depth of liquidity for mid and small-cap companies?

"Reverse the move towards eliminating private clients in favour of large institutional investors. Private clients are an essential source of small scale investment in small cap companies and without them the AIM market is useless. Government and stock exchange policy needs a radical overhaul."

"Rolling back some of the regulatory changes of recent years. In particular, the number of institutional investors investing in small cap funds has significantly fallen."

"A requirement for pension funds, insurance companies and other institutions to hold a certain percentage (say 3%) of their total portfolio in UK SME stocks."

"I would exempt AIM companies from MIFID2 research rules. Under MIFID2 access to research for smaller companies has declined substantially - this in turn impacts market liquidity."

"The analyst should be partly funded by other means to cover small caps. Else there could be biases. The equity markets need to be trustworthy - there seems to be interest parties propping up the stock. Hence you see massive drops in the price when results are released."

"Incentives to increase availability of financing for higher risk, early stage investments"

"The Government needs to reconsider the tax breaks given on dividends when added to pensions and ISAs to improve the attractiveness"

"Availability of really long term money as used to exist when pension funds were less taxed and in surplus and the risk reward ratio more favourable. private equity has too short a horizon. Investors should partner with owner managers for the long term not just for 3-5 years which is substantially less than the business cycle"

"Encourage long-term value seeking, reducing short-term bench-marking.
+ Increase tax relief on small cap investing.
+ Restrict collective investment schemes to stimulate direct stock-picking."

How can companies thrive in these conditions?

97% of quoted companies surveyed have taken some action to increase visibility with investors in the past year.

The most common action is to improve the corporate website, but investors cite holding a capital markets day as the best thing companies can do.

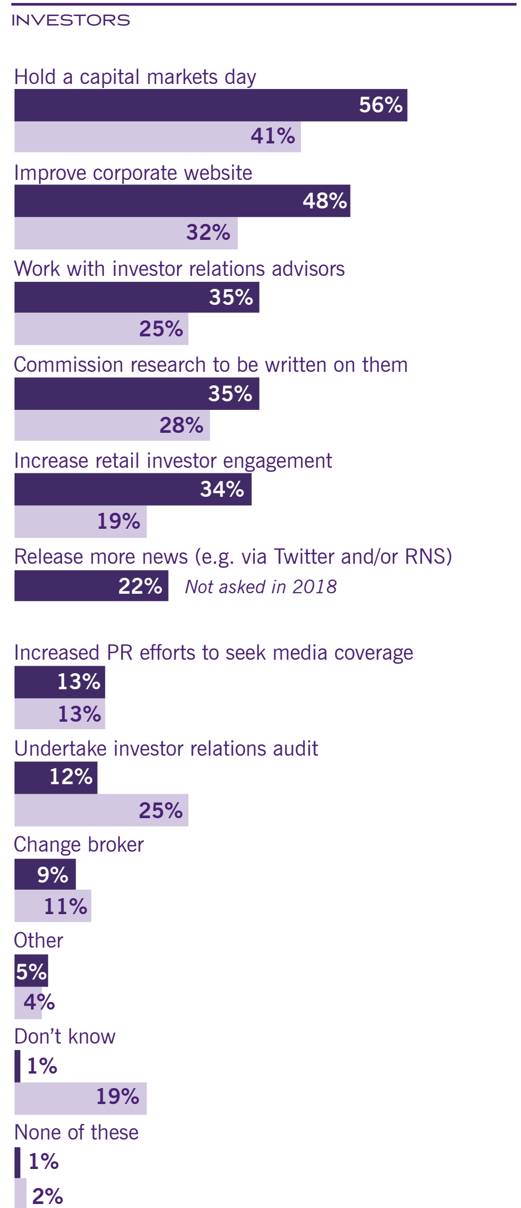
Capital markets days, improved websites and increased retail investor engagement would most help increase company visibility according to investors.

Q19. Which of the following, if any, do you think would most help companies to increase their visibility with investors?

(Please select your three most important)

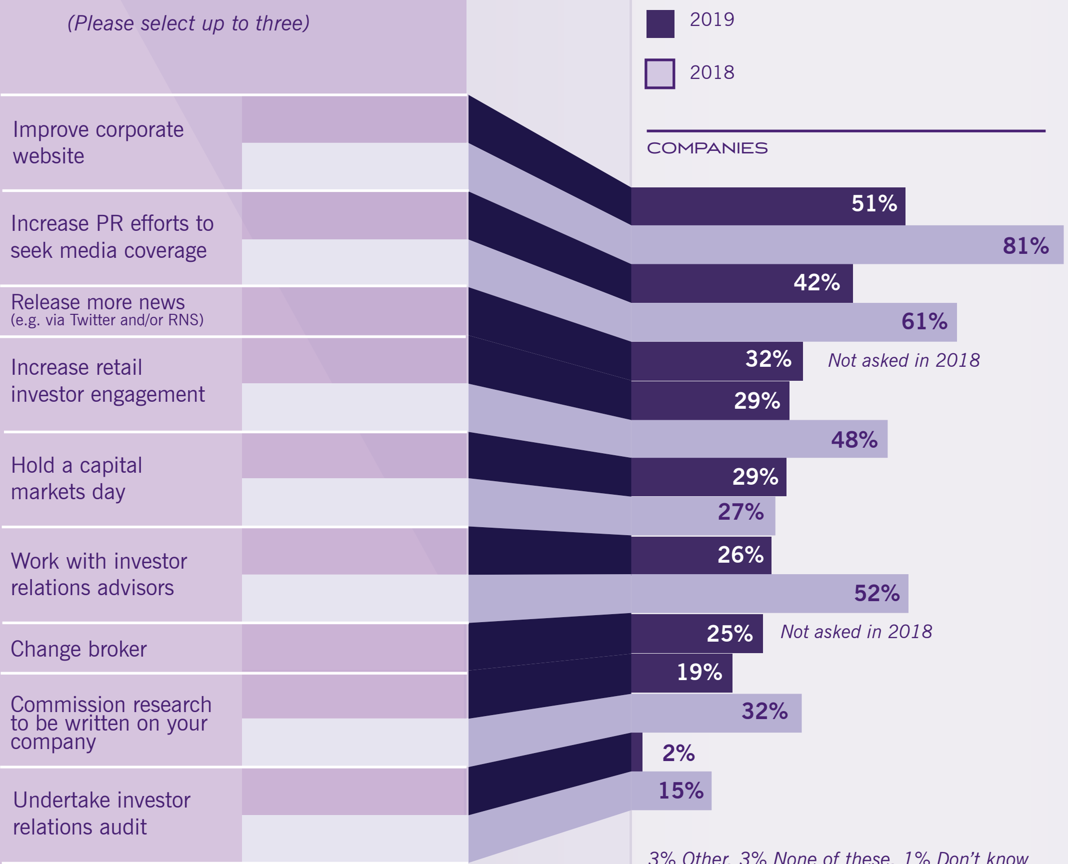
2019

2018



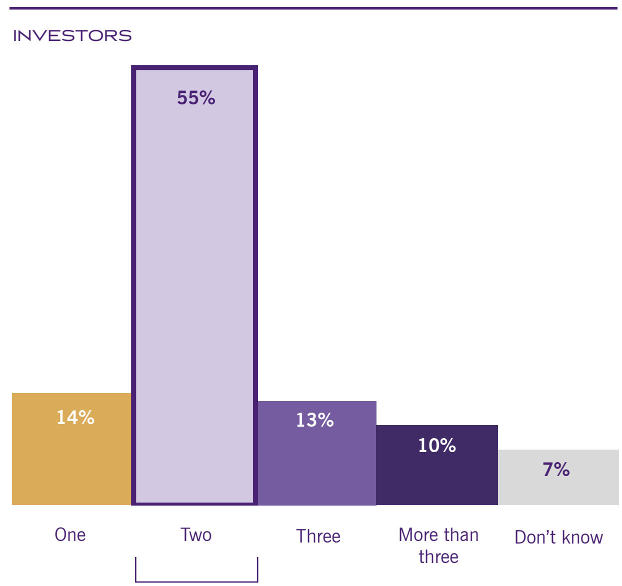
Q20. Have you taken any of the following steps to increase your visibility with investors?

(Please select up to three)



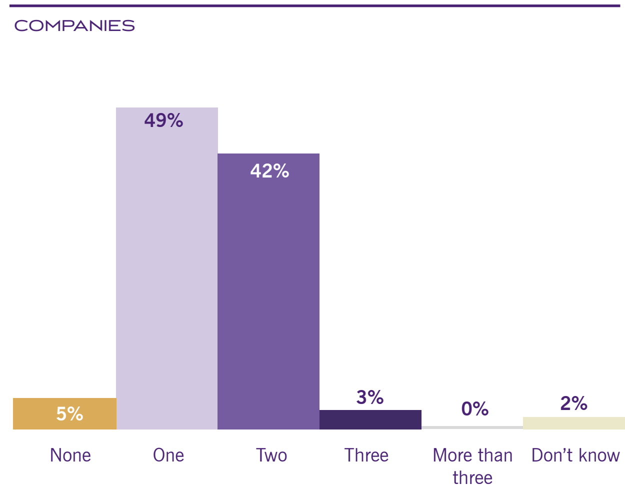
3% Other, 3% None of these, 1% Don't know

Q21. How many brokers do you think is acceptable for a company to have?



Two brokers per company is deemed acceptable for the majority of investors

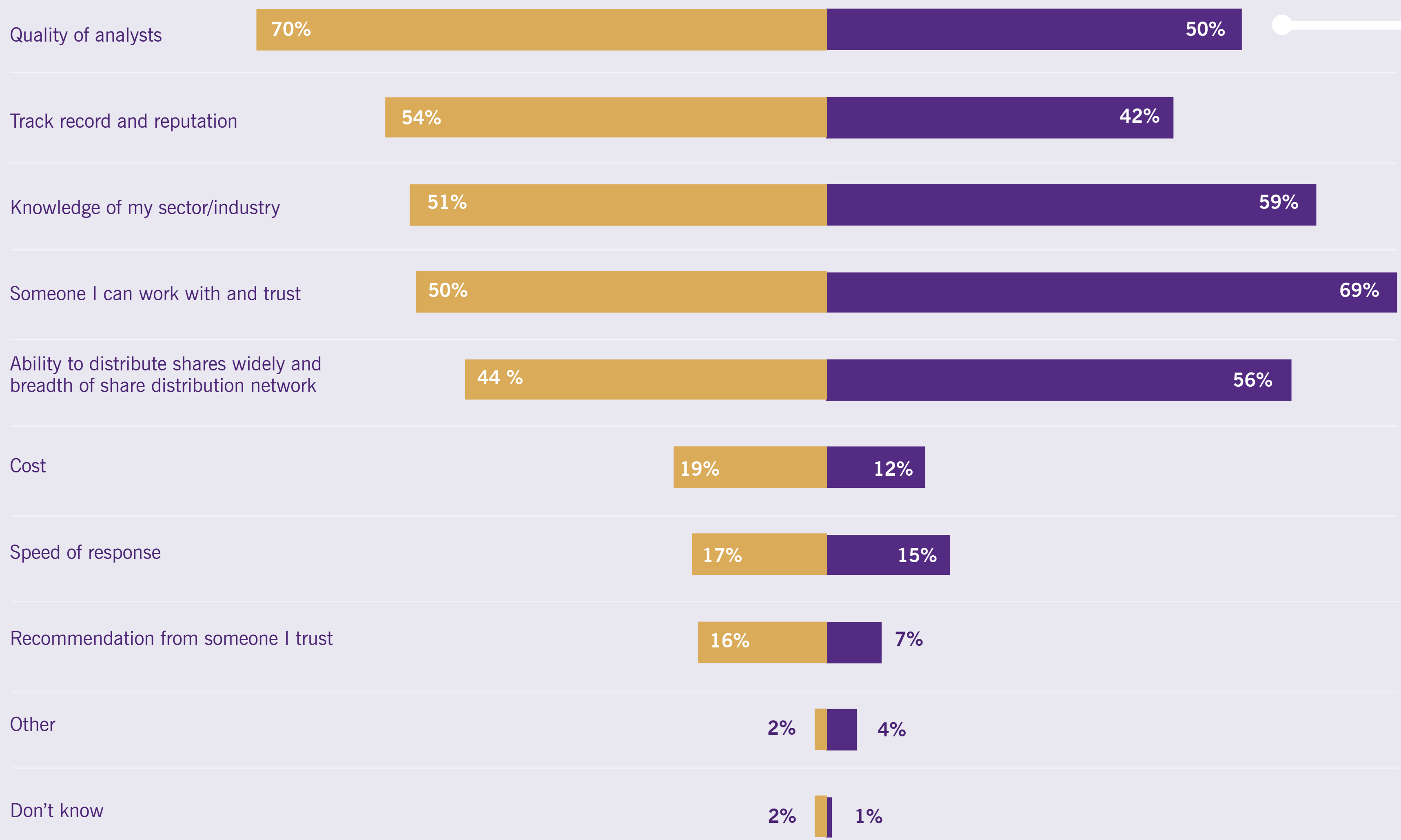
Q22. How many brokers does your company have?



Q23. What in your opinion are the most important attributes for a corporate broker?

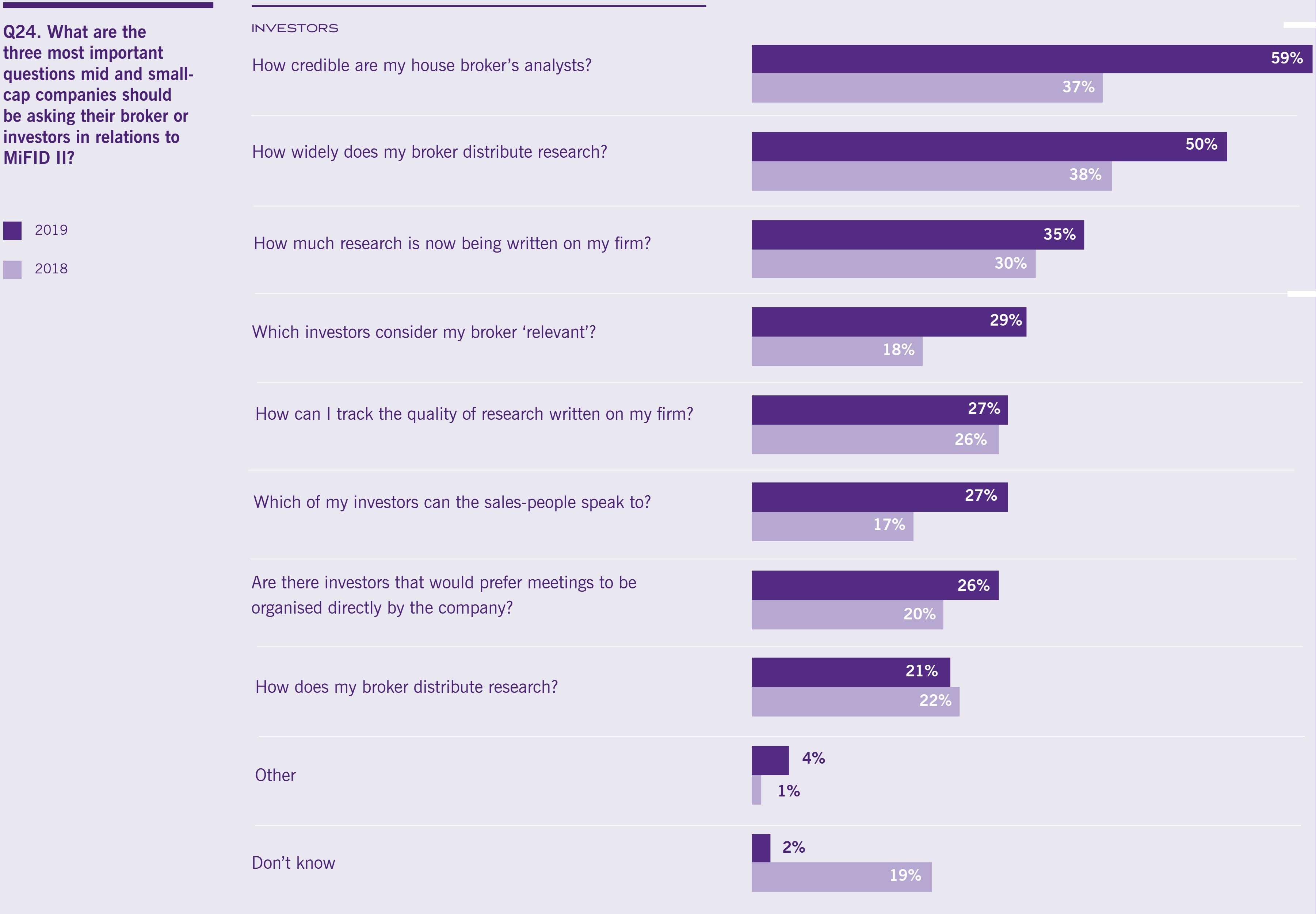
INVESTORS

COMPANIES



The quality of analysts is the most important attribute for a corporate broker according to investors, for companies it is regarded as most important that it is someone they can work with and trust.

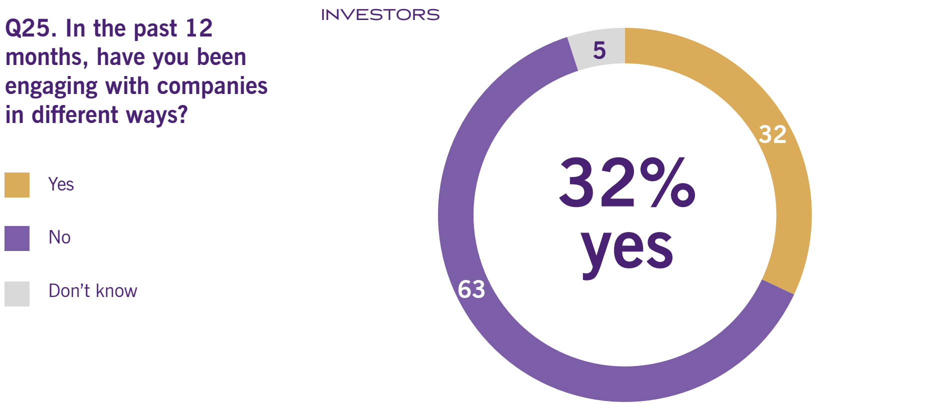
Q24. What are the three most important questions mid and small-cap companies should be asking their broker or investors in relations to MiFID II?



Credible house broker analysts, widely distributed research and volume of research remain the most important questions.

A third of investors say they have been engaging with companies in different ways

Q25. In the past 12 months, have you been engaging with companies in different ways?



Q26. You said you have been engaging with companies in a different way. If so, what are you doing differently?

INVESTORS

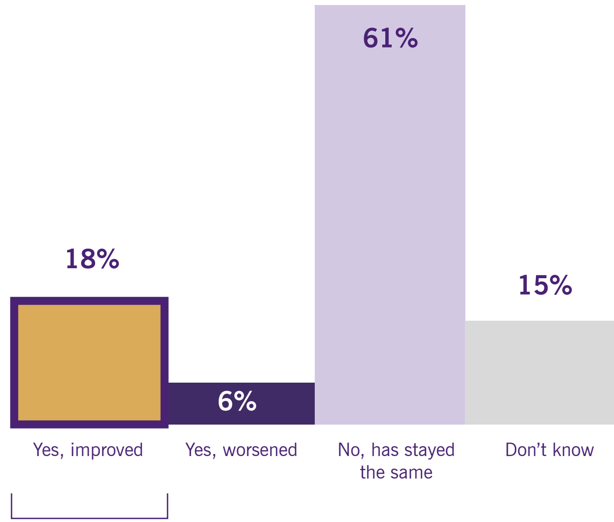
"More NED discussion, more actively discuss strategy and capital allocation as well as accounting practices with management teams"

"We have bought in the ISS Proxy voting system and their research is driving new questions from us to Boards. We will disagree with ISS recommendations after engagement with Boards, if appropriate."

"Big ESG focus. Engaging with management teams primarily around incentive schemes. Typically meetings with Chairmen of remuneration committees etc where we feel we can add value. This is not activism or private equity like interventionism but engagement is going to be a crucial differentiator for active managers in the battle with the passive industry. This is not passively following a voting policy outsourced to ISS or others proxy voting companies but genuinely thinking about how the management team are incentivised and suggesting improvements to primarily prevent short termism in growing their businesses. We need to help grow global market leaders out of the UK."

For three fifths of investors, the quality of corporate governance has stayed the same in the last year, although a quarter note a change.

Q27. Has the quality of corporate governance in mid and small-caps changed in the past 12 months?



18% have noticed an improvement.

This may relate to updated corporate governance rules on AIM (Rule 26), the predominant adoption of the *QCA Corporate Governance Code* on AIM, and an updated *UK Corporate Governance Code* for the Main Market.

Appendices

PEEL HUNT

1ST
In research

1,000+
Research relationships

£13BN
Equity raised

Peel Hunt is a leader in UK investment banking with a focus on UK mid and small-cap companies. Our joined-up approach allows us to consistently deliver value to corporates, global institutions and trading counterparties. We take a long-term view to building our business – for the benefit of our clients, our people and our partners.

Post MiFID II, we have 1000+ research relationships which is a +112% increase before MiFID II. We have expertise across a broad range of sectors offering high quality advice, ideas-led and highly rated research and flawless execution within a team-based and collegiate environment. Peel Hunt benefits from a powerful distribution platform that makes markets in c3,500 equity and fixed income products.

Since 2015 we have raised more than £13bn of equity for our clients including 36 IPOs. We have 148 retained corporate clients with 37 analysts covering over 389 companies.

Peel Hunt was ranked 1st in Research in the 2017, 2018 & 2019 Thomson Reuters Extel Survey of UK Small and Mid Cap Brokerage Firms. Peel Hunt also achieved more top three ranked sector teams than any other broker.

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies.

The value of our members to the UK economy is vast – as is their potential. There are around 1,250 small and mid-size quoted companies in the UK, representing 93% of all quoted companies. They employ approximately 3 million people, representing 11% of private sector employment in the UK, and contribute over £26bn in annual taxes.

Our goal is to create an environment where that potential is fulfilled.

We identify the issues that matter to our members. We keep them informed. And we interact to build the understanding and connections that help our members stay ahead.

The influence we have, the influence we use, and the influence we grow, ensures that our members always benefit from the impact of our initiatives.

YouGov plc is a global market research and data company built on a simple idea: The more people participate in the decisions made by the institutions that serve them, the better those decisions will be. YouGov completes thousands of interviews every year with senior politicians, business people, members of the media and other stakeholders, providing guidance for clients in how best to optimise their activities and communications.

The company was founded in 2000 and is now publicly listed on the London Stock Exchange's AIM market. It has over 800 employees in over 30 offices globally including several in the US but is headquartered in the UK. It is a member of the British Polling Council and is also registered with the UK Information Commissioner's Office.

Study Methodology

Investor survey

Between 24th September and 7th November 2019, YouGov conducted an online survey of 155 UK-based fund managers to explore their attitudes toward MiFID II.
Respondents were sourced from a combination of contact lists provided by Peel Hunt, the Quoted Companies Alliance and YouGov.

The survey lasted approximately 10 minutes and was completed on YouGov's online platform. All data was collected confidentially. Quotes taken from this sample are visualised in boxes.
This survey follows on from a similar study conducted in 2017 and 2018, using the same methodology. Some questions have been repeated or their scales amended slightly, and data from these earlier surveys have been used to highlight any changes during the interlude.

Corporate survey

110 interviews were conducted between 22nd October and 18th November 2019 from mid and small-cap UK quoted companies.

This survey has been conducted using an online interview administered to members and associates of the QCA. An email was sent to the QCA database, inviting them to take part in the survey and providing a link to it. A link to the survey was also circulated by the QCA to their contacts.

The sample definition is "mid and small-cap UK quoted companies". The responding sample is weighted by industry to be representative of mid and small-cap UK quoted companies, as derived from London Stock Exchange data.

Peel Hunt LLP: Disclaimer

This document has been prepared using sources believed to be reliable and accurate. Neither Peel Hunt LLP, nor any of its directors, employees or any affiliated company accepts liability for any loss arising from the use of this document or its contents.

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