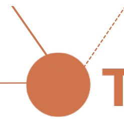

WHAT ARE THE EQUITY MARKETS FOR?

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This article is based on a speech from a panel seminar on "The New Corporate Funding" hosted by The IR Society of London on 25 January 2018. Many thanks to Richard Davies of RD:IR and ex-Chairman of the IR Society for inviting me to speak, and to Peter Montagnon of the Institute of Business Ethics and Simon Hollingsworth of Deutsche Bank for their excellent collaborative debate and input which has prompted some topics for future discussion.

I spent my professional career as a banker focused on the equity markets. Since 2016, my business The Deal Team has relied on a good flow of companies looking to list on the stock exchange, in London or across Europe.

So the questions of how equity markets have evolved, and how corporate use of them has changed, are fundamental to my business success. How do companies fund themselves these days? Are the public markets fulfilling their fundamental role as an efficient capital allocator to generate growth in the national wealth? While ICOs are possibly an interesting but irrelevant diversion for most companies, do they nevertheless ask important questions? In preparing for the IR Society event, I was asked to be provocative. As a result of this, I found myself questioning the rationale for equity markets today.

But Why? – 100 IPOs on the London Stock Exchange in 2017

It is true the LSE famously announced 100 IPOs completed on the LSE's platforms last year. It sounds a great achievement, and certainly is after a poor 2016 and several years of low primary equity market issuance in Europe.

I took a close look at that list of companies. After removing the Standard and AIM Listings, REITs, investment funds, international companies, GDRs, cash shells, etc., there were just 12 Premium Listings of UK companies with a market capitalisation over £100m at IPO.

I ran the numbers again to make sure. And then checked with the London Stock Exchange. Who confirmed that among other statistics, nine out of ten of the largest IPOs on this list came from outside the UK.

In a "good" year for issuance, there were just a dozen sizeable companies who partially or wholly contribute to the UK's national wealth who wanted to - or were able to – use the UK equity markets as a platform for their future development. The whole of the domestic UK mid and large-cap equity infrastructure, multiple banks with Research to Sales to ECM to Corporate Broking, was chasing only 12 deals.

I paused. And checked the Corporate Governance "Comply or Explain" statements which are required for a Premium listing. Only a handful – three – of these UK companies complied at IPO with the basic requirements of Chairman or Board independence.

The Longer View – the Number of Listed Companies Has Halved

According to the LSE's own statistics, in January 1999 there were 1,890 UK listed companies on the Main Market. In December 2017, there were 942. Less than half.

I looked at whether this was due to a juniorisation of the market, to see whether the equity markets were nevertheless still performing the role of providers of growth capital to small companies which are the lifeblood of economic growth. In 1999 there were just over 1,200 small companies with a market capitalisation below £50m. In 2017, there were 800. Again, materially lower. While inflation may be a factor here, it's not the main factor.

When compared to the total number of companies registered in the UK, which was 1.66 million in 2002 (the oldest reliable data I could find) and 3.7 million in 2017, the size of the fall is mind boggling.

Against the Backdrop of The Shrinking World of Equities

It's important for listed companies to have decent research coverage, to highlight investment opportunities and provide an independent voice to investors. However, as I wrote a year ago in our article The World of Equities is Shrinking (Part 1 here, Part 2 here), MiFID II is causing investors to ask which research products they really want to buy – and likewise banks to ask which they wish to keep. For those readers familiar with sellside equity research analysts, you will know they have been pretty miserable in the past few years.

Even before MiFID II, the number of research analysts globally fell by 10% between 2012 and 2016. It's hard to be positive that this trend will be reversed.

And even if this wasn't a factor – how attractive is it for a company to be listed in a market increasingly dominated by passive funds, who naturally only hold the largecap stocks. Who is going to buy the remaining companies? More importantly, how does a new company coming to market attract the attention of the shrinking number of active investors who are the ones that participate in and price equity transactions?

So How are Companies Being Funded?

A common theme in the investment industry in recent years has been the "wall of money" chasing yield. Low interest rates and cheap money have naturally driven up the prices of all assets. So it's unsurprising companies looking to fund themselves in this interest rate environment will naturally take advantage of the record low costs which are being sustained by central banks, before looking to more expensive equity financing.

To put a size on this, Thomson Reuters indicates global debt capital markets issuance was $5.6 trillion in the first 9 months of 2017. In 2007, that statistic was around $3.4 trillion.

McKinsey uses Preqin data to give a similar size of increase for the amount of private equity assets under management, from roughly $1.5 trillion in 2007 to $2.5 trillion today.

Private ownership seems to be ever more appealing. When unprofitable tech companies can grow to unicorn size without ever seeking public equity, *one has to ask what is the point of listed equity*. The role of equity markets when they were created – to diversify corporate funding and spread risk for investors – is no longer key,

ICOs - A New Hope?

Initial Coin Offerings have attracted a lot of attention. The 435 successful ICOs in 2017 (out of c. 900 launched) raised $5.6 billion of funding, all without diluting equity or pledging the companies' earnings or assets.

Although, the top 10 ICOs took the lion's share of those proceeds and the average raise was only $12.7m. For comparison – those 12 UK IPOs in 2017 – remember, a small number - were worth over $10bn at IPO.

ICOs are not yet a competitor for the public equity markets and certainly not for the debt markets. And the depth of the market for ICOs in a regularised market, where offering structures start following normal private placement requirements, is yet to be tested. My understanding is that ICOs seeking to be compliant are barring all US, South Korean and Chinese investors – some of the largest markets historically. What may appear to be extreme

measures could become the new reality, at least for those ICO promoters wishing to avoid being subpoenaed by the US Securities and Exchange Commission.

Not Only Driven by Animal Spirits

It's unfair however to blame this shrinking world of equities solely on the market dynamics. It's not all about animal spirits seeking efficient capital allocation. What about the regulatory environment. How much more difficult has the process of an IPO become?

When I started my professional career in equity capital markets in 1993, prospectuses were marketing-led documents written by the bankers. These were usually less than 100 pages long, including financials, and used a decent sized font that was actually legible.

Having a banker write a disclosure document without legal oversight is obviously not ideal. Prospectuses need a measure of independent scrutiny and disclosure to ensure the market is appropriately informed.

Yet today prospectuses are deliberately designed as litigation management documents, instead of the primary purpose of describing a potential opportunity to investors. They are 300+ pages long, in a ten-point font, closely spaced, and are required to be read, digested and understood in only 2-4 weeks. How can these be of any use to investors? Anecdotally, investors we speak to on the IPO process confess they become less interested after the executive summary, risk factors, strengths and strategy sections.

There is a real cost to this prospectus process. It's expensive to hire two sets of lawyers, several bankers, often an advisor as well, and spend months of management time on a document possibly at the expense of running the business. I am very pleased that this latter point has created the market for my business! Even with our help, however, it's hard not to conclude the complexity and business risks of an IPO process today are a real disincentive to listing.

Where to Begin?

Fewer companies are choosing to use the equity markets than a few decades ago, in spite of hugely higher levels of GDP and numbers of companies. The options for non-public ownership and funding are wider than ever before. ICOs ask useful questions of how companies are funded and controlled, even if they turn out to be a small tool in the private placement universe.

This article is intended to provoke debate on repositioning the role of the equity markets– just as I was asked to do in the original seminar. To frame that debate, I offer up four possible topics for further discussion.

1. **Equalisation of Corporate Governance and disclosure for private and public companies alike.** In the Corporate Governance world, regulators and politicians have focused on the listed companies as easy targets. Is this sufficient when an increasing part of national wealth becomes less transparent and answerable? The reason this is important is because…

2. **…Increasing wealth inequality, part of which is the inability of smaller investors to access higher return private assets**, and the consequent accumulation of wealth among the wealthiest. Raising the quality of governance for private companies, and equalising the competitive awareness and regulatory burdens between listed and privately held companies, could be options to recalibrate return profiles without imposing stricter, less capitalist-friendly measures. And would have the happy consequence of making it less of a burden to list on a stock exchange.

3. **Therefore, restoring the link between ownership and control.** This isn't a new topic. The recent European Corporate Governance Institute working paper is well worth reading for the long term context. However, in our view the recent trends of increasing passive vs active investment in equities, the globalisation of funds, the rise of private equity, and the greater use of non-voting stock, make this an acute problem.

4. **And in the meantime, regulatory engagement with the market to explore brave options.** It is surprising to reflect the SEC, viewed as the world's harshest regulator, has yet been publicly floating ideas both formally or informally, to lighten the burden of an equity listing. Recently these included exempting listed companies from securities class action lawsuits, and raising the bar for submitting shareholder proposals at GMs. Whether they are good proposals or not is a separate discussion – the SEC is demonstrating a willingness to ease the regulatory burden instead of piling rules upon rules.

We'd be delighted to enter an industry dialogue on the ideas in this article. As always, if you have any questions, we're here to help.

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