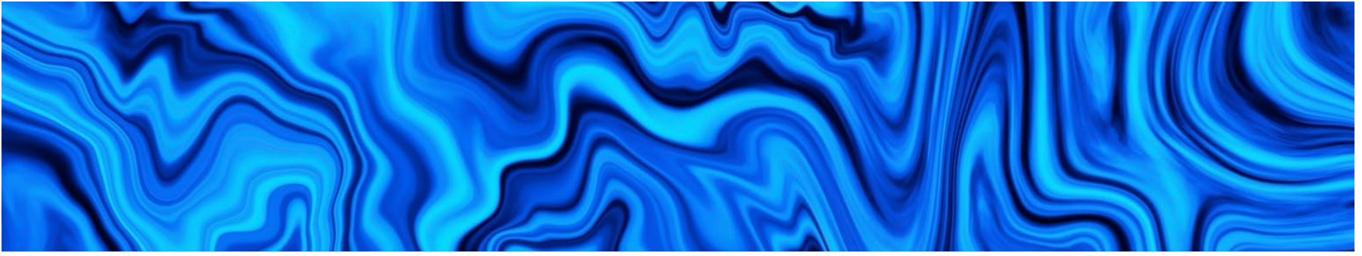
NEW FINANCIAL
Rethinking capital markets



THE FUTURE OF SMALLER COMPANY CAPITAL MARKETS IN THE UK

ANALYSIS OF THE DECLINE IN SMALLER LISTED COMPANIES, WHY WE SHOULD CARE ABOUT IT - AND WHAT WE CAN DO TO ADDRESS IT

October 2024

By William Wright and James Thornhill

In partnership with:

> This report argues that rebuilding a vibrant market for smaller listed companies is a vital part of the wider reform of UK capital markets to help drive long-term investment and growth. It paints a stark picture of the burning platform over the past few decades and how smaller companies have been hit harder than the wider market, highlights the unique role they play as a source of funding for UK plc, and outlines a vision to reverse their decline.

INTRODUCTION

The future of smaller company capital markets

The past few decades have been pretty brutal for public equity markets in the UK but smaller listed companies have been hit hardest of all. On virtually every metric - the decline in the number of listed companies and new issues, the collapse in demand from retail and institutional investors, or the reversal in performance - smaller companies have fared worse than the wider market. In the active debate around reforming the UK market over the past few years there is a risk that the unique dynamic of the smaller company end of the market gets lost in the noise. On many issues, such as the shift by UK pensions to a global equities allocation model, the specific impact on smaller listed companies has not been reflected in the debate.

Many of the challenges facing smaller companies are common across the wider market: stemming the exodus of pensions from UK equities; re-engaging retail investors; resetting risk culture and the balance between risk, growth, and stability; or addressing governance and regulatory hurdles. But there is a world of difference between the issues facing a big tech company like Arm Holdings (valued at £110bn) in its decision to list in the US, and its smaller cousin Raspberry Pi (valued at £725m) which listed in London this year. And there is a world of difference between Raspberry Pi and a £75m tech company listed on AIM.

In this report, we use a broader definition than usual of 'smaller companies' and include any UK listed company with a market capitalisation of less than £1bn. This is a deliberate decision to try to capture the dynamic of all smaller companies and to avoid getting too bogged down in a specific debate about AIM (which only accounts for a third of smaller listed companies by value). For our analysis of trends over the past 20 years, we have adjusted all market values for inflation into 2023 money.

It can be tempting to think that smaller companies don't really matter: they only represent 8% of the combined value of the UK stock market and there are bigger fish to fry. We think this is would be a mistake: smaller companies have a strong local footprint in every corner of the UK and make a big economic contribution to jobs, investment, and growth. Smaller company capital markets provide a big source of funding for UK plc and help provide a funding escalator for the bigger companies of tomorrow: one third of listed UK companies with a market value of more than £2bn today have been a smaller company on our definition at some point in the past 20 years and have since more than doubled in value in real terms.

The good news is that there is nothing inevitable about the decline in smaller listed companies: there are plenty of examples in markets like Australia, Canada, and Sweden where smaller listed companies have been thriving. This shows that with a concerted effort across government, regulation, and the industry, we can reverse the 'doom loop' and revitalise what should be a vibrant component of UK capital markets.

We outline a series of directional recommendations that focus as much on driving change in the wider market as on the specifics of smaller companies on the basis that a rising tide lifts all boats. These recommendations focus on rethinking five issues: tax and incentives (a risky move just ahead of the budget), demand, risk culture, governance and regulation, and market infrastructure and technology. The first part of this report condenses the whole report into less than 10 pages. The second part of the report analyses these themes in more detail for more motivated readers.

I would like to thank James Thornhill, Matilda Hames, and Christopher Breen at New Financial for collating and analysing the wealth of data that underpins this report; abrdn, Euroclear, the QCA and Winterflood Securities for partnering with us on this important project; and our members for supporting our work on building bigger and better capital markets. Any errors are entirely my own.

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EXECUTIVE SUMMARY

Here is a 10-point summary of the report:

1. **A focus on smaller companies:** in the active debate on UK public equity markets over the past few years there is a risk that the unique dynamic of smaller listed companies - which account for over 80% of all listed companies in the UK - is lost in the noise. This report focuses specifically on the challenges facing UK smaller companies in the context of the wider reform of UK capital markets.
2. **A burning platform:** it has been a pretty brutal few decades for the UK stock market but on virtually every metric, smaller listed companies have been hit hardest of all. The number of smaller listed companies has dropped by nearly a third; the number of new issues has fallen by 80%; share price performance has halved; and the ecosystem of smaller company brokers and asset managers is struggling to stay afloat.
3. **An engine of growth:** while smaller listed companies only represent 8% of the stock market by value, they have a strong local footprint across the UK, have raised nearly £250bn in real terms over the past 20 years, and play an important role in supporting jobs, investment, and growth in every corner of the country.
4. **The big companies of tomorrow:** many of today's smaller companies will grow into the big companies of tomorrow. Half of all listed UK companies with a market capitalisation of more than £1bn - and a third of companies worth more than £2bn - have been a smaller company with a market value in real terms of less than £1bn at some point in the past 20 years.
5. **A collapse in demand:** the biggest driver of this decline has been a breathtaking collapse in demand by institutional and retail investors. UK smaller company funds have just recorded their 36th consecutive month of outflows, and the number of local authority pension schemes with a dedicated allocation to UK smaller companies has fallen from 18 to just one over the past decade.
6. **A negative feedback loop:** the danger is that smaller listed companies have fallen into a self-fulfilling 'doom loop' of lower demand, lower valuations, lower performance, higher governance and regulatory requirements, and higher cost, which makes the market less attractive for issuers and investors.
7. **Some good news:** the good news is that there is nothing inevitable about the decline in UK smaller listed companies. There are plenty of examples in markets like Australia, Canada, and Sweden where smaller companies have been thriving. A concerted effort by government, regulators, and the industry can set smaller companies back on track.
8. **Rethinking tax and incentives:** ahead of the budget, we think it would be dangerous to abolish the tax reliefs on AIM stocks today. Instead, there is a strong case for proving longer-term certainty about these reliefs and the rates of tax, for extending the exemption from stamp duty on share trading from junior markets to all stocks outside the FTSE 100; and for perhaps introducing a lower differential rate of CGT and dividend tax for UK companies as is the case in Australia and Canada with dividends.
9. **Rethinking demand:** the priority in increasing demand should be to get more money into the system rather than focusing on channelling more money specifically into smaller companies, on the basis that a rising tide will lift all boats. Pension contributions need to urgently increase, stock and shares ISAs could be simplified and reformed to channel an additional £10bn a year into UK equities, and pension fund providers that have pledged under the Mansion House compact to invest more money in unlisted equities could allocate some of this to smaller companies.
10. **Rethinking risk culture, regulation, and market infrastructure:** wider reforms to reverse the culture of risk aversion, revitalise UK capital markets, recalibrate regulation and governance requirements, digitise the UK's archaic and anti-competitive shareholder framework, and adopt a digital first approach to capital markets would help reverse this doom loop and turn it into a virtuous circle of growth and investment.

Sir Douglas Flint
Chairman
abrdn

An engine of growth

Smaller companies play a vital role in the UK economy by creating jobs, channelling investment into a wide range of sectors, pushing the boundaries of innovation and driving technological advancement.

From an investment perspective the UK listed 'small caps' sector also has an extremely positive story to tell with a strong track record of delivering long-term, risk-adjusted returns. Successful smaller companies can deliver multi-year growth and performance returns with the potential to become the larger companies of tomorrow.

However, what should be seen as a key component of a well-balanced portfolio has dropped out of fashion as major investors have turned towards 'mega' caps and familiar global brands, At the same time the number of listed smaller companies has steadily declined, as has the flow of IPOs.

The reasons for this are various but the closure of defined benefit pension schemes, the structural risk aversion of the replacement defined contribution schemes, the 'higher for longer' interest rate environment, the plentiful supply of private equity capital and the trend towards more globalised portfolios have all played a part to a greater or lesser degree. Other cited factors include the costs and onerous obligations associated with heavy compliance, regulation, governance and audit requirements for smaller listed firms.

This means investors risk missing out on a significant opportunity. The UK listed smaller companies' sector offers attractive valuations and robust earnings which, coupled with the broader backdrop of a recovering economy, the prospect of further cuts in interest rates and a relatively stable political environment, makes for a compelling proposition. It is therefore perplexing that what should be a jewel in the crown for UK capital markets has become largely overlooked by major investors.

As a long-term, high conviction investor in smaller companies, abrdn recognises their economic and social importance, hence our enthusiasm for partnering with New Financial on this report along with the QCA, Winterflood and Euroclear.

This carefully considered report is a roadmap for revitalising this key sector. We would urge policymakers and regulators to consider the recommendations carefully and act to help the sector to achieve its full potential as an engine of economic growth and future global competitiveness.

Creating a UK smaller listed companies' sector which is comparable in size and vibrancy to those which exist in other markets will help to create prosperity and opportunity to all parts of the UK - a clear and commendable ambition this new government has set itself and one we fully support.

In summary, if there is an optimal time to put the listed smaller companies' sector under the spotlight, with a view to making it work better for the economy, investors and society at large, this must be it. Let's grasp the opportunity.

James Ashton
Chief Executive
QCA

A huge contribution to the UK economy

The smallest must shout loudest to be heard and this vital report helps us do just that on behalf of the companies that are by far the most populous on the London markets.

It underlines the case that small and mid-sized quoted companies contribute hugely to the UK economy and enjoy a broad geographic reach.

But it also emphasises the point that large companies were small not so long ago. It is true that running a vast FTSE 100 enterprise has little in common with a tiny AIM stock where resources are tight, but these companies are all part of the same ecosystem that should be nurtured.

Accordingly, some of the proposed initiatives here will lift all boats. What the report highlights is that smaller companies require special measures to help them flourish after an exceptionally tough period when major investors turned their backs on the asset class.

At the Quoted Companies Alliance, I am fortunate to spend time with ambitious companies from across geographies and industry sectors that know they can thrive despite challenges of cost, complexity and liquidity. Think what they could achieve if our markets were fully optimised to get behind them as they eye expansion and investment opportunities.

The way to grow a fresh crop of large UK companies is to start small. Measures such as the Mansion House Compact - focusing in on AIM and Aquis stocks - the British Business Bank supporting public as well as private companies and improved index coverage to draw in passive money can all contribute.

What is most encouraging about this work is that, by putting UK markets in an international context, it is clear that further decline is by no means inevitable.

New Financial's thoughtfulness and capital markets specialism has come into its own and its work is well read by senior politicians, civil servants and regulators. It has been a pleasure to collaborate with William and his team, alongside abrdn, Euroclear and Winterflood Securities.

But the work does not end here. Let's not let these policy recommendations go to waste.

WHAT IS THE PROBLEM WE ARE TRYING TO SOLVE?

A downward spiral

The headline numbers on the decline in smaller listed companies over the past few decades make for pretty depressing reading - with a stark decline in the number of listed companies and new issues, and a sharp reversal in the long-term outperformance of smaller companies. The good news is that the example of some other markets shows that there is nothing inevitable about this decline.

-31%

Decline in number of listed smaller companies in the past 20 years

The number of listed companies: over the past 20 years the number of smaller listed companies with a market capitalisation of less than £1bn in today's money has fallen by nearly a third (31%) which translates into a net loss of nearly 600 companies. The smaller the company, the bigger the decline: the number of large listed companies (with a market value of more than £1bn) has increased by a fifth, all listed companies have fallen by a quarter, smaller companies by a third, and micro-companies (with a value of less than £100m) by over 40%.

22

Number of new issues by UK smaller companies in 2023

The number of new issues: over the past decade the number of new issues by smaller companies has dropped by 80% to just 22, while the value raised by new issues has fallen by 90%. New issues cannot keep up with the relentless pace of delistings: in seven of the past 10 years more smaller listed companies have left the stock market than have joined it. Before the financial crisis 300 or so smaller companies a year were joining the stock market. While many of those companies might not have been suitable, the balance seems to have swung too far.

0.2%

Annualised total return on AIM stocks over the past 10 years

Poor performance: the historically strong performance of smaller companies has reversed over the past decade. Over 25 years, UK smaller companies including AIM generated an annualised total return of 7.4% in line with the S&P 500 (7.5%) and nearly 50% higher than the wider UK market (5.4%). But over the past 10 years this return has dropped below the UK market to just 4.5%, and over the past five years it has halved again. AIM-listed companies have performed poorly, with an annualised total return of just 0.2% over the past decade.

-149%

Fall in pretax profits at smaller company broking firms in the past decade

The wider ecosystem: the wider ecosystem of specialist broking firms and asset managers around smaller listed companies has struggled to adapt to the decline in activity. Revenues at brokers specialising in UK smaller companies have fallen by more than a quarter in real terms over the past decade (-27%) and the sector has swung from a healthy profit to a big collective loss. This has triggered a wave of consolidation in the past few years as broking firms struggle to stay afloat. Asset managers have closed or reallocated dedicated UK smaller company funds.

4.5x

Increase in annual number of smaller company IPOs in Sweden in the past decade

An inevitable shift?: the good news is that there is nothing inevitable about the decline in smaller company capital markets. There are plenty of examples around the world where smaller listed companies are thriving and activity has increased over the past decade, including Australia, Canada, Italy, Japan, and Sweden. This suggests there are lessons that the UK can apply to reboot smaller company capital markets in areas such as increasing institutional demand and making it much easier for retail investors to invest.

WHY SHOULD WE CARE ABOUT SMALLER COMPANIES?

A vital contribution

It may be tempting to think that smaller listed companies only play a minor role in the UK economy and UK stock market: they are - by definition - small and they only account for 8% of the value of the UK market. But they have a strong local footprint across the UK, make a big economic impact, provide a valuable source of funding for UK plc, and act as a funding escalator for the bigger companies of tomorrow.

1

Number of counties in England that do not host the HQ of a smaller listed company

A local footprint: smaller listed companies have a strong local footprint in every corner of the UK and support jobs, economic activity, and investment in communities from Devon to Derbyshire, and Lancashire to Lothian (you might even call it 'levelling up in action'). The only county in England that does not host the headquarters of a smaller listed company is Herefordshire. This local presence provides a direct connection between local communities and the stock market, which can often seem remote and abstract to most people around the UK.

£170 bn

Combined revenues of UK smaller listed companies

Economic impact: smaller listed companies have a big direct and indirect impact on the UK economy. They have combined revenues of £170bn and employ more than 1.1 million in the UK and overseas. Companies listed on AIM make an economic contribution of nearly £70bn to the UK economy, have a much higher proportion of international revenues than companies in the wider private sector, are growing faster with a 13% annual growth rate in revenues, and are 50% more productive per employee than the UK average.

82%

Proportion of UK listed companies that have a market value of less than £1bn

The engine room: while smaller listed companies only represent 8% of the value of the UK stock market they account for 82% of the number of listed companies in the UK. Over the past 20 years, more than 4,300 UK companies have at some point been smaller listed companies, supporting an ecosystem of asset managers and brokers. While performance has been disappointing over the past decade, on a 25 and 50 year view smaller companies have outperformed the wider UK market and generated higher returns than the S&P 500 for investors.

£240 bn

Capital raised by UK smaller listed companies over the past 20 years

A big source of funding: public equity markets have been a big source of capital raising for smaller companies over the past few decades. While new issue activity has slowed in the past decade, we estimate that smaller listed companies have raised nearly £250bn in real terms from the stock market in the past 20 years, with 80% of that coming from further issues by companies that are already listed. More than 3,000 AIM-listed companies have raised £170bn in funding over the past 20 years in real terms to invest in their business.

33%

Proportion of £2bn+ UK listed companies that have been smaller companies in the past 20 years

The big companies of tomorrow: public equity markets are a valuable part of the funding escalator for companies to access capital at different stages of their growth. Most listed smaller companies in the class of 2003 are no longer listed but 65 of them have graduated into big companies with a value of more than £1bn (representing nearly a fifth of the 257 large listed companies today). A third of listed UK companies with a market value of more than £2bn have been smaller listed companies at some point in the past 20 years (more than doubling in value).

WHAT HAVE BEEN THE MAIN DRIVERS?

A vicious circle

There is no single factor that has driven the decline in smaller listed companies. Instead, a series of interconnected challenges have fuelled each other to create a self-fulfilling doom loop, including: a collapse in demand for smaller listed companies from institutional and retail investors, a wider shift across the industry towards scale and automation, the increase in alternative sources of funding, and the increased burden of regulation and governance.

36

Number of consecutive months of net outflows from UK smaller company funds

A collapse in demand: there has been a breathtaking collapse in demand for smaller listed companies over the past decade. August was the 36th consecutive month of net outflows from UK smaller company funds; pension funds have slashed their allocation to UK listed equities and excluded smaller companies by shifting to a global market weighted allocation model; asset managers have been scared off by the regulatory focus on liquidity; and retail investors have increasingly opted for the easier, lower cost, and higher return option of an S&P 500 tracker.

1

Number of LGPS pension funds with a dedicated allocation to UK smaller companies

A shift to scale and automation: over the past few decades the financial markets have grown much bigger and become more complex and more international. This has led to a wider upwards shift towards scale and automation, which has effectively disenfranchised smaller companies. Investors are increasingly opting for passive funds and a 'global approach' to equities; equity markets have shifted toward high frequency trading; and the economics of smaller company broking and investment increasingly don't add up.

8x

Increase in investment in smaller companies by private capital over the past decade

Alternative sources of funding: smaller listed companies have been squeezed at both ends by the growth in private capital. At one end, an eightfold increase in early-stage investment in UK companies from venture and growth capital has reduced the need for public equity markets. At the other, the value of private equity-led acquisitions of smaller companies has more than doubled. The good news is that smaller companies have an additional source of funding. The bad news is that most investors are excluded from private markets and these returns.

2019

Woodford collapse and FCA warning on liquidity sends a chill across smaller listed companies

Increased regulation and governance: the perceived and real increase in corporate governance requirements for listed companies and the regulatory burden on smaller company brokers and assets managers has raised costs across the sector and led many companies and services providers alike to wonder whether it is worth being listed or supporting smaller listed companies. The Woodford collapse in 2019 and regulatory focus on liquidity in smaller company investment has sent a chill across the whole sector.

545

Number of smaller listed companies that have collapsed in past 20 years

A self-fulfilling doom loop: these factors have combined into a vicious circle. The fall in demand from investors has sucked billions of pounds out of the market and translated into lower valuations and lower liquidity. More listed companies may decide it's not worth being listed or may be picked off by private equity firms, increasing the number of delistings. Fewer companies think it is worth listing, which accelerates the reduction in new issues. This makes for a less dynamic market with lower returns, which further reduces demand. And round you go again.

WHAT CAN WE DO ABOUT IT?

A positive change

The good news is that there is nothing inevitable about the decline in UK smaller companies and that a combination of cultural and regulatory change, adjusting incentives, embracing technology, and stimulating demand can help move the dial. Many of our recommendations are as focused on driving change in the wider market on the basis that a shift in the overall investment and in the UK market more broadly on the basis that a rising tide will lift all boats.

1. **Rethinking tax and incentives:** making recommendations on tax and incentives a few weeks before a budget when there has been widespread speculation that the government is considering removing tax incentives on AIM stocks, changing tax relief on pensions, and raising capital gains tax is perhaps a foolish exercise. We think the government should retain business relief on AIM stocks and extend the stamp duty exemption on share trading to all UK stocks outside the FTSE 100. Any increases in the headline rates of CGT or dividends could be offset with indexation and increased allowances, and the government could consider introducing a differential rate on CGT and dividends for UK stocks (as is the case with dividends in Australia and Canada) to incentivise more investment in UK equities.

2. **Rethinking demand:** the priority in increasing demand should be to boost overall investment rather than focusing on channelling more money into smaller companies on the basis that savers will benefit and a rising tide will lift all boats. The government should commit to a timeframe for increasing pension contributions from their inadequate rate of 8% to at least 12% over the next decade. ISAs could be simplified and the tax reliefs on the 'top half' of subscriptions made conditional on investing in UK assets, and the principle of the Mansion House compact (under which big pension providers pledged to boost their allocation to unlisted equities) could be extended to smaller companies.

3. **Rethinking risk culture:** the balance between risk, growth, and stability in the UK regulatory system has swung too far and created a self-perpetuating culture of risk aversion. This is beginning to change but can be accelerated with a particular focus on resetting the balance between risk and protection (too many individuals are protected to the point of exclusion and exposed to the risk of taking no risk); enabling access to affordable advice by redrawing the boundary between advice and guidance; and a wider information campaign to encourage people to take more control of their financial future and engage with investing as much as they do with their savings or house prices.

4. **Rethinking governance and regulation:** a 'spring clean' of governance requirements for smaller listed companies would help identify what should be required, what is based on applying expectations of larger companies to smaller firms, and what might be redundant. This would also clarify which elements of governance can and should be different for smaller companies, and help create reset expectations for companies, investors, and proxy agencies. Removing cliff edges for smaller companies seeking to graduate to the main market and rethinking regulatory assumptions around risk and liquidity would help widen access for companies and investors alike.

5. **Rethinking infrastructure & technology:** technology can enable more engagement for individual investors with their financial well-being, nudge them into taking better decisions, enable wider access to capital markets, and facilitate better communications between companies and their investors. The upcoming recommendations of the Digitisation Taskforce offer a once in a generation opportunity to digitise the UK's archaic and anti-competitive shareholding framework, drag it into the 21st century, re-establish a direct link between companies and their owners, and embrace a wider 'digital first' approach to wider regulatory reform. The introduction of Pisces, a hybrid market with intermittent trading, will help blur the lines between public and private markets and provide additional options for companies seeking to raise capital and investors looking for longer-term growth.

Punching above its weight

Before diving into the detail, it is worth pausing to frame smaller companies in the context of the wider UK stock market. Our definition of a 'smaller company' for this report is any company that had a market capitalisation of less than £1bn as of the end of last year or that had a market cap of less than £1bn in real terms (adjusted for inflation into 2023 money) at the end of any year over the past two decades. On our count, there are 1,257 smaller listed companies from the UK and the Channel Islands, accounting for 82% of all listed UK companies (see Fig.1 on right).

Nearly 60% of these companies (738) are micro companies with a market capitalisation of less than £100m, while three quarters of them have a market cap of less than £250m (964 companies). This balance is reversed when you measure them by value: larger companies with a market value of more than £1bn account for 92% of the value of the UK stock market, with smaller companies representing 8% (and micro companies less than 1%). Of course, there is a world of difference in the challenges facing a £750m listed company and a £100m company. The aim of this report is to try to identify and address the common challenges facing all smaller companies valued at less than £1bn.

When you zoom in on UK smaller listed companies, they are roughly evenly distributed between the main market and AIM (with 46% each - see Fig.2). There are a further 107 smaller companies listed on Aquis (formerly NEX and Plus Markets). But the value of smaller companies listed on the main market is more than twice as much as AIM listed companies (67% of the total market vs 32%). One fascinating aspect of smaller companies is that many of them aren't 'companies' in the classic sense of the word: one fifth of smaller companies by number and more than a third by value are investment trusts.

Fig.1 Smaller companies and the wider market

The number and value of listed companies by market capitalisation (end 2023)

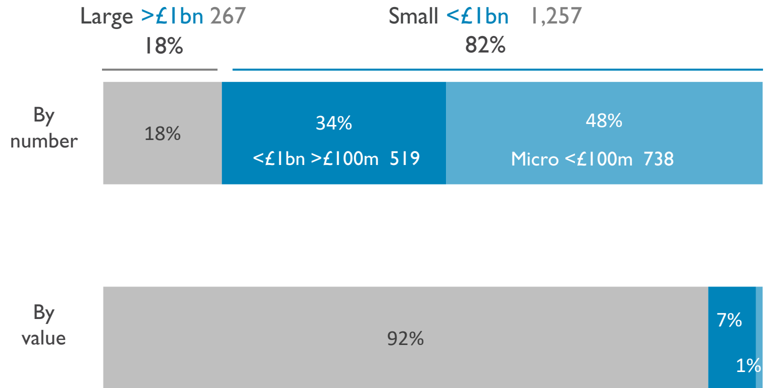
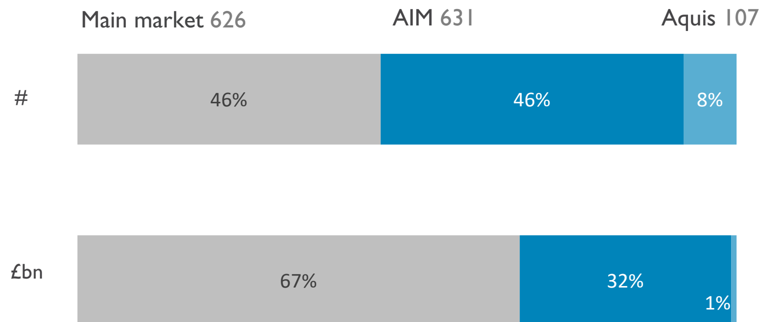


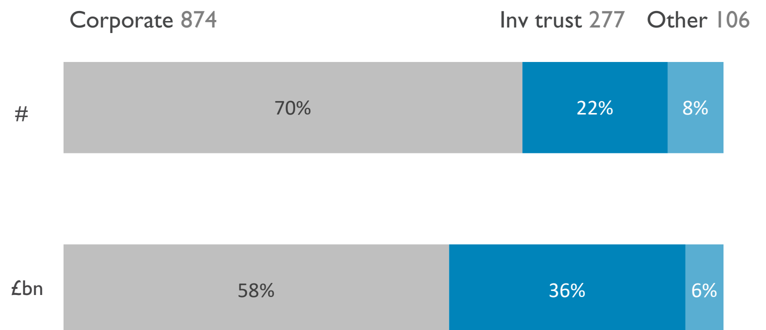
Fig.2 The composition of smaller listed companies

The number and value of smaller listed companies (end 2023)

i) Smaller listed companies by market



ii) Smaller listed companies by type of company



Source: New Financial analysis of LSEG data

A MORE DETAILED ANALYSIS

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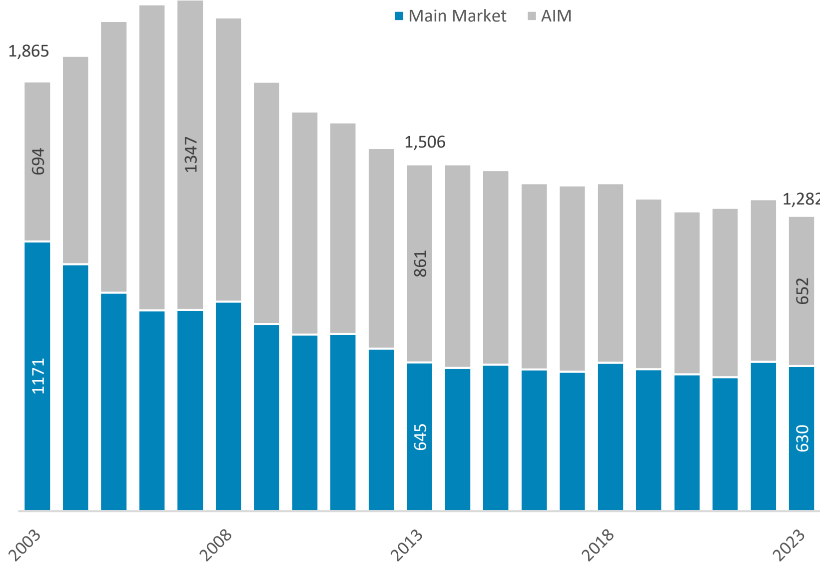
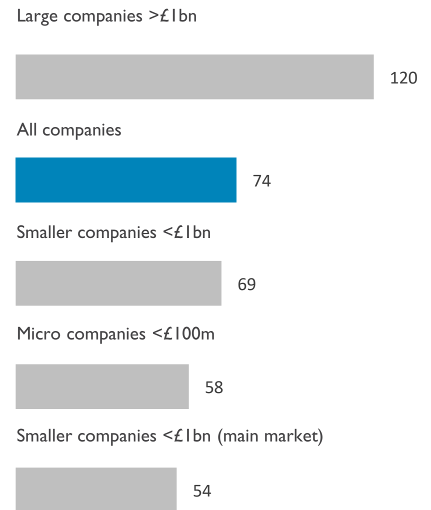
Fig.3 The decline in the number of smaller listed companies

i) Number of smaller listed UK companies from 2003 to 2023*
(market capitalisation of less than £1bn in 2023 money)



ii) Change in number of listed UK companies by size
(2013 = 100)



Source: New Financial ** our numbers exclude 107 smaller companies listed on Aquis as we do not have consistent data before 2019*

A brutal few decades

It has been a pretty brutal few decades for UK public equity markets but it has been almost existential for many smaller listed companies. Over the past 20 years, the number of smaller UK companies listed on the London Stock Exchange has dropped by nearly a third (-31%) which translates into a net loss of nearly 600 smaller listed companies. In the chart above on the left (Fig.3i) the blue columns show that the number of smaller companies listed on the main market has virtually halved over the past two decades (-46%), and the grey columns show the number of smaller companies listed on AIM is only down by 6% since 2003 but has more than halved from its peak in 2007.

The past two decades have been a tale of two halves for smaller listed companies. In the first decade, the number of smaller companies listed on the main market dropped by 45% (a loss of more than 500 companies) but has since remained relatively stable. On AIM, the first decade was a rollercoaster ride of rapid growth in new issues and the number of listed companies in the run up to the financial crisis (many of which were perhaps not ideally suited to being listed in the first place) followed by a sharp decline and steady downwards drift ever since.

It is striking that the smaller the company, the bigger the decline. The number of large listed companies with a market value in 2023 money of more than £1bn has (perhaps surprisingly) increased by a fifth over the past two decades (see Fig.3ii above right). The total number of listed UK companies has fallen by a quarter, smaller companies by nearly a third, and micro companies (with a market value of less than £100m) have dropped by more than 40%

The combined value of smaller listed companies has fallen slightly in real terms over the past 20 years from £225bn at the end of 2003 to £211bn at the end of last year. The combined value of smaller companies peaked at just over £300bn at the end of 2021 but has since fallen sharply. This has been driven by a combination of poor share price performance and the high number of delistings.

One step forward…

The main driver of the steep decline in the number of smaller listed companies has been the sharp slowdown in the number of new issues that has failed to keep up with the relentless pace of companies delisting.

The annual number of new issues by smaller companies has fallen by 80% over the past decade with just 22 companies joining the market last year (see Fig.4i). If you strip out the annual volatility in new issues and use a three-year rolling average, the decline over the past decade has been 'just' 40% to little more than 50 new issues a year. It is striking that there have been two 'false dawns' in the past decade: with the spikes in activity in 2014 and 2021 failing to translate into something more sustainable. If you look further back, the number of new issues has dropped more than 80% since the heady few years before the financial crisis when more than 300 smaller companies a year were listing.

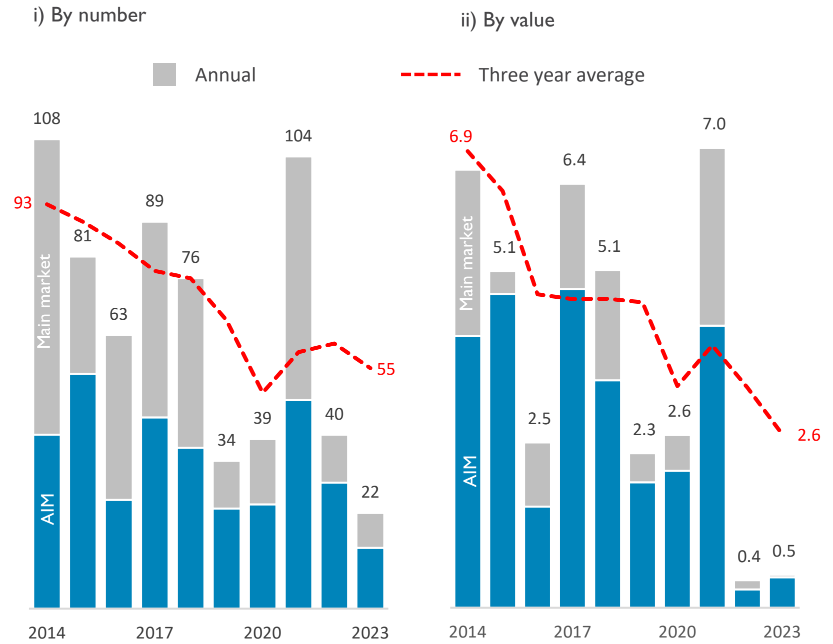
The fall in the value of new issues has been even worse (Fig.4ii): in real terms, the money raised by smaller companies going public has dropped by 90% on annual basis to less than £500m last year, and the three-year rolling average is down by two thirds.

…and two steps back

The big problem is that new companies joining the market cannot keep up with the pace of listed companies leaving it (mainly because they have been acquired or - in more than 500 cases over the past 20 years - they have collapsed). Fig.5 on the right shows that the number of new listings by smaller companies (in grey) has been lower than the number of delistings (in blue) in seven out of the past 10 years. The red line shows the net rate of delistings. The value of smaller companies joining the market has been lower than the value of companies leaving it in five of the past 10 years - and this seems to be getting worse.

Fig.4 A structural decline

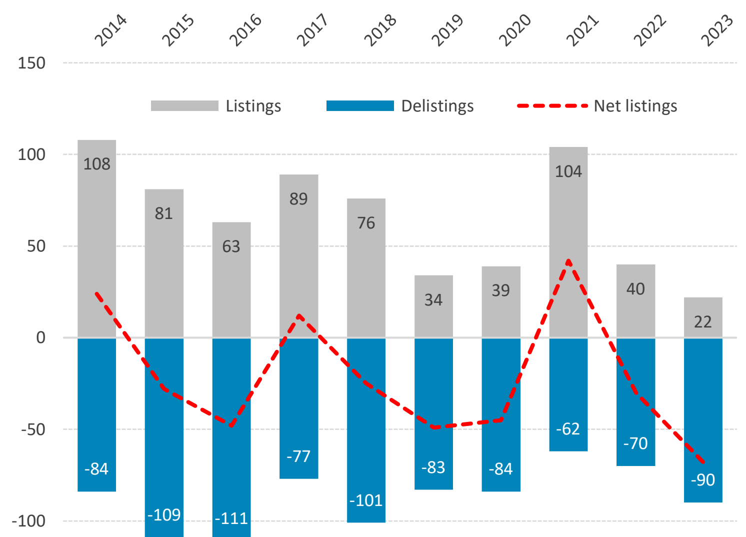
The number and value of new issues by UK smaller listed companies 2014 to 2023



Source: New Financial analysis of LSEG data

Fig.5 Struggling to keep up…

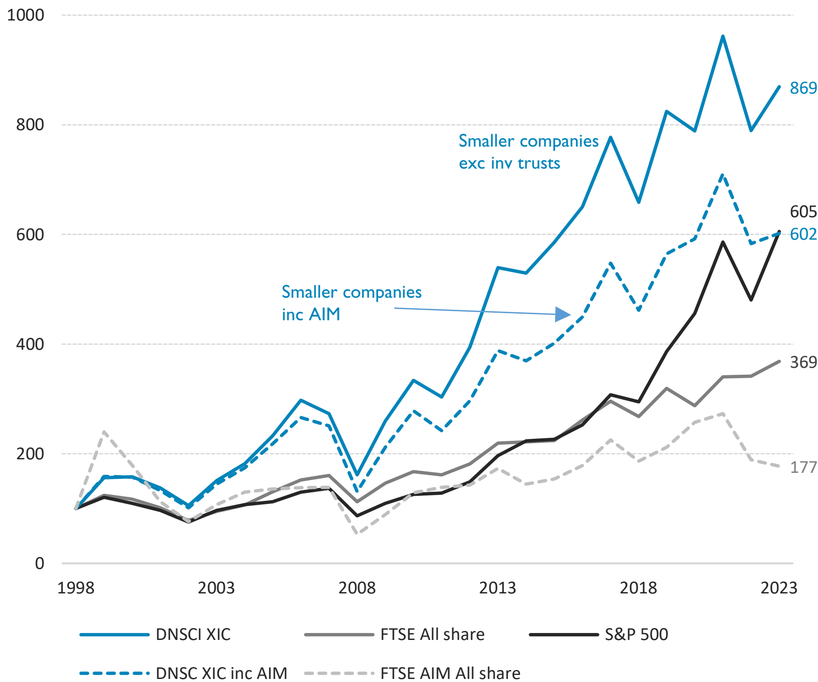
The number of new issues and delistings by smaller companies 2014 to 2023



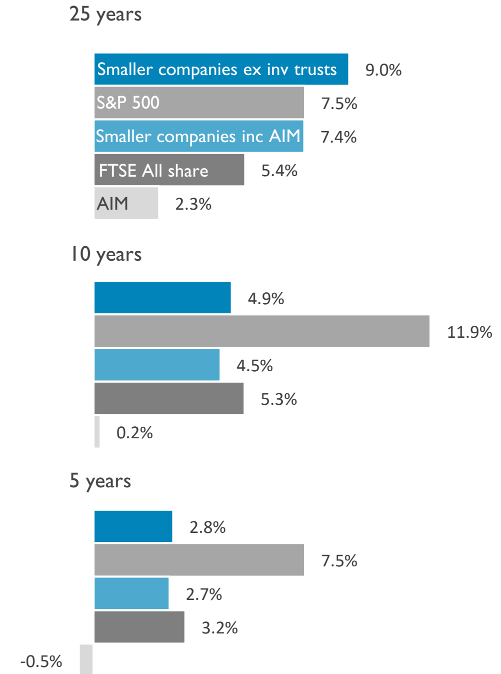
Source: New Financial analysis of LSEG data

Fig.6 How have smaller listed companies performed over the past few decades?

i) Cumulative total return of UK smaller companies vs other indices over 25 years
1998 to 2003



ii) Annualised total return over 25, 10, and 5 years



Source: Deutsche Numis Smaller Companies Index, FTSE, S&P, New Financial

A reversal of fortune

It wasn't that long ago that the smaller listed companies were one of the bright spots in the UK equity market. Over the 25 years to the end of 2023, the cumulative total return on UK smaller listed companies was over 500% - nearly double the performance of the wider UK market and in line with the S&P 500. The chart above left (Fig.6i) shows smaller companies on the main market and AIM (the dotted blue line) generated a cumulative total return of 502% over 25 years according to the Deutsche Numis Smaller Companies Index series (in other words, £100 invested at the end of 1998 would be worth £602 today assuming any dividends were reinvested). This compares with 505% for the S&P 500, 269% for the FTSE all share, and just 77% for the AIM all share. The best performing segment of smaller companies has been the smaller companies listed on the main market excluding investment trusts (the DNSCI XIC), which has generated a cumulative total return over 25 years of nearly 770%.

Over the past five to 10 years, this excess return on smaller companies has reversed. The chart above right (Fig.6ii) shows the annualised total returns for smaller companies, the FTSE all share, and S&P 500 over the past 25, 10, and five years. Over 25 years, smaller companies including AIM generated an annualised return of 7.4%, in line with the S&P 500 (7.5%) and a significant premium to the FTSE All Share (5.4%). But over the past 10 years, annualised performance for all smaller companies has dropped by more than a third to less than 5% (lower than the wider UK market). Over the past five years, annualised returns halved again to less than 3%. Trying to understand the factors behind this sharp reversal in fortunes in such a short period of time - and how to address them - is the main purpose of this report. One clue is the consistently poor returns of companies listed on AIM (with an annualised total return of just 2.3% over the past 25 years) that have dragged down returns across the wider smaller company market.

Changing the narrative

The good news is that there is nothing inevitable about the decline in smaller listed companies that we have seen in the UK. There are plenty of examples around the world of other markets where smaller listed companies have been thriving over the past decade.

The chart on the top right (Fig.7) shows the change in the number of IPOs by smaller companies in selected markets over the past decade (using a slightly different dataset). While the number of smaller company IPOs in the UK has fallen over the period, in markets like Australia, Canada, and Japan it has more than doubled. In Italy, new issues by smaller companies have roughly tripled over the past decade, while in Sweden they have increased more than fourfold. It is worth noting that smaller company activity has declined in the US.

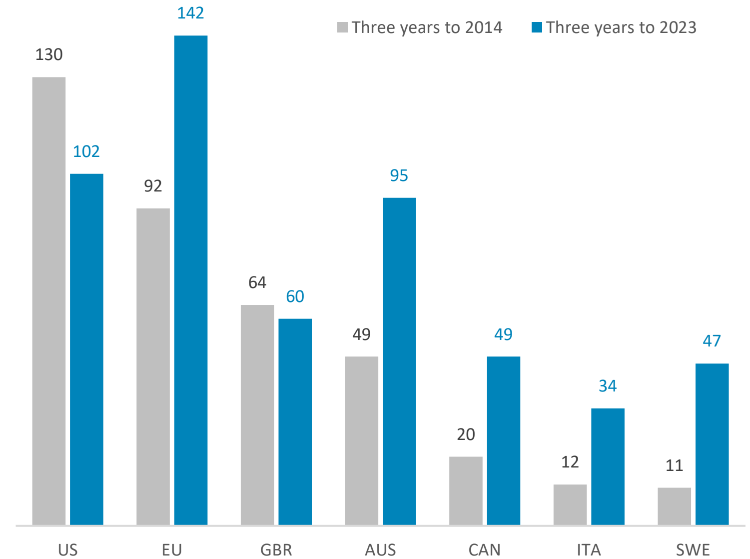
This suggests that the decline in smaller listed UK is specific to the UK rather than an inevitable structural shift in capital markets - and that the UK may be able to reverse this trend by identifying the ingredients that help support the growth in activity in other markets and applying some of them to the UK market.

There has been a remarkable renaissance in Swedish capital markets over the past decade and it has become a textbook example of how to nurture the development of capital markets. While the Swedish economy is just one sixth the size of the UK it has produced over 460 smaller company IPOs in the past decade - not far behind the 595 in the UK (see Fig.8).

The main ingredients have been a redesign of the pension system starting more than 30 years ago, a high level of retail engagement in capital markets (around 40% of Swedish adults have a simple and tax incentivised investment account called an ISK, compared with less than 8% of UK adults having a stocks and shares ISA), a deliberate government programme to support the development of capital markets, and tax incentives to encourage the development of tech and growth company clusters.

Fig.7 Bucking the trend

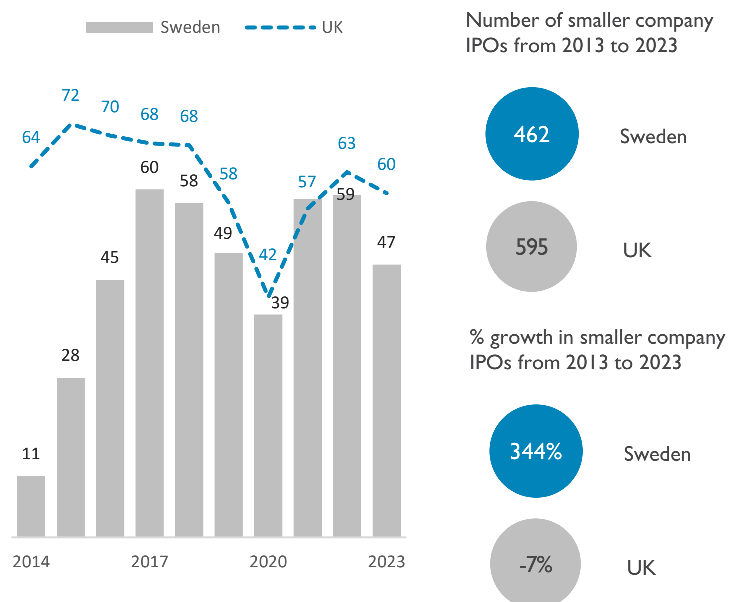
Change in the number of smaller company IPOs per year over the past decade
(IPOs of less than $250m in real terms, three-year average to 2023 vs 2014)



Source: New Financial analysis of data from Dealogic

Fig.8 The Swedish model

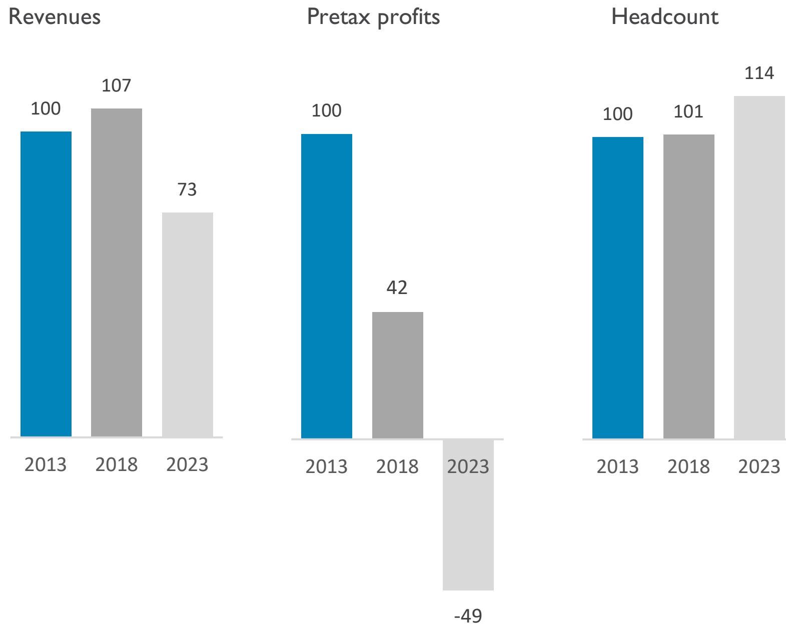
Number of smaller company IPOs in Sweden and the UK 2014 to 2023
(Three-year average, IPOs of less than $250m in real terms)



Source: New Financial analysis of data from Dealogic

Fig.9 Struggling to stay afloat

i) Performance indicators in real terms for a sample of 16 smaller company broking firms 2013 to 2023
Rebased to 2013 = 100



Source: New Financial analysis of annual reports

ii) Consolidation in smaller company brokers 2019 to 2024

2019
Stockdale acquired by Shore Capital

2021
GCA Altium acquired by Houlihan Lokey

2022
Arden Partners acquired by Zeus Capital

2023
Cenkos merged with finnCap

Numis acquired by Deutsche Bank

2024
Liberum merged with Panmure Gordon

WH Ireland's capital markets business acquired by Zeus Capital

Making ends meet

It is not just smaller companies and their shareholders who have been feeling the pain over the past decade: the ecosystem of smaller company specialist asset managers, broking firms, and advisers have been struggling with the sharp decline in activity, the drop in demand, and increased regulation.

Across a sample of 16 smaller company brokers, revenues across the sector have dropped by more than a quarter (27%) in real terms over the past decade from around £725m to £530m. Over the same period, headcount has increased by 14%, and pretax profits have swung by 150% from a combined profit of £146m to a combined loss of over £72m last year (see Fig.9i). The economic impact of the decline in smaller listed companies has only really kicked in over the past five years: between 2013 and 2018, revenues increased across the sample by 7%, and although pretax profits dropped by nearly 60% they did not tip over into a loss. Two thirds of these firms made a loss last year, and 80% of them posted a decline in pretax profits in real terms compared with a decade earlier.

The economic challenges faced by the industry have translated into a wave of consolidation in the past few years, adding to the drip feed of consolidation across the UK broking industry over the past three decades (see Fig.9ii). Since the beginning of last year alone, Cenkos and finnCap have merged, Numis (previously the largest independent smaller company specialist) has been acquired by Deutsche Bank, and Liberum has merged with Panmure Gordon.

We don't have an equivalent dataset for specialist smaller company asset managers but it looks like they have responded by closing down dedicated smaller company funds. At the end of 2021 UK smaller company funds had combined assets under management of £19bn according to data from the Investment Association (or £22bn once you adjust for inflation). By the end of 2023 this had halved to just £10bn. Given that net outflows from smaller company funds were around £3bn over this period, and that poor performance might have knocked another £4bn off the value of the funds, this suggests that up to £5bn in smaller company funds have been shut down or reallocated.

An upcoming vacancy?

It can be sometimes be difficult to feel sorry for investment bankers, even at smaller broking firms. But a big challenge for the industry and the wider ecosystem is that if smaller company specialists can't afford to support smaller companies, then who will?

Over the past few decades, larger investment banks in the UK have withdrawn from the smaller end of the UK new issue market (as part of the wider shift towards scale across the industry that we discuss on page 23). These charts compare activity by large banks and smaller company brokers on UK initial public offerings from 2014 to 2023. Each blue dot represents a bookrunner role on a UK IPO. We have used a log scale to highlight the (lack of) activity in the sub-£100m market.

The chart on the top right (Fig.10) shows that a sample of 10 large investment banks had 240 bookrunner roles on just over 100 IPOs by UK companies that raised £55bn in real terms over the 10-year period. But between them they worked on just four IPOs worth less than £100m. Most large investment banks don't get out of bed for an IPO worth less than £250m.

This is not because of a lack of activity. A sample of 10 smaller broking firms had 258 bookrunner roles on 209 deals over the same period that raised £32bn in real terms (see Fig.11). Of these, 118 raised less than £100m (see the bottom chart), adding up to around £5bn in total capital raising.

The problem is that the smaller company market is uneconomic for large investment banks and is scarcely profitable for the 30+ smaller firms that operate in it. A back of the envelope estimate suggests that the large IPOs that raised more than £100m generated around £1.8bn in fees, while the smaller deals generated around £250m in fees. If more smaller company specialists pull out, big investment banks are not going to step in.

Fig.10 Swimming in the deep end…

Value of bookrunner roles on UK IPOs by the 10 largest investment banks 2014 to 2023 (in real terms)
(each ● represents a bookrunner role on an IPO)

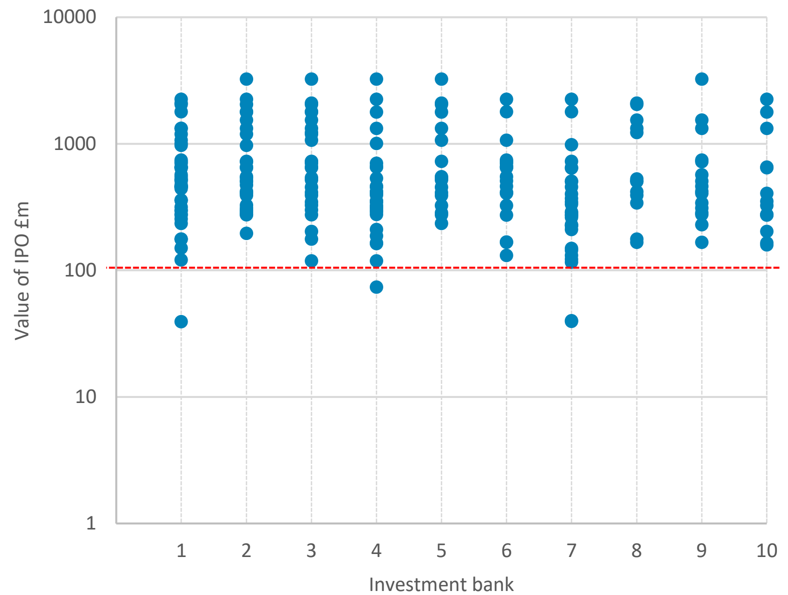
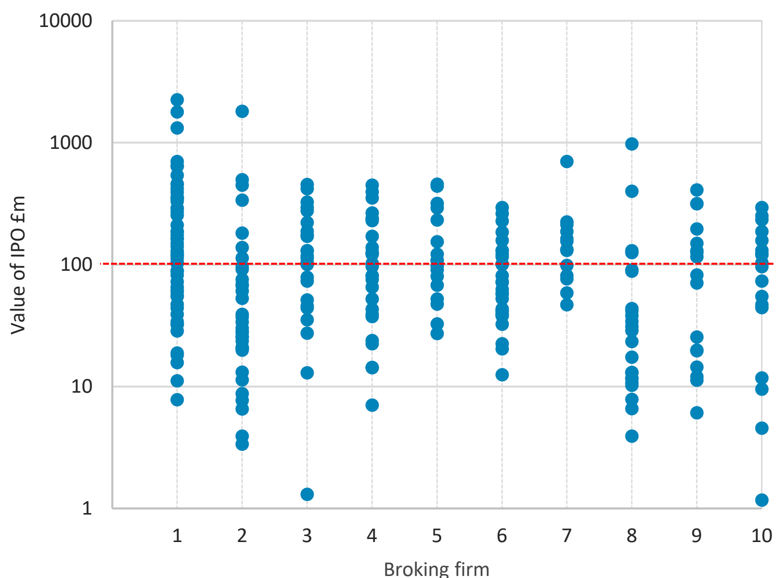


Fig.11 Paddling furiously in the shallow end…

Value of bookrunner roles on UK IPOs by the 10 most active smaller company broking firms 2014 to 2023 (in real terms)
(each ● represents a bookrunner role on an IPO)



Source: New Financial analysis of Dealogic data

WHY SHOULD WE CARE ABOUT SMALLER COMPANIES?

A significant contribution

This section outlines why we should care about smaller listed companies and analyses the role they play in the capital markets and wider economy.

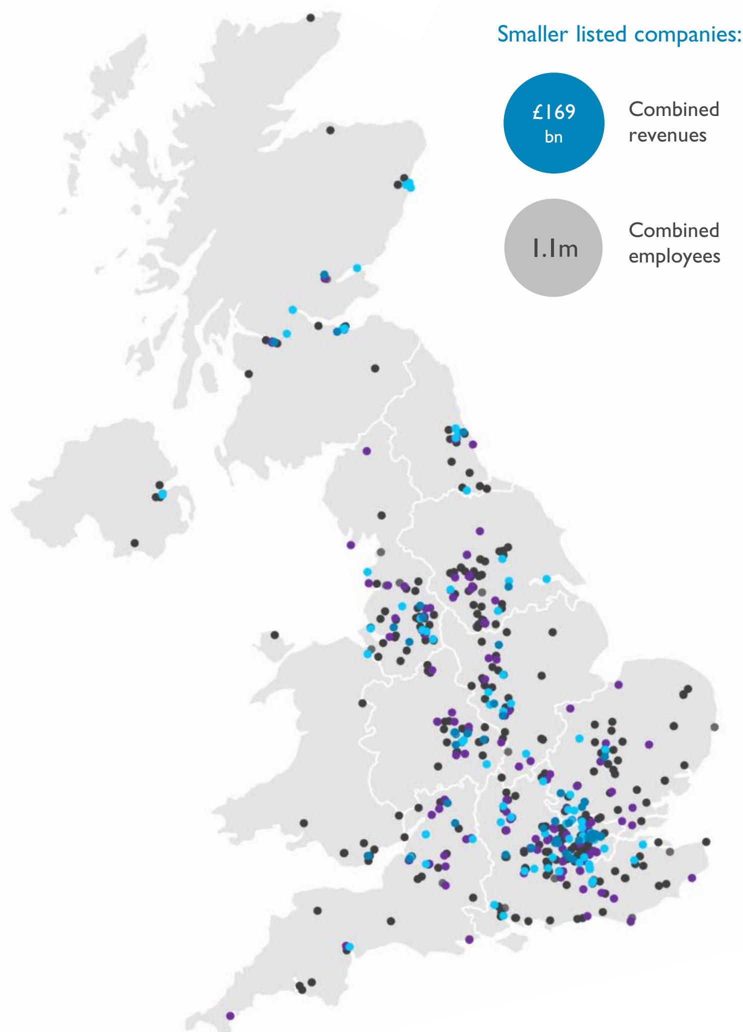
Local footprint and economic impact 19

A big source of funding 20

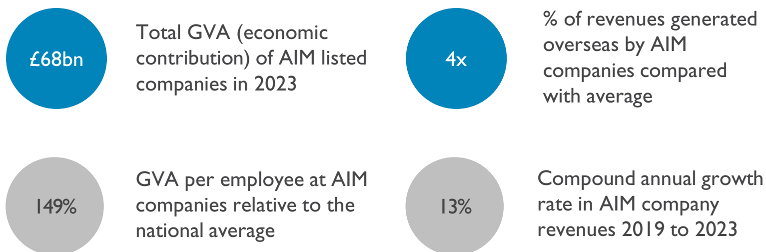
A long-term opportunity 21

Fig.12 The footprint of smaller listed companies in every corner of the UK

This map shows the location of the headquarters of every smaller listed company in the UK



The economic impact of AIM listed companies:



Source: New Financial analysis of data from LSEG, Aquis, S&P Capital IQ, and Grant Thornton

Levelling up in practice

The stock exchange may be headquartered in London but the smaller companies listed on it have a strong local footprint and economic impact in every corner of the UK.

The map on the left pinpoints the location of the headquarters of over 1,300 UK smaller companies listed on the main market, AIM, and Aquis. They are much more evenly distributed across the UK than FTSE 100 or FTSE 250 companies, which tend to be clustered in London and the South East. There is a strong concentration of smaller companies from London, up through the Midlands into Yorkshire and the North East, with a big cluster around Manchester and the North West. Every county in England except Herefordshire hosts the HQ of a smaller listed company.

This map understates their local presence: it only includes about 500 locations because there are nearly a thousand duplicate postcodes; and it only includes the location of the head office, not their actual operations. This footprint matters: it provides a direct connection between local communities and the stock market, and shows that smaller listed companies support investment and jobs in every part of the country.

Smaller listed companies also have a significant direct and indirect economic impact. They have combined revenues of £169bn and employ around 1.1 million people in the UK and overseas. Companies listed on AIM make an economic contribution of nearly £70bn to the UK, have much higher international revenues than companies in the wider private sector, are growing faster, and are 50% more productive per employee than average, according to research by accountancy firm Grant Thornton. They may be small, but they pack a powerful economic punch.

A vital segment

It may be tempting to dismiss the importance of smaller listed companies: their combined value is just 8% of the UK stock market and the 750 or so micro-companies (with a value of less than £100m) add up to just 0.7% of the market. But in many ways they are the engine room of the UK equity market, acting as providing a huge source of funding for UK plc; and providing an escalator for the bigger companies of tomorrow.

Smaller company markets provide an important 'escalator' for growth. Fig.13 shows that of the 1,865 smaller companies listed in 2003, just 437 (or 23%) are still listed. And of those, 65 have graduated to being 'big' companies with a market value of more than £1bn. While '3% of smaller listed companies grow into big companies over 20 years' may not sound great, it is more compelling when when you look at where today's big companies came from.

Of the 257 large listed UK companies with a market value of more than £1bn today, just under half (49%) have been a smaller company at some point in the past 20 years. A third of companies worth more than £2bn today have been smaller companies at some point in the past 20 years (and have more than doubled in value in real terms) and one fifth of them have been worth less than £500m at some point. Vibrant small and large company markets feed each other.

Over the past decade, smaller listed companies have raised just under £90bn in 2023 money from the stock market (see Fig.14). More than 3,000 companies listed on AIM have raised around £170bn in capital over the past 20 years. The focus on the new issues overlooks the important source of funding from further issues once a company has listed. Over the past decade, for every £100 raised by smaller companies when they list, nearly £400 has been raised by listed companies raising additional capital from shareholders.

Fig.13 A funding escalator

i) What happened to the smaller company class of 2003?

1,865 smaller listed companies (<£1bn)

In 2023…

- 1,428 no longer listed (77%)
- 437 still listed (23%)
- 372 still small (20%)
- 65 now big (3%)

ii) Where did the large companies in 2023 come from?

257 large listed companies (>£1bn)

- 131 have always been large over 20 years (51%)
- 126 have been small at some point in past 20 years (49%)
- 88 have been worth less than £500m at some point (34%)
- 65 were small in 2003 (17%)

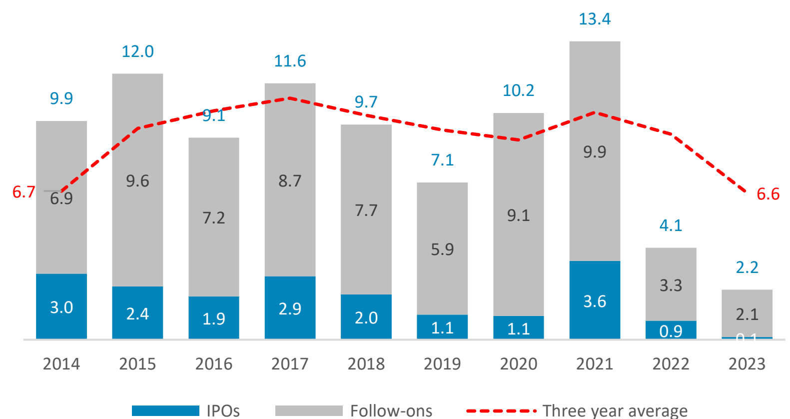
iii) Where did companies worth more than £2bn in 2023 come from?

150 UK companies with a market capitalisation of more than £2bn

- 49 have been small at some point (33%)
- 30 have been worth less than £500m at some point (20%)

Fig.14 A deep pool of capital

Amount raised by smaller companies in new issues and follow-on issues in real terms 2014 to 2023 (£bn real terms)



Source: New Financial analysis of Dealogic and LSEG data

Back on track?

There is no escaping the fact that the past decade has been pretty miserable for smaller listed companies in terms of both new issues and performance. But there is no reason that the market should be locked into this trajectory in perpetuity.

From a valuation perspective, over 50 years - the sort of timeframe that people coming into the workforce in the UK should be thinking of when it comes to their pension - smaller UK companies have delivered an annualised total return of between 12.2% and 13.3% compared with 11.1% for the S&P 500. The compound effect of this small difference over time translates into more than double the cumulative total return (see Fig.15).

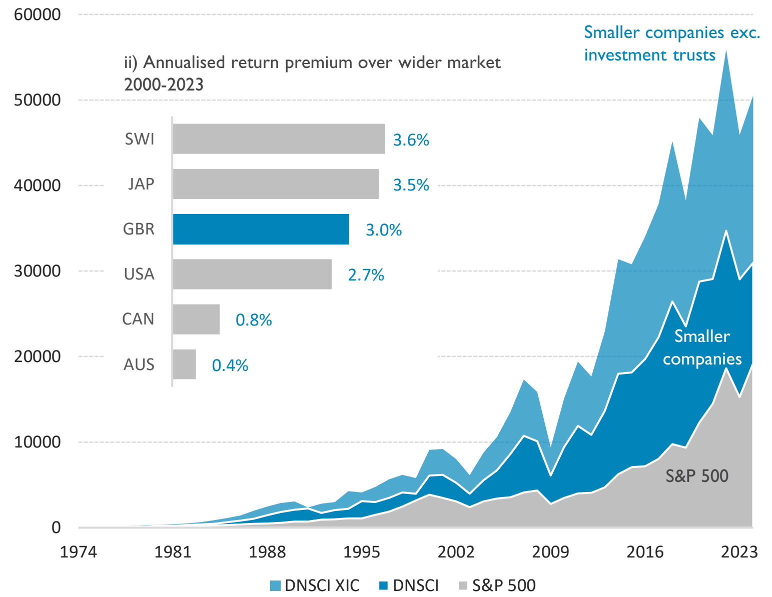
Smaller companies around the world have also offered a significant annual premium in returns compared with their wider local market. In the UK this premium of 3.0% a year since 2000 over and above the FTSE All Share is higher than the smaller company premium in the US, Canada and Australia.

From a valuation perspective, smaller listed companies are trading at a significant discount to the wider UK market (which itself has not been knocking the lights out recently). Fig.16 shows the gradual downwards drift in the average price earnings ratio for UK smaller companies listed on the main market over the past decade. The dotted blue line shows that relative PE ratio compared with the FTSE all share has been falling steadily and that smaller companies have had a lower valuation than the wider market in nine of the past 10 years.

If you believe that the smaller company market is heading towards extinction and that they will all be acquired in the next five to 10 years - and some do - the combination of this discount with any future takeover premium may suggest that there is a buying opportunity.

Fig.15 A long-term premium

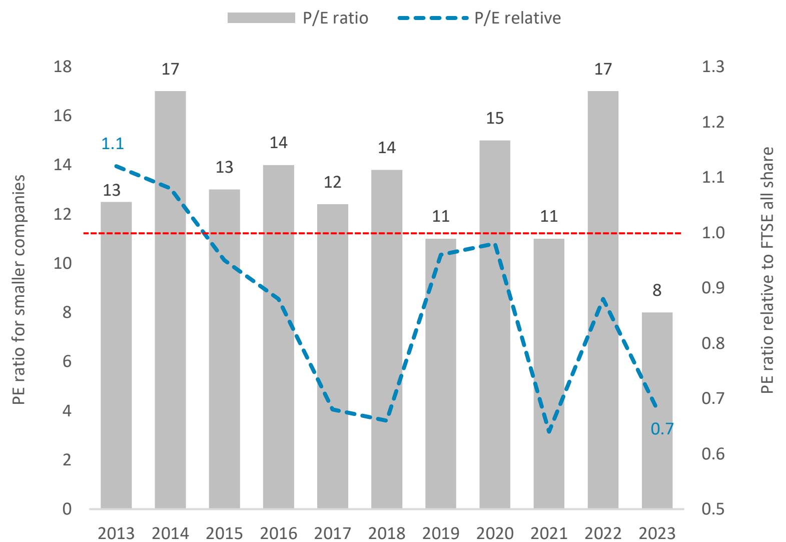
Cumulative total returns over 50 years from smaller companies and the S&P 500 1974 to 2023



Source: Deutsche Numis Smaller Companies Index, S&P

Fig.16 A deep discount

Price earnings ratio on UK smaller companies & relative PE ratio versus All Share 2013 to 2023 *(note: main market listed smaller companies only)*



Source: Deutsche Numis Smaller Companies Index

WHAT ARE THE MAIN DRIVERS OF THIS DECLINE?

A perfect storm

There is no single factor that has driven the decline in smaller listed companies over the past few decades. This section analyses the cumulative effect of a range of interconnected issues.

A collapse in demand 23

A shift to scale and automation 24

Governance and regulation - listed companies 25

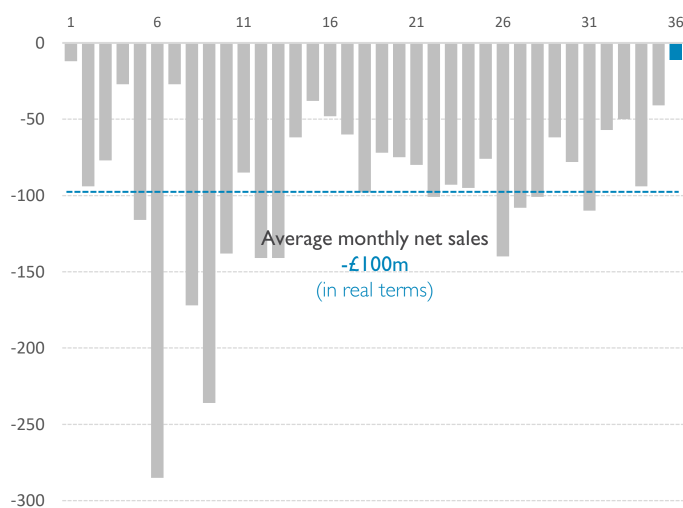
Governance and regulation - wider ecosystem 26

Availability of alternative sources of funding 27

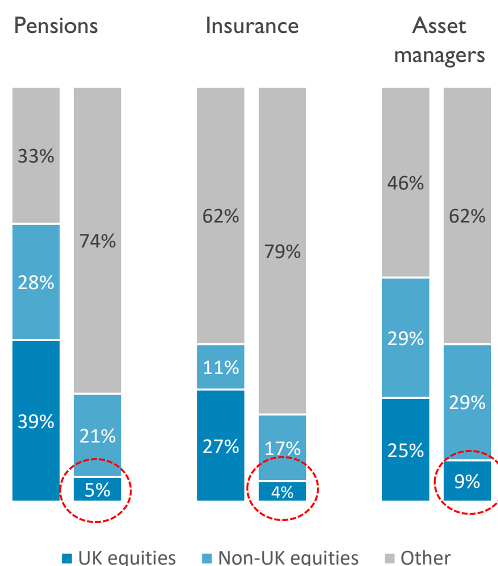
A negative feedback loop 28

Fig.17 A mass exodus

i) Net monthly sales of UK smaller company funds over past three years
September 2021 to August 2024



ii) Shift in asset allocation by UK institutional investors
2003 to 2022



Source: New Financial, Investment Association

Capitalism without UK capital

The biggest challenge for smaller listed companies over the past few decades has been the collapse in demand from UK institutional and retail investors. In August this year net outflows from dedicated UK smaller company investment funds of £11m was the lowest level in three years but unfortunately it also marked the 36th consecutive month of outflows (see Fig.17i above left). The cumulative outflow of £3.6bn in real terms over this period translates into losing almost 1% of the total assets in smaller company funds every month.

The important role in smaller listed companies typically played by retail investors (who often hold 30% plus of the register) has been undermined over the years. The share of households directly owning stocks has halved over the past 20 years from 22% to 11%; many private client brokers and wealth managers have withdrawn from active stock-picking and advice on smaller companies because of regulation around 'suitability'; investment platforms have cut services; and the antiquated infrastructure around shareholdings (with most direct holdings sitting in nominee accounts) makes it a lot harder than it should be for individuals to own stocks and for companies to engage with them.

There has been a mass exodus from the UK market by pension funds: our research shows that their allocation to UK equities has dropped from 40% to less than 5% over the past 20 years (see Fig.17ii above right) and they now have a lower allocation to domestic equities than almost all comparable developed pension systems. Much of this has been driven by the effective closure of most corporate defined benefit schemes over the past 20 years and the shift from a 'UK centric' to a 'global equities' approach across the industry (that we explore on the next page). Separately, the focus on low costs in defined contribution pensions means that most of their allocation to equities is in global passive funds.

Asset managers have responded to their clients and have increasingly focused on larger companies and global markets (the UK asset management industry's allocation to UK equities has more than halved to just 9% over 20 years). They have also responded to regulatory concerns over liquidity in the wake of the Woodford scandal in 2019 and either withdrawn from UK smaller companies completely, shifted to a European or global approach to smaller companies, or raised the minimum size of a company in which they will invest (often from £50m to £100m, or to £200m or more).

THE WIDER SHIFT TO AUTOMATION & SCALE

A structural change

The increase in scale and complexity of the capital markets and shifts in technology over the past few years has changed the economics of the industry and encouraged more focus on volume and the larger end of the market. The rise of passive investment, ETFs, algorithmic trading, and global asset allocation strategies - along with a relentless focus on lower costs and efficiencies - has increasingly disenfranchised smaller listed companies. Many investors, asset managers, and broking firms seem to have decided that smaller companies are more hassle than they are worth. Here are some examples if the impact of this shift.

33% — Passive share of UK assets under management

57% — LGPS pension funds that operate a 'global equities' approach

4 — Number of IPOs raising less than £100m run by large banks (2014 to 2023)

51% — AIM stocks with fewer than 10 trades a day

The rise of passive: the rise of passive investment over the past decade has largely bypassed smaller companies. A third of all assets under management in the UK are now run on a passive basis, but passive funds and ETFs are a low-cost volume game and for entirely sensible commercial reasons tend to focus on bigger and more liquid markets. This has also encouraged more outsourcing of engagement to proxy advisers, which tend to take a more uniform and more binary approach to corporate governance which is less appropriate for smaller companies (see next page).

Pension funds: one of the biggest structural shifts in the UK equity market over the past few decades has been a fundamental change in the way UK pension funds invest from a 'UK centric' approach (with perhaps a 20% allocation to UK equities) to a 'global market weighted' approach (with around 2% in UK equities).

Our research shows that 57% of the 86 funds in the Local Government Pension Scheme (a £400bn pool of assets) use a global equities approach, up from just 13% a decade ago. While there may be perfectly rational reasons behind this shift (such as cost, diversification, and returns), it effectively excludes smaller companies from their portfolio. In 2013, we identified 18 LGPS funds with a specific allocation to UK smaller companies. In 2023, we could only identify one. If local government pensions in the UK aren't going to invest in smaller companies, who is?

Specialist firms: this upwards shift has also been evident in the ecosystem around smaller companies. Large UK asset management firms that 20 years ago might have had dedicated smaller company funds have shifted their attention to global markets. Large investment banks have effectively withdrawn from the smaller company market (and have worked on just four IPOs that raised less than £100m between them in the past decade). This shift 'upmarket' where firms can make more money for the same effort and less risk has undermined interest and activity in smaller listed companies.

The impact on liquidity: given their size, liquidity in trading smaller company stocks has always been a challenge. But the problem has got worse. Smaller companies are less suited to continuous electronic trading and have been ignored by many of the new trading venues and specialist trading firms that have sprung up over the past decade. The value of trading in all UK stocks last year on all venues last year added up to nearly 300% of market capitalisation (a metric known as 'trading velocity'). This is more than four times higher than the equivalent measure of liquidity on AIM (64%). Even this low level of headline liquidity flatters the AIM market: roughly half of trading on AIM is concentrated in the top 20 stocks. Just 5% of companies trade more than £1m a day last year; nearly three quarters trade less than £100,000 a day; and half of AIM stocks have less than 10 trades a day.

An increased burden

A common theme in most discussions about smaller listed companies is the sense of an increase in the overall burden of corporate governance requirements on listed companies and regulation on the ecosystem around them over the past few decades. Smaller companies often feel that are being held to the same governance and disclosure standards as much larger listed companies, while brokers and assets managers often feel that the regulatory framework is disproportionate to their business. It is of course rare to meet a company that thinks corporate governance standards should be tightened or a broker who thinks that regulation is too light touch. But here are some specific examples of changes in the past decade that we think have had a direct impact on the relative attractiveness of public equity markets for companies, brokers and assets managers.

i) Listed companies and governance

A relentless drip feed: the gradual shift in governance and reporting requirements for listed companies adds up over time and translates into a significant increase in administrative cost for smaller companies. One simple yardstick to measure this impact is the increase in the length of annual reports. Research by the QCA found that the average length of an annual report for smaller companies listed on the main market has increased by over a third in the past five years, with an average of an additional of nine pages a year. For companies listed on AIM, annual reports have increased in length by 51% over five years, which translates into an extra six pages a year.

Concerns about increases in governance requirements can sometimes be a little nebulous, but participants in this project highlighted increases in non-financial reporting from 2013 onwards, additional mandatory disclosures on pay from 2019, and changes to diversity disclosures and climate reporting from 2022. For example: since 2022 the listing rules for companies listed on the main market require them to report on and meet diversity targets on a 'comply or explain' basis such as: 40% of the board being women including at least one senior board position, and at least one board member being from a minority ethnic background. And from 2022 any listed company with more than 500 employees (about 60% of the smaller companies in our sample) have to include specific climate change disclosures in their annual reports under the Companies Act. These disclosures include how the firm identifies and manages climate risk, the impact on its business model, and the KPIs the business uses to measure this.

In most cases, the debate is not so much about the substance of the reporting but whether the requirements are appropriate for smaller companies given their size and resources. They also raise the question of where to draw the line between governance from an investment perspective and the extent to which it is being used as a proxy for government social policy. While additional reporting makes smaller listed companies more transparent, it also widens the disclosure gap between listed and privately-held companies which contributes to making going public or staying listed less attractive.

Beyond expectations: part of the challenge with governance is not so much the requirements themselves as companies and investors struggling to meet each other's expectations. Smaller companies feel that they should not be held to the same reporting standards as much larger companies, and that there are specific areas (such as the independence of directors) where they should be granted more flexibility. Asset managers used to engaging with much larger firms may have unrealistic expectations of smaller companies and be less willing or able to engage with them to discuss specific concerns. This problem has been exacerbated by the spread of proxy voting agencies further down the market in terms of company size and the rise of passive investing. Reports by proxy agencies tend to favour binary metrics which leave less room for the specifics of smaller companies, who in turn may not have the resources to engage with these agencies or with investors. This can lead to the normalisation of standards that are not required for smaller listed companies and a stark choice of 'comply or else' instead of 'comply or explain'.

ii) Regulation and the wider ecosystem

A disproportionate approach: over the past decade it sometimes seems that the well-intended and widely agreed aim of reducing risk in the financial system has taken on a life of its own and morphed into an exercise in eliminating the risk of loss for consumers. This has bred a culture of 'safetyism' and risk aversion throughout the industry, which can protect consumers to the point of excluding from certain markets and products altogether.

This has had a disproportionate impact on smaller listed companies and the ecosystem around them. First, because they have tended to be more reliant on retail investors than larger companies. And second, firms in the ecosystem around them may not have the scale or resources to enable them to absorb additional regulatory requirements. Specific regulatory requirements that were commonly cited during this project include:

> **Suitability requirements:** since 2015 all firms have had to conduct a suitability review on the appropriate level of risk for their customers. For many brokers, private client stockbrokers, and wealth managers the default option has been to exclude AIM and smaller companies from the advice they provide to retail clients. There is a widespread sense that private client stockbrokers and wealth managers do much less stock-picking in smaller companies. More recently the introduction of the consumer duty has raised the bar further for wealth managers operating in and around smaller listed companies.
>
> **Liquidity requirements:** the collapse of former star fund manager Neil Woodford's £3.7bn fund in 2019 has sent a chill through the smaller company market. Woodford was overexposed to less liquid stocks (at one point only 8% of his fund could have been liquidated in a week) and he was forced to close the fund when he couldn't keep up with redemption requests from investors. This left more than 300,000 retail investors locked in the fund watching powerlessly as the value of their investment declined.
>
> The FCA responded by focusing on liquidity requirements for fund managers which has led to an industry wide reluctance to invest in smaller and less liquid stocks. It has also led to more caution in terms of the size of any individual stake in a smaller company with investors keen to avoid going above 5% or 10% of a company's shares. A natural corollary of this is that more asset managers have moved 'upmarket' and have set a higher floor for the size of company in which they will invest (a floor of £100m excludes nearly 60% of smaller listed companies, and a floor of £200m excludes over 80% of them). For smaller company funds managing liquidity and concentration risk is challenging: if a fund has £1bn in assets, for a holding to represent just 1% of the fund it would need to be at least £10m, which translates into 5% of a £200m company or 10% of £100m company.
>
> **Investment research:** since 2018 the rules on how investors pay for investment research were changed under Mifid II to require them to pay for it directly or pass the cost on to their clients. This 'unbundling' of research is widely seen in the industry as having undermined the provision and quality of research at the smaller company end of the market (smaller company brokers were less able to charge for their research than larger firms, and investors focused on smaller companies had less money to pay for it). The perceived value of research on smaller companies varies depending on whether you are talking with a broker, a company, or an asset manager but the shift further undermined the economics of the smaller company ecosystem and has contributed at least at the margin to the decline in investor demand.
>
> Last year, the government commissioned a review of investment research led by Rachel Kent, a senior financial services lawyer. Her report recommended (among other things) the introduction of a research platform with a focus on smaller companies to support and disseminate research, widening access to research for retail investors, and introducing a code of conduct for issuer-sponsored research. Her recommendations were accepted by the previous government and are currently working their way through the regulatory reform process.

A squeeze at both ends

A significant factor in the decline in the listed smaller company market is the increase in the availability of alternative sources of capital that has squeezed smaller company equity markets at both ends over the past few decades.

At one end, an increase in venture and growth capital investment has provided risk capital at scale that might previously only have been available from public equity markets, enabling companies to access capital and stay private for longer (or forever). And at the other, the increase in the firepower of private equity has led to more smaller listed companies being acquired.

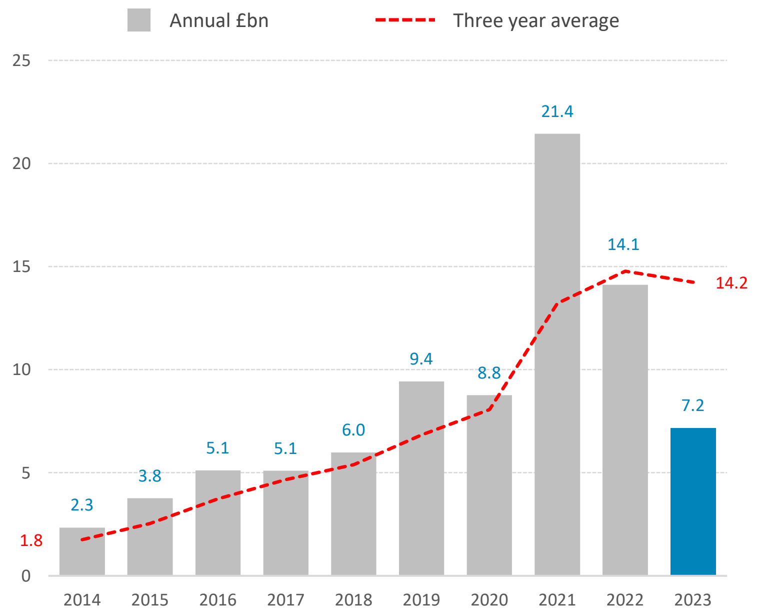
It is important to stress that the increase in the availability of alternative sources of capital is providing smaller companies that need it with access to capital (public equity markets do not and should not have a monopoly on providing capital to smaller companies) but it is equally important to highlight how this change over the past decade has affected listed smaller companies.

The amount of early-stage investment by private capital in UK companies has increased eightfold over the past decade to about £14bn a year according to our analysis of date from Preqin (see Fig.18). This excludes the earliest stages of funding such as angel, seed, and series A and B venture. The total invested over the past decade of £83bn in real terms is not far short of the £90bn raised by smaller companies on the stock market over the same period.

At the other end of the spectrum, the number and value of acquisitions of smaller listed companies by private equity firms has more than doubled over the past decade to around £5bn a year (see Fig.19). The £40bn in acquisitions by private equity firms over the past decade accounts for more than a third of all delistings of smaller listed companies.

Fig.18 The growth in early-stage investment

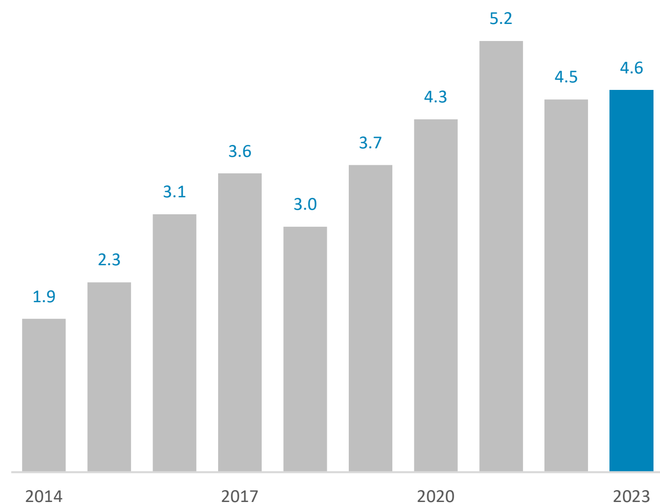
Early-stage investment in UK smaller companies in real terms (£bn) 2014 to 2023
(investments less than £100m, excludes seed, angel, series A + B, venture debt)



Source: New Financial analysis of Preqin data

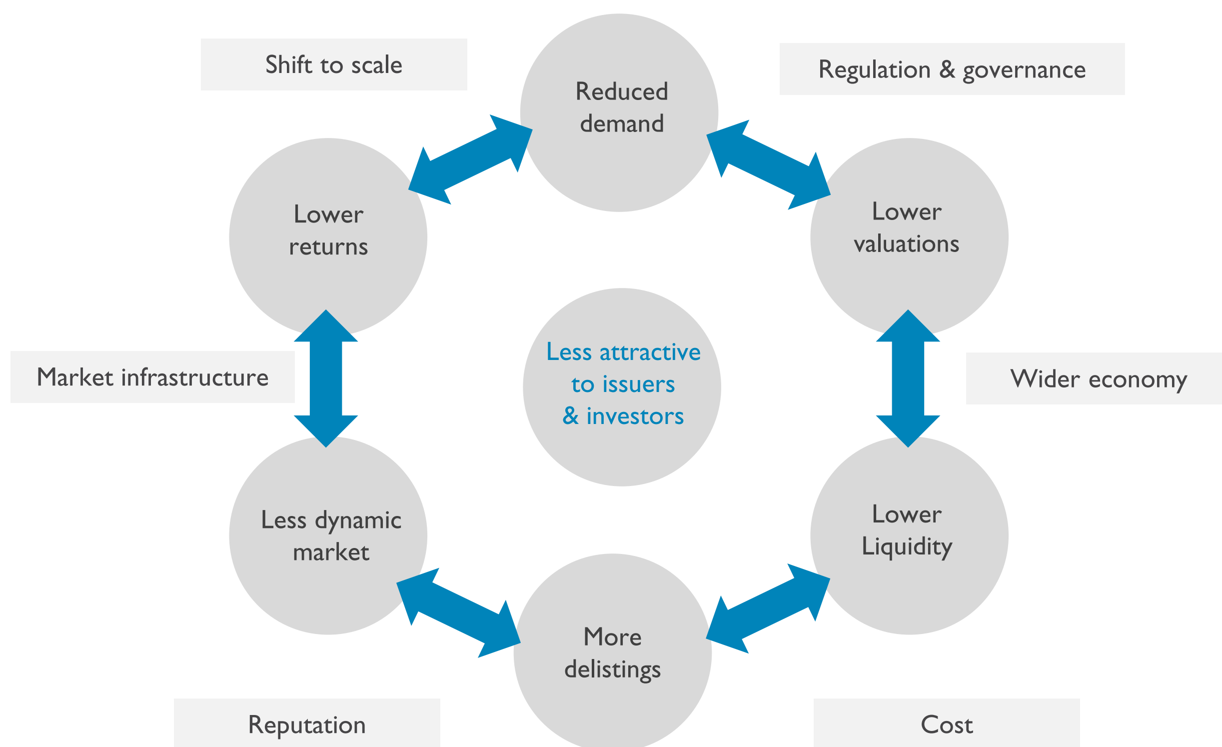
Fig.19 The rise of private equity

Value of acquisitions of listed smaller companies by private equity firms 2014 to 2023
(buyouts of less than £1bn in real terms - three year rolling average)



Source: New Financial analysis of Dealogic data

Fig.20 A self-fulfilling doom loop in UK smaller companies



A vicious circle

When you combine all of these factors together you risk falling into a self-fulfilling doom loop which makes for a less attractive market for issuers and investors. A sustained reduction in demand from pension funds, asset managers, and retail investors has sucked billions of pounds of natural demand out of the market and translates into lower valuations and lower liquidity. More smaller listed companies may decide it's not worth being listed or may be picked off by private equity firms or other buyers, increasing the number of delistings. Fewer companies may think it is worth listing, accelerating the reduction in new issues. This makes for a less dynamic market with lower returns, which further reduces demand. And round you go again.

In the background, in each turn of the cycle, the cumulative effect of regulation and governance requirements adds cost to listed companies and the ecosystem of asset managers and brokers around them; reputational issues catch the attention of regulators and scare off investors; market infrastructure makes it much harder than it should be for investors (retail in particular) to access smaller companies; and the wider shift to scale and automation across the capital markets disenfranchises smaller companies. The wider economic context - political uncertainty and instability, Brexit, low economic growth and flatlining productivity - hasn't helped.

The good news is that there is nothing inevitable about the decline in listed smaller companies, as we have seen in other markets like Sweden. In other good news, it will not take a big bang approach or radical shift to reverse this doom loop and turn it into a virtuous circle of more demand, higher valuations, fewer delistings, more new issues, a more dynamic market with higher returns that in turn attract more demand. A small change in behaviour or activity at each point in the cycle - particularly in stimulating additional demand - could have a disproportionate effect. The next section of this report outlines some recommendation to start to turn things around.

A combined effort

There is no silver bullet to reverse the doom loop in UK smaller companies. This section outlines a series of broad directional changes across government, regulation, and the industry to help revitalise the market.

- Rethinking tax and incentives
- Rethinking demand
- Rethinking risk culture
- Rethinking governance and regulation
- Rethinking technology and market infrastructure

i) Rethinking tax and incentives

1. **Just in time for the budget:** making recommendations on tax and incentives a few weeks before a budget when there has been widespread speculation that the government is considering removing tax incentives on AIM stocks, changing tax relief on pensions, and raising capital gains tax is perhaps a foolish exercise. But there is an opportunity for a new government focused on growth to adjust incentives for investment in smaller companies. Here are two specific recommendations:

    - **Business relief:** the 'nuclear option' of abolishing the business relief that effectively exempts investments in most AIM stocks from inheritance tax would cause huge disruption and we would not recommend it. Equally, we would not recommend extending it to smaller companies listed on the main market. Instead, we think the government should commit to retaining the exemption for a defined period to provide more certainty to companies and investors.

    - **Stamp duty:** stamp duty on trading in stocks on AIM was abolished in 2014 to boost investor participation in growth companies and help companies raise capital. While successive governments have resisted calls to abolish stamp duty across the whole market, there is a strong case to abolish it for all companies outside of the FTSE 100. This would provide a liquidity boost to hundreds of small and mid-cap companies, cost a fraction of the £3.6bn in 'lost' tax receipts from stamp duty, and provide a controlled experiment to help inform the debate on stamp duty across the market.

2. **Moving the dial:** we are not sure how any increase in headline rates of CGT or taxation of dividends would sit with the new government's mantra of 'invest, invest, invest'. But any changes that are designed to send a political message could be softened from an economic perspective by reintroducing indexation (so that investors only pay tax on the real gain) or, in the case of dividends, by extending the tax free allowance (that has been reduced from £5,000 to just £500 over the past decade) to encourage more retail investment. If the government really wants to move the dial on investment in UK stocks and other assets, it will need to change the after-tax return, and it could consider a differential rate on CGT or dividends for UK companies (similar to the differential rates on dividends in Australia and Canada) to incentivise more investment in UK markets.

3. **A longer-term commitment:** predictability and certainty over tax is as important from an investment perspective as the actual level of specific taxes. Last month the government confirmed that it has extended the Enterprise Investment Scheme and Venture Capital Trusts for another 10 years to 2035, and it has confirmed the extension by the previous government of the full expensing regime until 2026 (it would be a good idea to extend this by another three years to the end of this parliament). Potential abolition of business relief and IHT exemption on AIM stocks has long been a tail risk for investors and acted as a drag on demand. Far from abolishing it, the government could commit to extend it to at least the end of this parliament.

ii) Rethinking demand:

4. **More money in the system:** the priority in increasing demand should be to get more money into the system rather than focusing on channelling more money specifically into smaller companies on the basis that more investment will spread across the market. An urgent priority for the government's pension review should be to commit to a timeframe for increasing pension contributions under auto-enrolment from their woefully low minimum level of 8% (3% employer and 5% employee). This would be staggered over the next decade and aim to raise total contributions to at least 12% and ideally 15% to help address the looming social crisis of pensions adequacy for millions of people. Alongside this, the government should accelerate structural reform in UK pensions to ensure that the system is less fragmented, more efficient and all savers have access to a wider range of investments.

5. **A short circuit:** to specifically boost UK equities, the government could zoom in on the £450bn invested in stocks and shares ISAs and expand the last government's proposal for a UK ISA (which looks like it may be dropped). A simpler version would be to collapse the six versions of ISAs into two and extend the current annual limit to £25,000 (in line with inflation from when it was set at £20,000). The 'bottom half' of any ISA could be invested in anything that currently qualifies (cash, equities, funds etc). But the 'top half' would have to be invested in UK equities or other UK assets (to be defined).

   Nearly 80% of people who use cash or stocks and shares ISA would not be affected by this as they subscribed less than £12,500 last year. We estimate that this could channel something like an additional £8bn to £10bn a year into UK equities (after you adjust for the 25% or so allocation to UK equities in stocks and shares ISAs today); could introduce over two million people to investing rather than saving; and could be introduced far more quickly than pensions reform. Various proposals to require a specific allocation within ISAs to smaller companies would risk overcomplicating the system.

6. **A slippery slope:** mandating the asset allocation of pension funds is a potentially dangerous idea but there are at least three opportunities to encourage more investment in UK assets and smaller stocks in particular. First, encouraging the big pension funds providers that have signed up to the Mansion House Compact under which they have pledged to invest 5% of their default funds in unlisted equity to allocate at least some of this to AIM and Aquis stocks (which are officially 'unlisted' from a regulatory perspective). A small shift in demand from large providers could have a disproportionate effect and help reverse the 'doom loop' in smaller listed companies.

   Second, to reallocate some of the £48bn in tax relief on pensions to change the after-tax return on UK equities for pension, perhaps through a similar scheme to the dividend tax credits for pensions that were abolished in 1997. And third, to extend and reset the target for LGPS fund of investing 10% of their assets in 'private equity' by 2030 to include unlisted equities and smaller companies. Given the local footprint of smaller listed companies in every region of the UK, this could help make pensions and investing more tangible for millions of members of the scheme.

iii) Rethinking risk culture

7. **A philosophical shift:** the balance between risk, growth, and stability in the UK regulatory system has swung too far and created a self-perpetuating culture of 'safetyism' from the top down (as we argued in this recent report). This is reflected in the halving in direct retail participation in the stock market over the past 20 years and the increase in the proportion of household financial assets sitting in cash from a quarter to nearly a third in the past decade. The good news is that the regulatory framework is changing: UK regulators have a new secondary objective on competitiveness and growth, after years of consultations reforms to the UK regulatory framework (such as the new listings regime) are beginning to kick in. The mindset of senior regulators is beginning to change (the chief executive of the FCA has been explicit about the need to introduce more risk appetite into the system) but this will take time to filter through. The 'value for money' framework for pensions, which encourages them to focus less on low cost and more on long-term returns, should help reset expectations.

8. **The right balance:** resetting the balance between risk and protection should be a particular focus of moving the dial on risk culture. Too often, a narrow approach to consumer protection can lead to the exclusion of retail investors from sensible assets and activities in the capital markets when at the same time they can trade cryptocurrencies and other digital assets in a virtually unregulated free for all environment. This exclusion can be direct (regulation effectively limits their access) or indirect (market participants limit services to retail investors because of cost and regulatory risk). This exposes millions of investors to the risk of taking no risk at all.

9. **A call to action:** the longer-term issue is addressing social attitudes to risk and investment. Too many people think the stock market and investing are not for them (although 80% of employees are saving towards a pension). A public campaign encouraging people to take more ownership of their financial futures across their savings, pension and investments would help shift attitudes. There are plenty of examples of campaigns in the past that successfully encouraged investment from the 'Tell Sid' campaign in the UK to the NYSE's 'own your share of American business' campaign (that ran for more than a decade in the 1950s and 1960s and helped turn the country into a nation of investors). The industry cannot afford to sit back and wait for changes to tax incentives or regulation to ride to the rescue of the UK market. It could rally around the upcoming 'dematerialisation moment' in UK equity markets as a good opportunity to launch a wider campaign to encourage more engagement with the capital markets and to encourage people to take ownership of their financial futures. Everyone wants to get on the property ladder, but it is time to start a nationwide conversation about investment.

10. **Education and engagement:** financial education is not the silver bullet it is often painted to be, but a concerted industry-wide and government campaign to encourage individuals, pension funds, and institutions to take a longer-term approach to their investments, to rethink their approach to risk, and to broaden their investment horizons would have a huge positive impact in the long-term. Millions of people who have been brought into pensions by auto-enrolment, been channelled into default funds, and effectively been excluded from any decision-making or engagement with their pensions, are then expected when they reach retirement to make complex financial decisions. Pension funds should focus on better engagement with members and potentially give them more control over a portion of their pension (as is the case in Sweden).

iv) Rethinking governance and regulation

11. **A governance spring clean:** until 2017 we were able to joke that the UK has had more iterations of the corporate governance code than it has had Prime Ministers in the past 25 years. Each iteration adds new layers on top of the previous versions and sets new level of expectations on companies, but they rarely take any away. A 'spring clean' of governance requirements for smaller listed companies would help identify what is legally required, what is based on applying expectations of larger companies to smaller firms, and what might be redundant. This would also clarify which elements of governance can and should be different for smaller companies, and help create reset expectations for companies, investors, and proxy agencies.

12. **Rethinking cliff edges:** UK markets are riddled with regulatory cliff-edges - and smaller companies and their investors face more than most. For example, as successful companies on AIM mature they face significant hurdles if they want to graduate to the main market such as potentially losing a large part of their investors from EIS or VCT schemes, issuing a new prospectus, and suddenly incurring stamp duty on trading in their shares. A recent report by Barclays on graduating from junior markets outlined how more companies could be supported in moving 'upmarket' without additional and redundant documentation and potentially retaining their tax incentives.

13. **Closing the advice gap:** one of the foreseeable but unintended consequences of the reforms to retail distribution more than a decade ago was that the majority of individuals in the UK were effectively excluded from accessing the sort of financial advice and guidance they need to make better informed decisions. The FCA should accelerate its work on reviewing the rules that separate guidance and advice, potentially embracing a third option of 'personalised financial guidance' that could be largely tech driven to enable more people to engage with their investments at a reasonable cost.

14. **Rethinking liquidity:** it is perhaps ironic that on the one hand the government is encouraging pensions to invest more in less liquid assets such as private markets, infrastructure and unlisted equity, and on the other is encouraging pensions, asset managers and retail investors to avoid less liquid assets in public equity markets - such as smaller companies - particularly when many investors should be thinking of a anything from a 10 to 30-year horizon. A fundamental rethink of 'liquid is good and illiquid is bad' within the regulatory framework would help reset this balance.

v) Rethinking technology and market infrastructure

15. **A big moment:** the UK shareholding framework (what happens to shares after they are bought or sold) has not kept up with the adoption of new technology elsewhere in financial services or in society generally, exacerbating the high costs associated with being a smaller listed company. It is difficult to grasp why the UK's shareholding system is still so reliant on paper, why share certificates still exist, and why issuers are still required to communicate with their shareholders on paper by default. A single digital register of company shares, future-proofed for open finance, would support greater competition for the sorts of services that enable issuers and their ultimate owners to effectively and efficiently communicate up and down the chain of intermediary 'nominee' accounts.

    The government's Digitisation Taskforce led by Sir Douglas Flint (chairman of abrdn and author of the foreword in this report) is expected to publish its final recommendations soon and is an opportunity to focus on three key principles: i) to improve the transparency and communication between issuers and investors (whether they are ultimate beneficial owners or legal shareholders); ii) to adapt rules and legislation to enable the digitisation of the framework while maintaining investor rights and iii) to use the 'demat moment' to roll out a 'digital first' approach to wider regulatory reform, paving the way for an economy underpinned by 'smart data' sharing. The Swedish model is not the answer to every problem but it is striking that its fully digitised and dematerialised framework makes it easier for retail investors to own shares and engage with their investments (often in smaller, home-grown companies) based on their digital IDs.

16. **Engaging through technology:** technology has a significant role to play in driving engagement and making life easier for retail investors. Savers could receive automated nudges to consider investing when their level of cash deposits hits a particular level (over 70% of people with £5,000 or more in savings had not considered putting some of it in a stocks & shares ISA). The principle of a 'one stop shop' using open finance would enable investors to manage all of their accounts, savings, pensions in one place instead of treating them as separate pots. Technology can enable better communication between smaller companies and their investors, and enable wider access to new issues and other capital raising for retail investors (through platforms such as PrimaryBid). Investment platforms have a big role to play in using technology to ensure that retail investors have full access to smaller companies.

17. **A third way:** moving from being a private-held to a publicly-listed company represents a huge cultural and administrative shift for smaller companies The sudden glare of investors, increase in disclosure and reporting requirements, and drumbeat of continuous share trading can be a shock - even when it is softened by the lower entry requirements for junior markets. This shock is one of the factors in the shift in the relative attractiveness of public and private markets. The London Stock Exchange is working with government and regulators on a 'hybrid' or 'third way' market called Pisces that will blur the lines between public and private markets and enable companies to access capital and liquidity while only offering intermittent trading. This platform is set to launch in 2025 and while many in the smaller company ecosystem are suspicious of a proposal that might reduce liquidity further for smaller companies, we think it could point the way forward for a better balance between the competing demands of investors and smaller companies.

NEW FINANCIAL
Rethinking capital markets

About New Financial

New Financial is a think tank that believes Europe needs bigger and better capital markets as a force for social and economic good to help drive growth and prosperity.

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