4.2
Public Equity Markets

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Functions of public equity

The opportunities for SMEs to gain access to public equity markets have increased significantly since the 1970s. Although the experiences of those who have achieved listings in second-tier markets, in particular SMEs engaged in more traditional industrial sectors of the 'old economy', have not been universally felicitous, the advantages of a flotation as a source of finance for larger SMEs are sufficiently compelling to persuade some directors to embark on the 'going public' adventure.

Reason for flotation include:

- permanent capital for corporate development;
- substantial funds from a broader investor base with decreased dependence on one or several institutional investors and/or debt finance;
- quoted 'paper' which is acceptable consideration for acquisitions;
- exit route for private equity investors, including the owner-managers of the business;
- motivation of employees.

Provided that stock markets are buoyant, all of these objectives can be realised. If the market falls sharply in the period following flotation, as in the case of dot.com companies in 1999–2000, the first two objectives may have been achieved temporarily, but the last three are likely to be frustrated.

Until the 1980s, UK private companies had only two routes for raising public equity, following a consolidation of the smaller regional stock exchanges into the Stock Exchange, London at the end of the 1960s. They could seek a listing on the re-designated London Stock Exchange (LSE), which has strict entry requirements in terms of minimum market capitalisation and trading record *inter alia*. For smaller companies, the main stock market was so heavily regulated that market entry was either unattainable or inappropriate. As an alternative, SMEs could seek entry to the over-the-counter (OTC) market. The disadvantage of the latter was that it was largely unregulated and therefore unattractive to many investor groups, particularly institutional private equity investors.

In some western European countries, the absence of effective public equity markets for SMEs has been addressed by the creation of second-tier equity markets. A three-tier equity market is now a common structure, consisting of an official list, a 'junior' market or league of the official list for smaller companies with a less demanding entry and trading regime, and an unregulated OTC market.

The second-tier market enables SMEs to gain access to public equity at an earlier stage than waiting to qualify for a full listing. In addition to advancing the introduction of public equity, second-tier listing provides a vital ingredient in attracting private equity funds at an earlier stage – namely, the prospect of an exit route (other than a trade sale) within the three-to-five-year time span which venture capitalists expect and with which other private investors are generally comfortable.

UK public equity markets

The Official List

The Official List of the LSE is segmented by market capitalisation, as well as by industry sector classification, according to which data are published daily in the *Financial Times* (FT). The smallest segment is categorised as the FTSE Fledgling market (market capitalisation of less than £65 million) and the middle-size segment as the FTSE Small Cap market (market capitalisation of between £65 million and £400 million). The LSE also launched the All Small market index, which encompasses the FTSE Fledgling, Small Cap and techMARK indices. TechMARK is the 'market within a market', launched in November 1999, for some 180 companies with a technology bias already in the Official List.

TechMARK also has a less onerous listing procedure for innovative high-growth companies. The LSE introduced Chapter 25 (Innovative High-Growth Companies) into their listing rules at the beginning of 2000, which allows innovative, high-revenue growth companies to seek a listing and to join techMARK without a three-year trading record. A minimum market capitalisation at the time of listing of £50 million (based on the issue price) and a minimum value of shares sold to new investors of £20 million are required.

The contemporaneous arrival of NASDAQ Europe as a recognised investment exchange somewhat overshadowed the launch of techMARK, but the latter has flourished in spite of the collapse of some high-technology sector stocks.

Second-tier equity markets

The UK experience

Over the last 20 years, the United Kingdom has enjoyed a varied experience of second-tier markets. The Unlisted Securities Market (USM) was introduced in 1980 and was at first successful. Initially, it attracted most of the companies which had previously traded on the OTC market and a number of new entrants. However, the recession of the early 1990s caused the flow of new entrants to dry up. At the same time, the advantages of the USM were eroded by relaxation in the main market's listing rules, and the reduced liquidity of small company shares led to a decision by the LSE in 1993 to close down the USM. In the absence of a second-tier market alternative, investor and issuer pressures were exerted successfully to delay the final closure until 1996.

By this time, the LSE had conceded that the Official List alone remained insufficient as a channel to provide smaller companies with access to public equity and, in spite of the USM experience, the Alternative Investment Market (AIM) was established in its place. Subsequently, the general issue of whether UK equity markets provide an appropriate and sufficient capital base for smaller quoted companies (SQCs) was addressed by the Treasury Working Group on Small Quoted Companies under the chairmanship of Derek Riches, which reported to the Paymaster General in November 1998. The report concluded that the LSE could be more proactive in increasing the profile of SQC shares by creating a supportive market environment and helping to stimulate the launch of techMARK and recognition of the FTSE Fledgling and FTSE Small Cap market classifications.

The Alternative Investment Market (AIM)

Introduced in June 1995 as a second-tier market for small or young companies whose shares were not publicly traded, AIM grew strongly and by the end of 2000 had achieved a total market capitalisation of £14.5 billion with 524 companies listed. The 347 companies listed 12 months previously had a market capitalisation then of £12.1 billion. In fact, 2000 was a record year for raising capital in AIM, with some £3.1 billion raised – more than three times the amount raised in 1999 (£0.9 billion).

Altogether since its launch, more than £6.1 billion has been raised in AIM, while more than 70 of the companies listed have moved up to the main market.

In principle, as intended, the less onerous preconditions and operating requirements have improved smaller companies' access to public equity. Particular attractions are the absence of minimum:

- capitalisation requirement;
- asset levels;
- profit levels;
- free float of shares.

However, the attractions of AIM have been blunted for some companies as regulations have tightened both to maintain investor confidence and to encourage institutional investment. A revised set of AIM rules introduced in February 2001 now clearly prohibit AIM companies from issuing information which is misleading or materially incomplete.

Third-tier equity market

The unregulated OTC market within the United Kingdom is OFEX, an off-market trading facility launched in 1995 by J P Jenkins Limited, a market maker/agency broker. It was intended that OFEX would replace the unregulated Rule 42 market under the previous regime for companies not wishing to join AIM or the Official List. Although

OFEX is not regulated by the LSE, J P Jenkins is itself bound by Stock Exchange and Financial Services Authority (FSA) rules, and OFEX is expected to feed companies, as they qualify, into AIM or the Official List in the medium term. Since its launch, OFEX has raised £895.8 million through 586 issues and, as at the end of November 2000, 42 companies had graduated to AIM with a further upgrading to the Official List.

Pan-European equity markets

Current pan-EU markets

EASDAQ

Prior to the announcement of NASDAQ entry into Europe, the European Commission had already published *Risk Capital: A Key to Job-Creation in the European Union* (April 1998), which identified the need for a similar pan-European risk capital market to finance technology-based firms. A parallel development was the creation of EASDAQ in 1966, which is now regarded more as an exchange for high-growth mid-sized businesses rather than a market for small and medium-sized companies with a high-technology bias. Minimum listing requirements are total assets of €3.5 million and capital reserves of €2 million. Supervised by the Belgian Banking and Finance Commission and regulated by the Belgian Ministry of Finance, EASDAQ had 62 companies listed at the end of 2000 with a total market capitalisation of €23.9 billion.

Euro-NM

Euro-NM was a business and marketing alliance concept between the Amsterdam, Brussels, Frankfurt and Paris Stock Exchanges, launched in 1998 and enlarged in 1999 through the addition of the Milan Stock Exchange. Starting from May 1998, there were linked trading platforms at the Brussels Euro-NM and the Paris Nouveau Marché leading to common exchange membership. The declared objective of Euro-NM was to stimulate the listing and trading of high-technology European start-ups and growth companies. However, as a result of structural changes in equity capital markets, Euro-NM terminated its operations as of 31 December 2000.

Comparison of European second-tier markets

The average market capitalisation per company on AIM and OFEX in £million as at the end of December 2000 and of EASDAQ and Euro-NM in €million as at the end of November 2000 are compared in Figures 4.2.1 and 4.2.2 below.

Consolidation of European stock exchanges

With the acquisition of the London International Financial Futures Exchange (LIFFE) in October 2001, the Paris-based Euronext which

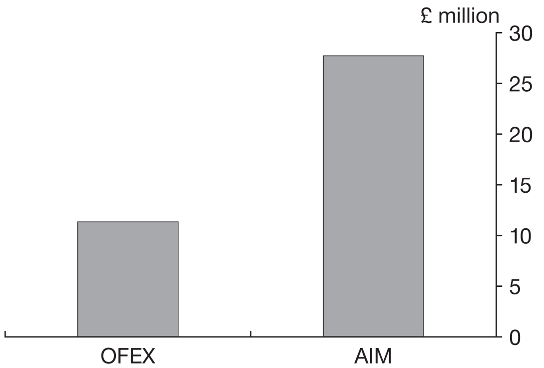

Figure 4.2.1 Average market capitalisation on AIM and OFEX
Sources: Datastream, London Stock Exchange and OFEX.
Data as at end-December 2000.

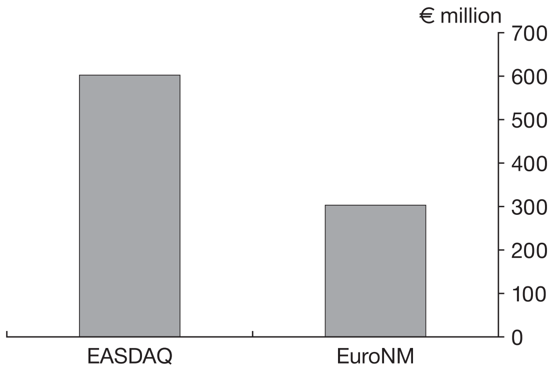

Figure 4.2.2 Average market capitalisation on EASDAQ and Euro NM
Sources: EASDAQ and Euro NM.
Data as at end-November 2000.

unites the Paris, Amsterdam and Brussels bourses has become a serious contender for the leadership of Europe's securities industry. A year ago, there were 33 regulated stock markets and 18 regulatory organisations within the European Union. Although a combined market would, in principle, offer higher capitalisation and liquidity, and thus more certain exit routes – the *raison d'etre* for last year's proposed link-up between the LSE and the Deutsche Börse – the obstacles are formidable and the London–Frankfurt project has foundered.

Having failed to merge with the Deutsche Börse in 2000 and having lost out in the contest to acquire LIFFE, the LSE is now in a seriously weakened strategic position, although it did successfully fight off the opportunistic bid by the OM Group of Sweden. The LSE is now itself a listed company and is again a potential takeover target – a factor reflected in its share price, which rebounded swiftly following the news of Euronext's victory.

The goal of an eventual single trading platform is only one step in creating European financial integration. The ultimate prize is 'global straight-through processing', which will fully automate the tasks of buying and selling any security and settling accounts worldwide. Although this further step in integration will significantly reduce the high costs of completing trades internationally, its achievement demands not only close collaboration both sides of the Atlantic between regulators and investment banks but also heavy investment to re-equip the banks to handle straight-through processing. This is hardly a propitious time to embark on such a commitment, and the move to next-day settlement in the United States, which is an essential prerequisite, has been put back from 2004 to 2005.

At present, there is more concern in the United Kingdom about the proposed Brussels prospectus directive, intended as a 'single passport' for securities to make it easier for companies to raise capital across borders within the European Union. The intention may be laudable, but the proposal involves more onerous disclosure and reporting requirements across the board and it is so far unclear how the directive, which the EU Commission claims is a broad framework only, would preserve companies' choice of listing on primary markets or on lightly regulated second-tier markets. Directors of smaller UK quoted companies fear that the costly requirements of the directive, such as mandatory annual updating of prospectuses, would sound the death knell for key second-tier markets such as AIM and the German Neuer Markt.

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