EDISON
ATLANTIC

EDISON EXCLUSIVE
September 2020

The prospects for capital markets, equities and economic recovery

RACING COVID'S CAPITAL CHASM

EXECUTIVE SUMMARY

While many companies have tapped the equity markets for money since the start of the pandemic, the process of recapitalisation has only just begun. The needs of most are currently unmet and, as at September 2020, it is far from clear that supply will match demand over the next six to 18 months.

The rate of equity capital raises in Europe has fallen by nearly 50% in the last decade. In the US, the average number of IPOs has halved from 300 annually 20 years ago. There has also been a 31.5% year-on-year decline in private equity sector activity in Q220.

There is, therefore, significant risk of a capital chasm – a deep gap between the legitimate need for capital and its available supply. This brings with it the potential to rupture both the US and UK economies.

Fidelity has already warned that institutions do not have sufficient capital for the task at hand and, with other sources at a low ebb, the risk of a chasm must be deemed significant.

Given investors' likely flight to safety with any further volatility, small- and mid-cap companies (SMIDs) are most at risk – as well as up to a third of all employment.

Although quantitative easing (QE) has inflated asset valuations, it has, so far, provided an effective 'crumple zone' for the US and UK economies. However, due to diminishing returns, QE is unlikely to be sufficient to prevent the emergence of a capital chasm.

What other actions should governments take?

Further extending QE beyond its conventional mechanics, especially more forays into equity purchases, could be effective. To prove optimal, however, a patient capital fund might need to be larger than market expectations.

Further government asset purchases should also be bolstered by changes to tax incentives and regulations to encourage more privately held capital to flow into SMID recapitalisations.

To avoid falling down the chasm, we urge all SMIDs to raise sufficient funds at the earliest possible opportunity. Those that have yet to do so should begin planning and executing before conditions worsen.

Even if a wide capital chasm does not emerge, the flow of capital may still be restricted to a tighter than usual cohort; investors will be more exacting when picking smaller-cap stock recapitalisations relative to larger ones. It is therefore important that all SMIDs in need of capital prepare to compete for funding.

Demonstrating a strong balance sheet will be fundamental, while investors are expected to be most responsive to those seeking to grow, improve pricing power and whose stocks will become more liquid after a raise.

To de-risk further, companies should be speaking to as wide an audience as possible by looking further along the long tail of investors. As there is a small number of very large institutions, investor relations efforts must be spread far beyond the usual suspects, especially in the US where investor appetite for foreign stocks is often underestimated.

Ch. 01

COVID-19'S CAPITAL CHASM

While the process of recapitalising equities has begun, the needs of most companies have yet to be met.

In the next three to 18 months there is a real risk of a capital chasm emerging in the US and UK – demand may greatly outstrip the supply of capital in both territories.

Small- and mid-cap companies are most at risk, but an initial capital chasm may eat away at the entire economy and trigger a capital black hole.

Large institutions have warned that they do not have sufficient capital for the task at hand and, with other sources of capital at a low ebb, the risk of a chasm emerging is significant.

THERE IS MUCH WE CANNOT CHANGE, INFLUENCE OR EVEN KNOW

As long ago as April, Richard Staveley, fund manager at Gresham House Strategic, made the point to Edison that the length of a nation's lockdown will affect what kind of recovery and what kind of economic environment it experiences as it emerges from the pandemic. It is perhaps telling that now, in September, there remains significant global uncertainty ahead of us, with much anxiety about the capacity to return to previous levels of employment and growth.

We are still learning about and exploring the implications of many factors and constraints that are beyond human control. We cannot currently affect the mathematics of COVID's transmission, how the virus influences mortality and its ability to mutate.

However, the uncontrollable issues are not born only of COVID. The global financial crisis (GFC) of more than a decade ago is also acting as a magnifier in the economic environment on many levels, most notably because interest rates remain low and nations have not emerged from the low yield environment it imposed.

It is also difficult to measure the impact – or even gauge the implications of – the unrelenting pressure that the pandemic is putting on our collective psyche. Its psychological footprint is magnified by its proximity to the GFC, which was still relatively fresh, if not raw, in most minds.

With so many unknowns being faced, society continues to debate lives versus livelihoods and the most adept political responses to balance tensions, loosen lockdowns and take strides towards new normalities.

No one can yet tell where all this will lead.

There remains significant global uncertainty ahead

WE CAN INFLUENCE THE FLOW OF CAPITAL

Some things are within our control. Governments and central banks have responded to the collapse in economic activity by providing massive fiscal assistance programmes and quantitative easing to offset the liquidity crunch, aiming to avert otherwise inevitable large-scale job losses that would exacerbate the looming recession. The Bank of England's last Monetary Policy Report expects unemployment to soar once the support from government schemes end, moving from the current 3.9% to 7.5%.

However, these programmes are a temporary fix and some of the funds will have to be repaid.

And so, we contend, there is one factor nation states can strongly influence that has not yet reached popular understanding, and one that is critical to the shape of our recovery. The extent to which a capital chasm goes unbridged over the next 12–36 months will likely determine the trajectory of our economic outcomes.

Capital is the lifeblood of all corporations and, because demand is necessarily higher during times of economic stress, the availability and willingness of capital's supply becomes critical – not just for corporates individually, but for the economy as a whole.

More specifically, the state into which we emerge will be dependent on how large the capital chasm is for small- and mid-cap (SMID) companies. While larger businesses will use their scale to sit tight, attract capital and navigate into clearer waters, SMIDs are less resilient and have to work harder than their larger-cap peers to access capital. They don't have the same access to credit markets, the same leverage on their lending banks and have to overcome challenges in terms of liquidity and sufficient equity research coverage. Andy Brough, fund manager at Schroders, points out that there are parallels to the last financial crisis: companies need funds to reach 'escape velocity' on their journey back from crisis to growth.

We underestimate the lynchpin role of SMIDs in our economies at our peril.

A study by the ESSEC Business School and GE Capital during the last financial crisis (2007–10) of SMIDs in the UK, Germany, France and Italy highlighted that while these companies represent a tiny proportion of overall commercial entities (between 1% and 2%), they generate one-third of private sector revenues and one-third of the respective countries' employment.

> The extent to which a capital chasm goes unbridged will determine economic outcomes

WE CAN INFLUENCE THE FLOW OF CAPITAL

In total, they contributed $1.5tn to GDP and while large companies in Europe lost 1.5 million jobs during the crisis, SMIDs added 280,000.

Yet we also know that this resilient potential for future job growth is strongly linked to the need for capital and the health of the IPO market. Data from the US from IHS Global Insight show that 92% of job growth occurs after a company lists.

As the extreme circumstances imposed by lockdowns ease in the UK and across much of the US, many SMIDs are in a race to cross their own capital chasms. The most fortunate are not just hoping to weather the pandemic, but to position themselves and exploit the growth opportunities the crisis has created.

So now is the right time to evaluate their current chances and ascertain how the capital might be provided, as the quality of these assesments will dictate our eventual economic outcomes. We have seen that policy can be swiftly implemented where the political will exists.

92% of job growth occurs after a company lists

NO OBVIOUS WAY ACROSS THE CAPITAL CHASM

Aside from the government, there are three main sources of capital: banks, public markets and private investment. By the mid-20th century, public equity markets had joined banks as the primary financiers of global capitalism.

However, there have been significant recent changes. One of the most significant capital market impacts of the GFC was its challenge to the reliance of corporates on bank-based financing. With collective opinion having lost faith in banks, policy makers and businesses spent more than a decade seeking alternative sources.

This demand-led search did not show up in the public markets and IPOs. European rates fell by nearly 50% in a decade, from 380 per year between 1997 and 2007 to 220 per year between 2008 and 2018. In the US, the average number of IPOs has halved from 300 IPOs 20 years ago to 150 IPOs today.

Given that the overall number of corporates has not changed significantly, we can unambiguously state that more chose to fund themselves without going public. In fact, equity markets were pushed into second place by venture capital (VC) and private equity (PE).

As the reason behind the shift was the desire to reduce reliance on bank-based financing, this turns out to be somewhat paradoxical. In many cases, the closeness of the relationship between PE firms and banks facilitates much higher leverage. And, given current economic conditions, we suspect many of these financing structures will be severely tested in the coming months.

There is also good reason to doubt the appetite for new private financing in the current climate. PitchBook Data shows that PE deal volumes in Europe have fallen to the lowest levels since 2013, declining 31.5% in Q220 on a year-on-year basis.

According to PitchBook: 'Sellers pressed pause on plans to offload portfolio companies, lenders focused on existing loans and deal makers assessed how best to revise their strategies.'

The climate, therefore, does not seem to suggest that a surge in private financing will cover a potential capital chasm.

If the last few months are indicative, COVID seems to have reversed the preference switch from private to public equity markets. The evidence for heightened capital demand is almost exclusively a public equity phenomenon.

> We suspect many private equity financing structures will be severely tested

NO OBVIOUS WAY ACROSS THE CAPITAL CHASM

During H120, £55bn was raised in Europe through IPOs and follow-ons, with London accounting for 43% of the total. This £23.7bn for H1 is 15% more than the total raised across the whole of 2019. IPO activity has remained subdued, but since 1 March, £17.4bn was raised in 249 follow-ons in the London market as companies raced to recapitalise.

In the US meanwhile, $136bn has been raised in H220. This is up a not in considerable $109bn for the comparative period in 2019.

And while the volume of IPOs fell from 92 in H119 to 73 in H120, the reduction is perhaps smaller than we might have expected during a global pandemic. US IPOs raised $26bn and 59 of these were for sub-$1bn market cap companies, raising a total of $11.6bn. 556 follow-ons raised $110bn, up from the $76bn raised in H119. Sub-$1bn market cap companies represented 369 of these follow-ons, raising $9.6bn in H220, up from $7.9bn raised in H119.

So will the public markets naturally emerge as the way forward?

There certainly seems to be deeper potential following on from the initial reaction. And capital raisings after the GFC amounted to £100bn in the UK.

However, the need for funding is greater and more broadly spread now than it was during the financial crisis – certainly much more than the £23.7bn raised to date. And yet the direction of change in the past 12 years does not support an argument of for increased capacity in equity markets. For example, UK pension funds, which used to absorb about 60% of UK new issuance, are now in de-risking mode and take up only around 20% of new issuance.

There are other reasons to be concerned about capacity more generally – US small-cap capital raising is up year to date, but the public capital-raising sector focus for US small-cap companies is predominantly biotech and special purpose acquisition company's (SPACs) dominant, with little activity outside these two areas.

So with banks remaining out of favour and unready, private equity appearing to be caught in the pandemic's headlights and doubts over the capacity of equity markets, there appears to be the very real possibility of a capital chasm – a shortfall in the funding needed to get us from the present day to a brighter economic future.

$136bn has been raised in H220, up a not inconsiderable $109bn

NO OBVIOUS WAY ACROSS THE CAPITAL CHASM

This conclusion will not come as a surprise to some well-positioned commentators. **Leading institutional asset management leaders have already highlighted that their industry cannot cross this chasm alone:**

- Anne Richards, Fidelity International's CEO, flagged that the asset management industry would struggle to provide sufficient capital to fix the solvency issues which public businesses face as they emerge from lockdown. She expressed concern that the scale of the cash required to repay the public funding businesses have received will be so large that it would depress recovery, and emphasised that as businesses recapitalise it is important they are able to access as many pools of capital as possible.
- Peter Harrison, CEO of Schroders, has stated that companies need more equity, not debt to secure jobs and promote growth. He has pushed for the UK government to create a £20–30bn patient capital fund to allow companies to maintain investment plans and protect jobs.

As these comments implicitly acknowledge, in determining how to cross the capital chasm we should also remain very conscious that all sources of capital are part of the same ecosystem. Corporates remain reliant on bank financing and the PE and VC industries need thriving equity markets to function as exit routes. The European IPO Task Force 2020 report makes a number of recommendations on how to achieve this, including simplifying regulatory requirements, creating an equity culture in Europe, allowing retail to participate more in IPOs, improving tax incentives for IPOs and promoting the provision of equity research on SMEs.

Companies need more equity, not debt, to secure jobs and promote growth

Ch. 02

THE RISKS IN EQUITY CAPITAL SUPPLY

Equity investors have, so far at least, been very supportive of companies looking to capitalise on growth opportunities, even in hard-hit sectors.

Moving forward, the potential for volatility is locked in; uncertainty is the only certainty.

Further lockdowns and slower, flatter recoveries will greatly increase the risk of a capital chasm emerging.

SEEK AND (SO FAR) YOU SHALL FIND

The initial evidence for the willingness and ability of equity markets to supply capital to companies during the crisis is positive.

As the epitome of contact reduction businesses, we might well expect the e-commerce cases from Ocado, Boohoo and ASOS, which raised £1.1bn in aggregate, to have been successful.

Yet companies in the sectors hardest hit by COVID-19 – travel and leisure, real estate and retail – were able to raise funds as well. Sectors looking to capitalise on potential growth opportunities – gaming, e-commerce, healthcare and TMT – were also well taken care of.

This success was consistent across all market cap bands.

The crossover point of capital raises in the hardest hit sectors by companies looking to fund growth opportunities was particularly notable. Segro's £680m raise supported European expansion and Supermarket Income REIT's oversubscribed £140m raise was to add further grocery assets.

Investors also backed raises such as Wetherspoon's £140m ask where they saw an opportunity for management to grow the company's share in a declining market and thus improve pricing power.

But perhaps more significant as an indicator of total investor appetite and the depth of pockets, there were a number of rescue rights issues as well. Aston Martin Lagonda, Ted Baker, easyJet and Kier Group all raised money to shore up their balance sheets and weather the downturn.

In healthcare, the London market raised £2bn in 40 deals in H120. Not all of this was COVID related, as the London Stock Exchange (LSE) noted that only 11 deals – £278m of the funds raised – mentioned COVID. Synairgen raised £14m to fund its highly successful trial of SNG001, a respiratory drug for COVID patients, while Oxford Biomedica raised £40m, in part to fund its COVID vaccine development and manufacture as part of the Jenner Institute consortium.

Technology was also well supported in London, with 42 H1 deals raising £4.4bn. With changing market dynamics, many companies raised money to support their acquisition activities – our notes on Boku and Keywords Studios contain more details.

> Companies in the sectors hardest hit by COVID-19 were also well taken care of

SEEK AND (SO FAR) YOU SHALL FIND

In the UK's sub-$1bn market cap bracket, funds were quite evenly distributed between five sectors, each of which benefited from 12–19% of capital-raising volume, including healthcare with 14%.

In the US, the dominant sectors by far were financials and healthcare, with the weight towards follow-on activity. Together they represented 87% of total capital raised and 94% of IPO capital raised by smaller companies – the financials component being heavily driven by SPAC and investment fund IPOs.

We find these trends concerning when considering the potential for equity markets filling the capital chasm.

Is the US smaller company capital raising environment extremely narrow from a sector perspective due to the lack of willingness in supply? Or have other sectors not been active in testing investors' appetites?

London

FTSE industry	Number of deals	Total capital raised ($m)	% of total capital raised
Basic materials	45	260	7
Consumer discretionary	21	552	15
Consumer staples	2	31	1
Energy	19	129	4
Financials	44	707	19
Healthcare	33	607	17
Industrials	22	481	13
Real estate	7	447	12
Technology	18	290	8
Telecommunications	2	7	0
Utilities	4	160	4

Source: London Stock Exchange

SEEK AND (SO FAR) YOU SHALL FIND

US (NYSE & NASDAQ)

Market cap range	Number of IPOs	Number of FOs	IPO capital raised ($m)	FO capital raised ($m)	Number of deals	Total capital raised ($m)	% of total capital raised
Basic materials		11		45	11	45	0
Consumer discretionary	4	23	180	971	27	1,151	5
Consumer staples		6		113	6	113	1
Energy		5		101	5	101	0
Financials	32	14	8,483	354	46	8,837	42
Healthcare	17	236	2,458	7,003	253	9,461	45
Industrials		28		246	28	246	1
Real estate	1	2	102	171	3	272	1
Technology	5	33	373	463	38	836	4
Telecommunications		2		7	2	7	0
Utilities		1		13	1	13	0

Source: Factset

UNCERTAINTY REMAINS THE ONLY CERTAINTY

We cannot predict how equity raises will be faring by the end of 2020 – too may significant factors exist for a reasonable prediction to be made. There is a very large range of credible potential scenarios – since the unlikely yet abjectly bleak emergence of not just a capital chasm but a capital black hole sucking in the rest of the economy, to the far rosier situation where no chasm emerges.

However, when planning for the next six months, we can find distinct clues in recent patterns to help understand which situations are most likely to occur. Unpicking that knot is therefore worthwhile.

Firstly, we must assume that the potential for astounding volatility remains.

With a growing belief that valuations were already stretched, Q120 saw the fastest market drop in history. Yet stocks then rebounded in Q2 on the auspices of massive government stimulus packages. The MSCI World Index was up 18.5% in Q220, leaving it down 5.8% for H120.

Alliance Bernstein provides a solid perspective of the (skewed) nature of the bounce. Aside from the primary driver of quantitative easing (QE) creating a vast supply of cheap capital, two trends stand out for stimulating investor demand:

1. **The signal of stringency:**
   Stimulus packages and the initial easing of lockdown tempted professional investors back into the market, relieved to find the Q1 spasm was short and sharp. Market movement was then driven by the stringency of lockdown. Exhibit 1 compares the stringency of lockdown based on an index published by Oxford University and the MSCI World Index.

2. **Animal spirits in retail, also known as the Robin Hood effect:**
   Reports from Australia, China, Korea, Singapore, the UK and the US have demonstrated the impact of retail investors and their active participation in the market since March. Charles Schwab had a 126% increase in daily active trades in Q220 compared to the same period in 2019, with the 1.62m active daily trades also ahead of the Q120 figure of 1.54m. This risk-embracing activity has been seen around the globe, with platforms including the trend's eponymous Robin Hood, Hargreaves Lansdown, AJ Bell, Plus500 and IG Group all reporting surges.

Risk-embracing activity has been seen around the globe

UNCERTAINTY REMAINS THE ONLY CERTAINTY

As well as understanding why the demand occurred, it is also revealing to consider where it was strongest. This pattern provides particular insight into the likely immediate appetite of investors for capital raises across geographies and economic sectors. And, in broad terms, these are the key phenomena:

1. **US tech led the global charge:**
   The US's tech-heavy indexes were rewarded for hosting companies facilitating remote working, e-commerce, in-home leisure and non-contact digital products and services.

2. **Smaller companies stood out:**
   Despite the segment's narrow capital raising, US small-caps were the best performing, ahead of US large-caps. **The UK has also seen smaller companies performing strongly. While the FTSE All-Share and the FTSE 100 indexes underperformed in Q220, the FTSE AIM All-Share delivered a 29.5% return, coming close to the NASDAQ Composite return of 30.6%.**

3. **Cyclicals outperformed defensives, growth outperformed value:**
   Exhibits 3 and 4 show cyclicals benefiting from the market recovery while growth continued to outperform value. The Global Industry Classification Standard (GICS) supersectors classify consumer staples, healthcare, telecoms and utilities as defensives, while cyclicals include technology, consumer discretionary and industrials. Value stocks include a large number of banks, where the outlook for lower interest rates and higher defaults is contributing to the underperformance.

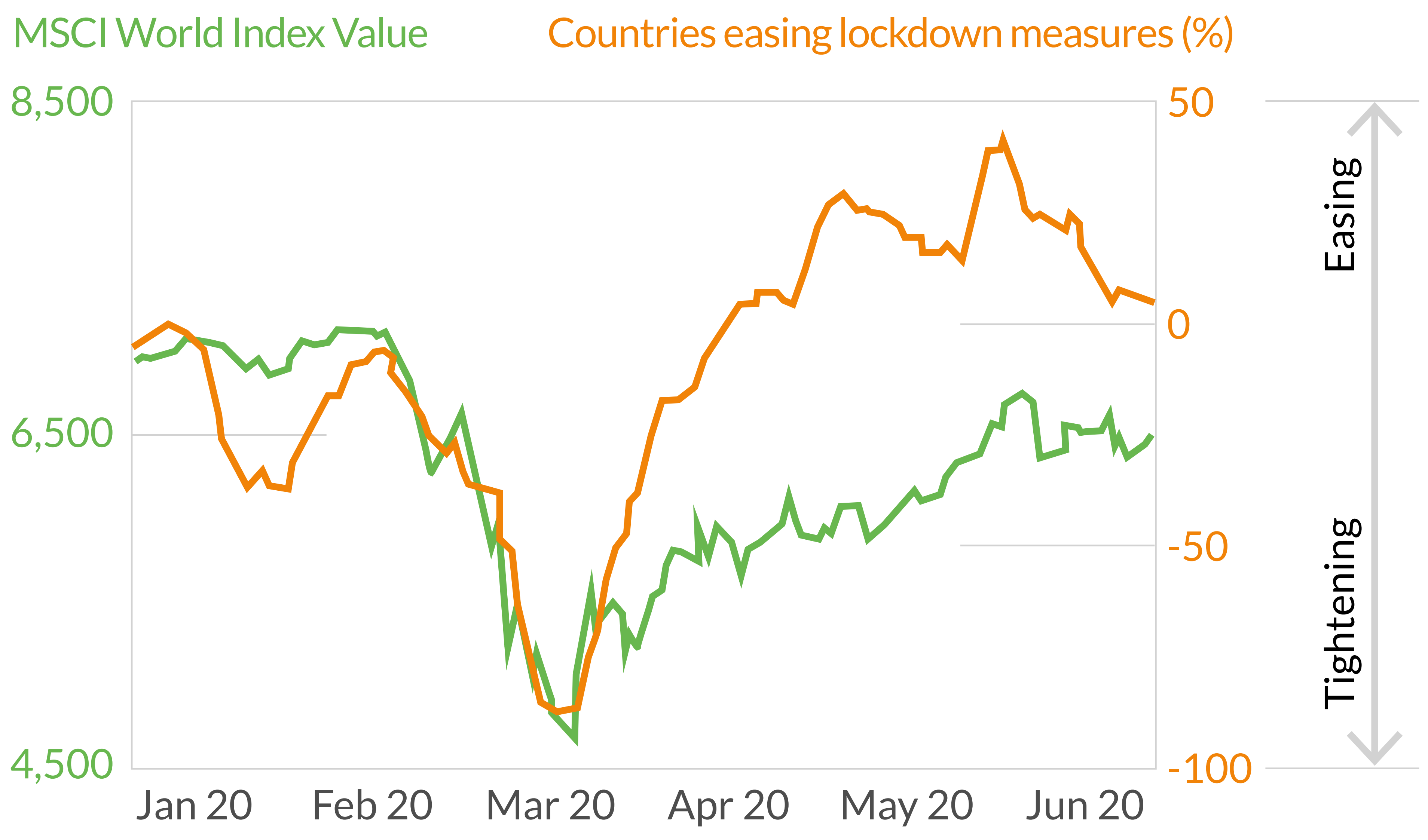
4. **Healthcare and basic resources performed strongly in the UK and US markets:**
   Drilling down in the sectors, Exhibits 5 and 6 show the top five and bottom five performing sectors in terms of returns from 1 March 2020 to 30 June 2020. Healthcare has been a strong beneficiary of investors looking for 'coronavirus stocks' while mining plays have been driving the returns in the basic resources sector, in part as investors look at the improving earnings and fundamentals as the gold price hits new highs. We will look at both these phenomena in greater detail in subsequent chapters.

The FTSE AIM All-Share delivered a 29.5% return

CH. 02: THE RISKS IN EQUITY CAPITAL SUPPLY

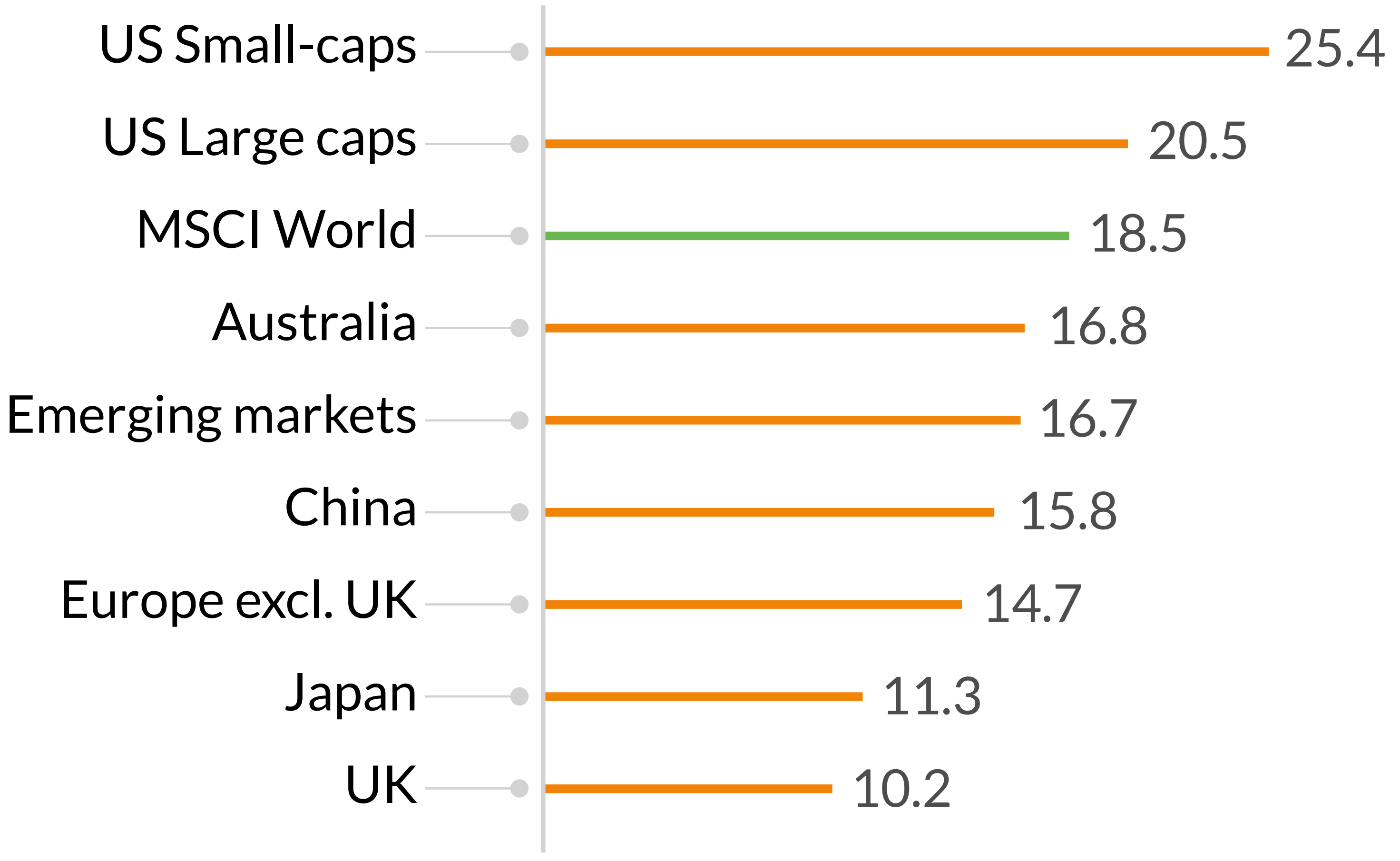
UNCERTAINTY REMAINS THE ONLY CERTAINTY

Exhibit 1: Global stocks vs lockdown measures



Source: Alliance Bernstein, Lopsided equity rally highlights growing market risks, 6 July 2020

Exhibit 2: US leading the returns while the UK underperforming

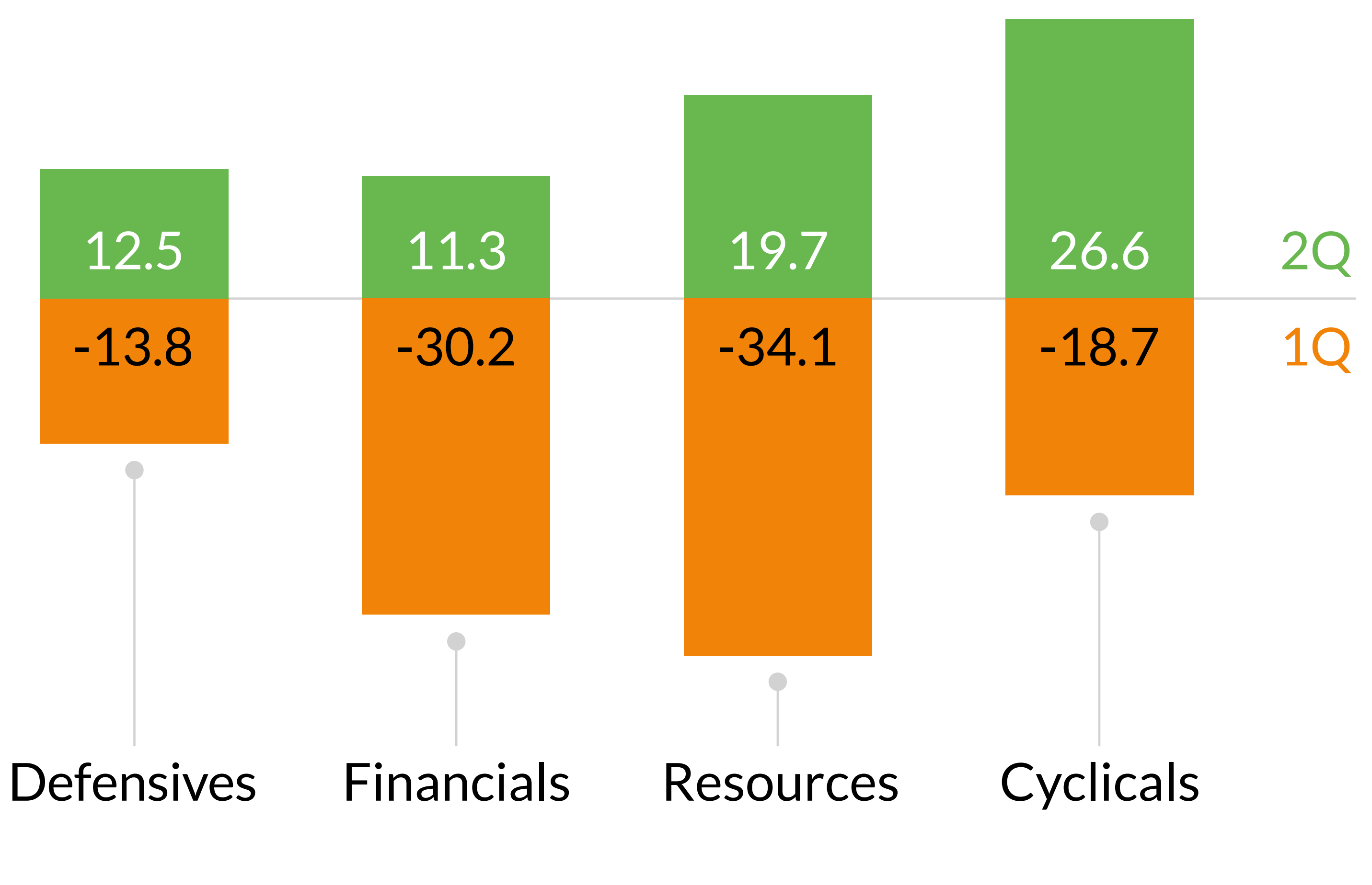


Source: Alliance Bernstein, Lopsided equity rally highlights growing market risks, 6 July 2020

UNCERTAINTY REMAINS THE ONLY CERTAINTY

Exhibit 3: Cyclicals outperforming defensives

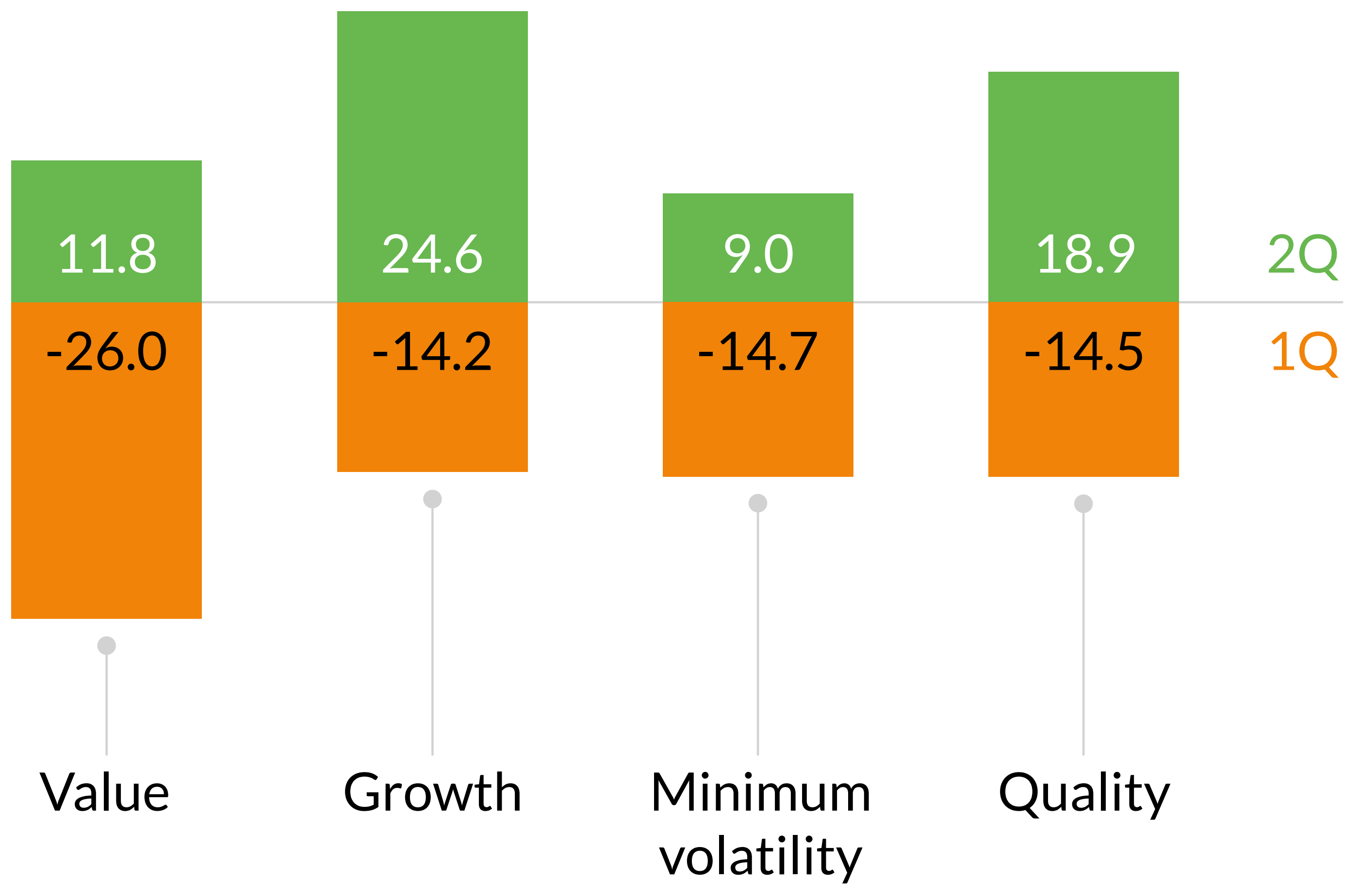
MSCI World Supersector returns (percent)



Source: Alliance Bernstein, Lopsided equity rally highlights growing market risks, 6 July 2020

Exhibit 4: Growth outperforming value

MSCI World Style Index returns (percent)

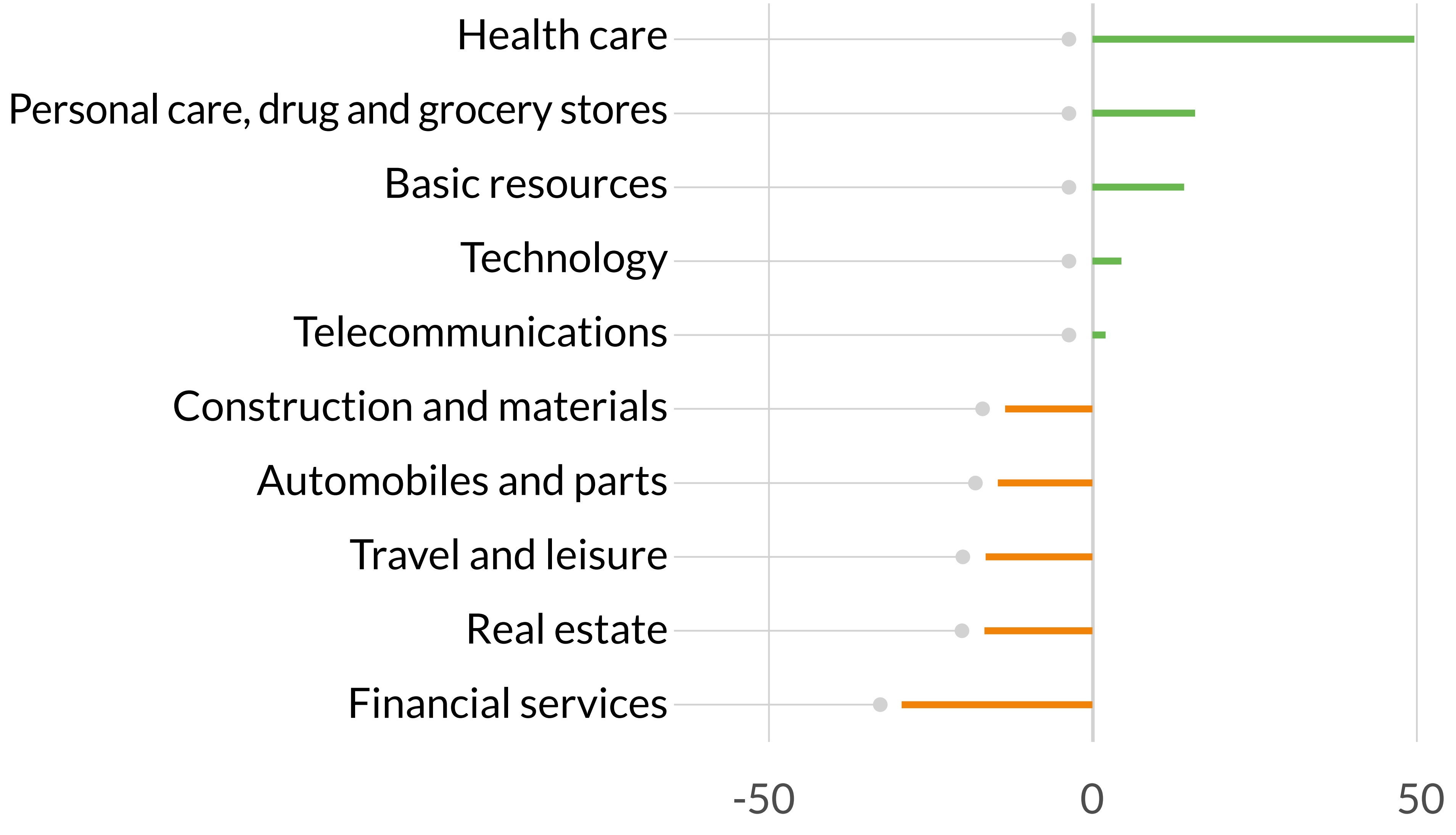


Source: Alliance Bernstein, Lopsided equity rally highlights growing market risks, 6 July 2020

CH. 02: THE RISKS IN EQUITY CAPITAL SUPPLY

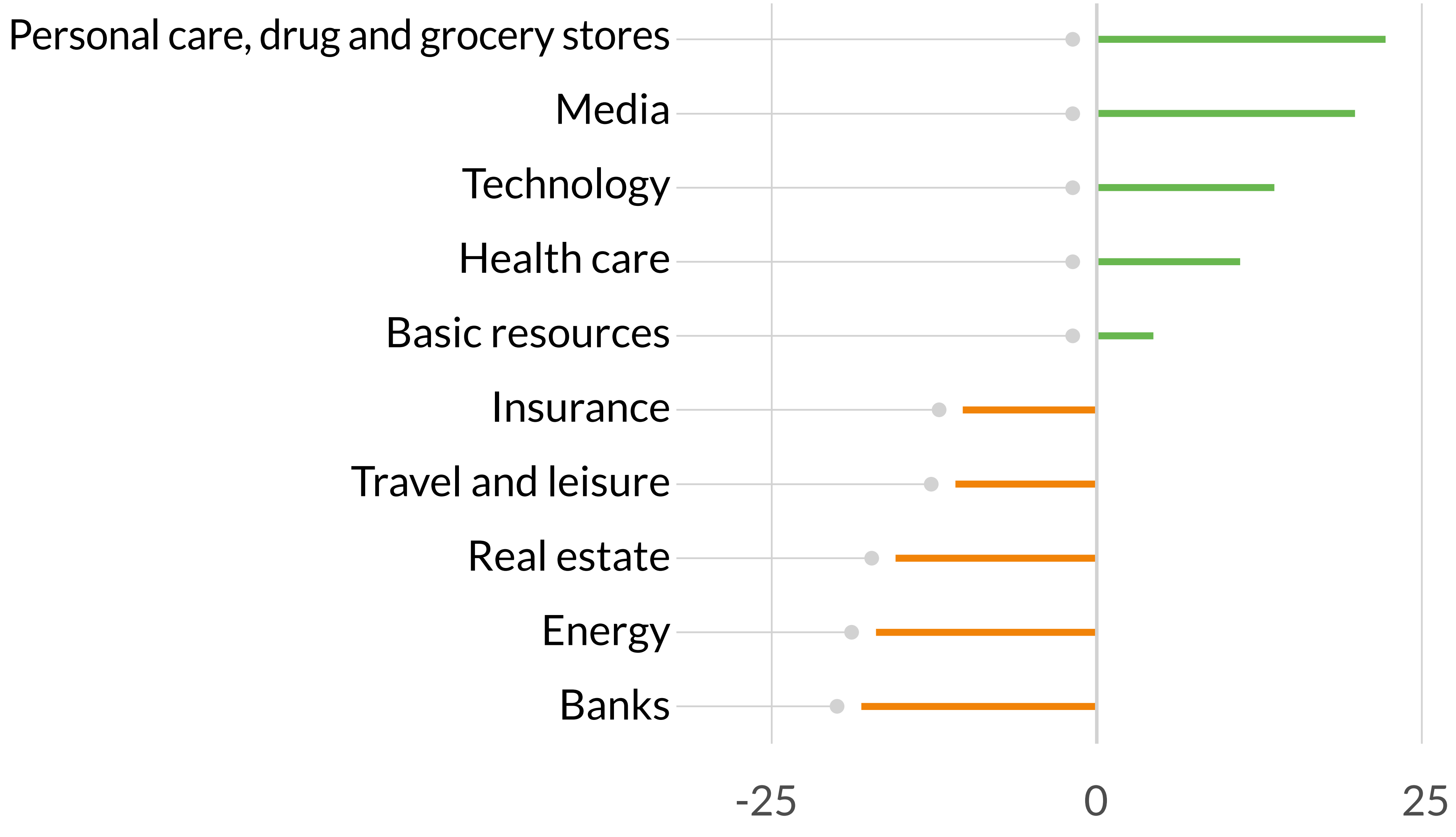
UNCERTAINTY REMAINS THE ONLY CERTAINTY

Exhibit 5: Top five and bottom five performing sectors in the UK since 1 March 2020



Source: Refinitiv

Exhibit 6: Top five and bottom five performing sectors in the US since 1 March 2020



Source: Refinitiv

UNCERTAINTY REMAINS THE ONLY CERTAINTY

In retrospect, as ever, the above trends seem obvious. And, from a smaller-cap perspective of needing to raise equity capital, it is relatively cheering, added to which we must remember that, historically, small- and mid-cap stocks have outperformed as the economy moves back into recovery. While noting that SMID stocks were hit harder in the Q120 falls, we did see this in the Q220 performance.

However, given the depth of the economic catastrophe, there is a debate that this time it is different. Small- and mid-cap outperformance is predicated on a recovery and if this recovery is more protracted, then as Tom Stevenson, fund manager at Fidelity points out 'in a slower, flatter recovery, investors will continue to favour big reliable companies with pricing power. This argues for larger rather than smaller companies.'

We conclude that until there are tangible signs of a recovery, investors are likely to focus on pricing power, balance sheet strength and stock liquidity.

We already see this reflected in the earnings composition of the FTSE 100, with large international companies increasing their share of earnings contribution to the index from pre-COVID levels (2019) at the expense of domestically focused and energy companies.

	Segments	% of Index Earnings			Key companies		Key companies (index weight)*
	MSCI UK Wgt (%)	2019	2020	2021	MSCI UK Wgt (%)	% Seg sector	
Internationals	59	49%	62%	57%			
Consumer staples		14	21	17	16	95	Diageo, BAT, Reckitt, Unilever
Financials		15	14	15	13	93	AstraZeneca, Glaxo
Health care		8	13	11	8	83	HSBC, StanChart, Prudentia
Industrials		7	8	8	6	62	RELX, BAE, Experian, Ferguson
Domestics		16%	15%	14%			
Financials		7	5	5	3	63	Lloyds, RBS, Legal & General
Discretionary		3	2	3	2	53	Next, Persimmon, Whitbread
Staple		2	3	2	1	73	Tesco
Energy/Materials		27%	17%	21%			
Energy		16	3	10	12	100	BP, Royal Dutch
Materials		11	14	11	9	77	Rio Tinto, BHP, Glencore, Anglo Am
MSCI UK					71		

Source: Bloomberg Intelligence
Note: Domestics have 70% of sales in the UK; Internationals have 70%+ abroad * Green companies have biggest contribution to estimated 2021 EPS growth. As of July 15, 2020

THE BASIS OF ONGOING VOLATILITY

While we can divine a broad list of favoured investment characteristics from recent history – and smaller-cap companies in tech and healthcare with a strong balance sheet, good liquidity and US exposure have the most to be thankful for – nothing can fundamentally override the crisis situation and the potential for further extreme volatility. There is no room for complacency.

In fact, the pattern of Q2 returns suggests five clear sources of volatility in H220, with stark implications for the likelihood of the emergence of a capital chasm:

1. **The risk of a continued first – or even second – wave, fuelling stringent lockdown:**
   There is no reason to believe the correlation between market performance and lockdown stringency will weaken. Nations which cannot control the virus without stringent lockdowns will therefore be less attractive for capital. While a case can be made to invest in some of the sectors most affected by COVID at distressed valuations (hotels, airlines, restaurants, entertainment venues and retail outlets) on the basis that consumer behaviour has a short memory and by December you may see a return to more normal levels of activity, this is unlikely to be the case if we move back into a more stringent lockdown in the winter.

2. **Removal of government support:**
   As employment and furlough schemes unwind, as deferred taxes have to get paid back and as interest payments start to kick in on government support loans, we would anticipate further job losses with a resulting knock-on effect on consumer demand. All of the above lead to earnings growth being depressed. The global economy is going through a major recession and there are likely to be negative surprises as companies come to report earnings in H220.

Nothing can fundamentally override the crisis situation

THE BASIS OF ONGOING VOLATILITY

3. A rush of earnings data:

Next, which we see as a role model in strategic assessment, set out in its earnings release a section on 'forecasting the unforecastable year'. With so much uncertainty, many companies have withdrawn guidance and investors are without the earnings data to make valuation assessments and monitor earnings revisions. This will not end well if investor assumptions are shown to lack sufficient imagination to capture the extent of the downturn.

4. Growth in concentration risk:

As investors looked for liquid defensive names able to grow and ride out the coronavirus impact, there has been a crowded trade as institutional and retail investors put money into the same stocks. This is most apparent in the technology sector. The largest five US stocks (Microsoft, Apple, Amazon, Alphabet and Facebook) accounted for 36.9% of the entire Russell 1000 benchmark as at 30 June 2020. Our equity strategist Alastair George reflects that investors have responded by creating a new class of 'digital defensives' which have strongly outperformed the overall market. This in itself poses a risk as historically such concentrations have reversed, and as Alastair notes, the valuations for the technology sector are at a five-year high on a forward price to book basis. While these digital defensives have benefited from the shift to working at home, they are not immune to an economic downturn and if those homeworkers start to lose their jobs.

5. Changes in the way we do things:

Unlike the financial crisis, consumers' habits and preferences have changed during confinement and will leave some businesses stranded unless they quickly develop new ways to meet their customers' needs. The challenge for both corporates and investors is correctly predicting what the future might look like; do we start returning to our places of work, do we start to fly as much as we used to, do we eat out as much as we used to?

Investors are without the earnings data to make valuation assessments

WHAT WILL THE FUTURE HOLD?

The only conclusion that can be drawn is that the risk factors and system complexity present in the current situation are such that even the near future is impossible to predict.

On the plus side, current levels of capital requirements have been met. While high-profile names are going into administration, especially restaurants and retail on the High Street, there has been no general collapse in the availability of finance for viable businesses.

All of this points to the very worst scenario remaining possible but being unlikely. And the same can be said for the very best outcome. However, some of the seemingly more likely outcomes in between the extremes do include a capital chasm for SMIDs. There is a plethora of circumstances that could act as a trigger.

For instance, given the level of uncertainty and the very high stakes, a single dramatic academic paper could convince governments to withdraw support too early; or the winter might bring a renewed wave of a mutated virus which will not be responsive to the vaccines or treatments about to become available; or earnings data could reveal that SMIDs are less well-placed to survive the pandemic than the market had been assuming.

In any of these and innumerable other scenarios, investors may swing behind the relative safety of larger stocks and be highly selective on the capital funding requirements of SMIDs. It might not be that the supply of capital would dry entirely, but it might be so constricted so as to be only available to a very tight cohort.

The question for SMIDs then becomes: 'How could we increase our chances of being in that cohort while markets are in the grip of a capital chasm?'

And the question for governments is:
'How do we prevent or, as a last resort, fix the emergence of a capital chasm?'

Even the near future is impossible to predict

Ch. 03

PREPARING FOR THE CAPITAL CHASM

The most effective way to avoid the chasm is to raise equity capital as soon as possible.

With high demand for equity capital, it will be important to find less well-known pools that other businesses will not exploit.

The US is the world's largest equity market and is therefore of particular importance – it has the deepest pool of investors, with long-tail distribution across both geography and scale.

The most successful equity stories are likely to emphasise pricing power and stock liquidity.

The surest way a SMID can avoid the risk of a capital chasm is to raise sufficient funds at the earliest possible opportunity. Ocado and dozens of others have clearly demonstrated how to execute such a strategy.

However, many smaller businesses in other sectors were unable to make such a positive and immediate response. Given this, how should they now go about it?

The first task is to understand the investor and market landscapes we are facing into.

HITTING THE RIGHT MARKET

The London Stock Exchange's Alternative Investment Market (AIM) and the US Nasdaq have historically supported smaller, growth businesses in the UK and US. As AIM celebrates its 25th anniversary, it is important to understand and exploit the changing market conditions and dynamics between them.

A key structural difference is their orientation. Nasdaq has a strong bias towards larger companies, whereas AIM - despite a modest increase in the size of companies completing IPOs – remains focused on smaller businesses.

Exhibit 7: Average market capitalisation at IPO ($m)

	AIM	Nasdaq
2015	95.92	504.88
2016	100.63	504.24
2017	103.69	450.12
2018	112.17	846.84
2019	140.72	1,089.95

Source: Dealogic

Exhibit 7a: Market capitalisation distribution – June 2020

	AIM	Nasdaq	AIM	Nasdaq
$0–5m	123	14	15%	1%
$5–10m	94	52	11%	2%
$10–50m	266	430	32%	16%
$50–100m	127	261	15%	10%
$100–500m	172	838	21%	31%
$500m–$1bn	25	306	3%	11%
$1–5bn	21	527	3%	19%
$5–10bn	1	113	0%	4%
$10bn+	0	204	0%	7%
Total	829	2,745	100%	100%

Source: London Stock Exchange

HITTING THE RIGHT MARKET

Despite this difference, AIM and Nasdaq are often thought of as competitors, whereas they are in fact entirely complementary. AIM is the sweet spot for companies valued between $30m and $500m. It serves as a bridge to larger, more liquid indices such as the London Main Market or Nasdaq. And AIM's attractions should be carefully considered. With less burdensome regulatory requirements, it offers small issuers the benefits of a longer-term, buy-and-hold investor base that understands smaller companies.

In the US, by contrast, the abundance of Venture Capital (VC) and Private Equity (PE) investment means companies typically list on Nasdaq later in their business cycle, and at much larger valuations. As Exhibit 1 shows, the average market cap of a Nasdaq IPO was just over $1bn in 2019.

Of course, both AIM and the Nasdaq have drawbacks for Small-mid capitalised companies (SMIDs). Unattractive valuations and a lack of liquidity leave some frustrated with AIM. Nasdaq, meanwhile, is relatively expensive and more heavily regulated. Its investor base also has a reputation for being rather fickle, with retail holders always hungry for positive news to justify holdings.

Key, therefore, to maximise benefit from an existing listing on either market, especially when looking for a follow-on, is to reach far beyond well-known holders of AIM and Nasdaq stocks. SMIDs should also be focusing on less well-accessed pools of equity capital.

AIM and Nasdaq are in fact entirely complementary

CH. 03: PREPARING FOR THE CAPITAL CHASM

MAPPING OUT SOURCES OF EQUITY CAPITAL

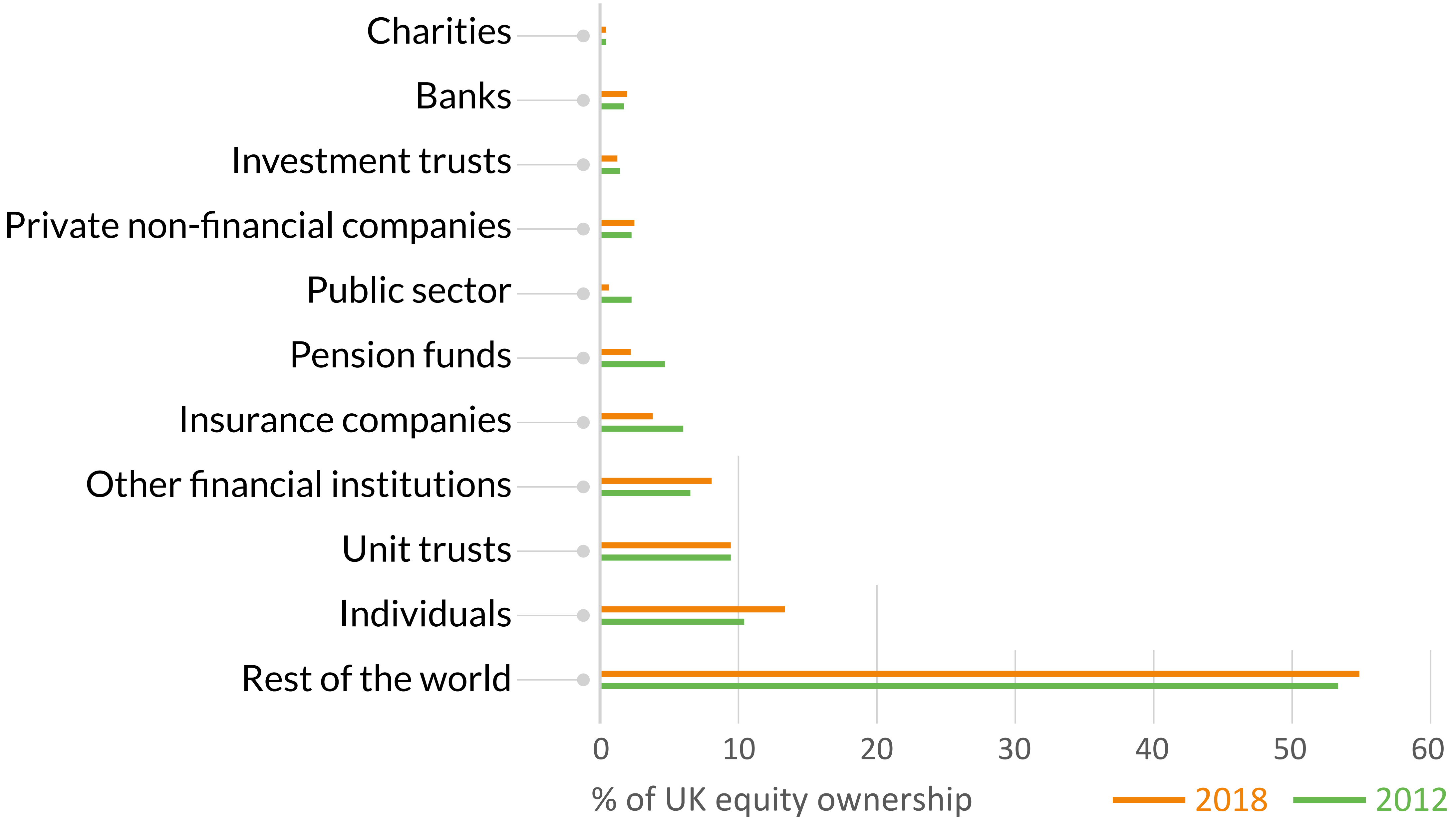
To access as much capital as possible, it is vital to have a map of the territory being searched. Yet comparing the equity landscape across European countries and the US is challenging. The data sources are compiled with different lag times, actual beneficial ownership is masked by nominee accounts and there is no like-for-like standard across these two territories. To provide a picture of equity ownership, we focus on the UK and draw some comparisons to European and US data.

The map of stock ownership in the UK

The latest release of data from the UK's Office for National Statistics (ONS) shows ownership for the year 2018 (see Exhibit 2) and covers incorporated companies listed on the London Stock Exchange.

In terms of making sense of what this means for capital raising activities ahead of the potential chasm, there are several trends to note. Three segments are on the up proportionately, while two are in decline.

Exhibit 8: Ownership of London-listed stocks, 2018



Source: UK's Office for National Statistics

It is vital to have a map of the territory being searched

MAPPING OUT SOURCES OF EQUITY CAPITAL

London is a deeply international market:

There is a significant and increasing flow into UK stocks from international investors, both institutional and retail. ONS data has international ownership at 54.9%, with the US and Canada accounting for about half of this. There is a general consensus that UK stock prices, held back by concerns over Brexit, have looked increasingly attractive from overseas. While the ownership is skewed towards larger stocks – with international holders of the FTSE 100 at 57.1% – AIM and the non-FTSE 100 Main board also have c 48% of their stock held overseas.

Retail investors matter:

UK-based retail investors account for 13.5% ownership. This has also been growing, up from 10.6% in 2013, with platforms such as Hargreaves Lansdown, AJ Bell and Interactive Investor reporting growth in account openings and inactive accounts reactivating. Retail investors are more active in SMIDs, and hold 25% of AIM, c 20% of non-FTSE 100 stocks on the Main board and yet only 11.3% of the FTSE 100.

However, UK retail is underweight to other markets. The average for Europe (including the UK) is 15.6%, the ASX reported 31% retail ownership in 2017 with growth in younger investors in particular, while the US has individuals owning 37.6%. The pattern of shifting away from financial brands to self-investing since the financial crisis is thought to be one driver of the growth. The growth in retail participation during the COVID-19 crisis is expected to grow this share further globally.

Institutions are persistent and rather consistent:

Institutional ownership, an aggregate of unit trusts, investment trusts and others, accounts for 19.1% of overall ownership, up just 1.3% from 2012, and shows no particular skew for large-cap or SMID equities.

What is notable for the small- and mid-cap sector in the UK is concentration. Citywire data has a total of 425 UK equity funds, with 323 fund managers. For small-caps, there are 52 funds and 63 managers and for mid-caps there are 17 funds with 18 managers. Mergers (Premier and Miton) and closures (Woodford) are expected to lead to further concentration. By contrast, in the US mutualfund.com reports on 521 US small-cap funds and 393 US mid-cap funds.

UK retail is underweight to other markets

MAPPING OUT SOURCES OF EQUITY CAPITAL

Pension funds' shareholdings are dwindling:

UK pension funds have been reducing their exposure to UK equities, with their share falling to 2.4% in 2018, down from 4.7% in 2012. Pension funds look to match assets to liabilities and, as the baby boomer generation starts to retire, there has been a switch from equities to bonds.

Insurance companies are withdrawing:

Insurers have also been reducing their exposure to UK equities. Their peak equity ownership was in 1997, when they accounted for 23.6%. By 2018, their share of overall ownership was at 4.0%, down from 6.2% in 2012. Changes in the insurance company solvency regime have put equities at a disadvantage; they have to take a 39% charge to own shares in listed equities, while they only take a 15% charge for debt instruments and no charge for treasury bonds issued by eurozone member states.

The map of stock ownership in the US

The US equities market is, by some margin, the largest in the world, accounting for c 40% of total world market capitalisation. With this scale comes a culture of owning equities; over 50% of US households own equities and there is a rich ecosystem servicing the market. And it is important for SMIDs to bear in mind that US investors are increasingly looking to diversify from the home market. Today c $9tn of their holdings are in non-US equities, with the 12% UK share a disproportionately large percentage relative to GDP.

These are the key US trends to note:

Dominance from longevity and scale:

The US has 45% of the $46.7tn global regulated funds market, according to the International Investment Funds Association 2019 yearbook. Mutual funds have been available since the 1920s and the regulatory framework in place since 1933. Funds growth has also been stimulated by 401(k) plans, a wide and available pool of funds (eg ETFs) alongside stock market growth and dividend reinvestment.

The long tail of capital pools continues to grow:

While the US represents an unparalleled breadth and depth of overseas capital opportunity for UK and European stocks, it does not follow that it is easy to access. The market operates across a large, ever-changing and highly fragmented landscape, which is complex to map and difficult to reach en masse.

Changes in the insurance company solvency regime have put equities at a disadvantage

MAPPING OUT SOURCES OF EQUITY CAPITAL

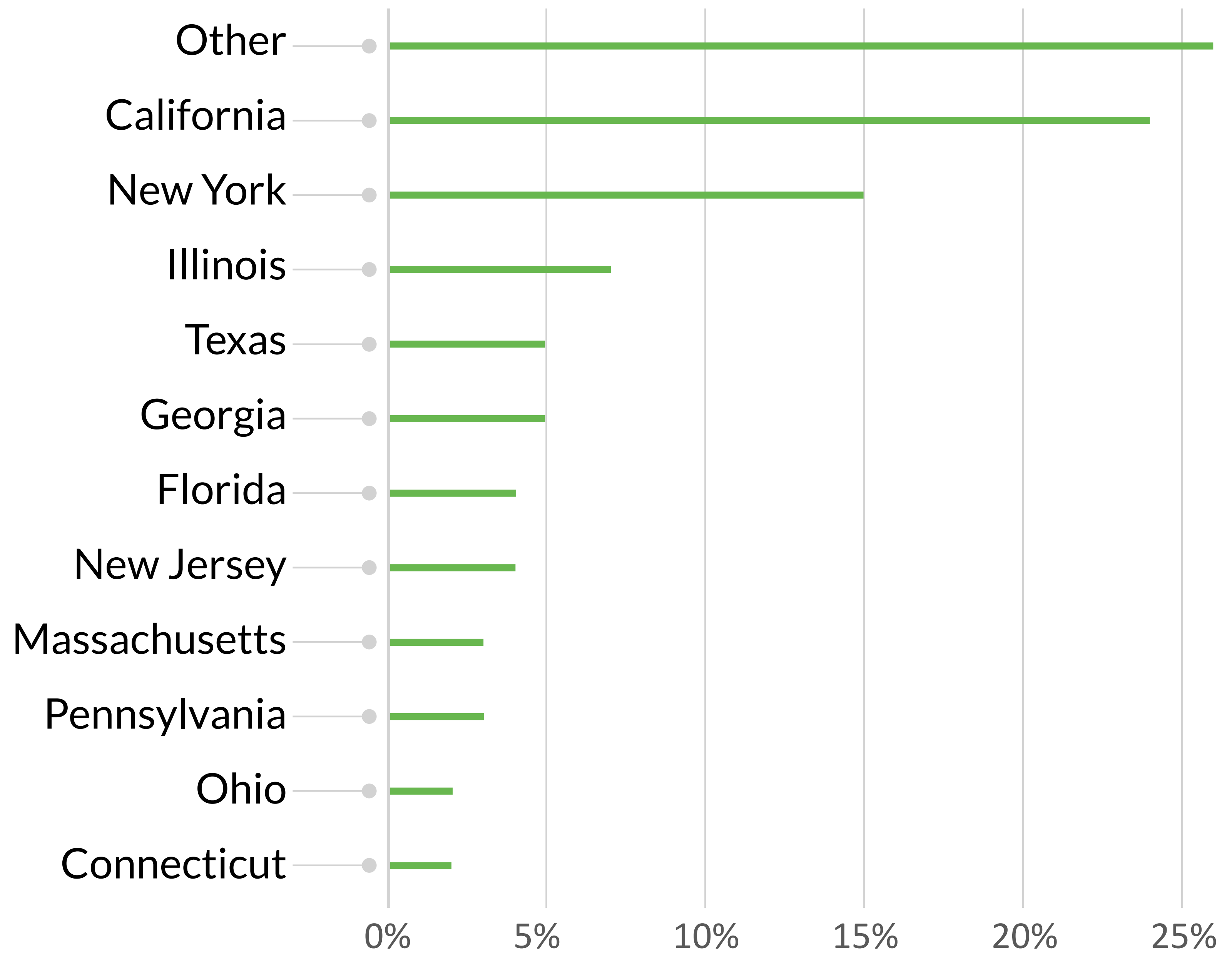
For instance, single family offices are in the ascendency. Campden Wealth reports a 41% increase between 2017 and 2019, with 3,100 offices and an average AUM of $852m. This suggests a total AUM of $2.6tn in the segment, with 38% allocated to equities. Based on data from Barron's, we estimate that the US private wealth managers segment has AUM of c $3tn. In comparison, UK private wealth AUM is c £1.1tn based on 2019 data from Compeer.

The geographical presence of these pools of capital is also more dispersed across the US than is generally realised, as shown in Exhibit 9. And with c 3,700 FINRA registered firms with c 156,000 branches in the US and c 29,500 registered investment advisors, it becomes clear that capital is not only concentrated in the traditional financial centres.

The rise of retail continues:

US retail AUM is significant. SEC Chair Jay Clayton outlined in a speech in 2018 that 43 million US households have a retirement account and 53 million own at least one mutual fund, with regulated advisors having a total AUM of $15.6tn. There has been very active participation in the market by retail investors since markets sold off in February and March. There has been significant account opening at retail brokers (Robin Hood, Schwab, E-Trade, Interactive Brokers, Ameritrade) as retail investors actively participated in buying sold-off stocks in April and May, with 4.5m new accounts opened in the first half of 2020. In a recent interview, Philip Berlinski, COO of Global Equities at Goldman Sachs, made the point that if you examine the baskets of stocks that the retail investors have been buying, most of the activity is in small-cap names.

Exhibit 9: Private wealth breakdown by state

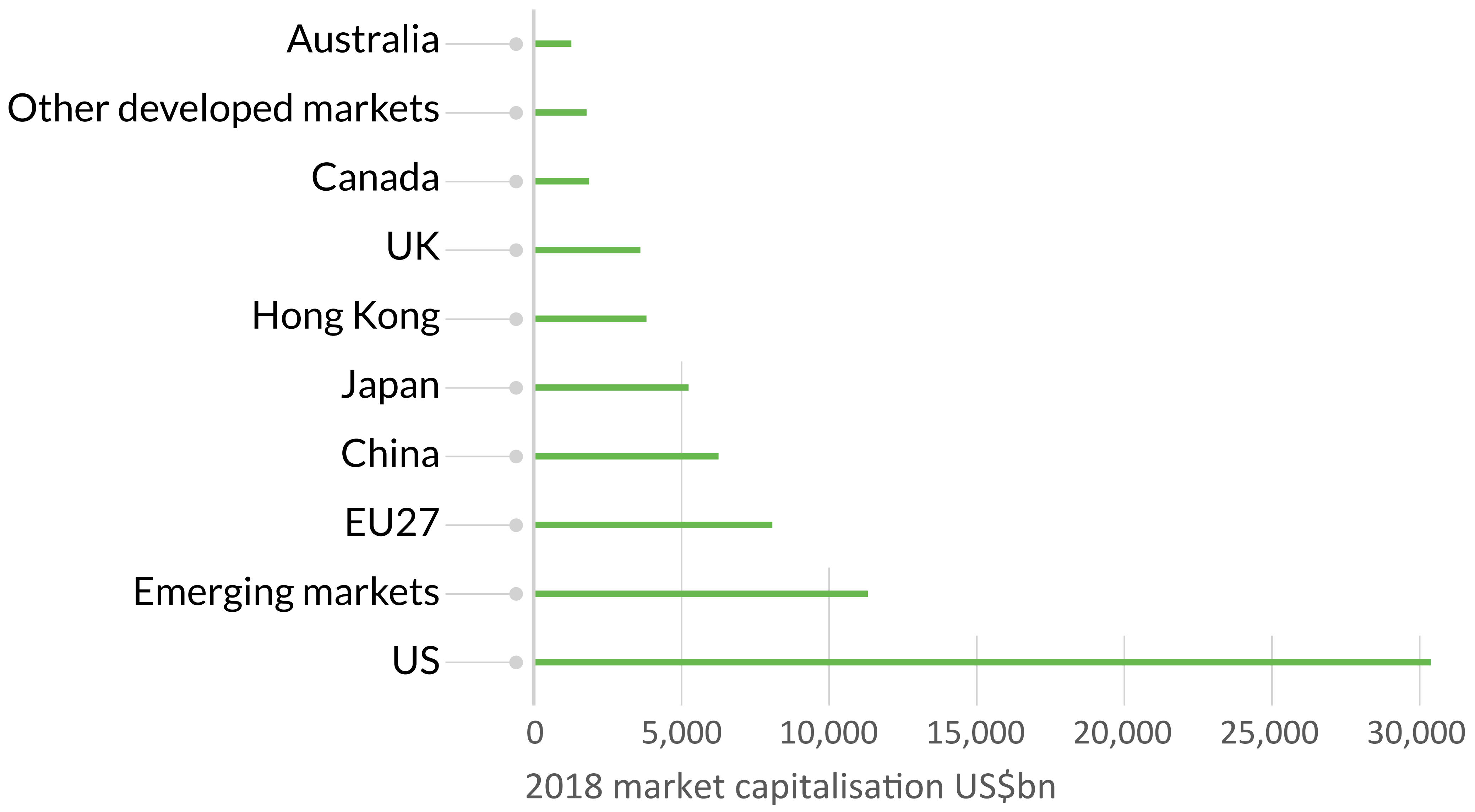


Source: Edison Group

Capital is not only concentrated in the traditional financial centres

MAPPING OUT SOURCES OF EQUITY CAPITAL

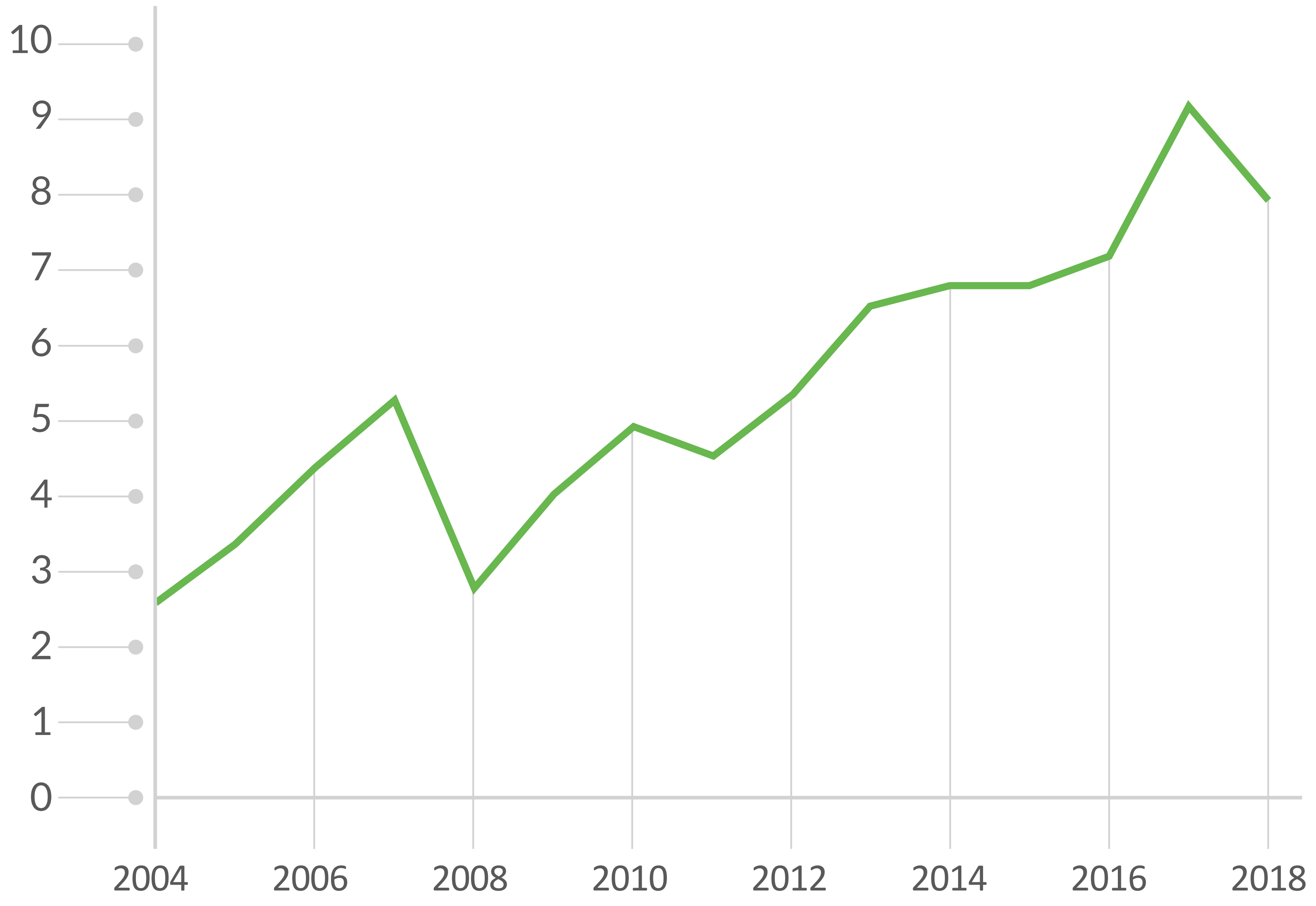
Exhibit 10: US equities dwarf other markets by capitalisation



Source: World Federation of Exchanges

Exhibit 11: The growth in non-US stock ownership

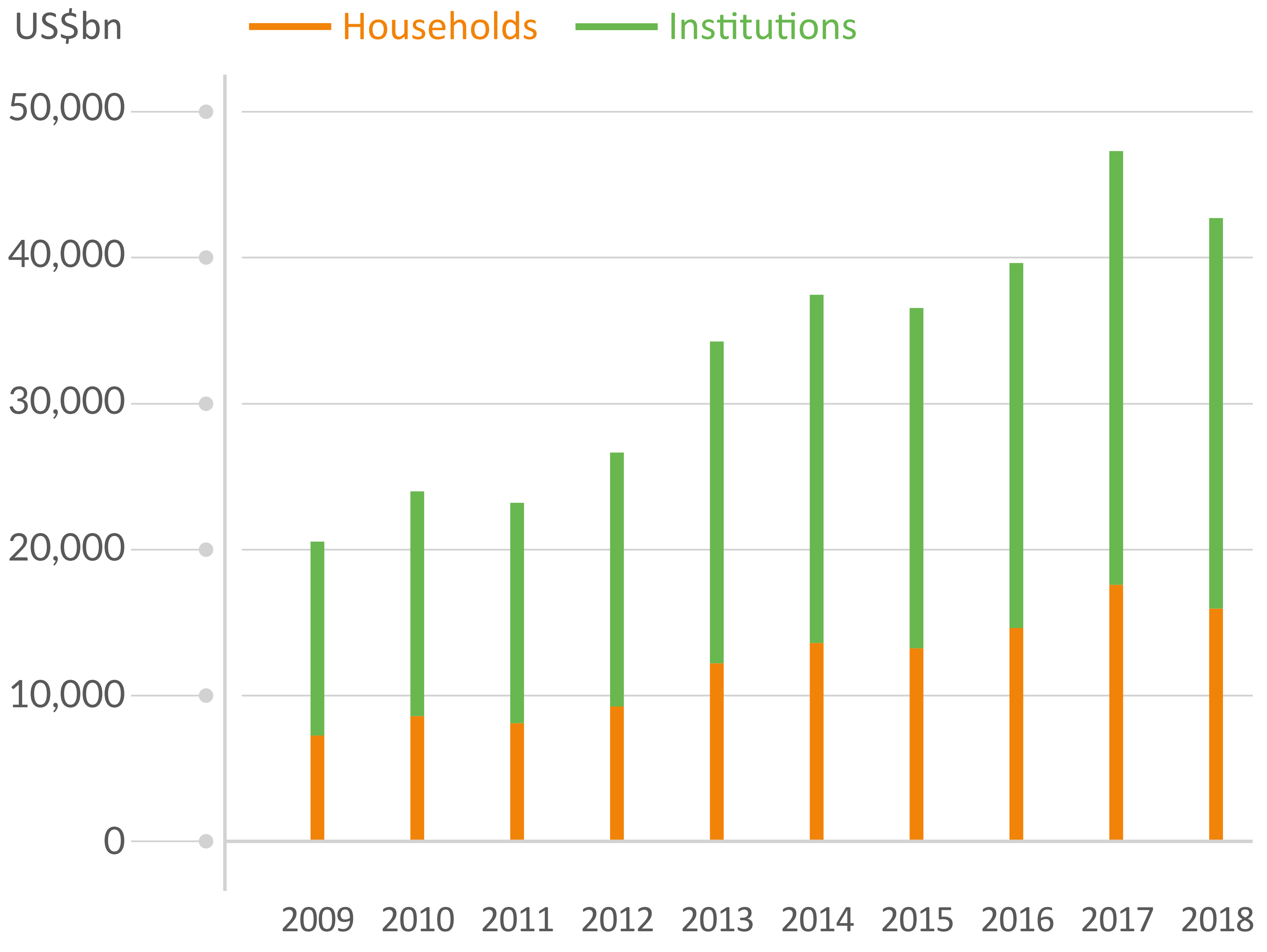
US holdings of foreign equities (US$tn)



Source: Federal Reserve Source of Funds Accounts

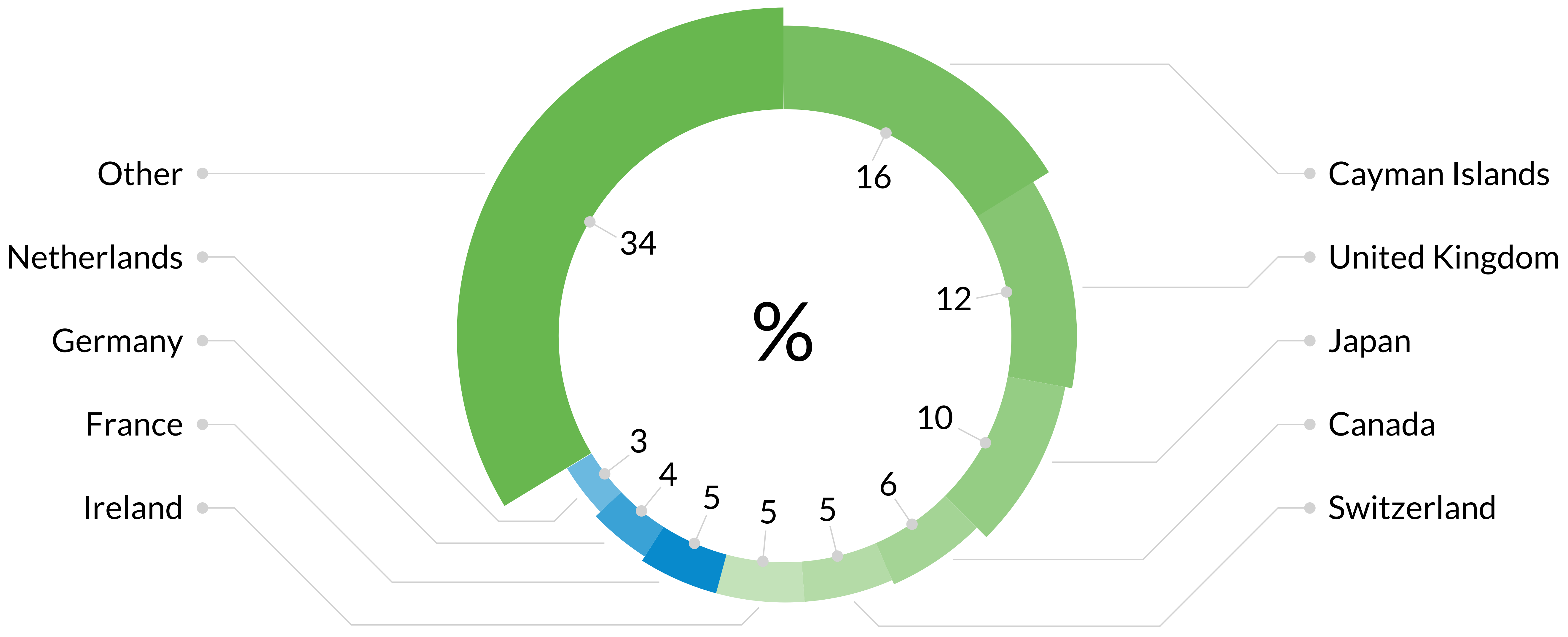
MAPPING OUT SOURCES OF EQUITY CAPITAL

Exhibit 12: Households are one-third of equity participation



Source: Federal Reserve Source of Funds Accounts

Exhibit 13: Foreign ownership by country



Source: US Department of Treasury

USING THE MAP FOR CAPITAL RAISES

Knowing where capital can be found is obviously a distinct advantage. But it is far from sufficient to ensure an optimal capital raise and avoid the impact of the capital chasm.

SMIDs would be well-advised to take other preparatory steps as well. The next primary building block is crafting the right equity story.

To create the most compelling narrative, listed companies must put themselves in the position of the investors they will be courting. What is it they need? What's their motivation to buy any particular equity?

Right now, as the emergence of digital defensives has demonstrated, the baseline need for investors is companies with business models and balance sheets that will emerge strongly from the COVID-19 crisis.

A successful equity story must, therefore, include a clear and confident view of the balance sheet on a pre- and post-money basis. And all financial projections must be supported by credible revenue and cost models that demonstrate how the business will perform in the current environment. Companies should anticipate many questions: What advantages does the business have during the pandemic? What adaptations have been proved to work and will continue to be strengthened? What other changes have yet to be made to produce the projected results? What contingency and mitigation plans are in place if further headwinds are encountered? What are the remaining risk factors?

Many of the investors we talk to – especially those who have participated in recent capital raises – report that successful equity stories are emphasising how the finance will be used to consolidate and improve a business's pricing power. Markets are also proving responsive to the idea that by virtue of the stock becoming larger and more powerful, its liquidity will improve as well. Given that market power and liquidity are two underlying reasons why investors may rush away from SMIDs and towards larger equities, being able to demonstrate these properties may prove particularly critical.

The primary building block is crafting the right equity story

USING THE MAP FOR CAPITAL RAISES

Another trend worth considering is the environmental, social and corporate governance (ESG) narrative. Ahead of the crisis there seemed little doubt that many investors were moving towards ESG methods of investing, not least because the trend was delivering above average rates of return. And as attention moves beyond the sole focus of COVID-19, we expect ESG to re-assert itself forcefully, not least because it is considered a proxy for both resilience and growth potential.

Having created an attractive, credible and deliverable equity story, the next step is to have the work validated. Any stock that is not well covered by traditional brokers – and many SMIDs now suffer this fate – will need to find alternatives. It is needless to say that Edison, as the originator of the issuer-funded research model, is one such alternative.

However, all of this may still prove insufficient. Once validated, the equity story has to reach the right screens. Financial PR certainly has a role to play here but given the scale of the potential investor universe, the extent to which it is scattered and the speed with which the equity story needs to be communicated, investor relations (IR) is the key.

And clearly your IR team needs to be armed with a detailed global capital map, with contacts reaching far beyond large institutions and particularly strong representation in the US, UK and EU. We expect many SMIDs will make the mistake of targeting too narrow a pool of capital.

We expect ESG to re-assert itself forcefully

Ch. 04

POLICY RECOMMENDATIONS AND CONCLUSIONS

Quantitative easing (QE) has inflated asset valuations and dampened price as a signal of underlying value, but has been very effective in acting as a ‘crumple zone’ for the US and UK economies.

However, QE in its present form is likely to be insufficient in preventing the emergence of a capital chasm.

The extension of QE to equity purchases, especially at larger than expected scales, could prove effective.

Changes to regulations, tax incentives and other government policies – especially towards equity capital – should also be used to increase supply.

QE HAS PROVEN EFFECTIVE SO FAR

Before we consider further policy recommendations, it is important to acknowledge that the fiscal response of most central banks and many governments has been sufficient so far. When looked at in the broadest of terms, it is clear that quantitative easing (QE) has been effective in keeping the capital taps turned on.

It is also true to say that QE has inflated asset valuations and dampened price as a signal of underlying value to investors – with implications that are only now starting to play out. However, given the scale of economic collapse triggered by the pandemic and lockdowns, these side effects are entirely preferable to the malaise.

The US has led the world with its entirely emphatic response, convincing general consensus that enough has been done to avoid domestic deflation. In the process, federal debt is now set to exceed 100% of GDP and the Federal Reserve (Fed) has increased its total assets to $7tn, up by $3tn since the start of 2020.

The Fed has also added corporate bonds to its stock of asset purchases – maxing out at 10% from a single issuer and 20% of ETFs with a broad portfolio – and is focusing heavily on forward guidance. It has indicated that it is willing to tolerate inflation moving above its 2% target and has created expectations that close-to-zero interest rates will persist for five years.

Others have followed this lead so that, across most major economies including the UK, US and EU, we expect continued support and relatively stable implementation of the policies already set out.

In the UK, as of August 2020, the Bank of England's (BoE) asset purchase target was at a smidge below £750bn, with interest rates being held at a record low of 0.1%. The British picture is perhaps tinged with slightly more risk than the US – the level of enthusiasm on the part of policymakers for QE, despite the UK economy sustaining more damage than most, appears lower than that of the US – and the EU, with its joint €750bn borrowing plan on top of national schemes.

Given the BoE is allowing its asset buying programme to undershoot targets by £50bn, many are hoping that an additional £100bn – which some commentators expect to arrive in the autumn – is indeed forthcoming.

QE has inflated asset valuations and dampened price signal

CH. 04: POLICY RECOMMENDATIONS AND CONCLUSIONS

WHY DOES MORE NEED TO BE DONE?

However, quibbles on numbers aside, governments and central banks are turning a potentially desperate situation for SMIDs into a far less negative environment, which begs two questions: (i) why is there still significant risk of a capital chasm emerging; and (ii) what should policymakers be doing to prevent it?

Firstly, we must acknowledge that the underlying reasons for stock market volatility, while having been kept at bay in Q220, will remain present in the system for at least another 18–24 months. We are not out of the woods yet and any loss of focus is likely to prove calamitous.

Given their experience in handling the global financial crisis (GFC), central banks are not the concern here. Governments and politicians, however, might not be as literate, patient or resilient in the face of popular opinion.

The serious systemic risks the global economy now faces are of even greater concern. The current response to the pandemic might well have used a significant proportion of our economic 'crumple zones'. Hit by an unstoppable economic force, a vast increase in government spending, mostly paid for by QE, has taken the brunt of the impact and shielded many people. The economy is badly shaken but a full recovery, albeit with scars and (hopefully mostly positive) behavioural differences is on the horizon within three to five years.

However, the ceteris paribus ('all other things being equal') assumption of economics has perhaps rarely been more pertinent. The scale of the downside risk of a further disturbance hitting the system could scrub off another significant percentage of the global economy and mean far greater human misery. QE is subject to diminishing returns and there can be little doubt, given the performance of global stock markets, that we have already ridden the most impactful part of its curve.

If we therefore conclude that the economic crumple zones of QE are nearing their capacity, a subsequent shock – or directly related aftershock – would be felt more directly and can be expected to generate disproportionate levels of misery without other policy responses. And in this scenario, it seems highly likely that SMIDs will be far more vulnerable than larger-cap stocks.

No matter how much ability QE has in reserve, it will be less effective for SMIDs.

Any loss of focus is likely to prove calamitous

SMIDS NEED MORE THAN QE ALONE

Current US experience is very instructive here. There is no doubt that the Fed has targeted smaller- and mid-cap stocks, releasing up to $2.3tn of loans to the cohort as well as buying high-yield bonds, collateralised loans and mortgage-backed securities.

However, the gap between the capital raising potential of large- and smaller-cap stocks continues to widen. Work by the Bank for International Settlements notes that while QE has improved larger corporate access to the bond market, smaller companies are being pushed out, with Bloomberg estimating that 78% of dollar bond issuers have revenues above $1bn pa.

This alone is concerning and creates significant risk of a capital chasm emerging and, if persistent over time, it may also lead to further polarisation of the stock market – and potentially many economic sectors – creating stronger bias towards the very largest companies.

In addition, the immediate risk of a chasm is also magnified by all capital belonging to a single ecosystem, as well as being separated into discrete markets. If investors take fright on news that SMIDs are effectively locked out of a particular capital market, in this instance bonds, stock prices may be hit. Once valuations are lower, bank capital becomes more expensive and difficult to access, and this in turn affects the pricing and availability of capital via bonds and securities.

Given the current economic environment and pause in the supply of PE capital, the emergence of a downward spiral fuelled by its own feedback loop is not an exaggerated expression of risk. And while we outline one such scenario above, there are a multitude of potential triggers leading to the same place. With the markets spooked, the economic recovery only just beginning and the possibility of more global-scale bad news from COVID or another source far from inconceivable, the opening of a capital chasm remains a very real risk for which policy planning – above and beyond current measures – is required.

> The chasm risk is amplified by all capital belonging to a single ecosystem

EXTENDING THE REACH AND EFFECTIVENESS OF QE

So where to turn?

Extending QE to buying equities is not without its issues, not least in muddying governance structures. But we believe it is likely to arrive before the crisis has burned itself out, not least because it is being openly discussed in the US, and other central banks would undoubtedly follow the Fed's lead. It seems like just one more unthinkable policy in the process of becoming economic orthodoxy.

To this end, the Bank of Japan has pioneered many measures which policymakers are now doubtless studying in great detail. We believe that body of evidence points to the fact that QE's future focus on SMID stocks will need to be magnified if it is to be capable of heading off a capital chasm.

It is on this basis that Peter Harrison's suggestion, namely that the UK government creates a £20–30bn patient capital fund to allow companies to maintain investment plans and protect jobs, seem eminently sensible.

While we might find the numbers indicated by the CEO of Schroders to be at the low end of what is eventually required, especially for any implementation in the US, starting national patient capital funds at larger than expected scales might ultimately reduce their total capital requirements over time. A strong start might well convince the markets that governments are serious in their commitment to the provision of equity capital to SMIDs, thus reducing the risk of under-supply from elsewhere in the capital ecosystem.

When considering the optimal initial scale, it is worth bearing in mind that the Japanese experiments might have grown very large but are generally considered to have started too timidly to have made the deepest possible impact. Subsequent policymakers will no doubt be sensible to these issues.

Other benefits include the very real possibility of the fund returning more money to the taxpayer, over the long term, than was initially invested. It is hoped this helps lower any remaining political barriers to the concept.

Patient capital funds at larger than expected scales might ultimately reduce their total requirements

REBALANCING CAPITAL MARKETS

However, more capital from central banks is not the only potential solution. In mature economies, especially in a low-yield environment, we may expect there to be large pools of capital open to flowing around the ecosystem from one market to another – in response to a rebalancing of relative risk-return profiles. If carefully constructed, such a rebalancing could reduce the risk of a capital chasm emerging without requiring the creation of yet more capital.

It is important to note that the current capital ecosystem is already – and quite correctly – distinctly skewed by regulations, tax incentives and other government policy. The potential to make meaningful change is therefore real. Perhaps the most significant change would be to incentivise the provision of equity capital to SMIDs. While loans and bonds are fine and necessary capital instruments, they also lead to interest accumulation and ultimately need to be repaid, potentially with further refinancing.

Faced with many years of economic recovery, this is unlikely to be optimal. Many viable companies, their existing shareholders and indeed our entire economies, may be better served with a shift towards equity capital – investment which comes without the need for repayment.

Tax regimes that currently favour loan capital should therefore be ripe for becoming less favourable. Incentives and tax breaks for the provision of new equity capital – either at IPO or for subsequent raises – should also be considered ripe for improvement.

To level the environment for SMIDs, rather than further fuel demand for larger-cap issuances and exacerbate the risk of a capital chasm, these incentives will need to be tapered. Fresh equity capital injected into micro-cap stock would almost certainly be worthy of the greatest advantages. Perhaps mega-cap investments would not attract any relief at all. There certainly needs to be a sliding scale of support between the two ends of the spectrum.

Tax benefits might also be conditional or proportional to the period over which the newly released equity is held, ensuring that investors cannot turn the intention of creating a patient capital scheme into one which delivers a fast buck.

Furthermore, we suggest that both these scales should remain flexible so they can be carefully calibrated on an ongoing basis to respond to changes in the capital ecosystem – pandemic economics are expected to continue delivering surprises.

> Tax regimes favouring loan capital should become less favourable

NOT JUST WHAT, BUT TO WHOM

Key in the success of such a policy will be the pools of capital to which the relief applies. In the US, it might be expected that the significant Robin Hood effect would make the retail market a rapid and highly effective mechanic. Fuelling another retail boom also has the economic and political benefit of focusing immediate optimism and future financial gains towards individual consumers.

However, a stampede of private investors into micro-caps might overshoot, producing significant volatility and other unintended consequences – within the wider economy as well as the capital ecosystem – and thus bring with it the potential of reversing, neutralising, or at least dampening the initial benefits. It is therefore recommended that all pools of capital are treated with reasonable even-handedness. The growing long tail of US family offices, along with institutions of all hues, should not be excluded.

In the UK, a rebalancing of capital markets also provides an opportunity for large pools of capital to regain their appetite for equities. As noted in Chapter 3, pension funds are retreating into bonds to properly serve their ageing demographic. A rebalancing of incentives would likely rekindle and lengthen their interest in equities without increasing risk. Potential also exists for insurance companies to allocate a higher percentage of capital to equity investments.

A stampede of private investors into micro-caps might overshoot

OTHER POLICIES TO CONSIDER

As capital markets are an ecosystem, the potential for rebalancing does not just apply to equities. SMIDs will also feel the benefits if other markets become cheaper and easier to access. A general improvement in the terms on which SMIDs can access any form of capital, with the greatest emphasis on equity markets, is perhaps the optimal approach.

Yet every policy must recognise that corporates remain reliant on bank financing and that the PE and VC industries need thriving equity markets to function as exit routes.

Longer term, the European IPO Task Force makes a number of recommendations in its 2020 report on how to achieve more efficient equity markets, much of which would further de-risk the potential for a capital chasm.

At Edison, we support simplifying regulatory requirements, fostering a retail equity culture, making IPOs accessible to individuals, improving tax incentives for IPOs and promoting the provision of equity research on SMEs.

Edison supports simplifying regulatory requirements

REACH OUT

If you'd like to find out how Edison can help you:

Neil Shah
Managing Director
of Content

NShah@edisongroup.com

Rachel Carroll
President, Managing Partner
Edison Atlantic

Rachel.Carroll@edisongroup.com

London
+44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York
+1 646 653 7026
1185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Frankfurt
+49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

Sydney
+61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia

GENERAL DISCLAIMER AND COPYRIGHT

This report has been prepared and issued by Edison. Edison Investment Research standard fees are £49,500 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

AUSTRALIA

AUSTRALIA

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

GENERAL DISCLAIMER AND COPYRIGHT

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.