AIM for growth businesses looking to scale up is still an option

29 APR 2019

AIM used to be the first port of call for growth companies looking to fund raise. To be so again it needs to attract institutional interest and improve transparency and governance, argues Ivan Sedgwick of LGB & Co

Ivan Sedgewick: AIM needs to regain investor confidence to return to growth

The Financial Crisis significantly altered the landscape for SMEs seeking growth funding. Where once the banks and the AIM market were the primary source of capital for growth companies, newer and more innovative funding options have emerged in the past decade.

Twenty four years on, AIM is focused not simply on early stage businesses looking to scale but established companies, which attract inheritance tax exemption. This subverts AIM's original purpose. Engagement by institutional investors with smaller AIM companies has reduced, affecting liquidity and reducing its attraction to growth businesses.

For AIM to retain or regain its premier position, it needs to attract institutional interest, and improve transparency and governance.

New challengers to AIM for growth

Before the Financial Crisis the primary fundraising route for growth companies was to list on AIM, which at its peak in 2005 saw 387 company listings. Starting in 1995, over 3,600 companies have listed on the market, including some great success stories. But since the 2008 crisis, the lack of bank funding and unstable equity markets has led to the rise of alternative sources of growth funding, particularly private equity (PE), challenger banks, family offices, P2P lending and crowdfunding. There was only one AIM IPO in Q1 this year.

The PE firms, who were in the UK more or less entirely focussed on buyouts, have followed their US peers – or parents – and set up venture and debt funds. Meanwhile, the current economic climate presents challenges for growth companies seeking scale-up funding with Brexit related political uncertainty and the Europe-wide economic slowdown the chief concerns. Funding from the European Investment Bank (EIB) – the lending arm of the EU – to UK growth companies has fallen by over two-thirds and the UK has now been overtaken by France, Germany, Italy and the Netherlands, as the EIB transitions away.

Big banks which slashed SME lending in the crisis also remain in practice reluctant to lend. Part of this is due to the dismantling of the infrastructure of the banks' own branch networks and the deskilling of their staff on the ground. The explosion of loan brokers, whose trade association now has 1600 finance broker members, very often staffed by ex-high street bank employees, is a symptom of this dislocation.

What options on the private market?

Venture capital (VC) is awash with cash but offers finance under the toughest conditions, which business owners very often find restrictive. Venture funders look for board influence or control, preferential rights in future capital raisings, preferential rights to the disposals, and have a track record of leveraging companies in ways that can engineer a change of control. The structure of PE firms' funds – which generally have a five year target life with a two year extension – drives them to seek exits in that time-frame, whether or not that is optimal for the business. They invest in companies that have usually achieved a certain scale. And they are unsentimental about removing founders. Though it can't be denied that that is sometimes the best thing for the business. It does however make them uncomfortable investors. And for many VCs it is simply not worth making the smaller investments that companies need to scale up. One scale-up venture team told us that they were not interested in less than £25m raises.

Debt avoids dilution to founders. Founders tend to start with unrealistic assumptions about how soon and how much they can raise, but in combination with appropriate levels of equity funding it can make sense. The challenger banks are more inclined to lend than the high street banks but remain small, and there are as yet no dedicated SME challengers.

Some other forms of funding such as invoice discounting and factoring are well established. Others are more innovative, or have come from large company finance. For example, secured medium loan note programmes, which we arrange for our corporate clients, present growth companies with an option to maintain their independence without having to give up equity in the business and at the same time provide them with the funds they need to grow.

Peer2Peer lending and crowdfunding platforms are still in their infancy and growth companies will, in most instances, not be able to raise enough funds to match their ambitions. The companies that attract a following tend to have particular public profiles – craft brewers, for example, have been successful in using them. And they seem to be focused on seed rather than scale-up rounds.

AIM still probably the best for scale ups

Beyond a certain level AIM remains a vital source of funding for growth companies looking to scale-up and it remains Europe's top destination for fast-growing firms looking to go public. In 2018, it was responsible for 59% of the funding secured by growth companies across European bourses, raising £5.5bn across 398 separate deals. This compares well with £17.7bn for the entire main market in London.

Enterprise Investment Scheme (EIS) tax relief and the creation of VCTs has distorted the market. Scaling up requires investors who are able to provide funding in serial rounds;

there are few companies which complete their funding on one shot. Yet private investors are often locked out of placings, and VCTs cannot keep ammunition for follow-ons. Permanent capital vehicles are more an aspiration than a reality.

But there is no question that AIM needs to regain investor confidence to return to growth. The lack of institutional investors willing to engage with AIM means entire sectors lack sufficient investment and liquidity. There are too many, too small companies, which listed on AIM and found themselves in the “valley of death”, without the profit record to support fund raises. There is a lack of specialist investment skills, for example, in life sciences where a NASDAQ listing is preferred for companies large enough to make the leap.

And there are governance issues. The self-regulation of AIM seems a hangover from another age, and the reluctance of institutions to get involved cannot be helped by the sense that investor protections are not up to main market standards. Research is patchy in its availability: MiFID has forced brokers either to make it publicly available, which many interpret as being available only to institutions, or to charge for it, which excludes private investors entirely. Companies talk about market expectations without those expectations being, in fact, available to the market. There is, therefore, too much reliance by private investors on unpoliced chat forums.

So while AIM remains a major part of the financing ecosystem, if less so than formerly, market participants need to think hard how to rebuild trust and primacy.

Ivan Sedgwick is Investment Director at LGB & Co