UK Finance

UK capital markets: the growth escalator

A diverse landscape of UK companies on UK public markets depends on a healthy pipeline of growth companies working towards that goal. The UK needs to strengthen that pipeline.

In strengthening the pipeline of UK growth companies, UK Finance supports:

- A review of government support for early-stage business finance to expand its scope and remove the potential funding “cliff edge” for firms on a growth trajectory.
- Measures such as the Mansion House Compact designed to help ensure that the shift to Defined Contribution pensions in the UK sees a boost to both listed and unlisted companies.
- Expanding Enterprise Management Incentives to help widen their scope to give all staff a stake in a company through a period of expansion.
- Ongoing review of the UK’s admission, disclosure and corporate governance requirements to ensure they are proportionate for UK companies accessing public markets.
- Measures to ease the transition to public ownership for smaller companies, including ideas for an intermittent trading venue.

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The backbone of UK capital markets must be a steady flow of companies up the growth escalator. Today's challenges on that growth escalator are a warning of wider weaknesses tomorrow.

The fundamental purpose of a capital market is to connect investors with companies and governments seeking funding. Capital markets are effectively a group of linked markets:

- Primary public markets - where companies raise new finance by issuing shares or debt to the public;
- Secondary public markets - where the shares and debt of companies can be bought and sold;
- Private markets - where professional investors, such as private equity investors, provide financing to private companies either in the form of an equity investment or debt.

Companies will access these markets at different stages, depending on their growth and development. One way to think about this is as an escalator on which companies ascend as they grow (see Fig 1). A company that develops in its early stages with, for example, angel funding, venture capital or private equity support may eventually become a 'publicly traded company' and seek further funding by issuing shares to the public.

Not every company needs, or will use, this escalator in the same way. Effective capital markets should be able to support a company's funding requirements as and when such support is required. As such, the effectiveness of a capital market can be measured by how well a growing company can access and ascend the steps on the escalator.

The final step of the escalator is participation in public markets via an initial public offering (IPO). 'Going public' is an important step for companies and enables them to access a wide variety of investors who can buy and sell their shares. This ability to buy and sell when required – also known as liquidity - is an important part of what attracts companies to join public markets.

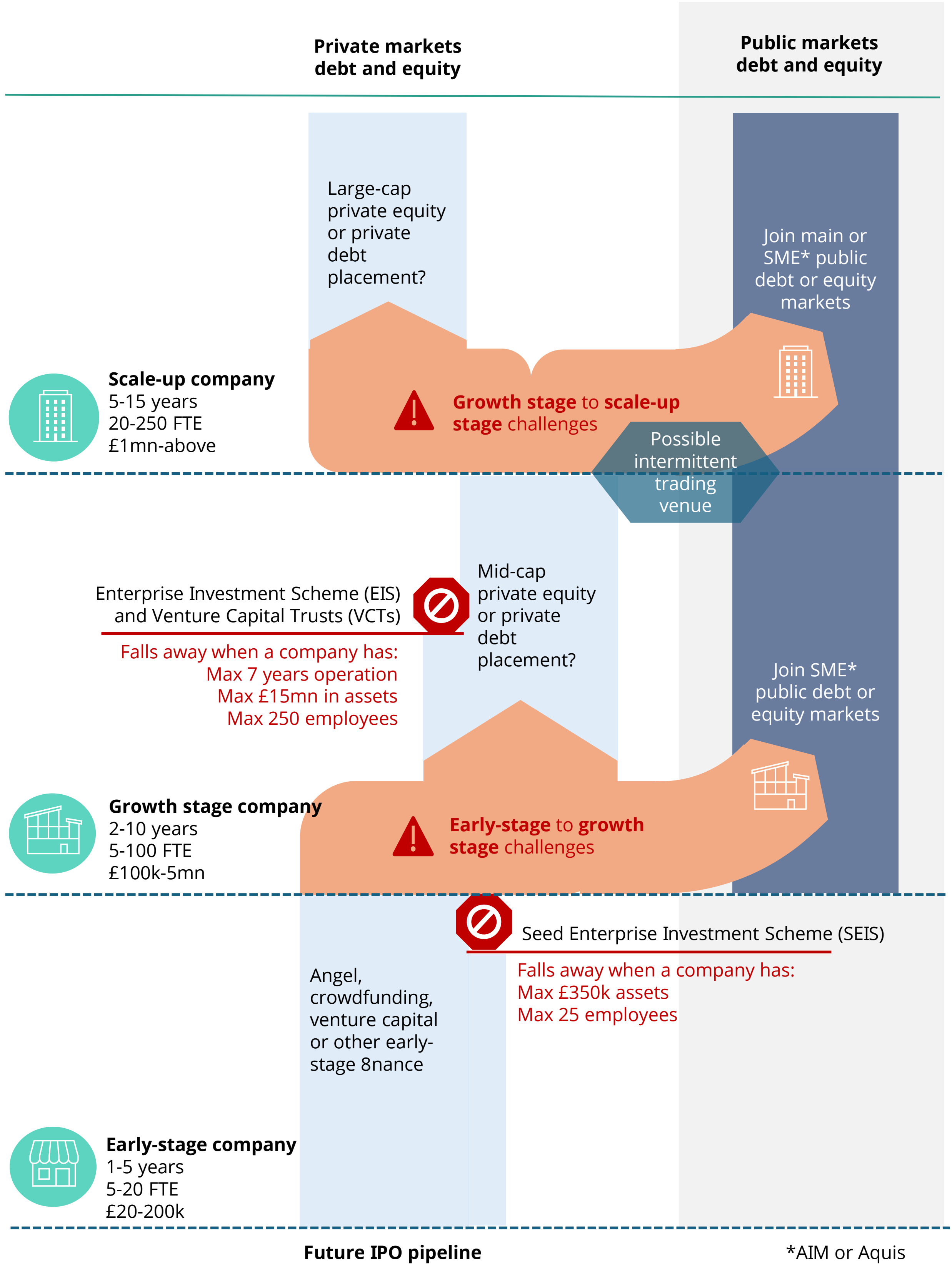
The success of public markets is ultimately dependent on the steps of the growth escalator that lead to them. A strong pipeline of private companies is needed today to create the large and successful public UK companies contributing to the employment, innovation and growth of tomorrow. Different steps on the growth escalator come with their own governance requirements, expectations on business' and their management and regulation. Moving one step to the next is often one of the biggest challenges in a business' life. For that reason, an holistic view of UK capital markets must consider not just each part of our markets but the important transition between them.

In that respect, the UK's growth escalator is not working as effectively as it could. In recent years, some of the most important steps on the growth escalator have become

The UK capital markets growth escalator

Fig 1: The UK capital markets are a growth escalator that take a company from establishment to scale. Each step of that escalator depends on the preceding steps.

Making the journey up that escalator for UK companies as simple as possible is key.
Note: company stage indicators are indicative only.



The challenge with this early stage of company growth in the UK is often the way that these early supports at start-up can fall away suddenly as a company grows or simply with time. This cut-off in support may be one factor in the UK's five-year company failure rate.

more dependent on overseas capital.[1] This can influence the trajectory of UK companies as they grow, including their future choice of public market or the location of their operations. The UK needs to develop and deploy its own capital to complement this international finance. Improving UK 'competitiveness' means ensuring UK-based companies can access growth finance from UK-based investors when they need it. It has also been increasingly recognised that the jumps between key steps on the growth escalator need close attention.

First steps on the growth escalator: start-ups and early-stage investment

The first steps on the growth escalator will generally be forms of finance targeted at start-ups and young companies. A mix of venture capital, angel finance and crowdfunding have helped produce a relatively healthy start-up ecosystem in the UK. The UK has company-creation rates higher than any other jurisdiction in Europe, although it lags the US and Canada.[2] This is true across many sectors, including tech, where the UK accounted for a quarter of all European start-ups in 2022. The UK is also a major European host of unicorns, with 104 in 2022, almost twice that of Germany and three times that of France.[3]

This is also an area where government plays an important role in making investing in early stage companies more attractive. For example, the Enterprise Investment Scheme (EIS), Seed Investment Scheme (SEIS) and Social Investment Tax Relief Scheme (SITR) all provide tax incentives for investors in UK-based early-stage companies. Venture Capital Trusts (VCTs) are investment companies that invest in, or lend to, unlisted companies. Helpfully, in 2023 the UK government extended sunset clauses for the EIS and VCT schemes from 6 April 2025 to 6 April 2035.

However, despite their extension, some challenges remain. One is the way in which these supports are cut off at defined thresholds of size and time, often long before options such as private equity investment or joining public markets are feasible. This can create a cliff edge for both investors and companies (see Fig 1). UK five-year business survival rates have hovered around 40% for the last decade, a full ten percentage points lower than in the US, where considerably deeper capital cushions for early-stage companies are available (see Fig 2).[4] The aim should not be to keep

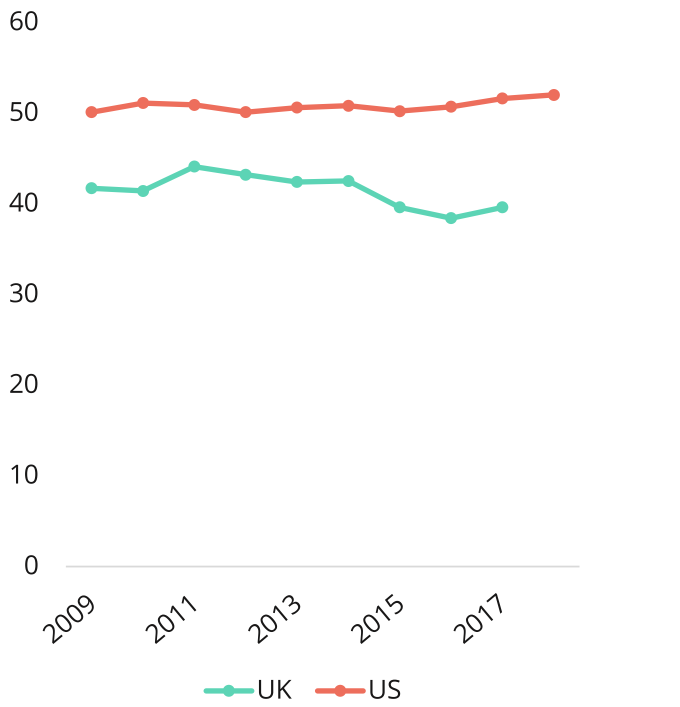
1 See our first briefing in this series for more on the changing composition of UK secondary markets and our second briefing for more on changes to the number of companies listing in the UK over the last decade.
2 See Global Entrepreneurship Monitor 2023 p53.
3 A unicorn is a privately-held company with a valuation over $1bn. See the Atomico State of European Tech 2023 Report p121.
4 One credible estimate of the relative levels of funding provided to US and UK start-ups at Rounds A-C between 2017 and 2022 placed it

unviable companies artificially alive, but to ensure that viable companies do not fail due to a lack of capital in this vital growth stage.

In that context, government and industry will need to consider how well current schemes support the challenges faced by growth companies. For example:

- Business supports (such as EIS/SEIS) could be expanded to include regulated fintech businesses - a sector in which the UK has a strong advantage and where new technology solutions often have strong potential for scaling and growth.
- Government-backed support through this phase could be redesigned to present less of a cliff edge for companies, providing a more tailored approach and phasing out company support rather than having it cease completely at fixed thresholds. This would help companies transition from this early-stage support to other forms of growth finance. The British Private Equity & Venture Capital Association (BVCA) notes that restrictions on support for companies over seven years old can be an issue for companies outside of London and the South East where the funding landscape can be more disjointed.[5]
- Enterprise Management Incentives (EMIs) should also be expanded. EMIs allow growing companies to extend the benefits of equity ownership to employees in a way that can inject both capital and commitment at a key time in a company's life.

Fig 2: The failure rate for UK start-ups at 5 years is 20% higher than for their US counterparts.
% 5-year survivals for business launched in year.



UK ONS, US Department of Labor

While most UK firms that choose to participate in public markets choose to do so in the UK, there is no question that competition from overseas venues is increasing. For this reason, the government should also consider ways in which an expanded set of taxpayer-funded supports for early-stage growth companies involve a two-way commitment and would become repayable in part or full if a recipient ultimately chooses to list, or move valuable operations, outside the UK. Where a UK company chooses to join public markets or locate is a choice for the company. However, there is a strong case for linking taxpayer supports to future commitments to using UK public markets and operating in the UK.

at a ratio of 2.4:1. See UK Finance, Building on Strong Foundations, 2023 p16.
5 BVCA written evidence to UK Parliament, September 2023 p5.

The UK's capital markets perform a variety of roles across the life cycle of a company. When these markets work well, they act as an escalator that take UK companies from establishment to scale to global success.

Later steps on the growth escalator: scale-ups and public markets

Once a company is well established, the next step on the escalator will often be to seek funding to scale it up. At this step on the growth escalator the UK's ecosystem for early-stage investment is complemented by an active landscape of private investors.

A key part of this picture is private equity. While private equity may not work for all companies, for many it is an important source of growth capital.[6] A challenge in the UK is the relatively limited number of domestic private equity funds able to lead on investments over £50mn, which will often be the required level for high growth companies in science and technology.

The BVCA notes that while UK funds dominate financing for smaller companies in the UK, over half of the Series B growth rounds in UK science and technology companies that raised more than £35mn in 2020-2021 were led by US funds.[7] This weighting of funding from non-UK investors matters as the investor makeup can heavily influence the company's choice of future listing destination or other strategic choices. While some UK companies have been tempted by US listings for apparent higher initial valuations, this does not necessarily serve a company well in the long term.[8]

The UK will need a range of strategies for ensuring that domestic UK investment is available for UK-based companies. For example, the UK's ambition to unlock greater Defined Contribution (DC) pension fund investment in unlisted companies via private equity funds could deliver benefits in this respect. This is especially the case if it can help strengthen UK funds in making larger investments in the kinds of fast-growing companies that the UK needs to keep rooted domestically.

In that regard, delivery of the 'Mansion House Compact' agreed in July 2023 would see UK DC pension funds allocate 5% of their default funds to unlisted equities by 2030. Creating a supportive framework for the pension industry and private equity providers will help match pension funds to investable companies, at a cost and level of risk acceptable to pension trustees.

Alongside a dynamic private equity sector, the UK's public markets provide routes for general investors to own and share in the success of larger companies. Joining the Alternative Investment Market (AIM) or Aquis markets for smaller companies or

6 The BVCA estimates that its members invested almost £30bn in UK companies in 2022, with almost £150bn available for investment in the next few years.
7 A Series B Round is the second round of financing for a start-up and will often be intended to help begin scaling-up a tested commercial proposition. See BVCA written evidence to UK Parliament, September 2023 p5.
8 See UK Finance, Building on Strong Foundations, 2023 p30.

making the transition to the main London Stock Exchange (LSE) market are pivotal moments in a company's life. Operating thereafter as a public company places new demands and requirements on companies in terms of financial management, regulatory disclosures, non-financial risk and other governance requirements.

Here the UK must address several challenges. One is simply ensuring a coherent and effective regulatory regime for listed companies that is proportionate and reflective of company and investor needs. The first steps into public markets are often the most challenging for growing companies. The unique role of the AIM and Aquis markets in the UK is providing this opportunity for smaller companies, including many high-potential technology companies. Both venues need to be supported in doing this by encouraging UK firms to consider using them and by promoting these markets to high-growth firms outside the UK.

Even with these specialist markets targeting smaller companies, one challenge for companies accessing public capital markets is meeting the necessary disclosure requirements and then sustaining liquidity requirements. Robust disclosure and governance standards are one of the hallmarks of UK capital markets and important for investors. It is nevertheless equally important to ensure that eligibility and continuing obligation requirements[9] remain proportionate to the capabilities of growing companies – the balance has not always been right in the UK. This proportionality test should be one of the prisms through which the UK reforms its listing and public offer rules in 2024 and conducts its ongoing review of UK corporate governance rules.[10]

One of the most important trends in UK capital markets in recent years has been companies spending longer in private ownership and delaying or choosing not to seek public listing. This shows up in the falling number of companies listing on UK markets.[11] For this reason policymakers and regulators have rightly asked if there is more that could be done to extend some of the benefits of public share ownership to companies that would otherwise not be ready or willing to take the full step to an IPO.

One example of such supports is the new Public Offer Platform regime proposed by the UK Financial Conduct Authority (FCA) to provide an alternative to traditional crowdfunding. Another is the Private Intermittent Securities and Capital Exchange System (PISCES) concept proposed by the UK government which would create a unique hybrid market in which private company shares would be available for trading at fixed intervals throughout the year (e.g. monthly), rather than permanently.

This would create an intermediate framework for fundraising that would give investors the confidence of regulated disclosure requirements but at a level more accessible to a smaller company. They would enable private companies to experience what it is like to operate like a publicly-traded company without having to comply with the

9 Continuing obligations are the ongoing rules and requirements that apply to firms joining a public market.
10 See our second briefing in this series for more on listing, disclosure and governance reform in UK capital markets.
11See our second briefing in this series for data on the fall in UK companies choosing to list in the UK.

full range of requirements from day one. An alternative source of liquidity would also enable them to allow existing investors to sell their stakes in a relatively simple way - and bring in new ones. While investors in growing companies need to take a medium to long-term perspective on returns, this liquidity is attractive to investors and will increase the 'investability' of participating companies.

There is also a potential role for securities tokenisation to play across these steps on the growth escalator as the technology and regulatory framework develops.[12] Tokenisation can help make otherwise low-liquidity assets available to a wider pool of investors, including in low-value tranches. This technology could, in time, provide an opportunity to make shares in start-ups, scale-ups and other unlisted equity available to a wider pool of investors, including retail investors. As the UK develops its regime for tokenised securities in the months and years ahead, it should actively explore potential applications to the growth escalator.

Conclusion

Cultivating a healthy pipeline of growth companies in turn ensures a healthy pool of companies joining public markets. UK policy makers, regulatory authorities and industry need to work together to continually assess the way the growth escalator is working at each of its steps. They also need to focus on the critical question of how easy it is to move between those steps. If the UK gets this right, a company pursuing growth outside of the UK should be a choice and not a necessity.

12 See UK Finance Unlocking the power of securities tokenisation 2023.

How can I support this agenda?

- Endorse the review of early-stage investment supports in the UK to widen their scope and smooth out cliff edges for companies seeking growth finance in every part of the UK.
- Support measures to raise the level of UK pension fund investment in unlisted equity, especially where this could boost UK private equity funds in making larger investments in highly innovative growth companies.
- Support the ongoing review of the UK's admission, disclosure and corporate governance requirements to ensure they are proportionate for UK companies accessing public markets for the first time.
- Support the exploration of new approaches to fundraising, admission to public markets and tokenisation in the UK that enable smaller companies to access some of the benefits of wider ownership without the costs and continuing obligations of a full IPO.