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HM Treasury
1 Horse Guards Rd
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Dear Treasury colleagues,

Invest 2035: The UK's Modern Industrial Strategy consultation

We welcome the opportunity to respond to your consultation on Invest 2035: The UK's Modern Industrial Strategy.

The Quoted Companies Alliance *Investor Working Group* and *Primary Markets Expert Group* have examined the proposals and advised on this response from the viewpoint of small and mid-sized quoted companies. A list of Expert Group members can be found in Appendix A.

As the Government develops its Industrial Strategy, it is vital that it fosters the investment environment needed for small and mid-sized quoted companies to access the capital they need to scale-up and grow. It is well understood that for the UK to thrive on the global stage it must focus on certain sectors. But whichever sectors are selected, those companies will all need access to deep, liquid pools of capital in order to fund their ambition, grow and compete. This largely London-based market infrastructure is vital to power growth and prosperity in every region of the UK.

The contribution of small and mid-sized quoted companies to the UK economy is significant. For example, in 2023, companies on AIM provided £68 billion Gross Value Added (GVA) to UK GDP; contributed £5.4 billion in corporation tax, and employed 778,888 people[1]. On average, AIM companies are more productive than the national average at £87,100 GVA per employee (compared to £58,327), and drive sustained growth across a number of metrics after initial public offering (IPO) including 12.7% employee growth and 40.8% operating profit growth five years after IPO[2].

Small and mid-caps are a vital engine of growth for the economy of now, and the future. One-third of listed UK companies with a market value of more than £2bn in 2024 were once a smaller company in the past 20

[1] Grant Thornton. *The Economic Impact of AIM Companies.* (2024). p. 6. Source: https://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/2024/aim-economic-impact-report_final.pdf
[2] Ibid. p.10.

years and subsequently have more than doubled in value in real terms[3]. Therefore, it is essential that there is a clear growth escalator for the UK's small and mid-cap sector of today to ensure they become the large caps of tomorrow.

In our response to this consultation, we focus on Questions 21 to 23. Specifically, we provide information on the factors that influence companies' investment decisions, particularly small and mid-sized quoted companies, alongside the current factors negatively impacting on their ability to raise equity finance, including capital outflows for this market segment and depressed equity valuations. We also highlight areas where tax incentives could be usefully applied to stimulate private capital through different types of investment vehicles including VCTs and a threshold for investments in UK equities as part of the ISA wrapper.

If you would like to discuss our response in more detail, please do not hesitate to contact us.

Yours sincerely,

James Ashton.

James Ashton
Chief Executive

[3] 'Smaller company' is defined here as a market capitalisation of less than £1bn. Source: New Financial. *The Future of Smaller Company Capital Markets in the UK.* (2024). p. 3.

Q21 What are the main factors that influence businesses' investment decisions? Do these differ for the growth-driving sectors and based on the nature of the investment (e.g. buildings, machinery & equipment, vehicles, software, RDI, workforce skills) and types of firms (large, small, domestic, international, across different regions)?

At the most basic level, a company's expansionary investment decisions (i.e. beyond that of maintenance capital expenditure) will be driven by i) financial considerations (which initiatives will drive the highest return on investment / quickest payback); or ii) strategic considerations (e.g. IP, skills, establishing distribution networks, market leadership position etc), where the financial payback may be less measurable in the short term.

The question of which investments are advanced will be a question of prioritisation according to affordability. Affordability is a function of the access to, and cost of, capital.

Capital intensive businesses may have greater access to debt funding (if the capital equipment can be secured against the debt), meaning that capital-light but perhaps knowledge-intensive, IP-rich businesses aligned to the UK's industrial strategy, may struggle to gain access to equivalent levels of debt funding, particularly for earlier stage companies who are not yet profitable. This presents a specific challenge to scaling up innovative new businesses.

For the majority of smaller growth companies, equity investment represents the most appropriate, stable and long-term approach to growth funding.

UK smaller companies, especially those listed on the UK's AIM and FTSE Small Cap indices, have witnessed a substantial decline in equity valuations (relative to international companies of equivalent size) in the last three years, reflecting sustained outflows from UK listed equities[4], and an array of other challenges undermining interest in the UK's listed small and mid-cap market.

This has resulted in a heightened cost of capital for such businesses which has, in turn, radically reduced the number of companies raising money for investment purposes. There has been a 24% drop in the average number of companies on AIM over the last three years compared to the 20 year average[5], and a dramatic reduction in IPO activity - where companies typically raise money to pursue growth opportunities - with a 65% decrease in the average number of IPOs on AIM over the last three years compared to the average over 20 years[6]. Moreover, an increasing number of companies are being acquired by overseas organisations, with both short-term and long-term negative implications for the retention of skills, growth and tax receipts in the UK.

We would therefore advocate stimulation of capital flows into the UK's listed and quoted ecosystem, and specifically into small and mid-caps, as the most powerful approach to addressing this equity valuation

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[4] In 2023, UK equities suffered £14bn in outflows in what was the eighth consecutive year of outflows. Source: Investment Association. *Press release: UK households feel the squeeze as £24.3bn taken from investment funds in 2023.* (2024): https://www.theia.org/news/press-releases/uk-households-feel-squeeze-ps243-billion-taken-investment-funds-2023

[5] There was an average number of 916 companies on AIM over a 20-year period (2004-2023). From 2021 – 2023, the average number of companies on AIM was 697. *Source:* London Stock Exchange AIM Factsheet December 2023.

[6] The three-year average for IPOs on AIM was 29 (2021 – 2023), while the 20-year average (2004-2023) was 82. *Source:* London Stock Exchange Primary Markets New Issues and IPOs.

discount, which would directly stimulate investment activity (please refer to our proposals in Q23 regarding this point).

Q22 What are the main barriers faced by companies who are seeking finance to scale up in the UK or by investors who are seeking to deploy capital, and do those barriers vary for the growth-driving sectors? How can addressing these barriers enable more global players in the UK?

As above, the main barrier for listed smaller companies is the cost and access to capital. Companies need to believe that issuing equity to fund investment will i) make economic sense (relative to cost of capital); and ii) be supported by a sufficient number of investors. The outflows experienced by the UK's capital markets over the last three years undermine both of these requirements. This is a market-wide challenge, impacting businesses of all sectors.

Addressing this challenge will encourage more global players in the UK. Listed and quoted markets represent a ready-made transmission mechanism for attracting overseas capital, but a key requirement for all investors (both domestic and overseas) is depth of liquidity, and market scale. Both of these are compromised by the current UK outflow dynamics. Reversing this trend could generate a "positive fly-wheel", where stimulating capital inflows, improves valuations, improves liquidity, which stimulates inflows and so on.

For investment funds, the ability to allocate into AIM and FTSE small cap with a view to long-term capital growth is hindered by liquidity metrics that are geared towards large cap companies. Additionally, the systematic rise of 'passive' investors and opposed to 'active' investors is problematic for companies to raise new capital as passive funds do not participate in IPO or follow-on issuance. This dynamic makes market entry more difficult for new companies.

In addition, if we are to foster certain industries and ensure they can access the funding they need, the UK capital markets need to develop specialist knowledge. This challenge is identified in Rachel Kent's Investment Research Review and is one reason for the creation of a Research Platform that would ensure small cap research is once again affordable and investment houses train a new generation of equity analysts. The implementation of this proposal would contribute to increasing equity research coverage for smaller company stocks thereby improving their access to capital.

Q23 The UK government currently seeks to support growth through a range of financial instruments including grants, loans, guarantees and equity. Are there additional instruments of which you have experience in other jurisdictions, which could encourage strategic investment?

This range of financial instruments feels sufficient, but in order to "crowd in" private capital alongside Government support, we believe Government support could take a different form; namely tax incentives to encourage investment into the UK companies.

This could include i) expansion of the VCT regime (perhaps a "Smaller Company Trust" involving less generous tax reliefs than VCTs, in exchange for a more relaxed eligibility criteria but aligned to the industrial strategy and increasing the cap on funding for such companies); and ii) aligning the UK tax reliefs awarded to ISA investors with a requirement that a proportion of those ISA investments be made into UK companies / those aligned to the industrial strategy. For example, if this proportion were set at 50% of the current ISA allowance, this would result in £7bn worth of investment being directed into UK equities[7].

We would also like to see the revised level of AIM business relief – whose impact investors are still working through – guaranteed until 2035, in line with VCT and EIS reliefs. This would provide certainty to companies and investors alike.

[7] New Financial. *A £10bn shot in the arm for UK equity markets: How ISAs could help kickstart a recovery in UK Capital markets.* (2023). p. 5.

Appendix A

The Quoted Companies Alliance *Investor Working Group*

Paul Stevens (Chair)	**Business Growth Fund (BGF)**
Natalie Bell	Liontrust Asset Management
Fraser Elms	Herald Investment Management Ltd
James Goodman	Schroders Investment Plc
Judith MacKenzie	Downing LLP
Katie Potts	Herald Investment Management Ltd
Richard Power	Octopus Investments
Eustace Santa Barbara	Canaccord Genuity
Gervais Williams	Premier Miton Group Plc

The Quoted Companies Alliance *Primary Markets Expert Group*

Samantha Harrison (Chair)	**Grant Thornton UK LLP**
Colin Aaronson	Grant Thornton UK LLP
Mark Brady	Spark Advisory Partners Limited
Giles Balleny	Cavendish
Andrew Buchanan	Peel Hunt LLP
David Coffman	Novum Securities Limited
Dru Danford	Panmure Liberum Limited
David Foreman	Zeus Capital
Bobbie Hilliam	Canaccord Genuity
Nick McCarthy	Shoosmiths LLP
Katy Mitchell	Zeus Capital
Nick Naylor	Allenby Capital
Jeremy Osler	Cavendish
Niall Pearson	Hybridan LLP
Mark Percy	Shore Capital Group Ltd
Oliver Pilkington	Shoosmiths LLP
George Sellar	Peel Hunt LLP
James Spinney	Strand Hanson
Fred Walsh	Stifel