GOVERNANCE

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CEO performance reviews

'CEO evaluation is an opportunity to assess and document performance, not just against key performance indicators, but also the behaviours and ways of working. It's an opportunity to move beyond subjective assessment of personality to an objective review of deliverables, achievements, behaviours and development needs.'

John Harte

Stopping the decline

'It is in the public interest to arrest the decline in the number of UK listed companies. There are a number of recommendations in the research report to achieve this. Making the UK's corporate governance regime more proportionate and less costly is a key one.'

Gbenga Ibikunle and Guy Jubb

Content

Feature

Stopping the decline

Gbenga Ibikunle and **Guy Jubb** consider the decline in the number of UK public companies and ask if it is time to move the UK's governance goalposts?

The UK may be at the forefront of global financial markets and services. But the number of public companies listed in London is in steady decline. Why? The All Party Parliamentary Corporate Governance Group commissioned a research team led by Professor Gbenga Ibikunle of the University of Edinburgh Business School to find the answers. The findings were revealing. The recommendations far-reaching.

The bleak landscape

Annual equity listings in London peaked at 320 in 2000. Since then, the trend has been downhill. The annual average number of London equity listings for the decade to 2019 was a mere 82. Indeed, none of the top 10 global IPOs in 2019 were in the UK. Hong Kong, China, the US and Germany swept the board.

The number of UK-listed companies peaked at 2,913 in 2006 but it had slumped to 2,026 in 2019. The UK is not alone. The number of US-listed companies has suffered an even more dramatic decline over the last 25 years and the UK's deterioration is not as marked as that of Germany and France. But the downward UK trend seems to be hastening. Technology and innovative growth companies have been flocking to have IPOs in the US and China during 2020. Meanwhile the UK continues to languish. This is a cause for concern for UK investors, companies and policymakers alike.

The research and its findings

The research team took an investigative approach, interviewing key stakeholders in relevant UK companies that have exited and recently listed in the public market. They also analysed secondary quantitative data from various financial databases, alongside other relevant sources.

They found that the following factors are key drivers of the decline in the number of companies listing in UK public markets.

- The increasing rebalancing of company assets towards intangibles favour companies staying private longer than was previously the case. Intangible assets, especially in early-stage innovation companies, can be difficult for non-specialist investors to value. This problem is exacerbated by an emerging reduction in smaller company equity research, an unintended consequence of MiFID II.
- Public companies generally face significantly higher governance costs than private companies. Also, the cost of taking a private company public remains prohibitively high for many early-stage and small companies.
- Investors are increasingly focusing on short-term returns. This problem was identified in the Kay Review. The research found evidence consistent with this trend, which constrains fund managers from making investment decisions in the long-term interests of investee companies.
- The significant growth in private equity funds. In particular, developments in the US have strengthened the financial muscle of private equity funds. This has led to investments in UK public companies which have subsequently been taken private. Indeed, 43% of companies that delisted from UK public markets in 2015 were purchased by foreign entities.

The importance of intangibles

Intangibles have been a game changer. As is now evident, with the growth of unicorns (privately held companies with a valuation of one billion dollars or more), there has been a surge in private equity funding, making it possible for companies to become billion-pound entities before listing in public markets. In the UK, over 20 unicorns have been established since 2007 – and hundreds more overseas. Valuation of these companies is often based on intangibles and unproven potential.

One former FTSE 250 company Chair told the research team that neither UK investors nor the UK analyst community really understand technology companies. This could account for why so many companies shun the UK market in favour of US and Chinese markets, where the analyst community is arguably more competent in understanding intangible based business models and their potential. Furthermore, for smaller and early-stage companies, the transparency required of UK public companies risks them revealing proprietary, commercially sensitive information to competitors.

There is no silver bullet to resolve this, but it is clear that the UK investment community – both fund managers and analysts – has an opportunity, and arguably a public interest obligation, to raise its game and deepen its understanding of technology companies. In particular of the 'knowledge intangible assets' which are a product of a company's R&D expenditure. The research report recommends that the Financial Conduct Authority address this in its training and competence regime, which was last updated in 2017.

Costs and complexities

The costs and complexities, to say nothing of the red tape, of going public are nothing new. The research confirmed that these, coupled with the on-going costs with the regulatory conditions of being a listed company, cannot be overlooked when deciding whether to raise capital in public or private markets.

Feature

Also, many who the researchers spoke to drew critical attention to the UK's excessive executive pay disclosure requirements, which they cited as making the UK public market less attractive than many of its competitors. In their eyes, these requirements make it difficult to attract and retain global talent. That said, evidence suggests that the executives of UK listed companies, especially the larger ones, are among the best paid in the world. However, smaller UK listed companies are unlikely to be able to justify such generous pay packages and may struggle to attract the talent they need to deliver the exponential growth that the market expects.

But the role of a robust regulatory regime in protecting investors cannot be exaggerated. Without it, investor confidence may be fickle, especially if enforcement is perceived as lacking teeth, and this has the potential to detract from a company's valuation and, thereby, the allure of a public market listing.

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To address these findings the UK Government could explore ways to balance the need for public market regulations to be not excessively onerous with the need to protect investors. This is within the remit of Lord Hill's review on listings, which was announced by the UK Government in November 2020.

The report recommends adopting a proportionate risk-based approach to corporate governance rather than the current 'one size fits all' approach that is a consequence of adopting the EU's definition of a 'public interest entity'. Also, it recommends that IPO investment banks and other advisers take a meaningful proportion of their fees in restricted shares, rather than in cash, and thereby better align their interests with those of investors.

Short termism & the rise of private equity

Investors' short termism in public equity markets has intensified over the last 20 years, which is inconsistent with not only the legal responsibilities of UK company directors to promote long-term corporate success but also the spirit of the UK Stewardship Code. This misalignment of incentives was a constant theme in the research findings. It has resulted in many innovative UK companies being left with little choice except to pursue growth through going private.

Indeed, in their data analysis the researchers found strong evidence that the growth in private equity funding is linked to the decline in the number of companies listing in the UK. One former FTSE 250 company non-exec told the researchers that private equity funds 'have got a lot of dry powder or money that they're willing to invest if opportunities come along'. This enables them to offer substantial premiums that makes it hard for company boards to decline, especially when the public market undervalues the company.

Private equity funds have another advantage. They can finance their purchases using debt. This provides them with a tax shield because, unlike dividends, the interest on the debt is tax deductible, thereby reducing taxable profits at a stroke. The tax shield benefit was not perceived by the researchers' respondents to be a level playing field.

The report makes several recommendations. First, tax incentives could be used to attract equity investment in smaller growth companies and to support first-time IPOs – for example, tax breaks based on a specified minimum holding period. Secondly, in line with the sentiments of the Kay Review, consideration should be given to tax incentives targeted at encouraging a long-term investment horizon. Thirdly, that the UK Stewardship Code should include an expanded emphasis on encouraging a long-term focus in investment decisions so that public companies do not feel pressurised by their institutional investors to prioritise short-term performance over long-term sustainable success.

Conclusion

It is in the public interest to arrest the decline in the number of UK listed companies. There are a number of recommendations in the research report to achieve this. Making the UK's corporate governance regime more proportionate and less costly is a key one. Without it, many of the UK's innovative entrepreneurial growth companies will continue to favour private equity funding as well as looking to list overseas, where institutional investors often appear to be better qualified to understand their business models and thereby their long-term potential. Lord Hill's review of listings could be a much-needed catalyst for change that will enhance the relative attractiveness of a London listing.

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