EDISON

Post Woodford

A spotlight on smaller company liquidity

Edison themes

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The recent suspension of the Woodford Equity Income Fund will, in our view, have longer-term implications for other daily dealing funds investing in smaller companies. Funds may come under pressure to demonstrate the liquidity of their portfolios, which may in turn affect the valuations of lightly traded equities. Companies should engage in self-help. Maintaining a pool of credible potential investors to support the shareholder register over the company's life cycle will help foster liquidity by promoting an ecosystem of analyst research, brokers and investment interest to ensure the equity opportunity remains properly valued. As Woodford has discovered, a listing is not liquidity. However, a properly managed listing opens strategic opportunities to facilitate further company growth, a win-win for all parties.

Woodford causing regulatory uncertainty on liquidity

The prolonged suspension of redemptions in the previously popular UK Woodford Equity Income Fund has cast a light on the issue of liquidity. Comments from Mark Carney, Governor on the Bank of England, that 'over half of investment funds have a structural mismatch between the frequency with which they offer redemptions and the time it would take them to liquidate their assets. Under stress they may need to fire sell assets, magnifying market adjustments and triggering further redemptions, a vicious feedback loop that can ultimately disrupt market functioning.'

This has heightened risk perceptions around low liquidity amongst the institutional fund management community, creating a greater onus on companies to step and build a pool of actual or potential investors and get the best out of their listing or as many have opted, to go private.

Likely winners…

- Companies that build an investment ecosystem and reap the full benefits of listed equity.
- Investment funds that insist investee companies maintain an active investor relations policy to maintain and promote liquidity in their equity securities.

Likely losers…

- Illiquid smaller companies that rely on a small club of historically supportive investors.
- Investment funds that carry exposure to less liquid securities where performance may suffer due to increased levels of FCA scrutiny and the prospect of further investment restrictions for regulated funds.

Winners and losers: the companies shown above do not translate into buys and sells as other themes (and valuation parameters) may conflict with this one.

From the street

"There is some real ambiguity in this area [liquidity in stocks]," says Gervais Williams. "The term small cap can apply to a company that is worth £50m or more, or "some loss-making, privately owned businesses where valuations are completely speculative". Moreover, companies can be illiquid in different ways depending on who has the holdings and how much of a company's shares they control. A company worth, say, £10m, but with a spread of investors, could be more liquid than a company ten times the size, but with one very large shareholder on the register."

Source: Moneyweek

Edison themes

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

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A spotlight on smaller company liquidity

The well-publicised difficulties at Woodford Investment Management have highlighted the fact that a public company listing does not necessarily imply an active market in a company's shares. For example, there were a number of listed but relatively illiquid holdings in Woodford's Equity Income portfolio. Furthermore, Woodford was often a significant investor by percentage of the register and contributed to a relatively high concentration of investors for these companies.

Now, Woodford's inflows have turned to outflows following a period of underperformance. The difficulties of unwinding the portfolio have become clear and led to the recent suspension of redemptions. The Woodford brand also attracted significant retail flows into private and smaller cap companies – individual investors who most likely would not have invested in such stocks directly. Smaller companies depending on equity finance may find that the surge of indirect retail flows gathered under the Woodford brand will not be repeated, at least in the near term.

Furthermore, in terms of investment funds, there may be a regulatory push for increased scrutiny of smaller company valuations where holdings are either unlisted or very thinly traded.

Yet we believe the broader issue has less to do with Woodford specifically but is a more general question of why so many smaller companies are failing to develop a functioning market in their listed equity.

This has a negative impact, and not only on funds with daily dealing that may in future face additional regulation for less liquid investments. Much more importantly, investors, companies, brokers and even the vibrancy of the SME market are suffering from the relative lack of trading activity in smaller companies.

Woodford: A play for outperformance that went wrong?

We do not wish to dwell on the difficulties faced by a single firm, however. The Woodford Equity Income Fund is not the first UK fund to suspend redemptions, although it is unusual given its investment objective and perceived bias to large-cap, income-producing equities.

On examination of the portfolio, we believe the combination of a relatively defensive large-cap portfolio combined with a tail of smaller company investments may have been designed to maximise the chance of outperformance. Due to the historical skew of individual stock returns within the overall stock market, a relatively few high-performing companies can deliver a disproportionate amount of the return for the whole market.

The idea, which assumes a level of informational advantage through skill and experience, may have been to create optionality within the portfolio to deliver the outperformance that would keep inflows coming. Nevertheless, it is not for us to make a snap judgement after the event on the quality of Woodford's portfolio. Given the early-stage nature of many of the holdings, there may well yet be (statistically) a winner in the portfolio which, if given time, could have delivered the hoped-for outperformance.

A listing does not equal liquidity

The issue at hand is that the Woodford fund has not been able to allow redeeming investors to exit because there is insufficient liquidity in these smaller company holdings. Having been forced into a suspension, the fund has lost its optionality as it has become a short-term seller, as investors attempted to rush to the now-blocked exit. In turn, it appears that a significant proportion of the illiquid assets of this fund will now be sold on in an auction to other institutional investors, at prices which we believe may even represent distressed values.

Regardless of the merits of Woodford's stock selection, it did not need to turn out this way. A more active market for UK smaller companies and a more diverse smaller company investor base would have accommodated Woodford's need for liquidity more easily. A local market with such attributes is a win for investors, intermediaries and the corporates which they serve.

In his letter of 18 June 2019 to the Treasury Select committee on the Woodford Fund suspension, Andrew Bailey, head of the FCA, highlighted how Link Fund Solutions, the authorised corporate director for the Woodford Fund monitored liquidity by breaking down the portfolio into four liquidity buckets, based on the number of days expected under normal market conditions to sell a holding (shown in Exhibit 1). We have also included as a comparator similar data for TB Amati UK Smaller Companies Fund.

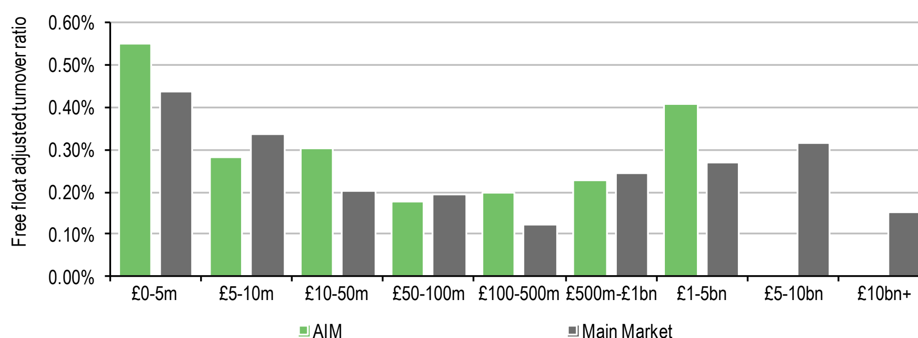
Exhibit 1: Woodford and Amati portfolios broken down into liquidity buckets

	30 June 2018 Woodford Equity Income fund	30 April 2019 Woodford Equity Income fund	13 June 2019 TB Amati Smaller Companies Fund
Bucket 1 (1–7 days)	21%	8%	59%
Bucket 2 (8–30 days)	24%	29%	36%
Bucket 3 (31–180 days)	30%	32%	4%
Bucket 4 (181–365+days)	25%	33%	1%

Source: FCA, Amati

Andrew Bailey's letter highlighted that in April 2019 two thirds of the Woodford Equity Income Fund was in the two most illiquid buckets taking 31 to 180 days and 181 to +365 days to liquidate. We can appreciate that no other fund manager wants to have similar analysis showing on their fund on the back of Woodford, hence the heightened sensitivity around stock liquidity today.

Exhibit 2: AIM and Main Market liquidity by market cap banding (free float adjusted)

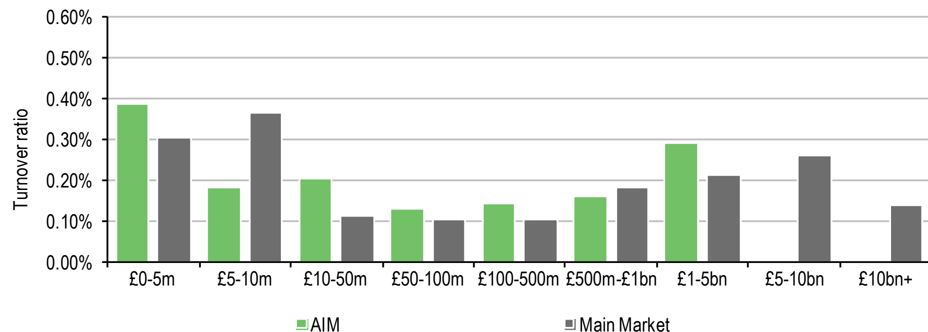


Source: London Stock Exchange, Bloomberg

The London Stock Exchange provides liquidity statistics by market capitalisation bandings for AIM and the Main Market on a free float adjusted basis (Exhibit 2). We have also produced similar data without adjusting for free floats (Exhibit 3).

From Exhibit 3 we observe that stocks in the £50m to £500m market capitalisation range have half the liquidity of the £1bn to £5bn market capitalisation range. At the micro cap end of the market it also seems to demonstrate an active retail market.

Exhibit 3: AIM and Main Market liquidity by market cap banding



Source: Edison, London Stock Exchange, Bloomberg

The picture is of course more complicated that this. The following is from Amati co-founder Paul Jourdan's letter of 20 June 2019:

'We should note that these reported share volumes only reflect shares traded in the market and ignore those traded in the so-called 'dark' pools, which means that we are potentially understating the liquidity actually available. The 5% which the TB Amati UK Smaller Companies Fund shows in buckets 3 and 4 consists of companies which are either a) dual listed with fungible shares, so that the share volumes being counted are an incomplete picture of the actual liquidity, or b) recently floated, so the share volumes have not had much time to build up yet, our holding in the retailer Cake Box being an example, where we believe in practice we could liquidate such holdings in a shorter timeframe than this analysis suggests if we needed to. Importantly, the fund has no 'locked in' holdings.'

What this highlights to us is two things:

- The need for a consolidated tape (as they have in the US). The issue around the dual listed fungible shares referred to in the quote above is something that is increasingly being called for since MiFID 2 came into effect. The call for this is sufficient that The European Securities and Market Authority (ESMA) has launched a consultation initially focused on equities that if delivered would show a more complete liquidity picture.
- The institutional nature of the London market is such that fund managers rely on their sell-side counterparts to work their orders, hence Amati's view that its holding in Cake Box could be liquidated quicker that the turnover statistics might lead you to believe.

Nonetheless, the points above do not outweigh the focus on liquidity. We understand traditional market-making activity may have declined due to increased capital costs and lower commissions, but there is also corporate responsibility to keep communicating the corporate message to a wider group of investors, if an active market in the stock is to be maintained.

In our experience the £50m to £500m market capitalisation stocks are often at the transition point, moving IR activity from the management team running the business to a dedicated IR team or team of advisors. Often management teams wrestle with creating a budget for this new activity.

In 2017 we ran an Exchange Partner event, inviting representatives from Stock Exchanges around the world to discuss MiFID 2. The quote of the day came from a fund manager panel, where a UK small cap fund manager stated that 'liquidity [not regulation] is the greatest protection against risk, it allows you to get in and out of stocks as events change.'

Put simply, this trade off between liquidity risk and the additional costs borne by a corporate to take on the responsibility for its corporate messaging to a wider group of investors can be weighed up by thinking of the following:

- On an average P/E of 10x, a £50m market capitalisation company is (in simple terms) making £5m post-tax. Adding an additional £100k to improve engagement with institutional investors would reduce the company's valuation by £1m.
- If a company's liquidity is such that it is falling into buckets three and four as per Exhibit 1, the liquidity discount is likely to be in the range of 20% to 30%, which would reduce its valuation by £10m to £20m.

Higher-risk growth stocks do not have to be lightly traded

We would expect total liquidity to be somewhat proportional to company market value, but this can be adjusted for by aiming for a certain turnover per year in the shareholder register, as the company evolves through its life cycle.

Liquidity is also separate from other investment risks; we can find low-risk investment trusts such as property REITs with very limited daily trading activity and, conversely, high-risk Nasdaq stocks which trade tens of millions of dollars per day. Just because an investment is early-stage or high-risk does not mean it should be illiquid or attract little investor attention.

One factor that does give rise to liquidity risk for institutional shareholders in our view is an overly concentrated share register and limited information flows, which deter outside interest in the company, leaving the free float to retail investors to set the marginal price. We would hope readers of this note would look unfavourably on the idea that this could be a useful situation for pumping a stock higher to allow insiders and management to exit.

More often, in such situations, we hear that management is frustrated as the ‘market’ does not understand its company and the share price is falling even as fundamentals remain intact. Often the first question to ask is whether a real institutional market for the company’s stock genuinely exists. For example, if management is only addressing current owners in its communications, it is missing perhaps nearly 100% of the potential buyers of the stock.

In addition to creating an imbalance of potential sellers versus buyers, which naturally leads to the sense of an overhang on the share price, companies which have not developed a broader communications strategy risk missing out on the primary benefit of a listing – which is to issue equity at ever higher prices to finance business expansion and achieve strategic business objectives through share-based M&A. Indeed, if a company never wished to make use of these benefits, we would question the purpose of the listing in the first place.

Communicating with the broader market

In our view, investor relations efforts should be focused on building a much deeper pool of public knowledge of a company’s prospects than the current shareholder register. This may extend, potentially, to several multiples of the current shareholder register, including institutions which may wish to invest, not just now, but in the future as a company evolves and matures.

There is increased effort in pursuing such a strategy and management time is also scarce. But the benefits are significant – a deeper pool of potential investors who understand the business and will be ready to participate in daily trading at times of market volatility to dampen swings in the share price. Furthermore, a better understood company is likely to be more highly valued in the stock market. A greater number of marginal investors provides a smoother demand curve for the stock and reduced information asymmetry lowers the risk premium for investors.

One perhaps overlooked point is that conversations with investors are not a one-way flow of information. Company executives can also benefit from interactions with experienced portfolio managers and analysts from the asset management industry. This may enable management to better inform company strategy. By aligning with investors rather than perceiving them as a threat,

companies are likely to be in a better position to fully take advantage of the equity financing that is potentially on offer from a listing, for the right and properly considered business strategy.

In this, non UK institutional investors should not be ignored. Edison recently ran an accessing US capital markets event. At this event, Rachel Carrol, from our US office, highlighted that among the most common assumptions that companies make is that they are not ready in terms of their business lifecycle to approach US investors or that their strategy will not work. The other major concern companies have is how long it may take to raise the capital they are looking for in the US.

Yet the US buy side complain about difficulties of attracting overseas companies. BNY Mellon recently published the results of a corporate access survey of 40 institutional managers that manage $11tn of equity AUM with 36% of their portfolios allocated to non-US equities. The survey found 85% of those institutional managers complained of difficulty accessing non-US companies and investors.

What many do not realise is that US fund managers are continually looking for attractive UK and European stocks and that from a US investor point of view, European and UK companies still look very attractive, arguably more so given recent currency market developments.

The OTC Markets Group recently commissioned a study by Oxford Metrica which also highlighted a positive impact on volumes traded.

Company action points post-Woodford

We believe that post-Woodford the FCA is likely to continue to focus on fund liquidity. Funds will have to respond by reinforcing investment constraints on shares with limited or little daily liquidity, both for existing holdings and potential new investments. The optimal response from the corporate sector will in our view include:

- Making a clear-headed assessment as to whether there is adequate normal daily liquidity in their company's listed equity and not just occasional block trades or results-day activity.
- Assessing the quality of the current shareholder register, in terms of key investor risk and the level of diversification.
- Redoubling efforts to ensure there is an adequate and fair disclosure to the market focused on potential rather than actual investors in the stock.
- Encouraging the publication of research to raise and maintain the company profile; IR teams and company management should be assessing not only the number of analysts covering them, but which institutions have agreed to receive the research produced under MiFID II rules.
- Actively reaching out and engaging with investment funds which, based on published investment objectives, could be potential investors, both domestically and internationally.
- Developing a rapport with the investment community that feeds into improved business strategies focused on meeting the needs of the investment community.
- Benefiting from higher valuations by taking advantage of the opportunity to issue equity into the resulting pool of investment capital to achieve strategic objectives, expand the company or use shares as currency for M&A.

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