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Alternative Investment Market: to aim or not to aim – that is the question

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Abstract

Much has been made recently of the rapid growth in the population of AIM-quoted stocks and of the runaway success of some of the businesses which started life and raised capital through that market. However, the manifold risks inherent in this profile, as well as that vested in many of the sectors which are well represented on AIM such as mining, bullion, commodities and technology, are often understated, scarcely apparent and misunderstood. The writer explores the strengths and weaknesses of the market, the rationale underlying its recent growth and increasing popularity, and the characteristics of businesses and management nuclei which flourish – and of others which wilt – during their listed lives. By identifying trends and statistics, and examining individual instances, he justifies and emphasizes his conclusion that the opportunities are accompanied by a high level of hidden risk, and that careful research is required before making financial commitments to companies listed on AIM.

There could scarcely be a more appropriate time in the history of markets to focus on the risks and rewards, the virtues and vices, the advantages and the drawbacks of AIM. Very few exchanges are not in or at play at the moment; ICE, IPE, LSE, Euronext, Deutsche Boerse … their share-prices are frantic, the bidders frenetic, the tactics remarkable and the fall-out spectacular.

To define precisely why all this action and reaction has come together here and now would need the skills of a scholar and the dimensions of a doctorate. On a less ambitious level, one could by way of answer legitimately hazard the catch-words globalisation, maturation, convergence and market share. Analysing the moving forces has been made more difficult by the recent tendency for any broker, trading platform or would-be software entrepreneur to reach for the words 'Exchange', 'Electronic Exchange' or 'Virtual Exchange' – amongst others. It blurs the edges and fogs the field, but it isn't illegal (yet) to borrow names in this way, and it reflects the subconscious commercial need to strive for two-way continuation-based business flow, for virtual monopoly and for bulk – volume – in a field in which commissions have already become razor-thin and margins as fine as a hair. Whoever originally said, "Stack 'em high and sell 'em cheap" – was it Jack Cohen, of Tesco? – if not, then a US-based grocer, surely – must have been the clairvoyant who foresaw well before time that trading securities on exchanges would obey his rule better than any other.

Theses, essays, lectures and books galore have been written on every aspect of exchanges, regardless of country of origin, constitution and commodity on offer. The challenge is to avoid the devil which is in the detail and focus on the aspects which this current context justifies. Our cause here and now is to identify and evaluate risk as the sparring partner of reward. Needless to say, every exchange displays plenty of each, and AIM is a long way up that list.

The essence and origin of Risk and Reward prevailing in securities exchanges – again, a topic which will have fuelled countless D Phils and BScs over the years – merit a brief reference, for their profile in the UK is a touch idiosyncratic as a result of the political backdrop here. This doesn't imply that exchanges elsewhere are fundamentally different, but every country has built up a unique balance between government, treasury, central bank, capital markets, legal framework and regulatory structure – not to mention historical accident – in forming its exchanges, and ours has hallmarks (purists and revolutionaries alike might say stigmata, instead) which need to be defined to appreciate the fickle nature of the risk-reward relationship.

Creditors and other victims

The inevitable and immediate victims where things go disastrously wrong are, of course, the investor, the managing director, the employees and the creditors. Disregard, for the moment, the Uriah Heep-like beneficiaries such as solicitors, trustees in bankruptcy, liquidators and receivers. Consider, instead that there are those who are positioned half-way along the spectrum: the intermediaries and professionals who are responsible for credit screening and management, for risk control and limitation, and for comparable functions. These are dangerously close to the centre-point of the food-chain, where the swing-factor, the rattling and the backlash are very severe as a result of the proximity of the agent to the epicentre of what goes wrong when the chain breaks. Murphy's Law is such that these dangers are emphasized by the fact that AIM – beckoning, as it does, to young, innovative and entrepreneurial companies and adventurers – offers bold and greedy investors the opportunity to get close to the action, to new ideas germinating, incipient growth and to the revolutionary technologies for which they thirst ... and which so often go unexpectedly, unforgivably wrong.

To throw a pre-emptive life-belt to those in such positions is difficult even once the roots of Risk and Reward, reaching far beneath the political and treasury systems, are understood, since they are for the most part firmly embedded there and won't budge. Beyond that, it becomes a matter not so much of airing statistics or of waving fat books of rules and listing requirements, which are intrinsically of limited value, but of considering trends and characteristics of the market, extrapolated from selective examples, which can help to evaluate the hazards as well as the opportunities of AIM.

First and foremost, AIM is a forum – literally as well as figuratively – which is restless, constantly changing. Pejorative terms would be

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'here today, gone tomorrow' and 'fly-by-night'. There is something of the gypsy encampment and the vagabonds-village-under-the-bridge about it. Inevitably there will be rogues and fugitives as well as minstrels and clairvoyants there.

Consider some of the factors and figures in play which illustrate the power of this arc-lamp of an exchange to entice the flying multitudes in to its beam. First, by year-end, 2004, close to 25 newly listed companies had raised over £200 million in new capital. Second, not far off 1,000 groups are currently listed on AIM; third, based on recent averages, between 10 and 50 new listings are completed every month (which begs the question as to how many companies fall from grace or go elsewhere: there are many, but, curiously, the rate of retreat is not chronicled). Fourth, there are numerous secondary reasons, some furtive, others virtuous, which draw to AIM investable capital seeking superior returns. For example, advantageous legislation has led to Venture Capital Trusts holding an estimated £500 million to invest in non-quoted and AIM companies, compared with a mere £50 million a year ago.

Fifth, there is a breadth and diversity of groups which emerges, offering challenges and opportunities as well as tripwires and landmines to those who march in regardless. A random cross-section of virtuosos throws up the, ASOS, the fashion retailer; Richard Branson's cosmetics and clothing entity, Victory Corporation; Celtic Resources, the miner; Vantis, provider of accountancy services; Computerland; Domino's Pizza (but does the Naked Chef still allow us to call pizzas virtuous?); TGM (Tellings Golden Miller), the coach and bus operator; Honeygrove Group, the regional builder; Inter Link Foods, the cake-baking maestro; Pipex, the telecoms group ... and so the list stretches on.

Risk and rewards

Sure as night follows day, there are the vagabonds and the vice-mongers mingled in with the virtuosos and the victors. As though it were example number one from the text-book on Risk-Reward Ratio Recognition Rules to show that there is no return without retribution, consider the current HM Revenue & Customs investigation in to the apparent scam whereby AIM-listed cash shells are used as tax avoidance vehicles.

Higher-rate taxpayers have begun to invest in such companies just before listing, bypassing various restrictions and netting substantial gains by donating their shares to charities and receiving a massive tax credit. The knock-on effect – yet another breach of the law of unintended consequences encountered earlier on – is the threat to charities overall looming from closures of loopholes and scaring off *bona fide* donors. Look also at Incite Holdings, with Dallaglio on its board – it has been censured many times over recently by the AIM authorities for procedural omissions and irregularities which have deprived investors of vital financial information demanded under the requirements of the exchange. Give a thought to Intermodal

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Resources – the transport leasing company figure-headed by Robert Montague, not long ago declared bankrupt following mismanagement and collapse at Tiphook.

Even if one ignores the jostling between vice and virtue amongst such companies, there is the separate but serious aspect of the inherent high risk evident in a large proportion of AIM-listed groups. Such risk is embedded not just in owner-manager and would-be investor behaviour but rather in the very nature of sectors and industry segments, of operations, regional presence, of resource- and investment-intensity, and in the very objectives of certain companies.

Resources and Commodities show up starkly in this filter, notably the new prospecting and exploration companies which either turn up trumps or drop down dead at the flick of a million-dollar bill. Likewise, mining, bullion, minerals and gemstones in particular attract as many determined minnow companies as unwary investors. Central China Goldfields has just completed its listing. For the 'Diamonds are Forever' fanatics, there are diamond miners without limit: Petra Diamonds, Firestone Diamonds, African Diamonds, Dwyka Diamonds, European Diamonds, Namibian Resources, Central African Mining & Exploration Company, Tertiary Minerals ... and for the risk-seekers who like to triple-deck their appetite for danger, they can pick a combination of country risk, conflict diamond dabbling, political risk, currency exposure, and the prospect of failure following refinancing in any number of such opportunities. Technology companies, of course, teem all over AIM.

Additional risk

At one remove from the market itself, of course, lies the additional risk inherent in investment banking activities focused on AIM companies. This aspect represents another encyclopaedia in its own right, but, to refer to the prominent points, first, narrow trading liquidity and wide spreads amongst traders and market-makers in small and medium companies can present significant difficulties. Second, corporate advisory and financing services supplied to such groups generate inevitable risk attributable to small groups with short trading histories and entrepreneurial management, and this risk is inevitably transferred to investors. Third, brokers' research, already under siege, does little justice – for commercial as well as practical reasons – to the opportunities and dangers lying hidden in that market. Brokers specializing in smaller companies do not have an easy time – the cyclicality, fashions, pitfalls and conflicting interests of their calling all combine to make their roles, despite every best effort and intention, unconvincing as a source of assurance and reassurance.

These principal risk-reward characteristics of AIM lead on to the justifiable knee-jerk reaction and question – what can be done, especially as regards the role of a risk-sensitive manager with equal and opposite responsibilities to foster business expansion,

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adventure and success, to identify, mitigate and counter these uncomfortably high levels and incidences of risk?

It may sound glib and slick to suggest it, but there are three ready remedies. First, everyone has the right to encourage and lobby the AIM officials – who, it must be said, have already galvanized themselves in this respect – to modify the structural, procedural and listing parameters of the market.

Second, permitting – admitting – encouraging, even – competition with AIM would bring about one benefit which competition spontaneously prompts, namely a more orderly, disciplined and self-regulating *modus operandi.*

Third, but far from last, pay homage to the good, old-fashioned values of research and analysis. The alternative is decidedly to side-step the disadvantages of traditional proprietary research and go for the few specialized Independent Research providers who specialize day-in, day-out in analysing smaller and mid-cap companies. These operate and succeed on the basis of dedicated and deep understanding of the segment, its constituent companies, their idiosyncrasies, their limitations and their potential.

The flaw is that there are not many such analysts out there, and those which are active are divided in to two distinct fields. First, there are a number of excellent providers which specialize in 'Issuer-sponsored Research', meaning that the corporates themselves pay the Independent Research entity to carry out and distribute research on them. This slants the absolute objectivity of the counterpart analyst who selects strictly his own targets to research, and reserves the right to say what he wants about them.

Of course such Issuer-Sponsored Research will be of good quality, learned and balanced – but it is hard to refuse to analyse a company, or to be disparaging about one, which represents your bread-and-butter.

Second, providers of Independent Research which have stuck to the ideal of analysing what they want, how they want are few and far between. (A number of providers which specialize in industry sectors, countries or themes may, of course, incidentally analyse an AIM company here and there, but this is not by way of devotion or dedication.) Independent Research providers in both these groups, also increasingly carry out confidential bespoke work for investors and others (industry participants; competitors; acquisitive peers; industry associations) alike. Yes, there are fees to be paid; but, as a fraction of the money to be made by investing in a successful company accurately analysed early on, or of the value saved by avoiding a tempting new issue which they pre-emptively and accurately label a dog, those fees shrink to become virtually irrelevant. Those who aim for AIM should also aim for Independent Research: QED.