Institute for Public Policy Research

TAKING A STAKE
PUBLIC EQUITY FOR ECONOMIC RECOVERY AND INDUSTRIAL STRATEGY

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INTRODUCTION

Firms with strong balance sheets are the backbone of productive capacity in any economy. However, corporate financial health has been hit hard by the pandemic. The Spending Review presented a chance to lay out a plan on how to help firms cope, but this opportunity was missed. The launch of a UK Infrastructure Bank was a welcome announcement, but this appears to be limited to infrastructure and not the wider, distressed private sector.

So far, the UK government response has mainly focused on encouraging firms take up more debt and providing small grants to help small businesses stay afloat. Bank lending to SMEs in the year to October was more than 40 times higher than in normal times, most of which was government-backed (Bank of England, 2020d). But, in order to restart business and the economy, much more needs to be done to help businesses struggling with large amounts of debt. Indeed, some firms have already reached the maximum borrowing limits under the schemes (ibid.).

For many firms, currently the only answer could be going into bankruptcy and ultimately liquidation – like Debenhams has – with large costs to employment and chances of an economic bounce-back. The ONS (2020a) finds that one third of UK businesses could be in severe financial distress in the next three months. At the same time, borrowing conditions for firms not aided by government loans are tightening (Bank of England, 2020d). Many of these businesses may indeed falter.

Policy measures should seek to prevent the closure of firms that would be viable once restrictions lift and aggregate demand returns. One means to address this is through the bankruptcy regime. The UK's bankruptcy regime was recently improved, now allowing firms to shed some of their debt through agreements with creditors, while continuing to operate in a stronger financial position (Djankov, 2020).

However, some firms will need further support. For many UK firms, in addition to debt restructuring, **injections of equity** could play a hugely important role. Contrary to debt, equity can better absorb losses, reduce leverage and in turn give other investors certainty around the long-term viability of a firm.

Mainstream macroeconomic organisations agree. The IMF (2020) argues that, across the world, "equity injections have often been necessary to prevent bankruptcies, particularly in hard-hit strategic firms." The Bank of England (2020, p 19) also argues that "equity finance likely has a role to play: as a source of finance for highly leveraged companies, to support entry of new companies and growth of incumbents, and as a means for some companies to repair their balance sheets."

In this note **we argue that public equity injections should play a key role in supporting businesses through the pandemic**. The state, with its strong balance sheet, will be able to provide equity in ways that the market alone will under-provide (Blanchard et al 2020). During the 2008 financial crisis, the state acted as the stabilising debt and equity investor, assuring markets, and boosting the economy. While initially incurring large costs many rescue operations did make a financial return, for instance, the shares of Lloyds Banking Group were ultimately sold at a profit (NAO, 2018). The same is likely true this time. A concerted and targeted injection of equity could help save hundreds of thousands of jobs in sectors where firms are currently at risk and the associated income in firms currently at risk.

Alongside this, as the TUC note, public equity stakes can provide three key benefits: they generate a return to the government over time; they enable government to influence and improve corporate behaviour through effective stewardship; and for many businesses, 'an injection of cash in exchange for equity is a less risky way of keeping afloat financially than taking out a loan.' (TUC 2020).

While a public equity injection would represent an intervention in the market, this would not mark a radical policy departure. It would be limited in size and aimed at addressing market failures, albeit through a new channel. Furthermore, such a public equity investment is considered the norm across Europe and other developed economies (Macfarlane and Mazzucato, 2018). This 'normalness' reflects a view that's commonly held around the world that such institutions and actions can grow public wealth, challenge inequality, and contribute to important economic, social, and environmental goals in the long-term.

In the remainder of this note we first argue what the financial and economic problems of UK firms are. We then argue how public equity could make a decisive difference. Third, we provide some detail on how it could work and address some common objections.

FINANCIAL AND ECONOMIC PROBLEMS OF UK FIRMS

We identify three problems facing firms in the UK. The first arises from the pandemic; the second and third are long-standing challenges in the UK economy. Addressing these problems together would both answer the immediate challenge and set the UK on a path to a stronger economy.

Problem 1: UK firms' productive capacity is seriously at risk

Firms are **increasingly leveraged**. In business support schemes so far, too much emphasis has been placed on debt as a means of bridging the large pandemic-related revenue shortfalls. As a result, many (potentially otherwise viable) businesses are under severe strain. By the 15th November this year, 1.5 million firms have been granted loans through government or government-backed schemes to a value of £66.4 billion (HM Treasury, 2020a) with some firms already reaching the maximum borrowing limit (Bank of England, 2020d).[1]

As of 1 November, one fifth of firms had seen their turnover collapse by more than 50 per cent and another fifth by between 20 and 50 per cent compared to pre-crisis levels (ONS 2020a). As a result, one third of firms did not have enough cash reserves left for the next three months (ibid).

Employment support schemes and grant funding have eased only a fraction of the strain on hard-hit businesses. According to the Bank of England (2020b), these fiscal measures have eased the cash flow deficit of firms by about a third.[2] The Bank concludes that further action is needed to reduce the remaining cash flow deficit of firms.

In Figure 1, we show the Bank's numbers indicating a highly conservative estimate for the remaining financing deficit. In this, we assume firms use *all* of their cash buffers to address their cash flow deficit. The overall deficit is estimated at £90 billion. Based on previous BoE estimates, about two thirds of

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[1] This includes the Bounce Back Loan Scheme (BBLS) (£42.2bn, 1.4 million firms), Coronavirus Business Interruption Loan Scheme (CBILS) (£18.5bn, 77,909 firms), Large Business Coronavirus Business Interruption Loan Scheme (CLBIS) (£4.8bn, 658 firms) and the Future Fund (£0.9bn, 874 firms).

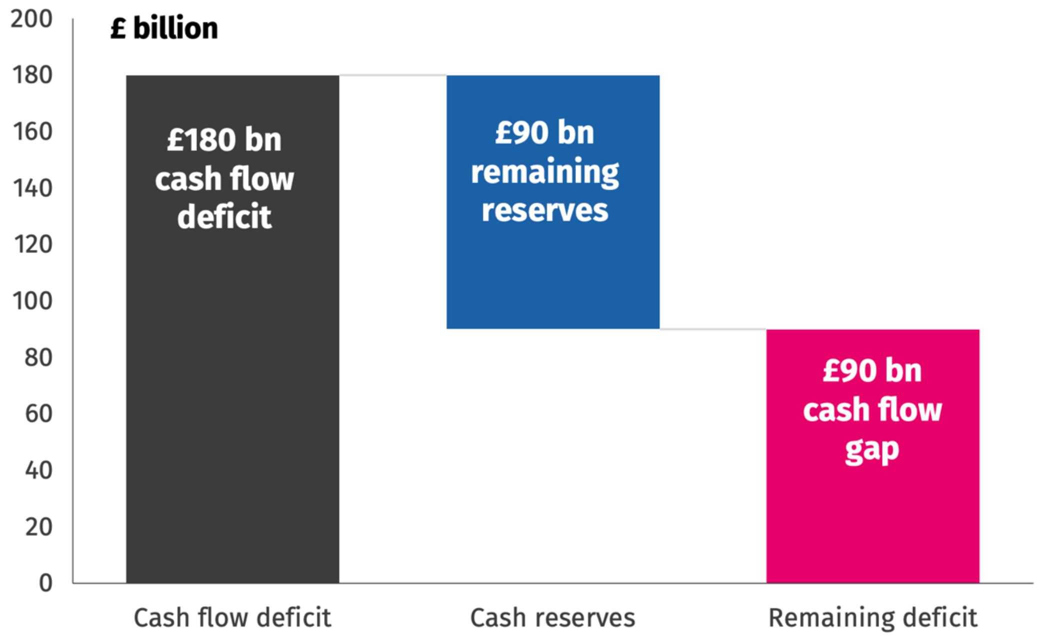
[2] This is based on BoE (2020b) analysis from May. The Bank has since not published a broken-down estimate for how much fiscal policies reduce the cash flow deficit. However, given no large-scale reforms to business support schemes were announced, this share is unlikely to have moved dramatically.

this deficit falls on larger and one third on smaller firms (Bank of England, 2020c).

These estimates are conservative for three reasons: (i) they assume that firms use *all* of their remaining cash reserves to finance their cash flow deficit which would, in practice, be unviable given the need for cash reserves for normal business activity; (ii) the estimates only cover the financial year 2020/21 and (iii) even firms with no continued cash flow gap may be in need of debt restructuring and equity injections. The true financing gaps could thus be significantly larger. The above should thus be seen as only an indication for the true degree of funding needed across UK firms.

FIGURE 1

UK businesses have large funding needs in 2020/21



Source: Bank of England (2020d).

Problem 2: UK productivity has been stagnant for over a decade and business investment is chronically low

The average annual increase in UK productivity in the decade following the last financial crisis was just 0.3 per cent, a historically very weak performance, and a sharp contrast to 1997-07, when productivity growth averaged around 2 per cent a year (ONS 2020c).

A key factor in productivity is investment and the UK has some of the **lowest levels of private and public investment in the OECD** (Tilly, 2018). At 17.4 per cent of GDP, the rate of public and private investment in the UK economy is 4.7 percentage points below the OECD average (World Bank, 2020). The UK has had below average business investment across sectors for three decades (ibid), holding back productivity growth, and further exacerbating increasing regional inequality (Haldane, 2018). In addition, smaller firms have low access to external finance, lowering their scope for productivity-enhancing investments in the first place (Bank of England 2020c). This is borne out by smaller firms tending to be less productive, doing less research and development, and being more short-termist in outlook (Bank of England, 2020a). Covid-19 has only exacerbated this challenge; between Q2 2019 and 2020, business investment had fallen by 26.1 per cent (ONS 2020b).

Problem 3: Several structural factors are making the UK economy less productive and less fair

A focus on maximising shareholder returns – a result of shifting legal, managerial, corporate governance, and ownership structures - has seen a growing share of corporate earnings distributed to shareholders in the form of rising dividends and share buybacks. For example, as Andy Haldane, Chief Economist at the Bank of England, has noted, in 1970 £10 out of each £100 of corporate profits was typically paid to shareholders through dividends; in 2015 that figure was between £60 and £70 (Weldon 2015), while between 2009 and 2018 FTSE 100 companies distributed on average 82 per cent of their total net income (dividends and share buybacks) to shareholders (Leaver et al 2020). The increase in the proportion of corporate profits distributed to shareholders has reduced the amount of retained earnings available to support increased business investment, raise real wages, improve R&D and training, or invest to improve sustainability and reduce environmental impacts. It also left many companies with less resilient balance sheets than might otherwise have been the case when Covid-19 struck.

Strategically important firms in sectors identified as being important to the UK's wider industrial strategy are at **risk of foreign take-overs**. This is as a consequence of both the ripple effects of the UK's exit from the EU and depressed and volatile share prices as a consequence of pandemic lockdown measures. Foreign takeovers present a problem as profits are more likely to flow out of the country than be reinvested into innovation or training; the ownership of intellectual property developed with government support moves overseas meaning the UK sows the seeds but fails to reap the rewards; and should international firms decide to consolidate their activities, jobs in the UK can be put at risk. A related example was the purchase by Japanese Softbank of Arm Holdings in 2016, in which case the UK government stepped in to guarantee jobs being kept in the country.

Furthermore, **increasing market concentration** reduces productivity and increases inequality. This is linked to what the political economist Brett Christophers terms the growing 'rentierisation' of the British economy. This refers to the growth of rent-seeking and rent as a share of economic activity, which he describes as "income derived from the ownership, possession or control of scarce assets under conditions of limited or no competition" (Christophers 2020). In this context, the generation of profit is increasingly linked to 'having' rather than 'doing', through the ownership of key types of scarce assets, such as land, intellectual property, natural resources, contract rents, digital platforms, and financial assets. Rentierisation is associated with low levels of investment and marked power imbalances in favour of asset-holders over stakeholders in the economy.

When functioning well, industrial policy can set a clear direction of travel and providing a predictable and consistent environment through its institutions. When used ineffectively, or changed too frequently, it can introduce significant frictions to growth. Whilst there has been a welcome return of industrial strategy in UK government policy (BEIS, 2019), significant **coordination problems** still exist. For example, skills policy and apprenticeships are still largely disconnected from the government's wider industrial strategy. Some sectors such as financial services, and automotive and aerospace manufacturing, receive targeted support and have benefited from an active state, but government policy speaks less to the so-called "foundational economy" of basic services and products where little indication of coordination exists. A more active role for the state – if performed to coordinate actors and give direction – creates better outcomes for the private sector and the economy in general. Business investment and innovation depend on the expectation of demand and the management of risk and uncertainty.

THE SOLUTION: PUBLIC EQUITY AS A FINANCIAL BOOST AND INVESTMENT CATALYST

One solution to the above problems is public equity stakes. By taking an equity stake in a firm the state could provide essential financing for firms to get through the pandemic. Furthermore, equity stakes could address the longer-term problems highlighted above by addressing coordination problems, fostering a high-investment culture, and acting as a steward for long-term value creation over short-term extraction as the operating model of the company. They would be a key form of stabilisation when the market is acting counter-cyclically and thus under-providing the necessary financial support (Blanchard et al 2020). Our proposal for public equity stakes would stand alongside a continuation of loan guarantees which could continue to be optimal for some firms, as well as existing mechanisms for debt restructuring and bail-in of junior creditors, which can be the best way to preserve a firm's productive capacity in some cases (ibid). For many firms a mix of the above – including public equity – can be the best way to prevent inefficient closure of firms (Philippon & Schnabl, 2013).

In the UK, public equity injections could take the following forms:

- **Offering firms the option to turn existing Covid support loans into public equity**, where the state receives a share of ownership of the company if the loan is not repaid (already offered through some government schemes such as the Future Fund, delivered by the British

Business Bank). For larger firms, assets could be held in a citizens' wealth fund.

- **A new equity-like investment product for SMEs**. Given most small firms are not listed, equity injections should be conducted via novel instruments, held in an equity fund. Financial institutions will be able to help to set up financial instruments and vehicles needed to facilitate this. Such equity stakes could ultimately be transferred when appropriate to an employee trust, seeding wider employee ownership across the economy
- **Tailored bailouts for firms** which have exhausted other options of government support but are strategically important or otherwise financially viable (known as Project Birch). A source of domestic equity finance for distressed but otherwise viable firms would serve, in particular, as protection against the risk of foreign takeovers of firms badly hit by the pandemic, further protecting jobs in the UK. This was a major justification for the formation of the German €100bn public equity fund this year (BMF, 2020).
- **Direct public equity stakes in a wide portfolio of firms,** to provide long-term patient equity investment and as a means to build public wealth. This is separate from the emergency funding objectives of the above three measures. It includes purchasing equity stakes via the secondary market (or in the case of unlisted firms from existing asset holders). These assets could be held in a citizens' wealth fund.

HOW TO MAKE IT WORK

Institutions

Central to making this approach work **is creating new institutions to govern public equity stakes** (Table 1). Here we outline the types of institutions that may be required, balancing the practical need to urgently support firms at risk of bankruptcy with the longer term need to establish robust institutional structures. Institutions we consider include a citizens' wealth fund, a national infrastructure and investment bank and a dedicated equity fund for strategic investments (Blyth & Lonergan, 2020; Detter et al., 2020). The citizens' wealth fund would require the most time to establish, with a focus of supporting a broad range of firms rather than singling out individual ones. We envisage a citizens' wealth fund being the ultimate, long-term holder of the equity stakes that result from emergency support measures once we transition into recovery from the current economic downturn.

TABLE 1

Institutions to manage public equity stakes

Type of institution	Core role	Investment style
SME equity fund	Emergency funding for SMEs	Holdings of equity stakes in SMEs as an emergency measure to support them through the recovery. Mostly passive due to small firm size and large number, but with a focus on incentivising them to invest in productivity-enhancing measures. SME equity stakes could ultimately be transferred, when appropriate to an employee trust, seeding wider employee ownership across the economy.
Fund for strategic equity investments (Project Birch)	Bail-out funding for strategically important firms	Strategic investment for larger, distressed firms with more active engagement and conditionality. Aligned to long-term industrial strategy aims.
National infrastructure and investment bank	Provide patient finance for strategic programs	Make long-term equity investment in more leveraged sectors, such as infrastructure. Independent financial advisors in investment bank actively engage with firm management. Socially defined mandate with no requirement for a fast return.
Citizens' wealth fund	Long-term holder of investments to build public wealth for a public return	Long-term ownership and management of equity stakes, including from pandemic-related debt-to-equity swaps of non-SME firms. Mostly passive, but with conditionalities and exercising voting rights in line with strong ESG principles, possibly both holding assets in the UK and abroad.

In countries such as Germany, France, Finland, and Brazil, as well as the EU via the European Investment Bank (EIB), national investment banks exist that are able to offer equity finance instruments (Macfarlane & Mazzucato, 2018). The UK lacks a national investment bank, which has limited the ability of the government to respond to the Covid crisis.[3] In the Spending Review the Chancellor announced a new UK Infrastructure Bank to replace some of the investment received from the EIB (which has invested a total of €53bn in the UK since the last financial crisis (House of Lords European Union Committee, 2019)), that will offer a mix of loans and guarantees, as well as taking equity stakes in infrastructure projects. The mandate of the bank is yet to be announced, but it appears that it will provide patient finance and equity investment but limited only to infrastructure projects, rather than supporting innovation, broader productivity improving investments across the economy, or viable businesses as the EIB can. **This could be a significant missed opportunity and the government should establish such a national investment bank** (as recommended by the IPPR Commission for Economic Justice).[4]

Investment strategies

As set out in Table 1, the diverse needs of firms and sectors should be matched by a diverse range of investment strategies. Some of these, such as the emergency fund to support SMEs, would be largely **passive ownership stakes**. That means public ownership stakes would be merely a long-term form of finance, next to other private investors, without much interaction with management. Other schemes, such as those targeted at distressed but strategically important firms, naturally require a more activist management that aligns to a wider government industrial and economic strategy and aims, such as the 2050 Net Zero target and 'levelling up' agenda.

However, government equity support should not be unconditional. Government should be willing to issue conditions upon the offer of equity (in the case of debt-to-equity swaps and strategic bailouts) or to use its ownership of equity to guide company behaviour (in the case of a wealth fund). Ultimately, where possible and appropriate, public equity should support the government's priorities and industrial strategy. Areas where this is particularly relevant include **commitments for investing in long-term growth, retaining jobs, staff training and upskilling, trade union representation, corporate governance, executive remuneration, fair pay for workers, fair tax practices, alignment with decarbonisation and sustainability targets**. All of these are already standard practice of mainstream ESG strategies, as

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[3] The Scottish National Investment Bank, set up by the Scottish Government, launched at the end of November 2020

[4] The mandate of the UK infrastructure bank is expected to be set at Budget 2021; however, all documentation suggests the bank will be limited to supporting infrastructure projects. This is a departure from the remit of similar national *investment* banks who are able to offer equity finance more broadly across the economy and in innovation projects. The National Infrastructure Strategy (HM Treasury, 2020b) states the new bank will "replace *some* of the activities of the European Investment Bank"; in 2019 the EIB provided €243M for infrastructure compared to €385M for SMEs and €6M for innovation (EIB, 2019).

reflected in the World Economic Forum's recent proposal (WEF, 2020). A precedent has already been set for such conditionalities via the government's support package for Celsa Steel (HMG 2020). Similarly, the TUC, who back calls for public equity injections, set out three major conditions for investment: Fair pay plans, Corporation tax should be paid in the UK, Decent jobs (TUC 2020).

It is important that whatever institutional form is chosen firms in which the government holds equity stakes are not exposed to political influence, the whims of ministers, or short-term thinking. To this end, all the equity-owning institutions described above should be managed through a robust and transparent governance structure that is otherwise separated from government operation but with a politically defined mandate. This arms-length body should be managed according to the highest professional standards but should not fully mimic the stewardship of commercial fund managers who often seek to maximise short-term returns. Instead, it should seek returns on capital at least equivalent to the capitalising government's medium-term cost of capital, but should not be profit maximising, given its prioritisation of social and environmental goals. Voting on shares and company engagement should reflect this.

Principles for public equity stakes

1. As a general principle, **singling out and supporting individual firms should be avoided.** For instance, debt to equity swaps should be offered to all firms that fulfil the below principles. The exception for this is strategically important firms. Support for these should only be extended based on a transparent and well-argued case, based on their regional and national employment significance as well as their potential to contribute to future growth, sustainability, and broader government priorities.
2. Firms must demonstrate that their **balance sheet difficulties are primarily driven by the impact of the pandemic**, rather than longer-term structural weaknesses.
3. Public equity investment also needs to avoid supporting firms in severe financial distress without prior remedial action. Firms that are **highly leveraged**, for instance, with a net debt to EBITDA ratio of more than 4 should be excluded. Well-defined exceptions could be introduced for sectors where leverage is naturally structurally higher, e.g., for infrastructure projects. This could be done via the national infrastructure and investment bank structure.
4. Similarly, supporting **'zombie firms'** with an interest rate coverage ratio below 1 should be avoided.
5. Both high leverage and 'zombie firms' should only be supported in conjunction with debt restructuring deals, which lower the burden of debt and promote future viability.

How equity stakes should be financed

With regards to distressed firms, our initial suggestion for public equity funding needed is £45 billion. This would be comparatively small, when compared to Germany's public equity fund of €100 billion. As pointed out above, our estimates for cash flow needs are a conservative lower bound, and cash flow deficits are only an imperfect indicator of debt and equity financing needs. There may therefore be a case for setting up a larger public equity fund. We calculate the size of the funding needed as follows.

In Roberts & Jung (2020) we argued that 50 per cent of the cash flow deficit for large firms could be filled through public equity, and 50 per cent through new borrowing from banks and capital markets. This would amount to about £32 billion equity for large firms and about £13 billion for smaller firms.[5] The above suggestions would not constitute a large-scale nationalisation, as some may fear. Public equity would only make up about 2 per cent of GDP and represent less than 0.3 per cent of net private wealth in the UK (ONS, 2019). At the same time, it would bring large economic benefits, as outlined above.

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[5] This based on the split between large and small firms in Bank of England (2020b). Note that using the BoE's revised estimates of the cash flow deficit of large firms means our public equity injection proposal for these firms is now at £32bn, up from our previous estimate of £25.7bn in Roberts and Jung (2020).

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