Developing equity financing for SMEs

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Fostering SMEs' growth should be both at the national and European level, but with distinct tools

Developing new financing capacities for small and medium-sized companies should be one of the main goals of an efficient Capital Market Union (CMU). If many milestones have already been reached since the beginning of the project in 2015, it seems that SMEs still face several hurdles while trying to diversify their financing, as the European Commission pointed out with its SME Growth Markets initiative in spring 2018.

That former initiative is typically relevant in order to review, regulation by regulation, every potential obstacle for the development of stronger companies within the European Union.

Nevertheless, **we need to distinguish two types of actions that may foster the development of SME markets in the EU.**

Firstly, a wider and more ambitious review of each regulation applicable to SMEs in the context of the new momentum we are trying to gather in the CMU initiative, through the very clear direction of alleviating the administrative burden for those companies. And everyone truly understands that that action imposes a European scale, which is of paramount importance in that dimension.

Secondly, the development of SME markets as an ecosystem of creators, researchers, financers, helpers, is primarily led at a national level. Indeed, even if it is without question a long-term objective, we must acknowledge that the very concrete impulse and dynamism in SME cycles of growth, development and financing are still concentrated at the national level, sometimes even regional level, among sponsors, banks, business angels, investing communities, etc. And that ecosystem should be fostered at a national level as we do in France with our clusters and communities we initiated and animâtes, such as the French Tech initiative.

Consequently, the CMU should largely include considerations on SME markets, bearing in mind that we must not miss the goal, which is to reduce the administrative burden each country and European regulations impose on those companies that are sometimes growing very fast. Therefore, an ecosystem-wide approach may not be relevant at the European level, no more than developing one-size-fit-all approaches or very costly >>>

>>> and non-targeted tax incentives, while European companies are still very different in sizes, financing practices and cultures within the European Union. Even if convergence remains the final goal, we cannot force it that way.

The development of SME markets is a major field of development for the CMU. Above-mentioned actions are relevant for the development of SME markets, but they are not sufficient. We may think of other options that could be useful in that dimension. First, the incentives to long-term investment could be boosted thanks to the review of Solvency 2, going further than the long-term equity investment portfolio created this year, which is a step in the right direction. Second, I expect that our work on securitization and insolvency will favor an easier way to fund business from its creation to its closing. Third, the development of capital-investment teams able to fund start-ups and scale-ups is of high relevance.

Last, the access to listing has been facilitated thanks to various initiatives, such as the SME Growth Markets initiative. However, some issues have not yet been fully addressed. For instance, financial research has been profoundly reshaped by MIFID and we observe that small and mid-cap issuers now have to fund it themselves. This may be considered as a supplementary hurdle to listing.

I expect the next Commission to look thoroughly at this subject when tackling the next CMU challenge. ●

Carmine Di Noia

Commissioner, Commissione Nazionale per le Società e la Borsa (CONSOB)

Rethinking the funding escalator? Some thoughts from Italian experience

Corporate financing is facing interesting structural changes.

We are witnessing a declining attractiveness of stock markets (except for Asia) counterbalanced by a growing role of private equity and an increased capacity, scale and variety of private capital markets.

> *"Developing equity financing for SMEs is crucial to meet the needs of both companies and investors."*
>
> - CARMINE DI NOIA

There is more money around (mainly in the hands of professional passive investors) but chasing fewer companies: the United States has lost almost half of its publicly listed companies in the past twenty years. There has also been a downward trend in non-financial companies' use of initial public offerings (IPOs) in advanced European economies. Companies now raise lots of money privately to fund their growth, and don't go public until they are already huge and mature and worth tens of billions of dollars.

On top of that, the innovations made possible by new technologies has helped to develop alternatives to the traditional markets. The digitalisation of assets, the use of blockchain network technologies to modernize market infrastructures and to cut out the "middle >>>

>>> man", the emergence of "marketplace investing" models offering a broad range of services are all accelerating the transformations at work in the financial industry.

In Italy, we are trying to close the gap by developing a more diverse funding escalator landscape. One of the new tool is the minibond. Minibond are debt securities (bonds and commercial papers) issued by private industrial companies, with a typically low amount that could be listed or not on a stock exchange. Italian SMEs, through the issuance of minibonds, have the opportunity to engage with sophisticated investors, acquire new skills on financial markets and 'practice' in the event of possible follow-up in more complex deals, such as allowing private investors to access the share capital, or listing on a stock exchange.

The advent of the minibond industry in Italy had also the effect of creating a new segment of investors (private debt funds) specialized in minibonds and direct lending to SMEs (another growing trend in our country). Interesting developments are also stemming from crowdfunding. The 2019 Italian Budget Law allowed equity crowdfunding platforms to host, together with the equity campaigns, issuance of debt securities targeted to professional investors or "sophisticated" ones' as defined by Consob. Even though crowdfunding remains a niche phenomenon in Italy, it is anticipating some inevitable future trends. Those platforms will increasingly act as a "one-stop-shop venue" where companies, regardless of their size, could gain access to different services (private placement, capital raising, crowdlending, secondary markets) making the idea of "listing" obsolete.

On the equity side, Italy introduced an alternative way of listing, less burdensome and faster compared to a traditional IPO, by the use of a Special Purpose Acquisition Company (SPAC), company that raises cash through an IPO without having any operations or physical assets aiming to find and acquire an existing unlisted company.

Enhancing the funding tool-box may not be enough. It is also paramount to develop a focused investor base (easing the legal constraints for retail but sophisticated investor) and to educate entrepreneurs, raising awareness on the importance of thinking long term, opening up to different financing options and develop internally sound corporate governance.

To conclude, developing equity financing for SMEs is crucial but it should take into account the way in which the financial world is changing. Going public is no longer the only route. Which financing channel will eventually deliver the desired outcome in terms of stable funding is difficult to tell in advance. The answers will not come from a mere easing of regulatory constraints but will involve the development of a comprehensive vision of financing in Europe, that takes into account differences in market depth and reconciles the development needs of companies with those of market robustness to attract investors. ●

Lukasz Januszewski

Member of the Board, Markets & Investment Banking, Raiffeisen Bank International AG (RBI)

Equity financing for SMEs

For which types of companies is it most important to develop equity financing?

Contrary to the mainstream view that equity financing is mostly suitable for larger, established corporates, RBI sees strong equity financing possibilities for companies across the entire life cycle, including SMEs. RBI itself launched a EUR 25m fintech-oriented VC fund in 2018.

Sources of equity financing differ depending on the life cycle stage of a given SME (business angels / VCs / PEs / public markets). In a number of circumstances, we advise our start-up / SME clients to consider equity financing: (1) High risk-return growth projects with relatively low cash-flow visibility in the short run, yet medium-to-long term financing needs. (2) Periods of financial distress / underperformance in mature businesses to help maintain a healthy balance sheet. (3) High loan costs coupled with scarcity of financing alternatives.

How important is the objective of developing equity financing for SMEs at a time when Quantitative Easing (QE) of the European Central Bank (ECB) provides wide liquidity in the market?

Despite their critical importance in growing jobs and stimulating >>>

>>> innovation, SMEs were not able to benefit as directly from QE as their larger peers. The ECB's corporate sector purchase programme targeted specifically large corporates with a public investment grade. Put differently, QE tended to benefit SMEs through indirect channels such as the loosening of eurozone financial conditions associated with ECB policy. Additionally, ECB QE obviously in general did not provide capital, but rather a supportive liquidity backdrop. In this respect, the argument for SMEs to consider equity financing remains as strong as ever: to improve their resilience to economic cycles.

Should there be more focus on leveraging the role played by banks in capital markets in the CMU? How could this be done and how could this benefit SME markets?

While there is a need from SMEs to enter and raise capital on public markets (i.e. supply of equity) and ultimately potential demand from investors, there are currently considerable market inefficiencies where banks can play a significant role.

Let's take the CEE region where SMEs are relatively small in EUR terms and their financing needs are accordingly limited. Given institutional investor portfolio concentration restrictions (i.e. can only hold a relatively small share of a given issue), this creates a cost hurdle for SME financing deals to overcome.

Banks could address this market gap via innovation with, for instance, introducing a standard reporting approach for SMEs they have relationships with. Bank participation in blockchain initiatives also has scope to support SMEs, not only through trade finance but also through more efficient collateral usage and reducing information asymmetries (which implies potentially lower deal costs).

One could also think of a Tier 2 capital type of solution leveraging the mechanism of a perpetual subordinated debt.

In this field, there are challenges to overcome, but it is also clearly an innovation opportunity for banks and markets to be won. The only question will be, who will be first? ●

Antonio J. Zoido Martínez

Chairman, Bolsas y Mercados Españoles (BME)

CMU and SMEs: focusing on the full development of the European capital market

A Capital Market Union (CMU) will take much longer to be completed than (politically) expected. That is relevant for SMEs.

The incomplete fulfilment of the expectations of the CMU Project have opened the way to question how to reset, or rebrand or, in fact, how to restructure the Project.

Should the construction of the CMU be the result of national market's efforts flowing, at the end, into an integrated market? Or should the building of a European Capital Market be the result of a concerted European Union effort from the beginning, at all necessary levels and areas required?

Both alternatives should accept a reality that, probably, has been consistently overlooked: patience is needed.

A look at the list of issues to be faced and solved, (the preferential treatment of debt over equity, harmonisation of securities and tax laws and harmonisation of reporting and supervision across jurisdictions…) show what a monumental task lies ahead.

Obviously, the reality of a CMU able to resist a certain comparison with the US market will take much longer than anticipated by politicians at the inception of the CMU Project.

An SMEs Market can only flourish as part of a sufficiently developed capital market of reference.

The shortcomings of SMEs as sources of homogeneous and potentially liquid assets for investment, highlight the need of their markets for additional support, such as tax incentives, ad hoc corporate structures and regulations…

The SMEs markets can only exist as part of the same ecosystem as capital markets. So, let's work for a developed competitive European Capital Market and SMEs will naturally find a way to satisfy their financing needs in that system, through specific markets or other means.

However, no work has to be interrupted until the perfect construction of a European Capital Market is declared concluded. Of course, not. Work has to continue even with imperfections.

One way to move forward in the area of SMEs would be to look at all the financing needs of those companies, not only at equity and classical debt. The balance sheet of many of these companies rely often in working capital needs that are met through the issuance of receivables or equivalent instruments.

Let's pay attention to this part of their balance sheet, which is full of suggestions, too, for promoting market-based finance.

One final observation. Vice-President Valdis Dombrovskis encouraged efforts to increase the number of Small and Medium Sized Companies listed on European stock exchanges from its current 3,000. That increase for SMEs is at the heart, he said, of the CMU Project.

That could be a good step forward. But let's mention here that in the USA a similar concern is ignored or, at least, away from the relevant public interest. In fact, there is no specific market for SMEs in the USA that compares to what we have in Europe. Why are they needed here and not there?

In the end, the number of SMEs listed could be more or less significant, as could be the existence of specific regulations for those companies. The important thing is to work for a more developed European Capital Market that would, and could, encompass easily our SMEs, or their specific markets, or market, providing them with the financing they need to flourish. ●

Niels Lemmers

Director, European Investors' Association

The pursuit of equity investment by retail investors in SMEs

Relevant stakeholders in the EU have for longtime been trying to get SME-equity listed. They have inexhaustibly exchanged views and presented initiatives on rebalancing companies' financial dependence from banks to capital markets. As this imbalance is part of Europe's finance culture, shifting this will take generations. Fortunately, a positive trend is noticeable. In the European Union, according to the 2018 SAFE results, SMEs reported that the most important sources of financing are credit lines (52%), leasing (47%) and bank loans (47%). Equity financing is relevant for 12% of the SMEs. In 2009 this was even as low as 1.6%. Despite all effort, the imbalance persists. Do we have to worry about that?

European Investors believes that EU citizens and SMEs should contribute to and benefit from well-functioning equity markets and gain of the associated economic growth. However, when it comes to SME financing through equity markets, wariness arises, especially if retail investors are approached. If bank financing or private financing isn't available for SMEs, one might consider that market financing is an option. This ignores that there are valid economic reasons why banks or private capital do not provide loans or investment arrangements. There might be significant risks attached to any prospect, numbers might be flawed and not all SMEs are Business Angels. Moreover, it is also critical that SMEs understand the mechanics and dynamics of capital markets to be able to navigate and leverage them. There is no such thing as a free lunch.

"Equity investment in SMEs requires a sustainable eco-system and a domestic approach."

\- NIELS LEMMERS

Consequently, the fact that SMEs are still overwhelmingly financed by credit and bank loans may be part of the well-functioning of equity markets. However, if we jointly decide to pursue shifting the balance, there are two key factors to discuss: sustainable eco-system and domestic approach.

Sustainable eco-system

Many regulatory initiatives have brought benefits to equity markets for SMEs, such as MiFID II and the Prospectus Regulation. These initiatives purported to balance market access, administrative burdens and investor protection. More should be done to build visibility amongst investors. Equity research, a key element of this visibility, is undermined by the transformation of research funding models. Exchanges, in their capacity as market places, and brokers are the central points for SMEs and investors to meet. They should promote equity listing by SMEs and foster interest from investors to weigh SMEs' investment proposals. Regulators and legislators have to participate as well by facilitating an efficient but thorough listing process. It is crucial to have a sustainable eco-system for SMEs and investors.

Domestic approach

Retail investors tend to have a domestic preference when investing in companies, especially SMEs. They feel more involved with companies in their own environment or companies from which they own products or purchase services. Linking this preference with regulatory or exchanges driven initiatives is key. An investment proposition has to be introduced properly, with all relevant information disclosed and investor protection assured. Essential liquidity has to be arranged and continuous transparency on trading is a condition. Then shifting the balance may have success. ●

Michael McGrath

Assistant Secretary, Department of Finance, Ireland

CMU - recognising existing complexities, what needs to happen?

The benefits of more integrated and deeper capital markets are known. Developing an EU Capital Markets Union (CMU) complements our efforts to strengthen the resilience of the banking system. However, greater clarity on what needs to done and who needs to take action would help our delivery.

Firstly, we must acknowledge the significant improvements made so far. We have delivered a range of legislative and non-legislative proposals – we all know these files. We have also delivered significant reform of the European Supervisory Authorities. Some may have wished for more centralisation, others placed greater emphasis on targeted and appropriate measures designed to strengthen the ESAs, while recognising the important knowledge base of national supervisors. We got a good and balanced package, which now needs to be implemented.

Secondly, CMU must be understood for what it is, and what it is not. In my view, CMU is first and foremost a multi-annual structural reform project. We seek to change lifetime habits of individual and institutional actors, so as to encourage deeper capital >>>

>>> markets that will provide new financing options for our enterprises. Moving the dial from the traditional bank financing model towards a much broader investment culture, with wider societal participation, should be a positive outcome. However, CMU must not become the "banner" from which we hang more tangential proposals and initiatives. Focusing on core and necessary policies that deepen CMU and provide funding for entrepreneurs is key.

Thirdly, in a more multi-polar and complex environment, of which Brexit brings additional complexity, clarity on what our new CMU priorities should be is vital. In that context, a greater appreciation is needed that not all of the financial market expertise and activities is now, or will ever be, within the EU. If we are to develop truly cross-border and deeper capital markets within the EU, we must remain open to cross-border activities both from within the EU, as well as from outside. Of course, in so doing, national and European policy makers and our Regulators have ever increasing responsibilities. Their role is key in ensuring a sustainable, safe and appropriate system to serve our economic needs.

"Focusing on core and necessary policies that deepen CMU and provide funding for entrepreneurs is key."

- MICHAEL MCGRATH

Fourthly, our response to "disrupters" of long-standing market practices and the regulatory environment needs to be developed. Other important policy goals such as developing the ESG and the Sustainable Finance agendas are important considerations when shaping our CMU priorities. Regulatory consistency within the EU and the ever-growing importance of transparency in all aspects of the financial markets must remain an important consideration as well.

Finally, we have yet to reap the full benefits of the steps taken so far. Appreciating this, and fully internalising it into our thinking, should provide greater clarity as we renew our collective effort to deliver a fit for purpose CMU for all of the EU over the coming few years. ●

Mario Nava

Director, Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

SME equity financing in the EU needs a boost

Although the EU already invests a lot of money and efforts into helping SMEs grow, they often remain unable to expand past the critical mass needed to compete globally. Funding support is crucial at the early stages, but many companies end up listing or being bought up by large corporates outside Europe, reducing the EU's competitiveness while other economies benefit from the EU's innovation potential.

"SME IPOs sharply declined in the aftermath of the crisis and have not picked up since."

- MARIO NAVA

The main challenges in the primary and secondary markets are still numerous despite all the measures introduced to date. The number of IPOs remains at a much lower level than the pre-2008 crisis, while the new listings are mainly concentrated on the largest exchanges and involve large and mature firms.

The number of SME IPOs sharply declined in the aftermath of the crisis and have not picked up since, leaving the European funding escalator broken. This limits high-growth companies' abilities to expand, innovate and create jobs, not only when they reach the sufficient size to go public, but also at earlier development stages. Indeed, without sufficient investors ready to invest in innovative companies' first listings, venture capitalists will also have less exit opportunities for their investments, thus weighing on their willingness to invest.

Regarding the secondary markets, the transaction costs are higher in smaller markets, trading activity is mainly concentrated on domestic shares and there is a limited retail investment participation in European markets.

Through the CMU Action Plan, the Commission has put forward several legislative and non-legislative measures which aim at addressing this market gap: proposal for the development of the SME Growth Markets, review of EuVECA, proposal on crowdfunding, assessment of the drivers of equity investments by insurance companies and pension funds, as well as contracted a study on the assessment of the impact of MiFID II research unbundling rules.

Insufficient investor demand increases the cost of capital raising for SMEs considering a new listing, therefore weighing on the pipeline of companies willing to access public markets. This leads to a vicious circle: as there are too few SMEs listed on exchanges, SME research remains largely bespoke (i.e., not mainstream), driving up its cost. On the other hand, the unavailability of SME research makes it more difficult for institutional investors to choose SMEs to invest in, regrettably leading to even less SME issuances in the first place. These negative, self-perpetuating dynamics are very difficult for the market to solve on its own, therefore justifying some form of public intervention to support investment into SME shares.

As set out in the political guidelines of the President-elect Ursula von der Leyen, the priority is to put forward a dedicated SME strategy to ensure further reduction of red tape and improving access to the market of the SMEs, as well as creating a private-public fund specialising in SME IPOs with a view of boosting new listings. Moreover, for the entire ecosystem to be adapted to capital markets and needs of SMEs, the challenges of further addressing the barriers of non-bank insolvency, supervisory convergence and addressing barriers to cross-border trade due to withholding tax still remain. ●