DEVELOPING EQUITY FINANCING FOR SMEs

1. Opportunities and challenges associated with the development of SME equity markets

Several speakers stressed the importance of developing equity markets in Europe, and SME markets in particular, for ensuring economic growth with a diversification of the funding of these businesses, providing more attractive saving opportunities for citizens and enhancing financial stability. Equity markets may also favour a better alignment of interests between companies and savers.

The possible challenges facing EU SME equity markets were also described. **On the investor side, MiFID II and the risks associated with SME equity were the two main obstacles mentioned.**

An industry representative stressed that the MiFID II requirements mandating the unbundling of research and trading costs have led to a reduction across Europe in both the quality and quantity of SME research, undermining investment in SMEs and the liquidity of SME stocks, as many small and medium brokers are closing their doors. Figures in Spain show that there has been a 30% reduction of the amount of research on SMEs and 25% of the number of analysts specialized in this segment, with similar trends throughout the EU. There is a growing number of 'orphan stocks', which are companies that lack any research. Ultimately, these MiFID II requirements go against the objectives of the Capital Markets Union (CMU), particularly concerning SMEs, the speaker felt. An investor representative explained that retail investors hear about companies through word-of-mouth or read about them in newspapers so there is often an emotional connection at the start. Research helps them to decide more rationally which companies to invest in and for how long.

Risk averseness of retail investors and the actual level of risk of SME stocks are a second barrier to the development of retail investment in SMEs. An industry representative noted that in most parts of the EU, a large part of savings is currently invested into bank deposits with limited or no remuneration. There is a demand for alternative investments with a guarantee in capital but these products, especially in the current interest rate situation, are not efficient. This is both an opportunity and also a barrier to investment in more risky instruments. An investor representative emphasized the importance of considering the risk aspects associated with SMEs for retail investors who only invest a limited number of times in stocks. On average only a small proportion of SMEs succeed, maybe one in four or five. While professional investors may tolerate a probable chance of losing their money on a failed SME, it is difficult to ask households to do the same. This risk can be reduced with diversified portfolios or by investing in SMEs that have listed debt before equity, for example, but it cannot be overlooked.

Several barriers to SME equity issuance were also mentioned.

The current low interest rate policy is a first obstacle to the development of public SME markets. An industry representative explained that low interest rates have increased the liquidity available for private equity funds which are buying a great deal of successful SMEs. As a result, the balance between takeovers and initial public offerings (IPOs) is tilted towards takeovers such that there are fewer companies going public and less investable money in the public equity markets. Another industry representative added that in many cases the external funding of SMEs is ensured through bank loans, which are widely available and cheap at present with the liquidity available in the banking system. Companies are therefore less likely to go public. However this could lead to a funding 'squeeze' in the future if conditions change.

Transparency requirements for going public are a second obstacle. An industry representative stated that many SME owners are reluctant to publish the financial information that is required of them when entering the public markets and they are more inclined to share this more privately with banks.

The limited financial literacy of many SME owners is a third issue. An industry representative called for more education on the importance of diversification in funding with both debt and equity, in order for companies to better withstand any issues that may arise, such as those that occurred during the financial crisis.

Finally, the unintended consequences of certain capital market regulations were also emphasized. A regulator criticised the Commission for extending the market abuse directive to not only address insider trading and market manipulation but also price sensitive information, reporting obligations and managing transaction registers. This extension was made for all issuers on MTFs, the result being that similar obligations apply to SMEs and to large caps. There is some proportionality such as simplified registers for market abuse but it does not work. Effective proportionality should be introduced on the occasion of the review of the regulation. The new prospectus regulation is also problematic, the regulator considered. It may not work on a cross-border basis for equities because of the inefficiencies created by the need for an additional approval of the prospectus by the national host regulator, when an issuer wants to list in another EU country. Putting in place a centralised approval system in the EU was proposed during the review process but was not adopted. An alternative could be to test a 27th or 28th regime for prospectuses.

Brexit is a further issue, an official stressed, that is impacting the European capital markets with potential liquidity loss and fragmentation, but opportunities may also arise in the longer term with the possibility for the EU27 to grow its capital markets.

2. Ongoing policy actions for developing SME markets

2.1. On-going CMU action plan

A policymaker stressed that developing SME capital markets is part of the objectives of the Capital Markets Union (CMU) but that there is a need to prioritise the development of these markets at the national level over the cross-border one. This is a long-term objective because many issues relating to culture, market structure and investor attitude need to be addressed. The Commission has put forward a number of legislative initiatives designed to help SMEs in the initial 'pre-IPO phase' during which they are more risky; after the IPO stage, enterprises usually move towards making more profits. Considering the diminishing number of IPOs over the last few years, the policymaker believed that a market failure may exist that should somehow be addressed through government action.

In addition, there is no scarcity of initiatives within the CMU action plan concerning SMEs markets, with measures to develop SME growth markets, the review of the European venture capital directive (EuVECA) and the European Long-Term Investment Fund (ELTIF) regulation and also proposals made to develop crowdfunding due to be completed by October. There has also been an assessment of the drivers of equity investment for insurance companies and pension funds and of the impact of the MiFID II research unbundling rules. However, beyond this, the development of SME equity markets is hampered by a lack of investor demand, which is hindering price discovery, together with some difficulties on the supply side. These are the main reasons leading to the stalemate that can currently be observed on the market.

2.2. Possible additional CMU actions

There is also a question as to whether additional actions would be needed in the CMU, the policymaker stressed. Most legislative proposals of the initial CMU action plan have now been implemented, but there is a realisation that further actions may be needed in certain areas. Several proposals are on the table[1], some concern SMEs, and priorities will need to be determined by the incoming Commission.

An official believed that the CMU has been successful in that a great deal of legislation has been brought forward. There is also significant political impetus in favour of SME financing but there is still a need for specific initiatives for improving the appetite of investors and addressing possible market failures in this area.

An official felt that the pan-European personal pension product (PEPP) and similar products can help provide better yields for pensioners and should be further considered as a way to develop investment in SME equity. In addition, the market needs to be opened beyond the EU so that SMEs can access investors outside the EU and external investors can access EU companies. An industry representative agreed that developing the access of institutional investors and pension funds to alternative SME markets would help retail investors to invest in these companies that tend to be too complicated or risky for retail investors to directly invest in. Tax incentives would also be necessary in this context.

An official moreover noted that the shift to IPOs and listed markets can be quite sharp for SMEs and instruments like private equity and crowdfunding are necessary to provide a form of 'funding escalator' to bridge the gap.

2.3. Improving MiFID II research unbundling rules and investor categorisation

A policymaker stated that the Commission has heard the criticisms levelled against the MiFID research unbundling rules and will act upon evidence ascertaining whether the rules have given rise to significant unintended effects.

A regulator supported the Commission's evidence-based approach but stressed that the evidence should be appropriately identified and assessed. The IMF, for example, has reported an overall increase in SME research but failed to distinguish unsubstantial research produced in an automated fashion with machine learning tools, which has increased, from true SME research, which has decreased in coverage. Quality research is only produced if there are economic incentives, but these no longer exist because of unbundling. There have been attempts in the US also to move towards independent research but these have not worked either. The speaker suggested that stock exchanges could play a role in providing research on this segment of the market.

An industry representative noted that there is a project at the Spanish stock exchange to produce research for orphan stocks. Another industry speaker felt that digital solutions based on artificial intelligence or big data solutions can help support useful research without putting an additional burden on entrepreneurs.

Some speakers emphasized that research and analysis is also needed from the buy-side perspective. MiFID addressed this issue mainly from a sell-side angle but a buy-side analysis of the factors relevant for investment is also essential, an investor representative emphasized. An official agreed that more information and greater transparency are required for retail investors but noted that this should not lead to an excess of information and the implications for those providing the information should also be considered.

A regulator suggested that the SME market also needs a group of investors willing to bear risk and ready to be recognized as such. Changes could be made to introduce in MiFID a new category of experienced retail investors in between retail and institutional ones, as proposed in a recent paper on the CMU[2], that could be an appropriate target for SME stocks. Crowdfunding is another positive development in this regard, as it involves having a category of semi-professional investors for whom requirements are adjusted, as is the case in the US. Another idea is for the authorities to have a list of qualified investors; this approach was tested by some domestic authorities when the prospectus regulation was reviewed, but it was abandoned.

3. Possible additional solutions for developing SME markets

3.1. Public - private support mechanisms

A policymaker stated that the private-public fund specialising in SME IPOs called for by Ms von der Leyen in her political guidelines for the new Commission could help to solve the apparent market failure in the pre-IPO phase. This fund would be set up with an initial investment from the EU that could be matched by private investors. The 'funding escalator' referred to earlier currently stops short of being a full escalator and a private-public fund can help address this.

An investor representative approved the suggestion to put in place this public-private fund. If the fund is kickstarted with public money up to 50%, it could be listed so that other investors can take the remaining 50% over the long-term if the fund is performing well. In addition to providing a number of SMEs coming to the market with a first investment, the fund could take care of the initial risk assessment on the investor side and would also allow SMEs to gain a first experience of the listing process before doing it by themselves. This fund should help to start up again the SME equity market and then market forces should gradually take over. This process should be incremental because the market needs time to develop. In this perspective developing local ecosystems that can support over the long-term SMEs initially financed by this fund will be essential.

An official noted that a number of mechanisms already exist in the local markets, for example government supporting agencies of industrial authorities that support taking equity in companies. There are also mechanisms at the regional level. However a great deal of SMEs have been 'burnt' previously when taking on debt and, as a result, they are reluctant to go back to the market and prefer to leverage internal resources. To increase demand on the issuer side, there is a need for clear and transparent information and for a balance in the rules between the needs of the investor and the interests of issuers. Rules also need to be standardised across the EU. Supervisory convergence, which should be strengthened following the recent European supervisory authorities (ESAs) review, should help to achieve this.

3.2. Issuer and investor education

A official suggested that long-term efforts are needed to deal with issues such as issuer and investor education, and improving financial literacy. Some quick wins could be identified after a stock taking exercise but this will mostly be a long-term effort for which pragmatism is needed. An industry representative noted that programmes have been put in place by stock exchanges in particular to educate companies that wish to go public. Topics covered include governance practices, which many companies find complicated to put in place when they go public because they lack the necessary infrastructure.

A regulator also highlighted the importance of education programmes for small SMEs. These can teach them the 'basics' of financing and can also allow the identification of the companies that really intend to put in place the actions needed for diversifying their funding sources, and are able to do so, and also support them in this process.

3.3. Developing SME bond markets

A regulator suggested that bonds, which should be seen as an instrument half-way between bank loans and equity, are appropriate for small firms that are not ready to open up to equity participation, but which are keen to make an entrance on the public market. These characteristics may also be attractive for retail investors. Evidence, notably from ECB research, shows that, when the market is tapped even with small bonds, there are benefits for the issuers on the bank funding side also with more loans granted at a lower rate and also for the valuation of these companies because they have begun to put in place improved procedures regarding e.g. governance and budgeting. The regulator felt however that there should be no pressure for SMEs to be listed on public markets as not every SME belongs there and this may create selection effects whereby only the worst companies go onto the market.

An industry player agreed that financing should be both in equity and debt and explained that an alternative fixed income market has been created in Spain to facilitate market access to debt instruments such as bonds and commercial papers. The level of growth of this market is very satisfactory and part of the companies present are not listed on the equity market.

4. The need for innovative solutions

A number of speakers considered that the issue of SME market financing is currently being tackled in a way that is too conservative, via traditional equity markets, stock exchanges and IPOs. More creative solutions are needed to ensure that offer meets demand in the SME equity market. An industry representative suggested that the cooperation that is developing between banks and fintechs could be a way of providing more innovative solutions. Perspectives from outside the industry are also needed to find new ways of investing that address the risk posed by SMEs, while answering customer needs. Using the analogy of a percentage of daily coffee spending invested in SME equity, the speaker suggested that innovative models supported by technology and big data allowing a large number of individuals to invest regularly small sums of money in SMEs at a regional level could help investment in SME equity to develop in a significant way, providing investors with diversification and risk mitigation. Regulation needs to facilitate the development of such mechanisms.

Picking up on this scenario other speakers suggested that some consumers could be interested e.g. in spending more on each coffee in return for a potential share of the profits if the shop grows. This type of mechanism seems feasible with a younger generation that is ready to combine spending and investing, supported by the increasing use of apps and the development of crowdfunding. Proper investor education that does not unnecessarily hinder investor appetite will also be important in this perspective. Another issue, an investor representative suggested, is how these new mechanisms, based on innovative fintech solutions, can develop in parallel with the existing infrastructure of exchanges and brokers that provide the transparency and price discovery that is necessary when SMEs grow. An industry representative also suggested that the design of regulations should strive to mirror the development of industry products that now uses faster development processes, based on prototyping and testing and involves clients and other stakeholders early on in the process.

[1] A recent working document of the IMF has called for action in 3 main areas: (i) transparency notably with the introduction of a standardised electronic reporting for all issuers, (ii) supervisory convergence and an improved regulation of certain areas (systemic entities, pension products); (iii) insolvency rules aiming to disseminate best practices. There are also calls for increasing capital market depth, for creating a safe asset at the Eurozone level or for more public intervention to foster long term investment.

[2] The Next CMU High-Level Group Report to Ministers and presented to the Finnish Presidency (October 2019) proposes to introduce the definition of a new category of experienced High Net Worth ("HNW") investors with tailor made investor protection rules.