Improving the funding of innovative and growing SMEs

Roger Havenith

Deputy Chief Executive,
European Investment Fund (EIF)

Navigating the twin transition: late-stage financing

With the coronavirus pandemic unfolding, there is little doubt that we are facing a health and economic crisis of unprecedented proportions in recent history. This comes against the backdrop of Europe's challenges related to digitalisation and the transition to a green economy.

As usual, it is the smallest actors in the economy that will find it hardest to cope. This is where public interventions need to help innovative European SMEs not only to navigate the transition, but also to lead it. With limited public resources, crowding in private funds will be key. Financial instruments have proven to be very effective attracting private funding and catalysing investment in support of European SMEs and midcaps. Research has confirmed that companies supported by EU financial instruments have seen greater growth in sales, assets and employment. It is now a question of using these instruments to target the industries of the future, secure Europe's competitiveness and harness them to support our values, policies and standards. This entails expanding established mechanisms to support innovative SMEs throughout their lifespan.

For many years, lack of sufficient early-stage funding was Europe's main equity market gap. Public measures aiming at catalysing private investments have successfully narrowed this gap. A second market gap, however, persists: when successful start-ups need funding to support further growth. In 2018, European VC-backed companies received just EUR 15bn in late-stage financing, compared to 24bn and 57bn for their US and Asian counterparts. In the absence of financial support in Europe, SMEs will relocate to more favourable financial climates. US and Chinese investments in Europe have been increasing and foreign investors – often government-backed – have been eyeing Europe's most promising companies, enticed by attractive valuations and driven by strategic interests. The recent CureVac case is indicative of this trend.

If we are to create global champions, late-stage support needs to be reinforced. The proposed SME IPO Fund would expand the range of EU support measures and help complete the VC ecosystem. The issuance of new SME stocks on dedicated markets in Europe has never fully recovered since 2008: amounts raised went from EUR 16bn in 2006 to less than EUR 3bn in 2018. Addressing this later-stage financing gap would significantly improve the exit environment for investors. In a recent EIF survey of more than 300 fund managers, 40% identified the poor exit environment as their greatest challenge.

In parallel, as we look to support key sectors such as AI, block chain, space, skills, climate and social impact, we also need to make progress in completing the CMU, strengthening the single market, and ensuring solid trade defence mechanisms and a competition policy framework fit for purpose. Faced with many challenges at the same time, Europe needs an ambitious and common Europe-wide response that addresses the immediate threats for the health of our citizens and needs of the real economy. A response, also, that is fit to address the longer-term challenges: sustainable economic recovery and maintaining the competitiveness and innovation potential of our companies.

Financial instruments are not a panacea. But they can be a critical building block of such a response, helping to fund the opportunities that will propel European businesses to the forefront of a sustainable recovery. ●

Carey Evans

Managing Director, Global Public Policy Group, BlackRock

A roadmap to an improved funding landscape for SMEs and innovative and growing companies

Despite the perception that Europe loses its highest potential companies to the allure of US venture capital and the US consumer market, many exceptional young companies do indeed choose to stay put in Europe. Furthermore, Europe is home to a significant number of more mature SMEs who are, in many ways, world-leading firms.

These companies can be exciting investment opportunities for many investors, and the companies themselves should be able to benefit immensely from access to capital market funding solutions in complement to bank finance. The refocused CMU agenda should ▶

▶ provide means to better-connect companies and investors.

We see three areas of focus for promoting a healthy ecosystem for financing these companies:
1) Provide companies with pathways to grow;
2) Facilitate and ease the listing process, and;
3) Promote a wider and deeper investor base for small companies.

The debate over incubating growing business tends to focus on the 'funding escalator' – a linear path through various stages of specialist venture and growth financing, ending with an IPO. This path is increasingly out of sync with how many companies grow from a financing perspective. Companies can stay private or go public, depending on their needs, but the crucial point should be providing the opportunities for companies to grow as businesses.

The untapped potential for the Single Market to help firms grow into a pan-EU marketplace beyond their own national borders is significant. Working capital is a key ingredient for helping small companies of all growth aspirations and trajectories thrive, but it is often overlooked in the policy debate around supporting SMEs. Promoting additional sources of working capital to complement bank finance – such as non-bank lenders, or ABCP programmes – would help companies meet a range of ongoing financing needs.

> *The refocused CMU agenda should provide means to better-connect companies and investors.*

When it comes to the companies for whom listing can be an acceleration of their growth and funding aspirations, improvements to the listing process can be made. Since 2013, 40% of European IPOs have failed – largely due to pricing expectations not being met. Promoting direct listings where a firm lists without raising capital is a positive intermediate step where firms can build a track record as a public company, and investors can deepen their familiarity before the firm looks to raise capital. In a limited sample size in Europe to date, direct listings have resulted in companies finding it easier to eventually meet capital raising goals than they had previously attempted in their IPO processes.

In the medium-term, it is imperative to grow a specialist investor segment focused on small companies. Widening the investor base by exploring whether policy can bring in new investors or accommodate increasing interest from larger institutional investors is critical. For example, looking closely at structural barriers like accounting issues for insurers and pension funds that keep them under-allocated to strategic long-term asset classes like early-stage equity should be a key focus for policymakers. We see exciting possibilities as well for bringing investment strategies focused on exposure to a range of growth companies at different points in their growth trajectory – from early stage providing continuous investment through to their development into more mature listed companies – to certain types of retail investors with long-term investment outlooks. The ELTIF provides a unique platform to grow this market; targeted amendments to the framework could help facilitate this further.

A roadmap to grow sources of funding for many SMEs is more necessary than ever as Europe faces recovery from the economic impact of the current pandemic. The CMU High-Level Forum is looking at closely these issues and we are hopeful that the range of recommendations result meaningful benefit for European companies and investors. ●

Henry Erbe III

Global Head, Strategic Relationship Management and Public Policy, Fidelity International

Financing sustainable innovation in the EU with an Electronic ESG IPO Exchange

With the start of a new decade, the EU Commission needs to take bold action to relaunch the European Capital Markets Union (CMU) initiative with stimulatory policy and stakeholder engagement to drive SME capital formation in the "real economy". Since 2015, the core aim of CMU remains the same - strengthen capital markets, finance SME innovation and create jobs. In 2020, Europe also finds itself as the world leader in promoting Sustainable Finance and Environmental, Social & Governance (ESG) initiatives - a position that Europe must maintain.

Fidelity International recommends that the EU consider establishing a dedicated electronic ESG IPO exchange (ProjectE3) to power SME innovation, European economic growth and job creation. The time for the EU to innovate and differentiate is now. In non-EU markets around the world, SMEs have historically pursued initial public offerings (IPOs) to access growth capital they need to hire new employees, develop products, drive growth, ensure governance, as well as to expand their businesses in home markets and globally.

> *The time for the EU to innovate and differentiate is now.*

In addition, IPOs also provide pension funds, other investors and employees who receive long-term equity incentives, an opportunity to share in the upside of successful companies (studies show that 90% of job and revenue growth occurs after a company's IPO). The EU has not yet delivered on CMU and one negative result has been an 85% decline in European equity new issuance since 2005. The development of a dedicated electronic IPO ▶

exchange focused on sustainable initiatives will tackle multiple policy objectives of the Commission. It would enable SMEs access to growth capital, while putting into practice the objectives of the European Green Deal, Sustainable Finance and the CMU. With online issuance and electronic secondary market trading, an IPO exchange would also showcase Europe's evolution in the Digital Age.

In practice, we envisage a consortium of EU exchanges and market participants - bank underwriters and asset managers - developing an electronic IPO platform for ESG and sustainable SMEs with distribution to both institutional and retail investors as well as pension funds. In practice, SME eligibility for the ESG exchange would be determined using the EU taxonomy framework for the "Environmental" - and social, labour, tax and other policy frameworks for the "Social & Governance". A centralized ESG exchange and IPO platform would also encourage EU research excellence, market making, liquidity and attract non-EU issuers as well. Inspiration could be found with global regulatory initiatives for young emerging SME companies e.g. the US Emerging Growth Company IPO Reform, UK Alternative Investment Market (AIM), Hong Kong Exchange Innovation Lab & New Listing Regime - as well as many of the successful online financial lending and investing platforms.

EU regulators have an important role to play both in terms of overseeing the development of the platform as well as ensuring prudent governance and future supervision. With strong Points of View on IPO Reform, Sustainable Finance, Investor Education & Protection and FinTech Innovation, Fidelity International is ready to play an active role in creating an EU IPO Task Force to further develop this idea and others.

Oliver Gilvarry

Head of Markets & CMU,
Ministry of Finance, Ireland

The importance of European retail investors & SMEs for European economic growth

The development of our capital markets will support the growth of our SMEs at different stages of their development, which in turn will ensure Europe has a dynamic and growing economy. In order to achieve the objective of developing a strong and deep European capital market to support our SMEs, we need to have the pools of monies to invest in such markets. The potential for increased participation of retail investors in EU capital markets is significant. In the EU, 30% of total household financial assets is held as cash and bank deposits, with wide differences between Member States.

To gain the maximum from increasing the level of retail investor participation in our markets, we need to ensure they can invest in products that support our SMEs along their growth cycle, from start-ups to becoming large corporates able to raise financing via global capital markets. This means ensuring that we have the range of financial instruments that SMEs can use to raise financing, such as through venture capital or private equity or debt issuance or IPOs. This will also benefit investors by allowing them to diversify their risk by investing in SMEs in different sectors, but also allowing them to diversify via investing in SMEs at differing stages of development.

Under the first phase of CMU we have made a number of amendments to enable our SMEs access additional sources of funding, we have amended the Prospectus Regulation, Market Abuse framework and EuVECA/EuSEF. We need to ensure the changes we have made across these different pieces of legislation, and others, are sufficient and are working in tandem with one another.

At the same time we need to consider, are we providing the correct amount and quality of information to investors to enable them make investment decisions? MiFID II has provided significant transparency to investors in the area of fees and we are seeing a change in behaviour as a result.

We need to build upon this by ensuring we are providing the right information in an understandable way for investors, along with aiming to reduce the burden on entities providing this information. By achieving these two objectives, we will help make access to our capital markets more efficient. The introduction of an additional class of investor under MiFID may be a way forward, but it must be designed in a way so as not to add more layers of regulation on firms or investors or lowering investor protection too far.

> *Another initiative could be to examine what needs to be done to improve take–up of the ELTIF structure.*

Another initiative could be to examine what needs to be done to improve take-up of the ELTIF structure. Its objective is to invest in debt and equity of non-listed companies. Therefore, it should be the ideal vehicle for Europe's SMEs during the early stages of growth. In the last phase of CMU we have made changes to the EuVECA/EuSEF structures; we should now do the same for ELTIF to help promote early stage investment in our SMEs.

To conclude, Europe has a growing and vibrant SME sector and we need to continue supporting it. This is even more important due to the impact Covid-19 will have on all our citizens and economies. Therefore the changes we need to consider in the next phase of CMU is how we increase retail participation, ensure we have the appropriate mechanisms for them to invest in our capital markets and that they and SMEs can invest and raise capital efficiently.