

# DEVELOPING EQUITY FUNDING

## 1. Importance of equity funding for the EU economy and current market trends

### 1.1 Importance of equity funding for the post-Covid recovery

The Chair stated that developing equity funding is particularly important for tackling the current recession during which saving rates have increased. Because of the major public intervention put in place people did not need to de-save as is usually the case during a recession. The supply and demand shock during the Covid crisis also meant that people were unable to spend. When the worst of the crisis is over, consumption should increase but some of this accumulated spending will also likely be ready to be invested, notably in equity.

An official commented that equity funding is key for the post-Covid recovery. Post-Covid, more people might also be aware of the importance of equity funding. The Covid pandemic has demonstrated that equity is a first buffer of resilience for corporates and helps them to face up to unintended events. The future growth of Europe will be linked to active investment in the economy with a significant proportion of equity. Increased equity financing from European investors would also help to retain control over EU corporates in the Union.

An official added that equity is particularly important for the financing of the young and innovative businesses that will drive structural change in the EU economy. These companies are indeed those that have the potential to put innovative ideas into practice, create jobs, and safeguard the foundations for future prosperity and growth in Europe.

### 1.2 Current investor trends

An official noted that, looking at the demand side, there is a great deal of money ready to be invested in equity. This is due to continue because monetary policy is creating significant liquidity and investors are struggling to find investments that provide sufficient return. The share of that money invested in EU corporate equity is however still relatively limited.

An industry representative stated that retail investors are essential for the equilibrium of the European capital market. 2020 was a very good year for retail investment. Statistics from a major French e-broker for example indicate that new client accounts increased by +120% in 2020 and 39% of all new clients are between 28 and 35 years old.

Another industry representative confirmed that retail investment increased in the last 12 months, which is encouraging. However, there is still a lack of critical mass of savers ready to invest in small and medium-sized enterprise (SME) equity and a scarcity of equity research available for investors concerning these companies. There are also very few dedicated fund managers for small caps or microcaps and not enough venture capital (VC) available for the necessities of these kinds of companies. In addition, these companies are not well

connected with the VC world and not sufficiently aware of the opportunities it offers. Going forward there should also be a stronger focus on the inclusion of SMEs in the portfolios of mutual funds, pension funds, insurance companies and retail investors.

### 1.3 Main issuer trends

An official commented that, when considering the issuer side, making equity funding more accessible to more corporates, beyond fast growing and technological companies, is an important objective. Many more traditional corporates would also need to have a more sustainable balance sheet. One challenge for issuers, which is a political and economic issue, is that investors still have an expectation of high return despite the current market conditions. It has remained at the same level as before the crisis. At the same time, in Europe at least, due to monetary policy there are very low interest rates. If a corporate in good health is asked whether it prefers a loan at 1% annual interest for eight years or some equity funding, which involves giving away some control over the company and up to 10% annual return, the choice is easily made in most cases.

From an economic standpoint, there is a need to increase the share of equity in corporate balance sheets in Europe so that corporates become more resilient and are able to finance their development. Equity funding does not only come from external investment however, corporates can also generate equity by improving their results, particularly if they are not able to access easily equity markets. There is an on-going debate in many member states about how to create the best environment for corporates to be able to generate profits and save part of them on their balance sheet. This discussion will remain relevant after the Covid crisis and should take into account all companies. If the focus is only on non-viable or fragile corporates, the capital reallocation mechanism will not operate. Some jobs might be saved in the short or medium term, but this will not increase the productivity and resilience of the whole corporate sector in Europe. The best way to do this is to enable some capital movement in terms of allocation. In the case of SMEs, this could include consolidation in some sectors that have been very badly hit by the crisis, because it is good that part of the equity should be brought by corporates in good shape to other companies.

A public representative stated that, even before COVID-19, many companies greatly preferred debt financing over equity, partly because of its more favourable tax treatment but mostly because debt is a financing channel that is easier to access. Companies have an existing relationship with their banks and can easily get access to more credit in many cases. Getting an equity injection is considerably more difficult and many entrepreneurs find equity financing less attractive and do not understand how an IPO would benefit them, because for privately held companies it implies giving up an ownership stake.

The COVID-19 crisis has moreover reinforced and amplified the trend in favour of debt. Governments and regulators have encouraged companies to take on additional debt and banks to hand out additional loans. That has been done for more than a year, so corporate debt levels are now quite worrying. At the same time, the potential for rebalancing the financial structure of European corporations has never been so high. Valuations in equity markets are sky high and many retail investors have rediscovered public markets to invest or speculate in. The time is right for companies to tap into equity markets, the public representative believed. IPOs in the US and the boom in the “blank-cheque” companies, the so-called special purpose acquisition companies (SPACs) going public, also demonstrate that there is some confidence in public markets at the moment. However, there are still some structural issues preventing companies, particularly smaller ones, from fully exploiting the situation. The listing process in the EU is still tiresome, which is probably the biggest hurdle for SMEs or Mittelstand companies at present. In addition, the market for equity research has been getting smaller over the past few years. This trend was visible even before the MiFID II Directive came into force, but it has accelerated since and companies are becoming less and less visible for investors. This issue needs to be addressed as part of the capital markets union (CMU) project and the upcoming MiFID II review.

#### **1.4 Equity market structure developments and challenges**

An industry representative outlined the positive developments in EU capital markets related to Brexit: a move of a large part of euro equity trading from London to the continent and an increase in the turnover of the exchanges and the multilateral trading facility (MTF) platforms based in the EU. However, the fragmentation of the EU trading market across multiple venues and financial centres still needs tackling.

A public representative considered that there are structural problems in the European equity market, particularly for smaller companies. There are few exchanges and little equity research for smaller companies. Listing is expensive, complicated and requires a great deal of disclosure that entrepreneurs are not always ready to make public. There are also few banks or investment firms in the EU that can partner with companies to guide them through a listing process because it is not the core business of most European banks. More of them should deal with the diverse situations in terms of equity raising, rather than just focusing on large IPOs. The other problem is that even successful SMEs are more likely to go to the same bank they have always done business with and the banks that SMEs use tend to be smaller institutions in most cases that find it difficult to fully support the growth of their clients. There will be a lag in SME equity financing until answers to these challenges are found.

## **2. Policy priorities for developing equity markets**

A public representative stated that three main actions are needed for improving the attractiveness of equity markets. These are partly legislative and partly market-driven. First, the European ecosystem and the market infrastructure should be improved to facilitate access to stocks and cater for different needs. This should be a

market-driven process possibly supported by national governments and money from the recovery funds. Second, listing rules should be easy to navigate and cost efficient for smaller companies in particular. For example a modernisation of listing rules is needed to provide founders with better options for retaining a certain degree of control; dual share classes could be an option for SMEs for example. Third, there needs to be a change in how people regard equity markets. A prolonged period of low interest rates is likely to bring more private capital to the equity market, because other savings provide very little interest. How to further encourage this evolution should be discussed in the MiFID II review. One example of issue that needs considering is that, as a private investor, it is almost impossible to have direct access to the equity markets, because this needs to be done through a financial institution. Some obstacles to equity retail investment can be tackled with legislation, but cultural change is also needed, as well simpler retail products and improved investment services. An industry representative concurred that a combination of regulation and other types of initiatives are needed to enlarge the number of retail investors ready to invest in equity and provide smaller companies with equity.

An official suggested that actions are needed on both the demand and the supply sides for developing equity markets and there is also a need to improve the functioning of markets. First, savers need to be encouraged to take more risks. Currently, financial institutions and distributors are not incentivised to allow savers to take risks, due to MiFID rules in particular. This has been seen for example in France in the context of some recent IPOs such as the privatisation of the French lottery, which was not an extremely risky investment, or with the limited success of envelopes offering privileged tax treatment for investments in shares. Second, more transparency is needed regarding listing rules and the way transactions are executed. The development of SPACs, for instance, should be closely monitored, as well as the way different dark venues are used for equity transactions. Third, the structure of the equity market should be improved to encourage the participation of institutional investors and the growth of funds investing in equity. Larger venture capital funds are needed in Europe. There are not that many pension funds in Europe either compared to the US, the UK and Australia. Europe could also have larger equity investment funds if insurers were allowed to invest more significantly in equity, which is hindered by Solvency II rules that make the holding of equity relatively costly for life insurers. There is a further question of whether it is better to conduct these actions incrementally or if there should be a more complete overhaul of equity markets taking a more holistic perspective. This may need considering because there have been already several attempts to tackle individual issues such as listing and prospectus rules, but the result has not been particularly satisfactory. A step change would be needed for the development of European equity markets, but that requires strong political will.

A second official emphasized the importance of supporting the financing of young and innovative businesses which are drivers of structural change in Europe, putting new ideas into practice, creating jobs and safeguarding the foundations for future prosperity

and growth. Supporting start-up companies and improving their financing opportunities, in particular during the capital-intensive scale-up stage is essential. The official outlined some measures that have been implemented in Germany for addressing these issues.

Before the crisis, German SMEs had quite high equity rates, at above 30% on average. Lost revenues during the Covid crisis mean that these companies now face lower equity ratios, which could affect their ability to invest e.g. in digitalisation and environmentally friendly technologies. To mitigate the consequences of the pandemic, the Federal Government is specifically helping start-ups and SMEs with a package of measures worth €2 billion. This program signals to the market that funding is available if required. Funding was reserved, but not all called. This shows that the VC market in Germany was not affected as badly by the pandemic as initially expected. In addition many start-ups were able to adapt to the situation thanks to their flexibility and some might even have benefitted from the situation, for example online or e-commerce platforms and start-ups in the health sector.

In addition, to support the financing of young and innovative businesses, several regulatory and tax-related measures have been implemented in order to increase Germany's attractiveness for funds<sup>1</sup> investing in these companies and actions have also been put in place to provide directly growing companies with additional capital. In the growth phase, the fund and ticket sizes of European providers are often too small. In addition, these businesses often have inadequate access to capital when it comes to second-stage and third-stage financing. The German government has therefore put in place different funding measures to tackle these issues. The German Future Fund will provide €10 billion over a 10-year investment period for an equity fund for future technologies, which will increase funding opportunities, especially for start-ups, during the capital-intensive scale-up stage<sup>2</sup>. Secondly, the federal government is aiming to strengthen the German VC market, which still has supply gaps, especially in follow-up and growth financing, with several measures in the coming years that will be conducted in partnership with the private sector, KfW and other European partners<sup>3</sup>.

### **3. On-going EU policies (CMU, MiFID): expected impacts on equity financing, priorities and additional actions needed**

The panellists generally considered that the measures proposed in the new CMU action plan and the on-going MiFID II review could help to develop equity financing.

An official emphasized the need for the EU to strengthen its capital markets and ensure their international competitiveness in the context of Brexit. The CMU action plan, MiFID quick fixes and the future MiFID II review will all contribute to this objective and also include

steps for improving the development of equity markets and, in particular, SME financing. Under the German EU Presidency in 2020, the Council prioritised several CMU initiatives for increasing equity financing: i) Establish a European-wide data hub for investors – the so called European Single Access Point (ESAP) – to facilitate access to the financial and non-financial information of companies without disproportionately increasing their workload; ii) Facilitate the access to capital markets, especially for SMEs, without lowering the high standards of investor protection and market integrity; iii) Strengthen the long term investment capabilities of insurance companies, banks, and other institutional investors in company equity, particularly concerning SMEs; iv) Examine the possibilities for simplifying the capital market regulatory framework; v) Examine if the regulatory framework for European Long-Term Investment Funds (ELTIFs) could be improved to facilitate the financing of SMEs and infrastructure projects through the non-banking sector. The official added that the MiFID quick fix changes will further facilitate investment in EU equity markets mainly by reducing costs and administrative burdens for intermediaries. The MiFID II review, which is expected later this year, also aims to improve the EU capital market structure. Together these reforms should contribute to further increasing liquidity in EU capital markets and improving the equity as well as non-equity financing conditions for EU enterprises, in particular SMEs.

An industry representative agreed that the main actions needed for developing equity markets have been identified in the CMU action plan and the MiFID II review and now need to be effectively put in place. The MiFID quick fix is also a step in the right direction with shorter term actions aimed at simplifying rules, speeding up processes and lowering costs. The quick fix recovery prospectus is a very good example, because for a listed company that is compliant with the transparency and market abuse regulations, all the information is already available and communicated to the market. A public representative however observed that most of the measures in the CMU action plan are relatively similar to previous action plans. More action and fewer plans would be preferable.

Some priorities within the CMU and MiFID II initiatives for developing equity financing were also highlighted by the panellists, as well as some measures that could be reinforced or completed.

An industry representative noted that the CMU action plan rightly puts forward actions for supporting the access of companies to the public markets and for improving the attractiveness of capital markets for all types of companies, bigger and smaller ones. The CMU action plan also proposes appropriate measures for developing retail investment. One important area is the improvement of financial literacy, although this appears to be a long term goal. The aim should be to empower investors through further financial knowledge

1. VAT exclusion to management fees of VC funds, new tax regulations for employee investment schemes, less red tape and more flexibility for investment fund managers

2. It will complete the multi-component funding architecture created more than 10 years ago for the founding and growth of medium-sized technology companies, consisting of High-tech Start-up Fund and ERP/EIF venture capital fund of funds.

3. To this end, KfW established a subsidiary, KfW Capital, in 2018 and bundled its financing in the area of venture capital and venture debt in this institution.

rather than just protecting them. The action plan also proposes the creation of a new category of qualified retail investors who have a sufficient understanding of the risks and the functioning of the market and of basic products such as bonds and shares. Adapting the requirements for these more qualified retail investors will help to decrease administrative burdens for financial institutions, avoid unnecessary safeguards for those investors with good financial knowledge and also contribute to making equity investment more attractive for them. Some measures are however missing in the CMU action plan, the industry speaker felt. This is the case in particular of tax incentives, which can be a very effective tool for fostering equity investment from retail and institutional investors. A minimum harmonising tax incentive for savings in SME shares could widen the pool of equity investment for example. Although this is a member state competence, a clear position from the Commission on this issue would support decision making by national governments in putting in place adequate tax incentives for investors and also levelling the tax treatment between debt and equity for issuers.

An industry representative stressed that more transparency is needed concerning equity transactions. More than 50% of transaction turnover on the Euronext market for example is produced after the closing, which is not sufficiently transparent for retail clients. The equity market is currently very expensive and if people do not believe they can make money with their investments they will not trade anymore. A consolidated tape (CT), as proposed in the recent CMU action plan, would improve transparency, however building it and financing it will be challenging, since market players will need to contribute to its financing. Increasing harmonisation in EU capital markets is also important. The inefficiency and high cost of cross-border post-trading within the EU still needs to be properly addressed. At present, many investors prefer to buy US shares over European ones partly because of this. Referring to previous comments made about venture capital and local markets, the industry speaker considered that while VC can provide attractive returns, it will continue to be a niche product and local markets are also important, but cannot be the only answer for developing European capital markets. What is needed for making a real difference, is developing cross-border transactions and increasing harmonisation within the EU. ESG (environmental, social and governance) is becoming an important factor in equity markets and investor decisions, but harmonisation is still lacking in this area, where establishing EU standards is a further priority.

An official stated that prudential regulations need reviewing because at present they hinder investment in equity by institutional investors. There is some room for improvement in that regard concerning insurance prudential rules, possibly taking a longer view than the one-year horizon of Solvency II for example. Basel

requirements are also an obstacle for the holding of equity by banks. France has developed a specific programme to try to alleviate these issues. Since it is too costly for banks to hold equity on their balance sheets, it is transferred to a fund with a State guarantee. Similar measures can also help insurers in terms of prudential treatment, but this means going through participating loans and equity loans, which are not really equity.

Measures are also needed to leverage the large sums of private money present in Europe for investing in European companies and completing the use of public money which should not be excessive in this area, the official emphasized. This could provide a better return for European savers and be a win-win situation. The solvency support instrument proposed by the Commission<sup>4</sup> is a really good idea, technically speaking, although it was not supported politically and had to be removed following discussions at the Council. It aims to finance mainly start-ups and scale-ups with solvency problems in a way that enables them to remain European and eventually be listed in Europe, and is not about saving zombie companies. If some member states were ready to support this type of initiative, together with the European Investment Bank, the European Investment Fund and the Commission, this idea would be worth pursuing.

4. The objectives of the Solvency Support Instrument are the following. It aims to mobilise € 300 billion for the European economy and is designed to help prevent insolvencies. The Solvency Support Instrument is due to channel guarantees from the EU budget in support of viable European companies that suffer from solvency issues due to the coronavirus crisis. This will be done by working with the EIB Group and in the framework of the EFSI. To benefit from the instrument, companies must be established and operating in the EU, be economically viable, have been hit by the pandemic and unable to secure sufficient financing themselves through the market and have had no financial difficulties at the end of 2019 according to the EU State aid rules. Companies operating in Member States and sectors which are more economically impacted by the pandemic, and where national solvency support is more limited, should benefit most.