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Developing EU Capital Markets for SMEs: Mission impossible?

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Bank lending is the most common source of external finance for SMEs, but it doesn't suit all of them. Young, innovative and fast-growing SMEs in particular do not have the required cash flows and collateral for bank financing and need alternatives to unlock their growth potential. Market-based finance is one alternative to help finance the activities of these SMEs. The European Commission's renewed activities to develop market-based financing need to be stepped up in order to develop a credible capital market to finance SMEs in the EU.

Raising capital on public markets broadens the financing alternatives available to firms. Firms can benefit by diversifying their investment base and by facilitating subsequent access to financing and merger and acquisition (M&A) activities. Ready access to equity markets, particularly for SMEs, also offers an 'exit strategy' for investors who invested in the earlier stages of a firm's life cycle. Moreover, diversification opportunities and increased transparency will further benefit investors.

SMEs primarily depend on internal funds to finance investments. Hence, internal funds or retained earnings account for almost two-thirds (63.3%) of investment finance, while external funds account for about one third (35%). Reliance on internal and external funding is especially related to the size of the firm. Micro and small-sized firms rely more heavily on internal funds, while for larger medium-sized and larger firms this is lees the case. Conversely, large firms rely more on external finance.

Looking more closely at the sources of external finance, bank financing is the most important external financing source. The use of market-based financing through public markets is of marginal importance,

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however. According to the EIB Investment Survey (EIBIS)[1] 2016/2017, bank-based funding[2] accounts for 68% and leasing or hire purchases for another 23% of SME funding.[3]

Table 1. Source of investment finance in the last financial year, EU28

	Micro %	Small %	Medium %	Large %
Internal funds or retained earnings	71	64	59	57
External finance	28	35	38	38
Bank loans	60	60	57	54
Other bank finance	11	8	10	11
Leasing	18	23	24	23
Factoring	2	3	3	4
Loans from family/friends	4	2	1	1
Grants	4	3	4	3
Bonds	0	0	1	4
Equity	0	0	0	1
Other	1	1	1	1
Intra-group funding	0	1	3	5

Note: All firms who invested in the last financial year (excluding don't know/refused responses).
Source: EIBIS 2016/2017.

Market-based sources of finance such as bonds (0.4%) and equity (0.3%) are rarely used by SMEs.[4] Initial Public Offering (IPO) activity in Europe has been moderate and rather volatile over time and barely exists for SMEs (see Figure 1). In 2016, European IPO activity declined significantly, with a drop of 27% in the number of IPOs compared to 2015, while the value of IPOs decreased by 51% to €27.9 billion (EC, 2017).

These figures suggest that over 2016 the deal size per IPO decreased. Nevertheless, large and mid-cap firms account for the large majority of the total deal value (66% and 24% of the total deal value respectively). The small-caps (market capitalisation up to about €1.75 billion), which includes almost all of the SMEs and some large firms, are responsible for only 6% of the deal value. Furthermore, the number of IPOs is much more volatile for smaller firms than it is for larger firms (OECD, 2015b).[5]

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[1] The European Investment Bank Group Survey on Investment and Investment Finance (EIBIS) is an annual EU-wide survey that gathers quantitative and qualitative information on investment activities by more than 12,500 firms across all 28 member states. See http://www.eib.org/about/economic-research/surveys-data/investment-survey.htm.

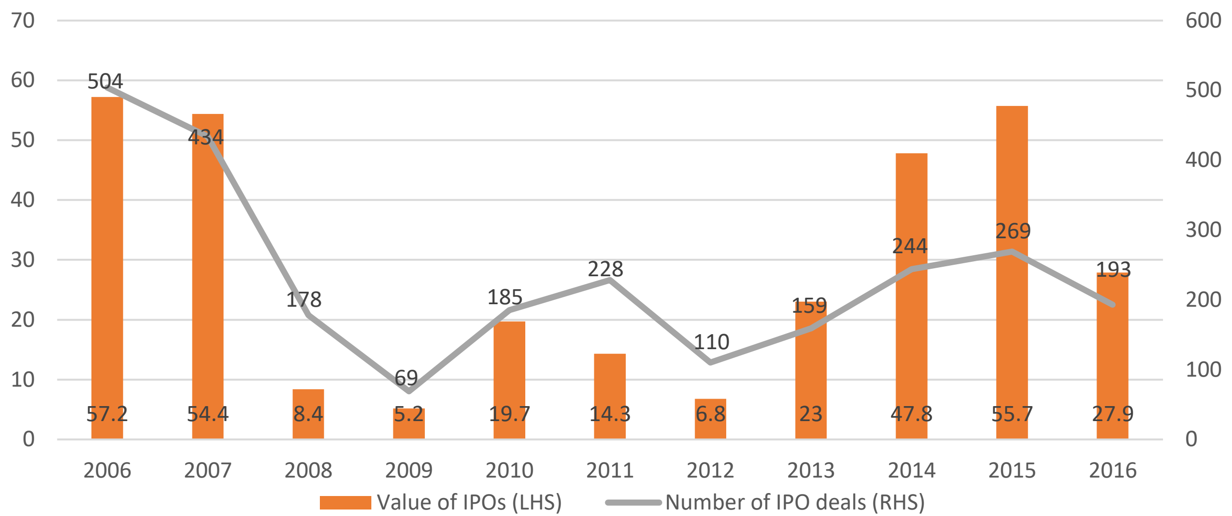
[2] Includes bank loans, overdrafts and other credit lines.

[3] Asset-based finance, such as asset-based lending, factoring, purchase-order finance, warehouse receipts and leasing, differs from traditional debt finance, as a firm obtains funding based on the value of specific asserts, rather than on its own credit standing. The key advantage of forms of financing is that firms can access cash faster and under more flexible terms than from a conventional bank loan, regardless of their balance sheet position and future cash flow prospects (OECD, 2015a). It also shows the risk-averse behaviour of firms in an uncertain economic environment.

[4] For large firms the numbers are 54%, 4%, and 0.5%, respectively. In terms of differences between SMEs and large enterprises, the crucial issue is that SMEs, mainly due to their informational opacity, are precluded access to liquid and developed public markets and have to meet their needs almost exclusively through private debt markets and private equity (Infelise, 2014).

[5] Which illustrates that the IPO market for small firms is less stable and more vulnerable to shocks.

Figure 1. European IPO activity by value (billions of euro) and volumes (number)



Source: Dealogic.

Equity finance is key for innovative companies that create value and growth, and especially, for companies that have a high risk-return profile. Seed and early stage equity finance can boost firm creation and development, whereas other equity instruments, such as specialised platforms for SME public listing, can provide financial resources for growth-oriented and innovative SMEs. Additionally, equity financing may be more suitable than debt financing for SMEs that lack collateral, have negative or irregular cash flows, or require longer maturities for their investments to pay off (Nassr and Wehinger, 2016).

In recent decades a large number of SME public equity markets have been established, but they failed to attract sufficient companies for listing and trading activity to maintain active markets. While information asymmetry is certainly not the only barrier to SMEs' accessing public financing sources, other major difficulties include high listing and maintenance costs; administrative and regulatory burdens; lack of equity culture; and inadequate management practices. Moreover, on the investor side of the market, high monitoring costs relative to the level of investment and low levels of liquidity act as a significant deterrent.[6]

Entering the public equity market is often the first step to accessing other forms of market-based finance, in particular corporate bonds. Issuance of bonds can offer an alternative source of finance to firms and provide an injection of liquidity to undertake investments or seize growth opportunities.[7] This is particularly the case for firms of a certain size and scale[8] with an established credit history and

[6] IPOs and debt underwritings are characterised by substantial fixed costs generated by public-market due diligence, red tape and regulatory burdens. The presence of fixed costs makes the decision to go public largely dependent on the size of a firm, and SMEs typically do not have the necessary asset size that would make the choice of exploring these options economically sound (Infelise, 2014). Furthermore, SMEs seeking public-equity financing must be sufficiently institutionalised to handle the reporting and corporate governance requirements (OECD, 2016).

[7] Financing through the issuance of bonds can be an especially attractive option when market interest rates are low, as the coupon rates over the life of the bond can be set at a convenient rate, and still attract investors. Also, with respect to equity, issuing bonds does not dilute ownership or the control of the company (OECD, 2015a).

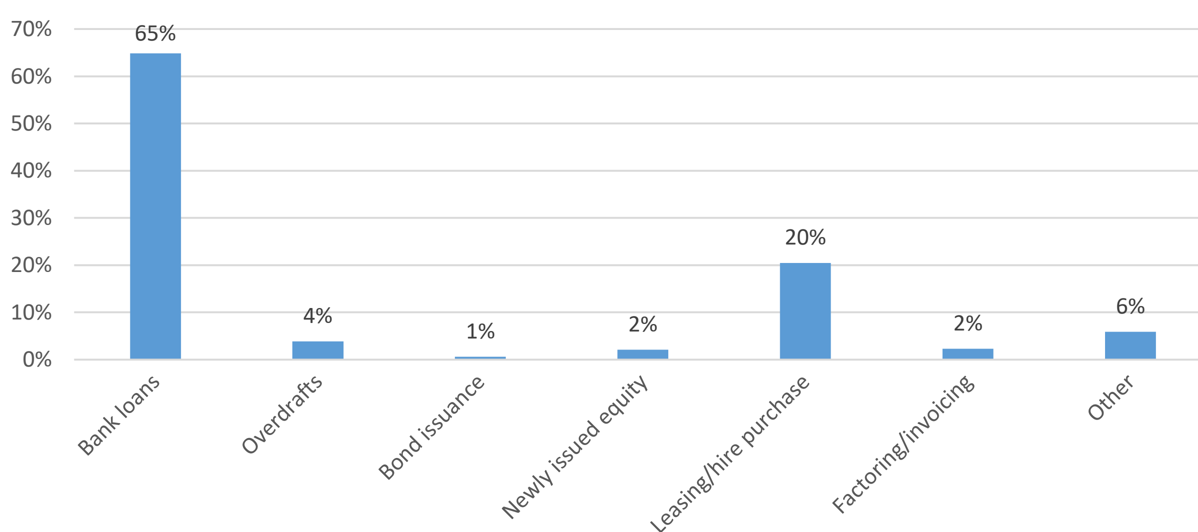
[8] In particular, larger SMEs (mid-caps) with an annual turnover of between €19 million and €400 million and even higher.

earnings record, and limited volatility on revenues and earnings. As most SMEs do not meet these criteria, in the bonds market they would attract low rating and high coupons and face difficulties in meeting their payment obligations. On top of that, the costly nature of such a procedure – the costs of bonds may be as high as 10% of issuance (OECD, 2015a) – makes corporate bonds rather unattractive for the majority of SMEs.[9] Latest data reveal that corporate bond issues increased in 2016 to 788, representing a volume of €240 billion, but this is largely attributed to large firms' activities (EC, 2017).

The importance of SMEs financing through public markets is well-recognised in the Commission Green Paper on Capital Markets Union (CMU) (EC, 2015). The reviewing of the Prospectus regime,[10] which was set as the number one priority, has now been completed and resulted (last June) in a Regulation that aims to: i) make it easier and cheaper for small companies to access capital; ii) introduce simplification and flexibility for issuers (in particular for secondary issuances and frequent issuers); and iii) improve prospectuses for investors. In addition, the action plan introduces a new category of multilateral trading facilities (MTFs) called 'SME Growth Markets', which will provide an opportunity for new companies to ready themselves for listing on a large exchange. Moreover, the Commission – together with the International Accounting Standards Board (IASB) – intends to explore the possibility of developing a voluntary tailor-made accounting solution, which could be used for companies admitted to trading in SME Growth Markets.

It is clear that the European Commission is committed to making capital markets a credible alternative to bank finance as part of its CMU initiative. But it remains questionable whether this is enough to reduce the information asymmetry and transaction costs. European equity and bond markets remain underdeveloped (partly due to capital market fragmentation) and access to public markets is lower for SMEs. As SMEs show little or no appetite to changing their external financing mix over the next three years (See Figure 2), much remains to be done.

Figure 2. Types of finance that SMEs wish to see more in the financing mix over next three years, EU28



Note: All firms that used external finance in the last financial year (excluding don't know/refused responses).
Source: EIBIS 2016/2017.

[9] In advanced (emerging) economies 87% (60-70%) of all public bond issues are performed by companies that are listed or are the subsidiaries of a listed company.
[10] The EU introduced rules on prospectus in 2003 (Directive 2003/71/EC), revised them massively in 2010 (Directive 2010/73/EU), and adopted a Regulation last June (Regulation 2017/1129).

Regarding equity issuance, a more flexible regulatory environment for SMEs, as well as lower barriers to entry and the cost of equity capital, should be top of the list. Specifically, further work is needed in the following directions: i) to encourage a diverse and attractive funding base in European public markets for SMEs,[11] ii) reduce administrative costs of listing for SMEs, iii) educate (training and mentoring) SMEs on financial reporting and corporate governance, and how to deal with investor due diligence requirements,[12] and iv) tax incentives for listed firms that would motivate unlisted (yet qualifying SMEs) to consider listing, at least in the short- to medium-term.[13]

Importantly, the focus should not only be on how to get SMEs to the public markets, but rather on the structural changes needed to create a regulatory and market ecosystem that will helps SMEs to reach their potential. Such a structural change would be to expand access to finance for SMEs by offering them capital formation options beyond the IPO, which is eased via the revision of the prospectus regime. There is evidence that smaller companies tend to remain small post-IPO, as they fail to build sufficient revenue to meet the costs of full public company compliance (Rose and Solomon, 2016). The registration process remains expensive and time-consuming, and such firms are not able to access inexpensive capital through loans or other conventional fund-raising activities.

The 'aftermarket support system' on which newly public companies depend for follow-on capital raises, is rather absent for smaller firms. The illiquid market in which small firms operate prevents investment by investors/traders who require a liquid trading market. The 'illiquidity tax' that investors have to pay makes investment in SMEs rather uneconomical relative to larger firms. Therefore, there is a necessity to improve the structure of the market for SMEs' stocks by creating special trading rules for such companies. For example, in an effort to enhance trading liquidity for smaller companies, the Securities and Exchange Commission (SEC) introduced in 2016 a two-year pilot programme that would widen the minimum quoting and trading increments (tick size) for stocks of small companies.[14]

Turning to bond markets, despite the strong increase in the volume of corporate bonds issuances in the EU since the crisis,[15] the EU corporate bond market still offers limited secondary market liquidity (which is thought to have decreased considerably with new rules imposed on liquidity providers such as broker-dealers and banks).[16] Measures to: i) reduce the costs of issuances, ii) remove requirements for institutional investors to invest in bonds, iii) increase the transparency of EU bond markets in MiFID II,

[11] Evidence suggests that the persistent absence of small IPOs stems from an anaemic demand for small IPOs by mutual fund investors (Bartlett et al., 2016). In particular, the sharp drop in small IPOs in 1998 reflected a sudden shift in investment preferences among all mutual funds away from IPO risk. Besides that, it is also necessary to improve the quality of SMEs business plans and investment projects, especially for the development of the riskier segment of the market. In many countries, a major impediment to the development of equity finance for young and small businesses is the lack of 'investor-ready' companies.

[12] There is also need for investor education: understanding the risks associated with investments in SMEs and how to be protected.

[13] But it is still unclear how effective these incentives could be as part of a longer-term strategy for developing well-functioning capital markets. Moreover, they could cause complications for policymakers and be politically difficult to retract.

[14] See https://www.sec.gov/news/pressrelease/2015-82.html.

[15] However, this increase is attributed to bond issuance by large firms, as the share of issuers with an asset size $250 million or less decreased quite substantially from 7% in 2000 to 2% in 2014 (OECD, 2015b).

[16] Furthermore, the reduced ability of banks to hold significant inventories due to regulatory constraints has impacted liquidity. Limited liquidity is a concern, particularly for investors who do not pursue a buy-and-hold strategy.

iv) foster multi-dealer electronic trading platforms, and v) standardise corporate bonds characteristics,[17] should contribute to developing liquidity and reducing costs.

Additionally, setting up an EU private placement (EU PP)[18] regime similar to those existing in Germany (i.e. *Schuldscheine*) and France (i.e. Euro PP) or mini-bond platforms (i.e. Italy) that will enable unlisted SMEs and mid-caps to issue debt instruments could help to increase the scale and liquidity of the market and further encourage cross-border investments.[19] The success of these initiatives lies in the: i) attractive risk/return tradeoff, ii) minimal documentation requirements, hence lower costs, iii) reporting obligations only vis-à-vis investors (no publicity obligations), iv) less time-consuming, v) no need for external rating, vi) lower transaction costs, vii) *tranching* option (i.e. *Schuldscheine* can split into smaller loans), viii) stable issue of spreads in volatile markets.[20]

To conclude, although these (proposed) measures will definitely improve the perspectives for capital markets for SMEs, it remains to be seen whether they will ever play a substantial role in the financing of European SMEs. The smaller size of SMEs will always make it more challenging to keep transaction costs low and create liquid markets, as for larger companies.

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[17] For example, issuing similar amounts and maturities at set times and using re-openings more frequently.

[18] The Commission launched a study in December 2016 to identify the barriers to building up the European private placement markets in more detail. The study should report later this year (October-November 2017) and from then on, the Commission will decide its next steps.

[19] For example, one possible approach could be the development of a Pan-European hybrid debt fund aimed at providing medium to long-term financing to smaller SMEs. Such a vehicle would be junior to bank loans and complementary to bank intermediation, and will allow SMEs to retain control while accessing longer-term financing.

[20] While in 2016 *Schuldscheine* reached an outstanding volume of €100 billion with total issue volume of almost €27 billion spread over 128 transactions (in 2015 it was €19.3 billion with 106 deals), the French Euro PP market shrunk. On the other hand, the number of Italian mini-bonds issued in 2016 increased at 106 (compared to 85 during 2015), reaching €3.57 billion in total volume. The issuers were mainly Italian SMEs, not listed companies, with at least 10 employees and over €2m turnover. The success of Italian mini-bonds could be partly attributed to the exemption from the requirement of prospectus issuance and the waiving of the respective cost for small companies (OECD, 2015c). Source: Global Capital (2017), http://www.italy24.ilsole24ore.com/pdf2010/Editrice/ILSOLE24ORE/QUOTIDIANO_INSIDE_ITALY/Online/_Oggetti_Correlati/Documenti/2017/06/16/minibond.pdf, and http://www.italy24.ilsole24ore.com/pdf2010/Editrice/ILSOLE24ORE/QUOTIDIANO_INSIDE_ITALY/Online/_Oggetti_Correlati/Documenti/2017/06/16/schuldschein.pdf.

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