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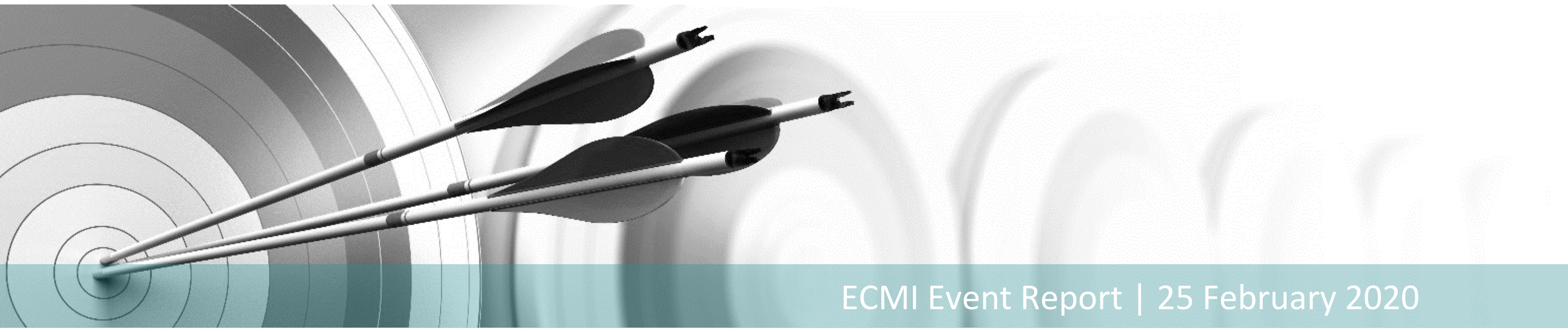

SME market financing: Is there more to it?

Apostolos Thomadakis*

Small and medium-sized enterprises (SMEs) – in particular those that are young, innovative and have risky projects – face minimal financing opportunities. In recent years, several initiatives (e.g. junior stock markets, SME Growth Markets, crowdfunding, and the Capital Markets Union) have been introduced to close this funding gap and promote the development of capital markets for these companies. Yet the financing mix of European SMEs has barely changed: it is still heavily tilted towards bank loans and internal funds. More recently, in an effort to further support SMEs to raise capital in public markets, the newly elected Commission President von der Leyen has proposed the creation of a private-public fund specialising in Initial Public Offerings (IPOs).

Speakers:

Joachim Schwerin, Principal Economist, SME Access to Finance, DG GROW, European Commission
Sophie Manigart, Professor of Corporate Finance and Faculty Dean, Vlerick Business School
Piotr Borowski, Chief Operating Officer, Warsaw Stock Exchange (GPW)
Eivile Cipkute, Senior Policy Officer, European Investment Fund

Moderated by **Apostolos Thomadakis**, Researcher at CEPS-ECMI

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The report is not a transcript of the speakers' interventions; rather, it should be understood as an interpretation of their views by the author.

Summary

Since the global financial crisis, capital markets have continued to develop and are now offering more alternative financing options to SMEs than previously. In the aftermath of the 2008 financial crisis SME access to finance has significantly improved.[1] However, bank credit remains the most relevant source of finance for SMEs in the EU, significantly more than in other parts of the world. Although bank dependency is not a substantive problem, the vulnerability of banks in times of crisis could also make SMEs financially vulnerable.

Market financing for young, small and innovative companies that do not have many tangible assets (making bank credit risky, and less forthcoming), is very limited. Issuance of equity and bonds is rarely used and not considered by SMEs,[1] while crowdfunding, which is very limited in size, did not live up to expectations post-crisis.[2] Business angel financing, even though it is underestimated and below the radar of SMEs', is of comparable size to venture capital (VC) funding. Private equity (PE) is the most preferred risk capital source of funding for more mature companies at the growth stage.

Although fundraising and investment by European VC and PE have increased over recent years, so has the gap with other regions. European VC and PE-backed firms are receiving less than 10% of the amount invested in their US counterparts, while the median fund size of all European funds invested in a given round is almost half that in the US.[3] Even though the gap is smaller for companies at their seed and early stage (seed and A round), it becomes significantly bigger when moving along the growth path and towards the last funding rounds (C, D, and E rounds). These discrepancies can in part be explained by the different scale-up mentality between Europe and the US: while in the latter companies and investors are not afraid to take risks (i.e. fast growing and fast shrinking firms), in Europe they are more risk averse (i.e. static firms).[4]

As companies grow, the transition from relying on risk capital to listing their shares on a stock exchange should become a natural step with significant benefits. However, while in Europe there are many different products (e.g. business angel, microcredit, VC seed and early stage, and social impact funds) for companies that are at their early stage, pre-seed, seed or start-up phase, there are few alternatives for growing companies that decide to go to the public markets. Initial public offerings (IPOs) are not the most preferred option given the requirement to make the company public and share information, which is a deterrent factor for many SMEs.[5]

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[1] While in 2009 access to finance was the second biggest obstacle for European SMEs (with almost 20% of them reporting it as a problem), ten years later access to finance is their smallest problem (7%). Instead, the main problem faced by SMEs is availability of skilled labour, followed by finding customers, costs of production or labour, regulation, and competition. See ECB (2019), "Survey on the Access to Finance for Enterprises in the euro area", November, European Central Bank.

[1] See Thomadakis, A. (2017), "Developing EU Capital Markets for SMEs: Mission impossible?", ECMI Commentary, No. 46. European Capital Markets Institute.

[2] See AFME (2019), "Capital Markets Union: Key Performance Indicators", Second Edition, October, Association for Financial Markets in Europe.

[3] See Duruflé, G., T. Hellmann and K. Wilson (2018), "From Start-up to Scale-up: Examining Public Policies for the Financing of High-Growth Ventures", in Mayer, C., S. Micossi, M. Onado, M. Pagano and A. Polo, "Finance and Investment: The European Case", Oxford University Press.

[4] See Coutu (2014), "The Scale-Up Report on UK Economic Growth", November.

[5] See Collewaert, V., S. Manigart and T. Standaert (2020), "European Scale-Up Report", January, Vlerick Business School.

Putting things into perspective:

- out of 20 million European SMEs, only 3,000 are listed in stock exchanges;[6]
- Europe produces less than half of the IPOs it used to produce pre-crisis (478 IPOs on average per year in 2006-07 compared to 218 IPOs between 2009-17);[7]
- lack of financing, among other factors, forces the most innovative and largest scale-ups to list in the US or Asia (31 EU companies listed in the US between 2012-15);[8]
- international investors are a key component of the European market (out of 447 European Investment Fund (EIF)-backed VC exited through acquisition between 1996-2015, 44% were acquired by non-EU investors, particularly from the US);[9]
- SME equity markets lack liquidity and have about 30% of the liquidity of main markets.[10]

In an effort to close the funding gap and boost investment in innovative start-up and scale-up companies across Europe, the European Commission and the EIF have launched, or are planning to launch, several initiatives (e.g. VentureEU, ESCALAR, AMUF, SDUF).[11] For companies in their growth phase, in December 2019 European Commission President von der Leyen proposed the creation of a private-public EU SME IPO fund, in an effort to support SMEs' listings on public markets. On its own, such a fund would not be a game-changer. However, combined with further measures from the Capital Markets Union (CMU) Action Plan and its upcoming follow-up, it is a useful initiative. Such a fund would need to tackle the genuine obstacles that SMEs are facing and at the same time be an attractive investment option for investors, asset managers and market participants. Currently, several questions remain to be answered, including how the fund will be designed and structured, who will participate and under what conditions.

Having in place an ecosystem that supports SMEs at all their stages (i.e. pre-IPO, IPO, and post-IPO), requires not only the participation of different actors, but also the right regulatory mix.[12] For example, anchor investors in the form of local institutional investors who are operating around the stock exchange should be encouraged and incentivised to support SMEs. Equally important are advisors who can help SMEs to navigate all available financing options, and investors to analyse and understand SMEs' complex/technical business models. Finally, liquidity providers, market-makers,

[6] See Finance Newsletter of December 2016, DG FISMA.
[7] See Finance Newsletter of May 2018, DG FISMA.
[8] See AFME (2017), "The Shortage of Risk Capital for Europe's High Growth Businesses", March, Association for Financial Markets in Europe.
[9] See Prencipe, D. (2017), "The European venture capital landscape: an EIF perspective – Volume III: Liquidity events and returns of EIF-backed VC investments", EIF Working Paper No. 41, April, European Investment Fund.
[10] See Peterhoff, D., J. Romeo and P. Calvey (2014), "Towards Better Capital Markets Solutions for SME Financing", Oliver Wyman.
[11] The VentureEU is a Pan-European Venture Capital Funds-of-Funds programme that aims to mobilise €410 million of EU funding and raise up to €2.1 billion of public and private investment, while the European Scale-up Action for Risk Capital (ESCALAR) will boost the size of VC funds and attract more PE investments. With the Asset Management Umbrella Fund (AMUF), EIF provides institutional investors inside and outside the EU the opportunity co-invest in a diversified pool of investments (e.g. VC, life sciences, growth capital, and private debt). Later this year, EIF is planning to launch the Sustainable Development Umbrella Fund (SDUF), which is aligned with the Green Deal and aims to support the green transition of SMEs.
[12] See Lannoo, K. and A. Thomadakis (2019), "Rebranding Capital Markets Union: A Market Finance Action Plan", CEPS-ECMI Task Force Report, Centre for European Policy Studies.

smaller brokers and boutiques specialised in SMEs are necessary components in ensuring sufficient liquidity and market depth at the post-IPO phase. Enhancing these roles will also be important.

On the regulatory side, many obstacles remain (e.g. taxation, insolvency, institutional investors' participation) both at EU and national level. Regulation should become proportional, acknowledging the fact that capital markets are structured and developed differently across member states, as well as the significant cultural and financial literacy differences. Governance and financial reporting standards for public companies – which are often too complex and difficult – should be simplified, with unnecessary and onerous compliance costs alleviated.[13] Furthermore, regulation should become fit for purpose in building a conducive and welcoming institutional environment for financing SMEs. Regulatory disincentives would need to be revised (e.g. in MiFID, Basel, Solvency II).

Finally, one of the biggest future challenges is digitalisation. On the one hand, work on crowdfunding has been completed and certain principles and rules have now been established. On the other hand, cryptoassets and tokenised securities, which are a big part of the digital revolution, are here to stay. Some European countries, mainly outside the EU, are advancing in this direction (e.g. stock exchanges that are digitising and tokenising securities) and have already adopted token laws. The Commission monitors these developments closely and has launched a consultation on a definition of cryptoassets and their regulation as part of the digitalisation initiative. An updated fintech action plan is expected in the third quarter of 2020.

[13] In Poland, for example, in the NewConnect growth market for SME of the Warsaw stock exchange, approximately 375 listed companies in 2019 had an average market capitalisation of €6 million. As these companies fall under the MAR regulation, complying with it incurs high administrative and compliance costs.

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