OPTIMIZING THE FINANCING OF EU CORPORATES

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Sustainable financing structures for a sustainable recovery

Before getting commonly associated with ESG issues, "sustainability" used to be, in finance, a word linked with the term "debt". As we all know, debt sustainability – notably with regard to corporate dimension - has been seriously put a risk, as the health emergency hit severely both advanced and emerging economies. The support measures adopted by governments in many advanced countries only partially mitigated the negative impact of the crisis.

In 2020, bank loans to Non-Financial Corporations (NFCs) increased sharply as a consequence of various measures – such as public guarantees adopted to support firms' funding. This has lessened the impact of the crisis, but it has also increased the weight of debt on corporate funding, heightening concerns about its final repayment. As shown by the recent CONSOB Report 'Trends and risks of the Italian financial system in a comparative perspective', the leverage of large listed NFCs increased in all European main countries, especially in Spain and Italy (where, however, the debt structure of large NFCs is more stable because of a lower incidence of short-term debt on total debt). At the same time, revenues declined substantially - especially in the services sector that suffered the most from the restrictions against the spread of Covid-19 - reducing firms' cash flow generation and so their future ease to repayments. In a recent publication, however, OECD frames such developments in a longer trend, finding that listed companies, at global level, experienced an increase in the aggregate debt-to-EBITDA ratio from 2x to 3x between 2005 and 2019 *(see: The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis)*.

Private contribution to recapitalization essential only if associated with efficient public markets.

In a low interest rate environment, excessive debt appears to be less worrying than it was in the past. However, in the medium term the increasing imbalances in the funding structure of firms may be a problem, especially in those countries where main industries experienced a deterioration both in profitability and financial indicators compared to their 10-years average. Huge equity injections are consequently needed to rebalance corporate capital structures.

Sustainability of debt, however, is only a first step: growth must follow. Corporate long-term profitability is driven by investments: notably, in the modern digital economy, R&D investments. Again, capital structure matters, according to OECD findings. Low-leverage firms are definitely more inclined to R&D compared to high leverage companies (more keen to Capex). Enhanced equity financing is then required also to finance riskier projects and boost European (companies') growth.

The CMU project has already put in place several measures to facilitate the access of enterprises, especially SMEs, to capital markets and to increase the recourse to sources of financing alternative to bank loans. Moreover, the implementation of the National Recovery and Resilience Plans under the Next Generation EU (NGEU) recovery package by the Member States is the occasion to improve the economic resilience of European NFCs (in particular of SMEs) and to make them more attractive to new investors. Indeed, fostering firms' investments in digitalization, promoting the enhancement of digital skills, encouraging the use of digital tools, facilitating the access to adequate digital infrastructures as well as strengthening firms' attention to sustainability issues and their ability to deal with climate risks can be crucial for their growth in the medium term and can represent a key factor in facilitating the access to alternative sources of finance.

However, further measures may be needed. For example, a rebalancing of tax incentives between debt and equity has been frequently suggested. In addition, the development of an appropriate information ecosystem on SMEs should be encouraged in order to mitigate information asymmetries that can impair investment.

The increasing private- equity funds' contribution to firms' recapitalizations is undoubtedly crucial, but only if associated with vibrant and efficient public markets, whose vital role in price discovery and corporate governance discipline can never be replaced. OECD data, unfortunately, highlight a dramatically clear trend in the opposite direction, with 30.000 companies globally delisted since 2005 and negative net listings since 2011, even if the very last data display an important increase of IPOs everywhere. Stronger financing structures, higher profitable investments and, in conclusion, robust prospects of growth for European economies need well-functioning equity markets: re-launching them must be the goal of policymakers and regulators.

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Improving the debt-equity mix: moving past the Covid shock

Dutch corporates, as well as European ones, are still more dependent on bank capital compared to their counterparts across the Atlantic. This is a longstanding issue, yet there is much room for improvement.

Overdependence on bank funding increases the risk of procyclicality in the economic system, as banks may cut credit flows during financial crises while market funding could serve as a 'spare tyre'. In addition, market financing focuses also on a higher-risk segment of firms, which are associated with innovations and higher productivity, leading to a more dynamic economy. Lastly, in the EMU context, cross-border market financing has the potential to reduce systemic risk and enhance financial stability, making the monetary union more robust. To sum up, a deeper European capital market can help support a) financial access, b) productivity and c) internal convergence.

Five quarters past the Covid shock of March 2020, the first data points suggest that the funding mix of corporates in Europe has not changed much. According to the BIS, 40% of the funding mix of Dutch corporates is bank-based. In the euro area, this is 55%. In the US, it stands at 33%. For Europe, the funding mix has barely budged since the Covid outbreak. If anything, government interventions following the Covid shock – which were needed and effective - have highlighted the bank-centered focus of the financial system and the wedge between smaller and bigger firms. First, governments in the EU have intervened by guaranteeing bank lending to corporates, strengthening the interdependence of the state, the banking system and the corporates. This 'nexus' can create risks for financial stability.

Second, central bank intervention kept capital markets afloat, but with only the larger firms able to access cheap bond market funding and smaller ones left dependent on banks.

Moving past the Covid shock ensuring the development of a true European Capital Markets Union is now a main priority. For both Dutch and European firms, the balance needs to be tilted further from debt to equity and from bank to market financing, while cross-border market integration in the EU needs to develop faster. Tackling the debt bias and the home bias can be done, although it will take a multitude of policy actions to get there. As regards the debt bias, in the Netherlands, for example, debt financing receives favorable tax treatment vis-à-vis equity financing, incentivizing firms to take on more debt than economically optimal.

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As regards the home bias, European financial markets can be further integrated by implementing a series of actions identified by the European Commission in its CMU Action Plan. These actions would make information on assets and markets more readily available to investors, ideally clustered in a European Single Access Point. Simplifying and streamlining regulation for listings is another obvious candidate here, as is more convergence between national corporate insolvency regimes.

Moving away from these supply-side measures, strengthening the demand side is also necessary to complete markets. For decades, US household participation in financial markets and venture capital has been much higher than in the Netherlands or the EU. Here, one could refer to the Dutch system of pension fund saving. Dutch pension funds essentially take up the role of indirect investor while supplying retirement benefits. Increasing savings in capital-based pension funds in the EU would aid deeper and more complete European equity and bond markets.

In the end, one can think of an eco-system in which European corporates and savers operate and facilitate each other's needs. Both investors and firms can then ideally find each other across the market, based on the risk/return structure that suits the participant. This deep market should range from risk-free bonds to venture capital.

All in all, we seem to recover from the Covid shock rapidly and decisively, thanks also to swift policy action. These interventions nonetheless highlight the bank-centered nature of the European financial system, and the divergence between larger and smaller firms in terms of funding opportunities.

Decisive action on the CMU by the EU and its member states has the potential to make the debt-equity mix more robust, increase funding opportunities for more firms and strengthen European savers, investors and firms in the long term.

ROGER HAVENITH

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Alternative financing platforms in the era of digitalisation

As we are cautiously coming out of the crisis, policy-makers across the EU are considering the best ways to extend a supporting hand to the most hard-hit – and smallest – actors of the economy. We have already seen a plethora of government support measures and an unprecedented EU response, including in the form of the European Guarantee Fund and the Recovery and Resilience Facility.

But given the European traditional over-reliance on debt, there is a very real danger of over-indebtedness. Smart debt is of course one way to tackle this, with a targeted offering of debt support.

Yet even with strong public support, the share of insolvent firms could increase by 6% across the EU, putting at risk the jobs of around 8% of the workforce.

The solution cannot simply be more of the same type of debt. Diversifying financing sources and securing more flexible alternatives that are designed to meet the needs of SMEs is a must.

This is not only about offering a variety of alternative financing possibilities to the SMEs and family businesses that we want to support, but also about drawing from institutional and private investors precious dry powder for investments in SMEs, marrying the need for flexible financing with investor demand for yield in today's low-interest climate.

What does that diversification look like? Boosting equity financing is one clear avenue. While the EU Solvency Instrument didn't see the light of day, we are nevertheless witnessing an increased appetite from public actors to mobilise private equity investments as a tool to support innovation and SMEs across Europe. The European equity market has been growing but we're still a few clicks behind the US, and while indispensable, this is only part of the response.

Alternative financing platforms harbour a lot of potential that needs to be harnessed and put to good use. Loan funds and crowd-funding platforms offer prospective investors access to an asset class that wouldn't usually fall into their line of work, and at the same time a new funding source for SMEs and family businesses.

As the digital wave revolutionises the world as we knew it, this potential only grows. Such alternative online, digital financing platforms often rely on very smart software, artificial intelligence and machine-learning capabilities to assess risk in record time and generate the sort of security that traditional financial institutions have spent generations trying to perfect.

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This predictive analysis can boost the attractiveness of the sector, despite its relatively limited track record. The tools at their disposal are also quite broad, ranging from convertible bonds to equity, cashflow financing or more classic debt instruments, bringing a plethora of alternative financing options to the table for SMEs across Europe. And as digitalisation and big data only grow and grow, so does the potential of this new sector. The digital dimension also means that we are seeing a lot of cross-border activity, which can help it scale and constitute an attractive option for institutional investors.

The European crowd-lending market is expected to exceed EUR 10bn in size very soon and the entry into force this coming November of the ECSP Regulation will add more clarity and certainty to the online alternative lending market. It is an opportunity that both policy-makers and policy takers should not be missing. We are already seeing European institutions channelling targeted support towards alternative finance providers and digitalisation and more can be expected through InvestEU, further catalysing private investment in this direction.

This of course does not take away from the importance of supporting the European traditional lending markets, where most of the business will still be taking place, or, for that matter, the private equity and venture capital ecosystem, which has been growing but still lags behind other regions like the US. And nowhere is this gap more evident than in the scale-up stage that still impedes innovative European businesses from reaching their full potential right here in Europe.

A sober mix of different instruments will constitute the best approach but the potential of alternative financing platforms is not to be taken lightly. Digitalisation has helped alternative finance take a critical step forward, increasing the volume and range of financing available for European SMEs at a time when it is badly needed.

As policy-makers focus on making sure the economy emerges from the crisis in good shape, helping the smallest actors to recover and become more resilient, alternative finance could prove to be a very useful tool.

BJØRN SIBBERN
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Equity and debt in the mix for growth

The European Commission's Capital Markets Union initiative continues to be a key policy priority for the creation of sustainable and inclusive growth across Europe. Multiple efforts both locally and at an EU level are needed to create long-term opportunities for both small and large companies and investors. This has become even more urgent in light of the immediate need for recovery from the economic effects of the pandemic.

Companies that opt for equity funding on the public markets create more jobs than companies that stay private, and it also allows a broader investor community to share the growth journey. This is why I am convinced of the societal benefits of equity funding.

In the Nordic and Baltic markets where Nasdaq operates both regulated markets and growth markets (Nasdaq First North), we see record number of companies leveraging the equity markets for financing. Multiple factors contribute to this, but one reason is that local policies since many years have promoted and achieved a relatively well-developed equity culture among private investors. As a result, there is now a financial ecosystem with many types of actors supporting companies on their journey through the funding escalator.

I strongly welcome the European Commission's initiative on rebalancing the current bias towards debt financing by alleviating the burdens on equity finance. This initiative should be at the core of CMU. Equity is more heavily taxed than debt in many countries. Interest payments on debt may be deducted from profits before they are taxed, whereas equity financing does not receive any form of tax relief. On top of that, equity is subject to significant taxation both in terms of capital gains and dividend payments. Hence, this structural bias towards debt financing incentivises companies to take on debt rather than equity. Tax policies should not discriminate between debt and equity.

While taxation is the competence of individual EU member states, any efforts by the European Commission in terms of coordination, sharing best – and worst – practices and finding common solutions have great potential to lead to positive outcomes for European companies and investors and the growth of stable economies as a whole.

Measures taken will gather more support and confidence by the business community if long-term foreseeability is guaranteed. As an operator of public markets, Nasdaq believes that long-term investments by engaged shareholders are crucial for supporting growth. Stable tax policies play an important part.

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Another factor is simplicity. One example of successful simplicity is the various versions of 'investment savings accounts' which have been introduced in different countries in recent years. For instance, in Sweden the tax reporting related to such investment saving accounts is automatic and relieves the investor of significant administration. It has attracted a lot of private investors, which plays an important role especially for the success of our growth market Nasdaq First North. Among several factors, I believe this simplicity has been one of the more important ones behind the success of these types of accounts.

Further measures to increase retail investor participation should also be prioritized, including considering if investor protection provisions in MiFID can be adapted to non-professional but still experienced investors.

Additionally, ensuring that the MiFID framework delivers a market structure that serves both larger and smaller investors fairly and efficiently, and provide equal growth opportunities for small and large companies alike, is key. For this, transparency and a robust price formation process is fundamental.

To support and ensure a good financing mix, I finally want to highlight the role of the corporate bond markets. Corporate bonds can often be a very appropriate financial instrument for a company as well as an investor. However, there is room to realize the potential of corporate bonds for smaller companies and smaller investors.

The regulatory framework currently incentivizes market participants to use the wholesale markets and instruments with relatively high denominations. For smaller companies, as well as smaller investors, instruments with lower denominations can often be more suitable. Seeing how the green bond market, which Nasdaq launched in the Nordics a few years ago, has grown exponentially, this also illustrates the importance and usefulness of green corporate bonds for the transition to a more sustainable society.

Equal opportunities for investors, companies and also financing should be a fundamental part of the Capital Markets Union, and Nasdaq supports any action that enables a more dynamic financial landscape where companies of all sizes are able to choose from a mix of different sources of capital, where investors are able to enjoy growth opportunities, regardless of if they want to invest €10 or €10 billion and where sources of funding are treated the same way no matter if they are debt- or equity based.

ED COOK

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Improving equity funding opportunities in the CMU

The past 18 months have shown the critical role that capital markets play as a financing tool for companies. In addition to the bank funding provided during the COVID crisis, many companies were able to tap debt markets to raise money, and the listing boom in recent months show that equity markets remain a deep and attractive source of (often transformational) investment opportunity for companies.

The bellwether of success in equity finance is often seen through the lens of the number of IPOs of high growth firms. Indeed, the debate over incubating equity finance tends to focus on the 'funding escalator' – a linear path through various stages of specialist venture and growth financing, ending with an IPO. But this path may not be in sync with the needs of many companies, and it is increasingly out of sync with how many investors look at company financing.

The more linear path may fit best with the trajectory of innovative high-growth firms (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).

But Europe is also home to a significant number of more mature private companies who are, in many ways, world-leading firms. For these firms, the 'funding escalator' narrative resonates less – this should not constrain their access to equity finance. Indeed, 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

Companies can stay private or go public, depending on their needs, but the crucial point should be providing opportunities for companies meet the financing needs of their businesses at any given time. We see two important areas for focus:

The final report of the High Level Forum (HLF) on CMU provides a strong policy roadmap to improve the ability of companies to raise both equity and debt financing.

For companies who do choose to list, improvements to the listing process can be made. Europe has a much higher rate of IPO failures than in other major capital markets – largely due to the pricing expectations of the companies not being met. Promoting direct listings, where a firm lists without actually raising capital can be positive step that can help bridge this barrier. 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.

From an investor perspective, the line between public and private market financing is becoming less clear cut. Where once, most 'mainstream' investors focused on public markets, while specialist alternative investors focused on private equity and debt finance, increasingly many investors are positioning themselves to capitalise on opportunities on both sides of the listing divide. This trend should be welcomed, and built upon to maximise opportunities for financing corporates no matter what their profile or growth ambitions.

Widening the part of the investor base who can play a robust 'cross-over' financing role – that is investing in both private and public companies – is critical. 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 and targeted amendments to the framework could help facilitate this further and really accelerate the investor interest in this space.

A key objective of the Capital Market Union (CMU) initiatives has been to help ensure that EU capital markets are able to more effectively serve the funding needs of European companies, and we strongly believe that targeted initiatives can help realise this aim. The final report of the High Level Forum (HLF) on CMU provides a strong policy roadmap to improve the ability of companies to raise both equity and debt financing.