OPTIMIZING THE FINANCING OF EU ENTERPRISES: MAIN ISSUES AND CHALLENGES

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1. The level of non-financial corporate (NFC) debt is high in Europe and is on an increasing trend

1.1 NFC debt levels are high in Europe, but the situation varies across EU countries

Expressed as a share of GDP, the debt level of non-financial corporates (NFC) was higher in the Euro area (106%) in 2019 than in the US (88%) and comparable to Japan (105%), according to the most recent BIS statistics (*see Chart 1*).

Moreover, this ratio has been continuously increasing over the last 15 years in the Euro area[1]. This increase in debt levels can be explained in part by the significant reduction of interest rates since the 2008 financial crisis (lending rates of loans and cost of market debt)[2]. On average European NFCs borrow at less than 2%, which is a historically low figure. The Covid crisis will likely lead to higher levels of indebtedness of EU NFCs, since bank credit has been widely used to support NFCs during the pandemic.

A significant part of this debt is constituted by cash holdings (30 to 40% in most European countries), the share of which has tended to increase over the last 10 years. Many companies indeed prefer to hold non-remunerated liquid assets rather than invest in more productive assets in order to build buffers against future economic shocks and also because of a lack of investment opportunity, especially in a context of heightened uncertainty, potentially showing certain limits of a monetary policy imposing a prolonged period of low interest rates[3].

Within the Euro Area, three groups of countries stand out (*see Chart 2*):

- A first group of countries had a debt to GDP ratio exceeding 140% in 2019, including: the Netherlands (154% of GDP), France (150%) and Belgium (146%);
- A second group had debt levels of approximately 90-100%: Austria (91%), Portugal (96%), Spain (93%);
- A third group had much lower levels: Italy (69%) and Germany (59%) in particular.

These differences in the level of indebtedness of NFCs across EU member states can be explained by several factors, including: the level of corporate tax (the higher the rate, the more debt financing is attractive compared to equity financing), the way NFCs organize their financing (for example in countries where intra-group financing is high, NFCs tend to use external sources of financing less) and the level of investment (a higher level of debt should normally contribute to more investment). Concerning the level of investment, a recent OECD report[4] points out that investment dynamics differ depending on the financing characteristics of companies. Low leverage companies indeed devote on average a larger share of their revenues to R&D relative to high leverage companies and the opposite is true for Capex, underlining the importance of equity financing to support riskier and innovative projects that require R&D investment[5].

When considering different Member States, the high level of indebtedness of French NFCs for example can be explained in part by a high level of corporate tax (33% in 2019, compared to an OECD average of 23%) and a relatively high level of investment[6]. However these investments mainly corresponded to the renewal of existing equipment rather than to new investments. Indeed, while "gross fixed capital formation" figures have increased in France over the last few years, net capital figures taking into account depreciation were stagnant[7].

By contrast, in Germany, there has been an increase of equity compared to bank loans in the funding of NFCs since the Great Financial Crisis (GFC) that may be attributable to three key elements, according to a

1. In some countries however, such as Spain or Italy, NFCs have significantly reduced their level of debt over the last few years.
2. With the aim to bring inflation back to its 2% target, the ECB gradually loosened its stance, from lowering its key interest rates to negative levels.
3. Some observers indeed point out that the preference for liquid assets and cash holdings in a context of low interest rates may reveal a liquidity trap situation, i.e. an economic situation in which efforts to stimulate the economic activity with low interest rates reach their limits or fail because economic agents prefer to save or hold cash rather than investing due to a negative economic view or to expectations that interest rates will remain very low for a long period of time or further decline.
4. The future of corporate governance in capital markets following the Covid 19 crisis – June 2021.
5. Having the lowest leverage among all industries, technology companies tend to generate the highest cash ratio with more than 20% of total assets in cash or short term liquid investment.
6. Standards & Poor's, "What's Behind The Rise Of French Corporate Debt?", March 2019.
7. Using 'Gross' fixed capital formation figures, may indeed be misleading according to P. Artus (Is there, or is there not, a corporate investment shortfall in France?", Natixis Economic Research, June 28, 2021) because it does not take into account the capital depreciation (required investment to make up for the capital obsolescence). Accordingly, taking the 'net' fixed capital formation provides a more appropriate view, showing that net corporate investment is stable over the last 15 years, with the exception of a strong decrease in 2020.

Bundesbank report[8]: first, the internationalization of the main German corporate groups, which has fostered the growth of intragroup liabilities instead of external debt financing; second, significant efforts to increase the equity base of the German corporate sector following the GFC in order to strengthen their financial resilience; and third an increase in their level of profits, as global demand bounced back after 2010.

CHART 1.

Euro area Corporate Debt Against the Rest of the World % of GDP

Source: BIS

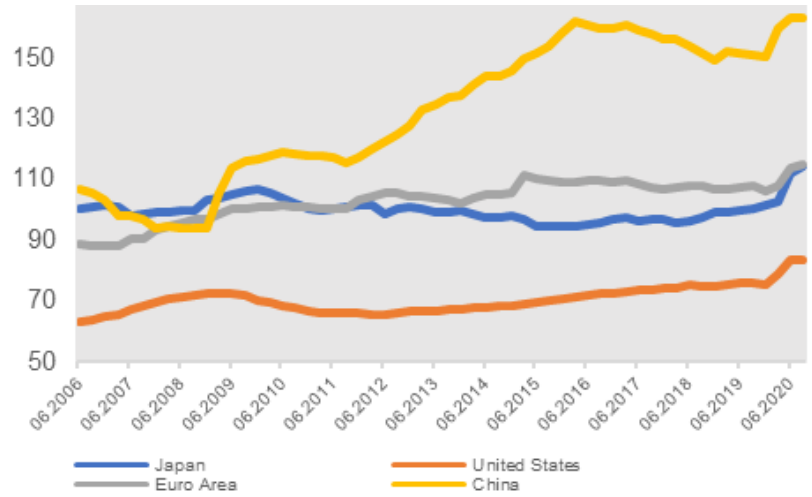
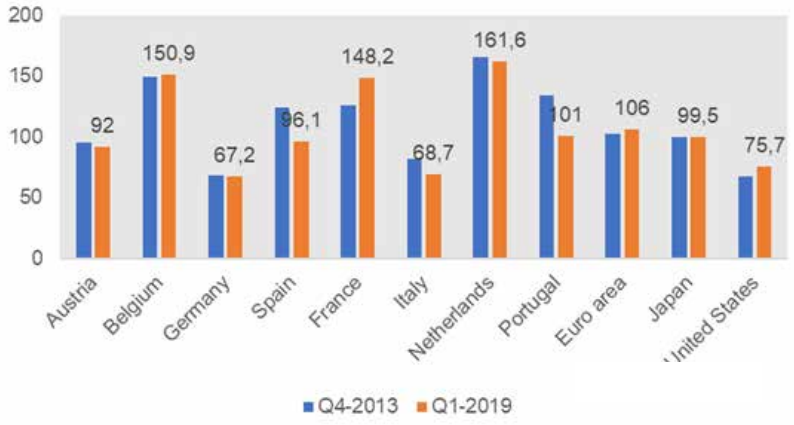


CHART 2.

Unconsolidated Non-Financial Corporate Debt, % of GDP

Source: BIS



1.2 Bank credit remains the dominant source of debt financing in the EU

While the use of all debt instruments has increased in the Euro area since 2008, the expansion of debt securities issuance has been more pronounced than that of bank loans.

The use of debt securities increased following the 2008 GFC and the EU Sovereign Debt Crisis of 2010-13 that saw a reduction of bank financing (*see Chart 3 for France*). Indeed, non-performing loans surged following the crisis, particularly in some southern and CEE countries, leading to credit contraction and bank deleveraging, and stricter prudential requirements increased the cost of lending for banks. During the same period there was a significant growth of the corporate bond market and a shift in the composition of NFC debt from bank loans towards debt securities due to a contraction of bank credit following the GFC and also more recently to the large-scale asset purchase programmes of the ECB, which were progressively extended to high quality corporate bonds[9]. In addition, bond financing has advantages for NFCs compared to ordinary bank loans, since it requires less restrictive covenants and potentially offers longer tenors, thus providing NFCs with longer term financing and a source of diversification of their capital structure. The same trend in favour of bond financing was seen at the international level with an average annual global issuance of NFC corporate bonds since 2008 amounting to more than twice the average issuance between 2000 and 2007[10].

8. "Trends in the financing structures of German non-financial corporations as reflected in the corporate financial statements statistics", Deutsche Bundesbank Monthly Report, July 2018.

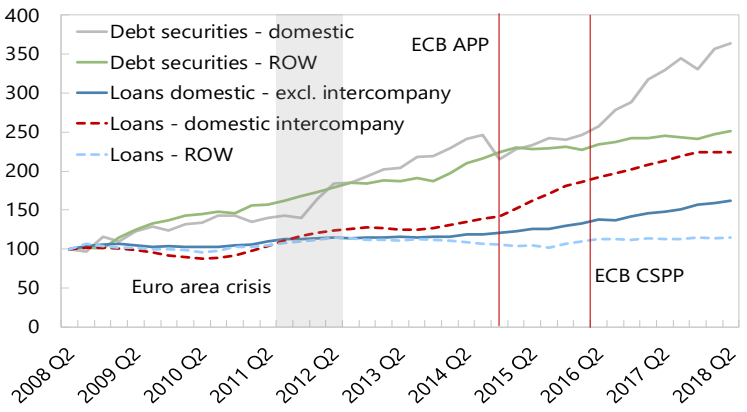
9. Bonds issued by non-financial firms in the EU significantly increased between 2013 and 2016, a trend that can be mainly explained by the accommodative path of the ECB, that embarked in a range of large-scale asset purchase programs in attempt to bring inflation back to its 2% target. Initially targeting public securities in 2015 as part of the Asset Purchase Program (APP), the program has been extended to the quality bonds (credit rating of at least BBB) issued by euro-area corporations other than banks under the corporate sector purchase program (CSPP). Source: "The euro area: corporate bond issuances are starting 2017 in good shape", Caixa Bank, January 2017.

10. The future of corporate governance in capital markets following the Covid 19 crisis – June 2021.

CHART 3.

Cumulative Flows of Debt Liabilities of Non-Financial Companies in France, in bn of euros (2008Q2= 100)

Source: IMF



Bank credit however remains the main source of debt financing in the EU and it is likely that the measures put in place to facilitate bank loans during the Covid crisis will have led to a further increase of bank credit in the total debt of NFCs.

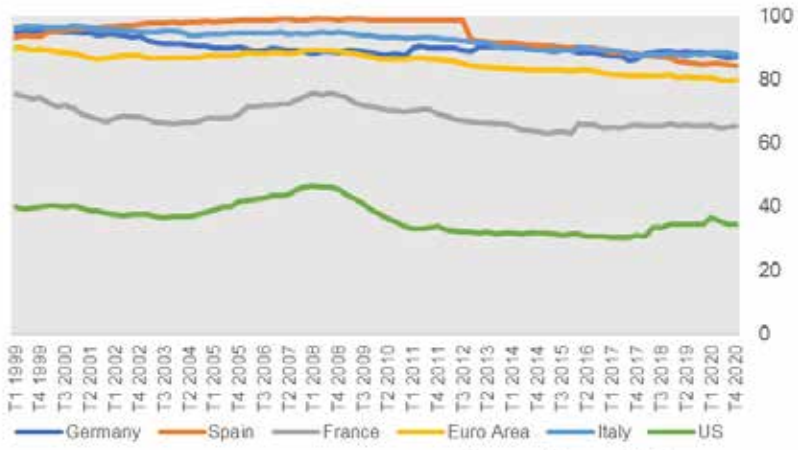
In 2019 about 80% of total financial debt consisted of bank loans in the Euro area (compared to 89% in 2008), according to the Banque de France (*see Chart 4*). This share exceeded 90% in most CEE countries and also in Greece and Cyprus, whereas in France the share of bank credit was closer to 65% in 2019. Comparatively, the share of bank loans compared to total debt in the US and Canada, where capital markets are more developed, did not exceed 40% at the same period.

When comparing aggregate NFC bank credit to GDP, the proportion of bank credit is also higher in Europe than in the US: 88,5% of GDP in the euro area, against 51% in the US, according to the BIS. Among advanced economies, only Japan (110,6%) exceeded this level.

CHART 4.

Share of Bank Credit in Total Corporate Debt, %

Source: Banque de France



2. While NFC debt seems more sustainable in the EU than in some other developed economies, its high level may be a drag on growth and reduce economic resilience

2.1 EU NFC debt seems more sustainable than in some other developed economies...

When considering the debt to gross surplus ratio[11], the situation of European NFCs in terms of debt sustainability appears to be more favourable than in the US or Japan on the whole. According to the OECD, the debt outstanding is 3.6 to 4.2 times larger than the annual flow of gross operating surplus in large European countries such as Italy, Germany and Spain in 2019, which is nearly half of the US level (8.8) (*see Chart 5*).

These statistics indicate that NFC debt may be relatively more sustainable in Europe than in the US for example, even if the level of debt of European NFCs compared to GDP is higher.

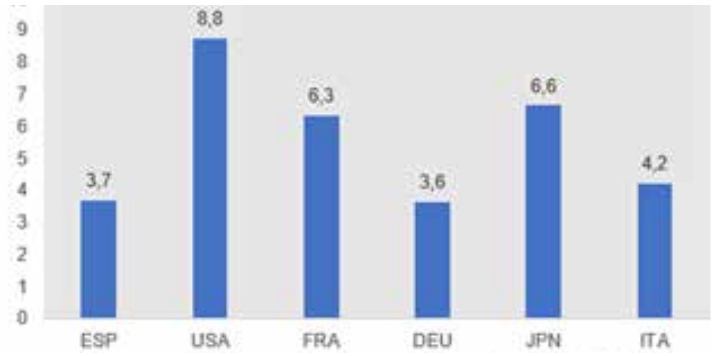
In addition, record-low borrowing costs contribute to supporting the sustainability of corporate debt in the short term with a significant decrease in interest payments in most advanced economies. A progressive normalization of monetary policy would nevertheless call this into question.

11. Considered as relevant for assessing the sustainability of debt, the debt to gross surplus ratio indicates the capacity of non-financial corporations to "meet the cost of interest and debt repayments with the operational profits generated", according to the OECD definition. Hence, "the higher (lower) the ratio, the greater (smaller) is the risk that non-financial corporations" may not be able to meet their debt repayments. Source na_glance-2014-34-en.pdf (oecd-ilibrary.org).

CHART 5.

Debt to Surplus ratio, 2019

Source: OECD



2.2 ...however high indebtedness is likely to impede the growth and resilience of EU NFCs over time

First, high indebtedness may reduce the economic performance of NFCs[12]. Although corporate debt is essential to finance tangible investments and the cash requirements of firms, an excessive level of debt reduces their future investment capacity and thus their growth potential, because it forces borrowers to use a larger share of gross cash flow to pay interest services, at the expense of financing new investments. In addition, highly leveraged firms are more exposed to roll-over risk (i.e. to the risk that lenders may not renew expiring short term credit lines), particularly during a crisis, when collateral values drop. Empirical evidence published by the ECB[13] shows for example that after the 2008 GFC, corporate investment declined more in EU periphery countries where NFCs had accumulated large amounts of debt prior to the crisis than in the overall Euro area.

Secondly, indebtedness reduces the resilience of NFCs. As debt levels increase, borrowers' ability to repay becomes progressively more sensitive to drops in income and sales, as well as to potential increases in interest rates.

Past examples moreover show that recovery after a crisis (for example after the 2008 GFC) is slower in a bank-based economy, such as the EU, than in a market-based economy such as the US [14]. This can be attributed in part to the fact that market instruments allow firms to take more risks in their investments than bank loans with less restrictive covenants and longer tenors, potentially generating higher returns and also to the greater exposure of banking activities to financial stability risks and economic cycles, leading to a greater potential rationing of bank funding in times of stress than markets [15].

Hence the objective pursued notably in the Capital Markets Union (CMU) initiative to further diversify the financing of EU corporates with more equity in order to increase their resilience and growth potential.

For smaller growing and innovative companies, which have limited cash flows and need significant investments notably in intangible assets, further developing equity financing is essential. Indeed the financing of intangible fixed assets relies more on equity and other financial debts than that of tangible assets, which can more easily be financed by bank credit[16].

Consequently, there is at present a strong deficit of intangible investment[17] in Europe: between 2014 and 2017, intangible capital amounted to 7,6% of GDP while it was over 10% in the US[18].

3. Equity financing remains under-developed in Europe despite some progress

3.1 Debt-to-equity ratios of NFCs are higher in the EU than in other developed countries and a significant proportion of firms are considered to have insufficient own funds

The average debt-to-equity ratio of EU27 NFCs stood at 58.5% in 2019 according to Eurostat statistics (*see Chart 6*), which is higher than many other major economies such as the US (50%), China (52%) and Japan (55%)[19].

12. Economists generally consider that debt-to-GDP levels become a drag on growth when they exceed 90%, which is the case for several European countries such as France, the NL, Belgium and to a lesser extent Portugal and Spain. Beyond this threshold, statistics show that a 1 percentage point increase in corporate debt is associated with an approximatively 2 basis points reduction in per capita GDP. Economic growth hence is more sensitive to the level of debt when the latter exceeds that threshold. Source: "The real effects of debt", BIS Working Paper, September 2011.
13. "Debt overhang, rollover risk, and corporate investment: evidence from the European crisis", Moreno et al (February 2019).
14. "Structure de la dette des entreprises et reprises économiques : analyse d'un groupe de pays", Grjebine, Szczerbowicz, Tripier, Banque de France (2018).
15. As highlighted in a working paper from the DNB "Banks overextend and misallocate credit in financial upturns and ration credit in financial downturns more than markets". The credit tightening of the banking sector during the EU Sovereign Crisis confirms that view (see Section 1.2). By contrast, market financing may contribute less to systemic risk, since they serve as platforms, directly channeling financial resources between savers and borrowers, rather than intermediating on separate balance sheets. "Markets are thus less dependent on highly leveraged institutions for the financial intermediation process, have more asset-liability matching, are financially less interconnected." Source Bank-based versus market-based financing: Implications for systemic risk, DNB Working Paper (December 2017).
16. Considering for example French companies, bank credit strongly contributes to the funding of tangible fixed assets (43%) but to a lower extent to the funding of intangible fixed assets (23%), according to Lé & Vinas in "The Financing of Investment: Firm Size, Asset Tangibility and the Size of Investment", Working Paper Banque de France (July 2020).
17. Computer software and databases, entertainment, artistic and literary originals, mineral explorations, design, new product development costs in the financial industry, research and development, branding, organizational capital and training...
18. According to INTAN-Invest.

When considering the situation across the EU, overall, there has been an improvement in the level of equity relative to debt since 2011 in most of the Member States and over this period, only 5 countries of the 27 experienced a surge of their debt-to-equity ratio. In addition, although there is a high dispersion of debt-to-equity ratios across EU Member States (ranging between 40% in Lithuania to 127% in Cyprus)[20], the largest economies of the block are close to the EU average, with Germany and Spain standing at 56,6% and 58% respectively, France at 61% and Italy at 65%.

As for the size of NFCs, debt to equity ratios tend to be higher in smaller companies in the EU, although an increase of the share of equity capital in total assets was observed for all sizes of firms until 2019.

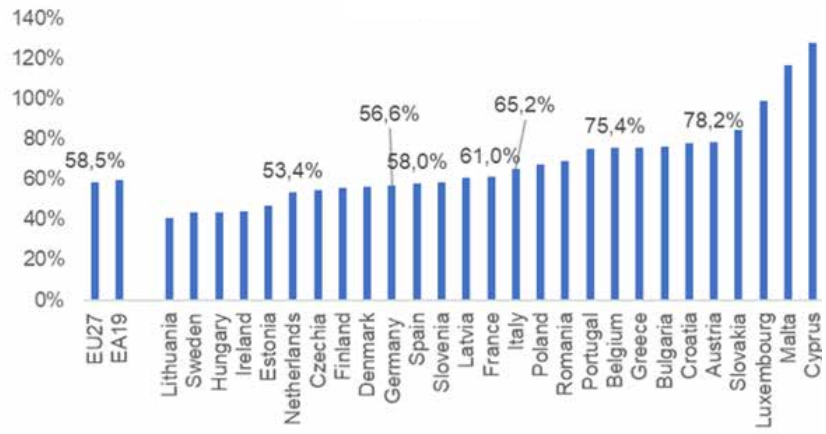
A significant number of smaller European companies are also considered to be under-capitalized. For example, in France, 20% of small companies are 'undercapitalized' according to the Banque de France, meaning that their total debt exceeds the level of equity by twice or more (i.e. a debt to equity ratio superior to 200%)[21]. Moreover significant equity financing gaps concerning SMEs have been identified by the EIB[22] in several member states including France (€ 146bn), Greece (€ 100bn), Germany (€ 98bn), Sweden (€ 97bn), Belgium (€ 68bn), the Netherlands (€ 41bn), and Denmark (€ 26bn).

CHART 6.

Debt to Equity Ratio in the EU Member States in 2019, %

Source: Eurostat, Eurofi calculations

Note: debt is the sum of Bank Loans and debt securtities; Equity includes «Listed Shares», «Unlisted Shares» and «Other Equity», as classified by Eurostat



3.2 Stock markets and venture capital investment are under-developed in Europe compared to the US and Japan

European stock markets are significantly smaller and less liquid than US stock markets.

In 2019, the capitalization of European Stock Markets totalled $ 10trn, which is less than one quarter of the US market ($ 45 trn). Moreover, compared to GDP the capitalisation of the EU stock market is much smaller than that of the US (60% for Europe compared to 180% for the US) and also other developed countries notably in Asia (e.g. Japan 120%, Korea 90%).

In terms of market issuance of equity (both IPOs and secondary offerings), the European market is also smaller, representing around 2/3 of the US (adjusted for GDP).

Concerning investments in smaller company equity, the difference between the EU and the US is even more striking with an amount of Venture Capital (VC) investment more than 10 times lower in the EU than in the US[23] in 2019, according to Bruegel[24]. In addition, around 84% of all venture debt deals in the last decade took place in the US and Canada, whereas only 6% were in Europe with most VC transactions concentrated in the UK, France and Germany. As a share of GDP, VC investment only accounted for 0,044% in Europe, versus 0,633% in the US; 1,83% in Singapore; 1,82% in China; 1,5% in India. One of the main reasons for this is the less developed, more risk averse start-up ecosystem in most EU countries, mainly relying on traditional bank financing.

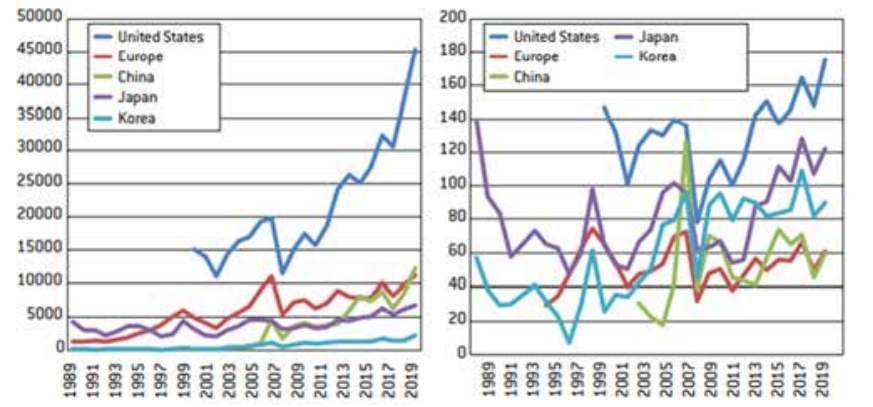
The same is true for investments in larger SMEs. In terms of private equity (VC and PE) markets, the US market was about three times the absolute size of the EU counterpart in 2017, when measured as equity issuance for nonfinancial SME corporates, according to a study from the European Commission[25].

19. The figures for the US, China and Japan are based on listed firms.
20. According to ORBIS database and data compiled by Bruegel, the average debt-to-equity ratio (i.e. proportion of debt compared to equity) of European listed firms is 1.41, meaning that European companies have $1.41 of debt for every dollar of equity i.e. 58%. This is the highest level among advanced economies, compared to 1.02 in the US, 1.09 in China, 1.20 in Japan and 1.14 in South Korea.
21. "Les fonds propres des TPE et PME", Observatoire du financement des entreprises (Mai 2021).
22. Gap analysis for small and medium-sized enterprises financing in the European Union" (December 2019).
23. The main providers of venture debt in Europe are funds, banks and international financial institutions such as the EIB. The EIB is Europe's largest provider of venture debt, with EUR 600 million per year in long-term financing for highly innovative companies.
24. Demertzis, M., M. Domínguez-Jiménez and L. Guetta-Jeanrenaud (2021) 'Europe should not neglect its Capital Markets Union', Policy Contribution 13/2021, Bruegel.
25. "Study on Equity Investments in Europe: Mind the Gap", Research and Innovation Department, European Commission (February 2021).

CHART 7.

Total Market Capitalisation, $ billions and % of GDP

Source: Bruegel based on World Federation of Exchanges database



4. Several factors explain the high proportion of debt financing used by NFCs in the EU

4.1 External listed equity financing is 4 times more expensive than debt financing for issuers at present

The external debt financing costs of NFCs (lending rates and market-based debt costs) have significantly decreased over the last 15 years in the Euro area and are lower than 2% since 2018.

During the same period, the cost of funding via listed equity has stagnated at a high level (see Chart 8): approximately 8% since 2014, according to ECB[26] estimates, compared to 5 to 7% in the US. In addition, the cost of external equity has not decreased during the Covid crisis, with shareholders maintaining their expectations in terms of return, when at the same time interest rates have decreased due to the action of the ECB[27]. This persistently high cost of equity funding in the EU, measured by a high "equity risk premium" (ERP) level[28] reflecting the compensation that investors demand for the risk of holding shares, is due to higher risk aversion and relatively lower expected earning on future investments in Europe than in the US in particular, according to the ECB[29].

This means that in effect the cost of external equity financing is 6 percentage points higher than debt[30] in Europe (or 4 times higher), putting equity financing at a strong disadvantage.

A further issue is the fiscal bias in favour of debt, which increases the cost of equity financing compared to debt financing. Indeed many corporate tax systems across the EU provide unintended incentives for debt financing via the tax-deductibility of interest payments, since a company can deduct interests attached to debt financing but not the costs related to equity financing, such as the payment of dividends. Six Member States (Belgium, Cyprus, Italy, Malta, Poland and Portugal) however have measures in place aiming to tackle this tax induced debt-equity bias. The measures differ in policy design but all provide for a tax allowance on equity funding calculated on the basis of the tax reduction that a firm would have obtained for an equivalent financing in debt.

CHART 8.

Nominal External Financing Cost of Euro Area Non-Financial Companies, %

Source: ECB

Notes: The latest observations are from February 2018 (short-term and long-term bank leading rates) and March 2018 (cost of listed equity and cost of market-based debt)

26. D. Kapp, K. Kristiansen "Euro area risk premia and monetary policy: a longer-term perspective", (April 2021).
27. Source Eurofi April 2021 Seminar Summary.
28. The ERP summarizes the potential for future corporate profits, the interest rate to discount such profits and the perception of risk related to the investment considered.
29. Source: "Euro area risk premia and monetary policy: a longer-term perspective", Daniel Kapp, Kristian Kristiansen (April 2021). Although the OECD report on the future of corporate governance (June 2021) referenced further up emphasizes that underwriting costs of IPOs for small and large companies are lower in Europe (3-4%) than in other major jurisdictions (US 7%, China 6-8% or Japan 6-8%).
30. The policy of lasting low interest rates has kept borrowing cost lower than equity cost, estimated through the equity risk premium (ERP). Source: Measuring and interpreting the cost of equity in the euro area (europa.eu).

4.2 Debt financing is more accessible than equity financing for most companies in the EU

Beyond the cost of equity financing vs debt financing and the favourable tax treatment of debt compared to equity, many companies prefer debt as a financing channel because it is easier to access, despite the positive features of equity financing (e.g. longer term funding, capacity to finance intangible investments...)[31].

Companies have an established relationship with several banks usually and can get access to more credit relatively easily in most cases thanks to this, except for financing intangible assets or a new business plan approach.

Obtaining additional equity financing is comparatively more difficult for most companies, particularly SMEs. Indeed it involves complying with regulatory and listing requirements such as establishing a prospectus, which are expensive and complex to handle for entrepreneurs, requires a great deal of disclosure on the company's strategy that entrepreneurs are not always ready to make public and also implies giving up an ownership stake and therefore losing part of the control over the company.

Small companies also face several structural problems inherent to the European equity market. These are related to the limited size of exchanges for smaller companies in Europe, to the fact that guiding smaller companies through a listing process is not the core business of many European banks and also that SMEs tend to use smaller banks in many cases that find it difficult to fully support the initiatives of their clients in this area[32].

There are also many obstacles to the development of equity financing on the investor side including limited financial literacy in most EU countries, risk aversion and an access to research on companies that has been reduced since the implementation of MiFID II unbundling requirements, according to many market stakeholders. The potential disincentives to equity investment created by MiFID investor protection rules for retail investors and distributors are also emphasized, as well as the obstacles to institutional investment created by Solvency II rules applying to life insurers.

These different challenges, including the tax bias in favour of debt, are being tackled in the context of the Capital Markets Union (CMU) initiative and the MiFID II review, however significantly improving these different issues remains a relatively long term objective.

31. See Eurofi April 2021 Seminar Summary "Developing equity financing".

32. See Eurofi April 2021 Seminar Summary "Developing equity financing"