# OPTIMISING THE FINANCING OF EU CORPORATES

## 1. Current structure of corporate financing in the EU

### 1.1 A strong debt and bank financing bias

A Central Bank official stated that data from the Bank for International Settlements (BIS) shows that the funding mix of European corporates is 55% bank-based compared to 33% in the US. Europe is still a bank-centric financial system where larger corporates go to the capital markets, but most small corporates are dependent on banks. In times of crisis this could make the economy more pro-cyclical as banks may cut credit flows. Increasing market funding would allow the provision of alternative financing in the event of a financial crisis and also the funding of immaterial assets that cannot be easily financed by banks.

There is also a debt bias in the financing of EU corporates, the Central Bank official observed. Most European countries have a favourable tax treatment for debt vis-à-vis equity financing, which incentivises firms to take on more debt than is economically optimal, leaving them vulnerable to shocks. Corporate indebtedness was already high in the euro area before COVID and has increased post-COVID, as have, for example, debt-to-earnings ratios. This may lead to a rising proportion of low productive 'zombie firms,' dependent on loose financial conditions and to a misallocation of capital to such firms, which could be put to better use. However this is not only a European challenge and is not the only productivity challenge facing Europe since ageing population and low productivity growth issues pre-date COVID. Another issue associated with debt is that highly leveraged firms invest less in research and development (R&D), which is vital for long-term high productivity growth, as shown in the OECD corporate governance study published in June 2021. Therefore too much leverage and too little equity and market funding are not positive for the economy's long-term potential. in addition market-based financing increases market resilience on an aggregate level and at the company level. Indeed, unlike bank-financing, market-financing focuses on the higher-risk share of firm financing associated with more productivity and innovation.

The Central Bank official added that there are fundamental ratios to consider for assessing the funding structure of enterprises and how equity is provided, which show that Europe does not have the same equity culture as the US. In the US private investors, including friends and family, provide 33% of US SME financing, but only 9% in Europe. Angel investment amounts to €20 billion in US SMEs, but €6 billion per year in Europe. Pension funds provide €15 trillion in the US, corresponding to 53% of equity, and €4.3 trillion in the EU, or around 30% of equity. The consequences of this equity shortfall in Europe are two-fold. First, SMEs are more fragile in times of difficulty or shock, even if the fundamentals are good. Secondly the pandemic would have been a disaster, and worse than in the US, without strong government support.

A market expert agreed that the current financial structure between equity and debt of European small and medium-sized enterprises (SMEs) is a major weakness. As a consequence these companies are less able to invest, in particular in R&D, as previously mentioned. A 2018 European Central Bank (ECB) study of the 2008-12 crisis found that firms with more equity were more resilient in terms of investment and development. Firms with less equity tend to cut investment more strongly. This is particularly an issue for start-ups which need equity at the beginning in order to develop and cannot correctly service debt because of limited cash flows. As a result it is easier to start a business in the US than in the EU and innovation potential is lost in the EU due to an insufficient culture of equity financing. The Chair added that a further issue in some countries is the difficulty to attract large investors to invest in SMEs notably, because of the limited liquidity and volume of issuance.

### 1.2 Impact of the COVID crisis on the financing structure of EU SMEs

A market expert highlighted the evolution of the financing of corporates, especially SMEs, during the COVID crisis based on figures for France, which can be considered to be representative of the rest of the EU, because the government support schemes put in place were similar. SMEs saw little change in retained profits on an aggregated level, thanks to government support. It was just below 7% of turnover in 2020, close to the pre-pandemic level.

Net investments dropped slightly in 2020, but were not hugely different compared to the pre-crisis level. Net borrowing increased significantly by +16% compared to +2% in 2019, including a +37% increase in net cash. The cash was probably needed for a period of time before government support programmes came into effect and the liquidity was then kept on balance sheets by firms for precautionary reasons. Considering the liability side, net and gross debt have both increased significantly in volume: gross debt increased by €224 billion and the cash balance by €215 billion. Looking at other ratios, gross debt compared to own funds for SMEs was 67% in 2019 and 74% in 2020, but net debt to own funds went from 30% to 26%. This shows that the crisis did not weaken company balance sheets significantly, thanks to government support programmes and the provision of state-guaranteed loans by the banking sector. The prime objective of these fiscal interventions was to restore turnover and business, maintain firm profitability and their capacity to develop and invest when the government programmes would stop. In addition, the financial structure of SMEs improved significantly over the past decade, as the gross debt to own fund ratio decreased from 90% in 2011 to 67% in 2019.

An IFI representative commented that, despite massive public intervention via guarantees and debt support, SMEs were hit harder than bigger EU companies, and the performance gap between them widened, partly because SMEs started out with a smaller buffer and had limited access to credit. An IMF report stated that public policies have mitigated only half of the rise in liquidity shortfall. Public support has addressed liquidity needs to an extent but only covered about 30% of the rise in equity gaps. Even with such public support, it is worrying that the share of insolvent firms could further increase by 6% across Europe and put at risk the jobs of around 8% of the workforce, the IFI representative believed, which shows that the crisis is not yet over.

### 1.3 Capital markets worked well through the COVID crisis in the EU

An industry representative stated that during the COVID crisis the equity market at the European and global levels worked well. Markets remained liquid so it was easy for investors to get in and out, spreads were tight, and listed companies were able to access capital to strengthen balance sheets or conduct M&As.

Access to initial public offering (IPO) capital also remained open for SMEs. When looking at the Nordic and Baltic region, markets worked very well for SME IPOs and an effective mix of bank lending and market financing has remained available, although statistics differ from market to market and some markets still have improvement areas. From January to the end of August 2021, the Nordics welcomed a record-number of 121 IPOs, among which around 100 concerned SMEs. Most of the IPOs occurred in Sweden, where market access works well and where there is a focus on supporting the access to capital of SMEs over the long-term thanks notably to a well-developed equity culture among private investors. The bond market also worked well during this period, as many larger listed companies issued debt securities, with sustainable bonds making up around 15% of those listed so far in 2021. Improving the financing of EU corporates is about getting the right setup and structure in each relevant market the industry representative concluded.

## 2. Main solutions for optimising the financing of EU corporates

### 2.1 Further adapting funding instruments to the needs of SMEs

An industry representative stated that companies want competition and choice for accessing capital and are agnostic about whether capital comes from private or public markets. Domestic market structures vary however in their capacity to support investment effectively across Europe. The CMU action plan is addressing some frictions that need to be removed concerning capital markets, but a major challenge for SMEs in the EU is deploying at scale. This is a key area that policymakers should focus on with the objective of encouraging the development of local markets adapted to the needs of different investors i.e. domestic and international ones, insurance companies, banks and retail savers.

An IFI representative observed that more quasi-equity and subordinated debt instruments are needed. SMEs also need more flexible, tailor-made financing solutions which can be in the form of loan funds, fintech financing or venture capital. It is also important that the private and public sectors collaborate in this area. As shown in a recent AFME study, many SMEs and family-led companies value the notion of control and are reluctant to give it up when using equity financing. They are ready to pay for less invasive solutions, which could be quasi-equity and subordinated debt. This is also supported by European Investment Bank (EIB) analysis showing a readiness for paying an interest premium for that. Subordinated financing is not a standalone solution, but a way to diversify SME financing sources taking into account the need to further provide SMEs with standardised, scalable, easily deployable and non-invasive forms of funding. This type of financing exists at national level in some countries, and others have launched recently such instruments, like France's 'prêts participatifs', but a pan-EU product is still missing and is needed. Such products and solutions were envisaged at EU level through a solvency instrument but did not materialise.

An industry representative suggested that more can also be done in terms of product innovation, in areas such as venture debt, digital lending and equity-light financing, which are more suitable for companies with intangible assets and are harder to cover with traditional forms of financing. There is no pan-European vehicle at present to cover these needs. The actions put in place by the US Small Business Administration for supporting the funding of SMEs could be interesting to replicate in the EU. A Central Bank official added that there is a need to create incentives for equity funding. An industry representative agreed that incentives could have an impact over time but warned that effects cannot be created overnight.

### 2.2 Supporting SMEs throughout the funding escalator

An IFI representative stated that financing solutions should also be adapted to the various development stages of SMEs. The traditional focus in Europe has been on early-stage finance, where there was a market failure and still is, particularly outside Western Europe. However, there is also a need for growth finance to keep well-performing, venture capital-nurtured companies in Europe because value creation does not stay sufficiently in Europe. 44% of unicorns supported by the EIF for example and for which the earlier, high risk financing stages were achieved in the EU, have exited European financial markets and are now either listed in the US or Asia or have been acquired by US or Asian firms. There is awareness about the need to support growth finance at EU level and some measures have been implemented for scale ups such as the European Scale-up Action for Risk capital (ESCALAR) instrument. The Commission is also working on the pre and post-IPO stages, but it will require sizeable interventions, coordination with national players, and solutions to attract private money, as public money alone cannot do the job.

An industry representative stated that the EU IPO fund which has already been decided needs to be activated. Another industry representative added that a more precise definition of SMEs is needed from a

policy perspective because growth SMEs, which create job innovation and boost productivity do not have the same characteristics and needs as other SMEs. An issue that needs considering is that a company going through different stages has to re-market itself to different providers of capital. This is part of the 'funding escalator' concept whereby SMEs go through various stages of specialist venture and growth financing before ending with an IPO. But there is in Europe a recognition that some steps are missing in the escalator and must be filled.

### 2.3 Leveraging the complementarities of banks and capital markets

An industry representative considered that the COVID crisis has shown that the perception of the juxtaposition of Banking Union (BU) and Capital Markets Union (CMU) as a zero-sum game i.e. with capital market financing potentially replacing bank financing is a false dichotomy. There is instead a 'mutualistic symbiosis' between the BU and CMU, which complement each other, ensuring a greater investor base heterogeneity and the availability of more diversified sources of funding and also allowing the progressive strengthening of Europe's corporate funding ecosystem. During the COVID crisis, firm sales went to zero in many cases and corporate balance sheets became illiquid, which accentuated short-term liquidity needs. Banks, which were in good shape thanks to the post-Global Financial Crisis (GFC) reforms and policy changes, were the immediate provider of short-term liquidity to allow firms to keep their business running and pay their employees. Corporates drew on revolving credit facilities (RCFs) and short-term lending facilities, and then turned those maturities out in the capital markets. Liquidity returned to the banks, who extended it to other companies that needed it for potentially a longer period of time.

An example of the synergies between bank and capital markets financing are minibonds which are used in Italy, the Chair mentioned. A 2020 paper on the Italian minibond market shows that after the issuance of minibonds,  the access of companies to normal debt financing by banks is improved, because the issuance of mini-bonds is a sign of quality. A market expert agreed that the example of the Italian minibond market illustrates the complementarity between bank and capital market financing. An ECB study on ex-post results shows that shortly after the issuance of minibonds, there is a reduction in lending rates by 40 basis points on average for long-term loans and 28 basis points for advances for the companies issuing them. Minibonds also reduce the amount of used bank credit by 35%, keep credit in the balance sheet, and, importantly, reduce the ratio of used credit compared to credit created significantly, giving companies the possibility to augment their total external funding capacity by 40% and to seize additional investment opportunities.

Another example of complementarity between banks and capital markets, the market expert mentioned, is the key role that banks play in the introduction of equity into the market and in the sales of securities to institutional and retail investors, mostly via investment funds. Maintaining this role however requires a review of banking regulation in order to ensure that banks continue to have the capacity to provide liquidity for market making activities. Banking regulations were rightfully strengthened after the 2008 financial crisis, but it is necessary to ensure that this does not prevent banks from playing their role in the development of capital markets. It is also essential not to introduce more severe regulation in finalising Basel III plus than what exists in the US.

### 2.4 Developing retail participation in equity markets

An industry representative stated that the increased retail participation in capital markets observed during the COVID crisis is encouraging. Many online brokers in Europe saw significant increases in the number of retail clients, as in the US. Going forward there should be a strong focus on developing retail investment in Europe, after the time previously spent on developing professional investment. The First North Growth Market in Stockholm for SMEs shows that 60% of trades and more than 40% of turnover are performed by retail investors, which is a high level of participation. In Sweden 80% of citizens have equities, directly or indirectly and part of these are SME equity, which means that retail investors are helping to fund SMEs in their growth period.

Attempts have been made to copy the Swedish model into other markets, with some success, but with some gaps also. An equity culture for retail investors cannot be built overnight, the industry representative believed. Sweden has focused on this objective for more than 30 years, starting with education and creating the right tax incentives for investing in SMEs with the introduction of a low-tax investment saving account where banks or brokers report taxation on behalf of retail investors, which encourages them to invest in small-upside growth companies. Stock exchanges have also been involved in the development of equity markets in Sweden, along with advisors, anchor institutional investors and pension funds. This has been a long journey, but as a result the Swedish market for SME growth companies and new listings is probably the most dynamic in Europe. This also requires political will and the backing of the industry as shown by other Nordic markets which are still struggling to develop their capital markets.

A Central Bank official added that Dutch pension funds, which act as an indirect investor in financial markets and then supply retirement benefits, are another positive example of retail participation in capital markets in Europe. Pension holders are indirect investors, but on aggregate represent a significant share of the market. Increasing savings in capital-based pension funds would contribute to develop and deepen EU capital markets.

An industry representative agreed on the need to develop Europe's equity culture, an objective which is often overlooked when considering possible policy levers. Europe is too reliant on debt funding. Reversing that balance notably requires increasing financial literacy and the understanding of citizens about retirement savings, and especially the role that equity can play in this perspective.

**2.5 The prospects of SPACs**

The Chair emphasized that there is an on-going debate among regulators about the role that Special Purpose Acquisition Companies (SPACs) could play in facilitating SME financing and retail investment and the regulatory approach needed for such vehicles. An industry representative explained that the US market has had more than 400 SPAC listings in 2021. In the EU Nordic market 7 SPACs, have been listed so far in Sweden and Finland. SPACs are an interesting concept, are part of the market structure and are there to stay, the industry speaker believed, however, US stats show that not all SPACs are performing well. SPACs offer many opportunities, but investors must conduct the necessary due diligence before investing in them in the same way as for traditional IPO companies, assessing the prospectus and IPO materials. Currently they are regulated on a local level, which means that rules differ across the EU. The EU could consider a broader regulation at EU level.

A market expert agreed that SPACs are an interesting instrument for developing capital markets alongside equity, crowdfunding, private equity or venture capital, especially when there is a difficulty with price discovery. For an innovative company where intangible assets are dominant or represent almost exclusively the value of the company, it is difficult to embark on a classical IPO. Using a SPAC allows for price discovery and establishing a basis for a price to then go to the market as a result of de-SPAC-ing. The European approach concentrated on real business objectives seems more appropriate than what is happening in the US where the development of SPACs seems excessive.

**2.6 Reviewing EU legislations impacting capital market financing**

A market expert noted that a number of EU legislations must be reviewed to improve the financing of EU corporates and particularly SMEs and suggested three priorities: (i) reviewing Solvency II prudential requirements, which are calculated based on a risk at one year for a multi-year investment and so disadvantage investment in the most volatile securities, especially equity; (ii) reviewing the ELTIF regulation: the European Long term Investment Fund (ELTIF) is a pan-European vehicle in private equity, attractive for savers, but regulations have led to negligible amounts of investment and this requires greater focus; (iii) reviewing the securitisation regulation, as it is an important way for markets to develop: with securitisation, the initial financing is done by banks, who have limits in their balance sheets for regulatory reasons, but are able to assess the quality of the risk, so securitising is an appropriate way to develop market financing and provide the EU economy with more financing.