SME EQUITY FINANCING

BENOÎT DE JUVIGNY

Secretary General - Autorité des Marchés Financiers (AMF)

Ever-changing capital markets framework and its impact on SMEs

It is a well-known fact that the European SMEs are more heavily reliant on private debt or equity financing (e.g. loan-based bank financing) than their peers in other major jurisdictions, namely in the US, which are mostly financed through their domestic capital markets.

During the Covid-19 crisis, European governments have put in place an arsenal of public measures that allowed SMEs to confront the sharp fall in demand and business opportunities. These supporting measures were mostly debt-based and included for example schemes involving public guarantees for loans granted to companies. This has generated a substantial increase of the level of debt on SMEs' balance sheets compared to the pre-Covid levels. Additional equity financing, and lower levels of leverage on companies' balance sheets are needed to re-balance the current corporate financial structure, and provide companies more room for manoeuvre for sustained growth.

During that same period, European legislators have enacted in an unprecedentedly swift manner certain legislative measures, in the context of an EU recovery package, in order to facilitate SMEs' access to capital markets. Among those measures, the European legislators created a temporary 'recovery prospectus', a new short-form prospectus, aimed at simplifying the procedure for listed issuers to swiftly seize opportunities to raise equity in the capital markets during the COVID-19 pandemic. At this stage and despite the significant number of capital increases in 2021 on financial markets, this new format has had very limited success.

In order to increase financial research activity on SMEs, the recovery package also removed, for SMEs only, the research fees unbundling obligation that was introduced in MIFID 2, with the goal to give small issuers more visibility for investors. MIFID 2 recovery package is helping SMEs to be better covered by financial analysts as it allows investment firms to recoup the costs of SME research with other income sources.

Targeted adjustments are worthwhile to tackle SMEs' access to capital markets.

As part of its 2022 work programme, the European Commission announced its intention to adopt a legislative proposal in the second half of 2022 to provide for additional regulatory simplifications and ways to reduce costs and red tape for companies, especially SMEs, and to foster their listing. This initiative is high on EU's CMU agenda, considering also that the global competitiveness of the EU is at stake. Indeed, following Brexit, the UK has also introduced significant changes to its Listing Rules, and is considering a fundamental overhaul of its Prospectus Regime with a view to further increase its attractiveness.

Overall, the existing European regulatory framework is sound and robust. Even if they entail costs and administrative burden for issuers, regulations such as Market Abuse or Prospectus are key for market integrity and investors' confidence. A comprehensive and structural change of those pivotal regulations under the Listing Act review could significantly scare off investors and destabilise the market. At the same time, targeted adjustments are worthwhile to tackle SMEs' access to capital markets. Proposals touching for instance on the prospectus requirements targeting SME growth markets are welcome. An interesting route could be to repeal the obligation to draw a prospectus for public offering in SME Growth Markets, and to transfer to market operators the responsibility to define the content of an information document that would be required by European law.

The ESAP project (European Single Access Point) is currently being designed in the EU so that such regulatory information, including financial and sustainability-related information of European companies, can be accessed in a digital format via a central entry point within the EU. ESAP will provide increased visibility for issuers, in particular smaller ones, increasing their chances of having access to a larger pool of investors. ESAP will facilitate investors' access to capital markets to make sound investment decisions. An important point of attention is that the project should not increase or modify companies' general reporting obligations, and should not generate additional costs for issuers.

Harmonisation in regards to the loan origination framework proposed by the European Commission is welcome as well. This will further encourage the funding to SMEs and provide them with an additional source of funding. This is also the case for the ELTIF proposition, which shall support the long-term growth of SMEs while providing an investment option for retail investors to participate in capital markets.

Retail interest and trading activity in the public markets have indeed significantly increased since the beginning of the Covid-19 crisis. This renewed interest may benefit publicly listed SMEs, which is why it is key to consider proportionate measures that would increase their visibility and facilitate their access to the public markets, without jeopardizing market integrity, key for long-term success.

ALAIN GODARD
Chief Executive Officer -
European Investment Fund (EIF)

Venture Capital in Europe – mind the (scale-up) gap

The EU Industrial policy has entered a new phase. It is a new phase that aligns the EU action to changes in the economic and geopolitical global landscape and which is built around powerful concepts such as Industrial Ecosystems or Economic Strategic Autonomy.

On this basis, the new policy clearly wants to address main topics such as a strong European presence in certain strategic productions, the issue of vulnerability of value chains, the promotion of an effective dual transition. With the clear understanding that a competitive Europe is a stronger Europe: economically, politically, in its capacity to influence other geo-political blocks.

In light of the above, the EU Industrial policy indicates the importance of startups and of the building of an appropriate context for their development. Startups represent ideas, jobs and growth. Startups are the future. And the Capital Markets Union reinforces this vision. As a matter of fact, one of its strategic objectives is to improve access to Venture Capital (VC) financing.

The EIF has been in the first line on this policy goal. The Fund has contributed to building the VC market and to its growth. It supported it during challenging times, including during the COVID recession. On that, there are good news coming from latest data. They indicate that the market quickly bounced back from the measurable harm of the first wave of lockdowns and does not show signs of "long COVID". The European VC market showed a new level of resilience, unseen during previous crises, with VC fund managers optimistic regarding their current state of business and the long-term perspectives of the VC market in Europe.

These are positive news but there is still work ahead. Some of the traditional features of European financial markets persist and there is still a significant and growing activity gap versus other regions of the World, in particular the US. One data is particularly meaningful: in 2020 VC fundraising in the US was 4.5 times the value in Europe.

Among the issues to be tackled is also ensuring the conditions for growth of startups. We still have an underdeveloped IPO market, the overall VC market is still too small, funds generally have limited sizes and there are too few large funds.

It is time Europe develops a capital market that helps and nurtures these ideas, supporting people from the start or their activities and throughout their entrepreneurial trip.

This latter aspect is especially worrying. The gap for large fund sizes between US and Europe is still striking. This is a difference with strong repercussions. Larger funds mean possibilities to invest bigger tickets (which are necessary in scale up financing) and also to achieve portfolio diversification. The consequences are known: for large financing rounds in Europe, non-European investors are filling the void. In turn, European entrepreneurs supported by foreign VC investors have a higher chance to experience a foreign exit or be acquired by a non-European buyer.

The stakes are high: risk of foreign relocation of European firms, brain drain, loss of tech leadership and negative sovereignty implications. We are, in sum, at the core of European Economic Strategic autonomy, at the core of creating a stronger Industrial Europe for future years.

What needs to be done to counteract this situation is also clear. It is, on one side, to continue working and strengthening the Capital Markets Union and, in parallel, to have a clear engagement by large institutional investors and public support for late-stage VC funds.

This is where the EIF is acting – fully aligned with the indication of European Industrial Policy; this is the bulk of the Scale up Initiative.

As a matter of fact Europe needs a Large Fund of Funds specialising in the later stage of equity financing: to help the constitution of European specialised fund in this segment, to bring institutional investors in this area; to create the conditions for NPI focusing in this direction.

It is a great European effort we have to spur. But is clearly in the right direction. Europe is at the forefront of research, our human capital is considered first class in Universities and research centres all over the world, our creatives are shaping tastes and visions in the global markets.

It is time Europe develops a capital market that helps and nurtures these ideas, supporting people from the start or their activities and throughout their entrepreneurial trip. This is one of the priorities of the European Commission and the aim of the Capital Markets Action Plan of 2020 which is speeding up its implementation.

Scale up is fully in that line. It is about ensuring that European ideas have the possibility of becoming big here. It is a technical concept, but with a political ambition clearly stated in the European Industrial Strategy.

The EIF, as the financial institution of the Union specialised in the financing of SME is and will be in the forefront in this challenge.

BEATRIZ ALONSO-MAJAGRANZAS
Head of Exchange - SIX

Exchanges promoting the capability for growing and consolidation of SMEs

It is well known that Small and Medium Enterprises are the backbone in supporting the economic tissue in Europe. In fact, this reality has only been reinforced during this long-lasting pandemic and the measures aimed at supporting SMEs in all financial sectors.

Moreover, SMEs cater for many needs of the financial sector, such as innovation, compliance with ESG and best practices, along with visibility for diversity and sustainability of business models. Nevertheless, SMEs still face multiple challenges, especially related to financing and visibility in the broader financial panorama, that constrain their potential and their capability for growing and establishing themselves as solid market participants.

There is a need for reviewing the regulatory and economic conditions that surround SMEs in order to provide them with additional legal certainty and proper ability to reach consistent sources of funding. Regulation must not create such a burden that it deters SMEs from entering the next stage of funding at regulated markets. In this sense, it is paramount that policy makers make a conscious assessment that brings balance between the inherent risks of financing of small and medium companies and the potential benefit they can create for the whole ecosystem.

This assessment inevitably goes through the revision of the proportionality of requirements, and the review of MiFID II and the current discussions about its content pose the most favorable moment to do so. Aspects such as the access of retail investors to SME assets, enough coverage of small and medium sized companies, and a consistent and homogenous concept of what is considered an SME are elements that stakeholders consider critical to support SME growth.

The targets included in the CMU Action Plan constitute another relevant contribution: in particular, the support to the access to public markets or to the vehicles for long-term investment. Also, there is the aim of building retail investors' trust in capital markets and enhancing cross-border investment in these kinds of companies.

The review of MiFID II is an opportunity to make our financial system more dynamic and inclusive, taking one decisive step forward in the completion of the CMU. The MiFID II Quick Fix has been a good movement in the right direction.

Exchanges and regulated markets have the expertise and tools to maximize the potential of SMEs.

The fostering of research services for SMEs will contribute to increasing the visibility and accessibility to SMEs to promote their portfolios.

The review of the Rrospectus Regulation and Market Abuse Regulation in the framework of the Listing Act is a welcomed initiative too. It is crucial to ease the requirements for SMEs to be listed and to carry on secondary issuances. Harmonizing the criteria that National Competent Authorities apply to register a prospectus for SMEs through a common guideline will also be very helpful. Finally, the adaptation of arket abuse rules to the capacities and structures of SMEs will be also of the utmost importance.

Other developments, even if they are not exclusively under the EC competence, are relevant. Tax incentives are effective, for example, for the involvement of retail investors. A carefully dimensioned tax regime, paired with tax incentives, needs to be implemented throughout the EU to level the playing field for SMEs vis-à-vis the rest of companies. Furthermore, the range of vehicles for investment currently available and well established (such as venture capital or ELTIFs) needs to be further assessed to make the most effective usage.

European companies in general need to pick up momentum in order to increase competitiveness vis-à- vis the rest of the world, and SMEs are no exception; this will also result in the building of a more sustainable EU in the long term and constitutes a step forward towards achieving the Capital Markets Union.

Exchanges and regulated markets play an important role in this environment, as they count on the expertise and the solidity to put tools at the disposal of SMEs to maximize their potential. SME Growth Markets create a relevant space for companies, putting the focus on their local imprint, allowing them to grow in a convenient ecosystem and accompanying them in their evolution. They provide visibility, transparency, and quality in terms of corporate governance under a regulated environment. In an earlier stage, initiatives from growth markets such as consultancy and fundraising prior to listing, legal and compliance guidance, and gap-bridging between companies and potential investors have the capacity to draw companies to the financial market.

RIMANTAS ŠADŽIUS
Member - European Court of Auditors (ECA)

Equity financing through better integrated capital markets – EU auditors' view

As the Union's independent external auditor, the European Court of Auditors (ECA) not only assesses the implementation of the EU budget, but also the performance of EU institutions and bodies in reaching their objectives. Among others, we evaluate actions of the European Commission, the European Supervisory Authorities, the European Central Bank as banking supervisor and the Single Resolution Board. Recent reports scrutinized the Commission's work on the Capital Markets Union (CMU) project and on the development of a Single Market for investment funds.

Equity is key for businesses as it enables risk taking, innovation and growth. The level of equity financing determines the resilience of businesses during economic downturns and crises and therefore of the economy as a whole. The EU enhanced the stability of bank financing through big steps in building the Banking Union. In contrast, the progress in integrating capital markets has been limited to date and the Commission's measures had little catalytic effect so far. However, integrated capital markets are crucial in providing more equity financing to EU businesses. Otherwise, in the absence of strong capital markets, extensive public support will be required during rainy days, resulting in excessive deficits.

In our assessment of the first CMU action plan, we observed that capital markets in the EU remain highly heterogeneous. They vary significantly in size, maturity, average financial literacy of SMEs and businesses and even financial products available. This hampers equity financing for SMEs in certain Member States and regions of the EU. Therefore, it is essential to push forward less developed capital markets in parallel to their EU-wide integration into one Single Capital Market. We recommend that the Commission should help Member States to achieve this through its technical assistance programs. This is especially relevant for smaller markets, which alone do not benefit from economies of scale and therefore lack investors' interest.

Investment funds also play an important role in equity financing for businesses, as they offer investors diversified and professionally managed portfolios paired with a higher level of investor protection. In our report, we conclude that while cross-border business was enabled through the passporting regime, the number of true cross-border funds remains limited.

Essential to push forward less developed capital markets in parallel to their EU-wide integration.

While UCITS was a great success in the EU and abroad, it did not yet result in the desired effects, such as real market integration and reduced costs for investors. As a result, smaller Member States with less developed capital markets are disadvantaged. We also conclude that this can change neither within the current framework nor through limited revisions of individual pieces of legislation.

The second CMU action plan foresees a number of helpful legislative and non-legislative measures. However, we found repeatedly that the use of Directives rather than Regulations in the area of financial services is inefficient, as their implementation is usually very slow, results in significant additional administrative burden on all levels and creates obstacles to supervisory convergence and effective enforcement. For instance, the complete transposition of the AIFMD Regulation in all Member States took eight years.

Non-legislative measures could be very valuable, in particular when they increase transparency of capital markets. One example is the European Single Access Point for information on listed companies, though it is not yet reality. Furthermore, we recommend a tool for the comparison of investment funds, allowing investors to understand key differences.

We also found that the European Securities and Markets Authority (ESMA) does play an important role in the integration of markets through its supervisory convergence work, but still faces significant challenges. The supervision of investment funds remains dominated by national interests and continues to differ within the EU. As a result, enforcement actions are rather rare. Only through introducing a more European perspective in the supervision of capital markets, deeper integration can become a reality. The establishment of EU banking supervision has already proven this.

The participation of retail investors in capital markets could foster equity financing of businesses in the EU, while offering them higher returns for their savings. However, obstacles exist. For example, inducements disadvantage investors significantly, as they create inherent conflicts of interest and high costs. They account for about half of the total costs charged to investment funds holders. Nevertheless, they are still the standard in most Member States. Thus, we recommend that the Commission propose stricter rules on inducements.

The ECA will continue to report on the EU's progress towards an efficient and resilient Single Market for financial services. We have recently started an audit to assess how EU banking supervision deals with the management of non-performing loans.