

# Improving SME equity financing

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## 1. Overview of the financing of SMEs in Europe

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The Chair introduced the discussion by emphasizing that the issue of small and medium-sized enterprise (SME) equity financing is a longstanding one. The new needs around the digital and green transitions will require more equity financing and at the same time, the Covid crisis has added more debt to SME balance sheets, which will necessitate a rebalancing of financing sources. The growth of retail participation in public equity markets observed since March 2020 is a trend that may be leveraged in this perspective. These objectives are at the heart of the new Capital Markets Union (CMU) action plan published in November 2021.

An official explained that SMEs are the most numerous and fragile enterprises in the EU economy. They represent two-thirds of gross domestic product (GDP) and in some countries almost 99% of enterprises are SMEs. Prior to the Covid crisis, SMEs were already quite indebted. The additional financing provided during the crisis to support SMEs was mostly in the form of debt, leading to higher SME indebtedness. The result was a 5 to 10 percentage point increase in indebtedness as a proportion of GDP and in terms of the debt to equity ratio. These figures are now reverting to their pre crisis levels, but there is still a substantial need to further diversify the financing of SMEs in the EU, notably with more equity investment.

Thanks to the interventions of central banks and public institutions, the European economy was kept afloat during the Covid crisis and is expected to return to a pre crisis level in 2022, the official added. While this evolution is positive, macro reports produced last year for example by the International Monetary Fund (IMF) and the European Capital Markets Institute (ECMI), estimate that Europe has an equity deficit of €600 billion, which is significant compared to other jurisdictions, notably the US. This gap is particularly acute for certain segments of enterprises such as start ups. The number of start ups in Europe has increased over recent years, but still lags behind the US. As a percentage of GDP, there is 10 times less investment in venture capital in Europe than in the US. Improving the financing of European scale-ups is also essential, because many of these companies end up being financed by US and Asian investment funds as a first step to listing on the NASDAQ or other non-EU exchanges. In Europe today, up to 75% of these fast growing companies are refinanced at a later stage by US

or Asian funds. An industry speaker confirmed that at present many innovative SMEs in Europe turn to other countries to be listed, because there are less obstacles and more liquidity available.

A policy-maker noted that the European economy has emerged from the crisis with more debt on the private and public sides and agreed that it is important to ensure that enterprises access new sources of finance in order to finance their development.

A second official emphasised the heterogeneity of the EU capital markets landscape. In Western Europe, there are countries with large and buoyant capital markets such as France, Germany or Luxembourg, but in Central Eastern Europe (CEE) bank financing remains prevalent and capital markets are under-developed. There are similar contrasts between the North and South of Europe. In this regard, it is worth considering concrete examples from the Baltic countries. All three Baltic countries have a stock exchange and an increasing capital market turnover, but the market capitalisation in these countries remains low, ranging between 3 and 10% of GDP<sup>1</sup> compared to 120% in Finland and even more in Sweden. Retail participation, crowd funding and investment funds are growing, but figures are limited compared to the EU countries with highly developed capital markets<sup>2</sup>. There are also very few initial public offerings (IPOs) happening in these countries. Many of the IPOs concern enterprises that were previously state-owned and these IPOs generally happen in the local market.

The official also stressed the importance of enhancing SME financing in the CEE region. Lithuania's economy for example is composed mainly of SMEs with 90% of enterprises having fewer than 10 employees. According to a survey carried out by the Bank of Lithuania, bank loans are the third most popular source of SME financing after internal savings of the owners and their relatives and state aid, which is mainly European assistance provided notably by the Cohesion Fund.

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## 2. Obstacles to the further development of SME equity financing in the EU

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### 2.1. Demand-side issues

An industry speaker observed that retail clients are interested in buying SME shares, but there are some

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1. Lithuania's market capitalisation is 9% of GDP and Estonia's is 10% of GDP, but Latvia's is only 3% of GDP. The annual turnover in the Lithuanian stock market was between €70 million and €90 million, but it has now increased to €100 million. The overwhelming majority of this is shares; bonds are non-existent.

2. In terms of retail participation, only 16,000 of Lithuania's population of 3 million participate in the stock market. 40,000 mainly younger people participate in crowdfunding, which is an important channel for SME financing. Crowdfunding has grown by €53 million to €650 million. While the investment fund market in Lithuania is substantial, Lithuania only has 14 domestic UCITS funds out of 64,000 in Europe, according to data from the European Court of Auditors (ECA). There are also 100 Alternative Investment Funds (AIF) in Lithuania, but 64 of these are purely real estate. Financial market instruments are almost non-existent.

practical obstacles that need to be considered. First, there is a lack of research on SMEs, which is being addressed by the MiFID II Quick Fix with amendments proposed to the current research and execution cost unbundling rules with respect to small and mid-cap issuers. Secondly, transaction costs in the EU are too high due to market fragmentation, particularly in the post-trading space, which increases the costs of intra-EU cross-border transactions. Fiscal fragmentation is another key issue here. As a result, French investors for example mainly purchase shares on their domestic market and if they purchase foreign shares, they tend to invest in US stocks rather than EU ones. Purchasing SME stocks also tends to be more expensive than blue chip ones, even on a domestic basis, due to the cost of clearing and settlement. The limited liquidity of SME markets is a third challenge, which has a particular impact when markets are volatile. If investors who need the money are trapped with SME shares, they may not re enter the market in the future.

These different issues show that SME markets remain fragile, the industry speaker stressed. Investors must be able to have trust in SME markets, otherwise they will purchase blue chip stocks or investment products such as exchange traded funds (ETFs), which are not appropriate for financing SMEs. More generally, there is a challenge around building investor trust and developing their level of autonomy. Digitalisation can help and some e brokers are making considerable efforts to train clients interested in trading on equity markets, but these investors often want to meet an advisor in person before initiating transactions. Additionally, the implementation of environmental, social and governance (ESG) standards by SMEs could create a real appetite for these shares. However, with the standards proposed, companies are considered to be either green or brown, which does not encourage investment. Savers want to see progress and invest in companies transitioning to higher ESG standards or contributing to the transition.

Another industry representative highlighted the challenges around financial literacy and investor incentives. It is encouraging to see that more young people are investing in stock markets, but there are major differences in the financial culture across European countries and across generations. The CMU action plan has proposed some actions to improve the engagement of retail investors such as the Retail Investment Strategy, but investors will not buy equity products if they do not consider them to be profitable. This is where tax becomes relevant. Tax incentives should be developed to encourage people to invest in equities. The Chair agreed that tax incentives could have an important effect on retail investment behaviours, although this is an area mostly outside the remit of European institutions.

An official emphasized the challenges that exist in the cultural landscapes of many CEE countries, where there is a heritage of reliance on state paid pensions. Previously, people did not have investments; they had a salary or a pension and just a few savings. Therefore, the older generation does not trust shares and considers bank deposits and liquid savings to be more reliable. CEE citizens need to be educated about investment, business initiative and entrepreneurship. There are often heated

debates in domestic parliaments of the CEE region about the need to protect citizens from the risks of financial investment. There is also a generational split: the younger generation is tech savvy and ready to invest in crowd funding and foreign stock markets, but they do not have the money to invest.

## 2.2. Supply side issues

An industry representative described several key issues that SMEs are facing when seeking to raise equity funding on the public markets and which make European markets less attractive and less advanced than those in the US or Asia. First, are the costs of going public and maintaining a listing, mainly due to disproportionate regulatory requirements, which lead many SMEs to seek other financing options, such as private equity. Investor protection is often put forward as the underlying reason for these requirements. While this is an essential aspect, a better balance should be found between the objectives of risk mitigation and economic growth with more proportionate listing requirements, allowing these companies, which are fundamental for the EU economy, to obtain the financing that is needed for their scaling up. This will in turn support the growth of the EU economy and provide investors with higher returns. Secondly, the lack of research on EU SMEs, which the MiFID II Quick Fix is attempting to solve, also has implications for SME issuers in terms of visibility in the market, access to funding and liquidity. Private initiatives have been set up in certain countries to alleviate this issue. For example in Spain, the stock exchange and the Spanish Institute of Financial Analysts (IEAF) have launched an initiative, which aims to increase the research coverage by providing free information on listed Spanish stocks. Thirdly, there is a need for a consistent definition of SMEs across the EU, which varies at present across regulations and member states. A homogenous definition would enable initiatives to be implemented more consistently with a stronger impact at EU level. Fourthly, many innovative companies do not have a regular cashflow, which means they have limited access to bank funding and due to their limited size they do not have sufficient visibility in the markets. Specific measures are also needed for these companies.

A regulator emphasised that tax also plays an important role on the supply side. The fiscal bias towards debt has huge consequences for the decisions made by SMEs about their financing structure.

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## 3. Policy initiatives to support SME financing in the EU

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### 3.1. Actions related to the Capital Markets Union (CMU) initiative

A policy-maker described the actions being taken by the European Commission to support and diversify the financing of SMEs and to develop investor demand in the context of the CMU. Progress is being made and now actions need to be implemented on the ground. The latest CMU action plan published in 2020 proposed actions in three main areas: supporting the twin green

and digital transitions and a resilient economic recovery; making the EU an even safer place to invest; and integrating national capital markets into a genuine capital market. This action plan includes measures aiming to remove some of the obstacles to the supply of financing for SMEs. For example, there is a proposal to redirect SMEs that have not obtained financing from banks to alternative providers of funding. There is also a proposal to implement a dedicated platform at EU level, the European Single Access Point (ESAP) to facilitate the access to financial and non-financial information on EU enterprises, including SMEs. A Listing Act review aiming to simplify rules for companies, particularly SMEs, wanting to raise funds on public markets is also due to be published in the coming months.

On the demand side of capital markets, the European Commission is also seeking to empower citizens through initiatives to improve financial literacy, the policy-maker added. The objective is to make them more aware of the risks and opportunities of investing and to help them to make their own investment decisions, rather than relying solely on investor protection rules which may hinder investment. The European Commission is working with the OECD on actions to improve financial literacy in a number of Member States. In Italy, for example, with the Financial Education Committee, a Netflix-type series has been created on investment in an attempt to reach a wide audience. Actions are also conducted in France and Portugal to make younger retail investors more aware of the benefits over time of regularly investing small sums of money. Banks across the EU are also doing a substantial amount of work on youth education regarding financial matters.

An industry representative stated that the CMU action plan is a very welcome initiative. The four legislative proposals published in November 2021 should indeed contribute to developing SME financing<sup>3</sup>. The ELTIF review is a step in the right direction, but the framework should not be limited to companies involved in the green and digital transitions and should also include scale-ups, which have important investment needs. The ESAP initiative could also increase the visibility of SMEs and should be linked to actions to increase the research available on these companies.

Some of the other actions in the CMU action plan should help develop equity investment in EU SMEs, the industry speaker believed. The Listing Act review proposed by the European Commission is an opportunity to improve the conditions under which SMEs can list their shares on public markets. This is happening alongside national initiatives. This review should address the direct cost of listing, help to simplify prospectuses and also make it easier for companies to move from growth markets to regulated ones. The simplified recovery prospectus<sup>4</sup>

facilitating secondary issuance was an adequate initiative in this perspective, although it has not been widely used. More generally, there should be more proportionality in the rules applying to SMEs (e.g. around sanctions and governance) and a harmonization of definitions across EU regulations (e.g. concerning the definition of SMEs and semi-professional clients). There are also some important issues to fine tune on the investor side. The actions to improve financial literacy and the information available to investors are highly relevant, because they will contribute to building investor trust. The dual voting structure is an interesting idea for encouraging more long term investment. Lastly, suitability tests for retail clients should be entirely reviewed and should be harmonised between the different regulations concerning retail investors or savers.

### 3.2. Regional initiatives

An official suggested that the heterogeneity of capital markets in the EU means it is necessary to develop smaller capital markets in parallel with their integration into a single EU capital market. The European Commission should help Member States achieve this through its Technical Support Instrument<sup>5</sup>, in particular in smaller markets which do not benefit from economies of scale and lack investor interest. There could be several benefits to including a regional approach in the building of the CMU. The three Baltic countries provide a relevant example of this. Specific legislation on covered bonds and securitisation has been drafted in the three Baltic States with the support of the European Commission and the European Bank for Reconstruction and Development (EBRD). There have also been initiatives to harmonise corporate law in some Baltic and Nordic countries which have similar legal systems. Another idea that has been suggested is the indexation of the Baltic countries into a single region in the MSCI index, which would create a larger market and increase their attractiveness for foreign investors. There could also be a benefit in consolidations of market infrastructures at the regional level, such as merging the Baltic stock markets. A further initiative could be an enforcement of European structural reforms through country specific recommendations. The intention of these proposals is not to create additional barriers between this region and the rest of the Europe, but to support the development of capital markets in Europe by creating stronger and more effective regional building blocks, the official explained. This approach was suggested in the recent report of the European Court of Auditors (ECA) on the CMU<sup>6</sup>.

A policy-maker agreed that the work conducted jointly by the European Commission and the EBRD was very

3. In November 2021, the European Commission put forward four legislative proposals for implementing the September 2020 CMU action plan: (i) set up a European Single Access Point to provide financial and sustainability related information on EU companies and financial products in a digitally useable format; (ii) improve the ELTIF (European Long-Term Investment Fund Regulation) framework in order to make ELTIFs more attractive for investors and easier for asset managers to operate and market; (iii) enhance the Alternative Investment Fund Managers Directive (AIFMD) to better integrate the EU AIF market, improve investor protection and better monitor the risks to financial stability posed by AIFs; (iv) review the Markets in Financial Instruments Regulation (MiFIR) in order to tackle the transparency and level playing field issues posed by current rules and enhance the international competitiveness of EU capital markets.

4. The recovery prospectus is a temporary regime that simplifies the procedure for raising capital for issuers during the COVID 19 pandemic. This prospectus focuses on essential information and is only available for the secondary issuances of shares.

5. Regulation (EU) 2021/240 of the European Parliament and of the Council of 10 February 2021 establishing a Technical Support Instrument, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0240&qid=1650611651118&from=en>.

6. Capital Markets Union – Slow start towards an ambitious goal ECA report November 2020.

relevant and has helped to create a regional market for certain financial instruments. While there should be an endogenous will within member states to reform their markets and ask for assistance from the European authorities, the European institutions should also be able to propose reforms to member states.

### **3.3. The potential role of digitalisation**

A policy-maker emphasized that digitalisation should also help to drive further investment in SMEs. Banks need to further digitalise their processes and regulators also need to adapt regulation and supervision to the increasing use of technology through the use of tools such as regulatory sandboxes. To this end, an EU Supervisory Digital Finance Academy is currently being launched with the participation of 26 European supervisors. However, digitalisation will also require an improvement of financial literacy, which is essential for customers to make the most of digitalisation.

An industry speaker confirmed that retail investors are increasingly interested in the opportunities offered by digitalisation such as tokenised assets. Digitalisation can also contribute to reducing post trading costs, which will benefit cost sensitive clients and issuers. Ultimately, this could create more liquidity for SME stocks. Digitalisation should also facilitate cross-border investment and enable market making on a cross border level.

### **3.4. The role of public support and investment programmes**

An official agreed that the actions proposed in the context of the CMU action plan are going in the right direction. Improving regulation will benefit scale ups and growth markets and contribute to attracting more private sector money into equity investment. However, these market gaps can also be addressed through other kinds of public action. Public investment programmes can bring more liquidity to certain markets and also attract more private investors, thus creating more financing and more support for European companies. Public programmes can also facilitate the provision of additional data, which can make the market more transparent, more liquid and attract private sector money. The Scale-Up Europe initiative<sup>7</sup> conducted under the aegis of French Presidency of the EU is an example of a programme supported by the public authorities aiming at making proposals for increasing investment in start-ups and fast-growing companies.

SMEs were also at the core of the response of the European institutions to the Covid crisis, the official noted. Massive support was provided to the economy by the European Union in coordination with member states. Equity, particularly for SMEs and start-ups, was a key component of this. The volume deployed in the context of these programmes was three times the volume that has been deployed in recent years.

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7. Launched by President Macron in March 2021, with the support of the European Commission and other Member States, the Scale-Up Europe initiative brings together a cohort of over 300 start-up and scale-up founders, investors, researchers and corporations, all sharing the same bold objective: for the continent to become home to 10 tech giants each valued at more than €100bn by 2030. <https://presidence-francaise.consilium.europa.eu/en/news/press-release-scale-up-europe-spurs-collective-action-to-accelerate-european-tech/>.