SME EQUITY FUNDING: LISTING ACT AND ESAP PROPOSALS

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Enabling SMEs to increase their equity financing

For a company, equity financing means raising money by selling shares in their business. Small and medium-sized enterprises (SMEs) become more resilient to external shocks such as changes in demand or in interest rates, or to contractions in bank credit linked to banking crises if they increase the share of equity financing in their overall funding. Also, especially for innovative SMEs, obtaining debt financing is harder, as they tend to have more intangible assets, which are difficult to use as collateral. From a macroeconomic perspective, private risk sharing, which works especially well with cross-border equity claims[1], helps dampen the effect of asymmetric shocks.

However, to date most SMEs fund themselves primarily from internal sources, while bank credit is their primary source of external funding.[2] Only 11% of SMEs indicate that equity funding was relevant to them.[3] And despite the creation of SME growth markets and a record number of SME IPOs in 2021, EU equity markets are still underused. Barriers often have to do with information asymmetries and comparatively higher costs for investors to serve SMEs. But company owners may also refrain from accessing external equity for fear of losing control over their business.

To address these issues, and to create incentives for a wider use of equity investment and for more diversified funding more generally, the Commission is taking important steps to ensure that SMEs can access the type and amount of funding that best correspond to their needs so that they can concentrate on their core business. This is especially important for companies that want to scale up.

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Public funds are also needed to leverage private investment. The Invest EU Programme aims at mobilising over EUR 372 billion of financing, with a product mix that responds to the current needs including through dedicated products in venture capital in early to growth stage companies. But ultimately, in view of the size of the investments needed, the private sector will be called to provide the bulk of the money. Deepening the Capital Markets Union (CMU) is therefore essential to unlock such private investments. A number of recent CMU initiatives are particularly relevant in this context.

The European Single Access Point (ESAP) will be a one-stop shop for investors who are ready to invest across borders. By making it easier for them to find information, it will give companies more visibility, opening up more sources of financing. This is particularly important for SMEs, as they will more easily be on the radar screen of EU, but also international investors.

Furthermore, the Commission is addressing the tax bias that disadvantages equity financing. At present, the cost of equity is relatively higher than the cost of debt because the interest that companies pay on debt is tax deductible, whereas their costs on equity are not. That is why the Commission proposed up an EU-wide Debt-Equity Bias Reduction Allowance (DEBRA).

The Listing Act aims to make it easier and cheaper for companies, in particular smaller ones, to access public markets. It will simplify and ease both initial and ongoing listing requirements to reduce costs and increase legal certainty for issuers. It will streamline the listing process and make requirements on companies deciding to get listed more proportionate to their size. To allow certain founders of smaller companies and their families to retain control while raising funding on public markets, the Listing Act proposed a minimum harmonisation of national legal regimes relating to dual class share structures across the EU.

Although facilitating the access to market-based sources of equity funding is a priority, it is clear that banks and insurance companies must also play a bigger role. This is why, in the area of prudential regulation, we need to ensure that the rules do not unduly hamper equity investments by banks and insurance companies. The treatment of equity exposures was an important consideration in the review of Solvency II and in the Banking Package.

1. *A Capital Market Union for Europe, IMF*
2. *OECD SME and Entrepreneurship Outlook 2021, OECD*
3. *Survey on Access to Finance of Enterprises, results 2022*

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The access of small and medium-sized enterprises to equity funding

Financial market infrastructure is essential to unlock the investments necessary for the green and digital transitions, to recapitalise the EU economy, increase resilience and gain in strategic autonomy. The Capital Markets Union Action Plan and ensuing legislative initiatives, such as most recently the Listing Act and the European Single Access Point (ESAP), are important steps in the right direction.

EU companies rely heavily on debt, and more diversified funding involving more equity would help them improve their financial situation and support investment. Furthermore, a more diversified funding strategy, involving both publicly traded debt instruments and equity, works as a stabiliser and a buffer against shocks. This is of special importance in times of corporate financial distress, economic uncertainty and when the cost of debt financing increases.

Unfortunately, the EU is not taking full advantage of its potential on equity funding. The number of listed companies in EU growth markets has barely increased since 2014, and SMEs, in particular, are still relying mainly on bank financing. To attract SMEs into equity funding, we need a well-functioning IPO market with a proper pre-IPO environment, along with equity research and an appropriate place in the portfolios of investors.

Bundling SME research with other services would increase the supply and distribution of reports. For that reason, the European Economic and Social Committee (EESC) welcomes the proposal to increase the unbundling threshold to EUR 10 billion. Independent research should also be encouraged, for which best practices in Europe should be observed.

To further ease access for family-owned companies to capital markets, we need EU-wide acceptance of a multiple-voting rights regime, as exists in most major global jurisdictions. The introduction of dual-class shares will help families to retain control after an IPO, making listing more attractive to them. The EESC agrees with the Commission that a detailed framework design should be produced at national level, while encouraging high-level EU harmonisation. However, the minimum 10% free float requirement should be flexible, as smaller markets can operate with a lower free float. This is essential to prevent abrupt de-listings.

Information and data, visibility of SMEs and financial education are key drivers of equity markets.

In the EU, the share of deposits in the total assets of households is three times that of the USA. It is the EESC's view that retail investors should have more choices to build their portfolios, and asset managers should be more confident on the prospects of the European equity markets. Beyond that, it is necessary to increase the financial literacy of EU citizens, and to create a stock ownership culture to ensure that everyone can benefit from new opportunities in capital markets. Without a doubt, this should be accompanied by a high level of investor protection and avoid any increase in the administrative burden on EU companies, while ensuring the availability of information and data for citizens and companies.

Transparency and disclosure are essential for investor protection and to create trust. However, excessive information in offer documents is not the preferred way forward. Streamlining the prospectus will significantly reduce costs and burden for issuers. Proportionality is key. The Commission proposal would allow all documents to be published in English only, except for the summary, which should also be provided in the local language. However, these documents should be accessible and reader-friendly for people at local level, so the possibility of issuing English-only documents could hinder the development of a national retail investment base. Other full-scale documents should be available in the local language, and specific incentivising measures in this regard should be implemented.

On ESAP, the Committee advocates for a more ambitious approach, by developing a tool that can process information and data and deliver sectoral and territorial reports. Interoperability with Eurostat or national registers should be guaranteed, and synergies between the Sustainable Development Goals and the Green Deal indicators should be ensured. Regarding consolidated tapes for financial assets, their success will rely on the ability to provide stakeholders with almost real-time data from EU trading venues. For both initiatives, it is fundamental to ensure the broadest access possible. To do so, consideration should be given to subsidising the cost for SMEs of gathering and submitting information, and the access to consolidated tapes should be free for all, and especially for SMEs and retail investors.

The Listing Act and the ESAP are remarkable steps forward in improving the access of SMEs to equity. However, to harness the full potential of equity markets, further measures are needed. The availability of information and data, the visibility of SMEs to investors, maintaining a high level of investor protection and increasing financial knowledge among EU citizens are all key elements.

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CMU as the new Green Deal – Avoiding the trap of vaguely formulated goals

The paramount challenge for capital markets in the EU is that the key measures for their successful development are not focused on primary regulation of financial markets, but rather on areas with wider, more horizontal impact on the functioning of commercial enterprises/businesses. It is striking that 30 years after the establishment of the single market, there are still obstacles to the free flow of capital and unique benefits offered by the EU as the largest market in the world, such as economies of scale, are not used to the full extent.

Where to focus

From investors' perspective, it is crucial to ensure legally stable environment across the EU, free of unnecessary administrative obstacles for investment operations. This concerns areas such as insolvency, restructuring, commercial law and enforcement of law in general. The Commission's initiative in insolvency framework harmonisation is just a first step in a long journey. Further efforts are needed in the field of digital solutions connecting IT systems and providing equal access to investors across the EU. The lack of trust between Member States and towards EU bodies also needs to be addressed. Here, a better organisation of EU supervision is worth thinking about with the system applied to credit rating agencies serving as potential inspiration.

Last but not least, we need to overcome the tendency of Member States to increase attractiveness of their own investment environment at the expense of the EU as a whole. Only then we will be able to build a genuine Capital Markets Union.

Politically, different perceptions of urgency to overcome these challenges are the main obstacle. Both from the perspective of the financial market needs, as well as broader economic interests of individual Member States. What is becoming more and more evident, however, is that fulfilling our ambitious green and digital agenda will be impossible without broad mobilisation of private capital. This in turn will not be possible without effective allocation of capital through fully functioning capital markets across the EU. Here, we have a unique opportunity to address the needs of the Capital Markets Union with broader political ambitions of the EU.

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Not taking advantage of this opportunity will be costly, as the EU might miss a train that will be impossible to catch later on in the context of increasing vulnerability and de-globalisation.

Green Deal as an inspiration

As alluded to already, current Commission's initiatives, such as European Single Access Point (ESAP), Debt-equity bias reduction allowance (DEBRA) and Listing Package, are going in the right direction, although in case of DEBRA specifically, challenges mentioned above are clearly materialising. Importantly, more fundamental changes outside the framework of financial services will be necessary, which will require significant political capital. In order to do this, clear quantification of objectives through performance indicators, such as KPI, are needed to better connect our policy goals with concrete measures. Otherwise, we will once again become victims of our own processes and the capital allocation across the EU will fail to improve. What's more, the EU will continue to lose out on valuable developing companies and start-ups, that will relocate to more attractive destinations. The cost of inaction in this scenario will be enormous.

The project of CMU therefore requires cross-sectoral support and a measurable path for its achievement. Luckily, the inspiration is right in front of us in green transition embodied in the European Green deal – an ambitious cross-sector initiative with clearly defined, measurable and comprehensive objectives.