How capital market finance can boost European businesses

By Kalin Anev Janse, Rolf Strauch

8 March 2024

The need for an integrated European capital market has been a focal point of the work carried forward by the Eurogroup. This work is expected to culminate in a statement indicating a path ahead for coming years. The programme of the European Commission on capital markets union (CMU) has had limited results so far and markets remain fragmented. In previous blog posts, the need for better market functioning and more integration has been highlighted. This time, we expand on the finance of small- and-medium-sized enterprises (SMEs). Improving access to capital markets for SMEs and start-up businesses will be essential to address the competitiveness challenges Europe faces.

SMEs essential to European economy, but tricky to finance

SMEs account for 99% of all businesses in the European Union (EU), employ around 100 million people, and are an essential source of entrepreneurship and innovation, making them central to Europe's economic development model.[1] Accordingly, Europe needs them strong to achieve its transition to a sustainable economy and harness the full potential of new technologies, such as artificial intelligence, while preserving its economic sovereignty in relation to other competing nations.

SMEs, particularly start-ups within the EU, are largely dependent on bank lending, whose declining accessibility in recent years has contributed to a widened financing gap. According to a European Central Bank survey, SMEs in the euro area have been facing greater financing obstacles than large firms, with 14% reporting financing constraints compared to 7% for large firms, the highest share since 2016.[2] While bank financing remains accessible for traditional SMEs, it is not sufficient nor well adapted to start-ups. At the same time, market financing for start-ups, in particular risk capital – often the stage prior to a public offering of shares – has failed to grow and provide an effective relay. Europe has no shortage of innovative and promising start-ups, but it lacks the funding tools needed to help them scale up. European businesses need an effective funnel of business angels, venture capitalists and private equity firms to lead them to capital market financing. The loss of London as the venture capital hub within the EU has

only exacerbated difficulties. A lot of venture capital and private equity funds are still based in London and run the venture hubs from there.

Some efforts have been made to improve the situation. On the CMU agenda, the European Commission has already set prioritising improved access to capital markets for SMEs, in particular start-ups, on the CMU agenda. Germany and France recently presented a roadmap for CMU, reaffirming capital markets' key role as an additional source of financing for start-ups.[3]

But more efforts are needed. Europe needs to bolster its risk capital sector to enable more SMEs, notably start-ups, to diversify their financing sources and support their growth. Simplifying the rules applicable to European long-term investment funds would be a step in this direction. In addition, making the rules and conditions under which SMEs and start-ups can go public more flexible and proportionate would foster a more favourable environment for these companies to grow. Europe should also improve the visibility of its companies by providing centralised and harmonised information to investors. Finally, greater harmonisation of insolvency regimes in the EU could stimulate cross-border investment and lending, thereby also enhancing the attractiveness of pan-European securitisations.

Financing too reliant on banks

Bank loans remain the predominant source of funding for firms in the EU. However, bank financing has proved less suitable for SMEs and start-ups and has been steadily declining since 2020 against a backdrop of rising rates, tighter SME lending criteria, and an uncertain economic outlook.[4] Banks have strict capital requirements that limit their risk appetite and force them towards a conservative loan pricing for SMEs, in particular for start-ups.

Market financing of SMEs in the EU is relatively underdeveloped compared with the United Kingdom (UK) and the United States (US). According to the Association for Financial Markets in Europe (AFME), the share of risk capital[5] has been between 2% and 5% of total SME financing since 2018, whereas in the UK it has almost always been over 10%, with peaks of 25% (see Figure 1). The amount of risk capital investments in the US has represented five to 7.5 times the amount in the EU over the last 10 years, following a general upward trend (see Figure 2). Furthermore, the risk capital sector is highly disparate and fragmented within the EU. The ratio of risk capital relative to total SME financing stands above 5% in 10 out of 27 EU countries, with two countries at

around 25% (Ireland and Netherlands) and eight between 5% and 15%. The 17 remaining EU countries show ratios below 5%.

Transitions from risk capital to initial public offering has also remained proportionally less frequent in the EU than in the UK or the US. According to AFME, the European market has remained significantly subdued in 2023, with volumes down 72% year-on-year and more than 10 times lower than in the US, while issued equity volumes in the EU, on aggregate, including firms already listed, has stayed comparable to last year. In the US and UK, the funnel of business angels, venture capital, private equity, and initial public offering works much better than in the EU. It is not uncommon for European start-ups to move to the US and UK to go public to increase their chances of success. Things must change if Europe is to accompany and nurture these companies and the innovation and financial resilience they bring.

Figure 1: Share of risk capital in total SMEs financing in the EU and the UK since 2018

(in %)

Source: AFME

Figure 2: Risk capital investments in the EU and the US since 2013

(in € billion)

Source: AFME

Improving SME access to capital markets needed

Strengthening the European risk capital industry would require the development of appropriate tools to ensure that more private investment goes into non-listed companies, particularly SMEs.

A well-functioning European long-term investment fund scheme could stimulate investors' appetite for SMEs not quoted on a stock market. Such funds, conceived as

long-term collective EU investment vehicles to channel investment notably into SMEs, have expanded slowly since their creation in 2015 and remain marginal. As of 2023, 80 were marketed for around €11 billion of assets under management.

European long-term investment funds should more explicitly target SMEs. It would also be useful to reduce the barriers to these funds for investors, notably by aligning the passporting rules across the EU, lowering the entry ticket, introducing more flexibility for repayments on investments, or adapting the product to insurance companies' business models. The efficient administration of taxation to cross-border investments and the study of incentives for long-term investments in Europe could also help. As of 10 January 2024, a new framework broadens asset eligibility and simplifies investment guidelines, marking a significant regulatory evolution for European long-term investment funds.

The EU has a comprehensive set of regulations for the listing of companies that ensure a high level of protection and transparency for investors looking to invest in European companies. However, they have proved too cumbersome and costly for SMEs, in particular start-ups tempted to go public.

Already at the end of 2022, the European Commission adopted strong measures to facilitate listing SMEs on EU capital markets. These included the creation of different voting regimes for stocks of innovative and high-growth companies to guarantee the control of the company by its founders, the lowering of the minimum free float requirement for listed companies to facilitate initial public offerings, the simplification of the prospectus applicable to quoted companies, and support for investment research in relation to SMEs through improved remuneration. The success of these adjustments needs to be measured over the coming years.

Additional measures would help. For example, the introduction of a pan-European stock market index for SMEs could greatly improve the visibility of listed SMEs and boost investor appetite. Applying a transition period for all newly listed companies, during which they would be exempt from certain elements of cumbersome regulations, could prove effective in reducing cost burdens for enterprises.

The introduction of a European single access point for information on European entities, scheduled for 2027, plans to offer a harmonised, transparent, and reliable source of financial information, including digital data, for listed and unlisted companies. This information hub aims to provide easy access to reporting data without imposing additional reporting requirements. The European Securities and Markets Authority, which

will lead the implementation, would do well to include SMEs to improve these companies' visibility.

Greater harmonisation of insolvency regimes in the EU could support bank lending to SMEs on a cross-border basis and increase the pool of SME loans available for banks' securitisation operations. The persistent heterogeneity of insolvency regimes in the EU has discouraged banks from engaging in cross-border lending and reduced investor appetite for securities backed by loans originated in other EU countries. The European Commission's proposal, in the case of a failing business, to allow time for a sale negotiation before any formal insolvency proceedings, would generalise a practice that has worked well in some jurisdictions. However, more could be done to provide the EU with common minimum standards in terms of the insolvency framework.

If we want to make CMU a reality and enhance Europe's economic development, we must boost the financing choices to harness the potential of these innovative powerhouses in Europe.

Acknowledgements

The authors would like to thank Olivier Pujal, Loukas Kaskarelis, Raquel Calero, George Matlock and Peter Lindmark for their valuable contributions.

Further reading

"Momentum builds for Europe's capital markets union."

Footnotes

[1] European Parliament: Fact Sheets on the European Union.

[2] European Central Bank, Survey on the Access to Finance for Enterprises (SAFE) – 29th round, November 2023.

[3] A French-German roadmap for the Capital Markets Union, September 2023.

[4] AFME, Capital Markets Union Key Performance Indicators – 6th Edition, November 2023.

[5] Risk capital encompasses venture capital, private equity, business angels, and equity crowdfunding, while total SME financing comprises risk capital plus bank lending.