

Increasing equity financing: trends and main priorities

1. Current trends in the EU equity market

The Chair noted that developing equity financing is essential for funding innovative and fast-growing companies and for strengthening the resilience of the European corporate sector. EU corporates and particularly SMEs, rely predominantly on debt for their external financing, resulting in a significant equity gap in Europe. Statistics from AFME show that IPOs (initial offers to the public of shares) have decreased by 50% and equity trading has also decreased over the last year.

An industry representative stated that there has been a rebound on global equity markets since the start of the year, with a 3 to 5% performance prolonging the growth of 2023. This is primarily US-driven, although European markets saw a 14% increase during 2023, with volatility below the long-term average of 21% at around 14%.

EU equity markets are however facing different issues. A first is in terms of an estimated \$60 billion equity outflow from Europe going into the US. The US market is well priced with the real earnings of companies well below consensus. In Europe it is the reverse and a better performance of companies can be expected than the market is anticipating. The valuation gap between EU and US companies is widening, with US companies trading above average at a 20 times price-to-earning (P/E) multiple and European companies trading below average at 13-13.5 times P/E, which means that EU companies are relatively cheap at present.

A second issue are the diminishing expectations of interest rate cuts, which might not be sufficient to ensure a soft landing of the economy. In the US, the market is pricing in a 70% chance of a first cut in June followed by four successive cuts totalling 100 basis points, whereas previously it was pricing in an 80% chance of a first cut in March and successive cuts totalling 150 basis points. The question is when demand for equity will pick up. 2022-23 was a very dry market in terms of equity issuances, which decreased by more than half compared to 2021 in Europe (around €100 billion compared to €269 billion in 2021). The decrease was even higher at the global level (\$500 billion compared to \$1.4 trillion of issuance in 2021). Investors have also been staying away from equities. They are now looking for growing companies that are also profitable, which is not the case for many IPO candidates.

The macroeconomic and geopolitical context is a third aspect to consider, the industry representative noted. There are many events happening or on the horizon including interest rate increases, inflation, volatility, the Ukraine conflict, Gaza, the US and European elections and China/Taiwan. These are progressively integrated by investors and normalised by the market with a 'house

of cards' effect. There is pent-up demand in both the public and the private market with \$3 trillion of capital to deploy and portfolios needing to be put to work in the market. This combination of pent-up demand and offer could have an exponential effect on the market. There have been some timid developments in the European market at the beginning of 2024, with a few IPOs and a desire to move more constructively in the equity market, but there is some hesitation due to the uncertain geopolitical and macroeconomic environment.

An official agreed that EU equity markets have been hurt by geopolitical turmoil, macroeconomic uncertainties and rising interest rates. Investments by equity funds in the EU dropped 11% in 2022 and equity exits dipped 27%. This negative trend continued in the first half of 2023. Unprecedented amounts of uninvested cash were also reached by private equity funds in 2022 after record funding, however funding significantly decreased in 2023. There are grounds to expect a rebound in the European equity market and reasons to be optimistic on a longer-term perspective. There is dry powder in funds which can be put to the benefit of innovative companies. The decline in the market is more moderate than that witnessed after the dotcom bubble and the great financial crisis. The progress made on the regulatory side and in the development of the market ecosystem is also a good basis to further develop capital markets in Europe. However, innovative SMEs with intangible assets and limited collateral remain constrained in their access to finance, as the European financial system remains very bank-centric.

Another industry representative agreed that the macroeconomic conditions have been difficult but concerns about inflation are subsiding. There has been a steady return to business and an ability to help SME financing, particularly in the Nordic and Baltic region. The European IPO pipeline is looking attractive with SME and main market spaces showing signs of picking up.

An official noted that equity markets in the EU are much smaller than in the US and Japan in terms of total market capitalisation relative to GDP, but there are also major differences within Europe. In a handful of countries, including Luxembourg, Ireland, Sweden, Denmark and the Netherlands, the total market capitalisation is much higher than in other European countries. The range of market depths between member states is also significant and is one of the reasons why harmonising capital markets is necessary, but challenging.

A regulator stated that figures from a report by New Financial show that the ratio between the least and the most developed capital market within Europe is 35:1. The average stock market cap over GDP in the EU is roughly 70% and in the most developed market it is 140%, which shows that there is significant potential for progress of market-based finance within the current EU framework.

Another regulator emphasised that equity markets are the most important part of capital markets for economic growth in Europe. The market has continued to decrease over the past 20 years, despite many new regulatory measures, leading to an equity gap with insufficient long-term investment and incentives for companies to go public. While consolidating the European capital markets regulatory framework is beneficial, this will take time. Stronger political impetus is needed at the political level to develop equity markets, as well as effective incentives and a greater capacity to mobilise capital.

2. Main issues and challenges to overcome for the further development of EU equity markets

The Chair asked the panellists for their views on the reasons for the limited development of equity markets in the EU from both an investor and an issuer perspective.

2.1 Investor perspective

An investor representative noted that the geopolitical context is worrying for investors. In addition, the lack of understanding and trust among investors about equity investment, notably in SMEs may limit the development of EU equity markets. The latest Eurobarometer shows that 45% of EU citizens do not feel confident about investing in the capital markets due to both cultural aspects and a lack of knowledge and transparency.

A regulator emphasised that the low level of investable long-term assets in Europe compared to the US is a major challenge. The amounts in the US market that can feed liquidity are incomparable. For example, the California Public Employees' Retirement System (CalPERS) fund, which covers two million public employees, has assets under management of \$462 billion. This is nearly 4 times more than what the nine million Spaniards hold in pension funds, which amounts to \$120 billion.

2.2 Issuer perspective

A regulator emphasised the importance of improving the incentives for companies to go public and increase their equity financing. This would have much more impact than shortening prospectuses. Europe has failed so far to address the asymmetry for companies of tax treatment between debt and equity financing. The Commission's debt-equity bias reduction allowance (DEBRA) proposal, which could have made a significant difference in the way companies approach the funding market was filed, which is a collective failure.

An industry representative stated that healthy secondary market liquidity is also crucial for the functioning of equity and bond markets, as it allows SMEs to come back to the market and raise additional capital during difficult times. In the Nordic and Baltic ecosystem there is good liquidity. SMEs have raised 26 times more capital than when they first IPO'd with the result that 130 of the SMEs listed in the region have moved from the growth market to the main market.

There is increasing demand in the private market to help such companies come to market and reach a wider set of investors.

An official noted that, while it is vital to fund start-ups in order to foster growth in Europe, more must be done to fund larger companies that reach the scale-up level. There is often not enough funding available to ensure that these companies continue to develop in Europe, which explains some of the investment flows out to the US. Actions are being conducted to facilitate investment in the European champions of tomorrow and encourage them to stay in Europe. The European Tech Champions Initiative (ETCI) created under the aegis of a group of European governments, is a €3.75 billion fund of funds, which supports large-scale venture capital funds and provides growth financing to European high-tech companies in the late-stage growth phase.

Another official noted that there are common issues in the EU but also specificities related to immature markets. Latvia, despite a strong regulatory framework and an integrated market infrastructure at the regional level, still lacks a liquid market with good exit strategies and a dynamic M&A market. Progress in the development of private equity and venture capital sectors is nonetheless observed in the Baltic region.

3. Possible solutions for developing equity markets

The Chair asked the panellists whether these objectives and challenges are being appropriately addressed in the Capital Markets Union (CMU) initiative and what further actions may be needed.

3.1 Expected impacts of CMU on EU equity markets

An industry representative welcomed the initiatives adopted in the context of the first CMU action plans to facilitate the financing of European companies through external equity including: a single access point for information on EU enterprises (ESAP), improved investment products with the ELTIF framework, the review of Solvency II prudential requirements, further integration of the post-trading landscape with the adoption of the Central Securities Depositories Regulation (CSDR) review and improved listing rules for companies. The MiFIR review is also expected to have positive effects on the competitiveness of primary and secondary equity markets, enhance the level-playing field between execution venues and provide investors with improved transparency and market data availability.

Much remains to be done to develop equity markets, but there is a window of opportunity with the current funding needs in Europe related e.g. to the twin transition, which require a further development of capital markets. Rules need to be further harmonised in areas such as securities and company law including a common definition of securities and shareholders, voting rights, share classes, takeover and threshold rules. This would reduce complexity for issuers and investors and enhance the

level playing field. There could also be more tangible efforts to increase the efficiency of withholding tax processes and harmonise the settlement finality rules. It is moreover essential to provide issuers and investors with appropriate incentives.

An official stressed that actions to further integrate EU financial markets may also foster the limited EU cross-border investment. Reforms that support information sharing and a level playing field are essential in particular to achieve this.

3.2 The role of regional initiatives and public institutions in the development of equity markets

A regulator acknowledged the potential benefits from the improvement of the capital market framework with the CMU and further EU supervisory convergence. However, initiatives at domestic level can also be effective for developing local capital markets, provided they do not hinder further integration and consolidation at EU level. The Nordic region shows that vibrant equity markets can be developed within the current framework. If the functioning of the Nordic market was extended to the rest of Europe the size of the European stock market could double.

An official supported the work on the CMU and emphasised the importance of a common effort at EU and also at regional and national levels to demonstrate that capital markets can work in practice for companies and citizens. Venture capital and private equity programmes supported by institutions such as the EIB, EIF and EBRD such as the Baltic investment Fund, as well as domestic instruments like the SME IPO state-supported accelerator fund in Latvia and Lithuania are playing an essential role in kickstarting the equity market in the region. A number of joint initiatives aimed at building a pan-Baltic capital market have also been undertaken since 2017, including the integration of market infrastructure and the creation of a MSCI index representing the whole Baltic region aiming to make the region more attractive for investors.

An industry representative commented that the equity markets in the Nordics and Baltics have developed due to a mini-CMU-type ecosystem at regional level with an integrated market infrastructure and harmonized trading systems and rules, which provides a consistent and seamless experience for participants across the region.

An official agreed that best practices from the Nordic region, where a successful ecosystem has been built, should be extended to other EU Member States. The official also confirmed that public-private institutions such as the EIF are playing a key role in the financing of growing companies. These institutions act counter-cyclically to support venture capital and private equity funds in periods of slowdown and also help to crowd in private investors. National development banks and the EIB also act as direct buyers and guarantors in the equity market. It is however challenging to attract resources from the insurance or pension funds sector to fund the activities of the EIF because of tax and regulatory obstacles.

A regulator noted that an appropriate balance is needed between the EU and the domestic levels in terms of

supervision. European level supervision is relevant for truly systemic and cross-border entities. However, central supervision is not a silver bullet for integration, as shown by the single supervision in the banking sector, which has not fostered cross-border funding in Europe so far, and is two to three times more expensive than national supervision. Giving ESMA more scope to fine-tune parameters in the law and adapt them to changes in the market - e.g. using no-action letters - also makes sense.

3.3 Increasing retail investment

An investor representative stated that academic research indicates that retail investors require more confidence to engage in capital markets. They must have a say and be more engaged in the companies they are investing in and must be adequately protected. There is somewhat of a balancing act when encouraging retail investors to invest in equity, particularly in SMEs. The measures taken to facilitate the issuance of SME stocks should not be to the detriment of retail investor protection with lower standards. There is also a need for more regulatory and supervisory convergence in the EU. In addition, a level playing field should be created throughout the EU in terms of class actions or mass damage actions. The directive on this requires more work, as the impacts have so far been quite limited.

An official agreed that there are cultural and literacy issues to tackle to develop retail participation. Employees who participate in pension funds for example do not have a good understanding of the returns that can be gained through investing in equity rather than in bonds.

An industry representative emphasised that retail participation in equity markets has been a fundamental part of the success of the Nordic and Baltic markets. Direct participation or indirect participation through investment funds and pension funds is essential to the health of SME equity markets. Having a stake in companies also gets households more involved in their country's economy and more committed to financing its growth. This skin in the game will unlock more investment and market capitalisation will grow over time.

The industry representative acknowledged that SME financing is risky and so investor education around risk is necessary. Regulation is important but it is also essential to empower households to understand the European landscape and local economies. The Nordic countries lead in Europe in terms of financial literacy with the inclusion of financial education in the school curricula aiming to nurture a financial culture and the ability to engage on one's private financial situation from a young age. Retail investment is also encouraged in Sweden with the provision of a simple to manage Investment Savings Accounts (ISK) and tax incentives. There is also a sense of getting excited about successful domestic SMEs with an effective marketing of small companies towards retail investors.

A regulator noted that, while enhancing investor protection and regulatory convergence is important, ultimately what drives investors is the prospect of return. An economic environment must be created where the underlying assets in which savers invest are

capable of delivering a better return than putting savings in a bank. The experience of pension funds in the Netherlands also shows that a significant proportion of the capital accumulated is invested abroad to obtain higher return. The objective should be to provide an environment where the prospect of a better return makes it attractive for European investors and foreign investors to invest their capital in European equity markets. A further digitalisation and integration of the EU economy would enhance EU competitiveness and also help the capital markets to grow.

3.4 Improving the IPO process

An industry representative observed that the perception of entrepreneurs planning an IPO in volatile markets and in the current geopolitical context needs considering. The IPO process can take up to seven months during which investors might change their minds and entrepreneurs have no visibility on the outcome of the process, which is quite complex requiring high legal fees. The framework needs to be simplified to speed up the IPO process and allow issuers to address investor demand in a more agile way. The Listing Act

will enable parties to reduce the offer period for an IPO to three days. That is feasible with private placement, but there are obstacles, such as the obligation for a compulsory retail tranche in France. Other measures could be proposed to attract retail investors to the market and protect them, that do not compromise the agility of the IPO process.

A regulator agreed that the IPO process and market practices related to this need to be rethought in Europe. In addition, it is necessary to keep European markets open, because outside partners are needed to provide international capital. This must be taken into account in the debate about open strategic autonomy. Further consolidation is also needed at the EU market infrastructure level, which requires having a sensible approach to competition policy at European level.

Another regulator agreed that the European capital market must remain open. In Portugal the largest companies are those that have significant international activities, which requires access to external markets and funding.