The pursuit of equity investment in SMEs

Relevant stakeholders in the EU have for longtime been trying to get SME-equity listed. They have inexhaustibly exchanged views and presented initiatives on rebalancing companies' financial dependence from banks to capital markets. As this imbalance is part of Europe's finance culture, shifting this will take generations. Fortunately, a positive trend is noticeable. In the European Union, according to the 2018 SAFE results, SMEs reported that the most important sources of financing are credit lines (52%), leasing (47%) and bank loans (47%). Equity financing is relevant for 12% of the SMEs. In 2009 this was even as low as 1.6%. Despite all effort, the imbalance persists. Do we have to worry about that?

European Investors believes that EU citizens and SMEs should contribute to and benefit from well-functioning equity markets and gain of the associated economic growth. However, when it comes to SME financing through equity markets, wariness arises, especially if retail investors are approached. If bank financing or private financing isn't available for SMEs, one might consider that market financing is an option. This ignores that there are valid economic reasons why banks or private capital do not provide loans or investment arrangements. There might be significant risks attached to any prospect, numbers might be flawed and not all SMEs are Business Angels. Moreover, it is also critical that SMEs understand the mechanics and dynamics of capital markets to be able to navigate and leverage them. There is no such thing as a free lunch.

Consequently, the fact that SMEs are still overwhelmingly financed by credit and bank loans may be part of the well-functioning of equity markets.

However, if we jointly decide to pursue shifting the balance, there are two key factors to discuss: market research and domestic approach.

Market research

Many regulatory initiatives have brought benefits to equity markets for SMEs, such as MiFID II and the Prospectus Regulation. These initiatives purported to balance market access, administrative burdens and investor protection. More should be done to build visibility amongst investors. Equity research, a key element of this visibility, is undermined by the transformation of research funding models. Exchanges, in their capacity as market places, and brokers are the central points for SMEs and investors to meet. They should promote equity listing by SMEs and foster interest from investors to weigh SMEs' investment proposals. It is essential to have a sustainable eco-system for SMEs and investors. Regulators and legislators have to participate as well by facilitating an efficient but thorough listing process.

Domestic approach

Retail investors tend to have a domestic preference when investing in companies, especially SMEs. They feel more involved with companies in their own environment or companies from which they own products or purchase services. Linking this preference with regulatory or exchanges driven initiatives is key. An investment proposition has to be introduced properly, with all relevant information disclosed and investor protection assured. Essential liquidity has to be arranged and continuous transparency on trading is a condition. Then shifting the balance may have success.

Equity investment in SMEs requires market research and a domestic approach.