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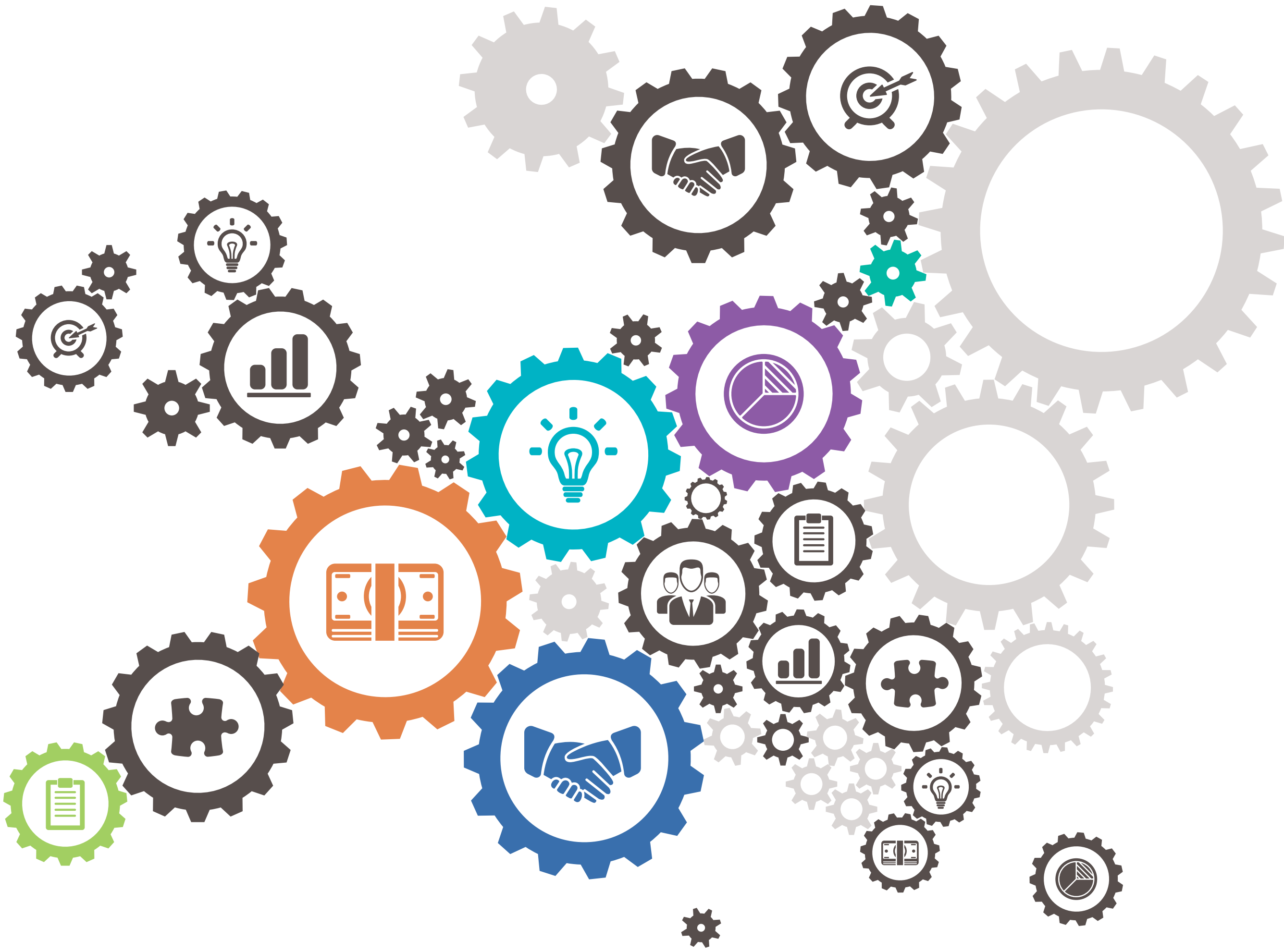

CAPITAL MARKETS UNION

The perspective of European growth companies

OCTOBER 2015

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TheCityUK

TheCityUK champions the UK-based financial and related professional services industry. We are a membership body, lobbying on the industry's behalf, producing evidence of its importance to the wider national economy. In the UK, the EU and internationally, we seek to influence policy which drives competitiveness, creating jobs and lasting economic growth. Our authoritative research and economic insight brings together the highest level of government and most senior industry figures, to shape better policy decisions, for the sector and its consumers.

The UK is Europe's financial centre, accounting for over 2 million of the EU's 11 million financial services jobs. TheCityUK has taken a leading role in producing robust evidence on behalf of our members to inform and shape the debate about the benefits financial services bring to the continent. Our evidence-based policy work shapes EU regulation to ensure the area remains competitive. Many firms see the UK as a gateway to the Single Market. One-third of the UK's surplus in financial services comes from trade with EU countries, nearly half of foreign banks in the UK are from the EU and 48% of UK Foreign Direct Investment comes from Europe. Twice as many euros are traded in London than in all the euro-area countries combined, equating to $930bn a day.

We work closely with our European counterparts to demonstrate the contribution the industry makes across the EU. We have articulated the reform our industry wants to see at an EU level to be ever more competitive in a global context and are now working closely with senior policymakers to understand how this programme can be advanced.

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1.0 SURVEY OVERVIEW

1.1 INTRODUCTION – THE CASE FOR A CAPITAL MARKETS UNION

The free movement of capital was one of the founding principles of the Treaty of Rome; and it constitutes one of the pillars of the single market. But across the European Union (EU), capital markets remain fragmented, underdeveloped and organised largely on national lines.

This matters, because if the EU as a whole is to return to strong and sustainable economic growth, to create jobs and to become more competitive in the global marketplace, which must be its overriding goal, it needs to invest much more in growing companies and in the infrastructure that supports economic activity.

For example, it is estimated that it would take an additional €1trn to complete pan-European networks in telecommunications, transport and energy. The capital markets need to play a larger part in meeting that funding challenge, by channelling additional finance to the economy at lower cost, right across Europe.

European businesses are currently heavily reliant on banks for funding – much more so than in the United States (US) – but in the wake of the financial crisis and the continuing difficulties of the Eurozone, the banks cannot finance a comprehensive European recovery on their own. Moreover, it is argued that the speed with which the US economy bounced back from the crisis was in part due to US companies having wider access to capital markets.

Reducing European companies' dependence on bank funding would also improve the stability of the financial system across the EU, widen the range of options for national central banks in terms of monetary policy levers and improve competition and choice in financial services.

European savers, for their part, tend to deposit more money in banks than savers in the US, who hold more of their savings in securities and investment products like pension schemes and life insurance. As life expectancy increases in all Member States and pressures on public services mount, bringing about a shift towards a system of funded pensions and greater use of broad investment portfolios, with higher returns than bank deposits could offer, would make a real difference in helping people secure a decent standard of living in retirement.

So there is a strong, and broadly-based, policy case for action:

- to identify and remove the barriers which stand between investors' money and the full range of investment opportunities across the EU;
- to tackle the obstacles that prevent businesses from reaching potential investors;
- to create conditions which encourage the supply of non-bank finance within and across member state boundaries; and
- to attract more investment into the EU from the rest of the world.

Against that background, the European Commission has proposed action to create a Capital Markets Union (CMU) for the EU.

TheCityUK strongly supports that initiative. The International Regulatory Strategy Group (IRSG), supported jointly by TheCityUK and the City of London Corporation, has submitted detailed evidence to the Commission's recent consultation on this subject.

TheCityUK considers that the ambition for a CMU should be the creation of a **deep and integrated single market for capital in Europe, for the benefit of savers, investors, pensioners and growing companies in all 28 Member States.** It should:

- maintain the global competitiveness of the EU's financial services sector;
- contribute to financial stability, investor protection and market integrity;
- embrace innovation and new technologies;
- wherever possible, seek non-legislative and market-based solutions in preference to new laws; and
- work alongside other EU policy priorities.

It must be underlined that banks and bank finance will always have a vital role to play. A CMU will work bests if it brings not only more sources of funding and more overall investment, but also ensures that alternative sources of finance operate in a complementary manner, so that companies can enjoy a blend of financing solutions to suit their circumstances and their plans for growth.

Capital markets won't be the right solution for all companies. For example, for the very smallest companies, because of the costs involved (although technological change may help bring those costs down). By the same token, banks will be able to support economic growth better if they aren't being asked to provide the kind of finance that the markets are better placed to offer.

Banks and capital markets have complementary and mutually beneficial roles to play in supporting growth and jobs. A CMU has to help them play those roles more effectively.

1.2 THE PERSPECTIVE OF EUROPEAN GROWTH COMPANIES

Against this broad policy background, TheCityUK asked EY to conduct a targeted, qualitative research study to look at the recent experience of a sample of growth companies across the EU in terms of access to finance; their assessment of future funding needs; and their views on potential sources of finance.

EY selected 37 medium-sized companies assessed as having strong-growth potential, across a range of strategically important sectors, in six different Member States – these included companies that might become large national companies of the next decade.

The sectors chosen were pharmaceuticals, biotechnology, advanced engineering and information technology, all high-growth areas where the EU must innovate and grow to compete on the global stage. They were also chosen because of their potential to create spin-off business opportunities that generate additional growth and employment in the wider economy, in particular through supply chains.

The Member States chosen, were selected to offer a broad and contrasting picture in terms of size, business structure, financial market infrastructure and government policies to encourage business growth. They are based in France, Germany, Italy, Latvia, Poland and Portugal. It was anticipated that the overall picture the survey would provide would be broadly representative of the conditions and economic dynamics cross the EU more widely.

Over the period from March to May 2015, EY staff in the relevant countries conducted in-depth, structured qualitative interviews with the chief financial officers and other executive team members of the selected companies.

These were supplemented by interviews with a selection of 16 financial market participants – banks, private equity houses, investment funds, peer-to-peer lenders, stock exchanges and an international development bank across the six Member States, for 'supply-side' evidence around the key issues surrounding the financing of medium-sized growth companies.

The findings from this qualitative research were then evaluated against two detailed quantitative studies conducted by EY in 2014 and 2015, both of which looked at issues of access to finance:

- the 2015 EY *Mid-Market Barometer*[1], which included 6,000 corporates, including 2,030 in the Member States included in this research
- the 2015 EY *European Banking Barometer survey*[2] of 226 senior bankers, including five of the selected countries

They were also compared with the outputs of an alternative financing benchmark report[3] by the University of Cambridge, in partnership with EY, which surveyed 255 leading European platforms, including 85 from the selected countries.

To situate the research study findings within their national context, EY reviewed the position of the wider Small and Medium-sized Enterprises (SME) sector in the countries selected, the main domestic policies in place to support growth companies and specific corporate tax incentives for SMEs (where they exist). Highlights for each country can be found in Section III of this report.

This report, and the study that underpins it, focuses on the practical experience of companies in raising finance to grow and expand; and sketches out some of the issues that this raises for policy-makers. However, it is also important to recall the broad economic case for a CMU in terms of growth and stability. The Appendix to this report summarises the key economic arguments and their relevance to growing companies.

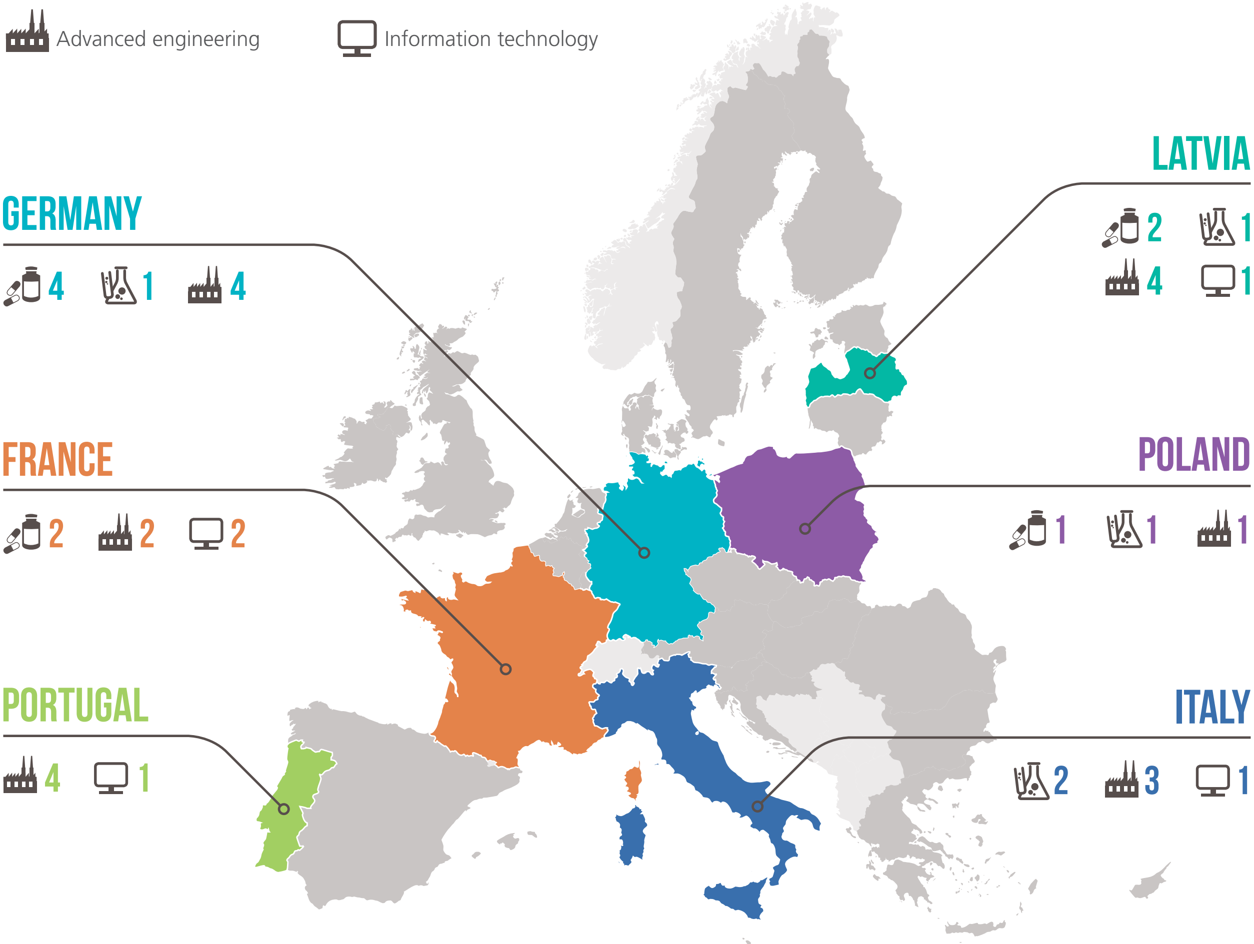
[1] http://www.ey.com/Publication/vwLUAssets/EY-european-mid-market-barometer-2015/$FILE/EY-european-mid-market-barometer-2015.pdf

[2] www.ey.com/ebb

[3] Cambridge – EY, 2015, http://www.ey.com/Publication/vwLUAssets/EY-and-university-of-cambridge/$FILE/EY-cambridge-alternative-finance-report.pdf

COMPANIES WERE SELECTED FOR INTERVIEW FROM SIX MEMBER STATES AND FOUR HIGH-GROWTH SECTORS

Pharmaceuticals
Biotechnology
Advanced engineering
Information technology



	Pharmaceuticals	Biotechnology	Advanced engineering	Information technology
France	2	–	2	2
Germany	4	1	4	–
Italy	–	2	3	1
Latvia	2	1	4	1
Poland	1	1	1	–
Portugal	–	–	4	1
Total	**9**	**5**	**18**	**5**

THE MEMBER STATES CHOSEN DIFFER WIDELY

GERMANY

TOTAL POPULATION
(Millions)

80.8

NUMBER OF SME EMPLOYEES
(Thousands)

16,721

NUMBER OF SME ENTERPRISES
(Thousands)

2,201

FRANCE

TOTAL POPULATION
(Millions)

65.9

NUMBER OF SME EMPLOYEES
(Thousands)

9,587

NUMBER OF SME ENTERPRISES
(Thousands)

2,598

ITALY

TOTAL POPULATION
(Millions)

60.8

NUMBER OF SME EMPLOYEES
(Thousands)

11,516

NUMBER OF SME ENTERPRISES
(Thousands)

3,718

POLAND

TOTAL POPULATION
(Millions)

38.5

NUMBER OF SME EMPLOYEES
(Thousands)

5,679

NUMBER OF SME ENTERPRISES
(Thousands)

1,475

PORTUGAL

TOTAL POPULATION
(Millions)

10.4

NUMBER OF SME EMPLOYEES
(Thousands)

2,264

NUMBER OF SME ENTERPRISES
(Thousands)

775

LATVIA

TOTAL POPULATION
(Millions)

2.0

NUMBER OF SME EMPLOYEES
(Thousands)

458

NUMBER OF SME ENTERPRISES
(Thousands)

88

1.3 SUMMARY OF FINDINGS, AND KEY AREAS FOR ACTION

While there were, unsurprisingly, some marked differences of experience between companies, sectors and Member States, some strong common themes emerged from the survey:

- a reliance on bank lending as the sole source of finance;
- a lack of awareness of complementary and alternative sources of finance;
- concerns about the level of advice and information provided by financial partners; and
- the significance of perceived costs and administrative burdens as a barrier to accessing capital markets.

The headline findings were striking. Two-thirds of those surveyed said that they intended to remain loyal to bank funding as their sole source of finance; while just over half of the interviewees' said that they had little or no knowledge of complementary and alternative sources.

This was true both for survey participants who described a clear strategy for their company's future financing and for those who did not. In fact, among interviewees setting out a clear forward strategy, the picture was even more pronounced: just under 90% of these declared an intention to stick with bank funding, while almost 75% confirmed they had no knowledge of complementary and alternative finance.

The survey results highlighted four areas where the senior executives interviewed by EY felt that policy action could be of benefit to their businesses, the first two of them mainly cultural in nature and the second two essentially structural.

i. Increasing growth companies' awareness of different sources of finance

"Our recent funding was sourced from our domestic market because of established bank relationships and local knowledge." (German advanced engineering firm)

"It is critical to have a global overview of products and alternatives we can find in the market." (French pharmaceutical firm)

"We do not have enough experience to access funds from other EU markets." (German pharmaceutical firm)

Current levels of financing for growth companies within the four sectors researched appear to be relatively healthy. The majority of interviewees had received all or at least some of the funding that they required. For the minority who had been unsuccessful in raising funds, the business environment continued to prove difficult: but this was not the case for most companies surveyed.

On the other hand, most of the interviewees recalled the difficulties they had experienced in raising funds during the economic and financial crisis; and recognised that exposure to a single source of finance could leave them vulnerable.

"During the 2009 crisis, no bank debt was available." (German advanced engineering firm)

"We were refused funding due to the exit of banks from the Baltic market during the 2009 crisis."(Latvian pharmaceutical firm)

"We were refused funding during the crisis, following heavy action from the banks, due to our exposure to non-EU markets." (Latvian information technology firm)

Most survey participants acknowledged that it might be desirable to have more diverse funding, but they stated consistently that they did not have the level of awareness or understanding of complementary and alternative sources of finance to give the issue serious consideration. Fewer than a fifth of interviewees had had any personal experience of different forms of funding; and the lack of information and awareness in this area was cited as a 'critical' or 'very important' issue by over half of interviewees.

In many cases, interviewees talked about the behaviour of their peers and competitors when discussing this topic. They argued that using different sources of finance when others were not doing so might constitute a degree of additional and unwanted risk for their business. On the other hand, if alternative sources were readily available and their rivals were using them for competitive advantage, they would look much more closely at them.

ii. Increasing expert advice and communication for growth companies from financial partners, and sharing best practice

Two critical factors highlighted by respondents that limited their financing requests were the level of confidence and certainty around the lenders' decision-making process. Interviewees were concerned that, if they did not properly understand the criteria they had to meet, they might apply for funding and be turned down; and were worried that this would affect their credit rating for the future. With this in mind, a number of companies had applied for less funding than they needed and were prepared to reduce the size of a funding application in order to secure a positive outcome.

> *"Occasionally we cannot understand the mood changes for the banks - they're not transparent."(Latvian advanced engineering firm)*

Interviewees said that there was a need for better, more consistent and transparent communication from finance providers about expectations in relation to applications for funding; and, where applications were declined, for feedback about the reasons for this. Over a quarter of the medium-sized companies surveyed identified the need for better advice and communication from financial partners as a critical factor.

The research also found a lack of familiarity with the requirements of new investors and the importance of preparing a good business case to support funding proposals. Many interviewees wanted advice on investor communities and on how to prepare in advance of meeting them.

The survey revealed a strong case for sharing of best practice among growth companies; and for encouraging a closer connection between companies and providers of professional advice.

iii. Reducing costs and administrative burdens

> *"We need to make the equity capital culture in Europe a CEO issue, at national government level, and then eliminate major barriers like tax and regulations."(German biotechnology firm)*

> *"Listing is a natural and logical next step: however, the costs associated in terms of compliance, disclosure and corporate governance are too high." (Italian biotechnology company)*

Over half the companies surveyed identified the costs and administrative burdens associated with different sources of finance as a critical issue for them.

The cost and management time needed to develop relationships with complementary and alternative sources of funding should not be underestimated. Of particular importance is the level and type of information companies need to disclose about their business in order to help a potential investor better understand the risks and opportunities involved in funding them.

Many of the interviewees raised specific points in relation to credit information and the requirements associated with producing a prospectus for an initial public offering (IPO).

Setting aside the cultural and emotional aspects of providing sensitive information about the underlying business to an external party, it is clear that growth companies may not have all of the data needed by a potential investor readily available and in an easily deliverable format. Also survey participants expressed concern at the level of effort and cost involved in producing this information.

However, for those companies surveyed that were based in countries where a central credit register was in operation – France, Germany, Italy, Latvia and Poland — some of the burden was absorbed as a cost of doing business, as a common set of data had to be produced for all companies.

Each type of funding represented in the investment chain (see Appendix) has a different set of compliance requirements. For those companies that had had their funding needs met in full, the issue of changing compliance requirements was a key factor influencing the company's decision whether to move along the chain, or remain with the existing type of funding – which was, overwhelmingly, bank lending. Cost, historical preference and regulatory requirements were dominant among the selection criteria for funding cited by the growth companies EY surveyed.

iv. Developing a richer ecosystem

> *"There is an insufficient amount of domestic equity capital for high-growth biotech firms." (German biotechnology firm)*

Since their peer groups were overwhelmingly using only traditional bank lending, most of the companies EY surveyed expressed reluctance to 'step into the unknown'. A number of interviewees said that there were insufficient alternative financing providers in their local market, and that there were inadequate incentives from their governments to bring about change. This was identified as a highly important issue by over a third of interviewees.

The senior executives interviewed by EY expressed the view that until there was a more vibrant ecosystem of providers, together with a wide range of professional advisors, it would remain difficult to consider any funding option other than bank finance. Only then would a majority of growth companies feel a sufficient degree of comfort to turn regularly to alternative forms of funding as a model for the future.

It was also apparent from the survey that participants expected any policy-led support for alternative finance to create sufficient incentives for the provision of services across member state borders to be a medium to long-term endeavour; this would not be an area for 'quick fixes'.

1.4 CONCLUSIONS

The EY survey shows that, while growth companies experienced funding difficulties in the wake of the economic and financial crisis, most are currently in a reasonably comfortable position in terms of finance — although some have opted to seek less funding than they would ideally require rather than see their applications declined.

The vast majority are still very heavily dependent on bank lending; and while they are aware that this is pro-cyclical in nature and leaves them exposed in the event of a future tightening of credit conditions, they are at present hesitant about turning to alternative sources of finance.

This underlines the policy argument for effective action to diversify funding for growth companies. But, in order for the capital markets to be an attractive option for these companies, there needs to be a much higher level of awareness of the options available, and better information and advice from financial providers and advisers.

Therefore there is **a strong case for public and private initiatives aimed at increasing awareness of different funding avenues** among growth companies.

By the same token, there are concerns among growth companies that access to the capital markets entails significant costs and administrative burdens. Such concerns constitute a barrier to change. Specific issues surrounding credit information and the formal requirements in relation to issuing prospectuses in view of an IPO were both prominent concerns of the companies interviewed.

It seems clear that **reviewing how credit bureaux and central credit registries facilitate disclosure of credit information for growth companies seeking finance** has a significant role to play in this context. Equally, **simplifying the information requirements set out in the EU Prospectus Directive** has the potential to make a positive practical difference.

There is also a broader perception that **there is not yet a sufficiently vibrant ecosystem of advice, design, promotion and delivery of alternative finance** across the EU to give growth companies, whether medium-sized or small, the confidence to move away from sole reliance on bank lending to support their growth ambitions.

These issues need urgently to be addressed both by the Commission and by national governments if the financial markets are to make their fullest contribution to Member States' economies, and if a CMU is to deliver its full potential across the EU as a whole.

It is clear that **a wide-ranging and sustained programme of work will be needed to create lasting change**.

2.0 THE SURVEY IN MORE DETAIL

2.1 AWARENESS OF DIFFERENT SOURCES OF FINANCE

A consistent theme was the **reluctance of growth companies to move away from their existing source of finance**. This was due to a lack of awareness of and familiarity with alternative sources of funding, coupled with an apparent scarcity of supply that heightened the perceived risk of deviating from established bank lending. Consequently, the executives interviewed were unwilling to change.

Over half of the companies surveyed identified the lack of awareness of alternative sources of finance as a critical or very important factor for them. It is therefore plain that, whatever else is done in policy terms to create a CMU, the Commission's action plan needs to address the low level of understanding of alternative sources of finance with a thorough communications and educational programme.

Fewer than 20% of the executives interviewed had experience of alternative sources of finance. At the same time, some commented that they would 'almost always' receive part or all of their funding needs from banks, so would find it difficult to justify any change. This finding was in line with the Commission's Survey on the Access to Finance of Enterprises (SAFE) report, which highlighted a strong preference among small and medium-sized companies to use bank loans, overdrafts and even hire purchase or leasing arrangements to finance their business.

The levels of awareness and experience of individual companies in accessing alternative sources of finance needs to be improved, as illustrated by the following examples:

- having recently returned to profitability, Company 01, an advanced engineering firm from Latvia, faced significant challenges in securing financing from its local banks. Only 30% of its requirements had been met and its contractual terms were inflexible owing to past poor performance. An inability to meet these requirements in full caused Company 01 to consider mezzanine financing, trade finance and factoring.
- Companies 03 and 05, pharmaceuticals companies from Germany and France respectively, said that they continued to secure their funding from existing sources, despite the terms over the past few years being 'limited' and 'inflexible'. Company 03, a well-established, family-owned firm that has used bank and shareholder funding for capital investment over the past five years, had considered issuing corporate bonds: but decided to remain with existing funding arrangements as they provided the comfort of a positive and reliable relationship with the existing bank lenders.
- despite the problems arising from a single source of finance, Company 24, an advanced engineering firm from Portugal said that it would not change its approach to funding or the options available.
- Company 23, a German pharmaceuticals firm, received adequate flexibility from its venture capital finance. However, the quantity of funding available was constrained by the size of its business. As a result, it recommended that **policies should be introduced to increase awareness of alternative financing, improve credit information and simplify the process for issuing a prospectus**.
- Company 26, a Latvian pharmaceuticals firm, had considered EU funding administered by a local bank as an alternative finance option. The main reason for considering only this form of alternative finance was due to the perceived complexity of other financial solutions and products. The interviewee stated that **the company's owners would not understand any other form of alternative finance**.
- Company 29, an advanced engineering firm in Portugal, was considering factoring due to perceived attractive business conditions.
- Company 36, a German pharmaceuticals firm, had experienced difficulties, having been refused an application for funding during the last five years. The reason provided by its bank was a restrictive credit policy at the time of the request. The company had no alternative sources available other than domestic bank finance.

- Company 25, a French pharmaceuticals firm, was **one of the few companies interviewed which was benefitting from alternative sources of funding. It had been successful in raising private debt from an alternative finance provider. The main challenge was in aligning the interests of the existing minority private equity investor with those of the new provider**. The company felt that it took a long time for existing funders to understand the new scheme and to feel comfortable with the alternative provider.

2.2 INCREASING ADVICE AND COMMUNICATION FROM FINANCIAL PARTNERS, AND SHARING BEST PRACTICE

The great majority of executives interviewed expressed concern that they did not know enough about how financial markets operate; nor did they have sufficient understanding of the different types of funding available. **More than half of respondents highlighted the need for more information relating to declined applications for finance, together with advice regarding alternative sources of finance**.

When asked about their key funding challenges, survey participants identified increasing levels of disclosure and a lack of knowledge of what was expected from them by funders. Executives interviewed also expressed concern that the company's credit rating could be negatively affected by a funding refusal; as was evidenced by their requests for greater transparency about the application process.

In order to increase their potential for securing access to funding, **the Portuguese companies interviewed were looking to improve their investor awareness and to present a more professional image**. To achieve this, they were developing initiatives such as collaborating with advisers to meet potential investors and increase confidence levels ahead of funding discussions — this was a positive step towards introducing best practice procedures and experience.

Some examples:

- Company 21, a Polish pharmaceutical company, was looking for long-term financing to support its plans to grow outside the EU. Recognising that expansion would expose the business to increased geopolitical and currency risk, it was seeking advice from its existing financial providers and the European Bank for Reconstruction and Development (EBRD) to determine the best sources of financing and to identify ways to minimise risk. The company has **two business segments, requiring distinct forms of financing**: a chemical drug business with a product development cycle of up to two years and average investment costs of US$5m-US$10m; and a biotechnology operation with a product development cycle of 7-10 years and average investment costs of US$70m-US$100m. The chemical drug business is considered to be predictable with a lower-risk profile, and consequently uses traditional bank lending. The biotechnology business, on the other hand, is considered to be higher risk. While bank financing was available, the company was assessing whether to extend financing options to include a risk-sharing arrangement, i.e. a joint venture or private equity investment. The company was not considering Peer-to-Peer (P2P) or crowdfunding options, as the amounts it was seeking would exceed typical P2P or crowdfunding levels. At the time of interview, the funding solution had not yet been agreed.
- Company 28, a Polish biotechnology firm, has a clearly defined business strategy of amalgamating high-risk, early-stage research start-up businesses and acquiring their intellectual property (IP) through a special purpose vehicle (SPV). It has no tangible assets to use as collateral and so it is seeking to utilise its IP assets. As the start-up businesses have yet to produce revenue, the company aims to provide investor returns through dividend payments or by selling off Intellectual Property (IP) assets. As a high-risk investment that relies on the success of an SPV, while not producing revenues, the company had encountered issues in attracting finance. It is majority owned by an entrepreneur keen to avoid dilution of investment, thereby limiting the possibility of private equity or venture capital funding. It had received feedback from domestic investors that listing on the national stock exchange small caps market may improve

its financing options: **but its most immediate need was for advice and guidance about alternative sources of finance**.

- Company 07, a Latvian biotechnology firm, has not considered any alternative funding options, despite its bank suggesting that the company should assess factoring and leasing as possibilities. The company still meets its full financing requirements through a combination of domestic bank borrowing and an established relationship with another source of finance.
- Company 15 is a fast-growing Italian information technology firm which had raised working capital in the form of short-term debt finance and had issued an IPO on the Italian AIM (small cap) market. It now needed to access long-term finance for long-term investments and thought that equity funding was the right way forward. Given the firm's experience, it strongly supported the need for **policies to encourage entrepreneurs to increase transparency and improve communications with investor communities as best practice**.
- the entrepreneur owner of Company 18, a Portuguese advanced engineering firm, suggested that **small and medium-sized companies should be able to launch small-scale equities backed by a third-party guarantee. He also expressed a need for an 'angel investor expert' or 'capital market expert' to be available to advise start-up entrepreneurs on the available options for funding**.

2.3 REDUCING COSTS AND ADMINISTRATIVE BURDENS

The cost and management time required to develop relationships with alternative sources of funding is a potential obstacle to diversification that should not be underestimated. **Over half of the interviewees identified the level and nature of information requirements associated with different forms of finance as an issue of critical importance**.

In more detail:

- Company 15, an information technology company in Italy, commented that it had only considered bank debt and equity finance from its existing providers. It highlighted the **cost of financing, the availability of information and the quality of existing relationships as the key factors influencing its funding decisions**. Regulation, tax and accounting rules were considered as being of moderate importance for this company when securing finance.
- of the two Latvian pharmaceutical firms interviewed, Company 11 changed its plans on the basis of its acquisition strategy and planned growth. It expected continued growth from domestic as well as EU and non-EU markets, requiring funding of €20m-€60m to realise the business opportunity this represented. When assessing its options, it had prioritised the **cost of financing, regulatory challenges and historical preference. It had considered issuing shares or bonds, but thought they would have been more expensive and complex to undertake**. In the end, it had decided to use domestic bank loans and lines of credit, as its requirements could be met in full with flexible terms. It thought that **EU policy focused on simplifying the process for issuing a prospectus would help improve access to finance**.
- Company 33, an advanced engineering firm in Latvia, had considered **bond issuance and secondary listing** as a means of meeting its financing requirements. It said that 80% of the financing decision was based on costs, with tax and accounting implications and financial

covenants making up the remaining 20%. It is listed on the stock exchange, and while it decided not to issue bonds at this stage, it will consider the option again in future. It considered a **simpler process for using prospectuses, awareness of alternative financing and improved feedback on funding applications** to be highly important factors in the context of its future funding strategy.

- Company 13, a French advanced engineering firm, highlighted the importance of maintaining a **strategic balance between financing maturity and repayments against cash-flow generation**. It was looking for finance that was flexible enough to align with each investment cycle and was struggling to find sufficient choice at the right price point. For this reason, it thought **it was critical to maintain a global overview of available products and alternatives**.
- Companies 14 and 01, Latvian advanced engineering firms, had considered alternative forms of finance; but had both settled for bank financing as the best available commercial offer. In assessing alternative funding options, Company 14 had prioritised the cost of finance and collateral valuations. It had considered issuing **bonds, leaseback and strategic investor options**, but none of these was deemed suitable for its specific financing requirements. The company would, however, continue to consider all alternative sources of finance. Company 01 had conducted an initial assessment of alternative financing solutions, prioritising the cost of finance over historical preferences, relationships and regulatory challenges. Both companies cited **lack of market choice** and a **focus on securing bank funding**, rather than securing a low interest rate or optimum terms.
- Company 14 was preparing to grow within the EU and beyond. It considered that **better credit information would help it access domestic funding** for its subsidiaries in other countries, perhaps through an **EU-wide information repository**.
- **costs, transparency of terms, maturity and internal awareness of the financial products** being considered were all factors highlighted by Company 07, a privately owned Latvian biotech company, in its financing criteria. It decided to continue financing itself through a combination of bank loans and private equity funding.
- Latvian information technology firm Company 22 had opted to continue using bank loans on the basis of price and ease of access, despite not securing its preferred flexibility in the contract terms. However, it would consider using alternative sources of finance in future. It identified **EU-wide credit information** as the most useful area for policy change that would help companies like it with access to external finance.
- Company 37, an advanced engineering firm in Latvia, had considered bonds and an IPO as options; but had decided to continue with bank lending after comparing costs, taking long-term relationship factors into account, and looking at tax and accounting implications.

2.4 DEVELOPING A RICHER ECOSYSTEM

The absence of a cohesive ecosystem of firms across the EU involved in providing the necessary advice, design, promotion and delivery of alternative sources of finance appears to be a major obstacle to success. **Over a third of interviewees thought that there was an insufficiently vibrant ecosystem to change corporate mindsets and behaviours**.

For example:

- one of the main challenges to raising capital highlighted by Company 02, a German biotechnology company, was the **limited number of reputable European venture capitalists operating in the sector**. The company had not been able to find viable alternative sources for funding in its domestic market. It had previously leveraged private equity investment and reinforced its expertise at board level, but was concerned about difficulties in progressing to the next stage of financing
- while Company 01, a Latvian advanced engineering firm, had yet to secure alternative sources of financing, it confirmed its openness to doing so in the future when the right opportunity arose.
- apart from Baltic private equity investments, the **Latvian** companies interviewed were dependent on a positive flow of competitively priced Nordic bank lending. One pharmaceutical firm, Company 11, stated that it didn't access alternative sources of funding owing to the complexity of changing from its traditional bank lending and the healthy availability of supply.
- during the financial crisis, Company 22, a Latvian information technology firm, had an application for funding declined. This was due to its non-EU operations increasing its risk profile. It had been considering an IPO at the time of the crisis, but market conditions had ruled that out. It had also considered bonds and quasi-debt as possibilities: but eventually decided on bank loans, due to price and ease of access. The company identified **greater awareness and availability of alternative sources of finance, and an increase in cross-border financing, as areas requiring attention. Changing requirements in relation to prospectuses could lead the company to reconsider its plans**.
- the majority of **Portuguese** companies surveyed emphasised **three factors** currently impacting on their **ability to raise funds** other than from traditional bank lending. These were **business plan preparation, development of financial key performance indicators and the appropriate level(s) of communication** needed to secure investor confidence.
- a small number of interviewees indicated an appetite to explore alternative finance options, where they existed. For example, Company 06, an Italian advanced engineering firm, commented that it had a preference for medium-term mortgages and leases to finance capital investment in machinery and long-life assets. Loans and account receivables were used in the short term to finance working capital and meet cash requirements of up to 90 days. The interviewee expressed a reluctance to tap into bank lending for expansionary projects and for strategic investments.

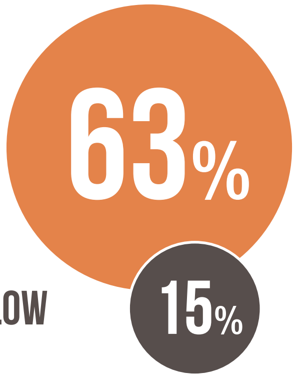
3.0 COUNTRY-BY-COUNTRY CONDITIONS

The influence and importance of small and medium-sized companies differs widely between individual Member States; as do national policies aiming to support them. Key aspects of national conditions in each of the Member States covered by the EY research study are set out below to provide additional context for the research findings summarised above.

FRANCE

KEY POINTS

SMEs MAKE UP 63% OF FRENCH EMPLOYMENT; MEDIUM-SIZED COMPANIES AROUND 15%. THIS IS SLIGHTLY BELOW THE EU AVERAGE.



A MIXED PICTURE ON ACCESS TO FINANCE WAS REVEALED BY EY'S 2015 EUROPEAN BANKING AND MID-MARKET BAROMETER REPORTS.

A CENTRAL POLICY INITIATIVE HAS BEEN CREATION OF BPIFRANCE, THE FRENCH PUBLIC INVESTMENT BANK, WHICH HAS BEGUN TO SECURITISE THE DEBT OF SMEs.

SOME SMEs ENJOY A REDUCED CORPORATE TAX RATE.

IN MORE DETAIL

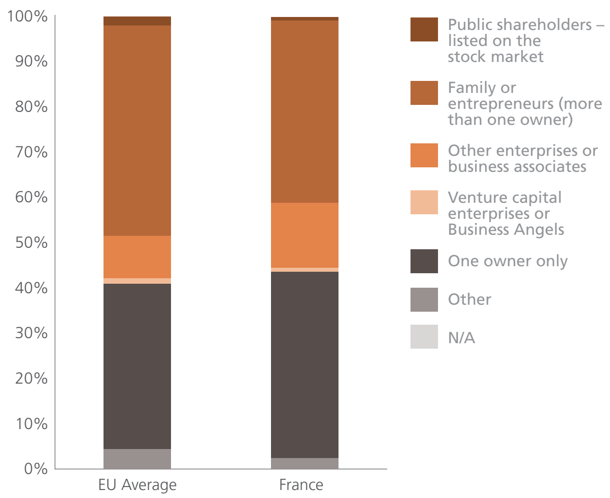
SMEs IN THE ECONOMY

Medium-sized firms are an integral part of the French economy, providing employment for 15.1% of the workforce. SMEs as a whole contribute a total of 63% of French employment, according to the European Commission's Small Business Act for Europe (SBA) Fact Sheet in 2014. The figures for France are marginally below the EU average of 17.2% and 66.9% respectively.

The French SME market is dominated by autonomous profit-oriented enterprises: 41% have a sole owner, and 40% are either owned by families or entrepreneurs.

Figure 1

Breakdown of SME ownership in France as compared with EU averages



Source: European Commission SAFE Survey 2014

ACCESS TO FINANCE

In terms of lending to French SMEs, 43% of bank executives surveyed in EY's 2015 *European Banking Barometer* expected corporate lending policies to be less restrictive over the next 12 months, with only 14% expecting the trend to reverse.

This compares with the 600 French medium-sized companies interviewed as part of the EY's 2015 *European Mid-Market Barometer*, who commented that they are still finding it difficult to access financing. 39% of respondents ranked access to external financing as 'fairly difficult' with 8% ranking it 'very difficult.' During 2014, 9% found it easier to access financing and 11% found it harder. Almost half of the French firms surveyed experienced difficultly in accessing funding for operating resources (47%), asset investments (48%) and expansion/ internationalisation (48%).

GOVERNMENT POLICIES

A key policy goal of the French Government has been to promote the growth and financing of SMEs. One major initiative was the establishment and subsequent reinforcement of BpiFrance, the French public investment bank. In September 2014, President Hollande announced that Bpifrance would start securitising SME debts, with the intention of freeing up bank balance sheets to enable them to lend more to business. The French Government also reformed insurance legislation, to enable insurance companies to lend directly to SMEs.

The European Investment Fund (EIF) is also active in France, investing in SMEs to support seed funding and start-up, early expansion and growth stages.

In April 2015, the EIF, Banque Populaire and the Fédération Nationale des Sociétés de Caution Mutuelle Artisanales (SOCAMA) signed a loan guarantee agreement in France under the EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME). This will provide SOCAMA with a counter-guarantee allowing it to increase guarantee volumes over the next two years and to launch a new loan programme dedicated to start-ups with limited collateral.

CORPORATE TAX INCENTIVES FOR SMEs

A reduced corporate tax rate of 15% applies to the first €38,120 of profits of SMEs where turnover is less than €7.6m and at least 75% of the company is owned by individuals or firms who themselves satisfy these rules.

CENTRAL CREDIT REGISTER

The Banque de France collects data on companies in the FIBEN company database and the Central Credit Register, which is a subset of FIBEN. FIBEN contains descriptive data, including ratings, legal proceedings and key events on over 5,000,000 entities, including 250,000 companies assessed with credit ratings. The Central Credit Register collects data on all loans above €25,000 extended by credit institutions.

GERMANY

KEY POINTS

THE GERMAN MITTELSTAND HAS BEEN A SUCCESS STORY NATIONALLY AND FOR THE EU AS A WHOLE.

SMEs ACCOUNT FOR 62.7% OF THE GERMAN WORKFORCE, SLIGHTLY BELOW THE EU AVERAGE. MEDIUM-SIZED COMPANIES ACCOUNT FOR 20.4%, WELL ABOVE THE AVERAGE.

62.7%

20.4%

THERE IS A GENERALLY POSITIVE PICTURE IN TERMS OF ACCESS TO FINANCE.

KEY POLICY LEVERS ARE THE KFW, THE STATE-OWNED LENDER TO SMEs, INVESTMENT GRANTS TO BUSINESS ANGELS, AND A SPECIFIC SME POLICY AGENDA WITH A GOVERNMENT 'SME ENVOY'.

IN MORE DETAIL

SMEs IN THE ECONOMY

The performance of the *Mittelstand* since the financial crisis has contributed significantly to the German economy. The *Mittelstand* uses a wider definition of SMEs than other EU Member States — up to 500 employees and €50m turnover. The *Mittelstand* makes up 99% of German businesses, contributing 52% of national economic output.

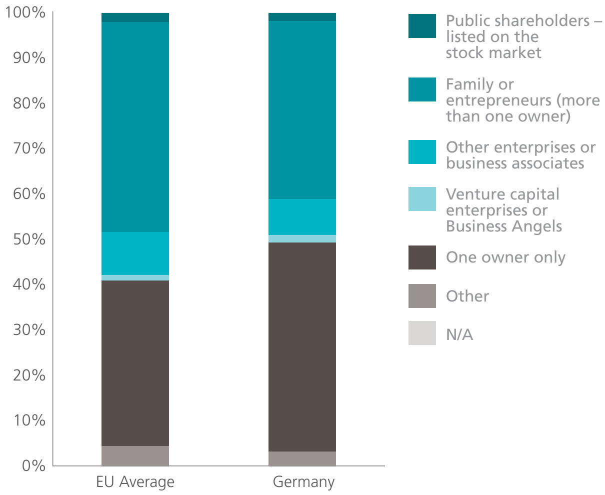
Medium-sized companies provide 20.4% of German employment; the SME sector as a whole provides 62.7%. These are respectively well above and slightly below the EU average.

The German SME sector outperforms its EU peers in access to finance, state aid and public procurement.

The German SME sector is dominated by autonomous, profit-oriented enterprises with 46% having a sole owner and 41% being owned either by families or entrepreneurs.

Figure 2

Breakdown of SME ownership in Germany as compared with EU averages



Source: SAFE

ACCESS TO FINANCE

Mittelstand financing conditions are generally reported to be excellent. According to the Federal Ministry for Economic Affairs and Energy, only 17.9% of SMEs reported last year that banks were pursuing a restrictive credit policy. This compares favourably with 42% in 2009. Adequate equity provision is reported for the sector, with the equity ratio having risen eight fold in the last 15 years. The DSGV 'Diagnose *Mittelstand* 2015 – Credit Financing or Capital Market' report identified that equity ratios for medium-sized companies had improved from 22.9% to 24.9% between 2012 and 2013. A network of regionally operated German banks continues to lend to the sector. These banks remain pre-eminent suppliers of finance, with medium-sized companies showing little appetite for alternative finance.

55% of bank executives surveyed in EY's 2015 *European Banking Barometer* expect corporate lending policies to be less restrictive over the next 12 months, with only 11% expecting the trend to reverse.

This compares with the 650 German medium-sized companies interviewed as part of EY's 2015 *European Mid-Market Barometer*, a significant number of whom who commented that they were still finding it difficult to access financing. 21% ranked access to external financing as 'fairly difficult' with 5% ranking it 'very difficult'. During 2014, 12% of companies surveyed found it was easier to access financing and 12% found it harder. A quarter of companies surveyed experienced difficultly in accessing funding for operating resources (25%), asset investments (26%) and expansion/internationalisation (29%).

GOVERNMENT POLICIES

KfW, a state-owned institution founded in 1948, is the biggest lender to SMEs in Germany. It provides both short-term and long-term loans to enterprises, either for working capital or investment.

In 2013, the German Government launched a scheme to provide investment grants to business angels. A business angel investing in a young and innovative SME can obtain a grant of 20% of the investment. The business angel must invest between €10k and €250k for a minimum of three years.

The German Government has an SME policy agenda and a national reform programme. This provides for an 'SME envoy' based in the Federal Ministry of Economic Affairs and Technology.

Government policy support measures changed recently to focus on fewer and more promising business ventures, typically high-technology related. An example of this is evidenced by changes to the '*Gründungszuschuss*,' a funding scheme for start-ups.

CENTRAL CREDIT REGISTER

Germany has a central credit register run by Deutsche Bundesbank for loans over €1.5m. The credit register collates all such reports and computes the total indebtedness of an individual borrower and then notifies the reporting institutions of the total amount of indebtedness of their borrowers.

ITALY

KEY POINTS

SMEs ACCOUNT FOR 79.6% OF ITALIAN EMPLOYMENT, WELL ABOVE THE EU AVERAGE.

79.6%

MICRO ENTERPRISES, OF FEWER THAN 10 STAFF, ACCOUNT FOR 45.8%, EVEN FURTHER ABOVE THE AVERAGE.

45.8%

BUT MEDIUM-SIZED COMPANIES EMPLOY JUST 12.7% OF THE WORKFORCE, WELL BELOW THE NORM ACROSS THE EU.

12.7%

KEY POLICY INITIATIVES TO SUPPORT THE SECTOR INCLUDE MEASURES TO ENCOURAGE THE ISSUING OF MINIBONDS.

IN MORE DETAIL

SMEs IN THE ECONOMY

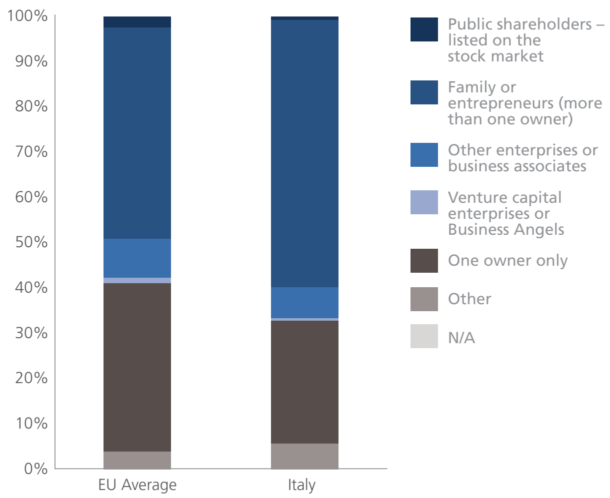
Micro enterprises are companies employing fewer than 10 staff and with a balance sheet of less than €2m. They constitute the majority of Italian industrial business. SBA reported that micro enterprises provided 45.8% of Italian employment in 2013, significantly above the EU average of 29.1%. These entities have been severely impacted by the crisis.

Medium-sized companies are an integral part of the Italian economy, providing employment for 12.7% of the workforce. As a whole, the small and medium-sized company sector contributes a total of 79.6% of Italian employment, according to SBA. These figures contrast with EU averages of 17.2% and 66.9%, respectively.

The Italian SME market is dominated by autonomous, family-owned businesses and profit-oriented enterprises; 59% of companies are owned either by families or entrepreneurs.

Figure 3

Breakdown of SME ownership in Italy as compared with EU averages



Source: SAFE

ACCESS TO FINANCE

In terms of lending to SMEs, 73% of bank executives surveyed in the EY 2015 *European Banking Barometer* expect corporate lending policies to be less restrictive over the next 12 months, with only 20% expecting the trend to reverse.

This compares with the 330 Italian companies interviewed as part of EY's 2015 *European Mid-Market Barometer*, a third of whom commented that they were still finding it difficult to access financing. When interviewed, 27% of respondents ranked access to external financing as 'fairly difficult', with 6% ranking it 'very difficult'. During 2014, 11% found it easier to access financing and 13% found it harder. Almost a third of the companies surveyed experienced difficultly in accessing funding for operating resources (28%), asset investments (30%) and expansion/internationalisation (36%).

European Central Bank (ECB) data regarding the funding mix adopted by Italian corporates in high-growth sectors shows a lower reliance on equity capital (41%) than France (57%) or the UK (55%), and a greater proportion of bank financing (35%) than France (23%) and Germany (29%).

According to the annual report issued by the Bank of Italy in 2014, bond financing represented only 10% of the total financial liabilities of domestic corporations. In particular among the Italian SMEs that obtained a bank loan in 2012, the median ratio of bank to total financial liabilities was 98%. This compared with 39.7% in Germany, 76.2% in France and 65.8% in Spain. This level of dependence on the banking sector for credit financing had particularly dramatic consequences when the credit crunch followed the 2008 financial crisis: bank lending reduced drastically.

GOVERNMENT POLICIES

Since 2012 the Italian Government has launched a number of initiatives to provide relief to SMEs looking for funding, including measures to speed up the payment of administrative debts, and to ease the repayment of debt to the public administration by permitting tax rescheduling. It has also provided a subsidised credit facility for buying or leasing new machinery, equipment and capital goods

The Italian Government has also supported measures to reduce the reliance of Italian companies on bank financing. It has aligned the taxation on Minibonds issued by private companies to that for public companies, and introduced a tax exemption for corporate income tax on interest income from debt issued by private companies. It has also homogenised the tax rate on interest accrued by investors purchasing securities in companies listed on multilateral trading facilities (MTFs) and private companies; and it has removed the ban on non-public companies issuing securities for an aggregate value above their net equity capital.

The Government has also made it easier for funds, including insurance funds, to invest in Minibonds; and has extended the options available to provide collateral against the issuance of new debt capital while maintaining use and possession of the collateral.

Finally, it has strengthened the SME Guarantee Fund ('Fondo di Garanzia per le PMI'), updating eligibility for funding, raising the financing ceiling to 80% of the cost, extending applicability to financial operations and professional services and simplifying the application procedure.

CENTRAL CREDIT REGISTER

The Central Credit Register is run by the Bank of Italy. All credit exposure above the threshold of €30,000 is reported and the Register collects and aggregates the data on the indebtedness of individual borrowers. The data can be accessed free of charge by individuals and corporates. The accuracy of the data remains the responsibility of the reporting banks and financial companies. Anyone can challenge and ask the bank to rectify incorrect information.

LATVIA

KEY POINTS

SMEs MAKE UP 78.5% OF LATVIAN EMPLOYMENT, AND MEDIUM-SIZED COMPANIES 24.7%, BOTH WELL ABOVE THE EU AVERAGE.

78.5%

24.7%

THE SECTOR HAS GROWN ACROSS ALL MARKET SEGMENTS SINCE THE FINANCIAL CRISIS.

THE LATVIAN GOVERNMENT HAS A RANGE OF POLICIES TO SUPPORT SMEs, NOTABLY THROUGH LOANS, WHILE THE EBRD IS ALSO A SIGNIFICANT ACTOR.

IN MORE DETAIL

SMEs IN THE ECONOMY

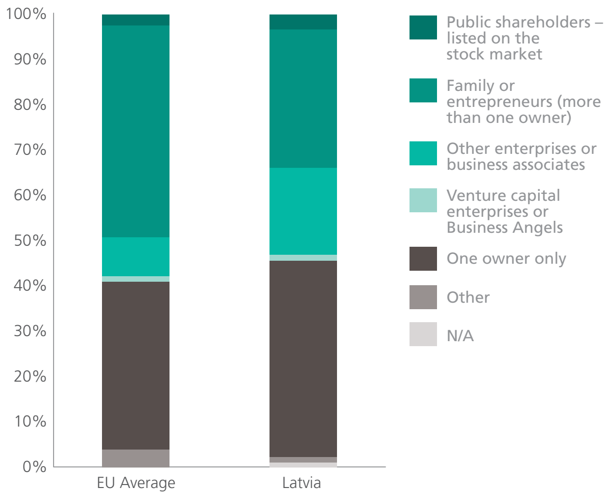
Medium-sized companies form a significant part of the Latvian economy, providing employment for 24.7% of the workforce. SMEs as a whole contribute a total of 78.5%, by comparison with the EU average of 17.2% and 66.9% respectively.

Post crisis, SME growth has occurred across all sectors, with the manufacturing sector and wholesale and retail trades providing the largest contributions to the Latvian export market. SME growth in Latvia is expected to continue at a moderate rate, primarily in domestic markets.

The Latvian SME market is dominated by autonomous profit-oriented enterprises, with 44% of medium-sized companies having a sole owner and 31% owned either by families or entrepreneurs.

Figure 4

Breakdown of SME ownership in Latvia as compared with EU average



Source: SAFE

GOVERNMENT POLICIES

The Latvian Government supports SMEs through the state-owned Mortgage and Land Bank of Latvia, which facilitates five state aid lending programmes supporting start-ups, investment and working capital.

There is also support from the Ministry of Economics, which provides loans to enterprises with high growth potential but little capital or equity; and the Investment and Development Agency of Latvia, which focuses on the development of business through increased foreign trade and direct foreign investment.

The EBRD has significant influence in the Latvian business environment, supporting medium-sized companies through its role in restructuring the Latvian financial sector and improving the competiveness of the export sector. It has supported credit recovery, and the development of private equity and mezzanine capital financing for the use of small and medium-sized companies.

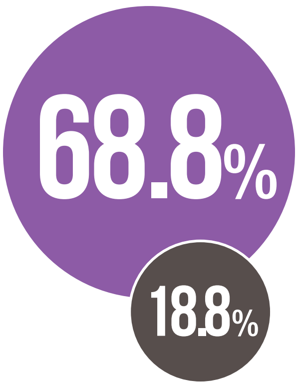
CENTRAL CREDIT REGISTER

The Bank of Latvia's credit register was established in 2008 and is a core component of the business environment. It is a legal requirement for financial institutions to provide information in respect of all types of loans, guarantees and financial obligations held by their customers.

POLAND

KEY POINTS

SMEs PROVIDE 68.8% OF TOTAL EMPLOYMENT IN POLAND, AND MEDIUM-SIZED COMPANIES 18.8%, SLIGHTLY ABOVE THE EU AVERAGE.



ACCESS TO FINANCE APPEARS TO BE BETTER THAN AVERAGE.

THE POLISH GOVERNMENT SUPPORTS THE SECTOR THROUGH SMALL GRANTS AND OTHER MEASURES, WHILE THE EIF AND EBRD ARE ALSO KEY ACTORS.

IN MORE DETAIL

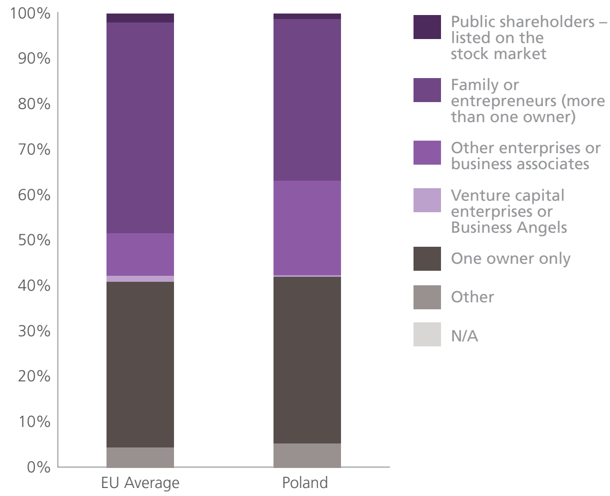
SMEs IN THE ECONOMY

Medium-sized companies are an integral part of the Polish economy providing employment for 18.8% of the workforce. SMEs as a whole contribute a total of 68.8% of employment, marginally above the EU average of 17.2% and 66.9% respectively.

The Polish SME market is dominated by autonomous profit-oriented enterprises, with 35% having a sole owner and 37% owned either by families or entrepreneurs.

Figure 5

Breakdown of SME ownership in Poland as compared with EU averages



Source: SAFE

ACCESS TO FINANCE

According to EY's 2015 Mid-Market *Barometer*, only 4% of Polish firms found it 'very difficult' to access financing through external capital and bank loans, while 20% found it 'fairly difficult'. This was significantly lower than the EU averages of 6% and 27%, respectively. EY's 2015 *European Banking Barometer* suggested that 9% of Polish firms found accessing finance easier in the previous year, while 9% found it harder. Over half of the medium-sized companies surveyed in Poland had experienced difficultly in accessing funding for operating resources (53%), asset investments (51%) and expansion/ internationalisation (59%).

Looking forward, 70% of banks surveyed in the 2015 EY *European Banking Barometer* expected to increase lending to SMEs over the next 12 months.

However, there appears to be a specific problem regarding collateral for loans. Approximately 20% of loan applications filed by SMEs in the last three years were rejected owing to lack of collateral, according to the EBRD.

GOVERNMENT POLICIES

In 2013 the Polish Government launched a programme of loan guarantees for SMEs; and it has also introduced Portfolio de Minimis, a scheme of small grants.

The Bank Gospodarstwa Krajowego, owned by the state, also provides guarantees to SMES, as collateral for the repayment of loans used to finance current operations or investments.

The EIF also supports Polish SMEs through guarantees and securitised transactions and the EBRD actively supports corporate bond issuance.

CENTRAL CREDIT REGISTER

There is no Central Credit Register in Poland, but a number of private credit bureaux collect information on individuals and sole traders.

PORTUGAL

KEY POINTS

SMEs ACCOUNT FOR 78.7% OF PORTUGUESE EMPLOYMENT, WELL ABOVE THE EU AVERAGE, BUT MEDIUM-SIZED COMPANIES, AT 15.4%, ACCOUNT FOR A SMALLER SHARE THAN THE EU AVERAGE.

78.7%

15.4%

MICRO ENTERPRISES MAKE UP A REMARKABLE 95.4% OF FIRMS IN PORTUGAL, AND ACCOUNT FOR 40% OF PRIVATE SECTOR EMPLOYMENT.

ACCESS TO FINANCE STILL APPEARS TO BE VERY DIFFICULT FOR MANY SMEs.

THE PORTUGUESE GOVERNMENT HAS INTRODUCED A RANGE OF POLICIES TO SUPPORT SMEs – LOAN AND EQUITY PROGRAMMES, TAX BREAKS AND TECHNICAL ASSISTANCE.

IN MORE DETAIL

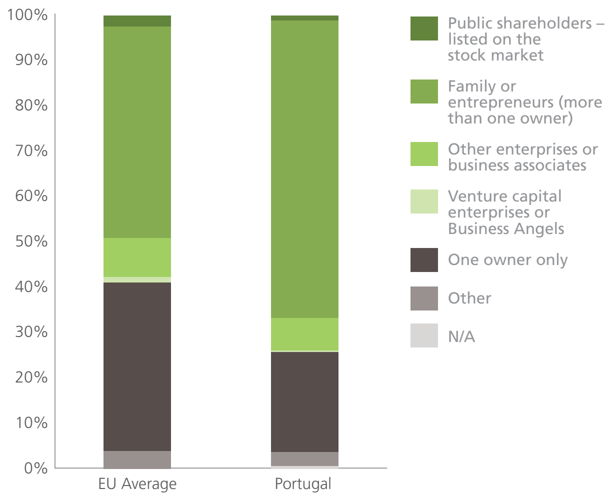
SMEs IN THE ECONOMY

Medium-sized companies are an integral part of the Portuguese economy, providing employment for 15.4% of the workforce. SMEs as a whole contribute a total of 78.7% of Portuguese employment. These figures contrast with the EU averages of 17.2% and 66.9%, respectively. Micro enterprises comprise 95.4% of firms in Portugal, who in turn generate more than 40% of private sector jobs.

The SME market is dominated by autonomous profit-oriented enterprises with 66% being owned by families or entrepreneurs.

Figure 6

Breakdown of SME ownership in Portugal as compared with EU averages



Source: SAFE

ACCESS TO FINANCE

43% of Portuguese medium-sized companies interviewed as part of EY's 2015 *European Mid-Market Barometer* reported that access to external financing was 'fairly difficult', with 6% ranking it 'very difficult'. During 2014, 10% had found it easier to access financing and 11% found it harder. Almost half of the medium-sized companies surveyed had experienced difficultly in accessing funding for operating resources (45%), asset investments (48%) and expansion/internationalisation (48%).

However, when assessing prospects in terms of turnover, medium-sized companies remained positive, with 92% of respondents expecting to either stay at current levels (34%) or grow (58%) over the short term. The 2015 *European Mid-Market Barometer* reported that 57% of Portuguese respondents believed their company performance would improve over the next six months.

GOVERNMENT POLICIES

The Portuguese Government has implemented a number of policies to improve SME access to finance, including lines of credit and tax incentives for productive investment. It has also introduced measures such as VAT by cash, to speed up reimbursement of VAT expenses, and faster settlement of debts owed to medium-sized companies by the state; and it has introduced interest-free loans which can in part be converted to cash grants on achievement of contractual goals.

IAPMEI, the state-owned Institute for Support to SMEs, has a number of support programmes for entrepreneurship and innovation; financial engineering; and support for national and international investments, through grants or loans with reduced or zero rates of interest.

Although efforts have been made to reduce the administrative and regulatory barriers to growth of SMEs, there are also some disincentives to growth. These relate to taxation, consumer or investor protection, and health and safety. For example, Portuguese companies face a 3% state surcharge on taxable profits of between €1.5m and €7.5m, which increases to a 5% surcharge on profits exceeding €7.5m.

CORPORATE TAX INCENTIVES FOR SMEs

There is a corporate income tax rate incentive for SMEs, with a tax rate of 17% applying to the first €15,000 of taxable income and a specific tax benefit for the reinvestment of profits. SMEs with annual turnover below €200,000 and total assets of less than €500,000 may also opt to be taxed under a simplified tax regime.

CENTRAL CREDIT REGISTER

The Central Credit Register, an administrative database established in 1978, is managed by Banco de Portugal. It collects information reported by institutions that extend credit facilities. The institutions can access aggregated information on the credit liabilities of each client. The reporting threshold in Portugal is one of the lowest for this type of register, at only €50.

APPENDIX: THE ECONOMIC CASE FOR A CAPITAL MARKETS UNION

The economic case for a CMU hinges on the link between credit and economic output growth via investment growth[4]. Improvements in the functioning of capital markets can improve economic outcomes by enabling a more effective transfer of funds between savers and investors. The financial system plays an important role in economies, by helping to match those who have money to invest with those who have investment opportunities to exploit (both within and across national borders), as well as facilitating risk transfer, maturity transformation and enabling price discovery. As such, the financial sector has the ability to help promote growth.

While the size of a country's finance sector is not directly linked to growth, the sophistication of a country's financial system has an important impact on economic outcomes. For example, there appears to be a critical level of financial development that is needed before economies are able to converge towards the market leader, with all economies below this level having strictly lower long-run growth rates.[5]

Similarly, the degree of financial development influences the number of trade partners that the country has, as well as how multinational enterprises structure their activities in the country.[6] What is important is not just the availability of bank-based finance, but also the availability of market-based forms of capital, with the two acting as complements rather than substitutes in their impact on economic growth.[7] Similarly, the extent of insurance market activity (which allows for risk transfer and pooling) has been linked to growth.[8]

While research highlights the role of the financial sector in long-run growth outcomes, the recent financial crisis has also emphasised the risks, leading to a desire to ensure there is an appropriate balance between promoting financial sector activity and ensuring there is adequate risk management. Even shocks affecting individual banks can have significant implications for volatility; for example, the experience of Japan between 1990 and 2010 suggests that idiosyncratic bank shocks explain 40% of aggregate loan and investment fluctuations.[9]

Improving the functioning of financial markets has the potential to help improve investment outcomes, and also growth performance, both by reducing the cost of financing and by improved matching and risk transfer mechanisms. For example, analysis suggests that tighter credit can lead to lower mean growth, through its impact on long-term, structural investments, which are typically associated with a higher liquidity risk, and therefore are both lower and more volatile in the face of credit restrictions.[10]

There is also a widespread view that funding in Europe is too reliant on bank financing relative to other options. For example, US medium-sized companies receive five times more funding through capital markets than they do in the EU and it is calculated that if venture capital markets in Europe were as deep as the US then, between 2008 and 2013, €90bn of funds would have been available to finance companies through this channel.[11] This concern is particularly acute with respect to small firms. Bank financing accounts for approximately 80% of total external funding for small and medium-sized companies (SMEs), rising to 90% in the UK when non-traditional methods like factoring and asset management are included.[12]

This reliance on bank funding is a particular concern given the sustained post-crisis reduction in bank loans. According to data from the ECB, loans by monetary and financial institutions in the Eurozone stood at €12.6T as of the end of March 2015, unchanged from a year before.

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[4] The following discussion is drawn from TheCityUK Independent Economists Group report Investment, growth and Capital Markets Union, June 2015.

[5] Aghion, P, Howitt, P and Mayer-Foulkes, D, (2005), "The Effect of Financial Development on Convergence: Theory and Evidence", The Quarterly Journal of Economics, Vol 120, 173-222.

[6] For example, the evidence suggests that firms prioritise which countries they trade with based on how easy or hard that will be. The resources they have available to establish trade links determines how far down the list they go, with only large, very productive firms trading with multiple partners in multiple countries. One of the factors that influences how easy it will be to trade with a country is the sophistication of their financial sector, so countries with a more sophisticated financial sector have more trade partners. See the discussion in Driver, R, (2014) "Analysing the case for EU Membership: How does the economic evidence stack up?", TheCityUK.

[7] See the discussion in Allen, F, and Gale, D, (2004) "Financial Markets, Intermediaries, and Intertemporal Smoothing", in Bhattacharya, S, Boot, AWA, and Thakor, AV, (eds.) Credit, Intermediation, and the Macroeconomy: Models and Perspectives, Oxford University Press.

[8] Arena, M, (2008) "Does insurance market activity promote economic growth? A cross-country study for industrialized and developing countries", Journal of Risk and Insurance, Vol 75, 921-46.

[9] Amiti, M, and Weinstein, D, (2013) "How much do bank shocks affect investment? Evidence from matched bank-firm loan data", Staff Report 604, Federal Reserve Bank of New York.

[10] Aghion, P, Angeletos, G-M, Banerjee, A, and Manova, K, (2010) "Volatility and Growth: Credit constraints and the composition of investment", Journal of Monetary Economics, Vol 57, 246-65.

[11] European Commission (2015) "Green Paper: Building a Capital Markets Union", http://europa.eu/rapid/press-release_IP-15-4433_en.htm?locale=en

[12] Ares & Co (2013) "Alternative Finance for SMEs and Mid-Market Companies", TheCityUK.

Prior to March, bank lending had experienced year-on-year contractions for 27 consecutive months.

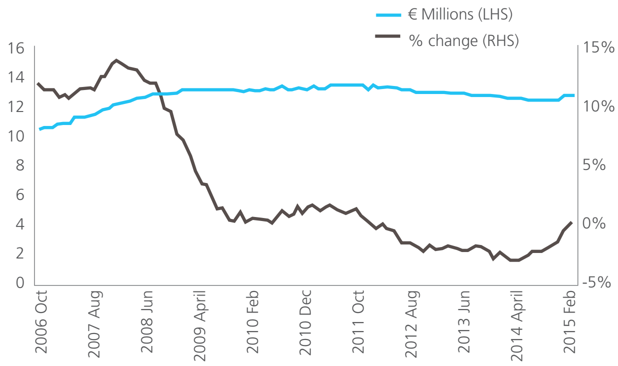
It does, however, seem probable that bank lending has been held back by weak demand. Some corporates may have been reluctant to take on more debt, given uncertain economic times. Other companies may have been judged as poor lending cases, given existing levels of debt and concerns about capacity to service higher levels. By the same token, regulators have pressed banks to repair their balance sheets, including by selling assets, and have increased capital requirements. All of these have contributed to restricting the availability of credit.

However, despite this continuing squeeze, the latest European Commission/ECB survey on the access to finance of enterprises in the euro area[13] reports that access to finance was not among the issues of highest concern to Eurozone firms as a whole. Plus perceptions of access to finance had improved relative to the previous survey. However, micro, small and medium-sized companies consistently report access to funding as more of an ongoing difficulty than larger firms.

Although a range of factors beyond access to finance, including political risk and uncertainty around the economic outlook, are currently constraining investment across the EU, deeper and more integrated capital markets could spur investment by two particular types of European company; small firms that often have the most growth potential; and innovative firms, which, contrary to popular perception, are often larger firms.[14] A key predictor of how

Figure 7

Euro area, lending to non-monetary and financial institutions excluding general government

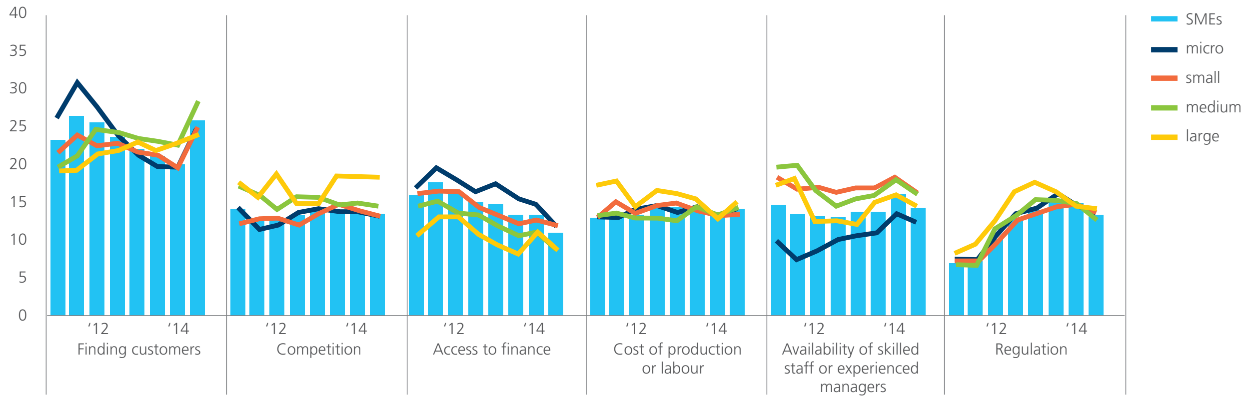


Source: ECB

Figure 8

The most important problems faced by euro area enterprises

(percentage of respondents)



Source: Survey on the access to finance of enterprises (SAFE)
Base: All enterprises. Figures refer to rounds five (April-September 2011) to 12 (October 2014-March 2015) of the survey.
Note: The formulation of the question has changed over the survey rounds. Initially, respondents were asked to select one of the categories as the most pressing problem. From round eight, respondents were asked to indicate how pressing a specific problem was on a scale from 1 (not pressing) to 10 (extremely pressing). In round seven, the formulation of the question followed the initial phrasing for half of the sample and the new phrasing for the other half. Additionally, if two or more items had the highest score in question Q0B on the 'pressingness' of the problems, a folow-up question (Q0C) was asked to resolve this, i.e. which of the problems was more pressing, even if only by a small margin. This follow-up question was removed from the questionnaire in round 11. The past results from round seven onwards were recalculated, disregarding the replies to question Q0C. In round 12, the word 'pressing' was replaced by the word 'important'. Please see Annex 3 for more information on the changes introduced to the latest version of the questionnaire.

[13] European Central Bank, Survey on the access to finance of enterprises in the euro area, June 2015

[14] The following discussion is drawn from TheCityUK Independent Economists Group report Investment, growth and Capital Markets Union, June 2015.

innovative a firm is, is the extent to which it is engaged in international markets. Firms that engage in foreign direct investment, outsourcing or exporting are typically more innovative than their domestically-focused rivals. Indeed, the more complex these international relationships are, the more innovative and productive the firm itself. It is also, of course, more likely that large firms will engage in international markets, not least because of the cost of market entry. So it is larger, more internationally engaged firms that tend to be the most innovative, not their smaller rivals.[15]

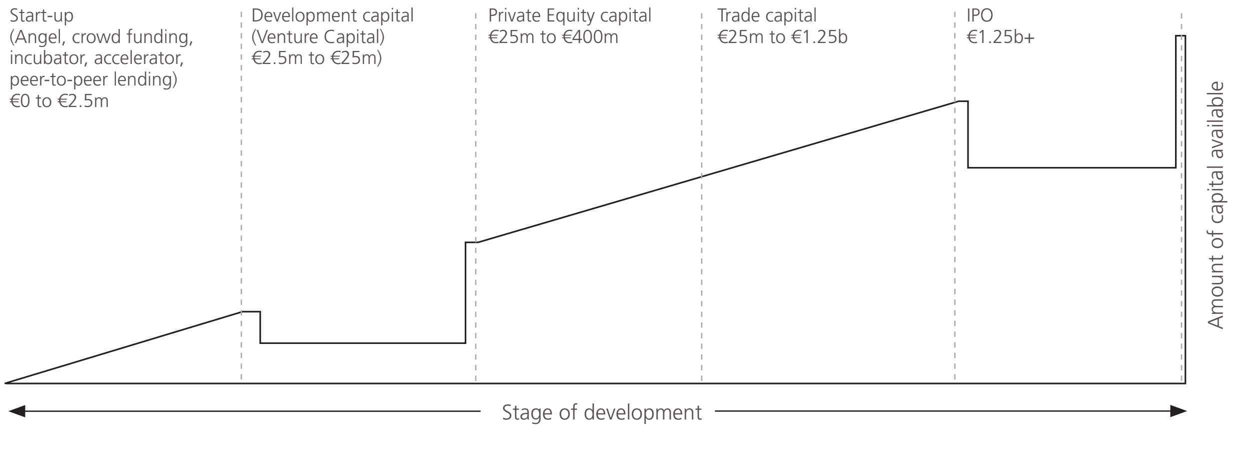
To identify the particular areas where deeper capital markets can improve economic outcomes by supporting the growth of high-potential small firms and firms with high levels of innovation, it is helpful to look at the typical 'investment chain' for businesses that can be seen, with local variations, across the EU. The diagram below outlines the basic model.

One example of local variation is the difference in access to venture capital. In France, for example, venture capitalists would usually be involved in deals from €500k up to €5m, with private equity houses operating at deal sizes starting at €3m – colloquially referred to as 'post -venture PE'. The French corporate finance market lacks some financing for the post-venture phase, which has been seen as 'death valley' for start-ups. This is explained by the lack of profitability of this segment. It typically comprises small deals made by small funds with small fees in absolute terms and a relatively high level of mandatory expenses in respect of the regulatory requirements for expertise within each fund. It is more normal to invest in bigger deals with larger funds, achieved with the same sized team.

Figure 9

The investment chain

The schematic below maps the stages of an entities development to the availability of capital in Europe
From our review of the investor landscape we believe there is a shortage of European capital at the development (VC) and IPO stages



Source: EY analysis

[15] See, for example, the discussion in Driver, R, (2014) "Analysing the case for EU Membership: How does the economic evidence stack up?", TheCityUK; Harris, R, and Li, QC (2007) "Firm Level Empirical Study of the Contribution of Exporting to UK Productivity Growth", UKTI; and Altomonte, C, Aquilante, T, Békés, G and Ottaviano, G.I.P (2013) "Internationalization and innovation of firms: evidence and policy", Economic Policy, Vol 28(76), 663-700.

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