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European SMEs’ struggle to raise equity capital

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Small and medium-sized European businesses find it hard to raise capital, especially during their development phase. This column compares the situation in the US and Europe and suggests that many SMEs in Europe still face significant difficulties in identifying and accessing sources of funding. Promoting greater equity involvement and improving access to and information on all of the various funding options would do much to boost growth.

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SME growth is firmly on the EU political agenda and has been heavily underscored in the European Commission’s Capital Markets Union (CMU) action plan (European Commission 2015). The reason is simple: throughout the EU, small and medium-sized businesses – which make up 99% of all companies in the region – are struggling to raise capital, particularly during the critical development phase.

Part of the problem is a general lack of awareness about the various sources of funding available. European small businesses tend to lean heavily on financing sources such as banks, and are often unaware of the existence of additional funding sources. Data from the Association for Financial Markets in Europe’s *Bridging the Growth Gap* report show that three times as much bank lending is provided to EU SMEs compared to their US equivalents (AFME and BCG 2015, p. 9).

Figure 1. Sizes and sources of financing for SMEs in Europe and the US

		Source	Stock (of outstanding financing) US (€B)	Stock (of outstanding financing) EU (€B)	Flow (of new financing in 2013[1]) US (€B)	Flow (of new financing in 2013[1]) EU (€B)
SME	Banks	Loans	464	1,425*	281*	712
		Securitised loans	30	118	5*	36
		Bonds/Equity[2]	Desk research and investor interviews indicate only marginal investments			
		Subtotal	494	1,543	286	748
	Non banks	Mutual funds	107	88	10	7
		Segregated Mandates	~5	~10	~1	0
		Pension Funds[3]	Desk research and investor interviews indicate only marginal investments via funds, mandates or securitisation			
		Insurance[3]				
		SWF[3]				
		Private Equity Funds	59*	32*	14*	9*
		Venture Capital Funds	104*	22*	26	5
		Family and friends	371*	168*	186*	84*
		Crowdfunding	3*	1*2	1	1
		Angel Investing	39*	11*	20	6
		Subtotal	688	332	258	112
	Government	Government guarantees and sponsored loans	54*	132*	27	66*
		Subtotal	54*	132*	27	66*
		Total	1,236	2,007	571	926

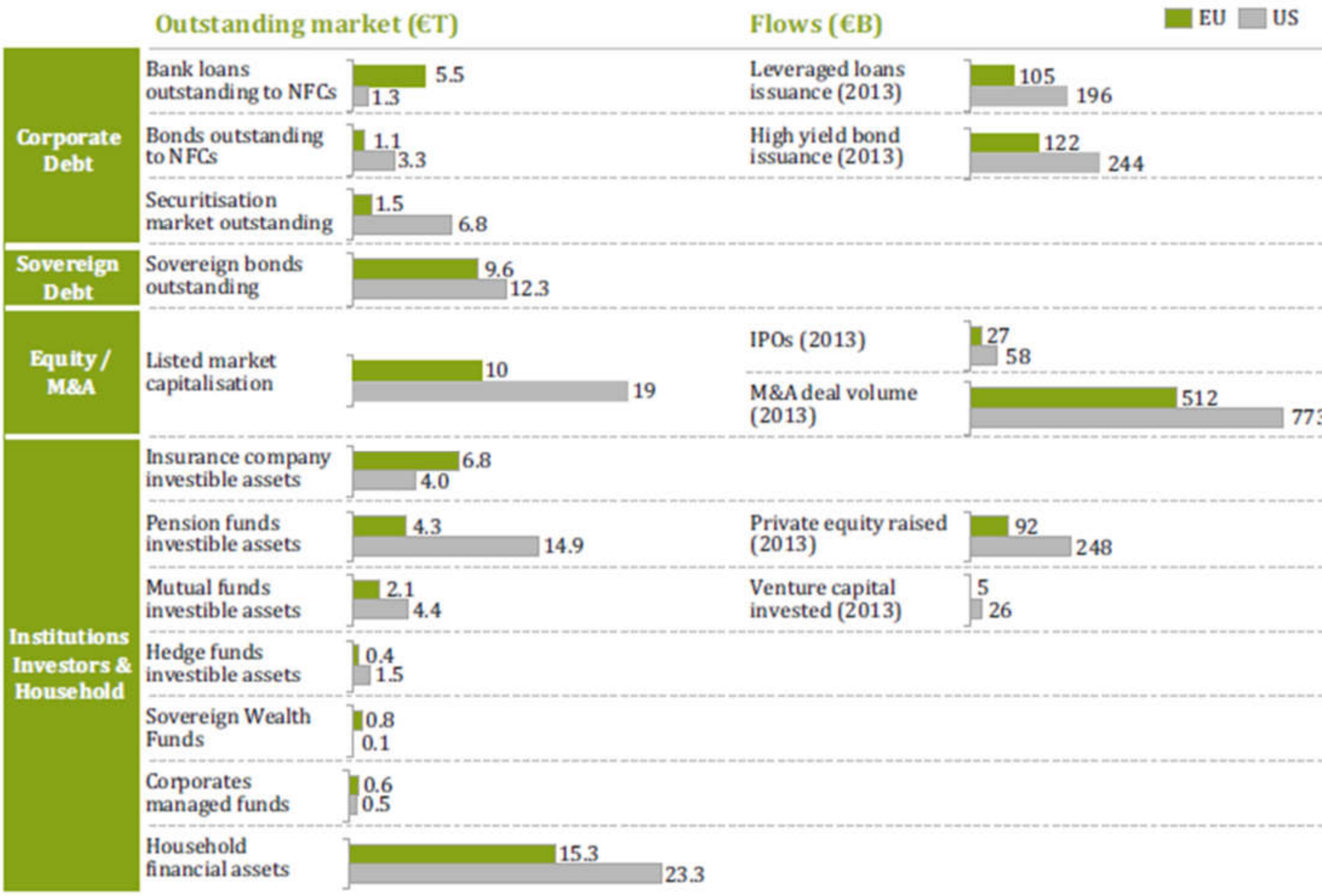
Sources: AFME and BCG 2015, Appendix 2. Please note that the table excludes the funds provided to SMEs by their owners through their own personal wealth.

This higher reliance on term lending has led to a lack of other sources of financing – such as venture capital and angel investing – being fully developed for SMEs in the EU. Yet, for start-ups or growing companies with negative cash flows, equity finance may be more suitable than loans.

Indeed, European SMEs are lagging behind their US counterparts in developing more diverse funding options. Currently, two thirds of EU SME business finance is bank-led, while in the US the majority of SMEs rely on other forms of finance than bank debt, including capital markets finance.

This could be due in part to the fact that Europe's savings market structures are less geared towards equity investing. EU pension funds provide a mere €4.3 trillion in investable assets, compared to €14.9 trillion in the US (see Figure 2).

Figure 2. European Union and the US: Different structures and sources of finance



Note: Illustration only – not exhaustive.

Source: AFME and BCG 2015, Appendix 1.

At the same time, Europe's SMEs also have trouble knowing where to find public funding, particularly cross-border funding. The multitude of financing available and the fragmented nature of pan-European support measures often make it difficult for SMEs to access funding opportunities.

Encouraging diversity in SME funding

The challenge for Europe is a structural one. In this respect, drawing some comparisons with the US market is a useful exercise, particularly given that the two regions have a similar annual GDP of around €17 trillion. However, it is important to bear in mind that the EU markets are different to those in the US and should be developed based on the different values and economic and political structures of Europe.

The US benefits from greater diversity and flexibility of funding sources. US private pension funds play a bigger role and their appetite for risk is greater than in Europe.

For example, they invest more in the equity asset class than their European peers (53% of funds managed in the US versus 37% in Europe).

In the US, friends, family, and other private investors provide 33% of SME financing, compared with just 9% in Europe. And in 2014, business angels in the US invested €19.9 billion in SMEs compared to only €5.5 billion in Europe (EBAN 2014).[1,2] The private equity and venture capital (VC) sector is also less developed in Europe. For instance, venture capitals invested €43 billion in US SMEs in 2014 compared to only €9 billion in Europe (EY 2015).

Venture capitals and business angels play a valuable role in the rapid evolution of the latest-generation entrepreneurial companies in the US. In addition to capital, they help with strategy and business contacts. Often, their expertise is invaluable to young businesses. In this respect, properly structured and regulated crowdfunding is important too, particularly for the smallest of SMEs.

It is clear that the EU needs to encourage more diversity in its SME funding landscape – in particular through capital markets – in order to improve access to market-based funding sources at all stages of SMEs' development. However, while it is interesting to draw comparisons with the US, Europe must adapt SME funding to the specificities of the EU market.

Cross-border funding opportunities

Another barrier for SMEs is identifying and accessing cross-border funding opportunities, despite the fact that many governments and pan-European institutions provide extensive loan and equity support.

For example, public institutions provide funding and advice to small businesses in a number of EU member states. In France, the public investment bank Bpifrance offers a number of initiatives for SMEs of all sizes, from *prêts de developpements* of up to €5 million with no security or guarantee to*aides à l'innovation*, including *prêts d'amorçage* (start-up loans) from €50,000 for SMEs involved in innovative projects. The key is knowing that these options are available and where to find them.

Then there are also pan-European support initiatives provided by the European Investment Bank and the European Investment Fund, which provide funds to partner intermediaries such as banks, private equity funds, and microfinance institutions in each member state.

So the funding opportunities are there, but for European SMEs looking to expand across borders, for example, it is not always easy to navigate the different funding sources offered by 28 member states and their individual treatment of tax on debt and equity. A more comprehensive and flexible approach to SME financing in Europe could thus be beneficial to growth.

Concluding remarks

It will be interesting to see how the Commission's CMU proposals improve access to finance for SMEs. Encouraging a culture of risk-taking and innovation among both SMEs and investors will be vital to this. Similarly, promoting greater equity involvement and improving access to and information on all of the various funding options will do much to boost growth. We hope that our information gathering on all of the various funding options will help (AFME 2015).[3]

References

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Footnotes

1 Center for Venture Research, University of New Hampshire, 2014

2

3 AFME (2015) "Raising finance for Europe's small & medium-sized businesses , October.