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Market Structure

Bringing SME back into Capital Markets -
Solving the SME conundrum

Part One: IPOs – The backbone of SME eco-structure

April 19, 2021

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As the mainstay of many major economies, small- and mid-cap businesses have a critical role to play in the post-pandemic recovery. In the US, small firms were responsible for 63% of net new jobs created between 1993 and mid-2013, or more than 14 million of the nearly 23 million net new jobs created during this period.[1,2] Similarly, SMEs accounted for 99.8% of all enterprises in the EU non-financial business sectors and represented 66.6% of total employment.[3] As a result, governments globally are looking to stimulate re-equitization and boost investment in SMEs; the question is how best to achieve this objective.

In this four-part series, *Solving the SME Conundrum*, we look at the challenges facing SMEs and their access to capital markets. In Part One we explore the reasons why primary markets are a critical component of a successful SME ecosystem and what needs to be addressed to encourage further SME growth.

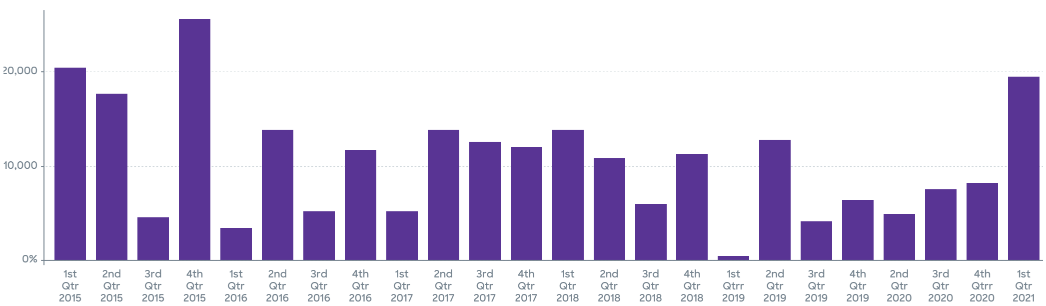
Stimulating SME Success

Increased governance and accountability lead to more transparent and better run companies, boosting the appetite for investment in these companies which fuels growth and innovation. Greater share ownership improves the democratisation of wealth creation which is better for society as a whole. But while a flurry of IPOs in 2020 and early 2021 in Europe reversed years of decline in the number of listings (*see Exhibit 1*), the question is whether the sudden increase can last and what the future of IPOs will be. The recent difficult debut of Deliveroo, a food delivery service, resulted in the underwriter, Goldman Sachs, being forced to buy £75M worth of shares to prop up trading after the company's market valuation fell from £7.6B to £5.1B. The IPO seemed to take place too late to capitalise on the tech stock surge of 2020, yet too early to benefit from the UK change in listing rules.[4]

The recent surge in IPO activity is not specific to Europe and also occurred in the US.[5] However, IPOs conditions are changing rapidly and while listing on public markets used to be considered a successful path for SMEs to raise new capital, this is now being challenged by the rise of alternatives to IPOs. In the US, traditional public IPOs are rapidly being outpaced by Special Purpose Acquisition Companies (SPACs) enabling firms to raise capital through private funding. In 2021, SPACs now represent almost 75% of IPOs in the US (*see Exhibit 2*). However, the SPAC boom may soon be over. Aside from growing regulatory concerns, the sheer volume of transactions and rising valuations are impacting access to "pipe" (private investment in private equity) financing to complete SPAC acquisitions—according to recent data 497 SPACs are still looking for a deal.[6] The SEC intends to review forward looking statements given to investors which according to the SEC, are "overstated at best, and potentially seriously misleading at worst."[7] The rise in regulatory concerns globally will force the industry to address the heart of the problem: how to make IPOs more attractive and profitable for SMEs.

Exhibit 1

European IPO activity (including UK)



Note: IPO proceeds in millions of dollars equivalent

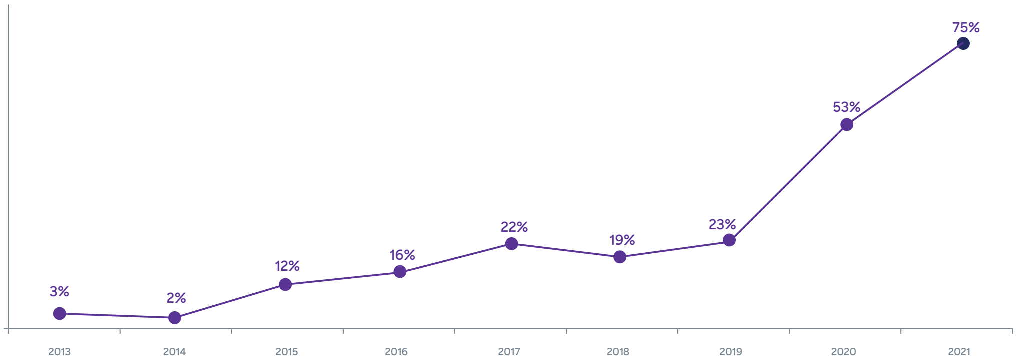
Source: Refinitiv

1 https://www.sec.gov/news/statement/helping-small-businesses-and-protecting-investors.html
2 https://cdn.advocacy.sba.gov/wp-content/uploads/2020/06/04144224/2020-Small-Business-Economic-Profile-US.pdf
3 https://ec.europa.eu/docsroom/documents/38365/attachments/2/translations/en/renditions/native
4 https://www.ft.com/content/bf75f260-33d8-42ea-85c3-6482aa1fb2ff
5 https://tabbforum.com/opinions/a-record-pace-for-ipos/
6 https://www.ft.com/content/19c021a5-a758-489e-875a-de5c99bbfbfe
7 https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws

Exhibit 2

SPACs as a percentage of US IPOs 2013-21

Market Share by Number of US-listed SPACs vs all US IPOs



Source: NASDAQ website and SPAC Research

While policy makers look to stimulate greater equitization and reverse a multi-decade decline in traditional initial public offerings, the rise in alternative sources of funding—private equity and venture capital as well as cheap debt—alongside increasing governance and regulatory obligations for companies and the listings ecosystem are hampering progress in investment in SMEs.

There are short-term immediate changes such as tax incentives that could make listings on public markets more attractive than debt, but the debate about what to address first and whether or not improving listings will ultimately deliver greater investment in SME is subject to debate. Differing views depend on where you are on the globe and the different obstacles affecting the issuer, the intermediary, and the investor.

UK Focus on Listings

In a report published in 2019,[8] the FCA outlined its first conclusion as to the impact of unbundling on the market and in particular on SMEs. Despite initial concerns, it appears that buy-side firms still have access to the research they need, and the majority of firms have not seen a decline in SME research (more to come on Research in Part Two of this series). It is unlikely the FCA will adopt the relief on unbundling for SMEs promised by Europe under MiFID II but will rather watch developments and the impact of such policy change on the market to ensure UK firms are not left at a disadvantage. Instead, the UK is focusing on making listings more attractive post-Brexit by rethinking the broader listing framework and tax incentives for equities. The UK objective[9] is to reduce the leakage of high growth UK companies deciding to list in the US, focus on sectors where the UK has a clear advantage such as the fintech and advanced manufacturing sectors while targeting regions where the UK already has a strong share of international listings such as in EMEA and Central Asia, where local markets may not be able to accommodate IPOs for larger companies.

The Biden Effect

Source: Vice President Kamala Harris Twitter account

Between January and September 2020, the number of small businesses in the US decreased by 27%.[10] In a recent speech on the importance of small businesses, President Biden noted how the impact of Covid-19 is disproportionally negatively impacting the sector. In absolute

8 https://www.fca.org.uk/news/press-releases/fca-finds-mifid-ii-research-unbundling-rules-working-well-investors
9 https://www.gov.uk/government/news/independent-review-recommends-reforms-to-uk-listing-rules-to-boost-growth-and-markets
10 https://www.sec.gov/files/2020-oasb-annual-report.pdf

terms, it is estimated that since the beginning of the pandemic 400,000 small businesses have had to close and millions are hanging by a thread.[11] Yet, these small businesses, representing 90% of businesses in the US,[12] have not been sufficiently shielded by the Paycheck Protection Program, which primarily benefitted bigger companies. The Biden administration is accelerating policies to improve support for SMEs including the American Rescue Plan that commits $50 billion to hardest hit small and mainstream businesses. The new administration has also voiced plans to encourage greater employee share ownership.[13] Gary Gensler, who built his reputation as Chair of the CFTC and has now been confirmed by the US Senate as the new SEC Chairman, is likely to push for a strong agenda including greater consumer protection (in particular following the Robinhood and GameStop issue) focusing on improving investor disclosures, whether in relation to ESG[14] or SPACs,[15] as a means of shoring up investor confidence. The SEC has also recently announced amendments to Regulation A exemptions as a means to stimulate greater investment in SMEs providing companies with a streamlined and less costly way to raise capital, so long as they provide the investing public with certain critical disclosures about the company and the securities being offered.[16]

According to the report from the US National Bureau of Economic Research,[17] it appears that minority- and women-owned businesses have also been disproportionately impacted by the pandemic due to an inability to attract the right investments from banks. Capital raising is more challenging outside of traditional investing hubs, as well as for women and minority founders whose networks are less likely to be high-net-worth.[18] Many women and minority founders find themselves pitching to investors and fund managers but do not "pattern match" with those investors' notions of successful entrepreneurs. This not only raises the question of pre-existing bias in capital markets and the notion of what is considered a profitable investment, but it also challenges current practices of matching investors with investees. Greater use of technology could help improve the mapping of investments; while investors in large caps will have limited interest in investing in a small company, fund managers able to take more risk or impact funds invested in supporting communities could potentially be a better match.

"Any review in Europe of the IPO process is still absolutely stuffed to the girders with self-interest. Banks view putting together a book as an art form and any move to automation would be the death knell of the art of syndication—irrespective of the reduction in errors or reducing unnecessary risk, it's the same resistance to change, which has nothing to do with whether automation is right, but just about protecting vested interests."

Head of Trading
UK Medium-sized Asset Manager

EU: Support for CMU

As part of the post-Covid-19 recovery package, the European Commission is looking to further accelerate the integration of European capital markets through the Capital Markets Union (CMU). This initiative is deemed essential to facilitate businesses' access to capital raising opportunities across the EU, in particular for SMEs and bolster their re-equitisation post-Covid instead of the historical reliance on bank lending. One of the recent measures put forward by the European Commission takes the form of the European Single Access Point (ESAP) that aims to make companies more visible to investors across Europe by publishing a wide array of financial and non-financial information and lowering the cost of capital. One other area of focus for Europe remains increasing the research coverage of SMEs by creating a consortium of firms that will support the production of SME research while finding new ways to facilitate the co-financing and sharing of research reports among investors.[19]

Key Areas for Policy Makers to Address

The growing electronification and automation of equities in the last decade alongside enhanced analytics based on machine learning has improved access to information pre-, at-, and post-trade. However, the arrival of Brexit and subsequent shift in liquidity formation is set to challenge recent success in trading SME, necessitating further innovation and automation in sourcing liquidity.

While improving secondary market liquidity is one important aspect to ensuring greater investment in SMEs, enhancing access to research is another. Not a reversal to traditional analyst coverage but improving access to company information—both financial and non-financial data—by digital means to optimise company exposure to investors across a more diverse base.

11, 12 https://www.whitehouse.gov/briefing-room/speeches-remarks/2021/02/22/remarks-by-president-biden-on-helping-small-businesses/
13 https://www.sec.gov/news/press-release/2021-14
14 https://www.sec.gov/news/public-statement/lee-climate-change-disclosures
15 https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws
16 https://www.sec.gov/news/statement/helping-small-businesses-and-protecting-investors.html
17 https://www.nber.org/system/files/working_papers/w27309/w27309.pdf
18 https://www.sec.gov/news/speech/miller-car-talk-capital-raising
19 https://www.accountancyeurope.eu/finance-investment/removing-barriers-to-support-smes-the-cmu-initiative/

1. Automating the IPO Process

Equity execution is now heavily automated, facilitating greater use of technology within the execution process—whether that is the use of Watch Lists to help PMs uncover liquidity, Targeted Invitations to identify previous holders with those looking to buy or sell in the dark; or the use of Investment Analytics to improve the timing and means by which to trade.

Although secondary markets make use of new technologies on a daily basis, primary markets are often left behind. Too often, companies end up pitching to the wrong investors, making an already laborious and expensive process discouraging for investees looking to raise capital. This is where new initiatives such as PitchBook,[20] which leverages technology to help match the right investor to the right investee, will improve the chances of it being more profitable for a company to go public.

The IPO process itself remains highly manual with allocations received based on the relationship asset managers can maintain with bulge bracket banks, the "underwriters." While some will argue that unbundling needs to be rolled back as it negatively affects investments in SMEs, one could argue that it actually needs to be extended and should focus on unbundling execution services as a whole. This is particularly relevant given asset managers are still forced to provide execution volumes to investment banks in order to remain on the 'list' and be considered for primary allocations. Automating the allocation process would reduce the risk of unnecessary errors both in IPO allocations and secondary placing applications.

2. Adjusting Listing Requirements

Free float is also often cited as a critical point to address to increase investment in SMEs. Suggestions by policy makers[21] to amend the Listing Directive to alleviate the requirement for National Competent Authorities (NCAs) to ensure that a sufficient number of shares of SMEs are distributed to the public through the stock exchange could be counterproductive and make investment in SMEs less appealing given the resulting liquidity risk. A minimum level of free float is desirable as companies with low free floats tend to experience high share price volatility as reduced liquidity makes it harder for shares to be bought or sold without impacting the price.

Instead of looking to reduce the required free float, regulators could ensure that a certain threshold is set for all SMEs across Europe which could be reached overtime, increasing liquidity and investments as a result. The main barrier for companies is to book-build as a single event in one day to reach the required 25% free float threshold.[22] A possible solution could be to retain a percentage-free float requirement but expand this to consider whether a company is likely to be sufficiently liquid in the aftermarket to ensure a more graduated approach.

3. Addressing the rise in IPO Alternatives

The lack of investments to further automate the IPO process and make it more accessible to all companies, regardless of their size, is forcing some organisations to look for alternatives. From private equity funding and bypassing the IPO process in its entirety to direct listings which enable firms to reach a broader range of investors and improve liquidity options for its existing shareholders, such as Slack in 2019 or Spotify in 2018.[23] While SPACs raise regulatory concerns over investor protection and are currently under review by the SEC,[24] the FCA[25] is also looking as part of its consultation on listing rules to implement minimum safeguards such as a minimum market capitalisation and a redemption option for investors to make these vehicles safer. The popularity of SPACs in Europe is de minimis relative to the US. There have only been 10 SPAC listings in Europe in 2020 and 2021 compared to 522 in the US,[26] partly due to the relative maturity of companies in Europe before they go public. However, the underlying message could not be clearer, the appeal to look at alternatives means the current IPO process may no longer be fit for purpose. Future IPOs may not take the form of traditional IPOs given the heightened risk with regards to investor protection however the current model needs to be challenged more than ever to provide for an effective re-capitalisation of companies post-Covid.

20 https://pitchbook.com/
21 https://www.gov.uk/government/news/independent-review-recommends-reforms-to-uk-listing-rules-to-boost-growth-and-markets
22 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32001L0034&from=EN
23 https://corpgov.law.harvard.edu/2019/12/17/evolving-perspectives-on-direct-listings-after-spotify-and-slack/
24 https://www.sec.gov/news/public-statement/munter-spac-20200331
25 https://www.fca.org.uk/news/statements/future-consultation-strengthening-investor-protections-spacs
26 https://www.reuters.com/article/us-spacs-europe-insight-idUSKBN2BL0FQ

4. Improving Transparency

In addition, firms themselves are recognising the need to make themselves more attractive in terms of what they offer. There is an argument that the failure of Deliveroo's IPO was partly due to poor market timing as lockdown restrictions start easing in the UK, reducing the appetite for takeaway food as restaurants and pubs reopen, but another reason is the "S" within ESG. The sub-par social conditions that employees work under are challenging for asset managers looking to transition their investments to ESG-compliant companies. The pandemic has increased awareness around the importance of management of human capital. The recent verdict by the UK Supreme Court that Uber drivers must be treated as workers entitled to a minimum wage and holiday pay rather than self-employed,[27] set a new precedent as ESG investing moves mainstream.

The "G" where the voting rights potentially impact index inclusion is also coming under scrutiny. Recently BlackRock called for a review of index providers who exclude certain companies from broad market indices due to governance concerns.[28] Although the asset manager noted some entrepreneurs' desire to maintain control of their company following an initial public offering (as the case with Deliveroo), there is an argument that companies should receive shareholder approval of their capital structure on a periodic basis via a management proposal on why the current capital structure is best for the company and its shareholders. Addressing the policy debate around voting rights will appropriate accountability to investors while also encouraging capital formation and opportunities for long-term value creation. Growth of SME companies is not just ensuring a successful IPO but also building a base of longer-term investors focused on a firm's future viability.

Next in this four-part series, we will be exploring the potential outcome of rebundling research and its impact on increasing investment in SMEs.

27 https://www.bbc.co.uk/news/business-56123668
28 https://www.blackrock.com/corporate/literature/publication/blk-a-potential-solution-for-voting-rights-and-index-inclusion-issues-october2017.pdf

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