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Market Structure

Bringing SME back into Capital Markets -
Solving the SME conundrum

Part Two: Is rebundling research the answer?

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Less SME research is perceived as leading to less investment in SMEs, less secondary trading liquidity, and ultimately fewer IPO listings across the Union.[1] The relaunch of the Capital Markets Union[2] to support the recovery of the real economy post-Covid—and SMEs in particular—centred on reducing red tape, such as making changes to prospectus regulation, improving access to capital, and encouraging greater retail activity to develop and strengthen the investor base. The solution from European policy makers to counter the decline in SME investments is to allow for an exemption from the current research unbundling requirement if brokerage and research provision pertain to issuers with a market capitalisation below €1B.[3]

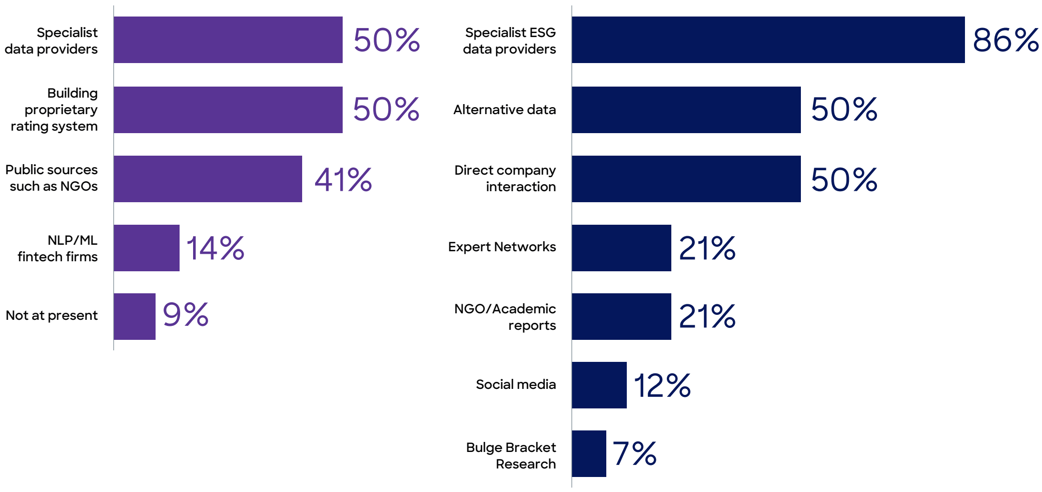
The UK is also considering rebundling as a way to increase SME coverage, but for SMEs with a market capitalisation of up to £200M only, together with exempting independent research providers from the inducement rules.[4] From FCA analysis,[5] nearly 80% of publicly traded companies with a market value of £250M or less, either have zero coverage or they are only covered by one analyst. The FCA note that there may be negative consequences from rebundling research and execution services, including reduced price transparency. But as demand for SME research is limited, the FCA anticipate inducement risk to be limited. Interestingly they also note that research alone may not be sufficient and are planning broader changes to improve SME access to markets.

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 looked at the importance of IPOs in the SME eco-structure, in Part Two we explore the potential outcome of rebundling research and its impact on increasing investment in SMEs.

While the new rules would only be optional, the question is whether rebundling research payments will increase research coverage on small- and mid-caps, particularly as a number of asset managers have already stated that they are unlikely to reverse course due to the operational difficulties of separating large and SME flow. The requirement to set up an annual research budget based on market cap when a company's market cap is a dynamic concept that constantly evolves makes this impossible to reconcile with an annual research budget. The rising focus on ESG and the need for greater non-financial data in the decision-making process is also altering what information is required and from whom, reshaping what constitutes research in the process (*see Exhibits 1 and 2*).

Exhibits 1 and 2

What new non-financial metrics do you now include in the investment process? 2019 vs. 2020



Source: Liquidnet Outreach June - September 2019/Liquidnet Outreach December 2019 - February 2020

1 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/2020-mifid-2-mifir-review-consultation-document_en.pdf
2 https://eur-lex.europa.eu/resource.html?uri=cellar:61042990-fe46-11ea-b44f-01aa75ed71a1.0001.02/DOC_1&format=PDF
3 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CONSIL:ST_13232_2020_INIT&from=EN
4, 5 https://www.fca.org.uk/publications/consultation-papers/cp21-9-changes-uk-mifid-conduct-organisational-requirements

The planned review and replacement of the Non-Financial Reporting Directive (NFRD) with the Corporate Sustainability Reporting Directive (CSRD)[6] will only increase the need to access non-financial data for investment decisions. The directive could capture up to 50,000 companies operating in the EU to report Non-Financial data, up from the current 11,700[7] companies currently subject to NFRD today. The change will further transform the type of insights asset managers will need to take into consideration, yet another sign that solving the SME problem by yesterday's methods will be insufficient for what is now required.

In an environment of shrinking margins, the ability to optimise research budgets by understanding what services have been consumed, at what cost and whether these services are worth continuing to pay for, means there is currently little appetite to reverse the level of transparency that unbundling provides. In addition, it is unlikely that end investors will accept the rebundling of research payments as well as having to pay for the research bill when investing in SMEs, putting these companies at a disadvantage. The EC and UK rebundling proposals could inadvertently have the opposite of its intended effect and deter investors from investing in small- and mid-caps.

In a recent analysis published,[8] ESMA looked at the impact of MiFID II on SME research coverage and established that the probability of a SME completely losing coverage did not increase post-unbundling, nor did the quality of research worsen. The EU regulator acknowledged that coverage of SMEs remains much lower than for large caps, but this was not a factor of unbundling, rather that the coverage was mediocre to start with. However, ESMA emphasised that the liquidity conditions of SMEs have deteriorated in comparison to large caps due to wider spreads, reinforcing the fact that regulators need to address secondary market liquidity to truly promote greater investments in SMEs.

The FCA recognised[9] that while the majority of corporate issuers had not seen a decline in the coverage of their companies, some have concerns over the future provision of research given increasing staffing and resources constraints on the sell-side. Yet, the FCA acknowledge that research alone will not solve the SME conundrum and liquidity needs to be taken into consideration. Low research coverage often affects micro and small companies where volumes traded remain thin, making it uneconomical for the sell-side to support research to maintain liquidity. However, at the same time, it is perceived that the lack of information on companies with a sub-£250M market cap acts as a deterrent for asset managers and result in wider spreads, 4.9% on average, compared to AIM and FTSE 100 companies with a bid-ask spread at 1.2% and 0.8% respectively.[10] As a result, it is likely that both the UK and EU will continue to review trading conditions for SMEs given the FCA's comments[11] that it will consider improvements on how these companies access capital markets, *"including the possibility of alternative venues that are better tailored to smaller companies."* The paper also refers to AIM stocks where analyst coverage slightly increased since MiFID II. We will be exploring the theme of liquidity in the next paper in this series.

What is now needed to invest?

Traditional research as a standalone product is no longer sufficient. Unbundling has allowed asset managers to re-assess the type of research they need and has led to greater data intake as part of the investment process. The pandemic is accelerating that transformation by redefining what constitutes research and relevant distribution channels.

The Do-It-Yourself (DIY) trend that is gaining traction does not make research redundant but rather reinforces the need for research providers to deliver value to their investors, information that they don't know yet and cannot access via the internet or their direct connection to the company and in a format that can be easily digestible by retail investors. Where brokers have long relied on emails to distribute en-mass their new research reports, a paying client will increasingly require a more tailored service that will meet its specific needs.

6, 7 https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en
8 https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1269_research_unbundling.pdf
9, 10 https://www.fca.org.uk/publications/consultation-papers/cp21-9-changes-uk-mifid-conduct-organisational-requirements
11 https://www.fca.org.uk/publication/consultation/cp21-9.pdf

Improving access to accurate and relevant data is the other critical component to direct greater investment to SMEs. Some data is already available free of charge on platforms such as AIM in the UK.[12] The publication of financial reports on a public website by all companies—regardless of their size—could also help improve data on SMEs. The frequency of publication could be adjusted according to the size of the firm. This type of website already exists such as the Brønnøysund, a Norwegian government agency responsible for the management of numerous public registers for Norway. Companies House in the UK also provides a platform for such publications but to date excludes the reporting of smaller companies under a certain threshold.

Publication of relevant company data will require a defined and agreed format to ensure the accessibility and comparability of data across Europe. This will also accelerate the use of technology to extract value from this data, thereby expanding the number of companies that can be researched and the breadth and depth of enquiry. Standardisation of non-financial data would improve companies' ability to scrape raw data and could facilitate a greater use of machine learning and natural language processing in this area.

The use of new technologies could also improve the production of research on SMEs at a lower price point as well as make the distribution process more efficient through better targeting and matching of the right report to the right analyst; ultimately improving the viability of research as a standalone value-add from the sell-side.

Looking Forward

Rolling back unbundling for SMEs under the threshold of €1B in Europe or £200M in the UK is unlikely to achieve the policy objective of increasing investment in small- and mid-caps. Instead, policy makers should focus on how the market structure needs to change to attract companies to raise capital locally rather than in the US or through private funding (see previous blog, Part One: IPOs - The backbone of SME eco-structure). The depth and innovative structure of US capital markets make them a prime candidate for European and UK companies wanting to go public, attracting over half of the $1B-plus European venture capital-backed companies, mostly via stock market listings.

To be able to compete, Europe and the UK should look at radical solutions, one of which being tax incentives to invest in SMEs but also the need to establish a fintech hub that will support the objectives of the CMU and investments in the real economy. Technology and capital markets can no longer operate in isolation. Whether by facilitating retail access to capital markets or the search of liquidity or by improving research capabilities, the pandemic has only accelerated the digital revolution that was underway. The question is no longer how to provide traditional analyst coverage in SME stocks but has become a broader debate about how information on companies can be accessed and distributed across the industry globally 24/7.

Enhanced digitalisation is particularly important given the ESG tsunami the market is experiencing. The industry is now looking for practical innovation from fintech, traditional research and third-party data providers to respond to investor and regulatory pressure to move to a more sustainable economy. The mark of any successful business is the ability to adapt and change as a market evolves, and only those who automate their investment process quickly and efficiently will be able to succeed in an increasingly competitive industry. Rising public concern about how individual active fund managers and investee companies operate as well as industry levels of transparency and accountability are starting to shift industry behaviour. Data and technology will be just the start of a long overdue digital transformation of the investment process from research to execution which will redefine active management, rebuilding trust for the investors whom active managers represent and the companies they invest in.

Next in this four-part series, we will explore further the need to improve secondary market liquidity to increase investment in SMEs.

12 https://www.londonstockexchange.com/live-markets/market-data-dashboard/price-explorer?markets=AIM

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5/21