Lessons in structuring SME dedicated exchange for developing capital markets – a practitioner's perspective

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Abstract

Access to finance is nowadays widely recognized as one of the main impediments for growth and development of the SME sector. As a direct consequence of global economic crisis, the problem of financing of SMEs has only recently come under closer scrutiny of policymakers, but has also attracted the attention of market operators. For several years, a number of public and market-based initiatives towards SMEs and investors have taken place in developed (and to much lesser degree in emerging markets), in order to promote visibility and access of SMEs on stock exchanges, as well as greater participation of investors' community. Designing the optimal market structure for SMEs in developing markets seems to be more of an art than the exact science as it requires not just finding the fine balance between increasing costs of the listing process for the SME issuer and acceptable mechanisms to protect investors, but also implies struggle with liquidity deficiency of the prime market listings.

Key words: *Small and medium enterprises, SME exchanges, MTFs, financing gap, equity financing, financing life cycle model*

1. Introduction

It is widely accepted that one of the major impediments to growth and development of SME sector nowadays is lack of access to external funding sources. Specifically stated, as small and medium enterprises do not have easy access to capital markets, their balance sheets typically heavily rely on long-term and short-term banking loans and trading finance (from suppliers) as main sources of external financing. This makes them especially vulnerable during times of economic crises and financial meltdown. Evidently, this was a case with recent global crisis during which (commercial) banks significantly refrained from giving or extending loans to enterprises, which especially adversely affected small and medium enterprises. In order to diminish such negative impact during crises when availability of long term external funding sources for SME dries up, other forms of external funding sources - specifically one that includes stock exchanges, have come into focus and closer attention of policymakers and other stakeholders on both sides of Atlantic. This came as no surprise as stock exchanges represent one of the key pillars of financial systems, at least in developed countries. In that context, the goal for exchanges, regulators and policymakers becomes the promotion of financing of mid and small cap and SMEs on capital markets in a period when banks are expected to face growing difficulties in financing SMEs (Naacke & Hirsch 2013).

Alternative methods of SME equity financing may take various informal (family, friends, business angels) and formal forms (such as venture capital funding & private equity funds, crowd funding and financing via SME dedicated platforms of stock exchanges). Without the intention to argue the significance of SME sector[1] in spurring economic development, growth and innovations which has already been widely discussed in numerous reports and empirical studies, this paper primarily deals with the ease of access of SME to one particular form of *equity financing* – one that occurs using capital markets in its narrow sense, notably stock exchanges.

This paper aims to contribute towards the growing debate on funding of SME through dedicated stock exchanges. We hope that this paper will serve as a useful contribution to policymakers, practitioners, and to other stakeholders to undertake certain steps and contribute to additional research.

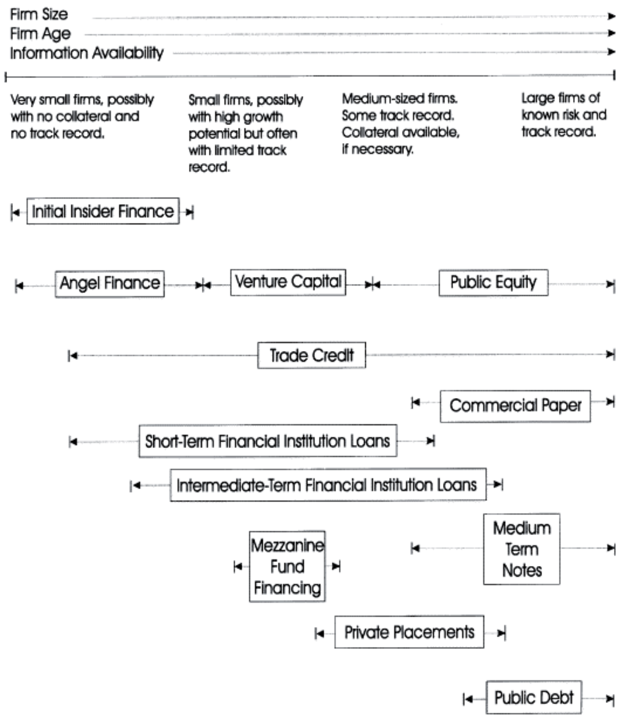
This paper is structured as follows: Section 1 presents a brief overview of the life cycle approach in SME balance sheet financing. Section 2 gives a brief overview of the role of stock exchanges and a snapshot of key differences between SME board and main market. Section 3 presents a discussion of main obstacles and challenges in designing functional SME dedicated exchange with certain propositions and policy recommendations, and Section 4 is the conclusion.

2. A Life Cycle Approach in SME balance sheet financing

Prior to researching SME dedicated exchanges, we will briefly pay attention to one of today`s common approaches in understanding the structure of SME balance sheet financing using firm`s *life cycle* approach, developed by Berger & Udell (1998:622), which presents firm`s typically available financing options along a size/age/information continuum. According to them “small business may be thought of as having a financial growth cycle in which financial needs and options change as business grows, gains further experience, and becomes less informationally opaque… Smaller/younger/more opaque firms lie near the left end of the continuum indicating that they must rely on initial insider finance, trade credit, and/or angel finance” (Berger & Udell 1998). It is worth noticing that debt and equity financing may, especially in later stages of SME balance sheets, represent rather complements than substitutes. With easier access to capital markets, SMEs might be able to balance their capital structure with more flexibility as lower leverage and strong equity base enable SMEs to take more debt in balance sheet.

[1] The definition of SME varies across the countries but it is most often related to a certain number of employees, assets size and turnover. According to EU criteria, SMEs were defined as companies with less than 250 employees and a turnover not exceeding EUR 50 million or annual balance sheet not exceeding EUR 43 million.

Figure 1. Firm continuum and sources of finance

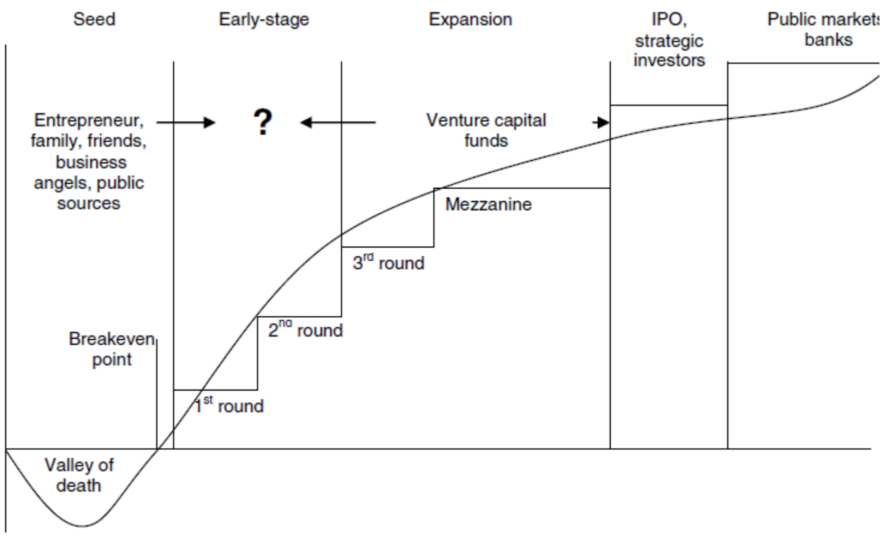


Source: N. Berger & F. Udell (1998)

Similarly to financing growth life cycle model, equity financing life cycle model of firm can be derived (Durvy 2006). Stages of equity financing are illustrated in Figure 2. The sources of equity finance evolve as firms move on from seed to later stages when prospects of firms become much clearer and revenues increase. In the early stage, debt is considered unsuitable for various reasons. On the other side, equity financing from formal sources, such as private equity can be quite expensive at this stage and entrepreneurs can be reluctant to dilute their ownership. IPO and public equity market generally take place at later stages. In the context of this model, *financing gap*[2] of SMEs in their early stage of development clearly exists.

[2] The term *financing gap* means that there are significant numbers of SMEs that could use funds productively if they were available, but cannot obtain finance from the formal financial system (OECD 2006)

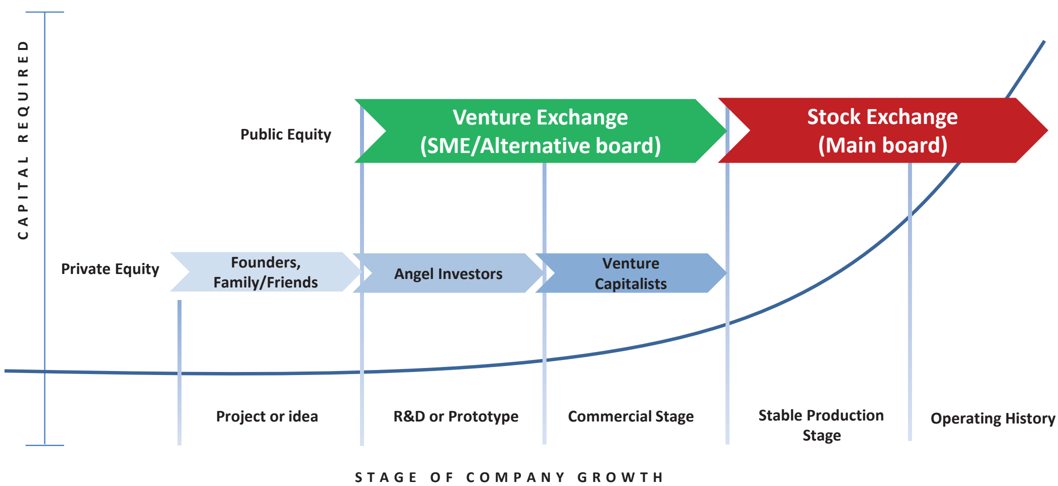
Figure 2. Stages of equity financing



Source: Durvy (2006).

Using SME focused stock exchanges characterized by relaxed listing requirements as shown in Figure 3 has recently arisen as another option for SME fundraising in its early stage.

Figure 3. Financing growth companies via venture exchange



Source: Adapted from TMX Group Limited (2013)

Thus, in this early stage of development with regard to equity financing, SMEs may opt for direct investment ranging from less formal (friend, family, business angels) and more formal sources (venture capital funds) or they can decide to go public for trading on public markets - regulated markets or on alternative trading venues such as MTFs.

3. The Role of Stock Exchange and SME Sector

Equity markets can be an effective mechanism of financing for large, and as evidenced on certain markets, for medium and small companies as well. Stock exchanges, irrespective of their country of residence, markets they serve, history, and organizational design, should have the basic role of "providing capital for companies to grow, and investment destinations for individual savers, thus contributing to the creation of wealth for the general public" (Saito, 2010:302).

Based on transparency and disclosure requirements, and irrespective of company size, listing on exchanges can take two basic forms: listing on regulated markets and listing on alternative trading venues such as the MTFs. Exchanges with different reputations and therefore listing standards can coexist.[3] In fact, to increase their revenues from listing fees and trading costs, exchanges may lower their listing standards so as to attract more listings, without lowering the listing standards for their main markets.

According to the size of issuer, securities markets may serve two types of issuers – large cap companies and SMEs. In general, SMEs have an option to be listed on regulated market or on alternative trading venue. Since exchanges with high listing standards attract blue chip issuers, whereas exchanges with lower standards attract lower quality companies (Grose & Friedman 2006), we find SMEs mainly listed on alternative trading venues and second-tier boards, while large cap companies or blue chips are frequently listed on regulated markets in prime segment or official listings. However, initiatives towards financing SME via capital markets in less developed capital markets are either still in embryonic phase or these initiatives proved to be unsuccessful according to IFC report (IFC 2010).

There are many advantages for companies raising funds through stock exchange such as the diversification of funding sources, access to broader base of potential investors' base, access to equity capital which generally enables carrying more debt in balance sheet, brand recognition and reputation, but also indirectly creates new jobs through entrepreneurship. However, complying with disclosure and other public markets requirements for SMEs is too costly in terms of explicit and implicit costs which usually contain certain fixed components.

In order to get broader picture of today`s SME financing via stock exchange it is interesting to note that in 2012, for all World Federation of Exchanges (WFE) members taken as a whole, mid, small and micro-cap accounted for 88% of the total number of listed companies, 38% of the number of trades, 11% of the market capitalization and 14% of the value of share trading.[4] The share of each market segment in each indicator for WFE members is presented in Figure 4.

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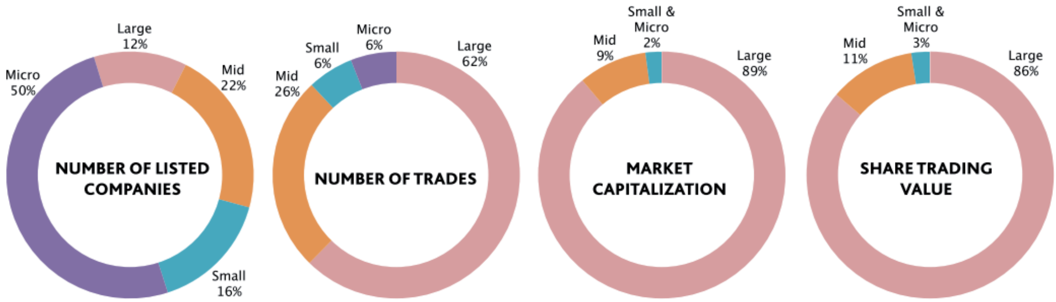
[3] Chemmanur & Fulghieri (2006)

[4] WFE, Focus, NO 249, November 2013; WFE 2012 Market Segmentation Survey.

Figure 4. Share of each market segment in each indicator for WFE members



Sources: WFE, Focus, NO 249, November 2013; WFE 2012 Market Segmentation Survey.

This figure clearly indicates that liquidity goes hand in hand with market capitalization. However, as figures reported are consolidated for "main board" and "SME/alternative board", generalizing this idea of a link between market cap and turnover, and diminishing the importance of SME funding via stock exchanges would be misleading without considering segmentation of exchanges. Although share trading value of micro-cap accounted for only 3% (14% for micro, small, and medium cap firms) of the value of share trading, they represent 50% (88% for micro, small, and medium cap firms) of total number of listed companies. This figure deserves to take closer look at distinctive characteristics of SME exchanges versus "regular" exchanges.

Regardless of their peculiar names and technological and functional design, SME dedicated exchange venues are increasingly gaining in popularity among renowned stock exchange operators. More prominent examples include NewConnect (Warsaw Stock Exchange), EnterNext and Alternext (Euronext), AIM (London Stock Exchange), AIM Italia - Mercato Alternativo del Capitale (Borsa Italiana), First North (NASDAQ OMX), Entry Standard (Deutsche Börse) in Europe, and TSX Venture Exchange (Toronto Stock Exchange), Mothers[5] (Tokio Stock Exchange), NASDAQ (in USA), BSE and NSE boards for SME (in India), SME Board (Shenzen Stock Exchange) overseas.[6]

[5] Acronym for *Market of the high-growth and emerging stocks*.

[6] For detailed list of markets serving SMEs see Grant Thorton (2008).

Table 1. SME dedicated trading venues in the five biggest European economies

Alternative market	**Operator**	**Country**	**Year of creation**	**Capitalization (€bn, end Oct 2013)**	**Average market capitalization (€mn)**	**No. of listed companies**
AIM	London Stock Exchange Group	UK	1995	82.8	75.6	1,092
Entry Standard	Deutsche Börse	Germany	2005	23	115	202
Alternext	NYSE Euronext	France	2005	5.9	31.7	183
MAB	BME	Spain	2009	0.76[a]	34.6	22
AIM Italia MAC	London Stock Exchange Group/Borsa Italiana	Italy	2008	0.77[b]	32	24

a) Value at end of May 2013

b) Value at end of June 2013

Source: Infelise (2014)

Successfulness of SME access to external equity funding via stock exchange in any country depends on joint and cooperative efforts of government and policymakers, regulator, capable market operator, representative bodies of investors' community (e.g. venture and private equity associations, association of business angels), investment firms and other stakeholders. In developed markets, a number of public and market-based initiatives have been undertaken in order to promote financing needs of SMEs.[7] Pulling together key characteristics from several successful SME markets, in Table 2 we summarize common distinctive features of SME exchange vs. main listing.

Table 2. Key differences between SME board and main market

SME board	**Main market**
Less extensive rulebook; usually regulated under rules of market operator, i.e. self-regulated	Strictly regulated by national securities (capital market) laws (and in EU relevant MiFID directives)
Publication of *information memorandum*(simpler than prospectus)	Obligatory publication of *prospectus*
Mandatory partners usually required (listing sponsor, certified adviser, market maker / liquidity provider)	Obligatory participation of investment company; in certain markets involvement of other agents and sponsors may be mandatory
Simpler and faster admission procedure and listing requirements; reduced administrative and procedural burden	More restrictive admission requirements and higher administrative and procedural burden

7 Summary review of these initiatives is presented by Infelise (2014).

Less strict information requirements	Stricter information requirements
Lenient reporting requirements	Stricter ongoing reporting requirements
Shorter financial history and lower accounting standards	Longer financial history and higher accounting standards
Sometimes government tax incentives & other subsidies	Generally no government incentives
Smaller investor base with institutional and retail investors (in certain markets retail investors prevail)	Broad investor base, suited for regulated institutional investors
Perceived higher investment and liquidity risk	Perceived lower investment and liquidity risk
Aimed at potentially high growth companies in the start-up or early stage (short track record), seeking to raise relatively smaller amounts (from a few hundred thousand and a few million euros)	Aimed at companies at an advanced stages of development, seeking to raise higher amounts of capital (from a few million up to a few billion euros)
Firms operating in innovative sectors, mainly with intangible assets, although some markets attract broad set of companies from different sectors	Firms operating in various sectors

Sources: Authors' compilation

Current regulatory regime of MiFID[8] in EU countries, proved to be incomplete from the point of enabling easy access of SMEs to financial markets. SMEs faced greater difficulties and costs to raise capital from equity markets than larger issues due to the lack of visibility of SME markets, the lack of market liquidity for SME shares and the high costs of an initial public offering (Baker & McKenzie 2012). New proposals of MiFID II introduce the creation of specific label for "SME growth markets" to facilitate SME`s access to capital markets in order to make these markets more attractive to small companies and investors than existing categories.

4. Lessons to be learned

With the basic infrastructure in place, initiatives, if any, toward stimulating funding of SMEs through majority of local stock exchanges in less developed markets in EU countries have been fruitless. To be more precise, the majority of stock exchanges in SEE post-transition countries simply have failed to thrive not only in attracting SMEs but also in attracting large issuers. Reasons are manifold and deeply interrelated. Symptoms are painful – these markets have only a few liquid listings, new IPOs are rare, and daily turnover frequently does not exceed a few million euros with only a few companies responsible for a large percentage of the total trading. The prospects for these local exchanges does not seem bright as globalization and technology enable larger issuers to dual list on local and global markets, or they simply switch home listing market, preferring foreign global markets versus local ones. In certain local markets issuers sometimes choose to delist themselves as they do not perceive any benefits of being listed.[9] Thus, as suggested by some researchers[10], local markets should turn themselves to serving SMEs instead serving prime

8 The Markets in Financial Instruments Directive – a European Union law that provides harmonised regulation for investment services

9 E.g. during 2013, 19 firms were delisted form regulated market of Zagreb Stock Exchange.

10 See Grose & Friedman (2006).

issuers. However, this suggestion may be misleading. As we shall point out later, certain local markets already serve SMEs, at least according to firm size definition used by WFE and FESE. Such defined, large issuers generally represent just a small percentage of total number of firms listed on local exchanges.

In order for SME dedicated markets to flourish, two basic presumptions should be in place. Firstly, benefits of SME accessing capital markets must outweigh the costs and secondly, there should be right balance between adequate investor protection on one side and affordable costs of SMEs` access to capital markets. However, size, depth and liquidity of securities markets may present major problems for both, issuers and investors.

In this section we outline SMEs classification issue, followed by observations on main obstacles and challenges that local exchange markets face in promoting SMEs fundraising, with some consideration given to Zagreb Stock Exchange, as it represents leading stock exchange among exchanges in Southeast Europe.

Current EU definition of SMEs has been developed for the purpose of controlling access to state aid. However, this definition is widely used in other, sometimes, inadequate contexts such as in the context of SMEs access to public capital markets. Under MiFID II, for the purpose of enabling easier access of SME to public capital markets and to accommodate the SMEs classification issue, threshold for SME in amount od 100 million euros of market capitalization is proposed. Why is SME classification relevant? Setting the criteria at too low a level would adversely impact investor perception of the SME markets as they would be regarded as only accommodating micro-cap, illiquid companies with consequences of reducing investors appetite and confidence (ESMA Securities and Markets Stakeholder Group 2012).

The comparison of EU and WFE classification criteria “clearly shows that the current EU Commission definition is too restrictive if the aim is to focus on the promotion of financing of SMEs by capital markets. Even for smallest exchanges, the number of SMEs according to EU definition is smaller than the number of micro-cap” (Naacke & Hirsch, 2013:22). However, only SME companies according to EU criterion could be targeted by public schemes. Illustratively, according to both WFE and FESE criteria, only four companies on Zagreb Stock Exchange would be classified as large cap companies (INA d.d., HT d.d., Zagrebačka banka d.d., and PBZ d.d.) with approximately 80% of the listed companies classified as a micro companies thus confirming narrowness of EU criterion for SMEs (see Table). Although local markets, because of variety reasons, naturally tend to be preparation hub for SME firms that wish subsequently to be listed on mainstream exchanges, majority of these firms (those classified in middle and small cap companies according to WFE and FESE criteria) actually will not be qualified for various EU or local government schemes. This classification gap is similar to other less developed markets.

Table 3. Classification criteria for companies listed on Zagreb Stock Exchange

Criteria	LARGE	MIDDLE	SMALL	MICRO	Total
WFE	**4**	**14**	**22**	**146**	**186**
in % of total companies	2,2%	7,5%	11,8%	78,5%	100,0%
FESE	**4**	**6**	**29**	**147**	**186**
in % of total companies	2,2%	3,2%	15,6%	79,0%	100,0%
EU (modified classification*)	**58**	**53**	**57**	**18**	**186**
in % of total companies	31,2%	28,5%	30,6%	9,7%	100,0%

Source: Authors (based on ZSE market capitalization data available at http://zse.hr/default.aspx?id=34350).

1. The table includes only companies listed on ZSE and classified in one of the sectors due to their principal economic activity for total of 188 companies. For companies with common and preferred shares, market capitalization is the sum of both.

2. WFE: World Federation of Exchanges; FESE: Federation of European Exchanges; EU: European Union.

* EU classification is modified in order to add certain degree of comparability with market cap classification criteria. Thus only size of assets is taken into account. The assumption made is that market capitalization represents one half of the assets size.

In order to promote greater success of SME listed on public markets, two general types of measures are implemented. One group of measures targets investors with main aim to expand investors' base and improve greater participation of investors, and the other group targets SMEs with the aim to promote companies' funding through public markets.

Ranked first, major obstacle that impacts investor interest in SMEs is *lack of liquidity*, followed with *lack of research coverage* (CFA Institute 2013), with this two issues inevitably interrelated. Having in mind that shares of SMEs are inherently less liquid, small-sized markets measured with market capitalization and trading volumes furthermore accentuate investors` negative perception. In order to reduce information asymmetries, the liquidity of SME stocks can be improved by research coverage. Tax incentives are one of the main ingredients of policies aimed at stimulating investments in small enterprise with growth potential but with little track record. (Arce et al. 2011). Apart from tax incentives, there is another set of measures suggested by practitioners that would possibly contribute to attracting investors interested in SME such as greater transparency, efficient market making mechanism, standardized trading platforms with low access costs, reduced capital adequacy and risk weighting for institutional investors, better sell-side coverage, etc.

Another group of measures that targets SMEs towards their greater participation on public markets aims to reduce two types of barriers: *cultural* and *economic* (Arce et al. 2011). Cultural barriers refer to lack of familiarity of entrepreneurs with securities markets that result in biases against the option of going to the markets. Other obstacles include potential for the founder to lose absolute control over the company and concerns over greater transparency. The basic antidote to this cultural barrier is providing adequate information by financial intermediaries and companies managing the trading systems (Arce et al. 2011).

The economic barrier is related to expenses associated with the listing process. Costs and expenses of this nature can be prohibitive for smaller enterprises relative to their size. Yoo (2007) points that successful new markets lower costs for firms by establishing flexible entry requirements, instituting light corporate governance rules, and reducing financial fees for listing and maintenance.

Thus, policy makers in certain countries developed various schemes[11] intended to facilitate the access of companies to the public markets. However, Arce et. al. (2011:35) suggest that “it may be a good idea to examine other formulas which are less of a burden on public funds and more effective in terms of encouraging more diligent behaviour on the part of the beneficiary companies”

Clearly, finding the right balance between costs for the issuer and investor protection is more of an art than the exact science. Properly designed, legal and regulatory framework may support achievement of this objective. Grose & Friedman (2006:8) suggest that “taking into account typical characteristics of many emerging markets, the obstacles to development that they face, and the difficulty of competing with global markets various, policy makers should “focus on development of a primary market that can provide capital to small and medium sized domestic companies, and related reasonable legal and regulatory framework that should not be a replica of regulatory environment in more developed markets but, instead, should concentrate on what is `necessary` rather than what would be `nice`”.

5. Conclusion

One of the main challenges nowadays for SMEs growth and development is to ensure access to external financing. While there is an entire set of external financing alternatives, one particular form of *equity financing* gained closer attention of policymakers, and market operators in particular – notably, financing through specialized types of stock exchanges dedicated to small and medium enterprises. Development of SME dedicated exchanges may benefit SMEs by enabling them to have easier access to equity capital while at same time creating vibrant environment for stronger development of local capital markets. There are additional advantages for companies raising funds through stock exchange such as the diversification of funding sources, access to broader base of potential investors’ base, access to equity capital which generally enables carrying more debt in balance sheet, brand recognition and reputation. SME dedicated exchanges have broadly based benefits for economy as a whole. Whereas in developed markets, such specialized SMEs exchanges have already yielded results, developing markets still struggle with structural deficiencies that negatively affect capital markets in general and that impede stronger focus on such efforts. Certain obstacles are lack of financial literacy, absence of “investment culture”, narrow investment base, utter insensibility and lack of support of government policymaker for development of capital markets in general.

Setting the proper landscape in order for SME dedicated exchanges to flourish is a great challenge for policymakers and other stakeholders (market operator, venture capitalists, private equity funds etc.). Without true enthusiasm, merely creating a board for SME (or MTF dedicated to SME) within the existing exchange does not promise success. Designing suitable architecture for SME dedicated exchanges in developing countries takes time. Certainly, with respect to legal and regulation framework, “one size fits all” approach does not work well, especially in developing

[11] These schemes may encompass subsidies, loans on favorable terms, grants, tax breaks, and certain forms of technical assistance.

countries with its own distinctiveness. We believe that in order for SME dedicated exchange to prosper, for each country separately, unique tailor-made approach must be designed and implemented with careful evaluation of achievements on other more developed markets.

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