

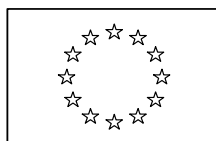


Directorate-General for Enterprise and Industry

Improving opportunities for Initial Public Offerings on growth stock markets in Europe

Report from the workshop held on
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European Commission

About this report

The workshop “Improving opportunities for Initial Public Offerings (IPOs) on growth stock markets in Europe” aimed to identify how the financial environment could be improved for high-growth and innovative companies in Europe, whether there was a common ground of views among the different categories of actors, and how the Commission could contribute to improving the financial environment. Representatives of the venture capital industry, stock exchanges, the banking sector and academia were invited to give their views on the subject. This document reports the main findings of the workshop.

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Improving opportunities for initial public offerings on growth stock markets in Europe

The EU needs more innovative and high-growth companies to drive economic growth. At the same time, these companies require a more efficient financial environment to address their financing needs. The workshop “Improving opportunities for Initial Public Offerings (IPOs) on growth stock markets in Europe” aimed to identify how the financial environment could be improved for high-growth and innovative companies in Europe, whether there was a commonality of views among the different stakeholders, and how the Commission could contribute to improving the financial environment. Representatives of the venture capital industry, stock exchanges, the banking sector and academia were invited to give their views on the subject.

There was some common ground among the different categories of actors regarding the crucial elements of a more efficient financial environment (see section 1). Different scenarios emerged on how to improve the financial environment and how to create better opportunities for IPOs (see section 2). There was a consensus on what the role of the Commission could be (see section 3).

1. Common ground between the different categories of actors

There was fundamental common ground regarding the importance of supporting start-ups, innovative and high-growth companies. The venture capital (VC) industry, the stock exchanges and the banks agreed that the following elements needed to be looked at when aiming for a more efficient financial environment for high-growth and innovative SMEs.

- **Fragmentation**

This includes a wide range of issues.

- The venture capital industry and the stock exchanges pointed to liquidity fragmentation, a direct result of capital market fragmentation. They also drew attention to the fragmentation of growth stock markets and market practices (such as home bias in investing) as well as legal fragmentation.
- The exchanges in addition highlighted the overall fragmentation of the investor base, intermediaries, and companies (in particular small caps) across European exchanges.
- Banks emphasised the importance of liquidity fragmentation between exchanges and countries.

- **Research**

The VC industry emphasised the lack of available research data on high-growth companies. They pointed out that this was especially true for sector-focused research. The result was a lack of comparability. At the same time banks stressed that research on growth companies must be financially worthwhile and therefore research is primarily conducted on those companies in the case of which sufficient trading volume could be expected.

- **Market-making**

The VC industry and the exchanges highlighted the importance of market-making on growth markets to the provision of sufficient liquidity for micro- and small cap stocks.

- **Local investor base**

All participants agreed that home bias remained extremely important in investing. Large pools of investment capital do not cross national borders while retail investors often act on a local basis.

- **Pan-European reach**

The VC industry and the exchanges pointed to the importance of attracting international investors, in particular into the technology sectors. A proper balance should be found between local base and pan-European reach.

- **Valuation**

The VC industry and the exchanges pointed out that the fragmentation of small-cap stocks across the European exchanges led to illiquid markets (and to lack of research) and ultimately to poor valuation of high-growth companies.

- **Tax incentives**

The VC industry, the stock exchanges and the banks agreed that tax incentives for investment in growth companies were necessary to raise investor interest.

- **Costs and barriers**

Cross-border clearing and settlement remains very costly. The exchanges pointed out that - as a result – also cross-border investing was expensive for retail investors.

- **Harmonisation**

The VC industry and banks agreed that harmonisation of the regulatory framework would be extremely helpful. The exchanges stressed that it would be better to have less requirements and burdens on SMEs.

- **Time for a new start**

The VC industry, the stock exchanges and the banks agreed that after past failures and the resulting loss of trust some action was needed to support growth stock markets.

2. Different possible scenarios to improve the financial environment and to create better opportunities for IPOs

There was agreement among the VC industry, the stock exchanges and the banks that liquidity fragmentation was the major problem, reflecting the fragmentation of markets and business practices (such as home bias in investing) as well as legal fragmentation.

There was consensus around the proposition that improving the liquidity of growth markets is an important goal. Three options were mentioned:

- **Develop a pan-European stock exchange:** This would be a costly endeavour as it would call for the creation of a common trading platform. It would also require further harmonisation, like a common framework of European company law and a single European regulator. However, it might not be a solution to the problems outlined, as it remained uncertain whether it would diminish home-bias by investors. This seemed to be an option for the more distant future.
- **“Wait and see” position:** No need for immediate regulatory action. There would likely be a process of diminishing regulatory fragmentation as the single market progresses.

Simultaneously market forces would lead to a consolidation of growth markets through competition, reducing fragmentation.

- **Intermediate position:** This would consist of developing a framework aimed at overcoming market fragmentation without interfering with the markets as such. This would involve facilitating cross-border trading as well as making the process of cross-border clearing and settlement easier and less costly. The participants suggested that the Commission could take onboard ideas from this position.

The venture capital industry was in favour of a single pan-European market for high-growth companies, preferably built on an existing exchange. It also stressed the importance of having a local base for growth companies. At the same time, it pointed out that technology companies - whatever their size - needed to reach international investors, and this could only be done with a pan-European market. The best solution would be a market with a cross-border market-making system. As a first step, a trading alliance among exchanges would be an interesting approach; an alternative could be a specialisation of exchanges in industry sectors. Moreover, cross-border syndication of related investment banking activities should be developed further. Along similar lines, the key actors should team up to improve liquidity on growth markets.

The exchanges emphasised that an eventual pan-European growth market had to be built on existing exchanges, on existing 'critical mass' (including pools of liquidity as well as an efficient and well-functioning system of financial intermediaries and advisors). Such a growth stock market should be open to all small caps (technology and non-technology).

The banks stressed that the supply of capital had not been hampered by the lack of a pan-European growth exchange. The (re)creation of such an exchange would suffer from a lack of trust (because of past experiences). However, a trading alliance among exchanges could be an interesting approach. Banks, too, underlined that a growth market should be open to all small caps, irrespective of their industry focus.

3. The role of the Commission

There was agreement among the VC industry, the stock exchanges and the banks that - in order to contribute to a more efficient financial environment – the Commission should establish the framework. This should take place, though, without interfering with market forces and could take one or more of the following actions onboard:

- Promoting reform, market liberalisation, and external competitiveness thereby facilitating cross-border trading as well as a reduction in clearing and settlement costs;
- Harmonising the regulatory burden on companies, with special attention to the needs of SMEs;
- Ensuring investor protection in a realistic way;
- Drawing attention to the importance of tax incentives for investments in growth and innovative companies;
- Implementing and enforcing directives;
- Promoting policies that facilitate a more predictable financial environment, where conditions increase investors' appetite for equity investments;
- Disseminating best practices.

Some participants also proposed that the Commission could further consider:

- Having a single or at least fewer regulatory bodies regulating securities markets;

- Harmonising corporate law across Europe through one body of unified European company law;
- Teaming-up of key players and stakeholders to address the problem of liquidity fragmentation.

Main points of the presentations and discussions

The workshop was organised into four sessions. The first three were dedicated to the presentations of the venture capital industry, the stock exchanges, and the banks, respectively. The event was closed with a session on the conclusions of the workshop.

The viewpoints of the venture capital industry, the stock exchanges and the banks are summarised below.

1. VENTURE CAPITAL INDUSTRY VIEWS

Analysis of the present situation

The following elements were considered to be missing in Europe:

- Strong IPO market. This has a negative effect on the valuation of high-growth companies;
- Sector-focused research coverage allowing for global comparisons (especially with the US) to help institutional investors better understand growth companies in the various technology sectors;
- Cross-border syndicates with the aim to better tap capital pools across Europe;
- Critical mass. This is a direct result of capital market fragmentation.

The following elements were considered to be already present:

- Some vibrant local markets (LSE/AIM, Nordic exchanges);
- Growing presence and influence of venture capital investors;
- The US Sarbanes-Oxley law had created an opportunity for European markets.

The view was that without action, research coverage of growth companies would remain limited and capital markets fragmented. As a result, institutional interest in growth equities would remain limited, IPOs would continue to depend on “home” market conditions and after-market trading volumes would remain low. Sufficiently large growth companies would continue to list in the US markets.

Recommendations

- A pan-European growth market was presented as the key to addressing the problem. The setting-up of a (single) pan-European market dedicated to high-growth companies would build up sufficient critical mass to attract companies, investors, financial intermediaries and advisors. This would improve access to capital and liquidity for Europe’s best growth companies. It would also rebuild confidence and enable the emergence of a pan-European and local investor base.

- Timing was deemed good for a fresh initiative, although the question was how to start over again after the experience of Easdaq. The key elements of any answer should include
 - Addressing the needs of institutional investors through
 - Consistent accounting standards and quarterly reporting;
 - Consistent rules of corporate governance;
 - Quality research coverage on growth companies.
 - Paying attention to the importance of market-making for micro- and small caps to provide sufficient liquidity on the market;
 - Promoting a single pan-European market for growth companies;
 - Teaming up of main stakeholders to address the issue of liquidity fragmentation.
- As an interim step a trading alliance among exchanges could be an interesting approach.

2. STOCK EXCHANGE VIEWS

Analysis of the present situation

- The fragmentation of small caps across European exchanges was seen to limit available investment for issuers, commercial returns for advisers, leading to illiquid markets (and to a lack of research) and poor valuations for growth companies;
- Uncertain market conditions following the dotcom crash had been a major reason for a weaker IPO environment;
- Tax incentives to raise investors' interest in innovative and growth companies had not been not available in a number of countries.

The exchanges also pointed out that cross-border clearing and settlement remained expensive for small and mid-size retail investors due to costs arising from fragmentation. A pan-European trading platform would still face post-trade fragmentation. Moreover, the whole 'infrastructure' (investors, intermediaries and companies) needed to be pan-European for a successful pan-European high-growth stock market to emerge. Furthermore, legal fragmentation would persist, including differences in stock ownership rules between countries, which would continue to make cross-border transactions more complicated.

Recommendations

- The ideal solution for a pan-European growth market was seen in a process building on the success of existing markets, especially on already existing pools of liquidity. However, the current high number of growth markets prevented rapid consolidation;
- A central platform across Europe for all growth companies, small cap investors and small cap advisers was needed. This would make detailed research on growth companies financially worthwhile and allow for further market growth;
- A pan-European growth market should have a pan-European reach with a local base;
- Appropriate regulation for SMEs was considered essential, including aspects of disclosure, compliance and entrance requirements;
- Commitment of liquidity providers/market-makers was seen as crucial;
- A pan-European growth market should be open to all sectors and not necessarily technology focused;
- Fiscal incentives were important to raise investor interest in growth companies (e.g. venture capital trusts in UK, young innovative company status in France).

3. BANK VIEWS

Analysis of the present situation

- The supply of capital had not been hampered by the lack of a pan-European growth exchange (e.g. AIM had been a success story);
- Growth IPOs were highly dependent on market momentum;
- Small cap investors were still very domestically focused. They wanted liquidity on the “home” market where the company had a natural investor base;
- Research on growth companies should be financially worthwhile and therefore research would be primarily conducted on companies where sufficient trading volume could be expected;
- There was scepticism about any effort of re-creating a pan-European growth exchange;
- Very large pools of investment capital seldom cross national borders – for instance, pension funds. Home-bias investing was seen not only as a retail but also as an institutional investor issue.

Recommendations

- Growth companies aiming for an IPO should
 - Bear in mind that that the period - in which conditions for an IPO are propitious - may be very short;
 - Ensure that the concerns of conservative investors (e.g. pension funds) were addressed.
- Governments should
 - Consider fiscal incentives to encourage investment in high growth companies.
- Exchanges should
 - Consider listing rules carefully. Less stringent rules were not necessarily better as investors might become wary towards an exchange seen to be lowering entry thresholds;
 - Work on local answers, rather than target a pan-European exchange (e.g. a unified trading platform might provide benefits while preserving local autonomy).
- Banks/advisers should
 - Increase support to second-tier exchanges. With increased liquidity would come increased confidence and an increased deal flow.
- A single pan-European exchange for growth companies was not yet seen as the answer (further steps were needed in terms of harmonisation e.g. in the case of settlement systems). However, a trading alliance among exchanges might be an interim step until the market would be ready for a pan-European exchange.

4. CONCLUSION

European Union needs more innovative and high-growth companies to drive economic growth. At the same time, these companies require a financing environment that corresponds to their needs.

The venture capital industry was in general in favour of a single pan-European market for high-growth companies, preferably built on an existing exchange. This goal should be approached step by step, starting, for example, with a trading alliance among existing exchanges. A large and liquid exchange would enable an efficient and well-functioning system of financial intermediaries and advisors to function. In contrast, the banks stressed that the supply of capital has not been hampered by the lack of a pan-European growth exchange.

The discussions of the workshop have provided the European Commission with useful feedback as it is looking at the effects of the fragmentation of growth stock markets in Europe. The issue will be further discussed in the "Risk Capital Summit 2005" organised by the European Commission and the UK Presidency of the European Council in London on 4 and 5 October 2005. All these discussions will be taken into account when the Commission develops its policy on risk capital.

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