Fulfilling the Promise of Venture-backed High Potential Companies

- Why we need to fix Small Cap Markets in Europe -

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An EVCA High Tech Committee Paper

European Private Equity & Venture Capital Association

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About EVCA

The European Private Equity and Venture Capital Association (EVCA) was established in 1983 and is based in Brussels. EVCA represents the European private equity sector and promotes the asset class both within Europe and throughout the world.

With well over 900 members in Europe, EVCA's role includes representing the interests of the industry to regulators and standard setters; developing professional standards; providing industry research; professional development and forums, facilitating interaction between its members and key industry participants including institutional investors, entrepreneurs, policymakers and academics.

EVCA's activities cover the whole range of private equity: venture capital (from seed and start-up to development capital), buyouts and buyins.

Introduction

An entrepreneur licences the intellectual property developed by a prominent University in Germany, raises €25 million of venture capital in successive rounds from a syndicate of three venture capital firms, and over the next four years builds a business reaching €20 million in revenues. Employees hold 35% of the company through options and founder shares. New sales offices are being opened in the US and Asia. Several acquisitions are being considered. The annual market for the company's products will exceed $500 million in 2-3 years time according to two prominent industry analysts.

At considerable expense, this company filed for an IPO on one of Europe's major stock exchanges, but found insufficient demand to complete the share offering. A year later the board decided to reincorporate the company in the US, move the headquarters to Boston, and list the company's shares on NASDAQ.

Although this scenario is hypothetical, it could quickly become reality if the fragmented European stock exchanges for small cap growth companies do not develop critical mass.

EVCA believes that one of the biggest barriers to success for European Venture Capital, in comparison with that in the US, is the lack of European capital markets to provide capital for small cap growth companies. An initial public offering (IPO) provides growth companies with access to capital, and a liquid currency for making acquisitions and issuing stock options to its employees. A successful IPO is an important step during which medium-term risk capital (provided by the venture capitalists) is replaced with permanent capital by the capital markets. Even in cases where a trade sale is favoured over an IPO, there is no doubt that value is enhanced if the company can present a credible alternative in which it remains independent and obtains shareholder liquidity via an IPO.

Although the major European stock exchanges have adequate liquidity for large market capitalisation stocks, the exchanges lack the critical mass and market focus to be effective stock exchanges for small cap growth stocks. Despite early hopes for success on the Neuer Markt, EASDAQ, Nouveau Marche and AIM, the European stock exchanges failed to consolidate interest in small cap growth stocks. This meant that companies that were listed on these exchanges lacked trading liquidity.

Why Liquidity Matters

Trading liquidity (price per share times average daily trading volume) is an important measurement to assess the price shock that an equity can absorb. A highly liquid stock like Microsoft with a market capitalisation of $275 billion and an average daily trading volume of over $1 billion could absorb a $100 million price shock (investor sale of stock, management exercise of options, or an acquisition) with little or no market impact. Conversely a less liquid technology stock with a market capitalisation of €30 million and an average daily trading volume of €0.25 million could have a 10-20% impact to its stock price based on a €1 million price shock. Liquidity exists when you can sell meaningful amounts of stock without materially damaging a stock price.

Trading liquidity is equally important to venture capitalists, investors and to the companies that turn to the capital markets for permanent sources of capital. Typically, venture capitalists have a fixed term mandate for the assets they manage. The capital they offer to growth companies must ultimately be turned into cash or into a currency such as publicly traded equity that can ultimately be sold for cash. It is important to differentiate the needs of venture capitalists/investors and management teams.

From a venture capital and investor perspective, active trading of small cap growth stocks (i.e., trading liquidity) is critical to:

1. Enable investors to come into or out of investment positions without significantly impacting the stock price;
2. Generate sufficient trading commissions to support high quality sellside research coverage (this generates positive and negative investment views which drives trading volume in the stock).

From a company perspective, the active trading of its shares is critical for:

1. The success of share offerings required to fund corporate growth;
2. The orderly sale of venture capital share positions to efficiently replace them with capital from institutional and retail investors;
3. Visibility and press coverage that comes from being an actively traded stock;
4. The perceived value of a stock option programme (stock can be an important motivator for employees, but it needs to be perceived as having value to be an effective motivation tool);
5. A liquid acquisition currency with which to buy other public or private businesses.

Ecosystem Fragmentation
The Main Cause of the Problem

There are many stock exchanges in Europe, over 20 in total. Despite the recent efforts of OMX and Euronext, stock exchange consolidation is expected to be slow and difficult in Europe as each stock exchange supports its own ecosystem of investment bankers, stock brokers, equity research analysts, traders, accountants, lawyers, stock exchange regulators, financial PR firms and other advisors.

Fragmentation is not a problem of the stock exchanges alone. The deeper problem lies in the very disparate market practices that still exist in different parts of Europe. Each stock exchange has its own set of listing criteria and regulations, disclosure requirements, IPO market practices, underwriting fees, and trading system.

Therefore, it is no surprise that many small cap growth companies find it very difficult to access capital and investors on a pan-European level. The local investment banks that are most likely to take on smaller stock offerings often lack global sector research expertise needed to attract institutional investors on an international basis, and their retail distribution channels are local in nature. The larger investment banks with broader reach to international investors generally do not have sufficient economic incentive to justify underwritings under €50 million.

Local stock exchanges may be adequate for large cap European companies, but are not able to provide the capital and liquidity requirements of small cap growth companies. Demand for shares in these companies is lower because there are few specialist small cap investment funds in Europe, there is inadequate sector-based equity research, and a retail equity culture is still developing.

Nearly every IPO practitioner that we interviewed agreed that a market making trading system, similar to that of NASDAQ, creates increased liquidity for small cap stocks. Hybrid trading platforms which include both market making and order-driven systems seem to be the preferred structure of many European stock exchanges so as to accommodate both small and large cap companies. In each case, we believe that it is important that stock exchanges take a proactive role in promoting market making platforms by creating incentives for brokerage firms to risk capital in this activity.

Fragmentation will continue to negatively impact both the IPO valuations, and aftermarket trading liquidity of small cap growth companies in Europe. Yet, at a time when the industry should be focusing on the consolidation of exchanges, we are witnessing the launch of new exchanges. EVCA believes that this will not serve to enhance market liquidity.

EVCA believes that rather than starting new exchanges, efforts should be focused on collaboration between existing exchanges to create a pan-European platform for the trading of shares in small cap growth companies.

Removing the Barriers
The First Step Towards a Solution

As a first step, EVCA believes that it is imperative to remove the barriers to cross-border capital flows in Europe. The European Union can play an important role here.

In recent years, there has been a substantial effort to develop harmonised trading and accounting regulations covering quoted European businesses. The International Financial Reporting Standards provide global accounting benchmarks that enable investors to make like-for-like comparisons irrespective of company nationality. The EU Prospectus Directive introduces common pan-European standards governing the issue of securities. There clearly needs to be harmonisation of listing criteria covering such issues as the free float minimum, financial history and reporting requirements.

Differences in legislation among European countries often create a legal no man's land when it comes to settling cross-border equity trades. For example, in France an individual owns a security at the time that the trade is agreed to, whereas in the Netherlands the individual owns the security only after settlement. The high cost and time consuming procedures associated with the settlement of cross-border equity trades must be resolved. Private individuals face significantly higher trade settlement costs when buying foreign securities. This has created a significant hurdle to cross-border trading.

Another challenge facing European exchanges and regulators is whether to promote market regulated exchanges (such as practised by London's Alternative Investment Market) or opt for a more conventionally regulated model like that of NASDAQ which is designed to provide safeguards for investors. With the light touch approach adopted by AIM, it is the nominated advisors (NOMADs) that take much of the responsibility for ensuring best practice and good corporate governance as they put their own reputations on the line.

Streamlined regulatory procedures for IPO filings similar to the "light touch" model adopted by AIM and more recently by Alternext must be favoured alongside the removal of regulatory barriers.

A pan-European Trading Platform
The Chicken and Egg Problem

Creating a pan-European trading platform and quoted market for small cap growth companies is not a trivial exercise. Previous efforts to do so – such as the creation of EASDAQ or the emergence of cross-border alliances between fledgling new markets – faltered for a variety of reasons including intense competition from national exchanges, poor timing, and a lack of financial industry support.

EVCA has spent time talking to the various members of the ecosystem, including its own members, the stock exchanges, growth companies, regional and global investment banks, and institutional investors. There is a broad consensus that it would be highly desirable to establish a pan-European trading platform and a view that aftermarket liquidity would be significantly enhanced provided that several important steps are taken. These include:

1. The harmonisation of listing criteria across exchanges. Specifically, standardised criteria regarding requirements for minimum total assets, years of trading history, and number of independent Directors;
2. The promotion of the cross-exchange platform through the marketing of sector indices and their inclusion in the financial press throughout Europe;
3. The involvement of additional non-domestic market makers willing to commit capital in the trading of small cap growth company shares;
4. The development of simple connectivity for investment banks in remote locations;
5. The implementation of low-cost settlement systems;
6. A streamlining of regulatory procedures for IPO filings similar to the "light touch" model adopted by AIM and more recently by Alternext;
7. Discrete and confidential listing approvals for secondary offerings;
8. The adoption of fair acquisition and minority squeeze out regulations and provisions.

Equity Research and Economics – The Missing Link

By their very nature, small cap growth companies represent a higher level of investment risk than large cap companies. Part of that increased risk is a function of the information disconnect between issuers and investors. Sector-specific research that compares European technology and life sciences companies on a global basis, and on a comparative valuation basis with their counterparts in the US and elsewhere, is needed in order for investors to make sound investment decisions.

Moreover, it is important that there are multiple sources of research on any given listed small cap company. Therefore, EVCA believes its members should support larger, geographically diverse underwriting syndicates as a means to stimulating broader research coverage for recently listed small cap growth companies. A small cap IPO issuer can expect that all of the investment banks in its underwriting syndicate will provide some degree of research support during the period following the IPO. More analyst coverage, including both positive and negative opinions, creates a market, driving trading volumes, investor participation and liquidity.

However research is not free. There needs to be sufficient economics to underpin the provision of quality research from multiple sources. In Europe, IPO underwriting fees are considerably lower on average than in the US. This results in smaller syndicates, i.e. fewer investment banks providing research and aftermarket support for newly-listed companies. Some UK banks have funded ongoing support of small cap corporate finance clients by charging annual corporate broking fees, but in many cases where broking fees are insufficient, it is not economic for a bank to publish research on small cap growth companies.

EVCA believes that in addition to sell-side research, there is a role for independent research which has either been commissioned by individual companies or is paid for directly by the institutional investors themselves. It may be necessary that stock exchanges take a more active role to promote independent research.

Conclusions

The lack of smoothly functioning capital markets for small cap growth companies in Europe is a very real problem with serious implications for the European Venture Capital industry, and of course, job creation and economic growth in Europe.

Removing barriers to cross-border capital flows is a tangible and realistic goal. EVCA supports the efforts of the European Commission and European Union member states in pursuing harmonisation of EU legislation covering financial services and corporate governance. But EVCA cautions against over-regulation, which would be very detrimental to the growth of a European small cap growth market.

A pan-European trading platform with critical mass and adequate liquidity needs to be put in place and there is a strong desire among venture capitalists, growth company management, bankers and institutional shareholders, to see one developed. EVCA believes that close collaboration between the existing exchanges or the broadening of the scope of one of them to be pan-European is the best route to achieving a successful pan-European market for small cap growth companies.

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