PRIVATE EQUITY AS FINANCING SOURCE FOR SMES – AN OUTLOOK

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Abstract: Nowdays, one of the main barriers against the growth of Small and Medium Enterprises (SMEs) are related to difficulties in accessing finance. These obstacles have multiple causes, such as cyclical, structural but should be also considered the international economic background.
SMEs are still dependent on bank loans for their external financing, therefore, suitable alternatives should be considered. Private Equity is an essential source for start-up, young and growth companies to create and add value, often through research and innovation. Anyway, equity should not be regarded as a substitute for traditional SME financing instruments. Rather, it serves a specific group of SMEs (including startups), which contribute in a great extent, to the innovativeness, productivity and development of the overall economy.
In this paper, there are highlighted the importance of equity finance for SMEs in different stages of their development (creation, survival and growth), the main trends and evolutions in the European market of the private equity funds and some prospects regarding the private equity financing.

JEL classification: G32, L21, M21

Key words: financing, private equity, SMEs, prospects

1. INTRODUCTION

Equity finance refers to the financial resources provided to companies in return for an ownership interest. The main categories of equity finance are private equity (PE) and public equity. The public equity concerns the listed firms that are traded at the stock exchanges, while the private equity regards the unlisted companies. Another difference consist on the fact that, the private equity investors assist the owners or managers during the development of the firm while the public equity investors are not involved in the company management.

There also should be considered the informal sources of equity finance, which include family and friends. In the countries with a developed equity capital market, the funds attaracted through the informal channels exceeds other venture finance, especially for start-up companies (Mac an Bhaird, 2010).

Equity markets could represent important sources of financing for firms that need long-term investment in order to sustain value creation and growth (OECD, 2019).

In fact, equity financing is important for new, innovative and high growth firms which generally have a high risk-return profile. Early stage equity finance can support firms creation and development and other equity instruments (such as the platforms for SME public listing) can supply the financial resources for growth oriented small and medium firms.

On the other hand, for SMEs, raising equity capital means an in increased cost compared to debt finance (costs of distribution and securities registration) (Berger and Udell, 2006). Besides, SMEs are often confronted with an underpricing on capital markets and the restraint of investors caused by the loss of control implied by the wider ownership of equity (Mac an Bhaird, 2010).

There are some impediments against the development of the European private equity market and the accessibility of alternative funding is still underdeveloped for SMEs, (venture capital or business angels). Despite these, the private equity is an essential source for start-up, young but also developed companies in order to create value and this should not be considered as a substitute for traditional SME financing instruments.

The public measures and actions in the area of SME financing in general, and external equity financing in particular, is determined by many factors, such as: the existence of information asymmetries between investor and recipient, the presence of fixed costs of investment and the existence of positive externalities determined by SMEs' innovation activities. In these circumstances, there are necessary some new initiatives and regulations at the European and international level.

2. SMES DEVELOPMENT STAGES – FINANCING NEEDS

SMEs contribute significantly to European job creation (66.6% of total employment) and economic growth, they generated 56.8% of total added value in 2017. (EIF, 2018).

In all stages of their life cycle - creation, survival and growth - the SMEs need to access the financing sources (figure 1).

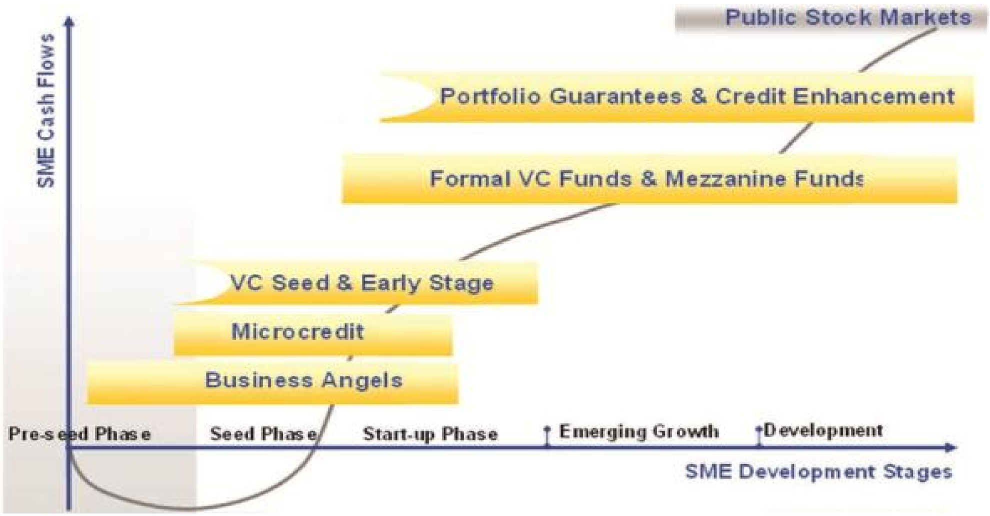

Figure 1. SMEs development stages

In the seed stage the firms need financing to do research, to complete product definition or product design, also including market tests and creation of prototypes. This funding is not be used to start mass production or distribution.

In the start-up stage, the SME need funds to begin the production or distribution and to cover the marketing costs. The capital will cover the expenditures and initial working capital.

In the next stage - growth stage - there is a a private equity investment in mature firms that need financing to develop, improve operations, enter new markets, accelerate business growth.

In the case of buyout, there is the financing resources provided in order to acquire a firm. In the case of rescue, there is financing resources for a business which has experienced financial distress, in order to regain its financial situation.

In the case of replacement capital there is a minority stake purchase from another private equity investment institution or from another shareholders.

Over the last years, the European economy has continued the recorvery on a steady path but the SME financing market still register structural failures. Therefore, a significant part of European SMEs still experience barriers in access to finance, generally, microenterprises, start-ups, young SMEs, and highly innovative firms.

Many SMEs rely on self-financing for their growth but new financing instruments (e.g. equity crowdfunding, peer to-peer lending) gain more and more importance and there were adopted policies to create an appropriate regulatory frameworks in order to support these developments (OECD, 2019).

3. PRIVATE EQUITY FUNDS - OUTLOOK

Considering the importance of different financing instruments, the banking products (loans and overdraft) are still the most popular instruments for SMEs, followed by leasing and hire-purchase. Equity and factoring represent just a small fraction of overall SMEs'external financing needs (figure 2).

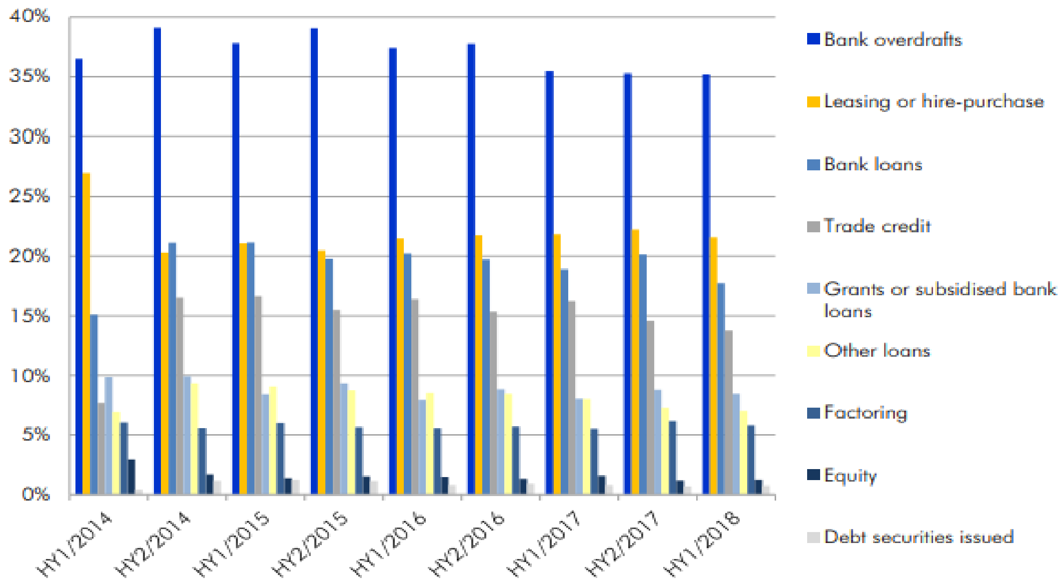

Figure 2. Financing sources by European SMEs

Source: European Investment Fund, European Small Business Finance-Outlook, 2018

Considering the purpose for which financing is used by European SMEs, the bank loans, leasing and equity is used especially for investments in property, plant or equipment while the trade credit and bank overdrafts are used mainly for working capital (figure 3).

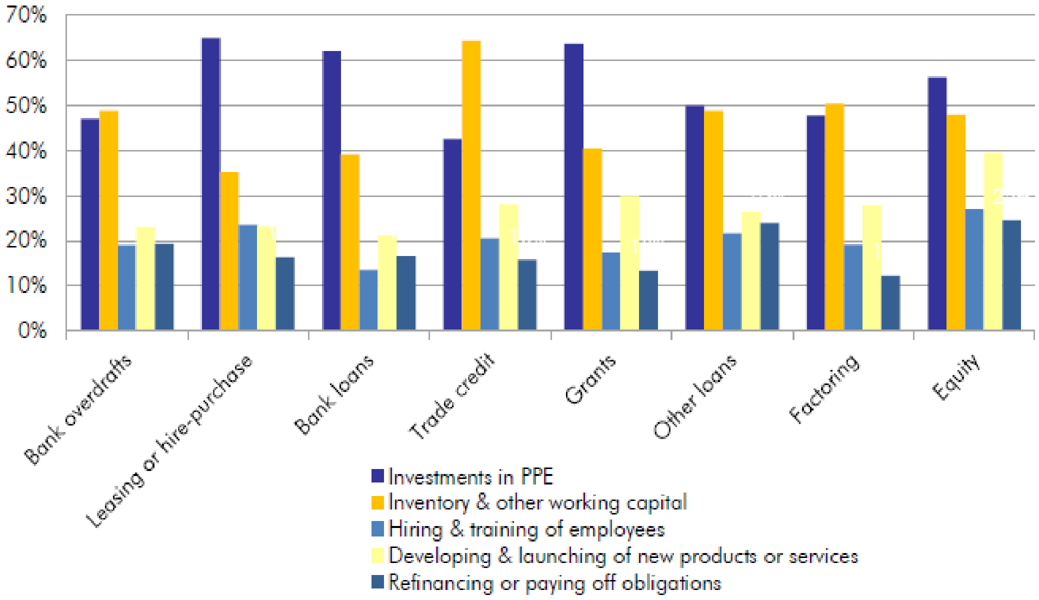

Figure 3. Financing Purpose by financing source - European SMEs
Source: European Investment Fund, European Small Business Finance-Outlook, 2018

The European private equity market recorded unconstant evolutions over the past 20 years. The highest peak was registered in 2006, when the total private equity funds in Europe reached an amount of 112bn EUR (EIF, 2018) (Figure 4).

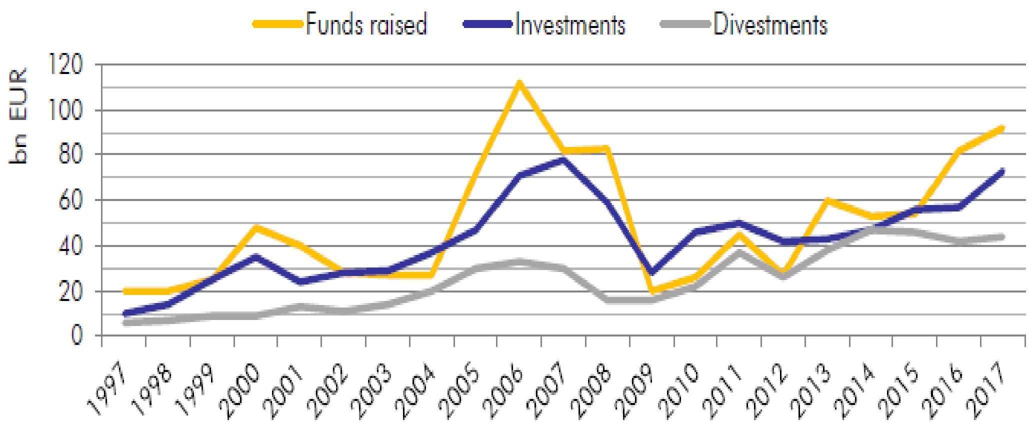

Figure 4. Private equity by European private equity firms
Source: European Investment Fund, European Small Business Finance-Outlook, 2018

In 2017, the overall private equity investment levels reached about 80 bn Euro but that level was followed by a high decline after the financial crisis from 2007. This was followed by a partial rebound, and in the last years, the fundraising and investment seem to be get closer to the pre-crisis levels.

In 2017, the total fundraising reached the Europe's highest level since 2006 and a 12% increase year-on-year. The pension funds provided 29% of capital, followed by funds of funds (20%), family offices and private individuals (15%), sovereign wealth funds (9%) and insurance companies (8%) (EIF, 2018).

Regarding the evolution of private equity funds in Europe, in 2017 was registered an high increase by 29% compared to the previous year. The investments by private equity funds in portfolio companies in Europe increased by 29% (Figure 5).

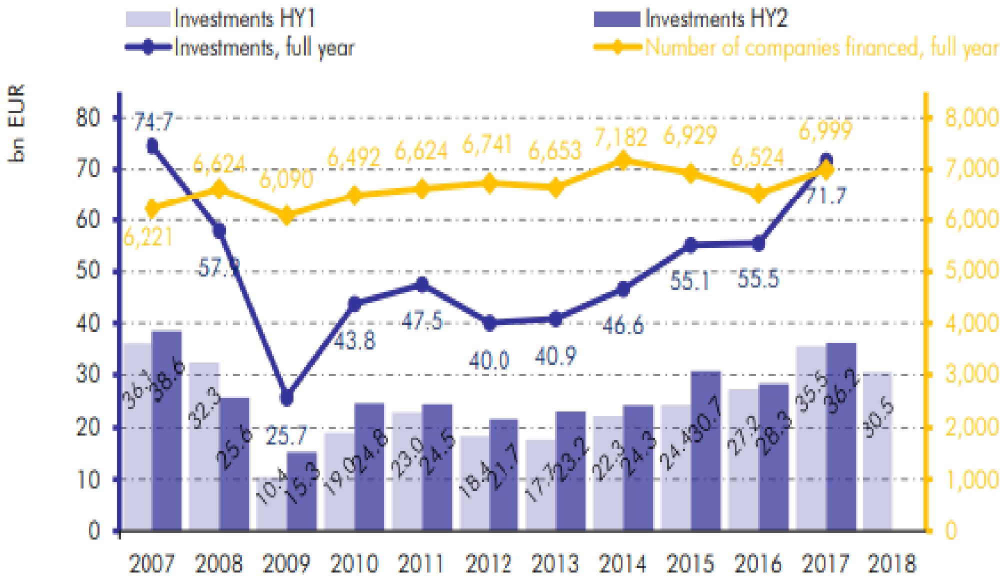

Figure 5: Private Equity investment in European portfolio companies

Source: European Investment Fund, European Small Business Finance-Outlook, 2018

A differentiation by stage focus reveals that investment moved towards the largest part of the PE market, i.e. the buyout segment (figure 6).

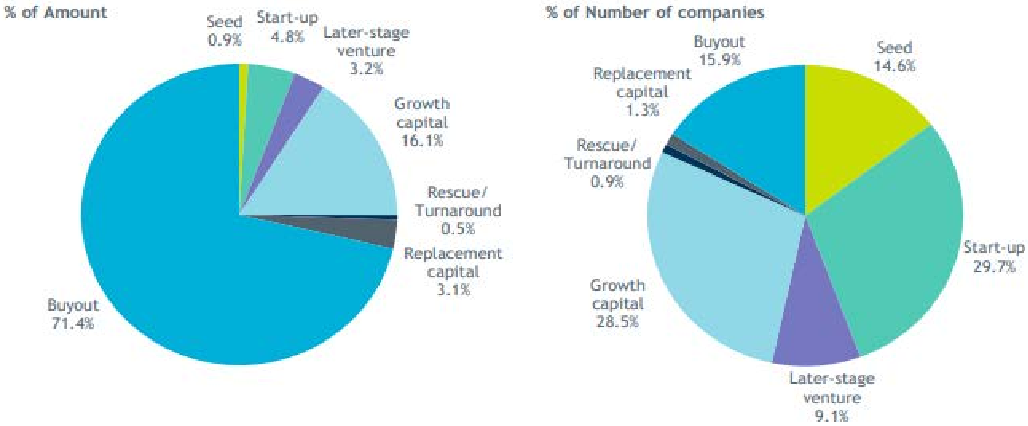

Figure nr. 6. Investments by development stage (2017)

Source: *Invest Europe, European Private Equity Activity, Statistics on Fundrising, Investment&Disinvestments, 2017*

An important increase was also recorded for replacement (28%) and growth capital (6%), while the segment of rescue, turnaround capital registered a decrease by 37%.

The increase in the total divestment amount in 2017 was mainly due to higher activity in the buyout segment of the market (21%). In contrast, divestments in the venture and growth capital segments decreased by 7%, respectively 5% (EIF, 2018).

4. Private equity financing – prospects

The recent changes in the global and European economic environment represent new challenges for the private equity market. As a result, considering the economic sector and the business models, the time necessary to grow from a start-up to a global leader have shortened considerably. Also, the recent favourable developments in the private equity market could be contested by risks related to the economic, monetary and political environment.

Another important factor is the digitalisation of the economy that determined a differentiation of market segments. The digital companies need limited resources at the beginning of their activity but soon the globalisation of their business models impose an increase of their funding needs.

In Europe, a period of 2-3 years represent a critical time and not many start-ups survive beyond this. Besides, a much larger share of firms remains static and fewer companies manage to grow into large firms (EC, 2017).

Despite this, in the last years the European economy has continued on a steady path towards recovery. The recent trends of recovery in the European economy has led to a decline of the insolvencies in most European countries, except the Central and Eastern European, Sweden and Belgium, where the insolvencies registered an increase (figure 7).

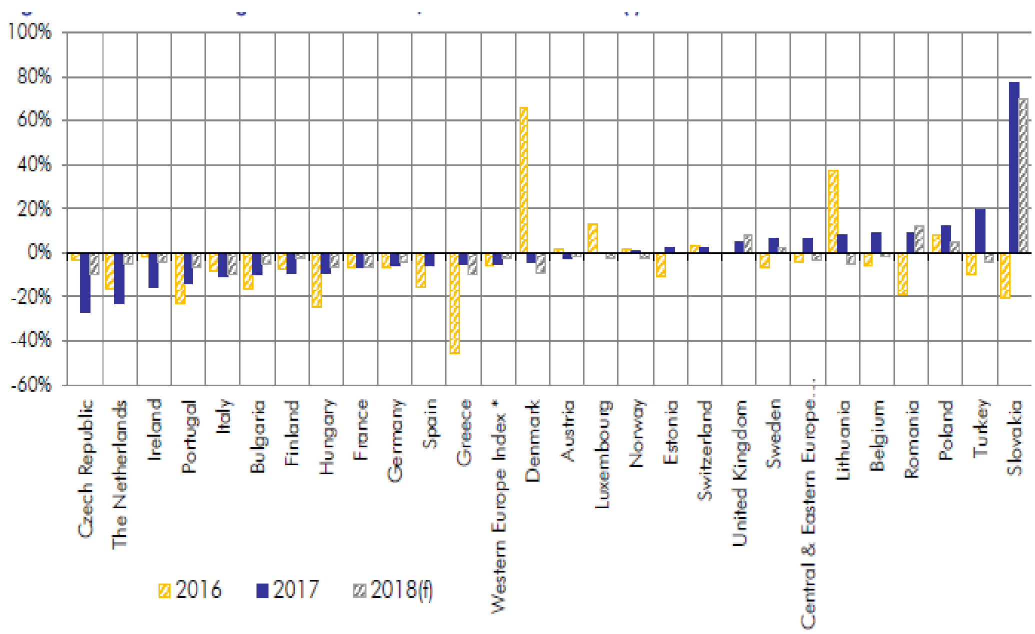

Figure 7. Rate of insolvencies in EU countries

Source: European Investment Fund, European Small Business Finance-Outlook, 2018

SMEs in traditional industries need flexible funding instruments (equity, mezzanine finance) for competing in a rapidly changing economic environment. On the other hand, the companies in growth-stage confront with a serious lack of funding in order to increase their external expansion and to face global competitors.

The recent evolutions conducted to a segmentation between early stage and late stage funding.

When there is a lack of private capital, the temptation is to use public sector resources primarily to mobilise private sector capital and to introduce new policy instruments which could substitute the private sector.

Therefore, Europe needs a complex portfolio of funding instruments and policies to support the various segments of start-ups, SMEs, to foster the recovery from the financial and economic crisis and to increase the firms' competitiveness and their contribution to economic development and innovation.

The funding tools should be complementary to existing instruments in terms of development stage, activity sector or geographic focus and regulatory simplification. As result, harmonization and promoting investment are important steps towards a less fragmented European equity market.

Europe's economic success depends largely on how the Small and Medium Enterprises can achieve their development potential. Therefore, one of the main priorities established in Europe 2020, in the Commission's Single Market Act and the Small Business Act is to facilitate access to finance for SMEs.

Europe needs a funding infrastructure to support the increasing corporate financing needs, an EU equity flagship facility to ensure a long-term perspective for different type of funding depending on the development stage of the firms.

5. CONCLUSIONS

Equity finance include the public equity instruments - which concern listed firms - and the private equity instruments, which are related to unlisted companies.

Equity markets are key factors for companies with high risk-return profile (new, innovative and high growth firms) and firms that need long-term investment in order to sustain value creation, growth and innovation.

A range of government policies to support the SME access to finance have been introduced since the financial crisis, including new policy initiatives, scaling up existing measures. Therefore, after the international crisis of European private equity markets in the years 2008-2009, some positive developments have been recorded in the last years.

In order to solve the problem of lack of liquidity on SME equity markets there were adopted Government policies in order to increase retail investment. These platforms require specific regulations, an infrastructure and a key challenge is to achieve a balance between greater flexibility and lower costs for SMEs in order to ensure the market integrity, transparency and a good corporate governance.

A permanent key challenge for policy makers is the extention of finance options available for SMEs is order to support their development and sustain the most dynamic enterprises, in the condition of a credit restricted environment. It also represents a challenge for improving the SMEs' capital structure, investment capacity and for reducing their reluctance to the traditional lending channels.

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