FESE position on the use of private-public funds for the IPOs of EU SMEs

9th June 2020

1. The proposal for an EU private-public fund to support IPOs

As President-elect for the European Commission, Ursula von der Leyen made it her priority to facilitate SMEs' access to finance by completing the Capital Markets Union (CMU). In parallel to reviewing the relevant legislation adopted in recent years, the Commission would launch a "private-public fund specialising in Initial Public Offerings (IPOs) of SMEs" to meet the new Commission President's objective of supporting SMEs' investment and financing opportunities[1].

FESE strongly supports Ursula von der Leyen's political guidelines for the current European Commission, and in the context of the current crisis, we believe that a revamped CMU is now even more necessary to build a more sustainable and resilient EU economy that works for people. The creation of an EU private-public fund for IPOs (also referred to as an 'EU IPO fund') is a welcomed step in this development. FESE believes that the EU IPO fund should support both IPOs and secondary issuances on the EU's Regulated Markets and multilateral trading facilities (MTFs).

If successful, this initiative would act as a long-term commitment to help bridge the companies' transition from private to public markets and potentially address their private and equity valuation mismatch. The proposal could also be an opportunity to increase the liquidity available for small and mid-cap issuers, both incentivising and boosting SMEs' access to public markets. In addition, it could encourage new intermediaries (or networks of intermediaries) and investors to co-invest and incentivise more pre-IPO investment interests in such companies. The creation of an EU IPO fund could thus potentially be a game changer for European equity markets.

The composition of the proposed EU IPO fund should be dedicated to professional fund managers that are involved in a company's pre-, post-and IPO stages. The fund should operate for a period of 3-5 years with a view to give companies 12/18 months of additional maturity before listing. This would favour specialised and active *cornerstone investors* at IPO who would be incentivised to commit with a longer lock-in period. In addition, the EU IPO fund could act as a basis to further complete the CMU objectives by:

- Supporting equity research on SMEs with the use of subsidies, to promote their visibility towards both institutional and retail investors;
- Stimulating SME Growth Markets with repayable loans to cover SMEs' IPO expenses, repayable by the SME after it has raised funding on the public markets. This would help SMEs cover pre-IPO costs for roadshows and advisory services (audit, equity, communication, etc.);
- Providing secondary market liquidity by lending stock in companies in which it has an investment to smooth trading and prevent volatile share prices when there is a shortage of deliverable stock. This could provide greater confidence for investors and thus help create further liquidity.

[1] A Union that strives for more: My agenda for Europe, Ursula von der Leyen

- Supporting secondary issuances

It would be important that the set-up of the fund is adapted to work in different markets as the local dimension (especially for smaller markets) is essential to cater for the specific needs of companies which are mostly SMEs. Moreover, regional exchanges across Europe host a larger share of IPOs for smaller companies as these companies are likely to be local and seek investors more familiar with their business.

2. Supporting the use of cross-over funds

The IPO fund that the Commission is proposing has some similarities with cross-over funds. These funds have been in use in the US for some time and are starting to emerge in Europe with some sector-specific funds[2]. Companies' private valuation under cross-over funds, are expected to be more in line with that of public investors, leading to a more correlated valuation of their share price with less risk of a devaluation for the companies concerned. This would foster convergence between public equity and private equity markets. Cross-over funds can be used to bridge the gap between private and public equity to smoothen the company's transition from one to another. Private equity funds can sell their stake in a company to another private equity fund (but this would only work for a limited number of rounds), a corporate (which most of the time will be a listed company), or IPO the company.

FESE welcomes the work currently being undertaken by the European Commission into the potential support of cross-over funds. Cross-over funds offer SMEs the possibility to expand their shareholder base prior to the IPO, allowing them to include traditional institutional public company investors. Providing access to Exchange investors in advance makes them familiar with the SME and increases the chances of counting with them in the IPO.

In addition, cross-over funds could help incentivise start-ups and SMEs to remain in the EU, as they are increasingly pushed to look for international capital (via international venture capital) and private equity funds abroad. An earlier entrance to capital markets would provide the required capital for start-ups and SMEs to continue to grow (while remaining independent), hence able to remain based in Europe whilst generating qualified employment, innovation skills and capital gains for the EU.

The presence of cross-over funds in European listing markets show that funds have either recently emerged or are currently emerging in the EU capital markets (see Annex I). Whilst discussions are ongoing about the set-up of similar new funds, lessons can potentially be learnt from successful examples of past experiences in the use of this type of funds. In considering the set-up of the EU IPO fund, there could also be an interest to share existing best practices in the set-up of cross-over funds.

[2] https://www.sofinnova.fr/sofinnova-partners-launches-healthcare-crossover-fund-with-e275-million-340-million/

ANNEX I – EU Cross-Over Funds

Feedback from Nasdaq indicates that there are cross-over funds active in the Nordic markets. Deutsche Börse has indicated that there are no cross-over funds active in the markets where they operate. However, measures currently being implemented in Germany to fight the corona pandemic (Wirtschaftstabilisierungsfond) are expected to have some cross-over fund characteristics as they shall be allowed to invest in both private as well as public companies. In the Netherlands, to stimulate investors to become active in the SME market segments, there are ongoing discussions around the creation of an Alternative Investment Fund to support the listing of local SMEs. This fund would allow for domestic institutional investors to invest in small and mid-cap companies pre-IPO and participate as their *cornerstone investors* post-IPO.

For the Spanish market, BME has indicated that, although no proper cross-over fund has been created, a number of private equity funds hold stakes in SMEs listed in the Spanish junior market, MAB. This is mainly due to some companies of their portfolio being willing to go public or through convertible loans granted by private-equity funds to listed SME. Some private-equity funds also invest in MAB companies eventually. A particular example in Spain was a small private-equity fund called Capital MAB FCR. It was created in 2014 by the Catalonian regional investment body (ICF or Institut Catala de Finances) and its target, although not exclusively, was to invest in pre-IPOs or IPOs of Catalonian companies going public in the MAB. The fund made a small number of investments through the years and in 2019 the ICF decided to close it. In Spain, initial conversations between private equity managers and national or regional development financial institutions are now taking place. This could be seen as a first step to the creation of cross-over funds.