Bridging the growth gap

Investor views on European and US capital markets and how they drive investment and economic growth

Summaries
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February 2015
Executive summary
Executive summary

At a time when Europe’s economy is struggling to expand, this report, based on a survey of leading institutional investors, compares the overarching differences between US and European capital markets and ways to improve delivery of finance in Europe. It focuses particularly on the key areas of small and medium-sized enterprises (SMEs), infrastructure and mid-sized corporates (via Private Placements).

The leading institutional investors taking part in the survey highlight the key differences in the markets in Europe and the US, as well as a number of measures to improve the investment landscape in Europe.

This second AFME report follows the first AFME Growth publication, Unlocking funding for European investment and growth (2013), which focused on identifying specific funding obstacles affecting growth. In response to this second report, AFME members are keen to make tangible contributions to address problems identified by survey investors, in order to help European economic growth.

In summary, the survey reveals a wide range of practical barriers cited by the investors we interviewed (Figure 1).

Figure 1: Investors see a range of barriers to investment in Europe

Our analysis reveals that Europe has a smaller pool of funding available for investment than the US (including bank and capital markets finance), with less equity risk capital, although its economy is a similar size. We estimate that Europe’s sum of identified investable assets is only approximately half the size of the US – with approximately €30tn of external funding outstanding, compared with approximately €49tn in the US (Figure 2). Similarly, Europe has only half as much listed equity capital – €10tn vs €19tn in the US. However, as described later, in certain sectors such as infrastructure and SMEs, Europe provides more funding than in the US.

Comparison with the US shows that the structure and sources of finance are a key challenge for Europe. While regulated entities such as banks and insurers are the main suppliers of finance in Europe, the US benefits from greater diversity and flexibility of funding sources. In the US, private pension funds, fund managers and other types of investors (e.g. angel investors, hedge funds, private equity and venture capital) provide a significantly larger proportion of funding to firms (see Figure 2) than in Europe.
However, when asked to assess whether the amount of funding available was holding back European growth, **77% of the investors interviewed said that they did not see the amount of financing available as being the chief barrier to growth.**

In addition, there is a **greater appetite for risk in US business culture, alongside larger pools of capital** (Figure 2). Private pension funds in the US provide a far greater amount of funding than in Europe, which more than offsets the fact that Europe’s insurer assets are twice as large as in the US. The same trend can be found in the amount of ‘dry-powder’ – committed, but not yet invested capital – by institutional investors into the private equity and venture capital asset class. In 2014, US private equity (PE) and venture capital (VC) funds had €488bn ready to be invested in comparison to comparable European funds having €245bn to be invested. In terms of risk appetite, US pension funds and fund managers invest more in the equity asset class than their European peers (53% vs 37% of funds managed).

Similarly, there is a **lower allocation of investments toward equities in Europe.** Part, but not all, of the lower risk profile of European asset allocation can be attributed to the larger role of state pension systems in Europe, whereby individual pension beneficiaries do not make the investment decisions that will impact their retirement income. This puts more pressure on national government finances, since governments will have to absorb reinvestment risks rather than those who benefit from the retirement provision.

**Figure 2: European Union and the US: different structures and sources of finance**

<table>
<thead>
<tr>
<th>Category</th>
<th>Outstanding market (€T)</th>
<th>Flows (€B)</th>
<th>EU</th>
<th>US</th>
</tr>
</thead>
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<tr>
<td>Corporate Debt</td>
<td>Bank loans outstanding to NFCs</td>
<td>1.3</td>
<td>5.5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bonds outstanding to NFCs</td>
<td>1.1</td>
<td>3.3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Securitization market outstanding</td>
<td>1.5</td>
<td>6.8</td>
<td></td>
</tr>
<tr>
<td>Sovereign Debt</td>
<td>Sovereign bonds outstanding</td>
<td>9.6</td>
<td>12.3</td>
<td></td>
</tr>
<tr>
<td>Equity / M&amp;A</td>
<td>Listed market capitalisation</td>
<td>10</td>
<td>19</td>
<td></td>
</tr>
<tr>
<td>Institutions Investors &amp; Household</td>
<td>Insurance company investible assets</td>
<td>4.0</td>
<td>6.8</td>
<td></td>
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<tr>
<td></td>
<td>Pension funds investible assets</td>
<td>4.3</td>
<td>14.9</td>
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<tr>
<td></td>
<td>Mutual funds investible assets</td>
<td>2.1</td>
<td>4.4</td>
<td></td>
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<td></td>
<td>Hedge funds investible assets</td>
<td>0.4</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sovereign Wealth Funds</td>
<td>0.8</td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Corporates managed funds</td>
<td>0.6</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Household financial assets</td>
<td>15.3</td>
<td>23.3</td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Illustration only – not exhaustive. Source: Appendix 1
Commenting specifically on SMEs, which represent 58% of Europe’s value-added and 67% of its employment, interviewees noted that lending by certain banks has fallen in the past few years, especially in crisis-affected countries. However, the European Central Bank (ECB) report, Survey on the access to finance of enterprises, reported an improvement in the availability of finance in net terms, with the exception of the smallest firms, in the six months from April to September 2014.

Bank loans are the greatest source of finance for Europe’s SMEs, especially the smallest firms, with the result that SMEs’ balance sheets are frequently under-capitalised. An EU member state government study found that 71% of businesses in that country approach only one provider when seeking finance, and that in more than half of cases it will be their main bank. SMEs in Europe rely heavily on their bank for finance, yet for small companies with limited profits or cash flows, bank loans are often not the most suitable form of financing. Equity may be more suitable in many situations.

Infrastructure spending, another critical driver of growth in Europe, is also down and below long-term averages. New infrastructure spending provides an immediate stimulus to the economy, and also builds an ecosystem for future businesses to thrive. Interviewees said there was no shortage of capital. Instead, it was mentioned that infrastructure spending was being held back by a variety of factors, including: the risk of governments “moving the goal posts”, an insufficient number of high-quality projects, regulatory treatment of investments, and the need for better management of demand/usage risk.

Finally, interviewees observed that many of Europe’s middle-sized and large companies would also benefit from alternative financing options such as Private Placements, especially when compared to other markets such as the US.

As well as differences in sources of funding and risk profile, four other key conclusions were reached:

- **Fragmentation**: Survey participants highlighted that fragmentation discourages investments in Europe; 65% of interviewees cited information/understanding differences across markets as a key barrier, and 60% cited national discrepancies in rules. Half cited differences in taxes and incentives. Information/understanding issues could include language differences, difficulty in finding information to compare cross-border investment risk issues, as well as inconsistencies between data sources. Successful US SMEs find it easier to achieve scale – due both to the single language and the ease of expanding across US state lines, compared to national boundaries in Europe.

- **SMEs**: Estimates show an outstanding stock of SME finance of €1.2tn in the US versus €2.0tn in Europe, with gross financing of €571bn in the US vs €926bn in Europe. Despite this higher overall funding for SMEs compared to the US, European SMEs suffer from a lack of financing avenues that could provide equity. This lack of equity is a key bottleneck to the provision of further overall SME funding; the US has a much more developed equity network for SMEs. Interviewees cited a European preference for debt funding over equity. Also cited was the widespread inability of European issuers to access equity investment by friends and family, business angels and private equity/venture capital. Public support for SMEs by the US Small Business Administration was also seen as more efficient and effective than the current fragmented European approach. See summary table of differences in the section, Better financing for SMEs.

- **Infrastructure**: European infrastructure would benefit from more targeted public support, to mitigate risks that cannot be accepted by private sector investors. These include usage/volume risks, as well as the risk of European issuers reducing tariff revenues after bonds have been sold. Europe has recently provided more funding for infrastructure than the US, although it relies much more on bank funding, while the US is more dependent on municipal finance. Interviewees also suggested a more coordinated issuance pipeline to aid investment planning and, in particular, support the Commission and EIB plan to develop a pipeline reporting initiative. It would also improve municipality planning match demand to overall strategy. Forty five per cent of respondents cited Solvency II concerns and 40% cited accounting concerns (Figure 1).
Executive summary

- **European Private Placements**: These would benefit from standardised documentation, which could be developed by the wholesale financial markets industry. This should also be complemented by clarification (possibly through some type of definition of a Private Placement) of regulatory and tax ambiguities that discourage investment. The US has two successful regulatory Private Placement regimes that reduce this investment uncertainty through ‘safe harbour’ exemptions (see summary of differences in the section, Raising the profile and use of Private Placements in Europe). The **Pan-European Private Placement (PEPP)** initiative should provide an important first step in the standardisation of Private Placement documentation for loans and notes/bonds.

**Better financing small and medium-sized enterprises (SMEs)**

In addressing how to better finance SMEs within Europe, as indicated above, **AFME found that the amount of money available is not the major barrier**. Analysis shows that more money is available to European SMEs than to US SMEs. Our estimates indicate that almost double the amount of total financing has been made available to SMEs in Europe from banks, non-banks and governments than to their US equivalents (Figure 3).

Of this, banks appear to provide a much larger proportion of SME financing in Europe than in the US, even after the recent decline in bank lending in certain countries. Data show that in 2013, €926bn of new funding of all types was provided to Europe’s SMEs, compared to just over €571bn in the US. Note that data in both regions excludes funding provided by personal financing, including funds made available to SMEs by their owners through their own personal wealth and retained earnings. Our analysis uses the European Commission’s SME definition, where explicit data are available, of turnover of less than €50m for the largest SMEs.

**Figure 3: Sizes and sources of financing for SMEs in Europe and the US**

Sources: Appendix 2. Please note that the table excludes the funds provided to SMEs by their owners through their own personal wealth.

Interviewees thought that a European culture of risk aversion among SMEs and investors might explain the reliance on bank lending. In particular, they contrasted Europe to the US.

Research and interviews found that **European SMEs strongly prefer bank lending over personal or alternative sources of financing**. This is evidenced by the under-developed nature of alternative sources of finance – such as venture capital and angel investing – available to smaller SMEs in Europe. For example, €26bn was invested by venture capital firms in SMEs in the US in 2013; against only €5bn in Europe. Over the same period, €20bn was invested by angel investors in US SMEs, versus only €6bn in Europe.
Insurance Company

For infrastructure, there is always a direct or indirect link with politics; if the regulatory framework is not clear and hasn’t been demonstrated to be solid, we won’t invest.

Solvency II is a real problem for long-term investors in Europe, and will hinder smaller players entering the infrastructure space.

Investors also noted that, in order to provide long-term financing to SMEs, a number of logistical barriers need to be addressed. SMEs could be made more aware of the differences between, and suitability of, debt and equity finance. Cost and size requirements for SMEs to issue debt/equity are often too high for many small firms, and current market conditions do not make the securitisation of SME loans particularly attractive.

To address these points, AFME believes that Europe should focus on increasing SME supply and demand for alternative forms of finance – particularly equity finance for small SMEs.

Increasing investment in long-term infrastructure projects

In seeking to increase investment in Europe’s infrastructure, it is important to recognise what Europe has achieved. The analysis shows that infrastructure spending in Europe is higher than in the US, with total infrastructure spending of €419bn in Europe in 2013, versus only €297bn in the US over the same period. It was also found that infrastructure spending as a percentage of GDP in Europe (4%) is almost double that in the US (2.2%). The structure of finance also differs, with most financing in Europe provided by the private sector, while in the US most is financed through government. This difference arises from a well-established and tax-efficient municipal bond market in the US, compared to a well-developed Public Private Partnership model in Europe (particularly in the UK). The level of private-sector involvement is also higher in Europe than the US in selected sectors, e.g. transport (Figure 4).

Figure 4: Infrastructure spending is higher in Europe than in the US

That said, there has been a long-term decline in overall infrastructure spending in Europe. So much so, that a large gap exists between the levels of infrastructure investment and spending required, and current levels of expenditure. The European Commission estimates that Europe requires an additional €1.5-€2tn of infrastructure investment to meet its 2020 goals.

Interviewees highlighted a number of potential concerns, including political interference by some governments in infrastructure deals, which asset managers said reduced their appetite for investing in long-term European infrastructure projects. Interviewees cited examples of governments having ‘moved the goal posts’ on commitments, which made them reluctant to enter into future investment deals with some European countries – especially relative to alternative US options.
Interviewees stated that **EU and national government support should be channelled towards ‘greenfield’ and ‘brownfield’ projects that would otherwise not be financially viable.** This is particularly true for projects with unquantifiable usage/demand risk. According to a recent Preqin study, 70% of all European infrastructure projects in 2013 were in operational or brownfield stage assets, which are already well established, and so have a lower risk and potentially a reduced contribution to economic growth. Please note that this study is primarily based on equity, debt and some, but not all, bank loan financing. It may not represent all infrastructure transactions.

Also raised were **significant concerns about the regulatory treatment of infrastructure investment.** It appears that the lack of a clear asset class definition for infrastructure investment is leading to disproportionate accounting regulation and capital charges for some long-term investors.

Turning to solutions, several improvements were suggested that would help encourage greater investment by institutional investors in European infrastructure projects. These were: greater visibility of the pipeline for infrastructure projects, better links with national growth strategies and frameworks, increased consistency in procurement processes across markets, and a greater appetite from governments for Public Private Partnership (PPP) deals. Many institutional investors reported that the size of their infrastructure investment teams may be difficult to justify if the deal flow does not increase soon.

Finally, several interviewees noted that direct investment in infrastructure was often not a viable option for smaller funds in Europe; especially across borders. This obstacle contrasted with the US, where the $3.5tn municipal bond market gives smaller US investors access to infrastructure in a tax effective way through the purchase of revenue bonds. While interviewees were quick to point out the benefits of such a scheme, they acknowledged that implementing an equivalent scheme in Europe would be difficult, given the lack of a unified tax system across nations.

AFME believes that solutions should seek to: reduce political and regulatory risk associated with investing in selected European countries; focus government support measures on projects/areas that are currently unviable potentially through partial guarantees; amend punitive accounting and capital charges associated with investing in infrastructure as an asset class; and increase the size and consistency of the project pipeline.

**Raising the profile and the use of private placements in Europe**

The desirability of promoting alternative funding avenues for mid-sized and large corporates was consistently mentioned by interviewees. They believed that **a larger and more visible European Private Placement market** would provide a faster, more flexible route for investing in European firms.

Interviewees regarded Private Placements as an important source of funding for European firms wishing to avoid the costly disclosure requirements that public market issuance often entails.

The status of the US as the long-standing leading centre for European deals was confirmed by investors, who viewed it as “the” global market. Interviewees were quick to point out that a European Private Placement market was still far from being a reality – despite rapid growth in the number and value of Private Placement deals taking place in Germany, France and the UK. The analysis indicates that the value of US Private Placement deals at €46.1bn ($58.3bn) in 2013 far outstripped the size of European deals, which totalled €20bn over the same period (Figures 5 and 6).
Executive summary

Differences in the legal framework of different countries are a key impediment to Private Placement in Europe. A Private Placement in the Netherlands is different to a Private Placement in France.

Interviewees emphasised that the lack of standardisation in deal documentation and processes significantly hindered European Private Placement transactions. They explained that Germany’s Schuldscheine notes benefited from a more established process than other continental European or UK transactions; with the latter often completed on unique terms involving more extensive and potentially expensive legal consultation. This contrasted with the US, where interviewees noted that more standardised documentation and processes resulted in a simpler, more cost-effective deal process. From a taxation perspective, the UK’s 2014 removal of interest on Private Placements from withholding tax is a good example of how the market can be encouraged.

Investors noted that the regulatory treatment of European Private Placements is ambiguous, leading to a more cautious use of this financing channel than in the US. The US ‘safe harbour’ exemption from SEC oversight gives investors greater certainty about regulatory treatment.

To address these points, AFME believes that solutions should seek to increase standardisation by establishing common documentation and processes for Private Placement deals, and to simplify regulatory treatment where ambiguity exists with certain types of investors.

Please note that, subsequent to the completion of these interviews, the Pan-European Private Placement initiative (PEPP) was launched by the industry. The PEPP initiative is an important first step in providing standardised documentation for Private Placements of corporate bonds. Additional details are available in Appendix 5.
Why Europe must act

This report details a number of observations from investors about differences between Europe’s financial markets and the US. As a next step, the wholesale financial markets industry recommends identifying aspects of US market structures that might be useful in Europe. The European Commission’s proposed Capital Markets Union is a good opportunity to do so.

The wholesale financial markets industry is keen to demonstrate that it is actively listening to end user needs and acting upon policymaker concerns about economic growth. Specific industry action steps prompted by the conclusions of this survey include:

1. **Active support for a stronger EU Capital Markets Union** and implementation of specific targets, such as increasing the market capitalisation of European equities as well as the percentage of European funding provided by capital markets instruments.

2. **Active support for promoting broader understanding of financial markets for borrowers, investors, and other stakeholders.** These include, concurrent with publication of this report, the following practical guides for specific categories of issuers identified in the survey: a) helping infrastructure issuers more easily tap various types of infrastructure funding; b) improving the chances of SMEs across Europe to achieve success with loan and equity investment applications and bond issues; and c) development of standardised industry practices for a pan-European Private Placement market (Appendices 3, 4, 5).

3. **Help promote a responsible equity risk culture** for all types of equity raising – important for the development of entrepreneurship, start-ups and growth expansion for jobs creation.

AFME is actively implementing these three steps, and will also be evaluating progress so that further AFME members' support for European growth remains vigorous.
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### Summary of identified roadblocks to investment and possible actions

<table>
<thead>
<tr>
<th>European roadblocks</th>
<th>US view</th>
<th>Possible solution</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SMEs</strong></td>
<td></td>
<td></td>
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<tr>
<td>Presence and accessibility of alternative funding avenues is underdeveloped for SMEs e.g. venture capital &amp; angel investing</td>
<td>Higher cultural risk appetite has led to better development of credible alternative funding avenues</td>
<td>Establish a more coordinated availability and consistency of borrowing and investing information for SMEs on a pan-European basis</td>
</tr>
<tr>
<td>Culture of risk aversion among SMEs relative to US peers</td>
<td>Strong culture of utilising internal funds and personal savings/wealth for SMEs</td>
<td>Increase the use of alternative financing sources e.g. VC/angel investing</td>
</tr>
<tr>
<td>Many European SMEs are unaware of risk assessment methodology used by lenders and their preference for more capitalised SMEs</td>
<td>US Small Business Association (SBA) is ‘one-stop-shop’ for SMEs providing access to required information in a user-friendly way</td>
<td>Produce easy-to-understand ‘how to’ guides for SMEs</td>
</tr>
<tr>
<td>European government funding is fragmented and difficult for SMEs to identify and access</td>
<td>Greater consistency in definition and application process, with no data restrictions applied at across states</td>
<td>Better sharing and linking of information about SMEs across nations and borders</td>
</tr>
<tr>
<td>The market for SME securitised assets is underdeveloped in Europe, with current legislation preventing increase in usage</td>
<td>Established national credit rating system (FICO)</td>
<td>Increase awareness and incentives for SMEs to raise equity financing</td>
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<td><strong>Infrastructure</strong></td>
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<tr>
<td>Examples of governments having ‘moved the goalposts’ has increased perceived political risk and regulatory uncertainty in some European infrastructure projects</td>
<td>US perceived to have high rating as a destination for infrastructure investing, based on political stability and a sound legal/insolvency regime</td>
<td>Increase the size and prevalence of SME securitisation within Europe</td>
</tr>
<tr>
<td>Lack of project linkages to investor demand</td>
<td>US municipal bond market provides access to retail investors in a tax-effective manner</td>
<td>Address tax code preference for debt over equity</td>
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<tr>
<td>Public involvement and credit enhancement not perceived to focus on most needed countries/projects</td>
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<tr>
<td>Accounting and regulatory treatment of investments currently punitive to long-term infrastructure projects</td>
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<td></td>
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<tr>
<td>Direct investing not easily accessible to smaller investors</td>
<td></td>
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<tr>
<td><strong>Private Placements</strong></td>
<td></td>
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<tr>
<td>A lack of standardisation in Private Placement deals and documentation</td>
<td>US Private Placement market well established and viewed globally as 'go-to' location</td>
<td>Establish an EU-wide legal framework to prevent issuers from lowering tariffs after purchasers have invested</td>
</tr>
<tr>
<td>Rating and regulatory treatment of Private Placement deals differs across nations, reducing desire to invest via Private Placements</td>
<td>Standardised documentation exists in US, e.g. Model Note Purchase Agreement</td>
<td>Establish a more comprehensive public review process for infrastructure to ensure planning is more strategically coordinated</td>
</tr>
<tr>
<td>Poor visibility of Private Placements conducted in Europe, with many investors unaware of this option to raise funds in Europe</td>
<td>Common legal framework used in assessment and application of deals with ‘safe harbour’ of SEC exemption through Regulation D</td>
<td>Increase focus of government and Europe-wide funding to financially unviable, but socially important projects (potentially through (partial) guarantees in order to make them viable)</td>
</tr>
<tr>
<td>All deals required NAIC rating through the Securities Valuation Office (SVO)</td>
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To build on these observations, AFME and its members have developed detailed SME, Infrastructure and Private Placement guides. A summary of these guides can be found in the appendices to this document.
SME, Infrastructure and Private Placement guide summaries
Summary of AFME’s guide to raising finance for Europe’s small and medium-sized businesses

Introduction

Every business needs to raise finance at some point. How well small and medium-sized enterprises (SMEs) are capitalised influences whether they succeed or fail. AFME’s guide to raising finance for Europe’s small and medium-sized businesses helps SMEs make educated choices about how much and what type of capital they need, where they should get it from, and how they should apply.

There are a growing range of options – from banks, through to different types of equity providers, and even peer-to-peer online platforms. The more SMEs know about these options, the better their chances of raising the right type of funding on the right terms.

The guide gives practical advice and guidance to SMEs across Europe. The kind of finance a business needs depends on factors such as its size and the purpose for which the money is needed. Is the money for working capital? Is it to finance a start-up? Or is it to expand an existing business?

The answers to these questions will determine whether a business seeks a loan, equity finance, asset finance, or even raise a bond, and whether the business is looking in the right place for that particular type of finance.

The main types of finance this guide examines are loans by banks and non-banks, equity funding, bond funding. The guide also looks at Europe’s government support schemes.

AFME members have keen insights into the practical issues surrounding SME fund raising, since they not only lend to SMEs, but are leaders in the placement of equity and bonds into the capital markets, depending on the size and characteristics of transactions.

Some members also can refer SMEs to other organisations, which may be able to provide products they might not offer themselves. In this guide, AFME reports the type of credit criteria used to make decisions, which may vary depending on business profile, sector of activity and type of finance provider. It also describes the information usually required by the various providers. Understanding how providers of loans, bonds and equity evaluate a business gives a better chance of finding the finance needed on the best possible terms.

Choices for loan finance

Bank loans remain by far the most common form of SME finance in Europe. Yet there are other types of lenders that might be more appropriate in particular circumstances. Banks, being primarily deposit-funded, will generally offer the lowest-cost loans and the widest variety of products.

Additionally, so-called non-banks (including crowdfunding and peer-to-peer platforms, leasing companies and invoice finance providers) lend to businesses. Loans from non-banks may have a higher cost to the borrower than loans from banks, depending on the non-bank’s source of funding.

It describes borrowing through bank loans, debt crowd funding and peer-to-peer lending, leasing/equipment finance, invoice finance and export finance.
Raising equity

Growing companies with unpredictable cash flows may find equity finance more suitable than loans. Such companies might include start-ups and early-stage companies, or established companies raising finance for expansion. Equity finance involves selling shares in a business to an investor, who then shares in the risks and rewards of ownership. It does not necessarily involve a transfer of control, although it can be structured in that way if desired. In some cases, equity finance can take a form that does not require giving up control or voting rights, although this is less common. Often, an investor may help to improve business strategy.

Equity investors seek a return from long-term growth in the value of their shares, as well as dividends. Frequently, they also plan an ‘exit’ at some point in time, when they will sell their shares, hopefully at a profit.

A wide range of sources of equity finance is available, depending on the size of the investment and the stage of growth of the company. The guide describes raising equity through family and friends, equity crowdfunding, business angels, venture capital and private equity, listing on a stock exchange, and other types of equity finance.

Bond issues for larger SMEs

Larger SMEs may raise debt capital through public bond issues or private bond placements, which can give access to broader and deeper pools of capital than loans. There are several source of debt finance in Europe for mid-sized companies with annual turnovers of between €25m and €500m. The minimum size for a bond issue or Private Placement is usually €20m, although it can be as little as €5m.

When issuing bonds, the issuer promises to repay investors by a specified date and to pay them interest in the meantime. The debt capital markets differentiate between these types of security, depending on their term to repayment as follows: bonds (maturity over three years); medium-term notes (maturity up to three years); and commercial paper (maturity of less than one year). This section describes issuing bonds in France, Germany, Italy, Spain and the UK.

Europe’s government support schemes

Many European Union and national support programmes are available through banks, and some are available directly.

The guide summarises the support available from Pan-European programmes (European Investment Bank, European Investment Fund), national development banks in the five largest EU countries (Bpifrance, KfW, Cassa Depositi e Prestiti, Instituto de Crédito Oficial and ENISA, British Business Bank) and the private sector (European Enterprise Network).

The AFME SME finance guide is available on the following webpage: www.afme.eu/Funding-Economy
Summary of AFME-ICMA’s guide to infrastructure financing

Summary of AFME-ICMA’s guide to infrastructure financing through bank loans, Private Placements and public bonds

Introduction

The Guide to infrastructure financing – bank loans, Private Placements and public bond markets (the Guide) produced by AFME and the International Capital Market Association (ICMA) is designed to raise awareness of infrastructure finance, with the aim of supporting the expansion of capital markets financing in line with the European Commission’s goal of bolstering economic growth through long-term financing.

The Guide is a reference source for participants in infrastructure financings. Addressing public authorities, project sponsors, project companies and issuers, it sets out the relative merits of bank and bond markets and describes transaction processes while taking account of planning and procurement issues and key considerations, and also sets out key considerations for investors in project bonds.

A combination of considerable untapped financial firepower of capital market investors committed to investing in the asset class, together with changes in the bank lending market that may, over time, make it less attractive for certain global banks to lend long-term for infrastructure finance, and the European Commission’s plans to raise €315bn through its European Fund for Strategic Investment (EFSI). The industry wants to be supportive of distribution of this important financing to all types of interested private investors to help ensure its success.

Underlying the Guide are four key principles which are explored in more detail in the document:

1. **Choice of funding**: infrastructure projects may be financed in a variety of ways, including the bank loan market, the Private Placement market and the public institutional investor capital market. Key decision criteria for issuers include needed flexibility for changes over time, tenor, confidentiality, nature of the risks, and investor needs.

2. **Credit enhancement and ratings**: an investment grade rating helps to broaden the investor base, as most institutional investors have a mandate to invest accordingly. Public guarantees and/or credit enhancement – partial or full – may be used to upgrade the rating of a transaction that might otherwise be less acceptable from a credit risk perspective to investors.

3. **Usage guarantees**: some transactions are financeable if the usage or demand risks are either short-term in nature, or alternatively, quantifiable, well-proven and appropriately assessed and measured. Transactions with unquantifiable usage risks may be unsalable at any price, and may require public guarantees to make them saleable.

4. **Restrictions on adverse post-closing changes, including tariff reductions**: regulators and public sector authorities should maintain transparency as well as consistency with regards to tariff-setting and/or regulatory controls post-financial close of a transaction. In the past, certain authorities have significantly lowered tariffs on transactions after the financial closing, which has caused large mark to market or permanent losses for investors. This can discourage further investment.

The Guide concentrates on project finance bank loans and bonds, defined as financings of single assets subject to (limited-life) long-term offtake agreements or concessions, or where revenue risk has been mitigated adequately.

Overview of bank loan and project bond markets

Europe’s sources of infrastructure finance are changing. While banks remain the dominant lenders to infrastructure projects, capital markets investors are starting to make significant inroads into the market as pension and insurance monies look for long-dated investments backed by stable cash-flow characteristics. Over time, this trend is expected to continue, giving project sponsors a greater diversity of funding sources.
Procurement and planning process

The process of identifying, creating, building, licensing and, in some cases, negotiating a concession contract to provide services (whether by public or private sector) involves four phases:

1. Selecting, planning and scoping appropriate projects
2. Procurement and contractual design
3. Construction period to completion
4. Operation of the asset

The first two phases – planning and procurement – are the most important. If mistakes are made at these stages, the project may fail later, regardless of the structure of the funding. Since a key benefit of the project finance structure is that it spans both the construction and operation phases, planning needs to cover the whole project lifecycle.

A key question for a public sector procurer is how to achieve best value for money, which depends on the competition between those tendering for a project, the mix of funding and the processes followed in discussions/negotiations. This section of the Guide highlights planning and procurement considerations relevant to infrastructure financing.

Financing choices: corporate finance or project finance, loan finance or bond finance

When deciding how to finance an infrastructure project, the sponsor has a number of choices. It can finance the project on its own balance sheet, or through a project company – in which case it has the option of bank loans or bonds. Making the right decision depends on a number of factors. This section of the Guide describes the different factors that will influence the sponsor’s choice.

Mechanics of a loan or bond issue – parties, roles and tasks

Once the funding phase of a project starts, the funds will be received in 3-4 months, which is part of the overall project finance transaction timeline, which takes longer. The exact timing depends on issues such as how long the bank’s in-house credit assessment team takes to evaluate the credit risk, the time required for credit review by ratings agencies and investors, preparation of disclosure documents such as an offering memorandum or prospectus, the listing process, the opening of bank accounts, planning and implementation of a roadshow marketing process and preparation of final closing documentation.

This section of the Guide elaborates on the first steps towards bond issuance and the parties involved, including a detailed example of how to calculate the all-in costs of a bank or bond financing. Section 10 of the Guide (Marketing, pricing and issuance process) describes the issuance process, including expected timing, in more detail.

Credit enhancement alternatives

Structuring a bond or bank loan to achieve a higher credit rating is likely to broaden the investor base, which should in turn lower the overall transaction cost for the issuer.

While capital markets investors have differing risk appetites, many invest only in investment grade transactions, whether rated investment grade by a credit rating agency or judged independently by the investor, and the size of the investor market for investment grade debt is much larger than for high yield/non-investment grade debt.

This section of the Guide considers the different forms of external and internal credit enhancement. The Guide also sets out highlights of the EFSI plan; an initiative intended to support projects that otherwise might not be funded.
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Credit review processes

Credit committees of banks, investors and credit rating agencies carry out comprehensive assessments of an infrastructure project’s credit risks, performing extensive due diligence and credit reviews. They generally require more information than that included in an offering memorandum or prospectus.

This section looks at the type of issues examined in the credit review process.

Project bond investor base

An understanding of what types of institutional investor invest in infrastructure, and their respective needs, is helpful when attempting to raise funds. This section describes the main types of infrastructure investors and gives examples of both fixed income and equity investors in infrastructure. Section 12 (Key considerations for investors) sets out further risk evaluation considerations for investors, including revenue risk and the risk of the decline in project tariff revenue.

Marketing, pricing and issuance process

In the case of bank loans, just one organisation (the bank) assesses the credit assessment and makes the lending decision. With a project bond issue, the rating agencies and investors assess the credit individually, after which the investment bank arranging the transaction sets the pricing. The issuer is also involved in this process.

This section describes the steps in the issuance process.

Disclosure and reporting best practice: EFR standardised guidelines

The European Financial Services Roundtable (EFR) is launching a constructive new initiative to support the standardising of disclosure and reporting requirements across Europe. In broad terms, the initiative proposes greater transparency into, and harmonisation of, project pipelines, structures, financing and performance; all of which should improve efficiency and help to make infrastructure more accessible as an asset class, which is described in more detail in section 11 of the Guide.

Key considerations for investors

Investment in project finance can present potentially attractive investment returns to institutional investors, if sufficient resources are available to analyse the various risks and rewards, as well as to monitor the ongoing performance of transactions.

This section includes a checklist of credit risk and non-credit risks, such as regulatory and political risks for investors when considering an infrastructure investment. It also describes two examples of investment review processes that may be of use to potential investors: a list of factors for rating project finance provided by the Bank for International Settlements (BIS); and a summary of the factors that would typically be considered by a credit rating agency.

Examples of European infrastructure project bond transactions

This section provides examples of the two main categories of transactions: greenfield and brownfield/operating (also referred to as secondary stage/asset refinancing stages). Included within each of these three categories are further classifications, including type of credit enhancement, and also whether investors face material project concession/demand risk.

Participants

The guide was written by Brian Scott-Quinn of the ICMA Centre at the University of Reading in the UK, supported by Deyber Cano, AFME and ICMA members and staff. In addition to the EFR, the International Regulatory Strategy Group (IRSG) was an observer in working group meetings.

The AFME-ICMA Guide to infrastructure financing is available on the following webpages: www.afme.eu/Funding-Economy and www.icmagroup.org
Pan-European Corporate Private Placement Market Guide summary

Introduction

Agreement on common market standards and best practices is essential for the development of a pan-European Private Placement market for corporate debt. The Pan-European Corporate Private Placement Market Guide (‘the Guide’), developed by the Pan-European Private Placement Working Group (PEPP Working Group) and published in February 2015 aims to support the development of this market by building on existing practices in the bond and bank loan markets, as well as in other international Private Placement markets. The Guide is intended to provide a non-binding framework of best practice for pan-European Private Placement transactions.

The Guide evolved from the Charter for Euro Private Placements, which was developed by the Euro PP Working Group – a French financial industry initiative bringing together corporate borrowers, investors and intermediaries, endorsed by the relevant French financial industry associations and supported by the Banque de France and the French Trésor. The Charter for Euro Private Placements was published in March 2014, and is available at: www.euro-privateplacement.com

The Guide identifies core issuers and investors, defines best practices and the role of intermediaries, while providing standard summary terms for discussion between borrowers and investors that is both documentation- and jurisdiction-neutral.

PEPP market objectives

This section sets out the PEPP market’s objectives, which include the following:

• To provide private, primarily unlisted, debt financing for medium-sized, rated and unrated, listed and private companies

• To provide a source of risk diversification for investors

• To set a market standard for PEPP transactions

• To strengthen the identity and recognition of the PEPP market

• To promote long-lasting and transparent market relationships

• To contribute to the development of a European Capital Markets Union

PEPP market characteristics

A PEPP is a medium or long-term, primarily unlisted, private debt financing transaction between a listed or unlisted company and a small number of institutional investors, based on deal-specific documentation negotiated between the borrower and the investors – generally but not necessarily with the participation of one or more bank intermediaries as arranger(s) acting in an agency capacity (i.e. not as an underwriter).

This section describes the PEPP characteristics in terms of target borrowers, rating requirements, target investors, private offerings of debt, unlisted debt, transferability, seniority and security, the role of arrangers, disclosure and issue structure.

Negotiation and documentation

Negotiation of contractual terms and conditions by the borrower and the investor is an important feature of a PEPP. This distinguishes a PEPP from public and syndicated bond issues, such as Eurobond issues, where investors subscribe to an issue without usually being involved in the negotiation of the terms and conditions.

The negotiation of PEPP terms and conditions therefore more closely resembles the negotiation process and contractual terms seen in the bank loan market.
Pan-European Corporate Private Placement Market Guide summary

Both the Loan Market Association (LMA) and the Euro PP Working Group have published standard model framework documentation for PEPPs in the form of loans and notes, to which users of the Guide are directed.

**Special case: listed PEPP transactions**

PEPP notes primarily take the form of unlisted securities. However, listed Private Placement transactions currently occur in some national European markets (for example, the French Euro Private Placement market and the Italian Private Placement market) as a result of domestic legal requirements and investor preferences. As a result, it is possible that parties to certain PEPP transactions may also seek to have the PEPP listed.

**Parties, documents and timetable**

This section summarises the main parties to the transaction, and their respective roles and responsibilities at its various stages. The Guide also describes the required transaction documents and includes an illustrative timetable. An indicative information memorandum template and form of non-disclosure agreement are included as appendices.

**Key processes – recommendations**

This section summarises key processes and recommendations, including: the levels of required borrower's information; the key economic and legal terms and conditions of the PEPP transaction; arranger and investors’ due diligence; and disclosures and monitoring of legal financial covenants. A detailed description of key points to be discussed between the borrower and the investor is included as an appendix.

**Participants**

The Guide was prepared by the PEPP Working Group – an umbrella European initiative led by ICMA, including: AFME, the French Euro Private Placement (Euro PP) Working Group, the Loan Market Association (LMA), TheCityUK, The Investment Association, and the European Private Placement Association (EU PPA). It also brings together representatives from major institutional investors (including Delta Lloyd, Fédéris Gestion d’Actifs, KBC Group, LGIM, M&G Investments, Muzinich, Natixis Asset Management) and benefits from the participation of major law firms, including Allen & Overy LLP, Ashurst, Bonelli Erede Pappalardo LLP, CMS Bureau Francis Lefebvre, DLA Piper, Gide Loyrette Nouel AARPI, Herbert Smith Freehills, King & Wood Mallesons, Kramer Levin Naftalis & Frankel, Linklaters, Loyens & Loeff, Simmons & Simmons, Slaughter and May, and White & Case.

This PEPP Working Group further enjoys the support of the official sector, participating in an observer capacity (including the Banque de France, the Bank of Italy, the French Trésor and HM Treasury).

The Pan-European Corporate Private Placement Market Guide is available on the following webpages: [www.icmagroup.org](http://www.icmagroup.org) and [www.afme.eu/Funding-Economy](http://www.afme.eu/Funding-Economy)
The present report is the result of multiple interviews, which took place across 30 firms, including fund managers, trade associations and exchanges.

1 Preqin website, www.preqin.com

2 European Central Bank. Survey on the access to finance of enterprises (SAFE)

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The Association for Financial Markets in Europe (AFME) is the voice of Europe’s wholesale financial markets.

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We believe that liquid capital markets and a well-functioning banking system are central to any successful modern economy.

We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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