

# Why equity markets matter

The heart of Europe's economy

December 2015



## / About AFME

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

We represent the leading global and European banks and other significant capital market players.

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.

### Focus

on a wide range of market, business and prudential issues

### Expertise

deep policy and technical skills

### Strong relationships

with European and global policymakers

### Breadth

broad global and European membership

### Pan-European

organisation and perspective

### Global reach

via the Global Financial Markets Association (GFMA)



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### Foreword

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Growth in the European economy remains subdued and unemployment rates stubbornly high. However, the outlook appears to be brightening with the European Commission forecasting real GDP growth in the European Union of 1.8% in 2015 and 2.1% in 2016. Behind these figures stand European companies and employers striving to grow their businesses and create more jobs. Yet in order to return economic growth to a strong and stable footing, European companies need to make full use of all available funding options.

AFME's report 'Why equity markets matter' explores the extent to which one of these sources for financing is not being used to its full potential: equity and equity markets. Our analysis of the potential benefits of European equity markets includes not only their provision of funding for high growth sectors, but also the contribution of investment returns from equities to retirement savings.

Equity capital complements funding sources like bank and non-bank loans and alternative sources such as bond financing, invoice financing and export finance through its ability to support different business risks. It comes from various sources such as family and friends, venture capital and private equity providers, business angels, crowdfunding platforms or public markets in the form of private placements or public offerings. Our report shows how equities can fund the growth of European businesses and create jobs. In addition, equity markets can make a much greater contribution to funding the growth of European businesses and creating jobs.<sup>1</sup>

We believe that equity markets offer a large pool of potential capital that is currently untapped. The scale of that foregone funding opportunity can be derived by comparing European and US markets. In 2015, the US equity market's capitalisation represented 159% of GDP, whereas Europe's was just 73.3%<sup>2</sup>. If Europe's market capitalisation-to-GDP ratio were to increase to 100%, this would imply that more than € 3.5 trillion in additional equity capital could be deployed in European companies, improving the balance between debt and equity funding<sup>3</sup>. This would also increase the pool of available equity investments, for example for pension saving.

Several important regulatory proposals are currently being developed that will influence the role of equity markets in the future. The most notable of these is the European Commission's initiative for a Capital Markets Union. It provides an ideal opportunity to help ensure that equity fulfils its potential as a crucial source of capital.

AFME and its members are committed to working with policymakers towards this important goal. Through our members we can contribute valuable insights into the functioning of equity markets, identify where current regulations work and where proposed and future regulation might benefit from a different approach. We intend to share further observations and recommendations in a subsequent report.

AFME's remit has long-term sustainable and efficient European capital markets at its heart. But capital markets are not a goal in themselves. Rather they form the foundation for the type of economic and jobs growth that the European Commission aims for.

We welcome your feedback.



**Simon Lewis**  
Chief Executive  
Association for Financial Markets in Europe

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<sup>1</sup> Europe has only half as much listed equity capital with €10 trillion compared to €19 trillion in the US. In addition, pension funds investible assets in Europe is 3.5 times lower than in the US (€4.3 trillion vs €14.9 trillion). Source: AFME Boston Consulting Group 'Bridging the growth gap'.

<sup>2</sup> SIFMA and Datastream.

<sup>3</sup> AFME calculation, using 2014 EU-28 GDP (€13.9 trillion) [http://europa.eu/about-eu/facts-figures/economy/index\\_en.htm](http://europa.eu/about-eu/facts-figures/economy/index_en.htm).

## Introduction

This is an opportune time to highlight the benefits of equity markets. The European Commission has set out its plan for a Capital Markets Union, stating that: “To improve the financing of our economy, we should further develop and integrate capital markets.” Equity markets are a vital part of the capital markets, delivering the share capital that every company needs at the core of its balance sheet.

European society needs healthy equity markets. They provide the region’s companies with long-term capital for growth, leading to higher levels of economic activity, greater wealth and more jobs. Equity capital is particularly important for funding companies in high-growth sectors such as technology, communications and energy. Yet equity markets remain under-developed, weakening the region’s economic potential.

This paper reports on how equity capital supports companies. It then uses examples to illustrate specific instances where equity capital has either helped companies to grow or is in short supply. Case studies include Italy’s small businesses, Europe’s leading aerospace engineering company and Germany’s need for equity to fund technology innovation.

Turning to savings, the paper shows how equities have historically generated higher returns than other asset classes. Europeans need these relatively high returns to boost returns on their pension funds, helping them to fund comfortable retirements.

But Europe’s equity markets depend on a delicate ecosystem, which is not functioning at its best. In the United States, the equity markets play a far greater part in funding the economy, as demonstrated by our recent ‘Bridging the growth gap’ report (see box below). The Capital Markets Union offers an opportunity to close this gap, improving the balance between equity and debt funding.

### Europe needs more equity capital for growth

Europe needs more equity capital to generate economic growth, according to a report published by AFME in February 2015. ‘Bridging the growth gap’ identified the fragmented nature of European capital markets and the lack of equity finance as key elements holding back economic growth. The report also highlights that equity capital is especially suitable for small companies with no financial history or with forecasted negative cash flows, which are not able to repay debt capital at that point in their development.

Equity, as opposed to debt, capital confers ownership rights in the company to the capital provider. The investor thus shares in the business risks of the company, participating in profits as well as losses. Such risk capital is crucial to further company growth, for example to expand into new markets or build new production sites, or to start a completely new business with uncertain outcomes.

Europe has significantly less listed equity capital than the US, with approximately €10 trillion invested in listed equities compared to €19 trillion in the US, according to the report, which AFME co-wrote with Boston Consulting Group.

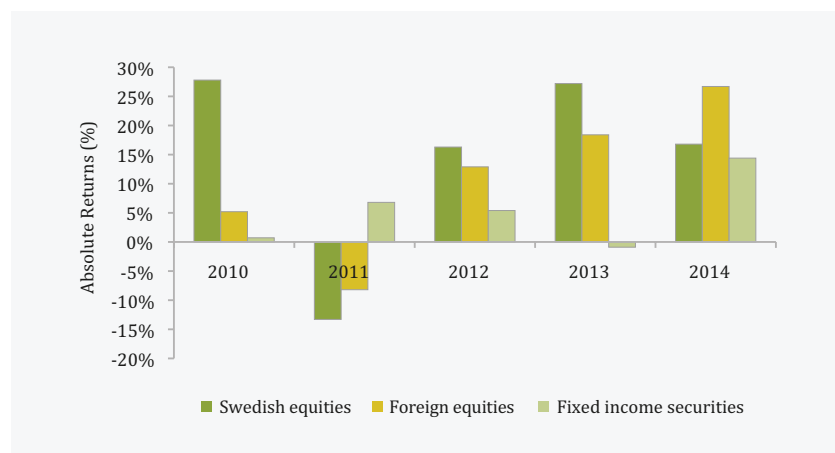
The report was based on a survey of global investors holding around €9 trillion in assets under management. These investors reported that in Europe there is less appetite for risk than in the US, which means that alternatives to bank lending are not as readily available.

‘Bridging the growth gap’ recommended that the EC Capital Markets Union initiative should set a target for equity capitalisation, backed by specific plans for action to promote a responsible equity risk culture.

### Summary

- Equity markets play an important social and economic role. Complementing bank finance as a source of capital, they foster Europe's economic development and employment, especially in high-growth sectors such as technology, communications and energy. Healthy, sufficiently large equity markets are essential for economic competitiveness, wealth creation and employment growth.
- Companies can gain access to the long-term capital they need for innovation, value creation and growth from equity markets. Equity markets channel capital directly from investors to companies, accessing sources of capital not open to banks. Moreover, equity investment is more suited to taking the risks necessary to grow businesses.
- Equity markets also provide an essential asset for saving. Over the long-term, equity markets have delivered the highest returns of all conventional, liquid asset classes (see Figure 1). Having diverse, liquid equity markets provides greater opportunity for investors such as pension funds. This is important at a time when Europe – like other developed economies – faces a challenge funding retirement.
- A comparison with the US shows the possibility for Europe to increase the size of its equity markets, improving the balance between equity and debt funding<sup>4</sup>. In 2015, US equity market capitalisation represented 159% of GDP, whereas Europe's was just 73.3%<sup>5</sup>. If Europe's market capitalisation-to-GDP ratio were to rise to 100%, more than €3.5 trillion in additional equity capital could be deployed in European companies.
- The European Commission's initiative to develop a Capital Markets Union presents an opportunity to increase the role of equity markets in funding the region's economy.

**Figure 1: Historical performance of equities and fixed income securities held by Sweden's AP2 Pension Fund**



Source: AP2 Fund Annual Report 2014

<sup>4</sup> The 'correct' split between a business's debt and equity funding is a topic of academic debate which this paper does not address.

<sup>5</sup> SIFMA and Datastream.



## Europe's long history of equity markets in action

When the Dutch East India Company was formed in 1603, it is reputed to have become the world's first multinational and first company to issue stock. This equity issue funded a business that over the next 200 years sent almost a million Europeans to work in Asia on 4,785 ships, bringing back more than 2.5 million tons of Asian trade goods. It also led to the building of the Amsterdam Stock Exchange, which opened its doors in 1611, becoming the world's first official stock exchange.

While some historians claim that stock trading started even earlier, the Amsterdam market was the world centre for equity trading in the 17th and 18th centuries. It formalised the creation of joint stock companies that paid investors dividends as a trading company progressed, evolving from the previous practice of raising capital for ventures to the New World for just one journey at a time. Over the years, Amsterdam's market performed in a similar way to modern exchanges. There were bull markets, bear markets and financial crises.

Across Europe, the great cities followed Amsterdam's example and developed their own stock exchanges. For example, the Paris bourse was established in 1639 and the Frankfurt bourse evolved from its origins as a currency exchange. Later on, the Swiss started exchanges in Geneva (1850), Zurich (1873) and Basel (1876). Norway's Oslo Stock Exchange was founded as Christiania Bors in 1819 for auctioning ships, commodities and currencies.

The London Stock Exchange was formally established in 1801, although organised equity trading in the United Kingdom dates back to 1698. By 1900, London's equity market was the world's largest, oiling the wheels of global and cross border finance.

Today, there are 24 European stock exchanges and 21 multilateral trading facilities (MTFs). They provide Europe with liquid markets to trade shares, linking businesses with investors.



### Funding growth

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Europe's equity markets give businesses access to the capital they need for innovation, value creation and growth. Each year, companies raise billions of euros of equity capital that complements the debt in their capital structures. Because it is long-term capital, equity allows companies to take a longer-term approach to the pursuit of growth. As businesses grow, they contribute wealth to the broader economy.

Equity capital encourages companies to grow. Unlike bank loans or bonds, equity capital never has to be repaid. It is permanently in place, giving managers the confidence to design and execute long-term plans. It encourages long-term investment in research, development, intellectual property, human capital, machinery etc, which will have a long-term positive impact on jobs, consumption and tax collection.

The underlying principle of equity markets is that companies should strive to grow their capital values and dividends. Chief executives and other key managers are often incentivised to grow businesses through pay that is related to long-term business performance – not only in terms of sales and profits but also characteristics including teamwork and ethical behaviour. This practice of performance-related pay is extending to incentivise employees in middle management and below.

Academic studies confirm the positive role of equity markets, although their optimum characteristics are much debated. One of the most widely cited academic texts on the subject concludes that equity market liquidity is robustly correlated with current and future rates of growth<sup>6</sup>. A number of other studies find that equity markets (similarly to banking systems) foster economic growth, providing they do not exceed a certain size<sup>7</sup>.

In the recent past, equity markets have helped to recapitalise southern Europe's economy and raised capital for fast-growing young companies, including challenger banks and technology innovators. They have provided capital that shares both the downside risks of a business and its upside rewards.

In the first half of 2015, for example, 723 companies raised a total of US\$154.7 billion (€137.8 billion) from European and Middle Eastern equity markets<sup>8,9</sup>. This was 17% below the US\$186.7 billion (€166.3 billion) raised in the first half of 2014, a record first half year. Spanish telecom companies, Telefonica and Cellnex Telecom, launched two of the period's biggest issues. In 2015, equity markets have also provided capital for growth companies such as the UK's Shawbrook Bank and cyber security company Sophos, both examples of successful IPOs (see 'Taking a world-leading cyber-security innovator to the next stage' case study).

Looking back to the first half of 2014, equity markets helped Europe's damaged economies to recover from the financial crisis. Some 67 companies from the countries on the periphery of Europe that were worst hit by the financial crisis — Portugal, Ireland, Greece and Spain — raised US\$36.4 billion (€32.4 billion).<sup>10</sup>

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6 Stock Markets, Banks and Economic Growth. Ross Levine and Sara Zervos. The American Economic Review. June 1998.

7 Financial structure and growth. Leonardo Gambacorta, Jing Yang, Kostas Tsatsaronis. BIS Quarterly Review, March 2014.

8 Dealogic. Global ECM Review. 1H 2015.

9 FX conversions at US\$1 = €0.89 (rate on 02.10.15).

10 Dealogic. Global ECM Review. First Half 2014.



The scale of Europe's equity markets is under appreciated. The region's exchanges and MTFs hosted trading for shares worth US\$10.4 trillion (€9.3 trillion) in 2012<sup>11</sup>. Without these equity markets, the businesses where a large proportion of the EU's 507 million people work would find it far more difficult to get the external investors they need to fund growth and development.

Equity markets are, arguably, more important than ever for Europe's economy. In spite of improving economic data, unemployment remains high across the region. Furthermore, equity capital is critical for funding the high-growth, high-risk companies that are major job creators.

### Creating jobs

A healthy equity market helps to create jobs. In the US, businesses have tended to grow far more quickly after raising capital on equity exchanges, with corresponding expansions in their workforces, suggesting that the same is likely to be true in Europe.<sup>12</sup>

Businesses listed on Europe's stock exchanges include many of the region's largest private sector employers. For example, the UK's Tesco supermarket is one of Europe's largest employers (more than 500,000 jobs)<sup>13</sup> and France's Carrefour is also a large employer (more than 380,000 jobs)<sup>14</sup>. Meanwhile, Airbus Group's industrial success has allowed it to grow its highly-skilled workforce by more than 50% in 15 years (see 'Supporting Airbus' flight to industrial success', page 8)<sup>15</sup>. Tesco is listed on the London Stock Exchange and Carrefour on the pan-European Euronext exchange. Airbus Group is listed on the Paris, Frankfurt and Spanish stock exchanges.

With parts of Europe still facing an unemployment crisis, and the public sector under pressure to restrain budgets, private sector companies such as G4S, Airbus Group and the continent's small and mid-sized companies are the best source of future jobs growth. Eurozone unemployment has remained stubbornly over 10% for the past five years, even exceeding 20% in some parts of Greece, Italy and Spain.

For Europe to tackle its jobs crisis, small-and-medium sized companies must have access to equity funding. They are the backbone of the economy, accounting for 99% of all enterprises and 85% of job creation between 2002 and 2010<sup>16</sup>. Often, SMEs are the fastest growing companies and create the most new jobs. Several stock exchanges in Europe exist solely to fund these young companies (see 'Helping Italy's small businesses grow', page 9).

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<sup>11</sup> Source: AFME, BCG, ECB (EU-18).

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<sup>12</sup> IPO Task Force 2011 CEO Survey; 92% of job growth in a company occurs post IPO.

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<sup>13</sup> [www.tescopl.com](http://www.tescopl.com).

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<sup>14</sup> [www.carrefour.com](http://www.carrefour.com).

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<sup>15</sup> Airbus Group annual report.

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<sup>16</sup> European Commission, "A Recovery on the Horizon?" Annual Report on European SMEs 2012/2013, DG Enterprise, 2013.

## Equity markets in action 1

### Taking a world-leading cyber-security innovator to the next stage

When Sophos raised £1.1 billion on the London Stock Exchange in an initial public offering (IPO) in July 2015, it heralded a new stage in the UK software company's development. Over the 30 years since its inception in 1985, this provider of cyber security products to mid-sized companies has grown to employ more than 2,500 people. The equity capital raised has funded Sophos for its next stage of growth, while also giving owners at the time of the fundraising the means to monetise their investment, which illustrates how equity markets can incentivise entrepreneurs.

Sophos has become a leader in its sector. Based in Abingdon, near the UK university city of Oxford, it serves more than 200,000 customer businesses and 100 million individual users in over 150 countries. Innovative products that are meeting the growing need for online security are fuelling its growth.



The Sophos IPO shows the important part that public equity markets play in growth companies' lifecycles. The equity issuance completed in July 2015 provides a way Apax Partners, the private equity firm, to monetise its majority interest acquired in 2010.

At the time of the IPO, Sophos anticipated it would herald a new stage of growth, by improving its access to capital and enhancing the global brand thereby enabling enterprises around the world to implement a simple and effective security solution.<sup>17</sup>

## Equity markets in action 2

### Supporting Airbus' flight to industrial success

Europe's equity markets have played a key part in the evolution of what is arguably the foremost example of European industrial integration. Almost 15 years after making its stock market debut, Airbus Group has roughly half of the world's market share for commercial jetliners, as well as leading helicopter, space and defence businesses.



When the Group, then called EADS, was created in 2000 by the merger of three leading European aerospace companies, the stock exchanges of France, Germany and Spain facilitated the transaction. Since then, its order book has grown more than six times, from €132 billion to €858 billion at the end of 2014. It now employs about 139,000 people, some 50,000 more than it did in 2000.

In addition to capital for growth, the equity markets have allowed management to implement some major strategic changes.

The equity markets gave Airbus Group the flexibility it needed to reorganise its ownership structure in 2013, reducing the influence of its state shareholders and allowing industrial shareholders Lagardère and Daimler to exit what was a non-core business for each of them. A major share buyback programme was launched by Airbus Group to facilitate this change in the shareholding restructure in order to and give its management greater strategic freedom.

By the end of 2013, the publicly held shares (free float) of Airbus Group had risen to well over 70% of the total number of shares, with the combined shareholding of the French, German and Spanish States being at around 26% without any special veto rights. Institutional shareholders such as pension funds were positive about Airbus Group's prospects and they acquired most of the balance.

17 Sources: Sophos Group plc offer document, Apax Partners 2010 annual report.

## Equity markets in action 3

### Helping Italy and Europe's small businesses grow

Italy's equity markets are gearing up to play a larger part in funding small and medium sized enterprises (SMEs) that are vital for the country's economy. SMEs form the backbone of the country's manufacturing sector, providing two thirds of added value for the sector and 80% of employment. Many Italian SMEs are exporters and occupy global leadership positions in niche industries.

AIM Italia, a member of the London Stock Exchange Group, hosts trading for 66 SMEs with a total value of more than €2.6 billion as of summer 2015. This dedicated market for SMEs is set to grow in the coming years due to a three phase programme launched by AIM in 2012 called ELITE.

ELITE is a long-term programme for SMEs that meet certain minimum growth and financial requirements. ELITE offers integrated services to help SMEs prepare and structure their businesses for continued growth and eventual equity capital markets access.

In the first two years, 150 companies from various industries in Italy enrolled in ELITE with an average turnover of €105 million. They range from Neomobile, which is just eight years old, to Marchesi de Frescobaldi, a Tuscany wine producer that traces its history back seven centuries. ELITE includes companies from areas within Italy that are traditionally not well represented in the ranks of listed firms. For example, 11 companies are based in Campania in Southern Italy.

One of the ELITE companies is already listed on AIM Italia and 15 others have announced their intention to do so. Other participants are pursuing various financing options within the programme.

In 2014, ELITE was extended to the UK. Overall, as of Spring 2015, 271 European companies are participating in ELITE from Germany, France, the UK, Italy and Romania.



### Delivering investment returns

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Equities are a vital asset class for investment. They have tended to deliver higher long-term investment returns than other asset classes, such as bonds or cash. At a time when Europe faces a challenge funding the retirement of its growing population, equities' typically superior returns are an invaluable part of the investment mix for pension funds.

The strong long-term returns of equities are well documented. Over the past 50 years, for example, European equities have delivered an average 6.0% return each year, compared with 4.9% for bonds and 0.9% for cash (in US dollars, after discounting inflation)<sup>18</sup>. This performance makes equities a suitable investment for pension funds, which have long-term liabilities.

With Europe facing a 'pensions time bomb', the potentially superior returns of equities have a particularly important part to play (see 'Providing for Sweden's pensioners' case study, page 11). Ageing populations are putting Europe's state and corporate pension systems under pressure. As the post-war baby-boomer generation starts to retire and the working population shrinks, Europe's state pension systems will struggle to maintain payments, while people aren't saving enough to supplement them.

The number of over 60s is swelling by about two million each year – a rate twice as high as in the late 1990s and early 2000s. By contrast, the number of people of between 20 and 59 will fall every year over the coming decades<sup>19</sup>. Longer life expectancy is compounding the problem. By 2060, men can expect to live another 7.9 years and women 6.5 years when compared to 2010, according to a European Commission paper<sup>20</sup>.

Europe's pay as you go pension system – where working peoples' taxes fund current pensions – is unprepared to take the strain. Across Europe, governments will have to introduce unpopular measures such as increasing the retirement age and encouraging people to save more.

Saving more, and maximising the returns on those savings, is clearly an important part of the solution. According to one estimate, Europe's citizens will have to save €1.9 trillion more each year in order to fund a comfortable retirement<sup>21</sup>. This assumes that people need a retirement income equal to 70% of what they were earning at the time of retirement<sup>22</sup>. But Europe's citizens also need to make sure that their savings generate the best possible returns, which means investing at least partly in equities.

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18 Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Yearbook 2015.

19 Europop 2010.

20 White paper: An Agenda for Adequate, Safe and Sustainable Pensions. European Commission. 16.2.2012.

21 The Pensions Gap Across Europe, Aviva.

22 OECD definition for 'adequate' retirement income.

## Equity markets in action 4

### Providing for Sweden's pensioners

Illustrating their importance for pension saving, equity investments have powered the returns of Sweden's five national pension funds. Introduced as a safety buffer to make sure the country's pay-as-you-go pension system would be able to meet its obligations as the post-war baby-boomer generation retired, the funds have relied largely on equities to generate investment returns.

One of the national funds, the Second AP Fund, shows how investment in equities has benefited Sweden's pension system. Established in 2001, the fund has since returned an average annual return of 5.7% (after inflation). In this time, it has invested more of its portfolio in equities than in any other asset class. For example, almost half of the portfolio was allocated to equities at the end of 2014 (48%), with bonds and alternative investments making up the balance.

With SEK 293.9 billion in the fund at the end of 2014, the Second AP Fund was one of northern Europe's largest pension funds. During a 13 year period since its formation in 2001, it has more than doubled the initial investment of SEK 134 billion.



### Secondary markets

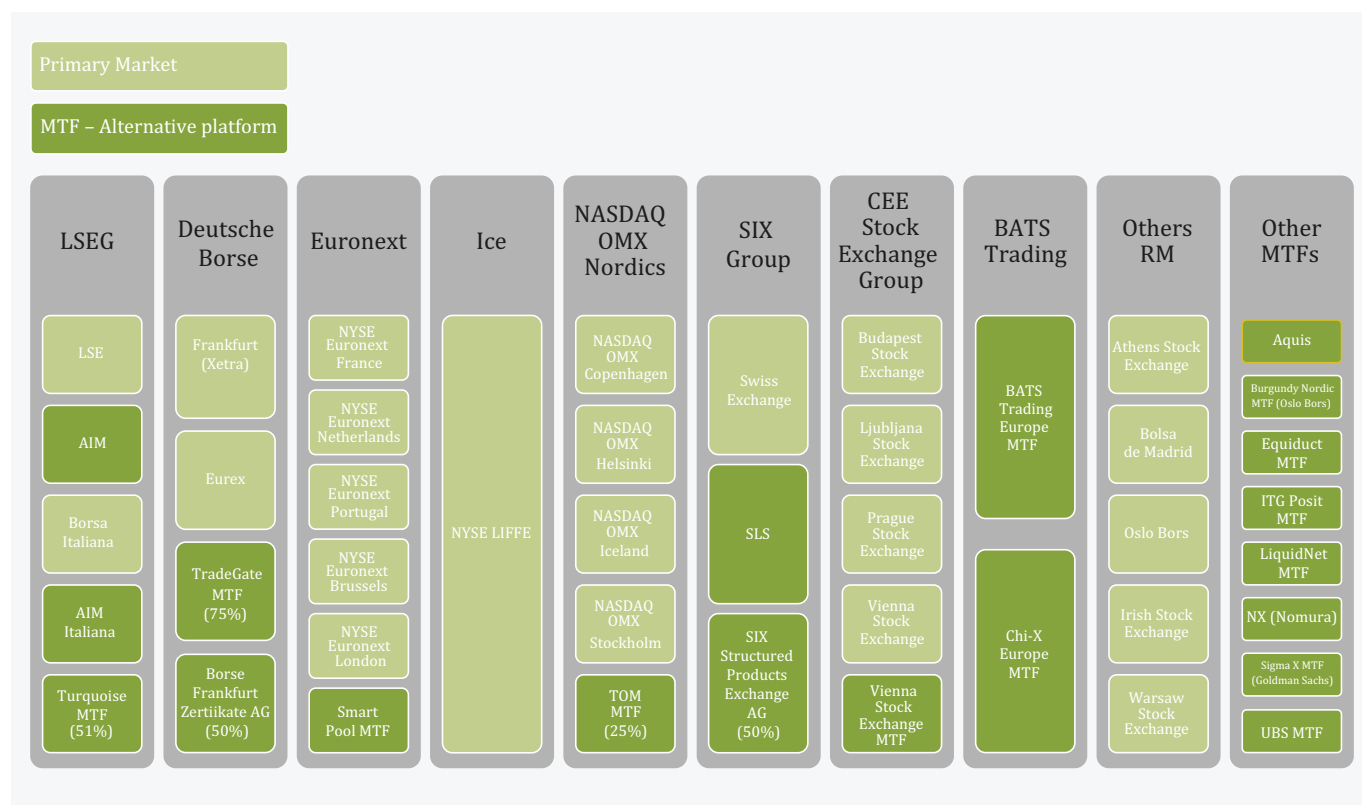
Equity markets are venues that match buyers and sellers. They set prices for companies' shares and provide a liquid market. Ideally, confidence in the market leads to a virtuous circle developing, in which liquidity grows and prices become more accurate.

Equity markets take the form of either stock exchanges, MTFs or over-the-counter markets. The equity market is one of the most vital components of a free-market economy, as it provides companies with access to capital in exchange for giving investors a slice of ownership in the company.

But the equity markets rely heavily on the support of brokers. Along with independent research providers, they write research, giving investors information to enable them to make buy or sell decisions. They also buy and sell equities on their own account, which creates liquidity.

Across Europe, there are 45 equity markets — 24 stock exchanges and 21 MTFs (see Figure 2). The former started out as national stock exchanges such as the London Stock Exchange or Deutsche Boerse, but in the last six years MTFs have proliferated.

**Figure 2: European trading venue landscape (2014)**





Increasing regulation may reduce liquidity in equity markets. For example, the Financial Transactions Tax (FTT) introduced in France and Italy has depressed trading volumes in these markets. Research into the Italian market shows that in the 18 months after Italy introduced its FTT trading volumes fell by 22%<sup>23</sup>. Over the same period, liquidity in other European equities increased by 11%.

### SME sensitivity

Smaller companies in particular rely on the support of brokers in the form of market making and research. Research distributed by brokers helps to inform investors about a company's progress and prospects, again helping liquidity. Academics have made a direct link between the health of an equity market and the health of an economy. Specifically, their studies show that a liquid equity market accelerates a country's economic growth<sup>24</sup>.

Europe's stock exchanges have set up a number of growth markets dedicated to financing and promoting small and mid-sized stocks. These include London's AIM market, AIM Italia (see case study on page 9), NYSE Euronext's Enternext, the Frankfurt Stock Exchange's Entry market, Nasdaq's First North serving the Nordic markets and Spain's Alternative Stock Market. Across France, Germany, Italy, Spain and the UK, over 1,500 companies are listed on growth exchanges or MTFs, representing nearly €126 billion<sup>25</sup>.

MiFID II will introduce specific measures designed to encourage these SME growth markets. The new MiFID regime aims to improve SME access to equity capital and encourage development of these specialist markets. However, measures in the regime relating to pre-trade transparency may reduce trading liquidity, making it harder for SMEs to raise equity capital.

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23 Credit Suisse AES Monthly Chartbook, October 2014.

24 Stock Markets, Banks and Economic Growth. Ross Levine and Sara Zervos.

25 AFME: Raising finance for Europe's small and medium-sized businesses.

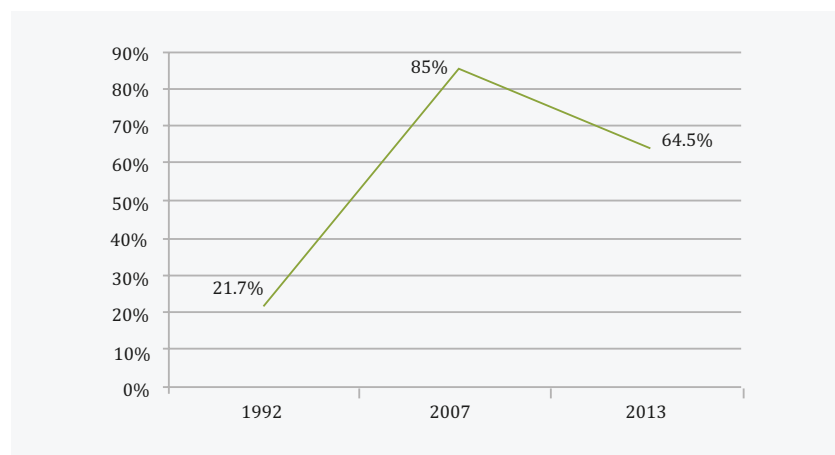
### Europe's opportunity

The European Commission recognises the importance of capital markets, including equity markets, for broadening Europe's access to finance. Its Capital Markets Union initiative aims to develop the role of capital markets, complementing the banking system.

A comparison with the US shows the scope for equity markets to play a greater part in Europe's economy. In 2015, US equity market capitalisation represented 159% of GDP, whereas Europe's was just 73.3%<sup>26</sup>. By increasing Europe's market capitalisation-to-GDP ratio to 100%, more than €3.5 trillion in additional capital could be deployed in European companies and increase the pool of available investment, for example for pension saving.

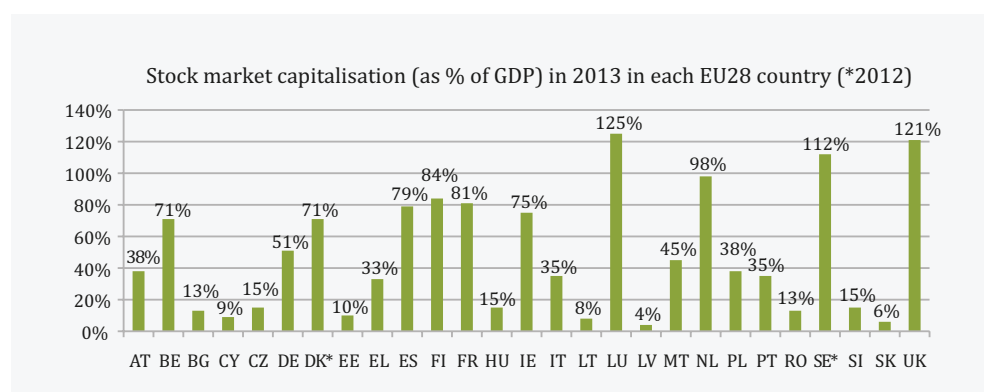
The US record on raising equity capital goes hand in hand with its entrepreneurial business culture. The result is that Europe has just €10 trillion invested in listed equity markets, compared with €19 trillion in the US. This divergence in financing cultures extends even to the structure of savings markets – notably, fund managers' average allocation to equities is 37% in Europe, versus 53% in the US<sup>27</sup>.

**Figure 3: Stock market capitalisation in the EU as a percentage of GDP**



Source: European Commission

**Figure 4: The situation of financial markets varies in the EU Member States<sup>28</sup>**



Source: European Commission

<sup>26</sup> SIFMA and Datastream.

<sup>27</sup> AFME/BCG: Bridging the Growth Gap.

<sup>28</sup> AT=Austria; BE=Belgium; BG=Bulgaria; CY=Republic of Cyprus; CZ=Czech Republic; DE=Germany; DK=Denmark; EE=Estonia; EL=Greece; ES=Spain; FI=Finland; FR=France; HU=Hungary; IE=Ireland; IT=Italy; LT=Lithuania; LU=Luxembourg; LV=Latvia; MT=Malta; NL=Netherlands; PL=Poland; PT=Portugal; RO=Romania; SE=Sweden; SI= Slovenia; SK= Slovakia; UK=United Kingdom.

Within the EU, the European Commission's data (from 2013, the most recent published) shows the role of the equity capital markets has declined since the financial crisis (see figure 3). The picture varies greatly from one country to another. For example, the UK had one of the highest equity market-to-GDP ratios, at 121% in 2013. Meanwhile, Germany's was among the lowest at just 51% (see figure 4).

Europe has a long history of preferring bank debt to capital markets as a source of finance. There is also a reluctance to raise capital on equity markets due to a desire by founder shareholders to retain all ownership rights. In Germany, for example, Mittelstand companies have chosen to build up their reserves of capital over the past decade by reinvesting profits rather than raising funds on equity markets (see "Germany seeks equity for IT innovation" case study below).

As Europe struggles to mount a sustainable, job-creating economic recovery, it is becoming increasingly obvious that the operation of equity markets matter. If Europe's equity markets recovered their previous highs relative to the size of the economy, still some way short of the level in the US, this would substantially increase the level of equity funding in the economy, encourage entrepreneurial businesses and enlarge the pool of potential investments for investors, including pension funds.

AFME believes the European Commission should set a target of expanding equity market capitalisation from its current level of 73.3% of GDP to 100%. While Europe's equity markets last touched this level in 2000, at the peak of the dotcom boom, it is far short of what the US has shown to be a sustainable level for many years. As Europe's businesses seek to compete internationally, its governments look to create jobs and its people save for retirement, equity markets matter.

### Equity markets in action 5

#### Germany seeks equity for IT innovation

In Germany, a political debate is brewing about how to fund the young innovative companies in sectors such as technology that are vital for 21st century growth and jobs. For this reason, the country's shortage of equity capital has become an important issue.

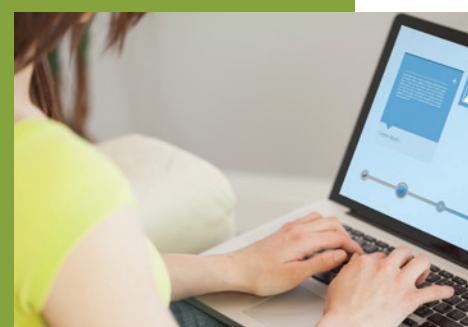
Over the past 15 years, equity issuance in Germany has dwindled to exceptionally low levels. In 2013, there were just five IPOs, down from a peak of 175 in 1999. But that's not to say German companies have become highly leveraged, relying on debt capital alone. Instead, they've spent the past decade building up equity from internal resources. By 2012, equity represented 27.5% of balance sheet capital, according to the Bundesbank, up from 18.6% in 2000<sup>29</sup>.

What is sparking the debate is the need for start-up and growth equity for the type of innovative young companies that are driving forward economies elsewhere in the world, improving countries' competitiveness and creating highly-skilled jobs. In particular, Germany has struggled to create new global IT players since SAP, the business software company, was founded more than 40 years ago. This will likely require new sources of capital.

Although the German government revealed a new 'digital agenda' earlier this year, the country still lags far behind the US in terms of technology innovation. In part, this stems from a lack of available venture capital funding.

"We have a lively discussion in Germany about private equity," explains Reinhard Kudiss, Senior Economist at BDI, the German industry federation. "But this assumes that private equity companies can sell their companies to the market. This topic of reorganising our financial markets is on the politicians' agenda, especially for smaller firms that are innovative."

By comparison with the US, and even some other European countries, Germany's equity markets are under-developed following the past 15 years' falling equity issuance. The country's politicians recognise the need for change if they are to remain competitive.



29 Source: Extrapolated results from financial statements of German enterprises 1997 to 2009; 2006 to 2012. Deutsche Bundesbank Eurosystem.

### Next steps

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This AFME paper is the first in a series of three devoted to the future of equity markets.

The following two papers will examine:

- The barriers preventing European equity markets from playing a greater part in funding business.
- How to overcome the barriers holding back equity markets.

We welcome any comments readers have on either this paper or any of these future topics.

## Contacts

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**Christian Krohn**  
Head of Equities  
[christian.krohn@afme.eu](mailto:christian.krohn@afme.eu)  
+44 (0)20 3828 2706



**April Day**  
Director, Equities division  
[april.day@afme.eu](mailto:april.day@afme.eu)  
+44 (0)20 3828 2682

**London Office**

39th Floor  
25 Canada Square  
London E14 5LQ  
United Kingdom

Switchboard:  
T: +44 (0)20 3828 2700

**Brussels Office**

Rue de la Loi, 82  
1040 Brussels  
Belgium

Switchboard:  
+32 (0)2 788 3971

**Press enquiries**

David Waller  
david.waller@afme.eu  
+44 (0)20 3828 2736

Rebecca Hansford  
rebecca.hansford@afme.eu  
+44 (0)20 3828 2693

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