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Recapitalising EU businesses post COVID-19

How equity and hybrid markets instruments can drive recovery

January 2021

Association for Financial Markets in Europe
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Contents

Foreword	2
Contributors	4
Executive summary	4
1. Introduction	13
2. Estimating the equity shortfall, and the need for private sector tools to complement public COVID-19 support	15
3. Challenges to recapitalisation	28
4. Solutions to support recapitalisation	43
Annex A: EU member state backed credit support programmes	56
Annex B: Review of capital markets financial instruments	57
Contacts	70

Foreword

After over 10 months of lockdown measures and still fighting the pandemic, COVID-19 vaccines are now being administered, so it is now time for Europe to further prepare its long-term economic recovery.

Until now government subsidies, debt issuance and bank lending have kept many EU businesses afloat, but public funding and debt alone cannot be solely relied upon going forward. Due to the ongoing health emergency, quarantine measures across Europe have been extended, which will put even greater pressure on businesses' strained or already depleted cash reserves. Moreover, many larger companies and SMEs will need to manage their increased leverage, while also trying to invest in their future.

For European businesses to recover from the economic crisis, alternative types and sources of funding will be required to help mitigate their mounting debt burden. Europe's capital markets can offer a number of efficient solutions, with the recapitalisation of EU businesses and utilisation of equity and hybrid market instruments having the potential to play a key role in Europe's recovery.

In proposing solutions to Europe's emerging equity funding gap, this report begins by presenting the estimated scale of the problem. Firstly, it quantifies the size of total equity financing needs and compares those with estimates of the equity resources available from the public and private sector. In summary, there is an estimated €1 trillion equity funding need, and we only have EU-wide public and private sector equity and hybrids availability of between €400 billion to €550 billion over an assumed two-year period. Europe's businesses will therefore need to access an additional €450 billion to €600 billion in non-debt funding to avoid a very damaging medium-term rise in the leverage and operating flexibility of the overall European corporate sector.

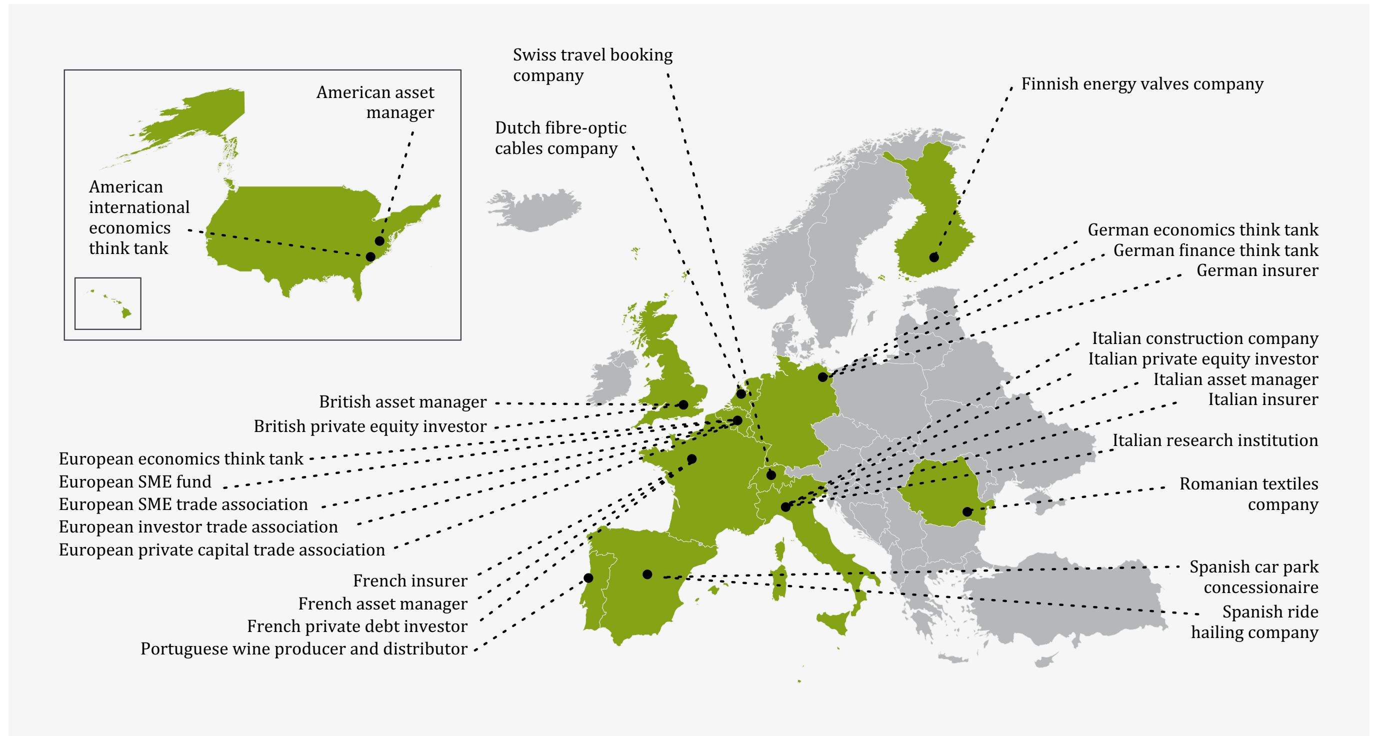
This report uses feedback from large and small corporates and private sector investors to determine what investors are and are not prepared to invest in to fill this gap and describes the nature of financial instruments best suited to do so. It also sets out a roadmap of short-term and medium-term initiatives to be undertaken by the private and public sectors to support businesses in accessing this additional funding. In exploring avenues for the roadmap, it draws extensively on some existing national solutions that are already in place in Europe. Lastly, this report outlines how the recapitalisation we propose must be supported by swift progress on the Capital Markets Union and further integration of the single market.

I would like to thank PwC for their analysis and interview insights that have helped bring this report to fruition.

Adam Farkas
Chief Executive
Association for Financial Markets in Europe

Recapitalising EU businesses post COVID-19

Contributors



Executive summary

The COVID-19 pandemic and associated public health measures to control its spread has prompted an unprecedented scale of public support to help businesses and employees through the crisis. However, while these measures have been crucial in ensuring business' survival in the short term, they do not address the rapidly upcoming need to repair the equity base of many EU27 corporates which has been severely eroded by COVID-19. **The purpose of this report** is to:

1. Describe the **magnitude of the capital impact** on businesses, which will need to be addressed largely with equity if there is to be a rapid recovery.

2. Provide **feedback from corporates and private sector investors** on what they **are and are not willing to issue and invest in** respectively.

3. Propose a **roadmap** of a) **short-term solutions**, including increased awareness of the details of existing capital markets equity, hybrids and other capital markets alternatives (including those utilised successfully in the banking sector), successful member state-specific hybrids that could be scaled further, and the expansion of existing EU-wide equity capacity available from the EIB/EIF, as well as b) **medium-term solutions** by proposing new a EU-wide hybrid instrument designed specifically for the corporate sector. This could be in the form of a new preferred shared instrument, which is state-aid compliant, to build scale and possible liquidity, and which ideally could be developed to comply with social investment objectives to attract maximum investor interest.

4. Emphasise how **this recapitalisation programme must be supported by Capital Markets Union delivery**, particularly for mid-caps and SMEs.

Despite good news on vaccines, the 'second or third waves' and longer-than-expected duration of the pandemic cast a shadow over the economic recovery in Europe. The economic constraints, caused by the measures to stem the tide of new infections and the extended timeframe for public health improvements, will have a significant impact on the viability of many EU corporates, which may be perceived as financially vulnerable. In the longer term, however, the planned vaccination programmes should allow a return to a more certain level of economic activity which could in turn make a wider range of companies investable again.

Fragilities are likely to manifest in the first half of 2021. A substantial number of companies may only have cash buffers for 2 to 6 months at normal rates of expenditure and may need to rely on further government intervention (some of which is forthcoming). The current low number of insolvencies in the EU belies the fragile health of EU corporates, as many member states have temporarily introduced not only public sector financial support but also changes to the insolvency regime to prevent companies from going bankrupt. These fragilities will be revealed as financial pressures amplify in 2021, with insolvencies expected to rise alongside the eventual winding down of loan schemes, tax holidays and other working capital relief.

Policymakers and the financial industry need to move beyond bridge finance in the form of debt to instead focus on long-term economic repair and recovery. Many companies, especially SMEs and those in structurally challenged industries, are reaching the limit of their supportable debt capacity.

Debt has largely provided the 'rescue', but equity recapitalisation is needed to accelerate the recovery. Additional equity or hybrid capital can help companies to survive through the remaining COVID-19 challenges and would mitigate further deterioration in firms' leverage ratios. Public markets have supported existing listed companies reasonably well to date. However, private markets lack the depth to support many corporates in need of recapitalisation. **A solution is needed for large but unlisted firms ("mid-caps"), which together with SMEs make up the vast majority of EU corporates.**

Help for SMEs. The need for recapitalisation will also be most acute for smaller- and medium-sized companies that have even less access to institutional funding than unlisted mid-sized/mid-cap corporates. The smallest-sized SMEs may only be able to access capital from founder-owners, public/state-guaranteed loans from banks or public-related sources such as grants in the InvestEU programme.[1]

10% of EU companies have cash buffers to last 2 to 6 months at normal rates of expenditure

Magnitude of the Problem – Corporate Losses. The European Commission estimates that the damage to EU corporate equity (from losses incurred) is in the order of €0.7-1.2 trillion in 2020 and 2021. PwC estimates that, within the EC's range, total losses may be closer to €1 trillion. They note, however, that the estimated loss figure will likely rise as the crisis persists. These losses are a direct erosion of corporate capital that will need to be replaced, and the sale and pace of replacement will determine the speed of the recovery.

1 The InvestEU programme consists of a fund to mobilise public and private sources for investment backed by EU budget guarantee, an advisory hub to provide technical advice for investment projects seeking funding, and a portal to facilitate information sharing.

Private and Public Sector Equity Available. In terms of **private sector sources** of 'traditional' or 'common' equity (e.g. immediately and fully dilutive), during 2020, €77.4 billion was raised in the **public markets** by listed EU27 non-financial corporates. However, this is only c.7.7% of the €1 trillion losses expected. There is additional "dry powder" – uninvested commitments – available from the private equity sector which Preqin estimate to be €270 billion and €59 billion in the European **private equity** and **private debt** markets, respectively.[2] Of the private equity figure, analysts expect venture capital to comprise nearly two thirds. However, the existence of 'dry powder' does not necessarily mean that capital will flow to where it is needed. The undeployed capital may be committed to specific investment purposes and, in any event, the terms on which private equity typically invests, including control and exit terms, may not suit many companies. During 2020, an estimated €16.4 billion of new equity has been invested in companies by private equity and venture capital investors.[3]

The total listed equity issuance in the EU for 2020 was €77.4bn, only 7.7% of the expected equity shortfall

In terms of **public sector funding** at the EU level, the main potential sources of equity include:

1. The European Investment Bank's new **€25 billion Pan-European Guarantee Fund (EGF)**[4] created as an immediate response to the COVID-19 crisis. If fully leveraged, it is meant to generate up to €200 billion in fresh financing targeted at mid-caps and SMEs, of which some is likely to be debt, quasi-equity products or guarantees,

2. Parts of the **European Commission's €750 billion Next Generation EU Recovery Fund,** including:

    a. the **€312.5 billion in expected Recovery and Resilience Facility (RRF) grants to Member States**, which could be partially considered an equity substitute if it directly alleviates corporate losses,

    b. the future **€26 billion InvestEU Fund**[5], with which the European Commission hopes to mobilise at least €400 billion[6] in total debt and equity investment, across (i) sustainable infrastructure (37.8% or around €9.9 billion); (ii) research, innovation and digitisation (25.1% or around €6.6 billion); (iii) small and medium businesses (26.4% or around €6.9 billion); and (iv) social investment and skills (10.6% or around €2.8 billion).

The above EU-level public sector resources are also expected to feed into or combine with equity available from existing Member State development/promotional banks such as KfW in Germany, BPI in France and similar programmes elsewhere.

At the time of writing, there is political intent to establish an SME IPO Fund as part of the overall InvestEU programme. The potential fund would invest into crossover funds that target companies in the pre-IPO, IPO and post-IPO stages.

Estimating the Equity Shortfall. It is difficult to estimate the potential equity shortfall across the EU as the mechanisms by which EU-wide public funds (such as the EU Recovery Fund) will be deployed (via grants, debt, equity, guarantees, etc.) have not yet been determined. Estimates of public and private sector equity available at an EU-level range from €400 billion to €550 billion depending on conservative or optimistic assumptions, as detailed in the core of this report. If the replacement equity need is around €1 trillion, we estimate a shortfall of between €450 billion to €600 billion in public and private sector equity (including hybrids) at an EU-level over an assumed two-year period, although this estimate **excludes any equity provided in individual EU member states** to mid-caps and SMEs directly or through national promotional banks. Meeting this gap will be a challenge for promotional banks in member states or EU-wide public and private markets, when public finances are stretched and where markets are less well-developed. But without this replacement capital, the recovery will be slower if the corporate sector is forced to rebuild its capital base and capacity to invest from retained earnings.

2 Preqin, Alternative Assets in Europe, September 2020

3 InvestEurope, 'Investing in Europe: Private Equity Activity H1 2020', October 2020.

4 The EGF is based on €25 billion in fresh guarantees provided to the EIB by Member States.

5 The InvestEU Fund is based on a €9.4 billion EU budget guarantee provided by both the NextGenerationEU Recovery Fund and the Multi-Annual Financial Framework (MFF) EU long-term budgetary framework.

6 European Parliament press release, InvestEU Fund agreed: Boosting strategic, sustainable and innovative investments, December 2020.

Key findings from interview programme

To learn more about what corporates are willing to issue and investors are willing to buy in the context of COVID-19 recapitalisation, AFME commissioned PwC to interview across a variety of industries and EU countries to learn more about their financial challenges, as well as develop potential solutions. Key interview findings are summarised below.

Companies

- Large corporates have generally been able to access debt and equity finance to manage through the crisis.
- Many corporates of all sizes would first look to cut costs and restructure before seeking recapitalisation.
- Those seeking capital are willing to pay a substantial premium (estimated to be 8.8 percentage points by the EIB) for solutions that avoid dilution of control.
- Mid-sized corporates and SMEs are open to hybrid alternatives to straight debt or equity if growth opportunities are available, so long as terms are clear and predefined.
- Perceived depressed valuations act as a barrier to raising equity.

Investors

- Insufficient corporate governance (in smaller firms) is a common barrier for investors.
- Technology has enabled roadshows to continue through lockdown periods but with some loss of due diligence richness.
- There is now more active and direct relationships between investors and companies.
- Fragmented accounting treatment of hybrids and differences in the corporate insolvency process leads to challenges in identifying investment opportunities.
- Tax incentives would encourage greater investment.
- Institutional investors face some regulatory barriers to investing in riskier corporates.

Intermediaries/banks

- Many corporates lack awareness of available hybrid instruments.
- Fragmentation across EU member states means due diligence is costly.
- Europe's debt culture could lead to more financially vulnerable firms.
- Equity issuances alongside convertible bonds have been popular during the COVID-19 crisis.
- To attract capital market investors, the industry could explore pooling SMEs' issued financial instruments into portfolios.

Trade associations and academics

- While there is a lot of 'dry powder' across the private equity industry, this will only be utilised for investable opportunities.
- There is variable distribution capacity in private equity and private debt markets across Europe.
- Corporate and bank balance sheets are expected to better reflect COVID-19 losses in Spring 2021.
- The EU needs a solvency instrument to grow out of this crisis and to be prepared for the next crisis.

The interviews confirm that mid-sized and SME corporates clearly do not want to give up control, but are willing to distribute a share of profits and losses and/or issue hybrids. Hybrid equity or debt instruments are ideally suited to address this need. With over €72 billion of corporate subordinated debt and roughly €77 billion of other hybrid instruments issued between 2016-2019, the EU27 already has a series of under-recognised private sector instruments which could be used to help lift unlisted EU corporates out of the crisis. Indeed, certain EU member states have a well-established range of hybrid instruments available, including subordinated debt, profit participation instruments such as "Genussschein" in Germany, as well as similar instruments in certain other countries such as Austria, France, Sweden and Denmark, and convertible bonds and payment-in-kind ("PIK") bonds.[7] These can be copied and improved to expand investor capacity, including possibly at an EU level. Examples of larger European corporates who have accessed the profit participation market are Bertelsmann, Draegerwerk AG, Wienerberger AG, chocolate maker Lindt & Sprüngli, and Roche.

Over 2016-2019, hybrid instruments have seen total annual issuance in the EU of €37 billion per year

7 PwC analysis of Dealogic, S&P Capital IQ, UniCredit, Scope Ratings and Osservatorio Minibond data over 2016 - 2019

These instruments offer subordinated financing; bridge issuer-investor pricing gaps; and in many cases avoid dilution of control. For example, in light of COVID-19, AXA's CAPZA fund has set up a €500 million recapitalisation fund to aid SMEs over a two-year period through equities investments and private debt. Interviewees suggest that with greater alignment in regulatory and tax treatment of hybrids across the EU and with greater corporate awareness of the available options, hybrids could offer a helpful solution to accelerate the exit of government support schemes and support smaller corporates struggling to access capital markets. A new pan-EU corporate hybrid instrument could be developed using the best design features from existing successful Member State structures and drawing on the experience from the use of hybrids in recapitalising banks following the 2007-2009 financial crisis.

The average hybrid issuance volume by EU27 NFCs is surprisingly high, at 59% of the average equity issuance over 2016-2019

EU27 equity and hybrid issuance (€m)

Instrument	2016-2019 total	2016-2019 annual average	2020
Listed common equity	252,186	63,047	77,354
Private equity and venture capital	69,470	17,367	16,418[8]
Total equity issuance	**321,656**	**80,414**	**93,772**
Preferred equity	20	5	49
Profit participating shares and debt[9]	N/A	N/A	N/A
Corporate subordinated debt[10]	72,154	18,039	24,864
Convertible bonds	38,870	9,533	20,043
Payment-in-kind (PIK) bonds	38,132	9,717	11,997
Total hybrid issuance	**149,176**	**37,294**	**56,953**

8 Full year data not available for private equity and venture capital. Annualised half year figure used from InvestEurope, 'Investing in Europe: Private Equity Activity H1 2020', October 2020.

9 Profit participating share or note issuance volumes are generally not reported publicly so no estimate is provided. See Table 3.1 for further details of the various hybrid instruments.

10 Includes Italian mini-bonds.

Existing and Proposed Financial Instrument Toolkit for Recovery

An economic rebuild will require multi-year commitments and realistic timelines. While the EIF's quick roll out of the Pan-European Guarantee Fund (EGF) was important and necessary, on its own it is insufficient for the long-term recovery of the EU economy. In some areas, the rebuild will need new infrastructures, such as wider distribution networks across jurisdictions, and therefore will require multi-year commitments and support up to 5 years and beyond. Whilst the InvestEU Fund has prioritised these types of long-term investments, it will likely require additional equity support above the €6.9 billion EU guarantee allocated to the SME window. Additionally, the requirement for state aid to be repaid as soon as possible raises the question of whether the current EU state aid framework is fit to address the systemic interventions which are necessary in the current crisis. **There is a significant opportunity for policymakers to work together on solutions with the private sector at the national and EU level to address the needs for corporate recapitalisation.** In our view, the instruments and schemes available to support corporate recapitalisation already exist in parts of the EU, but these need refining and expanding for the current situation. AFME recommends that there are four viable options which can be deployed in parallel:

- A **new equity-like hybrid EU-level recovery preferred share instrument** to cater for mid-caps and SMEs who do not have access to capital markets, which may be distributed through new programmes, or the distribution networks of Europe's intermediaries. This instrument could be designed at the EU level and could be exempted from firm-by-firm state aid restrictions when, which would improve its speed and effectiveness. Ideally, this instrument could be developed to comply with social investment objectives to attract maximum investor interest;

- **Scale up of existing EU-wide recovery support schemes** such as the EIF's EGF tailored to the needs of SMEs, particularly the smallest companies;

- **Increased uptake of the already existing equity-like hybrid instruments available in parts of Europe** by mid-caps and SMEs (but who may be unaware such options exist); and

- **Encouraging flexibility in the use of innovative instruments and processes**, such as **dual class shares**[11] to address the control concerns of companies, or **debt-for-equity swaps** to address over-indebtedness. Where national rules or practices currently prevent dual-class shares, an approach may be to allow dual-class shares, of limited duration with sunset clauses, to encourage more family-owned firms to seek a listing on public markets. Among the 14 EU member states analysed in-depth in a recent study by Oxera/European Commission, 5,000 family-run companies above €50 million in size remain unlisted—this could be a significant source of new listings.[12] In addition, corporates may also consider debt-for-equity swaps, in which a company can buy back bonds in exchange for equity at typically advantageous trade ratios (e.g. 1:2 bond value to share value).

However, **each of these options require private-public collaboration at some level.** We present a **roadmap** that can help achieve this through eight capital market initiatives. Some of the measures could be implemented in the relatively near term, while the others should be viewed as medium-term goals. Work to achieve them should, however, not be postponed.

11 Dual class shares are stocks from the same equity issuance but of separate classes, which usually have different voting rights (e.g. Class A shares may have more voting rights than Class B shares).

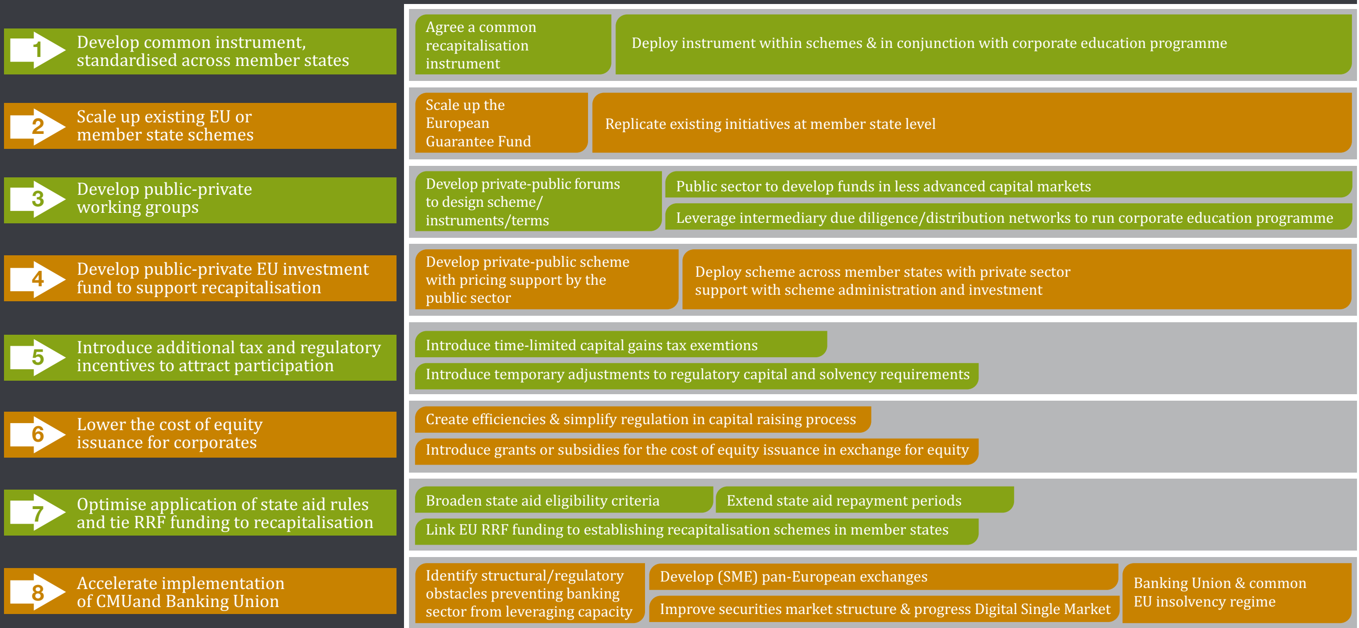
12 Oxera report for the European Commission, Primary and Secondary Markets in the EU, September 2020.

Our roadmap to support the toolkit for equity recapitalisations in the EU[13]

March-December 2020 | Short-term (6-12 months) | Medium-term (1-5 years) | Long-term (>5 years)

Existing EU policy response

- Temporary State Aid Framework to run until end of June 2021; the recapitalisation measures until end of Sept 2021
- €1,850bn to end not before March 2022
- Pandemic emergency liquidity facility for longer-term refinancing to run until 2021, each with a tenor of one year
- Maturing principal payments to be reinvested until end of 2023
- Asset purchase programme to continue at monthly pace of €20bn and run as long as necessary



13 €672.5bn of the EU's €750bn recovery package is offered through the Recovery and Resilience Facility (RRF).

1. To improve liquidity and economies of scale, develop a common EU-level state-aid-exempt recapitalisation instrument, such as a preferred share instrument, with standardised legal, accounting, tax bases, and economic conditions, for use across Member States: The EU private sector can work with EU institutions to drive the design of a common instrument to support equity recapitalisation, to supplement existing member state schemes with similar structures and incentive mechanisms. As previously mentioned, hybrid instruments, which share both debt- and equity-like characteristics, already exist in certain EU member states and could offer significant advantages to issuers with the right profile and capital structure, namely non-dilutive, low-cost equity, with limited effects on firm leverage, unlike ordinary debt finance. We believe a standardised COVID-19 equity preference security (or equity-like hybrid instrument) which would benefit from state-aid exemptions could form the basis for such an instrument and could have broad appeal amongst institutional investors seeking debt-type risk profiles with better returns. Additional depth and liquidity could be catalysed through standardisation of definitions, nomenclature, contractual terms, valuation approaches, features and tax and accounting treatment. Instruments may have to take into account national specificities and standardisation will take some time. Ideally this instrument could be developed to comply with social investment objectives to attract maximum investor interest.

2. Scale up existing recapitalisation schemes at the EU- or member state level and expand usage of existing hybrid instruments that are already available in certain EU member states: Existing recapitalisation schemes, such as the €25 billion EGF by the EIB Group/EIF and other initiatives at member state level, are beneficial and can be levered to improve scale. As they stand, they lack the necessary scale to address the entirety of the EU's recapitalisation challenge. There are opportunities to further scale up schemes like the EGF by broadening the eligibility criteria to enable more firms to be supported, or to draw on the distribution capacity of the private sector to increase reach. Alternatively, existing initiatives at the member state level, including development of best practices, could be replicated in other member states and tailored to specific national needs. **Pan-European tools such as subordinated debt, convertibles, PIKs and profit participation certificates also are already available.** These can be replicated and improved to expand investor capacity, including possibly at an EU level. In particular, some of the instruments already available in certain member states such as profit participation instruments are not well known outside of their home markets (for example, Germany, Austria, France, Denmark, Sweden and Switzerland). However, the private sector alone cannot solve the issue of scalability of any of these instruments.

3. Develop closer public- and private sector collaboration through industry and policymaking working groups, to share knowledge of successful member-state specific equity-raising instruments, and greater understanding of the existing capital markets products toolkit: Recapitalisation schemes should be private sector-led, with governments playing a "catalytic" or complementary role. A joint public and private sector approach through 'national equity recapitalisation forums' will ensure that recapitalisation schemes harness the expertise of investors, entrepreneurs, advisors and intermediaries in assessing the viability of candidates for recapitalisation. In some EU countries with less advanced capital markets, public sector support and changes to national laws and regulations may be needed to develop the necessary capacity and capability to facilitate these flows. Additional technical assistance may also be needed to support the development of the local investment funds sector. The public and private sector must work together to publicise these schemes and inform corporates about the range of financing options available. **We provide a succinct summary of existing capital markets equity-raising instruments** in Table 3.1 that **can easily be used by member state governments for educational and awareness raising purposes**.

4. To improve the visibility, scale and marketing appeal to European investors, coordinate the development of a public-private investment fund across the EU to support recapitalisation and avoid fragmentation: Co-investment schemes should be designed to mobilise private capital, either on a matched funding basis, or through a pari passu or other risk allocation approach across private and public investors. Such mechanisms would help ease investors' concerns over the uncertainty of the economic outlook and compensate them for additional risks around the pricing/valuations of recapitalisation investments, as well as helping to close the existing gap in valuation expectations between investors and issuers.

5. Provide tax and regulatory incentives to attract participation: The incentives for investors to provide recapitalisation capital could be sharpened by introducing allowances for equity investments to better align the tax treatment of equity to debt financing; by providing time-limited capital gains tax exemptions to enable qualifying long-term investments to be rolled over; or by introducing temporary adjustments to solvency requirements to encourage insurers to increase equity holdings, although these need careful calibration to avoid introducing unintended consequences.

6. Lower the cost of public equity issuance for corporates: Equity raising in public markets is much more costly than debt finance and can be prohibitive for smaller corporates. This cost could be reduced through grants or subsidy schemes and regulatory simplification in the capital raising process.

7. Recalibrate the state aid rules for a systemic crisis and tie EU Recovery and Resilience Facility funding to equity recapitalisation schemes: Broadening the eligibility criteria for state aid to reflect the systemic crisis and making the terms more flexible, for example through extended repayment or through tiered interest rates, can help firms rebuild for the future. The Commission should consider linking member states' eligibility for funding under the Recovery and Resilience Facility to establishing recapitalisation schemes that are optimised for success (e.g. broad range of instruments, private sector participation, investment into local operational and distribution capacity).

8. Accelerate the implementation of the Capital Markets Union (CMU) project, the Banking Union and other horizontal strategies: As the crisis has sharpened the focus of policymakers on supporting SMEs and the real economy, it has also revealed the need to accelerate the advancing of the CMU together with other major European projects such as the Banking Union, Digital Single Market and the EU Green Deal. In recommendations of the CMU High Level Forum and the Action Plan from the European Commission, there are areas which can be addressed immediately but this crisis should also be the spur to address more fundamental structural impediments to the scaling up of EU capital markets.

While some of these measures will require significant ambition and political will, acting now and in concert with public and private sector stakeholders will not only support the survival of EU businesses in the short term, but also help the EU economy emerge from the crisis poised for sustained, long-term growth.

1. Introduction

The current COVID-19 crisis presents a significant challenge to the global and EU economy and there is continuing uncertainty over the outlook

The imposition of lockdowns in the spring of 2020, necessary to contain the spread of the COVID-19 virus, has caused historic reductions in economic activity across Europe by curtailing the production and trade of goods and services, as well as corporate and consumer consumption.

Within the European Union, these challenges have been partially addressed by massive public support programmes such as the €750bn Next Generation EU budget, as well as EU-backed SURE loans to 16 member states so far, totalling €87.4bn.[14] [15] The ECB has also provided €1.35tr in asset purchase facilities, which in December was increased to €1.85tr. These programmes have provided effective but, in some cases, temporary cash flow support to firms facing working capital and liquidity shortages to keep businesses afloat.

However, there is continued uncertainty on the path of the crisis and recovery. The deteriorating economic outlook means that businesses are likely to face further financing and solvency pressures, particularly smaller and unlisted companies. There are likely to be particular "crunch points" if these challenges coincide with any reduction in public support measures and when short-term government guaranteed financing needs to be refinanced.

While debt and ECB support has provided the short-term rescue to the EU economic challenges presented by the current COVID-19 crisis, equity needs to drive the long-term recovery

Public support measures to date have focused on the use of debt to provide working capital relief. However, equity-led solutions, including types of equity-classified hybrids which do not cede voting control, will need to drive the recovery. Firstly, to reduce the risk of excessive leverage, which limits their future capacity to borrow, invest and grow. Secondly, it would also give those businesses the capacity to (i) rebuild their prior activities at a more rapid rate (potentially taking up capacity lost by other firms) and/or (ii) pursue innovation as a way of adapting to new circumstances.

In the EU as a whole and within individual member states, the private sector must be tapped to complement existing public sector solutions to address these challenges. The completion of the Capital Markets Union (CMU), will also be crucial to facilitate easier access and greater amounts of private sector capital markets for EU corporates.

The purpose of this report is to highlight where existing and, in some cases, unique European capital markets solutions can be already used to more widely support EU recapitalisations, and where further policy actions should be considered

- Provide facts and ideas on solutions which already are available both at an EU level and in specific member states, to help Brussels and national officials identify the best private sector financial markets as well as public policy tools for support.

- Identify the challenges to recapitalisation, from the perspective of issuers and investors, as well as market-wide or structural challenges, so officials can try to address obstacles.

- Identify the potential market-driven and policy solutions aligned to the broader aims of the Capital Markets Union (CMU) project to deepen and integrate European capital markets.

14 Note that of the €750bn Next Generation EU budget, €672.5bn is allocated to the Recovery and Resilience Facility to support businesses impacted by the COVID-19 crisis.

15 EC, 'COVID-19: Council approves €87.4 billion in financial support for member states under SURE', 25 September 2020.

AFME commissioned PwC to conduct the analysis for this study, with the input of AFME members, EU corporates, investors and official sector participants

Our findings are supported by:

- An analysis of the size of the recapitalisation challenge, including existing European Commission research, as well as other available market data and trends, drawing from a range of publicly available or external sources.[16]

- A broad outreach and interview programme, which involved around 30 institutions. This included: (1) European corporates from a range of industries and size segments across a number of EU regions (Western, Northern, Southern and Eastern Europe). Interviews were conducted with corporates from the industrials and construction, professional services, textiles, technology, transportation and travel sectors. (2) Investors, drawn from a range of institutional settings, including institutional investors (pension funds and insurers), private equity, and private debt funds, (3) investment banks, drawn mainly from AFME membership, and (4) academic institutions and think tanks that have produced research in this area or have been involved in policy discussions on recapitalisation at the member state or EU-level.

- In addition, this report also benefited from the insights and experience of AFME staff and the project steering group, which is composed of AFME members.

The rest of this report is structured as follows:

- Section 2 sets out the case for recapitalisation, including our analysis.

- Section 3 draws out the challenges of recapitalisation, from the perspective of issuers, investors and market challenges.

- Section 4 sets out the potential market-driven and policy solutions that could be taken forward by the private sector and EU policymakers.

16 S&P Capital IQ, Dealogic, Bank of England, ECB

2. Estimating the equity shortfall, and the need for private sector tools to complement public COVID-19 support

COVID-19 has had a significant impact on the European economy

The COVID-19 pandemic and the public health measures taken to contain its spread have had unprecedented impacts on the economy. The European economy shrunk by around 14.4% in Q2 compared to same period in 2019, due to comprehensive lockdown restrictions and weak consumer spending. In addition to many businesses facing strained cash flows and working capital and liquidity shortages, companies that were part of global or complex supply chains have experienced difficulty obtaining trade credit insurance due to increased counterparty credit risk.

The crisis has also introduced idiosyncratic impacts across sectors, with the sharpest declines in activity between 2019 Q2 and 2020 Q2 in the retail, hospitality, tourism, transport and arts sectors. Differences in sectoral composition of economies also meant that member states in Southern Europe, in which tourism and hospitality account for a larger share of economic activity, were also more adversely affected.

Financial market conditions have been generally accommodative, and businesses have been resilient, supported by public schemes and central bank action

The scale of public support measures has been unprecedented. Member States have provided liquidity support in the form of public guarantee schemes and deferred tax payments, amounting to almost 24% of EU GDP, as well as direct fiscal measures such as wage support schemes and direct grants to businesses, which amount to around 4.5% of GDP.[17]

The EU has approved the €750bn NextGenerationEU recovery package, of which the €672.5bn Recovery and Resilience Facility (RRF) is a key pillar. This is composed of loan and grant support to businesses, as well as support for long-term investments. This is in addition to funds already in place to provide a safety net for workers, businesses and member states.[18] These measures, including schemes approved under the temporary flexible EU State Aid rules, amount to over €3tr of support.[19] [20] The table below compares Next Generation and the EU's Multiannual Financial Framework figures:

17 European Commission, European Economic Forecast Autumn 2020, November 2020, p. 55.

18 European Council, A recovery plan for Europe, 21 July 2020.

19 ECB, NextGenerationEU: Commission presents next steps for €672.5 billion Recovery and Resilience Facility in 2021 Annual Sustainable Growth Strategy, 17 September 2020.

20 IMF, Policy responses to COVID-19, 23 September 2020.

2. Estimating the equity shortfall, and the need for private sector tools to complement public COVID-19 support

Table 2.1: **Overview of MFF and NextGenerationEU Public Support**

	MFF 2021-27 Amount (€bn)	NGEU 2021-23 Amount (€bn)	Total Amount (€bn)
Recovery and Resilience Facility (RRF)	0	672.5	672.5
of which loans	0	360	360
of which grants	0	312.5	312.5
InvestEU (EU budget guarantee for €26bn InvestEU Fund)	3.8	5.6	9.4
Just Transition Fund (JTF)	7.5	10	17.5
Rest of MFF (inc. CAP and other spending programmes)	1063	n/a	1063
Rest of NGEU (incl. ReactEU and other spending programmes)	n/a	71.9	71.9
Total	**1,074.3**	**750**	**1,824.3**

Source: European Council [21]

The ECB has also provided additional liquidity support through the €1.9tr pandemic emergency purchase programme (PEPP), targeted longer-term refinancing operations (TLTRO III) and non-targeted pandemic emergency longer-term refinancing operations (PELTROs). In addition, the EIB Group has also provided a €25bn Pan-European Guarantee Fund (EGF) which focuses on finance for small and medium-sized EU corporates.

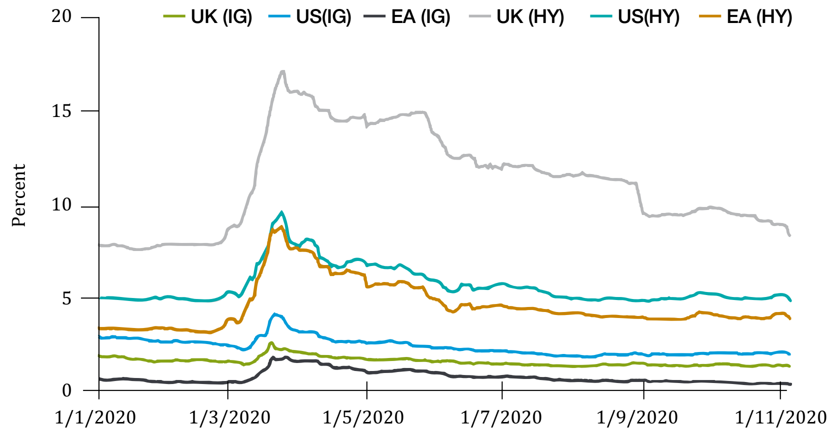
The swift fiscal and monetary policy response meant that, after an initial period of uncertainty and volatility, financial market conditions have calmed considerably (particularly in those sectors which benefit from the central bank purchase programme).

21 Based on MFF 2021-27 Regulation published in the Official Journal of the EU on 22 Dec 20 http://data.europa.eu/eli/reg/2020/2093/oj + Council table of commitments published on 17 Dec 20: https://www.consilium.europa.eu/media/47567/mff-2021-2027_rev.pdf

COVID-19 bond market changes in spreads

Corporate bond spreads rose sharply in April while market uncertainty was at its height. Spreads have since returned to more normal levels, although remaining somewhat elevated, particularly for high-yield debt.

Figure 2.1: **Investment grade bond spreads**

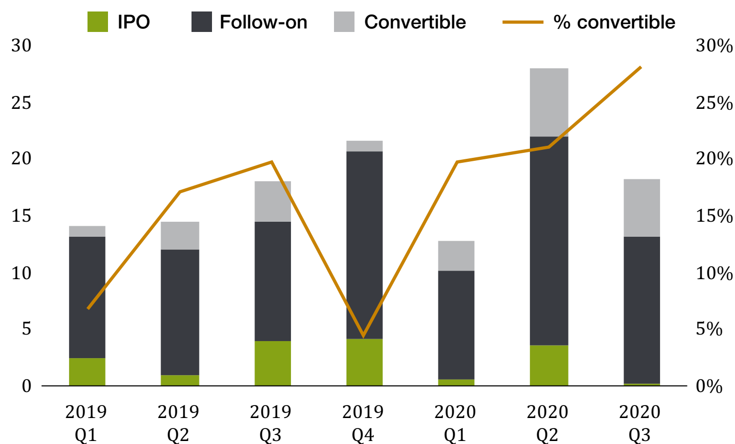


Source: EIKON by Refinitiv, ICE BoAML

Public equity markets across Europe have been resilient, but there are gaps

Equity market activity suggests that listed companies have been able to raise capital during the crisis. Dealogic data shows that equity issuance on European exchanges by non-financial corporates (NFCs) rose by 36% between March and August 2020.[22] This broadly consisted of follow-on issues, which rose by 71% over this period, while IPO issuance declined in most of these months, due to unfavourable market conditions.[23] This suggests that secondary equity offerings have provided recapitalisations for some listed corporates that already had access to public markets.

Figure 2.2: **Gross equity issuance by listed EU27 NFCs, 2019-20, €bn**



Source: Dealogic

22 Equity issuance includes IPOs, follow-on issues and convertible securities.

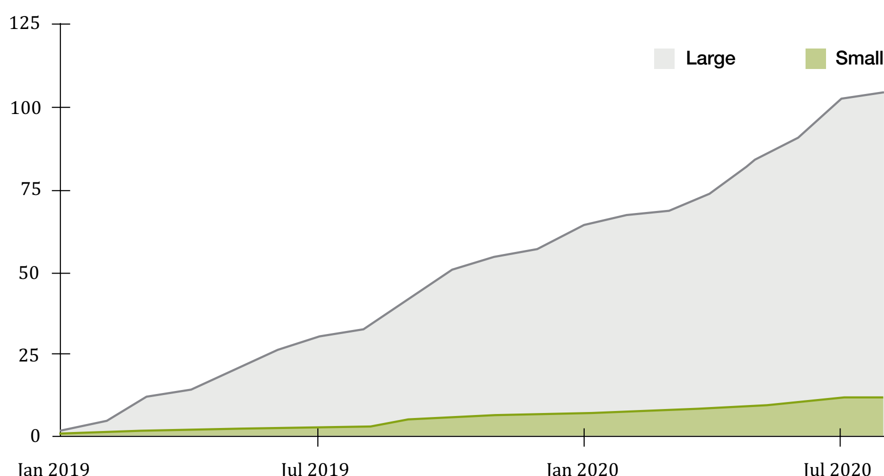
23 Examples of planned IPOs that were announced but subsequently cancelled or delayed include the listing of Italian cosmetics maker Intercos that was planned for April 2020. In October, UK gym operator Pure Gym and German real estate company OfficeFirst cancelled plans for their public offering.

While convertible issuance volumes remain low relative to IPOs and rights issues, their share of overall issuance has risen during the COVID-19 period. For companies of appropriate size in need of liquidity during the current environment, convertibles offer a cheaper solution to traditional debt instruments as they typically pay a lower coupon given the value of the attached equity option, while also offering issuers a path to equity issuance at stronger valuations post-crisis. Convertibles are also attractive to investors looking to protect themselves from downside risk (through its fixed income-like features), while offering the potential for equity-like appreciation.

Interviewees noted convertible bonds offer issuers a cheaper solution to traditional debt while offering investors equity appreciation potential

However, overall equity issuance activity to date has been driven mainly by larger companies, and in sectors that have been less affected by the crisis or have been able to grow as a result of opportunities presented by the crisis, for example, technology and digital, and healthcare. Our interview findings corroborate these observations, with interviewees observing that companies that can articulate a clear recovery strategy and growth beyond the crisis to investors have been largely able to raise capital.

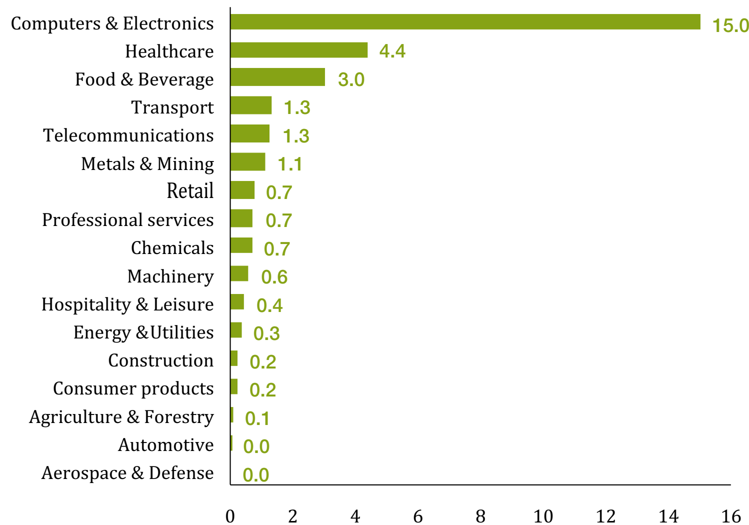
Figure 2.3: **Gross equity issuance by listed EU27 NFCs (cumulative), 2019-20, €bn**



Source: Dealogic (large listings based on listings on main exchanges, SME listings based on listing on junior exchanges)

A compelling business case when raising capital is of greater importance now than it was pre-COVID-19

Figure 2.4: **Gross equity issuance by listed NFC EU27 NFC corporates, by sector, 2020H1 (€bn)**



Source: Dealogic

Just as COVID-19 is accelerating trends in the real economy, for example, in digital transformation and the shift towards e-commerce, COVID-19 is also a 'trend accelerator' in financial markets. Technology has improved direct connectivity between investors and issuers. Following the lockdowns in Europe, market participants quickly adapted to virtual roadshows and meetings, which had the positive side effect of increasing the accessibility of investors and professional advisors. Avoiding the travelling involved to visit companies has increased the reach of corporates into parts of the investor community they might not have otherwise accessed, and vice versa. COVID-19 has also accelerated the shift towards institutional investors such as pension funds and insurance companies providing a more direct and active role in the businesses they finance.

Companies have been able to access both public and private debt financing from banks and markets, supported by public support schemes and loan guarantees.

As real interest rates have declined in the EU, so has the cost of borrowing for firms. Interest rates on bank debt have been on a long-term decline, and with interest rates at historical lows, borrowers are able access debt finance relatively cheaply.

Figure 2.5: **Bank interest rates on new loans, %**

Source: ECB

2. Estimating the equity shortfall, and the need for private sector tools to complement public COVID-19 support

While equity issuance has been largely limited to companies that were already listed prior to the crisis, debt markets, which in most cases only require a listing for withholding tax purposes, have been more flexible. They have provided a lifeline to many companies, particularly private companies which make up the vast majority of enterprises in Europe. Companies have been able to access both public and private debt financing from banks and markets, supported by public support schemes and loan guarantees.

Of the €509.6m bonds issued in Q2 2020, around 79% have been issued by private companies.

The volume of outstanding loans in the euro area rose by about 2.4% over Q1 2020 and 5.5% over Q2 2020 from the same periods in 2019, and continues to rise, albeit that the pace of the increase is slowing. Loan guarantees account for a significant share of this growth.[24] The use of market-based finance is also increasing, with increased ordinary bond issuance in Q2 above pre-crisis volumes. Of the €509.6m total bond issuance in Q2 2020, around 79% has been issued by private companies.

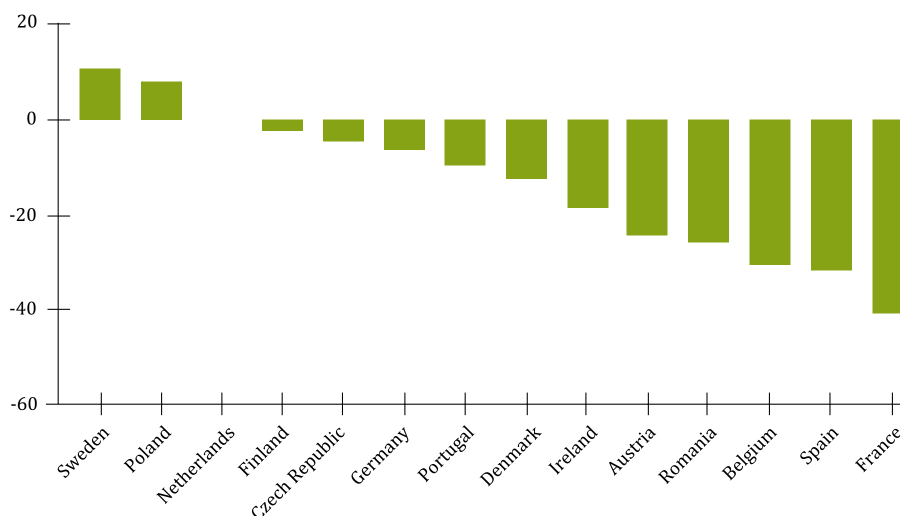
Private equity deal volumes fell by almost one-third in Q2 2020 compared to Q2 2019

Private equity deal volumes fell significantly by almost one-third in Q2 2020 compared to the same period last year.[25] There were however a few bright spots, such as in technology and healthcare, where deals have continued to close but there have also been a number of significant restructurings and distressed sales in the hospitality and leisure sector, as well as in physical retail.

The need for large-scale additional equity capital support is likely in H1 2021, but measures may need to be taken in anticipation of continuing difficult economic conditions

The combination of liquidity measures and working capital support have helped keep most businesses afloat. Apart from a few member states, the number of insolvencies in the EU in the first half of 2020 compared to the same period in 2019 has declined. This is also partly driven by changes to the insolvency regime to prevent companies from formally failing, including temporarily suspension of insolvency applications, preventing creditors from starting insolvency procedures or raising the requirements for triggering insolvency proceedings.

Figure 2.6: **Insolvencies in 2020 H1 vs 2019 H1, % change**



Source: Atradius

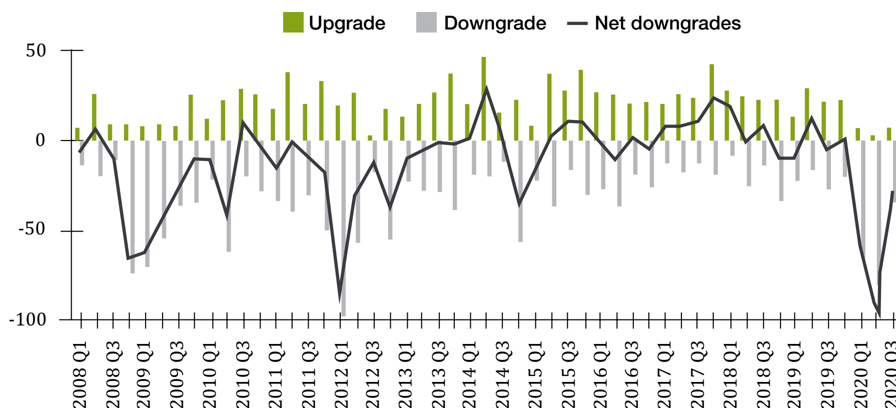
24 Anderson, J., Papadia, F. and Veron, N., Government-guaranteed bank lending in Europe: Beyond the headline numbers, Peterson Institute for International Economics, July 2020.

25 Perspectives, The Effect of COVID-19 on global private equity markets, July 2020. Based on Preqin data.

However, there is still considerable uncertainty over the short-term outlook and recovery path for the global economy. Many European countries are now facing a 'second wave', with nationwide lockdowns reimposed to regain control of the spread of COVID-19. The OECD's latest 'double hit' scenario projects that the Euro area economy will continue to shrink in Q4 2020, reaching an annual average contraction of 7.9% in 2020, before recovering in 2021.

Such pressures are already apparent in the pattern of credit rating downgrades in the EU, with the number of downgraded corporates soaring to 199 between Q1 and Q4 (to date) in 2020, compared to 87 for the whole of 2019.[26] The increase in the number of these 'fallen angels' has been unprecedented, growing at a much faster pace than witnessed during the global financial crisis and the euro area sovereign crisis.[27]

Figure 2.7: **EU NFC downgrades vs upgrades**



Source: S&P Capital IQ

Corporates could face significant financial challenges in Q1/Q2 2021

Research has found that under a worst case sales impact scenario (-75%) without fiscal support, "about 10% of all firms would become illiquid within six months".[28] For some of the hardest hit sectors, such as airlines, this breaking point could be closer to two months.[29] These estimates are corroborated by our interviews, in which corporates acknowledged that business conditions are likely to become much more challenging in Q1 2021 as government support schemes taper off. Businesses can extend this 2 to 6-month period by restructuring and reducing costs. However, the poor economic outlook will put significant pressure on companies' cash needs and working capital. This suggests that these financial pressures may well materialise in the first half of 2021, with insolvencies expected to rise over this period.[30]

2020 corporate downgrades have more than doubled in number, reaching 199, compared to 87 for the whole of 2019

26 Analysis correct as at 23 October 2020.

27 Fallen angels are corporates that have been downgraded from investment grade (BBB or higher) to high yield (BB or lower). Analysis based on S&P rating changes (Source: S&P Capital IQ).

28 De Vito, A. & Gomez, J.P. (2020). Estimating the COVID-19 cash crunch: Global evidence and policy. J. Account Public Policy, 39. https://doi.org/10.1016/j.jaccpubpol.2020.106741.

29 IATA (2020). COVID-19 Airlines' Liquidity Crisis.

30 A study by Atradius suggests that insolvencies are expected to increase by around 6-20% across the EU in 2020. See Atradius, 2020 insolvencies forecast to jump due to Covid-19, Atradius Economic Research, September 2020.

2. Estimating the equity shortfall, and the need for private sector tools to complement public COVID-19 support

The scale of recapitalisation required could be significant - up to €1.2tr

Studies suggest that the scale of recapitalisation required could be significant. For example, the European Commission's May estimate shows that a negative shock to GDP of around 8% to 15.5% in comparison to a non-pandemic baseline would lead to a damage to corporate equity of around €0.7-1.2tr in 2020 and 2021 in the absence of public support. We consider that the corporate recapitalisation needs going forward are likely to be at the middle of this range for the following reasons:

10% of EU companies have cash buffers to last 2-6 months at normal rates of expenditure

- The lower end of the EC's GDP impact assumption is broadly in line with other forecasts for 2020 growth, ranging from -7% to -8% GDP impact in 2020.[31]
- The EC analysis assumes 6 weeks of lockdown measures in its most optimistic (baseline) scenario, and a prolonged 10-week lockdown in its conservative scenario. The average length of the first lockdown in the EU was somewhere in between: our analysis of containment measures and policy data from the Oxford COVID-19 Government Response Tracker suggests that EU member states experienced an average of 8.3 weeks of lockdown measures.[32]
- While Q4 2020 lockdown measures were reimposed across the EU, these were likely to impact fewer sectors of the economy, resulting in a less severe demand shock than the prolonged lockdown of the 'first wave'. This is consistent with the results of the EC's 'second wave' scenario, which projects a demand shock that is larger than in a scenario with a shorter 6-week lockdown, but smaller than a scenario with a prolonged, 10-week lockdown. Businesses will also be better able to adjust their working practices in response to COVID-19 uncertainty and the fall in demand.
- While the first three points above point to the size of the capital shortfall being at the lower end of the range, the emergence of the B.1.1.7 virus variant and reimposition of lockdown measures around Europe in Q1 2021 means that the impact is likely to move towards the middle of the range

The range is corroborated by a study by Carletti et al. (2020)[33] which quantifies the size of the equity erosion experienced by Italian corporates as a result of the crisis. The study estimates that in a 3-month lockdown scenario, Italian corporates could see an equity erosion of €117bn. Increasing this estimate by 50% for the Q4 2020 and Q1 2021 lockdown measures and extrapolating this shortfall to the EU27 on the basis of economic impact yields a total equity erosion of €1018bn, or around €1tr.

Extrapolating the equity shortfall to the EU27 yields a total equity erosion of €1 trn

31 Consensus Economics September forecast (-7.7%), OECD September 2020 forecast (-7.9%), ECB September 2020 forecast (-8.0%), Eurozone Barometer July/August 2020 forecast (-8.2%).

32 Oxford COVID-19 Government Response Tracker, https://covidtracker.bsg.ox.ac.uk/.

33 Carletti et al., The COVID-19 Shock and Equity Shortfall: Firm-Level Evidence from Italy, 27 July 2020.

Estimating the Size of the EU27 Equity Shortfall

Private and Public Sector Equity Available. In terms of private sector sources of "traditional" or 'common' equity (e.g. immediately and fully dilutive), during 2020, €77.4bn was raised in the **public markets** by listed EU27 non-financial corporates. However, this is only c.7.7% of the €1tr expected losses incurred. There is additional "dry powder" – uninvested commitments – available from the private equity sector which Preqin estimates to be €270bn and €59bn in the European private equity and private debt markets, respectively.[34] Of the private equity figure, analysts expect venture capital to comprise nearly two thirds. However, the existence of 'dry powder' does not necessarily mean that capital will flow to where it is needed. The undeployed capital may be committed to specific investment purposes and, in any event, the terms on which private equity typically invests, including control and exit, may not suit many companies. During 2020, an estimated €16.4bn of new equity has been invested in companies by private equity and venture capital investors.[35]

In terms of public sector money at the EU level, the main sources of equity include:

- The European Investment Bank's new €25bn Pan-European Guarantee Fund (EGF)[36] created as an immediate response to the COVID-19 crisis. If fully leveraged it is meant to generate up to €200bn in fresh financing targeted at mid-caps and SMEs, although if fully leveraged some is likely to be debt, quasi-equity products or guarantees,
- Parts of the European Commission's €750bn Next Generation EU Recovery Fund, including:
    a. the **€312.5bn in expected Recovery and Resilience Facility (RRF) grants to Member States**, which could be considered an equity substitute if it directly alleviates corporate losses,
    b. the future **€26bn InvestEU Fund**[37], with which the European Commission hopes to mobilise at least €400bn in total debt and equity investment, across (i) sustainable infrastructure (37.8% or around €9.9bn); (ii) research, innovation and digitisation (25.1% or around €6.6bn); (iii) small and medium businesses (26.4% or around €6.9bn); and (iv) social investment and skills (10.6% or around €2.8bn).

The above EU-level public sector resources are also expected to feed into or combine with equity available from existing Member State development/promotional banks such as KfW in Germany, BPI in France and similar programmes.

In December, the establishment of an SME IPO Fund as part of the overall InvestEU programme was agreed. The potential fund would invest into crossover funds that target companies in the pre-IPO, IPO and post-IPO stages.

Estimating the Equity Shortfall. It is difficult to estimate the potential equity shortfall across the EU as the mechanisms by which EU-wide public funds (such as the EU Recovery Fund) will be deployed (via grants, debt, equity, guarantees, etc.) have not yet been determined. Estimates of public and private sector equity available at an EU-level range from €400bn to €550bn depending on conservative or optimistic assumptions, as detailed in the core of this report. If the replacement equity need is around €1tr, we estimate a shortfall of between €450bn to €600bn in public and private sector equity (including hybrids) at an EU-level over an assumed two-year period, although this estimate excludes any equity provided in individual EU member states to mid-caps and SMEs directly or through national promotional banks. Meeting this gap will be a challenge for promotional banks in member states or EU-wide public and private markets, when public finances are stretched and where markets are less well-developed. But without this replacement capital, the recovery will be slower if the corporate sector is forced to rebuilds it capital base and capacity to invest from retained earnings.

34 Preqin, 'Markets in Focus: Alternative Assets in Europe', September 2020, Table 1.2.

35 InvestEurope, 'Investing in Europe: Private Equity Activity H1 2020', October 2020.

36 European Investment Bank, 'Coronavirus outbreak: EIB Group's response'.

37 European Parliament, 'InvestEU Fund agreed: Boosting strategic, sustainable, and innovative investments', 8 December 2020.

2. Estimating the equity shortfall, and the need for private sector tools to complement public COVID-19 support

We have calculated these estimates of EU-wide public sector and private sector equity availability of €550bn on the high end and €400bn on the low end using more conservative assumptions. When estimating the high-end figure, we assumed a small leveraging of the €25bn EIF EGF guarantee fee, a slightly larger leveraging of the €6.9bn InvestEU money, and that some of the €312.5bn of RRF grants are allocated to equity investment. From the private sector we assume annualised listed equity and hybrid issuance at roughly 2020 figures, plus a small increase, to arrive at a combined figure of c.€550bn.

When estimating the low-end figure, we assumed no leveraging of the EIF or InvestEU amounts, no member state grants in equity form, and the same amount above from the public equity, hybrid, private equity and venture capital markets, to arrive at c.€400bn.

Either way, there is a shortfall which will need to come from member states' promotional banks or public or private markets, which could be a challenge where public finances are stretched and markets are less well-developed. But without this replacement capital, the recovery will be slower as the corporate sector rebuilds its capital base and capacity to invest from retained earnings.

There remains a clear risk that as the second wave being experienced across much of the EU becomes prolonged, equity repair needs are further exacerbated.

EU corporates face a number of challenging options in order to address this damage to their equity. To a certain extent, they can use up liquid assets, which reduces resilience to future shocks; or they can obtain short-term debt funding, but this merely defers the cost to equity investors and increases gearing. In both these options, provided the corporate can return to profit, then liquid assets can be restored, or debt funding reduced over time. However, the preferable and more sustainable solution is new equity capital.

While current financial markets remain accommodative and supportive of capital raising, public markets alone may be insufficient to support the scale of recapitalisation required. To put this into perspective, the total listed equity issuance in the EU27 by NFCs for 2020 was €77.4bn, or only 7.7% of the expected equity shortfall based on our estimate.[38]

The gap is likely to arise for smaller, private companies, as well as businesses in structurally challenged sectors

The need for recapitalisation is likely to be most acute for sectors that have been impacted the most by COVID-19, such as travel, hospitality and leisure - but current evidence from markets is that these sectors have found it most difficult to raise new equity.

Smaller companies and, in particular, private companies are at risk of falling into an equity financing gap given their size and lack of accessibility to public markets. The more precarious financial position of SMEs also explains why their business failure rate has increased by nearly 9 percentage points during the crisis.[39] The European Commission's analysis found that in both its baseline and stress scenarios around 60-75% of the total shortfall by the end of 2020 can be attributed to firms that are in the bottom quartile of profitability and are highly leveraged, of which SMEs make up a significant proportion.[40]

The total listed equity issuance in the EU27 by NFCs for 2020 was only about 7.7% of the expected equity shortfall

38 Total listed equity data from Dealogic. Share of expected equity shortfall is calculated by dividing the total listed equity issuance in the EU over H1 2020 (47.7bn) by the total expected EU27 equity erosion.

39 Gourinchas et al., COVID-19 and SME Failures, September 2020, p. 25.

40 European Commission, Identifying Europe's recovery needs, May 2020, pp. 11 and 36.

While some of these SMEs and companies in structurally-challenged sectors might eventually be solvent in the long run, they may find it difficult to raise additional finance as they reach the limits of lenders' risk appetites and are less able to access capital markets. Although high-yield bond markets have stabilised with spreads declining from their peak in April, they remain somewhat elevated, suggesting that these markets remain vulnerable to a reversal in risk sentiment.

Debt has provided 'the rescue', but equity needs to 'drive the recovery'

Additional debt will only worsen existing leverage problems

Firms with strong balance sheets may be able to weather the incurred losses by relying on liquid assets and working capital buffers. However, some companies, especially SMEs and those in structurally challenged industries are reaching the limit of their supportable debt capacity. While the cost of debt remains low, the high amount of leverage in the system poses default risks, as companies become more vulnerable to interest rate or earnings shocks.

Analysis by TheCityUK's Recapitalisation Group suggests that "unsustainable debt volumes of c.£67-70bn could arise in the UK by the end of March 2021", of which £20-23bn relates to government-guaranteed lending schemes".[41] In order to avoid exacerbating default risks, banks and loan providers are unlikely to further extend credit to already highly indebted companies.

Using a similar approach to TheCityUK's analysis and drawing on the ECB's latest GDP forecasts for the EU, we estimate by extrapolation that unsustainable debt levels in the EU could be around €324bn, about five times higher than the UK, of which 57% might be held by SMEs.[42]

Unsustainable debt levels in the EU could be around €324bn, of which SMEs hold about 57%

Table 2.2: **EU27 unsustainable debt, €bn**

	Total	Large corporates	SMEs
Unsustainable debt*	324	139	186

* Based on the outstanding stock of bank lending as at September 2020

Source: PwC analysis of ECB, ORBIS and TheCityUK data

41 TheCityUK, The Demand for Recapitalisation: Updated Estimates of UK Unsustainable Debt, September 2020, p. 3.

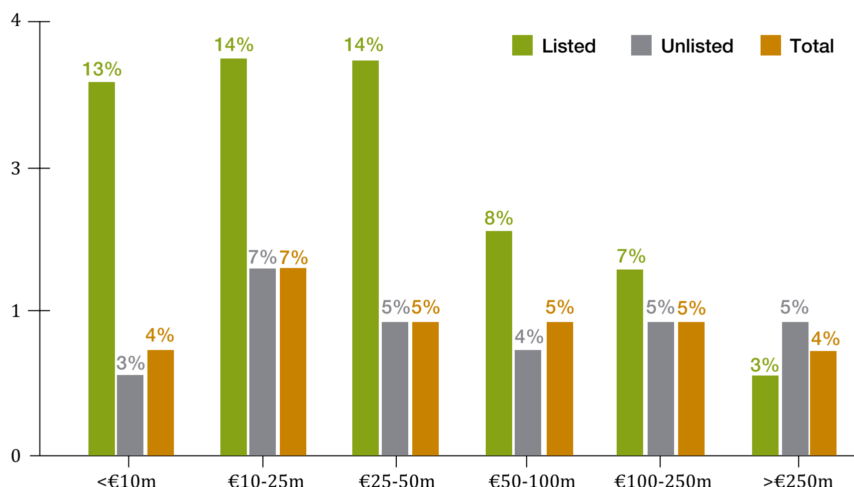
42 We applied a demand shock to the ECB's August 2020 estimate of volumes of new euro-denominated loans to euro area non-financial corporations (the latest available at time of publication). We assumed a demand shock equivalent to the average EU GDP contraction from 2019Q4 - 2021Q1 assumed by the ECB in its September 2020 Central Scenario, with no offsetting effects as business relief schemes taper to a close and variable cost reductions stabilise.

2. Estimating the equity shortfall, and the need for private sector tools to complement public COVID-19 support

Risk of creating more companies who are financially vulnerable

There is also risk that the increase in leverage in the system, may also perpetuate the problem of financially vulnerable firms[43], which could also be referred to as non-viable or financially troubled companies in the EU. This problem is not new. Our analysis of 2019 financial data of both listed and unlisted EU companies on Orbis shows that around 10% of these companies met the definition of a financially vulnerable company'.[44] Of those companies, 97% of were smaller companies with a turnover of less than €250m per annum.

Figure 2.8: **EU vulnerable corporates intensity by 2019 turnover**



Source: PwC analysis of ORBIS data

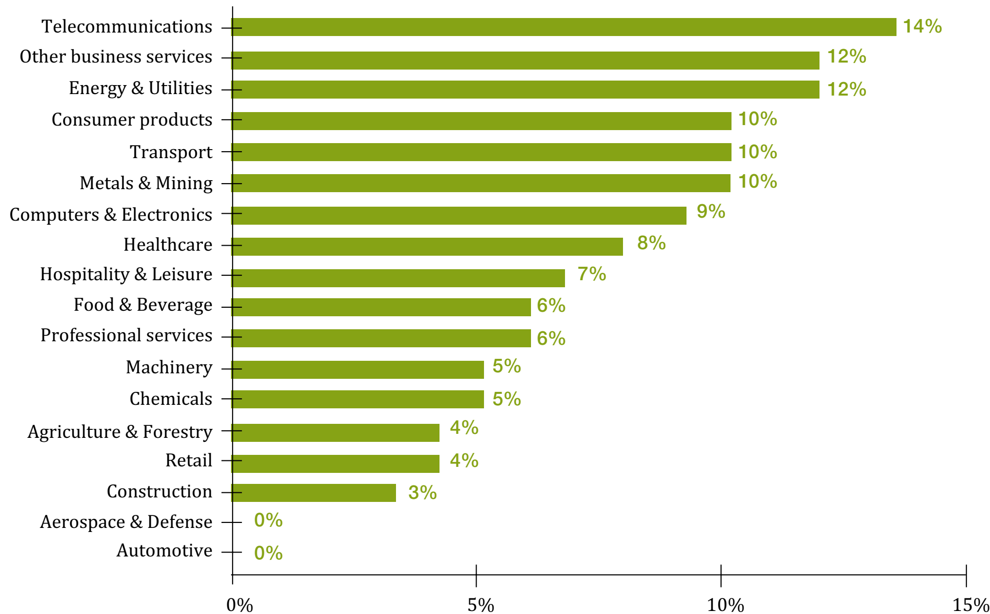
A deeper dive into companies within the €10-25m revenue range shows that around 14% of companies in this segment met the definition of vulnerable companies. Extending this analysis to private companies in the same revenue segment shows a smaller but nevertheless significant number for private companies (7%), which suggests that there is a broader prevalence of vulnerable companies across the EU. Some sectors have a higher prevalence of vulnerable firms than others, such as consumer products and transport, which have also experienced worse impacts from COVID-19 than other sectors.

In 2019, 10% of EU companies met the definition of a 'vulnerable company', of which 97% were smaller companies

43 "Financially vulnerable" firms refer to similar types of firms referring to in other studies as "zombies".

44 Defined as companies with less than 1x interest coverage ratio for 3 years in a row.

Figure 2.9: **2019 SME vulnerable firm intensity by sector (listed and non-listed EU corporates)**



Source: PwC analysis of ORBIS data

Over Q2 2020, Bank of America estimated that 10% of European non-financial companies were vulnerable firms, the majority of which are in the industrials sector.[45]

The rise in financially troubled companies will constrain investment and innovation, putting pressure on long-term productivity growth.

Interviewees cautioned against 'saving' vulnerable companies and that crises can trigger necessary restructuring

Detrimental impact on investment

The COVID-19 crisis has resulted in a drop in business investment, as demand uncertainty has deterred making investment decisions. EIB analysis also shows that European corporate investment could fall by more than half to meet cash needs.[46]

These weak investment trends risk being reinforced by an EU corporate sector which is unable to meet its equity recapitalisation need and a further rise in financially troubled companies. We do note that the recent positive announcements about vaccines is likely to be helpful in making certain companies which otherwise not be able to attract external investment, more attractive for investment.

Risks to financial support for customers unless debts become more sustainable

The high leverage ratios of some of the SMEs and companies in structurally challenged sectors could also negatively impact the financial sector. While bank capital ratios are currently strong, the transmission of corporate losses into non-performing loans and subsequently into write-offs is slow (notwithstanding IFRS-9 provisioning). For this reason, the full extent of the impact of COVID-19 on the European financial sector might not be fully revealed for some time. Therefore, even if banks remain adequately capitalised there is likely to be a negative hit to their earnings which may reduce their ability to fully support their customers and a broader economic recovery.

New equity capital which finances corporates is therefore needed to support growth, investment and reduce the risk of corporate defaults translating into a broader financial sector problem, which would exacerbate the negative impacts.

45 Analysis by Bank of America, see Barrons, There's a Growing Wave of 'Zombie' Companies in Europe. The EU Recovery Fund Could Be a Solution, Bank of America says, July 2020

46 VOXEU and CEPR, EU firms in the post-COVID-19 environment: Investment-debt trade-offs and the optimal sequencing of policy responses, 23 June 2020.

3. Challenges to recapitalisation

Challenges faced by issuers

Companies facing structural demand shifts require business restructuring

While there is continued investor capacity and appetite, private sector investment decisions will be made on a purely commercial basis; whether the investment proposition meets the required hurdle rate of return that is commensurate with the risk that investors are taking, and alignment against their investment strategy and approach. This means that companies facing structural challenges, or those struggling to articulate a realistic recovery path out of the crisis, will find it challenging to attract investor interest and private capital.

For such companies, the solution to these challenges is not necessarily equity recapitalisation but to engage in a process of restructuring to better position the businesses for growth or, in some cases, inevitable insolvency. These factors influence companies' preference for restructuring their businesses to release capital, through cost rationalisations, asset sale and leasebacks arrangements, and transactions of financial assets and liabilities.

Corporate interviewees stressed that they would look to restructure and cut costs before seeking refinancing options

While incentives to continue using debt finance are strong, we are risking deterioration of credit quality

The incentive for corporate financing in the EU, especially in the current environment, is tilted towards debt. A study by the EIB suggests that the historical dominance of bank finance in the EU has also spurred a "culture of debt", which is caused by, and reinforces, the underdevelopment of capital markets in the EU in comparison to the US and the UK. Firstly, as set out in Section 2, the cost of debt has declined over time, driven by the low interest rate environment. Publicly-guaranteed debt also appears to be widely available - analysis by the Peterson Institute suggests that the actual take-up of credit support in the EU has been much lower than the budgeted envelope of programmes.[47] The size of actual funds committed in Germany, for example, only account for 5% of the total announced envelope.[48]

A family-owned corporate reported that it would only consider financing options where the family remained the majority owner

47 Anderson, J., Papadia, F. and Veron, N., Government-guaranteed bank lending in Europe: Beyond the headline numbers, Peterson Institute for International Economics, July 2020.

48 See Annex B for a breakdown of the public support measures so far.

An EIB study found that corporates were willing to pay an 8.8 percentage point premium for a loan instead of external equity

Secondly, many businesses, particularly founder- or family-led businesses value control over management and financial decisions, as confirmed by our interviews with family-owned businesses. Family businesses make up around 60% of all companies in the EU, and account for a significant share of private sector employment (around 40-50%).[49] Studies show that the preference for debt-based financing is more pronounced in entrepreneur or founder-run family firms.[50] This translates into a willingness-to-pay a premium for financing instruments that do not entail control: analysis by the European Investment Bank suggests that firms are willing to pay an interest rate that is 8.8 percentage points higher than the cost of equity to obtain a loan instead of external equity, due to their reluctance to cede control and also because of the more favourable tax treatment of debt.[51]

Weighing the costs of equity recapitalisation against alternatives

There is a high cost to initial public offerings, which involves not only significant cash costs, but also material management time and resources required to carry out activities such as book building and roadshows to generate investor interest.

Equity issuance costs range from 3-7.5% for an initial offering of more than €100m, rising to 10-15% for an initial offering of less than €6m

The costs of issuance can vary substantially across companies and countries. However, a significant proportion of the costs of going public are also fixed, such as bank fees, legal fees, listing sponsors, audit fees, cost for prospectus and material and exchange fees, meaning that the costs can be proportionately higher for smaller issuances. Estimates by the Federation of European Securities Exchanges (FESE) suggest that issuance costs range from 3% to 7.5% for an initial offering of more than €100m, rising to 10% to 15% for an initial offering of less than €6m.[52]

In addition, there are one-off and ongoing post-listing costs, such as the cost of implementing new controls, listing fees, costs for sponsors, brokerage services as well as independent research, and the cost of regulatory compliance. As a result, a survey carried out by FESE showed that 36% of executives list the cost of going and being public as a cause of the decline in popularity of equity markets.[53]

However, we also note that the equity issuance process is becoming more efficient, advanced by technology during COVID-19, which has enabled companies to gain exposure to a broader group of investors over a shorter period of time.

One industrial corporate said that the procedural costs of its recent equity issue amounted to significant 28% of the amount raised

49 European Commission, Internal Market, Industry, Entrepreneurship and SMEs.

50 See for example Croci, E., Doukas, J., Gonenc, H., Family Control and Financing Decisions, European Financial Management Vol. 17 Issue 5, September 2011.

51 Brutscher, P-B and Hols, C., The corporate equity puzzle, European Investment Bank, October 2019.

52 Federation of European Securities Exchanges (FESE), European IPO Report 2020: Recommendations to improve conditions for European IPO markets, March 2020.

53 FESE, European IPO Report 2020, March 2020.

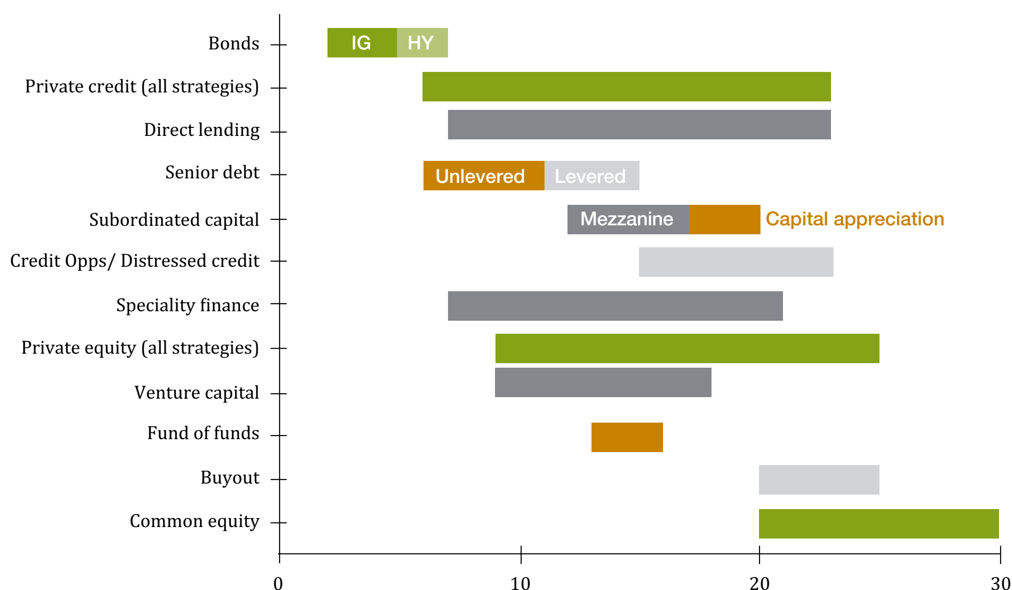
One Italian corporate that listed in June faced a valuation that was half of its expected EBITDA valuation multiple

While these costs should be balanced against the benefits of a public listing, such as improved exposure to investors and the possibility of additional capital raising at lower marginal costs, these costs can still be prohibitive for smaller companies, particularly in a climate where valuations are low, and as a result, therein the proceeds are even smaller relative to the cost of issuance. As an example, one corporate in the industrial sector that went for a listing in June reduced the amount of share capital available publicly to the regulatory minimum due to the relatively unfavourable valuation, which was half of its expected EBITDA valuation multiple and about a quarter of the EBITDA valuation multiple of a close competitor who had issued equity in recent years.

Interviewees noted that the current elevated level of market uncertainty is making pricing efforts much more difficult and complex, however such uncertainty is likely to abate once there is clarity on the outlook and recovery. That clarity should help narrow the gap in pricing expectations between corporates and investors.

The expected returns for investors can vary significantly by instrument and by the specific terms and covenants associated with these instruments. Figure 3.1 shows how target gross IRRs can vary across a number of typical financing instruments. One challenge this reveals is the relatively high cost of issuing hybrid instruments and the apparent gap in the 5-10% IRR investor target range, which contributes to low issuance volumes.

Figure 3.1: **Underwriting targets by instrument (gross IRR %)[54]**



Source: PwC analysis of Cambridge Associates, Preqin Pro, Macabus, Bocconi, EMPEA, BVCA, and interview data

Interviewees noted that there is not necessarily a fundamental mismatch in pricing but rather depressed valuations in the short-term

54 Private placements and Schuldscheine are typically purchased by direct lenders or senior debt investors. Mini-bonds and hybrids are typically bought by mezzanine capital investors. PIK bonds typically fall in the senior debt to mezzanine range but are junior to these investment types in event of liquidation. Convertible bonds are typically purchased by investors who are seeking anything between IG to capital appreciation credit. Profit participating loans are typically purchased by subordinated capital investors. Profit participating shares and Italian savings shares are typically purchased by venture capital investors.

Smaller and medium sized companies don't have the awareness, nor understanding of the existing range of recapitalisation solutions and already-established non-voting instruments in certain EU countries, including hybrids.

There is an increasing range of financing options available to corporates, particularly SMEs, that span the debt-equity spectrum. However, traditional debt instruments, such as bank loans, overdrafts and credit lines remain the preferred form of finance for SMEs. There are other hybrid instruments which offer a blend of equity and debt features, but the availability of these hybrid instruments varies across member states. For example, mini-bonds are primarily concentrated in Italy while profit participation instruments are primarily common to Germany, France and Austria.

Moreover, these tend to be more complex – as cited by a number of interviewees. Obtaining capital via public markets also typically favours certain size or scale requirements that SMEs do not meet. This, in turn, attracts lower ratings and the associated high coupons, which makes these instruments far less attractive and reduces take-up.[55]

Investors are also more inclined to risk their capital in companies that are transparent and properly governed, with robust and reliable information on their financial health. Smaller companies may lack the level of governance controls available in large companies. The lack of awareness or capacity to communicate their green credentials or provide sustainability information to investors, also constrains the available pool of interested investors. A number of investors and intermediaries have confirmed that ESG has gone from being a 'nice-to-have' to a key and central feature of business operations and an important screening criterion for investments. For smaller companies, this is exacerbated by the limited dedicated management resources for financial industry stakeholder engagement (e.g. investor relations functions) and lack of experience dealing with professional investors, which make it more challenging for them to present their funding case to investors.

2020 Q1 saw a 2.6 percentage point reduction in the share of insurers' equity exposures, bringing this to its lowest point over the past 10 quarters

Challenges faced by investors

Investors face a lack of incentives to provide equity recapitalisations

Insurers, pension funds, private equity and venture capital all play a pivotal role in supplying long-term capital to EU corporates. Unlocking capital could provide the scale necessary to address the recapitalisation challenge.

However, investors' incentives may not be geared towards this aim, for a number of reasons.

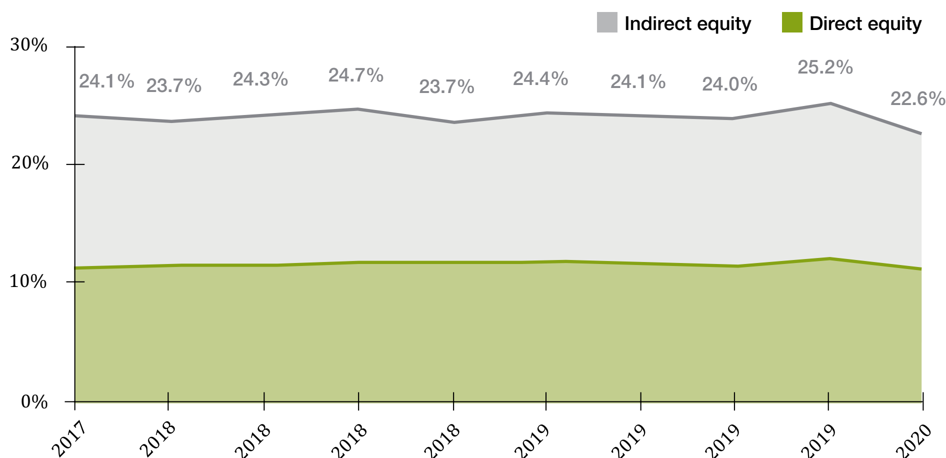
Firstly, while the low interest rate environment is causing a shift in institutional investors' investment allocations to increase their exposure to higher-yielding alternatives such as private markets and investment-grade private credit, the relatively risky profile of corporates in most need of recapitalisation may not be aligned to institutional investors' preference for lower risks and stable returns.

Our analysis of insurers' Solvency II returns to EIOPA suggests that insurers' exposures to both direct and indirect equity investments (through funds) have remained broadly stable over time, accounting for around a quarter of total investments. However, Q1 2020 saw a 2.6 percentage point reduction as insurers offloaded riskier assets during the crisis, bringing the EU insurer equity share to its lowest point over the past 10 quarters. Restoring their exposures to normal levels would unlock roughly an additional €219bn in investment capacity.

One insurer noted that insurers' investment approach is becoming procyclical, with a greater emphasis on downside risk protection rather than long-term value creation

55 OECD, New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, February 2015.

Figure 3.2: **Equity investment by EU insurers, share of total investment**[56]



Source: PwC analysis of EIOPA data

The size of the EU's pension market is also growing, with total assets rising by more than 40% across the EU between 2012 and 2018 reaching €3.8tr, and is set to increase by another 50% between 2018 and 2025.[57] European pension funds typically invest one-fifth of their assets in equities, a lower proportion compared to other regions like North America and Asia Pacific where equity shares account for 40-50% of total assets under management.

While pension funds may have a greater risk appetite than insurers, as indicated by their recent shift from investing in fixed income instruments to equities and alternative classes, they nevertheless have to fulfil financial obligations to their sponsors (corporates) and participants (employees) in terms of providing a steady stream of pay-outs. This may be incompatible with investments in equity recapitalisations.

Secondly, insurers and pension funds may be constrained by regulatory requirements to increase equity investments.

One interviewee noted that, in conjunction with low market rates, the stringent Solvency II regime has confined typical insurers to a regulatory straitjacket

For example, insurers will determine asset allocations to optimise returns within the confines of their risk appetite which is, in turn, influenced by Solvency II coverage ratio requirements. While increasing equity investments can result in a higher return on own funds, its higher risk also increases the solvency capital requirement, thus putting downward pressure on the Solvency ratio. There is some initial evidence that, depending on a company's risk appetite and Solvency ratio, this will (at a certain level) put constraints on increasing equity investments.[58] Some interviewees noted that the Solvency II framework is not compatible with a longer investment horizon that would be conducive to equity investments.

In addition, some member states impose restrictions on institutional investor equity exposures, or concentration limits or diversification requirements on pension funds, which could limit the appetite for recapitalisation. Within the pension fund sector, most funds flow to large caps, with only a small share allocated to micro- and SMEs.

56 Indirect equity refers to equity within collective investment undertakings, e.g. equity and private equity funds

57 PwC, Beyond their borders: Evolution of foreign investments by pension funds 2020 Edition, report for the Association of the Luxembourg Funds Industry,

58 Deloitte and CEPS for the European Commission, Study on the drivers of investments in equity by insurers and pension funds, December 2019.

Interviewees noted that the limited number of investors in unlisted midcaps is partly due to the high fixed costs of assessing SMEs

While retail investors provide a significant potential source of undeployed capital, equities are fairly low down in the hierarchy of investable assets due to the risks and costs of identifying and managing individual investments. Direct share ownership is also on a decline; data from CEPS-ECMI suggests that households own only 11% of Eurozone listed equity (mainly through packaged products), while foreign investors hold 32%. Despite the significant increase in household balance sheets, retail investments in capital markets account for only a small share of financial wealth (around 19%), compared to the US where shares account for 35.6% of their financial assets.[59] The level of uncertainty over the path of the recovery also makes it far more difficult for retail investors to fully assess the risk-return profile of potential investments. This uncertainty underscores the need for safeguards around the marketing of such products to retail investors to avoid the risks of mis-selling. In addition, the fragmented nature of this market makes it difficult to scale up capital from individual retail investors. Finally, the disclosure requirements for offering of instruments in denominations (that allow retail investors to participate) may exclude a relevant proportion of companies from pursuing this approach.

Capital gains taxes may also reduce the incentive to recycle capital from long-term investments into businesses requiring recapitalisation. While the average top marginal capital gains tax rate across EU is 19%, there is wide dispersion across member states, with some countries like Denmark levying the highest capital gains tax in the EU (at 42%), and others that do not levy capital gains taxes, such as Belgium, Luxembourg, Slovenia and Slovakia. Broadly speaking, Northern and Western European countries on average have higher capital gains taxes than Southern and Eastern European countries.

Some private equity funds may be constrained in their ability to deploy capital to support new recapitalisations

In principle, there is a substantial pool of private sector capital that could be deployed to supporting recapitalisation. Data from Preqin suggests that the amount of 'dry powder' available is around €270bn in private equity, and €59bn in private debt markets in Europe.[60] The notional value of debt facilities provided on an uncommitted basis has also significantly increased, growing by 12 to 15 times over the past decade.[61]

Interviewees also noted that while private debt markets have not grown as quickly as traditional bank loans due to the low interest rate environment which favours bank financing, there is significant scope for an increase in demand for private debt to fund the economic recovery and fill the gap left by banks as they near the limits of their risk appetites.

Preqin data (Figure 3.4) shows that following stable growth between 2015 and 2019, the number of global private debt funds in the market has grown to a record high. At the start of July 2020 there were 486 vehicles, seeking $239bn in aggregate capital, an increase of around 25% since the start of 2020. But there remains a funding gap in the private debt market for SMEs and mid-market companies due to the complexity of these products.

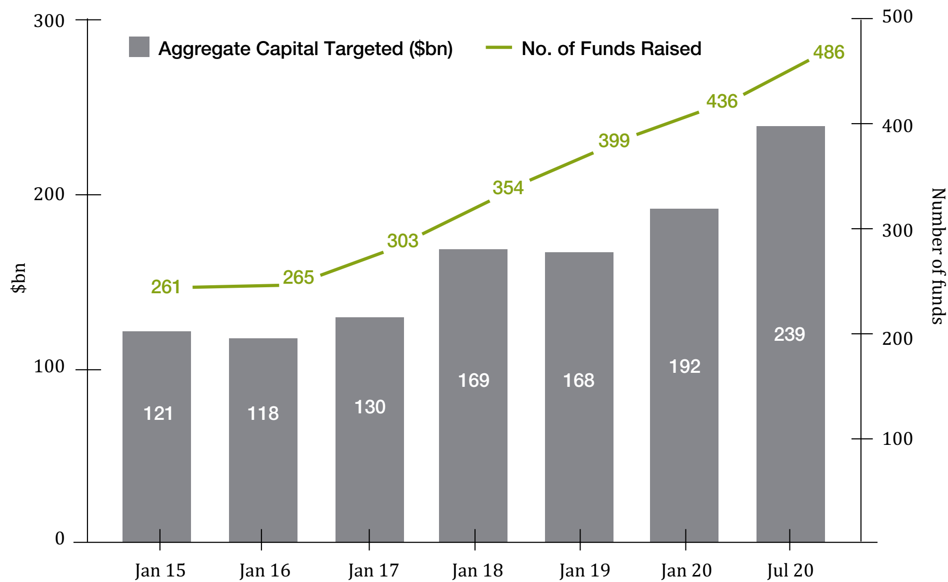
The amount of 'dry powder' available in private equity is around €270bn, and €59bn in private debt markets in Europe

59 Constâncio, V., Lanoo, K. and Thomadakis, A., Rebranding Capital Markets Union: A market finance action plan, CEPS-ECMI, June 2019.

60 Preqin, Alternative Assets in Europe, September 2020.

61 Private Equity International, Uncommitted debt: how to avoid getting stung in a downturn, February 2020.

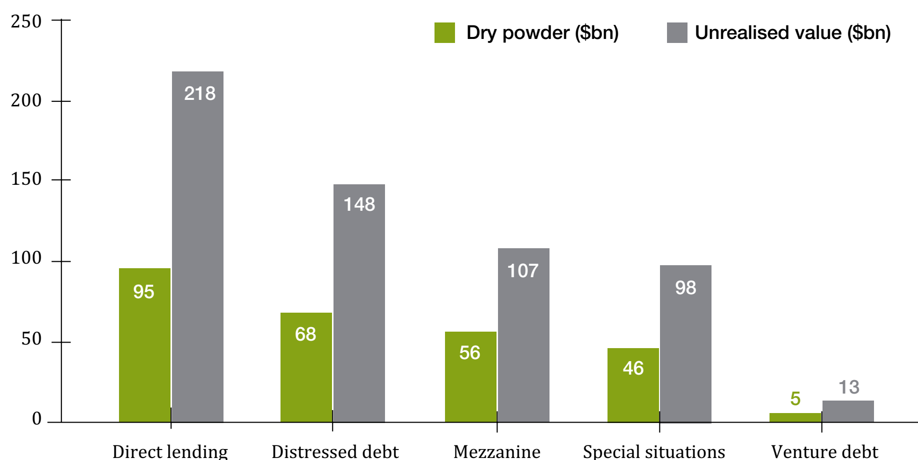
Figure 3.3: **Private debt funds available in the global market over time**



Source: Preqin

Private debt could fill a gap for corporates seeking financing above 3x EBITDA, which banks are less likely to provide

Figure 3.4: **Private debt - Global assets under management by fund type**



Source: Preqin

The existence of 'dry powder' does not necessarily mean that capital will flow to where it is needed. The existing stock of undeployed capital may be committed to specific investment purposes, which could limit its deployment toward SME recapitalisation or to certain instruments attractive to issuers. As mentioned above, private equity investments are also likely to be concentrated into corporates with a clear path beyond the current crisis, a position that is corroborated by our interviews. This would still leave some sectors, such as retail, hospitality and leisure, less able to raise capital.

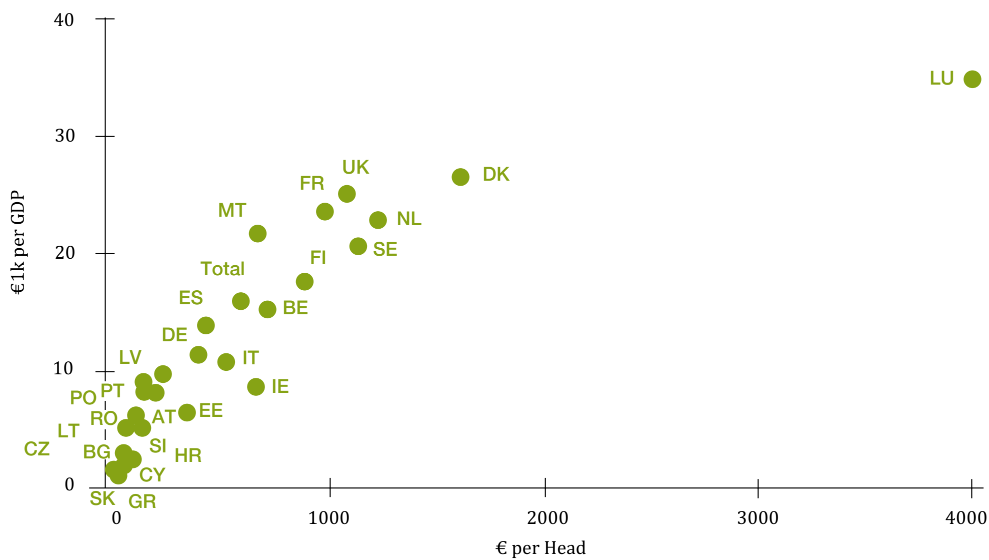
Other constraints in the ability of PE to deploy available capital could also include:

- Existing capital may be committed to investing either in companies already in a fund or at a later stage.
- Some funds may need to prioritise both effort and funding if many of their portfolio companies fall into difficulties, although there is no evidence to date that this is causing strain.
- Some funds may be fully invested and thereby unable to provide additional recapitalisation support. But there are a number of solutions that could address this constraint, for example the use of hybrid capital, sales to other funds, asset sales, borrowing at fund level etc.

There is also a structural skew in the distribution of PE investments (and presumably the capacity to make further investments) to a limited number of countries and segments. Invest Europe data reveals that:

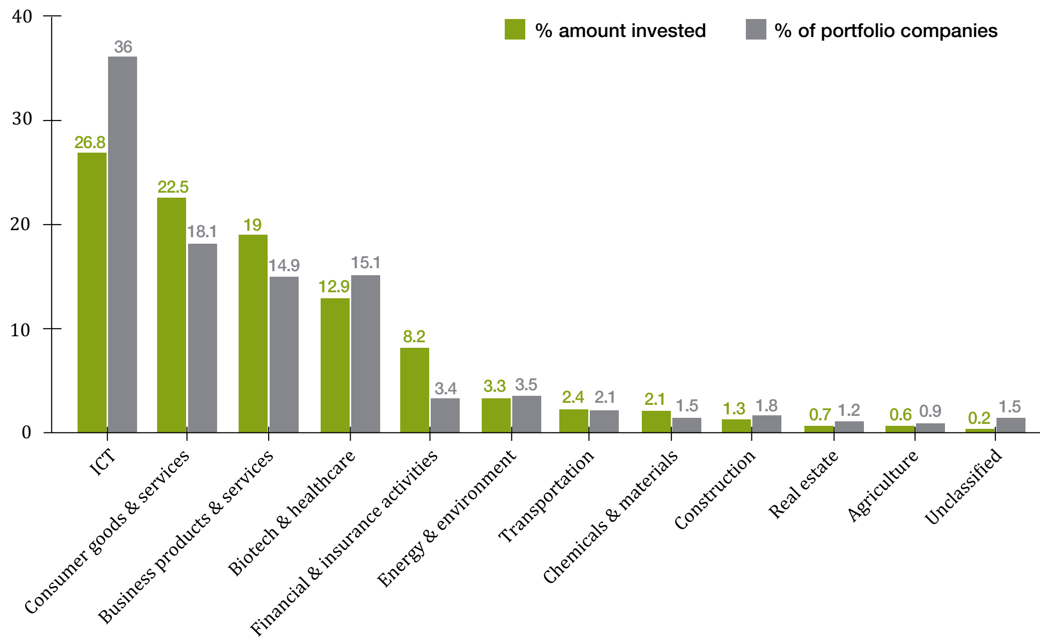
- Central, Eastern and Southern Europe have noticeably lower private equity investment per capita and per GDP than Western and Northern Europe.
- While SMEs account for about 84% of PE portfolio companies, they primarily attract venture capital. This suggests that the majority of private equity investments in SMEs may not be compatible with family-owned businesses who are unwilling to cede control, as VC investors typically require greater ownership stakes.

Figure 3.5: **Private equity investment across Europe (2019)**



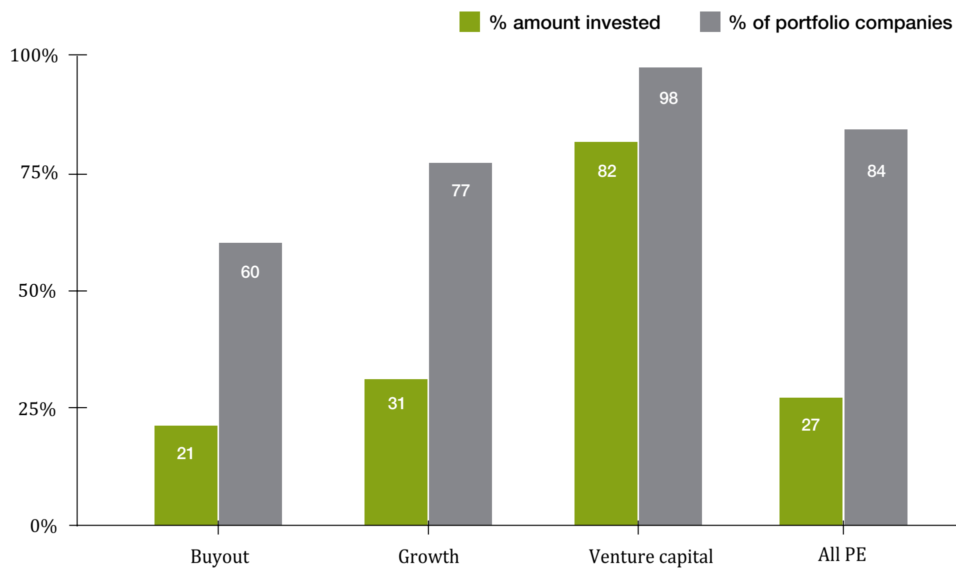
Source: PwC analysis of InvestEurope data

Figure 3.6: **Private equity investments by sector (2019)**



Source: Invest Europe / EDC

Figure 3.7: **Private equity investment in SMEs (2019)**



Source: Invest Europe / EDC
Note: SMEs defined as companies with fewer than 250 full-time equivalent employees

Market or structural challenges

Our interviews also highlighted a number of broader market and structural challenges that contribute to the mismatch between where private capital is likely to be available and where recapitalisation support is needed.

Toolkit of available country-specific instruments is good, but awareness is low

There is a broad range of instruments that could be used to support recapitalisation, from 'pure' debt instruments such as ordinary bonds, to common equity and dual class shares,[62] debt-for-equity swaps as well as hybrid instruments within the debt-equity spectrum which share both debt- and equity-like characteristics. Examples of hybrid instruments include convertible debt, profit participating instruments, and mezzanine finance (see Table 3.1 below). Some hybrid instruments such as subordinated debt have seen large issuance volumes over recent years (see Figure 3.9 below).[63]

A Spanish corporate noted that there are helpful hybrid instruments available for those wanting to raise capital but are experiencing pricing mismatches for equity or debt instruments.

While there do not appear to be any clear gaps in the range of instruments available along the spectrum of equity to debt-like instruments, the complexity and lack of understanding, or awareness of, the treatment of hybrid financial instruments for the purposes of credit assessment (outside credit rating agency methodology), accounting and insolvency treatment often limits corporates and investor interest and participation despite the benefits.

For example, each country has its own set of rules under accounting standards to determine whether the capital provided to a legal entity on an unconsolidated basis should be classified as equity or debt capital. For example, many EU member states have their own GAAP rules, specifically for reporting on an unconsolidated basis. While many of these principles are aligned to IAS/IFRS, there may still be important differences in the accounting of hybrid instruments, which can have consequences for income recognition and taxation.[64] These differences, and uncertainty over their treatment could limit their utility to companies and also constrain the pool of available investors at the national level.

Investors reflected that the fragmented accounting treatment of hybrids and the corporate insolvency process can make it challenging to apply a consistent approach in identifying viable companies across countries.

62 Dual class shares are stocks from the same equity issuance but of separate classes, which usually have different voting rights (e.g. Class A shares may have more voting rights than Class B shares).

63 See Appendix B for more detail on issuance volumes.

64 Seminogovas, B., Taxation of Hybrid Instruments, Procedia - Social and Behavioral Sciences 213 (2015) 299 – 303, 215.

Table 3.1: **Variation in terms for typical instruments across the debt-equity spectrum**

	Equity	Financial instrument spectrum								Debt
	Common shares	Preferred shares	Profit Participating shares[65]	Italian savings shares	Profit participating debt[66]	Hybrid bonds	Mini-bonds	PIK bonds	Convertible bonds	Ordinary bonds
Property rights	Yes	Yes	Yes	No	No	No	No	No	Yes**	No
Voting rights	Yes	No*	No	No	No	No	No	No	Yes **	No
Term	Perpetual	Perpetual	Perpetual	Perpetual	Fixed	Fixed / Perpetual	Fixed	Fixed	Fixed	Fixed
Coupon or dividend	Discretionary dividend	Discretionary dividend	Discretionary dividend	Discretionary dividend	Discretionary dividend and/ or Coupon	Discretionary coupon	Fixed coupon	Fixed coupon	Fixed coupon	Fixed coupon
Cumulative / non-cumulative	NC	Cumulative	Cumulative	Cumulative	Cumulative	Cumulative	N/A	N/A	N/A	N/A
Claim in liquidation	None	None/ Junior***	Junior***	None	Junior	Junior	Junior	Junior	Junior	Most Senior
IFRS equity credit / Financial liability	Equity	Typically equity	Equity / financial liability	Typically equity	Financial liability	Equity / financial liability	Financial liability	Financial liability	Financial liability	Debt
Ratings agencies equity credit	Equity	Partial	Partial	Typically debt	Typically debt	Partial	N/A	Debt	Equity / Partial	Debt
Market liquidity	High	Low	Low	Low	Low	Low	Low	Medium	Low to medium	High
Governing law	Regional	Regional	CH, DE, FR	IT	DE, AT, NL	Regional	Primarily IT	Regional	Regional	Regional

Source: PwC analysis of publicly available sources
* Except following prolonged suspension of dividends. ** if converted to equity. *** liquidation preference amount

65 E.g. Genussschein, bon de jouissance, dividend rights certificates

66 E.g. Participation certificates, partizipationsschein, bon de participation

The need to scale hybrid instruments

There is a clear dominance of traditional bank and debt capital market debt (including state guarantees) and common equity in EU capital raising. This is in sharp contrast with the US where markets-based financing plays a much bigger role. The prevailing 'debt culture' in the EU and corporates' historical reliance on bank finance means that the market for hybrids is relatively small and less liquid. The size of the European hybrid market however is not at all insignificant:

Table 3.2: **EU27 NFC equity and hybrid issuance (€m)**

Instrument	2016-2019 total	2016-2019 annual average	2020
Listed common equity	252,186	63,047	77,354
Private equity and venture capital	69,470	17,367	16,418[67]
Total equity issuance	**321,656**	**80,414**	**93,772**
Preferred equity	20	5	49
Profit participating shares and debt[68]	N/A	N/A	N/A
Corporate subordinated debt[69]	72,154	18,039	24,864
Convertible bonds	38,132	9,533	20,043
Payment-in-kind (PIK) bonds	38,870	9,717	11,997
Total hybrid issuance	**149,176**	**37,294**	**56,953**

This is also partly due to the structural problem of 'overbanking' in the EU, which has resulted in too many bank assets chasing too few profitable opportunities. The strengthening of bank capital positions following the financial crisis, declining profitability and the low interest rate environment have led to a proliferation of 'cheap' bank debt, limiting the market opportunity for specialised hybrid debt and alternative funds.

Due to their bespoke nature, the terms of hybrid instruments can also vary significantly, which further limits depth and liquidity. These factors combined with the complexity and lack of understanding and standardisation over the treatment of hybrid instruments result in relatively low overall issuance volumes of hybrid instruments over recent years and the specialised funds that focus on these instruments. Their complexity also means that the cost of issuance tends to be higher, once the issuance cost premium, liquidity premium, and complexity premium are accounted for, in turn, reinforcing the low overall volumes. Nonetheless, the European hybrid market is significant – over 2016-2019, total annual issuance of hybrid instrument within the EU was €149bn roughly 59% of listed equities issuance volume.

Due to the costs, certain hybrid issuances can only be justified with bigger tranches, which currently makes them less suited to the small ticket sizes required for recapitalisation.

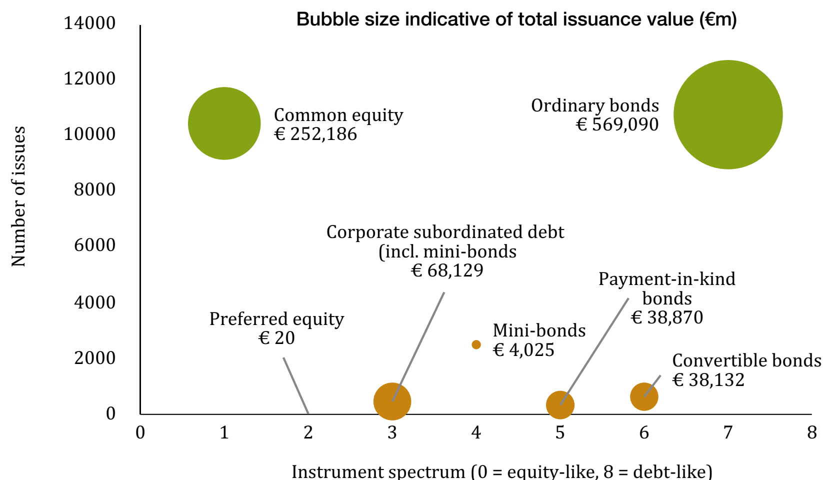
These challenges could be addressed by greater standardisation to increase market depth and volumes and reduce the cost of issuance. Indeed, as we heard from several corporates, there is appetite for hybrid financing, as long as the terms and conditions are predefined, and the instrument presents growth opportunities. Further discussion is provided in Box C and Section 4.

67 Full year data not available for private equity and venture capital. Annualised half year figure used from InvestEurope, 'Investing in Europe: Private Equity Activity H1 2020', October 2020.

68 Profit participating share or note issuance volumes are generally not reported publicly so no estimate is provided.

69 Includes Italian mini-bonds.

Figure 3.8: **Financial instrument issuance trends, 2016-2019**



Source: PwC analysis of S&P Capital IQ, Dealogic, SIX, UniCredit, Scope Ratings and Osservatorio Minibond data

While volumes remain small compared to traditional debt and equity instruments, interviewees also noted the growing importance of the role played by credit funds and distressed debt funds specialising in high-yield debt, subordinated debt and PIK notes, in providing additional capital to firms. The returns on offer make these an attractive alternative investment, with annual returns of 6.1% on distressed debt against 5.1% for global corporate and high yield bonds.[70] The key challenge here is to identify the distribution channels to improve the connectivity between corporate issuance opportunities to potential investors.

Box A: German profit participation shares ("Genussschein")

German profit participation shares known as "Genussschein" are well established and offer a subordinated financing option which is treated as equity on a solo accounting basis and can be designed to achieve IFRS equity. German corporates such as Bertelsmann have issued these instruments.[71] This instrument has historically been sold to retail investors but legislative changes, such as removal of withholding tax, could make it more attractive to institutional investors and a change in accounting treatment to equity for issuers, would motivate issuance, which slowed a few years ago when the IFRS accounting treatment changed. In a distressed scenario, the instrument absorbs losses before other debts. While the instrument may not be most appropriate for direct issues by the hardest hit corporates, it could work to the benefit of both issuers and investors if distributed within an EU sponsored fund, which would also improve the instrument's liquidity. We understand that issuance activity in Germany has declined in recent years, mainly due to accounting treatment.

70 PICTET, 'Prepared for distressing times', July 2020.

71 Bertelsmann, Profit Participation Certificates – Overview – Key Facts.

Tax and legal fragmentation in the regulation of financial markets across Europe complicates the growth of hybrid instruments

Many hybrid instruments have been created to serve national markets and therefore follow local tax, accounting and regulatory requirements. The continued challenge of fragmented regulation of financial markets across Europe, as well as numerous differences in rules, laws, regulations and cultural ways of operating across EU states limits the ability of corporates to access a broad pool of potential investors. For example, withholding tax is a key barrier for institutional investors with regard to German profit participation shares ("Genussschein").[72] Many of these challenges are not new, and have been discussed extensively as part of policymaking efforts to shape the Capital Markets Union (CMU) agenda in the EU. Specifically, the final report of the High Level Forum on the Capital Markets Union notes that "end investors often face difficulty and costs in exercising rights associated with the ownership of securities, as national rules on the allocation of ownership rights and execution of entitlements differ across member states", thereby discouraging cross-border investing.[73]

Investor interviewees noted that, even with a streamlined prospectus, tax and legal challenges across countries often hinder comparability

The private sector alone cannot solve the issue of scalability

The reality is that most small- and mid-sized corporates do not have the visibility and profile needed to attract the attention of large investors. For investors, direct exposures might work for a large corporate investment, but this may not be suitable for smaller corporates, where investors prefer a more diversified exposure.

The cost of conducting due diligence is also a key consideration for investors - the small ticket sizes and potential rewards may be insufficiently attractive to an investor to make the additional time costs of researching smaller companies worthwhile.

While there is a role for individual investors to support recapitalisations, and there are examples of investors (especially PE) investing directly in smaller companies, it is clear that the capacity within the private sector to execute a large volume of smaller, unquoted investments is currently insufficient to fully address the scale of recapitalisation required.

To encourage large-scale investing in equities, the following ingredients are needed:

- Build awareness amongst companies about the options and available instruments for equity investments, or enable cost-effective equity raising or recapitalisation. Table 3.1 above is a succinct summary that can easily be used by member state governments for educational purposes;
- Offer investors the opportunity to make meaningful investments in diversified portfolios; and
- Create efficiencies through the standardisation of instruments, practices and legal/regulatory frameworks.

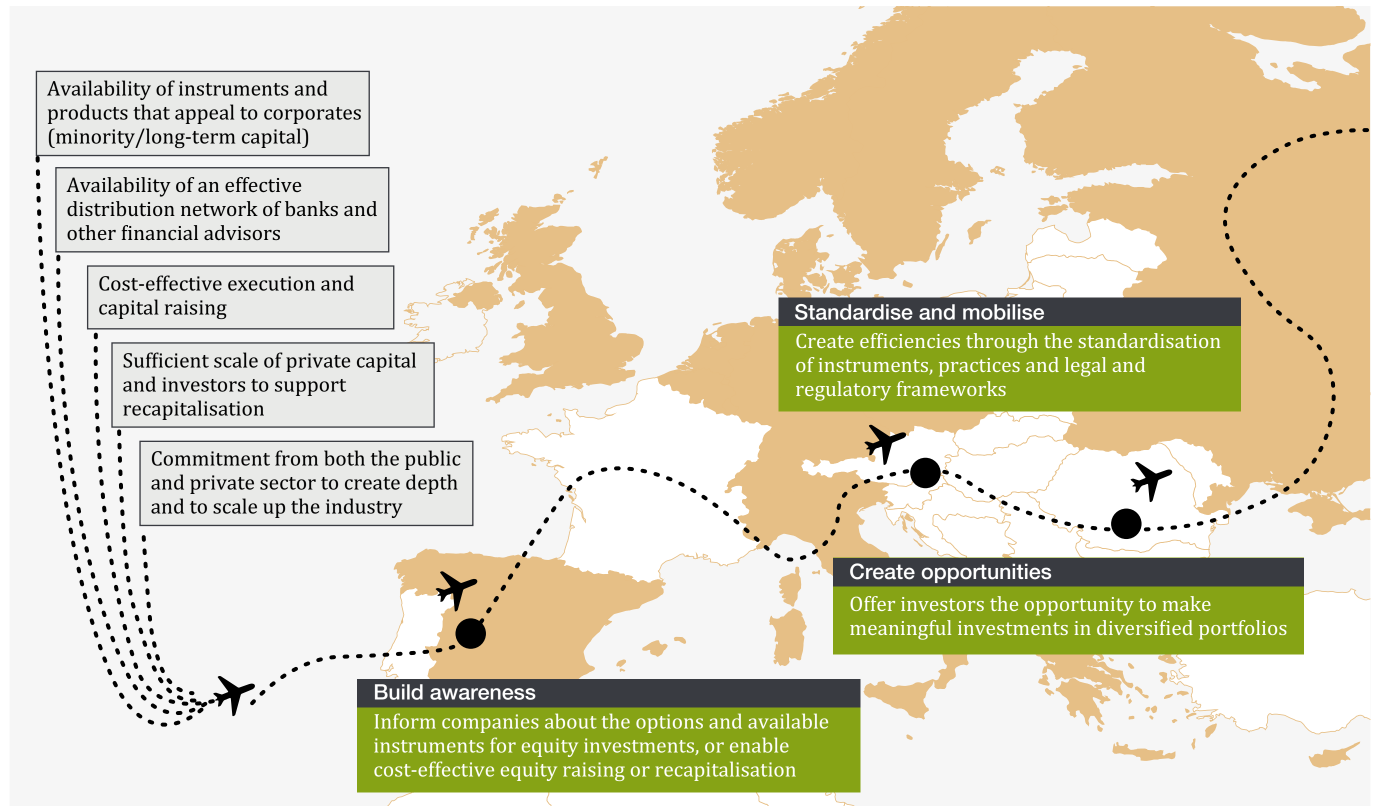
However, it is difficult to create the necessary scale and capacity without the following ingredients:

- The availability of instruments and products that appeal to corporates such as profit participating shares and preference shares (minority / long-term capital);
- An effective distribution network, including financial advisors;
- Cost-effective execution and capital raising;
- Sufficient scale of private capital and investors to support recapitalisation; and
- Commitment from both the public and private sector to create depth and to scale up the industry.

72 More details provided in Box A.

73 High Level Forum on the Capital Markets Union, A new vision for Europe's capital markets, Final Report, June 2020.

Figure 3.9: **Vision for a large-scale equity and hybrid investing industry**



4. Solutions to support recapitalisation

Equity and hybrids are needed to supercharge growth and innovation

As this report sets out, there are a number of reasons why in the current environment, an equity-based solution is a much more appropriate instrument for recapitalisation than debt-based solutions. In addition, a larger share of equity in corporates' funding mix not only provides working capital to survive the crisis, but also strengthens corporate balance sheets in order to invest in growth and innovation. By alleviating the constraints of regular debt and interest payments, equity finance can accelerate growth by enabling companies to invest for the long-term.

Equity financing may not be of interest to all firms (for example, larger corporates that are not over-leveraged and require capital for short-term needs may prefer debt-based funding), but to ensure that it is available for those companies interested in rapid recovery and growth, the structural inefficiencies in the EU capital markets ecosystem and the prevailing debt culture amongst companies and investors should be addressed.

Interviewees said the European bias towards debt over equity not as a market failure but rather a missed opportunity, which impedes wealth creation

Principles for solutions to support equity recapitalisation

A recapitalisation scheme needs to be carefully designed to address the challenges set out in Section 3. We suggest that a recapitalisation scheme should have the following features:

The use of instruments that allow companies sufficient flexibility while appropriately remunerating investors

Discussions with interviewees suggest that there is a current spectrum of financial instruments available, which offer significant variety in terms of features and usage, as we set out in Table 3.1 and Figure 3.2. The flexibility and diversity of financial instruments to support recapitalisation can be a significant advantage in supporting the recovery after the crisis. For example, the EIB and EIF's European Guarantee Fund (EGF) draws on a range of schemes and instruments, depending on the nature of support required.

Box B: Private and public sector co-investment through the EIB and EIF's European Guarantee Fund

The EIB and EIF's announced a €25bn European Guarantee Fund as part of an overall package of measures agreed by the Eurogroup on 9 April 2020 and further endorsed by the European Council on 23 April 2020. The Fund focuses on small and medium-sized European companies, mobilising up to €200bn in additional financing to support companies that are considered viable in the long-term but are struggling in the current crisis. As of 13 October 2020, around €2.6bn EGF financing has been approved, with up to €11.3bn expected to be mobilised.[74]

The Fund has risk-sharing and first loss features and distributes support through five specific schemes to address the equity gap based on individual corporate needs. These include (i) straight equity or hybrid equity to companies below their critical mass to attract initial investment; (ii) hybrid debt and equity to substitute minority equity for companies where dilution of control is an issue; (iii) equity or equity-like funding to existing portfolios who are at the end of their investment period and require additional funding; (iv) funding for private credit funds at the smaller end of the market, including turnaround funds; and (v) a product to replace defaulting investors in funds

74 EIB, European Guarantee Fund: The protection shield for European businesses, information correct as at 13 October 2020.

The choice of instrument for recapitalisation needs to strike the right balance between providing companies with sufficient flexibility over coupon payments to reduce cash flow burdens and limiting the dilution or loss of control (given the concerns raised by business owners), while providing investors with an adequate return on their investment.

In this respect, hybrid capital instruments could play a greater role in recapitalisation, such as instruments with profit participating elements, subordinated debt or payment-in-kind (PIK) notes.[75] With the right structure, hybrid instruments offer advantages to issuers with the right profile and capital structure, namely non-dilutive, low-cost equity, with limited effects on firm leverage, unlike ordinary debt finance.

With the right structure, hybrid instruments offer advantages to issuers with the right profile and capital structure, namely non-dilutive, low-cost equity, with limited effects on firm leverage.

As an example, profit participating loans or bonds are loans that are characterised by interest payments being wholly or partially dependent on the debtor's profit or proceeds, but do not entail control rights. These instruments can be found in a number of Western European and Nordic countries (Genussschein in Germany, vinstandelbevis in Sweden), but they are not commonly issued in public markets. Examples of trading activity can be found on the Dusseldorf[76] and Vienna Boerses[77].

By making interest payments dependent on business performance, instruments with a profit participating element can reduce the financial burden of making fixed cash coupon payments to investors while the economic environment remains challenged, but allows investors to participate in the upside potential of the company when it returns to growth.

Profit participating instruments already exist in DE, AU, FR, DN, SW and CH

Hybrid issuance activity is significant, with combined issuance volume of 59% of listed equity issuance. Increasing the scale of use of hybrid instruments, which is currently less in comparison to ordinary debt and common equity, is critical in creating broader, more liquid markets to drive down the costs of issuance, which, in turn, will further attract private sector supply and investor interest.

Learning from the creation of Additional Tier 1 (AT1) capital for banks

Following the global financial crisis, banking regulators sought to strengthen banks' balance sheets with an emphasis on common equity, but also other forms of loss-bearing capital which could be utilised in a crisis event. Additional Tier 1 capital has been created to absorb losses prior to, or at the point of insolvency. It consists of preference shares or highly contingent convertible securities that typically have no fixed maturity, nor any incentive for the issuer to redeem them. They rank above equity, but below other tiers of bank capital. By paying a regular coupon they offer investors a higher return than senior debt but allow interest payments to be tax deductible. They have been popular with investors and yields have gradually reduced as investors have become accustomed to the risk profile. Even during the COVID-19 crisis issuance has been strong. Over €33bn of new AT1 were issued by European banks through November 2020, which is similar to 2019 volume. While the triggers for conversion of these instruments are typically a breach in a regulatory bank capital measure (and therefore have no direct comparison to corporates), this demonstrates that specific hybrid instruments can be created which meet the combined requirements of issuers' shareholder governance, investor, accounting, tax and credit rating agency considerations. The European Banking Authority has established a template for issuance of AT1 which is facilitating the standardisation of the instrument across Europe.[78]

75 See appendix for a summary of the financial instruments available on the equity to debt spectrum.

76 https://www.boerse-duesseldorf.de/genussscheine

77 https://www.wienerborse.at/en/search/documents/?q=genussschein

78 Please see link to EBA template at https://eba.europa.eu/sites/default/documents/files/documents/10180/1360107/181c7ffe-f816-4bf1-a64b-3394a8c1fba5/Final%20AT1%20standard%20templates%20.pdf?

This solution does have its limitations. Investors may prefer more oversight and control over companies that have historically had less exposure to public markets and external scrutiny, which is not always possible depending on the type and structure of the instrument.

Another avenue is dual class shares, through which companies can issue equity in different share classes with a variable dilution of control.[79] These shares have been particularly prominent in the US, comprising about 35% of tech IPOs and 10% of non-tech IPOs in 2018.[80] While these instruments haven't been as prominent in Europe due to the commonly used one-share-one-vote basis, greater flexibility with regard to voting rights could be an alternative approach to raise much needed equity, without significantly diluting control, particularly for smaller and family-owned companies.

Corporates may also consider a debt-for-equity swap, in which a company can buy back bonds in exchange for equity at typically advantageous trade ratios (e.g. 1:2 bond value to stock value). These transactions are typically carried out in situations of excess leverage, where debt providers' capital repayment is at risk and where finance providers end up with a share of a smaller, but sustainable company.

Scalability

As set out in Section 3, the need for recapitalisation is likely to be most acute for smaller, unlisted companies such as mid-caps and SMEs, as well as businesses in structurally challenged sectors. These companies are likely to have smaller cash buffers and are less able to access capital from public markets compared to larger, listed corporates.

For the very smallest companies (e.g. micro companies), a capital markets-driven solution may not be feasible nor appropriate - there are a large number of businesses in this segment (of the 25m active enterprises in the EU, 93% of meet the definition of a micro SME[81]), with small ticket sizes and less complex financing needs - in which case policymakers could continue providing guaranteed bank loans or consider providing direct grants for training or to enable investments to help these businesses adapt, rather than providing equity investment. A new framework for synthetic securitisation, as agreed in the Capital Markets Recovery Package, could be particularly helpful to securitisation of large/midcap corporate, consumer and SME loans. A well-designed framework could provide opportunities for banks to manage their credit risk and capital requirements to support lending to these businesses.

For larger companies that are not served directly by capital markets or want an alternative to debt financing, a more sustainable solution is needed. The size and diversity of this segment (there are 1.7m small and medium-sized enterprises which employ nearly 70m people in the EU[82]) as well as the fact that many of them could face difficulty concurrently, suggests that a scalable solution, which can be replicated quickly across different sectors and contexts, is needed.

Issuing individual SME securities is not cost effective. However, the pooling of SME securities under schemes that are widely marketed to potential investors can also give non-listed corporates the accessibility required to raise external capital that they otherwise would not have had individually.

79 For example, Class A shares may have more voting rights than Class B shares.

80 Ritter, J.R. (2019), Initial Public Offerings: Dual Class IPOs.

81 Defined as an enterprise with fewer than 10 employees, based on latest available data for 2017.

82 Defined as enterprises with between 10 and 249 employees. SME share based on latest available data for 2017, number of people in employment based on 2019 data.

Simplicity, consistency, clarity and standardisation

As discussed in Section 3, the lack of understanding of and differences in accounting and tax treatments of hybrid instruments in particular hinder comparability and cross-country investing.

The design of the recapitalisation solution needs to be simple, transparent and easily understood to broaden its appeal to corporates and support scalability. This could be facilitated by the use of clear and transparent eligibility criteria, as well as terms and instruments that are simple and straightforward by design and construction. Greater consistency over the treatment of recapitalisation instruments in taxation, accounting (both under IFRS as well as local GAAP) and insolvency regulations under EU or member state laws would also increase the level of investor and corporate interest, and thereby generate higher volumes.

It is also important to ensure that Member States comply with the transposition deadline of the Directive 2019/1023 on preventive restructuring frameworks by mid-2021, as this Directive will grant flexibility in the restructuring processes.

In certain cases, countries have established legal eligibility criteria for financial instruments. This, in effect, standardises the instrument. The benefits include improved pricing comparability, enabling the use of central clearing and electronic trading, better information sharing through standardised data collection, as well as introducing additional certainty and consistency of enforcement measures should insolvency situations arise. In Box B we provide an example of how Member States can tap into existing instruments with similar standardised structures to scale up its use in domestic markets.

Box C: Austria's participation in standardised Schuldschein debt market

Schuldschein is a type of private placement and is a feature of the German and Austrian corporate debt market known for its standardised elements, including:

- a lean document structure of 20 pages or less
- limited negotiation bilateral loan agreement by German Civil Code
- no mark-to-market valuation required
- a fee structure of about 0.1-0.7% of the issuance volume
- no requirement of issuer credit rating
- medium to long-term tenure of 2-7 years
- low minimum issuance volume of €20-25m

Schuldschein share both debt- and equity-characteristics but are less expensive than bond issues and do not need to be listed or registered at a stock exchange, with simpler documentation requirements.

While German issuers account for the majority of the Schuldschein market, the market's potential has been realised in smaller EU member states, namely Austria. The country has on average held 10% of the Schuldschein market over the past decade. Issuance volumes have been down in H1 2020 due to COVID-19, but the country has still maintained about 3% of the market.

Austria's success in replicating the Schuldschein market suggests that smaller EU member states can tap into hybrid markets with similar standardised structures to scale up the use of specialised instruments within domestic markets.

83 Erste Group, Corporate Schuldscheindarlehen - Market overview and analysis for the first half of 2020, July 2020.

Recapitalisation should be private sector-led, with governments playing a catalytic role

Our interview findings suggest that recapitalisation schemes should be private sector-led, with governments playing a "catalytic" or complementary role to private investors. The role of the private sector should be to:

- Design the appropriate instruments that will garner broad market appeal.
- Leverage the expertise of private investors in decisions on the allocation of recapitalisation funds and use the direct interest of investors as a mechanism to properly assess the viability of smaller companies going forward.
- Harness the collective capacity and expertise of the investor and banking community and leverage existing origination and distribution networks. Proximity to markets is critical, meaning that such schemes, even if they are conceived at the national, regional or European level, must be executed locally, with the support of local distribution networks to ensure the greatest reach.

Many interviewees feel that the private sector provides valuable specialist knowledge on viable firms which is crucial to avoiding moral hazard risks of public support.

Specifically, the role of policymakers at the Member State level should be to:

- **Create scale** by coordinating design and establishing mechanisms to bring together the fragmented landscape of corporates and investors together. EU-level policymaking can also help set the overarching principles to guide mechanisms established at the Member State level.
- **Augment and complement private sector investment capacity**, for example through public and private co-investment funds. This could be supported by matched funding from the public sector to amplify the impact of private investment in recapitalisation.
- **Provide incentives to encourage participation and incentivise the right behaviours.** For example, matched funding mechanisms alone may not be enough to induce private investment if investors' threshold for business viability are not met or if the risk-return profiles are not sufficiently attractive, particularly in the higher-risk context of recapitalisations. This may require other incentives such as funding first-loss tranches. These schemes need to be designed with the right incentives to avoid perverse behaviours. For example, income-contingent schemes may be vulnerable to gaming if corporates artificially reduce profits to minimise payments to investors.
- **Limited public sector involvement in management.** There is a risk of the public sector over-reaching into the ownership and controls of EU corporates following COVID-19, which could have adverse effects on productivity and growth. Key company strategic and management decisions should be left to individual businesses and where appropriate, investors.

By empowering the private sector to make capital allocation decisions, the risks of 'moral hazard' typically associated with direct public sector recapitalisations, as well as the risk of crowding out and displacing private capital, are reduced.

Only targeted and conditional support by the public sector is needed

There are a number of risks associated with government involvement in recapitalisation, especially one that involves the use of a first-loss instrument.

Firstly, the risk with broad ranging support is that it could merely delay the inevitable for some corporates that are unlikely to return to profitability beyond the crisis. As with lending to vulnerable companies, there is also the risk that the misallocation of capital towards businesses that were already struggling before the crisis instead of firms with healthier fundamentals could exacerbate the problem. In such cases, companies should be restructured, sold off and ultimately if there is no viable future, allowed to fail.

Secondly, "cheap" equity / recapitalisation could introduce moral hazard risks. This was part of the rationale for why the €26bn Solvency Support Instrument (SSI) proposed by the European Commission to provide solvency support to European businesses was ultimately rejected by the European Council, due to concerns that sizeable transfers could be made to support failing companies with unclear conditions, and the linked budgetary concern about the need to increase the size of the EFSI guarantee fund.

One approach to address this risk is by introducing more stringent conditions around the usage of additional capital to restructure and recapitalise for growth and innovation, and to require companies benefiting from equity injections to provide detailed plans for how they will return to viability. This could possibly include ESG criteria.

Our roadmap to support equity recapitalisations in the EU

Based on these principles, we set out a potential roadmap that can help accelerate and scale up recapitalisation in the EU.

1. Develop a common recapitalisation instrument

The EU private sector could drive the design of a common instrument to support equity recapitalisation. This instrument could be rolled out across various member states' schemes with similar structures and incentive mechanisms, as well as standardised tax and accounting treatment to increase certainty and consistency to issuers and investors, to maximise pan-European participation.

In Box C, we set out the features that a potential 'COVID-19 preference security' could take. These instruments could also be designed with additional eligibility criteria or conditions, for example ESG eligibility to support Europe's transition to become a more sustainable economy and should be limited to viable businesses and not vulnerable companies.

Interviewees suggest that such an instrument could have broad appeal amongst institutional investors, such as pension funds and insurers, that are seeking debt-type risk profiles but with better returns, provided that they are able to properly assess the risk that they are taking on board. This can be a particular challenge for unrated issues, as is likely to be the case for a scheme that is targeted at corporates with limited capital markets exposure. This is where intermediaries have a role to play in providing those assessments and to perform these at scale, reinforced by public support to boost the sector's capacity.

Box D: Proposed instrument - COVID-19 preference shares or equity-like instrument

A COVID-19 instrument could be based on a preference share or equity-like instrument structure to strike a balance between delivering returns to investors while allowing corporates to preserve control. This could be designed with the following features:

- Low fixed basis preferred dividend to provide investors with some cash flow certainty.
- The preferred dividend could be combined with an increasing profit-sharing element (based on a step-up scheme) that would allow investors to benefit from an upside and provide corporates with an incentive to redeem these shares later on (and providing investors with an exit mechanism).
- Like a typical preference share, this instrument would not entail voting rights to address companies' reluctance to cede control at least in the short term.
- To sharpen the incentives for companies to take appropriate action to restore profitability as quickly as possible, this could after a certain time period be convertible into equity, or to provide investors with some say over the running of the company if investing for the long-term.
- To incentivise investors, the investment could be made tax deductible or be exempt from capital gains taxes in the first 5 years.
- Ideally this instrument could be developed to comply with social investment objectives to attract maximum investor interest.
- A small denomination of €25 could assist in distribution to a wide investor base.

With scale, these instruments can develop into a well-defined asset class, which will further encourage issuance and investment.

2. Scale up existing recapitalisation schemes at the EU- or member state level and expand usage of existing hybrid instruments that are already available in certain EU member states

A number of recapitalisation programmes and schemes have been introduced that leverage a matched funding approach between public and private sector investment, including for example:

- In Italy, the Italian state investment bank (Cassa Depositi e Prestiti) has a scheme to provide state funding matching any capital injection by private investors for businesses with a turnover between €10m and €50m, subject to a dividend ban.
- In Germany, a financing scheme for start-ups was introduced, enabling venture capital funds to receive additional public funding through the 'Corona Matching Facility' which is backed by the European Investment Fund and KfW.
- The EIB and EIF's €25bn EGF deploys a number of equity, debt funds and guarantees in cooperation with investors and financial intermediaries to support the recovery of SMEs and mid-caps.

In addition to these schemes, at the EU level, the third amendment to the State Aid Temporary Framework adopted on 29 June 2020 expanded the scope of the framework to support small enterprises, and also includes incentives for private investor participation in recapitalisation - if a private investor contributes at least 30% of new equity (on a pari passu basis as the State), some of the recapitalisation conditions (such as the dividend ban, management remuneration caps etc.) are relaxed.[84]

There are also examples of private sector participants stepping into the gap by introducing their own recapitalisation funds to support businesses. For example, Axa's private equity fund, CAPZA, has introduced a €500m recapitalisation fund to support the recovery of French SMEs.

Box E: Private sector mobilisation through AXA's CAPZA fund

French insurance firm AXA started CAPZA, a private equity fund in 2004. In light of COVID-19, CAPZA has set up a €500m recapitalisation fund to aid SMEs over a two-year period through equities investments and private debt. Its vanilla fixed-income product with loans allows for small businesses to retain ownership while investors receive an upside on the performance of the company, in a similar way to profit participation shares or loans. The fund is available to firms in all sectors of activity but aims to focus on companies with growth opportunities. Despite its relatively small scale, CAPZA is an example of how private sector funds can be quickly mobilised to support businesses.

The challenge with individual schemes is that these lack the necessary capacity to address the recapitalisation challenge across the EU. For example, while the EGF's €25bn fund can leverage up to €200bn of additional private sector investment, its size is unlikely to be sufficient to address the entirety of corporate recapitalisation needs. This suggests there are opportunities to scale up schemes like the EGF and to broaden the eligibility criteria used to enable more firms to be supported, or to draw on the distribution capacity of the private sector to increase reach. The €26bn InvestEU fund, which aims to mobilise €400bn in additional private and public investment between 2021 and 2027. This fund could be scaled up in a similar way to leverage additional private investment to close the recapitalisation gap.

Alternatively, equivalent funds at the member state level could be established, replicating the approach taken in countries like Italy and Germany. These could be suitably tailored to member state needs, namely the availability and capacity of private sector fund partners, targeted sectoral support, or mechanism and instrument design that is appropriate in the context of local tax, accounting and insolvency regulations.

In addition, many EU member states already have developed issuance frameworks for hybrid instruments, which are not well known outside of their home countries. Germany's profit participation shares "Genussschein" described in Box A and Austria's adoption of the German "Schuldschein" described in Box B (which are not hybrids, but are standardised) are some examples, but others also exist in Austria, France, Denmark and Sweden. These can be copied and improved to expand investor capacity, including possible at an EU level.

84 Debevoise & Plimpton, COVID-19 - Review of State-Sponsored Help for European Companies, August 2020.

3. Develop close public and private sector collaboration through industry and policymaking working groups

A critical success factor is the joint participation of the public and private sectors to design recapitalisation schemes that meets policy objectives, and address market gaps and failures. Schemes must also be executable, with operationalisation through 'national equity recapitalisation forums' or other structures.

The membership of these forums should be composed of corporates, investors, asset managers and other intermediaries (banks, market infrastructure providers), in addition to policymakers, with the purpose of designing the scheme, the appropriate instruments and terms of participation.

The private sector plays an important role in the execution of these schemes. Asset managers, investment firms and intermediaries are critical in assessing the viability of candidates for recapitalisation. Banks, through their advisory teams, can provide input to corporates on various alternatives, as can also independent corporate finance consulting firms. Banks in their role as intermediaries can also assist in distribution.

The sheer volume of companies that will require support, their non-standard approach to record keeping, reporting and forecasting and their lack of financial sophistication, makes viability assessments especially challenging. A scalable and 'user-friendly' solution requires an automated and straightforward solution, which could be based on a common financial reporting template that is independently verified to qualify for support to limit the element of judgement - and cost - involved. In addition, the public and private sector must work together to publicise these schemes to corporates that require support and educate them about the range of options available.

It is desirable that the public sector commits to developing the necessary capacity and capability within the private sector for the longer-term provision of finance. For example, the cost of running the UK Business Growth Fund (BGF) which targets smaller minority equity stakes is around 2.8% of total assets under management every year, more than double a normal equity fund. The public sector could help create scale and capacity by subsidising the cost of establishing investment operations, which could be considerable relative to the volume of transactions. Alternatively, EU central funds could be used to provide technical assistance to support the development of funds in economies with under-developed capital markets. This would allow funding to flow into regions that need it, not just those with existing distribution and technical capabilities, and to avoid reinforcing regional disparities in access to finance across EU member states.

4. Coordinate the development of a public-private investment fund across the EU to support recapitalisation and avoid fragmentation

Our discussions with interviewees suggest that public and private co-investment schemes could be one way to address the need for recapitalisation, which could be based on a matched funding approach by the public sector to mobilise private capital. This could also be designed with the public sector funding a first-loss tranche, which can help catalyse more risk-averse sources of capital and improve investability for the private sector. Alternatively, schemes where both the private and public sector invests on an equal ('pari passu') basis could be established, but with private investors gaining a bigger share of the upside (asymmetric returns) to incentivise participation. Such mechanisms (or pricing support) might ease investors' concerns over the uncertainty of the outlook and compensate them for additional risks around the pricing and valuations of recapitalisation investments.

The design of the scheme needs to be coordinated across the EU. While initiatives at the member state level may be more expedient to implement than pan-European schemes, introducing a patchwork of schemes with different eligibility criteria and sector coverage as well as various mechanisms and instruments increases the risk of fragmentation. This could undermine scale and the effective pooling of issuer and investor demand, hinder the creation of deep capital pools and limit cost and diversification benefits and, in the long-term, further complicate efforts to integrate European capital markets.

Therefore, one of the key outputs of these forums is to develop a common scheme in a coordinated way that can be replicated across the EU. Here, the private sector (investors and intermediaries) plays an important role by coming together and leveraging their European networks to develop the overarching principles underpinning the design of the scheme and to facilitate knowledge transfers across the region to enable greater alignment and standardisation, supported by local execution and tailored to local operational and regulatory requirements.

5. Provide tax and regulatory incentives to attract participation

The incentives for investors to provide recapitalisation capital could be sharpened by introducing allowances for equity investments to align the tax treatment of equity to debt financing, or by instituting temporary changes to the capital gains tax regime, for example by providing time-limited capital gains tax exemptions to enable qualifying long-term investments to be rolled over. This could be targeted towards recapitalisations, or to address specific sector needs or strategic needs, e.g. where rebuilding capital is required to support a green recovery.

The enterprise investment scheme (EIS) and venture capital trust (VCT) in the UK are examples of schemes to encourage investment in unlisted companies or companies listed in the Alternative Investment Market (AIM) in London, an SME growth market. Both the EIS and VCT schemes are designed to encourage savers to invest in unlisted or AIM-listed companies with the increased risks being compensated for by tax breaks. Both schemes offer tax reliefs if there are losses on the investment. Investments must be held for a certain number of years.

The availability of specific tax incentives to investors as well as issuers appears to have had a strong positive effect in the growth of the AIM market. In order to foster greater investment in other European SME growth markets, investors could be encouraged by similar or new schemes to incentivise investment whilst providing relief if a company fails.

Policymakers could also consider a temporary adjustment to regulatory capital and solvency requirements for insurers to reduce the capital charges associated with equity investments, although these need to be carefully calibrated to avoid introducing unintended consequences that could negatively impact financial stability. As noted in the CMU Action Plan of September 2020, the review of Solvency II should assess the appropriateness of the eligibility criteria for the long-term equity asset class, the risk margin calculation, and the valuation of insurers' liabilities, with the aim of both avoiding undue pro-cyclical behaviours and better reflecting the long-term nature of the insurance business.

6. Lower the cost of equity issuance for corporates

As noted in Section 3, the cost of raising equity can be prohibitive for smaller corporates. This cost could be reduced through efficiencies and regulatory simplification in the capital raising process. For example, EU legislators recently agreed an EU Recovery Prospectus which will be available for capital increases of up to 150% of outstanding capital within a period of 12 months. Beyond this measure, the Commission should prioritise the action as part of the CMU work programme to review whether the listing rules for public markets (both SME growth markets and regulated markets) could be further simplified in order to promote and diversify small and innovative companies' access to funding.

In the UK, the Pre-Emption Group issued a recommendation to temporarily relax the guidelines relating to pre-emption in issuances by companies of up to 20% of their issued share capital, rather than the existing "5% + 5%" threshold, to enable companies to move quickly to raise additional capital.[85] Similar action could be taken in the EU to ease capital raising, although this benefit is limited to companies that already enjoy access to public markets.

A grant or subsidy scheme, for which the government could be compensated with equity, could be a more direct way of reducing issuance costs for corporates, to reduce the up-front cash burden (or 'sticker-shock') to companies raising equity.

85 Pre-Emption Group, Pre-Emption Group expectations for issuances in the current circumstances, 1 April 2020.

7. Optimise the application of state aid rules and tie EU Recovery and Resilience Facility funding to equity recapitalisation schemes

While there is general agreement that there is a role for state aid in supporting businesses through the impacts of COVID-19 and that the Temporary Framework was welcomed by business representative groups, a number of interviewees noted that its design and application may be sub-optimal in fully addressing the recapitalisation and recovery needs of the economy.

These challenges include an overly restrictive definition of enterprises eligible for state aid (for example pre-COVID profitability requirements), and the requirements for early redemption of equity and debt support which constrains the use of patient capital for rebuilding over the longer-term. Broadening eligibility criteria or extending repayment periods would ensure that state aid support can be used to rebuild for the future, rather than constraining corporates with early repayment which could hamper investment.

State aid should also be targeted to support restructuring and recovery, rather than delay the inevitable for companies that would have failed regardless of support.

Current state aid rules could introduce competitive advantages, as countries with better fiscal positions are better able to provide support to businesses, while countries that are more vulnerable to the effects of the crisis are also those in weaker fiscal positions. This could lead to long-lasting impacts on the competitive dynamics between member states and exacerbate existing regional divisions in economic performance.

Box F: Checklist for RRF eligibility

Member states can submit recovery and resilience plans to apply for RRF funding, which would be reviewed by the Commission to consider whether the investments and reforms contribute to addressing country-specific challenges and the green and digital transitions, as well as strengthening the growth potential and resilience of the EU economy.

In addition, we propose that the Commission considers these plans for the inclusion of recapitalisation schemes, and specifically:

- whether the scheme includes a range of debt, equity and hybrid instruments to support recapitalisation for corporates that need it;
- whether the scheme involves private sector participants to design and test instruments and incentives that work for the market (terms, structure, tax/accounting treatment etc.); and
- whether there is sufficient investment into the operational and distribution capacity to disseminate capital and execute deals, and if not, how this will be addressed by the RRF or other sources of funding, particularly in countries with less deep capital markets.

The EU could also use the €672.5bn Recovery and Resilience Facility as a means to ensure that member states address the structural challenges of recapitalisation. Eligibility for funding could be conditional on meeting certain criteria (see Box E for some examples).

8. Accelerate the development of the CMU, the Banking Union and other pan-European projects

As the crisis has sharpened the focus of policymakers on supporting SMEs and the real economy, it has also revealed the need to accelerate the Capital Markets Union (CMU) project. Many of the financing challenges highlighted in this study, particularly those faced by SMEs, are not new.

The importance of capital markets in addressing the financing gap in these turbulent times is recognised by the European Commission. In December 2020, EU authorities reached agreement on a Capital Markets Recovery Package to enable businesses to access capital markets more efficiently to recover from the crisis. The package includes targeted changes to existing regulations, notably (1) amendments to MiFID II / MiFIR to streamline disclosure and information requirements for professional investors, to simplify requirements to enable the prompt execution of investment decisions, and to seek to increase investment research coverage of small- and medium-sized companies; (2) an extension of the framework for simple, transparent and standardised securitisation to synthetic securitisations and changes to the framework for the securitisation of non-performing loans, to increase banks' lending capacity to the real economy; and (3) the establishment of a new EU Recovery Prospectus – a shorter prospectus – to make it easier for companies to issue capital.[86]

However, beyond this targeted package, concerted policy action is needed to address other structural challenges and impediments to integrating European capital markets to support growth and the EU's green agenda. In September 2020, the Commission published a new Action Plan for the CMU with a number of key recommendations.

The following near-term deliverables in the CMU Action Plan should be prioritised for delivery in the next 12-18 months:

- Improving incentives for investors to support investment vehicles that channel financing to long-term investment projects, through a review of the ELTIF framework and Solvency II, as well as providing for an appropriate prudential treatment of long-term SME equity investment by banks. Equity investments by banks should not be over-penalised. The current very broad definition of venture capital should be aligned with the 2019 EBA guidelines, and all well-diversified equity portfolios should be defined for the purpose of CRR and attract a risk weight below 250%. These changes should be introduced at the earliest opportunity.

- As mentioned above, considering simplification of the listing rules for public markets in order to promote and diversify small and innovative companies' access to funding.

- Adjusting the regulatory treatment of securitisation to restore a well-functioning market in the EU.

- Work should be accelerated on the following medium/longer-term CMU deliverables:

- Improving securities market structure so that there are cost-effective channels for the issuance, distribution and trading of securities for the benefit of investors and corporate issuers. This means reviewing requirements in MiFID II / MiFIR framework to promote competitive capital markets that deliver good outcomes at low cost.

86 Council of the EU press release, Capital Markets Recovery Package: Council confirms targeted amendments to EU capital market rules, December 2020.

- Addressing impediments and frictions to intra-EU business arising from withholding tax collection procedures, insolvency regimes and other areas to facilitate cross-border investing and enable corporates to access a broader pool of investors. Insolvency regimes can differ significantly in time, complexity and administrative requirements, which can be a hindrance to pan-European investing.[87] A previous study by AFME highlights the potential economic benefits of reforming and converging insolvency frameworks across the EU, including encouraging greater access to finance, entrepreneurship, and a more integrated environment for cross-border trade and investment.[88]

- Improving the harmonisation and standardisation of shareholders' rights across the EU to facilitate cross-border / pan-European investment.

- Encouraging retail investor participation in capital markets, through reforms to national pension regimes and the promotion of best practices in member states.

Other European horizontal projects, complementary to the CMU, should also be pursued with ambition as they will support the economic recovery and sustainable growth objectives. This includes:

- Accelerating the Banking Union to address fragmentation in the banking sector along national lines, to improve banks' risk-sharing capacity and improve the allocation of bank resources. This could be enabled by allowing cross-border banks to manage their capital and liquidity at a consolidated level and to achieve diversification and economies of scale.

- Building the Digital Single Market to maximise the opportunities provided by new technologies to encourage cross-border capital flows, such as blockchain and crypto assets, while safeguarding consumer protection and market integrity.

- Aligning the recovery strategy with the EU Green Deal objectives. The transition to a more sustainable economy will require significant investment efforts across all sectors and will be an important lever in supporting economic growth and innovation in the coming years. The COVID-19 crisis could also provide momentum to further develop the social aspects in the ESG agenda, including better defining the parameters of an investment directed towards specific societal needs. This could mean, for example, investments of which the proceeds are directed to sectors with positive social externalities such as healthcare or education.

87 Insolvency procedures can take from around two years in some countries and up to eight in others (notably Italy).

88 Frontier Economics and Weil, Potential economic gains from reforming insolvency law in Europe, report for AFME, February 2016.

Annex A: EU member state backed credit support programmes

Country	Responsible body	Facilities	Date announced	Headline envelope (€bn)	Commitments as of 15 Nov 2020 or latest (€bn)
France	Ministry of Economy and Finance, via BPIfrance	70-90% guarantees	25th March	300	124.4
Germany	KfW	80-100% guarantees (including financing); syndicated loans	23rd March; coverage increased to 100% on 15th April	356 (increase in KfW's Treasury guarantee)	44.6[89]
Germany	BMWi, via the Economic Stability Fund (WSF)	Up to 90% guarantees	23rd March, approved by the European Commission on 8th July	400	6.5
Germany	BMWi, via regional guarantee banks (Bürgschaftsbanken)	Up to 90% guarantees	23rd March	Unclear	1.3
Germany	BMWi, large regional guarantees (Großbürgschaften)	Up to 90% guarantees	23rd March	Unclear	2.7
Italy	Central fund for SME guarantees (Fondo Central di Garanzia)	80-100% loan guarantees; 33% guarantees on payment obligations under SME loan moratorium (ii)	17th March	100	101.2[90]
Italy	SACE export credit agency (part of CDP)	70-90% guarantees	8th April	200	16.6
Spain	ICO	60-80% guarantees on loans; 70% on promissory notes	24th March; extended to promissory on 5th May; envelope increased on 3rd July	183	108[91]

Source: Bruegel, 'Loan guarantees and other national credit-support programmes in the wake of COVID-19', 25 November 2020.
Note: In all cases, the envelope amount refers to the maximum nominal amount of credit committed.

89 The €100bn allocated to support KfW in case it fails to raise funds on capital markets, is not included because it has not been activated. German regions (Länder) also offer own-funded guarantee programmes. Bruegel estimates that, taken together, German regional credit support via regional development banks (Landesförderinstitute) amounts to a maximum of €5bn.

90 The announced €100bn envelope for the Fondo Centrale di Garanzia PMI includes provisions for the SME loan moratorium guarantee programme. However, commitment figures do not include this programme. Commitments by the Fondo Centrale di Garanzia PMI are capped by its endowment. As of 17 March, the Fondo was set to guarantee up to €100 billion in loans. However, its endowment has since been increased though no announcements have been made about changes in the envelope. Value of loans that have passed the Fondo Centrale di Garanzia PMI automated screening (Portale del Fondo di Garanzia). These loans are subject to final approval by the Fondo's council, which typically occurs within three days. 100% of loans have been approved by the council at this stage.

91 For Spain, the announced €100bn + €40bn envelopes relates to the value of share of facilities under guarantee. For comparability, this figure is converted using the historical average of 76% guarantee coverage. Amounts include the €4bn allocated to the promissory note guarantee programme on Spain's Mercado Alternativo de Renta Fija (MARF) and the €0.5bn allocated to the counter-guarantee programme operated by CERSA. €140bn announced in two stages: €100bn on 24 March 2020 and €40bn on 3 July 2020. The second package is aimed at funding new investment projects. There is no data on commitments for the second package as of 23 September 2020. Includes the MARF and CERSA programmes (aggregated reporting by the ICO).

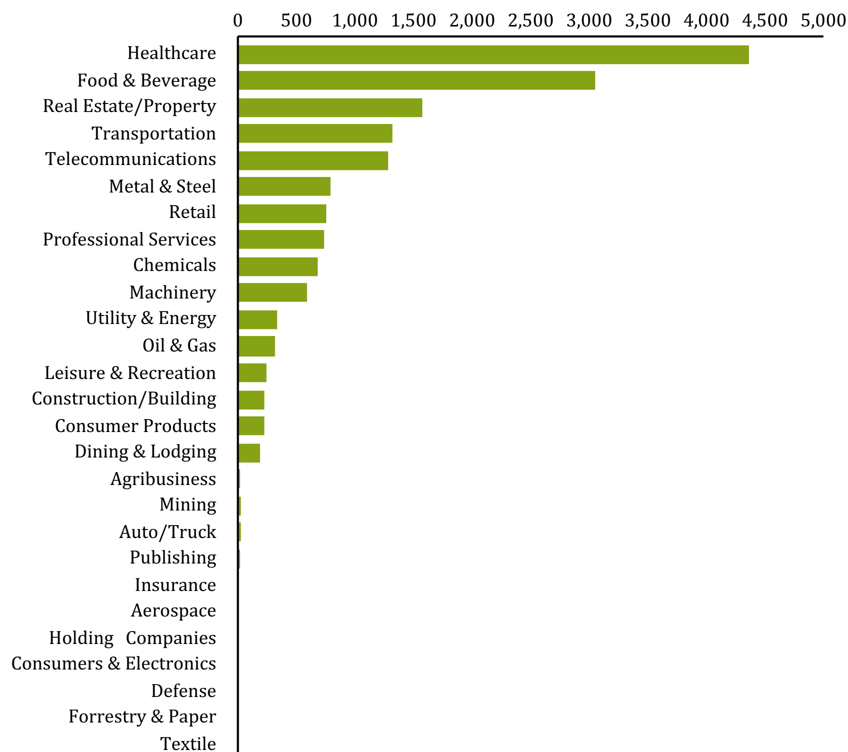
Annex B: Review of capital markets financial instruments

Table B.1: **Common equity**

Summary
• Security representing ownership in a corporation • Scrip dividends allows a company to pay investors in shares rather than cash • Available for both growth and value stocks, depending on investor's strategy

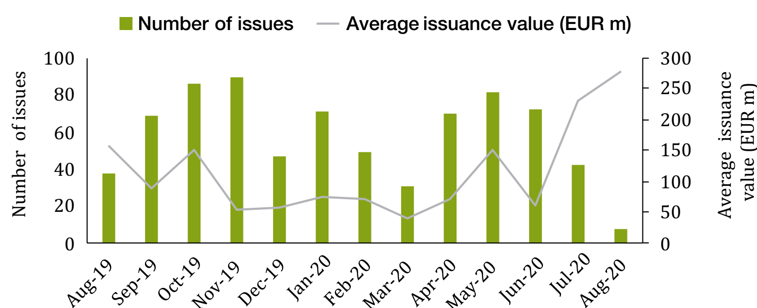
	Advantages	Disadvantages
Investors	• Voting rights and property rights • High potential for capital gains and dividends • Limited potential for capital losses and high market liquidity • Limited liability • Transactional simplicity • Pre-emptive rights • Ideal for long-term investment strategies • Gross IRR target of 20-30%	• Dividend is discretionary and non-cumulative (particularly for growth stocks) • While most common stock comes with voting rights, some companies will have non-voting common shares (e.g. Google) • In event of bankruptcy, no claim on a company's assets
Issuers	• No debt obligations • Option to consolidate ownership / increase value through repurchasing shares • Classified as equity under IFRS and ratings agencies	• Forfeit some ownership stake • Issuance begins with IPO, which is a laborious process (e.g. size thresholds for a good valuation, information disclosure, a company must work with an underwriting investment banking firm)

Figure B.1: **Common equity 2020 issuance values by sector in (EU27 NFCs, €m)**



Source: PwC analysis of Dealogic data

Figure B.2: **Common equity 2020 issuance values by sector in (EU27 NFCs, €m)**

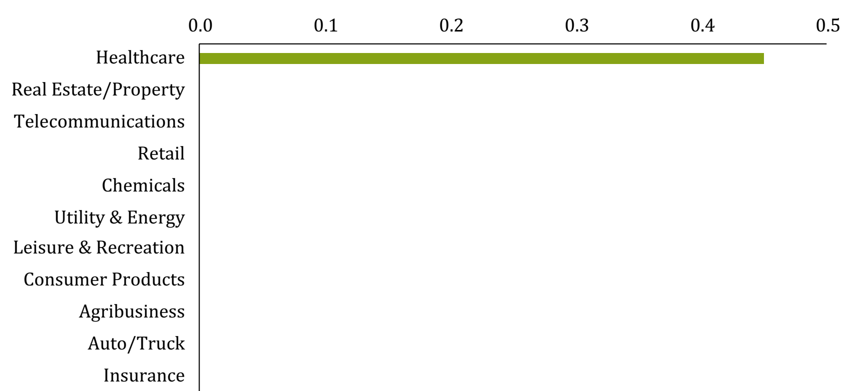


Source: PwC analysis of Dealogic data

Table B.2: **Preferred equity**

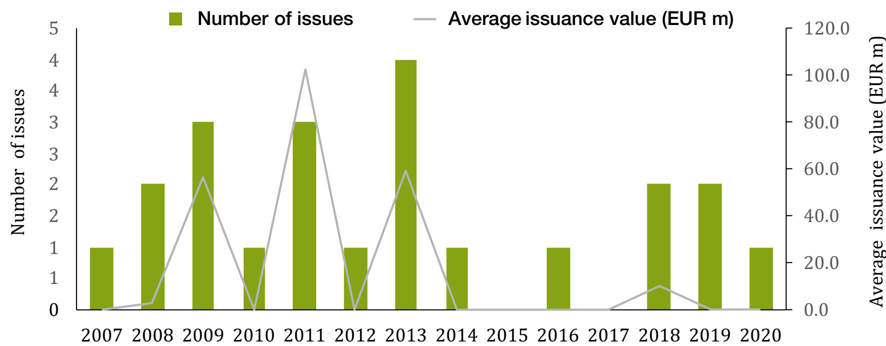
Summary		
• Security combining features of debt (pays discretionary dividends) and equity (potential to appreciate in price) • Limited rights, which do not include voting • Priority over common stockholders when it comes to dividends, which generally yield more than common stock		
	Advantages	**Disadvantages**
Investors	• Collect discretionary dividend payments before common shareholders • Convertible shares allow investors to trade preference shares for a fixed number of common shares (providing additional dividends above the fixed rate if the company meets certain predetermined profit targets) • Attractive for conservative investors who enjoy the comfort of downside risk protection baked into these investments	• No voting rights • Opportunity cost with fixed dividends if interest rates rise • Callable preference shares allow issuers the right to repurchase shares at their discretion • In event of liquidation, junior claim on assets (or no claim dependent on terms)
Issuers	• Callable preference shares afford issuers the right to repurchase shares at their discretion, which can bring down the cost of capital • IFRS classification as equity (in part or full) • Ratings agencies generally treat preferred equity as hybrids, offering 50% debt/50% equity, until shares become too big a part of their capital structure, at which point greater equity credit is given	• Higher issuing costs than debt • Cumulative preference shares allow for the accumulation of unpaid dividends which must be paid later

Figure B.3: **Preferred equity 2020 issuance value by sector (EU27 NFCs, €m)**



Source: PwC analysis of Dealogic data

Figure B.4: **Preferred equity issuance trends (EU27 NFCs)**



Source: PwC analysis of Dealogic data

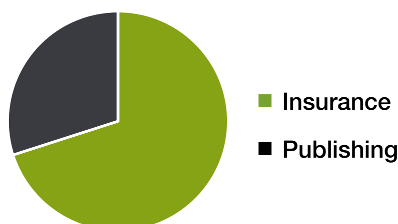
Table B.3: **Profit participating shares**

Summary		
• Equity paper which grants the holder the right to participate in the net profit and the liquidation proceeds and the right to subscribe to new shares, but without voting rights • Prevalent in Switzerland, Germany (Genussschein), Austria, Switzerland (dividend rights certificate) and France (bon de jouissance) • Similar to preferred shares in that they have face values and discretionary dividends (unless otherwise specified)		
	Advantages	**Disadvantages**
Investors	• Transferrable ownership rights and may be traded on stock exchanges in much the same way as shares • Right to preferred dividends as well as additional dividend dependent upon terms (e.g. common shareholder exceeds a specified per-share amount) • Sum of dividends ensures shareholders received payment equal to common shareholders • In event of liquidation, often right to receive purchasing price back as well as pro-rata share of remaining proceeds • Profit participation free from capital gains tax	• In Switzerland, can only be obtained by investors who already have a stake in the issuing company (e.g. employees and shareholders) • Some types do not pay dividends and all the earnings are retained • Low liquidity and large bid-ask spreads due to relatively low demand • No guarantee of voting rights • In event of liquidation, takes precedence over common stock but ranks below debt • Some are subject to withholding tax
Issuers	• Means of raising capital without having to take on new owners by selling stock • Flexible terms and conditions determined by issuers • Partial equity treatment by IFRS and ratings agencies	• Not tax deductible • Dividends are cumulative

Table B.4: **Italian savings shares**

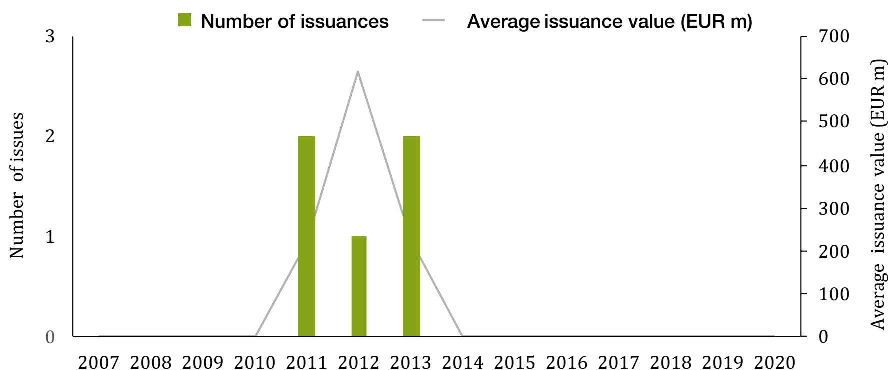
Summary		
• Similar to preference shares with a preferential, discretionary dividend • Designed for smaller shareholders • Currently only issued by Italian listed companies		
	Advantages	**Disadvantages**
Investors	• Extraordinary privileged, discretionary dividend • Preferential payment terms and cumulative • Special Assembly and Common Representative appointed to company's board to represent savings shareholders • Appeal to VC investors and investors who buy a share for its annual dividends rather than for price appreciation / business strategy	• No property or voting rights • Low liquidity (cases of companies converting savings shares to ordinary shares for greater liquidity) • Generally lower seniority on liquidation than ordinary shares
Issuers	• No dilution of ownership • Generally classified as equity under IFRS due to extraordinarily privileged dividends	• Limited governance rights • Legal requirement to specify the substance of the financial privileges • Internal organisational structure must have entity to protect interest of savings shareholders • Costly compared to mezzanine and convertible bonds • Often treated as liabilities by ratings agencies due to corporate obligations

Figure B.5: **Italian savings shares issuance value by sector (2007-H12020, EU27 NFCs, €m)**



Source: PwC analysis of Dealogic data

Figure B.6: **Italian savings shares issuance trends (EU27, NFCs)**



Source: PwC analysis of Dealogic data

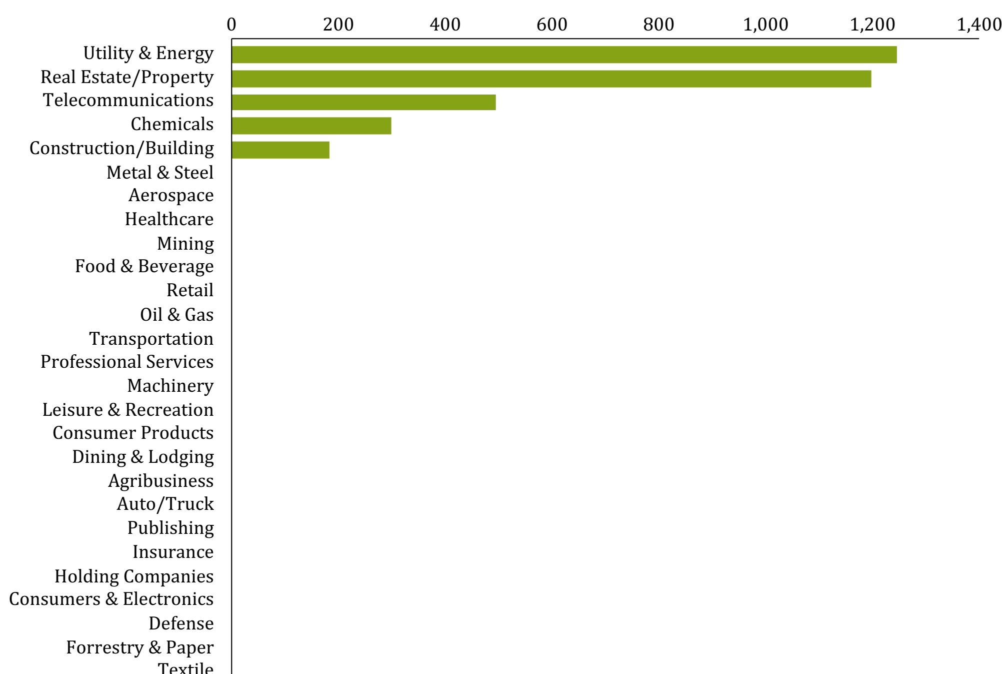
Table B.5: **Profit participating debt**

<table>
<tr><th colspan="3">Summary</th></tr>
<tr><td colspan="3">• Flexible product in which the lender receives a participation in the profits or turnover of the company in return for the provision of capital
• Either fixed coupon or discretionary dividend (or both) and Participation can be confined to the purpose for which the loan was provided or, alternatively, pertain to the whole business of the company
• Common in Germany (Partizipationsscheine), Switzerland (participation certificate) and France (bon de participation)
• Lender does not hold ownership in the company and does not participate in the company's losses</td></tr>
<tr><th></th><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td>Investors</td><td>• Does not participate in the company's losses and repayments are cumulative
• Potential for investors' direct effect on the return to the investment
• Simple due diligence (no concern about valuation or exit strategy)
• Appeals to subordinated loan investors</td><td>• No ownership rights or voting rights
• Dutch case law states that profit participating loans are subordinated to the claims of all other creditors
• Low market liquidity</td></tr>
<tr><td>Issuers</td><td>• Aligned investor-issuer interests
• Stock is preserved for later funding rounds
• Valuation is not a concern
• No dilution of management / board control or change to voting rights
• No need for exit strategy or event to provide investors liquidity
• Losses can be partially written off</td><td>• Can only be sold publicly with a formal sales prospectus
• IFRS liability classification (in part or in full) if obligation to pay any value leftover post-liquidation in addition to any fixed-income payments – otherwise classified as equity if the requirement to pay interest is solely profit-related
• Typically classified as liabilities by ratings agencies</td></tr>
</table>

Table B.6: **Corporate hybrid bonds**

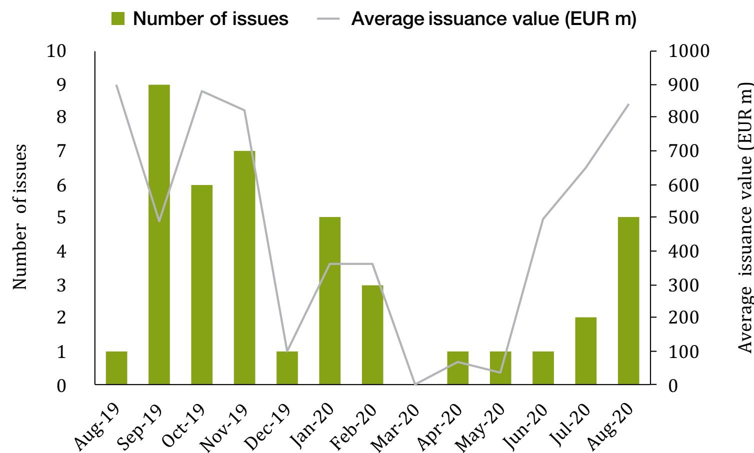
Summary		
• Subordinated debt instrument issued by non-financial companies, combining characteristics of bonds and of equities • Pays a discretionary coupon but can have fixed or perpetual maturity date • Issued primarily by Utilities and Telecommunications corporates, although the market has been gradually extending to other sectors		
	Advantages	**Disadvantages**
Investors	• Issuers typically have a high-quality financial profile (e.g. globally rated Investment Grade) • Illiquidity premium ideal for patient capital (e.g. insurers) • Attractive risk/yield ratio with rare incidents • Highly resilient in periods of economic distress • While subordinate to other debt in event of liquidation, coupons are cumulative and therefore must be paid at some point • Appeal to mezzanine capital investors – gross IRR ranges between 3-15% depending on risk	• Perpetual but normally redeemed at first call date (typically 5-10 years after issue) • Interest rate risk • Extension risk (valuation may fall if the hybrid is not called at the first call date) • Risk of a call at 101% of par • Volatility risk • Low market liquidity compared to ordinary bonds
Issuers	• Payment of coupon at discretion of issuer (balance sheet flexibility) • Issuance possible by non-rated issuers (subject to certain characteristics, e.g. first call date not too far away, stable or improving financial profile, etc.) • Reduced issuer's WACC while improving their rating agency position • No ownership dilution • Classified as equity (or partial equity) under IFRS if there is no contractual obligation to deliver • Ratings agencies regard as half-debt and half-equity, applying the concept of 'equity content'	• Deferral of the coupon payment may tarnish company reputation and may prevent issuer from tapping the bond market in the future • Recent proposals to reclassify as 100% liability under IFRS • Typically a minimum issue value of €200m

Figure B.7: **Non-convertible subordinated debt H1 2020 issuance values by sector (EU27 NFCs, €m, excluding mini-bonds)**



Source: PwC analysis of S&P Capital IQ data

Figure B.8: **Non-convertible subordinated debt issuance trends (EU27 NFCs, excluding mini-bonds)**

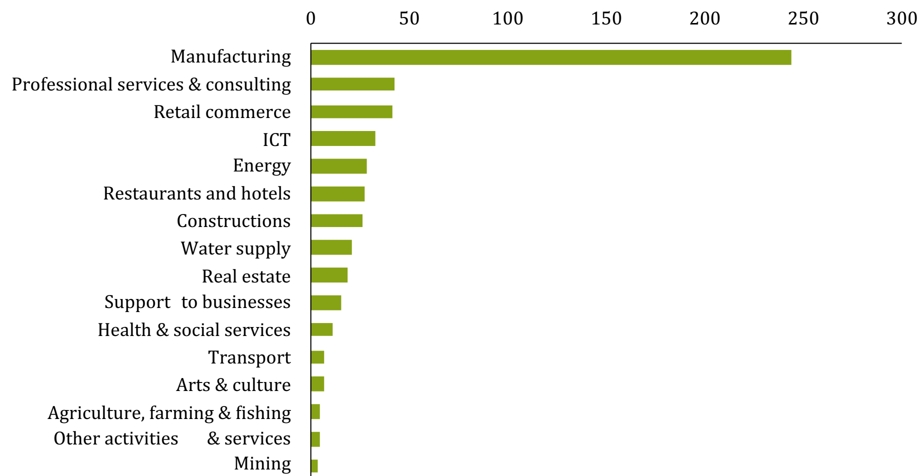


Source: PwC analysis of S&P Capital IQ data

Table B.7: **Mini-bonds**

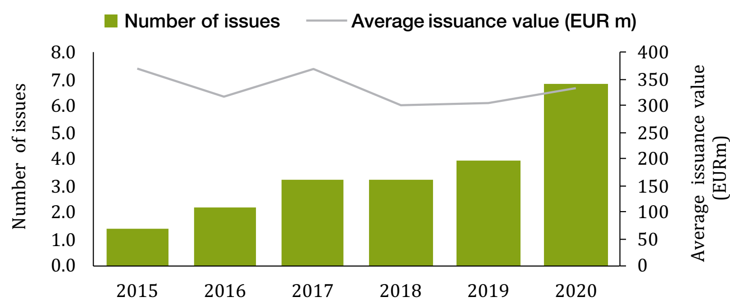
<table>
<tr><th colspan="3">Summary</th></tr>
<tr><td colspan="3">• No legal definition but usually refers to subordinated illiquid debt securities marketed to institutional and retail investors and overlap with payment-in-kind (PIK) bonds
• Fixed coupon depends on business performance (e.g. if business fails, investors may not see return)
• Usually issued by small or start-up companies, or companies that have difficulty raising funds from institutional investors or borrowing from banks</td></tr>
<tr><th></th><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td>Investors</td><td>• Mezzanine debt with high fixed coupon (e.g. ~7-8%)
• Investors may be offered some extra incentive in addition to the interest rate, akin to PIK bonds (e.g. Chilangos offered free burritos)</td><td>• Highly illiquid and inflexible
• No exit strategy
• Non-convertible
• Less stringent regulatory requirements than retail bonds suggest greater risk
• Heavy due diligence required for a small issuance or return
• In UK, normally no protection from the Financial Services Compensation Scheme (FSCS) if issuer is unable to repay investor's capital – In Italy, greater regulation but insolvency treatment generally depends on terms.</td></tr>
<tr><td>Issuers</td><td>• No dilution of ownership or voting rights
• Less stringent regulatory requirements than retail bonds
• No formal prospectus required
• Engagement with investors / brand advocacy
• Medium to long-term maturity (e.g. ~3-5 years)
• Tax incentives on interest and issuance costs
• Public rating disclosure not mandatory, in most cases, no rating requirement (particularly for SMEs)</td><td>• Generally issued for no more than €50m
• Inefficient market for small issuance values
• Higher issuance costs than ordinary bonds
• LCF scandal caused the FCA to ban marketing of mini-bonds to retail investors in UK
• IFRS classification as liability</td></tr>
</table>

Figure B.9: **Italian mini-bond issuance by activity (2019)**



Source: PwC analysis of Politecnico data

Figure B.10: **Italian mini-bond issuance trends**

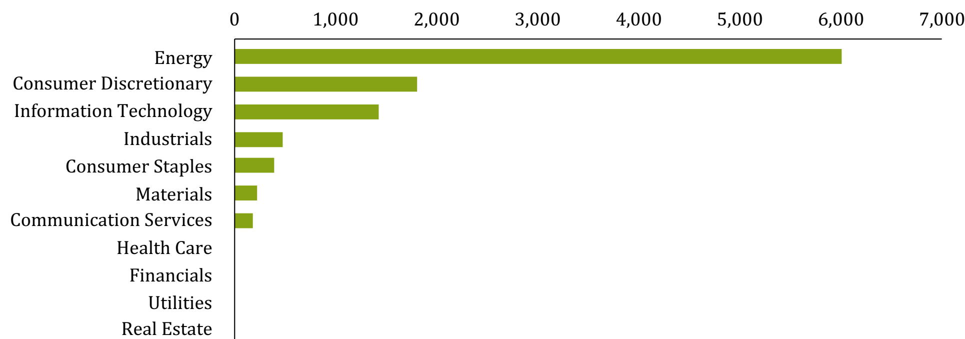


Source: PwC analysis of Politecnico data

Table B.8: **Payment in kind (PIK) bonds**

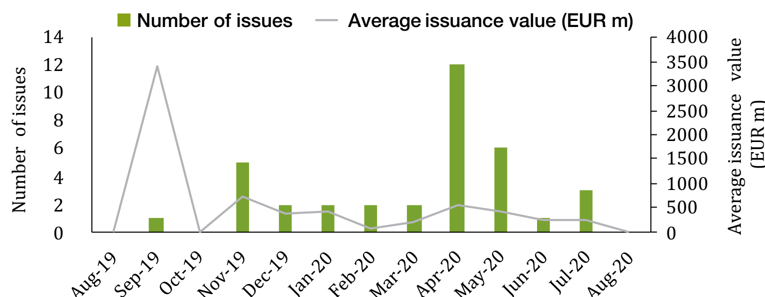
Summary		
• Subordinated fixed coupon to investors of bonds and notes with additional securities instead of cash • True PIK: Mandatory requirement to pay interest (or a portion of the interest) in kind, set out in the terms of the debt at the outset • Pay-if-you-can: Requirement to pay interest in cash if certain restricted payment tests are met, otherwise interest is payable in kind, usually at a higher rate • Pay-if-you-like / PIK toggle: Payment form at issuer's discretion		
	Advantages	**Disadvantages**
Investors	• Premium for foregone cash-paid interest throughout the term of the debt • Detachable warrant, allowing the investor to purchase equity shares / bonds of the company giving the investor a share of profit • In event of liquidation, paid before shareholders	• No regular income • Unsecured • Greater credit risk • In event of liquidation, paid after secured, senior and mezzanine debt • Market not as liquid as ordinary bonds
Issuers	• Mezzanine debt that lessens the financial burden of making cash coupon payments to investors • Flexibility allows issuers to leverage up without having a negative impact on their cash flow • Often used in advance of a cash-out event (for example, an IPO) in order to anticipate and lock-in cash realisations whilst preserving "upside" for the equity sponsor	• Contribute to liquidity problems / risk of default • Usually high early-repayment penalties • No refinancing permitted in the first few years • Generally classified as liabilities / debt by IFRS / ratings agencies as repayment obligated in some form, despite issuer's option to defer payment

Figure B.11: **PIK bond 2020 issuance value by sector (EU27 NFCs, €m)**



Source: PwC analysis of S&P Capital IQ data

Figure B.12: **PIK bond issuance trends (EU27 NFCs)**

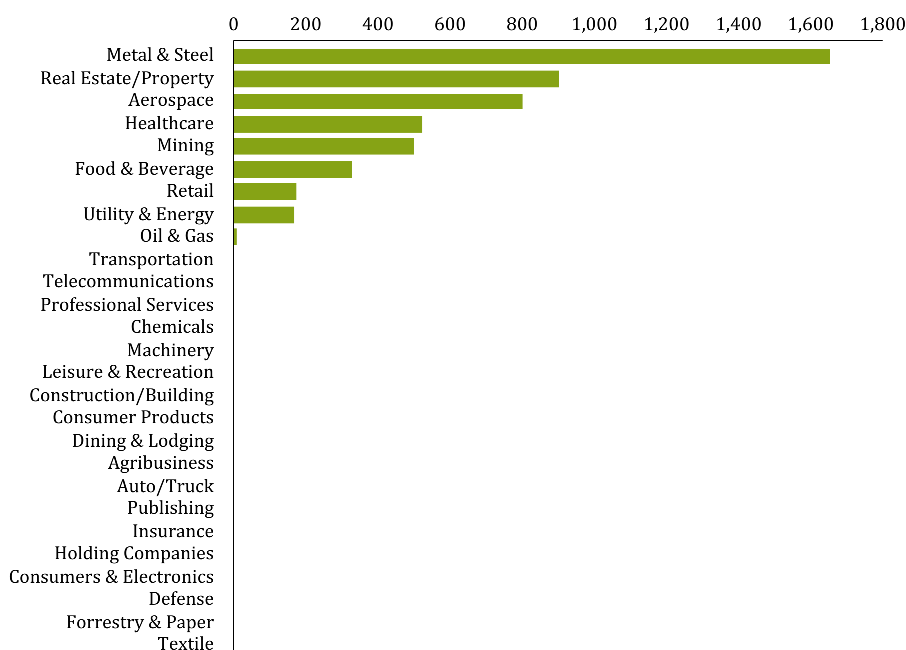


Source: PwC analysis of S&P Capital IQ data

Table B.9: **Convertible bonds**

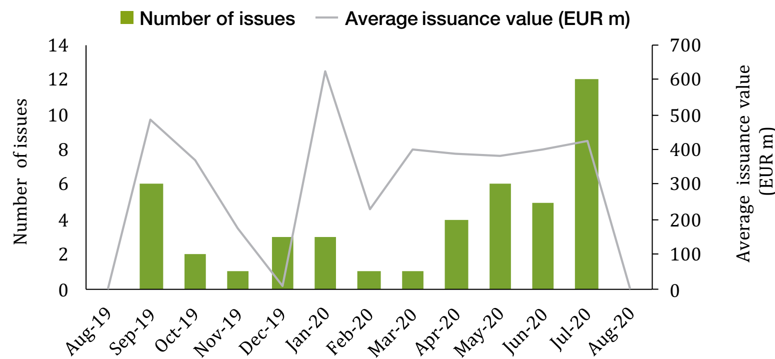
Summary		
• Fixed-income corporate debt security that yields interest payments but can also be converted into a predetermined number of common stock or equity shares at the discretion of the bondholder • In Germany called "Besserungsscheine" • Since 2008-09 Global Financial Crisis, held mostly by hedge funds, institutional investors		
	Advantages	**Disadvantages**
Investors	• Conversion at discretion of bondholder • Features of a bond, such as fixed coupon payments (~9-10% gross IRR) while also having the option to own the underlying stock • Asymmetrical profile appeals to investors in periods of elevated volatility	• Can decline more in value than common stock due to liquidity risk • Low market liquidity
Issuers	• Interest paid at issuer's discretion • Lower yield required to sell debt (appeals to issuers with poor credit ratings) • Rating not mandatory (~54% of global convertible bonds are unrated) • Reduced cost of obtaining scarce capital • Issuer only has to share operating income with the newly converted shareholders if it does well • Tax deductible • Generally lower coupon than an equivalent straight bond would carry • Given 100% equity rating by most agencies, although not all	• Risk of diluting ownership and voting rights • Greater risk of bankruptcy than preferred or common shares • Greater risk with shorter maturity • Stringent indenture provisions • In event of liquidation, IFRS classify as liability as long as it is serviced (with a yield pick-up to senior debt) – however, can be converted into equity under certain circumstances

Figure B.13: **Convertible bond issuance value by sector in 2020 (EU27 NFCs, €m)**



Source: PwC analysis of Dealogic data

Figure B.14: **Convertible bond issuance trends (EU27 NFCs)**

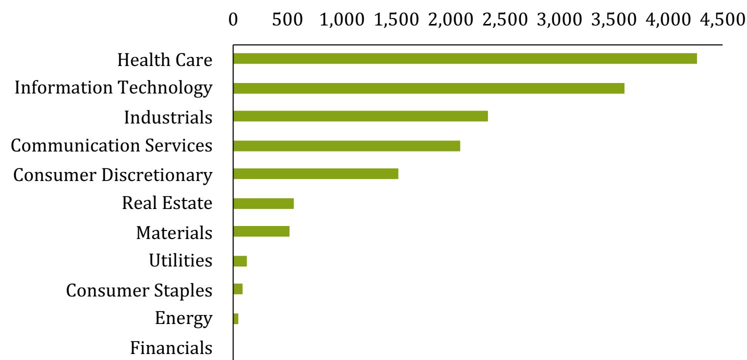


Source: PwC analysis of Dealogic data

Table B.10: **Private placements of senior debt (not a hybrid instrument)**

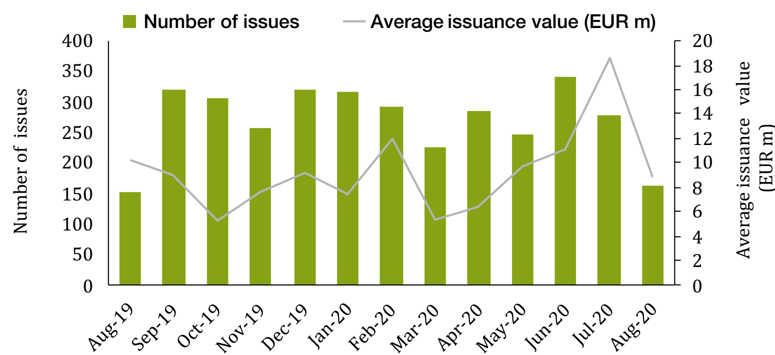
Summary		
• Privately placed, typically unsecured medium to long-term debt obligation • Unlike US private placements (governed by Rule 144A) which tend to be for bigger pieces of debt and therefore requiring many investors, Euro PPs are designed for SMEs and have a smaller number of investors • In Germany, known as "Schuldschein" (SSD) – also common in Austria		
	Advantages	**Disadvantages**
Investors	• Offers higher interest than publicly traded securities through fixed coupon • Attractive for buy-and-hold investors (pension funds, insurers) • Lending provided by a small group on investors • Transferrable • Gross IRR target ranges between 7-23% depending on risk • Senior claim in event of liquidation, pari passu ranking with other outstanding senior debt	• Typically no property or voting rights (unless converted to equity) • Low market liquidity • Unsecured
Issuers	• Pricing discussed early in process • Greater alignment of issuer and investor interests • Suitable for riskier issuers / projects (e.g. start-ups) • Low minimum issuance value • Several tranches with different maturities • Streamlined process relative to raising venture capital • Credit rating not mandatory but given partial equity credit by agencies • Flexible terms (repayable at maturity or by instalments, may be denominated in any currency)	• Smaller market • Typically have to price at a discount • IFRS classification as liability in event of liquidation

Figure B.15: **Private placement 2020 issuance value by sector (EU27 NFCs, €m)**



Source: PwC analysis of S&P Capital IQ data

Figure B.16: **Private placement issuance trends (EU27 NFCs)**

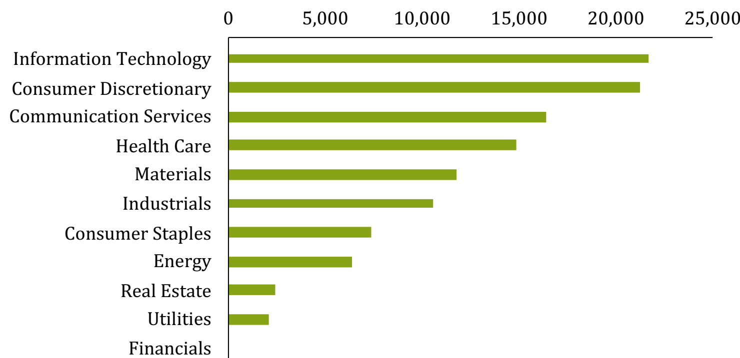


Source: PwC analysis of S&P Capital IQ data

Table B.11: **Public Issuance of Senior ordinary bonds (not a hybrid instrument)**

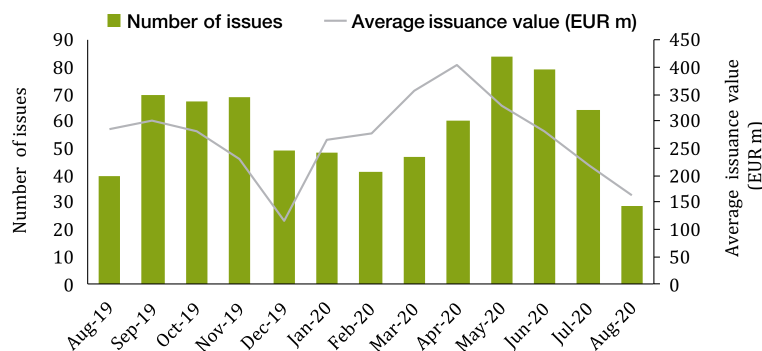
Summary		
• Senior fixed-income product with set maturity date • Principal of loan paid at end date to debtholder with variable or fixed interest payments made by borrower until end date		
	Advantages	**Disadvantages**
Investors	• Fixed coupon • Option to sell before maturity • Greater legal protection means bonds are typically a safer investment than equity (paid first in event of liquidation) • Variety of bond features to fit investor appetite • In event of liquidation, paid first along spectrum of equity-debt financial instruments • Gross IRR target range of ~2-7% depending on issuer credit rating	• Fixed-income so investor required to pay income tax on coupon payments, although tax-sheltered accounts available • Interest rate risk • Prepayment risk • Credit risk • Reinvestment risk • Lower ROI than equity • No property rights or voting rights
Issuers	• Often receive favourable tax treatment on interest • Option for call provisions to allow for early prepayment (can lower cost of capital for issuer) • Often liquid (issuers can sell large quantities without substantially affecting the price)	• Classified as liabilities on balance sheet (by both IFRS and ratings agencies) • Credit rating typically required

Figure B.17: **Ordinary bond 2020 issuance value by sector (EU27 NFCs, €m)**



Source: PwC analysis of S&P Capital IQ data

Figure B.18: **Ordinary bond issuance trends (EU27 NFCs)**



Source: PwC analysis of S&P Capital IQ data

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