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"TOWARDS THE CAPITAL MARKETS UNION": THE RELEVANCE OF ALTERNATIVE EXTERNAL FINANCING FOR EUROPEAN SMES.

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ACRONYMS

SMEs – "Small and Medium Enterprises"
EC—"European Commission"
ECB—"European Central Bank"
AIM—"Alternative Investment Market"
EU—"European Union"
VC—"Venture Capital"
PE—"Private Equity"
IPO—"Initial Public Offering"
LOC—"Line of Credit"
CDS—"Credit Default Swap"
NPV—"Net Present Value"

"Vastus animus immoderata, incredibilia, nimis alta semper cupiebat."
G.S.C

1. Introduction

The aim of this paper is to emphasize the crucial role played by the capital markets as preeminent sources of financing for the SMEs, *pari passu* with the bank-based financial structures. The study builds on several sources connecting academic literature from leading European institutions and empirical analysis provided by prime research entities active in the industry. As a means to support the aforementioned statement, this thesis will review the spectrum of the general framework related to the source of financing and the listing process. Particular relevance will be given to the Italian structure, to analyze impediments experienced by SMEs in accessing market financing. A section will be dedicated to the development of the capital markets in Italy and the case of the "Alternative Investment Market", from now on referred as AIM. Ultimately, the paper will examine public policies operating , both in the domestic market and in the European market, in support of a more facilitated access to the capital markets .

The European Commission defines SMEs as "those enterprises employing fewer than 250 persons that have a turnover of less than 50 million euros and/or a balance sheet total of less than 43 million euros" (Table 1).[1] SMEs are further classified, according to the previous criteria, into Medium Small and Micro-sized enterprises.

Enterprise Category	Employees	Turnover	Balance sheet total
Micro SME	0 to < 10	< €2 million	< €2 million
Small SME	10 to< 50	< €10 million	< €10 million
Medium-sized SME	50 to <250	< €50 million	< €43 million

Table 1: definition of micro, small, and medium-sized enterprises.[2]

[1] EC (2003) Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (Text with EEA relevance) (notified under document number C(2003) 1422),*Official Journal of the European Union, L 124/36 , 20 May 2003.*

[2] *Data Source :*Official Journal of the European Union, L 124/36 , 20 May 2003.

According to the Annual Report on European SMEs(EC 2019) [3], these enterprises "are the *backbone* of the EU-28 economy, accounting for more than 50% of the GDP". In 2018, There were slightly more than 25 million SMEs , of which 93% were micro SMEs. Essentially 99.8% of all enterprises in the EU-28 non-financial business sector (NFBS), generating 56.4% of value added and 66.6% of employment in the NFBS. In recent years, the growth in all components of the aggregate demand provided a favorable environment for these enterprises , a positive outlook that is forecasted also for the coming years. The importance of SMEs is paramount in the Euro zone system and is recognized also at a country level : Many member states have adopted an adaptive regulatory framework in the attempt to promote entrepreneurship and remove existing barriers to growth. Empirical evidence show how SMEs are, compared with Large Enterprises (250+ employees), the leading driver of economic growth, job creation and contribute significantly towards reaching the goals set in place by EU2020 strategy set by the EC.

	Micro SMEs	Small SMEs	Medium-sized SMEs	All SMEs	Large enterprises	TOTAL - All enterprises
Enterprises						
Number	23,323,938	1,472,402	235,668	25,032,008	47,299	25,079,312
%	93.0%	5.9%	0.9%	99.8%	0.2%	100%
Value added						
Value in € (million)	1,610,134	1,358,496	1,388,416	4,357,046	3,367,321	7,723,625
%	20.8%	17.6%	18.0%	56.4%	43.6%	100.0%
Employment						
Number	43,527,668	29,541,260	24,670,024	97,738,952	49,045,644	146,784,592
%	29.7%	20.1%	16.8%	66.6%	33.4%	100.0%

Table 2:Number of SMEs in the EU-28 NFBS in 2018-2019 and their value added and employment. [compared to Large enterprises, 250+ employees] [4]

Smaller firms are typically said to have "behavioral advantages in terms of rapid

[3] EC(2019) "Annual Report on European SMEs 2018/2019" – Retrieved from https://ec.europa.eu/docsroom/documents/38365/attachments/2/translations/en/renditions/native.

[4] Data Source: Eurostat, National Statistical Offices, DIW Econ.

decision making and flexibility. In contrast, the relative strengths of large businesses are predominantly material, as large firms have advantages linked to economies of scale and the availability of financial and technological resources"(Vossen 1998)[5].

Despite their important economic role, access by SMEs to long term market financing is still limited and continues to be a challenge for policy makers. In light of these considerations, traditional bank lending is as yet the predominant source of external financing for the SMEs, which are dependent on plain debt in order to realize their investments and cash-flow needs. A central argument that justifies somehow this peculiar yet unattractive feature is the information opacity that investor face when investing into SMEs: gathering and processing information concerning these enterprises is expensive and time consuming and seldom inconclusive. This represent a concrete obstacle for EU SMEs. In addition, many alternative sources of external financing that might be in line with the needs of this enterprises are still underdeveloped in Europe, therefore there is an increasing need for a custom tailor intervention to properly address these issues.

Lessons from 2008-2009 Financial Crisis

The excessive reliance on traditional bank finance exposes those enterprises towards greater risks, especially in case of financial distress.

Since the global financial crisis of the 2008-09, the credit transmission mechanism was "damaged" in terms of quantity, price and distribution of credit. The financial crisis revealed *de facto* a pattern of excessive risk taking and inadequate capital buffers, a period of considerable exuberance and unprecedented high-pace growth for the banking sector . Relaxed credit standards , wrongful incentives and compensation schemes revolving around short term profits allowed banks to neglect risk in favor for a short-lived gain, unproper capitalization and opaque and hazardous activities. The crisis affected all the large banking systems, triggering consistent losses , leading the global

[5] Vossen, R. W. (1998). Relative Strengths and Weaknesses of Small Firms in Innovation. International Small Business Journal, 16(3), 88–94.

economy towards a period of weak prolonged economic growth ,low inflation, and historically low nominal interest rates. The post-crisis scenario required a call for extreme measures in terms of regulation and supervision of the financial sector. From that moment onwards, banks have significantly reduced lending activities in order to meet more stringent prudential regulations in terms of capital and liquidity , undergoing a process which goes under the name of “deleveraging”. Among many provisions, it was imposed to the banks an increase in quantity and quality of capital, with the introduction of “countercyclical” capital buffers to reduce procyclicality. Also, two liquidity risk ratios were set as benchmark : The Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) measures aiming at promoting short-term bank resilience and ensuring a stable funding structure.

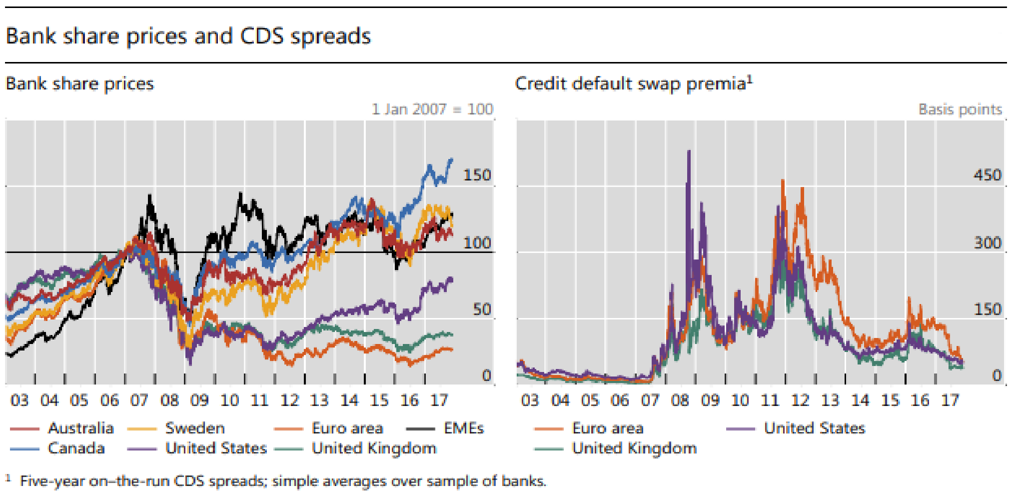

Table 3: Bank share prices and CDS spreads pre- and post-financial crisis.[6]

In some jurisdictions, those changes were also complemented by national initiatives. The crisis that started in the United States had, and to some extent still has, a severe impact also to the financial stability of the Eurozone. Few commentators argued that “the capacity of the euro-member countries to withstand negative and financial shocks was identified as a major challenge for the success of the euro from the beginning”(Lane 2012)[7]:indeed the pre-crisis decade in Europe spanning from 1997 to

[6] Data Source: (Datastream;Markit 2012).

[7] Lane, Philip R. 2012. "The European Sovereign Debt Crisis." *Journal of Economic Perspectives*, 26 (3): 49-68

2007, if analyzed with the benefit of hindsight, looks like a period in which "consistent growth and a benign financial environment masked the accumulation of an array of macroeconomic, financial and fiscal vulnerabilities" (Wyplosz 2006)[8]. In particular, there was a rapid increase from 2003 to 2007 of credit growth and current account imbalances that timed perfectly with the boom of securitization in international financial markets and the U.S. subprime episode. From a Euro perspective, the 2008 global financial crisis questioned the sustainability of such large external deficits and shook the continent as much as the United States.

It generated a large-scale reassessment of the resilience of the European financial market from the investor-side that took the form of large capital outflows. In the aftermath the tightening of credit conditions, the banking sector battling with loan losses and liquidity squeeze in funding markets, joint with a combined negative impact resulting from a domestic recession and financial distress , fueled the conditions for a Sovereign debt crisis.

In response to the global financial shock the European Central Bank (ECB) , jointly with major financial institutions worldwide, decided to reduce short-term interest rates and inject euro-denominated liquidity in the Euro system in attempt to stabilize the area-wide banking system and build market resilience. However, the financial crisis had asymmetric effect on EU members : In particular, countries that relied excessively on external financing were largely negatively affected and needed to resort to running deficit. This adverse development was reflected in rising spreads on sovereign bonds especially in Greece Portugal Spain and Italy. A decade later, Europe still endures economic stagnation: ten years into the global financial crisis brought only a timid recovery. Often compared to the Japan's "lost decade" , Europe has collected many warning signs: historically low rates, well-below target inflation rate , slow growth and growing unemployment.

[8] Wyplosz, Charles, (2006), European Monetary Union: the dark sides of a major success, *Economic Policy*, 21, issue 46, p. 207-261

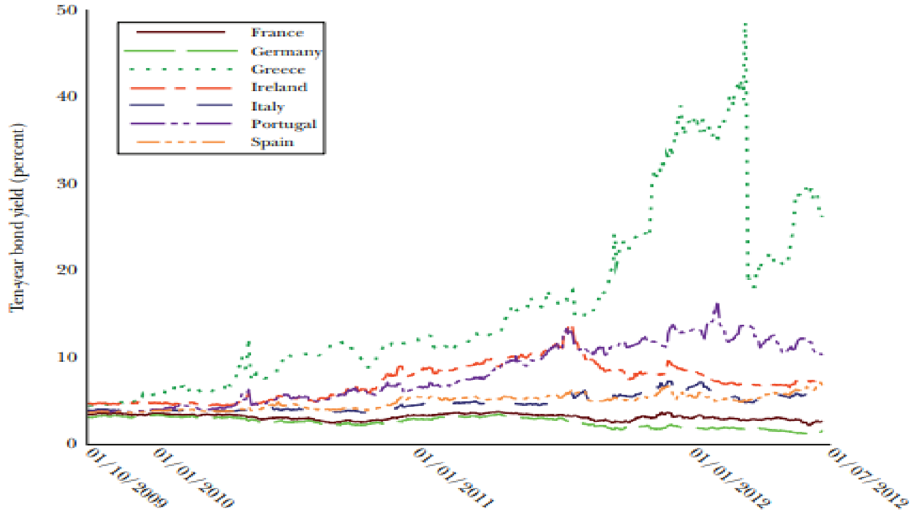

Table 4: Yields on Ten-Year Sovereign Bonds, 2009-2012.[9]

BCE precautionary measures injected liquidity in the banking system, in attempt to slow down the European credit crunch, which *de facto* affected asymmetrically European member states.

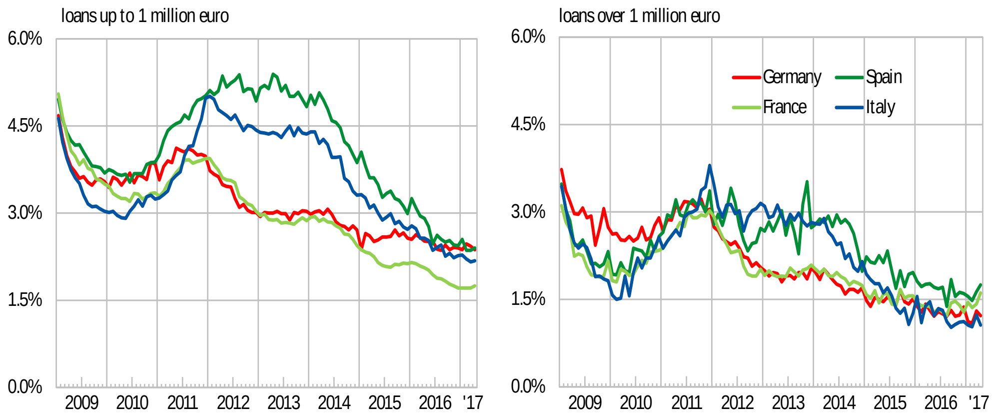

Table 5: Interest rates on bank loans to non-financial corporations in major euro area countries monthly data; January 2009 - April 2017)[10]

The arguments previously described highlighted the important role of the SMEs in the economy, with particular mention to their "contribution in terms of employment, value added, innovation and overall incentives to growth and financial structure development". On the other hand, so far, the analysis of these enterprises also remarked

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[9] Data Source: (Philip R. Lane – DataStream 2012)

[10] Source: ECB; interest rates on new loans.

their structural fragility , a substantial vulnerability towards banking systems dynamics and a constrained access to lending, especially in periods of recessionary pressure. In light of this considerations, a full disintermediation of SMEs financing is neither achievable nor desirable. Given the large cost of monitoring and the fixed cost of sourcing, a wider access to capital markets to fulfill cash-flow and financing needs would be beneficial for these enterprises and for investors, that could achieve further diversification and overperforming returns. Furthermore, as also explained in the "*life-cycle paradigm*" different sources of financing are of paramount importance at different stages of the firm's growth: equity financing does not exclude but rather will complement debt financing throughout the entire life span of the business, for example by providing sufficient collaterals to cover the debt exposure or to lever the capital structure of the firm.

2. Bank Finance versus Market-based Finance: A literature review

This excursus on the financial crisis that hit the global economy, with special distinction to the European area, and the early post crisis was fundamentally important for a reason: it highlighted the importance of developing a marked-based finance for SMEs as a complement of the more traditional bank-based finance. Indeed, the effect of the economic downturn previously described were particularly felt by small and medium-sized European enterprises, being heavily conditioned to bank lending. In a context characterized by a liquidity dry-out imposed by financial deleveraging, credit sources are much more limited, and SMEs are bounded to face considerable financing constraint.

Several theoretical studies are in favor of the dualism between traditional financing and improved access to securities markets, the debate concerning the optimal choice of financial structure dates to the early stages of modern economic investigation.

Indeed, since the beginning of the 19th Century , the *bank-based view* emphasized "the ability of banks of managing cross-sectional, intertemporal and liquidity risk and thereby enhancing investment efficiency and economic growth"(Allen et al., 1999)[11]. In contrast, the *market-based* view underlines the growth enhancing role played by competitive capital markets in "aggregating diffuse information signals and effectively transmitting this information to investors with beneficial implications for firm financing and economic performance" (Boot et al., 1997)[12]. Recent empirical research illustrates that , as countries develop economically, the services provided by capital markets tend to increase in importance for future economic development while those provided by banks will become less imperative to serve the growth purpose.

In a well-recognized paper by Levine et al.(2011)[13], in attempt to describe the evolving relationship between banks and capital markets, the authors found that the association between economic activity and securities market development increases as countries grow. Moreover, by controlling for *private credit* (deposit money bank credit to the domestic private sector as a share of GDP) and *stock value traded* (the value of stock market transactions as a share of GDP), they illustrate that as the Real GDP per capita rises the level of the bank development increases but its association with economic activity falls. The evidence is shown in the first panel of Table 3 (*as rise in private credit takes place (triangles) the marginal increase in real GDP per capita associated with such increase falls (circles)).* The results are the opposite for the securities market, where as countries develop economically ,securities market development increases and increases also its association with the economic activity (*the evidences are shown on the remaining panels of figure 3, where it is depicted a positive relationship between GDP , securities market and economic activity*).

[11] Allen, F., Gale, D. 1999. "Diversity of opinion and financing of new technologies". European Economic Review 39, 179-209.
[12] Boot, A.W.A., Thakor, A. (1997). "Financial system architecture". Review of Financial Studies 10, 693–733
[13] Demirguc-Kunt, Asli & Feyen, Erik & Levine, Ross. (2011). The Evolving Importance of Banks and Securities Markets. The World Bank Economic Review.

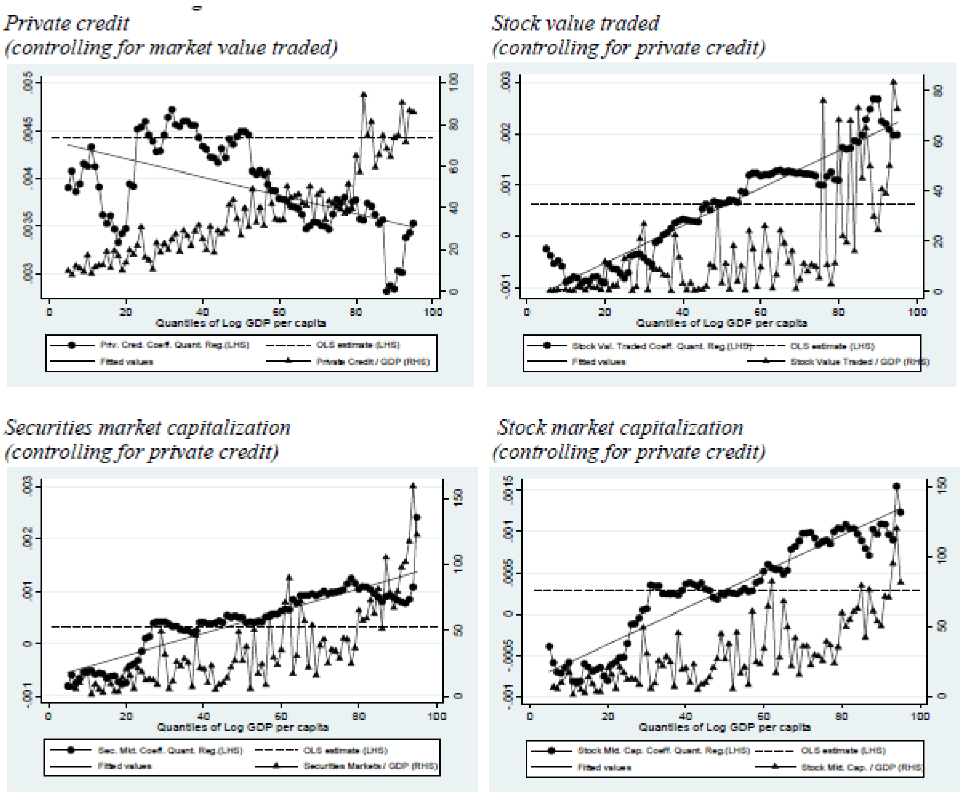

Table 6: Quantile coefficients for Private credit and Securities Market Activity[14]

There are several economic factors behind this result : one reason that might explain the positive increase of market-based financial intermediation, linked to the increase of the real GDP , is the increase in financial literacy and sophistication of the investors that requires access to services linked to capital markets. This findings are consistent with our primal objective, to demonstrate the importance of market-based finance for SMEs as a complement to the more traditional banking approach and key driver of economic growth: indeed, during the process of economic development , economies requires access to custom designed arrangements , mediated by capital markets , to support innovative and longer-terms projects : due to their size, heterogeneity and risk coefficient, SMEs activity fall within this scope.

Banks and markets behave differently in attempt to alleviate business cycle

[14] Demirguc-Kunt, Asli & Feyen, Erik & Levine, Ross. (2011). The Evolving Importance of Banks and Securities Markets. The World Bank Economic Review

fluctuations: “when the former are under pressure they necessarily have to restructure their balance sheet , while system that are more market-oriented may speed up the necessary deleveraging and paving the way for a sustainable recovery” (Bech 2012)[15]. As also explained by Gambacorta (2014) [16], “all financial systems combine bank-based and market-based intermediation, according to a particular mix changing across countries”. This blend provides different responses of banks and markets in periods of financial distress and determines the severity of recessions.

Output cost of recessions and financial structure

	Financial structure[1] (I)	Number of observations (II)	Total real GDP loss (d)+(r) (III)	Real GDP loss during downturn (d) (IV)	Real GDP loss during recovery (r) (V)	Primary fiscal balance to GDP (VI)
All downturn episodes	Bank-based	40	4.33	3.73	0.60	–2.11
	Market-based	31	3.73	3.92	–0.19	–1.62
no financial crisis	Bank-based	26	–0.09[2]	1.70	–1.79	–1.62
	Market-based	16	3.24	3.60	–0.36	–2.02
with financial crisis	Bank-based	14	12.54	7.51	5.03	–2.99
	Market-based	15	4.24	4.25	–0.01	–1.19

Table 7: "Output cost of recessions and financial structure"[17]

By taking into consideration a cross-section of downturns (*periods of one or more consecutives years with negative real GDP growth)* and subsequent recoveries from a sample of 24 developed countries over the period spanning from 1960 to 2013, it is possible to observe that an average of 4% of GDP is lost during a typical recession (*column 3 of table 4)*. Furthermore, the table summarized another important fact: in periods of no financial crisis , bank-based systems appear more resilient (*rows 3-4 of table 4*) , while countries with market-based systems experienced on average losses. This confirm the evidence that banks , under no particular situations of financial stress, are natural provider of resources that allow to absorb shocks. However, when recessions trigger financial crisis, countries that rely more on traditional banking services are severely hit , with a loss on average that is three times higher compared to market-oriented structures *(rows 5-6 table 4).* Also this evidence is in favor for a transition

[15] Bech et al (2012); OECD, *Economic Outlook Database*; World Bank, Global Financial Development Database

[16] Gambacorta et al. (2014)"Financial structure and growth," *BIS Quarterly Review*, Bank for International Settlements.

[17] Bech et al (2012); OECD, Economic Outlook Database; World Bank, Global Financial Development Database

towards a more integrated financial system comprehensive of both banks and capital markets, indeed not only the two performs several different functions that are beneficial for the economy and that foster financial development but also the shock-absorbing capacity of a country is unmatched whenever there is a successful juncture of these two structures.

Economic Growth and Financial Development

So far the paper guided the reader through valid arguments aimed at recognizing the prime role played by SMEs in the global economy and also discussed theoretical evidences in favor of a bifold financial structure that relies deeply on the coexistence of financial intermediation and market-based finance.

Regarding the latter, in the past years there has been an emerging consensus about the role of capital markets in promoting growth and in general economic development. This renewed interest caused a major shift towards a more market-oriented approach in many developed economies and , in some jurisdictions, triggered also a wave of liberalization of capital flows and significant reduction of tightening capital measures. Arguably, in order to better understand these previous statements and also to properly appreciate the main causes that determined this shift, it would be of substantial help to summarize the main empirical literature reviewing the relationship between financial sector development and economic growth. This will also serve the original purpose of this paper, that is to stress the importance of granting SMEs access to capital markets, by reviewing main advantages of well-functioning market environment.

A consistent amount of empirical research shows that financial intermediation significantly reduces cost of acquiring and processing information and lower transaction costs. In addition, in a well-functioning financial environment "the allocation of resources is enhanced, and a better risk management improves the liquidity of assets available to savers and encourage investments" (Obstfeld 1994)[18] .

[18] Obstfeld, M. (1994). Risk-Taking, Global Diversification, and Growth. *The American Economic Review, 84*(5), 1310-1329.

With the purpose of having a better understanding of the link between financial development and growth, we rely on two main paradigms widely implemented in academia to advance a further review of the principals theoretical evidences concerning this subject.

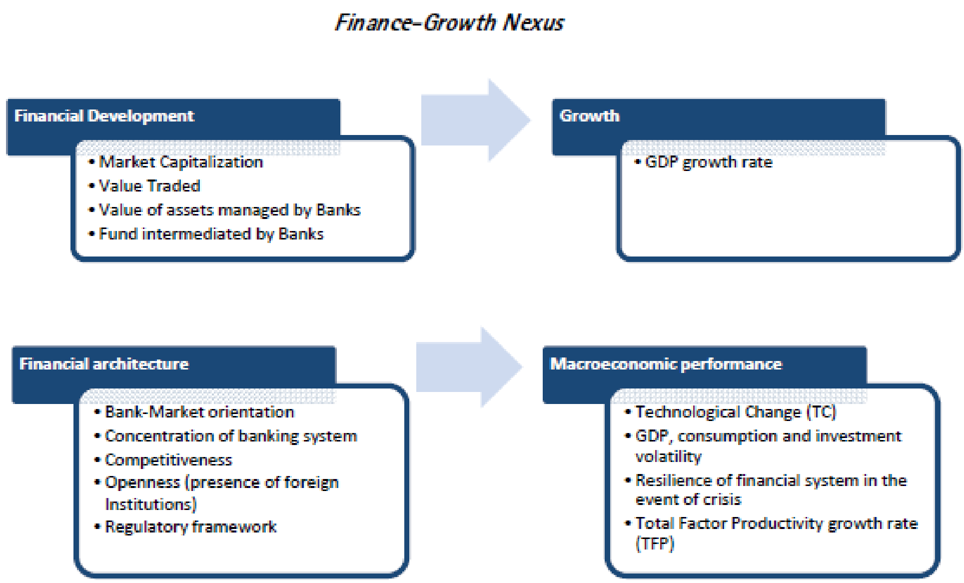

Table 8: Finance Growth Nexus[19]

The first paradigm is focused on describing the relationship between financial development and growth. An additional paradigm proposed by Giordano and Guagliano (2014) [20] revolves around the causal link between financial architecture (key aspects of the financial system) and the macroeconomic performance of a country. Financial development is a measure of how well market operators select and monitor firms and information, how efficiently the market is able to "mobilize" savings, pool risks and

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[19] L.Giordano , C.Guagliano (2014) "Financial architecture and the source of growth" *Quaderno di Finanza n.78* - CONSOB

[20] Ibidem

facilitate transactions. Few economists have focused in recent years on establishing the main elements of the afore mentioned relationship. Levine's work is arguably one of the first modern attempt to the matter: in his cross-sectional study, of which this paper earlier provided a brief summary, showed that "as countries develop economically, securities market development increases and increases also its association with the economic activity"(Levine et al. 2011)[21]. Therefore, a financial system that can ease risk diversification (via capital markets access) can "accelerate" technological change and develop financially.

Giordano et Guagliano (2014)[22] estimated a model to capture the effect of several features of a country financial system on the rate of technological change. In particular, they considered, among other variables, the percentage of foreign banks over the total number of domestic institutions, bank capitalization and the number of listed companies. They also introduce an estimate for the "Market-Bank" orientation (MB) of the country, which contains three relevant variables: "market size", "market activity" and "market efficiency".

By applying the regression in periods of no financial distress, it is noticeable how factors related to the Market-Bank orientation (MB) are all positive and statistically significative. This evidence suggest that a more market-oriented financial system drives financial development and innovation. In addition, a larger share of foreign banks in the domestic sector seems to be associated with a higher technological change. Financial globalization therefore is proved to be beneficial for economic activity and financial development. Furthermore, a larger number of foreign banks in the domestic market is associated to technological shift: financial globalization will boost technological progress by replicating from more advanced economies investments on innovative new ventures, firms that experience a liquidity shortage in domestic financing.

[21] Demirguc-Kunt, Asli & Feyen, Erik & Levine, Ross. (2011). The Evolving Importance of Banks and Securities Markets. *The World Bank Economic Review*

[22] L.Giordano , C.Guagliano (2014) "Financial architecture and the source of growth" *Quaderno di Finanza n.78* - CONSOB

		(1)	(2)	(3)	(4)	(5)	(6)
BM	Bank-Market orientation	0.0013** (2.34)	0.0013** (2.61)	0.0017*** (2.86)	0.0015*** (2.66)	0.0008* (1.71)	0.0014** (2.03)
FS_1	Concentration	-0.003* (-1.94)	-0.0039** (-2.60)	-0.0037** (-2.52)	-0.004*** (-2.67)	-0.0033 (-2.48)	-
FS_2	Foreign	0.0217*** (7.32)	0.0206*** (7.33)	0.0200*** (7.02)	0.0199*** (7.07)	0.0116*** (4.26)	0.0118*** (3.78)
FS_3	Volatility	-0.0091*** (-4.45)	-0.0099*** (-5.11)	-0.0100*** (-5.15)	-0.0102*** (-5.31)	-0.0080*** (-4.88)	-0.0098*** (-3.97)
FS_4	Listed companies	-	-	-	0.00004* (1.68)	0.00004 (0.120)	0.00002 (0.248)
FS_5	Lending-deposit spread	-	-	-	-	-	-0.0364* (-1.94)
FS_6	Bank capitalization	-	-	-	-	-	-0.0014*** (-3.25)
ME_1	Gdp	0.0259** (2.61)	0.0221** (2.35)	0.0266** (2.62)	0.0309*** (2.98)	-	-
ME_2	Trade openess growth	-	0.1082*** (3.75)	0.1101*** (3.82)	0.1161*** (4.03)	0.1053*** (4.29)	0.11286*** (4.40)
ME_3	Public expenditure	-	-	0.00952 (1.17)	0.0104 (1.29)	-	-
ME_4	Otuput-gap	-	-	-	-	0.0364*** (6.00)	0.0301*** (3.40)
	Costant	0.0042** (2.27)	0.0051*** (2.84)	0.0007 (0.17)	-0.0008 (-0.18)	0.0103 (5.32)	0.004 (1.64)
	Observation	132	132	132	132	126	74
	R^2	0.53	0.59	0.6	0.61	0.73	0.81

Note:***significant at 99%; **significant at 95%; significant at 90%.

Table 9: Fixed effects panel estimation in good times (2002-2007)[23]

Data from the regression suggest also that the presence of a well-developed equity market is positively associated with technological progress and financial development: brand new listed companies will embark on ambitious and cutting-edge projects that will cause a spillover effect of modernization over the economy as a whole. The main argument proposed by the study conducted by Giordano and Guagliano seems to coincide with the scope of this first part of this paper: it indeed provide evidence of the fact that a well-functioning capital market both in good times and in times of financial distress will have a positive correlation with financial development and technological progress: a more market-oriented financial system that comprises foreign banks, a substantial amount of listed companies (therefore, a facilitated access to equity market) will experience a generous amount of innovation over the years.

[23] L.Giordano , C.Guagliano (2014) "Financial architecture and the source of growth" *Quaderno di Finanza n.78* - CONSOB

So far, the paper discussed only a restricted pool of aspects pertaining the relationship between financial development , technological progress, and economic growth. Arguably, there are still many variables that might explain this relationship. Recent developments in the growth literature revolve in particular on the importance of equity markets. It is worth mentioning under this consideration, the study by Rosseau and Wachtel (2000).

	Country mean		Effect on growth rate of a 10 percentage point increase	
Ratio to GDP of:	1987	1995	Panel regression model	VAR (5-year horizon)
Liquid liabilities (M3)	58.73		0.15	0.8
Market capitalization	29.12	65.11	0.08	0.4
Total value traded	10.75	24.22	0.52	1.0

Table 10:"Equity markets, financial depth and growth: summary of panel regression.[24]

The authors of this paper considered two measure of the stock market as to serve the purpose of financial sector indicators: ratio of market capitalization to GDP and the ratio of Total Value traded to GDP also a panel VAR model to measure causality among growth and stock market indicator. The result of this regression illustrates that the development of a liquid and widely capitalized market have a positive incidence on growth.

Indeed, even if banks represent in many locations the only viable option towards financing, it is well known that the existence of capital markets represent an important contribution to a country financial system and should always complement the traditional lending activities. There are several reasons that legitimate the role of capital markets in this bifold structure: capital markets , and the equity market in particular, provide investors with a potential exit strategy for the venture capital investor that

[24]Rousseau and Wachtel (2000) " Equity markets and growth: Cross-country evidence on timing and outcomes, 1980-1995", *Journal of Banking & Finance*, 24, issue 12, p. 1933-1957

profits from a successful IPO of a company. Moreover, the existence of capital markets ease capital inflow and, especially in transition economies, allows deficits financing. The existence of capital markets, in addition, facilitates the collection and evaluation of information, significantly reducing asymmetries. This in turn will smoot corporate governance as performances and market evaluations are “out in the air” and will provide incentives to managers in order to exert more effort in monitoring risk: their compensation, indeed, is linked to stock prices which are of public domain. A deep equity market increases the efficiency of the overall financial industry, as it will provide value benchmarks that will be helpful to other companies and the entire sector.

This first part of the paper focused in particular on granting the reader a formalized notion of the SMEs following the structural definition provided by the EC, the primal regulatory body of these enterprises. Further, it examined the difficulties faced by SMEs in accessing financing and their excessive reliance on traditional debt. A concise summary of the main events that occurred during the main disruptive financial crises in Europe of last decades highlighted the fragility of these enterprises, a weakness that tends to increase in period of financial distress. A review of the main empirical research studies on the subject reveled the benefits of developing a market-based finance as a complement to traditional bank-based financial systems, and further analyzed the positive correlation between financial development, growth and technological progress. In light of these considerations and mindful of the events that followed the Subprime incident, given the ever-growing need for diversification by the SMEs there is strong evidence in favor of a transition towards a well-integrated financial sector in which capital markets are parallel to traditional finance in providing funding opportunities and risk allocation, a more resilient market structure that ultimately will promote economic growth and technological development.

3. Sources of Financing for EU-28 SMEs

Antecedently, with significant emphasis, this paper focused on acknowledging the crucial contribution of the SMEs to the economy in terms of financial development and technology, economic growth, employment, and value added. Furthermore, by reviewing the main empirical literature, the thesis also underlined the importance of promoting access to capital markets and the benefit of developing a market-based finance as a complement of traditional debt financing. The second part of the paper proposes an in-depth description of main sources of financing for small and medium-sized enterprises, revealing also structural impediments faced by the SMEs when accessing some of these viable options. Particular attention will be drawn to the Italian framework of the SMEs, the Italian capital market, and possible disincentives to the IPO process from the point of view of the Italian firms, given the predominance of small and medium-sized enterprises in the Italian system hence providing a great example of SMEs ecosystem to analyze and from which, consequently ,extract relevant evidences. Prior entering into more details, it is worthy noticing that a significant number of corporate finance theories seem to neglect the existence of small and medium-sized enterprises, being mainly interested in study the effect of empirical research on well consolidated firms. Nonetheless, capital structure decisions, involving also large and more mature firms, always proved to be "puzzling" (Myers, 1984)[25], especially in recent times due to the rise of a plethora of alternatives to the more traditional debt or equity financing approach. Arguably the most influential research on capital structure , a forerunner study for the modern theoretical framework of corporate financing is the work by Modigliani and Miller (1959)[26]. In their first joint effort, the authors developed a crucial proposition: "the value of the firm would be unaffected by its capital

[25] Myers (1984) "Capital Structure Puzzle," *Journal of Finance*, Vol. 39, No. 3, July 1984, pp. 575-592

[26] Modigliani Miller (1959)."The Cost of Capital, Corporation Finance, and the Theory of Investment": Reply. *The American Economic Review*, 49(4), 655-669.

structure"[27].

This conclusion hinges on several basic assumptions such as: the existence of perfect capital markets, the absence of agency and transaction costs, the exemption of taxes. Later in 1963, they amended their original research by proposing a correction that considered the fiscal impact on the capital structure of the firm. When corporation taxes and tax deductibility are taken into account, Modigliani and Miller concluded that firms would prefer debt vis-à-vis other form of financing, incentivized by the possibility of avoiding paying taxes on interest payments while still maintaining a "substantial reserve of untapped borrowing power"(Modigliani , Miller , 1963)[28] in order to preserve some degree of flexibility. An alternative solution is provided by Myers in 1984, when he introduced a modified "Pecking-Order-Framework". This theory suggests that firms finance their operations according to a specific hierarchy, an order that reflects the relative costs attributable to the various sources of financing. Firms will use first internally available funds, followed by debt and ultimately external financing. Myers argues that firms reasonably avoid financing real investments by issuing common stocks or other securities because they "do not want to run the risk of undersubscription during the listing process or negative forecasted outlook on the security, ultimately resulting in a negative NPV project"(Myers 1984)[29]. This last study, however does not exclude borrowing, but suggest the firm to stay "debt safe" (reasonably close to being default risk-free) to avoid financial distress and to maintain some "reserve borrowing power"(Myers 1984)[30], that grants the firm higher flexibility. Myers contribution is complete in the sense that acknowledge both the cost of financial distress and asymmetric information: indeed, in his work he explains that, by climbing the financing hierarchy, the firm will be more likely to incur costs related to financial distress and will reject projects bearing positive NPV due to an over risk adverse attitude towards securities issuance.

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[28]Modigliani, Miller (1963) "Corporate Income Taxes and the Cost of Capital: A Correction" *American Economic Review*, 53, 433-443.
[29] Myers (1984) "Capital Structure Puzzle," *Journal of Finance*, Vol. 39, No. 3, July 1984, pp. 575-592
[30] Ibidem

Arguably, the limit of these traditional finance theories on the capital structure dilemma is to consider firm financing as a latent process rather than a steady progression: a doctrine that correct the shortcomings of the main classical corporate finance paradigm, illustrated so far, is the financial "growth life cycle model". This particular framework proved to be useful especially when applied to the SMEs context: as a firm's funding needs vary over the course of its development, also the access to different sources of financing become available. The main advantage of this approach is that it takes into consideration main sources of financing for each stage of the firm life cycle, simplifying the analysis of potential funding gaps during the development of the firm. A description of this model was first proposed in 1978 by Weston and Brigham, however the concept of a gradual development of the firm is well-established in the financial literature and encompasses different notions taken from other empirical research on the matter, for example elements of "agency theory" and "pecking order theorem" by Myers that we previously discussed. Below an adapted description of the firm continuum and sources of finance, developed by Berger and Udell (1998)[31], is proposed. This graph shows in a stylized fashion the financial growth cycle of a small business, representing on a size-age-information "continuum" the most popular viable financing options for a firm at different stages of its evolution. The initial step of any firm financing is represented in the far-left side of the graph: newly born and more vulnerable firms that have no collateral nor performance ratings must rely on initial insider finance, trade credit or angel finance. This is particularly relevant to start-ups and very small firms, "the most informationally opaque" (Berger et Udell, 1998)[32] enterprises and therefore the ones that face most of the impediments when accessing to external financing. By insider finance it is to be intended all those resources pooled by friends & family of the firm or personal savings of the owner(s) at the time or prior the time of the firm inception. Angel finance is referred to an informal market for direct finance where, usually high net worth, individuals invest in small companies typically negotiating common stock contracts and, by doing so, bypassing financial intermediation.

[31]Berger, Udell, (1998) "The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle", *Journal of Banking & Finance*, 22, issue 6-8, p. 613-673

[32] Ibidem

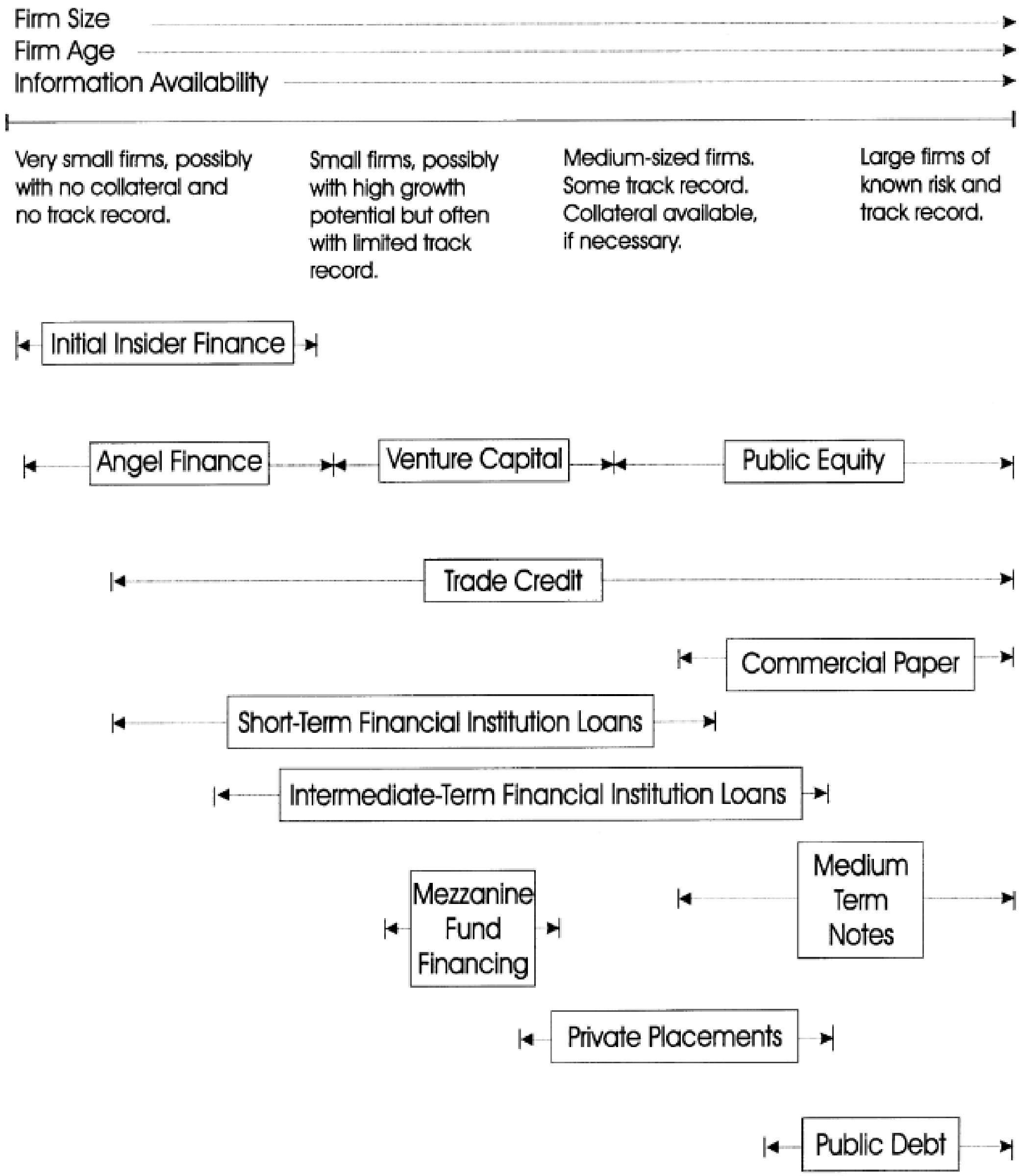

Table 11:“Firm continuum and sources of finance”[33]

This is a crucial step for the firm, as most enterprises might be undercapitalized during the early stage because of information opacity. As soon as the firm starts growing, and therefore successfully manages to survive the start-up phase, it gains access to financial intermediation in both the equity and the debt side. The middle phase is characterized by a wide population of firms that have great potential to growth, middle-sized

[33] Berger, Udell, (1998) “The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle”, *Journal of Banking & Finance*, 22, issue 6-8, p. 613-673

enterprises that have some collateral. Here, personal funding becomes less relevant as part of the operations are financed by earnings and " the overall accrual of firm's history mediates the access to trade credit and bank finance"(Berger , Udell 1998)[34]. As firms proceed further along this continuum, they are granted access to wider sources of external debt and equity capital. Finally, they eventually reach the latest stage where have access to a greater amount of capital in equity market and public debt. At this level, firm's size is considerably large, and the firm possess a great deal of known risk factors as well as track record.

This summary, that aimed at outlining the main academic findings related to the study of the capital structure decision, will introduce a more SMEs -specific analysis of the different sources of financing available.

Internal sources of financing

Self-financing plays an important role in the growth process of the SMEs, although with difference magnitude across countries and business sectors. Also referred as "insider finance", this source comprehends funds provided by the start-up team, family, or people closer to the firm. On average, this is the preferred option for start-ups due to their limited level of tangibles, no reputation, and no prior relationship with any financial institution. This "information opacity", indeed, makes external financing challenging to access ,at least during nascent stages. Also, from the point of view of the owner-founder, internal financing is ranked above bank finance and external equity because It does not involve "sacrificing a substantial ownership stake" (Berger and Udell, 1995)[35]. This consideration applies also to family business, that rely on inside finance or short debt in the event of financing new projects in order not to dilute excessively control. Empirical research illustrates that "almost a third of all SMEs in the EU rely exclusively on internally generated sources of revenue for their day-to-day operations and investments" (Moritz, Block and Heinz, 2017)[36]. The availability of

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[34] Berger, Udell, (1998) "The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle", *Journal of Banking & Finance*, 22, issue 6-8, p. 613-673

[35] Berger, Udell,(1995). Relationship Lending and Lines of Credit in Small Firm Finance. The Journal of Business, 68(3), 351-381.

[36] Moritz, A., J. Block and A. Heinz (2017), Financing Patterns of European SMEs: An Updated Empirical Taxonomy and Determinants of SME Financing Clusters.

internal funding varies across different European countries and for different firm sizes: the "empirical taxonomy of the SMEs financing pattern" developed by Moritz et al. showed how "solely internally financed SMEs result to be more often young and micro firms, especially single owner ones, with low degree of innovation and most likely operating in the service sector"(Moritz et al.2017)[37]. Also, the study highlights a correlation between internal financing as a unique source of financing and macroeconomics variables: there is a strong incidence of solely self-financed SMEs in economic environment that presents high inflation rate and volatility, low annual GDP growth rate, very low GDP per capita, more likely high unemployment rate.

External sources of financing

This section begins by considering the results of the SAFE[38] (Survey on the access to finance of enterprises) conducted by the European Central Bank in 2019, consequently will provide a description of relevant external sources of financing options for SMEs.
Banks are the main source of external finance for SMEs across countries. Until recent times, large literature argued that small banks in particular were more inclined to finance small and medium sized enterprises because particularly adapt to engage into "relationship lending": essentially a type of financing based on interpersonal and customized relationship between the financial institution and the customer, primarily based on soft type information gathered through continuous, direct contacts to mitigate the opacity issue; often referred as one of the SMEs financing obstacle. Nowadays, this concept eclipsed thanks to the wide number of financial products offered by the banks combined with an ever-increasing sophistication of the financial institutions that allows also large banks to enjoy a comparative advantage at financing SMEs.
External financing and, in particular, bank related products are predominant financing sources for European SMEs, as their use increases with firm size.

[37] Moritz, A., J. Block and A. Heinz (2017), Financing Patterns of European SMEs: An Updated Empirical Taxonomy and Determinants of SME Financing Clusters.
[38] "Survey on the Access to Finance of Enterprises "(SAFE) – April – Sept.2019 ECB – Euro system.

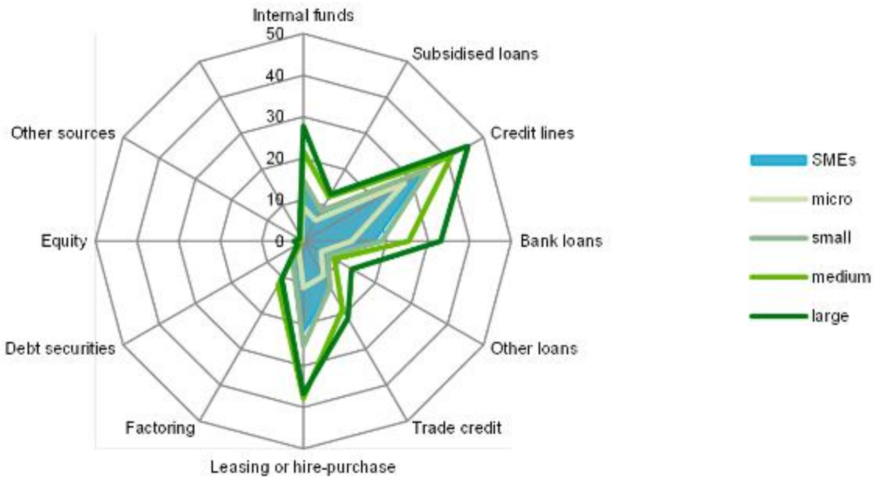

Table 12:Use of internal and external funds by euro area enterprises[39]

Short term bank finance (credit line, bank overdraft, credit card), in particular, remains the most popular choice. European SMEs continue to rely heavily on traditional debt instruments; however, the relevance of bank loans has been consistently decreasing. Debt financing (that comprises credit line, bank overdraft/ credit cards overdraft, leasing, factoring, trade credit, bank loan, subsidies loan, debt securities issued) accounts for 80% of the sources of financing of European SMEs from 2014 to 2019.

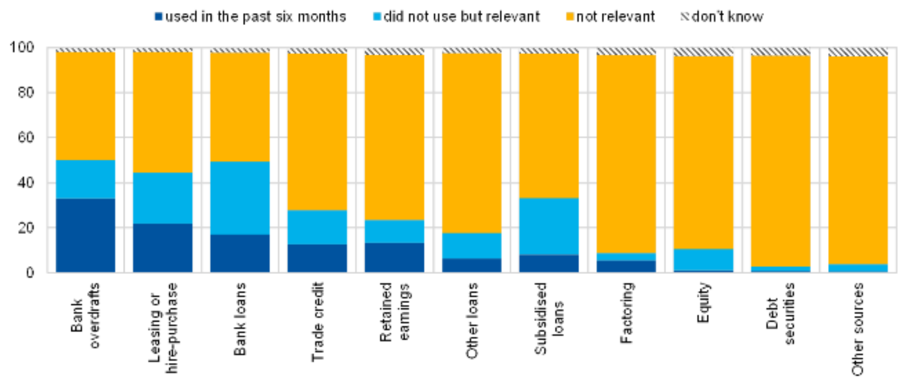

Table 13: Relevance of financing sources for euro area SMEs[40]

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[39] Survey on the Access to Finance of Enterprises "(SAFE) – April – Sept.2019 ECB – Euro system.

[40] Ibidem.

Bank Loans

In all EU member states, "80% of the SMEs used in 2019 some form of debt financing"(SAFE 2019)[41], the relevance of bank loans finance for SMEs in the eurozone is stable decreasing since 2014 yet bank lending is still the second most used source of SMEs financing. It is the preferred choice in the industry sector (21% of the firms in 2019). Bank lending , as the graph suggests, increases in relevance as the firm size increases.

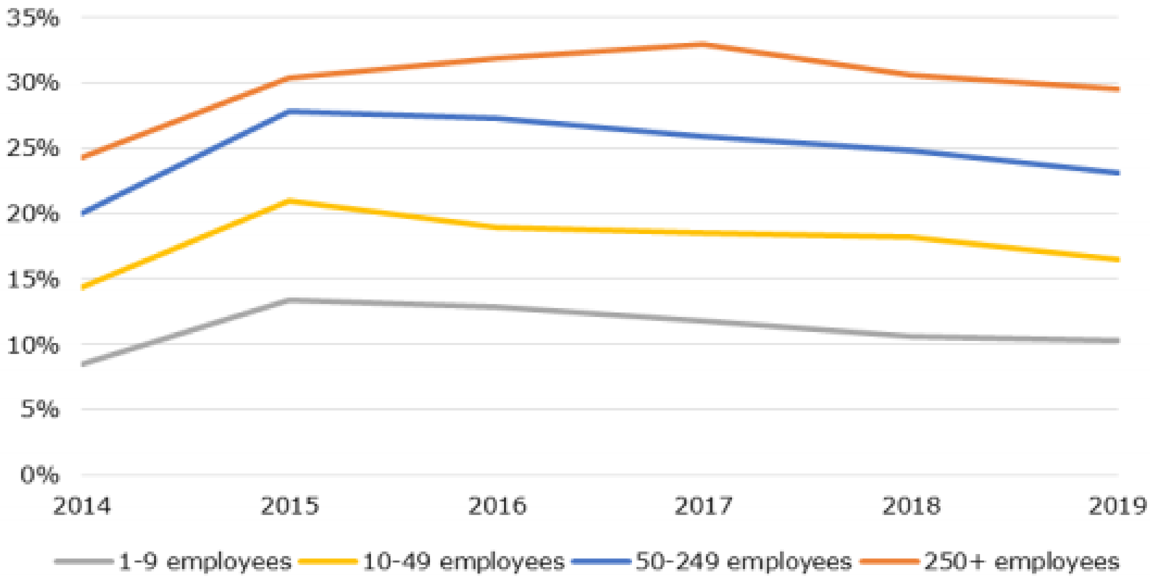

Table 14:Use of bank loans during April to September for SMEs EU28 2014-2019[42]

Bank overdrafts and credit lines , which are describe below, are preferred alternatives to bank loans for several reasons that will be explained later in this thesis. There exists in place also substantial impediments in accessing financing for some SMEs which will be covered extensively later in this section.

[41] "Survey on the Access to Finance of Enterprises "(SAFE) – April – Sept.2019 ECB – Euro system.

[42] Ibidem.

Bank Overdrafts and Credit Lines

Among traditional debt financing sources, business overdrafts and credit line are the "most popular choices" for EU28 SMEs. Essentially, overdraft borrowing happens whenever the firm execute an uncovered payment out of its current account. Overdrafts provide a safety net by granting access to financial resources that exceed funds availability: this provides the enterprise with greater cash flow flexibility to cover short-term funding needs. Overdraft often requires a collateral ("in this case it will be a secured overdraft") that will be liquidated in case of missed repayment. This is one of the main disadvantages of these particular sources of financing: young SMEs do not possess any asset to offer as a collateral, therefore they will be more exposed towards insolvency risk and will be required to pay a higher interest rate. Credit lines have essentially same features: it is an arrangement between the firm owner and a financial institution that establish a maximum amount that the customer can borrow, pay back and eventually borrow again: the lender decides whether to grant the loan, the repayment formula and the amount of interest according to the risk profile of the customer.

The main advantage of a line of credit vis-à-vis the traditional loan structure is that it allows the borrower to finance short-term financial needs and adjust repayment according to its cash flow: for example, settle the LOC payment in one solution. Credit line has same disadvantages of the bank overdrafts: this contract usually is secured, meaning that requires additional collateral from the customer perspective. The "information opacity" of the SMEs limits these newly founded enterprises to access unsecured bank overdrafts or credit line arrangements, as they require superior credit score which is completely absent in newly born firms. For more mature SMEs unsecured financing is a possibility, however it comes with higher interest rates, severe measures for late or missing payments and potentially a tendency to overspend.

4. Challenges Faced by SMEs in Accessing Credit Facilities

Small and medium sized enterprises generally rely on plain debt to finance their short-term cash flow needs and operations. In the aftermath of the financial crisis however financial institutions scaled back their lending in the process known as deleveraging: the result was that many SMEs faced obstacle in obtaining credit. At the end of the Subprime crisis , the recovery of the bank lending was hesitant, and the credit constraints further “highlighted the vulnerability of the SMEs sector to changing conditions in bank lending and regulations” (OECD , 2015)[43].

In more recent years , some categories of SMEs experienced easier access to credit and a general improvement of the economic environment: however, this has not “systematically led to more credit flowing to SMEs” (OECD 2018)[44]. Overall, large enterprises enjoy the benefits of an improved economy more than SMEs do as other segments of the SME population still faces obstacle to access to source of financing. A relevant example is provided by the following graphs: despite the moderate recovery of the economic conditions in the EU28 area in the past year, micro-enterprises, startups, young and innovative SMEs face a deterioration in both interest expenses, labor costs and other costs. This in turn has a negative impact on the firms’ turnover, which is one of the main indicators of creditworthiness from the bank perspective *de facto* impeding access to credit.

[43] OECD (2015), New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, OECD Publishing, Paris
[44] OECD (2018), Financing SMEs and Entrepreneurs 2018: An OECD Scoreboard, OECD Publishing, Paris

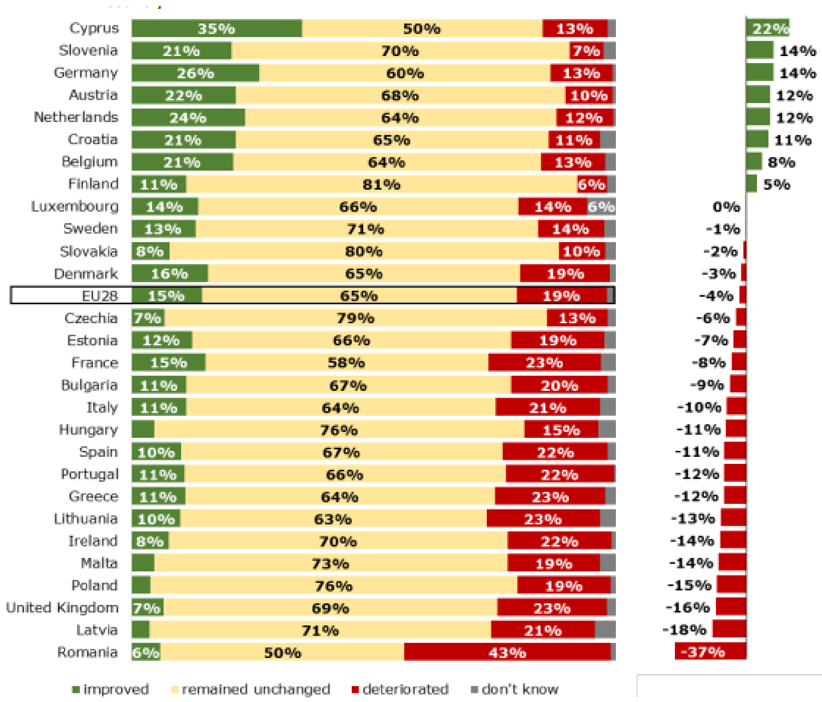

Table 15:Changes in interest expenses during April to September 2019 for SMEs in the EU28, by country”[45]

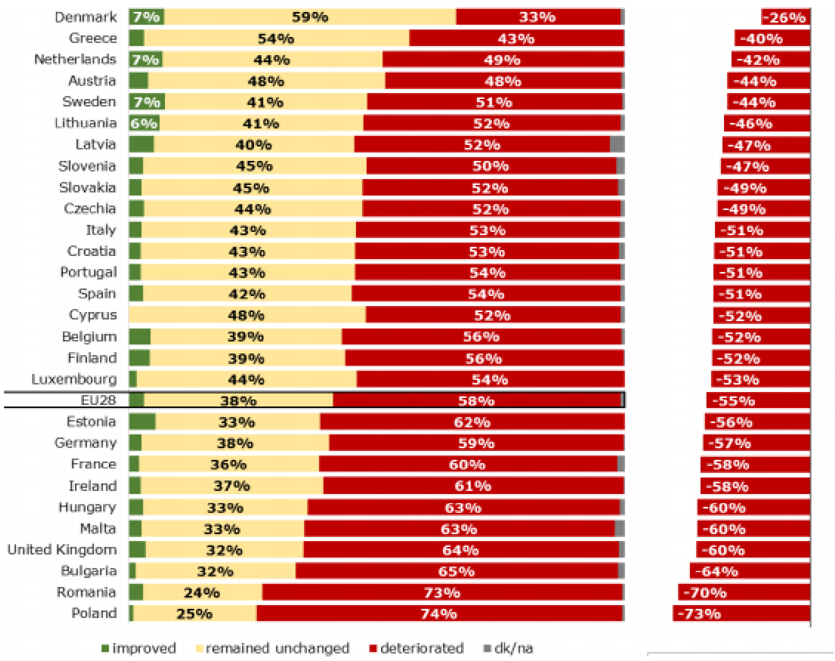

Table 16:“Changes in labor costs (including social contributions) during April to September 2019 for SMEs in the EU28, by country.[46]

[45] Source: European Central Bank – Eurosystem 2019
[46] Source: European Central Bank – Eurosystem 2019

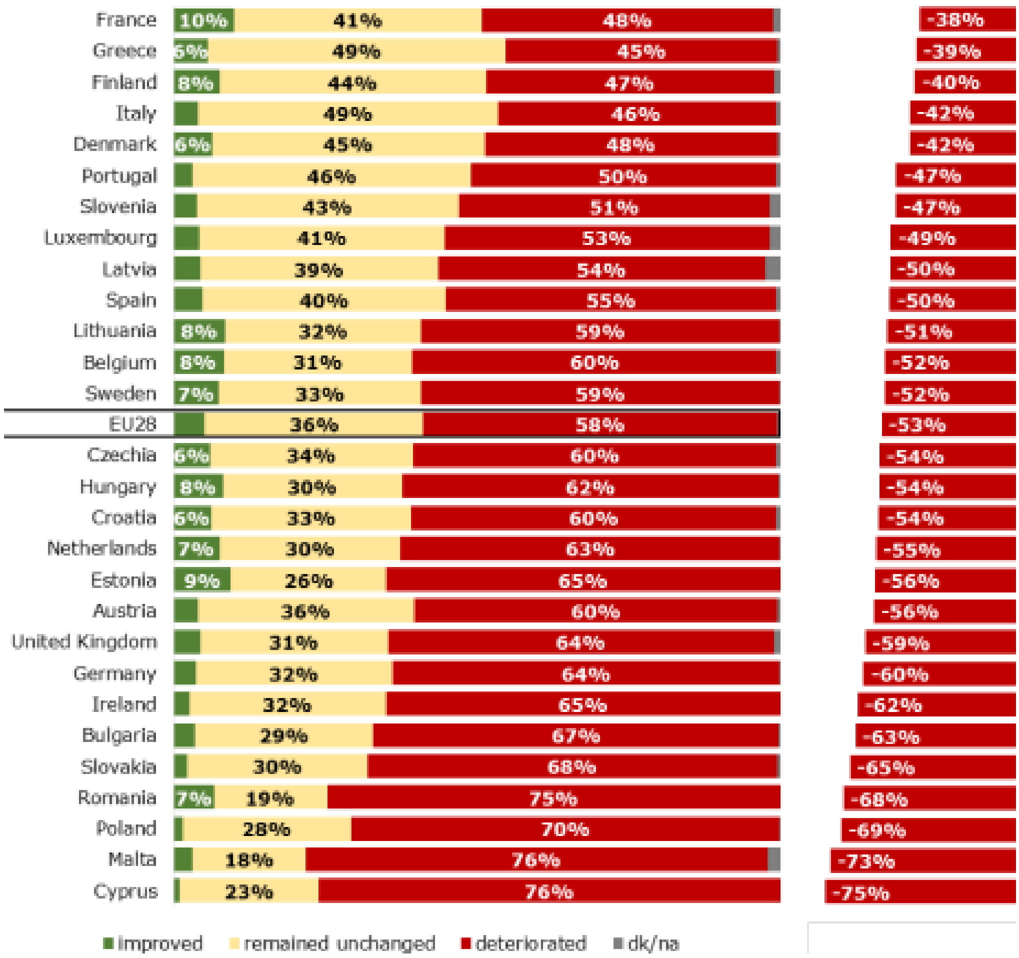

Table 17:"Changes in other costs (materials, energy, other) during April to September 2019 for SMEs in the EU28, by country"[47]

Another evocative data concerning the difficulties faced by SMEs in accessing financing is descripted in the table below. Apart from Portuguese and Dutch banks that faced an increase in loan demand and therefore eased the access to financing and French banks that experienced a decrease in loan demand, in all other countries bank tightened the supply of credit to SMEs while facing an increase in loan demand. This evidence shows an increase in the "financing gap" from bank supply perspective, bound to increase given recent turmoil in the global economy.

[47] Source: European Central Bank – Eurosystem 2019

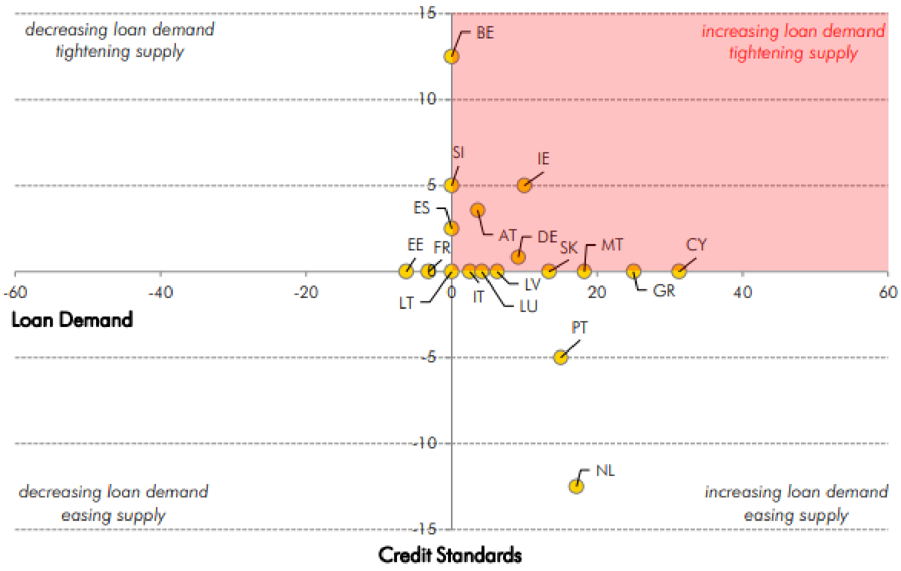

Table 18:"SMEs financing gap from a supply perspective" (HY1/2019)[48]

Economic conditions apart, there are other motives behind the unsuccessful relationship between banks and small enterprises. On the demand side, arguably "many entrepreneurs and owners lack the proper financial knowledge and the strategic vision to explore alternative path to straight debt financing"(OECD 2015)[49]. On the supply side however, "potential investors and institutional lenders face an overall opacity of the SMEs" (OECD 2015)[50] which is characterized by asymmetric information and a lack of exit options. Banks concentrate on "creating value under a controlled risk" (Pathrose 2005)[51], historically these institutions proved to be hesitant to lend to newly born small enterprises for several different reasons, that can be summarized as follow:

1. The lack of financial information and standardized financial statements that will result in information asymmetry.
2. The difficulty from the bank perspective in making qualitative assessment regarding possible bankable projects among all the available documentation.

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[48] Kraemer-Eis, Helmut & Lang, Frank & Gvetadze, Salome. (2013). European Small Business Finance Outlook. EIF Working Papaers. No. 20.

[49] OECD (2015), New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, OECD Publishing, Paris

[50] Ibidem

[51] Pathrose, P.P (2005),Banks must re-invent SME financing, The Hindu Business Line, 2018.

3. The high-risk profile associated to unsecured lending to SMEs, due to complete absence of additional collaterals, relevant financial and commercial track records.
4. The high failure rates of these enterprises and their low capitalization and market vulnerability.
5. The difficulty of assessing the technical and managerial skills of the firm's stakeholders, in terms of evaluating the "repayment ability" and the real profitability of the enterprise.
6. A legislative framework that seldom does not accommodate SMEs business nature, but in turns constitute a regulatory impediment towards SMEs awareness and discourage lending.

As a consequence of these impediments, SMEs viable financing options operates in modest-sized and illiquid markets, involving a reduced number of participants which drives down the desirability of investing in such business endeavors.

Alternative External sources of financing for SMEs

Although traditional bank financing will continue to be the most significant source of financing for most of the SMEs, expanding the spectrum of instruments to small and medium sized enterprises, by developing alternative external source of financing, would support long-term objectives of such enterprises and reduce their vulnerability also would integrate all those enterprises that historically were cut-out because missing financial and legislative requirements.

Low Risk/ Return	Low Risk/ Return	Medium Risk/ Return	High Risk/ Return
Asset-Based Finance	**Alternative Debt**	**"Hybrid" Instruments**	**Equity Instruments**
• Asset-based lending • Factoring • Purchase Order Finance • Warehouse Receipts • Leasing	• Corporate Bonds • Securitised Debt • Covered Bonds • Private Placements • Crowdfunding (debt) • Debt Funds / Loan Funds	• Subordinated Loans/Bonds • Silent Participations • Participating Loans • Profit Participation Rights • Convertible Bonds • Bonds with Warrants • Mezzanine Finance	• Private Equity • Venture Capital • Business Angels • Specialised Platforms for Public Listing of SMEs • Crowdfunding (equity)

Table 19:"Alternative external financing techniques for SMEs and entrepreneurs"[52]

[52] OECD (2015), New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, OECD Publishing, Paris

Not all the different techniques that are described in the table above are suitable to all the SMEs. The choice depends on several factors related to the firm such as the size, the "life cycle" stage, the risk-return profile associated to the particular enterprise, the scalability of the business and the management structure.

Provide an in-depth description of all possible alternative sources of financing as, given the increasing complexity of the financial markets and the technological integration with financial institutions, will be quite cumbersome. Therefore, this study will only touch upon the most relevant alternative instruments of external credit, their pros and shortcomings, as oppose to traditional debt available to EU28-SMEs.

Leasing and hire-purchase agreement

A proper definition of leasing, from an economic perspective, is to be found in the work of Fletcher et al. (2005)[53] : "a contract between two parties where one party , "the lessor" provides an asset for usage to another party, "the lessee", for a specified period of time, in return for specified payments".

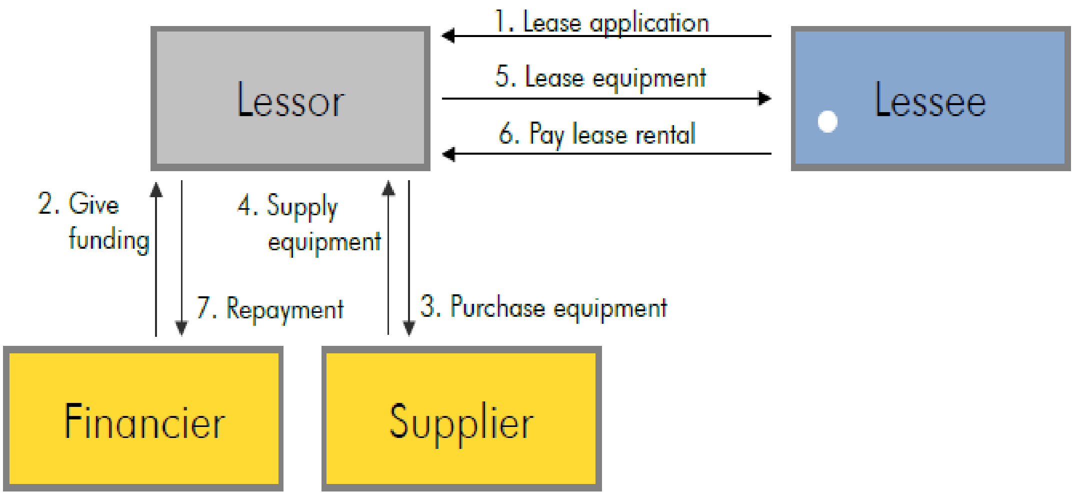

Table 20:The Leasing mechanism[54]

[53] Fletcher, M.; Freeman, R.; Sultanov, M. and Umarov, U. (2005). Leasing in development. Guidelines for emerging economies. IFC. 2005

[54] "Kraemer-Eis, Helmut & Lang, Frank. (2012). The importance of leasing for SME finance. EIF Working Paper.

Leasing is often categorized under "asset-based financing" practices (all forms of financing that are based on asset value rather than the debt capacity of the firm) and focuses on the capacity of the "lessee" to generate cash flows in order to pay for the use of the asset, while the "lessor" retains the ownership of the asset. A particular specification of the lease contract is the hire-purchase agreement: in this case the "lessee" transfers an initial down payment for the asset and pays the full amount plus interest in installments. Whenever there is no initial down payment and the ownership is then transferred at maturity , the hire purchase agreement falls within the scope of leasing financing. Leasing and hire purchase practices in the survey[55] that involved SMEs in the EU28 system appears to be the second most relevant types of finance for the 47% of the respondents, there are indeed several reasons that support this source of financing.

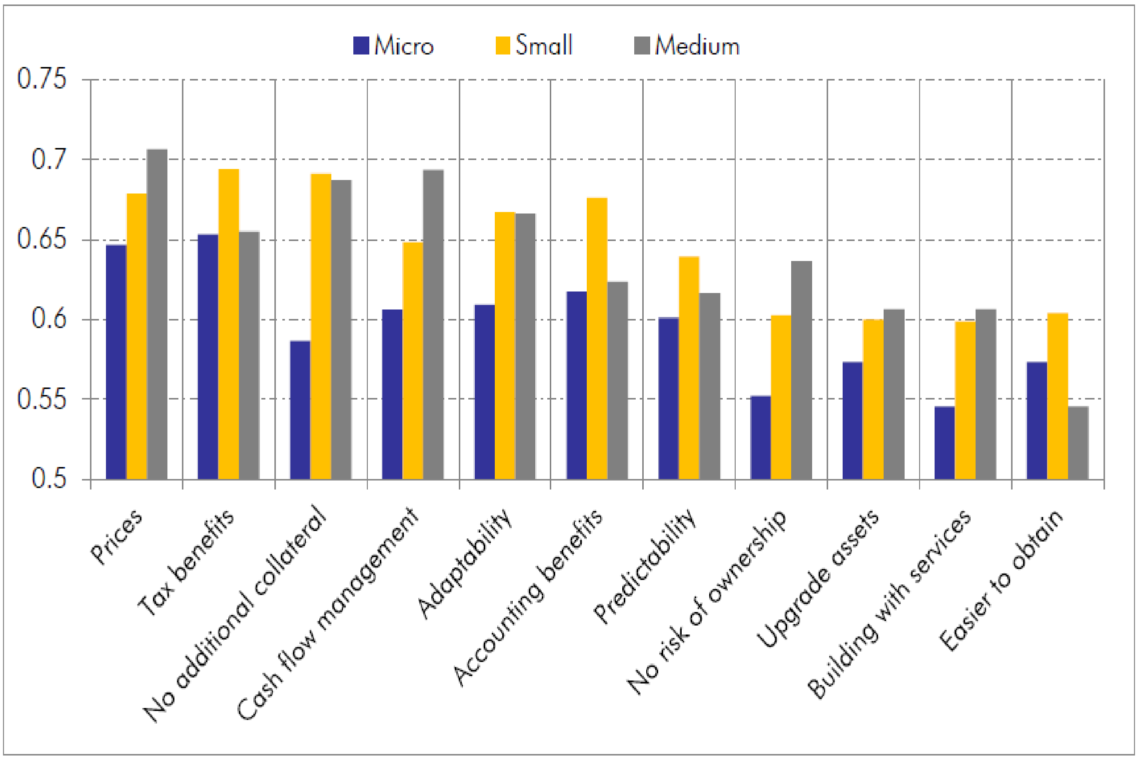

Table 21: SMEs' reasons to use leasing[56]

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[55] ECB(2019) "Survey on the Access to Finance of Enterprises "(SAFE) – April – ECB – Euro system.
[56] Source: "The use of leasing amongst European SMEs" – Oxford Economics (2011)

The graph above summarizes the main reasons behind the relevance of leasing as an alternative financing tool for small and medium sized enterprises. The decision seems to be ruled by price considerations: leasing is more convenient vis-à-vis other form of financing. Other considerations are that it leads also to better cash flow management and potential tax benefits. While the importance of a fiscal benefit might vary across countries due to different tax and regulatory environments, it is clear that leasing facilitates access to finance and therefore is a preferred alternative option to straight debt since enables young enterprises to overcome the information asymmetry limit and the opacity issue previously discussed. Indeed, this type of financing does not require collateral nor a credit track record, arguably two of the most pressing difficulties faced by SMEs in attempt to access traditional financing.

Bonds issuance

A naïve definition of a bond might take this form: it is an obligation issued by a company, that agrees on paying interest over a principal and to reimburse the principal at maturity. Despite the ease of this preliminary explanation, bonds and fixed income spectrum of securities come in different flavors and involve a high degree of sophistication: to investigate such complexity , despite its attractiveness, goes well beyond the scope of this paper. Essentially, they can be classified according to maturity, credit quality, and type of interest into a variety of cases.

Bond characteristics	Typologies
Maturity	Short-term (< 3 years)
	Medium-term (4-10 years)
	Long-term (>10 years)
Coupon rate	Fixed rate
	Floating rate
	Zero-coupon
Credit quality	Investment grade
	Non-investment grade (high-yield or speculative)
Priority claim	Senior debt
	Subordinated debt
Collateral	Secured debt
	Unsecured debt (debenture)

Table 22:"Corporate bonds by characteristics"[57]

[57] Source: What Are Corporate Bonds? (2013), Investor Bulletin, US Securities Exchange Commission, Office of Investor Education and Advocacy, www.sec.gov/investor/alerts/ib_corporatebonds.pdf

Corporate bonds are a considerable source of alternative financing for mid-sized firms that can meet the requirements imposed by market regulators linked to bond issuance. In a low interest rate financial environment, bonds might represent an attractive alternative to plain debt as the firm can set advantageous rate for the coupon payments over the life of the security. Also, bonds allow fund raising without excessively dilute the ownership or without major firm control loss, another advantage of this financial instrument.

The issuance of corporate bond, as a tool to raise financial resources, however is mostly a prerogative of large companies: indeed, the latter can easily obtain credit ratings and issue large denomination bonds that seldom are sold via private placement to institutional investors. Despite few European national initiatives (for examples Italian “Mini bonds”), bond finance for SMEs seems not a popular option. Indeed, these enterprises are not key player in corporate bonds market as there are some impediments that limits the attractiveness of SMEs from the investors’ perspective: the absence of rating , the high cost involvement in monitoring and analyze these enterprises, the absence of firms’ collateral hence the high risk profile associated to such enterprises.

These negative features (low liquidity, lack of transparency, rating absence and superior risks) overall lead to a low perceived quality of the investment, that discourage the market-maker to add such asset in its platform. In addition to the list of impediments so far described, SMEs bond issuance is unpopular also because it involves significant costs and exhaustive reporting: many young and innovative firms cannot afford bearing such expenses in early stages. Another unappealing future of bonds for SMEs concern the settlement formula: the fixed schedule imposed by interest payments requires a stabile cashflow , missing one of those payment will expose the enterprise towards default risk.

Private Equity

	Stages	Definition*
Venture capital	Pre-seed/Seed	Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase
	Start-up/ Other early stage	Financing for product development and initial marketing. Companies have not sold their product commercially and are in the process of being set up.
	Later stage venture	Financing for the expansion of an operating company.
Other Private Equity	Growth	Investment in relatively mature companies that are looking for capital to expand into new markets or restructure operations.
	Buyout	Financing to acquire a company. It may use a significant amount of borrowed money to meet the cost of acquisition.
	Replacement	The purchase of a minority stake of existing shares in a company from another private equity firm or from another shareholder or shareholders.
	Rescue/Turnaround	Financing made available to an existing business in difficulty, with a view to re-establishing prosperity.

Table 23:"Private Equity by Stage"[58]

Private equity comprises a range of external financial instruments that "allows the enterprise to obtain external private resources in exchange for a stake in the firm's ownership"(OECD 2015)[59]. Enterprises that are involved in P.E. investing are not listed in any public stock exchange and are mostly financed from early stage until maturity. These funds "scout" for companies with high potential to grow or companies that needs a "restructuring": the main objective is to provide capital, through an open-ended investment that will last on average 5 years , transform the enterprise (by bearing all the risks) and profit from exiting the investment (either via an IPO or by liquidating the stake of the ownership). Private equity is further distinguished into "Venture Capital" and "Other Private Equity": while the latter revolves around more mature businesses, the former focuses on newly born enterprises. Venture Capital is an essential source of financing for young , start-ups and innovative SMEs: indeed, it

[58] Source: "OECD (2014), Entrepreneurship at a Glance 2014, OECD Publishing, Paris"

[59] Source: OECD (2015), New Approaches to SME and Entrepreneurship Financing. Broadening the range of instruments, OECD Publishing, Paris

allows to bridge the gap caused by asymmetry and lack of collaterals and track records"(OECD 2015)[60], typical of disruptive newly founded enterprises.

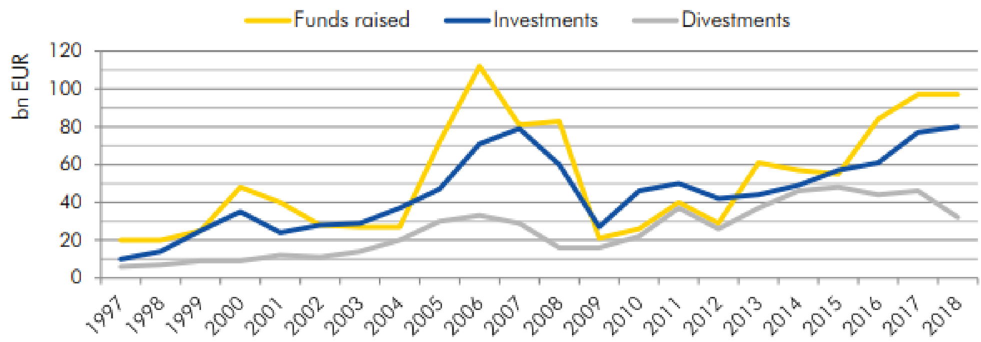

Table 24:"Fundraising, investment and divestment amounts by PE firms located in Europe"[61]

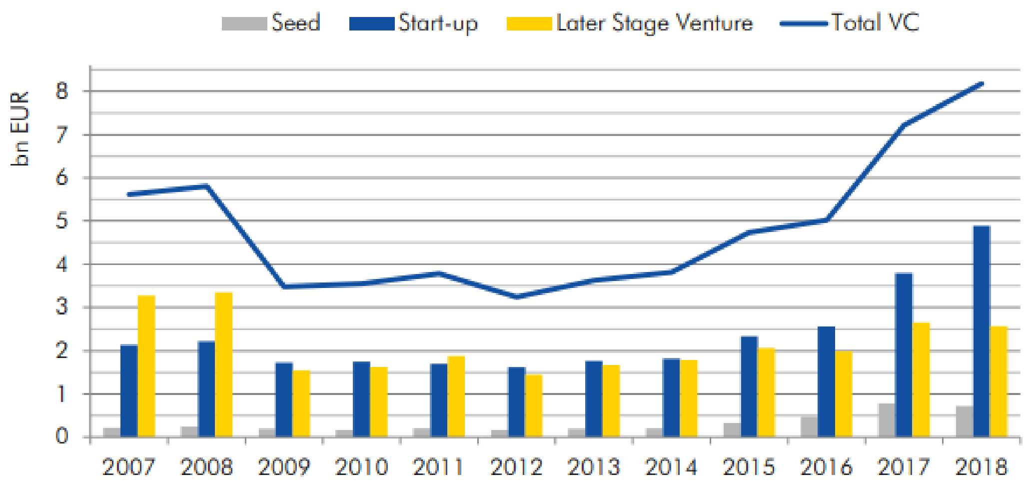

Table 25:"VC investment amounts by stage focus"[62]

In recent years (2017 onwards), Private Equity investment increased at a consistent pace in the European economic system. Venture Capital rose consistently from 2013 onwards (13% only in 2018) and represents the majority of PE investments. Within the VC segment, data also show an increase in Start-up investing (+30%), an evidence in

[60] OECD (2015), New Approaches to SME and Entrepreneurship Financing. Broadening the range of instruments, OECD Publishing, Paris

[61] Source: Helmut Kraemer-Eis et. al. "European Small Business Finance Outlook" – EIF Luxembourg June 2019.

[62] Source: Helmut Kraemer-Eis et. al. "European Small Business Finance Outlook" – EIF Luxembourg June 2019.

support of the importance attributed to PE as an external non-bank related source of financing for young, disruptive EU28 SMEs.

Public Equity Listing

Listing a company in a publicly traded stock exchange is one of the fundamental decisions taken by a privately owned firm. In the financial literature, this process is called “Initial Public Offering” (IPO). Usually, the interest in going public consolidates at a mature stage of the enterprise’s life cycle, possibly as a result of an existing strategy by a Venture Capital investor or whenever the company feels the need for additional resources to scale up the business. There are several steps to follow prior issuing new stocks in the market, many requirements to fulfill to be listed and some expenses to be matched along the process. The list of requisites changes across countries, mainly to differences in the legal framework and in the fiscal regime, however the mechanism follows almost the same steps in each European member state due to regulation at EU level. To provide the reader with a better insight of the listing process a short description of the Italian Listing process, for this purpose taken as reference, will follow:

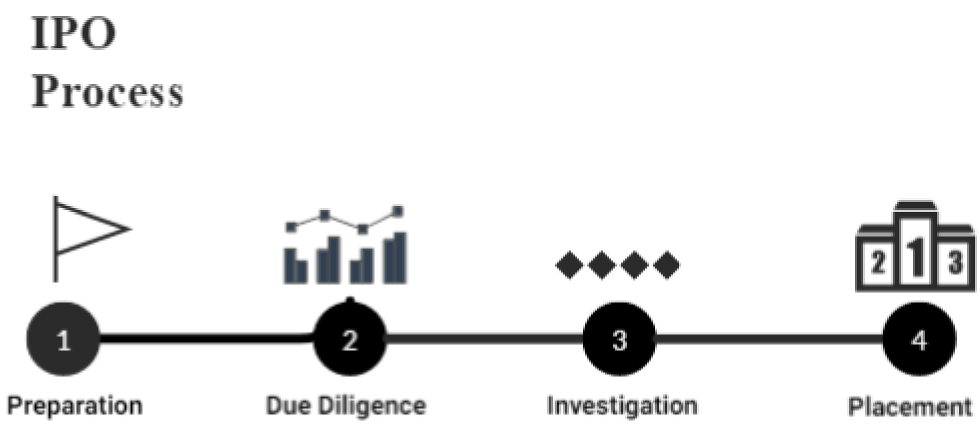

Table 26: "The IPO Process"[63]

[63] Source: Adapted from https://www.borsaitaliana.it/azioni/mercati/mercati - landingpage/slidedoc_pdf.htm

The average listing process takes from 6 to 8 months and involves several steps:

- **Preparation**: this is the preliminary step in which the firm analyzes IPO main reasons, appoints advisory board, coordinator and sponsors and the legal advisory board. This is also the frame in which the firm proceeds to reorganizing the business, the governance and implements controlling mechanism suitable for the firm and the targeted market. Also, it begins the drafting of the documents according to accepted accounting standards.
- **Due diligence**: In this step the enterprise drafts the business plan, file a prospectus of the offering, and perform business, legal and financial due diligence. The firm chooses also which market and the horizon of the listing process.
- **Investigation**: This step involves CONSOB, the public authority that regulates Italian financial markets and Borsa Italiana itself. In a process that lasts up to two months, the authorities audit the reliability of the data and the fulfillment of prerequisites prior the market admission.
- **Placement**: Last stage, involves organizing roadshow both at home and abroad to ”test the water” regarding a potential price for the to-be-issued securities and to attract potential investors. Placement also involves the book building practice for institutional investors.

IPOs worldwide faced a structural decline in the past decade, both in the quality and quantity of transactions. In particular, in Europe starting from the late 90’s there was a sustained decline in listing popularity, especially from the point of view of smaller and younger companies: this represents an additional loss to overall economic environment because these enterprises have higher growth potential vis-à-vis larger businesses.
The amount of SMEs financing that is provided by equity market is not considerably large. A coordinated plan of actions among capital markets and the banking system is necessary to incentivize small IPOs and trigger growth: at the end, public equity (as many other sources of external financing belonging to capital markets) should be seen as a complementary to traditional debt financing. Compared to US, where equity markets are more developed, in Europe bank financing continues to be the most

“predominant source” of financing for small and medium sized enterprises. There are several impediments to the development of capital markets in Europe, even though might be the most appropriate source of financing for a long-term solution to the pressing funding problem.

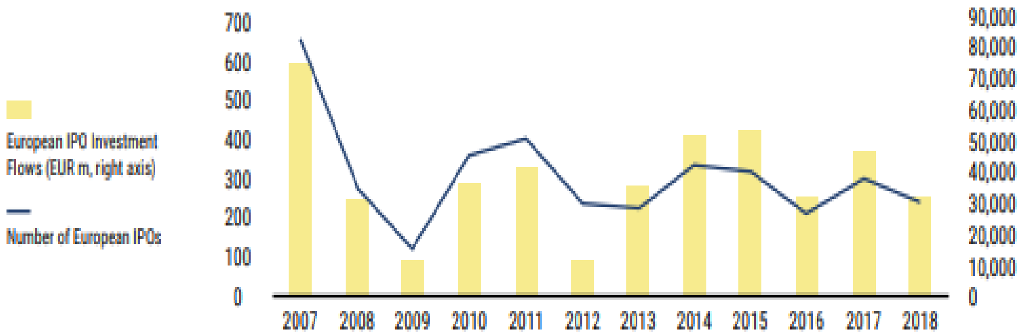

Table 27:“Evolution of European IPO markets 2007-2018”[64]

A wider use of this financing tool is hindered by disproportionately high admission costs as well as listing requirements: there are many expenses to be matched prior entering the market, hence an IPO results in a very expensive financing alternative for SMEs. The listing process involves (among others) admission fees, advisory fees, and broker commissions. In addition, there is also the indirect cost of heavy reporting, that is required to be considered eligible, and which represent another burden faced by the firm. Furthermore, SMEs have “substantial structural disadvantages that arise from limitations inherent to their nature” (Nassr et. al. 2016)[65]: irregular cashflow streams, lack of tangible collaterals, lack of transparent and standardized information, reduced visibility and attractiveness among investors are some of the obstacle faced by SMEs in accessing equity markets. On the other hand, public equity market listing has its benefits: other than providing a long-term sustainable source of financing for SMEs it

[64] Source: European IPO report 2020 – FESE

[65] : Nassr I.K. and G. Wehinger (2016), “Opportunities and limitations of public equity markets for SMEs”, OECD Journal: Financial Market Trends, Volume 2015/1.

will also contribute to increase their creditworthiness, transparency, and credibility. In addition, from the admission on, the firm will be strictly monitored by market authorities: this will indirectly encourage superior governance, increasing the quality of management practices and performance coverage. From the IPO further on, there will also be an increase in sophistication of the investor pool and enhance risk allocation thanks to the market.

Given the impediments faced by SMEs and their structural limits, many commentators root in favor of the development of a “SMEs specialized equity ecosystem”(Nassr et. al.)[66]: a dedicated platform linking companies with growth potential to a variety of financial institutions and custom made service providers. In this dedicated environment there e many participants serving different specialized functions, tailored to the needs of the issuer: investment banks, legal and financial advisor, authorities , analysts, and market makers, among others, cooperate in providing help to the issuer.

A healthy ecosystem made of a large number of participants would benefit the SME pre and post the quotation process. Arguably, it will reduce the information asymmetry that is typical of the SMEs fragmented sector, it will facilitate the access to financing and listing by reducing costs, it will enhance the quality and reduce the difficulty in data collecting and processing. Ultimately, there is also a need for a series of policies that consider the heterogeneity and complexity of SMEs nature in relationship to financing matter. A new regulatory framework, backed by the government and international legislative bodies, will be beneficial to promote SMEs awareness, trigger the discussion around equity market, increase financial literacy and equity culture, still underdeveloped in Europe.

[66] Nassr I.K. and G. Wehinger (2016), “Opportunities and limitations of public equity markets for SMEs”, OECD Journal: Financial Market Trends, Volume 2015/1.

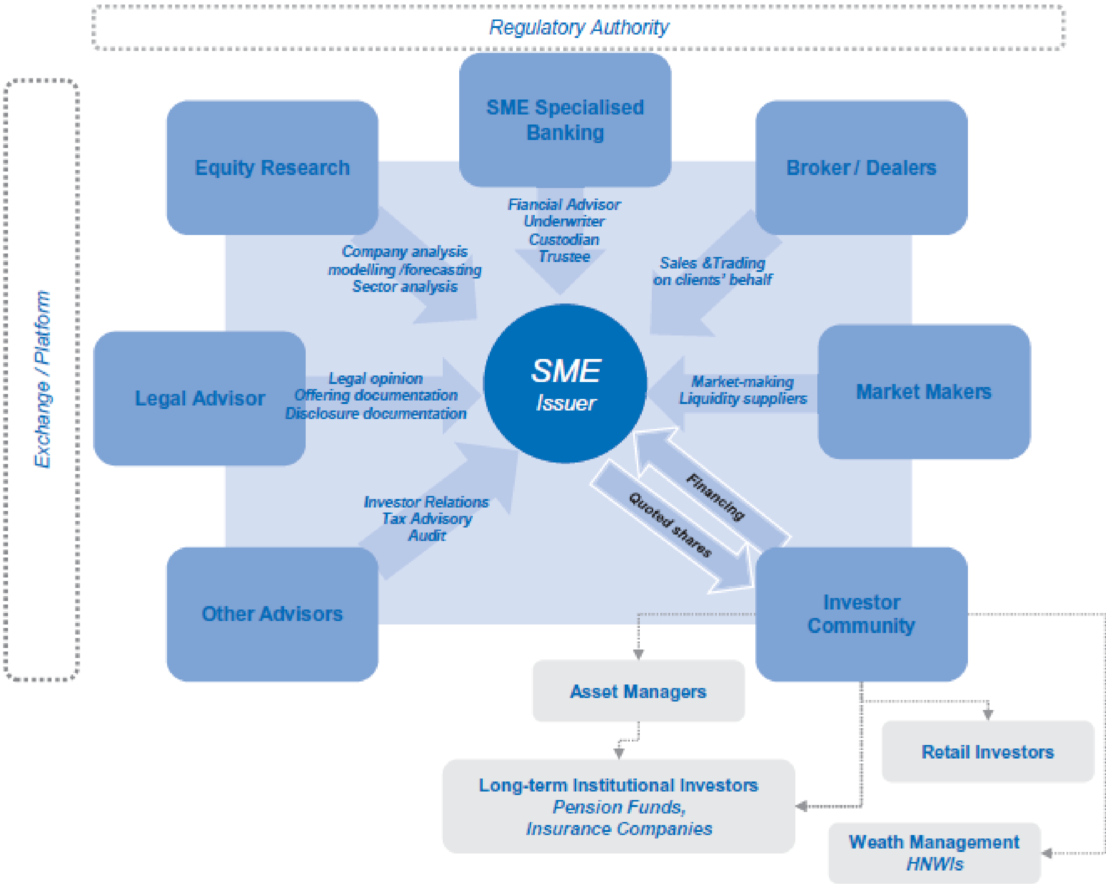

Table 28: "A valuable ecosystem for SME equity offerings"[67]

[67] Nassr I.K. and G. Wehinger (2016), "Opportunities and limitations of public equity markets for SMEs", OECD Journal: Financial Market Trends, Volume 2015/1

5. Italian SMEs Sources of Financing

Class size	Number of enterprises			Number of persons employed			Value added		
	Italy		EU-28	Italy		EU-28	Italy		EU-28
	Number	Share	Share	Number	Share	Share	Billion €	Share	Share
Micro	3,599,695	94.9%	93.0%	6,719,319	44.9%	29.7%	208.1	28.4%	20.8%
Small	172,324	4.5%	5.9%	3,088,490	20.7%	20.1%	151.8	20.7%	17.6%
Medium-sized	19,226	0.5%	0.9%	1,873,898	12.5%	16.8%	131.0	17.9%	18.0%
SMEs	3,791,245	99.9%	99.8%	11,681,707	78.1%	66.6%	490.9	66.9%	56.4%
Large	3,380	0.1%	0.2%	3,270,222	21.9%	33.4%	242.5	33.1%	43.6%
Total	3,794,625	100.0%	100.0%	14,951,929	100.0%	100.0%	733.3	100.0%	100.0%

Table 29: "SMEs basic figures"[68]

The predominance of SMEs in the Italian economic background is not a matter of debate: indeed, these enterprises account for almost 70% of the Italian non-financial business economy, consistently higher than the European average. Small and medium sized enterprises in Italy employ the majority share of the workforce, almost half of it represented by micro-firms' employees.

Access to Finance and Italian Capital Markets

Access to source of financing for small Italian enterprises is subpar vis-à-vis European SMEs average. As also discussed in the previous section, EU economies suffered from the credit crunch imposed by the financial institutions as a reaction to the 2007 Global financial crisis: with no exception, Italy also was severely impacted by the financial turmoil following the subprime incident. A series of domestic measures, combined with international initiatives, caused a sluggish improvement of the country's economy, that still struggles to fully recover. Traditional banking remains "the most important source of external financing" (OECD 2020)[69] for Italian SMEs: overall, in order of relevance, credit lines bank loans and trade credits were "the most popular options"[70]. Equity

[68] Source: SBA Factsheet – 2019 European Commission.
[69] OECD (2020), Financing SMEs and Entrepreneurs 2020: An OECD Scoreboard, OECD Publishing, Paris.
[70] "Survey on the Access to Finance of Enterprises "(SAFE) – April – Sept.2019 European Central Bank (ECB) – Euro system

capital accounted only for 1%[71] of the total amount financed. Arguably, a well-functioning capital market could represent a turning point for the country economy , and will be fundamental to boost employment, productivity, and innovation. Few research[72] emphasize that there are still in place numerous “structural impediments” towards the development of the country economy as a whole: excessive and anachronistic bureaucracy in the relevant decision making process, the lack of transparency and accountability, frequent and unclear political changes, a fragmented market made of highly leveraged and undercapitalized SMEs, a limited access to legal and justice services and poor law enforcement, a prohibitive tax regime are, among others, recurrent issues that require reforms in several sectors in order to restore confidence in the Italian market and incentivize economic growth. These issues pose an additional challenge towards unlocking alternative SMEs external financing and the growth of capital markets.

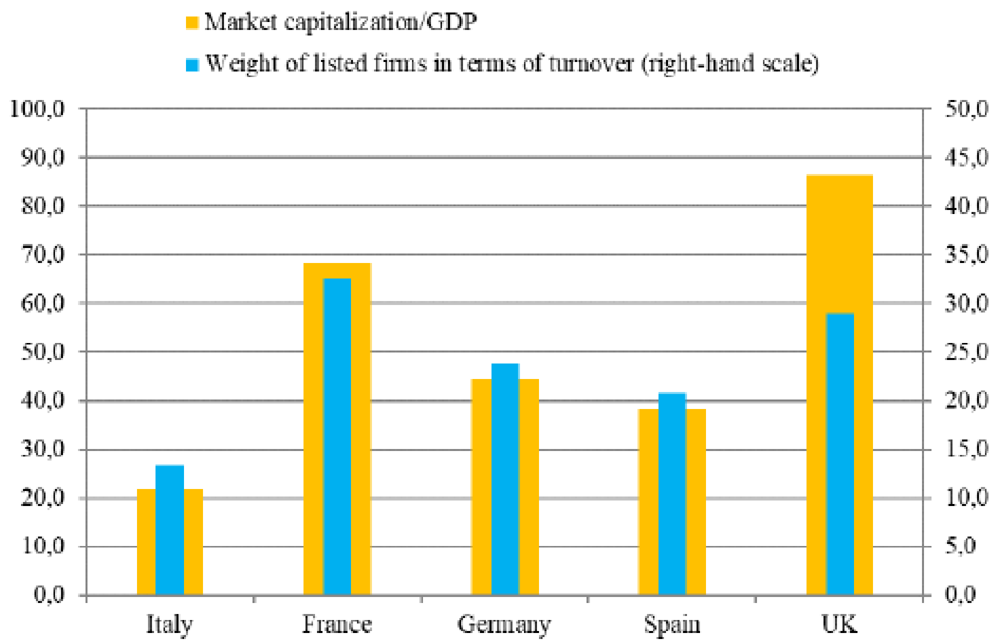

Table 30: “Size of the stock market for non-financial companies in 2016"(in %).[73]

Several domestic initiatives were introduced in Italy, in the past years, to stimulate the

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[71] ECB (2019) “Survey on the Access to Finance of Enterprises “(SAFE) – April – Sept.2019

[72] For example, “OECD Economic Surveys: Italy 2019” – OECD

[73] Finaldi Russo et. al. (2020) “Firms’ listings: what is new? Italy versus the main European stock exchanges” 2020 *Bank of Italy Occasional Papers*

use of alternative external funding opportunities, to promote stock exchange listing and bond financing. Despite these efforts, Italian capital markets are still underdeveloped vis-à-vis European countries.

IPOs and public equity market

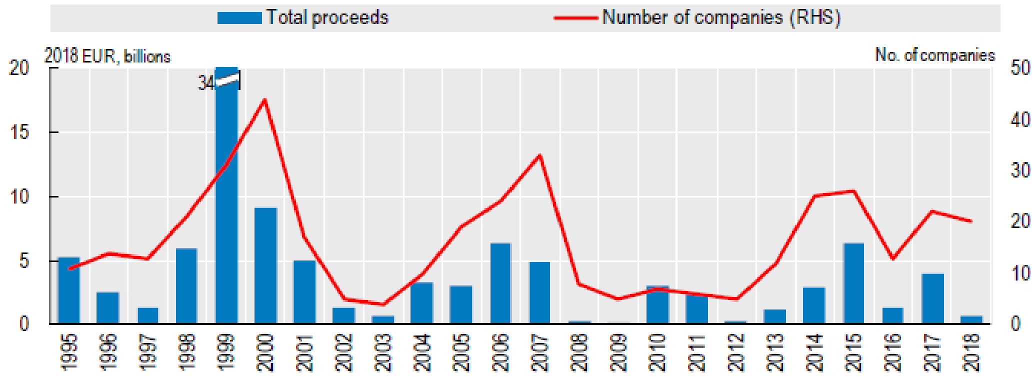

Table 31: "Initial Public offerings by Italian Companies"[74]

Initial public offering activity in the Italian market rose during the '90s , reaching a peak in 1999. From that moment onwards, the number of IPOs was irregular and overall raised less capital, compared to historical performances. The Global financial crisis hindered the IPOs activity: the subprime turmoil in 2008 and later the sovereign crisis of 2012 were the periods of lowest listing.

LISTING	30 DEC 2019	30 APR 2020	29 MAY 2020
MTA Domestic	239	236	237
of which STAR	77	75	75
MTA Foreign	3	3	3
of which STAR	1	1	1
MIV *	1	1	1
Global Equity Market	87	87	87
AIM Italia - MAC	132	129	127
Listed companies total	**462**	**456**	**455**

Table 32: "Borsa Italiana Listing – Monthly Update"[75]

[74] Source: OECD (2020), OECD Capital Market Review of Italy 2020: Creating Growth Opportunities for Italian Companies and Savers, OECD Capital Market Series.
[75] Source: Borsa Italiana Analisi e Statistiche – Monthly data update May 2020.

This downward trend is not, however, exclusively an Italian occurrence but rather a European decline.

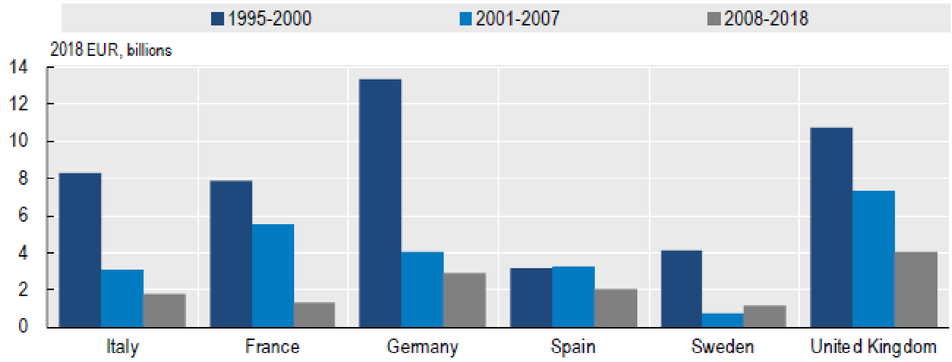

Table 33: "IPOs by non-financial companies from Italy and selected European Countries"[76]

Limits of the initial public offering

The Italian equity market is underdeveloped vis-à-vis other relevant European economies. In recent years, the stock exchange has recorded a significant drop in the number of listed firms, loosing *de facto* the ability to reflect a rather robust economic network made of enterprises located throughout the entire country. Empirical evidence shows how there exists a series of factors that might discourage the decision to go public, from the owner-founder perspective:

- Governance restructuring.
- Red tape ,mandatory reporting requirements.
- Excessively dilution of ownership.
- Mandatory periodic investors relations costs.
- Direct and indirect Listing costs (very expensive for micro-firms).
- Legal, financial, and fiscal advisory costs.
- Brokers, dealers' fees .
- Post-listing monitoring expenses.

[76] OECD (2020), OECD Capital Market Review of Italy 2020: Creating Growth Opportunities for Italian Companies and Savers, OECD Capital Market Series.

In addition to these factors, Giordano et. al. (2017)[77] argue that seldom "the IPO process is discarded in favor of alternative sources of external financing such as venture capital, more suitable for smaller investment (due to lower costs) and easier to arrange". Especially in Italy, where a vast number of firms are family-owned the involvement of managers and other members, external to the family might also contributes to avoiding the listing. Lastly, in general a lack of "financial literacy" and "equity culture" might also represent an obstacle: there is still low awareness of the benefit of such financing tool and, due to the limited size of such companies and for historical reasons, there is also a rather conservative attitude towards risk taking.

AIM Market

The Aim market is a "multilateral" trading facility administered by Borsa Italiana and entirely focused on firms with high potential, mainly Italian young and innovative small and medium sized enterprises. Created in 2009, it allowed trading activity to institutional and retail investors.

Essentially, AIM is an alternative "middle-tier equity market" that provides same services and benefits of the regular one, with some additional features. Indeed, it provides the newly listed firm :

- Resources to stimulate growth and realize new projects.
- Increased market visibility and brand awareness for potential investors, competitors, and customers.
- Increased reporting standard quality, which ultimately improve the transparency of the firm best practices and the value of the firm.
- Support to grow internationally.
- A tool to assess the value of the firm and to keep track of performances.

[77] L.Giordano , M.Modena (2017) "Implicazioni e possibili motivazioni della scelta di non quotarsi da parte delle medie imprese italiane" – Discussion Papers CONSOB

	MTA standard	MTA STAR	AIM
Floating rate	25 per cent	35 per cent	10 per cent
Certified balance sheets	3	3	1 (if it exists)
Accounting standards	International	International	Italian or international
Investors	Institutional/retail	Institutional/retail	Mainly institutional
Main document	Information statement (prospetto informativo)	Information statement (prospetto informativo)	A simpler document with some information
Market capitalization	Min 40 milion	Min 40 milion – Max 1 billion	No requirement
Governance	Recommended	Compulsory	No requirement
Principal advisor	Sponsor/Global coordinator	Sponsor/Global coordinator	Nominated advisor

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Table 34: "Eligibity and admission requirements to listing on the Italian stock exchange"[78]

The most important feature of this alternative market is that, compared to the standard exchange (MTA), it has significantly "more relaxed" admission requirements and lower costs, in addition to a simplified IPO process. Indeed, it does not require a prospectus, there is no minimum capitalization , no mandatory trimestral reporting , no requirements for corporate governance. Finaldi Russo (2020)[79] argues that "the launch of this second-tier market spurred incentives to go public for Italian non-financial companies , thanks to less burdensome IPO and post-IPO compliance rules". While being pivotal in boosting the Italian IPOs performances, investors have not reached a "consensus" on the financial credibility and economic performances of firms entering the AIM market, since price dynamics and operating results of this market segment are still missing. Arguably , despite this recent innovative introduction, the popularity of the country equity market is still far from representing the industrial potential of the nation: the growth of the Italian stock market seems still limited by "structural factors". Therefore, there is a growing need for policy measures aiming at fostering SMEs listings on the market, given their relevance for the country and for the entire EU28 system.

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[78] Finaldi Russo et. al. (2020) "Firms' listings: what is new? Italy versus the main European stock exchanges" 2020 *Bank of Italy Occasional Papers*

[79] Ibidem.

The European small and medium sized enterprises , as also previously discussed in this paper, are key players in the EU-28 economic environment, given their relevance in terms of employment , innovation and value added. Despite their relevance for the economy , SMEs potential is yet to be fully expressed partly due to their excessive reliance on traditional bank lending, partly due to a limited access to capital markets financing . The significant exposure of these enterprises towards the risk of bank dynamics and macroeconomics factors (for example , a credit crunch during recessionary periods) affects heavily SMEs vulnerability, which is already steep if compared with other type of businesses. European SMEs network is made of ,mostly, local and "heterogenous" firms that faces different obstacles while attempting the access to alternative sources of credit : in spite of such rich diversity there seems to be few repeating motives of the SMEs exclusion from capital markets financing instruments(OECD 2015)[80].

1. ***"SMEs Data deficiency and the absence of an adequate platform for information sharing"***

   A major obstacle faced by SMEs in accessing alternative instruments of financing is the absence of high-quality data concerning the creditworthiness of the firm: indeed, this information asymmetry combined with the high costs of researching and monitoring these enterprises discourage potential investors.

2. ***"The absence of a SMEs-centered financial environment"***

   There is a need for the development of a SMEs-centered environment that could support these firm in accessing capital markets and provide tailored services to such firms. A joint effort made of specialized figures such as brokers, advisors, banks, equity researchers and investor community that ultimately can enhance SMEs transparency and increase firms' market participation.

3. ***"SMEs educational gap"***

   there is a lack of awareness regarding possible alternative financing instruments

[80] OECD (2015), "Opportunities and constraints of marked-based financing for SMEs", OECD's report to G20 finance ministers and central banks governors.

available to these firms. Entrepreneurs seldom do not possess the appropriate financial literacy (especially when they confront themselves with the equity market) to exploit these financing options or prefer avoiding excessive risk-taking by refusing any alternative source to traditional debt financing.

These motives , among others , explains why SMEs depends on traditional debt financing as a primary source to satisfy their cashflow needs and projects. Clearly, given the high fixed costs involved in "relationship building" , credit rating , and monitoring of small and medium sized enterprises , a "complete separation from customary debt practices is far from being achievable".(OECD 2015)[81] On the other hand ,developing capital markets as a "complementary source" of plain debt would be a great opportunity to increase SMEs resilience to macro shocks, and especially in periods of recession, grant them access to a pool of resources from institutional and alternative investors. To serve this purpose, several domestic and international initiatives were introduced by policy makers.

6. Policies facilitating SMEs access to capital markets

Domestic measures

The Italian capital markets are considerably under-developed compared to the European counterparts. Previously , this paper analyzed empirical evidences from the Italian stock market and provided a list of possible factors that might discourage the IPO process. Concerning the equity market, one of the domestic measures, taken by the "Italian Stock Exchange", to incentivize local company listing is indeed the introduction of the "AIM" stock exchange, the platform entirely dedicated to innovative and ambitious SMEs. A parallel effort by "Borsa Italiana" is also the "ELITE" program, a project launched in 2012 addressing firms seeking external investors and international

[81] OECD (2015), "Opportunities and constraints of marked-based financing for SMEs", OECD's report to G20 finance ministers and central banks governors.

markets expansion , through a plethora of financing instruments belonging to capital markets. In terms of policies and incentives to Italian SMEs, CONSOB and the Italian government introduced with the "Law 116/2014" [82] the possibility for unlisted companies to issue two different categories of shares : multiple voting shares, "*voto plurimo*", and similarly "*voto maggiorato*" shares (shares granting additional voting rights to the holder) *de facto* overcoming the "one share one vote" principle. This process aimed at increasing the liquidity ,promoting long-term investing and ,at the same time, avoiding excessive ownership dilution : particularly in Italy, where many SMEs are "family-owned", this provision was functional in overcoming the owner's aversion towards listing. In addition, the 2018 "Budget Law" [83] introduced fiscal measures for SMEs listing in the "Italian Stock Exchange" such as tax credit accounting for half of the IPO costs faced by the firm. Investments in Italian companies were also backed by the 2017 "Budget Law"[84] that introduced tax exemptions for the "*Piani individuali di risparmio*" (PIR) ,long-term savings plan with the aim of "channeling" resources from families to entrepreneurs of Italian SMEs. In particular, the exemption covered ,(in full), taxes on returns and capital gains from assets listed in the "Italian Stock Exchange" with a least five years holding period.

European Measures: The Capital markets union initiative

The Capital Markets Union is an initiative proposed by the European Commission to strengthen capital markets for all EU-28 member states. The project hinges on one of the founding pillars of the union: allowing capital to flow smoothly across countries. By building a single market for capital, that is by set in place a capital market union, EC aims at increasing Europe's resilience and efficiency, ultimately promoting growth and offering funding opportunities for EU enterprises. Indeed, as also explained by the

[82] Gazzetta Ufficiale della Repubblica Italiana – Legge 116/2014 retrieved from https://www.gazzettaufficiale.it/eli/id/2014/08/20/14G00128/sg.
[83] Gazzetta Ufficiale della Repubblica Italiana – Legge 232/2016 retrieved from https://www.gazzettaufficiale.it/eli/id/2017/12/29/17G00222/sg.
[84] Gazzetta Ufficiale della Repubblica Italiana – Legge 205/2017 retrieved from https://www.gazzettaufficiale.it/eli/id/2016/12/21/16G00242/sg

EC(2017)[85], “by complementing the more traditional bank financing ,capital markets will also help the flow of capital in Europe to fund long term projects”, this will be particularly beneficial for small markets with growth potential. In addition, the increased availability of financing instruments, because of a better integration between financial and capital markets, will also increase Europe “resilience” to macroeconomic shocks. Ultimately, the possibility of share risks across border will deepen financial integration, this in turn will lower costs and increase EU competitiveness. The implementation of the CMU does not revolve on a single provision , but it is articulated into an “action plan”(EC 2017)[86] that it is further composed by three levels of objectives:

1. ***“Overarching objectives”:*** long-terms goals of the CMU, essentially achieving a superior support of investments, both public and private, through capital markets in all European countries and setting in place a process of financial integration that will improve the financial system of EU28.

2. ***“Strategic objectives”:*** Guidelines explaining how to achieve long-term desired goals: in particular, increase stability , competitiveness, and cohesion of capital markets.

3. **“Operational objectives”:** Compared to traditional debt financing, alternative external financing revolving on capital markets involves a plurality of entities in the transactions: the costs of collecting and processing information concerning such entities are high. Therefore, the operational objectives of the CMU plan are to promote data availability, increase access to markets and higher investor protection.

[85] EC (2017) - Mid-Term Review of the Capital Markets Union Action Plan.
[86] EC (2017) - Mid-Term Review of the Capital Markets Union Action Plan.

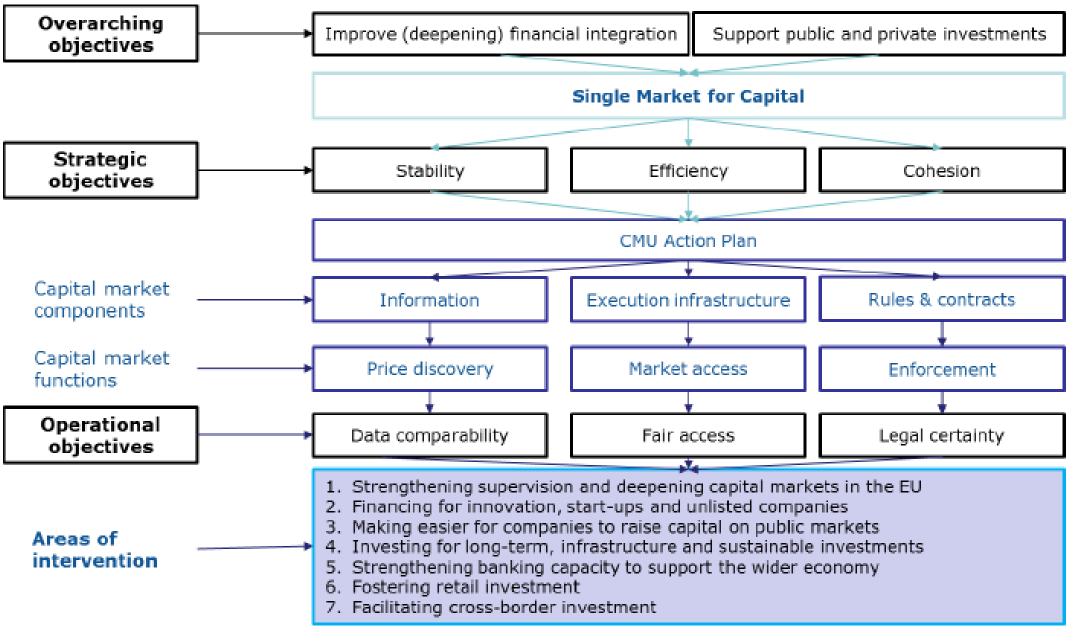

Table 35:" The CMU action plan"[87]

The plan of building a CMU spanning all EU-28 member states originates from the idea that financial intermediation and capital markets are "vital components" for the EU economic system, however there is an increased need for stronger capital markets in order to promote long-term growth. The ambitious project of a single capital market might represent a viable solution to EU most pressing challenges such as:

1. ***Developing innovative sources of credit for start-ups firms to invest in innovation.***
2. ***Increase the size of the EU equity markets, still underdeveloped compared to international peers.***
3. ***Assist banks, after the deleveraging imposed by the financial crisis, in originating new loans.***
4. ***Increase the awareness on instruments offered by capital markets and improve the engagement with retail investors.***
5. ***Promote investments across EU-28 borders by removing barriers to capital flow and diversification and therefore increase market liquidity.***

[87] EC (2017) - Mid-Term Review of the Capital Markets Union Action Plan.

Recent development in the EU political order , one for all the United Kingdom separation, legitimates the creation of an European single market for capital: in times of political and economic uncertainties, increase the “degree of interconnectedness” of EU-28 financial markets , promoting “cross-states” integration and ensuring the functioning of the markets is an even more relevant goal. A capital market unit that will promote members’ cooperation, boost confidence of external investor, increase the overall participations to European markets by also providing funding opportunities for the SMEs network would ultimately leads towards achieving “financial stability”, which is one of the leading objective of the European Union.

7. COVID-19 Impact on SMEs and possible remedies

The recent coronavirus pandemic , that started in China in late 2019 and at the beginning of 2020 reached Europe and hit severely Italy, has now scale up in proportions and is causing human losses and financial damages at a global level. The virus changed completely our life: the lockdown measures imposed to contain the spread of the COVID-19 determined a sharp drop in consumption, also altering people confidence and left our society in a state of uncertainty and fear. This pandemic affected in several ways also SMEs on both the transmission channels: on the “*supply side*”, indeed quarantine measures imposed by the health authorities determined a shortage of labor force and therefore an interruption of the “*supply chain*” while on the “*demand side*”, the sharp decrease in spending and consumption profoundly impacted revenues causing a contraction of the liquidity . The pandemic and the measures imposed by the authorities annihilated the work of SMEs operating in several sectors such as the tourism industry or transportation business. Clearly, in light of previously discussed considerations, the impact of this virus will be particularly felt by SMEs compared to large firms given the “structural fragilities” and financing impediments already acknowledge in this paper.

In Italy , the COVID-19 emergency began in February, in the northern part of the country where several cases of coronavirus were initially discovered. Since then, it spread non-homogenously across regions , interesting the entire Peninsula. After several weeks, Italy was among one of the most hit countries in the world in terms of both cases and deaths. The Italian government introduced “quarantine measures” in attempt to contain the spread of the disease, considering also that the capacity of the healthcare system was close to collapse. With a legislative decree in March, the Italian PM Conte imposed strong restrictions on the mobility across the country, limiting the flow of citizens and goods exclusively to first necessities motives. Arguably, the COVID-19 impact on the Italian economy has the potential to be the most severe and disruptive shock experienced by the country in recent history. A clear consensus regarding the post-COVID-19 scenario is yet to be reached: there are ,however, several forecasts that summarize the effect of this pandemic on the SMEs operating in Italy.

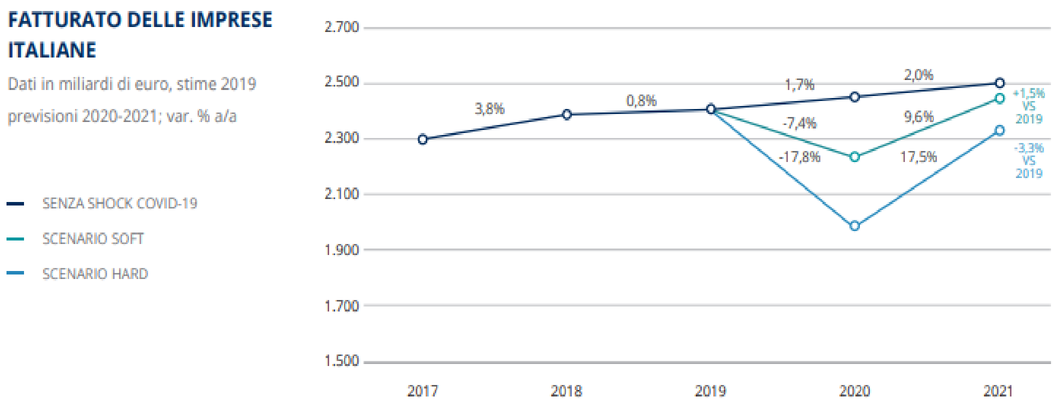

Table 36:"Italian Firms Turnover"[88]

The table above, based on a report by CERVED (2020)[89], shows the turnover of Italian firms considering three possible scenarios: the first scenario refers to the turnover of

[88] CERVED (2020) – Report “Nessuna impresa deve fallire per il COVID-19”
[89] Ibidem.

the firms without the spread of the virus ("SENZA SHOCK COVID-19" line in the table). The other two scenarios consider two different timelines of the lockdown measures:

1. ***"The soft scenario"*** is based on the forecast that the emergency will last until June 2020 and opt for a 2-months recovery period. In this scenario, there would be a loss in revenues for the firms of approximately 8% and a rebound in the next years.
2. ***"The hard scenario"***, on the other hand predicts that the coronavirus pandemic will last until December 2020 and opt for a 6-months recovery period.

In the first scenario, there would be a forecasted loss in revenues for the firms of approximately 8%[90] and an expected rebound in the following years. In the second scenario, the impact on firms' turnover would be more severe accounting for almost a 20% [91]loss in revenues and a subsequent loss also in the following years.

Consequently to losses in revenues, forecasts predicts that there will be important consequences on the liquidity and the risk exposure of Italian SMEs.

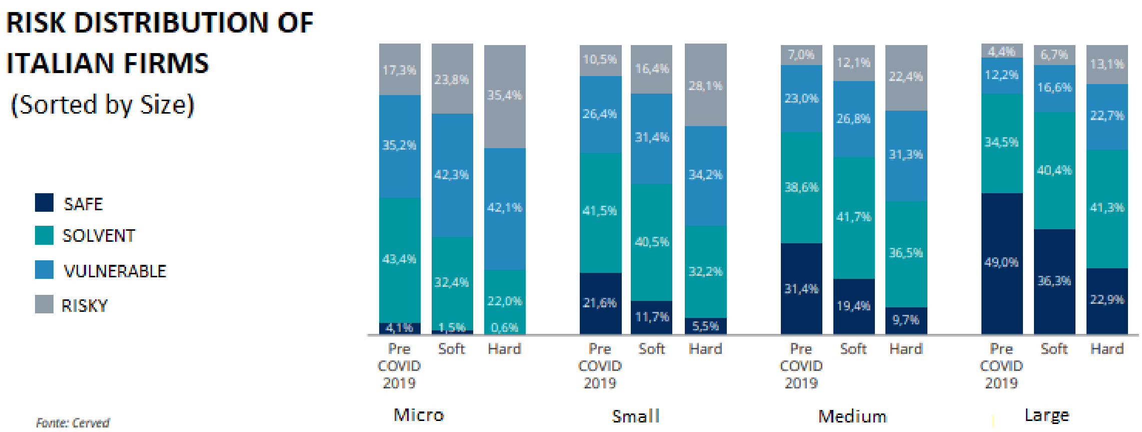

Table 37: "Distribuzione per classe di rischio delle imprese per dimensione"[92]

In the Pre-COVID19 scenario, the default risk of the Italian SMEs was relatively

[90] Based on forecasts illustrated in CERVED 2020 – Report "Nessuna impresa deve fallire per il COVID-19"
[91] Ibidem.
[92] Adapted and translated from CERVED 2020 – Report "Nessuna impresa deve fallire per il COVID-19"

limited. The majority of the firms indeed showed great fundamentals: "less than a third of the enterprises was considered to be vulnerable"(CERVED 2020)[93]. On the other hand, in the COVID scenario the exposure of the firms to default risk rises dramatically. Clearly the size of the firm also weights in the insolvency risk: Micro and small sized enterprises are the most vulnerable to default (in both scenarios). The share of the micro enterprises that will be vulnerable to risks will rise to approximately 43% , while in the hard scenario case, the share of the risky firms will more than double , reaching 35% . Same considerations apply to small-sized firms which ,in case of hard scenario, will become more exposed to bankruptcy risk: the share of safe firms will drop sharply accounting for only 5% of the enterprises.

EU-28 Policy response to COVID-19

The COVID-19 outbreak changed profoundly the expectations on the future of the EU, reshaped people's lifestyle and challenged the survival of the countries: unprecedented measures were introduced in several European countries in attempt to contain the spread of the virus. Many countries introduced also provisions tailored to SMEs needs such as:

1. Temporary workers lay-off, income benefits to companies and wage support.
2. Subsidies and grants to SMEs and , in several cases, direct institutional lending.
3. Deferral on tax payments, utilities, rent and rescheduling of loan installments.

Many of these provisions were targeting EU-28 SMEs, however, did not involve directly European start-ups. Indeed, these micro, highly innovative enterprises did not possess requisites to be eligible to receive bonuses and access liquidity programs. In attempt to overcome this obstacle, several countries introduced custom measures in support of start-ups. Relevant examples are the support schemes introduced in France, Germany, and United Kingdom.

[93] CERVED (2020) – Report "Nessuna impresa deve fallire per il COVID-19"

	France	Germany	United Kingdom
Date	25 March	31 March	20 April
Name	Emergency Plan to support Start-ups	Start-up Liquidity Programme 2020	Support Package for Innovative firms (Future Fund)
Size	EUR 4 billion	EUR 2 billion	GBP 1.25 billion
Objective	Strengthen bridge finance, liquidity and innovation for start-ups	Support availability of venture capital	Foster high growth and innovation
Target group	Start-ups	Equity funded businesses	High growth companies and R&D intensive SMEs
Instrument type	*Bridge finance for start-ups who are between two fund-raising round *State guaranteed treasure loans of two times the 2019 wage bill or 25% of annual revenue *An accelerated refund by the State of corporate tax credits refundable in 2020 * An accelerated payment of the PIA innovation support grants already allocated but not yet released *Support from Bpifrance for innovative companies, including for direct equity investments	*Additional public funding to public venture capital investors (both individual funds as well as funds of funds, e.g. KfW Capital) for funding rounds for start-ups as part of co-investments made jointly with private investors * Venture capital financing and equity replacement financing for small businesses and new start-ups that do not have venture capitalists as shareholders In parallel to the introduction of the Start-up Liquidity programme, Germany "Future Fund" (Zukunftsfonds) for start-ups which will offer additional liquidity of up to EUR 10 billion and should support the way out of the crisis in the medium term	*A Future Fund for high-growth companies in partnership with the British Business Bank will provide UK-based companies with between GBP 125 000 and GBP 5 million from the government, with private investors at least matching the government commitment. These loans will automatically convert into equity on the company's next qualifying funding round, or at the end of the loan if they are not repaid. * Targeted support for the most R&D intensive small and medium size firms through Innovate UK's grants and loan scheme.

Table 38:"“Start-up support schemes in France , Germany and United Kingdom”[94]

Domestic policy response to COVID-19 emergency

Italy , since the very beginning of COVID-19 European spread, was severely hit by the pandemic. At the beginning of March 2020 , the government introduced with “Law 18/2020”[95] (the “Healing Italy” Decree) a comprehensive set of provisions in attempt to respond to the crisis outbreak. The Decree, made of more than 100 articles, contains also policies related to Italian SMEs as also explained in the “OECD” report:

- “A “moratorium” on loans for Micro-enterprises and SMEs accounting for €220B, with loan installments frozen until September 2020”.
- “An increase in funding for the main credit guarantee infrastructure, the “Central Guarantee Fund for SMEs”, so to extend the possibility of rescheduling existing loans”.

[94] OECD (2020) : “Coronavirus (Covid-19): SME Policy Responses”
[95] Gazzetta Ufficiale della Repubblica Italiana – Legge 18/2020 https://www.gazzettaufficiale.it/eli/id/2020/03/17/20G00034/sg

Additional measures were also taken in support of small and medium sized enterprises: An increase in funding limits to the banking system by “Cassa Depositi e Prestiti”(the leading Italian institution for economic development) to address liquidity shortage and boost subsidies lending to SMEs, and subsequently the introduction of a new decree, the “Liquidity Decree” (“Law 23/2020”[96]) addressing in particular access to credit for Italian SMEs. The newly introduced law introduced €200B in public guarantees to banks in order to expand lending to businesses, provisions to assure firms’ continuity, measures aiming at safeguarding several strategic industries, most impacted by the crisis.

8. Concluding Remarks

The aim of this research was to emphasize the importance of developing capital markets and promoting access to alternative external sources of financing for SMEs operating in the European ecosystem. SMEs play “a fundamental role in the EU-28 economy , given their contribution to employment, innovation, value added and economic growth”(EC 2019)[97]. Under- developed capital markets and several “structural fragilities” explain the “excessive reliance of these enterprises on traditional bank lending”(OECD 2015)[98]. This particular source of financing, in turn, drives small firms towards a dangerous risk exposure, especially during periods of financial distress. A review of the main empirical studies showed different approaches towards the capital structure decision, a classical and on-going debate in the field of Corporate Finance. Nowadays, a crowded majority of scholars and commentators argue in favor of a “facilitated” access for SMEs to instruments available in capital markets: given the rich diversity of these enterprises and their high degree of innovation, this tools prove to be functional in promoting growth and

[96] Gazzetta Ufficiale della Repubblica Italiana- Legge 23/2020 retrieved from https://www.gazzettaufficiale.it/eli/id/2020/04/08/20G00043/s
[97] EC(2019) – “Annual report on European SMEs 2018/2019.”
[98] New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments OECD(2015).

satisfying long-term financial needs of this firms. On the other hand, SMEs heterogeneity and "financial opacity" results in "information asymmetry" and "adverse selection" and increases the costs of dealing with and monitoring these firms , more than often discouraging the investment. Therefore, in order to fully exploit the potential that resides in capital markets , there is an urge to mitigate constraints faced by SMEs while attempting to access to alternative funding. Governments and relevant policy makers play a fundamental role in facilitating the use of such facilities: this paper discusses several initiatives, both at the domestic and international level, that aim at fulfilling this scope.

While recognizing the unexplored possibilities arising from alternative financing, this paper ,on the other hand, does not propose a full disengagement of such enterprises from traditional bank finance. Given the inherent limitations of these firms vis-à-vis larger and established companies, combining both sources of financing would be an optimal approach: different forms of financing are not "mutually exclusive", therefore firms can choose the particular mix that reflects their needs. Combined with *ad-hoc* measures from regulatory bodies that recognize the importance and the specific needs of SMEs, this paper also recognized the importance of developing a dedicated "ecosystem" specialized in supporting long-term investments in SMEs , that ultimately will increase the attractiveness of this asset-class. A final consideration regards the impact of the COVID-19 virus on the already fragile SMEs network: the institutional response to the pandemic was meticulous, impaired in terms of number of provisions and praised at a global scale. On the other hand, the emergency highlighted once more the "vulnerability" of these enterprises to macroeconomics dynamics and the lack of inherent resources to withstand such events. From evidences collected in this paper, SMEs financing result to be an extremely diverse and complex matter. Indeed, the high degree of sophistication of emerging firms , both in terms of innovation and business scope, gives birth to unique challenges to be properly addressed by policymakers. In light of these considerations, a "coordinated effort" by regulatory agencies and relevant market players would be beneficial in removing existing obstacles for these enterprises, promoting an extensive use of capital markets , *pari passu* with traditional finance, increasing the flow of ideas and innovative solutions aiming at developing a healthy financial environment for SMEs.

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