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Potential in the development of non-bank finance: experience from EU countries in central and south eastern Europe

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Executive summary

- The EU countries in central and south eastern Europe are beginning to develop local capital markets more actively, including through published strategies. These efforts are now under the spotlight as the EU pushes its 'capital market union' agenda.
- A more prominent presence by private equity investors could be effective in preparing individual enterprises for a capital market presence. This is because private equity investors produce operational and governance changes within firms that are essential for portfolio investors in listed securities.
- The empirical literature on the PE industry in emerging Europe also underlines that investee firms have performed better not just in terms of sales growth and productivity but also in terms of overall investment and employment. Investors identify firms with strong growth potential and lift funding constraints.
- Private equity investments are highly concentrated in a few countries in emerging Europe. Of the firms that could potentially be relevant for PE investors in terms of growth and profitability characteristics only 2% had actually become targets. The regulatory aspects that define a country's attractiveness for private equity investors can be easily identified, and in emerging Europe shortfalls in investor protection and corporate governance have been the main impediments.
- Equity issuance on public markets has not been a significant funding source for companies in the EU-11 countries. Issuance costs for mid-sized companies are likely in the range of 6 to 10% of capital raised. EU regulation on disclosure and conduct by managers within listed firms have as yet discouraged issuance, though there is an effort to ease requirements for smaller companies.
- Stock markets in the EU-11 have been illiquid with the exception of Warsaw and Budapest. IPOs have only been significant in Warsaw, and in fact many companies have de-listed from the smaller exchanges. There is a trend towards cross-border cooperation and merging exchanges into the main European exchanges.
- The EU-11 countries have had more success in fostering corporate bond issuance. Liquidity in sovereign debt markets provided benchmarks at a range of maturities. IFI issuance in local currency and on local markets, and the presence of local institutional investors such as pension funds helped further.
- The adoption of EU-type rules on disclosure, insider dealing and other forms of self-dealing will foster market development in countries outside the EU. Within the EU-11 countries there is a concern that the latest EU rules raise issuance costs and discourage firms from seeking a capital market presence. The new prospectus regulation that is in effect from 2019 will seek to address these concerns for SME issuers.
- To foster equity and corporate bond market liquidity a link between the local central securities depository (CSD) and an international counterpart would facilitate the access by foreign investors to the local market, and ultimately there should be a central counterparty (CCP).

Contents

1. Capital market development in the new EU member states

The financial crisis of 2008-10 has led to a rethinking of financial development in emerging Europe. The established banking relationships within these countries had served the first phase of transition well. But a number of vulnerabilities built up in the process, most importantly in the form of foreign currency-based lending. In the aftermath of the financial crisis deleveraging – the reduction in cross-border bank-funding -- has been particularly sharp in emerging Europe where banking sectors are primarily foreign owned. While reductions in foreign funding have to some extent been made up by domestic deposits, a persistent gap between credit demand and supply has now opened up. Domestic capital markets, in particular private bond issuance, might serve as a 'spare tyre' of the financial system, crucially reducing unmatched foreign currency liabilities, and extending maturities of corporate funding.

More importantly, a growth model based on the emergence of young firms would be poorly served by banks. In the growth of a young firm, the early stages of development, when a business concept is still poorly formed, will not be suitable for traditional bank lending. Attracting seed and growth capital will require the presence of private equity and venture capital funds. Equity issuance by more mature SMEs would be beneficial for the real economy as more stock market financing has been shown to boost the levels of economic growth (Cournède et al., 2015).

Various policy initiatives have supported capital market development in the new EU member states (EU-11) over the past eight years.[1] Domestic agendas are now articulated through capital market strategies in Bulgaria and Hungary, and Poland and Lithuania are drafting similar documents. This is complemented by the international financial institutions ('IFIs'), and in particular the EBRD, through issuance and financing in local currency. More recently EU technical assistance has been aimed at adopting the increasingly complex capital market legislation. Private equity has recovered from its post-crisis decline, and empirical studies document how this type of finance has raised performance and growth in investee firms.

But eight years after the financial crisis domestic capital markets are not yet a significant funding source. Overall, external funding of companies through instruments other than bank loans is still extremely limited. Eurostat data indicate that debt securities amount to only 2.4% of overall company balance sheets in the EU-11, while trade credit and loans amounted to over 70%. In Poland, the most developed market in the region, corporate equity issuance amounted to no more than 0.3% of GDP on average over the seven years to 2016, even as the ratio of private credit to GDP rose by ten percentage points. Issuance in most regional stock markets has come to a standstill. Private bond markets have grown more meaningfully, though even here flows of gross funding exceeded 1% of GDP in only four countries. Due to limited scale and the poor trading infrastructure, foreign investors are severely underrepresented in these markets.

[1] We will primarily cover the eleven countries in the region that joined the EU since 2004 (henceforth the EU-11). Only occasionally the experience in a wider group will be considered, also including the four accession candidate (Albania, Serbia, Macedonia and Montenegro), and the three countries that have treaties with the EU (apart from Georgia, Moldova and Ukraine), which at that point will be referred to as CESEE.

This Policy Study reviews the experience with capital market development with a focus on the EU-11 countries. The capital market strategies adopted in these countries are relevant for countries in the EU neighbourhood, given comparable issuer base, underdevelopment of institutional investors, and illiquidity in markets. The study will cover three key asset types: private equity and venture capital, listed equity, and private bonds. For each the principal type of issuers and investee firms are described, the requirements of investors are reviewed, and market development in central and south eastern Europe is assessed.

2. Private equity and venture capital

Private, as opposed to listed, equity may be an important staging post in the development of liquid capital markets. This is because the efficiency and governance changes that the involvement of private equity investors produce is essential for the few companies which ultimately manage a public listing. In many emerging markets, the development of private equity has proven to be a catalytic intermediary stage in developing non-bank funding sources.

Private equity is of course controversial due to the deep governance and operational changes it will engender in investee companies. Established owners may be marginalised, and managers replaced or become subject to more rigorous performance criteria. Financial restructuring may well entail the write-down or sub-ordination of some bank claims. Nevertheless, investee companies will establish a successful track record, and reform governance and financial reporting in a way that will make these companies attractive for portfolio investors.

In the EU, the regulatory agenda for a capital markets union across all 28 countries has emphasized the need to develop private equity funding. The depth of the EU private equity market is less than 12% that of the US. The industry could be particularly important in Europe, given the preponderance of SMEs and the smaller average size of companies.

2.1 The business model of PE funds

In emerging Europe, the corporate sector may similarly outgrow the banking sector, but enterprises are as yet too small or too poorly governed to be viable entities listed on a public stock market. Private equity fills this gap, and caters to the funding needs of three key types of enterprises, none of which are suitable for banking products:

- The key target of PE investors are companies that are growing but which are capital-constrained. There is proven commercial concept and a track record. Private equity investors will acquire significant stakes and take investee firms into a further growth phase, for instance by assisting in international market expansion.[2]
- A sub-set of growth companies are those that are highly innovative or start-ups. Venture capital investors, a small but much sought after sub-sector of the private equity industry, have developed the tools and risk appetite to cater to such firms. Technology developed by investee firms may be several years away from commercial application and returns are highly uncertain. These companies may not have a predictable cashflow and earning stream, and

[2] In PE data this is considered buyout or growth capital, and accounts for up to 80% of the total PE investment in Europe in 2016.

little collateral against which a bank could lend. A start-up business may also rely on the so-called business angels who provide small tranches of debt and equity finance. These are high net worth individuals bring specific industry knowledge and contacts who will assist in the commercialisation of early innovative concepts.[3]

- Another subset of PE funds are turnaround investors which target companies which may be stagnating but which have considerable inefficiencies that can be addressed through a programme of operational and financial restructuring. Investors may inject senior debt, in addition to equity. In the EU there is a significant overhang of excess debt in enterprises, though this type of investment is as yet relatively uncommon in both emerging and advanced European markets.

A private equity fund collects commitments from a range of institutional and private investors who will be tied in for typically ten years. Within emerging Europe there are only few institutional investors who can act as limited partners ('LPs') in this way. LPs from the advanced EU countries may not have a mandate for funding private equity in emerging Europe, or to go outside the EU, or to countries with a sub-investment grade sovereign rating. The PE fund may finance the acquisition with a significant share of debt. This kind of 'leveraged buyout' is less common in emerging Europe but underlines that private equity investment will depend on the local banking sector.

Unlike the dispersed investors in a listed company, private equity funds are very actively engaged in the firm's management. Private equity funds are best known for their restructuring of the operations in the investee company. Value is created through a programme of cost cutting and repositioning the product and company in the marketplace. This goes hand-in-hand with reforms in the governance of the firm, as managers will be subject to more stringent performance targets. The PE business model is therefore not suitable where poor corporate governance or other obstacles to the engagement of minority investors complicate operational and governance change.

Private equity investors adopt an unusually long investment horizon. Once capital has been raised, a private equity fund would normally run and disperse investments for about ten years, with holding periods of about 5 to 7 years in individual investee companies. Disruptions in funding may therefore not immediately be noticed in recipient countries. Required returns are high and are in line with the cost of capital of the limited partners, and the expected risk in investee companies. Ultimately, the PE fund will seek a divestment in the local market or through a trade sale to another investor. Liquidity in the local capital market therefore helps, though it is not essential.

2.2 The empirical literature: impact on investee company performance

There is now an extensive empirical literature that substantiates the positive effects of private equity on an individual firm's performance. These effects are particularly strong in emerging Europe, where the involvement of PE investors will lift credit constraints, as opposed to the advanced countries where these investors focus on operational restructuring.

[3] For a survey of policy issues in stimulating seed, early stage, and venture capital finance see Wilson (2015).

EBRD (2015) conducted the most extensive study of private equity in the transition region to date, based on data for investee firms from over 100 funds. These investments were compared to a peer group within which firms were matched by sector, age and other characteristics.

The EBRD study found that operating revenues rose significantly more strongly in companies following a private equity investment. The positive effect on employment in investee companies in the sample is perhaps surprising, given the reputation of these firms to adopt a rigorous restructuring strategy. It was due to PE funds seeking out investee firms which had shown strong growth potential, though were constrained in their funding. Overall, labour productivity increased by a third more than in the control group, underlining that additional capital expenditure had raised operational efficiency. These positive effects typically set in within three to five years of the initial investment.

It is striking that the PE involvement helps investee firms gain better access to credit, on the back of more assets which were used as collateral. The PE involvement seems to serve as a signal that the company will be subject to close monitoring and that a promising business concept has been adopted.

2.3 Private equity in emerging Europe

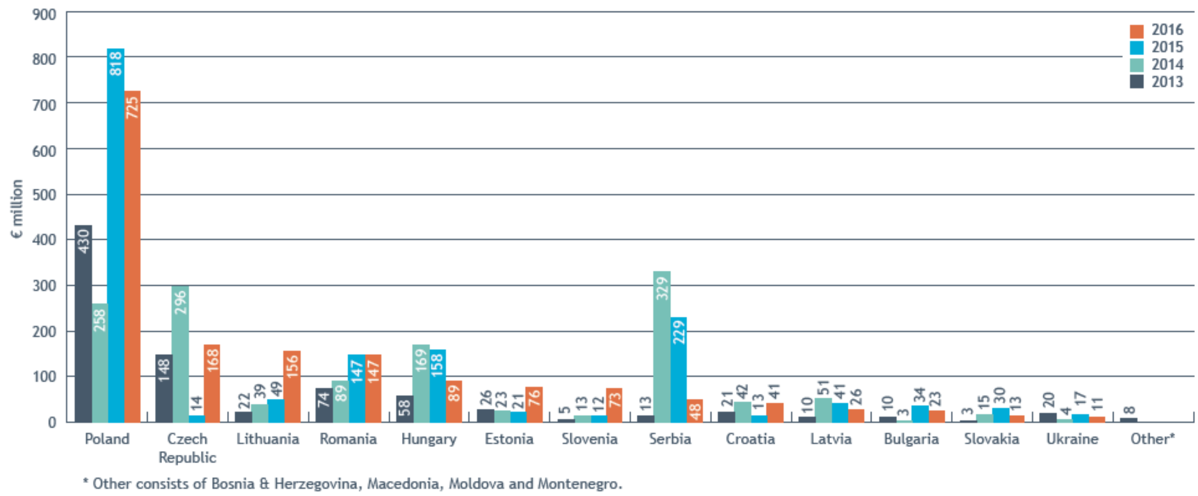
Private equity funds are backed by a wide range of institutional investors. In the EU in the four years to 2016 one third of funding was raised from pension funds, about 18% from investment funds and another 12% from insurance companies (European Commission, 2017). Limited partners have very specific mandates that constrain the investment universe of the private equity fund, possibly shutting out non-EU countries, such as Georgia. Government-owned funds account for a significant share (about 10% of total investments in Europe) and aim to support specific sectors or boost broader productivity growth. Fundraising by the industry is sensitive to liquidity and risk aversion in international debt markets, and consequently fell sharply in the immediate aftermath of the financial crisis.

The EU Commission (2017) presents encouraging recovery in private equity financing in Europe. In the four years to 2016 the amount of capital raised by PE funds recovered to double that in the same timespan immediately after the financial crisis. The industry funded 5,900 enterprises in 2016, predominantly SMEs. The number of private equity firms has shrunk as consolidation to larger funds continued, and the industry remains largely based in the UK.

That said, emerging Europe remains a backwater for the industry. The CEE share of total European fundraising is less than 1%, and investment activity only about EUR 1.6 billion, or 3% of the total. Investments represented barely a tenth of a % of GDP in the region on average, which is a fifth of the same ratio in EU leaders such as France or the Netherlands. In the CEE Poland alone accounted for 45% of the value, and a quarter of the number of enterprises funded by the industry in the region. The top five countries in the region (also including the Czech Republic, Lithuania, Romania and Hungary) accounted for 81% of investments made, underlining the difficulties of smaller markets to attract the internationally diversified funds, and expend the considerable costs on market-specific due diligence (Figure 1). EBRD (2015) estimated that 40,000 firms in the region could potentially be suitable targets for private equity investment, though only 2% had actually become such targets.

A wide variety of industries were funded, though information technology clearly stood out with roughly 21% of the value of investments. The distribution by type of investment is similar to that in the rest of Europe. Given the lack of liquid local capital markets, exit options remain a significant concern for the industry, and 46% by value were done through sales to other private equity firms.

Figure 1. Private equity investments in emerging Europe



Source: Invest Europe.

2.4 <u>A regulatory environment that is conducive to private equity</u>

Private equity firms are normally lightly regulated and operate globally from a small number of home bases. Nearly half of the European industry is located in the UK. Yet, the regulatory and business environment in the investee's home country deeply affects their willingness to engage and subsequent investment performance. This explains some of the backwardness of emerging Europe.

Receptiveness to risk capital and the deep changes in governance and operations that a PE fund will likely implement is a key determining factor. Key aspects are the quality of the corporate governance regime, specifically investor protection, transparency of financial information. In addition, contract enforcement and protection of intellectual property rights are crucial for start-up companies. There are broader conditions such as the macroeconomic outlook, and the innovation framework and official support to start-ups that may be particularly relevant for venture capital.

The Venture Capital and Private Equity Attractiveness Index (IESE, 2018) is now increasingly followed to assess regulatory conditions. It has offered a consistent summary attractiveness ranking for 125 countries for the past nine years, and is based on six criteria:

- Economic activity
- Depth of the capital market. Apart from the usual indicators such as market capitalization this also looks at issuing activity, and ease of access to bank loans and the outstanding non-performing debt.
- Taxation, crucially also ease of tax administration.
- Investor protection and corporate governance, including indicators of corporate governance, security of property rights, and the quality of the legal enforcement.
- Human and social environment, including the quality of education, and labour market rigidities.
- Entrepreneurial culture and 'deal opportunities', including innovation indicators, R&D intensity, and ease of running a business.

Emerging European countries generally rank in the lower half of the overall ranking.[4] Throughout emerging Europe the lack of depth in local capital markets is a constraint, and individual countries outside the EU rank poorly in terms of investor protection.

Table 1. The venture capital and private equity attractiveness index in the emerging Europe region

		Score (US=100)					
	Overall rank out of 125	Economic Activity	Depth of Capital Market	Taxation	Investor Protection and corp. governance	Human and Social environment	Entrepreneurial Culture and deal opportunities
Georgia	61	61	43	104	73	53	50
Czech Republic	33	85	48	102	71	73	73
Turkey	35	94	72	107	59	43	56
Poland	26	89	76	108	63	61	67
Ukraine	83	72	31	100	49	33	52

Source: VC and PE country attractiveness.

3. The regulatory environment for public markets

Ultimately, a company that is strongly growing or well established may seek to issue debt or equity in a public market.[5] This may be a sound decision from the perspective of the individual company's balance sheet and banking relationships. Whether it is realistic depends on the regulatory framework (which defines listing costs and disclosure requirements), the market infrastructure and liquidity, and the access of foreigner investors to the local market. Not all countries will meet the requirements for liquid and transparent local exchanges to make a public listing an attractive choice for an individual firm.

[4] Georgia at rank 61 scores well on the taxation regime and investor protection, though less well on the entrepreneurial opportunities.

[5] There have been important innovations in the European regime for private placements, under which the EU seeks to foster public listings through the initial bilateral transaction with individual investors that is not subject to the more onerous listing and other disclosure requirements.

Capital market development in the EU-11 has of course benefited from the regulatory framework within the EU single market. This framework is now increasingly 'exported' to countries in the periphery and neighbourhood as EU accession candidates adopt regulations and directives and the three DCFTA countries are committed to converge to these rules.

EU regulation provides a common standard for two aspects that are crucial for young markets: a first area is information transparency for all listed issuers, through rules such as the prospectus requirements. This is needed to overcome information barriers between investors and issuers of shares and bonds, both at point of issuance and through ongoing transparency requirements. The *quality* of information will depend on the local accounting framework and auditing profession. A second area concerns provisions that limit self-dealing. There is an inherent risk that listed companies engage in transactions that enrich insiders or benefit other related entities. This risk is partially addressed by EU insider trading provisions, though much of this area of law is of course under national competence, crucially in the case of more direct transactions with related parties.[6]

Unless both aspects are addressed, potential issuers of equity will not see that they will receive a fair price. Stronger companies may escape and use the sounder rules and institutions in a foreign securities market, but there is a limit to which they can distance themselves from the context in their home base. Weak companies with poorer governance standards will therefore dominate the market and liquidity will gradually deteriorate.

The key policy implication is that the adoption of EU law, and convergence towards it, can settle some crucial aspects of market regulation, though much will depend on national law, the functioning of the judiciary, and supporting private institutions. The latter is particularly important as capital market activities of smaller companies, which account for a larger share in emerging Europe than in advanced countries, will be more dependent on local research and the domestic investor base. Ultimately, the so-called 'ecosystem' that surrounds the IPO needs to develop. This includes the investment banks that underwrite the issue, brokers and research analysts, legal advisers, and those banks that quote a daily price ('market makers').

4. Listed equity and stock markets in the EU11

4.1 Which firms issue in the EU-11 equity markets?

For the individual firm the listing on the equity market is in the first instance a capital structure decision. External equity may reduce the cost of capital, even though only the costs of debt finance are normally tax deductible. There are less tangible benefits. New owners will contribute to the monitoring of the firm and equity from a public market will strengthen the firm's bargaining position vis-à-vis its banks.

Costs of going public can be substantial. The initial listing will entail underwriting fees, costs for legal advisers, accountants and auditors, and fees payable to the exchange. This is in addition to any reform in internal processes and corporate governance that the listing may require. These costs have

[6] Bael et al (2015) show that adoption of insider trading laws is key factor in furthering market development.

a substantial fixed component, so are more prohibitive for smaller companies. According to one study, issuance costs could range up to 15% of capital raised for an issuance volume below EUR 6 m, and between 6 and 10% for a volume up to EUR 50 m (FESE quoted in EU Commission, 2017). Once listed, there are ongoing costs due to more onerous disclosure requirements.

For this reason, only well-established and profitable large companies or high-growth and innovative SMEs seem to have overcome the various costs and other obstacles to an initial listing. A concern in some of the smaller stock exchanges has been a trend towards de-listing in particular by larger enterprises which either sought a listing on a mainstream European exchange or, once merged with a larger rival, benefitted from FDI-type finance.

In the EU-11 countries public equity is therefore still only a minor component of total corporate funding. Data from Eurostat shows higher shares for listed equity in Croatia (13.8% of total financial liabilities), and Poland (12.4%), though otherwise this financing is miniscule, and well below the EU average at about 21%.[7] In terms of funding flows, the value of equity raised through IPOs in the EU-11 was only 3.3% of the EU total, well below the region's weight in terms of GDP or corporate balance sheets.

4.2 The investor base

A key constraint in the development of local equity markets has been the relative scarcity of local institutional investors. Insurance and pension funds and other asset managers typically play a key role in the emergence of local securities markets. These investors have the capacity to hold risk capital over longer periods, given the longer maturity profile in their liabilities, which is reflected in their investment mandates. They are also a reliable and predictable demand for future issuance. Some of the 'waves' of IPOs in central Europe were predicated on the rapid emergence of local pension funds at the same time, for instance following Poland's initial pension reform in 1999. An additional benefit from the engagement of institutional investors is their input on corporate governance of the investee firms where they hold sufficiently large stakes.

In the 11 'new' EU member countries pension and insurance asset represent about 11% of GDP in 2015, compared to about 66% in the EU as a whole. Individual holdings of stocks and bonds amounted to 9% of GDP, compared to 34% in the entire EU.[8] There is clearly a much shallower investment by households in financial assets, in part due to the absence of suitable instruments for retail investment.

It is not likely that the institutional investor base within the EU-11 countries can be quickly expanded. A more realistic prospect is that locally listed bonds and shares in individual local markets are accessible to foreign investors. European equity funds that are focused on emerging Europe will seek an allocation to countries with investment grade sovereign risk, but also seek direct access through a well-established trade infrastructure. This is largely dependent on a direct link between the local central securities depository (CSD) and an international counterpart (ICSD), and ultimately a well-capitalized central counterparty (CCP).

[7] Figures quoted in EBCI (2018).
[8] Figures from AFME (2016).

There have been a number of structural changes in the mandates of European equity mutual funds that will affect the chances of smaller countries in emerging Europe to attract foreign investors. When participating in an IPO, funds will typically seek a minimum absolute tranche size, where there will be sufficient liquidity, and larger issues that ensure a minimum share of ‘free float’ or publicly traded shares. Cross-border diversification is likely to be reduced for smaller issues, and for markets with a sub-investment grade sovereign credit rating.

4.3 Stock exchanges: shrinkage and concentration

The experience with stock exchanges in the EU-11 region is somewhat sobering. All countries have an exchange, though in many instances these have become dormant institutions in search of an economic role. Among the EU countries, the exchanges in Poland, Hungary, Romania and Croatia have the highest number of listed companies, and capitalisation in the Czech Republic is second only to that in Poland. In the accession and neighbourhood countries, one of the two exchanges in Ukraine also shows high capitalisation and turnover in its 18 listed companies.

But low liquidity is a serious obstacle in attracting new issuers and institutional investors (EBCI, 2018). Only Poland and Hungary consistently showed share turnover ratios at above 40%, though even here trading is concentrated in a small number of companies that constitute the main indices. While many exchanges had a large number of constituent firms initially, including from the early wave of market-based privatisation, many firms have since de-listed. Increasingly onerous requirements on listed firms within the EU appear to play a role in this development.

With the exception of the Warsaw exchange, none of the stock exchanges still offer equity finance in a meaningful way to newly listing companies. 17 companies were newly listed on the Warsaw Exchange in 2016. This is a substantial decline from the number of IPOs in previous years, when also companies from neighbouring countries listed there. Now new business is declining as the reform of the Polish pension funds has significantly curtailed the institutional investor base, and as uncertainty over taxes and debt restructuring reduced investor interest in banking equity which accounts for a substantial share of the market.

World Bank research covering 59 emerging markets and low-income countries suggests that long term success of an exchange seems to be crucially determined by early growth (Alberquerque De Sousa et al, 2017). Without a minimum number of listings and turnover early on, exchanges fail to attract further capital and quickly become dormant. Banking sector development and availability of a national savings pool appear to be other important determinants. But surprisingly, small country size or legal system do not seem to be insurmountable obstacles. A number of small countries succeeded in establishing a role of a regional ‘hub’.

The poor record of stock exchanges in central Europe also seems to be in line with an international trend towards more concentrated trading.[9] Equity valuation – and hence the proclivity to seek a new listing – will be determined by liquidity. Issuance and trading will hence increasingly happen in a small number of larger exchanges and by larger companies. Most stock exchanges in emerging markets are now part of an international group structure, or pool trading. In the emerging Europe

[9] OECD (2016).

region, many exchanges have established cooperation agreements with neighbouring countries, as is the case between the Baltic stock exchanges and in the western Balkans region.[10] This experience suggests there is likely a viable role for small exchanges that act as a regional 'hub'.

SME exchanges

Despite this mixed record, some governments have attempted to establish capital markets specifically geared towards the needs of smaller companies, often as an alternative, or a precursor, to the main exchange listing. Such so-called junior markets promote issuance by SMEs through less demanding listing requirements, lower fees, and smaller issue sizes. Warsaw's *New Connect* market is an example of offering such preferences to smaller issuers. In 2017 the Zagreb stock exchange announced a trading platform for SMEs from Croatia and Slovenia.[11] In the current EU agenda for a 'capital market union' issuance by SMEs is supported through the definition of less onerous listing requirements in the new prospectus regulation.[12]

The World Bank has found at best mixed success with SME-focused markets. Only a small number of listings were done in the Asian exchanges that were established in this form. This may be due to preference of institutional investors for large and liquid listings (Abraham and Schmukler, 2017, and references cited there). SME exchanges are in any case an option only for established equity markets which want to expand into the SME segment on the back of an existing investor interest.

5. Corporate bonds

The development of a private bond markets is motivated by financial stability considerations to a much greater extent than is the case for equity finance. The view on the complementarity between a liquid local private bond market and the resilience of the financial system was first set out in Alan Greenspan's well-known speech of 1999 in which he called for a 'spare tyre' to support corporate sector funding in times of crisis. This appears to have happened in Europe, where the number of corporate bond issues nearly doubled between 2006 and 2016. In its study to review progress in integrating Europe's capital markets, the EU Commission indeed finds that corporate bond issuance has substituted for the decline in bank lending following the financial crisis.[13] This trend however was largely explained by large firms, whereas SMEs increasingly relied on internally generated funds.

The European financial crisis has also led to the realisation that external debt finance, and reliance on international bank funding builds up vulnerabilities in corporate balance sheet. This has stimulated wide-ranging policy initiatives in the development of local currency bond markets, supported by the IMF and by the EBRD in emerging Europe.[14] Policy efforts appear to have borne fruit in a number of emerging markets. In the largest emerging markets, such as the 'BRICs', corporate bond markets

[10] SEE Link is a project started by Bulgaria, Croatia and Macedonia and subsequently expanded to include the Ljubljana and Belgrade stock exchanges and two exchanges in Bosnia-Herzegovina. Local markets have integrated their IT systems, though without cross-ownership between the exchanges. This will ultimately allow investors easier access to regional markets through brokers in their home country.
[11] EBRD and Zagreb Stock Exchange present SME project for Croatia and Slovenia.
[12] Prospectus Regulation (2017/1129).
[13] European Commission (2017).
[14] IMF (2013).

have enjoyed annual compound growth rates in excess of 20% per year in the ten years to 2014, and in emerging markets more widely this growth stood at 14%.[15]

There are benefits beyond financial stability. Policy makers in the CESEE countries have supported bond market development as large enterprises appear to have outgrown capacity of local banking sectors, and as they sought to attract long-term investment, in particular in project bonds and municipal funds. Unlike bank relationships, a company's exposure to bond markets also underpins information disclosure. A growing firm will overcome the constraints of bank finance and of limited internally generated funds through the issue of a bond in the open market.[16] Firms that are well established will be in a position to bypass bank lending and access markets directly.

According to advocates of public support to bond finance, a few large bond offers will quickly build the private sector 'ecosystem' of local research coverage, rating agencies' credit assessments, and institutional investment. But the experience of for instance Poland and Romania suggest that a liquid money market at various maturities is an essential precursor.

5.1 The issuer base

The benefits of bond finance seem to have been reaped only by firms that are reasonably mature in the later stages of growth, and which have a well-established market position. Empirical studies have identified the characteristics that make a firm more likely to issue a bond as firm size, profitability and creditworthiness. Bond issuers are typically more strongly growing investment grade firms with good investment opportunities. The firm's reputation, in particular a record of previous issues of syndicated loans or the private bond placements, will increase the chances of a public bond issue. Firms which issue in international markets are typically larger, though also more leveraged, than those in domestic bond markets. Unlike in a loan contract with a bank, the terms of a bond cannot constrain the borrower's conduct excessively.

Even though private bond issuance has increased sharply since the financial crisis, firm size appears to have become *more* important, with the share of external funds raised by SMEs reduced to only 2% in 2014.[17] The direct issuance of bonds by SMEs will be constrained given the large issuance costs relative to the potential deal sizes. The cost of obtaining credit ratings, and the lack of a track record and transparent financial accounts will further discourage issuance and deter investors ultimately, issuance of a bond will be an option only for the largest enterprises.

Policy efforts in the EU-11 have been focused on the subset of private, local currency bonds issued under domestic law. But efforts were successful only in countries where there was already a liquid sovereign bond market extending over a range of maturities that could provide a pricing benchmark, such as Poland, Hungary or Romania. Moreover, regulatory reforms, and support to a number of issues only bore fruit where related markets developed in parallel, in particular IFI local currency bonds, asset-backed and collateralized issues, and sub-national sovereign or municipal issues.

[15] IOSCO (2015).
[16] World Economic Forum (2015).
[17] OECD, 2015a.

This is why a number of countries have attempted to structure securitized bank loans, which allow banks to transfer credit risk to the market and achieve capital relief, and covered bonds, where the asset remains on the bank's balance sheet. In Western Europe a number of countries have brought issuance costs for SMEs down by structuring market segments that are specifically aimed at the requirements of such firms, such as in Germany or Spain.

5.2 Market development and the investor base

In central Europe debt markets have expanded rapidly since the financial crisis, even though this has been primarily driven by sovereign debt. Hungary and Slovenia have public debt markets with capitalisation in excess of 75% of GDP, which is about half the ratio in the EU overall. Corporate issuance has been highest at 6.3% of GDP per year in the period 2010-16 in Poland, compared to over 14% in the EU.[18] Larger enterprises tend to access the Eurobond market and a small number of local currency denominated bank and municipal bonds are listed on local exchanges. The markets remain small, for instance at only 1% of GDP in Romania, and 3% in Poland. As is the case in the rest of the EU, corporate bond markets show very limited turnover as following some trading period after the initial issuance institutional investors adopt 'buy-and-hold' strategies.

Institutional investors will be deterred from supporting a public bond offering where there is a lack of liquidity and inefficient pricing. Secondary markets will be impacted by monetary policy operations, the presence of local institutional investors, and the capacity of local banks to act as 'market makers'. As in equity markets the key regulatory preconditions for market development are sound corporate governance, and a robust legal framework and efficient judiciary, in particular with regard to the enforcement of creditor rights.

The IMF (2013) acknowledges that the potential for a corporate bond market may be very limited in small countries, or where a well-developed and effective banking system is already in place which may already offer sufficient funding for the small number of large enterprises. In these countries, corporate bond market development is no longer seen as a policy priority. Countries that do develop an active agenda for corporate bond market development initially focus on a primary market framework, including a suitable regime for disclosure and approval procedures which can be less onerous than those for equity markets. Regulatory requirements for the private placement of an offer to individual investors may be considerably less onerous.

Bond finance will be complementary to bank finance. A number of functions are specific to banks and cannot be fulfilled by bond markets, even for large companies. These are contingent financing, for instance through a credit line or trade finance, customised products, and debt products where the borrower is in distress and the bank provides 'borrower-in-possession' type finance. Moreover, developing a local bond market will rely on investment banking services, which in most countries are conducted within universal banks. These services include the pricing and sale of the initial public offering, marketing of the bonds, and making a market through an ongoing public quote, and managing the potential default.

[18] European Bank Coordination Initiative (2018).

6. Conclusions: the outlook for small EU capital markets and implications for countries in the EU neighbourhood

Smallness of markets, fragmentation of liquidity and onerous issuance costs so far discourage a capital market presence for many of the mid-sized companies in emerging Europe, both inside and outside the EU. In this context the greater involvement by private equity investors offers not just access to equity finance and subsequently raise performance in investee companies, but also to prepare governance and operations to make companies ready for a capital market presence.

Within the constraints of an EU regulatory framework many smaller EU countries have also developed flanking measures aimed at a capital market presence for mid-sized and smaller companies. A number of SME-dedicated exchanges are being developed, and several countries offer support, including through grants, to SMEs in the pre-IPO phase.

But lack of liquidity in individual issues, and in markets overall, still stand in the way of foreign investor interest. These problems will become more onerous as established European fund companies shift towards index-based and passive asset management. Cooperation between national exchanges, as in the Baltics or in the western Balkans, are a good step to overcome the limitations of national markets. Another option may be to create a specific regime for the access by national investors and issuers to foreign markets.[19]

An additional problem for foreign investors lies in the fragmented post-trade infrastructure. In the first instance there needs to be a link between national securities depositories and the international counterparts. This access would normally be developed first for the local sovereign bond market but could subsequently extend to equities.[20] Crucially, the post-trade infrastructure should include a central counterparty (CCP) for the trading of bonds and equities in the cash market, but also in derivatives. A CCP stands at the centre between contract traded on financial markets, becoming “the buyer to every seller, and the seller to every buyer” (EBRD, and Oliver Wyman, 2015). As such it concentrates all counterparty risk and will be subject to stringent and operational capital requirements, which in the EU is regulated under the European Market Infrastructure Regulation (EMIR) of 2012. As these institutions are complex and costly to create, smaller exchanges now seek to use the clearing services of the CCPs that already exist in Poland, Hungary and Croatia.

The EU accession candidates, and the three countries in the neighbourhood which have committed to regulatory approximation under their Deep and Comprehensive Free Trade Agreements, should monitor developments in the smaller EU markets carefully. Cooperation between individual markets, and greater regional integration, may well open opportunities also for non-EU countries. There is an attempt to apply EU capital market legislation in a way that is more ‘proportionate’ to the requirements of the largely SME-type issuer base. While the rule making in capital markets is now largely complete, and unlikely to be reopened, implementing legislation may well respond to these needs.

[19] See for instance the project BSE International as set out in the Bulgarian capital market development strategy.
[20] See German Economic Team Belarus Technical Note 02/2017: Linking international central securities depositories (ICSD) with local central depositories.

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