Potential in the development of non-bank finance

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Outline

I. Capital market development in the ‘new’ EU member states
II. Private equity and venture capital
III. Listed equity and stock markets
IV. Corporate bond issuance
V. Conclusions and some implications for Georgia

References

I. Capital market development in the new EU member states

Capital market development in the CESEE

Supporting factors

- ✓ Cyclical upswing with credit demand robust in context of past deleveraging and now stagnant credit supply
- ✓ Innovation-based growth models: realisation that private equity and venture capital can only thrive in liquid domestic capital markets
- ✓ Collaboration, and joint ventures between national exchanges (Baltics, SEE)

Impediments and reversals

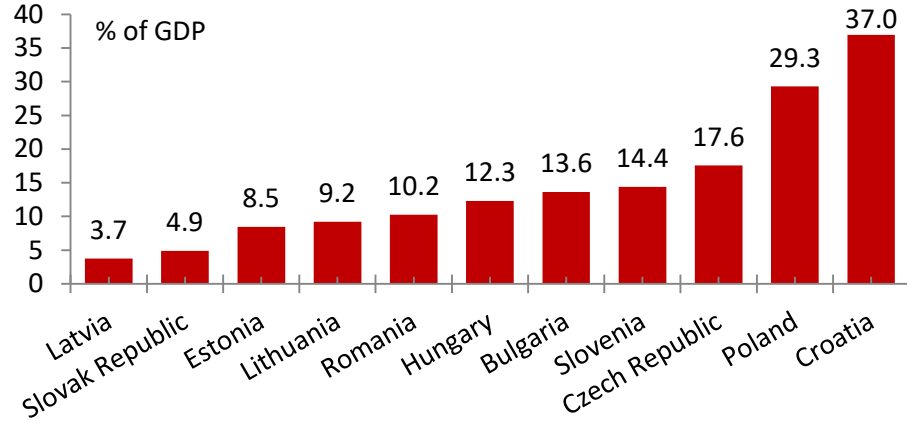
- Efficient, and predominantly foreign-owned banking sectors, where subsidiaries often half-hearted about underwriting/market making
- Parent companies of non-financial enterprises meet much of the demand
- Local institutional investors cut back in recent year, especially pension funds
- De-listings/lack of liquidity on stock exchanges
- Lack of financial education and household preference for deposits over securities
- Increasingly complex EU capital market legislation, which is not at all 'proportional' to the largely SME-type issuer base

CESEE capital market development: stylized facts

Liabilities of CESEE non-financial enterprises:

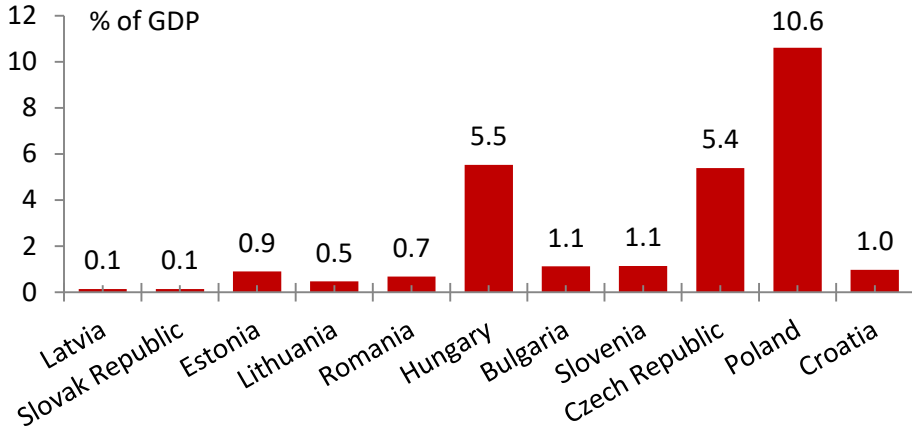
- Importance of bank loans still outsized compared to EU-28 average in both stock and flow terms
- Listed equity important only in some countries (e.g., Poland, Croatia) though overall no more than a third of EU level
- Close funding relationships with parent companies headquartered in western Europe
- Volume of IPOs low and declining since the financial crisis
- Debt markets expanded more rapidly, though sovereign issuance is the main growth driver

Stock market capitalization



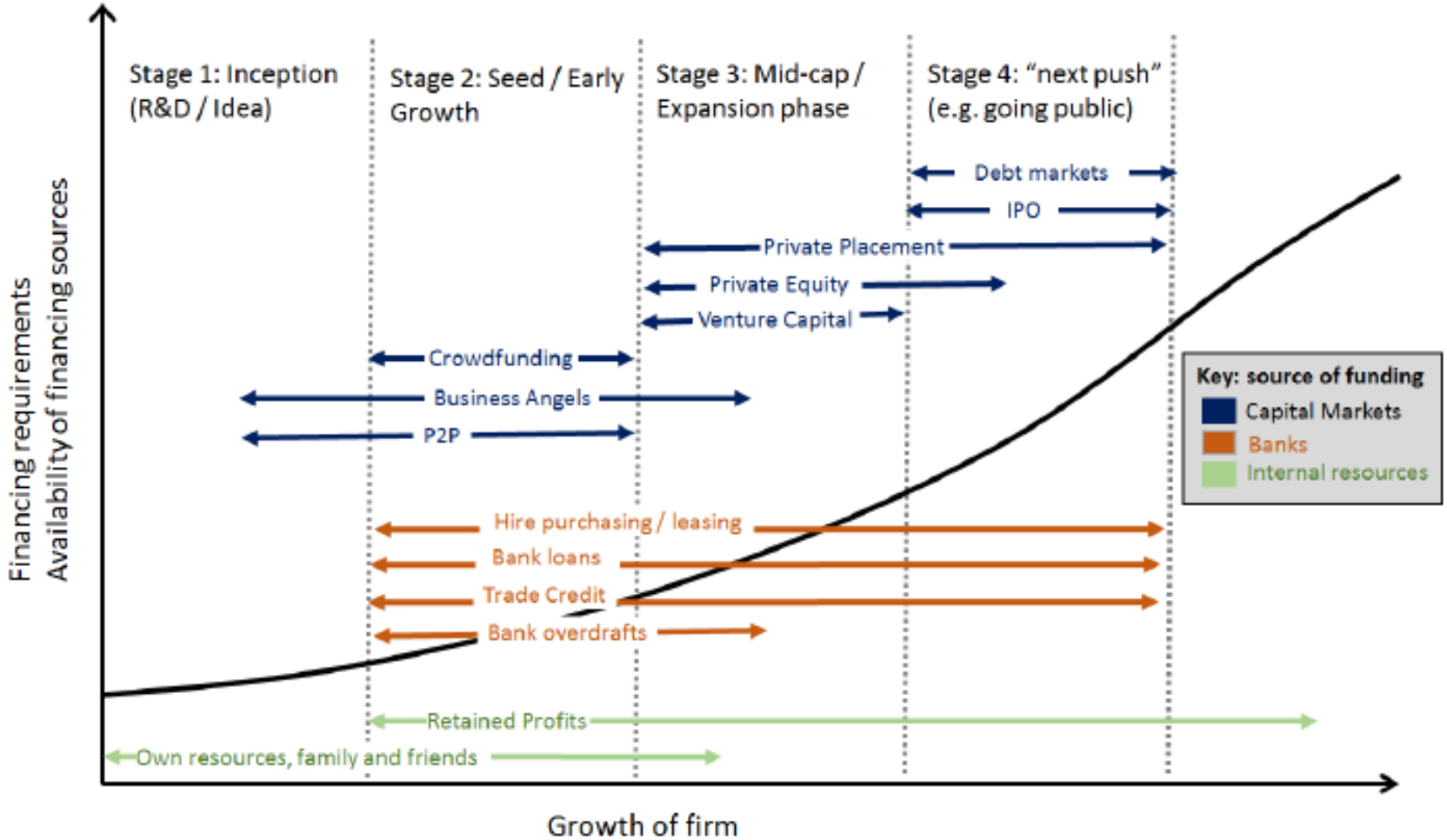
Source: World Bank Global Financial Development Database
Note: Most recently available datapoints

Stock market turnover



Source: World Bank Global Financial Development Database
Note: Most recently available datapoints

The funding escalator

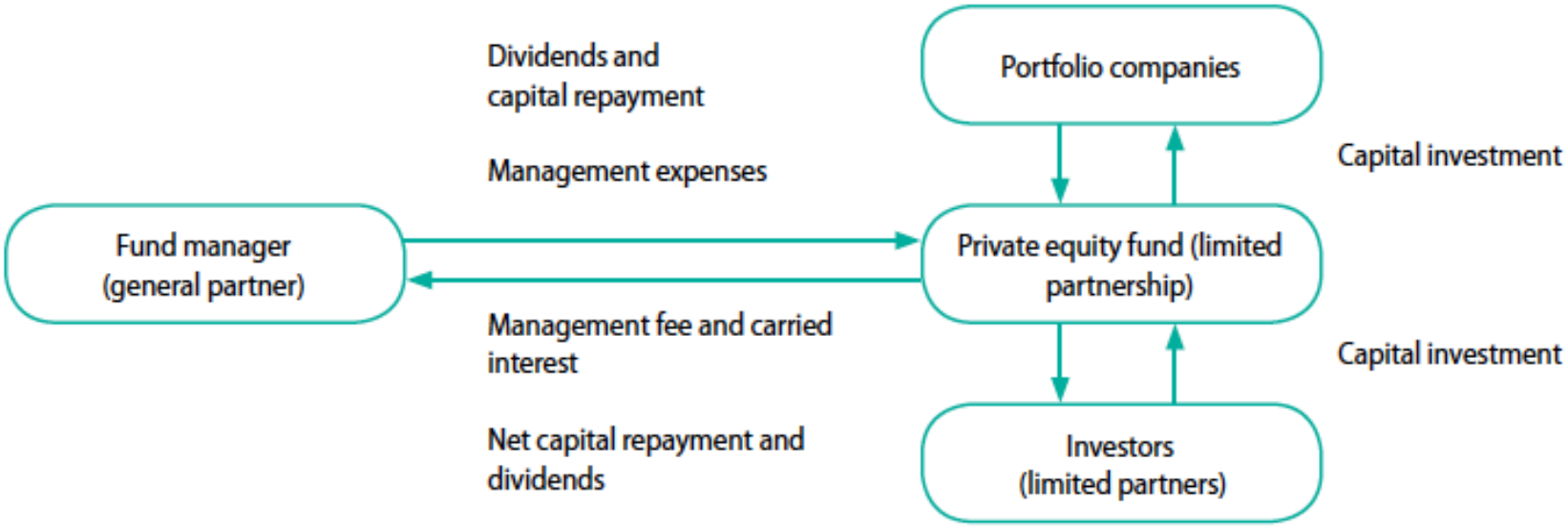


Source: EU Commission (2017).

II. Private equity and venture capital

The business model of private equity

- Suitable for an intermediary stage in corporate development: between internally generated and external finance, such as loans and listed equity.
  - Growth and buyout investment account for the bulk of private equity business. Investee companies have proven commercial concept and growth potential.
  - Pure venture capital is a niche segment.
  - Turnaround investors target mature companies with significant restructuring potential, which will benefit from debt restructuring.
- Unlike for listed companies, the incentives of managers and owners are closely aligned.
- Significant stakes (25% plus) and direct involvement by investors in operational restructuring (cost cutting and repositioning) and governance restructuring (incentives for managers). Not an easy option for existing owners.
- Holding period typically 5-7 years. Exit normally to capital market or in other PE trades.


Dividends and
capital repayment
Management expenses
Portfolio companies
Capital investment
Fund manager
(general partner)
Private equity fund (limited
partnership)
Management fee and carried
interest
Capital investment
Net capital repayment and
dividends
Investors
(limited partners)

Source: EBRD.

Venture capital

- Venture capital supports the pre-launch, launch and early stage development phases of a business (OECD).
- The key contributions are seed capital for R&D or product development, and growth capital for the early growth phase of a start-up enterprise.
- Innovative technologies take many years to develop and have unpredictable returns. Start ups do not have sufficient collateral or a sufficient business record. Bank credit is therefore not suitable.
- Business angels provide smaller financing that VC funds. These are high net worth individuals who directly invest part of their assets in start-up enterprises. They bring specific industry knowledge and contacts and will typically be involved through a non-executive board position. As they are sparse in the CESEE, conflict of interests may set in.

The economic potential

- Empirical literature on PE/VC involvement (e.g., EBRD, 2015)
  - PE funds help investee firm gain access to credit, and will raise its capital spending
  - Monitoring, governance and operational restructuring raises innovation and productivity within the firm
- Extensive empirical literature on private equity impact on wider economy, (also confirmed for the much smaller VC segment):
  - Positive impact on corporate revenue growth, employment and labour productivity, albeit only after about three years.
  - Capital expenditures in parallel to operational restructuring.
- VC will spur innovation by overcoming financing constraints of young companies. As a highly risky sector VC requires private sector expertise and risk sharing

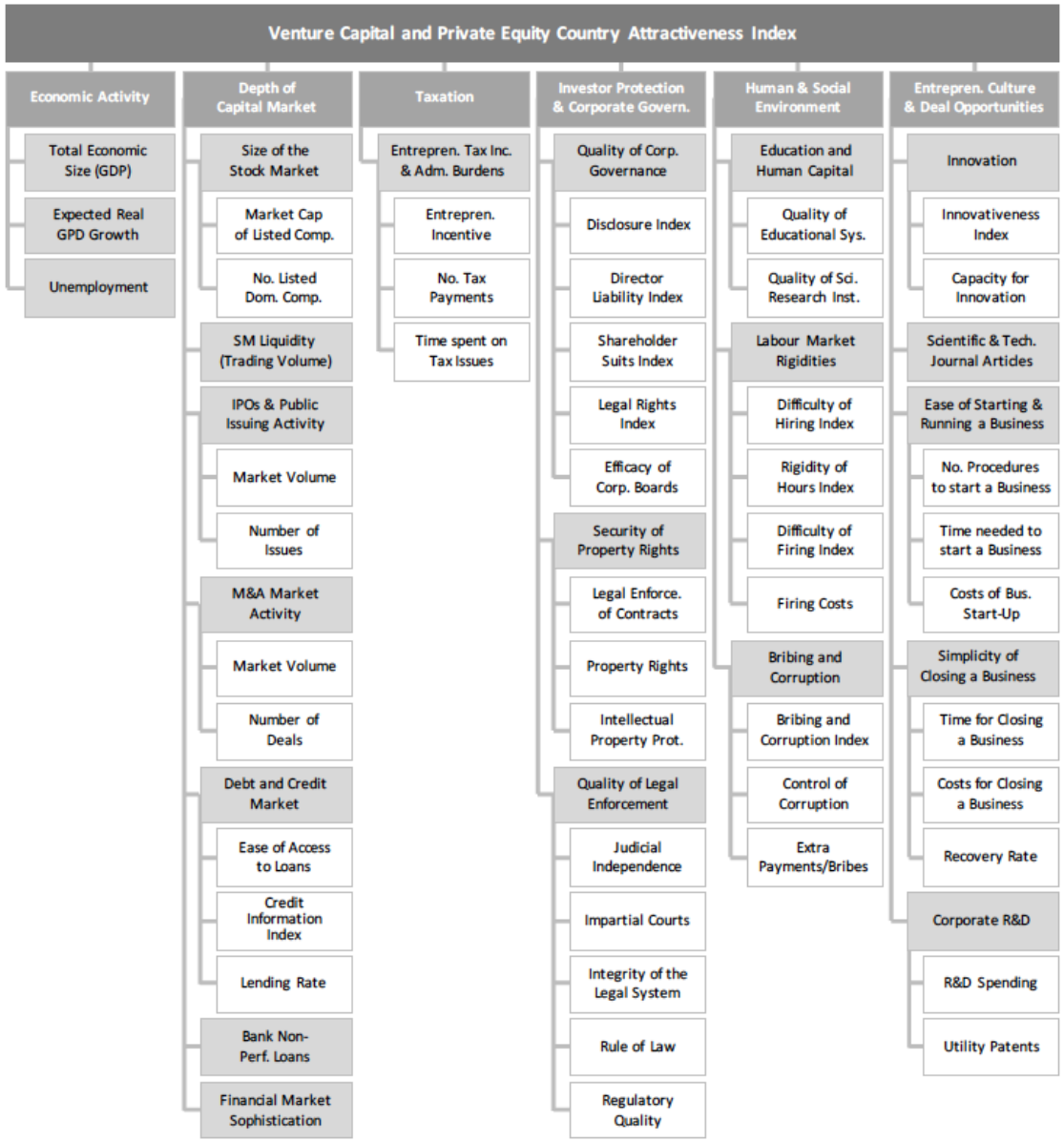
Regulatory and framework conditions

- PE/VC regulation is part of a broader environment that will need to be receptive for risk capital. Key aspects are:
  - Investor protection, corporate transparency and corporate governance.
  - Transparent and predictable taxation that is efficiently administered
  - Contract enforcement and protection of intellectual property rights
  - Liquid local capital markets as an ultimate exit option
- Poor corporate governance and protection of minority shareholder interests are the key concerns in CESEE
- The wider innovation framework and economic growth are also important:
  - Local innovative activity
  - Government R&D spending and start-up programmes will attract VC.

VC and PE attractiveness index (IESE Business School):

Now well-established assessment of local demand and expectation of efficient deal making based on six indicators:

1. Economic activity
2. Depth of capital market
3. Taxation
4. Investor protection and corporate governance
5. Human and social environment
6. Entrepreneurial culture and 'deal opportunities'.



Private equity framework conditions in the region

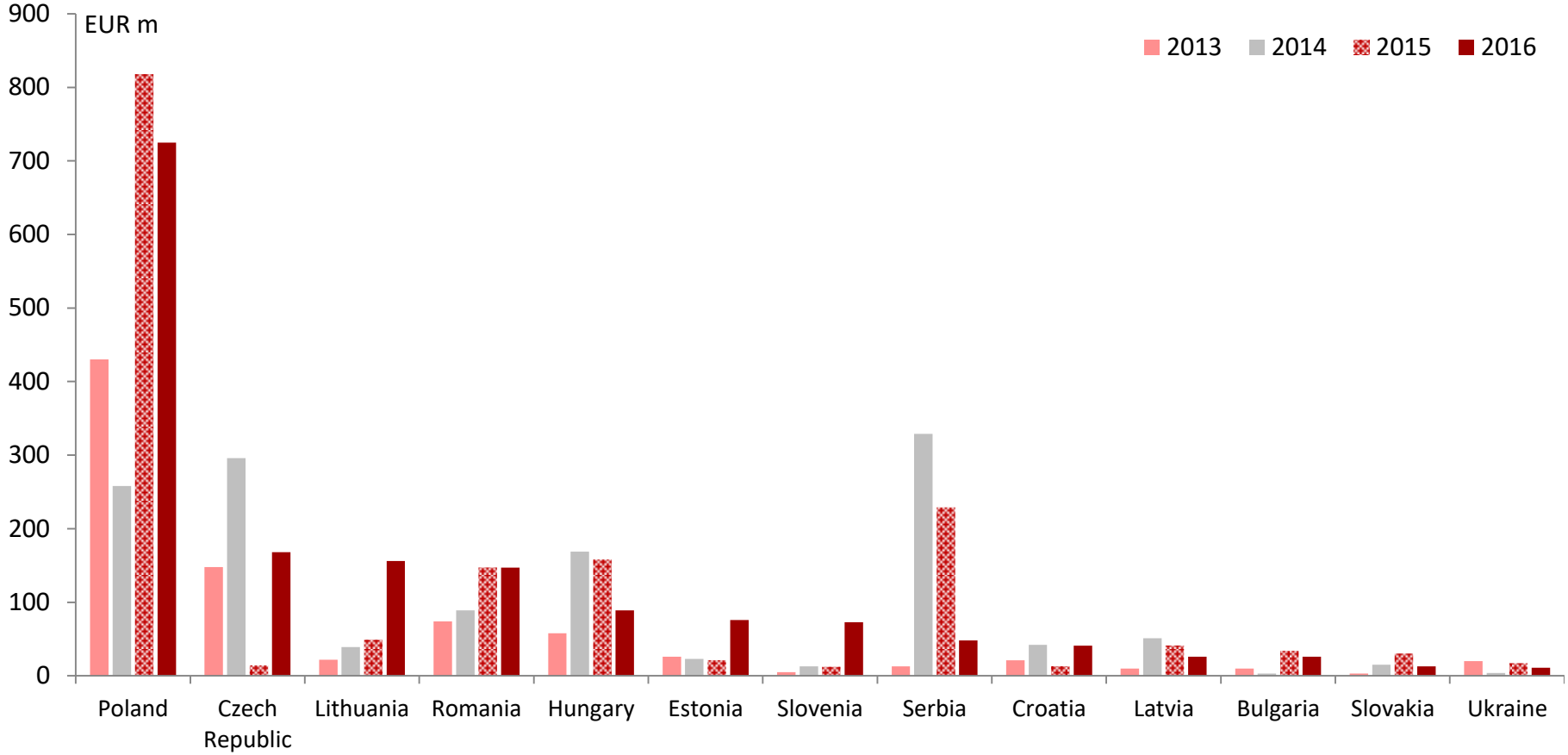
		Score (US=100)					
	Overall rank out of 125	Economic Activity	Depth of Capital Market	Taxation	Investor Protection and corp. governance	Human and Social environment	Entrepreneurial Culture and deal opportunities
Georgia	61	61	43	104	73	53	50
Czech Republic	33	85	48	102	71	73	73
Turkey	35	94	72	107	59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

Sources: VC and PE country attractiveness index.

The investor landscape in emerging Europe

- The sharp drop in global flows after the financial crisis has only partially been made up.
- CEE region still underserved by PE/VC: EBRD estimates number of suitable firms at 40,000, compared to only 800 recipients to date.
- Investor activity concentrated in central Europe, Russia and Turkey.
- VC normally a very small percentage of overall SME financing.
- The EU VC market is itself underdeveloped, depth is only about 12 per cent of that in the US.
- Figures understate fundraising by expatriate start-up enterprises in UK and US, and investment back in CESEE home countries

Private equity activity in emerging Europe



Source: Invest Europe, CEE Private Equity Statistics 2016.

III. Listed equity and stock markets

The difficult economics of going public

- Estimate for IPO costs for EU mid-sized companies: 6-10% of capital raised (EU Commission, 2017)
  - Underwriting fees
  - Legal fees
  - Listing fees
- Ongoing disclosure costs once listed
- Costs more onerous for the typically small firms in the CESEE region:
  - Upgrade of transparency, accounting standards
  - Changes in corporate governance
- Intangible benefits from governance restructuring are distant and hard to value

CESEE stock exchanges

- Institutions in search of a role: all CESEE countries have an exchange and capitalisation is sizable, though IPOs are now very few and highly concentrated. Warsaw is the only exchange which attracts foreign IPOs, including from Ukraine
- Turnover is also increasingly concentrated in Warsaw, Budapest and Prague.
- Some cross-border alliances (e.g., Baltics, SEE Link or Prague-Vienna)
- All exchanges have their central securities depositories (CSDs), though only Poland and Hungary have EMIR-compliant CCPs. A fragmented post-trading infrastructure not conducive to cross-border trading
- Experience of stock exchange is in line with World Bank research, showing that early growth and liquidity are key factors in long term success, and that many exchanges (Albuquerque et al., 2016).

Country	Name	Equities					
		Capitalisation	Turnover		Listed companies		IPOs
		EUR million	Total	Share turnover ratio	Domestic	Foreign	
			EUR million	%	Number	Number	Number
Bulgaria*	Bulgarian Stock Exchange (BSE - Sofia)	4,417	156	4%	365	0	1
Czech Republic**	Prague Stock Exchange (PSE)	40,721	6,213	15%	15	10	1
Estonia	Nasdaq Tallinn	1,888	149	8%	15	0	0
Croatia***	Zagreb Stock Exchange (ZSE)	16,834	387	2%	186	0	2
Latvia	Nasdaq Riga	1,277	45	4%	26	0	0
Lithuania	Nasdaq Vilnius	3,339	75	2%	29	1	0
Hungary	Budapest Stock Exchange (BSE)	16,246	7,005	43%	45	0	0
Poland	Warsaw Stock Exchange (WSE)	123,659	56,256	45%	838	64	49
Romania	Bucharest Stock Exchange (BVB)	17,027	1,865	11%	82	2	0
Romania	SIBEX	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Slovenia	Ljubljana Stock Exchange (LJSE)	5,523	340	6%	46	0	0
Slovakia	Bratislava Stock Exchange (BSSE)	2,119	6	0%	14	0	0

Source: EBCI (2018).

IV. Corporate bond issuance

Benefits of a corporate bond market

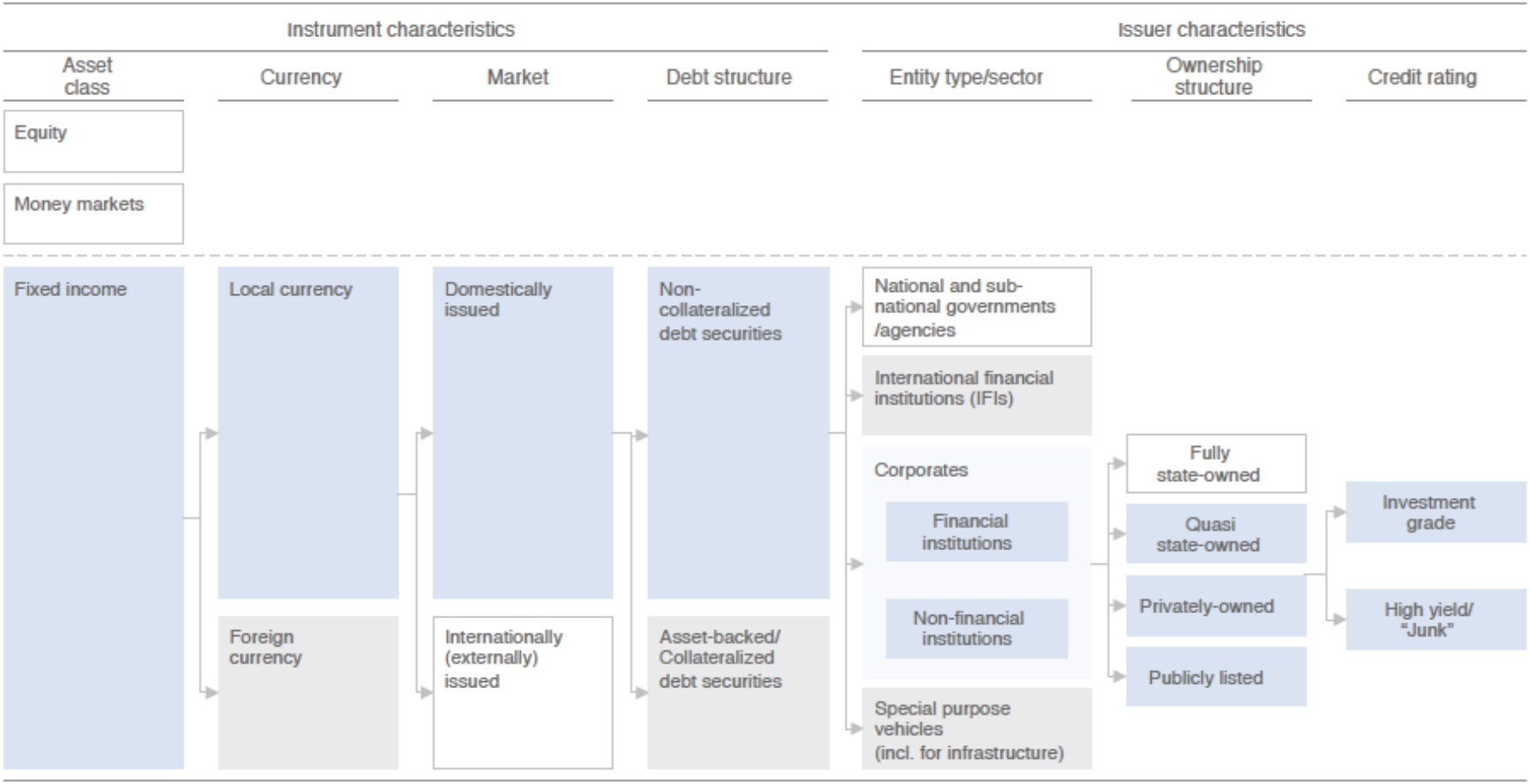
Financial stability:

- Countercyclical to bank lending (Greenspan, 2000) but may be positively correlated with bank lending (Jiang, 2001).
- Reduce fx mismatches
- Tailor maturity to project characteristics
- Light on covenants for larger issuers

Wider benefits:

- Development of an institutional investor base
- Liquid local market attracts foreign investors
- Imposes requirements of transparency and market discipline on issuers (e.g., through regular coverage by rating agencies)

Excessive focus on the domestic market may come at the cost of other options for funding and market development



Source: World Economic Forum.

Which firms could issue?

In general a firm is more likely to issue on a domestic bond market if it is:

- Relatively large
- Growing with a substantial investment programme
- At or above investment grade
- With a record of a syndicated loan

On the international market issuers are:

- larger
- more leveraged

Specific issues for SMEs and most firms in the CEE region:

- Median size of issuer has gone up since the financial crisis
- Issuance costs relative to deal size could be substantial
- Coverage by international rating agencies is patchy
- Transparency of accounts and auditing?
- Obstacles from investment mandates of institutional investors

Sources: Empirical studies reviewed in EU Commission (2017, and OECD, 2015).

Policy priorities

Primary market framework

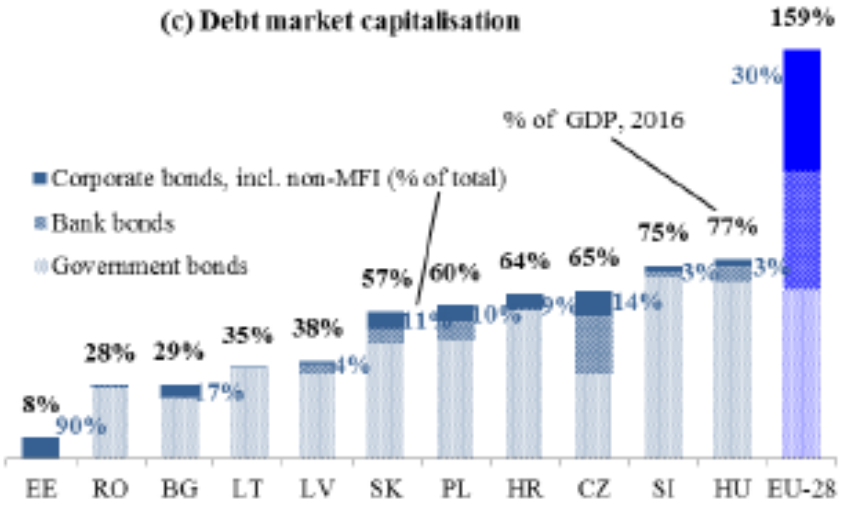
- Facilitate issuance through light disclosure requirements, and registration requirements
- Adapt the framework to the issuer base: large repeat issuers, SME first time issuers, and special projects (infrastructure).
- Offer simplified disclosure regimes for private placements

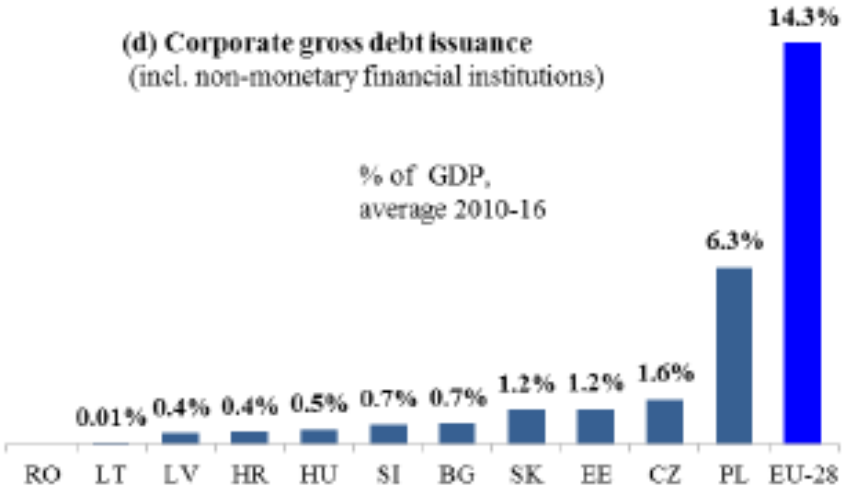
Secondary market framework

- Corporate bonds inherently less liquid than sovereign issues, given a largely 'buy-and-hold' investor base
- Make trading systems easily accessible for eligible market participants.
- Ensure transparency, at least following a trade, through centralized reporting (e.g., on a CSD)

Source: IMF (2013).

Corporate bond market development in the CEE





V. Conclusions and some implications for Georgia

Conclusions

- Private equity in the CESEE has played a key role in accessing a more diverse funding base, importing stronger governance standards, and preparing wider capital markets at the same time.
- LC debt issuance on domestic market has been a meaningful funding source, though only in the presence of local institutional investors.
- Sovereign and sub-sovereign debt, IFI bonds and ABS/collateralised issues all have benefits for the development of the core LC debt market.
- Few stock exchanges have thrived. But there is a good case to bundle liquidity there, and upgrade infrastructure, including through links between CSD and ideally a regional CCP.
- In attracting foreign investors, transaction costs, CSD integration and liquidity are key. A 'frontier'-type market offers diversification from advanced markets.
- EU legal requirements now seen as overly costly, and may discourage issuance. For non-EU countries regulatory convergence should be cautious.

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