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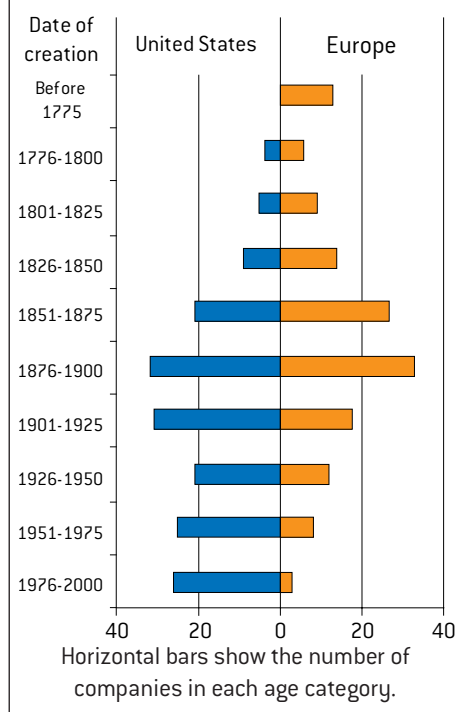
FINANCING EUROPE'S FAST MOVERS

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SUMMARY Arguments about structural policies in Europe, including the EU's Lisbon strategy, put a legitimate emphasis on labour and product market reforms, but often overlook the role of the financial system in fostering innovation and growth. **Corporate finance is crucial for the emergence of new companies, well beyond the much-analysed technology sector.** In a knowledge economy where companies rely less on physical investment, traditional bank loans are insufficient. While Europe has a world-class financial system for established companies, new instruments tailored to the needs of emerging firms remain underdeveloped in most EU countries.

Fig 1: 'Population pyramid' for largest US/European companies



Source: Bruegel, based on FT Global 500 ranking of the world's largest listed companies, 30 September 2007.

POLICY CHALLENGE

To improve financing for high-growth-potential emerging companies, policy-makers should focus on the legal and regulatory environment and on market incentives, rather than on subsidies or other direct intervention. Key areas for policy action include competition among intermediaries, securities regulation, insolvency legislation, taxes, and prudential rules. More generally, the ability to foster corporate growth should be given higher priority in EU financial policy, alongside existing objectives of financial integration and stability. Even if decisions fall within the national remit, information, benchmarking and discussion at European level would enhance the prospects of reform.



EUROPE is widely recognised as suffering from economic inertia. Felipe Gonzalez, the former Spanish prime minister who now chairs a committee tasked with charting the future of the EU, has recently declared: "Europe suffers from extraordinary corporate rigidity. And I am not only talking about the power of trade unions and labour rights. [...] Business, labour and political elites protect each other. We stifle innovation. That is why Europe has failed to produce a Bill Gates"¹.

The financial sector is key to unlocking Europe's growth potential. Even taking into account controversies generated by the current securitisation crisis, America's constantly self-reinventing corporate finance industry is often quoted as a crucial source of business dynamism. But discussions about structural reform in Europe, including the EU's Lisbon strategy, treat the financial system mostly as an afterthought: none of the strategy's 24 current 'integrated guidelines for growth and jobs' (2005-08) specifically focuses on finance². While the high-technology sector has been the focus of some attention, there is a startling lack of policy-relevant data when it comes to the financing of emerging companies more generally³. By underestimating the link between financial development and growth, policy-makers have neglected an important policy lever for achieving higher growth and employment in Europe.

In this Policy Brief, we consider how Europe's financial system can foster the growth of emerging companies, irrespective of the

technological content of their activities. Our focus on corporate finance deliberately leaves important policy questions, not to mention cultural factors, out of the scope of this brief⁴. In particular, measures specifically targeted at high-technology companies and their link with university research and 'innovation ecosystems' are not dealt with here. Also outside our scope are questions related to the size of lead markets for emerging firms, including how public procurement may help provide lead markets, an idea often raised in broader discussions about a 'European Small Business Act'⁵.

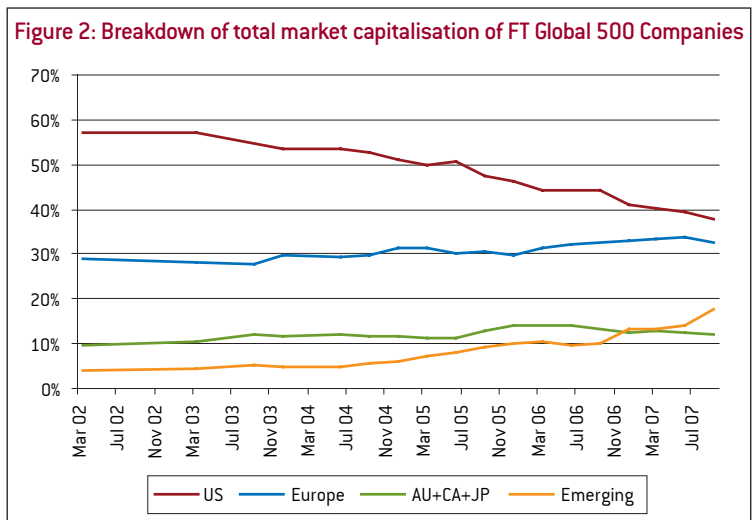
1. ESTABLISHED AND EMERGING FIRMS

Europe's corporate landscape is dominated by old, established companies. A look at the age distribution of the world's 500 largest listed companies shows that European 'champions' are generally much older than American ones, let alone those from emerging markets, as illustrated by Figure 1 [cover page]. Strikingly, Europe's corporate giants include only 12 companies born in the second half

of the twentieth century, against 51 in the US and 46 in emerging countries; of these, only three were created after 1975 in Europe, compared with 26 in the US and 21 in emerging markets.

The prominent old, established firms which form most of Europe's large-company landscape are doing well in the global competition, even better by some measures than their US counterparts. As Figure 2 illustrates, their relative weight in the global 'top 500' has slightly increased in the past half-decade, while that of US 'champions' has declined almost continuously as companies from emerging economies have gradually taken their place. Exchange rate fluctuations play a role but do not explain the trend, since much of the decline occurred in 2004-06, a period when the euro/dollar parity was fairly stable at around \$1.2-1.3 for one euro.

In fact, large US companies are not only being challenged from abroad but also from within: Figure 3 shows the constantly increasing rate of turnover in the highest ranks of US business. While in



Source: Bruegel calculations based on the FT Global 500 rankings, published on www.ft.com.

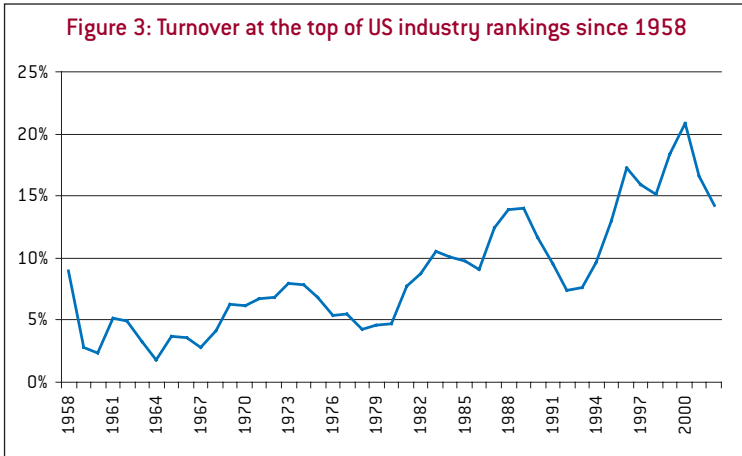
¹ Quoted in Financial Times, 'Rebel seeks innovators to shake up Europe', 15 January 2008.

² <http://ec.europa.eu/growthandjobs/>

³ GHK/Technopolis, 'Evaluation of data and sources underlying the analysis of market gaps in access to finance for SMEs in the EU', report for the European Commission, July 2007.

⁴ See Philippe Aghion, *A Primer on Innovation and Growth*, Bruegel Policy Brief 2006/06, October 2006.

⁵ Communication of the European Commission, 'A Single Market for 21st Century Europe', 20 November 2007.



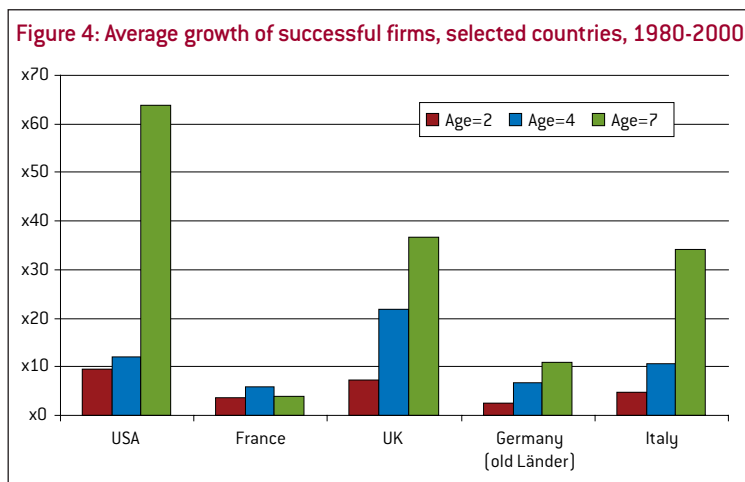
Source: update (including 2007 data) of figure 4 in Diego Comin and Thomas Philippon, "The Rise in Firm-Level Volatility: Causes and Consequences", NBER Working Paper No.11388, 2005. Industry leaders are firms in the top 20% of their industry based on market value. The figure shows the probability that a current industry leader exits from this group within the next 3 years. This turnover measure displays a clear upward trend over the post-war period. It is also procyclical, suggesting that leaders are more likely to be challenged in booms than in recessions.

Europe the largest companies are likely to stay on top for a long period, in the US they are vigorously challenged by new entrants and also by their own shareholders, who often force them to divest non-core activities or to split into separate entities. Similar pressures are mounting in Europe but remain less powerful than in America.

Does this matter for growth? An influential school of thought in Europe maintains that large companies are better able to innovate because they can hedge risks internally and cross-subsidise innovation with surpluses from mature divisions⁶. An alternative view, associated with Austrian economist Joseph Schumpeter, argues that "the process of creative destruction is the essential fact of capitalism"⁷.

Recent economic research has generally tended to confirm Schumpeter's argument, while making it more precise and more quantitative. Using establishment-

level data, a seminal work in 2000 found that one-third to one-half of aggregate productivity growth in US manufacturing is directly due to reallocation between firms, creation of new firms, and disappearance of unsuccessful ones⁸. More recent research found that countries where big companies are more likely to be challenged and displaced experience higher productivity and income growth⁹.



The bars represent average firm size relative to size at creation. Source: Eric Bartelsman, John Haltiwanger and Stefano Scarpetta, "Microeconomic Evidence of Creative Destruction in Industrial and Developing Countries", IZA Discussion paper No 1374, 2004. N.B. Methodologies may differ from one country to another as regards the definition of size at creation.

Moreover, there are several good reasons to expect creative destruction to become more important for Europe today than it has been in past decades. First, the development of financial markets has decreased the importance of risk diversification inside large firms, as there are now other ways to mitigate risk than in-house hedging. Second, since the end of the catch-up period that followed the second world war, most European countries compete close to the 'technology frontier' where innovation-based strategies are crucial, and innovation is often disruptive rather than incremental¹⁰. And third, reallocation effects are stronger in the fast-growing service sector than in manufacturing¹¹.

As the age distribution in Figure 1 suggests, young companies generally find it harder to emerge in Europe than in the US. More specifically, many new firms are created in Europe, but thereafter they tend to grow less briskly than in other economies. Figure 4 illustrates this on the basis of company-level

⁶ See for example *Pour une nouvelle politique industrielle*, report of the committee chaired by Jean-Louis Beffa on behalf of the French government, La Documentation Française, 2005.

⁷ *Capitalism, Socialism and Democracy* (1942).

⁸ Lucia Foster, John Haltiwanger and C.J. Krizan, "Aggregate Productivity Growth: Lessons from Microeconomic Evidence" NBER Working Paper No.6803, 2000.

⁹ Kathy Fogel, Randall Morck and Bernard Yeung, "Big Business Stability and Economic Growth: Is What's Good for General Motors Good for America?" NBER Working Paper No.12394, 2006.

¹⁰ Daron Acemoglu, Philippe Aghion and Fabrizio Zilibotti, "Distance to Frontier, Selection, and Economic Growth", NBER working paper No.9066, 2002.

¹¹ See note 8.



data analysed by the OECD. Among those firms that survive in the years following their creation, the pace of growth is much quicker in the United States.

Of course, there would be no point in penalising Europe's large and successful established companies in a context of fierce global competition. But it is in the interests of growth and job creation in Europe that new firms can challenge established positions.

Emerging firms should not be confused with small- and medium-sized enterprises (SMEs). Many SMEs are comfortable in their local niche, however small, and show no willingness or potential to grow. Many emerging firms, also, have already grown beyond the European thresholds that provide a formal definition of SMEs [fewer than 250 employees, maximum €50m in sales or €43m in balance-sheet total]. 'Emerging' firms are not meant here as a statistical category, but as those firms which are involved in a growth dynamic, for which they often need external financing. The rest of this Policy Brief is devoted to understanding better how the growth of these emerging firms, as opposed to established ones, is affected by the design of Europe's financial system.

2. THE FINANCIAL NEEDS OF EMERGING FIRMS

How much of the gap in emerging firms' growth in the US and Europe is due to differences in financial systems, rather than other factors? More research than is

currently available is needed on this question. One study suggests that, in terms of obstacles to growth, financial constraints are at least as important as labour market rigidities when observed over a sample of companies across different countries¹². To be sure, other obstacles to emerging firms are significant, including, in Europe: barriers to entry and imperfect competition in markets for goods and services; labour market constraints that discourage hiring in a risky environment; the stigma attached to failure, prejudices against rapidly-earned wealth, and a general lack of recognition of entrepreneurs in cultural and social frameworks; and a paternalistic management culture that emphasises control over local empowerment and delegation, which is incompatible with fast growth. There is no contradiction between recognising the undeniable impact of all these non-financial factors, and emphasising the importance of adequate corporate finance.

The relative underdevelopment of Europe's financial sector is sometimes presented as a chicken-and-egg problem: is there little entrepreneurship because there is no venture-capital market? Or no venture capital because there are no entrepreneurs? This way of framing the issue largely misses the point, which is about the dynamics created by appropriate incentives. Emblematically, initial public offerings (IPOs) in the US play a key

role in motivating young people to look for ideas and start companies. Without a vibrant exit market, investors might not see many entrepreneurs asking for finance. The academic literature of the past decade has robustly established that financial development is not only the consequence of growth but also a cause¹³.

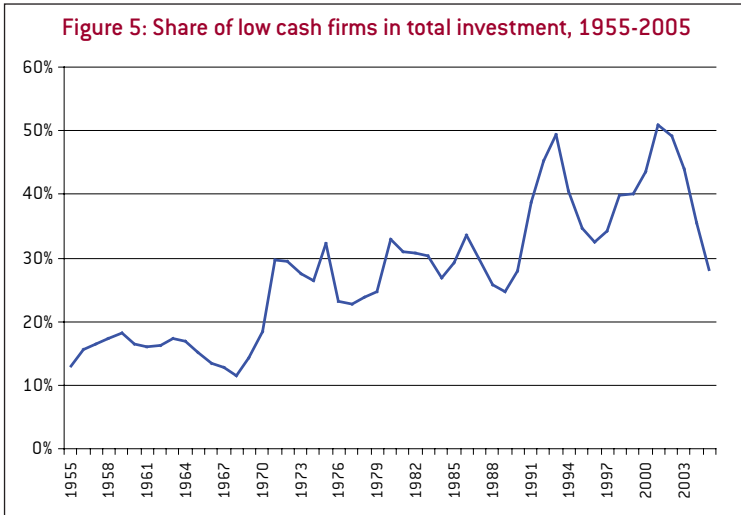
Established and emerging firms do not rely on the same financial instruments to meet their development needs. Established firms are often publicly listed, with a liquid market for their shares; many of them are rated and have access to the corporate bond market; they can tap the savings of worldwide investors through the highly efficient European wholesale markets, whose competitiveness gap with the US has now almost completely disappeared¹⁴.

Moreover, established firms typically generate significant cash flows and are therefore less dependent on external funds for expansion. Their issuance of securities is often linked with acquisitions; otherwise they rather buy back shares or distribute dividends. By contrast, emerging firms typically display low levels of cash flows and have limited or no access to wholesale capital markets, because the implied transaction costs are often prohibitive for small firms. Therefore, the need to find tailor-made solutions for their financing is crucial for their development.

¹² Philippe Aghion, Thibault Fally and Stefano Scarpetta, 'Credit Constraint as a Barrier to the Entry and Post-Entry Growth of Firms', *Economic Policy* 22/52, October 2007.

¹³ Ross Levine, 'Finance and Growth: Theory and Evidence', NBER Working Paper No.W10766, September 2004.

¹⁴ See for example 'Sustaining New York's and the US' Global Financial Services Leadership', report by McKinsey for Mayor Michael Bloomberg and Senator Charles Schumer, January 2007.



Source: Adapted from Thomas Philippon, "Why Has The U.S. Financial Sector Grown So Much?", Working paper, NYU-Stern, 2007, available at <http://pages.stern.nyu.edu/~tphilipp/research.htm>. The line shows the fraction of total investment done by firms whose cash flows are less than one third of their capital expenditures. Unfortunately, no comparable information is currently available for Europe.

One way to gauge the importance of access to finance is to study the investment of firms that do not have enough cash flows to cover their capital expenditures. Figure 5 shows the share of total investment accounted for by firms in the US whose cash flows cover less than one third of their capital expenditures. This share has risen over the post-war period, suggesting an increased ability of the financial sector to provide these firms with adequate funding to finance their investment. This contrasts with the 1950s and 1960s, when investment was mostly done by firms with large cash

flows and there was not much need for financial intermediation.

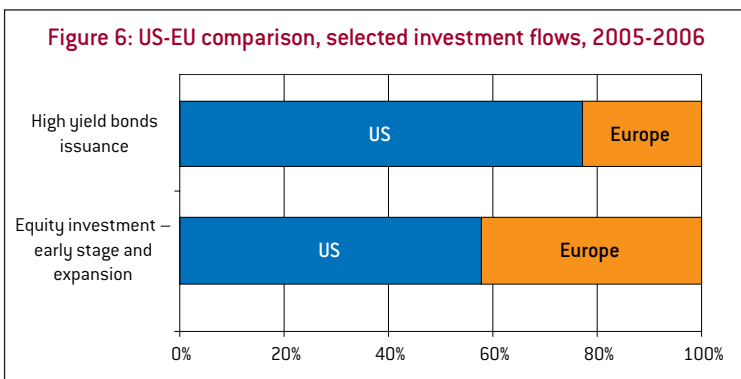
In the industrial age, emerging firms could finance their needs for investment, in spite of low cash flows, by pledging new equipment as collateral to obtain bank loans. But for service companies, which account for the bulk of today's growth in developed countries, or at the high end of manufacturing activities (such as design, research and development, and supply chain management), investment is

'Today's emerging firms need new financial solutions.'

mainly in intangibles that can less easily be used as collateral. Leasing, another popular financing solution, is also inaccessible to firms that do not invest in tangible assets.

Thus, today's emerging firms need financial instruments that are typically less senior than debt backed with physical assets. The US financial system has evolved quickly to provide these new solutions, such as high-yield bonds, mezzanine debt¹⁵, and private equity. Figure 6 shows the comparatively low level of development of subordinated financial offerings, which are more specifically suited to emerging firms, in Europe relative to the US. This does not contradict the fact that, at least until recent market developments, most of Europe's SMEs (including in central and eastern Europe) have not felt an alarming level of credit constraint¹⁶. This fact, while accurate, overlooks the concentration of financial constraints on firms with a high growth potential, which constitute only a minority of all enterprises and generally escape statistical categorisation.

The relative underdevelopment of financial services for emerging firms in Europe is aggravated by sharp intra-European heterogeneities. In the private equity segment, Figure 7, overleaf, shows the widely varying levels of intensity of professional equity investments in emerging companies: at early stage, during or shortly after creation, and in their phases of expansion (other large segments of private equity



Source: Thomson Financial, EVCA, NVCA / PricewaterhouseCoopers

¹⁵ Mezzanine debt typically includes warrants attached (or equity co-investments) to the debt obligation, along with the interest payment associated with debt.

¹⁶ See for example Flash Eurobarometer, 'SME Access to Finance', October 2005.



finance, such as leveraged buy-outs and restructuring, are excluded as they are less focused on emerging firms]. While the United Kingdom and Nordic countries generally display high private-equity activity, the level is lower in the rest of western Europe, and very low in central and eastern Europe. No comparable data are available for other types of financing aimed at emerging companies, but it is likely that similar geographical imbalances would also be observed. Geography matters, because corporate finance for growing firms often requires physical proximity and 'soft' information. As a result, heterogeneity of development is unlikely to be offset by the provision of financial services across borders.

3. HOW PUBLIC POLICY CAN HELP

Public policy can be a crucial enabler of financial and economic development, but it needs to stay up to date. During their catch-up growth in the post-war period, a time of capital scarcity, European countries relied on a range of public-sector financing instruments such as state banks, subsidised loans, or public loan guarantees. Some of these instruments are still useful and can address market failures at early stages of firms' development. The principle of subsidiarity should apply, and countries and local communities may want to be active in co-investments with private funds or loan guarantees as long as they remain compatible with EU competition policy and state aid rules. But it is

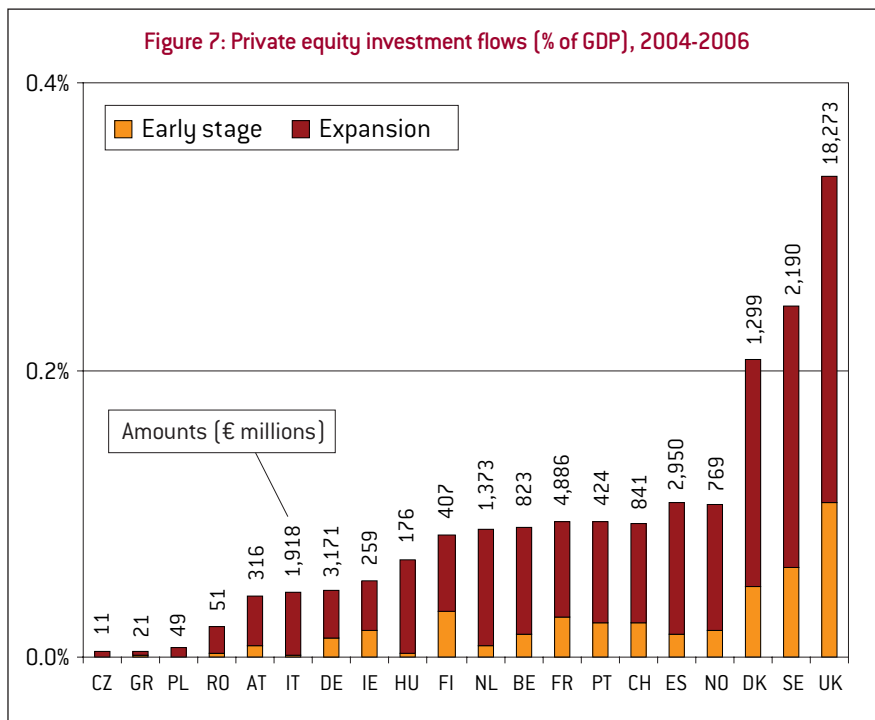
'Rather than direct intervention, public policy should focus on levelling the playing field.'

not obvious that EU-led programmes of direct funding to SMEs, such as the European Investment Bank's Global Loans or the European Commission's Competitiveness and Innovation Programme, can have much direct impact on SME growth, even in a tightening credit environment. Moreover, experience has taught time and again that incumbents are much better tooled than new entrants to capture the bulk of public support programmes.

Rather than aiming at direct intervention, public policy should focus on levelling the playing field for the optimal allocation of capital and the provision of tailored financing solutions to emerging firms, without artificial restrictions or distortions. Policy should facilitate the entry of investors when they are most needed for the development of companies, and their exit when other types of investors are better suited. While

keeping appropriate oversight to ensure financial stability – a prominent aspect these days – policy-makers should create an environment that favours financial flexibility and innovation, especially in corporate finance, in order to allow low-cash firms to invest, grow and drive the whole economy forward in Europe as they have in the US.

Therefore, we suggest that orientation of the financial system towards growth, offering optimal financial



Source: European Private Equity and Venture Capital Association (EVCA).



solutions to emerging firms, be elevated to a top-level priority of financial policy in the European Union and its member states, alongside the existing policy objectives of financial integration and stability. This amounts to a substantial reform programme, which this Policy Brief can only tentatively outline. It encompasses a number of legislative and regulatory areas which have a major impact on corporate finance.

- **Competition policy** is perhaps the most crucial enabler. In the European financial sector, competition has long been stifled by rigid prudential considerations, some of which are no longer justified¹⁷. Adequately supervised non-banking entities should be allowed to compete with banks on a wide range of services, eliminating current distortions: for example, non-banks are still prohibited from offering leasing or factoring services in Austria, France, Italy and Portugal. As banks rethink their business models in the wake of the current financial crisis, diversification of corporate finance offerings by a wider variety of providers would foster innovation, as is the case in Europe's wholesale financial markets, most strikingly in the City of London.
- **Securities regulation** is another high-impact area. As far as capital markets are concerned, the logic of regulation should be changed. Instead of having strong regulations with exceptions for small firms, who then need legal advice to understand not only the rules but also the

exceptions, it would be more efficient to have basic rules for everyone, and then add obligations for large companies, if necessary. A 'light-touch' regime of regulation for shares traded among professional investors should be implemented at EU level to leverage the scale effects of a cross-border market for shares of emerging firms. Part of the reason why the success of the London Stock Exchange's Alternative Investment Market (AIM) has not been replicated on the continent lies in fragmented and excessively prescriptive national regulations. Also, an appropriate regulatory framework could help develop corporate-loan securitisation, which is currently a tiny fraction of total securitisation in Europe as Table 1 illustrates. Securitisation has acquired a bad reputation since the start of the subprime crisis, but it remains a unique technique for allocating capital and enlarging the pool of investors for a given category of assets. Cross-border regulatory harmonisation would enable a much more dynamic European market for securitised corporate debt.

- **Insolvency legislation** plays a crucial role in determining the financial attractiveness of debt products, such as mezzanine debt or high-yield bonds, which are more useful to emerging firms with rapid growth and no physical collateral. Here, the key consideration would be a more predictable and inexpensive framework. Insolvency

rules should allow for the rapid workout of ailing companies, with the possibility of quick capital redeployment, and fairer compromises between different categories of stakeholders than currently exist in many countries¹⁸. Previous EU initiatives on insolvency rules have focused on settling jurisdictional conflicts and more recently on trying to diminish the 'stigma of failure' attached to unsuccessful entrepreneurs. But it is even more important to define clear rights and processes in insolvency situations, so that investors can more easily provide subordinated rather than senior debt when it is conducive to company development.

- **Tax policy** should be reformed in order to remove current distortions, especially between equity and debt. European countries should revise the current tax framework that allows tax deductibility of interest payments while generally submitting interest income and dividends to different and

Table 1: Issuance of asset-backed securities in Europe by underlying asset class, 2006

Residential mortgages	56%
Commercial mortgages	13%
Collateralised loan/debt obligations	11%
SME loans	7%
Automobile loans	2%
Other	11%

Source: Morgan Stanley, 'European ABS Outlook 2007: RMBS, Credit Cards, SMEs', December 2006.

¹⁷ See Elena Carletti, Philipp Hartmann & Steven Ongena, 'The Economic Impact of Merger Control: What is Special about Banking?', European Central Bank Working Paper No.786, July 2007.

¹⁸ See for instance 'Submission on Insolvency Law Reform', European High Yield Association (EHYA), April 2007, available at http://www.ehya.com/ads/PressRelease/Lette_UK_Treasury_April_2007.pdf.



often complex tax treatments. There is no economic rationale for such distortions, and the long run goal should be to obtain a level playing field for all types of financing, with tax regulations that are simple and free of loopholes. Specifically, the development of subordinated debt, which we advocate, should not rest on tax arbitrage relative to equity, but rather on its intrinsic value as a flexible tool for high-growth firms. Debt and equity should receive similar tax treatments at the corporate and individual levels. In late 2005, the US Advisory Panel on Federal Tax Reform proposed taxing all corporate cash flows at a flat rate, expensing all new investments, and eliminating business interest expense deductions for non-financial firms¹⁹. Europe should consider a similar move, to be introduced gradually and with great care to avoid any double taxation. But in the long run, the gains from a simple, harmonised, and unbiased tax system are too great to be ignored.

Another significant tax and regulatory issue are the

barriers to cross-border funds. EU efforts to address this have started with respect to venture capital²⁰ and should be continued, so that the fund management industry can benefit from currently unattainable scale economies.

- **Prudential regulations** that hamper equity (including private equity) investment by institutional investors such as pension funds and insurance companies should be revised, thus completing the already significant improvements made by many European countries in this area over the past few years.

As these recommendations illustrate, the policy instruments most likely to result in better financing of emerging firms are in large part in the hands of national governments, but momentum at the European level would help achieve the full benefits from financial development. Moreover, concerns about competition as well as regulatory and tax arbitrage could stifle reform if EU-level coordina-

tion is absent. EU-level discussion could also help overcome the severe lack of comparable data that currently hampers analysis in this policy area. Making the financial system more supportive of emerging firms is therefore within the scope of EU policy initiatives, just as financial integration and financial stability.

Governments and established companies have benefited immensely from the integration of Europe's financial markets. The next step is to leverage the same strengths in order to foster the growth of a new generation of successful enterprises. There is a goldmine here. In a time of fierce global competition, Europe should not leave it unexploited.

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Bruegel is a European think tank devoted to international economics, which started operations in Brussels in 2005. It is supported by European governments and international corporations. Bruegel's aim is to contribute to the quality of economic policymaking in Europe through open, fact-based and policy-relevant research, analysis and discussion.

¹⁹ www.taxreformpanel.gov.

²⁰ See Communication of the European Commission, 'Removing cross-border obstacles to cross-border investments by venture capital funds', 21 December 2007.

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