Wholesale Financial Markets Series

The Role of Wholesale Financial Markets in Financing Europe's Businesses

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1.
Wholesale Financial Markets
What they are and why we need them

Key messages

> Wholesale financial markets connect people and institutions that have money and are looking to invest it with people and institutions that need it.

> Large companies use the products and services available from wholesale financial markets:

  > to find the cash they need to invest and expand their operations – thus contributing to economic growth and job creation;

  > to guard against common business risks such as changes in currency exchange rates or interest rates and fluctuations in the prices of the commodities and raw materials they need; and

  > to manage their capital efficiently, ensuring they have enough cash to operate and that any spare cash is well managed.

> Without wholesale financial markets, important retail services such as pensions and mortgages would be more expensive and less readily available.

What are Wholesale Financial Markets?

Retail financial markets provide services such as day-to-day banking, savings and credit facilities to individuals, families and small businesses. Wholesale financial markets support larger organisations such as large companies, public sector organisations, governments and financial institutions like pensions funds. These have more complex requirements. They can use wholesale markets to raise finance or acquire products that enable them both to operate more efficiently and to reduce the risks of doing business. And there are important links between wholesale and retail markets. For example, without the ability to borrow money for short periods on the wholesale markets, retail institutions would be less able to lend money to customers for long periods through mortgages. This is often called 'maturity transformation'.

There is no universally accepted definition of a wholesale financial market. We tend to talk of a range of different markets e.g. capital markets, debt markets, derivative or commodity markets; each defined by the products or services it provides. Some of the main ways in which companies can use these markets are:

Wholesale market participants

Providing funding: If a company needs money to invest and grow its business, it will often need more than it has readily to hand from its normal cash flow. So to find another way to fund its investment, the company can go to the wholesale markets to raise the capital. And it can do that in a number of ways.

Firstly, it can seek corporate lending, usually from a bank. Here, banks take the money deposited with them by savers and lend it out to companies who need to finance growth or development. The interest the company pays on the loan feeds back in part to the original savers as interest on their deposits. European non-financial corporations had loans outstanding of €5.3tn at the end of 2012.

Secondly, commercial organisations and governments can use the capital markets to raise money directly by selling ('issuing') bonds (debt) or shares (equities).

A bond is effectively an 'IOU'. The bond will have a face value and an investor will pay that amount to the issuer for the bond. It will have a fixed term, e.g. 10 or 20 years. The bond will stipulate an agreed amount of interest that the issuer must pay to the investor each year until the full amount (i.e. the face value that the investor originally paid) is repaid at the end of the term.

With shares the company is selling shares in its business. An investor will buy the shares hoping to see the company succeed and the shares rise in value so that he can sell them at a profit and in the meantime enjoy a share of the company's profits each year in the form of a dividend.

In both cases a wholesale bank will underwrite the issue – that is they will agree to take responsibility for selling the bonds or shares in the market and also take the risk if all the bonds or shares don't sell. A wholesale bank will normally be better placed to do this as it has the capital raising ability and capital strength that a typical company does not. At the end of 2012, the value of finance provided by wholesale financial markets to European companies stood at nearly €10tn.

A crucial feature of wholesale markets today is that they are international. In Europe, the euro market alone might not have sufficient money ('liquidity') to support all the needs of European businesses. But through the markets companies are able to access funds from around the world. They can access capital in other currencies and use 'swaps' to bring the money back into whatever currency they need. This 'transformational' role is fundamental to Europe's financial centres.

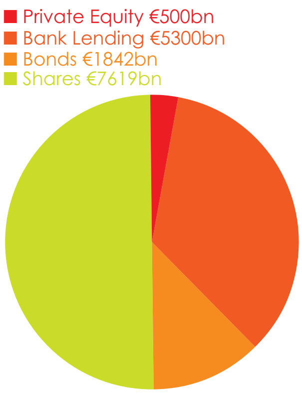
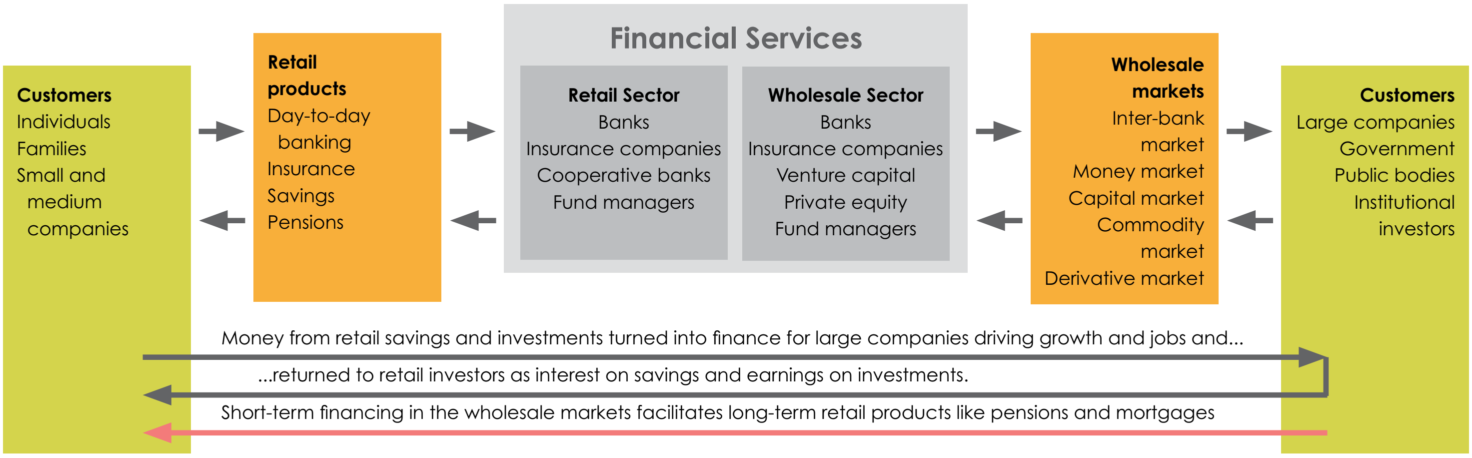


Figure 1.1
Financing for EU companies in 2012 (€ bns)

Source: TheCityUK

Wholesale Financial Markets
What they are and why we need them



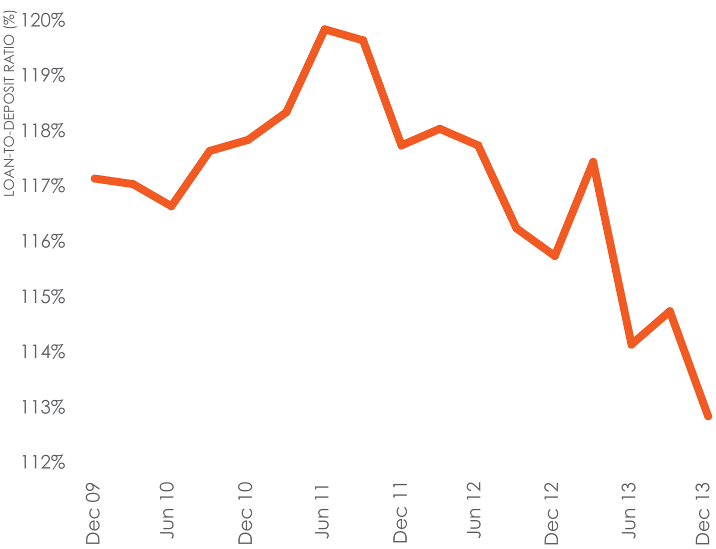


Figure 1.2
The wholesale financial markets help fill the gap between loans and deposits
Banks lend out more money than they have in deposits. They fill this gap, known as the loan-to-deposit ratio, with funding from wholesale financial markets.
Source: EBA

Managing risk: Companies that operate in different countries face risks that could undermine their business from, for example, fluctuating currency exchange rates, interest rates or the costs of the commodities or raw materials they need. To be able to plan effectively, companies need to insulate themselves against or 'hedge' these risks. To do this they can use a wide range of structured hedging products and 'derivatives'.

Managing capital: Companies need to manage their working capital as efficiently as possible. They must understand how much cash they need for their various operating costs, while at the same time maximizing the return or interest earned from any excess cash. In the money markets they can access a wide range of short-term investment or borrowing products to ensure they are making the most of their capital.

Supporting the retail market: Wholesale financial markets also include the interbank market – in which banks borrow from each other to support 'maturity transformation' – borrowing for a short period of time to enable long-term lending to retail customers, e.g. for mortgages. The gap between the amount of loans made by a bank and the deposits it holds is known at the loan-to-deposit ratio and stood at 112.8% at the end of 2013. Without the ability to fill this gap on the wholesale markets, retail products such as mortgages and loans would be more expensive and harder to come by.

Investing pensions: With the population in Europe living longer, state pension provision is coming under strain. This means private savings and occupational pensions are essential to people in retirement. Institutional investors pool and invest individuals' savings in the wholesale markets in a range of instruments of various levels of risk and return depending on an individual's circumstances, helping them save for retirement. European investors had built up savings of €18.9tn in 2012.

Pensions systems vary widely between countries. But with more people living longer it is likely that state provision will become increasingly expensive and private savings will thus play a greater role in funding people's retirement.

Case study

Benefit to individuals – insurance: Fire, floods, car accidents, injuries. We all hope to avoid them, but we cannot ignore the risk of something untoward happening. And that applies to companies and governments as much as to individuals. The most obvious way to protect ourselves is with insurance. In the EU, insurance companies paid out €949bn in claims in 2012. That is €265m for car accidents a day. A further €647bn was paid out in 2012 in long-term life assurance and pensions policies.

Insurance companies are able to combine the premiums from their thousands of customers and access hedging products and services that manage or spread the risk in the wholesale markets. Without the ability to do this they would not be able to offer the levels of cover to businesses and individuals that we have come to take for granted.

Conclusion

Companies, public sector organisations, governments, investors and financial institutions can use and benefit from wholesale financial markets in three broad ways: raising finance, achieving efficient financial management and managing risk. The interconnected nature of financial services means that this wholesale activity can in many ways underpin retail markets and products that directly benefit individuals and families, for example, access to insurance and mortgages. Without the wholesale financial markets companies would struggle to get off the ground and find it harder to grow. At the same time the range of financial products available for retail customers would be more limited and significantly more expensive.

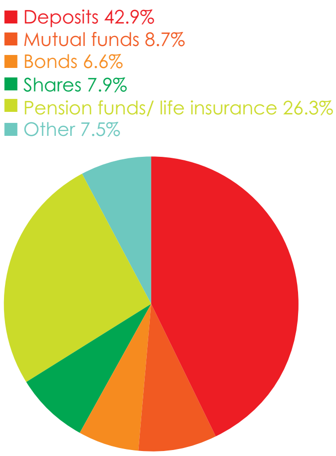


Figure 1.3
Composition of household savings in the Eurozone
Source: ECB

Figure 1.4
Insurance payouts in Europe
Source: Insurance Europe

2.
Wholesale Financial Markets
The engine-room of economic recovery: helping European companies set up and grow

Key messages

> European companies rely on wholesale financial markets:

> to raise money for investing in the growth and development of their businesses;

> to take advantage of a range of 'derivative' products that help manage business risks such as fluctuating interest and exchange rates; and

> to access products that enhance the stability and efficiency of their financial management.

> In their own right, wholesale financial markets contribute €263bn to the EU's economic output, equivalent to 1.5% of the EU's economy. Financial services firms employ 6.4 million people across the EU and related professional services firms employ 5.1 million people, in total over 11 million people, 5.3% of the EU workforce.

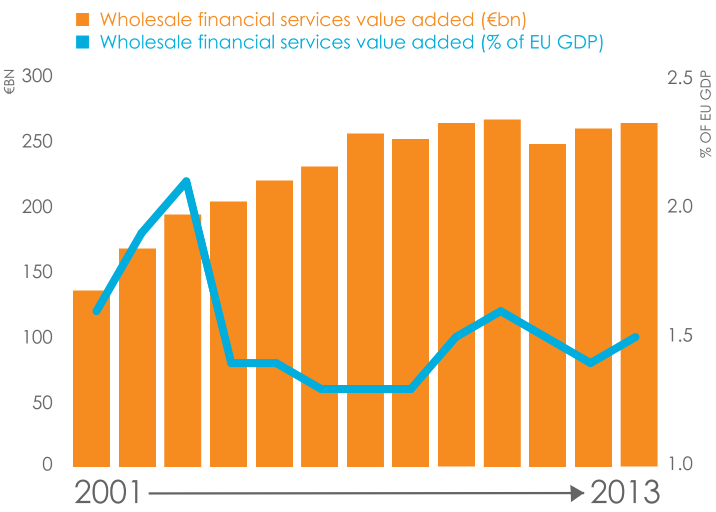


Figure 2.1

GVA of wholesale financial services

Source: London Economics

Why are wholesale financial markets valuable to Europe?

Wholesale financial markets will play a vital role in helping achieve one of the key goals of the European Union's 2020 Growth Strategy: "a smart, sustainable and inclusive economy"[1]. A wide array of companies rely on the wholesale markets to help them raise the money they need to invest and grow and to help them manage business risks and achieve efficiency in the way they manage their capital. The Europe 2020 Strategy calls specifically for "innovative instruments to finance the necessary investment" for growth. Not only do wholesale financial markets support the European economy, but the financial services firms operating in the sector make a substantial contribution to European output and are major employers.

From the Europe 2020 strategy: "tools for growth"

1. **Deepening the single market**: Wholesale markets are perhaps the most interconnected network.
2. **Investing in growth:** Financial services provide innovative instruments for investment.
3. **External policy instruments**: Wholesale markets enable macroeconomic policy coordination.

Enabling business

Wholesale financial markets make a significant contribution to the European economy by facilitating job creation and business growth across the wider economy. Products and services that companies can access in the wholesale financial markets do this in a number of ways e.g. by financing businesses or helping them manage risks or improve the efficiency of their financial management. A lot of this is achieved by using 'derivative' products. These come in many shapes and sizes and have a variety of uses some of which are illustrated in the following examples.

1. **Source:** http://ec.europa.eu/europe2020/reaching-the-goals/eu-tools-for-growth-and-jobs/index_en.htm

Financing: Deinove, a company specialising in biofuel technology, was able to raise €12m in 2012 in an initial sale of shares on the Paris Stock Exchange with the help of Invest Securities, a financial services group offering services to small and mid-sized companies. Together with €2.35m from Truffle Capital, a French based venture capital firm, the company obtained enough finance to cover the needs of its R&D programme for three years, allowing the company's 20 employees to continue the development and commercial exploitation of innovative biofuel production.

European wholesale markets helped 213 new companies raise €33.7bn in this way in the first half of 2014.[2]

'Forwards' manage the risk that the price of your product will fluctuate in the market: A wheat farmer in the south of France is subject to the risk that weather – good or bad – can affect her crop and the price she might get when she comes to sell it. In good weather farms across the country will produce large crops and abundant supply will see prices fall. In poor weather lower crops will drive up the price as supply struggles to meet demand. In order to mitigate the risk from price variation the farmer can buy a 'forward contract' which fixes the price at which she will sell her crop. This will reduce the volatility in revenues giving her a more stable operating income. This in turn feeds through to greater price stability for consumers.

The notional amount of commodity forwards and swaps outstanding at the end of 2013 was $1.3tn.[3]

'Options' manage the risk that the price of your raw materials will fluctuate: A German car manufacturer needs to buy significant amounts of steel. To guard against the risk of steel prices rising, the manufacturer may purchase a 'call option'. This fixes a future price for steel. If prices rise above the level fixed in the option he can buy at that fixed level.

If the price stays below that price, then he doesn't need to exercise the option and can buy at the lower price. The option thus provides some certainty to the car manufacturer over the

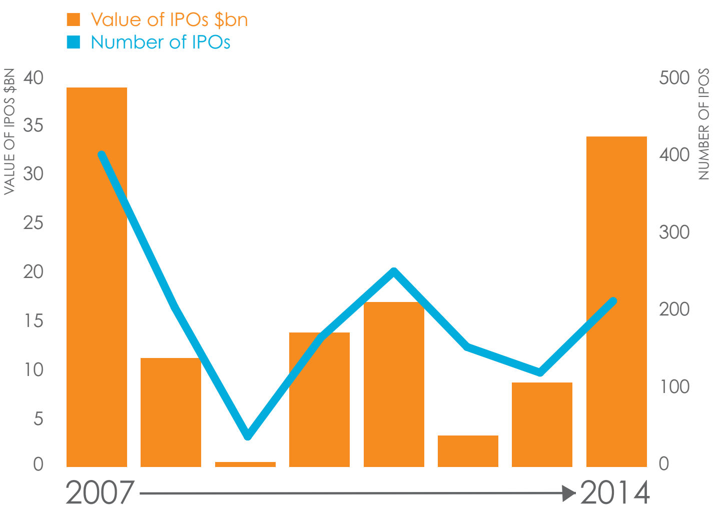


Figure 2.2
European equity raising
Source: PwC

2. PwC IPO Watch Survey 2014
3. Bank for International Settlements

cost of steel, protecting him if the price rises but leaving him free to benefit if the price stays low.

The notional amount of commodity options outstanding at the end of 2013 was $603bn.[4]

'Swaps' manage the uncertainty of changes in exchange rates: An Italian wine company exporting to countries around the world faces currency risk. The company will be paid in a variety of different currencies and, as exchange rates can vary, they face uncertainty over what they will eventually earn once it is all converted back to euros. To mitigate these fluctuations in export income, the wine company can purchase a 'swap' which enables it to exchange different currencies back into euros at pre-agreed rates. This ensures that the firm gets a consistent euro price for its wine and thus a more stable income.

The notional amount of euro currency swaps outstanding at the end of 2013 was $1.49tn for non-financial corporates. For dollar currency swaps this was $1.98tn and for sterling swaps, $436bn.[5]

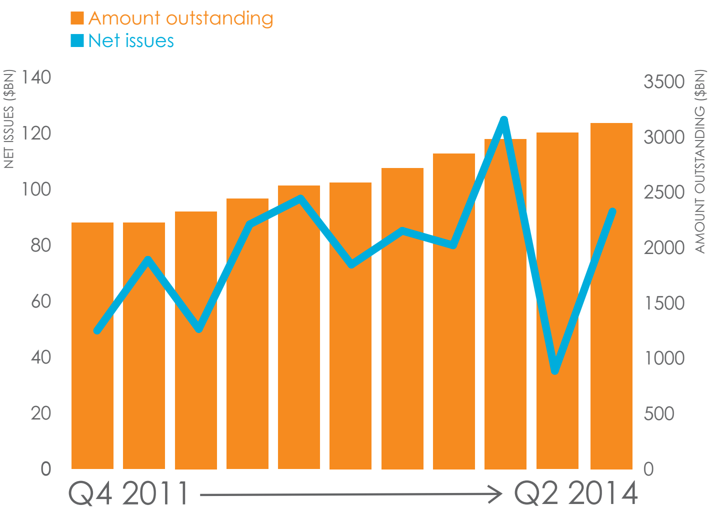


Figure 2.3

Net issues of international debt securities by non-financial corporates ($bn)

Source: Bank for International Settlement

'Swaps' manage the risks of changes in interest rates: A start-up brewery has a 5-year variable rate bank loan to help with start-up costs and working capital. However, payments to a variable rate loan can fluctuate month by month, leaving the company's cash flows unpredictable. So to bring greater certainty to its financial management, the company can buy an 'interest rate swap'. Under this arrangement, the company now pays a fixed interest rate to the seller of the swap who, in turn, covers the floating interest rate payments to the bank for the original loan.

Interest rate derivatives are the principal instrument used for risk management, accounting for 82% of global national value of all over-the-counter derivatives at the end of 2013.

In all these examples the derivative product costs money. But the benefit achieved in managing cash flow or mitigating business risks will often far out-weigh the cost of the derivative contract itself.

Direct value to Europe

Gross Value Added (GVA): The direct contribution that the financial services sector makes to GDP is usually measured in terms of the 'Gross Value Added' (GVA). Altogether, the EU financial services sector accounts for €636bn of GVA, nearly 6% of total EU economic output. Wholesale financial markets contributed € 263bn to the EU's economic output in 2013, equivalent to 1.5% of the EU's economy. This has increased from €193bn in 2003, meaning an average annual rate of growth of over 3%. The GVA contribution is largest in member states with international financial centres; the UK accounts for 35%, France 12%, the Netherlands and Italy 11% each, and Germany contributes 8%.

The wholesale market is also essential to the broader financial services sector. For example, the ability of banks to borrow

4. Bank for International Settlements
5. Bank for International Settlements

money over short periods from other banks enables them to support long-term products like mortgages for their clients. This is called maturity transformation and without it, mortgages and pensions would be less readily available and more costly.

A major European export: The EU wholesale financial services sector is also an important contributor to the EU's current account balance. The most recent data shows that in 2012, total exports of wholesale financial services by the EU to the rest of the world stood at €77bn, or a quarter of global financial services exports. Intra-EU trade is €84bn, a third of global FS exports.

Issuing shares
"The sale of new equity or stock by a firm to investors to raise money, typically to invest in and grow business."

Futures and forwards
"The buyer of the future or forward contract agrees to buy a product (e.g., a commodity or currency) at a fixed price at a specified period in the future."

Options
"A call option gives the buyer the right to buy a specified asset at a fixed price any time before expiration, and a put option gives the buyer the right to sell a specified asset at a fixed price before expiration."

Interest rate swap
"Provides the ability to convert variable interest rate payments on a loan to fixed payments."

Currency swap
"One participant offers to swap a set of cash flows for the other's set of cash flows of equivalent market value."

Conclusion

While the EU wholesale financial services generate significant employment and are a major EU net exporter in their own right, their most important role is that of supporting the wider EU business sector. Whether helping small start-ups through the provision of venture capital or raising capital through IPOs, wholesale financial markets help Europe's businesses fund growth and investment. Companies can use a wide range of products from the wholesale markets such as futures, forwards, swaps or options to achieve greater predictability of costs and revenue flows. The wholesale financial markets can provide the degree of certainty which underpins business growth, aids competitiveness and is essential for the success of organisations in the wider economy. With a successful and competitive financial services sector, Europe's wholesale financial markets contribute to the international competitiveness of European companies as a whole.

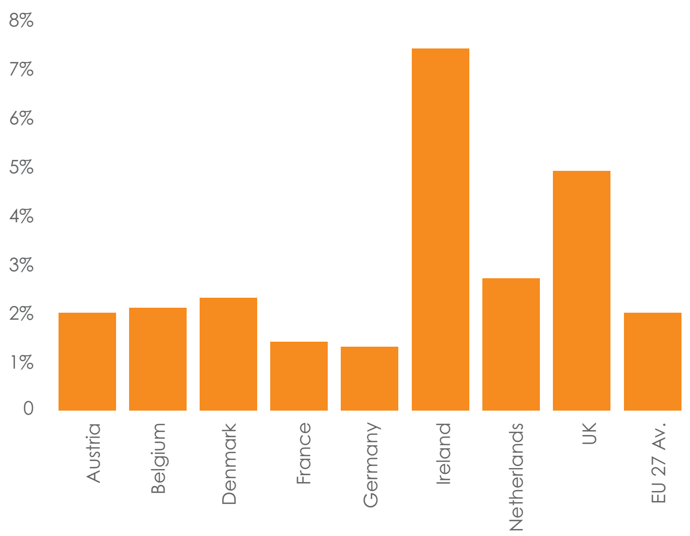


Figure 2.4
Wholesale financial services as % GDP for selected EU countries
Source: London Economics / City of London Corporation

3.
Wholesale Financial Markets
Why Europe needs international financial centres

Key messages

> International financial centres (IFCs) are hubs where cross border financial business can be conducted easily and efficiently.

> An international financial centre plays a major role in attracting new business to cities and countries.

> International financial centres benefit the European economy directly through tax contributions, providing jobs, and investment in local businesses.

> The whole country, and not just the city in question, benefits from having an international financial centre, as support services are often located outside the Centre itself.

> Specialisation has enabled multiple European financial centres to prosper; they are highly interdependent, with London being the largest.

What is an international financial centre?

An IFC is a centre (often based around a city) from which cross border financial business can be conducted easily, efficiently, and profitably within a strong regulatory environment. While some financial sectors retain a domestic focus, catering mainly to their local economies, others emerge with a regional, or global profile, providing a diverse range of financial services to clients from around the world. They need deep and liquid capital markets, leading IT and payments infrastructure, and access to a talented and well educated workforce. Moreover, IFCs are not simply places where financial firms congregate: a successful financial centre is a hub of other high value business services. There are a number of significant advantages for a country having an IFC, and in an increasingly global world it is vital for Europe to be home to a leading centre.

Benefits of an international financial centre

Providing jobs: The wholesale financial sector employs around 1.4 million people across Europe, although this underestimates the importance of the sector in direct job creation. The sector's key role in broader financial services means it is critical in supporting a major EU industry with 6.4 million people working in the broader sector across the EU.

Employment in financial services is particularly significant in major cities in the EU where the majority of wholesale financial market activity takes place. It employs 352,000 people in London, 270,000 in Paris, 76,000 in Frankfurt, 54,000 in Amsterdam, 48,000 in Luxembourg and 20,000 in Dublin (Figure 3.1).

However, an IFC is not just a cluster of financial service firms – it can be a magnet for a wide range of other high value business services, such as legal, accountancy, consultancy, maritime and many more, all of which facilitate cross-border financial transactions. In London alone an additional 240,000 are employed in these associated professional and business services.

Another way in which IFCs can contribute to the wider economy is in the creation of high value jobs – not just in their host city but across the country. Firms located in London have a large support infrastructure based elsewhere, including Glasgow (Morgan Stanley), Belfast (Citigroup), and Birmingham (Deutsche Bank), as well as overseas (Barclays in Czech Republic). There are similar national and Europe wide benefits from firms based in Paris and Frankfurt.

Raising tax: Thriving IFCs also make a considerable tax contribution. The financial services sectors in France, Germany, Italy and the UK combined generate nearly €208bn in taxes annually, equivalent to 6.6% of total tax receipts.

Supporting local business: Many investment firms based in Europe will be investing on behalf of local clients. European private equity and venture capital firms provided investment worth €35bn to over 5,000 European companies in 2013. The financial sector plays a key role in helping the European economy return to growth, particularly in the small and medium size sector: over 40% of companies receiving funding from European Venture Capital Association members in 2013 were early stage companies. Without a global international financial centre creating a hub for these sorts of investors, there would be less funding available to the companies across all sectors of the economy who will drive prosperity and job creation in the future. Thus IFCs are the engine-room of the private sector recovery that Europe needs.

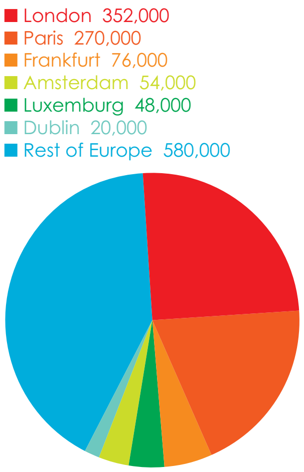


Figure 3.1
Employment in wholesale financial services
Source: London Economics

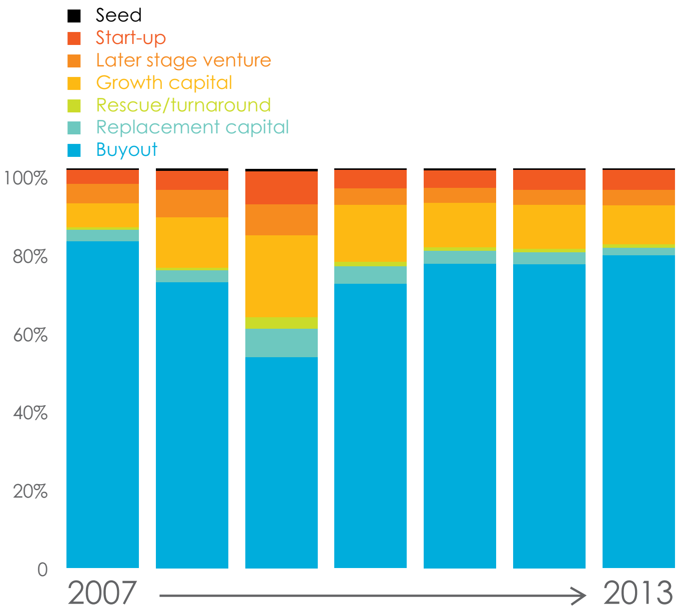


Figure 3.2
Investments – Industry statistics (by country of private equity firm)
Source: EVCA

Europe's international financial centres

World leaders: Europe's financial centres compete for business in a global market, and face competition from established centres like New York and Hong Kong, as well as newer emerging players such as Moscow, Dubai and others. For Europe to maintain the levels of employment and tax that accompany successful IFCs, it is essential that they continue to attract a significant volume of business. This is a challenge with the fast growth being seen in emerging economies. Europe has a number of highly successful IFCs including Amsterdam, Dublin, Frankfurt, Luxembourg, Madrid, Milan, Paris and London. Taken together, these European IFCs, with harmonized regulation and practices, act as a single "virtual" financial centre, which offers scale as well as developing specialisms to tailor their offer to local needs (Fgure 3.3).

London has a reputation for offering the greatest breadth of capabilities, not just in international banking, securities trading and fund management, but in niche areas such as carbon markets and maritime finance. But other European centres are all leaders in specific product areas – for example, Amsterdam specialises in pension management, Dublin in fund administration and Paris in fund management.

European IFCs are innovative too. London is the leading Western centre for Islamic finance, with six firms that are fully Sharia compliant and over 20 banks supplying Islamic finance, illustrating how the financial sector can innovate to meet evolving business requirements and market demand. Europe's International Financial Centres offer a full suite of services to clients. Their breadth and depth means they can successfully compete to attract major international businesses. For example, trading in the Chinese Renmimbi is a growing business, with 4 of the top 8 centres for renmimbi trading (outside China and Hong Kong) in Europe.

Greater than the sum of their parts: With increasing globalisation, many successful businesses no longer think of operating purely within national borders. The financial sector understands this, and has become ever more international in its outlook, for example, 22% of graduates recruited into London's financial sector are from outside the UK, including a high proportion from France and Germany.

City	Specialism
Amsterdam	Pensions management, financial logistics
Dublin	Fund management and administration, aircraft leasing
Frankfurt	International banking, fund management, trading in securities, derivatives and commodities, private equity and hedge fund management, carbon markets, maritime finance
Luxembourg	International banking, fund management
Madrid	Stock exchange, links with South America
Milan	Banking
Paris	Insurance, commodity exchange, fund management

Figure 3.3
Source: Europe Economics

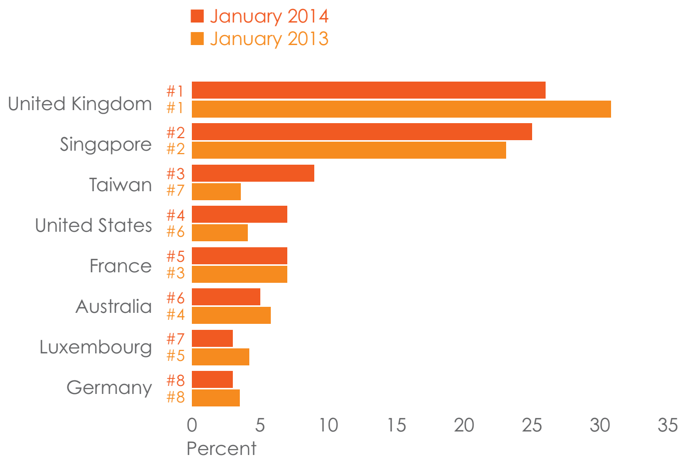


Figure 3.4
RMB top off-shore centres and rank (excluding China and Hong Kong)
Source: Swift's RMB tracker February 2014

This European interconnectedness runs far deeper than personnel. It is rooted in the markets themselves, which have become increasingly interdependent over the past decade. For example, Euronext is the first pan-European exchange, spanning Belgium, France, the Netherlands, Portugal and the UK.

Having the IFC situated in the EU means that the business is conducted under the EU's legal and regulatory framework.

This enables EU authorities to influence the levels of risk and capital taken on, and gives clients throughout the world confidence that the firms they are dealing with are operating in a well regulated environment.

This interconnectedness, allied to the freedom of movement within Europe, and a strong regulatory environment, enables Europe's IFCs to compete globally and deliver the most effective and efficient services to clients both within Europe and around the world.

Conclusion

IFCs are leading business hubs, providing employment to a talented and diverse workforce, and yielding significant tax returns. Most importantly, they attract investment which flows into local companies. The greater the breadth and depth of a financial centre, the greater its ability to attract investment and support the growth of surrounding economies. Conversely, if these markets were allowed (or encouraged) to decline, Europe would lose jobs, revenue from tax, investment in business and easy access to facilities for the wider economy.

As Europe looks to kick start the economic recovery, it is clear that it needs globally competitive IFCs to support this resurgence. Europe has a number of interconnected IFCs which will be at the heart of the effort to recover - including the leading global IFC, London – but their interdependence is essential to their success.

4.
Wholesale Financial Markets
Starting a business

Key messages

> Small and medium enterprises (SMEs) are important because of their contribution to:

- > Job creation – 67% of the EU's non-financial workforce is employed by SMEs;
- > Innovation – SMEs produce more innovations per employee than large firms;
- > Economic impact – 99.8% of the 20 million active enterprises in the EU are SMEs.

> Businesses can be launched with funding from a variety of sources, including:

- > Angel investors – It is estimated that there are up to 250,000 business angels in Europe investing between €4-5bn a year in early stage companies.
- > Venture capital – European venture capital firms invested €1.8bn of capital into start-ups in 2013 in the EU, which was on a par with 2012;
- > Crowdfunding – This is a new and fast growing sector of peer-to-peer lending. The UK's first site, 'Funding Circle', has raised $123m since its launch in 2010;
- > Bank lending – 80% of SME funding in Europe is from banks.

How companies get off the ground

Companies need finance as well as ideas and commitment to get off the ground. This paper looks at how companies can get access to finance. It focuses on small and medium enterprises (SMEs) since that is how even the largest companies start out. It looks at the importance of the SME sector to the European economy and analyses different funding options and the challenges that SMEs face in securing that funding. Experts reckon that there will be a shortfall of capital available to companies of all sizes in the next five years. In the UK alone, the Breedon report estimated this 'funding gap' at up to £191bn, nearly a third of which would be for SMEs. Finally, this paper has a case study of one firm's experience of growing from start-up, through venture capital, to a successful sale to a larger company.

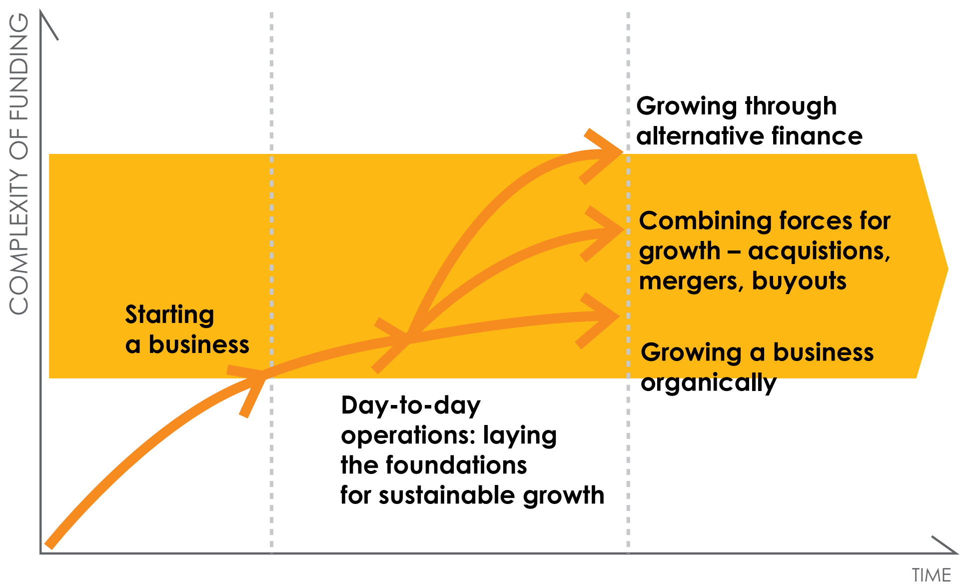


Figure 4.1
The lifecycle of growing and sustaining a business

The importance of SMEs

The EU defines an SME as a firm with fewer than 250 employees, and either a turnover of less than €50m or a balance sheet of less than €43m. The importance of SMEs (including start-ups) can be seen in several areas.

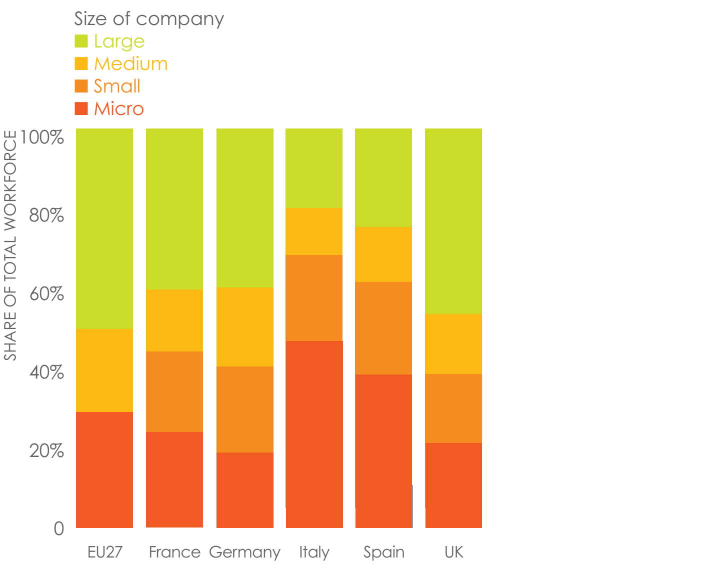
Job creation: SMEs make a significant contribution to the creation of new jobs in the EU. Around two thirds (66.5%) of the EU-28's non-financial business economy workforce is employed by SMEs.

Innovation: SMEs generate and disseminate innovative ideas into the economy, generating new business ideas and improving the efficiency of production. Research shows that despite their lack of formal R&D activity, SMEs produce more innovations per employee than large firms. This is often attributed to the lack of bureaucratic constraints in small firms.

Economic impact: Entrepreneurship creates economic growth in three ways. Firstly, entrepreneurship is a mechanism for generating value out of new ideas. Internet advertising, worth over €24bn in 2013, is dominated by firms that were start-ups a decade ago. Secondly, new entrants in a sector often help to increase competition and improve efficiency. Thirdly, new firms contribute to diversity and create variety, which is beneficial for consumers. Competition between new and existing enterprises allows the most viable and efficient firms to prosper.

The funding escalator

If SMEs are to be able to play this important economic role, they need an 'ecosystem' in which to grow: finance, regulation, employment, education etc. Here we look at the options for finance. These evolve with the company through its lifetime and are illustrated in Figure 4.3.



EU27	France	Germany	Italy	Spain	UK	
66.8%	60.3%	61.1%	81.4%	76.3%	53.8%	SME share of total workforce
87.8m	8.8m	13.8m	12.3m	9.3m	9.8m	SME workforce

Figure 4.2
Share of workforce by company size in 2011
SMEs make up a large proportion of the workforce across the EU
Source: Eurostat, Ares & Co analysis

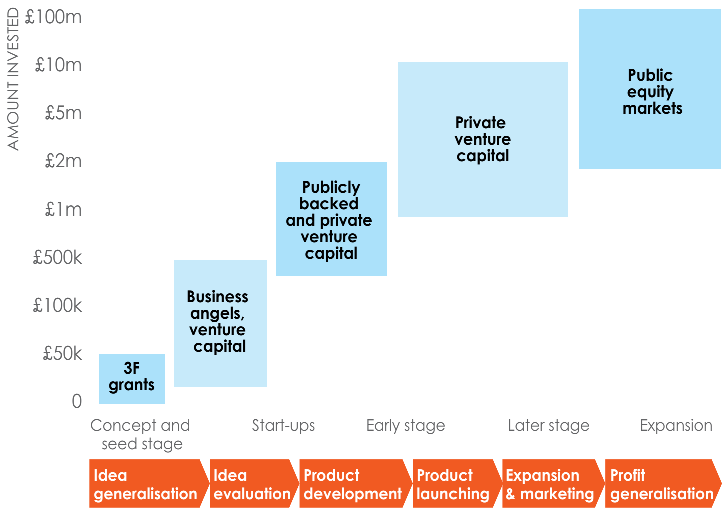


Figure 4.3
The SME equity funding escalator
Source: NESTA & City of London

Seed capital

The initial capital used to start a business. This early stage investment is designed to support the business until it can generate cash of its own.

Social investment

Funding from wholesale financial markets can enable innovative start-ups, such as investments expected to generate social and financial returns. In 2012, €413m of capital was invested for this purpose.

Table 4.1
Typical sources of finance used by SMEs

	% of firms using
Bank overdraft, credit line or credit card overdraft	39
Leasing or hire purchase or factoring	35
Trade credit	32
Bank loan	32
Retained earnings	26
Other loan	15
Grants or subsidised bank loan	13
Equity	5
Subordinated loans or similar instruments	2
Debt securities issued	2

Source: EC and ECB, *SME's Access to Finance Survey*, 2013.

Friends and family: The majority of funds at an early stage come from the founder, their friends, or family. This is often referred to as '3F grants'.

Bank lending: Bank loans and overdrafts are a common form of finance for SMEs. Companies, in particular SMEs and mid-caps, are highly dependent on bank lending in Europe – bank lending accounts for around 85% of outstanding debts for European companies.

Angel investors: Business angels are individual investors who use their personal wealth to invest in firms, typically at the start-up stage. They will often use their experience and expertise to aid the firm once they have invested. Investors may invest individually, or as part of a syndicate. It is estimated that €4-5bn is invested by angels annually in the EU.

Venture capital: Venture capital firms invest in companies which they think will grow quickly. They typically invest after the initial round of seed capital in return for an equity stake. In 2009 a pioneer in renewable energy took €28m of investment from a European venture capital firm. This company is now one of Belgium's biggest green energy companies, and for them the expertise and strategic advice from the investor was as important as the finance secured. In Europe, €3.4bn of venture capital was invested in SMEs in 2013.

Crowdfunding: This uses an online platform to link investors and businesses directly. This sector is growing quickly, but is still small in comparison to other forms of lending

Challenges in climbing the escalator

There are a number of challenges that a small, growing firm faces to access finance.

Inconsistent priorities of funders: It is normal for a growing firm to receive multiple types of investment. The business executive team will have to manage the contrasting stakeholder demands. For example business angels tend to invest for a longer period of time (up to ten years), whereas venture capital firms often seek a quicker exit (three to five years). This will have a bearing on the types of business decisions that the firm will make.

Gaps between funding types: The funding escalator is an idealised model; in reality funding gaps and frictions exist between different funding sources. Institutions and policies have the ability to lessen these gaps. The European Investment Fund supports SMEs by helping them to access finance. In 2013, the EIF invested €1.8bn, which mobilised €8.6bn of funding for European business.

Changes in bank finance: Based on the same level of business risk, SMEs are now less likely to be accepted for an overdraft than before the financial crisis (in 2001-2004 the overdraft decline rate was 10.9%; it increased to 16.4% in 2008-2009 but has slowly been returning to near pre-crisis levels). This illustrates reduced risk taking by banks. However, whilst it is more difficult to get a loan, the loan can itself be cheaper (due to low market interest rates). Barclays reported in September 2012 that the cost of lending for SMEs was cheaper than at any point in the last 25 years.

Big leap required to capital markets: For SMEs, the cost of issuing public or private bonds is prohibitive. Only 2% of SMEs have issued debt securities and 5% have issued equity or relied on external equity investors. Once the SME has grown and the amount of capital required has reached a certain level (typically over £2m), then the company can access capital markets directly, typically through a 'feeder market' like the Alternative Investment Market (AIM). These options are discussed fully in Chapter 5, *Growing a business organically through long-term finance* and Chapter 6, *Combining forces for growth: acquistions, mergers, buy-outs*.

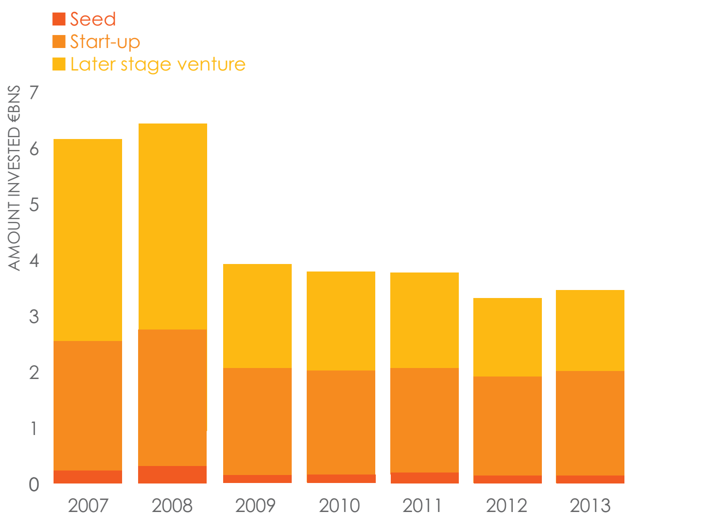


Figure 4.4
Venture capital investment in EU firms
Venture capital investment peaked in 2008 before dropping somewhat in 2009 and remaining flat since then across seed capital, start-up investment and later stage ventures.
Source: EVCA

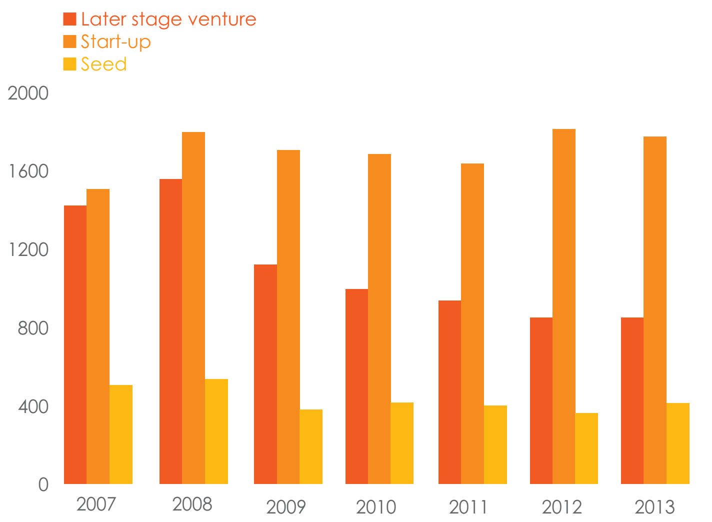


Figure 4.5
Number of companies attracting venture capital investment
The number of seed and start-up capital investments in the EU has remained fairly constant since 2007.
Source: EVCA / PEREP Analytics

Venturing to grow in biotech

The funding escalator in action: A UK based biotechnology firm was bought by a Dutch biotechnology company in a deal that could be worth £97m, generating a 13 fold return to the venture capital backers. The firm had been provided with start-up capital of £1m in 2001 and had two further rounds in 2004 and 2006, which raised the total amount venture capital firms had invested to £3m.

The two co-investors bought into the firm during 2004, when the company had 13 staff, sales of £400,000 and operated only in part of England. It now employs 80 staff, forecasts sales of £20m and has expanded its operations to the USA.

While the investors had considered both trade sale and IPO options as exit routes, they opted to exit through a sale to a larger competitor because the buyer was able to offer a better valuation based on the strategic fit of the two organisations.

The combined company plans to develop its expertise in personalised healthcare, using molecular diagnostics to predict patients' responses to cancer treatments in order to make them safer and more effective.

Conclusion

SMEs make an important contribution to growth through employment, innovation, and their economic impact on growth and competition. Some SMEs don't aspire to grow. Those that do often face significant challenges in securing funding. By ensuring each stage of the funding escalator is working effectively, stakeholders in European business can support the growth of the next generation of large enterprises.

5.
Wholesale Financial Markets
Growing a business organically through long-term finance

Key messages

> Long-term finance allows a business to grow with confidence that it can cover its future obligations.

> Companies use wholesale financial markets to:

> Access a range of sources of finance – Attracting bank finance has recently been challenging for companies. Companies, therefore, need access to a full range of funding sources such as bonds and equities, to ensure they can fund their future growth.

> Issue shares to raise finance – Over £3.8bn has been raised by new companies on the Alternative Investment Market since its launch in 1995.

> Issue bonds to raise finance – Net issuance of international debt totaled $345bn in 2013.

> Benefit from innovative partnerships between the public and private sectors known as PPPs – In the 20 years between 1990 and 2009, the combined capital value of these partnerships exceeded €250 billion.

Accessing long-term finance allows firms to plan for the future

Broadly speaking firms can grow in two ways: organically (for example, through increasing market share or through each customer spending more), or through the acquisition of other firms.

This paper will look at methods of finance in the wholesale markets that would be appropriate to support organic growth, firstly by looking at long-term bank finance, then equities, and finally bonds.

Which options are available to companies seeking organic growth?

The way in which a company uses wholesale markets depends on its size, maturity, and ownership structure.

Long-term bank finance

Companies access banks for long-term loans directly, and benefit from Europe's large banking sector, bank assets within the EU equate to 300% of GDP. Bank loans can be structured in instalments to match cash flow or only drawn on when necessary. However, some European banks have high debt to equity ratios. This has left them more exposed to the reduced liquidity in wholesale financial markets, and as a result they have been reducing lending to corporates.

Figure 5.1
Long-term financial needs

Wholesale Financial Markets
Growing a business organically through long-term finance

There is a funding gap for European companies: The future funding requirements for European businesses and governments are high. Some forecasts predict the amount of net new issuance required by European corporates (as opposed to simply replacing existing debt) will be as high as €195bn. As net new issuance has only exceeded €75bn twice in the past ten years, this suggests it may be difficult for firms to acquire funding in the next few years.

Companies will need to be flexible to meet their financing needs: Given that attracting bank finance has recently been challenging for many companies, and that debt may also be difficult to sell, companies will have to be flexible and have access to a full range of sources of finance, such as bonds and equities, to ensure they can fund their future growth. While most French companies still finance themselves through bank loans, by 2011 36% of French corporates were securing funding from other market sources.

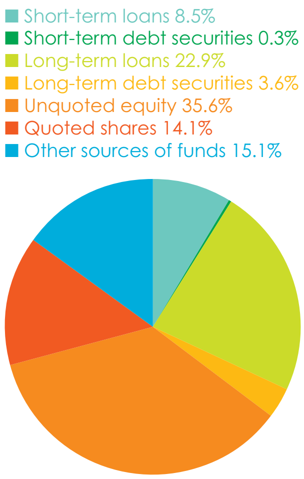


Figure 5.2
Capital structure of Euro area non-financial corporations
The share of equity remains the largest component but has reduced significantly compared with pre-crisis levels.
Source: ECB

"Even after 2008, we can still finance our short-term working capital needs through banks; it is the long-term finance where we have had to consider other options."
Vice-President Group Financing, major European components manufacturer

Equities

Internal equity financing: There are three main methods of raising equity internally within a firm; through personal networks, through employee ownership, and through retained earnings.

External equity financing – private placement: Private share placements allow equity to be exchanged for investment through private transactions. Investment banks often act as intermediaries to facilitate the exchange. Private placement suits those firms who wish to protect the confidentiality of their intellectual property (for example, production methods or technology that might have to be discussed in a public placement offering), or that lack the credit ratings required to sell bonds.

Software IPO

A UK based software company has developed a way to allow software developers in multiple locations to work together simultaneously. Within seven years of their launch, the company has had a highly successful IPO on the London Stock Exchange raising over £15m. The IPO was oversubscribed by over 300% and the list of investors included Fidelity, Legal & General, Blackrock and Standard Life.

AIMing high in healthcare

A healthcare business that provides clinical services to large, global pharmaceutical companies and biotechnology organisations recently listed on the Alternative Investment Market (AIM). The listing raised £15m, which valued the firm at more than £30m. It is now considering diversifying its portfolio to medicine.

French and German private placement markets are used by firms across Europe to raise finance. In 2012, issuance on the German Schuldschein market increased to nearly €13.6bn. This is double the value of 2011, reflective of non-financial corporates' shift towards alternative funding.

But these European options remain limited and some European firms are using the US private placement market for their financing needs.

"In 2012 we completed a US private placement for long-term financing. The US private placement market is well organised, but there is no European equivalent. We need a well organised private placement market in Europe." **Vice President of Financing, electronic materials manufacturer**

External equity financing – public offerings: Firms wishing to sell shares in their business will often enlist the help of an investment bank to provide advice and promotion, to ensure the share is pitched at the right price and raises sufficient interest among investors. Banks can also underwrite the issue, so if the share doesn't sell as expected, the bank will step in to stabilise the price. A global automotive manufacturer was able to emerge from bankruptcy protection in 2010, by using capital markets to raise $20bn in a public offering.

Bonds

Bonds finance long-term debt: Bonds provide a company with external funds for long-term capital investment, such as building new plants, purchasing equipment to expand the business, or re-financing existing debt.

A firm will have to pay more interest on a bond if it is for a long duration, or if the firm is considered to be a risky investment (for example, if it has a poor credit rating). International and domestic bond issuance by EU companies raised an estimated €120bn in 2012.

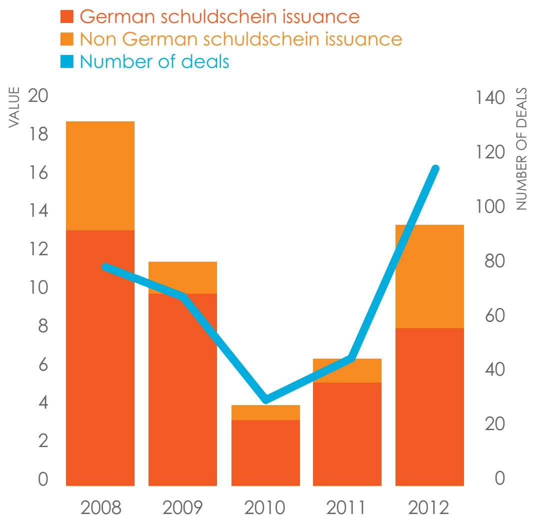


Figure 5.3
Growth of private placement in Germany
Source: PwC

Commercial paper

Short-term debt issued primarily by corporations. Maturities range up to 270 days but average about 30 days. Many companies use commercial paper to raise cash needed for current transactions, and many find it to be a lower-cost alternative to bank loans.

Bonds

A debt instrument where an investor lends money to an entity (corporate or government) that borrows the funds for a defined period of time at typically a fixed interest rate.

Net new issuance

This is the amount of new bonds being sold in the market as opposed to simply replacing bonds which have reached their maturity date.

The importance of bonds as a source of finance for European companies has increased, partly due to a decline in bank lending.

'Commercial paper' is a specific type of corporate bond, which is short-term (usually maturing within 270 days), and cannot be used by the company for investment in long-term capital projects. Commercial paper is used for funding operating expenses and for cash management. The UK and France are among the countries with a significant number of issuers.

Bonds are flexible to meet demand: Bond maturities typically range from a 90-day Treasury bill to a 30-year government bond. Corporate and government bonds are typically in the three to ten year range. However, there has been demand for increasing the duration of bonds, where investors have confidence in the firm they are investing in. In March 2012 one of the world's largest utility companies launched the first ever Euro 100-year bond, for a low coupon of 5.95%. This 'century bond' was commended by the Association of Corporate Treasurers, and helped the firm raise €100m in financing for long-term projects.

Bond issue improves credit rating

A German automotive manufacturer sought to raise €1bn by issuing bonds in 2011. The demand for the bonds, as shown by the order book, was over €3.5bn. After the success of the bond issue, the firm was given a better credit rating, which will allow it to raise money more cheaply in the future.

Other long-term finance methods

Innovative methods are growing: Direct funding from outside Europe's formal banking sector is an increasing portion of non-financial corporates' balance sheets[6]. This includes innovative new funding mechanisms such as peer-to-peer lending and crowdfunding.

Conclusion

The ability of non-financial corporates to create jobs and sustain growth will assist Europe's economic recovery. Accessing bond and equity markets will be increasingly important as firms look to long-term sources of funding other than bank loans. This will help them to take the long-term perspective needed to grow in business and trade whilst remaining internationally competitive.

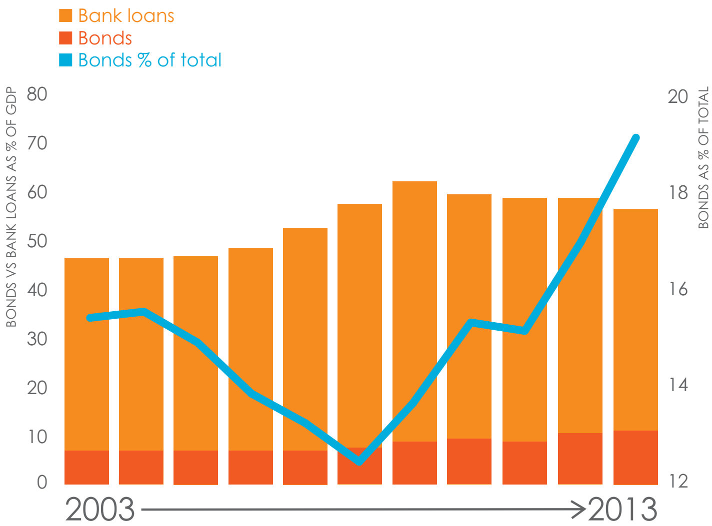


Figure 5.4
Corporate debt financing: bank loans vs bonds
The funding mix is shifting towards capital market instruments.
Source: ECB, Deutsch Bank Research

6. For more details, see Chapter 7, *Growing a business through alternative finance*

6.
Wholesale Financial Markets
Combining forces for growth: acquisitions, mergers, buy-outs

Key messages

> Acquisitions allow companies to enter new markets, benefit from economies of scale, gather intellectual property, and access human capital.

> Methods by which companies can grow by joining forces include:

  > Merger and acquisition (M&A) – The number of European M&A deals reached 13,000 in 2013;

  > Joint ventures – These allow firms to work together and achieve greater flexibility;

  > Private equity – Companies have gathered over €300bn of private equity investment in Europe since 2007;

  > Management buy-outs (MBO) – Across Europe, 228 companies' management bough themselves out of private equity firms in 2013, at a combined value of €1.2bn. Although the number of deals was flat compared with previous years, the value of deals in 2013 was double that of 2011 and 2012.

> Companies can use financial services for advice and to finance these deals.

How companies can combine forces for growth

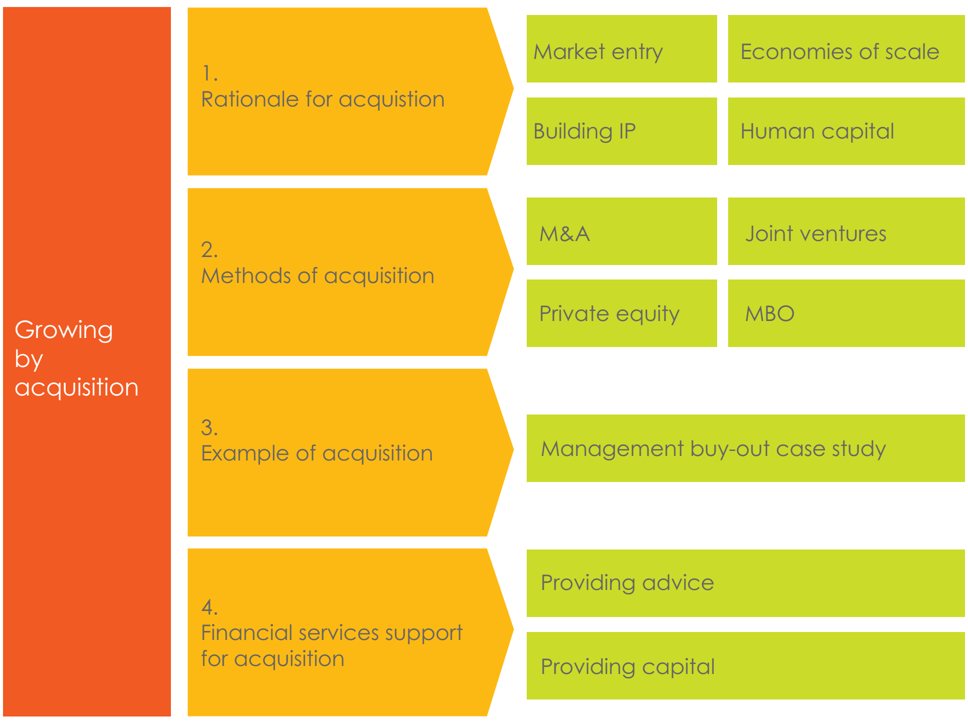
This paper examines the reasons companies have for seeking to join with other companies to achieve a commercial edge. There are a number of ways of doing this e.g. acquisition, merger, joint venture, private equity financing, and management buy-out. The ways in which financial services can facilitate and support these activities are then examined.

Rationale for change

Purchasing another firm, or changing the firm's ownership can provide a solution to several business challenges more quickly than organic growth. These challenges can include the following:

Market entry: Acquiring a company already in a particular market will allow that market to be entered quickly. The acquired company may also have entrenched advantages such as supplier relationships, reputation with local governments, and understanding of local demands. In 2012 a European water cooler manufacturer announced a joint venture with an Indian water purification company, in order to enter the Indian market.

Figure 6.1
Long-term financial needs



Economies of scale: By increasing the volume of production, cost per unit can decrease. This can be through increased negotiating power with suppliers, or the ability to invest more in specialised machinery. Alternatively, a company acquiring their supplier can control their supply chain more effectively, which can lead to cost savings.

Building intellectual property: To access new products and ideas, companies can develop them within the firm, or license them from others. As both research and development, and licensing can be expensive, an alternative is to purchase the firm holding the patents on the technology. One technology firm made a $12.5bn acquisition in May 2012, largely to own the target firm's catalogue of 17,000 awarded patents.

Accessing human capital: Acquiring a firm also acquires its staff, and this can be a way to access the best talent.

Options for change

The ways in which a company can achieve these benefits include:

Direct acquisition: This is purchasing all of another company's shares, which can be made through cash or through stock.

Mergers: A merger is when two firms agree to join together. Traditionally, an acquisition referred to a takeover of a smaller firm by a larger one, whereas a merger was between two similarly sized parties. However this distinction has now become blurred; for example with the assistance of financial markets, companies can now acquire firms much larger than themselves. The difference between a merger and an acquisition is now best seen as how amicably the parties wish to see the deal viewed in the public domain.

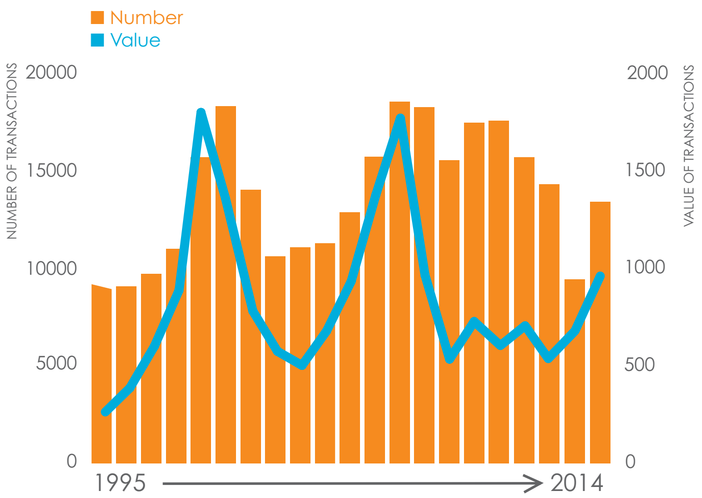


Figure 6.2
Announced mergers and acquisitions in Europe
Source: Institute of Mergers, Acquisitions and Alliances, 2014

Table 6.1
The ten largest M&A deals in Europe are from across a wide range of industries

Rank	Year	Acquiror**	Target**	Transaction value (€bn)	Transaction value (€bn)
1	1999	Vodafone AirTouch PLC	Mannesmann AG	202.8	204.8
2	2007	Shareholders	Philip Morris Intl Inc	107.6	68.1
3	2007	RFS Holdings BV	ABN-AMRO Holding NV	98.2	71.3
4	2000	Glaxo Wellcome PLC	SmithKline Beecham PLC	76	74.9
5	2004	Royal Dutch Petroleum	Shell Transport & Trading	74.6	58.5
6	2006	Gaz de France SA	Suez SA	760.9	44.6
7	1999	Vodafone Group PLC	AirTouch Communications Inc	60.3	51.7
8	2004	Sanofi-Synthelabo SA	Aventis SA	60.2	50
9	2008	InBev NV	Anheuser-Busch Cos Inc	52.2	39.7
10	1999	Total Fina SA	Elf Aquitaine	50.1	48.3

Source: Institute of Mergers, Acquisitions and Alliances, 2014

Private equity serves up growth

A SME manufacturer of self-service coffee machines has been sold to one of Europe's biggest coffee chains, after private equity expertise helped improve their product development and supply chain. Between the private equity investment in 2008 and the company's sale in 2011, revenues, staff numbers and profits all doubled, with earnings hitting €7m by the time of sale.

Joint ventures: For companies wishing to work together, but not on a permanent basis or not across the whole of their business, starting a 'joint venture' is possible. This creates an entirely new legal entity, usually wholly owned by the two firms, which exists for a particular purpose. Using this method can reduce risk in case the project is not successful, and also allows for easier exit strategies for each party. The joint venture could eventually be closed, floated on the stock exchange, sold to another company, or one party may buy the other out.

Accessing private equity: Where a business needs rapid investment and restructuring, private equity investment can provide the expertise, contacts and skills to make an immediate impact. Once the company's performance has been improved, the private equity firm typically sells or makes a public issue of the company's equity. There are more than 2,500 private equity firms globally, and they raise many billions of dollars in capital every year. In 2013, the aggregate value of private equity investment globally was $249.5bn. Although the number of deals in 2013 was lower than 2012, the value of the deals increased. European private equity firms provide financing to about 5,000 companies per year, of which around 80% are SMEs.

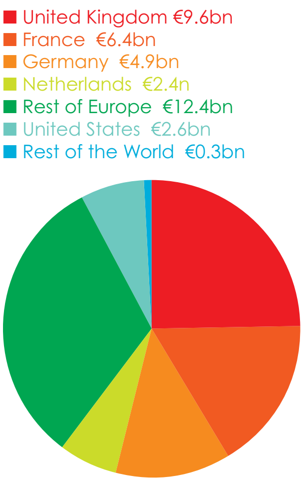


Figure 6.3
Top destinations for European private equity
Source: EVCA

A buy-out for retirement

A local family company had been handed down over the years and was now on its third generation. Historically the shares had transferred on the passing away of the shareholder. The current owner had just reached retirement age and was looking to exit from the business. The next generation of the family were already running the company, but the current shareholder required a capital sum in order to facilitate his retirement.

At the same time, the junior (non-family) management team were becoming key to the future success of the business and a solution was needed to release cash to the exiting shareholder and to motivate the junior management team.

The owner decided to offer a management buy-out, which would release cash to the current shareholder, create shares in the business, and motivate the junior management team via share options. A number of funding offers were also received to give the current management the financial backing to buy-out the firm.

The MBO went ahead, giving the retiring owner a substantial lump sum and still with a large majority stake in the company. The junior management team were motivated by the share options. Since completing the deal, the company has now substantially increased turnover and profitability.

Management buy-outs: Where the management of a firm purchase that firm for themselves, usually with the help of financial backers. Directors have to make a sizeable personal contribution, and then banks or venture capitalists make up the shortfall. The equity of the business is then split accordingly. For example, a four-strong team buying a publishing company may be able to gather €20,000 each. The €80,000 combined total may not seem much when set against for example the €1m put up by their bank, but could be a lot for them individually and this gives the bank the assurance that they are personally committed to making the buy-out a success.

Financial services support

To enable these changes of ownership, wholesale financial services can provide the expertise to help the purchase happen.

Advising the firms: The investment banking divisions of banks provide advice to companies looking to invest funds in another firm. Banks can also conduct due diligence on these targets, and assess their asset quality and strategic fit with the acquirer, as well as the likelihood of a successful acquisition. Banks can also be approached by firms who may be looking to be sold; this is often when a parent company wishes to divest a portion of its business. The bank can measure the market value of those companies wishing to be bought and sold, and then pitch the firm to potential buyers to get the best price. Finally, a bank can provide advice on suitable defensive tactics, if a company has launched a hostile takeover of one of its clients.

Providing the capital: The company wishing to make the purchase will not necessarily have the cash to do so. The financial institution will be able to help raise the funds, often through a bond issue or sale of another part of their business. The company may also wish to pay for the business using its own stock, and financial institutions can arrange this.

Conclusion

Supporting acquisition activity enables firms to develop through a change of management to grow more quickly than through organic growth alone. The mechanisms described in this paper can enable business expansion throughout the EU, and allow successful firms to grow and create jobs.

7.
Wholesale Financial Markets
Growing a business through alternative finance

Key messages

> Alternative finance is a way of providing credit that involves entities and activities outside the regular banking system.

> Companies can use alternative finance to:

  > Sell their commercial paper (short-term debt) – Money Market Funds in the euro area had around €1tn under management in 2012, of which around half is invested in commercial paper.

  > Attract investment from hedge funds – European hedge funds had around $550bn of assets under management in 2013.

  > Free up assets into cash by turning money owed to a company into a marketable security – in Europe, €180bn of securitised products were issued in 2013, on a par with the levels in the early 2000s (from a height of €800bn in 2008). This is compared to around €1.5tn of issuance in the US in 2013.

> The flexibility of this funding sector allows it to evolve to meet business demand, aided by appropriate legislation and strong market institutions.

What is alternative finance and how can it help?

For many years firms have used non-bank institutions to access credit. In the USA companies have traditionally been much more active in seeking alternative routes to finance their activities. The collection of these methods has been variously called 'le système bancaire parallèle', 'shadow banking', 'market finance', or 'alternative finance'. The term 'alternative finance' will be used throughout this paper.

This paper considers how companies use three areas of alternative finance; 'securitisation', 'money market funds', and 'hedge funds'. Finally, this paper will consider the impact of a strong market infrastructure, through exchanges and clearing houses.

Alternative finance involves entities and activities outside the regular banking system. These include:

Entities: Special purpose vehicles, money market funds, exchange traded funds, hedge funds, and finance companies providing credit guarantees.

Activities: Securitisation and repurchase agreements.

The benefits of the alternative finance sector

This sector is a market-funded credit intermediation system that involves maturity transformation (changing the time until the debt is due to be repaid) and/or liquidity transformation (the ease of converting the debt to cash). It exists at least partly outside the traditional banking system. This has meant that providing credit to the wider economy is no longer just a bank activity, but can involve a network of banks, broker-dealers, asset managers and alternative finance providers which fund themselves through the capital markets.

Europe could face a large corporate funding gap during the next few years (corporate financing needs are estimated at €4trn between 2012 and 2016), and bank lending has already fallen. European banks could shed assets worth up to €2trn according to the IMF. One of the main benefits of the alternative finance sector is that it could provide funding to help the economy grow, while banks continue to reduce the amount of credit available to companies.

The alternative finance sector globally was worth $71 trillion in 2012, having doubled in size since 2002. This represents 25-30% of the total financial system and half the size of bank assets.

Securitisation

Where individual assets are 'pooled' together into a new asset, and portions of this asset are sold to investors.

Credit intermediation

This is the process of acquiring funds (or credit), either through deposits or the capital markets, and then lending these funds to other people or institutions.

Securing growth

For one large family-owned French firm, a lack of bank finance meant it had limited options to raise funds. It turned to securitisation, whereby they transferred their receivables into a new company, which then issued commercial paper. This, along with private placements, now forms 50% of all its long-term financing needs.

The options available

Securitisation: Companies who wish to raise funds from an asset, loan or other revenue source, can consider 'securitisation'. For example, a corporate could pool its receivables (i.e. monies due from customers), and create a financial instrument from this. This instrument could be sold on capital markets to raise funds for investment.

The total value of European securitisation issuance has increased since 2001, growing from $152.6bn in 2001 to $180.8bn in 2013, but has been volatile over the period. 2013's securitisation issue represents a quarter of its pre-crisis peak of $711.1bn, in 2008. The U.S is the global leader in securitisation, with total issuance of $1.5tn in 2013, representing 78% of global issuance.

This shows that the global market is still much smaller than pre-2008. Securitisation can contribute to the provision of credit and improve banks' access to funding. However the market, and company access to it, is limited by uncertainty over future regulation, and a negative perception of this type of funding.

"Re-establishing securitisation on a sound basis remains a priority in many jurisdictions in order to support provision of credit to the real economy and improve banks' access to funding."

Financial Stability Board to the G20 in November 2011

Money market funds

Large firms in the wider economy often raise funds to cover their short-term liabilities, and they do this by issuing 'commercial paper'. These are short-term funding notes, usually denominated in issues of €100,000 or more, in which money market funds can then invest. Other smaller investors can then invest indirectly in the company by purchasing shares in the money market fund. Most trading in money market instruments takes place in New York, Tokyo, Frankfurt and London.

A money market fund is an open-ended investment mutual fund that invests in short-term securities. Money market funds are often regarded as being as safe as bank deposits, yet provide a higher return. One of the distinguishing features of a money-market fund is that it must be composed of high quality debt, and on average the fund portfolio must 'mature' in 60 days or less.

Hedge funds:

Hedge funds invest in firms, helping them to raise equity and providing liquidity to financial markets. They also provide a way for companies to invest retained profits which are otherwise not generating a return. A hedge fund is an actively managed investment vehicle which collates a range of investments together. Hedge fund strategies vary enormously, but this could include buying and selling shares, profit from different prices in different markets of the same commodity, or trade options and bonds. They aim to reduce volatility and risk while delivering these returns.

Worldwide hedge fund assets totaled $2tn at the end of 2012, an increase of 6% on the previous year.

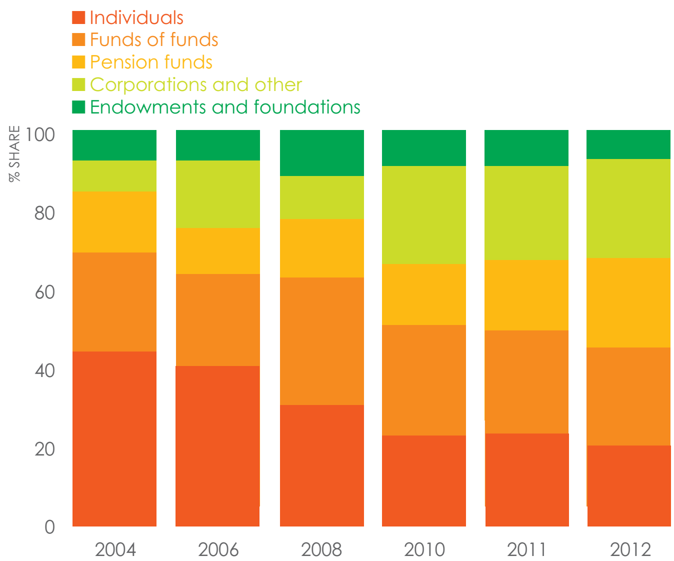


Figure 7.1
Global hedge funds by source of capital
Corporations have doubled their share of hedge funds' assets since 2008, showing the increasing importance of hedge funds to large companies.
Source: Hennesse Group LLC; FSA; TheCityUK estimates

Figure 7.1 shows the split of where hedge funds get their assets from. In 2008, 11% of the total capital was from corporations, but by 2012 this had more than doubled to 25%, showing their increasing value to companies in the wider economy.

Other options

As the definition of this sector is broad, it also covers some of the largest non-bank credit providers, such as **insurance** companies and **pension funds** (these are discussed in Chapter 1, *What they are, and why we need them*). In this sector, corporates could also access **credit unions, sovereign wealth funds, peer-to-peer lending,** and **private equity funds' debt divisions**.

The building blocks of the financial market

There are multiple types of institution that aid the smooth functioning of financial markets. Without these, markets would not be able to function effectively. Here we highlight two:

Stock exchanges: If a company wishes to sell equity or marketable assets for the best price it may use an exchange. This is an institution which hosts a market where stocks, bonds, options, commodities or futures are traded. Buyers and sellers come together to trade when the exchange is open.

Exchanges also govern the 'terms of trade', ensuring transactions follow the regulations. Over 10,500 companies are listed on stock exchanges in EU member states, double the number as in the US. €98bn was raised on stock markets of EU member states in 2012.

French commercial paper

"France has an active commercial paper market, in terms of cost and resilience. It works well because there are efficient buyers, including the money market funds. One must have efficient purchasers of the commercial paper at the front end. Anything that restricts those purchasers will restrict the funding for the corporates."
Deputy CFO, Major European Construction Company

Clearing and settlement: A deal to buy a share in a company can be agreed between parties in seconds, but the legal documentation and transferring ownership of the equity share itself can take much longer. Once a transaction has been agreed, the clearing house takes on the risk of either party defaulting. Having this infrastructure improves the liquidity of the markets, and encourages confidence in investment. A more efficient post-trade system has a direct boost to GDP growth too.

Conclusion

As bank lending has reduced, alternative finance has become more and more important, as corporates may require a range of options for them to access sufficient finance. Securitisation, money market funds and hedge funds are a selection of these options. Future regulation should be aware of companies' interest in having these options available to them, and in having strong market institutions to support investment in firms.

8.
Wholesale Financial Markets
Day-to-day operations: laying foundations for sustaining growth

Key messages

> To sustain business growth, short-term finance is crucial to the day-to-day business of European corporates.

> Companies use wholesale financial markets in the short term to:

> Manage their cash flow – Working capital finance is often arranged through major wholesale banks;

> Grow through trade – Trade finance allows firms to grow through exporting, with world exports of goods surpassing pre-crisis levels at $19tn in 2012;

> Reduce risk – Wholesale financial markets connect corporates seeking to reduce risk with financial firms specialising in risk management: allowing corporates to specialise in their own core activities and work more efficiently.

What do businesses need in the short term from wholesale financial markets?

A range of financial offerings exist to help businesses in their daily operations and to allow them to grow sustainably. This paper looks at ways to help businesses meet their daily financing needs (in particular working capital finance and trade finance). This paper also considers risk management tools which can remove unwanted risks to short-term business performance.

How do businesses finance their working capital?

The current account of a firm: A business needs money available for day-to-day trading operations from which it can fund activity. This is its working capital, calculated as the current assets minus the current liabilities. For many companies, this is largely composed of **trade debtors** (i.e. customers who have not yet paid for goods and services) and **trade creditors** (i.e. suppliers the company has not yet paid).

Typically financed by banks: Firms often have access to flexible bank credit (similar to an overdraft on a current account), which can cover working capital needs in the short term. When there is less liquidity in the wholesale financial markets, banks reduce the supply or increase the price of credit to non-financial corporates.

Figure 8.1
Short-term financial needs

Europe's non-financial corporates depend heavily on banks for short-term finance; of total non-financial corporate debt outstanding in 2013, bank loans and other advances accounted for around 80% in the Euro area. This contrasts with 53% in the USA. This suggests regulation that reduces liquidity to banks will have a disproportionate effect on European companies. The EU has tried to mitigate this through initiatives like the European Investment Fund (EIF). In November 2012 the EIF signed its first guarantee agreement with Spain, which released €120m of additional loans to small businesses.

Financed through the supply chain, and via the financial markets: Supply chain finance gives the suppliers to companies access to immediate credit sometimes at reduced rates. Once the firm has approved payment of an invoice, the supplier's bank will supply immediate credit. 38 of the largest companies in the UK have signed up to a supply-chain finance government initiative, expected to generate £20bn of cheaper financing. Firms can also use 'commercial paper', which is a type of short-term bond[7].

"We need to have a buffer of very flexible credit through banks."
Vice-President Group Financing major European components manufacturer

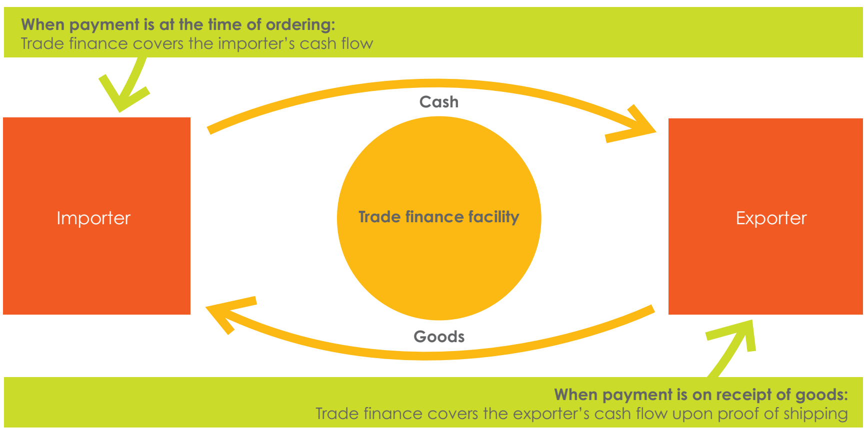
"The impact of the crisis has particularly affected our supply chain and customer base."
Senior Vice-President of Treasury global oil and gas company

What is trade finance?

International trade can be risky: Companies often grow through trading internationally. However, there are significant risks to doing so. For example, when a good is purchased, whichever party pays upfront for the product takes a risk that the transaction will not complete successfully. If the importer pays on order, he takes the risk that the goods may not arrive. If the exporter accepts payment on delivery, then he takes the risk that the importer will not pay in full. Either way there can be a long delay between the purchase of raw materials and final payment of the goods.

Banks can help reduce risk: Banks assist by providing short-term bridging loans to cover the gap, and reduce risk for the companies. For example, the importer's bank may provide a letter of credit to the exporter (or the exporter's bank) providing upfront payment upon proof that the items have been sent. Around a third of total trade, estimated at $19tn in 2012, is facilitated by financial institutions providing trade finance to the companies involved.

Figure 8.2
Trade finance facility[7]



7. For more detail see Chapter 5, *Growing a business organically through long-term finance*

Trade finance can be flexible to each firm: Trade finance can also help companies export by providing guarantees that they'll get paid, advance payments of export contracts ('letters of credit'), or provide protection against debtor non-payment ('debt factoring').

European banks are major providers of trade finance: According to a recent World Bank study, large eurozone banks accounted for 36% of global trade finance in 2011. However eurozone banks have been cutting back their trade finance operations in response to pressure to consolidate activities in domestic markets. One reason for this is that short-term trade finance is easy to trim in order to meet regulatory capital requirements.

"Trade finance is very important, and it can cover many different risks; for example currency risk, political risk, and trade risk, but liquidity requirements will directly decrease the amount of trade finance available to a business."

Chief Executive Officer, French consultancy

How do businesses use financial services to manage market volatility?

Corporates can use financial services products to reduce risk: Every business purchases goods and services to use as inputs. The price of these inputs can rise and fall in relation to the demand and supply for these goods. These goods could be tangible such as steel or copper (raw materials for production), or intangible such as a loan with a flexible exchange rate. For corporate treasurers responsible for risk and cash management, avoiding volatility in input prices is worth paying for.

A range of tools are available: Financial tools which are used by corporate treasurers to achieve a stable cash flow include derivatives (e.g. forwards and options), and swaps (e.g. for interest rates and currency). These are defined and described in Chapter 2, *The engine-room of economic recovery: helping European companies set up and grow.*

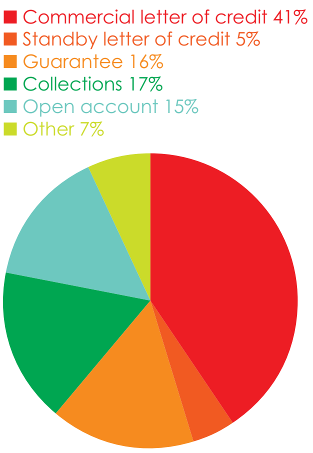


Figure 8.3
Global export transactions volume % share
Commercial letters of credit are by far the most popular form of trade finance, with 41% of the volume.
Source: ICC Global Survey 2014

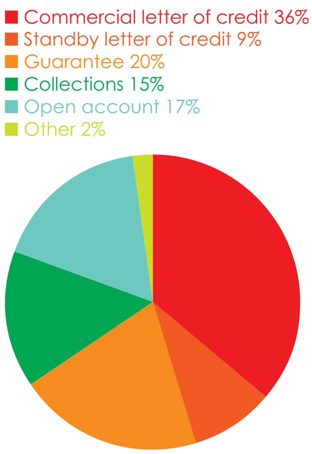


Figure 8.4
Global import transactions volume % share
Bank guarantees are more popular when importing compared to exporting.
Source: ICC Global Survey 2014

Engineering risk management

A multinational engines manufacturer produces large engine components for major industrial projects. It is a large firm employing over 10,000 people in countries across Europe.

The business challenge: The company's major concerns were that some of the recent regulatory developments could mean that funds they might be spending in their primary business for product development, research and development and job creation, could instead be either spent on credit charges or tied up in clearing houses as collateral.

Variety of risks covered: Some of the underlying business risks (actual or forecast) that this firm either currently hedges, (or has considered hedging), are:

> Foreign exchange risk on cash flows;
> Commodity price exposures;
> Energy price risk;
> Credit risk, for example the purchase of a credit default swap (CDS), or other similar instrument;
> Employee share scheme liabilities;
> Emissions trading scheme liabilities;
> Inflation risk;
> Pensions scheme liabilities.

Other non-financial firms will have their own set of specific risks that they may wish to hedge via derivatives, such as the risks of the weather, or property prices.

"We hedge risk using derivatives, the most common for us being foreign exchange risk; these products are absolutely necessary for companies to manage their business, and reduce risk."
Deputy Chief Financial Officer, materials manufacturer

Key question:
Why is the derivatives market so large?

The size of the market: Various figures are given to indicate the size of the derivatives market, and views have been expressed that it might be out of proportion with the bond and equities markets. According to the Bank for International Settlement, the total amount outstanding of OTC derivatives in December 2013 was $710tn, (€515tn).

Terminology is important: Any lack of clarity is often a result of the terms used. **'Notional amount outstanding'** adds up all the value of every security that has a derivative based on it. There may be multiple derivatives on a single security, some of which may expect the value of the underlying asset to rise, and some of which expect the value of the underlying asset to fall.

The **'gross market value'** nets out all of these to produce an aggregated net risk position, which is significantly lower. The estimated gross market value of all OTC derivatives outstanding was $25tn in 2012, which is a fairer direct comparison with the equity and bond markets, which have market capitalisations of $50tn and $89tn respectively.

Conclusion

Businesses require a range of options for short-term finance and to ensure sustainable growth, and European financial and professional services firms provide them. Corporate banks with deep pools of liquidity help manage working capital and trade. Tools are available in the financial markets for financial risk specialists to purchase business risks from corporates. This allows the risks to be managed effectively. Firms can then focus on their own core activities, to help them grow in the long term.

9.
Wholesale Financial Markets
Supporting business: liquidity and market making

Key messages

> Businesses require ready access to funds to fund their business, manage their cash flows and meet unforeseen events.

> Wholesale financial markets can support businesses in maintaining access to liquidity:

> > Companies can raise new funding in the market by issuing new shares or debt;

> > Companies can sell assets quickly and at a fair price to raise cash in the secondary market;

> > Firms can unlock future cash flows for investment by securitising future receivables;

> > Companies can manage their surplus cash either in bank deposits or by investing in money market instruments.

> Liquid secondary markets also lower the cost of capital for businesses as investors typically require lower returns for liquid assets, which allow them to sell the asset if needed.

> Liquidity is important to deliver businesses' long-term investment strategies as it creates investor confidence in the business and the market more generally.

Firms across Europe depend upon liquidity for a number of reasons

Managing their financial obligations: Liquid assets can be turned into cash quickly, meaning that in the event of a short term obligation or opportunity a company can easily source the capital they need.

Raising investment capital: A firm's costs of capital will be reduced where a broad set of investors are able to access, price and exchange debt and equity capital with low transaction costs and price impact.

Providing confidence to plan ahead: Fixing future costs through hedging and forwards markets enables a firm to plan ahead so that they may allocate future cash flows to meet future liabilities.

This paper will focus on the importance of liquidity to small and large businesses and how businesses can manage this efficiently to underpin business growth.

Understanding the importance of liquidity

Why is liquidity important to businesses across Europe?

Liquidity directly impacts European companies' ability to operate effectively as it governs their cash flows and ability to grow (i.e., through investment in research and development). Businesses of different sizes face different challenges and benefits related to liquidity. As such, there are many different reasons why liquidity is important to various businesses across Europe.

What is liquidity?

At its highest level, liquidity refers to the ability to sell, buy or gain access to cash at a fair price at any given time. However, liquidity can be used to describe the following characteristics:

The 'liquidity' of a business: describes the extent to which a business has liquid assets to meet its short term liabilities.

The 'liquidity' of a market: describes the ease of buying and selling in a market place. The higher the number of buyers and sellers completing trades each day, the more liquid a market. For example, a liquid market is one in which a participant can easily find ready market counterparts willing to buy or sell an asset with competitive pricing, and with low transaction costs.

The 'liquidity' of an asset: refers to how easily a business can transform an asset into cash with minimum effect on price – the more easily an asset can be bought or sold the more 'liquid' it is considered. For example, if stocks held by a business in a listed company can be easily sold on the stock exchange as a result of available liquidity, this would be considered a liquid asset. However, if a business wants to sell its infrastructure investments, but is unsure who to sell them to, or how long it would take to sell, this would be considered an illiquid asset.

The importance of business liquidity to businesses across Europe

Understanding and managing business liquidity is of critical importance to how companies operate and grow. While companies may own many assets, from land and manufacturing equipment to government bonds, the ability to transform these assets into cash is a factor in them being able to operate successfully on a day-to-day basis.

Immediate access to funds: A business needs funds to pay its liabilities, support growth plans or fund unforeseen costs. The ease with which it can access these funds is reflected in its business liquidity position. For example, in the event of staff leaving, a business with high liquidity levels has the cash flow available to pay temporary staff premiums as they recruit to re-fill the role. With low levels of liquidity, a business may be unable to free up the cash they need to staff the position immediately, negatively impacting the workforce and potential earnings.

Investor confidence: Since business liquidity indicates whether a company can afford to pay its liabilities, higher levels of business liquidity enhance investor confidence and may increase funding opportunities. Investors often look at the liquidity level of a business before making investment decisions. For larger companies, higher investor confidence can mean higher valuations, which in turn benefits companies as it means higher stock prices.

What happens if a business has too little or too much liquidity?

If a business has too little liquidity and cannot gain access to the funds required the results can be devastating. In the worst case, the business will be unable to pay its liabilities and will be forced to close down or enter liquidation. In the best case the business will be able to access funds but this will likely be at a higher level of interest (for example through high interest pay-day loans).

However, it is possible for a company to have too much liquidity, a reality often faced by major corporations. Typically, businesses will hold on to liquid assets if there is a lack of confidence in the market place, an expectation that interest rates will rise or an anticipated large expense. Yet, when businesses hold onto excessive liquidity the repercussions are often.

Limited earnings: By holding onto excessive liquidity businesses can lose out on interest available from long-term investing. For example, certificates of deposit offer higher interest rates than savings accounts but require the depositors to keep their funds for longer periods of time.

Limited growth: If a business maintains unnecessarily high levels of liquidity by holding onto too much cash then they tie up funds that can be used to support growth plans. For example, a booming business choosing to invest in liquid bonds over adding an additional staff member to support the company's growth.

To achieve the optimal level of liquidity, businesses may need to divest or enhance their liquid assets. There are many ways to achieve this.

Divesting liquid assets

Once companies have met their liquidity requirements, they are able to invest in long-term assets or grow. Divesting liquid assets can be done through funding strategic areas to support business growth or through purchasing long-term investments (i.e. infrastructure assets or private equity investments).

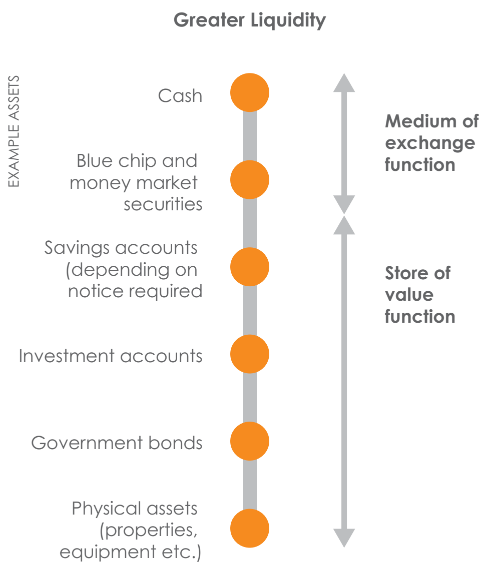


Figure 9.1
Liquidity spectrum – assets from exchange functions to store of value functions

Enhancing liquidity

For small to medium businesses enhancing business liquidity levels can prove challenging as they may receive limited opportunities to approach investors, especially in difficult market conditions. Larger businesses may be better positioned to take advantage of funding opportunities available to known and trusted brands by selling shares to investors globally through stock exchanges.

Free cash for investments: businesses may be in a position to free cash for investment by assessing overhead costs for potential reductions, divesting unnecessary or unproductive assets, ensuring accounts receivables are effective, enhancing profits, or negotiating longer payment terms with vendors along supply chain.

Funding through business banking: Businesses can utilise financial facilities (such as overdrafts, deferred payments or term loans) to enhance their short-term liquidity levels. Small businesses may find it challenging to secure high levels of funding, especially if the marketplace is illiquid, due to high amount of perceived risk. Crowdsourcing or angel investing may prove to be viable options for some small businesses.

Case study:

Generating Liquidity through the Stock Exchange

Velocys, a leading technology innovator, was a small company with approximately 20 staff that chose to increase its liquidity through the Stock Exchange.

The business challenge: The business required liquidity for its growth plans to complete a reverse takeover of a US company. Due to the significant amounts of funding needed to support of research and development for technology innovations future cash flows were uncertain and the company realized that raising growth capital would not be possible through bank finance. Velocys realized that they would need to find investors who believed in the business.

The funding solution: Velocys decided to be listed on the AIM market of the London Stock Exchange (an international market for small businesses) in 2006. Susan Robertson, Chief Financial Officer noted: 'We had a good relationship with our bank, but it would be unrealistic to expect a bank to fund a technology that is still in development and not expected to lead to a return in the near future.'

The results: Since enhancing liquidity by being selling shares to interested investors Velocys has been able to expand to approximately 100 employees. The success of Velocys has been built on its possession of a compelling technology and its record of delivery. It has repeatedly set and then met targets, giving investors confidence in the company's management.

Funding through wholesale financial markets: Large businesses may interact with wholesale markets to increase liquidity levels by raising new funding by issuing shares or debt, either by being listed on the stock exchange, being promoted by a market maker or becoming available ‘over the counter’. The largest businesses often turn to global markets for funding to diversify risk, increase resilience, ensure they receive the best terms and maintain the diversity of their funding. Global markets are able to offer this security of due to the extensive number of participants in the marketplace and the subsequent liquidity and price stability it brings with it. Small businesses may be able to utilise customer relationships with large-scale companies and governments to enhance liquidity through supply chain financing or by unlocking future cash flows for investment through securisation.

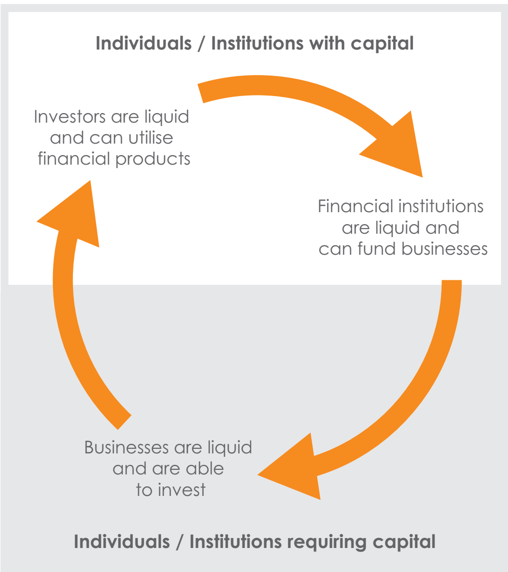


Figure 9.2
Funding liquidity cycle – enhancing manufacturing business liquidity through funding is dependent on the liquidity of financial institutions and investors

Managing liquidity

Businesses will often seek to ensure that their liquid assets are as productive as possible (i.e. generating a return) until they need it. For many businesses, particularly small businesses, this is likely to be placing the cash on deposit with their bank to receive interest. For larger businesses, the money markets can be used to manage their liquidity, both for investing their surplus cash to generate a return (while ensuring quick access should they need it) but also to raise extra cash to meet any unexpected funding requirements at short notice.

The importance of market liquidity to businesses across Europe: A liquid market ensures an orderly and well-functioning market place, and facilitates market confidence which benefits businesses in a number of ways, including:

Securing investment capital: Businesses will be able to lower their cost of funding when issuing new shares or debt if there is a liquid secondary market, as it allows investors to sell the assets in the future if they need to. Investors usually require a higher return on assets which are less liquid (known as the ‘liquidity premium’). Having liquid stock and debt markets therefore contributes to the growth of enterprises by lowering their cost of capital, as well as offering investors more stable opportunities to invest in businesses that need long-term capital.

For small businesses, high levels of market liquidity mean that SME funding may be more readily available.

Confidence to plan ahead: As price volatility exists in many markets, the futures market gives large firms the option to plan ahead by pre-purchasing at a known cost. For example, as commodity prices fluctuate, the futures market allows firms to pre-purchase supplies at a known cost, helping the business understand and control the cost of the supplies they require. As business demands change, having a liquid futures market

Market makers

Liquidity enhancers
As market making has progressed significantly over time and differs between locations, a concrete definition does not exist, however the key attribute of market-making is ensuring two-way prices (i.e. both a price to buy and sell) in a given security in a given market. The difference between the buy and sell price is known as the bid-offer spread and is the compensation that market-makers receive. The bid-offer spread is also an indication of how liquid the asset is – the narrower the spread, the more liquid the asset.

Market makers typically participate in the stock and currency exchanges. A number of market makers brings stronger competition and increased market depth which benefits both the listed companies and investors.

Importance to the European economy
Secondary market liquidity provided by market making has a significant positive impact on the European economy and will be an important factor for ensuring growth. In addition to maintaining liquidity levels, market makers benefit the economy by:

1. Enhancing investor protection and market confidence (which in turn enhances the number of investors and liquidity level of a market place).

2. Contributing to allocating capital to the most efficient investments within the economy and provide mechanisms for saving, risk pooling and management.

means that the risk of investing funds to specific future supplies is significantly reduced (provided the market for the specific supply is liquid).

For small businesses involved in manufacturing, sourcing or professional services, the confidence of major corporations to plan ahead and place large-scale orders in advance can help businesses enhance their liquidity position by providing them with large cash payments ahead of delivery.

Conclusion

Businesses require access to liquid assets and liquid markets so that they can manage cash flows, unforeseen events, ensure sustainable growth and attract investors. Businesses should understand their liquidity requirements and the options available to them to manage, alter enhance or reduce their liquidity levels. For many businesses, the wholesale financial markets play a critical role in generating liquidity and enabling growth by ensuring a financial market. Businesses, both large and small, must continually monitor the levels of liquidity internally and in the marketplace to ensure the right balance is struck.

Authors

The Wholesale Financial Markets Papers are compiled by Accenture Research for the IRSG, the CBI, MEDEF and Paris Europlace.

About IRSG

The International Regulatory Strategy Group (IRSG) is a practitioner-led body of the financial and professional services industry, dedicated to shaping the international regulatory regime so that it promotes open, competitive and fair capital markets and supports economic growth.
It is an advisory body to the City of London Corporation and TheCityUK.

About MEDEF

MEDEF is the leading network for entrepreneurs in France, with over 780,000 member firms, 90% of whom are small or medium businesses with less than 50 employees.

About Paris Europlace

Paris Europlace represents all participants and users of financial services: businesses, investors, financial intermediaries and regulators. Its role is to promote the conditions to enable the competitive financing of the wider economy in a globalised world.

About CBI

The CBI is the UK's leading business organisation, speaking for some 240,000 businesses that together employ around a third of the private sector workforce.

www.cityoflondon.gov.uk/business

www.TheCityUK.com