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QUARTERLY COLUMNS SERIES ON CAPITAL MARKETS

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Contents

Inaugural issue

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Why the need for a Quarterly Column Series on Capital Markets?

Since 2012 Bocconi University and Equita have teamed up with the objective to produce and disseminate a strong culture promoting the role of capital markets for the Italian economy among policymakers, scholars and students. The lack of a robust financial infrastructure of capital markets, the need to strengthen the investor base and the intermediation structure of capital markets were clear factors of competitive disadvantage for Italy vis-à-vis other European countries.

In the past ten years, the research team has produced annual reports centred on the key pillars of the capital market infrastructure: the investors, the issuers and the intermediaries. Well before the outbreak of the pandemic, the overall evidence presented in a series of annual events showed that capital markets in Italy were still underdeveloped.

On one hand, Italy still lacks a strong base of domestic investors able to absorb the debt and equity instruments issued by domestic companies (Caselli et al., 2014; Caselli et al., 2015; Caselli et al, 2017; Caselli et al., 2018). On the other hand, the still-overwhelming dominance of traditional bank lending has reinforced the dependence of companies, particularly small and medium sized firms (SMEs), on this form of financing. Lastly, the investment banking business is dominated for large segments of Italian companies by large international intermediaries, with only a minor role played by domestic investment banks/integrated financial intermediaries (Caselli et al., 2020).

After ten years dedicated to developing and disseminating the 'culture of capital markets', Bocconi University and Equita now feel the need to move one step forward in their collaboration. This need is more urgent due to the effects caused of the unprecedented crisis brought on by Covid-19. The unique possibility offered by the extraordinary times we are living to re-imagine and rebuild the capital market infrastructure must be seized, to give Italy and the EU a solid foothold on the path toward a full post-pandemic recovery.

Yet, this possibility is more concrete now than ever, given the increased attention that at international level the European Union is dedicating to strengthen capital markets circuits, with a special focus on SMEs (Technical expert Stakeholder Group (TESG) on SMEs, 2021). More and more, the European Union is considering capital markets and market-based corporate finance as the key for the relaunch of the Eurozone (High Level Forum on the Capital Markets Union, 2020).

Against this backdrop, the Quarterly Columns Series on Capital Markets is a new project that Bocconi University and Equita have set up to further enhance the attention towards capital markets. Moreover, we seek to actively propose solutions and tools for decision-makers to achieve the objective of the reform of the European and Italian financial infrastructure. The Quarterly columns target a broad audience, not necessarily confined to academics, scholars and students.

It is clear that this objective requires a multidisciplinary approach. The rethinking of the role, functions and structure of capital markets in Europe stretches across multiple disciplines including finance, macroeconomics, corporate and tax law, governance and management. This multidisciplinary attitude of the Series implies that the contributors will belong to multiple knowledge areas where Bocconi University is active.

It is equally clear that the objective of the Quarterly Columns cannot be limited to the analysis of Italian capital markets. Past years' research by the Bocconi-Equity group has sometimes covered a broader perspective not necessarily restricted to the Italian context (Caselli et al., 2016; Caselli et al., 2020). However, the success of post pandemic recovery requires an even more focused approach on European Capital Markets as a whole, in line with the growing attention given to the creation of the Capital Market Union.

The *Quarterly Columns* will be published at the end of each quarter and available at the website address www.equitalab.eu

The next issues will be dedicated to the analysis and policy recommendations of:

- Growing corporate debt and the zombie company effect
- The need to diversify corporate finance sources: equity and DCM

Some preliminary indications of the contents of the forthcoming Quarterly Columns are provided in the following Sections.

1. Growing Corporate Debt and the zombie company effect

In July 2020, in a period still characterised by the heavy effects of the first wave of the Pandemic, Bocconi and Equita organised a discussion panel with the objective of analysing the current situation and highlighting the challenges posed to corporates and governments by the strong recession induced by the lockdowns.[1] The discussion centred on the Italian financial system but also covered issues common to other European Union Countries.
Here are some of the conclusions the panel helped define:

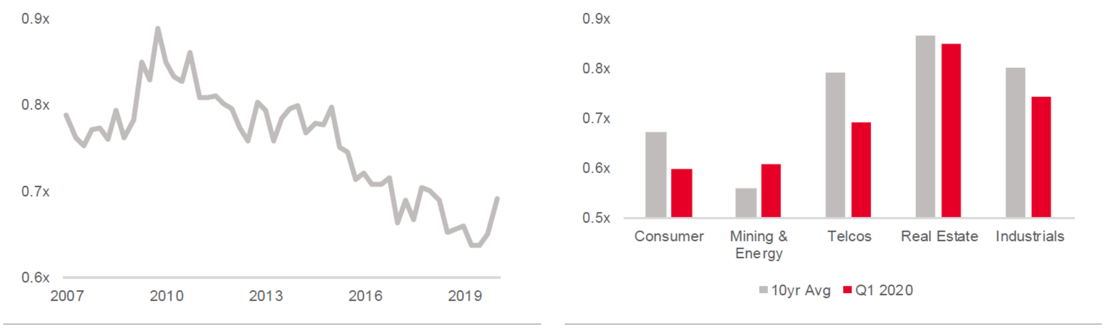
- The Eurozone has always been an economic area with a strong vocation for cross border economic activity and export, with some national champions in Italy, Germany and France in well-defined sectors.
- Hence, the full post pandemic recovery would require a complete re-establishment of international trade, something that at the time was complicated by growing production delocalization and by the disruption of long supply chains.
- A further constraint to a full recovery was represented by the difficulty of managing operations in factories given the prolonged lockdowns determined by the first pandemic wave.
- The outbreak of Covid-19 severely compressed operating profit margins. In the Eurozone, many managers, even in sectors less affected by the pandemic, were signalling negative effects on prices and volumes, with obvious impacts on financial soundness, particularly for highly leveraged, smaller companies or for high yield issuers.

At that time, against the backdrop on an unprecedented emergency like the pandemic, the first reaction of EU Governments was to create a safety net against the liquidity crunch faced by corporations. This liquidity crunch was generalized across the whole EU.

In early Summer 2020, Société Générale estimated that the quick ratios of companies belonging to the high yield index in Europe – the more vulnerable to the effects of the pandemic – were below 0.7x, one of the lowest levels of the past 13 years. The effects were stronger in some sectors like consumer, telcos, manufacturing/industrials). See Exhibit [1].

[1] *Bocconi University – Equita, The Italian financial system and its role in the post Covid-19 pandemic, Webinar,7 July 2021*

Exhibit 1: Quick ratios of euro high yield companies (left panel) and breakdown by sector (right panel)



Source: Société Générale, Cross asset research as of June 2020

All across the Eurozone, many of the rescue measures set up by Governments concentrated on debt instruments, a large majority on traditional bank lending:

- liquidity back up measures (liquidity injections and moratoria on maturing debt);
- State Guarantees granted to banks for extending new financing to corporations.

Furthermore, the European Central Bank implemented extraordinary emergency measures to provide liquidity to the economy and to keep interest rates at historic rock bottom levels. We will not comment here on the technicalities of the different facilities that have been made available. Suffice to say that the Central Bank action has sustained corporate bond prices and imposed for fixed income investors a scenario of 'low for longer' rates.

The effects of these emergency measures, 12 months since our Discussion Panel, are clear. The Institute of International Finance (2021) indicates that the ratio of nonfinancial corporate debt over GDP in the Euro area stands at 115%, 8% points higher than the corresponding value 12 months before.

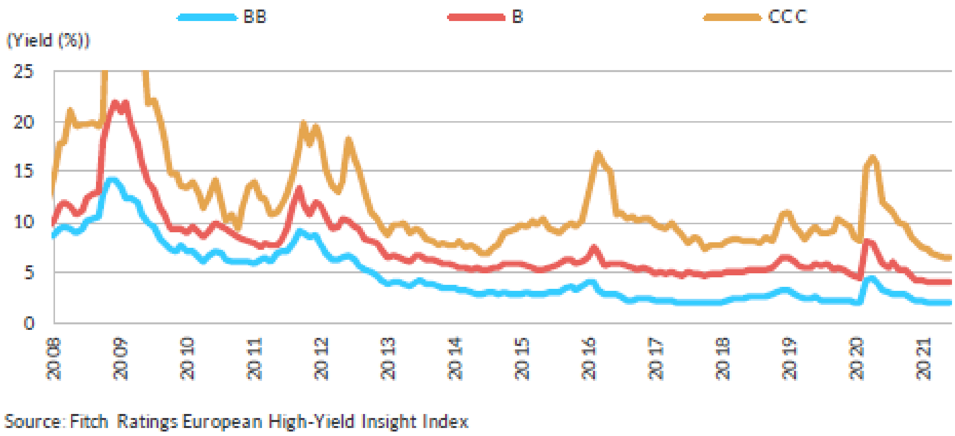
Also, corporate fundamentals are showing signs of weakness. If we look at the Investment Grade (IG) segment of European Companies - arguably the most solid companies in the corporate universe - the ratio of Net Debt/EBITDA has surpassed the 2.5x threshold while the interest coverage ratio has deteriorated moving from 7x to almost 5x during 2020. See Exhibit 2.

Exhibit 2: Net debt/EBITDA ratios (left panel) and interest coverage ratios (based on EBIT, right panel) for US and Euro IG companies

Source: Bloomberg and Amundi Research

It is an interesting paradox to observe that corporate bonds, even for the riskiest segment of corporate issuers, are trading at their tightest levels since 2008 despite a clear worsening of corporate fundamentals (see Exhibit 3).

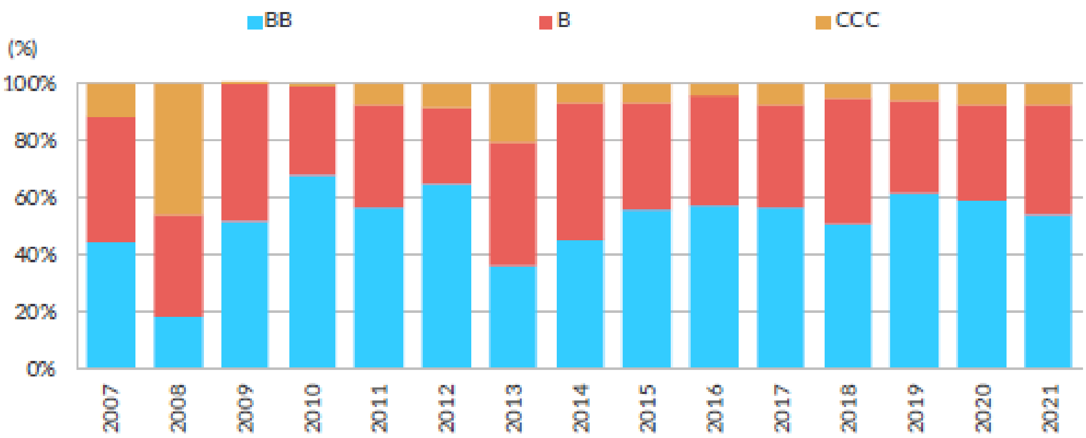
Exhibit 3: European High-Yield – Yields by Rating



Source: Fitch Ratings as of September 2021

On the volume side, the latest 12-month issuance (as of June 2021) of European high yield bonds hit a record of 150 billion euro, an amount higher than the 2017 peak of 119 billion euro. Interestingly, year-on-year changes were also positive for the riskiest segments of single B and CCC issuers (see Exhibit 4). The easy explanation for this paradox is that the quantitative easing measures put in place by the European Central Banks forced fixed income investors to move down the risk spectrum in search of a decent level of yield.

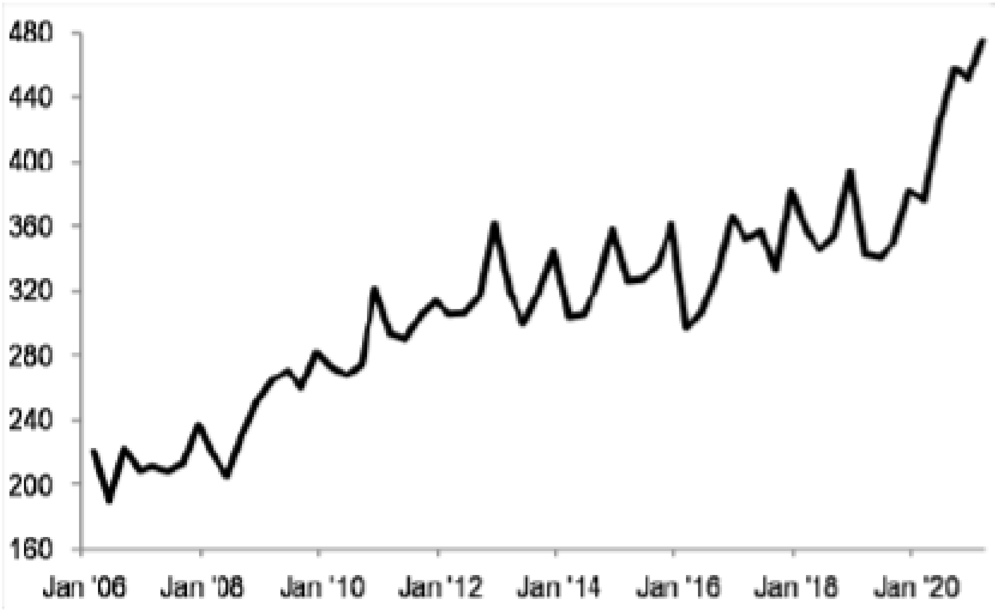
Exhibit 4: European High Yield bond issuance by Rating



Source: Fitch Ratings (2021)

So, it also comes as no surprise to see that the liquidity profile of European corporates now is healthier than 12 months ago, with cash balances of European IG companies surging from slightly more than 350 billion euro to almost 480 billion euro in H1 2021 (see Exhibit 5).

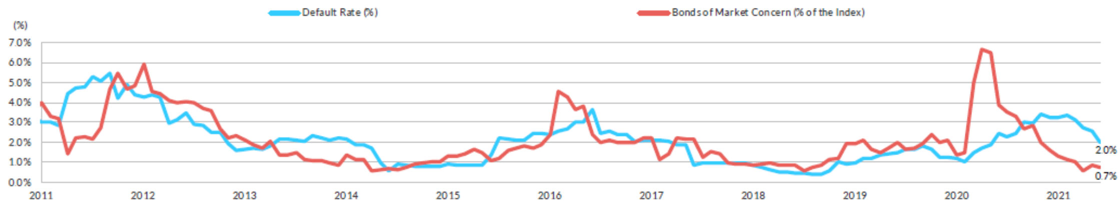
Exhibit 5: European IG cash on balance sheet (euro Billion)



Source: Credit Suisse Research

Lastly, the governments' extraordinary rescue packages and the ECB quantitative easing measures have contributed to an appreciable reduction of the default rate of riskier borrowers (see Exhibit 6).

Exhibit 6 Bonds of Market Concern and default rates[2]



Source: Fitch Ratings (2021)

So apparently the current financial situation of European firms has returned to a non-emergency situation, and the firepower put in place by governments and the ECB have been effective in stopping severe impacts on productivity and employment.
We are not saying that what has been done was either wrong or unnecessary. We are firmly convinced that these measures have allowed healthy firms to withstand the effects of the pandemic. Indeed, Ebeke et al. (2021) calculated that rescue policies helped save about 15% of labour force and about 25% of the European corporate valued added.

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[2] *With specific reference to the Italian bond market, Fitch (2021) indicates a drop of yields for High Yield bonds from more than 3% to almost 1% and from about 7% to about 4% between the beginning of 2020 June 2021 for BB and single B issuers, respectively.*

However, these rescue programs have also allowed non-viable, weak firms to survive and to attract financial resources that would otherwise be funnelled to better uses and more efficient capital allocation. The survival of such firms (in the post pandemic scenario) could trigger unintended side effects in the form of higher financial fragility, higher default rates and higher nonperforming loan levels in European banks' loan portfolios.
Helmersson et al. (2021) have analysed these negative side effects determined by the survival of so- called 'zombie companies' (Velimukhametova, 2019), firms that show low levels of profitability (low ROA), weak capital structures (low debt servicing levels) and modest investment rates. Their study indicates that the percentage of firms qualifying as 'zombie' before the pandemic was 3.4%.[3] AFME (2021) has quantified the level of unsustainable debt in the EU in 324 billion euro, of which 57% represented by debt of small and medium enterprises.
The consequence of unsustainable debt (or, put differently, excess leverage) is a projected equity funding need of about 1,000 billion euro. Considering that public and private sector equity and quasi-equity instruments in Europe are available for an amount between 400 and 550 billion euro, the total required to strengthen the capital structure of European companies stands at an impressive 600 billion euro (AFME, 2021). Similar conclusions are proposed by Ebeke et al. (2021) who argue that an equity gap of about 2-3% of the European GDP must be filled in to avoid European companies remaining in a 'difficulty' state.[4]
Almost 90% of zombie firms have had access to public financial support and to loan moratoria during the pandemic, in most cases with interest rates not much higher than rates paid by stronger and more viable companies. All of these measures have allowed zombies to lower the pressure of debt servicing and highly leveraged capital structures.
With banks that faced Covid-19 with stronger capital buffers and with investors in debt capital markets in search of yield, Helmersson et al. (2021) indicate that currently banks and capital markets for debt instruments are characterised by a certain degree of 'complacency', something that in the medium term could lead to higher NPL ratios for banks and higher default rates for high yield bond investors (Fitch, 2021).
Considering the still pending uncertainty regarding the evolution of the pandemic variants and the possible consequences on the strength and the duration of the recovery, all the evidence suggests that the 'way of debt' cannot be the exclusive one to guarantee European firms the best conditions for a relaunch. This is even more evident for SMEs which, compared to larger firms, cannot access debt capital markets instruments and are more dependent on traditional bank lending.
More robust capital structures and more equity is needed to allow European firms to strengthen their financial profile and to capture the extraordinary opportunity of relaunch offered by the post pandemic phase. The recommendations proposed by the High Level Forum on Capital Market Union and by the Technical expert Stakeholder Group (TESG) on SMEs indicate a number of policy and regulatory/supervisory actions useful to increase the financial flexibility of European firms and to reform European capital markets to make them more functional for the relaunch of the Eurozone economy.

[3] The same analysis was carried out in UK by TheCityUK (2020). The report indicates that of the total unsustainable debt of UK firms as of March 2021, 33% was due to government-guaranteed lending schemes.

[4] The authors quantify the equity gap assuming that the 'state of difficulty' is based on two thresholds: a) the sum of losses in the end-2020 balance sheet exceeds half of its subscribed share capital; b) the debt/equity ratio (book values) exceeds 7.5x.

2. The need to diversify corporate finance sources: equity and DCM

To relaunch enterprises, a determined and capillary action of capitalisation is necessary. This is the most important challenge for our country – and for the EU overall – as more patient capital makes it possible both to have liquidity for immediate survival, but above all to have the appropriate solidity to plan the revival and growth, with minor risks. Not only that, but more equity means more credit and the ability to get funding from the banking system. It is precisely this, the great challenge that our system is facing: to complete the 'takeoff phase' of the economy in order to reach a 'cruising speed' that allows the system to return to normal and embark on a determined path of growth, which allows the country to absorb many (zombie) companies that have survived only thanks to state incentives. If this does not happen, it is inevitable that many companies will be able to enter a phase of default and that the State must continue to intervene with extraordinary measures that involve only expenditure and more public debt.

How to capitalise on companies? A single recipe is not possible, even if the need is the same and across the board impacting the two million companies in Italy. This is because companies come in different sizes, operate in different sectors and a general intervention of private equity and venture capital is unthinkable, left up to the financial markets and direct European intervention. Conversely, the urgency of capitalisation needs to be addressed by distinguishing a number of successive levels, starting from a common base and gradually concentrating on a smaller number of larger size or companies with solid potential.

The common basis, which involves everything from the smallest business to the largest enterprise, is tax leverage. The Italian 'Relaunch Decree' of 2020, proposed again in 2021, addresses this aspect and in the coming weeks it should garner the needed support to move towards a more general taxation reform, as is planned. On the way down this path, this ambitious work can also take into account the recommendations of the 'Colao Commission'. Tax leverage must not only level the difference between debt capital and risk capital, but must encourage virtuous behaviour, so that capital consolidation is not one-off but becomes a recurring behaviour. Fiscal leverage must act on two sides: for the company and for the shareholder.In the first case, on several occasions our country has seen attempts to action incentives in this direction (the DIT of Visco, the ACE of the Monti Government) without adopting a structural mechanism. A consolidation of the ACE at an attractive rate, calculated no longer on the change in risk capital but on the full amount, would make the issue of risk capital much more serious. To date, the ACE has an ordinary regime with a low rate of 1.3%, which is accompanied by an 'innovative ACE' regime with a rate of 15% and a ceiling of 4 million euro (only for 2021). Here the clear intention is making available to the system a sort of 'shock' intervention. A reasonable and definitive balance must be struck between the marginal nature of the ordinary system and the significant extent of the extraordinary system. In the second case, shareholders (and small business owners) must have an incentive to transfer part of their wealth to their company. A reduction (elimination?) of the tax on dividends for those who hold the capital over a certain period of time and, much more courageous, a reduction of the IRES or IRPEF rate for those who invest in capital increase: these moves would mark an epochal turning point. Going in the right direction is the recent indication of the 2020 Relaunch Decree to favour the recapitalisation of SMEs (those below 50 million euros in turnover) through tax credits equal to a percentage of the capital increase. However, this does not yet have the characteristics of a structural measure that is standard for all.

In addition to the common basis, the use of the financial market and the involvement of investors (private equity, venture capital, PIR) should be promoted for larger companies and those with higher development potential. The salient issue today is how to reconcile this requirement with the equally important need to use public resources, both national and European, i.e. through the recovery fund. The risk to avoid is State intervention in equity capital and a displacement of the market. The right path instead is to find the conditions so that the intervention of the State is valued fully and follows the logic

of flanking private capital. There are four fundamental considerations here. First, the use of the capital market is decisive, as the known advantages (visibility, access to additional resources, growth potential) are even more important in a crisis. In this case, it would make sense to play the card of an additional prize for both ACE and shareholders. Secondly, risk capital investors, whether listed or not (thus venture capital, private equity, PIR) must be valued with a clear incentive on capital gains, which is the real element that creates the market and therefore attracts investors by generating liquidity. Thirdly, state intervention must take place either with a clear and independent market logic or through the necessary support for private investors. A mechanism in this case of public-private partnerships would in fact give the force of shock - the presence of the State - with agility and orientation to the typical profit of the private. Fourthly, the relationship between companies approaching the financial market or those already listed must develop in a decisive and simple way. Some innovations on this are essential. As proposed for example in the report 'Empowering EU Capital Market for SMEs', it is essential: on the one hand, to set a maximum limit on the size of information prospectuses and their cost, and, on the other, to open up a broader reflection on the scope for retail investment to allow more resolute access to liquid and illiquid equity instruments of small and medium-sized companies. Furthermore, defining a set of rules to identify SMEs which are still private but not yet ready to go public is a promising area that it makes sense to work on. A final thought is on the issue of bank credit and the role of the public guarantee, a step taken in the early days of the crisis. The use of the banking channel may be useful in the immediate term, but it has a negative impact in the short term: companies become more indebted, their central risk worsens, the space to obtain credit in the future can shrink. In this respect, maintaining the State guarantee against the granting of credit should in the future be anchored to a capitalization mechanism: the state guarantee on credit should be given only if the company carries out a defined capital increase on a fixed percentage of the amount in question. In this way, interventions would become synergistic.
The issue is that the taxation of liabilities does not provide any educational or selective mechanism, but only a cap on the deductibility of interest anchored to an indicator that is not rational (the EBITDA). By this we mean that it is not related in any way to the structure of liabilities as a whole or to the cost of capital. Reshaping taxation could be very useful to promote precisely the concept of 'greater quality of capital', which is functional to a more appropriate structure of companies in relation to their current stage in the development cycle. The scheme we propose may include: a) the abolition of the ceiling on deductibility of interest; b) the non-deductibility of interest payable on general credit facilities; c) a possible premium for small and medium-sized enterprises that replaces bank overdrafts with medium-long-term loans (with a minimum duration of 5 years), plus deductible interest (thus increasing it to 120% or, possibly, up to 140%) for 2-3 years.

The purpose of the overall plan is therefore to move the debt capital in a determined way towards the medium- long-term by keeping the tax shield for transactions that are clearly aimed at supporting the divestiture of trade receivables and eliminating a variable unrelated to financial planning, such as 30% of EBITDA. Again on the debt side, the use of long-term bonds (for example, over 10 years), with interest linked to the recovery in turnover, may be the right choice. This leads to a variety of solutions that extend to bonds dedicated to individual production chains or to individual territorial clusters, or social bonds with a logic of deep intervention in areas that need real reconstruction. The path of the market and the use of private resources should be followed in a determined way.

3. Conclusions and implications for research and policy actions

The need for a major fiscal reform is emerging in the political debate, especially in the agenda of the Government, as a means of reviving the economic system and restoring social equity. This is a unique opportunity that should not be wasted: the overall reform of the tax system is a

prospect presented few times in history (remember in Italy, with different tenors, in 1974, 1986 and then 1996). Such a reform opens the possibility of setting the reference framework, the objectives and rules of the relationship between taxpayers and taxes, which, year after year, should be progressively adapted or altered according to the needs that emerge rather than, unfortunately, the electoral needs. This time is more critical than other occasions not only because of the authoritativeness of the government but also due to the PNRR, which drags and imposes specific objectives in terms of growth and development for the country in a broad sense. The next few months must be used to design the bases of a robust fiscal system, able to offer the country rules of conduct that are not adapted simply to the convenience of the moment. If we look at business taxation, for instance, there are two areas of reflection that are necessary. First, what should be given before taking away? Secondly, what are the basic objectives that business taxation must achieve?
If we start from the first area of reasoning, the design must be directed above all to what the tax must give to companies before taking away, read tax reduction. If it is true that the global trend is a progressive reduction of corporate taxes as a stimulus to development, the central point of a reform is not so much (or rather, not only) cutting the rate of taxation of profits on businesses. This has happened in our country over the last 20 years, where the rate of corporate income has risen from 37% in 1996 to 24% today. The central point is to question which elements the tax must guarantee, to allow companies to carry out their activities for the benefit of all its stakeholders. This means working first of all on the number of different taxes, on the time required to pay them, and on the overall tax burden that, beyond the nominal income tax rate, includes incentives that stimulate the most useful behaviours for the stakeholders themselves. The World Bank's 'Doing Business 2020' by ranks Italy in 58th place in the world for simplicity of the fiscal and regulatory framework for companies. We are far behind the main European countries: Great Britain in eighth place, Germany in the twenty-second, Spain in the thirtieth and France in the thirty-second. If the top positions (on the podium New Zealand, Singapore and Hong Kong) seem guided by contexts of smaller size and characterised by unique combinations of geographical location and political choices, in the first ten places we still find, in addition to the United States, three countries in Northern Europe besides Great Britain.
But above all, these data highlight how the high tax burden on the profits of companies (53%), behind only France (60%) and among the top 20 countries in the world, does not correspond to an environment that is favourable to companies. Three specific rankings highlight these aspects. The number of taxes to which enterprises are subject (14, a number which is not similar) and the time devoted to dealing with these taxes (238 hours, or 29.75 working days), compared to a European average of 150 hours: these are elements that oblige companies to shift the focus from business management to worthless bureaucracy. Worse still is how long it takes for a refund of VAT on credit: 62.5 months versus 5 in Germany and 16 in Spain. Or the time spent on enforcing contracts that are not respected: over 1000 days, more than twice as long as France, Germany, Great Britain and Spain, with a cost that is in the order of 27% of the value of the contracts themselves. To give a better position to Italy and therefore a favourable environment to enterprise is the first condition.
The second area of reasoning is just as important. What are the basic objectives that we want to achieve with business taxation? 'Lower taxes' is a general statement that has the flavour of an election campaign. More important is using fiscal leverage to contribute to achieving the major objectives that the country faces, which correspond to growth, combined with employment, impact and sustainability. This is thanks to the basic approach and incentives that the tax can generate in addition to the use of the tax rate - 24% of IRES and 3.9% of IRAP. These are not monoliths; instead they can be differentiated precisely to achieve these objectives. The example of 12% IRES, as envisaged in the latest development law for some companies located in the ZES, is a first embryonic example that must be exploited on a large scale.
The key point is growth. Our country must get rid of the eternal dilemma between SMEs and large companies. Both are essential and must be preserved, but without large scale and investment we cannot compete globally, attract talent or innovate to transform the world. It is not possible to order growth by law, but it is possible to

set incentives. It's two different sides of the same coin: business strategies and financing. For enterprise strategy, here are some essential points: support for M&A operations with an accentuated deductibility of the merger deficits that, above all, from a reduction in the overall IRES tax for a number of years after the acquisition, as a 'premium' for growth and subordinated both to the growth of turnover but also to the growth of employment; successive incentives in Italy have seen different mechanisms (from the 'Visco' on investments, to the 'Tremonti' to reach the most recent super-depreciation) that can be effectively replicated with a logic of increased or accelerated deductibility, covering the entire spectrum ranging from plant and equipment to real estate; incentives on intangible investments, where the experience of hyper-depreciation can be replicated; but a standard should be added to consolidate the structural investment in R&D of companies. In this regard, the incentive logic used in the United States can be very effective: in addition to the normal deductibility, a substantial tax premium is added if the R&D expenditure of the year is higher than the average of the three previous years. This in fact generates a structural incentive to grow research and development as a factor of competition.

In terms of financing, it is essential that the collection of financial resources is not indifferent to the growth and robustness of the enterprise, starting from the smallest size. This means giving priority to raising equity capital, as a form of protection against adverse events and prevention of default. The previous paragraph gave an in-depth overview of actions required to set-up a favourable ecosystem to finance companies, according to their different sizes.

But growth, to bring benefits in the broad sense and to contribute to reducing inequalities, must be interpreted in terms of employment on the one hand and impact and sustainability on the other. If we look at employment, the biggest challenge here can be to link the reduction in the IRES rate (and IRAP) to an increase in the number of permanent employees. This would be an unprecedented signal that can then be applied appropriately (and with various elements of a tax premium) compared to the different areas of growth: growth that occurs after aggregations and mergers, the slow but progressive growth of a startup, the growth that happens thanks to innovation. Or even stronger but necessary, to lower IRES can be linked to diversity goals, both gender and generational. Moving in this direction, a reduced IRES rate could serve as a rule of attraction not only for brains but also companies that want to set up shop in Italy, guaranteeing long-term employment. Impact and sustainability in the same way can become guiding elements. It can be a risk (to run) to think of a more favourable taxation for B-Corp. Much less risky, but equally useful, to insert a more favourable taxation for impact bonds dedicated to projects with defined social and environmental impact.

The debate on tax reform must be addressed and the historic moment makes this possible. The real courage must be to aim for a single rate of corporate taxation, even higher than the current sum of IRES and IRAP, but with significant reductions that capture and value all aspects of growth, employment, impact and sustainability faced by companies. A result that would make Italy a country surprisingly different, for once in a positive sense.

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