

How to create a conducive SME exchange

Aarthi Sivanandh

It has been repeatedly proven that there exists a close relationship between growth in different industries and countries and the structure of financial institutions in that country. The primary function of a financial institution is to improve the allocation of funds in the economy.

Entrepreneurial finance, the world over, involves the entrepreneurs' own money, money from friends, family, angel investors, venture capitalists and, eventually, the public equity markets.

Venture capitalists are focused on exit and, in general, look for rates of return of between 20 per cent and 40 per cent, business angels lesser than 20 per cent, if at all. Initial public offerings are the preferred route of exit for investors, since they yield the highest return, but they are not the most common. It is estimated that fewer than one in a thousand new ventures have an IPO. However, entrepreneurs are much more optimistic than this record would warrant.

One study estimated that 70 per cent of new technology firms believed that a public stock offering was 'highly likely' or 'probable!' Trade sales are the most common exit route of business angels, accounting for over 40 per cent of exits, followed by sales of shares to other shareholders and sales to third parties. IPOs account for just over 10 per cent of business angel exits.

GLOBAL EXAMPLES

To ensure stable flow of finance into small and medium enterprises (apart from bank-oriented concepts), governments often craft and

link policies to the structure similar to the main equities exchange of the country. India attempted to finance SMEs by setting up in 1992 a financial institution, The Over the Counter Exchange of India. Hailed to be ahead of its time, the OTCEI crashed owing to several reasons, including a bearish market in the early 1990s, stringent regulations on a par with the main stock exchange, a depository system of handling in a situation where the depository law was in not place, minimal marketing effort, high trading costs, and so on. This article seeks to decipher what else is needed to create a conducive financial institution for the SME ecosystem.

A new market exchange that has a system capable of being an enabler of growth for small companies has the potential to generate entrepreneurs, attract varied investor profiles, reduce information asymmetry, and nurture new markets for equity financing.

More than 24 countries have already created such a new system, examples being AIM London, KOSDAQ Korea and TSX Venture Exchange Canada. Collectively, these exchanges attract more than 450 listings every year and list more than 4000 firms. All three exchanges take the form of a separate market exchange, while other exchanges in the world work as a separate board within the exchange, operating in parallel to the main board.

Mostly, the new market exchanges are smaller in size than the main exchange and qualitatively vary in terms of the innovativeness and productivity of the companies that approach it (this in turn will dictate the investor interest in such



An exchange's success depends on retail investor participation.

exchanges). The vibrancy of the new exchange also depends on the size of financings and number of listings it interests to hail its success.

MONITORING THE PULSE

The liquidity of listing in such markets will be the prime mover of investors and companies to list in it. While the liquidity in the SME exchange will be lesser than while approaching the main market exchange, it can nevertheless be a

great success if the turnover ratio turns out to be high (trading value to market cap). As retail investors tend to contribute more to the turnover ratio and liquidity than institutional investors, the exchange's success depends on the retail investor participation.

Exchanges also become attractive based on the kind of listings they attract — whether it is a high capital or high research-oriented, hi-tech, highly innovative or industries with

high operating risk. Hercules (Osaka) and Mothers (Tokyo) rank high in attracting industries with high R&D and high risk innovation, followed by China's GEM and KOSDAQ. The institutional environment at its nascent stage is thus very fundamental to an exchange's success. To avoid messy legislation and regulations, the regulator needs to have the exchange's pulse monitored continuously, providing the framework for quick delisting should companies threaten to decrease the credibility of the exchange.

Thus, while the benefits of a new market exchange are indisputably beneficial in enabling growth and balanced development, fostering new entrepreneurs and new investment communities, a developing country ought to bear in mind that simply creating a board within the main exchange does nothing to ensure the vitality of the exchange. The real challenge lies in it being embraced by entrepreneurs, the investors and the government.

This requires an understanding of the experience in the 24 markets that have adopted this; how to strike a balance between applying easy regulations for small companies, while garnering investor confidence, providing incentives in the form of tax breaks, facilitating networking among investors and ensuring information symmetry.

Here's wishing the new SME exchange lots of market architecture intelligence, as hope alone won't do it.

(The author is a Corporate Law Partner at VICHAR PARTNERS, a Chennai-based law firm that focuses on corporate law and dispute resolution.)