The Italian capital market: Measures needed for its expansion

Executive Summary

- The Italian stock market is modest in size compared to the country's economy and the major European and world stock markets. France has twice as many listed companies and more than four times the market capitalisation.

- To narrow the gap, there is a need to encourage new companies to list. But it is also necessary to promote the participation of individual and institutional investors.

- PIRs incentivise Italian savings to invest in the domestic economy by channelling resources to companies, but have so far played an insufficient role.

- Pension savings have so far played an even more modest role, which, following the example of France, should be decisively enhanced.

The Green Paper on The Competitiveness of Italian Financial Markets in Support of Growth, published in early 2022 by the Treasury Department of the Ministry of Economy and Finance (MEF), presents a set of initiatives aimed at fostering

> a structural 'change of pace' in the relationship between companies and the capital market; on the one hand by removing regulatory and operational constraints on companies' access to the market, and on the other hand by introducing measures to stimulate, on both the demand and supply side, the channelling of investments to companies via the markets (p. 2).

The document follows the OECD Capital Market Review of Italy 2020 - Creating Growth Opportunities for Italian Companies and Savers, published in early 2020, which in its opening highlights that

> The future prosperity of Italian households will depend, to an appreciable extent, on how successfully they are able to channel their savings into long-term investments in the real economy that can create additional jobs and sustainable growth. Entrepreneurs, companies and households should therefore have the opportunity to take advantage of the rapid developments in the world of finance today. Drawing on the strengths of Italian companies and international experiences, this study offers general recommendations for improving the institutional and regulatory framework, with the aim of providing companies with better access to finance and ensuring equal opportunities for savers.

In line with the recommendations of the OECD Report, the Green Paper groups the initiatives examined into four themes:

1. Improve the listing process in Italy and make it more efficient for Small and Medium Enterprises (SMEs) in particular to enter and stay in markets.
2. Improve conditions for market participation by investors and encourage participation in Italian capital markets by institutional investors.

3. Enhancing the potential of digital for market access by companies and investors.
4. Making the enforcement system more efficient and effective.

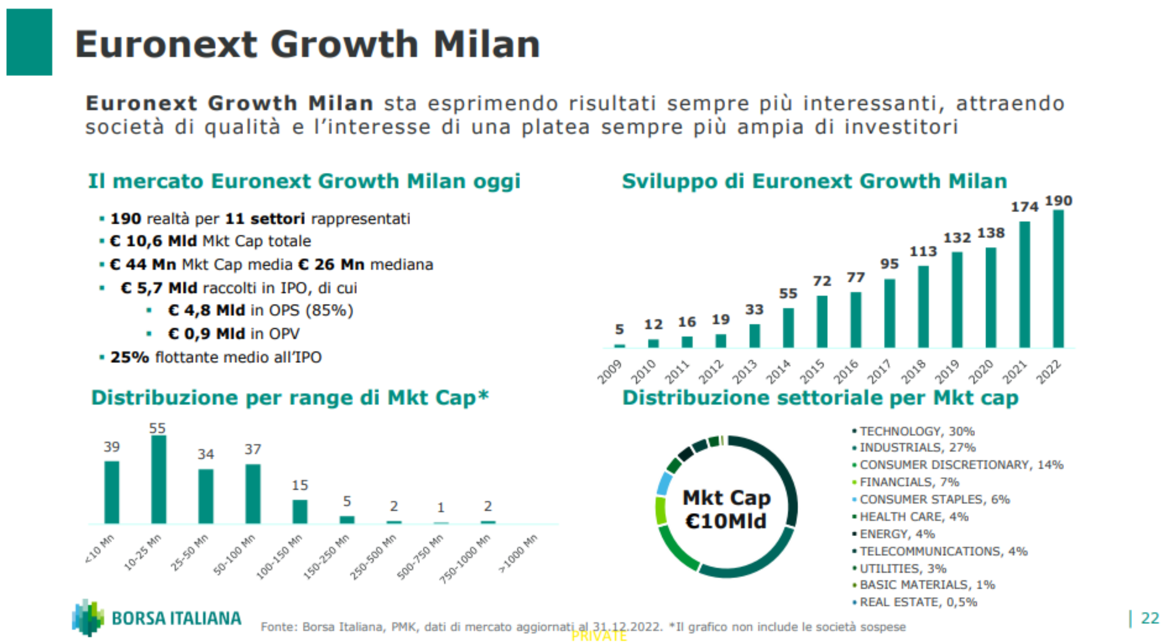
The publication of the document was followed by a seminar at the MEF – see morning session and afternoon session – and a public consultation, which gathered 24 contributions.

Improving the listing process

The topic that garnered the most attention, both in the paper and in the contributions, was the first. The graph on p. 11 of the Green Paper shows admissions and withdrawals in Borsa Italiana from 2011 to 2021. In the period there were 287 admissions and 188 withdrawals, for a positive difference of 99.[1] Of these, admissions on the main market EXM (Euronext Milan, Ex-MTA) were 49 and withdrawals 123, for a negative difference of 74, while admissions on EGM (Euronext Growth Milan, Ex-AIM Italy), the market dedicated to SMEs, were 232 and withdrawals 59, for a positive difference of 173.[2]

Thus, a picture clearly emerges of a steady net outflow of companies from EXM, more than offset by an equally steady net inflow of SMEs on EGM.

Borsa Italiana's commitment to SMEs, combined with that of other market players and the presence of tax incentives for listing, has resulted in an undoubted and significant success for EGM:



In the wake of this success, the initiatives presented in the Green Paper and discussed in most of the contributions, aimed at further improving the conditions for SMEs to access listing, are useful and meritorious. But their overall effect on the development of Italian financial markets will remain

[1] The difference is erroneously reported as 110 due to an error in the 2020 difference.

[2] Full data, including 2022, are available here for admissions and here for withdrawals. In 2022, there were 31 admissions (5 on EXM and 26 on EGM) and 24 withdrawals (16 on EXM and 8 on EGM), for a positive difference of 7 (-11 on EXM and 18 on EGM).

limited until equally important results are achieved by initiatives concerning the second topic presented in the book.

It is good to encourage companies to take their shares to the stock market, but then it is necessary to make sure that there are investors interested in buying them.

Improving investor participation

To this end, it is necessary to start from the observation that, once the listing process has been completed and the proceeds of the initial public offering (IPO) have been received, listed SMEs struggle to attract the interest and participation of Italian investors.

As shown on p. 8 of the stock exchange presentation, at the end of 2022 there were 414 listed companies in Italy with a total capitalisation of EUR 662 billion. Of these, 334 were SMEs, defined as companies with capitalisation below 1 billion, of which 144 were listed on EXM and (see table above) 190 on EGM. The total capitalisation of SMEs was about 45 billion euro,[3] of which (see table) 10.6 billion was in EGM companies. Thus, while 81% of the companies listed on the Italian Stock Exchange are SMEs, their market value represents 6.8% of the total, of which 1.6% in EGM companies.

These are the companies most in need of the change of pace advocated by the Green Paper. For this to happen, the participation of investors, both individual and institutional, must be encouraged.

Individual investors: PIRs

The most important initiative aimed at stimulating Italian savers to invest in SMEs was the introduction of Individual Savings Plans (PIRs) in 2017. Although it has gone through alternating phases, it has been a successful initiative: according to the latest PIR Observatory compiled by Assogestioni, at the end of 2022 the PIRs promoted by the association's member companies were worth 18.9 billion euro, of which 17.4 billion in Ordinary PIRs and 1.5 billion in Alternative PIRs. This is an appreciable sum: 1.9% of the assets promoted in open-ended funds and closed-end securities funds, amounting to 989 billion, but almost double the total invested in Italian Equity Funds (8.2 billion) and Italian Bond Funds (1.6 billion).

However, in order to assess its actual impact, the figure needs to be framed in more detail. Indeed, the association between PIRs and SMEs leads to the erroneous assumption that PIRs are largely invested in listed SMEs. But the reality is quite different. According to PIR Observatory estimates, at the end of 2022 the amount invested by ordinary PIRs in Italian equities was 8.3 billion. Of these, however, 3.7 billion were invested in the large capitalisation stocks included in the MIB index; 3.7 billion in the mid-cap stocks included in the Mid Cap index; and only 0.8 billion were invested in listed SMEs, of which 0.5 in EXMs and 0.3 in EGMs. Even smaller were the sums invested in corporate bonds of listed SMEs – just 44 million in EXM companies and 9 million in EGM companies – while 1.1 billion were invested in unlisted corporate bonds.

On balance, then, it is clear that Ordinary PIRs have responded only minimally to the purpose for which they were created: to channel Italian savings towards SMEs. Contrary to what is commonly

[3] Source: Factset.

imagined, barely 5% of the countervalue of Ordinary PIRs is invested in securities of listed SMEs – slightly above the minimum level of 3.5% set by the law.

In response to this shortcoming, Alternative PIRs were established in late 2020, for which the minimum investment in SMEs was raised from 3.5% to 70%. However, the value of Alternative PIRs is still low compared to that of Ordinary PIRs. In addition, the PIR Observatory estimates that, out of the 1.5 billion countervalue,[4] 0.9 billion are in cash/commitments and feeders, while only 0.5 billion are actually invested in stocks, bonds and other 'vehicles'. Of these, no less than 82% are invested in unlisted securities, while the percentage invested in listed SMEs is only 15%, amounting to just 75 million – 30 million on EXM and 45 million on EGM. This is just 5% of the total invested in PIR Alternatives, far from the 70% required by law.

The decision to invest mainly in unlisted SMEs is commonly justified by the belief that Alternative PIRs are particularly appropriate for financing the so-called 'real economy', so defined in contrast to the 'financial economy'. However, this is a fictitious contraposition: the value of a company is the same regardless of whether its securities are traded on a public market or not. The substantial difference is that listed SMEs have been able to complete the listing process which, as well put the Borsa Italiana presentation (p. 11), increases their status, visibility and competitive ability. While the unlisted ones have not yet done so or do not intend to do so, and seem to be sheltered from economic trends only because their value remains unexpressed and not sanctioned by a market price. But apart from that, listed SMEs are just as 'real' companies as unlisted SMEs. In addition, because they are more credible, transparent and subject to market scrutiny, they are less risky and more liquid investments. Their low weight within Alternative PIRs is again at odds with the guiding principle of PIRs and the objective of increasing the size and value of the Italian stock market.

It must therefore be acknowledged that even Alternative PIRs have largely failed to meet the objective of increasing Italian savers' participation in the capital of listed SMEs. While Ordinary PIRs are predominantly invested in securities of medium-large companies, Alternative PIRs are predominantly invested in unlisted securities.

The result is that, out of a total of 18.9 billion invested in PIRs, only 5%, or 0.9 billion, is invested in listed SMEs – barely 2% of their capitalisation. Paradoxically, the companies that should be the main beneficiaries of PIRs are those that benefit the least.

The paucity of PIR investments in listed SMEs is in direct contrast with the first theme of the Green Paper. PIRs are ideal long-term investors, but they currently play a wholly insufficient role. Suffice it to say that, as the PIR Observatory shows, the capital raised in 2022 alone on EGM, between IPOs and capital increases, was 0.9 billion, equal to the entire value of PIR investment in listed SMEs.

It should be noted that at the start of PIRs in 2017 there was the opposite concern: that PIR investments in SMEs could be too unwieldy and cause liquidity problems in the market. But after more than six years, and with the value of PIRs similar to that at the end of 2018, it is clear that the problem does not exist. The PIR Observatory estimates that the value of listed SMEs not in the hands of controlling shareholders and therefore available on the market is 9.5 billion (5.9 billion on EXM companies and 3.6 on EGM companies), or 21% of their capitalisation. It follows that PIRs hold 9% of the free float of listed SMEs – a decidedly modest amount compared to the goal of elevating PIRs to

[4] To this sum one must add the funds of companies that are not members of Assogestioni, first and foremost Azimut, which, according to the latest PIR Monitor prepared by Equita SIM, managed 731 million euro in Alternative PIRs (third quarter 2022 data). Adding these funds together, the value of Alternative PIRs rises to 2.5 billion.

the role of primary long-term investors. So much so that IR Top Consulting's EGM Observatory estimates that, as of May 2022, foreign institutional investors held a larger share of EGM capitalisation than Italian institutional investors (5.3% vs. 3.7%).

In conclusion, it should be recognised that for PIRs to play the important role for which they were created, it is necessary for Ordinary PIRs to be directed to invest a much higher share in listed SMEs, and for Alternative PIRs to change their focus from unlisted to listed SMEs.

Institutional investors: pension funds and social security funds

Another important potential source of financing for SMEs is pension savings. As shown in the latest COVIP Report and in the COVIP Report on the investment policies of pension funds, at the end of 2021 the total assets invested by the Italian social security system amounted to 321 billion euro, of which 213 billion in pension funds and 108 billion in social security funds.

Of these, 72 billion were equity investments: 51 billion in pension funds, or 29% of the total (see Table 1.21 of the Report)[5], and 21 billion in social security funds, or 19% of the total (see Table 4 of the Report). The total equity exposure included 48 billion in direct equities and 24 billion in indirect equities, i.e. underlying UCITS and derivatives.

Looking at domestic investments (see Section 3 of the Report), these totalled 77 billion: 40 billion in pension funds, or 23% of the total, and 37 billion in social security funds, or 34% of the total. But of these, 42 billion (or 54%) were invested in government and other debt securities (81% for pension funds and 25% for social security funds) and 21 billion (or 28%) in real estate, including real estate UCITS (8% for pension funds and 50% for social security funds). Only the remaining 14 billion – 18% of domestic investments and 5% of total assets – were invested in equities, UCITS units and units in other securities UCITS: 6 billion in pension funds and 8 billion in social security funds. Of these – which the COVIP Report defines as 'the financial resources allocated to Italian companies' (p.23) – 4 billion were invested in bond instruments, 5 billion in equity instruments, and 5 billion in securities UCITS.

It is therefore clear that, as the Report itself comments below, 'When compared to the total financial liabilities of Italian companies, the contribution made by pension savings remains modest, at around 0.4%'. A similar comment is made in the Report (p. 49):

> Excluding Italian government bonds, the contribution that the complementary forms system makes to the Italian economy is limited, even by international comparison. The reference to diversified market benchmarks on an international scale, in which the weight assigned to Italy is marginal, given the small number of Italian listed companies and the limited development, at a national level, of private equity and debt markets, are still valid as possible braking factors.

The low weighting of Italian equities is thus determined by the choice to geographically diversify equity investments based on market capitalisations, combined with the small size of the Italian equity market compared to the country's economy and the major European and world equity markets. Considering then that benchmark management requires that the amount allocated to Italian equities be predominantly invested in the large companies included in the MIB index or its

[5] The total net assets of pension funds shown in Table 13 are 176 billion euro, corresponding to investments directly attributable to supplementary pension schemes.

international equivalent MSCI Italy, we conclude that pension funds and social security funds are virtually absent from the capital of listed SMEs.

Thus, the situation of PIRs is reproduced in extreme form. Retirement savings, already underinvested in the Italian stock market, are not invested at all in listed SMEs.

This is in contrast to the objectives of the Green Paper, which would require pension funds and social security funds to adopt a substantial Home Country Bias – an allocation to domestic equities significantly larger than the benchmark allocation, with an appropriate portion allocated to SMEs. Such an investment could conveniently take place in place of the currently prevailing domestic assets: government bonds for pension funds and real estate for social security funds, allowing, among other things, access to the same tax benefits as PIRs (see Circular 19/E 2021 of the Agenzia delle Entrate).

As indicated in the Green Paper (p. 34) and the OECD Report (p. 16, 21, 45), and as already experimented for investments in Private Equity and Private Debt (see Report, p. 148), the most appropriate form for an investment in listed SMEs would be that of a fund of funds. Such a fund would invest in a selected portfolio of PIR-compliant funds – both in existing ones and in new ones that would be stimulated to emerge – allocating a portion of the total to each, so as to ensure greater liquidity and diversification.

A PIR-Compliant fund of funds of, say, 3 billion euro would amount to a modest 1% of the total assets of pension and social security funds, but would have three important positive effects:

1. It would provide resources for the financing and growth of SMEs that have had the ability to complete the listing process and the merit of opening their capital to public investment.

2. It would create an important natural source of demand, encouraging the listing of new companies and expanding the size, value and importance of the Italian stock market.

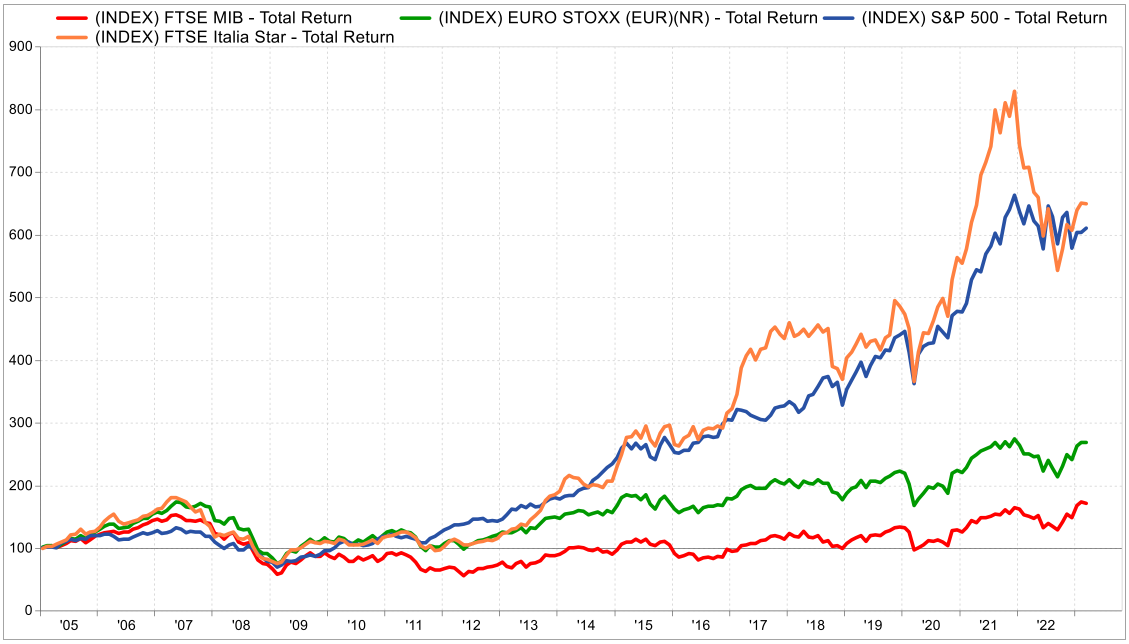
3. It would facilitate the creation and growth of investment funds focused on the Italian stock market, increasing their liquidity and efficiency, and developing research, knowledge and analytical capabilities.

Not least, the fund would allow the social security system to invest in Italian companies with the greatest growth potential, to the benefit of members and the Country.

In this regard, it is necessary to correct the assertion that the Italian stock market, in addition to being small, offers lower returns in the long term than other markets, and first and foremost the US stock market. A closer analysis, in fact, shows that what at first glance appears to be a chronic underperformance of the MIB index can actually be limited to a specific period – from 2010 to 2013 – when Italy was involved in the European debt crisis. Before then, the MIB index had performed in line or better than the other indices, and from then on it was in line with the Euro STOXX index of Eurozone countries.

It is also evident that the STAR segment of the Italian Stock Exchange, in which the shares of companies with a capitalisation of between 40 million and 1 billion euro, a minimum free float of 35% and the obligation to comply with high standards of information transparency, corporate governance and liquidity, has performed over the long term significantly better than the MIB and Euro STOXX indices, and in line with the S&P 500 index.

The savings of Italians should be much more exposed to the growth of the country's excellences.



The good example of France

In order to fully understand the benefits of a direct involvement of domestic institutional investors in the development of the country's capital market, it is worth looking at the success story of France, where pension funds and insurance companies, robustly pushed by the central government, have long been playing an important role in driving the asset management industry.

The result is that France is the leader in asset management in the Eurozone, with more than 4,800 billion euro under management, more than 700 asset management companies, of which more than 450 are independent companies and more than 200 have been created in the last five years. The industry employs 85,000 people, of which 26,000 are in the asset management companies.[6]

On Euronext Paris there are more than 800 listed companies – twice as many as on Euronext Milan – with a total capitalisation of more than 3 trillion euro – more than four times that of Italy and equal to more than 100% of Gross Domestic Product. There are more than 80 funds specialised on domestic SMEs.

The wide gap between France and Italy will continue to widen until the change of pace called for in the Green Paper is translated into ambitious and effective practical measures.

[6] Data at end 2021.