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Ser Keng ANG
Singapore Management University, skang@smu.edu.sg

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SER-KENG ANG

Singapore Management University

Emergence of Private Markets and Exchanges as an Alternative Source of Financing for Small and Medium-Sized Enterprises in Singapore

Introduction

Small and medium-sized enterprises (SMEs) are the engine for growth for any economy, whether big or small, developed or emerging. In the US, small firms with less than 500 employees represent 99% of all employers, provide over 80% of net new jobs and account for about one-half of the national workforce. In Singapore, the government agency responsible for the development of local SMEs, Enterprise Singapore (ESG), estimates that there are over 180,000 SMEs, making up 99% of all enterprises in Singapore, contributing nearly half of Gross Domestic Product (GDP) and employing around 70% of the workforce. Naturally, the well-being of the SME sector in Singapore is hugely important in the growth and development of its economy.

In practice, financing of privately owned companies, particularly small companies, is a challenge. In general, their small size makes private firms more susceptible to exogenous shocks. This makes lenders assess SMEs as riskier credits, and thus makes them more hesitant with financing. This problem was amplified during the Global Financial Crisis (GFC) in 2008-09 as huge amounts of liquidity were withdrawn very rapidly from the capital markets. Many SMEs failed as they were not able to obtain much needed liquidity to stay afloat. This would explain why in 2020 various governments around the world immediately responded to provide SMEs with lines of credit to tide them through the COVID-19 crisis.

While the methods for regular short-term financing, such as working capital financing and factoring and export financing, continue to be relevant, the scene for longer term financing of SMEs has evolved rapidly over the last several years. This paper investigates such shifts in the market and expounds how such changes can affect both SMEs' choice of financing as well as the overall development of this critical sector and Singapore's capital market.

Emergence and Growth of Private Capital Markets

Traditional forms of long-term financing for SMEs include limited bank loans as well as listing in an Initial Public Offering (IPO) or a Reverse Take-Over (RTO). These provide the firm with access to wider sources of capital because they can tap the investing public for financing. An IPO is also one means of exit for Venture Capital (VC) and Private Equity (PE) investors. IPOs can be done via the mainboard or the second board such as Catalist in Singapore. The former is for sizeable SMEs with successful track records, whereas the latter is for smaller SMEs that are in the high growth stage of their lifecycle.

However, in recent years, the trend has been for companies to stay private for a longer period of time. Several motivations appear to drive this trend. Firstly, public exchanges across the Asia-Pacific region have underperformed in the last five years. Figure 1 shows the underperformance of selected regional stock exchange indices for the recent 5-year period. The implications of such market underperformance are that firms considering IPOs might not be able to obtain fair valuation in their listing. In addition, should the firm's stock price be dragged down by the overall market performance, it will have to contend with additional pressure from the investing public over the failure to deliver satisfactory stock price performance.

The *Financial Times* reported on 18 June 2020, that in just six months of 2020, the Singapore Exchange (SGX) suffered nine de-listings compared to only five listings (Lockett and Ruehl, 2020). This is the second consecutive year in which there have been more departures than additions to the SGX, marking a worrying trend for the Singapore bourse. Most of the de-listings are attributed to a lack of liquidity as well as governance scandals, such as with the Noble Group and in the Hyflux debacle. The situation re-

Figure 1: 5-Year Performance of Selected Regional Stock Exchange Indices

Singapore: 4.0000, 3.3333, 2.6667, 2.0000; 2.8700; 1 Jan16, 1 Jul18

Malaysia: 2.1000, 1.8000, 1.5000, 1.2000; 1.7400; 1 Jan16, 1 Jul18

Indonesia: 12,0000.00, 9,333.33, 6,666.67, 4,000.00; 8,555.00; 1 Oct16, 1 Dec18

The Philippines: 44.00, 34.67, 25.33, 16.00; 32.70; 1 Jan16, 1 Jul18

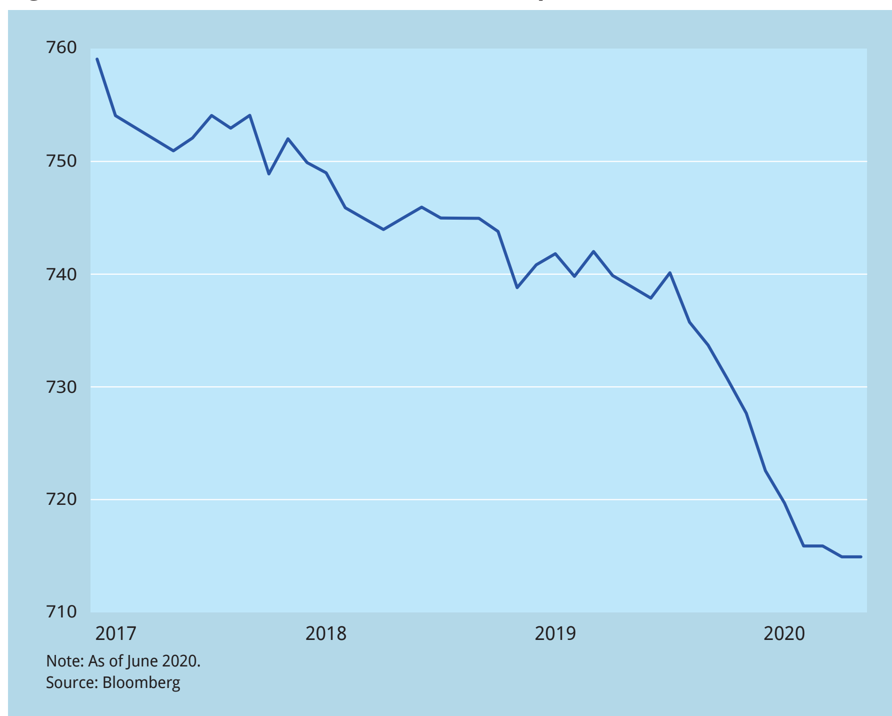
Note: As of 8 December 2020.
Source: Yahoo! Finance

mains dire for SGX. If not for the tweaks it made to its listing rules, such as scrapping a minimum trading price requirement, another 54 listed companies were facing the prospect of involuntary de-listing. Figure 2 depicts the decrease in the number of companies listed on the SGX. Some homegrown companies, such as Osim, have also decided to de-list on SGX and re-list on the Hong Kong Exchange (HKEX).

Secondly, while IPOs can be an effective means for companies to access public capital, they also face the possibility of being exposed to additional risks if the process is executed unsuccessfully. For example, a firm doing an IPO would be taking additional reputation risk, which could prove detrimental in situations such as if it were denied listing (non-listing). Non-listing would send a negative signal to the market, implying that something is wrong with the firm and damaging its reputation.

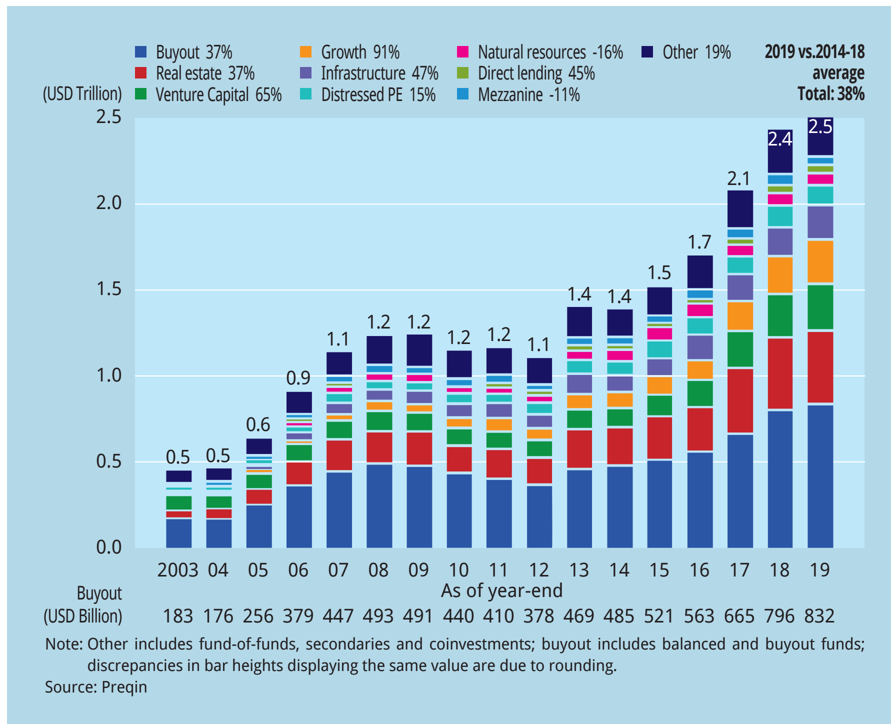
Thirdly, in going public firms and CEOs alike face increasing demand to meet the performance expectations of the market. Pressures from the market may lead the firm's executives to alter long-term

Figure 2: Fall in the Number of SGX-Listed Companies



Note: As of June 2020.
Source: Bloomberg

Figure 3: Growth of Dry Powder in Global Private Market Finance



Note: Other includes fund-of-funds, secondaries and coinvestments; buyout includes balanced and buyout funds; discrepancies in bar heights displaying the same value are due to rounding.

Source: Preqin

strategies, hence sacrificing long-term business goals. Such responses are necessary because changes in stock prices affect the firm's cost of capital (Ben and Bradley, 1983). Remaining private can shield the firm from succumbing to short-term market pressures at the expense of long-term developmental goals.

Fourthly, private capital markets have experienced strong growth of low-risk, highly liquid assets, or dry powder, stemming from demand from wealth managers, family offices, VCs, PE, and sovereign wealth funds. At the end of 2019, dry powder assets for the private market totalled a staggering USD2.5 trillion (Bain, 2020). Figure 3 shows the growth of global dry powder. Such high levels of funding have supported the growth of firms while remaining private without tapping the public markets for financing.

Overview of the Private Capital Market

The global private capital market in general has expanded rapidly over the last decade. A recent report by McKinsey indicated that since 2010 the assets under management in the global private market expanded by USD4 trillion, translating to an increase of 170% (McKinsey, 2020). This compares very favourably to the 100% growth in public finance markets during the same period.

In Asia, the typical size of private market transactions for the past five years since 2015 was USD122 million (Bain, 2020). In the ASEAN region, average deal sizes are smaller compared to those in North Asia, around USD27.0 million. Table 1 shows the number of private deals as well as the aggregate deal value and average deal sizes from 2014 to 2018 for ASEAN.

Of the Southeast Asian markets, Singapore, the region's financial hub, is a natural catchment area for private market financing. According to Preqin, the number of fund managers and investors in VC and PE total 262 and 91 respectively in Singapore, compared to 63 and 29 in Malaysia, 16 and 8 in the Philippines, 23 and 14 in Thailand, and 21 and 7 in Vietnam. In 2019, VC and PE deals in Singapore reached a value of approximately USD6.5 billion.

Development of Private Market Financing in Singapore

An important development for private financing in Singapore was the liberalization that began with the introduction of Securities-based Crowdfunding (SCF) licences by the Monetary Authority of Singapore (MAS) in 2016. This was aimed to spur the growth of start-ups, particularly in the fintech space. The MAS considers crowdlending as a form of Peer-to-Peer lending, which falls under the Securities and Futures Act (SFA). However, unlike other forms of financing under the ambit of the SFA, SMEs raising financing under SCF are exempt from its strict prospectus requirements, under certain conditions. Under Sections 272A and 272B of the SFA, SMEs

Table 1: Number of Deals, Aggregate Deal Value and Average Deal Size in ASEAN

Year	No of deals	Aggregate deal value (USD Billion)	Average deal size (USD Million)
2014	305	10.0	32.79
2015	430	7.5	17.44
2016	453	10.2	22.52
2017	503	19.5	38.77
2018	508	11.8	23.23
			5 year average= 26.95

Source: Preqin

wishing to raise not more than SGD5 million and/or to distribute to not more than 50 investors within a 12-month period, do not need to issue a prospectus. Likewise, offers made to Accredited Investors (AI) and institutional investors are also exempt from the prospectus requirements, since these are regarded as savvy investors. The definition of AI differs across jurisdictions, and in Singapore MAS defines AI as those with income of not less than SGD300,000 in the preceding 12 months and/or with net personal assets exceeding SGD2 million.

Fundnel, FundedHere, Crowdo and Funding Societies, are some Singapore-based crowdfunding platforms licensed under SCF by the MAS. Platforms such as Fundnel are democratizing private capital markets by redefining access to alternative sources of capital for SMEs and private tech companies. A major contribution of these platforms is the connection of AIs and institutional investors to private firms with high potential for growth. These alternative avenues for financing are not only accessible, but also come with less onerous requirements, which allow private firms an opportunity to access financing and/or diversify their funding sources. The provision of financing by the private market enables private firms to delay their pursuit of an IPO until they establish strong performance records at a pivotal point in their business, which translates to much higher valuation at IPO. A good example is Grab, the Singapore-based unicorn, whose CEO announced that it will only consider going public after it becomes profitable (Soon and Choudhury, n.d.). Beyond gaining from higher valuation, owners of IPO firms can also minimize the under-pricing effect, which is a well-documented and significant cost of an IPO. Under-pricing is largely attributable to the presence of asymmetric information between investors (Rock, 1986), resulting in high levels of ex-ante uncertainty for investors purchasing stocks at an IPO and hence making under-pricing of IPO issuances a common phenomenon (Beatty and Ritter, 1986; Ljungqvist, 2007). This is particularly true for high-tech or smaller firms (Engelen and van Essen, 2010). The practical implication of under-pricing to the owners of private firms would be dilution of control and earnings per share (EPS) resulting from the IPO.

Simultaneously, in such cases, valuation optimization and price discovery would have unfolded from the first institutional investor round (Series A) to pre-IPO rounds. Public market investors who enter belatedly–at the point of an IPO–are less likely to experience price appreciation. Private market investors, on the other hand, will realize gains because the bulk of value has been captured in the private rounds. From this perspective, both SMEs and private investors benefit from the emergence of a strong private financing market. If this key development continues, it will bode well for the growth and development of the SME sector in Singapore, and hence of the Singapore economy.

Another key development in the private market was the rapid emergence of private exchanges–stock exchanges for privately held firms. Like crowdfunding platforms, private exchanges are required to be licensed under SFA. These private exchanges facilitate investment in private firms. To SMEs, private exchanges not only provide access to capital, but also proffer a market mechanism for firm owners to monetize their shareholding. In the past, this would only be possible if the firm went public. This benefit extends to employees who have received shares as a significant part of their compensation. Furthermore, private exchanges allow private firms to ease into the high standards of corporate governance and operational efficiency required of fully publicly listed firms.

Private exchanges are able to facilitate the movement of capital in the private markets between high-growth companies (e.g., unicorns and decacorns) and investors keen to gain access to higher returns in the event of their exit. For example, Southeast Asia's first member-driven private exchange, the Hg Exchange (HGX), a collaboration between Fundnel, PhillipCapital and PrimePartners, boasts an unrivalled database of over 500,000 investors and brokers, which facilitates order matching and provides unparalleled liquidity opportunities. Another example is 1exchange (1X), a private exchange licensed by MAS and backed by CapBridge and SGX.

Interestingly, the growth of private exchanges is not necessarily at odds with the well-being of public bourses such as the SGX. In fact, there is a significant symbiotic relationship between the two segments. From a macro perspective, a well-functioning private exchange sector can provide the SGX with a healthy pipeline of private companies that wishes to go public.

Finally, another potential source of private market financing that SMEs can tap is strategic investors. In mergers and acquisitions (M&A) parlance, these are also known as trade buyers. In essence, they are investors who are in the same trade or sub-segment of a trade as the private firms that are raising capital. Strategic investors have several distinct advantages over financial investors (largely VC and PE investors). Besides cash injections, an underlying business provides opportunities for a firm to leverage the strategic investor's platforms and networks to achieve (greater) operational efficiency. For example, the use of the strategic investor's global procurement network allows a firm to source materials at a much lower cost than it would have paid otherwise. Another noteworthy advantage to the private firm is that these investors are invested for the long haul–there is little pressure for exits, unlike with financial investors. Seen from this angle, financing from strategic investors may be combined with funds from private exchanges to provide the avenue for cashing out without the rush to go public.

Challenges for the Growth of Private Market Financing

Several challenges may inhibit the growth and development of the private capital market in Singapore. Firstly, compared to other jurisdictions, Singapore adopts a conservative approach to AI accreditations. Singapore's stringent and onerous accreditation may limit investors' access to firms seeking funds in the private market, thus reducing liquidity and depressing valuations in private markets. This may hamper the growth of the private market as AIs flow to other countries with more favourable accreditation regimes, like the US and UK, where the onus on establishing suitability lies with the issuer of private securities. In addition, some countries, such as the US, UK and Canada, allow for self-accreditation. In Asia, Indonesia does not even distinguish between the different types of investors. That said, a rigorous accreditation process may be necessary to ensure the integrity of the private market. The real question is whether the regulator, in this case the MAS, can strike a balance between taking too much and too little risk.

Secondly, a burgeoning private market arising from the significant stock of dry powder in the market as mentioned

above may lead to the creation of a bubble, with too much money chasing after too few good deals in the market. Of several plausible consequences, the first is a precipitous rise in the valuation of private firms. This may lead to lower standards of due diligence and quality as investors scramble to put their money to work and could in turn lead to widespread failures in the private market. The corollary is a loss of confidence in private market financing and ultimate failure of the private market. While there are no precedents specific to the private market, we must take guidance from the securitization market that caused the GFC in 2008-09. In that situation, lapses in due diligence resulting from a financial system that had been flush with liquidity led to widespread business failures (Solomon, 2012).

Conclusion

The SME sector is the engine of growth for economies around the world, and Singapore is no exception. The continued strong growth and development of the SME sector relies heavily on access to capital. With the emergence of high-tech firms, traditional sources of financing such as bank debt might not be suitable, as SMEs tend to have low levels of assets available for bank collateral. Bank debt without collateral (borrowing on a "clean" basis) may be too costly.

Going public via an IPO is a potential source of capital that a private firm may consider. However, going public too early results in dilution of control and reduction of EPS, as any firm lacking a successful performance record will have to under-price its shares at IPO. In addition, the private firm may not be ready to handle the strict requirements of a publicly listed firm, in terms of corporate governance and operational efficiency as well as expectations about corporate performance.

The recent development of the private market in Singapore not only addresses the issues relating to traditional forms of financing for SMEs but also provides additional and suitable forms of financing that would spur the growth of Singapore's SME sector, particularly private firms in the fintech and technology sectors. The advent of crowdfunding and emergence of private exchanges, combined with the appropriate inclusion of strategic investors, bodes well for the continued growth of Singapore's SMEs.

However, the rapid pace of growth in the private market, and hence the growth of private firms, especially SMEs, in Singapore, may be at risk as competition for AIs may lead such investors to flock to other jurisdictions where the accreditation process is less stringent than in Singapore. The MAS needs to strike a balance between the different levels of risk as it considers easing the AI accreditation criteria. Finally, there is concern over a bubble build-up resulting from the increase in dry powder assets in the private market. Market players and regulators alike, must take stock of the potential for too much liquidity chasing too few good investments in the private market. This may lead to laxity in the due diligence process which could result in widespread market failures, which would be disastrous both to the promotion of the private market as well as to the overall capital market in Singapore.

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SER-KENG ANG

Principal Lecturer of Finance, Singapore Management University

Dr. Ser-Keng Ang is a Principal Lecturer of Finance as well as the Academic Director for the EMBA and MBA programs at the Singapore Management University (SMU). Dr. Ang has been actively teaching undergraduate, executive and post graduate programs since 2003. Besides his teaching appointment, Dr. Ang serves as the director for the UOB-SMU Asia Enterprise Institute, which works closely with SMEs.

Dr. Ang is also actively engaged in investments as well as the local VC space. Not only does he teach entrepreneurial finance to practitioners, he serves as a mentor at a VC fund. Prior to his academic appointment at SMU, he was an investment banker in London and Hong Kong.

Dr. Ang received his PhD in Finance from UNSW Business School, MBA from London Business School, Master in Business Research from the University of Western Australia, and Bachelor of Accountancy (BAcc) from the National University of Singapore (NUS). He is also a certified executive coach. In 2016, Dr. Ang was awarded the Commendation Medal by the President of Singapore for his contributions to the education and public sectors.