UNICE
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POSITION PAPER

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SMEs AND ACCESS TO FINANCE

UNICE COMMENTS

I. Introduction

As European Union policy-makers are discussing Commission proposals for the next generation of financial instruments for small and medium-sized enterprises (SMEs)[1], UNICE would like to draw attention to specific obstacles to the accessibility of finance for SMEs.

The availability of finance for SMEs is a crucial condition for achieving the Lisbon goals: SMEs, which make up ninety-nine percent of Europe`s companies and two thirds of employment, not only create the majority of new jobs in the EU. They also have an enormous growth and innovation potential often not matched by bigger companies.

However, in a number of EU countries, access to various financing instruments might be restricted or unduly expensive for SMEs, preventing the employment, innovation and growth potential from being released.

Taking into account the variety of market structures and of financial instruments available to SMEs in EU policy, public policy can make a contribution to improving SME access to finance in particular in two areas which have been identified by UNICE as priority needs:

- Overcoming the fragmentation of Europe`s debt, equity and quasi-equity markets
- Supporting the supply of a wide range of financial instruments other than bank loans available to SMEs In order to properly assess the suitability of various products for their financing, SMEs need to understand these different instruments, which in turn requires efficient communication between companies and financial institutions.

[1] See Commission proposal for a Decision of the European Parliament and of the Council establishing a establishing a Competitiveness and Innovation Framework Programme (2007-2013), 6.4.2005. Available at: http://europa.eu.int/comm/enterprise/enterprise_policy/cip/index_en.htm

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II. The changing environment of SME financing

Recently, several developments have impacted strongly on the accessibility of funds for SMEs:

- **Increased risk sensitivity of lenders**

  The new capital requirement rules agreed by the Basel Committee and transposed into EU law via the Capital Requirements Directive will align capital charges of EU banks and investment firms more closely with the actual risks incurred in their exposures. Even before these rules enter into force in 2007, many banks have begun determining the individual risk profile of the borrower through an internal rating procedure. This implies increased scrutiny on the part of the lending institutions of a borrower`s business operations and financial structure. In order to properly assess the risk involved in a lending transaction, the financial institutions need to have sufficient knowledge about the line of business a company is involved in. This applies, in particular, to start-up companies.[2] Adding to this development is a renewed emphasis on profitability and restructuring in the finance sector which also enhances the risk sensitivity of lending operations.

- **Increased risk adversity of private equity investors**

  Potential investments in SMEs are met with increased scepticism by private equity investors due to high profitability expectations, regulatory obstacles to cross-border investment and limited exit opportunities. Institutional investors are often restrained by high required minimum market capitalisations and investment values in their portfolios. These obstacles weigh particularly heavily on the venture capital industry.

- **Strict interpretation of state aid rules**

  Public-sector guarantees for banks` lending operations are subject to increased scrutiny by the European Commission. It has become difficult for public authorities to provide guarantees and funds in support of financial institutions and financial instruments targeted towards SME clients.

[2] UNICE seminar “SME access to finance: a better understanding“, 27 September 2005

III. The challenges to SME financing

- **Increased need to build up an equity base**
  Over the last few years, SME equity quotas have tended to decrease in many EU countries. However, a strong equity base is crucial for SMEs in order to offset potential losses and address specific financing problems such as exhausted credit lines or insufficient internal retained profits. Equity is a particularly important financing instrument in the early phases of a company`s life as the ability to repay loans is restricted and would come at the expense of necessary investments in the company.

  This is all the more important in the near future, as equity quotas will have a more direct impact on SMEs` ability to obtain loan financing: under the EU Capital Requirements Directive, increasingly risk-sensitive lenders will take a close look at a company`s equity base when determining whether to grant a loan and at what price. In particular during an economic downturn, when overall profitability is below the financing costs for external capital, equity capital is needed as a buffer. Banks will take this into account when calculating default risks and making lending decisions.

  There are distinctive differences between the targets of private equity investments and venture capital investments. While private equity is instrumental in financing growth and expansion, restructuring or bridging operations of a company that is often already well established, venture capital is needed in the seed and start-up phases for companies. In many cases it is the established, mid-sized firm planning to finance growth, often right after its start-up phase, which experiences most difficulties in raising equity capital. While so-called *buyout firms* concentrate on the bigger, established companies, *Venture Capital funds* invest in the early stages of a company.

  Moreover, SMEs would greatly benefit from long-term equity investments by retail investors. This would be a much-needed complement to the predominance of institutional private equity participations.

- **Increased need for venture capital**
  But the difficult conditions of SME financing also affect start-ups in need of risk capital. Risk capital investments in the EU are roughly half those in the US, in absolute terms and in relation to GDP. The size of individual investments is also much smaller. The availability of risk capital is vital for economic development. There are clear market failures in this area, mainly due to information problems between investors and target companies relating to the risks and the profitability of the investment, which need to be addressed by public policy. Venture capital is particularly required for investments between 200 000 and 2.5 million Euros. The thresholds determined by private equity investors` portfolio policies and required return targets often make investments of under 2.5 million Euros unattractive to them. An added advantage of venture capital is that many investors, in particular so-called business angels, not only provide funds but also mentoring to a young company.

- **Increased need for transparency between banks and SMEs**
  On the one hand, it is even more important in the new environment for banks to explain their lending decisions, so that entrepreneurs are confident when applying for credit. Knowledge of the bank's risk assessment procedures might encourage enterprises to develop active strategies to improve their rating. On the other hand, the lender will require adequate documentation from the entrepreneur about his business in order to provide an adequate picture of the risk profile.

IV. General objectives of Community instruments for financing SMEs

Investors in young companies or those planning to invest in established SMEs hesitate if the growth potential of the firm cannot be released due to insufficient finance. This is where Community means can make a difference by leveraging private investments (such as promoting additional loan financing through the guarantee programme) and by risk-sharing (such as extending the guarantee programme to equity and quasi-equity capital and by investing through the ETF start-up facility in venture capital funds).

Generally, Community financial instruments should:

- provide leverage to private investors and to national programmes: they must stimulate private commercial investment without prescribing narrow investment targets,

- share the risk of investments with private investors without providing the latter with excessive protection against commercial risk, thus provoking a problem of moral hazard.

Consequently, the envisaged Commission instruments should be shaped in such a way as to enhance the ability of financial intermediaries to take on additional risk. The choice of, for example, what constitutes "high growth" sectors of economic activity should be left to professional investors: banks, investment firms, asset management firms and private equity companies.

V. Priority areas for EU policy

UNICE has identified three priority areas to be addressed by EU financial services policy and by EU financial instruments for SMEs:

- Elimination of obstacles to the creation of cross-border markets for loans, private equity and venture capital,

- In some EU countries, there is a perceived need for SMEs to diversify their financing structure and increase their equity base,

- Development of private risk capital markets.

1. EU policy needs to address primarily those shortcomings that hinder the functioning of cross-border loan, private equity and venture capital markets. The fragmentation of these markets along national lines needs to be overcome. The lack of a genuine internal market for these products entails costs for all market actors involved and it is responsible for the poor level of liquidity. For example, EU venture capital fund volumes are small compared with their US counterparts; they make most of their investments in their home country; and their investment volumes are also comparatively low. This is in many cases due to different national legislative environments, which do not permit investors from different countries to invest in the fund because the fund structures do not fulfil regulatory requirements.

2. UNICE highly welcomes the Commission`s focus on extending the guarantee window to equity and quasi-equity means of finance for SMEs under the *SMEG Facility,* but would like these investments to cover the seed and the start-up phases as well as the expansion phase of SMEs. UNICE also welcomes proposals to provide quasi-equity means of finance through the ETF Start-up Facility. Instruments placed between loans and equity, such as mezzanine funds, can be vital to bridge the gap between the working capital needs of a company and the funds the company is able to raise. Public policy participation in these instruments can contribute significantly to the creditworthiness of companies and thus open access to new financial means from credit institutions. They are in many cases more appropriate to SMEs than pure equity as they do not require changes in corporate structures. UNICE would like to remind policy-makers that there must be clear requirements to ensure that financial intermediaries are channelling EIF funds to SMEs.

In addition to these hybrid means of finance, the development of a secondary market for SME loans through securitisation is of great importance to SMEs. It increases their sources of liquidity by providing lending institutions with more leeway for new loans through the transfer of risk. In cases of clear market failures, in particular with regard to financing gaps when the required size of a transaction is large due to economies of scale, public sector investments in SME securitisation instruments are needed.

While UNICE welcomes the CIP proposal for extending guarantees to securitised SME debt portfolios, it would also like to draw attention to potential problems for SMEs arising from these market operations which might adversely impact the desired effect on liquidity if not addressed jointly by private lenders and public policy: Borrowers whose loans have been sold off to new investors can experience severe difficulties when having to renegotiate terms and conditions, as the original lender has ceded substantial rights.

3. While public policy should concentrate on providing the right framework for healthy competition between potential investors as far as *private equity* is concerned, it must be pro-active when it comes to supporting *venture capital investments*. Financial needs are greatest in the early part of the life-cycle of a company, when initial funding is no longer available to finance growth investments. The Risk Capital Action Plan 1998-2003, which set the regulatory framework for the EU`s private equity market, provides the right conditions for

fostering healthy competition between market actors, but it does not address the specific problems.

As foreseen in the recently proposed Competitiveness and Innovation Framework Programme 2007-2013, the Commission plans to set up a *High Growth and Innovative SME Facility (GIF)*, under which it would allocate resources to investments in venture capital and in risk capital funds providing equity or quasi-equity capital to SMEs in their seed, start-up and expansion phases. UNICE highly welcomes this initiative, but would prefer higher thresholds than the ones foreseen by the CIP, up to which GIF can invest in venture capital funds and in risk capital funds.

VI. Specific comments

- **"Exit opportunities" for investors have to be enhanced**

  Investors have to be certain that at some point in the future they can sell their participation in an SME. To this end, exit opportunities have to be improved, such as possibilities for unquoted SMEs to "go to the market." This can be done by the creation of stock market segments. The added value of creating a European equivalent to the US Nasdaq market, concentrating on innovative growth firms and offering lighter, and hence less costly, listing and reporting requirements than regular markets, should be explored. National governments should provide the right legal framework conditions to allow for such alternative listings.[3] Public markets can also assist SMEs in funding growth.

- **A common EU-wide structure for funds needs to be established**

  Regulators should agree on a common, EU-wide definition of a venture capital and private equity fund so that funds active in cross-border operations no longer need to establish a range of parallel intermediary structures. Currently, parallel fund structures serve in particular to gain access to investors in a cross-border market and to avoid double taxation of fund investments in EU countries other than the country of establishment. The common structure would be optional for funds. Given the complexities of agreeing on a common structure, mutual recognition of national structures would be a first step to making cross-border operations easier.[4]

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[3] Exit opportunities for investors in start-up companies are particularly important in R&D-intensive sectors, such as biotechnology, where investors` knowledge about the industry and the risk-return profile of the investment is often scarce and the risk of reaching the market stage is high. This resulted from discussions during UNICE seminar "SME access to finance: a better understanding", Brussels, 27 September 2005

[4] See also European Private Equity & Venture Capital Association (EVCA), EVCA Public Policy Priorities, Brussels, January 2005

- **Tax policy must provide incentives for increased equity financing of SMEs**

  National governments must ensure through their tax systems that capital flows to the most productive assets in the economy. They must remove from their tax systems those distortive elements that put SMEs at a disadvantage compared with bigger companies or that reduce the attraction of investing in SMEs.

  - different forms of financing – debt, equity, retained earnings - must receive equal tax treatment. This is particularly important to encourage greater equity financing by SMEs. Tax-related disincentives to reinvesting profits must be eliminated and on balance with current tax incentives for external financing such as deductibility of interest on loans must be provided. To this end, the cost of raising equity, including listing costs, should be treated as a tax-deductible expense, as is the cost of raising debt,
  - collective investments in SMEs by institutional investors have to be reinvigorated. To this end, the risk of double taxation for funds investing across borders must be eliminated,
  - in many corporate tax systems there is still double taxation of dividends This must be eliminated as it not only distorts companies` financing choices, but also discourages potential retail investors, who are becoming increasingly important as shareholders in SMEs.

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