Quo vadis EU? Financing SMEs in the EU

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Summary: These last years, some European regions and then European institutions have realised the importance of SMEs as instruments of development. The action of DG Enterprise and DG Regio of the European Commission has grown to a large extent out of this realisation. However, access to finance often remains one of the key factors in setting up and developing SMEs. It is an issue that is common to all European Union Member States, and possibly one that also affects a number of States in the US. It is increasingly recognised that SME access to finance is hampered by a number of market failures. But as opposed to the US, the EU does not have a programme equivalent to that operated by the SBA—United States Small Business Administration. So far...

This short study is trying to deal with the question of what are the possibilities of changing the ways of recent times.

1. Background

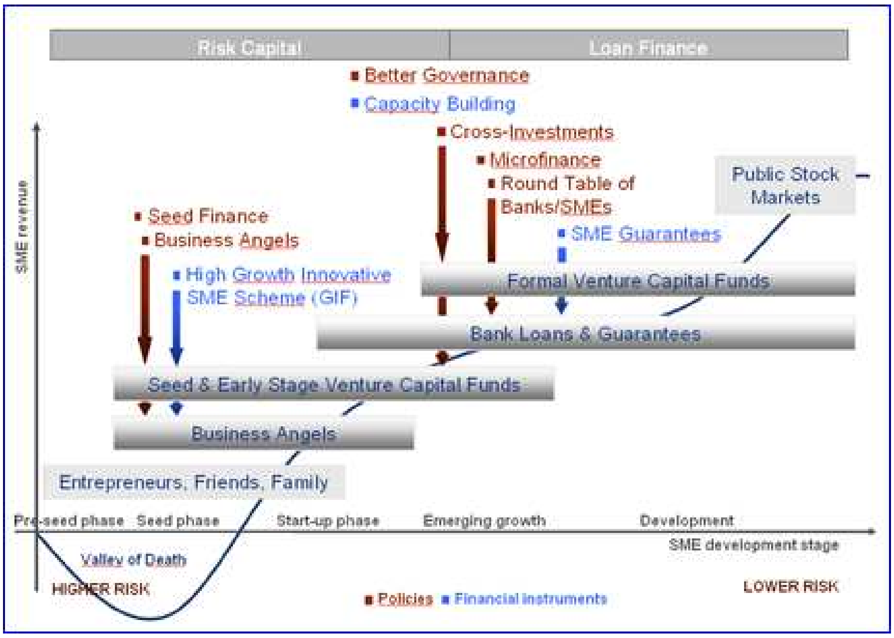

Figure 1.
Development stages of SMEs and the ways to finance them
From: Eurostat, 2006.

The concept of access to finance, as a starting point the following classification is pertinent:

Lack of availability: where there is demand from small and medium sized enterprises (hereafter: SMEs) for finance but no suppliers due to market failure i.e. there has been failure of market to understand that commercial returns could be made. Both traditional and new types of SME could be affected by this phenomenon. Such circumstances are sometimes used as a rationale for public sector involvement to fill a ‘market gap’. Such interventions might demonstrate that the ‘gap’ is commercially attractive and encourage the private sector to play a role. The gap may pertain to a type of SME or type of finance.

Lack of access: Circumstances where there are well-informed financial institutions but a belief by the market that the returns of financing (particular types of) SME and type of finance are not worth it (profitable). The ‘normal’ reasons include: high risk, low return, and high costs of administration/management, better returns elsewhere, lack of experience etc. Other reasons may include aspects of ‘discrimination’.

High cost of access: Circumstances where there is demand and a well informed financial sector but the charges and or guarantees required lead to a lack of take up and hence supply. Essentially this is a difference in perception between SMEs and finance suppliers. The high cost may pertain to a type of SME or type of finance.

The consideration of the above definitions and concepts will provide a basis for the critical assessment of the information such as data and indicators that is currently used to characterise SME access to finance.

I will examine the financing system devided into two parts: financing from banks, and financing from venture capital. In this study, I will focus on the side of bank, while the venture capital is alone worth a lecture.

2. Financing SMEs in a global scale

2.1. The problems are international

Small and medium-sized enterprises are the backbone of all economies and are a key source of economic growth, dynamism and flexibility in advanced industrialised countries, as well as in emerging and developing economies. SMEs constitute the dominant form of business organisation, accounting for over 95% and up to 99% of enterprises depending on the country. They are responsible for between 60-70% net job creation in OECD countries. Small businesses are particularly important for bringing innovative products or techniques to the market.

Microsoft may be a software giant today, but it started off in typical SME fashion, as a dream developed by a young student with the help of family and friends. Only when Bill Gates and his colleagues had a saleable product were they able to take it to the marketplace and look for investment from more traditional sources.

While not every small business turns into a multinational, they all face the same issue in their early days –finding the money to enable them to start and build up the business and test their product or service.

SMEs are vital for economic growth and development in both industrialised and developing countries, by playing a key role in creating new jobs.

Financing is necessary to help them set up and expand their operations, develop new products, and invest in new staff or production facilities. Many small businesses start out as an idea from one or two people, who invest their own money and probably turn to family and friends for financial help in return for a share in the business. But if they are successful, there comes a time for all developing SMEs when they need new investment to expand or innovate further. That is where they often run into problems, because they find it much harder than larger businesses to obtain financing from banks, capital markets or other suppliers of credit.

This “financing gap” is all the more important in a fast-changing knowledge-based economy because of the speed of innovation. Innovative SMEs with high growth potential, many of them in high-technology sectors, have played a pivotal role in raising productivity and maintaining competitiveness in recent years. But innovative products and services, however great their potential, need investment to flourish. If SMEs cannot find the financing they need, brilliant ideas may fall by the wayside and this represents a loss in potential growth for the economy. The “bagless” vacuum cleaner and the “wind-up” radio or flashlight which need no batteries are now common household items, but nearly failed to see the light of day because their inventors could not find financial backing to transform their ideas into production.

Already, differences are emerging between countries in terms of how easy it is for innovative SMEs to grow and develop. This sector has been very dynamic in the United States and a few other countries, but has lagged in many continental European countries and Japan, to the detriment of job creation and competitiveness.

In most countries, commercial banks are the main source of finance for SMEs (Figure 3), so if the SME sector is to flourish it must have access to bank credit.

The overall SME financing gap is particularly pressing in non-OECD countries, since the bulk of them report a widespread shortage of financing for all categories of SMEs. Even though SMEs account for a large share of enterprises, and represent potential employment and economic growth in emerging economies, they receive a very low share of credit. Indeed, most of them are denied any access to formal financial markets.

The characteristics of the banking system in emerging markets frequently inhibit SME lending. Many banks are state-owned, their credit may be allocated on the basis of government guarantees or in line with government targeting to develop specific sectors. Often banks are subject to ceilings on the interest rates they can charge, which makes it difficult to price credit in a way that reflects the risk of lending to SMEs. Many banks may have ownership and other ties to industrial interests and will tend to favour affiliated companies. In a market where banks can earn acceptable returns on other lending, it will not develop the skills needed to deal with SMEs.

Market-based banking, where banks are accountable for achieving high returns to shareholders and maintaining high prudential standards, is gaining acceptance on a global level. This model creates a competitive market where there is more incentive for banks to lend to SMEs, but many emerging markets have been comparatively slow in implementing this model.

2.2. A way of solution: venture capital in the USA

The National Venture Capital Association of the USA published a survey in 2007[1], with the results of venture capital based companies. I quote the details from their report.

[1] Venture Impact – The Economic Importance of Venture Capital Backed Companies to the U.S. Economy, 2007

Venture capital backed companies outperformed their non-ventured counterparts in job creation and revenue growth. Employment in venture backed companies jumped by 3.6 percent, while national employment grew by just 1.4 percent, between 2003 and 2006. At the same time, venture capital backed company sales grew by more than 11.8 percent, compared to an overall rise in U.S. company sales of 6.5 percent during the same period. (Figure 2.)

The U.S. venture industry provides the capital to create some of the most innovative and successful companies. But venture capital is more than money. Venture capital partners become actively engaged with a company, typically taking a board seat. With a startup, daily interaction with the management team is common. This limits the number of start ups in which any one fund can invest. Few entrepreneurs approaching venture capital firms for money are aware that they essentially are asking for 1/6 of a person!

Yet that active engagement is critical to the success of the fledgling company. Many one- and two-person companies have received funding but no one- or twoperson company has ever gone public! Along the way, talent must be recruited and the company scaled up. Ask any venture capitalist who has had an ultrasuccessful investment and he or she will tell you that the company that broke through the gravity evolved from the original business plan concept with the careful input of an experienced hand.

For every 100 business plans that come to a venture capital firm for funding, usually only 10 or so get a serious look, and only one ends up being funded. The venture capital firm looks at the management team, the concept, the marketplace, fit to the fund's objectives, the value-added potential for the firm, and the capital needed to build a successful business. A busy venture capital professional's most precious asset is time. These days, a business concept needs to address world markets, have superb scalability, be made successful in a reasonable timeframe, and be truly innovative. A concept that promises a 10 or 20 percent improvement on something that already exists is not likely to get a close look. Many technologies currently under development by venture capital firms are truly disruptive

technologies that do not lend themselves to being embraced by larger companies whose current products could be cannibalized by this. Also, with the increased emphasis on public company quarterly results, many larger organizations tend to reduce spending on research and development and product development when things get tight. Many talented teams have come to the venture capital process when their projects were turned down by their companies.

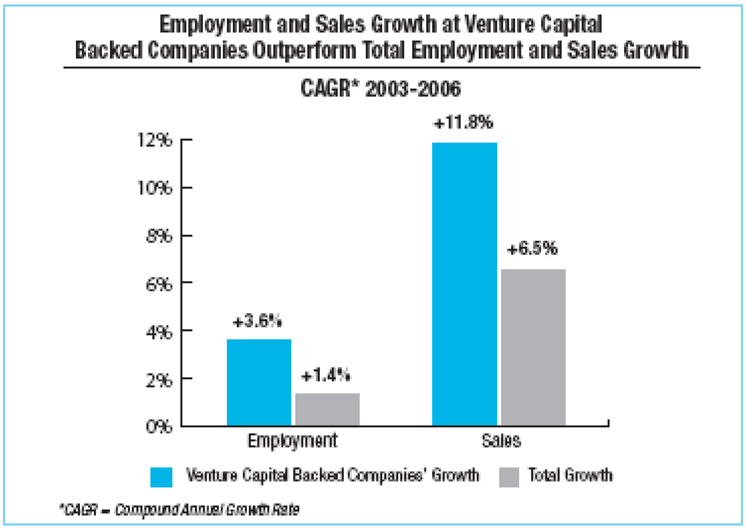

Figure 2.

From: Venture Impact - The Economic Importance of Venture Capital Backed Companies to the U.S. Economy, 2007

As a comparison to other countries, let's see why we see the United States of America as the leader in venture capital investments:

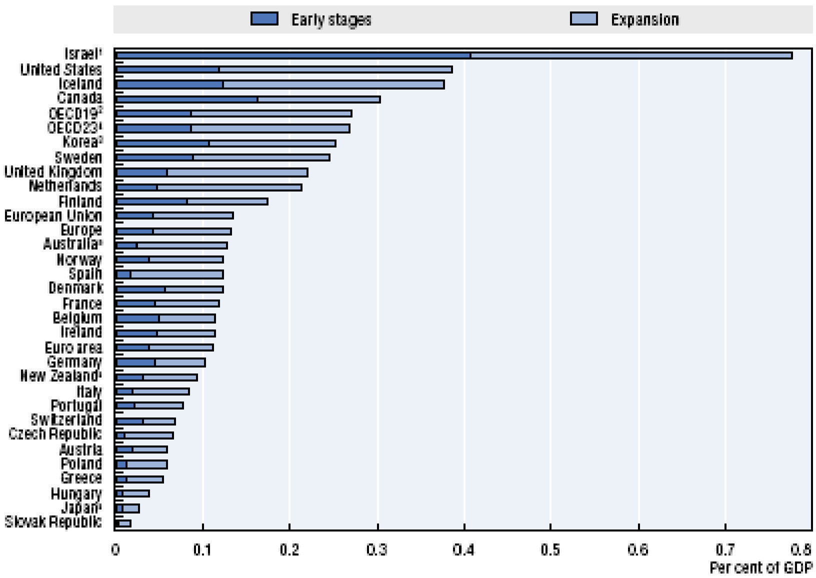

Figure 2.

Venture capital investments by stages.

From: OECD survey, 200-2003

3. Financing SMEs in the EU

3.1. Short fact on the SMEs in the EU

Companies classified as small and medium-sized enterprises are defined officially by the EU as those with fewer than 250 employees and which are independent from larger companies. Furthermore, their annual turnover may not exceed €50 million, or their annual balance sheet total exceed €43 million. This definition is critical in establishing which companies may benefit from EU programmes aimed at SMEs, and from certain policies such as SME-specific competition rules.

SMEs account for a large proportion of Europe's economic and professional activity. In practice, 99% of businesses in the European Union are SMEs, and they provide two-thirds of all private sector jobs. So small firms are, in fact, the real giants of the European economy. Micro-businesses (those with fewer than 10 employees) dominate employment in countries such as Italy (47%) and Poland (41%), whilst the share of large enterprises in total employment in the United Kingdom is just 46%.

Despite its huge importance for the European economy, entrepreneurship is not a preferred career option for most Europeans. As many as 60% of EU citizens say that setting up their own business has never even occurred to them. It is a challenge for policy-makers both at the European and at the national level to reverse this trend.

SMEs comprise all types of firms ranging from one-person businesses to co-operatives. Whilst some SMEs offer very traditional services or craft products, many others are fast-growing high-tech companies. Despite their differences, though, Europe's SMEs share many challenges.

2.3. Access to finance tree in the EU

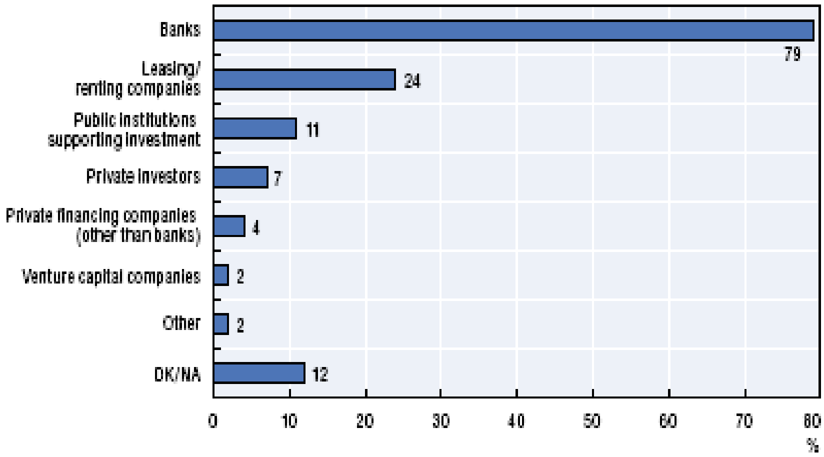

Figure 2.

Financing SMEs in the EU

From: EOS Gallup Europe (2005), "SME Access to Finance", Flash Eurobarometer 174, October.

2.3.1. Financing problems in general

Europe is characterised by its very diverse cultural context. This diversity is also apparent in the fields both of entrepreneurship and of corporate finance. Clearly, the European Union can currently be described as a dual world with an Anglo-Saxon and a Latin component. Differences are measurable in terms of:

- the degree of acceptance among businesspersons of third-party investment in their company;
- the variety of funding sources available in a country;
- the level of maturity of the different market segments that constitute the business finance supply chain.

Public authorities in Europe also share issues relating to the formulation of programmes that actually address genuine equity gaps, and the lack of sufficiently varied funding procurement channels available to SMEs.

The partnership for growth and jobs is the flagship policy of the European Commission. Its success depends on Europe's small and medium-sized enterprises achieving their potential, for they are crucial in fostering the entrepreneurship, competition and innovation that leads to sustainable growth and development. Further, the conclusions of the spring 2006 European Council emphasised that a fully integrated financial market and sufficient access to finance are crucial for the growth of small and medium sized enterprises. The Lisbon process offers a framework within which to improve access to finance, through reforms at national and EU levels.

This improvement is needed despite the fact that the features of a world class environment for SME finance can already be found in many Member States. In the recently published world top 20 ranking on capital access, half are Member States[2]. One of the main challenges is therefore to spread good practices across the EU. In improving access to finance, the diversity of European SMEs is an asset. They are as different in their cultures as in the ways they innovate. Some provide cutting-edge technology, while others make incremental adaptation of processes and products or develop new marketing strategies. Still others hardly innovate at all, yet their contribution to society is indispensable. This diversity entails different financing needs of individual SMEs. It also creates potential for Member States to improve their policies by learning good practices from each other, so making access to both risk capital and debt finance easier.

Europe needs to work on the availability of risk capital to SMEs with high growth potential. After a strong decrease from €4.2 billion in 2001 as a result of the bursting of the technology bubble, European venture capital investment in early stage firms has stagnated at around €2 billion. If the increase in the number of investments in companies in their expansion phase since 2004 gives cause for some encouragement, European stock markets appear to fall short of providing a passage to the next stage for a significant number of successful companies whose continued growth is so important for the EU.

A recent survey[3] has shown that 14 per cent of the 23 million SMEs registered in the European Union need better access to debt finance, for they can still encounter difficulties in seeking a loan or a microcredit for their next project.

On the demand side, many entrepreneurs need guidance on the advantages and disadvantages of alternative forms of finance and on how best to present their investment projects to potential financiers. Investment readiness programmes, too, need to build on best European practice. Overall, Europe needs to develop a mindset in which entrepreneurs and financiers alike are more willing to take and to share risk.

2.3.2. Debt financing

European banks and guarantee societies are experienced in financing later stages of firm development. This strength needs to be leveraged to ensure growth and

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[2] Best Markets for Entrepreneurial Finance, Milken Institute, 2005 Capital Access Index, October 2005

[3] Flash Eurobarometer 174 Survey, September 2005

employment. The new capital requirements for banks ('Basel II') have reinforced the trend for banks to emphasise the need for thorough risk assessment of their clients. This has created a changing environment in which European SMEs need to maintain a close dialogue with financial institutions. The Commission continues to support this dialogue.

Effective competition in the financial markets improves access to finance by lowering the cost of capital. The Commission has launched inquiries in the financial services sector, examining whether competition is working in these markets. These actions complement the Commission's initiatives to remove regulatory barriers from the single market. Member States are invited to implement good practices in the use of guarantees to support bank lending in full compatibility with EU State aid rules. In particular, guarantees should be used to help innovative SMEs finance research and innovation (including eco-innovation), and for business transfers. Loan guarantees lower the risk of bank lending, and partial, welltargeted, public guarantees can have a large effect on lending to SMEs. Guarantees can also be countercyclical, helping to maintain banks' lending volumes in a downturn. Member States are also invited to ensure that national legislation facilitates the provision of microfinance (loans of less than €25 000). Such loans offer an important means to encourage entrepreneurship through self-employment and micro-enterprises, in particular among women and minorities. This instrument favours not only competitiveness and entrepreneurship, but also social inclusion.

In different phases of their life cycle, SMEs may encounter specific financing needs, such as strengthening their balance sheet or financing business transfers. Mezzanine finance (hybrids of loans and equity) offers scope for innovative solutions to such problems. For example, mezzanine instruments can avoid the dilution of ownership while being effective in financing growth; they may help meet the need for stronger balance sheets to address banks' expectations in the new financial environment; they may also help finance business transfers (this is all the more important since, as entrepreneurs retire, over 600 000 SMEs every year are expected to change ownership and many transfers require financing that is attractive for all participants). Member States should therefore encourage the expansion of the hybrid market, keeping in mind that these are not soft loans, that it is critical to avoid crowding out private financing, and that they should ensure that government programmes are sustainable and do not distort the market. The Commission will identify good practices in the use of hybrid instruments.

2.4. Round table between banks and SMEs 2006-2007

The European Commission organised its Fifth Round Table between banks and SMEs from 2006 to 2007. This Round Table looked at transparency and dialogue between banks and SMEs; mezzanine finance; and the securitisation of lending to SMEs. The objective was to draw up an inventory of good practices in these fields. Participants included SME organisations, bank associations, the accounting profession and mutual guarantee societies.

The Capital Requirements Directive has increased the use of rating procedures and credit scoring systems in banks, having also an effect on many of their SME customers. To ensure a good rating, it is essential to be aware of the factors influencing it. If SMEs can improve the quality of information they supply to banks, they may obtain better credit terms reflecting their real creditworthiness. Thus increased transparency and a constructive dialogue between the two parties are essential.

Therefore, the Round Table made the following recommendations:

- ***Banking associations should initiate or pursue a dialogue with SME organisations at national level about ways of increasing mutual understanding. This process should be fostered by public policy makers who should provide a regular forum for such discussions.***
- ***To improve the quality of firm information provided to banks, SMEs should have the tools for enhanced transparency. To this end SME organisations should help their members with their understanding of financial terminology and concepts by developing tutorials and glossaries.***

Mezzanine finance that combines features of loans and equity (for example subordinated loans) can help to finance the start-up and expansion phases of SMEs, including innovation and business transfers. It can be an important complementary source of finance for firms. Although the use of mezzanine finance instruments has recently expanded, they remain little used compared with normal loan financing. SMEs in some Member States have a choice of a wide range of mezzanine products, but in others there is a lot of ground to make up.

The traditional users of mezzanine finance are larger and well-rated SMEs that often require amounts in the region of €2 million. Other SMEs might have smaller needs, including those family-owned companies that are looking to finance the transfer of ownership. These more limited financing needs can be for amounts smaller than €250 000. Providing suitable amounts of mezzanine finance to smaller and lower rated SMEs is essential to expand the use of this form of finance. This can be facilitated through mechanisms that help private issuers of mezzanine finance to share their risks. To foster the development of the market, the Round Table identified some key actions:

- ***Financial institutions that have the task of improving SMEs' access to finance should develop programmes of mezzanine finance focusing on smaller amounts. In particular, securitisation of such mezzanine finance should be facilitated and the Member States should encourage***

the expansion of the mezzanine finance market overall.

• ***Banks, banking associations, financial advisors (for example accountants and chambers of commerce) and SME associations should consider introducing information programmes which would educate SMEs about innovative financing tools such as mezzanine finance.***

Venture capital is essential for financing the growth of innovative SMEs. It is also global, competing for funds and for best investment opportunities. To be able to compete, European venture capital markets need to increase their efficiency and profitability – one way of doing this is to extend the benefits of the single market to venture capital funds by making cross-border investment easier.

In Europe, the venture capital market is fragmented along national lines, which makes cross-border investments complicated, hinders the growth of venture capital funds and lowers investment levels. To facilitate investment in, and the growth of innovative SMEs, the Commission is working on removing obstacles to crossborder investment.

To identify and remove obstacles, the Commission has consulted both investment professionals and the Member States. It is clear that many European venture capital funds are small and do not have the resources to be permanently present in other countries, even if they might want to occasionally invest in them. Many funds are limited by their size as they cannot make large investments nor can they

diversify across borders. In a union of 27 Member States, the fragmentation of venture capital fundraising and investing limits the efficient operation of the industry. Therefore, the Member

States should act together to remove the identified obstacles. The goal is that venture capital funds that are registered in one Member State could operate in others without separate structures in each country they want to invest in, and without separate registration and regulation processes.Apart from exchanging good practices and improving coordination, the experts that the Commission consulted supported in general progress towards the mutual recognition of the existing national frameworks on venture capital funds and made the following recommendations:

• ***The Member States should recognise venture capital funds from elsewhere in the EU as being equivalent to domestically registered funds. This would mean that a fund would be established and registered only in its home Member State but would be able to invest in others with the same terms as domestic funds. For this to happen, the competent Member State authorities should recognise that venture capital funds from other Member States are subject to***

equivalent regulatory regimes in their home country.

• ***The same approach should be applied to management companies of venture capital funds.***

• ***These two steps could then gradually lead towards a mutually acceptable regulatory framework that all Member States could adopt if they so wish.***

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