Volume 3

Access to Finance for SMEs:
Early stage and Technology Businesses

Follow-up of the FEE Round Table Access to Finance for SMEs – Early stage and Technology Businesses, Wednesday 6 July 2011, 9.30 – 11.45 CEST, FEE Offices.

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Funding high-growth firms: Whose job is it?

In Europe and indeed around the world, a small minority of the businesses born each year tend to account for a disproportionately large share of job creation and value added – the top 4-5% fastest-growing firms in a given cohort may be responsible for as much as 40%-50% of jobs created.[1] Hence, given the limited resources available to policymakers, it is very compelling to prioritise support for high-growth firms in order to maximise return on investment. On the other hand, given their impressive performance, one might think that high-growth firms should have no problems accessing finance; this, however, is not the case.

Growth firms take greater risks, are more likely to have a majority of their value tied up in intangible assets and their most profitable projects can remain cash-negative for some time before they start paying off. This generally means that debt will not always be a suitable means of financing their growth. In fact, Europe's high-growth SMEs are significantly (ca. 23%) *less* likely to obtain all of the bank lending that they apply for than other growing or even steady-state businesses. Yet more than 75% of high-growth SMEs still report that their preferred source of finance would be bank lending,[2] and EU SMEs in general use more bank finance than their counterparts in the US.

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[1] Lilischkis S. (2011) *Policies in support of high growth innovative SMEs.* Inno-Grips Policy Brief No. 2 http://www.proinno-europe.eu/sites/default/files/INNO-Grips_PB2_High-growth_SMEs.pdf
[2] The Gallup Organization [Gallup] (2009) *Access to Finance – Annex* EC/ECB Flash EB Series #271 http://ec.europa.eu/enterprise/policies/finance/files/survey_access_to_finance_annex_part_a_en.pdf http://ec.europa.eu/enterprise/policies/finance/files/survey_access_to_finance_annex__part_b_en.pdf High-growth businesses are defined here as those achieving average annualised revenue growth of 20% over the last three years.

Apart from this strong preference for bank lending, high-growth firms finance themselves opportunistically, including through public funding or subsidies. In fact, one in nine high-growth SMEs (11.2%) use grants or subsidised loans, and there is evidence that young high-growth firms benefit significantly from such funding, especially if it is given selectively.[3] Unfortunately, other potentially suitable types of finance meet with much greater aversion.

Business angels: delivering on the promise of networks

At the moment, only a small minority of fast-growing EU SMEs (ca. 4%) use external equity finance, and only about 7% cite it as their preferred source of financing.[4] While raising external equity is neither an appropriate nor an efficient solution to most businesses' financing needs, it is potentially much better suited to high growth firms. In fact a good deal of the financing of high-growth SMEs already takes place through quasi-equity instruments such as directors' loans[5] which may, to some extent, be compensating for the incompleteness of the venture capital market. This is corroborated by the fact that high-growth firms are more likely than other SMEs in Europe to report that the types of funding they need is not available at any price.[6] Although high-growth and innovative firms are generally likely to need more funds than other SMEs, for amounts between €100,000 and €1m the difference in demand between high growth and other SMEs is greatest.[7]

Business angels are crucially important to filling the lower end of this gap, and yet Europe's business angel sector is still only one quarter of the size of its US counterpart– even though Europe's SME output is larger.[8] Still, the financial crisis has pushed more dealflow towards Europe's business angel networks not only through the retrenchment of other venture capitalists but also by raising awareness of non-bank sources of finance. Applications have doubled throughout Europe and angel network numbers are growing, although this is almost entirely due to significant progress in Eastern Europe.[9]

In such times it is very important to manage the expectations of entrepreneurs and policymakers. Although the targeted investment of business angels can go a very long way, angel networks only channel funds to about 1%-4% of all the businesses whose business plans they receive.[10] This ratio can only be improved in a sustainable way by either improving the calibre of applicants and plans submitted or investing in the skills of investors themselves. Even among Europe's high-growth SMEs, the majority of owners and managers say they would not be comfortable talking to equity investors',[11] and changing this will require that networks further engage the rest of the business support industry, both public and private.

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[3] Colombo, M.G., Giannangeli, S., and Grilli, L. (2006) Paper presented to the Riunione Scientifica Annuale della Società Italiana degli Economisti Verona, October 2006 http://www.sie.univpm.it/incontri/rsa48/papers/Colombo-Giannangeli-Grilli.pdf
[4] Gallup (2009) *op cit*
[5] See for instance Gibson, B. (2006) 'Accounting standards and small business debt and equity: an international research agenda' Paper presented to the Rencontres de St-Gall, Wildhaus, September 2006 . Gallup (2009) discusses the prevalence of such funding among high-growth SMEs.
http://www.kmu.unisg.ch/rencontres/RENC2006/Topics06/D/Rencontres_2006_Gibson.pdf
[6] Gallup (2009) *op cit*
[7] Gallup (2009) *op cit*
[8] EBAN (2010a) *Early Stage Investing: An Asset Class in Support of the EU Strategy for Growth and Jobs* (Brussels: EBAN) *http://www.eban.org/index.php?option=com_docman&task=doc_download&gid=163&Itemid=179* SME output estimates prepared for ACCA (2010) *Small Business: A Global Agenda* (London: ACCA).
http://www2.accaglobal.com/pubs/general/activities/library/small_business/sb_pubs/pol-afb-sbaga.pdf
[9] EBAN (2010b) *Statistics Compendium 2010* (Brussels: EBAN) http://www.eban.org/interactive/share-a-document/doc_download/176-statistics-compendium-2010-executive-summary
[10] EBAN (2010b) *op cit.*
[11] Gallup (2009) *op cit.*

One factor hampering such efforts is that there is currently no such thing as ‘good practice’ among angel networks. A shake-out appears to be very likely in this sector over the coming years, as many of the multitude of business angel networks are currently operating models that are simply unsustainable. Regardless of which network models survive this, it is already clear that angel networks generally have the potential to deliver value to angel investors and companies seeking investment alike[12] and thus supporting network growth and increasing professionalism should be a major agenda for policymakers, networks and the business support community. Other objectives of this shared agenda should be to ensure a steady flow of new investors (including more women), to avoid the need for external regulation, and to firmly establish angel investment as an asset class in its own right.

While investment by business angels makes an important contribution to Europe’s economic dynamism, it’s important to note that their strong bias towards the ICT (Information and Communication Technologies) sector[13] does not reflect the actual sector distribution of high-growth firms – which are not over-represented in ICT and are, if anything, over-represented in services.[14] Rather, it most likely reflects the interests and career paths of high-net-worth individuals, many of whom will have made a significant share of their fortunes in the days leading up to the dot-com bubble. Seen in this context, the gradual shift of angel funding towards the creative industries is worth both celebrating and supporting.

Investment readiness, coaching and mentoring

It is tempting to infer that the lack of easily accessible alternatives to bank lending could be forcing high-growth SMEs in Europe to make sub-optimal financing decisions. However, lack of awareness and investment-readiness may be even more significant barriers.[15]

Typically, equity investors respond to high quality business plans with significant personal input from the entrepreneurs; documented market Unique Selling Points (USPs); high growth potential; appropriate Intellectual Property Protection; realistic pre-money valuations; and viable exit plans for investors. While some of the above lie within the scope of traditional business support, significant investment in mentoring and capacity building among entrepreneurs and potential investors is necessary as well. Projects such as *Ready for Equity!*[16] have the potential to address such needs but they will need to work with professional advisers to expand their scope and reach.

Investment readiness schemes, however, are neither a quick fix nor a cheap one.[17] Building up the required expertise, reputation and administrative capacity is time consuming and expensive, and the costs cannot be borne by the end-user. The most successful programmes are those that engage in the (more costly) critical diagnostic and business support components and which provide connections to other business support programmes. It is these functions in particular that would benefit substantially from the input of professional advisers such as accountants.[18]

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[12] Mason, C. M. and Harrison, R. T. (2011) *Annual Report on the Business Angels Market* (London: BIS) http://www.bbaa.org.uk/sites/default/files/media/files/bis_business_angel_annual_report_2009-10.pdf
[13] EBAN (2010b) *op cit.*
[14] Henrekson, M. and Johansson, D. (2008) ‘Gazelles as Job Creators – A survey and interpretation of the evidence’ Research Institute of Industrial Economics (IFN) Working Paper #733 http://www.ratio.se/pdf/wp/mh_dj_gazelle.pdf
[15] Lilischkis (2011)
[16] http://www.readyforequity.eu/article/2010/about_the_project/
[17] ACCA SME Committee (2011) *Mentoring – A Small Business Perspective* (London: ACCA)
[18] Mason, C. M. and Kwok, J. (2010) Hunter Centre for Entrepreneurship Working Paper 10-03 http://www.strath.ac.uk/media/departments/huntercentre/research/workingpapers/WP_version.pdf

Investing in Exit Routes

Both entrepreneurs and investors in high-growth firms are motivated by the prospect of successful exits. Since the publication of the Demarigny report[19] in early 2010, the EU institutions have considered quite rigorously how Europe's regulatory environment can become less daunting for would-be small issuers. That said, it is still the case that trade sales are a much more common exit route than Initial Public Offerings (IPOs), which are generally reserved only for the best performers. Trade sales also tend to be more common but also less successful in Europe than in the US.[20]

Therefore improving support for business transfers needs to be at least as high a priority for both the public and private sectors as the more glamorous subject of small business IPOs. The accounting profession, in particular, has a role to play in advising SMEs on such transactions, including on the protection and valuation of intangible assets. It will also need to broaden its offering to include elements of stakeholder management as well as the ability to provide unbiased feedback to the entrepreneur.

CRDIV: What price will fast-growth SMEs have to pay for stability?

International efforts to strengthen bank capital and liquidity requirements are a welcome response to the financial crisis of 2008-9 and the Capital Requirements Directive (CRD) IV package, Europe's contribution to this important initiative is to be welcomed. However, this forum has already pointed to the risks involved for lending to smaller businesses and called for a thorough SME impact assessment for the new capital and liquidity rules.[21] We are therefore disappointed by the Commission's assertion, in the impact assessment presented alongside the Commission's proposals for the associated regulation,[22] that the provisions of CRD IV will not hit SMEs disproportionately.

This view directly contradicts the findings of every other international organisation to examine the issue, including the Financial Stability Board's (FSB) Macroeconomic Assessment Group (MAG) itself.[23]

The Commission's argument is that the effect on SMEs will not be disproportionate because:

a) *Evidence from the adjustment to higher capital requirements already underway among European banks suggests that large businesses have been affected to a greater extent than small ones.*

b) *SMEs transact mostly with smaller banks, which are better capitalised.*

c) *The benefits of financial stability are greater for SMEs than for large businesses.*

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[19] Demarigny, F. (2010) *An EU-Listing Small Business Act: Establishing a proportionate regulatory and financial environment for Small and Medium-Sized Issuers Listed in Europe (SMILEs)* Brussels: http://www.mazars.com/mazarspage/download/37683/867875/version/2/file/SBA-smiles-english.pdf

[20] Hege, U., Palomino, F. and Schwienbacher, A. (2009) 'Venture capital performance: the disparity between Europe and the United States' Revue de l'association française de finance 30: 7-50 https://studies2.hec.fr/jahia/webdav/site/hec/shared/sites/hege/acces_anonyme/papers/HegePalominoSchwienbacher_VCPerf2009.pdf

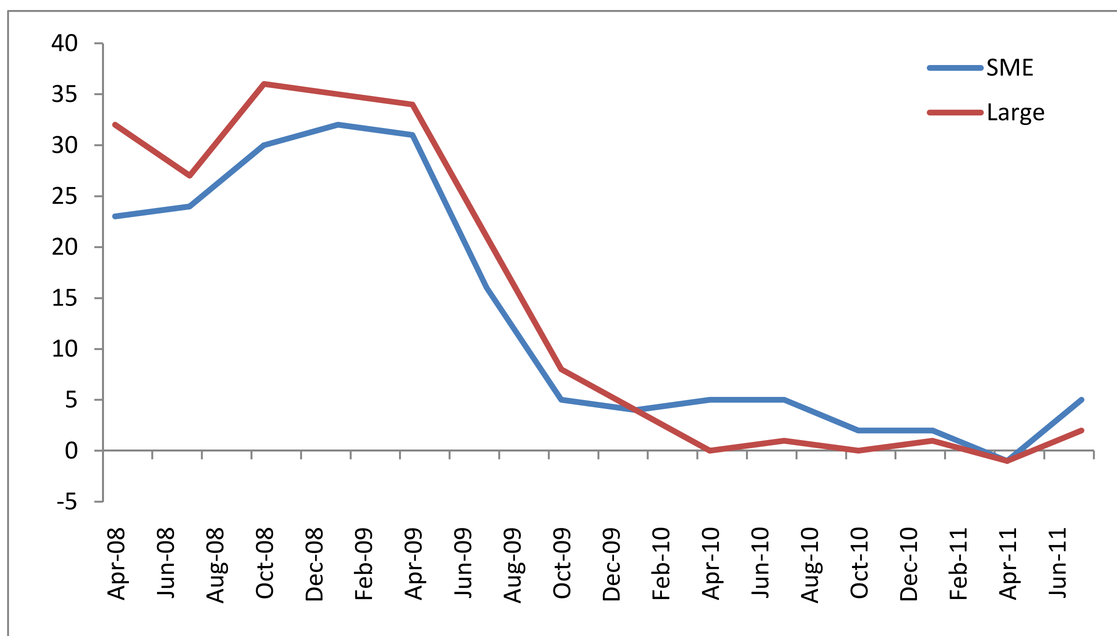
[21] FEE Paper 'Access to finance for SMEs: In search of innovative solutions, vol. II', March 2011 http://www.fee.be/fileupload/upload/Final%20Pub%20Volume%202%20Access%20to%20Finance%20for%20SMEs%2011030896201133120.pdf

[22] European Commission [EC] (2011) Impact Assessment accompanying the document 'Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms' SEC(2011) 949 final. http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/IA_regulation_en.pdf

[23] ACCA (2011) *Framing the debate: Basel III and SMEs* London: ACCA http://www.acca.co.uk/pubs/general/activities/library/small_business/sb_pubs/pol-af-ftd.pdf

Overall, it is best not to treat the brief period from Q4 2010 to Q1 2011 as indicative of trends in future of small business lending as the Commission's impact assessment does. This period has been atypical in many ways and follows unprecedented levels of support from governments to both banks and SMEs, accompanied with significant political pressure on banks to increase lending. Nor does this period represent the amount of time during which banks have known about (and begun to prepare for) the likely provisions of Basel III – December 2009 would be a more appropriate benchmark.[24] Since that time but not before, and always according to the same data cited by the Commission, European banks' margins on loans to SMEs not characterised as 'risky' have consistently widened faster than those for large businesses (see Fig. 1).[25]

Figure 1: Changes to European Banks' margins on less risky loans to enterprises, by size (diffusion index)



Moreover, it's important to note that low-growth, steady state firms, which form the majority of the SME population, especially after a recession, rarely face difficulties sourcing finance; it is faster-growing firms with strong financing needs that face more difficulties.[26] In the UK, for instance, 1% of the SME population (established, high growth, consistently profitable and cash-positive businesses) accounted for 13.4% of the demand for finance in 2007, but failed to obtain about 19% of the finance they sought.

[24] Basel Committee on Banking Supervision (2009) *Strengthening the resilience of the banking sector* (Geneva: Bank for International Settlements) http://www.bis.org/publ/bcbs164.pdf
[25] European Central Bank [ECB] (2011) *Time Series of the results of the ECB bank lending survey* https://stats.ecb.europa.eu/stats/download/bls/bls/bls.zip
[26] Balling, M, Bernet, B., and Gnan, E. (2009) 'Financing SMEs in Europe – Some Stylised Facts' in Balling, M, Bernet, B., and Gnan, E. (eds) *Financing SMEs in Europe* (Vienna: SUERF) http://www.suerf.org/download/studies/study20093.pdf

Another 10% of the population that had the same profile but exhibited steadier growth accounted for 44% of all demand and only failed to obtain 0.2% of the finance they sought.[27]

Finally, while it is true that smaller banks tend to carry more SME loans as a percentage of their assets than large ones, it is not necessarily true that most SMEs, especially faster-growing ones, do business with small banks.[28] If anything, the behaviour of loan margins suggests that the bulk of the reaction to capital and liquidity requirements is so far coming from banks with significant bargaining power.

Moreover, smaller banks with less centralised decisionmaking in less concentrated sectors are more likely to use rationing (including discouraged demand) as opposed to pricing strategies to manage their exposure to SME loans, so the effect of their more modest recapitalisation on overall lending volumes could be significant.[29]

In light of the evidence on the likely impact of CRD IV on lending to SMEs, we welcome the European Commission's decision to introduce a review clause on the preferential risk weight for exposures to SMEs under €1 million. However, what is needed is not an ad-hoc fix but a proper appreciation of the risk posed by small business loans. The implicit assumption in proposed capital ratios remains that loans to SMEs are about sixteen times as risky as government bonds – when a glance at any economic website or broadcast would tell otherwise.

While regulators have a crucial role to play in mitigating the effects of CRD IV on lending to SMEs, there is also a significant role for the banking industry to play, or indeed both sides working together. Lenders can help lending to SMEs, especially fast-growing ones, recover much sooner by doing the following:[30]

- Improving risk and loan-loss provision models, data quality and internal reporting systems
- Ensuring that demands for security are reasonable and take intangible assets properly into account; considering covenants as a complement or alternative to security where appropriate
- Shifting more assets from trading into lending to the real economy
- Making a point of attracting SME deposits as a more stable source of funding
- Reviving the market for securitisation of state-guaranteed SME loans; even in 2006, it was estimated that only about 1%-2% of SME lending that could benefit from such a treatment was actually being securitised.[31] Even worse, about three quarters of all SME loan securitisation pre-crisis was taking place in Spain and Germany alone.[32]

[27] ACCA (2009) Submission to the Rowlands Review of Growth Capital, August 2009. Estimate is based on a model of the Rowlands Review's terms of reference based on the BIS 2007 Survey of SME Finances.

[28] "In many [European] territories, two to four banks have historically maintained a tight grip on 80% or more on the available revenues." Oliver Wyman & EFMA (2006) *Who are you calling small? The big business of small business banking* (London: Oliver Wyman). In the UK, over 90% of all business loans are held by the major 5 banks. Independent Commission on Banking [IBC] *Interim Report – Consultation on Reform Options* London: IBC http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf

[29] ACCA (2011) op. cit.

[30] List adapted from ACCA (2011) op. cit.

[31] Euro Debt Market Association [AMTE] (2006) *Supporting SME Financing Using Securitisation Techniques - AMTE Final Report* (Paris: AMTE) http://www.icmagroup.org/ICMAGroup/files/9c/9c5b5036-afc2-4fea-9ba4-eb9ea5066bbc.pdf

[32] Spaeth, M. (2008) 'SME securitisation in Eastern Europe: an underexploited market?' http://siteresources.worldbank.org/EXTECAREGTOPPRVSECDEV/Resources/570954-1211578683837/Spaeth_Unicredit_Securitization_in_CEE.pdf

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