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Alternative Financing Instruments for SMEs and Entrepreneurs: The case of capital market finance

John Thompson,

Kris Boschmans,

Lora Pissareva

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Alternative Financing Instruments for SMEs and Entrepreneurs: The case of Capital Market Finance

By John Thompson, Kris Boschmans and Lora Pissareva

Abstract

The present report analyses the extent to which capital markets have provided capital to SMEs since the GFC, focusing on three kinds of financial instruments that have proven especially important in providing finance to SMEs undergoing major transitions during the past few years:

· Private Equity;

· Private Debt; and

· Collective Investment Vehicles

It is part of the 2017-18 Programme of Work and Budget of the Working Party on SMEs and Entrepreneurship (WPSMEE).

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1. Introduction and Summary

1.1. Rationale

Small and medium enterprises (SMEs) traditionally rely on banks and similar deposit-taking institutions for external financing. Immediately after the post 2007-Global Financial Crisis (GFC), however, banks in many OECD countries scaled back their lending, with SMEs often encountering difficulties in obtaining credit. After the end of the immediate crisis, the recovery in bank lending has been uneven and often hesitant, as illustrated by the OECD Scoreboard on Financing SMEs and Entrepreneurs.

In addition to inducing a general contraction in lending to SMEs, the GFC aggravated a problem of scarce access to finance for certain important kinds of SMEs which had been observed well before the crisis. Among the categories of SMEs, the OECD singled out as facing particular difficulties in accessing finance, were those in innovative sectors, those seeking to enter new lines of business, and those with above-average growth potential.[1] Moreover, the broader population of SMEs and micro-enterprises remain very vulnerable to changes in the credit market a decade after the onset of the crisis, and would also benefit from the wider use of alternative financing channels.

Capital markets have the potential to contribute to mitigating the SME financing gap. In the first place, there are significant segments of the capital markets where banks, which are constrained by risk and capital considerations, can transfer part of their SME exposure to investors.[2] In addition the capital market is particularly well suited to enterprises embarking on riskier endeavours, particularly start-ups, fast-growing ventures or established firms which undergo a major transition such as a change in ownership, accelerated growth or to transformation into a firm with a stronger market position. The present report analyses the extent to which capital markets have provided capital to SMEs since the GFC, focusing on three kinds of financial instruments that have proven especially important in providing finance to SMEs undergoing major transitions during the past few years:

- Private Equity;
- Private Debt; and
- Collective Investment Vehicles.

1.2. Background

The study adds to a growing body of knowledge carried out by the Working Party on SME and Entrepreneurship (WPSMEE) in the field of alternative finance instruments for small and medium-sized firms. The importance of a diversified set of financing options for SMEs and entrepreneurs was emphasised in a report entitled *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*. That report provides

[1] OECD (2006).

[2] For a discussion of these market segments see Kraemer-Eis et al (2014,) and Nassr and Wehinger (2015). Also see Section 2.1

detailed analysis on a wide range of financing instruments and identifies the potential – and challenges – to broadening the financing options available to SMEs and entrepreneurs. The study contributed to the OECD-wide project on New Approaches to Economic Challenges (NAEC) and was welcomed by G20 Finance Ministers and Central Bank Governors in February 2015.

A report entitled "Fostering Markets for SME Finance: matching business and investor needs" is under development and builds on the "New approaches" study, mapping a set of barriers on both the demand and supply sides of finance markets that commonly restrict SMEs' uptake of alternative financial instruments with policy recommendations on how to increase the interest and take-up of these instruments by SMEs, as well as raise the profile of SME finance markets as investment opportunities. In addition, the G20/OECD High-Level Principles on SME Financing, welcomed by G20 Leaders in November 2015, provide a comprehensive framework and guidance to policy making in this area.

This work adds to the body of analysis developed by the WPSMEE, including case studies on credit guarantee schemes, mezzanine finance and crowdfunding. For each of these reports, a brief description of the financing technique was provided, as well as its main drivers, constraints and opportunities, and enabling policy initiatives and good policy practices were discussed. This report contributes to this workstream.

1.3. Organisation of this report

OECD, 2015c, identified a range of instruments other than bank financing, along the risk-return spectrum. This report provides more in-depth information on recent developments for three instruments, a) private debt, b) private equity and c) collective investment vehicles, marked in red in Table 1. A distinctive feature of the first two instruments is their private nature: They are open only to qualified investors rather than to the general public. Collective Investment Vehicles, in contrast, are instruments through which the general public provides funding to SMEs through capital markets by pooling resources and executing an investment strategy (see Table 1.1).

Table 1.1. Alternative External Financing Techniques for SMEs and Entrepreneurs

Low Risk/return	Low Risk/Return	Medium Risk/Return	High Risk/Return
Asset-based Finance	Alternative Debt	"Hybrid" Instruments	Equity Instruments
Asset-based lending Factoring Purchase Order Finance Warehouse Receipts Leasing	Corporate Bonds Securitised Debt Covered Bonds Private Placements Crowdfunding (debt) Tradeable loans Collective Investment Vehicles (debt)	Subordinated Loans/Bonds Silent Participations Participating Loans Profit Participation Rights Convertible Bonds Bonds with Warrants Mezzanine Finance Leveraged loans Private debt funds Collective Investment Vehicles (hybrid)	Private Equity Venture Capital Business Angels Specialised Platforms for Public Listing of SMEs Crowdfunding (equity) Collective Investment Vehicles (equity)

Source: OECD (2015c)

In Part II, the report will identify those factors that influence SMEs in deciding whether to use a) the banks or b) the capital market, and in the latter case which particular segment of the market to choose. It will then explain why SMEs, when turning to capital markets, mainly seek funding in the private capital markets. One of the recurring themes of this

report is that due to their inherent properties (e.g. opacity, high monitoring costs and small scale), SMEs face serious obstacles in accessing public capital markets. Therefore, the segment of the market that is best suited to SMEs is the private capital market. The private capital market has developed numerous financing techniques, several of which are highly relevant to SMEs and particularly those with high growth potential and high risk that are undergoing a major transformation. The report then identifies the kind of investors that participate in the private capital markets, such as high net worth individuals, institutional investors and other major holders of funds for professional management. Part II also describes the private investment partnership which is the main vehicle used in the private investment market and explains why the private investment partnership is well-suited to investment in SMEs.

Part III discusses SME-related activities in the private capital market. Two main instruments are discussed; a) private equity funds, which have been active in financing SMEs for decades in many countries, and b) private debt funds, which are a more recent innovation. The report will explain how each instrument functions and how it fits into overall spectrum of SME finance. Following the analytical discussion of each instrument, the report will present data and analysis and explain how that instrument has evolved in the past few years in OECD countries and regions.

Part IV considers the efforts of OECD countries to make it possible to offer investment vehicles specialising in SME finance to the general investing public. Efforts to offer securities issued by SMEs directly in public markets have had only limited success. The main vehicle that have enabled SMEs to obtain funding from the general public is through collective investments, i.e., special instruments under which small investors pool their savings and hire professional managers to execute a stipulated investment strategy. Because of the special characteristics of SMEs, it is usually not possible to finance SMEs through traditional Collective Investment Schemes (CIS). A special legislative and institutional framework adapted to meet the specific problems of SMEs must be established. Only a handful of OECD countries have actually introduced the necessary legal framework for SME investment.

Part IV then presents cases studies in the use of collective investment which enable retail investors to invest in SMEs in Member countries. The report then considers specific collective investment vehicles for SMEs in Canada, France, Portugal, the United Kingdom and the United States.

In Part V, the results of the repot are summarised, implications for policy are considered and some possible areas for future work are suggested.

1.4. Main findings

The development of capital market finance for SMEs differs widely among member countries. While the extent of capital market financing to SMEs is largest in the United States, its use has been expanding rapidly in other countries and the capital market is fairly well developed in Australia, Canada, Israel, Korea and the United Kingdom as well. In Europe, several countries such as France, Germany, the Netherlands and Sweden have also moderately high levels of use of capital markets. By contrast, market development tends to lag in several countries in Southern Europe, as well as in some economies in Central and Eastern Europe.

With respect to high growth companies, private equity is a widely recognised vehicle for financing potential high growth SMEs. This technique was well established before the

crisis, and indeed the high point of activity was reached in the dotcom bubble that burst in the year 2000. It may well be the case that, with the market having grown too large and speculative, a period of retrenchment was inevitable. After contracting during the GFC, private equity is experiencing a resurgence, at least in those countries where it had already gained a foothold before the GFC. Fund raising and investment for private equity are now approaching their pre-GFC highs, and exits (i.e. the sale of companies that have been transformed by private equity) are at or near all-time highs.

A major innovative technique that has gained prominence since the GFC is the private debt ("alternative lender") markets in which investors create a fund that operates outside the banking system and offers debt financing for SMEs. Alternative lenders constitute an entirely new capital market instrument that is becoming increasingly prominent in a number of markets and is still growing rapidly.

In the United States, the assets of private debt funds at the end of 2015 amounted to some USD 260 billion. The European component of the global private debt market is only about half the size of its American counterpart, but growth in Europe is faster and Europe accounts for a rising share of the world market. However, as with all capital market techniques, the growth of the private debt market is not evenly spread among European countries.

In both private equity and private debt, the level of "dry powder," (i.e. funds that have been committed by investors but not yet invested) is near all-time highs. In other words, investors are pouring resources into private debt and equity funds faster than the industry can deploy those funds. In its current state, the private capital market has huge potential resources available for further investment. By definition, these investments are not available to the general public. The main holders of private equity and private debt are institutional investors, high-net worth individuals and other qualified investors.

Some instruments that are available to the general public, particularly collective investment vehicles, have shown dynamism since the GFC, although their total impact to date has been modest. Collective investment vehicles are legally recognised investment vehicles that assemble portfolios of claims on SMEs (debt or equity) for investment by retail investors, i.e. persons who do not qualify as "high net worth individuals" and may only purchase publicly offered securities.

Collective investment vehicles that specialise in financing SMEs are found in a limited number of OECD countries. In the United States, Business Development Companies (BDCs) have emerged as a major force in the capital markets with the volume of assets under management tripling to USD 60 billion between 2005 and 2014. These instruments are now an established feature of the financial system and a significant source of financing for SMEs. In 2014-15 a pause occurred as many BDCs began to trade at substantial discounts to net asset value[3], but this divergence narrowed in the course of 2016. Looking ahead, it is uncertain whether the strains that appeared in 2014-15 were simply a minor episode in the longer-term expansion of the BDC sector, or whether further structural changes in the in the BDC sector are likely.

[3] A BDC is trading at a discount when the price of its share in the market is less than the value of the assets BDC per share.

Other collective investment vehicles that support SMEs are found in the United Kingdom[4] and France[5], where these instruments are held on a moderately high scale by high-income retail investors, but have not shown notable expansion since the global financial crisis, and has recently been introduced in Portugal.

In Canada, a scheme for retail participation in SME investment, known as Labour-Sponsored Venture Capital Corporation (LSVCC) or tax-advantaged funds, has been present for decades. In the province of Quebec these instruments, which operate with sizeable tax incentives, are widely held by the public and have emerged as an important feature of the overall landscape for SME finance. In other parts of the country, their progress has been limited and most provinces have withdrawn fiscal incentives.

Collective investment instruments for the SME sector probably have substantial potential for expansion, and the authorities of OECD countries would be well advised to explore the possibility for future development. At the same time, the diverse experience of OECD countries suggests that it is essential to design these instruments carefully in order to achieve their targeted objective, drawing on international practices in collective investments and the experience of other countries.

[4] Venture Capital Trusts (VCTs).

[5] Fonds communs de placement dans l'innovation (FCPI) and 2) Fonds d'investissement de proximité (FIP).

2. Bank and Capital Market Financing for SMEs

2.1. Bank and capital markets: the distribution of risk and return

Unlike larger companies, which have moved from banks to capital markets in search of lower cost funding[6], SMEs generally prefer to rely on banks, which are still usually the least expensive form of funding for this type of firm. In addition, banks make fewer demands on the company for public disclosure and are less likely than outside investors to interfere in the operation of the firm. .

Because banks are the main supplier of funds to SMEs - and usually the preferred supplier - in nearly all countries, most of the financial instruments discussed in this report are of relevance only to a small subset of the SME universe. The defining feature of capital market financing instruments for SMEs discussed in this report is that they are suitable only for certain categories of SMEs at certain defined phases of the corporate life cycle. Specifically, the techniques are relevant for firms that undergo major changes, such as expansion, strategic changes in business models, upscaling or change of ownership. To a lesser extent, these techniques can be used to rescue SMEs that are financially impaired and in need of restructuring. When a firm is at an important inflection point in its life cycle, it will have the potential to achieve major transformation, but only at high risk. It is at that point that the firm may turn to the capital market.

By the nature of their business, banks face losses when borrowers cannot repay loans but derive few additional benefits when the borrower is very profitable. Therefore, banks will often pass up potentially lucrative but risky proposals, and prefer companies with steady cash flows and collateral. The situation is different when the firm embarks on an innovative project or structural transformation, such as increasing the scale of operations, introducing new products or expanding geographically. Banks often reject such proposals as too risky. In those circumstances, a possible solution for an SME is to forge a partnership with a capital market intermediary that specialises in analysing and accepting the risks of corporate transformation. The capital market intermediary then structures a financing vehicle that distributes risk and reward between the present owners of the firm and outside investors.

However, the separation between banking and capital markets is not as sharp as it may appear. Capital market intermediaries frequently collaborate with banks, each institution operating in its own field of specialisation. Most SMEs will have relationships with one or more banks for services such as payment as well as lines of credit which firms can use for short-term borrowings. In addition, the SME may have need of longer term capital for investment which banks satisfy by making term loans, i.e. loans with more than one year's maturity. In some cases, the bank may decide to keep the loan on its own balance sheet.

[6] Large issuers generate large volumes of securities that are traded in transparent and liquid markets. By dealing in those markets, investment bankers alter the risk/reward characteristics of securities using financing innovations, including derivatives, thereby lowering financing costs to levels below those available from banks. Following the initial shock of the GFC, market conditions for large companies have been highly favourable and larger companies have been able to improve their financial strength, through re-financing of debt and share repurchases. Major equity markets have continued to reach new records while borrowing in public bond markets occurs in larger volumes and on highly favourable terms.

Banks also have the option of encouraging firms with which they have a relationship to tap the capital market in an operation in which the bank acts as an intermediary in selling all or part of the loan to investors. The bank's motivations in encouraging the borrower to use the capital market are basically: 1) to lower its concentration of risks; 2) to meet prudential requirements regarding capital assets ratio; and 3) to shift from interest-based income to fee-based income. Instead of earning interest on the loan, the bank will earn investment banking fees on the operation.

2.2. Private capital markets

In discussing capital market financing, a basic distinction must be made between a public market, which is open to all investors and a private market, which is limited to a restricted set of investors. The public capital market is subject to the full set of regulations prescribed by an officially designated supervisory authority concerning disclosure and other investor protection requirements. An individual investor in the public capital market who does not qualify as a high net worth individual is often called a "retail investor".

A private capital market is open only to a designated set of investors. The official body responsible for capital market oversight may designate certain categories of investors as "qualified", i.e., exempt from the full range of investor protection laws and regulations. Private markets are frequently less liquid and transparent than the public markets. In the private market, companies are not subject to public disclosure requirements, and information may be shared on a confidential basis among "insiders" such as owners, managers, financial intermediaries and investors. Investors in the private capital market, who are considered professional or sophisticated, waive the full range of investor protection regulation in order to invest in restricted market niches. It should be mentioned that many participants in private markets are active in public markets as well.

With respect to SMEs, the private market often suits the needs of both issuers and investors. The opacity and illiquidity in SMEs, concentrated ownership, the high costs to SMEs of compliance with investor protection regulations, and the costs to investors of monitoring SMEs, represent a serious obstacle to SMEs access to public markets. At the same time, since SMEs typically offer higher returns with higher risk and /or less liquidity than other asset classes investors have incentives to target SMEs as a means of enhancing returns.

2.2.1. Investors in private capital markets

Some of the major categories of investors in private capital markets are:

High net-worth individuals

Most jurisdictions specify minimum levels of income, wealth and financial sophistication that are required for designation as an exempt "high net-worth individual." Private asset managers may also set requirements that are more stringent than the legal minimum.

Family offices

These are private wealth management advisory firms that serve ultra-high-net-worth investors. There are two types of family offices: single family offices and multi-family offices (MFOs.) Single family offices serve one ultra-affluent family while multi-family offices are more closely related to traditional private wealth management. Family offices combine asset management, cash management, risk management, tax planning, legal services and insurance. The family office will also formulate and execute an

intergenerational wealth transfer plan covering the transfer or management of business interests, the disposition of the estate, management of family trusts, philanthropic desires and continuity of family governance.

Corporate investors

Many large corporations have investment departments that enable them to screen companies in a targeted sector. The companies identified as targets may be possible candidates for M&A operations that enable the parent company to pursue its business strategy.

Public entities

Many national and sub-national governments have formed funds that invest in private capital markets, including venture capital, mezzanine, private debt and private equity. A partial list of institutions that engage in such activity include the British Business Bank (United Kingdom), BpiFrance (France), Kreditanstalt für Wideraufbau (KfW Germany) and the Development Bank of Canada. Some international organisations such as the EU, the EIF, the EBRD, and the IFC are active in these markets.

These publicly owned institutions invest alongside private investors. In addition to the motives of maximising returns that characterise other investors, public funds are expected to achieve other aims such as to develop the capital market or to compensate for market failures. For example, in France, the activities of BpiFrance focus on smaller companies and on growth capital, rather than on leveraged operations, as evidence shows that larger SMEs are able to finance themselves relatively adequately through the private market. Similarly, the Development Bank of Canada has recently conducted an analysis of its market and identified places where viable firms are not receiving funding. It is therefore considering participation in parts of the private equity market.

Fund of funds

This is a special form of fund that diversifies investments over a selected category of funds. It is suitable for qualified investors who lack the size or the capacity to select individual private debt or equity funds. Allocating investments to the asset class via a dedicated private equity (or private debt) fund of funds diversifies exposure across geographic regions, types of investment (primary, secondary, co-investments) and financing stages (venture, growth, buyout and turnarounds). Similarly, deploying capital across multiple vintage years diversifies the risk of being concentrated in one vintage or deploying capital at the market peak. One possible drawback of funds of funds is that they add another level of fees to the already high fees of private investment partnerships.

Endowments and foundations

These institutions, which are designed to provide revenue for the operation of non-profit institutions such as hospital and universities, are major investors in private markets. For example, among endowments and foundations in the United States, it has long been the practice to invest in “alternative assets,” which includes private equity and private debt.

Institutional investors

The participation of institutional investors (i.e. pension funds, insurance companies) in private investment partnerships differs greatly among OECD countries.[7] Levels of development of institutional investors also differ widely among countries. According to the OECD *Statistics on Institutional Investors*, the ratio of the assets of Institutional Investors to GDP ranges from as low as 25% in countries such as Greece, Portugal, Mexico and some central European countries, to over 200% in countries such as the Netherlands, Switzerland, the United Kingdom and the United States. Where institutional investors are not well developed, they are obviously limited in the role they can play in financing SMEs.

Even in countries where institutional investors have reached a fairly high level of development, prudential regulations have often required institutions to invest in narrowly defined categories of fixed income assets. Furthermore, regulations in some countries forbid institutions from investing in unlisted securities, which precludes participation in private capital markets. Moreover, private investment partnerships pose many challenges in valuing portfolios, which deepens the hesitancy of supervisors to authorise investments in this asset category. This said, the trend has been for supervisors of pension funds and insurance companies to take a more accommodating approach towards investment in non-traditional assets. Thus, supervisors in Denmark, Ireland and Mexico have adopted more flexible policies in the past few years.

All institutional investors can use investments in SMEs to increase yields and diversify their portfolios. Two particular categories of institutional investors that have a special interest in investing in fixed income assets through the capital markets are 1) insurance companies and 2) defined benefits pension plans. Both of these categories of institution have significant long-term obligations. One of the challenges of in-house risk management for these institutions is to match these long-term liabilities with payments flows sources of steady predictable income for extended periods.[8] Similarly prudential regulations often require that these institutions match their long-term assets and liabilities. Fixed income claims on SMEs can often help to achieve tighter matching of assets and liabilities.

Sovereign wealth funds

Sovereign wealth funds (SWFs) consist of pools of money which are set aside by governments for long-term investment, generally outside the country. SWFs are generally established by countries with foreign exchange earnings that exceed current needs. The assets in SWFs are expected to be invested in longer term assets for the long-term benefit of the country's economy and citizens. The types of acceptable investments included in each SWF vary from country to country.9

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[7] According to the OECD there are three kinds of institutional investors 1) pension funds); 2) insurance companies; and 3) collective investment schemes (CIS) which includes mutual funds, units trusts and similar institutions. CIS are considered in Part IV.

[8] For discussion of the use of fixed-income claims on SMEs for matching assets and liabilities of insurance companies, see Kramer-Eis et al (2014.)

[9] Blundell-Wignall, Hu and Yermo (2008).

2.2.2. Private investment partnerships

The main legal instrument though for investment in SMEs in the private market is the Private Investment Partnership (PIP), which operates independently of the banking system using funds provided by qualified investors. Part III discusses the two main kinds of PIPs that are relevant for SMEs, a) private equity and b) private debt, both of which use the PIP as a legal form. The PIP can be used to execute other strategies such as hedge funds and infrastructure investment.

In a generic PIP, the investment manager and the investors conclude a partnership agreement in which the investment manager is the "general partner (GP)" whiles the investors are the "limited partners (LPs)." Private Investment Partnerships are limited to a specific number of LPs (usually 100). The minimum investment in such funds is usually high. In the United States, the minimum investment is usually USD 250 000 for an individual and considerably higher for an institution. The LPs commit to provide a specified amount of funds within a specified time frame. When the GPs are able to deploy the funds, "capital calls" are made to LPs who must produce the stipulated amount of funds by a specified date. In the private investment industry; money that has been committed by LPs but not yet drawn by GPs for investment is called "dry powder."

PIPs are subject to minimal official regulation and have considerable freedom to innovate. Relations between investors and investment managers are based upon customary industry practice, rather than official law and regulation, and therefore tend to be similar throughout the world.

PIPs raise funds at particular points in time and have a defined life, usually 8-10 years for equity and less for debt. Normally, in its early years the fund will focus on identifying good opportunities and building a portfolio of companies. The fund will receive payments and the corporate transformation will continue during the medium phases of the company's transformation. In later stages, transformation will be completed, exit strategies will be implemented, loans are repaid, equity positions are closed and money is returned to investors. Toward the end of the cycle (sometimes called the harvest period) the fund is wound down and terminated. A private investment firm will ordinarily have more than one active fund at different stages of the cycle.

The PIP creates a Fund which invests in a portfolio of assets, which may take the form of debt, equity (including equity derivatives) or some combination of these. Debt positions of the fund are typically held to maturity while equity positions are liquidated through sales to other investors. Investors agree to supply funds upon demand by the fund and have very little flexibility in liquidating positions. Under normal circumstances, the investor will hold the position throughout the life of the fund. There may be limited possibility to liquidate investment positions before maturity, but only under rather restrictive conditions and late in the life of the fund.

One distinguishing feature of private investment partnerships is that the portfolio of a private debt or equity fund is frequently completely illiquid and opaque in pricing. Most of the assets held in the portfolio of the fund cannot be sold to an outside investor and cannot be valued independently of the capacity of the GPs and the management of the company to effect the planned corporate transformation. This situation can be contrasted with that of a conventional institutional investor such as a pension fund, insurance company or collective investment scheme (CIS) which holds a portfolio of liquid publicly traded assets such as bond or equities, with prices that are available from observing trades in public markets. The

portfolios of these conventional institutions can be valued frequently and performance measured on an ongoing basis.

For the most part, the portfolios of PIPs are composed of assets that do not trade. They will be valued less frequently (seldom more than quarterly) and the valuation will be tentative. Since the objective of the PIP is to liquidate all the assets in the portfolio in the specified time frame, the performance of the investment is definitive only at the end of the investment cycle when the debt assets of the investment are repaid and when the equity investors are compensated.

One of the common ways of measuring fund performance is through the Internal Rate of Return (IRR), which is the discounted value of all cash flows from the fund's inception until the date at which it is measured. The IRR is the discount rate that makes the net present value of all cash flows equal to zero. The normal pattern of private equity is to experience negative IRRs in the early years of the funds life with the IRR becoming strongly positive and then flattening out. Since money flows are discounted to reflect the time value of money, the GPs will seek to exit relatively rapidly.[10]

Portfolio managers in private debt and equity are compensated on the basis of their ability to deliver positive results. The compensation structures of Private Investment Partnerships reflect the premium that is placed on the portfolio manager's ability to find and nurture good prospects. These funds compensate the investment manager by a fixed percent of assets under management (AUM) which is typically 2%. In addition, the sponsors of each fund receive a share of the earnings on the assets, above a specified minimum or "hurdle" rate, such as 8%. Given this fee structure there are strong incentives for GPs to develop skills at identifying promising investments and interacting with corporate management to deliver value to investors.

As the discussion in the preceding paragraph makes clear, each of these forms of investment is rather expensive. If investors expect a net return of upwards of 8% and the investment manager is compensated for exceeding these rates, the cost to borrowers will be higher. Consequently, the PIP will normally scrutinise a very large number of companies and select a small subset of those companies, with the highest likelihood of successful transformation in order to satisfy the criteria of risk and reward.

[10] For a discussion of IRR and other metrics see Murphy (2006), Demaria (2013), Fraser-Sampson (2010), and Goedhart, Cindy Levy, Morgan (2015). For a concise discussion of the basic terms used in this section see Pictet (2016).

3. Private Equity and Private Debt

The following sections consider the two main categories of the private investment partnership (PIP) that are relevant for SME finance: private equity and private debt. Under each category the report discusses 1) Structural characteristics; 2) Level of development in OECD countries; and 3) Trends in OECD countries.

3.1. Private equity

3.1.1. Structural characteristics of private equity

Private equity is a technique that enables investors to take equity positions in a portfolio of companies that are seeking to effect major transitions such as expansion, recapitalisation, change of ownership, transmission among generations or mergers and acquisitions. The position of a private equity investor can be contrasted with the position of a portfolio investor who aims to hold the company for a specified period (which may be long or short depending upon the investor's strategy) and to liquidate the position by selling assets in a liquid market. It is also different from a strategic corporate investor who may hold a position indefinitely as part of a broader corporate strategy.[11]

By injecting outside capital and working intensively with the management of the company, the private equity investment manager seeks to transform the company through active ownership over a period of 3-8 years (5 years on average) at which point the investors expect to exit by selling their stake in the company. The buyers might be large corporations seeking to execute a strategic acquisition as part of their corporate strategy, larger financial investors or stock market investors (through an initial public offering or IPO). There is also a "secondary" market in which a group of private equity investors purchase an existing position in a private equity fund from the original LPs. The objective is to liquidate the entire portfolio by the end of the fund's life (usually 10 years.)

The private equity industry asserts that returns on private equity are consistently higher than on more traditional asset classes, which it attributes to 1) the premium that investors receive for holding illiquid assets and 2) the ways in which private equity can discover and realise value in companies. Private equity investors screen large numbers of companies and will only select a small number for actual investment, i.e. those it is convinced will produce rates of return exceeding its targeted return. Consequently, it is only relevant for a limited subset of the SME universe.

Since private equity is a high-risk, high-return operation, it is only relevant for companies with very specific characteristics. While long-term investors hold equity investments in companies that are expected to produce returns to shareholders over a prolonged period, the private equity investor targets firms only at critical periods in their life cycle and focuses the equity value of the company in the medium term. It aims at financing a specific operation and aims at an exit once the transformation is accomplished. The firms that meet these conditions may enter a high-growth phase in the period following restructuring or change of ownership, for example. Private equity sometimes focuses on firms are in

[11] Pictet Alternative Advisors SA (2016).

"turnaround" or "rescue" situations, i.e. facing financial impairment, but with the potential to become viable with restructuring and change of management.

The current model of ownership, governance, management and remuneration of the private equity industry is well established and similar in all countries. While the senior management has operational responsibility, private equity investors, who are represented on the board, are active in issues relating to the company's capital structure and balance sheet as well as strategic initiatives such as mergers and acquisitions, joint ventures, and management restructurings. Information is exchanged among insiders as needed.

Box 3.1. The social dimension of private equity

Over the years, some critics have argued that private equity is basically destructive. More specifically, it is suggested that private equity transitions often lead to burdening companies with debt, closing of factories and layoffs of workers while investors walk away enriched. It is argued that these operations may provide profits to the managers and organisers of the operation but at a loss to society as a whole. Private equity is also criticised for its use as an aggressive tax minimisation vehicle. Most of these charges are levelled against large LBOs rather than the operations in the SME sector.

This report does not attempt to resolve definitively the issue of the social utility of private equity. Although the above criticisms need to be considered, and employment appears to be negatively impacted in particular, it should be noted that research shows that private equity has substantial benefits to society as well. In particular, several studies have found that private equity tend to invest in firms with higher than average levels of innovation and productivity growth. These studies also show that on average firms funded by private equity have higher rates of investment expansion and sales as well as higher employment growth than the average firm. It should also be noted that since this accusation, several public bodies charged with promoting the SME sector have concluded that private equity is an important part of an overall strategy for official support to the SME sector.

An emerging trend in private equity has been the emergence of Social Impact Investing by private equity firms. Impact investments are investments made into companies and organisations, with the intention of generating social and environmental impact alongside a financial return. Impact investment is closely related to socially responsible investment (SRI) which has occupied a niche in financial markets for several decades.

Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances. The growing impact investment market provides capital to address social challenges in sectors such as sustainable agriculture, clean technology, microfinance, and affordable and accessible basic services including housing, healthcare, and education. Providers of funds for impact investing include pension funds, private foundations, insurance companies, development finance institutions, family offices and individual investors.

Source: Woelfel, Thorley and Sirull (2012); Saltuk, Bouri and Leung (2011); Campbell and Campbell (2008); The Economist (2007), "The trouble with private equity, 5 July 2007; Chassany and Jones (2013); Harford and Kolasinski (2013); Frontier Economics (2013); and Blundell-Wignall (2007), European Commission/OECD (2015).
For more information about impact Investing see: https://thegiin.org/impact-investing/need-to-know/#s5

3.1.2. Patterns of revenue: the "J-curve"

The distinctive pattern of expected cash flows in private equity is often described as a "J-curve." In the early years of a private equity investment, cash flows are negative as the firm makes heavy outlays for expansion or development (and possibly debt service) while revenue gains remain small. In later phases expenses will decline as the expenditures on corporate transformation are completed. If all goes in line with the plan, the cash flow of the company improves steadily as revenues increase. Given this pattern of earnings, the performance of a private equity investment can only be definitively measured after the fund is liquidated. Due to the higher expected returns on equity and the use of internal rate of

return (IRR) as a performance benchmark, the fund managers will seek to replace equity with debt quickly and to exit as soon as possible.

3.1.3. Categories of private equity[12]

This report focuses on private equity that is relevant for SMEs which, having survived the early phases of their existence and achieved positive earnings, are in phases of growth or maturity.[13] In this section private equity is subdivided into a) growth capital which involves only equity; and b) leveraged private equity which involves a combination of equity and debt.[14]

Growth capital

Growth capital (sometimes called expansion capital) refers to equity investments, most frequently minority stakes, in relatively mature companies that are looking for capital to expand or restructure operations, develop new products, enter new domestic or foreign markets or finance a major acquisition without a change of control of the business. The target companies are characterised by fast-growing markets and the potential of the firm to achieve a dominant market position. In the language of management consulting, these companies are often called the "stars", i.e. companies that, with the infusion of outside capital and skills, have the position to develop into market leaders. Growth capital can also take the form of "replacement capital" which consists of acquisition of minority stakes in a company looking for management or owner transition without taking on any additional debt.

Another description of the kinds of firms that are candidates for growth capital can be described as firms that are entering a "scale-up" phase.[15] This term refers to established companies that have passed through the earlier stages of their life cycle and are financially viable. The next phase (scale-up) is to increase the "scale" or market position of the companies in order to make them dominant market players. The owners and managers of the company formulate a plan that can transform the company into a market leader and seek financing to put their plan into operation. Private equity supports this targeted transformation.

Expansion could entail expenditure on research and development, marketing and advertising, purchasing new capital equipment or hiring new staff. Since growth capital focuses on increasing the scale of the company, it aims to increase revenues. In the parlance of business, it seeks to grow "the top line" (i.e. sales) rather than the "bottom line" (i.e. profits). In fact, during a period of growth capital investment one would expect profitability

[12] There may be some variations in terminology in different regions of the world. In Europe, the most commonly used definitions are those of Invest Europe: http://www.investeurope.eu/research/about-research/glossary.

[13] Private equity is a technique that is not confined to SMEs. In fact the preponderance of private equity deals in money terms involves large companies. There are also other significant parts of the private equity market involving SMEs. Thus, Venture Capital provides equity finance to SMEs in the earlier stages of their life cycle.

[14] The discussion in the text is on a high level of generality. For more in-depth discussion see Fraser-Sampson (2010), Demaria (2013) and Lerner, Leamon and Hardymon (2012).

15 See Deloitte UK (2014), AVCAL (2016), Coutu (2014), and Zwilling (2013).

to decline initially as the firms spends heavily on R&D or marketing while sales do not immediately rise commensurately. The role of growth capital is to support a growth/scaling strategy.

Two distinctive characteristics of growth capital as compared to other forms of private equity should be emphasised. First, in growth capital private equity investors normally do not replace the incumbent management of targeted firms. The private equity investor along with the owners and managers of the company agree on a growth strategy that will be implemented over a 3-5-year horizon. Private equity investors assume a position as minority investors. They expect to be represented on the board of the company and to have some influence over the direction of the company but final control remains with the original owners. Second, growth capital does not require the use of leverage (i.e. debt). The transformation can be exclusively (or at least primarily) accomplished with equity.

Leveraged private equity

In a leveraged transition a private equity firm assembles a package of investment instruments and brings together a group of investors with various risk/return preferences. The package may include senior debt, subordinated debt, preferred equity and common equity. Those in the equity position will seek to use leverage (i.e. debt) because increasing the presence of comparatively low-priced debt in the firm's capital structure increases the final return to the equity investor. The senior lenders accept a comparatively low rate of return in exchange for the right to be paid first. The junior lenders accept an intermediate position while the equity investors accept all residual risk but "own the upside" (see Box 3.2).

Box 3.2. Risk and leverage in private equity

One common way of measuring leverage is to consider the company's debt as a multiple of its earnings or EBITDA , i.e. earnings before interest, taxes, depreciation and amortisation. EBITDA is a commonly used measure in finance in many countries as an indication of a company's operational earnings. It is assumed that as leverage increases, the risk of exposure to the company rises, and those providing finance will demand progressively higher risk premiums. Thus, a bank will provide credits under a revolving credit line of up to one year's earnings and will expect a return in the neighbourhood of 3-4% in current conditions. Senior secured debt has first priority in payment in the event of a company's liquidation. In cases of deteriorating performance, the lender can stop new lending and obtain repayments rather quickly. A senior term loan with a will have similar security, but the lender has less flexibility in reducing exposure in a deteriorating environment. In this case the required return rises to the 6-8% range. If leverage exceeds 3.5 years' earnings, for example, the company may have to resort to junior (i.e. subordinated) loans for additional funding.

Many rating agencies use 3.5 times EBITDA as the dividing line between investment grade and sub-investment grade debt. The investor in the junior loan will expect a higher return. To invest in this category of debt, the investor in junior bonds must be convinced that earnings will grow sufficiently to 1) pay all senior creditors and to 2) pay junior creditors. At higher levels, the investor must believe that the company has some possibility of achieving exceptionally high increases in earnings. Finally, if the plan entailed debt that would extend beyond those limits for junior debt, it would have to be undertaken with a combination of debt and equity. Thus, a group of investors would construct a plan to add senior debt up to the limit, to add junior debt and to make an equity contribution. In the case of such a fundamental transformation, the investors will seek partial or total control of the company.

Sources: Kencel (2016) and Willis Towers Watson (2015).

The equity investor will only participate when convinced that earnings will grow sufficiently to satisfy all obligations to creditors (both senior and junior) plus enough additional gain in net earnings to achieve gains for the equity investor in the range of 15-20% annually. The investor is also likely to seek sufficient control over the company to ensure that the company evolves in line with the plan so as to assure returns to investors. In many cases the private equity firm will gain majority or total ownership of the company.

In many markets, the largest number of private equity transactions occurs in growth capital rather than leveraged private equity, although the value of deals tends to be smaller. As a result, the amounts invested in leveraged operations tend to be larger.[16] A simplified presentation of the major kinds of leveraged private equity is shown in Box 3.

Since private equity regularly uses debt to support its operation, there is a parallel class of assets that are major features of the market, namely the "sponsored debt" market. Many debt operations, either bank loans or bond issues are "sponsored" in the sense that they are

[16] In addition to the general works on Private Equity, see Preqin Special Report: Distressed Private Equity (2011), https://www.preqin.com/docs/reports/preqin_special_report_distressed_private_equity.pdf.

not “stand-alone” vehicles, like a traditional bank loan or corporate bond. Instead, they are designed to provide the debt component of a private equity package containing debt and equity instruments.

Box 3.3. Major categories of leveraged private equity operations

Development capital targets established companies with positive cash flows and solid market positions, but where the entire market is not growing rapidly enough to justify growth capital. The operation could use debt to finance some part of the expansion plan, such as expanding into a new geographic area, building a factory or installing new equipment. In that case, the operation is commonly described as a money-in deal. Alternatively, an existing owner may wish to exit from the company through acquisition of equity which will result in the payment of dividends and eventually in the sale of the company to another owner. The latter operations are known as a money-out deal.

In buy-outs, investors purchase a controlling interest in an existing company and execute a strategic transformation. Buyout funds usually invest in mature, established companies with a strong market position. The buyout manager, together with the company’s management, draws up a business plan to grow the company further, either organically and/or by applying a "buy and build" strategy. The latter process consists of acquiring a company of a significant size, and then adding smaller companies to the initial acquisition in order to create a significant player in the industry. The GPs will support the company's management in formulating and executing its acquisition plan, negotiating possible debt financing and efficiently consolidating the business. The plan may also include some cost restructuring measures, the disposal of non-core assets or the sale of unprofitable divisions. Buyout transactions make sense when GPs believe they can extract value by managing a company for a period of time and exiting it after significant value has been created.

There are several variants of buy-outs, especially management buy-outs where the existing managers of a company buy the company from its current owners using debt as well as equity to effect the transaction. A variation of this operation is a management buy-in in which an external group of owners acquires managerial control of an existing company and seeks to affect some kind of a transformation of the company.

Turnaround/ rescue is an investment in the debt or equity in a company facing financial difficulty with the belief that private equity investors can restore the company to profitability. Some PE firms specialise in these kinds of operations while others will pursue this strategy along with other investors. Distressed debt involves purchasing debt securities that are trading at a distressed level, in anticipation that those securities will have a higher market valuation and generate, or taking a position to potentially gain control of an asset. Turnaround investments focus on purchasing equity in companies that are in distress, and aiming to subsequently restore the company to profitability. Special situations investments focus on event-driven or complex situations, where a fund manager may be able to exploit pricing inefficiencies due to an expected or actual significant event.

Source: In addition to the general works on Private Equity, see Preqin Special Report: Distressed Private Equity (2011).

Debt financing for private equity can be obtained from a number of sources. In the most basic case, a bank may simply keep the loans on its own balance sheet. Alternatively, the loan may be sold to investors via the syndicated loan market. Syndicated loans (typically

of 4-7-year maturities) are originated by banks and sold to groups (i.e. syndicates) of banks and institutional investors. In recent years sponsored loans have accounted for 30-40% of total middle market loan operations in the United States. [17]The private debt market, which will be discussed below, initially consisted almost entirely of sponsored debt, and most debt in that market is still sponsored. Finally, collective investment instruments, which are marketed to retail investors (e.g. Business Development Companies or Venture Capital Trusts), may invest in sponsored debt.

3.1.4. Distinctive characteristics of private equity in individual OECD countries

Thus far, the private equity sector has been discussed as a single global entity, but in fact fundamental differences are found in size and structure among OECD countries (see Figure 1). It should be emphasised that the data shown in the table do not only cover the SME sector. In most countries data on private equity include 1) venture capital 2) middle market private equity and 3) larger transactions. In some countries and regions, it is possible to separate operations by size of company. On a global level, however, such a separation is not possible.

The market has been historically dominated by the United States but the share of Europe in total activity has been rising steadily.[18] In 2007 the United States accounted for some 75% of aggregate global activity. It is estimated that in 2015 the United States accounted for 60%, of worldwide activity against 30% for Europe and 10% for the rest of the world, mostly in the Asia Pacific region.

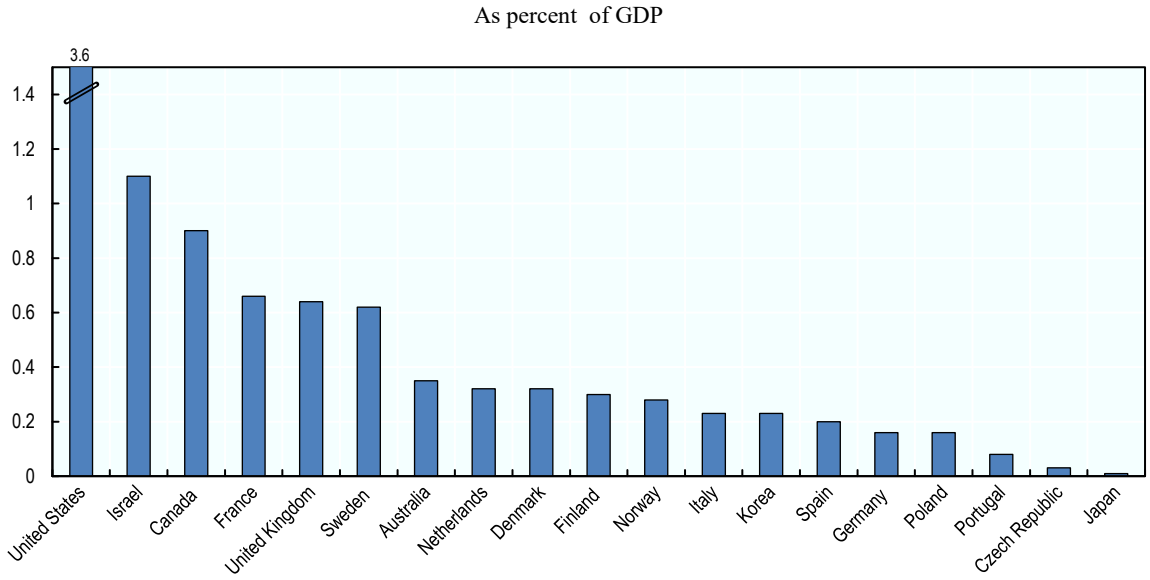
Figure 1 shows the size of all funds raised as a share of GDP in key OECD countries. The United States has a private equity sector that is substantially larger than any other country. In addition to the fact that the private equity market is larger in the United States by any measure, there is an additional factor at work. The public equity market has been contracting in terms of new issues and volumes of shares outstanding with a larger contraction for smaller companies than for large ones. Thus, many larger equity operations which are done on public markets (i.e. vis stock market listings) in other advanced countries are increasingly done in private equity markets in the United States, thus inflating total activity. [19]

[17] Thomson Reuters (2015.)

[18] In this text "Europe" refers to countries that belong to Invest Europe (formerly the European Venture Capital Association or EVCA), the industry association for the private debt and venture capital industry in Europe. Invest Europe is the basic source of data and analysis for private equity and venture capital in Europe. OECD Member countries account for overwhelming share of activity in Europe.

[19] For a discussion of declining use of public market see Doidge, Karolyi, and René M. Stulz, (2016,) Ernst & Young(2017and 2017b), and Mauboussin, Callahan, Majd (2017.)

Figure 3.1. Private Equity investment in selected OECD countries, 2016



Source: Data from European countries comes from Invest Europe. All others from national private equity associations. Data on GDP from https://stats.oecd.org/index.aspx?queryid=60702.

Canada, Israel and several European countries also have highly developed private equity sectors,, reflecting the particular historical, legal, social and economic structures of these countries. Moreover, acceptance of market-based reorganisations and changes of ownership in the business sector have facilitated the growth of private equity. At the other extreme, the market in Japan is relatively small with an estimated average investment of JPY 620 billion (USD 7 billion equivalent) in 2010-14, below volumes observed in some smaller countries.[20]

The differences among European countries are also striking with relatively well-developed markets in France, the United Kingdom and less activities taking place in Southern and Central European countries.

Some notable differences among the countries of Europe occurred between 2007 and 2016. First, despite the recent recovery, the level of investment in 2015 was still only 60 % of its peak in 2008. The United Kingdom has traditionally been the largest single market in Europe, but its lead over other counties has been declining and France overtook the United Kingdom as the largest market in Europe. The Nordic countries and the Netherlands had relatively active markets. Activity has fallen off in Germany in the past two years, while activities have been picking up in Greece, Italy, Portugal and Spain, albeit from a low basis.[21]

Table 3.1 shows the wide differences in the sources of fund raising among OECD countries. On average, Europeans receive somewhat less from institutional investors, foundations and

[20] Bain & Company (2015), and Gopalan (2016).
[21] Invest Europe (2016b).

endowments than in the United States but more from sovereign wealth funds and government entities.

Table 3.1. Sources of Funding for Private Equity by Region, 2016

As a percentage of total

	Europe	United States	Japan	Australia	Canada
Banks	4	5	18	0	0
Capital markets	1	6	11	0	0
Corporate investors	6	6	53	9	16
Endowments and foundations	3	23	0	4	0
Family offices	6	9	0	3	14
Fund of funds	27	6	8	15	20
Government agencies	15	3	0	1	17
Insurance companies	6	7	2	0	0
Other asset managers (including PE houses other than fund of funds)	3	4	4	2	0
Pension funds	16	22	4	34	23
Private individuals	0	0	0	5	11
Sovereign wealth funds	0	3	0	20	0
Unclassified	13	6	0	7	0

Source: Sources: Invest Europe, Preqin Investor Intelligence, Private Equity International, CVCA, and AVCAL. Data from the United States refer to 2014.

In Japan, investors tend to allocate funds on a pan Asian basis. It is estimated that 49% of commitments profiled are to funds that focus on the entire Asia-Pacific region. Of these, just over half invest in Japan only. Corporates comprise the largest proportion of Japanese LPs. Data from Private Equity International indicate that these institutions invest 89% of their funds in venture capital and growth equity strategies. Banks/Financial Services are the second most active category type of institutional provider of funds. Japanese public pension plans are far less active than their corporate counterparts elsewhere, with only the Japanese Government Pension Investment Fund (GPIF) and the Pension Fund Association (PFA) active. The GPIF has not yet invested into the asset class, but it indicates that it has firm intentions to do so. The PFA currently allocates 2.3% of total investments to private equity and has plans to increase this allocation further. Growing interest in private equity - as well as infrastructure - from Japanese pension funds was the main motive for Partners Group to establish a joint venture with the Mizuho which will develop and distribute private equity and infrastructure products to the Japanese pension market.[22]

In Australia, one of the distinguishing characteristics of the PE market is the prevalence of foreign investors, especially from Asian countries. Overseas investors overtook domestic investors as a source of new commitments in FY2015, accounting for USD 2.1 billion (70%) of total new funds raised. New commitments from Asia surged by 261% from the previous year, to USD 920 million, compared to USD 856 million by Australian investors. Asian investors accounted for 30% of all new PE and VC commitments, whilst Australian investors accounted for 28%. Meanwhile, North American and European LPs increased their contributions to Australian PE fundraising from 16% and 3% in FY2014, respectively,

[22] Private Equity International (2016)

and to 23% and 9% in FY2015. Pension funds were again the biggest source of capital for PE in FY2016, contributing 34% of total PE funds, followed by industry funds (25%), and fund-of-funds (15%).[23]

The data also reveal very sharp differences among European countries (See Table 3). In the United Kingdom institutional investors such as pension funds and insurance companies are the main suppliers of funding for this sector. Pension funds are major investors in the Nordic countries and to a lesser extent in the Netherlands. These countries have large holdings of institutional assets and the supervisory authorities responsible for pensions and insurance have been willing to permit investment in these instruments. In Switzerland, large pension funds exist, but they are apparently not major private equity investors. The role of pension funds is less prominent in most other countries.

France has a comparatively high share of public capital as a source of funding. This is partly due to the heavy presence of officially operated investment funds that obtain funding from public sources but invest alongside private investors. Thus, public funds provide about half of all resources in venture capital funding and more than 25% of growth capital funds. The share of public entities is also high the Netherlands. In Germany, the year to year changes in the share may be explained by very large individual operations, sometimes supported by official institutions.

The countries of Southern Europe (Greece, Italy, Portugal and Spain), which all have very small private equity sectors, are characterised by a concentration of investors in the form of private individuals and family offices, along with a paucity of institutional investment.

Table 3.2. Sources of Funding for Private Equity in Europe, 2015

As a percentage of total

	Banks	Insurance	Official	Pension funds	Family offices	Corporate	Sovereign wealth fund	Fund of funds	Other
UK, Ireland	4	11	3	29	8	2	15	20	8
Germany, Austria, Switzerland	11	1	68	3	14	2	0	1	0
France, Benelux	2	12	27	10	18	6	4	18	3
Nordics	10	3	13	21	8	0	21	15	8
Southern Europe	4	3	17	10	39	0	0	28	1
CEE	6	0	48	16	8	8	0	9	5

Source: Invest Europe

The countries of Central and Eastern Europe are distinctive.[24] With the exceptions of Hungary and Poland, the markets remain very underdeveloped. At the same time, these countries depend upon foreign sources for funding. Most funding is provided by international organisations, such as the EIF and the EBRD. Even the non-official sources of funding (e.g. institutional investors, fund of funds, family offices, etc.) tend to be foreign rather than domestic. Due to the region's historical circumstances, the accumulation of personal and family wealth, as well as the development of foundations and endowments, are still rudimentary. There have been sizeable efforts to develop domestic institutional

[23] AVCAL (2015)

[24] See EVCA (2015)

investors especially through funded pension schemes, but in many cases the financial supervisors discourage investments in unlisted securities.

3.1.5. Trends in private equity in OECD countries and regions

On several occasions in the past two decades, the private equity market has been subject to wide cyclical swings as private equity funds, both in Europe and the United States, have periodically attracted pools of money that exceeded their capacity to invest productively. One of the factors driving activity in the global private equity market—and exaggerating cyclical swings in the markets—have been trends in corporate equity valuations, i.e. the prices at which companies are traded in relation to various measures. Some of the commonly used metrics are price to earnings and price to book value. Prices in the private equity market markets tend to move in tandem with prices of listed companies. Thus, when multiples are high and investors are willing to accept high valuations, it is fairly easy to unload companies from private equity fund portfolios and activity and GPs will realise attractive gains. Conversely, when the market is stressed, exits will be difficult. One of the factors driving the present boom in private equity has been the rising global trend of corporate valuations. An additional factor has been the historically low returns on conventional investments as returns on low-risk assets, especially government bonds.[25]

Activity of all kinds in the global private equity market (e.g. fund raising, investments and exits) soared just before the year 2000 as the dotcom bubble reached its apex. Many companies that were not ready for investors obtained funding while initial public offerings (IPOs) reached a record high as investors poured huge sums of money into the industry. It is now almost universally agreed that the funds that investors poured into the market greatly exceeded the capacity of the industry to deploy those funds usefully. With the bursting of the speculative bubble after 2000, years of sluggish activity ensued. In 2005-07 activity appeared to be gaining traction, but it again dropped off sharply with the GFC in 2007. It is noteworthy that despite its periodic instability, the private equity market has rebounded strongly from each crisis.

Both fund raising and investment are recovering at this time. Meanwhile, spurred by high valuations for companies, exits in Europe and the United States now are at record levels. Since about 2010, investors of various kinds have been increasing their commitments to this asset class at a rapid pace. This partly reflects the inherent attractiveness of the asset class, but to some degree it also reflects the compression of yields in traditional markets, especially fixed income markets. Consequently, there is a growing amount of "dry powder" in the market, meaning that substantial amount of resources is committed and available for investment. This can be seen in Table 3.3, which shows global fund raising and non-invested capital ("dry powder") since 2010. As the table indicates, fund raising in North America and Europe doubled between 2010 and 2015. Following a slight dip in 2015, rapid expansion ensued in 2016. Although the United States remains the world's biggest market, Europe has narrowed the gap. Meanwhile, Asia has essentially remained at the same nominal level of activity as in 2010 with its relative share declining while countries outside of Asia, Europe and the United States have contracted in nominal terms.

[25] This point is agued at length in OECD (2016).

Table 3.3. Global Private Equity: Fund raising and un-invested Capital, 2010-16

In USD billions

	2010	2011	2012	2013	2014	2015	2016
North America	80	87	95	176	189	168	199
Europe	40	44	64	86	77	70	116
Asia	36	54	42	37	58	37	40
Rest of world	16	17	18	12	15	12	9
Total	172	202	219	311	339	287	364
Global un-invested capital ("dry powder")	622	601	565	666	695	752	869

Source: Preqin.

Despite a steady rise in investment, dry powder continues to increase to record levels. On balance, there is a large amount of resources at the disposal of the world private equity industry that is eagerly seeking attractive deals. One possible explanation for the rising level of dry powder is that the willingness of investors to supply funds that will be invested at very high rates of return is outrunning the capability of investment professionals to find opportunities that can satisfy these criteria. In effect, this could mean that high rates of return in this market sector and/ or the very high rates of remuneration of GPs may come under downward pressure.

There were slight variations on this general pattern in various world regions. Table 3.4 shows trends in the middle market private equity market in the United States. Middle market fund raising hit a high point in 2007, but as the crisis deepened and spread, the number of new deals declined while private equity funds had difficulty deploying the funds that had been raised. From about 2011 onwards, fund raising had almost recovered to its pre-2007 levels. Meanwhile, in terms of funds actually invested, activity was already back to pre-2007 levels by 2014. In 2015-16, fund raising and investment were off marginally. During this period, patterns of the use of debt have changed. Before the GFC, private equity deals tended to be leveraged by a factor of 2:1.[26] Use of debt declined during the GFC and at the trough of the cycle in 2009 debt accounted for less than half of the total market. Subsequently, leverage has returned to pre-GFC levels. Indeed, preliminary data suggest that in 2014-16 leverage levels have been pressing against historic ceilings.

Table 3.4. Trends in Middle Market Private Equity in the United States, 2007-16

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Number of funds closed	193	172	99	94	117	119	169	177	165	164
Funds raised (USD billion)	121	113	77	52	86	90	108	133	125	110
Number of deals closed	1 861	1 284	719	1 299	1 460	1 876	1 704	2 155	2 159	1 908
Capital invested (USD billion)	352	194	94	237	272	318	301	441	400	367
Number of Exits	735	483	287	652	731	879	813	1 060	1 056	860
Value of Exits (USD billion)	89	44	26	75	79	90	75	120	110	78
Median debt (%)	63	60	49	57	53	57	65	65	65	NA

Note: These figures include only SMEs using the US definition whereas earlier tables covered all private equity.
Source: Pitchbook (2016).

[26] Every unit of equity invested in the average deal was supported by one unit of debt.

As noted previously, a private equity investment ends with an exit. Exits occur when the fund disposes of the companies in its portfolios and the proceeds of the exit are distributed to investors. According to data from Pitchbook, exits were at record levels in 2014-15, surpassing the high levels reached before 2007. At present, most exits take the form of sales to corporate acquirers and this share has risen appreciably since the GFC, reflecting strong demand to acquire new companies and build synergies in the corporate sector. The share of exits through secondary buyouts (i.e. sale to another group of investors) has declined. At the same time, a small share of exits occurs through Initial Public Offerings (IPOs) where the equity of the firm is floated on a recognised public exchange. The number and value of exits declined somewhat in 2016, but remain just below their historic high levels.

Table 3.5 shows major trends in the amounts invested in the SME sector of the European private equity market from 2007-16. Unlike earlier tables in this report, these figures cover only companies with less than 250 employees. In keeping with the practice of Invest Europe and most national associations in Europe, the data are divided into a) venture capital, b) growth capital and c) buyouts. As in most segments of the markets before the GFC, activity was rather robust but a sharp contraction ensued, especially in fund raising. The pattern of post-GFC rebound has been similar to the global trend and by 2016, levels of investment were back to pre GFC levels. The composition of operations changed significantly, however. Essentially, venture capital has contacted substantially over the period with the number of companies financed down slightly and the volume of financing off sharply. Buy-outs remained at about the same level in terms of companies financed and increased somewhat in terms of volume. The most dynamic sector in private equity has been growth capital where five times as many companies were financed in 2016 as compared to just before the GFC. In that same period, the volume of financing has expanded at a similar pace.

Table 3.5. Trends in Private Equity in Australia, 2006-16

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Total Private Equity										
Number of companies	4 072	4 580	4 065	4 191	4 135	4 339	4 412	4 773	4 272	4 897
Value (EUR billion)	13.1	13.1	8.1	11.0	12.1	10.7	9.7	12.6	14.5	14.7
Venture Capital										
Number of companies	3 178	3 556	3 086	2 986	2 922	2 947	3 018	3 199	2 800	3 031
Value (EUR billion)	5.1	5.7	3.5	3.4	3.5	3.1	3.3	3.5	3.6	3.6
Buy-outs										
Number of companies	602	608	358	415	432	473	429	513	516	493
Value (EUR billion)	6.0	5.7	2.9	4.4	6.1	4.6	4.3	5.7	7.3	7.6
Growth Capital										
Number of companies	222	326	517	685	721	855	904	1 023	908	1 436
Value (EUR billion)	1.4	1.1	1.5	2.9	2.3	2.8	1.6	3.3	3.4	3.3

Source: Invest Europe

Table 3.6 shows the private equity sector in Australia, where activity is still below its pre-crisis levels, but it is accelerating. The drop-off in activity was particularly sharp with respect to fund raising which is still well below pre-crisis levels. Smaller companies (i.e. those with enterprise value of less than AUD 250 million) have accounted for the preponderant share of activity in the past few years. Fund raising activity notably picked up in 2015, but trailed off somewhat in 2016 ending 30 June 2016. Investment activity has been rising steadily. After a string of successful exits in FY 2014, GPs took advantage of

new opportunities arising in the local market to replenish their portfolios. In 2016, venture fundraising rose to a record AUD 568 million level while private equity fundraising retreated somewhat. Dry powder reached AUD 7 billion as at 30 June 2016, across 60 private equity and venture capital funds. Almost 87% of this amount was held by private equity fund managers in 39 funds. Buyout and later stage funds accounted for 52% of the total private equity dry powder.[27]

Table 3.6. Trends in Private Equity in Australia, 2006-16

	Funds raised			Funds invested	
	Number of GPs	Funds raised	Amount (AUD million)	Number of companies	Amount (AUD million)
2006	32	15	4 093	118	3 128
2007	36	20	8 690	106	5 837
2008	36	17	2 052	103	4 194
2009	40	14	1 034	113	2 916
2010	45	9	1 190	97	2 156
2011	40	10	2 014	86	3 801
2012	39	15	3 031	70	3 080
2013	34	11	720	67	2 729
2014	35	9	933	67	2 120
2015	36	7	2 702	84	3 269
2016	36	7	2 170	60	3 680

Source: AVCAL

A surge in interest from investors from Asia has been noted as alone equalling the level of new commitments by Australian investors in 2016. Among domestic investors, Australian superannuation funds accounted for 54% of total fundraising, with the balance coming from private individuals and corporates.

Table 7 shows the volume of investments in Canada.[28] Although a full data set is not available for years before 2013, the Canadian Venture Capital and Private Equity Association (CVCA) reports that the country followed the trend observed in other markets and is now approaching levels experienced before the GFC. Although the number of deals has been rising steadily through 2016, the volume of activity in 2014-15 was swollen by a few mega-buyouts.

Despite the fall in total volumes invested, CVCA Reports that in 2016, investment in the middle market was buoyant with CAD 1.5 billion invested over 43 deals in the CAD 20-50 million deal size range, an increase of 41% invested (over 34 deals) in 2015. For transactions of less than CAD 20 million, there were 461 deals with total value of CAD 1.1 billion. At CAD 3.2 billion, 2016 venture capital investment exceeded 2015 by 41 per cent, the highest growth rate on record since 2001. The two sectors with the largest amount of activity were ICT, with almost CAD 2 billion invested in 330 deals, and Life sciences, with investments of CAD 730 million over 103 deals. Early stage companies received CAD 1.6 billion (half of all venture capital investments) over 261 deals, up 29% from 2015's CAD 1.2 billion.

[27] AVCAL(2016.)

[28] Due to problems with databases, figures before 2013 are not available from CVCA.

In Canada, the data may somewhat understate the extent of actual activity. Canadians take part in the domestic private equity market as well as in a broader North American market, where the dominant player is the United States. Thus, a Canadian firm may seek private equity funding in a deal where many of the investors are from the United States, or Canadian LPs may invest in a deal in which the targeted company is in the United States.

Table 3.7. Trends in Private Equity in Canada, 2013-16

	Number of GPs	Funds Invested	Amounts (CAD billion)
2013	34	268	11.3
2014	35	335	42.2
2015	36	424	22.9
2016	NA	536	13.7

Source: CVCA.

It is worth repeating that in all OECD regions, including the United States, Canada, Australia and Europe, the private equity sector has raised considerably more than it has invested. The private equity industry has large cash resources and is actively seeking new deals. Thus, the main impediment to even higher levels of activity is the availability of investment-ready deals at current expected rates of return.

3.2. Private debt/ Alternate lenders

3.2.1. Structural characteristics of the private debt market

Before turning to the detailed analysis of the private debt market, it is useful to situate this market in a wider institutional and historic context. There are a number of capital market segments and instruments that specialise in lending to SMEs. Some of these have been functioning for decades, while others have been established since the financial crisis as banks reduced lending to SMEs in its immediate aftermath. Some of these instruments were developed spontaneously by private market participants, and others had substantial official support.

Due to their heterogeneous nature, any categorisation of these instruments is problematic. In an article that is partly aimed at identifying the various categories of operation, Kraemer-Eis (2014) identifies three kinds of direct lending models by non-banks.[29] The first kind, described as "private placement," is a well-established market in which banks sell loans to investors (especially insurance companies) seeking a predictable stream of payments in which credit risk is easily managed. It should be noted that, while a significant part of the loans traded in this market are SME loans, most are not. The investor must develop some capability to analyse the credit risks of the borrower. This market is very well developed in the United States, where it is probably still the largest single source of capital market financing to SMEs. For example, according to data from Thomson Reuters, average annual volumes of new middle market issues in the United States have amounted to USD 150-200 billion in the period 2010-15. This market has been expanding in many European countries.

[29] Kraemer-Eis et al (2014). For discussions of the broader market in SME debt, also see Nassr and Wehinger (2015).

A similar instrument that has existed for many decades is the *Schuldschein* market in Germany.

The same article identifies a model of co-origination as second category, which has become fairly widely used in Europe where a bank agrees to originate loans and to pass all or part of the loans to investors, mostly insurance companies. These operations involve risk-sharing arrangements to facilitate the alignment of incentives between the bank and the investor. In a number of European countries, private market participants with the support of the authorities are developing special facilities under which banks originate portfolios of claims on SMEs which are shared with investors.

The common characteristic of both these operations is that they essentially represent means for the banks to transfer assets to non-banks while maintaining borrower relations and earning origination fees. The loans that are sold to investors in this way are often the traditional low/risk low return loans from banks to SMEs. These loans tend to be of longer maturity than those that banks keep on their own books. The Financial Stability Board (FSB) designates these markets as part of the "shadow banking system."

A third category, "specialised loan funds" correspond to the term "private debt" as discussed in this paper. In this mechanism, the originator, who is typically not connected to a bank, originates a portfolio of loans to SMEs which are placed in a fund that is managed in the same way as a portfolio of equity under a private equity operation. The separation between the bank and the capital market intermediary is much sharper and the loans packaged in this manner tend to be higher/risk higher return loans. Such structures can be similar to securitisation of diversified portfolios; other transactions are closer to private equity and the loans represent the debt components of leveraged private equity operations.

Kraemer-Eis introduces a second dimension by which debt investment funds may be categorised; a diversified fund versus a selective fund. In a diversified fund, a portfolio of loans is bought from an originating bank, which keeps the relationship with the borrower and services the loans. These funds (sometimes sponsored by banks) are characterised by risk sharing between investors and the originating bank. Diversified funds often base investment decisions on sponsor and/or third party's rating system(s). In general, these funds originate packages of low risk low return loans. Diversified funds can be contrasted with selective funds which represent selected portfolios of designated kinds of fixed income asset that are assembled, based upon the asset managers capability to build more concentrated portfolios by screening attractive opportunities while measuring and pricing credit risk. In general, these assets in the fund will be higher risk with higher expected return.

The private debt market (also alternative lender or specialised loan funds) is a new category of capital providers has emerged that uses the private investment partnership as an investment vehicle but engages in debt rather than equity finance. Many of the legal and institutional features of this instrument were imported from the private equity market. The institutions that have emerged as financial intermediaries in this sector are already rather diverse and are becoming more so as new kinds of institutions enter the market. "Alternative lenders" may be specialised subsidiaries of larger financial groups (which may include some banks) or independent asset managers. In the United States, more recent entrants range from publicly-listed venture capital companies, through community banks, to financial technology (also known as FinTech) enterprises. Credit hedge funds have

become active in the market as well, as well as some official entities. A recent trend in the industry is for institutional investors to sponsor their own funds.[30]

One sign that direct lending is an increasingly mature sector, is the emergence in the United States of finance companies specialised in alternative lending. These specialised groups use this financing technique in a variety of sectors, including for SME lending. For example, infrastructure finance has been a sector in which the use of alterative debt vehicles has gained prominence.

The private market is not exclusively a market in loans to SMEs, however, and some lenders specialise in other categories of lending. However, the SME sector is a major area in which alternative lenders operate. Thus, in a recent survey by the Alternative Investment Management Association (AIMA), 77% of funds indicated that SME lending was one of the sectors in which they held some of their portfolio.[31] In the same survey, lenders indicated that more than 80% of lending was for acquisitions and expansion with much smaller shares for working capital and bridge finance.

For reasons already detailed in this report, commercial banks tend to prefer the low risk/low yield parts (i.e. senior and secured debt) of the market. They generate earnings by performing various services for their corporate customers as well as from lending by providing working capital. Additionally, they wish to retain some liquidity since they may have to contract their exposure. Alternative lenders, unlike banks, operate in a wider spectrum of the risk/ return continuum, such as subordinated debt, second lien debt or distressed debt, where risk and return are higher, but they still assume less risk than equity investors. Suppliers of funds to alternative lenders are willing to commit some portion of their assets to operations of higher risk and less liquidity, but will also expect higher returns. Alternative lenders will not consider deals with yields below a specified "hurdle" rate. In contrast to private equity lenders who expect income to come in the pattern of J-curve, investors in private debt expect positive cash flows throughout the investment period.

One of the advantages of the private debt markets (as opposed to banks) is its superior capacity to deal with liquidity and funding risks. Banks depend upon relatively short-term deposits for funding and therefore are exposed to withdrawals of deposits in difficult market conditions. Alternative lenders have effective means to match their claims and their funding, using private investment partnerships similar to those in the private equity market in order to commit investors to long-term funding. It is estimated that some 2/3th of funds are closed-end, with most having maturities in excess of 3 years.[32] Even in cases where investors have enlarged flexibility to liquidate their position, fund managers are increasingly imposing restrictions whereby the invested funds cannot be redeemed before a specific "lock-up" period expires.

Although private debt is in competition with traditional bank debt to some degree, there is significant complementarity between these two providers of debt capital, in part due to the higher risk appetite of the former. For example, the AIMA study reveals that almost 80%

[30] For example, see TIAA CREF (2015).

[31] AIMA (2016).

[32] AIMA (2015).

of companies financed by alternative asset managers have obtained bank co-financing; an increasingly common recent pattern is for banks and non-banks to lend cooperatively, with banks preferring to retain the primary customer relationship and continue to provide less capital-intensive products and services.[33] In this way banks can use non-bank lending partners to meet their customers' credit needs without using scarce capital. The great majority of deals in the market are sponsored by a private equity firm.

3.2.2. Trends the private debt market and sources of data

Since this segment of the market has only recently reached proportions that can affect the market in SME finance, the data are incomplete. Moreover, most of the data are produced by private information providers or vendors and are not regularly made available to the general public. The main supplier of data on the global alternative lending market is Preqin, based in the United States, which produces data for sale. One group that has been producing highly useful data on this market segment is Deloitte (London) which produces a quarterly *Deal Tracker*, a major source of information on the European market. At this stage Deloitte provides significant information on the number of deals concluded in various geographic areas, as well as about the characteristics of deals, but aggregate data in terms of actual volumes of credit outstanding is not yet available on a regular basis.

Preqin estimates that between 2006 and 2015, the global private debt industry has nearly tripled in size, with AUM increasing from USD 152 billion to USD 440 billion (See Table 3.8). Almost 1/3th of this market consisted of "dry powder" (unused capital commitments), meaning that substantial funds for new investments are on hand. Preliminary figures suggest that the pace of expansion may have moderated in 2016. Thus, total assets under management of the Private debt industry rose from USD 555 billion at the end of 2015 to USD 595 billion in June 2016 while dry powder rose from USD 216 to USD 224 billion over the same period.

Table 3.8. Global Private Debt Market: Fund Raising by Region, 2011-15

In USD billion

		2011	2012	2013	2014	2015
North America		31	36	37	47	54
	Percent of World Total	66	58	66	64	59
Europe		13	18	18	23	31
	Percent of World Total	28	29	32	31	34
Asia		3	8	1	3	6
	Percent of World Total	7	13	1	4	7
Total		47	62	56	73	90

Source: Preqin.

It is noteworthy that this market has expanded steadily, with no visible slackening during the GFC. The largest single market is the United States with around 60% of the world total, but the fastest growth is occurring in Europe whose share since 2010 has grown from 10% of the world market to 30% at the end of 2015. In terms of new funds raised, Preqin estimates that Europe-focused private debt fundraising increased 35% in 2015, with 29

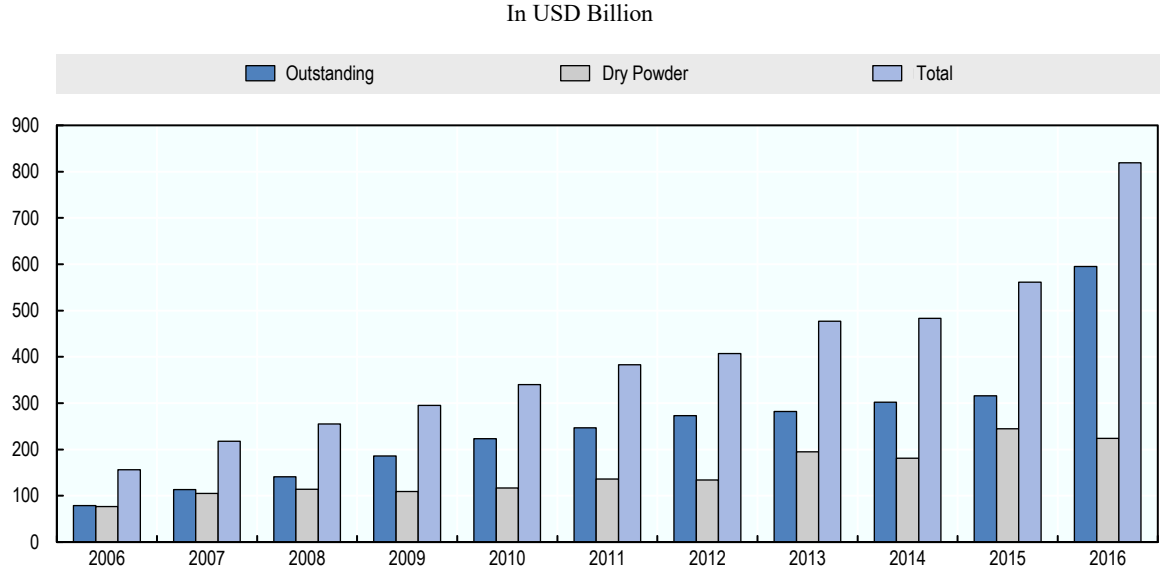
[33] AIMA (2016.)

funds reaching a final close and raising an aggregate USD 31 billion, compared with USD 23 billion across 39 funds closed in 2014. Meanwhile Europe-focused funds collected 34% of total capital raised within private debt, as the European share of global fund raising continued to rise steadily. Moreover, the AIMA surveys of potential lenders indicate that investors see the potential of Europe as very high. The survey revealed that eight of the nine markets with highest potential were in Western Europe.

The largest market in Europe is the United Kingdom, but substantial activity has been observed in France and Germany. Potentially, the growth of this market segment has greater significance for the supply of capital to SMEs in Europe over the United States, where several channels for alternative debt finance are already operating. The Deloitte Deal Tracker indicates that through the third quarter of 2016, there was some moderation of growth. An actual decline in the volume of business in the United Kingdom was offset by growth elsewhere with the volume in France up especially sharply. Some growth was visible in Italy in 2016 although activity remains sparse. The AIMA survey indicates that lenders see Italy and Spain as markets with better than average prospects for expansion.

Figure 3.2 shows the amounts outstanding under private debt funds and the amount of dry powder in the industry. As can be seen the amount of funds lent globally is approaching USD 600 billion while the amount of "dry powder" exceeds USD 200 billion. In other words, with the funds currently raised the private debt industry could increase lending by almost 40%.

Figure 3.2. Outstandings and "Dry Powder" in the Global Private Debt Market, 2006-16



Source: Preqin

The private debt market which originally arose as an appendage of the private equity market is becoming a stand-alone section of the market. Until recently, virtually all of the private debt market was "sponsored", meaning that it was the leverage component of a private equity operation containing both equity and debt. However, in the past two years the sponsor-less share of total transactions has been rising. In the third quarter of 2016, the sponsorless portion of total transactions in Europe stood at 27% but many analysts expect

further increases in sponsor-less deals as this part of the market becomes better known.[34] The private debt market could conceivably compete with more traditional parts of the debt market, although the high levels of fees in this market constitute a barrier to expansion at this time.

[34] Deloitte Deal Tracker, fourth quarter 2016.

4. Public Capital Markets

4.1. Limited use of public markets by SMEs

The preceding discussion covered the private capital market. This section explores investment possibilities for the general public (or retail investors) in the SME sector. Entities wishing to offer investment instruments to the general public must accept the obligations in terms of disclosure and investor protection imposed by the official entity in charge of capital market oversight as well as possible additional requirements of self-regulatory organisations (SROs). Whereas the private markets can operate when the participants agree informally among themselves on how to conduct business, public operations require a defined legal and regulatory framework.

Regulations usually require adherence to standards of transparency and disclosure in which the issuer must produce an offering prospectus and make periodic disclosures of relevant data. Additional regulations typically cover issues such as insider trading and other forms of market manipulation. In the case of equity investments, still further requirements are imposed to safeguard the rights of minority shareholders.

Use of public markets imposes significant burdens on the issuer in terms of reporting requirements with associated costs and also exposes the company to risk of litigation for failure to comply with investor protection laws and regulations. Even many larger companies choose to use the private markets partly to avoid these burdens of public markets.

Many SMEs have characteristics that make them ill-suited to public markets; they are opaque, they are usually closely held and they do not produce information on a scale that would be required to support use of the public market. Despite these inherent problems, some SMEs have succeeded in issuing modest amounts of bonds and equities that are available to retail investors.[35]

4.2. Collective investments in the SME segment: closed-end funds

The main way in which retail investors can invest in SMEs is through the use of collective investment vehicles. One of the major developments in the financial systems of OECD countries in the past few generations has been the emergence of collective investment as the main channel though which individuals participate in the capital market. These instruments are known by various names in OECD countries, including mutual funds, unit trusts, investment companies and investment trusts. This report refers to all of these instruments as Collective Investment Schemes (CIS), the generic term favoured by the International Organisation of Securities Commissions (IOSCO) which brings together securities regulators from all over the world.

Whatever its name in a given jurisdiction, collective investment instruments enable individual investors to resolve the dilemma that while many opportunities are available in the capital market, most individuals lack the requisite skills to invest profitably and cannot

[35] For a discussion of SMEs' use of public equity and debt markets, see Nassr and Wehinger (2016) and (2015) and OECD (2015a).

afford sufficiently diversified portfolios or efficiently execute investment strategies. A firm specialised in investment management creates a fund for collective investment with a stipulated investment strategy and markets the fund to the public. The investor acquires the right to proportional shares in assets of the CIS and the income generated by those assets in the form of interest, dividends and capital gains.

As with all publicly offered investments, the process of collective investment must take place inside a recognised legal and regulatory framework. The legal structure for a collective investments vehicle must be established by law and typically the supervisory authority responsible for capital markets sets standards for investor protection. Most countries have reasonably well-developed markets in CIS with attendant legal and regulatory frameworks, but the system is generally oriented toward open-ended funds that trade liquid securities (See Box 4).

Box 4.1. SMEs and open-end funds

The great majority of CIS in most countries are open-ended funds, meaning that no fixed number of units is issued. The assets in the fund are valued at specified intervals under a prescribed set of rules. An investor purchasing a unit of the CIS acquires a proportional share of all the assets in the fund at net asset value (NAV) at the time of purchase, and the inflow from this investment leads to the creation of new units in the CIS. Similarly, an investor who liquidates a position in in the CIS does so at the NAV at the time of sales, with the number of outstanding units reduced. Traditional CIS hold liquid securities, NAV is set at short intervals (usually daily) and investors may buy or redeem shares on any day. Transparency in pricing and liquidity are essential components of a thriving open-end CIS market.

A certain number of open-end CIS that invest in the SME sector are found in OECD countries, but there are natural limits on the size of this market segment. The strongest factor limiting the development of open-ended CIS to invest in SMEs is that CIS generally invest in publicly offered securities that are transparently priced and have liquid markets. For reasons discussed throughout this report, most of the securities issued by SMEs do not trade sufficiently in order to have transparent pricing. Therefore, the supply of assets from which an SME-oriented open-end CIS can be constructed is limited. An additional problem stemming from the scarcity of liquid securities is that open-ended CIS have problems with large net inflows and outflows. Consequently, if investors decide to move into a CIS specialising in the SME sector, CIS will have difficulty deploying the funds and this may have to hold large portions of their portfolios in cash equivalents. Conversely, if investors seek to liquidate positions, the CIS cannot sell such assets without provoking an extreme drop in price.

There are a number of small capitalisation equity funds in many markets, but usually only a small number of listed companies that can be included in their portfolios. Many investment analysts have made credible arguments that small capitalisation companies tend to outperform larger companies and have founded a sizeable number of "small cap" funds in many OECD countries. Those firms that are available tend to be the largest in the middle market. There is also some possibility to include some illiquid assets in a larger open-end CIS. However, illiquid assets without transparent prices pose a problem for fund valuation and in any case the supply of such assets is small.

Source: Hulbert (2015) and Damodaran (2014).

One collective investment vehicle that can be adapted to SMEs is the closed-end fund (CEF). A CEF issues a fixed number of shares that are not redeemable by the fund, with investors receiving shares proportional to their individual investment. While a CEF is a publicly offered investment and therefore subject to a formal regime of investor protection, it may invest in private or unlisted securities, i.e. those that are not issued on a public market and are not subject to full official disclosure and investor protection

regimes.[36] In Canada, some tax advantaged funds that invest in illiquid claims on SMEs use an open-end structure, but this is exceptional (see below.)

Since CEFs can function with limited liquidity and opacity in prices, they are particularly relevant for SMEs. With respect to valuation, most private securities issued by SMEs do not trade sufficiently to use market transactions as a basis for valuation. Therefore, the net asset value (NAV) of a CEF is calculated using agreed accounting procedures and typically takes place at long intervals such as quarterly or semi-annually.

There are two basic approaches used in addressing the lack of liquidity and opacity of the assets of the CEF:

- A fixed life structure is similar to that of a private investment partnership, in which the fund aims to liquidate all the assets in its portfolio at the end of a pre-determined period. Investments are made so as to terminate operations at the end of its stipulated life. As in private equity and debt, all of the assets in the fund are sold and returned to investors by the termination of the fund;
- A listed "evergreen" structure. In this system the fund has a perpetual (i.e. "evergreen") life. Shares in the fund are traded on a recognised stock exchange. The price per share, which is determined by supply and demand, is usually different from the underlying book value or net asset value (NAV) per share of the investments held by the fund. The fund is said to be at a discount or premium when it trades below or above the NAV, respectively.

There are advantages and disadvantages to both systems. On the one hand, the fixed life structure has very little liquidity and the investor must wait until the fund is liquidated to recover the full investment. On the other hand, the investor is assured of collecting all of the value of the assets in the fund. The evergreen structure has higher liquidity since the investor can sell the investment at any time. At the same time, the investor may have to sell at a discount to NAV. If the discount should widen the return on the investment will be low even if earnings on the underlying portfolio are high. In the case of evergreen facilities, the investment manager usually has the option of winding up the fund by selling the assets in the fund and distributing the proceeds to investors.

SME-oriented CEFs usually operate under the general supervisory regime for CIS, but often with a special additional legal and regulatory framework for SME-oriented vehicles. Rules and standards will cover issues such as valuation of portfolios, practices for redemption of shares and return of investment as well as rules governing disclosure. Each of the investment vehicles discussed in the rest of this section have been specifically authorised by the securities regulators of their own countries.

The common characteristics of these Collective Investment Vehicles (CIVs) for SMES are

- CIVs mostly operate as CEFs under a special legal framework designed to accommodate the special needs of retail investors seeking to invest in the SME sector;
- Laws and regulations prescribe the assets that may be included in the portfolios of CIVs usually requiring a high share in claims on eligible SMEs;

[36] There are some private CEFs; this Report only considers public CEFs.

- Most CIVs are authorised to use leverage within limits;
- The CIV receives earnings in the form of interest and dividends from companies in its portfolio and pass them through to final investors;
- CIVs must pass earnings through to investors in order to maintain a favourable tax status;
- CIVs may engage in direct managerial interaction with companies in their portfolios.
- With the exception of tax-advantaged funds in Quebec (Canada) CIVs use the closed end (CEF) structure.

4.3. Country experiences

An overview of special collective investment vehicles for SMEs in selected OECD Countries, (Canada, France, United Kingdom and United States) is presented in Table 10. All these countries, (except Canada) use the CEF as the vehicle through which investment is conducted. The main difference between these mechanisms is that in United States and United Kingdom the instruments are listed on a stock exchange and trade regularly. Investors can exit at any time, but the price at which they exit will probably not be the same as net asset value (NAV.) In France the exit mechanism is through liquidation and sale at termination of the fund as in a private debt or equity partnership. There is limited possibility to exit at any other time and hence the investment must be held for a very long time.

Investors in the instruments in Canada, France and the United Kingdom who hold the assets for a prescribed time receive substantial tax relief. Investors in Business Development Companies (BDCs) in the United States have no special tax advantage. In addition, the Portuguese Government introduced a collective investment vehicle in 2017, which is summarised in Section 3.5.

Table 4.1. Collective investment vehicles for retail investors in SMEs in OECD countries

	Vehicle	Structure	Exit	Liquidity	Tax Advantaged?	Outstandings as percent of bank loans to SMEs[37]
United States	Business Development Company (BDC)	Evergreen	Sale on exchange	High	No	13
United Kingdom	Venture Capital Trust (VCT)	Evergreen or fixed life	Sale on exchange or upon liquidation	High	Yes	NA
France	*Fonds communs de placement dans l'innovation* (FCPI) *Fonds d'investissement de proximité* (FIP)	Fixed life	Payments as fund is liquidated	Low	Yes	3
Canada	Labour-sponsored Venture Capital Corporations/ Tax-advantaged funds	Evergreen or fixed life (Tax-advantaged funds in Quebec are open-ended)	Upon retirement or at end of contract (minimum 7 years.)	Very Low	Yes	NA

Note: National sources.

Until recently these instruments had only modest significance in the overall financing of SMEs in their respective markets. However, due to its rapid growth in the past few years, the BDC model has achieved a fairly prominent role in overall SME finance in United States. In Canada, the tax-advantaged fund is an established feature of the market in the province of Quebec and is an important part of the overall finance for SMEs, but of marginal significance in other provinces. In France and the United Kingdom, SME-oriented collective investment vehicles have attracted a certain amount of interest among investors but are niche products used by upper middle income households partly to lower their tax burden.

4.3.1. United States

The primary vehicle for investment in SMEs through public markets is the Business Development Company (BDC), a specialised CEF that invests in and small, growing, or financially troubled US-based businesses. A BDC combines the liquidity of a publicly traded instrument with the possible benefits of investing in growth or expansion stage companies. BDCs are regulated by the Securities and Exchange Commission (SEC), the federal agency responsible for capital market oversight with respect to investor protection. In many ways, BDCs structures and rules parallel those of Real Estate Investment Trusts (REITs) which are well-established similar vehicles that invest in real estate. In addition to the publicly traded BDCs discussed in this report, there is a smaller market in private BDCs which has operated since 2008.

The BDC industry was launched with the enactment of the Small Business Investment Incentive Act of 1980, which amended the Investment Company Act of 1940. The Investment Company Act is the basic law governing the CIS (mutual fund) sector in the United States. The objective of the 1980 law was to encourage investment in small, growing businesses by removing some of the restrictions under the 1940 Act that prevented private equity managers from offering their products to the public. At the time the law was enacted there was an expectation that there would be a flood of private equity and venture capital

firms seeking to form BDCs, but the expected surge did not materialise until after the year 2000.

Investors do not need to meet the income, net worth or sophistication criteria imposed on private equity investors. Also, unlike private investment partnerships, which are limited to small numbers of investors, BDCs have no such limits. Any person with a recognised brokerage account is eligible. Investments can be in very small amounts.

The status of BDCs as a CEF has both advantages and disadvantages. Managers of BDCs have access to "permanent capital" that is not subject to shareholder redemption as are open-end CIS. Because BDCs invest mostly in debt securities at rather high interest rates, they generally receive steady flows of income which is passed through to investors. Unlike the severe restraints on access to capital invested in a private investment partnership, the investor can always sell shares, but may have to exit at a price that is different from NAV. In effect this means that a new investor can sometimes buy existing shares at a depreciated price and receive high income flows whereas an investor who bought at a higher price might face a loss upon exit. At the same time, there are a few BDCs that have announced policies of terminating the fund at some future time. If a fund were to trade consistently at less than NAV, the fund managers could close the fund, wind down the fund and return all money to investors.

Investment portfolios

BDCs generally make investments in small to medium-sized privately held businesses, primarily in the form of debt, but sometimes with equity components. BDCs provide loans to small (EBITDAs of less than USD 10 million) and middle-market (EBITDA of USD 10 million- USD 50 million) businesses. BDCs have increasingly focused in recent years on debt and mezzanine and investments that generate current income rather than aiming for capital appreciation through equity. Most of the borrowers are unrated or rated as below investment grade. BDC investment may focus toward the top of the capital structure in senior secured loans or further down in subordinated or mezzanine debt. Target companies are mainly private companies with BDCs, private investment companies and banks as their sources of capital. Some BDCs originate loans, or at least significantly influence the terms of loans, while others purchase portfolios of syndicated debt.

A BDC must have at least 70% of its total assets in certain specified categories of assets: The main categories of qualifying assets are privately issued securities of "eligible portfolio companies". A US-based issuer can be characterised as an "eligible portfolio company" by meeting at least one of the following conditions:

- It has less than USD 250 million in common equity listed on a national securities exchange;
- It is controlled by a BDC meaning that the BDC owns more than 25% of a portfolio company's voting securities and an affiliated person of the BDC is a director;
- It is subject to a bankruptcy proceeding, reorganisation, insolvency or similar proceeding;
- It is a small and solvent company with total assets of not more than USD 4 million and capital and surplus of not less than USD 2 million.

A BDC has discretion to invest in any other investments with the remaining 30 percent of its portfolio. Collateralised loan obligations ("CLOs") are a common example of unqualified investments that BDCs hold. Other regulations limit portfolio concentration;

thus, no single investment can account for more than 25% of total holdings. The BDC investment Portfolio is usually much more diversified than a private equity partnership.

Portfolio valuations

As mentioned earlier, CIVs (in contrast to open-ended CIS) have difficulties in valuing their portfolio at frequent intervals by using transparent price data. In a small number of cases prices are available from trades on public markets, but this is the exception. BDCs mark their loan portfolio to "fair value" on a quarterly basis, with any unrealised gains or losses reflected on their income statements. Fair value is defined as the price that would be obtained to sell an asset or paid to transfer a liability in an orderly transaction between market participants at measurement date. An alternative definition set by the SEC is "fair value as determined in good faith by the board of directors." Fair value is determined by the BDC's management and board of directors, often with participation from internal auditors and third-party valuation firms which conduct yield analysis and enterprise value calculations to arrive at portfolio valuations. [38] Unlike banks, BDCs cannot establish loan loss reserves against future losses in their portfolios.

Leverage

BDCs have more flexibility to use leverage than other CIS. By using external credits, the pool of assets the BDC can support has a larger volume of financing with any given level of shareholder equity. BDCs typically borrow from banks and/or bond markets. Banks often provide a long-term credit facility to the BDC, which the BDC may use as a support for a bond issue. One of the commonly used markets for borrowing is the exchange traded bond (ETB) market, sometimes known as "baby bonds." Most ETBs have face value of USD 25 in contrast to a typical bond of USD 1 000. These bonds, which pay interest quarterly, often pay high coupon rates and have embedded call options. Under current regulations, BDCs must maintain a 200 percent asset coverage ratio, which equates to a 1-1 debt-to-equity ratio, which is less restrictive than the 300% asset coverage requirement imposed on traditional closed-end funds and mutual funds. Proposals to increase permissible leverage are under consideration in the Congress.

Assuming all goes according to plan, BDCs earn the spread between the interest rate on their borrowings (1.25%-4% in current conditions) and their lending rates (6.5%-15% in current conditions), depending on the borrower and their position in the capital structure.

Relationships with portfolio companies

Unlike most CIS, BDCs are not passive investors.[39] Rather, a BDC is required to make available "significant managerial assistance" to the companies in its portfolio. Making available significant managerial assistance means, among other things, any arrangement

[38] Sweeney and Roll (2014).

[39] The term "passive investors" means that most institutional investors, who are minority investors, do not actively engage management or provide positive advice with respect to the operations of the company. Currently, a major trend is "investor activism", which refers to actions mainly on the part of institutions in publicly traded companies. Institutional investors actively engage in communications with boards and management, as well as in exercising their voting and other ownership rights. Typically, institutional investors intervene to align the activities of the management and controlling shareholders with those of minority shareholders.

whereby the BDC, through its directors, officers or employees, offers to provide, and, if accepted, does provide, significant guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company through monitoring of portfolio company operations, selective participation in board and management meetings, consulting with and advising a portfolio company's officers or other organisational or financial guidance.

Fee structure, expenses and compensation

The fee structure of a BDC is similar to that of a private investment partnership. In most cases, the investment adviser receives a management fee equal (usually 1.75% to 2.5%) of the assets of the BDC's portfolio (including borrowings), paid quarterly in arrears. Under SEC regulations, open-ended CIS face severe restrictions on "performance" fees." By contrast the investment manager of a BDC is permitted to charge additional fees when investment result exceeds certain benchmarks. The investment adviser of a BDC also receives performance-based compensation, based upon success in generating net investment income. Net investment income includes interest income, dividend income but excludes capital gains. The fund pays the investment manager 20% of its cumulative realized capital gains less cumulative realised capital losses.

Tax status

Investors in BDCs receive no special tax benefits. However, the BDC itself pays no taxes as long as it distributes at least 90% of taxable income (interest and dividends) to investors. In practice, most pay out almost all taxable income (and all short-term capital gains). BDCs also pay dividends at a relatively stable pace as most of their portfolio investments are in debt securities.

Ownership and control linkages to other capital market intermediaries

BDCs are frequently part of larger financial groups. The financial group may include a full range of banking, capital markets and insurance business. Alternatively, they may be parts of financial groups that more narrowly focus on the middle market and offer a wider range of products than simply BDCs. Many BDCs operate as part of, broader investment "platforms" to finance SMEs that include other funds with investment strategies that overlap those of the BDC. The ability to use these broader platforms to access investment opportunities can be highly beneficial to the BDC and its shareholders (as well as to affiliated funds). Such a group may engage in private equity, manage an alternative debt fund, and issue "sponsored" debt in the loan market. The objective of the overall operation is to enable the company to effect the planned corporate transformation, using all relevant parts of the market. For instance, a deal may involve private equity for the equity component, the syndicated loan market and/or the private debt market for senior debt and the BDC segment for junior debt.[40]

Governance of BDCs

BDCs have an independent board of directors. Since the BDC is a widely held investment company with high monitoring costs and many investors having limited access to information, there are possible agency problems. The investment manager has an incentive

[40] The SBIC is considered of form of mezzanine finance. See OECD (2012).

to use leverage to increase the assets of the fund, since compensation is partly based upon AUM. There are also possible conflicts when shares of the BDC trade at a discount because at that point the investment manager may seek to repurchase shares. Many BDCs have come under scrutiny from activist investors who use various means to force management and the board to enhance transparency and to align the activity of the management with those of the shareholders. With the growth of the BDC sector and the 2014-15 slump in valuations, appropriate conduct by boards and investment managers is an area of active discussion.

Trends in the BDC sector

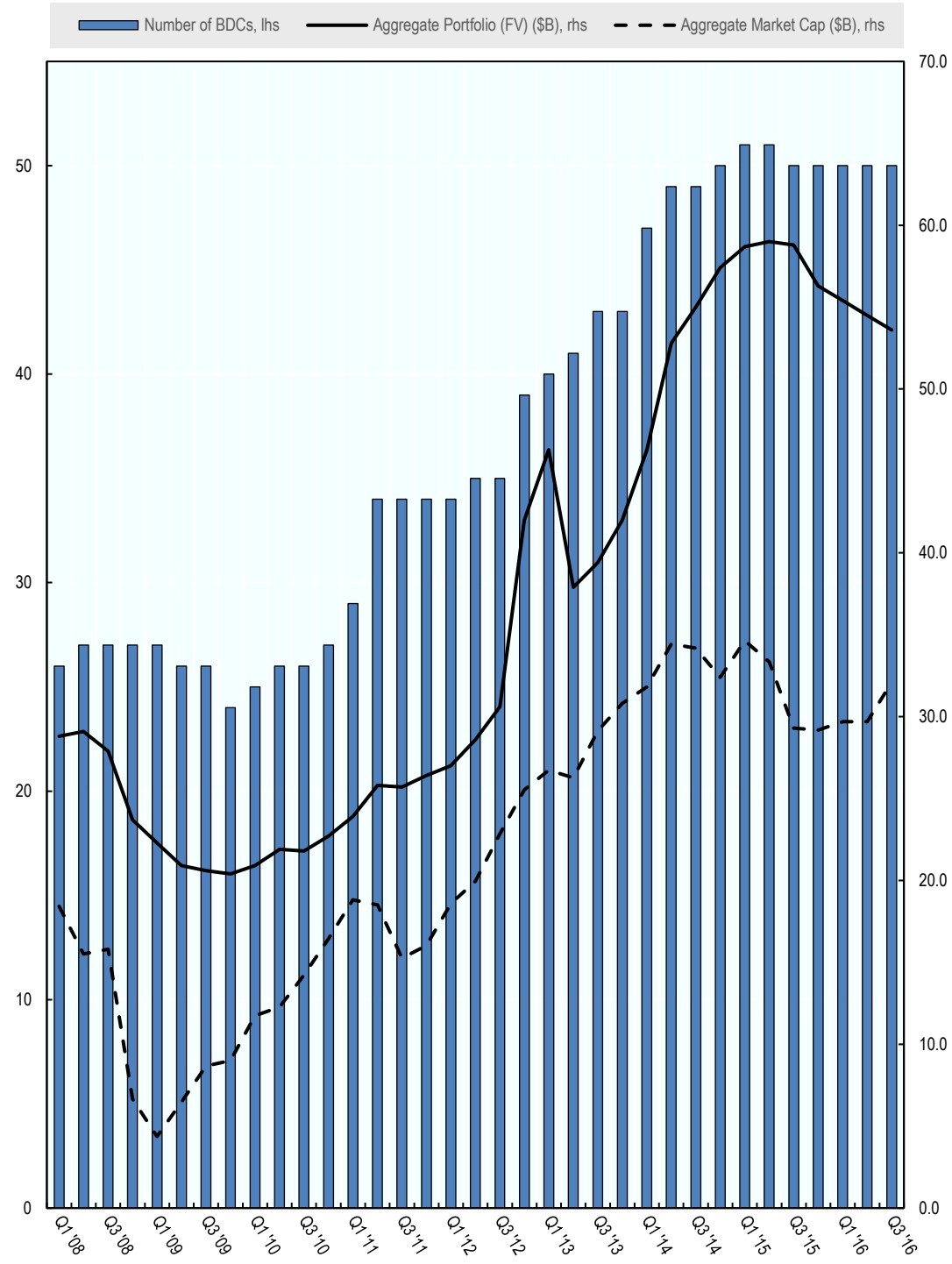
Although the industry was launched in 1980, only a limited volume of business took place until the year 2000. In 2000, there were only seven BDCs with USD 10 billion in assets under management (AUM).

After the year 2000, the BDC model gradually became accepted in the marketplace. Thus, investment bankers in the private equity sector regularly marketed sponsored debts to BDCs or banks could include BDCs in syndicates when selling loans to investors. A supporting infrastructure of research and information developed, with many investors becoming interested in the product. With specialised publications and the internet, investors could track BDC performance and evaluate the prospects of individual BDCs.

On the eve of the GFC, the aggregate assets of BDCs amounted to slightly more than USD 20 billion. In 2005-07 the BDC sector began a period of expansion that was momentarily cut short by the GFC. After 2008, BDCs emerged as major supplier of funds to SMEs. By 2015, there were 50 BDCs, with nearly USD 60 billion under management (see Figure 4.1). There was a small decline in late 2015 and in 2016. At the end of the third quarter of 2016 there were 48 BDCs with AUM of about USD 53 billion.

Figure 4.1. Activity in the BDC Sector, 2008-16

In USD billion



Source: Keefe, Bruyette & Woods, Inc..

In order to keep expanding business, BDCs must periodically raise new capital by issuing shares. The factors that affect the capability of the BDC sector to raise new capital are 1)

general sentiment in financial markets and 2) by the extent to which BDCs trade at premiums or discounts. Issuance of new shares of BDCs has therefore tended to be concentrated. As can be seen in Table 10, issuance tends to rise when BDCs trade above book value, but becomes more difficult when trading takes place at a discount. Since BDCs generate high levels of revenue, it may still be an attractive proposition for an investor to purchase discounted BDCs in order to obtain the high returns with the possibility of recovery enhancing the potential gain even further, while of course accepting the risk of further declines. However, it is very difficult to launch new issues when most BDCs are trading at sizable discounts.

Table 4.2. Issuance of new shares of BDCs, 2007-16

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Issuance of Shares (USD million)										
Follow-on Issues	3752	1444	823	1498	657	3368	3844	2361	648	601
IPOs	1060	141	0	534	642	500	312	586	118	0
Total	4812	1585	823	2032	1299	3868	4156	2947	766	601
Number of BDCs										
Above NAV	11	1	7	14	10	24	26	16	11	10
Below NAV	9	19	14	12	21	13	15	34	39	40
Total	20	20	21	26	31	37	41	50	50	50

Source: Keefe, Bruyette & Woods, Inc. and Raymond James Financial.

There were surges in issuance, both in IPOs and follow-on issues, in the period just before the financial crisis. Issuance dropped off after the GFC, but additional spurts occurred in 2010-14. By 2014, many BDCs were trading at discounts to NAV and thus investors' appetite for new issues waned. During 2015, discounts continued to widen and late in the year the average BDC was trading at 85% of NAV. By late 2015 almost 4/5 of BDCs were trading at discounts.

As a result of widening discounts several BDCs were subjected to challenges by investor activists and many agreed to waive fees and/or to consider share buy-backs. A certain amount of de-leveraging took place in some BDCs. Serval consolidations of BDCs also took place as stronger BDC sponsors bought out under-performing ones, with two BDCs disappearing. During 2016, prices of BDC shares began to recover. By the end of the year most BDCs were trading at discounts, but the average BDC was trading at 90% of NAV and the average debt-oriented BDC was trading a 97%. With price appreciation plus the high dividend yields, returns on investments in BDCs exceeded 20% in 2016. The level of new issuance was still subdued, but many industry participants believed that conditions were firm enough that many BDCs will consider new share issues.

In summary, the BDC sector in the United States is large and active. It accounts for a sizable share of finance for the middle market and has survived several crises. While structural changes are certain to occur, it will be most likely remain an integral component of the capital market infrastructure to finance the middle market.

4.3.2. United Kingdom

The Venture Capital Trust (VCT), which was first introduced in the Finance Act 1995, is a mechanism for collective investment in SMEs by individual investors.[41] A venture capital trust (VCT) is a tax-advantaged closed-end collective investment vehicle that has a mandate to seek opportunities in small unlisted firms to generate higher than average risk-adjusted returns for its investors. Although VCTs contain the words "venture capital," their investments tend to be in established SMEs with positive cash flows.

VCTs, which are listed on a recognised UK Stock Exchange, invest in other companies which are not themselves listed. They are managed by fund managers who are usually members of larger investment groups and are exempt from corporation tax on any capital gains arising on sale of their investments. VCT investments are limited to companies carrying on a qualifying trade with fewer than 250 full time equivalent employees at the time shares are issued, and gross assets of no more than GBP 15 million. Qualifying companies can raise up to GBP 5 million in any 12-month period from VCT investment or a similar scheme, but each individual investment cannot make up more than 15% of the VCTs' assets.[42]

Investors subscribe for shares in a VCT, which then invests in qualified companies. A VCT typically raises around GBP 5-10 million at launch, which is then invested in 25 to 35 companies. Within three years of its launch, at least 70% of the VCT's assets must be invested in "qualifying holdings." The balance of 30% can be invested into assets such as government securities or other shares. "Qualifying holdings" are defined as holdings of shares or securities, including loans of at least five years duration, in unquoted companies or those whose shares are traded on the alternative investment market (AIM). If an investment is held in a company that becomes quoted on a recognised exchange, it can continue to be treated as a qualifying VCT investment for five years.

Profits from the underlying companies are distributed as dividends. VCTs are increasingly structured to pay dividends, usually worth between 3% and 5% a year. Since dividends paid by VCTs are tax-free, they are attractive to higher-rate taxpayers.

VCTs can pursue several investment strategies. Generalist VCTs pursue a private equity-like approach of investing in unquoted companies, which requires considerable skill in identifying attractive companies and conducting due diligence and negotiations. VCT investments in unquoted companies are typically made through a combination of loan notes, preference shares and common equity. Once invested, the VCT's management team will often place directors on the Boards of a company to monitor their investment and help guide the business to an eventual "exit". Some generalist VCTs focus on earlier-phase companies while others focus on more mature businesses. Usually, after five to seven years,

[41] The Venture Capital Trust (VCT) scheme is one of three tax–advantaged Venture Capital Schemes, the others being the Enterprise Investment Scheme and the Seed Enterprise Investment Scheme. The latter two schemes enable to make direct investments in individual companies, rather than in a professionally managed portfolio of companies.

[42] The GBP 5 million limit includes investment via the Enterprise Investment Scheme (EIS) or Seed Enterprise Investment Scheme (SEIS) as well as any other investment the company has received via any measure covered by the European Commission's Guidelines on State aid to promote Risk Capital Investment in Small and Medium-sized Enterprises.

the underlying companies are sold and the money made is returned to investors, as in private equity.

Limited Life (or Planned Exit) VCTs are at the most conservative end of the VCT spectrum. Limited Life VCTs reduce some of the uncertainty about valuation and illiquidity by launching with the stated goal of winding up after the minimum five-year holding period. As these VCTs are managed with a specific time horizon, their investment strategies have a heavy emphasis on income generation and preservation of capital concentrating on low-risk fixed income assets that mature at the time the fund is liquidated.

AIM VCTs focus on investing (usually in common equity) in qualifying companies that are listed on AIM, the main platform for listing small companies in the United Kingdom. AIM VCTs are typically managed by teams from fund management rather than private equity investment backgrounds.

Investors in VCTs receive significant tax benefits.[43] The tax reliefs available to investors are:

- Income tax: Individual shareholders obtain income tax relief at the rate of 30%[44] and of up to GBP 200 000 annual investment, provided their shares are held for at least five years;
- Dividend: No income tax is payable on dividends from ordinary shares in VCTs; and
- Capital gains tax: No capital gains tax is payable on profits from sales by individuals of ordinary shares in VCTs.

According to a recent study commissioned by HM Treasury, tax relief is a key driver of investors' decisions to invest, with 79% of survey respondents saying this was either very important or essential for the investment.[45]

Developments in VCT Market

As Table 4.3 shows, the VCT market has maintained a high level of activity since its inception in 1995. (Data are shown in tax years, which begin on 6 April). The VCT sector expanded rapidly after the enactment of the law in 2005, in line with the worldwide boom in investment in smaller companies (i.e. the dot.com bubble) but contracted during the next few years. Capital-raising reached its peak in the 2005-06 tax year. After dropping off with the GFC, activity has been edging steadily upwards steadily in recent years with a fairly strong surge in 2016-17, but it is still well below its peak.

[43] http://www.hmrc.gov.uk/manuals/vcmmanual/Index.htm.

[44] The rate of tax relief has been changed several times since 1995.

[45] Colahan et al., (2016).

Table 4.3. Venture capital trusts in the United Kingdom, 1995-2017

Funds raised and number of funds

Year [1]	Funds raised	VCTs raising funds in the year	VCTs managing funds	Rate of Income Tax Relief (%)
	Amount	Number	Number	
1995-96	160	12	12	20
996-97	170	13	18	20
1997-98	190	16	26	8
1998-99	165	11	34	20
1999-00	270	20	43	20
2000-01	450	38	61	20
2001-02	155	45	70	20
2002-03	70	32	71	20
2003-04	70	31	71	20
2004-05	520	58	98	40
2005-06	780	82	108	40
2006-07	270	32	121	30
2007-08	230	54	131	30
2008-09	150	46	129	30
2009-10	340	68	122	30
2010-11	350	78	128	30
2011-12	325	76	124	30
2012-13	400	65	118	30
2013-14	440	66	97	30
2014-15	435	57	94	30
2015-16 [r]	445	45	80	30
2016-17	570	38	75	30
Total	6 995	*	*	

Source: United Kingdom, H.M. Treasury (2016.).

Total outstandings of VCTs in 2016-17 were GBP 5.7 billion, equivalent to about 6% of total bank credit to SMEs or about half the corresponding ratio for BDCs in the United States. In sum, VCT financing has an established position in the market and has recovered from its low in 2008-09.

4.3.3. France

In France there are two specialised vehicles for collective investment in SMEs, *Fonds communs de placement dans l'innovation (FCPI)* and *Fonds d'investissement de proximité (FIP)*. Each of these instruments is structured as a closed-end fund with a definite life

similar to a private investment partnership. Both of these instruments qualify as CIS and are subject to oversight by the AMF[46] which is responsible for securities supervision.

FIPs, which were created in 2003, are designed to provide financing of French SMEs. FIPs must invest at least 60% in unlisted French enterprises with less than 250 employees. Companies listed on designated SME exchanges such as *Alternext* or *Marché libre* are considered unlisted for the purposes of the law. FIPS have regional restrictions. The enterprises must be located in no more than four contiguous regions and at least 20% must be invested in enterprises that are no more than eight years old. The FCPI is the other main vehicle for investment in the SME sector using the collective investment model. As with FIPs, FCPIs must invest at least 60% of assets invested in unlisted French enterprises (or listed on *Alternext* or *Marché libre*) with less than 250 employees. Only 20% of assets may be invested in companies listed on recognised exchanges (other than designated SME exchanges). In addition, the enterprise must be certified as "innovative" by BpiFrance or must dedicate a high share of its resources to research and development. Some of the companies in which investments are made benefit from guarantees from BpiFrance or from French mutual guarantee associations. These two categories of funds face some restrictions on the amounts of funds that may be outside of recognised investments and thus there are strong pressures to invest quickly rather than to wait for favourable market conditions. In addition, these funds have limitations on the use of leverage. They thus must invest in growth capital rather than leveraged operations.

Investors in FCPI and FIP receive substantial tax advantages. Funds invested in either product will result in an 18% reduction in taxes. A married couple can receive up to EUR 4 320 in tax relief for an investment of EUR 24000 while a single taxpayer can receive half that amount. The amounts can be doubled if investments are made in both FCPI and FIP. Some of these instruments are eligible only for tax relief for income tax while others can be used to reduce the wealth tax (ISF).[47] Table 4.3 shows key data on the market in FCPI and FIP since 2008. 140 000 persons invested in these instruments in 2016, down from a peak of 145 000 in 2008. Total funds subscribed rose as a high as EUR 1.2 billion in 2008, but dropped off in the crisis. Investment has been recovering in the past four years but remain below pre-crisis levels.

Table 4.4. Fund raising by FCPI and FIP in France, 2008-16

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Number of asset managers	33	39	39	39	35	34	34	34	31
Number of investors	145 000	156 000	127 000	92 000	85 000	90 000	97 000	99 000	114 000
Average investment (EUR)	8 140	6 180	7 000	8 180	7 260	7 740	7 930	8 740	8 500
Number of funds raised	87	115	121	123	106	70	76	80	146
FIP	46	65	65	64	58	36	42	46	73
FCPI	41	50	56	59	48	34	34	34	73
Total funds raised (EUR million)	1 180	962	894	757	646	699	773	861	967
FIP	588	460	418	388	356	381	439	490	557
FCPI	592	502	476	369	290	318	334	371	410

Source: AFIC and AFG.

[46] Autorité des marchés financiers.

[47] Impôt de solidarité sur la fortune.

Total funds invested through these mechanisms at the end of 2015 amounted to EUR 6.8 billion, equal to about 3% of bank credit outstanding to SMEs. While these two instruments are now established features of the market, they are less expansive than their UK and US counterparts.

There is little possibility to exit the fund before it termination date and performance can only be known at the end of the fund. As a result, it may be difficult to market these products to unsophisticated investors. There is not a deep information infrastructure concerning these products and it is difficult to obtain information other than from brokers who market these products. Most marketing material relies heavily on their tax advantages as opposed to investment performance.

Evaluation by the Cour des Comptes

Since FIPs and FCPIs receive substantial support in the form of tax relief to investors, policy makers want to determine whether these funds are efficient in reaching their stated objectives. This issue was addressed in part by the *Cour des comptes*, an independent audit body of the French Government[48] in a letter in November 2105 to the Ministers of Economy and Finance and the Secretary of State for the Budget.[49] The letter dealt only with institutions that provided relief from the *Impôt de solidarité sur la fortune* (ISF) but its observations are pertinent to all FIPs and FCPIs. Much of the analysis was devoted to questioning whether investments made through funds should receive different tax treatment than investments that are made directly in companies, which is not of great relevance for this report. The letter noted that the revenue forgone through this mechanism was sizeable and therefore the efficiency of the scheme should be scrutinized on an ongoing basis.

The letter also criticised certain aspects of the operation of these funds, which are of direct relevance to this report. In particular, the *Court des comptes* called attention to certain weaknesses in these instruments, notably their relatively small size, high fees and low returns. In the studies undertaken by the *Cours des comptes*, fees amounted to 4.5% annually of funds placed by investors, with a substantial share of fees received by the financial intermediary that distributes the product. The *Cours des Comptes* also performed an analysis of the performance of a sample of 40 funds and determined that the final return to investors was low and frequently negative. Some industry sources replied that the very low reported rates reflect the fact that the *Cour des comptes* used 2013 (a rather unfavourable year) as a base and that performance improved in later years. In any case, the fact that is very difficult to obtain information on fund performance suggests that there are gaps in the information infrastructure that would normally be expected for an active segment of the financial market. Finally, the letter noted that information and disclosure practices with respect to these instruments was meagre and often not in conformity with minimum standards of the AMF, the country's supervisory authority for capital markets.

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[48] The Cour des comptes (sometimes translated as Court of Auditors) is a quasi-judicial body of the French government charged with conducting financial and legislative audits of most public institutions and some private institutions, including the central Government, national public corporations, social security agencies. The Court's three duties are to conduct financial audits of accounts, conduct good governance audits, and provide information and advice to the French Parliament and Administration.

49 Cours des Comptes (2015.)

The Ministers to whom the letter was addressed replied in February 2016.[50] Their reply mainly concerned efforts to align French legislation with European law and justifications for differences in tax treatment. Their reply did not attempt to refute any allegations concerning the shortcomings of FCPIs and FIPs as investment instruments.

4.3.4. Canada

In Canada a system that enables small investors to participate in financing SMEs through collective investment has been in place for decades. The most important collective investment vehicle for investment is SMEs is the labour-sponsored venture capital corporation (LSVCC), also known as labour-sponsored investment fund (LSIF) or simply retail venture capital (RVC). The federal government and some provincial governments offer sizable tax credits to LSVCC investors. As will be explained in later sections, there is a basic difference between the way the system has operated in the province of Quebec and in the other provinces. The system in Quebec has reached significant proportions and has a number of supporters, whereas elsewhere in Canada use of this instrument is declining.

Quebec

In contrast to the rest of Canada, a substantial market in collective investments that provide financing to SMEs has emerged in the province of Quebec. These collective investment instruments receive substantial tax benefits and are widely held by the general public.

The concept of creating special vehicles for investment in SMEs was first raised in Quebec in 1982. Against a background of recession, widespread business failures and a perceived lack of financing for SMEs, the Quebec Federation of Labour (FTQ)[51], the province's largest labour grouping, proposed a "solidarity fund." A Commission established by the provincial government to study the financing situation of SMEs noted the absence of a venture capital system as well as other difficulties faced by small promising companies in gaining access to financing.[52] In order to fill this perceived gap, the Commission recommended the formation of dedicated collective investment vehicles. In 1983, provincial laws authorising such vehicles were enacted in Quebec and in May 1985 a federal tax credit was granted to individuals who invest in LSVCCs.

The system has evolved considerably in the past three decades. At present, three institutions operate as "tax-advantaged funds"[53] under special provincial legislation: 1) the *Fonds de Solidarité FTQ* (FSTQ); 2) the *Fondaction*; and 3) the Regional Capital Cooperative Desjardins 54(CRCD). Basic data about these funds are summarised in Table 4.4.

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50 Ministre des Finances et des Comptes Publics (2016)

[51] Fédération des travailleurs et travailleuses du Québec.

[52] Commission québécoise sur la capitalisation des entreprises, La capitalisation des entreprises au Québec, Report to the Department of Industry, Trade and Tourism, 1984.

[53] "Tax advantaged funds" (fonds fiscalisés) is the term currently used in Quebec. While the FSTQ and the Fondaction are LSVCCs, the CRCD is not sponsored by trade unions and is not a retirement product although it is a collective investment product that invests in SMEs and receives tax support.

54 Capital régional et coopératif Desjardins (CRCD)

Table 4.5. Tax-Advantaged Funds in Quebec

(Situation as of mid-2016)

Name of Fund	Year established	Sponsoring organisation	Number of Participants	Assets under Management	Name of Fund
FSTQ	1983	Quebec Federation of Labour	613000	11.2	Until retirement
Fondaction	1996	Confederation of National Trade Unions	131000	1.4	Until retirement
CRCD	2001	Groupe Desjardins	99700	1.6	Minimum 7 years

Each fund is authorised under a special provincial law and each has slightly different characteristics. The largest fund, the FSTQ was created by FTQ in 1983. Fondaction was established in 1996 by the CSN55, a smaller grouping of trade unions. CRCD, established in 2001, is associated with the Desjardins Group, the largest association of credit unions in North America with 376 local credit unions and 5.8 million members.[56] The Desjardins Group offers a broad range of financial services, mostly to middle income groups.

Each tax-advantaged fund is a long term saving scheme (or pension plan) with strong ties to a sponsoring entity with broad reach among the general population. Those participating in the plans can opt to have contributions made through automatic payroll deductions at their place of work, at a financial institution or by lump sum contributions. Any resident of Quebec may invest in any tax-advantaged fund. Some 844 000 individuals, about 19% of the labour force in Quebec invest in tax-advantaged funds.[57]

Fund sponsors claim that these funds have been very useful in encouraging savings among low middle and lower income households, the groups in which savings for retirement are believed to be insufficient and where it is an important policy priority to increase retirement savings. FSTQ has a parallel financial planning programme that aims to educate its investors about the need to save especially for retirement and to hold appropriate portfolios. Research by FSTQ indicates that persons who invest in tax-advantaged funds in any given year tend to repeat their investments in later years and diversify their portfolios away from tax-advantaged funds to a wider range of assets. The FSTQ has a network of local representatives (LRs), trained union members who promote the product in their places of work or localities.[58]

Each tax-advantaged fund has strong "social" orientations, with mandates to promote regional development in Quebec and to support SMEs and the middle market as well as to produce competitive returns to investors. This policy can be contrasted to the situation on most countries, where CIS (including all others discussed in this report) set return to final investors as the overarching (and usually the only) objective of their investment policies.

In many countries, there are a certain number of socially, environmentally or ethically oriented CIS that pursue socially responsible investment (SRI) policies. Investment

[55] Confédération des Syndicats Nationaux
[56] Caisses populaires Desjardins
[57] Data on labour force from

http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/lfss02b-eng.htm

[58] (FSTQ 2016.)

managers exercising SRI mandates typically endeavour to maximise return to investors, subject to certain social or ethical constraints. For example, some SRI mutual funds have accepted the constraint of not investing in companies that manufacture armaments or tobacco products or in companies that do not adhere to agreed labour or environmental standards. Some other institutional investors incorporate SRI into their investment policies. While accepting these constraints, the SRI fund manager's objective is still to maximise return to investors.

By contrast, tax-advantaged funds in Quebec have a specific mandate to serve a wider set of stakeholders than their investors. These stakeholders include the provincial government, local communities, small enterprises, workers and regions. They also have a commitment to environmental sustainability. Their investment objective is usually specified as to achieve a "stable" and "reasonable" return to investors, rather than the highest possible return.

As the names suggests, all tax-advantaged funds receive significant tax support. Both FSTQ and Fondaction are classified as LSVCCs and thus receive a tax credit on federal taxes, currently 15%. Investors in the FSTQ also receive a credit of 15% on provincial income taxes, while Fondaction investors receive a 20% credit. Investors in both of these funds are eligible for additional federal tax relief if they are included in an approved individual retirement savings scheme, known as a registered retirement savings plans (RRSP).The CRCD is not an LSVCC but a special long-term savings plan operating under a special law.

Tax-advantaged funds are active in both a) equity venture capitals for newer and innovative companies and b) private equity type investments in SMEs for mature companies, using both equity and debt. [59] At the end of 2014, tax-advantaged funds held 78% of their funds in private equity and 22% in venture capital. Operations tend to be small with 80-90% of all activity of less than CAD 2 million.[60]

Each tax-advantaged fund makes its eligible investments both 1) directly through a mix of investments in debt and equity investments (either as majority or minority shareholder) in eligible companies or by purchasing unsecured debt and 2) indirectly by participating in funds that make such investments. Tax-advantaged funds may make direct investments alone or as co-investors with other entities.

In addition to their direct investments, tax -advantaged funds sometimes as portfolio investors in other funds, where they invest in funds alongside private investors who operate on more strictly commercial grounds. Spokesmen for tax-advantaged funds argue that they are active in persuading venture capitalist and private equity funds from across North America (and sometimes outside the region) in investing in targeted sectors in Quebec.

Unlike private equity investments and most other CIS that support the middle market, tax-advantaged funds use no leverage. Although each fund may invest in SMEs through debt, unlike most other vehicles for investment in the SME sector the funds themselves do not borrow. Each fund has teams of financial specialists who have in depth knowledge of the sectors and regions where they are active as well as a full range of financial products. For example, FSTQ has a team of 100 specialists.

[59] The terminology used by tax advantaged funds divides investment into a) venture capital (capital de risque) and development capital (capital de développement). Venture capital is identical to the standard usage everywhere, while development capital refers to SME private equity as used in this report.
[60] Deloitte (2016.)

Tax-advantaged funds provide financing on terms comparable to those of other sources of finance. When tax-advantaged funds co-invest, investments are made on the same terms as the other investors in the deal. In certain sectors (e.g. IT, Bio-tech), more than 80% of the investment deals are made with co-investors (often private venture capital funds) and all investors agree on the terms of the deal. In certain very specific cases (for example firms where many jobs are at stake), tax-advantaged funds will offer funds on rates somewhat lower than the return usually expected for non-secured capital but always higher than traditional bank lines of credit. In the large majority of investment deals, return expectations are on par with the expectations of any investors in that asset class.

To evaluate the financial risk on a deal, finance professionals in tax advantaged funds use many other quantitative and qualitative approaches, Moody's Analytics tools. Based upon several metrics the fund assigns a risk rating which allows the fund to set the targeted return for that level of risk. These funds act as long-term investors. The average holding period for a company in the portfolio of tax-advantaged funds is 6.4 years against 4.3 years for the average Canadian mutual fund.[61] Proponents of the system argue that since funds are not available to final investors for prolonged periods, managers can invest with a longer time horizon.

These funds are major players in the market for SME finance in Quebec, especially for companies with financing needs that cannot be fulfilled by traditional financial institutions. At the end of 2014, tax-advantaged funds in Quebec had invested CAD 156 million in venture capital (32% of the total invested in the province) and CAD 559 million in middle market private equity (16% of the total invested.)

A Pan-Canadian Perspective

Following the launch of FSTQ in 1983, the system of tax advantaged funds was already well established in Quebec by the mid-1980s. In May 1985, a federal tax credit of up to CAD 1 000 per annum was extended to individuals who invest up to CAD 5 000 in LSVCCs. During the late 1990s, LSVCCs began to spread outside Quebec, owing both to generous tax breaks from federal and provincial governments and attractive returns to investors as the technology bubble gathered momentum. In theory, LSVCCs are supposed to promote the development of high-growth SMEs, and the fund must typically invest a stipulated part (usually 60 %) of its capital contributions in such businesses.

Both the federal government and a number of other Canadian provinces allow any person to incorporate an LSVCC, in a manner similar to the incorporation of a commercial company. Unlike Quebec where each collective investment vehicle is managed by a team of in-house financial professionals, each LSVCC outside Quebec represents an alliance between a labour union which sponsors the fund and the fund manager which is generally a company that is engaged in asset management, with links between the sponsor and the fund management much looser than in Quebec. The LSVCC accepts capital contributions from individual investors resident in the province of incorporation (except for federally incorporated funds, which may accept contributions from residents of any province). Most LSVCC are organised as an evergreen corporate closed-end fund. As in any CIS, the fund managers theoretically seek to invest the capital contributions in pursuit of yield.

[61] Deloitte (2016.)

Only individuals may contribute to an LSVCC, and due to the low maximum tax benefits these investors are less sophisticated than the average retail investor. As in any mutual fund, the fund managers seek to invest the capital contributions in pursuit of return to the investor, unlike Quebec funds which are mandated to pursue goals other than simple return maximisation.

Tax incentives

Heavy fiscal support is one of the key features of LSVCCs. Historically, the trend was a) first to increase the amounts of fiscal subsidies to LSVCCs through the year 2000, but b) to reduce or eliminate those subsidies in later years. In 2016, the newly-elected federal government has committed to a partial expansion of the tax benefits.

In 1985, the federal government introduced a matching federal tax credit for individuals who invested in provincial LSVCCs. It also encouraged other provinces to follow Quebec's lead and establish LSVCCs and several followed suit. Matching tax credits of 15 % were paid by the incorporating province and the federal government, for a total tax credit of 30 %, up to a maximum investment of CAD 5 000.

In 1988, the federal government authorised federal LSVCCs. The first federal LSVCC was the Working Ventures Canadian sponsored by the Canadian Federation of Labour and funded with a CAD 14.55 million federal grant. In 1992, the federal tax credit was increased to 20% on a maximum investment of CAD 5 000 and that tax credit was also available if the investment was made through an individual's RRSP (personal retirement account.). The generous tax befits likely provided a stimulus to the expansion.

In recent years, the amount of tax benefits accorded to LSVCCs has been on a downward trend. By 2012, the Ontario provincial government had phased out the labour-sponsored funds tax credit. Until 2015, the federal government maintained the 15% tax credit on a maximum investment amount of CAD 5 000 per year. That credit was reduced to 10% for 2015, 5% for 2016, and was to be eliminated after 2017. In a partial reversal of this trend, the federal budget of March 2016 restored the federal LSVCC credit to 15% for purchases of provincially (not federally) registered LSVCCs for the 2016 and later tax years. The federal LSVCC credit for federally registered LSVCCs will remain at 5% for 2016 and will be eliminated after 2017.

4.3.5. Portugal

On June 30, 2017, the Portuguese Government announced the authorisation of SIMFEs[62] a new collective investment vehicle to support investment in SMEs. This instrument is a part of the "Capitalizar Programme," announced in August 2016 with the objective of strengthening and diversifying the financing sources for SMEs.

SIMFEs are public limited companies for collective investment in securities issued by eligible companies with a fixed capital, and which cannot operate as financial dealers, with a duration of not less than 10 years extendable once for an identical period. The shares can

62 Sociedades de Investimento Mobiliário para Fomento da Economia (Securities Investment Fund for Economic Development)

be admitted to a regulated market located or functioning in Portugal, within a maximum period of 1 year following its incorporation.

Prior to beginning operations, SIMFEs must be registered with the Portuguese Securities Market Commission (CMVM).[63] SIMFE's internal organisational and must be in conformity sound and prudent management requirements. Each SIMFE must demonstrate to the CMVM that it has organisational and governance structures, internal resources and procedures appropriate and proportionate to their size and complexity of the activities undertaken.

The registered office and effective administration of the SIMFE must be in Portugal. The members of the governing bodies of SIMFE must can ensure a sound and prudent management, be of good repute and have proven qualifications, work experience and availability. Each year, the SIMFE must provide CMVM with information on the main instruments in which they trade, the main risk positions and the most important concentrations in the portfolio they manage, and notify CMVM whenever the assets under their management exceed certain risk related limits.

At least 70% of any SIMFE's investments must be in securities issued by "eligible companies." Eligible criteria include:

- Small and medium-sized companies as defined by the EU; -
- Other companies qualified as mid-caps or small mid-caps not issuers of negotiable securities are admitted to trading on regulated markets. Mid-caps are companies that employ between 500 and 3 000 employees. Small mid-caps are companies with 250-500 employees;
- Companies trading on regulated markets which, on the average of the last three calendar years, have had a market capitalisation of less than EUR 50 million. Securities listed on a designated SME market will also qualify.
- SIMFEs may not invest more than 15% of their assets in securities issued by a sole eligible company or group of companies.

The assets of the SIMFE can be the following:

- Shares and other interests in the capital of eligible companies;
- Bonds and other debt instruments issued by eligible companies, so long as the same have not been offered to the public and have an original maturity of 5 years or more;

The minimum capital for a SIMFE is EUR 125 000 and the shares must be admitted to trading on a regulated market located or operating in Portugal, within not more than one year after incorporation. It is uncertain whether investors can sell their shares on the exchange. SIMFEs will be taxed like other collective investment schemes in Portugal.

[63] CMVM - Comissão do Mercado de Valores Mobiliários).

5. Conclusions and Recommendations

The financial crisis sent a shock wave throughout the world financial system. Although the crisis originated in the capital market (specifically, securitised mortgage debt), its most disruptive impact has been on the banking system and there are indications that banks have become more risk-averse than in the pre-crisis period. In that context, the private capital market offers advantages to SMEs looking for finance, mainly through its flexible form and conditions, and especially for small firms with a higher risk profile. Finance through capital markets, through a full range of debt and equity instruments, often complements rather than replaces bank financing; banks typically provide short-term working capital, and they often work cooperatively with investors in order to steer companies toward a mix of financial products that suits their needs. This pattern of financing might become more prevalent in the future, with banks operating at the short-term low- risk part of the market, while investors focus on higher-risk high –reward and low liquidity operations.

Historically, OECD countries have had different balances between bank and capital market intermediation. Regardless of any country's starting point, however, the recovery from the financial crisis may enlarge the role of the capital market, which is already making a substantial contribution to the financing of SMEs in most OECD countries and has the potential to contribute more. While any broad categorisation risks oversimplification, it might be useful to think of OECD countries as falling into three broad groups with respect to the state of capital markets support for SMEs.

In the first category covers the United States, where the capital market already provides more than half of funding to the SME sector and a diverse range of financial products and instruments is in place to support the SME sector. The private equity market in the United States is distinctive mainly because of its large share. Aside from the generally advanced state of the American capital market, one of the main explanations for the large contribution of private markets is that the use of the public markets has been generally declining for two decades; the number of publicly listed companies in 2016 is only about half the level of 1996. There are two basic explanations for the shift from of public to private markets: 1) the great flexibility shown by private markets and 2) the perceived high burdens of using the pubic markets. These burdens include higher disclosure cost and legal liability as well as increased exposure to investor activism and "short-termism". Whatever the explanation, the move from public to private markets is undeniable. In addition, the move away from public capital markets is more pronounced among smaller companies than larger ones. Whereas smaller companies accounted for a sizable number of IPOs through the mid-1990s, offerings by small companies has become a small share of a rapidly falling number of IPOs. The Securities and Exchange Commission (SEC) has expressed concern over these developments and has proposed several measures to ease the burden of public listing.

In a second group of countries, which includes Australia, Canada, Israel, ,France, Korea, the United Kingdom, and most of Northern Europe, the use of the capital market is large and growing, but less extensive than in the United States. In addition, banks, mezzanine finance and official sources play an active role in the provision of SME finance. It is uncertain whether these countries will gravitate towards more intermediation through capital markets in the future.

In a third group, mostly consisting of Southern Europe and Japan, SMEs have traditionally relied on banks and the take-up of other sources of finance has remained relatively limited,

although some countries, notably Italy and Spain, have observed an uptick in recent years It is possible that some countries' unique historical and cultural characteristics, corporate ownership structures, business practices as well as the legal and institutional structure system, operate in such a way that only a small number of candidates for financing through capital markets [64](i.e. "investment ready" companies) are present in the country. In addition, well-functioning capital markets benefit from a community of institutional investors who are willing and able to invest in SMES, which may be smaller in some countries than in others (see next session)..

Many of the countries in this category have reached high levels of income with their existing institutional infrastructure. In these instances, it may be appropriate to consider whether adjustments in previous patterns of corporate ownership and finance are needed for the country to advance into the next phase of development. Thus, another area where the WPSMEE may want to consider additional work is to determine to what degree it is possible for the authorities to foster an enabling environment for the development of an active market in mezzanine, private equity and private debt finance.

Institutional investors

One factor that appears related to the level of development of the capital market for SMEs is the presence of substantial communities of institutional investors who are ready and willing to invest in private capital markets. In most of the countries with low activity in investment in private capital markets institutional investors are not major holders of assets. If countries are considering broader policies to foster development of institutional investors, the capacity of these investors to promote the development of financial markets is a major consideration.

Even where institutional investors have reached a fairly high level of development, prudential regulations often require institutions to invest in narrowly defined categories of fixed income assets, and in some countries regulations prohibit institutions from investing in unlisted securities. Private debt and private equity may not have the transparency and liquidity that regulators of institutions have seen as prudentially necessary. While the primary consideration of prudential supervisors is the soundness of the institutions and markets under their supervision, there may be a case for applying prudential norms flexibly. This consideration may be particularly important for pension funds and insurance companies in the present environment of low yields on traditional investments. Policies of requiring institutional Investors to invest in listed securities could force institutions to hold assets with minimal yields for the foreseeable future. Conversely, if regulators were to adopt more flexible policies it would simultaneously make more capital available to the SME sector and help investors to escape from the present low-yield trap.

Other possible areas for future consideration by the WPSMEE

As noted previously, the private debt market is only one segment of the capital market that is capable of providing funding in the form of debt to the SME sector. In fact, the private debt market, as currently structured, functions best in offering higher risk, high-yielding credit to SMEs.. In the United States, for example, the estimated size of outstanding funds in the private debt market is some USD 260 billion, which is more than half of the estimated outstanding loans by banks to SMEs according to data from the FDIC (Federal Deposit

[64] This includies mezzanine, private debt and private equity.

Insurance Corporation) , with a substantial portion channelled to SMEs. Meanwhile, new issues of debt by middle market borrowers through the privately placed loan markets have been averaging some USD 150 billion annually. In a number of European countries, significant efforts have been launched to promote mechanisms that facilitate the acquisition of fixed income assets (often claims on SMEs) that were previously held on bank balance sheets by investors. Further efforts by the WPSMEE to take a holistic view of the debt market, including both the fixed income market and bank lending activities, could be pursued.

Selective public investment in the capital market for SMEs

Even countries that have an active market in private debt and equity, may identify a financing gap for some kinds of firms and choose to intervene to fill this gap. In France, Germany, the Netherlands and the United Kingdom, for example specialised public institutions invest in the capital markets for SMEs in tandem with private investors.

The investment policy of these institutions is specifically targeted at certain market sectors, frequently smaller companies, where private investors are hesitant. This policy is implemented mostly by creating funds that invest in private equity funds alongside other investors, such as institutional investors or high net worth individuals. In many cases the public investors will only invest if a specified amount of private funds is invested. The policy of investing only in partnership with private investors is seen as having two benefits. First, it ensures that all investments are screened by private investors mainly concerned with profit. Second, it has the "leverage effect" of bringing private funding into all deals, thereby enabling more funding than would be possible otherwise. Any country considering the expanded use of direct public intervention in the private capital markets should carefully consider the design of its programs and learn from the experience of other countries. The WPSMEE might consider further analysis on the potential and conditions for government participation as investors in the capital market alongside private investors, and for a sharing of best practices among institutions active in this domain. One highly pertinent question in this area is how the authorities responsible for investment in partnership with private investors determine whether market failure is present and what form of official intervention is appropriate.

Collective investment in the SME sector

This report has considered the experience of selected OECD countries which have created legal and institutional frameworks for collective investment instruments to invest in unlisted securities of SMEs. Both in order to broaden financing sources for SMEs and to enable the general public to invest in SME-related assets, it is desirable to use this mechanism as much as possible.

At the risk of oversimplification, the main findings of this report regarding CIVs can be summarised as:

- The United States has developed a structure (the BDC) which has demonstrated great potential to supply capital on a sizeable scale to the SME sector. While the past few years revealed some strains, which may prove to be impediments to further expansion, the problem has been partly resolved spontaneously as private market participants have reacted with solutions, such as share buy-backs and consolidation of funds. BDCs are now fairly close to NAV, which may lead to renewed issuance and enhanced financing capability in the BDC sector. In any case, owing to the

potential of collective investments in SMEs and the success of the BDC experience the situation merits further monitoring.

- In the United Kingdom and France, collective investment instruments for SMEs have attained a modest presence in their respective markets. It is conceivable that the use of these products could be expanded if the authorities were to consider broadening the range of products and/or altering their characteristics. In particular it might be useful to consider products with fewer tax benefits than current products, but with wider scope for investment.
- In Canada, the situation is mixed. In Quebec the industry has, arguably, reached a rather advanced state of development thanks to the special conditions in that province. At the same time, other provinces have reduced their support through tax benefits. This appears to be a case where it is difficult to draw conclusions for other jurisdictions.
- Portugal established a collective investment scheme in 2017. It is too early to assess its impact.

On balance it would probably be possible to expand the use of collective investments, both in order to make it possible for individuals to invest in this sector and to widen the range of financing options available to SMEs. Collective investment instruments are particularly significant for policy makers, as this is one area in which official intervention is essential. While private debt and equity markets essentially function on their own with practices largely determined by market participants, a market in collective investment instruments can only thrive if the authorities create a robust legal and regulatory framework to permit such investment. Since most OECD countries have never tried to introduce collective investment vehicles for the SME sector, the number of cases from which inferences can be drawn is small.

In view of 1) the key role of the legal and regulatory system in the development of the collective sector; and 2) the desirability of exploring new options for SME finance and new investment opportunities for the public, the OECD may wish to consider additional work on this subject.

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