New Approaches to SME and Entrepreneurship Financing

BROADENING THE RANGE OF INSTRUMENTS



OECD

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BETTER POLICIES FOR BETTER LIVES

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Foreword

The pressing need to enhance the role of small and medium-size enterprises (SMEs) and entrepreneurs as drivers of innovation, job creation and growth is increasingly recognised by governments as they pursue efforts to put the global economy back on track. This means addressing both cyclical constraints and structural barriers. Access to finance represents a longstanding hurdle to entrepreneurship and SME growth, which was exacerbated by the global financial and economic crisis. Bank lending to SMEs and credit conditions have still not recovered to pre-crisis levels in many countries, and evidence suggests that credit restrictions for SMEs are likely to persist for the foreseeable future.

In this context, a two-pronged approach is needed to improve access and conditions for SME finance. On the one hand, it is essential to restore banks' health to improve lending, as bank financing will continue to be crucial for SMEs. On the other hand, it is necessary to enable SMEs to diversify their sources of finance towards non-bank instruments and to support private investment. Yet, at present, financing instruments alternative to traditional debt still represent only a small source of SME funding.

New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments *seeks to improve awareness and understanding on the part of SMEs, financial institutions and governments on these alternative financing instruments. The report provides a comprehensive taxonomy of available financing options along the risk-return spectrum, investigates their potential for responding to the diverse needs of SMEs and entrepreneurs, and proposes specific policy recommendations. As such, it provides a tangible contribution to national and international efforts to ease SME finance constraints and support business growth.*

The report suggests that asset-based finance can enable young and small firms to access working capital on rapid and flexible terms. Supply chain and trade finance provides important support for SME integration in global value chains. Alternative forms of debt, such as corporate bonds, enable SMEs to invest, expand and restructure. Hybrid tools and equity instruments can help boost investment in innovative start-ups and high-growth SMEs.

To further expand the use of these instruments, it is necessary to enhance the financial skills and strategic vision of start-ups and SMEs and to improve the quality of their business plans and investment projects. Greater transparency in SME finance markets is needed to encourage greater investor participation and reduce financing costs for SMEs. The regulatory framework should facilitate SMEs' access to a broad range of financing instruments without compromising financial stability and investor protection.

This report is part of the OECD initiative on New Approaches to Economic Challenges (NAEC), which aims to encourage discussion among a broad range of stakeholders in a collective effort to achieve sustainable and inclusive growth and greater societal well-being. The analysis underpinning this work also contributes to the G20 dialogue on enhancing SME access to finance.

The OECD will continue to analyse the opportunities and challenges of the diverse financing options for SMEs and entrepreneurs, as well as to measure the supply of finance to SMEs and monitor trends in this area. This evidence is critical to foster a dialogue among governments, financial institutions and SMEs aimed at supporting policies that will improve SME access to timely, sufficient and adequate sources of finance.



Angel Gurría

OECD Secretary-General

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The report was written by Lucia Cusmano, Senior Economist in the OECD Centre for Entrepreneurship, SMEs and Local Development (CFE), under the guidance of Miriam Koreen, Deputy Director of CFE. The work benefited from case studies undertaken by different authors on specific financial instruments. Virginia Robano (Policy Analyst, CFE) provided input on crowdfunding (Chapter 5), John Thompson (Consultant, CFE) on mezzanine finance (Chapter 6) and SME public listings (Chapter 7), Iota Kaousar Nassr (Economist, OECD Directorate for Financial Affairs – DAF) and Gert Wehinger (Senior Economist, DAF) on securitisation, private placements and bonds (Chapter 4). Useful comments were received at the occasion of the joint ADB-OECD workshops on "Enhancing Financial Accessibility for SMEs: Lessons from Asian and OECD Areas' Crises", which took place in Manila and Paris in March and October 2013. The report was enriched by continuous discussion and exchange with colleagues at the OECD, including Sergio Arzeni (Director, CFE), Marco Marchese (Policy Analyst, CFE) and Kris Boschmans (Policy Analyst, CFE). Soňa Fazikova and Helen Maguire (CFE) provided technical support.

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Acronyms and abbreviations

ABL	Asset-based lending
ABS	Asset-backed securities
ACPR	Autorité de Contrôle Prudentiel et de Résolution
ADB	Asian Development Bank
AIM	Alternative Investment Market
AMF	Autorité des Marchés Financiers
AUD	Australian dollar
AWS	Austriawirtshaftsservice
BA	Business Angel
BAN	Business Angel Network
BDC	Business Development Bank of Canada
BOJ	Bank of Japan
BSE	Bombay Stock Exchange
CAD	Canadian dollar
CFLA	Canadian Finance and Leasing Association
CIP	Competitiveness and Innovation Framework Programme
CIS	Collective investment schemes
CONSOB	Commissione Nazionale per le Società e la Borsa
CRD	Capital Requirements Directive
EBAN	European Business Angel Network
EBITDA	Earnings before interest, taxes, depreciation and amortization
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EIF	European Investment Fund
EU	European Union
EUR	Euro
EVCA	European Private Equity and Venture Capital Association
FCI	Factors Chain International
FCPI	Fonds Commun de Placement en Innovation
FSA	Financial Services Authority
G20	Group of 20
GBP	British pound
GDP	Gross domestic product
GP	General Partner
HNX	Hanoi Stock Exchange
IABL	Intangible asset-based lending

IBO	Institutional buyout
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
IPO	Initial public offering
ICT	Information and Communication Technology
IP	Intellectual Property
JOBS	Jump-start Our Business Startups
KOSDAQ	Korean Securities Dealers Automated Quotations
KRX	Korea Exchange
LBO	Leveraged buyout
LP	Limited Partner
LSE	London Stock Exchange
LVR	Loan-to-value ratio
MAI	Market for Alternative Investments
MBI	Management buy-in
MBO	Management buyout
M&A	Mergers and acquisitions
MFG	Mezzanine Facility for Growth
MIFID	Markets in Financial Instruments Directive
MOE	Ministry of Environment
NAEC	New Approached to Economic Challenges
NAFIN	Nacional Financiera
NAIC	National Association of Insurance Commissioners
NASDAQ	National Association of Securities Dealers Automated Quotations
NIB	Nordic Investment Bank
NOMAD	Nominated advisor
NSE	National Stock Exchange
NVCA	National Venture Capital Association
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
ORB	Order Book for Retail Bonds
OTC	Over-the-counter
PE	Private equity
POF	Purchase Order Finance
PP	Private placement
PSE	Philippine Stock Exchange
P2P	Peer-to-peer lending
R&D	Research and development
SAFE	Survey on the Access to Finance of Enterprises
SBA	Small Business Administration
SEC	Securities and Exchange Commission
SET	Stock Exchange of Thailand
SME	Small and medium-sized enterprise
SPV	Special Purpose Vehicle
SZSE	Shenzhen Stock Exchange
TRACE	Transaction Reporting and Compliance Engine

TSX	Toronto Stock Exchange
UCC	Uniform Commercial Code
UK	United Kingdom
UKLA	United Kingdom Listing Authority
US	United States
USAID	United States Agency for International Development
USD	United States dollar
VAT	Value-added tax
VC	Venture capital
WHR	Warehouse receipts
WPSMEE	Working Party on SMEs and Entrepreneurship

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Executive summary

Bank lending is the most common source of external finance for many SMEs and entrepreneurs, which are often heavily reliant on traditional debt to fulfil their start-up, cash flow and investment needs. However, traditional bank finance poses challenges to SMEs, in particular to newer, innovative and fast growing companies, with a higher risk-return profile. Capital gaps also exist for companies undertaking important transitions in their activities, as well as for SMEs seeking to de-leverage and improve their capital structures. Yet, for most enterprises, there are a few alternatives to traditional debt.

Bank financing will continue to be crucial for the SME sector. However, as banks face more rigorous prudential rules and modify their business model, credit restrictions for SMEs will likely persist for the foreseeable future. It is therefore necessary to broaden the range of financing instruments available to SMEs and entrepreneurs, in order to address diverse financing needs in varying circumstances, increase SMEs' resilience to changing conditions in credit markets and improve their contribution to economic growth.

Increasingly complex and interconnected financial markets offer opportunities to serve the needs of the SME sector, but a diverse set of actions is needed to overcome challenges to market development. The present study maps the main features of a broad range of external financing techniques alternative to straight debt, including asset-based finance, alternative debt, hybrid instruments, and equity instruments; highlights key enabling factors for their development; discusses major market trends and obstacles to SME uptake; and suggests some key areas of policy action.

Asset-based finance is a widely used instrument to provide working capital to young and small firms on more rapid and flexible terms that traditional lending. Regulatory reforms that enable the use of a broad set of assets to secure loans have favoured the development of these tools. In some countries, direct public funding and guarantees are used to enhance asset-based financing for SMEs. In particular, factoring is increasingly supported as a means to ease their inclusion in value chains.

Alternative debt instruments in the capital markets, such as corporate bonds, have had only limited usage by the SME sector. To boost market development, policy action has especially focused on transparency and protection rules for investors. In some countries, SME trading venues have been created, the participation by unlisted and smaller companies has been encouraged and regulatory reforms have been introduced to allow *private placements* of corporate bonds by unlisted companies. However, information gaps, illiquid secondary markets and differences in insolvency laws across industry players and jurisdictions still limit the development of these markets.

Debt securitisation and covered bonds, which also rely on capital markets, have developed at a high pace in the past decade, as an instrument for refinancing of banks and for their

portfolio risk management. However, in the wake of the 2008-09 financial crisis, they have come under scrutiny, as one major driver of risk leveraging and financial instability. The post-crisis deleveraging in the banking sector has contributed to reviving the debate about the need for an efficient and transparent securitisation market to extend SME lending and measures have been introduced at different levels to re-launch the market.

Crowdfunding has grown rapidly in recent years, although it still represents a very minor share of financing for businesses and mainly serves to finance specific projects rather than broad enterprise needs. Donations, rewards and pre-selling currently lead the industry, but peer-to-peer lending and equity based crowdfunding are expected to play an increasing role in the future, particularly as reforms are introduced in some countries to lift the ban on equity investments and increase transparency in the market.

Hybrid instruments, such as mezzanine finance, represent an appealing form of finance for firms at a turning point in their life cycle, which need a capital injection, but have limited access to debt financing or equity. As they require stable earning power and market position, and a certain level of financial skills, these techniques are not well-suited for many SMEs. Nevertheless, in recent years, with the support of public programmes, hybrid tools have become increasingly available to SMEs with lower credit ratings and smaller funding needs than what would be the practice in private capital markets.

Private equity investments, such as venture capital and angel investing, have developed substantially over the last decades, providing new financing opportunities for innovative and high growth start-ups, although the global financial crisis severely affected investments. Policy makers have placed increasing attention on these markets, mainly through supply-side measures, such as tax incentives, direct investment and co-investment, and support to industry networks and associations.

Public listings of SME equity have the potential to provide funding to innovative and high-growth SMEs, but markets are currently small. Difficulties include high listing and maintenance costs, administrative and regulatory burden for SME, but also the lack of an equity cultural and inadequate management practices in small businesses. Investors are deterred by high monitoring costs relative to the level of investment and low levels of liquidity. Recent regulatory approaches recognise that these platforms may require specific regulation and infrastructure and policies have been addressing the liquidity problem, through tax incentives and encouragement of retail investment.

Common obstacles exist for SMEs to reap the benefits of a more diversified financial offer. First, the limited awareness and understanding about alternative instruments on the part of SMEs, the difficulties by SMEs in dealing with investor due diligence requirements and the low quality of investment projects have slowed the development of these markets. In addition, the large heterogeneity and opacity of the SME sector contribute to increase the risks perceived by investors and the financing costs for SMEs.

Furthermore, recent regulatory reforms, which aim at making the financial sector safer, are perceived to be unduly onerous by some investors, who are also affected by the enduring uncertainty arising from expected regulatory revisions. In some countries, the public share of funding in higher risk segments has significantly increased in the aftermath of the financial crisis, as governments stepped in to fill the gap left by private investors' withdrawal.

Finally, the evidence base about SME use of alternative instruments is currently patchy, which limits the capacity of investors to monitor the market, as well as the design, implementation and assessment of policies.

A diverse set of actions is needed to overcome these challenges, including:

- **addressing SME skills gap in finance** to improve their strategic vision for their financing needs, understanding about alternative finance instruments and ability to access them;
- **implementing regulation that navigates potential trade-offs** between financial stability, investor protection and the opening of new financing channels for SMEs;
- **developing information infrastructures for credit risk assessment** to reflect more accurately the level of risk associated with SME financing and encourage investors' participation;
- **implementing policies that leverage private resources and develop appropriate risk-sharing mechanisms** with the private sector, to finance innovative and high-growth SMEs;
- **improving the evidence base** to better understand the different needs of the SME sector and how evolving financial markets may respond to them, as well as to enhance policy making.

Chapter 1

The challenges and benefits of alternative finance for SMEs

This chapter presents key findings and policy implications from the study. It discusses the new reality in SME finance, with changing conditions in bank lending and limitations to financing for new, innovative and fast-growing companies. It highlights the need to broaden the range of financial instruments for SMEs and entrepreneurs and illustrates the range of options available across the risk-return spectrum, including asset-based finance, alternative debt, hybrid tools and equity instruments. It briefly illustrates the main features of these instruments and comments on recent trends and policies to support their development across OECD and non-OECD countries. It concludes by discussing common obstacles to the SME sector to fully reap the benefits of a more diversified financial offer and suggests some key areas of policy action.

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The new reality for SME finance

More than half a decade after the start of the global financial crisis, access to finance for SMEs and entrepreneurs remains a major concern globally

The 2008-09 global financial crisis profoundly changed the business environment for small and medium-sized enterprises (SMEs) and entrepreneurs, and access to finance was particularly affected. In many OECD countries, the crisis exacerbated the financial constraints typically experienced by SMEs, mainly as a result of information asymmetries in financial markets, and financial resources dried up for the most dynamic enterprises.

Across OECD countries, bank lending is still the most common form of external finance for SMEs, but as banks face more rigorous prudential rules and modify their business models, a business environment with less credit is likely to become the "new normal". There is increasing recognition that SMEs and entrepreneurs are being disproportionately affected by financial reforms, and the rapid pace of their implementation, since they are more dependent on bank finance than large firms and less able to adapt to significant changes in credit markets.

The vulnerability of the SME sector to changing conditions in bank lending has become more evident

The financial crisis underscored the vulnerability of the SME sector to changing conditions in bank lending. The long-standing need to strengthen capital structures and decrease dependence on borrowing has now become more urgent. Indeed, many firms were obliged to increase leverage in order to survive the crisis. What is more, policy responses to the financial crisis may have exacerbated the problem of SME over-leveraging; indeed, emergency stabilization programmes tended to focus on mechanisms that enabled firms to increase their debt (e.g. direct lending, loan guarantees), as funding from other sources became more scarce. Furthermore, since the crisis, banks in many OECD countries have been contracting their balance sheets in order to meet more rigorous prudential rules. Thin capitalization and excessive leverage impose costs on SMEs, in the form of higher interest rates, and increase the risk of financial distress and bankruptcy.

Traditional debt is ill-suited for new, innovative and fast-growing companies

SMEs and entrepreneurs are often heavily reliant on straight debt to fulfil their start-up, cash flow and investment needs, but traditional debt has limitations for responding to the different financing needs SMEs encounter at different stages of their life cycle. In particular, debt finance is ill-suited for newer, innovative and fast growing companies, which have a higher risk-return profile. The "financing gap" that affects these businesses is often a "growth capital gap". Substantial funds may be needed to finance projects with high growth prospects, while the associated profit patterns are often difficult to forecast. These financing constraints can be especially severe in the case of start-ups or small businesses whose business model relies on intangibles which are highly firm-specific and

difficult to use as collateral in traditional debt relations. Capital gaps also exist for companies seeking to effect important transitions in their activities, such as ownership and control changes. Yet, for most enterprises, there are few alternatives to traditional debt. This represents an important challenge for policy makers in their efforts to support a sustainable recovery and long-term growth, since these companies are often at the forefront in job creation, the application of new technologies and the development of new business models.

There is a pressing need to broaden the range of financial instruments available to SMEs and entrepreneurs

It is therefore necessary to broaden the range of financing instruments available to SMEs and entrepreneurs, in order to enable them to continue to play their role in investment, growth, innovation and employment. Financial stability, financial inclusion and financial deepening should be considered as mutually reinforcing objectives in the quest for a sustainable recovery and long-term growth. While bank financing will continue to be crucial for the SME sector, a more diversified set of options for SME financing is needed to support long-term investment and reduce the vulnerability of SMEs to changes in the credit market. An effective financial system is one that can supply financial resources to a broad range of companies in varying circumstances and channel financial wealth from different sources to business investments. As the banking sector struggles to adjust to the new regulatory environment, institutional investors and other non-bank players, including wealthy private investors, have a potential role to play in filling the financing gap.

Improving financing conditions for SMEs and entrepreneurs is key to strengthen the resilience of economies and foster new sources of growth

Financial markets worldwide are more integrated and interdependent than ever before. Since the crisis, this increased complexity has been under scrutiny as the source of unsustainable fiscal imbalances. There has been a call for the financial system to return to fulfilling its essential role of intermediation and provide the necessary capital for productive activities, in order to increase macroeconomic stability and improve resilience of economies to large shocks (OECD, 2014a). In particular, financial resources should be channelled to support the creation and expansion of firms, as key sources of employment and value generation. Improving financing conditions for SMEs and entrepreneurs and diversifying their sources of financing will contribute to reducing systemic risk, increasing the resilience of the real economy to large shocks and fostering new sources of growth.

Broadening the range of financing instruments for SMEs and entrepreneurs

Increasingly complex and interconnected financial markets offer opportunities to serve the needs of the SME sector

There is an increasing range of financing options available to SMEs, although some of these are still at an early stage of development or, in their current form, are accessible only to a small share of SMEs. Up to now, a lack of awareness and understanding on the part of SMEs, financial institutions and governments of these alternative instruments, their modalities and operations has held back their broader use. Improving knowledge of the full range of financing instruments for SMEs and entrepreneurs represents a first step towards broadening access to these finance options.

Traditional debt includes instruments such as bank loans, overdrafts, credit lines and the use of credit cards. This type of finance offers moderate returns for lenders and is therefore appropriate for low-to-moderate risk profiles, i.e. firms that are characterised by stable cash flow, modest growth, tested business models, and access to collateral or guarantees. Alternative financing instruments alter this traditional risk sharing mechanism (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)	• Subordinated loans/bonds • Silent participations • Participating loans • Profit participation rights • Convertible bonds • Bonds with warrants • Mezzanine finance	• Private equity • Venture capital • Business angels • Specialised platforms for public listing of SMEs • Crowdfunding (equity)

Source: OECD (2013).

Asset-based finance is a widely used instrument to provide working capital to young and small firms on more rapid and flexible terms than traditional lending

At the one end of the risk/return spectrum are financing instruments that sustain the short and medium-to long-term financing needs of SMEs, but rely on different mechanisms than traditional debt. This is the case of asset-based finance (e.g. asset-based lending, factoring, leasing), whereby a firm obtains cash, based not on its own credit standing, but on the value of specific assets, including accounts receivables, inventory, machinery, equipment and real estate.

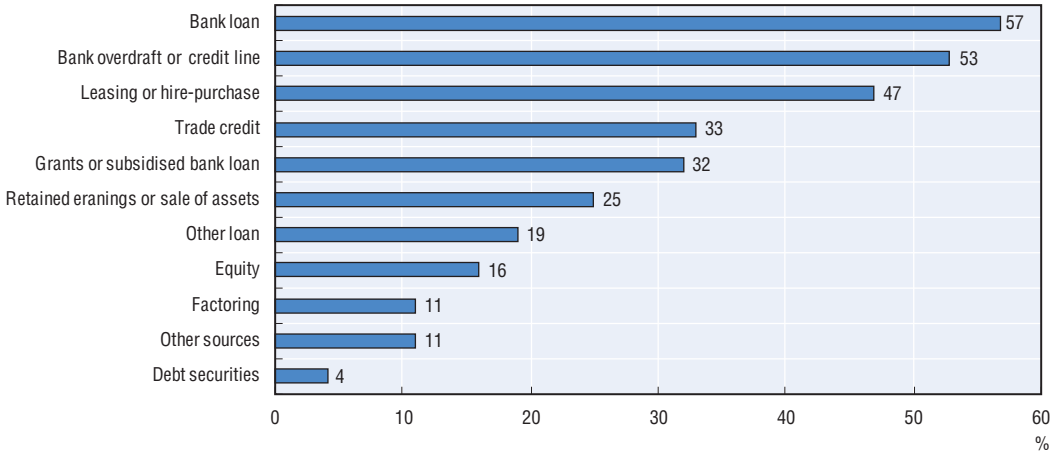
The key advantage of asset-based finance is that firms can access cash faster and under more flexible terms than through conventional secured lending, regardless of their balance sheet position and future cash flow prospects. Furthermore, with asset-based finance, firms that lack a credit history, face temporary shortfalls or losses, or need to accelerate cash flow to seize growth opportunities, can access working capital in a relatively short time. Asset-based agreements often allow for revolving funds; as advances are paid off, the borrower can secure additional funds backed by other assets. In addition, asset-based financiers do not generally require any equity or personal guarantee from the entrepreneur. On the other hand, the costs incurred and/or the complexity of procedures may be substantially higher than those associated with conventional bank loans, and funding limits are often lower than in the case of traditional debt.

Asset-based finance is widely used by SMEs across OECD countries, and increasingly in emerging economies, to meet their working capital needs, support domestic and international trade, and, in some cases, for investment purposes. In Europe especially, the prevalence of these instruments for SMEs is about on par with conventional bank lending (Figure 1.1). Asset-based finance has grown steadily over the last decade, in spite of repercussions of the global financial crisis on the supply side.

Policies to promote asset-based finance relate primarily to the regulatory framework, which is key to enable the use of a broad set of assets to secure loans. Across OECD countries, active policies exist to support asset-based finance for businesses that are

Figure 1.1. **Relevance of financing types for SMEs, EU28, ECB/EC SAFE survey, 2014**

% firms that used in the past or considered using in the future



Source: EC (2014).

StatLink http://dx.doi.org/10.1787/888933292086

unable to meet credit standards associated with long-term credit. In particular, factoring has been supported as a means to ease SMEs' access to trade finance and promote their inclusion in value chains. In emerging economies, the diffusion of factoring and leasing is favoured by less stringent requirements, in terms of an efficient legal and judicial system, than traditional and asset-based lending.

The potential of alternative debt instruments in the capital markets to finance SME investment is starting to be recognised

Alternative debt differs from traditional lending in that investors in the capital market, rather than banks, provide the financing for SMEs. Alternative forms of debt, such as corporate bonds, have had only limited usage by the SME sector, even within the larger size segment which would be suited for structured finance and could benefit from accessing capital markets, to invest and seize growth opportunities. Corporate bonds typically require the issuer to have a certain size and scale, an established credit history and earnings record, and limited volatility on revenues and earnings. As most SMEs do not meet these criteria, in the bond market they would attract low rating and high coupons and have limited dividends to cover these regular payments.

On the other hand, corporate bonds present some advantages for mid-sized firms that can meet the criteria requested by the market, and which can respond to the reporting requirements linked to bond issuance. Financing with corporate bonds can be an especially attractive option when market interest rates are low, as the coupon rates over the life of the bond can be set at a convenient rate, and still attract investors. Also, unlike equity, issuing bonds does not dilute ownership or the control of the company.

To foster the development of a corporate bond market for SMEs, mainly mid-caps, policy makers have targeted transparency and protection rules for investors, to favour greater participation and liquidity. Recent programmes have also encouraged the creation of SME trading venues and the participation by unlisted and smaller companies. In some countries, public entities participate with private investors in funds that target the SME bond market, with the aim of stimulating its development.

In some countries, the regulatory framework allows private placements of corporate bonds by unlisted companies, which are subject to less stringent reporting and credit rating requirements (Nassr and Wehinger, 2015). However, insufficient information on issuers and a lack of standardised documentation; illiquid secondary markets; and differences in insolvency laws across industry players and jurisdictions currently limit the development of these markets.

SME loan securitization is receiving increasing attention as a way to support capitalization of banks and foster SME lending

Debt securitization and covered bonds are instruments for the refinancing of banks and for their portfolio risk management; these instruments have developed at a high pace in the past decade. Through securitization, various types of contractual debt are pooled and sold to investors, who acquire rights to receive the cash collected from the financial instruments that underlie the security.

Securitization allows banks to transform SME loans in their balance sheets into liquid assets, which can be used to increase lending itself. Also, securitization reduces the bank's exposure to credit risk, which is transferred to the capital market. This has important implications in the light of the recent financial reforms (i.e. Basel III), as risky assets are taken out of the banks' balance sheets and the capital to risk-weighted asset ratios is improved. Ultimately, by giving capital relief, securitization reduces the bank's total cost of financing.

Covered bonds work similarly to securitised debt, except that assets remain on the issuer's consolidated balance sheet. Thus, they cannot help to strengthen the issuer's capital ratio. Asset encumbrance implies that they are seen as a complement, rather than as substitute to securitization. At the same time, because covered bonds are secured, they are considered to be less risky than unsecured bank bonds, which implies low-cost funding for the issuer.

However, in the wake of the financial crisis, debt securitization has come under scrutiny and criticism, as one major driver of risk leveraging and financial instability. Although it was not at the core of the financial turmoil, SME loan securitization, which had started to expand just before the crisis, came to a halt or decreased significantly, affected by contagion in financial markets and in public perceptions. Over the last few years, however, it has attracted renewed attention by policy makers and financial authorities, as an important instrument to foster SME lending.

Crowdfunding is still in the early stages of development as a source of business finance, but is expected to play an increasing role in the future, as this instrument becomes more regulated

Crowdfunding has grown rapidly since the mid-2000s, and at an increasing rate in the last few years, although it still represents a very minor share of financing for businesses. One specificity of this instrument, by which external finance is raised from a large audience through web platforms, is that it serves to finance specific projects rather than an enterprise. It has been used in particular by non-profit organisations and the entertainment industry, where non-monetary benefits or an enhanced community experience represent important motivations for donors and investors. Nevertheless, over time, crowdfunding has become an alternative source of funding across many other sectors, and it is increasingly used to support a wide range of for-profit activities and businesses (OECD, 2014b).

While donations, rewards and pre-selling currently lead the industry, lending and equity based crowdfunding are expected to play an increasing role in the future. Peer-to-peer lending can be attractive for small businesses that lack collateral or a credit history to access traditional bank lending. Equity crowdfunding can provide a complement or substitute for seed financing for entrepreneurial ventures and start-ups that have difficulties in raising capital from traditional sources.

The development of the Web 2.0 has been critical to the diffusion and evolution of crowdfunding platforms and practices and efficient banking systems have eased their development, by providing the infrastructure for payments, as well as information about the creditworthiness of the entrepreneurs. However, while the pace of technological developments has enabled a rapid diffusion of crowdfunding, the regulatory environment has limited the expansion of its use, especially for securities-based crowdfunding, which is still not legal in some countries. Hence, in recent years, crowdfunding has received close attention by regulators in some OECD countries. The exemptions to general rules to secure investors or the implementation of ad hoc regulation are expected to facilitate the growth of the industry.

With the support of public programmes, hybrid instruments are increasingly available to lower-tier SMEs

Hybrid instruments, which combine debt and equity features into a single financing vehicle, have developed unevenly in OECD countries. Hybrid techniques represent an appealing form of finance for firms that are approaching a turning point in their life cycle, when the risks and opportunities of the business are increasing, a capital injection is needed, but they have limited or no access to debt financing or equity, or the owners do not want the dilution of control that would accompany equity finance. This can be the case of young high-growth companies, established firms with emerging growth opportunities, companies undergoing transitions or restructuring, as well as companies seeking to strengthen their capital structures. At the same time, these techniques are not well-suited for many SMEs, as they require a well-established and stable earning power and market position, and demand a certain level of financial skills.

The use of hybrid instruments, such as mezzanine finance, which lies in the middle of the investors' risk/return spectrum (Table 1.2), has followed divergent patterns in the aftermath of the crisis. The commercial market contracted and, in some countries where private lenders were in retreat, recourse to officially supported mezzanine credit grew substantially, as governments stepped in to fill the void. However, throughout the recovery, as banks retreated from lending to non-investment grade companies, debt financing targeting private capital markets has been increasing.

In recent years, with the support of public programmes, it has become increasingly possible to offer hybrid tools to SMEs with lower credit ratings and smaller funding needs than what would be the practice in private capital markets. Governments and international organizations mainly intervene through: i) participation in the commercial market with investment funds that award mandates to private investments specialists; ii) direct public financing to SMEs under programmes managed by public financial institutions; iii) guarantees to private institutions that offer SMEs the financial facility and; iv) funding of private investment companies at highly attractive terms.

Table 1.2. **Comparison of mezzanine finance and other financing techniques**

	Senior debt	Mezzanine	Equity
Economic perspective	Debt	Equity	Equity
Legal perspective	Debt	Debt	Equity
Ranking	Senior	Contractually subordinated	Junior
Taxation	Debt interest deductible	Debt interest deductible	Tax on capital
Covenants	Comprehensive restrictions	Tracks senior, but looser	None
Security	Yes -1st ranking	Yes -2nd ranking	No
Investor's involvement in management	No direct involvement	Moderate involvement; board seats	Direct involvement
Purpose	Contractually specified	Not specified	Not specified
Term	4-5 years	5-10 years	Open ended
Interest costs	Cost of funds + 255-350 basis points	150-300 basis points above senior	None
Repayment	Amortizing from cash flow	Bullet[1] upon exit or at maturity	None
Warrants	None	Almost always	None
Total expected return	5-13%	13-25%	> 25%

1. The payment for the principal is not made over the life of the loan, but rather as a lump-sum payment at exit or maturity.

Source: Adapted from Crédit Suisse (2006).

Private equity investment has developed substantially in recent decades, partly offsetting stagnation in public markets

Equity finance is key for companies that seek long-term corporate investment, to sustain innovation, value creation and growth. Equity financing is especially relevant for companies that have a high risk-return profile, such as new, innovative and high growth firms. Seed and early stage equity finance can boost firm creation and development, whereas other equity instruments, such as specialised platforms for SME public listing, can provide financial resources for growth-oriented SMEs.

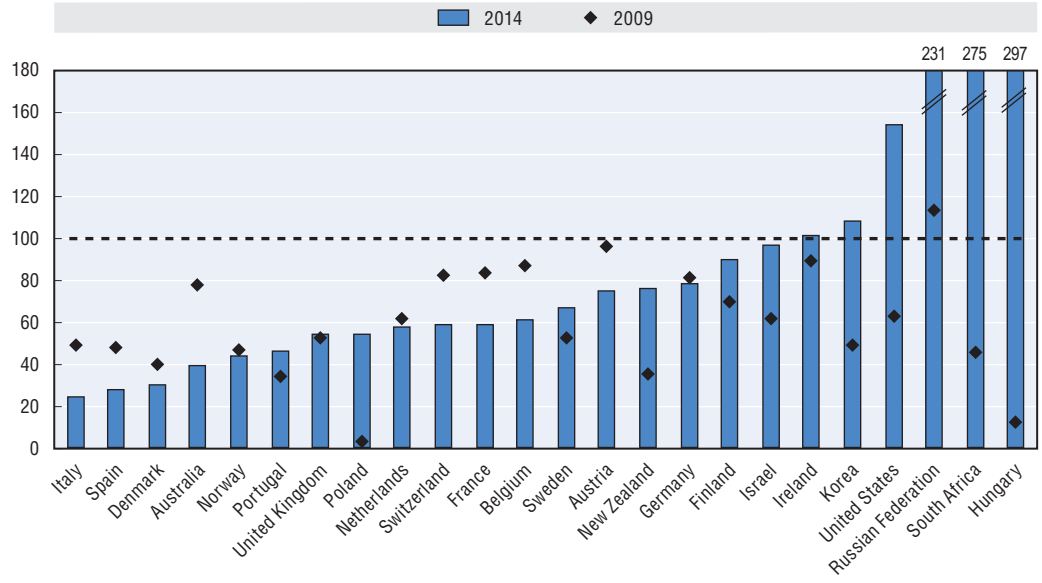
Across OECD and non-OECD countries, private equity investments have developed substantially over the last two decades. This has partly offset the stagnation in public markets, although, following the global financial crisis, exit options have become more challenging for private equity investors. In particular, venture capital and angel investing have been providing new financing opportunities for innovative, high growth potential start-ups, mainly, though not exclusively, in high-tech fields. Their role has been increasing over the last decade, as the industry has become more formalised and organised, including through syndicates, associations and networks, although the global financial crisis severely affected the venture capital industry. In 2014, in most countries the level of venture capital investments was still below the pre-crisis level, and, in some cases, below the level it reached in 2009 (Figure 1.2).

Venture capital funds and business angels are characterised by different motivations, targets, scale and operating models, but are highly complementary in the financing continuum for early stage firms. Business angels need a well-functioning Venture Capital (VC) market to provide the follow-on finance that some of the businesses they support will require. At the same time, a well-developed angel market can create more investment opportunities and increase the deal flows for VCs.

Policy makers have placed increasing attention on these equity markets, as a way to mobilise financial resources and entrepreneurial expertise towards innovative ventures. The policy mix has been largely composed of supply-side measures, such as tax incentives, direct investment and co-investment, support to industry networks and associations, to

Figure 1.2. **Venture capital trends, 2007-14**

2007 = 100



Source: OECD (2015).

StatLink http://dx.doi.org/10.1787/888933292091

increase visibility and scale and favour match-making with entrepreneurs. To a lesser degree, policies target also training, mentoring and coaching for investors. As in the case of other instruments, the demand side has received less policy attention and resources, although countries are increasingly implementing measures that target the skills of existing or would-be entrepreneurs.

Public listings of SME equity have the potential to provide funding for innovative and high-growth SMEs, but markets are currently small

For decades, private market participants and officials have been seeking to encourage the development of specialised exchanges or similar trading platforms to satisfy the demand of SMEs for equity finance. Public listing of SME equity through primary and secondary issuance has the potential to provide funding for a company's growth and can support subsequent debt financing. Existing SME owners can realise their capital gains and tap a wider investor universe, including retail investors and sophisticated long-term institutional investors.

A number of equity markets targeting smaller listings have been established in different parts of the world. Compared to generic stock exchanges, specialised platforms for SMEs, or "new markets", offer more flexible listing criteria, eased disclosure requirements and comparatively low admission cost so as to cater to SMEs. At the same time, new markets typically adopt operating practices to preserve investor interest and market integrity.

Despite their potential, the share of SME financing provided through capital markets is currently very small. Important obstacles to the wider use of public equity for SMEs remain to be resolved. In addition to cost, red tape and reporting requirements, cultural factors and management practices also constitute challenges for SMEs. Lack of confidence to go through the offering process, fear of being exposed to share price volatility, aversion to sharing sensitive information, but also lack of education around the process of listing and life after an IPO are other reasons for SME reluctance to join equity capital markets.

In addition, entrepreneurs tend to be unwilling to relinquish ownership or control of their business or accept potential lock-in periods upon listing.

On the investor side of the market, financiers are confronted with high monitoring costs relative to the level of investment, regulatory obstacles and investor protection considerations. Low levels of liquidity in SME growth markets (inherent in the SME asset class) act as one of the main deterrents to investment in public SME equity.

Policy has sought to mobilise retail investment to address the lack of liquidity in SME equity markets, for instance by increasing the threshold level at which public disclosure and related requirements kick in, or by providing tax breaks for investment in unquoted companies which may subsequently list. Recent regulatory approaches recognise that these platforms may require tailored regulation and infrastructure, to facilitate access by SMEs while preserving investor interest. In some countries, new markets offer growth-oriented entrepreneurs dedicated services, such as the introduction to experienced investors, or the possibility to retain a higher level ownership than a traditional IPO.

Key challenges and policy implications

The challenges to SME uptake of alternative financing instruments need to be addressed

Common obstacles exist for the SME sector to fully reap the benefits of a more diversified financial offer through alternative financing instruments. Policy makers and stakeholders need to address these challenges if the increasingly complex financial system is to serve the needs of the real economy.

SME skills and strategic vision for their financing needs should be improved

SME skills and strategic vision are a key ingredient in any effort to broaden the range of financing instruments. The limited awareness and understanding about alternative instruments on the part of start-ups and SMEs have limited the development of these markets. It is not only a matter of increasing knowledge about individual instruments, but also supporting SMEs in developing a long-term strategic approach to business financing, that is, understanding how different instruments can serve different financing needs at specific stages of the life cycle, the advantages and risks implied, and the complementarities and possibility to leverage these sources.

It is also necessary to improve the quality of start-ups' business plans and SME investment projects, especially for the development of the riskier segment of the market. In many countries, a major impediment to the development of equity finance for young and small businesses is the lack of "investor-ready" companies. Furthermore, SMEs are generally ill-equipped to deal with investor due diligence requirements. Indeed, an increasing concern about the lack of entrepreneurial skills and capabilities and low quality of investment projects is driving more policy attention to the demand side, although supply-side policies are still prevalent. This includes measures such as training and mentoring.

Effective regulation should be designed that balances financial stability and the opening of new financing channels for SMEs

The regulatory framework is a key enabler for the development of instruments that imply a greater risk for investors than traditional debt finance, from asset-based finance to equity financing. Thus, designing and implementing effective regulation, which balances

financial stability, investors' protection and the opening of new financing channels for SMEs, represents a crucial challenge for policy makers and regulatory authorities. This is especially the case given the rapid evolution in the market, resulting from technological changes as well as the engineering of products that, in a low interest environment, respond to the appetite for high yields by financiers. New financing models are emerging that may engage relatively inexperienced investors, such as in the case of crowdfunding, or in which the misalignment of incentives may place at risk the stability of the system, which is made more vulnerable to risk by an increased interconnectedness of financial markets.

Securitization is a case in point in this regard. Recent regulatory initiatives address pitfalls brought to the fore during the global financial crisis, such as the misalignment of interests between originators and investors and of regulatory capital with credit risk, as well as the lack of due diligence by investors. However, regulatory reforms intended to make the financial sector safer are perceived to be unduly onerous by many investors, who are withdrawing from the market. Also, the lasting uncertainty arising from expected regulatory revisions creates disincentives to investors and hampers the re-launch of the market. Certainty is part of a sound regulatory framework for investors.

Also, efforts should be made to foster the wider use of public equity for SMEs, which is currently held back by high costs, regulatory burdens, lack of liquidity and trading practices that create disincentives for intermediaries. The right balance between administrative and regulatory burden and due diligence needs to be achieved, so that the flexibility provided to SMEs does not compromise investor protection, integrity of market participants, corporate governance or transparency. Policy should provide incentives that encourage capital market participants to take a longer-term approach, and offer additional services to growth-oriented entrepreneurs. Creating the right ecosystem for public equity for SMEs will also support the development of other, non-traditional SME equity instruments such as equity private placements, equity crowdfunding, listed funds (with potential co-funding and risk sharing between the private and public sectors), and corporate venturing.

Information infrastructures should be developed to reflect more accurately the level of risk associated with SME financing and encourage investors' participation

Addressing information asymmetries and increasing transparency in the markets are priorities to boost the development of alternative financing instruments for SMEs. Information infrastructures for credit risk assessment, such as credit bureaux or registries or data warehouses with loan-level granularity, can reduce the perceived riskiness investors fear when approaching SME finance and help them identify investment opportunities. More reliable information about risk may also help reduce the financing costs which are typically higher for SMEs than for large firms. The higher risks and costs stem from the large heterogeneity and opacity of the SME sector, with entrepreneurs often less prone, willing or able to share risk-sensitive information.

In some countries, policies seek to address the information gap between SMEs and potential investors by facilitating their direct interaction, with different degrees of public engagement, from awareness campaigns to brokerage and match-making. In the business angel market, for instance, public action has largely aimed at improving information flows and networking opportunities between financiers and entrepreneurs. In some cases, however, the facilitation efforts have not produced the desired results, due to the lack of maturity of local markets, i.e. little scale or lack of investor-ready companies.

This highlights the need for a policy mix that takes into account existing limitations on both the supply and the demand sides.

Policies should be implemented that leverage private resources and develop appropriate risk-sharing mechanisms with the private sector

For some hybrid or equity instruments, policy makers face the challenge of kick-starting the offer for SMEs, or extending it to SMEs with lower credit ratings and smaller financial needs than those usually served by private investors, while ensuring long-term sustainability. In the aftermath of the global financial crisis, as private investors withdrew from some market segments, public policies have also aimed at sustaining these markets, with governments stepping in to fill, at least in part, the financing gap for innovative or growth-oriented enterprises. As a result, the public share of funding in these higher risk segments has significantly increased. A key challenge now is to leverage private resources and develop appropriate risk-sharing mechanisms with private partners.

The evidence base should be improved

In spite of their growing importance for financiers and SMEs, the evidence about the use of these various tools by SMEs, and how different instruments respond to their needs, is currently patchy. The lack of hard data on non-debt financing instruments represents an important limitation for the design, implementation and assessment of policies in this area. This limitation is particularly critical when seeking to take account of SME heterogeneity in the process of policy design. Micro data and micro level analysis are essential to improve understanding about the different needs of the SMEs sector and may help to better understand the potential and challenges of new business models emerging in the financial sector.

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Chapter 2

Traditional debt finance and alternative financing instruments for SMEs

This chapter provides the rationale for the study and illustrates the objective and structure of the report. It describes traditional lending technologies and related credit-risk mitigation techniques. It comments on their limitations for financing young and small firms and for sustaining long-term investment and growth. It discusses how financing instruments alternative to straight debt alter the traditional risk-sharing mechanism and proposes a categorization of these instruments across the risk/return spectrum, i.e. by differing degrees of risk and return.

SME finance in the post-crisis environment

Bank lending is the most common source of external finance for many SMEs and entrepreneurs, which are often heavily reliant on straight debt to fulfil their start-up, cash flow and investment needs. While it is commonly used by small businesses, however, traditional bank finance poses challenges to SMEs and may be ill-suited at specific stages in the firm life cycle.

In particular, debt financing appears to be ill-suited for newer, innovative and fast growing companies, with a higher risk-return profile. The "financing gap" that affects these businesses is often a "growth capital gap". Substantial amounts of funds might be needed to finance projects with high growth prospects, while the associated profit patterns are often difficult to forecast. The financing constraints can be especially severe in the case of start-ups or small businesses that rely on intangibles in their business model, as these are highly firm-specific and difficult to use as collateral in traditional debt relations (OECD, 2010a). Yet, for most enterprises, there are few alternatives to traditional debt (OECD, 2006). This represents an important challenge for policy makers pursuing sustainable recovery and long-term growth, since these companies are often at the forefront in job creation, the application of new technologies and the development of new business models.

While alternatives to traditional debt finance are particularly important for start-ups, high-growth and innovative SMEs, the development of alternative financing techniques may be relevant to the broader population of SMEs and micro-enterprises. Capital gaps exist also for companies seeking to effect important transitions in their activities, such as ownership and control changes, as well as for SMEs seeking to de-leverage and improve their capital structures. The thin capitalisation and excessive "leverage" (excessive reliance on debt financing compared to equity) impose costs, as loans to companies that already have considerable amounts of debt tend to have higher interest rates, and increase the risk of financial distress and bankruptcy.

In the aftermath of the 2008-09 global financial crisis, the bank credit constraints experienced by SMEs in many countries have further highlighted the vulnerability of the SME sector to changing conditions in bank lending. The long-standing need to strengthen capital structures and to decrease dependence on borrowing has now become more urgent, as many firms were obliged to increase leverage in order to survive the crisis, and, at the same time, banks in many OECD countries have been contracting their balance sheets in order to meet more rigorous prudential rules. As banks continue their deleveraging process, there is a risk that a large-scale reduction in bank assets could lead to a credit crunch (IMF, 2012a, 2012b). There is a broad concern that credit constraints will simply become "the new normal" for SMEs and entrepreneurs and that they could be disproportionately affected by the on-going financial reforms, and especially by the rapid pace of their implementation, as they are more dependent on bank finance than large firms and less able to adapt readily (OECD, 2012).

It is therefore necessary to broaden the range of financing instruments available to SMEs and entrepreneurs, in order to enable them to continue to play their role in growth,

innovation and employment. Financial stability, financial inclusion and financial deepening should be considered as mutually reinforcing objectives in the quest for sustainable recovery and long-term growth. While bank financing will continue to be crucial for the SME sector, more diversified options for SME financing could support long-term investments and reduce the vulnerability of the sector to changes in the credit market. Indeed, the problem of SME over-leveraging may have been exacerbated by the policy responses to the financial crisis, as the emergency stabilisation programmes tended to focus on mechanisms that enabled firms to increase their debt (e.g. direct lending, loan guarantees), as funding from other sources (e.g. business angels, venture capital) became more scarce (OECD, 2010b, 2012).

An effective financial system is one that can supply financial resources to a broad range of companies in varying circumstances and channel financial wealth from different sources to business investments. As the banking sector remains weak and banks adjust to the new regulatory environment, institutional investors and other non-bank players, including wealthy private investors, have a potential role to play for filling the financing gap that may widen in the post-crisis environment.

However, a lack of awareness and understanding on the part of SMEs, financial institutions and governments of alternative financial instruments, their modalities and operations constitute a major barrier to their use. Through the present report, the OECD intends to help broaden the finance options available to SMEs and entrepreneurs, by improving understanding about the full range of financing instruments they can access in varying circumstances and by encouraging discussion among stakeholders about new approaches and innovative policies for SME and entrepreneurship financing.

For this purpose, the present report maps a broad range of financing techniques alternative to straight debt, providing insights about their functioning, the profile of firms that are suited for them, key enabling factors for their development, major trends in the market and access by SMEs, and policies to support a broader uptake by the SME population. The remainder of this chapter describes traditional lending technologies and related credit-risk mitigation techniques, comments on their limitations for financing young and small firms and for sustaining long-term investment and growth, and briefly introduces the main financial instruments alternative to straight debt, categorizing them across the risk/return spectrum.

Traditional debt finance

Traditional debt finance – bank loans, overdrafts, credit lines and the use of credit cards – is the most common source of external finance for many SMEs and entrepreneurs. The defining characteristic of straight debt instruments is that they represent an unconditional claim on the borrower, who must pay a specified amount of interest to creditors at fixed intervals, regardless of the financial condition of the company or the return on the investment. The interest rate may be fixed or adjusted periodically according to a reference rate. Straight debt does not include any features other than payment of interest and repayment of principal, i.e. it cannot be converted into another asset, and bank claims have high priority in cases of bankruptcy ("senior debt").

Traditional lending technologies

In traditional debt finance, the extension of the credit is primarily based on the overall creditworthiness of the firm and the lender considers the expected future cash flow of the firm as the primary source of repayment. However, the techniques to assess and monitor

the firm's creditworthiness, thus addressing the problem of information asymmetry between lender and borrower, may vary significantly. Different lending technologies combine different sources of information about the borrower, screening and underwriting procedures, structure of the loan contracts, monitoring strategies and mechanisms. The literature distinguishes *transaction lending*, based primarily on "hard" quantitative data, and *relationship lending*, largely based on "soft" qualitative information (e.g. Berger and Udell, 2002, 2006). Under the first category are: i) financial statement lending, which depends on the availability of informative and audited financial statements on the side of the borrower and thus applies to informationally transparent borrowers, and; ii) small business credit scoring, which, on the other hand, may be applied to informationally opaque SMEs, as much of the information concerns the personal history of the owner, rather than the enterprise (Box 2.1).

Box 2.1. **Straight debt finance: Transaction lending technologies**

Financial statement lending

Financial statement lending is based primarily on the strength of a borrower's financial position and implies availability of informative and reliable financial statements, such as audited statements prepared in accordance to widely accepted accounting standards. It is thus reserved for informationally transparent firms. The extension of the credit depends on a strong financial condition as reflected in the financial ratios calculated from these statements, such as current ratio (current assets over current liabilities), debt to equity ratio, gross profit percentage (gross profit over gross sales), return on assets (net income over total assets), and return on equity (net income over net worth).

Small business credit scoring

Small business credit scoring is based on the analysis of large amounts of historical data about the SME's owner as well as the firm. It may thus be applied to informationally opaque SMEs. The data are entered into a loan performance prediction model, which yields a score for the loan. The approach allows reduction in costs and time of granting a loan, greater consistency of credit evaluation and focus on difficult cases or large loan requests. The scoring method was first adopted in consumer lending, based on the large amounts of data readily available for banks on the performance of consumer credits and on the characteristics of borrowers. In the case of SME lending, however, the data needed to manage credits on a statistical basis may be available only to large banks, which are in fact the main adopters of credit scoring, or to smaller financial institutions that share or 'pool' data. There exist also credit reference agencies that provide credit scoring systems to banks which lack their own historical database. The credit scoring provided to banks by external agencies can cover both the business and the individuals in the business, based on their personal credit experience and rating.

Source: Berger and Udell (2006), DeYoung et al. (2010), OECD (2013b).

In the case of relationship lending, information is gathered directly by the loan officer through contact over time with the enterprise, the entrepreneur and the local community, and by observing the SMEs' performance on all dimensions of its banking relationship, including loan contracts, deposits and other financial products. The loan officer may often remain the proprietor of the soft information, as this may not be easily observed and verified by others. This gives rise to agency problems, which may be better addressed by

small banking organisations with few managerial layers and closer coordination between the management and loan officers (Berger and Udell, 2002; Stein, 2002). Also, small banks are often headquartered closer to potential relationship customers, reducing problems associated with transmitting soft information from loan officers to senior management. In fact, greater hierarchical and/or geographical distance between the information collecting agent and the loan approving officer may lead to less reliance on subjective information and more on objective information (Liberti and Mian, 2009).

Empirical studies support the argument that small banks may find it more convenient than large institutions to engage in relationship lending. For instance, based on a survey of SMEs' finance in Japan, Uchida (2011) finds that, in the screening process to grant loans to SMEs, smaller banks give more importance to the relationship factor, also using third-party information as a reference. Furthermore, smaller banks tend to place greater emphasis on the collateral value of borrowers than large banks, suggesting that small banks might need to insure their relationship lending through the requirement of collateral. Matching data on US small businesses, the banks that lend to them and the contract characteristics of loans, Berger and Black (2011) also find that small banks have a comparative advantage in relationship lending. However, they also suggest that this advantage may be strongest for lending to the largest firms, whereas in the case of smallest firms credit scoring is increasingly preferred.

It is often the case, however, that banks adopt a mix of lending techniques to evaluate the firm's creditworthiness and assess the credit risk. Investigating the choice of the lending technologies on a sample of SME loans in Japan, Uchida et al. (2006) find complementarity among technologies. In particular, financial statement lending and relationship lending are often used jointly. In a study on lending practices towards Italian manufacturing firms, Bartoli et al. (2010) also find the distinction between transaction lenders and relationship lenders to be rather blurred, as firms may obtain debt finance from the same bank through different lending technologies. This form of complementarity is found at both large and small banks, suggesting that transactions lending techniques, such as credit scoring, are used to "harden" – or codify – the soft information collected through relationship lending. However, the study also finds that the way soft information is embodied in the lending decision differs depending on the main approach used by the bank. In particular, soft information appears to raise (lower) the probability of credit rationing if the bank adopts mainly transaction (relationship) lending technologies. In other terms, banks that mainly use hard information to screen borrowers tend to use soft information as a mechanism for further discriminating loan applications.

Credit risk mitigation in traditional lending

Specific challenges limit traditional bank lending to SMEs. These are largely related to the greater difficulties that lenders encounter in assessing and monitoring SMEs relative to large firms (OECD, 2006, 2013b). First, *asymmetric information* is a more serious problem in SMEs than in larger firms. SMEs often do not produce audited financial statements that yield credible financial information and have no obligation to make public disclosure of their financial reports, although they are generally obliged to produce them and make them available to relevant authorities upon request. Furthermore, in smaller enterprises, the line of demarcation between the finances of the owner(s) and those of the business is usually blurred. Unlike established public companies, which are expected to observe standards of corporate governance with clearly defined roles for shareholders, managers

and stakeholders, SMEs tend to reflect the idiosyncrasies of their owners and their informal relationships with stakeholders. Hence, the entrepreneur has better access than the financier to information concerning the operation of the business and has considerable leeway in sharing such information with outsiders. The implications of asymmetries in information are made more severe by the large heterogeneity in the SME sector. SMEs are characterised by wider variance of profitability and growth than larger enterprises, and exhibit greater year-to-year volatility in earnings (OECD, 2006).

Second, *the principal/agent problem*, which is inherent in all financing operations, is particularly acute in the case of SMEs. Once financing is received, the entrepreneur may use funds in ways other than those for which it was intended. An entrepreneur might undertake excessively risky projects since all of the "upside" of the project belongs to the entrepreneur while a banker would prefer a less risky operation, even if profitability is less than under the riskier alternative. A large firm wishing to undertake a comparatively risky activity could select a different technique with appropriate formulas for sharing risk and reward, such as equity issuance, but the range of choice available to small firms is usually narrower (OECD, 2013a).

Financial institutions have developed several methods to mitigate the incidence of these challenges in SME lending. The main objective is to alter the risk-sharing mechanism in order to align incentives between lender and borrower.

Commonly used methods to manage SME credit risk include (OECD, 2013a):

i) Requests for high equity contributions by prospective borrowers

ii) Requirements for collateral. i.e. an asset of the borrower, the possessive right of which is provided to the lender in case of default

iii) Credit guarantees, whereby should the borrower default the guarantor compensates a pre-defined share of the outstanding loan

iv) Loan covenants, i.e. a condition imposed by the lender with which the borrower must comply in order to adhere to the terms in the loan agreement. Common loan covenants include:

   a) Hazard insurance/content insurance, under which the borrower is required to keep insurance coverage on the plant/equipment or inventory in order to safeguard against the catastrophic loss of collateral;

   b) Key-man life insurance, which insures the life of the indispensable owner or manager without whom the company could not continue. The lender usually gets an assignment of the policy;

   c) Requirements for payment of taxes/fees/licenses, whereby the borrower agrees to keep those expenses up to date. In fact, failure to pay would result in the assets of the company being encumbered by a lien (i.e. legal claim on property) from the government, which would take precedence to the one from the bank;

   d) Provision of financial information on the borrower and guarantor, whereby the borrower agrees to submit financial statements for the continuing assessment by the bank;

   e) Borrower prevented from taking specific actions without prior approval, such as: change in management or merger, demanding more loans, or distributing dividends.

In the post-crisis environment, it is recognised that bank financing will continue to be crucial for the SME sector and policy measures in many countries are still largely oriented

towards facilitating SMEs' access to debt finance. However, it is increasingly acknowledged that more diversified options for SME financing are needed, to address the generalised "growth capital gap", to support long-term investment, to reduce the vulnerability of SMEs to shocks in the credit market, and to cope with the changing regulatory environment and more rigorous prudential rules.

Alternative financing instruments

Traditional debt finance generates moderate returns for lenders and is therefore appropriate for low-to-moderate risk profiles. It typically sustains the ordinary activity and short-term needs of SMEs, generally characterised by stable cash flow, modest growth, tested business models, and access to collateral or guarantees.

Financing instruments alternative to straight debt alter this traditional risk-sharing mechanism. Table 2.1 provides a list of external financing techniques alternative to straight debt, categorised into four groups, characterised by differing degrees of risk and return, whose main features (modalities/operational characteristics, enabling factors, trends, support policies) will be outlined in detail in this report.

Table 2.1. **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)	• Subordinated loans/bonds • Silent participations • Participating loans • Profit participation rights • Convertible bonds • Bonds with warrants • Mezzanine finance	• Private equity • Venture capital • Business angels • Specialised platforms for public listing of SMEs • Crowdfunding (equity)

Source: OECD (2013a).

At the one end of the risk/return spectrum are financing instruments that sustain the short and medium-to-long term financing needs of SMEs, but that rely on different mechanisms than traditional debt. This is the case of *asset-based finance*, such as *asset-based lending*, *factoring* and *leasing*, whereby a firm obtains cash, based not on its own credit standing, but on the value that a particular asset generates in the course of its business. The close relationship between the liquidation value of an asset and the amount borrowed, as well as the broad range of assets that can be used to access lending, are the key factors that distinguish asset-based lending from traditional secured or collateralised lending, in which the loan amount and conditions also depend on the overall assessment of the firm's credit worthiness. Furthermore, asset-based lending generally provides more flexible terms than conventional secured lending, often allowing for revolving funds; as advances are paid off, the borrower can secure additional funds backed by other assets (see Chapter 3).

Trade credit is also an important source of finance for many SMEs and start-ups, which can substitute or supplement short-term bank lending. This mainly consists of the extension of traditional credit instruments and credit-mitigation tools, such as loans and guarantees, to sustain import and export activities. Guarantees can take the form of letters of credit (L/C), which represent a bank obligation to pay, thereby reducing an export's payment risk on an importer/buyer.

Alternative forms of debt also exist, which can be considered "innovative" in the context of SME financing because they have had until now limited applicability to the SME sector. These alternative debt instruments include *corporate bonds*, *securitised debt* and *covered bonds*, in which investors in the capital markets, rather than banks, provide the financing for SMEs (see Chapter 4). While corporate bonds are direct instruments of debt finance for SMEs, securitisation and covered bonds represent "indirect" tools for supporting SME debt financing, in that the product issued to the firm is a loan. In particular, securitisation of SME debt allows banks to transfer their credit risk to the capital markets, as SME loans are sold to a specialised company, which creates a new security backed by the payments of SMEs. In this way, banks achieve capital relief and free up capacity for new loans to SMEs. Over the last decade, securitised debt has grown rapidly, although the financial crisis hit this market severely. On the other hand, few SMEs have succeeded in issuing corporate bonds, because of difficulties that small privately held companies have in meeting investor protection regulations and the high relative cost of bond issuance for small companies (OECD, 2013a).

At the other end of the risk/return spectrum are financing instruments that enable an investor to accept more risk in exchange for a higher return, and are expected to produce a better alignment of the interests of certain kinds of SMEs and the providers of finance. *Hybrid instruments*, such as mezzanine finance, form a bridge between traditional straight debt and pure equity (see Chapter 6). *Seed and early stage finance* addresses the high risk-return segment of the business financing spectrum, boosting firm creation and development, whereas other equity-related instruments, such as *private equity* and *specialised platforms for SME public listing*, can provide financial resources for growth-oriented SMEs (see Chapter 7).

The report also considers the potential for SME financing of new instruments, such as *crowdfunding* or *peer-to-peer lending*. These have grown rapidly in some countries and have attracted increasing attention by policy makers and regulators, also with a view to address concerns about transparency, investors' risk awareness and consumer protection (see Chapter 5).

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Chapter 3

Asset-based finance for SMEs

This chapter describes the functioning of asset-based finance, which includes asset-based lending, factoring, purchase-order finance, warehouse receipts and leasing, and comments on how it can serve diverse SME financing needs in varying circumstances. The chapter compares the functioning mechanisms of the different asset-based tools, comments on the profile of firms that are suited for each one of them, and discusses the key enabling factors for their development. It then illustrates trends in asset-based finance across world regions and provides examples of regulatory reforms and policy programmes to support the development of asset-based financing for SMEs.

Asset-based finance, which includes asset-based lending, factoring, purchase-order finance, warehouse receipts and leasing, differs from traditional debt finance, as a firm obtains funding based on the value of specific assets, rather than on its own credit standing. Working capital and term loans are thus secured by assets such as trade accounts receivable, inventory, machinery, equipment and real estate.

The key advantage of asset-based finance is that firms can access cash faster and under more flexible terms than they could have obtained from a conventional bank loan, regardless of their balance sheet position and future cash flow prospects. Furthermore, with asset-based finance, firms that lack credit history, face temporarily shortfalls or losses, or that need to accelerate cash flow to seize growth opportunities, can access working capital in a relatively short time. In addition, asset-based financiers do not generally require any personal guarantee from the entrepreneur, nor that s/he give up equity.

On the other hand, the costs incurred and/or the complexity of procedures may be substantially higher that those associated with conventional bank loans, including asset appraisal, auditing, monitoring and up-front legal costs, which may reduce the firm's levels of profits. Also, funding limits are often lower than in the case of traditional debt.

Forms of asset-based finance

Asset-based lending

Modalities

Asset-based lending (ABL) is any form of lending secured by an asset. It is thus a transactions lending technology in which financial institutions address the problem of information asymmetry by focusing on a subset of the firms' assets, as the primary source of repayment (Berger and Udell, 2006). Typically, four types of asset classes are secured under ABL: accounts receivable, inventory, equipment and real estate.

The amount the firm can borrow depends on the appraised value of the selected assets, rather than on the overall creditworthiness of the firm, taking into account the ease to sell off the assets should the borrower be unable to generate cash to repay the loan. The amount of credit extended is linked to the liquidation value of the assets, which is estimated and monitored on the basis of hard data, often relying on industry-specific knowledge. Thus, monitoring and asset evaluation methodologies are of the utmost importance for this type of lending, which explains the historical use of "tangible" assets to secure loans and, on the other hand, the limited exploitation of intangibles, such as trademarks, patents and copyright. However, as methodologies for evaluating intangible assets become more accepted, these assets can also increasingly be used as collateral (Box 3.1).

The asset-based loan agreement often allows for a revolving arrangement, whereby, if the borrower needs other advances, these can be secured by more assets, such as more receivables, as others are collected and paid off. Hence, as the borrower generates receivables from new sales or builds more inventories, these assets are generally eligible for inclusion in the 'borrowing base'. This arrangement requires constant monitoring of

Box 3.1. **Intangible Asset-Based Lending (IABL)**

Intangible Asset–Based Lending (IABL) leverages a portfolio of Intellectual Property (IP) or other intangible assets to secure a loan. The loan can be backed by the stream of revenues tied to a single intellectual asset or to the firm's entire portfolio. In either case, firms can secure their intellectual assets in addition to a blanket lien against common collateral such as real estate or receivables.

In recent years, a variation on IABL, royalty financing arrangements, has developed, especially in the pharmaceutical and biotechnology sectors. In this case, lending is secured by royalty interest and revenue interest transactions, whereby, similar to a securitization transaction, loans are backed by a current or prospective royalty stream. Whereas "royalty interests" are already cash-flow positive, the "revenue interests" are riskier for the financier, as these are revenues anticipated to be derived from an identified product and related intellectual property. They apply to firms that are close to the commercial launch of a product or device and, due to the greater level of risk, the investing institution is generally able to negotiate more favourable terms. Unlike a securitisation, the loans are generally not bundled and sold to the general public, but held by a speciality investment fund.

Typically, firms specialising in IABL partner with banks or private equity firms that ultimately provide the funds, to secure a line of credit for the target company. As IABL requires flexibility and specialisation to account for differing and unique factors inherent in intangible assets, these specialised firms provide financial institutions with additional protections to offset the complexity and uncertainty surrounding intellectual assets valuation.

Source: Ellis and Jarboe (2010), Jung and Tamiseia (2010), EC (2014a).

collateral by the lender to control and manage the credit risk. Typically the lender audits the borrower's assets daily, to monitor and secure the performance of the loan (GE Capital, 1999; Caouette et al., 2008).

As unsecured loans, asset-based loans expose the lender to the generic credit risk, that is, to the risk related to "integrity, moral character, debt-paying habits and ability of the proposed borrower" (Clarke, 1996, p. 15). In addition the asset-based lender is exposed to risks that are specifically related to the securing mechanisms underlying ABL, such as (Caouette et al., 2008):

- Collateral risk, i.e. the risk that the collateral securing the loan will decline in value after loan inception and be insufficient to liquidate the loan. In the case of account receivables, for instance, the asset can be diluted by credit notes (for returns, errors or damages), write-offs (i.e., for bad debt), payment discounts, as well as customer rebates and allowances (Benchaya and Anderson, 2010);
- Collateral illiquidity, i.e. the risk that the process to liquidate the collateral will be time-consuming and costly, detracting from the ultimate returns. Accounts receivable are considered to be highly liquid assets, whereas inventory may be more difficult to value, monitor and liquidate;
- Legal risk; i.e. the risk of incurring costly legal mistakes, due to inadequate legal documentation or mismanagement of the loan facility.

In light of the above risks, particularly of the expected asset value dilution and losses, asset-based lenders typically lend at a discount to the actual value of the secured assets. For accounts receivables, a loan-to-value ratio (LVR) of 80-85% is considered normal

(Caouette et al., 2008). On the other hand, in the case of less liquid assets, the LVR can be significantly lower. For instance, if inventory is the secured asset the lender might extend a credit of up to 40% of the estimated value. Lenders often seek advice regarding the appropriate LVR from specialised appraisal firms, which evaluate the collateral value of inventory goods (GE Capital, 1999). The interest rate applied on the loan also reflects quality and liquidity of the assets, and is often higher than the rate on conventional bank loans. Furthermore, a service charge to cover the costs of administration of the account adds to the costs for the borrower.

Although the costs of funds may be higher than in traditional lending, a decline in the costs of asset-based lending has been observed over the last decades, as this type of financing, which was earlier considered to be a last resort option for firms in financial difficulties, has become widely accepted by financiers and increasingly popular in the business community (Caouette et al., 2008). Over time, the increased competition within the industry has also contributed to bringing down the costs of asset-based lending, as a variety of players entered the market, including traditional commercial finance companies, hedge funds and cash-rich companies seeking to diversify their business.

Against this medium- to long-term trend, however, the 2008-09 global financial crisis has brought about increased costs for asset-based lending, as with other more traditional forms of lending. This is in part because the value of collateral decreased, while the probability of default increased. Basel III has also been producing effects in the industry, raising the prices of lending products, although, as Nuccio and Loewy (2013) note, the new regulatory framework does not especially disfavour loans secured by inventory and receivables. Rather, some indirect effects are to be expected, in the sense that the new regulatory standards may increase the costs of funding from bank regulated entities, and may reduce the level of assets deployed by banks to this sector. This may create opportunities for non-bank lenders, which are not subject to the same costly capital requirements.

Profile of firms

The use of assets to generate cash flow presents advantages for start-up companies, which have limited credit history, but also for fast-growing and cash-strapped firms, which can respond more rapidly to their short-term cash needs than through traditional debt channels.

ABL can serve in particular the needs of SMEs that are at a growth stage or that face seasonal build-up of inventory or receivables, whose value can be hardly reflected into traditional loans that have already been underwritten. In this regard, ABL allows for more flexibility than traditional lending in accessing a credit line, whose limit can be expanded quickly, as the value of the underlying assets change. For instance, in the case of a revolving credit facility secured by receivables, the outstanding loan amount may fluctuate on a daily base, providing a significant degree of flexibility to the borrower to finance evolving working capital needs.

The lender's close monitoring of the secured assets' value also implies that highly leveraged firms, or firms that have experienced recent losses, can obtain cash flow more easily than it is generally the case for conventional lending. This is because conventional lenders, which do not rely on specific assets to support their loan and are not closely monitoring any underlying collateral, typically require borrowers to maintain a conservative financial position over the loan terms (Smith & Howard, 2013). In this regard, through ABL, companies with strong accounts receivables and a solid base of creditworthy customers

can overcome temporarily lending constraints or accelerate access to working capital. For this reason, ABL is usually considered to be a transitional source of financing, to weather temporarily cash flow shortfalls, when the firm does not qualify for traditional bank lending, or to take advantage of growth opportunities.

The broad range of assets that can be used to secure the loan (e.g. stocks or inventory, plant and machinery, property, brands and intellectual property) implies that ABL can serve firms in many different sectors, including manufacturing, retail and distribution, and other service industries.

Asset-based lending is also apt to fund businesses at times of transition and restructuring, such as in the instance of mergers and acquisitions, management buy-ins and by-outs, when there is a need for increased liquidity in a short time. Indeed, in the case of acquisition, it is possible to use the assets of the company being acquired to finance the acquisition itself. This can be especially advantageous when the value of receivables or inventory of the target firm is significant in relation to the price of acquisition (GE Capital, 1999).

Enabling factors

ABL relies on a sophisticated and efficient legal system (Beck and Dermirguc-Kunt, 2006). In particular, the commercial law in security interests is crucial in determining the efficacy of the collateral in the loan contract. As Berger and Udell (2006) highlight, key issues include clarity in the country's commercial law on how a collateral lien (i.e. the obligation or claim annexed to a property) can be perfected, how collateral priority is determined, and how notification of a lien is made.

As a case in point, in the United States, the growth of the ABL market is favoured by Article 9 on "Secured Transactions" of the Uniform Commercial Code (UCC), which includes blanket filings on account receivables and inventory,[1] and a well-developed electronic registration systems, which temporally defines lien filings. On the other hand, asset-based lending is made especially difficult by commercial laws that do not allow lenders to file a single lien on all existing and future accounts receivable and inventory, but rather require that each single asset is identified by invoice and serial number as it is generated (Berger and Udell, 2006).

The development of ABL also depends on specialised expertise by financiers, which need to appraise industry-specific assets, within the framework of rapidly changing financial and economic environments. Industry-specific knowledge is thus typically required and field examiners may spend considerable time assessing the assets proposed by the borrower for securing the loan. In the case of trade accounts receivables, for instance, this may include confirmations, testing of invoices, review of customer agreements, and analysis of accounting reserves, among others (Banchaya and Anderson, 2010). The professional appraisal by a reliable firm is generally a key element in the decision to lend (Clarke, 1996) and, for this reason, the growth of specialised service firms can importantly support the development of ABL markets.

Factoring

Modalities

Factoring is a supplier short-term financing mechanism, whereby a firm ("seller") receives cash from a specialised institution ("factor"), in exchange for its accounts receivable, which result from the sales of goods or provision of services to customers ("buyers"). In other terms,

the factor buys the right to collect a firm's invoices from its customers, by paying the firm the face value of these invoices, less a discount. The factor then proceeds to collect payment from the firm's customers at the due date of the invoices. The difference between the face value of invoices and the amount advanced by the factor constitute the "reserve account". This is paid to the seller when the receivables are paid to the factor, less interest and service fees. Typically, the interest ranges from 1.5% to 3% over base rate and service fees range from 0.2% to 0.5% of the turnover (Milenkovic-Kerkovic and Dencic-Mihajlov, 2012).

Factoring is thus a transactions funding technology, based on "hard" data, similar to asset-based lending, as the financing depends on the value of an underlying asset, rather than on the creditworthiness of the firm. However, it is different from asset-based lending in the following aspects: i) it involves exclusively the financing of accounts receivable, rather than a broader range of assets; ii) the underlying asset is sold to the factor at a discount, rather than collateralised; iii) it is a bundle of three financial services, i.e. a financing component, a credit component, and a collections component, as in most cases the borrower outsources to the factor its credit and collection activities (Berger and Udell, 2006).

Factoring also differs from conventional bank lending and asset-based lending, in that it does not generate debt on the firm's balance sheet and there are no loans to repay. By selling accounts receivables to a factor, the firm is able to rapidly convert accounts receivable into another asset, cash.

A key aspect of factoring is that the problem of asymmetric information between lender and borrower is addressed by focusing on the quality of a third party, the borrower's customer. It is the latter that becomes the debtor and responds for its obligations directly to the factor, which entirely assumes the credit risk and the collection of accounts.

Through factoring, thus, it is the factor which assumes the costs implied by collecting information about buyers, which explains the specialisation of factors on specific industry segments, to develop more accurate market knowledge and credit-risk assessment (Soufani, 2011). In the case of "ordinary factoring", when the firm sells its complete portfolio of receivables, these costs can be significant, as the factor needs to collect credit information and calculate the credit risk for many buyers. For this reason, ordinary factoring is most frequently observed in countries with a well-developed financial infrastructure (i.e. credit bureaux, credit registries), which allows the factor to access information about many buyers at a relatively low cost, while diversifying risk.

In the case of "reverse factoring", the factor purchases accounts receivables only from selected customers of the firm. In this way, the factor increases its risk exposure to one customer, but the costs of acquiring information and assessing credit risk are lower and, typically, only high-quality receivables are accepted. In this regard, reverse factoring can be especially suitable for financing receivables from accredited firms that are more creditworthy than the seller, such as large firms or foreign groups. In other terms, factoring may allow high-risk suppliers to transfer their credit risk to their highest-quality customers. Indeed, a reverse factoring arrangement is typically engineered by a large customer that is purchasing goods from a number of small suppliers. In this case, the factor agrees to finance any of the receivables of the large firm generated by invoices from the small suppliers. The benefit for the large customer is that, in exchange for working capital financing, the sellers may agree on more favourable sales terms (Berger and Udell, 2006; Klapper, 2006).

Reverse factoring is a key component in Supply Chain Finance, a set of arrangements between members of the supply chain, mainly in terms of financial intermediation. In this

setting, reverse factoring is a means for creditworthy buyers to facilitate favourable financing options for their suppliers, by explicitly confirming deliveries and resulting payment obligations to a factor (Klapper, 2006; van der Vliet et al., 2013).

Factoring can also take place across borders ("export" or "international" factoring), reducing the risk of international sales. By outsourcing the credit function to a factor, exporters can significantly reduce the cost of collecting credits overseas, as well as the exchange rate risks. The "export factor" identifies an "import factor" in the foreign market and assigns this correspondent the receivables. It is the import factor that, for a fee, investigates the credit standing of the buyers and establishes lines of credit with them. In fact, export factoring presents advantages also for buyers, which do not need to open letters of credits and sustain the related charges. The import factor collects the full invoice value at maturity and transfer funds to the export factor, which then pays the exporter the outstanding balance (FCI, 2013). As the evaluation of the buyers' credit standing is conducted by the import factor before agreeing to purchase the receivables, the approval of the factoring arrangement can also provide the seller an important signal about the foreign business partners (Klapper, 2006).

In this regard, factoring is also an instrument of *trade finance*, which is often a key tool for SME international activity and comprises other diverse financing mechanisms, such as lending, issuing letters of credit, export credit and insurance.

Although under factoring financing does not depend on the firm's overall creditworthiness, information about the seller may be used by the factor to determine the "advance rate" of receivables, that is, the share of their value advanced to the seller. This rate is typically based on historical dilution experience and may be adjusted over time to take into account changes in specific receivables (Klapper, 2006).

The seller may incur additional costs, such as credit protection charges, in the case of "non-recourse" factoring, whereby the factor assumes title of the accounts and most of the default risk, because it does not have any claim (i.e. "recourse") against the supplier if the accounts default. On the other hand, in the case of "recourse" factoring, the factor has a claim against the seller for any account payment deficit. However, even under "non-recourse" factoring, there is some risk sharing between the factor and the seller, in the form of the "reserve account", i.e. the difference between the actual value of the accounts and the advance rate, which can be used by the factor to cover payment deficiencies. Across OECD countries, "non-recourse" factoring is largely adopted, whereas in emerging markets most factoring is done on a "recourse" basis, due to the greater difficulties the factor encounters in assessing the default risk of the underlying accounts.

Profile of firms

As a source of working capital financing, factoring is of particular interest for high-risk and informationally non-transparent firms, as well as firms with a solid base of customers but high investments in intangible assets, which cannot be used to secure bank loans. This is because the factor primarily evaluates the creditworthiness of the firm's customers and the validity of invoices, rather than the firm's financial statements, its fixed collateralisable assets or credit history. Hence, factoring may be especially advantageous for a SME that has difficulties in accessing bank lending but supplies larger customers, which are seen as more creditworthy than the firm itself. Milenkovic-Kerkovic and Dencic-Mihajlov (2012) underline in particular the advantages of factoring for service firms, which tend to be

payroll-intensive, have usually little proper collateral that can be used to secure traditional bank loan, and may have high investments in intangible assets, which are not always reflected in financial statements.

Factoring may also represent an instrument of choice to manage credit risk when the seller has a very sparse specialised investment in its customers and the cost of monitoring them is high (Smith and Schnucker, 1994). This can be the case also for customers located overseas, when export or international factoring is used. Through factoring, the seller outsources the monitoring functions and may indeed consider acceptance of invoices by the factor as a signal of its customers' creditworthiness.

Factoring is also useful for firms that grow faster than their credit lines, as, similarly to asset-based finance, it provides greater flexibility than conventional loans. In fact, as each account receivable is evaluated individually, in the event of increased sales, new receivables can be sold rapidly to a factor and the advanced cash used to respond to new orders.

As the extension of working capital does not depend on the firm's credit history, factoring can also serve the needs of new and young companies. At the same time, however, start-ups with low turnover may be little attractive to factors, as they are often too small, have an inadequate customer base and lack a track record in sales and economic management (Soufani, 2001).

Enabling factors

On the regulatory side, factoring requires a legal environment that allows to sell or assign accounts receivables and enforce the underlying contracts, such as norms that entitle the factor to take legal recourse for recovering assigned receivables from the client's customers. In this regard, a reference to factoring in the law, or even a "Factoring Act", which recognises it as a financial service, can clarify the nature of the factoring transactions and the ruling in case of default of sellers or customers.

Factoring can be favoured by commercial laws that recognise it as a "sale and purchase". In this case, factors are not creditors, hence, in the event of the seller's bankruptcy, the factored receivables are not part of the bankruptcy estate. Rather, they are recognised as property of the factor on which other creditors cannot advance claims (Klapper, 2006). On the other hand, in some countries, especially civil law countries, factoring may encounter important legal restrictions, such as prohibition of transfer of future and bulk receivables or obligatory notification of the debtor, which may limit transferability of receivables or create additional costs (Milenkovic-Kerkovic and Dencic-Mihajlov, 2012).

However, since the underlying assets are removed from the firm' s bankruptcy estate and owned by the factor, rather than being pledged as collateral, factoring depends less on good collateral laws and efficient judicial systems than traditional and asset-based lending (Berger and Udell, 2006). According to Klapper (2006), this explains why this funding mechanism might play an especially important role for SMEs in emerging markets, characterised by weak contract enforcement.

Nevertheless, the development of factoring can be constrained by other tax, legal and regulatory aspects. With regard to tax treatment, factoring can be at disadvantage with respect to traditional debt financing if interest on factoring is not deductible in the same way as interest payments to banks. Also, VAT taxes may be applied on the entire transaction, rather than on service fees only, and stamp taxes may be imposed on factored invoices.

A weak information infrastructure may discourage factoring, imposing excessive burdens on factors for collecting information about customer's creditworthiness and for assessing credit risk. Since the factor needs to collect information and assess credit risk for all of the firm's customers (or a selected number of high quality buyers), the cost and time required strongly depend on the availability of a good credit information infrastructure, for instance in the form of well-developed credit bureaux or registries.

Purchase Order Finance

Modalities

Purchase Order Finance (POF) is a highly targeted form of asset-based finance, intended to allow a firm to fill a particular customer order, thus to seize the market opportunities that would be lost due lack of financial resources to buy inputs and deliver the output.

POF funds the production stage of an SME's activities, as it consist in a working capital advance to cover part of the production of a good or service demanded by one or more specified customers. In more details, through POF, the SME obtains a verified purchase order from a customer and estimates the direct costs required to produce and to deliver the product, which may include labour, raw materials, packaging, shipping, and insurance. The purchase order is submitted to a financier, which bases the credit decision on whether the order is from a creditworthy customer or is backed by an irrevocable letter of credit from a reliable bank and on whether the SME can produce and deliver the product according to the terms of the contract. If the loan is approved, the financier advances a share of the total order value, typically paying the approved costs directly to the suppliers. Once production and delivery are completed, the accounts receivables from the customer are either assigned to the financier, as in the case of factoring, or the payment is directed into an account under the financier's control. Similar to factoring, when the financier receives payment, it deducts the amount advanced and interest or fees, and remits the balance to the SME (USAID, 2009).

As in the case of factoring, POF allows the SME to transfer the credit risk to a more creditworthy customer, which is often a larger firm or a government agency. However, the advance rate is generally lower than in the case of factoring, as POF implies higher costs and risks for the financier. In fact, this mechanisms requires more intensive monitoring of the firm's operation and the financier assumes the risk in the case that the firm will not be able to meet the order, as well as the risk related to payment deficiencies by the customers. As a consequence, interest rates and fees are typically higher than with other forms of asset-based finance. Also, the financier can take guarantees and other collateral, such as inventory and bills of exchange, to mitigate risk.

Furthermore, the PO lender may require that a factor intervenes in the transaction, if the payment terms of the customer are beyond a certain threshold (i.e. 60 or 90 days). The factor buys the outstanding invoices at a discount and thus provides immediate payment to the PO lender, and collects the full amount of the invoices at a later time. As the factor adds its profit in the process, the overall costs of the operation for the SME may be significantly higher.

Pre-export finance transactions are similar to POF operations, but are specifically applied to export orders. They consist of the extension of financing against orders that have been placed and confirmed by foreign buyers, after the lender has evaluated their

creditworthiness. In addition to risks implied by a traditional POF operation, the financier needs also to evaluate the political and legal risks implied by the cross-border transaction, such as the risk of expropriation, sanctions, discriminatory change of law or the impact of local insolvency law.

Profile of firms

POF can serve the needs of growing firms, with little access to working capital and poor cash flow, which receive orders that are larger or more frequent than their current capacity to pay suppliers upfront. In this regard, POF is generally not a replacement for conventional financing. Rather, as it provides rapidly large amounts of new capital, it can be used alongside lending facilities to handle surging capital requirements brought on by accelerated growth or peak seasonal sales (Maselli, 2000; USAID, 2009).

At the same time, as the financier primarily considers the creditworthiness of the client who has created the purchase order, it can also apply to new firms with little credit history and to high-risk and informationally non-transparent firms, which would not qualify for conventional bank loans. As in the case of factoring, the SME's creditworthiness is typically enhanced by the link to a larger company placing the purchase order. In this regard, POF can be an effective financing instrument for small firms participating in supply chains, as part of the Supply Chain Finance arrangements.

As a financing mechanism that supports the production or distribution activity, the type of businesses that qualify for POF are usually producers, distributors, wholesalers or resellers of manufactured products.

Enabling factors

The development of credit risk assessment technologies has favoured the consolidation and broader diffusion of POF. POF, factoring and trade finance, as we know them today, date back to the Middle Ages, to the business practices of English factors in the 14th through the 17th centuries, as England grew from an agrarian economy to a modern commercial economy. These practices evolved out of experiences of banks in 13th century Italy, which were grounded in factoring practices of the Roman Empire.[2] Throughout centuries, POF was provided by financial intermediaries engaged in a relationship model with customers, where the purchase order would act as sufficient collateral to finance the project (Davidson, 1986). In recent decades, particularly since the 1990s, the advances in technological platforms to assess risk facilitated the development of POF as an instrument to fund SMEs (van der Vliet et al., 2013), without restricting this to the relationship lending business model.

Warehouse receipts

Modalities

Warehouse receipts (WHR) are an asset-based financing mechanism, whereby loans are secured by commodities deposited at a certified warehouse. Under this arrangement, commodity producers and traders deposit commodities at a warehouse, which offers secure storage and issues a receipt that certifies it is in possession of a specified quantity of a commodity that meets specified standards. The receipt can then be used by the depositor as collateral for a loan, whereby the lender places a lien on the commodity, so that this cannot be sold before the loan is repaid (USAID, 2009).

As in the case of asset-based lending, the amount that the firm can borrow is typically a share (50-80%) of the stored commodity value. The costs implied by the mechanisms for the borrower include interest, taxes and storage fees.

WHR can be organised under different warehousing arrangements: a) private warehouses, where manufacturing and warehousing take place under the same roof. It is thus the same manufacturer (borrower) that can issue a warehouse receipt to be used as a collateral with the lender; b) public warehouses, where a specialised operator stores commodities for third parties for a set fee and issues receipts; and c) field warehouses, in which a collateral management or credit support company takes over the warehouse of a depositor or a public warehouse by leasing the storage facility for a nominal fee, and becomes responsible for controlling the commodities to be used as collateral (Höllinger et al., 2009).

Beside the warehouse operator, the WHR system engages specialised service providers, such as those offering both depositors and lenders certification and inspection services, to ensure the warehouse meets necessary standards for safe and secure storage. In addition, insurance companies generally provide protection against commodity losses at the warehouse.

As the warehouses typically maintain records about producers' performance, this system may also work to build information on current and potential borrowers, which can be useful to financial institutions over time, especially when other credit history information is lacking. Also, as the system is based on consistent standards, their incorporation into receipts improves knowledge in the market, reducing information asymmetry along the value chain about products' quality and availability.

Profile of firms

WHR are apt for producers and traders of commodities that lack credit history or other collateral to access lending finance. The financial services provided by the system combine with other potential benefits, such as access to reliable storage and hence the possibility to sell the product over time, rather than solely at harvest periods, when prices of commodities may be especially low.

As such, WHR is especially advantageous for producers and traders of storable agricultural commodities such as grain, sunflower seeds and sugar. In these sectors, the use of stored commodities as collateral represents a solution to enhancing agricultural lending, and provides a valuable addition to the traditional use of real estate and land as loan collateral (Höllinger et al., 2009). For small producers, however, storage fees may be too high. This creates an incentive to pool commodities among small firms to access the WHR system (USAID, 2009).

Enabling factors

The WHR system relies on a legislative framework that protects the rights and interests of depositors in public warehouses, ensures the transferability of warehouse receipts and their legal equivalence with the stored commodity, defines clear procedures in case of bankruptcy of the warehouse operator, and protects a collateral lien. Furthermore, the system depends on a clear licensing framework for warehouses and a well-functioning mechanism or their control and oversight. In some countries, a Government Regulatory Agency exists, which is responsible for the licensing, regulatory and inspection procedures (USAID, 2007, 2009).

A well-defined system of grades and standards and access to reliable information on commodity market prices and conditions by depositors and lenders are key to the functioning of WHR. A good market information system reduces uncertainties regarding the value of the stored goods and allows for adequate evaluation of the collateral.

According to Höllinger et al. (2009), WHR also requires a predictable policy environment that preserves the incentives for private storage and financing, and governments should refrain from heavy and erratic intervention in commodity markets. In fact, a certain level of seasonal price fluctuation is needed to attract participants and enable them to recover storage and financing costs.

On the side of lenders, the system demands familiarity with the WHR mechanism and specific expertise on commodities, in order to monitor market trends and value loans properly. As Höllinger et al. (2009) highlight, based on the experience of WHR development in transition economies, building confidence in extending finance against warehouse receipts takes time. Initially, banks may only be willing to lend up to 55% to 65% of the collateral value. As confidence in the system grows, this level may increase to 80% or even higher.

Leasing

Modalities

In many countries, leasing is a common mechanism to finance use and purchase of equipment, motor vehicles and real estate by firms. Analogous to other forms of asset-based financing, underwriting depends on the value of an underlying asset and on the ability of the firm to generate sufficient cash flow from business operations to meet regular payments, rather than on its overall creditworthiness as assessed though financial statements, credit history and fixed assets. Typically knowledge about results of business operations is used by the financier to generate indicators of the adequacy of prospective cash flows (Gallardo, 1997).

Specifically, a lease is an agreement whereby the owner of an asset (lessor) provides a customer (lessee) with the right to use the asset for a specified period of time, in exchange for a series of payments.[3] The lessor remains the legal owner of the asset throughout the contract, and ownership may or may not be transferred to the lessee at the end of the contract.

Under a "financial lease", the customer carries the risks and rewards of the asset's ownership, although the lessor remains the legal owner of the asset throughout the contract. In other terms, the lessee benefits from the economic life of an asset in a similar way to a legal owner and takes on related risks, such as maintenance and insurance responsibilities. This includes contracts where the length of the lease is close to the useful economic life of the asset, as well as contracts where the lessee has the possibility to become the owner of the asset at the end of the lease, automatically or purchasing the asset for a specified nominal amount (Oxford Economics, 2011). Typically, financial leases are used by firms to finance long-lived assets, instead of resorting to long-term borrowing for acquiring these assets (Clarke, 1996).

A "hire-purchase" contract works in a similar way to a finance lease, as the customer pays for an asset in regular instalment, while benefiting from its use. However, hire-purchase is a type of instalment purchase, with a well-defined purchase option for the customer, who agrees to pay the cost of the asset over time, including principal amount

and interest for the period the asset is used. In this case, the purchaser acquires the property of the asset on signing the agreement, but the ownership is transferred only upon the full payment of the purchase amount.

On the other hand, an "operating lease" is typically of a shorter duration than the useful economic life of the asset and the customer has no possibility to purchase it at the end of the contact, or can acquire at a higher price than under a finance lease. An operating lease is thus essentially a rental contract for the temporary use of an asset (Oxford Economics, 2011; Kraemer-Eis and Lang, 2012).

In comparison with conventional bank financing, in a lease contract no or limited up-front cash down-payment or security deposit is required. In this way, leasing can finance a higher percentage of the capital cost of equipment thereby allowing the business entity to preserve its cash resources or existing bank facilities to meet working capital needs (Gallardo, 1997). On the other hand, over the economic life of the asset, the overall cost of accessing it may be higher than in the case of outright purchase, and the firm does not build equity in capital assets.

Another relevant difference with respect to conventional debt financing may concern the impact of the leasing contract on the firm's a balance sheet. A finance lease is generally capitalised on the balance sheet, thus adding to the leverage of the firms, although the firm can decompose the lease payment into interest and principal repayment and expense the interest paid on the lease each year, as well as depreciate the cost of the asset over the life of the asset. On the other hand, an operational lease is accounted among the expenses. In this regard, with respect to a bank-financed purchase of assets, the main advantage of lease financing is a significantly lower discounted present value of cash disbursements over the term of the lease. In fact, the aggregate periodic lease rental payments, which result from interest-related financing costs and payments against principal, can be booked by the lessee as a business expense to shield against tax liability on income realised (Gallardo, 1997).

As a form of short- and medium-term financing, leasing also presents relevant non-monetary advantages for businesses. Mainly, leasing contracts are typically flexible towards customers' needs. They may allow buying the asset at termination of the contract, cancelling the lease before maturity of the contract, renewing the lease for additional periods, protecting the customer from increases in future lease rates, as well as tailoring lease payments to the cash flow generation pattern of the lessee (Slotty, 2009; Kraemer-Eis and Lang, 2012).

Leasing agreements are distributed through different channels, including bank networks, leasing companies, vendors and dealers of equipment. In many countries, the most popular channel for accessing lease contracts is at the point of sale of the asset, or through the vendor channel (Oxford Economics, 2011). The main advantage of this form is that leasing works as a "one-stop-shop", for both the purchasing and the financing of the equipment.[4]

Profile of firms

Leasing can respond to the capital investment needs of new firms, which lack the working capital that may be needed for outright purchase of asset and lack the credit history that is generally required to source this capital from traditional bank channels. More generally, leasing can serve SMEs that do not qualify for conventional bank lending, due to high risk, opacity and lack of collateral. In fact, the lessor's credit decision is mainly

based on the lessee's ability to generate cash flow from business operations, in order to meet lease payments.

Leasing can be an option also for firms facing financial difficulties. In some instances, cash flow is indeed generated by the use of the leased asset, which makes access to the leasing instrument easier for cash-constrained firms. Also, under bankruptcy rules, lease payments generally have priority over loan payments, so that the lessee is usually allowed to continue paying the lessor, which can always opt for taking back the leased asset (USAID, 2009). In this sense, as a legal owner of the asset, the lessor has a stronger security position than a traditional lender, which may imply less stringent criteria in the negotiation with lessees in the first place.

However, leasing can also be attractive for SMEs that have access to traditional bank lending, as a more flexible mechanism for using the services of capital assets, while preserving cash reserves. Leasing contract can be arranged in a relative simple and quick manner, since security arrangement is not needed, and lease payments can be aligned to the pattern of the expected cash flow.

Leasing can be especially advantageous for firms that anticipate changing their capital assets frequently, as it allows accessing equipment with minimal initial costs and moving rapidly to more up-to-date assets without incurring further capital outlays.

Enabling factors

The operation of leasing does not require a strong lending infrastructure. Indeed, as Berger and Udell (2006) underline, a weak regulatory environment that does not support the use of collateral and bankruptcy rights may encourage the use of alternative instruments, where the lender owns the asset. At the same time, leasing can be difficult to implement in countries that lack a national asset register, as illegal on-selling of leased assets is easier, or with weak laws on repossession, which undermine the ability of the lessor to repossess the asset in the case of default (USAID, 2009).

The development of leasing also depends on the rules that govern the institutions offering lease services. Leasing companies are typically non-deposit taking institutions and are therefore subject to less stringent capital requirements than banks, which may allow them higher leverage. On the other hand, the cost of money can be higher for these institutions, as they have to source funding from more volatile and expensive markets (Gallardo, 1997). In some countries, however, minimum capital requirements are imposed on non-bank lessors, implying limitation of lending to a proportion of their net asset value.

Tax regulation may affect leasing decision of firms, although the empirical evidence is not conclusive in this regard (Lasfer and Levis, 1998). In principle, tax breaks can make the leasing option advantageous over bank financing, particularly in the case of operational lease. In this case lessees can offset their full lease payments against income before tax, compared to the depreciation allowance or the interest charges on bank loans. In the case of finance lease deduction applies only to the interest component of the payment. The overall tax benefits of finance lease, however, depend on the type of asset leased and the rules over depreciation, which can be claimed by the lessee in its balance sheet. In addition, lessors may be able to pass on to lessees some tax benefits related to their depreciation charges as owners of the asset leased, by lowering their financing costs (Gallardo, 1997).

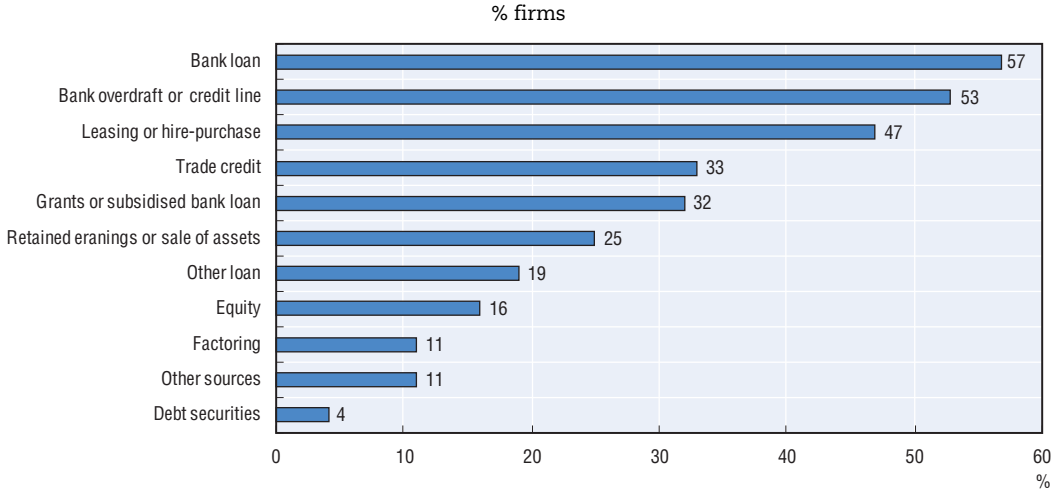
Trends in asset-based finance

Asset-based finance is a popular form of finance for SMEs, whose diffusion has substantially increased over the last decades, although, on the supply side, it has been significantly affected by the financial crisis. In the case of leasing, for instance, refinancing conditions for leasing companies worsened in many countries (Kraemer-Eis and Lang, 2012). At the same time, as awareness increased and access to other bank debt has become more difficult for many businesses, demand for asset-based instruments has significantly increased since the 2008-09 global financial crisis. In the UK, for instance, the Asset Based Finance Association (ABFA) has reported a 10% growth for the industry over June 2012-June 2013, accounting for the highest level of advances to companies since 2008, in sharp contrast to the declining net lending figures in the country. Both small and large firms are contributing to this positive trend, with advances to small firms (GBP 500 000-1 million) recording a 6.2% growth in the second quarter of 2013.

Asset-based lending has been expanding in many OECD countries. In the United States, the Commercial Finance Association (CFA) has recorded steady increase in new credit commitments among asset-based lenders in 2011-12, following a decline in 2009-10. Its Quarterly Asset-Based Lending Index, built on evidence from 22 of the largest CFA members, shows that in 2Q2012 total commitments rose by 7.7% compared to the same quarter in 2011. However, businesses' persistent difficulties are reflected in loan performance: lenders' non-accruing loans as a percentage of their total asset-based loans outstanding rose slightly in 2011, after declining over 2010.[5] In the UK, the level of assets financed has increased by 33% since 2006, to GBP 36.2 billion in 2012, according to PricewaterhouseCoopers.[6]

In the aftermath of the crisis, asset-based lending has also been used as part of a loan package, the so-called "bifurcated collateral loan", whereby a portion of the loan is secured by accounts receivable or inventory (ABL portion) and another part is structured as a traditional term loan, secured by remaining assets, such as real estate, machinery and equipment or intellectual property (Migliero, 2012).

Figure 3.1. **Relevance of financing types for SMEs, EU28, ECB/EC SAFE survey, 2014**



Source: EC (2014b).

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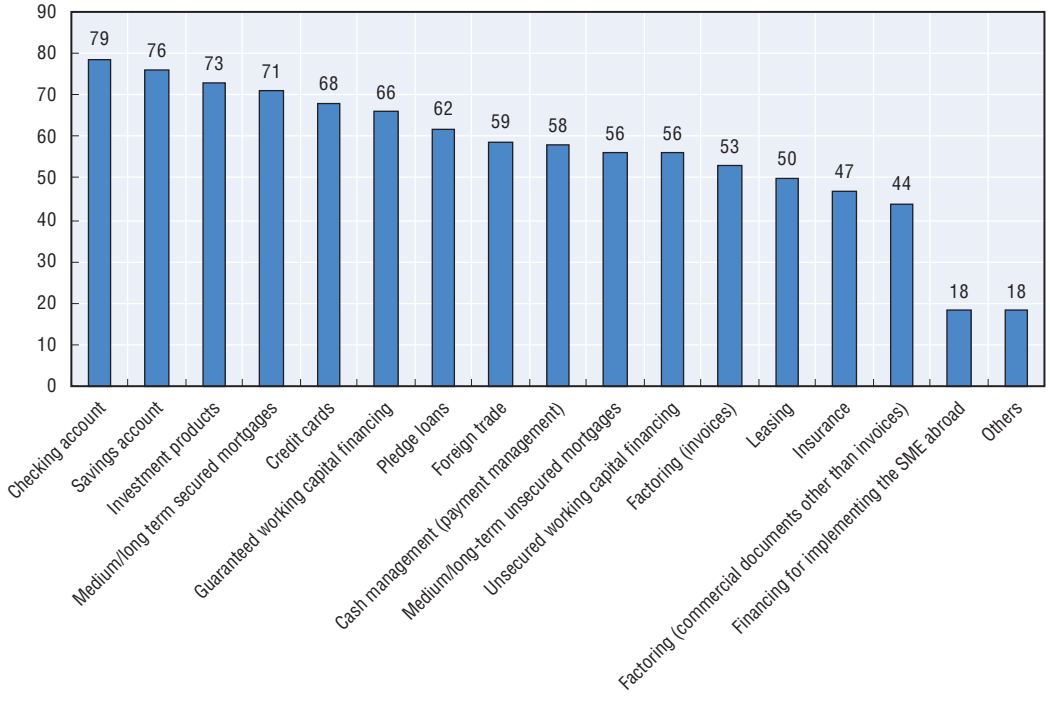
In Canada, the Canadian Finance & Leasing Association (CFLA) estimates the asset-based financing and leasing industry to be the largest provider of debt financing to business customers and consumers in the country after the traditional lenders (banks and credit unions), with value of assets financed having increased from CAD 50 billion in 1997 to CAD 105.4 billion in 2007.[7]

The 2014 Survey on the Access to Finance of Small and Medium-sized Enterprises (SAFE), conducted by the European Central Bank and the European Commission, shows that, in EU28, "leasing or hire-purchase" ranks high among SME sources of finance. Nearly half of respondents (47%) used these asset-based instruments in the past or considered using them in the future. This is about at par with the use of "bank overdrafts or credit lines" whereas "bank loans" remain the main source of external financing for small businesses over time. The survey also indicates that trade credit is considered as a main source of external finance by 33% of SMEs in the European Union.

The 5th Regional Survey on Banks and SMEs in Latina America, conducted in 2012 by the Inter-American Development Bank on 106 banks across 20 countries, illustrates the range of products offered by banks to SMEs, and highlights in particular the increasing importance of asset-based instruments such as leasing and factoring (Figure 3.2). Leasing is supplied to SMEs by 50% of the surveyed financial institutions, whereas factoring is provided by 44% of the banks (IDB, 2012).

Figure 3.2. **Type of financial products offered by banks to SMEs, Latina America and Caribbean, 2012**

% of banks providing a product



Source: IDB (2012).

StatLink http://dx.doi.org/10.1787/888933292117

According to a survey conducted in 2012 by the International Chamber of Commerce (ICC) on more than 200 banks located in 110 countries, trade finance is in high demand, with the majority of transactions being based on *commercial letters of credit*, although a

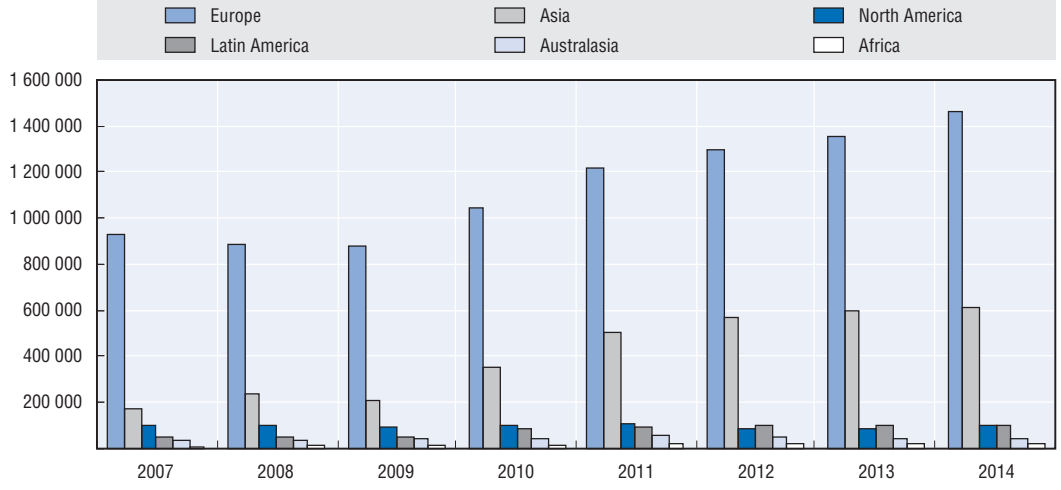
shortage of liquidity and a disproportionate aversion to risk continue to drive up interest rates on loans and advances in a number of countries (ICC, 2012).

Factoring is a key instrument in trade finance. Worldwide, the factoring industry has grown rapidly since the 1990s: the factoring volume increased by 88% between 1998 and 2004 (Klapper, 2006) and by 80% between 2007 and 2014 (FCI, 2015). However, most of the factoring business is concentrated in Europe, which accounted for 62.3% of the global turnover in 2014, with the four largest countries (UK, France, Germany and Italy) accounting for about 40% of the world volume. In the same year, the US and Japan accounted for 4.2% and 2.2% of the worldwide factoring turnover (FCI, 2015).

During the 2000s, factoring has been growing steadily in emerging economies, as recorded by Factors Chain International, a global network of leading factoring companies, which represents about 80% of the global cross-border factoring volume. In particular, the factoring industry has experienced important growth in China, recording an increase in world turnover share from 0.5% in 2004 to 9.4% in 2010 and to 17% in 2014, overcoming the United States and Japan in terms of factoring volumes. Overall, factoring in Asia has grown steadily since 2009; in 2014, it represented 26.2% of world turnover (Figure 3.3).

Figure 3.3. **World factoring turnover, by region, 2007-14**

EUR million



Source: FCI (2015).

StatLink http://dx.doi.org/10.1787/888933292121

A 2006 study by the International Factors Group[8] estimates that across the EU, 80% of factoring customers are SMEs and that 69% of the industry turnover is generated by contracts with SMEs, although cross-country differences are significant, with, for instance only 20% of the turnover being generated with SMEs in Germany. As illustrated by the 2010 Eurostat survey, the share of SMEs that revert to factoring for accessing external finance is significant (16%) though lower than the share of SMEs that use leasing (55%) (OECD, 2012).

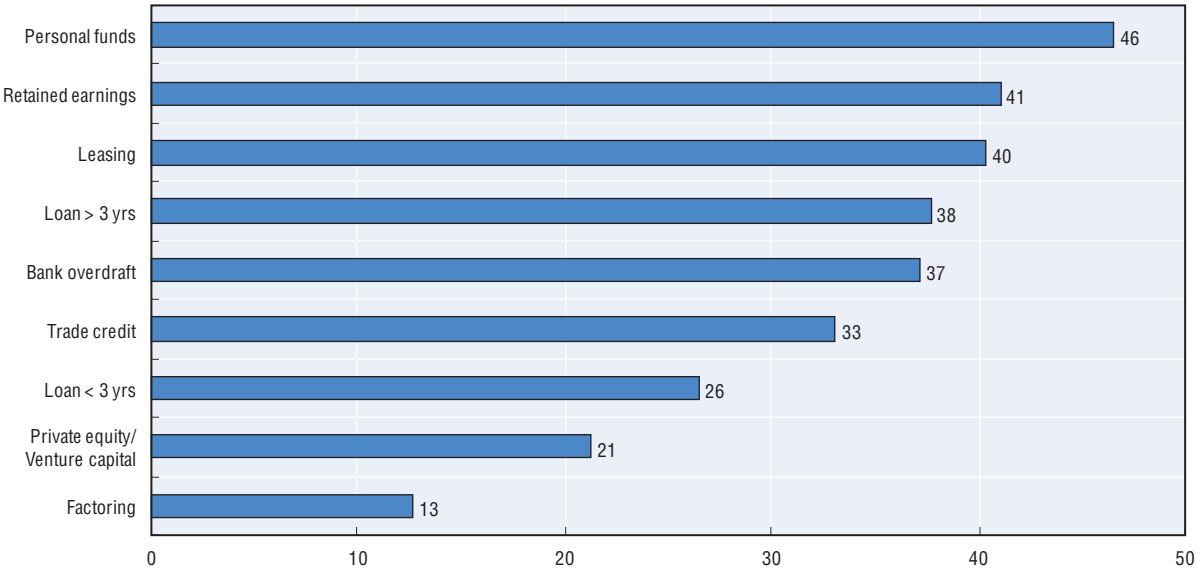
More detailed data by firm size are available for leasing, particularly in Europe, where SMEs account for 52% of the total business leasing volume, that is, for a leasing market estimated at about EUR 100 billion in 2010.

A 2011 survey-based report produced by Oxford Economics for Leaseurope, the European Federation of Leasing Company Associations, confirms the prominent and growing role of leasing for SMEs' business investment.[9] The study shows that, in 2010,

leasing was the most popular source of external finance, accessed by 40% of SMEs, compared to 38% that had accessed a bank loan with maturity greater than three years (in line with the average two to five year duration of a lease), 37% that had used a bank overdraft, and 13% that had funded investment through factoring (Figure 3.4). A similar picture is provided by the Eurostat survey on SME finance, which shows that, in 2010, of the surveyed SMEs searching for finance, 55% had accessed leasing and 16% had used factoring (OECD, 2012b).

Figure 3.4. **Investment by funding type, European SMEs, 2010**

% of firms using finance type



Source: Oxford Economics (2011).

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The survey by Oxford Economics (2011) further highlights the greater use of leasing by larger SMEs (over 50% of medium-sized firms, compared to 40% of small firms and about 30% of micro firms), which can be explained by the overall more limited access by micro firms to external finance.

The evidence about "penetration rates" (total value of assets leased over investment) shows that SMEs use leasing to finance a greater proportion of their investment (16.7%) than business firms on average (12.9%). Also in relation to this indicator, medium-sized firms appear to use leasing more intensively, while micro firms rely more importantly on cash/equity (Figure 3.5).

The survey also indicated a positive trend in leasing's penetration rate for SMEs, which was expected to increase to 18.6% in 2011, in contrast with the expected decrease in the share of investment funded by bank lending (from 31.2% in 2010 to 28.3% in 2011). Again, the increase in leasing's share of total investment is driven by medium-sized firms, which were expected to increase their share from 17.6% to 20% in 2011.

The survey provides support to the argument that leasing can be advantageous for young firms, which encounter greater difficulties than established businesses in accessing traditional bank channels: about 50% of firms aged between two and five years use leasing compared to about 40% of firms aged more than ten years (Figure 3.6). A result along this line

Figure 3.5. **Source of funding for fixed asset investment by European SMEs, 2010**

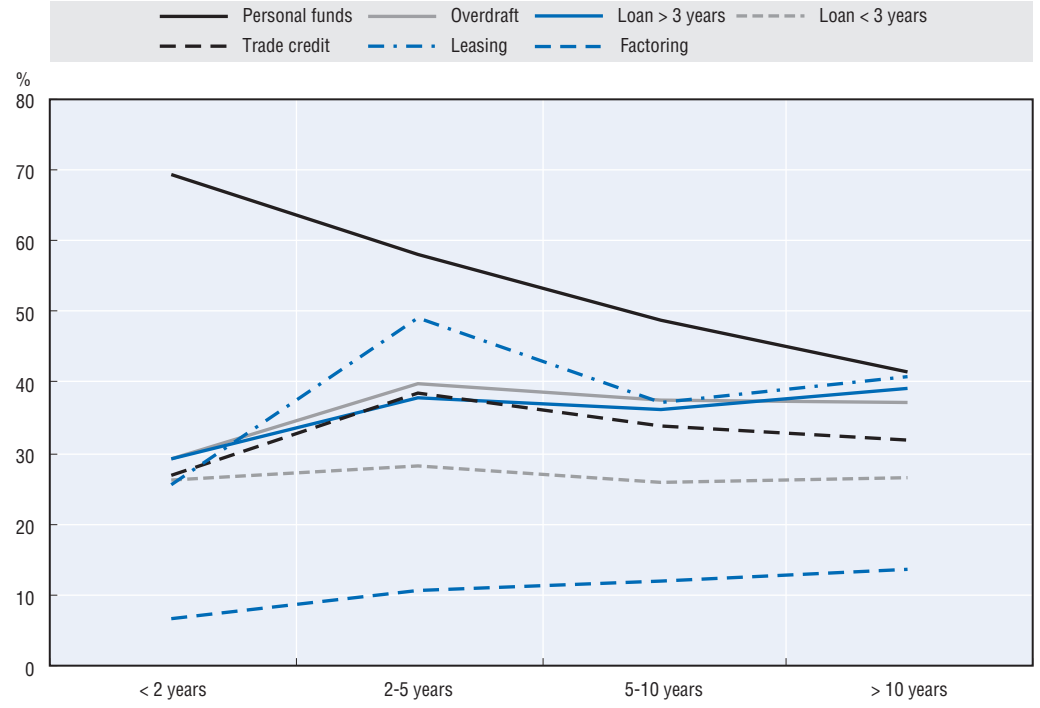
By firm size



Source: Oxford Economics (2011).

StatLink http://dx.doi.org/10.1787/888933292149

Figure 3.6. **European SMEs using financing type by age, 2010**



Source: Oxford Economics (2011).

StatLink http://dx.doi.org/10.1787/888933292151

is highlighted by OECD (2012), taking into account the success rates in obtaining leasing, which, across Europe, is relatively high for young, high-growth enterprises ("gazelles"), similar to the acceptance rates experienced by firms with a different growth pattern.

The study further illustrates that SMEs lease an extremely broad range of assets, although sectorial differences exist, with capital intensive industries leasing especially

machinery and industrial equipment and service firms financing larger sums on vehicles and ICT investments. The competitive price of leasing relative to other forms of finance is the advantage of leasing that is mostly cited by SMEs, although the instrument appears to be similarly appreciated across a broad range of other benefits, including cash flow management, absence of collateral requirements, and ability to adapt the length of the contract to the firm's needs.

According to other survey-based studies of SME financing practices, the share of small businesses using lease financing is smaller in other OECD countries than in Europe, though not marginal. For instance, according to the 2011 Survey on Financing and Growth of Small and Medium Enterprises by Industry Canada, 36% of Canadian SMEs reported some type of external financing, with 26% requesting debt, 8% trade credit, 7% leasing, 4% government financing and 2% equity.[10]

On the other hand, leasing appears to have played an important role in broadening SME access to finance in transition economies and emerging markets, as it was the case of the lending boom experienced by countries of Central and Eastern Europe over the last decade (EBRD, 2006). Haiss and Kichler (2009) estimate that, in 2006, across transition economies, leasing accounted for 7.9% of GDP, higher than the in EU-15, where on average leasing represented 4.7% of the GDP. The relevance of leasing in transition economies can be related to the bank lending sharp constraints for many SMEs, due to lack of collateral and limited track record, as well as to the restructuring process taking place in the banking sector of these economies (IFC, 1996; Beck et al., 2004).

USAID (2009) also notes that, largely due to improvements in the legal and regulatory environment for leasing, the leasing industry experienced spectacular growth in emerging markets during the 1990s, with medium-sized enterprises accounting for a relevant share of the activity.

Policies to enhance asset-based finance for SMEs

Regulatory framework

Policies to promote asset-based finance relate primarily to the regulatory framework, which is key to enable the use of a broad set of assets to secure loans in the case for asset-based lending, or to sell/assign specific assets to financiers, such as accounts receivables in the case of factoring and purchase order finance. Commercial laws that clearly define protection of a collateral lien are required. Also, the efficiency of the judicial and bankruptcy systems, including the length of time for bankruptcy, is critical for using assets to access credit. The power of collateral *ex ante* ultimately depends on whether the priority rights of secured lenders are upheld in bankruptcy *ex post* (Berger and Udell, 2006). In empirical work about institutions and bank behaviour in 20 transition economies, Haselmann and Wachtel (2010) find that collateral is the main trigger for creditors to lend to informationally opaque firms, and that the willingness to accept collateral depends on both the actual legal system and the perception by financiers of the legal environment. Hence, confidence in the operation of the legal system is as relevant as the laws enacted. Also, the broader the range of assets accepted as collateral, the more the banks appear to be willing to engage in lending that involves considerable asymmetric information.

According to Udell (2004) and Berger and Udell (2006), well-defined and strongly enforced laws on security interest partly explain the significant development of asset-based

lending in countries such as Australia, Canada, the United Kingdom and the United States. For instance, in the United States, under bankruptcy law, the judge is required to preserve the collateral claim of secured creditors and to give them "adequate protection" if the collateral or its proceeds are denied to the secured lender. Also, in the United States, an important role for the growth of the asset-based finance can be ascribed to the norms on "Secured Transactions" included in the US Uniform Commercial Code (UCC) and to a well-developed electronic registration system, which temporally defines lien filings.

These regulatory aspects have proven to be especially challenging for policies intended to develop asset-based lending, which demands a sophisticated and efficient legal system, in transition economies and emerging markets, as these generally present deficiencies in areas such as the scope of assets that can be secured, registration and filing, priority and enforcement (EBRD, 2003). In the 1990s, in most of the countries whose process of transition was supported by the EBRD, no rule on secured transactions existed, or rules were deemed outdated or inadequate, making it highly difficult for a lender to increase the chances of debt repayment by taking security over the borrower's assets. A key element in EBRD's support to economic reform, thus, has consisted in a "Model Law on Secured Transactions", intended to: illustrate the principal components of a secured transactions law and the way in which they can be included in legislation; act as a reference point and checklist for the law reformer; provide guidance as to expectations of international investors and lenders; and harmonise the approach to secured transactions legislation.[11]

According to IFC (2010), the efforts made in overcoming the weaknesses in creditor rights during the period of transition, as well as the large market share of multinational banking groups that may have used leasing as a more secure way to provide financing to firms in riskier environments, may contribute to explain why the leasing sector developed more in Central and Eastern Europe than in other emerging regions.

In some countries, the development of asset-based instruments has been promoted through an explicit and coherent set of rules, to overcome the overall weak legal environment for secured transactions. This is the recent case of emerging countries, whose reforms aim at easing access to finance for SMEs and boosting trade. In India, a Factoring Regulation Bill was passed by the Parliament in 2011, which regulates the assignment of receivables in favour of a factor, and was expected to address, among other issues, the problem of delayed payments to micro and small firms by large companies.

Policy programmes

Across OECD countries, active policies to support asset-based finance have received increasing attention, as governments seek to broaden the financing instruments available to businesses. Asset-based programmes are largely intended for businesses that are unable to meet credit standards associated with long-term credit. This is the case of the credit lines offered in the United States by the Small Business Administration (SBA), under the CAPLines programme, an umbrella programme that helps SMEs meet short-term and cyclical working capital needs. Two types of asset-based lending are offered: i) *Standard Asset-Based Line,* an asset-based revolving line of credit, which provides financing for cyclical growth, recurring and/or short-term needs. Repayment comes from converting short-term assets into cash, which is remitted to the lender. Businesses continually draw from this line of credit, based on existing assets, and repay as their cash cycle dictates. However, because these loans require continual servicing and monitoring of collateral,

additional fees may be charged by the lender; ii) *Small Asset-Based Line*, an asset-based revolving line of credit of up to USD 200 000, which operates like a standard asset-based line but with less strict servicing requirements, providing the business can consistently show repayment ability from cash flow for the full amount.[12]

New initiatives have been also launched more recently, as access to traditional bank lending became restricted in the aftermath of the global financial crisis and following regulatory reforms. This is the case of Japan, where the Bank of Japan (BOJ) in 2010 created a new line of credit to support asset-based lending, with the explicit aim to allow smaller firms, which do not have access to traditional lending under strict banking norms, better access to financing. Initially, the programme intended to provide up to Yen 3 trillion (USD 36.8 billion) in loans to private banks for up to four years, at a 0.1% interest rate, to lend to 18 high-growth sectors, including renewable energy and medicine. The BOJ later decided to lend up to Yen 500 billion specifically for equity investments and loans without real-estate collateral or guarantees, that is, asset-based lending. However, while loans to growth-sector firms neared the Yen 3 trillion ceiling in 2012, lending to equities and ABL only totalled about Yen 89 billion, well below the target limit.[13]

Policies have been aimed at strengthening longer-established instruments, such as leasing and factoring. For instance, in Europe, guarantees on lease have been included among the financing tools of the European Commission's Competitiveness and Innovation Framework Programme (CIP). Under the SME Guarantee Facility of the CIP, which provides loan guarantees to encourage banks to make more debt finance available to SMEs, the European Investment Fund (EIF) offers financial institutions with guarantees that cover part of the expected loss of a portfolio of new SME leases/loans. The instrument has proved useful in incentivising leasing providers to offer financing solutions to risk categories which were hitherto not approved, and thus cover new leasing volumes to SMEs and micro-enterprises (Kraemer-Eis and Lang, 2012).

In 2013, the Nordic Investment Bank (NIB), an international financial institution owned by eight countries,[14] signed a EUR 80 million loan agreement with private financial institutions for financing equipment leasing to the Norwegian SME sector.

In Japan, the Ministry of Environment (MOE) has been subsiding leasing businesses to support diffusion of low carbon-emitting and energy-saving equipment at households and SMEs, which may find it difficult to cover the high initial investment costs. Under the "Eco-Lease Promotion" programme, launched in 2011, the MOE provides corporations 30% of the total lease fee for leased equipment to generate and use renewable energies.

In other countries, public measures intended to foster leasing were discontinued after evaluating that the market could meet SME capital leasing needs. This is the case of Canada, where, in 2002, a capital leasing pilot project was launched by Industry Canada, with the objective of testing the viability and utility of the established Canada Small Business Financing Program for this financing tool. However, over the five-year timespan of the project, only 1 500 leases worth CAD 136 million were registered. This uptake was less than 7% of expected activity. At the same time, Statistics Canada's *Survey on Financing and Growth of Small and Medium Enterprises* showed that, in 2007, 17% of Canadian SMEs sought capital lease and, of these firms, 92% had their application authorised. It was then deemed that the vast majority of Canadian small business' capital leasing needs are being met in the marketplace without government assistance, and the pilot project was discontinued in 2007.[15]

Among asset-based instruments, factoring has been supported as a means to ease SMEs' access to finance and promote their inclusion in value chains. In Mexico, in 2001, Nacional Financiera (NAFIN), a state-owned development bank, launched the "Production Chains Programme", which offers SMEs on-line factoring services (Box 3.2).

Box 3.2. **NAFIN's Production Chains Programme: Reverse factoring and supply chain building**

The Production Chains Programme, launched by Nafin, Mexico's state-owned development bank, in 2001, allows small suppliers to use their receivables from large buyers to receive working capital financing. Under a typical reverse factoring scheme, a SME can access more and less expensive financing by transferring the credit risk to high quality customers. NAFIN does not factor receivables directly, but rather coordinates factoring services through an electronic platform. It requires all the factoring services it brokers to be offered without additional collateral and service fees. Two types of factoring are offered under the programme: i) factoring without recourse, at a maximum interest rate of 4% above the interbank rate, and ii) contract financing, which funds up to 50% of confirmed contract orders from large buyers, at a fixed rate.

Beside its role as a broker, NAFIN also provides financial training and assistance to SMEs. Furthermore, the platform mechanism, whereby suppliers are grouped in "chains" to large buyers, allows large firms to strengthen their relations with suppliers, and allows SMEs to build up a credit history, which may help then access bank lending. A unique feature of the programme is that nearly all services are provided electronically, which reduces time and labour costs, and improve security. In addition, as the platform allows all commercial banks and SMEs to participate, it gives both national reach to regional banks and access to national financing networks to rural firms. Furthermore, it favours competition of multiple lenders for factoring suppliers' receivables.

As of mid-2009, the programme comprised 455 large buyers, more than 80 000 SMEs and about 20 domestic lenders, including banks and independent finance companies, and had extended over USD 60 billion in financing.

Source: Klapper (2006), IFC (2010).

Other forms of asset-based finance, such as Purchase Order Finance and Warehouse Receipts, have received increasing attention in emerging economies, where international organisations and donors have been actively promoting projects intended to foster supply chain finance, as well as to develop stabilisation mechanisms in commodity markets. This is the case of programmes launched by USAID, which, based on the successful experience with these asset-based instruments in the United States, has introduced them in emerging markets such as Armenia, Azerbaijan, Bolivia, Kosovo, Macedonia, Moldova, and South Africa, both through banks and specialised non-banking financial institutions (USAID, 2009). Box 3.3 illustrates the case of a POF pilot project in Bolivia.

Box 3.3. **USAID pilot project for Purchase Order Finance in Bolivia**

In 2005, the USAID-funded Rural Competitiveness Activity (ARCo) initiated operation to improve licit productive activities and access to financial services in coca-growing Yungas and Chapare regions of Bolivia. After conducting supply- and demand-side analysis of the local financial sectors, to understand SME finance needs and available services, ARCo identified Purchase Order Finance (POF) as a potentially valuable instrument to tackle the main financial challenges for local producers. It selected FIE, a private financial fund and a leading microfinance institution in Bolivia, to implement the POF pilot project. The agreement with FIE included a small subsidy to start operations and technical assistance to train staff. FIE committed to use its own funds for the loan pool and issued USD 2.5 million in POF credits over two years.

One of the first operations under the programme, in 2007, involved a transaction between Cooperativa Agropecuaria Integral Noreste, a 260-member association of small coffee producers, and A. Van Weely BV, a Dutch-trading company specialised in organic food. This latter had issued a purchase order for a full container of washed Arabic organic Bolivian coffee, but Integral Noreste needed financing to process and ship the order. FIE issued a USD 30 000 POF loan to Integral Noreste for 90 days at 12% annual rate. This allowed Integral Noreste to purchase coffee beans from producers and for post-harvest packaging. Integral Noreste transferred its accounts receivable to the buyer, which kept control of the funds and paid suppliers for bills incurred by the cooperative, without imposing other fees or requesting collateral. The POF loan allowed Integral Noreste to pay its suppliers upon delivery of the coffee, which created greater incentive for members to sell their coffee to the cooperative, as previously Integral Noreste could pay them only after it received payment from the buyer, usually three to four months after delivery.

Source: Ortega (2008); USAID (2009).

Notes

1. The UCC filing is a public document that informs all other lenders and creditors that a specified collateral is secured. The so-called UCC-1 filing specifies the types of assets being secured. Often, firms have several UCC-1 financing statements filed against them, each mentioning a specific asset. Lenders that want to secure their loan with all the firm's assets file "blanket" UCC-1 statements. Once the firm pays off the secured loan, it can request that the lender terminates its UCC-1 filing (see *www.dandb.com/credit-resources/business-management/what-you-need-to-know-about-ucc-filings*). The establishment of the UCC has made it possible to put a lien on any kind of property. As Clarke (1996) describes, before the creation of the UCC, in 1952, there was no standardised way to place a lien on a company's inventory, equipment or finished good and, to obtain warehouse financing, a firm would need to physically move an asset into the lender's warehouse.
2. See *www.ifgroup.com/files/customer/images/Articles/History%20of%20Factoring.pdf*.
3. International Accounting Standard for Leasing (IAS 17).
4. See *www.leaseurope.org*.
5. See *www.cfa.com/eweb/upload/CFA%20Version%20-%20ABL%204Q%202011%20Quarterly%20Index.pdf*.
6. See *www.pwc.co.uk/assets/pdf/restructuring-trends-growth-of-asset-based-lending.pdf*.
7. See *www.cfla-acfl.ca*.
8. The International Factors Group comprises more than 160 members from the factoring industry across more than 50 countries. It was founded in 1963 as the first international association of factoring companies (see *www.ifgroup.com*).
9. The study is based on a survey of about 3 000 SMEs in eight European countries (France, Germany, Italy, the Netherlands, Poland, Sweden, Spain and the UK).

10. See *www.ic.gc.ca/surveys*.
11. See *www.ebrd.com/pages/sector/legal/secured.shtml*.
12. See *www.sba.gov*.
13. See *http://online.wsj.com/article/SB10001424052970204276304577264763230389428.html*.
14. Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden.
15. See *www.ic.gc.ca/eic/site/csbfp-pfpec.nsf/eng/la03016.html#a4_3*.

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Chapter 4

Alternative debt as a source of finance for SMEs

This chapter illustrates alternative forms of debt for SMEs, which appeal to investors in the capital market. The chapter covers "direct" tools for raising funds from investors in the capital market, such as corporate bonds, and "indirect" tools, such as securitised debt and covered bonds, which can be used by banks to transform SME loans in their balance sheets into liquid assets, and thus increase lending itself. The chapter provides details about the functioning of the different instruments, key enabling factors for their development, the profile of firms that are suited for corporate bonds, recent trends in alternative debt markets and policies to strengthen their development.

Alternative forms of debt differ from traditional lending, in that investors in the capital market, rather than banks, provide the financing for SMEs. These include "direct" tools for raising funds from investors in the capital market, such as corporate bonds, and "indirect" tools, such as securitised debt and covered bonds. With alternative debt, the SME does not access capital markets directly, but rather receives bank loans, whose extension is supported by activities by the banking institutions in the capital market.

These instruments have existed for some time, but they can be viewed as "innovative" financing mechanisms for SMEs and entrepreneurs, to the extent that they have had until now been applied in a limited fashion to the SME sector.

Corporate bonds

Modalities

Corporate bonds are debt obligations issued by private and public corporations. By issuing bonds, the company makes a legal commitment to pay interest on the principal, independent of the company's performance, and to return the principal when the bond matures. The terms of the contract can however provide the company with the right to "call", i.e. buy back, the bond before the maturity date. If it calls the bond, the company will pay back the principal and possibly an additional premium, which depends on when the call occurs in relation to the actual maturity date (SEC, 2013).

Bonds can be classified in relation to several characteristics, such as maturity, type of interest, credit quality, priority claim, and collateralisation (Table 4.1). The terms and conditions of the bond contract can combine these dimensions differently, giving rise to a large variety of cases.

Table 4.1. **Corporate bonds, by characteristics**

Bond characteristics	Typologies
Maturity	Short-term (< 3 years) Medium-term (4-10 years) Long-term (> 10 years)
Coupon rate	Fixed rate Floating rate Zero-coupon
Credit quality	Investment grade Non-investment grade (high-yield or speculative)
Priority claim	Senior debt Subordinated debt
Collateral	Secured debt Unsecured debt (debenture)

Source: Adapted from SEC (2013).

With regard to maturity, bonds can be classified as *short-term* (less than three years), *medium-term* (four to 10 years), or *long term* (more than 10 years). The longer the term, the

higher the risk for the bond-holders, hence the higher the interest rate. Interest payments are called *coupon payments* and can be at a *fixed rate* throughout the term of the bond, or at a *floating rate*, based on a bond index or another benchmark, such as government bonds. There also exist bonds that do not pay interest, so-called *zero-coupon bonds*, which rather make a single payment at maturity that includes a premium with respect to the purchase price.

The price of a bond is negatively correlated with the market interest rates, as these determine the relative convenience to investors of the coupon rate attached to the bond. Hence, for a given coupon rate, if market rates increase, i.e. the bond pays relatively less, the bond's price decreases. On the other hand, a reduction in the market interest rates will imply a relatively greater value of the coupon, thus an increase in the price of the bond.

The credit quality of the bond is determined by credit rating agencies, which assign and periodically review bond ratings. In accordance with these, bonds can be distinguished in investment grade (e.g. BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's) or non-investment grade. These latter are also defined as high-yield or speculative bonds, which pay investors a higher interest rate in exchange for the higher default risk.

A corporate bond can be either secured over specific assets, whereby the company pledges specific collateral as security for the bond, or be unsecured (so-called *debenture*). In this latter case, if the issuer defaults on its bonds, the investor has only a general claim on the company's asset and cash flow. Also, the bond can rank ahead of all other obligations of the borrowers (senior debt), hence have priority claim in case of default, or be subordinated. In any case, in the event of bankruptcy, the bond investors have priority over shareholders in the claim of the firm's assets.

The bond-holder is exposed to specific risks, which generally reflect into the bond price and coupon rate (SEC, 2013):

- *Credit or default risk*. The risk that a company will not be able to make timely payment of interest or principal, that is, that may default. The credit ratings by specialised agencies are intended to estimate this risk. To limit credit risk, the bond contract may include covenants, that is, conditions for the debtor, for instance in terms of financial ratios or limitations to the amount of debt the firm can take;
- *Interest rate risk*. The risk that market interest rates may become relatively more favourable than the coupon rate. The longer the maturity of the bond, the greater is the risk that rates will change, hence the higher is generally the coupon rate;
- *Inflation risk*. The risk that inflation will reduce the real value of the investment and coupon payments;
- *Liquidity risk*. The risk that the bond may not be easily traded, or that the investor may not receive a fair price when selling the bonds in secondary markets;
- *Call risk*. The risk that the bond may be called back by the issuing company before the maturity date, for instance following a decrease in interest rates that make the coupon rate relatively more onerous for the company (but more convenient for the investor).

Reporting requirements on bond issuers are intended to increase transparency and reduce investors' risks. For instance, in the United States, a company that intends to issue bonds for sale to the public must file a prospectus with the Securities and Exchange Commission (SEC). The prospectus describes the financial conditions of the company, the terms of the bond, the risks of investing in the offering, and how the company plans to use

the proceeds from the bond sale. Also, companies that have issued bonds in a public offering are required to file quarterly and annual reports (SEC, 2013).

Another mechanism to protect investors is the *trustee*, a financial institution that is given fiduciary power by a bond issuer to enforce the contract terms. In practice, the trustee is responsible for the registration and transfer of the bond, and for the timely payment of the coupons and principal. Importantly, the trustee acts on behalf of the investors if the borrower violates certain conditions and protects their interest in case of default.

Bonds are primarily traded in a non-centralised dealer market, where investors shop between dealers for the best quotes (Hotchkiss and Jostova, 2007). In other terms, contrarily to publicly traded stocks, there is no central place or exchange for bond trading. Rather, the majority of corporate bonds are traded "over-the-counter", i.e. via a dealer network. By creating a "market" for bonds, i.e. quoting a price to buy and sell, bond dealers provide "liquidity" for bond investors, that is, they made it easier for demand and supply to coordinate. Beside dealers, the market is comprised of institutional bond investors, such as financial institutions, pension funds, mutual funds and governments.

Institutional investors are the main player in this market. In 2010, in the US, institutional investors held about three quarters of the USD 7.5 billion outstanding corporate bonds issued by US firms (Cai et al., 2012).

Typically retail investors buy corporate bonds from funds, which hedge risk across a large number of issuers. However, corporate bonds can be also issued "publicly", that is, directly to retail investors. "Direct bonds" allow saving on the fees of the dealer network, but can include additional costs, such as those related to marketing and the possible fees of other brokers.

In some countries, the regulatory framework allows Private Placements (PP) of corporate bonds, i.e. the offer of bonds to a few, select investors by unlisted companies. These are subject to less stringent reporting requirements and do not need a formal credit rating, although some credit rating agencies have been providing specialised services for investors to better navigate this opaque market. In fact, lack of information on issuers, lack of standardised documentation, illiquid secondary markets and differences in insolvency laws currently limit the development of these markets (Nassr and Wehinger, 2015).

Profile of firms

The corporate bond market has been traditionally dominated by large firms with long pedigree, stable earnings and relatively low volatility stocks. On the other hand, only a very minor share of SMEs has approached the market (Ashcroft, 2011).

Corporate bonds typically require the issuer to have a certain size and scale, an established credit history and earnings record, and limited volatility on revenues and earnings. As most SMEs do not meet these criteria, in the bond market they would attract low rating and high coupons and have limited dividends to cover these regular payments. Also, bonds are a relatively costly instrument to raise finance. In fact, the costs of bonds may be as high as 10% of issuance (Ashcroft, 2011). Beside the costs of issuance, another relevant unattractive feature of corporate bonds for SMEs is the rigidity implied by the fixed schedule of interest and principal repayments, which requires a relatively stable cash flow pattern. If payments are missed, the company defaults and becomes vulnerable to bankruptcy. Also, the amount of debt enters the firm's balance sheet, which could affect future borrowing costs.

On the other hand, corporate bonds present some advantages for mid-sized firms that can meet the size, earnings stability and cash flow criteria requested by the market, and which can respond to the reporting requirements linked to bond issuance. Overall, corporate bonds can provide an injection of liquidity to undertake investments or seize growth opportunities. Financing with corporate bonds can be an especially attractive option when market interest rates are low, as the coupon rates over the life of the bond can be set at a convenient rate, and still attract investors. Also, with respect to equity, issuing bonds does not dilute ownership or the control of the company.

In the post-crisis environment, while raising capital remains difficult, the potential for a bond market for the larger segment of the SME sector is starting to be recognised by entrepreneurs. For instance, according to a survey conducted in February 2013 by BDO, a financial services group, and the Quoted Companies Alliance, on small and mid-cap UK quoted companies and advisory companies, 38% of small and mid-cap firms would be interested in issuing debt as an alternative source of funding versus 57% of advisors who would recommend them to their clients.[1] The survey, however, also suggests limited knowledge by entrepreneurs and their advisors about corporate bonds as a potential alternative source of funding. More than one fifth (22%) of small and mid-cap businesses did not know what the main benefit of issuing corporate bonds was and only 16% of advisors believe that there is sufficient information available for companies to evaluate the market effectively for corporate bonds. Also, half of advisors (49%) were not aware of new initiatives aimed at fostering access to corporate bonds by SMEs, such as the London Stock Exchange's Electronic Order Book for retail bonds (see trends section).

Private placements may be attractive to smaller companies with limited visibility in the public markets, given that there is no minimum size limit and that they function through a direct relationship between borrowers and lenders, which may negotiate specific terms. At the same time, the lack of standardised documentation increases the issuing costs and inhibits broader usage of these instruments by SMEs (Nassr and Wehinger, 2015).

Enabling factors

The improvement of trading and clearing conditions for debt securities has represented a major driver in the development of corporate bond markets over the last decade, although the effective transparency in over-the-counter markets is still a matter of debate. For instance, according to Bessembinder and Maxwell (2008), the US corporate bond market became much more transparent with the introduction of the Transaction Reporting and Compliance Engine (TRACE) in July 2002. Before that, corporate bonds were primarily traded in an opaque environment, with quotations available only to market professionals, most often by telephone. With TRACE, bond dealers have been required to report all trades in publicly issued corporate bonds to the National Association of Security Dealers, which in turn make transaction data available to the public. As a consequence, the cost of trading corporate bonds has decreased, but so has the quality and quantity of the services formerly provided by bond dealers.

The growth in bond markets is also favoured by a low interest rate environment, as corporate bonds can provide convenient alternatives to investors and, at the same time, they may allow firms to raise funding with relatively low coupon rates. Low inflation rates also favour the use of fixed rate corporate bonds, as investors typically factor in the impact of inflation.

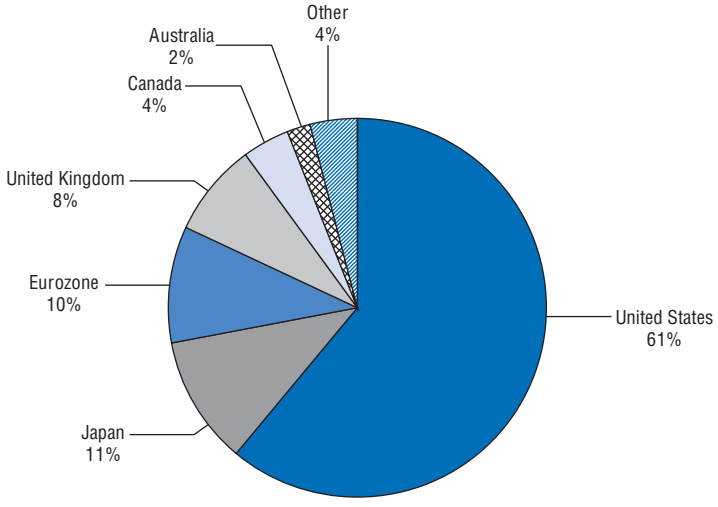
Similarly, the market for private placements benefits from greater standardisation of documentation and information on the creditworthiness of issuers. A large part of the success of the US PP market is attributed to the role of the National Association of Insurance Commissioners (NAIC), which gives credit scoring on PP issuances and provides investors with regulatory guidance on capital weighting (Nassr and Wehinger, 2015).

Trends in corporate bond markets

Corporate bond markets have been expanding at high rate in the aftermath of the financial crisis. As other sources of finance dried up in some countries, especially bank lending, corporations increasingly turned to debt capital markets, further encouraged by the low interest rate environment. On the demand side, investors' interest in corporate bonds has increased, particularly as a result of low government yields.

According to the Bank for International Settlements, in 2012, bonds by non-financial corporations represented 12% of the debt securities market, following government bonds (49%) and financial-corporation bonds (39%). The US corporate bond market is the most developed and liquid market in the world: in 2012, US residents accounted for 61% of the global bond securities issuance, followed by Japan (11%) and the euro area, which accounts for only 10% of the global market (Figure 4.1).

Figure 4.1. **Global outstanding corporate bonds, by issuers' country of residence, June 2012**



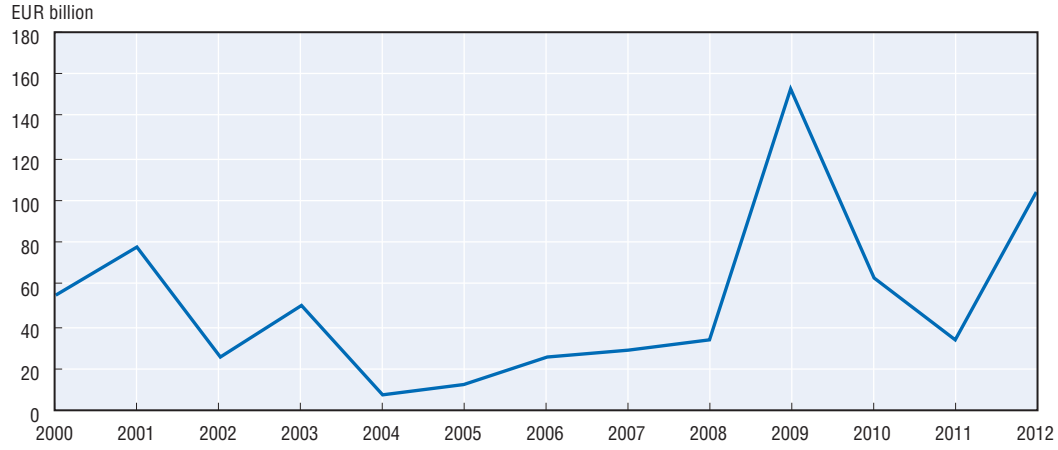
Source: BIS (2012).

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Nevertheless, in Europe, where debt securities have historically represented a minor share of non-financial corporations' liabilities, issuance peaked up in 2102, after the 2009 all-time-high and the substantial drop in 2011, as a consequence of the negative market sentiment in general (Figure 4.2). Deutsche Bank (2013), however, highlights the diversified country-level trends underlying this general picture. In particular, changes in corporate bonds issuance appear to be correlated with conditions in bank lending. That is, there is evidence that bond issuance increased especially in peripheral euro area economies, where access to bank loans had become particularly difficult.

In the UK, corporate bond issuance in 2012 was the highest since 2003, when the Bank of England records began, amounting to GBP 40.5 billion. Over 2011-12, the increase in bond

Figure 4.2. **Net issuance of long-term non-financial corporate debt securities in Europe**



Source: Deutsche Bank (2013).

StatLink http://dx.doi.org/10.1787/888933292179

issuance for all enterprises more than offset the decrease in bank lending, which suggests the corporate sector is changing the composition of debt, rather than clearly deleveraging (RBS, 2013).

The above trends basically refer to issuance by large corporations, which, as mentioned above, dominate this market. Nevertheless, in some countries, innovations in the market for SME corporate bonds have taken place in recent years, which are expected to result in greater attractiveness for and access by SMEs, or mid-cap firms.

In 2010, the London Stock Exchange's Electronic Order Book for Retail Bonds (ORB) was launched. This is an electronic platform for private investors trading fixed income securities, which provides continuous, transparent, two-way tradable prices for gilts (i.e. British government bonds) and retail-size corporate bonds on-exchange for the first time. It thus offers an easier and more transparent mechanism for issuers to raise debt capital from a retail audience, in deal size as low as GBP 100. This initiative is modelled on Borsa Italiana's successful MOT market, which was launched in 1994 and has evolved in Europe's largest retail fixed income market, with EUR 230 billion worth of trading in 2009. This model is expected to favour small investors as well as to provide more opportunities to smaller companies for raising funds through debt securities.

In Germany, in 2010, the Stuttgart Börse created a special bond platform for SMEs (Bondm), offering issues in the EUR 25-EUR 150 million range. The platform allows companies to issue bonds directly to the retail investor in the primary market, during the subscription phase, without the assistance of an underwriter, which reduces issuance costs and gives the individual investor a price advantage over the first listing. After the initial bond offering, the instrument is then traded openly on the Bondm market. As of 2012, some 25 SMEs were listed, for a combined value of assets of about EUR 1.6 billion (Hillion et al., 2012).

In France, innovative schemes have been launched to increase attractiveness of small size bonds. With the support of the French government, in the form of guarantees issued by OSEO (now bpifrance), the GIAC bond programme allows for the mutual issuance of bonds by SMEs and mid-caps. GIAC, a borrowing group funded in 1961 to provide financial support to French enterprises, manages a securitisation fund, which invests in small to

mid-sized bonds (EUR 500 000-2.5 million) and gets financing on the market by issuing itself obligations of different types, acquired by institutional investors. Also, the fund is guaranteed by a mutual fund participated by the bond issuing companies, whose contribution amounts to 7% of the requested funding. These companies are selected in accordance with specific criteria, such as a solid financial position, good profitability and development plans. In 2013, EUR 80 million were raised by this innovative scheme.[2]

In 2013, a new debt fund was launched in France to stimulate the development of the SME bond market. "Fond NOVO" is a EUR 1 billion fund subscribed by *Caisse des dépôts* and 17 large insurance companies. The fund will have a 10 year life and is expected to finance 30-40 enterprises, contributing with EUR 10 million-50 million lending for their development.

In 2013, NYSE Euronext has increased efforts to stimulate bond issues among smaller companies through its new EnterNext subsidiary. This is dedicated to companies that have a capitalisation of under EUR 1 billion and, as of May 2013, it covered about 750 SMEs listed on NYSE Euronext's European markets in Belgium, the Netherlands, Portugal and France.

Policies to foster corporate bond markets for SMEs

The main actions undertaken by public authorities in corporate bond markets have aimed at improving transparency and protection for investors, to favour greater participation and liquidity. This is the case of the above-mentioned Transaction Reporting and Compliance Engine (TRACE), introduced in the US in 2002 by the Securities and Exchange Commission (SEC), and, for private placements, the credit scoring provided by the US National Association of Insurance Commissioners (NAIC).

To foster the development of a corporate bond market that is still barely accessible by SMEs, the European Commission has proposed reforms to improve market structure through the creation of new trading venues, enhance transparency and information efficiency, enhance requirements to reduce short-term and speculative trading activities, and improve investor protection (EC, 2013).

In other cases, like in Germany, relevant regulation was reformed to allow greater flexibility on the side of issuers and investors. The new German Bond Act, which came into force in 2009, aims to align German bond law with international standards and to improve the ability to affect bond restructurings outside of insolvency proceedings. To this end, the Act allows amendment of the bond terms by way of a majority resolution of the bondholders, with the issuer's consent, and to hold creditor meetings also in virtual form (Vogelmann and Halasz, 2013). The reform is expected to ease bond issue by German Mittelstand. Also, to this end, the larger German stock exchanges in Frankfurt, Munich, Stuttgart and Düsseldorf have developed a special segment where those Mittelstand bonds can be listed and traded publicly.

In some countries, recent policies have especially targeted the SME sector, in order to encourage unlisted and smaller companies to raise money via the bond market and move away from solely relying on their bank lenders.

This is the case of Italy, where, in 2012, the government designed rules for a new debt security instrument, the so-called "minibond". This is a typology of corporate bond that can be issued by non-listed SMEs, under certain conditions. The new regulation abolishes rules that restricted the amount of debt companies could issue, as long as the bonds are listed on a regulated market platform, and indicates for these bonds the same tax treatment as debt issued by listed companies, including tax relief on interest costs and

issuance expenses. Furthermore, there are relatively few, and simplified, regulatory requirements for issuing the debt instruments. However, retail investors cannot buy these instruments directly. The Milan stock exchange has set up a special trading platform for mini-bonds (ExtraMOT PRO), which is active since March 2013. As of May 2014, around thirty unlisted firms had used mini-bonds (OECD, 2014). Also, in the wake of these regulatory changes, in 2013 some Italian banks launched Mini-bond Funds, open to institutional investors, which allow investors to gain exposure to the country's large unlisted private sector.[3]

In other countries, credit risk mitigation instruments typically applied to bank loans have been extended to bonds. In Japan, the credit guarantee instruments of the SME Unit of the Japanese Finance Corporation (JFC), a public corporation entirely owned by the government, extend to SMEs that fall short of collateral when issuing corporate bonds. The JFC also acquires newly issued bonds by SMEs.

Debt securitisation and covered bonds

Modalities

Securitisation is an instrument for the refinancing of banks and for their portfolio risk management, which has been widely used in the past, especially in the US, mainly for mortgages and, to a certain extent for corporate loans. Through securitisation, various types of contractual debt are pooled and sold to investors. These acquire rights to receive the cash collected from the financial instruments that underlie the security.

In the case of SME loan securitisation, a bank ("the originator") extends loans to its SME customers (the "primary market"), bundles them in a pool (the "portfolio") and sells the portfolio to capital market investors through the issuance of notes, by a Special Purpose Vehicle (SPV) backed by the loan portfolio (Asset-Backed Securities, ABS). These asset-backed notes, rated by agencies, are placed with capital market investors, but can also be retained, at least in part, by the originator banks (Kraemer-Eis et al., 2010).

Once the assets are transferred by the originator to the SPV, there is normally no recourse to the originator itself. Through the securitisation process, assets are taken off the balance sheet of the originator. Thus, with this "originator to distribute" model, the bank becomes a "conduit", which derives its income from originating and servicing loans ultimately funded by third parties. According to Martin-Oliver and Saurina (2007), this model is changing the relationship of banks with customers, which is fading, in favour of a transaction-based bank whose main proceeds come from the fees they earn originating and packaging loans.

An alternative securitisation model, the "synthetic securitisation", combines the above described mechanism with credit derivatives, whereby the loans remain in the balance sheet of the originator, whereas the credit risk of the loan portfolio is transferred to a SPV, which places credit-linked notes, classified by risk categories, in the capital market (Kraemer-Eis et al., 2010).

Debt securitisation presents some advantages for banks, and, indirectly, for SME lending. First of all, securitisation reduces the bank's exposure to credit risk, which is transferred to the capital market. This has important implications also in the light of the recent financial reforms (i.e. Basel III), as risky assets are taken out of the banks' balance sheets and the capital to risk-weighted asset ratios is improved. In other terms, securitisation can represent an instrument for risk-reduction and "regulatory capital arbitrage". Ultimately, by giving capital relief, securitisation reduces the bank's total cost of financing.

Securitisation allows banks to transform SME loans in their balance sheets into liquidity assets, which can be used to increase lending itself. In an empirical study of loan securitisation by Spanish banks, Martin-Oliver and Saurina (2007) show that liquidity needs have been a key driver of securitisation, with higher probability of using this mechanism for banks with rapid credit growth, less interbank funding and a higher loan-deposit gap. Kraemer-Eis et al. (2010) note that securitisation can be especially important for smaller banks, which face lending restrictions due to their size. Transferring risks to the capital market increases their lending capacity. Furthermore, securitisation of SME loans can be an effective option for them, as their closer customer relations and better monitoring capabilities give them a competitive edge in lending to smaller companies.

Covered bonds work similarly to securitised debt, as they are debt securities (corporate bonds) backed by the cash flows from mortgages or loans. In the European Union, the Capital Requirements Directive (CRD) limits the range of accepted collateral to debts of (highly rated) public entities, residential, commercial and ship mortgage loans with a maximum loan-to-value ratio of 80% (residential) or 60% (commercial), and bank debt or mortgage-backed securities (Packer et al., 2007).

An important difference with respect to securitisation is that covered bond assets remain on the issuer's consolidated balance sheet, except under specific variants of the general model. Thus, they cannot help to strengthen the issuer's capital ratio. As the investor does not own the assets, the interest is paid to them from the issuer's cash flow, as in the case of traditional corporate bonds. If the underlying assets default, the issuer continues to pay interest to investors. However, in case of default by the issuer that is unrelated to these underlying assets, the lender can take possession of them. As covered bonds are secured, they are considered to be less risky than unsecured bank bonds, which implies low-cost funding for the issuer. At the same time, asset encumbrance implies that they are seen as a complement, rather than as substitute to securitisation.

On the demand side, securitised debt has some desirable risk characteristics for investors. Mainly, as secured assets, these investment options may present lower risk than other market offers. In addition, as they have limited correlation with the more traditional asset classes in the financial market, they can improve the risk return profile of the investors' portfolio. In itself, the bundling of different assets into the securitised portfolio is an element for risk diversification. In the case of covered bonds, the fact that they remain on the balance sheet of the originator may provide investors with more confidence with regard to the assessment of risks and backup for their claims (Wehinger, 2012). In fact, in case of default, investors have a double recourse, to the issuer and the cover pool. For this reason, covered bonds benefit from a more favourable regulatory treatment than securitised debt, and greater liquidity in the market. It should be noted, however, that in most cases, the market for SME covered bonds is relatively new. Indeed, the use of SME loans as an asset class in covered bonds is not permitted in the legislation of most countries with an active covered bond market. In some others, changes in regulation that allow this form are recent (Nassr and Wehinger, 2015)

Trends in securitisation markets

Securitisation activity increased at high rates before the 2008-09 global financial crisis, even in countries where it had been little used in the past. At the peak of the market in 2006, issuance of structured finance securitisation in the United States was almost four times that of Europe, where however a remarkable growth had started, at least in some

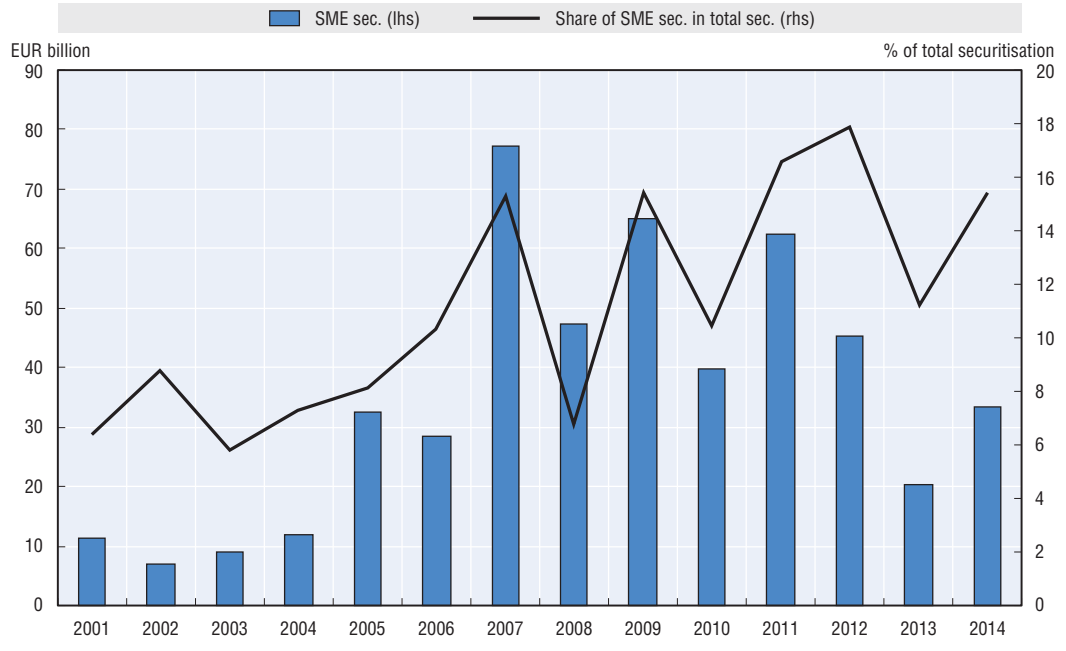
national markets, such as Germany, Italy, Spain and the UK (Kraemer-Eis et al., 2010; Blommestein et al., 2011).

However, in the wake of the crisis, securitised instruments came under increasing scrutiny and criticism. In particular, the US subprime securitisation market was seen as a catalyst for the global credit crisis (Blommestein et al., 2011). The securitised instruments, which were conceived to hedge risk, have appeared to have the potential to undermine financial stability, by facilitating the leverage of risk. Lack of transparency with regard to the underlying risks of securitisation, and poor management of those risks, have been identified as major drivers of the financial turmoil. Moreover, an important misalignment of incentives along the securitisation chain has been highlighted, in particular the laxer screening of borrowers by banks, due to their transferring of these risks to the capital market (Gambacorta and Marques-Ibanez, 2011).

In the aftermath of the crisis, securitisation markets plummeted, reflecting the drop in investors' confidence and increasing spreads with respect to other investment classes. For instance, in Europe, where most of the SME securitisation originates from a few countries (i.e. Germany, Italy, Benelux, Portugal and United Kingdom), the volume of total securitisation grew by 460% over 2001-08. From the 2008 peak, it then fell by 42% in 2009, when the market volume dropped from EUR 711 billion to EUR 414 billion. The market segment for SME securitisation, whose share had increased over 2001-07 from 5% to 15%, continued to grow until 2009, when however it came to a halt, as no placement was made in the public market (Kraemer-Eis et al., 2015) (Figure 4.3).

Figure 4.3. **Development of debt securitisation in Europe**

Total and SME



Source: Kraemer-Eis et al. (2015).

StatLink http://dx.doi.org/10.1787/888933292186

In contrast, volumes in the US securitisation markets fell sharply in 2007 and 2008, but have slowly increased in 2009 and 2010, although around two-thirds of the market was

based on mortgage-backed securities by the federal mortgage agencies. At the end of 2010, total securitisation outstanding in the US market was equivalent to USD 8.2 trillion, four times that of European issuance. Furthermore, in the first quarter of 2011, more than half of the outstanding European securitisation was estimated to have been "retained" by the originating banks, compared to less than 10% in 2007, which shows the funding difficulties faced by European banks in capital markets (Blommestein et al., 2011).

In this framework, while some asset classes such as subprime mortgages had been built on inflated asset prices, the SME debt securitisation market segment, which had performed relatively well, has suffered by and large from contagion effects, through financial markets and in the public perception (Kraemer-Eis et al., 2010).

The relatively low level of SME securitisation issuance placed in the primary market is also due to the high required yield that cannot be serviced by the cash flows of the asset pool. In other terms, SME issuance is regarded as uneconomic by some investors, who are seeking high yields, particularly in the light of asset quality considerations and low liquidity of the issuance. Since investors perceive the lack of liquidity in the market and that the underlying SME loans are riskier than residential mortgages, they typically expect an additional premium. Thus, for SME securitisation to be considered economically viable, asset spreads charged on SME loans by the originators would need to increase. Alternatively, the yield required by investors would need to decrease, which could happen if, for instance, more information were available to quantify the risk involved in SME issuances (Nassr and Wehinger, 2015).

Furthermore, market participants regard the current regulatory environment (i.e. Basel III, Solvency II) as unfavourable, generating disincentives for originators and investors. The complexity of the regulatory framework affecting securitisation is perceived to create imbalances across market participants, which face different capital charges, and across jurisdictions. Also, in Europe, the extensive process of consultation and revision of regulations has led to regulatory uncertainty, further hampering the development of the market (Nassr and Wehinger, 2015).

On the other hand, the market for covered bonds has emerged relatively unscathed from the crisis. This is also because of a more favourable regulatory treatment than securitisation, especially in Europe, as a simpler tool than complex originate-to-distribute models, and which may allow channelling funds to the real economy while ensuring financial stability. However, in many countries, still there exist statutory limitations that do not permit the use of SME loans as an asset class for covered bonds (Nassr and Wehinger, 2015).

Policies to enhance SME debt securitisation

The post-crisis deleveraging in the banking sector has revived the debate about the need for an efficient – and transparent – securitisation market, which may allow the banking sector to access funds at relatively low cost, to extend SME lending. In Europe, both the ECB and the EC have indicated the importance of developing primary and secondary markets for the securitisation of SME loans, in order to foster SME lending.[4] In 2012, of the total euro area securitised bond market, whose value amounted to EUR 1 trillion, only some EUR 140 billion was backed by SME loans, a minor share if compared with the EUR 1.5 trillion estimated value of bank loans to SMEs (IMF, 2013).

The European Commission's 2013 Green Paper on the "Long-Term Financing of the European Economy"[5] puts forward ideas for the re-launching of securitisation markets,

including adequate prudential rules and supervision systems; the development of simple securitisation products, using well-selected, diversified and low-risk underlying assets; the creation of dedicated markets especially for SMEs; and market-based initiatives, such as labels for high-quality, transparent and standardised securitisations.

According to IMF (2013), the following policy measures may help strengthen SME debt securitisation:

- Addressing the asymmetric treatment of securitised assets *vis-à-vis* other assets with similar risk characteristics;
- Introducing government guarantees for SME securitisation, which may offset some of the informational asymmetry and SME credit risk that typically discourage investors from buying these securities, especially in the case of investors that can only buy securities with certain minimum credit ratings;
- Including SME loans in the collateral pool for covered bonds, as at present only mortgages, municipal, ship and aircraft loans are eligible collateral for covered bond issuance;
- Improving risk evaluation for SME securities by regulating and standardising information disclosure, which would reduce investors' uncertainty about the quality of SME securities.

Some measures undertaken in Europe in recent years, at both the supra-national and national level, are in line with these policy priorities. The European Investment Bank (EIB) Group has introduced measures to re-launch the securitisation market, in order to foster new SME lending. For instance, the European Investment Fund, which is Europe's leading provider of triple A-rated credit enhancement in SME securitisations, guarantees certain tranches of notes (mezzanine and senior tranches) issued through a SME securitisation transaction.

In June 2013, the European Council approved a joint proposal by the European Commission and the European Investment Bank to establish one single SME support instrument with a total worth of EUR 10.4 billion. This will be used for loan guarantee instruments and securitisation instruments with a maximum leverage ratio of 1:10.[6]

At the country level, securitisation of SME financing has received stimulus from national support schemes. For instance, in Germany, in 2000, KfW launched the PROMISE (Promotional Mittelstand Loan Securitisation) platform, open to financial institutions from all over Europe, which provides intermediation between financial institutions and investors, allowing for a reduction of transaction and market entry costs. In this model, KfW only acts as an intermediary in the securitisation process, that is, it does not take the economic risk of the underlying SME reference portfolio and does not replace any of the other involved parties. According to GBRW (2004), the platform succeeded in raising the profile of the SME asset class in the ABS markets by developing a recognised brand name and structure.

In Spain, the government has supported SME securitisation since 1999, with the FTPYME Securitisation Scheme, which facilitates transactions and offers guarantees to lower the overall funding costs for the originator. To qualify for the FTPYME Securitisation Scheme, at least 80% of the pool to be securitised must comprise SME loans, and the originator must commit to reinvest 80% of the proceeds obtained from the financing in the SME sector, within the maximum period of one year (EC, 2007a).

At the same time, as Wehinger (2012) underlines, policies in this area face a challenging environment, as the SME securitisation can only work when there is confidence in the

banking system. However, the currently high spreads suggest that confidence is low, partly as a result of sovereign debt overhang, but also due to a fundamental solvency problem that has not yet been addressed.

Notes

1. See *http://bdoqcasentimentindex.co.uk/downloads/QCA-BDO-Small-and-Mid-Cap-Sentiment-Index-February-2013.pdf*.
2. See *www.giac.fr*.
3. See *http://blogs.wsj.com/moneybeat/2013/07/12/mediobanca-launches-first-mini-bond-fund/*.
4. In May 2013, the ECB governing council announced it would start consultations with other European institutions on initiatives to promote a functioning market for asset-backed securities collateralised by loans to non-financial corporations.
5. *http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0150:FIN:EN:PDF*.
6. See *www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/137634.pdf*.

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Chapter 5

Crowdfunding for SMEs

This chapter illustrates the emergence of crowdfunding as a means to finance businesses and discusses its potential for financing SME investments. The chapter comments on the origin of crowdfunding and describes its different forms. It illustrates the profile of investments and business models that are suited for crowdfunding, it discusses the key factors that enable the development of crowdfunding activities, it describes recent trends in the crowdfunding industry, and it presents recent regulatory reforms and policies that are intended to ease the development of this financing channel, for both debt and equity funding.

Crowdfunding is a technique to raise external finance from a large audience, rather than a small group of specialised investors (e.g. banks, business angels, venture capitalists), where each individual provides a small amount of the funding requested.

The concept of "crowdfunding" is related to the one of "crowdsourcing", which refers to the outsourcing to the "crowd" of specific tasks, such as the development, evaluation or sale of a product, by way of an open call over the internet (Howe, 2008). Through online platforms, the task, traditionally performed by contractors or employees, can be undertaken by individuals for free or in exchange for some specified return, whose value is however generally lower than the one of the contribution made to the firm. Crowdsourcers may in fact have intrinsic motivations, such as the pleasure of undertaking the task or participating to a community, as well as extrinsic motivations, related to monetary rewards, career benefits, learning or dissatisfaction with the current products (Kleeman et al., 2008).

Forms of crowdfunding

In the case of crowdfunding, individuals provide the firm with financial help. Crowdfunding generally takes place through social networks, internet especially, with the entrepreneur detailing the business activities and objectives, in some cases in the form of a business plan, and requesting funding under specific terms and conditions. This represents the main innovation of crowdfunding with respect to other forms of finance, as the entrepreneur does not need an intermediary, such as a banking institution, to seek funding and can source directly the savings of a large audience.

Crowdfunding is not only a mean to raise funds, but can also represent an important mechanism to share information with a large public, increase awareness about projects and products, seek feedback to improve them, and get recognition which may help in future commercialisation (Metzler, 2011).

The type of contributions by the investor – and related rewards – may vary, depending on the internet platforms, the type of firms and the projects. Indeed, as new platforms are created across countries, in a context of low regulation, new features and business models are continuously emerging. The types of funding may range from donations to equity, thus giving rise to processes with different degrees of complexity and different contractual relationships between the firm and the individual investor.

In broad terms, crowdfunding can take the form of (Hemer, 2011; Mitra, 2012):

1. *Donations*, whereby contributors donate funds, mostly for charities and non-profit organisations, although for-profit organisations can also receive donations through this channel.
2. *Reward or Sponsorship*, whereby contributors receive a pre-defined reward, such as a small token of appreciation or some type of service, like a public acknowledgment for their contribution and marketing.

3. *Pre-selling or pre-ordering*, whereby investors provide funding to help produce some product or service and in return receive an early version of the product, or the product at a reduced price.
4. *Lending*, whereby investors receive the interest and the principal at the end of the lending period. There exist also crowd-lending forms based on the revenue-sharing principle, that is, where creditors are not paid interests at the end of the defined lending period, but rather an amount which includes an agreed share of the earnings, in case of good performance of the debtor.
5. *Equity*, whereby a privately-held company offers securities to the general public, through the medium of an online platform. Investors receive a share in the business and may acquire voting rights.

Donations, rewards and pre-selling (i.e. the so-called "non-financial" crowdfunding) represent the most widespread forms of crowdfunding and constitute an important share of the funding raised by private companies through this channel, providing also non-financial benefits to companies and investors. While these forms currently lead the industry, lending and equity based crowdfunding are expected to play an increasing role in the future.

Lending-based crowdfunding, or *peer-to-peer lending* (P2P), has started as a form of loan transactions in which individual consumers borrow from and lend money to one another, by means of unsecured personal loans, without the mediation of a financial institution. This community lending implies direct contact between the parties and, often, exchange of information that, through the internet platform, is visible to other current and potential borrowers, and may help to broaden the creditor base. In fact, P2P lending communities operate on the principle of "full financing," i.e., the loan request gets funded only if it receives enough bids to cover the entire amount requested by the borrower within an established pledging period, which may range from a few weeks to several months (Herzeinstein et al., 2008).

However, over time, crowd-lending has become increasingly mediated by online intermediaries. In the case of lending platforms, typically the lenders purchase notes issued by the sites, which use those funds to lend through Paypal or WebBank to borrowers (Mitra, 2012). Thus, the online platform acts as an intermediary, for instance, collecting loan pledges from the crowd for private projects, releasing them at the moment a target is reached, according to a threshold principle, collecting repayment instalments from the debtor, and forwarding them to each crowd-lender.[1] In some business models, the pledged amounts are transferred to an escrow account,[2] which is managed by the platform or a partner bank. Once the threshold pledge is reached, payments are transferred from the escrow account to the project's account (Hemer, 2011).

Peer-to-peer loans are usually unsecured loans, i.e. no collateral is required on borrowers, although, in some cases companies may offer secured loans. Nevertheless, transaction fees and interest on loans are charged by the online intermediary, which depend on the borrowers' credit risk, as assessed by accessing credit information from third parties or on the basis of information submitted by the borrowers themselves. The online platforms typically develop credit models for loan approvals and pricing, and perform credit checks of borrowers. Indeed, P2P platforms make profits from commissions instead of the spread between deposit and loan. The longer repayment period that a loan lasts, the higher fees the borrower has to pay (Lin, 2009; Chen and Han, 2012).

In the case of *equity or investment crowdfunding*, a firm offers a certain proportion of its equity for a set amount of capital it is aiming to raise. Crowdfunded businesses do not have to adhere to the strict accounting standards required of public companies and, at the same time, unlike other risk capital providers, crowdfunding investors may have no experience in making such investments. As Collins and Pierrakis (2012) underline, as the model taps into the sub-section of the public with an interest in entrepreneurship, in many cases investment will also be motivated by non-financial aims, such as becoming part of an entrepreneurial venture or supporting a particular individual or business.

The business model of equity platforms typically implies that entrepreneurs or project initiators define with the partner platform a funding threshold and a time period for reaching the target, which is divided into equal shares. These are offered as equity shares through the platform and, in a similar way as the threshold model for crowd-lending, once the threshold is reached the investment takes place (Helmer, 2011).

A key step in this process is the valuation of the business, in order to establish the amount of equity to be offered in exchange for the target capital to be raised. In most cases, it is the entrepreneur him/herself that performs this valuation, although the platform may allow for some upward flexibility in the amount of equity that is offered, as the fundraising progresses and if the observed investment rate does not allow reaching the threshold within the agreed timeline. Some platforms operate a market-driven approach to setting valuation, whereby the entrepreneurs set out the amount of equity and number of shares they are offering, and, through a bidding process, investors who are willing to pay the most for the shares get in on the deal. Some platforms also provide to entrepreneurs training on how to value a business, engaging ex-investment bankers, fund managers and venture capitalists (Collins and Pierrakis, 2012).

An emergent business form of equity crowdfunding platform is the "holding model", as defined by Hemer (2011), whereby the platform creates a subsidiary company, which operates as an individual holding for each of the crowdfunded ventures. In this case, it is the holding company that owns the company shares and sells them to the crowd, acting as a single investor in the firm, alongside other potential investors from the conventional capital market.[3]

As experience and professionalism increase, crowdfunding platforms are evolving into more sophisticated intermediaries, which may offer other services beyond the facilitation of funding, such as due diligence, consulting, search for co-investors or management of a co-investment fund (Hemer, 2011).

Profile of firms

Since the late 1990s, the diffusion of crowdfunding practices has been especially related to non-profit organisations and the entertainment industry, where non-monetary benefits or an enhanced community experience represent important motivations for donors and investors. To date, projects with a creative or social focus, where non-financial rewards are offered in return for donations, have been the most successful at raising finance from the crowd (Collins and Pierrakis, 2012).

Nevertheless, over time, crowdfunding has become an alternative source of funding across many other sectors and it is increasingly used to support a wide range of for-profit activities and businesses. New product-development is an activity for which crowdfunding can provide specific advantages, as the financial dimension is importantly complemented by direct contact and feedback from current and potential customers.

In this regard, Belleflamme et al., (2011) highlight the importance of community-based experience for crowdfunding to be a viable alternative to traditional funding. In relation to reward or pre-purchase funding, however, they also show that crowdfunding is the most profitable option only for lower levels of finance, when the entrepreneur can use the mechanism to apply price discrimination, where consumers with the highest expected valuation are willing to pre-order, i.e. to crowdfund, at a higher price than other customers. When the amount required becomes larger, the entrepreneur is forced to distort more the prices to attract a larger base of crowdfunders, which reduces the gains from price discrimination.

The crowd-lending, or P2P lending, option can be attractive for small businesses that lack collateral or credit history to access traditional bank lending, as the loans offered are typically unsecured. P2P lending, however, is not only attractive to highly risky or "unbankable" borrowers. Indeed, the main platforms for crowd-lending have been increasingly targeting high quality credit risk, often providing loans to refinance credit-card debt, and incentivising lenders to conduct thorough credit checks of applicants before accepting them, which has limited default rates. On their side, borrowers can receive lower rates than those offered by banks, since overhead costs and regulatory burdens are lower, as well as benefit from the interaction with customers that these platforms typically provide.

Equity crowdfunding can provide for a complement or substitute of seed financing for entrepreneurial ventures and start-ups that have difficulties in raising capital from traditional sources, like bank loans, venture capital, business angels and also public programmes, because they are too innovative to be understood, too complex, too risky or simply because the business plans are poorly presented (Helmer, 2011).

Crowdfunding has the potential to deliver equity finance to ventures that have greater levels of risk attached relative to the potential financial gains they can deliver. The non-monetary motivations of crowdfunding investors, such as being part of an entrepreneurial venture or receiving non-tangible rewards, can explain, at least in part, why they may be willing to accept more risk or less return than traditional risk capital investors. At the same time, the small amounts committed to many ventures may allow them to effectively spread their risk, in a cost effective way (Collins and Pierrakis, 2012).

By design and because of regulatory limitations, crowdfunding is suited to start-ups and businesses that request relatively small amounts of funding. However, this depends on the extent to which larger investors participate in the process, as there have been some cases where the potential of the model to raise larger amounts has also been shown (Collins and Pierrakis, 2012). Indeed, large companies have been increasingly investing through crowdfunding platforms, which can offer access to promising start-up ventures. In some cases, crowdfunding challenges have been set up by large firms, offering the most competitive start-ups to match the funds they raised from smaller investors.[4]

According to Collins and Pierrakis (2012), some business models and sectors may be more suited to crowdfunding than others. In particular, consumer–facing businesses may find the instrument more suitable to their needs, as traction with the potential customer base, as shown by the ability to raise fund through the platform, is an integral part of proving to investors the viability of their proposition. Signalling is one of the most important functions of crowdfunding, and a large number of supporters suggests that there exists already a core market for the firm's product or service, which can be easily mobilised to broaden the market through personal contacts and social networks (Hemer, 2011).

Also, crowdfunding can benefit new ventures built on some R&D output, as the interaction with customers may allow the entrepreneur to validate the untested product or service (OECD, 2015).

On the other hand, the crowdfunding channel may be less suited for business models that are based on complex intangibles or innovations in very high-tech and cutting edge areas, which require specific knowledge on the side of investors (Collins and Pierrakis, 2012). In this regard, however, Hemer (2011) notes that the crowdfunding mechanism may attract a certain group of investors that seek ventures with some degree of innovation in specific fields, such as IT experts, engineers, scientists or people with visions of future applications. Besides funding, they may also bring in knowledge, experiences and networks to shape business strategies and craft products (OECD, 2015).

Furthermore, crowdfunding may not be appropriate to fund firms for which business information and financial details are too sensitive to be shared with a large number of potential investors, as it is either impossible or legally very difficult to arrange non-disclosure agreements with all of them. In addition, crowdfunding may not be suited for businesses that are particularly capital-intensive in early stages or those that require the types of post-investment support that can only be provided by institutional investors (Collins and Pierrakis, 2012; Hemer, 2011).

Enabling factors

Crowdfunding activities require a reliable internet connection, access to the banking sector (in the form of bank accounts for entrepreneurs and investors) and/or online payment systems for the funds to be transferred. In this regard, an efficient banking system can ease the development of crowdfunding platforms, by providing the infrastructure for payments, as well as information about the creditworthiness of the entrepreneurs. In the case of crowdlending, for instance, the platforms may use credit history to decide on whether to accept a project for financing through their site and on the interest rate to charge (OECD, 2015).

The development of the Web 2.0 has been critical to the diffusion and evolution of crowdfunding platforms and practices. Through the Web 2.0, access and use by many different individuals is made easier, knowledge and resources from several sources can be combined, and openness allows users to contribute freely to different projects. This can especially broaden the capabilities of small businesses, allowing user content to inflow and create value for the firm (Lee et al., 2008). With the evolution of the technology, as more applications are possible, crowdfunding platforms have been experimenting with new business models and financing forms.

The diffusion of crowdfunding has also been favoured by an emerging internet-based community culture, whereby individuals are motivated to share ideas and contribute to some collective endeavour, as in the case of "open source". However, as Belleflamme et al. (2011) note, crowdfunding differs significantly from the open source model, when the resources belong to the community, which can exploit them on an individual basis. In the case of crowdfunding, the key resource, capital, ultimately belongs to the firm, which will be the only one able to use it.

While the pace of technological developments has enabled a rapid diffusion of crowdfunding, the regulatory environment has limited its diffusion, especially for securities-based crowdfunding, which is still not legal in some countries. The nature of

crowdfunding does not make it possible to regulate the offer as "private placements to accredited investors". Rather, it is considered as public offering of securities, which is highly regulated in most countries and often requires the publication of a sales prospectus that must be accepted by a supervisory authority. The procedures involved are typically complicated, time-consuming and costly, and can be prohibitive for the entrepreneurs or small businesses approaching crowdfunding (Hemer, 2011; Mitra, 2012). To overcome such difficulties, some platforms set up "investment clubs", which potential funders can join. In this case, the regulatory provisions are less strict, since the members of the club are regarded as qualified investors who need less protection than the "general public" (Hemer, 2011).

Another regulatory obstacle to crowdfunding is the legal limit to the number of private investors a company can have. By its nature, crowdfunding aims to collect contributions from a large base of investors. Also for this reason, most crowdfunding initiatives do not offer shares, but other types of rewards, such as a product or membership (Belleflamme et al., 2011).

To date, the nature of the business has led to great caution by regulators. At the same time, the lack of a clear regulatory framework *vis-à-vis* a new form of debt or equity issuance has contributed to caution by the investment community, in the light of concerns about how much protection they have against fraud, the public disclosure of sensitive information, and the management of a large number of shareholders (Collins and Pierrakis, 2012). Especially, crowdfunding practices raise questions with respect to corporate governance and investor protection, as crowdfunders are most likely to be offered very little protection. Relatively to traditional bank finance, the industry is more vulnerable to the risks of cyber-attacks, identity and payment data theft, as well as money laundering (OECD, 2014). Also, as the individual investment is generally small and the investors typically lack experience, there is a lack of incentive or capacity to intervene in case of mismanagement or abuse (Belleflamme et al., 2011).

It is however to be noted that the regulatory environment is changing rapidly. In recent years, important regulatory changes have been proposed or implemented in some OECD economies, to enable greater access and use of crowdfunding by entrepreneurs and investors. The exemptions to general rules to secure investors or the implementation of ad hoc regulation are expected to facilitate the growth of the industry (see policy section).

Securing an exit for crowdinvestors is also important for the spread of equity crowdfunding. The evidence about successful exits is still limited, but some recent cases suggest that, even when the crowdfunded business is sold to a large investor, it is likely that the shares of previous investors will be diluted, following other crowdfunding campaigns or separate deals with angel investors.[5]

Trends in crowdfunding activity

The crowdsourcing industry has grown rapidly since the mid of the 2000s, and at an increasing rate over the last few years, although it still represents a very minor share of business financing. According to Massolution, a research firm that produces an annual report on the crowdfunding industry,[6] globally, there were 536 active platform in 2012, a 23.5% increase with respect to the number estimated in 2011 (434), and nearly double the number of platforms observed in 2010 (283). The rate of increase of the volume of funds raised has been even more pronounced, from USD 1.5 billion in 2011 to an estimated USD 5.1 billion in 2013.

Crowdfunding is mainly centred in North America and Europe, which, in 2012, accounted respectively for 59% and 35% of the capital raised worldwide. In 2012-13, North American crowdfunding volumes grew by 105% up to USD 1.6 billion, whereas in Europe crowdfunding volumes grew by 65%, reaching USD 945 million. In the rest of the world, growth was even more pronounced with a 125% average annual growth rate.

However, an important difference exists between the US and Europe with regard to the type of crowdfunding raised, which can be explained to a large degree by the different regulatory frameworks in place. While in the US equity crowdfunding has been hindered by regulatory limitations, so that, in most cases, it takes the form of donation- or reward-based crowdfunding, in several European countries, equity-based platforms have been in operation for some years. However, the size of equity crowdfunding in Europe was estimated to be in the range of EUR 50-100 million in 2013, still a very minor share of the market, if compared, for instance, with the EUR 26 billion value of the IPO market (OECD, 2015).

Worldwide, donations and reward-based crowdfunding are the most widespread, accounting for USD 1.4 billion in 2013 and recording an 85% increase in volumes over a year. The second largest category is lending-based crowdfunding, which however exhibits a higher rate of expansion. Equity-based crowdfunding still represents a minor share of the market, growing at a relatively moderate pace (Table 5.1).

Table 5.1. **Crowdfunding categories: Amounts and growth rates, 2013**

Crowdfunding category	Amount (USD million)	Annual growth %
Donation and reward based crowdfunding	1 400	85
Lending based crowdfunding	1 200	111
Equity based crowdfunding	116	30

Source: Massolution (2013).

In 2012, the most active crowdfunding category was that related to social causes, which represented 30% of the campaigns monitored by Massolution. At the same time, business and entrepreneurship ventures have increased their relevance in the industry (16.9%), accounting in 2012 for a share slightly smaller than the one of the entertainment sector (19.4%), in which the crowdfunding phenomenon had first boomed (Table 5.2).

Table 5.2. **Crowdfunding campaigns, by type of venture, 2012**

Category	%
Social causes	30.0
Business and entrepreneurship	16.9
Films and performing arts	11.9
Music and recording arts	7.5
Energy and environment	5.9
Others	28.0

Source: Massolution (2013).

Policies to ease the development of crowdfunding

In recent years, crowdfunding has been the object of important regulatory attention in some OECD countries. The regulatory efforts have aimed to ease the development of this financing channel, while addressing concerns about transparency and protection of investors.

In the United States, where regulatory limitations had hindered the development of investment crowdfunding, the 2012 Jump-start Our Business Startups (JOBS) Act provides explicit legal support to investment crowdfunding, defining the rules that apply to different types of investors and companies that campaign for funds (Box 5.1).

Box 5.1. **Crowdfunding and the JOBS Act in the United States**

In the United States, the Securities Act of 1933 states that entities cannot offer or sell securities to the public unless a) the offering is registered with the SEC, or b) there is an available exemption from registration. The 2012 JOBS Act introduces exemptions that provide explicit support to debt and equity crowdfunding.

In particular, under the JOBS Act:

i) Companies can raise up to USD 1 million from investors and up to USD 2 million if they provide audited financial statements;

ii) Financial statements disclosure is not required for companies whose number of shareholders is below 1 000;

iii) Investors with an annual income of less than USD 100 000 may invest up to the greater of USD 2 000 or 5% of their annual income in crowdfunded companies. For income above USD 100 000 per year, investment is permitted up to 10% of total salary, but should not exceed USD 100 000.

Source: www.whitehouse.gov/economy/jobsact; Mitra (2012).

However, for the reform to be effective, the Securities Exchange Commission (SEC) must issue its regulations. The first of these, in July 2013, lifted the ban on public solicitation and created a new type of offering, called 506(c), which allows companies to advertise that they are fundraising to the general public, as long as they take reasonable steps to verify that the investors are accredited investors, such as members of the Crowdfunder's verified Accredited Investor Network.[7] In October 2013, the SEC published a set of proposed requirements for the platforms, the borrowers and the investors. In particular, platforms would be required to fully disclose their finances, loan origination and practices. Entrepreneurs conducting a crowdfunding campaign would also need to file certain information with the SEC, provide it to investors and the relevant intermediary facilitating the crowdfunding offering (OECD, 2015).

In Europe, in October 2013, the European Commission has launched a public consultation to explore the potential benefits, risks, and the design of an optimal policy framework to untap the potential of crowdfunding.[8] In 2014, it set up the European Crowdfunding Stakeholders Forum (ECSF), an expert group that will assist the Commission in raising awareness, promoting transparency, developing training modules and exchanging best practices (OECD, 2015).

However, in some member states, regulators have already taken significant steps to provide a clearer framework for the industry. In particular, Italy was the first country in Europe to adopt an ad hoc regulation on equity crowdfunding, which came into effect in July 2013 and allows "innovative start-ups" to raise equity through crowdfunding platforms (Box 5.2).

Equity crowdfunding is permitted in other countries, such as the United Kingdom, where, like in the US, regulation is framed in terms of exemption to the general rule that

Box 5.2. **Crowdfunding regulation in Italy**

In December 2012, the Italian Parliament approved the Growth Act 2.0 ("Decreto Crescita 2.0"), which includes a crowdfunding law that allows for equity investments through a crowd funding platform. In July 2013, the authority responsible for regulating the Italian securities market (Commissione Nazionale per le Società e la Borsa – CONSOB), signed the rules and provisions to allow for the law implementation.

According to these rules, "Innovative startups" are the only companies that are allowed to raise capital through equity crowdfunding platforms. An "Innovative startup" is a newly defined legal entity in the Italian system. This is any joint-stock company or cooperative society incorporated under Italian law or any Societas Europaea residing in Italy:

1. which has been established and operating for no more than four years;
2. which has its headquarters in Italy;
3. with a total annual output no greater than EUR 5 million according to its most recent balance sheet, starting from the second year of life of such company;
4. which does not distribute, nor has distributed so far, net incomes;
5. exclusively aimed at developing, producing and marketing innovative products or services;
6. which was not established as a result of a company's merger, split up, sale of business or transfer; and
7. which meets at least one of the following requirements:
   i) the R&D expenses are equal to or higher than 15% of the highest between the company's total annual costs and the correspondent outputs;
   ii) one-third of the total number of its employees or consultants either holds a PhD or is attending a PhD program or holds a master's degree which includes a three-year research program certified at a public or private institute in Italy or abroad, or two-third of the total number of its employees or consultants holds a long-cycle degree; and
   iii) it owns, or has been granted, a license for a design/invention patent, or owns rights related to a primary computer program enrolled at the public register for computer programs.

For the crowdfunding campaign, it is required that the innovative startup refers to a professional investor, a bank foundation, a financial corporation or an incubator that subscribes at least 5% of the capital offered. The maximum amount that the company can raise is set at EUR 5 million. Furthermore, the innovative startups are required to insert a clause in their statute which guarantees to the investors the right to withdraw from the investment and to sell their shares, in case the major shareholder sells its stake to a third party.

The crowdfunding investment is not limited to any specific category of investor. The only requirement for investors is to take a test to demonstrate that they are aware of the risks they are taking when investing, and that they can afford the possible loss of the amount invested. At the same time, Investors can withdraw their commitment at any moment until when the crowdfunding campaign is closed.

Two categories of entities are allowed to start an equity crowdfunding platform: i) banks and other financial institutions and; ii) individuals that meet certain requirements of professionalism (e.g. experience in the field) and trustworthiness (e.g. absence of prosecutions). The platforms are then requested to guarantee transparency and investors protection. For instance, they are responsible to verify that the startups have all the necessary requirements to register on the portal and that the amount invested by the crowdfunders is congruent with their income.

Source: CONSOB (2013); *www.crowdvalley.com*.

forbids offering securities to the general public. The exemption concerns companies that i) produce a prospectus which is approved by an authorised person; or that ii) offer the shares only to "exempt persons", such as high-net-worth individuals/sophisticated investors or

investment professionals (e.g. business angels, venture capitalists). There is a further exemption to the rule requiring an official prospectus for the companies that raise less than EUR 5 million, although the promotion needs to be approved by a person authorised by the Financial Services Authority (FSA) (Collins and Pierrakis, 2012).

In other countries, regulatory reforms recently came into effect. In France, in 2013 some first steps were taken by the Government and relevant authorities to develop a more favourable regulatory framework for crowdfunding, while ensuring the security of investors. In September 2013, the French government announced the first version of a new legal framework for crowdfunding, and launched a six-week consultation process. This proposed framework was preceded by the creation of a specific status for crowdfunding platforms, the "crowdfunding investment service provider" (*conseiller en investissements participatifs*). Also, in May 2013, guidelines on crowdfunding were issued, by the French *Autorité des Marchés Financiers* **(**AMF) and *Autorité de Contrôle Prudentiel et de Résolution* (ACPR), which require crowdfunding platforms to be authorised as either a payment service provider, an investment service provider or a credit institution. As of 1 October 2014, the new regulatory framework on crowdfunding came into effect. For P2P lending, this establishes an upper limit of EUR 1 million for the funds that can be raised for a single project. If an interest is charged, retail investors can lend up to EUR 1 000, per borrower and per project, and the loan term cannot exceed 7 years. In the absence of interest, the loan limit is extended to EUR 4 000. The new rules also establish some minimum requirements for the contracts and obligations for the platforms to disclose information on their status and on the criteria for selecting projects and entrepreneurs, intended to increase transparency in the market. The law also requests platforms to provide investors with instruments that may assist them in evaluating their financing capacity.[9]

Public action may also take the form of support to industry networks or aim at improving information about crowdfunding opportunities. For instance, Bpifrance has taken an active role in supporting crowdfunding, by launching in 2013 a crowdfunding portal (*http://tousnosprojets.bpifrance.fr*). This works as a search engine for crowdfunding platforms, which are selected by Bpifrance and engage in respecting regulation and promoting good practices. The site intends to strengthen industry networks and make investment easier for the large public, which can select projects through a simple interface. Bpifrance simply manages the platform and does not intervene in the design/selection of projects or in the fundraising process.

Notes

1. This model is for instance applied by the German platform *smava* (*www.smava.de*).
2. An escrow account is a temporary account that is held by a third party during the process of a transaction between two parties, until the transaction is completed, that is, until all the conditions between the buyer and the seller are settled.
3. Examples of holding model platforms are the British platform Bandstocks (*www.bandstocks.com*) and the French platform WiSeed (*www.wised.com*) (Hemer, 2011).
4. See "Big companies show they are in with the crowdfunding", *Financial Times*, October 9 2013, *www.ft.com/intl/cms/s/0/1234e5f6-30e5-11e3-b478-00144feab7de.html#axzz2hY7mOjON*.
5. See for instance *www.growthbusiness.co.uk/comment-and-analysis/2459512/the-great-crowdfunding-exit-debate.thtml*.
6. See *www.massolution.com/*.
7. See *www.sec.gov/news/press/2013/2013-124-item1.htm*.

8. See *http://ec.europa.eu/internal_market/finances/crowdfunding/*.
9. See *www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000029463569&categorieLien=id*.

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Chapter 6

Hybrid finance instruments for SMEs

This chapter describes the functioning and development of hybrid finance instruments, which combine features of both debt and equity into a single financing vehicle. Hybrid instruments include: subordinated debt (loans or bonds); participating loans; silent participation; convertible debt and warrants, and; mezzanine finance, which combines two or more of these instruments within a facility. The chapter discusses the profile of firms that are suited for hybrid financial tools and the pre-conditions for the investment. It highlights the key enabling factors for the development of a commercial market for hybrid instruments, which typically concerns larger SMEs in need of substantial capital injection, and comments on mechanisms to facilitate the downsizing of this type of finance and access by lower-tier SMEs. It illustrates recent market trends and typologies of policy intervention to sustain the development of mezzanine finance and ease access to hybrid instruments by lower-tier SMEs.

This chapter draws largely on OECD (2013), *Alternative Financing Instruments for SMEs and Entrepreneurs: The Case of Mezzanine Finance*, OECD, Paris.

Hybrid financing instruments lie in the middle of the investors' risk/return spectrum, from "pure" debt to "pure" equity, combining features of both debt and equity into a single financing vehicle. These instruments differ from straight debt finance, in so far as they imply greater sharing of risk and reward between the user of capital and the investor. The latter accepts more risk than a provider of a senior loan and expects a higher return, which implies a higher financing cost for the firm. However, the risk and the expected return are lower than in the case of equity, which thus implies the cost of financing for the enterprise is lower. In the event of insolvency, where the firm is unable to meet all its contractual obligations, investors in hybrid instruments have lower rankings than other creditors, but higher ranking than investors in "pure" equity capital.

Some of the most commonly used hybrid instruments include: i) subordinated debt (loans or bonds); ii) participating loans, with profit or earning participation mechanisms; iii) silent participation; iv) convertible debt and warrants, whereby investors can convert debt into stock, thus receiving a reward that reflects the increased value of the company enabled by the capital provision, and; v) mezzanine finance, which combines two or more of these instruments within a facility.

Forms of hybrid instruments

Subordinated debt

Subordinated debt is composed of loans or bonds in which the lender agrees that senior or secured creditors will be fully paid before any interest or principal is paid.

Subordinated loans (or junior debt) are unsecured loans where the lender's claim for repayment in the event of bankruptcy ranks behind that of providers of senior debt but ahead of equity investors. Subordinated loans usually carry a specific rate of interest, which is independent of the state of the firm's finance. The provider of financing is entitled to this payment under all conditions, subject only to the condition that senior debt holders must be paid in full before any payment is made to subordinated debt holders. Principal is usually repaid in "bullet" form, i.e. at the end of the loan. In some instances, the facility may provide for payment in kind (PIK) in which both interest and principal are paid at the loan's maturity. In this case, it carries a higher interest rate than one where interest is paid throughout the course of the loan.

Subordinated bonds are unsecured bonds that offer the investor periodical interest payments (coupons) and full redemption at maturity. In the event of liquidation or bankruptcy, the claims of subordinated bond holders are inferior to those of senior creditors, but are superior to those of shareholders, because their bond coupons have to be honoured before any share dividends can be distributed by the firm. The interest rate tends to be significantly higher than that of non-subordinated bonds, to compensate for the higher risk.

Participating loans

Participating loans are loans whose remuneration is contingent upon the results of the debtor firm rather than being fixed. The remuneration can be linked to the firm's sales or turnover, profits or share price. On the other hand, participating loans do not share losses. In the event of bankruptcy, providers of participating loans share in the results of the liquidation in the same way as other loan creditors.

Sales or turnover participation rights provide the investor receives with a payment based upon the performance of the firm, in terms of revenue, turnover, or earnings. Both the interest rate and the capital repayment can be linked to this performance and the payment can take the form of PIK, i.e. received at the maturity of the loan.

Profit participation rights are equity investments that entitle the holder to rights over the company's assets (e.g. participation in profits or in the surplus on liquidation, subscription for new stock). The owner of the profit participation right is not a shareholder of the company and is not entitled to ownership rights, including voting rights and the right to attend the company's shareholders' meeting. However, profit participation rights are not defined by law and can therefore to a large extent be negotiated and designed to suit the parties. They can be designed to resemble borrowed capital by contractually agreeing on minimum interest payments which are independent of the company's profits or resemble equity capital if they grant the right to participate in the company's profits and/or liquidation proceeds.

"Silent" participation

"Silent" participation is closer in legal form to an equity investment than subordinated or participating loans. In this form of financing one or more persons take an equity stake in a company, but without assuming any liability to the company's creditors. In other terms, the silent partner is a "limited partner", since his/her liability is usually limited to the amount invested in the company. The typical "silent" participation affects only the company's internal affairs and is not apparent to outside observers. The silent partner has the right to monitor the company's business and can also be granted rights to be informed and to participate in the company's decision making. However, the details of participation in profits or losses, involvement in the company's management, supervision and information rights can be structured flexibly. As a case in point, usually the silent investor participates in losses up to their invested capital amount, but the parties may remove this feature partially or completely from the contract.

Convertible debt and warrants

Convertible debt is a debt instrument with a maturity date and stated repayment terms, which includes an option to convert the debt into another financial instrument, such as other forms of debt, derivatives or stocks. The conversion option is not separable from debt; hence the value of a convertible bond is equal to the value of the bond component plus the value of the option component. Also, repayment of debt and exercise of the conversion option are mutually exclusive, that is, exercise of the option extinguishes the debt, and repayment of the debt cancels the conversion option.[1] Corporations usually have call options on the convertible bonds they issue. This allows them to call the bonds in order to force their conversion.

Detachable warrants, which give the holder the right to purchase a specific number of shares at a predetermined price, differ from convertible debt in that they can be traded

separately from the securities to which they are related. Also, warrants are typically of shorter duration than convertible bonds. Their value is the difference between the price at which a share of the company can be purchased by exercising the warrant (the strike price) and the market price. The value of this instrument can be determined by market process where the company is publicly traded or is sold to an outside investor through a merger or acquisition (M&A). In cases where no such basis for pricing the equity interest is available, the value of the equity warrant is determined using a valuation technique specified in the contract. In the case of both convertible bonds and warrants, the holder is not entitled to receive any cash dividend distributed by the firm before exercise of the option. However, the exercise prices are automatically adjusted for any stock split or stock dividends.

Mezzanine finance

Although there is no commonly agreed definition of the term, mezzanine finance is generally intended as a technique that combines two or more of the above investment instruments (tranches) within a facility that is sold as a single entity to investors. The exact mix of instruments in a specific facility can be tailored to suit the needs of the firm and the investors. To the extent that the facility has a large share of fixed rate current pay assets, it will tend to have a low but steady yield. Yield can be enhanced by increasing the proportion of higher risk assets in the facility or by delaying payments until later stages of the operation. The more risk assumed by the investor, the more the investor attempts to captures the "upside" of the investment.

A simple mezzanine facility contains: i) one or more categories of subordinated debt; ii) a tranche in which the investor receives a "success fee", i.e. a share of the firm's earnings or profits and/or; iii) an equity-related tranche ("equity kicker") in which an investor receives a payment whose value is contingent upon a rise in the value of the company, usually reflected in the company's share price.

A commercial mezzanine investment usually takes the legal form of a private investment partnership, a vehicle that is restricted to a limited number of sophisticated investors (Limited Partners – LPs) each of whom must commit a substantial sum. The investment is organised by General Partners (GPs), professionals in management of mezzanine investments who contribute their skills in identifying good companies, guiding them through the mezzanine cycle, monitoring their performance, often participating in their boards, and liquidating the fund at the end of its mandate. The GPs receive fees for all assets under management (usually about 2%), as well as a share of the profits of the investment.

Due to the need to monitor companies actively, mezzanine funds usually only hold a limited number of companies in their portfolios, with 20-30 companies on average. Furthermore, mezzanine finance usually has covenants restricting the activities of the companies, although they tend to be less rigorous than those of commercial banks.

The mezzanine fund has a pre-determined life (usually 7-10 years) and investors are expected to remain invested throughout this period. Normally, in its early years, the fund will have large shares of assets in cash as investible projects are sought. During the middle years of the fund life, assets are usually fully invested. Toward the end of the fund's life, earnings will flow into the fund and investors will receive cash. At the end of its life, the fund is wound up and all investors receive a share of the earnings of the fund.

Mezzanine investments are most often buy-and-hold products. Unlike high-yield bonds, which are often listed on exchanges in Europe or made eligible for electronic trading between

qualified institutional buyers (QIBs) in the US market, mezzanine debt securities are rarely traded. As a result, many mezzanine investments have limited liquidity (Robinson et al., 2013).

Typically, mezzanine investors expect to realise value by exiting in the later stages of the investment. Most commercial mezzanine investments are taken out either through a change-of-control sale or recapitalisation of the company. For this reason, mezzanine providers may look to invest in companies that represent strong IPO candidates. In some cases, the company may be sold to strategic investors. More frequently, the mezzanine capital provider is bought out by the initial owner through a recapitalisation with inexpensive senior debt, through the accumulated profits generated by the business or through an acquisition of the company by a competitor.

Mezzanine investors generally do not wish to acquire more than 3-5% of the equity of any company in their portfolio and do not seek to participate in its management (Crédit Suisse, 2006). However, in return for the lower ranking and unsecured nature of mezzanine capital, investors require detailed and prompt information on the economic progress of the business, and usually define specific financial indicators, or covenants, which the company must observe. For the investee companies – especially SMEs – this gives rise to increased requirements as regards accounting, oversight, and information policies. It also requires intensive monitoring on the part of mezzanine investors.

Profile of firms

Hybrid instruments represent an appealing form of finance for privately held companies that are approaching a turning point in their life cycle, when the risks and opportunities of the business are increasing, but they have insufficient equity backing, and, for this same reason, face difficulties in accessing debt capital (Crédit Suisse, 2006). Thus, hybrid instruments may serve companies that are in need of capital injection, but that cannot increase their leverage, are not suitable for public listing and/or in case the owners do not want the dilution of control that would accompany equity finance. This can be the case of:

a) Young high-growth companies, which may have used venture capital in earlier phases of growth but seek for cheaper expansion capital and less dilution of control for the founding entrepreneurs.

b) Established companies with emerging growth opportunities in cases where the funding requirement exceeds what can be obtained using traditional debt financing and/or their profile, in terms of sector, region or projected rate of return, does not appeal to venture capitalists.

c) Companies undergoing transitions and restructuring, as in the case of spinoffs or transformation from a closely held family run business into a transparent company with professional management.

d) Companies seeking to strengthen their capital structures, as in the case of SMEs that are excessively leveraged, particularly closely owned and/or family companies. In these instances, mezzanine capital can be a bridge to equity finance, either because: i) the company increases equity through retained earnings or ii) the company is recapitalised at the end of the period for which mezzanine is utilised, either through a sale to strategic investors or through an initial public offering (IPO).

An important precondition for raising mezzanine capital – intended as a single hybrid instrument or a combination of two or more hybrid tranches – is that the earning power and market position of the business should be well established and stable. A company must

demonstrate an established track record in its industry, show a profit or at the very least post no loss, and have a strong business plan for the future. For this reason, mezzanine capital is a suitable form of finance for SMEs with a strong cash position and a moderate growth profile.

The presence of a mezzanine finance facility may favour increased access to debt financing by the firm and lower the financing costs with respect to equity. In fact, most debt incurred through mezzanine facilities will be classified as "subordinated debt", thus it will be considered equivalent to an increase in equity by banks and other traditional borrowers. The more favourable ratio of equity to debt can lead to an improvement in the firm's credit rating, implying more favourable loan conditions and greater scope for raising additional debt capital. At the same time, mezzanine investors generally target a 15-25 % IRR (internal rate of return) compared to more than 25% for equity investors (Crédit Suisse, 2006; EC, 2007; Silbernagel and Vaitkunas, 2010) (Table 6.1).

Table 6.1. **Comparison of mezzanine finance and other financing techniques**

	Senior debt	Mezzanine	Equity
Economic perspective	Debt	Equity	Equity
Legal perspective	Debt	Debt	Equity
Ranking	Senior	Contractually subordinated	Junior
Taxation	Debt interest deductible	Debt interest deductible	Tax on capital
Covenants	Comprehensive restrictions	Tracks senior, but looser	None
Security	Yes – 1st ranking	Yes – 2nd ranking	No
Investor's involvement in management	No direct involvement	Moderate involvement; board seats	Direct involvement
Purpose	Contractually specified	Not specified	Not specified
Term	4-5 years	5-10 years	Open ended
Interest costs	Cost of funds + 255-350 basis points	150-300 basis points above senior	None
Repayment	Amortising from cash flow	Bullet* upon exit or at maturity	None
Warrants	None	Almost always	None
Total expected return	5-13%	13-25%	> 25%

* The payment for the principal is not made over the life of the loan, but rather as a lump-sum payment at exit or maturity.

Source: Adapted from Crédit Suisse (2006).

Mezzanine finance is often used in conjunction with leveraged buy-outs (LBOs). In fact in most countries, the bulk of mezzanine transactions occur in the buy-out market. However, these operations mostly involve larger companies. With regard to SMEs, it is a form of finance that mainly supports growth plans of medium-sized companies, whereas it does not generally apply to the smaller segment of the SME sector. The traditional market for mezzanine finance has been upper-tier SMEs, with high rating (BBB+ or above) and demand for funds above EUR 2 million. Nevertheless, in recent years, some financial institutions, particularly public financial institutions, have started to extend mezzanine finance to SMEs below the upper tier and with smaller funding needs (EC, 2007).

Enabling factors

Mezzanine finance takes place in private capital markets, whose development is thus essential for the diffusion of hybrid instruments. Private capital markets are characterised by fewer formal disclosure requirements and a smaller degree of official regulation and formalised investor protection than the public markets, which are open to the general investing public (institutional and retail investors). In most cases, private markets are restricted to professional, institutional or sophisticated investors.

The traditional market for commercial mezzanine finance has been upper-tier SMEs, with high credit ratings and demand for funds above EUR 2 million. Securitisation and standardisation of mezzanine instruments are used to facilitate the downsizing of mezzanine finance and access by lower-tier SMEs. Securitisation can contribute to a greater availability of hybrid instruments as banks are able to sell their risk exposures to the financial markets thereby regaining liquidity and the potential to lend more to the SME sector overall (EC, 2007).

Standardisation of mezzanine instruments can reduce the costs of provision and increase transparency and accessibility by SMEs, which may lack knowledge and understanding about hybrid techniques. In fact, the use of mezzanine finance instruments requires a certain level of financial skills on the side of entrepreneurs and SME managers, who often lack awareness and capabilities to understand and access a wider range of financial options than traditional debt. Public programs that aim at increasing access to mezzanine capital by lower-tier SMEs often combine the financing with advice and mentoring.

Trends in mezzanine finance

In OECD countries, a well-developed commercial market in mezzanine finance has functioned for more than two decades with minimal public involvement. In the 1980s the market was dominated by insurance companies and savings and loan associations. Nowadays investors also include high net worth individuals, family offices, pension funds, hedge funds, and banks with specialised mezzanine subsidiaries (Silbernagel and Vaitkunas, 2010).

Despite the growing importance of mezzanine finance for financial institutions and SMEs, the evidence about the volume of the overall market for commercial mezzanine finance is still patchy. The main reason is that definitions of mezzanine finance differ across countries. Furthermore, not all mezzanine finance is registered, as in the case of silent participation (EC, 2007).

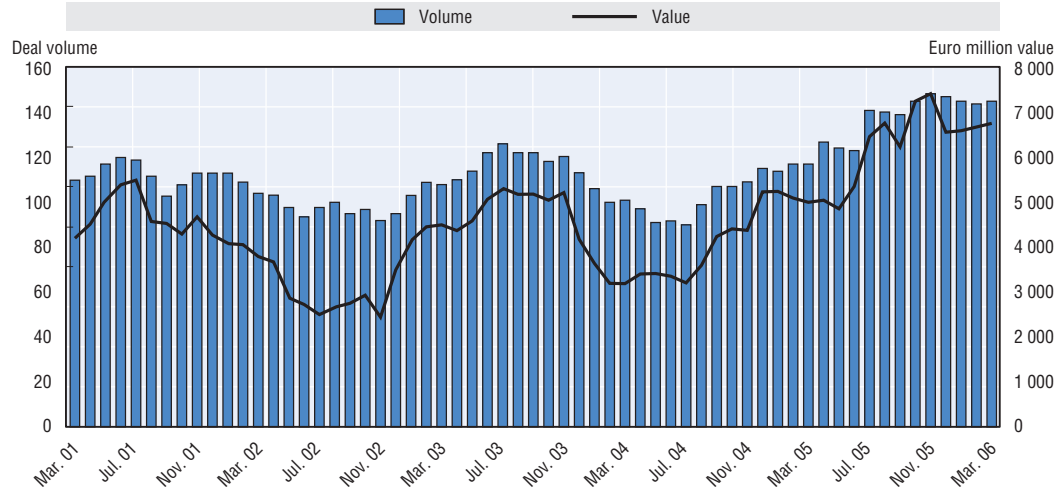
In most countries, the 2008-09 global financial crisis hit this market segment significantly. In Europe, mezzanine investments, which had grown steadily over 2004-06 (Figure 6.1), sharply contracted as the crisis burst. The use of mezzanine finance has followed divergent patterns in the aftermath of the crisis. The market contracted in commercial mezzanine finance, as did the demand for officially backed mezzanine finance in many countries where the technique was well established. In other countries where private lenders were in retreat, recourse to officially supported mezzanine credit appears to have grown as governments stepped in to fill the void. However, throughout the recovery, as banks retreated from lending to non-investment grade companies, debt financing targeting private capital markets has been increasing. CEPRES, an industry research firm, estimates as much as USD 80 billion of new deal flow opportunity worldwide between 2012 and 2015-16.[2]

Even as rates on traditional credits have tended to decline with the fall of interest rates since 2007, the coupon rate on mezzanine notes and expected returns of mezzanine investments have remained relatively steady. This is consistent with long term trends in the market. In fact, unlike assets such as traded equity, high-yield debt, and interest rates which exhibit volatility in the face of changing economic and financial conditions, commercial mezzanine finance tends to have consistent and stable yields. (Silbernagel and Vaitkunas, 2010).

On the qualitative side, it is possible to note relevant differences between the US and European markets. In the US, with a more mature private capital market, mezzanine

Figure 6.1. **Mezzanine deals in Europe: Volume and value, 2001-06**

EUR million



Source: EC (2007).

products come mainly as a variation of publicly traded bonds, as it is the case for convertible debt and warrants. In Europe, where bank lending plays a greater role in corporate financing, a private mezzanine market has been developing that is closer to debt financing, in the form, for instance, of subordinated and participating loans (Nijs, 2014).

In the European market, US-based and British GPs play a major role, particularly among large-cap funds. On the other hand, small and mid-cap segments are led by French funds, followed by German, UK, Finnish and Italian funds (Figure 6.2). The capital to be deployed by funds, or "dry powder" (i.e. marketable securities that are highly liquid and considered cash-like, allowing investors to purchase assets), is however much larger in the large-cap segment (above EUR 500 million), than in the small and mid-cap space. According to Idinvest (2014), in Europe, on average, small and mid-cap funds deploy EUR 0.4 billion per year, while mid to large-cap funds deploy EUR 2 billion. France remains the leading European market for mezzanine debt with a total of 35 transactions in 2013 (the end of October), for a total amount of EUR 1.6 billion, up from EUR 1 billion on 2012 (Figure 6.3). In the case of small and mid-cap companies, mezzanine debt is largely used to finance organic growth and buy-outs.

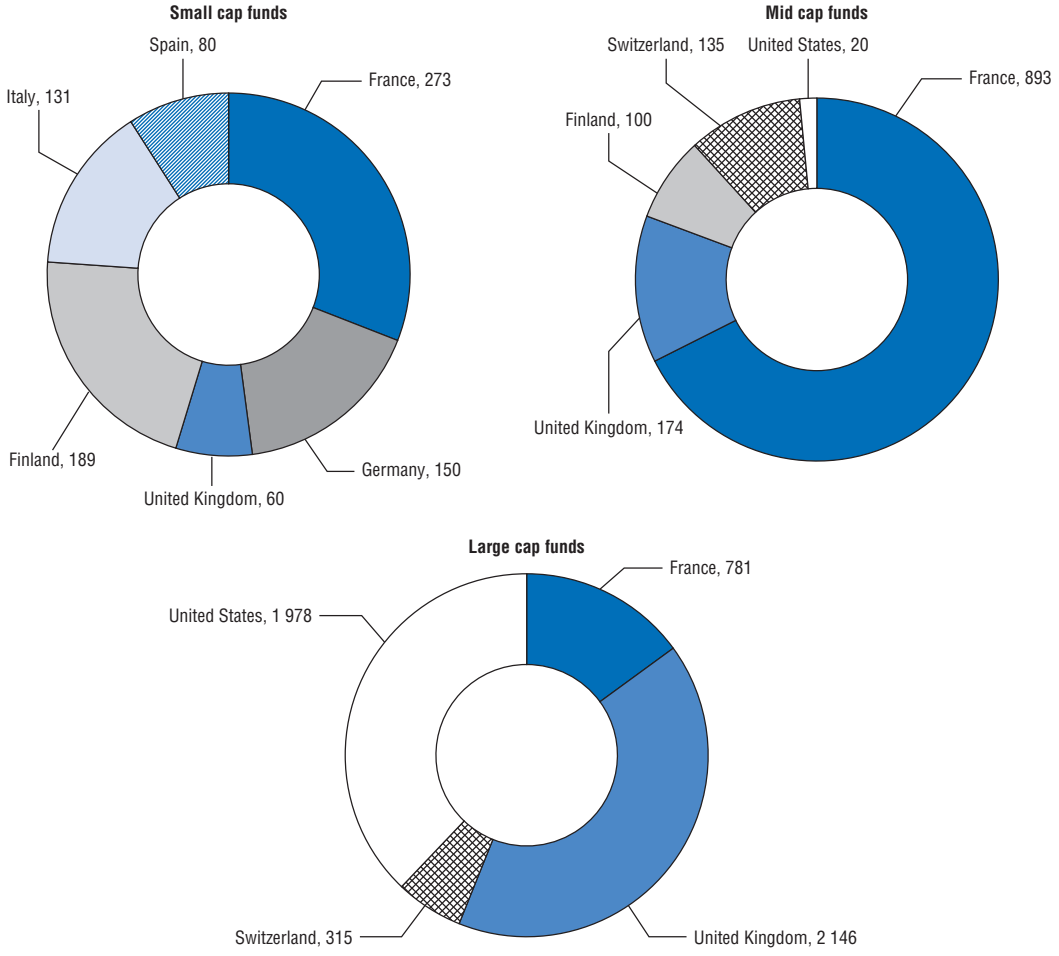
Policies to support the development of mezzanine finance for SMEs

In recent years, policy makers have sought to encourage the use of mezzanine finance, due to its potential to provide finance efficiently to key categories of SMEs, and to extend it to SMEs with lower credit ratings and smaller funding needs than the companies most commonly served by commercial providers.

Public intervention can be classified into three categories:

1. Participation in the commercial mezzanine market, through the creation of investment funds that target certain categories of SMEs and award mandates to private investment specialists. In many OECD countries, governments have formed special investment funds that invest alongside private investors in SMEs. Some of these funds may only invest in mezzanine vehicles, while many have flexible investment mandates that

Figure 6.2. **Dry powder in mezzanine funds in Europe, by country of General Partners, 2013**



Note: Funds in fundraising mode.
Source: Idinvest (2014).

StatLink http://dx.doi.org/10.1787/888933292191

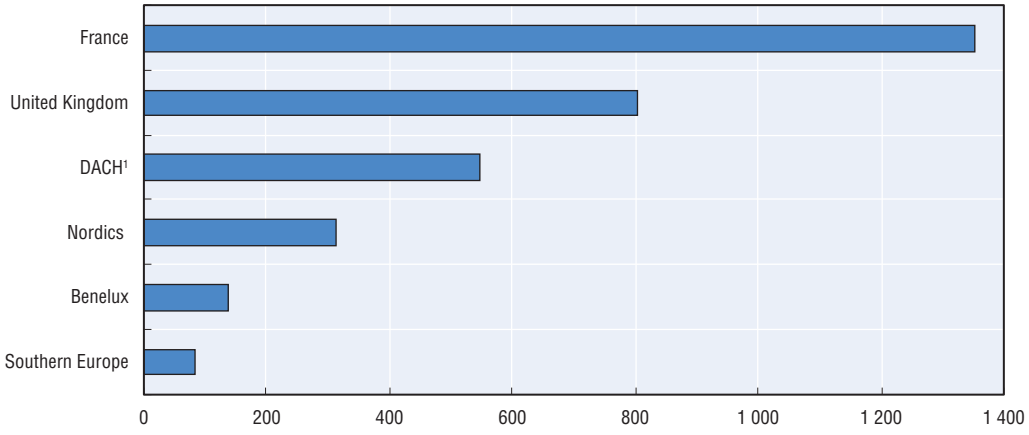
permit them to invest in a broader range of assets. There are two main ways in which public entities invest in SMEs through funds:

- a simple fund structure in which the public entity joins other public and private entities and provides resources (equity, debt or mezzanine) to SMEs or
- a fund of funds structure, in which the public entity allocates funding to several funds that provide financing to SMEs.

2. Direct funding to SMEs can be provided by a special agency, (e.g. an SME support agency or development bank) under a specific programme. Typically, these programmes contain some mix of subordinated loans with a mechanism for participation in the sales, earnings or profits of the company, when performance is good. Alternatively, the official agency may provide guarantees while private institutions offer the facility.
3. Funding of private investment companies at highly attractive terms. This modality of government support to mezzanine finance development is observed specifically in the United States. Under the Small Business Investment Company (SBIC) mechanism, a government agency, the United States Small Business Administration (SBA), issues debt

Figure 6.3. **Mezzanine debt market in Europe, 2011-13**

Deals in EUR million, yearly average



1. Germany, Austria, Switzerland.

Source: Idinvest (2014).

StatLink http://dx.doi.org/10.1787/888933292207

and makes funding available to SBICs. These are privately owned and managed investment companies that provide funding (in equity or mezzanine form) to SMEs. The SBA is a senior creditor of the SBIC and receives interest regardless of the performance of the companies in the SBIC's portfolio. The SBA does not sponsor a fund that makes investment in SMEs, nor does it provide direct funding to any. Instead, government support takes the form of funding at highly attractive terms.

All of these mechanisms require private funds to complement public funding, and all require SMEs to pass various tests of financial viability in order to qualify for official support.

Unlike commercial mezzanine finance, which has tended to converge toward a uniform global pattern, in the case of public participation, the specific pattern of mezzanine finance has tended to be guided by the laws, institutions and policies of the jurisdiction in which it operates. These operations are less standardised than fully private market operations and depend upon the decisions that each country has made regarding the best way to structure its own programmes.

Nevertheless, most public mezzanine programmes avoid equity-like instruments such as convertible debt or debt with warrants and instead favour silent partnerships or "success fees" under which the agency receives a share of the profit or turnover of the company but does not acquire an active equity stake in the company. In fact, these facilities generally entitle the agency to receive information about the state of the company, but no right to take part in decisions of the company. This is the case of the Development Contract (*Contrat de Développement Participatif*), introduced in France by OSEO (now bpifrance) in 2009. The main component in the DC is a subordinated loan of seven-year maturity with two-year grace (i.e. no principal repayments are made for the first two years). The interest rate may be fixed or variable and is set according to the risk rating assigned by the Banque de France. OSEO receives additional compensation in the form of a share (usually about 5%) of the increase in firm turnover following the loan, and its risk is limited by a public guarantee fund, which covers 80% of the risk, plus a 5% deposit by the company.

With regard to accepting equity-like positions, the Business Development Bank of Canada (BCD) would appear to be one exception among public financial institutions, as it

is rather flexible in structuring facilities to fit the situations of the target firms, aiming at a 15-17% target rate of return. A typical BDC mezzanine facility contains a subordinated loan which provides a stipulated rate of return as well as other facilities that provide additional income linked to the performance of the company, including: a) royalties on sales or EBITDA,[3] b) interest based on enhanced value of the company; c) equity warrants; or d) other factors that can be negotiated with the client.

An alternative model of public support is for an official agency to maintain a programme of guarantees where actual funding comes from a private institution, such as a bank. This is the case of AWS' Guarantees for Mezzanine Investments in Austria, which guarantees maximum 50% of mezzanine investments in SMEs, up to EUR 7.5 million, provided it sustains projects related to the modernisation or capacity expansion of a firm, plans to enhance R&D, or the acquisition of another company located in the country. At European level, the financial instruments of the Competitiveness and Innovation Framework Programme (2007-13) offered the possibility of mezzanine type financing through one of the windows of its SME Guarantee Facility (the "Equity Guarantee Window"),

Another way for governments to support the development of mezzanine markets consist in facilitating the participation of new investors, including smaller (i.e. retail) investors. In fact, there is only limited possibility for these to invest in SMEs in any form, including mezzanine. This is the case of specialised collective investment schemes (CIS), which receive the savings of smaller investors and purchase assets that are traded in private markets. Some OECD countries have authorised the creation of special investment vehicles in which retail investors can purchase shares of special CIS that invest in SMEs through instruments such mezzanine finance, venture capital funds and unlisted equities. Indeed, in some countries the authorities have decided to grant preferential tax treatment to these specialised CIS. For example, in France a special investment vehicle, the *Fonds Commun de Placement en Innovation* (FCPI), has been created to facilitate investment in companies that are certified as innovative under criteria established by OSEO. Investment in FCPIs is tax deductible and capital gains on investment on FCPIs held for a specified period are tax free.

Public suppliers of mezzanine financing include supra-national institutions. In 2009, the European Investment Fund (EIF) launched a fund with a dedicated mezzanine mandate, the Mezzanine Facility for Growth (MFG). This is a EUR 1 billion fund of funds mandate granted by the EIB to the EIF to be invested in hybrid debt /equity funds throughout Europe, with a view to playing a catalytic role in this market segment. The fund supports entrepreneurs who are endeavouring to keep control of their companies as the company expands or address companies which need complex reorganisation of their capital structures. Mezzanine also caters for later stage technology companies which have reached breakeven but do not yet have access to standard funding (Kraemer-Eis et al., 2013).

As a case in point, the European Commission's CIP programme guarantees Boost'PME, the participating loans programme of ISODEV, a French quasi-equity player that set up a securitisation fund to finance micro enterprises. ISODEV managed to attract institutional investors by developing a very selective approach to the risks linked to micro firms. The participating loans of EUR 15 000 to EUR 150 000 are provided as a top-up to bank loans. The guarantee agreement under the CIP is expected to enable ISODEV speed up the deployment of this innovative offer, aimed at improving the financial structure of SMEs and ease their access to credit.

Notes

1. See *www.gaaplogic.com/convertible-debt/*.
2. See *www.cepres.com*.
3. Earnings Before Interest, Taxes, Depreciation and Amortization.

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Chapter 7

Equity finance for SMEs

This chapter describes typologies of equity financing for SMEs, the profile of firms and the business stage that are suited for the different equity instruments, key enabling factors for their development, recent market trends and policies to boost equity investments in new and small companies. The chapter discusses private equity finance, focusing on and comparing venture capital and angel investments, and public equity, in the form of specialised platforms for public listing of SMEs.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Equity finance refers to all financial resources that are provided to firms in return for an ownership interest. Equity investors participate in the entrepreneurial risk, as no security is provided by the investee company, and the investment return is entirely determined by the success of the firm. Investors may sell their shares in the firm, if a market exists, or they may get a share of the proceeds if the firm is sold (OECD, 2009).

The main categories of equity finance are private equity and public equity. Whereas public equity concerns companies that are traded in some form of stock exchange, private equity investors provide capital to unlisted companies. Also, while public equity investors are not generally involved in the management of the company, private equity financiers provide advice or assist the owners or managers in the development of the firm.

There also exist informal sources of equity finance, which include family and friends. Indeed, for start-up companies, the amount of funds raised through these informal channels generally exceeds other venture finance, including in countries with a well-developed equity capital market, such as the US (Mac an Bhaird, 2010).

Equity markets are key for companies that seek long-term corporate investment, to sustain innovation, value creation and growth (OECD, 2013b). Equity financing is especially relevant for companies that have a high risk-return profile, such as new, innovative and high growth firms. Seed and early stage equity finance can boost firm creation and development, whereas other equity instruments, such as specialised platforms for SME public listing, can provide financial resources for growth-oriented SMEs.

On the other hand, for SMEs, raising equity capital may be significantly more expensive than accessing debt finance. For instance, the process of raising capital through an IPO of common stock is more expensive per share for SMEs than for large firms, due to the fixed costs of due diligence, distribution and securities registration (Berger and Udell, 1998). Also, SMEs often face a problem of under-pricing in capital markets. Beside costs and the burden of complying with regulatory requirements, it is often the case that entrepreneurs themselves are reluctant to approach capital markets due to the loss of control implied by the wider equity ownership (Mac an Bhaird, 2010).

Forms of private equity: venture capital and business angel investing

Private equity financing includes a broad range of external financing instruments, whereby the enterprise obtains funds from private sources in exchange for an ownership stake of the firm. The capital is provided to *private* companies, i.e. companies whose shares are not freely tradable in any public stock market, across the entire life cycle, from seed financing to buyouts (OECD, 2009).

Through private equity, wealthy individuals, investment funds or institutions participate fully in the entrepreneurial risk of the business, as capital is made available without provision of security. Compared to other forms of external finance, the investor accepts more risk and expects a higher return, typically above 25% IRR (internal rate of return) (see Table 6.1).

The investment is open-ended, though equity investors generally provide capital over a medium- to long-term horizon (3-10 years). The objective of investors is to make profit by "exiting" (i.e. selling their shares through an IPO, a trade sale or buyback by the other shareholders) once the firm has increased its share value.

Private equity investments are less volatile than those in the stock market. Trading does not have an impact on the asset class, as assets are held until maturity and valued on the basis of corporate fundamentals rather than depending on market fluctuations. The lower sensitivity to market variations provides investors a form of protection against equity market downturn and enables them to have stable and attractive returns. For instance, in Europe, since 2001, returns in the private equity segment have outperformed those in public equity markets by 9.4%. The 2008-09 financial crisis further widened the gap return between these markets (Idinvest, 2014).

Private equity is divided into two distinct components, namely venture capital, targeted at new and early stage companies, and other private equity, such as growth capital and buyouts, targeted at mature businesses (see Table 7.1).[1] Buyouts, whereby shares are bought from existing shareholders and control of the company is acquired, include a number of specific types of investments, such as management buyouts (MBOs), management buy-ins (MBIs), institutional buyouts (IBOs) and leveraged buyouts (LBOs). In LBOs, which account for the largest proportion of private equity funds, investors and a management team pool their own money, together with borrowed money, to buy the shares in a business from its current owners. Usually, the assets of the company being purchased are put up as collateral for the funds borrowed, and the cash flow of the same company is used to repay the debts. In this way, investors can acquire a company without the need for a large business capital.

Table 7.1. **Private equity by stage**

	Stages	Definition[1]
Venture capital	Pre-seed/Seed	Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase
	Start-up/Other early stage	Financing for product development and initial marketing. Companies have not sold their product commercially and are in the process of being set up.
	Later stage venture	Financing for the expansion of an operating company.
Other Private Equity	Growth	Investment in relatively mature companies that are looking for capital to expand into new markets or restructure operations.
	Buyout	Financing to acquire a company. It may use a significant amount of borrowed money to meet the cost of acquisition.
	Replacement	The purchase of a minority stake of existing shares in a company from another private equity firm or from another shareholder or shareholders.
	Rescue/Turnaround	Financing made available to an existing business in difficulty, with a view to re-establishing prosperity.

1. *www.evca.eu*.
Source: OECD (2014b).

Private equity firms are usually structured as a limited partnership. The General Partner (unlimited liability) receives capital from Limited Partners (e.g. pension funds, insurance companies, hedge funds, wealthy individuals). For these investors, the key economic incentive is the opportunity to earn a high rate of return on their invested capital through access to a portfolio of investments sourced and managed by an investment team that is expert in the target sectors or geographies of the fund (Naidech, 2011). Contrary to stock markets, private equity is based on the principle that unlisted markets are inefficient,

due to large information asymmetry. To exploit these inefficiencies and gain returns, an in-depth understanding of the opportunities available on the market is needed, based on corporate fundamentals and assessment of growth potential. Thus, private equity managers must have access to detailed data about potential investee companies and conduct in-depth due diligence (Idinvest, 2014). In this regard, for equity investors the skills and reliability of fund managers are critical.

Fund managers are generally rewarded with fee income and a share of other income and capital gains. To further align the interests of investors and fund managers, fund managers must generally invest alongside the investors, on the same terms in any fund (Gilligan and Wright, 2008).

Private equity companies typically focus on high growth potential or under-performing companies that can be transformed and subsequently sold or floated, fostering rapid corporate restructuring (Blundell-Wignall, 2007). In this regard, they differ in strategy, structure and objective compared to other investment funds. In essence, private equity fund managers seek to control the businesses they invest in and to choose an optimum capital structure for their investee companies. To do so, they generally operate with better information and stronger controls and influence over management than funds holding quoted equities. While fund managers do not exercise day-to-day control, they are actively involved in setting and monitoring the implementation of the firm's strategy. To achieve this, the private equity funds forego liquidity in individual investments and take on financial risk in each investment through the use of debt (Gilligan and Wright, 2008). Furthermore, the closed structure of the equity fund prevents fund managers from exiting prematurely and strengthens their long-term engagement with the investee company (EVCA, 2007).[2]

The main providers of equity finance for start-ups and SMEs are family, friends, business angels and venture capitalists. However, interest in upper-tier SME investment by other private equity funders has increased in recent years, as low interest rates have pushed investors to seek yields and diversification within their portfolios.

In 2013, deals under EUR 500 million accounted for over 97% of the Buyout deals carried out in Europe, while 45% of capital raised by European buyout funds was allocated to the mid-market segment, i.e. deals in the range of EUR 250 million-500 million. According to a survey on 450 institutional investors in alternative assets worldwide, conducted by Perquin in 2013, 52% of investors believed that the mid-market segment offers the best investment opportunities. 62% planned allocations to small to mid-market buyouts for the following year, compared to 18% which planned investing in venture capital (Figure 7.1).

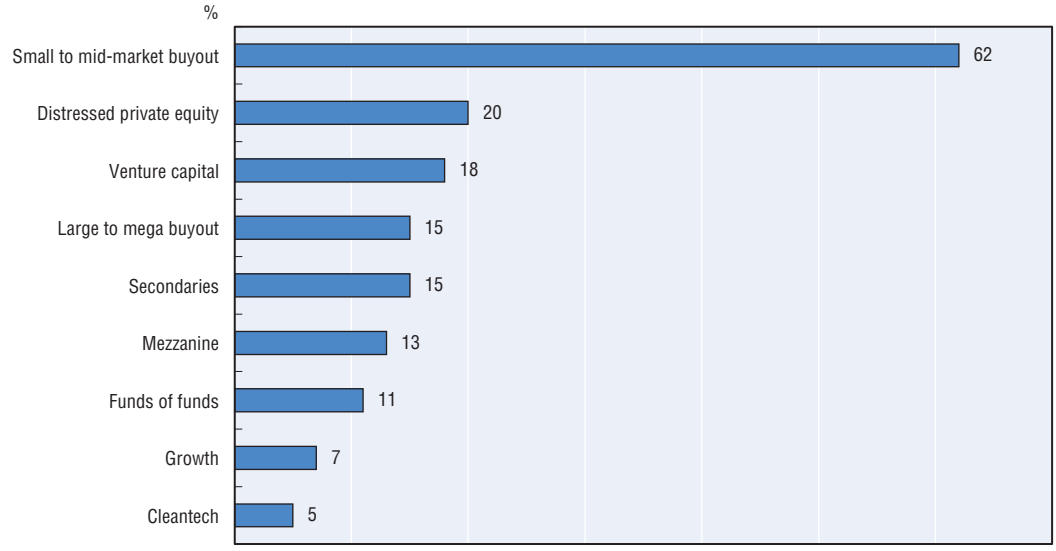
Indeed, as of 2013, small buyouts (less than EUR 250 million) had outperformed larger ones significantly, in terms of return on a 10-year horizon. The outperformance observed has been driven by the growth of the investee companies and by operation improvements. Small and mid-market buyout deals also benefit from low leverage and a higher share in the company's equity, which reduces the risk profile of the investee and increases its potential margins for external growth (Idinvest, 2014).

Venture capital

Modalities

Venture capital (VC) is equity investment aimed at supporting the pre-launch, launch and early-stage development phases of a business (OECD, 2014b). Although it is commonly assumed to be the main source of seed and early stage financing, in fact the majority of venture

Figure 7.1. **Investors' planned allocation to Private Equity for the next 12 months (450 institutional investors worldwide, H2 2013)**



Source: Idinvest (2014) based on Prequin (2013).

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capital firms intervene at a later stage, with a typical investment size of USD 3-5 million, while the seed and early stage market is the main target of "informal" investors, such as business angels (Table 7.2) (OECD, 2011a; OECD, 2013a).

Table 7.2. **Equity investors at the seed, early and later stages of firm growth**

INFORMAL INVESTORS		FORMAL INVESTORS
Founders, friends and family	Angel investors (typical investment size: USD 25-500 K)	Venture capital funds (typical investment size: USD 3-5 M)
Seed stage investments	*Early stage investments*	*Later stage investments*

Source: OECD (2013a).

Indeed, venture capitalists often invest in companies that have already received one or more rounds of angel finance. They typically intervene after a business idea or product has been successfully test-marketed, to finance full-scale marketing and production. Sometimes, however, venture capital may be used to finance product development costs when those costs are substantial, such as for clinical trials in the biotechnology industry (Berger and Udell, 1998).

Venture capital involves "formal" or "professional" equity, in the form of a fund run by General Partners, aimed at investing in early to expansion stages of high growth firms. Typically, venture capital firms raise funds from wealthy individuals, insurance companies, and pension funds, among others. These Limited Partners pay the General Partners to collect management fees (usually 1-2% of the capital committed), which cover the operating costs and enable the fund to hire a group of professionals.

The VC fund's investment portfolio includes various asset classes, such as stocks, bonds and real estate. Venture capital is part of the so-called "alternative investments", a higher risk asset class, from which investors seek to obtain higher returns. Within this asset

class, the equity fund invests in a portfolio of companies, knowing that some will succeed, some will fail and the majority will have average or sub-par performance (OECD, 2013a).

A venture capital fund typically has a 10-year life, at the end of which the partnership dissolves and distributes its assets to the partners. However, an extension may be agreed upon by the Limited Partners, so that some VC funds operate for 15-20 years. Generally, the investments in start-up companies are made throughout the first three/four years of the fund, with follow-on investments in portfolio companies being carried out for another few years. In fact, for early stage projects, venture capital typically involves the provision of several rounds of finance rather than a one-off injection of funds. The VC funds need a sufficient scale to be able to provide multiple financing rounds. At about the middle of the fund's life, when some early harvesting of the first successful businesses may have occurred, the General Partners may start to raise an additional fund, recycling some of the investment success money and adding new limited partner investors. For most of the portfolio companies, returns from the investment, through exit, occur from years four through ten (Wright and Robbie, 20013; Hadzima, 2005).

VC companies are increasingly specialised by stage of development (i.e. start-up, product development, revenue generation, profitable) or by round (i.e. seed, first, second or later stage). Usually, the later the round, the greater the funding invested in a round. Also, the funds close to the end of their life cycle are more likely to invest in later stage deals that are closer to exit, to gain a higher perceived return potential rapidly (Ernst &Young, 2014).

Deal selection skills are crucial for venture capitalists, who perform an important screening and signalling role in the market. In fact, they intensively scrutinise firms before providing capital, based on objective information and analysis, as well as their intuition, "gut feeling" and creative thinking (Hisrich and Peters, 2002; Martel, 2006). They are extremely selective in choosing their investment and are especially interested in businesses with a very high growth potential, which may provide high yields over the medium- to long-term investment horizon, through a successful exit.

Besides the funding, venture capitalists bring in technical and managerial expertise and provide new firms with a bundle of services. These include general business strategy advice, development of a marketing strategy, support to hire key staff, a financing plan and design for an exit, as well as advice for scenarios in which the business does not succeed. Empirical evidence suggests that venture capitalists play a key role in the professionalisation of the start-up companies they finance. At the same time, they may exercise strong control on the management and even drive or impose changes in top management.[3]

On the other hand, entrepreneurs seek a venture partner that may provide expertise, experience, contacts and reputation, alongside funding. There is a value in being associated with experienced and well-connected venture capitalists, to rapidly gain information about markets, to attract highly skilled employees and partners and, at the exit stage, to appeal to good IPO underwriters. Evidence suggests that entrepreneurs are willing to accept a discount on the valuation of their start-up in order to access the capital of venture capitalists with better reputation. In this regard, the reputation of venture capitalists, which depends on their experience, information network, and direct assistance to the portfolio firms, is more distinctive than their functionally equivalent financial capital (Hsu, 2004).

The exit prospect, i.e. the way for venture capitalists to cash out on their investment in a company, is critical in the venture capital industry, as investment decisions are partly determined by the exit possibility. Typically, exit takes the form of an IPO, when the company

shares are sold to the public, or, most commonly, a merger and acquisition (M&A), whereby investors receive stocks or cash from the acquiring company (Gompers and Lerner, 2001; Pearce and Barnes, 2006; Espenlaub et al., 2009). Thus, trends in IPO and M&A markets have an important effect on the VC industry, as in the aftermath of the 2008-09 global financial crisis, when reduced exit opportunities discouraged VC investments and increased time to exit.

An acquisition often involves a sale to a "strategic buyer", such as a supplier, distributor or competitor in the same industry as the start-up, rather than to a "financial buyer", who purchases companies solely for their investment value (Vinturella and Erickson, 2013). Among strategic buyers, large companies play an important role in screening venture capital-backed start-ups, with the aim of identifying early-stage companies that may provide radical innovations or new business models that may be scaled-up, or represent an interesting partner for their open innovation strategy.

Profile of firms

Venture capitalists bridge the financing gap caused by information asymmetry for new and innovative firms. Financing constraints tend to be more acute for young firms to the extent that they have limited internal funds and a track record to signal their ability to investors. The problem may be exacerbated by the lack of collateral for start-ups and the extremely risky nature of new innovative ventures. Indeed, the problem of insufficient collateral, which affects a large proportion of SMEs across all sectors, is exacerbated for companies whose business model is largely based on intangibles, as it is the case for sectors driven by knowledge-based capital investments, such as R&D and design (OECD, 2013a).

Venture capital targets a small pool of high-growth-potential companies with the capacity for high returns in a relatively short time frame. In fact, the venture capital industry is extremely selective and concentrated in sectors with high growth potential from scaling up innovative or disruptive business plans. Only a few firms have the potential to attract interest of venture capitalists, and only a minority is able to secure funding. According to the US National Venture Capital Association (NVCA, 2014), for every 100 business plans that are submitted to a venture capital firm for funding, about 10 are closely examined, and only one ends up being funded.

Typically, firms financed by venture capital feature a high commitment by the entrepreneur to invest his/her own money alongside the external financier, a solid market potential and prospects for high growth and high returns within a relatively short timeframe (35-40% IRR), high R&D spending, a strong and experienced management team, and the willingness of the entrepreneur to give up a significant share of ownership (Industry Canada, 2004).

These criteria account for the concentration of VC investments in a few industries, such as the digital economy (i.e. ICT, internet, electronics) and healthcare sectors (i.e. life science, biotech and medical device technology). In 2012, these industries raised, respectively, USD 8.8 billion and USD 3.2 billion venture capital fund worldwide (Idinvest, 2014). In 2013, ICT companies received the greatest share of VC investments in some of the key global markets, such as the US, Canada and Israel, both in terms of number of deals and value share. In these three markets, the subsectors which attracted most investments were software and consumer information services. In particular, software accounted for 70% of all VC funding to ICT. The preference of venture capitalists for consumer services and ICT can be partly explained by the direct and immediate connection with consumers, which

allows for rapid feedback on whether the investment is likely to pay off, as well as for a fast route to value creation. On the other hand, healthcare sectors are particularly popular in mature markets, such as the US and Europe, where an ageing and wealthy population represents a source of value (Ernst&Young, 2014).

Enabling factors

An enabling environment for innovative entrepreneurship is key for the development of the venture capital industry, which itself can positively affect the entrepreneurial environment (Dossani and Kenney, 2002). In many countries, a major impediment to the development of venture capital is the lack of "investor ready" companies appropriate for VC. A culture of risk-taking and self-confidence, social recognition for an entrepreneurial career, and regulations that ease market entry and exit are among the enabling factors for a critical mass of entrepreneurs to emerge. However, access to knowledge and skills is critical for *innovative* entrepreneurs, which especially benefit from knowledge networks and linkages, at the local and the global level. More broadly, innovative entrepreneurs require – and are pillars of – an open and dynamic innovation system, in which a diverse network of knowledge producers, users and institutions exchange knowledge and cooperate (OECD, 2010a; OECD, 2010b).

Highly innovative enterprises are often spin-offs from research institutions and are closely linked to academia, allowing for the commercialisation of innovative outputs. High growth potential may also be identified in spin-offs from established companies, which harness both technological and market knowledge accrued in the parent company to launch the business.

The technological and sectorial dimension of the innovative opportunities also matters for the venture capital development. In fact, venture capital can flourish when there is a constant flow of opportunities that have great upside potential. Historically, ICT has been the business field that has offered the longest series of opportunities, which explains the high concentration of VC investments in this area (Dossani and Kenney, 2002).

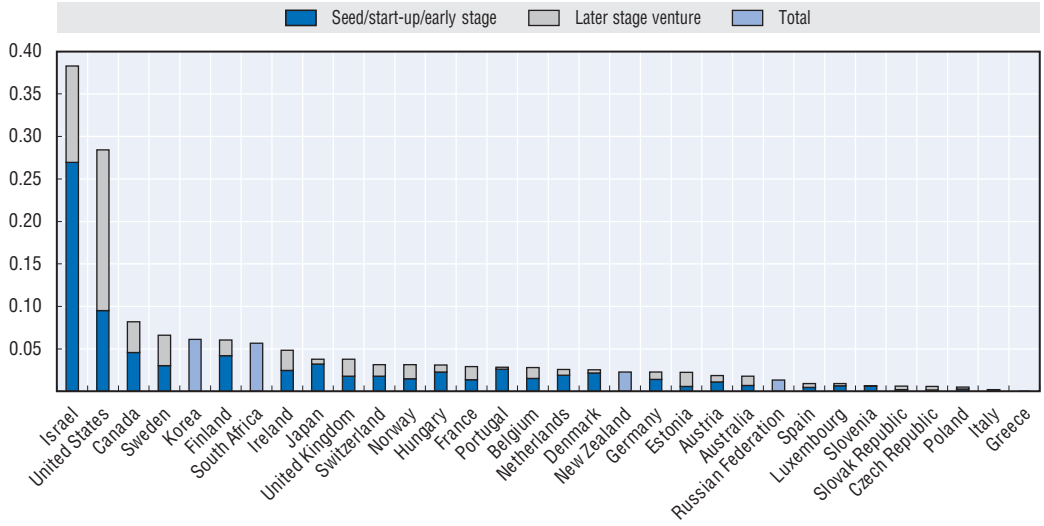
The existence of exit options is another critical factor for venture capitalists. The portfolio companies of a VC fund are typically cash-constrained growth ventures that do not pay dividends in the investment period. Rather, returns are gathered as capital gains when divesting the venture. In this regard, illiquid capital markets, in which venture capitalists find it difficult to sell their shares or engineer an M&A, represent an impediment to VC expansion (Landström and Mason, 2012). It also follows that taxation of capital gains is especially relevant for venture capitalists, as well as start-up entrepreneurs who may expect a return in terms of share participation, although the empirical literature on the effects of taxation on VC investments is not conclusive.[4]

There may exist regulatory barriers to investment in seed and early stage ventures. These include regulation that makes it difficult for venture capitalists to operate as limited liability entities, and regulation that limits the investment in these stages of certain types of institutions, such as banks, pension funds and insurance companies (OECD, 2013a).

Trends in venture capital markets

Across OECD and non-OECD countries, venture capital represents a small fraction of GDP, most often less than 0.05%. The countries in which the industry is relatively more developed are Israel (0.38%), the US (0.28%) and Canada (0.08%) (Figure 7.2).[5]

Figure 7.2. **Venture capital investments as a percentage of GDP, 2014 or latest available year**



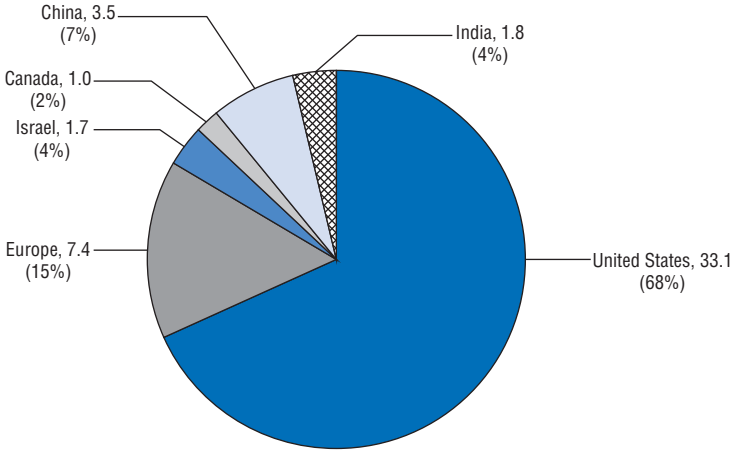
Source: OECD (2015).

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The US VC market is the largest worldwide, accounting for 68% of global VC activity in 2013 (Figure 7.3). Between 1995 and 2010, venture capital investments in the US were on average three times the size of investments in Europe. However, the number of venture capital deals in Europe is higher than in the US; in other words, European venture capitalists disperse funds more broadly through smaller deals (OECD, 2013a).

Figure 7.3. **Annual venture capital investments, main global markets, 2013**

USD billion, %



Source: Ernst&Young (2014), based on Dow Jones Venture Source.

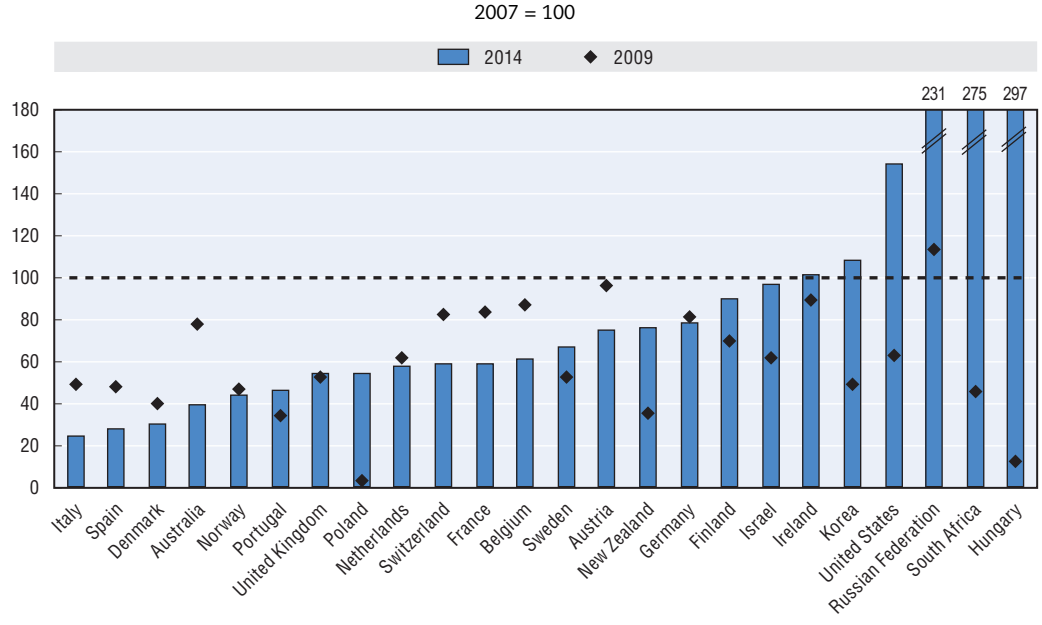
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In Israel, the structure of the VC industry is characterised by the prevalence of seed and early stage financing, whereas in the other major markets the greatest portion of VC funding supports later stage ventures, when companies are perceived to be partially de-risked and close to their revenue generation stage. This trend is particularly marked in emerging economies, with China and India recording high median size in second and later

rounds. Nevertheless, in China, with intensified competition between investors in later stage companies, VC funds are increasingly looking towards earlier stage investments, contrarily to what observed in Europe and the US (Ernst&Young, 2014).

The 2008-09 global financial crisis severely affected the industry. In 2014, in most countries the level of venture capital investment was still below the pre-crisis level, and in some cases still below the level it reached in 2009 (Figure 7.4). This is in line with the general downward trend observed in equity markets, in spite of the increasing interest in alternative instruments by investors, in search for opportunities to diversify their portfolio and for higher returns. Although the assets under management of the private equity funds experienced a dramatic surge in the pre-crisis period, the sector has stagnated since 2008 and did not offset the decline in IPOs. In fact, the role of stock markets as a destination for growth companies is decreasing, as reflected in the falling number of IPOs across the globe. Over 2010-13, the number of VC-backed M&A exits also continuously declined. Furthermore, a significant shift has been observed in fundraising through IPOs in equity markets, from OECD economies to emerging economies (OECD, 2013b; Ernst&Young, 2014).

Figure 7.4. **Venture capital trends, 2007-14**



Source: OECD (2015).

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Policies to enhance venture capital markets

As economies become ever more dependent on innovation and entrepreneurship for achieving sustained growth, venture capital markets have received increasing attention by policy makers, which have deployed a mix of policy instruments, directed at both the demand side (e.g. tax incentives for innovative start-ups, entrepreneurship training, incubators) and the supply side (e.g. tax incentives for risk capital investors, direct and co-investment) (Da Rin et al., 2006; OECD, 2013a).

In 2012, the OECD conducted a survey on policy interventions to sustain seed and early stage financing (OECD, 2013a). The evidence about 32 OECD countries shows that policies largely focus on the supply-side measures, which may be perceived as being more visible

and direct than demand-side support. The main policies observed include *front-end* tax incentives, i.e. tax deductions on investments in seed and early stage ventures, and *back-end* tax reliefs, which relate to capital gains and losses, including rollover or carry forward, and are often intended to encourage investors to reinvest in early stage firms. In the majority of countries, these types of support have increased in recent years, especially in the form of front-end tax incentives (see Box 7.1).

Box 7.1. **Tax incentive schemes for equity investors in SMEs: The case of the UK**

In the UK, the government operates three programmes that provide equity investors in small companies with tax incentives to encourage investment in small and growing higher-risk businesses. The Enterprise Investment Scheme (EIS), first launched in 1994, offers tax incentives to investors who purchase new shares in small higher risk trading companies. Private investors can invest up to GBP 1 million in qualifying shares and receive 30% of the cost of the investment as a relief against their income tax liability. In addition, capital gains tax liability on disposal of an existing asset can be deferred if reinvested in EIS shares within a certain period. If EIS shares are disposed of at a gain, the profit is exempt from capital gains tax. If the investor incurs a loss, this may be set against income tax in some circumstances.

In 2012, the UK government introduced another scheme that offers a range of tax reliefs to investors in small, early-stage companies, the Seed Enterprise Investment Scheme (SEIS). Shares must be held for at least three years and income tax relief is available at 50% of their cost, up to GBP 100 000. SEIS provides 50% exemption on capital gains reinvested in SEIS. If SEIS shares are disposed of at a gain, the gain is exempt from capital gains tax. If the investor incurs a loss, this may be set against income tax in some circumstances.

The third programme, Venture Capital Trust Scheme (VCT), started in 1995, offers a relief against income tax at 30% of the investment cost, up to GBP 200 000 to incentivise individuals to make indirect investment via intermediaries into small and growing higher-risk businesses. Investors buy shares in a VCT, which must fulfil a number of qualifying criteria including being listed on a primary stock exchange. The VCT then onwardly invests into qualifying companies, primarily through equity or quasi-equity instruments. The investor must hold their shares in the VCT for 5 years to qualify for the tax reliefs. Dividend payments and capital gains on the shares in the VCT are also exempt from the respective taxes.

Source: BIS (2013), *www.hmrc.gov.uk*.

If tax incentives are aimed at favouring investments by the private sector, government equity programmes are the common direct form of intervention to sustain the VC supply side. These include direct investment in start-up companies through government funds, fund-of-funds and public/private co-investment funds. According to the 2012 OECD survey, these programmes have been increasing in the recent past, especially fund-of-funds and co-investment funds, both of which seek to leverage private sector investment. In particular, co-investment funds, whereby public funding matches private investment, are often seen as a driver in building, growing and professionalizing the seed and early stage investment market. The majority of these funds are *pari passu* (on the same terms), but some schemes are asymmetric, i.e. they provide a premium to private sector investors, which get a higher proportion of the returns and a smaller share of the losses (OECD, 2013a).

An example of *pari passu* co-investment fund is the New Zealand Seed Co-Investment Fund (SCIF), which was launched in 2005 to provide matched funding for seed and early stage firms alongside "approved" private partners, typically private investor groups, including business angels or syndicates. The purpose of the fund goes beyond the direct funding to new ventures, as it also aims at catalysing private funding, enhancing networks for early stage investments and increasing the depth of specialist skills needed to assess and manage these investments (OECD, 2013a).

The attraction of foreign investors can help to train and develop local investors, as it was the case with Israel's Yozma Programme, which kick-started the country's VC industry in the 1990s (Box 7.2). However, only a few OECD countries have structured programmes in place to attract foreign investors, although in some cases equity and tax programmes are open at foreign investors. An exception in this regard is Australia's Venture Capital Limited Partnerships programme (VCLP), which aims at increasing foreign investment in the Australian venture capital sector. It does so by offering exemption from capital gains tax to

Box 7.2. **Attracting foreign investors to build a national venture capital industry: The case of Yozma programme in Israel**

The Israeli venture capital industry was built through government funding which leveraged financing from foreign corporations and institutions. The government created the YOZMA group in 1993 to use public funds to leverage foreign financing, primarily from the United States. Co-investors also included financiers from Germany and Japan. This was accompanied by equity guarantees for foreign investors, programmes to link Israeli firms with foreign business angels, and exits of Israeli venture firms on foreign stock exchanges.

In more detail, in 1993 the Israeli government supplied USD 100 million to start YOZMA, a venture capital fund investing in high-technology start-ups, mainly in ICT and life science/biotechnology sectors. This leveraged funding by foreign investors, under the obligation for the new VC funds to invest in start-up companies in Israel. Over a period of three years, the Group established ten hybrid public/private funds, each capitalised with around USD 20 million. In parallel, YOZMA started making direct investments in start-up companies. A five-year option was given to private partners to buy out the Government's share at predetermined conditions. This option was exercised in most cases, leading to the privatization of the VC funds. Initial individual investments typically ranged between USD 1 million and USD 6 million, and additional capital was reserved for follow-on investments. With the backing of prominent American, European and Israeli investors, YOZMA launched its second fund in 1995. Investment decisions regarding where and how to invest were mainly taken by the international partners.

The YOZMA Group also developed close working relationships with several of the leading academic institutions and technology incubators in Israel. Some of the most promising companies in the YOZMA portfolio have come directly from these institutions. As part of its efforts to involve senior executives and founders of successful enterprises in the activities of YOZMA, the Group created the YOZMA III CEO Club, which became a valuable source of deal flow.

By 2000, the Israeli venture capital industry had reached the stage whereby the private sector led the public sector in investments. The government phased out both the YOZMA equity programmes and the equity guarantees in the late 1990s when the success of the pump-priming efforts was evident.

Source: Baygan (2003).

fund managers that seek to raise a new VC fund of at least AUD 10 million for investment in Australian businesses with assets of up to AUD 250 million. Also, registration with the scheme entitles a fund to flow through taxation treatment, i.e. only the investors are taxed on revenues, not the entity itself (OECD, 2011b).

The 2012 OECD study highlights that demand-side policies are often overlooked in countries policy mix, although a recent growth in demand-side programmes, such as match-making and networking services, incubators and accelerators, is observed. In recent years, a new generation of "accelerators" developed, which provide tailored mentoring and support to a small group of entrepreneurial teams, selected on a highly competitive basis. Both incubators and accelerators provide business strategy advice, mentorship and workspace in a business-fertile environment, but differ in the pace of the support (much faster for accelerators) and the model for supporting start-ups financing. Whereas business incubators ease the linkages of entrepreneurs with prospective financiers, including venture capitalists, accelerators seed-invest in start-up companies, in exchange for a certain amount of equity. This is the case of the Vigo programme in Finland, which aims to fill the gap between early stage technology firms and international venture funding. It does so by carefully selecting "accelerators", which are independent companies run by internationally proven entrepreneurs and executives. These accelerators help start-ups to grow faster and access the global market, by co-investing with the new ventures.[6]

The networking side is even more important as public equity markets stagnate. If IPOs on stock exchange are difficult, the main option for entrepreneurs and their investors to realise gains is to sell or merge their firm with another company at an appropriate time. Building links with investors and large companies can increase the opportunities for this type of exit (OECD, 2013a).

Also, an increasing concern about the lack of entrepreneurial skills and capabilities and low quality of investment projects is driving attention on measures that target the skills of existing or would-be entrepreneurs. This is the case of investor readiness programmes, which help entrepreneurs anticipate the need of investors and prepare for submitting their funding demand. For instance, Impact Invest Scandinavia support ventures that are in early commercial phase or wish to seek capital to scale-up, by providing training and access to a global network of investors.[7]

Business angels

Modalities

Business angels (BAs) are high net worth individuals who invest their own money directly in seed or start-up companies, with no family relationships, in return for stock in the companies (Mason and Harrison, 2008). Thus, BAs capitalise their returns by disposing of the start-up shares, through an IPO, a merger or an acquisition, and often re-invest the gains into new ventures. This is the case also because a BA is typically financially independent, i.e. a possible total loss of the angel investments will not significantly change the economic situation of his/her assets.

BAs are often former successful entrepreneurs who are interested in supporting other entrepreneurs by providing both funding and expertise. As it is the case for VCs, BAs generally take an active involvement in the start-up company, providing strategic and operational expertise, as well as connections to other key players in the system. Typically, BAs make investment decisions based on their experience in a particular sector and invest in

companies within their local area (OECD, 2011a). Indeed, with respect to venture capitalists, BAs are usually less deterred by gaps in the start-up management team, because they can contribute missing expertise through their own involvement (Mason and Stark, 2004).

In spite of their direct engagement in the management of the start-up, often BAs wish to remain minority shareholders, as they are aware of additional funding needs of the entrepreneur at later stages, to which other investors may respond, and prefer that the entrepreneur remains in control of the business with significant stake in the result and incentives to succeed (OECD, 2011a).

Angel investing of this sort has existed for centuries, but, over the past couple of decades, the angel investment sector has gained increasing recognition, as a powerful source of financing for high-growth companies, and has become more formalised and organised, including through syndicates, associations and networks (Ibrahim, 2008; OECD, 2011a).

Recognition has come with more regulation, although the angel investing market is largely informal, i.e. BAs act privately and generally prefer to maintain anonymity (CSES, 2012). In the US, angel investors need approval as "accredited investors" under securities laws, whereas in other countries certification is necessary but can take the form of a self-certification. These requirements are intended to ensure that the investors have the necessary financial resources as well as an understanding of the implications of investing in start-up companies (OECD, 2011a).

The typical angel investment size is in the range of USD 25 000-500 000, that is, BAs operate in a seed/early stage investment segment which falls in between informal founders, friends and family and formal venture capital investments (see Table 7.2). Since VC is increasingly focused on later stage investments, to some degree BAs are filling the financing gaps in the early stages (OECD, 2011a). Angels may therefore be seen as providing a vital kick-start to innovating businesses both in terms of investment and business-building skills (Wiltbank, 2009).

BAs tend to invest in a portfolio of companies, diversifying risk, and can operate alone or invest jointly with other institutional investors, for example in a seed fund, or join forces with other BAs. This is the case of formal or informal syndicates (or groups), in which experienced angels pool their capital and expertise to achieve a critical mass and offer a broad range of managerial skills. Furthermore, investing through a syndicate allows BAs to assess a wider range of deal opportunities and to identify potential co-investment partners. Usually the investor pays for the syndicate, and the syndicate will assess the potential investment for the BA to make the final decision. Syndicates may be member-led, i.e. managed by a lead angel or a committee, or may be run by professional managers. In any case, members are generally allowed to make their own investment decisions, although minimum annual investment requirements may be set by the syndicate (OECD, 2011a; CSES, 2012). The recent growth in BA syndicates may be related to the increased awareness about angel investment opportunities and a greater demand for pooled angel capital, to fill the market gap between individual angel investment and venture capital (OECD, 2011a).

In recent years, Business Angel Networks (BANs) have diffused at the local and national level, particularly in Europe. BANs do not invest themselves in start-ups, but rather play a match-making function between angel investors and entrepreneurs. They help increase the visibility of the angel activity in a region, without necessarily making the individual BA more visible, as they act as a "front door" for entrepreneurs looking for financing (OECD, 2011a). BAs that are associated to the network make their own individual

investment decisions, and the BAN does not decide which investors will invest in a deal. BANs also often provide a number of added value services to both angels and entrepreneurs, such as investment readiness or syndication opportunities (CSES, 2012). BAN operating model, membership criteria and sectorial orientation greatly differ across countries and regions. They may focus on particular sectors, gather groups of people with similar backgrounds, experiences, cultures or nationalities (e.g. university alumni, diaspora groups) or include also service providers and other non-angel financial investors (OECD 2011a; OECD, 2013a).

Increasingly, BA syndicates and networks are using online tools to favour the matching process. In addition online matching platforms have developed, which provide matching services to registered investors and entrepreneurs. Although these platforms can reduce information search costs for both the investors and entrepreneurs, they do not replace personal contact and face-to-face interaction, which are mostly needed in a financing model largely based on confidence and trust (OECD, 2011a).

Business angels vs venture capital

Business angels and venture capitalists act and interact in a common space of opportunities, that of innovative, high growth potential start-ups, but are characterised by different motivations, targets, scale and operating models (Table 7.3).

Table 7.3. **Key differences between angel and venture capital investors**

Characteristics	Angel investors	Venture capitalists
Background	Former entrepreneurs	Finance, consulting, some from industry
Investment approach	Investing own money	Managing a fund and/or investing other people's money
Investment stage	Seed and early stage	Range of seed, early stage and later stage but increasingly later stage
Investment instruments	Common shares (often due to regulatory restrictions)	Preferred shares
Deal flow	Through social networks and/or angel groups/networks	Through social networks as well as proactive outreach
Due diligence	Conducted by angel investors based on their own experience	Conducted by staff in VC firm sometimes with the assistance of outside firms (law firms, etc.)
Geographic proximity of investments	Most investments are local (within a few hours' drive)	Invest nationally and increasingly internationtally with local partners
Post investment role	Active, hands-on	Board seat, strategic
Return on investment and motivations for investment	Important but not the main reason for angel investing	Critical. The VC fund must provide decent returns to existing investors to enable them to raise a new fund (and therefore stay in business)

Source: OECD (2011a).

First of all, although capital gains represent a common and primary objective, the non-financial motivations of BAs, and their entrepreneurial background, often imply they are willing to consider a wider range of sectors than VC funds, including non-high-tech fields, and geographical areas that are different from VC hotbeds. Whereas venture capitalists must produce returns for VC investors, the use of personal funds gives BAs the flexibility to invest for non-financial reasons and target sectors and local areas in which they may give back to the entrepreneurial community through "for-profit philanthropy" (Ibrahim, 2008).

The non-financial value that BAs can bring to a project is an important factor in their decision to invest. This also implies that, although in both cases financiers have an active role in the management of the investee business, BAs tend to take a more hands-on role in the company than VCs and place greater importance on their relationship with the entrepreneur. These differences in the investment motivations are also reflected in the emphasis that they give to growth potential, with greater emphasis by VCs on businesses that may become significant global players (Mason and Stark, 2004). Also, the non-financial motivations for angel investment help to explain the greater use of informal contracts, whereby the investor does not apply highly protective terms in order not to signal a lack of trust in the entrepreneur (Ibrahim, 2008).

The stage of investment and scale of funding are other important differences between the two financing models. BAs target seed and early stage ventures, investing relatively small amounts per venture, whereas VC funds (increasingly) focus on later stage investments and need sufficient scale to be able to provide multiple financing rounds.[8] Hence, angel investors have much lower cost structures than VC funds. The early stage of investment by BAs, and the little historic performance data on which judgements about investments can be based also explain their greater weight on the attributes of the founders of businesses, when screening deal opportunities (Stuart et al., 2007). However, the growth of BA syndicates or "super angels", wealthy individuals – often serial entrepreneurs – that attract also capital from other investors, has created a segment in-between the angel and VC market, in which operating models and contractual relationships are close to those of the VC industry, with full time managers getting a share of the investment profits (OECD, 2011a).

There are also important complementarities between angel and venture capital investors, which Harrison and Mason (2000) synthesise in: sequential investing in businesses at different stages of business development; co-investing in deals; provision of finance to venture capital funds; and deal referring.

Firstly, BAs provide start-ups with small scale early-stage capital, which is often followed by larger-scale second and subsequent stage capital by VCs. In fact, investment by BAs often serves as a signalling effect for other investors, demonstrating that the firm has passed a first screening of due diligence by investors with experience in the field. Furthermore, the interest by VCs may provide an interesting exit route for BAs to realize their investment (Harrison and Mason, 2000). At the same time, it is more frequently observed that BAs themselves support the investee company through exit, instead of relying on VCs to step in. This is especially the case for firms in the internet and social networking sectors, which require smaller amounts of initial capital that traditional high tech fields, and are characterised by more rapid testing and adjustment of products or business models (OECD, 2011a).

BAs may also invest jointly with VC funds. VC funds are increasingly recognising the contribution of angels and, in some cases, are collaborating on early-stage investment with them (OECD, 2011a). The BA typically benefits from reduced risk and better quality investment opportunities, given the screening on a higher number of potential deals by VCs. On their hand, VCs can benefit from the BA's experience in the sector and direct engagement in the management of the start-up. This is especially relevant for relatively small deals, in which the opportunity cost of management time may be considered too high by VCs. Also, the presence of angel investors among the funders usually implies that the capital is more "patient" than in the case of institutional investors, reducing the pressure on VC fund managers to generate rapid returns (Gifford, 1997; Harrison and Mason, 2000).

High net worth individuals, including BAs, are among the financiers of VCs. The investment in VC funds represents for the BA an option for diversifying the portfolio risk and may be attractive if the angel investor has difficulties in evaluating investment opportunities and structuring deals, as it may be the case for individuals with time constraints, poor referral networks or lack of experience in the industry (Harrison and Mason, 2000).

Deal referring is another area of complementarities between BAs and VCs. The network of a BAs can represent an important source of investment opportunities for VCs. At the same time, VCs can provide BAs with access to funding deals that are outside their resources or expertise. According to Harrison and Mason (2000), which analyse the UK venture capital market, cross-referring of investment opportunities is the most commonly cited form of complementarity by VCs, while BAs tend to highlight the importance of co-investing to a greater degree.

Profile of firms

Angel investment concerns mainly seed and early stage companies, including young firms that are beyond the start-up phase but need capital to develop their product or business strategy. BAs invest largely, though not exclusively, in knowledge-based sectors. In fact, compared to VCs, BAs invest in a wider range of sectors, including traditional ones, and geographies, which are not limited to VC hotbeds and are typically related to the BA's entrepreneurial experience and personal networks. However, a common trait of the target companies is a high-growth potential and likelihood to generate substantial revenues over the mid- to long-term (3-8 years). In other terms, BAs and VCs look for scalable investments, that is, companies that can substantially grow their revenues within a few years (Villalobos and Payne, 2007).

As is the case for VCs, angel investors bridge the financing gap for new ventures that is largely due to information asymmetry. Since they tend to invest in an earlier stage of the business development than VCs, for BAs the asymmetry may be even more relevant. This also explains the greater emphasis placed by BAs on the personal relationship and trust with the entrepreneur, who should be willing to relinquish some control on the firm and accept an active role of the BA in the development of the business strategy.

Generally, the most appropriate time for companies to seek angel investment is when a product or service is developed or near completion and there exists a base of customers or potential customers that confirmed their interest in buying it. BAs are usually under little pressure to make an investment in order to generate income or capital growth. They can afford to wait until they identify the right opportunity and the right person. This means that entrepreneurs that seek angel investments need to be able to present not only an appealing idea and business plan but also themselves effectively (Stuart et al., 2007).

Enabling factors

For the angel investment model to work and the market to grow, a well-functioning entrepreneurial ecosystem is needed (OECD, 2011a). Similarly to the VC sector, BAs need a critical mass of high-growth opportunities, to screen and select appropriate ventures and scalable business models. Therefore, a diffused culture for risk-taking, social recognition for an entrepreneurial career, low barriers to market entry by new entrepreneurs and high levels of appropriability of the returns from innovation are all factors that favour opportunities for angel investment to emerge. Also, access to knowledge and skills for entrepreneurs to launch innovative businesses is crucial. These are not confined only to

high-tech sectors, for which good linkages with R&D centres and Universities are essential, but may concern traditional or mature industries, in which opportunities to rapid growth may exist for innovative start-ups.

Angel investing benefits from an integrated and well-functioning financial system, which allows profitable exit to take place, through IPOs or trade sale. In this respect, secondary stock markets in which SME shares are traded can provide an important channel for BAs to realise their investments. A well-developed VC market can also provide BAs with an effective exit route.

Angel activity benefits from broader synergies with the VC industry. BAs need a well-functioning VC market to provide the follow-on finance that some of the businesses they support will require. At the same time, a well-developed angel market can create more investment opportunities and increase the deal flows for VCs (Harrison and Mason, 2010).

Awareness about angel investment opportunities is relevant for the growth of the industry, to attract would-be BAs and to raise the interest of entrepreneurs that seek early-stage funding. In many countries, the development of BANs and online platforms has improved the visibility of the angel market at the local level and reduced the information gap between angel investors and entrepreneurs. Until recently, entering a deal with a BA was often a challenge for entrepreneurs, which had to work their personal networks to identify and meet potential financiers and then negotiate privately. The match-making services offered by BANs can substantially reduce the search costs and time and increase the likelihood that valuable projects get financed. The visibility of the industry has also improved with the diffusion of angel groups or syndicates, which are generally easier to find for entrepreneurs than individual angel investors (OECD, 2011a; Ernst &Young, 2014).

Trends in business angel investments

Analysing trends in angel investments is difficult, due to the lack of data and little harmonization in definitions. Currently, the only data available is that collected by angel associations from angel groups and networks. This however only captures the "visible" market and overlooks the largest part of investments, which are carried out by individual BAs. It has been estimated that, when taking into account the "invisible" share of the market, the total amount of angel investment is likely greater than VC investments (Kerr et al., 2010).

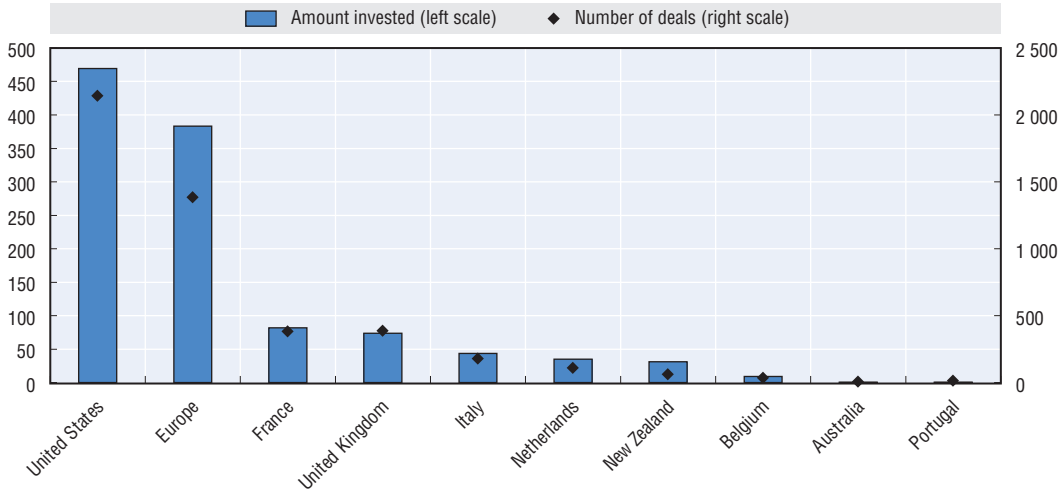
Taking this important limitation into account, OECD (2011a) shows that the US and Europe are the most active BA markets, with France and the UK leading the European market (Figure 7.5). In the US, angel investment boomed in the dot com era, rising at a high pace and then falling off, as did venture capital. The constant growth of BA activity over the last decade came to a halt during the 2008-09 financial crisis, though the fall was not as dramatic as in the VC industry (OECD, 2011a). In this regard, BAs appear to be less sensitive to market cycles than are professional VC investors. Nevertheless, also for BAs the lack of opportunities represents an important challenge, which may discourage or defer investment in the first place.

Overall in Europe, in 2009, total investment through angel networks had already surpassed the seed component of the VC industry (Figure 7.6), which may be also explained by the increasing orientation by VC funds towards later stage financing. BA investment in seed/early stage VC funds has also increased in recent years (OECD, 2011a; Ernst&Young, 2014).

Although BAs invest across a broad range of sectors, the VC-preferred fields (ICT and healthcare sectors) feature high in BAs' investment choices. According to the European

Figure 7.5. **Investments by business angel networks/groups in selected countries, 2009**

USD million

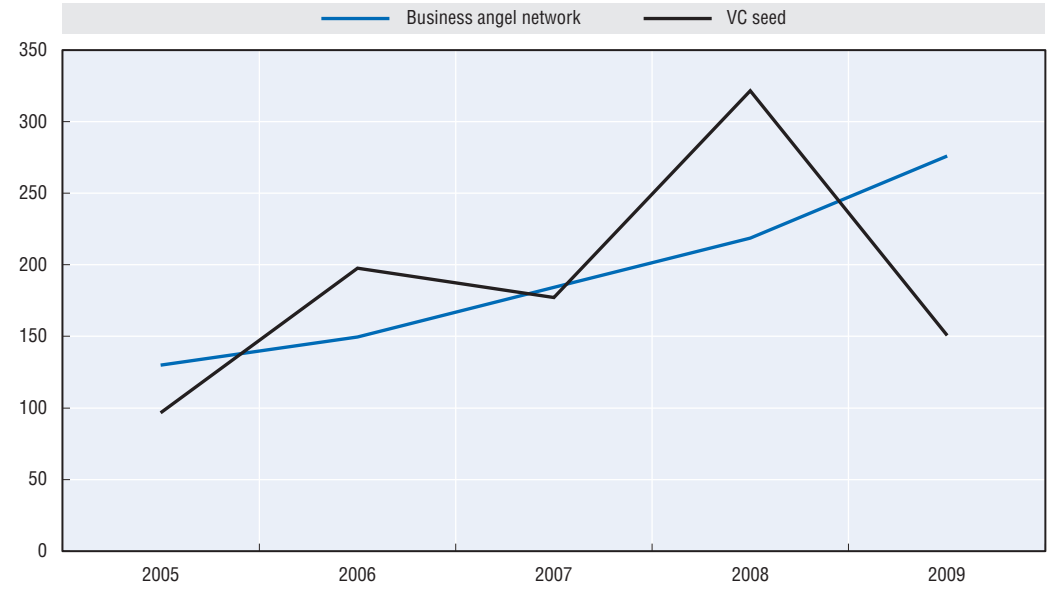


Source: OECD (2011a).

StatLink http://dx.doi.org/10.1787/888933292258

Figure 7.6. **Business angel network and venture capital seed investments in Europe, 2005-09**

EUR million



Source: OECD (2011a).

StatLink http://dx.doi.org/10.1787/888933292267

Business Angels Network (EBAN), in 2013, in Europe, ICT collected 32% of investment preferences, followed by Biotech and Life Sciences (10%) and Mobile (10%).[9]

Only a minor share of BA deals are cross-border, whereas most investments are local. This may be related to the importance of personal relationship and trust in the angel investment process. Cross-border deals are only possible when the necessary trusted

relationships are in place, there is sufficient knowledge about the market and the legal and tax systems permit BA types of deals (OECD, 2011a).

Policies to sustain business angel investment

Angel investing is increasingly encouraged and supported by policy makers in many countries, as a way to mobilise financial resources and entrepreneurial expertise towards dynamic new ventures. In most cases, supply-side measures have been introduced, which mainly take the form of tax incentives and public co-investment. Given the local dimension of angel investing, in some countries, such as the US and Canada, support is provided at the local level rather than at the national level.

Front-end and back-end tax incentives aim to increase the number of BAs as well as the amount of capital invested. Typically, incentives are conditional on the shares being held for a minimum number of years or the capital gains being reinvested in new ventures. For instance, in 2008, Italy introduced tax relief for business angel investments, which consists of a tax exemption for capital gains on the sale of a start-ups' undertakings, provided that the start-up is less than seven years old, that the investor holds the shares for at least three years, and that the capital gains are reinvested in another start-up in the next two years (OECD, 2014a).

Japan has introduced an angel tax system since 1997, which comprises reduced taxation on capital gains and carry forward of losses. However, as angel taxation was only used for a small amount of investments, to further increase angel funding, the system was amended in recent years with the introduction of an income exemption system, whereby, under specific conditions, BAs can deduct from their annual income an amount of money substantially equivalent to the investment carried out in the same year (OECD, 2011a).

Another common supply-side measure consists in the creation of co-investment funds, which match public funds with those of private investors that are approved under the scheme. In some cases these funds target all seed and early stage investors, including also VC funds (see Box 7.3), but there exists also programmes that are especially focused on BAs. In the UK, the Angel CoFund invests amounts of GBP 100,000 to GBP 1 million into SMEs with high growth potential, working in partnership with syndicates of experienced BAs.

In some countries, public support has been provided to BA associations, networks or groups to help start these organisations. For instance, EBAN was created in 1999 as a federation of BANs across Europe with financial support of the European Commission. In the US, it was the Kauffman Foundation which supported the creation of the Angel Capital Association (ACA) in 2004. In some cases, however, the public support to start national associations did not produce the desired impact, due to relatively immature markets and the difficulty for these associations to build enough momentum to develop (OECD, 2011a).Some policy measures target the specific skills required for angel investing, promoting training, mentoring and coaching, although this type of measures have been less popular than tax incentives or financial support. In the US, the Kauffman Foundation created the Angel Capital Education Foundation (ACEF), which offers education programmes about angel investing, with the engagement of experienced angel investors as lead instructors (OECD, 2011a).

On the demand-side, investment readiness programmes are intended to help entrepreneurs develop their business plans and presentations, in order to appeal to angel investors. To do so, emphasis is placed on better understanding the needs and expectations of potential investors and how to present a business plan that appeals to these expectations.

Box 7.3. **Co-investment funding in seed and early stage ventures: The TechnoPartners Seed Facility in the Netherlands**

In the Netherlands, TechnoPartner is an integral programme that aims to improve the economic climate for technology-based start-ups ("technostarters") by: giving technostarters access to capital, knowledge, experience and equipment; motivating knowledge institutes and investors to invest money and knowledge in pioneers; providing a platform where technostarters can ask questions, explore ideas and make comments.

TechnoPartner carries out four programmes

- TechnoPartner Knowledge Exploitation Subsidy
- TechnoPartner Seed Facility
- TechnoPartner Certificate
- TechnoPartner Business Angel Programme

The TechnoPartners Seed Facility matches funds from both VC firms and BA syndicates. Participating funds that invest in high risk "technostarter" can apply for a loan, for a maximum of 50% of the fund's investment and up to EUR 4 million. The scheme is characterised by a three phase payback period mechanism. Once revenues are generated the fund will have to pay back 20% until it has earned back its investment. After that, the fund will have to pay back 50% until TechnoPartner has earned back its investment. If revenues still accrue, the additional income is divided between the fund and TechnoPartner on a 80% - 20% basis.

Under the TechnoPartner Business Angel Programme (BAP), TechnoPartner informs (starting) entrepreneurs and starting informal investors (virgin angels) about the possibilities of informal investment. Within this framework TechnoPartner uses information sessions on starting capital and a booklet "Starting Capital".

Source: http://erawatch.jrc.ec.europa.eu; OECD(2011a).

Other measures that aim to improve information flows and networking opportunities between financiers and entrepreneurs, including business incubators and accelerators, may also concern BAs. The support to broader networking activity in the entrepreneurial ecosystem may also improve the exit prospects of BAs, as these are able to strengthen linkages with other players, such as VC funds, which may step in at a later stage of the investment, or large companies, which might become M&A partners.

Public equity: specialised platforms for public listing of SMEs

Modalities

For decades, private market participants and officials have been seeking to encourage the development of specialised exchanges or similar trading platforms to satisfy the demand of SMEs for equity finance. Public listing of SME equity through primary and secondary issuance has the potential to provide funding for a company's growth and can increase the availability of, and improve conditions for, subsequent debt financing. Existing SME owners can realise their capital gains and tap a wider investor universe, including retail investors and sophisticated long-term institutional investors (OECD, 2014c).

In this method of financing, an SME issues equity on a public market[10] while simultaneously disclosing basic information about the company's activities and financial situation, usually through a prospectus. Once it is listed, the company is required to make

regular disclosure, and trading takes place under rules established by the exchange.[11] These exchanges are usually regulated by a securities regulatory authority, but the regulator may delegate the authority to set rules to the exchange itself or to other "self-regulatory organisations" (SROs).

SME trading platforms can take the form of a separate board within an established exchange market and operate in parallel with the main market or can be developed as a separate market. This latter is the case of some of the most developed platforms, such as AIM (Alternative Investment Market), London Stock Exchange's (LSE) international market for growing small businesses, KOSDAQ in Korea and TSX-V in Canada. As regulated equity markets, SME listings exclude the least regulated or unregulated over-the-counter (OTC) markets, where securities or derivatives are bought and sold directly between the purchaser and seller.

In most cases, new markets adopt a "junior market" strategy, in which listed firms graduate to the main market, i.e. the companies listed on the SME exchange are allowed to migrate to the main market as and when they meet its listing requirements. Acting as a "feeder" for the main market, the new market may offer visibility to listed firms and be used as an alternative to venture capital rounds. Important exceptions exist, such as NASDAQ in the US and KOSDAQ in Korea, which started as platforms competing with the main market and still hold a competitive position by retaining large venture-backed firms (Yoo, 2007; Gadha et al., 2010).

Compared to the main stock exchanges, specialised platforms for SMEs, or "new markets", set looser listing and disclosure requirements, typically allowing more relaxed criteria on operating history, minimum number of shareholders, past financial performance and number of free-float shares, i.e. outstanding shares that are held by investors other than restricted shares which are held by company insiders. Also, most new markets charge lower listing and maintenance fees than the main market. At the same time, new markets typically adopt operating practices to preserve investor interest and market integrity. These include a lock-up period for major shareholders around equity offerings (i.e. a predetermined period following an IPO where large shareholders are restricted from selling their shares), institutional arrangements for mentoring, and strict delisting rules (Yoo, 2007).

As a case in point, the entry criteria for London Stock Exchange's AIM, launched in 1995, do not include requirements for trading record, minimum size, prescribed levels of shares held by the public, nor they demand pre-vetting of admission documents by the Exchange or by the United Kingdom Listing Authority (UKLA) (Table 7.4). The AIM Rules do not mandate any corporate governance code or disclosures. However, companies need to provide details on their website as to whether or not they have followed a governance code and, if they have not, narrative details of their practices. Furthermore, to ensure investor protection, during the admission process and its time as a public company, the firm must work closely with a Nominated Advisor ("Nomad"), a corporate finance advisor approved by the LSE, who is responsible for confirming to the LSE that certain rules have been complied with. A Nomad undertakes extensive due diligence to ensure that a company is suitable for AIM, provides guidance throughout the flotation process, prepares the company for being on a public market, helps prepare the AIM admission document, confirms appropriateness of the company to the Exchange, and acts as the primary regulator throughout a company's time on AIM (LSE, 2010).

Table 7.4. **Differences between admission criteria and continuing obligations for London Stock Exchange's AIM and main market**

AIM	Main market
• No minimum market capitalisation	• Minimum market capitalisation
• No trading record requirement	• Normally three-year trading record required
• No prescribed level of shares to be in public hands	• Minimum 25 per cent shares in public hands
• No prior shareholder approval for most transactions[1]	• Prior shareholder approval required for substantial acquisitions and disposals (Premium Listing only)
• Nominated Adviser required at all times	• Sponsors needed for certain transactions (Premium Listing only)
• Admission documents not pre-vetted by the Exchange or by the UKLA in most circumstances. The UKLA will only vet an AIM admission document where it is also a Prospectus under the Prospectus Directive	• Pre-vetting of prospectus by the UKLA

1. Unless the transaction is a reverse takeover or disposal resulting in a fundamental change of business.
Source: LSE (2010).

To gain investor trust and reduce the risk perceived by investors in the equity of small, high-growth firms, an opposite approach may be taken, with higher standards in the new market than in the main one. This is the strategy adopted by Brazil's Novo Mercado, a listing segment of BM&F Bovespa (São Paulo Stock Exchange) for companies that voluntarily abide to additional obligations, which are intended to increase shareholders' rights and enhance the quality of information commonly disclosed by listed companies under the Brazilian Law and CVM (Brazilian Securities and Exchange Commission). The companies' commitment to fulfil additional listing requirements is stipulated in an agreement with BOVESPA that gives the exchange authority to oversee and enforce its regulations and even to impose penalties when necessary. In light of these stricter rules, when Novo Mercado was created in 2000, two intermediate corporate governance level were established, to ensure that already listed companies had a path to follow toward improving their corporate governance practices (Box 7.4). These intermediate segments between the traditional BOVESPA market and the Novo Mercado are intended to serve as stepping stones that facilitate gradual adaptation by companies when direct migration to the top level is not considered feasible (Santana et al., 2008).

Box 7.4. **Principal requirements for companies listed in the special corporate governance segments of the BOVESPA market (São Paulo Stock Exchange), Brazil**

Novo Mercado

Transparency: Improvements in the disclosure of financial data, including quarterly statements with cash flow demonstration and consolidated statements, reviewed by an independent auditor. Present the annual financial statements in an internationally recognised standard (International Financial Reporting Standards or US Generally Accepted Accounting Principles). On a monthly basis, disclose information about the company's securities and its derivatives traded by the insiders and the controlling group. Whenever the contracts between the company and any related party exceed R$ 200 000, or one per cent of the company's net worth, in a 12-month period, the company must inform BOVESPA.

Corporate governance and shareholders' rights: Issue only voting shares. Give tag-along rights to all shareholders at the full price of the deal. Make a public tender offer at least at the economic value in case of delisting or cancellation of the Novo Mercado's contract with

Box 7.4. **Principal requirements for companies listed in the special corporate governance segments of the BOVESPA market (São Paulo Stock Exchange), Brazil** *(cont.)*

BOVESPA. The board of directors must have a minimum of five members, all with unified mandates of up to two years, and a minimum of 20 per cent of independent board members. Discuss through arbitration any shareholder-company dispute that arises related to the listing rules, the company bylaws, Corporate Law provisions, and other norms of the Brazilian capital market. The company also commits to maintain at least a 25-per cent free float.

Level 2

Requires companies to abide by all of the obligations set forth in the Novo Mercado regulations, with a few key exceptions. First, Level 2 companies retain the right to maintain existing preferred shares and issue new ones up to the level permitted by the law. These preferred shares enjoy tag-along rights at the minimum of 80 per cent of the price received by the selling controlling shareholder and are also entitled to voting rights in some key situations (such as company mergers and incorporations and contracts between the controlling shareholder and the company), provided they are voted in a general shareholders' meeting.

Level 1

Requires companies to become more transparent by disclosing additional information, such as more comprehensive financial statements (including quarterly statements with cash flow demonstration and consolidated statements, reviewed by an independent auditor). On a monthly basis, disclose information about the company's securities and their derivatives traded by the insiders and the controlling group. Whenever the contracts between the company and any related party exceed R$ 200 000, or one per cent of company's net worth in a 12-month period, the company must report the details to BOVESPA. Listed companies should also maintain, at least, a 25-per cent free float.

By 2002, BOVESPA had amended its mandatory listing rules to require that any new listings involving a public share offering must be registered, at a minimum, as Level 1.

Source: Santana et al. (2008).

Exchanges can also offer SMEs with a variety of services other than the venue for the trading of their securities. For instance, they can connect SMEs to different types of investors (such as angel investors, VC and private equity) and help them gain access to ancillary professional services, such as stakeholder coordination and management, due diligence and prospectus writing, investment case development, IPO roadshow support and financial PR and marketing services. The exchange can also connect companies to professional services such as accountants and legal advisors, which can increase the quality of their financial reporting, thus also supporting investors considering the investment in SMEs (Oliver Wyman, 2014).

Profile of firms

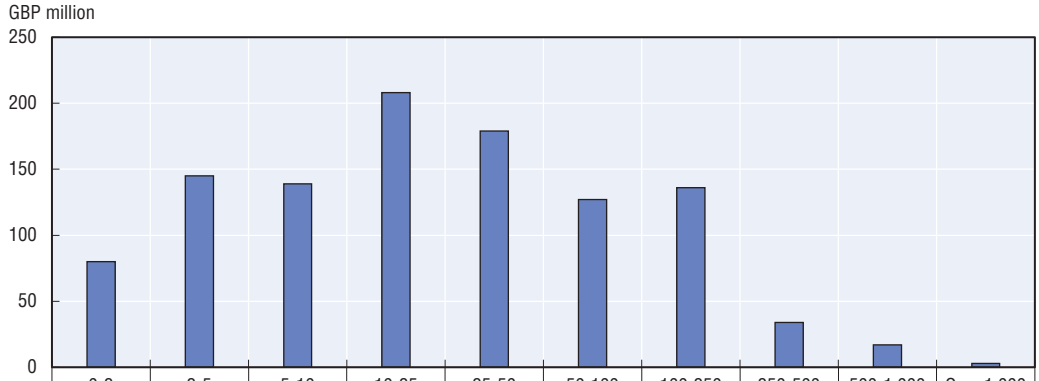
The major public equity markets in the world are dominated by large companies, partly because investors are attracted by their high volumes of tradable equity. These companies usually have highly structured governance and management systems with extensive disclosure, making them intelligible to market intermediaries, credit analysts

and investors. Indeed, while larger companies often obtain financing through the capital markets, smaller companies generally have difficulties accessing those markets. For SMEs, admission cost and listing requirements in main markets may be discouragingly high. Thus, even for the small number of SMEs that are suitable for listing, the rules that are imposed on the large companies are generally modified to allow more flexible listing criteria, eased disclosure requirements and comparatively low admission costs, although the costs for companies to list (USD 80 000-100 000) and remain listed on a platform (USD 100 000-120 000 per annum) remain typically high (Oliver Wyman, 2014).

Specialised exchanges can be particularly useful for fast growing and innovative SMEs. This subcategory of company often progresses rapidly through the life cycle, from start-up through the expansion phases. For this group of SMEs, exchanges serve both as a source of capital in the later phases of the growth cycle and as "exit vehicles" for successful SMEs at the end of the cycle. To take a stylised case, an entrepreneur with a new idea for a product would obtain funding from "family and friends" before advancing through several rounds of venture capital financing. At the end of the cycle all of the parties involved in the endeavour realise gains through an Initial Public Offering (IPO).

New markets generally cater to young, small and high-risk firms, whose market capitalization is significantly smaller than the average in main markets (Yoo, 2007). For instance, as of November 2014, on AIM, the large majority of listed companies (68.3%) had a market value of less than GBP 50 million. The most common market value (18.9% of listed companies) was in the range of GBP 10 million-GBP 25 million (Figure 7.7). For 21.1% of the companies the market value was greater than GBP 50 million, with a combined equity value of GBP 60.416.6 million (84.2% of the AIM companies' equity value).

Figure 7.7. **Alternative Investment Market (AIM): Distribution of companies by equity market value, November 2014**



	0-2	2-5	5-10	10-25	25-50	50-100	100-250	250-500	500-1 000	Over 1 000
Number	80	145	139	208	179	127	136	34	17	3
%	7.5	13.6	13.0	19.5	16.8	11.9	12.7	3.2	1.6	0.3

Source: Adapted from AIM statistics (*www.londonstockexchange.com/statistics/historic/aim/aim.htm*).

StatLink http://dx.doi.org/10.1787/888933292276

Historically, new markets have represented a source of equity financing for young high-tech companies. In fact, the prototypical model of an SME exchange was NASDAQ in the United States, founded in 1971, which was heavily weighted toward new and high technology companies, although it has then evolved into the listing place of choice for many of the largest companies in the world. Over time, most new markets have increasingly

diversified, in terms of size and sector of the listed firms, broadening participation to mid-caps and including more traditional sectors such as mining, oil, gas and real estate (Mendoza, 2008). In the case of Canada's TSX-V, the initial focus was on resource exploration junior companies, i.e., those whose assets, business and market capitalization were too small to be listed on the Toronto Stock Exchange (TSX), but over time it also came to include new high technology ventures.

Enabling factors

Listing in SME growth markets benefits in most cases from more flexible or somehow "lighter" regulations than main markets require. Nevertheless, there are numerous instances where rules and regulations may obstruct the flow of funding to SMEs. The right balance between administrative and regulatory burden and due diligence needs to be achieved such that the flexibility provided to SMEs does not result in weak investor protection or compromised integrity of market participants, weak corporate governance or insufficient transparency. The AIM model of Nominated Advisors and the Listing Sponsors of NYSE Alternext address this need (OECD, 2014c).

Furthermore, recent market practices may inhibit the development of SME equities. These include high-frequency trading and low cost trading execution, whereby information mining displaces fundamental investing and increases short-termism, by definition incompatible with SME listed shares (Weild et al., 2013; OECD, 2014f).

Difficulties facing SMEs seeking public equity financing are not limited to cost (admission fees, advisors and broker commissions), red tape and reporting requirements. Cultural factors and management practices also constitute challenges for SMEs. Lack of confidence to go through the offering process, fear of being exposed to share price volatility, aversion to sharing sensitive information but also lack of education around the process of listing and life after an IPO are important reasons for SME reluctance to join equity capital markets. In addition, entrepreneurs tend to be unwilling to relinquish ownership or control of their business or accept potential lock-in periods upon listing (OECD, 2014c). Evidence shows that the lack of an equity culture represents a greater impediment in Europe than in the US. For instance, in Germany, only 13.8% of the population invests directly (7.1%, 2013) or indirectly via funds (6.7%, 2013) in listed equity securities, compared with around 50% in the US (45% in 2008, ICI Survey/52% in 2014, Gallup Survey) (Schuller, 2014).

On the investor side of the market, the existence of well-functioning market-making systems[12] is instrumental to the fostering of SME markets, where information asymmetries lead to potentially high monitoring costs relative to the level of investment and low levels of liquidity act as an important deterrent to public investment in SME equities.

A lack of liquidity may be inherent to the SME asset class. In addition, the relative low volume of shares traded on new markets compared to main markets and the limited free float that small caps regularly offer (due to the retained stakes by management and owners) as well as buy-and-hold strategies limiting day-to-day trading are all problematic, particularly when seeking to attract institutional investors. SME exchanges typically have about 30% the liquidity of main markets. Hence, for small-cap stocks, capital to support liquidity, sales and equity research may be essential to sustain active markets (Weild et al., 2013; OECD, 2014c; Oliver Wyman, 2014). For instance, the NYSE Alternext model is based on a dual approach to trading, where investors can choose the preferred method depending on the company's liquidity (Box 7.5).

Box 7.5. **NYSE Alternext trading model**

NYSE Alternext is an equity trading market for SMEs that was launched in 2005 by the parent pan-European platform Euronext (now NYSE Euronext). The market is not a regulated market within the meaning of EU directives. It is a multilateral trading facility (MTF) operated under the Alternext name by the relevant market operator in Brussels, Lisbon and Paris. Companies that seek to be listed on Alternext have to choose a listing sponsor to assist them during the admissions procedure and guide them throughout their time of listing on Alternext. The listing sponsor is a company acting as an investment-services provider, audit firm, legal counsel or corporate finance specialist. It assesses a company's suitability for listing, participates in drafting the prospectus or offering circular, it coordinates the due diligence process and liaises with the regulator and/or the market operator of Alternext.

NYSE Alternext market model combines trading both on and off the Central Order Book to consider the liquidity profiles of SMEs and maximise order execution possibilities for investors.

The first method of trading is based on Liquidity Providers (LPs), who signs a commercial contract with NYSE Euronext, aims to provide simultaneous buying and selling prices in accordance with a minimum quantity, set as a number of shares or as a minimum capital amount, keeping within a maximum price spread. LPs act on behalf of the listed company and protect against changes in volatility, guarantee trades at all times at the best price, and increase the volume of trades in the Central Order Book.

The most liquid NYSE Alternext equities (which execute more than 2 500 trades per year) are traded the Central Order Book, i.e. they are traded continuously between 09:00 CET and 17:40 CET. There are also pre-opening (07:15-09:00 CET) and pre-closing (17:30-17:35 CET) phases, at which times orders can be entered, modified or cancelled in the Central Order Book, where they accumulate without being traded. There is also a Trading at Last (TAL) quoted price phase between 17:35-17:40 CET. All other equities are traded through a daily auction held at 15:30 CET. From 07:15-15:30 CET, orders accumulate in the order book but are not executable. Once the order accumulation period ends, buy and sell orders are centrally matched through an auction procedure to establish an auction price. This takes place at 15:30 CET. The auction price of a share is based on its reference price and is used as a basis for the following day's auction. The auction is followed by a 30 minutes Trading-at-Last phase (TAL), between 15:30 and 16:00 CET which allows trading at the auction's price only. Thereafter, orders are accumulated until the following day's auction.

Source: www.euronext.com/en/listings/nyse-alternext.

The taxation regime is also relevant for the development of SME listings. The absence of a level playing field between equity and debt financing, in terms of tax treatment, contributes to explain the limited development of SME public equity financing (OECD, 2014c).

Trends in SME public listings

It is estimated that at least 24 countries operate separate boards and exchanges aimed at SMEs. The most notable examples include the Alternative Investment Market (AIM) in the United Kingdom, NYSE Alternext in Europe (Brussels, Lisbon and Paris), KOSDAQ in Korea, TSX-Venture Exchange (TSX-V) in Canada and the Market of the high-growth and emerging stocks (Mothers) in Japan.

The currently established new markets mainly result from the last of several waves in SME listings development. In the late 1970s and early 1980s, new segments were created within national stock exchanges, according to the feeder principle. The quotation of technology-based small firms (TBSFs) was favoured by low entry requirements and low information standards. However, these early experiences were largely unsuccessful and did not survive the 1987 stock market crash. Most investors perceived that feeder markets quoted poorly-performing companies and preferred to wait the best ones to be promoted to the main market. Also, low reporting standards deterred foreign investors (Posner, 2004; Gadha et al., 2010).

In the 1990s, the wave of new markets marked a shift from the "feeder principle" to the "NASDAQ model", characterised by low listing requirements and high information standards, to offer security to investors (Gadha et al., 2010). However, most new markets opened during a period of high and rising valuation of technology stocks worldwide, which was followed by a steep, protracted fall since mid-2000 (Bottazzi and Da Rin, 2002). As a result of the intrinsic difficulties of SME exchanges and of the burst of the dot.com bubble, a large number of SME exchanges have been created which failed to attract sufficient companies for listing or to achieve sufficient trading to maintain active markets. This was the case of EASDAQ (European Association of Securities Dealers Automated Quotations), a European electronic securities exchange established in 1996 and headquartered in Brussels, trading stocks and shares across Europe independently from any national market. Founded originally as a European equivalent to NASDAQ, it was purchased by the American exchange in 2001 and became NASDAQ Europe. In 2003, it shut down operations as a result of the burst of the dot-com bubble.

In addition, according to Weild et al. (2013), SME equity trading has been negatively affected by the emerging listing models, characterised by the reduction in "tick size" (i.e. the minimum increment in which prices can change) and bankable spreads, due to the rapid proliferation of electronically posted orders from electronic communication networks, crossing networks and other alternative trading systems. The ability of market makers to earn a profit on capital deployed is necessary to support smaller company stocks that trade episodically, rather than continuously, and require constant support through marketing and capital commitment. In a comparative study of 26 jurisdictions over 1996-2006, Weild et al., (2013) find that countries with higher than average tick sizes as a percentage of share price in smaller stocks, such as Australia and Canada, have significantly increased their relative ranking in the number of small IPOs that are under USD 50 million in proceeds. The United States, which has low tick sizes as a percentage of share price, has fallen from the first place for small IPOs in 1996-2000 to twelfth place in 2001-06. Also, the recent decline in equity research and inactive secondary markets for small cap offerings imply that only those institutional investors that command a special expertise in the relevant industry sector are likely to participate (OECD, 2014c).

Especially in Europe, equity capital markets remain fragmented and not highly attractive to SMEs and mid-caps, with low levels of cross-border investment. Nevertheless, despite undisputable efficiencies that are to be gained by standardising and unifying regional markets, the existence of separate platforms might have strong merits in terms of financial stability and risk management ("fail-safe mechanisms"), which are increasingly important in today's interconnected financial system (OECD, 2014c).

Over the last decade, several SME listings have been launched in emerging economies. This reflects the general growth of stock markets in non-OECD countries since the 2000s.

According to Ernst&Young (2012), stock market capitalization in non-OECD economies more than doubled from 2000 to 2007 as a share of GDP, after hovering around 20%-25% of GDP for most of the 1990s. From late 2007, the global recession caused a sharp correction in emerging markets' share prices that continued through 2008. There was recovery in 2009 and 2010 and since then the collective capitalization ratio for developing markets has been hovering at just under 40%. As a result, since the beginning of 2000s, the share of emerging markets in the global stock market capitalization has risen from 7% to approximately 30% in 2012.

In emerging economies, public equity exchanges for SMEs are increasingly seen as a tool to foster innovative entrepreneurship, in line with national growth strategies. For instance, in South Africa, Alt-X, a public equity exchange for SMEs, was launched in 2003, as a feeder for the Johannesburg Stock Exchange (JSE) Main Board, replacing the failed venture capital and development capital boards established in the 1980s. The purpose was to encourage entrepreneurship, especially among South Africa's emerging black middle class (Gstraunthaler, 2010).

SME listings have found fertile environment in Asian emerging economies in particular (Table 7.5). SME boards under the stock exchange, along the model of AIM in the UK, have been recently established in Malaysia, Singapore and Thailand. In China, the Shenzhen Stock Exchange has developed a three-tier market venue, comprising the Main Board, the SME Board (in May 2004), and ChiNext, a high-tech venture board (in October 2009), in line with national economic strategies. In these new markets, as of the end of 2012, more than 1 000 firms were listed with a market capitalization of USD 594 billion. In Hong Kong, the Growth Enterprise Market (GEM) is an alternative stock market for high-growth enterprises, operated by the Stock Exchange. India has recently developed dedicated stock exchanges for SMEs, following the recommendation of the Prime Minister's Task Force in June 2010. The Bombay Stock Exchange (BSE) launched the SME Exchange in March 2012 and it had 82 listed SMEs as of December 2014. The National Stock Exchange of India also launched in 2012 an SME platform, EMERGE, intended for fast growing companies with good governance standards, whose small size does not allow their listing on the main board (ADB and OECD, 2014).

Table 7.5. **SME equity markets in selected Asian countries**

Market type				Market capitalization		
Country	Market	Exchange	Established	No. of listed/ registered companies	USD (million)	Year of data
China	SME Board	SZSE	2004	701	456 482	2012
	ChiNext	SZSE	2009	355	138 371	2012
Korea	KOSDAQ	KRX	1987	1 005	96 871	2012
India	SME Platform	BSE	2012	22	188.8	2013 (April)
	EMERGE	NSE	2012	3	..	2013 (April)
Malaysia	ACE	Bursa Malaysia	2009	112	2,244	2012
Philippines	SME Board	PSE	2001	2	14	2012
Thailand	mai	SET	1998	81	4 280	2012
Viet Nam	UPCoM	HNX	2009	132	1 386	2012

BSE = Bombay Stock Exchange, HNX = Hanoi Stock Exchange, KOSDAQ = Korean Securities Dealers Automated Quotations, KRX = Korea Exchange, mai = Market for Alternative Investments, NSE = National Stock Exchange, PSE = Philippine Stock Exchange, SET = Stock Exchange of Thailand, SZSE = Shenzhen Stock Exchange.
Source: ADB (2013).

Policies to support the development of SME public listings

There is a role for policymakers to create a conducive environment for small cap and SME equity research, brokers, sales, ratings and specialised SME banks. It is important for policymakers to incentivise market participants in a way that diverts them from short-termism and competition based on price of trade execution, which inhibit the development of SME markets. Pure for-profit models for growth platforms can have perverse incentives and cannot ensure sustained capacity to bring SMEs to the market and, equally importantly, support them in the aftermarket (OECD, 2014c).

In this regard, according to Weild et al. (2013), the declining trend in trading spreads and tick sizes in all stocks should be reversed. While this may have reduced transaction costs for investors, it has generated disincentives for intermediaries of small caps, undermining the infrastructure and services required to support their development. One-size-fits-all stock market structures harm SME listings, which are typically less liquid than large cap stocks and require broker-dealers to support liquidity, sales and equity research.

Recent regulatory approaches recognise that SME platforms may require tailored regulation and infrastructure, to facilitate access by SMEs while preserving investors' interest. This is the approach followed by the European Commission with the Markets in Financial Instruments Directive (MiFID) II, adopted by the European Parliament and the Council in 2014. The Directive amends existing provisions on authorisation, conduct of business and organisational requirements for providers of investment services, with the aim to strengthening the protection of investors. It also specifies requirements in relation to the authorisation and the organisational rules applicable to different types of trading venues, among them a new type of trading venue, designed to cater specifically for SME issuers.

In some countries, government policies address the lack of liquidity in SME equity markets through measures that foster retail investment. The US JOBS Act helps improve access to funds by creating more room in the retail investor space, by moving the threshold level at which public disclosure and related requirements kick in, from 500 or fewer investors to 2000 or fewer. The change allows more scope for certain types of private investment funds to advertise and attract retail clients without having to register as public investment companies.

In order to help reduce the cost of capital for growth businesses over the medium to long term, and increase liquidity, in the UK, from April 2014, Stamp Duty and the Stamp Duty Reserve Tax (SDRT) are no longer chargeable on transactions in eligible securities on London Stock Exchange's AIM and High Growth Segment. In addition, in the UK, the Enterprise Investment Scheme, launched in 2012, provides tax breaks for investment in non-quoted companies, which may subsequently list.

While it is a common view among policy makers, market practitioners and SMEs that a bias exists in the tax treatment of debt against equity (e.g. tax deductibility of interest across the board), views differ over the effectiveness of tax breaks as a means to resolve the issue of suboptimal investment in SME equities in the long run, as they would not address the structural cost disadvantages of small size deals (OECD, 2014c).

In some countries the new market and the government provide services aimed at nurturing young enterprises that are or will be listed on the market, such as promoting institutional investment, boosting the visibility of listed firms, and raising public

awareness of alternative investments (Yoo, 2007). In Canada, TSX-V helps SMEs go public through the Capital Pool Company (CPC) program, which provides an alternative, two-step introduction to the capital markets (Box 7.6).

Box 7.6. **Capital Pool Company (CPC) program, TSX Venture Exchange, Canada**

The Capital Pool Company (CPC) program at TSX Venture Exchange provides a unique listing vehicle to experienced investors and growth-oriented entrepreneurs. The program introduces investors with financial market experience to entrepreneurs whose growth and development-stage companies require capital and public company management expertise. Unlike a traditional IPO, the CPC program enables seasoned directors and officers to form a Capital Pool Company with no assets other than cash and no commercial operations, list it on TSX Venture Exchange, and raise a pool of capital. The CPC then uses these funds to seek out an investment opportunity in a growing business. Within 24 months, the CPC identifies an appropriate business as its "qualifying transaction" and issues a news release to announce that it has entered an agreement in principle to acquire the business. Once the CPC has completed its "qualifying transaction" and acquired an operating company which meets the Exchange listing requirements, its shares continue trading as a regular listing on the Exchange.

The CPC program provides an alternative route to accessing capital that allows company founders to retain a higher ownership than through a traditional IPO, and public companies benefit from greater visibility, stock options and M&A currency for acquisitions via share issuance.

The program applies especially to companies that are in a too early stage for a broadly distributed regular IPO, when venture capital financing is not viable or the management prefers not to use it, or when market appears to reward growth business of the target company's sector.

Source: www.tmx.com/cpc.

Notes

1. For a review of definitions by selected venture capital associations, see OECD (2014b).
2. Private equity funds are structured as closed-end investment vehicles. They are permitted to raise capital commitments only for a limited period (typically 12 to 18 months), after which the fund may not accept additional investor commitments.
3. Based on a large sample of young high technology firms in Silicon Valley, Hellmann and Puri (2002) show that venture capital backed companies are more likely and faster to bring in outsiders as CEOs. These CEO replacements are often accompanied with the founder departing from the company.
4. See Poterba (1989), Gompers and Lerner (2001), Da Rin et al. (2006), Achleitner et al. (2011), among others.
5. There are no standard international definitions of venture capital investments and their breakdown by stage of development. Furthermore, the methodology for data collection differs across countries. The figures presented result from re-aggregation to fit the OECD classification of venture capital by stages. See OECD (2014b) for details.
6. See *www.vigo.fi*.
7. See *http://impactinvest.se*.
8. It is however to be noted that BAs often invest in multiple ways at the same time, as individual angel investor, through groups or networks. Also, these wealthy individuals have often multiple non-angel investments, through other financing vehicles and in more mature companies (OECD, 2011a).

9. See *www.eban.org*.

10. A public market is one that is open to the general investing public while a private market is restricted to a narrower class of professional investors or high net worth individual.

11. In this section the expression "exchange" is used to mean a system in which equity can be listed and traded under a formal set of rules. Originally, exchanges were conceived as physical places for trading that set rules for listing by companies and rules for trading for investors and intermediaries (brokers, dealers, investment bankers, etc.). At this time, most trading takes place without an exchange floor. In a later stage of development it became possible to trade equities on a multiplicity of electronic systems (or platforms), each with its own trading rules. Eventually equity could be listed on a particular exchange but trading might take place on other platforms.

12. The US Securities and Exchange Commission defines a "market maker" as a firm that stands ready to buy and sell stocks on a regular and continuous basis at a publicly quoted price. By providing sufficient liquidity, market makers reduce volatility in prices and maintain a "fair and orderly market" for stocks.

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Glossary of key terms

Back-end incentives

Incentives that are proportional to an investment's capital gains, including capital gains tax provisions, rollover and carry-forward of gains or losses. See also *Front-end incentives*.

Business Angel

A private investor who provides both finance and business expertise to an *investee* company in exchange for ownership equity. Business Angels typically participate at an early stage of a firm's life. Business Angels are considered to be informal investors who, unlike venture capitalists, typically do not manage the pooled money of others through a professionally-managed fund. However, angel investors are increasingly organising themselves into angel networks or angel groups to share research and pool their own investment capital.

Business Angel Network

An organisation whose aim is to facilitate the matching of entrepreneurs (looking for financing) with business angels.

Buy-and-hold investors

An investor who buys and holds assets for a long period of time, regardless of fluctuations in the market. An investor who employs a buy-and-hold strategy may actively selects assets, but once in a position, is not concerned with short-term price movements and technical indicators.

Buy-Out

A transaction in which private equity capital is used to acquire a private or public company from the current shareholders. After buyout, the purchased firm usually becomes a private company. Buyouts include a number of specific types of investments, including management buyout (MBO), management buy-in (MBI), institutional buyout (IBO) and leveraged buyout (LBO).

Buyout Fund

A Private Equity fund whose strategy is to acquire other businesses.

Deal Flow

The total number of investment opportunities available to a Venture Capital firm.

Debt Financing

Capital provided to a firm with an obligation that it be paid back. It includes a wide variety of financing such as loans from individuals, banks, or other financial institutions; selling bonds, notes or other debt instruments; and other forms of credit such as leasing or credit cards. The lender gains no equity position in the firm and the borrower's obligation is to repay the debt, usually with interest.

Development Capital

See Expansion Capital.

Due Diligence

Process of evaluation of a project by a potential investor based on material facts. For private equity professionals, due diligence can apply either narrowly to the process of verifying the data presented in a business plan/sales memorandum, or broadly to complete the investigation and analytical process that precedes a commitment to invest. The purpose is to determine the attractiveness, risks and issues regarding a transaction with a potential investee company. Due diligence should enable fund managers to realise an effective decision process and optimise the deal terms.

Early Stage

General term applied to all the firm life's stages prior to the *expansion stage*. Thus, it includes the pre-seed, seed and start-up stages of a business. While a firm may enter the expansion phase at an earlier date, the early stage is usually considered to be the first 3 to 5 years of the firm's life. Firms with a growth objective normally require financing during this stage.

Early-Stage Fund

A venture capital fund focused on investing in companies in the early part of their lives, prior to the *Expansion Stage*.

Equity

Ownership interest in a company, represented by the shares issued to investors.

Equity Financing

Financial resources that are provided to firms in return for an ownership interest. Equity investors have no guarantee that any specific amount of money will be returned. Rather, their return on investment will be determined by the success of the firm. They may sell their shares in the firm, if a market exists or they may get a share of the proceeds if the firm is sold. The large category of equity finance is sub-divided into *Public Equity* and *Private Equity*.

Equity-related debt

Convertible debt or bonds with equity warrant are a type of bond that the holder can convert into shares of the company or cash of equal value, at an agreed-upon price and up to a specified expiration date.

Exit Stage

The stage at which Venture Capital, Business Angel or other private equity investors liquidate their holdings in a *portfolio company*. Methods of exiting an investment include: trade sale, sale by public offering (including *IPO*), write-offs, sale to another equity investor or sale to a financial institution.

Expansion Capital

Financing provided for the growth and expansion of a company, which may or may not be operating profitably. The capital may be used to fund market or product development, finance increased production capacity or provide additional working capital. Also called *Development Capital*.

Expansion Stage

Stage at which the firm is producing and selling products or services, while seeking to expand output of products and/or services and to increase revenues. Usually, at this stage, operating revenues are not sufficient to fund the expansion and thus the firm seeks financing through formal and informal risk capital and/or debt. Normally a firm is in operation for 3 years before the expansion stage.

Family Office

An office that provides services to one (i.e. Single-family office) or several families (i.e. Multi-family office). Services can range from investment management and advice, accounting, tax and financial advice to educational planning or concierge services.

Front-end incentives

Incentives that are proportional to the amount invested, including capital gains tax provisions, rollover and carry-forward of gains or losses. See also *Back-end incentives*.

General Partner

A partner in a private equity management company who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.

Grace Period

The period in a term loan when no principal repayments are made. Thus, in a 5 year term loan with 2 years grace, principal repayments begin in the third year.

High Growth Enterprise

All enterprises with average annualised growth in employees greater than 20% per annum over a three year period and with 10 or more employees in the beginning of the observation period.

Initial public Offering (IPO)

The sale or distribution of a company's shares to the public for the first time. An IPO of the investee company's shares is one the ways in which a private equity fund can exit from an investment.

IPO candidate

A company that is suitable for an IPO.

Innovative firm

A firm that has introduced a product, process, marketing or organizational innovation, according to definitions of the *Oslo Manual*.

Investee Company

The company or entity into which an equity investment is made, whether from a Venture Capital fund, a Business Angel or other informal capital. Also known as *Portfolio Company*.

Junior debt

A class of debt that, in the event of liquidation, is subordinate to another class of debt issued by the same debtor, but ranks ahead of equity investors Junior debt is more risky for an investor to own, but it pays a higher rate of interest than debt with greater security. See also *Senior debt*.

Late Stage

Late or Later Stage is a term used loosely by different organisations to refer to various types of investing in mature firms including spin-outs of operating divisions, expansion, turnaround, replacement capital and buyout.

Leverage

The amount of debt used by a firm to finance its assets. A firm with significantly more debt than equity is considered to be highly leveraged. Also, the use of various financial instruments or borrowed capital to increase the potential return of an investment.

Leveraged Buy-Out (LBO)

An acquisition of a company (or single assets like a real estate), where the purchase is financed through a combination of equity and debt and in which the cash flows or assets of the target are used to secure and repay the debt. A significant share of the equity of the company is replaced by debt, which usually has a lower cost of capital than the equity. The Principal vehicle for LBOs is the LBO association, which is organised as a private investment partnership. The general partners organise the buyout and also monitor management. The limited partners, typically institutional investors (insurance companies, pension funds and money management funds), provide most of the equity capital. The limited partners along with banks provide most of the debt financing, which typically constitutes 80-90% of the deal.

Limited Partner

An investor in a limited partnership (i.e. mezzanine, venture or private equity fund).

Limited Partnership

The legal structure used by most venture and private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the management

firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). The general partner receives a management fee and a percentage of the profits. The limited partners receive income, capital gains, and tax benefits. The general partner (management firm) manages the partnership using policy laid down in a Partnership Agreement. The agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.

Market capitalization

A company's outstanding shares multiplied by its share price.

Mezzanine finance

A combination of debt and equity financing. The investor in a mezzanine facility accepts more risk than a provider of a senior loan and normally receives a higher return. Common forms of mezzanine finance include subordinated loans, participating loans, and equity-related mezzanine instruments such as convertible bonds and bonds with warrants. A mezzanine facility usually contains more than one of these instruments. Mezzanine finance is often used as expansion capital.

Participating loan

A special form of loan, by which the investor receives a payment linked to the profits or turnover of the company in which the investment is made. Fixed interest payments can be also included in the contract.

Payment in Kind (PIK)

A feature of a security permitting the issuer to pay dividends or interest in the form of additional securities of the same class, i.e. a financial instrument that pays interest or dividends to investors of bonds, notes or preferred stock with additional debt or equity instead of cash.

Portfolio Company

See Investee Company.

Preferred shares/stock

Shares which have preference over ordinary shares, including priority in receipt of dividends and upon liquidation. In some cases these shares also have redemption rights, preferential voting rights, and rights of conversion into ordinary shares. Venture capitalists generally make investments in the form of convertible preference shares.

Pre-Seed Stage

The earliest stage in the development of a business idea. At this stage, an idea is born and a business plan may be in development but no concrete steps have been taken to set up a business. The term pre-seed is often associated with efforts to commercialise research.

Private Equity

Capital provided to private companies, whose shares are not freely tradable in any public stock market, in return for ownership equity. The term applies to provision of equity capital

across the entire cycle from seed financing to buyouts. Thus, Private Equity is used both for early and expansion stage financing of young, developing firms and for *Buyout* of mature firms.

Private Equity Fund

A vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies. These are generally private companies whose shares are not quoted on a stock exchange. The fund can take the form of either a company or an unincorporated arrangement such as a Limited Partnership.

Prudential rules

Bank regulation intended to reduce the level of risk to which bank creditors are exposed, that is, to protect depositors and reduce systemic risk.

Public Equity

Equity investments made in companies whose shares are quoted in some form of stock exchange. Normally, public equity investors make hands-off purchases of shares in these listed companies. The investors are not involved in providing advice or otherwise assisting the owners or managers in the development of the firm.

Risk Capital

Private equity capital provided by investors to firms in pre-seed, seed, start-up and expansion stages. It includes investments from both formal (Venture Capital) and informal (Business Angels or individuals) sources, but does not include any debt finance.

Security

Enforceable claim or lien created by a security agreement, or by the operation of law, that secures the fulfilment of a pledge. A lender or obligee has a security interest in the collateral provided by a borrower or obligor to guaranty timely payment of a debt or performance of an obligation. An asset pledged to guarantee the repayment of a loan, satisfaction of an obligation, or in compliance of an agreement. Security gives a lender or obligee a legal right of access to the pledged asset and to take their possession and title in case of default for a foreclosure sale.

Seed Stage

A development phase when founders require financing to conduct research, develop products and explore market potential. This is prior to start-up and also prior to entry into entrepreneurship. The future business entity is beginning to take shape but founders have not yet established commercial operations.

Seed-stage finance

Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.

Senior debt

A debt that has higher priority compared to another in the event of liquidation of the debtor. That is, in the event of financial difficulties or liquidation of the borrower's assets,

holders of senior debt will have a priority claim. Because senior debt has a relatively secure claim, it is less risky from the point of view of the lender and it pays a lower rate of interest compared with debt of the same issuer having a subordinate claim. See also *Straight debt* and *Junior debt*.

Short Term Debt Financing

Short Term Debt Financing applies to money needed for the day-today operations of the business, such as purchasing inventory, supplies, or paying the wages of employees. Short term financing is referred to as an operating loan or short term loan because scheduled repayment takes place in less than one year. A line of credit is an example of short term debt financing.

Sophisticated investor

An investor recognised by a third party as someone who is sufficiently knowledgeable to understand the risks involved with investing in an unquoted company. The individual has already made previous investments and has a long history of investing in a range of financial instruments.

Start-Up

Discrete event that is synonymous with the enterprise birth. This is the point at which the firm becomes an operating enterprise.

Start-up Stage

While the start-up or birth of a firm takes place at a point in time or during a limited period of time, the start-up stage is considered to cover a period in the early-stage life of a firm. During this stage, the firm has begun operations and is paying salaries but product development work may still be under way and sales and revenues may be zero. In the start-up stage, a firm often requires capital for activities such as product development and initial marketing. The start-up stage begins with the *enterprise birth* and extends through to the start of the expansion stage. As such, there is no universally-accepted period of time associated with the start-up stage.

Straight debt

Straight debt does not include any features other than payment of interest and repayment of principal, i.e. it cannot be converted into another asset, and bank claims have high priority in cases of bankruptcy. See also *Senior debt*.

Subordinated debt

Loans or bonds in which the lender agrees that senior or secured creditors will be fully paid before any interest or principal is paid.

Venture Capital

Equity capital provided through formal, organised professionally-managed funds to co-finance, with the founder or entrepreneur, an *Early Stage* or *Expansion Stage* venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment. The Venture Capitalists supply not only financing but also expertise in

the form of domain knowledge, business contacts and strategic advice. Venture Capital is a subset of private equity.

Venture Capital Fund

Generally a private partnerships or closely-held corporation that pools money from private and public pension funds, endowment funds, foundations, corporations and wealthy individuals, to provide equity investment for young, rapidly growing companies that have the potential to develop into significant economic contributors.

Warrants

Type of security usually issued together with a loan, a bond or preferred stock. Warrants are also known as stock-purchase warrants or subscription warrants, and allows an investor to buy ordinary shares at a pre-determined price.

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