Financing alternatives for SMEs

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The collapse of bank financing has had a disproportionately negative impact on SMEs. Given persistent difficulties securing bank credit, development of alternative forms of direct financing for SMEs is imperative.

The drought in bank credit will not be short-lived, making it imperative for SMEs to tap alternative sources of financing, through either debt or equity markets. Debt financing options range from commercial paper or bond issuance, securitization of loans, or creation of investment funds to invest in SME debt. However, these SME debt-financing options would need to overcome investor risk perceptions, illiquidity, high costs to the issuer, and regulatory barriers. Equity finance could be channeled through the already existing Alternative Investment Market (MaB), which could potentially provide a lower cost equity option to SME issuers, among other benefits, such as brand image and diversification. For this to be the case, MaB's existing shortcomings and current negative dynamics will have to be addressed over time.

One of the most significant characteristics of the current crisis in Spain is the collapse of bank financing. The most recent data on loans for productive activities published by the Bank of Spain (funding of non-financial companies) reveal a further acceleration in the fall of the amount of outstanding lending to companies, with a YoY decline of 7.2% in November. Even without knowing the breakdown of this figure by company size, it would not be wrong to say that it is small and medium-sized enterprises (SMEs) which are most affected by this dysfunction on the part of banks. The situation of SMEs is further aggravated due to their lack of recourse to alternative sources of funding.

Paragraph 27 of the July 2012 Memorandum of Understanding associated with the bank bailout requires the government of Spain to prepare proposals for strengthening non-bank financial intermediation. This is a logical requirement if we consider that the SMEs' financial weakness stands in contrast to their contribution to job creation and generation of value added: in the European Union, SMEs (including microenterprises) generate more than 50% of value added, and more than 60% of jobs, but only receive 10% of financial flows. Since the drought in bank financing will not be short-lived, the development of direct financing mechanisms, in the form of both equity and debt, becomes an imperative. In this article we analyze various alternatives to bank financing of SMEs, through either debt or equity. In some cases, such as the *Mercado Alternativo Bursátil* (MaB-Alternative Investment Market), a financing channel for small and mid-cap companies, despite its defects and shortcomings, already exists. The other possibilities analyzed are not yet developed in Spain, but as in the case of corporate bond funds have shown their virtues in other markets such as the UK.

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Debt financing

In general, the instruments of disintermediation (direct issue of commercial paper or bonds) for SMEs face two basic problems. The first is investor distrust of the risk of default, together with the disadvantage of the security's lack of liquidity. The second problem is the total cost to the company of the debt instrument, which tends to be high because it includes not only the investor's return, but also the structuring costs and underwriting commission. The fixed costs of issuance are hardly affordable for small issues, of less than 5 million euros.

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Moreover, if a bank undertakes to place the issue among its deposit customers, it assumes a reputational risk in case of non-payment by the company receiving the funds, risk that financial institutions can hardly afford in the current circumstances. The level of reputational risk assumed by the underwriter, high in any case, will also depend on the complexity of the product and on whether other agents participate in the process, whether it be the National Securities Market Commission (CNMV in Spanish) if the placement is retail, or the rating agency which analyses the issuer's credit quality.

Securitization of loans

The securitization of loans allows a bundle of illiquid financial assets to be transformed into a series of negotiable instruments, which are liquid and have specific payment flows. The securitization of loans to SMEs would be an innovation inasmuch as securitization in Spain has been focused on mortgage lending. Securitization does not affect the companies whose loans are securitized and, therefore, does not translate into a diversification of the company's sources of funding. However, the securitization of loans to companies would provide financial institutions with the liquidity to finance new loans to SMEs.

In general, rating agencies play a key role in the securitization process. The securities issued in each tranche of the fund must have one or more credit ratings from different agencies. The rating agencies also have a decisive role in designing the structure of the tranches of the fund with regard to priority in the absorption of losses.

The securities issued would be discountable at the European Central Bank (ECB), provided that they meet the following conditions:

- Rating by two agencies.
- AAA rating at the time of issuance.
- Minimum rating of A during the life of the bond.

The rating of the different tranches of the securitization fund would take account of the characteristics of the loans (sectoral diversification, geographical dispersion, profile of companies) and the additional collateral. The more granular the portfolio of securitized loans with regard to debtors (average amount), sectors of activity and geographic area, the better the rating will be.

However, for the financial institution to remove the securitized loans from its balance sheet (and transfer the corresponding risks for the purposes of capital consumption), it must have sold at least 80% of the initial loss tranches, and 50% of the intermediate risk tranches[2], requirements that may not be easy to fulfill.

For the investor who acquires the securities, one of the main drawbacks is the restricted liquidity of these assets. The conditions for investing in this product would be comparable to those of a fixed term deposit, with a penalty for early redemption. The retail investor's perception of risk can be mitigated by the transparency provided by CNMV supervision and the requirement for reports from independent third parties to evaluate the price of the issue.

Another element providing confidence to the retail investor is that, in the majority of securitizations by Spanish banks, the originator (the institution conceding the securitized loans) continues to administer them. In order to increase the attractiveness to investors, the provision of guarantees can be arranged. The use of government guarantees for securitization funds is currently limited to the FTPYME funds[3], these are closed funds with a specific deadline for applications that were created in 2010 and 2011.

Also, the securitization funds could incorporate guarantees from mutual guarantee companies (SGR in Spanish), but they would only cover the individual loans to the borrowing companies. Inasmuch as the SGR guarantee may increase the company's financing cost, it would be convenient to determine the positive effect on the rating of the securitized loans.

Issue of securities directly by the company

As can be seen in Table 1, regular issuance of bonds by Spanish non-financial companies is limited mainly to large companies in the energy, telecommunications and infrastructure sectors.

Theoretically, Spanish SMEs could issue bonds directly if they comply with the requirements of the Securities Market Law. If the nominal individual value of the debt instrument is less than 100,000 euros, the issue is considered a "public offering" and requires a prospectus approved by the CNMV. If the offering is classified as public, the administrative burden for the company is high: the issuer assumes obligations of corporate governance and information (relevant facts, annual corporate governance report).

The following aspects should be considered with respect to the limitations on the SME segment with regard to direct issues of bonds.

- It is not mandatory for the issue to be rated, although this facilitates the approval of the price (interest rate) by the CNMV. A rating of better than B- is usually only awarded to companies of a significant size (sales > 500 million euros, EBITDA > 70 million euros). For a medium-sized company (sales < 500 million euros), a rating above B- would only be possible with very low debt levels. Therefore, an issue by an SME will be unrated or will have a very low rating.

- The reputational risk of the underwriter with an investor will be high. In rated issues, as it is a third party which provides an opinion on the credit quality of the issuer, the risk is mitigated, but the low rating that an SME can expect to achieve may have an adverse effect.

- In terms of the yield that the security should offer investors, on which the CNMV will have to deliver its opinion if it is a public offering, we estimate that, at present, it should be between 10% and 15% depending on the company's credit quality, and at a term of less than two years.

[2] As set out in the BoS Circulars 4/2004 and 3/2008.

[3] Bonds issued by funds under the FTPYME program, administered by the Ministry of Industry, Energy and Tourism, and the Ministry of Economy and Competitiveness, are backed by a State guarantee on condition that the financial institutions that contribute their assets reinvest at least 80% of the liquidity obtained in new loans to SMEs.

Table 1

Public Issues of bonds by Spanish non-financial companies in 2011 and 2012

Issuer	Date Emission	Maturity	Amount € Million	Coupon %
IBERDROLA FINANZAS SAU	10-feb-11	10-feb-14	750	3.88
TELEFONICA EMISIONES SAU	7-feb-11	7-feb-17	1,420	4.75
GAS NATURAL CAPITAL	9-feb-11	9-feb-17	600	5.63
RED ELECTRICA FIN SA UNI	18-feb-11	16-feb-18	600	4.75
OBRASCON HUARTE LAIN SA	30-mar-11	15-mar-18	425	8.75
IBERDROLA FINANZAS SAU	7-abr-11	7-abr-17	750	4.63
PESCANOVA SA	20-abr-11	20-abr-17	180	5.13
RED ELECTRICA FIN SA UNI	29-abr-11	29-abr-20	550	4.88
GAS NATURAL CAPITAL	24-may-11	24-may-19	500	5.38
AMADEUS CAP MARKT	15-jul-11	15-jul-16	750	4.88
IBERDROLA FINANZAS SAU	25-oct-11	25-ene-16	1,000	4.75
TELEFONICA EMISIONES SAU	3-nov-11	3-feb-16	1,000	4.97
REPSOL INTL FINANCE	12-dic-11	12-feb-16	850	4.25
REPSOL INTL FINANCE	19-ene-12	19-feb-19	750	4.88
GAS NATURAL CAPITAL	13-feb-12	13-feb-18	750	5.00
REPSOL INTL FINANCE	7-feb-12	19-feb-19	250	4.88
TELEFONICA EMISIONES SAU	21-feb-12	21-feb-18	1,500	4.80
IBERDROLA INTL BV	11-abr-12	11-oct-18	1,000	4.25
TELEFONICA EMISIONES SAU	19-sep-12	5-sep-17	1,000	5.81
GAS NATURAL CAPITAL	25-sep-12	27-ene-20	800	6.00
IBERDROLA INTL BV	21-sep-12	21-sep-17	1,000	4.50
RED ELECTRICA FIN SA UNI	4-oct-12	16-feb-18	150	4.75
ENAGAS FINANCIACIONES SA	5-oct-12	5-oct-17	500	4.25
TELEFONICA EMISIONES SAU	19-oct-12	20-ene-20	1200	4.71
GAS NATURAL CAPITAL	23-oct-12	24-abr-17	500	4.13
ENAGAS FINANCIACIONES SA	22-oct-12	5-oct-17	250	4.25
IBERDROLA INTL BV	22-oct-12	11-oct-18	400	4.25
ABERTIS INFRAESTRUCTURAS	25-oct-12	25-oct-19	750	4.75
Total 2011			**9,375**	**4.94**
Total 2012			**10,800**	**4.82**

Source: Bloomberg.

- In terms of cost to the issuer, this nominal return would be increased by the underwriting commission and the costs of issuance. For medium-size businesses with a good financial situation, the cost of bonds may exceed that obtainable on bank financing. In this case, the appeal of the bond for the company is not the cost, but the diversification of funding sources and the direct access to investors.

The issuance of bonds of multiple companies would allow "packaged" marketing. In this case, the bonds to be sold would be issued by companies of similar credit quality, and the bonds would be grouped into portfolios with a limited composition (for example, four or more bonds).

As we have indicated, the main drawback for the marketer of uncovered company bond issues is the reputational risk in the event of default. One way to avoid the reputational risk is to issue the bond with the explicit guarantee of the underwriting financial institution. The investor will have a double guarantee: the issuing company and the underwriting financial institution. The advantage for the financial institution is a lower risk-weighting for the guarantee in RWAs (75% *vs* 100%); in turn, the financial institution would charge the company for the guarantee. Once the investor becomes familiar with the product and the company has demonstrated its ability and willingness to pay the investor, it may be possible for the company to issue bonds regularly without the financial institution's guarantee.

The Government has announced its intention of promoting the creation of an alternative fixed income market, where commercial paper and bonds can be traded, though given the issue sizes required for the cost of issuance not to be prohibitively expensive and the minimal or non-existent liquidity that the securities would have, it is not realistic to consider issues of SME securities as a feasible alternative to bank financing.

Debt Funds

Another alternative to boost the financing of SMEs would be the creation of investment funds investing in SME debt, and benefiting from tax advantages, as occurs with venture capital funds.

Current Spanish legislation does not allow collective investment institutions (CII) to make large-scale investments in debt instruments not traded in markets, as they cannot invest more than 10% of their equity in unlisted securities. In addition, hedge funds must meet liquidity requirements, which do not allow them to invest in unlisted corporate loans. Similarly, venture capital entities must have 60% of their eligible investment assets in equity or quasi-equity instruments.

Therefore, in order to promote the use of debt funds, the government would need to introduce legislative changes, for which there are basically two options. Firstly, the creation of *ad-hoc* legislation for debt funds, which could take the form of legislation very similar to that existing for venture capital (Law 25/2005 of November 24th, regulating venture capital entities). The quickest solution could be to allow debt funds within venture capital funds, by modifying their "Investment regime" (chapter II of Law 25/2005), incorporating ordinary loans as an investment instrument alongside equity loans and capital. The constitution of the debt fund and its managing company would need to be authorised by the CNMV.

The existence of tax advantages for debt funds (like those for venture capital) would be important to encourage use of the instrument.

The aim of the new regulation would be to maximize the participation of private investors. Initially, the participation of public investors may be necessary to provide confidence in the instrument. This has been the model of the Business Finance Partnership (BFP) in the UK. In an initial phase, it would be desirable to limit retail investment by stipulating a minimum investment of 100,000 euros, accessible to family offices and private banking clients.

The investor's remuneration from debt funds could occur much earlier than with venture capital funds, because the loans accrue and pay interest, and moreover they have a schedule of partial amortizations. It would not be necessary, therefore, to wait for disinvestment in the company, as happens with venture capital funds. The establishment of a specified amortization profile in debt funds would help to enhance confidence in the instrument.

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The debt fund would be managed by the venture capital managers, who will seek registration as managers of debt funds. Management fees for debt funds should be lower than those for venture capital funds, as these include a success fee based on the capital gains.

The loans in debt funds could be guaranteed by mutual guarantee companies to further reduce the risk for investors.

Equity finance: The *Mercado Alternativo Bursátil* (MaB - Alternative Investment Market)

As a complement to the debt instruments already discussed, the MaB offers SMEs a way to raise equity. The MaB's segment for growing companies began to function in 2009. As Cano[4] correctly points out, the MaB is not an official secondary market under the Securities Market Act, but rather a multilateral trading system. Hence it is not affected by some of the requirements for initial public offerings (IPOs), and the responsibility for establishing effective monitoring mechanisms and supervisory procedures lies with the coordinating entity, in this case *Bolsas y Mercados Españoles* (BME), while the CNMV has the power to impose penalties for non-compliance that could be regarded as breaches of conduct.

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Therefore, due to these less onerous requirements, which should result in lower costs of market access and maintenance, this type of market (known as an "alternative" or junior market) is aimed at small cap companies seeking to finance their growth. Nevertheless, it is true that not all the companies joining the MaB have raised new funding, and companies in their document of incorporation into the market also express other motivations, such as achieving visibility, a higher profile and brand image, diversification of funding sources, broadening the shareholder base, possibility of carrying out business operations using shares as a form of payment, and others.

Its development since then has probably been slower than expected. During the first year, two companies were listed (Zinkia Entertainment and Imaginarium, the toy distribution chain). In 2010 there were 10 listings, an increase that raised great hopes for the development of this market.

[4] Cano, David (2008): "El AIM británico y el Alternext francés como referencias para el MAB EE español". *Análisis Financiero Internacional*, no. 132. Ediciones Empresa Global (Escuela de Finanzas Aplicadas). Madrid.

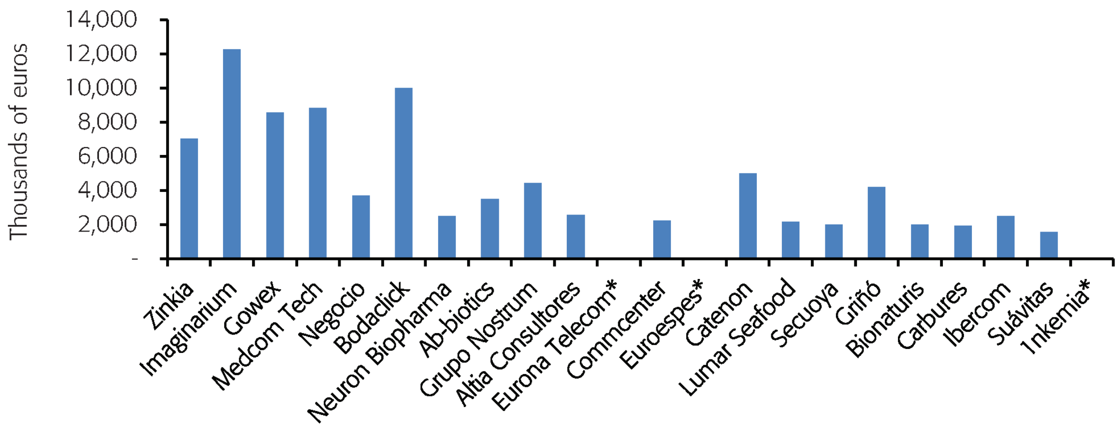
However, in both 2011 and 2012 there were five listings, which raised 13.4 million euros and 8.5 million euros of new funding in each respective year. This has lowered expectations, at least until there is a general revival of new issues markets, because it is true that similar operations in the main market have also reduced significantly in the 2009-2012 period when the two markets have coexisted. There are currently 22 companies listed (though two are suspended due to their delicate financial situation), which have raised a total of almost 90 million euros on the MaB.

However, what has been evident is that the MaB has provided a window for additional funding for companies that are already listed. In fact, during 2012 six companies (AB Biotics, Eurona Wireless Telecom, Medcom Tech, Carbures Europe, Secuoya and Let´s Gowex) have increased their capital by a total of 40 million euros, the most notable being telecommunications carrier Let's Gowex with an increase of 18 million euros.

How does MaB's performance compare to those of other international markets? Although MaB has many counterparts around the world, which moreover have proliferated in recent years, it has two clear precedents in the UK's Alternative Investment Market (AIM), where 1,096 companies of were listed as of last December 31st, and Alternext with headquarters in Paris (although it brings together the stock exchanges of Amsterdam, Brussels, Lisbon and Paris) with 180 companies listed at year end. Such figures are very far removed from the Spanish market, though it should be borne in mind that the British market was launched in 1995 and the French one 10 years later, with the consequent advantage of the prolonged period of economic growth that preceded the current crisis. For example, as many as 1,694 companies were listed on AIM at the end of 2007, 55% more than at present. The performance of these markets in 2012, in terms of the number of new issues, has been inferior to the previous year, as has happened in the case of Spain. Alternext, for example, saw 14 new entries to the market (compared to 34 in 2011), of which only eight were new issuances, while the rest were transfers from other markets[5], either from Euronext or from Free Market. The funds raised by these new issuances were 37 million euros[6]. In the case of AIM, 71 companies were admitted in 2012 (90 in 2011) raising new funds of 3.1 billion pounds,

Exhibit 1

New funds raised by IPO´s on the *Mercado Alternativo Bursátil* (2009-2012)



* These members did not raise new funds in IPOs.

Sources: Afi, BME.

a stratospheric amount is compared to the Spanish market, but for AIM it was the lowest since 2004.

What does the MaB need to become a real funding alternative for Spanish medium-size companies? "Time" would be a general and immediate response. More specifically, drawing on Afi's experience as a Registered Adviser[7] in this market since its birth, we believe that it has entered into a vicious spiral whose origin is complicated to discern. On the one hand, there is a lack of appetite on the part of the institutional investor for this type of company, which has progressively reduced the average size of new issuance (as can be seen clearly in the above graph), not because the needs or expectations of the companies floated were not higher, but because they have not found sufficient demand. This has led to a relative increase of initial public offering (IPO) costs. In fact, compared with the initial estimate of costs ranging between 8-10%, the most recent new issuances have greatly exceeded this figure being, on average, closer to 15-18%, which in turn has deterred a significant number of companies from opting for this financing alternative, and those turning to this market in recent months have been those with a pressing need for which they found no other alternative.

[5] In the Spanish market, the transfer from the main market to MaB is a long and costly process, as it is necessary to make a delisting tender offer and subsequently a new share issue.

[6] In reality, the total funds raised were of 1.52 billion euros, but one, corresponding to the Brazilian bank Banco Pactual BTG, raised 1.48 billion euros, so for comparison purposes we eliminated it to avoid distortions.

[7] The role of the Registered Adviser is characteristic of this kind of stock market. His main task is to help companies comply with the information requirements, both in the IPO process and subsequently during the phase of listing on the secondary market. Afi was the Registered Adviser of Zinkia Entertainment in its IPO on the MaB.