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FINANCING GAP FOR SMES AND THE MEZZANINE CAPITAL

Abstract

Mezzanine capital is a hybrid instrument which combines the benefits of debt and equity and represents an alternative source in financing the start-up and expansion of SMEs.

The paper analyzes the mezzanine financing instruments that include private placement instruments (private mezzanine) and capital market instruments (public mezzanine) and the level of development in the market for mezzanine financing that varies across Europe: while SMEs in some countries can choose from a wide range of different products, other countries still have ground to make up in this area.

Taking into consideration the financing gap of the SMEs in EU, the mezzanine capital represent an important option for covering this gap. This instrument should be considered in the context of the international financial crisis which affects dramatically the possibilities of financing for the SMEs. Thus, the paper presents the main features and advantages offered by this hybrid financing instrument from the firms and investors' perspective but also the main challenges.

Keywords: *financing, SMEs, mezzanine capital, gap, equity, debt, EU*

I. INTRODUCTION

SMEs are key players for the development of local and regional communities being at the heart of the Lisbon Strategy, whose main objective is to turn Europe into the most competitive and dynamic knowledge-based economy in the world.

SMEs offer special advantages that generate some unique contributions to the economy such as: SMEs create an important part of the new generated jobs and therefore contribute to the reduction of unemployment and poverty. As well, SMEs are considered main actors for industrial growth (Acs, Carlsson, Thurik, 1996), (Thurik, 1996), (Nooteboom, 1994); SMEs add dynamism and flexibility to business activity and improve economic performance; SMEs are considered a source of considerable innovative activity and contribute to the development of entrepreneurship (Johnson and Cathcart, 1979), to the increase of competitiveness (Song and Parry, 1997).

The ability of SMEs to grow depends highly on their potential to invest in restructuring, innovation and qualification. But all of these investments need capital and therefore access to finance.

However, access to finance often remains one of the key factors in setting up and developing SMEs. Thus, despite specific global efforts to strengthen the SME sector, these

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businesses face a number of financial and regulatory barriers, particularly in developing and emerging countries (Newberry, 2006). In the same time, the SMEs are the emerging private sector in developing countries and form the base for private sector-led growth (Hallberg, 2000). It is also recognized that these actors in the economy may be underserved, especially in terms of finance (Beck, 2007), (Ayyagari, Demirgüç-Kunt, Maksimovic, 2006), (Berger and Udell, 2005).

Financing is necessary to help the SMEs to set up and expand their operations, develop new products, and invest in new staff or production facilities. But the motivations and criteria of different funding parties vary according both to the type of product presented and the level risk linked to it. Also, for the entrepreneurs, it is important to understand that all forms of finance do not have the same aims.

Many small businesses start out as an idea from one or two people, who in general, invest their own money. At a next stage, the developing SMEs need new investment to expand or innovate. At this moment, the SMEs begin to face the financing problems, because the access to financing resources (banks, capital markets or other suppliers of credits) is more difficult than in a case of larger enterprises.

At present the firms have to face the increasing competition, difficult economic conditions and an increasing need for major investments. Moreover, the effects of the international financial crisis become more and more obvious and in these circumstances, even the well managed and highly profitable businesses have limited options for financing growth or strengthening their equity resources. Therefore, alternative forms of financing such as *mezzanine capital* are becoming more and more a supplement to the traditional forms of corporate financing for SMEs (Brokamp, Hollasch, Lehmann, Meyer, 2004). It typically involves a mix of debt and equity financing, which allows investors to achieve gains through capital appreciation and interests on debt-repayment.

Mezzanine finance is not new, it has been developed for more than two decades. In the 1980's, the business was dominated by insurance companies and savings and loan associations. By the 1990's, limited partnerships (LPs) had entered the arena. Today, investors include pension funds, hedge funds, leveraged public funds, LPs and insurance companies, as well as banks that have established standalone mezzanine efforts (Silbernagel and Vaitkunas, 2006).

II. ACCESSING FINANCE - A PRESENT PROBLEM FOR SME

The difficulties that SMEs encounter when trying to access financing can be due to an incomplete range of financial products and services, regulatory rigidities or gaps in the legal framework, lack of information on both the bank’s and the SME’s side. Banks may avoid providing financing to certain types of SMEs, in particular, start ups and very young firms that typically lack sufficient collateral, or firms whose activities offer the possibilities of high returns but at a substantial risk of loss. In addition, SMEs often have a weak equity position, which is further undermined by the late payment culture in Europe. In fact, depending on the country, SMEs have to wait between 20 and over 100 days on average to get their invoices paid and accordingly to the statistics, one out of four insolvencies is due to late payment (EU, 2008).

In fact, one fundamental problem in dealing with the SME financing gap is lack of basic information about just how big such a gap may be. Often the only evidence is in the form of complaints from SMEs themselves and this is difficult to use for analysis or comparison. Moreover, the definition of an SME varies between countries and financial institutions, some only compile figures by size of loan and some do not keep regular statistics of SME lending at all.

SMEs tend by their very nature to show a far more volatile pattern of growth and earnings, with greater fluctuations, than larger companies. Their survival rate is lower than for larger companies – for instance, manufacturing firms with fewer than 20 employees are five times more likely to fail in a given year than larger firms (OECD, 2006). Thus, SMEs are at a particularly severe disadvantage when trying to obtain financing relative to larger and more established firms. It can also be difficult for potential creditors or investors to distinguish the financial situation of the company from that of its owners.

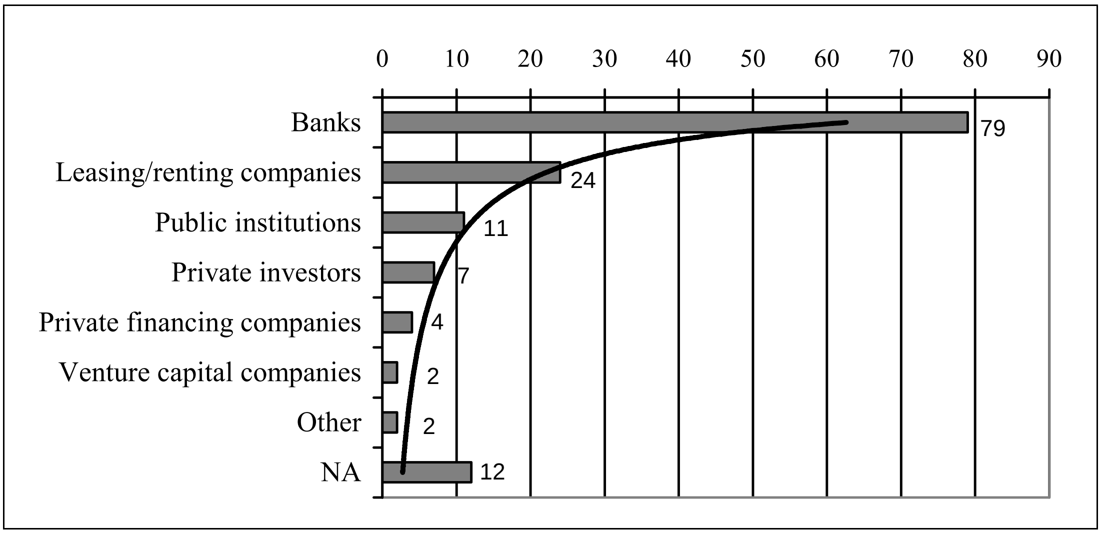
Therefore, there is a very different set of financial circumstances faced by banks when dealing with large well-established firms, so the whole risk assessment is different. Banks and other traditional sources of credit may decide that SMEs represent a greater risk than larger companies, and respond by charging higher interest rates. This makes it more difficult for SMEs to borrow than for bigger companies, and may make it effectively impossible for many SMEs to borrow money because the price of credit is too high.

If entrepreneurs cannot gain access to finance through the regular system, they may not start up a business or simply go out of business which means a potential loss to the economy. But the other danger is that they will abandon the formal system altogether and operate in the informal economy, sidestepping taxes and regulations, and thus not making a full contribution to economic growth and job creation.

In most EU countries, commercial banks are the main source of finance for SMEs (Figure 1), so if the SME sector is to flourish it must have access to bank credit.

Figure 1.

Sources of financing for EU SMEs



Source: European Commission, SME Access to Finance", Flash Eurobarometer 174, EOS Gallup Europe October 2005

Countries have launched a number of programs to use public funds to facilitate SME lending, and the available official surveys suggest that banks' efforts to develop the SME market, supported in some cases by a moderate amount of government guarantees, have resulted in a situation where a large share of SMEs have access to bank financing.

Nonetheless, EU governments are convinced that there are still enough instances of market failure in SME finance to justify focused government intervention.

On the other side, the banks replaced their traditional risk assessment models with new techniques to distinguish high-risk and low-risk SME borrowers, and to identify those likely to expand and survive. Banks are also altering the nature of their products, with an increasing proportion of their revenue coming from fees for services rather than interest on loans, which favors lending to entities such as SMEs. But the new financial crisis imposes new restriction in bank financing and the SMEs are one of the most affected by this situation.

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

The characteristics of the banking system in emerging markets frequently inhibit SME lending. Many banks are state-owned, their credit may be allocated on the basis of government guarantees or in line with government targeting to develop specific sectors. Often banks are subject to ceilings on the interest rates they can charge, which make it difficult to price credit in a way that reflects the risk of lending to SMEs.

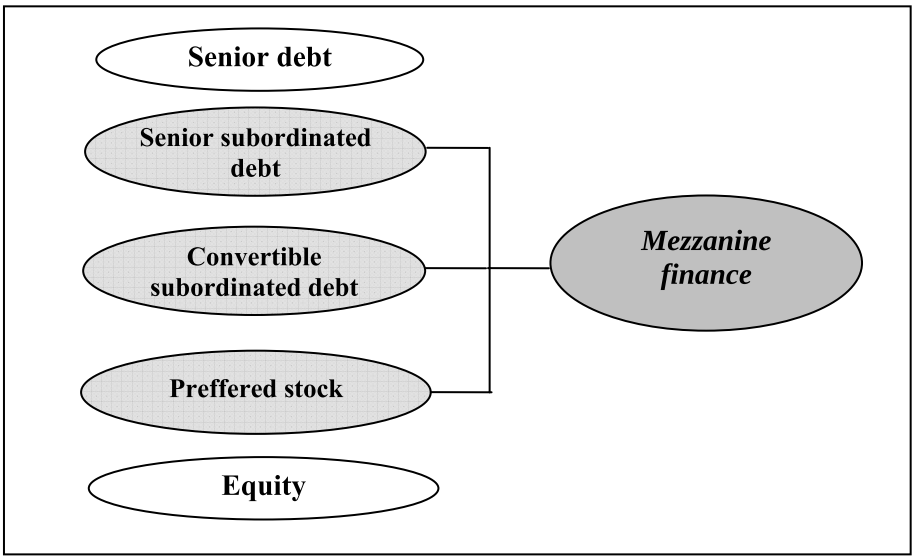
Therefore, the SMEs have to find new financing alternatives and the new hybrid instruments and mezzanine finance could be one of these.

III. MEZZANINE FINANCE INSTRUMENTS AS ALTERNATIVE FOR SMES FINANCING

Mezzanine finance is a collective term for hybrid forms of finance which forms a bridge between the two main types of finance: senior debt and pure equity financing (figure nr. 2).

Figure 2.

Mezzanine finance – filling the gap between senior debt and equity



Source: Silbernagel, C., Vaitkunas, D., Mezzanine Finance, Bond Capital, Jan. 2006

Structurally mezzanine capital is subordinated in priority of payment to senior debt, but senior to common stock or equity used to fund a growth opportunity, such as an acquision, new product line, new distribution channel or plant expansion (Silbernagel and Vaitkunas, 2006).

The gap in funding between senior debt and equity is common for the following reasons:

- accounts receivable, inventories and fixed assets are being discounted at greater rates than in the past for fear that their values will not be realized in the future;
- many balance sheets contain significant intangible assets;
- as a result of defaults and regulatory pressure, banks have placed ceilings on the amount of total debt a company can obtain.

Additional liquidity can be obtained from equity investors but equity is one of the most expensive source of capital. Besides, equity capital, by its nature, dilutes existing shareholders. As a result, mezzanine capital can be an attractive alternative way to get the needed capital and it can be helpful in financing the start-up, expansion of SMEs, innovation and business transfers.

The requirements for mezzanine financing for firms are the followings:

- insufficient/unaivable possibilities for funding from own resources or loans;
- healthy financial position, stable cash flows and steady profit growth;
- focused business strategy and long-term development prospects;
- appropriate finance and accounting function, open information policy.

The most important mezzanine financing instruments include private placement instruments (private mezzanine) and capital market instruments (public mezzanine) (Figure 3).

The private placement instruments are the followings:

- *subordinated loans (junior debt)* are the most common form of mezzanine financing and they are unsecured loans with a lower ranking in case of bankruptcy compared to senior debt;
- *participating loans* are normal loans, but rather than being fixed, their remuneration is contingent upon the results of the business;
- the *"silent" participation* - the distinguishing feature of this form of financing is that one or more persons take an equity stake in a company, but without assuming any liability to the company's creditors.

The capital market instruments (public mezzanine) are the followings:

- *profit participation rights* are equity investments under company law that entitle the holder to rights over the company's assets but not to the right to be consulted on business decisions.
- *convertible bonds.* In addition to the usual right to fixed interest payments and repayment of principal, holders of *convertible bonds* have the right to acquire shares or other equity instruments of the company instead of accepting repayment of the bond.
- *convertible bond with warrants*, when the warrants (subscription rights) are separate from the bond and can therefore be traded separately.

A common feature of these various mezzanine financing instruments is that they can be structured flexibly in many different forms, and combined in almost any way desired, in order to provide tailor-made solutions for the specific financing requirements of private and listed companies. (Credit Suisse, 2006).

For the SMEs, mezzanine finance instruments have been gaining in importance but remain little used compared to classic loan financing. In general, the option of mixed financing including subordinated mezzanine loans enables financing to be undertaken in situations which would not be possible using traditional financing instruments. But in these circumstances, should be taken into consideration the advantages and disadvantages of the mezzanine financing instruments.

Mezzanine finance products usually have the following positive features:

- ❖ improves the balance sheet structure;
- ❖ offer a better access to additional loans or equity (leverage effect);
- ❖ greater entrepreneurial freedom for the company and limited right of mezzanine investor to be consulted. SMEs can retain control over the company and avoid surrendering ownership rights, using the appropriate form of mezzanine finance;
- ❖ strengthens economic equity capital without the need to dilute equity holdings;
- ❖ stability of financing given its long-term availability;
- ❖ offer tax-deductible interest payments and flexible remuneration structure;
- ❖ flexible structure: flexible terms to better match borrower requirements and business risks; financing with little concern for collateral; long term, fixed rate structure;
- ❖ it can be a very useful financial tool in the cases of business expansion, business transfer, innovation and public to private transactions.

From the investors' perspective, mezzanine financing have also some advantages, as follows: access to a new investment segment; returns similar to those on equity; investment platform independent of stock and bond markets; optimal opportunities for diversification; lower exit risk and better protection of capital compared with private equity investments.

But mezzanine finance provides also some challenges for SMEs:

- ❖ the understanding of mezzanine finance by SMEs is limited: SMEs are often not aware of the opportunities and the requirements;
- ❖ mezzanine finance is often difficult to obtain by small firms because there are more stringent transparency requirements to meet in order to obtain this type of finance;
- ❖ mezzanine finance is more expensive than debt financing;
- ❖ the interest component and the debt-like characteristics of mezzanine finance make it difficult for suppliers of mezzanine finance to small firms to arrange an early exit;
- ❖ mezzanine finance is in principle unsecured. The level of control by the finance provider is dependent on the mezzanine product chosen and this gives SME owners the option to retain control of the company, which is one of their main concerns;
- ❖ in contrast to equity capital, mezzanine funds are generally made available for a limited period of time, until the business can generate sufficient "genuine" equity capital from retained profits;
- ❖ this form of financing is not appropriate for particular types of company and business phases such as financing restructurings; the companies with a weak market position and negative development prospects; with inadequate finance and accounting function; with high leverage, low equity resources.

There are also few disadvantages of mezzanine finance for investors such as: the difficulty to exit early and the wrong assessment of creditworthiness leads to lower returns. Besides, the mezzanine provider cannot rely on real security in making an investment decision because mezzanine capital is subordinated and unsecured.

IV. EVOLUTIONS ON THE EUROPEAN MEZZANINE FINANCE MARKET FOR SME

The European mezzanine finance market has shown considerable growth over the past decade. Traditionally, commercial mezzanine finance has been used as a (short-term) bridging loan. Nowadays, it is increasingly used as an instrument to improve the balance sheet structure and in cases of transfer of ownership, business succession and company expansion.

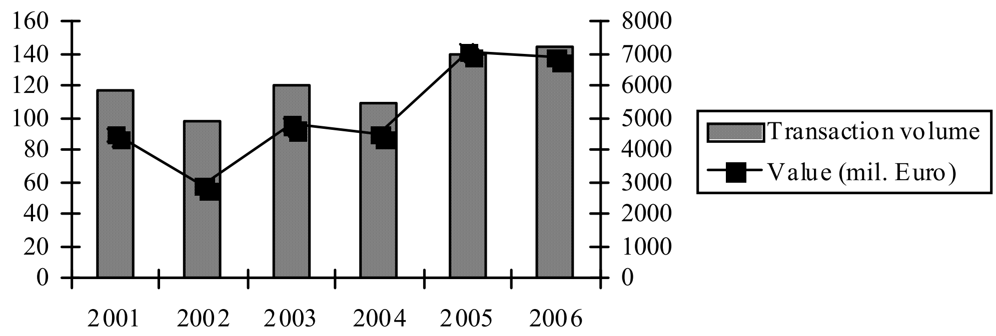
A major factor influencing the development has been the growing number of management-buy-ins, management-buy-outs, mergers and acquisitions. Other driving forces have been competitive pressures on traditional lending rates and the growing demand for tailor-made products.

Despite the growing importance of mezzanine finance for financial institutions and SMEs, statistical data is incomplete and rather vague due to the unclear definition of "mezzanine finance" but some development trends can be observed (figure 3).

The level of development in the market for mezzanine financing varies across Europe, especially where SMEs are concerned. While SMEs in some countries can choose from a wide range of different products, other countries still have ground to make up in this area. For instance, 50% of mezzanine finance is invested in the UK and Ireland but its share in continental Europe is rising (Suhlrie, 2005).

Figure 3.

Evolutions of Mezzanine finance market



Source: Mezzanine Monitor: Mezzanine investors pause for breath?, Private equity Europe, Issue 76, Q1 May 2006

But mezzanine transactions usually involve larger companies and larger deals; access to mezzanine finance for SMEs has been very limited so far.

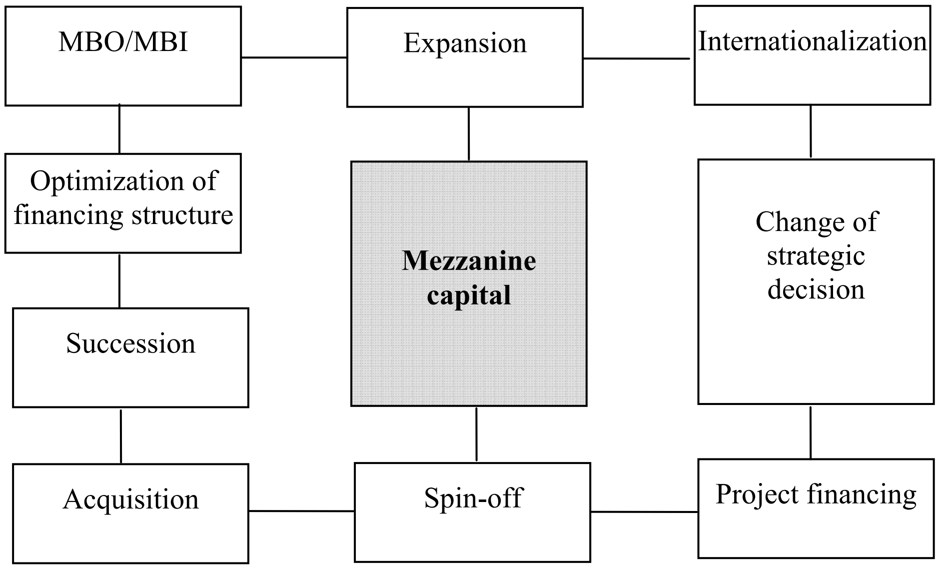
Also it should be taken into consideration that mezzanine capital can be used in a wide range of situations and business phases (figure 4). Therefore, this applies first to the financing of start-ups or early-stage companies. But mezzanine capital can be used in a wide range of situations, particularly given the fact that the purpose is not specified in the financing agreement. Thus, companies have the greatest possible degree of flexibility in terms of how they use the subordinated mezzanine capital as a complement to traditional loan financing.

In terms of a company's development phase, the focus of mezzanine finance is on financing growth and expansion projects, and in particular management buyouts or management buyins in the context of company succession arrangements or spin-offs of parts of the business (figure 4).

Mezzanine capital is a particularly suitable financing solution for such cases, since the management team normally does not have sufficient security available to satisfy the requirements for traditional loan financing. But hybrid forms of financing can also be employed in less dynamic periods (maturity phase) in order to optimize the financing mix.

Figure 4.

Situations of using mezzanine capital



Source: Credit Suisse, Factsheet CSA Mezzanine, 2006

Bridge loans and refinancing are also suitable for the use of mezzanine capital. In these business phases, mezzanine financing constitutes a valuable addition to classic debt and equity financing, and represents an attractive option for companies with appropriate cash flows and growth prospects. Also, qualitative factors such as the track record and quality of the management, as well as appropriate accounting systems, play an important part in the investment decision. As a result, established businesses with stable, healthy cash flows and the prospect of long-term positive business development are the prime candidates for mezzanine financing.

On the other side, the mezzanine is unsuitable for financing restructurings or turnarounds as cash flows are usually volatile during these phases and difficult to forecast; for companies with a weak market position and negative development prospects; with inadequate finance and accounting function, with high leverage or low equity resources.

Some closely held companies, particularly those that are family controlled, are reluctant to consider mezzanine financing because it requires relinquishing a certain amount of ownership. In fact, a typical mezzanine transaction has the mezzanine fund as a minority equity holder, with buyout terms to remove the mezzanine fund at the appropriate time. It is also important for a business owner to analyze the difference in value between an ownership interest in a stagnant or underperforming business and an ownership in a growing company. Moreover, having mezzanine debt in place actually can help a company secure more total capital and avoid the small business pitfall of being under capitalized.

CONCLUSIONS

Mezzanine loans are a hybrid form of financing which by definition combine characteristics of equity and debt. As the third form of growth capital alongside private equity and venture capital, mezzanine provides economic capital (subordinated capital with equity characteristics). Mezzanine loans therefore enable smaller and medium-sized companies with a good and promising earnings position to obtain finance for expansion, a management buyout or succession. Therefore, this financing instrument should gain a better position in the capital structure of the SMEs.

In order to improve the mezzanine financing for SME, supplementary measures and actions should be taken by the European Commission and the member states.

The EU public support such as the Competitiveness and Innovation Framework Programme (CIP), provides over €1 billion to support SMEs' access to finance. Moreover, by 2013, Cohesion Policy will provide some €27 billion explicitly dedicated to the support of SMEs and around €10 billion will be contributed through financial engineering measures, including JEREMIE and some €3.1 billion through venture capital. The European Agricultural Fund for Rural Development also benefits SMEs as it promotes, among other things, entrepreneurship and encourages the economic diversification of rural areas (EC, SBA, 2008).

The following measures should be taken in EU member states (EC, 2007):

- ❖ Member States should encourage the expansion of the market for mezzanine finance. They should avoid crowding out private financing and support schemes from public;
- ❖ Member States should their tax systems and to address existing disincentives for private investors to provide finance to SMEs directly (e.g. business angels) or indirectly (investments funds);
- ❖ Member States should consider the possibilities for a more neutral taxation of the different forms of financing including hybrid products;
- ❖ More transparency by banks regarding the criteria used for the classification of mezzanine products could help SMEs choose the appropriate mezzanine finance;
- ❖ Introduction of some simplified products within programs and increased transparency by SMEs could help the development of the mezzanine finance market;
- ❖ Public promotional financial institutions are encouraged to develop programs which improve SMEs' access to mezzanine finance. Such programs have to be in line with the existing state aid regulations and should foster the development of the market for mezzanine finance products.

Besides, as recognition of the role of SMEs for economic growth, European Commission elaborated in June 20008 a new law: „Small Business Act for Europe" (SBA) which creates a new environment for the development of these firms in EU. The main objective of the SMA is to define principles and measures in order to improve the environment of the European SMEs, taking into consideration their diversity.

A special attention is paid to the principle which regards the access of the SMEs to financing sources (especially, venture capital, micro-credits and mezzanine finance) and the development of a simulative legal and business environment. Concerning mezzanine finance and venture capital the Small Business Act should give priority to "down sizing" which would mean giving access to these instruments also to smaller enterprises. Also, the programs on mezzanine and venture finance should not be solely concentrated on innovation but should also support the financing of business.

Accordingly with the SBA, the member states are also invited to: develop financing programs that address the funding gap between €100 000 and €1 million; tackle the regulatory and tax obstacles that prevent venture capital funds operating in the Single Market from investing on the same terms as domestic funds; ensure that the taxation of corporate profits encourages investment; make full use of funding available in cohesion policy programs and the European Agricultural Fund for Rural Development, in support of SMEs.

Despite the favorable trends registered last years and the new European support initiatives, the context generated by the international financial crisis is not an optimistic one and this adds new concerns regarding the access to financing sources for SMEs. Therefore, the market for commercial mezzanine finance, expressed in numbers of SMEs, is expected to remain relatively small.

Possible market failures in SME finance provision must be identified and corrected to further develop the European risk capital markets, to improve SMEs' access to micro-credit and mezzanine finance and to develop new products and services. Furthermore, many entrepreneurs need guidance and education on the advantages and disadvantages of different forms of finance and on how to best present their investment projects to potential financiers.

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FINANCIJSKI JAZ ZA MALA I SREDNJA PODUZEĆA I MEZZANINE KAPITAL

SAŽETAK

Mezzanine kapital je hibridni instrument koji kombinira koristi duga i kapitala i predstavlja alternativni izvor za financiranje osnivanja i širenja malog i srednjeg poduzetništva.

Rad analizira instrumente mezzanine financiranja koji uključuju instrumente privatnog plasmana (privatni mezzanine) i instrumente tržišta kapitala (javni mezzanine), kao i stupanj razvoja tržišta za mezzanine financiranje koji se razlikuje diljem Europe: dok mala i srednja poduzeća u nekim zemljama mogu birati iz široke ponude raznih proizvoda, druge zemlje na tom polju još uvijek imaju puno prostora za poboljšanja.

Uzimajući u obzir financijski jaz malog i srednjeg poduzetništva u EU, mezzanine kapital predstavlja važnu opciju za pokrivanje deficita. Taj bi se instrument trebao razmatrati u kontekstu međunarodne financijske krize koja dramatično utječe na mogućnosti financiranja malog i srednjeg poduzetništva. Stoga ovaj rad predstavlja glavne čimbenike i prednosti koje nudi ovakav hibridni financijski instrument s gledišta tvrtki i investitora, kao i glavne izazove koje donosi.

Ključne riječi: *financiranje, malo i srednje poduzetništvo, mezzanine kapital, jaz, kapital, dug, EU.*