Investment

Essentials

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Financing SMEs: looking for the magic potion

by

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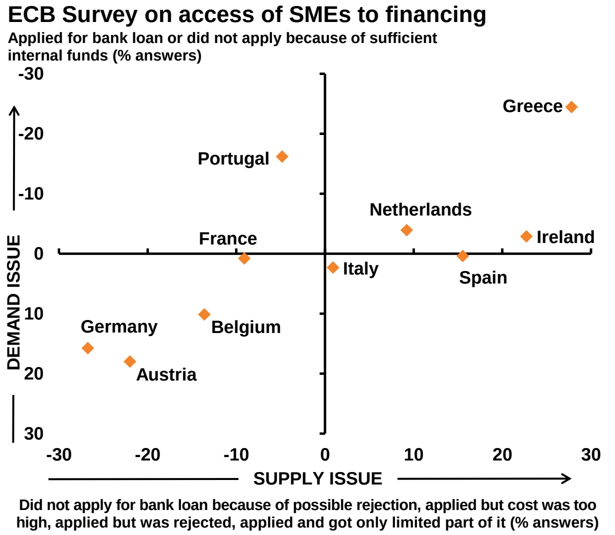
Exhibit 1

Credit to SMEs: a problem of supply and demand



Source: ECB, AXA IM Research

Note: The zero level represents the simple average of sampled countries

Key points

- Small and medium enterprises (SMEs) have suffered from both changes in regulation (Basel III) and a 'flight to quality' of European banks since the crisis.
- While they account for a dominant share of jobs and wealth creation, their financing conditions have deteriorated markedly, in both absolute and relative terms, compared to larger firms.
- We review the different solutions currently being discussed or implemented, from public initiatives and alternative investors to market-based financing and securitisation.
- All of these solutions have merit but none will be sufficient on its own: pursuing all of them at the same time seems necessary.

The transmission mechanism song

If there is one 2013 summer hit in European economic circles, it certainly is the "transmission mechanism" tune. For many observers, including yours truly, the impaired channelling of easy monetary policy to the private sector in peripheral countries has become the greatest threat to recovery in the euro area.

The main casualties are small and medium enterprises (SMEs),[1] usually more risky borrowers, for which evidence of a severe credit crunch is building. In this article, we seek to give a detailed and nuanced analysis of the problem of SME financing in Europe. We elaborate on possible solutions, drawing from recent initiatives and proposals, related to supporting bank intermediation and strengthening alternative market-based financing.

nonfinancial corporations in the euro area was down 5%yoy in June and the flow of new loans has been negative since December 2011. But one could argue that this outcome is a reflection of both supply and demand: in a recessionary environment, firms are less willing to increase leverage. A better way of disentangling supply and demand factors is to use the ECB survey on SME access to finance. This data shows that in some countries (France, Portugal), demand issues are stronger than supply issues, while the reverse is true in others (Spain, Ireland) and both are equally at play in Greece (*Exhibit 1*).

Another way of looking at the question is to measure the lending rate premium for small companies compared to large ones (proxied with the size of the loan). **This premium was around 40-80bps in 2007 in all European countries,**

Exhibit 2
In Europe, "small is plentiful"

	Share of enterprise's				Share of employment				Share of value added			
# Employees	**0-9**	**10-49**	**50-249**	**250+**	**0-9**	**10-49**	**50-249**	**250+**	**0-9**	**10-49**	**50-249**	**250+**
Germany	83%	14%	2.6%	0.5%	19%	23%	21%	37%	15%	18%	21%	46%
France	93%	6%	0.9%	0.2%	28%	20%	16%	36%	26%	17%	15%	41%
Italy	95%	5%	0.5%	0.1%	46%	21%	12%	20%	29%	23%	16%	32%
Spain	94%	5%	0.7%	0.1%	40%	21%	14%	25%	28%	21%	17%	34%
UK	89%	9%	1.5%	0.4%	20%	19%	15%	46%	19%	15%	16%	50%

Source: European Commission & AXA IM Research

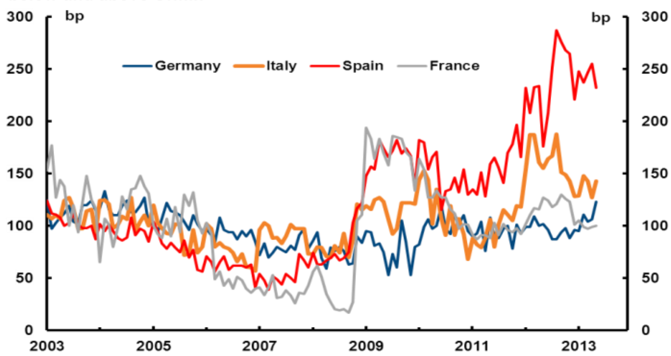
SMEs in Europe: counting beans

Getting a grasp of why SMEs matter in Europe is straightforward. *Exhibit 2* contains simple statistics broken down by firm size: **in all countries, especially in Southern Europe, SMEs account for a dominant share of companies, jobs and value added**. In Italy, 46% of employees work in a micro enterprise (employing fewer than 10 employees) and 80% in an SME. In Spain, 99% of companies have fewer than 50 employees.

The incredibly growing SME premium

Ample evidence of tight credit conditions to corporates has emerged. The stock of credit to **and then shot up, first with the financial crisis in late 2008 and once again with the sovereign turmoil that began in 2010** (*Exhibit 3*).

Exhibit 3
The SME lending premium across the euro area



Source: ECB & AXA IM Research

[1] According to the EC, a company is considered an SME if i) it has fewer than 250 employees et ii) either turnover below €50mn or a balance sheet whose value is less than €43mn.

Interestingly, the premium has not declined post crisis, even in core countries like France, where small corporates are stuck at a 100bp spread, while they were being offered the most attractive conditions before the crisis.

In a banker's shoes

Why have SMEs borne the brunt of the credit crunch? In difficult times, large banks tend to allocate their funding capacities to large corporates generating generous side-business revenues, while smaller regional banks focus on the firms they have tight relationships with. SMEs are often more opaque and fragile, which makes them risky counterparties. But here is the vicious circle: tighter credit conditions lead to higher solvency risk, leading to even tighter credit conditions.

A paper by the Bank of Italy[2] confirms these intuitions, showing **a significant 'flight to quality' (shying away from riskier borrowers) on the part of banks since the crisis, and even more so for lowly capitalised institutions**. Interestingly, the flight to quality has been more marked for large banks compared to smaller ones. Is it because small banks know their clients better and can therefore tolerate short-term uncertainty out of virtuous patience? Yes but not only. The paper shows that small banks are more prone to 'evergreening' (provision of cheap funding to a borrower with high risk of default in order to postpone credit losses). Evergreening is presumably easier for a smaller bank where discretion in lending decisions is higher and the weight of credit scoring is lower than for a larger bank, where lending decisions are based on more automatic processes.

As a side remark, the paper also shows that evergreening is usually not accompanied by higher interest rates: the "zombie borrower" is kept alive through affordable funding. As such, the sharp rise in the SME premium in Spain compared to Italy suggests that risks of evergreening may be greater in the latter. This point is also reinforced by the structure of the banking system: Spanish financial institutions are relatively few and large, so are less likely to evergreen, compared to Italy.

The other key factor that has driven banks away from corporate lending since the crisis is Basel III. In the new regulation due to enter into force in 2019, risk weights for SME loans and equity are significant, especially at longer maturities. As a result, banks have started to reallocate their exposure towards less penalising assets (short-duration investment grade and sovereign).

Reviving lending

A number of policy initiatives have been launched to fight the credit crunch. First, a long-awaited joint report from the European Commission (EC) and the European Investment Bank (EIB)[3] revealed a planned increase in SME lending by the EIB to about €13bn a year for 2013-2015. The EIB is also developing several bilateral initiatives in peripheral Europe, including support to trade finance, loan guarantees and securitisation (see below).

Looking ahead, the EC is looking to combine existing funds devoted to SME financing (such as COSME and the ESIF[4]) with **the leverage capacity of the EIB to increase firepower to €55-100bn**.

National and bilateral initiatives have also been launched. The Spanish Public Credit Institute (ICO) is planning to extend €22bn in lending to companies in 2013. In June, it also sealed an agreement with its German equivalent, KfW, to jointly invest €1.6bn in long-term financing or capital for Spanish SMEs.[5]

In France, public credit institutions recently merged into BPI France, which is planning to invest €12bn through 2017, mostly in SMEs. A new network, "Planète PME", is being launched too. The government is working on creating a new tax-free savings vehicle that will allow retail investors to invest in SMEs, both in debt and equity. It is estimated that an additional €2bn

[2] See Credit Crunch, Flight to Quality and Evergreening: An Analysis of Bank-Firm Relationships After Lehman, U. Albertazzi and D. Marchetti, Banca d'Italia Working Paper 756, April 2010.

[3] See Increasing lending to the economy, Joint Commission-EIB report to the European Council, June 2013.

[4] More details on COSME here and on the ESIF here.

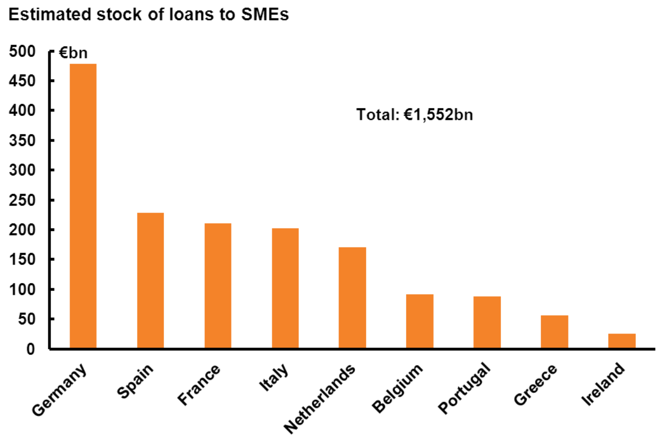
[5] See details in the press report.

of financing could be made available through this channel.

In July 2012, the UK government, together with the Bank of England, launched its Funding for Lending Scheme, aimed at encouraging banks to lend by assuming some of the credit risk.

Are these initiatives large enough to deal with the problem? The total stock of SME loans in the euro area is roughly €1,550bn (*Exhibit 4*). **As a result, adding up all these measures would make only a small difference in our view**.

Exhibit 4
SME loans outstanding in the euro area



Source: Nomura, OECD & AXA IM Research

Finding an alternative

Financing can be delivered through other institutions than banks: these are the alternative or disintermediated channels. While 70% of corporate funding is raised through markets in the US, this channel is limited to about 30% in Europe and nearly exclusively to large companies. A key question is therefore to what extent and how Europe can move closer to the US model.

Asset managers, insurance companies and pension funds have innovative solutions for financing the economy and a key role to play. Targeted corporates are not primarily large caps which have easy access to diversified sources of funding (equities and bond markets, attractive bank conditions) but mostly midcaps and SMEs. These are too small to access bond markets and generally unwilling to comply with public information requirements or public ratings.

On the one hand, experienced asset managers are allowed to provide alternative funding along bank financing lines, in a confidential relationship with corporates (no mandatory public rating and no listing of instruments). Execution is smooth, thanks to a well-known range of funding instruments and experienced resources, and there is less underwriting risk.

On the other hand, alternative funding is usually more expensive due to higher borrower costs compared to banks and public money, especially in a context of historically low-interest rates. Against this premium, a wise CFO will ask for advantages: it enables the company to diversify its sources of funding (especially after having faced temporary liquidity disruptions from its usual partners), to extend the debt maturity average, and to preserve bank lines' headroom for specific requests (undrawn lines). For some of them, it also offers a first step before considering raising money publicly.

Other actors are venturing into the lending business, either out of interest or by necessity. In 2012, a large French insurance company set up a unique partnership with banks to co-invest in private debt. Regulators are following suit: several initiatives aimed at easing up legislation for such alternative players are in the works in France, Italy and Spain. In July 2013, the French Insurance Code was amended to ease constraints on direct funding to corporates. In the US, hedge funds and private equity firms have started to set up lending arms to small, including distressed, companies in order to benefit from the retreat of banks[6]. In peripheral Europe, large corporates are reported to have started lending to their stronger suppliers to keep them alive[7].

Traditionally, banks have opposed alternative financing in a bid to fight competition on lending. But as banks become more risk adverse, their

[6] See "As Banks Retreat, Hedge Funds Smell Profit", Wall street Journal, 23 July 2013.

[7] See "Credit Crunch Broadens European Business Rifts", Wall street Journal, 18 April 2013.

lobbying efforts against alternatives have gotten weaker.

Such alternative options, and the 'sweet spot' of aligned interests between corporates, banks and investors, need to be supported by regulation. Examples include regulated treatment of lending (capital requirement, accounting) and a harmonised European framework (for instance on tax issues).

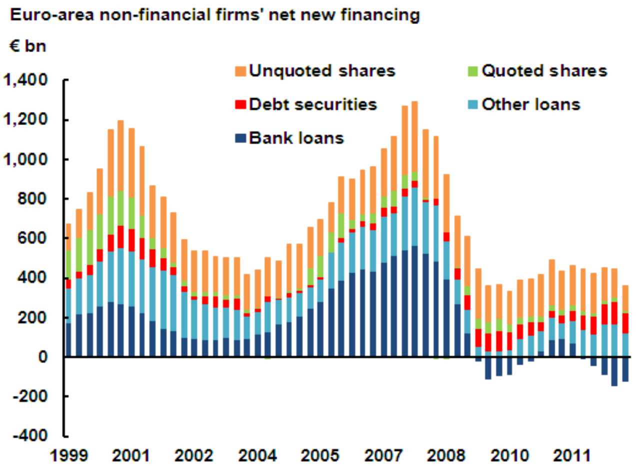
Overall, we believe that alternative financing is an important part of the solution for SMEs, and a recent statement from Italian Finance Minister Saccomanni, arguing that a more robust "shadow banking system" is needed, is telling[8]. **Asset managers, pension funds, insurance companies and venture capitalists all have a role to play in supplementing bank financing of the private sector**.

Shopping on the market

Another avenue for SMEs is market-based financing. At the aggregate corporate level, **data show a large substitution effect away from bank loans and toward other financing channels, especially market-based instruments** (*Exhibit 5*). Total euro-area corporate financing fell dramatically, from €1,300bn in 2007 to just above €300bn in 2012, of which 45% was disintermediated.

Exhibit 5

Moving away from bank loans



Source: ECB & AXA IM Research

[8] See "Italy Told to Embrace Shadow Banking", Wall Street Journal, 16 July 2013.

Several new platforms have been created on national stock exchanges to foster market-financing for SMEs:

- The Italian Stock Exchange set up ExtraMot Pro earlier this year, on which about €3bn have been raised by ten unlisted SMEs. Debt servicing is tax-deductible.
- Enternext was born on 23 May 2013 and brings together 750 (aiming for more) companies with capitalisation below €1bn. It is conceived as a marketplace dedicated to SMEs, both for bonds and equities, at a pan-European level. It will allow them to be more easily listed on Alternext or regulated Euronext markets, and/or issue debt. IBOs (Initial Bond Offering) were made possible as early as mid-2012.
- Now three years old, Bondm is a corporate bond trading platform for SMEs that is part of the Stuttgart Stock Exchange's regulated unofficial market. Besides trading (secondary market), retail investors have the opportunity to participate directly in bond subscriptions (primary market), which was originally limited to institutional investors. Bondm is thereby serving a similar goal as its elder brother Bondx, putting private and institutional investors on a level-playing field towards selected large corporate and government bonds.

Bondm allows SMEs to reach retail investors at low cost (no need for underwriting, candidates are supported by a Bondm coach), while retail investors can benefit from the primary issue's usual discount alongside institutional investors.

Issues are on average ten times smaller on Bondm than on the main credit markets, and may be as small as €25mn. Liquidity issues are managed by QLPs (Quality Liquidity Providers) – just as designated market makers provide liquidity on most organised markets.

Rating is another important parameter for SMEs to reach bond investors. Only very few issuers are investment-grade rated. So default and delisting are part of the game (four have occurred on the German SME debt exchange since Bondm was created). Transparent information on financial profiles and bond covenants is key to investor confidence.

Equity comeback?

A striking feature of the European financing landscape, especially compared to the US, is the weakness of equity financing. Several years after the financial crisis, a convergence between US and European banking business models seems to be taking place, in the direction of the former. This may seem odd, if we consider that the nature of the crisis was not exactly the same. In the US, the emphasis was on controlling leverage, whereas European universal banks had adopted a centralized risk approach.

This simple difference in fact reflects how risk is perceived on each side of the Atlantic. In old Europe, risk aversion is omnipresent: investors' protection is on top of the political agenda and a constraint to entrepreneurship. **Stock markets are primarily a way to access liquidity for a majority shareholder, rather than a source of funding for new businesses**. In the US, investors still have a pioneer mindset, and thus are more willing to give up some of their ownership to raise financial resources to expand the business and simultaneously reduce their own risk.

Going forward, with the new banking regulation pressuring credit creation, **we expect to see a gradual shift towards the equity market as a source of financing. But in the short term, with central banks keeping monetary policy easy, companies should continue to favour credit over equity. Additional regulation like Solvency II is also delaying the renaissance of equities in Europe.**[9]

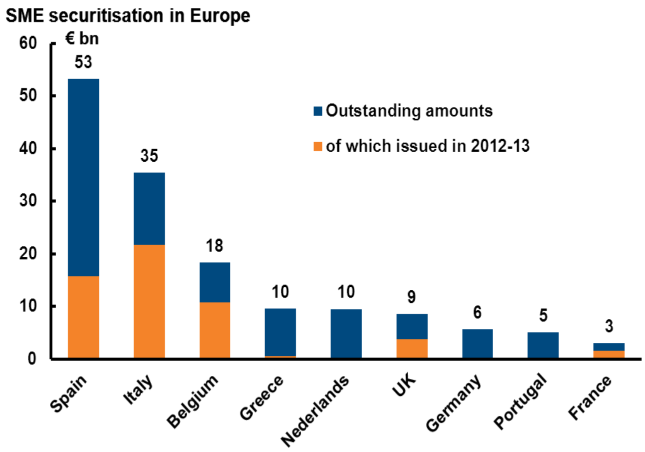
In their bid to revive growth, European governments have started to work on schemes for SMEs to better access equity markets. Enternext is an illustration of that (see above), much like the French "New Market" of the 1990s. But our take is that these projects are often quick fixes, rather than part of a coherent plan to create a supportive environment for small firms. Raising taxes on capital gains and penalising regulation for equity holders are just two examples of this schizophrenia. Incentives for institutional investors to remain in equities for the long term is, in our view, an essential part of the solution.

In the meantime, the fragmentation of **financial markets, both across countries and in terms of the size of firms, creates opportunities for stock pickers**. From 2011 on, financing conditions have become a central theme of investing in Europe: overleveraged companies suffered while companies accessing the bond market benefited. From a competition perspective, financial market' fragmentation is also creating new entry barriers, for companies already facing high labour costs and a strong currency.

Securitisation is part of the solution

The SME-backed ABS segment represents a relatively small part of the European securitisation market, partly due to the difficulty of pooling various profiles of SME loans into a standard, granular and easily risk assessable product. Transactions have historically been either cash or synthetic, sometimes benefiting from a national guarantee. Supply was about €60bn in 2011 and €50bn in 2012 (*Exhibit 6*), most of it retained by the originating banks and potentially used as collateral for central bank funding. While publicly placed deals were limited in 2011 and 2012, investor appetite improved in 2013, as attested to by the first public issuance of Italian SME-ABS since 2008.

Exhibit 6
Peripheral countries lead the European ABS market



Source: AFME & AXA IM Research

[9] See Investment Essentials "Solvency II has and will make corporate bonds more expensive", Mathieu L'Hoir and Mathilde Sauvé, November 2012.

Recent initiatives from the ECB and the EC seek to reinforce the role of securitisation as a tool not only to finance the real economy but also to transfer risk from banks to other investors. The joint report by the EC and the EIB describes two options for setting up a securitisation instrument using public money, aimed at supporting €65-100bn of lending for SMEs. In July, the ECB announced a further reduction in haircuts to ABS for repo transactions (from 16% to 10% for AAA to A-ratings), after similar moves in 2011 and 2012. It is noteworthy however that the impact of easing collateral rules is ambiguous: while it may encourage banks to underwrite ABS and place them with the ECB, it also impairs the development of the market by preventing placements of ABS with investors.

The securitisation market still faces regulatory uncertainties and potential hurdles. For insurers, the current Solvency II draft proposal on the ABS capital charge is very punitive in absolute and relative terms compared to other asset classes. For banks, the Basel Committee published a consultation paper in early 2013 discussing revisions to the securitisation framework. The proposed risk weights for ABS do not differentiate among asset classes and structures so that, for example, the capital charge for SME loans would be well above that of SME-backed ABS (75% to 100% for SME loans vs. 20% for AAA and AA SME-ABS).

In May 2013, the European Banking Authority (EBA) published a consultation paper on retention requirements in securitisation[10]. Retention rules have been in place since 2011 and are welcomed as a way to ensure alignment of interests between originators and investors. But the EBA now recommends European CLO portfolio managers to be the retaining party, which is likely to impair the recent recovery in the CLO new issue market.

The outlook for European ABS is still dependent on initiatives by central banks and regulators aimed at improving the market's infrastructure and encouraging investors to step in. Since 2012, the ECB has required banks to disclose loan-by-loan data and performance metrics on their RMBS, SME and CMBS transactions in a standardised way. It has been part of the ECB's goal to restore confidence in the securitisation market and may be a step towards an integrated European SME securitisation platform.

Restoring confidence in securitisation after the financial crisis is a critical challenge. The PCS (Prime Collateralised Securities) initiative[11] created in 2012 by banks, insurers and securitisation third parties (law firms, data providers, etc.) is a step in the right direction. It seeks to define and promote standards of best practices in the securitisation market by granting a label to high-quality transactions. In 2013, around 80% of eligible newly issued ABS/RMBS have been granted the PCS label.

Overall, we would expect the slow recovery of the securitisation market to continue, with more publicly placed SME-ABS to be issued in the coming months, especially from Italy. For European securitisation as a whole, as regulators and central banks increasingly embrace ABS, the general opinion towards securitisation should also improve. As a result, it will play an increasingly important role in funding the real economy.

In sum

The question of financing SMEs in Europe is difficult insofar as it is a cyclical problem that requires a structural solution. The 'flight to quality' of European banks after the financial and sovereign crises, and the ensuing change in regulation, have made the need for alternative financing channels urgent. Unfortunately, these take time to materialise.

As reviewed in this piece, there are several solid pillars for SME financing in the future. We believe that all of them have merit and none will be sufficient on its own: the magic potion seems to be a subtle mix of the above ingredients and it will be necessary to pursue all directions at the same time. But this may take more time: it is a long way between a Norwegian pension fund and a Portuguese fisherman.

[10] See the EBA webpage for more details.

[11] See the PCS website.

Investment Essentials

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***Our research** on the internet*

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Our last two publications:

Emerging unrest: looking for a pattern

Emerging economies are in the limelight due to a wave of social unrest amidst market pressures attributed to the phase out of monetary easing in the US. Manolis Davradakis argues that there is a common pattern in these waves of social unrest which, unlike the 'Arab Spring' is a consequence of the rise of the middle class whose aspiration for further social and economic development is capped by poor institutions. According to Manolis, Brazil and Turkey could encounter a sovereign rating action due to the prolonged social unrest.

Rendezvous in September

Over a quiet summer (fingers crossed!), economic data across the globe confirm our 'global healing' scenario, adding ever more weight to the market's rendezvous with the Fed in September. With that in mind, we remain overweight global equities and neutral on government bonds and credit.

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