Roundtable between bankers and SMEs



EUROPEAN COMMISSION

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## **EXECUTIVE SUMMARY**

Mezzanine finance can be a complementary source of finance to debt and equity and can be helpful in financing the start-up, and expansion of SMEs, innovation and business transfers. Mezzanine finance instruments are gaining in importance but remain little used compared with loan financing. 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.

Mezzanine finance is a collective term for hybrid forms of finance: it has features of both debt and equity. There are various types of mezzanine finance, each having its own unique characteristics. The most common forms of mezzanine finance include the subordinated loan, participating loan, 'silent' participation, profit participation and convertible bonds; the structuring possibilities are almost endless. Providers of mezzanine finance have claims that are subordinated to senior lenders and possess priority over equity investors. Consequently, mezzanine investments generate returns that are higher than traditional bank lending rates and lower than the returns required by most equity investors. Mezzanine finance is in principle unsecured. The level of control by the finance provider is dependent on the mezzanine product chosen. This gives SME owners the option to retain control of the company, which is one of their main concerns. At the same time mezzanine finance is a relatively expensive financing tool and difficult to obtain for most SMEs compared with debt finance.

Mezzanine products can be complex. In cases where they are not obviously debt or equity, the instrument and/or the depends on national international classification of regulations/principles such as the prevalent national accounting principles or Basle II. Whether a mezzanine product can be classified as equity mezzanine or not is a very significant question for both the lender and the recipient. Accountants can advise SMEs on the impact of the classification as debt or equity within financial statements. Equity mezzanine may positively influence the internal bank rating and/or the external rating of an SME and thus the price of finance. It also impacts on the aspects of tax-deductibility; and the level of default risk borne by the financial institution. However, there is no industry standard with regard to the criteria for dealing with mezzanine products in the banks' rating systems, and consequently there can be different treatments of the product depending on the lending institution's rating policy.

The traditional market of mezzanine finance is **upper-tier SMEs**. These are high-rated companies. They often have a demand for larger mezzanine tickets ( $\notin$  2 million). To obtain mezzanine finance SMEs have to fulfil strict criteria: they must have a sound track record, stable cash-flows and an experienced management team. Furthermore companies should have sound financial and business information reporting capabilities, allowing the providers of mezzanine finance to monitor their key risks and success drivers. Provision of certification services by auditors enhances the credibility of the reported information by SMEs and thus could reduce (unexpected) risks for banks.

The traditional suppliers of mezzanine finance to **middle-tier SMEs** have been informal investors e.g. business angels. Following the success of mezzanine finance for upper tier SMEs some financial institutions have started to offer mezzanine products to the group of SMEs below the upper tier. The mezzanine tickets demanded by these SMEs are frequently smaller than those demanded by upper-tier SMEs. The aim of these programmes has been to strengthen the regional economy by financing projects of sound companies already established in the region or willing to transfer business activities to the region. Presently there are two main target groups of mezzanine finance in the middle tier SME market. In the first target group there are SMEs

striving for further expansion. In the second group there are mature family-owned companies with a requirement for succession planning and a need to plan for the eventual transfer of ownership.

**Low-tier SMEs** have a much lower rating than upper-tier SMEs and often have a financing need for smaller amounts (less than  $\notin$  250,000). Most of the time they do not fulfil the requirements of the commercial mezzanine market regarding company history, revenues or reporting. Enabling the supply of hybrid finance to this group of companies often involves public support. Many issuers of mezzanine finance to low-tier SMEs can be found amongst public promotional banks, development agencies or equity investment companies run by mutual guarantee institutions. Financing in these cases is often supplied in combination with regular loans and additional support, such as advice and mentoring in order to stimulate the development of these companies and to create leverage effects.

Although **business angels** are an important source of mezzanine finance for SMEs and many business angel networks are active throughout Europe, their potential for providing capital to SMEs is still insufficiently utilised.

It is important to point out that low- and middle-tier SMEs together include the overwhelming majority of SMEs in Europe. The process of **'downsizing'** (providing smaller tickets of mezzanine finance to lower rated SMEs) is expected to pick up as the mezzanine finance market matures and borrowers become more aware of this type of finance. This will in particular be facilitated through public support for mezzanine finance, leading to private issuers of mezzanine finance participating in mezzanine deals through risk sharing and syndication of smaller individual investments. Until this happens external support to SMEs is required to help them become more familiar with these instruments and help them take full benefit of these tools.

**Standardisation** and the **securitisation of mezzanine instruments** are often used, at present, to facilitate the downsizing of mezzanine finance. Standardisation can reduce the costs of provision. Securitisation can contribute to a greater availability of hybrid products 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.

The Round Table discussions have identified the following key areas for action:

- Member States should **encourage the expansion of the market** for mezzanine finance. They should avoid crowding out private financing and should ensure that support schemes from public or semi-public providers are sustainable and do not distort the market.
- Member States are invited to review their tax systems and to address existing **disincentives for private investors** to provide finance to SMEs directly (e.g. business angels) or indirectly (via investments funds).
- Member States are invited to 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.

- An attempt at introducing some **simplified products within programmes** could help the development of the mezzanine finance market.
- **Increased transparency** by SMEs can contribute to the development of mezzanine finance products. In this respect, there is an important role for accountants to play.
- **Public promotional financial institutions** are encouraged to develop programmes which improve SMEs' access to mezzanine finance. Such programmes have to be in line with the existing state aid regulations and should aim to foster the development of the market for mezzanine finance products and facilitate the provision of lower levels of funding.
- **Promotional financial institutions** are invited to develop additional products by using mezzanine instruments with profit sharing elements to finance the start-up, expansion and transfer of SMEs as well as SME innovation projects.
- The securitisation of low- and middle-tier mezzanine instruments should be facilitated. In this respect fostering the development of the SME loan securitisation market can make an important contribution (see also the Final Report of the Fifth Round Table on SME securitisation).
- Banks or banking associations in cooperation with financial advisors, such as accountants, Chambers and SME associations should consider introducing **information programmes** which would educate SMEs about innovative financing tools such as mezzanine finance.

### **1. WHAT IS MEZZANINE FINANCE?**

Mezzanine finance is a collective term for hybrid forms of finance. It forms a bridge between two main types of finance: senior debt and pure equity financing. It thus has features of both debt and equity. There are various types of mezzanine finance, each having its own unique characteristics.

The most common form of mezzanine finance is the **subordinated loan**, which is an unsecured loan with a lower ranking in case of bankruptcy compared to senior debt. Providers of subordinated loans receive a fixed interest rate and are ranked before equity investors should the borrower be wound up. **Participating loans** are normal loans, but rather than there being a fixed return, their remuneration is contingent upon the results of the business. Despite sharing in profits, participating loans do not give rise to an ownership relationship. Participation in losses is contractually excluded. In legal terms, a **"silent" participation** is closer to a stockholding than a subordinated or participating loan. 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 typical "silent" participation in profits and losses and contractual rights of approval and control are structured flexibly.<sup>1</sup>

There are also equity related mezzanine finance instruments. These instruments present a greater risk profile to the lender and, in turn offer a higher rate of return. Mezzanine products with **profit participation rights** are more related to equity and under company law the holder is entitled to rights over the company's profits. In general the financier has no voting or management rights. However, the instrument is rather flexible and the right to be consulted on business decisions can be included in the contractual documents. A further equity mezzanine financing instrument is the **convertible bond**. In addition to the usual right to fixed interest payments and repayment of principal, holders of convertible bonds or bonds with warrants have the right to acquire shares in the company instead of accepting repayment of the bond. This right is exercisable for a defined period and at a predetermined conversion or subscription rate. This way the issuer may convert debt into equity. Another equity mezzanine financing instrument is the warrants (subscription rights) are separate from the bond and thus can be traded independently.<sup>2</sup>

One characteristic which the various mezzanine instruments share is that they can be structured flexibly in many different forms, and can be combined in numerous ways, to provide tailor-made solutions for the specific financing needs of the company in question. Mezzanine products can be complex. In cases where they are not obviously debt or equity then the classification of the instrument depends on national and/or international **regulations/principles** such as the prevalent national accounting principles or Basle II. Whether a mezzanine product can be classified as equity mezzanine or not is a very significant aspect for both the lender and the recipient. Equity mezzanine may positively influence the internal bank rating and/or the external

<sup>&</sup>lt;sup>1</sup> Economic Briefing No.42, Mezzanine Finance- A Hybrid instrument with a Future, Credit Suisse Economic Research, 2006.

<sup>&</sup>lt;sup>2</sup> Economic Briefing No.42, Mezzanine Finance- A Hybrid instrument with a Future, Credit Suisse Economic Research, 2006.

rating of an SME and thus the price of finance. It also impacts on the aspects of tax-deductibility; and the level of default risk borne by the financial institution.<sup>3</sup>

Providers of mezzanine finance have claims that are subordinated to senior lenders and possess priority over equity investors. Consequently, mezzanine investments generate returns that are higher than traditional bank rates and lower than the returns required by most equity investors. The level of control by the issuer is strongly dependent on the type of mezzanine finance chosen. Some types include contractual rights of approval and control, or even position the issuer as participating entrepreneur, while in other types the mezzanine capital provider only takes the position of creditor. Several combinations of fixed and performance-dependent compensations are possible, ranging from high interest payment to interest in combination with an option to purchase shares in the company at a previously agreed (discounted) price, the so-called "equity kicker". In several EU Member States the interest payment on some types of mezzanine finance is tax-deductible (e.g. Germany, the Netherlands and UK).

Mezzanine finance instruments have been gaining in importance but remain little used compared to classic loan financing. Mezzanine finance products usually have the following positive features:

- Mezzanine finance is in principle unsecured. Mezzanine finance is subordinated to senior loans. This results in an improved balance sheet structure and better access to additional loans or equity (leverage effect).
- By choosing the appropriate form of mezzanine finance SMEs can retain control over the company and avoid surrendering ownership rights.
- In general the cost of mezzanine finance for SMEs is lower than for pure equity.
- Interest payments on some types of mezzanine finance are tax-deductible.
- Mezzanine finance can be a very useful financial tool in the cases of business expansion, business transfer, innovation and public to private transactions
- The confidence of a mezzanine capital provider increases the image of the company. Banks will invest more easily in a company that has the trust of a risk taking investor.
- For equity providers mezzanine finance can lead to smaller, more conservative stakes in companies with potentially higher returns.
- The revenues for providers of mezzanine finance are higher than for senior debt.
- Providers of mezzanine finance are often more willing to offer advice and valuable strategic assistance than providers of debt finance, especially when the return on the investment is partly dependent on the performance of the company.

Mezzanine finance provides also some challenges for financiers and 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 low-and middle-tier SMEs. There are many requirements to meet in order to obtain this type of finance. In particular, the transparency requirements are very high and stringent. In addition, the financing contract may include restrictive covenants that the borrower has to abide by such as not to acquire additional capital.

<sup>&</sup>lt;sup>3</sup> There is no industry standard with regard to the criteria for dealing with mezzanine products in banks' rating systems, and consequently there can be different treatments of the product depending on the lending institution's rating policy. To enhance transparency and ease uncertainty among SMEs on mezzanine finance, banks affiliated to the initiative known as Initiative Finanzstandort Deutschland (IFD) have prepared, from the perspective of banks, a summary of criteria which are important in evaluating the equity-capital character of mezzanine capital. This summary allows companies to better assess the consequences of using mezzanine products and find the product which best suits their individual needs. (See also www.finanzstandort.com.)

- 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 low and middle-tier SMEs to arrange an early exit. For the upper-tier SME segment secondary markets exist.
- Individually structured mezzanine deals will often take several months to complete.

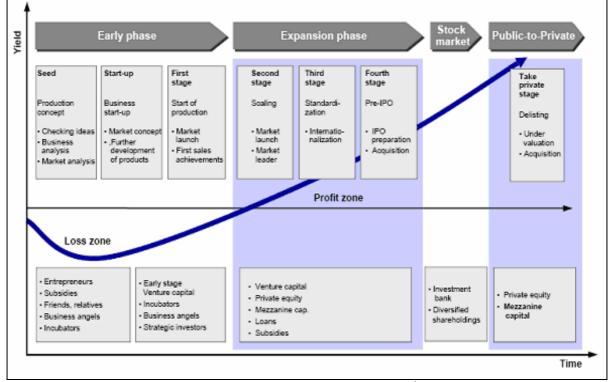


Figure 1. Phases in a company's development and used financing instruments<sup>4</sup>

This report uses its own segmentation of the SME sector. Beside the European definition of SMEs, a distinction into upper, middle and low-tier SMEs is made. <sup>5</sup> Upper-tier SMEs are regarded as companies with approximately a rating of BBB+ or better. They often have a demand for higher mezzanine tickets ( $\notin$  2 million).<sup>6</sup> Middle-tier SMEs are companies with approximately a B- to a BBB rating. The mezzanine tickets demanded by these SMEs are frequently smaller than those demanded by upper-tier SMEs, i.e.  $\notin$  250,000 to  $\notin$  2 million. Low-tier SMEs are companies with at most a B-rating. Often, though, these SMEs do not have a rating assigned by an independent rating agency but rather a credit-scored 'internal' rating assigned by their bank. It is important to point out that low- and middle-tier SMEs together include the overwhelming majority of SMEs in Europe. In terms of mezzanine finance low-tier SMEs have a financing need for smaller amounts (often less than  $\notin$  250,000). The report also describes interventions by public institutions such as the European Investment Fund and promotional banks. In those cases the segmentation of SMEs is based on the official European definition of SMEs.

<sup>&</sup>lt;sup>4</sup> Deutsche Industriebank, presentation Dr.I. Natusch, Round Table Talks October 23th 2003

<sup>&</sup>lt;sup>5</sup> The European definition of a medium-sized SME includes the following criteria: a headcount of less than 250, maximum turnover of  $\notin$  50 million or a maximum balance sheet total of  $\notin$  43 million. For small SMEs the same categories are as follows: a headcount of less than 50, maximum turnover of  $\notin$  10 million or a maximum balance sheet total of  $\notin$  10 million.

<sup>6</sup>In the case of external ratings the report uses the rating system of Standard and Poor's.

## 2. MEZZANINE FINANCE FOR UPPER-TIER SMES

The traditional market for mezzanine finance has been upper-tier SMEs. This commercial mezzanine market primarily finances high-rated SMEs (BBB+ or better). They often have a demand for higher mezzanine tickets ( $\notin$  2 million). To obtain mezzanine finance, SMEs have to fulfil strict criteria: they must have a sound track record, stable cash-flows and an experienced management team. Companies should have sound financial and business information reporting capabilities, allowing the providers of mezzanine finance to evaluate and monitor their key risks and success drivers. Due to relatively high costs, commercial upper-market focussed mezzanine finance providers usually seek a return of up to 20 per cent on their investment. In the case of highly standardised mezzanine finance products and a highly rated company the interest rate may be lower.

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 ('transaction mezzanine finance'). In these cases mezzanine finance is often provided in combination with senior debt and/or equity financing. A major factor influencing the development has been the growing number of management-buy-ins (MBIs), management-buy-outs (MBOs), 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, it is still difficult to obtain reliable figures on the volume of the EU market for commercial mezzanine finance. The main reason is that definitions of mezzanine finance differ across Member States. Furthermore not all mezzanine finance is registered: for instance the extent of silent participation is highly difficult to measure. However, Figure 2. gives a fairly good indication of the growth of the volume and value of mezzanine finance in Europe.

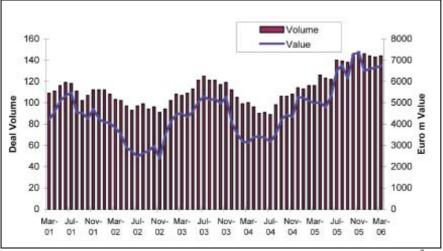


Figure 2. Mezzanine volume and value of all European deals with Mezzanine<sup>7</sup>

<sup>&</sup>lt;sup>7</sup> Mezzanine Monitor, Q1 2006: Mezzanine investors pause for breath?, Private equity Europe, Issue 76, May 2006

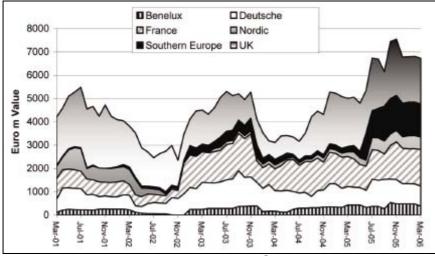


Figure 3 Value of Mezzanine invested by region

The market for commercial mezzanine finance in Europe is forecast to grow further especially as private banks and institutions seem prepared to lower the amount of their investment limits.<sup>9</sup> Nevertheless, the market for commercial mezzanine finance, expressed in numbers of SMEs, is expected to remain relatively small, due to the limited size of the upper tier SME market and the small number of SMEs interested in mezzanine finance.

<sup>&</sup>lt;sup>8</sup> Mezzanine Monitor, Q1 2006: Mezzanine investors pause for breath?, Private equity Europe, Issue 76, May 2006

<sup>&</sup>lt;sup>9</sup> KfW Research, Mezzanine-Finanzierungen für den Mittelstand: Der Markt ist in Bewegung. Issue 1, July 2005.

## 3. MEZZANINE FINANCE FOR THE MIDDLE SME MARKET

Now that the supply of mezzanine finance for upper tier SMEs is established some financial institutions have started to offer mezzanine products to the group of SMEs below the upper tier. The mezzanine tickets demanded by these SMEs are frequently smaller than those demanded by upper-tier SMEs. The KfW Bankengruppe in Germany, as a promotional institution, has already started this downsizing of investment amount limits to amounts of less than €2 million.

Another trend has been the lowering of the required rating for mezzanine finance. Although in the recent past only the best ranked SMEs have been able to obtain mezzanine finance, some downsizing to SMEs with BB or even lower rating can be noticed. In this middle-tier SME market segment mezzanine finance is mostly used as a supplement to senior debt or pure equity which is already in place.

For providers of various financial products, the supply of mezzanine finance offers good opportunities for cross-selling. For SMEs in the middle tier market segment, which normally have to rely on regular loans or equity to meet their funding requirements, the downsizing of mezzanine finance, enables broader choice, more tailor-made financing and, due to improved liability ratios, better conditions for negotiation on the terms for new senior debts and equity.

Clearly, a much higher number of SMEs fall into the middle-tier category than the upper. Presently there are two main target groups of mezzanine finance in the middle tier SME market, i.e. SMEs in their third stage of development, such as companies striving for further expansion, and mature family-owned companies with a need to change ownership. The transfer of ownership of a business is usually more expensive than starting a new business, since in addition to material and financial assets, intangible assets such as goodwill may have to be bought. Business transfers often fail due to refinancing obstacles for the intended successors, resulting in the loss of jobs and detrimental impact on the local economy. From a financing point of view, the solution is usually not uniform. In each individual case the different interests have to be taken into account, resulting in a specific mix of equity and debt investments. For both target groups, mezzanine finance can fill this financing gap.

While private banks usually offer mezzanine finance with transaction volumes larger than  $\notin$  1 million, some regionally operating promotional banks try to open the market for smaller SMEs. An example of such an approach can be found in the German federal state of North Rhine-Westphalia (see Annex 1).<sup>10</sup> The group of mezzanine finance providers who are offering mezzanine financing to middle-tier SMEs also includes regionally operating financial institutions, such as the German Landesbanken. One example is the "Mezzanine-Kapital für den Mittelstand" offered by Nord/LB, a regional bank operating in the northern part of Germany.<sup>11</sup> The underlying objective of these financial institutions is to strengthen the local economy by financing ambitious plans of sound companies already established in the region or willing to transfer business activities to the region.

Similar initiatives to support the provision of mezzanine finance to the middle tier SME market are taken by nationally operating public financial institutions. Many members of the Network of European Financial Institutions for SMEs (NEFI) are already active in this field. An example of

<sup>&</sup>lt;sup>10</sup> NRW.BANK, North Rhine-Westphalia's public and regionally operating promotional bank, is planning to launch a standardized mezzanine finance programme to the middle SME market by the end of 2007

<sup>&</sup>lt;sup>11</sup> The fund offers mezzanine finance for amounts ranging from  $\leq 500,000$  to  $\leq 7$  million with a minimum rating of BB.

an initiative to offer mezzanine finance through private banks is the Innovation Development Contract programme launched by OSÉO (see Annex 1).<sup>12</sup> Specialised mezzanine funds are also becoming active in the middle SME market segment. In general, these funds are focused on specific SME groups. An example of such a fund is FIDEME, which provides mezzanine finance to businesses in France whose focus is renewable energy (see Annex 1).

The financial instruments of the Competitiveness and Innovation Programme 2007-2013 will aim to help SMEs obtain access to mezzanine finance through the SME Guarantee Facility. Guarantees for equity or quasi-equity fund investments in SMEs will include investments by local or regional funds which provide seed capital and/or capital in the start-up phase, as well as mezzanine finance funds, in order to reduce the difficulties which SMEs face because of their weak financial structure, and those arising from business transfers. The equity or quasi-equity opportunities of the SME Guarantee Facility will cover a part of the risk taken by the financial intermediary in a financing portfolio of individual transactions. The financial criteria governing the eligibility under the SMEG Facility will be established with the aim of reaching as many SMEs as possible.

<sup>&</sup>lt;sup>12</sup> The partners in the Network of European Financial Institutions (NEFI) for SMEs include ALMI (Sweden), AWS (Austria), Oséo/BDPME (France), Finnvera (Finland), Hipoteku Banka (Latvia), ICO (Spain), KfW Bankengruppe (Germany), MCC (Italy), MFB (Hungary), SNCI (Luxembourg), SZRB (Slovakia) and Encouragement Bank of Bulgaria.

## 4. MEZZANINE FINANCE FOR LOW-TIER SMES

Unlike upper and middle tier SMEs, low tier SMEs usually lack most prerequisites for commercial mezzanine finance, such as a proven track record, an experienced management team or solid cash flows. Low-tier SMEs are companies with at most a B-rating. In terms of mezzanine finance low-tier SMEs have a financing need for smaller amounts (often less than € 250,000). In order to enable the supply of mezzanine finance with low fees and favourable conditions for this group of companies public or private financial support (i.e. by some banks, such as Rabobank Eindhoven-Veldhoven in the Netherlands) needs to be provided. Many issuers can be found amongst public promotional banks, development agencies or among non-profit investment entities e.g. from mutual guarantee schemes. Mezzanine finance in these cases is often supplied in combination with regular loans and additional support, such as advice and mentoring in order to stimulate the development of these companies and to create leverage effects.

Mezzanine finance to low-tier SMEs can include companies in the early phase of their development requiring external capital for their preparation, start-up and marketing activities. They often face heavy constraints in tapping sufficient external capital due to the fact that they are considered high-risk and are usually still operating at a loss. The primary target group for most issuers of not-for-profit mezzanine finance are companies, which rely on their own capital, subsidies, business angels and capital provided by relatives and friends. An example of mezzanine finance supplied by a private, not-for-profit organisation, is offered by the German Mittelständische Beteiligungsgesellschaften (MBG) (see Annex 2).

In addition informal suppliers of mezzanine finance to the lower tier SMEs have been important. The objectives for this group to invest privately in these small companies range from pure profitseeking to a combination of commercial and idealistic motives. The capital amounts invested per informal investor are mostly much below  $\notin$  2 million and many of them co-invest with other private investors.<sup>13</sup> Although no reliable European figures on informal investors and the capital investments involved are available, the general feeling is that informal investors are an important source of quasi- and pure equity for SMEs and that the market has developed dynamically in recent years.<sup>14</sup>

One way to create an incentive for private investors to extend mezzanine (or equity) finance to SMEs can be by reducing the risk for the investor by developing new guarantee products. For example the Austrian promotion agency AWS (Austria Wirtschaftsservice) already offers guarantees to investors that cover 50 % of their capital invested (Equity Guarantees) (see Annex 2). The room for development includes mezzanine instruments with profit sharing elements.

In recent years some public financial institutions, operating on a national scale and united in NEFI, have increased their efforts to provide mezzanine finance to low-tier SMEs. Their focus is on promising start-ups and young innovative SMEs. An example is the Innovation Loan of ALMI in Sweden (see Annex 2).<sup>15</sup>

<sup>&</sup>lt;sup>13</sup> In several countries this has led to the development of so-called business angel networks. These business angel networks have established a European Business Angel Network.

<sup>&</sup>lt;sup>14</sup> Research on the Dutch capital market executed 10 years ago estimates that at that time the total size of the informal capital market was at least equal to that of the formal one. The role of informal investors in the Dutch Venture Capital Market, K+V, Arnhem 1996

<sup>&</sup>lt;sup>15</sup> Another example is the KfW Programme "ERP Capital for start-ups". The programme offers subordinated loans for start-ups, with the following features: (1) The capital is available in full for seven years before repayment begins. (2) The interest rate is subsidized out of the ERP Special Fund. (3)

Regionally operating public financiers have also increased their presence in the mezzanine finance market. Recently twenty institutions - operating in 9 EU Member States - launched a network project, called FinNetSME, to improve the access to finance to low-tier SMEs.<sup>16</sup> In some cases, mezzanine finance offered by regionally and locally operating public financial institutions is backed up by national government funding. This is the case in UK, where the Early-Growth Funding Programme complements the regional funds by providing risk capital, averaging around € 70,000, for start-ups and early-stage SMEs.

A relatively recent trend in many EU Member States has been providing risk bearing finance to low-tier SMEs through non financial public bodies, such as universities. Once again, the capital of these funds is often supplied by national authorities, but sometimes complemented with donations from private and other public organisations.

Private financial institutions in Europe with ethical motives, such as Triodos Bank<sup>17</sup> operating in UK, the Netherlands, Belgium and some developing countries have also become active in offering mezzanine finance to low-tier SMEs. Frequently the products are offered to specific niches in the low-tier SME group such as SMEs focused on social awareness and environmental sustainability.

Financing share: the own funds contributed from the start-up may not be less than 15% of the eligible investment amount (basis for calculation) or 7.5% in the new federal states and in Berlin. (4) Funds from the ERP Capital for Start-ups programme may be added up to an amount equalling 40% of the eligible investment amount.

<sup>&</sup>lt;sup>16</sup> Many of their members provide mezzanine finance and NRW.Bank, active in the German federal state of North Rhine-Westphalia, is one example of this.

<sup>&</sup>lt;sup>17</sup> Triodos Bank's goal has been to finance institutions and projects that add cultural value; benefit people and the environment.

# 5. CHALLENGES IN THE PROVISION OF MEZZANINE FINANCE TO SMES

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.<sup>18</sup> Despite the efforts by suppliers and support by the public sector, the development of the mezzanine market in Europe – beyond the commercial upper-tier one - is mostly limited to the top segment of the middle-tier SME market.<sup>19</sup> It needs to be highlighted again that low- and middle-tier SMEs together include the overwhelming majority of SMEs in Europe. As stated by a European expert group, there is currently a clear demand for more risk-taking capital in the €200,000 and €2.5 million range.<sup>20</sup> Due to recent developments (after Basel II) there is now also a clear need for more risk related finance below € 200,000.

#### 5.1. Mezzanine finance for growing and expanding SMEs

Middle-tier SMEs in the second stage of their development often require risk capital for product introduction and expansion. However, many of these companies are reluctant to give up equity stakes to outside investors as it would result in the loss of control over the company. Mezzanine finance could provide a solution here.

Many potential mezzanine finance suppliers, in turn, are deterred by the high costs of providing such finance. Several cost items are fixed and can represent a large proportion in case of lower value deals. This creates more interest for larger ticket deals and the upper-tier SME segment. Furthermore as middle-tier SMEs often are not familiar with the various mezzanine finance products, providers can incur high communication costs to eliminate possible misunderstandings. The process of 'downsizing' (providing smaller amounts of mezzanine finance to SMEs) is expected to pick up as the market matures and borrowers get more sophisticated. This however requires time.

Public-private initiatives, where financial institutions on different levels co-operate to downsize mezzanine finance to offer tailor-made products to SMEs are not sufficiently widespread. KfW's Entrepreneur Capital Programme (component "Capital for work and investments" – Annex 3) and NRW's aforementioned programme though have aimed to downsize mezzanine products to middle tier SME groups (see Annex 3).

Although business angels are an important source of mezzanine finance for SMEs and many business angel networks are active throughout Europe, their potential for providing capital to SMEs is still insufficiently utilised. To improve the situation, many attempts have been made for better co-operation between banks and business angel networks, but frequently they **operate** disconnected. Often business angels have other motives beyond the commercial ones and this

<sup>&</sup>lt;sup>18</sup> The Association of German Banks (www.germanbanks.org), in cooperation with the Federation of German Industries (BDI), has made a key contribution to raising awareness about the importance of mezzanine capital. The two organisations held a workshop on "Mezzanine capital for SMEs – discovering opportunities", at which small and medium-sized companies were able to meet representatives from the banking industry and learn from speeches and discussions about the various forms and potential applications of mezzanine financing.

<sup>19</sup> In Germany, the MBG, which are private sector non-profit entities, are though involved in the provision of mezzanine finance to the lower and middle-tier segments.

<sup>&</sup>lt;sup>20</sup> Report of the Meeting of the Focus Group on the Innovative Companies Scheme in Luxembourg, dated 27 April 2004

can be in contrast to the motivations of banks interested in optimising their return on investment.

An attempt to funnel informal capital towards middle- and low-tier SMEs has been the setting-up of business angel capital funds by professional financers such as the IQ Capital Fund set up in UK in December 2006. The fund cooperates with three prominent UK business angel networks. The fund partners exclusively collaborate with a selected group of business angels. They provide investment for early stage high-tech businesses, as well as fast growing companies in non-tech sectors. Typically the fund invests  $\notin$ 200,000 to  $\notin$ 1 million in the first round and follow-on funding can bring the total amount invested up to  $\notin$ 2 million.

In November 2006, CDC Entreprises, a 100% subsidiary of the French Caisse des Dépôts et Consignations (CDC) dedicated to private equity, launched a new French Investment Program (France Investissement). The Programme, offering equity and mezzanine to funds and funds of funds consists of  $\notin$  2 billion to be invested within the next 6 years and will also finance some business angels initiatives (see Annex 3).

#### 5.2. Mezzanine finance for business succession

It is estimated that each year approximately 610,000 SMEs in the EU will need to be transferred to the next generation, potentially affecting 2.4 million jobs.<sup>21</sup> A business transfer generally requires substantial funds. Business transfers can also involve the transfer of intangible assets. Banks are often reluctant to finance such transactions for their high level of risk. There is no one-fits-all solution: in each case the different interests at stake have to be taken into account and the appropriate solution will often be a specific mix of equity, quasi equity and debt.

The combination of a better understanding of this type of finance and commercial investment in the local economy can provide a solution. Rabobank, a Dutch co-operative bank, by means of its Innovation Capital Fund, offers support to their locally affiliated banks in the efforts to supply tailor made products to their members/SMEs (see Annex 3).

In general mezzanine capital funds focussed on business successions, working on national level and dealing with relatively low amounts ( $\notin$  100,000 to  $\notin$  500,000) are largely missing in Europe. Some special mezzanine funds for this target group exist, but they are only regionally active, such as "Finance Wales Mezzanine Investments" or they only focus on the upper tier SME segment.

The access to mezzanine finance of low- and middle-tier SMEs with more modest growth prospects and a need to improve the structure of their balance sheet can be supported by assetbased loan securitisation. In SME loan securitisation transactions 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. The experience with the PREPS programme, launched in 2004 by Germany's HypoVereinsbank and the Capital Efficiency Group as well as the equityNotes programme, launched in 2005 by Deutsche Bank and IKB Deutsche Industriebank has proven to be very successful.<sup>22</sup> A great number of mezzanine programmes for profit sharing rights, at least in the German market, rely on securitisation and guarantees. In other EU Member States the importance of securitisation and guarantees for mezzanine finance is growing.

<sup>&</sup>lt;sup>21</sup> Estimations of the Enterprise DG's expert group. on the transfer of SMEs, Final report, 2002

<sup>&</sup>lt;sup>22</sup> L-Schmidt-Ott and B. Wilkinson, The Capital Markets and Small and Medium-sized Enterprises. The beginning of a new story, in Financial Engineering News

## **6.** RECOMMENDATIONS

The Round Table discussions have identified the following key areas for action:

- Member States should **encourage the expansion of the market** for mezzanine finance. They should avoid crowding out private financing and should ensure that support schemes from public or semi-public providers are sustainable and do not distort the market.
- Member States are invited to review their tax systems and to address existing **disincentives for private investors** to provide finance to SMEs directly (e.g. business angels) or indirectly (via investments funds).
- Member States are invited to 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.
- An attempt at introducing some **simplified products within programmes** could help the development of the mezzanine finance market.
- **Increased transparency** by SMEs can contribute to the development of mezzanine finance products. In this respect, there is an important role for accountants to play.
- **Public promotional financial institutions** are encouraged to develop programmes which improve SMEs' access to mezzanine finance. Such programmes have to be in line with the existing state aid regulations and should aim to foster the development of the market for mezzanine finance products and facilitate the provision of lower levels of funding.
- **Promotional financial institutions** are invited to develop additional products by using mezzanine instruments with profit sharing elements to finance the start-up, expansion and transfer of SMEs as well as SME innovation projects.
- The securitisation of low- and middle-tier mezzanine instruments should be facilitated. In this respect fostering the development of the SME loan securitisation market can make an important contribution (see also the Final Report of the Fifth Round Table on SME securitisation).
- Banks or banking associations in cooperation with financial advisors, such as accountants, Chambers and SME associations should consider introducing **information programmes** which would educate SMEs about innovative financing tools such as mezzanine finance.

## ANNEX 1 MEZZANINE FINANCE PROGRAMMES FOR MIDDLE-TIER SMES

#### Standardized Mezzanine Program of the German NRW.BANK

The NRW.BANK is developing a standardized mezzanine programme for SMEs in the German State of North Rhine-Westphalia targeting the market gap for mezzanine finance for companies with revenues of less than  $\notin$  20 million, financing requirements of less than  $\notin$  2 million and with a sub-investment grade rating. While the minimum rating for individual businesses will be BB-, NRW.BANK aims at a portfolio rating of BB. The standardized mezzanine programme will have the following key characteristics:

- Financing portions provided will range from € 250,000 to € 1 million, with an average transaction volume of € 500,000;
- No collateral is needed;
- Mezzanine finance is usually structured as equity capital;
- Interest costs will follow risk adjusted pricing;
- Credit investigation is standardized;
- Standardized agreements are used;
- The program of NRW.BANK follows the theory of portfolio diversification with respect to the sectors represented in the portfolio.

The market potential for this standardized programme is approximately 9,900 SMEs in NRW with sales between  $\notin$  5 million and  $\notin$  50 million. The programme is expected to be launched by the end of 2007.

#### **Innovation Development Contract in France**

The product is implemented in partnership with commercial banks. There are two options both combining a subordinated loan and a guarantee as promotional elements. In the first option OSÉO/BDPME, the SME Development Bank within OSÉO, co-finances up to 50% of the project costs with a subordinated loan depending on the amount of intangible assets involved in the project costs. The commercial bank and OSEO/BDPME then both benefit from a guarantee provided by OSEO/Sofaris, the guarantee fund within OSÉO, which covers up to 60 % of the risk. In the second option, the project is completely funded by OSEO/BDPME. In turn, OSEO/BDPME shares the risk with Sofaris and a commercial bank. Again, OSEO/Sofaris provides a guarantee of up to 60 % of the project costs, the remaining 40 % of the risk are equally shared between OSEO/BDPME and the commercial bank. The rationale behind OSEO's product is that a company needs working capital in order to get started. Therefore, with public funds provided as a guarantee and a subordinated loan of up to 80 % of the project costs, public leverage is high.

#### **FIDEME Mezzanine Fund in France**

FIDEME is a  $\notin$  45 million public private investment partnership, which provides mezzanine finance to renewable energy companies in France. The French Environment and Energy Management Agency (ADEME) provide subordinated loans. The private investors brought most of the investment into the fund. Their risk is reduced by the more junior position of the public investor. In addition, investing in the fund is attractive for tax purposes. FIDEME grants mezzanine financing to the project companies in order to help them find easier senior debt financing. Financing of projects is always based on proven technologies, verified by ADEME, focussed on improving the environment. <a href="http://www.ademe.fr">http://www.ademe.fr</a>

## ANNEX 2 MEZZANINE FINANCE PROGRAMMES FOR LOW-TIER SMES

#### Silent Partnerships by MBG (Mittelständische Beteiligungsgesellschaften)

The German Mittelständische Beteiligungsgesellschaften (MBG), which with 3.500 investments represents about 50% of the total number of investments of the German Venture Capital Association, primarily provides silent partnerships, at attractive interest conditions. While the target population ranges from start-up and business transfers to established companies engaged in innovation and expansion, the investment range spans from  $\in$  50,000 to  $\in$  2.5 million, thus straddling the lower and middle tier investment classes. The average investment amount is  $\in$  350,000, which is a low ticket size. The MGB silent partnerships feature a number of advantages: Banks can reduce their overall risk by including the MGB investment in the structure of the financial offer made to the client. The silent partnership is attractive to fast-growing companies financed by venture capital funds, as the MBG does not interfere in the business policy. It also has to be emphasised that MBGs serve companies for all sectors and commit for long-term investments of usually 10 years. Last but not least, the investment is systematically guaranteed through a 70% guarantee issued by the partner Guarantee bank<sup>23</sup> improving the company's access to credit financing.

http://www.bvk-ev.de/privateequity.php/

#### Equity Guarantee (by AWS - Austria Wirtschaftsservice)

By covering part of the risk of the investor the programme offers an incentive to invest in SMEs through equity or quasi equity instruments. The guarantee covers 50 % of the capital invested in the SME. The maximum amount of the equity and mezzanine finance guaranteed is  $\notin$  1 million (provided by one or more investors) per company. The programme is especially directed at private investors who invest in young companies that are innovating or expanding. According to AWS's experience with the programme about 75 % of the investments guaranteed are done via mezzanine finance instruments. The average of Equity Guarantee, from the Austrian promotial bank, the AWS (Austria Wirtschaftsservice), is  $\notin$  90,000.

#### Innovation Loan from ALMI, Sweden

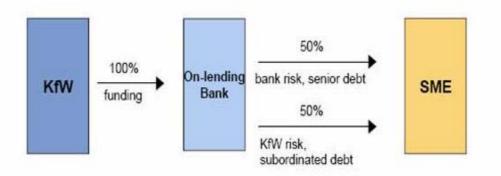
The promotional loan programme of ALMI, the public financial institution operating in Sweden, pursues the goal of providing funds for the start-up of a company. ALMI commits itself in a very early phase to finance a share of the project costs via a subordinated loan. The financing decision is purely based on the project idea and the expected revenues, so that normally no collateral has to be provided. The programs functions as a "door opener". With ALMI's early financing commitment, the availability of additional private funds from other banks or venture capital companies is reinforced, which would otherwise probably not be provided. ALMI provides the subordinated loan with a fixed market-based interest rate which reflects the relatively high risks related with a start-up. The maturity of the subordinated loan is up to five years. Repayment starts immediately after disbursement as ALMI provides financing from a revolving fund with a fixed budget. The default risk is taken by ALMI with risk-sharing from the Swedish government. ALMI is looking for risk-sharing elements at national and European level. As the technical risk for projects in this program category seems to be more controllable in comparison to other more

<sup>&</sup>lt;sup>23</sup> The German Guarantee Bank Association (Verband Deutscher Bürgschaftsbanken) is member of AECM, the European Mutual Guarantee Association, which represents 32 guarantee associations from 1§ Member States as well as Turkey

research-intensive ones, the external know-how provided concentrates on free of charge "management advice" to prepare the founders for management and strategic questions and to assist in the preparation of a reliable business plan. ALMI uses its own experts.

## ANNEX 3 FILLING THE GAP IN MEZZANINE FINANCE

Features of the KfW Entrepreneur Capital Programme ('Capital for Work and investments')



Capital for Work and Investment is a scheme from KfW Mittelstandbank offering subordinated loans to established SMEs that have been operating in the market for more than 5 years. The loans granted, carry different interest rates depending on the applicant's credit standing. Businesses with a good credit standing will benefit from low interest rates, whereas weaker companies are still offered access to capital but at risk-adjusted interest rates. The scheme is part of a wider programme offering also subordinated loans to start-ups (ERP Capital for Start-up) and young, expanding companies (ERP Capital for Growth). What all three funds have in common is that banks are relieved from the risks of a possible loss of the subordinated capital. These risks are assumed either by the German government or by KfW Mittelstandsbank.

As shown in the figure, the loan offered to an SME in the Capital for Work and investments scheme consists of 2 tranches of equal size: a classic senior debt provided by KfW through the on-lending bank in which the risk is carried by the on-lending bank and a subordinated loan provided by KfW through the on-lending bank but 100% secured by KfW.

http://www.kfw-mittelstandsbank.de/EN Home

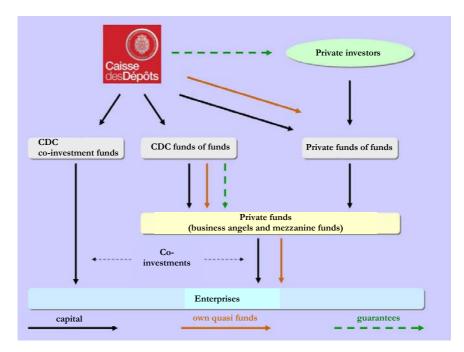
## Long-term French Investment Program (France Investissement) of CDC Entreprises

The main objective of CDC Entreprises is to stimulate the development of SMEs with strong growth perspectives based on technological innovation by offering risk taking capital. The new € 2 billion French Investment Program has two main targets: first, to increase seed and expansion fund investments; second, to develop new operations such as:

• Investment in funds of funds. France Investissement takes a minority stake in venture capital funds providing equity to SMEs. In this respect the programme has a selective approach and invests on best cash returns, long-term value creation, professional management of the funds of fund's teams and commitment on first round of business financing. Mezzanine finance by the funds of funds is not essential but can play a role.

- Supporting business angels' funds by providing them with capital, offering a helping hand in working together and helping them to organise their governance rules and increase their selectivity ratios.
- Investments in small mezzanine funds. Currently there are only a few players in France. Therefore, the programme wants to stimulate the creation and development of these new players as an alternative to pure venture capitalists.

Within the programme CDC Entreprises is also considering securitisation by asset-backed securitisation vehicles. Furthermore the programme is funding the OSÉO Guarantee system, which will guarantee 35% of the capital invested by the funds and the business angel funds. Below is an overview of the various activities:



#### Rabo Innovatiekapitaalfonds (Rabobank Innovation Capital Fund)

Rabobank Innovation Capital Fund invests in start-ups which deliver innovative and endurable products or services. Applicants must adhere to the principles of People Planet Profit for socially responsible business practices. The companies in which it invests have already passed the product development phase and technical risks have been practically eliminated. They have taken the first steps in marketing or are ready to introduce the product into the market. To support this introduction into the market, the investment is applied, for example, towards the start-up of production or sales and marketing. The minimum investment is  $\pounds$  125,000 the maximum being  $\pounds$  1,000,000 in the form of risk-bearing capital with or without subordinated loans. The fund becomes a financial participant and also strives to utilise the Rabobank Group network in order to optimise the possibility for success.

http://www.raboparticipaties.nl

## FIFTH ROUND TABLE BETWEEN BANKS AND SMEs

#### PARTNERS

Association of European Chambers of Commerce (EUROCHAMBRES)

European Association of Craft, Small and Medium-sized Enterprises (UEAPME)

BusinessEurope (UNICE)

European Association of Cooperative Banks (EACB)

European Savings Bank Group (ESBG)

**European Banking Federation (EBF)** 

Network of European Financial Institutions for SMEs (NEFI)

European Mutual Guarantee Association (AECM)

European Federation of Accountants (FEE)

http://www.eurochambres.be

http://www.ueapme.com

http://www.businesseurope.eu

http://www.eurocoopbanks.coop

http://www.esbg.eu

http://www.fbe.be

http://www.nefi.be

http://www.aecm.be

http://www.fee.be