Small and Medium-sized Enterprises and their Access to Business Finance

Prof. Dr. Thomas Henschel

Hochschule für Technik und Wirtschaft, Berlin

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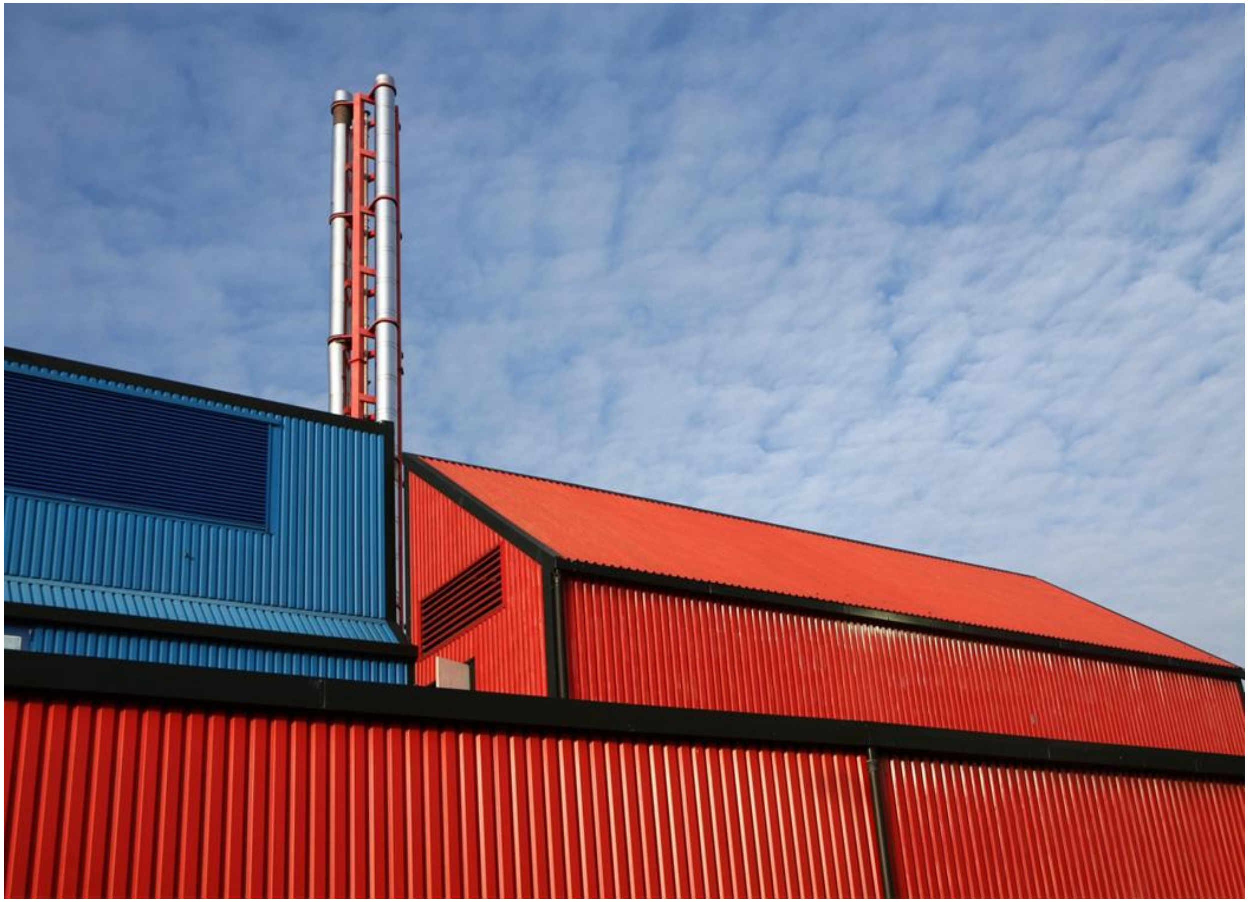


SME definition

SME thresholds	Staff	Turnover (Millionen €)	Balance sheet total (Millionen €)
Micro enterprise	0-9	up to 2	up to 2
Small enterprise	10-49	up to 10	up to 10
Medium-sized enterprise	50-249	up to 50	up to 43

Source: European Economic Community (2008)

"**Legal independence criterion**": A maximum of 25 % is owned by one or more enterprises which themselves do not match the threshold conditions above.

SMEs role in the European Economy

- Create **entrepreneurial spirit** and **innovation** which is essential to promote competitiveness and employement . They are the major source of jobs.(European Commission, 2011).

- SMEs generate **66.7% of employment** in the European Union, employing over 90 million people (Eurostat, 2011).

- **92%** of firms in the euro area are **micro firms**, 7% are small firms, 1% are medium-sized firms and 0.2% are large firms (European Central Bank, 2013).

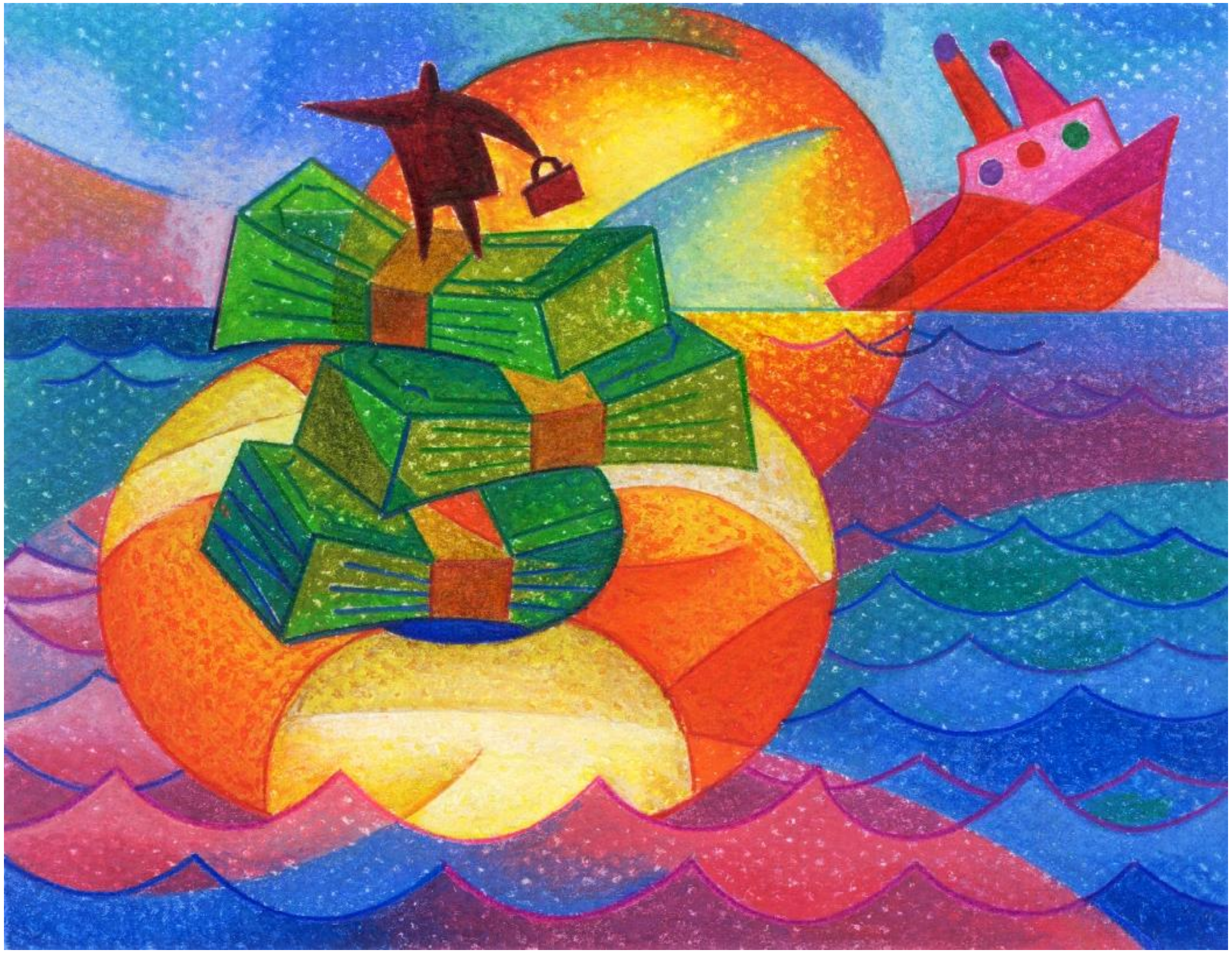
- SMEs are companies with **limited resources** due to their size. They must overcome huge difficulties to cope with open up foreign markets, market evolution and legislation changes (Marcelino-Sadaba et al., 2014).

2. Financing of the small firm: Characteristics and obstacles to growth

Financing of the small firm: Characteristics and obstacles to growth

- The entrepreneurial risk is linked with the loss of wealth.
- Information opacity
- High involvement of owner in running and managing the firm.
- Limited resources
- Limited access to organised capital markets (Equity Markets).
- Investment and Financing decisions are closely interrelated.
- Small knowledge of management techniques, especially in owner-managed firms.
- The bookkeeping and the preparation of the financial statements is done by the tax advisor, especially in micro and small firms.

3. Financial situation of SMEs in the Euro area



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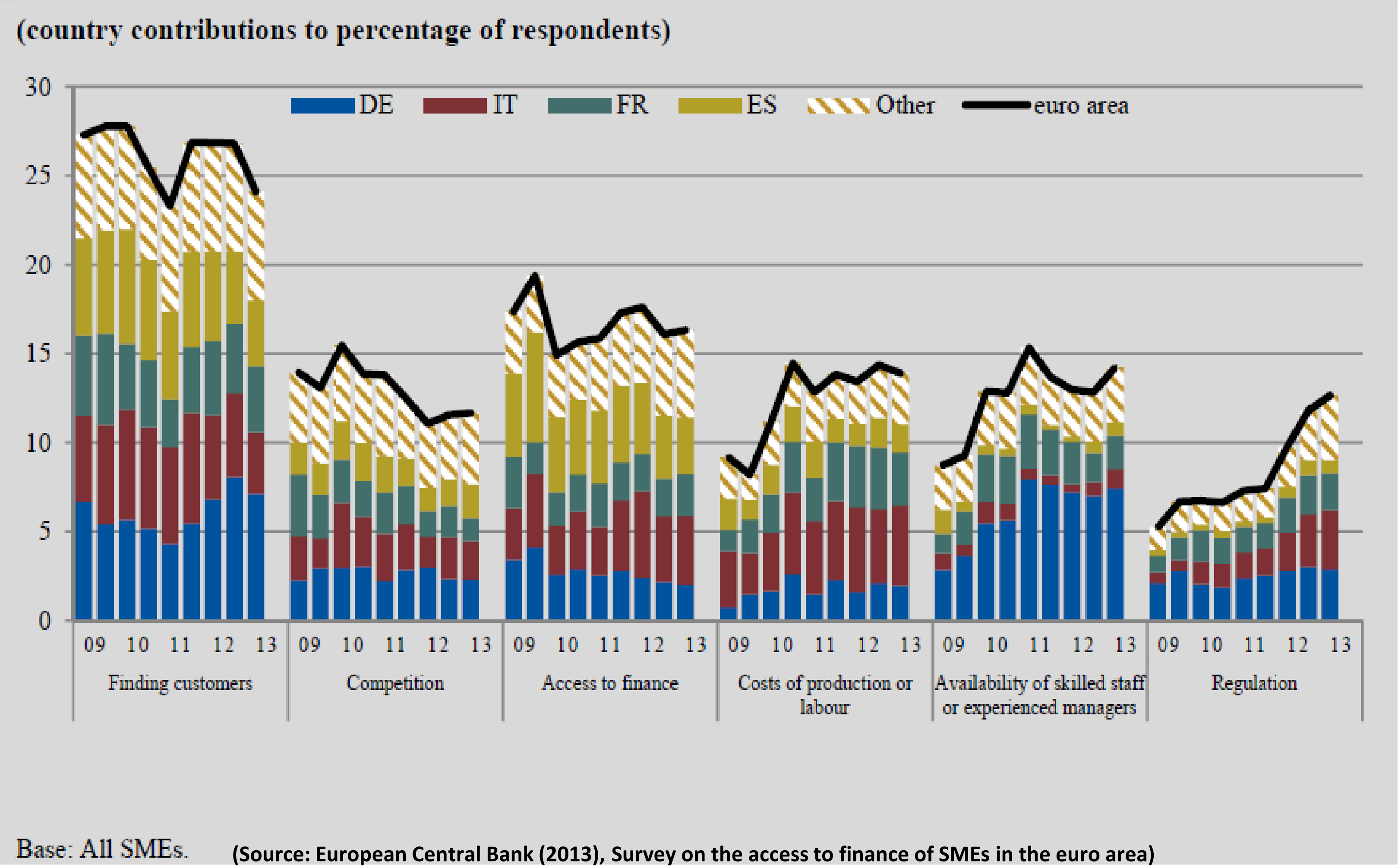
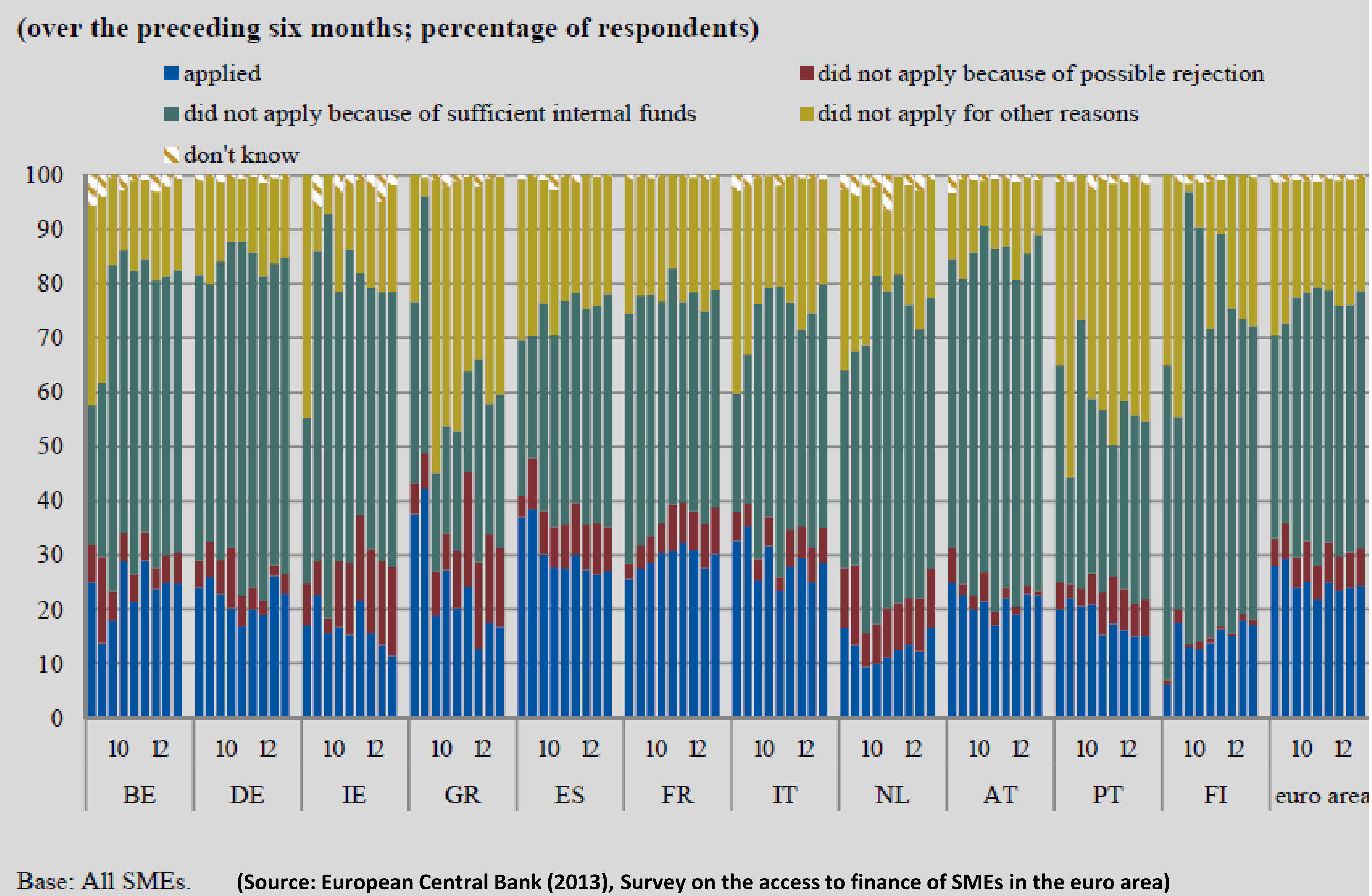
Country contributions to the most pressing problems faced by Euro area SMEs



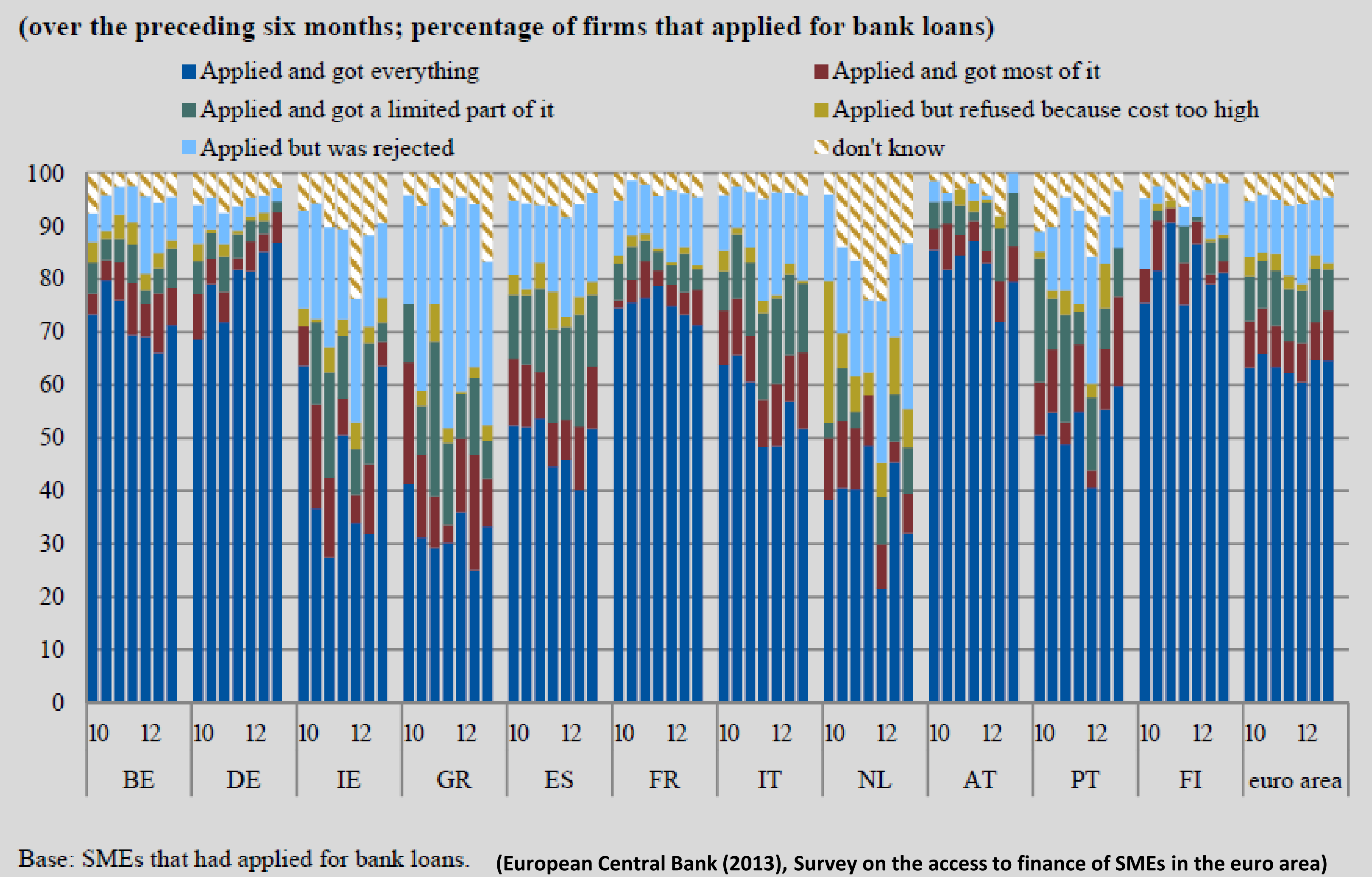
(Source: European Central Bank (2013), Survey on the access to finance of SMEs in the euro area)

Applications for bank loans by SMEs, across euro area countries



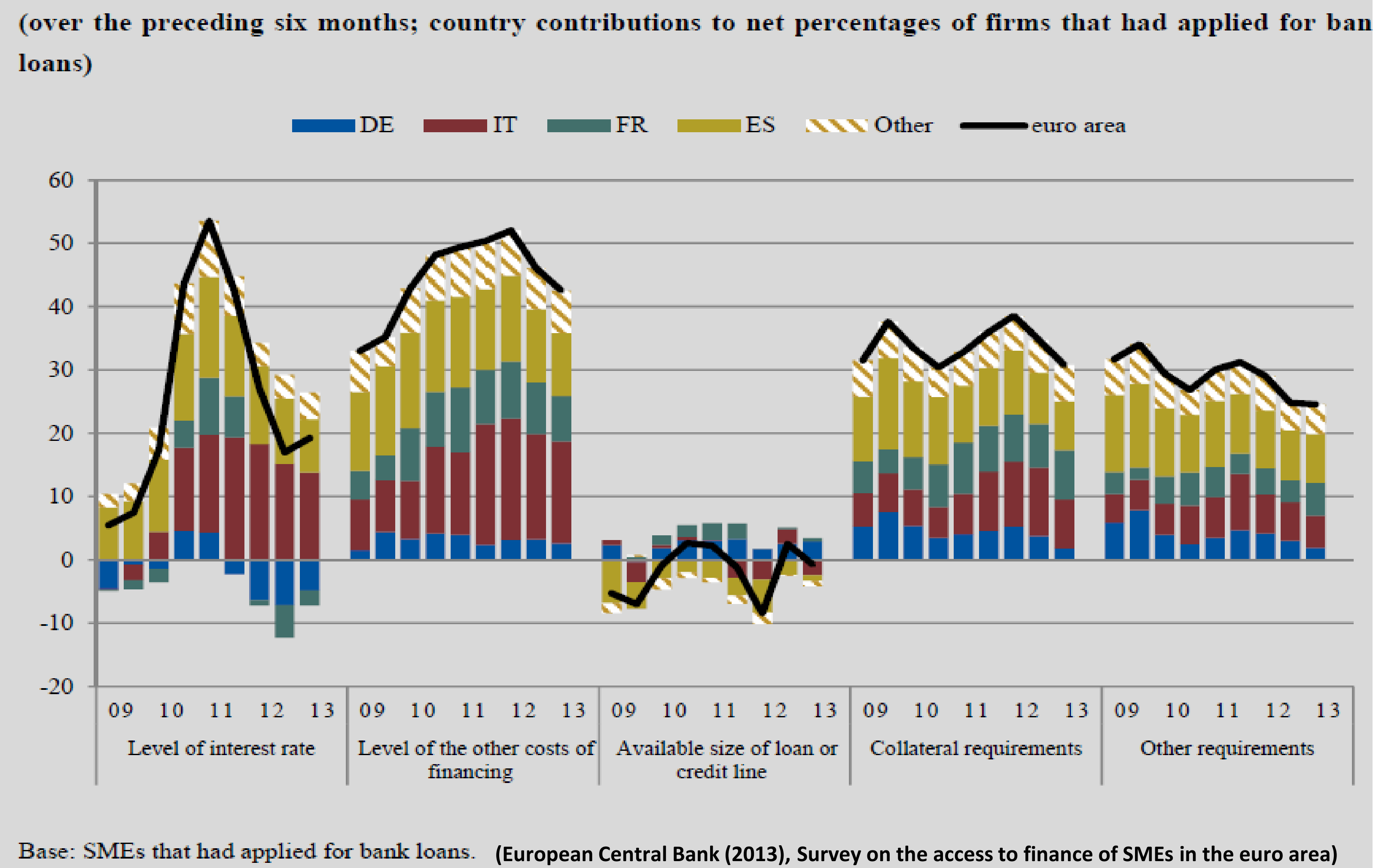
(Source: European Central Bank (2013), Survey on the access to finance of SMEs in the euro area)

Outcome of the application for bank loans by SMEs across euro area countries



(European Central Bank (2013), Survey on the access to finance of SMEs in the euro area)

Country contributions to the change in terms and conditions of bank loans granted to Euro area SMEs



(European Central Bank (2013), Survey on the access to finance of SMEs in the euro area)

Summary of survey findings

- Finding customers and **access to finance** remain the dominant concerns for euro area SMEs.
- SMEs report a **marginal deterioration** in the perceived availabilty of bank loans.
- Survey points to an increase in **interest rates** offered to SMEs, while conditions still differ significantly across countries.

(Source: European Central Bank (2013), Survey on the access to finance of SMEs in the euro area)

4. Evaluation of financing sources in the light of Basel III

Features of Basel III

- Strengthening of higher global **minimum capital standards** with respect to equity quality and risk weighting.
- Implementation of **Leverage Ratio** for banks.
- Development and fixing of **global liquidity standards** (liquidity coverage ratio and Net stable funding ratio) for financial institutions to promote short-term and long-term resiliency to liquidity shocks.
- Setting up of a **capital buffer** and a **counter-cyclical buffer** to foster the availability of external financing by banks.

Consequences for SMEs access to finance

- Banks have to set aside **more equity** for loans to SMEs compared to Basel II capital requirements.
- The new „Leverage Ratio" will **cap** the lending volume of a bank.
- This can lead to a **deterioration in the availablity** of bank loans for SMEs.
- SME will face a **worsening** of terms and conditions for bank loan financing. Or the bank will even **deny an additional financing** to carry on with an investment project.

Financing strategies for SMEs to mitigate these obstacles

Levers for optimization of financing strategies:

- Increase of **SMEs attractiveness** as a prospective borrower
- **Banks' attitude towards SME lending** (bank's business model, amount of equity capital, profitability)
- Use of financial products which are **independent** from **Basel III** regulations (eg. Equity or Mezzanine capital).

Increase of SMEs attractiveness as a prospective borrower (1/2)

- Knowledge on how the bank is calculating the risk weighted assets for counterparty credit risks.
- Critical factors for the **calculation of risk weighted assets**
  - Improvement of internal or external rating
  - Amount and typ of collateral
  - Denomination of the loan among several lending banks

Increase of SMEs attractiveness as a prospective borrower (2/2)

- Development of a **pro-active relationship** with the lending bank
  - Improvement of financial communication and information
  - Preparation of regular financial reporting packages, addressing R&D activities and investment plans
  - The reduction of information asymmetries will support a better analysis of risks and opportunities of the borrower. This will lead to a reduction of screening and monitoring costs for the bank.

Banks’ attitude towards SME lending

- **Strong equity base of bank** -> clear impact on the lending volume by the bank
- **Deposit-funded lending businesses** such as saving banks and co-operatives will reduce the repayment terms for their loans due to the matching maturities principle (long-term funds = long-term loans).
- The new **leverage ratio** will hit banks which mainly serve smaller clients most.

Financing which is independent from Basel III regulations

- **Standard Financing**
  - Venture Capital, Private Equity
  - Subordinated Loans, Mezzanine Financing
  - Leasing, Factoring, Sale and Lease Back
- **Grants or subsidised bank loans**
  - Support from public sources in the form of guarantees
  - Reduced interest rate loans
- **New Financing**
  - Debt securities issued
  - Special segment on the stock market for SME debt securities

Credit guarantees as means to mitigate the pressing problems

Bank denies loan to SME	Reasons: Higher default risk Lack of sufficient collateral Higher credit processing costs
Guarantee Bank provides guarantee	Bank supports SME with application Viable business project is required
Bank provides loan	Guarantees are securities of first rank for the bank Guarantees reduce credit risk
Learning process	Bank: Some SMEs are not so risky SME: How to improve management What information is needed
SME gets loans without guarantee	Borrowers „graduate“ to borrowers without guarantee

Source: Valentin (2013)

5. Conclusion and Recommendations

Conclusion and Recommendations

- The increase of the **equity ratio** is an important precondition for the sustainable development of SMEs.
- The **standard financing strategy** via bank loans will decrease in the future. However, especially for start-up financing it will remain an important source of funding.
- **New financing products/programmes** will increase with the result of a reduced debt-dependency.
- A sound **management** and provision of **prospective financial information** will be very important to get access to external finance at acceptable terms and costs.

References

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Thank you for your attention!