OLIVER WYMAN

Financial Services

TOWARDS BETTER CAPITAL MARKETS SOLUTIONS FOR SME FINANCING

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Small and medium enterprises (SMEs) – businesses with fewer than 250 employees – play a critical role in global economic development. They are the engines of innovation and new job creation. Yet SMEs find it difficult to obtain financing. Given their small size, SMEs have tended to rely on bank lending. However, following the global financial crisis, this source of financing has become increasingly expensive and therefore difficult to access. This threatens to suppress the growth of SMEs and economic development.

SMEs can bypass traditional bank lending by instead issuing equity and debt securities in the capital markets. The fixed costs make this more difficult for SMEs than for larger firms, but not impossible.

Given the importance of SMEs to national prosperity, it is essential that stakeholders work together to develop new capital market based mechanisms to support SMEs. This *Oliver Wyman Perspective* proposes some innovative solutions to enable better access to financing:

- Information platforms and support services via exchanges
- A pan-regional SME market place
- Virtual bulletin boards across exchanges
- Government supported SME platforms
- Hybrid models linking banks and exchanges
- SME mutual guarantee networks
- Retail orientated solutions, such as crowd funding
- High-end institutional solutions

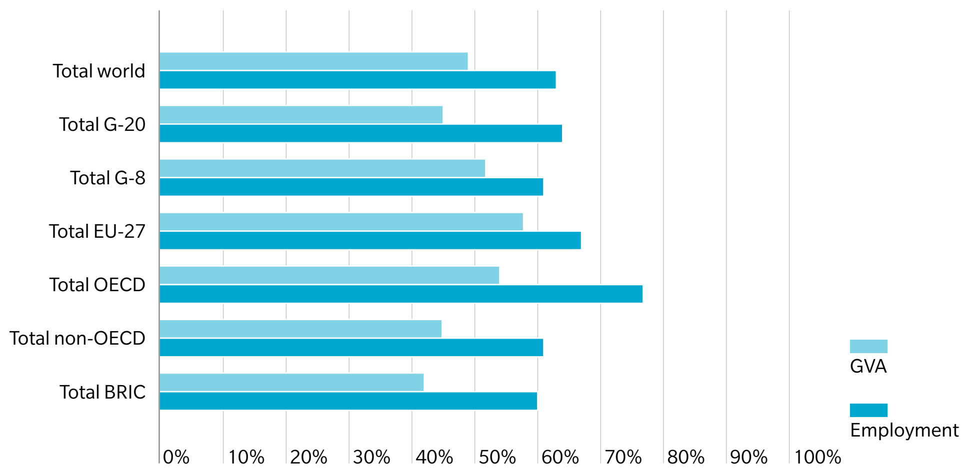
We also take a closer look at the economic importance of SMEs, the financing market and the strengths and weaknesses of current capital market mechanisms. Looking forward, we outline recommendations that will be imperative to the future growth of SMEs.

PART ONE: SME FINANCING TODAY

1. SME MARKET CONTEXT AND IMPORTANCE

SMEs account for nine out of ten businesses globally. They provide more than 60% of overall employment world-wide and roughly 80% of jobs in the developed world. SMEs contribute approximately 50% of global Gross Value Added (GVA), and an even larger percentage in developed countries.

Exhibit 1: GVA and employment contribution of SMEs



Source ACCA, Small Business: A Global Agenda, 2010

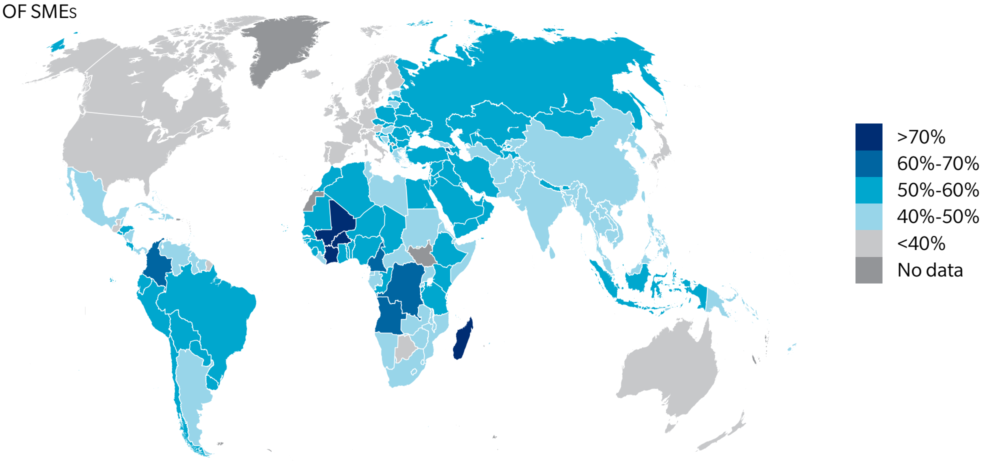
SMEs require financing throughout their development lifecycle – from seed capital during start up, through to growth investment in their development stage. However, they face significant challenges in accessing finance, thus limiting their ability to rise above SME status and stifling their economic growth. 70% of SMEs do not use formal lending facilities, while another 15% are underfinanced from such sources. The total unmet demand for credit by all formal and informal SMEs is estimated to total $3.5 TN (equivalent to 30% of all formal SME credit outstanding). The International Finance Corporation (IFC) estimates the formal SME credit gap to be $1.5 TN globally[1] – a third of it in high-income Organization for Economic Co-operation and Development (OECD) states and two thirds in emerging markets and developing countries. Restricted access to finance was cited by SMEs worldwide as their greatest constraint on growth.[2]

1 IFC Enterprise Finance Gap Database 2011

2 IFC, AFME, Oliver Wyman analysis

Exhibit 2: Credit gap of unserved and underserved SMEs

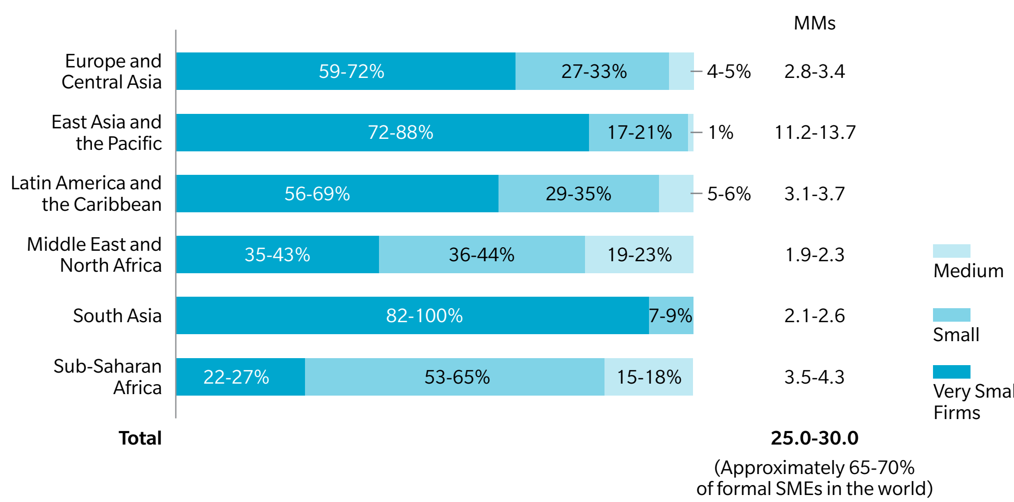
% OF SMEs



Source IFC, Enterprise Finance Gap Database, 2010/2011; Oliver Wyman estimates

Exhibit 3: Formal SMEs globally

% BREAKDOWN AND TOTAL # OF SMEs

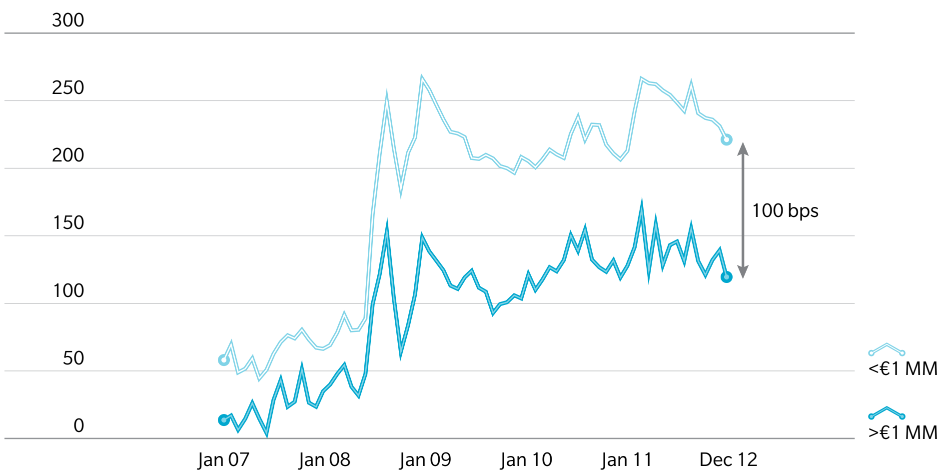


Source IFC, "Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises", 2013. Formal SMEs defined as registered entities

The global financial crisis has left its mark on SMEs as banks and regulators have applied more cautious risk management and credit underwriting processes, most obviously, through the application of Basel III. This has pushed the quantity of SME lending down and the price up. A comparison of the average cost of loans in Europe shows the widening gap between lending to SMEs and to large firms.

Exhibit 4: Cost of new loans in Europe by ticket size

2012, BPS



Source ECB, ECB SME funding survey 2012, Oliver Wyman analysis (Averaged across tenor; Spread calculated as corporate loan interest rates minus base Euro area base rate)

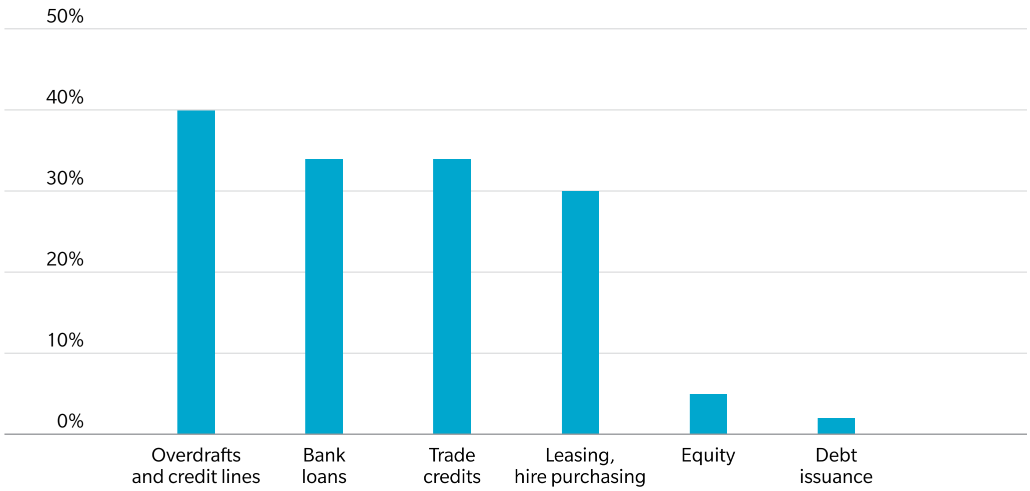
Governments can help to improve the flow of capital to SMEs – not by lending to them directly but by ensuring that the institutional environment is conducive to SME lending. Specifically, the wider use of capital market-based solutions can help bring the private and public sectors together to realize broader economic and social benefits of lending to an SME.

2. CAPITAL MARKET FINANCING SOLUTIONS FOR SMEs

SMEs have been forced to alter their funding mix as the cost of finance has risen while economic conditions have remained poor. SMEs predominantly use short-term funding options including overdrafts, lines of credit and bank loans. Such sources can be valuable in the start-up stage but they do not provide the long-term financing required as companies mature or seek growth.

Exhibit 5: SME financing sources in Europe

% OF SMEs USING EACH SOURCE, 2013



Source ECB, ECB SME funding survey 2012, Oliver Wyman analysis

Capital markets are the obvious alternative to bank lending. However, raising capital by issuing equity or debt securities involves high average transaction costs, onerous listing requirements and complex legal and regulatory frameworks. For these reasons, it has typically been the preserve of large firms. In 2013, from a sample surveyed (see Exhibit 5), only 5% of SMEs in Europe issued tradable equity and 2% issued debt. Nevertheless, we believe that up to 20% of SME funding could be sourced from the capital markets.

Capital markets solutions available to SMEs can be divided into three broad categories ("platform" is used below as a general term encompassing exchange-like trading mechanisms).

Exhibit 6: Categorization of existing capital market based mechanisms

	TYPICAL SME SIZE	TYPICAL SME LIFECYCLE STAGE	RELATIVE COST OF FINANCE	TIME TO RAISE FINANCE	SOURCE OF LONG TERM FINANCE
SME EQUITY PLATFORMS	Medium sized SMEs (e.g. 150-200 FTEs[3])	Established/ mature companies	High	High	High
SME DEBT PLATFORMS	Medium sized SMEs (e.g. 150-200 FTEs)	Established/ mature companies	High	Medium	High
ALTERNATIVE LISTING VENUES (WITHOUT TRADING)	Smaller sized SMEs (e.g. <150 FTEs)	Developing/ established companies	Low	Low	Low

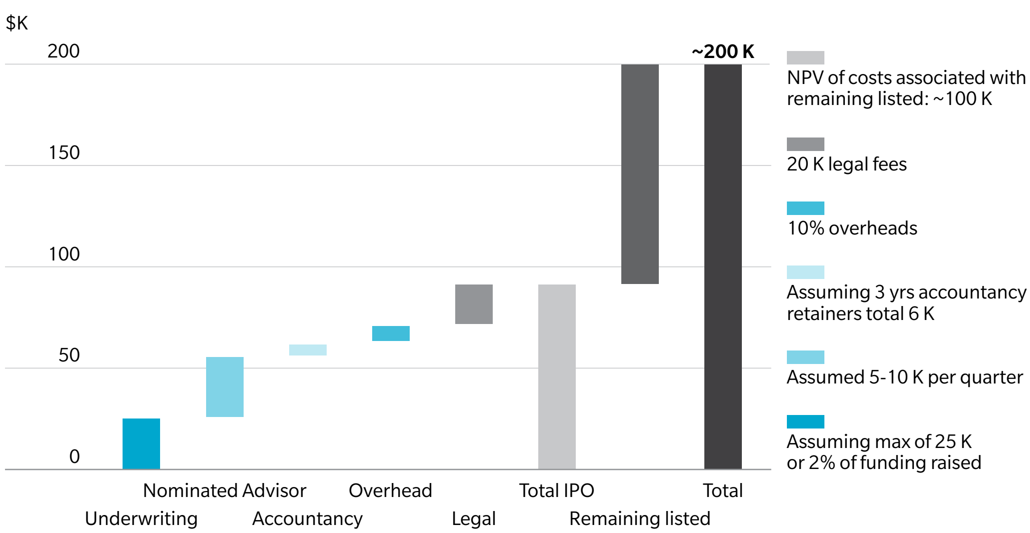
3 FTEs-Full Time Employees

A. SME EQUITY PLATFORMS

SME-focused equity platforms have been established across the globe, offering an alternative to main listing boards on national stock exchanges. Equity platforms provide SMEs with the opportunity to IPO once they have become well-established. In most markets the SME platform acts as a second-tier listing alternative to the main stock exchange. Such platforms are characterized by lower listing requirements and costs to list than the main board, helping to make it a viable solution for SMEs seeking finance. SME equity platforms are best suited to the largest SMEs (i.e. the medium segment) given the initial cost and on-going listing requirements most platforms demand.

Several platforms around the world have proved successful: the Alternate Investment Market (London), TSX Venture (Canada), HK GEM (Hong Kong), Mothers (Japan), Alternext (Europe) and AltX (South Africa). Each of these markets has grown rapidly and maintained a sizeable number of listings. Given the observed costs of setting up such platforms, 15-20 IPOs are required for launch with a critical mass of 100-150 listings in place after five years[4].

Exhibit 7: Cost of listing on an SME platform: assuming 1x market cap: turnover and 50% float



Source Oliver Wyman analysis based on reviewing the listing cost on SME equity platforms

However, there are still obstacles to SME equity platforms becoming widely used. The cost for companies to list ($80-100 K) and remain listed on a platform ($100-120 K per annum) is high. In addition, because most SME issuances are small, many institutional investors are reluctant to buy and trade them. This reduces downstream liquidity, with SME exchanges typically having about 30% the liquidity of main markets.

Investors have also been deterred from playing an active role on many SME platforms by their complex legal and regulatory frameworks. For example, some equity platforms failed

4 Oliver Wyman analysis based on review of SME exchanges

on account of loose listing and de-listing regimes that led to a lack of confidence from investors utilizing the platform.

B. SME DEBT PLATFORMS

Given the low interest rates seen in most developed markets, issuing debt securities has become a better option than equity IPOs. In Europe there has been an increase in small bond issuances of less than €10 MM. As with equity platforms, issuing debt securities is better suited to the more mature and larger SMEs.

Spain has recently set up MARF, an alternate fixed income platform, which aims to ease access to the market for both issuers and investors. NYSE Euronext has recently announced plans to promote the issuance of corporate bonds by SMEs via its Alternext capital markets platform. And several regional stock exchanges in Germany have successfully launched SME debt platforms in recent years. Over 50 SMEs have raised close to €2.7 BN via the SME bond market platforms established individually by the Düsseldorf, Frankfurt, Hamburg-Hannover, Munich and Stuttgart exchanges.

Yet the vast majority of SMEs still do not use debt market platforms to raise funds. In 2013, less than 2% of SMEs in Europe used debt capital markets for financing (see Exhibit 5).

C. ALTERNATE LISTING VENUES (WITHOUT TRADING)

Platforms have emerged that allow non-banks to lend directly to corporates and individuals. Such venues are suitable for SMEs in their early development stage and most support the smaller SMEs: i.e. companies with fewer than 100 Full Time Employees (FTEs).

These loan matching platforms facilitate the lending process between borrowers and investors through peer to peer (P2P), peer to business (P2B), investor to peer (B2P) or investor to business (B2B) transactions. They provide borrowers with access to a broader base of lenders, while providing lenders with opportunities for higher yield and diversification. There are four basic business models for these loan matching platforms:

- **Pure match model:** Platform enables direct contact between investors and borrowers: e.g. Deal Market, FinPoint
- **Marketplace model:** Lenders fund borrowers at defined interest rates: e.g. Lending Club
- **Auction model:** Lenders bid on loans. Successful bidders are lenders with lowest offered rates: e.g. Funding Circle
- **Crowd-funding:** Investors fund start up projects in return for an unlisted equity share: e.g. Kickstarter and Indiegogo

Investors can be wary of using such platforms because limited screening of SMEs can lead to some poor quality companies being listed. To attract investors, these platforms should specify minimum criteria for companies to join a platform and form a committee to review applications.

3. BENEFITS OF SUCCESSFUL CAPITAL MARKET SOLUTIONS FOR SMES

Despite the challenges faced by the current platforms, vibrant SME capital markets promise benefits for many stakeholders.

Issuing equity and debt securities can provide SMEs with the stable, long-term financing that bank lending typically does not. Because these securities are tradable, their prices provide information about the performance and value of the SMEs concerned. This transparency, combined with the ease of exit created by tradable equity and debt, makes SMEs more attractive investments for venture capitalists (VCs). And it creates a discipline on SMEs' management, improving their internal governance and external communications.

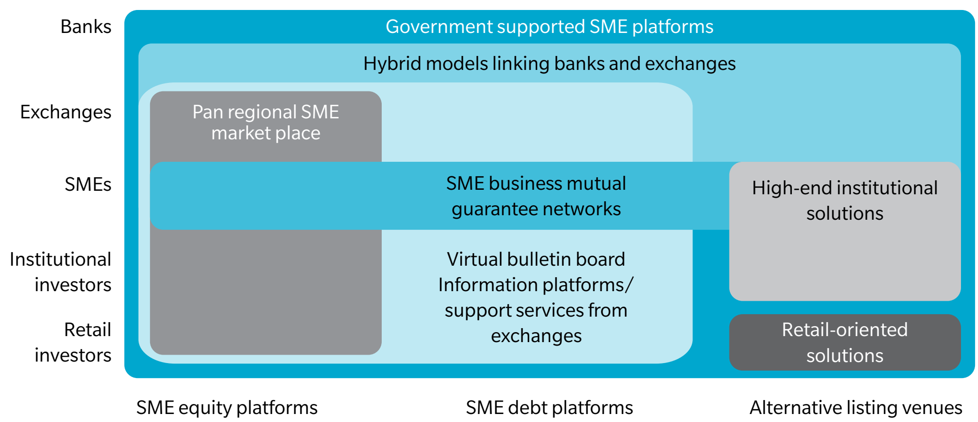
SME securities give investors access to a broader and more diverse set of investment opportunities within a regulated and transparent environment. And exchanges earn new revenue streams by intermediating SMEs and investors, while helping to increase the number of companies that subsequently graduate to their main exchange board.

By encouraging more SMEs to start up and to expand, SME capital markets stimulate economic growth and job creation. Based on our analysis, successful SME capital markets can add up to 0.1-0.2% uplift in the contribution of SMEs to overall GDP each year, while supporting the creation of hundreds of thousands of new jobs globally.

PART TWO: TOWARDS BETTER CAPITAL MARKETS SOLUTIONS FOR SME FINANCING

The IFC estimates the SME financing gap to be $1.5 TN.[5] We believe that capital market-based solutions could provide 5-10% of this shortfall i.e. between $75 BN and $150 BN. To do so, barriers to their use must be lowered. In this part of the report we recommend a number of measures that we believe will help to achieve this.

Exhibit 8: Impact range of the proposed solutions



1. INFORMATION PLATFORM AND SUPPORT SERVICES FROM EXCHANGES

Exchanges can do more for SMEs than providing a venue for the trading of their securities. They can also connect SMEs to different types of investors (such as angel investors, VC and private equity) and help them gain access to ancillary professional services. These services could include stakeholder coordination and management, due diligence and prospectus writing, investment case development, IPO roadshow support and financial PR and marketing services.

The exchange can also connect companies to professional services such as accountants and legal advisors. This would prove valuable not only to the SMEs but, by increasing the quality of their financial reporting, would be valuable to investors considering SMEs. A major gap for investors at present is the limited amount of information on SMEs; more is required to make informed investment decisions. Exchanges can help to supplement this gap by either directly providing research and company information, or connecting investors to such sources of data through an online platform.

5 IFC Enterprise Finance Gap Database 2011

Exchanges can also help to attract investors to their platform by providing greater pipeline information on upcoming IPO's. This would help to build interest in SMEs that are planning to list and allow investors to plan ahead on investment opportunities.

2. PAN-REGIONAL SME MARKET PLACE

A pan-regional SME exchange allows SMEs from many countries to list on a platform that covers multiple jurisdictions. This platform would be focused on supporting SMEs in the later stages of their development as they look to raise investment for growth.

A pan-regional market would more easily achieve the critical mass of listings and liquidity that national platforms have historically struggled to attain. A pan-regional market would also bring cross-border investment flows, benefiting SMEs in countries with less developed investment industries and helping to promote economic growth. Investors are provided with a wider and more diverse set of companies to invest in. By increasing liquidity, such a pan-regional platform would also increase ease-of-exit prospects for SME investors and thereby encourage them to make initial investments.

Incumbent exchanges in each country can benefit by creating a virtual window to the pan-regional platform. This could increase liquidity flowing to the domestic exchange, and allow the exchange to move illiquid small cap stocks from its main board onto the platform.

However, a pan-regional framework would require considerable work to overcome challenges created by national differences, including different currencies, tax regimes, listing and disclosure requirements, anti-fraud and post-trade rules and, in some cases, restrictions on foreign ownership. The integration of European Union countries makes these difficulties easiest to overcome in Europe. Not surprisingly, the first example of a pan-regional platform is Europe's Alternext. However, first attempts at pan-regional exchanges are also being made in the Middle East and Africa.

3. VIRTUAL BULLETIN BOARDS ACROSS EXCHANGES

A virtual bulletin board can be created by connecting SME exchanges in a number of countries through a single virtual venue. Such venues use the platforms and operations of existing exchanges, making them significantly easier, faster and cheaper to set up than physical exchanges. Running and maintenance costs are also lower.

Because the cost of listing on a virtual board is significantly lower than on traditional exchanges, smaller firms can more easily gain access to equity or debt funding. And because they are international in scope, virtual boards give SMEs access to a wider range and greater number of potential investors. On the flip side, virtual boards give institutional and retail investors access to a wider spectrum of companies than purely national SME markets do.

As with pan-regional SME exchanges, virtual bulletin boards require a sound (cross-border) legal setting. And they must account for operational differences between their "member" markets when being established.

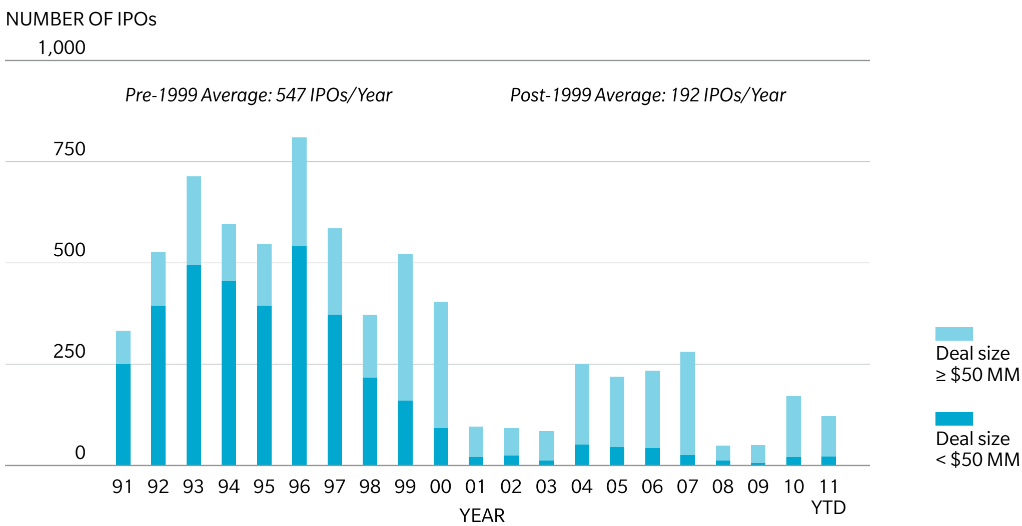
4. GOVERNMENT SUPPORTED SME PLATFORMS

Governments can help SMEs access capital markets funding in several ways

A. IPO TASK FORCE

The number of SME IPOs has fallen significantly in recent years. To help turn this around, governments can establish an IPO taskforce to provide direction and support to SMEs. The task force can lobby on behalf of SMEs and help to remove barriers to SMEs' finding financing solutions. The US IPO taskforce has made a number of recommendations to promote SME listings, including improved availability of information and greater transparency for investors, investor tax incentives for buying and holding IPO shares, and education of issuers about how to succeed in the new capital markets environment. A similar IPO taskforce has now been set up in Europe led by the Federation of European Securities Exchanges (FESE), European Private Equity & Venture Capital Association (EVCA) and European Issuers (EI).

Exhibit 9: Number of IPOs in the US



Source IPO Task Force, Rebuilding the IPO On-Ramp, 2011

B. FINANCIAL MEASURES

Governments can create favorable financial terms for SMEs. Such measures include capital gains tax relief for entrepreneurs when selling small business equity stakes, tax deductions for small business equity, and stamp duty exemption for the shares of SMEs. Reducing the cost of regulatory compliance costs is critical for encouraging SMEs into the capital markets. This cost is cited as a major deterrent for companies considering an IPO in Europe.[6]

C. CENTRALIZED SME RATING DATABASE

A centralized SME rating and information database, either on a national or pan-regional level, would increase the transparency of SME investments. Information could be collected by various government bodies (e.g. Companies House) and then analyzed by a third party company using standardized risk methodologies. If made available via a website, it would allow investors to quickly analyze and benchmark potential investments.

D. ADVISORY SERVICES

Dedicated advisory services can educate SMEs about every phase of development, from investment-environment reforms and building management skills, through to opportunities for accessing capital markets funding. This will help new and growing SMEs overcome their lack of experience and knowledge in these areas.

5. HYBRID MODELS LINKING BANKS AND EXCHANGES

Banks and exchanges are currently operating independently in the SME segment, with the former providing lending and the latter capital market solutions. A hybrid model for SMEs, linking expertise and financing solutions together, would increase market information and transparency for issuers and investors, particularly in countries where bank finance remains dominant.

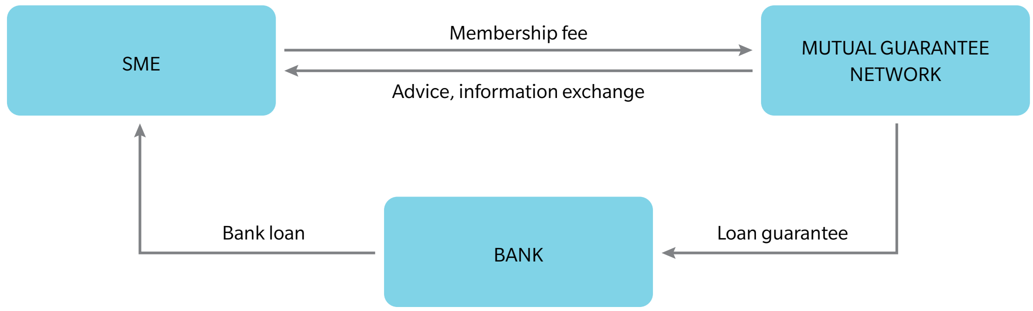
SME credit brokerage is an example of such a hybrid model. SMEs would gain support in financing and wider access to credit via brokerage firms. Investors would benefit from increased information about SMEs provided by the brokers.

Such hybrid models should be cost-efficient to set-up and run because they can piggy-back on banks' current financing platforms and technologies.

6. SME BUSINESS MUTUAL GUARANTEE NETWORKS

A mutual guarantee network for SMEs aims at enabling participants to access credit by granting a collective guarantee for loans issued to their members. In turn, members take part directly or indirectly in the formation of the equity and the management of the scheme.

6 ESMA SMSG Report



Members often have a limited capacity to access traditional bank loans because they are under-collateralized, have a limited credit history or, perhaps, lack the expertise needed to produce sophisticated financial statements. It is therefore important for the mutual guarantee network to set up a rigorous peer review process to control default risks. Since members are companies of similar size and background, the analysis process can be enriched by the SMEs knowledge of products, technological developments and local competition.

Mutual guarantee networks can be used not only to secure financing on more attractive terms than would be received by stand-alone borrowers, but to receive peer advice and build suitable financial structures. And if mutual guarantee networks operate pan-regionally or cross-sector, they provide an effective way to diversify exposures and reduce risk.

Successful nation-wide SME business mutual guarantee networks include Spain's *Sociedades de Garantía Recíproca* and Portugal's *Sociedade de Investimento*. In Italy, a large number of SME business mutual guarantee networks (Confidi) operate at a local level, typically in industrial areas that are characterized by clustering of highly specialized and interconnected SMEs.

7. RETAIL-ORIENTED SOLUTIONS

Retail-oriented solutions connect SMEs directly with a wide investor base. They take three main forms:

- **Reward:** The funds are used to start up a project. Investors receive no financial return on their donation but are compensated by a "reward", such as the SME's product. In addition to providing financing, this model can serve to attract new retail customers to SME businesses
- **Lending:** Investors lend small sums of money to SMEs. By bypassing banks, investors achieve higher yields while SMEs usually receive cheaper funding or better terms
- **Equity:** Retail investors exchange money for a small stake in an SME

This kind of financing requires little infrastructure. A simple online platform is sufficient, which is quick and cheap to set up and maintain. Such platforms already exist, including Deal Market and FinPoint in Europe. SMEs will need to provide information about their business plans and legal documentation for investors to gauge their earnings potential.

Retail-oriented solutions are a cheap form of financing for businesses, with platforms only charging small service fees. It usually costs less than $100 to list an opportunity on the platform. They have proven to be one of the fastest forms of financing for SMEs, with money being transferred as soon as the deal is made, contrasting favorably with the slow bank lending and exchange listing processes.

8. HIGH-END INSTITUTIONAL SOLUTIONS

Institutional solutions are platforms aimed at private equity firms, VCs, angel investors, and family offices looking to invest in SMEs through equity or debt financing. These platforms usually provide services to match investors with the companies that best meet their investment criteria and provide detailed information and data on the respective businesses. Safe exit opportunities for such investors are crucial in such a solution.

NASDAQ Private Market is an example of a new type of platform that allows for the trading of shares in companies that have yet to issue stock to the public. This enables SMEs to obtain early stage investment alongside building relationships with investors that can support later IPO issuance. The platform is targeted primarily at institutional investors or retail investors that access through brokers.

Institutional alternative financing solutions are similar to retail platforms in the sense that they provide a large transparent market place for SME financing in addition to traditional channels such as banks and exchanges.

CONCLUSION

SMEs contribute 49% of global private sector output and 63% of employment world-wide. Given this substantial economic and social contribution, the widening funding gap for SMEs ($1.5 TN in the formal economy) poses a threat to economic growth around the world. It is critical to the economic prospects of many nations that SMEs are provided with the financial support they need.

Government bodies and other interested parties must create the right environment for the provision of private capital to SMEs. The wider use of capital markets can help bring the private and public sectors together and support SMEs' access to financing.

We believe the set of capital markets solutions outlined in this paper can contribute to closing the SME financing gap (by 5-10%), increasing SMEs' contribution to GDP by up to 0.1-0.2% per annum and creating hundreds of thousands of jobs globally. However, this requires multiple parties beyond the traditional SME-bank relationship.

It is imperative that the private and public sectors work together to improve SMEs' access to financing and realize the wider economic and social benefits of lending to an SME.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, and organisation transformation.

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