MEZZANINE FINANCE: A TOOL FOR BROADENING SME ACCESS TO CAPITAL

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Structure of the presentation

• Some relevant OECD work
• The SME “finance gap”
• Study method
• What is mezzanine financing?
• Mezzanine on spectrum of financing tools
• Types of SMEs suited to mezzanine
• Nature of commercial mezzanine
• Role of public policy for mezzanine finance
  1. Public participation in funds
  2. Direct public funding to individual SMEs
• Case studies of public participation – France, USA
• Conclusion
The SME “Financing Gap”: Theory

• As risks rise, finance providers should sufficiently increase interest rates to bring supply and demand into balance.

• Stiglitz & Weiss, 1981: Rational for banks to engage in “credit rationing” due to asymmetric information and agency problems.

• Banks have difficulties distinguishing good risks from bad risks and monitoring borrowers once funds are advanced.

• Banks hesitate to use interest rate changes to compensate for risk in the belief that by driving out lower-risk borrowers, high interest rates may lead to a riskier loan portfolio.

• Banks could maximise their return by setting an interest rate that leaves large numbers of potential borrowers without credit.
The SME “Financing Gap”: Particularities of SMEs

• Asymmetric information
  – Less transparent accounts
  – Greater use of informal finance
  – Wider variance in profits and lower survival rates
  – Difficult to distinguish financial situation of the firm from the owner
  – Stakeholder relations reflect personal relationships to a higher degree

• Agency problems
  – More likely to be motivated to undertake excessively risky projects
  – Less trained managers that may be more likely to make erroneous decisions
  – Asymmetric information makes it more feasible to undertake risky projects
  – Owners may not wish to relinquish any control
The SME “Financing Gap”: Range of Instruments

• Various financial instruments can help overcome the asymmetric information and agency problems:
  – trade credit places the risk on the asset not the SME
  – collateral can compensate for loan losses
  – equity offers some monitoring and control and investor participation in the “upside” risk

• An efficient financial system should have a range of instruments that matches needs of firms

• If the right instrument is available for the risk/return profile the market could provide finance for a viable project

• But some public “market prodding” may be required
### The SME “Financing Gap”: Types of firms

<table>
<thead>
<tr>
<th></th>
<th>Established stable SMEs</th>
<th>Start-ups</th>
<th>Growth SMEs</th>
<th>SMEs in transition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk/return profile</strong></td>
<td>Low risk, ongoing returns</td>
<td>High risk, later returns</td>
<td>High risk, later returns</td>
<td>High risk, later returns</td>
</tr>
<tr>
<td><strong>Finance needs</strong></td>
<td>Small, ongoing</td>
<td>Small to large</td>
<td>Large</td>
<td>Large</td>
</tr>
<tr>
<td><strong>Finance sources</strong></td>
<td>Overdraft, loans, asset-based finance</td>
<td>Loans, equity</td>
<td>Loans, equity</td>
<td>Loans, equity</td>
</tr>
<tr>
<td><strong>Adequacy of supply</strong></td>
<td>Adequate in most OECD countries</td>
<td>Gaps</td>
<td>Gaps</td>
<td>Gaps</td>
</tr>
<tr>
<td><strong>Public role</strong></td>
<td>Loan guarantees</td>
<td>Risk capital</td>
<td>Risk capital</td>
<td>Risk capital</td>
</tr>
</tbody>
</table>
Some relevant OECD work (1/2)

- Challenges/benefits of alternative finance
- Debt finance and alternatives
- Asset-based finance
- Alternative debt
- Crowdfunding
- Hybrid instruments
- Equity finance
Some relevant OECD work (2/2)

Ministerial statement, including: “Use a pluralism of tools adapted to specific needs”

Recent finance trends, business angels, country profiles
Study method

- Review of published material
- Interviews with market participants
- Interviews with national experts in OECD member countries and experts in international organisations
- Questionnaire to OECD governments on public programmes for start-up and early stage finance
- Questionnaire to OECD governments on public mezzanine finance support:
  - Describe official funds managed by private investment managers;
  - Describe programmes for direct mezzanine financing to targeted SMEs
What is Mezzanine Finance? (1/2)

- Hybrid instrument – typical mezzanine facility blends several instruments:
  - Subordinated loan (interest rate above senior loan; principal normally repaid at end as “bullet”)
  - Participation in ongoing revenue or profits
  - Participation in upside share price growth with equity “kicker” (commonly an “equity warrant” allowing purchase of shares at floor price, or equivalent remuneration)
- Operates in private capital market, in private investment partnerships (with up to about 100 private investors)
- Funds supplied by private investors (Limited Partners) – high net worth individuals; family offices; pension funds; other institutions
- Managed by General Partners
What is mezzanine finance? (2/2)

• Has a defined life span (5-10 years) – tend to select investees and do deals in first 3 years, then hold and close fund taking returns at around 8-10 years

• At maturity fund is liquidated and money returned to investors

• Rules determined by market practice
Mezzanine in a continuum of external finance instruments

<table>
<thead>
<tr>
<th>Target return by investor</th>
<th>(Appropriate form of financing at level of leverage)</th>
<th>Finance required by entrepreneur as share of earnings¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%+ p.a.</td>
<td>8x</td>
<td>8x</td>
</tr>
<tr>
<td>10-16% p.a.</td>
<td>4.5x</td>
<td>4.5x</td>
</tr>
<tr>
<td>6-8% p.a.</td>
<td>3.5x</td>
<td>3.5x</td>
</tr>
<tr>
<td>3-4% p.a.</td>
<td>1x</td>
<td>1x</td>
</tr>
</tbody>
</table>

Equity

Junior debt

Mezzanine

1st lien senior loan

Bank revolver (overdraft)

Assets pledged here: cash accounts, receivables, inventories, plant and equipment, real estate, intangibles, stock

Undrawn; bank is the senior creditor and can withdraw quickly

¹ earnings expressed as EBITDA; based on a standard medium-sized firm project
Mezzanine finance vs. private equity

Interesting features for the SME:

✓ Less loss of control
✓ Mature companies acceptable
✓ No geographic restrictions
✓ Lower profit hurdles / target rates of return
✓ Lower cost of capital
Candidates for Mezzanine Finance

- Suited to profitable companies that want to retain control
- Company Profile
  - Positive Cash Flow
  - Strong Management
  - Established Market Position
  - Credible Business Plan
- Objective: a transformation of the company’s situation: expansion, change of control (e.g. transmission to children or professional managers) etc
State of practice

• Uneven presence of commercial mezzanine in OECD countries
• Tends to be focused on larger firms and LBOs
• Not generally issued to SMEs but have features that suit SMEs
• Public intervention may be needed to stimulate the sector and extend to SMEs
Public intervention 1: Participation in the market through mandates to private funds

• Dedicated funds; fund of funds
• Public investors
  – National/ regional investment institutions
  – SME promotion agencies
  – International organizations (EBRD, IFC, ADB, EIF)
• Managed by private fund managers like a commercial fund
• Often require private co-investment
• Examples:
  – Europe: EIF Mezzanine Facility for Growth
  – Germany: Mezzanine Dachfonds für Deutschland
Public intervention 2: Direct provision of funds to SMEs

- Public entity – special vehicle – provides funds directly to company
- The public sector is the only player involved in the fund – rather than one of several Limited Partners around table
- Operate under a structured official programme
- Typical structure: subordinated loan + participation in “upside”
- Risk sharing with private financiers typically required
- Sometimes includes loan guarantees to investors
- Programmes mandated to be self-sustaining
- Examples
  - France: BPI/Contrat de Développement Participatif (CDP)
  - Canada: Business Development Bank of Canada
Public intervention 3: Guarantees/preferential funding of private investment companies

• Government can guarantee loans taken out by private investment companies to help fund their market portfolio

• Government can fund private investment companies at highly attractive terms
  – Lend at government borrowing rate plus a risk spread
  – Investment company must pay interest and repay principal on closure of investment

• Examples
  – USA: Small Business Administration (SBA) Small Business Investment Companies (SBIC)
Case study 1: BPI France / CDP (1/2)

• Justification:
  – Only about one-quarter of French owner or family-managed SMEs would be open to outside equity
  – Returns commonly not high enough for equity finance
  – Straight bank finance hard to obtain for large amounts

• Firms must be more than 3 years old with less than 5000 employees; usually in traditional not high tech sectors

• Firm must obtain funding at least twice as large as the BPI contribution through a loan or an increase in equity (e.g. from existing shareholders)

• BPI can guarantee up to 70% of the senior bank loan
Case study 1: France, BPI / CDP (2/2)

- CDP provides a subordinated loan of 7 years maturity with two years grace (no principal repayments made for the first two years), ranging from EUR 300,000 to EUR 3 million.
- Can be used for intangible expenses (meeting environmental norms, acquisition of other companies, IT, training and recruitment of personnel, foreign expansion, advertising and marketing etc.)
- An insurance policy covering key owners or executives must be purchased.
- A well-rated company pays a spread of 266 basis points over Euribor while a firm in the lowerst rating category eligible pays a spread of 606 basis points.
- BPI receives additional compensation in the form of a share (approx. 5%) of the increase in firm turnover following the loan.
Case study 2: USA, SBA / SBIC (1/2)

- SBICs are privately-owned and managed investment funds, licensed and regulated by SBA, that use their own capital plus funds borrowed with an SBA guarantee.
- SBA matches the private investment 2:1 (exceptionally 3:1).
- SBA takes 10-year unsecured senior debt in the SBIC.
- The SBIC repays interest semi-annually and repays the principal on loan maturity.
- Borrowing cost is based on US Treasury rate plus a spread of approx. 60-80 basis points.
- SBICs are required to investment in small business (net worth less than USD 18 million and taxable net income less than USD 6 million).
Case study 2: USA, SBA / SBIC (2/2)

- At least 25% of an SBIC’s funds must be invested in smaller businesses (net worth less than USD 6 million, taxable net income less than USD 2 million)
- SBA caps interest rates at 19% for straight loans and 14% for facilities with equity features
- Most companies are referred to SBICs by intermediaries such as investment banks, accounts, lawyers and other SBICs
- SBIC can reach its own deals with investee companies
- Most mix senior debt, junior debt, a Payment In Kind (under which interest payments are deferred until maturity of the subordinated loan), and equity warrants
### Case study summary

<table>
<thead>
<tr>
<th>Name</th>
<th>Form</th>
<th>Public investment range</th>
<th>Public contribution</th>
<th>Rights of investor</th>
<th>Mezzanine elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>BPI/CDP</td>
<td>BPI funds SMEs directly</td>
<td>EUR 300 000 to EUR 3 million</td>
<td>Subordinated loan to the SME</td>
<td>Information rights</td>
<td>Senior debt; Subordinated debt; Upside share in turnover growth</td>
</tr>
<tr>
<td>SBA/SBIC</td>
<td>SBA lends to SBICs, which fund SMEs</td>
<td>2-3 times private contributions</td>
<td>Senior loan to the SBIC</td>
<td>SBIC takes information rights; board seats</td>
<td>SBIC takes senior debt; subordinated debt; payment in kind; equity warrants</td>
</tr>
</tbody>
</table>
Conclusion (1/3): the mezzanine niche

- Mezzanine financing can respond to a market failure in finance for established companies seeking to grow or effect transformations.

- It involves features that respond to asymmetric information and agency problems affecting SME finance, allowing higher returns without taking control.

- It is a relevant niche in the spectrum of finance instruments:
  - Bank loans - suited to established low-risk companies, but not to growth firms (with large finance needs, delayed returns and reasonable potential upside).
  - Private equity – suited to SMEs and start-ups that expect high growth, but large numbers are rejected and not suited to established SMEs (with modest returns and unwilling to relinquish control).
Conclusion (2/3): responding to a market failure

• Mezzanine finance can fill the gap – SME owner not required to cede control, can pay the principal at the end, the investor accepts more modest returns but can take a share of the upside

• Should lead to more growth in existing SME sector

• Does not create a tax burden and does not destabilise the financial system

• OECD countries even with similar financial structures have vastly different levels of mezzanine usage
Conclusion (3/3): the policy gap

• The public sector can play a role in stimulating this part of the market

• Public role appropriate when banks and private equity are not supplying enough finance to existing SMEs seeking expansion or transformation

• Several OECD countries fund the instrument valuable, e.g. France, Germany, USA

• But in half of OECD countries there was no public mezzanine programme and officials were not familiar with the product

• More understanding of this technique is needed among public officials and SMEs