Are SME's destroying value by not tapping the corporate bond market?

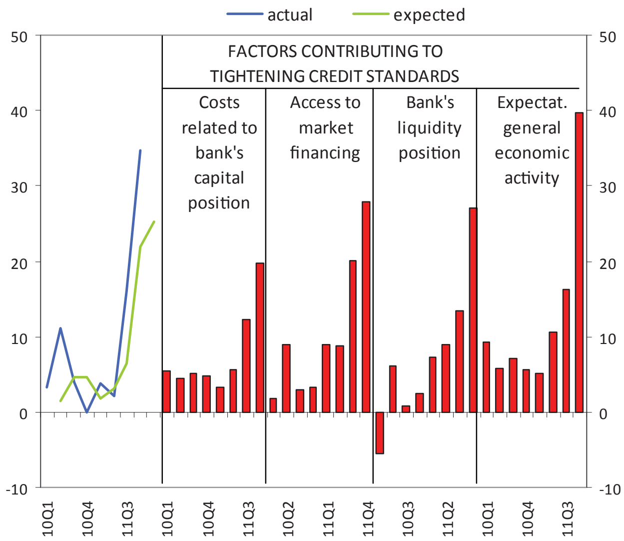
London, 18 April 2012, by Arjan van Bussel and Paolo Geurtsen

Since the beginning of the global financial crisis in 2007, many European corporates have first-hand experience of banks tightening their lending criteria, and thereby making it more difficult for corporates to access banking credit. This holds true for large corporates but especially for small, medium-sized and smaller large corporates. It is therefore no surprise that small and mid-cap enterprises say that raising debt financing is one of their two most pressing problems. Against this backdrop, we expect the European banking market to become more disintermediated, as corporates will be looking to by-pass banks and tap the debt capital markets directly. Large corporates have been doing this for years and, as we argue in this paper, we expect their smaller peers to follow this example. Initiatives taken by stock exchanges across Europe to promote the issuance of corporate bonds and to make it easier for small and mid-cap corporates to access capital markets strengthen our belief.

Introduction

A recent survey conducted by the European Central Bank ('ECB') revealed that attracting funding is a major concern for SMEs in the euro area[1]; 16% of the respondents replied that access to finance was even their most pressing problem, only to be superseded by "finding customers" which was the most pressing problem for 23% of the respondents. Separately, the ECB examined the reasons behind the deterioration in availability of banking loans and the surge in the tightening of the credit standards.[2] The results, summarised in Figure 1 show that 28% of euro area banks reported that difficulties in accessing market financing impacted their decision to tighten their credit standards in the last quarter of 2011. Additionally, 27% of the banks said that their liquidity position had impacted their credit standards, and 20% of the banks reported that their credit standards were tightened in response to the costs related to their own capital position.

Figure 1: Changes in credit standards (net percentages of banks contributing to tightening standards)



Source: European Central Bank, 1 February 2012.

The tightening of bank lending criteria for SMEs has also led to a steep increase in loan applica-

1 European Central Bank, "*Survey on the access to finance of small and medium-sized enterprises in the Euro area*", 1 December 2011.
2 European Central Bank, "*The Euro area bank lending survey*", 1 February 2012.

Figure 2: Loan applications by SMEs (as percentage of total applications)

	2007			2010		
	Successful	Partially Successful	Unsuccessful	Successful	Partially Successful	Unsuccessful
Belgium	92.4%	5.4%	2.2%	83.1%	11.2%	5.7%
Finland	98.1%	1.9%	0.0%	95.9%	3.9%	0.2%
France	94.5%	3.6%	2.0%	83.3%	9.7%	7.0%
Germany	85.3%	8.0%	6.7%	75.9%	15.9%	8.2%
Greece	87.6%	11.7%	0.7%	59.6%	29.6%	10.8%
Ireland	96.9%	2.1%	1.0%	53.2%	20.2%	26.6%
Italy	86.6%	12.2%	1.2%	78.4%	16.7%	4.9%
Netherlands	84.3%	8.9%	6.8%	61.3%	16.2%	22.5%
Spain	87.3%	9.7%	3.0%	59.1%	27.8%	13.2%
Sweden	84.2%	7.0%	8.7%	79.7%	14.1%	6.1%
UK	88.4%	6.1%	5.6%	64.6%	14.7%	20.8%

Source: Eurostat, "Access to finance statistics", data from Sept 2011.

tions being rejected. This is demonstrated in Figure 2.

The implementation of Basel III, which will be implemented in a phased process starting in 2013, is expected to increase the capital that banks have to hold against SME loans, making it more expensive for banks to fund these loans, a cost which they will want to pass on to their clients. Or alternatively, the likely higher capital charge might further discourage banks from granting loans to SMEs, thereby triggering a further shortage of finance for this sector.

Governmental support helpful but limited

Given the importance of SMEs to national economic prosperity, growth and employment, a wide range of measures and actions have been taken by governments, both at national and international levels, to remove the obstacles hampering SMEs' access to finance. These initiatives are either focused on reducing the funding costs for banks, or are structured as risk-sharing schemes whereby governments or supranational organisations guarantee part of the banks exposures to SMEs, either on a loan-by-loan, or portfolio basis.

In our view it is unlikely that these initiatives are enough to provide the sector with the funding it needs. Especially the larger SMEs, but also the smaller large corporates, are at risk of being overlooked. These companies often fall outside the strict SME-definition applied by governments and international organisations and therefore do typically not qualify for any of the above-mentioned initiatives. And even if they are eligible for these support programmes then it is unlikely that this provides them with sufficient opportunities to attract all the funding they need from banks. As a result these companies are looking for alternative funding sources, one of which is tapping the debt capital markets directly.

Germany leading the way for access to debt capital markets by SMEs

SMEs, and smaller large corporates, especially in Germany, have, with increasing frequency, been tapping the capital markets directly to raise debt financing. The trend of bank disintermediation in Germany was clearly enunciated by Moody's in their February 2012 publication.[3] Many German stock exchanges anticipated this shift towards more bond issuances by creating new market segments targeting SME corporate bonds. These new segments on the stock exchanges in Düsseldorf, Frankfurt, Hamburg/Hannover, Munich and Stuttgart offer SMEs the opportunity to more easily access the debt capital markets; and as Figure 3 demonstrates, with success. The German SME corporate bond market is flourishing with 50 issuances in just over 2 years. Contrast this situation with the Netherlands where only one company in this category has tapped the

3 Moody's, "*German corporate debt financing shifting from bank lending to bond issuance*", 20 February 2012.

Figure 3: SME bonds listed on dedicated segments of German stock exchanges

Issuer	Issue date	Maturity (yrs)	Coupon	Amount (EUR mln)	Industry / sector	Rating issuer
Hamburg / Hannover - Mittelstandsbörse Deutschland						
BKN Biostrom AG	Jun 2011	5	7.500%	25	Energy	BBB
Albis Leasing AG	Oct 2011	5	7.625%	50	Leasing	BB+
Düsseldorf - Mittelstandsmarkt						
Semper idem Underberg GmbH	Apr 2011	5	7.125%	50	Alcoholic beverages	BB+
Valensina GmbH	Apr 2011	5	7.375%	50	Fruit beverages	BB
FFK Environment GmbH	May 2011	5	7.250%	25	Waste treatment	BB+
E.N.O.Energy GmbH	Jun 2011	5	7.375%	25	Renewable energy	BB+
Katjes International GmbH & Co. KG	Jun 2011	5	7.125%	30	Fruit gum and liquorice maker	BB+
GIF - Gesellschaft für Industrieforschung mbH	Aug 2011	5	8.500%	15	Supplier automotive industry	BB
Procar Automobile Finanz-Holding GmbH & Co. KG	Oct 2011	5	7.750%	12	Automotive	BBB
Bastei Lübbe GmbH & Co. KG	Oct 2011	5	6.750%	30	Publisher	BBB
HKW Personalkonzepte GmbH	Oct 2011	5	8.250%	10	Human resources	BBB
Textilkontor Walter Seidensticker GmbH & Co.KG	Feb 2012	6	7.250%	30	Textile industry	BB+
Katjes International GmbH & Co. KG	Mar 2012	4.3	6.170%	15	Fruit gum and liquorice maker	BB+
MT-Energie GmbH	Apr 2012	5	8.250%	30	Renewable energy	BBB-
Friedola Gebr. Holzapfel GmbH	Apr 2012	5	7.250%	25	Plastic - home textiles, leisure, technology	BB
Stuttgart - BondM						
Windreich AG	Mar 2010	5	6.500%	50	Renewable energy	BBB+
Dürr AG	Sep 2010	5	7.250%	225	Supplier automotive industry	NR
Solarwatt AG	Sep 2010	5	7.000%	25	Solar components	BB+
Nabaltec AG	Oct 2010	5	6.500%	30	Aluminiumhydroxid products	BBB-
Air Berlin PLC	Nov 2010	5	8.500%	200	Airline	NR
3W Power S.A.	Dec 2010	5	9.250%	125	Energy	B-
RENA GmbH	Dec 2010	5	7.000%	75	Solar Energy	BB+
Centrosolar Group AG	Jan 2011	5	7.000%	50	Photovoltaic systems and solar components	BBB
MAG IAS GmbH	Feb 2011	5	7.500%	50	Mechanical engineering	B+
SiC Processing GmbH	Feb 2011	5	7.125%	80	Renewable energy	BBB+
German Pellets GmbH	Mar 2011	5	7.250%	80	Wood pellets	BBB
Joh. Friedrich Behrens AG	Mar 2011	5	8.000%	30	Mechanical engineering	BB-
Payom Solar AG	Mar 2011	5	7.500%	50	Solar components	B-
Air Berlin PLC	Apr 2011	7	8.250%	150	Airline	NR
Albert Reiff GmbH &. Co.KG	Apr 2011	5	7.250%	30	Automative	BBB
Uniwheels GmbH	Apr 2011	5	7.500%	50	Supplier automotive industry	BB+ / BB+
Windreich AG	Jun 2011	5	6.500%	75	Renewable energy	BBB+
KTG Agrar AG	Sep 2011	5	6.750%	50	Agriculture	BBB
"Royalbeach" Spielw. und Sportart. Vertriebs GmbH	Sep 2011	5	8.125%	25	Sports and leasure wear	BB+
Air Berlin PLC	Oct 2011	3	11.500%	100	Airline	NR
Ekosem Agrar GmbH	Mar 2012	5	8.750%	50	Agriculture	BB+
Mitec Automotive AG	Mar 2012	5	7.750%	50	Car traction technology	BBB-
Frankfurt - Entry Standard						
S.A.G. Solarstrom AG	Dec 2010	5	6.250%	25	Photovoltaic plants and solar energy	BBB+
Golden Gate AG	Apr 2011	3.5	6.500%	30	Healthcare real estate	BB
DIC Asset AG	May 2011	5	5.875%	70	Real estate	NR
SeniVita Sozial GmbH	May 2011	5	6.500%	15	Nursing homes, healthcare	A-
KTG Agrar AG	Jun 2011	6	7.125%	100	Wood pellets	BBB
S.A.G. Solarstrom AG	Jul 2011	6	7.500%	25	Photovoltaic plants and solar energy	BBB+
Maschinenfabrik Spaichingen GmbH	Jul 2011	5	7.250%	50	Machine manufacturer	BB
Eyemaxx Real Estate AG	Jul 2011	5	7.500%	25	Real estate development	BBB+
Peach Property Group GmbH	Jan 2012	4.5	6.600%	50	Real estate development	BBB-
Scholz AG	Mar 2012	5	8.500%	150	Iron, metal and aluminium recycling	BB
Singulus Technologies AG	Mar 2012	4	7.750%	60	Solar cells, optical disc technologies	NR
Golfino AG	Apr 2012	5	7.250%	12	Sport (golf) clothes	BBB-
Eyemaxx Real Estate AG	Apr 2012	5	7.750%	12	Real estate development	BBB+

Note: No SME corporate bonds are currently listed on the dedicated M:Access segment of the Munich stock exchange. The first listing is expected later this quarter.

capital markets in the same period.

Figure 3 summarises the main characteristics of the corporate bonds listed on the dedicated SME segments of the various German stock exchanges. This table shows the great variety of amounts being raised, ranging from EUR 10 million to EUR 225 million, albeit that the EUR 225 million was raised by Dürr AG in two steps: initially only EUR 150 million was issued but this was raised to EUR 225 million one month later. The documentation of many German SME bonds allows for this kind of flexibility as typically "*up to*" a certain amount can be raised during the subscription period, which can last for a long time, sometimes even up to one year or more. This flexibility allows issuers to issue additional bonds, even if trading on the secondary market has started already.

Additionally, Figure 3 illustrates that, despite the relatively short time since these dedicated segments were established, four parties have tapped the market already for a second or third time. In March 2012, Katjes International tapped its bond by adding an additional EUR 15 million to its 7.125% bond. This tap issuance was priced at 103.50, offering a 6.17% yield to maturity. Air Berlin even tapped the debt market three times within one year; Eyemaxx is currently in the market with its second issuance and KTG Agrar has bonds listed on two different stock exchanges. These repeat issuances are probably the best testimony of the success of the dedicated SME corporate bond platforms and demonstrate that tapping the debt capital markets truly offers an alternative to bank financing in Germany. This latter holds true for smaller transactions as well: 74% of the German issuances are EUR 50 million or less. But despite these relatively modest transaction sizes, and the fact that the denomination of an individual bond is only EUR 1,000, a substantial part of most issuances are aimed at institutional investors rather than retail clients. For example, the most recent Katjes International issuances were exclusively aimed at institutional investors, whereas 80% of the recent Singulus issuance was allocated to institutional investors and only 20% to retail accounts.

The coupon on the bonds has fluctuated from 5.875% for a 5-year bond issued by the real estate investor DIC Asset AG to 11.5% for a 3-year bond issued by Air Berlin. This wide range of coupons illustrate that investors discriminate between bonds, although no significant correlation seems to exist between the public rating of the issuer and the coupon it has to pay. Concentrating on issuers who have tapped the market on multiple occasions, we see that the coupon fluctuates substantially over time, something that can also be observed when looking at coupons paid by large corporates and governments on bonds issued in 2010 and 2011. But despite this wide range of coupons, Figure 3 illustrates that more than 50% of the bonds have a coupon of 7.25% or less.

Comparing these coupons with the pricing on bank loans is complicated by the differences between both products. Bank credit is, especially following the wave of new regulatory requirements, typically conditional on the enterprise's financial strength and the availability of collateral and guarantees. Moreover, bank facilities tend to be of a short-term nature and require a certain minimum amortisation each year. German SME bonds, on the other hand, have commonly a longer maturity, are typically unsecured with no, or limited, covenant protections, and require no amortisation during the life of the instrument.

Looking at the borrowers, we notice that they are mainly active in consumer goods, renewable energy and waste management, machinery production and real estate. In other words, companies whose bonds are listed have typically a good (local) name recognition to the wider public, are socially acceptable innovative enterprises or are asset rich (investment) enterprises. Moreover, a substantial number of borrowers already had shares listed on a stock exchange before tapping the debt capital markets aiding name recognition for investors.

To protect investors and foster appropriate standards of transparency, conduct and due diligence, the German stock exchanges impose minimum listing requirements. Each stock exchange is free to determine its own listing rules, but in general a prospectus approved by the supervisor ('BaFin') is required, as is the disclosure of annual and semi-annual accounts, a brief company profile and any price-sensitive information that is relevant for the bondholders, to be furnished on an ongoing basis during the life of the listed security. With the exception of the stock exchange in Hamburg/Hannover, stock exchanges require the issuer to be rated by Fitch, Moody's, S&P, Creditreform, Euler Hermes or PSR Rating (unless the company is already listed on a regulated stock exchange, which explains why some of the issuers in Figure 3 are not rated). The Düsseldorf stock exchange even goes one step further and requires a minimum BB rating. Notably, Creditreform rates all but four issuers shown in Figure 3, four issuers are rated by Euler Hermes and S&P rates one issuer, whereas Fitch and Moody's rate none.

The German SME bonds issuances are typically not underwritten by an investment bank but instead the issuer is assisted by a listing sponsor: all German stock exchanges require that an expert with ample capital market experience supports the issuer. The listing sponsor must, in consultation with the company and its legal advisers and auditors, ensure that the company meets all applicable listing criteria and that the company fulfils its on-going reporting and disclosure obligations. Additionally, the listing sponsor typically advises the issuer with arranging and structuring the transaction and placing the bonds. After the issuance, the listing sponsor is required to support the company in complying with on-going obligations. Issuers whose securities are already listed on a regulated market do not necessarily need a listing sponsor.

The SME dedicated segments on the German stock exchanges are improving the access of retail investors to attractive investment opportunities offered by SME debt securities. The exchanges in Frankfurt and Stuttgart, for example, have an infrastructure in place where orders in the initial placement are placed with the stock exchange just like purchase orders in the secondary market.

To further increase the liquidity of the SME bonds listed on the BondM segment in Stuttgart, Euwax AG assumes the role of quality liquidity provider ('QLP'). The QLP is committed to provide continuous price information and quotes for each listed bond in the BondM trading segment. There is at least one price determination per trading day.

Signs of life outside of Germany too

Germany's advances have not gone unnoticed in the rest of Europe. NYSE Euronext (in Amsterdam, Brussels, Lisbon and Paris) has now also launched initiatives to promote the issuance of corporate bonds by small and medium-sized companies. NYSE Euronext has been actively promoting capital market access for SMEs since 2005 when it launched Alternext, a market segment dedicated to small and medium cap entities. Initially, Alternext was mainly focused on helping SMEs raising equity, and only recently started to look more pro-actively at opportunities for SMEs to raise debt. For example, in November 2011, NYSE Euronext announced the development of a new pan-European offering for the listing, placement and trading of corporate bonds designed especially for listed and unlisted SMEs. In January 2012 NYSE Euronext launched new measures to make it easier for SMEs to access capital markets and to improve their visibility and liquidity on this markets. These new measures are aimed at ensuring that an SME bond issuance is subject to clear, efficient and rapid procedures with simplified documentation, tighter deadlines, competitive issuance costs and no additional declaration requirements for companies that are already listed on NYSE Euronext markets.

The Alternext listing rules prescribe that an offering circular needs to be published before a bond is listed. If a public offering is requested then the offering circular must meet the Prospectus Directive requirements (which needs to be confirmed by the financial market authorities), whereas an information memorandum approved by the stock exchange suffices for a private placement. However, in both scenarios investors in bonds listed on Alternext should realise these bonds are not admitted to an EU-regulated stock market and therefore the stringent transparency requirements and investor protection regulations that have been standardised for organised markets across Europe do not apply.

Strictly speaking no historical financial information needs to be disclosed when a company is seeking a listing of debt instruments on Alternext. This is in sharp contrast with an initial public offering of shares. Another significant difference with equity is that the minimum amount that needs to be raised at the time of the first admission to trading is only EUR 200,000 whereas for equity it is EUR 2.5 million. The reduced volume threshold for debt is important and many SMEs are unaware that capital markets funding is truly within reach.

Unlike the German stock exchanges, Alternext does, at this stage, not prescribe the issuer to be rated, but it does require, just like the German stock exchanges, that a listing sponsor, registered with, and approved by, NYSE Euronext, supports the issuer during the admission process and for the duration of the listing.

Finally, and again in line with the German stock exchanges, NYSE Euronext makes use of the services of liquidity providers who act as market makers and protect investors against variations in volatility on the market and guarantee transactions at all times at the best price. Liquidity providers mainly focus on small and mid-cap companies, as large listed corporates generate greater liquidity without the help of such party.

Conclusion

SME's access to bank credit has been severely impacted by the financial crisis, the European sovereign-debt meltdown and the wave of new regulatory requirements imposed on banks. As banks look for ways to free-up capital, they are reducing their risk-weighted assets and shrinking their balance sheets. This has tightened their lending behaviour and thereby triggered a shortage of debt funding for the SME sector.

To bridge this gap, SMEs should look at tapping the debt capital markets directly. Issuing corporate bonds has recently become easier, as various European stock exchanges have now dedicated special platforms to the SME bond segment. Especially the recent experiences on the German stock exchanges are very encouraging in this respect. However, we do not recommend replacing bank financing completely. In our view there is a role for both bank facilities and listed corporate bonds in the funding of any corporation.

Banking facilities and listed corporate bonds have different characteristics and requirements. Corporate bonds, for example, are often unsecured with longer maturities, whereas banks commonly have strict requirements regarding any collateral or guarantee. This does make it difficult for SMEs to easily compare the two instruments. The temptation is often to compare the headline interest rates/margins, but this is an all too simple and often misleading comparison. We would encourage SME and smaller large corporate borrowers to seriously consider accessing the bond markets alongside any bank borrowing and to seek independent advice when considering debt raising in order that both capital markets and bank funding options can be thoroughly and accurately evaluated.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you (info@bishopsfieldcapital.com).