European Small Business Finance Outlook

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Executive summary

This European Small Business Finance Outlook (ESBFO) provides an overview of the main markets relevant to EIF (equity[1], securitisation, microfinance). It is an update of the ESBFO May 2012.

We start by discussing the general market environment, then look at the main aspects of equity finance and the SME Securitisation (SMESec) market. Finally, we briefly highlight important aspects of microfinance in Europe.

Market Environment:

- Since the publication of the last ESBFO in May this year, the global economic prospects have deteriorated and dangers remain high.
- Available data for the business environment of SMEs show a deteriorated situation. Moreover, the imbalances between EU Member states remained significant.
- The ECB bank lending survey reports a further net tightening in credit standards applied by euro area banks for loans to non-financial corporations. Moreover, the *additional* net tightening has increased. Looking forward to the fourth quarter banks assume, on balance, some further tightening of credit standards, which is expected to affect large firms more than SMEs, and long-term loans more than short-term ones.
- According to the ECB MFI interest rate statistics, the interest rate spread between small and large loans has continuously increased since July 2011 and has reached a record level in August 2012.
- According to another ECB survey, access to finance remained a more pressing problem for euro area SMEs than for large firms. The net percentage of SMEs reporting a deteriorated availability of bank loans increased further, mainly due to the general economic outlook. Looking ahead, SMEs are expecting on balance a further deterioration of access to bank loans and bank overdrafts.
- For 2012 and 2013, insolvencies are expected to rise again, due to the difficult economic environment. In the euro area, the rise in the number of insolvencies is expected to be even sharper than in previous years. Unsurprisingly, countries in the European periphery are expected to be particularly affected.

[1] We are using the term "equity finance" to combine linguistically the areas of Venture Capital (VC) and Private Equity (PE). However, if we refer here to equity activities, we only consider the activities of EIF's investment focus which neither includes Leveraged Buyouts (LBOs) nor Public Equity activities. The reader can find a Private Equity glossary in Annex 1.

Private equity:

- Following the deep crash in 2008/2009, private equity investment had partially rebounded in the years 2010 and 2011. However, in the first three quarters of 2012, preliminary figures show that private equity and venture investments recorded a downturn which was at least partially due to the very difficult general economic environment.
- Some of the gap left by the fall in VC investment has been filled by increased business angel activity; their proximity to the market has been beneficial during this difficult period.
- According to EVCA preliminary figures, total private equity and venture fundraising decreased substantially in the first three quarters of 2012. Alongside the developments of private equity fundraising and investment activity, also divestments appear to have fallen considerably.
- VC performance, although still disappointing, has slightly improved. EIF is observing an increasing number of early-stage companies which show an unprecedented pattern of growth and good potential to positively impact the funds' performance.

SME Securitisation:

- Originators continue to mainly retain newly issued deals in order to create liquidity buffers and to use the assets as collateral with central banks. The revitalization and further development of SMESec is important for the future growth of SME financing and SMESec will be particularly relevant in the leasing area.
- The SMESec market (excluding pure ECB-related transactions) slowly restarts from the more sophisticated markets, i.e. in the "traditional" countries.
- Given the dominance of the securitisation of residential mortgages (RMBS), SMESec remained a relatively limited but important segment of the European structured finance market.
- Despite the financial and sovereign crisis, the European securitization market in general performed so far relatively well; also the SME segment shows low default rates.

Microfinance:

- The microfinance market in Europe in general shows trends towards efficiency, professionalization, and self-sustainability, but needs access to stable funding.
- However, in this market, standardised, regularly available indicators to explain market developments for microfinance in Europe do not yet exist, or focus only on Eastern Europe. The new EMN survey helps to improve this situation.
- The survey shows, inter alia, that between 2009 and 2011 the European microfinance sector as a whole was growing in terms of the number of loans disbursed.
- The impact of the on-going crisis on the availability of microfinance is a central issue of the sector. In times of crisis, like today, microfinance clients, be it as an enterprise or a self-employed, typically find capital even harder to obtain; not to mention the additional challenges faced by certain vulnerable groups such as ethnic minorities or female entrepreneurs

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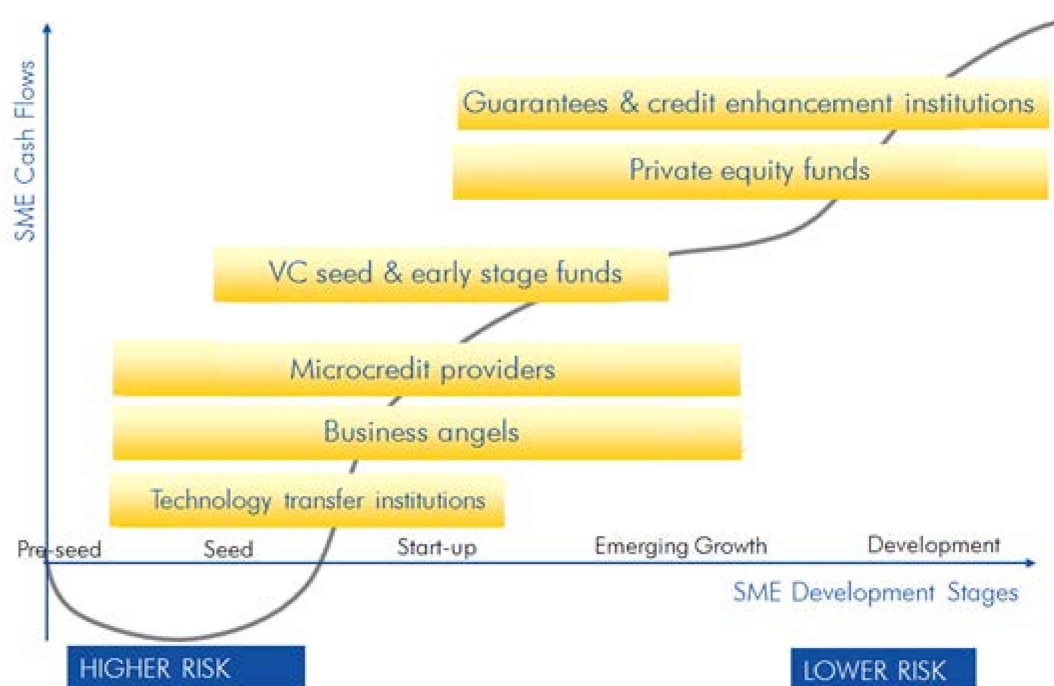
1 Introduction

The European Investment Fund (EIF) is the European Investment Bank (EIB) Group's specialist provider of risk financing for entrepreneurship and innovation across Europe, delivering a full spectrum of financing solutions through financial intermediaries (i.e. equity instruments, guarantee and credit enhancement instruments, as well as microfinance). The following figure shows the range of EIF's activities:

Figure 1: EIF tool kit for SMEs



Source: EIF

The EIF focuses on the whole range of micro to medium-sized enterprises, starting from the pre-seed, seed-, and start-up-phase (technology transfer, business angel financing, microfinance, early stage VC) to the growth and development segment (formal VC funds, mezzanine funds, portfolio guarantees/credit enhancement).

Against this background the European Small Business Finance Outlook (ESBFO) provides an overview of the main markets relevant to EIF (equity[2], securitisation, microfinance). It is an update of the ESBFO May 2012.

We start by discussing the general market environment, then look at the main aspects of equity finance and the SME Securitisation (SMESec) market. Finally, we briefly highlight important aspects of microfinance in Europe.

[2] Please see footnote 1 concerning the term "equity finance".

2 Economic environment

Since the publication of the previous ESBFO in May this year, the global economic prospects have deteriorated and dangers remain high. The International Monetary Fund (IMF) has forecasted a slowdown of global growth from 3.8% in 2011 to 3.3% for 2012, while global growth is expected to increase again to 3.6% in 2013. However, compared to IMF's previous projections (made in April 2012) these forecasts have been decreased by 0.2 and 0.5 percentage points for the years 2012 and 2013 respectively (IMF, 2012).

The forecasts have been reduced as the US economy has slowed and spill-overs from advanced economies affected emerging market and developing economies. The global economy is also suffering from high government debt in many countries. The world growth projections for 2013 are inter alia based on the anticipation of better government policies in the euro area and a rather stable pace of global fiscal tightening. However, the downside risks remain considerable. Specifically, the euro area crisis could be intensified once again due to renewed concerns over sovereign risk of periphery countries and the ambiguous effects of austerity on the real economy. One of the forces which results in sluggish growth is a general feeling of uncertainty. Worries about the ability of policymakers to control the euro crisis are deteriorating business sentiments.

Furthermore, the divergence between growth in advanced and emerging economies is expected to persist. Specifically, the IMF slightly reduced its forecasts for the growth in advanced economies to 1.3% for 2012 and 1.5% for 2013 and for emerging and developing economies to 5.3% for 2012 and 5.6% for 2013. The output growth projections for the euro area were slightly reduced to -0.4% for 2012 and 0.2% for 2013. The projections for Central Europe and Eastern Europe were slightly increased, to 2.0% for 2012 and reduced, to 2.6%, for 2013. Additionally, the European Commission (EC) in its latest European Economic Forecast (see table 1) has also updated its projections to similar levels, expecting -0.3% growth for the European Union (EU) and -0.4% for the euro area for 2012.

Table 1: Main features of the European Commission autumn 2012 forecast for the EU

(Real annual percentage change unless otherwise stated)				Autumn 2012 forecast		
	2009	2010	2011	2012	2013	2014
GDP	-4.3	2.1	1.5	-0.3	0.4	1.6
Private consumption	-1.5	1.1	0.1	-0.6	0.0	1.2
Public consumption	2.2	0.7	-0.1	0.0	-0.4	0.4
Total investment	-13.0	0.2	1.4	-2.2	0.1	2.8
Employment	-1.9	-0.5	0.2	-0.4	-0.2	0.6
Unemployment rate (a)	9.0	9.7	9.7	10.5	10.9	10.7
Inflation (b)	1.0	2.1	3.1	2.7	2.0	1.8
Government balance (% GDP)	-6.9	-6.5	-4.4	-3.6	-3.2	-2.9
Government debt (% GDP)	74.6	80.2	83.0	86.8	88.5	88.6
Adjusted current-account balance (% GDP)	-0.7	-0.6	-0.5	-0.2	0.4	0.6
Contribution to change in GDP						
Domestic demand	-3.1	0.8	0.3	-0.7	0.0	1.3
Inventories	-1.1	0.8	0.3	-0.5	0.0	0.0
Net exports	-0.1	0.5	1.0	0.9	0.5	0.3

(a) Percentage of the labour force.

(b) Harmonised index of consumer prices, annual percentage change.

Source: European Commission (2012)

For 2012, high unemployment in the EU is expected to further restrict private consumption, while public consumption is expected to shrink in 2013 under the efforts to assure the sustainability of public debt. Furthermore, weak domestic demand is unlikely to support GDP growth as well as import growth. To the contrary, net exports will be the most powerful growth driver in 2012 and 2013 due to the recent depreciation of the euro against foreign currencies and an expected upturn of the global economy. For 2014, domestic demand is expected to step in as the main contributor to growth (European Commission, 2012).

3 Small business environment

3.1 SME business climate

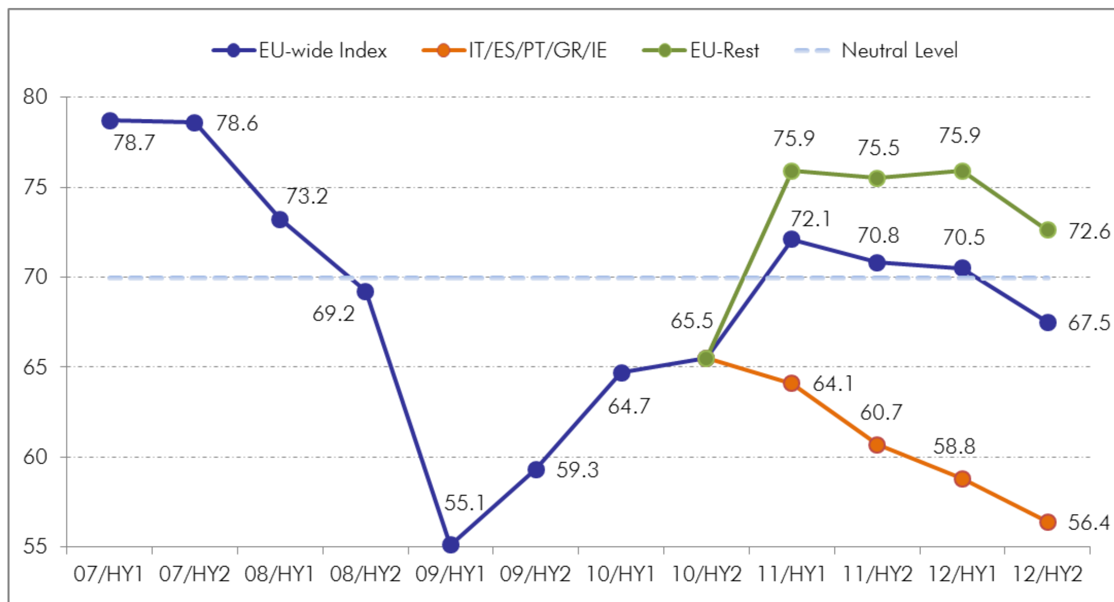
According to the UEAPME SME Business Climate Index, the overall business environment of European SMEs, which kept being stable for three consecutive semesters, now declined by 3 percentage points. In the second half of 2012, the index stands below its neutral level of 70%. During 2012, more and more SMEs were faced with a deteriorated business situation, which resulted in the pessimistic outlook.

The imbalances between the EU Member States that were firstly identified in the beginning of 2011 are still significant. In fact, in those countries that were hardest hit by the sovereign debt crisis, SMEs have not found their way out of contraction as SMEs in the rest of the EU countries seem to have done since the end of 2010. To the contrary, the reported Business Climate Index for the country group Italy, Spain, Portugal, Greece, and Ireland is again at the levels of early 2009, showing a clear lack of confidence among SMEs concerning the current and upcoming developments. As a result, two diverse country groups are formed within Europe with the gap between them amounting to 16.2 percentage points as depicted in figure 2 (UEAPME Study Unit, 2012).

Figure 3 shows the balance of "positive minus negative" answers reported by European SMEs, regarding situation, turnover, employment, prices, investments and orders on a semi-annual base, starting from the second half-year 2008, with the last column being a forecast for the overall second half-year 2012. During the first semester of 2012, all economic indicators have turned negative. Except for prices and investments, all results were in line with what SMEs expected one semester earlier.

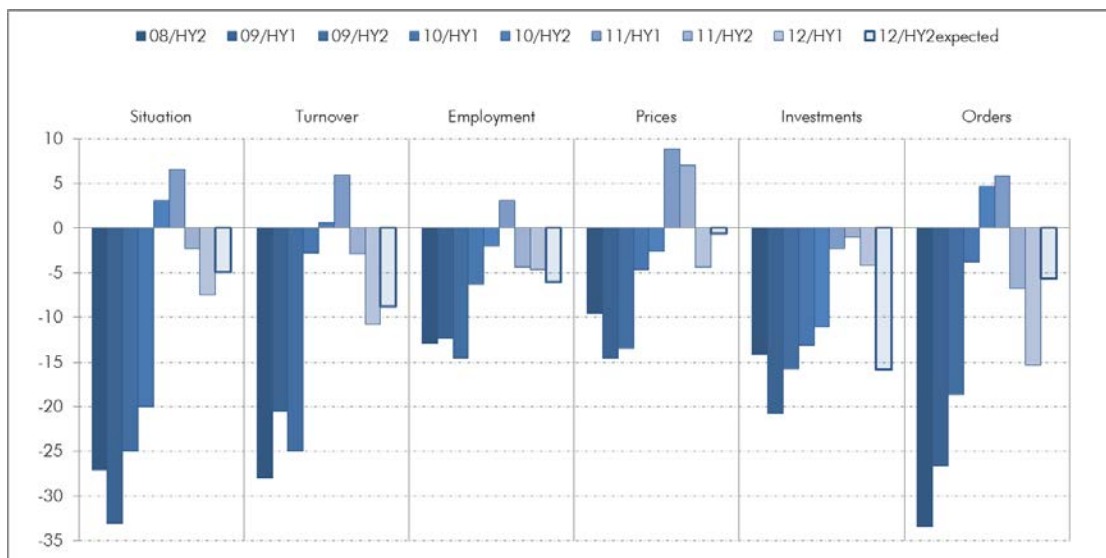
Specifically, in the second half of 2012, turnover, orders and employment were on balance expected to fall by (-8.8%), (-5.7%) and (-6.0%) respectively, corresponding to the macroeconomic forecasts. Moreover, expectations for investments are on balance even worse (-15.9%), driven by the uncertain business environment for SMEs and the difficult situation in lending that they face from European banks. Lastly, SMEs, in line with previous semesters, continue to expect lower prices (however, only with a balance of -0.6%), most probably as a result of the downward pressure on sale prices in order for SMEs to stay in the market.

Figure 2: SME Business Climate Index[3]



Source: Based on UEAPME Study Unit (2012)

Figure 3: Main Results of the EU Craft and SME Barometer 2012/HY1[4]



Source: Based on UEAPME Study Unit (2012)

[3] The UEAPME SME Business Climate Index is calculated as the average of the current situation and the expectations for the next period resulting from the sum of positive and neutral (meaning: no change) answers as regards the overall situation for the business. For example, for "semester A" with 25% positive, neutral 55%, and 20% negative answers, the Index would be (25 + 55 =) 80 and for "semester B" with 40% positive, 30% neutral, and 30% negative answers it would fall to (40 + 30 =) 70. However, the respective balances of positive minus negative answers would show an opposite result growing from "semester A" (25 – 20 =) 5% to "semester B" (40 – 30 =) 10%. Therefore these balances should also be examined and are reported in UEAPME's EU Craft and SME Barometer.

[4] The EU Craft and SME barometer builds on surveys that are conducted by UEAPME member organisations. The 2012/H2 results are based on about 30,000 answers collected between 2011 and September 2012. The balanced figures mentioned in the text show the difference between positive and negative answers, with national results weighted by employment figures. The surveyed categories include overall situation, turnover, employment, prices, investment, and orders. For details see: http://www.ueapme.com/IMG/pdf/Barometer_2012H2_final.pdf.

The balance between expectations and final results for the first half of 2012 is depicted in figure 4. The most remarkable magnitude is observed for investments. This positive balance shows the "adaptive behaviour" of SMEs. A sharp drop (22.7%) in investments was projected, as SME entrepreneurs would not expect an increase of associated production capacity in times of uncertainty and sluggish growth, but they needed to invest in order to keep their capacity and to match the orders (UEAPME, 2012).

Figure 4: Expectations of SMEs and real outcome for 2012/HY1

Source: Based on UEAPME Study Unit (2012)

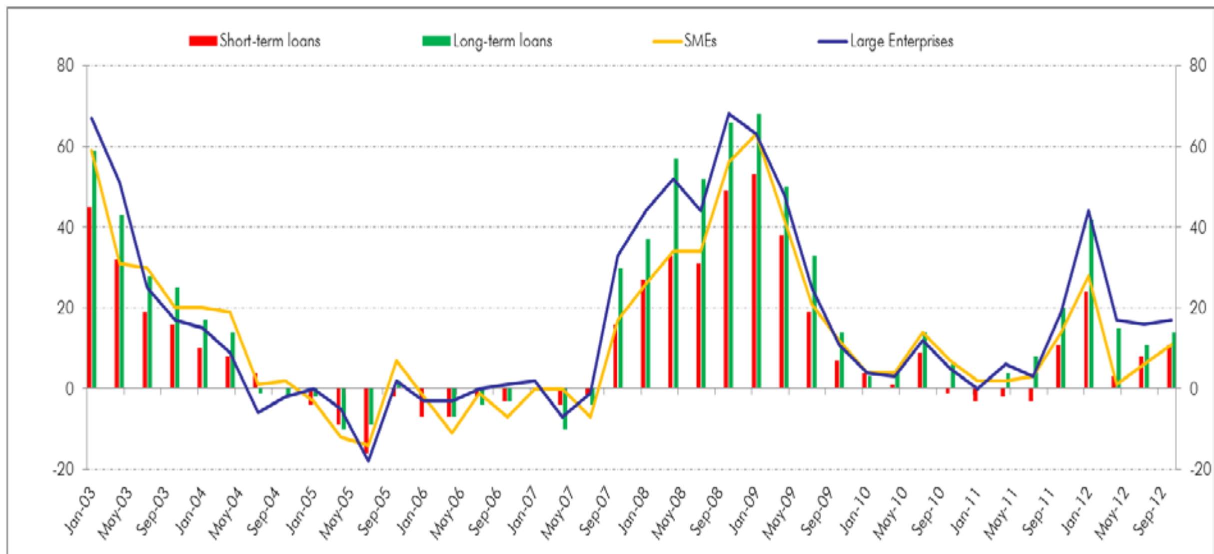
3.2 Bank lending activity

The current status of bank lending has been analysed in the ECB's latest Bank Lending Survey (BLS)[5]: On balance, the reporting euro area banks have further tightened their credit standards to non-financial corporations (NFCs). Moreover, the survey reports a slight increase in the additional net tightening[6]; a net 15% of banks reported a tightening in Q3/2012, compared to 10% in the previous quarter. As shown in figure 5, the net tightening of credit standards on loans to SMEs increased from 6% in Q2/2012 to 11% in Q3/2012, and that of credit standards on loans to large firms increased slightly from 16% to 17% (ECB, 2012b). The BLS examines the net tightening also with respect to the loan maturity: the overall tightening of credit standards influences loans with longer maturities more than short-term loans.

[5] This survey was conducted on 131 euro area banks and reports changes during the third quarter of 2012 (Q3/2012) and expectations of changes in the fourth quarter of 2012 (Q4/2012).

[6] Text and diagram refer to *net* percentages of banks contributing to tightening standards (difference between the sum of the percentages of banks responding "tightened considerably" and "tightened somewhat" and the sum of the percentages of banks responding "eased somewhat" and "eased considerably").

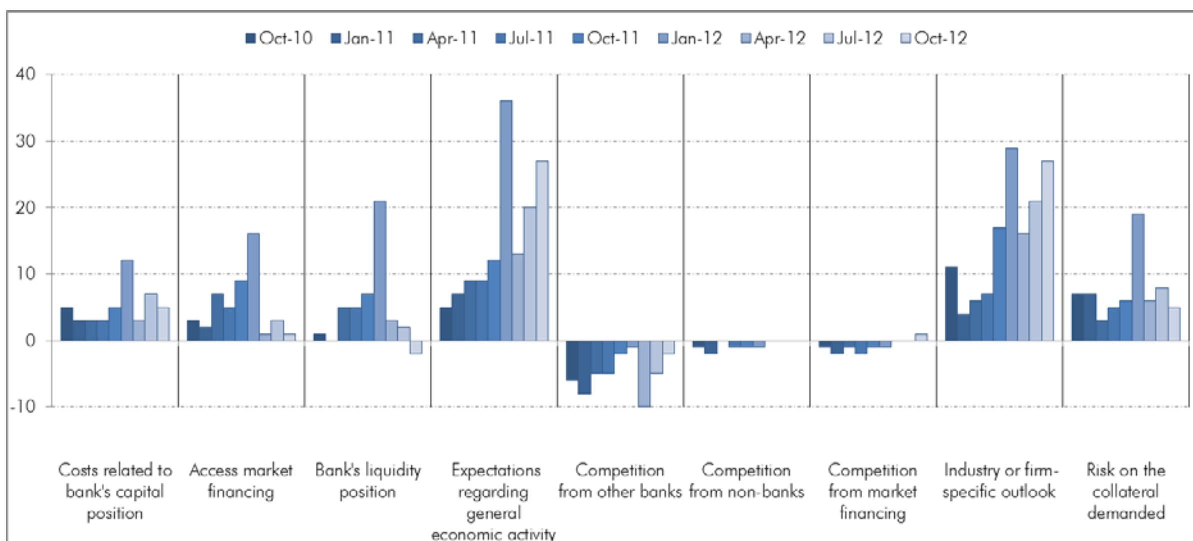
Figure 5: Changes in credit standards applied to the approval of loans or credit lines to enterprises (SMEs versus large enterprises)



Source: Based on ECB (2012b)

In Q3/2012, in net terms and as far as SMEs are concerned, the factors that were most and increasingly mentioned by banks as having contributed to tighter credit standards were the expectations concerning the economic outlook (27% in Q3/2012 compare to 20% in Q2/2012) and industry specific prospects (27% in Q3/2012 compare to 21% in Q2/2012). In contrast, banks liquidity position and competition from other banks were on balance reported as having taken away some tightening pressure from credit standards (see figure 6).

Figure 6: Factors contributing to tightening credit standards for SMEs[7]



Source: ECB (2012b)

[7] The net percentages for responses to questions related to the factors are defined as the difference between the percentage of banks reporting that the given factor contributed to a tightening and the percentage reporting that it contributed to an easing.

According to the reporting banks, the decrease in net *demand* for loans to NFCs was slightly more pronounced in Q3/2012 (-28% compared to -25% in Q2/2012), mainly driven by lower demand for mergers and acquisitions, inventories, and working capital. By contrast, declined financing needs of firms for fixed investment and for internal sources of finance contributed less to the deteriorated net demand for loans (ECB, 2012b). Concerning the projections for Q4/2012, some further tightening is on balance expected to affect large firms (10%) rather than SMEs (7%), as well as primarily long-term loans (15%). The demand for corporate loans is on balance expected to further decrease, but less pronounced than before.

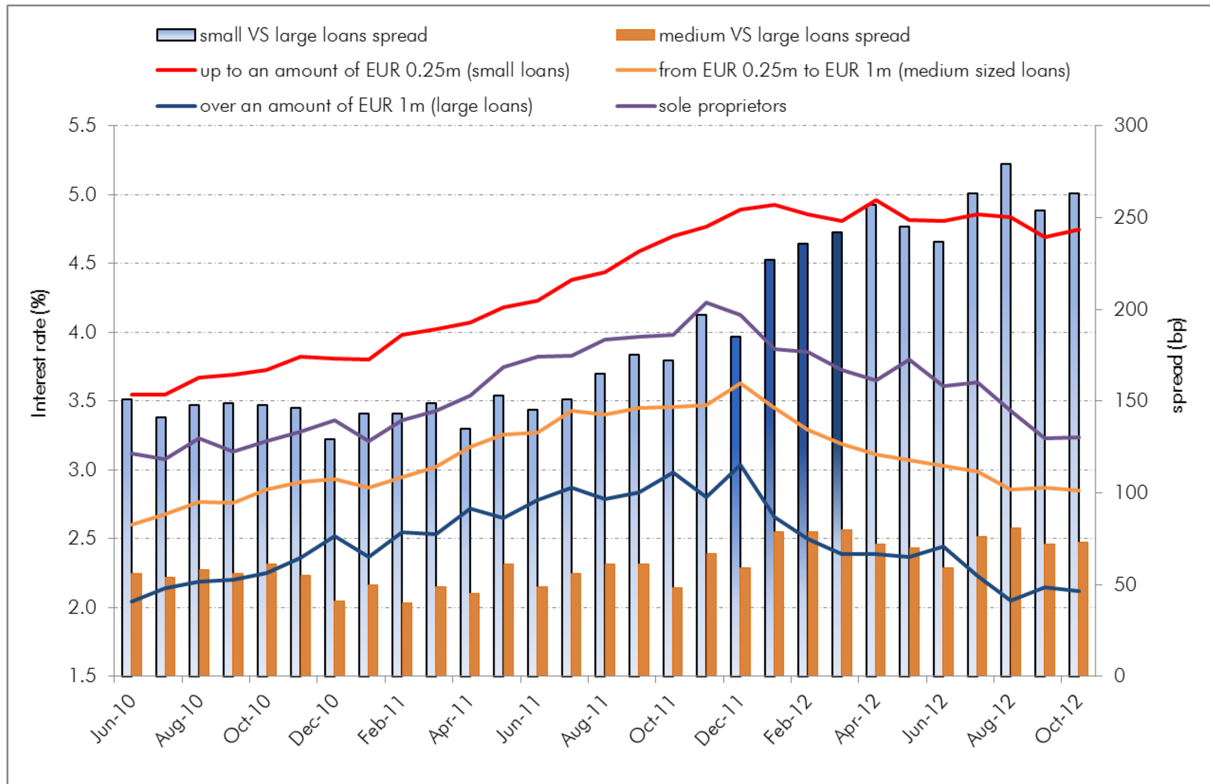
3.3 ECB interest rate statistics

The monetary financial institutions interest rate statistics, published by the ECB, provide information about the interest rates and volumes for different size classes of new euro-denominated loans. Since June 2011, the former category of loans to euro area non-financial corporations up to EUR 1m is divided into two sub-categories, one includes loans up to and including EUR 0.25m and another loans over EUR 0.25m and up to EUR 1m. Based on the assumption that the average size of new loans for SMEs is smaller than the typical loan size for large enterprises (Huerga et al., 2012), this categorisation enables us to have a closer look at the financing cost of SMEs.

Loans of amounts over EUR 0.25m up to EUR 1m (medium-size loans) had a rather stable spread over loans of more than EUR 1m (large loans), averaging 60 basis points (bp) for the period June 2010 to October 2012 (see figure 7). Loans up to an amount of EUR 0.25m (small loans) have a higher spread over the large loans, and it was relatively stable until July 2011 at a level of 145bp. From that point, this spread has shown an increasing trend to a record level of 279bp in August 2012. Using small loans as a proxy for the financing cost of SMEs, this elevated divergence may point to some degree of discrimination by banks against small firms as a consequence of the divergence in firm-specific risks, in particular in the countries most affected by the deepened sovereign debt crisis.

These spreads can be explained partially by the fact that smaller enterprises are more dependent on their domestic banking sectors where they face more adverse conditions compared with larger enterprises that are more flexible to benefit from global financial markets (ECB, 2012a). In addition to that, loans to sole proprietors (small-scale unincorporated businesses and self-employed persons) were granted with an interest rate between that of small and medium sized loans for the whole examined period.

Figure 7: Evolution of monetary financial institutions interest rates on new loans to non-financial corporations[8]



Sources: Based on Huerga et al. (2012), ECB (2012d) and own calculations

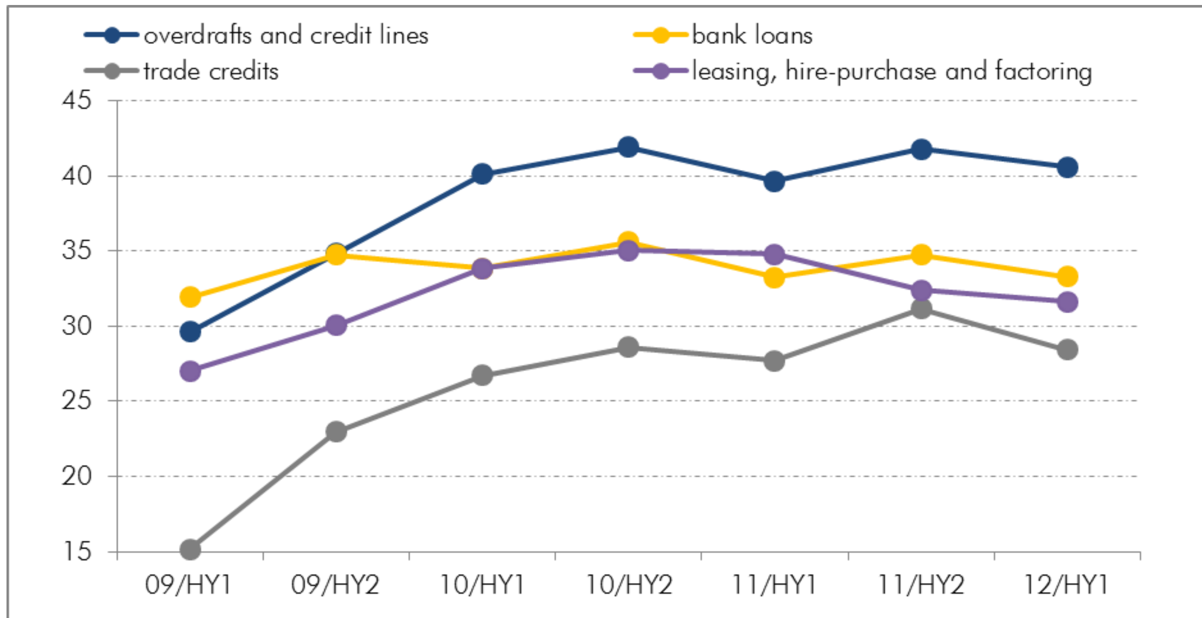
3.4 Access to finance

According to the ECB's "survey on the access to finance of SMEs in the euro area", covering April to September 2012 (ECB, 2012c), access to finance remained the second most pressing problem for euro area SMEs. Moreover, it appears to be still a more severe concern for SMEs than for large firms. However, the most pressing problem for SMEs and large firms was once again "finding customers".

Compared to the previous ECB survey (covering the period October 2011 to March 2012), there has been a slight decrease in the percentage of SMEs having used debt financing through its most popular forms overdrafts and credit lines, bank loans and trade credits, leasing, hire-purchase or factoring. Traditional bank financing (overdrafts, credit lines, bank loans) remained the most important external funding source (see figure 8).

[8] New loans to non-financial corporations with floating rate and up to three-month initial rate fixation by loan size and new loans to sole proprietors (percentages per annum excluding charges; period averages). The series about new loans to "sole proprietors" have an initial rate fixation period of up to one year and not up to three-months as the rest of the series used in the graph because data for lower rates of fixations are not collected.

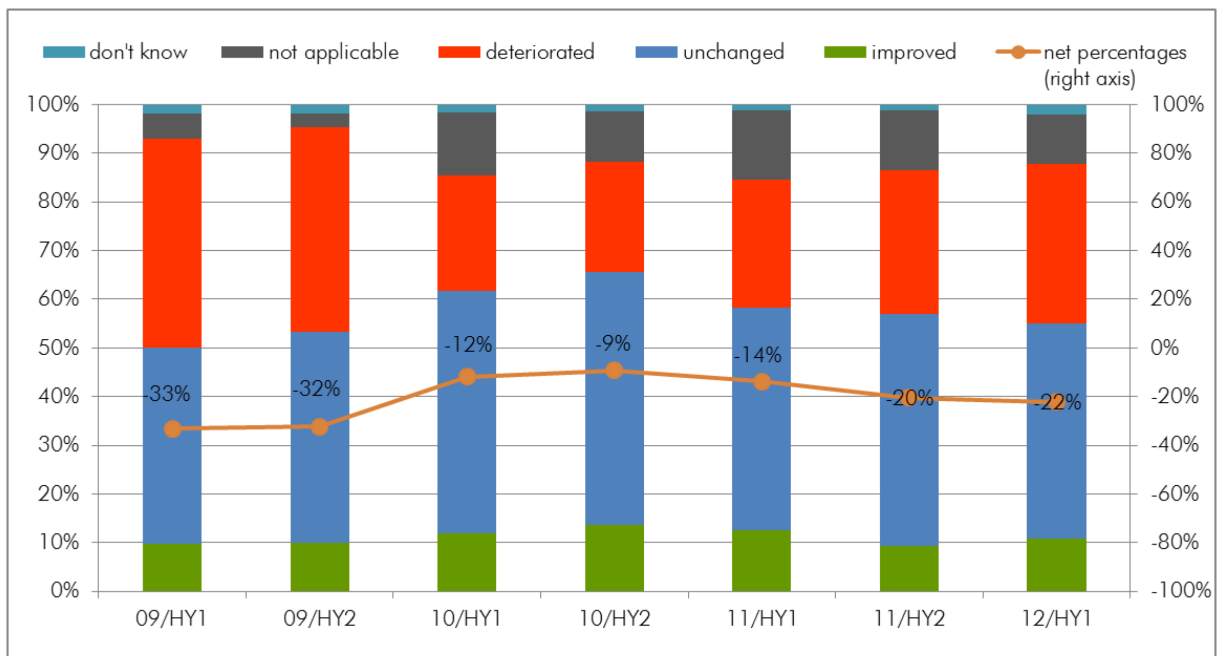
Figure 8: Sources of external financing of euro area SMEs
(over the preceding six months; percentage of respondent SMEs having used the different financing sources)



Source: Based on ECB (2012c)

During the reference period, the net percentage of SMEs reporting a higher *need* for bank loans slightly decreased compared to the previous survey. At the same time, the net percentage[9] of SMEs that perceived a deteriorated *availablity* of bank loans increased further (see figure 9).

Figure 9: Change in the availability of bank loans for euro area SMEs
(over the preceding 6 months; % of respondents; base: SMEs that had applied for external financing)



Source: Based on ECB (2012c)

[9] "Net percentage" means the difference between the percentage of firms reporting an increase (or an improvement) for a given factor and that reporting a decrease (or a deterioration).

Moreover, SMEs also reported a deterioration in the availability of bank overdrafts and trade credits, indicating an overall worsening in the access to finance for euro area SMEs. However, the reported deterioration is still below the 2009 levels following the Lehman Brothers bankruptcy.

According to the responses of surveyed SMEs, the main factor which negatively impacted the availability of external financing was the general economic outlook. In addition, a larger share of SMEs reported a further decline in banks' willingness to provide loans. Moreover, the net percentage of SMEs reporting increases in costs of financing (52%) and collateral requirements (39%) was still at high levels. In contrast, the net percentage of SMEs reporting an increase in interest rates dropped to 27% (from 42%), which can be the consequence of the slight moderation in aggregate short-term and variable bank lending rates on small-sized loans since April 2012 (ECB, 2012c).

When looking at actual applications for external financing, 24% of SMEs applied for a bank loan between April and September 2012. The main reason for SMEs not to apply for a bank loan was the availability of sufficient internal funds (see also box 1). When looking at the actual success of loan applications, SMEs continued to report a higher rejection rate than large firms. Moreover, SMEs reported increasing rejection rates for bank loans and unchanged rates for bank overdrafts.

Box 1: Economist Intelligence Unit's SME survey

To take the pulse of SMEs, the Economist Intelligence Unit (EIU) conducted a survey of over 530 SMEs[10] across five developed economies—France, Germany, Japan, the UK and the US in July and August 2012 (EIU, 2012). Unsurprisingly, 59% of the respondents confirm that the business environment has become much tougher during the past three years. However, the on-going crisis dampens optimism and a clear majority of 58% expect the situation to further worsen over the next three years.

Similar to the ECB report on SMEs' access to finance, the EIU survey reported a high number of SMEs that are worried about their debt financing (51% of respondents) and about deteriorating access to finance in general (41%). Instead of looking for outside resources, some managers tried to use internal funds (EIU, 2012).

Looking ahead, SMEs are expecting on balance a further deterioration of access to bank loans and bank overdrafts. Particularly pessimistic SMEs were observed in Greece, France, and Portugal; the most pronounced decrease in expectations was reported for France.

In order to alleviate the difficulty for SMEs in accessing finance, EIF is playing a counter-cyclical role: via a wide range of financial intermediaries, such as banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks or any other financial institution, it provides financing to SMEs, or guarantees for SME financing. Besides EIF guarantees for securitised SME financing instruments (see chapter 5), EIF offers guarantees/counter-guarantees for portfolios of micro-credits, SME loans or leases.

[10]However, it has to be noticed that the SME definition for this survey is wider than the EU SME definition.

As part of its mandate activity, EIF manages the SME Guarantee Facility (SMEG) under the Competitiveness and Innovation Framework Programme (CIP) on behalf of the European Commission (EC). Under this facility, losses are covered using the EC budgetary resources specifically allocated. Moreover, EIF continues to deploy its financial products in order to catalyse EU structural funds with a view to enabling SME financing in countries less supported by "traditional" EIF products, namely risk-sharing loans and portfolio guarantee instruments under JEREMIE[11]. Under the JEREMIE First Loss Portfolio Guarantee (FLPG), EIF covers part of the credit risk relating to a new portfolio of loans and/or leases granted by a financial intermediary to SMEs. Moreover, EIF further implemented a risk sharing loan product, the Funded Risk Sharing Product (FRSP), whereby EIF provides funding to banks for the financing of new portfolios of SME loans (such loans to be co-financed by the financial institutions) and shares part of the credit risk relating to the portfolios.

In addition, EIF launched the Risk-Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps (RSI) Facility in 2011. RSI is an EIF, EIB and European Commission joint pilot guarantee scheme aimed at improving access to debt finance for innovative SMEs and small mid-caps (enterprises with fewer than 500 employees) in support of research, development and innovation projects. RSI complements the scope of the existing Risk Sharing Finance Facility (RSFF), which is managed by the EIB and mainly addresses large corporates and mid-caps. With RSI, EIF makes available loans and financial leases through selected financial intermediaries. Serving as a basis for the EU 2014-2020 programming period, RSI complements the existing EU SME support schemes.

At the end of 2011, the EIF guarantees loan portfolio totalled over EUR 4.4bn in close to 220 operations, positioning it as a major European SME guarantees actor and a leading micro-finance guarantor.

[11] JEREMIE stands for Joint European Resources for Micro to medium sized Enterprises. The initiative, developed in cooperation with the European Commission, offers EU Member States, through their national or regional Managing Authorities, the opportunity to use part of their EU Structural Funds to finance SMEs by means of equity, loans or guarantees, through a revolving Holding Fund acting as an umbrella fund. A JEREMIE Holding Fund can provide to selected financial intermediaries SME-focused financial instruments including guarantees, co-guarantees and counter-guarantees, equity guarantees, (micro) loans, export-credit insurance, securitisation, venture capital, Business Angel Matching Funds and investments in Technology Transfer funds. For more information please visit: http://www.eif.org/what_we_do/jeremie/index.htm

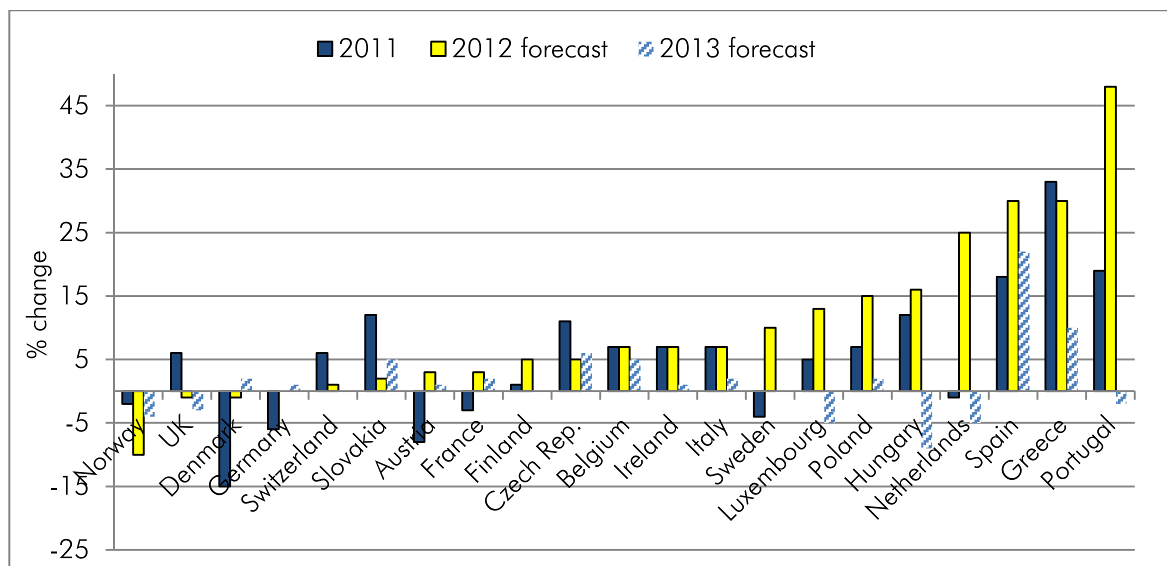
3.5 Insolvencies

The current economic developments will also lead to growing insolvencies. Recently, Euler Hermes (2012b) updated the predicted increase in global business insolvencies in 2012 to an even slightly more pessimistic level. For 2012 the Euler Hermes Global Insolvency Index[12], which analyses changes in business insolvencies across the world, forecasts a +4% increase after two consecutive years of improvement (reduction of -6% in 2010 and -4% in 2011).

Concerning the euro area, the Insolvency Index reported an increase in bankruptcies by +7% in 2011 and the projection for 2012 has been recently updated by Euler Hermes to a more pessimistic level of +17% (compared to +13% projected in April 2012). For 2013 the Insolvency Index is expected to decrease to +11%. At the same time, the regional disparities have significantly increased as indicated by figure 10. In 2011, insolvency indexes increased at a record speed of +33% in Greece, +19% in Portugal, and +18% in Spain, while a few central and eastern European countries also recorded double-digit increases (Hungary +12%, Slovakia +12% and Czech Republic +11%). On the other hand, the most significant falls in European insolvency indexes were recorded in, Denmark (-15%), Austria (-8%) and Germany (-6%).

Insolvencies in 2012 are now expected to worsen in the European periphery countries (Spain +30%, Greece +30% and Portugal +48%) as a result of the tightened credit conditions, the austerity plans and reduced demand (Euler Hermes, 2012b). The core countries in Europe, facing internal budget adjustments and being exposed to the downturn in euro area demand, are also expected to have increasing insolvency figures, e.g. for the Netherlands a strong increase of insolvencies (+25%) is forecasted for 2012 - but with an improvement in 2013 (Euler Hermes, 2012b).

Figure 10: Rate of change in insolvency, 2011-2013

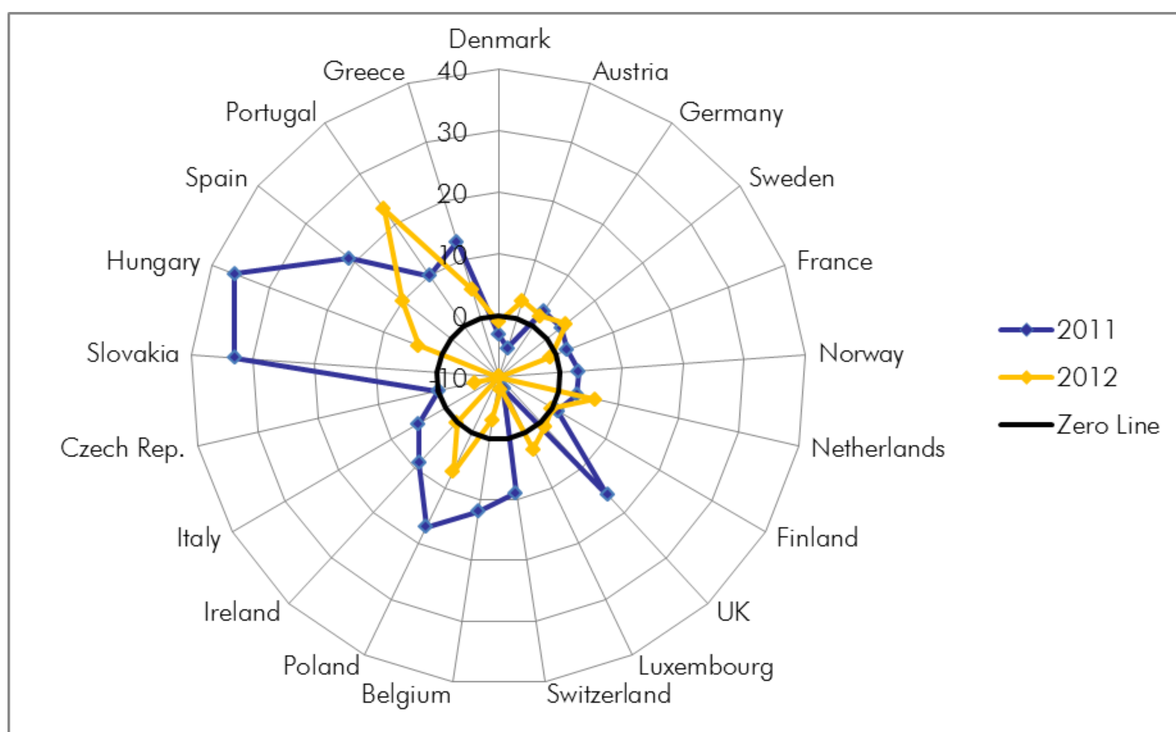


Source: Based on Euler Hermes (2012b)

[12] For each country, an insolvency index is calculated, using a basis of 2000=100. Global Insolvency Index (GII) is the weighted sum of the national indices. Each country is weighted according to its share of the total GDP (at current exchange rates) of the countries included in the study, which account for more than 85% of world GDP at current exchange rates for 2010 (Euler Hermes, 2012b).

For some countries, the Insolvency Index for 2011 varies significantly from the projections made 6 months earlier and reported in previous versions of our ESBFO. On top of that, the updated forecast for 2012 also shows important deviations from the forecast for 2012 reported in the previous ESBFO, reflecting the deteriorating economic environment (see figure 11). For example Luxembourg: In 2011, the real change of insolvencies was 8% better than the projection reported in the previous ESBFO (negative rate of change, hence: blue spot inside the zero line), while the new projection made now for 2012, was 3% worse than the previous projection made for 2012 six months earlier (positive rate of change, hence: yellow spot outside the zero line); please see also footnote 12.

Figure 11: Insolvency Index – gap of current and previous projections per country[13]



Source: EIF, based on data from Euler Hermes Global Insolvency Index 2012

[13] The gap is calculated as following: For 2012 the gap is the difference of the current projection of Insolvency Index per country and the previous projection (reported 6 months earlier in ESBFO 1/2012). For 2011 the gap is the difference of the actual level of Insolvency Index per country and the projection made 6 months earlier (as reported in ESBFO 2/2011). The spots of the graph that are out of the black circle – zero line (positive) represent a deterioration of the forecast in percentage points (more insolvencies). The negative points (inside the black circle) show an improved situation in terms of business insolvencies.

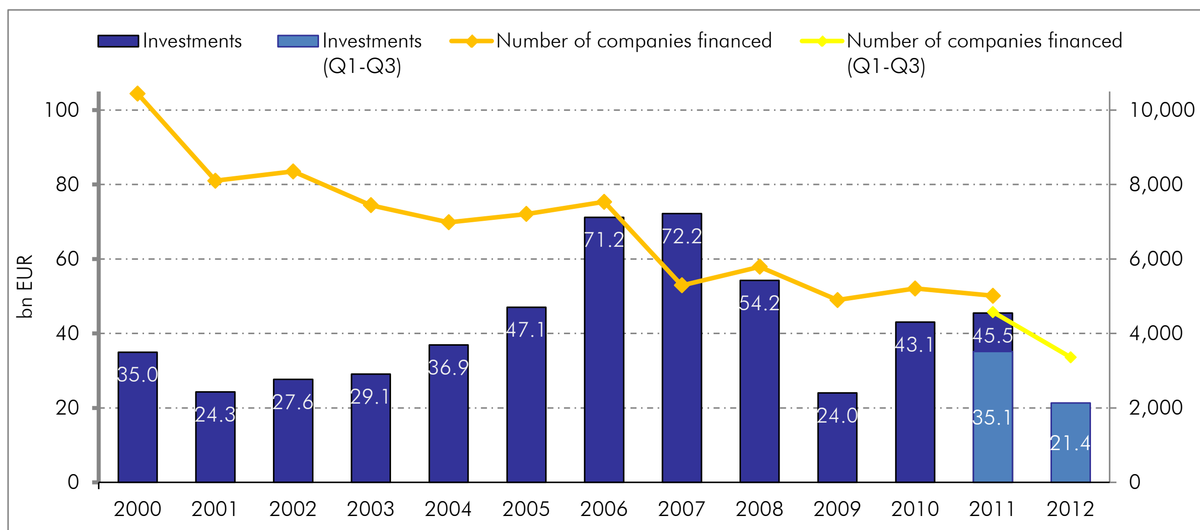
4 European private equity market

4.1 Investment activity

Following the deep crash in 2008/2009, private equity investment had partially rebounded in the years 2010 and 2011. However, in terms of activity volumes, the recovery appears to have suffered a setback during the first three quarters of 2012. During this period, according to EVCA quarterly figures, total private equity investment activity slumped by 39% to EUR 21.4bn compared to the same period one year before. In parallel, the number of companies which benefited from private equity investment decreased by 27% to less than 3,400.

However, conclusions from quarterly EVCA data should be drawn much more carefully than when interpreting annual data. A significant number of funds report business figures to EVCA only in the fourth quarter of a year. Thus, annual data can differ to a relatively large extent from the data of the first three quarters of a year, and quarterly figures should be seen as having preliminary character. EVCA assumes that total 2012 PE investment activity might end up significantly above the 2009 crisis figures.

Figure 12: Investment activity (values and number of companies) financed by private equity firms located in Europe[14,15]



Source: Based on data from EVCA

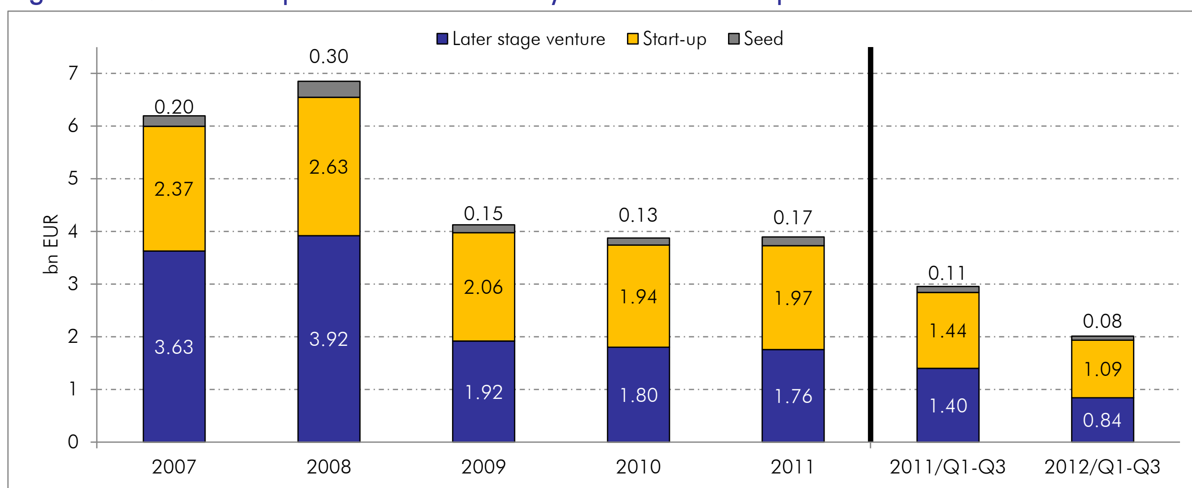
With the exception of replacement capital, all private equity market segments so far (Q1 to Q3) appear to have recorded a relatively weak year. In the buyout sector, which forms the largest part of the market, investment activity decreased by 40% to EUR 16.4bn, but also growth capital investments (-53%) so far showed remarkable weakness. Venture capital investment dropped by 32% to EUR 2.0bn. According to the preliminary EVCA quarterly figures, all VC stages declined in the first three quarters of 2012 (see figure 13), however, later stage venture investments so far showed the strongest downturn (-40% to EUR 0.8bn).

[14] The EVCA figures mentioned in this chapter show investment activity by PE firms located in Europe ("industry approach" or "office approach").

[15] All investment figures are equity value, i.e. excluding leverage.

These developments are at least partially driven by the severe general economic downturn to which private equity – and in particular the buyout sector being the biggest segment of the market – is exposed to a relatively large extent.

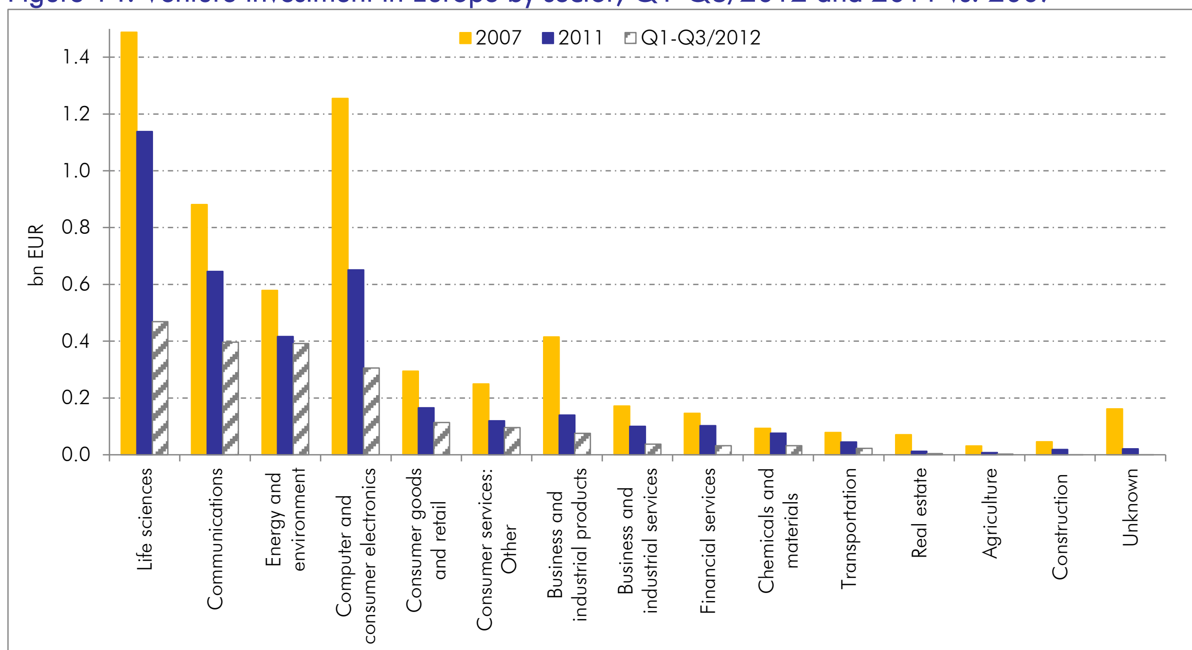
Figure 13: Venture Capital investment activity evolution in Europe



Source: Based on data from EVCA

The recent developments in venture investment by sector are shown in figure 14. The relative importance of sectors shows certain stability over time. Life sciences, communications, energy/environment, and computer/consumer electronics remain the most relevant industries for venture investment. However, within these sectors, the share of total VC investment activity in the energy/environment sector has most increased (from 9.7% in 2007 to 19.7% in the first three quarters of 2012). Moreover, while the relative importance of investments in the communications sector has also increased (from 14.8% to 20.0%), the share of computer/consumer electronics has decreased (from 21.0% to 15.4%) during the last years.

Figure 14: Venture investment in Europe by sector, Q1-Q3/2012 and 2011 vs. 2007[16]



Source: Based on data from EVCA

[16]Figures based on market approach (i.e. by country of portfolio company), due to data availability.

Box 2: Business Angel activity

Business Angels represent an important class of private equity investors, primarily consisting of high-net-worth individuals. They tend to invest their own money, either individually or in formal or informal syndicates, in businesses which are not publicly traded.

Business Angels differ from VC funds, who primarily invest third parties' funds (e.g. Institutional Investors') in that typically Angel-financed companies are in earlier stage of their development compared to the VC-backed ones. Moreover, Business Angel Investments are usually short term with median holding period of approximately six years. The past three years have seen an increase in Business Angel Investments in Early-stage high-growth companies as VC funds have migrated to less risky later-stage investments. Business Angels offer a number of advantages compared to VC funds:

- Lower transaction costs allow them to invest on a lower scale
- Business Angels are geographically more dispersed, and often invest in local markets
- They are very 'hands-on' investors

There are potential difficulties in measuring the size of the Business Angel community, the main ones being identification and definition. Business angels typically prefer to stay anonymous, and the details on their investments are rarely disclosed. Further, nothing can prevent an individual from identifying oneself as a 'virgin' angel, although he/she may have never actually invested. Others may have occasionally acted as angels, but are no longer looking for investment opportunities. Moreover, the so called "invisible market" (which can be assumed to be of significant size) makes a precise estimation of the angel market difficult. Such difficulties must be borne in mind when describing the market.[17]

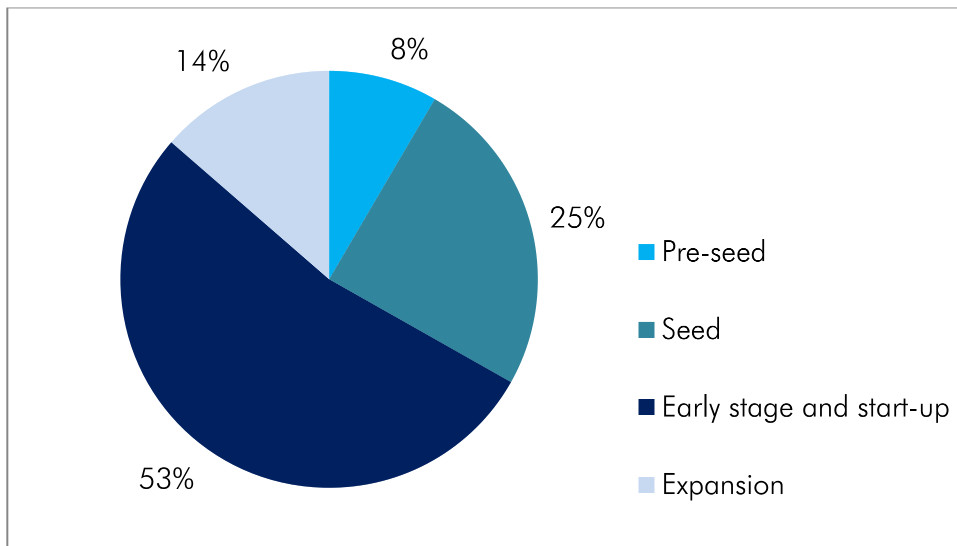
According to the European Business Angel Network (EBAN), the number of angel investors active both within networks and independently (individually or in syndicates) is estimated at around 75k in Europe. In terms of overall investment, EBAN estimates (i.e. based on data provided by members) the average annual amount invested by Business Angels to be in the area of EUR 4bn in the EU, even though it has been affected up to a certain degree by the global financial crisis. Regarding the size of their funding, Business Angels, investing together in syndicates, provide on average around EUR 200k per deal in Europe, with individual angel investments ranging from EUR 15k to EUR 1m.

Of the 392 identified Business Angel Networks in Europe (incl. Russia and Turkey), around 15% are direct EBAN members. The median number of investors in a typical European Business Angel Network is 50. Figure 15 below represents a breakdown by investee's growth stage of the Business Angel investments reported by EBAN members.

[17]For a general description of Business Angel financing we also recommend to refer to OECD (2011) and to Kraemer-Eis and Schillo (2011).

Box 2: Business Angel activity *(continued)*

Figure 15: Investees' growth stages of Business Angels reported by EBAN members

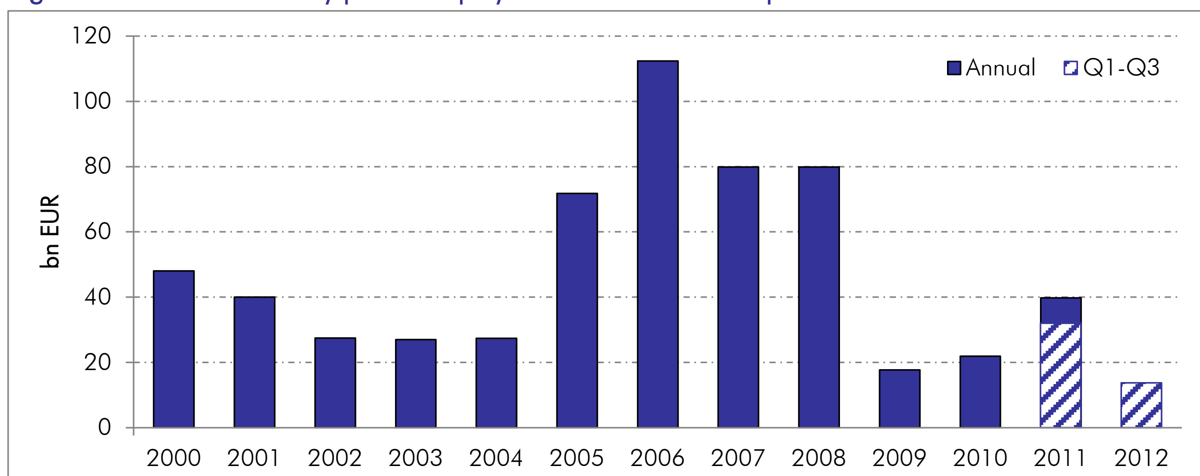


Source: EBAN, based on preliminary figures

4.2 Fundraising activity

Total private equity fundraising appears to have substantially decreased. For the first three quarters of 2012, EVCA preliminary quarterly figures report a 57% drop (compared to the same period one year before) in funds raised by private equity firms located in Europe to EUR 13.8bn (see figure 16).[18] Fundraising decreased over all stages of the European private equity market. However, the largest contribution came from the buyout sector where fundraising is reported to have fallen by EUR 10.8bn. In addition, growth capital fundraising decreased by 94% to a level of only EUR 248m.

Figure 16: Funds raised by private equity firms located in Europe

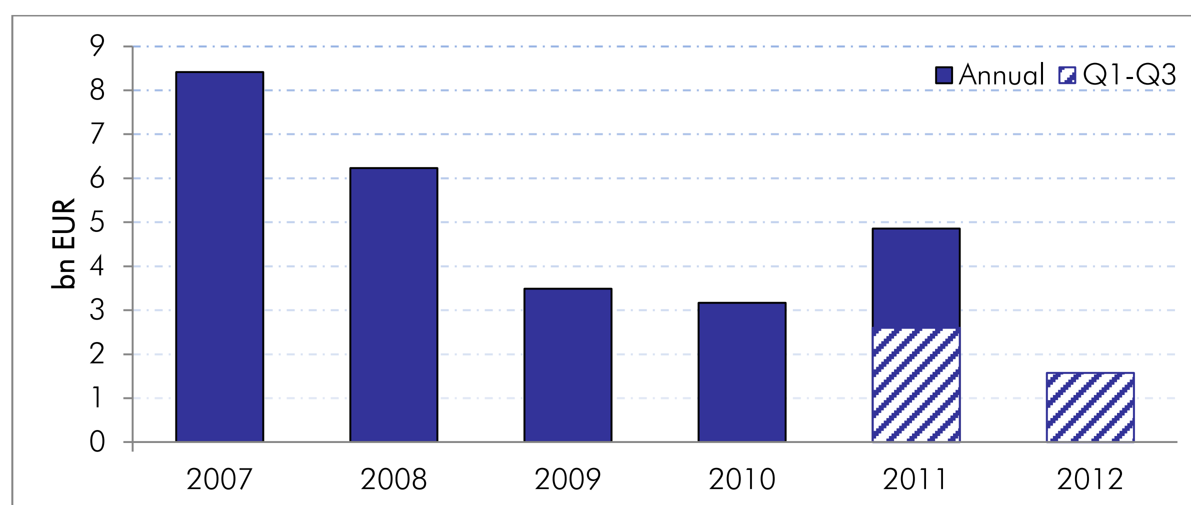


Source: Based on data from EVCA

[18]Figures show fundraising activity (incremental closings during year) by private equity firms located in Europe ("industry approach" or "office approach").

Moreover, the positive rebound in venture capital fundraising which was recorded last year seems to have come to an end. In the first three quarters of 2012, European VC fundraising decreased by 39% to EUR 1.6bn compared to the same period one year before, according to EVCA preliminary quarterly data (see figure 17). This is the lowest VC fundraising level that EVCA has reported for the first three quarters of a year since the beginning of the crisis in 2008. However, again bearing in mind that annual EVCA data can differ significantly from the data of the first three quarters of a year, it needs to be awaited if the annual figures will confirm this trend. Current EIF data support the view that 2012 might finally show better results than EVCA preliminary figures suggest so far.

Figure 17: Funds raised by VC firms located in Europe



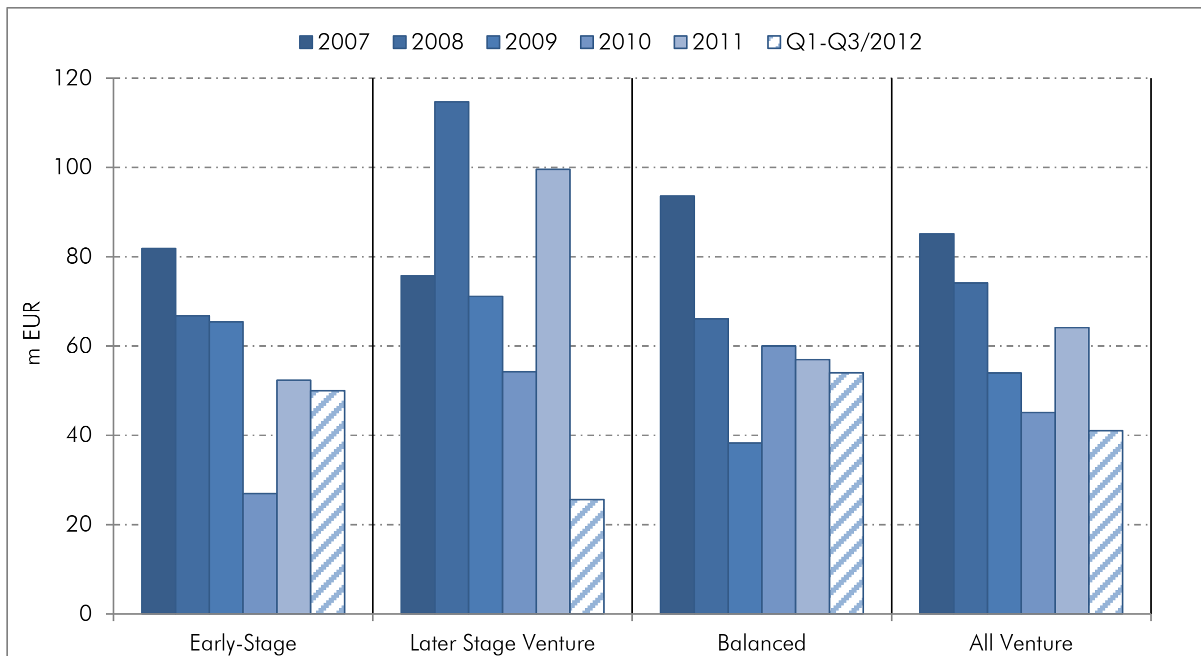
Source: Based on data from EVCA

The EVCA figures also indicate that the average VC fund size has continued to follow the downward trend of the past years – with a disruption in 2011 (see figure 18). In the first three quarters of 2012, the average VC fund size has fallen considerably to EUR 41m. However, these preliminary figures should not be overstated as they are based on the very tiny number of only five fund closings.

Another sign of investors' currently cautious sentiment towards venture capital is the shift in the investor base which has been going on during the past years (see figure 19). According to EVCA preliminary quarterly figures, government agencies accounted for approximately half of total investors into venture capital funds in the first three quarters of 2012.[19] However, even if this share is unsatisfyingly high for the long term, it is noteworthy that government agencies continue to play their role and support the market in a counter-cyclical way, in particular in a year which showed a significant deterioration of the economic environment

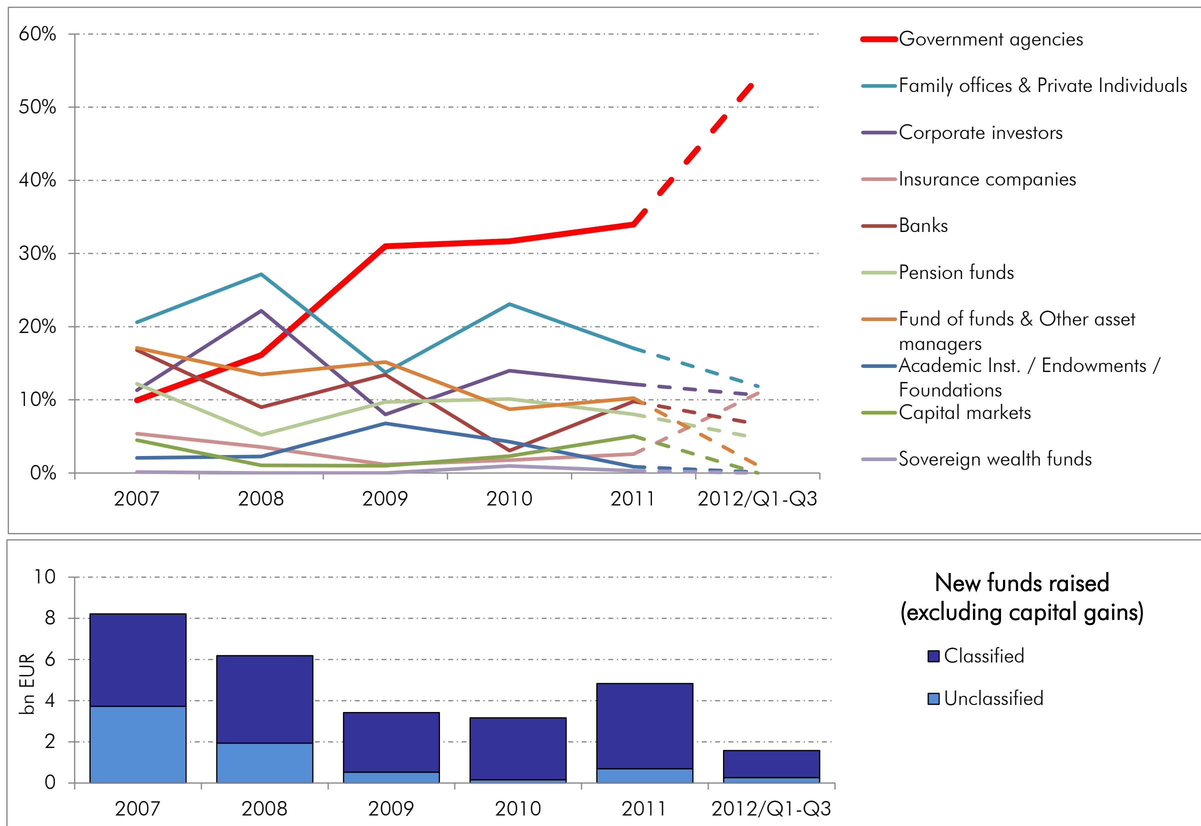
[19] It has to be considered that the figures with regard to the investor base are highly volatile for short time periods and have to be carefully interpreted. (For example: according to EVCA data, the reported share of government agencies in VC fundraising was 57% in HY1/2011 and came down to 34% with the inclusion of HY2/2011.) Moreover, it has to be considered that, for the calculation of the percentages, a) the underlying amounts of funds raised have changed significantly (as shown in the diagram) and b) that the amounts that could for technical reasons not be classified have been deducted (extrapolation).

Figure 18: Average VC fund size (based on final closings)



Source: Based on data from EVCA

Figure 19: Investor base: Share of government agencies in VC fundraising

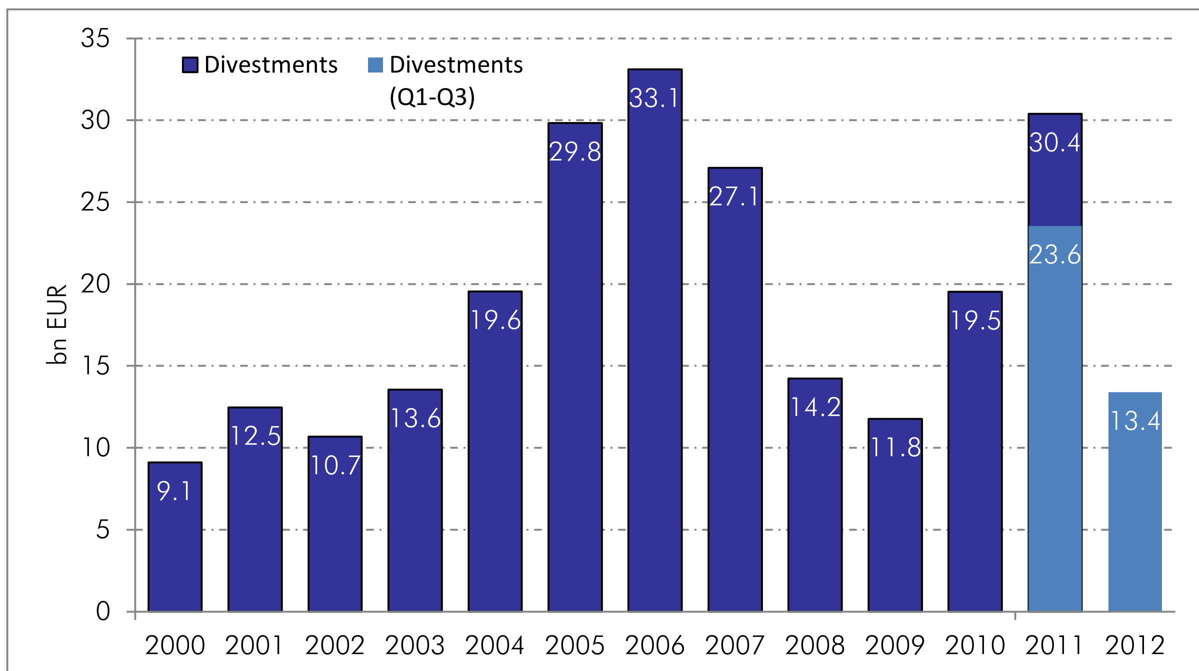


Source: Based on data from EVCA

4.3 Divestment activity

Alongside the developments of private equity fundraising and investment activity, also divestments appear to have fallen considerably. In the first three quarters of 2012, total divestments in Europe amounted to EUR 13.4bn which was 43% below the value during the same period one year before (see figure 20). According to EVCA preliminary quarterly figures, the downturn was relatively similar for the buyout/growth stage and for venture capital. Divestments in these market segments decreased by 41% and 47% respectively, and amounted to EUR 12.3bn for the buyout and growth stage and to EUR 1.0bn for the venture stage. Despite the recent market weakness, total PE exits will still exceed the levels of the crisis years 2008 and 2009. However, venture exits are so far below those levels which were reached during the worst years of the market – but, as stated above, it needs to be awaited if annual figures will confirm this preliminary picture.

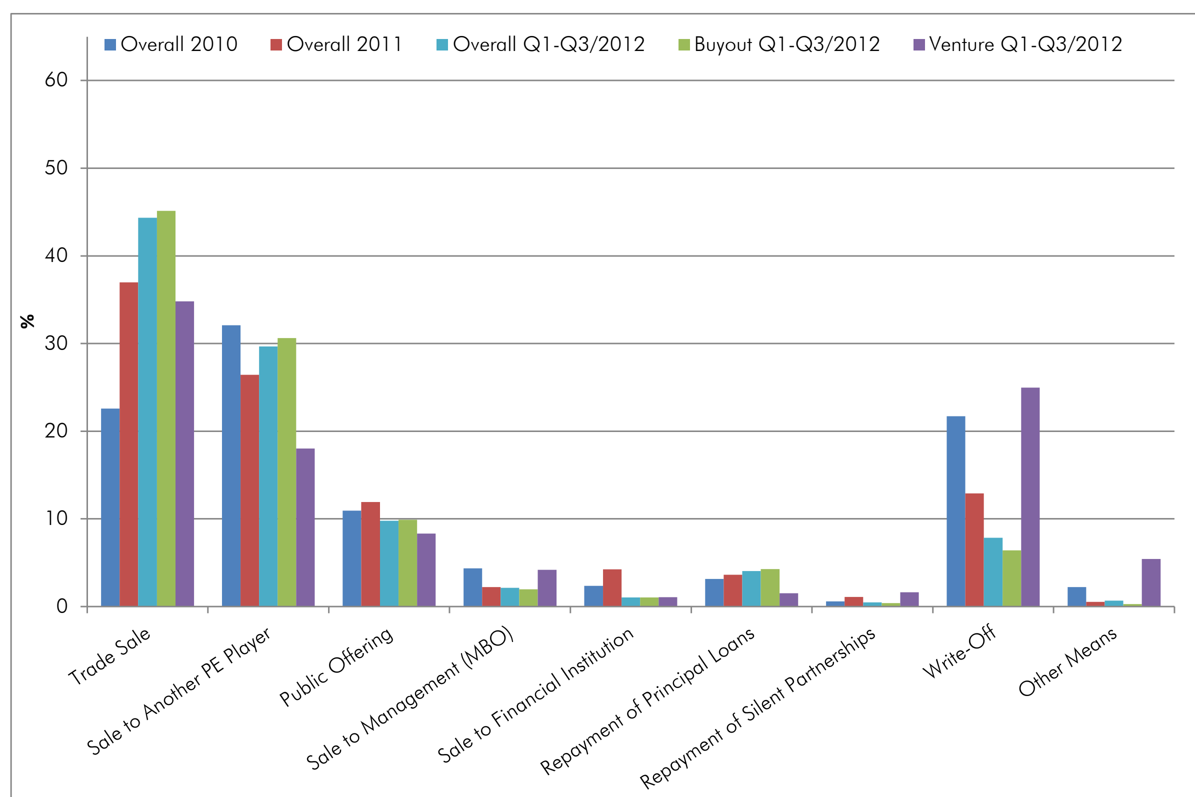
Figure 20: Divestments by private equity firms in Europe



Source: Based on data from EVCA

Some comfort can be taken from figure 21 which shows that the relative importance of write-offs as a form of divestment has continued to decline in the first three quarters of 2012. Trade sales have become the most popular form of divestment. Together with sales to another private equity house they are accounting for almost three-fourths of total exit value. However, while write-offs made up only 6.4% of all buyout and growth stage divestment amounts, they accounted for 25% in the venture part of the market.

Figure 21: Divestment routes (shares)[20]



Source: Based on data from EVCA

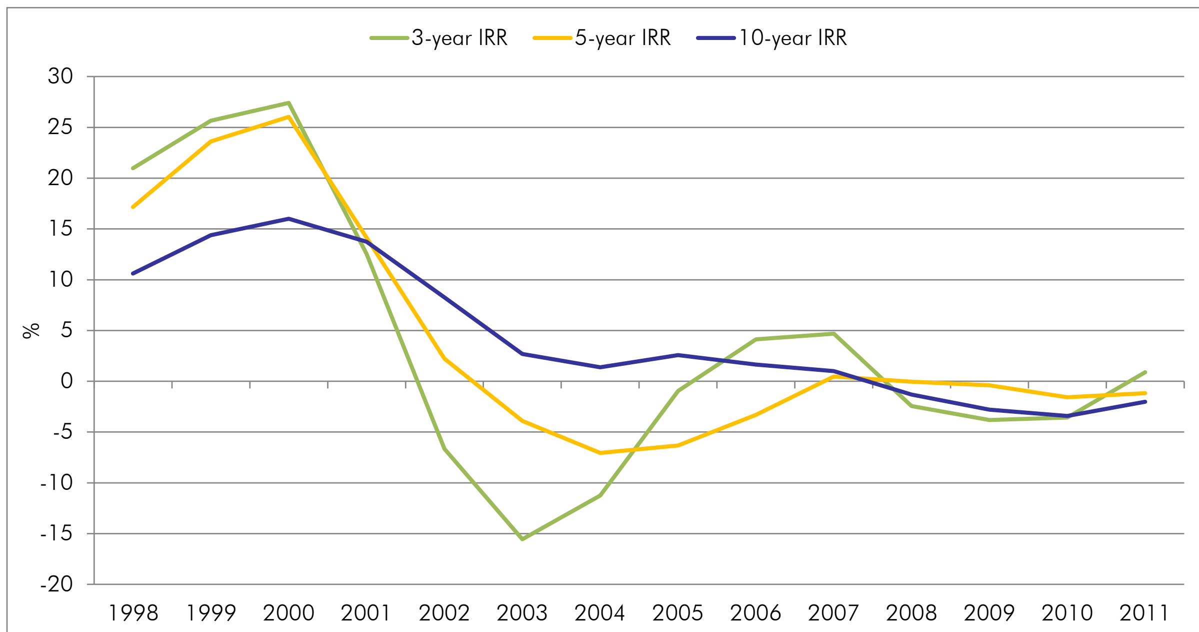
4.4 Performance trends

An analysis of European private equity performance was already provided in the previous ESBFO. As these data are available only on an annual basis, the analysis in this chapter is still based on figures up to 2011. However, Thomson Reuters recently refreshed their performance figures and based it on a larger set of funds. Thus, it is worth to look into the revised data and to analyse some further details here.

According to EVCA and Thomson Reuters data, European venture capital performance slightly improved in 2011. The 3 year rolling horizon Internal Rate of Return (IRR) amounted to 0.9% which is good news after three years of negative returns. However, when looking at longer term performance figures, the picture is less bright (see figure 22). The rolling horizon IRRs for the 5 year (-1.2%) and the 10 year (-2.0%) periods are reported to be still in the negative area. Nevertheless, in 2011 European VC performance has improved compared to 2010 for all three reported rolling horizons periods.

[20]Shares based on amounts at cost divested. Market approach (see footnote 15).

Figure 22: Rolling Horizon IRR European Venture Capital (in %)



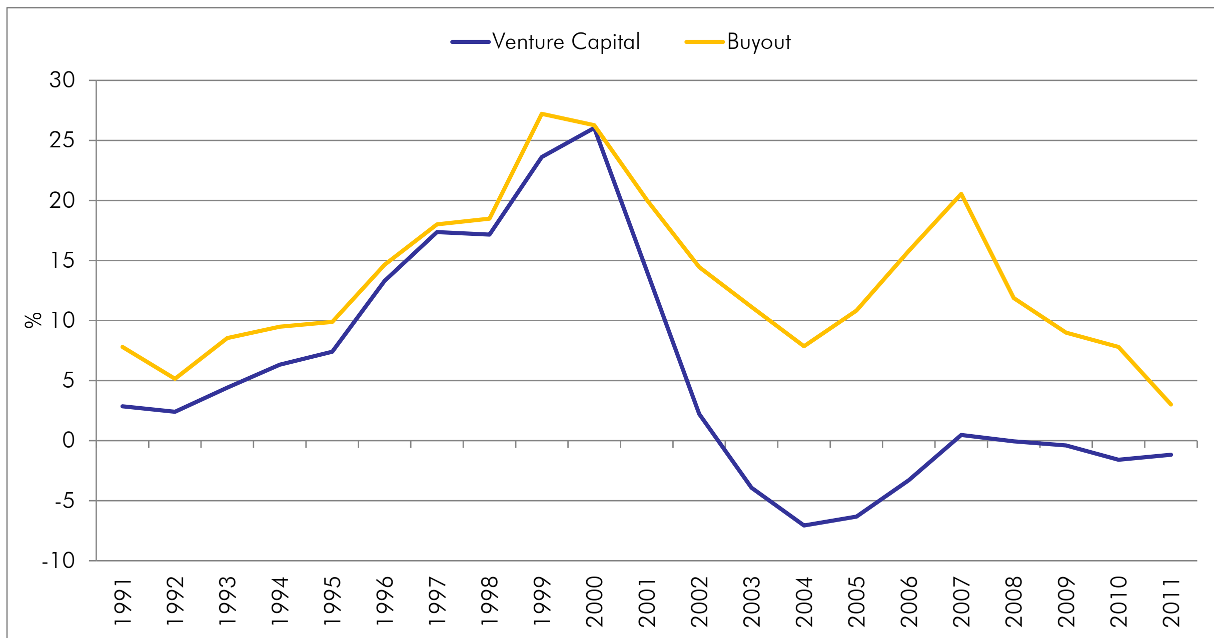
Source: Based on data from EVCA and Thomson Reuters

As concerns total private equity, EVCA and Thomson Reuters data show a net-pooled IRR for all covered PE funds of 9.2% (9.8% in 2010) from inception to 31 December 2011. Once again, the buyout sector contributed the largest share with a net-pooled IRR of 11.6% (12.3% in 2010) in contrast to 8.8% (8.2% in 2010) for mezzanine funds and 1.2% (0.9% in 2010) for all venture funds.

When looking only at the top-quarter, total venture performance was at 13.8%, thereby emphasizing the importance of careful selection by investors. Top-quarter buyout (29.0%) and mezzanine funds (20.0%) were performing much better than the VC peer group.

This general picture holds even when looking at pooled horizon IRRs until 31 December 2011. With the exception of 1-year horizon IRRs, for which all venture capital (5.3%) has slightly outperformed other PE market segments, the venture sector as a whole has underperformed compared to the buyout and the mezzanine sector for all other reported (3-year to 20-year) horizons. For the 5-year horizon IRR, figure 23 shows that the relatively good performance of the buyout sector compared to venture capital in Europe holds true also when looking to the past, in particular in the last decade. However, the IRR figures for the buyout and the venture sector are converging.

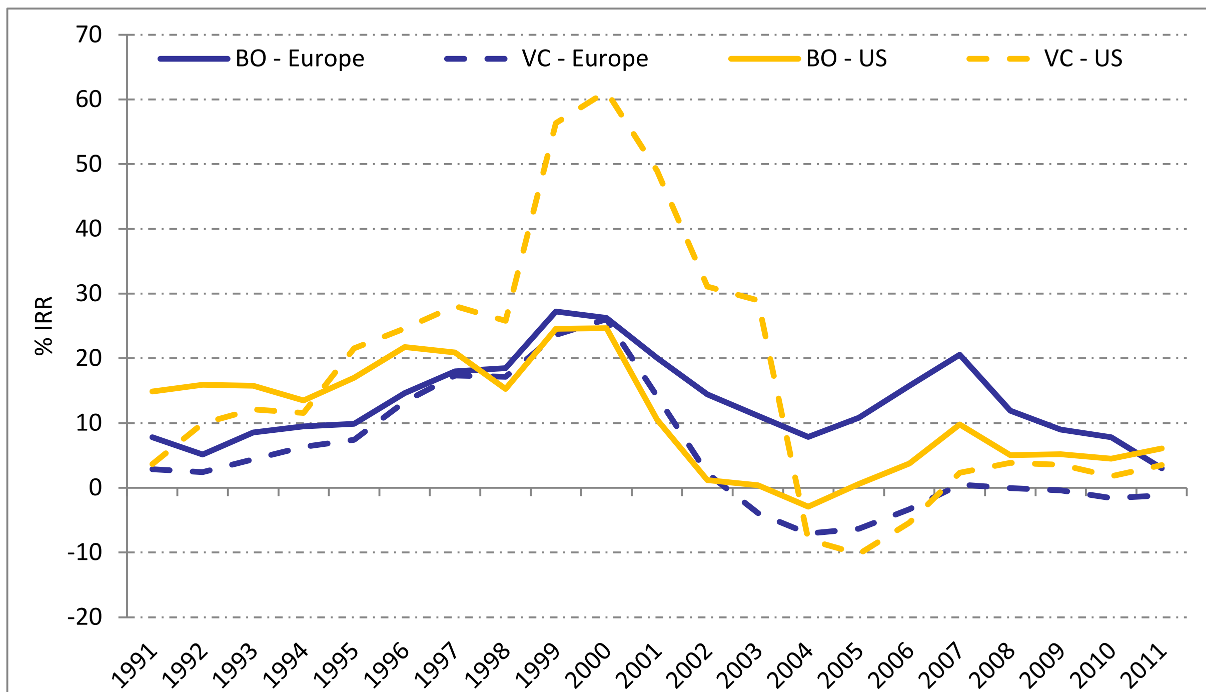
Figure 23: Five-year horizon rolling net IRRs for European venture and buyout funds



Source: Based on data from EVCA and Thomson Reuters

From a geographical point of view, the European picture looks relatively brighter for the buyout sector than for the venture capital part of it. Figure 24 shows that buyout performance (measured as five-year horizon rolling IRR) in Europe was better than in the US between 1998 and 2010 while the European venture sector performed worse than its American benchmark in almost all years. Only during 2004 and 2006, when US VC performance entered negative territory, its European counterpart performed slightly better.

Figure 24: Five-year horizon rolling IRRs for Europe and the US



Source: Based on data from EVCA and Thomson Reuters

4.5 Prospects

The current economic situation and various regulatory initiatives make the private equity environment very challenging. As regards financial regulation, on the one hand, the Alternative Investment Fund Managers Directive (AIFMD), the European Venture Capital Fund Regulation, and the European Social Entrepreneurship Funds Regulation aim at creating an improved EU-wide regulatory framework and facilitating fundraising across all EU Member States for funds investing into SMEs and social businesses. However, on the other hand, AIFMD "may not only reduce the number of new funds investing into SMEs [...] but will also increase the burden of administration and reporting for SMEs held by such funds and could also imply an increase in the cost of capital for such SMEs" (ESMA, 2012). Moreover, Solvency II and CRD IV "will make it more difficult for insurance companies and banks to indirectly invest into SMEs via private equity and venture capital funds" (ESMA, 2012). According to ESMA (2012), "the balance between costs, restrictive application and benefits remains to be seen."

In addition, the current market environment is hampering the fundraising perspectives. According to Grant Thornton's recent global survey of private equity houses, there are currently no signs of improvement. Rather, 72% of global PE firms reported the outlook for fundraising efforts as negative. Many PE firms fear that current economic developments will negatively impact their portfolio companies. "Growth inhibits returns and diminishes capital reserves for new investments, while institutional investors re-allocate and cautiously manage their liabilities, complicating fundraising for all parties involved" (Tappe, 2012). In this environment, fund managers' track records are becoming increasingly important. Due to the current crisis, the situation in Europe is even worse and institutional investors' capital even scarcer than in other regions of the world. According to the report, this leaves room for other investor types to step into the European PE market.

In this context, EIF has increased - as reference catalytic investor in European venture and growth capital funds - its counter-cyclical role in providing financing solutions to boost entrepreneurship and innovation. In the coming years, EIF will continue to cornerstone across the spectrum of Technology Transfer through Venture Capital to the Lower Mid-Market and mezzanine financing. This also includes the launch of new/pilot initiatives - such as the European Angels Fund (a co-investment fund to provide equity to Business Angels, launched in March 2012 in Germany; it is in the process of being extended to other European countries in view of a pan-European coverage) or such as partnerships with corporate investors (structured as innovation platform in order to establish collaboration between fund managers, strategic investors and portfolio companies).

With regard to performance, the medium term perspective remains uncertain as the difficult general economic and financial environment will also strain the performance of private equity – in all of its segments. EIF is however observing an increasing number of budding companies in the early-stage segment which show an unprecedented pattern of growth. Should this trend continue, the potential return of these companies would have a significant positive impact on the performance of the financing funds. As a consequence, the medium term perspective of the European Venture Capital market would be more positive than the backward looking statistics reveal.

Furthermore, a crisis is also a source of opportunities in private equity as valuations are decreasing and acquisitions can be completed at more favourable prices. Finally, the outcome of the on-going fund selection process in the market might not only be negative (in terms of fewer investors), but may also result in a more efficient investor base.

Box 3: Mezzanine Finance Market

Many SMEs have demand for (mezzanine-) capital to finance their expansion, which is often not met by capital markets' supply or by banks, especially in the present period of the financial crisis. SMEs, and in particular family-backed or entrepreneurs-controlled companies, have inter alia financing needs in the following situations:

- *Growth financing*: medium sized companies which are growing strongly have a critical need for long term financing to ensure their development. Mezzanine, combined with minority equity when appropriate, offers a flexible means of financing which can be adapted to a large variety of situations: financing of internal growth, build-ups / external growth, consolidation of the financial structure of an expanding company, etc.;
- *Shareholding evolution*: mid-market companies face a number of situations where they need equity or quasi-equity financing (offer liquidity to exiting minority shareholders, enable business owners to realise part of the value accumulated in their companies, small and mid-caps suffering from the illiquidity of the smaller segments of the stock exchange);
- *Sponsorless buy-outs*: mid-market companies held by buy-out funds represent a promising reservoir for management-led secondary buy-outs. There is attractive potential in partnering, in sponsorless transactions, with manager-shareholders who have demonstrated the success of a first buy-out and wish to obtain or regain their independence with the help of a stable and experienced minority financial partner.

During the financial crisis, there was not only a sharp retrenchment in the availability of pure debt and pure equity capital, but also the mezzanine market suffered. Moreover, the mezzanine finance for smaller companies and in small amounts is not yet sufficiently developed in Europe. In 2009, the EIF began to support this market and began to offer mezzanine finance, by launching a fund with a dedicated mezzanine mandate, the Mezzanine Facility for Growth (MFG). MFG is a EUR 1bn fund of funds mandate granted by the EIB to the EIF to be invested in hybrid Debt /Equity funds throughout Europe, with a view to playing a catalytic role in this market segment.

This tailor-made solution is meeting market demand and provides financing to support entrepreneurs who are endeavouring to keep control of their companies as the company expands or to companies which need complex reorganisation of their capital structures. Mezzanine also caters for later stage technology companies which have reached breakeven but do not yet have access to standard funding. It can be tailored to meet the specific financing requirements of these companies and in the current market situation, where bank lending remains limited, it is well adapted to long-term financing. EIF is usually involved early in the launch process of mezzanine funds, taking a significant participation at first closing. These Mezzanine Funds typically offer hybrid debt/equity products to their portfolio.

Box 3: Mezzanine Finance Market *(continued)*

In 2011, EIF committed a total of EUR 236m in six hybrid debt-equity funds, spreading its contribution between two first-time teams composed of experienced professionals and four established teams raising new funds. Five of the funds backed by EIF in 2010 and 2009 made further closings in 2011, demonstrating EIF's catalytic role in allowing first closings and in generating new investors' interest which amounted to EUR 1.2 bn. In 2012, EIF is continuing to play a critical role in stimulating the development of this market.

Under the umbrella of the MFG mandate, which covers EU 27, in 2012, the "Mezzanine Dachfonds für Deutschland" (Mezzanine fund-of fund for Germany, MDD) has been established. MDD is a EUR 200m fund-of-fund, targeting hybrid debt/equity fund investments in Germany. MDD is funded by EIF (under the MFG mandate), the BMWi (German Federal Ministry of Economics and Technology), LfA Förderbank (the development bank of Bavaria) and NRW.BANK (the development bank of North Rhine-Westphalia).

5 European SME Securitisation[21]

5.1 Market activity[22]

The European Structured Finance market had grown steadily from the beginning of the decade until the outbreak of the crisis. During the crisis, issuance remained at high levels, but these volumes were almost exclusively driven by the eligibility of Asset Backed Securities (ABS) as collateral for ECB liquidity operations. In 2009 and 2010 the overall market activity decreased to pre-crisis levels (after having peaked in 2008) due to regulatory uncertainties and tighter Euro system collateral rules.[23] Rating downgrades, based on negative credit trends and revised rating agency criteria, contributed to the negative market sentiment. However, despite the crisis, the European securitisation market in general performed relatively well with comparably low default rates (see chapter 5.2).[24]

SME Securitisation (SMESec), as important element of the financing of SMEs in Europe, is still suffering from the economic and financial crisis. The near-collapse of the European structured finance market, in tandem with the other markets around the globe more generally, has profoundly affected the status and outlook of SMESec and unfortunately the situation has only slightly improved since our previous report. It is still the case that originators mainly retained newly issued deals in order to create liquidity buffers and to use the assets as collateral with central banks for re-financing purposes.

As a consequence, overall securitization activity was so far high during the crisis - but this mainly reflects retained transactions. In 2011 the total securitisation *issuance* in Europe was EUR 372bn, compared to EUR 383bn the year before (-3%). For the full year 2011, the retention (see figure 25) was at around 76% (2010: 77%). So far in 2012 (Q1+Q2) the retention rate was significantly lower (67%); at first sight this looks encouraging, but this is only in relative terms - it has to be considered that the overall issued amounts went down by 30% (Q1+Q2/2011: EUR 182bn, compared to EUR 127bn in 2012 (Q1+Q2); see also figure 26) and the amounts placed with investors went down by almost 17% (Q1+Q2/2011: EUR 51bn, compared to EUR 42.3bn in Q1+Q2/2012). The most active markets so far this year in terms of issuance were the UK (market share in Q1+Q2: 31%), Italy (22%) and the Netherlands (22%).

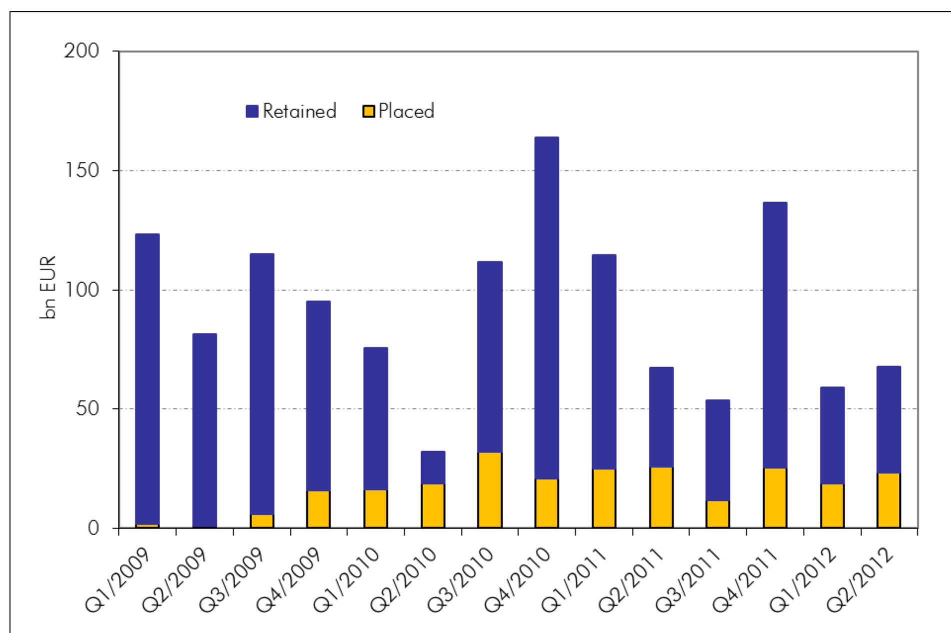
[21]The reader can find a securitisation glossary in Annex 2. The term SME Securitisation (SMESec) comprises transactions based on SME loans, leases, etc. For background information with regard to the importance of SMESec see Kraemer-Eis, Schaber and Tappi (2010).

[22]If not flagged otherwise, the data source is AFME, the Association for Financial Markets in Europe.

[23]The ECB's asset repurchase or "repo" facility allows (among other assets) Asset Backed Securities to be used as collateral for funding.

[24]Please note that, due to structural protections available to transactions, weakening portfolio performance does not necessarily result in downgrades or even defaults of transactions.

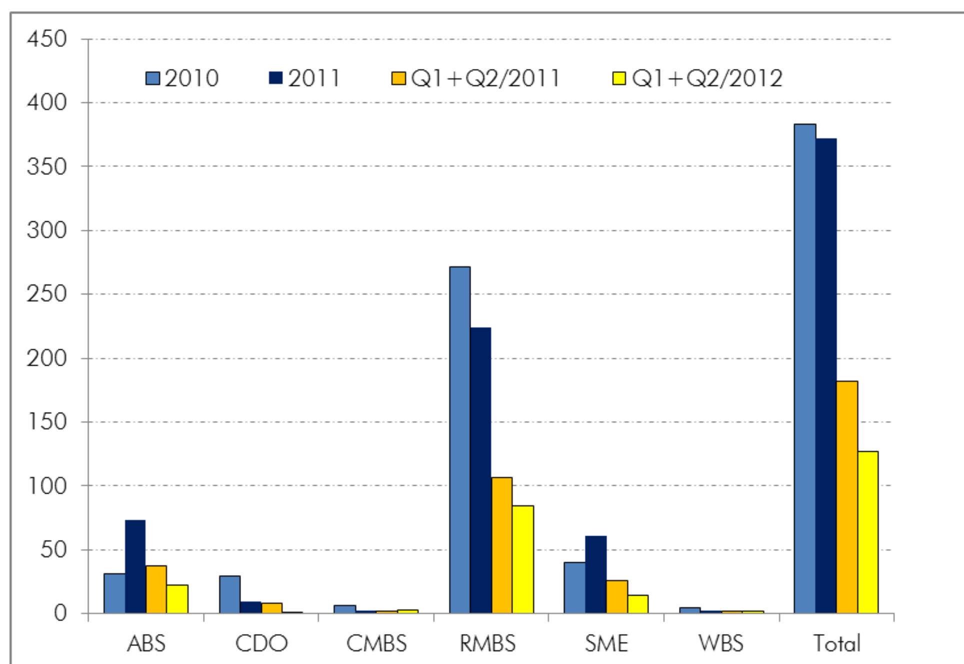
Figure 25: European securitisation issuance by retention (bn EUR)



Source: Based on data from AFME (2012a)

Given the dominance of the securitisation of residential mortgages (RMBS), SMESec remained a relatively limited but important segment of the European structured finance market (see figure 26).

Figure 26: European Securitisation Issuance by collateral (bn EUR)[25]

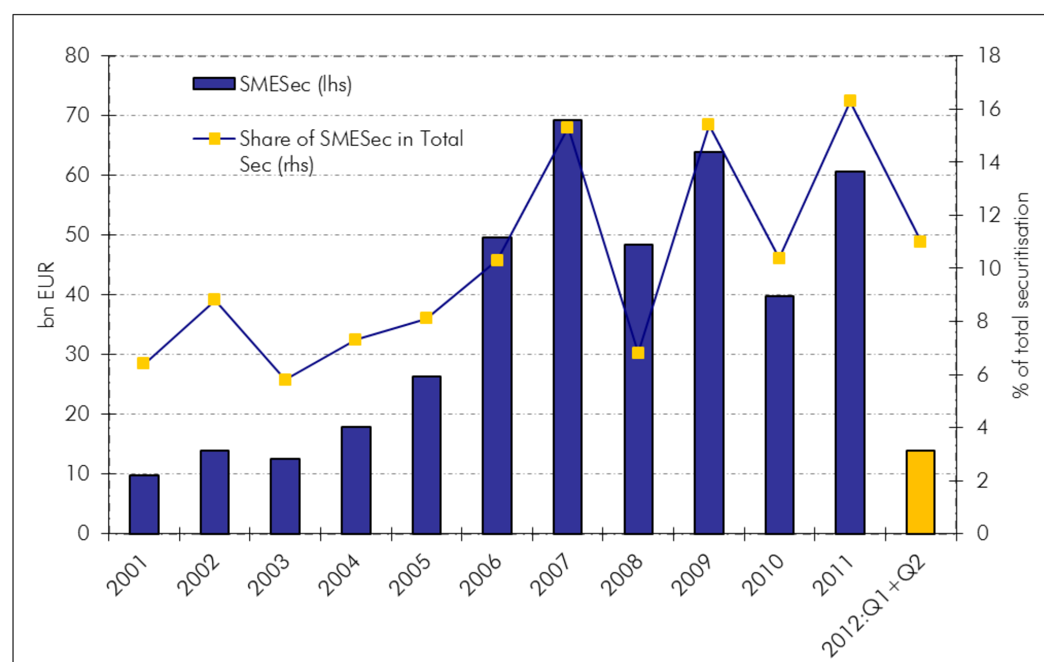


Source: Based on data from AFME (2012a)

[25]AFME definitions: European ABS issuance includes auto, credit card, leases, loans, receivables and other. European CDO issuance numbers only include issuance denominated in a European currency regardless of the country of collateral. A substantial percentage of CDOs are backed by multi-jurisdictional collateral. Historical CDO issuance totals have been revised due to periodic updates of the sector. WBS: whole business securitisation – a securitisation in which the cash-flows derive from the whole operating revenues generated by an entire business or segmented part of a larger business.

The market share of SMESec was between 6% and 16% of total yearly issuance during the past decade. In 2011, the share was 16.2%, the highest value ever registered in Europe (see figure 27). In the first half of 2012, the share of SME issuance went down to 11% (EUR 13.9bn out of a total issuance in Europe of EUR 126.9bn). If we compare the two first half years (2011, 2012), SME related issuance was much lower (-47%) so far this year, with main activity in Belgium and Spain.

Figure 27: SMESec volumes in Europe and share of SMESec in total securitisation

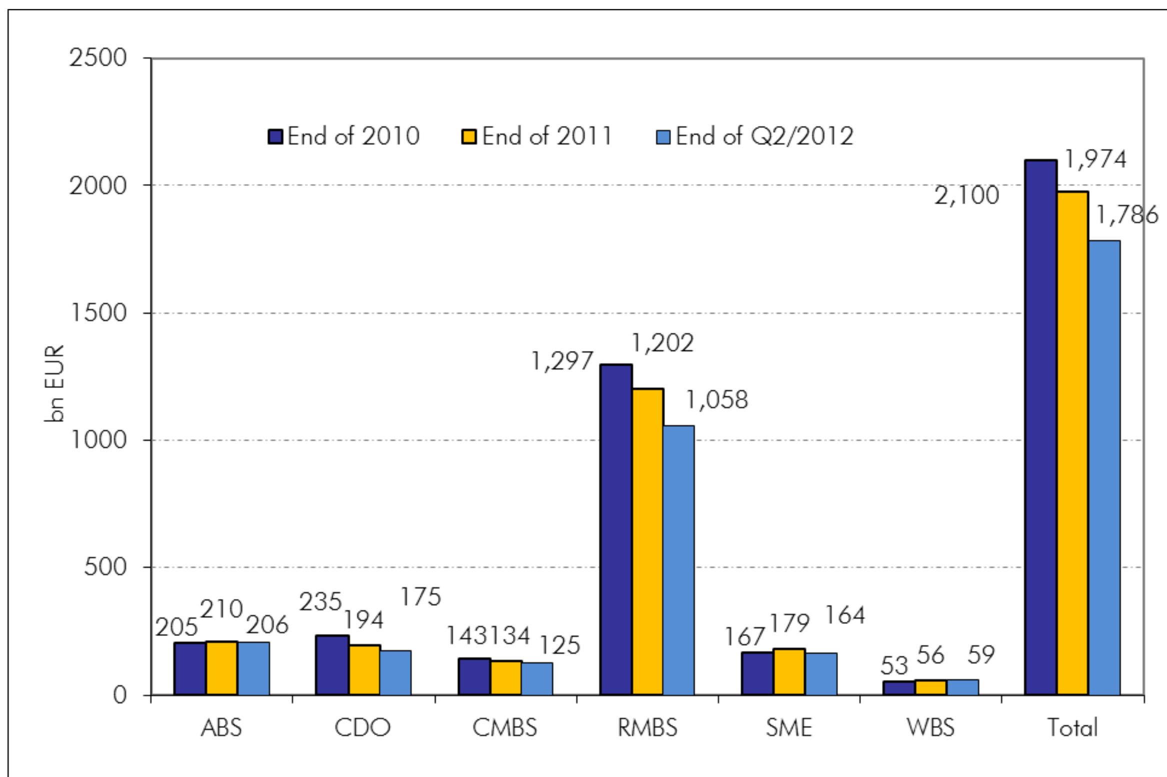


Source: Based on data from AFME and KfW

With regard to the *outstanding transactions*, compared to end of 2010, the total outstanding decreased by 6% from EUR 2,100bn to EUR 1,974bn. In 2012, so far, the outstanding decreased further to EUR 1,786bn (see figure 28). The regional distribution of the outstanding is similar to the distribution of the total issuance: in terms of volumes UK ranks first (27% of the EUR 1.786bn), followed by the Netherlands (17%), Spain (14%) and Italy (11%).

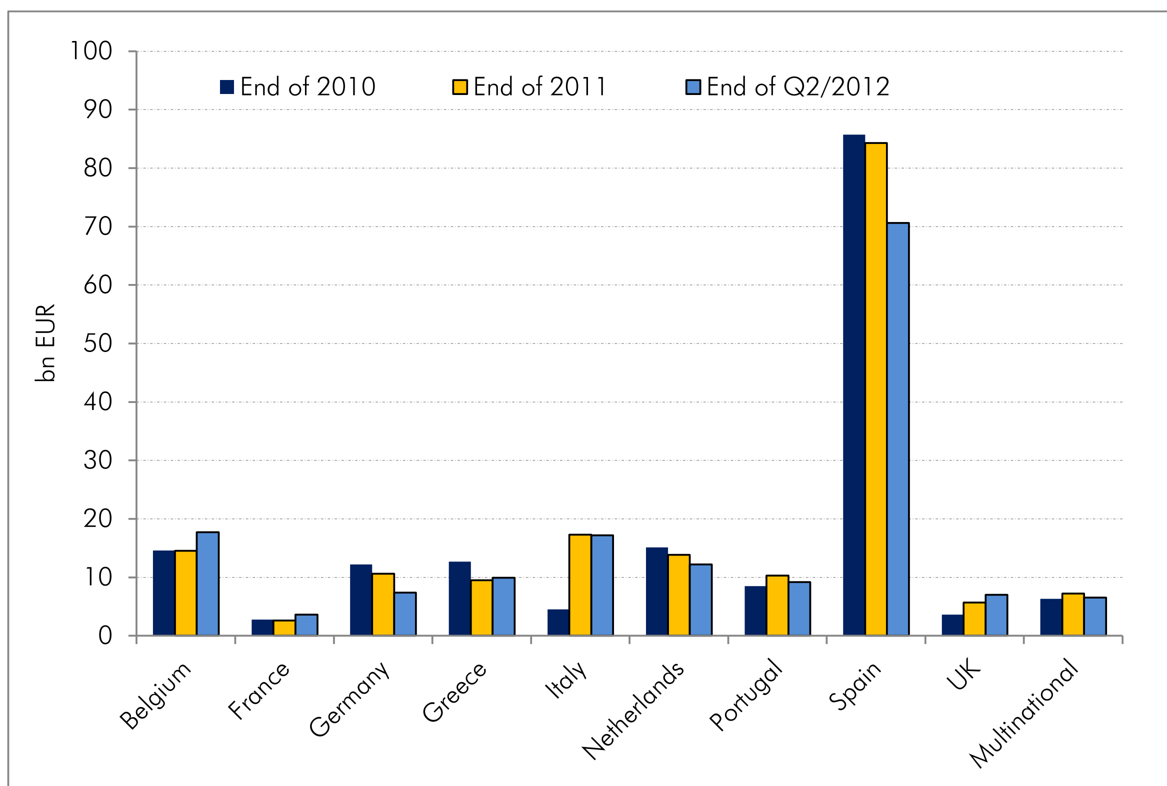
Since end of 2011, outstanding SMESec decreased by more than 8% (from EUR 179bn to EUR 164bn). If we break down the EUR 164bn of outstanding SMESec by country, the significance of the Spanish market becomes obvious. The regional market distribution for SMESec did not change much since end of 2011 (see figure 29), with the exception of a reduction in Spain.

Figure 28: European outstanding securitisation transactions (by collateral, bn EUR)



Source: Based on data from AFME (2012a)

Figure 29: European SMESec outstanding by country (bn EUR)



Source: Based on data from AFME (2012a)

5.2 Performance trends

Despite the financial and sovereign crisis, the European securitization market in general performed so far relatively well. According to the rating agency Standard & Poor's the European structured finance default rate since beginning of the crisis (mid-2007) remains low: only 1.1% of European structured finance securities outstanding in mid-2007 have defaulted; this default rate is well below the one of US pendants (14.8%). For the SME segment, the rating agency registered defaults[26] of 0.23% (Standard & Poor's, 2012), also other rating agencies confirm low losses for this asses type (e.g. Fitch, 2012b).

These low losses are not only based on the typically high granularity/diversification of these transactions, but also on structural features that helped to counterbalance negative effects of the deteriorating European economy (i.e. increased SME default rates). As shown above, the track record of SMESec in Europe is relatively short; the market started only towards the end of the 1990's – at the time, this segment was unknown to investors and rating agencies, and the technique of securitisation was also new to most of the originators. The related uncertainty was one of the reasons for conservative structures in the general SMESec segment.[27]

However, the sovereign crisis and weak macroeconomic fundamentals in many European countries had negative effects on SME transactions and it is expected that the credit quality of existing portfolios in stressed markets will further deteriorate – the performance of SME portfolios is typically dependent on GDP growth trends. Moreover, many counterparties in SME related transactions will continue to suffer from the on-going stress in the European banking system.[28] We mentioned earlier the tightening of credit conditions for SMEs; although this development has a direct negative impact on the SMEs it has indirectly a positive effect for new loan vintages, and hence the quality of newly securitised portfolios, as banks have become more risk averse.

With regard to SME transactions, figure 30 depicts cumulative credit events (or defaults) on original balance by vintage for the EMEA region[29] (transactions analysed by Moody's). It shows a relatively constant development over time for most vintage years (but mirrors the relatively bad performance of 2006 vintages). However, the performance differs from country to country (see figure 31). Moody's e.g. reports that the recent performance of EMEA SME ABS transactions showed weak trends in Greece and Italy and stable trends in most of the other jurisdictions.

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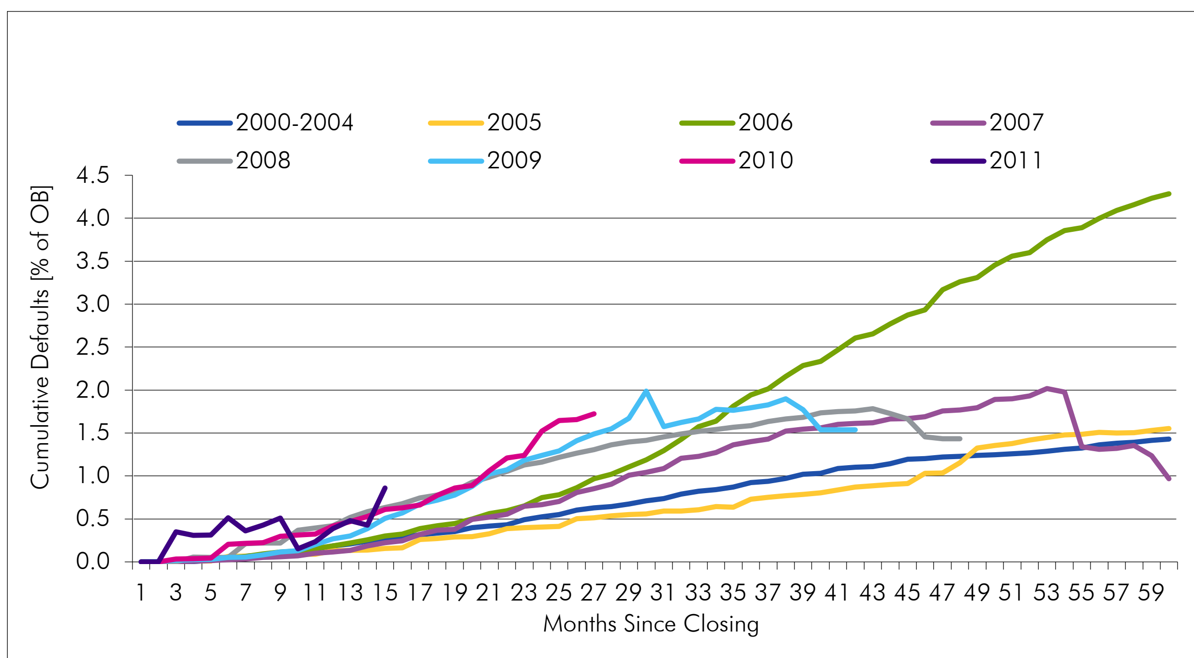
[26] Weighted by notional value at issuance rather than by number of tranches.

[27] In the years running up to the crisis there were first signs also in Europe of a drift away from key principles and main success factors for SMESec – i.e. granular portfolios and transparent structures – for example in the form of hybrid transactions (i.e. the so-called German Mezzanine CDOs) with non-granular portfolios, larger (mid-cap) borrowers and non-aligned incentive structures. The generally poor performance of these transactions provides lessons for the future of SMESec.

[28] We discussed the impacts of the sovereign crisis on securitisation transactions in more detail in our ESBFO one year ago: http://www.eif.org/news_centre/publications/eif_wp_2011_12.pdf.

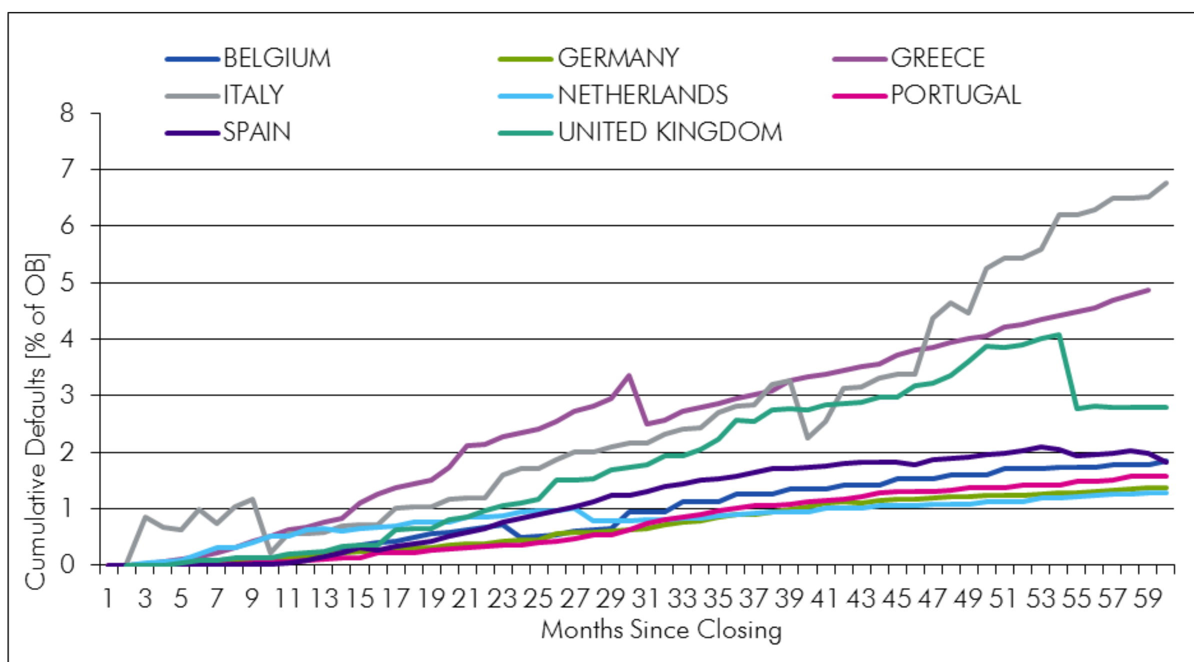
[29] The "EMEA region" includes Europe, Middle East, and Africa; with regard to Structured Finance most of the transactions in this region are in Europe.

Figure 30: EMEA ABS SME cumulative credit events or defaults on original balance (seasoning by vintage)[30]



Source: Moody's (2012)

Figure 31: EMEA ABS SME cumulative credit events or defaults on original balance (seasoning by country)



Source: Moody's (2012)

[30] Terminated transactions are included in the index calculation; Moody's believes that this information must be included for an accurate representation of trends over time. Additionally, Moody's notes that vintage seasoning charts might move unexpectedly for the last few data points because transactions start at different points in time within a vintage and hence some transactions may be more seasoned than others.

Notwithstanding the solid performance of the overall European structured finance sector with regard to defaults so far, there were many rating adjustments by the rating agencies and also in 2012 there is still a strong tendency for downgrades in Europe. In 2011, according to AFME data, Moody's adjusted 2,183 ratings of securitization transactions (with 58% upgrades – after a strong wave of downgrades the years before). In the first half of 2012, 93% of the rating adjustments were again downgrades (552 out of 594). Standard & Poor's adjusted in HY1/2012 2,199 ratings (with 69% downgrades) and Fitch Ratings changed 872 ratings (with 88% downgrades).

Due to various reasons and as explained in more detail in our previous reports, also the SMESec market has been hit by a wave of downgrades. The rating transition data shows that the downgrade pressure for SME transactions was across all tranche levels. The following example (table 2) shows the tranche rating migration since transaction closing of the SME Collateralized Loan Obligation (CLO) transactions that have been rated by Fitch. For example: of all tranches that have initially been rated AAA, 26% (by number) have paid in full (pif), only 14% are still AAA, 28% moved to AA etc. Compared to our previous report, this picture got worse in the higher rating classes (where e.g. still 40% of the AAAs remained in this class) but improved in the lower rating classes.

Table 2: Fitch European SMEs Rating Transition Matrix (November 2012) [31]

% of tranches		Current rating									
		PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf
Initial Ratings	AAAsf	26%	14%	28%	17%	13%	2%	0%	1%	0%	0%
	AAsf	11%	0%	32%	11%	13%	13%	13%	5%	3%	0%
	Asf	4%	0%	13%	40%	10%	13%	12%	4%	2%	2%
	BBBsf	2%	0%	0%	5%	13%	23%	11%	25%	14%	7%
	BBsf	0%	0%	0%	0%	7%	20%	20%	20%	20%	13%
	Bsf	0%	0%	0%	0%	0%	50%	30%	0%	0%	20%
	CCCsf	0%	0%	0%	0%	0%	0%	0%	10%	30%	60%
	CCsf	0%	0%	0%	0%	0%	0%	0%	0%	33%	67%
	Csf	0%	0%	0%	0%	0%	0%	0%	0%	0%	100%

Source: Fitch (2012a)

5.3 SMESec prospects

The pressure on European banks to deleverage continues, and banks have to raise fresh capital or to reduce their balance sheets in order to fulfil future Basel III rules. One possible reaction is to downsize lending activities; another direction could be to use securitisation as tool: a recovery of the securitisation markets could play a role in unlocking credit supply and economic recovery (AFME, 2012b). However, the image of securitization is still damaged (with related negative impact on the image of SMESec as well[32]), i.e. due to the understandably bad reputation of the

[31] The addition sf indicates a rating for structured finance transactions.

[32] The contagion effects for SMESec have been discussed in more details in our Working Paper 2010/7: http://www.eif.org/news_centre/research/index.htm (Kraemer-Eis, Schaber and Tappi, 2010).

US sub-prime products, and potential impacts from the regulatory side (i.e. Basel III/CRD IV liquidity categorisation and Solvency II principles) are increasing the uncertainty for originators and investors (see e.g. ESMA, 2012).

During the crisis we have seen a clear and on-going tendency towards simpler securitisation transactions and improved transparency. There are useful market driven initiatives to introduce quality standards, i.e. the Prime Collateral Securities (PCS) initiative, aims at establishing certain SME securitisations as a brand with key attributes such as quality, simplicity, transparency and liquidity (see AFME, 2012b). PCS, officially kicked-off on the 14. November 2012, is an industry-led, non-profit initiative to develop a label for high quality securitisations (PCS, 2012). Eligible asset classes that can obtain a PCS high-quality standard are auto loans and leases, consumer ABS, credit card ABS, Leasing ABS, RMBS and SME loans. Re-securitizations and synthetic transactions are excluded from PCS eligibility and cannot obtain the quality certificate (UniCredit, 2012). Another important new element to improve the transparency in the securitisation markets is the ECB's ABS Loan Level Initiative (see box 4).

Box 4: The ECB's The Loan Level Initiative (LLI)

In this context, the ECB intends to progressively introduce requirements in its collateral framework for ABS originators to provide loan-level data on the assets underlying these instruments and to establish a data warehouse to process, verify and distribute standardised securitisation information to market participants. In addition to improved transparency for the ABS markets this initiative shall facilitate the risk assessment of ABSs as collateral used by Eurosystem counterparties in monetary policy operations:

The Governing Council of the ECB decided in 2010 to establish loan-by-loan information requirements for asset-backed securities in the Eurosystem collateral framework. Loan-level data will be provided in accordance with a template which is available on the ECB's website, at least on a quarterly basis. To allow the processing, verification and transmission of the data, the Eurosystem encourages market participants to establish the necessary data-handling infrastructure. When the necessary data-handling infrastructure has been established, the provision of loan-by-loan information will become an eligibility requirement for the instruments concerned. The Eurosystem continues to accept securities not meeting the new information criteria until the obligation to submit loan-level data comes into force. The "SME template" is applicable to all SME transactions with the exception of those where the underlying assets are constituted by leasing contracts. The template covers both stand-alone and revolving structures. The Eurosystem introduced the loan-by loan information requirements for residential mortgage-backed securities (RMBSs) first (03.01.2013) and then gradually to other asset classes: SME transactions (03.01.2013), commercial mortgage-backed securities (CMBSs, 01.03.2013) and to consumer finance ABSs, leasing ABSs and auto loan ABSs (01.01.2014). A nine-month phasing-in period applies for each asset class. Where loan-level data are incomplete on that date, they must gradually be completed in the course of that transitional period (ECB, 2012e and ECB, 2012f).

Box 4: The ECB's The Loan Level Initiative *(continued)*

The LLI led to the creation of the European Data Warehouse GmbH. This new company, based in Frankfurt/Main (Germany), has been established independent of and external to the Eurosystem; investors are global banks and institutions. It is going to facilitate the reporting of loan-level data of ABS transactions and will ensure that the data is made available to market participants in order to increase transparency.

This attempt will make more information available to market participants and it is expected that it contributes to the re-start of the markets. However, as always if medicine shall help: it is a matter of doses and it has to be seen how this approach develops; too many requested details could hamper the development of the SMESec market.

EIF is trying to stimulate SME financing in various ways, amongst others by acting as guarantor for the AAA tranche of securitised transactions in order to enhance liquidity. In the current market, securitisation is virtually only funding driven: the AAA tranche is either placed or retained and used as collateral for ECB loans. Despite some promising first attempts to revive this asset class, the SME securitisation deal flow - both in terms of number of transactions and volumes placed with market investors - is still expected to remain well below pre-crisis levels for some time.

In general, driven by secured funding needs, more originators are expected to return to the market (especially from Spain and Italy, but also other countries), however, for the time being and as explained above, the majority of these transactions will be for ECB placement and structured in line with the respective eligibility repo-criteria to minimise the funding costs of the originators. This situation is expected to continue, also for SME transactions and i.e. against the background that the ECB eased in June 2012 collateral requirements in European System operations for Asset Backed Securities (wider eligible pool, lower rating requirements). However, against the background of a low yield environment, investors are already progressively returning to the securitisation markets, so far especially to the areas of RMBS and auto loan/leases ABS (where spreads have rallied). It can be expected that lower spreads of SME transactions will make this segment more attractive again in the medium term.

A continuation of the gradual recovery of the European Structured Finance market is expected. However, this will not only depend on the development of market fundamentals and the enhancement of investors' confidence but also strongly on the direct and indirect impact from regulatory priorities. Hence, future/potential regulatory treatments of SMESec have to be duly analysed. Investors will only return in volume if they regain trust in the quality of the transactions and if there is satisfactory secondary market liquidity. Originators will return if transactions are economically feasible. For both, a stable and reliable regulatory framework is a key precondition as well.

6 Microfinance

6.1 Microfinance business environment

One part of the Europe 2020 strategy[33] is the initiative "European platform against poverty and social exclusion" which sets out actions to reach the EU target of reducing poverty and social exclusion by at least 20 million people by 2020. Although combating poverty and social exclusion is mainly the responsibility of national governments, the EU can play a coordinating role for example by making funding available. One key action is the "better use of EU funds to support social inclusion and combat discrimination" including improvements in the use of microcredits (e.g. via the JASMINE initiative and PROGRESS financial instruments).[34]

In order to assess the achievement of the Europe 2020 poverty/social inclusion target, Eurostat measures the indicator "people at risk of poverty or social exclusion".[35] Figure 32 depicts the headline indicator, corresponding to the sum of persons who are at risk of poverty or severely materially deprived or living in households with very low work intensity (i.e. a combination of the three sub-indicators).[36] In Eastern Europe, the incidence of poverty or social exclusion is the greatest, although the difference between the EU15 and EU27 figure is relatively small. When comparing 2011 to 2010 and 2009, the situation became worse in most of the countries. Within the EU, the highest risks of poverty or social exclusion are recorded for Bulgaria, Latvia and Lithuania; in general countries on the right-hand side of the diagram are countries from Eastern Europe as well as from South West Europe which are suffering most from the impacts of the current sovereign debt crises (Greece, Ireland, Spain, Portugal, and Italy).

Figure 33 shows another indicator of social welfare, the unemployment rate and the long term unemployment rate[37]. In 2012, several EU Member States (in particular Greece and Spain) showed significant deteriorations in both figures compared to the year before while other countries

[33] The Europe 2020 strategy is the growth strategy of the European Union for the current decade. For details please see the Europe 2020 website http://ec.europa.eu/europe2020/index_en.htm.

[34] For more information on Europe 2020's social inclusion/poverty initiatives and actions please see http://ec.europa.eu/social/main.jsp?catId=961&langId=en and http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2010:1564:FIN:EN:PDF, p. 8. For information on JASMINE, the European PROGRESS Microfinance Facility, and EIF microfinance activities please see: http://www.eif.org/what_we_do/microfinance/index.htm.

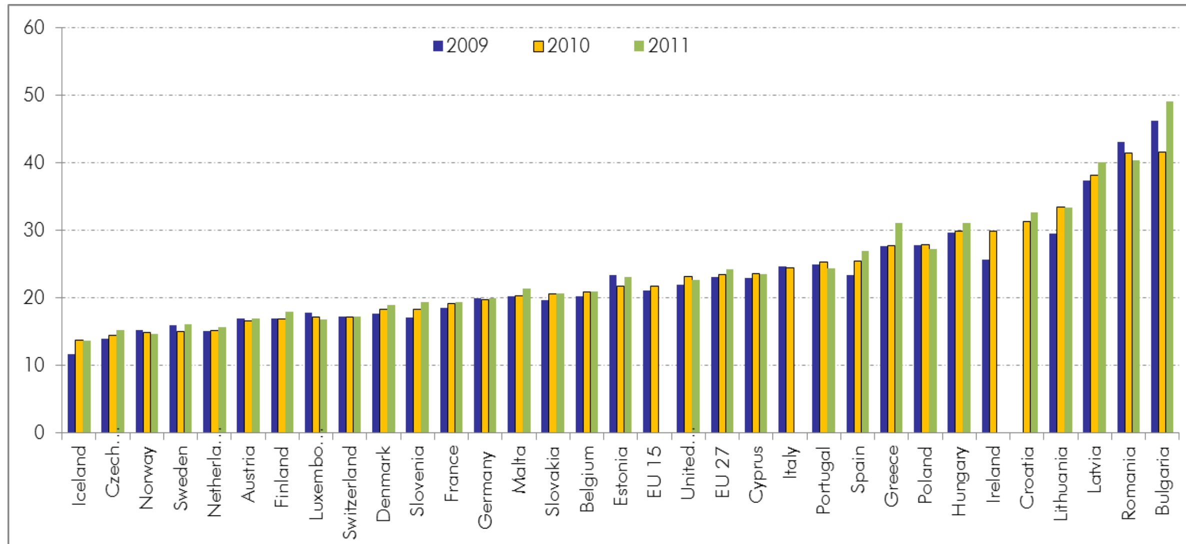
[35] The indicator is a union of the three sub-indicators "People living in households with very low work intensity", "People at-risk-of-poverty after social transfers", "Severely materially deprived people" See the Eurostat internet site on the Europe 2020 indicators at: http://epp.eurostat.ec.europa.eu/portal/page/portal/europe_2020_indicators/headline_indicators

[36] Persons are only counted once even if they are present in several sub-indicators. At risk-of-poverty are persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers). Material deprivation covers indicators relating to economic strain and durables. Severely materially deprived persons have living conditions severely constrained by a lack of resources. People living in households with very low work intensity are those aged 0-59 living in households where the adults (aged 18-59) work less than 20% of their total work potential during the past year. For more information please see: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=t2020_50

[37] The rates are based on the average of quarterly values of unemployment and long term unemployment rates available in 2012.

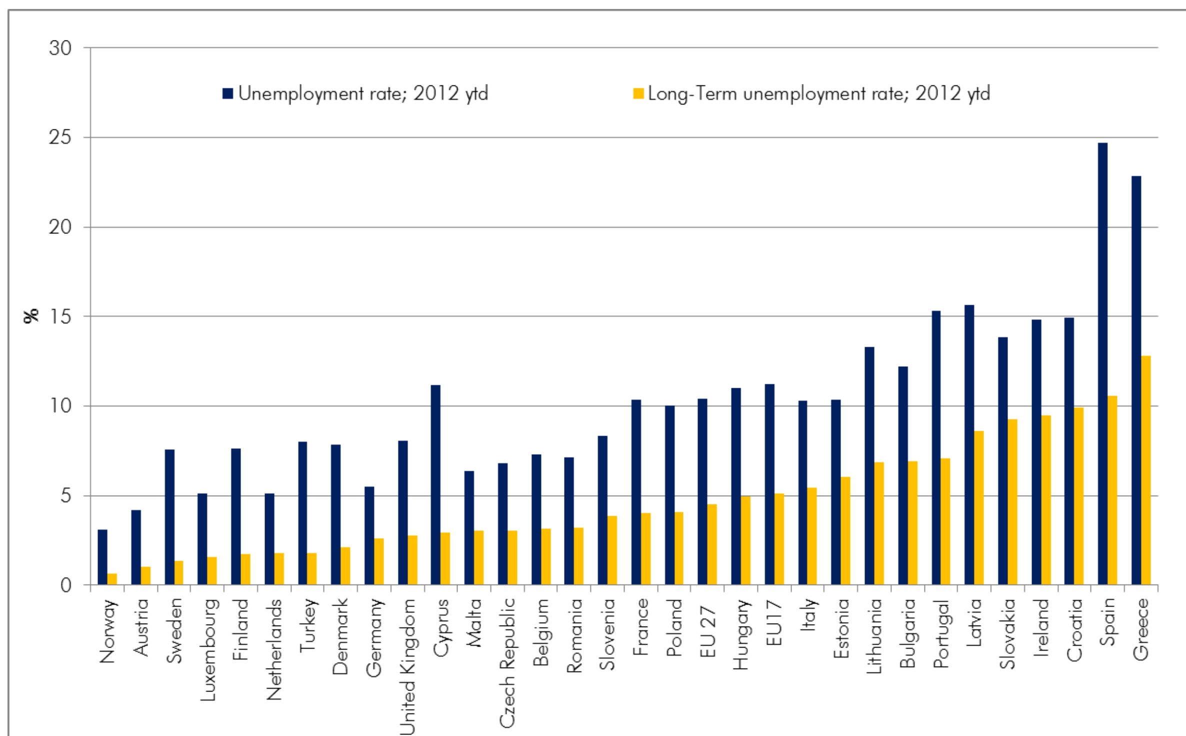
(e.g. Lithuania, Norway and Germany) improved significantly. Again, most Eastern European countries are placed at the right hand side of the chart (meaning higher long term unemployment).

Figure 32: People at risk of poverty or social exclusion (percentage of total population)



Source: Based on data from Eurostat

Figure 33: Unemployment rate and long-term unemployment rate



Source: Eurostat

The relatively poor performance of East European EU member states in social welfare indicators, combined with low bank penetration rates, is one reason for the significant market for microfinance (i.e. commercial microfinance) in this region

6.2 Microfinance market

Microfinance in Europe consists mainly of micro-loans (less than EUR 25,000) tailored to micro-enterprises (91% of all European businesses) and people who would like to become self-employed but are facing difficulties in accessing the traditional banking services (see also box 5). Throughout the EU, 99% of all start-ups are micro or small enterprises and one third of those were launched by unemployed people.

Box 5: What is "micro"?

Microfinance is the provision of basic financial services to poor (low-income) people (who traditionally lack access to banking and related services) (CGAP Definition, Consultative Group to Assist the Poor).

Microcredit is defined by the European Commission as a loan or lease under EUR 25,000 to support the development of self-employment and micro-enterprises. It has a double impact: an economic impact as it allows the creation of income generating activities and a social impact as it contributes to the financial inclusion and therefore to the social inclusion of individuals.

A **microenterprise** is any enterprise with fewer than 10 employees and a turnover below EUR 2m (as defined in the Commission Recommendation 2003/361/EC of 6 May 2003, as amended).

A **microfinance institution (MFI)** is an organisation/financial intermediary that provides microfinance services. There is a wide spectrum of different MFI business models in Europe.

As outlined in previous versions of our papers[38] the European microfinance market is still a young and heterogeneous sector, due to the diversity of legal frameworks, institutional environments and microfinance providers in European countries. In addition to commercial banks, that target microenterprises as a part of their general SME lending activity, the spectrum of European microcredit developers includes many profit oriented and non-profit associations: microfinance associations, credit unions, cooperatives, Community Development Financial Institutions (CDFIs), non-bank financial institutions, government bodies, religious institutions and Non-Governmental Organizations (NGOs).

The latter has the highest share among the institutional types (22% in 2011) according to the new edition of European Microfinance Network (EMN)'s *Overview of the microcredit sector in the European Union for the period 2010-2011* (EMN, forthcoming). This new report, expected to be published by the end of this year, is based on a survey among 154 MFIs in 32 countries;[39] it has been supported by the EIF and, inter alia, preliminary results of this survey are presented in this chapter[40]. As the data availability for microfinance in Europe is still very limited, this study contributes significantly to the improvement of the situation.

[38] E.g. previous version of our ESBFO or our papers specifically referring to microfinance; see http://www.eif.org/news_centre/research/index.htm

[39] 376 MFIs have been contacted, 154 (in 32 countries, of which 18 are EU Member States) contributed data. The geographical distribution of organizations that participated in the survey shows an overrepresentation of institutions from Western Europe. Out of the 154 organizations, only 56 (37%) are from Eastern Europe (EMN, forthcoming).

[40] As indicated, the results are currently preliminary and final results might still change.

Many of the surveyed organizations are very small and provide less than 10 loans per year. The total number of loans provided by the surveyed MFIs is 204,080, equivalent to an amount of EUR 1,047m. The average number of loans per MFI is significantly higher in Eastern Europe than in Western Europe (2,390 versus 1,226).

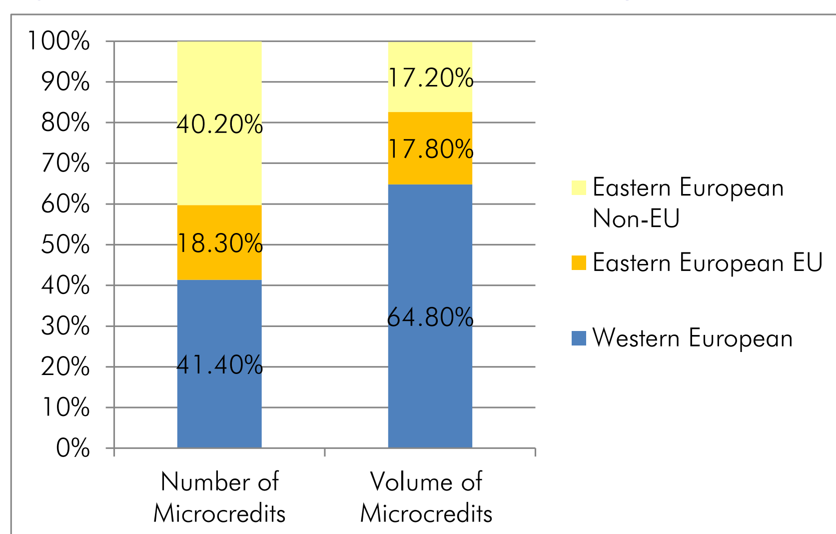
Box 6: Microenterprise lending versus social inclusion lending

Based on the nature of microlending, the analysis introduces the differentiation of lending models into *microenterprise lending* (targeting the upper end market of microfinance providing loans to bankable or nearly bankable microenterprises) and *social inclusion lending* (focussing on self-employed individuals lacking an access to banking services due to their socio-economic status). The average volumes of the provided loans to the latter group are much lower than in the microenterprise lending model. According to the survey, the majority of the organizations can be classified as social inclusion lenders (approx. 63%). Their activity includes promoting start-up businesses, creating jobs, supporting socially excluded people, reducing poverty, etc. Clients below the poverty line make up 13% of total lending activity.

These two approaches are not mutually exclusive, i.e. there exist overlaps and common approaches in micro-lending between these two 'more idealized' models. Nevertheless, it is deemed useful to apply a proxy solution to differentiate between these two, as in this way market segments can be established, which are feasible for the deduction of blueprints for institution building and sustainability approaches (EMN, forthcoming).

The majority of microcredits in the European Union in 2011 were reported from Western Europe (84,561, or 69% of all reported microcredits in the EU). The total volume of these credits was EUR 680m (78% of the total volume reported). By contrast, speaking about Europe as a whole, Eastern European Non-EU member states dominate in number of loans provided. Figure 34 shows the distribution of microcredits across Europe. The proportion shows that average loan sizes in Eastern EU member states are significantly lower than in Western European countries, but significantly higher than in Eastern Non-EU countries.

Figure 34: Distribution of microcredits across Europe

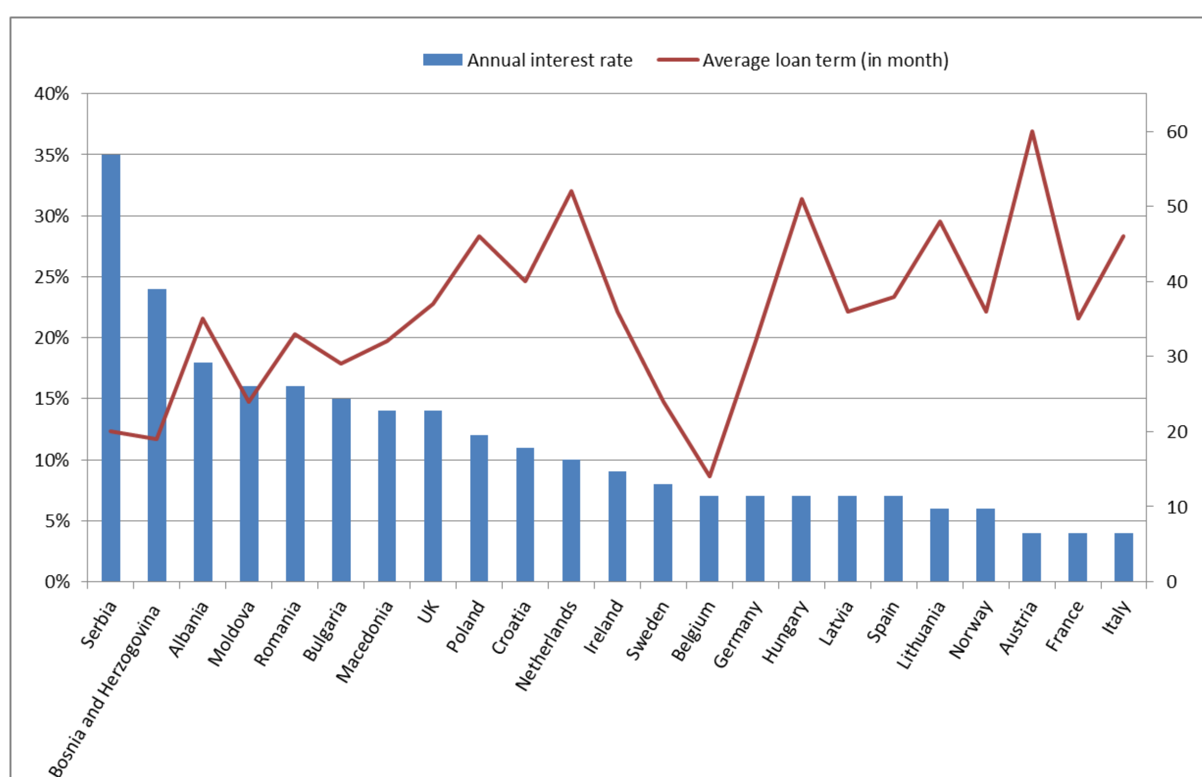


Source: Based on data from EMN (forthcoming)

According to the EMN survey, the conditions for microloans are very diversified across countries. The average interest rate is 11%, but ranging from 4% in countries like France, Italy and Austria to interest rates around 20% and even higher in Balkan states. Average interest rate at a microfinance market is related to the composition of lending models and institutions, pricing policy, level of subsidies. Without usury laws and rate ceilings, in the micro-loan business model, the smaller is the loan size, the higher is the interest rate charged, on average (for example, to cover the fixed service cost). In developing countries and emerging markets the average loan size tends to be smaller (EMN, 2010). For example, in Romania, where the average loan amount is less than the average, in absence of these restrictions, a high interest rate (16%) is charged.

Similarly, the spread of average loan durations varies across countries. Long loan terms can be found in Austria (60 months) and Hungary (51 months). Typically, shorter loan terms are observed in countries with high average interest rates and low average loan volumes (see figure 35).

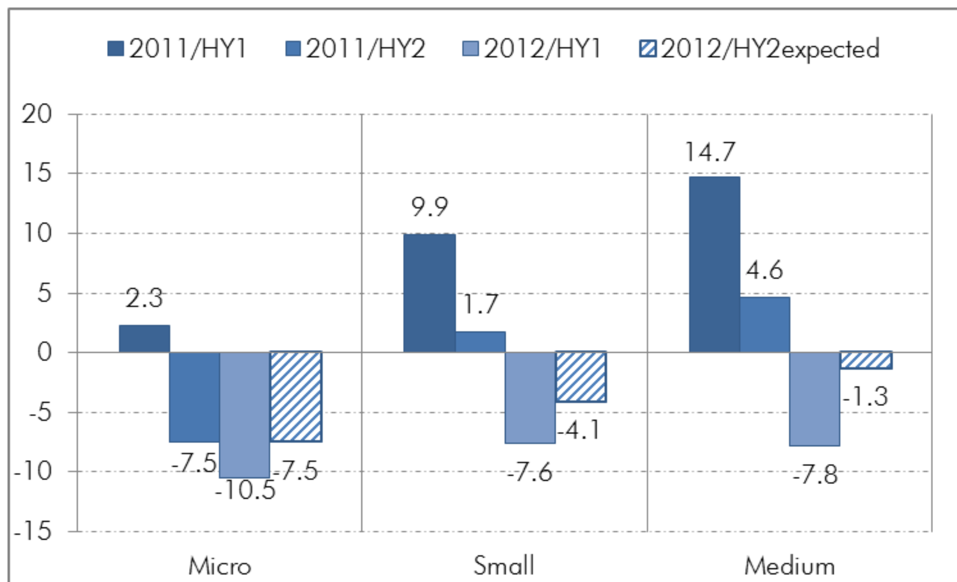
Figure 35: Microcredit conditions in Europe



Source: Based on data from EMN (forthcoming)

When looking at the business climate of micro-enterprises, the EU Craft and SME barometer shows that micro-enterprises on balance estimated their overall situation less favourable than SMEs in the first half of 2012 (see figure 36). Moreover, micro-enterprises expected on balance a further deterioration of their business situation for the second half of 2012. Similar results were reported for the survey questions on turnover and orders in the first half of 2012. All in all, the figures reveal stronger difficulties for micro-enterprises than for other SMEs.

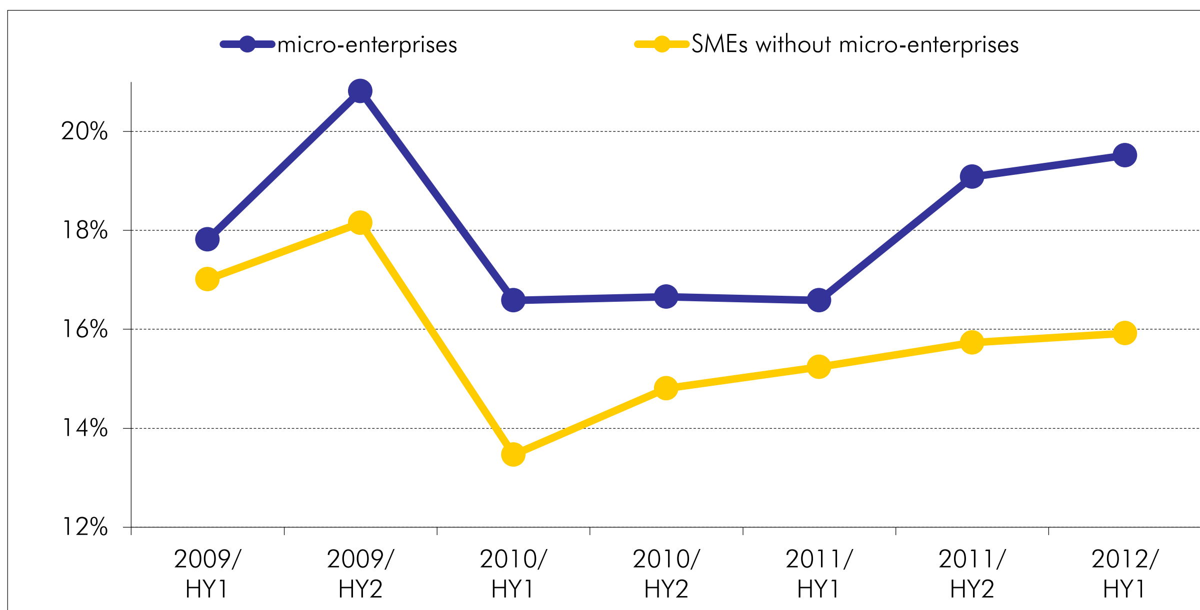
Figure 36: Overall situation of European micro-firms compared to other enterprise size classes



Source: Based on UEAPME Study Unit (2012)

According to the data from the latest ECB survey on the access to finance of SMEs in the euro area (ECB, 2012c), the share of enterprises which see access to finance as their most pressing problem is larger among micro-enterprises than among other SMEs. Moreover, the situation seems to have deteriorated even stronger for micro-firms during the last year (see figure 37). In line with this development, the ECB (2012c) recently stated another significant increase in the bank loan rejection rate for micro firms (from 20% to 24%, compared to an increase from 13% to 15% for all SMEs).

Figure 37: Share of enterprises reporting access to finance as their most pressing problem



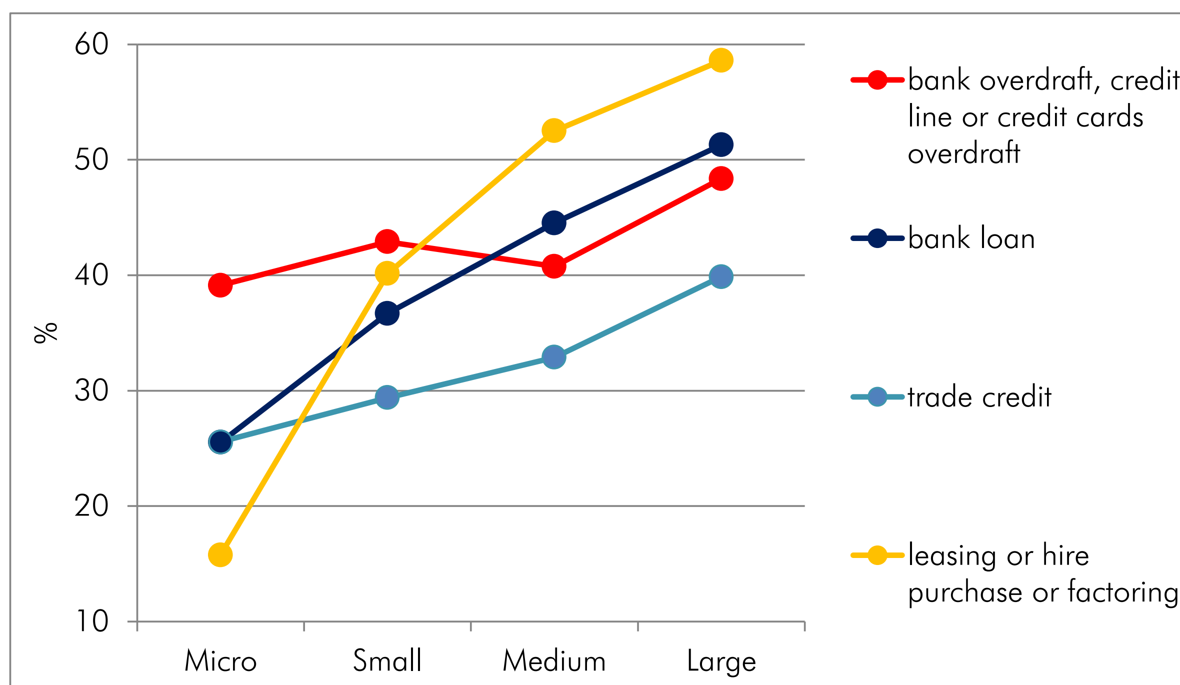
Source: based on ECB data[41]

[41] ECB Statistical Data Warehouse. Survey on the access to finance of SMEs in the euro area.

Difficult access to finance, in particular to bank loans, might be one key reason why micro-enterprises in Europe use bank loans and other external financing sources considerably less than other SME size classes. Figure 38 shows that the usage of different financing sources on average typically increases with the size of the SME. Nevertheless, despite all unfavourable conditions faced by micro-enterprises, in 2011 the number of loans increased by 45% and the total volume by 5% compared to 2009 (EMN, 2012).

Figure 38: Enterprises having used different financing sources (by enterprise size class)

(over the preceding six months; percentage of respondents; survey conducted from April to September 2012)



Source: based on ECB data[42]

[42]Data of the ECB Survey on the access to finance of SMEs in the euro area.
http://www.ecb.eu/stats/money/surveys/sme/html/index.en.html

6.3 Microfinance prospects

The impact of the on-going crisis on the availability of microfinance is a central issue of the sector. In times of crisis, like today, microfinance clients, be it as an enterprise or a self-employed, typically find capital even harder to obtain; not to mention the additional challenges faced by certain vulnerable groups such as ethnic minorities or female entrepreneurs. If commercial banks reduce their lending to the "typical" microfinance clients this provides as well an opportunity for non-bank MFIs to strengthen their position in the market. On the demand side, the increased levels of unemployment in many European countries, especially in Southern Europe, might increase as well the demand for microfinance – from the perspective of social inclusion lending but as well from the viewpoint of enterprise lending. It can be expected that especially many young people will try to start self-employment (EMN, forthcoming).

We mentioned that there is no common microfinance business model in Europe and the microfinance market is immature and fragmented – but there is a trend towards efficiency, professionalization, and self-sustainability. However, without the access to stable funding, the prospects of the sector with regard to growth and self-sufficiency are limited. According to the EMN survey, i.e. based on the qualitative interviews with the MFIs, the general public support for the microfinance sector is expected to decline in the coming years, due to budget restrictions and high deficits at national and regional level (EMN, forthcoming).

We discussed the rationale for public support in the microfinance area in one of our previous working papers[43] and explained the chosen approach for the Progress Microfinance mandate as support on European level; in the current market environment this support is even more important. The intervention logic is based on the market structure and its significant diversity. It seeks to maximise outreach through a flexible investment approach in terms of eligible types of investments and types of financial intermediaries. The key target group are non-bank MFIs, but the range of financial intermediaries is extended also to banks with good outreach to microfinance clients, such as cooperative banks or micro-banks.

Through the implementation of Progress Microfinance we receive regular updates from financial intermediaries regarding the demand for microcredit throughout EU27. Progress Microfinance now covers 15 countries with the largest projected microcredit volumes in the Netherlands, Romania and Poland. Non-bank MFIs have been the most active lenders in the initial phase of Progress Microfinance. As of end-September 2012 more than 70% of the actual microcredit volume achieved had been originated by non-bank MFIs. Over time it is expected that the share provided by banks will increase significantly.

In addition, it is expected that the financing of MFIs will not only focus on enhanced access to finance, but also include more capacity building elements to open up EU financing for smaller non-bank MFIs.

[43] See i.e. Bruhn-Leon, Eriksson and Kraemer-Eis (2012).

7 Concluding remarks

Europe's sluggish and uneven economic performance continues and there are a number of downside risks. Top issues are still the concerns surrounding the large funding requirements of sovereigns and banks. Macroeconomic policy tightening with strong adjustments for fiscal consolidation in many advanced economies is important to ensure future growth, however it is also a burden for economic growth prospects in the short term. The number of SME insolvencies remains high and the overall European picture hides some significant regional disparities. Expectations with regard to the development of insolvencies are rather negative in Europe. Moreover, SMEs' expectations are worsening and there is a challenging environment with regard to access to finance for SMEs.

In this context, public support is very important but it is also important to realise that public support cannot be the only solution – it needs to play a catalytic role to enhance access to finance for SMEs.

It is a key priority for the EIF to help establish a well-functioning, liquid *equity market* that attracts a wide range of private sector investors, and develop new and pioneering financing instruments in order to reach to parts of the market currently not accessible through existing public support instruments. The objective is to leverage EIF's activity and seize market opportunities in all areas of the equity eco-system which are relevant for the sustainable development of the industry. EIF has increased - as reference catalytic investor in European venture and growth capital funds - its counter-cyclical role in providing financing solutions to boost entrepreneurship and innovation. In the coming years, EIF will continue to cornerstone across the spectrum of Technology Transfer through Venture Capital to the Lower Mid-Market and mezzanine financing. This also includes the launch and extension of new/pilot initiatives - such as the European Angels Fund and partnerships with corporate investors.

With regard to the *securitisation market*: Given that SMEs have no direct access to the capital markets, banks are the most important source of external SME finance and hence banks' limitations have a direct impact on SME lending capacity. Thus, securitisation or similar techniques such as e.g. SME covered bonds are important in order to access the capital markets and allow mitigating the inherent illiquidity of SME portfolios. After a period of serious imbalances in the securitisation markets, the re-emergence of the European SME securitisation market would be an important element able to contribute to ensuring that SMEs in Europe will not experience a credit crunch.

However, it is important not only to look at banks when analysing SMESec but equally to leasing companies and trade receivables financing which form part of the SME securitisation market. We expect in particular leasing companies to play a larger role in the market for SME finance as banks will at least partially retreat. Given that bank financing is and will be less available for leasing companies post crisis, we expect that SME securitisation will be particularly relevant in the leasing area.[44]

[44]See for more information on the importance of leasing for SMEs finance: Kraemer-Eis and Lang (2012).

With regard to *microfinance*, there is no common business model in Europe and the microfinance market is immature and fragmented – but there is a trend towards efficiency, professionalization, and self-sustainability. An increasing number of unemployed people is a source of demand for microcredits. The results of the EMN survey show that between 2009 and 2011 the European microfinance sector as a whole was growing in terms of the number of loans disbursed. However, without the access to stable funding, the perspectives of the sector with regard to growth and self-sufficiency are limited. Commercial banks in Europe are expected to further reduce their lending to financially excluded people, small start-ups and microenterprises. Moreover, the general public support for microfinance provision is expected to decline in the coming years. Therefore, the MFIs prepare to react to this with developing more efficient and lean processes, by reducing the costs for the provision of microloans and looking for additional sources for funding.

Microfinance as a tool is important to overcome the effects of the financial crisis and to support inclusive growth; EIF provides funding, guarantees and technical assistance to a broad range of financial intermediaries, from small non-bank financial institutions to well-established microfinance banks to make microfinance a fully-fledged segment of the European financial sector.

ANNEX

Annex 1: Private Equity Glossary

(selection, from EVCA)

- **Buyout:** A buyout is a transaction financed by a mix of debt and equity, in which a business, a business unit or a company is acquired with the help of a financial investor from the current shareholders (the vendor). See management buyout (MBO), management buyin (MBI), institutional buyout (IBO), leveraged buyout (LBO).
- **Buyout fund:** Funds whose strategy is to acquire other businesses; this may also include mezzanine debt funds which provide (generally subordinated) debt to facilitate financing buyouts, frequently alongside a right to some of the equity upside.
- **Capital weighted average IRR:** The average IRR weighted by fund size.
- **Captive Fund :** A fund in which the main shareholder of the management company contributes most of the capital, i.e. where parent organisation allocates money to a captive fund from its own internal sources and reinvests realised capital gains into the fund.
- **Carried interest:** A share of the profit accruing to an investment fund management company or individual members of the fund management team, as a compensation for the own capital invested and their risk taken. Carried interest (typically up to 20% of the profits of the fund) becomes payable once the limited partners have achieved repayment of their original investment in the fund plus a defined hurdle rate.
- **Closing:** A closing is reached when a certain amount of money has been committed to a private equity fund. Several intermediary closings can occur before the final closing of a fund is reached.
- **Commitment:** A limited partner's obligation to provide a certain amount of capital to a private equity fund when the general partner asks for capital.
- **Deal flow:** The number of investment opportunities available to a private equity house.
- **Disbursement:** The flow of investment funds from private equity funds into portfolio companies.
- **Distribution:** The amount disbursed to the limited partners in a private equity fund.
- **Divestment:** See exit.
- **Drawdown:** When investors commit themselves to back a private equity fund, all the funding may not be needed at once. Some is used as drawn down later. The amount that is drawn down is defined as contributed capital.
- **Early stage:** Seed and start-up stages of a business.
- **Early stage fund:** Venture capital funds focused on investing in companies in the early part of their lives.
- **Exit:** Liquidation of holdings by a private equity fund. Among the various methods of exiting an investment are: trade sale; sale by public offering (including IPO); write-offs; repayment of preference shares/loans; sale to another venture capitalist; sale to a financial institution.
- **Expansion capital:** Also called development capital. Financing provided for the growth and expansion of a company, which may or may not break even or trade profitably. Capital may be used to: finance increased production capacity; market or product development; provide additional working capital.
- **Follow-on investment:** An additional investment in a portfolio company which has already received funding from a private equity firm.
- **Fund:** A private equity investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies (investee companies). These are generally private companies whose shares are not quoted on any stock exchange. The fund can take the form either of a company or of an unincorporated arrangement such as a limited partnership. See limited partnership.
- **Fund of Funds:** A fund that takes equity positions in other funds. A fund of fund that primarily invests in new funds is a Primary or Primaries fund of funds. One that focuses on investing in existing funds is referred to as a Secondary fund of funds.
- **Fund size:** the total amount of capital committed by the limited and general partners of a fund.

- **Fundraising:** The process in which venture capitalists themselves raise money to create an investment fund. These funds are raised from private, corporate or institutional investors, who make commitments to the fund which will be invested by the general partner.
- **General Partner:** A partner in a private equity management company who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.
- **General Partner's commitment:** Fund managers typically invest their personal capital right alongside their investors capital, which often works to instil a higher level of confidence in the fund. The limited partners look for a meaningful general partner investment of 1% to 3% of the fund.
- **Generalist fund:** Funds with either a stated focus of investing in all stages of private equity investment, or funds with a broad area of investment activity.
- **Holding period:** The length of time an investment remains in a portfolio. Can also mean the length of time an investment must be held in order to qualify for Capital Gains Tax benefits.
- **Horizon IRR:** The Horizon IRR allows for an indication of performance trends in the industry. It uses the fund's net asset value at the beginning of the period as an initial cash outflow and the Residual Value at the end of the period as the terminal cash flow. The IRR is calculated using those values plus any cash actually received into or paid by the fund from or to investors in the defined time period (i.e. horizon).
- **Hurdle rate:** A return ceiling that a private equity fund management company needs to return to the fund's investors in addition to the repayment of their initial commitment, before fund managers become entitled to carried interest payments from the fund.
- **Inception:** The starting point at which IRR calculations for a fund are calculated; the vintage year or date of first capital drawdown.
- **Institutional investor:** An organization such as a bank, investment company, mutual fund, insurance company, pension fund or endowment fund, which professionally invest, substantial assets in international capital markets.
- **Internal rate of return (IRR):** The IRR is the interim net return earned by investors (Limited Partners), from the fund from inception to a stated date. The IRR is calculated as an annualised effective compounded rate of return using monthly cash flows to and from investors, together with the Residual Value as a terminal cash flow to investors. The IRR is therefore net, i.e. after deduction of all fees and carried interest. In cases of captive or semi-captive investment vehicles without fees or carried interest, the IRR is adjusted to create a synthetic net return using assumed fees and carried interest.
- **IPO (Initial public offering):** The sale or distribution of a company's shares to the public for the first time. An IPO of the investee company's shares is one the ways in which a private equity fund can exit from an investment.
- **Later stage:** Expansion, replacement capital and buyout stages of investment.
- **Leverage buyout (LBO):** A buyout in which the New Company's capital structure incorporates a particularly high level of debt, much of which is normally secured against the company's assets.
- **Limited Partnership:** The legal structure used by most venture and private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the management firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). The general partner receives a management fee and a percentage of the profits. The limited partners receive income, capital gains, and tax benefits. The general partner (management firm) manages the partnership using policy laid down in a Partnership Agreement. The agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.
- **Management fees:** Fee received by a private equity fund management company from its limited partners, to cover the fund's overhead costs, allowing for the proper management of the company. This annual management charge is equal to a certain percentage of the investors' commitments to the fund.
- **Mezzanine finance:** Loan finance that is halfway between equity and secured debt, either unsecured or with junior access to security. Typically, some of the return on the instrument is deferred in the form of rolled-up payment-in-kind (PIK) interest and/or an equity kicker. A mezzanine fund is a fund focusing on mezzanine financing.

- **Multiples or relative valuation:** This estimates the value of an asset by looking at the pricing of "comparable" assets relative to a variable such as earnings, cash flows, book value or sales.
- **Pooled IRR:** The IRR obtained by taking cash flows from inception together with the Residual Value for each fund and aggregating them into a pool as if they were a single fund. This is superior to either the average, which can be skewed by large returns on relatively small investments, or the capital weighted IRR which weights each IRR by capital committed. This latter measure would be accurate only if all investments were made at once at the beginning of the funds life.
- **Portfolio company:** The company or entity into which a private equity fund invests directly.
- **Pre seed stage:** The investment stage before a company is at the seed level. Pre-seed investments are mainly linked to universities and to the financing of research projects, with the aim of building a commercial company around it later on.
- **Private Equity:** Private equity provides equity capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies (also called venture capital), to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. It can also resolve ownership and management issues. A succession in family-owned companies, or the buyout and buyin of a business by experienced managers may be achieved by using private equity funding.
- **Private Equity Fund:** A private equity investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies. These are generally private companies whose shares are not quoted on a stock exchange. The fund can take the form of either a company or an unincorporated arrangement such as a Limited Partnership.
- **Quartile:** The IRR which lies a quarter from the bottom (lower quartile point) or top (upper quartile point) of the table ranking the individual fund IRRs.
- **Rounds:** Stages of financing of a company. A first round of financing is the initial raising of outside capital. Successive rounds may attract different types of investors as companies mature.
- **Secondary investment:** An investment where a fund buys either, a portfolio of direct investments of an existing private equity fund or limited partner's positions in these funds.
- **Seed stage:** Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.
- **Start-up:** Companies that are in the process of being set up or may have been in business for a short time, but have not sold their product commercially.
- **Target company:** The company that the offeror is considering investing in. In the context of a public-to-private deal this company will be the listed company that an offeror is considering investing in with the objective of bringing the company back into private ownership.
- **Top Quarter:** Comprises funds with an IRR equal to or above the upper quartile point.
- **Track record:** A private equity management house's experience, history and past performance.
- **Venture Capital:** Professional equity co-invested with the entrepreneur to fund an early-stage (seed and start-up) or expansion venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment. Venture capital is a subset of private equity.
- **Venture Capitalist:** The manager of private equity fund who has responsibility for the management of the fund's investment in a particular portfolio company. In the hands-on approach (the general model for private equity investment), the venture capitalist brings in not only moneys as equity capital (i.e. without security/charge on assets), but also extremely valuable domain knowledge, business contacts, brand-equity, strategic advice, etc.
- **Vintage year:** The year of fund formation and first drawdown of capital.
- **Volatility:** The volatility of a stock describes the extent of its variance over time.
- **Write-off:** The write-down of a portfolio company's value to zero. The value of the investment is eliminated and the return to investors is zero or negative.

Annex 2: Securitisation Glossary

- **Basket Trade:** A single order or trade in 15 or more securities, especially in large amounts.
- **Credit Default Swap:** An agreement used in synthetic securitisations where the originator (protection buyer) sells the credit risk of an underlying portfolio to a counterparty (protection seller) without transferring the ownership of the assets.
- **Credit Enhancement:** Refers to one or more measures taken in a securitisation structure to enhance the security, the credit quality or the rating of the securitised instrument, e.g. by providing a third party guarantee (such as the EIF guarantee). The credit enhancement could be provided in the form of:

  (i) Structural credit enhancement (tranching of the transaction in senior, mezzanine and junior tranches);

  (ii) Originator credit enhancement (cash collateral, profit retention mechanism, interest sub-participation mechanism);

  (iii) Third party credit enhancement (EIF or monoline insurers).
- **Credit Linked Notes (CLN):** A security issued by an SPV (or directly from the balance-sheet of the originator) credit-linked to the default risk of an underlying portfolio of assets. Usually used in synthetic securitisations for the mezzanine tranches of a transaction.
- **Collateralized loan obligations** (CLOs) are a form of securitization where payments from multiple middle sized and large business loans are pooled together and passed on to different classes of owners in various tranches.
- **First Loss Piece:** Part of a securitisation transaction which is usually kept by the originator (as an "equity piece") and which covers the risk of first loss in the portfolio. Its size is a function of the historical losses, so as to protect the investors against the economic risk (estimated loss) of the transaction.
- **Issuer:** Refers to the SPV which issues the securities to the investors.
- **Mezzanine Risk:** Risk or tranche which is subordinated to senior risk, but ranks senior to the First Loss Piece.
- **Originator:** The entity assigning receivables in a securitisation transaction (funded transaction) or seeking credit risk protection on the assets (unfunded transaction).
- **Primary market:** The market in which securities are issued.
- **Secondary market:** The market where issued securities are traded.
- **Senior:** The class of securities with the highest claim against the underlying assets in a securitisation transaction. Often they are secured or collateralised, or have a prior claim against the assets. In true sale structures they rank senior in the cash flow allocation of the issuer's available funds.
- **Servicer:** Refers to the entity that continues to collect the receivables, enforcement of receivables, etc. Generally, the originator is also the servicer.
- **Special Purpose Vehicle (SPV):** Issuing entity holding the legal rights over the assets transferred by the originator. An SPV has generally a limited purpose and/or life.
- **Subordinated:** The classes of securities with lower priority or claim against the underlying assets in a securitisation transaction. Typically, these are unsecured obligations. They are also called Junior (or Mezzanine) notes and bonds.
- **Synthetic securitisation:** A transaction where the assets are not sold to an SPV but remain on balance sheet; and where only the credit risk of the assets is transferred to the market through credit default swaps or credit linked notes.
- **Tranche:** A piece, a portion or slice within a structured transaction.
- **True sale:** It refers to the separation of the portfolio risk from the risk of the originator, i.e. there is a non-recourse assignment of assets from the originator to the issuer (special purpose vehicle). To be contrasted with synthetic securitisations where only the underlying credit risk is transferred.
- **Whole Business Securitisation (WBS):** Securitisation of the general operating cash flow arising from a certain line or area of the business of the originator over the long term.

Annex 3: List of acronyms

- ABS: Asset Backed Securities
- AFME: Association for financial markets in Europe
- AIFMD: Alternative Investment Fund Managers Directive
- BLS: Bank Lending Survey
- BMWi: Bundesministerium für Wirtschaft und Technologie
- bp: basis point(s)
- CDFIs: Community Development Financial Institutions
- CDO: Collateralized Debt Obligation
- CGAP: Consultative Group to Assist the Poor
- CIP: Competitiveness and Innovation Framework Programme
- CLN: Credit Linked Note
- CLO: Collateralized Loan Obligation
- CMBS: Commercial Mortgage Backed Securities
- CRD: Capital Requirements Directive
- EBAN: European Business Angels Network
- EC: European Commission
- ECB: European Central Bank
- EIB: European Investment Bank
- EIF: European Investment Fund
- EMEA: Europe, Middle East, and Africa
- EMN: European Microfinance Network
- ESBFO: European Small Business Finance Outlook
- ESMA: European Securities and Market Authority
- EIU: Economist Intelligence Unit
- EU: European Union
- EU15: the 15 countries which formed the EU until April 30, 2004
- EU27: the 27 EU Member States
- EVCA: European Private Equity & Venture Capital Association
- FLPG: First Loss Portfolio Guarantee
- FRSP: Funded Risk Sharing Product
- GDP: Gross Domestic Product
- GII: Global Insolvency Index

- GmbH: Gesellschaft mit beschränkter Haftung
- IMF: International Monetary Fund
- IRR: Internal Rate of Return
- JASMINE: Joint Action to Support Microfinance Institutions in Europe
- JEREMIE: Joint European Resources for Micro to Medium Enterprises
- KfW: Kreditanstalt für Wiederaufbau
- LBO: Leveraged buy out
- LFA: Förderbank Bayern
- LLI: Loan Level Initiative
- MDD: Mezzanine Dachfonds für Deutschland
- MFG: Mezzanine Facility for Growth
- MFI: Monetary Financial Institution
- NFC: Non-financial corporation
- NGO: Non-Governmental Organisation
- OB: Original Balance
- OECD: Organisation for Economic Co-Operation and Development
- PCS: Prime Collateral Securities
- PE: Private Equity
- RMBS: Residential Mortgage Backed Securities
- RSFF: Risk Sharing Finance Facility
- RSI: Risk-Sharing Instrument for Innovative and Research oriented SMEs and small Mid-Caps
- SME: Small and medium sized enterprise
- SMESec: SME Securitisation (comprising transactions based on SME loans, leases etc.)
- SPV: Special Purpose Vehicle
- UEAPME: European Association of Craft, Small and Medium-sized Enterprises
- VC: Venture Capital
- WBS: Whole Business Securitisation

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About …

… the European Investment Fund

The European Investment Fund (EIF) is the European body specialised in small and medium sized enterprise (SME) risk financing. The EIF is part of the European Investment Bank group and has a unique combination of public and private shareholders. It is owned by the EIB (61.9%), the European Union - through the European Commission (30%) and a number (25 from 16 countries) of public and private financial institutions (8.1%).

EIF's central mission is to support Europe's SMEs by helping them to access finance. EIF primarily designs and develops venture capital and guarantees instruments which specifically target this market segment. In this role, EIF fosters EU objectives in support of innovation, research and development, entrepreneurship, growth, and employment.

The EIF total net commitments to venture capital and private equity funds amounted to over EUR 5.4bn at end 2011. With investments in over 300 funds, the EIF is the leading player in European venture capital due to the scale and the scope of its investments, especially in the high-tech and early-stage segments. The EIF commitment in guarantees totalled over EUR 14.7bn in close to 160 operations at end 2011, positioning it as a major European SME loan guarantees actor and a leading micro-finance guarantor.

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