Due Diligence Forum Research Paper

GLOBAL INCOME OPPORTUNITIES IN THE LISTED SMALL CAP SECTOR

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This research paper argues that the disintermediation for capital raising for SME's has opened up significant investment opportunities for direct lenders. In short, SME's needs are the same as medium- to large-sized enterprises but access to capital is not the same, thus producing an environment where investors can cherry pick their deal prospects. The credit crunch has exacerbated the situation as lending sources have all but evaporated. Lenders are able to procure much higher quality/lower risk deals at significantly higher yields as the market continues to tighten lending options, creating an almost infallible investment product. Available capital is the key to capitalising on the opportunity.

In most countries, SMEs refer to small and medium sized enterprises with up to 500 employees. However EU Member States define companies with fewer than 50 employees as small and those with fewer than 250 as medium. In the United States, a small business refers to a company with fewer than 100 employees and a medium-sized business defines those with up to 500 employees. Canada defines an SME as any business establishment with 0 to 499 employees and less than $50 million in gross revenues. The Australian Bureau of Statistics defines a small business as one that employs up to 20 people, and a medium enterprise as having no more than 200.

SMEs COMPRISE THE ENGINE THAT DRIVES EMPLOYMENT GROWTH WORLDWIDE

It is generally accepted that SMEs make up a significant portion of developed countries' economies. They can be a reliable source of employment and contribute to overall GDP. The end of the twentieth century saw accelerated growth in the number of SMEs, mostly in the United States and Europe. In 1990, there were over 18 million of self-employed and SMEs within the EU, up from 11.6 million in 1988[1] employing roughly two-thirds of the workforce.[2] At the same time, in the US, SMEs accounted for about 53 percent of the workforce.[3] In the words of The Economist: "Despite ever-larger and noisier mergers, the bigger change coming over the world of business is that firms are getting smaller."

Large firms are often viewed as having greater economies of scale and R&D advantages over smaller firms due to the high risk and cost of innovation. Bigger companies can minimise risk by diversifying their R&D efforts, increasing the likelihood of at least some successes. Compared to larger firms,

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[1] Eurostat, Panorama of the European Union, Enterprises in Europe SME Database, 1999 Edition
[2] European Observatory for SMEs Fifth Annual Report, 1997, Executive Summary
[3] Small Business Administration Small Business Economic Indicators 1997, Executive Summary

SMEs are often the product of innovative ideas, and thus place innovation (rather than market presence) at the centre of their strategy for advancement. They also enjoy less bureaucracy and potentially less inertia in their operating structures. However, they have thinner management ranks with less experience on average as well as smaller capital budgets due to inverted capital structures.

Some additional advantages of SMEs compared to larger companies include:

- Innovative activities may flourish more in the small or start-up environment;
- Intensified global competition due to transportation, information, and communication improvements has led large diversified manufacturers to sell off less-competitive holdings and has forced all producers into leaner manufacturing;
- Significant increases in the degree of uncertainty due to high rates of interest, inflation, unemployment, exchange rate volatility, and growth slowdown in industrialized countries may have favored smaller, more versatile firms in the 1970s and 1980s;
- Intensified market fragmentation due to growing consumer demand for differentiated products may have favored smaller, more versatile firms; and,
- New mechanisation methods and computerisation may have further provoked more differentiation and specialization of products and leaner manufacturing. [4]

The result is that since the 1970s, small firms have been of increasing importance both to EU and US economies generally, and to their investors and capital markets in particular.

According to 1997 statistical figures released by the Small Business Administration and the European Commission, there were 18 million SMEs in the European Union and over 15 million in the United States.[5] The European Commission (2000) revealed that the total number of firms existing in the European Union in 1998 mounted up to 19 million from which 99.8% were self-employed, small and medium-sized enterprises.[6]

It appears that SMEs are more important in Europe than in the US when measured in terms of economic activity and turnover generated. In 1995, SMEs within Europe contributed just over 55% of sales as compared with just over 47% in the US for the same period. In 1998, these SMEs provided approximately 65% of European companies' turnover[7].

SMEs also represent a dynamic component of the Canadian economy and provide a considerable source of economic growth and prosperity. Based on statistics from Canada's Business Register, in December 2000, SMEs made up 99.7% of the one million employer businesses in the country.[8]

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[4] Zoltan J Acs, Bo Carlsson and Roy Thurik, ibid. p 25-28, and 63-125.
[5] 1997 Small Business Economic Indicators, 1998, US Small Business Administration Office of Advocacy, Executive Summary and A Comparison of Small and Medium Sized Enterprises in Europe and in the USA. Manuscript, p54
[6] The European Observatory for SMEs Fifth Annual Report 1997, ibid. Executive Summary and 15 1997 Small Business Economic Indicators, ibid. Executive Summary
[7] F. Sogorb 2002. " How Some Uniqueness Affects Capital Structure: Evidence from a 1994-1998 Spanish Data Panel".
[8] SME Financing in Canada, 2002 — Part II: A - Profiles of SMEs and Entrepreneurs.

The economies of Asia and Australia are very dependent on their SME sector. At the beginning of 2009, the Asia-Pacific Economic Cooperation (APEC) reported that SMEs make up approximately 90% of all businesses in the region, and employ 60% of the workforce.[9]

In developing economies in South East Asia, SMEs carry significant importance as a major source of income and GDP contributor. In Bangladesh, SMEs contribute about half of industrial GDP and provide employment to about five million people, or 82% of the total industrial sector employment. In 2001, Bhutan counted around 409 small-scale and 43 medium-scale enterprises[10]. In Nepal, SMEs constitute more than 98% of all establishments covered by censuses, and contribute 63% of the value-added segment, with 80% of the national value-addition in manufacturing coming from the SME sector[11]. It is estimated that in India and Pakistan, SMEs contribute as much as 30% to each country's GDP[12]. In Sri Lanka, the SME sector comprises largely well-established businesses of which sole proprietorships and partnerships account for 80% of all SMEs.[13]

In China, the majority of the SMEs are privately owned. State Development and Reform Commission (SDRC) statistics show that by the end of 2002, China had a total of 2.43 million private firms and 23.77 million owner-operated businesses. These companies accounted for 81.5 million or about one third of the total jobs in urban areas. In 2001, non-government sectors made up one third of China's GDP and 45 per cent of the total capital investment.[14] Figures released by the American Embassy in China show that in 2009, there are 3.02 million SMEs in China that produce half of the country's GDP. They also contribute to 60% of the country's exports and 43% of its tax revenue. Chinese and foreign experts estimate that SMEs currently account for about 60% of China's industrial output and employ about 75% of the workforce in China's cities and towns. SMEs are responsible for creating most new urban jobs, and they are the main destination for workers laid-off from state-owned enterprises (SOEs) that re-enter the workforce.[15]

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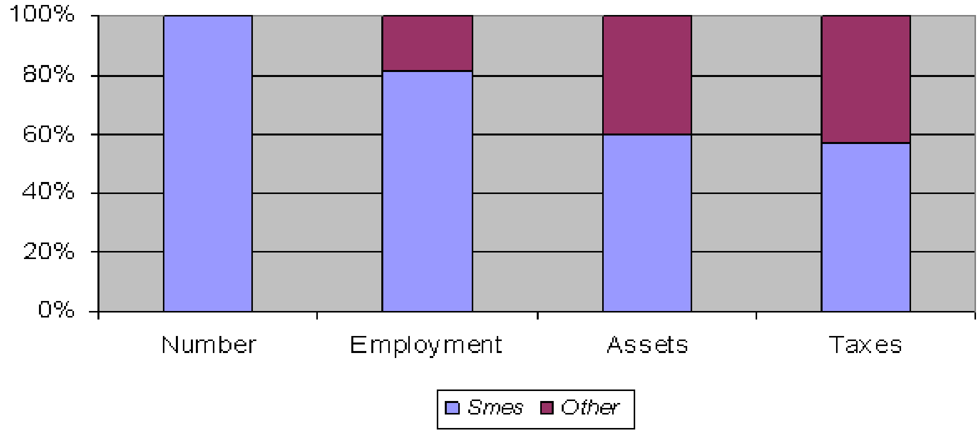
[9] www.apec.org . Web. June 2009. Retrieved August 2009.
[10] Zaman, Arif " South Asian SMEs need to globalise**".** The Financial Express. March 2008
[11] ibid
[12] ibid
[13] ibid
[14] China Daily, 2003. Web article. Retrieved August 2009.
[15] American Embassy in China. Web. Retrieved August 2009.

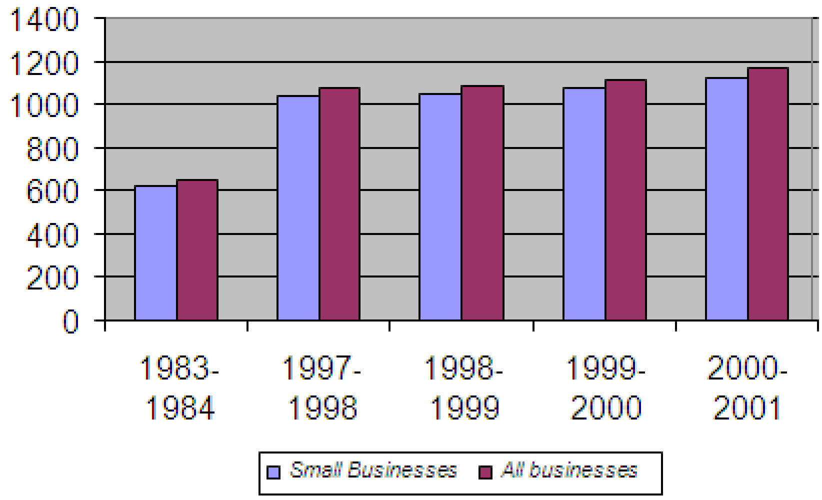
Figure 1: SME share of China's economy – 2001



Source: Yoa, Yang. "SMEs in China: Efficiency, Job Creation, and Constraints." China Center for Economic Research

In Australia, the SME sector also performs a vital role in the economy, as SMEs act as highly flexible and responsive suppliers to larger firms, customers of larger firms, and as suppliers to end-use customers in their own right.[16] The Australian Bureau of Statistics reported that in 2001 there were 1.2 million private sector small businesses, or 97% of all private sector businesses. The sector employs around 4.1 million people or 42% of total workforce in Australia and is estimated to have contributed around $426 billion or 46% of the value of Australia's GDP in that year.[17]

Figure 2: Number of businesses in the private sector in Australia



Source: Australian bureau of Statistics. Small Businesses in Australia. 1321.0.2001

[16] Ergas, H and Orr, J. "SMEs Trends and Achievements". CRA Project No: D10971-01. p.3
[17] Ergas, H and Orr, J. "SMEs Trends and Achievements". CRA Project No: D10971-01. p.3

The contribution of SMEs to the Australian economy has been increasing over time. At June 2006, there were over 100,000 more employing SMEs than at June 2004, and 183,000 more than at June 2003.[18] SME contribution to Australia's GDP is estimated to have increased by $23.8 billion in real terms over the period of 2004 to 2006[19]. SMEs are making a substantial contribution to domestic production in a wide range of industries. For example, SMEs contribute 95% of the value of Australia's agriculture, forestry and fishing production, 80% of the value of Australia's construction industry output, 67% of property and business services production and 42% of the value of national manufacturing industry output. SMEs contribution in these four industries alone accounted for around 20% of the value of Australia's GDP in 2006.[20]

FINANCING GROWTH

SMEs by definition have a comparatively narrow capital base, high dependence on internally generated funds and considerable working capital needs to support investment and sales. This explains the fact that SMEs employ predominantly short term debt as debt financing and SMEs with more growth opportunities include more debt in their capital structures.

Analysis of SMEs on a sectoral basis has shown that there is little difference between Europe and the US. Thus it is reasonable to assume that funding requirements are similar. Data collected for Germany will be used as a representative for Europe, due to Germany's significant number of SMEs. A total debt/equity ratio for SMEs in Germany was 187%, mostly from the construction and services sectors that have the highest leverage. The debt/equity ratio for USA was half that of Germany at 91% (figures are based on 1994 data calculated for German enterprises with between € 7 and 40 million turnover and US estimates by the Federal Reserve Board for non-farm, non-financial corporations and nonfarm non-corporate businesses with less than US$25 million in assets).[21] The difference between the ratios reinforces the perception of the maturity of US capital markets and the availability of private equity reducing the requirement for debt financing in the US.[22] The US is much more aggressive with the use of financial instruments. It makes greater use, for instance, of specialized equipment and vehicle finance, export credits, leasing, mortgages and longer term credit instruments. These facilities complement and make more efficient the use of capital contributed by all the SME sponsors.

US small-caps generally profit from an investment climate that is comparatively friendlier toward risk than in Europe as the US has the largest pool of investment capital in the world with estimates that $14 trillion worth of investment capital currently fuels US firms. As a result, although the GDP of the US and the EU are roughly equal, the US hosts far larger markets for equity benefiting both large and

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[18] Excludes non-employing SMEs. Figures sourced from ABS 2007, Counts of Australian Businesses, including entries and exits, June 2003 to June 2006, Cat. No. 8160.0, Table 10, p. 14.
[19] Ergas, H and Orr, J. "SMEs Trends and Achievements". CRA Project No: D10971-01
[20] ibid
[21] Institut Für Mittelstandsforschung, Bonn, 1998, SMEs in Germany - Facts and Figures 1998, Hans-Eduard Haouser, IfM Bonn, p42
[22] Small Business Administration, Washington DC, 1997, The State of Small Business 1996 – A Report of the President, US Government Printing Office, Washington DC, Chapter 2, p 42

small-cap listings.[23] Indeed, some firms regard the US as the most dynamic place to seek capital, and list there rather than in Europe, as it can be seen of the smaller-cap European firms listing on NASDAQ.

Financing gap

Despite their strategic importance in the economies of their countries, SMEs encounter many barriers to success when it comes to accessing growth capital. Until the end of 2007, bank lending was the largest source of external SME financing and banks took a dominant position regarding external loan finance. Institutional loans could be used for financing investments, working capital and stock financing. Lending could be secured or unsecured and would depend on the credit rating of the particular SME.[24] However, since the beginning of the Global Financial Crisis in 2008, traditional financial institutions are no longer wiling to adequately meet the needs of particular groups of potential borrowers. These classes include (but are not limited to) small businesses, risky firms, and knowledge-based enterprises. SMEs firms may face disproportionate difficulty obtaining debt capital when the cost of lending is too high to be economical for financial institutions. Financial institutions also lack the flexibility in their terms and conditions on loans to SMEs.

Findings suggest that firm size, knowledge orientation, and risk may be dimensions according to which lenders ration credit. Firms with least access to credit are those that do not have established relationships with lenders (for example, new firms), those that are unable to provide collateral (a signal of creditworthiness), and those whose management is unable to communicate effectively the firm's creditworthiness.[25] Many small, new firms lack the track record and business relationships needed to secure traditional funding. This under capitalisation is often cited as one of the main causes of start-up business failure. [26]

Vogel and Adams (1997) identify two principal circumstances under which small firms may face disproportionate difficulty obtaining debt capital.[27] The first condition arises when the cost of lending to SMEs is too high to be economical for financial institutions. This high cost stems from two sources: the risk premium that lenders could expect; and, fixed costs of evaluation and monitoring. The second situation arises when lenders place importance on the availability of collateral and whether small firms have sufficient collateral available in terms of the quality and quantity required. Again, this is not an imperfection in the credit market – rather, this condition is an aspect of the normal operation of credit markets. Experience suggests this situation, where lenders require collateral that SMEs do not have, is common to many young small firms and their failure. [28]

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[24] Audretsch, D, Van der Horst,R. Kwaak, T. and Thurik, R. "First Section of the Annual Report on EU Small and Medium-sized Enterprises" January 2009. p 34
[25] Gaps in SMEs Financing: An Analytical Framework 2002, Small Business Industry Branch. Industry Canada
[26] J.L. Seglin, Financing Your Small Business (New York: McGraw-Hill, 1990) at 41.
[27] Vogel, R. and C. Adams, 1997. Costs and Benefits of Loan Guarantee Programs, The Financier, 4 (1 & 2): 22-29
[28] Gaps in SMEs Financing: An Analytical Framework 2002, Small Business Industry Branch. Industry Canada

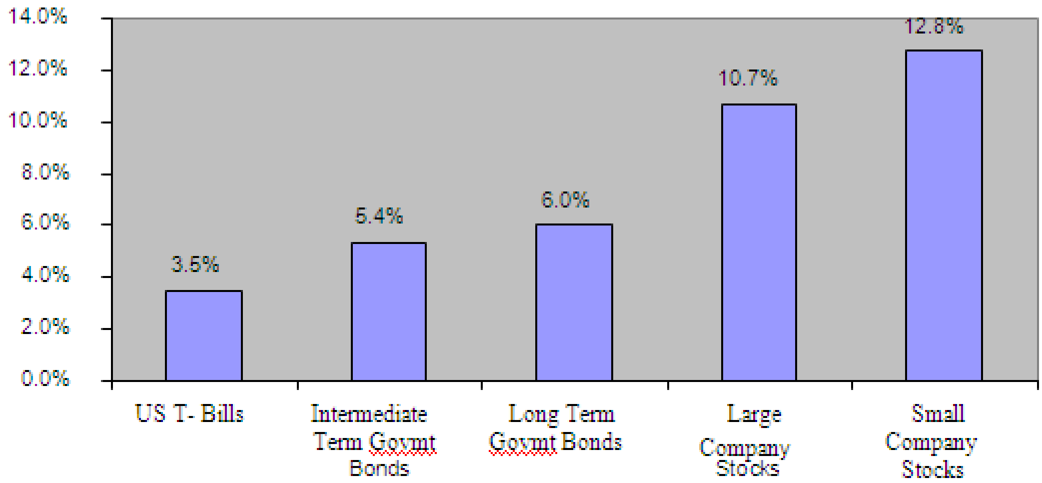
Other reasons that affect the ability of SMEs to attract debt financing include the fact that many are not listed and lack analyst coverage, and their lower liquidity makes them less attractive to investors. There are also weaker communication channels between smaller companies and investors, and entering the market has high fixed costs that are more disproportionately expensive for smaller firms. These include fees paid to stockbrokers, registrars, lawyers, merchant bankers, and financial PR companies, as well as the exchange fee and auditing, printing and distribution of accounts[29]. The geographic location and the industry in which the company operates can also impact negatively the extension of credit.

RISK AND RETURN

Small-cap markets – including both SMEs and larger companies – continue to form and grow in the world's financial centers, and some IPOs of smaller companies generate significant returns.[30] Investing in SMEs means taking a high risk, and this market is suitable only for well-informed investors who are aware of the risks that they run. The average net annual return from a venture capital portfolio in dollars runs at about 10% to 15% over a period of eight to ten years.

Risk negatively correlates with the size of companies – the larger the company, the lower the risk measured by price volatility and chance of default. Basic financial theory then suggests that investors would only focus on SME capital markets if they are convinced that returns on investment would be higher than in the comparatively stable blue-chip investments. Returns were indeed higher for smaller firms in the US from the 1920s through the mid-1990s.

Figure 3: Gross annual return by assets (1926-1995)



Source:

[29] A Comparison of Small and Medium Sized Enterprises in Europe and in the USA. Manuscript. p 187
[30] ibid. p 173

As a strategy to better guard against default risk, and potential problems of adverse selection, and moral hazard, creditors require guarantees to their lending, materialised in collateral assets (Myers, 1977; Scott, 1977, Harris and Raviv, 1990), and the issuance of personal loan guarantees. This kind of assets will retain value in case of a potential liquidation of the firm, and could be sold in the market to face the firm's payment commitments.

Information asymmetry can be mitigated in at least three ways, each of which reduces information opacity and provides sound information to investors and lenders:

- Through a firm's ability to somehow signal its credit worthiness (strong financial statements, collateral as security on loan);
- By establishing and sustaining a strong relationship with its lender; and,
- Through due diligence and the lender's examination of the business plan and other lender requirements for documentation. [31]

Aside from the risk of business failure, many SMEs lack the appropriate resources to put in place effective risk management practices, and have to navigate through trial and error to achieve sound financial growth. This is another determinant of credit denial by traditional financial institutions. Alternative investment funds can mitigate these risks by offering the necessary knowledge, resources and financial advice to these SMEs, while simultaneously monitoring the borrowers' activities from an internal viewpoint.

Whereas the process of financial intermediation was once human capital and relationship intensive, it is now heavily influenced by technological innovation and consumer demand factors which have tended to disrupt the monopoly power of financial intermediaries.[32] As many traditional financial institutions refuse to lend to some potential borrowers, due to increased risk exposure in this tense economic atmosphere, a widening opportunity is available for other suppliers of capital to fill the gap. These lenders can then hand pick the best investments out of the demand pool based on the companies' willingness to pay the going rate (interest rate, cost of capital) and their ability to repay the borrowed funds.[33] Access to all forms of debt and equity capital is positively associated with business owners' managerial capacity. Thus the need for thorough due diligence processes to sort and identify the firms with the strongest proven managerial track record.

Additionally, due to informational asymmetries, firms prefer internal to external capital sources. This suggests that highly profitable companies will tend to finance investments with retained earnings rather than using debt. This way of firm financing could easily be applied to SMEs through the following reasoning: SMEs managers, who are usually at the same time shareholders of the company, do not like to lose their property and control to financial institutions. When SMEs need external funding, they would choose debt that does not reduce managers' operability – that is, short-term

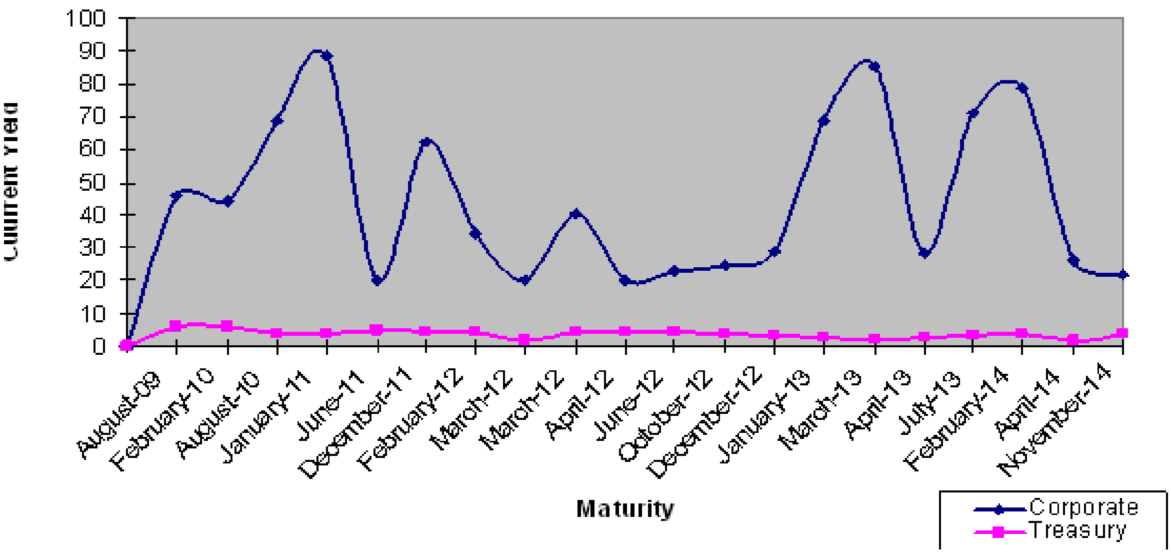
[31] Gaps in SMEs Financing: An Analytical Framework 2002, Small Business Industry Branch. Industry Canada
[32] J Trainor. "The Internet Direct Public Offering: Establishing Trust in a Disintermediated Capital Market"
[33] Gaps in SMEs Financing: An Analytical Framework 2002, Small Business Industry Branch. Industry Canada

debt that is not likely to include too restrictive covenants.[34] To overcome the fact that SMEs owners tend to welcome short term investments that generate quick, positive cash flows (managers myopia), suppliers of capital are able to lend funds at a higher level of seniority.[35]

Considerable consolidation has characterised the supply side of the specialised finance market. Consequently, asset-based financing and leasing are becoming more standardized in terms of products and approaches. The asset-based financing and leasing industry financed as much as 25% of total business investment in machinery and equipment in 1998.[36]

Figure 4 illustrates annual gross revenues of small and large companies compared to government bonds from 1926 to 1995.[37]

Figure 4: Yield (%) comparison – Treasury Bonds vs Corporate Junk Bonds



[34] Gaps in SMEs Financing: An Analytical Framework 2002, Small Business Industry Branch. Industry Canada
[35] Gaps in SMEs Financing: An Analytical Framework 2002, Small Business Industry Branch. Industry Canada
[36] A Comparison of Small and Medium Sized Enterprises in Europe and in the USA. Manuscript.
[37] Source: “Risk Capital: A Key to Job Creation in the European Union,” Communication of the European Commission, SEC (1998) 552 final, April, 1998, p. 6.