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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 2/2011 that was published in December last year.

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 December, the global economic prospects have gradually improved, but dangers remain high. The divergence between growth in advanced and emerging economies is expected to persist. Economic forecasts for Europe were slightly revised upwards.
- Available data for the business environment of SMEs still show a relatively stable situation. However, the imbalances between EU Member states have continued to grow.
- The ECB bank lending survey reports a further net tightening in credit standards applied by euro area banks for loans to non-financial corporations. However, the *additional* net tightening has decreased. Looking forward to the second 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 August 2011.
- 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. On balance, SMEs expect this process to continue in the next months.
- On average, business insolvencies decreased in 2011, however with large regional differences. For 2012, insolvencies are expected to rise again, due to the difficult economic environment. 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:

- In 2011, private equity investment has only slightly increased following its big jump in 2010. However, the downward trend of venture capital investment has continued. Some of the gap left by the fall in venture investment has been filled by increased business angel activity; their proximity to the market has been beneficial during this difficult period.
- According to EVCA figures, private equity fundraising significantly increased in 2011. Moreover, venture capital fundraising stopped its downward trend and increased by more than 50%.
- PE divestments have continued to grow in 2011. This was again mainly due to the contribution of the buyout and growth segments. The downward trend in venture exits has come to an end in 2011.
- Venture performance has slightly improved in 2011. However, European VC performance is still far below the returns reported for the private equity industry as a whole.

SME Securitisation:

- Turning to SME securitization (SMESec), 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 SMESec market (excluding pure ECB-related transactions) slowly restarts from the more sophisticated markets, i.e. in the "traditional" countries (UK, Germany, Benelux, Italy etc.).
- Looking forward, regulatory reforms will impact the securitisation market. Investors will only return in volume if they regain confidence in the quality of transactions and if there is satisfactory secondary market liquidity. Originators will return if transactions are economically feasible.
- 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.

Microfinance:

- With regard to microfinance, standardised, regularly available indicators to explain market developments for microfinance in Europe do not yet exist, or focus on Eastern Europe. Thus, in this report we focus on the framework conditions for microfinance which are covered by the regularly updated Eurostat indicators for poverty and social inclusion, and by data on micro-enterprises.
- The microfinance market in Europe in general shows trends towards efficiency, professionalization, and self-sustainability, but needs access to stable funding.

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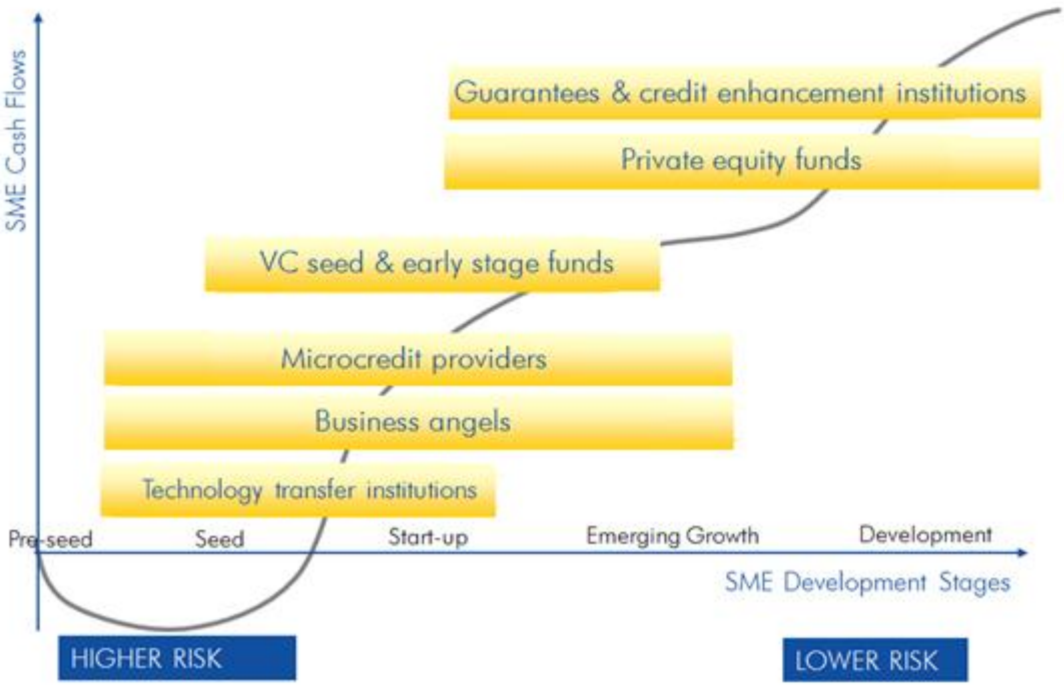
1 Introduction

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 2/2011 that was published in December last year.

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] 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 do neither include Leveraged Buyouts (LBOs) nor Public Equity activities.

2 Economic environment

Since the publication of the last ESBFO in December, the global economic prospects have gradually improved, but dangers remain high. The International Monetary Fund (IMF) has forecasted a slowdown of global growth from 3.9% in 2011 to 3.5% for 2012, while global growth is expected to return to 4.1% in 2013. However, compared to IMF's previous projections (made in January 2012) these forecasts have been increased by 0.2 and 0.1 percentage points for the years 2012 and 2013 respectively (IMF, 2012a). Also the OECD stated in its latest Economic Outlook in May 2012 that the global recovery is fragile, extremely uneven across different regions, and could be derailed by the crisis in the euro area (OECD, 2012).

This slightly improved forecast is mainly based on enhanced financial conditions, with activity expected to strengthen in the US and recover in most emerging and developing economies. Additionally, the increased world growth projections are based on the anticipation of better policies in the euro area, a rather stable pace of global fiscal tightening and special factors like the reconstruction in Japan and Thailand. However, the downside risks remain considerable. Specifically, the euro area crisis can be intensified once again due to renewed concerns over sovereign risk of periphery countries and the ambiguous effects of austerity on the real economy.

Furthermore, the divergence between growth in advanced and emerging economies is expected to persist. Specifically, the IMF slightly raised its forecasts for the growth in advanced economies to 1.4% for 2012 and 2.0% for 2013 and for emerging and developing economies to 5.7% for 2012 and 6.0% for 2013. The output growth projections for the euro area were slightly raised to -0.3% for 2012 and 0.9% for 2013. The projections for Central and Eastern Europe were more significantly increased, to 1.9% and 2.9% respectively. Additionally, the European Commission (EC) in its latest European Economic Forecast has also updated its projections to similar levels, expecting 0% growth for the European Union (EU) and -0.3% for the euro area for 2012. Besides Greece and Portugal for which negative growth for 2012 was forecasted already in autumn 2011, this is now also the case for Spain, Italy, Cyprus, the Netherlands, Slovenia and Hungary.

For 2012, high unemployment is expected to further restrict private consumption, while public consumption is expected to shrink both in 2012 and 2013 under the efforts to assure the sustainability of public debt (see table 1). Furthermore, weak domestic demand is unlikely to support GDP growth as well as import growth. To the contrary, net exports are anticipated to rise due to the expected acceleration of global growth combined with the recent depreciation of the euro against foreign currencies (European Commission, 2012a).

As far as financial stability is concerned, policy makers have taken some important steps to regain the confidence of financial markets in the euro area. First of all, the European Central Bank (ECB)'s decision to offer unlimited liquidity to banks through the three-year longer-term refinancing operations (LTROs) has significantly eased bank funding strains (IMF, 2012b).

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

(Real annual percentage change unless otherwise stated)	2008	2009	2010	Spring 2012 forecast 2011	2012	2013
GDP	0.3	-4.3	2.0	1.5	0.0	1.3
Private consumption	0.3	-1.8	1.0	0.1	-0.3	0.7
Public consumption	2.3	2.1	0.7	-0.1	-0.5	-0.1
Total investment	-0.9	-12.5	-0.2	1.3	-0.9	2.2
Employment	0.9	-1.9	-0.5	0.2	-0.2	0.2
Unemployment rate (a)	7.1	9.0	9.7	9.7	10.3	10.3
Inflation (b)	3.7	1.0	2.1	3.1	2.6	1.9
Government balance (% GDP)	-2.4	-6.9	-6.5	-4.5	-3.6	-3.3
Government debt (% GDP)	62.5	74.8	80.2	83.0	86.2	87.2
Adjusted current-account balance (% GDP)	-2.0	-0.8	-0.9	-0.7	-0.4	0.0
Contribution to change in GDP						
Domestic demand	0.4	-3.2	0.7	0.3	-0.4	0.8
Inventories	-0.2	-1.1	0.9	0.2	-0.3	0.0
Net exports	0.1	0.0	0.5	1.0	0.7	0.4

(a) Percentage of the labour force

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

Source: European Commission (2012a)

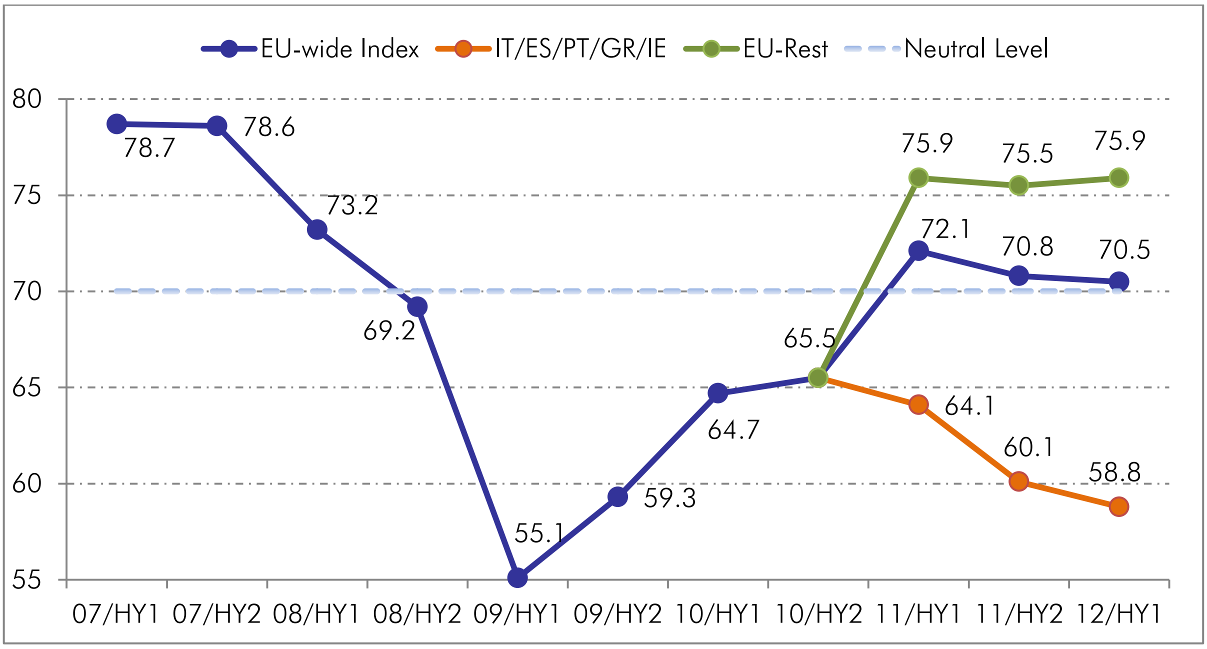
Bank funding markets have partially re-opened, however, the pressure on European banks remains. Although the need for deleveraging does not necessarily imply lower credit to the private sector, the evidence suggests that it contributes to a tighter credit supply. Specifically, the IMF (2012b) expects that the need for reduction of the banks' balance sheet size will reduce the outstanding credit supply in the euro area by 1.7%. On top of that, deleveraging is also expected to reduce growth in the euro area, according to the IMF (2012a) by 1% this year.

3 Small business environment

3.1 SME business climate

According to the UEAPME SME Business Climate Index, the overall business environment of European SMEs is relatively stable. For a second semester in a row, the index stands just above its neutral level of 70% (UEAPME Study Unit, 2012). Moreover, the number of SMEs that consider the business conditions as stable increased to a record level, corresponding to a decreasing number of SMEs that consider the conditions as improved. This indicates a business environment which is characterized by uncertainty with SMEs waiting for the upcoming economic developments. However, although the average index shows stabilization at neutral levels, the imbalances between the EU Member States that were firstly identified in the beginning of 2011, have continued to grow. 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 end of 2009 levels, showing a clear lack of confidence among SMEs concerning the current and upcoming developments. As a result, two diverse country groups are formed inside Europe with the gap between them increasing to a record high of 17.1 percentage points as depicted in figure 2.

Figure 2: SME Business Climate Index[3]

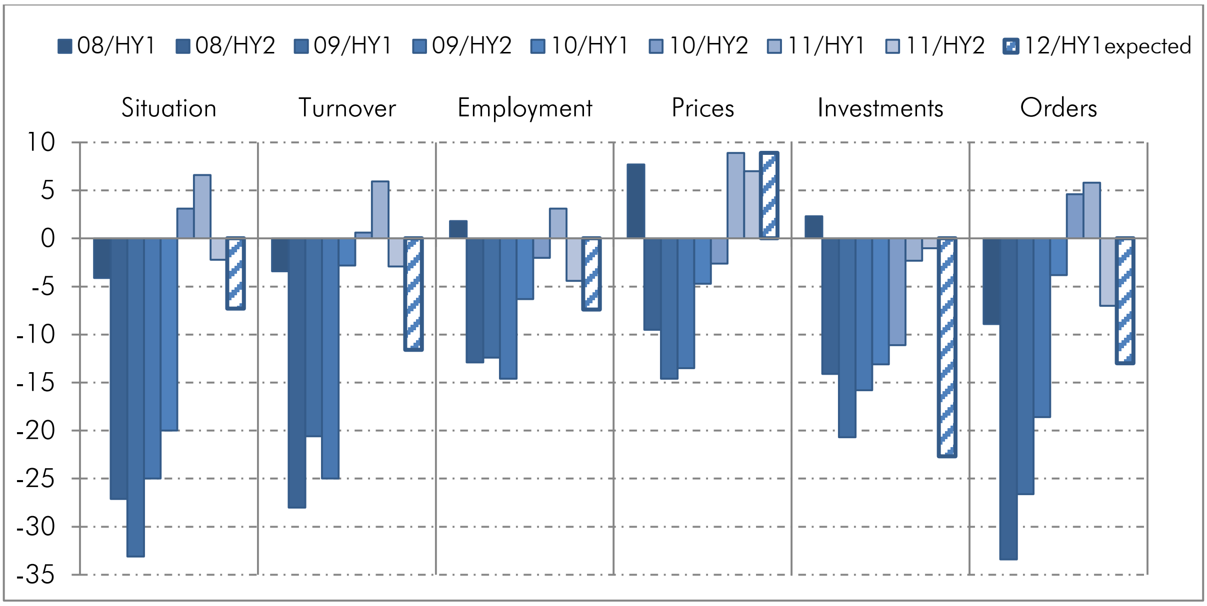


Source: UEAPME Study Unit (2012)

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.

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 2008, with the last column being a forecast for the overall first half-year 2012. During the second semester of 2011, all economic indicators, except for prices, have turned negative for the first time since the beginning of 2010. However, this was not in line with what SMEs expected one semester earlier, probably because the economic environment deteriorated at a faster than expected pace. These deviations are depicted in figure 4 and are possibly one of the reasons for the more negative outlook that SMEs show for the first semester of 2012.

Figure 3: Main Results of the EU Craft and SME Barometer 2011/HY2[4]

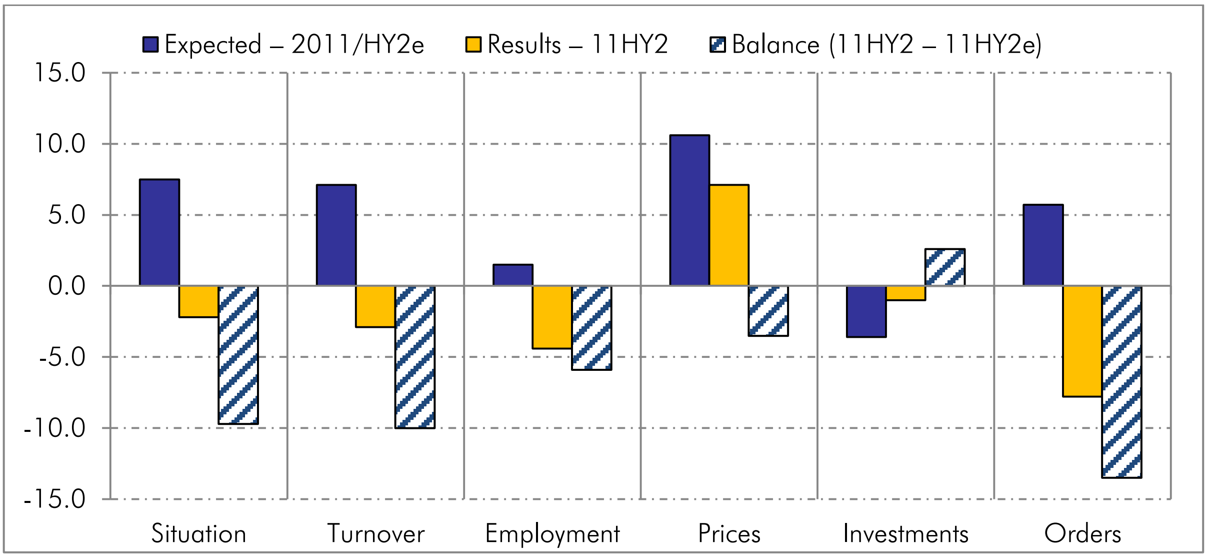


Source: UEAPME Study Unit (2012)

Specifically, in the first half of 2012, turnover, orders and employment are on balance expected to fall by (-11.6%), (-13.0%) and (-7.4%) respectively, corresponding to the current macroeconomic forecasts. Moreover, expectations for investments are on balance even worse (-22.7%), driven by the uncertain business environment for SMEs and the more difficult situation in lending that they face from European banks. Lastly, SMEs, in line with previous semesters, continue to expect higher prices (balance of +8.8%), most probably as a result of increased energy- and commodity-prices.

[4] The EU Craft and SME barometer builds on surveys that are conducted by UEAPME member organisations. The 2012/HY1 results are based on about 30,000 answers collected between December 2011 and February 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/120228_Barometer_2012H1_final.pdf.

Figure 4: Expectations of SMEs and real outcome for 2011/HY2



Source: UEAPME Study Unit (2012)

Box 1: Do SMEs create more and better jobs?[5]

According to a recent study presented by the European Commission, SMEs create more jobs than large enterprises in the EU. Between 2002 and 2010, 85% of all net new jobs (new jobs created minus jobs lost in a given period) were created by SMEs. This figure is considerably larger than the share of SMEs in total employment (67% in 2010). Moreover, SMEs have a much higher employment growth rate (1% annually) than large enterprises (0.5%).

Within the SME size-class, micro-enterprises contributed the largest part of total net employment growth in the business economy. Their annual employment growth rate of 1.3% was the highest among all enterprise size classes. Moreover, micro-enterprises have the highest probability to hire long-term unemployed people and to hire employees aged 50 years or more. These results show the important social role of these firms.

With respect to enterprise age classes, newly born SMEs (up to 5 years old in 2008) accounted by far for the largest part of employment growth between 2004 and 2008. Employment growth of these new firms more than compensated for the employment destruction caused by enterprise deaths in all age groups and size classes. Moreover, 85% of the jobs created by newly born SMEs during 2004 and 2008 still existed in 2008.

As a result of the economic crisis, the number of jobs among all SMEs has on average decreased by 2.4% annually (large enterprises –0.95%). Enterprises reported also a decline of overall demand, increased customer payment terms and a shortage of working capital as negative effects of the crisis. However, innovation seems to be a good defence against the crisis. Innovative enterprises and enterprises from more innovative countries more often reported employment growth and had higher employment growth rates. Moreover, the share of enterprises reporting a decline in overall demand was lower in more innovative countries. In contrast, micro-enterprises are particularly vulnerable towards the crisis.

[5] This text box is based on EIM (2011) and European Commission (2012b).

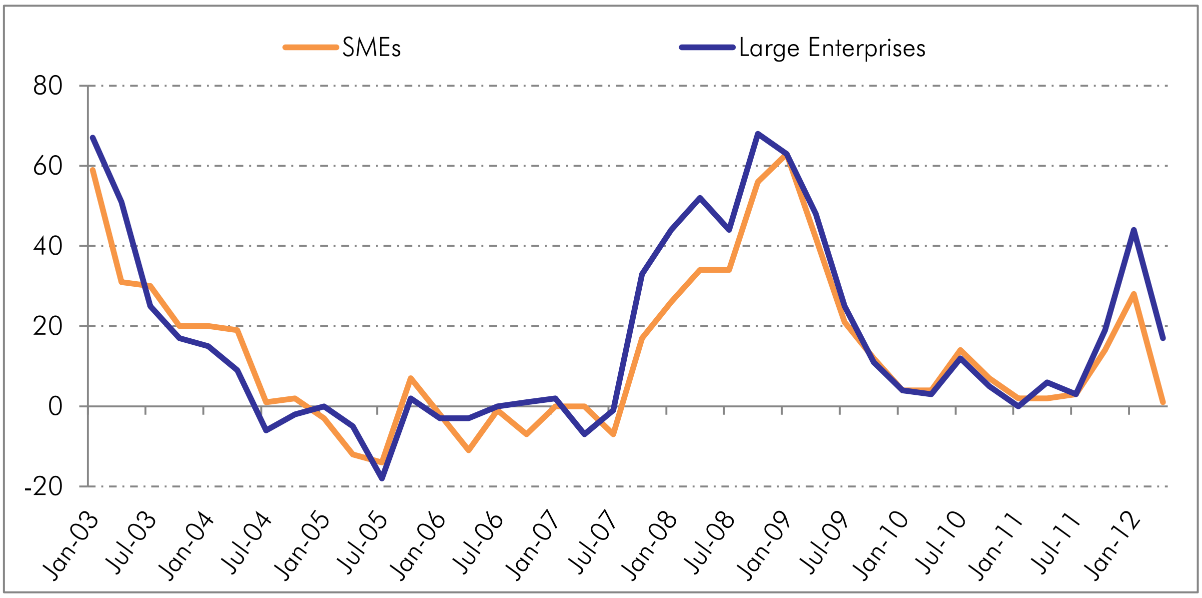
Box 1 continued:

As far as job quality is concerned, jobs in small enterprises are reported to be less productive, less remunerated, and less unionised than jobs in large enterprises. However, micro-enterprises report that they have a competitive advantage in "soft" job aspects such as working climate, work-life balance or working-time arrangements.

3.2 Bank lending activity

The current status of bank lending has been analysed in the ECB's latest Bank Lending Survey (BLS)[6]: On balance, the reporting euro area banks have further tightened their credit standards to non-financial corporations (NFCs). However, the survey reports a significant decrease in the additional net tightening[7]; a net 9% of banks reported a tightening in Q1/2012, compared to 35% in the previous quarter. On top of that, the drop is even greater than anticipated one quarter earlier by survey participants, when it was expected to be 25%. As shown in figure 5, the net tightening of credit standards on loans to SMEs fell from 28% in Q4/2011 to 1% in Q1/2012, and that of credit standards on loans to large firms declined from 44% 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.

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



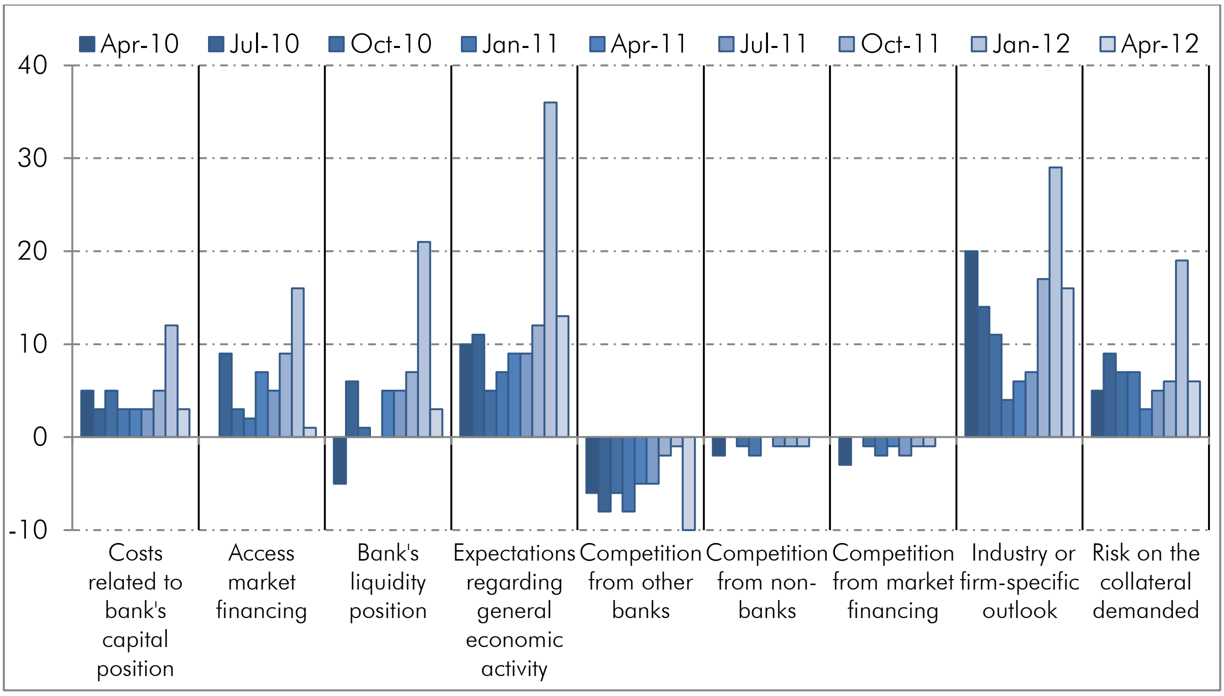
Source: ECB (2012b)

[6] This survey was conducted on 131 euro area banks and reports changes during the first quarter of 2012 (Q1/2012) and expectations of changes in the second quarter of 2012 (Q2/2012).

[7] 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").

In Q1/2012, in net terms and as far as SMEs are concerned, all the factors that have contributed to a tightening of credit standards (according to the banks) have declined markedly, i.e. expectations concerning the economic outlook contributed substantially less to tighter credit standards for SMEs (13% against 36% in Q4/2011) (see figure 6).

Figure 6: Factors contributing to tightening credit standards for SMEs[8]



Source: ECB (2012b)

According to the reporting banks, the net *demand* for loans to NFCs dropped significantly in Q1/2012 (-30% compared to -5% Q4/2011, mainly driven by a further sharp drop in the financing needs of firms for fixed investment, complemented by a decline in financing for mergers and acquisitions, a slightly negative contribution from financing needs linked to inventories and working capital, and a moderate decline related to higher availability of internal funds (ECB, 2012b)). Concerning the projections for Q2/2012, some further tightening is on balance expected to affect large firms (8%) rather than SMEs (2%), as well as primarily long-term loans (13%). The demand for corporate loans is on balance expected to rise again.

3.3 ECB MFI interest rate statistics

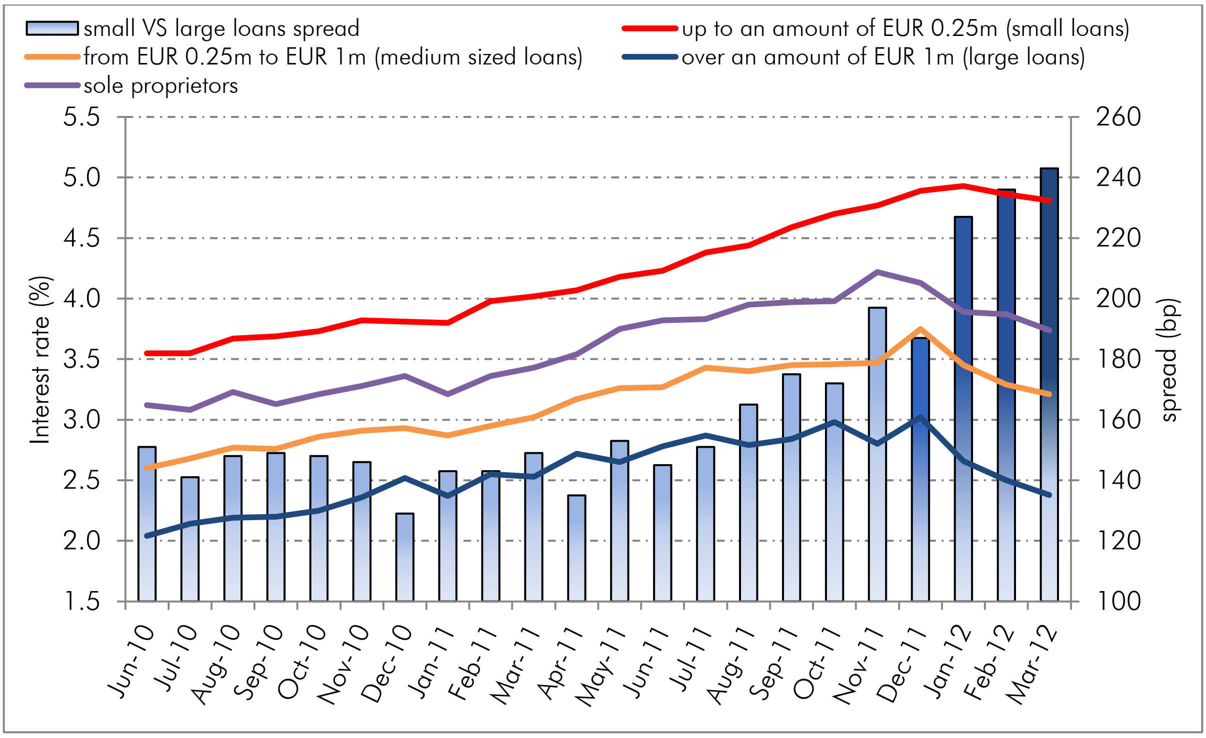
The monetary financial institutions (MFIs) interest rate statistics, published by the ECB, provide information about the interest rates and volumes for different size classes of new euro-denominated loans. Since June 2011, the former category of loans to euro area non-financial corporations up to EUR 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

[8] 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.

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) have a rather stable spread over loans of more than EUR 1m (large loans), averaging 58 basis points (bp) for the period June 2010 to March 2012 (see figure 7). In contrast, 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 243bp in March 2012. Using these 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, in particular in some jurisdictions" (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 MFI interest rates on new loans to non-financial corporations[9]



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

[9] 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.

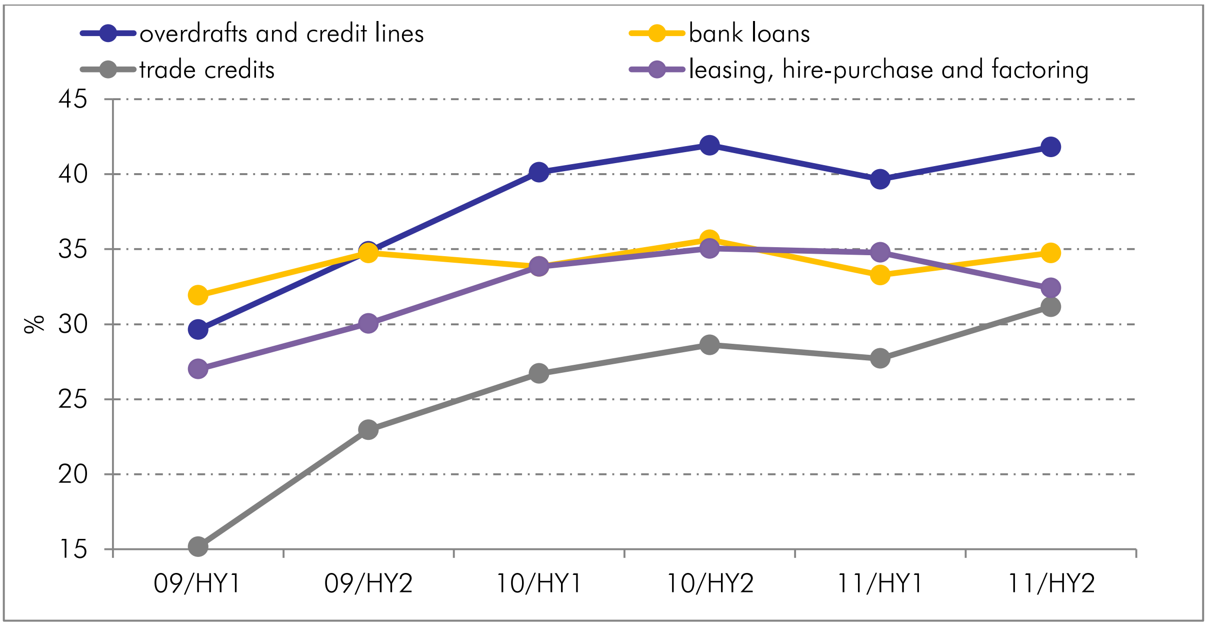
3.4 Access to finance

According to the ECB's "survey on the access to finance of SMEs in the euro area", covering October 2011 to March 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 April to September 2011), there has been an increase in the percentage of SMEs having used debt financing through its most popular forms overdrafts, credit lines, bank loans and trade credits. In contrast, the percentage of SMEs having used leasing, hire-purchase or factoring has decreased. Bank financing (overdrafts, credit lines, bank loans) remained the most important external funding source (see figure 8).

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)

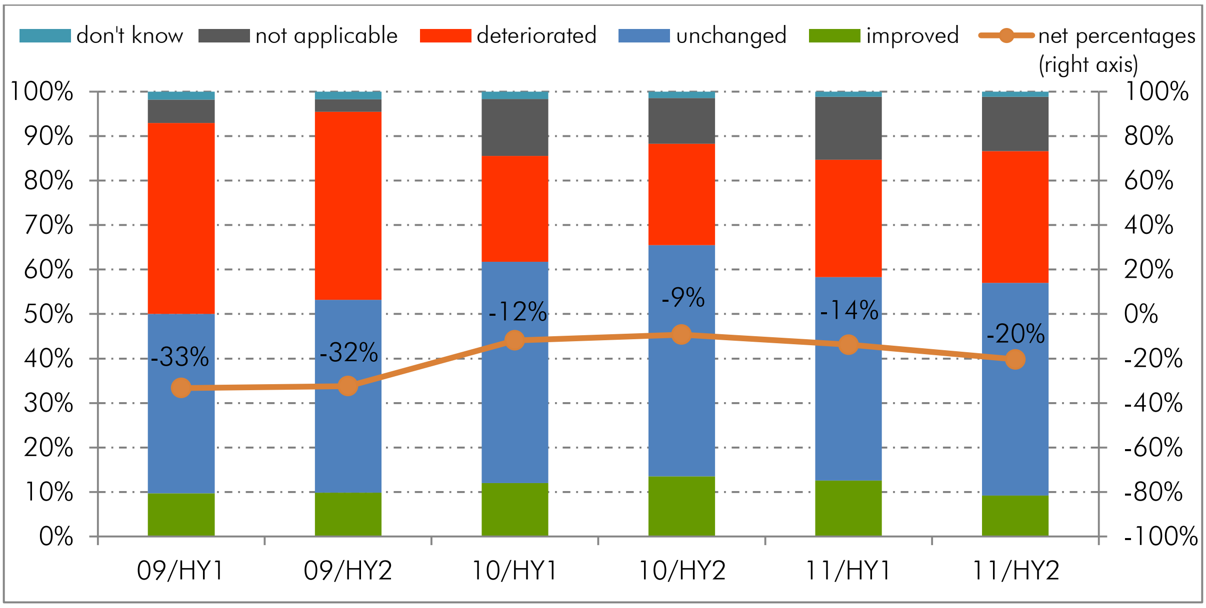


Source: ECB (2012c)

During the reference period, the net percentage of SMEs reporting a higher *need* for bank loans slightly increased compared to the previous survey. At the same time, the net percentage[10] of SMEs that perceived a deteriorated *availablity* of bank loans increased further (see figure 9). 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.

[10] "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).

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: ECB (2012c)

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 interest rates, other costs of financing and collateral requirements was still at high levels.

When looking at actual applications for external financing, 25% of SMEs applied for a bank loan between October 2011 and March 2012. The main reason for SMEs not to apply for a bank loan was the availability of sufficient internal funds. 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 bank overdrafts.

Looking ahead, SMEs are expecting on balance a slight further deterioration of access to bank loans and bank overdrafts. Particularly pessimistic SMEs were observed in Greece, while SMEs in Finland and Germany on balance expected slight improvements for the period April to September 2012.

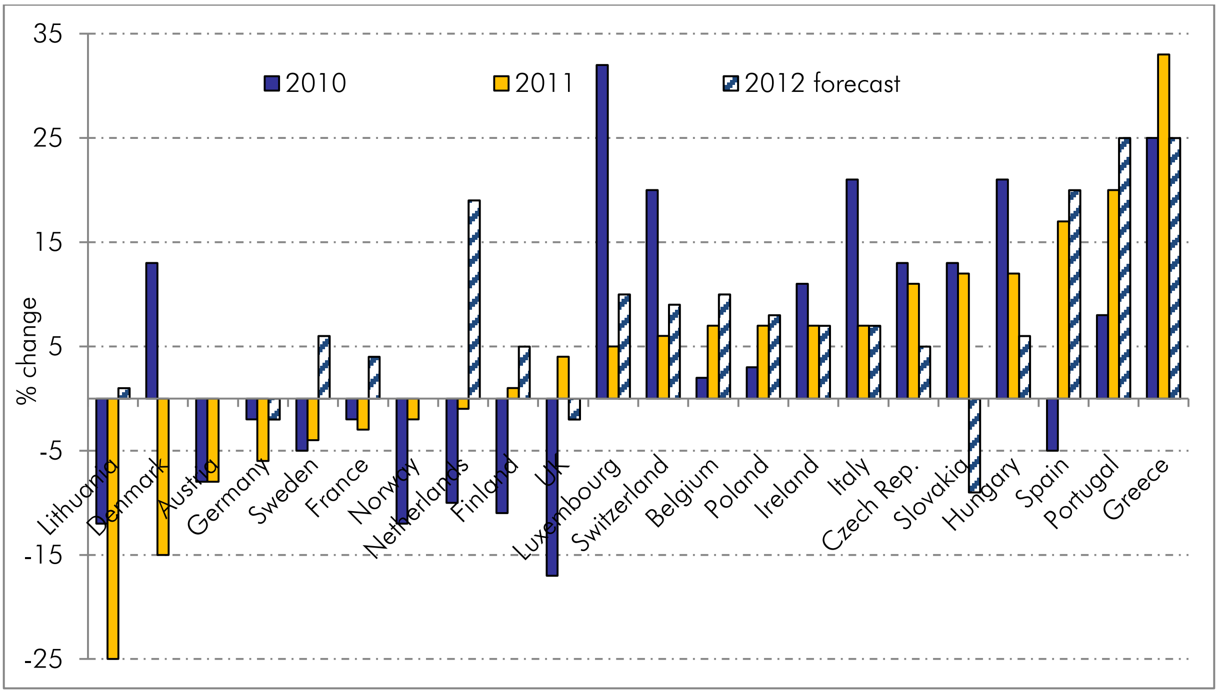
3.5 Insolvencies

The 4% fall in global business insolvencies in 2011 was even more pronounced than expected (-3%), as a result of the improved economic situation in the US. However, for 2012 the Euler Hermes Global Insolvency Index (Euler Hermes, 2012), which analyses changes in business insolvencies across the world, forecasts a +3% increase after two consecutive years of improvements (reduction of -5% in 2010 and -4% in 2011).

Concerning the Eurozone, the Insolvency Index has increased by +7% in 2011 and the projection for 2012 is a further increase of +13%. At the same time, the regional disparities have significantly increased as indicated by figure 10. In 2011, insolvencies increased at a record level of +33% in Greece, +20% in Portugal, and +17% 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 Lithuania (-25%), Denmark (-15%), Austria (-8%) and Germany (-6%).

For 2012, at the European level, insolvencies are expected to increase by +13% in 2012, while insolvencies for the Asia Pacific region are expected to grow only slightly by +2% and to fall by -10% in the Americas. Insolvencies are expected to worsen in the European periphery countries (Italy +17%, Spain +20%, Greece +25% and Portugal +25%) as a result of the tightened credit conditions, the austerity plans and the reduced demand (Euler Hermes, 2012). The core countries in Europe, facing internal budget adjustments and being exposed to the downturn in Eurozone demand, are also expected to have increased insolvency figures. The only predictions that show a modest reduction in insolvencies (-2%) are for Germany and the UK; for Germany this is based on strong fundamental figures; for the UK it is a result of statistical base effect (Euler Hermes, 2012).

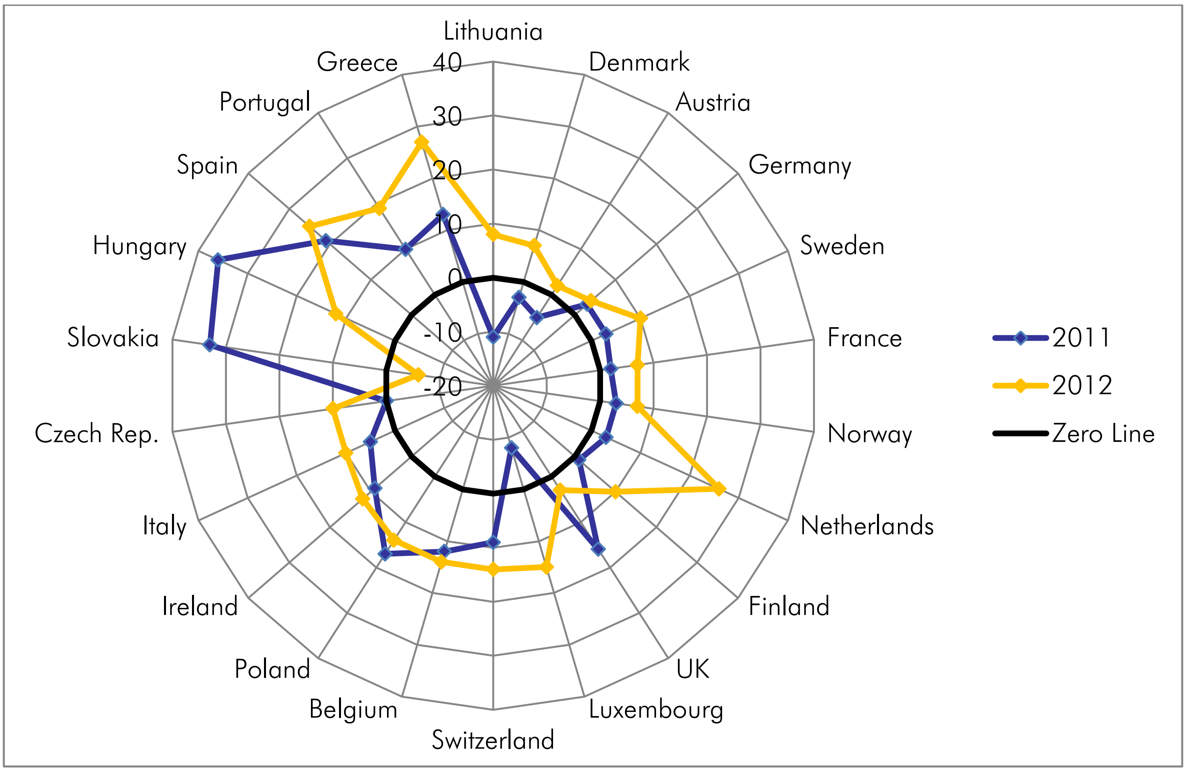
Figure 10: Rate of change in insolvency, 2010-2012



Source: Euler Hermes Global Insolvency Index 2012

For some countries, the Insolvency Index for 2011 varies significantly from the projections made 6 months earlier and reported in the previous version 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 in insolvencies, hence: blue spot inside the zero line), while the new projection made now for 2012, was 15% worse than the previous projection made for 2012 6 months earlier (positive rate of change in insolvencies, hence: orange spot outside the zero line); please see also footnote 11.

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



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

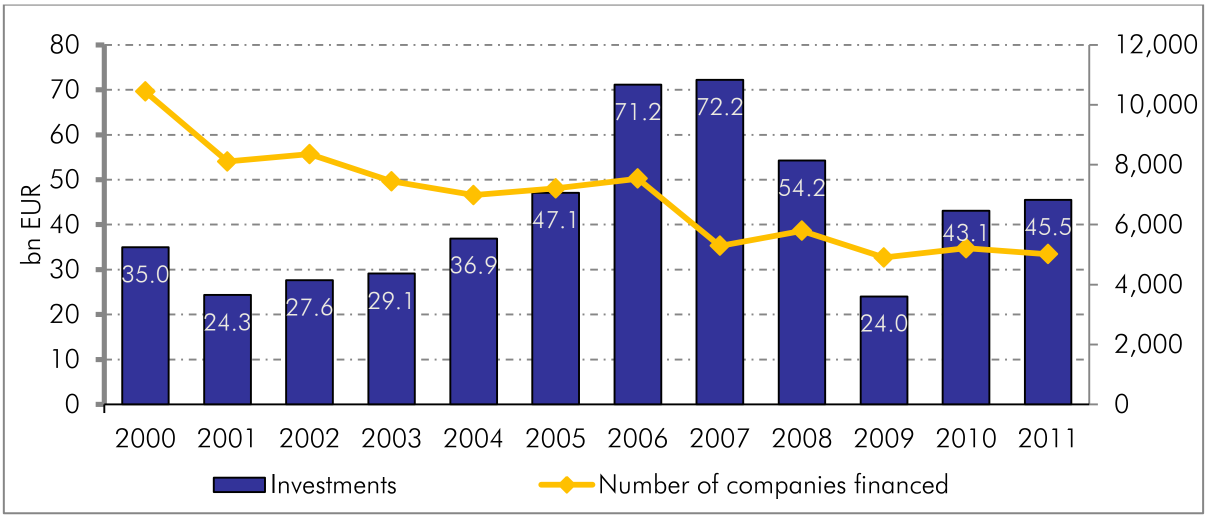
[11] The gap is calculated as following: For 2012 the gap is the difference of the current projection of Insolvency Index per country and the previous projection (reported 6 months earlier in ESBFO 2/2011). For 2011 the gap is the difference of the actual level of Insolvency Index per country and the 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

After a jump of 77% in 2010, private equity investment activity in Europe has balanced close to its 2005 levels. In 2011, investments remained relatively stable at EUR 45.5bn, recording an increase of 5.6% compared to last year. Hence, more than 5,000 companies benefited from private equity investment while SMEs[12] accounted for 85% with an average investment of EUR 3m (EVCA, 2012).

Figure 12: Investment activity (values and number of companies) financed by private equity firms located in Europe[13]



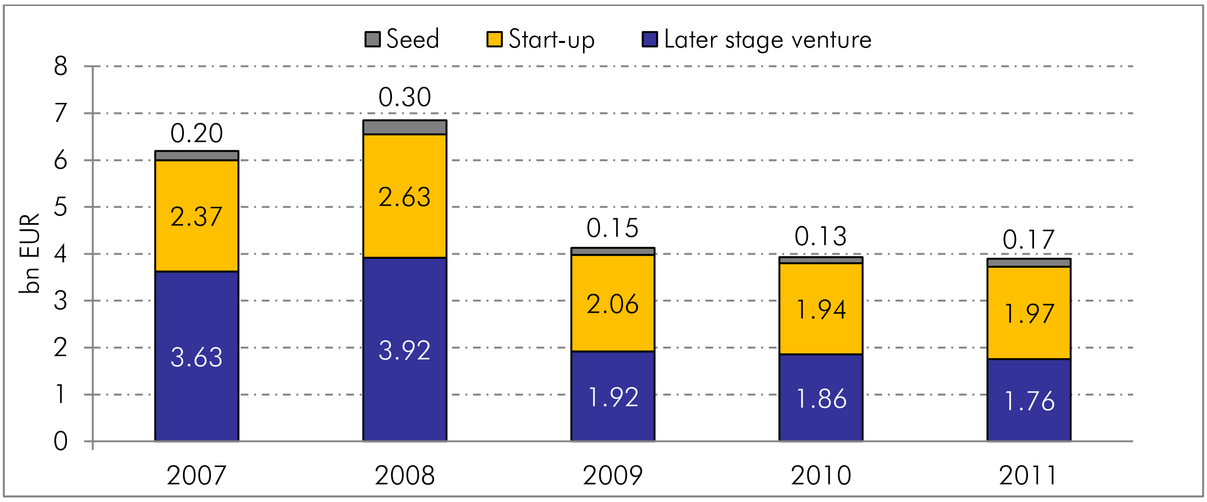
Source: EVCA

All in all, private equity investment has partially rebounded after its deep slump in 2009. This evolution is driven by buyout and growth investments which have more than doubled since 2009, while venture capital investment has slightly reduced since then. Thus, venture capital investment activity is still far from its 2008 levels, but showed a relative stability in all the different stages over the last year (see figure 13).

[12] EVCA defines SMEs as enterprises with less than 250 employees.

[13] Figures based on industry statistics (or "office approach"): Industry statistics are an aggregation of the figures according to the country of location of the private equity firm's office in charge of the deal. At the European level, this relates to investments made by European private equity firms regardless of the location of the target company.

Figure 13: Venture Capital investment activity evolution in Europe



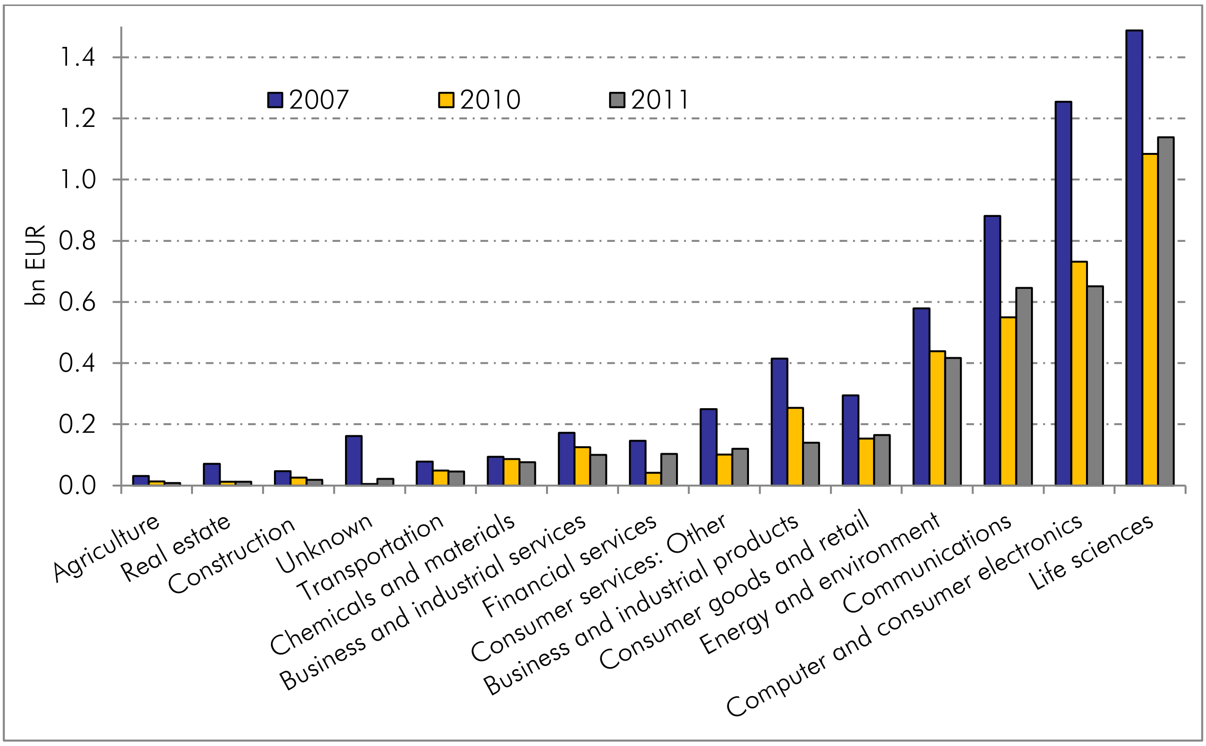
Source: EVCA

According to the latest data from Preqin, Europe is still the second most active area for VC deals globally (with UK, Germany, and France as hubs of activity). However, while 22% of all deals in 2010 (registered in Preqin's global database) where in Europe, this figure fell to 18% in 2011 – a signal of growing importance of other regions in the VC sector, i.e. China and India[14] (Preqin, 2012b). Such drifts are also a result of past performance and return expectations.

In terms of sectors targeted by venture investment, figure 14 shows certain stability over time. Life sciences, computer/consumer electronics, and communications remain the most important - followed by energy and environment. However, the *relative* importance of VC investment in the different sectors (measured as a share of total VC investment activity) changed significantly in the period 2007-2011. Specifically, in 2011 and compared to 2007, venture capital targets to a stronger extent life sciences (increased from 23.5% to 31.1%), communications (increased from 14.8% to 17.6%), energy/environment (increased from 9.7% to 11.4%), and to a lesser extent computer/consumer electronics (reduced from 21% to 17.8%).

[14]In terms of volumes, according to Preqin data, Europe's share was in 2010 13% and in 2011 10% (Preqin, 2012b).

Figure 14: Venture investment in Europe by sector – 2011 and 2010 versus 2007[15]



Source: EVCA

4.2 Fundraising activity

In 2011, funds raised by private equity firms located in Europe substantially increased by 82% to EUR 39.8bn[16], according to EVCA figures (see figure 15). However, even if the increase seems quite impressive, it has to be seen in the light of the dramatic slump recorded in 2009. Thus, in 2011, fundraising was still far below the numbers observed during the years 2005 to 2008, when the European private equity industry raised on average EUR 86bn per year.

Venture capital fundraising stopped its downward trend and increased by 53% to EUR 4.9bn in 2011. However, this figure is still 42% below the 2008 VC fundraising amount. According to Preqin data, Europe-focussed VC fundraising fluctuated over the past years around a level of 15% of global VC fundraising (Preqin, 2012b).[17]

Moreover, even if the increases in VC fundraising were significant in 2011, more impressive growth rates were recorded for the growth, buyout, and mezzanine sectors which – taken together – almost doubled (+95%) their fundraising amount. However, buyout funds, accounting by far for

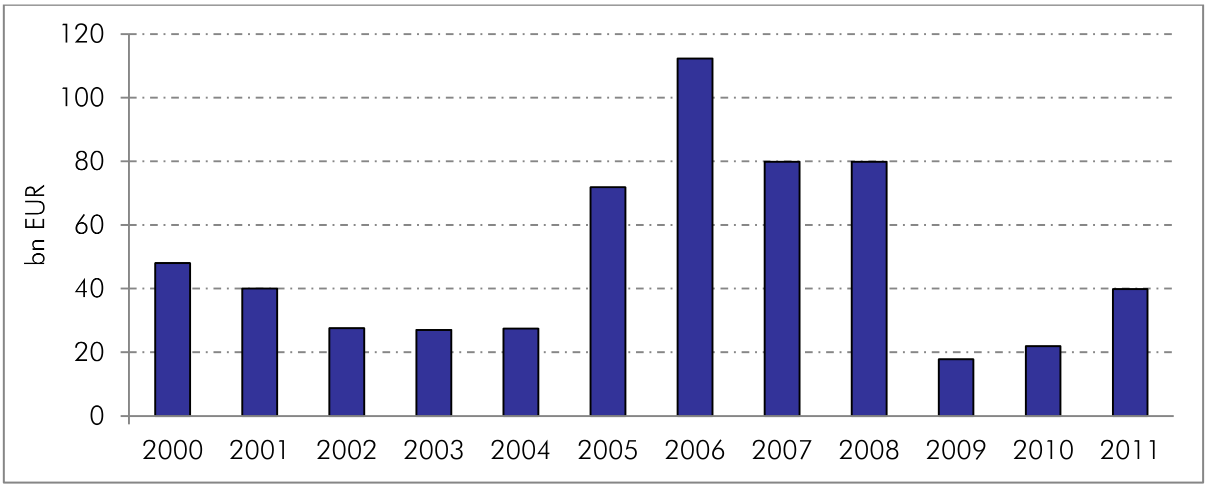
[15]Figures based on market statistics: Market statistics are an aggregation of the figures according to the location of the portfolio company. At the European level, this relates to investments in European companies regardless of the location of the private equity firm.

[16]Incremental amounts raised during year. The EVCA statistics for final closings (cumulative amounts raised since inception) by independent funds amounted to EUR 26.1bn for private equity in 2011, and to EUR 3.2bn EUR for venture capital.

[17]Data: 2005 to May 2012; however, with an outlier of more than 21% in 2008 (Preqin, 2012b).

the largest share of the market, are still far below pre-crisis amounts and recorded only 44% of the fundraising volume which they had achieved in 2008.

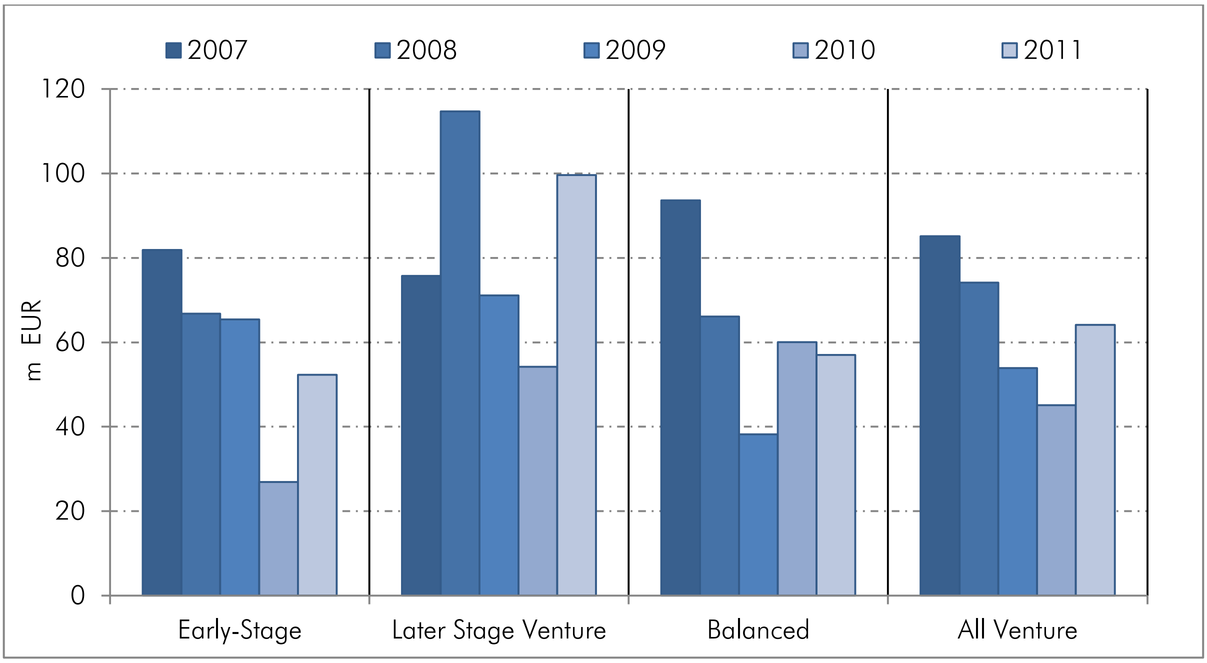
Figure 15: Funds raised by private equity firms located in Europe



Source: EVCA

The EVCA figures also indicate that the average VC fund size has grown considerably to EUR 64m in 2011, the downward trend of the past years seems to have come to an end (see figure 16 below). While the size of later stage venture funds averaged EUR 99.6m in 2011, the average early-stage fund size amounted to EUR 52.3m.

Figure 16: Average VC fund size (based on final closings)

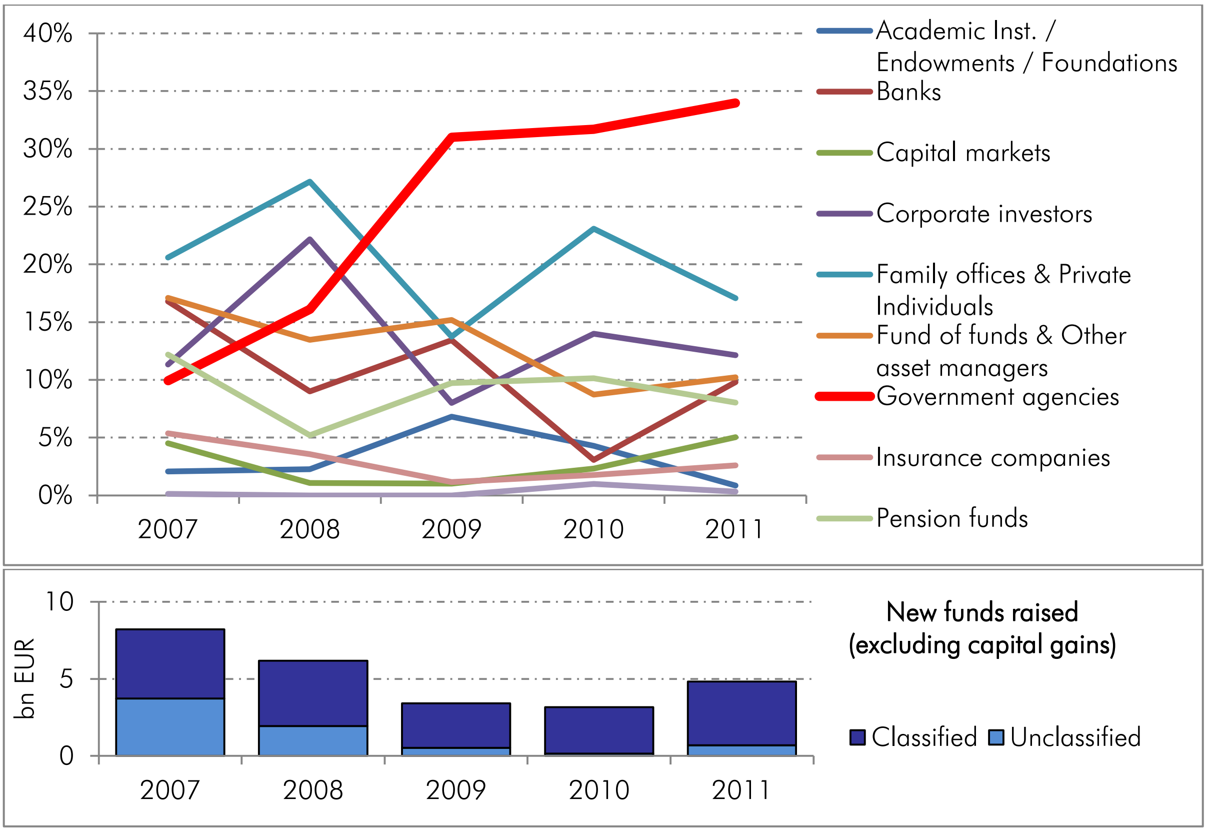


Source: EVCA

Another sign of investors' currently cautious sentiment towards venture capital is the shift in the investor base which has been going on during the last years (see figure 17). In 2011, government agencies accounted for a third of total known investors into venture capital funds. 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.

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 %ages, a) the underlying amounts of funds raised have changed significantly (hence shown below) and b) that the amounts that could for technical reasons not be classified have been deducted (extrapolation).

Figure 17: Investor base: Share of government agencies in VC fundraising



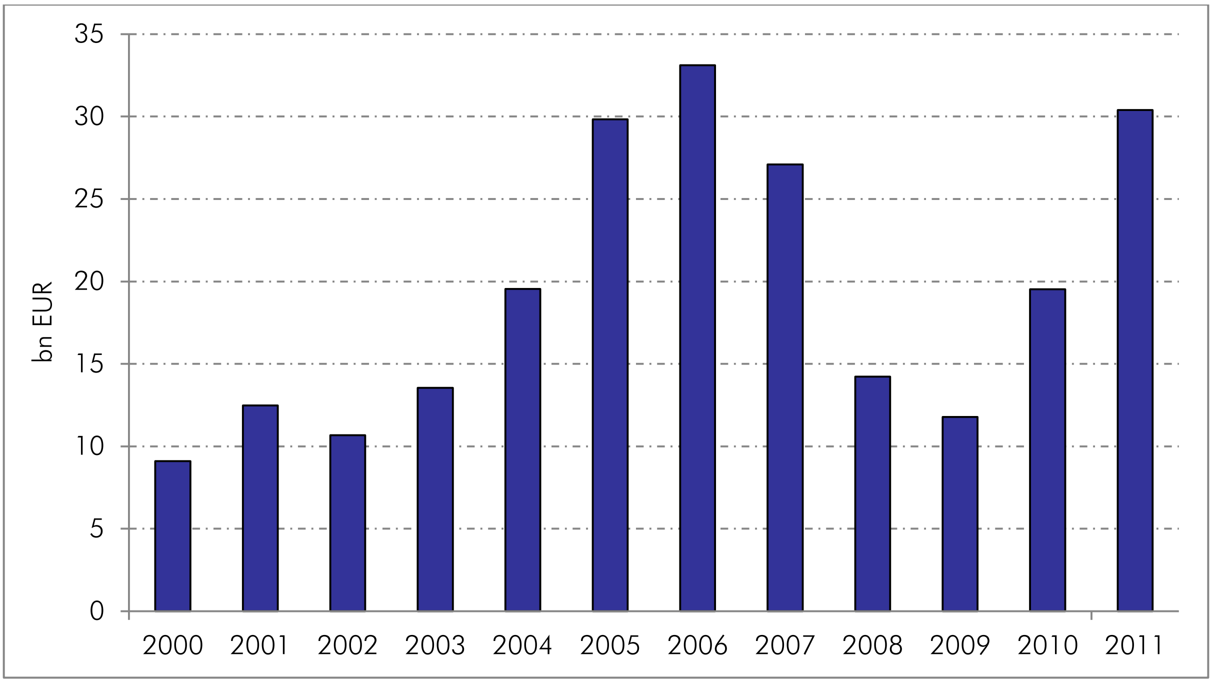
Source: based on EVCA data

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 2011, the volumes of equity signatures (transactions signed by EIF) soared to an all-time high of EUR 1.1bn. Compared to the past, EIF's average stake and average commitment in individual funds has been increased. Also in the coming years, EIF will continue to cornerstone across the spectrum of University 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; in the future, it will be extended to other European countries and/or regions 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).

4.3 Divestment activity

Divestments have continued to grow, but the exit markets weakened after the summer. In 2011, total divestments conducted by private equity firms in Europe amounted to EUR 30.4bn which was 56% above the value one year before (see figure 18). This was again mainly due to the contribution of the buyout and growth stage where exits increased by 62% to EUR 27.8bn. The downward trend of venture exits has come to an end in 2011. Divestments conducted by VC funds amounted to EUR 2.6bn, corresponding to an increase of 13%. However, divestment amounts recorded for buyout and growth funds already exceeded the 2007 levels by 17%, while the total value of venture exits is still 24% below the 2007 levels.

Figure 18: Divestments by private equity firms in Europe[18]

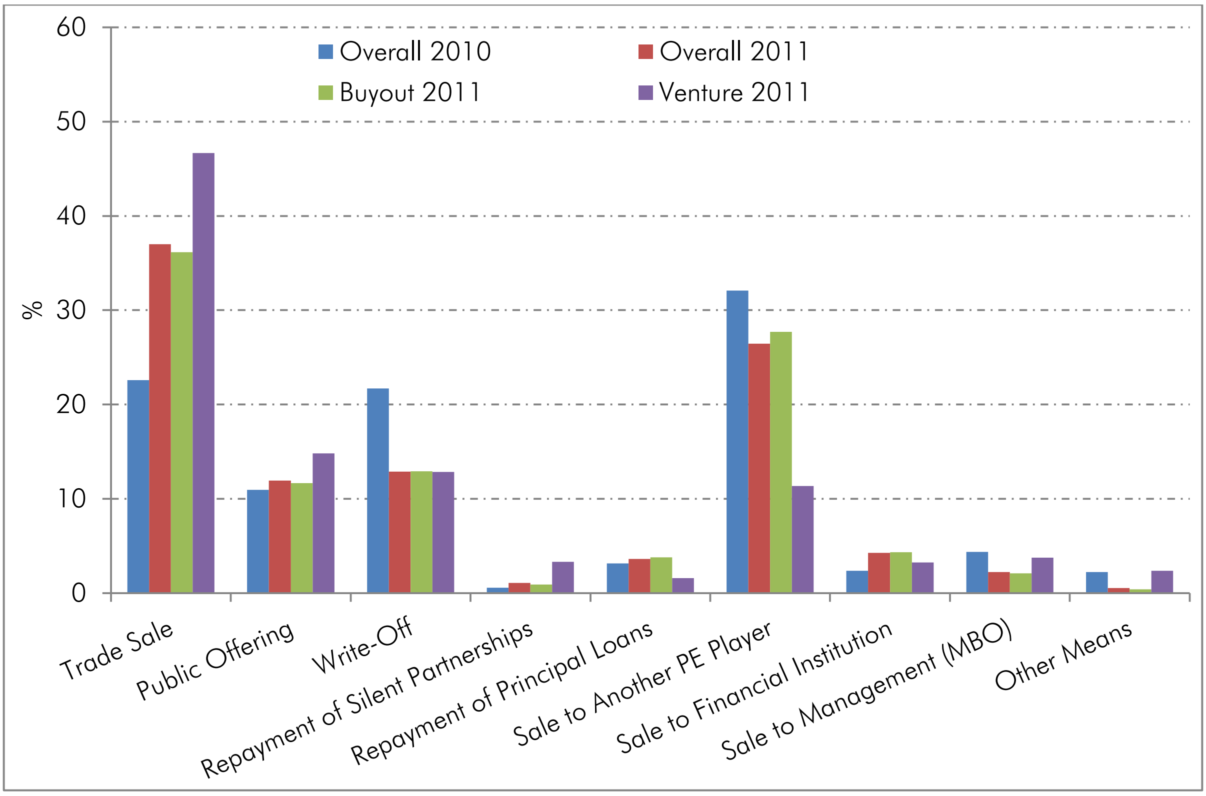


Source: EVCA

[18]Office approach. See footnote 13.

Some comfort can be taken from figure 19 which shows that the relative importance of write-offs as a form of exit has continued to decline in 2011. Rather, trade sales have become the most popular form of divestment. Together with sales to another private equity house they are accounting for almost two thirds of all exits.

Figure 19: Divestment (by amount at cost divested)[19]



Source: EVCA

Box 2: IPO development in Europe[20]

According to PWC (2012), in 2011 global IPO activity lost some of the momentum from 2010, due to the difficult economic conditions. All major markets experienced flat or declining IPO money raisings. However, Europe was the only region to experience growth for both volume and value.

In the last year, a total of 430 IPOs in Europe raised EUR 26.5bn. However, while the number of European IPOs increased by 13% year on year, the total IPO value stayed rather flat (+1%). According to PWC, the year was "plagued by delays and postponements due to market volatility resulting from the Eurozone crisis". Average deal values dropped by 10% to EUR 77m. The year was dominated by a few large transactions with the top 6 European deals raising EUR 16bn (60% of total IPO proceeds across Europe), compared to 37% (EUR 9.6bn) in 2010.

[19] Market approach. See footnote 15.

[20] This text box is mainly based on the IPO Watch Europe survey 2011 published by PWC. The survey covers all new primary market equity IPOs in Europe's principal stock markets and market segments. For more information see PWC (2012).

Box 2 Continued:

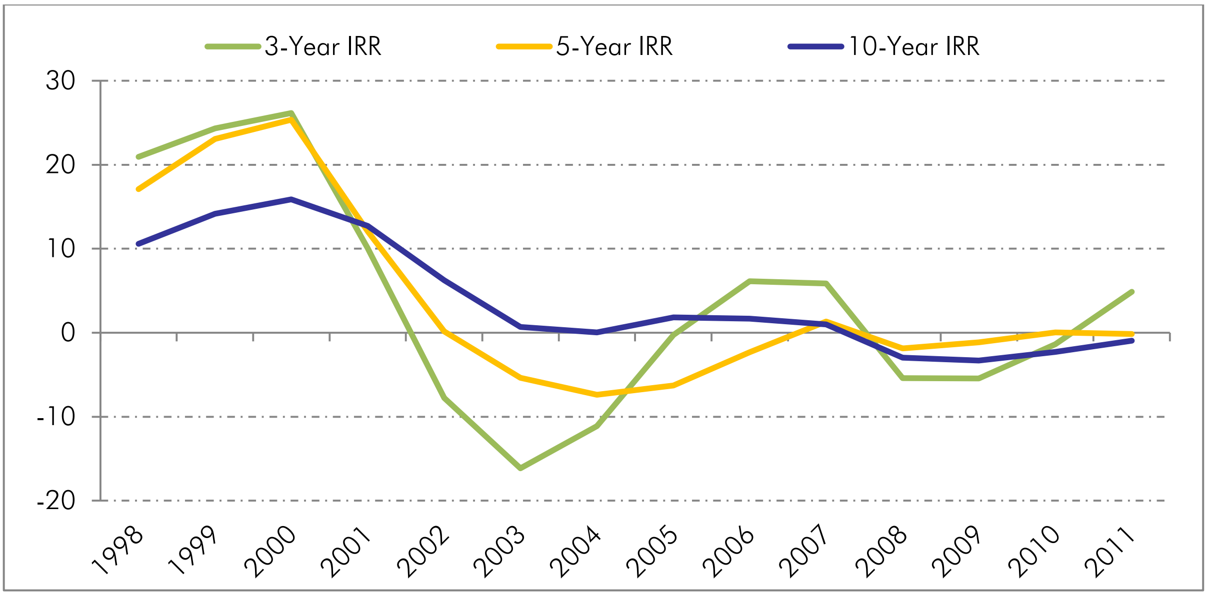
More than half of the money raised in Europe was generated on the London Stock Exchange (EUR 14.1bn). However, London hosted only a quarter of the IPOs across Europe. The Warsaw Stock Exchange hosted the most transactions (203), albeit at a low average value.

The reported evidence from two stock exchanges with a focus on SMEs and mid-caps was mixed. PLUS, a small and mid-cap stock exchange in London, hosted 21 IPOs raising EUR 7m in 2011, an increase of 5% by volume and 40% by value compared to 2010. Marché Libre, an exchange-regulated market operated by NYSE Euronext which addresses small and medium-sized firms, hosted 14 IPOs in 2011, raising a total of EUR 3m. The IPO volume at Marché Libre dropped by 48%, from 27 IPOs in 2010, though money raised tripled from EUR 1m to EUR 3m.

4.4 Performance trends

According to preliminary EVCA and Thomson Reuters data, European venture capital performance has slightly improved in 2011. The 3 year rolling horizon Internal Rate of Return (IRR) amounted to 4.9% 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 20). The rolling horizon IRRs for the 5 year (-0.1%) and the 10 year (-0.9%) periods are reported to be still in the negative area. Nevertheless, European VC performance has overcome its 2008 and 2009 lows.

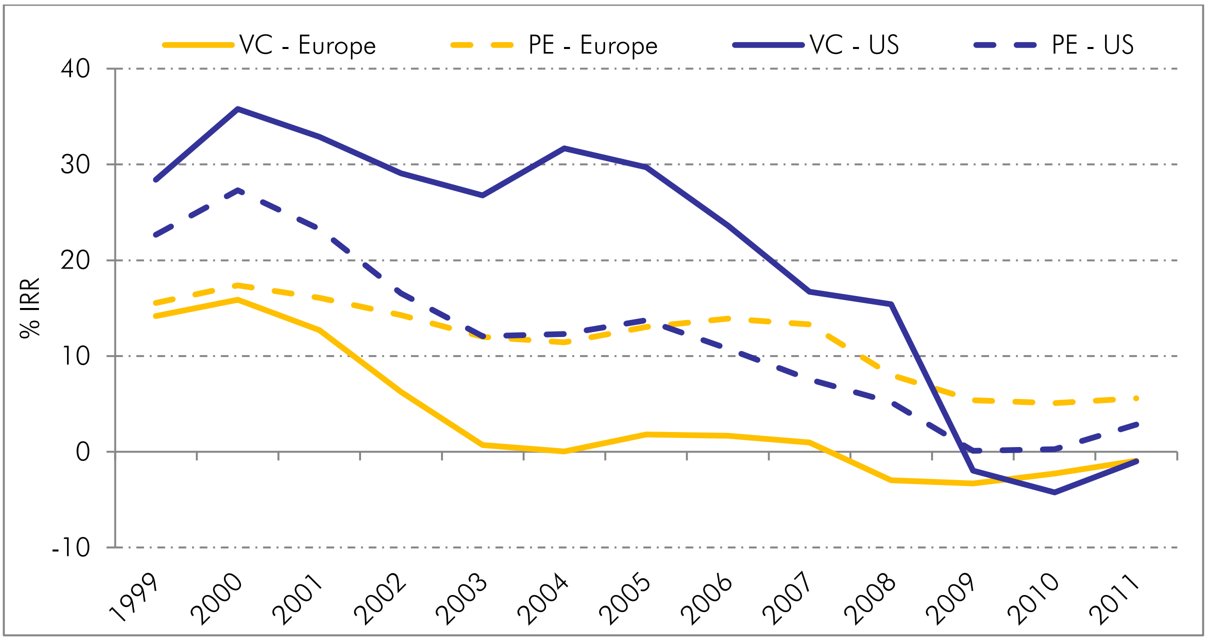
Figure 20: Rolling Horizon IRR European Venture Capital (in %)



Source: EVCA/Thomson Reuters

However, VC performance in Europe is still far below the returns reported for the private equity industry as a whole which also includes the buyout and the mezzanine segment of the market (see figure 21). From a geographical point of view, the European PE industry outperforms its American benchmark already since 2006, according to EVCA/Thomson Reuters statistics. In 2010 and 2011, European VC performance was also slightly above that reported for the US. Of course, this result should not be over-interpreted as US VC performance seems to also show stronger values to the upside in good years, as also shown in figure 21.

Figure 21: Ten-year horizon rolling IRRs for Europe and the US



Source: EVCA/Thomson Reuters

Preqin (2012a) recently also reported increasing performance figures for the PE industry in Europe and America while PE focussed on other regions generally continued to follow a downward trend. Moreover, "funds with a primary geographic focus on Europe are currently outperforming North America-focused funds for all vintages from 1999 to 2005, while North America-focused funds are showing higher median returns for more recent vintage years. However, these funds are still early in their fund lives and returns could change as fund managers seek to add value to their investments" (Preqin, 2012a).

Looking ahead, in the expected general economic scenario of a moderate recovery it is likely that the market will further pick up. However, should the high risks to economic prospects materialise, performance figures will probably fall again. Nevertheless, we repeat our statement from previous reports: a crisis is also a source of opportunity in private equity as valuations are decreasing and acquisitions can be completed at more favourable prices.

Box 3: Business Angel activity

As already stressed in previous versions of the ESBFO, Business Angels (BAs) represent an important private equity investor class and we present in this box updated information on the BA market, based on the latest available information from EBAN.[21] They invest their own money directly in businesses which are not publicly traded, either individually or in formal or informal syndicates.

BAs differ from VC funds, who primarily invest third parties' funds (e.g. Institutional Investors') in that typically companies that receive BA financing are smaller than VC-backed companies, and Business Angel Investments are usually short term – the median holding period is approximately four years. Furthermore, BAs do not provide only financing, but also relevant expertise and mentorship to the companies they invest in.

The past three years have seen an increased prominence of Business Angel investors for 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 BA community, the main ones being identification and definition. Business Angels typically prefer to stay anonymous and their investments tend not to be disclosed. Furthermore, nothing can prevent an individual from identifying oneself as a 'virgin' angel, although he/she may never actually invest. Others may have occasionally acted as angels, but are no longer looking for investment opportunities. Moreover, the so called "invisible market" makes even more difficult a precise estimation of the angels market. Such characteristics must be borne in mind when analysing the market.[22]

According to EBAN, the number of angel investors, active both within networks and independently (individually or in syndicates), is estimated at around 70k in Europe - for comparison: the number of active BAs in the United States in 2011 is estimated to be in the area of 318k (Center of Venture Research, 2012). Their number has slightly declined over the last year, following a period of continuous increase over the prior periods.

In terms of overall investment, the amount invested by angels annually is in the area of EUR 3.5 to 4bn in the EU, even though it has been affected up to a certain degree by the global financial crisis. For comparison: according to the Center of Venture Research (2012), the total investment amount of BAs in the United States in 2011 was EUR 17.6bn (USD 22.5bn). This means that the amounts, invested annually by Business Angels, are higher than the amounts invested by Venture Capital funds in seed and early stages (in 2011 – Europe: EUR 2.1bn, US EUR 7.4bn (USD 9.4bn).[23])

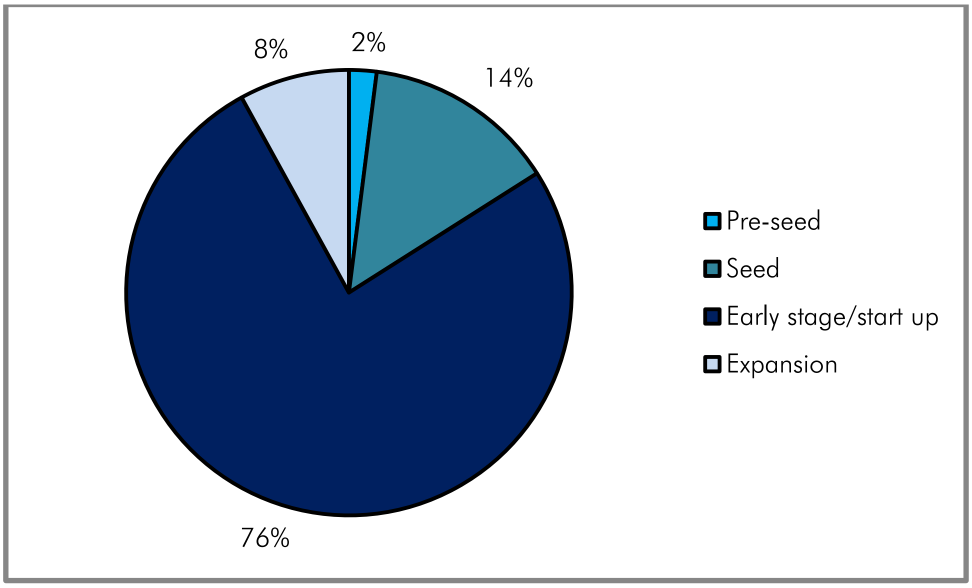
[21] The European Trade Association for Business Angels, Seed Funds, and other Early Stage Market Players.
[22] For a general description of Business Angel financing we also recommend to refer to OECD (2011) and to Kraemer-Eis and Schillo (2011).
[23] Based on data from EVCA (Europe) and NVCA (US).

Box 3 continued:

Regarding the size of their funding, Business Angels, investing together in syndicates, provide on average EUR 160k per deal in Europe, with individual angel investments ranging from EUR 18k to EUR 500k.

Direct EBAN members are approximately 15% of the 392 identified Business Angel Networks in Europe (incl. Russia and Turkey). The median number of investors in a typical European Business Angel Network is 79. The figure below represents breakdown by investee's growth stage of the Business Angel investments reported by EBAN members.

Figure 22: Investees' growth stages of Business Angels reported by EBAN members



Source: EBAN

5 European SME Securitisation[24]

5.1 Market activity[25]

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.[26] 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).[27]

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 (see figure 23). For the full year 2011, the retention was at around 76% (2010: 77%). This situation is expected to continue, also for SME transactions and i.e. against the background that the ECB eased in December 2011 collateral requirements in European System operations for Asset Backed Securities backed by SME loans (to single A rating at issuance).

Following the year 2009, in which there was no public placement of an SME transaction, in 2010 and 2011 the SME securitisation market showed some signs of reopening, with EIF playing a key role in some benchmark transactions. However, 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.

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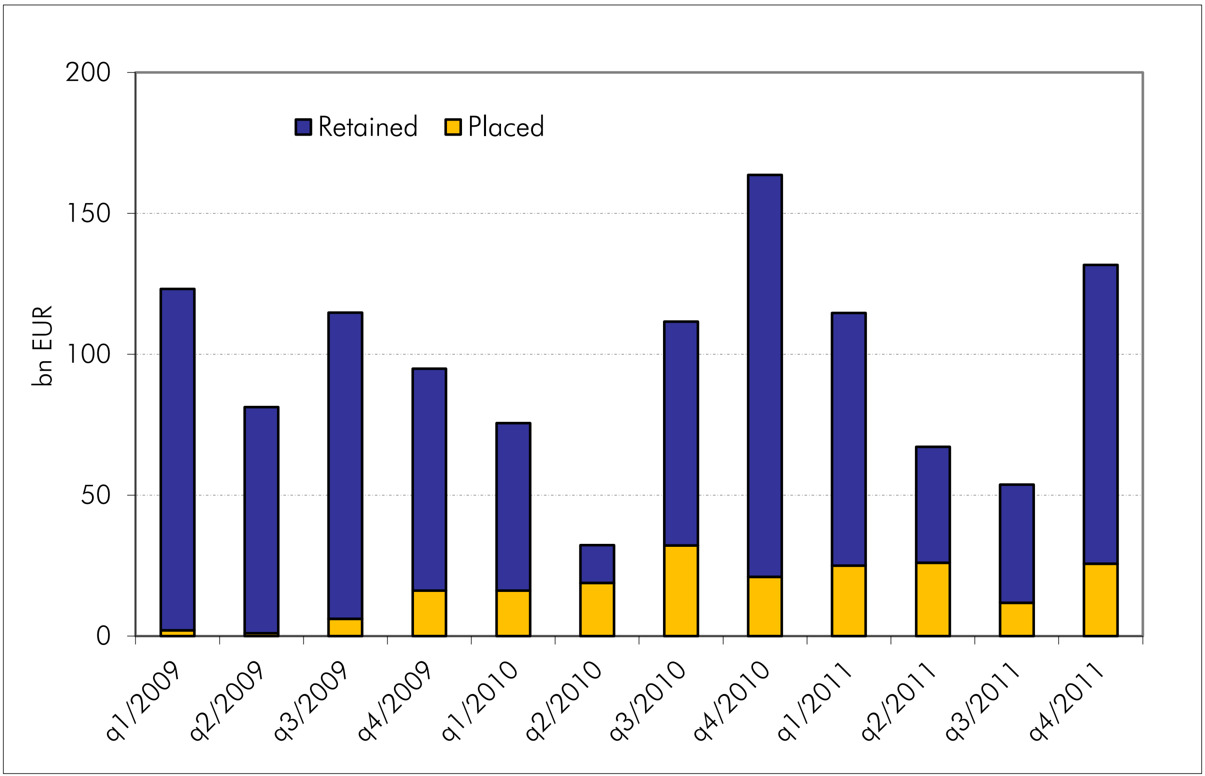
[24]The reader can find a securitisation glossary in Annex 2. The term SME Securitisation (SMESec) comprises transactions based on SME loans, leases, etc. For background information with regard to the importance of SMESec see: Kraemer-Eis et. al. (2010).

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

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

[27]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 23: European securitisation issuance by retention (bn EUR)

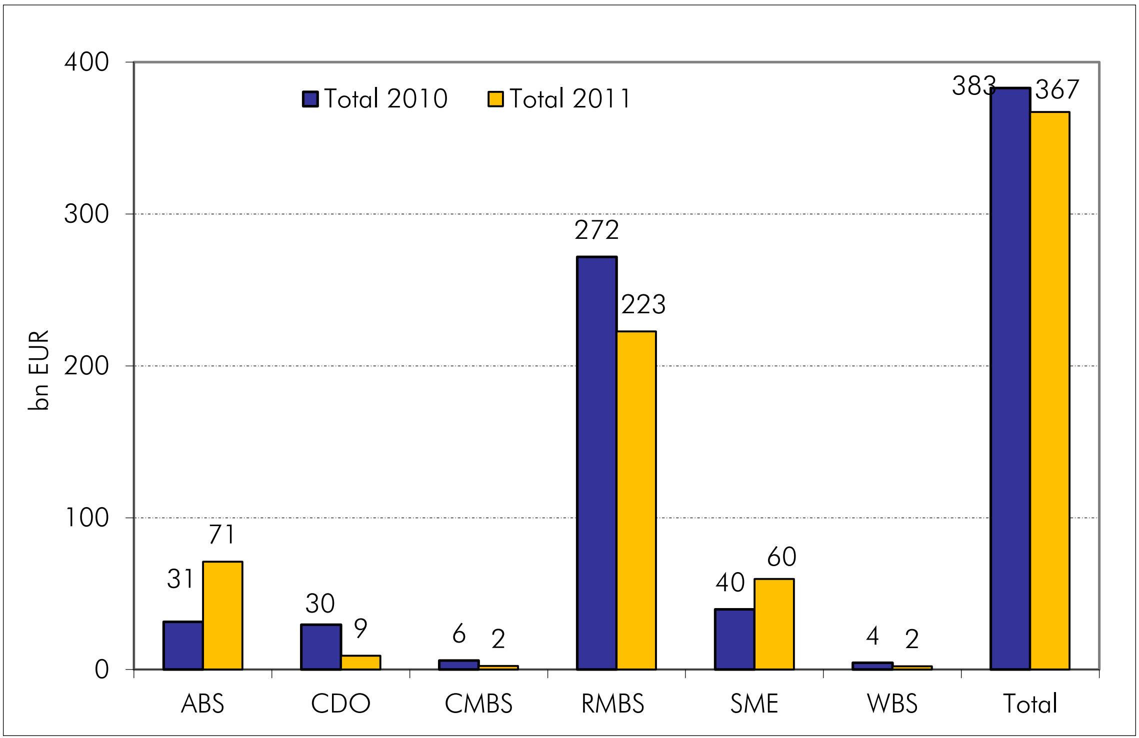


Source: Based on data from AFME (2012)

In 2011 the total securitisation *issuance* in Europe was EUR 367.2bn, compared to EUR 382.9bn the year before (-4%), with the main activity in the UK (EUR 99.5bn), the Netherlands (EUR 85.6bn), and Spain (EUR 44bn).

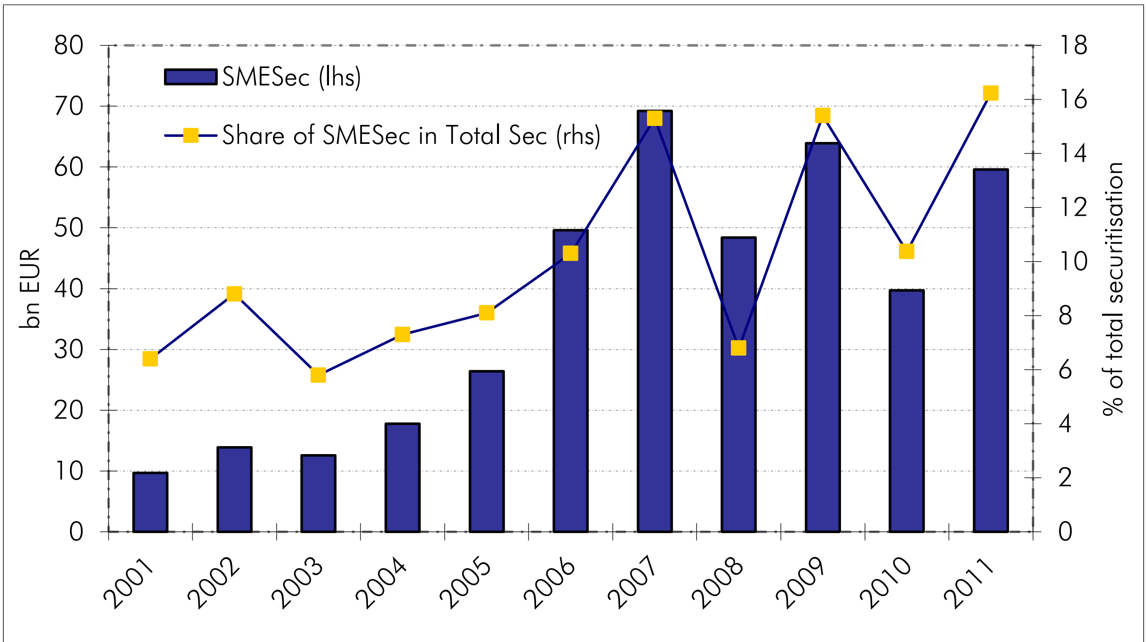
Given the dominance of the securitisation of residential mortgages-RMBS (see figure 24), SMESec remained a relatively limited but important segment of the European structured finance market (between 6% and 16% of total yearly issuance during the past decade). In 2011, the share of SME securitisation was 16.2% (2010: 10.4%), the highest value ever registered in Europe (see figure 25). In terms of volumes, European SME issuance was significantly stronger than in 2010: the issuance increased by 50% to a volume of EUR 59.6bn, compared to EUR 39.7bn the year before. Geographically, the main activity in 2011 was in Southern Europe: Spain (52% of total SME issuance), Italy (28%) and Portugal (12%).

Figure 24: European Securitisation Issuance by collateral (bn EUR)[28]



Source: Based on data from AFME (2012)

Figure 25: SMESec volumes in Europe and share of SMESec in total securitisation

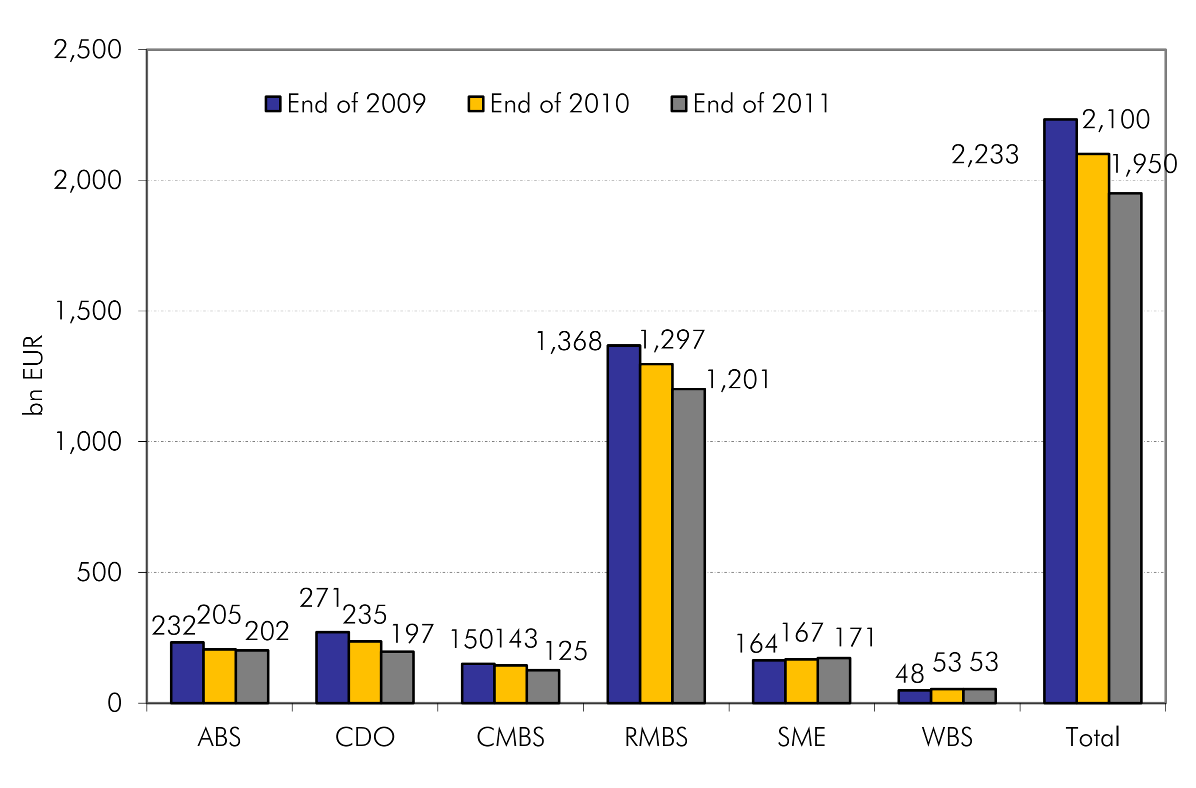


Source: Based on data from AFME and Kf

[28]AFME definitions: European ABS issuance includes auto, credit card, leases, loans, receivables and other. European CDO issuance numbers only include issuance dominated 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.

With regard to the *outstanding transactions*, compared to end of 2010, the total outstanding decreased by 7% from EUR 2,100.1bn to EUR 1,949.7bn (see figure 26).

Figure 26: European outstanding securitisation transactions (by collateral, bn EUR)

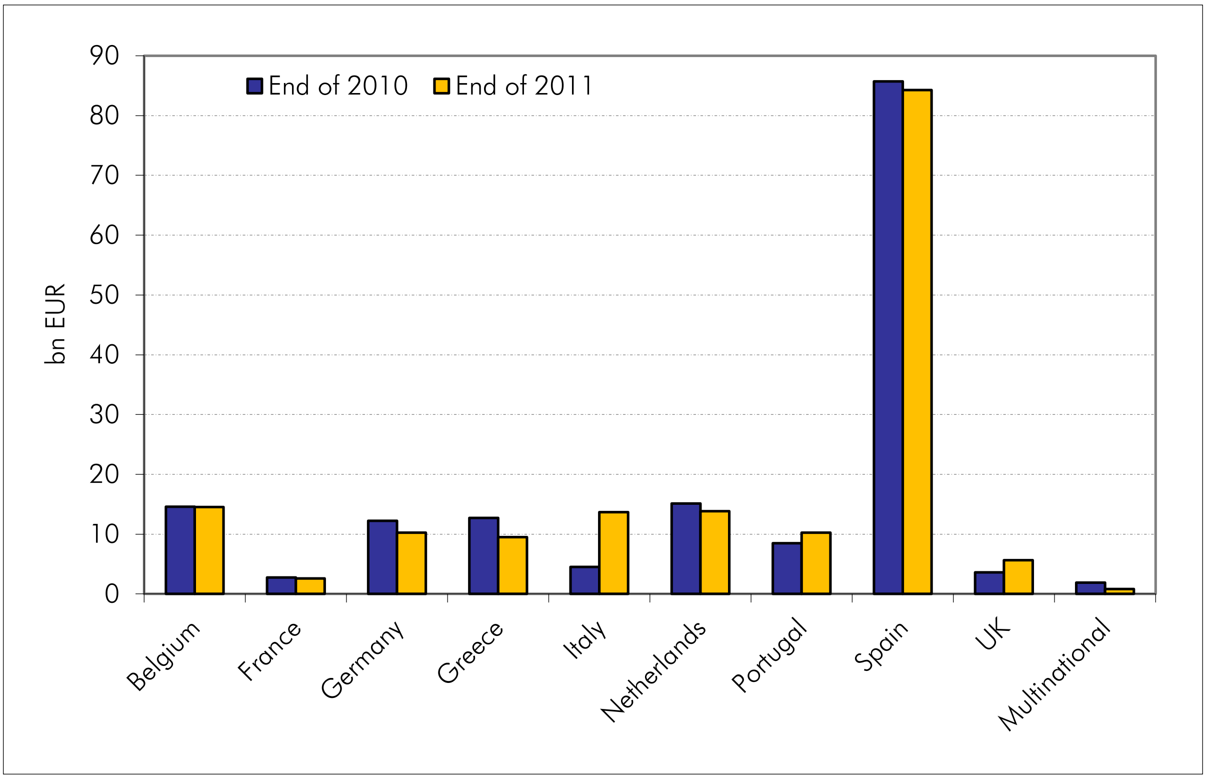


Source: Based on data from AFME (2012)

The regional distribution of the outstanding is similar to the distribution of the total issuance: in terms of volumes UK ranks first (29.2% of the EUR 1.949.7bn), followed by the Netherlands (16.1%), Spain (14.4%) and Italy (10.1%).

Since end of 2010, outstanding SMESec increased slightly, by 3% (from EUR 166.2bn to EUR 171.4bn). If we break down the EUR 171.4bn 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 2010 (see figure 27), with the exception of a relatively strong increase for Italy.

Figure 27: European SMESec outstanding by country (bn EUR)



Source: Based on data from AFME (2012)

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% of European structured finance securities outstanding since then have defaulted; this default rate is well below the one of US pendants (13.1%). For the SME segment, the rating agency registered defaults[29] of 0.2% (Standard & Poor's, 2012b).

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 this year – the performance of SME portfolios is typically dependent on GDP growth trends (see box 4). Moreover, many counterparties in SME related transactions will continue to suffer from the on-going stress in the European banking system (Moody's, 2012b).[30]

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

[30] We discussed the impacts of the sovereign crisis on securitisation transactions in more detail in the previous ESBFO: http://www.eif.org/news_centre/publications/eif_wp_2011_12.pdf.

Box 4: GDP growth trends and SME portfolio performance

Empirically there is typically a close correlation between the business cycle and insolvency figures. Euler Hermes (2011) assumes that there is a high elasticity of insolvency to growth and that 2% to 3% of GDP growth is needed to stem the rise of insolvencies and "a GDP growth reduction of 1 percentage point implies a 5% to 10% increase in insolvencies." (Euler Hermes, 2011). This general pattern has been observed since the early 1990s but has been broken at the peak time of the crisis (2008): the "normal shock" has been intensified by exceptional factors directly stemming from the nature of the crisis and Euler Hermes sees financial constraints, affecting businesses from summer 2008 onwards, behind half of the rise in the 2008 insolvencies. From 2009 onwards, again, economic growth (or its collapse) explains the bulk of the rise of insolvencies (Euler Hermes, 2011).

The dependence of default probabilities on macroeconomic conditions has often been topic of academic research. The analysis of this relationship is also key to understand and forecast the behaviour of credit portfolios and the inherent risk, respectively the possibility to diversify this risk. Some portfolio risk models are trying to capture the macro-micro link of credit risk to bridge the gap between macro-econometric models and credit quality variables. A lot of research and analysis is on-going, within the academic community, the financial industry (including the EIF[31]) and central banks, to further advance the modelling techniques in this area (see Castren et. al., 2009, also for a brief overview of approaches).[32]

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. According to AFME data, Moody's adjusted in 2009 4,128 European securitisation ratings – with 98% being downgrades; in 2010 80% of the Moody's rating adjustments were downgrades (out of 826) but in 2011 upgrades became the majority (with 58% out of 2,183). However, this picture is not uniform across the rating agencies – Standard & Poor's and Fitch's rating adjustments are still mainly downgrades (2011: S&P's - 80% downgrades out of 2,467 rating changes/Fitch 81% downgrades out of 888 rating changes).
- the image of securitization is still damaged (with related negative impact on the image of SMESec as well[33]), i.e. due to the understandably bad reputation of the US sub-prime products.

With regard to SME transactions, figure 28 depicts cumulative credit events (or defaults) on original balance (OB) by vintage for the EMEA region[34] (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 as well as early defaults in more recent vintages).

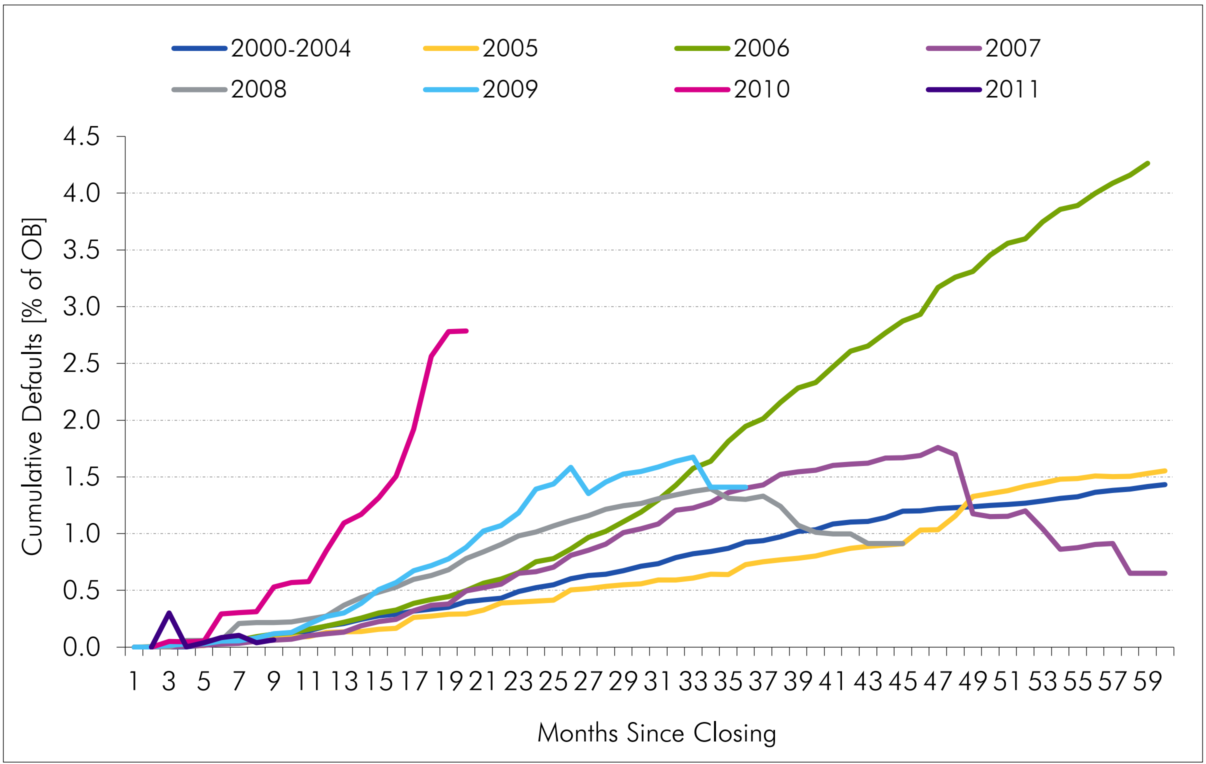
[31] In cooperation with the University of Luxembourg.

[32] See Standard & Poor's (2012a) for an analysis of macroeconomic variables and European structured finance rating movements.

[33] 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, Tappi, 2010).

[34] 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 28: EMEA ABS SME cumulative credit events or defaults on OB (seasoning by vintage)[35]

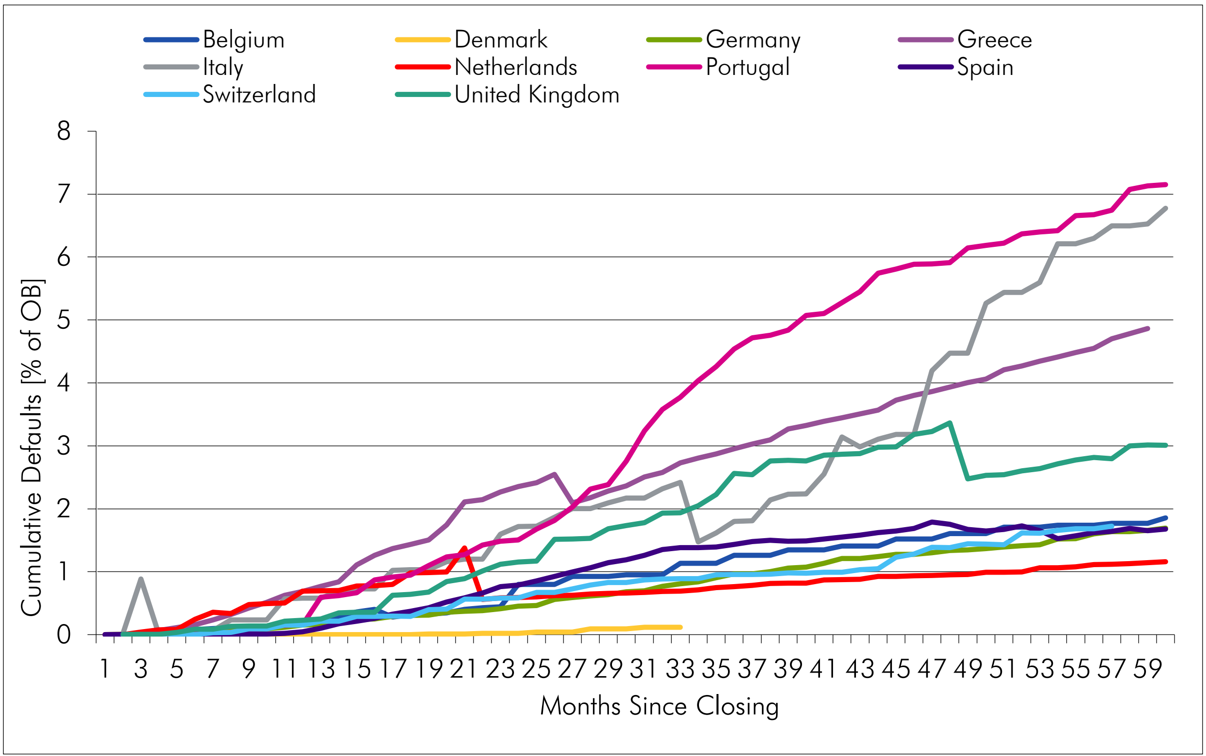


Source: Moody's (2012a) EMEA ABS SME Indices

However, the performance differs from country to country (see figure 29). Moody's e.g. reports that the performance of EMEA SME ABS transactions in 2011 was varied, with especially weak trends in Portugal, Greece and Italy and with stable trends in the Netherlands and Germany. Also Moody's outlook for SME ABS transactions is, based on weak economic fundamentals, negative for Greece, Portugal, Italy and Spain (Moody's, 2012a,b and Deutsche Bank, 2011).

[35] 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.

Figure 29: EMEA ABS SME cumulative credit events or defaults on OB (seasoning by country)



Source: Moody's (2012b) EMEA ABS SME Indices

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, 25% (by number) have paid in full (pif), 40% are still AAA, 4% moved to AA etc.

Table 2: Fitch European SMEs Rating Transition Matrix (May 2012) [36]

% of tranches		Current rating									
		PIF	AAAsf	AAsf	Asf	BBBsf	BBsf	Bsf	CCCsf	CCsf	Csf
Initial Ratings	AAAsf	25%	40%	4%	18%	9%	3%	1%	0%	0%	0%
	AAsf	8%	8%	26%	15%	8%	13%	15%	3%	5%	0%
	Asf	2%	0%	6%	47%	9%	15%	11%	6%	2%	2%
	BBBsf	0%	0%	0%	5%	17%	21%	10%	26%	14%	7%
	BBsf	0%	0%	0%	0%	3%	23%	20%	23%	17%	13%
	Bsf	0%	0%	0%	0%	0%	10%	70%	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 (2012)

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

5.3 SMESec prospects

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 (Moodys, 2012b). In this report 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. Securitisation remains an important tool for the refinancing and risk/portfolio management of banks. Going forward, 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 (i.e. in the context of CRD IV and Solvency II) 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.

During the crisis we have seen a clear and on-going tendency towards simpler transactions and improved transparency. 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. This attempt will make more information available to market participants and may contribute to the re-start of the markets – however, as always if medicine shall help: it is a matter of doses and too many details can make securitisations too complex. Moreover, there are market driven initiatives to introduce quality standards, i.e. the Prime Collateral Securities (PCS) initiative, supported by EIF, aims at establishing certain SME securitisations as a brand with key attributes such as quality, simplicity, transparency and liquidity.

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, we are of the opinion that 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 (against this background we are planning to provide a working paper on SME leasing in the forthcoming months).

6 Microfinance

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).

The European microfinance market is still a young and quite heterogeneous sector, due to the diversity of legal frameworks, institutional environments and microfinance providers in European countries. Only recently, the European Commission published a European code of good conduct which contains recommendations and standards for the provision of microcredit in order to foster best practice in the microfinance sector (European Commission, 2011a).

Standardised, regularly available indicators to explain market developments for microfinance in Europe do not yet exist, or focus on Eastern Europe. A new version of the bi-annual European Microfinance Network (EMN) overview report is currently in preparation and will be covered in the next edition of the ESBFO. Thus, we will focus in this section on the framework conditions for microfinance which are covered by the regularly updated Eurostat indicators for poverty and social inclusion, and by data on micro-enterprises.[37]

One part of the Europe 2020 strategy[38] 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

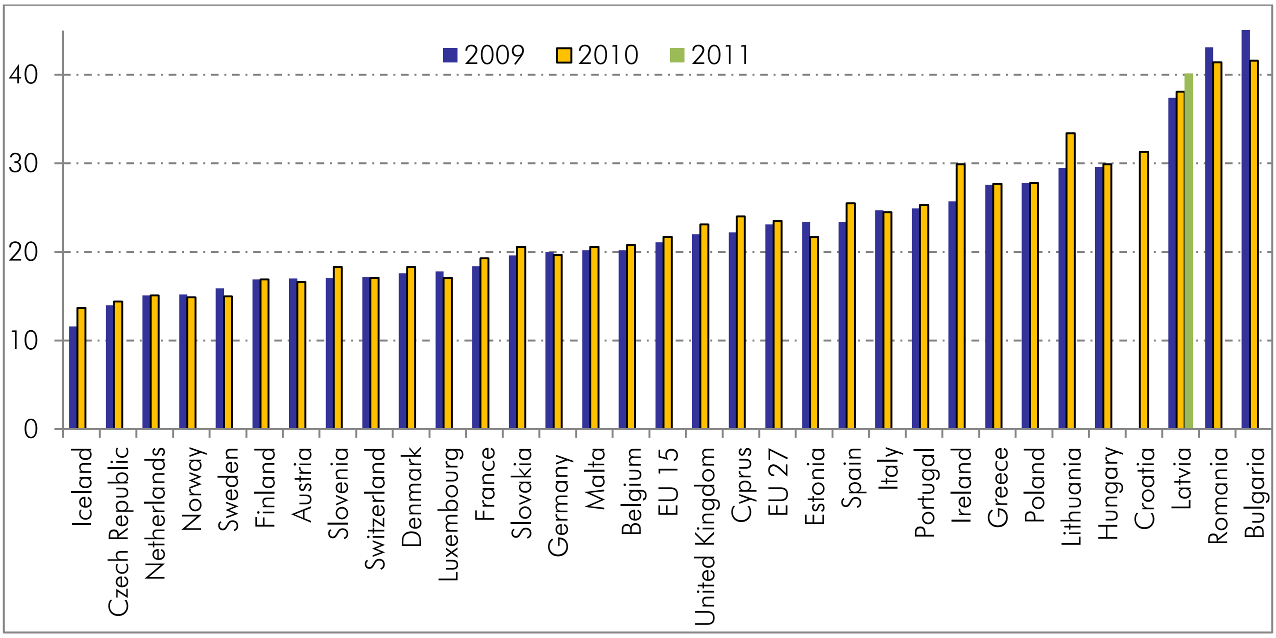
[37] For a general overview of the European microfinance market we refer to the EIF working papers 2009/001, see http://www.eif.org/news_centre/research/EIF_WP_2009_001_Microfinance.pdf, and 2012/13, see http://www.eif.org/news_centre/publications/eif_wp_2012_13_microfinance.pdf.

[38] 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.

social inclusion and combat discrimination" including improvements in the use of microcredits (e.g. via the JASMINE initiative and PROGRESS financial instruments).[39]

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" as 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".[40] Figure 30 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).[41]

Figure 30: People at risk of poverty or social exclusion (percentage of total population)



Source: Eurostat[42]

[39]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.

[40]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

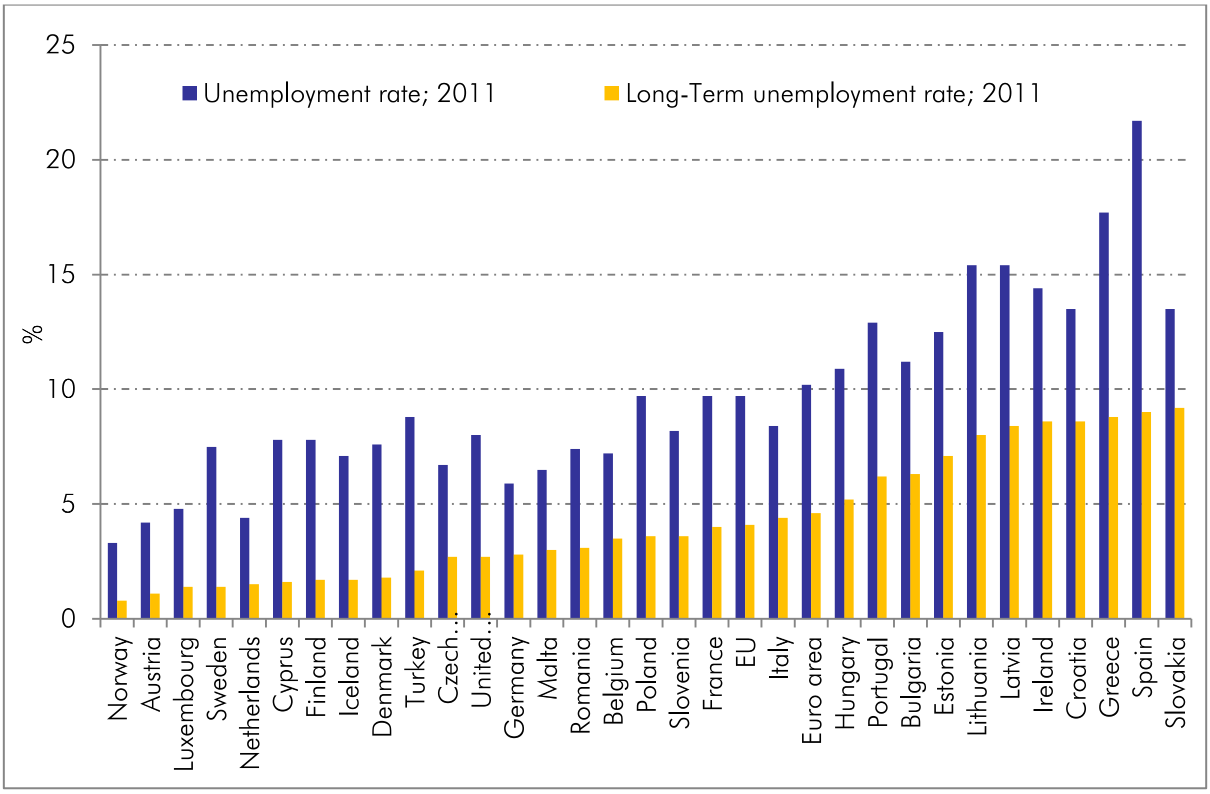
[41]Persons are only counted once even if they are present in several sub-indicators. At risk-of-poverty are persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers). Material 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

[42]2011 data so far only available for Latvia.

In Eastern Europe, the incidence of poverty or social exclusion is greatest, although the difference between the EU15 and EU27 figure is relatively small. When comparing 2010 to 2009, the situation became worse in most of the countries. Within the EU, the largest aggravations were observed in Ireland, Lithuania and Spain. Remarkable improvements were recorded for Bulgaria, Romania and Estonia, however, they can still be found on the right-hand side of the diagram which is the case for most parts of Eastern Europe as well as for those West and South European countries which are suffering most from the impacts of the current sovereign debt crises (Greece, Ireland, Spain, Portugal, and Italy).

Figure 31 shows another indicator of social welfare, the unemployment rate and the long term unemployment rate. In 2011, several EU Member States (in particular Greece and Spain) showed significant deteriorations in both figures compared to the year before while other countries (e.g. Estonia, Belgium 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 31: Unemployment rate and long-term unemployment rate

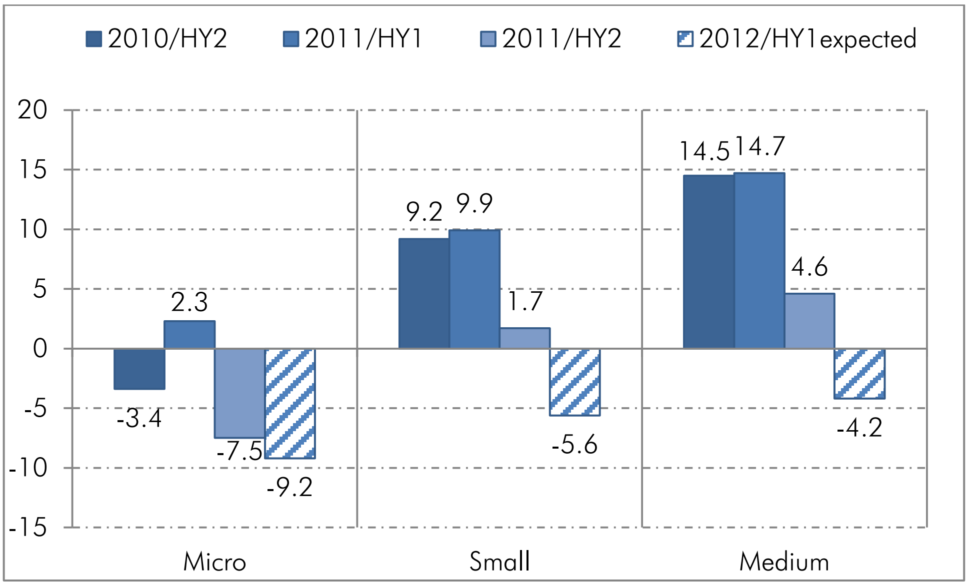


Source: Eurostat

The relatively poor performance of East European EU member states in social welfare indicators is in part why there is a tendency for microfinance in this region. Some surprising exceptions are likely to be due to the generally larger size of the informal economy in this part of Europe, and the less widespread incidence of benefits, making people less likely to register as unemployed.

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 substantially less favourable than small or medium sized firms in the second half of 2011 (see figure 32). In contrast to the other enterprise size classes, the share of micro-firms which stated a deteriorated situation was larger than those having reported a positive development. Moreover, micro-enterprises expected on balance a further deterioration of their business situation for the first half of 2012. Similar results were reported for the survey questions on turnover and orders in the second half of 2011. All in all, the figures reveal stronger difficulties for micro-enterprises than for other SMEs.

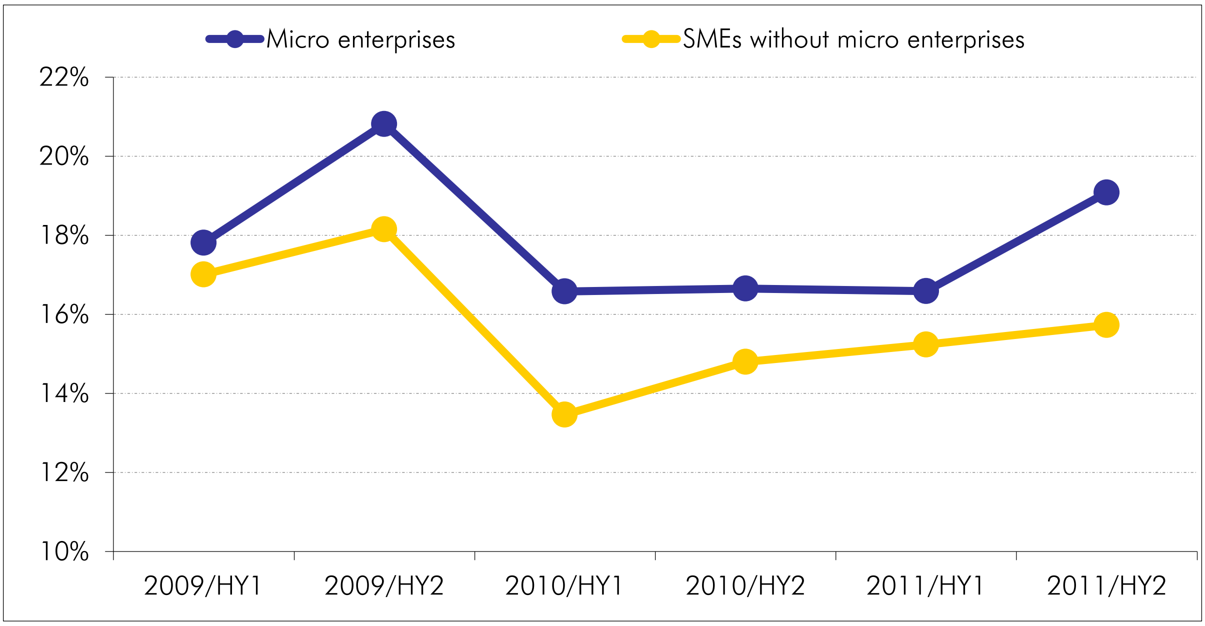
Figure 32: Overall situation of European micro-firms compared to other enterprise size classes



Source: 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 most recent survey period (see figure 33). In line with this development, the ECB (2012c) recently also stated a significant increase in the bank loan rejection rate for micro firms (from 15% to 20%, compared to an increase from 10% to 13% for all SMEs and a stable rejection rate at 3% for large firms).

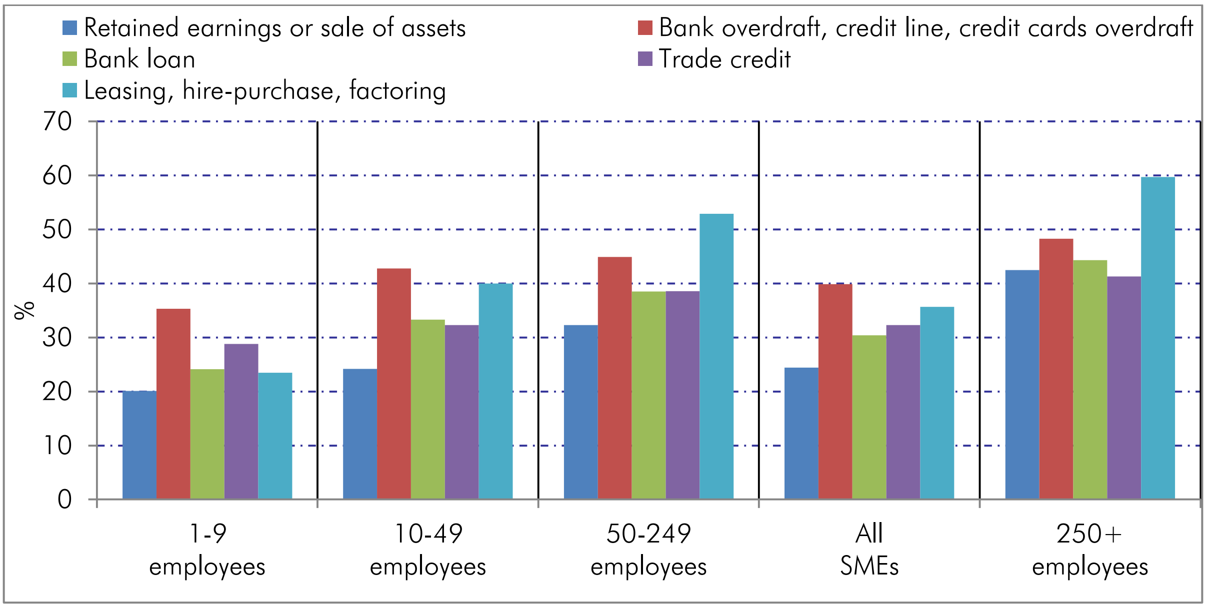
Figure 33: Share of enterprises reporting access to finance as their most pressing problem



Source: EIF, based on ECB data[43]

Difficult access to finance, in particular to bank loans, might be one key reason why micro-enterprises in the EU use bank loans and other external financing sources considerably less than other SME size classes. Figure 34 shows that the usage of different financing sources increases on average with the size of the SME.

Figure 34: Enterprises having used different financing sources (by enterprise size class)
(over the preceding six months; percentage of respondents; survey conducted from Aug. to Oct. 2011)

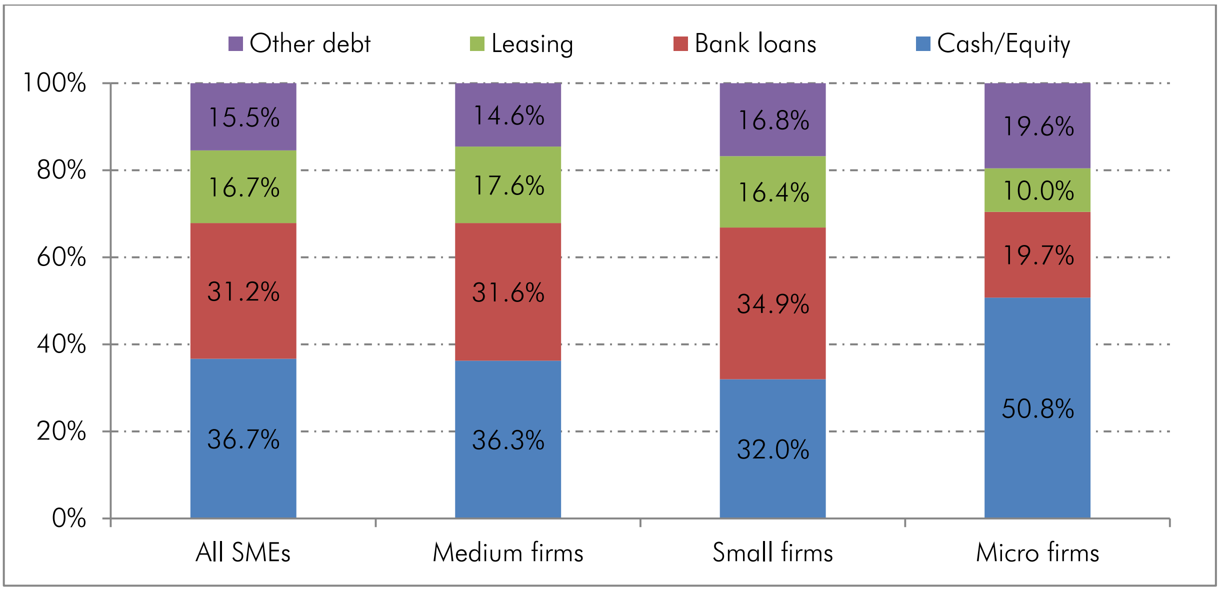


Source: European Commission (2011b)

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

When looking at the actual investment sizes financed by different sources the picture becomes even clearer. According to Oxford Economics (2011), the investment shares which micro-enterprises finance by bank loans or leasing are much smaller than for other SME size classes (see figure 35). Based on the ECB (2012c) results described above, this might be explained by the more difficult access to these financing forms for micro-firms.

Figure 35: Proportions of SMEs' Fixed Asset Investment financed by different sources in 2010



Source: Oxford Economics (2011)

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 perspectives of the sector with regard to growth and self-sufficiency are limited. We discussed the rationale for public support in the microfinance area in our previous working paper[44] and explained the chosen approach for the Progress Microfinance mandate as support on European level. This 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.

Through the implementation of Progress Microfinance we receive regulator updates from financial intermediaries regarding the demand for microcredit throughout EU27. Progress Microfinance now covers 12 countries with the largest projected microcredit volumes in Romania, Greece and Poland. Non-bank MFIs have been the most active lenders in the initial phase of Progress Microfinance. As of end-March 2012 more than 75% 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.

[44] 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 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.

With regard to the *securitisation market*, the revitalization and further development of SMESec is pivotal for the future growth of SME financing. We expect that SME securitisation will be particularly relevant in the leasing area. Properly applied SMESec can enhance access to finance for SMEs and it is a replicable tool for SME support that provides a multiplier effect; i.e. the investing in/guaranteeing of relatively small (mezzanine) tranches facilitates the securitisation of much higher volumes and is as such an efficient way of deploying public sector support.

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. However, without the access to stable funding, the perspectives of the sector with regard to growth and self-sufficiency are limited. 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/ESF: Association for financial markets in Europe/European Securitisation Forum
- BLS: Bank Lending Survey
- bp: basis point(s)
- CDO: Collateralized Debt Obligation
- 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
- EIM: EIM Business & Policy Research (www.eim.nl)
- EMEA: Europe, Middle East, and Africa
- ESBFO: European Small Business Finance Outlook
- 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
- GDP: Gross Domestic Product
- GP: General Partner
- IFC: International Finance Corporation
- IMF: International Monetary Fund
- IRR: Internal Rate of Return
- JASMINE: Joint Action to Support Microfinance Institutions in Europe
- LBO: Leveraged buy out
- LP: Limited Partner
- LTRO: Longer-term refinancing operations
- MFI: Monetary Financial Institution
- M&As: Mergers and acquisitions
- MENA: Middle East and North Africa
- NFC: Non-financial corporation
- NGO: Non-Governmental Organisation
- NVCA: National Venture Capital Association
- OECD: Organisation for Economic Co-Operation and Development
- PE: Private Equity
- RMBS: Residential Mortgage Backed Securities
- SIFMA: The Securities Industry and Financial Markets Association
- SIV: Structured Investment Vehicle
- 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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