



Research note on market-based long-term financing solutions for Small and Medium Enterprises (SMEs) and infrastructures. November 2014.

IOSCO has published, on the 29th September, a research note describing a compilation of recent examples of capital market solutions that have contributed to the financing of Small and Medium Enterprises (hereinafter SMEs) and infrastructure projects, that has been prepared for the G 20 Finance Ministers and Central Bank Governors. The banking sector reduced ability to grant long-term financing (hereinafter) since the global financial crisis and the limited public funding have produced a gradual shift from an almost exclusive bank-funded model towards a model that includes a greater share of capital market-based funding.

IOSCO Board mandated the preparation of this note to the Long Term Financial Task Force (LTFTF) created in November 2013 with the participation of Spain (CNMV). The LTFTF has reviewed numerous projects from both emerging and developed capital markets and has selected 20 examples of successful market-based financing solutions for PYMES and infrastructures due to its innovative features, size, and impact of LTF provision, ability to be replicated and geographic diversity.

The report is divided into solutions of LTF for SMEs, on one hand, and for infrastructures, on the other hand. SMEs play an important economic role (sustainability of employment and contribution to GDP) but also are attributed a relatively higher risk because of their limited scale and heterogeneity within investors. Infrastructure projects cannot currently be undertaken only by the public sector and the growing funding gap is a major concern globally due to the consequent damage to the economic activity, so that private capital should be channeled in support of infrastructure through the capital markets. The note classifies **the funding solutions for SMEs and infrastructures in four market segments: equity capital market, debt capital market, securitization and collective investment vehicles**, and concludes with **common and specific conclusions** observed in the financial solutions described.

A) Market-based solutions for SMEs.

.- Equity capital markets: three are the case studies all of which involve multi-tiered markets designed to address the capital raising needs of SMEs of various sizes and at different stages of development.

- Neeq-China: The latest addition to this type of multi-tiered market is the National Equities Exchange Quotations (NEEQ) in China that adds flexibility for SMEs so that they trade on a regulated market. As of 30 June 2014, 881 were listed on NEEQ with a total capitalization of 30.6 billion dollars.
- TMX-Canada: The TMX Group Limited manages the Toronto Stock Exchange (TSX) which is focused on large and medium-sized issuers and the TSX Venture Exchange (Venture) which is the equity market for SMEs. The system allows to transit from Venture to TSX in simplified form. As of 30 June 2014, there are 2,042 companies listed on Venture with a market capitalization of 32.9 billion dollars. As of 31 December 2013, 339 issuers listed on TSX had first been listed in Venture.
- Capital Pool Company (CPC) Program-Canada: consists of an initial public offering (IPO) and a Venture listing obtained by a newly created company which has only cash and has not yet commenced commercial operations. The funds raised under the IPS are then use to acquire assets that, once acquired, will qualify the resulting issuer for a regular listing on Venture. Over 2,400 institutions have used the CPC program and 84% have completed their acquisitions. 663 companies trading on Venture and 90 companies on the TSX began as a CPC.

.- Debt capital market: There are two case studies of debt capital market solutions.

- **SME Loan Asset-backed Securities (ABS) Quadrevio- Europe:** is an initiative launched by the European Investment Bank (EIB) in association with the European Investment Fund (EIF) to support enhanced debt finance to SMEs that involves the securitization of SMEs loans so risk is transferred from the originating banks to the capital market. The total issuance of the ABS amounted 390 million euros (541 million dollars) by June 2014.
- **Microcredit Alibaba-China:** Alibaba provides unsecured micro-lending to SMEs vendors on its internet and mobile commerce platforms as well as its payment processing arm. Outstanding loans are packaged into asset-backed securities tradable on the Shenzhen Stock Exchange. Up to June 2014, Alibaba provided lending services to over 800.000 customers with a cumulative notional value of over 32.2 billions dollars.

.- Securitization: there are four case studies described. The originator is able to advance future payments of the outstanding credits granted to PYMES that are packaged into asset-backed securities and assign it for a fee to a third party who places the issuance of different classes of securitized loans in the capital market. The originator is not required to provision for credits yielding thereby it increases its financing capacity.

- **SME Leasing Mittelstand-Germany:** involves the securitization of receivables from equipment lease contracts between SMEs and the leasing company, IKB Leasing GmbH (IKBL). The total emission of the securitized assets is 227.3 million euros divided into three classes: Class A (196 million), Class B (13 million), and Class C (18.3 million), having the EIB invested in Class A tranche which provided IKBL with financing amounting 97 million euros (129 million dollars).
- **Trade Receivables Trafigura-Europe:** is the securitization of trade receivables relating to obligors (PYMES) that have ask Trafigura for loans for the purchase of key commodities in their production process. Currently the Trafigura securitization program -the largest of Europe- is funding up to 3 billion dollars.
- **Franchise royalties Domino's-USA:** is the securitization of the rights to future cash flows generated from franchise assets to a separate legal entity (Domino's Pizza Master Issuer) who in turn issues securities to investors. Approximately 96% of Domino's stores are franchised with the majority of franchisees being SMEs. In 2012, Domino's Pizza Master Issuer raised 1.675 billion dollars in a private placement transaction.
- **Auto Loan Hyundai-Korea:** is the securitization of auto loans originated by credit specialist companies such as Hyundai Capital Services (HCS). The SME portion of auto loans and installment in the pool is usually around 10% in cross-border transactions and about 70% for domestic transactions. This type of issuance is well received by international institutional investors and, over the years, HCS has sourced around 15% to 20% of its total funding requirements from the ABS market.

.- Pooled Investment Vehicles: there is one example under this category.

- **Listed SME Investment Vehicle-USA:** The Business Development Companies (BDC) are closed-end investment funds whose shares are listed on the US national exchanges. They invest primarily in SMEs and provide managerial assistance to SMEs and other financially troubled business. The BDC have approximately 70 billion dollars in assets under management as of June 30 2014.

B) Market-based solutions for infrastructures.

.- Equity capital markets: there are two equity markets solutions in this note.

- **Asset Spinoff YieldCo-USA and Canada:** YieldCos are created through the spin-off of a power generating asset class of a power producer that have a more stable cash flow profile resulting from credible long-term power purchase agreements and cost structures that are less cyclical. YieldCos have become an emerging asset class in North America and its relative stability and growing dividend make them attractive to investors.
- **Infrastructures Projects Corporation Initial Public Offerings (IPOs)-Malaysia:** The Infrastructure Project

Corporation (IPC) makes public offerings of their shares on the basis of government concessions secured by an infrastructure project company rather than solely considering parameters such as a track record of profitability. During the Asian financial crisis in 1997, 1.47 billion dollars was raised via IPC listings.

.- Debt capital market: The note includes four case studies.

- **Municipal bonds Lagos State-Nigeria:** a legal framework was established in order to boost investor interest and confidence in the purchase of these municipal bonds including the creation of a sinking fund to increase the certainty of payments to bondholders. The Lagos State launched a bond program amounting to 2.32 billion dollars in 2008, with two issuance series to finance various infrastructural projects.
- **Sukuk-Islamic countries:** Sukuk are generally referred to as Islamic bonds, but are essentially an asset-based investment whereby the sukuk investor owns an undivided interest in an underlying asset proportionate to the investment and earns a return on that asset, so that the element of interest which is not permissible under Shariah is eliminated. TNB Western Energy Berhad Sukuk issued a Sukuk worth 1.09 billion dollars to finance the construction of a power plant in Malaysia.
- **Project Bond Initiative (PBI)-European Union:** is a European Union initiative and consist in enhancing the credit of senior secured project bonds to achieve a credit rating that would be attractive to institutional investors which enables the financing of infrastructure at lower cost. For 2020, the EIB expects that PIB will mobilize up to 4.6 billion euros (6.3 billion dollars).
- **Sector Specific Bonds-green bonds-worldwide:** they are fixed-income securities that raise capital for a project or projects with specific environmental benefits. The market has been dominated by supranational organizations like the World Bank but, in recent years, the private corporate sector has begun to issue green bonds in considerable volumes. The Climate Bond Initiative, a nonprofit organization based in London, estimates that the overall green bond market will reach 40 billion dollars in 2014 and 100 billion dollars by 2015.

.- Securitization: There is one case study under this category.

- **Low income Housing Infonavit Fovissste-Mexico:** is the securitization of the mortgage loans portfolio by Fovissste and Infonavit which are funded through mandatory payroll contributions (5% of salaries and wages) from private sector and government employees. This structure provides an important source of mortgage funding for low and middle-income borrowers and assists in meeting housing policy objectives.

.- Pooled Investment Vehicles: there are three case studies described in the note.

- **ASEAN Infrastructure Fund (AIF)-East Asia:** is an innovative regional co-operation and integration promoted by the Association of Southeast Asian Nations (ASEAN) to fulfill the large infrastructure financing in the region. It is expected that AIF, with the participation of the Asian Development Bank (ADB), will generate long-term financing exceeding 13 billion dollars by 2020.
- **Emerging Africa Infrastructure Fund EAIF-Sub Saharan Africa:** The EAIF addresses infrastructure financing and other projects that promote economic growth and reduce poverty. The EAIF has capacity to make investments in infrastructure in the long term (15 years) and has grown to become a 587.02 million dollars fund in 2014.
- **Fund of Pension Funds IFM-Australia:** IFM is an investment owned by 30 of Australia's largest industry-based superannuation funds and is one of the largest infrastructure investors in the world with total funds under management of 17.9 billion dollars.

C) Conclusions

The gap between the supply of and demand of LTF for SMEs and infrastructure can be observed in developed and

emerging markets around the world. In order for the real economy to be less reliant on traditional bank financing, it is necessary to develop stable funding sources based on the markets. Securitization is the segment that has experienced a significant setback and its recovery needs and appropriate regulation and supervision and a structure based on well identified and transparent underlying asset pools with predictable performance.

.- A non-exhaustive list of **common conclusions** extracted from themes observed on financing SMEs and infrastructure cases is the following:

The regulatory framework directly impacts the ability of SMEs and infrastructure project companies to access the capital market, so it shows **the need for regulatory changes**. Regarding SMEs, recent trends have indicated that SMEs have not accessed the capital markets, so the needed regulatory changes should promote that access like including multi-tiered equity markets (such as NEEQ-China and the Canadian TMX markets) or improving investor protection through enhanced disclosure and the establishment of suitability requirements for investors. Related to infrastructure project companies, listing requirements are tailored to provide alternative route for the direct listing of these companies. Some incentives have also been utilized to influence issuers and investors for their participation in SME and infrastructure financing, for example: i) commercial banks benefit from regulatory capital relief by issuing ABS of SME loans, which is the case of Quadrivio; and ii) the eligibility of Lagos State bonds as liquid assets increases institutional participation that could benefit from favorable treatment for the purpose of calculating their liquidity ratios.

All of the examples in the note successfully show **improving financing conditions** caused by different reasons: i) catering to existing investors' needs, for example, YieldCos, BDC and IPC cater to the needs of the dividend growth investor base, sukuk and green bonds are tailored products that can fulfil specific niche investor requirements generally institutional investors, and IFM caters to the needs of pension funds to invest in assets that generate stable income over a long period; ii) accessing a wider investor base, Hyundai, Trafigura and Mittelstand have widened their investor base by securitizing underlying assets with stable cash flows, and capital markets (Neeq-China, TMX-Canada, IPC, BDC, and the CPC Program) provides issuers with a wider range of investors including retail investors; iii) developing of new investors/intermediaries (AIF, EAIF, IFM, Fovisste and Infonavit); and vi) the development/establishment of new markets, such as the municipal bond market in Lagos State or securitization markets like Quadrivio and Alibaba.

The **role of governments and development banks**. Governments can help catalyze the market for SME securities by encouraging institutional investor participation and development banks could increase their participation in the ABS market enhances the perception of the market and attracts new investors, such as in the case of Quadrivio. About infrastructures, intervention by development banks and governments to co finance and stimulate the private funding sources. A mixture of public and private funding sources using private sector fund management is the solution as showcased in the case studies of AIF, EAIF, PBI and Lagos State Bond. While most of the examples represent national attempts, new initiatives as the AIF or EAIF have also started developing at regional level. In the European Union, the Regulations on European Social Entrepreneurship Funds (EuSEF) and on European venture capital funds (EuVECA), along with the future Regulation on European long term investment funds (ELTIF) aim to promote long-term investments in real economy.

Increased information transparency and reliance on partners with specialized knowledge and information are key elements to resolve **the challenges of dealing with third parties to provide services (deal sourcing and due diligence)**. For example, NEEQ-China, TMX Canada, IPC and YieldCos require standardized initial and ongoing public disclosures of information, Alibaba uses data from its e-commerce platforms to assess potential borrowers for credit approval, the CPC program is used by individuals with successful track records of deal sourcing, and the BDC case illustrate how experience teams rely, at least, partially, on partners who have existing relationships and data CE requires the participation of people with proven experience and decisions investment, of the BDC are based, at least in part, on the expertise of partners who have existing relationships and data on borrowers.

. The **SMEs specific findings** themes are the following:

Micro-credits pools and securitization automated process of loans allows for **economies of scale**. Alibaba pools and securitizes outstanding SMEs loans which in turn allow it to grow its micro-lending operations. For the Domino's franchise securitization, standardization is enables the franchisor to raise funds from the capital market. In the case of Hyundai, Mittelstand and Trafigura, standard types of credits are provided to their SMEs customers and funds are raised through pooling a large number of loans.

SMEs are generally perceived to be riskier investment than larger corporations and their assets may be unsuitable for use as collateral, so **mechanisms for risk management** should be placed. The examples above have provided

solutions to these challenges: i) collateral-based financing, Quadrivio, Hyundai, Trafigura and Mittlestand use tangible assets as guarantees, while Domino's use intangible assets (franchise royalties) ; ii) retention of first loss by the issuer, in all of the securitization example, the first loss risk is retained by the issuer; iii) credit enhancement, in the case of Quadrivio, the senior tranches of ABS backed by the SME loans received higher ratings due to the provision of EIF guarantees; and iv) loan monitoring and recovery, for example, Alibaba is able to monitor and automate early risk warnings using data from its integrated electronic platforms.

.-The **infrastructure specific findings** themes are the following:

Infrastructure projects are perceived to be risky due to their long duration, complexity and the presence of a number of risks (political, operational, and interest rate) and, accordingly, the availability of LTF has been cut. Despite these difficulties, examples of the report serve to conclude that: i) public equity issuances (YieldCos and IPC) can be permanent sources of financing capital; ii) Islamic bond or Sukuk is a viable alternative to other bonds of long-term debt; iii) collective investment vehicles with permanent capital contribution (EAIF and IDA) may be an alternative source of funding; iv) the IFM increases the availability of LTF by pooling and investing pension fund assets; v) green bonds serve to fulfill specific social responsibility purposes.

The **lack of knowledge and experience** are obstacles that, given the complexity of the infrastructure funding, may deter investors. EAIF uses an external fund manager and works with the largest commercial bank in Africa, AIF leverages the operational and technical expertise of its partner, the Asian Development Bank and the IFM has grown, over the years, its own investment and support operations for infrastructure investing.

The perceived high risk related to infrastructure projects can be overcome through **mechanisms of risk management and risk sharing arrangements with the private sector**. YieldCos includes only assets that have eliminated certain risks and are expected to generate more predictable cash flows, EAIF provides a system of risk-sharing where equity contributions from public sources serve as a first loss protection for private investors, and the Sukuk example, investors are assured of repayment through the use of guarantees from the parent company. The deduction of cash flow at the source (Lagos State bonds, and Foviste infonavit) increases the certainty of repayments to investors. In addition, in order to attract foreign capital, Lagos State Bonds and EAIF both have currency hedging mechanism in place.

The **challenge for large-scale infrastructure projects** is the management of communications and relationships with a large group and usually very diverse investors. Some of the cases in the report illustrate methods of pooling capital from either a heterogeneous or homogeneous set of investors, for example, AIF, EAIF MFIs and green bonds.

If you want to read the complete research note on market-based long-term financing solutions for SMEs and infrastructures, please, click here: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD452.pdf>