BEST PRACTICES POLICIES

INNOVATION ON SME FINANCING

I N O F I N

THE PORTUGUESE FRAMEWORK PROGRAM

IAPMEI

Parcerias para o Crescimento

Portuguese Agency for SME and Innovation

CONTENTS

SUMMARY

The INOFIN Framework Program, implemented in Portugal during the last two years, has a goal to contribute for the national economic development, improving the general conditions of the financial markets and providing sound and integrated programs to entrepreneurs and companies that promote innovative processes.

INOFIN is based on the principle well recognised that in order to overcome the incomplete nature of the financial markets, the answer is not to focus on direct allocation of public money such as cash grants or subsidies, but to favour elements that will promote efficient bank intermediation and involve the full range of the equity markets.

Assuming public and private partnerships, based on existing market players and on state funded mechanisms, both financial and non-financial actions were established to promote access for SMEs to alternative and innovative financing solutions, namely through the following measures:

- Establishment of 2 billion euros credit global lines with banks, combined with risk-sharing instruments, to reinforce the availability of funding for certain targets and improve the conditions, namely in terms of price and maturities;
- Co-investment and risk-sharing mechanisms available to the venture capital industry, that currently has an annual investment capacity of around 100 million euros - less than 0.1% of the GDP;
- Encourage 100 talent entrepreneurs along the company creation process (FINICIA Program) and 500 fast growing companies (FINCRESCE Program), to reinforce internal capabilities and gain financial leverage, through customized financial and more qualitative tools made available in partnership with local networks;
- Launch of an awareness program for 2.000 companies regarding the impacts of the adoption of the new Basel II rules in SME financing;

- Create objective conditions through a new legal and fiscal framework, as well as investment readiness programmes associated with 12 deal flow origination platforms, for an increasing number of companies to participate in the equity markets arena;

- Support the appearance of new market players, such as one technology transfer accelerator, the first 6 business angels networks, 2 corporate ventures, 2 independent asset managers, and 2 junior capital markets.

INOFIN is a long term Program that assumes the financial system or the overall economy financing model as an operating spectrum, and the incomplete nature of the financing markets as reason for taking action in favour of Portuguese SMEs.

1 CONTEXT

1.1 SME: Key Players in the Economy

The current dynamics of global economic integration, resulting in highly significant changes to the market structure, has brought strong competitive pressure to bear on the European economy, which consequently is showing very limited growth.

The Portuguese economy faces extra challenges because, in addition to having a business structure based on sectors with strong competitors from emerging economies, it has a very small internal market and is highly dependent on the European economy.

Portugal also suffers from structural imbalances, associated, for example, with rigidity in the state budget and the evolution of the country's demographics, which are hard to reverse.

In order to promote change in the economic development paradigm, the Portuguese Government launched an agenda focusing on knowledge, technology and innovation as key factors for the national economy. These are inseparable from the modernisation challenges Portugal faces, in accordance with the priorities established by the Lisbon Strategy.

Clearly, SMEs are essential to "stimulate innovation and facilitate the adaptation of new means of production to the challenges of globalisation through promotion, adaptation and use of new processes, organisational methods, and goods and services."[1]

According to official data, SMEs represent 99.6% of the 275,000 companies operating in Portugal, and are responsible for 76% of employment and 58% of turnover. In the first years of the decade, the number of SMEs increased at an

[1] http://www.planotecnologico.pt/PT_OQP.htm

average annual rate of 8.8%, with an employment growth of 5.6% per year and a turnover growth of 4.3%, in real terms. It should be noted that the other countries of the European Union present a similar pattern.

Clearly, “SMEs represent the backbone of the European Economy and the largest potential source of employment and growth. This is why the European Commission gave a new stimulus to the European policy of SMEs, focussing its action on tackling the SMEs’ needs and improving their financial and regulatory environment.”[2]

1.2 Access to Financing

“The improvement of access to financing is a major factor in the promotion of the European entrepreneurial spirit.“[3] In fact, the financial markets will always be incomplete, because of the players rationale on both sides, the supply and demand of financial services:

- Demand Side Constraints - (SME’s, Entrepreneurs)	- Supply Side Constraints - (Investors, Intermediaries)
Lack of perceived quality of the disclosed financial information	High level of concentration (reduced number of potential financiers)
Difficulty in sharing market information, mainly in technological projects, which makes measuring risk difficult	Transaction costs only affordable in major projects and within traditional sectors (innovative projects difficult to tackle)
Poor financial culture, reduced scale and negociation capacity	High level of sophistication
Difficulty in assuring guarantees, particularly in the start-up stages	Collateral demands, despite efforts developed recently by risk analists
Excessive concentration in ownership and	Reduced liquidity in the capital

[2] Günter Verheugen, Vice-President of the European Commission

[3] COM(2003) 713 final, Bruxels, 01.12.2003, Commission’s Report to the Council and the European Parliament: Access of Small and Medium Entreprises to Financing.

- Demand Side Constraints - (SME's, Entrepreneurs)	- Supply Side Constraints - (Investors, Intermediaries)
resistance to accepting new equity partners	markets, with primacy for large companies
Lack of an entrepreneurial culture and investment in R&D projects	Lack of partnerships with proximity agents - v. business angels or coachers

Restrictions on access to financing are predominantly felt by small companies, in companies operating in critical stages of their life cycle and in companies that promote innovative processes. The only external financing source they normally can expect will be bank credit.

It is important to note that credit institutions will always play a fundamental economic role in the allocation of investment savings, bearing in mind their unique and distinctive attribute: the ability to assess risk widely in the business field.

There is a wide consensus within the public authorities that the policies oriented to growth and job creation must focus more on adequately structured programs related to access to financing for those type of companies, particularly micro-companies and SMEs.

Such measures must be implemented in partnership with existing market players and mechanisms, namely those that promote access for SMEs to alternative and innovative solutions.

That is the case of guarantee schemes involving credit institutions, risk-sharing with formal or informal venture capital investors, and a supportive approach to capital markets. This will provide a greater convergence between the equity availability conditions in Europe with for example the venture capital activity in the USA.

Concerning the bank intermediation process in Portugal, apart from the general issues of competitiveness, quality, transparency and diligence, positive discrimination measures must be implemented for specific target segments, such as SMEs and start-ups.

On the capital markets the challenge is totally different because they don’t offer concrete alternatives for the Portuguese companies. The current activity essentially incorporates transactions in the secondary market and highlights institutional investors who, in the allocation of resources, operate in a wider context of globalisation.

This is highlighted by the absence of initial public offerings (IPOs) and the asset allocation of the institutional investors’ portfolios. The Portuguese companies, basically blue-ships, represent 3% to 4% of the total funds managed, and the weight of the stocks not listed approximately 0.5%, over the last 3 years.

Given this context, the venture capital industry cannot find alternative ways to raise funds or shuffle portfolios of securities, which results in caution when they analyse investments in smaller companies with projects that require a more complex risk assessment and low liquidity.

Despite the recent emergence of some independent fund managers and corporate ventures, the supply of venture capital continues to be limited almost entirely to resources and players from the state and banking sector, reflecting the institutional approach how they operate in the market.

The Portuguese venture capital industry is currently represented by two dozen players and has an annual investment capacity of around 100 million euros - less than 0.1% of the GDP. This corresponds to approximately 120 operations, with average capital invested of around 800,000 euros.

To reverse this trend it is essential to create objective conditions for an increasing number of companies to participate in the venture capital arena, be it through a direct listing on stock markets, or through securitisation mechanisms.

2 DEVELOPMENT

2.1 Strategic View

2.1.1 Reasons for INOFIN

The diagnosis and challenges presented earlier impose a new, holistic view of the problems SMEs face in accessing financing. This justifies the implementation of the **INOFIN Framework Program – Financial Innovation on the SME's Market in Portugal.**

INOFIN is based on the principle, well recognised in modern economies, that in order to overcome the incomplete nature of the financial markets, the answer is not to focus on direct allocation of public money such as cash grants or subsidies, but to favour elements that will promote efficient bank intermediation and involve the full range of the equity markets.

Public incentive mechanisms, together with regulation, must act upon those two market subsystems that comprise the basic financing model of the economies: debt and equity instruments. These allow for risk sharing and lower transaction costs, leading to the efficient allocation of savings to business investment.

2.1.2 INOFIN's Objectives

With the double purpose of providing to SMEs **a real advantage** when accessing financing as well as contributing to the **quality and sustainability** of business projects, INOFIN is designed to support public policies at three different but complementary levels:

1. **Favourable Business Environment** - The main purpose is to create the necessary conditions to:

    - reinforce the efficiency of the bank intermediation process developing the mutual guarantees system, credit securitisation vehicles and other forms of direct cooperation with credit institutions;

- stimulate the expansion of the equity markets, particularly the venture capital industry, business angels networks, technology transfers accelerators, private equity investors and secondary markets.

2. **Achieve Macro-Economic Goals** – The main purpose, providing risk-sharing and co-financing facilities to financial intermediaries, is to stimulate companies whose activity and investment contributes directly to national purposes in terms of:

    - entrepreneurship and innovation;
    - competitiveness and internationalisation;
    - job creation and regional development.

3. **Support Business Dynamics** - The main purpose is to highlight companies and help them gain financial leverage according to their life cycle needs or the new challenges from the market changes, through customized financial and more qualitative tools make available from networks partnership in order to:

    - valuing the factors that contribute to reinforce internal capabilities essential to enhance their risk profile, such as the knowledge available, the quality of the organisation, systems and human resources, the performance and the access to the markets;
    - implementing new management capabilities and corporate governance standards in their relationship with different stakeholders, essential to develop a consistent position in the markets that will improve their reputation and bargain power;
    - diversifying sources of financing, from credit lines established to innovative financial services or more oriented capital market solutions.

2.1.3 INOFIN Key Factors

The reference assumed for INOFIN is the rationale of the financial market players, which defines the incomplete nature of the capital markets.

The contribution of the State for the improvement of financing conditions for the companies will always be important but subsidiary, based on an integrated and extensive framework focussing on supply and demand sides.

In terms of the supply side, the main needs are as follows:

- **Right Environment**: Efficient legal framework and tax system, as well as reduced administrative burdens;
- **Provide Scale**: Aggregation of assets in portfolios grouping according to risk profiles (v. best performing SME), cooperation mechanisms (v. mutual guarantee system);
- **Risk Sharing**: Guarantees and reinsurance facilities (v. counter-guarantees), co-investment vehicles and syndication of operations;
- **Boosting Liquidity**: Refinancing (v. fund of funds), credit-enhancement (v. securitisation vehicles), matching services (origination platforms) and secondary markets.

In terms of the demand side, the main needs are as follows:

- Promoting the entrepreneurial spirit;
- Providing training and information;
- Contributing to IT systems and governance;
- Reinforcing the competitive capacity;
- Assessing the financial information and making it credible;
- Improving the market position.

2.2 Operational Perspectives

2.2.1 A Structured Three-Level Approach

The nature of the problems SMEs face in accessing financing, particularly for innovative projects, requires a structured approach at different levels.

In fact, measures must be taken to improve the general conditions of the markets, as a whole, while simultaneously ensuring differentiated measures that concentrate on real targets, in order to speed up the integration of innovative and potentially successful companies into the market.

The governmental agencies in charge of SME's programs must perform both financial and non-financial actions, involving private and public partnerships, supported by risk sharing instruments that encourage business financing.

In order to bring to the market strategically sound and integrated programs that can contribute decisively to economic development, the following intervention plans were established:

Favourable Business Environment	Reinforcement the efficiency of the bank intermediation process, namely making available credit enhancement facilities either for specific companies (mutual guarantees) or for portfolios of pre-defined companies (securitisation).
	Enlargement of equity markets, particularly the development of venture capital industry, business angels networks, technology transfer accelerators, private equity investors and secondary markets.
Achieve Macro-Economic Goals	Establishment of global lines of financing with intermediaries, combined with public incentive schemes, to support investments with positive externalities or that point directly to objectives such as Entrepreneurship and Innovation, Competitiveness and Internationalisation, Job Creation and Regional Development.
Support Entrepreneurial Dynamics	Stimulate talent entrepreneurs along the company creation process - **FINICIA Program**.
	Stimulate fast growing companies to consolidate their competitive advantages - **FINCRESCE Program**.
	Stimulate the transfer of businesses to gain efficiency, through processes of management buy-out/in or mergers and acquisitions **- FINTRANS Program**.

2.2.2 Favourable Business Environment

The diagnosis made of the conditions of access to financing by SMEs determines that emphasis must be placed on the difficulties in the allocation of savings to company investment. This allocation, which has a macro-economic impact, can be sub-divided into two major processes:

- Bank intermediation, through which credit institutions raise resources to (re)finance their lending activities namely to SME's;
- Capital markets, including individual or institutional investors, other portfolio managers, financial intermediaries, corporations and companies.

Access to Credit

Access to credit, particularly as far as small companies and emerging business are concerned, generally presents two types of problems: a basic one concerning the availability of sources of financing, and a complementary one, related to the credit conditions, namely in terms of price and maturities,.

With the objective to provide micro-companies and SMEs better conditions to access financing, two state-owned instruments of guarantee were established in the Portuguese financial system:

- The first instrument, the Mutual Counter-Guarantee Fund, acts on the process of banking intermediation in order to share part of the risk assumed by mutual guarantee companies. These entities, with mainly private governance, interact directly with companies to provide them a better capacity to get bank loans;

- The second instrument, the Guarantee Fund for Credit Securitisation, acts on the process of banking intermediation in a different direction, contributing to qualify credit portfolios in securitisation transactions, with the objective of leveraging the credit capacity of the banks in pre-determined market-segments.

The measures chosen to enhance the efficiency of the bank intermediation process include:

- The launch of an awareness program regarding the impacts of the adoption of the new Basel II rules in SME financing;
- Extending the range of products offered in the Mutual Guarantees System and reinforcing their reach in new business segments;
- Implementing a Credit Securitisation Program for SMEs that would be accessible in term-deals, following the pilot-experience of 2005/2006, while

preparing the implementation of a warehousing mechanism for all players and smaller portfolios.

Access to Capital

Constraints on access to equity are a major difficulty for launching a business or support its growth, since the capital market does not perform its economic function of being a consistent alternative to the traditional credit way.

Initiatives launched over the years to stimulate new segments of the capital markets, particularly the venture capital industry and stock exchanges for smaller capitalisations, contributed in the first case positively but in a very limited way to solving the problem, and in the second case with no impact at all.

A Venture Capital Syndication Fund was launched to reduce the liquidity difficulties in the venture capital industry and to share risks taken on by the investment vehicles on the SMEs sector. This state-owned Fund offers refinancing, co-investment, syndication and guarantee facilities.

A new legal and fiscal framework has been prepared and a strategic repositioning of the two major state-owned players was established with a view to increasing their specialisation. One as a Venture Capital Syndication Fund manager and the other one oriented to the most notorious market failures.

A new opportunity should come from the participation of new market players, such as independent asset managers, business angels and corporate ventures, or the appearance of alternative secondary markets for SMEs and the settlement of fundraising mechanisms to introduce a link between the venture capital and the institutional investors activities. Given the increasing internationalisation of capital flows, it is also essential to encourage a link to specialised international private equity investors with both financial capacity and technical competence.

Complementarily, in order to stimulate the global venture capital activity, there is also a need to develop investment readiness programmes on the demand side and intensify the connection between companies and the entities that support innovation.

With that in view, Deal Flow Origination Platforms have been established throughout the country on a decentralised basis. These Platforms are public and private partnerships that involve proximity agents relevant to SMEs and start-ups, within the FINICIA, FINCRESCE and FINTRANS Programs.

Within INOFIN’s framework, the measures designed to stimulate the capital markets include:

- The strategic repositioning of *PME Investimentos* and the *PME Capital*, the referred two state-owned entities, in order to focus on both the system failures identified in the venture capital market and the relationship with segments of demand;
- Develop the Project Origination Platforms supporting the FINICIA, FINCRESCE and FINTRANS Programs, and create the INOFIN Portal to list and promote investment opportunities for venture capital players, thus offering greater interaction among companies and investors;
- Establish a new instrument for promoting the economic value of knowledge acquired in the scientific and technological structures, supporting technology transfer processes;
- Establish a fundraising mechanism to channel savings and diversify investors in private equity, which acts as a fund of funds in order to reinforce the investment capacity of the industry and encourage a new generation of players;
- Contribute to the emergence of new investors, players and financial products, namely proximity agents (such as business angels, corporate ventures and co-investment vehicles), secondary markets (including Euronext-Alternext and PEX) and financing instruments (such as *mezzanine*, *stock-options* and structured products).
- Provide conditions for the significant reduction of transaction costs associated with minimizing the risk in investments on innovative or technological projects.

2.2.3 Achieve Macro-Economic Goals

Access to financing is a relevant condition in the formulation and success of every business strategy. This fact makes it a fundamental factor to consider when inducing the convergence of entrepreneurial behaviours with economic policy.

The state-owned instruments – the Mutual Counter Guarantee Fund, the Guarantee Fund for Credit Securitisation and the Risk Capital Syndication Fund – will offer their refinancing and risk-sharing capacity through their relationship with the market players, in order to sustain financing lines for the creation of target portfolios, in accordance with pre-established priorities.

The interest in increasing the capacity of the market players, namely the selection and the follow up of the companies, or the distribution network consisting of five thousand banking agencies, becomes more relevant to allow the State agencies to reduce their effort given the budgetary restrictions. In addition, the consumption of public resources with the credit enhancement facilities is often restricted to a statistically foreseeable default rate based on the accumulated scale of operations.

In this context, within INOFIN's scope, two levels of intervention are established:

- **Global financing lines** - Define target portfolios, promote the alignment of financial players' interests with public policy objectives, based in sectoral and regional allocation criteria, size and type of investment projects, as well as the financing configuration (i.e.: maturities);

- **Incentive Schemes to Support Investment** - Coordinate with the authorities in charge of the national or regional incentive schemes to improve the financial coverage for business initiatives with positive externalities or that point directly to economic policy objectives.

2.2.4 Support Business Dynamics

Although SMEs have generally similar challenges, as a whole they are also heterogeneous, thus a differentiated effort is required when designing programs to support the promotion of business.

INOFIN considers the life cycle as an initial criteria for market segmentation, trying to correspond to the stages of start-up, growth, maturity and decline:

- Generally, a company starting out is financed almost entirely by promoters' equity (normally their own savings and from their close circle, or even personal debt), as it is difficult to access credit with no historic records or without financial guarantees. The company also suffers the effects of lack of notoriety in the market and contacts network ;

- When it reaches the growth stage, the functions become more complex and the staff more specialised, bringing the need for organisation, information and control. This stage generally requires new financing rounds, particularly equity but also debt, to sustain the growth strategies;

- As it approaches maturity, the company faces the need to explore new products and new markets. At this stage access to credit is usually easier. The challenges here are cash management and financing business expansion.

- Finally, the decline stage, since organisations tend to persist with logics and processes, products get old and other companies find new and better ways to satisfy their clients. It is difficult to reverse decline, as it tends to occur at a later stage, when the advantage of the competition has perhaps become excessive.

Conscious of those life cycle barriers, INOFIN designed three packs of transversal solutions for each of these stages:

- **The FINICIA Program**: Aims to promote new, innovative projects, facilitating access to financing for entrepreneurs and small companies in the initial stages of the life cycle. This Program, launched almost one year ago in 2006, is structured oriented to three key targets:
    - Projects with a strong innovation content and high-growth potential;
    - Emerging businesses launched by qualified entrepreneurs;
    - Other entrepreneurial initiatives of regional interest.
- **The FINCRESCE Program**: Aims to contribute to the optimisation of financing conditions for companies that are following growth strategies and reinforcing their competitive base. This program, recently launched in 2007, includes three intervention fields:
    - Enhance Risk Profile;
    - Better communication with the market;
    - Differentiated offer of financial products and services.
- **The FINTRANS Program**: Aims to stimulate processes of business transfers, succession and/or reframing of assets in new value chains, thus inducing the regeneration of the economic structure. This Program, which will be implemented at the end of 2007, intends to create a market for the business transfer, and will work towards two main goals:
    - Scale effect (Mergers and acquisitions);
    - Management capabilities (MBO – MBI).

In accordance with INOFIN's principles, these three Programs need institutional partnership networks in order to mobilise functionalities that will:

- Identify entrepreneurs and companies that fit the Programs, which aim to stimulate the creation, growth and transfer of business property;

- Develop the endogenous potential of the companies and their performance, through access to financial products and services made available by private entities in preferential conditions or using state-owned instruments;
- Promote a better interaction among companies and their environment, improving the quality of public financial information, encouraging validation through external entities, and boosting the visibility of the companies in the market;
- Provide companies with financial products and services in accordance with their needs, benefiting from the scale effects, the established partnerships and also the state-owned risk sharing instruments.

Apart from the Programs adapted to the different profiles of the companies in the different stages of their life cycle, the interactions resulting from INOFIN’s activity encourage the development of real answers that will enable companies to adapt to change in their environment.

Among the initiatives currently in place or programmed for the near future, we can highlight the establishment of conditions for:

- The operation network of the mutual guarantee enterprises in the Iberian market, as an answer to the companies' requirements;
- The reinforcement of the companies’ working capital to assist the activity increase brought by the new economic cycle.
- The empowerment of companies to adapt to Basel II Reform;
- The proximity of companies to the capital market.

3 MANAGEMENT

INOFIN assumes the financial system or the overall economy financing model as an operating spectrum, and the incomplete nature of the financing markets as reason for taking action in favour of SMEs.

Such ambition requires a methodological perspective of a virtual operator in the continuous process of identification of needs and in the preparation of adequate responses, independently of institutional boundaries, certain that the combination of efforts generates a better output.

INOFIN's implementation means essentially the activation of a wide and diversified network of stakeholders that, although pursuing different interests, want to maintain a stable and lasting relationship, established common objectives and shared responsibilities, benefits, and goals.

In order to consolidate in the public domain the framework instigating the dynamics needed to make INOFIN efficient, there are activities forseen at a European and national level in order to reinforce the global coherence of the public entities. It is also worth pointing out the strengthening of the cooperation between IAPMEI and the European Investment Fund (EIF).

In order to stimulate the rational use of the public resources dedicated to the different activities and to better serve the interests of the target business segments, the implementation of INOFIN's strategic and organisational framework complies with the following principles:

- **The integrated approach of the instruments** must provide new horizons in relation to its own strategic compliance with the objectives followed by the public policies, contributing to the smoothing of excesses, overlappings, omissions or conflict of interests;

- **The focussing of instruments towards real targets of action** must be balanced and induce a widespread commitment to the principles of specialisation, subsidisation and decentralisation.

- **The clarification of boundaries for the action of public players in relation to the private ones**, bearing in mind the goals of simplification and modernisation of the public structures, and establishing the areas where direct action from the public players is needed, as well as those where there is a need to stimulate the intervention of the other market agents.

- **The introduction of a monitoring and control model that is dynamic and transparent**, based on a contract by objectives, incorporating systematic functions of impact monitoring and assessment and promoting organisational developments that can boost performance, organize cooperation and support cross-selling.

IAPMEI – Portuguese Governmental Agency for SMEs and Innovation, in the context of partnerships established with public entities, financial institutions, agents of the national innovation system and business associations, has a core responsibility in the INOFIN management model.