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SMEs Embrace the Bond Markets

In these days of tight money and tough credit, smaller businesses are looking to the corporate bond market for financing. The risks are high but so are the returns.

In the old days, the owners of small and medium-sized enterprises (SMEs) would simply unveil a flashy business plan in front of a group of bankers and all would nod in agreement that the proposal was worth millions.

That was before 2008. Today business owners are lucky to find a banker who will listen to them. New laws, like Basel III, that raise capital requirements and reduce leverage in the financial system, make it difficult for bankers to extend credit. For SMEs – especially those in Europe, where economies are still struggling with the euro crisis - credit is tight.

In the absence of bank loans or credit lines, many mid-cap companies are turning to the bond market for financing. "Growth in corporate bond issuance was particularly pronounced in Germany, where net issuance swung from relatively flat in 2007/2008 to an annualised growth rate of 17 percent during the loan drawdown period," INSEAD Professor of Finance **Pierre Hillion** writes in his case study on alternative financing **Dürr: Disintermediation in the German Mid-cap Corporate Bond Market**.

In Germany, smaller companies without an established name risk being shut out of the credit market altogether. To address this problem, the Stuttgart Börse created a special bond platform for SMEs, offering issues in the €25-€150 million range.

In Stuttgart, which is home to Daimler, Porsche and Robert Bosch, the financial community rallied in support of the new "Bondm" segment. "I think the community knows that the industry needs alternatives to bank financing," **Sabine Traub** of the Stuttgart Stock Exchange told INSEAD Knowledge. "If you go into the Anglo-American area it's normal to issue bonds. And I think central Europe is still very focused on bank financing."

Bypassing the Underwriters

In a radical departure from the traditional fixed-income culture, the Bondm model allows companies to issue bonds directly to the retail investor in the primary market – during the subscription phase - without the help of an underwriter. The retail subscription saves companies the fees incurred by issuing through an underwriter; it also gives individual investors an early price advantage over the first listing. After the Initial Bond Offering (IBO), the instrument is traded openly on the Bondm market. Some 25 SMEs are currently listed on the Bondm, and the combined value of assets is just over €1.6 billion.

Targeting retail investors "is a fairly big deal if you do not have your bond subscribed by institutions," says Traub. The Exchange promotes a balanced mix of investors. "Our target is to have the same ratio for private and institutional investors. And now we have about 40 percent of private investors on average in our bonds."

Companies seeking access to capital on the market work with a "Bondm coach", a type of financial advisor who guides them through the regulatory requirements of listing. According to Traub, "The regulations are strict enough for the capital markets but not too strict for a small and mid-sized company to choose the way to the capital market."

Not Without Investor Risks

INSEAD's Pierre Hillion points out that liquidity and reputation are two of the biggest risks to investing in the Bondm market. Good companies might avoid the market if they see only bad or risky SMEs issuing, he writes. Also, "Will the market be liquid if and when tail risks (systematic to the economy or specific to an issuer) occur?"

To address concerns about liquidity, the Stuttgart Börse has employed so-called QLPs (Quality Liquidity Providers) who "provide a kind of market making lite," Traub says. These "QLPs ensure full execution of orders and safeguard the best price principle." The trader EUWAX AG acts as QLP for the Stuttgart Börse, matching buy/sell orders and, if need be, buys and sells for their own account in an effort to ensure liquidity for small trades. Settlement is within two days, similar to stocks.

Since the creation of Bondm in 2010, several companies have teetered on default or delisted from Bondm altogether, all of them in the renewable energy sector. Also only six bonds were ranked "investment grade" status on Bondm (BBB- or higher on Standard & Poor's) in January 2013. Traub is transparent about the risks and adds, "The best safeguard to prevent a default for an investor is education and information. And on our webpage of the Stuttgart Börse (https://www.boerse-stuttgart.de/) we give all information an investor needs, for example, on ratings, rating summaries, securities prospectuses or general company information."

Continued Investor Appetite

Despite the inherent risks, investors are drawn to the Bondm because yields are high and there's still a good deal of transparency. The European real estate sector is slowly recognising the value of the Bondm market. A new 7-year bond by the developer IPSAK (Immobilien Projektgesellschaft) was oversubscribed in less than two hours back in November 2012 – a record time for the Bondm. SME bonds also introduce a new asset class to portfolios and are accessible worldwide by way of an International Securities Identification Number (ISIN).

The popularity of the Bondm trading segment has spread throughout Germany and into France, inspiring SME debt markets in Frankfurt, Düsseldorf, Hamburg and Munich. In Paris on the NYSE Alternext (Euronext) last November, the real estate developer and promoter CAPELLI raised up to US$11.7 million in the market's first SME bond offering.

For European companies in need of external financing, the Bondm segment is an attractive alternative. But companies issuing on the Stuttgart Börse must now convince nervous investors that their business plans are worth millions - an uphill battle as the euro crisis rages on. The money is there but small and medium-sized companies will have to work harder to get it.

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