

Capital Market-Oriented Financing Prospects for Austrian SMEs

Michael Halling,
Alexander Stomper,
Josef Zechner¹

The performance and growth of the Austrian economy largely depend on small and medium-sized enterprises (SMEs). Despite their diminutive size, SMEs offer attractive investment opportunities that are, however, financed primarily by debt for a variety of reasons. The financing concept presented in this study adopts an innovative approach to provide access to quasi-equity forms of financing to Austrian SMEs, which have successfully and responsibly generated business in recent years and which currently enjoy attractive growth potential. At the same time, it aims to strengthen the Austrian capital market by increasing the investment opportunities of the broad mass of both private and institutional investors.

Introduction²

The performance and growth of the Austrian economy largely depends on small and medium-sized enterprises (SMEs). Austria currently has approximately 250,000 SMEs, of which more than 80% are of the smallest size with only 1 to 9 employees. Despite their diminutive size, SMEs offer attractive

investment opportunities. The average investment ratio – across all sizes of enterprises – is about 5% to 8% of sales. To finance these investments, however, SMEs rely primarily on debt financing. An analysis of data from 2001, for instance, reveals capital ratios of –25% for the smallest enterprises and +20% for the largest (see table 1).

Table 1

Capital Ratios of Austrian SMEs in 2001 by Sales						
%	Up to EUR 0.5 million	EUR 0.5–1 million	EUR 1–2 million	EUR 2–4 million	EUR 4–7.5 million	EUR 7.5–100 million
Selected NACE groups	–24.8	–10.6	1.6	5.7	13.2	19.8
Manufacturing industry	–19.4	–3.6	4.9	11.4	18.6	35.0

Source: KMU FORSCHUNG AUSTRIA.

Possible reasons for the low capital ratios of Austrian enterprises are, among others, institutional determinants such as Austria's current tax system, its bankruptcy law and the traditionally close, long-term relationships between enterprises and their banks (see Dirschmid and Waschiczek, 2005). It should be noted, though, that the generally low level of capital ratios is much more than a mere “blemish” from a financial perspective: The extremely high debt levels of many enterprises suggest that financing restrictions prevent them from fully exploiting their investment opportunities. A number of reasons may be responsible

for this limited access to capital; they are summarized in the following paragraphs.

First, there are demand-side explanations for why owners of highly indebted SMEs may abstain from raising fresh capital for investment. This effect, which is described as “under-investment effect” in financial literature, reflects the fact that owners of a highly indebted enterprise expect that the bulk of any additional income from investment would accrue to the firm's existing creditors. Its impact on SMEs' investment activity is underpinned by empirical evidence. The paper by Stomper and Zulehner (2005), for

¹ The project team of the University of Vienna would like to thank the representatives and experts of the Board for the Austrian Capital Market – in particular, Michael Eberhartinger, Edith Franc, Erich Kühnelt and Siegfried Neumüller – for many valuable contributions and stimulating discussions.

² Translation from German.

Referred by
Vanessa Redak,
Markus S. Schwaiger,
OeNB.

instance, shows that highly levered SMEs in the Austrian hotel sector tend to under-invest in market share.

However, there are also supply-side reasons why highly levered SMEs have limited access to financing for new investment. These are primarily the effects that are described as credit rationing in the financial literature. They occur when highly indebted enterprises cannot raise additional debt capital without raising equity at the same time but cannot obtain equity financing. The imminent introduction of Basel II will probably further exacerbate such problems, at least for large SMEs. Although the findings of the Basel Committee's Third Quantitative Impact Study (QIS 3) do not suggest that lending standards will be immediately tightened in the aftermath of Basel II (see Tscherteu, 2003; Altman and Sabato, 2005), it cannot be ruled out that for certain corporate segments, bank loans will be more expensive or harder to obtain than before the introduction of Basel II. This will tend to apply more to SMEs that either seek to finance bigger investment projects or already have a high debt-to-equity ratio (see Heimer and Köhler, 2004).

In conclusion, the high debt-to-equity ratio of Austrian SMEs is likely to be costly for the national economy, as these enterprises refrain from carrying out profitable investment projects and the probability of bankruptcy as well as bankruptcy costs increase correspondingly. Furthermore, given the liquidity function of equity in periods of economic downturn (see Dirschmid and Waschiczek, 2005), sound capital adequacy ratios of the corporate sector are highly significant for financial stability. The financing concept presented in this study is designed to help reduce SMEs' debt-to-equity ratios and, thus, to help avoid these costs. Our concept

is targeted at Austrian SMEs that have successfully and responsibly generated business in recent years and enjoy attractive (but not necessarily spectacular) growth potential. We aim at providing these SMEs with access to equity or quasi-equity forms of financing and at reducing their debt-to-equity ratio, thus facilitating additional investment. At the same time, the implementation of our proposal should strengthen the Austrian capital market by expanding the investment opportunities of private and institutional investors on a large scale. This is desirable because Austrian enterprises typically consider going public only when they have reached a certain size or a very advanced stage of their life cycle. From an investor's perspective, therefore, the opportunities to invest in Austrian corporate equity are currently very limited, even though we think that many SMEs are actually in need of equity capital. Linking our financing concept to Austria's capital market will also give SMEs an edge, e.g. by expanding the range of available financing options and creating positive marketing effects. This paper shows how intermediated financing can improve the capital ratio of Austrian SMEs and ultimately expand the general public's range of investment opportunities in the Austrian capital market.

Theoretical Background

The issue of equity financing is addressed in many scientific papers. There are basically two different forms of financing: the first is via the public capital market, and the second is intermediated financing, e.g. venture capital financing. Although quite distinct in terms of their institutional structure, these forms of financing have certain features in common that impact on the capital costs. The high

degree of information sensitivity of the value of equity is probably the most important common feature. The following paragraphs discuss how this feature of equity financing tends to increase the cost of such financing in the presence of information asymmetries between issuers and investors.

Information Asymmetries in the Primary Market

Information Asymmetries Between Issuers and Investors

Information asymmetries between issuers and investors drive up equity capital costs. This effect has been frequently analyzed in the financial literature, for instance in the pioneering paper by Myers and Majluf (1984), who argue that investors are only willing to provide equity capital if they receive the equity at a discounted price. They are, after all, well aware of the fact that issuers will issue equity only when they know that the profitability of an enterprise's previous investments will be below the investors' expectations. In fact, the issuers would be acting against the best interest of existing equity investors if they shared future profits with the buyers of newly issued equity.

If, in addition, enterprises can choose between issuing equity and raising debt, the more profitable ones will – again in the interest of existing equity investors – tend to raise debt for two reasons: first, debt financing will allow these investors to continue to fully benefit from the enterprise's upside potential, and second, it will not dilute the investors' participating interests. Moreover, debt financing reduces (or altogether eliminates) costs from price discounts incurred in equity issues. Thus, an enterprise which still issues equity will simply have to offer a discount, as investors will assume that it

does not rank among the more profitable enterprises which issue debt rather than equity.

This theory helps explain the “equity gap” problem. It postulates that enterprises follow a “pecking order” in raising funds: While the most profitable enterprises use retained profits to finance investment, less profitable companies raise debt and even less profitable ones issue equity. According to this theory, enterprises should seldom resort to issuing equity; the discount at which such issues are offered in the primary market is significant.

Information Asymmetries Between Investors

Enterprises may also be required to sell equity stakes at a discount in the primary market owing to information asymmetries between different investor groups. This theory is supported by Rock (1986). He postulates that better informed investors use their informational advantage to practice “cherry picking,” i.e. to invest primarily in the equity of exceptionally profitable enterprises. Accordingly, it is the poorly informed investors who hold the equity of less profitable enterprises. Knowing this, however, these investors will be prepared to buy the equity of an enterprise only if they are offered a sufficiently high discount.

However, it is not only less profitable enterprises that have to offer discounts due to information asymmetries between investors. If a profitable enterprise issues more equity than the better informed investors are willing to acquire, the enterprise will either have to raise less equity or persuade more poorly informed investors to purchase equity stakes, too. Both these options entail high costs: While

they are incurred by insufficient equity being raised in the first instance, they arise in the form of high equity costs out of the need to sell equity to poorly informed investors in the second.

These theoretical findings are supported by empirical evidence: According to Loughran et al. (1994) who compared the returns on initial public offerings (IPOs) in several different countries, these returns amount to as much as 80% on average in some countries. During the last wave of issues, returns on IPOs in the German market amounted to more than 40% according to Aussenegg et. al. (2005). From the issuer's perspective, such high returns tend to make equity issues unprofitable.

Investment Asymmetries in the Secondary Market

The equity costs of an enterprise also depend on what information about its performance is available to investors *after* the equity has been raised, as well as what opportunities investors have to respond to unsatisfactory results. Many recent studies in the area of financial research are devoted to this issue. Johnsen et al. (2000), for instance, coined the term "tunneling" to denote the transfer of corporate profits via transactions between an enterprise and its controlling stockholder with the aim of withholding profits from the enterprise's minority stockholders. Empirical findings on the volume of such transactions can be consulted, for instance, in the study by Bertrand et al. (2002), while the impact on the financing of enterprises by these and similar problems is analyzed by Townsend (1979). Once again, the cost of equity capital increases because it is not possible to contractually determine the rel-

ative profit shares of controlling and minority stockholders to the satisfaction of both parties. Since minority stockholders anticipate that profits could be withheld from them, they are prepared to invest only if equity is offered to them on reasonably favorable terms. By contrast, debt financing has an advantage as a form of financing owing to the effective contractual guarantee of an enterprise's promise to pay its creditors.

Cost of Issuing Equity and Enterprise Size

The typically small equity issuance volumes of SMEs directly incur extra costs for these enterprises in addition to the above mentioned reasons for the high equity cost. First and foremost, these are fixed costs for the procurement of information incurred by both investors and underwriters, which cannot be covered by corresponding economies of scale for small issuance volumes. In addition, smaller enterprises will typically wait for a longer period of time before they carry out a possible secondary offering and thus benefit a second time from having invested in the fixed costs of a primary issue.

In addition to the problem of covering the fixed costs of small equity issues, the typically low liquidity of such issues increases the issuance costs. Investors are prepared to invest in relatively nonliquid stocks only if they receive a discount that covers the costs of a possible future liquidation of positions entered into. Furthermore, as investors will hardly be prepared to acquire larger stakes of such issues, the enterprise will have to convince a disproportionately large number of investors to buy such issues, which again increases the costs.

The “Equity Gap” Problem and Possible Solutions

The reasonings given above lead to an obvious conclusion: Equity financing is frequently subject to considerable market frictions, which makes this form of financing more expensive than debt financing. There are three reasons why this especially applies to SMEs: First, information asymmetries between outside investors and management are particularly pronounced. Second, shares of SMEs do not have much, if any, liquidity in the secondary market, and third, the fixed cost charged for raising external equity is particularly high for SMEs. Therefore, SMEs frequently dispense altogether with all equity financing by outside investors. From a macroeconomic perspective, this gives rise to the “equity gap” problem: Equity issues seem to be worth carrying out only from a specific issuance volume upwards, as smaller volumes do not justify the higher issuance costs.

In the following, we will present possible solutions as derived from financial literature. The highly noted contributions by Townsend (1979), Diamond (1984), as well as by Gale and Hellwig (1985), for instance, indicate that – in case there are significant information asymmetries between an enterprise’s investors and its management about the enterprise’s performance – it is always advantageous to use forms of financing that guarantee clearly defined cash flow claims to investors. These advantages, however, are partly offset by higher anticipated bankruptcy costs and by the suboptimal investment behavior of highly indebted enterprises.

Considering preferred stock can help eliminate or at least reduce this suboptimal investment behavior according to Heinkel and Zechner

(1990). The advantages of preferred stock as a financing instrument are also underlined by DeMarzo and Duffie (1999). They emphasize that preferred stock financing offers many of the benefits that accompany debt financing without increasing the risk of bankruptcy. Like debt, preferred stock usually also involves a relatively firm promise of payment, i.e. the preferred dividend, the non-payment of which results in the common stockholders losing their control rights. As with debt financing, this provides outside investors with a limited right to intervene in the enterprise’s management, but the common stockholders do not stand the risk of losing complete control as a result of bankruptcy. If, in addition, the preferred stock is correctly structured, it is highly probable that the preferred dividend will be paid. Thus, the outside investors’ situation is similar to that of lenders: They need less information to correctly value preferred stock than they need for common stock and are therefore prepared to invest on terms that are relatively favorable for issuers.

Apart from preferred stock financing, it can also be advantageous to raise mezzanine capital. A hybrid form of equity and debt financing, mezzanine financing is very flexible and ideal for granting outside investors the same promise of payment and similar control rights as preferred stock. Unlike preferred stock financing, however, mezzanine financing may lead to an increase in the financed enterprise’s debt.

DeMarzo (2005) analyzes a financing model via asset pools, which can be considered as groups of SMEs in the present context. His study shows that it can be advantageous to finance several SMEs via a common fund that carries out securities issues and distrib-

utes the issuance income to the SMEs. This finding is based primarily on two arguments that form the core of DeMarzo's analysis. First, if SMEs jointly issue preferred stock, they can use the profits generated by several SMEs (instead of only one) to pay the preferred dividend. This minimizes the risk of common stockholders losing control to outside investors and maximizes the probability that the promised preferred dividend will be paid to the preferred stockholders. Second, the structure of asset pools makes it possible to avoid the cherry-picking cited above. If SMEs issue securities separately, more poorly informed investors – reckoning that they will subscribe primarily to less profitable issues – will therefore be ready to do this only if they receive an appropriate discount. Pooling issues prevents better informed investors from investing exclusively in more profitable SMEs.

Small enterprises, in particular, enjoy an additional advantage above and beyond the aforementioned general benefits derived from the pooling of equity issues. Pooling allows the high fixed costs of equity issues to be distributed among a group of issuers. In addition, pooling can concentrate the market liquidity available, thereby avoiding or, at the very least, reducing discounts induced by illiquidity.

The SME Financing Concept

In this section, we present our SME financing concept, through which Austrian SMEs could gain direct access to external equity financing and indirect access to the capital market. This concept is a synthesis of theoretical considerations and empirical insights obtained in the course of numerous discussions with practitioners.

In this concept, a company referred to as *Mittelstandsbeteiligungsge-*

sellschaft (MBG) in German acquires equity stakes in several SMEs. These investments have all important characteristics of equity but yield contractually specified returns (as current forms of mezzanine capital do) that are passed through to the MBG's investors. Two groups of investors provide the capital to an MBG: common stockholders and preferred stockholders. However, preferred stocks are issued only when the MBG already has a portfolio of SME investments. The issuance income is used to repay the debt that was raised to prefinance these investments.

The institutional details of an MBG must take into account the needs and requirements of all parties involved, which poses a major challenge for its design. On the one hand, it aims at helping SMEs with bright, but not necessarily spectacular, profit prospects raise equity capital without their common stockholders having to cede too many control rights. On the other hand, it has to provide the MBGs' investors with sufficient guarantees and rights of co-determination to make them want to invest in the SMEs.

MBGs are basically set up in two stages. In stage 1, they are provided with advance financing via equity (approx. 25% to 35%) and debt (approx. 65% to 75%). This capital is invested in different SMEs which are selected by the lenders of equity (or, alternatively, by a management company instructed to do so by the lenders of equity). The specific characteristics of the MBGs' SME investments are described in detail in the sub-sections below.

In stage 2, the MBGs issue preferred stock via the stock exchange and use the proceeds generated by these issues to repay the debt incurred in stage 1. Investors can use an MBG's ex-

isting SME portfolio to evaluate its investment policy and so correctly value its preferred stock. The features of this preferred stock and the role of preferred stockholders are described in detail in the sub-sections below.

Contractual Structure of MBG Investments in SMEs

A key objective of this SME financing concept is to increase the equity ratio of SMEs. Hence, MBG investments in SMEs must constitute equity under Austrian commercial law. Furthermore, they should also constitute equity for banks' rating systems so that they lead to an improved rating and correspondingly reduce the SMEs' debt financing costs.

However, it must be ensured that SMEs are permitted under Austrian tax law to deduce dividend payments to MBGs from the profits that are liable to corporate income tax. This ensures that the financing costs of such investments remain attractive for SME owners relative to debt financing costs.

In addition to creating a favorable legal environment for such investments in SMEs, it is particularly important to prevent the cost of equity from increasing owing to asymmetric information problems between the SME owners and the MBG. This is feasible only if the SMEs' dividend payments to the MBG are relatively calculable, as they are e.g. for preferred stock or mezzanine capital. The use of such forms of financing has a further advantage, which is frequently of major importance in practice: Unlike pure equity financing, mezzanine financing leaves the original SME owners with most of their decision-making powers; MBGs are, however, provided with strong control and intervention rights that become applicable only if an SME performs badly.

In short, the SME financing concept via MBGs has the following characteristics:

Calculable dividend payments: The SMEs and the MBGs agree on calculable minimum dividend payments that are stipulated either by the right to a fixed minimum return or by being pegged to a variable interbank interest rate (e.g. LIBOR). This prevents a possible information lead of SME owners over an MBG from taking effect in the form of increased capital costs. These dividend payments reduce the corporate tax base of SMEs.

Indefinite maturity: Investments in SMEs held by MBGs have a long or even indefinite maturity. This feature ensures that investments comply with the definition of equity as stipulated under Austrian commercial law. The original owners of SMEs, in which an MBG has a stake, should, however, be given the chance to repurchase the latter's investments against payment of an appropriate premium subject to a certain period of non-negotiability.

Temporal flexibility of dividend payments: Contractually stipulated minimum dividend payments by SMEs to an MBG can be deferred. In this case, the MBG's claims accumulate, bearing interest. Failure to pay a dividend will not necessarily lead to the SME's bankruptcy.

Conditional control rights: If an SME fails to make the contractually specified minimum dividend payments to the MBG in part or in full over a certain period of time, the MBG will be given appropriate control rights as well as wide-ranging rights to intervene in the SME's management. If the SME makes all dividend payments as stipulated, the MBG will only be entitled to information rights and to limited control rights, not to rights of direct intervention.

Subordination to debt: In the event of liquidation, an investment held by an MBG is subordinated to the SME's debt.

Loss sharing: An MBG's investment in SMEs includes loss sharing. This means that the nominal value of an MBG's investment in an enterprise is reduced if the enterprise's equity is exhausted. In the event of the SME going bankrupt, not only is the MBG's investment subordinate to the SME's debt, but the formal claims of the MBG are also reduced. This feature of the MBG's investment also underlines its equity nature.

The MBG Concept – Investor and SME Perspective

From the perspective of common stockholders, investments in MBGs offer considerable leverage effects thanks to the latter's capital structure. An MBG with a ratio of e.g. 1:3 of equity to debt or preferred stock generates attractive returns for the common stockholders even if it invests exclusively in SMEs enjoying modest growth and low risk. Investments in an MBG's capital stock can also be structured to include attractive exit opportunities for common stockholders, e.g. via an IPO after a specific period of time (e.g. ten years). In the course of this IPO, the MBG either repurchases preferred stock via a cash payment or via a stock swap. As the MBG's preferred stock has been traded for a long time, the general public may be expected to have sufficient information about its performance so that the common stockholders can exit on reasonably good terms.

From the perspective of preferred stockholders, MBGs represent an opportunity to invest in the equity of Austrian enterprises without incurring

especially high risks. Our concept's approach reduces the risk of such investments in two ways. First, the MBG's structure – a pool of investments in the equity of several SMEs – generates considerable diversification effects. Second, the dividend payments by SMEs to the MBG are broken down into two separate tranches. One of them is an agreed dividend that is paid out to the preferred stockholders (preferred dividend) before the common stockholders receive a possible dividend. This means that it is actually the common stockholders who bear an MBG's risk, whereas the preferred stockholders receive calculable dividends and thus bear a far smaller risk.

The concept of MBG preferred stocks should appeal above all to institutional investors and particularly to providers of subsidized personal pension schemes (SPPS), given that providers of SPPS products must invest at least 40% of their assets in equity and that MBGs' preferred stocks meet all the relevant requirements for such investment. This 40% restriction can be quite a significant obstacle to diversification for SPPS portfolios (see Halling et al., 2004). It is therefore of particular importance to create additional investment opportunities that enable SPPS providers to generate attractive risk-adjusted returns.

The aforementioned arguments clearly show that our SME financing concept offers investors a considerably expanded range of investment opportunities in the Austrian capital market. Furthermore, the concept offers Austrian SMEs an expanded range of financing opportunities. The reasons why an MBG's investment will appeal to SME owners can be summed up as follows:

Equity under Austrian commercial law, tax deductibility of investment returns: MBGs provides SMEs with capital that constitutes equity under Austrian commercial law, thereby improving the SMEs' capital structure and reducing their remaining debt costs. Additionally, dividend payments to MBGs reduce the SMEs' tax base.

Flexible contractual ties: MBGs provide SMEs with investment capital without this capital having to be repaid at the end of a specified maturity. The SME owners are, however, permitted to repurchase an MBG's investment against payment of a premium after a certain period of non-negotiability. Until then, they are obliged to make certain dividend payments, as they would otherwise have to cede considerable control rights. The failure to make dividend payments will, however, not necessarily lead to the SME's bankruptcy.

Conditional control rights: Unlike other types of equity investment, an MBG's investment in an SME does not lead to a significant loss of control for the SME's original owners. The MBG's control rights are in fact very limited provided the SME makes the specified dividend payments.

Link to the capital market: MBGs' investments in SMEs indirectly link the latter to the capital market. From the perspective of SMEs, this can have several advantages. First, numerous studies show that enterprises with a stock-exchange listing profit from a significant marketing edge in the product market (see Stoughton et al., 2001). In addition, such enterprises achieve a direct PR effect owing to the mandatory presentation of all enterprises in the MBG's portfolio when its securities are sold via the stock exchange. Furthermore,

a stock-exchange listing is a positive signal for many customers: As a rule, customer confidence and also the relations with other stakeholders (such as employees and suppliers) may be expected to improve simply because the enterprise was selected by the MBG's management and because it will be subject to monitoring and to specific disclosure requirements (see Pagano et al., 2002).

Second, empirical evidence shows that an enterprise's bargaining position with banks and other lenders improves after a stock-exchange listing. Pagano et al. (1998), for instance, consider this to be one of the reasons to go public. Even though our SME financing concept does not provide for an SME's direct stock-exchange listing, it is nonetheless likely to produce similar effects which would also further reduce the SME's debt financing costs.

Moreover, as the MBG investment allows SMEs gather experience in dealing with the Austrian capital market, the probability of subsequent direct stock market flotations via IPOs or bond issues increases.

Comparison with Small Business Investment Companies

The SME financing concept presented in this study reveals similarities with the Small Business Investment Company (SBIC) program in the U.S.A. This program, which was introduced in 1958, is a success story in the domain of financing support for SMEs. Before turning to a comparison of the SBIC program with our MBG concept, we will briefly summarize other existing SME financing models. It should be highlighted in this context that several initiatives to improve the capital structure of European SMEs are currently being launched within the EU both at national and EU levels (see European

Commission, 2003, for an overview of these initiatives). For instance, policy-makers in the United Kingdom are considering the launch of a quasi-SBIC program – so-called Enterprise Capital Funds (ECFs) – to support British SMEs (see Small Business Service, 2003)³. In Germany, we are aware of initiatives undertaken by the State Development Bank of North Rhine-Westphalia and by private banks, which are also designed to strengthen the capital structure of established SMEs using mezzanine financing products.⁴

In Austria, an attempt was made as early as the 1980s to implement capital market-oriented equity financing of Austrian SMEs in the form of a dividend-right certificate model. Apart from similar objectives, this model and our MBG concept have very little in common. The key difference briefly considered here is the different risk-sharing approach. Unlike the MBG concept, the dividend-right certificate model lacked common stockholders who took the risks and were responsible for the portfolio composition. Instead, a venture fund company, which bore hardly any risk itself, was responsible for the selection of investments.

In the following, we will focus on the key common features and differences of the U.S. SBIC program and our MBG model. We refrained from including a detailed description of the SBIC program; please refer to Brewer et al. (1995) and Bannock Consulting (2001) for details.

To begin with, both the SBIC program and the MBG concept address

established SMEs and not high-tech start-ups. Generating attractive returns for the lenders of equity to SBICs and MBGs – who are investing in relatively low-risk SMEs – is therefore of key importance. Both programs achieve this objective by means of leverage gearing. Whereas SBICs in the U.S.A. issue pure debt, the MBG concept in Austria uses preferred stock that is listed on the stock exchange. Therefore, the Austrian variant would allow for profit in excess of the preferred dividends to be shared. Still, the leverage gearing of the return on the common stock is similar.

Even though MBGs and SBICs differ in their mode of financing, they nonetheless share key common features – most notably the fact that dividend payments to investors can be deferred. This feature was only included in the SBIC model's 1994 reform. Prior to this, SBICs that failed to make coupon payments to lenders of debt in time went bankrupt, which led to numerous bankruptcies in the period before 1994. Generally speaking, the MBG concept provides for a flexible solution and also includes the explicit option for SMEs to defer dividend payments.

Another difference lies in the investment structure. SBICs focus on traditional equity investments or traditional loan financing, whereas MBGs would specialize in subordinated forms of investment of an equity nature.

A further key difference lies in the role of the government. Whereas the U.S. government is closely involved

³ On May 5, 2005, the British program was officially approved by the European Commission on the basis of the community rules on state aid. From June 2005 onward, this decision is to be followed by the so-called pathfinder initiative, a kind of test run with approx. three to four ECFs, in order to gauge how the market reacts to this specific product and how British SMEs react to the additional funding offer.

⁴ In 2004, the volume of preferred pooled shares transactions (so-called preps) carried out by HVB and the Swiss Capital Efficiency group, for instance, came to EUR 850 million. However, it should be borne in mind that only 15% of this capital flowed to enterprises that comply with the European Commission's SME definition.

as guarantor in the SBIC program via the Small Business Agency (SBA) in both a monitoring and regulating capacity, the Austrian government is not accorded such an influential role in our MBG concept. Its role would be limited to granting tax relief to MBGs and their investors.

Summary

The MBG concept presented in this study is an innovative approach designed to provide Austrian SMEs with access to equity or quasi-equity forms of financing and to broaden the range of investment opportunities in the Austrian capital market.

The advantages of the MBG concept for the different parties involved can be summed up as follows:

Common stockholders of MBGs: They profit from attractive returns that can be generated via the leverage gearing effect and, possibly, by the provision of tax relief for MBGs. In the start-up phase, the MBGs' common stockholders are provided with guaranteed debt. In the event of conditional control rights being invoked, the MBGs' common stockholders can be granted a greater say in the SME's management than they would have with traditional minority interests in the SME's

common stock or with investments via dividend-right certificates.

Preferred stockholders of SME investment companies: Preferred stockholders receive calculable returns at a level of risk that is low compared with common stock.

SMEs: The investments held by MBGs in SMEs are characterized by calculable dividend payments, indefinite maturity, temporal flexibility of dividend payments, subordination to debt and loss sharing. They thus represent investments of an equity nature that also benefit from tax deductibility of returns paid on investments. The failure to make specified payments does not directly result in the SME's bankruptcy. Unpaid dividends accumulate and accordingly bear interest. Furthermore, SME owners have to cede considerable control rights if – and only if – the specified dividends are not distributed. In addition, the indirect link to the capital market can generate positive marketing effects and strengthen the SMEs' bargaining positions vis-à-vis other lenders. Finally, SMEs garner experience in dealing with the capital market, which may be useful for a stock-exchange listing at a later date.

References

- Altman, E. I. and G. Sabato. 2005.** Effects of the New Basel Capital Accord on Bank Capital Requirements for SME. Working Paper.
- Aussenegg, W., P. Pichler and A. Stomper. 2005.** IPO Pricing with Bookbuilding and a When-Issued Market. Vienna Graduate School of Finance Working Paper.
- Bannock Consulting. 2001.** Innovative Instruments for Raising Equity for SMEs in Europe. Abschlussbericht. Study Contract ETD/00/503116.
- Bertrand, M., P. Mehta and S. Mullainathan. 2002.** Ferreting Out Tunneling: An Application to Indian Business Groups. In: Quarterly Journal of Economics 117(1), 121–148.
- Brewer, E., H. Genay, W. E. Jackson III and P. R. Worthington. 1995.** Performance and Access to Government Guarantees: The Case of Small Business Investment Companies. In: Economic Perspectives. Federal Reserve Bank of Chicago. 16–32.
- DeMarzo, P. and D. Duffie. 1999.** A Liquidity Based Model of Security Design. In: Econometrica 67, 65–99.

- DeMarzo, P. 2005.** The Pooling and Tranching of Securities. In: Review of Financial Studies. (Forthcoming).
- Diamond, P. 1984.** Financial Intermediation and Delegated Monitoring. In: Review of Economic Studies 51. 393–414.
- Dirschmid, W. and W. Waschiczek. 2005.** Institutional Determinates of Equity Financing in Austria. In: Financial Stability Report 9. Oesterreichische Nationalbank. 77–92.
- European Commission. 2003.** Access to Finance of Small and Medium-Sized Enterprises. Communication from the Commission to the Council and the European Parliament. COM(2003) 713 final.
- Gale, D. and M. Hellwig. 1985.** Incentive Compatible Debt Contracts. In: Review of Economic Studies 52. 647–663.
- Halling, M., G. Mosburger and O. Randl. 2004.** Die Prämienbegünstigte Zukunftsvorsorge: Ein attraktives Instrument? In: Journal of Financial Markets and Portfolio Management 18(4). 399–418.
- Heimer, T. and T. Köhler. 2004.** Auswirkungen des Basel II Akkords auf österreichische KMU. Study commissioned by the Austrian Federal Ministry of Finance.
- Heinkel, R. and J. Zechner. 1990.** The Role of Debt and Preferred Stock as a Solution to Adverse Investment Incentives. In: Journal of Financial and Quantitative Analysis. 1–24.
- Johnsen, S., R. La Porta, F. Lopez-de-Silanes and A. Shleifer. 2000.** Tunnelling. Harvard University Working Paper.
- Loughran, T., J. R. Ritter and K. Rydqvist. 1994.** Initial Public Offerings: International Insights. In: Pacific Basin Finance Journal 2. 165–200.
- Myers, S. C. and N. S. Majluf. 1984.** Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have. In: Journal of Financial Economics 13. 187–221.
- Pagano, M., F. Panetta and L. Zingales. 1998.** Why Do Companies Go Public? An Empirical Analysis. In: Journal of Finance 53. 27–64.
- Pagano, M., A. A. Roell and J. Zechner. 2002.** The Geography of Equity Listing: Why Do Companies List Abroad? In: The Journal of Finance 57. 2651–2694.
- Rock, K. 1986.** Why New Issues are Underpriced. In: Journal of Financial Economics 15. 187–212.
- Small Business Service. 2003.** Bridging the Finance Gap.
- Stomper, A. and C. Zulehner. 2005.** Why Leverage Affects Pricing: Theory and Evidence. Vienna Graduate School of Finance Working Paper.
- Stoughton, N., K. P. Wong and J. Zechner. 2001.** IPOs and Product Quality. In: The Journal of Business 74. 375–408.
- Townsend, R. 1979.** Optimal Contracts and Competitive Markets with Costly Stage Verification. In: Journal of Economic Theory 22. 265–293.
- Tscherteu, A. 2003.** The Third Quantitative Impact Study (Basel II): An In-Depth Analysis of Regional and International Results. Financial Stability Report 6. Oesterreichische Nationalbank. 74–85.