Ex ante assessment of the German Micro-Mezzanine Fund - Summary

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Michael Unterberg
Daniela Richter
Dr. Stefan Meyer
Ann-Kristin Torkler

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The ex ante assessment that is obligatory for financial instruments (FI) co-financed by ESI Funds is a planning instrument aiming at an evidence-based determination of the adequacy of the envisaged FI against an identified market failure or suboptimal investment situation and to ensure that the FI will contribute to the achievement of the Programme and the ESIF objectives. Its basis is article 37 of the Common provisions regulation (CPR), which requires an assessment in seven steps. The objectives are:

- an analysis of market failures and suboptimal investment situations that allows to determine the financial resources needed to meet the demand,
- an assessment of added value and coherence,
- an estimation of leverage effect and multiplier effect,
- an assessment of experiences with and results of predecessor programmes or similar FI,
- an assessment of the envisaged investment strategy in comparison to alternative options for implementation,
- a specification of the expected contribution concerning the achievement of objectives,
- the definition of criteria to review and update the ex ante assessment.

The object of this ex ante assessment is the German Micro-Mezzanine Fund. The programme was launched by the German Federal Ministry of Economic Affairs and Energy (BMWi) in the last funding period and shall be continued in the funding period of 2014–2020. As result of the analysis it can be noted that the planned FI is

- an economically reasonable continuation of a targeted programme,
- an effective instrument to reduce market failures concerning the supply of small-volume quasi-equity financing,
- geared for strengthening the equity base and competitiveness of start-ups and small enterprises.

**Analysis of market failures and suboptimal investment situations**

Since 2012, start-up activities in Germany are characterised by a negative balance of foundations and liquidations. The number of full-time entrepreneurs even dropped to a historical low in 2013. Two areas, especially, show room for improvement: full-time start-ups by women entrepreneurs are inadequately represented with a proportion of only one third, and start-ups by migrants or previously unemployed persons face special difficulties on their way to setting up business. All in all, the development of the number of SMEs in Germany can be seen as stable. Micro enterprises, however, show a decline in their equity ratio that goes hand in hand with an increased vulnerability to crisis.

The planned FI addresses typical market failures concerning the access to financing of start-ups and small enterprises. As a quasi-equity instrument it is designed to improve the equity base of non-bankable enterprises, thereby enabling them to gain access to regular financing in the future. Its specific target groups are women, migrants and start-ups by previously unemployed persons.

The analysis of market failures follows the approach suggested by the EU commission. The investment gap is quantified by comparing the supply of adequate financing available on the market with the potential demand. It is evaluated to what extent the derived gap is attributable to market failures (on the basis of, e. g., lack of collateral, discouraged borrowers, high transaction costs, excessive risk sensitivity of banks) or to a lack of economic viability on the side of the business projects. By a rough estimate based on statements made
by experts, a proportion of around 50% can be attributed to market failures in each target group (start-ups and existing SMEs).

Since micro-mezzanine capital is often used as a substitute for external financing, the ex ante assessment includes all external funding in its calculation of the supply and demand of financing. The estimation of the unsatisfied demand for start-up financing draws essentially on data from a survey conducted by the German national promotional bank KfW. On the basis of the proportion of start-ups that feel exposed to credit rationing (21%), and the average invested capital of EUR 22,500, an annual gap of EUR 200-300 million in start-up financing can be derived. According to the KfW’s data in connection with financing for existing SMEs, 26% of the overall need for financing originally planned by SMEs in Germany (EUR 102.3 billion) can be allotted to the target group relevant for the German Micro-Mezzanine Fund. Taking into account only the portion that was not covered by credit financing (EUR 22.5 billion), this is equivalent to around EUR 5.9 billion per year. The proportion of enterprises with financing difficulties amounts to 17%. In relation to other data given in the KfW’s survey, this amounts to an annual gap in SME financing of approx. EUR 500 million. Overall, the annual gap in external financing that can be addressed by quasi-equity instruments can be estimated to amount to approx. EUR 700-800 million.

Although the planned FI will be provided with a considerably lower capitalization, its capital endowment can be assessed as adequate, as micro-mezzanine capital is relatively unknown and only infrequently in active demand on the market. Nevertheless, taking account of the demand in the current funding period, the ex ante assessment estimates that the demand potential is considerably higher.

**Added value and coherence of the German Micro-Mezzanine Fund**

Principally, an added value of the instrument can be considered as existing, as it extends the range of financing offers for the target group, and contributes to the reduction of the identified investment gap. Considering the extent of the verified market failures, the proportionality of the intervention can be seen as given.

Above all, the added value of this quasi-equity instrument must be assessed in comparison to existing alternatives of funding for the target group, e. g. grants or subsidised loans. In this context, the ex ante assessment evaluates qualitative and quantitative components as well.

To begin with, the quantitative value added lies in the leverage effect as defined in article 223 VO (EU) Nr. 1268/2012: “The leverage effect of Union funds shall be equal to the amount of finance to eligible final recipients divided by the amount of the Union contribution.” On the basis of its co-financing structure a leverage effect of at least 1.7 is assumed for the German Micro-Mezzanine Fund. Taking into account the additional financial resources activated by the instrument, the expected leverage effect rises up to 5.1. Moreover, it is to be expected that the final recipients’ own resources will be activated in the majority of cases.

Considering the fixed annual remuneration of 8%, together with the possibility of a variable, profit-dependant remuneration of max. 1.5%, the intensity of subsidy of the envisaged micro-mezzanine financing operations can be assessed as relatively low. With a funding ceiling of EUR 50,000 the FI falls within the guidelines of the EU’s de minimis Regulation. The estimated subsidy share of the dormant equity holdings granted through the German Micro-Mezzanine Fund is lower than 5% of the funding volume provided.
With regard to the coherence of the instrument the ex ante assessment bears out that the German Micro-Mezzanine Fund shows almost no overlap with existing instruments. The small financing amounts, especially, in connection with a low-threshold application procedure answers to market failures not addressed by other instruments.

Lessons learnt

The funding sponsor possesses experience with the implementation of the instrument from the past funding period. In addition, the ex ante assessment examines experiences made with similar programmes.

The need for a federal micro-mezzanine programme is proved by the high demand the instrument generates in the current funding period. This is induced by the precise fit of the product, for which the interviewed experts regard the lean application procedure via regional agents as crucial, among other things. Additionally, the instrument achieves good access to the primary target groups (e. g. enterprises managed by women or migrants). More than half of the final recipients can be assigned to one of the specific target groups.

The BMWi has already gained experience with the implementation of a similar programme, the German micro-credit fund. These experiences have influenced the incentives for remuneration and the way in which the target group’s direct access to the German Micro-Mezzanine Fund is guaranteed. Also, years of experience with the programme ERP-Kapital für Gründung provide hints, e. g. with regard to the expected default risks.

The investment strategy and its implementation

Since 2013, the management of the German Micro-Mezzanine Fund resides with the NBank, who was assigned fund manager by the BMWi within the framework of a public tender. This collaboration shall continue in the next funding period. As in the past, the target group’s access is ensured via the Mittelständischen Beteiligungsgesellschaften (MBGs), active in each federal state in Germany. All operations connected to the micro-mezzanine recipients reside with them, especially the processing of applications, controlling and account of financing. Moreover, the MBGs are obliged to conduct a permanent monitoring of the micro-mezzanine recipients. Target group access is broadened through a compulsory inclusion of local disseminators. The following illustration presents an overview of the investment strategy:
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The planned FI aims to reach a broad target group of start-ups and small enterprises. Commercial banks are not involved in the allocation process. However, from the ex ante assessment’s point of view market distortions are not to be expected, since the target groups of the German Micro-Mezzanine Fund are not (yet) bankable due to market failures. The application of the German “Hausbankenprinzip”, that gives precedence to commercial banks as allocators of funding, would excessively restrict the target group’s access to the FI.

The conditions of the charges to be paid by the fund to the MBGs are designed to encourage broad target access and, also, to address the necessity to keep default risks as low as possible over the long term. The fixed remuneration of EUR 800 is not economically viable for the MBGs, but offers them the chance to attract new clientele. Overall, the incentive structure can be assessed positively.

**Contribution to the achievement of the specific objectives**

The funding through micro-mezzanine capital is assigned to the specific objective „to support technology-oriented start-ups, to assure sustainability of start-ups and jobs“ in the ESF-OP of the German government. The ex ante assessment evaluates the designated indicators of outputs, results and effects and quantifies the target values. On this basis, the following numbers are a realistic estimate for the whole funding period:

- around 1,550 to 2,200 financing operations for business projects and start-ups;
- of these, 600 to 1,200 new start-ups;
- gross effect: 3,100 to 4,400 secure jobs.

Additionally, the FI contributes to the indirect effect of an improved access to financing for start-ups and small enterprises and, subsequently, to economic resilience and corporate growth.

For a long-term control of positive effects and to be able to intervene in negative developments on short notice, the authors recommend an actualisation of the ex ante assessment at the end of the first pilot phase (end 2015). This applies especially if signs appear for a decrease in demand or if the specific target group’s participation falls below 30%.