DOCUMENTS

PRIVATE EQUITY: IS THERE A PLACE IN EUROPE FOR MICRO ENTERPRISE?

Europe has long debated the issue of access to financial instruments outside the sphere of the banking system for small and medium businesses. One major measure is the approval of financial instruments by the "2007-2013 Competitiveness and Innovation Programme", intended to bridge the market gap that occurs when SMEs need to take risks

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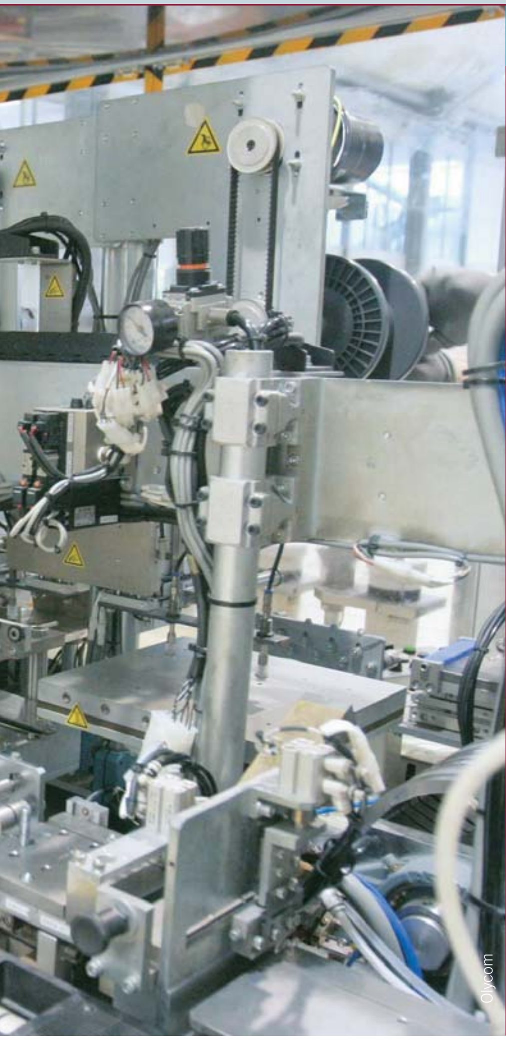
Notwithstanding the evolution of the regulatory framework, of the intense process of privatization of publicly-owned companies and of the significant changes that have taken place in the European financial scene, including greater integration of the banking sector, during the last 15 years Italy has presented an example of development of bond markets and above all of risk capital that has disappointed expectations.

This sluggish development has proven particularly problematic for small businesses, which perhaps more than others experience difficulty in accessing sources of external financing, in spite of the growing focus on this issue both in Italy and in Europe.

Attention on access to financial instruments arises from the specific characteristics of the European industrial structure: according to data from the Observatory of European Small and Mid-sized Companies (2004), over 92% of the European entrepreneurial framework consists of micro enterprises (with less than ten employees) and 6.5% employ from 10 to 50 employees (small businesses).

To a greater extent than other European countries, Italy abounds with micro (almost 95%) and small (4.5%) enterprises, as surveyed by ISTAT [National Institute of Statistics] in 2007. Moreover, according to the Observatory already cited, the PMIs [Small and Mid-sized Businesses] employ an average of four workers in Italy (only Greece employs less, 2) and value added per worker in the PMIs is greater than the European average (89 compared to 74).

Nevertheless, Italian companies – micro and small, but to a certain extent even mid-sized companies – can be singled out from their European counterparts by their less than robust financial structure, marked by considerable under-capitalization, widespread use of traditional forms of bank financing (particularly short-term



The terminology of private equity

VENTURE CAPITAL is that segment of private equity that invests primarily in companies at the initial stage of their life cycle (seed or start-up capital, which together make up early-stage capital) or in the development phase (expansion capital). In general, venture capital investments are targeted to companies strongly oriented toward growth, often in sectors under expansion.

BUSINESS ANGELS are so-called "informal" private investors, due to the fact that they are persons (entrepreneurs, managers or consultants) endowed with significant personal resources of capital, experience and professional expertise that can be made available to new enterprises. In addition, they are investors who employ different and more flexible methods with respect to regulated procedures applied in stock exchanges or by institutional investors.

Lastly, there is the BUY-OUT SEGMENT. Buy-out operations involve acquisition and restructuring of already existing companies, usually of large dimensions, in mature sectors. This segment is normally less risky than its venture capital counterpart.

loans with personal guarantees) and frequent reliance on multiple lines of credit from banks.

There is also evidence in the Bank of Italy's Annual Report of the infrequent use of external financing: though the proportion of financial debt as compared to GNP is rather contained when compared with other major European countries (with the sole exception of Germany), leverage is higher than in France and Spain and slightly lower than in Germany. Principally a measure of the contribution of risk capital to a company's finances, leverage is an important indicator of its financial structure. Moreover, the configuration of financial debt reflects scarce reliance on bond issues on the part of Italian companies as compared to their European counterparts. Finally, there is evidence of a lack of development of venture capital resources in Italy, principally due to the scant participation of institutional investors, such as pension funds, and of underdevelopment of the stock markets, which make disinvestment more complicated. The **box** sets out the definition of venture capital, as well as illustrating other features of the capital risk marketplace.

These elements reveal a remarkable difficulty in accessing sources of external financing, as reported by De Caprariis and Guiso (2004). With respect to company access to financing, Italy rates a score of 4.10 for venture capital and 4.39 for risk capital on a scale from 1 to 10, where 10 indicates ease of access. Italian scores are much lower than the EU averages and only approximately one-half of those recorded in Northern Countries. Belli and Giordano (2007) instead show that, in 76.6% of companies surveyed, third party capital contributions are very limited: less than 10 percent. Moreover, only the large companies offer a partial exception: 17.6% offer ample access to external partners, as compared with 6.2% of mid-sized and 8.1% of small companies.

Some of the factors explaining the limited use of risk capital by Italian small businesses principally involve structural issues impacting organization and the functioning of specialized capital markets. Secondly, an examination of the role that credit intermediaries play in the access to innovative financial instruments on the part of small businesses could turn out to be critical. On this point, Ferri, Minetti and Rotondi (2007) have collected empirical evidence for the presence of an initial complementarity between a close bank-company relationship and access to risk capital.

ACCESS TO SOURCES OF EXTERNAL FINANCING

In Europe, the subject of access by PMIs to financial instruments not traditionally provided by the banking system has been the focus of attention for some time. An effective measure consists of a series of financial instruments created by the Program for Competitiveness and Innovation 2007-2013, which were designed to fill the market gap in access by the PMIs to risk capital and borrowing, including microcredit and mezzanine debt. These instruments are targeted to entrepreneurial projects still in the evaluation stage (seed capital) and to innovative and high-growth potential PMIs not yet mature (seed, start-up or expansion capital). Moreover, there is a provision for guarantees by the banks for loans made to PMIs. In addition, there are a number of joint projects with the European Investment Bank, such as JEREMIE [Joint European Resources for Micro to Medium Enterprises], on innovative forms of financing (for further details please visit http://www.eif.org/jeremie), "pilot actions", such as CREA [Center for Regional Economic Analysis], designed to test new financial instruments, research studies and conventions and subsequent communications, and European Commission proposals regarding the various aspects of the relationship between PMIs and the financial system (for a current list of respective publications please visit the European Commission's website, http://ec.europa.eu/enterprise/entrepreneurship/financing/publications.htm).

As illustrated in **Chart 1**, emphasis is focu-

sed primarily on investments of risk capital, including more informal types such as business angels, and venture capitalists involved in providing seed and start-up capital.
Moving also in this direction is Italy, with Industry 2015, a legislative proposal for a new industrial policy approved in September 2006. The creation, among others, of an "Enterprise Finance Fund" is intended as a rational approach to organizing the current multiplicity of existing measures: for example, the new fund draws together resources contained in previous venture capital funds. Secondly, there is a provision for the fund to exploit a number of measures in support of "participation in the availability of risk capital by companies... and participation in structured finance operations", especially on the part of small and mid-sized enterprises (see, Article 6 of the Industry 2015 legislative proposal).

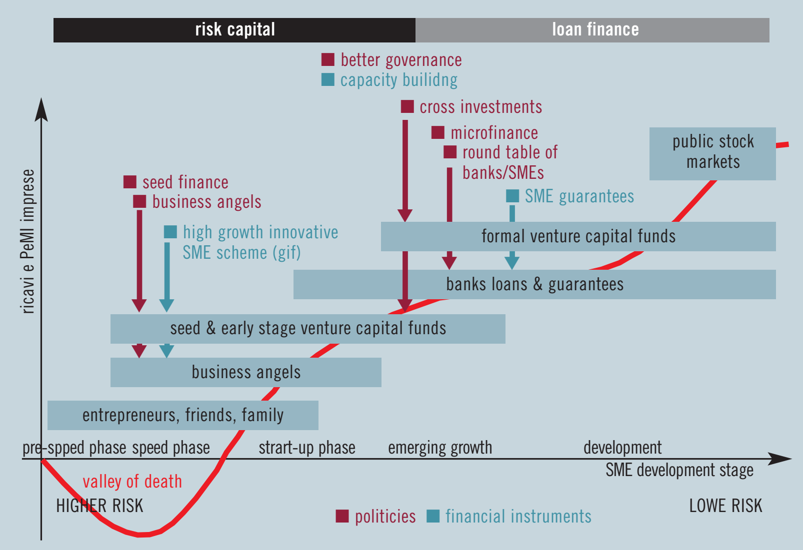
A WEAK CAPITAL MARKET FOR MICRO ENTERPRISES

The choice, among the possible industrial policy measures, of an instrument to facilitate access to risk capital primarily by small and mid-sized companies, was by no means casual: according to EVCA [European Venture Capital Association], in 2006 the percentage of Italian GNP invested in private equity (0.33%) was decidedly less than the overall European average (0.55%). Only Germany recorded a slightly lesser amount (0.31%), while Spain, and above all France, registered higher values (respectively 0.37% and 0.61%).
With respect to the venture capital segment, for the period 2000-2003 OCSE [Organization for Cooperation and Economic Development] (2006) reports a lower average of investment as a percentage of GNP in Italy (0.08%) with respect to Germany (0.11%), France (0.12%) and Spain (0.13%), lower even than the European average (0.14%). The United States instead invested 0.39% of GNP in venture capital operations.
Finally, with regard to younger enterprises, which are necessarily of more limited dimensions, for the 1996-2005 period the average of investment in risk capital as a percentage of GNP was 0.27% in the USA, 0.10% in Europe and only 0.05% in Italy, according to the aforementioned Bank of Italy Annual Report. Within the European context, the Italian private equity market presents the following features:

- continual increase of the number of national operators, though considerably fewer than those active in other countries. In October 2007 AIFI, the Italian Association for Private Equity and Venture Capital, had 116 members, while those participating in respective national associations numbered 239 in France, 197 in Germany and a mere 90 in Spain;
- a growing trend with respect to the total amount invested annually, surpassed only in France. In 2006 (most recently available annual data) EUR 3.7 billion were invested compared with 10.2 billion in France. Germany instead invested 3.6 billion, while Spanish investment amounted only to EUR 2.8 billion;
- new capital formation is on the rebound, but lower than in other European countries. EUR 2.3 billion were raised in Italy in 2006, as compared with 10.3 billion in France, 3.6 billion in Spain and 2.8 billion in Germany;
- capital raised for the most part from foreign sources, though the foreign share is in decline. In 2006, 50% of the total amount raised in Italy consisted of foreign capital, as compared with 39% for France and 44% for Germany. In Spain, instead, 55.7% of capital raised came from foreign investment. The significant quota of capital from foreign sources in Italy is a sign, on the one hand, of international confidence in the Italian private equity market, and of the limited propensity of Italians themselves towards risk capital, on the other.

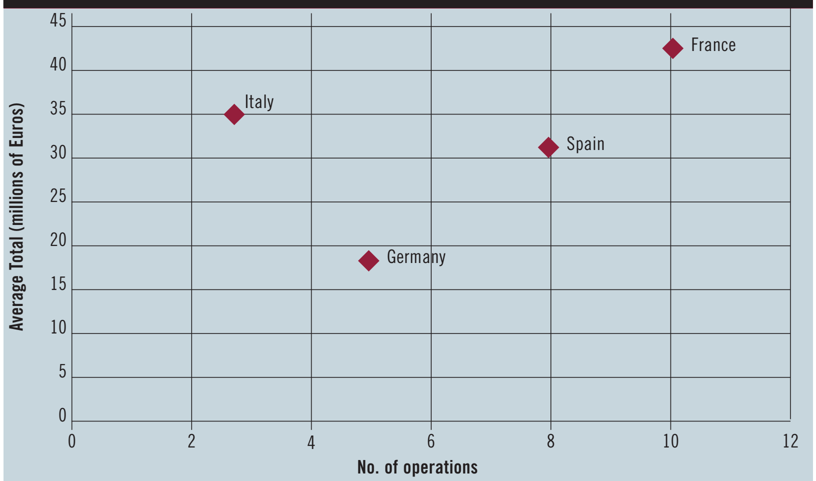
Chart 2 summarizes a number of market features in 2006 (most recent annual data available). Private equity operators in Italy can be distinguished for their low number of operations per capita (3 contrasted with 5 for their German colleagues, 8 for Spaniards and 10 for the French) and for the high pro capita amount invested annually (EUR 35 million, second only to the French, who reach a high of 42 million).
Similarly, during the last four years the Italian private equity market has stood out in Europe for its small number of annual operations, of higher average dimensions, as illustrated in **Chart 3**.
During the last 10 years, risk capital investment in companies with less than 20 employees has accounted for 34% of the total, an increase compared with 1997. Nevertheless, as evidenced by **Chart 4**, there has been a noticeable decrease in

1. POLICIES OF THE PROGRAM FOR COMPETITIVENESS AND INNOVATION AND FINANCIAL INSTRUMENTS



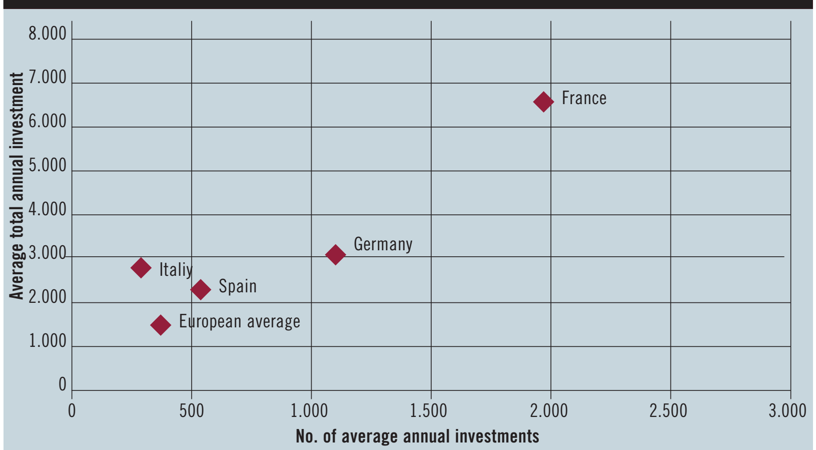
Source: http://ec.europa.eu/enterprise/entrepreneurship/financing/index_en.htm

2. 2006 PLACEMENT (PRO-CAPITA VALUES)



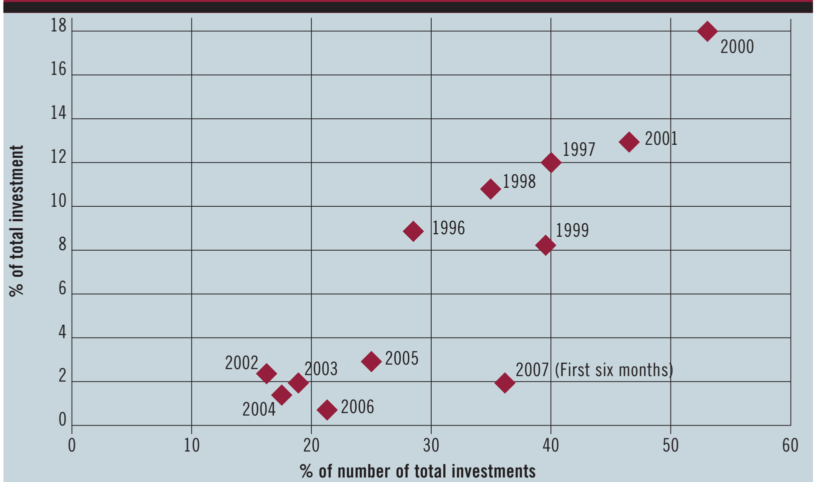
Source: our processing of AFIC, AIFI, ASCRI and BVK data

3. POSITIONING OF THE ITALIAN PRIVATE EQUITY MARKET, 2002-2006



Source: our processing of AFIC, AIFI, ASCRI, BVK and EVCA data

4. INVESTMENTS IN EARLY STAGE (SEED CAPITAL AND START-UP)



Source: our processing of IFI data

early-stage operations involving micro and small enterprises as compared with 1996, both in terms of number of operations and of total amount with respect to total investments.

Likewise at the international level, there has been weakness in early-stage activity: the number of operations in Europe is higher than that in the United States, but the average size of the operations is very small. This suggests that European venture capital has difficulty in reaching adequate levels of investment and, once projects of value have been identified, in amassing the necessary capital. Data for the first half of 2007 however presents evidence of an inversion of the trend at the European level: USD 2.9 billion were invested in 667 early-stage operations in the U.S., as compared to EUR 704 million in 131 operations in Europe, and EUR 0.7 million in Italy. Consequently it seems that, partly due to the difficulty of monitoring smaller projects, and partly due to very substantial investments by institutions such as pension funds, venture capital operators have begun to focus on larger scale investments.

The difference in the performance of the early-stage segment on the European market can be explained by a number of considerations. First of all, companies in the initial phase of their activity may not have the traditional instruments of external financing available to them, such as bank loans, due to their uncertain or limited cash flows, to the absence of the respective guarantees and to elevated levels of informational asymmetry between the entrepreneur and potential investors. To this must be added a potential misalignment of the interests of the venture capitalist (short to mid-term) and company expectations (longer term).

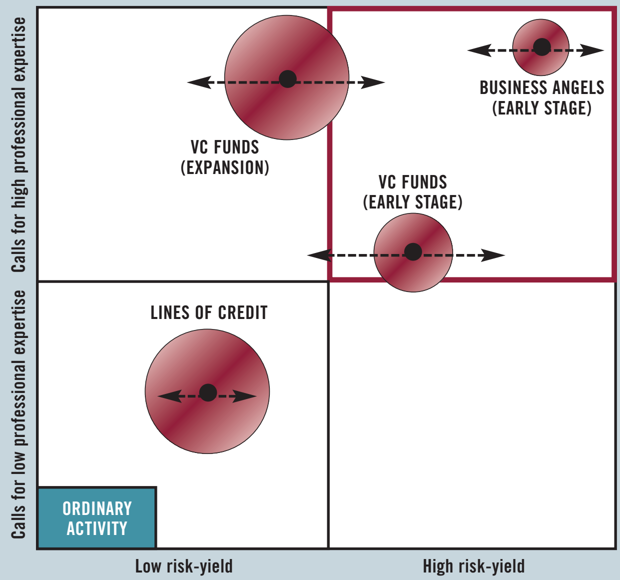
Moreover, venture capital, including the early-stage segment, is not merely an alternative method of financing, but also represents a source of managerial expertise for the companies in which it operates. Finally, the higher risk connected with venture capital investment (particularly the early-stage type), compared with risks associated with buy-outs, which primarily involve mid to large companies, may be the cause of the relative low profitability of the former and may be the basis of the

somewhat limited growth of the corresponding market.
According to the European Central Bank, yields of European venture capital funds during the period of 1994-2003 averaged 8.3% annually, while buyout funds yielded 12.7%. During the same period, early stage funds resulted only in meager yield of 1.3 percent. The corresponding values for the same period in the United States were decidedly higher both for venture capital investments and for buyouts (25.4% and 7.8%, respectively). Most striking of all, early-stage investments yielded a whopping 37 percent.

THE RISK CAPITAL FLOP

As underscored in the final (2005) report of the Working Group on Venture Capital jointly sponsored by the U.S. Department of Commerce and by the European Commission's Directorate-General for Enterprise and Industry, there is undeniable evidence of market failure with respect to early-stage activity. This market failure is the cause of an imbalance in the supply and demand for risk capital, principally as regards micro and small enterprise.
Figure 2, taken from the UniCredit Bank Small Business Report (2006), takes a multidimensional approach to illustrating the reasons for this failure. The market for capital (debt and risk) available to small business can be divided into three segments:
1. the risk-yield profile;
2. the level of professional expertise necessary to successfully manage the respective operations;
3. the critical mass that must be assembled.
In **Chart 5** the level of professional expertise necessary for managing operations is represented along the vertical axis, while the risk-yield profile is for the sake of simplicity represented by points, but in reality it would be more precise to indicate intervals – the horizontal bi-directional arrows drawn in the figure – where the point in reality represents an average. In fact, there are also a number of superimpositions and contiguities with respect to the finance diagrams discussed here.
Finally, critical mass is represented by the diameter of the circles, and understood as the comprehensive total of the funds available to finance the operations, taking into consideration the qualitative and quantitative characteristics of the respective marketplace.

5. POLITICS FOR COMPETITIVITY AND INNOVATION PROGRAM FOR FINANCIAL INSTRUMENTS



Source: Unicredit Bank Small Business Report

Small company financing operations can be contextualized within the representational matrix resulting from the combination of the three aforementioned dimensions.
In the case of relatively low risk-yield and necessary professional expertise profiles (lower left quadrant), operations can be executed by means of debt capital, supported by additional collective guarantees. In fact, it is typically a matter of operations having a similar financial structure, without the need for highly professional expertise.
The remaining quadrants instead involve risk capital financing with diverse profiles. It is useful in particular to distinguish among operations of expansion, early-stage operations with formal investment (venture capital funds) and of early-stage operations with informal investment (business angels).
Expansion operations refer to a segment which can be satisfied by private equity markets due to their considerable critical mass. In consequence, they are not susceptible to the market failure that affects early-stage operations.
Early-stage operations in general enjoy a risk-yield profile which is in itself sufficient to attract financial resources. Nevertheless, in the case of micro and small businesses the average size of the operation is so small as to make it difficult for it to attract the interest of a private equity fund seeking an adequate return for its investors. Moreover, the professional management of the business activity of the micro and small enterprises in which risk capital is invested may require specific expertise, not necessarily easy to find. The risk inherent in such investments is consequently much greater and could seriously compromise the expected average return of the operation. These are the reasons that determine the failure of the market and the lack of investment in micro and small enterprises in their start-up phase.
Up to this point we have analyzed the "supply" side. What can be said for the "demand" side? Are small entrepreneurs, the typical family-based small businesses, prepared to change their tried and true framework, thus abandoning an almost exclusive debt-based financing scheme, and switch to financing which has a component of risk capital, with the concomitant entry of external investors? Is there room (even potentially) for a bank to act?
To look for answers to this question, UniCredit Bank (2006) conducted a survey sampling 2,303 micro and small

enterprises. Beginning with the essentials, and with issues regarding the need for capital on the part of these enterprises, we have gleaned a number of initial suggestions with respect to a possible new role for banks in this environment.

A majority of small entrepreneurs interviewed were favorable to the banks' participation in risk capital (52.1% of the sample), and this was confirmed by data that was fairly homogenous for all Italian Regions. The opinion of those interviewed was similarly unanimous with respect to the opportuneness of the moment for the bank to effect this operation, that is, during a growth phase of business activity (27.9% of the sample). This was followed by the initial start-up of activity (14.2%) and that of reorganization (5.6%). Slightly over 1% would require assistance to access foreign markets or to invest in high technology.

Beyond what may be termed "declared" preferences (reflecting personal subjective conditions), a selection was eventually made of the interview subjects to identify investors in possession of the prerequisites to become a candidate for private equity investment. The three objective criteria used to identify "suitable" enterprises were the following:

- growth or expected growth, or a general increase in sales, clients or employees;
- whether the entrepreneur was prepared to waive full control of the company in
- order to benefit from the opportunity for growth;
- undersized company with respect to potential market.

Enterprises with growth potential accounted for 77.5% of the sample. Nevertheless, only 39.3% of the entrepreneurs interviewed were prepared to relinquish their respective decisional independence to promote growth, they were ready to strengthen the level of respective capitalization through financing (35.7%) or to grant access to a new partner (3.5%). Of the latter subsample, 67.7% see the bank as a good financial partner when considering the probability of achieving greater solidity in capitalization or improved expectations for growth. Those opposed, while acknowledging a useful role for private equity, notwithstanding the possession of the "key" prerequisites, are not in fact prepared to admit the bank as a partner, either from fear of losing their respective decisional independence, or because they do not believe such a measure could help to resolve their respective issues, or because they find it preferable to deal with a physical person. It should be noted that, though it was initially applied generally, the term "financing" was afterwards given the meaning "participation in risk capital".

The fundamental fact is nevertheless different: only 16.8% of entrepreneurs qualified as heading a company that was undersized with respect to market potential.

In conclusion, it is important to understand exactly what the entrepreneur is prepared to do. What clearly emerges from the report is the importance of entrepreneurial individualism: among the 387 entrepreneurs judged to be "qualified" for private equity investment, 58 are not prepared to undertake risky measures, nor to share the management of the company with the bank, thus abandoning a substantially conservative approach to their decisions. An additional 204, while having the intention of enacting growth strategies, prefer to risk their own resources in order to preserve full control of the company. Finally, "only" 89 entrepreneurs (3.9% of the initial sample) were prepared to relinquish complete control of the business for the prospect of further growth. Though this finding may seem quantitatively unimportant, it is nonetheless highly significant because it applies to the world of the micro and small enterprises, to those companies, that is, that both in terms of sheer numbers as well as of value added constitute for the most part the Italian entrepreneurial fabric and with respect to which, moreover, there is a substantial failure of the risk capital market.

... AND ITS POSSIBLE SOLUTIONS

One possible response to the failure of the market would be, on the one hand to empower the operations of business angels, and, on the other, to create a partnership of private (private equity investors, industry associations, credit pools and banks) and public subjects (local, national and Community entities) which for various reasons are interested in the birth and growth of new enterprises.

Recourse to business angels affords obvious advantages for companies in the start-up phase of their activity because it offers more flexible and less stringent terms for negotiation and operational assistance (including contacts with new clients and qualified employees and encouragement pure and simple). Moreover there are synergies among business angels and venture capital operators: the former support the latter by researching and evaluating new projects, thus increasing the number of start-ups and enlarging the supply of operations available to venture capital investors. Additionally, business angels can be of assistance to companies seeking growth during negotiations with venture capital operators, thus making it possible for them to obtain more favorable terms. Finally, thanks to the entry of venture capital in the company, business angels are able to realize their investment objectives.

There is a need for the co-participation of various subjects, each playing a specific role, in order to make this virtuous circle a reality. In particular, banks can favor the process of birth and growth of new enterprises through two specific channels: by providing debt capital, and even more by becoming promoters and coordinators of the partnership among the various private and public subjects involved in the process.

One market which aspires to this type of role for banks is the Alternative Investment Market (AIM) in London. In fact, small and medium sized companies can only obtain listing on this market upon introduction by an advisor, primarily a bank, which "guides" them toward new forms of investment. This praxis has also been recently introduced in Italy with the creation of the Alternative Capital Market (MAC), which however targets medium sized companies. Consequently there is still a role banks can play in facilitating access to risk capital for smaller companies, in consideration of the complementary link between a close bank-company relationship and innovative financial instruments.

This article reexamines and develops the theses originally discussed in Chapter 6 ("Is there a new place for risk capital in the 'capitalism of smaller companies'?", pages 167-196) of the UniCredit Bank Small Business Report, III Ed. 2006/2007: "Credit for the territory and the bank". The members of the working group are: Francesca Bartoli, Serena Frazzoni, Franco Mosconi (Science Chief), Massimiliano Riggi and Zeno Rotondi