Joining other European markets in the context of the MiFID directive is a key driver for an effective midsize company bond market to function well in Spain. This is even more important due to the particularly difficult credit conditions. Spanish companies need a larger and more liquid credit market. Setting up a domestic bond market for Spanish SMEs may not be feasible in the very short term in the absence of domestic institutional investor interest for such an asset class. But on the positive side one should recognize that some European institutional investors are reallocating part of their money into investments on corporate debt. This has somehow materialized in France since the beginning of the year and insurance companies are expected to become more visible as corporate lenders. As geography also plays a role in the “diversity score” of portfolios, Spanish companies with good financials - there are many - could also attract interest of “cross border” institutional investors and should take advantage of that.

Keywords: to compensate for the lack of bank credit and of a domestic bond market Spanish midsize companies should contemplate tapping other European bond markets that are developing.

JEL Classification: G1, G2.

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ABSTRACT

RESUMEN

Unirse a otros mercados europeos, en el contexto de la directiva MiFID, es un factor clave para que el mercado de bonos de empresas de tamaño medio pueda funcionar bien en España. Esto es aún más importante debido a las condiciones de crédito particularmente difíciles. Las empresas españolas necesitan un mercado de crédito más grande y más líquido. La creación de un mercado interno de bonos para las PYME españolas puede no ser factible en el muy corto plazo, debido a la falta de interés de los inversores institucionales nacionales por tal tipo de activos. Pero en el lado positivo hay que reconocer que algunos inversores institucionales europeos están reasignando parte de su dinero en inversiones en deuda corporativa. Esto de alguna manera se ha materializado en Francia desde principios del año 2013 y además se espera que las compañías de seguros asumen un papel más activo como prestamistas corporativos. Como la geografía también juega un papel en la «puntuación de diversidad» de las carteras, las empresas españolas con buenos fundamentos financieros - hay muchas - también podrían atraer el interés de los inversores institucionales «transfronterizos» y deberían aprovecharse de ello.

Palabras clave: crédito bancario, mercado de bonos doméstico, PYME.

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* Partner One to One Capital Partner Madrid, Chairman of Spanish Financial Advisors Association. Contacto: carlos.orduna@onetoonecp.com
** BRCASAS Paris, member of CNCEF - Chambre Nationale des Conseils Experts Financiers. Midsise companies in the Spanish economy. Contacto: dominique.pasquier@brcasas.com

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1. MIDSIZE COMPANIES IN THE SPANISH ECONOMY

In late 2010, Spanish midsize companies represent 99.9% of the Spanish non-financial corporate sector, in terms of company numbers, and they accounted for 76% of its employment and 68% of its overall added value. These percentages exceed by about ten percentage points those observed for the whole of the European Union (EU), which reflects a greater involvement of midsize companies in the Spanish economy.

It becomes even more significant when compared with the other major EU economies. Whereas the Spanish Large Caps in 2010 generated 24% of employment of non-financial firms, this percentage rose to 40% in France, 39% in Germany and 46% in the UK. In terms of value added, Spanish Large Caps contributed 32% of it, contrasting with the 44%, 46% and 59% of the aforementioned countries. Among the major EU economies, only Italy had a parallel situation to Spain, with contributions from large companies reduced to 19% of employment and 29% of value added.

2. TRADITIONAL FUNDING OF SPANISH “PYMES” SMALL AND MIDSIZE COMPANIES

Traditionally, Small and midsize Spanish companies have almost entirely relied on funding from Banks. This is because financing for such companies had always been carried on in this way and they saw no reason to change. As a result they have become particularly vulnerable in the current credit crunch situation.

- Firstly, the former abundance of credit and efficiency of the banking system in Spain over the last twenty years before the credit crisis occurred.
- Secondly, the reluctance of firms to use a funding source that might jeopardize existing shareholders’ control.
- Thirdly, the greater transparency required by incoming investors including the regular submission of specific financial statements and the prompt reporting of anything that might affect the value of the company.
- Finally, the incorrect assumption that raising funds on the financial market is more expensive than approaching the Banks for funding

The historical reluctance of many family businesses to borrow from the market, combined with the seemingly inexhaustible supply of credit by financial institutions over the past quarter century, have led to

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entrepreneurs’ belief that they only needed to raise money from banks.

The evolution of corporate borrowing in recent years has amplified this trend. The Spanish economic model of growth during the last decade relied too much upon the construction and real estate industries. And both these industries have in turn been too exposed to funding from the Banks. The consequence of this has been a level of non-financial corporations’ indebtedness which has ballooned tenfold since 1986 and tripled in a decade from half a billion to one billion and a half, representing 140% of GDP.

At this point it is important to compare the financial structure of corporate entities in Spain with those in other countries.

The significant differences can be observed primarily in the breakdown of the debt and to a lesser extent in the relative level of the equity (Spain: “Patrimonio neto”) vis a vis liabilities. Germany is an exception. In Germany, the financing of Large Caps is supported by a higher equity contribution.

One of the most significant differences relates to the relative contribution of bank financing to the debt of the company. It is higher in small and midsize companies than in large Caps that are benefitting from more options for diversifying their borrowing base. So while bank financing represents, on average, 39% of total

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**Balance sheet structure: non financial companies**

![Chart showing the breakdown of debt and equity for different countries and company sizes]

Source: BACH

(*) includes equity funds and provisions

g: large companies

p y m: pym, medium size companies

GE: Germany FR: France IT: Italy SP: Spain

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debt for Spanish midsize companies under consideration, this percentage drops to 20% for Large Caps. In Spain, Banks are responsible for 42% of small and midsize companies’ financial indebtedness whilst representing 24% of their overall funding needs. As far are Spanish Large Caps are concerned, such type of debt only represents 24% of the total, and 13% of their overall funding.

The recent banking system bailout has shrunk even more credit flow as almost half of financial institutions, mainly saving banks, are merged or virtually closed.

Furthermore, the two main Spanish banks have avowed that credit would not come back on the short term in Spain due to balance sheet structure very hit by bad real estate assets provisions.

Bank of Spain, together with ECB, is following very closely the destination of the credit.

With the exception of three banks, the rest of the system has had to receive financial assistance. Based on available information, we can see that the situation regarding funding represents a big challenge at present for Spanish midsize companies.

As illustrated in the graph below, the short and medium term outlooks raise concerns about the normalization of credit and the impact of new prudential regulation on the intermediation capacity of the banking sector.

Source: ECB and BoS.

With the continuing financial crisis and economic recession there is a clear consensus now that a significant proportion of midsize companies need to tap into their internal cash or accumulated equity. Some of them even could even be forced to consider their shareholders’ personal wealth as a substitute for bank facilities and loans.

A recent survey by the European Central Bank of the present situation and of the short-term outlook, with respect to access to bank credit by small and midsize companies in the euro area, does not give much hope that the difficulties will soon subside. One draws the conclusion that the Spanish situation is quite similar to that of most other Euro zone countries. But the other
Conclusion one could draw is that the average level of credit lines available to midsize companies is lower in Spain than in most other Euro zone countries. This can be explained by the smaller size of Spanish corporate entities.

Hence it is becoming crucial to identify alternative funding. The issuance of bonds has now become a top priority. Spanish authorities are working on a draft of a project to create a bond market for medium size companies. We think however that a purely domestic market would not work. This is due to a lack of liquidity and interest by institutional investors, as explained by the small size and adverse macro situation of the country.

In Spain, bond market and non bank financing are virtually nonexistent for midsize companies. It is only through the AIAF (“Asociación de intermediarios de activos financieros”) that debt interests can be traded for corporate entities (and also for banks having low liquidity).

We firmly back the project of a unique Euro zone bond market for midsize companies, provided in the Mifid to be approved in 2015. This project would permit Spanish companies to benefit from a wider range of investors and a liquid market.

In other neighboring countries, the banks also play a dominant role in providing midsize companies with funding solution and also leaving little room for the development of other sources of external funding, such as venture capital, bond or equity markets. Even though funding from non-bank entities is developing in Germany, only 40 midsize companies (Mittelstand) have issued bonds there.

### 3. IS LENDING TO FRENCH “ETIS” SIMILAR TO LENDING TO SPANISH “PYMES”?

There are some similarities between the financing conditions of midsize companies France and in Spain.

In France, alternative sources of funds for midsize companies are just starting to become available. 92% of French midsize companies’ external resources are Bank loans or credits:

<table>
<thead>
<tr>
<th>Source</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>France - Mid Cap External Financial Resources - 2012</td>
<td></td>
</tr>
<tr>
<td>Bank Loans</td>
<td>92%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>7%</td>
</tr>
<tr>
<td>Financial Markets</td>
<td>1%</td>
</tr>
</tbody>
</table>

Though they still contribute marginally to the funding of French midsize companies, Financial Markets are expected to gradually supplement banks in granting them long term financial resources. Due to the impact of Basel 3, Bank lending policy tends to be more restrictive. Furthermore Basel 3 and Solvency 2 have had the effect of diminishing amounts of private equity being supplied by Banks and Insurance Companies.

As a result, following the recommendations from the Institut Montaigne, NYSE Euronext and market players have taken early steps to help midsize companies gaining access to the bond market. Though French authorities and market regulators are in the process of setting up a “Bourse des PME” and trying to help midsize companies (the so called ‘ETI’ for ‘entreprises de taille intermédiaire’) to issue bonds as a substitute to long term bank loans, it remains to be seen whether their efforts will pay off in the end.

At the moment it is worth mentioning the recent issuance with a rating (Fall 2012) of bonds from the French midsize company Capelli as well as the issuance of bonds from various French midsize companies that have been collectively bought by the fund "Micado France 2018" (also in Fall 2012). This fund is managed by Portzamparc Gestion.
As far as debt funds are concerned, the other major event in 2012 was the initiative taken by GIAC (“Groupement des industries Alimentaires et de Grande Consommation”) has taken of launching a securitization issuance (“FCT” for “commun de titrisation”) the aim of which is to lend to midsize companies.

Both are useful examples of viable alternative funding in France.

4. RATING AGENCIES’ CONTRIBUTION

The change envisaged above will be helped by the instructions of the French AMF (“Autorité des Marchés Financiers”) to have midsize companies credit-rated. The expectation for a developed midsize companies’ bond market is highly correlated with the acceptance of credit rating agencies by these issuers. France, Spain and Portugal belong to the group of European countries where a domestic rating business has been introduced since the 1980’s (1986 in France, 1988 in Portugal, 1989 in Spain). Today, in France, rated corporate entities only number 120 (all Large Caps), a still negligible figure in a country of more than 4500 corporate midsize companies (‘Entreprises de taille intermédiaire’). The current process of registering Credit rating agencies as carried out by the European Securities Market Authority is a good template for a larger field of players, dedicated to the rating of European corporate entities.

The rating methodology is designed to provide the financial market with a thorough understanding of each component of the credit risk. With regard to debt instruments, the first step to take is to assess the ability and willingness of the issuer to meet its entire obligation in a timely manner. The most important part of the process is dedicated to the issuer, who is viewed as having the primary responsibility for the legal compliance of the debt service. The security package, if any, will also form part of the analysis.

Credit risk assessment derives from an approach that is based on relevant expert opinions and forecasts, taken after careful consideration of the facts and with accurate forward planning. This method of approach is designed to make it easier to appraise both the issuer’s ability to withstand adversity and its ability to adapt to change. In other words, unless there are unforeseen major changes, it provides a vision “through the cycle”.

The rating analysts must follow various ‘methodological directories’ that have been developed by the rating agencies for each type of issuer (corporate entities, banks, financial institutions, munis…). Such guides are intended to refer, in a prescribed way, to the required collated information.

The diagram (see the flow chart on the following page) clearly illustrates how such an analytical approach could work in the case of a midsize company. Furthermore, it illustrates the particular information that will be required in order for an issuer to be correctly credit-assessed.

As for the “buy side”, it is worth noting that specialist investors in midsize companies’ bonds have little in common with the international investors playing “globally” on the international markets. For the former, the decision is not so much driven by the official rating of such issuances than by a thoroughly documented rating report.

The rating process thus plays a major role since the rating report is closely scrutinized by bond investors to check whether the opinion of the rating agency reflects their own.

5. RECOMMENDATION

Returning to the funding model of Spain, only the issuance of bonds could make midsize companies less vulnerable to a credit crunch. At present there is a dramatic disproportion between bank credit financing and financing through bonds and notes. The outstanding amount of bonds was 27 000 million Euros in the first quarter of 2011, whereas outstanding loans exceeded 1 459 000 million.
The situation has become critical in Spain, now that bank lending has virtually disappeared even for some Large Caps. Its financial sector shrunk by half in 2012 and there are regions where no entity can apply for credit. When compared to the situation of other countries, Spain is overly dependent upon credit with only 20% of total funding obtained through the markets. That is in marked contrast with the 50% mark existing in Germany for example. For some of the companies that rely up to 98% on their financial needs upon bank facilities, the credit crunch has introduced a huge risk of illiquidity which could easily lead to bankruptcy.

There is thus an urgent requirement for a bond market to be set up in Spain for midsize companies. As reported by the Spanish Markets and Exchange Authority, there are potentially 800 Spanish midsize companies that would be interested in such an alternative. In all countries, specialist investors in midsize companies’ bond issuances have little in common with the international investors playing “globally” on the international markets. For the former, the decision is not so much driven by the official rating of such issuances than by a thoroughly documented rating report.

It is very important to define the necessary conditions for an effective midsize companies’ bond market to function well in Spain:

- Better integrate within other European markets as reflected in the new draft directive MiFID. That is even more important for Spain than for any other country due to the particularly difficult situation of Spanish companies needing to benefit from a larger and more liquid credit market. At the present time, setting up a domestic bond market for Spanish SMEs may not be feasible, in the absence of institutional investor interest for such an asset class. Another option could be to issue bonds in foreign markets, (Euronext for example), in order to facilitate access to funding. However this option must be made available to midsize companies.

- Organize the process so as to engage the different gears smoothly and to avoid significant discrepancies when funding moves from one stage of growth to another. In particular, the existence of a dense
network of specialized investors focusing their attention to unlisted companies could be a stimulating factor for growth of the bond markets. It could contribute to an increase of the number of first issuers, attract the attention of new investors into the market and create the critical mass in the volume of business that may be needed to achieve economies of scale in the negotiation, analysis and marketing processes.

- Resolve the issue of the lack of domestic rating agencies in Spain who would have the opportunity to make effective judgments upon the dynamics of Spanish corporate entities, leaving aside the consideration of the usual whole “country risk” assessment. Presently the local Spanish agency only delivers «unsolicited» rating on behalf of financial institutions who specifically ask for an independent analysis of the creditworthiness of the customer. There is also a need for having ratings solicited by the issuers themselves.

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