FINANCING THE NEW ECONOMY

TOWARDS A POSITIVE CONSPIRACY

Businesses, Financial Institutions, and Governments
Partners in a stronger Canada

Project Report

June 1994

..."Small business must have access to adequate capital...

... New practices and attitudes on the part of the lending community are essential. That is particularly true with high growth, knowledge-intensive firms"...

The Budget Speech
February 22, 1994

...The ability to respond effectively to small business needs is crucial to the country's well-being. Governments, the private sector, and other institutions must act together in a decisive way to realize common objectives...

Growing Small Businesses (Budget)
February 22, 1994

NOTA BENE

This report, prepared by Paul Toriel of Industry Canada, represents the views of the members of the committee. It does not necessarily reflect the views of the organizations represented by committee members, nor do all members necessarily agree with all recommendations and/or comments in the report.

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EXECUTIVE SUMMARY

CONTEXT

Economies are changing rapidly, ideas and innovation are becoming increasingly the drivers of economic growth, and competition from international firms is now a fact of life for virtually all sizes of Canadian companies. It is in this environment, which has been called the "new economy", that Canadian firms must grow and prosper.

Due to the nature of the fast-changing pace of the new economy, small- and medium-sized enterprises (SMEs) are playing an even greater role in contributing to economic growth and job creation. The SME sector is typically more nimble and innovative in responding quickly to market opportunities. SMEs do, however, face significant challenges in competing internationally. One area, which is a major challenge for rapidly growing, export-oriented SMEs, particularly knowledge-based firms, and the focus of this project, is **access to financing.**

FINANCING ISSUES

Access to financing is a critical determinant of the success of knowledge-based SMEs. Many reports and studies have recognized the difficulties encountered by these SMEs in obtaining both debt and equity financing. For reasons originating both on the financial supply side and the demand side, the principal areas of difficulty include: equity investments/risk capital in amounts under $750,000; working capital and medium term financing for soft assets; servicing of knowledge-based SMEs by financial institutions and governments; risk assessment and pricing; availability and access to export financing; and working capital for small exporters.

OBJECTIVE OF THE PROJECT

This project was designed to work with private and public sector providers and users of capital to:

- *Develop and recommend improved private and public sector approaches to providing capital, particularly debt financing, to knowledge-based SMEs.*

- *Develop and recommend improved private and public sector approaches to providing financing to export-oriented SMEs.*

COMMITTEE MEMBERS/STRUCTURE

To undertake the work, a committee was formed comprising representatives from: private and public sector financial supply side; SMEs; Industry Canada, Foreign Affairs and International Trade (FAIT), and the Department of Finance; the provinces of Ontario and Quebec; and from institutions such as the Western Business School, the Canadian Institute of Advanced Research, and the Canadian Labour Market and Productivity Centre. The committee was chaired by Paul Toriel of Industry Canada.

Given the scope of the work to be addressed by the Committee, two sub-committees were formed as follows: debt and equity financing, chaired by Paul Toriel of Industry Canada; and export financing, chaired by Roger Ferland of FAIT. The Committee has agreed on the following recommendations:

RECOMMENDATIONS

DEBT AND EQUITY FINANCING

1. Servicing by financial institutions and governments

- Banks[1] should accelerate the process started by some of the banks of establishing special units to service knowledge-based SMEs.
- Public sector programs and services should only address market gaps and complement, not compete with, those offered by the private sector. Their focus should be to graduate SMEs to private sector services.
- Government supplied/facilitated financing should not carry a pricing subsidy; it should be priced to reflect risk and be as close as possible to market price.
- Government programs, federal and provincial, should be reviewed regularly to address concerns about overlap and continued rationale.
- Canada Business Service Centre (CBSC) information should be shared widely among business intermediaries.

[1] The word "banks" in this report generally means "private financial institutions", including trust companies, credit unions and caisses populaires as well as chartered banks.

2. Risk Assessment/Pricing

- Banks, venture capitalists and informal investors should work together as partners to share the due diligence and risk assessment. This will allow for more informed decisions on taking the risk of financing knowledge-based SMEs (and therefore reduce the risk of losses). They should form strategic partnerships with "experts" (such as the Provincial Research Organizations, for example) who can help provide fast, reliable and cost effective technology assessment assistance.

- Banks should explore innovative ways to finance higher risk transactions. These could include low interest rates early in the life of the loan but higher rates later when the borrower is better able to pay; or loans where returns are based on participating in the growth of the company through, for example, royalties on sales. Equity participation through warrants or other instruments could also be considered. The Government should not react unfavourably to higher pricing for riskier transactions,

3. Working Capital Issues

- FBDB should be allowed by Government to expand its support for working capital by complementing the private sector through direct loans and/or guaranteeing private lenders' top-up working capital lines.

- The Government should consider introducing measures/incentives to accelerate bank financing of knowledge-based SMEs. Such incentives could include limited guarantee program delivered selectively by private sector lenders to cover the performance risk of rapidly growing, exporting, knowledge-based SMEs.

- Governments and their agents should be encouraged to set an example in making payments to SMEs within 15 days of the receipt of invoices and in having a 'fast track' process for multiple invoicing situations

4. Equity/Medium Term Lending

- Private sector financial institutions should adopt the FBDB 'venture loan' concept and should explore other innovative financial concepts for knowledge-based SMEs.

- FBDB should expand its Venture Loan program.

- Banks and the FBDB should forge alliances to develop their knowledge in technological areas and in providing clients with packaged loan and advisory services.

- Fiscal incentives, such as a reduction of capital gains tax, should be adopted to encourage individuals to invest in SMEs. One source of funding for such initiatives could be a reduction of fiscal incentives to investors in labour-sponsored venture capital funds.

- Existing labour- and government-sponsored funds should be encouraged to make smaller investments, less than $750,000, in SMEs, and/or to follow the example of Solidarité, and invest in community-based funds focusing on small investments in knowledge-based SMEs.

- The Government should expand the resources of FBDB's venture capital program and allow FBDB to direct it specifically towards investments of less than $750,000.

- Securities regulations across the country should be reviewed, harmonized, and simplified.

- Taxation of SMEs should be reviewed to encourage retention of profits

- Fiscal incentives should be enhanced for investors/entrepreneurs reinvesting in small businesses.

EXPORT FINANCING

5. Information/Access

- Changes should be implemented to improve SMEs' access to exporting and international business development information and services provided by private sector intermediaries and governments.

6. Short Term Financing

- Private financial institutions and EDC should address the scarcity of short term financing for exporting SMEs by examining their current practices, especially in regard to foreign accounts receivable financing, and by reviewing opportunities to increase the availability of short term financing to exporters.

7. Partnership among private financial institutions, EDC and the government

- Financial institutions, EDC and government should establish a working group to develop a framework for cooperation on the provision of medium and long term financing to Canadian exporters, particularly for SMEs.

These export financing issues were the subject of a May 6th meeting of the financial institutions and the Ministers of International Trade, Finance and Industry. Minister MacLaren's action plan establishing a series of working groups on these issues was endorsed. A progress report is to be prepared by September 1st, 1994.

CONCLUSION

To provide for better and more innovative financing to knowledge-based SMEs in the New Economy, a new partnership is needed between businesses, financial institutions and governments. We have to move **towards a positive conspiracy**.

FINANCING THE NEW ECONOMY

FINAL REPORT

June 1994

FINANCING THE NEW ECONOMY

FINAL REPORT

CONTEXT

Economies are changing rapidly, fuelled by the increasing pace of technological developments and the concomitant globalization of markets. Ideas and innovation are becoming increasingly the drivers of economic growth. Competition from international firms is now a fact of life for virtually all sizes of Canadian companies. It is in this environment, which has been called the "new economy", that Canadian firms must grow and prosper.

Due to the nature of the fast-changing pace of the new economy, small- and medium-sized enterprises (SMEs) in Canada, and in other countries, are playing an even greater role in contributing to economic growth and job creation. The SME sector is typically more nimble and innovative in responding quickly to market opportunities. SMEs do, however, face significant challenges in competing internationally: lack of access to strategic information and skilled resources, dealing with regulations, and tax burdens imposed by governments, are just a few of the impediments constraining the growth of the SME sector. One area which is a major challenge for rapidly growing, export-oriented SMEs, particularly knowledge-based firms, and the focus of this project, is access to financing.

CHARACTERISTICS OF THE NEW ECONOMY

It is important to first provide additional information on the "new economy" which could be characterized as follows:

- Recognition that knowledge has become a decisive factor of production, superseding land/resources, labour and capital.
- Increased use and development of new technologies.
- Shift from large to small or medium size firms — size no longer confers the same economic advantage as in the past; large organizations often lack the flexibility required to keep up with a rapidly changing environment.
- Strong orientation towards exports — the distinction between domestic and international markets has been eroded; trade, time and distance barriers are being reduced.
- Major role played by the service sector which now accounts for almost two-thirds of GNP.

- More participative form of management with strong emphasis on teamwork — it is not unusual for key employees to be shareholders and co-decision-makers.

- Formation of new types of economic associations such as strategic alliances, joint ventures and other forms of partnerships.

KNOWLEDGE-BASED SMEs

It was very difficult to specifically identify those sectors which are characteristic of the "new economy", and which face major challenges in obtaining financing. An attempt to focus the project on particular sectors would risk missing issues and opportunities related to other "low tech" sectors which have a high knowledge component in their operations. As such, the project focused on knowledge-based SMEs, defined as SMEs having some or all of the following characteristics:

- assets mainly intangible;
- high knowledge component to operations;
- highly skilled labour force;
- high level of R&D, high level of product/service innovation;
- use of advanced technology;
- products/services tradeable internationally;
- short life expectancy for products/services.
- number of patents, of works copyrighted, and/or of registered industrial designs.

For example, some sectors which clearly would be classified as new economy sectors include: computers; semiconductors; software; biotechnology; telecommunications; advanced industrial materials; and environmental services. However, the definitional issue becomes more problematic in cases where firms in so-called "low tech" sectors are using advanced technology, employing skilled staff and exporting their product.

FINANCING ISSUES

Access to financing is a critical determinant of the success of knowledge-based SMEs. Many reports and studies[1] have recognized the difficulties encountered by these SMEs in obtaining both debt and equity financing. Principal areas of difficulty include:

- equity investments/risk capital in amounts under $750,000;
- financing for soft assets (working capital and medium term);
- servicing of knowledge-based SMEs by financial institutions and governments;
- risk assessment and pricing by lenders;
- availability of and access to export financing (e.g., foreign accounts receivable/contract financing, and pre-shipment financing); and
- working capital for small exporters (foreign accounts receivable).

Reasons cited for such difficulties, generally dealing with issues such as risk/reward, transaction cost, and information/awareness, include:

On the financial supply side ...

- Lack of technical competence of bankers and investors in being able to assess an innovative project/product/service.
- Difficulty in forecasting success of innovation/high tech product/service.
- Presence of soft assets — for example, financing ideas is not part of banking practice.
- High cost of due diligence process relative to the size of some transactions — costs incurred in analysing a small transaction are often the same as for larger ones.
- Inability of certain financial institution cultures and financial instruments (e.g., standard commercial loans and related practices) to compensate for higher risk.
- Early and strong orientation towards exports, requiring special skills by financiers.
- Difficulty of linking lenders and SMEs with informal investors ('angels').

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[1]For example, see National Advisory Board on Science and Technology: Report of the Committee on the Financing of Industrial Innovation; Chamber of Commerce: Focus 2000 Report On Making Investment Capital Available; OECD: National Systems for Financial Innovation.

- Lack of coordination/linkages between existing government programs; difficulty for SMEs to access them. Slow delivery process.

- Insufficient cooperation between private and public financial institutions.

On the demand side ...

- Lack of skill and experience in developing internationally competitive firms and in managing growth.

- Dilution of ownership and/or control concerns.

- Lack of understanding about the roles, responsibilities and requirements of the financial suppliers (e.g., equity versus debt).

- Rapid growth/low profitability with related requirements for cash, yet internally generated capital typically insufficient to sustain growth.

- Reluctance to divulge proprietary technologies.

- Lack of adequate collateral.

- Lack of a "trading culture".

- Lack of networking between SMEs, as well as between SMEs and larger exporters.

- Unwillingness to pay for the assistance provided.

OBJECTIVE OF THE PROJECT

The issue of financing for knowledge-based SMEs is critical. Many would argue that SME growth and contribution to job creation is being constrained by difficulties in obtaining financing. The various stakeholders agree in principle that additional efforts need to be undertaken to improve the situation.

This project was therefore designed to work with private and public sector providers and users of capital to:

- *Develop and recommend improved private and public sector approaches to providing capital, particularly debt financing, to knowledge-based SMEs.*

- *Develop and recommend improved private and public sector approaches to providing financing to export-oriented SMEs.*

COMMITTEE MEMBERS

To undertake the work, a committee was formed comprising:

- representatives from the private and public sector financial supply side: banks, Canadian Bankers Association (CBA), Federal Business Development Bank (FBDB), Export Development Corporation (EDC), Canadian Commercial Corporation (CCC);

- representatives from SMEs: Information Technology Association of Canada (ITAC), Canadian Federation of Independent Businesses (CFIB), Canadian Exporters Association (CEA), Canadian Advanced Technology Association (CATA), as well as one knowledge-based entrepreneur;

- representatives from the federal government: Industry Canada, Foreign Affairs and International Trade (FAIT), and the Department of Finance;

- representatives from the provinces of Ontario and Quebec; and

- representatives from other institutions: Western Business School, the Canadian Institute of Advanced Research (CIAR), and the Canadian Labour Market and Productivity Centre (CLMPC).

RESEARCH AND ANALYSIS

The research and analysis focused on debt and export financing, from the domestic perspective, as well as covering international best practices in selected countries.

Canadian Research and Analysis

On the financial supply side, this covered policies and practices of the banks, other private sector lenders such as Caisses Populaires, public sector lenders such as the Federal Business Development Bank, agencies such as the Export Development Corporation and the Canadian Commercial Corporation, and provincial agencies such as the Société de développement industriel.

On the SME side, research, consultations and analysis involved:

- industry associations including: Canadian Exporters Association, Canadian Federation of Independent Businesses, Canadian Advanced Technology Association, Information Technology Association of Canada, Canadian Chamber of Commerce, and Canadian Manufacturers' Association;

- owner/managers of knowledge-based SMEs; and
- Canadian Institute for Advanced Research.

New economy financing issues were discussed with provincial government representatives in British Columbia, Ontario and Quebec; Industry Canada officials in Ottawa, Montreal, Toronto and Vancouver; and officials from the Department of Foreign Affairs and International Trade and the Department of Finance.

International Research and Analysis

To identify best international practices which could be adapted to Canada, discussions were held with representatives of government departments, industry associations, banks, export agencies, and venture capital firms in the United Kingdom, France, Germany, Switzerland, Austria, and the OECD. In the United States discussions were held with the Long Beach U.S. Export Assistance Center, the California Export Finance Office, and two local banks. Additional work involved a review of recent books, reports, studies and papers on financing and SME issues. Various reports, statistics, and analysis related to the above are available following this report.

COMMITTEE STRUCTURE

Given the scope of the work to be addressed by the Committee, two sub-committees were formed as follows:

- debt and equity financing, chaired by Paul Toriel of Industry Canada; and
- export financing, chaired by Roger Ferland of FAIT.

The following is a summary of the analysis and related recommendations of the two sub-committees.

DEBT AND EQUITY FINANCING SUB-COMMITTEE REPORT

1. Servicing by financial institutions and governments

Problem 1.1: *Knowledge-based SMEs present significant challenges to lenders utilizing conventional lending practices.*

Knowledge-based SMEs require special knowledge on the part of the financial community. Linkages/active partnerships between lenders and investors are also very important to help manage the inherent risk in financing knowledge-based SMEs.

It is recognized that it would be very difficult to train all account managers to understand the challenges of lending to new economy SMEs and to be prepared to present them with innovative solutions. While knowledge-based SMEs are increasingly prevalent and located across the country, they tend to be concentrated presently in some 20 to 25 areas.

Recommendation:

- **Banks should accelerate the process started by some of the banks of establishing special units to service knowledge-based SMEs.**

  The Royal Bank in Ottawa, the Toronto Dominion Bank in Markham, and the Bank of Montreal in Kitchener-Waterloo, have created and tested special units to service knowledge-based SMEs. Integrated networks of such 'expert' branches or units should be established to service the needs of knowledge-based SMEs across the country.

  In the design of these 'expert' branches, banks could consider the following:

  - locating the units strategically across Canada where the need is greatest, and linking them to specialized credit officers situated centrally at the Head Office or regional office of each bank; in locations not provided with a specialized unit, a local branch could act as a relay;

- providing special training to account managers of these units and linking them across the country to accelerate the cross training process (Information on a model used by National Westminster Bank in the U.K. is provided in Attachment I[2]);

- linking them with the bank's international trade unit since knowledge-based SMEs tend to be exporters;

- linking them with the federal and provincial program and information initiatives such as the Canada Business Service Centres, and with federal and provincial agencies. (See Figure 1 attached which illustrates the present situation and Figure 2 attached which shows the knowledge-based SME serviced by three networks: 'financial' centred on a specialized banking unit, Government centred on the CBSC, and the 'business' network);

- linking them to universities, private laboratories and/or other technology and knowledge experts where appropriate;

- having account managers also act as a supplemental pathfinders (together with accountants and lawyers) to other sources of capital, such as private investors and venture capital. (See Attachment II on the Silicon Valley Bank model for further information[3];)

- taking into consideration that each geographical area may have a different knowledge-based industry focus; and

- examining internal organizational and reporting structures as well as promotion, reward and compensation programs to ensure that there are no impediments to the formation and success of these specialized units. The emphasis should be on developing a cadre of "expert" Account Managers who can achieve long term career goals while giving the SMEs a "stable" interface to financing.

For their part, the federal and provincial governments, and their agencies should support these units through personal contacts, and by providing access to their data base of information (including industry information).

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[2]Refer also to the "European Fact-Finding Mission" report by Paul A. Toriel and Jamal A Khokhar, dated February 12, 1994.

[3]Refer also to the "Report on Trip to California" by Paul A. Toriel, dated April 20 1994.

Problem 1.2: *There is overlap, and even competition at times, between the more than 700 government programs, federal and provincial, and private sector services.*

This overlap may not have been present at the initiation of the program but may have resulted due to an increasing willingness of the private sector to engage in the activities originally pursued by the government.

Recommendations:

- **Public sector programs and services should only address market gaps and complement, not compete with, those offered by the private sector. Their focus should be to graduate SMEs to private sector services.**

- **Government supplied/facilitated financing for domestic transactions should not carry a pricing subsidy; it should be priced to reflect risk and be as close as possible to a market price.**

- **Government programs, federal and provincial, should be reviewed regularly to address concerns about overlap and continued rationale.**

Some examples were cited by Committee members of specific cases where government agencies competed for loan accounts on what were seen as subsidized terms and conditions, e.g. lower than market interest rates. Improved cooperation between the public and private sectors in the provision of service to knowledge-based SMEs would help to alleviate these situations (for example, refer to Figure 2).

On the other hand, when a Canadian SME is competing internationally, there is a rationale for a government agency, such as EDC, to provide insurance on accounts receivable even though this may compete with the private sector, and/or to provide 'concessional financing' to a foreign buyer of Canadian goods or services even though this represents a subsidy.

A Secretariat is being set up by the Federal Government to review all existing government programs.

Problem 1.3: *Information on private and public programs, sources of capital, technology, etc., is time consuming to obtain and generally difficult to access.*

Knowledge-based SMEs generally consult trusted linkages for information: their accountant, banker, lawyer, or business association; and even customers, suppliers, competitors or government officials. These sources are often not well informed on the availability of information on subjects such as sources of capital, government programs, or technology information, even though this information exists[4]. As well, the potential users of this information do not always have a clear idea of their needs.

Recommendation:

- **Canada Business Service Centre (CBSC) information should be shared widely among business intermediaries.**

  Given that the primary source of information for SMEs is accountants, bankers, lawyers and business associations, it is critical that government information initiatives like the CBSCs take advantage of these sources (perhaps via their professional associations) and use electronic databases where appropriate. These CBSCs should be explicitly mandated and designed to provide information to business intermediaries (banks, accountants) in addition to providing information directly to entrepreneurs. These comments also apply to other sources of information both federal and provincial, such as the Canadian Technology Network. Governments should not duplicate or compete if the information is available from a private source, but rather refer the user to that source.

2. Risk Assessment/Pricing

Problem 2.1: *There is a perceived higher risk in lending to or investing in knowledge-based SMEs.*

Several studies[5] discuss the perceived higher risk in lending to or investing in high-tech SMEs.

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[4]For example: "Guide to Government Assistance for Canadian Business"; editor Donna Prudhomme; published by Carswell in 1992. "Export Assistance Programs"; published by Royal Bank of Canada. "SRI International", of Menlo Park, California, is one of several private companies providing Technology Monitoring. "Business Centurions" of Toronto is one of several private groups involved at introducing SMEs to private investors. "Innovitech" of Montreal is involved in advising knowledge-based SMEs and creating business networks.

[5] Commission of the European Communities, "Communication from the Commission on the financial problems experienced by small and medium-sized companies", Brussels, November 10, 1993.
OECD, "National Systems for Financing Innovation", Paris, draft dated February 22, 1994.
"Making Technology Happen", by D.J. Doyle; third edition, 1992.

A European Union study indicates conventional business have a failure rate of 50% in the first five years of trading in the absence of counselling and other supportive measures, and innovative new businesses are considered "high risk", having only a 5% chance of attracting external financing. An OECD study attributes the cause of this perceived higher risk to the high level of uncertainties related to innovation.

SMEs at the "seed" stage (R&D, business plan, but no sales) are perceived as the highest risk and are generally only able to obtaining financing from "friendly" sources such as relatives or friends. Among "seed" stage SMEs, knowledge-based SMEs and particularly high-tech ones are considered by lenders or investors among the highest risks, so their chances of getting financing are even poorer than the average "seed" stage SME.

Finally, because entrepreneurs are innovation driven, a disproportionate number of high-tech firms are at the "seed stage" and as a result have difficulty in obtaining financing.

Recommendation:

- **Banks, venture capitalists and informal investors should work together as partners to share the due diligence and risk assessment. This will allow for more informed decisions on taking the risk of financing knowledge-based SMEs (and therefore reduce the risk of losses). They should form strategic partnerships with "experts" (such as the Provincial Research Organizations, for example) who can help provide fast reliable and cost effective technology assessment assistance.**

Our research indicates there is actually a higher risk in lending to or investing in seed and start-up stages knowledge based SMEs, but that this risk can be reduced substantially: on one hand by a better preparation of the entrepreneur (e.g. good business plan), and on the other by a specialization of the lenders and investors. In all cases of specialized units we studied, the loan losses were lower than average.

Banks should adopt the 'Silicon Valley Bank Model' (refer to attachment II) which reduces risks through a close cooperation between venture capitalist and banks in the selection, co-financing and follow-up of knowledge-based SMEs. The specialized venture capitalist or informal investor invests at the "seed" stage, and the bank becomes a lender at the "start-up" stage (when the SME starts selling).

Professor Roger Blais, of Montreal, is presently working at designing and testing a technological assessment tool for investors and lenders.

Problem 2.2: *Pricing for loans varies within a very narrow range and banks prefer to turn down a proposal rather than charging a higher spread or taking an equity participation to compensate for the higher risk.*

Recommendation:

- **Banks should explore innovative ways to finance higher risk transactions. These could include low interest rates early in the life of the loan with higher rates later when the borrower is better able to pay; or loans where returns are based on participating in the growth of the company through, for example, royalties on sales. Equity participation through warrants or other instruments could also be considered. The Government should not react unfavourably to higher pricing for riskier transactions.**

  Banks' specialized units will be able to use the experience gained in financing new types of transactions to better understand new economy firms and their industries. It is understood however, that only riskier transactions would be assessed higher pricing, and not all SME loans.

  Banks are presently only allowed to exercise warrants equivalent to 10% or less of a company's shares. However they may hold larger amounts which could be sold to third parties.

3. Working Capital issues

Problem 3.1: *Knowledge-based SMEs are often limited in their growth because of inadequate working capital, often due to a lack of adequate 'hard' collateral.*

Traditional working capital items (accounts receivable, inventory) for knowledge-based SMEs are usually more difficult to value or are seen as having less value in the event of default than for traditional firms.

As mentioned by Denzil Doyle[6], "... it is easy for purchasers of sophisticated products or services to haggle over the exact nature of the deliverables and the terms of acceptance"; while a non-payment or a partial payment could have a devastating effect on the firm. As well, accounts receivable often result from export sales, with terms of payment that are often longer than what is commonly accepted in Canada. Again, according to Doyle, in the fast-moving world of high technology, inventory can became obsolete very quickly and adequate provision must be made for write-down at all times, including fixed assets such as sophisticated test equipment.

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[6]"Making Technology Happen" by D.J. Doyle; third edition, 1992.

Furthermore, the bulk of knowledge-based SMEs' initial capital is often spent for R&D purposes which is expensed rather than capitalized. In other words, funds spent on R&D may result in a long term asset which is intangible and therefore cannot be pledged in support of working capital loans.

Recommendations:

- **FBDB should be allowed by Government to expand its support for working capital financing by complementing the private sector through direct loans and/or guaranteeing private lenders' top-up working capital lines.**

  With a delivery network of 78 branches across Canada, FBDB is well-positioned to play a more substantial role as a 'small-business bank'. The Committee therefore supports the recent creation of a $50 million *Working Capital for Growth* program which will deliver top-up financing up to $100,000 as a complement to bank lines of credit. The FBDB mandate presently under review should allow this agency to play a larger role as a complement to bank financing.

- **The Government should consider introducing measures/incentives to accelerate bank financing of knowledge-based SMEs. Such incentives could include a limited guarantee program delivered selectively by private sector lenders to cover the performance risk of rapidly growing, exporting, knowledge-based SMEs.**

  The Government could, for example, consider developing a specialized component of the SBLA program which would provide guarantees for working capital provided by selective technology lending units of financial institutions to knowledge-based SMEs. This program which could be kept separate from SBLA while administered by the same people, could be capped in amount and limited to two years. Cost/benefits of such a program as well as potential utilisation by financial institutions would have to be further studied. In order to keep this program fiscally neutral, several options may be considered such as reducing the amount of financing permitted under the SBLA program for leasehold improvements (presently 100%), or an earlier than scheduled reduction of the amount of the government guarantee (for further details on a possible guarantee program, refer to Attachment III).

  Several countries have programs to assist banks in financing working capital. In the United States 85-90% guarantee programs are offered by Eximbank, the Small Business Administration, and several states such as California. In France, SOFARIS offers a 50% guarantee program. Several provinces, such as Quebec, Alberta and British Columbia have programs to assist pre-shipment financing.

Problem 3.2: *Slow payments from domestic buyers appear to be a severe problem for many SMEs.*

While some of these problems are due to economic circumstances, it appears that generally the worst offenders are governments and their agencies, and larger companies which use SMEs as a source of financing.

Recommendation:

- **Governments and their agents should be encouraged to set an example in making payments to SMEs within 15 days of the receipt of invoices and in having a 'fast track' process for multiple invoicing situations.**

  Presently, the federal government policies allow 45 days from the date of receipt of an invoice or of the good (whichever is later) to pay. In practice, while government agents are endeavouring to make payments within 30 to 45 days, SMEs are complaining that delays are caused by the time it takes to receive internal government approval for their invoices.

4. Equity/Medium Term Lending

Problem 4.1: *Medium term loans are difficult to obtain for knowledge-based SMEs under conventional lending guidelines because of lack of 'hard' assets, difficulty in evaluating 'soft' assets, and perceived low success rate.*

Banks' medium term loans are usually secured by tangible fixed assets such as buildings, equipment, and machinery, not by intangible assets such as R&D, human resource skills, and market networks. Due to the nature of many knowledge-based SMEs, loans to these firms are generally considered unsecured or of a quasi-equity nature, and are therefore not bankable under present practices. Since SBLA loans are for fixed assets only, this Program does not address the soft asset financing needs of knowledge-based SMEs. The FBDB has developed a financial instrument, 'venture loans', to address this market with activity to date of 63 venture loans for a total of $22 million.

Recommendations:

- **Private sector financial institutions should adopt the FBDB 'venture loan' concept and should explore other innovative financial concepts for knowledge-based SMEs.**

- **FBDB should expand its Venture Loan program.**

These instruments could be tailored to individual situations and have flexible payment arrangements for principal and interest with terms of 3 to 5 years, without the usual security requirements. Pricing would reflect risk and therefore be higher than conventional loans (refer 2.2 above.)

- **Banks and the FBDB should forge alliances to develop their knowledge in technological areas and in providing clients with packaged loan and advisory services.**

  Under pre-established situations, a short-term loan at a bank could be matched with a medium-term facility at FBDB. Ideally, the client would apply to the financial institution and its due diligence would be used by FBDB.

Problem 4.2: *Access to equity by knowledge-based SMEs is difficult for amounts under $750,000.*

At the end of 1993, some $1.9 billion of capital was available for investment by venture capitalists, $1 billion of which was in three hybrid funds; representing a 5-year supply[7]. However, it is generally difficult for these large funds to make smaller investments.

These difficulties are related to the cost of due diligence, the ongoing costs of monitoring and advising, the inability of the company to provide the high returns required by investors, as well as the unwillingness of entrepreneurs to share ownership. The problem therefore is not really one of a lack of capital, but rather the difficulties faced by the larger funds, including labour-sponsored ones, in making these smaller investments.

There is also a trend for funds to become more risk averse and a general lack of 'patient' capital in Canada. This compares with the United States where the venture funds are seen to be more receptive, timely and willing to be in for the long term (5 years and over). Informal investors play the primary role in providing equity financing to growing, smaller firms. According to the CLMPC[8], there is between $5 and $10 billion in informal capital in Canada.

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[7]Source: "The Venture Capital Market in Canada" (Revised Version), dated March 1994, by Macdonald & Associates.

[8]"Access to Capital Resources in Canada" by Canadian Labour Market and Productivity Centre, dated November 1993.

According to a report prepared for Industry Canada in May 1993 by Alan Riding and others[9], one of the hindrances to informal capital is the Canadian tax policy on capital gains in comparison, for example, to the U.S. one which gives more incentives to investors.

Recommendations:

- **Fiscal incentives, such as a reduction of capital gains tax, should be adopted to encourage individuals to invest in SMEs. One source of funding for such initiatives could be a reduction of fiscal incentives to investors in labour-sponsored venture capital funds.**

  In 1993, fiscal incentives encouraged individuals to contribute $369 million to venture capital funds (mainly to labour-sponsored venture funds and mostly in Quebec)[10]. It should be noted that the Quebec Government has established a ceiling of $100 million per year for contributions to Solidarité.

  New incentives could include: reduced capital gains tax for investment in SMEs held for 5 years or more (patient capital), or for profits reinvested in other SMEs.

- **Existing labour- and government-sponsored funds should be encouraged to make smaller investments, less than $750,000, in SMEs, or to follow the example of Solidarité, and invest in smaller community-based funds focusing on small investments in knowledge-based SMEs.**

- **The Government should expand the resources of FBDB's venture capital program and allow FBDB to direct it specifically towards investments of less than $750,000.**

  FBDB has now $40 million available under this program, some $38 million already invested, with investments averaging $1 million. The current financial mandate of FBDB constrains them to transactions where costs may be recovered should be reviewed to allow smaller transactions which will generate a higher administration cost.

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[9] "Informal Investors in Canada: The Identification of Salient Characteristics", dated May 23,1993, by A. Riding, P. Dal Cin, L. Duxbury, G. Haines and R. Safrata.

[10] Same source as footnote 6 above.

Problem 4.3: *Compliance with provincial securities regulations causes high legal and accounting costs which act as an impediment to investing in SMEs by informal investors.*

As indicated by Jeffrey MacIntosh[11], the current structure of securities law does not generally accommodate smaller investments. Direct costs relating to complex disclosure rules are particularly onerous on smaller firms.

Recommendation:

- **Securities regulations across the country should be reviewed, harmonized, and simplified.**

This would foster the participation of more potential angels and venture capital investor in investing in knowledge-based SMEs. For example, security regulations should be harmonized or even centrally administered. Consideration could be given to exempting SMEs from the prospectus requirements for offerings under $2 million[12]. Disclosure rules should be made easier for small businesses seeking investors, while at the same time maintaining adequate investor protection.

Problem 4.4: *The tax system does not encourage reinvestment of profits in the business to the extent it could.*

SME business organisations such as the CFIB indicate that the retention of profits for a significant minority of growing SMEs is being restrained by the failure to adjust for inflation the $200,000 small business rate limit. The reduced corporate tax rate for small businesses has remained at the $200,000 level of taxable retained earnings since 1982. Since retained earnings constitute the largest source of funds for SMEs (29.9%)[13], this build-up of equity is particularly important for knowledge-based SMEs because of their rapid growth and large expenditures on R&D.

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[11] "Legal and Institutional Barriers to Financing Innovative Enterprise in Canada" by Jeffrey G. MacIntosh of the Faculty of Law of the University of Toronto. Draft dated April 29, 1994.

[12] Same source as footnote 10 above.

[13] "Strategies for Success" by Statistics Canada. Project leader, John Baldwin.

Recommendations:

- **Taxation of SMEs should be reviewed to encourage retention of profits.**

  For example, the $200,000 limit could be increased to $400,000 over a number of years, or the tax rate could be graduated at $100,000, $500,000, and $1 million, rather than the single small business deduction for the first $200,000. The second example could be revenue neutral, with some SMEs being "winners" and others being "losers". The proposed change in taxation would not only strengthen the equity base of growing businesses, but also improve the capacity of these to attract informal investors and lenders. This could as well encourage more small businesses to graduate to medium size, with all the benefits that such growth implies (jobs, exports, etc).

- **Fiscal incentives should be enhanced for investors/entrepreneurs reinvesting in small businesses.**

  Investors/entrepreneurs who reinvest their capital gain from the proceeds of the sale of a SME in another SME within a reasonable period of time should be encouraged by fiscal incentives.

EXPORT FINANCING SUB-COMMITTEE REPORT

5. Information/Access

Problem 5: *The lack of ready access to information on export financing and on international business development support, both programme and information/intelligence support, is an impediment to Canadian SMEs' success in international markets.*

Canadian firms, particularly SMEs new to exporting, are poorly served by the fragmented sources of information on the financial and international business development support available from the private and public sectors. There are too many uncoordinated programs and services for exporters from both governments and financial institutions. This problem results in firms either not exploring/exploiting international opportunities or, if they do venture into international markets, doing so at a greater risk or cost than is necessary. SMEs are then at a disadvantage compared to their foreign competition resulting in a lower probability of success and reentry into international markets.

Recommendation:

- **Changes should be implemented to improve SMEs' access to exporting and international business development information and services provided by private sector intermediaries and government.**

  Their action plan will consider the following elements:

  - the development of a user friendly road map on international business services and programmes including export financing;

  - the production of definitive export financing/international business development assistance kits, for neophyte and experienced firms, to be distributed by financial institutions, other intermediaries and government;

  - enhanced coordination of efforts, cross referral of expertise and services between the private and public sector organizations involved in export/international business development through cross-training and an electronic bulletin board outlining the organizations' services and products;

  - financial institutions will review means of improving communications within their organizations to ensure that their export services/products are being marketed to clients or the client is referred to other organizations for the needed assistance, regardless of the client's initial point of contact.

  FBDB has a export training initiative within their 'Community Business Initiatives' program, called 'Export CBIs'. This consists in bringing together SME exporters in a community to share export experiences.

  The Canadian Exporters' Association has an export buddy initiative to bring experienced exporters together with SMEs; furthermore regional chapter meetings provide SME networking opportunities.

6. Short Term Financing

Problem 6: *SMEs find the current shortage of short term financing to be an impediment to exporting.*

Access to adequate levels of short-term financing against either pre-shipment or post-shipment financing requirements of companies can be problematic, but seems to be particularly troublesome for SMEs. Performance risk is greater for SMEs.

Recent changes to EDC's regulations should help to mitigate this situation but there is also a need for changes within financial institutions and for an investigation of other means to address this problem.

Recommendation:

- **Private financial institutions and EDC should address this scarcity of short term financing by examining their current practices, especially in regard to foreign accounts receivable financing, and by reviewing opportunities to increase the availability of short term financing to exporters before and after shipment.**

This should be done through innovative responses to the changing regulatory framework and by investigating other means of responding to this need in the future.

Within the action plan addressing the need for increased short term financing, the following initiatives are to be undertaken:

- banks will review internal process and procedures to ensure that exporters are more consistently awarded maximum allowable working capital leverage against U.S accounts receivable and insured foreign accounts receivable, consistent with bank internal policies;

- private sector financial institutions will increase the availability of working capital based on expanded EDC insurance coverage (ie., insurance cover on domestic accounts receivable) made possible through changes in its regulations (EDC will survey its clientele in six months to evaluate the impact of this joint effort);

- EDC is to investigate further the feasibility and cost of its establishment of a foreign receivables guarantee facility geared to broad-based SME usage and delivered through the banks' networks.

On a pilot basis, FBDB has been experimenting in Quebec with loans to SME exporters. The program is called 'Direct Export Financing' and consists in revolving loans in US$ not exceeding US$ 250,000 secured by U.S.accounts receivable and other usual security as well as personal guarantees. This program which includes counselling as well as financing will be expanded to 10 locations across the country.

The Canadian Commercial Corporation (CCC) is presently working at a 'Progress Payment Program' which could be made available to assist in the pre-shipment financing of SMEs.

7. Partnership among private financial institutions, EDC and the government

Problem 7: *There is a need for improved support for Canadian firms active in foreign markets, particularly in terms of the availability of medium and long term financing.*

The integration of global markets, the presence of competitors' extended term financing, emerging interest in foreign markets by Canadian banks and Canadian firms' increasing participation in offshore markets precipitate the need for improved support of Canadian exporters, particularly in terms of medium and long term financing. This type of support will be developed best within the context of a partnership framework among EDC, the financial institutions and the government.

Recommendation:

- **Financial institutions, EDC and government should establish a working group to develop a framework for cooperation on the provision of medium and long term financing to Canadian exporters, particularly for SMEs.**

  The principles to be embodied in the framework are the following:

  - The interests of the Canadian exporter are paramount. The participation of private financial institutions should result in more financing being made available to exporters at more competitive terms and conditions. Exporters should always have a choice on any transaction of financing support from EDC or from private financial institutions.

  - There should be no additional costs to the treasury.

  - Risk-sharing between the private financial institutions and EDC is essential to partnership and should reflect market realities.

These export financing related issues were the subject of a May 6th meeting of the Chief Executive Officers of private financial institutions, the EDC, and the Ministers of International Trade, Finance and Industry. At this meeting, there was a consensus to take immediate action on these issues. Minister MacLaren's action plan establishing a series of working groups on these issues was endorsed and the working groups are to provide their results by September 1st at the latest.

IMPLEMENTATION PLAN

While the Committee has put forward a number of recommendations for both the private and the public sector, these will be useful only if all parties are involved in the process of implementing them. In this regard the following implementation plan is proposed:

Debt and Equity Financing

Action plan regarding recommendations for private financial institutions:

The banks and other private sector financial institutions will receive a copy of the final report. They will individually decide whether to implement some or all of the Committee's recommendations. Competition and market forces will provide the necessary stimulus.

Action plan regarding recommendations for governments and public sector agencies:

The following action plan is proposed in regard to recommendations affecting federal and provincial governments or public agencies:

- The final report will be submitted to both Small Business Working Committees on June 21.
- Several ad-hoc working groups with members drawn from: New Economy Committee/Industry Canada/Working Committees/Department of Finance/FBDB will be formed to develop detailed implementation plans for priority recommendations.
- Implementation plan proposals will be submitted by October 1st, 1994.

Action to be coordinated by Paul Toriel, with the cooperation of Industry Canada and the Working Committees' Secretariat.

Export Financing

Action plan and priorities have already been decided with several task forces being assigned to work on specific issues related to the recommendations. Progress reports and or plan to be submitted by September 1st, 1994.

Action to be coordinated by Roger Ferland, with the cooperation of FAIT, the CBA, the banks, EDC, and Industry Canada.

CONCLUSION

This report concentrated on financing issues for knowledge-based SMEs. Other important matters such as training needed for both the supply and the demand sides, the removal of inter-provincial trade barriers, the harmonization of taxes and tax collection processes between jurisdictions and other business environment issues have not been covered, and are left for others to look into.

However these recommendations, if implemented, could go a long way to provide for better and more innovative financing to knowledge-based SMEs in the New Economy.

It is evident that in Canada, as in other countries, neither the private sector, nor the public sector can do it alone. A new partnership is needed between businesses, financial institutions and governments. Canada has to move **towards a positive conspiracy**.

ATTACHMENT I — The NatWest Model

In 1989, the National Westminster Bank, or 'NatWest', one of the largest U.K. banks, established a 'technology unit' within its small business service division to provide specialist support to technology-based businesses.

- Small central team of ten experienced managers and research assistants.

- Supporting over 150 trained Technology Account Managers located in selected NatWest branches throughout the U.K and serving local technology-based firms.

- The Central Unit provides technology account managers with:

  - specialized training;
  - up-to-date information;
  - expert advice on new developments in technology;
  - commercialization of innovative products.

- The Central Unit actively fosters the growth of the UK technology sector by:

  - sponsoring key personnel, organisations, awards and projects;
  - influencing the Bank's policy to ensure technology clients' problems and needs are being taken into account.

- Specialists provide practical solutions to clients including:

  - specially designed financing products and packages,
  - new technology appraisal services, and
  - networking with technical and business specialists as well as 'business angels'.

This has allowed NatWest to dominate the technology and knowledge-based SME market in the U.K. while benefiting from below average loan losses in this sector and a good profitability.

ATTACHMENT II — The Silicon Valley Bank Model

This small California bank (assets of US$ 992 million) has emerged as a leader in lending to the technology industry with over 1500 clients coast to coast in the technology sector (from start-ups to public companies.)

Their technology portfolio amounted to US$ 320 million in early 1994. Over the last 10 years, They have experienced only US$ 2 million in losses in technology lending.

What is their secret?

- Specialized experience of the lending officers operating in an integrated technology group.
- Technology loan committee.
- 20 to 28 borrowing accounts per loan officer
- Close working relationship/partnership with specialized venture capital companies (due diligence, risk assessment, 'seed' stage, problem resolution).
- Outsider's scrutiny considered key factor of success.
- Target for new client :
  - start-up
  - developed/saleable product
  - US$ 3 and 10 million in sales (actual or forecasted)
  - audited financials
  - business plan.
- Lines of credit are essentially supported by receivables and cash flow (not geared to net worth.)
- Amount of lines of credit: Generally between US$ 500,000 and US$ 10 million.
- Security:
  - Receivables (domestic and foreign) and inventory
  - No real estate security or personal guarantees.
- Loan pricing: Prime plus 2%, 1% front-end fee <u>and</u> warrants.
- All bank services are extensively cross-sold to technology clients.

ATTACHMENT III

Limited Working Capital Guarantee

Government working capital loan guarantee for **knowledge-based SME exporters** covering **50%** of facilities. Available only to financial institutions having **specialized technology/knowledge-based units** and to the clients serviced by these units.

Eligible business size:	Maximum of $10 million in annual sales Actual or potential exporter and knowledge-based SME
Maximum line size:	$1,000,000, at least 50% of the line of credit shall be incremental
Maximum interest rate:	Prime + 3%
Up-front government fee:	Yearly, 3% of the line of credit
Refinancing:	Not applicable
Percentage of financing permitted:	100% of the total line of credit
Amount of Government guarantee:	50% of any loss, maximum $500,000
Maximum term:	18 months, renewable
Classes of loans:	Working capital facility, including loans, letters of credit and guarantees.
Security:	In keeping with normal bank practice: inventory, domestic and foreign receivables, EDC insurance, etc. Pari-pasu between Government and banks. If other lines of credit are available, security on a pro-rata basis.
Approval:	By financial institution as per SBLA.
Advantages:	Simple and easy to administer/implement; added to SBLA. Low cost to government.
Disadvantages	No Government control, will help only marginally acceptable risk.
Incrementality	Enhanced by targeting specialized units.

Figure 1

PRESENT SITUATION

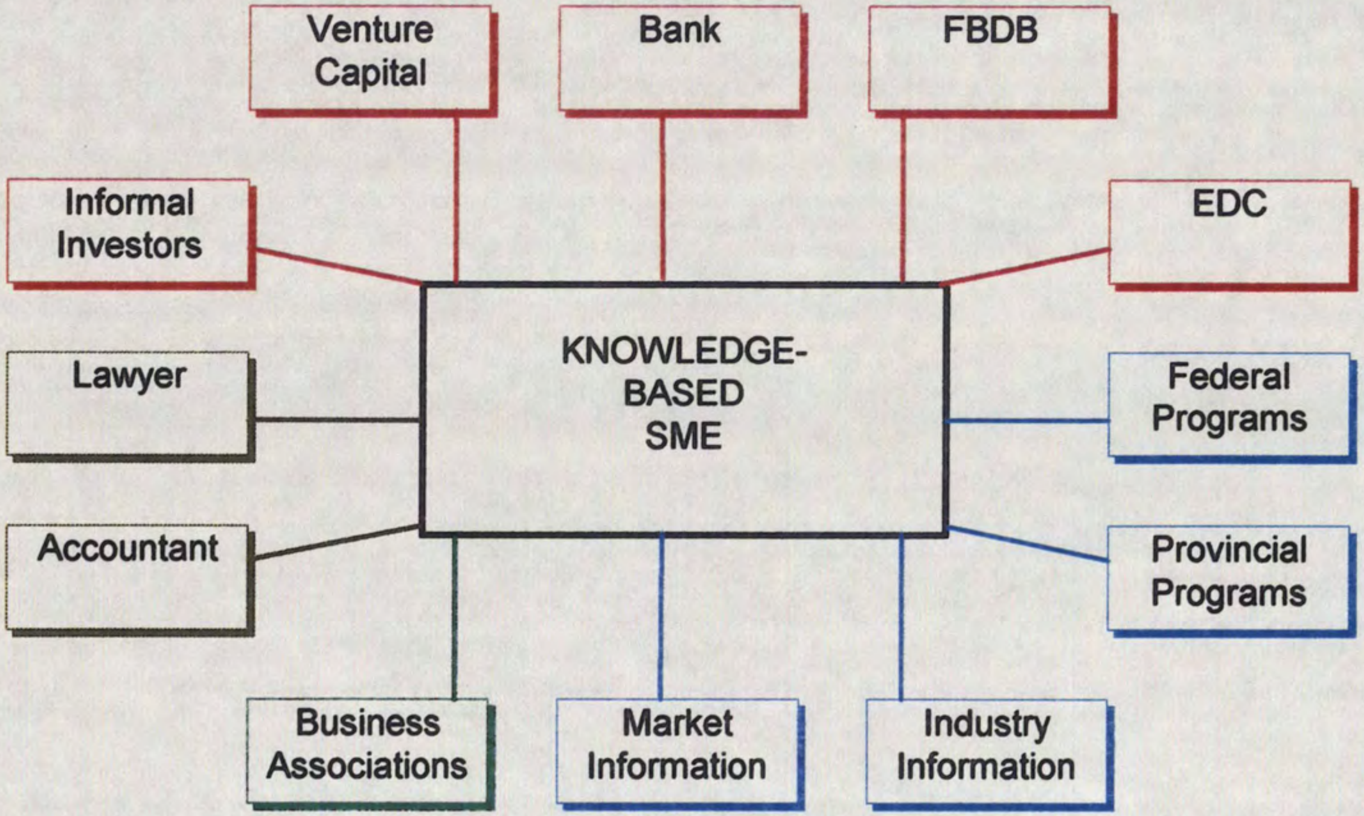
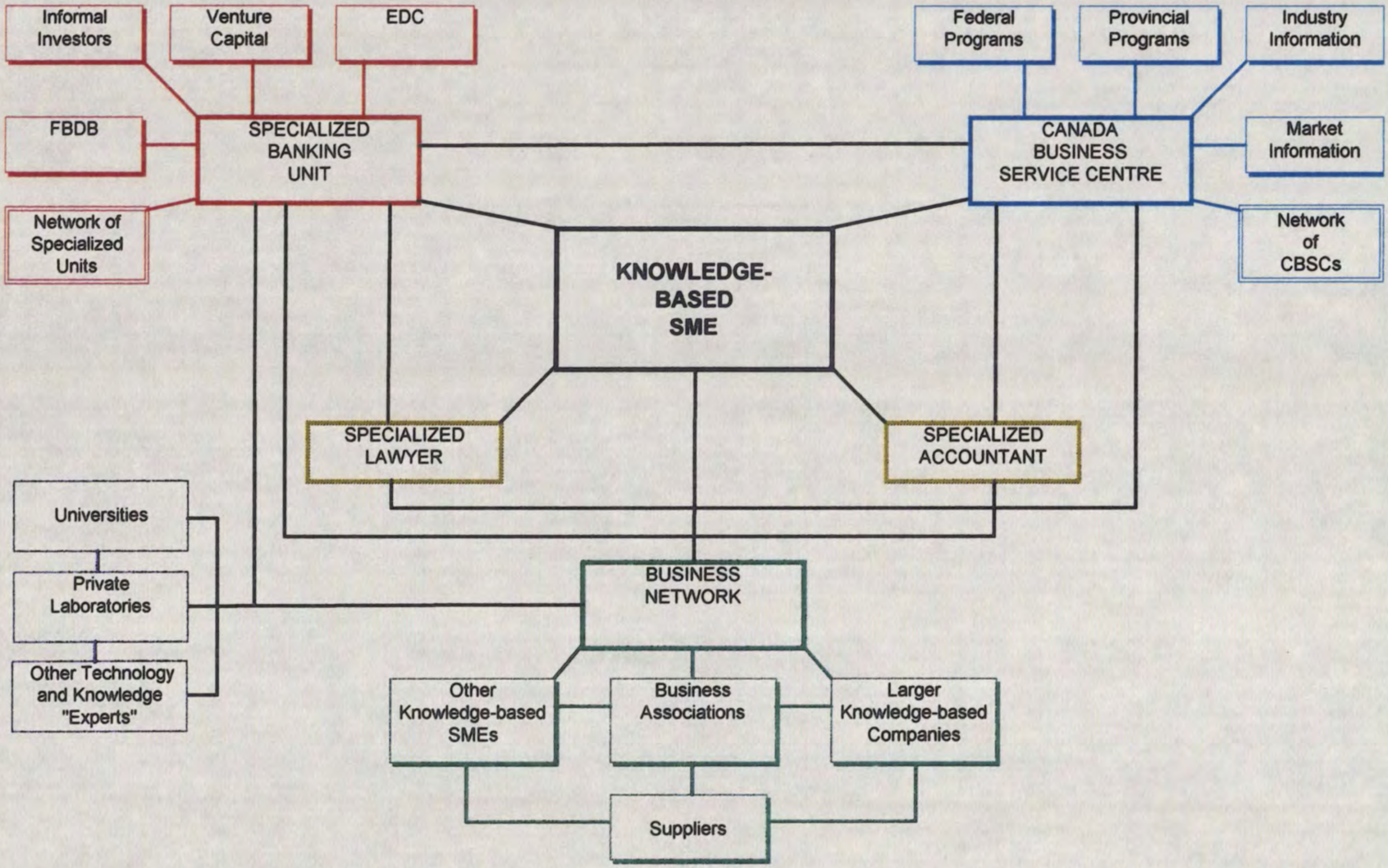


Figure 2

RECOMMENDED SOLUTION



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FINANCING THE NEW ECONOMY PROJECT

REPORT ON TRIP TO CALIFORNIA - April 17-20, 1994

Paul A Toriel

Introduction

The object of this trip was to analyze local initiatives to encourage SME exporters and knowledge-based SMEs and to possibly identify best practices we could use in Canada.

I attended the opening of the **Long Beach U.S. Export Assistance Center** where I had the occasion to meet bankers, government agencies officials and entrepreneurs. I also visited the **California Export Finance Office (CEFO)** in La Palma, and two local banks: **Silicon Valley Bank** in Newport Beach, and **Imperial Bank** in Redondo Beach.

1) California, a major exporter

With US$ 69 billion of exports in 1992 , California is by far the largest exporter among U.S. states (as a comparison, Canada's exports for the same year were US$ 134 billion). California is also the fastest growing exporter with US$ 15 billion growth between 1989 and 1992. In 1992, industrial machinery, computers, electronic and electrical equipment represented close to US$ 30 billion of the export total. The major foreign markets are the European Community (US$ 16 billion), Japan (US$ 9.7 billion), Canada (US$ 7.3 billion) and Mexico (US$ 6.6 billion).

2) U.S. Export Assistance Centers (USEACs)

Four pilot USEACs were established in January 1994: in Baltimore, Chicago, Miami and Long Beach. These "one-stop shops" are to provide seamless delivery of export promotion and trade finance services to local SMEs. Presently, some **19** federal agencies are involved with export promotion or financing. These centres are an attempt to group as many as possible of these services under one roof. The sponsors of the centres are the U.S. Department of Commerce, the Export-Import Bank of the United States (Eximbank) and the Small Business Administration (SBA). The Long Beach USEAC is run by the SBA, and has as additional sponsors the Agency for International Development (AID) and five State of California agencies and private partners.

The primary focus of the USEACs is **export-ready SMEs**. The USEAC staff (mainly civil servants) evaluate the needs of the clients and help them develop customized international business strategies based on the client's experience and commitment to exporting. The USEAC staff works with SMEs and direct them to appropriate resources to help them meet their export objectives.

The following services are available: export counselling (one-on-one counselling), and trade finance assistance (export credit insurance, pre-export financing, marketing loans, etc.).

Because of the little time these centres have been in operation, it is difficult to make any comments on their performance. There is some resemblance between the USEACs and our Canada Business Service Centres, except that the USEACs are devoted solely to exporting.

3) SBA Export Working Capital Program (EWCP)

This new program provides **guarantees** for up to **85%** of a private sector loan up to **$750,000;** subject to approval by the SBA staff. It can support single or multiple transactions, generally for 12 months, but renewable twice for a total of 36 months. SMEs can use EWCP proceeds to finance labour and materials for manufacturing goods for export, to purchase goods or services for export or to finance accounts receivable generated from export sales. SMEs have to be in existence for more than one year but do not need to be already exporting. This SBA program is actually in competition with the working capital guarantee program offered by Eximbank, which is not liked by banks.

In California, this guarantee may be blended with the CEFO guarantee to reach **$1.5 million** (see CEFO below). This is a good example of a federal program which is **complementing** a State program. Similar type of complementarity is also needed in Canada between provincial and federal programs, however we should avoid the double bureaucracy (CBA and CEFO analyze the transactions).

4) Service Corps Of Retired Executives (SCORE)

This 13,000 members volunteer program, sponsored by the SBA, matches volunteers with SMEs that need expert advice. About 80% of these volunteers are retired and the rest are still employed. This program has existed since 1964 and is available in 800 locations throughout the United States. SCORE volunteers provide management counselling and training to SMEs and to those considering going into business. SCORE counselling is provided without charge; there is a nominal fee for training programs.

This is similar to the CASE program offered by FBDB, or a counselling program offered by SDI in Quebec. With all the early retirements of qualified senior personnel of large corporations and banks presently taking place in Canada, the Canadian programs could perhaps be expanded which could be very beneficial to SMEs.

5) National Trade Data Bank (NTDB)

This data bank for exporters is prepared by the U.S. Department of Commerce and is available on CD ROM. It is updated monthly, and is available for a subscription cost of $360 per year. I saw the program, which is quite extensive, but one has to wonder how many SMEs in Canada would have a CD ROM at their disposal or would need all the information. NTDB is available in the USEACs. Refer to attachment 1 for details.

6) California Export Finance Office (CEFO)

This State agency was created in 1985 and has received an excellent press both with business people and with banks. They manage the most successful export guarantee program in the U.S.A. The team of people is pragmatic, responsive and helpful to SMEs, and works closely with bank account managers to resolve SME export problems. Irene Fisher, the Director of CEFO, is presently on secondment in Washington to assist the SBA in the implementation of its EWCP.

I met with James Newton, Acting Director; Caroline Brown, Senior Loan Officer and Mark Bertrand, Loan Officer.

The program consists of a 90% loan guarantee to participating financial institutions (presently 34 banks and 6 other financial institutions). These guarantees cover short term loans (3-18 months) by California-based companies and for products or services having at least 51% California content. The maximum guarantee is US$ 750,000 per transaction; multiple transactions are allowed. Insurance coverage is provided for foreign risk.

Three types of loan guarantees are offered:

Pre-shipment Working Capital Guarantee: To purchase materials, services and labour for a firm's export order. CEFO must be satisfied that the transaction is creditworthy and that the exporter can fulfill the performance requirements to complete the export sale.

Post-Shipment Accounts Receivable Guarantee: Allows exporters to extend terms to a foreign buyer for the purchase of California goods and is usually extended in conjunction with Eximbank insurance or private credit insurance. CEFO's guarantee covers post-shipment risks pertaining to exporter performance not normally covered by Eximbank or private insurers.

Combination Guarantee: This guarantees applies when pre-shipment financing is required, but the nature of the transaction includes post-shipment exposure, prior to the buyers obligation to pay. The guarantee conditions are similar to those stated above for pre and post shipment guarantees.

The program is funded by a US$ 5 million fund to secure loan guarantees. The fund had a balance of US$ 6.8 million as at March 31, 1994. Present authorized leverage is 4 to 1, therefore allowing for US$ 27.4 million of guarantees outstanding at any one time. (This is a very conservative leverage in comparison to the French Sofaris model 12 to 1).

Since inception in 1985, 974 applications were reviewed, 705 were approved, and 568 guarantees for a total of US$ 143 million were issued (refer attachment 2). Export sales of US$ 829 million were supported which generated according to CEFO over 16,500 jobs. **During the life of the program, CEFO has received only 11 claims and paid US$ 1.3 million, a default rate of only 1%.**

One should note that CEFO reviews in detail all applications and that the process is rather heavy (10 different forms); this and the low funding explains why the utilization of this program is low: only 99 guarantees issued in 1992-93. However banks find this process a lot lighter than that of Eximbank. Also, this review process has allowed a very low loss ratio and the fund has therefore increased in value.

The major users of this guarantee program are SMEs involved in high tech (33%), general manufacturing (32%), and export trading SMEs (16%). 53% of guarantees are issued to support sales in Asia, 26% in Europe and 8% in the Middle-East.

The following fees are charged by CEFO: US$ 100 application fee, 1/2% facility fee and 1/4% per 90 days usage fee.

7) Silicon Valley Bank (SVB)

I met with Barbara Kamm, Senior Vice President, Southern California Technology Group.

This small bank (assets of US$ 992 million) has emerged as a leader in lending to the technology industry. After losing money in 1992, due to real estate loans, it has returned to profits in 1993. While SVB is now quoted on the stock market, it was founded by a group of venture capitalists to finance the technology sector and has maintained very close links with specialized venture capital. Its focus has been to provide financial services to emerging growth and middle market technology companies. SVB has now over **1500 clients** coast to coast in the technology sector, from start-ups to large public companies. The technology offices are located in Santa Clara, Palo Alto, Menlo Park and Newport Beach, California; Wellesley, Massachusetts; and Beaverton, Oregon.

The technology portfolio amounted to **US$ 320 million** in early 1994, divided as follows: medical/biotechnology, 20%; software, 17%; peripherals, 11%; industrial instrumentation, 11%; telecommunications, 8%; semiconductor manufacturing, 7%; other 26%. **Over the last 10 years, SVB has experienced only US$ 2 million in losses in technology lending.**

What is the secret for such low losses in an industry perceived to be "high risk"? Barbara Kamm was very open and provided me the following information:

- The **specialized experience of the lending officers**: 5 with over 20 years experience in technology lending and 6 other with over 10 years. These operate in an integrated technology group where experience is shared and passed on to newer officers. Loans are reviewed/approved by a **Technology loan committee.**

- Only **20 to 28 borrowing accounts per loan officer**, to ensure they have the time to gain an extensive experience in their clients' industry, they keep close touch with their clients, and they may quickly intervene to assist in case of problems.

- **Close working relationship/partnership with specialized venture capital companies** which perform most of the due diligence and the risk assessment, before referring the account to SVB. These venture capital companies have also invested in the SME when it was at the "seed" stage, and will assist in case of problem in the future. As a matter of fact, SVB does not lend to a technology SME without a specialized outside investor (this may be an informal investor, but this is considered riskier as the amount of money available in case of problems is limited). **This outsider's scrutiny is considered very important.**

- The target new SME client has between **US$ 3 and 10 million in sales**, but may have less than US$ 1 million if it is perceived to be high growth. At the very least, it is already a **start-up** which has successfully gone through the seed stage and **developed a saleable product**. It has a business plan, and financials are prepared by a qualified accountant.

- Lines of credit are essentially supported by **receivables and cash flow** and not geared to net worth. Soft assets are not included in Tangible Net Worth, but if such deduction caused the net worth to become negative, a line of credit may still be offered based on receivables. Receivables are carefully examined by the lending officer and are margined at 40 to 80 %, but generally at 70%. Terms of up to 90 days are included. Foreign receivables are accepted either on their own risk, if the name is known, or insured. Federal government receivables are generally not considered, as they cannot be assigned.

- An exception to the above is made for **Biotech SMEs** to which medium term loans are made available secured by capital equipment. Biotech are considered very good risk, especially at the earlier stage. Facilities are often made in alliance with a leasing company with SVB being first in first out. SVB applies a "Remaining months liquidity ratio", requesting investors to add extra funds below a certain liquidity level.

- The amount of available lines of credit is generally **between US$ 500,000 and US$ 10 million.** The security consists of receivables and inventory. No real estate security or personal guarantees is taken (because of outside investors). When a client has problems, SVB is known to keep banking the client and, with the cooperation of the investors, to help the client through difficult times until a solution is found.

- The loan pricing is rather reasonable: **Prime plus 2% and 1% front-end**. However as a sweetener, SVB requires **warrants**. These warrants are not included in the pricing package, but represent the "gravy" when the company goes public. Over 200 SVB technology clients have gone public. These warrants also compensate the bank for the cost of specialized account managers with relatively small portfolios.

- All **services are extensively cross-sold to** technology clients: Foreign exchange, international trade financing (SVB is a big user of CEFO guarantees), cash management services, term loans for acquisition financing, account receivable factoring and private banking for SME executives.

A lot of interesting lessons for Canadian lenders are found in the above, and could be duplicated.

8) Imperial Bank

I met with Richard Myers, Jr. SVP and Manager and Roger Kratz, VP, of the Beverly Hills office as well as Peter Knudson, SVP and Manager and Herve Lacorne, VP, of the Corporate Service Center in Redondo Beach. This bank is very active in export financing. Interestingly, both VPs mentioned above spoke French, and Peter has had an extensive international career in Europe and Asia.

Imperial is a 30 year old US owned bank with US$ 2.8 billion in assets. Its two founders, George Graziado and George Eltinge, are still active in the bank as respectively Vice Chairman, CEO and President and Chairman of the parent company, Imperial Bancorp. Imperial has 12 banking offices, all in California, where it is the 10th largest bank.

It is only a business bank and does not offer retail services except to accommodate its business clients. The majority of its clients are SMEs with sales between US$ 5 to 50 million. Imperial has a concentration and special banking divisions in the entertainment, health care and garment industries.

The Redondo Beach office services the international banking needs of the bank clients throughout California. Loans may be supported by foreign receivables.

Peter Knudson indicated his appreciation for CEFO working capital guarantees and the people working in that agency. He indicated his bank avoided using the related Eximbank program. Indeed Eximbank takes 6 to 8 weeks to make a decision, is very bureaucratic and often finds ways of not paying on their guarantees. CEFO pays well and makes quick decisions.
The SBA program is still at a pilot stage.

Overall a very interesting trip in a State very active in both our priority concerns: knowledge-based SMEs and exporting SMEs.

FINANCING THE NEW ECONOMY PROJECT

BEST PRACTICES IN EUROPE March 14, 1994

Paul A. Toriel

Below is a summary of the best practices observed during Paul Toriel and Jamal Khokhar's recent trip in Europe:

Servicing SMEs

1) **French banks**, as an exception to the general credit tightening versus SMEs observed in Europe, appeared to compete with each other in providing **service packaging** and in the **pricing** of those services.

A majority of lines of credit to SMEs are fixed rate or fluctuating medium to long term (up to 12 years) without the possibility for the bank to unilaterally terminate the relationship.

(Here it is important to note that most French banks have direct or indirect state-ownership. Servicing SMEs appear to reflect government policy objectives rather than purely commercial interests).

Export financing

2) Without exception, banks and governments officials are hesitant to push SMEs to export, especially to difficult markets or those far afield. Again, the goal is to assist SMEs to grow and not exacerbate the already high risk factors. SMEs are encouraged to export, indirectly, as sub-suppliers, or directly, as exporters to border states. Only once an SME develops experience and sophistication in exporting to these relatively easy border markets, are they assisted in going further to more "exotic" markets.

3) France's government funded export credit agency, **COFACE**, encourages SMEs to develop three year to five year market development plans which it reviews, helps refine, and then provides funding to cover part of their marketing expenses on a cost-recovery basis. COFACE appears to cover its market well and provides SMEs with services ranging from protection for exchange rate fluctuations to some export counselling. Such levels of support, however, involve a significant draw (and incur concomitant losses) on that government's fiscal framework.

French banks indicated they were pleased and eager to introduce an SME to their partner, the export credit agency. No apparent sense of competition existed.

4) In the provision of export financing, financial institutions, both public and private, work very closely together and cooperate to assist the SMEs. Competition is not an issue except in the case of Germany's Kreditanstalt fuer Wiederaufbau (KfW), a state owned bank (80% federal; 20% local states) specialized in SME financing. KfW, through subsidized loans, competes directly with private sector banks. KfW is the tenth largest bank in Germany. Refer 16 below.

The countries visited have well coordinated ***team*** approaches which Canada should endeavour to emulate. Their players actually do work together: chambers of commerce, large and small companies, regional officers, trade officers abroad, export credit agencies and banks to coordinate country risk assessment, market development strategies and resource allocation decisions. ***Team Canada*** has been a concept which has existed for years, but never really implemented to the degree needed.

In all cases, the foreign commercial officers and trade commissioners are integral parts of a country's export team and are regularly consulted and actively engaged by banks and export credit agencies.

5) **Banque Cantonale Vaudoise**, one of the largest semi-public bank in Switzerland, refers all exporting SMEs to specially trained "international" account managers who are better able to provide expert advice.

Factoring/Discounting

6) **Factoring**, the discounting or purchasing of accounts receivables and/or trade bills, was recognized by most the countries visited as a financial tool needing to be developed and used further. Factoring would assist SMEs, especially with foreign receivables, in improving their working capital requirements.

Recourse discounting of trade bills is a financing tool very much utilized by French banks. They have recourse against the drawer, the drawee and the aval (if any). Receivable financing is made easy by the bank becoming the **owner** of the account receivable, with payment made to the bank (actually this is similar to **factoring**).

Knowledge-based SMEs

7) The only financial institution, in any of the countries visited, which we found to have developed a program to service knowledge-based SMEs was **NatWest**. Specifically, in 1989 NatWest established a "technology unit" within the bank's small business service division to provide specialist support to technology-based businesses. This consists of a small central team of ten experienced managers and research assistants supporting over 150 trained technology account managers located in selected NatWest branches throughout the U.K and supporting local technology-based firms. These specialists provide practical solutions including specially designed financing products and packages, technology appraisal services and networking with technical and business specialists as well as "business angels". This has allowed NatWest to dominate the technology and knowledge-based SME market in the U.K.

NATWEST has a 30% market share of UK SMEs. Its policy is to **screen out losers** in a market full of inexperienced entrepreneurs. NATWEST motto is to "help the SMEs help themselves".

Government Guarantee Programs for SMEs

8) France's **SOFARIS** government guarantee of 50% of a commercial bank credit to SMEs could be used as a model, specifically as this facility serves to spread the risk between the commercial banks and the government. Moreover, the SOFARIS model ensures that applications are reviewed and decisions are taken quickly (between 24 and 48 hours of receiving an application), based on the commercial bank's analysis (no duplication of work). All of the above implies a closer linkage between banks and government agencies and comprehensive packaging of services.

SOFARIS 50% guarantee scheme to banks lending to SMEs is based on the notion of **"risk sharing" between private and public sectors.** SOFARIS has less than 100 employees, and power is delegated to representatives in the regions who have lending limits. As a result, 85-90% of decisions are taken in the region within 48 hours of the bank submitting its request and supporting documentation. For small transactions (under $500,000) large banks may even approve the SOFARIS guarantee on their own under a delegation of power, thus reducing red tape to a minimum. Guaranteed loans have a term of 2-15 years, with an average of 5-7 years. The failure rate is 4.4%. Banks as well as government are shareholders in SOFARIS. If a loss ever occurred all shareholders would be called to recapitalize the company.

Venture Capital Funds

9) The Midland Bank (U.K.) has created small regional funds investing in SMEs the equivalent of between C$50,000 and C$300,000 for up to 10 years. Such an initiative could be adopted by the Canadian banks and/or their subsidiaries, perhaps with the participation of the Canada Investment Fund being created.

Midland Bank, which is a subsidiary of Honk Kong and Shanghai Bank, has a 13-15% market share of SMEs and is specialized in international trade services.

10) The U.K. is home to ***3i*** the world's oldest and largest venture capital fund. ***3i*** could be very useful in advising on the development of a Canadian Investment Fund. Some form of Canadian alliance/partnership or participation may be possible as ***3i*** is also involved in foreign markets. 3i (Investor in Industry) was founded in 1945. Among its main shareholders are Bank of England and 7 commercial banks (the larger shareholder is NATWEST with 22%). It has 18 offices in the U.K. and 6 in continental Europe.

Net worth: 1.3 billion pounds; total assets: 3.4 billion pounds; portfolio of 3700 companies mainly in the manufacturing and in the distribution and service sectors. 61% of investments are for less than the equivalent of $500,000 (14% of the amounts). Since its creation it has invested 6 billion pounds in over 11,800 businesses.

One-Stop Service

11) One stop service for SMEs is being tried in the U.K. (the Business Links program). DTI expects to open 30 "Business Links" (one stop shops) in the summer. They have 4 presently and have a target of 200.

However, while it is too early to judge, we were not convinced of the eventual success of this endeavour. One can have the right "institutional structure", but *people are the key*. There must be a combination of the right people with the right skills being in the right place. Without this together with a common set of objectives, clear direction and responsibilities, and a high degree of cooperation, such endeavours risk failure.

Networks

12) In most European countries, industry and private sector groups play a key role in educating and providing assistance to SMEs and in establishing networks between both themselves and larger companies.

Mid-sized SMEs

13) UK Department of Trade and Industry (DTI) has shifted from helping SME start-up to helping SMEs to grow. Indeed, there are not enough mid-size companies in UK, where 97% of businesses employ less than 20 people and have an annual business turnover of less than the equivalent of $ 2,000,000.

14) *3i* calls " **Superleague companies**", the SMEs with annual sales between 500,000 and 100 million sterling pounds. This small group (3489 SMEs) sales doubled between 1989 and 1990 to 18.4 billion sterling pounds; it provided employment for 244,000 people, a 30% increase over the 2 years; and had aggregate profit growth of 70% over 2 years compared with a decline of more than 50% for all SMEs during the same period.

Code of Conduct

15) UK banks have a **code of conduct for SME business**. This is new and was developed as a result of SMEs complaints to government. It is written in plain English and is very easy to understand.

Subsidized loans

16) The common financing scheme in Germany is subsidized low rate medium to long term loans to SMEs. The low cost funding is offered to the banks by KfW, a government owned bank specialized in SMEs financing, and banks pass the savings to the SMES. **Please note that, except for export financing, KfW does not lend directly but only through banks. Banks are responsible for any losses.** KfW is also very active in export financing for SMEs (refer 4 above).

International Alliances to help SMEs

17) CEPME, the French equivalent of FBDB, has made several international bilateral accords to support SMEs when they establish subsidiaries in foreign countries (one such accord is with Quebec SDI). They only lend for medium and long term to SMEs.

Credit Rating for SMEs

18) Banque de France (central bank) has detailed statistics on each company (size, financial information, payment problems) as well as a credit rating. This information is made available to all financial institutions and commercial creditors.

Financing the New Economy:
European Fact-finding Mission

Paul A. Toriel, Industry Canada
and
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February 12, 1994

MISSION OBJECTIVE

Within the context of the project on *Financing the New Economy*, we wanted to determine the issues and problems faced by Small and Medium-sized Enterprises (SMEs) in other countries and how they are handled, with a view to possibly adopting some of these solutions in Canada. Key areas of interest included debt, export and equity financing. Particular focus was given to high growth, knowledge-based and export-oriented SMEs.

The following countries were visited: the United Kingdom, France, Germany, Austria, and Switzerland. As well, the OECD in Paris was also visited. Unless otherwise noted, the following observations refer to conditions in the countries visited.

INTRODUCTION

While SMEs in each country operate under a particular set of conditions, the general issues and problems related to the financing of SMEs appear universal. However, while the issues and problems may be universal, the perception of the need to address the problems is not the same in all countries. What we, as Canadians, may view as problems needing to be addressed often do not carry the same degree of importance or sense of urgency in these other countries.

This report is not intended to be a descriptive overview of the circumstances faced by SMEs nor a review of other government's programs. Rather, it serves to provide general observations that are relevant to the Canadian context and indicates some "directions" for further work and study by the project team. It is important to note that, in a homogeneous world, one could easily seek to apply the "best practices" of other countries to the Canadian situation. However, many of the specific issues and the means of addressing them reflect significant structural differences in the types of institutions that exist (public and private), as well as how they interact. Clearly, there are significant differences among countries in the degree of intervention and, indeed, the amount of resources governments are able and willing to dedicate towards business support programs. Ultimately, the basic problem facing suppliers of financing to SMEs is one of managing risk. The types of support initiatives that can be put in place will directly reflect how much of that risk governments are able to offset. Finally, there are intrinsic cultural, educational, and behaviourial differences which, however desirable, cannot be readily transplanted nor adopted. Therefore, the directions below only include those that can be applied within the existing Canadian framework. That is not to say, however, that there is no need nor scope for longer-term structural change.

GENERAL OBSERVATIONS

Definitions of SMEs:

Definitions of SMEs vary. However, in general, they are classified as those enterprises having more than one and fewer than 500 employees and annual sales (turnover) not exceeding the equivalent of C$100 million. It is important that SMEs not be considered or treated as one block of companies. Rather, there are different segments (by employment size and/or by sales) into which they can be further classified. Each of these segments has its own specific needs.

In France and the U.K., over 90% of all SMEs have fewer than 10 employees. In Canada, close to 93% have fewer than 20 employees. The failure rate of all SMEs within three to five years of start-up was between 40-50% in the countries visited. Because of this, many of the SMEs are quite young.

"Life-Style" SMEs:

In studying SME development in the countries visited, it is important to recognize the significance of "life-style" companies. These are companies created to provide an income to achieve a certain quality and standard of life, not necessarily to create a fast growth, dynamic enterprise. Typically, SME owners are quite independent and do not wish to lose control over their company. There can be resistance to growth or to undertaking a greater range of activities, particularly when this involves accepting equity from outside sources. It is interesting to note that fiscal and tax incentives to encourage the creation of SMEs (e.g. VAT exemptions) actually resulted in the emergence of such small "life-style" companies, rather than those that seek to grow into more resilient medium-sized companies.

It would be interesting to study the significance of this phenomenon in Canada.

A Difficult Environment:

Across Europe, there has been a certain tightening of the availability of bank financing for SMEs. In Switzerland, for example, the larger banks are leaving the SME market to the public or semi-public cantonal banks. France demonstrated an exception to this general tightening. Banks there appeared to compete with each other in providing service packaging and in the pricing of those services. (It is important to note that most French banks have direct or indirect state-ownership. Servicing SMEs appears to reflect government policy objectives rather than purely commercial interests).

Overall, this contraction in financing can be understood as a result of the continuing recession as well as the high failure rate of SMEs.

Jobs... :

In terms of job creation, it was generally agreed that SMEs do provide a net increase in jobs. However, because of the high "churn" factor (i.e., great number of start-ups and failures), the real growth of permanent jobs results from helping small companies grow to become medium-sized, as well as lending support to the growth of medium-sized companies. Because of the "life-style" company syndrome, many companies remain small and do not generate a significant number of lasting jobs. It is only a very small percentage that are willing and successful in making the jump from small to medium-sized companies. It can be argued that it would be better for government to spend $x in helping a company of 50 employees overcome a barrier in growth and double in size, rather than spend the same sum to create 10 companies each with five employees, with the likelihood that half will fail within three years. Of all the countries visited, only Germany, through strong cooperation between the private and public sectors, has been successful in creating a significant sector of medium-sized companies. These medium-sized companies (the "middle class") are often the ones best able to venture into the export arena. Ironically, in general, it is this same sector of medium-sized companies that is least targeted to receive the benefits of government support programs.

... and Exports:

Generally, it appeared that the larger the SME is, the more likely it is to be both interested in exporting and able to export successfully. Other factors such as management capability, financial structure, product and service innovation, export awareness and know-how, and language skills all play determinant roles. Without exception, bank and government officials are hesitant to push SMEs to export and certainly not to difficult markets or those far afield. Again, the goal is to assist SMEs to grow and not exacerbate the already high risk factors.

SMEs are encouraged to export, indirectly, as sub-suppliers, or directly, as exporters to border states. In the case of Austria, this often means exporting only to southern Germany and northern Italy. In the Alsace-Lorraine region of France, exports are concentrated in regions of Germany, Switzerland, and Benelux with which they share borders. Only once an SME develops experience and sophistication in exporting to these relatively easy border markets, are they assisted in going further to more "exotic" markets. France's export credit agency, COFACE, encourages SMEs to develop three-year to five-year market development plans which they review, help refine, and then provide funding to cover part of their marketing expenses on a cost-recovery basis. In the provision of export financing, financial institutions, both public and private, work very closely together and cooperate to assist the SMEs. Competition is not an issue (except in the case of Germany's export credit agency, KFW, which, through subsidized loans, competes directly with its private sector banks). In all cases, the foreign commercial officers and trade commissioners are integral parts of a country's export team and are regularly consulted and actively used by banks and export credit agencies.

The "New Economy":

The "new economy" for most OECD countries will be based on the development of high technology and knowledge-based industries. Assessing the risk and collateral associated with knowledged-based SMEs presents problems for both public and private financial institutions. However, neither the relevance of knowledge-based SMEs to economic growth nor the financing of knowledge-based and high-technology SMEs had been considered as being major issues. Moreover, with the exception of the U.K.'s National Westminster Bank (NatWest), public and private financial institutions were not generally well prepared to meet these challenges. Indeed, in meetings with the OECD officials, we raised this question to find that their new Working Group on SMEs had also overlooked this aspect of SME development. Our interventions appear to have resulted in the OECD officials recommending that the financing of knowledged-based SMEs be the subject of a separate workshop in the Working Group Meeting to be held in September 1994 in Seville.

Technology Units and Knowledge-based SMEs:

As mentioned above, the only financial institution, in any of the countries visited, which we found to have developed a program to service knowledge-based SMEs was NatWest. Specifically, in 1989 NatWest established a "technology unit" within the bank's small business service division to provide specialist support to technology-based businesses. The unit consists of a small central team of ten experienced managers and research assistants supporting over 150 trained technology account managers located in selected NatWest branches throughout the U.K to support local technology-based firms. These specialists provide practical solutions including specially designed financing products and packages, technology appraisal services, and networking with technical and business specialists as well as "business angels".[1] This has allowed NatWest to dominate the technology and knowledge-based SME market in the U.K.

Programs:

As a final general observation, as in Canada, each country has a plethora of public and private sector business support programs. However, everyone admitted that these programs were neither generally well known nor easily accessible by SMEs.

[1] Generally, "business angels" are high net-worth individuals with considerable management and commercial experience usually as a result of owning and operating their own enterprise. Typically they are semi-retired and look for investment opportunities which would allow them to be somewhat active in managing or providing advice to the companies in which they are investing. Often, governments provide tax incentives to encourage such investment.

POSSIBLE DIRECTIONS

The following "directions" result from information obtained in the countries visited. These "directions" are preliminary observations, requiring further analysis and study. Their fiscal/budgetary implications have not been studied or evaluated.

I. Debt and Equity Financing:

"Technology/knowledge-based support units" of banks.

We are aware that some Canadian banks do have initiatives directed towards supporting knowledge-based SMEs. The integrated units of NatWest (see above) are an interesting concept capable of duplication here. Using this concept, knowledge-based account manager teams could be placed strategically across Canada where a high concentration of knowledge-based SMEs already exists and where networking with private and public entities could best be put in place. These units could also create networks with "business angels" and government programs.

Closer linkages between the FBDB and the commercial banks for medium-term lending.

Similar to what was observed in the U.K., Canadian medium-term lending to SMEs does not appear to be adequate, particularly in relation to what is available in France or Germany. Consideration could be given to the Federal Business Development Bank (FBDB) playing a role in guaranteeing or co-financing medium-term lines of credit. In this regard, France's SOFARIS government guarantee of 50% of a commercial bank credit could be used as a model, specifically as this facility serves to spread the risk between the commercial banks and the government. Moreover, the SOFARIS model ensures that applications are reviewed and decisions are taken quickly (between 24 and 48 hours of receiving an application), based on the commercial bank's analysis (no duplication of work). This approach implies a closer linkage between banks and FBDB and comprehensive packaging of services.

Short-term financing support to knowledge-based SMEs by the FBDB.

While short-term financing is a very important component of the overall financing of Canadian knowledge-based SMEs, it is quite difficult to obtain, in part due to the lack of adequate collateral (i.e., soft assets are not viewed as collateral). Here again, a guarantee by FBDB (or FBDB co-financing) to compensate for lack of adequate collateral for an otherwise promising young knowledge-based SME could be an attractive solution.

Greater cooperation among FBDB, EDC and Canadian Trade Commissioner Service.

As in other countries, particularly Germany, there is scope for greater cooperation between the FBDB and EDC which could result in the delivery of a business development "consultative and advisory" service combined with appropriate financial support packages. The Trade Commissioners could also play an important role here.

The commercial banks and small venture capital funds.

The lack of small equity investments is a problem everywhere. The Midland Bank (U.K.) has created small regional funds investing in SMEs the equivalent of between C$50,000 and C$300,000 for up to 10 years. Such an initiative may be adaptable by Canadian banks and/or their subsidiaries, perhaps with the participation of the Canada Investment Fund. With this in mind, the U.K. is home to *3i* the world's oldest and largest venture capital fund. *3i* could be very useful in advising on the development of a Canadian Investment Fund. Some form of Canadian alliance/partnership or participation may be possible as *3i* is also involved in foreign markets.

II. Export Financing:

Supporting increased exports through export financing is generally not so much an issue as is the provision of working capital and venture capital. The focus would be better placed on supporting SMEs to develop into stronger companies and then helping them to export.

Packaged EDC commercial bank short-term financing.

EDC's short-term financing/insurance programs are considered to serve SMEs well in comparison to programs in other countries. The worst case scenario is in the U.K., where the privatization of their programs has resulted in a reduction of coverage for SMEs because of an increase in the cost of insurance premiums. France's COFACE appears to cover its market well and provides SMEs with services ranging from protection for exchange rate fluctuations to some export counselling. Such levels of support, however, involve a significant draw (and incur concomitant losses) on that government's fiscal framework.

French banks indicated they were pleased and eager to introduce an SME to their partner, the export credit agency. No apparent sense of competition existed. It may be possible to improve existing EDC programs in cooperation with the commercial banks, possibly packaging EDC insured bank lines of credit for SMEs having foreign or even domestic receivables.

A working capital guarantee program for SME exporters is another area for study and review.

A real Team-Canada approach for medium and long-term export financing.

On the medium and long-term export side, EDC could consider guaranteeing or co-financing transactions, as well as providing direct lending. This could reduce or hopefully eliminate the present perception of competition between EDC, the banks, and others, as well as leverage the amount of financing available. It could also encourage banks, as a *quid pro quo*, to look at financing smaller export transactions for SMEs and to direct more business to EDC. The key is to be able to provide *additional* support through co-financing and cooperative arrangements and not by "market splitting".

Other countries have well coordinated *team* approaches which Canada should endeavour to emulate. Their players actually do work together: chambers of commerce, large and small companies, regional officers, trade officers abroad, export credit agencies and banks, to coordinate country risk assessment, market development strategies, and resource allocation decisions. Perhaps this is a result of some of the structural, cultural and educational factors alluded to earlier. Whatever the case, *Team Canada* has been a concept which has existed for years, but never really implemented to the degree needed.

Financing via Factoring.

Factoring, the discounting or purchasing of accounts receivables and/or trade bills, was recognized by most the countries visited as a financial tool needing to be developed and used further. Factoring could assist SMEs, especially with foreign receivables, in improving their working capital position. While some factoring companies exist in Canada (some being bank subsidiaries), not enough business is directed their way.

Forfaiting, similar to factoring for medium-term accounts receivables, is not being used substantially in the other countries (with the exception of the U.K.'s ECGD). Nevertheless, this, too, is a financing instrument worth developing.

Linkages between the banks' SME account managers and their international trade specialists.

SMEs involved in exporting in many countries often complain of not receiving adequate assistance from their bankers. The Swiss banks have tried to deal with this, referring all exporting SMEs to specially trained international account managers who are better able to provide expert advice. While such a referral exists within the Canadian banks, it is clear that it does not appear to function as well as it could. Strengthening the relationship and referral system between banks' account managers and their international trade specialists would provide exporting SMEs with the level of service they require.

III. Other

"One-Stop Service Centres" with a concentration around private sector units.
Better coordination between federal, provincial, regional and private sector efforts.
Red-tape, and other administrative and regulatory reduction.

One-stop service for SMEs is being tried in the U.K. (the Business Links program). While it is too early to judge, we were not convinced of the eventual success of this endeavour. One can have the right "institutional structure", but *people are the key*. There must be a combination of the right people with the right skills being in the right place. Without this, together with a common set of objectives, clear direction and responsibilities, and a high degree of cooperation, such endeavours risk failure.

We would favour a concentration around private sector units and better coordination between federal, provincial, regional and private sector efforts. This reinforces the need for non-financial support by government in providing one-stop information centres (i.e., the Canada Business Service Centres), reducing red-tape, and other administrative and regulatory problems.

CONCLUSION

While the aforementioned "directions" relate largely to government and the banks, businesses, too, have a responsibility to help themselves. In most European countries, industry and private sector groups play a key role in educating and providing assistance to SMEs and in establishing networks between both themselves and larger companies. Private sector groups should be encouraged to concentrate more of their effort on these activities.

Lack of funds is a common problem for the governments of most countries. Therefore, efforts should be focussed on assisting larger SMEs or knowledge-based SMEs with clear potential to grow and export. It is important not to push SMEs beyond their capabilities. Newly exporting SMEs should begin with easier markets before going to more "exotic" ones. They should be encouraged to export indirectly as sub-suppliers or in some form of vertical integration with larger companies or in consortia with other SMEs. The objective is to create a broader network of better prepared and more resilient companies. Furthermore, the government should ensure that barriers hindering companies in making the transition from small- to medium-sized are removed. In this way, innovative, growth-oriented and long-term job creating entrepreneurs can truly become engines of the new economy.

It is more important than ever that each player also be part of the solution and not only part of the problem.

LIST OF VISITS

Government and Government Agencies
Department of Trade and Industry (U.K.)
Sheffield T.E.C. (U.K.)
Austrian Department of Economy (Austria)
SOFARIS (France)
CEPME (France)

Commercial Banks
National Westminster Bank (U.K.)
Midland Bank (U.K.)
Banque Cantonale Vaudoise (Switzerland)
RZB (Austria)
Commerzbank (Germany)
Deutsche Bank (Germany)
CIAL (France)
Crédit Lyonnais (France)
Banque Nationale de Paris (France)
Banque Française de Commerce Extérieur (France)

Export Agencies / Credit Insurance
ECGD (U.K.)
NCM (U.K.)
Borgesbank (Austria)
COFACE (France)

Venture Capital Companies / Associations
3i plc (U.K.)
British Venture Capital Association (U.K.)
Groupement pour la promotion du capital risque (Switzerland)
BDW (Germany)

Others
Federation of Small Businesses (U.K.)
British Banker's Association (U.K.)
Confederation of British Industry (U.K.)
Austrian Trade Commission (Austria)
Conseil pour le développement économique (Switzerland)
OECD (Paris)

FINANCING THE NEW ECONOMY

NOTES ON THE FINANCIAL PROBLEMS EXPERIENCED BY SMALL AND MEDIUM SIZED COMPANIES

COMMISSION OF THE EUROPEAN COMMUNITIES - NOVEMBER 10, 1993

PAUL TORIEL JANUARY 24, 1994

This 60 page document is an excellent analysis of the problems affecting SMEs in Europe, of the programs available in the European Communities (EC), in United States and in Japan, as well as proposed solutions. The reader will find a lot of similarities with the Canadian situation. Please find below a summary of main points:

I - Introduction

- A number of EC SMEs continue to experience major difficulties in seeking financing at a reasonable interest rate without having to pledge excessive amount of personal assets as security.

- SMEs comprise 99.9% of total enterprises in the EC, they provide 70% of total employment, and account for 70.5% of total business turnover (sales). They are also responsible for the creation of 40% of all new jobs in manufacturing; this trend is strengthening and the EC economic health is dependant on a flourishing SME sector.

- SMEs are considerably more reliant on bank financing than larger firms; they also tend to be under capitalized in comparison with their equivalent in USA.

II - Access to finance problems

<u>Conventional business start-ups</u>

- New firms have a failure rate of 50% within the first 5 years; when counselling and other supportive measures are provided, this failure rate is cut in half.

- The major problem is that too few of those starting a business know how to either assemble a convincing proposal for a bank, or to present it properly. Common faults are to overestimate initial sales and to underestimate the time it will take to reach profitability. Also inadequate management skills contribute to failures.

- A potential financial gap exists when a start-up has sufficient security or financial aid to secure initial financing but is unable to raise financing for expansion.

High risk start-ups

- These are new business established in order either to research or exploit a new process in an existing field or an entirely new discovery.

- Financing gaps here are created because earlier projects submitted to venture capitalists all too rarely met the rates of return required by these investors, and the cost of supervision proved disproportionately high.

The first stage of significant expansion

- This is another period of high vulnerability for SMEs. The root of the failure is often inadequate management rather than lack of access to finance. Banks could do more advising to SMEs, requiring regular progress reports and ensuring deadlines are observed.

- SME management does not give enough priority to build the proper level of confidence with their lender.

- Venture capitalists are generally not interested in financing amounts of less than ECU 350,000.

III - Sources of Finance

Banks

Banks remain the dominant source of financing, but the following negative points are being indicated by SMEs:

- an increasing tendency to rely solely on credit scoring;

- a growing practice to give more importance to the security available rather than the quality of the proposal;

- undue restrictions towards existing SMEs; for example reduction of line availability when risk has not deteriorated;

- increased fees.

The author of the EC report is concerned with the high degree of SME dissatisfaction with banks and comes with the following explanations:

- New technologies used by banks have led to a withering away, in many cases, of the traditional "one to one relationship" between the banker and borrower. Decision taking is centralized and remote.

- Banks' ability to lend more imaginatively and competitively has been undermined not only by their massive losses on loans, but also by the provision of the Basle Agreement on capital adequacy by the BIS.

Other sources of private sector capital

The concept of business angels is not very developed in Europe. In UK, 5 pilot projects are currently underway with government assistance. Furthermore, some 30-40 regional structures in France and 14 in UK channel private money to local projects.

Leasing

This type of financing is more or less unavailable to newly created businesses.

Factoring

The author considers this a most useful and appropriate financial instrument for SMEs, which is not used enough because of its perceived higher cost and unfounded fear to offend customers by the introduction of a third party.

Venture capital and seed capital

The problem here is the lack of money available for small investments (less than ECU 250, 000) . The reasons for this gap are:

- the amount of time needed to analyze and to supervise many small investments is out of proportion with the return;

- the number of SMEs failure is too high;

- the difficulty in getting paid at the end of the planned period.

As a result the major venture capital funds now tend to be risk averse; thus a financing gap.

IV - Examples

The report then give a description of a number of programs available to SMEs in the EC; among these the following are of particular interest to our project:

The European Seed Capital Fund Scheme: It is too early to judge the success of this initiative. Its objective is to foster enterprise creation by strengthening the financing opportunities available to new enterprises and improving the quality and survival rate of seed stage projects. After 3 years, it appears this initiative not only has led to the creation of funds that might otherwise not have existed, but also has indirectly helped to double the fund raising from private sector sources.

Eurotech Capital: The object of this scheme, started in 1990, is to stimulate private capital funding of transnational high technology projects.

SPRINT Programme: This programme is designed to bring together firms having innovative projects with potential investors. Also, the **SPRINT Technology Performance Financing** has been launched to stimulate the uptake of new technology in traditional industries. In practice this means that a supplier can install new technology in a customer firm and receive payment from the buyer over 2 to 3 years, depending on pre-established performance targets. A third party (commercial bank) provides unsecured financing to the supplier to bridge the gap in payments. SPRINT underwrites a portion of the bank risk.

Mutual Guarantee Systems: This scheme enables SMEs to guarantee each other on a cooperative basis to obtain funding by banks. It also provides assistance to SMEs in preparing their financial presentations to the banks.

V - Identifiable gaps and possible new initiatives

In summary, the most common problems are:

- lack of management and financial skills by many aspiring entrepreneurs;
- restricted amount of security offered to banks;
- inadequacies of management controls in many expanding SMEs, exacerbating working capital shortages;
- high and irrecoverable costs involved in the supervision and assistance of SMEs receiving small loans;

- the need for SMEs to react positively to changes in market structure;
- the lack of knowledge by the financial sector of the actual financial needs of SMEs;
- the inadequate number of agencies bringing together informal investors and SMEs;
- SMEs are generally unaware of sources of finance other than banks;
- the lack of venture capital funds available for small investments;
- the increasingly rigid lending policies of banks;
- the present reluctance of some leasing companies to finance the acquisition of plant and machinery;
- the relative short horizons of many venture capitalists, together with a growing aversion of the majority to take risks;
- a lack of suitable exit routes for venture capitalists;
- the almost total lack of a properly functioning "over-the-counter" stock market within the Community;
- the over rigid categorisation of investments by lenders.

Please find below some of the **recommendations** made by the EC author:

New and original initiatives to improve managerial and financial skills of entrepreneurs:

- build on existing schemes to offer integrated and comprehensive advice and counselling for new and existing SMEs;
- make any access to financial and other assistance by governments conditional upon attendance at courses providing basic instruction in management skills;
- for more established SMEs, encourage use of outside professional advisers accredited by a recognized professional association.

Assist the private sector in reducing its cost of investigating, supervising, and advising recipients of small amounts of loans and/or equity:

- Assist financial institutions with the cost of supervision in appropriate and approved cases. This assistance should be in the form of advances wholly or partially repayable depending on portfolio performance.

- Mobilise existing advice and counselling resources in order to assist.

Encourage the formation of more Mutual Guarantee Systems:

- This is a practical way of easing the access to finance of a substantial number of SMEs.

Financial assistance for product development:

- Especially for SMEs involved in defence activities; but also for new technology emanating from research.

Improve links between potential investors and those seeking funds:

- Train staff in financial institutions to better understand the needs of SMEs.

- Create agencies to bring together investors and entrepreneurs.

Fiscal initiatives:

- To encourage reinvestment of profit in the capital of the SME.

- To encourage private investors to invest in SMEs.

Refundable contribution to venture capital companies towards administrative overhead and creation of guarantee funds.

- To encourage investment in smaller SMEs, both SMEs and public sector should contribute to the fund.

Encourage banks to test innovative programs.

VII - Conclusions of the Report

A number of programs to assist SMEs already exists, what appears to be missing is a link between them which could promote best practices, reduce the danger of duplication, and avoid any waste of financial resources.

SMEs have to make more efficient use of their financial resources by better financial planning, coupled with an improvement in the standard of information they provide to their bankers. They should be assisted through management training and more accessible counselling, together with a greater availability of financial guarantees.

Priority should be given to stimulate funds making investments in high technology, without trying to pick winners. These investors require assistance in covering the cost of investigating small proposals, and better exit routes.

If carefully planned and fully coordinated with existing initiatives, the proposed measures should prove, over time, **self-financing** through increased production of higher value-added products, improved employment, and better tax yields.

FINANCING THE NEW ECONOMY

NOTES ON OECD REPORT - NATIONAL SYSTEMS FOR FINANCING INNOVATION

PAUL TORIEL DECEMBER 15, 1993

The world in which Canadian small- and medium-size enterprises (SMEs) are evolving is changing dramatically and rapidly; ideas and innovation are becoming the driving force of economic growth. Several economists have studied this evolution and a consensus may be found around the following main ideas:

- Growth results from the accumulated increase of an endogenous (coming from within) factor; depending on the theory, this factor is: gross investment incorporating technical progress (Scott), the store of useful knowledge underlying technical progress (Romer), or human capital (Lucas).

- This endogenous factor is a source of increasing returns (snowball effect: growth generates growth).

- The performance of the "engine of capitalism" depends on a right mix between private and public "technological fuel".

- Investment in the wide sense exerts a decisive influence on long-term growth.

- Investments need not only to be quantitatively sufficient, but also directed towards the right targets.

- The make-up of investment governs the ability to offset decreasing returns on capital and research by increasing returns on the commercialisation of research applications.

While globalization has opened up opportunities abroad, competition has intensified considerably both on the domestic and the international market. Therefore process and product innovation have become the preferred and most effective way for companies to differentiate their products or services and win market share.

Market failure in providing adequate financing for R&D is evident in general, and this problem has required government intervention to bridge the gap. According to OECD, SMEs are the ones suffering the most from this problem.

The same liberalization and globalization of financial markets, which has been so beneficial to large companies and enhanced the overall efficiency and flexibility of the financial system, has had a negative impact on SMEs.

- The least profitable projects are discarded by more demanding financial investors.
- Risks that cannot be securitized are more difficult to finance (this affects particularly knowledge based SMEs).
- Intermediation costs of financing SMEs are higher.

Market failures

- The financial system (banks, investors, etc) is unable to properly quantify the risk of financing innovation, especially in the case of a new SME.
- Innovation outcome is difficult to protect; imitations or upgraded versions made by competitors shorten the life of a new product/service making it difficult for the investor to earn sufficient revenues to compensate for the risk.
- Difficulty to divide technological investment; a minimum investment is needed which generates a succession of new investments, and this makes it impractical to share the financing between different parties.

As a result of the above, not only private but also public money tends to go towards the larger companies. According to OECD, 97% of US federal assistance to R&D goes to companies with more than 1000 employees. In France, SMEs with less than 500 employees receive only 7.5% of government assistance while they contribute to 16% of the R&D.

Financing systems

The study goes on to analyze the major types of financing systems:

- Market-based:
  - weakly mediated: USA
  - strongly mediated: UK, Australia, Canada;
- Credit-based:
  - global contractual governance: Japan
  - participatory governance: Germany
  - bank-centered governance: France, Sweden;

and concludes that each one has advantages and disadvantages, and that no universal solution to finance innovation may be found as each system has to find the best solution within its own criteria. There is no convergence towards a single model, but a "bringing together" on certain points of different existing systems.

Government financing

70% of government R&D expenditures correspond to non-economic objectives, mainly national defence, with USA and UK leading the pack.

For a number of reasons, including lower military budgets, the ratio of public/private R&D funding has declined for most countries in the last 10 years.

There are **879 programmes in the 22 OECD member countries and the EECI**; 159 of these have a principal objective of "strengthening of R&D capabilities": subsidies - 47.9%; loans - 2.5%; fiscal incentives 38.5%; and mixed instruments - 11.1%.

In several countries, very large projects have traditionally received a massive share of government support for technology development.

Conclusion

"The report shows that isolated SMEs suffer considerable handicaps in access to sources of finance, and that the globalization of financial markets makes this problem more acute. So far, aid to SMEs in most Member countries has led to only meagre results. **One of the major lessons from the experience of several countries is that aid to individual enterprises produces little effect when it is not incorporated in an overall strategy of support for innovation networks."**

Financing the New Economy

Statistics

Financing the New Economy - Statistics

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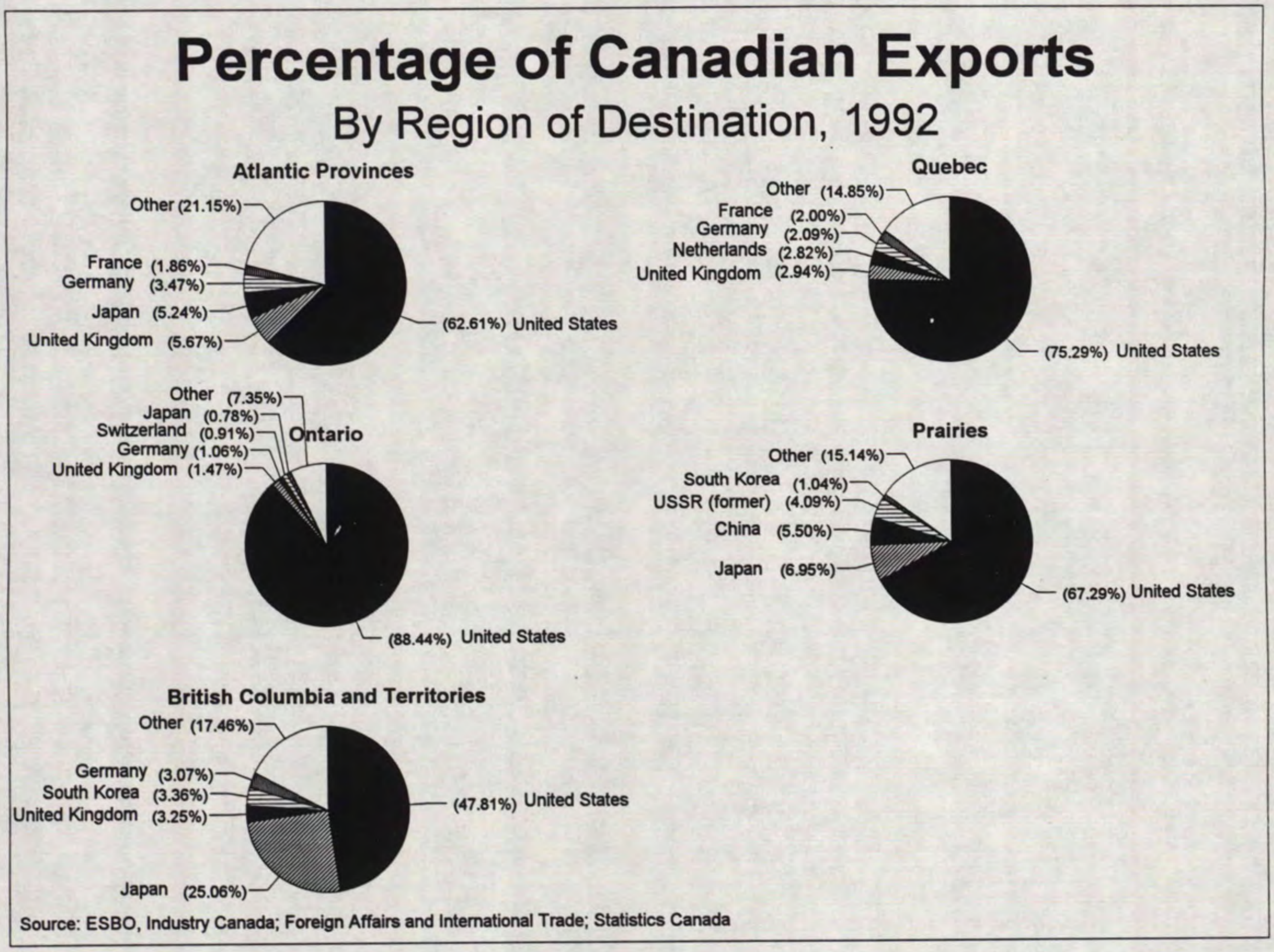
Export Statistics

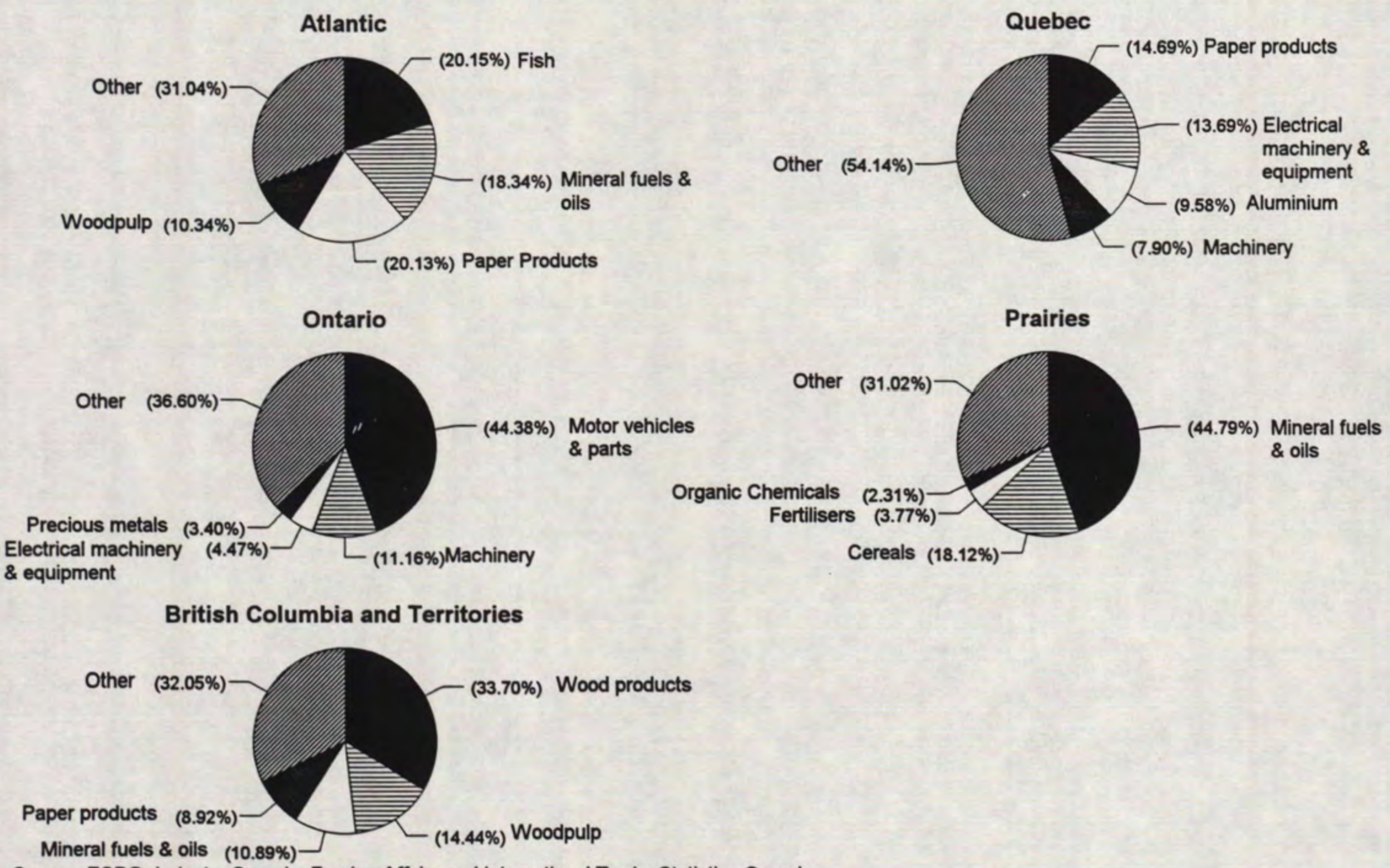
Chart 1



Percentage of Canadian Exports
By Region of Destination, 1992
Atlantic Provinces
Other (21.15%)
France (1.86%)
Germany (3.47%)
Japan (5.24%)
United Kingdom (5.67%)
(62.61%) United States
Quebec
Other (14.85%)
France (2.00%)
Germany (2.09%)
Netherlands (2.82%)
United Kingdom (2.94%)
(75.29%) United States
Ontario
Other (7.35%)
Japan (0.78%)
Switzerland (0.91%)
Germany (1.06%)
United Kingdom (1.47%)
(88.44%) United States
Prairies
Other (15.14%)
South Korea (1.04%)
USSR (former) (4.09%)
China (5.50%)
Japan (6.95%)
(67.29%) United States
British Columbia and Territories
Other (17.46%)
Germany (3.07%)
South Korea (3.36%)
United Kingdom (3.25%)
Japan (25.06%)
(47.81%) United States
Source: ESBO, Industry Canada; Foreign Affairs and International Trade; Statistics Canada

Percentage of Exports By Commodity

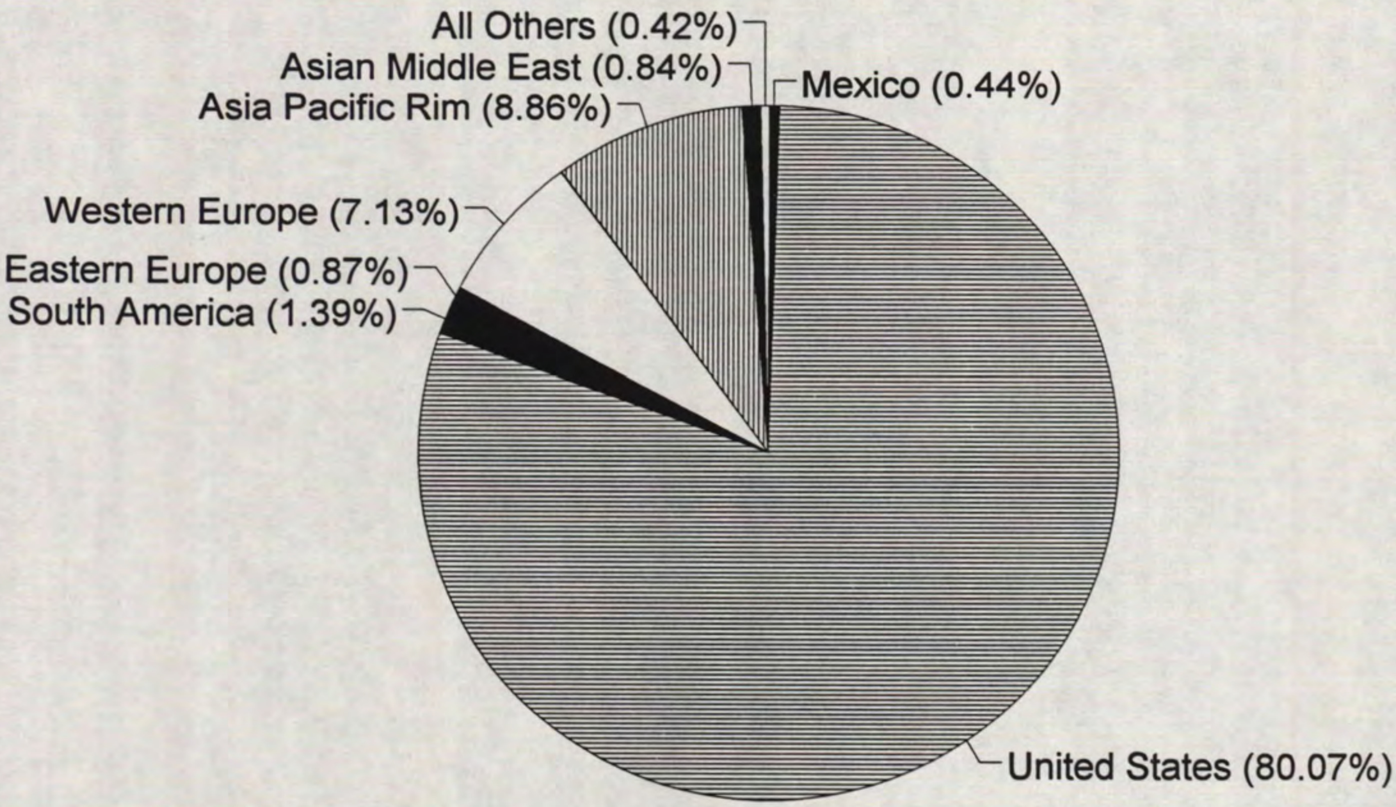
By Region, 1992



Source: ESBO, Industry Canada; Foreign Affairs and International Trade; Statistics Canada

Percentage of Canadian Exports

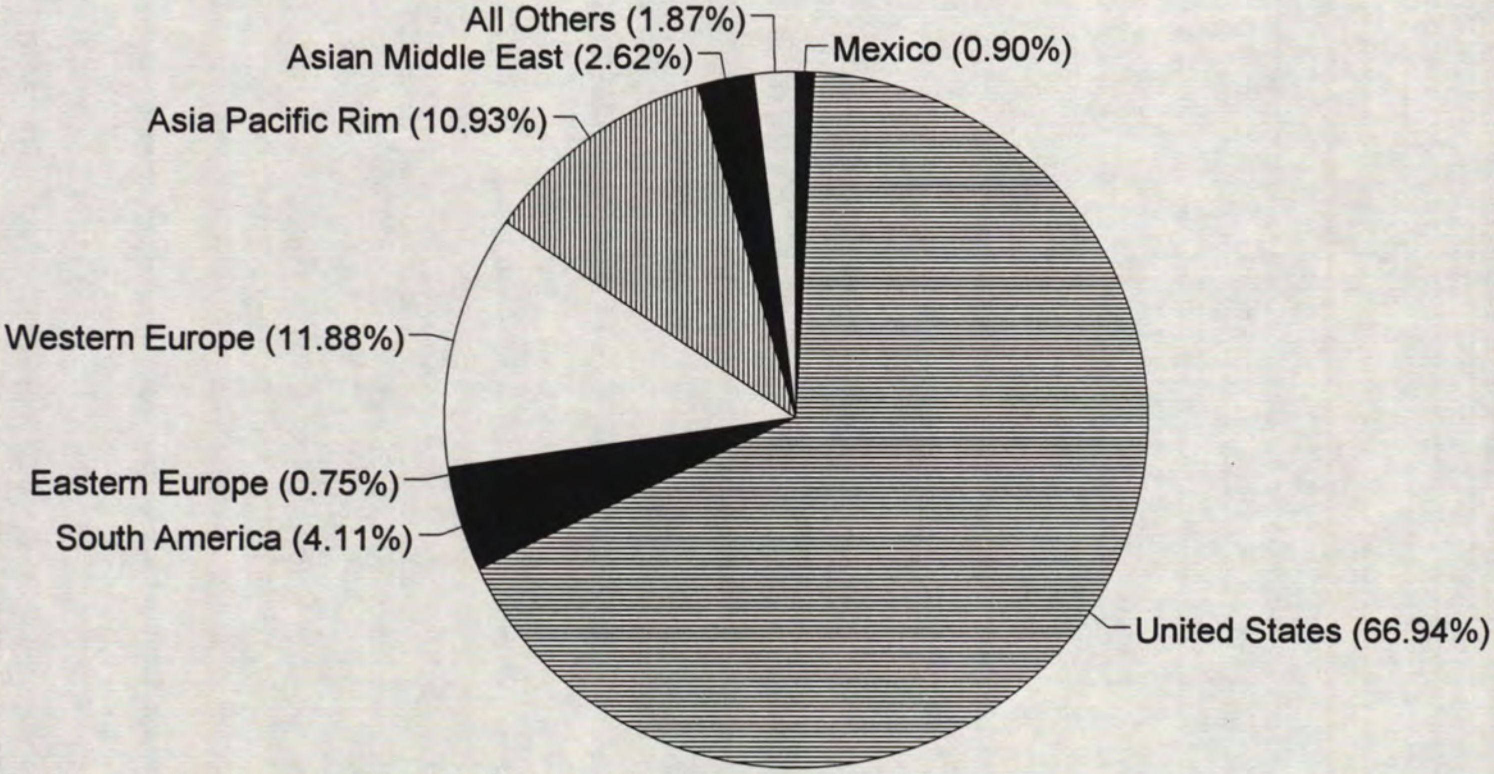
By Region of Destination, 1990



- Percentages represent the dollar value of exports from Canada to each region, relative to the rest of the world.
- Source: ESBO, Industry Canada; Statistics Canada.

Percentage of Canadian SME Exports

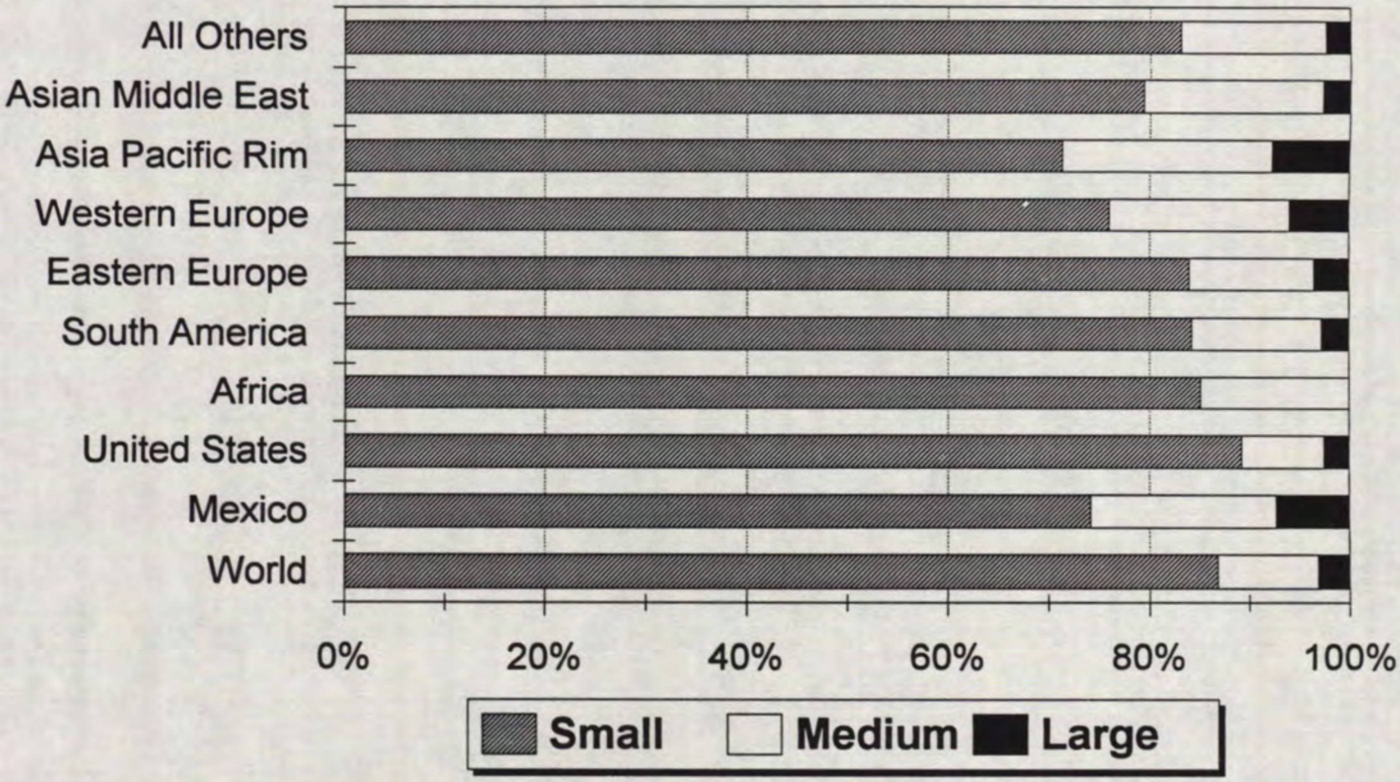
By Region of Destination, 1990



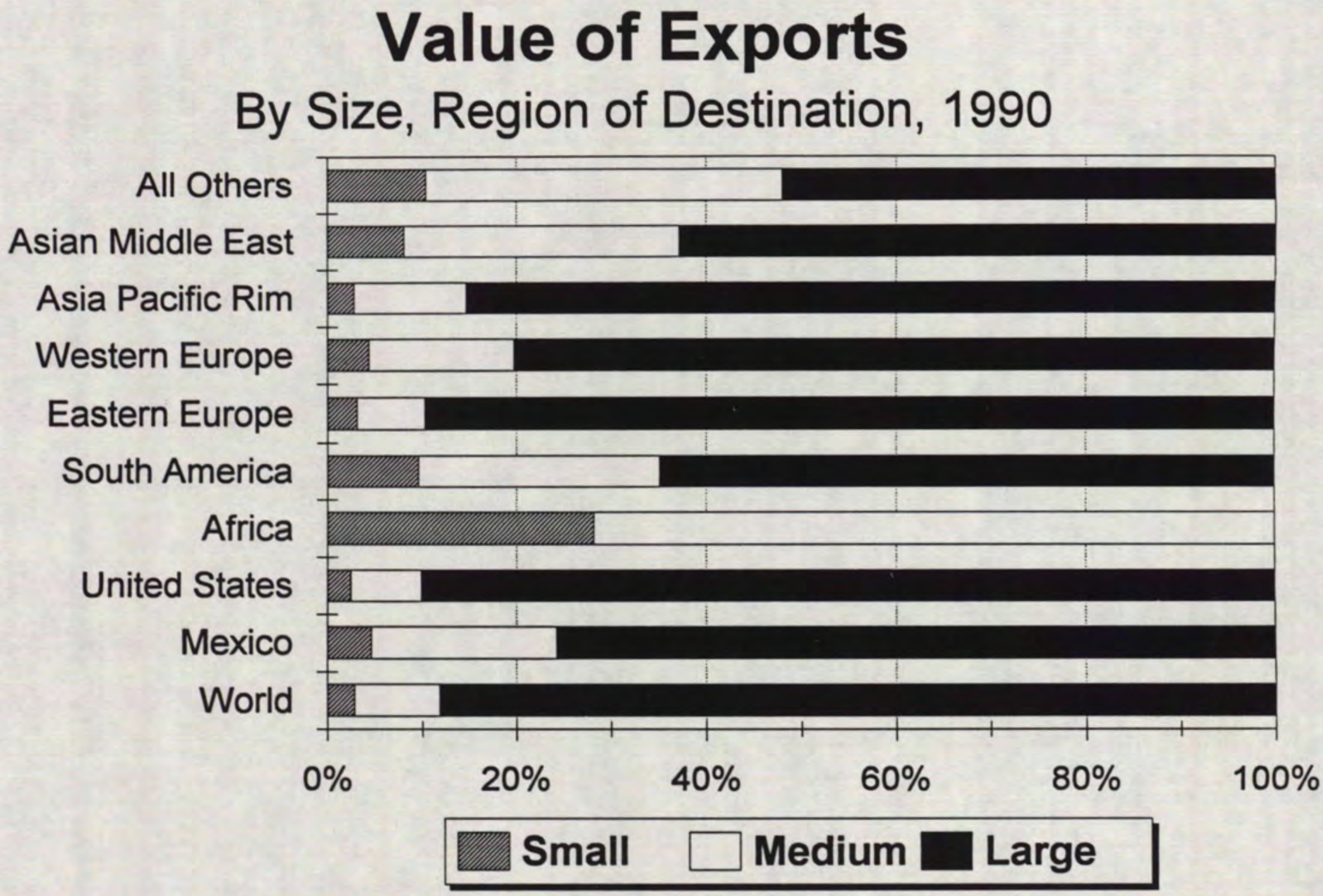
- SMEs are defined as companies which export goods worth less than $5,000,000.
- SMEs are more diversified in regions of destination than Canadian exporters as a whole.
- Source: ESBO, Industry Canada; Statistics Canada.

Number of Exporters

By Size, Region of Destination, 1990



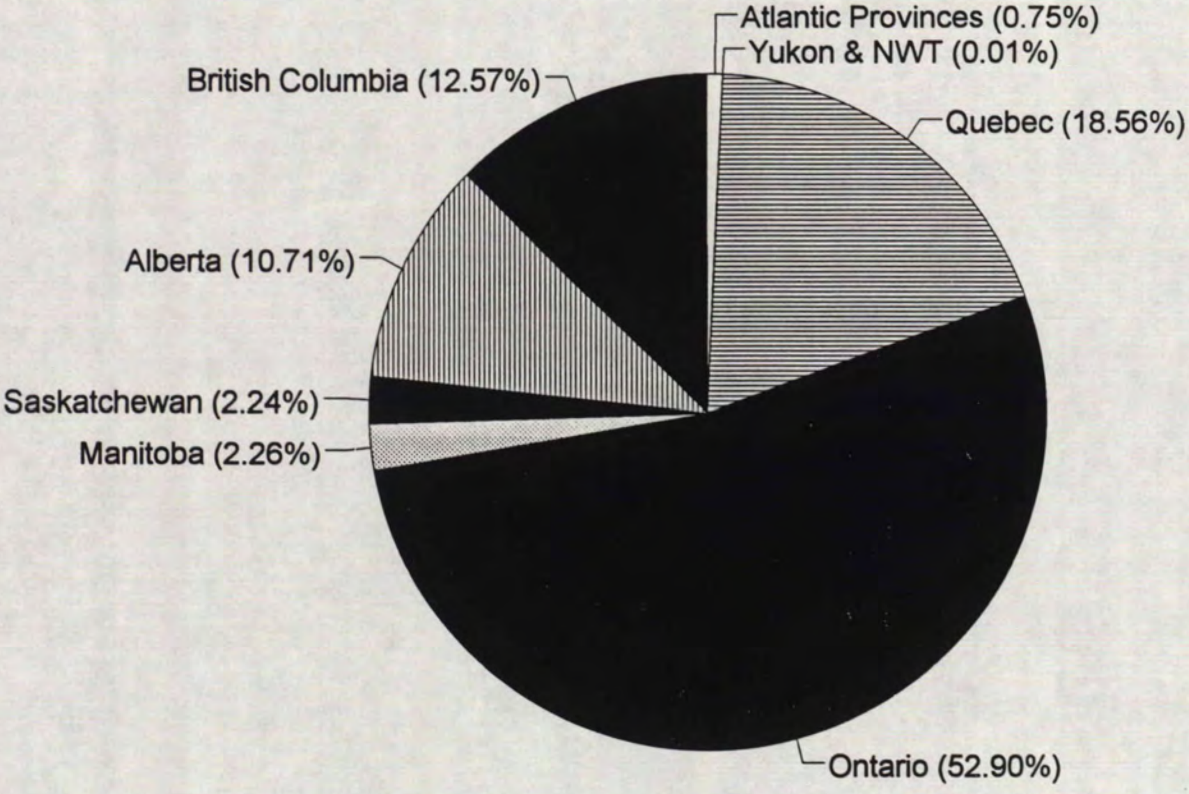
- Definitions: Small is exports less than $500,000; medium is exports between $500,000 and $5,000,000; and large is exports greater than $5,000,000.
- Source: ESBO, Industry Canada; Statistics Canada.



- Definitions: Small is exports less than $500,000; medium is exports between $500,000 and $5,000,000; and large is exports greater than $5,000,000.
- Source: ESBO, Industry Canada; Statistics Canada.

Percentage of Canadian Exports

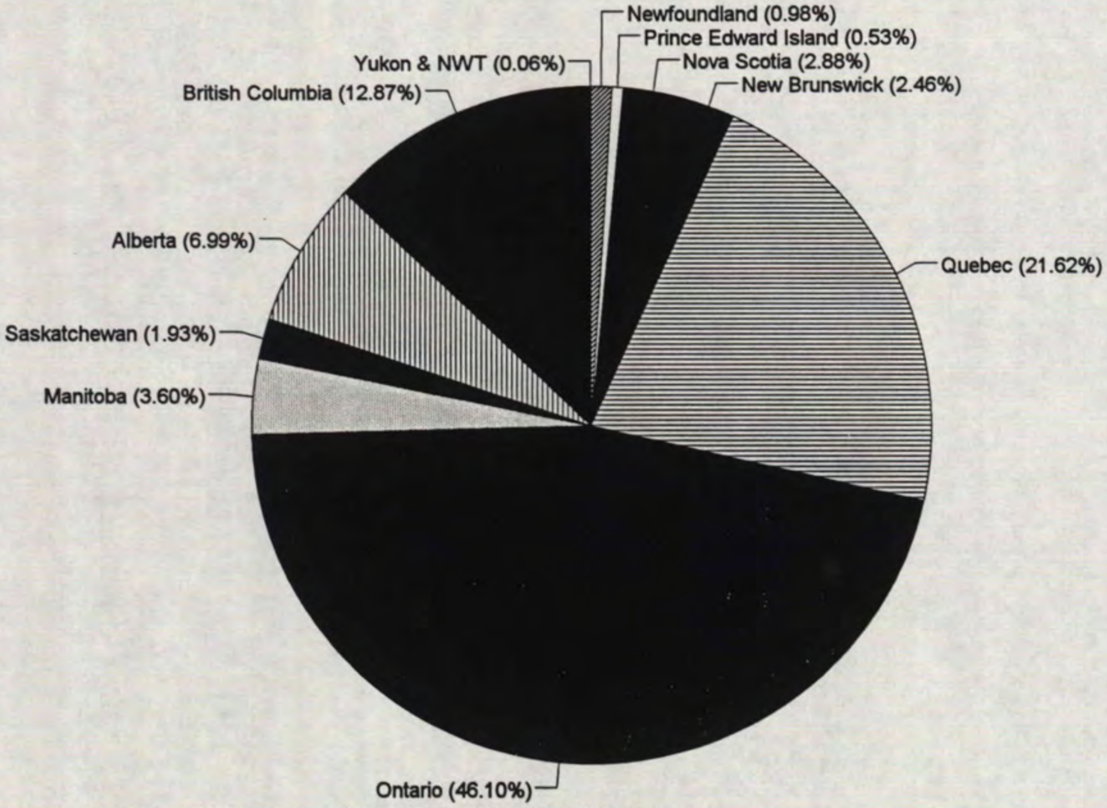
By Province, 1990



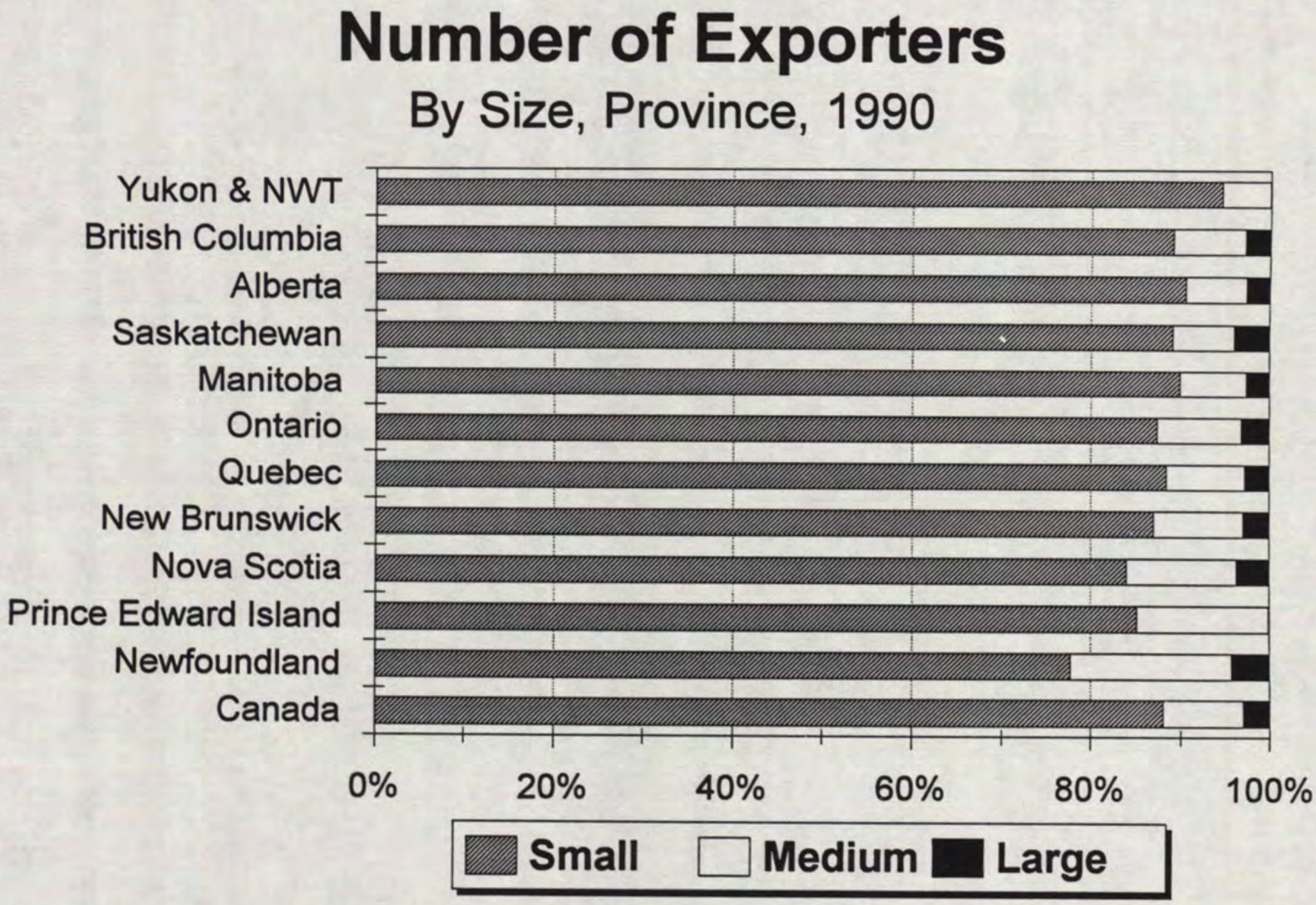
- The figures are based on total dollar value of exports by Canadian firms.
- Quebec and Ontario represent 2/3 of all Canadian exports.
- Source: ESBO, Industry Canada; Statistics Canada.

Percentage of Canadian SME Exports

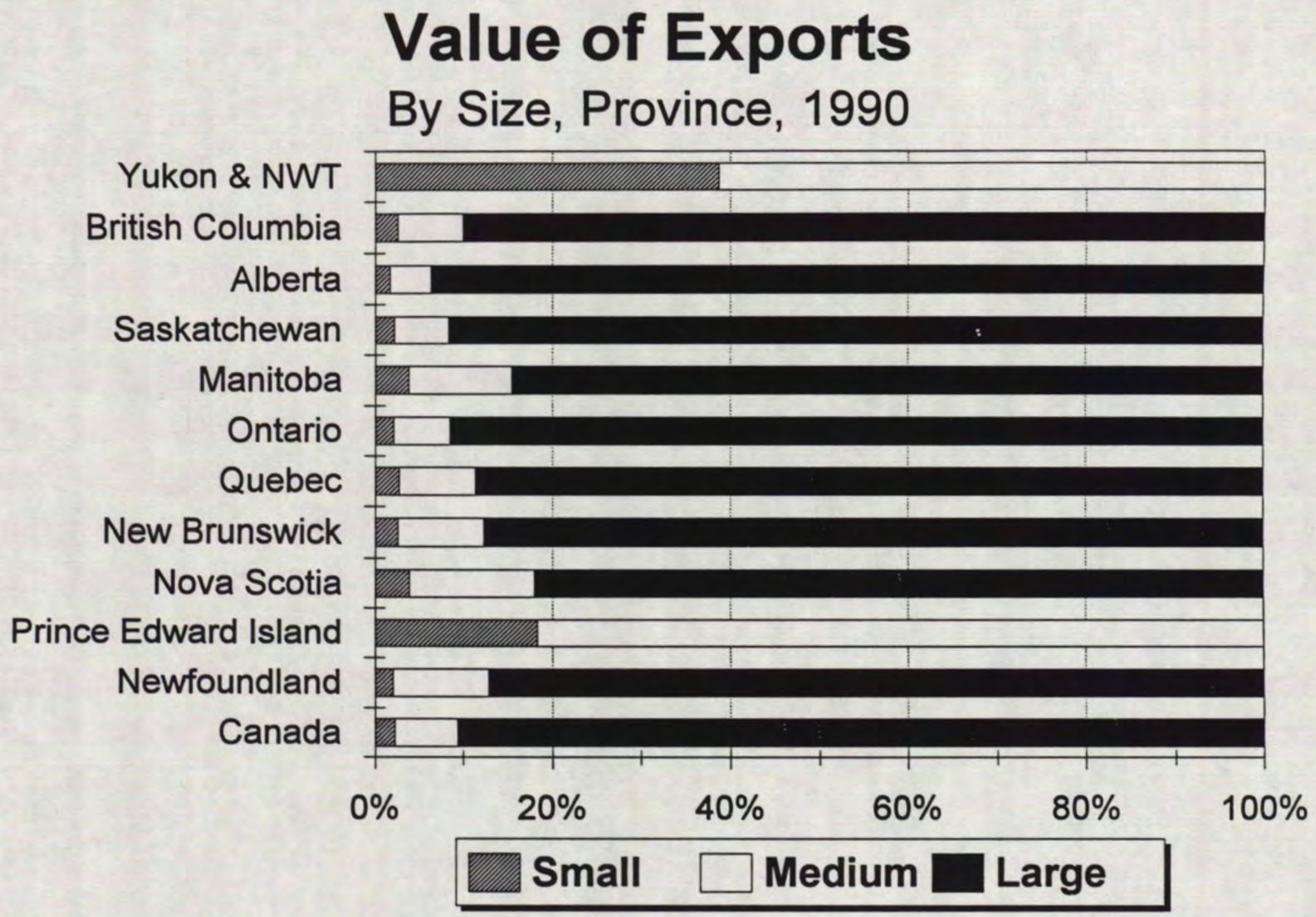
By Province, 1990



- SMEs are defined as companies which export goods worth less than $5,000,000.
- It is interesting to note that Quebec SMEs export a greater relative proportion than Quebec exporters as a whole.
- Quebec and Ontario account for 2/3 of all SME exports.
- Source: ESBO, Industry Canada; Statistics Canada.



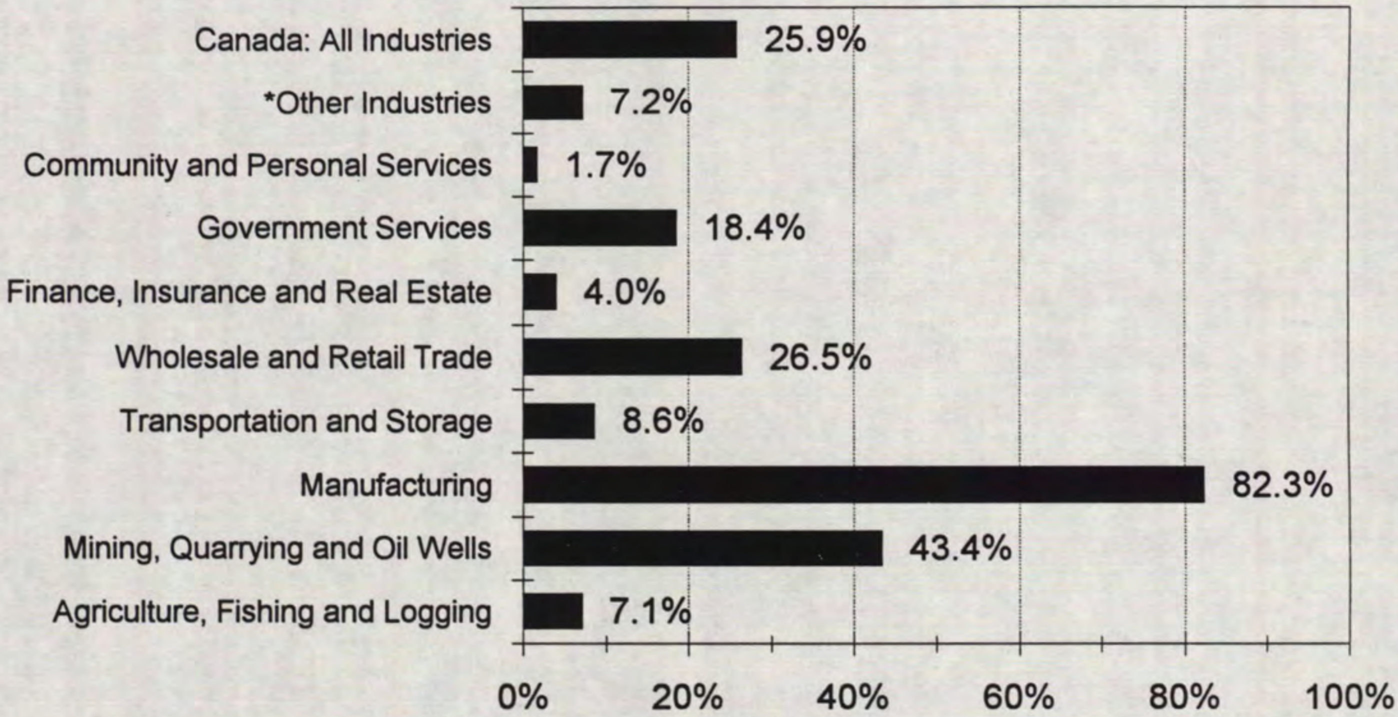
- Definitions: Small is exports less than $500,000; medium is exports between $500,000 and $5,000,000; and large is exports greater than $5,000,000.
- Source: ESBO, Industry Canada; Statistics Canada.



- Definitions: Small is exports less than $500,000; medium is exports between $500,000 and $5,000,000; and large is exports greater than $5,000,000.
- Source: ESBO, Industry Canada; Statistics Canada.

Exports as a Percentage of Industry Gross Revenues

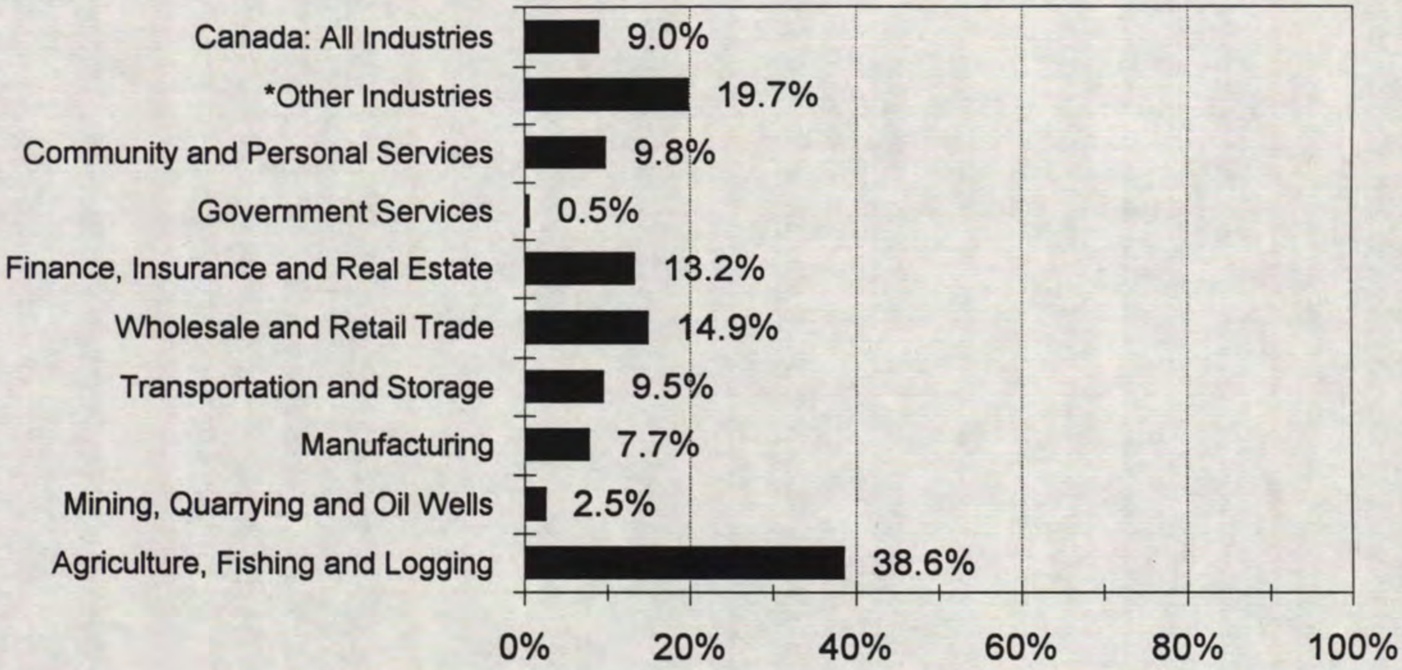
By Industry, 1990



- The majority of the manufacturing sector's exports are from the automotive industry.
- "Other Industries" includes: construction; communication and other utilities; and industries not elsewhere classified.
- Source: ESBO, Industry Canada; Statistics Canada.

SME Share of Exports

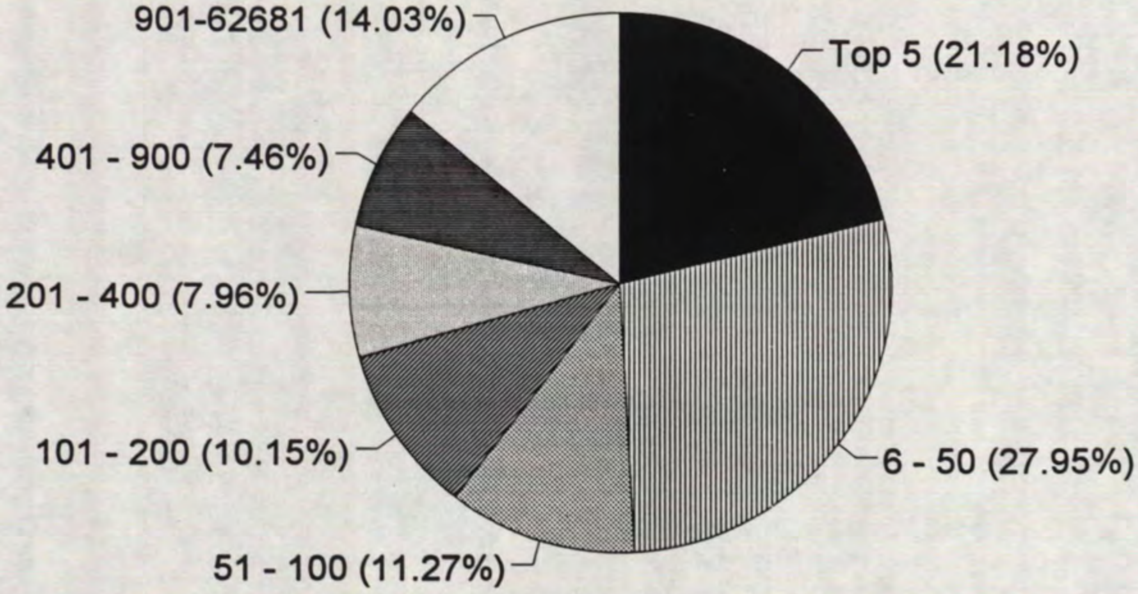
By Industry, 1990



- SMEs are defined as those companies which export goods worth less than $5,000,000.
- Canada exports over 25% of its GDP, yet SMEs only contribute 9% to total exports.
- SMEs do play a significant exporting role in agriculture, fishing and logging.
- While over 80% of manufacturing output is exported, only 7.7% of those exports originate from SMEs.
- Exports do not include "service exports".
- "Other Industries" includes: construction; communication and other utilities; and industries not elsewhere classified.
- Source: ESBO, Industry Canada; Statistics Canada.

Contribution to Exports

By Ranked Groups of Exporting Firms, 1990

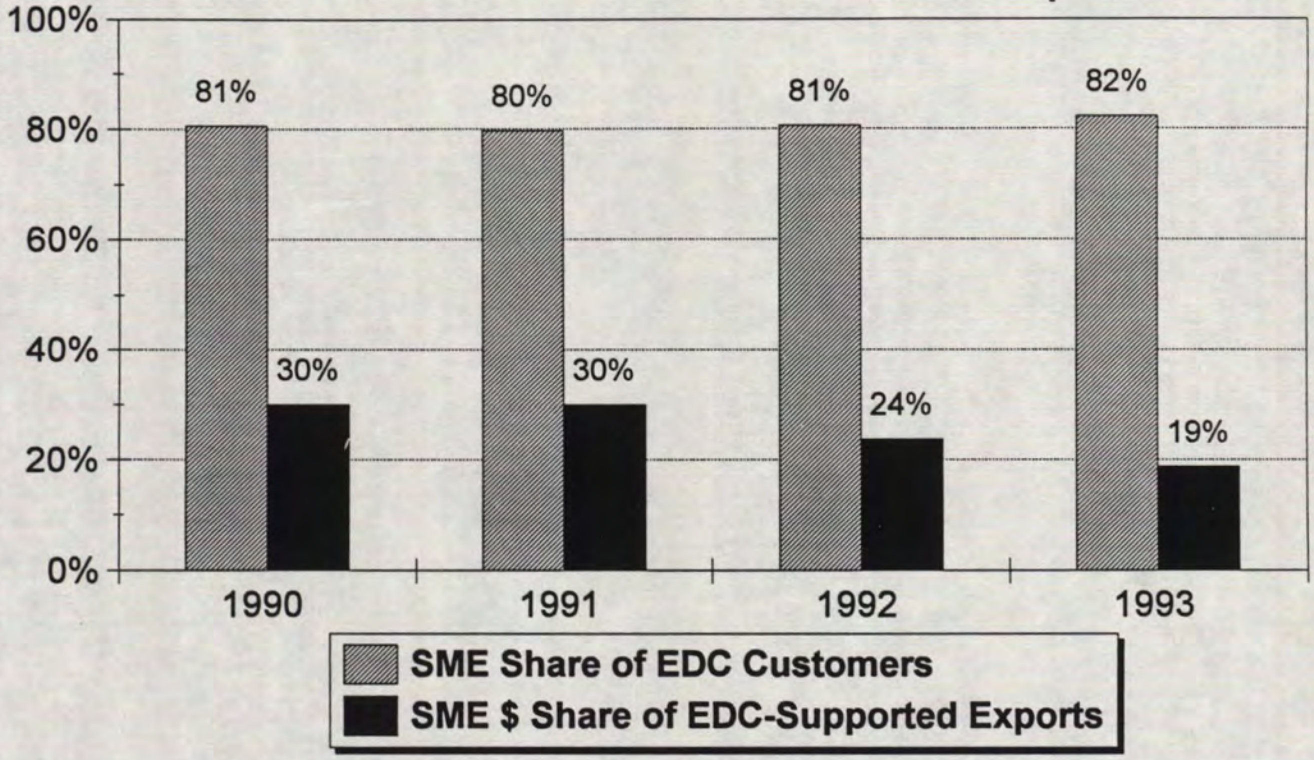


- Firms were ranked, and then grouped according to the value of their exports.
- Exports are dominated by a few firms.
- The top 100 firms account for over 60 % of all exports.
- The top 900 firms account for 85 % of all exports.
- The total number of exporting firms were 62,681.
- Source: ESBO, Industry Canada; Statistics Canada.

Chart 14

Export Development Corporation

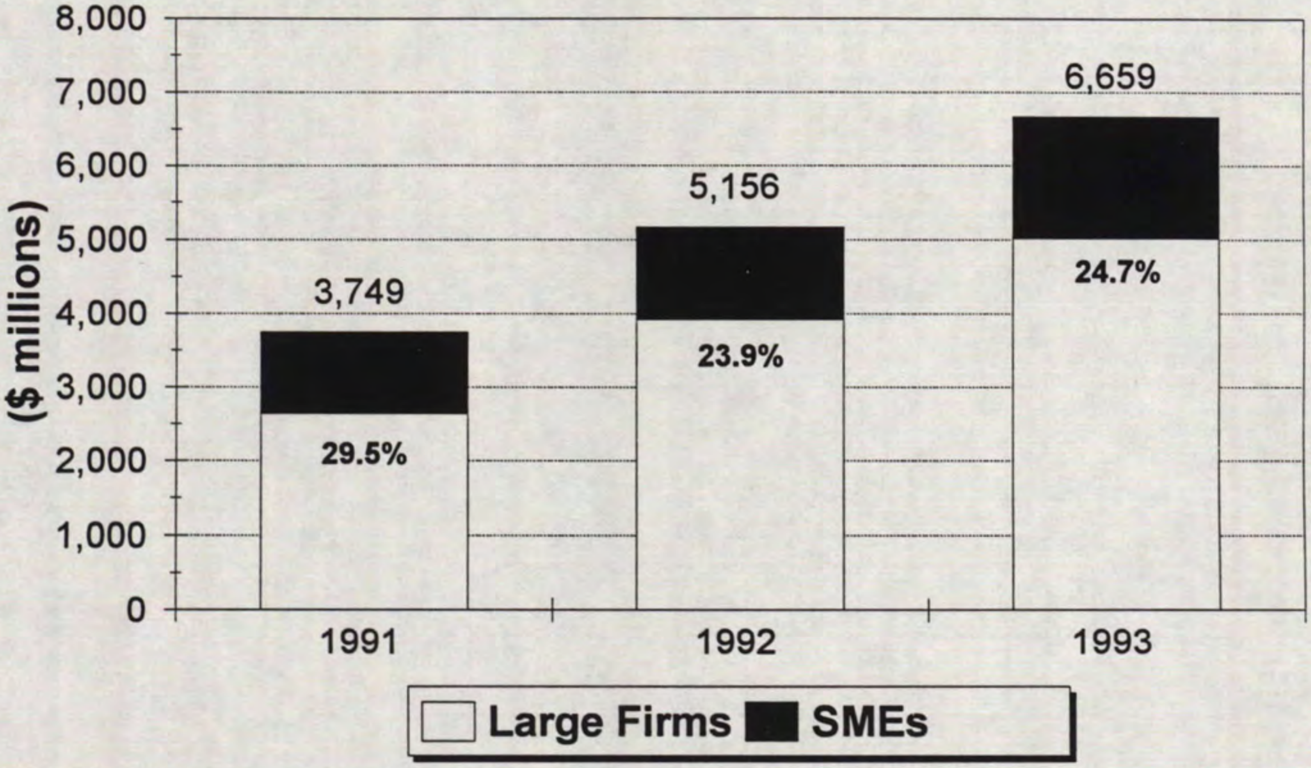
SME Share of Customers and Exports



- SMEs are defined as companies with sales of less than $25,000,000.
- While SMEs have remained a consistently large proportion of the EDC's clientele, the value of the exports that those SMEs represent has declined from 30 % to 19%. This is primarily due to growth in long-term export financing, where SMEs do not play a significant role.
- Source: ESBO, Industry Canada; Export Development Corporation.

Export Development Corporation

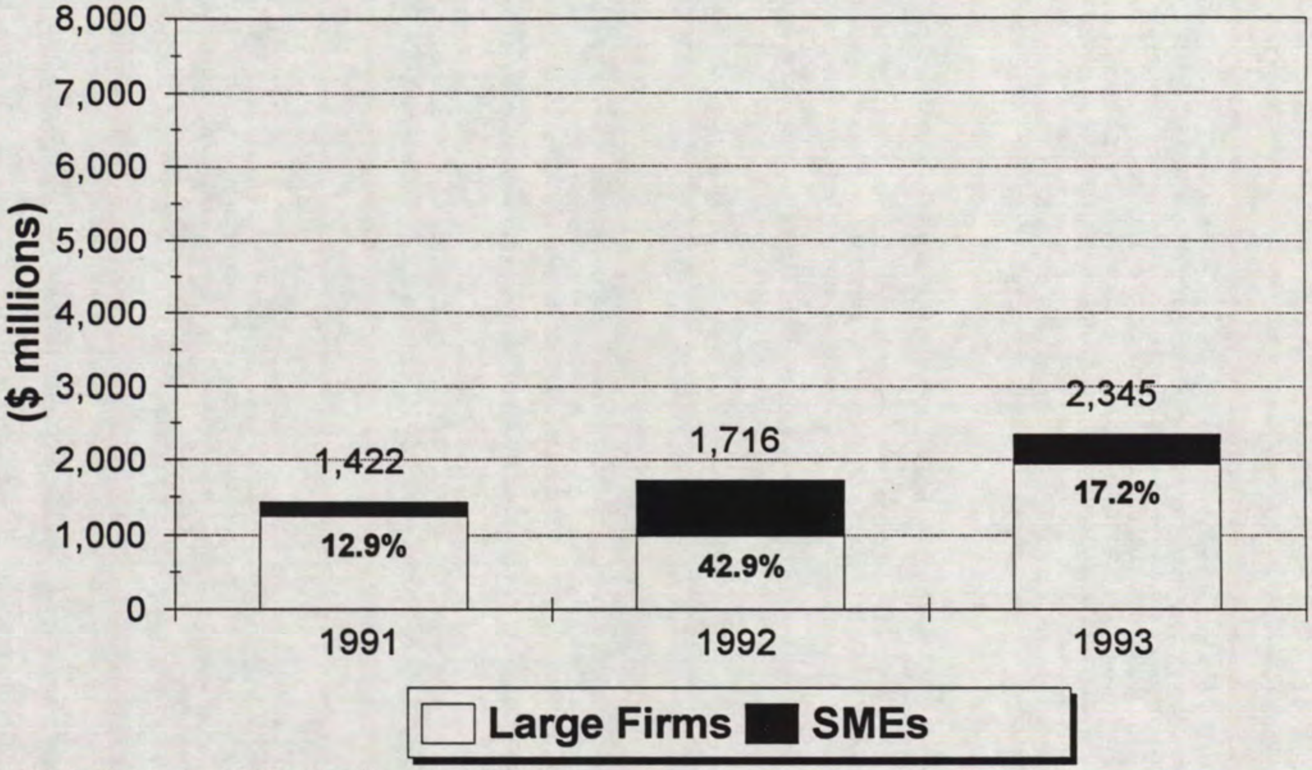
SME Share of Short Term Insurance



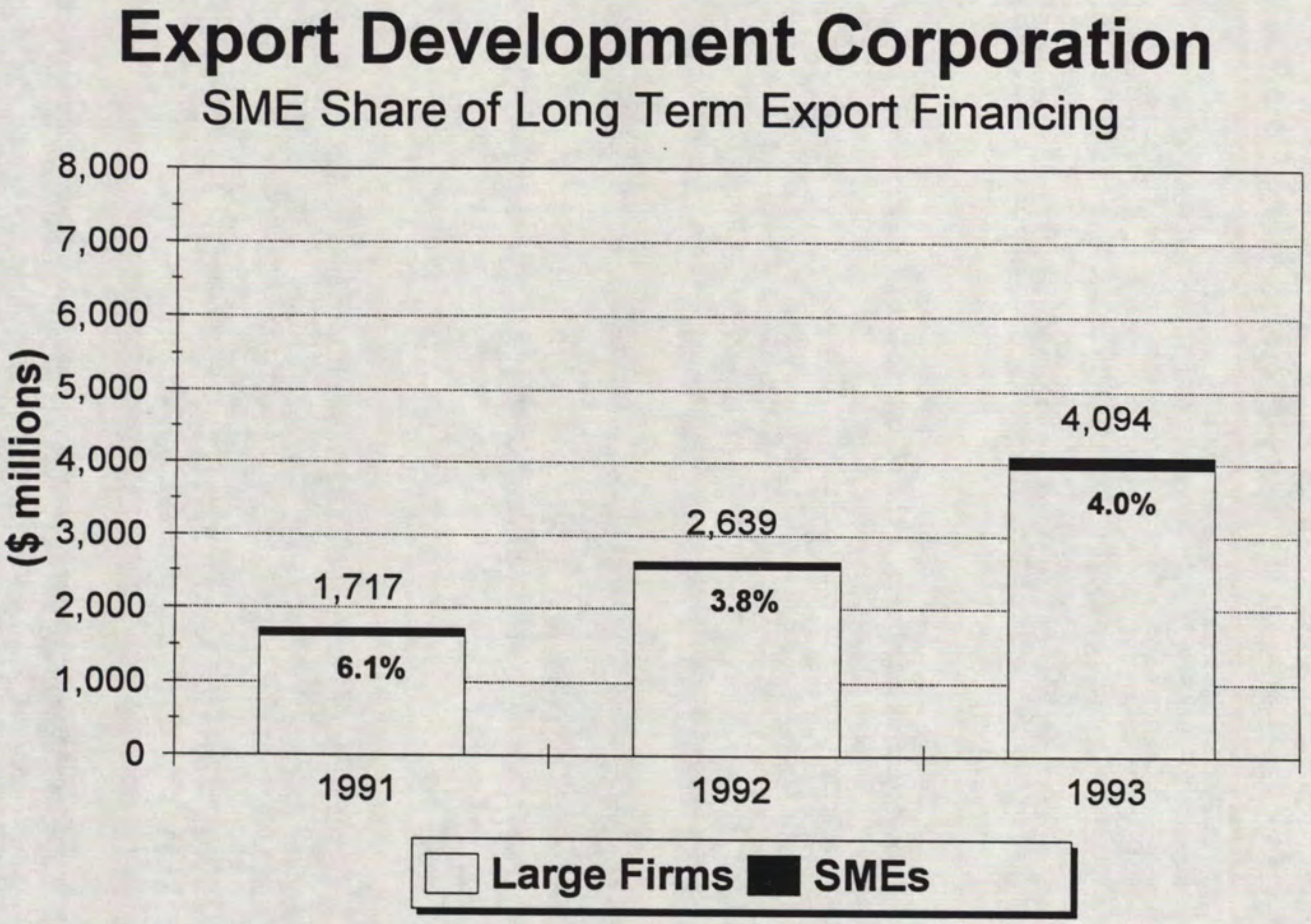
- SMEs are defined as companies with sales of less than $25,000,000.
- SMEs are receiving a growing amount of EDC short term insurance.
- Source: ESBO, Industry Canada; Export Development Corporation.

Export Development Corporation

SME Share of Medium Term Insurance



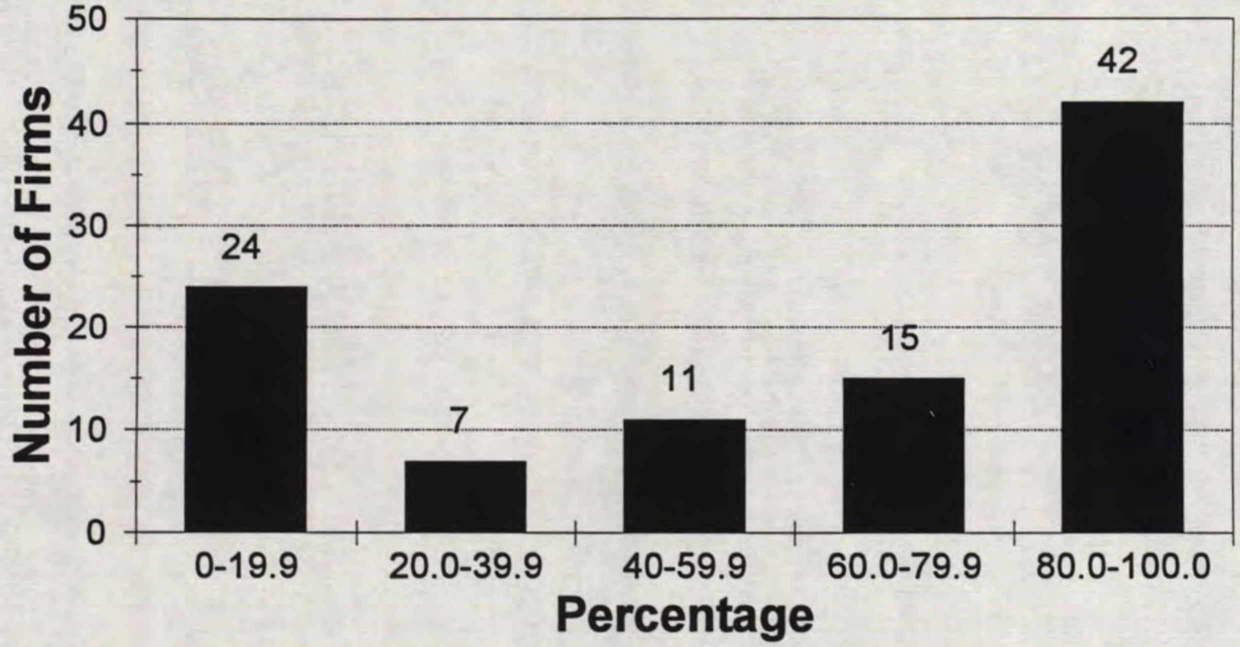
- SMEs are defined as companies with sales of less than $25,000,000.
- Note that medium term insurance includes foreign investment insurance, which is not particularly relevant to SMEs. If this component were excluded, SME share of medium term support would dramatically increase. For the years 1991 to 1993, foreign investment insurance represented 516, 558, and 860 million dollars respectively.
- Source: ESBO, Industry Canada; Export Development Corporation.



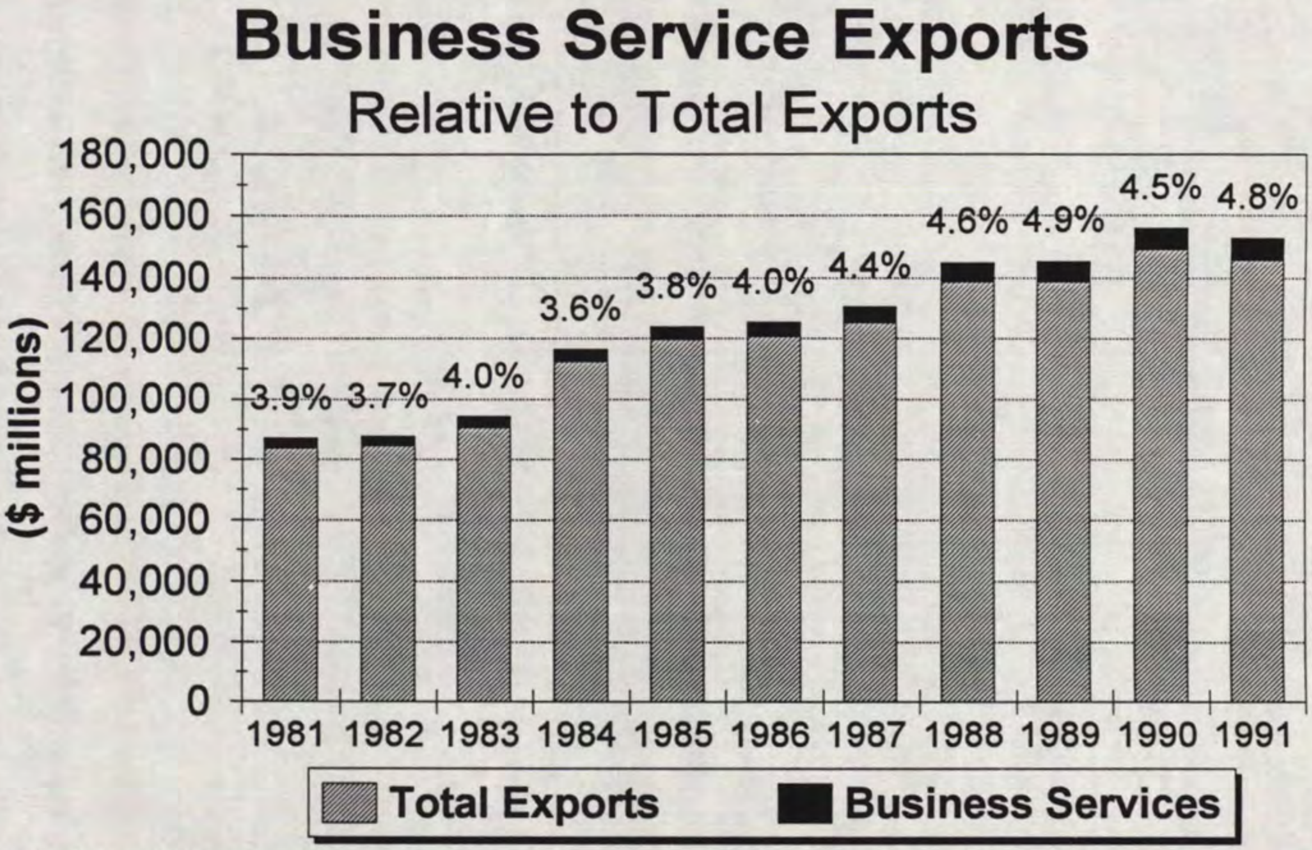
- SMEs are defined as companies with sales of less than $25,000,000.
- SMEs are receiving a relatively stable amount of EDC long term export financing.
- Source: ESBO, Industry Canada; Export Development Corporation.

Top 99 Canadian Software SMEs

Export Revenues as a Percentage of Total Revenues, 1993



- The top 100 independent firms were listed according to their 1993 revenues. Only the top firm in the industry had to be excluded, because it has more than 500 employees, and is thus not an SME. The next 99 firms are SMEs.
- Software products revenues includes licence fees, maintenance and support, but excludes revenues from systems integration and professional services activities and hardware sales. To be included in the list, the company must generate 50 percent or more of its revenue from software products and it must be based in Canada. Hence, hardware companies and foreign software multinationals are excluded.
- It is interesting to note the importance of exports and SMEs to this industry. As well, the ability of SMEs to capture significant revenues from exports. These facts are not common to most traditional Canadian industries.
- Source: ESBO, Industry Canada; Financial Post Magazine; The Branham Top 100 Independent Software Companies in Canada survey.



- Exports have been growing over the past decade, and business service exports have increased even quicker. They now represent nearly 5 percent of all exports.
- The table represents all size firms, not specifically small firms.
- Business Services are: consulting; management and administrative services; research and development; commisions; films and broadcasting; advertising and promotional services; computer services; franchises and similar rights; equipment rentals; communications; refining and processing services; and tooling and other automotive charges. Excluded were insurance and other financial services.
- Source: ESBO, Industry Canada; Statistics Canada.

COMPARATIVE TABLE: EXPORT WORKING CAPITAL (PRE-SHIPMENT) PROGRAMS FOR SMEs

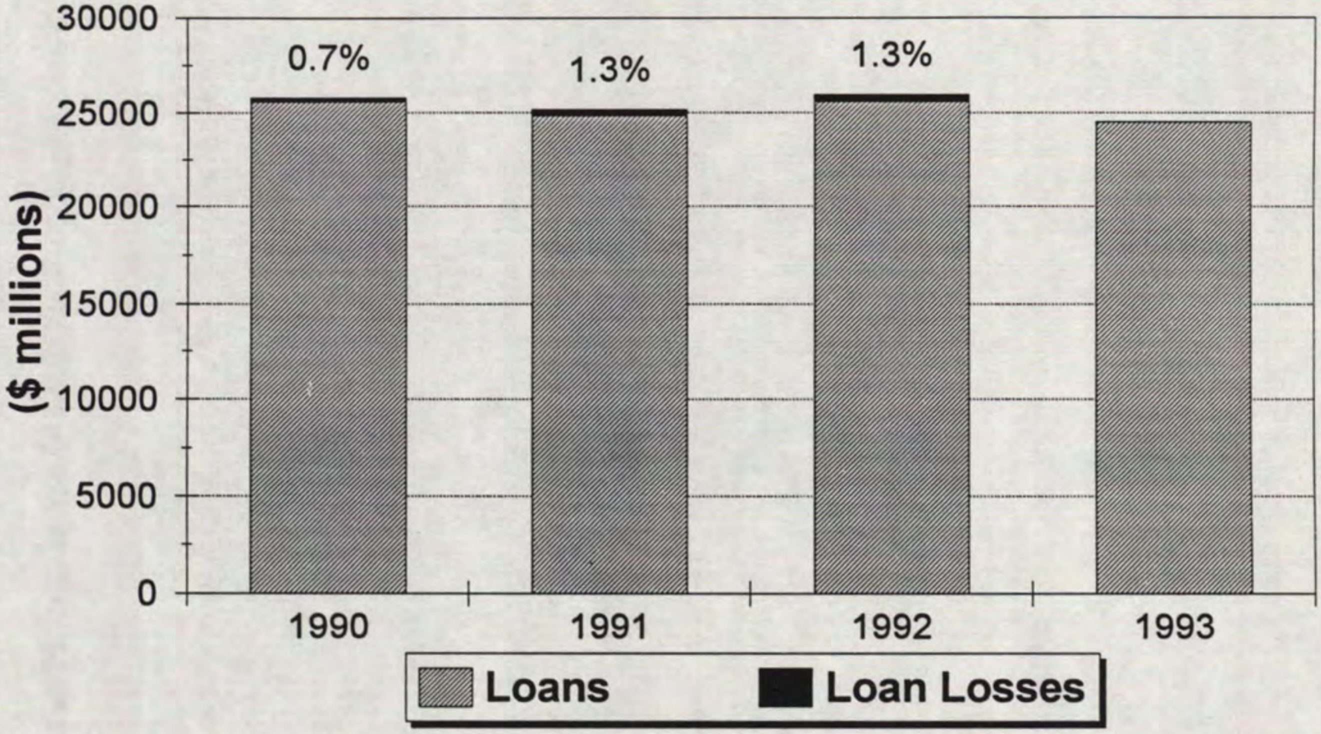
MODEL	FUNDED/ UNFUNDED	% GUARANTEE	MAXIMUM GUARANTEE	MAXIMUM TERM	AVAILABILITY	OTHER COMMENTS
Société de Développement du Québec (SDI)	Unfunded	80%	No limit.	1 year renewable	Through SDI only.	Covers lenders' line of credit. Only for Quebec exporters.
British Columbia Trade Development Corporation (BC Trade)	Unfunded	85%	$2.5 million (per borrower).	Up to 3 years	Throught the lender and BC Trade.	Cover lenders' line of credit. Only fo BC SMEs. All "exports" out of B.C.
Eximbank (USA)	Unfunded	100%	No limit.	180 days (extension possible).	Through Eximbank. Delegated authority for loans below US$750,000 to some banks	Lots of red tape. Very little usage. Available to any exporter operating over one year.
SBA (USA)	Unfunded	85%	US$750,000 (per transaction).	Up to 36 months	Through SBA and banks.	New program. covers lenders' line of credit. SME over 1 year old. Possibly to combine with State program (see below).
CEFO California Export Finance Office	Funded. US$6.8MM. Leverage 1 to 4.	90%	US$750,000 (per transaction) SBA + CEFO: US$1.5MM	Up to 18 months	Through CEFO and banks.	Relatively successful program. Low losses. Appreciated by banks. Only for California SMEs.
SOFARIS (France)	Funded. FRF 1.6 billion (50% by government and 50% by banks). Leverage 1 to 12	50%	FRF 5 million (C $1.3MM)	Up to 3 years	Through banks (delegated authority). Referral to SOFARIS for larger transaction.	Several types of guarantees available to banks. Special emphasis for young SMEs (less than 3 years old).

Other SME Statistics

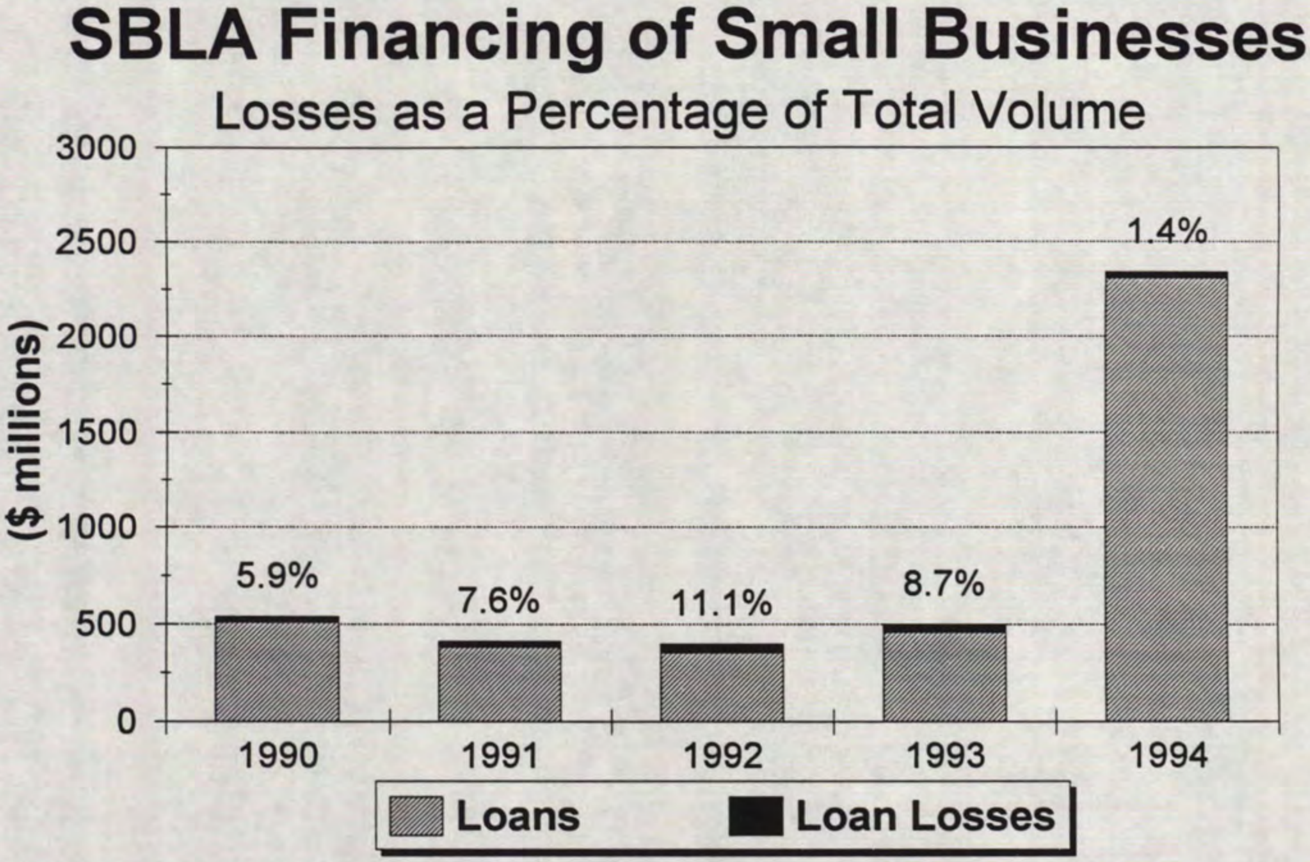
Chart 20

Chartered Bank Financing of Small Businesses

Losses as a Percentage of Total Volume

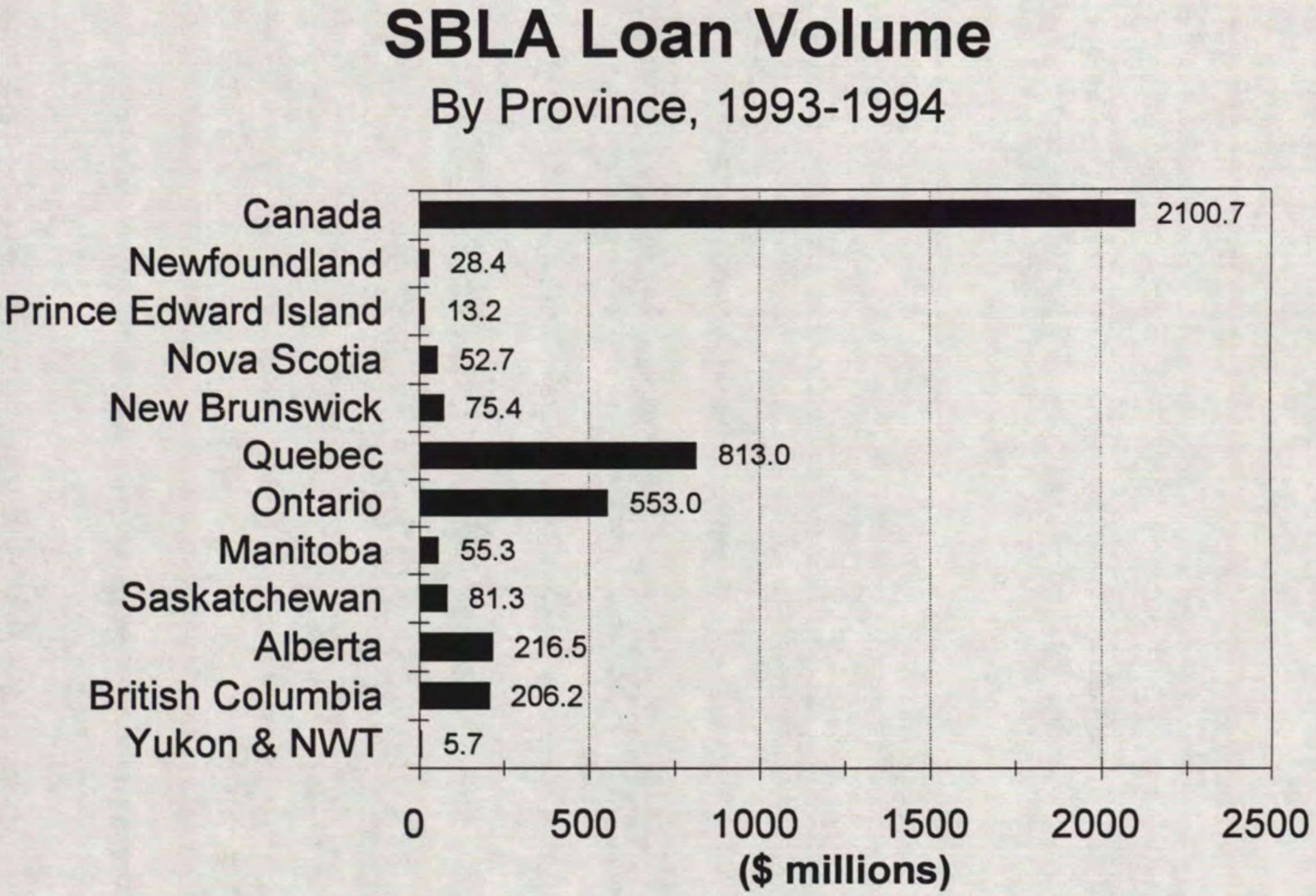


- Small businesses are defined as those receiving loans of less than $1,000,000.
- Loan losses for 1993 are not available as of April, 1994.
- Note that chartered bank statistics are as of October 31 each year.
- Source: ESBO, Industry Canada; Canadian Bankers Association; Bank of Canada Review.



- The SBLA program has suffered an increasing proportion of losses to total lending volume.
- As expected, the SBLA program has suffered significantly higher losses than were experienced by the chartered banks, until 1994.
- SBLA loans have represented between 2 and 10% of all loans to small businesses.
- The dramatic increase in SBLA loans in 1994 is primarily attributable to April 1, 1993 amendments which increased the number of firms eligible for the program, and greater promotion of the program by lenders.
- Note that SBLA statistics are as of March 31 each year.
- Source: ESBO, Small Business Loans Administration, Industry Canada.

Chart 22

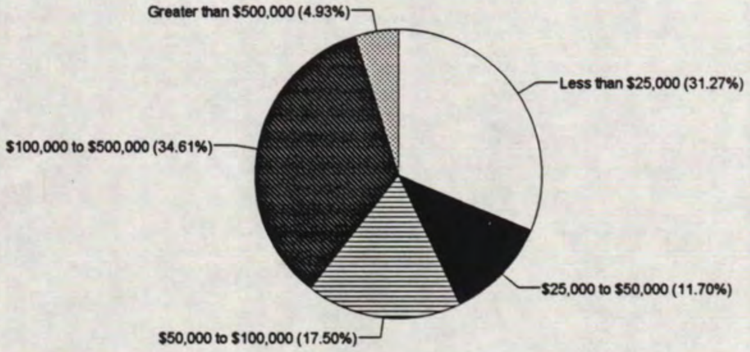


- SBLA loans are concentrated in central Canada.
- Source: ESBO, SBLA Databank, Industry Canada.

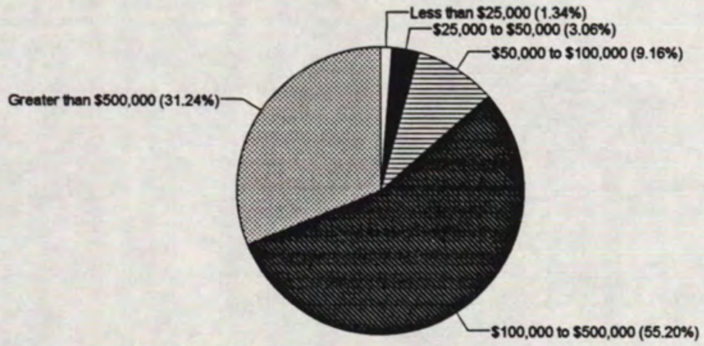
FBDB Loans and Guarantees

By Size, 1993

Number

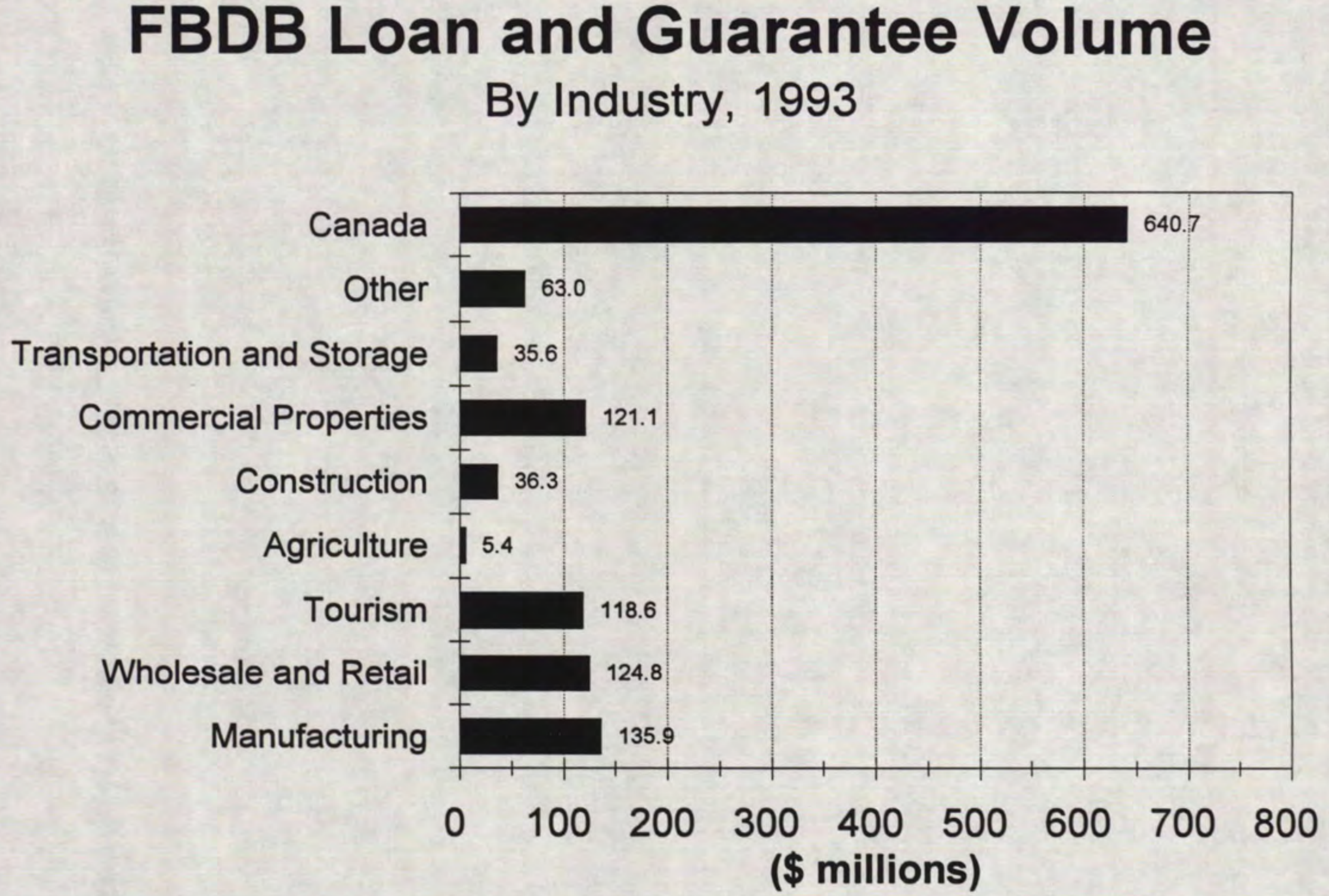


Value



● Source: ESBO, Industry Canada; FBDB.

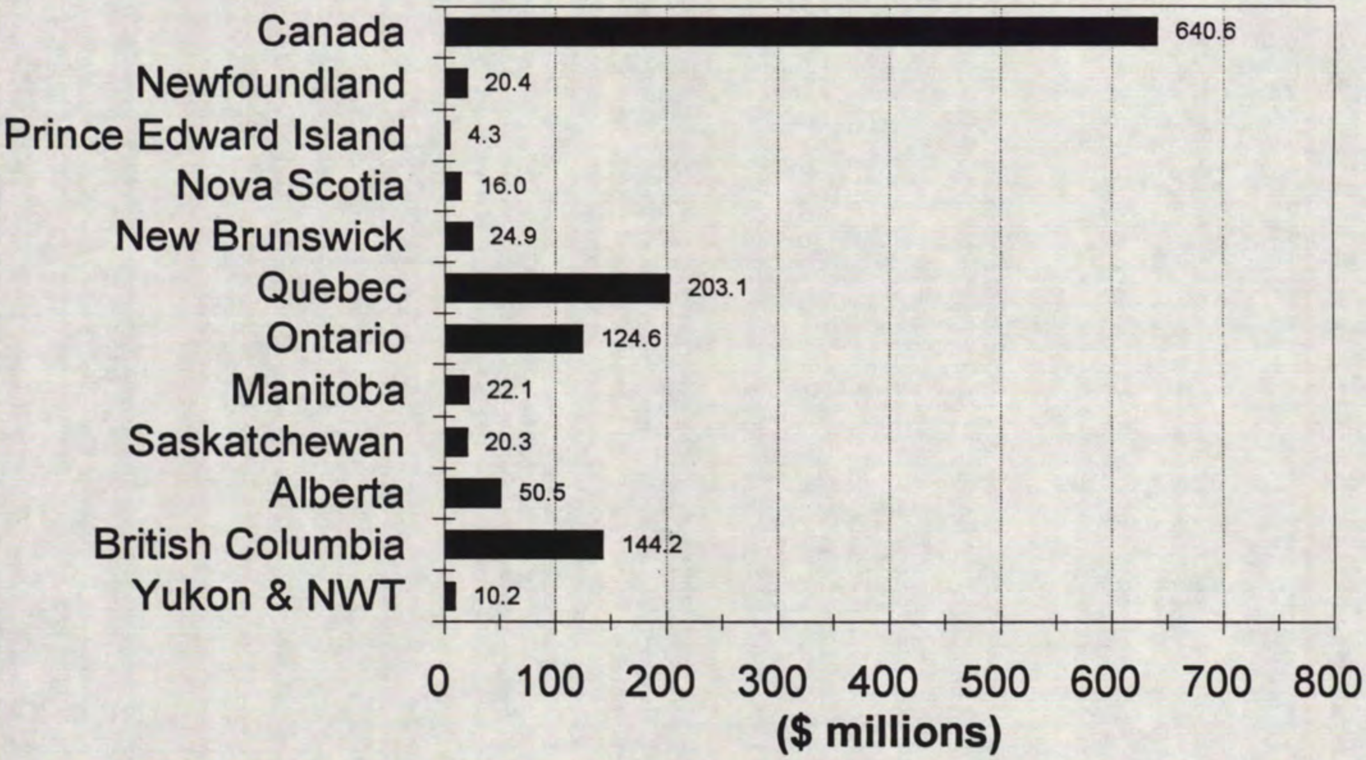
Chart 24



- FBDB loans are concentrated manufacturing, trade and tourism.
- Source: ESBO, Industry Canada; FBDB.

FBDB Loan and Guarantee Volume

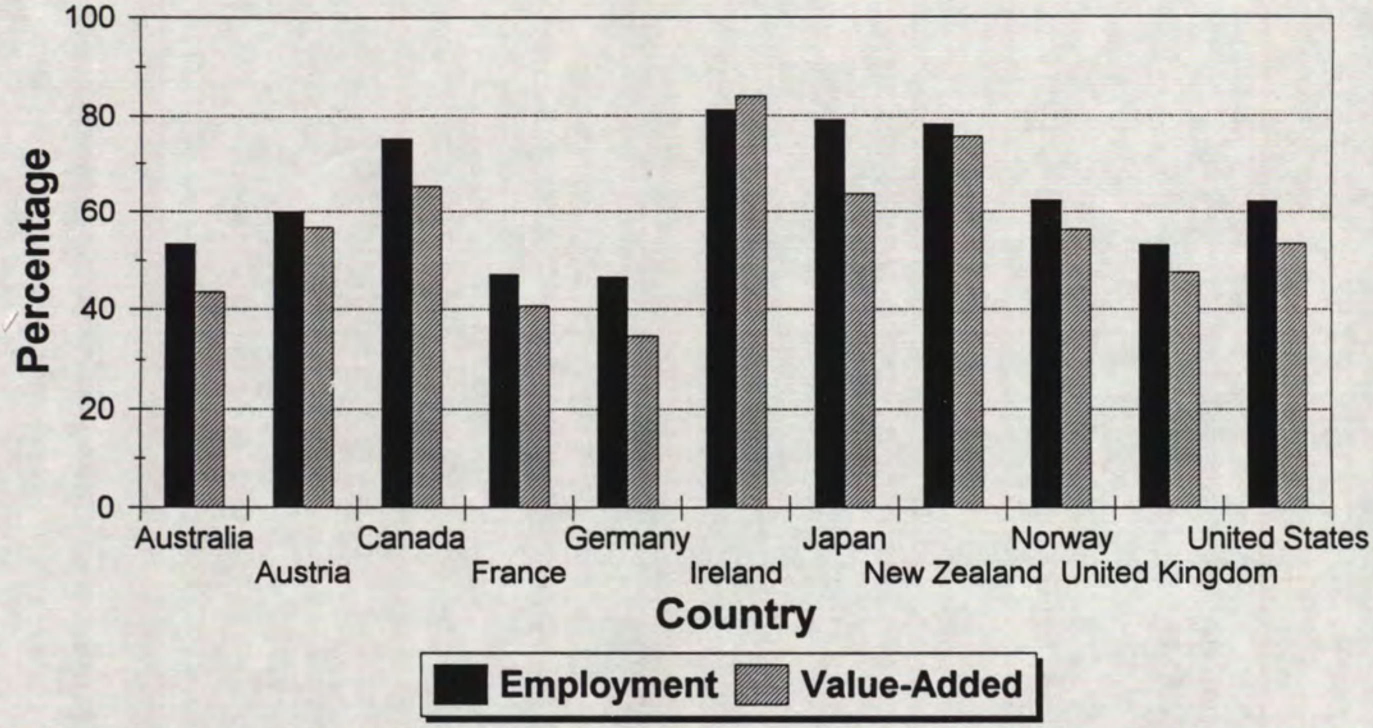
By Province, 1993



- FBDB loans are concentrated in central Canada and British Columbia.
- Source: ESBO, Industry Canada; FBDB.

SME Share of Employment & Value-Added

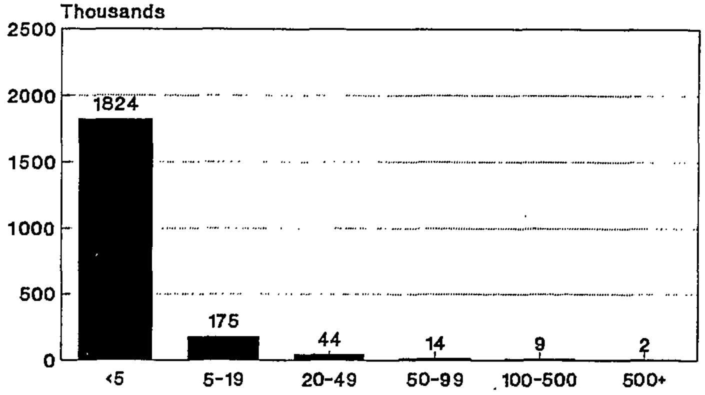
Manufacturing Sector, By Country, Various Periods: 1979-89



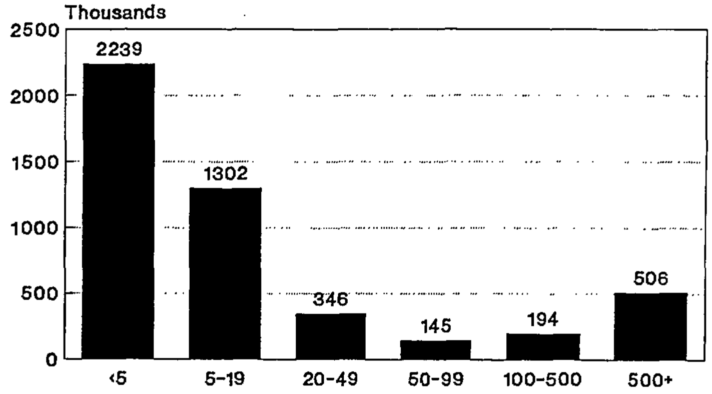
- Canadian SMEs had a greater share of employment in the manufacturing sector than the United States or Germany
- Canadian SMEs made a greater contribution to value-added in the manufacturing sector than the United States, Japan, or Germany.
- Note: Dependent upon the country, the years of analysis varied with the availability of data.
- Source: ESBO, Industry Canada; United Nations "Small and Medium-sized Transnational Corporations"

Firm Distribution by Number of Employees

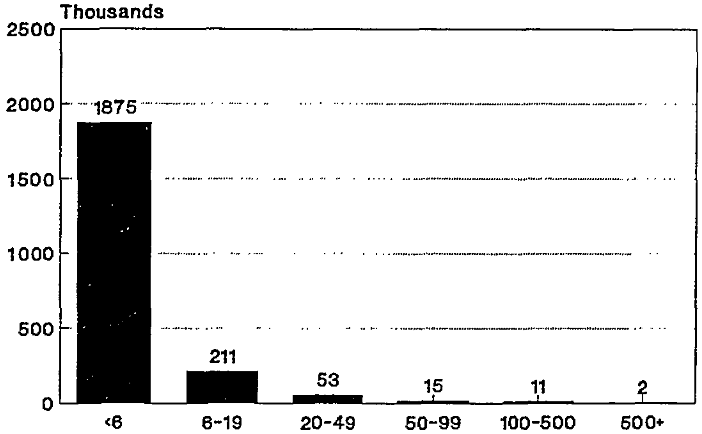
Canada (1991)



United States (1987)



France (1991)



United Kingdom (1992)

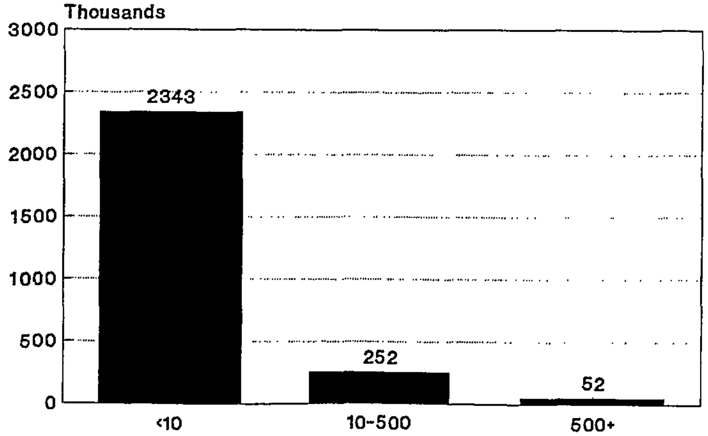


Chart 27

International Comparisons

- SMEs constitute the vast majority of firms in the nations analyzed.
- The United States is the only country analyzed with a significant proportion of medium and large firms.
- Note the similarity in the distribution of firms between Canada and France. In addition, the two nations have practically the same number of SMEs, despite the fact that France has double the population of Canada.
- Source: ESBO, Industry Canada; Canada, Statistics Canada; United States, "The State of Small Business: A Report to the President"; France, "La Strategie Des PME"; United Kingdom, "Federation of Small Businesses".

Exports by Region of Destination, by Size, 1990

Region	Size	Number of Exporters	Percentage of Exporters	SME Percentage of Exporters	Value of Exports	SME Value of Exports	Value of Exports	Percentage of Value of Exports	SME Percentage of Value of Exports
World	< $500,000	74,795	86.84	96.89	4,298,826,066	18,031,312,712	152,168,707,806	2.83	11.85
	$500,000 to 5,000,000	8,654	10.05		13,732,486,646			9.02	
	> $5,000,000	2,681	3.11		134,137,395,094			88.15	
Mexico	< $500,000	273	74.18	92.66	30,486,369	161,578,513	666,849,811	4.57	24.23
	$500,000 to 5,000,000	68	18.48		131,092,144			19.66	
	> $5,000,000	27	7.34		505,271,298			75.77	
United States	< $500,000	61,845	89.23	97.45	2,996,600,765	12,069,327,011	121,834,635,874	2.46	9.91
	$500,000 to 5,000,000	5,694	8.22		9,072,726,246			7.45	
	> $5,000,000	1,773	2.56		109,765,308,863			90.09	
Africa	< $500,000	172	85.15	100.00	18,346,050	65,293,412	65,293,412	28.10	100
	$500,000 to 5,000,000	30	14.85		46,947,362			71.90	
	> $5,000,000	0	0.00		0			0.00	
South America	< $500,000	2,302	84.20	97.26	202,966,558	741,890,866	2,113,247,100	9.60	35.1
	$500,000 to 5,000,000	357	13.06		538,924,308			25.50	
	> $5,000,000	75	2.74		1,371,356,234			64.89	
Eastern Europe	< $500,000	431	84.02	96.50	41,191,926	135,640,104	1,328,485,065	3.10	10.21
	$500,000 to 5,000,000	64	12.48		94,448,178			7.11	
	> $5,000,000	18	3.51		1,192,844,961			89.79	
Western Europe	< $500,000	4,619	76.02	93.99	470,151,002	2,141,688,212	10,845,385,692	4.34	19.75
	$500,000 to 5,000,000	1,092	17.97		1,671,537,210			15.41	
	> $5,000,000	365	6.01		8,703,697,480			80.25	
Asia Pacific Rim	< $500,000	3,359	71.33	92.25	377,211,987	1,971,548,907	13,477,129,387	2.80	14.63
	$500,000 to 5,000,000	985	20.92		1,594,336,920			11.83	
	> $5,000,000	365	7.75		11,505,580,480			85.37	
Asian Middle East	< $500,000	1,026	79.41	97.29	102,778,646	472,316,928	1,271,207,309	8.09	37.16
	$500,000 to 5,000,000	231	17.88		369,538,282			29.07	
	> $5,000,000	35	2.71		798,890,381			62.85	
All Others	< $500,000	768	83.12	97.51	59,092,763	337,322,171	631,767,568	10.43	48.02
	$500,000 to 5,000,000	133	14.39		212,935,996			37.59	
	> $5,000,000	23	2.49		294,445,397			51.98	

Exports by Province, by Size, 1990

Region	Size	Number of Exporters	Percentage of Exporters	Value of Exports	Percentage of Value of Exports	Value of Exports by Province	SME Value of Exports by Province
Canada	< $500,000	67003	88.09	3,425,682,961	2.25		
	$500,000 to 5,000,000	6786	8.92	10,827,699,866	7.12		
	> $5,000,000	2275	2.99	137,915,324,979	90.63		
Newfoundland	< $500,000	310	77.69	21,739,831	1.98	1,096,149,614	140,106,930
	$500,000 to 5,000,000	72	18.05	118,367,099	10.80		
	> $5,000,000	17	4.26	956,042,684	87.22		
Prince Edward Island	< $500,000	212	85.14	13,908,743	18.25	76,193,278	76,193,278
	$500,000 to 5,000,000	37	14.86	62,284,535	81.75		
	> $5,000,000	0	0.00	0	0.00		
Nova Scotia	< $500,000	1,411	83.94	89,178,018	3.91	2,281,504,621	410,175,348
	$500,000 to 5,000,000	207	12.31	320,997,330	14.07		
	> $5,000,000	63	3.75	1,871,329,273	82.02		
New Brunswick	< $500,000	1,428	86.91	71,973,005	2.53	2,850,114,964	350,133,918
	$500,000 to 5,000,000	166	10.10	278,160,913	9.76		
	> $5,000,000	49	2.98	2,499,981,046	87.72		
Quebec	< $500,000	14,283	88.35	726,152,231	2.67	27,221,105,282	3,080,938,605
	$500,000 to 5,000,000	1,434	8.87	2,354,786,374	8.65		
	> $5,000,000	449	2.78	24,140,166,677	88.68		
Ontario	< $500,000	29,428	87.37	1,573,847,300	2.03	77,599,320,446	6,570,293,546
	$500,000 to 5,000,000	3,189	9.47	4,996,446,246	6.44		
	> $5,000,000	1,066	3.16	71,029,026,900	91.53		
Manitoba	< $500,000	2,830	89.90	125,732,682	3.79	3,313,437,202	512,552,343
	$500,000 to 5,000,000	236	7.50	386,819,661	11.67		
	> $5,000,000	82	2.60	2,800,884,859	84.53		
Saskatchewan	< $500,000	1,628	89.06	71,075,937	2.16	3,291,476,381	274,621,048
	$500,000 to 5,000,000	126	6.89	203,545,111	6.18		
	> $5,000,000	74	4.05	3,016,855,333	91.66		
Alberta	< $500,000	5,947	90.53	259,160,921	1.65	15,712,471,518	996,306,966
	$500,000 to 5,000,000	457	6.96	737,146,045	4.69		
	> $5,000,000	165	2.51	14,716,164,552	93.66		
British Columbia	< $500,000	9,441	89.07	469,795,323	2.55	18,437,524,597	1,833,996,193
	$500,000 to 5,000,000	857	8.09	1,364,200,870	7.40		
	> $5,000,000	301	2.84	16,603,528,404	90.05		
Yukon & NWT	< $500,000	85	94.44	3,118,970	38.67	8,064,652	8,064,652
	$500,000 to 5,000,000	5	5.56	4,945,682	61.33		
	> $5,000,000	0	0	0	0		

Exports by Industry, 1990

Industry	Total $ Value of Exports	SME $ Value of Exports	GDP (At Factor Cost)	Exports as a % of GDP	SME Share of Exports
Agriculture, Fishing and Logging	1,147,918,756	443,229,082	16,091,900,000	7.13%	38.61%
Mining, Quarrying and Oil Wells	9,311,093,718	230,546,663	21,476,100,000	43.36%	2.48%
Manufacturing	87,553,245,299	6,755,036,444	106,320,400,000	82.35%	7.72%
Transportation and Storage	2,018,992,495	191,392,168	23,348,600,000	8.65%	9.48%
Wholesale and Retail Trade	18,082,438,445	2,692,315,293	68,227,400,000	26.50%	14.89%
Finance, Insurance and Real Estate	3,782,558,446	500,743,412	94,590,500,000	4.00%	13.24%
Government Services	7,392,076,926	36,755,739	40,080,000,000	18.44%	0.50%
Community and Personal Services	1,135,906,379	111,566,799	65,909,000,000	1.72%	9.82%
*Other Industries	6,789,141,635	1,340,762,157	94,584,800,000	7.18%	19.75%
Canada: All Industries	137,213,372,099	12,302,347,757	530,628,700,000	25.86%	8.97%

Contribution to Exports: Exporter Concentration, 1990

Rank	Number of Exporters	% of Number of Exporters	Value of Exports ($ millions)	% of Value of Exports
Top 5	5	0.01%	29065.5	21.18%
6 - 50	45	0.07%	38348.2	27.95%
51 - 100	50	0.08%	15463.9	11.27%
101 - 200	100	0.16%	13924.4	10.15%
201 - 400	200	0.32%	10921.2	7.96%
401 - 900	500	0.81%	10236.4	7.46%
901-62681	61,781	98.56%	19,253.7	14.03%
Total	62,681	100.00%	137,213.3	100.00%

Export Development Corporation: Support to Exporters

	Number of Customers All Firms	SMEs	SME Share	Value of Exports ($ billions) All Firms	SMEs	SME Share
1993	2,057	1,693	82.30%	11.8	2.21	18.73%
1992	1,928	1,554	80.60%	8.7	2.07	23.79%
1991	1,905	1,518	79.69%	6.5	1.95	30.00%
1990	1,663	1,340	80.58%	6.1	1.83	30.00%

	Customer Support Number of Customers *Short Term Insurance	Medium Term Insurance	Export Finance	Value of Support to all Firms ($ millions) Short Term Insurance	Medium Term Insurance	Export Finance	Value of Support to SMEs ($ millions) Short Term Insurance	Medium Term Insurance	Export Finance
1993	1,543	96	54	6659.3	2,344.8	4,094.1	1,643.0	403.0	161.8
1992	1,382	138	36	5,156.0	1,715.9	2,638.7	1,234.2	735.3	101.2
1991	1,354	134	38	3,748.6	1,422.1	1,717.0	1,106.5	183.9	104.0
1990	1,223	89	26	n/a	n/a	n/a	n/a	n/a	n/a

Canadian Software SME Exports, 1993

Percentage of Revenues from Exports	Number of Firms In Each Catagory
0-19.9	24
20.0-39.9	7
40-59.9	11
60.0-79.9	15
80.0-100.0	42

Business Service Exports: 1981-1991			
Year	Receipts ($ millions)	Total Exports ($ millions)	Business Service Sha of Total Exports
1981	3257	83811	3.89%
1982	3131	84530	3.70%
1983	3611	90613	3.99%
1984	4085	112384	3.63%
1985	4530	119475	3.79%
1986	4804	120670	3.98%
1987	5449	125087	4.36%
1988	6378	138498	4.61%
1989	6747	138701	4.86%
1990	6719	148979	4.51%
1991	7057	145660	4.84%

SBLA and Chartered Bank SME Financing						
Year	SBLA Loans ($ millions)	Loan Losses ($ millions)	Losses as a % of Portfolio	Small Business Loans For Six Largest Banks ($ millions)	Loan Losses ($ millions)	Losses as a % of Portfolio
1990	539.79	31.59	5.85%	25,778	180.45	0.70%
1991	412.81	31.50	7.63%	25,146	326.90	1.30%
1992	397.44	44.27	11.14%	25,928	337.06	1.30%
1993	500.55	43.46	8.68%	24,541	n/a	n/a
1994	2343	32.85	1.40%	n/a	n/a	n/a

International Comparison of SME Share of Employment and Value-Added, Various Years		
Country	% of Employment	% of Value-Added
Australia	53	43
Austria	60	57
Canada	75	65
France	47	41
Germany	47	35
Ireland	81	84
Japan	79	64
New Zealand	78	76
Norway	62	56
United Kingdom	53	48
United States	62	54

International Comparison of Firm Size Distribution											
	Canada (1992)		United States (1987)			France (1991)			United Kingdom (1992)	
Firm Size	Number	%	Number	%	Firm Size	Number	%	Firm Size	Number	%
<5	1,824,447	88.21%	2,239,432	47.33%	<6	1,875,200	86.54%	<10	2,342,600	90.10%
5-19	174,966	8.46%	1,301,516	27.51%	6-19	210,800	9.73%	10-500	252,200	9.70%
20-49	43,588	2.11%	345,658	7.31%	20-49	53,100	2.45%	500+	5,200	0.20%
50-99	13,897	0.67%	145,297	3.07%	50-99	15,000	0.69%	Total	2,600,000	100.00%
100-499	9,334	0.45%	194,219	4.10%	100-499	10,800	0.50%			
500+	2,020	0.10%	505,572	10.68%	500+	2,000	0.09%			
Total	2,068,252	100.00%	4,731,694	100.00%	Total	2,166,900	100.00%			

Exports by Country of Destination, 1992

Region	Exports ($ thousands)	Percentage
Atlantic Provinces	**6,756,947**	**100.0%**
United States	4,230,483	62.6%
United Kingdom	383,295	5.7%
Japan	353,899	5.2%
Germany	234,648	3.5%
France	125,650	1.9%
Other	1,428,972	21.1%
Quebec	**25,671,644**	**100.0%**
United States	19,327,780	75.3%
United Kingdom	755,228	2.9%
France	724,158	2.8%
Germany	537,416	2.1%
China	514,451	2.0%
Other	3,812,611	14.9%
Ontario	**77,370,028**	**100.0%**
United States	68,424,244	88.4%
Japan	1,136,184	1.5%
Mexico	818,994	1.1%
Germany	703,438	0.9%
United Kingdom	600,808	0.8%
Other	5,686,360	7.3%
Prairies	**27,785,108**	**100.0%**
United States	18,696,897	67.3%
Japan	1,929,887	6.9%
China	1,527,347	5.5%
USSR (former)	1,135,561	4.1%
South Korea	290,072	1.0%
Other	4,205,344	15.1%
British Columbia and Territories	**16,718,596**	**100.0%**
United States	7,993,249	47.8%
Japan	4,189,110	25.1%
United Kingdom	542,539	3.2%
South Korea	561,429	3.4%
Germany	513,087	3.1%
Other	2,919,182	17.5%

Exports By Commodity, 1992

Region	Exports ($ thousands)	Percentage
Atlantic	**6,756,947**	**100.0%**
Fish	1,361,195	20.1%
Mineral fuels and oils	1,239,140	18.3%
Paper products	1,360,193	20.1%
Woodpulp	698,941	10.3%
Other	2,097,478	31.0%
Quebec	**25,671,644**	**100.0%**
Paper products	3,771,598	14.7%
Elect. mach. & equip.	3,513,221	13.7%
Aluminium	2,459,891	9.6%
Machinery	2,027,827	7.9%
Other	13,899,107	54.1%
Ontario	**77,370,028**	**100.0%**
Motor vehicles & parts	34,337,352	44.4%
Machinery	8,635,364	11.2%
Elect. mach. & equip.	3,455,740	4.5%
Precious metals	2,627,641	3.4%
Other	28,313,931	36.6%
Prairies	**27,785,108**	**100.0%**
Mineral fuels & oils	12,443,884	44.8%
Cereals	5,034,024	18.1%
Fertilisers	1,046,593	3.8%
Organic chemicals	642,434	2.3%
Other	8,618,173	31.0%
British Columbia and Territories	**16,718,596**	**100.0%**
Wood products	5,634,876	33.7%
Woodpulp	2,413,575	14.4%
Mineral fuels and oils	1,820,790	10.9%
Paper products	1,490,765	8.9%
Other	5,358,590	32.1%

SBLA Loans, by Industry, by Province, 1988

	Canada	Newfoundlan	Prince Edward Islan	Nova Scotia	New Brunswic	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia
Fishing & Trapping	14	0	7	2	1	0	0	0	0	0	4
Manufacturing	607	4	5	4	13	215	215	16	19	50	61
Construction	535	9	7	17	20	171	159	10	16	59	52
Transportation & Storage	380	8	2	23	15	101	78	14	17	68	47
Communication & Other Utilities	21	0	0	0	0	10	2	1	1	2	5
Wholesale Trade	312	5	6	7	3	107	81	9	19	30	41
Retail Trade	1020	26	5	17	16	387	272	35	62	91	91
Finance & Insurance	8	0	0	0	0	0	2	1	0	0	3
Real Estate & Insurance Agents	66	1	1	2	0	15	18	1	4	11	10
Business Services	237	3	2	3	3	70	88	2	5	32	24
Education Services	16	1	0	0	1	5	2	0	1	3	3
Accomodation, Food & Beverage Services	601	9	2	12	8	195	197	18	13	61	72
Other Services	431	4	6	6	10	146	107	15	21	46	54
Total	**4248**	**70**	**43**	**93**	**90**	**1422**	**1221**	**122**	**178**	**453**	**467**

FBDB Loans and Guarantees, By Province, 1993

Province	Number	Value ($ millions)
Yukon & NWT	65	10.2
British Columbia	827	144.2
Alberta	476	50.5
Saskatchewan	348	20.3
Manitoba	238	22.1
Ontario	628	124.6
Quebec	1208	203.1
New Brunswick	167	24.9
Nova Scotia	110	16.0
Prince Edward Island	12	4.3
Newfoundland	162	20.4
Canada	**4241**	**640.6**

FBDB Loans and Guarantees, By Industry, 1993

Industry	Number	Value ($ millions)
Manufacturing	838	135.9
Wholesale and Retail	854	124.8
Tourism	606	118.6
Agriculture	248	5.4
Construction	379	36.3
Commercial Properties	512	121.1
Transportation and Storage	137	35.6
Other	667	63.0
Canada	**4241**	**640.7**

FBDB Loans and Guarantees, By Size, 1993

Size of Loan or Guarantee	Number	Value ($ millions)
Less than $25,000	1326	8.6
$25,000 to $50,000	496	19.6
$50,000 to $100,000	742	58.7
$100,000 to $500,000	1468	353.6
Greater than $500,000	209	200.1
Canada	**4241**	**640.6**