SME RESEARCH REPORT

Rating SMEs and MidCaps

Characteristics of SMEs and MidCaps in Germany and specific considerations in the assessment of credit risk

15 November 2017

Summary

- Amid ongoing uncertainty affecting the banking sector and structurally driven shifts in financing decisions, SMEs and MidCaps have shown growing interest in capital market financing. Policy makers and regulators have also been pushing for SMEs to depend less on banks for financing.
- As SMEs tap capital markets for more of their funding needs, they will find it increasingly necessary to document their creditworthiness through external ratings assigned by a rating agency widely accepted by investors. Stable, risk-adequate SME ratings are essential for ensuring acceptance of these ratings.
- Any rating methodology designed for SMEs requires a thoroughgoing understanding of the characteristics of these companies. These characteristics can differ from large multinational corporations in many ways, including all processes and organisational structures. Their smaller size relative to large multinational companies can present both advantages and disadvantages for a credit rating.
- The SME rating methodology published by Euler Hermes Rating in June 2017 under the brand **TRIB**Rating was developed for the purpose of fully capturing SMEs' characteristics in an independent methodology. The scorecard in this SME rating methodology represents a decision to favour simplicity and enhance transparency.
- We assume that SMEs' demand for capital market financing will continue to rise. Investor interest in this asset class will also rise again due to stable, risk-adequate and transparent assessments of credit risk, which will drive up the number of capital market transactions by SMEs and establish capital market financing as a key component of these companies' funding strategies.

Changed financing environment for SMEs and MidCaps

The complex change processes sweeping through financial markets as a result of tighter regulatory requirements for banks and structural adjustments have had visible impacts on the European environment for SME financing, particularly in Germany.

Other factors are also driving a change in SME financing: Companies have to structure their financing in a way that accounts for the growing risks posed by greater volatility in sales and supply markets. Further challenges may arise from structural changes resulting in investment profiles increasingly shifting towards intangible assets (goodwill, research and development, software, etc.). Also, the burgeoning complexity of investment structures has driven the companies' need to strengthen long-term financing components.

Finally, as SMEs become more internationalised, so does their financing.

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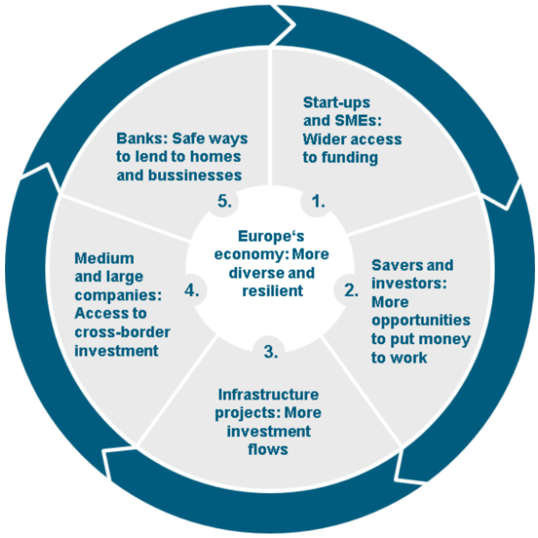
Policy makers drive non-bank SME financing

In 2015, the European Commission published its action plan for building a Capital Markets Union[1] This action plan underscores the Commission's intention to standardise individual capital markets across Europe and encourage non-bank financing of SMEs (and infrastructure projects).

Figure 1: Objective of the Capital Markets Union



Source: European Commission

The proposed plan for promoting capital market financing for SMEs consists of several components. They include effective markets for shares, bonds and private placement, the revitalisation of the securitisation market and regulatory facilitations for debt funds.

Also, streamlined standards for prospectuses will provide SMEs with an efficient regime for accessing alternative sources of funding.

For investors to treat SMEs as an independent, sustainable asset class, credit information on SMEs will have to become more readily available. At the same time, these institutional investors are under more regulatory pressure to establish appropriate risk management processes and utilise reliable credit risk assessments.

SMEs increasingly rely on internal and capital market financing

The change in the financing environment has given rise to two major broad-based changes in SME financing.

First, SMEs are increasingly relying on internal financing. This trend is reflected in a steady increase in economic equity ratios. Besides expanding their equity basis, these companies have also been reducing their liabilities to banks, resulting in an overall improvement in their capital structure over the past years.

Second, SMEs have demonstrated a growing interest in capital market financing. There has been an increase in the number of bond issuances and a significant rise in corporate Schuldschein loan transactions.

[1] https://ec.europa.eu/info/publications/action-plan-building-capital-markets-union_en

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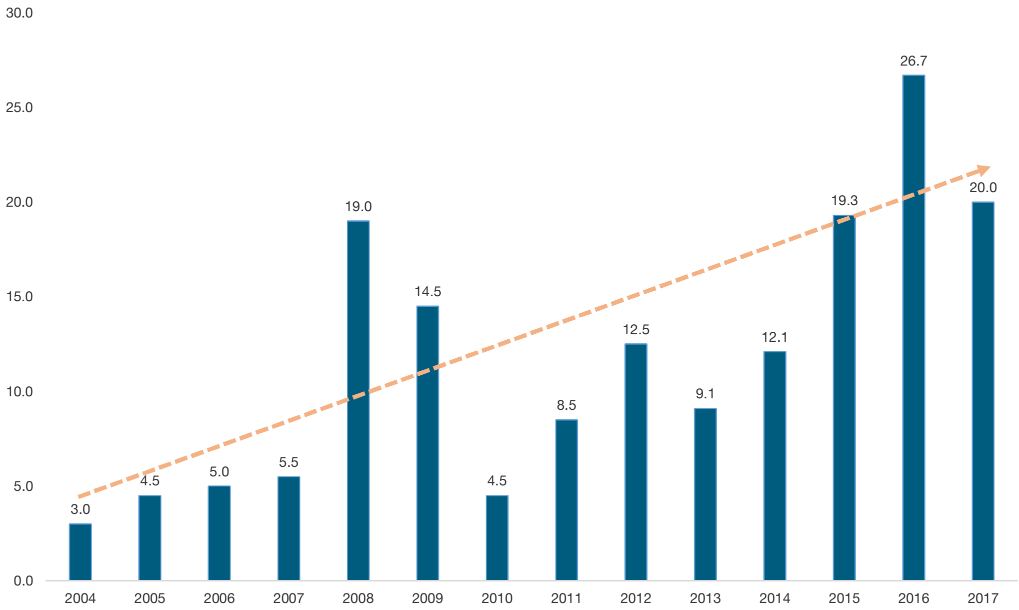
Figure 2: Corporate Schuldschein market
Gross new investment volume in billions of EUR



Source: BayernLB, Thomson Reuters

Fuelling this trend is an upwelling of interest in alternative investments among institutional investors. For years, these investors have faced the structural challenge of identifying attractive investments despite low interest rates and regulatory tightening. European institutional investors have been reducing their holdings of government bonds and seeking to allocate an even larger share of their portfolio to corporate bonds.

The growing popularity of capital market financing has spurred the creation of special market segments for SME bonds. These segments are characterised by lower issuance volumes, among other things.

In keeping with this trend, Deutsche Börse, for example, opened the new SME segment Scale in March 2017 in order to make it easier for small and medium-sized enterprises to access the capital market.

Given the ongoing uncertainty affecting the banking sector and structurally driven shifts in financing requirements, we expect that SMEs' demand for capital market financing will continue to rise in the future and be supported by new initiatives.

External ratings play an essential role

The obstacles to SMEs obtaining capital market financing, in our view, include inadequate transparency at some companies, reduced availability of (credit) research and the limited resources that institutional investors have dedicated to internal risk assessment. These obstacles prevent potential investors from thoroughly evaluating the credit risk posed by SMEs and effectively allocating their capital.

Rating agencies play a pivotal role in capital market financing since they serve as information intermediaries, which objectively and impartially assess the credit risk of issuers and issuances. Stable, risk-adequate ratings are essential for ensuring acceptance of ratings.

Bond issues by small and medium-sized enterprises started to climb precipitously in 2010 and have since been followed by numerous defaults. The default rate in the SME segment currently hovers around 25%. In retrospect, the fact that the ratings for many of the defaulting companies were very high prior to issuing the bonds, but in some cases had to be adjusted radically in the following years, demonstrates that some of the original ratings did not accurately reflect the actual risks.

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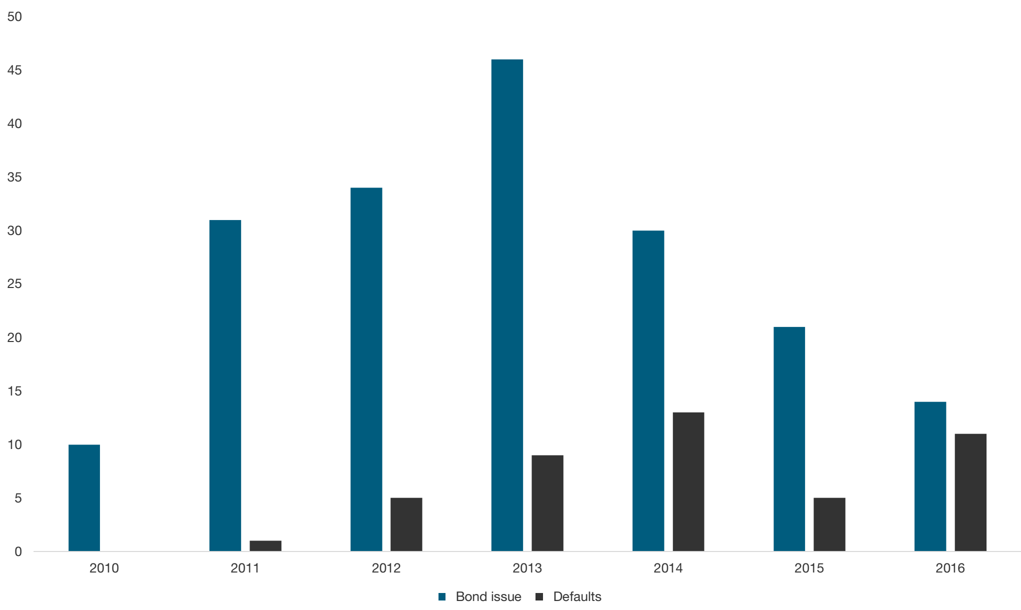
Figure 3: Number of issuances / defaults



Source: Euler Hermes Rating

We believe that the rating inaccuracy was largely attributable to the complexity of rating small and medium-sized enterprises and the vast amount of experience and expertise needed to perform this task adequately. In our view, it is often more difficult to rate small and medium-sized enterprises than large multinational corporations.

Clearly, a rating methodology for small and medium-sized enterprises will only be appropriate and effective if it gives due consideration to the unique characteristics of SMEs.

Characteristics of SMEs and MidCaps from a rating perspective

To assess the credit risk of small and medium-sized enterprises, rating agencies must have a thoroughgoing understanding of the characteristics of SMEs. We believe that methodologies designed for multinational corporations fail to consider the unique traits of SMEs and can mislead analysts when selecting and weighting qualitative rating criteria, determining which financial ratios to use in the rating process, deciding how the ratios will be weighted, and establishing ranges for them.

SMEs can exhibit specific characteristics with respect to virtually any processes or organisational structures. Their smaller size relative to large multinational companies can, in our view, present both advantages and disadvantages compared to their larger companies.

Competitive position: Economies of scale versus flexibility

One of the main differences between SMEs and large corporations is that SMEs have limited capabilities to use economies of scale. This disadvantage can weaken their competitive position relative to large companies. Also, due to their smaller size, they have less bargaining power with suppliers and customers than large companies.

On the other hand, smaller companies are also typically more nimble, in our view. This greater flexibility can improve a company’s ability to adapt to changes in demand structures, and hence improve the competitive position.

Diversification affects sensitivity to cyclical trends

Another key difference between SMEs and large multinational corporations lies in diversification. SMEs tend to be less diversified in terms of sales markets, segments, products, customers, suppliers or other dimensions.

Being less diversified, smaller companies cannot withstand unfavourable market conditions as easily as large, highly diversified enterprises, in our view. A relative lack of diversification can also increase sensitivity to cyclical trends. On the other hand, small and medium-sized enterprises can acquire a competitive advantage by developing special expertise in niche markets.

SMEs may also be less diversified in terms of their financing structure. By concentrating their borrowing among few sources of financing, companies may become perilously dependent on individual financing partners. Moreover, in our view, SMEs' risk profiles and creditworthiness may deteriorate in case of uneven maturity profiles together with bullet maturities.

Specific management and governance structures

In our opinion, small and medium-sized enterprises also tend to exhibit specific management and governance characteristics. Many SMEs are dominated by the personality of the entrepreneur who serves as both the company's CEO and shareholder. As a result of this dual role, these companies tend to be more heavily impacted by their entrepreneur's personality and their creditworthiness is greatly dependent on his or her skill and experience.

SMEs may be dependent on other key people within the organisation as well, which we believe may adversely affect their creditworthiness.

By the same token, SMEs that are managed by their owners tend to focus more on their long-term success and survival than on short-term financial interests since their shareholders' interests and management's interests are perfectly aligned. This is clearly a strength.

By contrast, we believe that large corporations may expose themselves to greater financial risk to satisfy shareholders' short-term financial interests, which may adversely affect their creditworthiness.

Effective planning and control systems are critical to success

In our view, companies perform strongly when they have effective planning and control systems that create a virtuous feedback loop between strategic management and controlling. Financing partners are also very interested in precise, comprehensive external reporting. Delays in publishing company financials or the publication of incorrect financials may be indicative of poor internal controls and can distort assessments of underlying credit risk.

In our experience, SMEs often have weaker reporting and are less transparent than large corporations. It is essential for these companies to provide prompt, precise information on the development of their business.

Susceptibility to event risks

SMEs also tend, in our view, to be more sensitive to event risks than large corporations due to their smaller sizes and higher concentration, which can potentially increase their credit risk.

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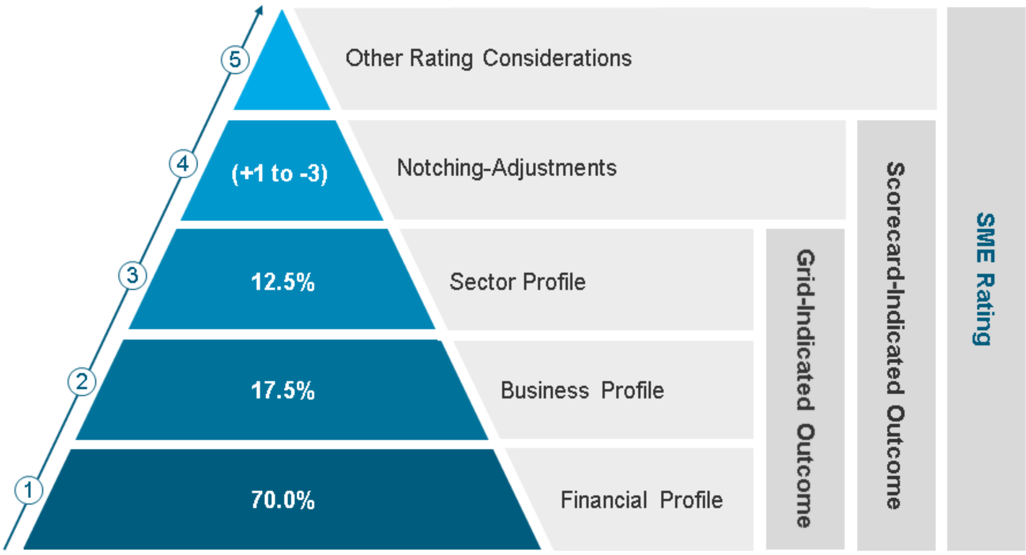
Assessing credit risk of SMEs and MidCaps in Germany

The SME rating methodology published by Euler Hermes Rating in June 2017 was developed for the purpose of fully capturing SMEs' characteristics in an independent methodology. It is built primarily on data and statistics of approx. 37,000 companies with financials from 2002 to 2016 and revenues typically between €10 million and €500 million. The cross-sectoral methodology is also based on a comprehensive experience of assessing the credit risk of SMEs in Germany.

Elements of the Euler Hermes Rating SME methodology

The SME rating methodology is essentially built around a scorecard. The scorecard's basic elements are three broad rating factors and four notching adjustments. Other rating considerations are incorporated into the methodology as well.

Figure 4: Basic structure of the SME methodology



Source: Euler Hermes Rating

Rating factors / grid-indicated outcome

SME analyses begin with the three broad factors assessed in the rating grid:

- Sector profile
- Business profile
- Financial profile

Empirical evidence suggests that belonging to a specific sector is a core determinant of a company's default probability. This highlights the importance of analysing sector profiles, especially in a cross-sectoral methodology.

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Sector risk is determined by assessing the sector volatility and sector outlook in particular. We put considerable importance on the assessment of sector volatility since each sector responds differently to fluctuations associated with economic, market or innovation cycles.

The sector outlook also figures prominently in the sector risk assessment since changes in market conditions of a sector can affect the creditworthiness of an SME.

Business risk is determined by assessing the SME's competitive position and concentration risk, which we view as the main sub-factors for identifying SMEs' business risk.

The competitive position is analysed by qualitatively assessing how a company's intrinsic business characteristics position it within its industry and particularly vis-à-vis its direct competitors. The factors considered include (1) the company's scale relative to competitors, (2) its current and projected market shares, (3) the depth of services/products offering as well as (4) its cost position and/or ability to control costs.

Concentration risk is included on the assumption that companies with multiple business segments and a broad product range generally have more stable revenue streams than competitors with a tighter business focus. Concentration risk is evaluated based on a multi-dimensional assessment of potential concentration risks (segments, regions, customers, suppliers).

Financial risk figures prominently in any assessment of the credit risk of small and medium-sized companies. Sub-factors of the financial profile include (1) size, (2) profitability, (3) leverage, (4) capitalisation and (5) interest coverage.

While those sub-factors related to size, profitability and interest coverage are each assigned one financial ratio, leverage and capitalisation – which are both identified as highly relevant sub-factors – are each assessed using two financial ratios. Adjusted financial ratios are assigned to rating categories based on a rating scale derived from available data and statistics.

Once the three broad rating factors and their sub-factors have been assessed, the factors are weighted in the scorecard as shown below. They are combined to get to the grid-indicated outcome.

Figure 5: Weighting of main factors

Broad factors	Factor weighting	Sub-factors	Sub-factors weighting
Sector profile	**12.5%**	Sector volatility	7.5%
		Sector outlook	5%
Business profile	**17.5%**	Competitive position	10%
		Concentration risk	7.5%
Financial profile	**70.0%**	Size	5%
		Profitability	10%
		Leverage	27.5%
		Capitalisation	22.5%
		Coverage	5%

Source: Euler Hermes Rating

Notching adjustments / scorecard-indicated outcome

Next, the SME rating methodology includes four notching adjustments that address other rating factors, which are not fully scalable and so cannot be included in the rating grid. Notching adjustments are made for (1) liquidity, (2) debt structure, (3) strategic and operational management as well as (4) governance and financial policy. The notching adjustments can either lower the final rating, have no rating impact or – in very rare cases – improve the final rating.

Liquidity is analysed based on the company's liquid funds, ability to tap external lines of financing, compliance with covenants and ability to liquidate assets. Its debt structure, by contrast, is assessed to determine whether it is reasonably diversified and has an uneven maturity profile. Unhedged exposures are considered as well.

Strategic and operational management is assessed on a variety of levels, most notably the plausibility and operationalisation of strategic goals, the quality of planning and the ability to correct deviations from the plan. The notching adjustment related to governance and financial policy, for its part, depends heavily on the alignment of interests between shareholders and management as well as the sustainability of the company's financial policy.

The assessment of the four notching adjustments can influence the rating as shown below. This results in the scorecard-indicated outcome.

Figure 6: Notching adjustments

Notching adjustment	Adjustment
Liquidity	+1 to -3
Debt structure	+1 to -2
Strategic and operational management	+1 to -2
Governance and financial policy	+1 to -2

Source: Euler Hermes Rating

Other rating considerations

The scorecard in this SME rating methodology represents a decision to favour simplicity and enhance transparency. Accordingly, the three broad rating factors and the four notching adjustments do not constitute an exhaustive treatment of all of the considerations that are important for assigning ratings.

Other rating considerations include but are not limited to:

- Legal structure / external influence
- Reporting and transparency
- Event risk
- Limiting factors

It should be noted that key risk factors may occasionally require the consideration of other risk aspects when applying the SME rating methodology, and so the analysts may consider different weights for the rating factors than presented in the scorecard.

Once the three broad rating factors, four notching adjustments and other rating considerations have been analysed, a formal rating committee assigns a final SME rating that gives due consideration to the characteristics of small and medium-sized companies and transparently explains how the rating was derived.

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