

SWP 51/91 "THE EUROPEAN MARKET"

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COMPARISON OF ECONOMIC RESULTS

<u>European Monetary System</u>		<u>Average monetary value 1990 in relation to sterling</u>				
German mark	DEM (100)			34.068		
French franc	FrF (100)			98.990		
Italian lira	ITL (1,000)			0.455		
Spanish peseta	ESP (100)			0.540		

	<u>UK</u>	<u>France</u>	<u>Germany</u>	<u>Italy</u>	<u>Spain</u>
GDP 1989 (£billion)	457	522	660	475	207
GDP growth	1.6%	2.5%	4.2%	2.6%	3.5%
Trade balance (£billion)	-189	-70	+437	-5	na
Unemployment rate	5.8%	8.9%	5.0%	11.1%	16.2%
Inflation	9.3%	3.8%	3.0%	6.3%	6.5%
Employment growth	1.2%	1.1%	2.5%	1.5%	2.4%
Interest rates (long term)	9.66%	9.38%	7.60%	12.30%	14.46%
Interest rates (short term)	14.48%	10.89%	8.05%	13.37%	15.98%
Equity in relation to total balance sheet	46%	19%	24%	27.2%	35.6%
Debt in relation to total balance sheet	7.4%	27%	17.6%	13.3%	17.2%
Level of self-financing	77%	68%	84%	63%	77%
Amounts levied on firms (as % of GDP) :					
- taxes on dividends	4.0%	2.3%	2.0%	3.5%	na
- total taxes	6.6%	5.0%	2.7%	4.0%	na
- national insurance	3.5%	12.2%	7.2%	8.7%	na
Wage costs, social and fiscal charges (% turnover)	21.5%	26.3%	30.1%	20.2%	21.8%
Growth of investment capital (88-89) :					
- funds available	33%	60%	35%	29%	22%
- new funds raised	69%	152%	56%	-3%	-27%
- new investments	21%	29%	121%	54%	-8%
Stock market capitalisation (% GDP)	98%	36%	31%	na	na

CORPORATE CULTURES

CORPORATE CULTURES

European corporate cultures undermine the generally accepted belief that bigger is better

British, French and German cultures present striking contrasts in management styles, performance targets, corporate strategies and in the way they treat workers and shareholders. These contrasting cultures are the key to the collective and individual prosperity of member countries.

In Germany, companies in general set more store by turnover than by profits, and tend to be relatively generous to their employees.

In France, the corporate culture values profitability more highly but still places considerable emphasis on employee rewards relative to returns to investors.

The British corporate culture again values profits more highly than turnover, but strikes the balance of rewards between employees and shareholders much more in favour of the latter than anywhere else in the EC.

There are no clear frontiers between the three spheres of influence, some European countries exhibit attributes of the German culture at one end of the spectrum (Denmark, the Netherlands), others resemble that of Britain at the other end (Italy, Spain). However it is clear that the gulf between the German and British cultures are so great that it is hard to see how they can coexist in a fully integrated European community. At both ends of the spectrum there are contrasts in basic philosophy about what companies are and what their roles are to be in society.

In the list of the top 500 European companies, the most striking aspect is the numerical dominance of UK firms. UK industrial companies, whilst not the largest, account for more than 40% of the companies in the list, whereas the UK GDP accounts for 15% of the EC total. Germany, on the other hand, which accounts for more than 25% of the EC GDP, accounts for less than 16% of the top 500 companies. Industrial concentration in the UK is higher than in any other country.

Differences in the degree of concentration are the result of economic, financial and political history. Several of France's large companies are the products of state-ownership and the nationalisation programme. Germany's corporate giants reflect the strength of the German economy and the emphasis placed on turnover. In the UK, the most powerful force for concentration has been the sophistication of corporate finance, inspiring a high level of mergers and acquisitions activity. In Italy, state ownership has also been an important generator of large companies. And in contrast to the trends of privatisation elsewhere in Europe, the Italian state sector is still growing.

However, there is also a widespread belief that size is good for business - that if companies are to successfully compete internationally they have to be big.

An indication of the significance of large companies in their domestic economies is given by the proportion of GDP for which they account. If the 'big is best' theory holds up, the countries in which major companies account for a large proportion of GDP have the most prosperous economies (measured in terms of GDP per head).

But they have not.

The Danish economy is the EC's most prosperous, but one of its least concentrated. The highly prosperous German economy is only the fourth most concentrated, whilst the UK economy, much the most concentrated, is only the eighth most prosperous. Evidently economic prosperity has no correlation with the degree of industrial concentration.

In fact, the belief that big is best must be abandoned in favour of a more fundamental quality - that of competitiveness. The EC's most prosperous economies are those with the most competitive companies. This does not necessarily mean either the largest companies or the most profitable ones.

Comparison of different European corporate cultures

United Kingdom

Fourth largest of the EC economies but only the eighth most prosperous (measured in terms of GDP per head). UK industries are highly concentrated by EC standards. Companies enjoy high margins and pay an unusually low proportion of value added to employees. The UK economy exemplifies the vicious circle of high inflation and high interest rates, leading to high unemployment and low growth. Its experience suggests that low-wage economies have trouble in sustaining non-inflationary growth, and that favouring shareholders rather than employees inhibits sustained productivity growth. This analysis suggests that widespread public listing, coupled with a shareholder preference for dividends rather than capital gains could be unhealthy, and that financial sophistication and high profits do not guarantee prosperity.

Germany

The ECs largest economy and its second most prosperous. German industries are only moderately concentrated and companies are distinguished by low margins and an unusually high proportion of value added paid to employees. The German economy exemplifies the virtuous circle of low inflation and low interest rates, leading to relatively low unemployment and high growth. Its experience suggests that high-wage low-profit economies have many advantages and that favouring employees at the expense of shareholders improves the quality of the workforce and stimulates productivity. The recent performance of the German stock market also suggests that investors are more than compensated for their low dividends by firms' high capital gains.

France

The ECs second largest economy and its fourth most prosperous. French industries are relatively concentrated and companies are distinguished by high margins, a low proportion of value added paid to shareholders and a relatively high proportion to employees. The French economy is in a state of transition as its large state-owned sector - one of the reasons for its relatively high concentration - is gradually dismantled, and companies are moving from nationalisation to increasing privatisation. French inflation has been constrained in recent years by the high interest rates needed to sustain the franc within the European exchange rate mechanism.

Italy

The ECs third largest economy and its sixth most prosperous. Industries are remarkably unconcentrated for such a large economy. Companies have relatively high margins and pay a moderate proportion of value added to employees and a relatively high proportion to investors. Despite low corporate concentration, there is a high concentration of industrial power. This is partly reflected in the state sector, which, unlike France, shows every sign of remaining in place. The concentration of power helps explain the relatively high profitability of Italian companies, although it is unclear whether these high margins will be sustained in the integrated market. Italian inflation and interest rates have been high in recent years.

Spain

The ECs fifth largest economy and the ninth most prosperous. Its industries have reached a low level of concentration, but this could change as its many family-owned companies are progressively consolidated with the help of an active stock market. Spanish companies are similar to the UKs in paying a high proportion of value added to investors and a relatively low proportion to employees. They are not, however, very profitable. Like Italy, rapid growth in recent years has generated high inflation that has had to be constrained by high interest rates.

Giving workers a larger share of corporate spoils leads to economic prosperity

There appear to be links between the strength of an economy and the generosity of companies towards their employees. Financial sophistication leads to greedy investors, lower wages, lack of international competitiveness and, ultimately a less prosperous economy.

It has always been assumed that high wages, characteristic in Germany, are the result of prosperity, not the cause. The opposite may be the case. Companies with strong economies generally have companies that pay relatively large proportions of the value they create to employees, and relatively small proportions to investors. Weaker economies are more likely to do the opposite.

UK and German companies provide stark contrasts. Whilst the average German company pays more than 75% of the value added it creates to employees, the average UK company pays 60% (Value added is wage costs plus profits before interest and depreciation charges). The companies in other member states pay out between 60% and 70% of value added to their employees. On the other hand, UK companies pay out, on average, 8% of value added to shareholders, whilst investors in German companies get 2.7%.

Part of the reason is that the German economy has a high percentage of private companies, who are less susceptible to the demands of shareholders. Often the need of quoted companies to generate returns to shareholders (high profits) significantly inhibits their distribution of value added to employees.

Distribution of value added

<u>Country</u>	<u>Listed companies</u>	<u>Investor share</u>	<u>Employee share</u>
UK	201	8.1%	60.2%
Spain	10	8.1%	65.6%
Italy	25	7.3%	64.1%
France	111	3.7%	69.2%
Denmark	15	4.3%	69.8%
Germany	81	2.7%	75.7%

Biggest profits piled up by companies in the least prosperous economies

Conventional wisdom states that highly profitable companies are a recipe for strong, vibrant economies and affluent, well-paid workers. Conventional wisdom is wrong. Analysis of the top 500 European companies shows that the economies of countries with the most profitable companies are generally less prosperous than average.

The ECs three richest economies (measured by output per head) are Denmark, Germany and Luxembourg. Yet the companies in these economies are generally less profitable than those in poorer countries such as the UK or Italy. German companies, which produce more output per head than any other EC national group, are the least profitable of all.

Compare, for example, GEC (UK) and Siemens (Germany) : they have similar product ranges, are highly diversified and have both acquired many companies. But in terms of their profit and loss accounts they are oceans apart. Siemens' 1989 turnover of Ecu 30 billion was four times that of GEC, but its profits of Ecu 754 million were only 6% greater. This indicates Siemens' profit margin on sales was 2.5% compared with GEC's margin of 10%.

These contrasts prevail throughout all sectors. In the electronics industry, for example, Germany's five companies with a combined turnover of Ecu 50.4 billion had an average margin of less than 4% in 1989. The average for the four UK companies with a turnover of Ecu 12 billion, was almost 11%.

The overall picture tells the same story. The 81 German companies in the EC top 500 achieved an average profit margin of 3.6%, whilst the average for the 201 UK companies was 9.5%. The 111 French companies had, on average, a margin of 6.8%.

Comparison between profit margins and prosperity

<u>Country</u>	<u>Profit margins</u> (1989)	<u>GDP/head</u> (thousand Ecu)
UK	9.5%	12.1
France	6.8%	15.8
Italy	6.7%	14.5
Spain	6.0%	8.8
Denmark	5.9%	19.1
Germany	3.6%	18.2

There are several explanations for the striking differences in margin between EC members' corporate cultures. The most significant contrast is the remarkably low average margin achieved by German companies, which begs the basic question of whether this is a cause or result of the basic strength of the economy. Do low margin economies become prosperous or do prosperous economies become low margin ?

One reason could be the relatively low German interest rates, which reduce the cost of capital and thus the need to raise profits to cover financing costs. Between 1985 and 1989, the average German lending rate was 9% against 11.4% in the UK and 16.3% in France.

Another explanation could be the differing relationships between firms and their sources of finance. In Germany, few companies are listed, and they have much closer links with their banks than any other EC country. By contrast, many more UK companies are listed, and are therefore more exposed to the demands of institutional investors. This gives UK investors much more power over corporate strategy decisions than customers or employees, and leads to higher earnings per share to satisfy dividend expectations. These higher earnings must be financed by higher margins.

A third reason is that retained profits are an important source of corporate finance, and companies feel the need to protect the real value of their profits through their product pricing. In general this means that companies operating in countries where inflation is high must be more profitable than companies operating in a less inflationary climate. Germany's average inflation rate for 1985-1989 was 1.2%, against 3.6% for France and 5.3% for the UK.

Different competitive climates in domestic markets also help to explain the differences such as the high margins of Fiat in Italy (11.5%) and Peugeot in France (11.9%), compared with the relatively modest profitability of BMW (5.4%) and Volkswagen (4.1%). Historically, the German motor industry has been less well insulated from foreign competition than its French or Italian counterparts, and domestic competition has also been more intense.

One of the various corporate cultures will dominate a fully-integrated European economy. Will it be the low-margin German pattern or the high-margin UK one ? Or will the European model settle down to an intermediate margin closer to the French pattern ?

If the long-term trend is towards greater financial sophistication in all markets, the artificially low cost of capital enjoyed by German companies is bound to move up towards UK levels, putting upward pressure on German margins.

However, low-margin cultures, such as those of Germany and Japan, are inextricably bound up with international competitiveness. In the long run therefore, the need for companies to compete effectively in global markets could have a far more powerful influence on profitability than the appetites of bankers and investors.

Source :

International Management - April 1991

THE UNITED KINGDOM

THE UNITED KINGDOM

I. THE ECONOMY

1990	
GDP	457 billion pounds
GDP growth	1.6%
Unemployment rate	5.8%
Trade deficit	189 billion pounds
Inflation	9.3%
Employment growth	1.2%

In 1990, economic activity remained virtually stationary. At the end of the first quarter, the GDP growth rate was 2.5% (annual rate), but this growth slowed down so much towards the end of the year that the United Kingdom at the start of 1991 can be said to be in a period of recession - defined as 3 consecutive terms of slowdown in economic activity.

Internal demand slowed down, mainly due to the government's austere economic policy, designed to reduce household spending. The slowdown in demand led to fewer imports and therefore a slight improvement in the trade balance, but there is still a large deficit. The competitiveness of English products is weak, and export growth has slowed down due to a new appreciation in sterling, necessary because of the weak position of the pound in the EMS.

The tightening of the economic policy has meant an exceptionally high interest rate. An increasing number of firms are going through a very difficult period with high levels of debt. Industrial production has greatly slowed down. The number of firms going bankrupt increased by 63% in the last quarter of 1990 compared with the same period the previous year.

Entire sectors of activity are threatened - especially banks, construction, distribution and automobile, whose sales are down by 20% - leading to numerous redundancies. Unemployment, previously the strong point of the British economy, is thus rapidly again becoming a big problem.

However interest rates are coming down - February 1991 a reduction from 14% to 13.5%, and then again to 13%, and then again to 12.5% in May - and they should continue to fall. Moreover, firms have continued to invest despite the difficult environment.

The government's priority has always been the fight against inflation, which, at the end of 1990 reached an alarmingly high level, threatening the stability of the pound. In 1991, it would seem that the austere economic policy, coupled with the new strength of the pound with its entry into the EMS, is starting to have an effect : inflation is falling rapidly, which has meant a new dynamism of the pound in foreign exchange markets. A recent Treasury report estimates that inflation should fall to 4.6% in the last quarter of 1991. This fall, together with the reduction in interest rates, should restimulate economic activity, but, according to a recent study by Indosuez, not until at least the third quarter of 1991.

Sources :

Perspectives Economiques de l'OCDE (December 1990)

Les Echos (1991)

Le Nouvel Economiste (June 1991)

II. THE BANKING SYSTEM

Central bank

The Bank of England

Clearing banks

Barclays (number 1)
National Westminster (2)
Midland (3)
Lloyds (4)
Royal Bank of Scotland
Abbey National (previously a building society)
Coûts & Co (highly prestigious, a minimum deposit is required)

Clearing banks are the main banking organisations in England, serving as high street banks and management of fortune. They receive the majority of bank deposits and carry out many different types of operation - current accounts, deposit accounts, loans and overdrafts.

National Savings Banks

Trustee Savings Bank (5)
Girobank (6)

Building societies

Halifax
Nationwide Anglia
Woolwich Equitable
Cheltenham & Gloucester
National & Provincial
Leeds
Bradford & Bingley
Alliance & Leicester
Town & Country
Bristol & West
Portman

The building societies manage more accounts than all the banks. Most of their business comes from savings accounts, as they offer a better rate of interest than the banks. Over recent years they have become serious competitors to the traditional clearing banks.

Merchant banks

Kleinwort Benson
Morgan Grenfell
Samuel Montagu
Hambros
Schroders
Warburg
Hill Samuel

Present in several areas of banking activity : commercial deals, international capital markets, financing of firms, the financial and stock markets. Concerning the financing of firms, the merchant banks intervene at all stages : increase in working capital, creation; and they are also expert in the field of mergers and acquisitions.

English banks, especially the clearing banks ensure the essential of SMEs financial needs.

Over the last few years, faced with SMEs who play an increasingly important role in the economy and much interbank competition, the clearing banks have been increasingly forced to modify their conservative attitudes and to offer new methods of financing which are more adapted to firms needs.

Equity financing has never really been part of traditional operations.

Loans given to SMEs mainly take the form of advances and overdrafts, and more recently, medium and long term loans.

It is estimated that bank loans to SMEs represent about 1,5 thousand million pounds each year ; 23 thousand million if all the facilities from which they benefit are added, notably overdrafts (short term, normally renewable each year).

The principal problem is to avoid too high a level of debt. However, the level of debt of British firms is, in general, low (7.4% of total balance sheet, equity representing 46%) compared with firms in other European countries. The level of self-financing for British firms is also high : 77% ; it is the main financing method used by British firms.

The cost of credit for British SMEs is between LIBOR +2.5 and LIBOR +5.

Short-term credit (3-6 months) :

Advances constitute the essential part of credit to firms ; they take two forms : overdrafts and loans, and are given by the clearing banks.

Medium-term credit :

Previously this type of credit was mainly used to finance export operations. It is either provided by the clearing banks who give credit for 18 months or more in the form of a guarantee, or by the merchant banks who give credit for a specific project. Since the end of the 1970s, medium term credit has been increasingly used to satisfy the needs of the economy. Clearing banks have therefore begun to give long term credit, especially to SMEs.

Long term credit :

Clearing banks are increasingly giving long term credit to firms. These loans are for the acquisition of new equipment, the creation of new industrial establishments, and are insured by a floating charge. Merchant banks also carry out long term operations for firms - financial engineering, minority participations, leasing.

The banks' adaptation to the demands of the SME can be seen by the creation of more flexible products, for example a choice between a fixed and variable interest rate with, under certain conditions, a delay in redemption date ; the length of the loan can be up to 20 years. In addition, the banks have set up information and advice centres for SMEs in order to help them improve their financial management.

The clearing banks have also set up more specialised financial structures :

Barclays - has segmented its client market by the creation of a national network. The Barclays Business Centres are designed for medium and large sized firms, whilst other sales points specialise in services for SMEs.

Nat West - puts its network of consultants at firms' disposal.

Midland - ensures the collaboration of its development advisors in firms in order to support regional directors.

Lloyds - has set up the Lloyds Bank Commercial Service in order to help medium sized firms. In addition, to attract small firms, it has set up technical and financial advice counters (Small Business Centres) in several of its agencies which provide help and advice for the creation and management of firms.

Royal Bank of Scotland - at a European level it has signed an agreement to work with the Banco Santander (Spain) for the financing of SMEs.

SMEs access to the trading floors :

Barclays has just recently set up a network of trading floors specially designed for medium sized firms. Four centres of this type (one in London, three in other regions) are currently in operation. Each one comprises experts in the entire field of treasury and foreign exchange (foreign currency, exchange options, interest rate options, share swaps etc...). They are designed for firms with an annual volume of foreign exchange transactions of between 5 and 10 million pounds. As for smaller firms, they can go to special international finance centres, which can be found all over the country.

Sources :

Le financement du développement des PME - Commissariat Général du Plan (1989)
Les petites et moyennes entreprises - Institut d'études bancaires et financières (1989)
Les Echos (1991)

III. FIRMS

Two official definitions of a Small or Medium sized Firm (SME) :

- in the manufacturing industry : number of employees less than or equal to 200
- in trade and commerce : turnover less or equal to £400,000

SMEs account for approximately 94% of British firms, which represents about 1,300,000 firms.

They account for : 36% of the total private sector employees
 25% of the total number of employees
 20% of the total turnover of the economy

Legal status :

The principal forms of business organisation apart from government-owned concerns are:

- companies, including branches of foreign corporations
- partnerships and sole proprietors

A company must either be public or private. A public company must :

- be registered as such,
- have a share capital of at least £50,000, with the nominal value of each share at least a quarter paid up and any premium fully paid up,
- include the designation 'Public Limited Company' (plc) in its name,
- have at least two directors,
- have a trading certificate before commencing business.

Only a public company may offer shares or debentures to the public although these do not necessarily have to be quoted on the stock market.

All other companies are private. For private companies there is no minimum share capital, nor must its shares be paid up. There need only be one director, and it can commence business directly after registration. A private limited company must include the designation 'Limited' (Ltd) in its name.

Almost any form of business may be carried on in the UK by a partnership. In general a partnership may not consist of more than 20 people, but exceptions are made to this, for example in the case of lawyers and accountants. The partners are not only jointly liable to the creditors for the debts and obligations of the partnership, but also each partner is personally liable for all the debts of the firm not satisfied by the partnership assets.

Partnerships are generally not subject to the same degree of statutory control as companies, nor to the same level of public disclosure. For example, there is no public filing of their accounts.

Regional distribution :

The situation in 1986 was largely biased in favour of the South of England, however today the picture is changing. There has been a marked movement away from London towards the west and the north of the country (decentralisation) where it is cheaper to set up and operate a business. In addition, the south has been the area the worst hit by the current recession.

<u>Region</u>	<u>Number of firms</u> <u>1986 (thousands)</u>	<u>% of firms created</u> <u>1980 - 1986</u>
South East	498.6	19%
East Anglia	59.6	15%
South West	140.5	14%
West Midlands	125.8	13%
East Midlands	99.7	14%
Yorkshire/Humberside	112.7	9%
North West	136.6	7%
North	58.2	9%
Wales	77.4	10%
Scotland	110.3	11%
Northern Ireland	50.6	16%
UK total	1,468.0	14%

(Source : Business Statistics Office 1986)

Distribution by economic sector :

<u>Sector</u>	<u>Turnover</u> <u>£21 - £100m</u>	<u>Turnover</u> <u>£101 - £500 m</u>	<u>Turnover</u> <u>£501 - £1000</u>
Agriculture	9.5%	8.7%	4.2%
Mining	0.1%	0.1%	0.2%
Manufacturing	7.8%	11.7%	17.5%
Construction	16.2%	12.2%	12.7%
Transport	4.7%	3.8%	5.6%
Distribution	23.1%	32.4%	30.7%
Other services	38.6%	31.1%	29.1%
	100.0%	100.0%	100.0%

(Source : VAT Statistics 1987)

Sources :

Doing business in the UK - BDO (1989)

Les petites et moyennes entreprises - Institut d'études bancaires et financières (1989)

IV. THE DEVELOPMENT OF INVESTMENT CAPITAL

The British investment capital industry is the most important and most developed in Europe. It has reached a high level of stability, with a number of experienced investors and a high level of concentration.

There are several factors which account for the rapid development of capital investment during the 1980s :

- 1) Close trading links with the USA, which allowed British investors to draw experience from that well established market.
- 2) The strong performance of the British economy during the 1980s, and especially the development of the entrepreneurial spirit under the Thatcher government.
- 3) A legal and fiscal environment which has always been favourable to capital investment. Investment firms are authorised to adopt the status of a "limited partnership", which has tax advantages. In addition, the tax rate on firms was reduced considerably during the 1980s.
- 4) The creation of the Unlisted Securities Market (USM) in 1980, which has a much higher liquidity and level of trading activity than other secondary stock markets in Europe. This market, where the SMEs are quoted, has favoured the development of capital investment as it provides an exit route for investors and entrepreneurs alike. However, despite the comparatively large number of exits achieved through a stock market flotation, acquisition or trade sale remains numerically the most important exit route for British investors.
- 5) The rapid growth in the number and size of management buy-outs.

For 1988-1989, the growth of capital investment slowed :

<u>88 - 89</u>	<u>Growth</u>	<u>Average Europe</u>
Available funds	33%	34%
New funds	69%	67%
Investments	21%	24%

(Source : EVCA 1990)

The start of the 1990s shows a more worrying economic situation : the United Kingdom is in a recession and the SMEs consequently have to face up to increasing pressures and especially to high interest rates and a high level of debt. This has led to a sharp drop in profits, and as a result, to lower profits for investors as well. The number of funds invested fell by 15% compared to 1989, mainly due to the collapse of the buy-out market. However, the number of firms financed only fell by 0.6%.

Distribution of investments by stage (1989) :

Expansion/development financing - 57% of the total number of investments, and nearly one third of the capital invested.

MBO/MBI - 26% of total investments, 59% of total amount.

Creation/start-up - 10% of total investments.

Principal capital investment organisations :

There are three main types :

- independents, who represent the majority of the activity, accounting for two thirds of total funds invested and three quarters of total investments,
- subsidiaries of large banking or insurance groups,
- firms who are a part of a large group but who act independently.

	<u>Funds managed</u> (million pounds)	<u>Portfolio</u> (number of firms)
1) <u>Independents :</u>		
3i plc	unlimited	5,000
Charterhouse ltd	varying	200
Electra Kingsway	unlimited	200
Murray Johnstone	100	150
Candover	unlimited	na
2) <u>Subsidiaries :</u>		
County Natwest	unlimited	231
CIN Ventures	100	230
Prudential	varying	175
Legal & General	20	150

The unquestionable dominance of the 3i group, easily the largest single competitor in the UK market, must be noted. With its extensive network of regional offices and growing international presence, it remains a major force. In terms of funds invested, it has a market share of 40%, and 50% in terms of total investments made.

Sources :

1990 EVCA Yearbook

Le Capital Risque en Europe - Eurostaf (1989)

Initiative Europe Monitor (March 1991)

FRANCE

FRANCE

I. THE ECONOMY

1990	
GDP	522 billion pounds
GDP growth	2.5%
Unemployment rate	8.9%
Trade deficit	70 billion pounds
Inflation	3.8%
Employment growth	1.1%

For 1990 there has been a sharp slowdown in growth, mainly due to the low level of internal demand and the high interest rates. In the last quarter of 1990 the GDP fell for the first time since 1987.

The most worrying problem for the government is the upward trend in the unemployment rate. Firms are not hesitating to adjust their employee levels in accordance with their predictions, so, faced with the current uncertainties most of the industrial sectors have announced thousands of job losses.

New job creation is also slowing down due to the fall in demand and growth.

According to OFCE, the main cause of unemployment is the high interest rates, which are forcing the government to adopt austere economic policies.

In addition, the trade deficit has increased, in spite of seven years of an economic policy principally designed to reduce the pressures on external trade. However, the total deficit for 1990 is less than the total recorded for 1989.

In 1990, the rhythm of exchanges slowed dramatically. Imports only increased by 3.3% and exports by 2.9%. World demand for French products slowed down, especially in the car industry, where the increase in exports to the EC was half what it was in 1989. French demand for foreign goods decreased at the same rhythm as investments.

Inflation has also increased. The maintenance of high interest rates to counteract the inflationary pressures has led to a new appreciation of the franc, and thereby to a loss of competitiveness. Competitiveness has also been affected by the exceptionally mediocre level of productivity. The production figures for 1990 show a decrease of 1.9% for the last quarter of 1990 ; for the year as a whole production remained practically stationary, with manufacturing even showing a considerable decline. This decline affected all sectors, with the exception of energy and building.

The level of confidence has invariably fallen sharply, and the level of new investment has followed suit. The registered number of firm failures has increased by 15.3%.

However, predictions for 1991 remain relatively optimistic : growth in GDP of between 1.5% and 2% is predicted, to be accompanied however by an increase in the trade deficit, which could reach as much as 80 million pounds.

Sources :

Perspectives Economiques de l'OCDE - December 1990
Les Echos/La Tribune (1991)

II. THE BANKING SYSTEM

Central bank	La Banque de France
Commercial banks	Crédit Agricole (number 1) Banque Nationale de Paris (2) Crédit Lyonnais (3) Société Générale (4) Groupe Caisses d'Epargne (5) Compagnie Financière Paribas (6) Compagnie Financière Suez (7)
Merchant banks (Banques d'affaires)	Lazard Frères Edmond Rothschild Suez Paribas Clinvest (Crédit Lyonnais) Banexi (BNP) Union d'Etudes et d'Investissements (Crédit Agricole) Marceau Investissements
Special credit institutions	UFB-Locabail Sovac Comptoir des Entrepreneurs Crédit National CEPME

Research has always shown the fragility of French SMEs in relation to their foreign competitors. This is mainly due to the low level of their equity capital (19% of total balance sheet) and to the high level of debt (27%, an increase of 20% in 1990). Their level of self-financing stands at 68%, which underlines their level of dependance on the banking system.

In relation to other countries, short-term credit is the most widely used. Whilst medium and long-term credit account for an important part of total loans (23%), their use is becoming less frequent.

There are several new types of short-term credit, and formulas set up for large firms have been made available to SMEs as well, for example :

- variable rate credit
- credit in foreign currency (ECU or another)
- long-term credit accompanied by an injection of equity capital to finance takeovers or industrial development
- working credit, with the aim of financing all daily operating costs and equipment needs.

Important role of interfirm credit - specific to France.

Important role of leasing - approximately 20% of total credits.

The banks play an important role in providing credit to French firms. The increase in new investment since 1987 (increase in volume of 8.8% each year) coupled with the development in taking of minority shareholdings (the amount has nearly quadrupled in three years), has absorbed nearly a third of firms' ressources, and thus provoked a new

call on bank debt. In 1989 it was mainly SMEs who increased the amount of their bank loans (88% of their total loans), compared with a slight decrease on the part of large firms (65%).

There is currently fierce competition between banks and the offer is greater than the demand. This benefits the SMEs who have a wider choice, and can obtain the best credit conditions. Banks have been obliged to modify their rather conservative attitudes, and to offer less restrictive credit terms which are more adapted to firms' needs. They have introduced a wide range of new services and additional benefits.

Commercial banks

The principal French commercial banks are considered to be "universal" banks, as they aim to offer the complete range of available financial services, including those of a merchant bank and leasing. The 8 main groups control nearly 80% of all distributed loans and credits.

However, the basic banking activity remains that of receiving deposits and giving loans; revenues from mergers & acquisitions and equity capital contributed much less to bank results for 1990. In order to affront a heightened competition, the banks have diversified their traditional "product" towards equity and half equity-half debt products, leasing, factoring..., but credit has never ceased to be the main source of their external finance.

The slowdown in the economy has meant a large reduction in firms' demands for credits for investment and financing. Demands for cash advances are however continually increasing ; in 1989 this type of credit grew by 17%, and even more in 1990.

Short-term credit has undergone major structural modifications, which has led in particular to a decline in credit adapted to specific uses (commercial loans, discounts), in favour of more general forms. For example, commercial loans only account today for 18% of all short-term credit, as compared with 43% ten years ago. Over the same period, bank overdrafts have increased from 25% to 42%. However, as these more general products are less profitable, and faced with a difficult environment, banks are trying as hard as possible to diversify their activities away from the traditional forms of credit. In order to maintain market share without at the same time losing profits, they are developing dynamic business policies towards firms : marketing services, opening of agencies and trading floors specially designed for SMEs or setting up of computerized and telecommunications services to help with treasury management.

Three main products of commercial banks :

1) General working credit. Much used today, it covers firms' short-term needs of finance. It can be given in French francs or in a foreign currency, and its rate is linked to that of the money market. According to its financial structure, the firm can negotiate the percentage of profit taken by the bank. This type of credit is mainly used to finance SMEs.

2) Fixed term deposits. This type of credit underwent a new lease of life in October 1990, when the compulsory reserve mechanism to which the banks were subjected was relaxed. The firm deposits a certain sum of money at the bank for a time period which is fixed at the start, the bank deciding the rate to be applied. Payment at the end is net, the firm pays neither an entry subscription nor a management charge.

3) Trading floor products. Traditionally, access to the trading floor was reserved for large firms, or to quantitatively important deals. The exchange control regulations, coupled with the volatility of exchange rates, made any financing in foreign currency very difficult for SMEs ; generally their financing was limited to discounts and overdrafts.

However, the opening of international trade, the development of new financial products and the competition between banks for the SMEs market, have all led the banks to develop regional trading floors, dealing with smaller orders, and therefore accessible to medium-sized firms.

Merchant banks

These financial institutions have developed a lot since 1984, due to two factors :

1) deciding to profit from market deregulation, and aware of the necessity of reaching a certain size in order to compete in the European market, firms have increasingly sought after the services of merchant banks.

2) the banks, for their part, have been able to respond even more willingly as the regulations that govern their activities have been relaxed.

This has led to an increase in competition in the traditional merchant bank market, and from 11 in 1987, their number increased to 36 in 1989. In order to be able to offer a service specially targetted at firms, whilst distinguishing this from their traditional credit activity, certain large commercial banks have set up special merchant bank subsidiaries : this is the case with BNP, who has Banexi, Crédit Lyonnais with Clinvest and Crédit Agricole with Union d'Etudes et d'Investissements (UEI).

The business of merchant banking in its strictest sense (financial engineering and equity investment in firms) is never carried out alone, as the results are too uncertain. Instead, merchant banks carry out one or two other financial activities as well, such as the management of fortune and trading floor activities.

The intervention of a merchant bank can take one of several forms. The most common consists of a sale or purchase mandate. This type of advice relies mainly on the research and evaluation of targets, but can also include advice on financial engineering in order to optimise the legal and fiscal aspects of the deal. In addition, the banks' know-how in the field of stock market transactions means they are often called in to act as intermediaries for mergers & acquisitions of quoted firms. The wave of OPA (Offre Publique d'Achat - takeover bid) registered in the Stock Exchange during 1988 and 1989 therefore represented a not-inconsiderable source of commissions. The banks also profited from the RES/LBO (buy-out) boom by taking equity participations in purchased holdings.

The increased competition has led the merchant banks to offer more and more sophisticated financial products and to develop new financial engineering techniques, such as mezzanine financing (halfway between debt and traditional bank debt in buy-out operations), or a new technique which allows debts to be taken out of the firm's balance sheet. The recent market evolution can only accentuate these trends.

The sectors usually favoured by merchant banks are however starting to suffer : the American recession and the Gulf crisis have depressed the capital markets and slowed down transactions.

Three products of merchant banks :

1) Convertible bonds. On the subscriber's initiative, these bonds can be converted into shares in the issuing firm, according to the conditions established in the initial contract. This right can be exercised within a certain time period, but normally the bond is convertible at any time. The bond allows the issuing firm to be in debt and to increase its capital at the lowest possible cost, whilst the subscriber, for his part, limits his risks and benefits from a higher return than on normal shares.

2) Titres subordonnés à durée indéterminée (securities with an indefinite length). These particularly suit firms who, in order to raise long-term funds, can neither increase their debt nor proceed with a simple share issue, due to controls on their capital, or their currency being too weak. The TSDI reinforce the equity structure of the firm without changing its overall capital structure, and they provide a higher return to the subscriber.

3) Subscription note. When a firm issues shares or bonds, a subscription note allows it to postpone an increase in capital, whilst being able to collect the liquidities straight away.

Leasing

Leasing allows firms to finance their property needs. Over the past few years it has undergone a rapid development (annual growth rate 40%), accompanied by many new entrants into the market, and the appearance of new types of product, which are increasingly being targetted to SMEs. Many of the main commercial banks have set up special leasing subsidiaries (for example Crédit Agricole's Ucabail). The main actors are either specialists in the financing of firms, such as Crédit National, property agents like UFB Locabail, Sovac or Comptoir des Entrepreneurs, or "pure" leasing firms, which are either independent or linked to institutional investors.

Sources :

Le financement du développement des PME - Commissariat Général du Plan (1989)
Option Finance (April 1991)

III. FIRMS

Classification of firms :

<u>Size of firm</u>	<u>Number of employees</u>
Very small	0 - 10
Small	10 - 100
Medium	100 - 500
Large	over 500

In relation to all French firms, the small and medium sized firms (SMEs) account for :

- 99.9% of all firms
- 66.8% of all paid workers
- 57.8% of total turnover
- 53.6% of total production added value
- 44.8% of total investments
- 50.1% of total exports

Legal status :

The most common types of firm are :

- Public limited company (Société Anonyme - SA). There is a minimum capital which is divided into transferable shares. Each shareholder is responsible for the debts according to the number of shares he holds. It is managed either by a board of directors with its chairman, or by an executive board working under the control of a supervisory board. This form accounts for 2% of French SME, representing 48% of all paid workers.
- Limited liability company (Société à responsabilité limitée - SARL). The minimum capital is divided into parts, each partner is liable for the amount of his capital contribution. It accounts for 14% of the SME and 16% of total paid workers.
Since July 1985, French business law has recognised the creation of a limited liability firm with only one single partner, a EURL (entreprise unipersonnelle à responsabilité limitée).
- Partnership limited by shares (Société en commandite par actions - SCA). The capital is divided into shares, and there are two types of partner : the active partners (commandités) and the sleeping partners (commanditaires) who do not participate in the management of the firm and whose liability is limited to their capital contribution.
- General partnership (Société en nom collectif - SNC). No minimum capital is required. The partners are jointly and indefinitely liable for the partnership's debts.

Other recognised types of firm are :

- Joint venture (Société en participation). A joint venture can be civil or commercial, and is formed by a written agreement between parties that requires neither registration nor public notice.
- Civil company (Société civile). This company is empowered to take on civil (non-commercial) operations. The members are indefinitely liable for the firm's debts.

- Intercompany partnership (Groupement d'intérêt économique - GIE). This is a company form, part joint venture part private, designed to extend the business activity of its members. Members are liable for its debts.

Employees :

<u>Number of employees</u> (1988)	<u>Number of firms</u>	<u>Percentage</u>
0	1,251,354	52.7%
1 - 9	966,487	40.6%
10 - 19	78,482	3.3%
20 - 49	52,573	2.2%
50 - 99	15,451	0.6%
100 - 199	7,225	0.3%
200 - 499	4,055	0.2%
Total SME	<u>2,375,627</u>	<u>99.9%</u>
Over 500	2,222	0.1%
Total	<u>2,377,849</u>	<u>100.0%</u>

Sectors of activity :

SMEs account for 70.2% of all service industries and 35.8% of all industrial ones.

Sectors with high concentration (SMEs represent less than 35% of all firms) :

- energy (SMEs 10%)
- household goods (SMEs 10%)
- insurance (SMEs 27%)
- capital goods (SMEs 25%)
- intermediate goods (SMEs 29%)

Sectors with low concentration (SMEs represent more than 70% of all firms) :

- building (SMEs 76.5%)
- commerce (SMEs 81.4%)
- consumer goods (SMEs 69.7%)

Sectors with medium concentration (SME represent between 35% and 70% of all firms) :

- agriculture/food (SMEs 60.2%)
- transport and telecommunication (SMEs 40%)

Regional implantation :

The two regions where the SMEs carry the most weight are the Paris region (SMEs account for nearly 30% of total French SMEs) and the Rhône-Alpes region (10.2%).

Sources :

- Small business in Europe - Burns & Dewhurst (1986)
- Doing business in France - BDO (1991)
- Le financement du développement des PME - Commissariat Général du Plan (1989)
- M&A in the EC (Janvier 1990)
- Les PME en France - Etude du CEPME (1990)

IV. THE DEVELOPMENT OF INVESTMENT CAPITAL

The French investment capital market is currently the third worldwide (behind the United States and Great Britain) and the second in Europe. Like other "products", investment capital follows a traditional life cycle. Today in France it is entering into its third stage of development :

- the first stage began in 1955 with the creation of state-aided firms to help regional development (Sociétés de Développement Régional - SDR), and carried on until 1982, by which time there were 40 investment capital firms in France.
- the second stage (1983-1990) began with the creation of the Second Market. During this stage the investment capital business in France "exploded", with an annual growth rate of between 30% and 40%. Both the number of investment capital firms and the amounts invested increased rapidly, and by 1990 there were approximately 250 - 300 actors who had invested between 4 and 5 thousand million francs.
- 1991 should mark the start of the third stage, which will be characterised by a slowdown in growth and, more especially by a market concentration.

The rapid growth between 1983 and 1990 can be explained by a particularly favourable environment : on one hand a strong and healthy economy, on the other hand the tax rate on firms was reduced from 50% to 34% in 1991, which allowed investment capital firms to make large profits on their investments.

At the start of 1991, the environment is less favourable and therefore the investment capital business is becoming harder :

- a reduction of the tax rate of the same proportions over the coming years seems improbable.
- it is becoming increasingly difficult to raise capital for new investment funds, especially from institutional investors.
- there is a rapid slowdown in growth, and people are even talking of a recession. The stock market has already felt the effects of this deterioration and, since 1989, the number of new introductions of firms into the Second market has been halved (33 in 1989, 17 in 1990). This means that, whilst investors will need to realise their investments more quickly by means of stock market introductions, failures will also probably materialise more quickly. Investors will therefore need a strong financial strength in order to "weather the storm".
- large actors are showing proof of their desire to establish themselves in the market, and their position in the market is becoming increasingly significant. This is the case with banks, who see investment capital as a high quality activity which complements their traditional role as lenders.

As a result, the "specialists", that is those firms whose sole business is investment capital, are adopting two strategies : on one hand internationalisation, in order to establish a European network ; on the other hand regionalisation, which allows them to be close to local markets and to make up for their handicap in relation to the banks, for example, who have a huge network of agents.

The combination of these factors should lead to a large concentration of market shares. However there will always be a place for small, efficient, specialised structures.

<u>1988 - 1989</u>	<u>Growth rate</u>	<u>Average Europe</u>
Available funds	60%	34%
New funds raised	152%	67%
New investments	29%	24%

(Source : EVCA 1990)

The period 1988-1989 was characterised by an increase in average investment size, and increased syndication of financings, notably with domestic partners. Expansion and buy-out transactions totalled 75% of 1989 investment activity, whereas early stage investment (seed and start-up) actually decreased by 25%. Replacement investment also accounts for a significant proportion of French investment activity.

Investment activity in 1989 was concentrated mainly in the consumer related sector (23%), manufacturing (12%) and construction (10%). Investment in high technology sectors such as telecommunications, computers, electronics and biotechnology has declined, mainly due to the decline in interest in early stage investment.

There are three types of legal status for investment capital firms :

- Sociétés de Capital Risque (SCR)
- Fonds Commun de Placement à Risque (FCPR)
- Sociétés Financières d'Innovation (SFI). This last status is being phased out, the SFI progressively adopting the status of a SCR.

Some firms, such as 3i, Charterhouse, Elysée Investissements, prefer to adopt the status of a public limited company (Société Anonyme - SA), as it is less restrictive in terms of activity than the SCR or the FCPR.

The French fiscal environment is generally considered favourable to investment capital. Taxation of capital gains for the FCPR and SCR are 15% and 16% respectively. Taxation of investments in buy-outs (Reprise d'Entreprise par des Salariés - RES) is favourable both to employees, who can deduct interest on the borrowings, and to investors, who can exchange shares of the company against shares of the holding company without being taxed.

For 1991, the government is expected to announce two changes :

- a more simple legal status will be granted to the SCR
- the government will stop funding the secured lending activity of the Sociétés de Développement Régional, and will stress a more favourable environment in order to stimulate early stage investment.

Principal investment capital firms :

Independents :

- 3i
- Siparex
- LBO France
- Initiative et Finance
- Alan Patricof
- Alpha Associés (Group Advent)
- Baring Capital Investors
- Euroventures

Bank subsidiaries :

- Clinvest (Crédit Lyonnais)
- Banexi (Banque Nationale de Paris)
- Financière Saint Dominique (Crédit National)
- UEI (Crédit Agricole)

GERMANY

GERMANY

I. THE ECONOMY

1990	
GDP	660 billion pounds
GDP growth	4.2%
Trade surplus	437 billion pounds
Unemployment rate	5.0%
Inflation rate	3.0%
Employment growth	2.5%

With the effect of reunification and the creation of five new states in ex-East Germany, the German population has increased from 61 million to 78 million inhabitants, and the GDP from 2,400 to 2,700 billion DM. Germany now accounts for 30% of total Common Market GDP ; as much as Great Britain and Italy together.

The level of economic activity has progressed rapidly, production increasing at an annual rate of 7.5%. Thanks to this high level of activity, the rate of new employment continues to increase and the unemployment rate has once again fallen. In addition, firms still seem strong and dynamic and continue to invest.

The economy is at full capacity and there are therefore increased inflationary tendencies. Despite this however, the rate of inflation is still low and in 1990 the level of the Mark rose against the dollar. On the other hand productivity gains have been reduced due to the growing pressure on production capacities, and labour costs have risen sharply. Interest rates are also on an upward spiral.

Internal demand is still high, which has allowed producers to increase their profitability margins. External demand has, however, fallen sharply and the trade surplus is lower than for the same period in 1989. The level of exports has fallen (-26%) whilst imports have increased (+11%), mainly to cope with the huge needs of ex-East Germany. The trade surplus for unified Germany has been put at 110 billion DM for 1990, which represents a decrease of 22.7% compared with the surplus for West Germany alone in 1989.

There is a strong probability that reunification will mean enormous costs for Germany, who has to cope with the problems of setting up effective reconstruction programmes.

In ex-East Germany, the recession is worse than anticipated : unemployment is rising steadily (+18%), the level of industrial production has decreased by 50% and the country has debts of nearly 50 billion marks. In addition, whilst there is a huge need for new infrastructure, the anticipated budget scarcely covers the day to day expenditures.

The cost of aid to ex-East Germany has led to a deterioration in the financial situation : the large budget deficit in 1990 could reach 70 billion DM in 1991 with the costs of the Gulf war also taken into account. A deterioration of the trade balance is also expected.

In order to cover the costs of both reunification and the Gulf war, the government has been forced to raise taxes (VAT from 14% to 15%) and to reduce state subsidies. This increased tax rate will probably reduce household consumption, slowing down the economic growth. Germany seems thus to be at the start of a period of slowdown in her economic growth which seems likely to last for several years. Provisions for growth in 1991 are much lower than for 1990 (2.5 - 3%) and inflation is expected to rise.

Sources :

Perspectives Economiques de l'OCDE (December 1990)

Les Echos

M & A in the EC (January 1991)

II. THE BANKING SYSTEM

There are two main categories of banks :

1) Commercial banks (76% of total turnover). In Germany there is no distinction between clearing banks and merchant banks, and the commercial banks cover the whole range of financial activities : short and long term loans, deposits, stock market transactions, participations in the capital of firms.

2) Small specialised banks, who are limited by law to one particular activity, for example a savings bank or investment bank. Their activities are centered around property loans and loans to public collectivities. They provide long term credit for the financing of new property, for modernisation and for industrial and agricultural investments.

Central Bank	Deutsche Bundesbank
National commercial banks	Deutsche Bank Dresdner Bank Commerzbank and their three subsidiaries, separate legal entities.
Regional commercial banks	Bayerische Hypotheken und WechselBank Bayerische Vereinsbank Norddeutsche Hypotheken und WechselBank
Public specialised banks	Ausfuhrkredit (medium and long term financing of exports) Kreditanstalt für Wiederaufbau (loans for investment and exports) Deutsche Ausgleichsbank (financial support to the economy and to SME)
Private specialised banks	Privatdiskont (private discounts for the financing of foreign trade) Industriekreditbank (medium and long term financing for firms)

The Federal Republic of Germany is therefore completely covered by a network of numerous financial establishments which are either public or state-supported. In 1986, approximately 1,030 billion DM were assigned to help finance firms. The level of debt in relation to the total balance sheet lies at 17.6%, whilst the level of equity is only 24% of the total balance sheet.

However the level of self-financing for German firms is very high : 84%.

Short-term credit (less than 3 months) :

Represents approximately 60% of total loans. In terms of volume, an overdraft in a current account remains the most common source of short-term loans. The rate of interest for this is sometimes determined by a level set by the central bank, but it is mainly set independently.

The activity of discounting bills of exchange is frequently used, whilst factoring is used much less.

Medium-term credit (3 months to 4 years) :

Often used as a substitute for long-term loans which are difficult to obtain.

Long-term credit (more than 4 years) :

Financial promissory notes (IOUs) are used as a back-up to long-term loans. They allow financial institutions, such as insurance companies to invest through a bank intermediary. The banks therefore act as intermediary between these financial institutions and firms. Long-term financing of exports is assured by the Ausfuhrkredit or the Kreditanstalt für Wiederaufbau.

Mortgage banks and national savings banks provide mortgage loans to finance firms' plant and equipment.

In addition, banks carry out leasing operations through specialised subsidiaries.

Credits are given at a rate which is on average 1 or 2 points lower than the market price. Recently these credits have increasingly been assigned to SMEs for creation, reinforcement of their equity capital, innovation or as a "safety net" in case of threatened bankruptcy.

At the end of the second world war, two state banks were set up with the specific aim of financing the reconstruction of firms that had been destroyed, and the creation of new ones. Today, these banks are increasingly given over to the financial support of SMEs, granting special rate credits which they themselves subsidise. These banks are :

1) Kreditanstalt für Wiederaufbau (credit institution for reconstruction). Initially set up as a central credit institution for the reconstruction of the economy, it acts today as a national investment bank, a bank for external trade and a bank which gives financial support to the development of SMEs.

2) Deutsche Ausgleichsbank (German standardisation/equalisation bank). Central credit institution which acts as a support to the economy and especially for the financing of SMEs.

The German banks have for a long time had close links with firms, not only as sources of credit but also as shareholders. They hold an important portfolio of industrial shares. In addition they can use the voting rights of individuals depositing their shares at their counters if these individuals authorise them to vote for them at firms' board meetings. As individual shareholders often side with the banks, the banks therefore have access to nearly 60% of total shares. The three largest banks, for example, hold 21% of total German shares. Because of these privileged links, the banks play an important role in the shaping of the industrial tissue, and public takeovers are therefore rare.

Access of SMEs to the trading rooms :

Concerning the trading rooms, a three strata system has existed for a long time, which means that daily transactions are completely decentralised.

To conduct an transaction in a foreign currency, the SME clients of the Deutsche Bank (leading German bank) meet with the person in charge of their account : thanks to the computer system installed in the bank, an exchange rate can immediately be proposed to them, identical throughout Germany. If the firm needs advice about a certain transaction, they can enquire at special bank subsidiaries to be found in large towns (there are

currently around 20 throughout Germany), or they can meet with a foreign exchange specialist.

Special transactions are carried out in one of the three national trading rooms. This system, although rather rigid, satisfies everyone. It is true though that competition between banks to obtain firms as clients is less fierce than in other European countries (England, France for example), due to the often frequent financial links between banks and firms.

Sources :

Le financement du développement des PME - Commissariat Général du Plan (1989)
Les petites et moyennes entreprises - Institut d'études bancaires et financières (1989)
Les Echos (1991)

III. FIRMS

The German federal government uses the following firm classification proposed by the Institute of Research on SMEs :

<u>Firm size</u>	<u>No of Employees</u>	<u>Turnover</u>
small	0 - 49	0 - 1 million DM
medium	50 - 499	1 - 100 million DM
large	over 500	over 100 million DM

In 1987, the SMEs accounted for :

- 99.8% of all German firms
- 55% of total sales
- 41% of gross national investment
- 64% of total employment
- 49% of total GDP
- 50% of total German turnover

Legal status :

German law defines four major types of firm :

1) Offene Handelsgesellschaft (OHG) : a personal firm who has no separate legal personality but operates with a certain legal capacity.

2) Komanditgesellschaft (KG) : a personal firm with no legal personality. The business of the firm is carried out by the active partners, who are entirely responsible for the firm's liabilities. They are supported by the sleeping partners, whose responsibility is limited in principal to the amount they hold in the firm.

There are other types of KG, for example one where at least one of the active partners is a public firm (AG & Co. KG), and another which is ranked alongside a capital firm (KGa.A.). Many national and even international German firms have the legal status KG.

3) Gesellschaft mit beschränkter Haftung (GmbH) : medium sized firms often use this status, equivalent to a limited liability firm (Ltd) in England. In Germany there are approximately 375,000.

4) Aktiengesellschaft (AG) : status mainly used for very large firms, equivalent to a public limited company (plc) in England. There are approximately 2,370.

Up to 50% of the capital of an AG can be made up of shares with non-voting rights.

Only the AG and the KGa.A. are authorised to be quoted on the Stock Market : today there are approximately 590 quoted German firms, a much lower percentage than in England or France.

Publication of accounts :

"Personal" firms (OHG, KG, CoKG) and limited liability firms (GmbH) are under no obligation to publish accounts.

"Capital" firms are divided into three categories (small, medium and large) and, starting from a certain size are obliged to publish accounts. These accounts consist of a balance sheet, results for the financial year, and sometimes the state of stocks. They are either deposited at the Chamber of Commerce or are published in an official journal (Bundesanzeiger).

This means :

- a total lack of financial information on personal firms, of which there are many, some of considerable size.
- often no possibility of getting hold of information, as even if the accounts are not supplied there is no legal sanction, unless the demand for information comes from a partner, a creditor or the works council.

Taxation of firms :

Tax on revenue - applies to individuals, individual operating companies and individuals who hold a participation in a personal firm. Because personal firms in Germany have no legal or fiscal personality, the partner is taxed directly on the share of the benefits he receives, according to the appropriate tax rate. The tax rate on revenue varies progressively between 19% and 53%.

Tax on firms - applies to the capital firms (GmbH, AG and KGaA.). The tax rate is 50% for non-distributed dividends and 36% for distributed dividends.

Size of firms :

<u>No of employees</u>	<u>No of firms</u>	<u>Percentage</u>
1 - 9	1,654,491	85.56%
10 - 19	145,247	7.51%
20 - 49	82,202	4.25%
50 - 99	26,309	1.36%
100 - 499	21,135	1.09%
Over 500	4,300	0.22%
Total	1,933,684	100.00%

Evolution in the number of employees over the period 1977-1987 :

<u>Size in 1977</u>	<u>1987</u>
1 - 19	+ 24.0%
20 - 99	+ 5.6%
100 - 499	+ 1.7%
Over 500	- 6.1%

Sectors of activity :

<u>Sector</u>	<u>Percentage of SMEs</u>
Services	36.5%
Craft	28.7%
Professional	19.3%
Commercial	10.3%
Industrial	5.2% (highly concentrated)

Sources :

Le cadre juridique et fiscal des acquisitions d'entreprises en Allemagne (1990)

Allemagne : Acquérir à l'Ouest (1990)

Le financement du développement des PME - Commissariat Général du Plan (1989)

Les petites et moyennes entreprises - Institut d'études bancaires et financières (1989)

Small business in Europe - Burns and Dewhurst (1986)

IV. THE DEVELOPMENT OF INVESTMENT CAPITAL

The German investment capital market is still fairly underdeveloped when compared to its counterparts in other major European countries, given the size of the national economy. Several factors explain this slow development :

- 1) The dominant position of the commercial banks in all aspects of business financing.
- 2) The lack of an equity tradition in the capital structure of German companies, entrepreneurs are naturally suspicious of external partners because of their fear of losing control of their firm.
- 3) A low level of mergers and acquisitions activity.
- 4) High salary levels in the public sector which dampen enthusiasm for entrepreneurial risk taking.
- 5) A broadly unfavourable fiscal environment both for entrepreneurs and for investment capital firms. Apart from the legislation introduced in early 1987 which gave authorisation to the UBG (investment capital firms), giving them a slightly more favourable tax status than other types of investment firm, there have been no government incentive schemes designed specifically to promote investment capital in Germany. At the end of 1989, a fiscal reform was passed which increased the tax on capital gains. Previously capital gains were taxed at half the normal rate, but starting from January 1990, only the first 30 million DM of capital gains benefitted from this, the remainder being taxed at the normal rate (56%), which is among the highest in Europe.
- 6) The absence of an active secondary market. The secondary market (Geregelter Markt) was created in May 1987 and works alongside the main stock market (Amtlicher Handel) and the Unlisted Securities Market (Telefonverkehr). However the prospects of achieving an exit through the flotation of a portfolio company on the German stock market are poor. Although the secondary market does exist, there is very little liquidity and the number of quoted companies is small. Moreover, the major German banks almost completely dominate the bringing of companies to the stock market, and they tend not to float firms which are externally funded. Trade sales therefore continue to represent the primary exit option for many German investors.

Despite these constraints, the investment capital industry is now showing significant growth. This has come from existing German investment capital organisations, from new foreign entrants and through bank affiliates.

<u>1988 - 1989</u>	<u>Growth</u>	<u>Average Europe</u>
Available funds	35%	34%
New funds raised	56%	67%
New investments	121%	24%

(Source : EVCA 1990)

An equivalent to the British Venture Capital Association was created in 1989 : Bundesverband deutscher Kapitalbeteiligungsgesellschaft (BVK), to represent the interests of all investment capital firms.

In terms of the amount invested, activity in 1989 continued to be heavily focused on the provision of expansion capital (40% of total). The buy-out activity increased rapidly and by the end of 1989 accounted for 41% of total investments. Seed and start-up investments fell to 26% of the number of investments, but did increase to 19% of the total amount invested.

Technology related businesses account for a high proportion of investment capital activity in Germany. In 1989, investments in computer related, communications, electronics and biotechnology firms accounted for 77% of total investment amount.

The German investment capital industry divides broadly into three main categories :

- 1) Unternehmensbeteiligungsgesellschaften (UBG). These are independent firms, tending to adopt an active approach to investing, emphasising "added value" to their portfolio companies. There are approximately 15 such firms.
- 2) Kapitalbeteiligungsgesellschaften (KBG). Traditional equity participation companies, many of which are bank related, and who have for many years been providing equity capital to SMEs as passive investors. There are currently about 60 KBG.
- 3) large diversified corporate finance/asset management houses, such as the Matuschka group, who conduct significant development capital operations.

However, it is the banks who continue to carry out the majority of equity transactions.

Principal investment capital groups :

	<u>Funds managed</u> <u>(million DM)</u>	<u>Portfolio</u> <u>(no of firms)</u>
1) <u>Bank subsidiaries :</u>		
Deutsche Beteiligungsgesellschaft	306	92
2) <u>Independents :</u>		
Matuschka Gruppe	na	178
Technico Venture Management GmbH	270	50
Genes GmbH Venture Services	104	30
Neu-Europa HiTec & Biotec	77	32

Sources :

1990 EVCA Handbook

Le Capital Risque en Europe - Eurostaf (1989)

Le cadre juridique et fiscal des acquisitions d'entreprises en Allemagne (1990)

ITALY

ITALY

I. THE ECONOMY

1990	
GDP	475 billion pounds
Growth of GDP	2.6%
Unemployment rate	11.1%
Trade deficit	5 billion pounds
Inflation	6.3%
Employment growth	1.5%

In 1990, there was a slowdown in GDP growth (growth rate in 1989 was 3.2%). However, over the last decade the economy has grown steadily stronger, mainly due to the vast network of dynamic and innovative SMEs.

Internal demand and consumption are increasing rapidly, due to the growth in employment. However, consumption only grew by 2.5% in 1990, compared with the 3.8% recorded for 1989.

In spite of the Gulf crisis, which has led to predictions of lower supply and demand, and which has increased social tensions, firms are still continuing to recruit new staff, and unemployment is thus falling continuously. However, the level of unemployment remains very high, and there has been a sharp drop in workforce in the largest industrial firms.

1990 was characterised by a continual slowdown in industrial production, which meant a negative industrial growth : the industrial productivity index for 1990 showed a drop of 0.1% compared with 1989. However, firms have continued to work at nearly full capacity, which has led them to modernise their equipment and invest in new machines and materials.

Wage costs and retail prices are on the increase, leading to an increase in inflation and weakening the competitiveness of the economy. The high interest rate also constitutes a handicap for firms, even if the reduction in the bank lending rate has meant a slight reprisal.

There has been a decrease in competitiveness, and the level of imports have risen sharply. Exports however, stimulated by the increase in world demand, increased by 5.6% for 1990, leading to a reduction in the trade deficit.

The budget deficit increased by 5.8% compared to 1989. This increase, together with the reduction in the savings rate, makes Italy increasingly dependant on external sources of capital.

The Gulf crisis led to a sharp slowdown in household consumption at the beginning of 1991. The country now finds itself in a semi-recession, and predictions for growth for 1991 are only about 1.5% to 2%. However as a whole, it is much better armed than ten years ago to face up to this more difficult economic environment.

Sources :

Perspectives Economiques de l'OCDE (Décembre 1990)
Les Echos (1991)
Science et Vie Economique (Février 1991)

II. THE BANKING SYSTEM

Central bank	The Bank of Italy
Public banks	Banca Nazionale del Lavoro (number 1) Istituto Bancario San Paolo di Torino (2) Monte dei Paschi di Siena (3) Banco di Napoli (5) Banco di Sicilia (9) Banco di Sardegna
National interest banks	Banca Commerciale Italiana (4) Banca di Roma (6) Credito Italiano (8)
Ordinary banks (most important)	Banca Nazionale dell'Agricoltura Banco di Santo Spirito Banco Ambrosiano Banco Toscana
Cooperative banks (most important)	Banco Popolare di Novara Banco Popolare di Milano
National Savings Banks (most important)	Cassa di Risparmio delle Province Lombarde (7) Cassa di Risparmio di Torino Cassa di Risparmio VE per le Province Siciliane Cassa di Risparmio di Roma
Public legal establishments	Artigiancassa Mediocredito Centrale Istituto Mobiliare Italiano

Within the Italian banking system there are many groups with a wide range of activities. However only about a dozen of them are of significant national or international size.

The state plays an important role, indirectly or directly controlling two-thirds of the credit market. The Istituto per la Ricostruzione Industriale (Institute for industrial reconstruction - IRI) was set up several years ago to give credit support to firms. Today it acts as intermediary between the state and firms.

The level of debt of Italian firms accounts for 13.3% of their total balance sheet, and equity for 27.2%. Their self-financing level is only 63%, which signifies a fairly strong dependence on the banking system.

There has always existed a separation between short-term and medium-term credit. Initially the banking system was fairly specialised: the clearing banks gave short-term credit whilst the specialised establishments gave medium-term and long-term credit. But today there is an increasing trend towards generalisation, and the clearing banks control nearly 30% of the medium-term credit market.

Short-term credit groups :

Previously, they were only entitled to deal with loans of less than 18 months. However, this rule was somewhat relaxed in 1972, and even more in 1987, with the authorisation for these groups to increase their medium-term credit operations.

1) Public banks : held by the state and other public bodies, their main activity is that of credit/deposit through a network of local agencies. Some of them, in addition, have participations in medium and long-term credit organisations. They account for 23% of the total credit market and 19% of deposits (1985).

2) National interest banks : private firms, quoted in the stock market. Their main shareholder is the IRI. They represent 13% of total credit and 24% of total deposits.

3) Ordinary banks : there are more than 125 of these banks, which are similar in size and legal status. The majority of them are private. As their main activity is credit/deposit, they are in direct competition with the public banks. They account for 14% of total credit and 10% of deposits.

4) Cooperative banks : their activity is no different from that of the other banks, except that they work as a cooperative. 8% of all credits, 17% of all deposits.

5) National savings banks : the most densely implanted network. They have independent sections which are specialised in the medium-term financing of SMEs. 17% of all credits, 29% of deposits.

6) Rural/craft banks : operate at local town or village level, giving credit to farmers and craftsmen. They have reduced financial means and infrastructure.

Financial establishments specialised in medium and long-term credit :

It is via certain of these groups that the state intervenes in the economy : it supports the creation and development of SMEs by giving loans and subsidies at reduced rates. These establishments are mainly public legal groups, whose role is to subsidise the banks to finance SMEs.

1) Artigiancassa : by its refinancing operations, it enables banks to give credits to craftsmen in order to finance investments, creation, development etc. Its main activity is to ensure that medium-term credits at a special rate are given to craftsmen. In order to do this, it manages a special fund, subsidised by the state.

The amount of special rate credits to which craftsmen are entitled is limited to 180 million liras.

In 1988, the volume of the Artigiancassa's operations totalled nearly 500 billion liras, which led to investments of 6,500 billion liras and the creation of 66,500 jobs.

2) Mediocredito Centrale : its role is also to give banks the resources necessary to enable them to finance the investments of SMEs. It gives special rate credits to promote exports, as well as credit to finance internal purchases. It also manages a state fund, which gives bank credit to SMEs. In addition, it has set up two investment capital firms, but their activity remains fairly modest.

3) Istituto Mobiliare Italiano : acts as a merchant bank to promote industrial development. Most of its participations are in large industries, but it also tries to respond to the SMEs financial needs in which area it is in strong competition with certain regional groups.

The state controls the majority of the group, together with several banks and insurance groups. It controls nearly a quarter of the medium-term credit market.

Merchant banks give advice and assistance to firms in financial matters, and sometimes organise the financing of firms as well.

A new project has just been announced by the IRI : the creation of a bank to help the development of southern Italy - Mediobanca del Sud.

Sources :

Le financement du développement des PME - Commissariat Général du Plan (1989)

Science et Vie Economique (Février 1989)

M&A in the EEC (Janvier 1990)

III. FIRMS

Firms in Italy have two particular characteristics. Firstly, the state controls a large part of the economy by means of a large number of institutions, who do not necessarily adopt the traditional legal status of a firm, but who are controlled to different degrees by legal administration. This is the case, not only of certain holdings such as the IRI, but also of many of the leading banks.

Secondly, many large private groups have more or less succeeded in ensuring their control by means of informal or formal alliances, including share swaps or exchanging representation on boards of directors. In addition, several members of families who control large groups of firms have resurrected the legal statut Société en commandite par actions (partnership limited by shares), which for a long time was rarely used. The aim of this is to avoid a weakening of control of the firm, in the case of death, for example, or a loss of control for any other reason. The control of huge firms is thus in the hands of a very few number of people.

<u>Size</u>	<u>Number of employees</u>
Mini	1 - 19
Small	20 - 99
Medium	100 - 499
Large	over 500

The SMEs account for 90% of all industrial firms, and employ 83.4% of total employees.

In Italy, a family firm is defined by the direct participation of the entrepreneur and his family in the production process, as well as by the fact that the firm employs no more than 40 people.

Legal status :

Italian law allows for a large number of types of business, whether they take the legal form of a firm or not. These range from firms with one sole person through to large limited companies, including general and limited partnerships. The most common legal status for larger firms are the Società per Azione (SpA), which corresponds to a public limited company, and the Società a responsabilità limitata (Srl), a limited liability company.

Distribution by sector of activity :

<u>Sector</u>	<u>1 - 19</u>	<u>20 - 99</u>	<u>100 - 499</u>	<u>over 500</u>
Electricity/gas	15.8%	28.7%	34.6%	20.9%
Manufacturing	35.2%	23.7%	21.3%	19.8%
Construction	73.1%	20.2%	6.1%	0.6%
Total industry	41.0%	23.3%	19.1%	16.6%

(Source : Istituto Centrale di Statistica (ISTAT), Censimento Industriale, 1981)

Distribution by region :

<u>Region</u>	<u>Number of employees</u>			
	<u>1 - 19</u>	<u>20 - 99</u>	<u>100 - 499</u>	<u>over 500</u>
North West	35.8%	41.9%	48.2%	52.8%
North East	25.7%	26.9%	25.6%	15.1%
Centre	21.7%	19.3%	14.8%	14.4%
South	16.8%	11.9%	11.4%	17.7%

(Source : ISTAT, Censimento Industriale, 1981)

Evolution in the number of employees 1971-1981 :

<u>Number of employees</u>	<u>% change</u>
1 - 2	+13.6%
3 - 5	+27.3%
6 - 9	+47.7%
10 - 19	+60.0%
20 - 49	+17.1%
50 - 59	+ 4.6%
100 - 199	+ 8.1%
200 - 499	- 2.1%
500 - 999	+ 1.3%
Over 1,000	- 9.9%

(Source : ISTAT, Censimento Industriale, 1981)

Sources :

M&A in the EEC (January 1990)

Le financement du développement des PME - Commissariat Général du Plan (1989)

IV. THE DEVELOPMENT OF INVESTMENT CAPITAL

The Italian investment capital market has undergone rapid growth over the last few years, especially among foreign investors.

The dynamism of the economy, especially the SMEs, coupled with the traditional entrepreneurialism and the new demographic trends (increase in creations and transmissions of firms), all mean that the investment capital market has an enormous growth potential.

The strength of established financial institutions has contributed to a competitive structure, in which investment capital activity is dominated by bank-affiliated organisations. New legislation introduced in 1987 authorised banks to make investments in firms and, since this date they have constituted the largest single source of funds for investment capital. The role of the state is also important, especially its interventions in favour of SMEs in underdeveloped regions like the South. Investors in the South are given special fiscal incentives.

<u>1988 - 1989</u>	<u>Growth rate</u>	<u>Average Europe</u>
Available funds	29%	34%
New funds	-3%	67%
New investments	54%	24%

Development capital transactions are the most common. However, "start-up" investments also increased considerably in 1989. The size of MBO/transmission operations remains, for the moment, relatively small, but is likely to increase as many managers of SMEs are approaching retirement age and there is a growing need for help in management of succession.

The majority of investments are in the consumer goods (23.2%) and services (30.5%) sectors, which constitute the strong points of the economy. However, investment in high technology, such as electronics, computers and biotechnology is also increasing rapidly, due to the increase in start-up activity. Investment in manufacturing and industrial sectors has decreased sharply.

Two principal factors hinder the growth of capital investment in Italy :

1) The financial markets remain highly regulated, in spite of the removal of currency controls.

The national investment capital association (AIFI) was set up in 1986. It has demanded a more favourable fiscal environment for investment capital, notably with a reform of investment restrictions and taxes on capital gains. To date their efforts have produced little in the way of concrete legislative changes, but there is hope that increased European integration and interest from foreign investors will spur the authorities into action.

2) Neither the principal stock exchange nor the secondary market present significant opportunities for flotation. Despite the reform of the secondary market in 1987, the number of listed companies remains small, consisting largely of bank shares. In addition, the number of shares that can be quoted on the stock market can only represent 50% of the total assets of the firm.

The difficulties in finding an exit route have led investors to adopt a "hands on" strategy towards their investees.

Investment is nearly all directed at the domestic market, but 1989 saw the first significant volume of investment abroad (22%, exclusively in Europe). Such investments are usually undertaken as part of a transnational syndicate.

Main capital investment firms :

	<u>Funds managed</u> <u>(milliard lires)</u>	<u>Portfolio</u> <u>(number of firms)</u>
1) <u>Bank subsidiaries :</u>		
Credipar SpA	130	8
2) <u>State controlled :</u>		
Friulia SpA	403	162
SPI Promozione E Sviluppo Imprenditoriale	200	82
3) <u>Independent groups :</u>		
Iniziativa SpA	na	na
Invest SpA	180	17
Societa Finanziaria di Partecipazione	83	29

Sources :
1990 EVCA Handbook
Le Capital Risque en Europe - Eurostaf (1989)

SPAIN

SPAIN

I. THE ECONOMY

1990	
GDP	207 billion pounds
GDP growth	3.5%
Unemployment rate	16.2%
Budget deficit	na
Inflation	6.5%
Employment growth	2.4%

GDP growth fell to 3.5% in 1990 compared with an average of 4.7% since 1986. In 1989, the performance of the Spanish economy was the best of all the countries in the EC.

In 1989, in order to slow down demand and the growth of an overheated economy, the government put a series of austere economic policies into operation, notably the tightening of monetary policy. The effect of these policies was that internal demand fell sharply, leading to a reduction in the growth of imports. In spite of an increase in costs, growth of exports was higher than for imports, thanks to a reduction of pressures on demand and to increased economic capacity. As a result, the upward tendency of the trade deficit stopped, although it still remains very high. In addition, there has been a marked decrease in revenues from tourism.

Besides this slowdown, the economy is still faced with persistent inflationary pressures, due to an increase in wage costs which hinders competitiveness. It is also hindered by high interest rates. At the start of 1991, inflation increased sharply (+1.2%), but this is due to a combination of exceptional factors, notably the increase in the price of electricity and rent of public housing. However, faced with the expected recovery of productivity levels, wage costs should come down and eventually lead to a reduction in inflation. In addition, the peseta seems to be maintaining its strong position in the EMS.

The level of unemployment remains one of the highest in Europe, but the creation of new jobs is also increasing thanks to real industrial expansion. Firms however seem to have stopped investing due to the uncertain "wait-and-see" climate as a result of the Gulf crisis.

Predictions of GDP growth for 1991 have recently been put at 2.5%. At the start of 1991, unemployment has begun to rise again, and the trade deficit has also increased, whilst the budget deficit has decreased slightly.

Sources :

Perspectives Economiques de l'OCDE (December 1990)
Problèmes Economiques (January 1991)
Les Echos (1991)

II. THE BANKING SYSTEM

Central Bank	Banco d'Espana
Private commercial banks	Banco Central (number 1) Banco Hispano Americano (2) Banco Espanol de Crédito (4) Banco Bilbao Viscaya Banco de Santander Banco Exterior Banco Popular Banco de Sabadell
National savings banks	Caixa de Depositos (3) Caja de Madrid Caixa de Barcelona
Official credit institutions	Banco de Crédito Industrial Banco de Crédito Agrícola Banco Hipotecario de Espana Banco de Crédito local

The Spanish banking system is made up of four types of institutions :

1) Private commercial banks : since 1973 their activity has been of a general nature, and they offer the whole range of financial services to firms and to the public. They receive 50% of all deposits, and give 62% of the total number of credits.

Banco Exterior, in which the state holds a majority share, specialises in the financing of exports. Banco de Sabadell is specially geared towards a clientele of SMEs. Banco Bilbao Viscaya has a real industrial role, having significant shares in a number of the country's large firms. It intends to regroup all of its industrial participations by sector of activity, thereby creating huge corporations which it will manage collectively.

2) National savings banks : private, but mainly non-profit making. Their importance in the banking sector has increased significantly; since 1977 they have been authorised to carry out nearly all banking operations, with the result that they are now formidable competitors of the commercial banks. They currently receive 45% of all deposits, and provide 35% of all credits.

3) Official credit institutions : completely nationalised, their role is to give medium and long term credit at a special rate to firms, alongside the government's economic policy. They are controlled by ICO (Official credit institute).

- Banco de Crédito Industrial : specialised in the financing, at a preferential rate, of priority sectors. In 1987, it gave about 5.4 milliard pesetas of credit to SMEs.
- Banco de Crédito Agrícola : gives credit exclusively to farmers and agricultural/farm produce firms to finance construction and purchase of land and equipment.
- Banco Hipotecario de Espana : specialised in the financing of housing and construction, notably in the tourism and hotel trades.
- Banco de Crédito local : official financing body of local authorities.

4) Credit cooperatives : act uniquely for the cooperative sector, notably agriculture. Receive 5% of all deposits and give 3% of total credits.

In Spain, a great importance is given to the financing of firms by financial institutions - every financial body is expected to ensure the distribution of credit to SMEs under privileged conditions, and each give a part of their budget over to subsidising SMEs. Some have even created specific financing bodies and set up privileged financing mechanisms specially designed for SMEs.

In terms of financing of SMEs, the Banco de Crédito Industrial is the most active.

In 1987, the total amount of credit given to firms by the banking sector was about 21,993 milliard pesetas.

As a result, the level of debt of Spanish firms relative to their total balance sheet is fairly high (17.2%). Equity represents 35.6% of total balance sheet. The level of self-financing is 77%.

Short-term credit (up to 18 months) :

Bank overdrafts hardly exist. Instead, the substitute is a "poliza de credito", a contract of the loan, signed in the presence of a stockbroker or lawyer, and in which the credit conditions are rigorously set out. The firm can either receive the total amount of credit straight away and keep it until the repayment date, or can use it as and when it needs to. Firms also use trade discounts (bill of exchange, IOU) and treasury bills (especially large firms).

Medium term (18-36 months) and long term credit :

They are only given on authorisation from the Bank of Spain. For an amount up to 1,500 million pesetas, no preliminary authorisation is required, but the credit conditions must be communicated to the Bank of Spain 15 days before the conclusion of the deal.

The main types of credit provided by private banks are the following :

- credit for the financing of investments
- credit for the sale and purchase of capital goods
- credit for construction
- credit for imports and exports

For a firm to be allowed to take advantage of a special SME loan, it must fulfil one of the following criteria :

- 1) net capital assets not exceeding 200 million pesetas
- 2) number of employees not exceeding 100
- 3) no more than a third of its capital held by a large firm.

In addition, the proposed development project must lead to the realisation of at least one of the following objectives :

- creation of new jobs
- development of export activity
- technological innovation.

The size of Spanish banks is very small : the banking sector is only between the 15th and 20th biggest European sector, and the 50th worldwide. In order to prepare better for the liberalisation of capital markets and the competition from Europe that will follow, the Spanish government has decided to merge all six state-owned banks into one large firm, the Corporation bancaria de Espana (CBE). From now on, the Banco Exterior, the post office bank and the four national credit institutions controlled by ICO will constitute one single holding. This does not yet constitute a merger, except in the case of Banco Exterior and Crédito Industrial, but this is expected to follow in the future.

This Spanish "megabank" will be the most important in Spain, with net assets of more than 86 milliard pesetas. However, it will only control 12% of the Spanish credit market.

The government hopes the private banks will follow suit so that they will be able to face European competition at the time of liberalisation of the movement of capital in 1992.

Sources :

Le financement et développement des PME - Commissariat Général du Plan (1989)

Problèmes Economiques (January 1991)

Le Figaro (May 1991)

III. THE DEVELOPMENT OF INVESTMENT CAPITAL

Investment capital only began in Spain in 1983/84, so it is therefore in the relatively early stages of development.

Spain's entry into the EC in 1986 led to a restructuring of the national economy in order to catch up on its delay and become more competitive. This new dynamism and buoyant economic conditions have meant a significant growth of investment capital over the past few years.

The industry remains dominated by the banks. In addition, certain state-owned bodies with a strong focus on regional development play an important role. There are two types of these public sector organisations :

- les SODI (Sociedades de Desarrollo Industrial)
- les SCRIAS (Sociedades de Capital-Riesgo promovidas por las Comunidades Autonomas).

Of the new funds raised in 1989, 42% were provided by the state, 28% by the banks, and only 16% by corporate investors.

The law of March 1986 on investment capital defined two main types of organisation :

- investment capital firms with the legal status Société Anonyme (SA), equivalent of a public limited company
- special investment funds with the main activity being capital investment

These two types of organisation were set up with the aim of promoting innovative high technology firms with a high growth potential, by taking temporary participations in their capital. In the aim of promoting SMEs, 75% of the total assets of these organisations must be invested in firms who are not quoted on the official stock market.

Distribution between sectors of activity (1989) :

Creation/Start-up : 35% of total amount invested, 52% of total companies financed.

Development/expansion : 36% of amount invested, 25% of number of investments.

MBO/MBI : 23% of total investments.

The buy out market is still in its early stages. Although there are a number of privately owned companies, the current economic and fiscal environment is not generally favourable to buy-outs in Spain. Spanish companies tend to be highly geared, and thus have relatively weak balance sheets from which to launch a buy-out. High interest rates are also a deterrent.

<u>1988-89</u>	<u>Growth</u>	<u>Average Europe</u>
Available funds	22%	34%
New funds	-27%	67%
New investments	- 8%	24%

(Source : EVCA 1990)