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Public provision of sales contingent claims backed finance to SMEs: A policy alternative

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Abstract

In Europe (and elsewhere) governments intervene to stimulate innovation in the SME sector, and because SMEs face financial constraints in particular, governments encourage the provision of debt and equity (venture capital) finance to such firms. This paper discusses sales contingent claim (SCC) backed finance – funding secured only on a claim written on sales – that offers a different repayment profile to debt and equity. The attractiveness of such finance to firms as well as the behaviour of firms financed in this way are analysed. For various reasons SCC-backed financial instruments are generally not available to SMEs on the market, but it is argued that wider availability could further stimulate the growth and innovative activity of SMEs. The correction of this market incompleteness by the introduction of government schemes providing SCC-backed corporate finance for SMEs in higher risk (higher tech) sectors is recommended. The workability of such a scheme is explored by looking at existing examples aimed largely at project finance for larger firms.

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1. Introduction

There has for many years been a desire in Europe to improve the innovation performance of economies in general and the SME sector in particular. A special area of concern has been the availability of finance for SMEs both for innovation and investment more generally. Despite many changes over the last 10 years in the European financial environment there is no evidence that the findings of Hall's (2002) survey are less apposite today, viz. that:

(i) there are financial constraints to investment and innovation in Europe,
(ii) small firms are more likely to be financially constrained in their innovative activity,
(iii) firms (especially small and start-up firms) in R&D-intensive industries face a higher, pooling equilibrium cost of capital, and
(iv) the evidence for a financing gap for large and established firms is harder to establish.

It is still reasonable to conclude that in Europe, the innovative activity of small and medium enterprises is

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constrained by financial factors and that this problem is widespread despite the diversity and heterogeneity of member states' national innovation systems (Nelson, 1993).

Over the years, policy interventions intended to address these financial constraints have included tax subsidies for R&D, other SME-favourable tax schemes and public finance for innovative projects. Yet two policies in particular are especially relevant: (i) finance guarantees for SMEs and (ii) support for greater provision of venture capital. The purpose of both has been to make finance either cheaper or more readily available to SMEs. The former is exemplified by a scheme operated by the European Investment Fund where "loan guarantees support enterprises with growth potential with up to 1000 employees".[1] With regard to the latter (venture capital), both national and EU-wide initiatives have been implemented over a number of years to encourage the development of a larger early-stage venture capital industry (OECD, 1997). Despite the potential benefits of loan guarantee schemes and the stimulation of venture capital, it is argued here that there is an alternative policy instrument that has properties in particular contexts that make it at least as appealing as either of these initiatives and thus may be a valuable component of a portfolio of policy instruments. This instrument involves a class of funding that we label sales contingent claims (SCCs).

The prime example of an SCC-based scheme is the provision of Launch Aid to support innovation in civil aerospace manufacturing in a number of different European countries (although for a wider viewpoint see Chapman, 2006). The essence of this paper is to argue that such a policy may usefully and justifiably be extended to smaller companies – SMEs – to support their innovative activity. It might seem that this is not the most apposite time to make this argument when the US and Europe, in the context of competition between Boeing and Airbus, are continuing to argue over whether Launch Aid is a subsidy or not. It is our view however that the existing literature has tended to ignore the theoretical foundations as to how SCCs work, why they are not generally available on the markets, why governments provide them, and how one may judge whether they involve subsidy. In addition certain European countries are currently beginning to consider further Launch Aid instruments. In France public support for SMEs has been available from the *Agence Nationale de Valorisation de la Recherché* (ANVAR) in the form of 'repayable advances', and a recent review of French industry and technology policy recommends the creation of an Industrial Innovation Agency that would further extend the availability of this funding.[2] The provision of a more solid foundation to such policies and SCCs in general is thus in fact, despite first appearances, quite timely. In this paper, we address how SCCs differ from debt and equity instruments, and why they might be preferred by firms. We further address why they might not be supplied by the market and whether they represent subsidies. We also consider past experience with some examples of SCC schemes and also devise a number of recommendations as to where the public provisions of such SCC finance might be best employed.

In the next section, we discuss the nature and representation of innovation before considering sales contingent claim backed funding, the behaviour of firms so funded and their preferred choice between SCC funding, equity and debt. Section 3 considers the market availability of SCC instruments and considers whether public provision of SCCs represents a subsidy. Section 4 then looks at examples of public provision of SCC backed finance. In Section 5 the argument is brought together as a policy recommendation and in Section 6 conclusions are drawn.

2. Innovation and sales contingent claims

2.1. Innovation

Innovation can take many forms but the two most commonly discussed are product and process innovation. The former concerns the introduction of new products produced in existing ways, while the latter concerns the introduction of new means of making existing products. Innovation may be the result of in-house R&D, or it may be the result of learning from experience or perhaps result from design activities. Innovation may also result from the acquisition of licenses from other firms to manufacture new products, and/or new capital goods from capital good suppliers embodying new methods. Innovation is always an investment process – costs are incurred ahead of the returns that are to be enjoyed in the future – and is necessarily a risky or uncertain process. The future returns to a project may be subject to the vagaries of the market, the uncertain efficiency of new processes, and the uncertain response of consumers to new products, etc. Also, future production costs cannot necessarily be known with certainty.

[1] http://www.eif.org/Attachments/productdocs/sme_gf_summary.pdf (page 1).

[2] See Beffa (2005).