EVALUATION OF THE FUNDING SUPPORT MADE AVAILABLE TO THE PRIVATE SECTOR IN THE 2014-2020 PROGRAMMING PERIOD

Thematic Evaluation of the SMEi Financial Instrument

Written by CSIL
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Executive Summary

The **aim** of this thematic evaluation is to assess the SME Initiative (SMEi) implemented in Malta through the Operational Programme “Stimulating private sector investment for economic growth”, under the Thematic Objective 3 - *Enhancing the competitiveness of small and medium enterprises (SMEs)*.

The **SME Initiative** is a joint financial instrument launched at European level by the European Commission (EC), the European Investment Bank (EIB) Group, i.e. the EIB and the European Investment Fund (EIF). The SMEi provides two types of products (or a combination of both, depending on the needs of each territory): an uncapped guarantee for SME loans (called ‘the SME Initiative Guarantee Facility’ or ‘the Guarantee Facility’) or a joint securitisation instrument for SME loans. In Malta, it was decided to implement only the guarantee product and the public contributors that supported the SMEi are: (i) the Republic of Malta, from its 2014-2020 ERDF allocation; (ii) the EC through H2020 resources; and (iii) the EIB Group (including the EIF) through its own resources. More specifically, ERDF resources cover the first loss piece, while Horizon 2020 and the EIF join to absorb the second-loss piece, and EIB covers the senior tranche.

This evaluation is based on five **evaluation criteria**: relevance, effectiveness, impact, coherence, and efficiency. The evaluation strategy stems from the Terms of Reference requirement to conduct a theory-based impact evaluation complemented with a counterfactual impact evaluation. In order to address the evaluation questions, a triangulation process was used combining evidence from a range of sources: a comprehensive document review; the quantitative analysis of monitoring data; a programme of interviews including national stakeholders and SMEs; five firm-level case studies; and the counterfactual analysis.

Before presenting the main findings, a **caveat** is necessary. Since the full operational cycle of the SMEi spans from 2016 to December 2023, this thematic evaluation is *de facto* an interim evaluation: it offers an assessment of what happened until 2020 and, whenever possible, until 2021. The long-term effects remain difficult to assess because, on the one hand, their materialisation takes time, and, on the other hand, balance sheet data are published with a one-two years delay. Therefore, the study could not capture the full impact generated by the support provided through the SMEi.

Relevance

When launched in Malta, the SMEi responded to one of the most pressing needs of Maltese SMEs, especially start-ups, that is, difficulty accessing credit. Overall, all interviewees agreed on its relevance in the Maltese context. The SMEi addressed the main limiting factors preventing Maltese SMEs from accessing finance: high interest rates (ranging from 3.5% to 4.5%) and high collateral requirements (often reaching 100% of the total loan amount). With the outbreak of the COVID-19 pandemic, in a context of a pandemic-induced investment slowdown, according to Financial Intermediaries (FIs), the relevance of the SMEi to support working capital has increased. Pre-COVID-19, it was almost exclusively used to guarantee loans financing tangible and intangible investments.

Effectiveness

The SMEi proved effective in helping financial intermediaries selected by the EIF **to address SMEs’ needs. This is confirmed by the rapid roll out of the instrument.** In 2018, due to the success of the instrument, the Maltese authorities decided to increase the total ERDF allocation from EUR 15 million to EUR 22 million and to extend the implementation period until end December 2023. According to the Annual Implementation Report for 2020, the SMEi deployment as at the end of the year was good: with EUR 73.9 million committed to more than 745 SMEs, while absorption stood at 83%. The leverage stood at 3.4 (vs a target of 4). In December 2020, the funding allocation for the SMEi was increased for the second time (by EUR 7 million) to bolster support to SMEs affected by the COVID-19 pandemic. The uptake after the second increase has been slower compared to the previous years. COVID-19 played a role in this as firms are more reluctant to invest in crisis times. Moreover, according to financial intermediaries, the competition provided by national guarantee schemes set up by the Malta Development Bank (MDB) soon after the COVID-19 outbreak to sustain working capital also contributed to a reduction in the demand for SMEi support. Nevertheless, the financial intermediaries are confident that all allocated resources will be availed of by the end of 2023.

Whilst the overall roll out of the instrument was very successful, the same does not hold for the H2020 compartment of the SMEi. According to AIR 2020, the absorption of H2020 loans is still low (circa 25% of the target) and there is a real possibility that the target will not be achieved by 2023. According to both the MA and the financial intermediaries, this is largely explained by the fact that few of the innovation eligibility criteria are indeed applicable to Maltese SMEs. Thus, the failure to achieve H2020 loans targets is not due to a misalignment of interest between the EIF/MA and the FIs but to the nature of applicable innovation criteria. Penalties are not considered an appropriate incentive to induce FIs to reach the Horizon 2020 target portfolio amount.

The SMEi features effectively attracted Financial Intermediaries (FIs). In fact, thanks to the SMEi guarantee they are able to benefit from risk-sharing and lower regulatory capital requirement. Indeed, the SMEi allowed them to free part of the capital that they would otherwise need to set aside in order meet capital adequacy ratios. Moreover, the FIs' interest was driven by the following factors: 1) the success of the forerunner JEREMIE initiative[1], pointing to a well-established demand for guarantee instruments; 2) the fact that the SMEi was perceived as an opportunity to widen the range of financial products offered to SMEs; and 3) the "uncapped" nature of the SMEi, which allowed passing on more benefits to final recipients.

The conditions granted by the SMEi are attractive for SMEs as shown by the high uptake of the instrument and the interviews with firms. Overall, the following benefits were reported: 1) lower interest rates (i.e. reduction by 2% compared to the reduction by 1% achieved under the former JEREMIE initiative); 2) lower collateral requirements compared to other loan instruments; and 3) a convenient calculation of the gross grant equivalent. For these reasons, the SMEi was viewed beneficial especially for start-ups who in their early years of operation need capital to invest and lack collateral.

Impact/additionality

The SME Initiative positively contributed to an increase in the total assets of beneficiary companies, compared to similar firms that did not access the instrument. According to the counterfactual analysis[2], beneficiaries have experienced an average yearly increase in total assets, which is between 7% and 15% higher than their non-beneficiary peers. This result is coherent with the fact that most beneficiaries access the SMEi to purchase machinery and equipment, i.e. company's long-term non-current investment rather than current assets, including cash equivalents, working capital and other liquid assets.

The increase in asset accumulation of beneficiaries has, in turn, positively impacted the growth rate of their turnover; the additional impact ranges between 7% and 14%, on average. An impact on the return on assets only emerges at least one year after the loan agreement. Overall, these findings corroborate the hypothesis that effects on firms' profitability generated by investment

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[1] The joint initiative "JEREMIE" (Joint European Resources for Micro to Medium Enterprises) was launched by the European Commission (EC) and the EIB Group in the end of November 2005, when it was presented to the EU regions at a conference held in Brussels. The Memorandum of Understanding (MoU) was then signed between EC and EIF on 30 May 2006. The initiative was introduced with the aim to improve access to finance and to develop micro-credit for SMEs in the regions supported by the ERDF and ESF funds in the 2007-2013 programming period by means of equity, loans or guarantees, with the option of implementing the initiative through a Holding Fund acting as an umbrella fund. In Malta, the Managing Authority decided to confer the holding fund's management role to the EIF, which then selected Bank of Valletta as Financial Intermediary. The latter supported SMEs through a First Loss Portfolio Guarantee (FLPG), i.e., a capped guarantee, which provided credit risk protection and loans at preferential interest rates. Through the FLPG, the EIF, as guarantee fund manager, shared the risks of providing SME loans with the Bank of Valletta.

[2] The analysis is based on a population of 1,895 SMEs, 721 of them (38%) benefitting from the SMEi in the period 2016 – October 2020.

in machinery, equipment and assets materialise with some delay with respect to the date of the investment.

Using the results of the counterfactual analysis an attempt has been made to gauge the aggregated benefit generated by the SMEi, assuming additional investment and turnover are positively correlated to firm profitability. In this context, it has been estimated that, thanks to the SMEi, **EUR 160 million of additional investments (assets) and EUR 161 million of additional turnover were generated in the economy**.

There is evidence of the added value of the SMEi. Indeed, the credit conditions ensured to SMEs thanks to the SMEi guarantee ensured the immediate implementation of more ambitious projects than it would have been the case without it and/or enabled accelerating investments. Micro enterprises, especially start-ups (representing 20% of beneficiaries), would have encountered difficulties finding the same amount of money by accessing standard bank loans or other traditional credit channels. These difficulties would have negatively impacted investment decisions by causing implementation delays or reducing their scale.

Coherence

With respect to internal coherence, the offer of financial instruments backed by EU funds appears to be coherent. The InnovFin SME Guarantee Facility and the Energy Efficiency Renewable Energy (EERE) Malta Financial Instrument respond to different needs with respect to the SMEi, hence no displacement occurred.

However, there seems to be less coherence externally. The supply of guarantee products in Malta increased first with the establishment of the Malta Development Bank in 2017 and then in response to the COVID-19 crisis. Despite this increase, the demand remained quite high until the COVID-19 outbreak. After that, the demand decreased for two joint reasons; 1) the propensity to invest during a crisis is lower than in normal times; 2) the COVID-19 guarantee facilities offered by the Malta Development Bank were specifically designed to address the new needs of firms. These facilities will terminate in mid-2022, but displacement effects could materialise in 2022-23, when the MDB is expected to launch new financial instruments, including an uncapped guarantee product.

Efficiency

The results generated by the SMEi are reasonable given the ERDF contribution. Against an ERDF contribution of EUR 29 million, which includes management costs and fees, the SMEi has generated 882 new loans to 745 SMEs for a total amount of EUR 73.9 million (by the end of 2020). In addition, according to the results of the counterfactual analysis, these new loans generated altogether EUR 161 million of additional turnover[3] in the conservative scenario. If one compares EUR 161 million of turnover against the EUR 29 million, the benefit cost ratio is 4.3[4]. Although the latter is overestimated because it is calculated using turnover instead of profits and it does not take into account the costs borne by the FIs, this finding is consistent with the view that the SMEi has been a cost-effective way to support Maltese SMEs through EU budgetary resources.

Overall, the view of the main stakeholders is that the perceived benefits of SMEi have exceeded the costs. However, some inefficiencies and potential unnecessary costs are identified, especially with reference to the control phase. The necessary controls and audits from different entities (i.e., the EIF, the Managing Authority, the Audit Authority, the European Commission) needs to be better coordinated. Lack of coordination between these bodies may cause an unnecessary cost, absorbing an excessive volume of human resources (at different levels) thereby reducing the attractiveness of the instrument.

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[3] In the counterfactual analysis, 721 beneficiary firms were considered. See section 3.2.3.1 for details.

[4] Taking into account a financial discount rate equal to 5% in a 5-year period.

Recommendations

Based on the above findings, the evaluation makes some recommendations, which are further developed in the report.

- Consider a more substantial involvement of national stakeholders in the design of financial instrument(s) backed by European Structural and Investment Funds to reduce the risk of displacement effects.
- Provided the necessary coordination with national stakeholders is ensured, a guarantee scheme (possibly uncapped) to support SMEs could be renewed, for instance, by activating the so-called ‘Member State compartment’ of InvestEU.
- To the extent that widening private financing to SMEs is the primary policy goal, it is recommended to keep on offering guarantee schemes with broad eligibility criteria.
- The ESIF funds could be used to establish pilot SME support schemes including new products such as blended instruments (e.g., combination of financial instruments and grants for technical support) and equity schemes.