

- ESF
- EUR 83.3 million
- Mezzanine capital
- Social inclusion and entrepreneurship
- Germany

Mikromezzaninfonds, Germany

Case Study

...supporting enterprises of socially excluded groups through European Social Fund co-funded mezzanine capital...



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The authors of this study are a consortium of five companies: Sweco (lead), t33, University of Strathclyde – EPRC, infeurope and Spatial Foresight.

Abbreviations

Abbreviation	Full name
BMAS	'Bundesministerium für Arbeit und Soziales' – German for 'Federal Ministry of Labour and Social Affairs'
BMWi	'Bundesministerium für Wirtschaft und Energie' – German for 'Federal Ministry for Economic Affairs and Energy'
ERDF	European Regional Development Fund
ERP	European Recovery Programme
ESF	European Social Fund
ESIF	European Structural and Investment Funds
KfW	'Kreditanstalt für Wiederaufbau' – German for 'Reconstruction Credit Institute Development Loan Corporation'
MBG	'Mittelständische Beteiligungsgesellschaften' – German for 'Investment companies for small and medium-sized enterprises'
NBank	'Investitions- und Förderbank Niedersachsen' – German for 'Investment and Development Bank of Lower Saxony'
OP	Operational Programme
SME	Small and medium-sized enterprise



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1 Summary

Mikromezzaninfonds Deutschland, or Mikromezzaninfonds, is a financial instrument co-funded by the European Social Fund (ESF) within the ESF Operational Programme (OP) at federal level in Germany. It provides mezzanine capital through silent partnerships, where the investment is normally treated as a loan but the investor participates in the profits of the enterprise. The final recipients include mainly small and medium-sized enterprises (SMEs) as well as enterprises led by disadvantaged people – e.g. women, migrants or the unemployed – that are excluded from financial services due to insufficient equity or no credit history. Enterprises pursuing a social or ecological mission are also targeted, such as the 'Kindersuite' ('Suite for Children') that offers child care on an hourly base.

This case study shows that it is possible to promote social inclusion through mezzanine capital if a funding gap for this type of finance is clearly identified, and financial intermediaries are experienced and well-established in the relevant areas. In the case of the Mikromezzaninfonds, the involvement of 15 regional investment companies ('Mittelständische Beteiligungsgesellschaften', or MBGs) with suitable local knowledge and networks, made it possible to reach 1 781 enterprises providing employment for 7 775 people (up to December 2015).

Identifying enough social enterprises with a viable business model may be a challenge to developing a sustainable financial instrument, so even with efficient implementation structures, target groups may need to be combined to reach critical mass. Designing a lean management structure and ensuring compliance with ESF requirements can also be demanding, as can striking a balance between flexibility and the need to focus on strategic targets.

Mikromezzaninfonds was set up towards the end of the 2007-2013 programming period. Due to demand, the initial funds were increased twice, to more than EUR 83 million (ESF and national resources). This amount is fully allocated and by December 2015 EUR 74.5 million had been disbursed. Because of the high demand and based on the recommendations of an ex-ante assessment, the financial instrument is continuing in the 2014-2020 programming period, providing another EUR 85 million (ESF and national resources) for micro-mezzanine financing.

Mikromezzaninfonds, Germany

THE FINANCIAL INSTRUMENT

Funding source

ESF OP at federal level in Germany 2007-2013, ERP Special Fund¹

Type of financial products

Mezzanine capital in the form of silent partnerships

Financial size

EUR 83.33 million OP resources (EUR 50 million from ESF and EUR 33.33 million from the national ERP Special Fund)

Thematic focus

Promoting employment and social inclusion

Timing

September 2013 to December 2015

Partners involved

Federal Ministry of Labour and Social Affairs (BMAS) (managing authority of the national ESF OP)
Federal Ministry for Economic Affairs and Energy (BMWi) (intermediate body responsible for management and implementation of the Mikromezzaninfonds)
The Investment and Development Bank of Lower Saxony (NBank) (fund manager)
15 investment companies for SMEs (financial intermediaries)

ACHIEVEMENTS

Absorption rate

89% of OP resources (December 2015)

EU leverage

1.7 times²

Leverage of public resources

One time³

Reinvestment

n.a.

Main results

From September 2013 to December 2015, 1 781 enterprises have been supported with approximately EUR 74.5 million. Around 7 775 jobs have been secured. Some 2%, or 35 of the 1 781 supported enterprises, are social enterprises.

1 The European Recovery Programme (ERP) is the official name of the 'Marshall Plan', an American initiative to aid Western European countries after World War II. The United States gave USD 13 billion (or approximately USD 130 billion in current dollar value) to help rebuild Western European economies. In the Federal Republic of Germany, this money was used as low-interest loans and investments in a revolving fashion. Much of it is still available today as a special fund ('ERP-Sondervermögen', or 'erp-sv') managed by the Federal Ministry for Economic Affairs and Energy and the state-owned 'Kreditanstalt für Wiederaufbau' (KfW).

2 EU leverage is here calculated as the expected total amount of finance reaching final recipients (i.e. EUR 83.33 million) divided by the total amount of ESF allocation to this financial instrument (i.e. EUR 50 million).

3 Leverage of public resources is here calculated as the expected total reaching final recipients (i.e. EUR 83.33 million) divided by the total amount of operational programme allocation to this financial instrument (i.e. EUR 83.33 million).



2 Description of the financial instrument

Set up in 2013 using funds from the ESF and from the German European Recovery Programme (ERP) Special Fund, Mikromezzaninfonds⁴ is a national fund contributing to the specific objectives for 'Securing and sustainability of existing start-up enterprises' and 'Increasing the number of technology-oriented start-up enterprises' of the 'ESF Bund Deutschland 2007-2013', the ESF OP at federal level in Germany.⁵

It provides 'silent partnership' investments, a hybrid form of finance that combines elements of both debt and equity, having advantages for the final recipient. By receiving this finance, enterprises can enlarge their capital base and, consequently, improve its credit rating and the terms and conditions for bank finance. Additionally, it is not necessary to provide the investor with collateral, or voting or management rights. As with other forms of mezzanine capital, 'silent partnership' investments have a lesser priority than senior debt with regard to repayment obligations but a higher priority than normal equity. As these characteristics make them a high-risk investment, interest rates are usually comparatively high and additional terms and conditions can be agreed between the lender and the borrower.

Table 1: Advantages of 'silent partnership' investments / mezzanine capital

FOR THE BORROWER	FOR THE LENDER
Larger equity base and higher credit rating	Comparatively high interest rates
Better terms for current and new loans	Flexible additional terms and conditions
No collateral required	For repayment: higher priority than equity
No voting or management rights for the investor	

2.1 Rationale

The need for equity investment had already been highlighted by a study on microfinance and mezzanine capital for enterprises, conducted on behalf of the Federal Ministry of Labour and Social Affairs (BMAS) in 2009.⁶ This study highlighted a gap in financing for investments between EUR 25 000 and EUR 150 000. It also recommended that this gap could be closed by both significantly enlarging the range of microcredits and by providing mezzanine capital, as smaller enterprises' access to mezzanine finance was substantially restricted in Germany.

Since 2012, before the Mikromezzaninfonds was established, more enterprises were closing than opening in Germany. Women were particularly underrepresented among start-up entrepreneurs, but migrants and previously unemployed people also faced considerable challenges when starting

4 More info and additional resources:
- <http://www.mikromezzaninfonds-deutschland.de/>;
- <http://www.esf.de/portal/DE/Foerderperiode-2014-2020/ESF-Programme/bmwi/mikromezzaninfonds-existenzgruendung.html>.

5 CCI: 2014DE05SFOP002.

6 Studie im Auftrag des Bundesministeriums für Arbeit und Soziales (2009), 'Mikrofinanzierung und Mezzanine Kapital für Gründungen und KMU', http://www.esf.de/portal/SharedDocs/PDFs/DE/Aktuelles/2009/2009_09_21_BMAS_Kurzstudie.pdf.

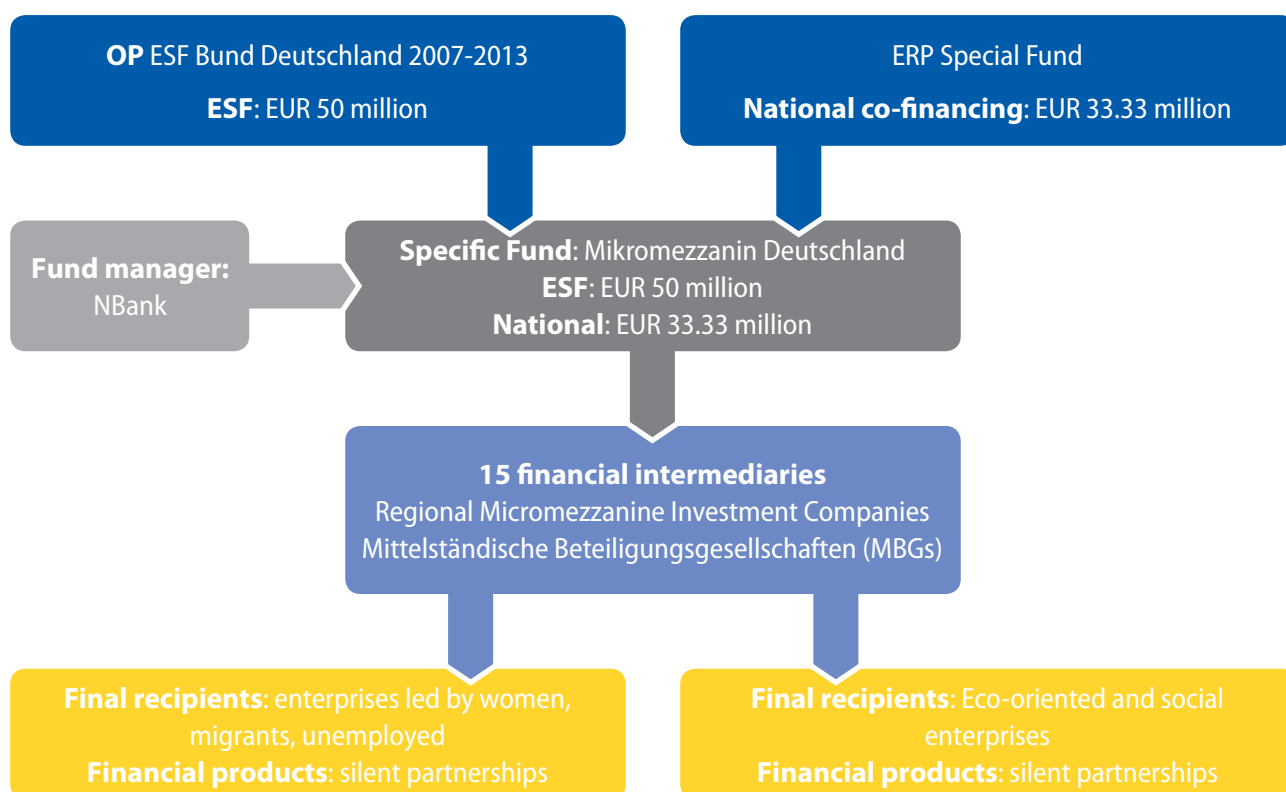
a business. Although the business of existing SMEs was stable, microenterprises were particularly affected by a decline in equity. Lower profits reduced reinvestment in the business which, in turn, made them more vulnerable during the economic and financial crisis.

2.2 Organisational structure

The Federal Ministry of Labour and Social Affairs (BMAS) is the managing authority of the ESF OP at federal level in Germany. Under the lead responsibility of the BMAS and the supervision of the European Commission, the Federal Ministry of Economic Affairs and Energy (BMWi) is the intermediate body responsible for the management and implementation of the Mikromezzaninfonds. The BMWi entrusted the state-owned Investment and Development Bank of Lower Saxony (NBank), with fund management through a public procurement procedure.

The financial intermediaries are 15 regional micro-mezzanine investment companies, the 'Mittelständische Beteiligungsgesellschaften', or MBGs. Founded in the 1970s, these regional investment companies cover all of Germany and have since then supported SMEs from all sectors and especially start-ups. The shareholders of the MBGs are chambers of commerce, business associations, banks and public development institutions owned by the German federal states.

Figure 1: Mikromezzaninfonds organisational structure



Kindersuite GmbH ('Suite for Children Ltd') – Objectives

Kindersuite offers childcare and educational services for two to nine-year old children on an hourly base and is located in Baden-Württemberg's state capital and largest city, Stuttgart. Although the enterprise is a for-profit company, providing social services by closing the gap in childcare and, this way, increasing the flexibility of parents are the main objectives and hence the core of the business.

Investment was needed to establish the enterprise. Without support from the Mikromezzaninfonds the business could not be set up at all. The capital was used to renovate the facility, finance the inventory and buy toys and teaching material. The personal financial contribution of the owner was used as registered capital.



2.3 Financial products and financial terms

Mikromezzaninfonds addresses new micro, small and young enterprises, especially companies that train, and those new business started by disadvantaged people, e.g. women, unemployed people and/or with a migrant background. Commercially oriented social enterprises and green business are also targeted, as the lower expected returns connected with their social mission can often make conventional banks and financial service providers reluctant to lend. Companies under recovery regime and firms in difficulty are excluded.

Mikromezzaninfonds provides silent partnership investments of up to EUR 50 000 under the *de minimis* regulation and for up to 10 years. The investments increase the enterprise's capital base, which facilitates follow-up funding from private and public sources. No collateral is required and repayment of the capital is made after seven years in three equal annual instalments. There is a one-time processing fee of 3.5% of the mezzanine capital. During the grace period for repayment of the principle, the enterprise has to amortise an annual fixed premium of 8%, which is paid quarterly in arrears. Depending on the economic viability of the enterprise, the mezzanine investor receives up to 1.5% of the profits per annum.

According to the eligibility rules, 'Mikromezzaninfinanzierungen' (holdings) will be granted to firms which have sufficient economic viability and give sufficient assurance that the arrangement will be fulfilled. The MBGs advise potential final recipients during the application process, reducing a potentially significant barrier for targeted entrepreneurs. With their small-scale investment expertise and long-standing experience with mezzanine instruments, they can provide additional assistance if requested by the applicants.

Kindersuite GmbH ('Suite for Children Ltd') – Financing gap

The owner of Kindersuite was self-employed before founding the new enterprise. However, commercial banks were reluctant to lend money to a self-employed and new entrepreneur and requested the collateral. The concept of Kindersuite is a new and innovative approach and commercial banks did not have any experience in the field or comparisons they could draw on to reduce their requirements. As the entrepreneur could not provide the requested collateral, Mikromezzaninfonds was a suitable alternative.

3 Strategies to support social inclusion and entrepreneurship

The combination of social and ecologically-oriented enterprises with other target groups that are not usually bankable such as women, the unemployed, migrants and young entrepreneurs enabled the financial instrument to reach the critical mass needed. Lean application and approval procedures, together with the involvement of well-established financial intermediaries contributed to high demand so, during implementation, the fund size was increased to double the original amount.

3.1 Design phase

BMWi and NBank could use their experience in setting up financial instruments for mezzanine and start-up financing, as well as the findings from the gap analysis, when developing and designing this financial instrument. This has produced a cost-efficient structure and ensured that the financial instrument effectively addresses the market weakness.

In the selection procedure, the main precondition for applicants, whether they are social enterprises or other target groups, is to be profitable. Purely charitable enterprises are not supported. Financial sustainability is verified with a business plan and based on market experience. There is no standard scoring for applicants and the MBG has flexibility when assessing potential investees. On this basis, MBGs can adjust support to their own regional situation, although no support may be given to enterprises in difficulty.

Target groups facing similar challenges were combined to reach the critical mass that made the financial instrument sustainable. This ensured that if demand from any group was less than expected the financial instrument would still be economic, ensuring commitment from the financial intermediaries.

3.2 Set-up phase

The application and approval procedures were established to be as simple as possible to minimise the burden and make the financial instrument more attractive for final recipients. The financial intermediaries could use their existing structures and their long-term experience in mezzanine financing, which made the selection process cost-efficient. Additionally, as each of the MBG has well-established networks, reaching target groups including social entrepreneurs in their respective regions was comparatively simple.

The MBGs developed a specific reporting and monitoring system. This covers the number of supported enterprises, their economic sectors, secured jobs, the extent to which the target groups could be reached, and the number and amount of repayments and defaults. In addition to this, regular reports are prepared in compliance with ESF requirements set-up in EU regulations. This approach has led to efficiency in on-going monitoring and made it possible to have a constant overview of implementation.

Kindersuite GmbH ('Suite for Children Ltd') – Application and administration

Due to comparatively high interest rates, the application for Mikromezzaninfonds was initially a 'fall-back' option in case commercial banks were unwilling to grant a loan. Once the decision to apply had been taken, the application process only took around two months. All questions were directly answered by the same contact person at the regional investment company, 'Mittelständische Beteiligungsgesellschaft Baden-Württemberg', so the process could be concluded without major complications for the entrepreneur. Compared to previous experience with commercial banks and their internal hierarchies, the administrative burden was therefore low.

3.3 Implementation phase

The initial size of the financial instrument of approximately EUR 35 million was increased to EUR 70 million due to the high demand. A second, smaller, increase to EUR 83.33 million was necessary to overcome a potential gap due to delays in programming for the 2014-2020 programming period.

Although social enterprises are mentioned and addressed as a single target group in publications and informational material, in December 2015 they only account for 2% of all final recipients. This may be due to the limited number of commercial social enterprises. The total number in Germany is not known but estimates suggest that there are less than 1 000. Since there are 40 000 to 70 000 social enterprises in Germany, the share of commercial social enterprises is very low.

Clearly defining which social enterprises are eligible for Mikromezzaninfonds support has been difficult, especially in comparison to other target groups (unemployed people, migrants, and women), which are clearly defined. Thus, few potential social enterprises may be aware that they are eligible.

Based on experience, a loss of 10-20% is expected over the life of the financial instrument. The final recipients are considered to be well set up, however financial sustainability will only be proven after several years.

Kindersuite GmbH ('Suite for Children Ltd') – Advantages and challenges of the financial instrument

The main advantage is that the loan is granted regardless of the borrower's financial situation and that, apart from the registered capital of EUR 25 000 necessary to found a limited liability company in Germany, no equity capital had to be invested and no collateral was required for the loan granted under the Mikromezzaninfonds. The loan and its conditions made it easier for the entrepreneur, since the available equity capital was not sufficient to start the business.

From the entrepreneur's perspective, the main challenge was to find out about the existence of such an instrument. Therefore, the owner emphasises that everybody who plans to set up an enterprise, should look in detail for existing instruments and attend events or seminars that could be relevant.



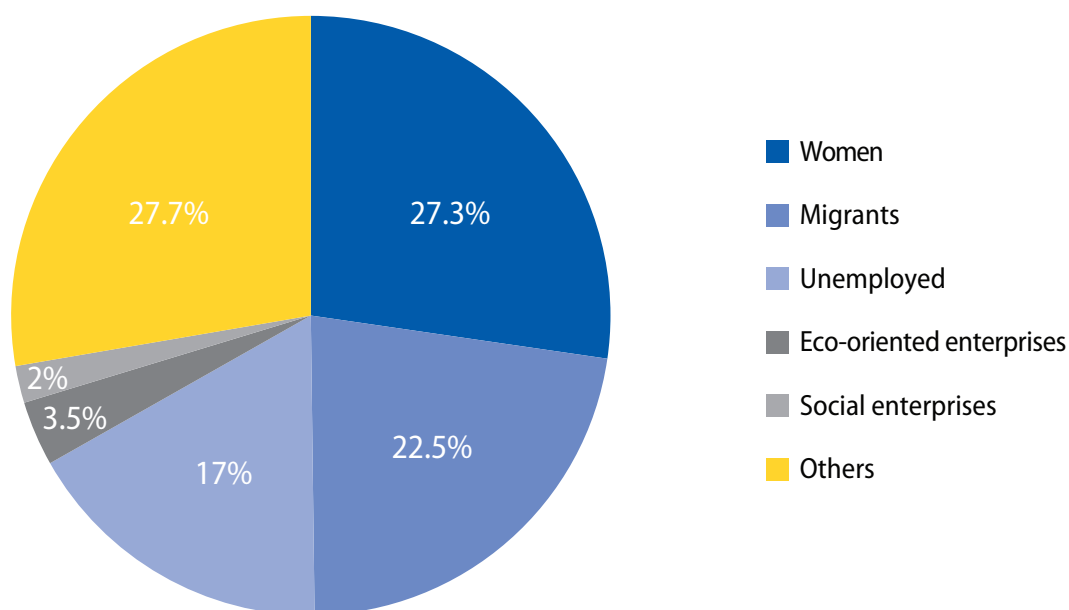
4 Achievements and challenges

The Mikromezzaninfonds helps promote the development of a comprehensive system to improve the access of small businesses to mezzanine finance. Demand for mezzanine financing was high and enterprises led by women and migrants benefited the most, fostering the Europe 2020 strategy objective of inclusive growth. Although it is too early to assess long-term benefits for the final recipients and their performance and competitiveness, previous experience suggests that the support provided should have improved their ability to access the finance needed for further development.

4.1 Outcome

By December 2015, 1 781 enterprises had been provided with EUR 83.33 million of mezzanine capital, of which EUR 74.5 million had been disbursed. This helped secure 7 775 jobs. Around 27% of disbursements were made to enterprises led by women, 23% were for migrants, 17% for previously unemployed persons, 3.5% went to ecologically oriented and 2% to social enterprises.

Figure 2: Shares of mezzanine financings granted to different target groups



Source: Mikromezzaninfonds Deutschland

Experience from the MBG shows that mezzanine finance can improve the creditworthiness of final recipients through an increased capital base, which makes banks more willing to provide additional capital. This should also help make financing conditions affordable for start-ups and SMEs. There are no figures on the additional loans granted to final recipients following Mikromezzaninfonds financing in the 2007-2013 programming period, but this information will be collected for the 2014-2020 programming period.

Additionally, it is considered that support from the financial instruments have helped social enterprises to better focus on financial sustainability, increasing their ability to get additional finance and leading to a more general improvement of their business capacity.



In the long run, it is expected that the success of Mikromezzaninfonds could make conventional banks and financial service providers increasingly consider micro-mezzanine capital as an attractive market niche. On this basis, they may want to expand the range of financing available to the target enterprises.

4.2 Operational achievements

All the mezzanine capital provided is due to be paid back by final recipients by 2025. At that time, the survival rate of the supported enterprises will show the extent to which the financial instrument helped the target groups to establish and continue their businesses. However, it can already be seen that the situation for the target groups has improved as the enterprises can now benefit from guarantees issued by public owned guarantee banks ('Bürgschaftsbanken'), which support bank financing in close cooperation with the MBGs.

4.3 Main challenges

Designing and setting up a lean management structure for the Mikromezzaninfonds with efficient application processes and controls that met ESF regulatory and administrative requirements was demanding. Additionally, as social enterprises make up a heterogeneous group, it was difficult to estimate their specific demand beforehand, as well as address them as a target group in the implementation phase.

Other challenges can be expected for the future, as higher than expected losses could reduce the financial instrument's success and sustainability. If this is the case, it will become clearer from 2020, when the first tranches of mezzanine capital become due.

Additionally, if in the past the selection of final recipients was left to the discretion of the 15 MBGs, which gave them the flexibility to focus on specific regional needs and conditions, more specific strategic targets may need to be identified in future as well as mechanisms to steer and coordinate investments across regions.

Kindersuite GmbH ('Suite for Children Ltd') – Achievements

The investment from Mikromezzaninfonds allowed the entrepreneur to establish the enterprise and hire three employees (part-time). After only four months, the enterprise is not yet economically viable. This makes it challenging for the owner to offer good working conditions and wages, although higher revenues are expected in the near future. In the long-term, the concept should be further developed and refined, with new branches and expanding the idea also outside Stuttgart. The entrepreneur expects to self-finance these developments from the enterprise's revenues.

5 Lessons learned and outlook

The study on microfinance and mezzanine capital commissioned by BMAS in 2009 analysed the major financing gaps in depth. The ex-ante assessment for the Mikromezzaninfonds for the 2014-2020 programming period⁷ showed that small enterprises and start-up entrepreneurs often have no access to finance and identified an annual gap of EUR 700 to 800 million annually. Similar to the BMAS study, the ex-ante assessment recommended closing this gap with a financial instrument providing mezzanine capital for small start-ups. This would enlarge their capital base and, consequently, improve their access to conventional financial services. Women, migrants and unemployed people were identified as specific targets for this financial instrument due to their vulnerability to this market weakness. Social enterprises were not explicitly considered, but were included in the other target groups. This has helped to tailor the financial instrument to the specificities of the target groups and the regional context, showing the importance of a thorough and detailed market analysis.

The nature and conditions of the product have been key factors in making the support attractive. The long period of silent partnership gives enterprises up to seven years to establish their market position. Although the annual premium of 8% has to be paid, the conditions are flexible and enable the final recipient to apply for additional loans if required.

If efficient application and assessment procedures can minimise the administrative burden, making support appealing to SMEs and social entrepreneurs, local knowledge and networks of financial intermediaries also contribute to demand. The possibility for financial intermediaries to use their existing structures and processes can reduce their costs and lead to increased involvement.

Using the same financial instrument to address different target groups might be needed to reach critical mass. If the demand from some target groups is lower than expected, other target groups can ensure economic viability for financial intermediaries. Narrow approaches that focus only on one target group make the financial instrument more vulnerable.

Due to high demand, Mikromezzaninfonds is continuing during the 2014-2020 programming period with a fund of approximately EUR 85 million. The share of the different target groups using this instrument in the future, however, cannot be specified at this stage.

⁷ http://www.mikromezzaninfonds-deutschland.de/downloads.html?file=files/mmd/downloads/2015_09_28%20Zusammenfassung%20Ex-ante-Bewertung.pdf.

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