Exit Strategy For SMEs – Macro-economic Relevance and Challenges

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SMEs:
Macro-Economic Relevance
Evolving Role of SMEs

View on SMEs changed over time

- disadvantaged sector to growth sector
- shift in policy approach and regulatory structure

Two types of SME markets

- **Vibrant**: short-lived, innovative, aiming to attract investment and grow, easy exit → critical for labor absorption & growth
- **Inert**: long-lived, static, inability to grow because bureaucratic-legal obstacles, difficult exit → kills jobs and structural productivity deficit
# Economic Importance of SMEs

<table>
<thead>
<tr>
<th>SMEs</th>
<th>EU</th>
<th>Japan</th>
<th>Latin America</th>
<th>India (of industrial units)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company market share</td>
<td>99.8%</td>
<td>99.7%</td>
<td>99%</td>
<td>95%*</td>
</tr>
<tr>
<td>Labor market share</td>
<td>67%</td>
<td>69%</td>
<td>67%</td>
<td>40%</td>
</tr>
<tr>
<td>GDP share</td>
<td>60%</td>
<td>55%</td>
<td>30%</td>
<td>17%</td>
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* (of industrial units)
SMEs in the Crisis Context

European Financial Crisis

- Household debt crisis - Unlike Latin American & Russian sovereign debt crises, or Asian corporate debt crisis

SMEs particularly exposed

- Examples: (2009 figures)
  - Finland: 17% SMEs declared solvency problems
  - Italy & Spain: 25% increase of insolvency filings
  - Ireland: SMEs created 172,000 jobs 2000-7

Current crisis highlights SME’s vulnerabilities

- Drop in revenue as business declines & late payments
- Income deterioration and personal wealth reduction
- Reduced access to credit as banks tighten lending
- Lack of effective rehabilitation due to weak legal/regulatory framework
Why Does the IMF Care About SMEs?

Public debt enhanced risk sustainability (due to possible bank recapitalization costs or “bail-out” schemes for certain sectors (e.g., mortgages, SMEs)

Banks weaken as NPLs increase, capital erode, uncertainties increase

Drain on growth as consumers cut back on spending

SME & Private debt impedes recovery

Mortgage debt and dropping real estate prices protract recession
SME Exit Strategies: Importance & Challenges
SMEs – Building Blocks

**Market Entry:**
Encourage entrepreneurship
- Low bureaucratic thresholds
- Low cost
- Short time

**Foster Growth:**
Access to credit & business continuity
- Ease in licensing
- Access to credit
- Fiscal facilities

**Market Exit:**
Critical to Efficient & Entrepreneurial Market
- Sustains entrepreneurial capital
- Encourages innovation and risk taking
- Aims at business continuity
## Key Challenges to SME Exit

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Definitional issues</strong></td>
<td>No special legal framework due to different definitions of SMEs</td>
</tr>
<tr>
<td><strong>Access to credit constraints</strong></td>
<td>Common restructuring regimes depend on new credit, which SMEs typically do not have access to</td>
</tr>
<tr>
<td><strong>Fiscal constraints</strong></td>
<td>Lack of adequate tax incentives for distressed SMEs</td>
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<tr>
<td><strong>Constraints on Early Rescue</strong></td>
<td>Lack of robust insolvency framework to support fresh start for entrepreneurs or early rescue for viable SMEs</td>
</tr>
<tr>
<td><strong>Special Guarantee Regime</strong></td>
<td>SMEs typically secure business ventures with personal guarantees and mortgages; business and personal assets are mixed</td>
</tr>
<tr>
<td><strong>Social &amp; Political Considerations</strong></td>
<td>Social and political considerations impact exit strategy for SMEs</td>
</tr>
</tbody>
</table>
UNCITRAL Guide has provided useful guidance that can be further developed and tailored for SMEs. Limitations are:

- **Applicability**: many SMEs are not incorporated
- **Complexity**: procedures are too complex, rigid and lengthy for SMEs
- **Commercially unviable**: difficulties to get new financing, complications of personal guarantees/mortgage aspect, limited possibilities for commercial/financial downsizing
- **Weak business continuity**: procedures tend to be geared towards liquidation
SME: Personal Insolvency Procedure

No International Best Practices exist, but cross-country experience provides guidance.

**Applicability**
limited to individuals and sometimes small firms, but not to partnerships and other unincorporated entities

**Weak business continuity**
lack of effective restructuring procedure, no fresh start in all cases, lengthy discharge period

**Formalism**
mostly court based procedures with costs and delays
SMEs: Out-of-Court Regime

INSOL Principles

- May be selectively applied to SMEs

Availability

- Special out-of-court regimes for SMEs are not widely available, however, some countries do have them (e.g., India).
- Where they do exist, they tend to be ineffective (e.g., lack of incentives).

Recent Developments

- Some countries recently adopted special out-of-court regimes for SMEs (e.g., Spain and Portugal)
- Their effectiveness remains untested.
Special Regimes for SMEs

Spain (9/2013) – Out-of-Court Procedures

- Access limited to individual entrepreneurs and legal entities with fewer than 50 creditors and liabilities below €5m
- Enforcement actions stayed up to 3 months (excluding secured or public creditors)
- Mediator appointed by the Commercial Registrar
- Payment plan with a mandatory cap of not more than 25% on haircut and deferral of 3 years
- Approval by creditors of 60% in value
- Not affect secured or public creditors
Special Regimes for SMEs

Portugal (2012) – Out of Court Procedures

- SIREVE targeted at SMEs
- Facilitated by IAPMEI, a mediation entity associated with MoE
- Tax and social security authorities required to participate in the negotiations
- Standstill applicable to creditors participating in the SIREVE
- No cram down
Preliminary Observations
Preliminary Observations

Increasing Importance
- Account for a large share of the economy
- Macro-economically critical
- Ineffective current legal regime for market exit
- Need a targeted insolvency regime to help preserve SMEs

Tailored Legal Regime
- Simplified procedures
- Speedy process
- Lower costs
- Fresh start for individual entrepreneurs
- Early rescue of viable SMEs
- Out-of-Court procedures

Supporting Factors
- Efficient exit needs support of other laws (e.g., tax incentives)
- Provide for additional financing (e.g., from government)
- Raise awareness and make available information
- Need efficient institutional framework (mediation, arbitration, insolvency administrators, court system)
Thank You!