Scale Replaces Entry Standard
Will this Rehabilitate SME Bond Financing?

New issuances of bonds from German SMEs (small and mid-sized enterprises) have nearly come to a standstill, a direct result of the high rates of default. Deutsche Börse seeks to revive financing for German SMEs through a new venture from 1 March 2017. But can the revamp from 'Entry Standard' to 'Scale' rehabilitate the segment?

As the low interest rates persist, the desire for high yields remains substantial. Scope strongly welcomes the introduction of tight minimum quantitative criteria for new issuances, which can help win back investors' trust. The new listing requirements might lead to a more 'professionalised' investor base, with a shift from retail investors towards institutional investors – already achieved by other European alternative bond segments such as Spain's MARF and Italy's ExtraMOT PRO.

Minimum standards separate the wheat from the chaff

The quantitative criteria for admission into the Scale segment, namely with regards to leverage and interest coverage, must be met not only by new issuances, but also by the 47 bonds currently listed as Entry Standard[1] (Figure 1). New issuances must additionally have a minimum volume of EUR 20m. In line with Scope's rating methodology, the criteria on leverage and interest coverage correspond to a financial risk profile of B+ (except for companies in outlier sectors like real estate and utilities).

Figure 1: Minimum criteria for Scale segment

Minimum criteria			
Fulfil at least 3 criteria	1	EBIT/interest coverage	≥ 1.5x
	2	EBITDA/interest coverage	≥ 2.5x
	3	Risk-bearing capital	≥ 0.2x
	4	Total debt/EBITDA	≤ 7.5x
	5	Total net debt/EBITDA	≤ 5.0x
	6	Total debt/capital	≤ 0.85x
Additional criteria			
		Issuance volume	≥ EUR 20m

Source: Deutsche Börse, Scope

Scope believes the new criteria create from the outset a valid filter for new issuances, to prevent default rates of over 20% seen in the current SME market. Current Entry Standard bonds whose issuers fail to meet the new criteria must then move to the open-market segment. However, issuers that manage the switch to Scale can use this as a positive signal. Scope expects that only half of the issuers with one or more bonds listed at Entry Standard will achieve a listing at the Scale.

Conclusion: institutional investors 'professionalise' the investor base

From Scope's standpoint, the relaunch of the SME segment is a step in the right direction, even when acceptance among issuers and investors is yet to be established. The introduction of minimum quantitative criteria – and Scope welcomes the tighter standards – will generate stronger appeal among institutional investors, as seen already in other alternative markets like MARF in Spain, ExtraMOT PRO in Italy, and ABM in Scandinavia.

[1] Among those also issuers and bonds rated by Scope: Adler Real Estate AG (BB-), Alno AG (CC), Karlie Group GmbH (D), Stern Immobilien AG (B+) and Vedes AG (B+) [all issuer ratings]

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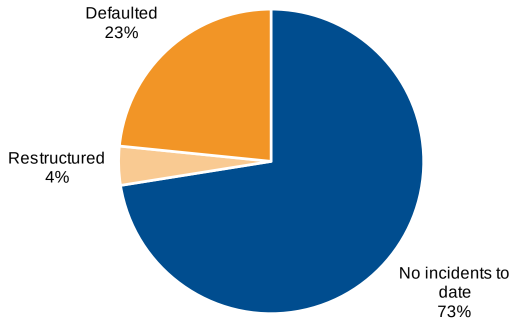
High default rates in current SME segment

25% repaid; > 20% defaulted

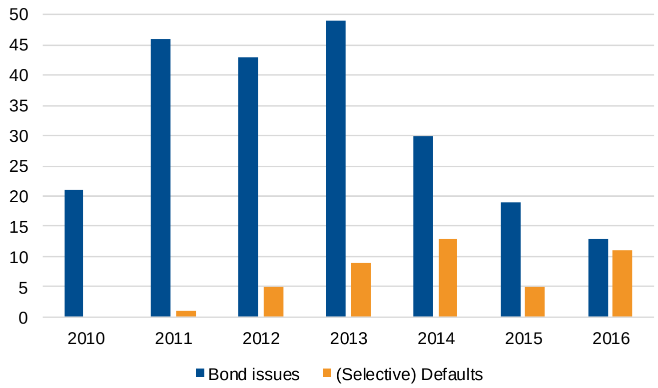
To date more than 20% of issues in the German SME bond segments have defaulted; at a total volume of roughly EUR 9.3bn from more than 200 bonds. This corresponds to a default rate of about 25%, which is an extraordinarily high default rate, even for a high-yield segment. It should be mentioned, however, that 53 bonds, or 25% of the market, were repaid either on time or early. Even so, it was the bad news that dominated market sentiment. Moreover, reports of expected recovery rates of less than 30% in many cases did nothing to help. These developments were hardly conducive to building confidence, and led to a gradual decline in successful new issuances (Figure 3).

Figure 2: Default rates by number of issuance



Source: Scope Ratings

Figure 3: New issuances vs defaults (including selective defaults)



Source: Scope Ratings

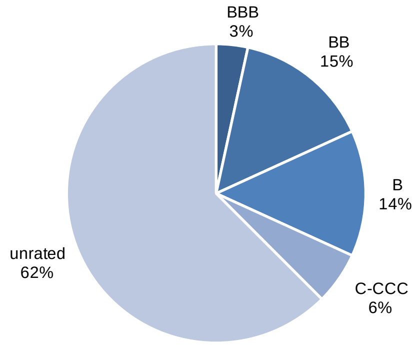
Refinancing wave for German SME bonds soon to peak

More defaults and bond restructurings expected

As seen in the ‘refinancing wave’ for German SME bonds (Figure 5), the main refinancing round begins in 2017. Roughly EUR 800m is set to mature in 2017 across 21 bonds that have not been repaid early or are not in default. In 2018, this figure is EUR 1.7bn over 37 bonds; in 2019, EUR 1.3bn over 27 bonds.

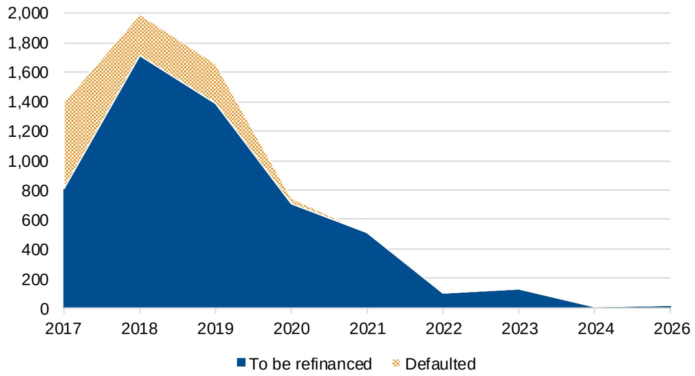
For 2017 and 2018, Scope expects more defaults and bond restructuring measures (e.g. maturity extensions, lower coupons, or haircuts) for the current SME segment. However, Scale should help rehabilitate the high-yield segment and assist the (re)financing of the more solid issuers, by renewing confidence for SME financing. However, a number of more solid issuers are expected to leave this new market and turn towards non-public alternatives like bank loans or private debt placements (such as ‘Schuldschein’).

Figure 4: Issuers of outstanding bonds by rating



Source: Scope Ratings

Figure 5: Refinancing wave in German SME segment (EUR m)



Source: Scope Ratings

Up or out

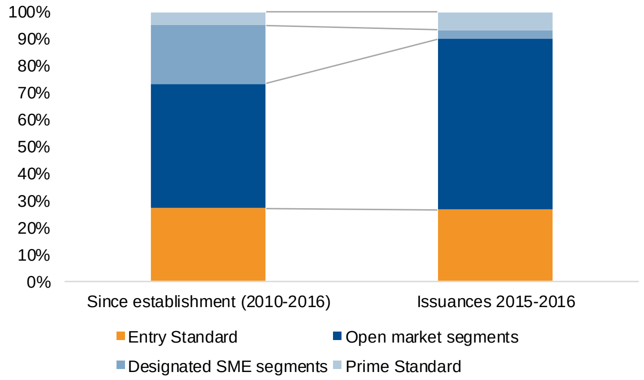
More recent issuances in less regulated open market

Of the 180 bonds classified as SMEs by Scope, roughly 30% are still listed as Entry Standard. From 2014, as a result of high default rates and market turbulence in the current SME segment, more issuances were launched in the less regulated open-market segments in various regional exchanges in Germany (Figure 6), which Scope regards as a signal of issuances made by comparatively weaker creditors.

Only about half of Entry Standard issuers fulfil Scale standards

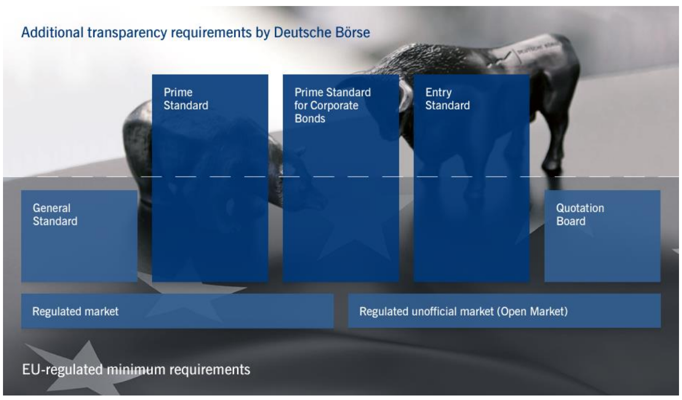
In Scope's view, the minimum criteria are a good way to weed out issuers that are already excluded from other external forms of financing. Scope deems that more than half of those issuers which still list one or more bonds in Entry Standard do not meet the new minimum standards[2]. These companies will then be forced to trade in the open market, thereby growing the share of open-market issuances even further. Those that manage the switch to Scale will, in Scope's view, win investors' trust. Moreover, Scope expects that other bond issuers whose bonds are listed in other designated SME exchanges (i.e. Bondm, m:access) will strive for a listing at Scale.

Figure 6: Current SME bond market by segment



Source: Scope Ratings

Figure 7: Deutsche Börse: share of regulated market versus open market segments



Source: Deutsche Börse

[2] The average rating (median) of issuers with a corporate bond listed at the Entry Standard currently stands at B+; among them five issuers in (selective) default.

Specialised alternative fixed-income markets not only in Germany

Minimum standards and focus on institutional investors a recipe for success

Alternative bond segments are a particularly popular and strong-yielding investment, given the persistently low interest rates. Alternative bond segments in Spain, Italy, Norway, the UK and France have shown that these markets can function without scandals or defaults (the Norwegian ABM since 2005 is an example). Scope especially views the market's criteria, as well as the near-exclusive focus on institutional investors, as a recipe for success. In this regard, Scale is absolutely heading in the right direction.

Figure 8: Overview: Other European alternative fixed-income markets

Alternative bond segment	Market place	Minimum issuance volume	Main requirements or recommendations for issuances *	Target investors
Scale		EUR 20m	• Max. leverage • Min. interest coverage	Institutional and retail investors
MARF		EUR 20m	• Credit Rating[3] • Common sense among leading transaction banks regarding maximum leverage and corporate size[4]	Institutional investors
ExtraMOT PRO		EUR 15m	n/a	Institutional investors
Alternext/Euronext		EUR 5m	n/a	Institutional and retail investors
Nordic ABM		NOK 100m (~EUR 11m)	• Positive existing cash flow (CF) usually required	Institutional and retail investors
ORB			n/a	Primarily retail investors

* in addition to requirements on documentations and transparency

Source: Scope Research

Conclusion

From Scope's standpoint, the introduction of the new Scale segment is a step in the right direction, even when acceptance among issuers is yet to be established. The introduction of minimum quantitative criteria – and Scope welcomes the tighter standards – will likely generate stronger appeal among institutional investors. The confidence promoted by the new standards will likely help create significantly better (re)financing conditions for new issuances.

With a view to the upcoming refinancing of issuers, not only in Entry Standard but also in the other designated, SME segments, Scale will open up a valid refinancing option for the better creditors. Despite this, more issuers will likely move away from the bond market towards more traditional financing methods, for example, MS Spaichingen AG, Bastei Lübbe AG, Karlsberg Brauerei AG and MITEC Automotive AG (refinancing through traditional bank loans); or Edel AG and Sanochemia Pharmazeutika AG (refinancing through Schuldschein).

3 The median issuer rating of issuers with a MARF bond stands at BB+.

4 While it is not required by the MERCADO ALTERNATIVO DE RENTA FIJA, it seems to be a common sense among transaction banks to accompany only issuers which display a maximum leverage of Debt/EBITDA) von 3.5x and a minimum corporate size measured by an EBITDA of at least EUR 12m.

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