



OLIVER WYMAN

The supply of financing to Canada's small and medium-sized enterprise market

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Prepared as requested for the Business Development Bank of Canada

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1. Executive summary

The Business Development Bank of Canada (BDC) has requested Oliver Wyman to prepare a report that identifies past, present and future trends in financing provided to small and medium-sized Canadian enterprises (SMEs). Our assessment includes several components. First, we provide a fact-based summary of the structural trends in the market over the past decade from both a supply and demand perspective. The focus of this analysis has been on identifying segment trends by various key dimensions, including:

- Brief overview of the composition of the SME market by industry, regional location, stage of development and various other dimensions
- How financial institutions segment and serve the SME market
- Sources of financing for SMEs
- Types of financial institutions participating in the market, their relative market share, and trends among competitors
- Profitability or economic characteristics of SME financing
- Observations on the structural and cyclical difficulties some SMEs may face in accessing credit in the market

The first portion of the analysis relies principally on external – or publically available – sources of data (i.e. Bank of Canada, Statistics Canada, The Conference Board, Industry Canada, other) and internal marketing and research reports made available to Oliver Wyman by the BDC as well as Oliver Wyman’s own market experience and intelligence. A complete list of these sources is provided in the appendix of this report and citations are made throughout the document for specific tables and charts. The main findings from this section may be summarized briefly as follows:

- The SME segment occupies a prominent place in the Canadian economy generating nearly half of GDP and employing close to sixty per cent of the labour force
- It is a remarkably stable segment when viewed from a macro perspective (i.e. little net change in business formations or debt levels over time)
- Industry segments also have been fairly constant over the time frame in review. However, manufacturers continue to decline gradually in relative importance while service and “knowledge-based” companies continue to grow
- Debt financing is overwhelmingly provided by the major domestic banks and leading credit unions with an important role also played by non-bank finance companies
- For most full service financial institutions, the economics of small business banking have improved over time due to better credit and operational processes, enhanced cross-selling, and relatively benign loss rates on credit exposure

A second component of our analysis is a summary of the major trends and themes we have observed among financial institutions participating in the SME market in addition to certain trends among the SMEs themselves. We have selected five major themes for closer examination both because these are most reflective of the actual challenges and

concerns banks and non-bank financials have had in providing services to the segment and also because they continue to have an influence over the likely future course of developments for the market. These themes include:

- A progressively greater understanding among financial institutions over the past decade of true economics and risk-adjusted profitability of the SME banking business. For many financials, the SME segment historically has presented challenging economics, and optimizing the business to achieve minimum rates of return on bank capital has been a significant strategic priority
- A focus on capturing ever greater volumes of cross-sell revenue (revenue coming from selling all other bank products and services) from SMEs, particularly among full-service financial institutions capable of offering a full breadth and depth of products. In particular, we suggest that gathering deposits from SME customers generally offers the single best means of enhancing profitability for many financial institutions
- Efforts to achieve more constructive segmentation of the customer base, especially between “micro” and “small” business. When such segmentation is utilized, micro lending is generally handled through branch banking channels while small business retains a relationship manager-centric servicing model
- The introduction of business internet banking and telephone servicing, and the attendant gradual retreat of the relationship manager from servicing and monitoring responsibilities
- The move towards scored credit (a simplified means of assessing the relative riskiness of a customer) as a way both to reduce costs of servicing SMEs and refine risk assessment generally

These trends do not by any means represent an exhaustive list of the issues observable in the market over the past decade but represent those that have had, and are likely to continue to have the greatest impact on SME access to credit and the quality or extent of service they may receive from their primary financial institution.

We will also highlight a selection of additional themes including: the development and growth of securitization markets, especially for receivables and its influence on market dynamics; the emerging willingness of certain financial institutions to “play” the capital structure of small businesses with subordinated or second-lien financing; and the changing nature of SMEs themselves with a diminishing presence of bricks and mortar manufacturing companies in favour of service companies and so-called “knowledge-based” enterprises – which many financial institutions have a more difficult time financing. Finally, some attention will also be devoted to the question of regulatory trends (i.e. Basel agreements on capital standards for banks) and their possible impact on credit appetite for private sector banks towards their SME segment. It is our conclusion that regulatory issues likely will not have a major impact of the supply of credit for SMEs.

The third and final section of the report seeks to identify structural and cyclical market deficiencies which may still be present over the next five to ten years in the provision of

credit and financial services to the SME market for which the BDC could play a complementary role to the private sector in filling. During the course of our research, we identified numerous possible opportunities for consideration, several of which the BDC is already pursuing. In creating this list we tried to identify spots or segments in the market where there may be a market deficiency in coverage *as well as* general trends among the SMEs which the BDC should consider as it formulates its basic approach to market. Each option presents specific challenges and we conclude the report by presenting our assessment of those challenges and considerations for successfully positioning the BDC to continue in its role as a valued participant in Canada's financial services industry.

Initiative summary

Market deficiencies created by recent financial crisis which BDC is filling (or could fill by extension)	<ul style="list-style-type: none"> ▪ ABS liquidity provider and/or ABS arranger (ABS purchase facility) ▪ Up-market credit extension (Partially done through BCAP) ▪ Offering working capital credit (working capital lending and guarantee program) ▪ Guarantee of company-specific leasing needs or direct origination of leases
Apparent structural deficiencies in financing	<ul style="list-style-type: none"> ▪ Select industry segments (i.e. KBIs; R&D intensive companies, exporters in need of term lending) ▪ Lending to earlier stage companies and younger entrepreneurs ▪ Offering subordinated credit where appropriate and in compliance with strict credit guidelines

Throughout the document various terms are used which may not be familiar to a reader not actively working in the financial services industry. To help explain these terms we have provided a Glossary at the end of the report with basic definitions.

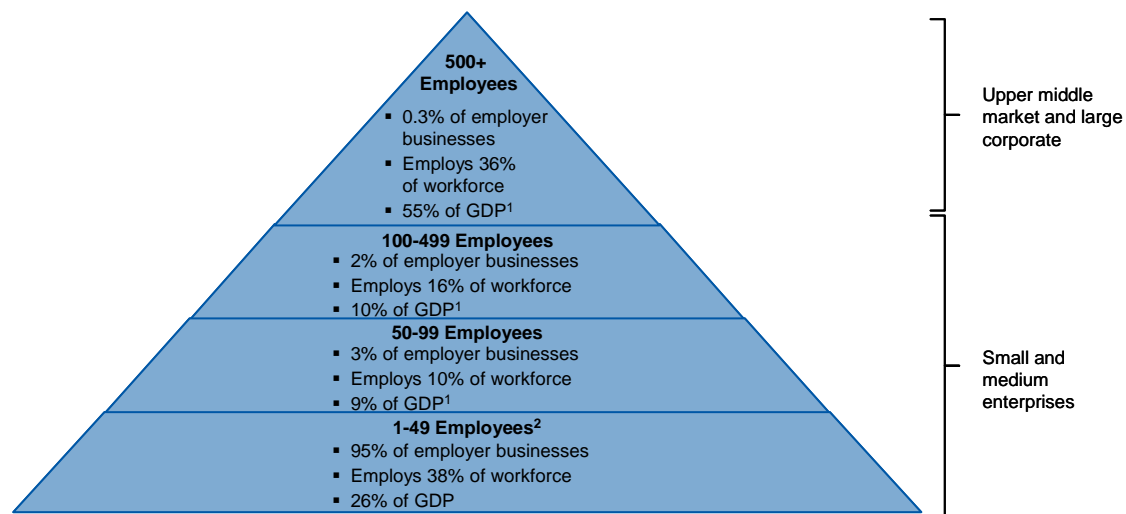
2. Canada's SME market as defined by financial institutions

This section will provide: 1) a brief description of the Canadian SME market (i.e. composition and characteristics of SMEs); 2) observations on how SMEs finance themselves; and 3) information on the providers of debt financing and their generic business models.

2.1. Brief profile of SMEs in Canada

Although it is sometimes difficult to define exactly what constitutes a small business, taken as a whole, SMEs constitute a significant portion of the Canadian economy. Figure 1 illustrates the relative contributions of the SME segments against the middle market and large corporate portion of the economy. In addition to accounting for nearly ninety-eight per cent of all business establishments by number, SMEs represent approximately forty-five per cent of Canadian GDP and employ close to sixty per cent of the work force. This level of GDP contribution and employment has remained relatively constant over the past decade and underscores the significance of SMEs to the overall economy. These numbers are typical of those seen in developed economies. A recent survey conducted by the International Finance Corporation (IFC), for example, found that in the thirty high-income countries of the Organization for Economic Cooperation and Development (OECD), SMEs with fewer than 250 employees accounted for approximately two-thirds of total employment and nearly half of gross national product¹.

Figure 1: Size of the SME market relative to large corporate and middle market



1. Oliver Wyman analysis

2. British Columbia Statistical Service

Excludes companies without any payroll employees (1.2 MM establishments employ only contract workers, family members and/or owners)

Sources: Key SME Statistics – Industry Canada – Jan, 2010

¹ Source: International Finance Corporation, "The SME Banking Knowledge Guide," 2009

Appendix A provides a series of charts and graphs with more detail on the composition of Canada's SME market by various dimensions. In particular we examine the growth of the SME market by number of business establishments over the past decade, the regional and industry segment distribution of companies, the important role SMEs play in supporting Canadian exports, and various other observations on SME demographics.

Here it is sufficient to say that the SME segment has remained relatively stable over the past ten years. Indeed, the number of employer businesses has barely grown in absolute terms regardless of underlying company size during that timeframe. Also notable has been a gradual shift in the location of small businesses towards Ontario and the West even as Ontario and Quebec still account for 56% of all SMEs. Lastly, the industry composition of SMEs has also undergone change. Manufacturing and agricultural businesses have declined in number since 2000 while the mining, oil and gas, and select other knowledge-based companies have grown.

Economic challenges have been especially acute for manufacturers as they grapple with a strong dollar, emerging market competition and soft markets exacerbated by the recent international financial crisis and steep drop in consumer demand. Between 2000 and 2006, some 4,370 small manufacturers ceased to exist either because of bankruptcy, acquisition or consolidation, or general liquidation. This contributed to a net decline of employment in the sector of over 73,900.

Conversely, net company and job growth have tended to come from companies in the service sector. The Conference Board of Canada estimates that just over half of all jobs in Canada are accounted for by the commercial services sector. This covers a wide range of business segments including professional services; information technology; retail trades; and financial advisory. The recent recession has caused consolidation and job losses in this sector too but they have been slight in comparison with previous recessions and other segments.

2.2. How SMEs finance themselves

Small businesses rely on a variety of sources to fund their working capital needs and long-term growth. In addition to cash flow generated by the businesses themselves, the sources may be broadly divided between different forms of debt and equity. As indicated in Figure 2, equity financing typically comes from family members and friends, employees, or other private or public sector investors. Debt financing (i.e. short-term operating lines of credit, long-term loans, and leases), however, represents the most common form of external financing for the segment as a whole.

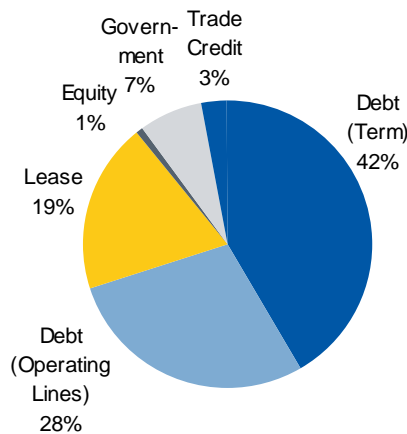
Based on work we have done for banks and non-bank financials, Oliver Wyman estimates that in the Canadian market about 60% of debt financing available to small businesses is provided in the form of term facilities (i.e. maturities greater than one year) while the balance comes in the form of operating lines of credit which revolve much like a credit

card.² This percentage split varies from financial institution to financial institution with some players preferring to emphasize lending of shorter-term operating lines of credit while others focus more on offering term debt.

It is worth mentioning that the type of financing available to small businesses is frequently dependent on the stage of development of the company. Not surprisingly, start-up companies have the most difficult time raising financing of any sort, debt or equity. As a company grows and establishes a financial track record, it becomes easier to raise funding. A typical progression would be to establish an operating line of credit first, usually secured by receivables and inventory, then obtain term financing for specific capital equipment purchases or long-term funding needs of the business.

Figure 2: Sources of funding for SMEs broken down by product

New debt financing requests (2007)



Equity financing (2007)

Requested source of equity financing	% of small businesses that utilized source
Friend or relative of the business owners	49%
Private investor from outside the firm unrelated to the firm and its owners	40%
Crown corporation or government institution	15%
Employee of the business	9%
Other	23%

SMEs defined as all companies with <500 employees and <\$50 MM in revenue
Source: Survey of Financing of SMEs, 2007, Statistics Canada

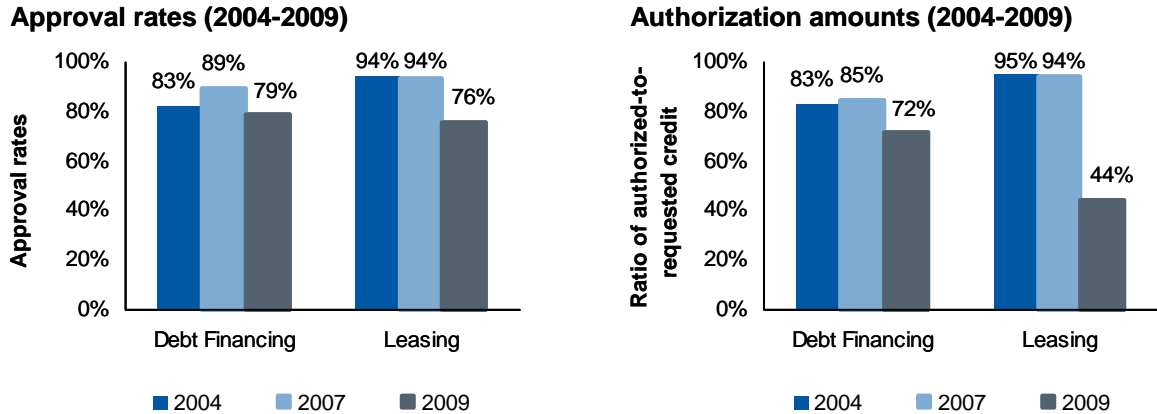
The other major factor influencing the supply of credit to SMEs is the business cycle itself. Industry Canada recently sponsored an extensive survey on credit conditions for small businesses with comparative data pre-and post-financial crisis. The results, partially summarized in Figure 3, showed that approval rates for debt and lease financing dropped significantly between the last full pre-crisis year, 2007, and 2009. The drop was especially pronounced for lease financing which declined by roughly twenty percent over the period in question.

The survey further suggested that there was a market deficiency created by the recession with both requests rates from small businesses declining steadily (driven overwhelmingly by a diminishing absolute need for financing due to economic conditions *and* some fears that financing requests would be rejected or deferred in any case or be too expensive).

² Please note that Figure 2 represents data for new financing requests within a given year while the percentage split mentioned above represents the approximate accumulated distribution at a given point in time (stock versus flow).

Indeed, approval rates for new financings also dropped substantially from pre-crisis levels as banks and finance companies tightened their lending criteria or faced liquidity constraints (discussed further below).

Figure 3: Approval rates and authorization amounts



SMEs defined as all companies with <500 employees and <\$50 MM in revenue
 Source: Survey on Credit Condition, 2009, Statistics Canada

2.3. Providers of debt financing to SMEs

Financial institutions seek to define the SME segment by one or more dimensions such as number of employees, annual revenue, loan sizes or occasionally even behavioural characteristics of the underlying companies. That said, banks and others will set their specific segment boundaries differently depending on their own internal organizational structures (i.e. coverage models for relationship managers, geographic footprint), risk management processes, or even product offerings. In Figure 4, we have provided some generic descriptions of the types of segment boundaries and characteristics for small business that can be observed from market practice.

Most financial institutions draw a distinction between the very smallest small business customers, often referred to as the “micro business segment” and traditional “small business” clients. This distinction often rests on how the lending requests of customers are actually adjudicated (decided) through the risk management process. Micro businesses frequently are assessed based on statistical “scoring” models similar to the credit scoring models used by credit card companies for consumers. The process is designed largely to be automated and to require a minimum of human intervention. We will see later that this may have implications on small business access to credit and/or the quality of the service received by their financial institution. Traditional small business credits tend to be “risk rated” which involves assessment of company financial statements and other quantitative and qualitative information about the client. Typically this is done by dedicated credit analysts. What complicates the segment definitions is that different

financial institutions will set the boundaries for each process differently depending on the confidence they have in their respective risk assessment models.

Regardless of these distinctions, the next general break point in defining the SME segment tends to come into play as the company grows in size and requires larger amounts of financing or presents more complicated product needs and requirements to their financial partner. For most banks in Canada this occurs at around a credit or loan value of \$2.5-3 MM dollars. These accounts are generally known as “commercial” or “middle market” clients and may be characterized as having more customized financing terms with their banks or debt providers. As commercial-middle market companies grow in size they start to take on the characteristics of larger corporations and many financial institutions will draw a further segment distinction for these so-called “upper middle market companies” as well.

Figure 4: SME segment defined from the financial institution perspective

Segment	Characteristics
Micro Business	<ul style="list-style-type: none"> ▪ Small number of employees (typically 1-10) ▪ Often start-ups with limited financial history ▪ Credit needs can range up to \$250,000; offered in standard “package” ▪ Frequently adjudicated in a credit scored risk environment (no dedicated Account or Relationship Managers)
Small Business	<ul style="list-style-type: none"> ▪ Credits can range between \$250,000 to \$3 MM depending on institution ▪ Usually assigned dedicated Relationship Managers (RMs) ▪ Lending is risk rated with dedicated credit analysts ▪ Usually well defined terms and conditions on lending
Commercial (Middle Market)	<ul style="list-style-type: none"> ▪ Credits between \$3 to \$50 MM, still usually held by one main financial institution ▪ Wide range of product and service needs (foreign exchange, derivatives, merchant credit cards, payments, other) ▪ Served by dedicated RMs ▪ Risk rated credits with fair degree of customization in credit terms
Upper middle market	<ul style="list-style-type: none"> ▪ Typically credits greater than \$50 MM and up to \$200-500 MM ▪ Exposures often shared or syndicated among several banks ▪ Display many of the financial services needs of large corporates (i.e. capital structures more complex, derivatives and foreign exchange needs) ▪ Risk rated, structured credit terms with dedicated relationship managers also reasonable for coordinating cross-sell
Large corporate	<ul style="list-style-type: none"> ▪ Larger, sophisticated companies with wide range of needs ▪ Broader access to capital markets for debt and equity solutions

In Canada, there are many different providers of debt financing and the main types of financial institutions active in the market may be summarized as indicated in Figure 5. Major participants include the Schedule I domestic banks which maintain national branch networks and offer the broadest array of products and services to their clients. Two large credit unions, Desjardins and Vancity, are especially prominent in their respective regional markets of Quebec and British Columbia. In addition, there are an estimated

1,000 other credit unions and *caisses populaires* operating throughout the country mainly with a community or narrowly defined geographic focus.

Each participant in the market may have a unique business model which it is pursuing but some general statements can be offered about the different groups. For example, the domestic Canadian banks tend to be quite prudent in their lending standards. This is evident when examining several dimensions to their lending practices:

- Term (the willingness to lend beyond a certain number of years)
- Leverage amounts (the maximum amount of credit a bank is willing to extend to a given company)
- Collateral requirements (the need for a bank to receive pledges of collateral or security in order to advance credit)
- Type of debt (senior debt versus subordinated)

Although exceptions do exist for the most credit worthy customers, Canadian banks seldom extend term loans beyond five-years to small business customers and frequently prefer to offer operating lines on a demand basis (i.e. the facility can be terminated at the lender's discretion if the borrower fails to meet certain terms and conditions in their credit agreements such as financial performance ratios). Leverage ratios (the amount of debt available relative to the cash flow that a business generates) are usually capped in the 2.5 to 3.0 times debt to cash flow range for senior debt and tend to be lower than those observed in other markets, such as the United States. Credits are invariably secured against some form of collateral (customer receivables, inventory, plant and equipment) which in turn means that second-lien or subordinated financings generally are not offered. Indeed, as we will discuss later in the Market deficiency section, Canada has never really developed a deep subordinated debt market. All of this means that pricing on the loans themselves can be comparatively low (indeed, credit spreads on small business loans tend to be lower in Canada than many other developed markets) thus requiring the banks to augment segment returns by cross-selling other products and services and by gathering deposits from customers.³

Other participants include a wide range of non-bank financials and vendor financing companies. Non-bank financials are not deposit taking institutions and typically must raise their own funding through the issuance of various public debt instruments (i.e. bonds, commercial paper, inter-bank borrowings) or by securitizing (bundling loans into securities, bonds) the credit exposures that they generate for distribution to other institutional and retail investors. Non-bank financials pursue many different business models. Some focus on providing working capital lines of credit (secured against a "borrowing base" composed of customer accounts receivable or inventory) while others may provide lease financing for specific pieces of capital equipment used by business

³ This observation is based both on historical Oliver Wyman project work in different geographies and historical studies done by The Canadian Bankers Association citing research by The Loan Pricing Corporation and the World Economic Forum.

clients. Vendor financing companies are similar in nature but tend to be captive providers of financing associated with specific equipment manufacturers. Regardless of the specific business model being pursued by these players, emphasis is placed on having a deep understanding of the residual asset values underpinning the financing (the value of an asset after a lease or loan is repaid and the finance company may have to re-sell the asset for the transaction to be profitable).

Figure 5: Suppliers of credit to SMEs

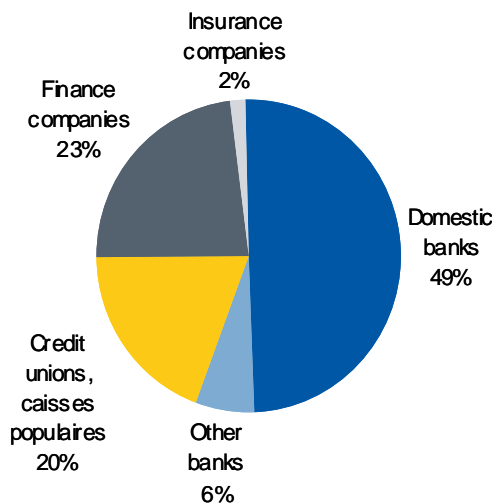
	Schedule 1 domestics	Large credit unions	Smaller credit unions	Foreign banks	Finance companies	
					Non-bank financials	Vendor financing
Examples	<ul style="list-style-type: none"> ▪ CIBC ▪ Scotia Bank ▪ TD ▪ Royal Bank ▪ BMO ▪ National Bank of Canada 	<ul style="list-style-type: none"> ▪ Desjardins ▪ Vancity 	<ul style="list-style-type: none"> ▪ Coast Capital ▪ Servus ▪ Meridian ▪ ~1,000 	<ul style="list-style-type: none"> ▪ HSBC ▪ Capital One 	<ul style="list-style-type: none"> ▪ GE ▪ CIT ▪ Wachovia Capital Finance 	<ul style="list-style-type: none"> ▪ GMAC ▪ Caterpillar ▪ Dell
Characteristics	<ul style="list-style-type: none"> ▪ Credit still lead product ▪ Deposits, cash management vital additions ▪ Very broad product set in wealth, other areas ▪ Sophisticated risk management 	<ul style="list-style-type: none"> ▪ Prominent players in core geographic markets ▪ Reasonably broad product set outside of credit ▪ Many of the same approach to market strategies as larger Domestics 	<ul style="list-style-type: none"> ▪ Highly fragmented segment of providers ▪ Emphasis on local or community relations ▪ Limited but growing product suite 	<ul style="list-style-type: none"> ▪ Variety of models pursued ▪ Full service players with branch presence ▪ Remote or centralized players with virtual presence ▪ Some dedicated to particular segments or communities (i.e., ethnic groups) 	<ul style="list-style-type: none"> ▪ Credit product is principal offer with higher risk clients ▪ Focus on both working capital lines and term lending ▪ Characterized by intensive account monitoring ▪ Deep knowledge of residual values of equipment and machinery (value after a loan or lease is repaid) 	<ul style="list-style-type: none"> ▪ Captive finance companies supporting parent manufacturers ▪ Range from small to larger ticket financings

In 2008, the last full year for which information is available, both short and long-term debt financing authorized to SMEs totalled approximately \$148 BN. (This figure excludes leasing volumes which are touched upon below). As shown in Figure 6, just over half of this amount was provided by the domestic banks with credit unions and *caisses populaires* providing another 24%. Finance companies are the third largest supplier of debt financing at 16% although their share has declined considerably over the past decade in part for reasons related to the difficulties in the securitization market which we discuss in Section 3. Foreign banks and insurance companies make up the balance of providers. (The role of insurance companies is largely limited to longer-term financings greater than

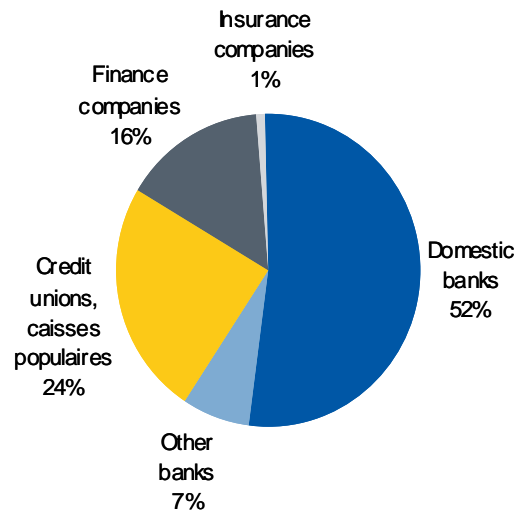
five years in maturity and often secured by real estate). Foreign banks have a checkered history in Canada with many entries and exits observable over the past decade – together with a noticeable retrenchment in the 2008-09 financial crisis. Some focus entirely on large corporations while others have delved into the middle market and small business-consumer banking segments.

Figure 6: Changes in the composition of the SME debt financing market over time

Providers of debt financing (2000)
Total authorized limit: \$144 BN



Providers of debt financing (2008)
Total authorized limit: \$148 BN

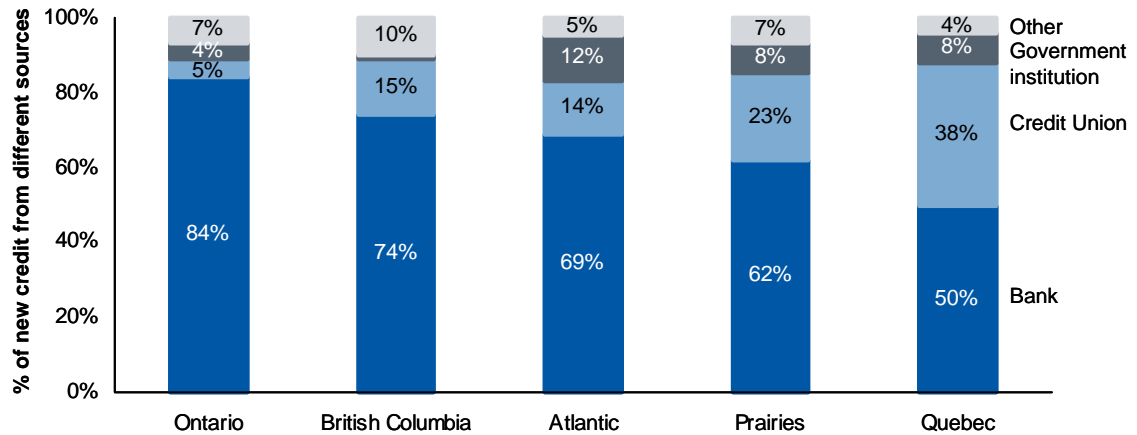


SMEs defined as all enterprises with a authorization size of less than \$1MM
Source: Survey of Suppliers of Business Financing 2008, Statistics Canada

As indicated, the role of credit unions is more significant when data is considered on a regional basis. Credit unions are especially prominent in Quebec and the Prairies with a significant – but smaller – portion of the markets in British Columbia and Atlantic Canada as well. Ontario is largely served by the major banks.

Figure 7: Regional differences in providers of SME debt financing

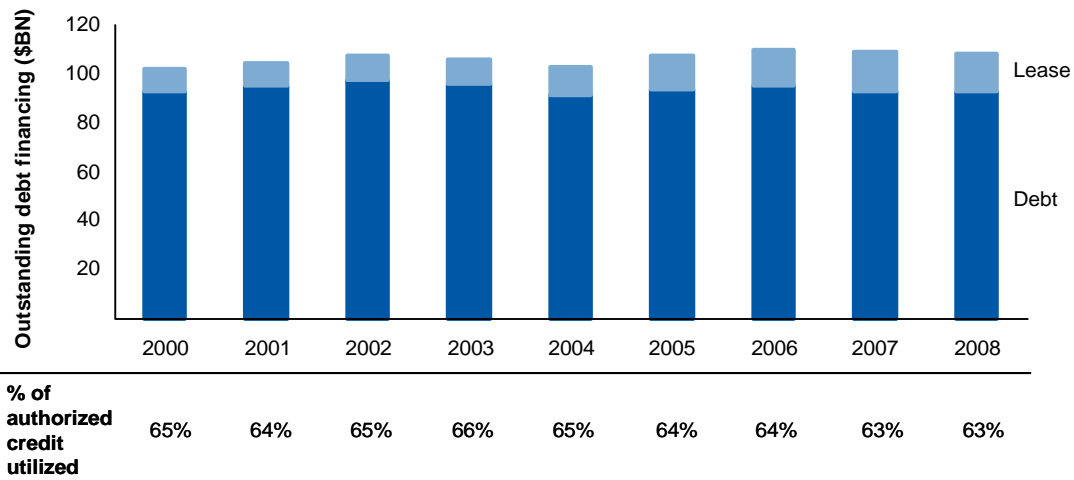
Provincial breakdown of new debt requests by provider (2007)



SMEs defined as all companies with <500 employees and <\$50 MM in revenue
 Source: Survey of Financing of SMEs, 2007, Statistics Canada Table 3

The amount of both short and long-term loan and lease financing provided to Canadian SMEs is presented in Figure 8. The total authorized limit for the market was \$173 BN in 2008, the last year for which data was available at the writing of this report. Of that amount available, approximately 63 per cent, or \$108 BN, was actually drawn by SME customers. By and large the amount of credit available in the market and the corresponding utilization rate has changed very little over the past decade.

Figure 8: Outstanding financing and percentage of authorized credit utilized (2000-2008)



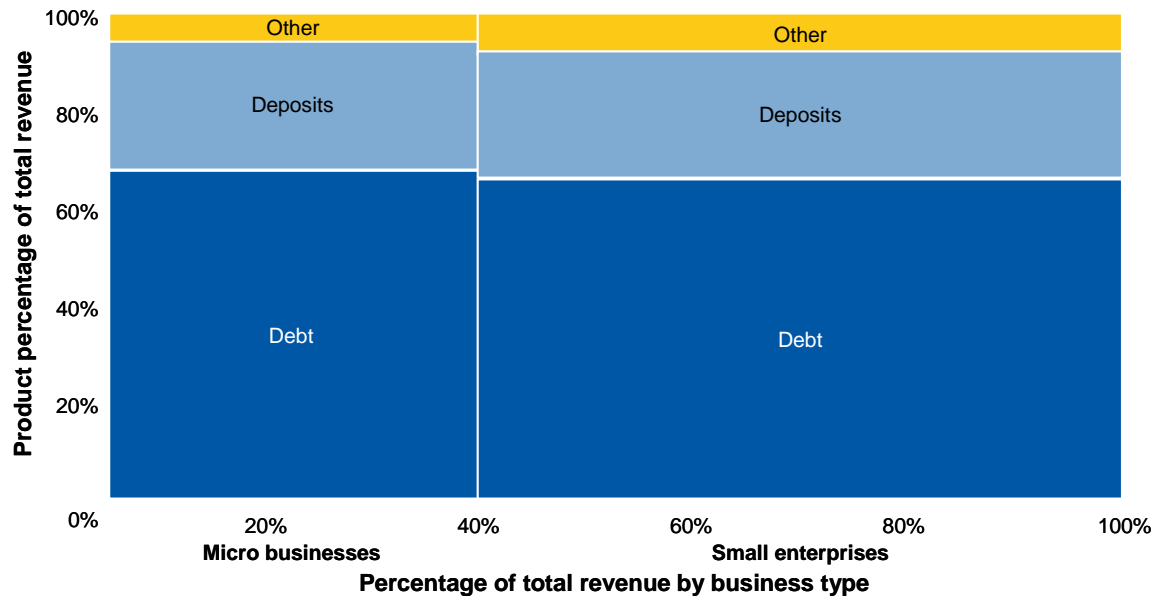
SMEs defined as all enterprises with an authorization size of less than \$1 MM
 Source: Survey of Suppliers of Business Financing 2008, Statistics Canada

Although Section 3 touches upon the micro-economics of lending to small businesses and its influence on risk appetite and credit supply, it is worth noting that the small business segment does represent a significant revenue pool for the industry as a whole.

Figure 9 is our estimate of that revenue pool broken down by broad segment categories and products. We roughly estimate that the core small business segment generates just over \$5 BN of revenue for the industry with the lion’s share of that coming from interest rate spread on the credit product. By way of comparison, the largest domestic Canadian banks as a group generated revenue of nearly \$100 BN in 2009.

It is also true that growth rates for SME banking do not always compare favourably with other lines of business within a full-service financial institution. Over the past decade, retail banking and capital markets businesses for large corporations generally have outpaced the growth rate of SME banking. Revenue from consumer, or retail, businesses grew at approximately 14% over this period while capital markets revenue grew at 12%. Of course, this is only one measure of relative attractiveness of the business segments. Returns in capital markets businesses, for example, display much greater volatility through a business cycle than SME banking.

Figure 9: Revenue pool (composition) of micro and small business segment



Small and Micro business defined as all enterprises with an authorization size of less than \$250,000 Medium enterprises defined as having an authorization size greater than \$250,000 and less than \$1 MM
 Source: Oliver Wyman estimates, Survey of Suppliers of Business Financing 2008, Statistics Canada

3. Historical trends and themes

We now turn to the second component of our analysis: a summary of the major trends and themes we have observed among financial institutions participating in the SME market in addition to certain trends among the SMEs themselves. As indicated, we have selected five major themes for closer examination both because these are most reflective of the actual challenges and concerns banks and non-bank financials have had in providing services to the SME segment and also because they continue to have an influence over the likely future course of developments for the market. These themes include:

- A progressively greater understanding among financial institutions over the past decade of true SME segment profitability after adjusting for all sources of revenue from customers and applying appropriate assumptions for credit loss charges.
- A focus on capturing ever greater volumes of revenue from SMEs, particularly among full-service financial institutions capable of offering a full breadth and depth of products with deposits from SME customers generally offering the best means of enhancing profitability for players in the segment.
- Efforts to achieve more constructive segmentation of the customer base, especially between “micro” and “small” business. When such segmentation is utilized, micro lending is generally handled through branch banking channels while small business retains a relationship manager-centric servicing model.
- The introduction of business internet banking and telephone servicing, and the attendant gradual retreat of the relationship manager from servicing and monitoring responsibilities.
- The move towards scored credit as a means both to reduce costs of servicing SMEs and refine risk assessment.

Although it is often argued that these trends have helped to make credit cheaper and perhaps more widely available to SMEs, it is also pointed out that many of these trends have had the effect of reducing the amount of time and attention offered to small and medium-sized businesses on a day-to-day basis. Indeed, the basic promise of credit scoring, better segmentation, and increased focus on phone and internet banking in particular was to: 1) lower the cost to serve customers, especially at the lower end of the small business banking market; 2) increase the speed at which credit decisions could be made both for new applications and renewals; and 3) provide more accurate pricing tied to relative risk of a given company. In theory, these represent benefits to both suppliers of financing and to the companies themselves.

On the flip side, one could argue that these trends had some negative implications for the customers as well. In many instances, the application of credit scoring and refined segmentation meant that basic loan and product packages were standardized (i.e., one size fits all) and that may have upset customers who previously had customized loan features or sought such features. Also, Relationship Managers (RMs) were expected to handle more accounts (because the loan offer was standardized) but that too meant that the

personal attention previously afforded a customer may have been lost or greatly diminished. Lastly, credit scoring in particular was often accompanied by centralization of credit decisions and this too may have had to a perception among some customers based in regional jurisdictions that the decision maker for their banking relationship was located far away and not personally vested in their success.

In any event, these trends do not represent an exhaustive list of the issues observable in the market over the past decade. We will also highlight the development and growth of securitization markets, especially for receivables and its influence on market dynamics; the emerging willingness of certain financial institutions to “play” the capital structure of small businesses with subordinated or second-lien financing; and the changing nature of SMEs themselves with a diminishing presence of bricks and mortar manufacturing companies in favour of service companies and so-called “knowledge-based” enterprises. Some attention will also be devoted to the question of regulatory trends and their possible impact on credit appetite for private sector banks. Lastly, we will look at the recent financial crisis and the impact it had on lending to SMEs.

3.1. Understanding the economics

It is sometimes difficult for observers outside of the financial services industry to learn that, for many full service financial institutions, the SME banking segment historically attracted very little strategic emphasis especially when compared to either the retail or large corporate lines of business. In Canada, retail banking (i.e. consumer banking and wealth management) has driven industry profits in recent years and has a reputation for stability and low loss volatility. Large corporate or wholesale banking – including capital markets activities and sales and trading – grabs the big headlines whether for the mammoth deals completed during the peak of the business cycle or the equally impressive credit or market losses in the trough of the cycle. In contrast, SME banking is often seen as the poor cousin, caught in between those two segments and never causing either undue excitement or alarm.

Over the past decade however, there has been a marked improvement in the appreciation of the SME segment both here in Canada and in other markets as well. This began first with an increased awareness of segment economics driven by improvements in data capture and profitability analytics at banks and non-bank financials. Historically many financial institutions presumed that the credit product (i.e. loans) were the principle if not only true source of revenue to be derived from SMEs. This created the impression for many banks that SME banking represented a poor return on capital. Oliver Wyman typically observes that the stand-alone return on equity for lending at many banks and non-bank financials in the SME segment is in 6-12% range, less than most institutions’ target minimum rates of return of between 15-18%. Figure 10 illustrates the typical economics of a small business lending segment for a typical bank. {Please note that the assumptions are composite and drawn from many different sources and thus not meant to depict any particular institution}.

Figure 10: Hypothetical small business banking P&L

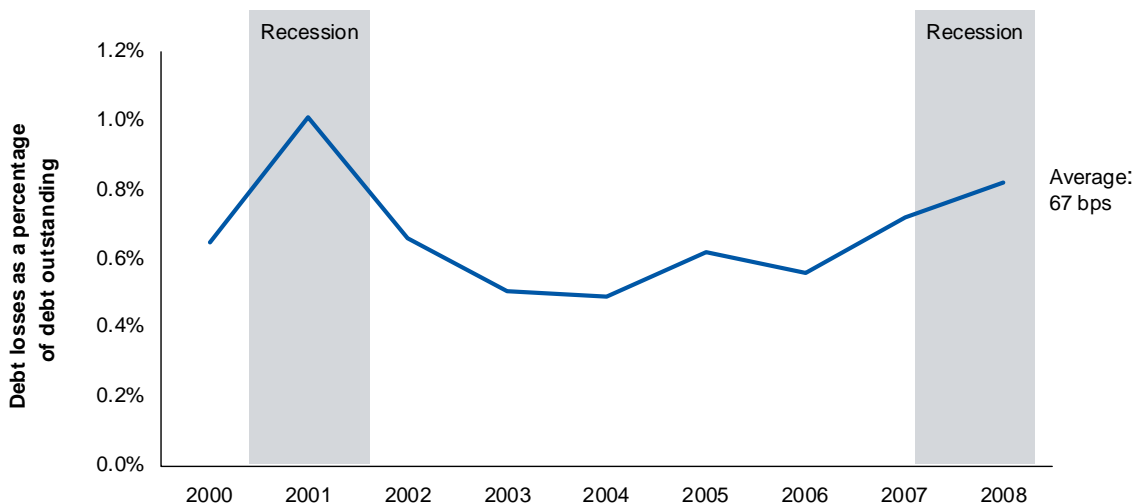
Implicit risk adjusted P&L		
	Lending revenue	\$30 MM
	Deposit revenue	\$10 MM
	Other fees	\$5 MM
	Total Revenue	\$45 MM
Less	Operating expense	\$18 MM
	Operating Income	\$27 MM
Less	Expected loss	\$7 MM
	Pre-Tax Risk Adjusted Profit	\$20 MM
Less	Taxes (35%)	\$7 MM
	Net Income	\$13 MM
	Capital	\$80 MM
	RAROC	16%

Main assumptions	
▪	Balance sheet outstanding assets total \$1 BN
▪	Outstanding credit spreads are 300 bps
▪	Deposit : Loan ratio is 1 : 1
▪	Deposits transfer priced at 100 bps
▪	Other fees are 20% of lending revenue
▪	Operating expenses are ~ 40% of Revenue
▪	Expected loss is 70 bps
▪	Taxes are 35%
▪	Capital is 8% of outstanding assets

Source: Oliver Wyman analysis and industry experience

This “typical” Profit and Loss Statement underscores the important contribution of deposits (which attract no capital from a regulatory perspective), the need to maintain reasonable and consistent levels of credit losses over time, and the imperative of keeping operating costs in check. Fortunately, credit losses in the Canadian small business segment, although susceptible to economic and business cycle peaks and troughs, are generally low and predictable. Figure 11 shows that the average losses for the segment worked out to approximately 67 basis points over the past decade.

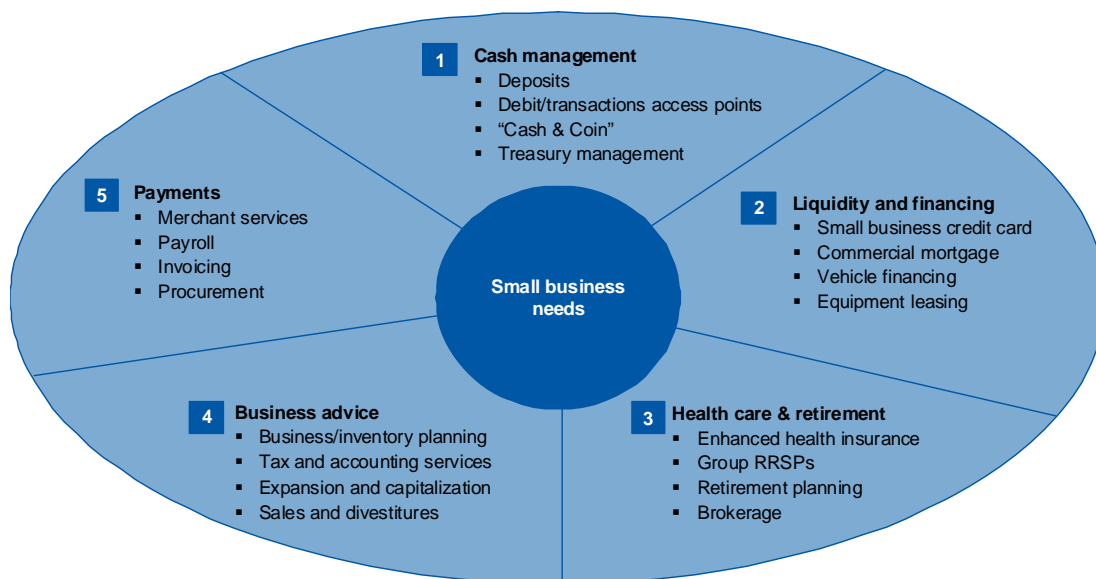
Figure 11: Default trends for SMEs over past decade



SMEs defined as all enterprises with an authorization size of less than \$1 MM
 Source: Survey of Suppliers of Business Financing 2008, Statistics Canada

With improved analytics however, banks began to understand that SMEs provided revenue through many different products and channels aside from credit and that taking a broader, more holistic perspective on the customer relationship was essential for understanding the true value of the business. One of the first observations to be seen in this light was the important contribution of deposits to a bank’s revenue stream. SMEs frequently represented an outstanding source of deposits for many banks both because they carried deposit balances from normal working capital fluctuations and because some SMEs simply generate more cash than need for credit. Deposits are of course important to banks because they represent a low cost source of funding and typically can be priced 50 to 150 basis points below the cost banks would otherwise have to pay to attract funding from large institutions or other banks. (Note that in the current low interest rate environment the importance of deposits as an economic driver of good SME segment performance is diminished, but one could argue that this is a temporary phenomenon from a historical perspective). Other significant profit pools for financial institutions from SME customers include foreign exchange, simple derivative instruments like currency hedges, and a plethora of cash management and transaction service products usually associated with the collection of customer receivables.

Figure 12: Additional SME sources of revenue for FIs



3.2. Optimizing the cost to serve

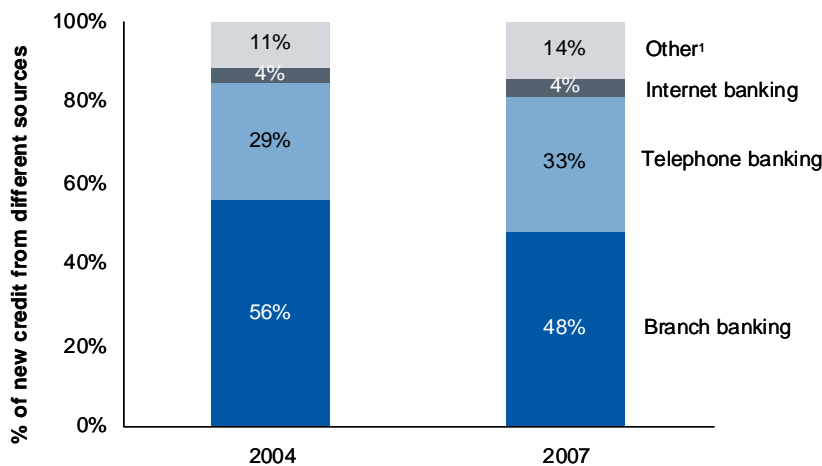
Once institutions began to aggregate all the various sources of revenue from a small business customer they began to realize that the segment was considerably more attractive than previously thought. That said, focusing only on the revenue side of the equation still would not be sufficient to achieve optimal returns. This meant that attention had to shift as well to the cost of delivering services to SME customers. Historically many financial institutions operated this segment with a traditional relationship manager-centric business

model. This meant that each small business client was assigned a dedicated relationship manager who was in effect the face of the bank. RMs would prepare credit applications, handle routine inquiries, and resolve any disputes or discrepancies that might arise in the normal course of the banking relationship. In turn, relationship managers were supported by a complementary set of credit analysts whose responsibility it was to assess and adjudicate credit applications and provide ongoing monitoring support for the portfolio.

Banks soon realized however that most SME customers had fairly simple banking requirements and that the risk profile associated with the segment was relatively predictable and easy to define. Indeed it can sometimes be quite difficult to distinguish between some small businesses and the owner-operators who run them from a credit perspective. This led to a drive to segment the customer base into tiers of service coverage. Customers with relatively simple banking needs were offered standardized products or banking packages with little or no variation allowed in basic terms and conditions. Typically these customers were served through the branch banking networks of the financial services providers or through internet or phone-based channels. Customers with more complicated banking needs retained the relationship manager coverage model and were often provided with bespoke terms and conditions for their credit facilities together with more intensive monitoring of financial data and collateral requirements. Relationship managers also became responsible for identifying opportunities to cross-sell other bank products and services and investments were made by many financials to improve so-called customer relationship management (CRM) databases to assist in identifying likely needs over time.

Figure 13: Distribution channels (2004-2007)

**Distribution channels
(2004-2007)**



1. Other includes mail and fax applications in addition to other unspecified banking channels
 SMEs defined as all companies with <500 employees and <\$50 MM in revenue
 Source: Statistics Canada, Survey on financing of SMEs, 2004, 2007

3.3. Trend toward credit scoring

Credit scoring is best defined as the process associated with assigning a relative risk grade to a business (or individual) based on a series of usually simple quantitative or measureable factors which have some proven statistical ability to predict default probability. The concept of credit scoring has existed in the financial services industry for quite some time but efforts to apply it to the small business segment took on greater prominence in the past decade for a variety of reasons. First, banks and various third-party vendors of credit scoring technology had amassed significant samples of data on relative credit performance in many banking segments, including commercial and small business. This enabled the creation of scoring models which could be sold to banks and then customized to fit the unique characteristics of a given bank's portfolio or focus. Banks themselves sought to have a cheaper and more effective means of assessing credit risk which could replace the cumbersome process of "manual adjudication" by a credit analyst who would apply personal expert judgment to determining a risk score but which could prove inconsistent in application across a large portfolio of credits being adjudicated by many different analysts. Lastly, demonstrating a robust credit scoring model could also allow regulated banks to apply for reduced capital levels for various lines of business where those models were applied.

The introduction and wide spread adoption of credit scoring tools in the small business segment tended to reinforce some of the trends highlighted above. For example, if the personal dimension of adjudicating credit was largely removed then it became possible to segment the market more efficiently between simple and thus standard credits and those requiring greater involvement by relationship managers and risk analysts. This facilitated the move toward alternative origination channels such as internet banking and phone-based applications with attendant speed in credit decision making and responses to clients, which in turn was a potent competitive advantage for some players in the market. This in turn allowed new entrants to target a greater share of the small business market without having to incur the expense of building a branch-based banking platform and associated personnel costs. One can point to the example of various credit card companies in the United States (Capital One, MBNA, American Express) as all having taken advantage of this technology to grow share among small businesses and their owner-operators. These same companies also found it possible to enter or expand in new geographic markets such as Canada where their historical presence had been more limited by structural considerations.

3.4. Other notable trends

We have also identified five other trends or issues observable over the past decade worthy of mention:

- Growth of the securitization market for SME assets
- Willingness of some financial institutions to provide riskier forms of financing to the segment

- Changes within the structure of the SME customer base itself with relatively diminishing importance of manufacturing companies in favour of service-based firms
- Impact of regulatory changes on credit or risk appetite for providers of financing
- Impact of recent credit crisis

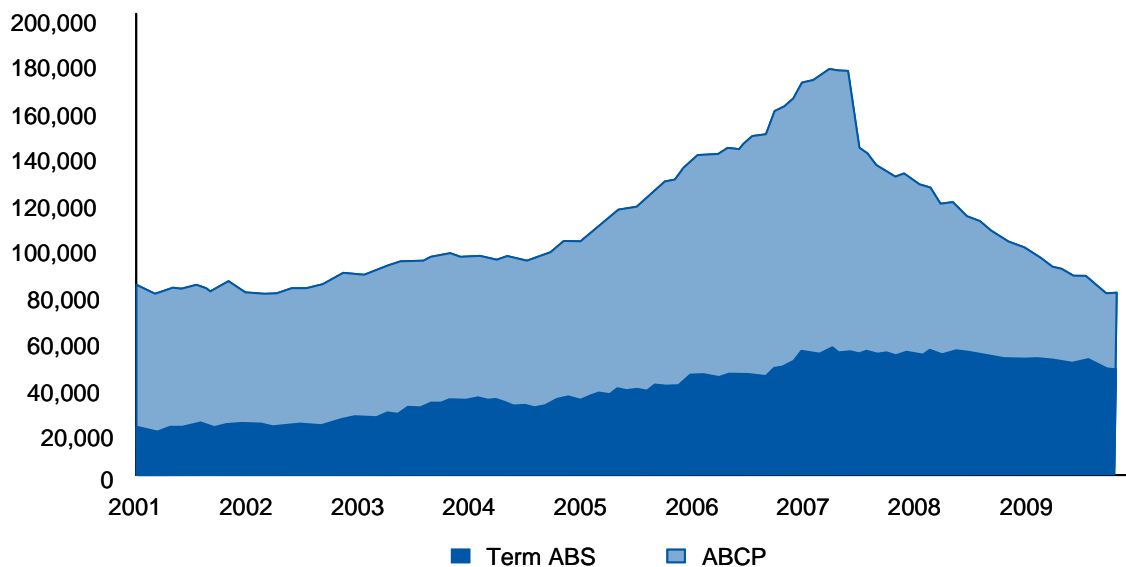
Growth of the securitization market

Securitization refers generally to the process of bundling like assets together for the purpose of creating a homogenous and tradable security for distribution to investors who would otherwise not typically be able to access the asset class being securitized. This practice has long existed in the financial services industry. In most geographic markets retail asset classes have been the common candidates for securitization (i.e. credit cards, auto loans, mortgages) because they represent large pools of homogenous but highly diversified assets. For the financial intermediaries arranging securitizations, the fees associated with structuring and distributing the transactions can be significant. In some cases, the asset classes in question were the whole loans provided by financial institutions to the segment. So, for example, it was not an unusual practice in Canada to package term real estate loans into securitized instruments that were in turn sold to various institutional investors and other counterparties. The securitized instruments could be structured and sliced into tranches that reflect varying degrees of risk (based on first loss potential) and thus appeal to many different levels of risk appetite on the part of investors. Other assets originating from the SME and commercial segments were also subject to this practice with auto loans (including fleet programs and floor financing for dealers), commercial accounts receivable and other commercial equipment assets representing the largest share of underlying exposures.

The importance of securitization should not be underestimated when assessing the state of the SME market especially for non-bank financials like leasing companies which do not collect deposits for funding. When securitization markets are healthy, it is possible for these financials in essence to increase their lending capacity to targeted segments by allowing them first to originate loans and then sell them on to other third parties, thus freeing their balance sheet to continue the process. Without this channel to distribute assets, originators of loans must hold the assets on their own balance sheet which can be constrained by other competing business demands and the finite nature of a bank's capital.

As was the case in the United States and elsewhere, Canada's securitization markets were adversely effected by the recent financial crisis as investor liquidity evaporated and fears arose over the underlying value of exposures in various securitized vehicles. This caused a significant drop in the value of securitizations from 2008 to the present although there are now some signs of market recovery. A recent report by DBRS, for example, estimates that securitization market volumes in Canada declined some 34% from a pre-crisis peak of \$178 BN while Figure 14 shows the trend of both term ABS and commercial paper ABS over the past decade.

Figure 14: Total Canadian ABS and ABCP market



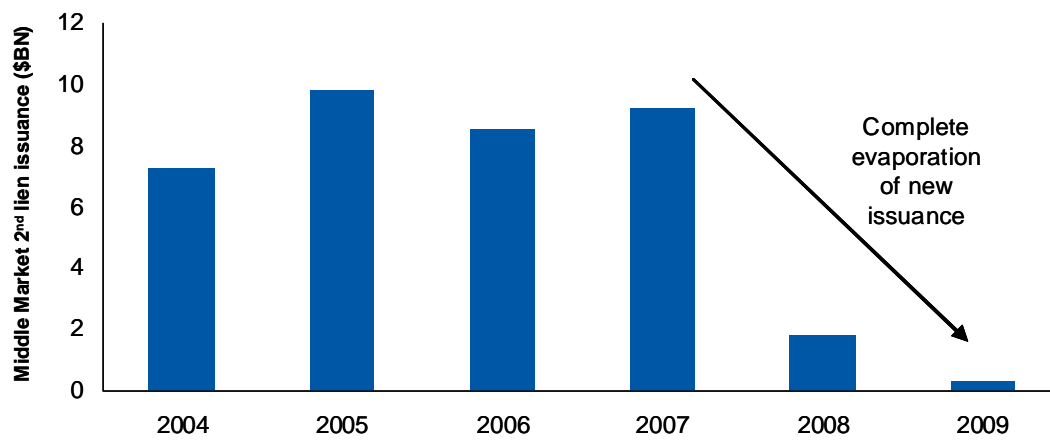
Source: DBRS, TDSI, Oliver Wyman analysis

Willingness of financial institutions to provide riskier forms of financing

Another major trend in recent years has been the willingness of some financial institutions to offer riskier forms of lending into different elements of a company's capital structure or by easing terms and conditions on traditional credit instruments such as working capital lines. The former practice has been influenced by the historical trend of providing such types of subordinated credit to the large corporate customer segment. For the past twenty to thirty years, corporations have assumed ever increasing amounts of leverage (i.e. debt) and most traditional banks have been willing to provide both senior secured credit facilities as well as subordinated debt to facilitate transactions with their best customers.

In the past decade, there has also been an increased willingness to provide subordinated debt to middle market and commercial companies as well. In the United States, for example, this manifested itself in the creation of the second-lien loan market for commercial enterprises. As is evident in Figure 15, this market grew rapidly in the years prior to financial crisis and was characterized by significantly higher credit spreads than were available on traditional bank credit while offering effectively no collateral protection in the event of a default by the underlying recipient of the loan. Many of these loans have since defaulted and the market has virtually dried up.

Figure 15: US second-lien loan issuance: (2004-2009 trend example)



Source: Thomas Reuters LPC

A similar willingness to push the risk envelope could be viewed even in the offering of traditional bank products such as working capital lines of credit. Typically these lines are short term in duration and secured against a margined borrowing base of a company’s receivables and inventory. For example, if a customer has \$500,000 of customer receivables a bank or finance company might be willing to lend up to 80% against that, or \$400,000. Similarly, inventory can be “margined” in the same way. (Financials will typically not lend 100% of the receivable or inventory value in case they need to liquidate those assets in a bankruptcy. The lower lending value provides a cushion against not being able to realize full value in a distressed liquidation). Banks have tended to offer such facilities with relatively conservative advance rates and comprehensive reporting requirements but numerous non-bank financials, especially from the United States, have been willing to offer credit against higher advance rates thus providing companies with more funding than they would otherwise normally receive. Many financial intermediaries active in this market have experienced significant losses over the past 18-24 months and there are lingering questions whether the appetite for this kind of lending will ever return. To be certain, Canada never developed the kind of subordinated debt market observable in other countries but at the margins the competitive landscape was influenced by this trend and taking up the slack left by credit providers no longer committed to this activity in Canada may represent a future funding gap and is considered in more detail below.

Changes to the make up of the SME customer base

Another trend worth considering has been the changing composition of the SME segment itself, particularly when viewed from an industry perspective. As already noted, the manufacturing sector in Canada, as in many developed countries, continues to diminish in relative importance. This is true both for the economy as a whole and for small businesses with underlying causes (a strong dollar, emerging market competition) only exacerbated by the recent international financial crisis and steep drop in consumer demand. Between 2000 and 2006, some 4,370 small manufacturers ceased to exist either because of bankruptcy, acquisition or consolidation, or general liquidation. This contributed to a net decline of employment in the sector of over 73,900.

Conversely, net company and job growth have tended to come from companies in the service sector. The Conference Board of Canada estimates that just over half of all jobs in Canada are accounted for by the commercial services sector. This covers a wide range of business segments including professional services; information technology; retail trades; and financial advisory. The recent recession has caused consolidation and job losses in this sector too but they have been slight in comparison with previous recessions and other segments.

Changes in industry composition are important to consider in the context of debt financing for SMEs for several reasons. First, many service sector businesses do not have the same kind of tangible assets to pledge as collateral compared to manufacturers. Financial institutions tend to prefer tangible assets as a way to mitigate default losses and historically have had difficulty providing financing against intangible assets (i.e. software, patents for various forms of intellectual capital, biotechnology or unproven technologies). Within the Canadian market, for example, we have observed over the past decade several failed attempts by traditional providers of credit to build sustainable financing operations to SMEs active in the technology sector. Canada is by no means unique in this respect; this is a pattern observable in many markets around the world. In our estimation, it will remain a challenge for banks and non-bank financials to establish the lending parameters and guidelines that will enable them to have a higher degree of comfort with this type of lending activity.

Impact of regulatory changes to risk appetite

One final area worth examining is the possible impact of regulatory changes on the risk appetite of private sector banks offering financing to SMEs. During the past decade, much has been written about the impact of new regulatory capital guidelines such as Basel II and now Basel III. For the vast majority of financial institutions, however, we believe that regulation will have only a minimal effect of SME lending. Many of the changes being discussed in regulatory circles will affect all business lines of a bank in equal, or similar, ways. For example, the recommendation to increase the relative amount of core Tier I capital (mainly composed of equity) over cheaper forms of Tier II capital (which may include various forms of debt or equity-like instruments) is fundamentally a

“top of the house” capital rule that applies to the entire banks’ balance sheet and should not have a disproportionate impact on any one business like SME.

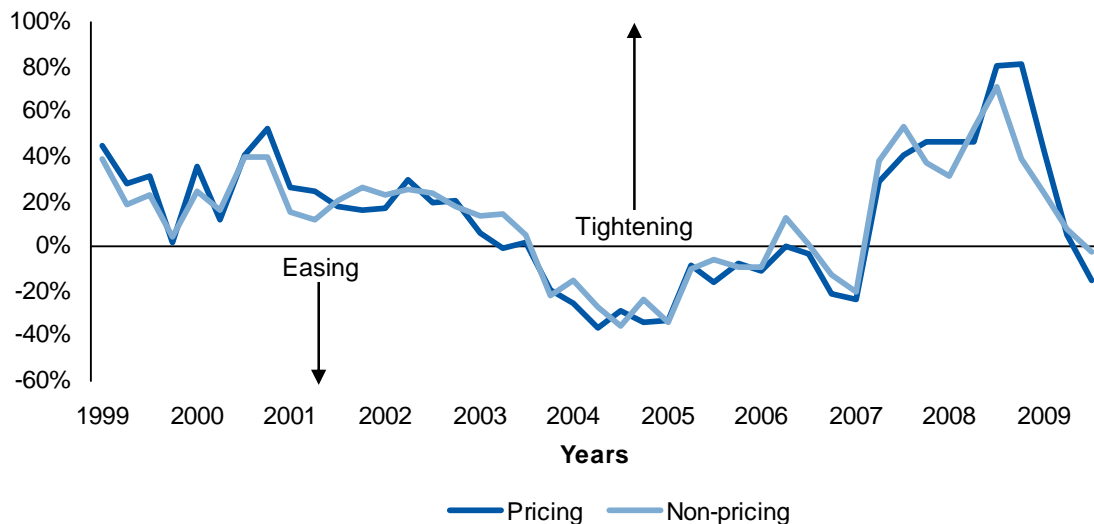
Conversely, Basel III will likely require banks to hold long term funding for long term assets. Long-term funding can either come in the form of debt issuance or a proportion of deposits that are viewed as stable. As deposits are normally cheaper than long-term issuance, Basel III creates a big incentive for banks to raise deposits. Under the proposed rules, small business and retail deposits are treated as being more stable than inter-bank borrowings, so they’re more attractive. As we have seen, small business relationships tend to be a lot more deposit rich (and the deposits are very cheap) hence Basel III could make SME banking for deposit taking financials a more attractive business.

Regardless of specific nuance on regulatory issues, we simply do not believe that the domestic banks and credit unions with established small business banking operations will curtail their efforts to grow the segment. All of the major players have invested heavily in their banking platforms and product suite for small business customers. There are further revenue considerations when one considers the extensive amount of retail and wealth management business that the banks receive from the owner-operators of small business clients as well. Indeed, one regulatory change recently proposed in the March 2010 federal budget, regarding the elimination of provincial restrictions for credit unions, is likely to enhance competition in the longer term as efforts will likely be made to effect combinations, partnerships, and common product brands to achieve greater critical mass in operations.

Impact of recent financial crisis

The recent financial crisis, which began during the summer of 2008, also had a significant impact on debt financing for SMEs. We already have noted how the market for so-called asset-backed securities, which finance companies rely on for funding, dried up thus leaving many non-bank financials incapable of lending at pre-crisis levels. Beyond this, however, was the simple reality that even well funded and secure financial institutions tightened their lending standards and pricing. This is a common reaction as an economy heads into recession because there is a fear that credit defaults will rise beyond normal levels. Figure 16 shows how both pricing conditions and other credit terms (i.e. collateral requirements and covenants) tightened significantly in the months leading up to the crisis and for much of the year thereafter.

Figure 16: Price and non-price lending conditions: Balance of opinion*



Source: Bank of Canada

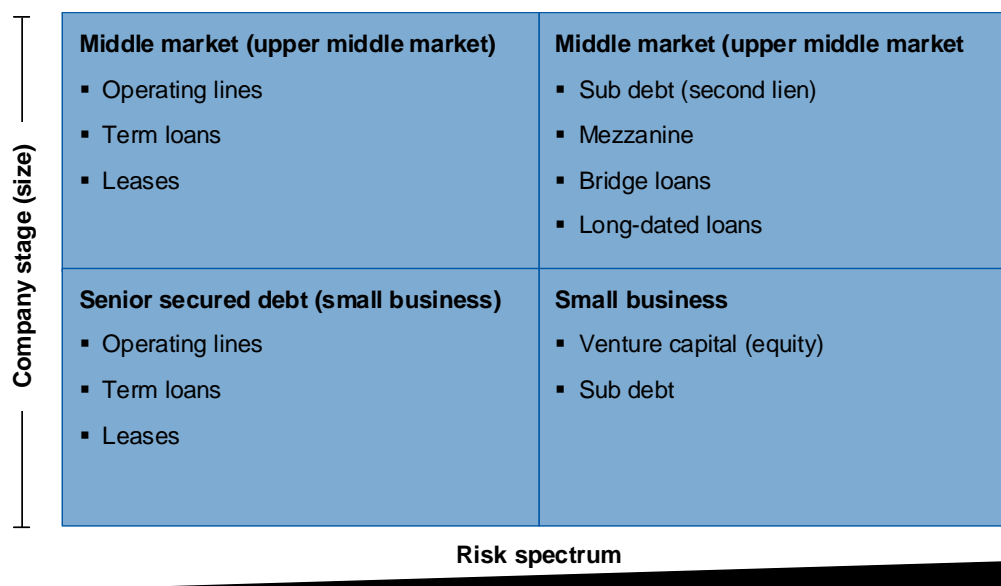
These conditions have started to ease considerably as this report was being written but the fact remains that banks will react to underlying economic conditions and become conservative in advancing credit if those conditions warrant such action (the same figure shows similar tightening during the last recession of 2001-02). Other information presented in this report supports this conclusion as well (i.e. approval rates for loans dipped in 2009 as did percentages of authorizations relative to requested amounts from borrowers).

4. Identification of market deficiencies

The third and final section of our report seeks to identify possible market deficiencies over the next five to ten years for the BDC to consider in the provision of credit and financial services to the SME market. These recommendations are made based on a review of data available on the market for the SME segment but do not take into consideration a *detailed* assessment of the BDC’s current capabilities or gaps in operational effectiveness or its own approach to market strategies.

As a starting point, we believe the BDC should have an over-arching framework for considering opportunities to play a complementary role with private sector financials. This framework needs to consider the trade-offs inherent in broadening its mandate or introducing new capabilities as suggested by Figure 17. Most choices for the BDC will come down to weighing the trade-offs between assuming risk where the private sector typically does not (or limits risk exposure) and filling legitimate needs for SMEs which may be under-served currently.

Figure 17: Strategic choices



During the course of our research, we identified numerous areas for the BDC to add value in support of private sector financing - several of which the BDC is already pursuing. In creating this list we tried to identify spots or segments in the market where there may be a private sector gap in coverage *as well as* general trends among the SMEs which the BDC should consider as it formulates its basic approach to market. Each option presents specific challenges and we conclude the report by presenting our assessment of those challenges and considerations for successfully positioning the BDC to continue in its role as a complementary player in Canada’s financial services industry.

4.1. Filling market deficiencies created during the credit crisis

As a result of the recent financial crisis, the BDC is already playing a stepped up role in the market across several areas:

- Provider of funding for Asset-Backed Securities (ABS) market (ABS purchase facility)
- Up-market credit extension to larger companies (Partially done through the BCAP)
- Offering additional working capital credit (working capital guarantee program)

In essence, all three of these initiatives have served to provide additional liquidity into the SME market, albeit in slightly different forms. The root cause behind the need for this liquidity was, as we have seen, the difficulties faced in the ABS market; the curtailment of lending among certain non-bank financials active in leasing; and the desire of Canadian domestic banks to have an additional participant for the syndication of larger middle market loans (due to a decline in syndication participants from the financial crisis). As The Conference Board of Canada pointed out in their recent publications on the crisis, the BDC played an important “shock absorber” role during the crisis by pursuing these initiatives.⁴

We would anticipate that the BDC will continue to be needed in this capacity for at least some time as there remains an investor aversion to ABS paper in both Canada and other geographic markets; several of the foreign non-bank financials are unlikely to resume lending in Canada at similar volumes to those witnessed pre-crisis; and underlying SME demand for financing is likely to start growing again as the economy recovers. Indeed, given this context, the BDC could consider offering a loan guarantee program specifically directed at equipment leasing needs of small business customers. To do this effectively, even on a risk sharing basis with the primary lease originator, would require some investment in additional resources to understand residual values trends and risks associated with equipment to be financed. Also, regardless of prevailing economic conditions, the BDC itself effects better diversification of its financing portfolio by complimenting its lending activities with these expanded lending activities as well.

The financial crisis of 2008-09 was marked by a general tightening of liquidity and thus lending in all banking markets – including Canada. This crisis was especially severe insofar as several large financial institutions in the US and Europe either entered bankruptcy proceedings or were the subject of forced mergers or effective nationalization. Although Canada escaped the degree of distress observed in many other markets, the country did enter a recession and many FIs instituted stricter lending standards for all customer segments: retail, small business, large corporate. Indeed, some foreign FIs operating in Canada curtailed virtually all lending.

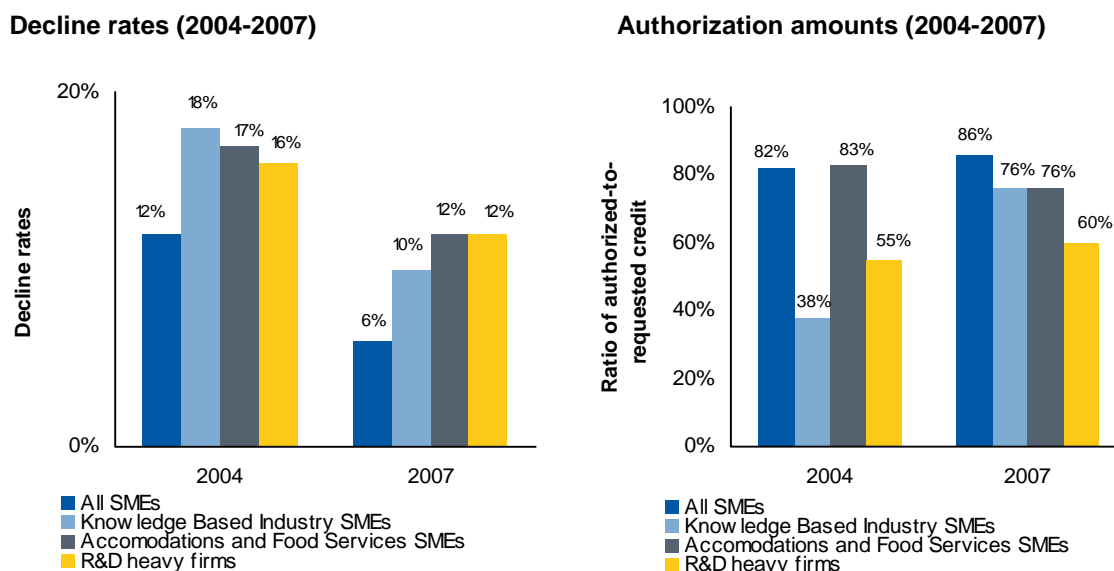
⁴ The Conference Board of Canada, *Lessons From the Recession and Financial Crisis Series*, January-February 2010.

During this period, the BDC played an important role in providing additional lending capacity through the programs and initiatives already mentioned above. In assessing the organizations role over the next decade, the possibility of similar economic downturns can not be discounted. Accordingly, even if demand for the BCAP program or the ABS liquidity program decline over time as markets return to normal there should still be a general expectation that such initiatives may need to be reinstated if conditions change. We believe that such a conclusion is both prudent and also consistent with efforts currently being made in other countries to make certain stronger mechanisms are in place to provide this kind of “shock absorber” capacity to the private sector when needed.

4.2. Structural financing deficiencies observed

Throughout the course of our review, we looked for specific segments or niches in the SME market where businesses may be having difficulty accessing credit, as evidenced in comparison with market averages. Figure 18, shows that credit decline rates for three industry segments – knowledge-based companies (KBIs); the accommodation and food service industries; and firms which had significant R&D expenditures, were all higher than industry averages. Moreover, even when credit was approved, authorization amounts (the amount actually approved relative to what was applied for) were also lower than average.

Figure 18: Acceptance rate segmented by type of business



SMEs defined as all companies with <500 employees and <\$50 MM in revenue

Note: R&D heavy firms defined as all firms with greater than 20% of their expenditures spent on research and development

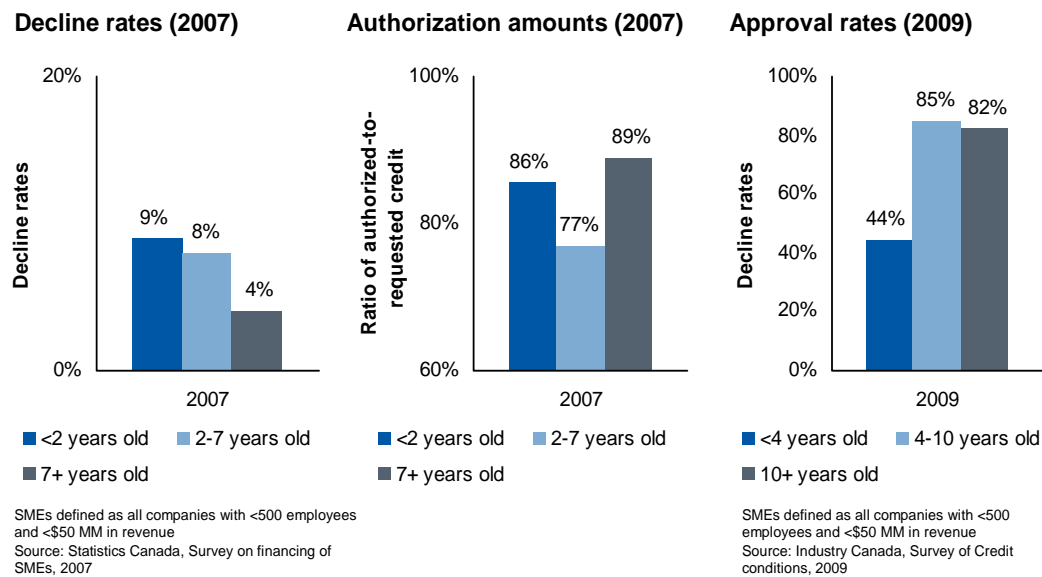
Source: Statistics Canada, Survey on financing of SMEs, 2004, 2007

There can be many explanations for this apparent difference. KBIs, as we have seen, frequently cannot offer the types of tangible assets (i.e., factories, machinery, plant or

equipment) preferred by many lenders as collateral for loans. The retail food service segment is especially volatile while the hotel and accommodation segment can be pummelled by recessionary conditions. At first glance, one might think that firms investing heavily in R&D would not have a difficult time getting credit but again such companies could be investing in new or not fully proven technologies, another area where traditional lenders may not have high degrees of comfort.

Another noticeable skew in approval rates was observed for younger, earlier stage companies. Figure 19 shows approval rates segmented by age of companies with data compiled from two different sources (Statistics Canada for 2007 and Industry Canada for 2009). The Statistics Canada data shows that decline rates are more severe for younger companies and then start to decline as companies age and establish a financial and business track record. Similarly, the Industry Canada data showed a very steep difference in approval rates, by slightly different aging categories, in their 2009 survey of credit conditions.

Figure 19: Approval rates segmented by age of company



Once again, there are plausible reasons why private sector financial institutions have greater difficulty advancing credit to younger companies than seasoned ones. Figure 20 provides some more detail on the characteristics of younger firms which may help to explain this gap. The most obvious factors at play include the lack of track record for a new company and the realization that many new companies will not survive beyond the first year or two of existence (while the “survival rates” for companies improves with age – refer to Figure 30 in the Appendix). Other observations include the tendency of new businesses to be started by owners who themselves are relatively young (and thus without much personal financial track record or ability to offer personal guarantees against their business) and that a larger than average number of new companies are focused on early

stage development of products or services requiring higher degrees of initial investment – without the certainty that such investments will pay off as the business ages.

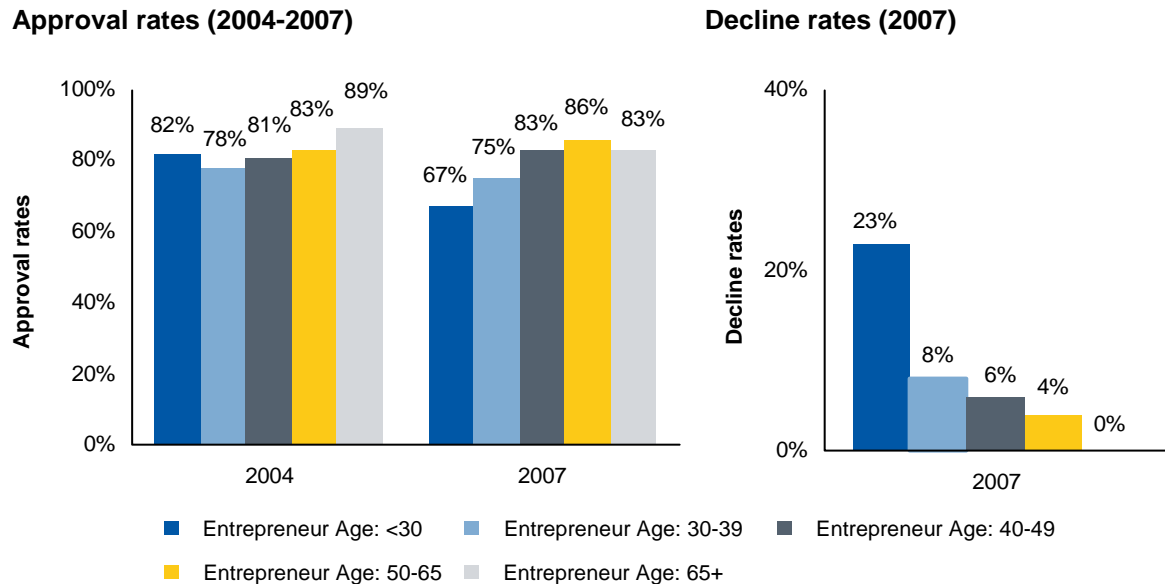
Figure 20: Profile of younger SMEs

Smaller companies	<ul style="list-style-type: none"> ▪ 17% of Non-employers / self employed SMEs are new ▪ Only 5% of SMEs employing 100-499 employees are new
Knowledge based and Accommodations and food services industries	<ul style="list-style-type: none"> ▪ 24% of knowledge based industries and 23% Accommodations and Food Services are new ▪ 9% of agriculture/primary and 9% of manufacturing industries are new
Urban environments	<ul style="list-style-type: none"> ▪ SMEs created in the past two years are more likely than other SMEs to be based in urban environments
Non-export revenue	<ul style="list-style-type: none"> ▪ SMEs created in the past two years are less likely than older SMEs to be exporters
Younger majority owners	<ul style="list-style-type: none"> ▪ 46% of SMEs with owners under the age of 30 are new, while 32% of SMEs with owners are between the ages of 30 and 39
Research intensive	<ul style="list-style-type: none"> ▪ 26% of SMEs with heavy R&D expenditures are new

Source: Statistics Canada - Survey of Financing of SMEs, 2007

Closely correlated to the age of a company is the age of the company’s owner-operator. As indicated in Figure 21, younger entrepreneurs have a comparatively more difficult time getting approved for credit than older business owners. Indeed, the Statistics Canada data comparing 2004 with 2007 suggests that if anything this has become even more problematic with the passage of time. Many of the same factors that apply to younger small business decline rates likely come into play for younger owners as well.

Figure 21: Approval rates segmented by age of entrepreneur



SMEs defined as all companies with <500 employees and <\$50 MM in revenue
 Source: Statistics Canada, Survey on financing of SMEs, 2004, 2007

An additional gap was also observed with respect to term lending needs of companies with a high propensity to export. This is evident from the data compiled below from Statistics Canada which showed that exporters had a higher request rate for term debt than the market average and experienced a much lower rate for these requests (79% versus 91% for non-exporters).

Figure 22: Exporters access to term financing

	Request rate for term lending	Approval rate for term lending	Authorization amounts for term lending
Exporters	25%	79%	83%
Non-exporters	15%	91%	81%
All SMEs with 1 + employees	16%	89%	82%

Source: Statistics Canada

There are many hypotheses for why this disparity might exist because at first glance one might assume an exporter would have access to larger revenue pools from different geographic markets and thus present less risk to a financial institution for debt financing. Our assumption is that many exporters need to build inventory in anticipation of greater

eventual sales in foreign markets and that this stretches their leverage (debt) ratios. The requests for term financing may represent an effort to convert some shorter-term operating line debt into longer-term debt with defined repayment terms, thus freeing up operating credit to build more inventory or float customers' credit in new markets. What appears as positive for the SME however may create uncertainty or reservation for a lender.

A separate study completed in 2007 completed for Industry Canada also observed that *early stage* SME exporters were more than four times as likely to have operating credit applications turned down than established non-exporters.⁵

One last gap worth examining relates to offer of subordinated debt exposures or loans with second-lien positions. The data has suggested that even if a debt request is approved it may not be at the amount or level requested by the initial loan application. This is true across almost all categories of SME lending. In other words, almost no segment reports that they get the credit they think they deserve – even if the gap is generally less than 10-15% of the initial amount requested.

We have already noted that the generally good credit performance of the SME segment in Canada can be attributed in part to the more conservative leverage standards of the major players in the market (i.e. they provide customers with the credit they conclude they can reasonably handle and expect to have repaid). For certain it can be argued that this difference between what is asked and what is granted represents a structural financing gap which is otherwise not filled because Canada has never developed a deep subordinated debt market.

Our principal observation here is that filling this gap should only be considered with the greatest of caution. As we have seen, the second-lien loan experience in the United States was marked by significant default rates and low recovery by financial institutions who participated in that activity. Any effort to expand BDC's balance sheet with subordinated credit should be done only according to strict lending parameters or guidelines and then only with approval at the highest levels of the organization.

⁵ Industry Canada, Financing Canadian SME Exporters, June 2007

5. Concluding remarks

Our primary objective in writing this report was to examine the supply of debt financing to Canada's small and medium-sized enterprise market. In doing so, we have examined the conditions prevailing over the past decade, the major trends and issues that have shaped the market for SME debt financing, and the financing deficiencies – both structural and cyclical – which may be present.

Our review of the data shows that the SME market is a large and significant component of Canada's GDP and exports. The health and free flow of credit to SMEs is thus an issue of profound significance to policy makers and the country as a whole. At a high level, the market appears largely stable especially when measured by number of enterprises or their consumption of debt financing. The financial institutions which have dominated the market over the past decade are also familiar domestic names. Yet, it is equally important to understand that this market is also fluid and subject to changing economic conditions and appetite to lend. The market contains both structural financing deficiencies which are primarily the result of the lack of financial institutions' interest in assuming certain risks and more subtle gaps which can be the result of the underlying business cycle.

The BDC has played an admirable role in offering credit where none may be easily available and yet the data suggests that even more could be accomplished. We have been careful to present considerations which fill these deficiencies while not subjecting the BDC to imprudent risks. Striking that delicate balance is never easy and that will be the challenge for the BDC as it embarks on the next decade.

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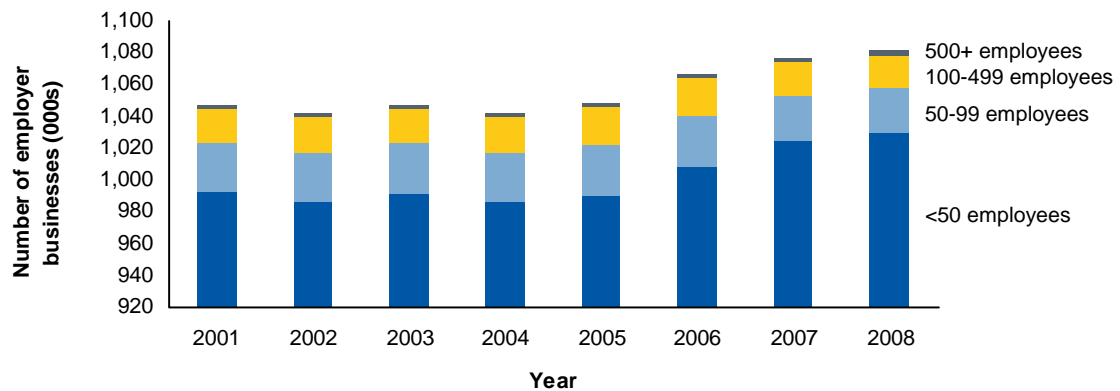
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Appendix A. Additional information on the profile of SMEs in Canada

This Appendix presents a series of figures and charts detailing the nature of Small and Medium-sized Enterprises (SMEs) in Canada. In particular we provide information covering the following characteristics or dimensions:

- Growth of the market over time by number of business establishments
- Regional concentrations of SMEs
- Segmentation of the SME market by industry
- Profile of industry segment with high and low-growth SMEs
- Breakdown of average revenue of SMEs
- Role and importance of exports
- Select demographic observations on small business owner-operators
- Relative age of SMEs
- Survival rates (the average length of time SMEs have been in business)

Figure 23: Growth of SME market

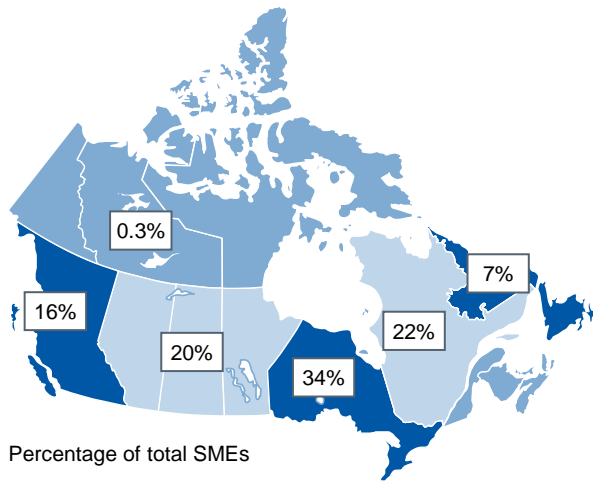


Group	# of employer businesses	CAGR since 2001	Change since 2001
500+ employees	3,026	1.4%	10%
100-499 employees	20,123	-0.6%	-4%
50-99 employees	28,644	-1.1%	-7%
1-49 employees	1,029,175	0.5%	4%

Excludes companies without any payroll employees
Sources: Key SME Statistics – Industry Canada – 2008

Figure 24 shows that the location of SMEs has shifted somewhat towards Ontario and the West with time. Ontario and Quebec still are home to about 56% of all small and medium-sized businesses followed by Alberta and the Prairies, British Columbia, and the Atlantic provinces. Quebec, Atlantic Canada, and the Territories recorded a net decline in small and medium-sized business numbers over the past decade.

Figure 24: Regional concentration of SMEs



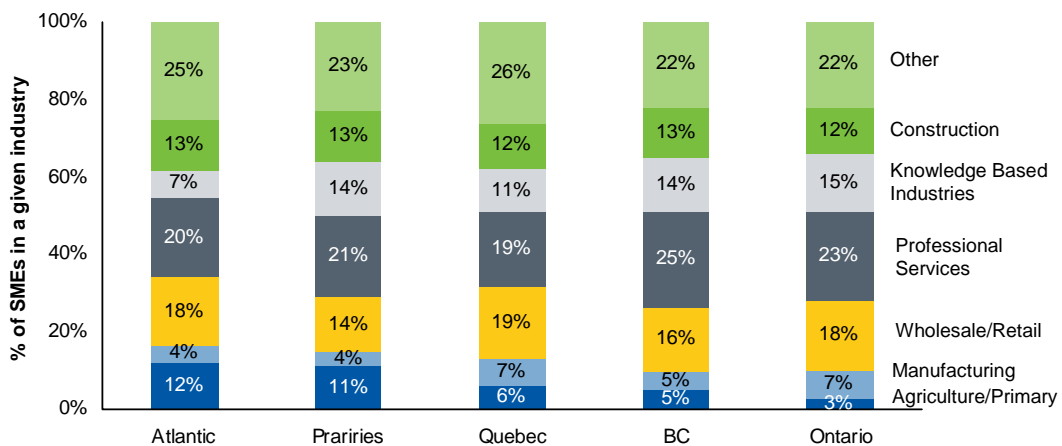
Region	Number of SMEs	% of total SMEs	Change from 2001
Atlantic Provinces	78,440	7%	-7%
Quebec	235,449	22%	-3%
Ontario	370,418	34%	7%
Prairies	220,853	20%	4%
British Columbia	169,083	16%	7%
Territories	3,681	0.3%	-10%
Canada	1,077,924	100%	3%

Percentage of total SMEs

SMEs defined as all companies with <500 employees, excludes companies without any payroll employees
Source: Key SME Statistics – Industry Canada – 2008

There are of course regional differences in the industry concentrations of SMEs. The Maritime and Prairie provinces have a higher than national average share of farmers and agricultural businesses, for example, while Quebec and Ontario have a higher than average proportion of manufacturing and professional services firms.

Figure 25: Breakdown of industries by region

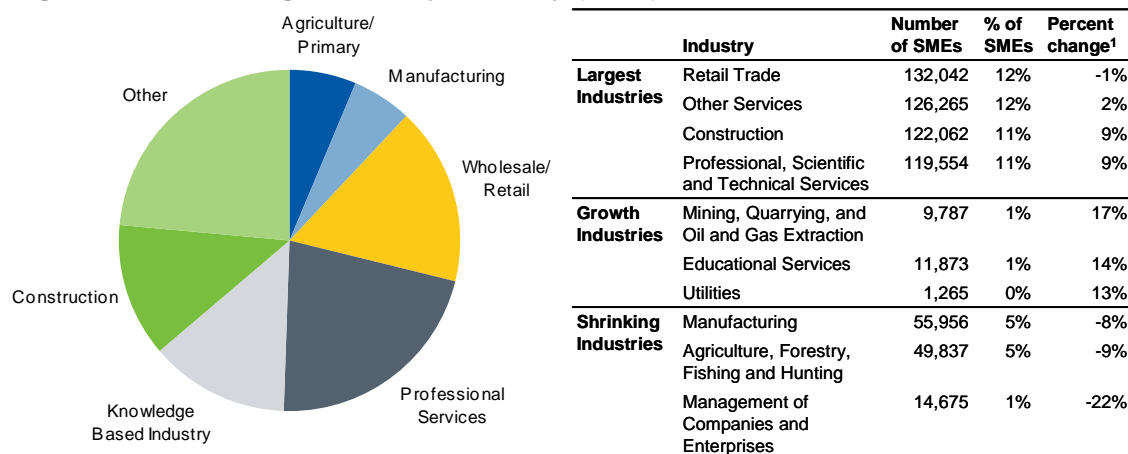


SMEs defined as all employer enterprises with fewer than 250 employees and greater than \$30,000 in annual revenue
Source: 2000-2006 SME Data Warehouse – Statistics Canada 2009

Notes: Agriculture/Primary: Agriculture, forestry, fishing, hunting mining and oil and gas extraction Professional Services: Finance and insurance, real estate and rental and leasing, management of companies and enterprises administrative and support waste management and remediation services educational services, health care and social assistance Knowledge Based Industry: Information and cultural industries and professional, scientific and technical services

Another dimension to consider is how SMEs may be classified according to industry segment. Figure 26 depicts this breakdown. Retail and other services account for about one-quarter of all SMEs with construction trades and other professional services companies (lawyers, accountants) representing a further twenty per cent. Once again, there is remarkable stability in the proportion of companies across industry segments. It is possible to observe a gradual decline in the number of pure manufacturing companies over the past decade and we comment on this further later in the report. At the same time, primary resource sector companies (oil and gas, mining) have also grown in absolute numbers even as they represent a relatively small slice of total SMEs.

Figure 26: SMEs segmented by industry (2008)



1. Changes shown are from 2000-2006 and are based on SME Data Warehouse – Statistics Canada 2009

SMEs defined as all companies with <500 employees, excludes companies without any payroll employees

Source: Key SME Statistics – Industry Canada – 2008

Notes: Agriculture/Primary: Agriculture, forestry, fishing, hunting mining and oil and gas extraction Professional Services: Finance and insurance, real estate and rental and leasing, management of companies and enterprises administrative and support waste management and remediation services, educational services, health care and social assistance Knowledge Based Industry: Information and cultural industries and professional, scientific and technical services

Absolute and relative industry segment growth rates is one way to get a sense of changing patterns in the SME market but it is important to note that even industries experiencing a net decline in share may still have high growth companies within the segment. Figure 27 shows the percentage of companies within select industry segments which have recorded high revenue growth rates in recent years (defined as greater than 20% average annualized growth in revenue over the surveyed period). By this standard, it is notable that even an industry segment in relative decline – such as manufacturing – may still have a significant number of high growth companies within the segment.

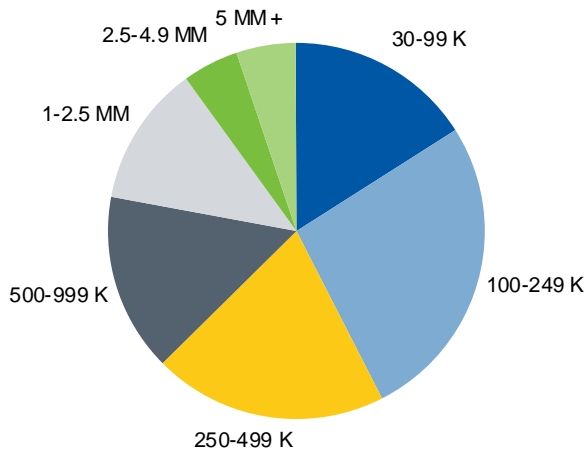
Figure 27: Industries with high growth SMEs

	Industry	% of SMES which are high growth
Industries with large segments of high-growth SMEs	Mining, Quarrying, and Oil and Gas Extraction	21%
	Construction	14%
	Professional, scientific and technical services	12%
	Transportation and Warehousing	10%
	Manufacturing	10%
Industries with few segments of high-growth SMEs	Agriculture, forestry, fishing and hunting	7%
	Health Care	6%
	Utilities	6%
	Retail trade	5%
	Arts and entertainment	5%
	Accommodation and food services	3%

SMEs defined as all companies with <500 employees and <\$50 MM in revenue
Source: 2000-2006 SME Data Warehouse – Statistics Canada 2009

Another important element in understanding small and medium-sized businesses comes from appreciating the size of the companies by revenue generated. Figure 28 underscores the point that over three-quarters of all small businesses earn less than \$1 MM of revenue annually. Indeed, even the majority of those companies earn under \$250,000 in revenue. Conversely, only 5% of small businesses generate annual revenue in excess of \$5 MM. In general, these percentages have remained fairly constant over the past decade.

Figure 28: Breakdown of Annual Revenue of SMEs



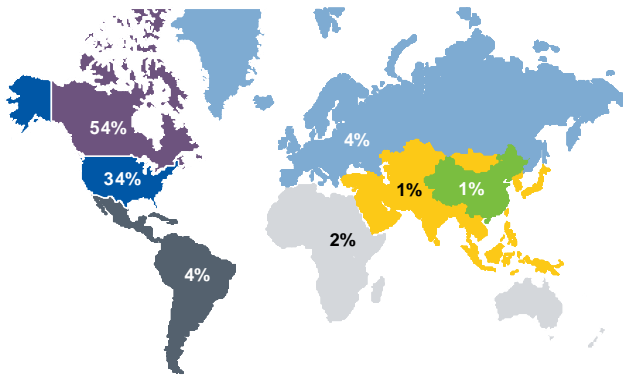
SMEs defined as all enterprises with fewer than 250 employees and greater than \$30,000 in annual revenue
Source: 2000-2006 SME Data Warehouse – Statistics Canada 2009

The SME segment also contributes significantly to Canada's exports. This is true principally by aggregate *value* of exports as indicated in Figure 29 below given that the percentage of SMEs that export is relatively small. The data shows that 94% of all exporters may be classified as SMEs and these firms account for 56% of total exports by value.

According to Statistics Canada, however, nearly three-quarters of exporting businesses had exports of less than \$1 MM per annum so the concentration of value among a small percentage is readily apparent. It's also interesting to note that SMEs that export still rely on the domestic market for the majority of their sales (54%) with the United States accounting for the largest export market followed by Europe and Latin America. The share of Canadian exports destined to the US has been declining steadily over the past decade and nearly 20% of exporters in fact concentrated their sales in non-US markets only.

The same Statistics Canada study indicated that new exporters accounted for 4.5% of all exporters in 2007. Again, the average value exported by each new firm was fairly modest at \$1.5 MM. Of note, most firms falling into this new exported category did not belong to the manufacturing sector.

Figure 29: Source of revenue breakdown for SME exporters



	Number of exporters	Value of exports (CAD\$ MM)
< 50 employees	33,403	125,556
50-99 employees	5,478	60,675
100-199 employees	3,551	47,458
Total	42,432	233,689
SMEs as a % of total Canadian exporters	94%	56%
SME exporters as a % of all SMEs	5%	N/A

SMEs defined as all companies with <200 employees
 Source: Statistics Canada – Survey of Financing of SMEs – 2007
 Source: Statistics Canada – A Profile of Canadian Exporters – 2007

Our next series of observations take a look at some of the basic demographic trends in the composition of small businesses. Figure 30 summarizes the change observed for three categories of SME ownership: female owners; relative age; and immigrant or minority status. Female ownership of SMEs has remained largely constant according to survey data collected by Statistics Canada at three points over the last decade. More interesting perhaps is data that shows small business owners are aging rapidly with over 56 per cent within 15 years of the traditional retirement age of 65. This trend is consistent with the demographic trend of the country as a whole but it raises interesting questions around succession planning, wealth management, and inter-generational asset transfer. Lastly, it is also interesting to observe that the number of minority owners and new immigrants is rising noticeably as a proportion of total SMEs. We would expect this trend to continue – if not accelerate – in the future.

Figure 30: Demographics of small business owners

Female owners			Age of owners					Minority/immigrant owners	
	Half or majority female owned	Minority female owned	Owner age: < 30	Owner age: 30 – 39	Owner age: 40 – 49	Owner age: 50 – 65	Owner age: 65+	Visible minority owned	New immigrant owned
2007	35.7%	10.8%	2.8%	12.1%	28.0%	44.6%	12.6%	9.6%	2.6%
2004	36.6%	11.0%	2.9%	15.3%	35.1%	37.0%	9.6%	7.2%	1.4%
2001	36.4%	10.9%	2.4%	19.5%	68.2% ²		9.9%	7.3%	N/A ¹

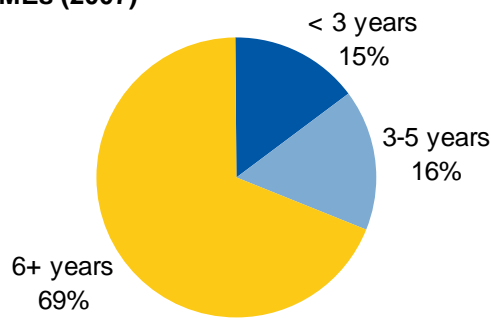
1. Data not tracked

2. Data not split between 40-49 age group and 50-65 age group.

Source: Statistics Canada – Survey of Financing of SMEs, 2007, 2004, 2001

Despite the relative stability of the key dimensions for small businesses that we have noted thus far, it is important to understand that there is a fair amount of underlying volatility and change in the market on a micro level. New businesses are in a constant process of being born while other businesses cease operations because of default or bankruptcy, sale, or other factors. Figure 31 shows the trend in age of SMEs between 2001 and 2007, the last year for which data is available. Firms that have existed for three years or less accounted for 15% of all SMEs in 2007 while those that had been in existence for 3-5 years represented another 16%. As we shall see later in the report, younger firms have a more difficult time accessing financing for obvious reasons (i.e. lack of financial track record).

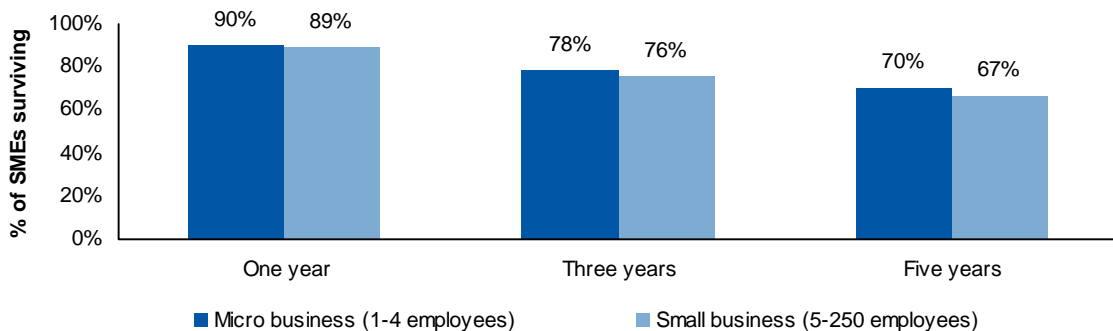
Figure 31: Relative age of SMEs
Age of SMEs (2007)



SMEs defined as all companies with <500 employees and <\$50 MM in revenue
Source: Statistics Canada, Survey on financing of SMEs, 2007

Aside from default rates, which we examine later, the most common measure of the underlying volatility of the small business is the “survival rate.” This shows the percentages of companies that survive or grow past various points in time. Figure 32 presents this data over one, three, and five years broken down by relative size of the small business. Not surprisingly, the data shows that truly small companies, when measured by revenue, have lower survival rates than larger firms. On balance, however, it should be noted that survival rates for Canadian SMEs compare favourably with those of other countries.

Figure 32: Survival rates for SMEs (2001-2006)



SMEs defined as all enterprises with fewer than 250 employees and greater than \$30,000 in annual revenue
Source: 2000-2006 SME Data Warehouse – Statistics Canada 2009

Appendix B. Glossary

Basel II (III): International guidelines created by the Bank for International Settlements (headquartered in Basel, Switzerland) that provide national financial regulators with a framework for determining the minimum amounts of capital a bank should hold. The financial services industry affected by these guidelines is currently governed under the provisions outlined in Basel II while changes to these provisions are proposed in a new series of guidelines dubbed Basel III.

Bridge loan: Usually a short-term loan designed to facilitate a specific acquisition (such as purchase of a company or specific equipment) which is meant to be repaid by creating a more permanent term credit facility at a later date. These are often arranged because timing is of the essence in completing a transaction or purchase.

Credit spread: Essentially the difference between what it costs a bank to fund itself/pay operating expenses and what it charges a customer on a loan. In other words, the “spread” represents the gross profit on a customer relationship. Credit spreads vary from FI to FI because they may have different cost structures and access to funding. The spread is also often related to the underlying riskiness of customer. More risky customers are charged higher spreads while lower risk customers tend to have lower spreads.

Credit scoring: The process by which an FI risk rates a customer. This is based on inputs about a customer’s financial history and prospects. Credit scoring tends to be based on simplified financial models that reflect statistical probabilities of default. The output of the process, a credit score, is used to rank relative riskiness of a customer and often used as input in the bank’s decision process over whether to extend credit and at what credit spread.

Cross-sell and cross-sell revenue: Refers to the revenue generated by a bank or other financial from selling products and services *other* than loans. This could include foreign exchange for trade purposes, cash management accounts for the collection of receivables from customers or payments of bills, simple derivatives to fix the rate of interest on borrowings etc.

Foreign exchange or FX: Used in reference to any currency related banking activity. This would include exchanging monetary instruments from one currency to another (spot fx) or contracting to buy currency based on future expected rates of exchange (forward fx).

Full-service financial institution: One which offers a wide range of products or services to its clients in addition to simple lending. In Canada, the Schedule I banks would all be classified as full-service institutions. In contrast, some financial institutions focus only on offering a single product (typically loans or leases) or a simplified, limited suite of products.

Hurdle rate (of return): Refers to the minimum return on capital a financial institution expects to earn from a line of business, division, or bank as a whole. Banks in Canada, for example, tend to have established hurdle rates in the 15-18% range through a business cycle.

Knowledge Based Industries (KBIs): In 1996, based on research undertaken by Industry Canada and the Business Development Bank of Canada, a definition of knowledge-based industries (KBI) was developed using the North American Industrial Classification System (NAICS). This definition includes science and technology-based firms, composed of knowledge producers and a set of “high knowledge” firms which, based on measures of research and development and knowledge worker inputs, could be considered to be business innovators and high-knowledge users.

Lease: A form of debt typically secured by a specific piece of equipment such a vehicle, heavy machinery, or other types of capital equipment. The security (collateral) rights of a lessor are limited to the value of the underlying asset which is the subject of the lease.

Long-dated loan: No commonly accepted definition but usually refers to a loan with a term to maturity of greater than five years. Most banks, for example, tend not to extend term loans to corporate borrowers for periods beyond five years except under select circumstances. Long dated loans usually carry higher credit spreads to compensate for the duration.

Mezzanine debt: A term often used interchangeably with subordinated debt and referring to a debt instrument that is junior in repayment priority to senior secured debt and carrying a high relative credit spread. Mezzanine debt is sometimes structured similar to preferred shares and often is used on a short-term basis to help facilitate peak borrowing by a company.

Non-bank financial: A financial institution which does not accept deposits yet provides lending and other financial services to its customers. Funding for such institutions typically is provided by issuing debt to investors or by borrowing from international money markets and inter-bank brokers.

Operating line of credit: A frequently short-term (one-year maturity) revolving debt facility which is often secured by the receivables and inventory of the borrowing company. An operating line is distinct from a “term loan” because it used mainly for day-to-day working capital purposes. A credit card operates on the same principles.

Risk rating: For virtually all small business, commercial, or large corporate banking clients, banks will assign a risk rating based on an assessment of a company’s financial condition, management, industry segment and market, and other factors. The risk rating is meant to allow banks to distinguish relative riskiness of clients across an entire portfolio of exposures. Margins on loans are typically set as a function of risk rating; less risky clients receive better pricing than higher risk clients.

Schedule I bank: This refers to Canada's larger domestic banks and includes: TD Bank, RBC, Scotia Bank, CIBC, and the Bank of Montreal along with National Bank of Canada and Laurentian Bank.

Second - lien loan: A form of financing which is junior to senior debt but still has a security claim on the underlying assets of a company in the event of liquidation. The claim can only be paid after all other senior debt obligations are repaid. As a result, second-lien loans frequently are the functional equivalent of subordinated debt. This form of financing was gaining popularity in the United States market prior to the onset of the 2008 financial crisis.

Senior debt: Debt which is senior to all other debt in repayment priority upon an event of default and subsequent wind down of a company. Typically this debt is priced lower than other forms of debt because it provides more rights of recovery to the senior lender(s).

Subordinated debt: A form of debt which, as the name implies, is subordinate or junior in rights to that of senior debt. Sub debt, as the term is often shortened, is typically a more expensive form of credit and only offered in select circumstances when a company is deemed capable of paying higher rates and repaying the principle over time. Upon an event of liquidation the subordinated debt holders are only reimbursed after senior debt holders have recovered their principle and interest.

Term debt: Debt which carries a final maturity of greater than one-year from the date of origination. Contrast with Operating Line of Credit.

Terms and conditions: The specific conditions under which credit is advanced by a financial institution to a customer. Terms and conditions are summarized in a Credit Agreement, a legally binding document meant to codify the relationship between lender and borrower. Terms and conditions include requirements for pledging collateral (security), financial ratios or benchmarks that a company must meet in its performance, timing of repayments, as well as other commitments by a borrower.

Vendor financing: Financing provided by the captive financing operations of a specific manufacturer and designed to help facilitate the sale of the manufacturer's products.

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