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Credit where credit is due

BY JUSTIN MUZINICH AND RICHARD GRECO

Italy has all the elements needed for a growth spurt – almost. The missing piece in the puzzle is a crucial one: credit. Lending money to Italy's myriad small businesses is fundamental to its economic recovery.

The dashboard of a Riva speedboat, icon of the Made in Italy luxury design. Like many symbols of La Dolce Vita, Riva started as a family venture in 1842. The Riva remains a limited series of 60 to 80 boats a year, the smallest involving 1,000 hours of work.

Italy is a wealthy country. Morgan Stanley, in November 2011, published a report that concluded the average Italian household has €340,000 in net assets, half of which is in financial assets and half of which is in real estate. This is a stronger net asset position than any other G7 country. This wealth has been accumulated over a long period of time, particularly over the 70 years since World War II and the beginning of Italy's economic miracle.

Italy is also the seventh largest economy in the world and the fourth largest in Europe, with a GDP of $1.8 trillion. It is one of the most enterprising and creative countries, with nearly six million registered companies, or one company for every ten people. Italy also has the highest patent productivity and highest per capita research and development investment in all of Europe, according to the Institute for Management Development quoted by the Italian National Institute for Foreign Trade.

Of Italy's six million companies, there are 3,921 businesses with revenues from €15 million to €330 million. While these small and medium-sized businesses, or SMEs, are a small percentage of the total number of companies, they are hugely important to the economy, as many of the remaining six million businesses are one or two person entities. SMEs represent 50% of Italy's manufacturing value added and 70% of all Italian non-farm jobs. They typically derive 40%-50% of revenues from exports. In 2010, the last year for which data is available, Italian SMEs grew sales by 9% but still remained 7% below 2007 sales level, suggesting strong growth potential for the near future. Ac-

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A woman withdraws cash from a bank's automated teller machine in Rome.

cording to the IMF, Italian SMEs are the cornerstone of the corporate economy, and exports by SMEs are expected to lead the economy to growth in 2013. This is good news, especially since "Made in Italy" products – whether in design, engineering, or manufacturing – are widely recognized as high quality. In fact, Italy is geographically well positioned to reach 600 million consumers in Eastern Europe, North Africa, and the Middle East who are coming of earning and purchasing age.

Consumers around the world seek the engineering, craftsmanship, and style of Italian products, especially in fashion, mechanics, motors, and cosmetics. They are even willing to pay premium pricing. Unfortunately, however, many Italian entrepreneurs currently lack one fundamental element necessary for success: capital.

Capital is not really a problem for Italy's 325 publicly traded companies, who have access to international financial markets. The problem is that the 3,600 privately held SMEs grew up on and have remained almost entirely dependent on bank credit for financing. By contrast, bank credit in the United States accounts for only 30% of corporate financing. Unfortunately bank credit to Italian SMEs dropped from 0.4% year over year growth in November of 2011 to a 4.0 percent year over year decline in March 2012, according to Mediobanca.

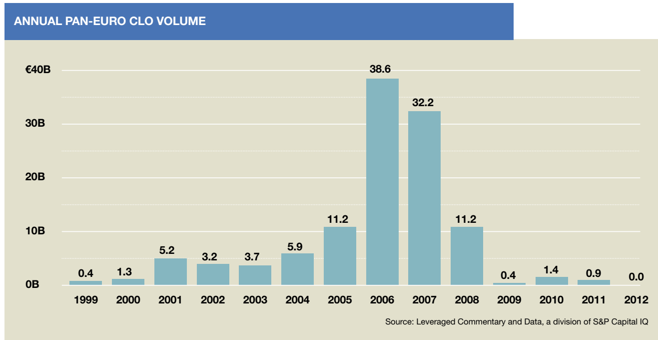
The credit problem for Italian SMEs will only grow worse in the future. Banks are in need of balance-sheet repair from the financial crisis, and they will naturally focus less on the middle market and more on large companies.

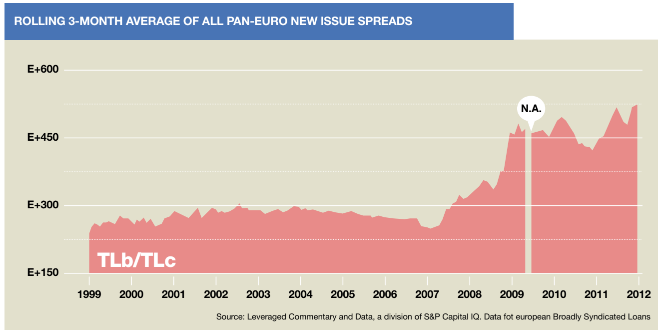
Furthermore, stricter regulatory requirements, such as Basel III, are increasing the costs for banks to hold middle market loans. Morgan Stanley estimates, for example, that Italian banks will need to reduce assets by over €200 billion over the next two to three years in order to meet the regulatory requirements of Basel III. This is not just temporary; these regulations are permanent. Moreover, no new Collateralized Loan Obligations, or CLOs, are being created. These securitization vehicles were created to pool the loans of SMEs to make them attractive for sale to non-bank investors, thus making room on bank balance sheets for additional lending. Approximately 98% of CLOs will end their investment period by December 2014, according to Standard & Poor's, and there are hardly any plans to replace them.

With banks not lending and the CLO market closing, where are Italian SMEs to go for the credit they need to help them execute their often very credible international growth plans?

The Italian government has recognized the problem. It is actually more than a problem – it is an existential threat. If the Italian middle market is capital starved, it will surely wither, and with it jobs will be lost and the economy will contract, perhaps irreversibly. As a result, the government passed Law #134, also known as the "Growth Decree of 2012," which has removed tax and issue size impediments for non-listed companies, making it more attractive for non-bank credit providers to lend to SMEs.

Law #134 will substantially improve the access to private debt capital by non-listed medium size enterprises. Now – in a sharp break with the past – the middle market companies will able to deduct interest expense for *private* debt as well as equity participations issued in connection with private debt. In addition, they will no longer be limited to issuing debt at greater than or equal to 2X net worth, and withholding tax requirements have been eliminated for funds domiciled outside of Italy.





Italian businesses benefit in several ways by accessing non-bank capital. First, these businesses can lock in long term financing from capital providers who are not as leveraged as banks are. Second, Italian businesses can diversify their sources of capital. Banks were understandably often not available to do business with companies during the difficult years of the Great Recession, precisely when companies needed them most. As a result, it is prudent for any borrower to diversify its sources of capital. The emergence of non-bank financing will facilitate this.

Banks, too, can benefit from partnering with non-bank sources of capital. Business models for most banks rely on lending in order to develop relationships with companies that might need other services, such as foreign exchange transactions or simply a place to deposit cash. Partnering with non-banks would allow banks to maintain their relationships even if they cannot deploy the same amount of capital. To illustrate, if previously a bank had the capacity to make €200 in loans, and two companies each needed a €100 loan, the bank could fulfill the needs of and establish a relationship with both companies. However, in a capital constrained world, a bank might only have €100 to lend. Instead being forced to choose one or the other customer, the bank can lend €50 to each company, and the non-bank can provide €50 to each. The two companies therefore receive the required capital to realize their growth plans, and the bank is able to maintain both relationships, strengthening the bank's business.

As with anything new, the addition of non-bank private financing to the spectrum of capital available to Italian SMEs will happen gradually, but it necessarily will require the support and encouragement of Italian institutions and government. *The Wall Street Journal* recently reported that Italian SMEs – shut out from domestic banks – are turning to international financial sources. But for reasons of efficiency, sustainability, and ultimately market stability and health, the primary sources of capital *for* Italy must come *from* Italy. Italian pension funds, insurance companies, and even government entities are the logical providers of capital for companies now that the banks are lending less. These institutions often have excess liquidity, and they now have an opportunity to earn excellent risk-adjusted returns by providing capital to businesses, partnering with those who have the expertise to perform credit analysis. A new path always requires leadership, and it will be up to Italy's foremost institutions to show the country the way.

JUSTIN MUZINICH *is the President of Muzinich & Co., a $20 billion credit fund based in New York.*

RICHARD GRECO, JR. *is the President of Filangieri Capital Partners, a merchant bank based in New York, and a Senior Advisor at Muzinich & Co.*