NUS National University of Singapore
Source: *The Business Times*, p24
Date: 14 April 2020

The case for state-owned pseudo-equity: saving S'pore SMEs

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THE Covid-19 pandemic is an extraordinary event in human history that has had epic health and economic consequences. On the economic dimension, many responsible governments, including Singapore's, have come up with large stimulus, care and support financial packages to firms and their employees that will help sustain households, jobs, the citizen's health and the overall economy. Despite being massive, in the order of 25 per cent of GDP in major countries such as Germany and the US, most of such government support is in the form of debt that is repayable and, in any case, will only sustain workers and firms for a while.

Reports of the damage to businesses around the world are commonplace. While almost all firms, large and small, have felt the Covid-19 shock, the damage to small and medium enterprises (SMEs), particularly in hospitality, entertainment, travel and tourism, has been particularly severe. Singapore's economy is particularly concentrated in these sectors, along with international trading firms more generally, and is even more badly hit than many other countries. Our view is that providing debt finance at concessional rates may help in the near-term, but it will become a millstone around the necks of firms, particularly SMEs, in the long run. We believe that the infusion of equity finance is the only reasonable solution, for all firms, but more so for SMEs with limited access to capital markets.

How can such assistance be structured for the badly affected Singaporean SMEs, such as restaurants, travel/tourism companies and the like? As one of us proposed in the European context in a recent policy paper, Singapore could try making "pseudo-equity" available to SMEs to financially assist the most badly affected, yet previously profitable, private enterprises during the Covid-19 pandemic period.

We emphasise the importance of a long-term solution for all firms in Singapore, especially for the struggling SMEs, which according to the Department of Statistics is a key pillar of Singapore's economy. In 2019 alone, SMEs contributed 45 per cent of value-add to Singapore's GDP of S$507.6 billion, provided around 72 per cent of the 3.5 million in total jobs, and constituted 99 per cent of all its enterprises, which, at last count, comprised 273,100 firms. Most of these firms have no link to the capital markets and rely almost exclusively on bank finance or the resources of the owners.

We reiterate that the reason why SMEs may not use the traditional bank borrowing window is because the loan interest rates may be too high, they are reluctant to be saddled with more debt, or they have limited access to such loans given the present stressed conditions, even for banks. In the present crisis, any additional bank loan would be just too burdensome and unsustainable for SMEs, especially when the global economy is in a deep crisis of uncertain duration, with virus-related strains on credit markets and financial liquidity, in general.

Our proposal is to provide pseudo-equity finance. How would this work? We propose an ownership structure by which the state provides "equity financing" in the usual manner, allows for temporary "partial ownership" of the business, and collects "dividends" in the form of higher corporate taxes for a certain number of years. The business has the right to "buy back" the equity at a reasonable valuation at a future date.

More specifically, the Singapore government creates a state-linked government special purpose vehicle (g-SPV) funded by state monies that, for example:

- determines which SMEs are deemed profitable pre-pandemic, say, by using profits after tax based on their past three years' average financial results;
- provides arms-length, pseudo-equity financing to the struggling SMEs. This could be in proportion to the business' past three years' revenues, say, 25 per cent of the average (annualised) revenues in 2017, 2018 and 2019.
- Ensures that the business will start paying "dividends" in the form of higher corporate taxes, which will be passed through to the g-SPV. These payments will commence after the pandemic dust settles. Say, a 20 per cent tax (instead of the usual 17 per cent) on profits based on pandemic-adjusted assessment years, with a one-year holiday: for example, July 1, 2021 to June 30, 2022, 1 July 2022 to June 30, 2023, and so on.
- The SME, after a set number of years, will have the option to buy the pseudo-equity back from the g-SPV at an appropriate buy-back or forward price, which is determined beforehand as part of the overall valuation exercise.

The amount and duration of the incremental dividend payout to the g-SPV, which is +3 per cent of profits in our example, can be worked out using standard corporate finance valuation techniques or real options analysis; the latter better accounts for the impact of uncertainty on pseudo-equity valuation. A potential benchmark for comparison would be extant SME working capital loans in Singapore – SME loans for up to S$1 million in financing, and a five-year repayment period currently commanding interest rates ranging from 6.5 per cent to 7.5 per cent per annum. In any case, we are just illustrating the broad contours of pseudo-equity financing. The precise numbers have to be determined based on simulations with actual data.

The pseudo-equity stakes could also be sold by the g-SPV to an SME-friendly investor on a willing-buyer and willing-seller basis once the crisis abates, or via other feasible exit strategies such as securitisation, given the attractiveness of Singapore to global investors.

There are standard risk management issues the g-SPV must worry about, for example, adverse selection and moral hazard. Due to adverse selection, the SME would know more about its true health, condition and commitment than the g-SPV does, ex ante. There is asymmetric information between the two, the g-SPV and the business. Good relationship management can mitigate the problem by inculcating an appreciation for long-term reputational effects, and when push comes to shove, by introducing an "adverse selection haircut" to the financing amount.

The other risk is moral hazard, which arises when the SME recipient of g-SPV financing, ex post, siphons off the funds for unauthorised purposes, be it unnecessary risk-taking or consumption of perquisites. As the insurer of last resort, the government cannot protect itself by buying additional SME default insurance. However, as governments have punitive authority, any fraud or egregious wrongdoing can be prosecuted. Alternatively, in a less blatant form of business misconduct – for example, using the money to pay for a corporate offsite in Niseko Village – the SME could be "blacklisted" by the government. In a well-run country like Singapore, where tax compliance is good, these effects would be smaller than in many other jurisdictions.

Finally, reputable institutions like the Singapore Business Federation or Enterprise Singapore (or both) could be roped in to assist the state in risk managing the pseudo-equity financing programme.

As one of us wrote in a commentary for the Asian Bureau of Finance and Economic Research (ABFER) recently, Singapore's US$42 billion "Care, Stimulus and Support" financial package, which works out to around 12 per cent of its GDP, is both efficient and effective. It deals with all the key relief elements that any government should necessarily provide when the state intervenes as the insurer of last resort.

It can perhaps explore one more dimension – taking on a pseudo-equity role in the resuscitation of formerly profitable SMEs in Singapore, which are now struggling to survive due to Covid-19. And if the long game is played, the funds (and the attendant breathing room provided by such financing) could perhaps convince SMEs to upgrade their capabilities, innovate, transform, digitise and even internationalise their operations, which they otherwise couldn't have, given the pandemic. Singapore could emerge from the crisis stronger than before, as it did after the global financial crisis.

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