# operations

**SMEs** 

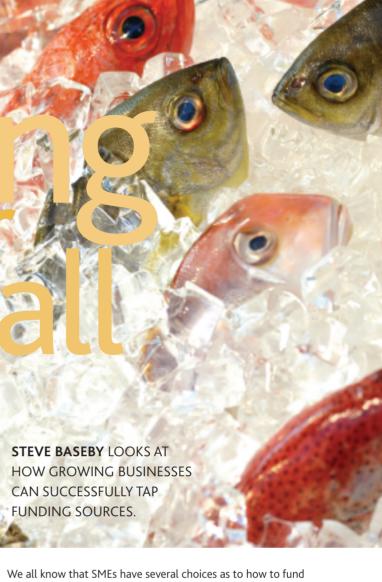
# **Executive summary**

Growing businesses' view of the world of finance is very different from multinationals' view. Growing businesses need to know what bankers really want, what finance is available and on what terms.

uch modern talk and television revenue is based on the premise that the best source of money for a growing business is a venture capitalist. But, in reality, the bank remains the main source of funding for small and medium-sized enterprises (SMEs), as the dragons in the BBC2 programme The Dragons' Den consistently point out to budding entrepreneurs. The dragons usually do this when querying why the entrepreneur's recession-proof brilliant idea has not already received the local bank manager's blessing. There is good reason for the longterm popularity of the bank: the bank manager is accessible, the bank wants to lend, its charges are tax-deductible, and the bank does not want a share of the growing business. But what the bank does want is to know that it can be repaid.

This article is for those who work for or advise enterprises which have already moved their entrepreneurial idea forward and are seeking funds to expand, whether organically or by acquisition. If the business is at an earlier stage than that, you are probably in need of a venture capitalist, even if the only one to hand is your mum.

MOST BUSINESSES NEED ASSETS There was a brief interlude during the 1990s when society believed that businesses could turn in profits without having any assets and, surprisingly, society gave them money even though they did not need to buy assets. You can be sure that many pension funds continue to have tucked away in the back blocks of their portfolios a few shares in dotcoms which proved that premise so catastrophically wrong. The truth is that most businesses need assets, whether they be stock, plant, or housing for the people who are the enterprise.



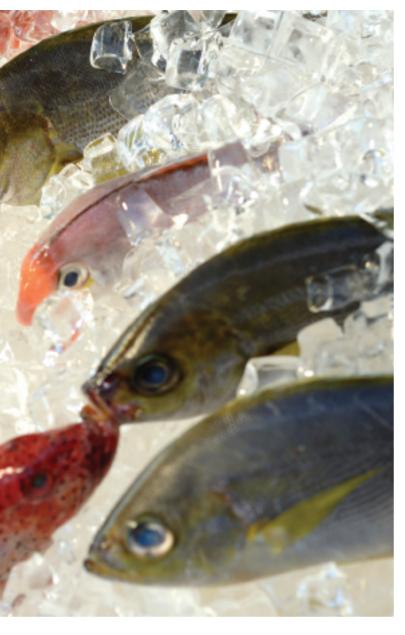
their asset base. They include:

- asset-specific finance, such as finance leases, operating leases and mortgages;
- unstructured short-term loans, often as on-demand overdrafts;
- some form of factoring, usually a mix of the above but often marketed as a dark art; and
- heavily documented term loans, with degrees of security from debentures to general liens over the business and sometimes the entrepreneur's personal possessions.

How a business mixes these options will affect its access to further finance as the enterprise grows. The tendency is that the smaller the enterprise, the more it relies on the first three options – but only because it has to. No one funds a startup unless they are sure that they can seize and sell the assets if the business fails.

Two issues entrepreneurs find difficult to grasp as they grow are:

- the essential advantages of moving towards corporate-level rather than asset-specific financing. The advantages include greater flexibility, no termination penalty for selling an asset the business owns, and the lender's commitment for a given period of time (so the loan cannot be called in unless its terms are breached); and
- to regard debt as another form of long-term financing and not as a move to the dark side. Remember, the banker does not want to own the business, and equity is not free money - equity owners either want to sell the business on or start receiving a dividend.



Entrepreneurs who do not understand these two issues prefer to rely on finding the money when they need the asset, and on overdrafts because they always believe they will pay them off. In short, entrepreneurs are optimists.

WHAT BANKERS WANT Now, let us try to look at a deal from the banker's viewpoint. Bankers are conservative souls. They rely on a salary and a pension entitlement. They probably get share options of some form which only have value if the bank stays profitable. They like to sleep peacefully at night – otherwise they would be entrepreneurs. Readers will grasp that I am not talking about investment bankers here – you only need them when you have a full-blown, fully listed established business on your hands. For that matter, you can only afford them when you have a full-blown, fully listed established business on your hands.

Let us consider what bankers need to avoid insomnia when they provide an SME with access to their investors' equity, their depositors' money, and their liabilities to the interbank market. Bankers needs to know:

- that the business model shows there is cashflow to repay the debt within the income-generating life of the assets;
- that they are not lending against assets over which someone else has security;
- that no subsequent lender will subordinate them;
- that the assets cannot be sold before (or without) their being repaid;
- that the business's risk will not change adversely after they have lent it finance.

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Asset-specific finance sidesteps these questions to some extent. Bankers can take possession of the asset, sell it, and usually come after the business, and possibly its directors, for any shortfall. The bankers' only real risk is that the business dies and the repayments stop long before they realise that they need to do this.

COMPARE AND CONTRAST Let us divert for a few minutes to consider the very different world of the large corporate. The corporate runs an established operation; is listed on the main stock exchange; is publicly reported on through the stock exchange, by rating agencies, and all manner of equity and credit analysts; has access to many sources of finance which compete for attention; and increasingly under the baleful gaze of some form of regulator are only too happy to publicly announce their cashflows and profit margins. They don't need to disclose their business plans – the financial press and equity analysts do that.

The big boys get as close to genuinely unsecured finance as is possible. Anything from overnight to 50 years. They even on occasion borrow money just because the price is right. They have bank loan facilities which they never draw but just keep them around to bulk out their credit profile! It is a pleasant world in which to be a treasurer; you get as close to free lunches as is humanly possible, but it is not the world the SME lives in and it is this difference which makes the relationship with the banker far more defined and definable.

The SME's problem is to ensure that the jump forward in scale and size does not define the banker's role so well that it obstructs the business's development.

**WHAT IS ON OFFER?** Banks try to make the process simple. They do not want to become involved in the intricacies of your business. That is what venture capitalists are for.

So what is on offer? Simple:

- The security is over the entire business no matter how subtly worded: you stop paying, they take control.
- The performance measure is earnings before interest, tax, depreciation and amortisation (EBITDA) after removing any non-cash distortions, and adding back changes in working capital so the bank can get as close to seeing the cashflow as possible without becoming a treasurer.
- The trigger on the banker's gun is the covenant test nowadays usually debt times EBITDA, and EBITDA times interest.

Simple? What about all that debt the SME already has which is

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CAPEX NEEDS TO BE SHOWN TO BE APPROPRIATE TO THE ENTERPRISE (NO EXECUTIVE JETS IF YOU ARE A ONE-PLANT BOTTLING COMPANY IN BARNSLEY), ACQUISITIONS NEED TO BE SEEN TO UNDERGO APPROPRIATE DUE DILIGENCE (REMEMBER MARCONI?).

secured on assets? What about the debt within a newly acquired business? The banker cannot have them as part of the security because other lenders already have them as their security. What about the cheap fixed-rate finance lease debt which has a large premium to exit? What about the next big idea the chief executive wants to keep secret but will require even more funding?

This brings us to the next layer of detail about what is on offer.

■ Structural subordination Lenders are coy as to how much secured debt they will allow but they typically prefer not more than 25% of the debt to take priority over their corporate debt and so you need a good reason if you want to exceed that level. Specific carve-outs are required and/or negative pledge clauses (Thou shalt not pledge more than...).

- Further investment Yes, they will allow headroom for growth by capital expenditure (capex) or acquisition, but they will want to know what the new toy brings with it before releasing the money. Capex needs to be shown to be eminently appropriate to the enterprise (no executive jets if you are a one-plant bottling company in Barnsley), acquisitions need to be seen to have undergone appropriate due diligence (remember Marconi?), and so do not regard committed headroom as a blank cheque.
- **Disposals** Every business will dispose of assets because they are worn out, outmoded or outgrown, but the banker who funded their purchase will want to know what is going to happen to the proceeds. You will need to agree a materiality limit on proceeds, usually an annual sum, beyond which the debt gets paid down unless you can convince the banker otherwise.
- Distributions As with disposals, the banker needs to have comfort that dividends and share buybacks are not means of stripping cash out of the business while debt remains unpaid. Ensure that you model the dividend policy your shareholders expect so that the financial covenants can let the dividends be made.
- Reporting The lack of public information will make your banker keen to get the covenants reported often and with proof. In contrast, you probably only report audited data once a year, perhaps some interims. There is a cost to doing more: time in diversion and salaries and audit fees. You also need to consider your equity holders and market disclosure rules, which tighten as you climb the stock listing ladder. Quarterly is forgivable but probably has to stop once you are full exchange-listed; monthly implies you are a highly leveraged project finance deal.
- Further debt Bankers do not like other bankers getting in on their patch. In theory they should have no issue with someone else lending at corporate level providing they do not get better security

and that the financial covenants continue to be respected. In practice, though, that first corporate lender will want to ringfence the business so that they remain the sole corporate lender. The degree to which you agree this depends on how desperate you are for the money, but fight to the deadline because it can be the most constricting and expensive of undertakings, which requires you to pay the costs of completely refinancing when the next big opportunity comes along. More importantly, it will restrict your ability to start refinancing progressively in more diverse markets such as private placements (which are the SME equivalent of the corporate bond markets).

#### DON'TS Try to avoid:

- granting a monopoly on ancillary services such as your clearing banking – the business should go to whichever provider is the most appropriate;
- defining your insurance beyond "normal for nature of business" because bankers are risk-averse and will want to insure out every risk regardless of your expense (but do accept "key man" insurance if your entrepreneur is really as essential as they believe);
- agreeing the undeliverable your English subsidiary can provide an enforceable upstream guarantee, your French subsidiary cannot, you can say you are not in default now but not that you will not be in the future;
- over-tight financial covenants debt:EBITDA of 3:1 is reasonable for a business with a track record, interest cover of 5:1 is generous unless you also want distribute the whole profit;
- lock in fees. There is no breakage fee on floating rate other than breaking the current interest period – any more is greed; and
- fully hedged deals unless what you wanted was fixed-rate.

**DO** Accept your business may have some peculiarity which means you may need to concede more than the norm. A one-asset business really is more risky to fund than a multi-asset business. A novel idea really does warrant amortising debt rather than a bullet – but don't let them price five-year debt if the average life is three. Peculiar accounting policies will lead to peculiar covenants, suspicion, and constant re-explaining. An appropriate financial adviser (appropriate experience, that is, not your opinion of the fee) will save bundles in the short- and long-run because they will know the terms of trade of the market. Arrangement fees are a necessary evil. Commitment fees are the insurance premium of liquidity, not a sunk cost.

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