SHORT ON FUNDS

The range of funding options for smaller corporates and SMEs has never been greater, but it is likely to remain a fragmented market. Paul Golden reports

Funding challenges faced by businesses ranging from the smaller corporates right down to start-ups have attracted headlines and even ire from political and business quarters. Much of the disapproval has been aimed at an apparent lacklustre offering from mainstream banks in relation to this part of the business world.

Studies suggest that SMEs may not be exploiting all the possibilities, however. Research from the Association for Financial Markets in Europe (AFME), for example, highlights the fact that European SMEs find it difficult to access equity finance and that many SMEs remain unaware of the options available to them. Bank loans remain the most common source of SME finance in Europe. Italian SMEs received €233bn in loans in 2013 compared with just €1bn in private equity (PE) capital, while in Spain, €273bn was advanced through bank loans compared with less than €1.5bn from venture capital and PE sources, according the AFME report.

Regulatory changes aren't likely to ease the situation, at least in the UK. Banks will continue to compete for business from the biggest and most profitable companies, but there is little evidence that they are improving their service to larger SMEs or small corporates. That is the view of UserCare Treasury Consultancy director Brian Welch, who says that the separation of banks into transaction and investment functions in the UK, for instance, is going to lead to higher costs and that it is unclear which part of the bank corporates will deal with. "The objective is to increase the financial security of the banks, but other EU countries and the US are not forcing their banks to make the same changes, so UK institutions may become less competitive," he adds.

So what does this mean for corporate treasurers? According to Practical Car and Van Rental group FD Len Jones, the key cash, working capital and liquidity management challenge is still to find the right type of funding. "In some instances, a straightforward overdraft is not the best option, as it can be inflexible and fail to take account of strategic changes in capacity," he says. "We rely heavily on asset-based finance, because we have long-term assets that are held typically for six to 18 months to generate rental income."

Jones refers to a stocking plan for rental companies developed in conjunction with finance company Lombard, which accommodates retention periods on fixed assets and day-to-day flexibility on the number of vehicles on the facility as an example of finance houses fine-tuning their lending criteria in response to general economic conditions. "Liquidity is obviously a big issue, but the key to obtaining the credit line in the first place is to have a clear

idea of why you want it and how you can manage the stakeholder's expectations, which is becoming more of a part of the treasury function," he continues. "In the recent past I have seen signs that banks are more willing to work with their customers and are trying much harder to maintain sustainable banking, and realising they have to sit with their customers through difficult times."

Stephen Pugh, FD at brewery, hotelier and wine merchant Adnams, explains that the company has net debt and seeks to ensure that all balances are pooled to minimise the cost. "Cash forecasting is important, but we are lucky in having strong asset backing, so that facility levels have never been beyond a level at which our bank feels comfortable.

"As for whether banks are improving their service to larger SMEs and small corporates, our experience is that they are keen to lend and that terms are much more competitive than a few years ago, and starting to approach pre-2008 levels," he adds.

Looking for alternatives

Yet many start-up and early-stage enterprises still find it hard to access bank finance, which explains growing interest in alternatives such as crowdfunding, angel investment and peer-to-peer (P2P) lending. Business angel investments range from £10,000 to £1m, although syndication can result in deals reaching £2m-plus.

The potential to raise funds via P2P or alternative finance provision is growing, but is still mainly of interest for the smaller end of the market. According to *The UK Alternative Finance Industry Report 2014*, published by innovation charity Nesta, the average amount raised by equity crowdfunding is just under £200,000. Just over half (54%) of the businesses that raised funds this way were seeking expansion capital.

Alternative finance volumes are growing steeply, but have a long way to go before they reach quantum. These sources provide only a tiny fraction of the total amount raised annually in Europe, observes Rick Watson, head of capital markets at AFME and one of the authors of the association's SME funding guide. "For the overall economy, these types of platforms are important, since many SMEs need small amounts," he says. "As the alternative finance industry grows, it is important that there is a strong focus on governance to reduce opportunities for fraud and mis-selling. This should be accomplished with the right type of dialogue between the funding platforms and the regulatory community."

Jones agrees that there is a place for alternative sources of business funding, provided there are sufficient safeguards around fundraising and the stewardship of these funds. "The advantage is that (in theory) people know what they are

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getting into and perhaps take a greater interest in the projects. There will still be a place for banks and larger institutions in the business finance marketplace – alternative finance is more suited to start-ups and riskier ventures than banks would normally fund."

Welch is more upbeat about the potential of private/direct loans. "I am the trustee of a medium-sized (£400m) pension fund and we have just agreed to invest £20m into a fund designed to lend to medium-sized companies and SMEs," he explains. "One of the funds will be valued at about £500m and the other may be up to £2bn. Pension funds that want a longer-term, higher return are keen to invest. I used private loans as a corporate treasurer in the 1980s when the market was mainly US-based and the investors were US insurance companies with long-term liquidity to invest."

It is also worth noting that the vast majority of SME clients never borrow from their bank, but instead rely on it for a wide range of other services, says Watson. "For example, a number of banks now offer general advisory services to their SME clients to assist them with the challenges of growth, including governance."

Banks that engage with their customers most effectively and give their customers the best guidance, tools and services will be successful, concludes John Davis, MD of business application developer BCSG, whose research suggests that, while almost half of small businesses have considered switching banks at some point, most have been with their current bank for more than five years.

Supply chain finance – big numbers, small benefits

According to research by business management consultancy McKinsey, there is approximately $2 trillion in financeable, highly secure payables worldwide. However, the firm also notes that only one-tenth of the potential market for supply-chain finance (SCF) is being exploited.

Welch worked for a company that was an early adopter of SCF. "The traditional view is that it is a way for SMEs to finance their activities, but my experience was different," he recalls. "The company I was working for wanted to take longer to pay its suppliers, so in practice our suppliers were financing a larger company's longer credit terms. The bank that provided the facility also supplied software to manage the programme, so everyone made money out of it except for the supplier, which had to wait longer for its money."

Welch observes that, although larger companies' stronger credit ratings should enable smaller suppliers to borrow on better terms than they would be able to achieve on their own, in practice that wasn't necessarily the case, since the larger suppliers refused to agree to the extended credit terms.

Adnams has found itself on the wrong side of SCF, says Pugh. "It is very frustrating to have large customers coming to us demanding very lengthy payment periods, but saying that we shouldn't worry as they can provide the finance," he says.

While accepting that a transparent, long-term relationship is the key to making SCF deals work, Jones is more supportive of the concept.

"We have practised this for years as a franchiser," he explains. "The basic premise is that firms should collaborate more and perhaps share open-book accounting, manage each other's margins and have proper discussions about supply and demand."

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Smaller corporates' headaches

SMEs, like any sub-investment-grade group, will always struggle to attract institutional attention, of course, so it seems likely that market responses to their funding woes – such as SCF and internet-based alternative finance providers – will remain fragmented for the time being. The headaches aren't necessarily relieved as entities grow, either. A study from rating agency Moody's, for instance, into newly rated companies, found that companies rated for the first time in the nine months to September 2015 were unduly optimistic in their projections. On average, they expected to achieve full-year revenue growth averaging around 7.1% (up from the 5.1% revenue growth that companies first rated in 2014 expected in their first year), but in reality may see a shortfall in that revenue growth of 3%, according to the report's findings.

Moody's also found that achieving cash-flow goals becomes more challenging for companies in their first year of achieving a rating. Some 62% of 2014's newly rated companies missed their cash-flow expectations for the following year, up from 58% in 2013. "The increasing percentage of newly rated speculative-grade companies that miss their own cash-flow forecasts in the year of rating assignment further increases the risk of weakening liquidity among speculative-grade companies and could ultimately pressure ratings for some," say the report's authors.

Newly rated companies, it seems, show similar vulnerabilities, along with added pressures around generating results persuasive to backers.

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