SME Risk Finance
Small-cap SME Mezzanine
Finance Masterclass

Overview

The master class consists of six Chapters:

- **Chapter 1** – **SME Risk Finance sector**
- **Chapter 2**
- **Chapter 3** – **The SME and entrepreneur**
- **Chapter 4** – **The Investment process**
- **Chapter 5** – **Understanding financial terms**
- **Chapter 6** – **Lessons learned**

Target market

Risk Finance	Private equity
Generates its returns from: • Loan repayments (interest), and • Risk/profit sharing mechanisms (ratchets)	Mainly generates returns from: • The sale of a business that has achieved growth (assets and/or share price)
Traditionally generates more, smaller returns	Generates fewer, but bigger returns
Business Development services is bought with the transaction	Business Development services are only provided to those businesses owned by PE firms

SME Risk Finance sector

- Special sector in finance industry
- Role players:
  - SME Risk Finance practitioners
  - Investors
  - Other role players
- Relatively new sector
- Unstructured
- Current organic growth led by few pioneering organisations.

Target market

- Start-up and early stage SME
- Finance from US$150,000 to US$5m
- Lack of track record, collateral and/or own contribution
- 250 or less employees
- Sales of <EUR50 million; balance sheet of <EUR43 million
- Single investee or small management team
- Business/management skills lacking

The make-up of a Investment Manager

Contextualising Investment Managers in Risk Finance

An Investment Manager can be many things to many people. In some sectors an Investment Manager is a person that takes care of a group of key clients focusing mostly on marketing activities. In other sectors it can be an individual responsible for managing relations with suppliers. In the context of Risk Finance an Investment Manager's role is split in two:

1. Before the transaction; and
2. After the transaction, also called pre and post implementation.

Contextualising Investment Managers in terms of SMEs

It is the Investment Manager's responsibility to supplement these skills and know when which is necessary in the business's growth cycle. Thus, in the context of the SME, an Investment Manager is like a big brother who is there to assist the entrepreneur with skills and information to help the business achieve its maximum potential.

The SME and entrepreneur

Understand the entrepreneur

In Risk Finance decisions the entrepreneur as person is central in making a decision to commit to a deal or not. Thus, some consideration of the entrepreneur is prudent in order to help understand what normally makes up a good entrepreneur versus a bad one.

Certain key traits are prevalent in successful entrepreneurs. Such people normally have one or more of the following:

- Role models that were entrepreneurs
- Relevant experience
- Good ethics and values
- Good people and communication skills
- Good leaders and motivators; and are usually
- Creative problem solvers.

Not all entrepreneurs have these traits, but the majority of successful entrepreneurs do. A person who perhaps has been involved in business that had questionable practices or entrepreneurs that treated their suppliers or customers badly can be dangerous. What prevents the entrepreneur form behaving in the same manner towards the Investment Manager or Fund Manager?

The Investment Process

Transaction origination

- A high qualifying rate.
- A healthy pipeline.
- Stretching investment targets.

Transaction screening

After a new application is received from origination activities the deal is put through an 'early desirability' test. This is done for several reasons:

- To ensure that only good deals are investigated further
- To save the Investment Manager, Fund Manager and client time and money
- Ensure the deal meets with minimum fund criteria; and
- To identify features of the business that must be investigated further or risks that must be mitigated against (assuming the deal will be pursued).

Understanding financial terms

Money Multiple

In investment, more specifically the venture capital industry, the most common and arguably the most.

Internal Rate of Return (IRR)

Internal Rate of Return is a rate of return used in both capital budgeting and the finance industry to measure and compare the profitability of investments.

Financial instruments

There are many financial instruments that can be used but keeping in mind that we are discussing finance to SMEs, the following instruments are commonplace. Each is discussed in more detail:

- Term loan
- Revenue share payments
- Equity
- Shareholder's loan
- Moratorium.

Environment Management System

- Developing an environmental policy
- Planning the EMS
- Implementing the EMS
- Checking the system
- Acting on it.

Risks to be managed

Consequence	Mitigation
1. Wrong profile client	
• Poor deal flow • Waste of resources • Investment profile not in line with strategy	• Clear understanding of product offering • Clear understanding of target market • Accurate marketing

The exit

Exiting a deal can be done in one of three ways:

1. Early settlement
2. Normal settlement (self-liquidating instrument); and
3. Legal action.

Business monitoring

Once disbursement and implementation have been completed the Investment Manager again takes a leading role through the process of business monitoring. Business monitoring involves regularly:

- Keeping contact with the client
- Doing site visits
- Carefully monitoring:
    * Repayments
    * Bank statements
    * Insurance policies; and
    * Financial statements.

Lessons learned

Lessons on the application

- Business plans developed by consultants/intermediaries are usually insufficient and of poor quality.
- Sufficient 'hurt' money must be invested by clients/Shareholders/developers to prevent them from walking away when times are difficult.
- Financial projections are often unrealistic and over-optimistic. Base cash-flow on conservative sales estimates.

Lessons on the assessment of the application

- If there is no proof of market or technology, the transaction is off.
- Don't allow the client to pressurise you for a quick answer, rather say: "no".

Lessons on ensuring a successful outcome

- The four basic reasons for failure of businesses are:
    * A faulty business plan
    * Incompetent management
    * The market failed to develop; and
    * Bad luck.