SME LENDING

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Non-bank lenders are positioning themselves as partners to SMEs going through transformative events. **Andy Thomson** hears about perceived opportunity and concerns about the cycle

From left: Grant Paul-Florence, Chris Walters, Richard Coldwell, Dalit Nuttall and John Harrison

"Private debt is growing into its own asset class. Investors are able to assess returns better and there is a bigger range of investor groups with different rationales and approaches now coming to the table. Previously, when defined as either fixed income or as private equity allocators, they had more constraint," says Dalit Nuttall, a senior partner at London-based placement agent Arbour Partners.

But while the crowds flocking to invest in the mid-market space – direct lending in particular – have been well documented, it seems that the opportunity to support smaller businesses has dipped somewhat below the radar.

To discuss the SME lending landscape, *PDI* brought together a group of five experts around a table at the offices of Octopus Investments in London's Holborn district. Grant Paul-Florence, head of intermediate capital at Octopus, agrees that – amid a crowded lending landscape – the SME market feels relatively becalmed.

"At the start-up stage, there appears to be plenty of funding, and also for mid-market SMEs," he says. "But we focus on the £1 million ($1.3 million; €1.1 million) to £5 million EBITDA bracket, and that is under-served. The banks are now required to hold more regulatory capital and so are lending less, causing them to prioritise larger borrowers rather than offering bespoke solutions to these SMEs. VCTs used to service these SMEs but have been hit by European state aid rules, severely limiting their ability to provide funding to profitable SMEs and so have been largely forced to withdraw."

John Harrison is a senior managing director at Harbert Management Corporation, an investment firm which has its corporate headquarters in Birmingham, Alabama but invests across the US and also from three European offices in London, Madrid and

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RICHARD COLDWELL

Director, investments, British Business Investments

"FOR BUSINESSES WITH EBITDA OF LESS THAN £1 MILLION, PLATFORMS HAVE A ROLE TO PLAY"

- The commercial arm of the British Business Bank makes loans or investments of between £5m and £200m in finance providers to smaller businesses
- Aims to support the development of diverse debt and equity finance markets
- Works with mid-market direct lenders, debt funds, asset finance providers, P2P lenders, venture capital funds and challenger banks
- Has made a gross return on average capital invested of 7.4% and made pre-tax profits in 2016-17 of £55.1m

BREXIT: RECESSION TRIGGER OR PATH TO PROSPERITY?

With Brexit negotiations ongoing – or stalling – those around the table are as much in the dark as anyone else when it comes to knowing what the UK will look like once the exit date has arrived in March 2019.

However, given the feeling that the good times can't last forever, there is a sense that the uncertainty surrounding Brexit could be a trigger for – or have a compounding effect on – what lies ahead.

"We have not seen a big Brexit impact yet, as we invest in UK SMEs with minimal European operating presence. At this stage, our main concern is that it will trigger a full-on recession," says Octopus's Paul-Florence.

Coldwell of British Business Investments says: "European institutions have to date, generally been more enlightened than those in the UK in seeing this as an attractive asset class."

However, adds Harbert's Harrison, these same institutions now have a lower appetite for the UK as a result of concerns over Brexit.

But despite this, SMEs appear to have a high level of confidence in their prospects – perhaps feeling that Brexit offers them an opportunity to shed some red tape. Paul-Florence points out that most of the trading within Octopus's SME portfolio is within the UK so the firm has not experienced many adversities resulting from cross-border trading.

Coldwell, meanwhile, detects split opinion between the capital and the rest of the UK. "In London, there is typically more caution around Brexit, but around the UK regions, many SMEs see it as an opportunity. There is a view that it will be positive for many SMEs."

"AROUND THE UK REGIONS, MANY SMEs SEE BREXIT AS AN OPPORTUNITY"

RICHARD COLDWELL

Paris. He says the US and European SME markets have evolved very differently in terms of finance provision: "In the US, there is a long history of major non-bank players such as GE Capital and CIT and borrowers have less reluctance to borrow from NBLs. For certain private equity-type deals such as acquisitions or growth capital, there used to be fewer options than there are today, but the likes of property, equipment and working capital finance have been available from NBLs for a long time."

THE NBLs EMERGE

In Europe, the banks have dominated the scene. In the words of Richard Coldwell, a director of investments at British Business Investments – the commercial arm of British Business Bank, the economic development bank formed by the UK government – they are still "the first port of call".

The NBLs have emerged and made progress at a time of strong liquidity but some think the banks have held their ground and that the NBLs have less traction in Europe than in the US.

Paul-Florence says the population of NBLs in the lower mid-market is very small. He estimates that in London there are around 100 private debt funds but only a handful of these are targeting the sub-£5 million EBITDA category.

Nonetheless, times are changing. In the past, small companies would naturally have sought finance from the banks, which would have held their hands through the process. But as bank influence weakens, new dynamics are coming into play. Intermediaries matching borrowers with suitable funders are playing a more active role, but arguably not yet active enough.

"For organic growth or development purposes there are a lot of easily identifiable funding sources," says Paul-Florence. "But when companies of this size want to do something more event-driven, such as a bolt-on acquisition or shareholder realisation, they often have no idea where to find appropriate funding. Some are literally searching on Google. We have to go out and look for them – and, when we find them, it's often a case of 'This is great, this is the solution we wanted'."

That solution often relates to the kind of transformative event Paul-Florence points to, such as an acquisition. "Our finance fits companies at an inflexion point," says Harrison. "It's the type of finance that they need today. In five years' time, they won't need it. The inflexion point can be a number of different types of event, but typically it's not traditional finance that's required."

Paul-Florence says Octopus uses multiple sources to assist with origination of deals, including intermediaries, corporate financiers and brokers. These sources provide access to small businesses in the UK regions. He adds that his team contact around 200-300 businesses a year, of which five or six may be in need of the kind of financing Octopus provides.

The firm also talks to non-executive directors, who sometimes come forward with suggestions about how to unlock an opportunity. One individual who fits this description is seated next to Paul-Florence in the form of Chris Walters, who worked with Octopus when it backed TSC Inspection Systems, the electromagnetic testing technologies firm where he was CEO.

POLAR EXTREMES

Walters says he likes to work with financiers which avoid the "polar extremes" of the banks – "which are hands-off and tell you to get on with it" – and private equity firms "which tell you exactly how to do it". "When you're at an inflexion point, you already have a pretty good idea what you want to do and want to work with a more aligned lender, such as Octopus," he points out.

"The key thing for me is the level of trust between borrower and lender," adds Walters. "You are often dealing with very proud founders of a business and that trust aspect is vitally important."

JOHN HARRISON

Senior managing director, Harbert Management Corporation

- HMC invests across real estate, private capital and absolute return strategies
- The private capital strategy covers European growth capital, growth equity, independent power and credit solutions
- The credit solutions group typically provides $3m-$15m in subordinated debt to companies in need of capital for organic growth, acquisitions, recapitalisations or management buyouts
- Targets a 13-14% coupon on loans with five-year terms

"TO INVEST EQUITY ALONGSIDE THE DEBT MAKES SENSE, BUT YOU'VE GOT TO AVOID STYLE DRIFT"

Paul-Florence says one of the reasons that opportunities have opened up for alternative lenders is the eroded trust in banks. "After the global financial crisis, decisions got pulled back to credit committees and what should have been minor quick fixes such as small covenant breaches led to the banks taking very aggressive stances. The relationship managers were no longer in control and that was hugely damaging to the banking sector."

However, it would be wrong to think the banks have been marginalised by alternative lenders. Those around the table say they often partner with banks on their own deals, taking the junior piece while the banks

DALIT NUTTALL

Senior partner, Arbour Partners

"THE MID-MARKET MANAGER IS FIGURING OUT HOW WHOLE INDUSTRIES ARE BEING RESHAPED AND UNIQUE SITUATIONS BEING CREATED"

- Arbour is a placement agent, founded in 2010 with offices in London, Berlin, Paris and Copenhagen
- Claims to connect global investors with the major opportunities in credit and growth capital
- Clients include Funding Circle, Beechbrook Capital, Pemberton and ICG
- Nuttall was previously a principal at WestValley Capital where she connected institutional investors to opportunities in private equity, venture capital and real estate

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TSC: NAVIGATING CHOPPY WATERS

Milton Keynes-based TSC Inspection Systems was not the easiest of deals for Octopus Investments. An electromagnetic testing technologies firm, specialising in testing safety-critical infrastructure such as offshore platforms, the firm was hit hard by the oil and gas slump.

Octopus provided a £2.7 million loan and £300,000 of equity to TSC in 2012. Octopus then found itself having to "realign the capital structure, re-incentivise the management team and inject some cash", according to Octopus's Paul-Florence.

"Then we had to stabilise performance and pursue a measured business improvement strategy while closely monitoring cash. In parallel with this we sought to optimise the exit value by taking the necessary time and running an orderly process which resulted in a successful outcome."

"We were a small business that had grown fast and had changed its focus from manufacturing to services," says Chris Walters, who was chief executive of TSC at the time. "With Octopus's help, we were able to continue the development of the strategy."

Walters says Octopus also provided appropriate incentivisation for the management team and was able to provide support when the firm was sold to Canada's Eddyfi Technologies in May this year.

take a senior position or provide working capital or various transaction services.

One area where the banks have been increasingly prominent is in the emerging area of online lending. "Banks have formed numerous partnerships with the online SME platforms in making micro-loans to very small businesses," says Nuttall. "We will see more of that in the future.

"In a world of machine learning, AI and disintermediation, the mid-market and the micro SME spaces are shaped by these changes very differently. The mid-market manager is figuring out how whole industries are being reshaped and unique situations being created. The SME platforms are themselves reshaping the financial industry. They are the disrupters. It is here where institutional investors are going to see the greatest progress from technology as diverse risks are sourced more efficiently."

Walters stresses the importance of working with lenders that understand your business – and questions how possible that really is through an online portal. However, Nuttall points out that average loans for online platforms are typically around £60,000-£70,000 and are a very different value proposition from the "inflexion point" financing previously discussed. "For businesses with EBITDA of less than £1 million, platforms have a role to play," says Coldwell. "One of the appeals to SMEs is the ease of dealing with a platform, such as not having to wait weeks or months for a credit committee to come to a decision."

However, he also questions whether all platforms will survive a downturn. "It requires discipline for fund managers to provide credit lines to SMEs when they are also participating in the equity of those businesses," adds Coldwell. "But as an investor, participation in equity can assist the returns by compensating for losses elsewhere and supplementing the interest margin."

GRANT PAUL-FLORENCE

Head of intermediate capital, Octopus Investments

"VCTs USED TO SERVICE THESE SMEs BUT HAVE BEEN HIT BY EUROPEAN STATE AID RULES"

- Octopus has backed 'hidden gem' companies such as Zoopla Property Group, Secret Escape and SwiftKey
- Has also backed more established smaller companies such as supply chain firm SCM World, automotive firm Clifford Thames and healthcare business HST
- Paul-Florence is responsible for sourcing and making new investments, monitoring portfolio companies and fundraising

CONTROL ISSUES

Having spent time at the table discussing the role of banks and the extent to which they provide competition, the point is made that in many situations lenders actually find themselves competing with private equity firms rather than banks.

"Often there is a decision to be made around the issue of control," says Paul-Florence. "Do I take private equity and give up on the economics and control of the business, or do I take debt with covenants that I might breach and potentially lose control that way? Many of the management teams we have backed are attracted to our strategy of investing a minority equity stake as part of our debt-led funding because there is greater alignment of interests."

"Some private owners may not want to sell control of their companies, but still need to raise capital for initiatives they are pursuing," says Harrison. "We provide some kind of solution to companies that don't want to relinquish control."

Often, the lenders will themselves provide equity to borrowers. "Whether it's preferred shares or warrants, we won't do a deal without equity," says Harrison. "To invest equity alongside the debt makes sense, but you've got to avoid style drift."

It requires discipline to be a credit investor when you're also investing equity, but there is a view that if you don't have upside participation, the returns may not be attractive.

In discussing returns, Paul-Florence says Octopus Intermediate Capital "aims for mid- to high-teens, and we have achieved that historically through a combination of debt and equity". At a time when mid-market private debt is perceived to be getting crowded, this on the face of it makes SME lending a compelling proposition.

"I think it's a huge opportunity," says Paul-Florence. "We position our hybrid debt and minority equity capital as being more value-added than a traditional bank lender but far less dilutive than a pure private equity solution. Our investors can take comfort from the fact that in our deals our debt is always secured and includes all the usual debt covenants as well as having higher levels of access to management and being able to influence the strategy of the business via our board seats."

However, it does not appear that the opportunity is particularly well recognised by investors at this point. "There is more work to be done to gain confidence in the track record of managers in SME lending," says Coldwell. "There are fewer managers focused on this type of lending but the returns are attractive. However, investors need to perform more diligence to gain comfort on the relevant experience of the manager."

CHRIS WALTERS

Entrepreneur and former chief executive

- The former chief executive of TSC Inspection Systems, Walters is a chartered engineer, naval architect and Fellow of the Institute of Marine Engineering Science & Technology. He has 25 years' experience in the marine and energy sectors
- Held senior positions over a 12-year period with the Lloyd's Register Group, where he was the director of marine operations and senior vice-president of oil & gas certification
- Prior to joining Lloyd's Register, Walters spent 10 years in the P&O Group, the UK shipping and logistics company

"THE KEY FOR ME IS THE LEVEL OF TRUST BETWEEN BORROWER AND LENDER"

Coldwell says this is partly due to a lack of data in the SME space. Nuttall agrees. "The mission is clear: to build a bridge between the savings market and institutions," she says. "We need to make the data gathering more systematic and help the broader investor universe analyse and understand the SME lending market better."

Nuttall also thinks larger pools of money may be required to tap the opportunity. "Investors see interesting opportunities in the lower mid-market space, but are constrained – the funds being too small for the larger investors to be able to invest. Is there perhaps a role for funds of funds, as we saw in the earlier days of private equity, where you could diversify across different specialist strategies through one large investment?"

WHEN WILL IT ALL END?

As in pretty much any corner of the investment universe, those involved in SME finance are thinking hard about the possibility that the relatively benign environment for lenders post-crisis will come to an end – and what the implications of that will be. "We expect the economic cycle may take a turn for the worse at some point in the near future," Paul-Florence says frankly. "How severe will it be? That could depend on a number of factors such as the UK government and the Brexit process."

"It's not a case of 'if' the next recession comes along but 'when'," says Harrison. "And then it's about the returns that are achieved through it and how the industry goes about recovering."

Coldwell reflects on the fact that, up to now, many managers have not managed funds through a downturn. For some, recession may present a challenge. "It will be the first test for this asset class," he says. "There are a number of managers that I think will prove resilient but losses incurred by investors would damage investor appetite for the asset class."

If SME financiers are to be among the ones proving their resilience, they will need to deliver returns in line with investor expectations while also acting as the value-adding partners that borrowers say they need when navigating major deals. But for now, the market is ticking along nicely. ■