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SME Finance Analysis and Policies and Procedures



Objectives

- Demonstrate lending context
- Understand context
 - Who is the client?
 - What are the SMEs' needs? What are the bank's needs?
 - What are the external and internal environmental considerations
- How do SMEs compare to corporate clients?



Agenda

Day 1

- Objectives of Seminar
- SMEs
 - Definition
 - Characteristics
 - Financing needs
 - Risks
- Bank
 - Target market
 - Credit policy

Day 2

- Loan products
 - Loan process
- Best practices in lending to SMEs
 - Target market
 - Products
 - Procedures
 - Structure/Organization
 - Risk mitigation



SMEs – Definition Criteria

- Employees
- Assets
- Sales
- Size of loan



SME Characteristics

- Lack of formal structures
 - Managerial
 - Financial
 - Organizational
- Influenced by, rather than influencing, external environment
- Flexible
- Creative
- Make decisions quickly
- Little management depth
- Owner=manager
- Significant portion of owner's net worth



SME Financing Needs

- Raw materials
- Finished goods
- Working capital
- Asset purchase
- Marketing
- Credit terms to clients



SMEs' Risks

- Start at beginning and go through entire cycle
- Unwilling to pay obligations
- Unable to pay obligations
 - External environment
 - Raw materials supply
 - Materials themselves
 - Suppliers
 - Infrastructure
 - Power
 - Water
 - Communications
 - Transport
 - Government
 - Crime
 - Civil disorder
 - Regulations
 - Licenses
 - Corruption



SMEs' Risks (continued)

- Unable to Pay Obligations (continued)
 - External Environment (continued)
 - Weather
 - Industry
 - Suppliers
 - » Few
 - » Many
 - » Reliability
 - Producers
 - » Few
 - » Many
 - » Relative strengths versus: Other producers, Clients, Suppliers
 - Market
 - » Size
 - » Seasonal
 - » Factors of differentiation
 - » Key factors in buying decision
 - » How price sensitive



SMEs' Risks (continued)

- Unable to pay obligations (continued)
 - Internal environment
 - Raw materials
 - Ordering
 - Quality control
 - Production
 - Bottlenecks
 - Efficiency
 - Planning/scheduling
 - Managing
 - Quality control



SMEs' Risks

- Unable to pay obligations (continued)
 - Internal Environment (continued)
 - Finance
 - Cost control
 - Margin calculation
 - Break-even analysis
 - Cost accounting
 - Management reports
 - Rule of thumb data
 - Human resources
 - Hiring
 - Training
 - Welfare



SMEs' Risks

- Unable to pay obligations (continued)
 - Internal Environment (continued)
 - Sales
 - Too few clients (concentration risk)
 - Too many clients (marketing cost)
 - Basis of sale
 - » Relationship
 - » Price
 - » Quality
 - » Combination
 - Balance of power



Bank Considerations – Target Market

- Industry
 - Size of company
 - Sales
 - Employees
 - Assets
 - Other (from break-out groups)
 - Match bank target market with SME definition
 - Overlap or mis-match ?
 - Ways to resolve



Bank Considerations – Credit Policy

- Credit policy should be fundamentally the same for all borrowers
- Must be flexible but within a set framework
- 5 « C »s of credit
 - Character
 - Owner/manager must want to repay loan
 - Capacity/Cash flow
 - Company must generate enough cash to repay loan
 - Capital/Net worth
 - Owner must have funds in business
 - Evidence of re-investment in business
 - Collateral
 - Conditions
 - Use of funds
 - External environment



Bank Considerations – Credit Policy (continued)

- 3 ways out
 - Cash flow
 - Corporate finance
 - Refinance
 - Spin-offs
 - Sale of some assets
 - Additional equity
 - Sale of collateral



Bank Considerations – Credit Policy (continued)

- Limit on % of loans to any 1 borrower
 - Individual
 - company
- Limit on % of loans to any 1 industry
- Required number of signatures
- Credit authority levels
- Is there a clear distinction between loan officer and credit officer
 - Loan officer can have credit authority but it must be specifically granted NOT simply by virtue of title
 - Basis on which credit authority is granted to bank officers



Bank Considerations – Credit Policy (continued)

- Types of security/collateral accepted
 - Cash
 - Negotiable instruments
 - Stocks
 - Bonds
 - Land
 - Buildings
 - Stock
 - Finished goods
 - Raw materials
 - Personal guarantees
 - Life insurance policies
 - Supply contracts with large companies



Bank Considerations – Credit Policy (continued)

- Also : matching of loans to loan funds
 - Fixed or floating rate
 - Term
 - Currency
 - Term/maturity
 - Source of loan funds
- Match bank credit policy with SME definition
 - Overlap or mis-match ?
 - Ways to resolve



Bank Considerations – Loan Products

- Revolving credit/Overdraft
- Term loan
- Cash flow lending vs. collateral based lending
- Match bank loan products with SME needs
 - Overlap or mis-match ?
 - Ways to resolve



Bank Considerations – Loan Processes

- Relative roles of
 - Loan officer
 - Credit officer
 - Legal department
 - Does bank incentive structure align with respective roles ?
- Source of clients
 - Approach from bank
 - Approach from client



Bank Considerations – Loan Processes (continued)

- Initial screening criteria
 - Does company operate in target industry(ies)
 - Length of time in business
 - Usual minimum 3 years
 - Profitable now
 - Possibly could consider if profitable in past but not profitable this year
 - Does company have a bank account
 - Security offered for loan
 - Financial statements available
 - Possibly accept un-audited statements
 - Minimum 10% own contribution to funds required
 - Ratio of debt :equity
 - Maximum 4 :1 ?



Bank Considerations – Loan Processes (continued)

- Full application by client
 - Company details
 - Company registration number
 - Company tax number
 - Terms of sale : does company receive deposit/full advance payment from customers
 - Terms of supply : does company receive credit from suppliers
 - Shareholder details
 - Management details
 - List of proposed assets for collateral
 - Business plan
 - Cash flow forecast
 - Free cash flow
 - All liabilities including off balance sheet liabilities



Bank Considerations – Loan Processes (continued)

- Preparation of written application to credit committee
 - By loan officer
- Due diligence on company and information
 - By credit officer
- Presentation to credit committee
 - By loan officer
- Decision of credit committee
- Communication of decision to client
 - By loan officer
 - If no, must be clear why credit was denied and what client can do to get credit
 - If yes, discuss any conditions imposed by credit committee
- Issue commitment letter
 - Terms of loan
 - Conditions precedent to disbursement
 - Must have expiry date



Bank Considerations – Loan Processes (continued)

- Documentation required
 - Loan agreement
 - Amount
 - Term
 - Interest rate
 - Prepayment
 - Conditions precedent to disbursement
 - Representations and warranties
 - Legal standing
 - All information correct: Absolute, « Best knowledge »
 - No material adverse change



Bank Considerations – Loan Processes (continued)

- Documentation Required (continued)
 - Loan Agreement (continued)
 - Covenants
 - Monthly financial statements
 - Maintenance of specified minimum ratios:
 - Pretax profits or free cash flow/total interest paid – min 2x ?*
 - Operating income/sales – not to drop below previous 3 yr average ?*
 - Total debt/capitalization (debt+equity) – max 75% ?*
 - No new debt
 - No liens
 - No dividends or owner drawings
 - No mergers
 - No sale of assets
 - Capex limit
 - Operating: Dividends, Asset purchases, Asset sales, Change in nature of business, Acquisitions
 - Events of default, grace period,
 - » Non-payment of: Principal, Interest, Fees, Default on covenants



Bank Considerations – Loan Processes (continued)

- Documentation Required (continued)
 - Tax certificate
 - Financial statements
 - Company resolution authorizing
 - Loan
 - Signatory



Bank Considerations – Loan Processes (continued)

- Disbursement
- Monitoring of loan
 - By loan officer
 - Need for TA
 - Monthly financial statements are **key indicator**
 - How often
 - Monitor by exception
 - Balance between simple and effective
- Default
 - When – at expiry of grace period
 - For events of default specified in loan agreement
 - Are all defaults equal
 - Classifications
 - Past due
 - Non-accruing
 - Non-performing
 - Delinquent
 - Central Bank regulations ?



Bank Considerations – Loan Processes (continued)

- Default (continued)
 - Options
 - Forgiveness
 - Re-scheduling
 - Change terms
 - Collect
 - Who is responsible for decisions on how to treat defaulted loans ?
 - Loan officer
 - Senior management
 - Credit officer
 - Specialized department
 - Legal
 - Advantages and disadvantages
 - Who is responsible for carrying out decisions ?
 - Loan officer
 - Specialized department
 - Legal
 - Advantages and disadvantages



Best Practices in Lending to SMEs

- Target market
 - Focus on a few industries
 - Balance need to understand industry with risk of portfolio concentration
 - Lend to several entities within those industries
 - Lend along value chain of an industry
 - Lend to suppliers of corporate customers
 - Lend to clients of corporate customers
- Products
 - Must match SME needs
 - Flexibility within framework
 - Should strongly encourage if not require TA
 - Approved service providers
 - Include cost of TA in loan



Best Practices in Lending to SMEs (continued)

- Procedures
 - Keep simple
 - Require SME participation in process
 - Evidence of commitment
 - Evidence of investment
 - Indicator of SME understanding of their own business – key risk factor
 - Reduces bank cost
 - Same procedures for all loans, not just SME loans
- Structure/Organization
 - Separate SME department for loan origination only
 - Same credit rules
 - Same monitoring process
 - Same collection process



Best Practices in Lending to SMEs (continued)

- Risk mitigation
 - Match SME objectives with bank objectives ; listen to client
 - Identify risks throughout process ; develop ways to mitigate those risks
 - Key risks and mitigation
 - Unwillingness to repay
 - Mitigation :
 - Character
 - Relationship
 - Inability to repay due to
 - Internal factors
 - Mitigation
 - » Monthly financial statements
 - » Company visits
 - » Rule of thumb data
 - External factors
 - Mitigation
 - » Insurance
 - » Monitor industry



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