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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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