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
September 2007

This presentation was produced for review by the United States Agency for International Development by John Jepsen of Haiti MSME for Kate Naughton for Chemonics under contract number GEG-I-00-02-00013-00 TO# 3 for the USAID/Haiti MSME Project.

The author’s views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.