CERTIFIED EXPERT IN SME FINANCE

UNIT 1: INTRODUCTION TO SME FINANCE

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Development Finance | e-Campus

Certified Expert in SME Finance

Unit 1: Introduction to SME Finance

Symbols:

⇨	**Definition**
🕮	**Further Reading**
!	**Key Message**
✓	**Example**
✎	**Exercise**
🖵	**Video**

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Contents

Learning outcomes

By the end of this Unit you should be able to:

- understand the nature and definition of Small and Medium Enterprises (SMEs) as well as challenges in defining SMEs,
- know the importance of SMEs to economic development,
- recognise Specific issues relating to SME lending operations,
- understand key issues and challenges in serving SMEs.

Note: The present Unit is intended to summarise work already developed in the industry and not to duplicate concepts and work. Further readings play a crucial role and will, where indicated, form part of the requirements to pass the Unit's assessment test. It represents the authors' experiences in developing SME finance worldwide.

For the purpose of brevity, we have used the male gender form in many instances that apply to both males and females.

Initial scenario

You work in the business development department of a financial institution which focuses on providing the full range of financial products and services to the corporate sector and in retail business. An internal survey of your retail business four years ago led to the conclusion that 30% of the respective customer portfolio at that time were microfinance clients. Consequently, the management board decided to establish a dedicated microfinance unit, which is running successfully.

Over the last few months, increasing access to finance for SMEs has attracted attention in the financial sector and in the media. Additionally, the government is increasing its effort to support the sector. At the same time, the microfinance unit is reporting that it is unable to meet the needs of clients who are now larger than micro-business. It therefore has called for further products and services to be developed for SMEs.

During the last strategic planning meeting of the management board, it was decided to establish SME Finance as an additional business line, to close the gap. You were assigned to lead the project and gather initial information on the sector. You report directly to the Chief Operating Officer, who asked you to develop a strategic paper summarising the main challenges and key topics to enter the sector.

1 What are SMEs?

1.1 Common Characteristics of SMEs

Usually Small and Medium Enterprises (SMEs) are founded by one or a few persons as an initiative to earn their livelihoods by using their skills. They provide their products and services first in the region of their establishment and are therefore very much dependent on economic development within their communities. Only later do they expand to conquer national or foreign export markets. They have great operational flexibility and the limited number of decision-makers permits speedy decision making. Low overhead costs, improvisation, and flexibility permit attractive prices for smaller businesses up to the level where the economies of scale of larger-size production gain importance.

The enterprises are typically managed in a family-business style. Founders/managing owners, rather than employed managers, take key decisions, even if the company has been growing over time. The success of SMEs relies on the competencies and entrepreneurial spirit of the owner (and his family), who plays most key roles in the company. His vision and willingness to take risks for return defines an SME's actions. This ensures the success of any SME[1], but also poses risks to their future development.

At a certain size, SMEs have to face the challenge of putting organisational and managerial structures in place to cope with growth. A further challenge is the move from management by the owner(s) to employed managers, and an often difficult issue is succession/handing over the company to a different person when the founder(s) reach a certain age. In line with the family-oriented management approach, many SMEs operate in an informal or only semi-formalised manner. The level of formalisation is referenced by the clear distinction (or lack thereof) between the business' and the family's finances (i.e. separate banking accounts for each).

The more formal the enterprise, the clearer the distinction between these two. As an example, you might find a situation where a business owner has not formally registered his business and that private investments, like housing or private vehicles, are financed out of the business. This is especially true in developing and transition countries where often SMEs are not integrated into a formal and well-controlled taxation system. In such cases, they often lack proper accounting methodologies. The level of formalisation clearly depends on the country where they operate, their market environment, and of course their size.

[1] SMEs often start as micro enterprises, and have therefore overcome hurdles during their development to grow to their current size.

This presents challenges for a financial institution to establish appropriate risk management. It also presents interesting opportunities to cross-sell. The managing-owner of a business, his family and relatives might be attractive clients for private wealth and consumer lending products. The characteristics of SMEs vary between different countries, regions and institutions, so it is a good idea to consider a proper definition of SMEs.

1.2 Definition of Small and Medium Enterprises (SMEs)

⇨ ***An enterprise*** *is a business (privately owned and profit oriented), firm (can also be public and/or non-profit oriented) or company (organised with more than one person) that combines resources for the production and supply of goods and services.*

Internationally, there are many differing definitions of the SME sector, often depending on perspective. Financial institutions following a client segmentation approach to focus marketing activities will have a different interest than tax authorities intending to target their tax control initiatives. Similarly, governments interested in increasing their success in supporting the sector might choose other definitions than regulators interested in introducing workplace security standards.

In the framework of the Certified Expert in SME Finance e-learning course, we focus on definitions of players in the financial sector. As the present course is pitched at a global level, it will not be possible to review individual countries' situations. The examples presented are therefore chosen to illustrate different approaches. Definitions of "SME" vary according to the economic development stage of a country or a region. The definitions of multilateral institutions such as the World Bank (WB) and European Union (EU) are important, as the SME support programmes that are funded by such organisations are mostly based on their own definitions. But they also serve as a good benchmark on typical approaches on how to classify SMEs.

According to the World Bank Group and the European Investment Bank (EIB), enterprises defined as micro, small, and medium-sized enterprises as summarised in the tables below. In addition to the staff headcount ceiling, an enterprise is regarded as an SME if it meets either the turnover ceiling or the balance sheet ceiling, but not necessarily both.

Table 1: SME Definition in the EU[2]

	Headcount	Annual Turnover	Balance Sheet
Medium	<250	<EUR 50m	<EUR 43m
Small	<50	<EUR 10m	<EUR 10m
Micro	<10	<EUR 2m	<EUR 2m

The definitions of the World Bank are shown in the next table, where enterprises must meet at least two out of the three characteristics:

Table 2: SME Definition at the WB[3]

	Headcount	Annual Turnover	Assets
Medium	<300	<EUR 15m	<EUR 15m
Small	<50	<EUR 3m	<EUR 3m
Micro	<10	<EUR 100K	<EUR 100K

The World Bank also mentions proxies for loan sizes as shown in the following table:

Table 3: The World Bank indicative loan sizes in SME lending

	Loan size proxy
Medium	<USD 1 million (<USD 2 million for some advanced countries)
Small	<USD 100,000
Micro	<USD 10,000

The above examples provide a good understanding of the two main approaches to defining SMEs in the financial sectors worldwide. One may take into consideration business characteristics (typically assets, annual turnover, and headcount) or rely on the loan size provided. The approach one may choose depends, as mentioned initially, on the objective you need a definition for.

Using loan sizes as a proxy have the strong limitation of giving no information on the nature, development stage, and complexity of the business. They may not be suitable for targeting marketing activities (e.g. of new products) or give an indication of which lending methodology to apply. Additionally, they often do not take into consideration the total debt an enterprise has in the financial system, but only an individual institution's risk with a company. Loan sizes are therefore insufficient for assessing information about a single company.

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[2] Recommendation 2003/361/EC regarding the SME definition ensures that enterprises which are part of a larger grouping and could therefore benefit from a stronger economic backing than genuine SMEs, do not benefit from SME support schemes.

[3] Ayyagari, M.; Beck, Th; Demirgüç-Kunt, A.: Small and Medium Enterprises across the Globe, 2005, http://siteresources.worldbank.org/DEC/Resources/84797-1114437274304/SME_globe.pdf

On the other hand, the three categories of assets/balance sheet, turnover, and headcount may vary between industries which might lead to extensive lists of varying definitions in different (sub) sectors. For example, for small businesses you will find over a thousand definitions in about a hundred sub sectors according to the United States Small Business Administration.[4]

For the purpose of this course, we assume that most participants come from financial institutions interested in entering the SME sector or enhancing their SME activities. As part of customer segmentation for targeted marketing and effective risk management, other criteria could be integrated, such as the development phase or age of the business in order to distinguish micro-enterprises (early seed or start-up phase) from small enterprises in later stages of their development. Companies usually require different financial products and services depending on their development, size, and complexity.

With the above in mind, it is possible that every reader will have a different definition of SMEs. For example, while a trading company with ten employees and about 5,000 EUR in fixed assets (excluding land and buildings) in Bangladesh might be considered a small enterprise, the same business would be a micro enterprise in China or Turkey. Therefore, the principles in risk assessment and management presented in this course can also be applied to micro enterprises, although normally in much less depth.

⇨ ***SME instead of MSME***
For the purpose of this course, micro enterprises (as per EU definition) are included as SMEs, rather than distinguishing between micro, small, and medium enterprises (MSMEs) and SMEs.

Ayyagari, M.; Beck, Th; Demirgüç-Kunt, A.: Small and Medium Enterprises across the Globe, 2005,

[4] See http://www.sba.gov/content/small-business-size-standards

1.3 The Relevance of SMEs for Economic Development

SMEs are the backbone of national economies. In most countries, they are the most important source for employment and income. They operate mainly at local and regional levels, where they increase access to goods and services and therefore – together with job creation – increase quality of life.

One of the most frequently mentioned impacts is the **job creation** effect by lending to SMEs. Many studies have shown that the employment creation effect of small loans is higher than that of larger loans. The effect is measured in jobs created per loan and/or jobs created per million monetary units of loans disbursed to SMEs: with a given amount of money, more jobs can be created by disbursing many smaller loans to micro and small enterprises, compared to disbursing few loans to medium enterprises. [5] In addition to the social and economic development impact, especially for private commercial financial institutions, the profit dimension plays a prominent role: **SME finance** can be an attractive business segment, generating profit through a comprehensive service to SMEs.[6]

At the same time, studies in different countries show that the survival of SMEs - especially in the initial five years - is limited. As many as 85% of SME start-ups will not continue trading for five years, leading financial institutions to be reluctant in financing such enterprise sectors. It is clear that SMEs need funds to grow; however, most SMEs do not grow quickly. For example, in Turkey most of the enterprises that have survived the start-up phase remain the same size after five years of business[7]. In Pakistan the average life of a company is eleven years, and 80% of newly established firms close within five.[8]

Many international surveys of SME owners and managers – including those carried out by the World Bank[9] - report that lack of finance from banks is serious constraint on their growth. It follows therefore, that SME finance is of economic importance, and financial institutions and national/regional/international organisations design and implement programmes to improve access to finance for SMEs.

But how can the positive impact be measured (e.g. growth of enterprise and job creation)? First of all, measurable targets must be identified.

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[6] IFC: Benchmarking SME Banking Practices in OECD and Emerging Markets, 2007
[7] Sak, G.: The Impact of Globalization on Turkish SMEs, Tepav, Ankara, 7/12/2009
[8] Amdeed, K.: SME Banking Conference speech, TEB, Karachi, 15/03/2011
[9] http://www.doingbusiness.org/economyrankings/

1.4 What impacts can we measure?

In the context of SME finance, one can measure the access to finance, the number of jobs created, and social impact. The following table shows that measuring key indicators depends on the availability of reliable data, and leads to further questions.

Impact to be measured	What can we measure?	Challenges/Problems
Access to finance	▪ Number of enterprises that have a banking account ▪ Number of enterprises that have a loan	What portion of enterprises need a loan? What do we know about informal finance-money lenders?
Access to finance	▪ Percent approval rates of loans	Wrong lending methodology or "bad clients"?
Job creation	▪ Jobs created per loan ▪ Jobs created per one million EUR of loans	Unregistered workers, temporary, part time jobs, income?
Social impact	"Percentage of increased employment" can be a better indicator than "number of jobs created"	Are statistics available?
	Workers safety: number of accidents reduced	Are statistics available?
	Increase of local taxes	Importance of "grey" economy?
	Education level/literacy	Are statistics available?
Regional impact	Migration flows reduced	Are statistics available?
	Development of regional GDP	If figures of regional GDP are available they also include other sectors (e.g. public construction or electricity production). This may not have an impact on the business of the SMEs.

While the motivation behind multilateral development organisations, governments, and other development institutions to measure such impacts is obvious, this is often not the case for private and commercial financial institutions. But these financial institutions can also benefit from a close tracking of the development of their client base:

- First, from a marketing perspective it is important to have an understanding of the clients' development over time in different dimensions. Gathering such data, analysing it, and understanding the underlying patterns and drivers help to develop and market additional products, or adjust existing ones. We could assume that a client whose employee headcount grows over time might be interested in installing an ATM at his premises, or provide consumer loans to his employees with salaries as a guarantee of reimbursement. A targeted cross-selling approach helps improve product offer and gain market share, as well as support client retention.
- Second, gathered data can be used for Corporate Social Responsibility (CSR) initiatives, which support the branding of an institution.
- Third, attractive refinancing is made available by multinational institutions which normally require reporting on such data for the reasons mentioned above.

Such impact data is interesting for many players: academic researchers, governments and government bodies, business associations and financial apex organisations (second tier wholesaling mechanisms that lend and offer non-financial assistance to microfinance institutions). All the actors can be stakeholders when developing a comprehensive review for a region or country.

While it is often mentioned that SMEs need loans to be able to grow, they often require more than just financing. In fact, they often require the same full range of banking products and services as corporate clients, just higher frequency and lower transaction amounts.

A study[10] analysed growth factors of SMEs and contrasted them with those of large firms. It concluded that SMEs are extremely diverse and feature in most sections of the economy. Consequently, the growth patterns in the SME sector cannot be deduced from size or age of a firm alone. The study suggests that there are many interrelated factors that affect their growth, including ownership, size as well as the equity ratio and profit. For example, according to the report, workforce growth is positively related to profit for privately owned SMEs.

[10] Bannier, C.; Metz, S.: Are SMEs large firms en miniature?, Frankfurt School Working Paper No 142, 2010

> **!** ***Conclusion:***
>
> - *A rigid single quantitative SME definition is not suitable for describing the SME banking sector as a whole because of the differences in the SME markets in developed and developing countries. The appropriate definition of the sector ultimately depends on the local banking context*
> - *Loans to SMEs are necessary to trigger their growth and contribute to economic development, which gives an important role to* ***financial institutions***
>   - *Most micro and small enterprises grow with the first loan and much less with repeat loans*[11]
>
> *However, many companies do not grow much and many disappear after a few years. This makes financial institutions cautious when lending to SMEs.*

[11] Findings of studies of A. Winkler, Frankfurt School of Finance and Management

2 Challenges and Obstacles to SME Finance

Financial institutions in most major economies offering business services (as opposed to retail) tend to target corporate accounts. Consequently, the financial needs of the corporate segment are generally well served. Micro-businesses are also often well provided for through microfinance institutions (MFIs), especially in developing and transition countries. This leaves a financing gap for the SMEs. This gap has generally been filled in high-income countries – hence the SME sector in these countries has a relatively improved performance and contribution to the economy.

Yet, despite this wide range of sources of funding for other segments, SMEs often face major financing obstacles. This is largely because of the perceived risks in the segment. SMEs rely highly on the external finance provided by financial institutions, because, unlike large companies, they are too small to have access to finance through capital markets. The financing challenges are more serious in developing countries because of legal and structural circumstances (e.g. the ability of financial institutions to collect debts and to sell collaterals).

Nevertheless, new trends in SME finance can be observed for SMEs in OECD countries **(please read "Funding the Future"** [12] **,** which gives an interesting and comprehensive overview on different internal and external funding sources for SMEs).

The significant gap in SME access to finance is a complex problem driven by factors including lower returns, higher risk perceptions, unfavourable regulatory environments, and a lack of financial intermediation skills, experience and capacity[13]. However, most governments have policies to support SME finance, though there is no single framework for effective support[14].

In many lesser-developed countries (LDCs), microfinance institutions (MFIs) focus strongly on the smallest businesses. In these countries, banks tend to serve large companies. Consequently, there is a financing gap for SMEs.

[12] Funding the future – Access to finance for entrepreneurs in the G20, Ernst Young Growing beyond, June 2012
[13] Report on Support to SMEs in Developing Countries Through Financial Intermediaries, Dalberg, November 2011
[14] The SME Banking Knowledge Guide, 2nd edition, IFC, 2010,

SMEs face the following problems:

- The SME sector is widely considered a profitable and promising area for financial institutions. But it is still not sufficiently provided for in developing countries;
- Highly opaque and risky SMEs, as well as start-up businesses, tend to be excluded from financial support;
- Macroeconomic conditions and legal regulations of financial institutions make SME lending into a major challenge;
- Banking technologies are inadequate to meet the needs of the SME sector;
- SME lending is sometimes seen as too costly in terms of analysing, screening and monitoring.

However, the biggest challenges that many SMEs face is not always being able or willing to provide a comprehensive and audited set of financial statements for financial institutions to use in their analysis.

Incomplete financial statements

In some cases, there are entrepreneurs that do not provide the analyst with comprehensive data that truly reflects the financial situation of the enterprise. Often the financial documentation provided may either under-state income or over-state expenses in order to <u>hide profits</u>. There are also enterprises that exaggerate income to the bank because they hope to obtain a larger loan. Others do not report all costs to the bank because they employ unregistered staff. While this phenomenon clearly has an impact on the <u>risk assessment</u> conducted by the financial institution, it also limits the <u>understanding of the business</u> and its dynamics as such, limiting or overstating the perceived cross-selling potential.

Obtaining correct figures about income is difficult when a business is active in a sector or region where cash transactions without invoices and receipts are common. As an example, an enterprise could buy fruit in cash from a farmer and sell dried fruit for cash on a market, with neither transaction being supported by a receipt. This makes tracking income and expenses more difficult for the analyst.

When evaluating the expenses of SMEs (<u>particularly smaller enterprises</u>) careful attention should be placed on determining if and to what extent private expenses are declared as business expenses, which reduce taxable profit. At times, cash flows from one enterprise to another (within family or social networks) and is often mixed with personal expenses of the business owner.

The choice of the enterprise's legal status may also be tax-driven. Bigger commercial activities can be split into <u>several small legal entities</u> in order to pay <u>lower tax rates</u> and/or to avoid certain accounting and reporting obligations. In some countries, there are "associated company rules", which means that such companies have to be considered as one entity. However, especially when different persons of the same family register the smaller units under their name, it can be difficult to prove that they act as one company.

Staff can be registered at a low "official" salary while earning a higher salary that is not registered. Employees can also be forced to represent themselves as self-employed when the employer wants to save on social security contributions or other legal obligations, such as paid holidays. Therefore, in some countries special rules have been introduced to protect workers. For example, a person that works regularly according to a company's instructions at a fixed working place is considered a *de jure* employee.

The United Kingdom (UK) is an example of a developed economy where many SMEs have good access to finance. But even in the UK loan acceptance processes became more difficult after the 2008 financial crisis. Many UK politicians urged banks to start lending again to the SME sector in order to stimulate the economy.

> **!** *The main reasons for SMEs not keeping financial records that accurately reflect the performance of the business is the lack of skill sets in financial management, as well as a desire to avoid taxes.*

> **!** *Building a close relationship with SME clients and taking the initiative to conduct one's own investigations are fundamental to understanding the business, its needs, and the potential for cross-selling.*

> *The IFC has developed an SME Toolkit[15] and website which provide entrepreneurs globally the basics of how to start a business and guide it through the start-up or growth phase.*

[15] http://www.infodev.org/articles/ifc-sme-toolkit

3 Introduction to SME Banking

3.1 Organisational Set-up of an SME Department

The basic and underlying principle for any structure development or adjustment is the "structure follows strategy" commandment. This is also true for the **incorporation of SME finance as an independent business line**. Frankfurt School believes that the attention to SME clients should be integrated in the structure of the financial institution as an equal counterpart to other clients, i.e. corporate or retail clients.

An institution might nevertheless choose to attach SME finance as part of corporate or retail banking, always depending on the underlying definition of SMEs in the organisation's business context.

A sound institutional governance and efficient process management is key to all banking activities. High commitment of management will be necessary to improve institutional governance of SME finance in the financial institution and overcome middle management's possible reluctance to change.

Products vs. customer profitability

Another strategic issue to be considered is the orientation towards product profitability or customer profitability, especially when designing the marketing and distribution channels. The older and the larger an institution (geographically or in terms of assets or client base), the more likely it will have a clear client segmentation and client profitability orientation. Often small and relatively young institutions have a product structure, with management and reporting lines linked to the products offered.

Product profit focus is often found in MFIs that start initially with simple lending products, and then later also offer banking services and deposit products. However, even in "older" institutions the customer orientation might still rely on product profitability. Profitability calculations require proper accounting and allocation of incomes and expenses on segment, product or client levels. Often MFI's and smaller banks cannot afford advanced accounting systems, another challenge in SME finance.

However, product focus can lead to organisations failing to recognise the importance of low income or even loss-generating products, though these unprofitable products may well be important to attract or retain customers. For example, current accounts often do not generate attractive income for all target segments, but for the SME client segment they are an important "door opener" for cross selling other profitable services.

Another approach is to define attractive client (sub) segments, e.g. SMEs in industries with high cash transactions and hence cheap refinancing opportunities through current accounts. It is possible to attract such clients, even while accepting losses on current accounts, but enhancing overall profitability through the cross-selling of high-income-generating products. Sub-segmentation allows for targeted marketing and improved client acquisition - products and product packages might be developed addressing needs and preferences of these sub-segments.

As SMEs require a broad range of products, cross-selling opportunities are higher and they merit an integrative approach that takes into consideration the overall business profitability that is possible even with a single client. By segmenting client sectors and sharpening the customer focus, marketing efforts ranging from product design to promotion and distribution can be targeted in a better way.

Downscaling vs. up scaling

The decision on how to incorporate SME finance in an existing financial institution depends on the current set of clients. When looking at an MFI entering SME finance that is mostly focused on small retail client and micro enterprises, they are usually faced with an increase in transactional business and average loan size per client. Previous experiences with such clients are limited, especially true with the lending business. It is important for the organisation to build institutional knowledge of the needs of these bigger clients and how to service these needs efficiently.

Lending to SMEs can present an organisation with many new challenges. One solution is to centralise loan decisions at headquarters, initially, to gain experience with the client segment. Later this centralised control can be decentralised gradually as the institutional lending knowledge and systems are improved and refined ("learning curve").

On the other hand, the situation is the opposite for commercial banks with large corporate client lending portfolios. The new smaller business client segment requires lower levels of average loan size; transactions tend to be for lower amounts and exchanged at higher frequencies. The solution is often the same, though: lending decisions may be centralised for the time it takes the institution to adapt to the needs of its new clients. Once the institutional lending knowledge and systems are improved and refined the new segment can be managed in a more decentralised way.

Segregation of duties

Typically, and in accordance with Basel requirements, the sales/marketing and risk functions are segregated for significant individual loans. This requirement aims to balance the opinion of commercially driven front office staff with the independent opinion of risk officers. In line with the above mentioned and focusing on SME finance only, it could be argued that MFIs introducing SME finance should separate front and back office functions, while larger commercial banks with large corporate clients as the traditional client segment might not need to do so. The decision on this depends on a number of factors, such as the nature and scale of business activities, strategic orientation and risk appetite of the institution and regulatory framework.

In the present chapter, we focus on the segregation of duties between the relationship management and credit-risk assessment in SME finance, i.e. front and back office in the lending business.

Commanding and reporting lines

Growing and changing the business will be simpler if the organisation already has a disciplined and open approach to reporting lines and responsibilities. Moreover, employees need to know how they and others fit in an organisation. Lack of clarity can be confusing and demotivating.

We differentiate between disciplinary and functional commanding lines::

- Disciplinary command: the respective manager/supervisor is responsible for the day-to-day guidance of the employee(s) assigned to him. He decides on quantitative and qualitative aspects of performance reviews and has the final word on the HR development of his subordinates.
- Functional command: the respective manager/supervisor is responsible for the quality assurance of certain functions to be carried out by an employee. He has an opinion in performance reviews on quantitative or qualitative aspects (depending on the function, e.g. business development, credit risk assessment, etc.).

The introduction of these different commanding lines requires clear communication within the financial institution and a clear set of responsibilities for those involved (whether employees, managers or supervisors).

The reporting and commanding lines can be seen in the policies and procedures governing the credit committee, which stipulate how and whom have the stipulated authorities for loan approval. The higher the loan amount, the higher the credit committee level, e.g. loans up to

EUR 1M will be decided at branch level, loans up to EUR 10M will be decided at regional level, while loans over EUR 10M will be decided at the headquarter level.

The experience of financial institutions serving SMEs in each stage of the value chain points to a number of emerging lessons for financial institutions that want to strategically engage the SME market and to develop the most appropriate structures internally.

The SME Banking Knowledge Guide, IFC, 2010

3.2 Lending Methodologies and SME Products

3.2.1 Lending Methodologies

We differentiate three main methodologies for the management of SME lending:

- Individual cash flow-based lending
- Credit scoring
- Relationship lending (banking) approach

Other approaches exist. They will be presented briefly below.

1 Individual cash-flow-based lending

Individual cash-flow-based lending is perhaps the most common lending technology worldwide in SME finance. It is based on the individual cash flow that meets the day-to-day needs of the clients' business. The cash-flow-based approach requires financial statements, which often need to be set up with the clients. The approach does not focus solely on collaterals, instead it assesses the repayment capacity of each client. Loan terms are determined according to the need of the business and the analysed repayment capacity.

The cash-flow statement is usually divided into three sections:

- Operational Cash Flow (OCF)
- Investment Cash Flow (ICF)
- Financing Cash Flow (FCF)

!

The cash flow statement is analysed together with the Balance Sheet (BS) and Profit and Loss statement (P&L, also called income statement).

The SME certification course is based on the cash flow lending methodology.

2 Credit scoring models

A scoring system enables a financial institution to protect its performance as it grows and ensures portfolio quality by creating consistency in loan decisions. There are two main approaches:

- Judgmental
- Statistical credit scoring

Credit scoring models are based on client characteristics (demographic, industry and business-related characteristics, investment plan, financial ratios, etc.). Scores are given for specific characteristics, based on expert judgment or historical bank statistics. This approach can be combined with aspects of individual cash flow-based lending.

Sufficient data might not be available to establish a score - especially during initial phase of introducing a new client segment - and other approaches can be applied.

Credit Scoring, CGAP IT Innovations Series,
A. Latimer. Credit Scoring A Tool for More Efficient SME Lending: SME issues Vol.1 No. 2, November 2000.
A. Ono. The Role of Credit Scoring in Small Business Lending

3 Relationship lending (banking)

There is a large body of evidence that shows “relationship banking” is more effective than “transactional banking” in the SME sector. Relationship banking involves developing a relationship with the client, to discover their financial needs and, where possible, match the needs with appropriate bank products and services. This takes time and can therefore be very costly. Transactional banking involves developing products and services – often because the bank has the capability to provide them, rather than because there is evidence that the market requires them - and selling them to as many customers as possible with little regard to whether they actually need them.

In Relationship Lending, the financial institution acts as the main financial service provider to the client, providing custom made products specifically designed for each client, rather possessing a set of products that it sells in bulk. Effort is made to develop a close relationship with the client so that the organisation understands the client’s needs, *modus operandi* and its strengths and weaknesses.

A close relationship between the financial institution and its customer has advantages for both sides. The client is able to receive personalised customer services and reduce transaction costs. The financial institution has greater control of its client's development and can judge credit worthiness based on past experience.

The length of relationship between the financial institution and its SME customers is also important to reduce information asymmetry (see below). Each time a loan contract is renewed, the renewal acts as an acknowledgement of the firm's ability to meet its debt obligation. An established relationship helps to create economies of scale in information production. Once trust is established, it is often found that SMEs will share "private" financial information with banks. This often enables the financial institution to make a more reliable financial assessment of the SME. Borrowers may reveal more information than in other non-lending transactions, since they will benefit if a loan is approved. Reliable information can lead to improved risk assessment, improved cross-selling and improved customer satisfaction. Additionally, once it is stored it is available throughout the financial institution and only needs updating during meetings with the client.

Some financial institutions attempt to establish long relationships with many SMEs. Long relationships allow the financial institutions to build up a good picture of the firm, the industry within which it operates, and the calibre of the people running the business. The closer the relationship, the better the signals that the financial institution receives concerning managerial attributes and business prospects.

There are clearly compelling reasons for financial institutions involved in the SME market to attempt to build strong relationships with clients to build up data on clients. However, many organisations do not provide a full relationship service – i.e. personalised products, because the costs of providing a full relationship banking service cannot be justified.

⇨	***Information asymmetry*** *The financial organisation does not have access to the all the information that the client knows about his business. It is highly likely that at least some relevant information is known only to the client. Information asymmetry causes markets to become inefficient, since all parties involved in a transaction do not have access to all the information that they need for their decision-making processes*

!	*Based on its broad international expertise, Frankfurt School usually provides technical assistance in each of the above-mentioned lending methodologies and is also able to develop mixed models according to the local market needs. In fact, we favour a mixed model using different components of the main approaches.*

Others:

⇨ ***Group lending or joint-liability approach***

Group lending is the main approach in classical microfinance, especially for rural or remote areas. By using group lending or joint liability lending technologies, the financial institution allows clients who do not possess collateral to benefit from the financial institutions' loan products. The financial institution, on the other hand, can reduce risk as the group members take responsibility for the loan and further can win over a new client segment that would not be able to borrow money using traditional loans since they do not possess sufficient collateral. It is especially suitable for micro businesses in remote areas where individual loan assessments and loan collections are too costly.

⇨ ***Collateral-based lending***

collateral based lending is when a loan is secured by a pledge of assets. Loans secured by collateral are primarily commercial loans; the ultimate source of repayment is the borrower's assets, rather than the borrower's character, reputation or cash flow. In some countries, however, it is difficult to register collateral or even enforce collateral because of weak judicial systems.

Collateral-based lending also applies for SMEs – if the legal environment (e.g. for collateral registry and enforcement) allows. It gives the financial institution the possibility to not rely on financial statements. Depending on the regulatory environment, a financial institution might choose to rely exclusively on collateral provided (e.g. land and buildings) and give loans based on the collateral value. The regulatory authority normally also defines which financial data has to be reviewed, which then should be considered as a minimum threshold.

The main risk is that the value of the collateral can fall when a financial institution attempts to sell it. This can result in non-performing loans and bad debts.

⇨ ***Psychometric testing***

Psychometric testing is a new approach used in the screening and risk evaluation of loan applicants. The 40-minute, computer-based test assesses traits like honesty, ethics, intelligence, and motivation. These tests seem to achieve the same or better results than traditional ways of assessing a borrower's future success and ability to repay a loan. It may also enable the financial institution to extend loans to clients whose credit histories are sparse or non-existent.

Comprehensive approach

A comprehensive approach to lending uses a combination of quantitative and qualitative information when assessing a borrower's credit worthiness. The quantitative information includes, among other factors, the client's credit history and demographic characteristics (scoring), financial statements including the cash flow, collateral valuation including guarantor schemes and non-financial risks. The qualitative parameters relate to the character of the client, the business competitiveness, industry prospects, market development, regulations and, the credit policy targets of the financial institution.

! *There exist different lending methodologies for SME banking, their application depends on market and regulatory environment, the strategic orientation of a financial institution as well as information available.*

A. N. Berger, G.F. Udell. A More Complete Conceptual Framework for SME Finance, 2006.
The SME Banking Knowledge Guide, IFC, 2010.

3.2.2 SME Products

This section is a brief introduction into the products and services for SMEs. It shows the range of needs that SMEs have and why financial institutions may decide to fulfil these needs for creditworthy customers.

A key feature of building effective client relationships is the focus on gathering specific customer information. This information can be used in many ways. This can lead to improved credit decisions. It can also lead to improving profitability since customer knowledge can provide opportunities to cross-sell other profitable products.

SMEs have a number of specific business and financial needs, and in response financial institutions have developed a range of solutions to address them. This can be grouped under the following headings:

- Working Capital
- Business Expansion
- Business Protection
- Profit Enhancement

Working capital

Cash-flow management is a key issue for most SMEs. They have a range of transactional requirements. Banks provide services that include payments, collections, and trade finance.

Payments must be made efficiently and by the due date. These can be made via cheques, telegraphic payments, regular payments, and through the internet or mobile banking, all products that can be offered by a financial institution. At the same time, an SME must be able to collect guaranteed payments from customers in order to maintain its own cash levels. These could be in local or foreign currency.

Business expansion

Many SMEs wish to expand their business and plan for long-term growth. However, often many do not know the key considerations of capital budgeting for business growth. Business growth requires capital investments in new equipment and facilities. These are usually medium to long-term investments that can be financed by:

- Retained business profits (often "parked", e.g. in term deposits);
- New capital from business owner(s), previously managed through private wealth management solutions;
- Loans from financial institutions. These will be assessed and repaid based on projected, future cash flows.

Many financial institutions are capable and willing to finance SMEs using a range of short-term, medium-term, and long-term loans if they have <u>properly planned needs</u> including working capital and business expansion.

Business protection

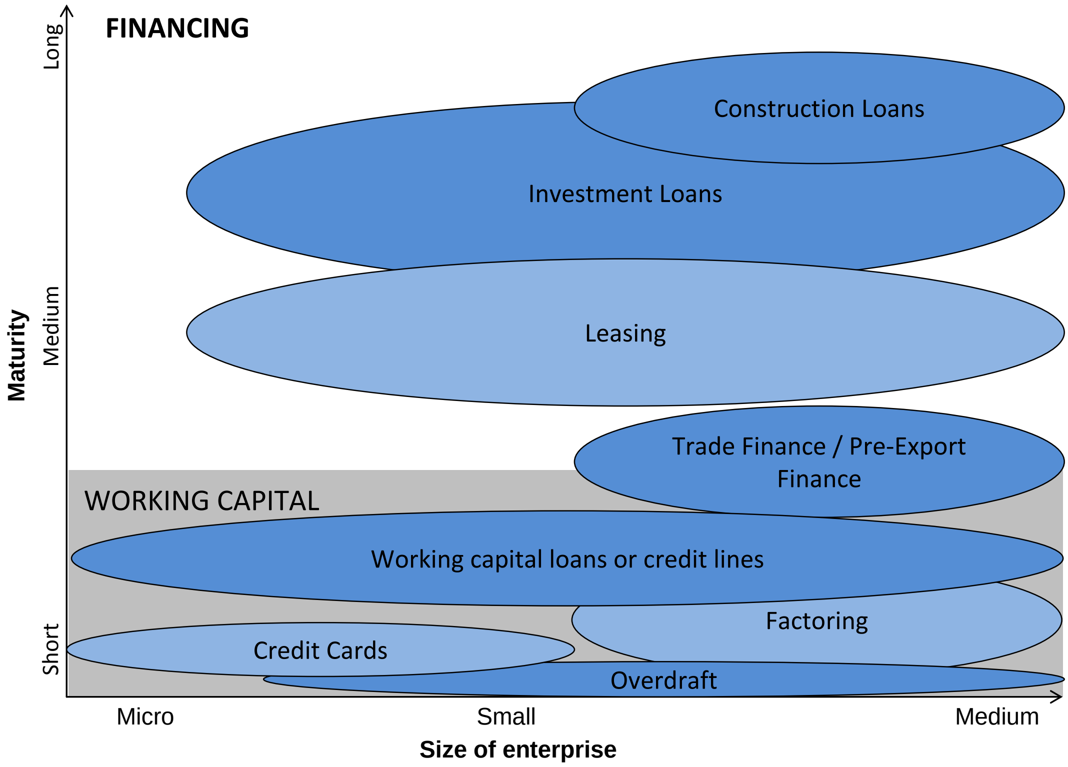
SMEs face a range of business risks against which they seek protection. Many financial institutions provide expert advice on a range of risk management needs, including a range of asset insurances. A few unforeseen risks include fire, theft or the death of a key employee.

Profit enhancement

Profit enhancement includes the provision of <u>investment advice</u> and providing deposit accounts that pay market rates for surplus cash.

> **!** *It is possible to lend safely to SME's and to develop profitable non-lending products.*

The range of products can be demonstrated:



Financing or lending products are often the main interest for many SMEs. In order to grow they usually rely on external finance and are interested in obtaining it from financial institutions, rather than from informal money lenders or family and friends. This is especially true for larger companies as they grow and gain a better credit record. SMEs, therefore, rely on offers from the financial sector, which also helps them to further formalise their activities since increasing loans sizes typically also increases legal and compliance requirements. As SMEs grow larger, they become more visible and are likely to be targeted by official control bodies, e.g. tax authorities.

A main challenge lies in providing SMEs with adequate financing. Although many SMEs have access to finance, the question of access to adequate finance is important. Frankfurt School has observed in many countries that investment projects with a lifetime of three to five years are financed through short-term working-capital loans (maturity of less than 12 months). This approach puts high pressure on businesses in terms of liquidity management and substantially increases liquidity risk.

4 Introduction to credit risk analysis

4.1 Risks in SME lending

4.1.1 Why SME's are sometimes considered to be too risky

Some SMEs are opaque (due to their incomplete financial statements and behavioural traits). SMEs are also highly vulnerable inherent in their very nature, i.e. their limited size implying such typical characteristics as the concentration of knowledge and decision with the owner or reliance on a few customers or suppliers, etc.. Size is also an issue for SMEs due to their lack of products and markets. In addition they have problems realizing economies of scale and scope. These points justify a cautious stance towards them and constitute a main obstacle to their financing.

The most effective way to understand SMEs and their financials is to build a close relationship with the clients. The more clients the financial institution has in the same sector, the easier it is to understand whether an applicant is submitting plausible financials.

In Europe, SMEs are not viewed as higher risk simply because they are small. But a financial institution needs to adapt its risk management methods (including relationship management) to suit the type and size of organisation it serves.

There are key differences in risk perception between corporations and SMEs. One difference is the amount of information available in order to assess creditworthiness. There is often a large amount of publicly available information for large corporations who are usually able to supply audited annual reports. In addition, rating agencies often evaluate corporations and are commented on in the financial press. They often shop around, approaching various financial institutions using sophisticated staff to achieve the best deal. As for risk assessment, this is often essentially based on the financial information of the corporate, balance sheets, income statements etc.

The situation is different with SMEs. It is often necessary to collect information from the customer. Relationship aspects are important: the financial institution develops a partnership or close relationship with the customer in order to fully understand the risk. Moreover, qualitative criteria tend to be much more important when assessing the risk of an SME.

There are a number of economic terms that are sometimes used when discussing SMEs. These are discussed below:

a. Asymmetric Information

In many cases, financial records are not kept by the enterprise because the owners may not be trained or experienced in accounting matters and require financial management training. In addition, qualified accountants may be scarce, not available, or simply too expensive for the enterprise. In some regions or business sectors, it may be unusual to have an "enterprise culture".

Tax evasion is often linked to high nominal tax rates and extensive reporting that disfavour truthful taxpayers compared to their dishonest competitors. One could argue that tax evasion sometimes becomes essential to remain competitive. Simple and just tax systems as well as "affordable" tax rates are the basis for a culture that comprises correct invoicing, accounting, and comprehensive financial statements. This information would also support increased lending to the sector as it enables a financial institution's analyst to trust a client when assessing a loan application. Unfortunately, this is not the case in many countries, and the lack of reliable financial information hinders the engagement of more financial institutions in the SME sector.

Additionally, the analyst may wonder whether the applicant is unable or unwilling to provide complete and correct information. In the case where the applicant is unable but ready to share his knowledge with the financial institution, the analyst can make his own investigations and evaluations (in essence, help to create the financial statements). If the applicant is unwilling, the analyst has to decide whether he wants to have such a person or business as a client.

This ambiguity can extend beyond the loan application into the full maturity of the loan. The capacity and willingness of the client to provide full information once the loan has been disbursed should also be a factor in the analyst's decision, before the financial institution and the client are contractually linked.

For these reasons, a financial institution entering the field of SME finance should adapt its loan assessment to the degree of trustful financial information available in its (target) client base. This means that whenever an applicant cannot provide the necessary information, the analyst has to do his own investigations of the most important financial figures through Cross Checking (See Unit 3) and often has to set up bank internal financial statements for the client. This is accomplished through plausibility checks, observations on site, and comparisons with regional and sectoral benchmarks. The financial institution may have these benchmarks in its own database or it may obtain them from a third party, such as a chamber of commerce.

b. Granularity

In absence of high quality information, financial institutions lending to SMEs face problems in good risk evaluation. If the financial institution does not give enough time and effort to an efficient credit analysis, it may lack the ability to distinguish between good and bad risks. There might be a strong degradation of the link between the estimated risk level and the loan price. In other words, some risks are over-priced and others are completely under-estimated. This can lead to high Portfolio at Risk (PAR) levels.

c. Pecking Order (Borrowers' Perspective)

Resulting from the statements above, potential clients may have no access to banking finance or the formal lending procedure is too expensive. In this case, the only solution is to rely on informal lending, which comes from informal sources as family members, close friends or the black market.

d. Moral Hazard

Another challenge for financial institutions occurs once the credit has been disbursed to the client. Once the credit is disbursed, the client might be tempted to behave in a more risky manner, since he is making decisions with another institution's money. The financial institution wants the client to use the loan for the specific purpose agreed, but it is impossible to be certain this will be the case.

e. Transaction Costs

If the financial institution lacks information, credit analysis can become very time-intensive, as the institution and its agents must spend time to gather and reconstruct the necessary data (both financial and non-financial). These high costs of research in relation to the small loan sizes boost transaction costs.

4.1.2 The main SME risks

A financial Institution faces a number of risks when dealing with SMEs. These can affect or undermine the ability of the SME to make repayments.

a. Integrity risk

The intentions and trustworthiness of the owners is a fundamental risk. Do they intend to use their best efforts to ensure repayment?

b. Management risk

There are a number of management risks, deriving from lack of developed management skills and capabilities:

- Sales and marketing
- Accounting and internal control
- HR management
- Operational skills including the use of technology and process efficiency
- Appropriately trained back-up / successor

c. Concentration risk

There is also a concentration risk: the risk of a dominant client or supplier that may fail or cancel a contract, causing severe difficulties for the SME.

d. Governance risk

Who controls the business? Are there related companies also owned by the client that might pose a risk for the SME if it got into difficulties?

e. Market risk

The market conditions clearly affect the SME's prospects in a particular business sector.

f. Financial risk

The inability of the business to meet its financial commitments is a major issue.

g. Legal risk/compliance

Problems can occur if the SME does not possess the required documentation and certification (business registration, trading certificates, and tax obligations). Changes in policies, laws or regulations may affect the SME's business conditions.

h. Environmental risks

There are extensive environmental protection laws in most countries now. If the business has a negative ecological impact or negative social impact it may well face prosecution. Furthermore, if a business has damaged the environment it often affects its reputation and /or sales and infringes its licence to trade.

i. Performance risk

The risk that the company is unable to supply products or services in a manner that is:

- Cost effective
- Timely
- Efficient
- Ensures sufficient quality

j. Collateral risk

There is a risk that the collateral is incomplete and insufficient to repay the loan in the event of default.

> **!** *There are many situations where perfectly honest people are unable to make repayments.*

4.1.3 Collateral

The fact that many SME loans are backed by some form of collateral (usually in the form of property) may be the single most important factor - beyond risk grading - that the financial institutions use to counter the risk of unreliable information from SMEs. The existence of collateral means that financial institutions often rely less on detailed investigation and analysis of the borrower's business. At one level, collateral can be viewed as a relatively efficient form of insurance for financial institutions. However, at a more fundamental level, collateral serves as an important incentive motivating borrowers to avoid defaulting on loans. It constrains the behaviour of SMEs: if they fail to repay their loan then they will forfeit their collateral. The ability of SMEs to provide collateral is also a sign of their creditworthiness: They have accumulated assets in the past and they are prepared to risk them to support their business.

In situations where the owner of the SME is willing to offer the family home as collateral against the loan, it is reasonable to assume that the incentives on the owner to avoid default will be relatively strong. Collateral also provides a useful signalling device. A borrower's willingness to accept a collateralised loan contract offering a lower interest rate (relative to unsecured loans) can be inversely related to its default risk.

The importance of collateral does, however, depend on other factors. As a generalisation, collateral is more important when one or more of the following conditions apply:

- The business is small. Larger SMEs generally have other attributes that diminish the need for collateral such as strong cash flow and credit ratings etc.;

- The enterprise has only been in business a short time (or is a start-up business). In this situation, financial institutions have fewer track records to call upon to inform their lending decision;
- The borrower does not have an established relationship with the financial institution. Reputation and character are important variables in the lending decision.

While collateral is a key tool for dealing with the implications of unreliable information, it is possible that the incentives it creates are something of a "double-edged sword". The emphasis on collateral, particularly when it involves residential property, can discourage risk taking. The incentives to avoid the risk of default are likely to be stronger where the family home is used to obtain business finance. To the extent that taking risks is an important part of business, especially growing businesses, factors that impede risk taking might not always be a good thing.
Below we give some rules for collateral management:

Rule 1: Know your borrower

Character is very important. There should be no questions as to the integrity or good intentions of the borrower, whether an individual, member of management, or one of the shareholders of the SME. Here are some guidelines to follow:

Guidelines:

- Be aware of the financial institution’s level of risk tolerance;
- Follow policy and procedure;
- When conducting a credit analysis, use the same rigour for a secured and an unsecured loan;
- Emphasise the borrower’s character (payment history, managerial skills and experience, business strategy, etc.);
- Emphasise the borrower’s capacity to repay (cash flow);
- Pay close attention to the purpose of the loan and the borrower’s normal operating cycle.

Rule 2: Obtain legal rights to the collateral

Collateral is country-specific. Each country has its own laws and regulations concerning property rights, lien protection, asset repossessions, and asset sales. In some emerging market countries, laws and regulations have yet to be put in place to recognise ownership rights in a lending or liquidation situation.

Guidelines:

- Take title to assets offered as collateral whenever possible ("take title" means that the property is transferred into the name of the financial institution which has full powers of sale until the loan is fully repaid);
- Remember that title equals clear, unequivocal claims to collateral;
- Beware of statutory priority claims on capital: taxes due, worker's compensation, social security contributions, and so on;
- Make sure the asset is legally owned;
- Work with skilled legal counsel (lawyers);
- Follow changes in relevant laws.

Rule 3: Make sure you are well protected

The analyst takes security or collateral as a protective measure. This may be because due diligence and credit analysis has revealed some weaknesses. The borrower is frequently unable to provide a satisfactory financial cushion (spare or reserve liquid assets that are readily available to repay any loans). The collateral taken, therefore, must give adequate protection.

Guidelines:

- Work with professional valuer and establish the most accurate market price for the collateral.
- Review collateral values at least once a year (and, some cases, more often).
- Leave room for a margin. Never lend against the full value of the collateral except if the collateral is cash or cash equivalents.
- Allow for the illiquid nature of most collateral provided. It usually takes time to obtain cash after the collateral has been seized. In the meantime, interest costs continue to rise, reducing the margin between the loan and the collateral value.
- Monitor carefully the valuation of collateral items such as commodities, where collateral values can be volatile.

Rule 4: See that controls are in place

Taking collateral is of no use if the analyst does not check to see that it is there. Case histories in banking have shown that secured loan losses have been greatest when the collateral has disappeared – the forms mislaid or incorrectly completed. Control procedures are essential. Control procedures oversee the value and the care of the asset and the related documentation, ensuring that proper coverage of the financial institution's exposure to the borrower is maintained.

There are two parts to control: external and internal. The guidelines for each are as follows.

Guidelines:

1. Exercise external control:
   - Visit the collateral in the case of real estate:
   - Inspect the receivables and inventory accounts, including physical counts and quality checks.
2. Exercise internal control:
   - Check, on an on-going basis, whether the facility limit has been exceeded, especially where the collateral value is close to the loan amount;
   - Review and check loan agreement covenants. Have borrowers breached any of the agreements?
   - Check receipt of customer monitoring information (interim financial statements, receivable ageing reports, performance or construction phase reports, etc.);
   - Complete regular call reports.

Rule 5: Multiple guarantees are better than one

- Social pressure is quite effective. The guarantee of a wealthy individual, whose resources are shown to be adequate to cover the borrower's debt in case of default, tend to dilute the notion that loans should be repaid in the mind of the borrower. A better approach would be to enlist group pressure by requiring a number of guarantors who may be borrowers themselves. Such groups are widely active in the microfinance sector, where financial institutions specialise in small business lending. These institutions lend frequently to small borrowers backed by group guarantees.

Rule 6: Focus on cash flow

- Cash flow generated by a business is the only source of loan repayment, apart from cash-collateralised loans. Collateral is a secondary source of repayment, in case the expected cash flows fail to materialise. Whenever possible, the analyst should estimate a business's cash flow generation capacity. This may require helping the borrower to prepare financial statements, but it is well worth the effort. The analyst learns about the business and the business owners learn more about themselves and their financing needs.

Suitable Collateral

Collateral comes in many forms but usually falls into one of the following categories, in an approximate order of liquidity (except when hard-pressed to sell):

- Cash and cash equivalents
- Marketable securities
- Accounts receivable
- Real Estate
- Equipment
- Inventory
- Collectibles
- Third-party guarantees (Letter of Comfort)

The items at the top of the list are somewhat easier to sell. In general, the analyst is willing to lend a higher percentage of the value of the items at the top of the list than those at the bottom of the list.

Cash and cash equivalents

This item refers to cash balances and time deposits, usually in the form of certificates of deposits (CDs), saving bank books, saving bank certificates, or simply bank deposits. In some instances, it may include money market mutual funds, due to their highly liquid nature in most developed financial markets. However, like certificates of deposits, this form of security may require special documentation if it is issued or managed by another financial institution. There is no better collateral than deposits, CDs, and money market mutual funds held by the financial institution making the loan. Such accounts are a known quantity and can easily be liquidated by the financial Institution itself.

Advantages

- Easy to take and store; (no additional cost incurred)
- Tangible
- Valuation is not needed
- The value tends not to depreciate unless inflation is a problem in the country

Disadvantages

- If stored at another financial institution, difficult to supervise
- Accrued value is small due to the non-existing or low interest rate on deposits

Marketable securities

Marketable securities generally include government bills, notes and bonds, and stocks and bonds issued by well-known quality corporations and financial institutions.

Although highly liquid if of high quality, taking marketable securities as a form of collateral is somewhat risky. This is due to the price volatility of stocks and bonds and even government securities.

Their chief attraction, however, remains ease of sale by the financial institution, assuming proper documentation has allowed the financial institution to perfect its lien against the securities.

A rule of thumb is to lend 30% - 70% of the face value of marketable securities. This variable depends on the regulatory margin requirements in effect in most countries with developed securities markets.

Advantages

- Easy and cheap to take on deposit
- Title can be obtained easily
- Usually easy to sell
- Simple valuation

Disadvantages

- Value fluctuates, sometimes extremely
- May be restricted due to market conditions
- If not quoted on a public stock exchange difficult to estimate its value

Accounts receivable

Borrowing against accounts receivable or uncollected customer accounts is a good way for a growing company to finance itself in the early stages of its development. The borrower pledges a certain portion of its outstanding accounts receivable (for example 75%) in exchange for a loan of that amount. Receivables financing can take two forms: non-notification and notification.

Non-notification means that customers continue to make payments to the borrower and will generally be unaware that receivables have been pledged to the financial institution. When the customer pays the relevant invoice for goods or services, the borrower submits the payment to the financial institution where the loan has been made. When receiving the payment, the financial institution deducts from the borrower’s loan the relevant portion of the payment received (including interest and fees, for example 75% of the payment plus interest and fees applicable), and credits the remaining to the borrower’s current or savings account (25% less interest and fees). If the borrower's loan limit has been reached, new receivables created by shipments of goods or services rendered must be presented/pledged to the financial institution, if the borrower needs to borrow more.

In the case of notification, the borrower's debtors are aware that the amount due has been pledged, and pays the financial institution directly. The financial institution deducts the relevant amount due from the loan (capital plus interest and fees) and credits the borrower with the balance.

A related form of receivables financing is the discounting of notes receivable (bills of exchange). In most countries, notes, as evidence of money owed, tend to offer greater legal security compared to the open-invoice nature of regular receivables. The financial institution is advised to discount the notes on a recourse basis, just in case.

It is advisable to lend between 60% - 80% of the face value of receivables, depending on the quality of the underlying customer (the customer who issued the invoice or note).

Advantages	**Disadvantages**
▪ Easy to value (if receivables are reliable)	▪ Not tangible
▪ If accounts receivable are regularly updated, financial institutions gain an insight into the company's business backlog	▪ Supervision is difficult; often depends on the reliability of the borrower to deliver the accounts receivable list on a timely basis
▪ Ideal for seasonal businesses	▪ Notification may damage the solvency reputation of the borrower
▪ Easy and fast to liquidate (if debtors pay regularly)	▪ Checking is time consuming when there are a lot of debtors with small amounts
	▪ Debtors may become insolvent, weakening the borrower's financial situation

Note: accounts receivable lending is different from accounts receivable factoring: in factoring, the receivables are "bought" outright by a factoring company,

Real estate

This form of collateral has long been considered ideal since its chief attributes are tangibility and usually increasing value. However, this is not always the case. A forced sale situation can cause values to fall and weak property markets can result in difficulties in realising (selling) the asset. The pitfalls of real estate taken as collateral are most evident in emerging markets where property rights are sometimes difficult to enforce. In these cases, the rules can be unclear, inconsistent, and hard to implement.
Nonetheless, real estate values in most countries can be reasonably established in most cases and can be realised fairly quickly if there is enough time to arrange for sale.

When taking real estate as collateral, the analyst should first have the property valued independently. This will establish a value against which to lend. The values can range from very conservative to somewhat optimistic. Consequently, the loan amount can vary significantly depending on which value is used.

Advantages

- Long-term asset, usually with a life span of over 50 years
- Right or title is evidenced in written legal documents
- Can be easily valued by an expert
- Tends to increase in value
- In countries where a land registry operates, ownership is easy to check

Disadvantages

- Repair and maintenance costs
- May be difficult to obtain vacant possession if occupied by tenants
- May be difficult to sell, particularly if the building is very large or the sale has to be conducted under pressure

Lend 75% to 85% against the independently estimated appraisal value.

Equipment

Equipment can be more illiquid than real estate due to its specialised and value-sensitive nature. Much depends on the type of equipment. Motor vehicles are easier to sell than printing presses – even to other printers. However, lending secured by equipment is a classic and profitable banking activity if done properly. There is no standard rate for equipment loans since it is a matter of negotiation between the financial institution and the borrower. The more marketable and less specialised the equipment, the higher the analyst is willing to loan against it. The lender should keep depreciation in mind when estimating the value of equipment, especially in sectors that have a high level of innovation (computers, for example, depreciate very quickly and can become unsellable within a couple of years).

Lend between 40% - 70% of the cost of equipment based on verifiable marketability.

Advantages

- Tangible
- Can be valued by experts or according to official stocktaking lists
- Transferable (e.g. new location)

Disadvantages

- Sometimes difficult to value as the price of the assets depends on the condition of the item
- Equipment can become broken, and/or need to be repaired
- No theft-protection

Inventory

Inventory is a very tangible asset for a going concern, but it can easily "disappear" if an SME is liquidated. Selling inventory can be problematic.

A financial Institution will typically advance 40% against inventory, but the percentage fluctuates depending on the nature and marketability of the inventory. In general, semi-finished goods are the most difficult to sell and may only have scrap value (minus transport costs).

Lend as much as 40% to 50% of inventory cost or market value, whichever is lower.

Advantages

- Tangible
- Can be valued

Disadvantages

- Perishable or in poor condition
- Ownership is contestable
- Difficult to supervise
- Difficult to value exactly unless consumer goods

Collectibles

Collectibles include items such as paintings, antiques, jewellery, and other valuables. Lending against collectibles is difficult because these items are perhaps the most illiquid of all assets a borrower might possess. Collectibles are personal assets, and may only appeal to a limited number of people. Appraisal value is of utmost importance and marketability is crucial. In view of the special nature of each collectible item, there are no rules of thumb concerning lending standards.

Advantages

- Tangible
- Not perishable

Disadvantages

- Often difficult to value
- Ownership contestable
- Price fluctuation
- Difficult to sell under pressure
- Storage often inconvenient

Third-party guarantees

If, after careful analysis, the borrower's financial condition is not strong enough to support the loan, the analyst has the option to consider a third-party guarantee.

The guarantor provides the added assurance of an alternative source of loan repayment. The guarantor can provide that assurance by:

- Agreeing to repay the loan if it is in default;
- Investing in the borrowing company;
- Putting up assets to secure the loan.

The analyst should assess the creditworthiness of the guarantor in the same way as the borrower.
Maximum loans depend on the guarantor's financial strength, collateral given, and type of financing requested.

> **!** *Taking collateral provides the financial institution with risk mitigation for a loan. However, collateral, is also fraught with risks as indicated in the discussion of the various forms above.*
>
> *The borrower's capacity to repay a loan should receive the greatest emphasis in a credit decision. Collateral is taken as a precaution.*
>
> *Analysts often over-emphasise the importance of collateral when making a loan decision to the detriment of other suitable sources of repayment.*
>
> *Cash flow from business operations should be viewed as the primary source of loan repayment. Collateral is taken in case that cash flow fails to materialise.*

4.1.4 Risks related to products

1 Working capital proposals

Short term working capital facilities – either overdrafts or loans – assist businesses in paying their bills as they fall due, rather than waiting for payment from accounts receivable.

Overdrafts/short-term loans are appropriate for financing seasonal needs and temporary working capital shortfalls. Borrowings can be made and repaid on a short-term basis.

The main assessment tools for this type of facility are profit and cash flow forecasts (see Unit 5). Is there evidence that the business will be able to generate sufficient cash to repay the facility by the repayment date?

a. Risks - overtrading

Overtrading is a risk for the financial institution – i.e. that the SME may be conducting too much business for the available resources. If a business is increasing its sales it will usually need more working capital. If the business has reached a point where its cash resources are under pressure, it may be obliged to offer discounts to customers to ensure early receipt of payments. Reducing margins can have a severe impact on *profit levers* (see later) and substantially affect profits. A revolving credit (short term working capital loans or overdrafts) tends to become solid debt when a borrower's financial position deteriorates. Regular monitoring of short term facilities is required to ensure that businesses are still sustainable and in a position to repay the facility (See Unit 6 – Monitoring and Control).

b. Risks – poor trading performance

Poor trading performance is another risk to the financial institution – i.e. that the customer is unable to pay its bills due to lack of profitability, or losses that have reduced the amount of available working capital. This far from ideal situation is unfortunately the reason why many SMEs ask for short term working capital loans or overdrafts. It may be tempting to help a business that has got itself into temporary difficulties. However, care should be taken to ensure that the business is now capable of producing a sustainable cash flow in the future and that trading difficulties have been effectively surmounted.

c. Risk for the SME

The expense of the short term revolving facilities is a risk for the SME. This type of facility is usually only agreed for short terms and tends to be expensive: interest costs are high. They are repayable on demand by the financial institution, so SMEs should not rely on them for long term financing needs.

4.1.5 Managing risk

There will always be risks and a request for finance should not be refused simply because a proposition is risky. After risks have been identified, the key question is "Does the SME have the ability to manage the risks?" Obtaining evidence that the SME can manage risks relies to some extent on soft information and subjective assessments by the analyst.

> ! *It is preferable to have evidence, but this is not always possible, and in these cases the analyst's judgement and experience are important.*

a. Integrity risk

To some extent, assessing moral integrity depends on the perception of the analyst. It is possible to obtain references from suppliers, financial institutions, employee's and people in the locality. Details of the SME's payment behaviour are helpful.

Stability factors can also be helpful. These are factors which indicate that it is less likely that the customer will disappear and default:

- Dependent family
- Length of time in job / at present address
- Professional qualifications
- Local standing and position in the community
- Track record with this or other financial institutions

b. Management risk

Reviewing evidence of senior management's education and business experience is helpful. Previous experience in different small businesses is not always a good indicator of suitability. Asking the following questions can be helpful:

- What are the business plans for the next one to three years?
- What are the HR policies regarding incentivising, remuneration, and motivation?
- What are the accounting policies and the internal controls?
- Who is the trained management cover?
- What would be the effect on the business if a member of senior management were absent for a long period of time?
- What are the policies for the use of technology and process efficiency?
- How does the business compare with its competitors?
- What is the employee satisfaction level?
- Concentration of clients/suppliers - Examine supplier and customer invoices to establish the extent to which the SME is reliant on a small number of suppliers / customers. What would be the effect on the SME if one of these key businesses cancelled its contract or failed?
- How successfully does the SME negotiate with suppliers, customers, and employees?

c. Governance risk

- Who are the majority shareholders and what is the decision-making process?

- What is the level of executive compensation (pay) and dividends?
- What are the procedures for change of control?
- Auditing: What is the quality and reliability of the auditor?
- Related business analysis: do the shareholders own other businesses? If so, are the other businesses to be assessed? Consider the risk that money may be switched into a related business and the risk that it might fail, possibly causing the failure of other businesses within the group;
- Related parties (e.g. business network or family members that might require financial support).

d. Market risk

- What is the industry/sector outlook, including international markets? How will this affect output and sales?
- What is the market analysis and what is the strength of the competition?
- Consider input factors such as the availability of raw materials, operating supplies, skilled employees, etc.;
- Consider the customer satisfaction data;
- Consider the Technology risk. Does the SME utilise appropriate technologies? What new technologies are expected and what effect will they have on the position of the business?

In providing goods or services, the SME should always focus on the needs of the customer. Businesses can improve their competitive position by delivering superior quality, by offering better customer service and / or by delivering superior innovation of new products and services. It is probably true to say that business efficiency is an entry point criteria.

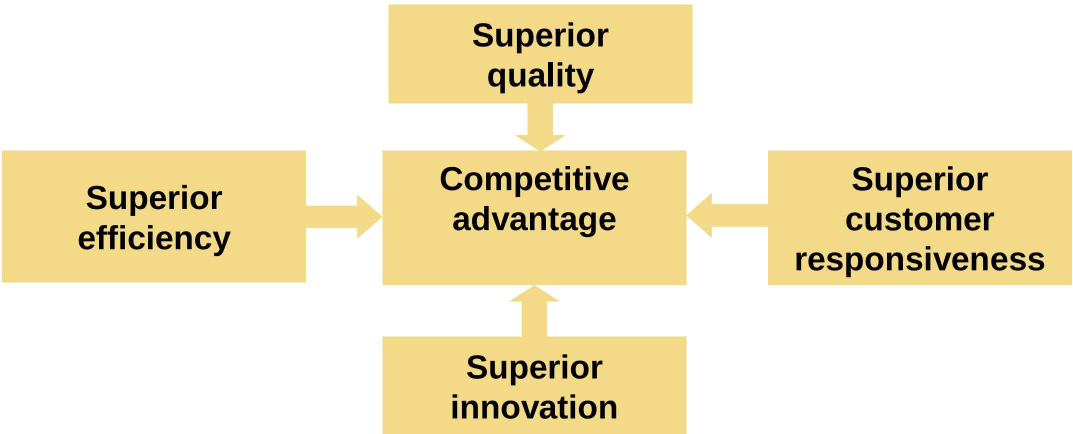


Figure 4.1: Competitive Advantage

Competition and demand are measures of whether the business has a realistic opportunity to generate sufficient sales at a price that is profitable. It may also face concentration risk (See definition below). The financial institution should know the basics about its customer base. What factors influence their buying decisions: quality, brand name, price, availability, timely delivery etc.? Which distribution system does the business use to ensure that the finished products reach the buyers?

Demand risk is greatly influenced by the competition in the market place. Thus, the financial institution should gather information about the market where the client operates. What are the forces determining this market? Who are the key competitors? What are their strategies for selling competing products in the market? What does the management do to counteract this threat?

⇨ ***Concentration Risk***

A company with a wide range of buyers spread across different sectors is less exposed to demand risk than one that has to rely on a single/few major buyer(s). Similarly with suppliers, if the company has only one/small number of supplier(s) it faces severe problems if the supplier(s) is(are) unable to provide sufficient supplies to fulfil its orders.

e. Financial risk

Once sales are made the company has to collect its account receivables. An SME that sells for cash has no **collection risk**. Most SMEs, however, sell on credit terms. The credit analyst must therefore consider:

- Who are the SME's customers?
- What credit terms does the company offer?
- Which factors might prevent their customers from paying?
- Are the receivables insured against losses?
- Do the sales and accounts departments efficiently control the account receivables, and at what cost?

Factoring enables receivables to be sold at a discount and immediately converted into cash. This might be cheaper than keeping an expensive accounting department.

If the company exports/imports goods, consider Currency/Forward Exchange (FX) risk. This is the risk that the value to be paid / received will be affected by changes in currency values. How has the company protected itself from this risk? It is possible to obtain a forward exchange contract (agree a future price) to purchase or sell the currency required for a foreign transaction.

- How reliable are the client's customers? Do they have the necessary resources to settle outstanding invoices?
- How sustainable are the SME's cash flows?
- What credit controls and cash collection procedures does the SME use?
- What is the level of available reserves in case of a bad debt?

f. Legal risk/compliance

Consider whether the SME has the required documentation and certification (business registration, trading certificates, compliance certificates, tax payment certificates).

- Do they comply with the environmental regulations for their sector?
- What is the likelihood that the government will introduce new regulations that will have a negative impact on the SME in the future (e.g. strengthening of tax regime)?

g. Environmental (reputational) risks

This risk is particularly pertinent for manufacturers, although any business can damage its reputation through inappropriate behaviour. SMEs can have a negative social impact through the type of business they conduct, e.g. traffic and trade in arms/weaponry, alcohol production and trading, tobacco production and trading, or other illegal activities.

Consider the negative ecological impact that manufacturers cause (chemical producers, leather producers etc.). Have they undertaken all appropriate steps to reduce the impact and obtained the appropriate environmental compliance certificates?

Could the company become subject to government regulations forcing it to spend a lot of money to control pollution at its factories? Are there any environmentally dangerous by-products?

h. Performance risk

There are a number of business barriers that can impact the performance of the business, i.e. the ability of the organisation to deliver. Is the SME able to produce the required volume per month at the right quality, price and deliver on time to its customers?

The barriers to performance include:

- Strategic management control
- Staff training, pay and motivation
- The SME's corporate culture
- The lack of appropriate resources and capabilities
- Logistics expertise
- Cost controls

Infrastructure: a manufacturing company should ensure that its machinery is well maintained and up-to-date.

- Are obsolete machines regularly replaced by investments in improvements or new equipment?
- Is there sufficient cash flow to allow for these investments?
- Is the company dependent on one or a few machines for a major part of its production? What happens if these machines fail? Does the factory and stock room appear to be clean and orderly?
- Is electricity always available and at what cost?

Employee costs are always a major factor for SMEs, yet staff motivation ensures that customers receive the quality products and services that generate long-term customer satisfaction.

- Are the staff members well trained?
- What does management do to maintain staff expertise?
- What does the company do to retain skilled employees?
- How many days are workers absent due to illness?

i. Collateral risk

The primary emphasis when making credit decisions should be on <u>repayment capacity</u>. However, the analyst should also take collateral into consideration when assessing the credit application. Collaterals include stock exchange securities, guarantees, or other items of value that the borrower may own to back a loan request. For the analyst, collateral means <u>protection</u>. It enables the analyst to realise (sell) the collateralised assets in the event of the borrower's failure to repay the loan – principal, costs and interest.

A key mistake made by too many analysts is considering collateral to be the most important lending criterium and making a credit decision solely based on the quality of collateral or securities.

The prudent and well-trained analyst looks to the <u>cash flow</u> for repayment of a loan and takes collateral only as a <u>precaution</u>. In short, collateral is not a substitute for <u>sound credit analysis</u> of a borrower's <u>capacity to repay</u>.

The main collateral risks are:

- <u>Valuation risk</u> – the difficulty of obtaining a reliable valuation. Asset prices can fall due to a downturn in the market;
- <u>Documentation completion risk</u> – the collateral is unenforceable because the forms are not completed (perfected) and registered properly. This is particularly the case for land

collateral in countries where land ownership records are not clear;

- Realisation risk – the collateral is difficult to sell. This can have the effect of delaying repayment of the loan. In the meantime, interest continues to accrue. This can sometimes result in bad debts or partial write-offs.

> ! *Collateral should be viewed as a secondary source of loan repayment. Cash flow or asset conversion should be viewed as primary sources of repayment.*

2 Loan proposals

Loans are agreed for a variety of reasons. The most common purposes are to assist with:

- Replacement of assets
- Purchase of land or buildings
- Purchase of new assets for:
  - Business modernisation
  - Business efficiency
  - Expansion of capacity through the purchase of additional equipment
  - Acquisition of another business

Loans are usually agreed for periods of more than 12 months. Flexible repayment plans can be agreed to suit the SME's expected cash flows. Repayment holidays (or grace periods) can be considered. For example, it may take a few months to generate cash flows from a new machine, which makes it difficult for the business repay in the early days of the project.

Loans are repaid according to a specified amortisation (loan reduction) schedule which meets both the borrower's repayment capacity and the lender's needs. In terms of repayment, the lender and the borrower agree upon periodic instalments.

a. Main risks

Risks to consider include:

- Does demand for the SME's products justify the investment?
- Will business expansion cause a need for additional working capital? How has this been planned?
- Does management possess the skills necessary to manage:
  - A larger business?
  - A newly purchased business?

b. Risk mitigation

- Ensure that the predicted cash flows are realistic and sustainable;

- Ensure that the repayments be financed from existing cash flow (which are easier to prove);
- Repayments may be more uncertain if they rely on the cash flow from new assets. In this case, a market analysis and evidence of potential new sales is required.

> **!** Some risk departments offer to lend less than the SME needs and sets unrealistically short repayment terms to reduce the risk. In reality, reducing the amount needed and / or setting an unrealistically short term often increases the risk since the business may be unable to meet its financial commitments, and face business failure.

Chapter 4: Exercise 1

Please answer the following questions:

Which of the following requests for loans appear to be the most risky and the least risky?

The owner of a small tourist agency asks for a 6-month loan to pay for salaries and office expenses;

A farmer asks for a 6-month loan to pay for seeds and pesticides for next season's crop;

The owner of a garage for automobile repairs asks for a 12-month loan to cover half of the purchase cost of new diagnostic equipment (the owner will contribute the other half).

Please give your reasons

Assume that there is no collateral, or the availability of collateral is similar in the three scenarios.

Solutions: Please refer to Chapter 6

4.2 Entry selection of clients

To establish a lending process, a simple filter system can be used to determine whether a full lending assessment should be carried out. This filter system can save time and costs. This early filter system can be easily implemented via judgmental/expert scoring or – often in a later stage – statistical scoring solutions.

Passing this first filter allows the potential client's request to be examined in an in-depth review of the client's risk profile. The entry selection therefore follows two objectives in terms of efficient time management:

- Avoid investigating clients that do not have a suitable profile for your institution's risk appetite;
- Avoid wasting the client's time when there is low probability to obtain a loan, especially if they have to spend considerable time in providing the necessary loan documentation – financial statements, market assessments, etc.

The purpose of the filter system is to increase the efficiency of services to eligible clients by lowering time spent on non-eligible client assessments.

Typical questions and their respective answers could look like this:

Criteria	Source	Range
Age of borrower	Client declaration/ID	18 < x < 65
Age of business	Client declaration/ Registry	> 2 years
Reputation of borrower/business	Vicinity or supplier references	Without findings
Equity/Total Liabilities (incl. new loan)	Client declaration / credit bureau	> 50%
Loan amount	Application	According to the financial institution's loan product characteristics
Industry	Client declaration/ Business registry	Exclusion of certain industries
Total assets	Client declaration	EUR 50,000 < client's assets < 10M
Total sales	Client declaration	EUR 1M < client's sales < 20M
Number of employees	Client declaration	According to the financial institution's loan product characteristics
Permanence in current location		> 2 years

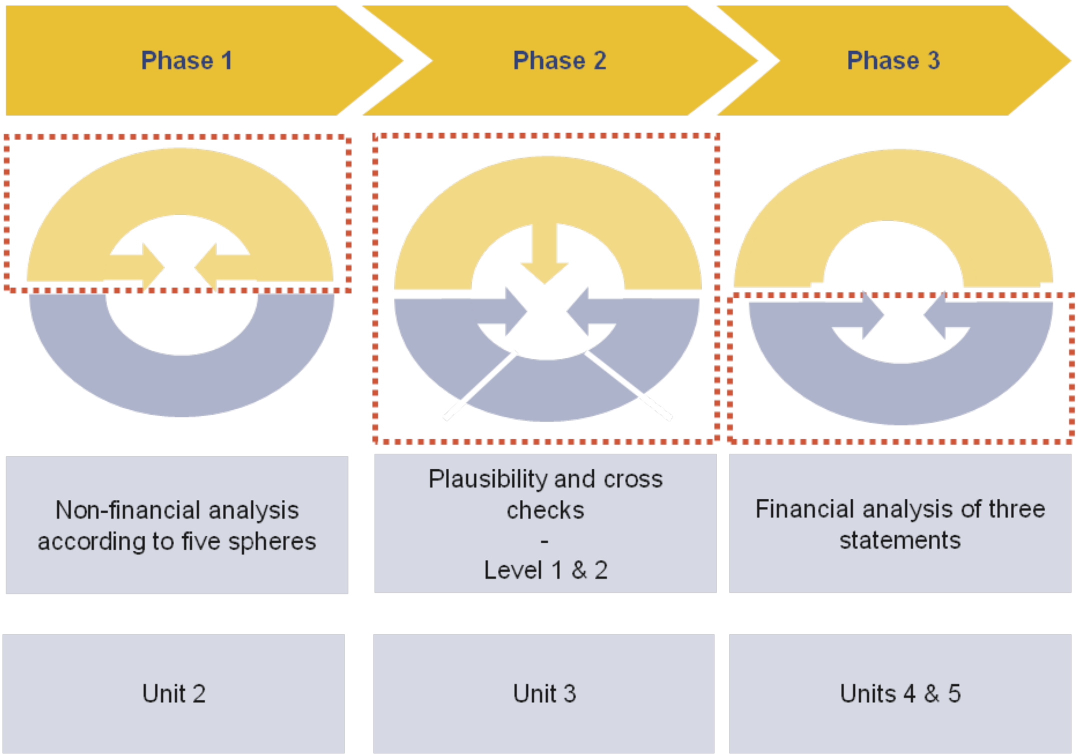
While a client might not apply for an SME loan or product, it is still possible that he qualifies for other products in the institutions' portfolio.

Whilst this first assessment (filter) of the general eligibility of a client can be based on his own declarations, the in-depth assessment has to be carried out more thoroughly.

4.2.1 Credit risk analysis of eligible clients

Once the decision has been made to visit or further review the application of an individual client, the following process can be segmented into several steps, which present the basic principles of client investigation.

Our proposed approach of credit risk assessment has three phases, which will be handled in the following units.



Unit 2 deals with Phase 1 of the analysis. This is the collection and assessment of non-financial information. Non-Financial information is usually qualitative information about the company that helps an analyst understand the way the company is run and its future prospects. It is often ignored by many analysts but it is very important, especially in the SME sector where the financial information can often be unreliable.

Topics covered in the Unit include:

- Industry and economic factors
- Industry structure: Porter's model

- Key market forces
- Corporate strategies and implementation
- SWOT analysis

Quantitative non-financial information can also be very useful. This can include:

- Measures of customer satisfaction,
- Quality,
- Market share

Non-financial performance measures are sometimes considered to be leading indicators of future financial performance, while current financial performance measures such as earnings or return on assets are commonly considered to be trailing measures of performance.

Unit 2 also provides some basic bookkeeping information to help prepare the ground for the detailed financial analysis that is found in the later units.

Unit 3 deals with phase 2 of the analysis: cross checking. Cross checking provides a range of techniques that can be used to assess the validity and reliability of a business's financial statements. This is particularly important in the SME sector where financial statements can often be very unreliable. Cross checking allows an analyst to develop questioning skills to ask a range of different questions that will hopefully confirm basic information:

- Sales
- Purchases
- Gross margins
- Cost of goods sold (COGS)
- Profits

The figures can also be verified by using mathematical techniques to compare different financial information and ensure they match. For example, it is possible to verify the relationship between Total sales per period (financial item) – Current account receivables (financial item) – Terms of Trade (non-financial item). We will also provide you with an excel tool to cross check the information provided by clients.

Assignment 1 requires you to apply non-financial analysis techniques and cross checking techniques in a detailed case study.

Unit 4 deals with the first part of Phase 3 – financial analysis. You will find detailed discussions and examples to ensure that you have a clear understanding of how to assess historic financial statements:

- Balance sheets
- Income statements (Profit and Loss)

There are in-depth explanations of ratio analysis focussing on understanding an SME's:

- Growth profile
- Profitability Analysis
- Working capital and liquidity analysis
- Solvency analysis
- Return

There are a number of case studies and exercises to help develop knowledge.

Assignment 2 requires you to apply financial analysis techniques to a detailed case study.

Unit 5 deals with the second part of Phase 3 – cash flow analysis. Detailed discussions and examples ensure you have a clear understanding of how to assess cash flow and projected financial statements:

- Cash flow analysis
- Profit forecasts
- Cash flow forecasts

The Unit will deal with the creation and analysis of these important documents. In addition, there is an explanation of project analysis using:

- Payback analysis
- Discounted cash flow analysis
- Net Present Value (NPV)

Assignment 3 requires you to apply financial analysis techniques to a detailed case study including cash flows, projections and project analysis.

Unit 6 deals with the steps that are necessary once the loan has been granted. This includes all the steps vital to ensure that loans are full repaid and that Non-performing loan levels (NPLs) are kept to a minimum. This is crucial to ensure that the loan book remains buoyant and profitable.

Unit 7 deals with other key skills for managing an SME division of a bank, including marketing management and HR management.

5 Summary

This unit reviewed the basics of SME finance. SMEs often operate in an informal or semi-formalised manner, depending on the distinction between the handling of private and business accounts. Definitions of SME vary according to the economic development stage of a country or a region, and between countries and institutions. Multilateral institutions support SMEs because of their importance to economic development and the importance of accessing finance in order for businesses to grow. This also stimulates job creation and increases quality of life.

Because of the challenges associated with financing SMEs (lack of financial information or information on the sector) and the obstacles they face in accessing finance (lack of knowledge and skills), it is important that governments support SME finance. However, governments must be careful not to over-regulate, which can hinder the entrepreneur from growing. Rather they should implement supporting measures such as establishing a transparent legal framework that creates incentives for enterprises.
In addition to governments, development banks support SME finance by providing medium and long-term funding to local financial institutions; This enables the latter to on-lend and provide loans to SMEs. Typically, technical assistance also goes in hand with these "global loans" for strengthening the operations of the local financial institution. Such measures include trainings for SME officers or the setup of SME departments. This is an area where Frankfurt School has a large amount of experience.

The organisational set up of an SME department or unit depends on the strategy of the financial institution (product versus customer profitability, downscale or upscale). Frankfurt School believes that attention to SME clients should be integrated in the structure of the financial institution as an equal counterpart to other client segments, i.e. corporate or retail clients. Nevertheless, an institution might choose to attach SME finance as part of corporate or retail banking, always depending on the underlying definition of SMEs in the organisation's business context. It is very important that the financial institution clearly defines the segregation of duties and the reporting channels for the SME business unit.

With the strategy and set up of the SME department in place, the financial institution may use various methodologies for the management of SME lending (credit scoring, individual cash flow based lending, and relationship lending approach). A mixed model is favoured with different components of these main methodologies. In fact, there is a large body of evidence that shows that "relationship banking" is more effective than "transactional banking" in the SME sector. Relationship banking involves developing a relationship with the client. This can often take time. However, once trust is established it is often found that SMEs will share "private" financial information with financial institutions. This often enables the financial institution to make a more reliable financial assessment of the SME.

The basis of relationship banking is to understand the market. This means conducting a market survey to define the market and research the specific concerns and preferences of SMEs in the area. Once the client's needs have been evaluated, the financial institution will decide which customer needs it is able to satisfy profitably. At this time, a marketing strategy and plan will be developed focusing on the target market segments, appropriate products and the appropriate technology to deliver the product and service in a timely manner.

SMEs have a number of specific business and financial needs. In response, financial institutions have developed a range of solutions to address them. These include loans for working capital and business expansion, business protection, and profit enhancement. With increasing competition, product innovation becomes more and more important.

Finally, we introduced the basic credit risk evaluation approach used in the present course. This requires both non-financial and financial analysis of the client. Non-financial analysis requires looking at the internal and external business factors. Internal factors include such things as lack of managerial capabilities in sales and financial planning and control. External factors include changes in the economy, government interference, levels of taxation, and the level of interest rates. Moreover, when the borrower's character plays a prominent part, dimensions that need to be assessed are the client's repayment willingness and repayment capacity. These are important to assess since the financial information of SMEs will often be insufficient to rely on it alone.

6 Exercise Solutions

Chapter 4: Exercise 1
Please answer the following questions: Which of the following requests for loans appear to be the most risky and the least risky? a. The owner of a small tourist agency asks for a 6-month loan to pay for salaries and office expenses; b. A farmer asks for a 6-month loan to pay for seeds and pesticides for next season's crop; c. The owner of a garage for automobile repairs asks for a 12-month loan to cover half of the purchase cost of new diagnostic equipment (the owner will contribute the other half). Please give your reasons Assume that there is no collateral, or the availability of collateral is similar in the three scenarios.
Solution: a. This is likely to be the most risky. A business should have sufficient cash to pay wages and office expenses. It is possible that it is a seasonal business if it mainly focuses on holidays. In this case, it may have substantial commissions due from the travel companies. b. This is usually less risky. Farmers usually need time for their crops to grow. They often only have one crop per year and therefore their cash flow can be short for long parts of the year. For an experienced farmer, the main risk would usually be crop failure due to weather. If the harvest is very good prices may be forced down by excessive supply. c. This is likely to be the least risky situation. The owner has managed to save 50% of the cost of the equipment. It is likely that this equipment will improve efficiency and could improve profitability significantly.