BUSINESS GROWTH FUND

RESEARCH PAPER

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Australian Government

Australian Small Business and Family Enterprise Ombudsman

Contents

The funding gap

To address the funding gap for patient capital, small to medium-sized enterprises (SMEs) need capital over 5-7 years to commit to and sustain growth. Currently, banks offer funding up to three years but this can take up to two months from application to decision. Banks claim the regulations of the Australian Prudential Regulation Authority (APRA) force banks to apply a high-risk rating to lending to small businesses. The outcome is limited funding offered by banks for no more than three years.

In a survey undertaken by Scottish Pacific for their growth index, 'The Index found that 59% of growth SMEs are seeking additional finance or capital to fund their projected growth, with one in three looking to borrow $50,000 - $250,000 and a similar proportion seeking $500,000 - $2million.'[1]

Alternate lenders have less regulation but a high cost of capital. The outcome is funding offered at high interest rates for short periods between 6–18 months. Also revealed in the Scottish Pacific report was that 'Alternative lenders are firmly on the radar of SMEs, who are attracted by the fast approval turnaround times and streamlined compliance requirements.'[2]

The Australian financial market has not demonstrated sufficient size or sophistication to address this funding gap. Our recommendation is the establishment of a private investment fund focussed on long-term funding solutions for SMEs. The fund will offer both debt (loans) and equity (investment) to support growth of SMEs, offer amounts between $250,000 and $5 million, with terms up to seven years, secured against the business.

The Judo Capital/East&Partners SME Banking Insights Annual Report in September 2018 has found that the funding gap is estimated to be in excess of $80 billion[3]. As identified in the Scottish Pacific report 'Of the 733 respondents planning to seek new credit, more than half (56.5%) would prefer a loan secured against non-personal assets, and a quarter (almost 23%) would prefer to borrow against receivables.'[4]

Recommendation

Establish a private investment fund focussed on long term funding solutions for SMEs. The fund will offer both debt (loans) and equity (investment) to support SME growth. SMEs can apply for amounts between $250,000 and $5 million, with terms up to seven years, secured against the business.

Fund structure

The fund would be headed by a private corporation providing the administrative functions to support debt funding and equity investments. Recognising that debt and equity investments should be structured differently, the funds will be established and managed separately at all times.

The corporation will have a set of fund criteria to balance the portfolio risk, which will include:

- a cap on the overall funds available, no more than a half per cent of the total capital market, so total exposure is contained

[1] Scottish Pacific Business Finance, *SME Growth Index*, September 2018, page 4

[2] Scottish Pacific Business Finance, *SME Growth Index*, September 2018, page 10

[3] Judo Capital, *SME Banking Insights Annual Report,* September 2018.

[4] Scottish Pacific Business Finance, *SME Growth Index*, September 2018, page 12

- the portfolio has a large variety of companies across diverse sectors to minimise exposure to a given company or industry sector
- each investment to be within a certain range to prevent a few large investments in only a few companies
- no investment to have majority control in the company.

The corporation will:

- provide online systems to review and process applications for funds and opportuntites for investment
- develop and maintain systems to establish, monitor and manage the loans and investments
- employ a network of finance industry lenders and equity fund specialists to
  - undertake assessment of funding opportunities
  - provide mentoring and education to SME business owners.

Investing in a single fund will disperse the risk through a pool of funds from the above sources, with returns to funders derived from the combined performance of a pool of SME businesses.

Debt (loans)

Funding source

- Will offer variable loan terms of up to seven years, which will meet investors need for liquidity and yield
- The end product to be developed in consultation with potential funders to ensure it becomes an attractive asset class
- Funds to be sourced from Australian Deposit-taking Institutions (ADIs) and non ADI banks, domestic and international superannuation funds, professionally managed debt fund investors including high net worth individuals and family offices

Product

- Loans up to $5 million, out to seven years
- Assessed against business track record, business financial performance and future business plans with projections
- Secured against business assets and director guarantees

Equity (investment)

Funding source

- Target investments of less than $5 million
- Investment criteria, exit plan and financial outcomes to be developed in consultation with potential funders to build an attractive asset class
- Potential funds to be sourced from ADIs, institutional investors across life insurance, superannuation and managed funds, the Australian Future Fund, private investment funds, high net worth investors and family offices
- Structured on the principles and disciplines used in the private equity sector, with pooled equity invested in a series of businesses
- The fund will only take minority equity positions of not more than 49%

Product

- Equity investments of not more than 49 per cent of share capital
- Invest with a long term view, five years or more
- Investment to be made with clearly defined exit plans and financial outcomes (this is a critical difference to current private equity investing)

Government

- Provide leadership in facilitating discussions with potential shareholders to establish the corporation and to promote the fund, particularly in the early stages of fund development
- No direct Government involvement providing funds or determining allocation of funding

Outcomes to date:

Canada

- Timeline to establish ~ 6 months
    - Jan '18 CEO, George Rossolatos, appointed
    - May '18 capital raised
    - Jul ;18 open to borrowers
- Target size C$1.5 billion with capital to be raised in tranches
    - First tranche closed in May 2018 and raised C$545 million
    - Investors being banks (10) and large insurers (3)
- Target return of the fund is 11-12 percent
- Product offering
    - Investment between C$3 – C$20 million
    - Long term
    - Through convertible notes
    - Equity positions between 10 – 40 per cent
    - Application process time around 16 weeks
- Current pipeline 170 companies
    - working on 24 proposals
    - looking at investments C$15 million or higher
- looking to prove the model then expand the fund and products
- currently one office and 14 lenders
- monitoring expense to investment ratio with the aim to keep reasonable
- believe lending to smaller businesses
    - takes more time
    - higher overheads
    - higher risk

British Growth Fund

- Initial investments between £1 - £10 million
    - Take a minority interest
    - Funding via equity, loan notes or a combination
- Since inception in 2011, total investment by June 2018 has reached £1.5 billion
    - Total companies invested in 231
    - There have been 35 full exits since 2011
- Distributes products through 14 offices around the United Kingdom
- Product delivered over an bespoke investment platform