

The Graham Enquiry on the use of the SFLG– March 2004

This submission is from Finance South East ('FSE') which is owned by SEEDA and the SE Regions six Business Links. FSEs purpose is to help stimulate supply and demand for funding for growth SMEs in the South East.

This response has been divided into the same three sections as in the Call for Submissions.

1. Understanding the market

The market for finance for SMEs is becoming more sophisticated as evidenced by the gradual fall in the importance of access to finance in many surveys of smaller business resource needs.

On the supply side there is more structured business angel activity (aided by tax incentives), Regional Venture Capital Funds and greater use of Factoring and Confidential Invoice Discounting.

On the demand side there have been numerous programmes to help business become Investment Ready for the market.

At Finance South East a £10m loan fund is being launched to meet a perceived gap in the market. It will lend up to £100,000 to growth companies in the South East region for businesses that cannot attract equity. The loans will have interest margins at c.8% over base and also participate (typically 2%p.a.) in turnover.

On the supply side, Finance South East, the region's Business Links and Enterprise Hubs are assisting numerous businesses to become Investment Ready. As part of a funding mapping exercise, a web site is about to be launched which will help entrepreneurs on the **Journey to Finance** using their own resources, bootstrapping, grants, borrowings and arms length risk capital. For those who can not find the funds they seek, there will be encouragement to use **Financial Design** to adjust their business plans to suit the needs of funding sources.

The use of scoring systems has been introduced in some banks for customers over a certain maturity and track record. It is considered that it would be a retrograde step for this to become more universal, as it would militate against the personal judgement of bank managers to write business.

Experience shows that if an entrepreneur has been involved in a business failure (at any time) then almost all banks will decline to assist.

There is no view on other specific issues in this section.

2. Understanding how it is used today

In the experience of funding advisers at FSE and its 6 Business Links, it is commonplace for funding proposals to be changed to *introduce* the use of SFLG where its use was not previously planned. However, this is often as part of a package of other measures to make a proposal Investment Ready. Common extra measures include requesting a further cash injection from the entrepreneurs and a downwards adjustment of the gross funding requirement by setting different business milestones.

Furthermore it is commonplace to have to give informal advice to entrepreneurs as to disclosure of wealth so that there is compliance with the SFLG “full financial commitment” rules.

Too many applicants (and their advisers) are encouraged to start from the viewpoint that they want “their £100,000 [or £250,000 for older businesses]” of “government money”.

Whilst it is recognised that references are made to ‘viable’ and ‘workable’ business proposals, it is **recommended** that the promotional literature should make it clear that:

- Applicants should have a **sound business model** that clearly indicates that interest payments will be covered by pre-interest profits, and the surplus cashflow can cover interest and repayments
- SFLG is not for speculative or unproven ideas.
- Applicants should be ready to mould their plans to suit the ability to pay interest and repayments (i.e. there is a reasonable cover for interest by the pre interest profits).
- A business should have a reasonable equity base – which is mostly commonly provided by the entrepreneurs themselves, or their friends and family, and **NOT** from arms length risk capital. Experience shows that many lenders of SFLG look to see an equity contribution coming in, often on a 50/50 matched basis.

Those bank managers who use the SFLG find it a valuable tool to help leverage themselves into new business opportunities. Conversely, other bank managers look strictly to their business targets and find other ways to achieve them.

New users of the scheme should be encouraged. However, experiences shows that new users of the SFLG have little difference to way the leading clearing banks have used it. A more important issue is to ensure that the managers in the leading banks have enough incentive, promotional support and training to use the Scheme. Support and training at HO level does not appear to cascade down to the branches.

The SFLG is frequently used as part of a larger package to help fund proposals.

There is no view on the profile of types of SFLG loans in the region, nor the level of guarantee or guarantee premium.

3. Delivery and Administration of SFLG

There is great inconsistency in application by bank managers of the rules for personal financial commitment. It is believed that this stems from the inclination of individual managers to use SFLG to achieve their targets.

In certain instances, SFLG has been used on weaker propositions against the security of the guarantee rather than the strength of the proposition. Resultant failures have tarnished the scheme in the eyes of bank staff.

There is a dichotomy between the need for the entrepreneurs to have made “full financial commitment” and the need for a bank to have comfort for the 25% unguaranteed portion. Some banks have sought cash into deposit accounts to cover the 25% unguaranteed portion – which is outside the spirit of the rules.

In the South East a particular problem is arising where entrepreneurs have an expectation of living in property of a certain price bracket, say, £500,000 to £600,000 and have a mortgage near to the maximum calculated on family income of, say, £250,000 to £300,000.

Experience in Finance South East and the regions Business Links shows that an entrepreneur in such a ‘property/mortgage trap’ is often able to make a *modest* further equity injection from their resources or those of family or friends. This can encourage bankers to provide the SFLG.

It is **recommended** that if the entrepreneur can make a cash injection of, say, 15% of the value of the proposed loan (from any source, but likely to be themselves, friends or family) into **equity** at the time of drawdown of an SFLG, that the financial commitment rules are relaxed to being a potential equity loss of £50,000 per 20%+ equity shareholder (including allowance for the value of any existing equity stake)

It is **recommended** that SFLG is only offered to incorporated businesses and that it becomes standard practice to take floating charge security. This will then accord with policy to encourage businesses to be incorporated. It may also give more comfort to banks and so more loans may be advanced.

It is **recommended** that the Small Loan Arrangement limit of £30,000 is increased to £50,000. This will reduce the number of referrals to Sheffield and make a useful improvement in delivery time in the £30,000 to £50,000 loan range.

Some points arise from frequent questions to the SBS SFLG enquiry desk.

It is **recommended** that the promotional literature explains the State Aid rules.

It is **recommended** that the promotional literature has further questions & answers on:

- How much export is allowable?
- What if the parent company is based abroad?
- How DTI R&D Grant are treated in the *de minimis* State Aid rules?

There is no view as to the need to adjust the ten year rule, nor changes in other aspects of the loan size, turnover limits nor industry exclusions.