Newsletter 3: Finance Models

One of the most challenging features of running a successful SME is the financing aspect. However, SMEs often struggle to access appropriate support features and networks and further lack the necessary financial literacy. Hereby, it is important to not only give SMEs access to different instruments, but to assist them in identifying the most useful ones for their business and to correctly identify advantages and risks of the offered methods and resources.

A big barrier to successful financial investment of SMEs is the quality of their business plans and investment projects. Thus, the development of equity finance for SMEs is often hindered by the lack of "investor-ready" companies. Equity finance refers to all financial resources that are provided to firms in return for an ownership interest. However, SMEs are generally ill-equipped to deal with investor due diligence requirements due to a lack of entrepreneurial skills and capabilities.

A framework which offers development tools and instruments, e.g. in the form of training in mentoring, is therefore vital to aid SMEs increase their financial and investment abilities and potential. Moreover, such a framework can aid SMEs keep up with the ever-changing landscape of financing models, balance the unequal information infrastructures within the financial market and help reduce financial costs for SMEs. Indeed, an increasing concern about the lack of entrepreneurial skills and capabilities and low quality of investment projects is driving more policy attention to the demand side, although supply-side policies are still prevalent. This includes measures such as training and mentoring. The INBETS project allows SMEs in the Baltic Sea region to access this vital support.

There are many different ways in which business transfers can take place in relation to finances. For this reason, the INBETS project has developed a number of financial models for business transfers which can aid SMEs with the financial side of their business transfer which is often the most challenging part.

Finance Model 1- Buyout:

Experts speak of a buyout when equity investments are made where a company or an asset or parts of the company are bought from the current owners (stakeholders) of the company. Usually, a group of investors, either the already existing management or employees of the company or external stakeholders, pool their resources to buy shares of a business from the current owners.

Important to note is that selling to existing employees can be much quicker than transferring a company to an external stakeholder. This is made even more complicated as the number of parties involved in the transfer process increases. Therefore, SME owners usually tend to focus primarily on potential buyers they are familiar with as they will know the new owners and know that their business is being passed onto a group they know and trust. On top of that, it is usually the easiest, quickest and least risky way to step up into an ownership role for interested buyers. Nevertheless, it is important to support SMEs to also find suitable buyers within but also outside of their own company as buyouts are also an excellent opportunity to involve not only the younger generation, but to also increase involvement of underrepresented groups within SMEs such as women and immigrants.

Of course there is a difference between a management buyout and an employee buyout. As mentioned above, SMEs generally lack financial expertise and literacy. This lack of knowledge and practice can be more of an issue with employee buyouts as management level staff may have greater expertise and experience compared to general employees. Additionally, it is often easier for management level employees to acquire the financial means to buyout an existing company which is a general problem for business transfers. For this reason, the EU is hoping to assist already existing employees to takeover SMEs rather than starting their own ones to preserve jobs and help the European economy grow in the long run.

Finance Model 2- Loans:

Another widely established financing model for business transfer comes in the form of loans. Loans are understood as an amount of money that is being borrowed and must be paid back, usually together with an extra amount of money that the borrower has to pay as a charge for borrowing. Loans and the conditions of loans and their payback rates differ in funding and pricing between different providers, mainly banks, depending on the suggested business model and source of the funds. The loans further vary with industry of the SME which is being acquired, the offered collateral and the internal legal and financial structures of a company. Therefore, it is common to negotiate loans and to do research on different loan providers in advance to ensure a successful business transfer.

Financing a business transfer in the form loans has many perks but also a number of downsides, like every finance model. While loans generally have the advantage to be fixed, they usually take a long time to arrange and the paying back of loans may jeopardise future investments. Loan financing

without guarantees usually results in higher interest rates and involvement of lenders (e.g. family members) within important business decisions which might lead to the failure of business in the long-run and could damage relationships.

In contrast to unsecured loans, loan financing with guarantees (e.g. bank loans) usually run more thorough credit assessments and require more detailed business strategies and financial plans and expertise. However, this requires SMEs to have good financial literacy skills and experience which is often not the case with SMEs. Additionally, banks often require a high collateral and have high interest and payment rates which particularly smaller businesses are unable to pay. This, again makes it more difficult for employees in non-management positions, as well as immigrants, women (due to the gender pay gap) and young people without extensive financial literacy, assets and experience to take on secure loans and thus, in turn, regularly leads to business transfer failures.

For this reason, it is so essential to provide SMEs and their employees not only with expertise and training to expand their economic and financial capabilities, but also to provide regulatory structures and networks for SMEs and potential SME buyers in order to prevent SME takeovers from failing to secure local and European economic growth and prosperity.

Finance Model 3: Co-financing by the Transferor

Co-financing is often provided by a transferor to ensure that the business transfer is successful. The advantage of this form of financing is that there are no hard and fast rules, as the pay-out's level is dependent on a number of factors, including the size of the business. This can be used to bridge the gap between differing expectations from the successor(s)/buyer(s) and transferor(s)/seller(s).

However, there are a number of key considerations, aside from the cash compensation, which needs to be taken into account. For instance, it needs to be determined who the crucial members of the organization are and whether an earnout is extended to them. Additionally, the parties involved need to negotiate the length of the contract and the executive's role with the company post-acquisition. The agreement should also specify the accounting assumptions that will be used going forward. Although a company can adhere to generally accepted accounting principles (GAAP), there are still decisions managers have to make that will have effects on the entire business. For instance, assuming a higher level for returns and allowances will lower earnings.

The advantage of this kind of financing is that no partner is needed for the transfer. On top of that, modalities and collateral can be regulated during the negotiations which helps to eliminate uncertainty for the buyer. Another perk of having a transfer solution is the fact that a transferor may offer better conditions as they are interested and invested in the company's future and its further development. On the other hand, the continuous interest of the transferor in the business may lead to conflicts in the future.

Other finance models:

Of course, there is a wide variety of financing models available to SMEs wishing to transfer their business. On top of the already introduced models of loans, buyout and co-financing by transferor, SME transfers can also be financed through silent partnerships, high-net-worth individuals and crowdfunding.

A silent partner is an individual whose involvement in a business is limited to providing capital to the business. The investor is often also known as a limited partner, since their liability is typically limited to the amount invested in the partnership. In this form of financing one or more parties take an equity stake in a company, but without assuming any liability to the company's creditors.

Another form of investment can come from high-net-worth individuals, who are looking for investments with reasonable risks and reasonable returns and are focused on long-term capital appreciation. Both of these traits are well matched by investing, for example, in family businesses. Instead of merely relying on one or a small number of investors, another way to finance a SME transfer is through crowdfunding. Crowdfunding is a technique to raise external finance from a large audience, rather than a small group of specialised investors, where each individual provides a small amount of the funding requested. Crowdfunding generally takes place through social networks, with the entrepreneur detailing the business activities and objectives, in some cases in the form of a business plan and requesting funding under specific terms and conditions.