Liquidity and Working Capital Funding

SMEs and smaller commercial companies seeking non asset based lending

A significant opportunity to respond to companies in the lower end of the middle markets and SME segments which are crying out for liquidity funding is seemingly being missed by Australia's mainstream commercial banks. Businesses in these two segments are demanding working capital funding solutions that are based on the state and potential of the business itself rather than on bricks and mortar securities. This is because many businesses in the SME (companies turning over A$5 to 20 million) and smaller commercial (A$20 to 100 million) market segments no longer want the family home put up as security. These companies are increasingly looking for solutions other than asset based financing and are increasingly looking to service providers other than their incumbent banks.

SMEs want their homes back

Historically, banks have had only modest appetite for lending that has no recourse to the borrower's physical assets as collateral. With the boom in residential property that has taken place over the past five years, company owners have actively extracted more equity from the value of their family home to fund the growth of their business. This has delivered accessible and flexible funding lines but with the Australian housing cycle now having peaked, continued use by small business of this debt funding source is being squeezed.

Much of the Australian economy's growth is being driven by SMEs and smaller commercial companies. Almost 30 percent of SMEs say they want to borrow more over the next 12 months. But the response from banks is typically to talk of increased overdraft facilities or term funding lines backed with additional bricks and mortar securities. This model acts as a major brake on the segment's ability to grow, as lending decisions remain firmly grounded on valuations of assets generally independent of the business itself rather than the business's stand alone ability to service and repay.

Banks' inflexibility causing new market dynamics

This somewhat monoline approach to the provision of flexible and innovative working capital funding on the part of commercial banks is leading to a number of consequences, now increasingly visible in the markets:

- The continuing 25 percent plus growth taking place in debtor finance, invoice discounting and factoring, which can have effective interest funding costs to the customer of more than 45 percent. This is a now a A$34 billion a year market.
- The proliferation of second tier financial services companies now providing innovative financing solutions, particularly in the leasing market.
- Explosive growth in broker activity, in part driven by SMEs looking for alternate cash flow funding solutions that come with different collateral conditions, even at a higher price.
- A high level of churn in lender. Once a commercial bank has an SME owner's residential property as security, the SME finds it difficult to negotiate relaxed collateral conditions and finds it easier to "get the home back" by changing lender.

New players making haste while banks dawdle

Although banks do have cash flow financing businesses, they are constrained in part by regulatory issues and self imposed credit processes, particularly in the case of Authorised Deposit Taking Institutions (ADIs). These are effectively inhibiting their ability to be as responsive in meeting SMEs' demands for liquidity funding as perhaps they themselves would like.

Exhibit 1

Average Rating Reported
1 —— 2 — 3 — 4 —— 5
(important) (satisfied) ... (unimportant) (dissatisfied)

	Current	Previous
Importance of Lending Solutions to SMEs		
Overdraft Facilities	1.44	1.56
Australian Currency Term Loans	1.57	1.68
Commercial Bills	2.67	2.55
Leases	1.87	1.96
Receivables Funding	1.81	1.88
SME Satisfaction with Lending Solutions		
Overdraft Facilities	2.10	2.15
Australian Currency Term Loans	2.04	2.09
Commercial Bills	2.72	2.68
Leases	2.08	2.14
Receivables Funding	2.07	2.11

East & Partners SME Banking Markets program
Note: previous is 6 months earlier

This vacuum effect is creating opportunities for alternate providers which are responding quickly and offering innovative, non asset based funding solutions.

Financial service providers such as Challenger, Alco, some niche trade financiers and others, are coming to the fore with working capital offerings.

The major commercial banks are currently all singing from the same hymn book about taking a more advisory, business focussed rather than traditional banking approach to their customers. They are also seriously re-engineering their middle market businesses to get much closer to this customer segment.

A major opportunity in funding, in a prudent manner using credit assessments less weighted toward recoverable bricks and mortar assets that have nothing to do with the way borrowings are being applied by the business, exists to fund the growth ambitions of tomorrow's corporates.

If not, a new, alternative community of lending providers could well emerge, in which commercial banks are not participating.