Closing the funding gap

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Mid-sized businesses are turning to the debt capital markets to secure funding

Introduction

Mid-market businesses around the world are facing a funding gap, holding back growth and development. The World Bank estimates this funding gap to be in excess of US$5.2 trillion.

Businesses hungry for investment are increasingly turning to the debt capital markets (DCM) to raise finance. In a little over a decade DCM has moved from a niche funding option for mid-market businesses into the mainstream.

DWF has long been a strategic partner to some of the world's most innovative businesses helping them address the challenges associated with growth and success. The firm has a sophisticated international DCM practice and a strong track record, helping businesses raise over GB£1.5billion in the last year alone.

This report will explore the reasons why businesses turn to DCM, the benefits and challenges of DCM funding, the views of arrangers and their demands, and the experiences of borrowers.

DCM is a source of funding that will continue to grow yet is not fully understood by many of those who would potentially benefit. We hope this report will go some way to address that.

We would like to thank Absolute Capital Partners, Banca Akros, Alibert, Azizi Developments Ipopema Securities, Link Lease Equipment Rental LLC, Menara Capital, Navigator Securities, The JLG Group and Zenzic Partners for their contributions.

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The funding gap

The sources of finance for businesses are many and varied. Traditional bank lending dominates the market for smaller businesses, with increasingly complex financial products including debt capital markets (DCM) accessible to larger and more sophisticated businesses.

Start-up and small businesses are likely to find themselves facing what can at first appear to be an overwhelming number of funding options – from business angels, leasing, crowd-sourcing, and receivables financing – yet bank lending continues to dominate. This is due in no small part to political pressure from domestic governments directed towards banks to ensure they provide the funding smaller businesses need.

At the other end of the market, large, multi-national organisations will have the financial clout and the sophisticated advisory teams that enable easy access to complex and structured finance products.

It is increasingly clear, however, that there is a sizeable funding gap for mid-sized businesses that are often privately or family owned – the engines of economies around the world. That gap widens when those businesses do not fit the often rigid criteria offered by banks, or who operate in sectors considered risky.

In 2018 The World Bank estimated this funding gap globally to be an eye-watering US$5.2 trillion.

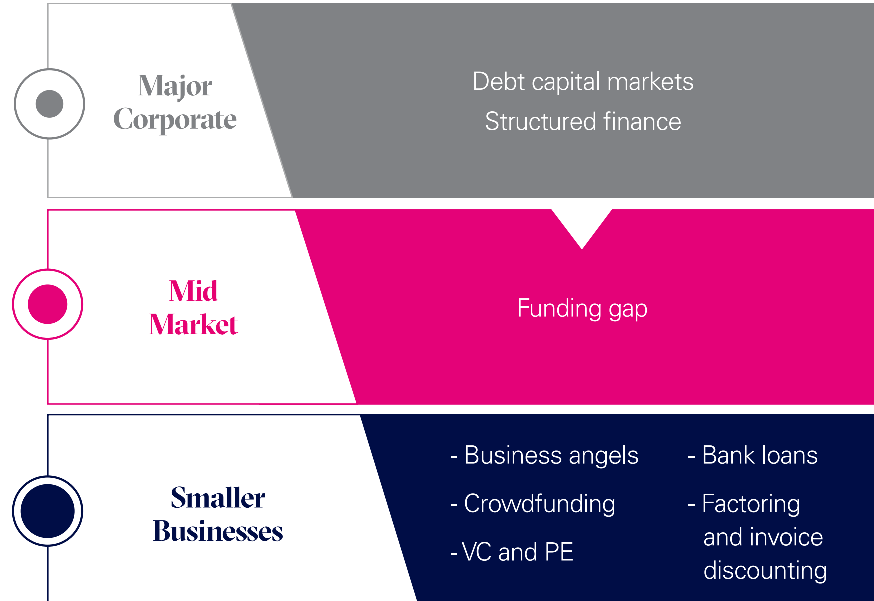
Whilst there is uniformity in the requirement for funding, there are differences in the demands and drivers of DCM cross-region and cross-jurisdiction.

Across much of Europe, bank funding appears to be more readily available in core countries thanks to support from the European Central Bank. Individual countries have also responded in innovative ways to help better channel funding into mid-sized businesses.

In the Middle East and North Africa formal financing of the private sector is limited, with loan activity focused on larger corporations or government-backed entities. Consequently, mid-sized privately-owned businesses rely heavily on the informal markets.

Businesses that cannot secure traditional bank funding or do not wish to divest equity are increasingly turning to DCM.

Our report explores the opportunities and challenges business face when looking to the debt capital markets, who might benefit, and how the market is likely to grow. We also share the experiences of businesses who have successfully raised funds via the debt capital markets.



"...outrageous demand for credit in the small and medium sector and a short availability of credit. We are talking about a US$40 billion gap in credit to the SME market."

Steve Williams, Link Lease Equipment Rental LLC – UAE

The rise of debt capital markets

Arrangers interviewed for this report estimate that DCM currently provides between 15-20% of all SME funding needs. All expect it to continue to increase.

Our research has not attempted to chart the exact levels of funding into mid-sized and privately-owned businesses via the debt capital markets, choosing to focus more on the drivers behind DCM funding. Large corporates have long used DCM to raise funds, yet almost all DCM funding into SMEs has emerged within the past decade. This is well illustrated by the market in Saudi Arabia, which has grown from nothing a decade ago to a market today worth tens of billions of dollars – and a picture echoed across Europe. DCM funding continues to grow.

The number and variety of arrangers providing DCM funding also continues to increase to include boutiques focused on retail and mini bonds, on individual industry sectors, or on specific countries. Niche funds created to do one specific thing and once seen as esoteric – such as providing funding for private equity – are now viewed as mainstream and supported by large teams. Arrangers will typically offer a range of financing options for companies.

Our research suggests that arrangers tend to focus their activity on domestic markets – with funding directed to home-grown businesses and backed by domestic investors. That is in no small part driven by the relationship funders have with domestic regulators. UK arrangers, on the other hand, have a much greater international focus driven by the strengths of Eurobond activity and the nature of English law.

The size of bond issues varies enormously from US$20m at the lower end to US$500m. Borrowers will often seek many rounds of DCM funding.

Driving demand

The growth in DCM funding into mid-sized corporates varies from country to country but is driven primarily by two common factors: the reluctance of the banks to fund them, and the increasing desire by corporates to introduce diversified and flexible funding streams.

"An established business, say a family-owned business with a good track record and good credit, will have access to bank finance that is priced well. Yet banks may still be reluctant to make available the amounts needed," explains one European arranger.

"Then there are those businesses that are doing OK but have, perhaps, had historic trouble with investors or have been through a turnaround process and have yet to show positive numbers. They are systematically out of bank funding," the same European arranger adds.

Borrowers have little choice but to look to alternative funding streams.

Private equity is often one of the first sources of funds businesses will consider, yet the demands of private equity investors do not always sit comfortably with management teams.

"Issuing equity is either very cheap or very expensive, depending which way you look at it," explains one borrower. "It's cheap because you don't pay interest, but expensive because at the end of the day you lose control of your business and the loss of capital growth. We didn't like equity because we were giving up control before we had even started."

This view is echoed by arrangers. "There are a lot of management teams that still bridle not just at the equity dilution but the governance aspects of PE funds, where they are, rightly, accountable to investors, having to adopt business plans on three to five year horizons because they [the PE funds] have closed their big funds."

DCM arrangers take a different approach, looking beyond the size of a company, its revenues and history. Individual assets or revenue streams are used as security on funding, matched with flexibility on drawing down those funds.

"Investors look at the interest rate, the security, they look at the business itself and the industry it is in," explains Robert Boot of The Just Loans Group, following its recent DCM fundraising. "And they look at the management team – our experience and whether we are qualified to do what we are doing."

Banks are not entirely out of the picture – indeed they are often the starting point in the funding journey for businesses. But when they can lend, they are often very slow in making a decision.

Those participating in this report told us that banks in France can routinely take anywhere between six to eight months, and occasionally up to 12 months to make a lending decision. Despite bank lending costing around 2% compared against 8% for DCM funding, French companies, particularly real estate companies, increasingly turn to DCM for the speed in funding decisions to ensure deals are not lost.

The drive for greater diversification in funding and the increased flexibility of non-banking funders is also driving activity – a reaction in no small part due to the Credit Crunch a decade ago. The UK in particular has seen an "explosion" in specialist funders with many different types and sizes of arrangers.

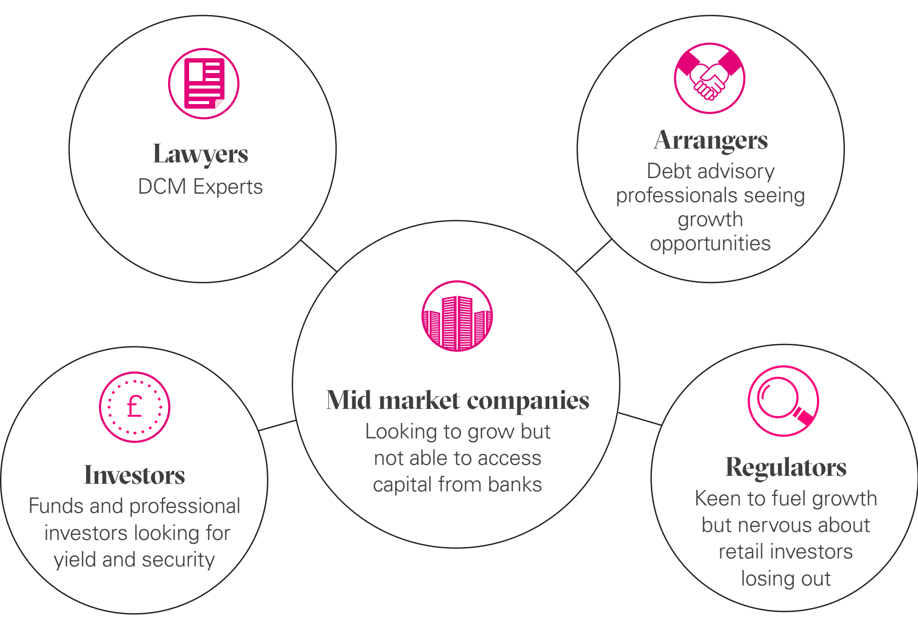
"If liquidity in markets is difficult, [borrowers] can fall back onto other funding streams," as one arranger succinctly stated.

"Bank loans to our type of business were not available. In terms of private equity funding, we didn't have the track record… we wanted to maintain control, and that we were able to do by raising loans on the debt capital markets."

Robert Boot, JLG Group PLC - UK

The rise of debt capital markets

The evolving DCM landscape



DCM growth

DCM is not an appropriate funding source for all businesses and "rarely the 'S' in SME". Companies need to "look inside themselves" to see if they are really ready for DCM funding in terms of their business growth cycle and governance. Questions that arrangers will want answered include whether the transaction has the capacity to achieve a rating, and whether there is the expertise to drive forward a DCM transaction.

"Private debt can be expensive and requires strong securities," explains a European arranger, "and that may hold businesses back – particularly those that don't feel able or comfortable in providing that security."

Our discussions with arrangers around the globe suggest that most companies would be successful in raising funds through DCM, yet there are certain industry sectors more active than others.

Real estate companies have enthusiastically embraced DCM, particularly when looking to fund land acquisitions. It is estimated that in Poland, for example, 50% of all DCM transactions are to real estate businesses.

The commodities sector also does well in raising DCM funding, having "suffered more than most sectors" at the hands of traditional lenders as they "represent a lot of reputation risk for banks with a lot of heavy compliance".

Finance companies - particularly those involved in leasing, loans and invoice discounters, and gaming and lottery businesses find the flexibility of DCM funding attractive, particularly the ability to draw down funds in stages and thus avoid the "cash drag of interest payments" on funds that are not being utilised.

And manufacturers successfully turn to DCM to fund expansion. One Italian pasta manufacturer, Alibert, told us that they successfully raised DCM cash for a new production plant, securing funds within just three months.

It is clear from our discussions with arrangers, however, that the majority of mid-market businesses do not fully understand the potential benefits of DCM funding.

The speed of decisions matched with ability to retain equity and thus the ability to control company growth are clear and tangible benefits that senior management teams do understand. So too is the ability for funding to be made available in tranches.

Arrangers believe, however, that many borrowers fail to grasp the wider benefits.

Demand & Barriers

Drivers of demand	Barriers
Access to capital	Costs front loaded
Flexible - multiple trenches, variable rates, SPVs, longer terms	Danger the investor community doesn't buy the bonds
Less onerous covenants than banks and less likely to act against you	Financial and government scrutiny
Raise profile amongst investor community	More expensive than banks in France and Italy
Quicker to arrange - in France	
Don't need to give up equity or control	
Cheaper than banks in the Gulf	
Diversified lenders	

Borrowers can return again and again to DCM for future funding rounds, with individual assets or revenue streams isolated as security. Investors react well to the increased market visibility companies have through DCM funding, with future funding rounds becoming easier.

Borrowers too need to understand how DCM markets work, particularly in terms of up-front costs, reporting and governance.

"[Businesses] do not understand the private debt sector and how we work," explains a European arranger. "Businesses do not understand the obligations they will have once they tap into this funding in terms of reporting and compliance."

That, and the lack of a secondary market for most bonds, are often deciding factors as to whether DCM is the most appropriate route for borrowers.

A future market

The arrangers and borrowers interviewed for this report look to a DCM market that will continue to grow and become an increasingly important source for funding for mid-market SMEs. These companies are the engines of the global economy and their access to funding is critical.

Investors play a role in the growth of DCM, with fixed income credit remaining a significant allocation. This marriage will drive demand.

It is clear that a greater degree of education is needed amongst mid-market corporates around the world. Arrangers believe that it is advisers to businesses that are the key to unlocking DCM, but they too must play an important role.

"We are trying to convince entrepreneurs that with a bond you get longer maturity and a more fluid structure in comparative terms to amortising finance from a commercial bank."

A European arranger

"you've got to know what you're doing… this isn't for mavericks and have-a-goes. You've got to have an awful lot of patience because it inevitably takes longer, and you've got to have a war chest because it inevitably costs more. But as access to capital in an otherwise capital starved environment, there is nothing else like [DCM] available. And I can't see how that's going to change in the next three to five years."

Steve Williams, Link Lease Equipment Rental LLC, UAE

The rise of debt capital markets

Regulators will have a role to play in the growth of DCM. In 2013, the Italian government created a new listing segment – ExtraMOT Pro – with lighter documentation and a faster listing process. Designed with institutional investors in mind, it is proving successful, driving down the costs for issuers.

ExtraMOT Pro has been successful in the Italian market with some 350 listings raising on average around €5m. It is however only open to Italian issuers and investors.

The Vienna Stock Exchange has also introduced a similar listing for small bond issues, typically under EUR5m – that is open to overseas issuers and investors. It has been very successful and is being closely watched by other jurisdictions with a strong SME sector.

There do, however, remain barriers and factors that have the potential to slow the growth of DCM. In Europe, cheap bank money underpinned by the European Central Bank is a draw to businesses that fit bank lending criteria. Businesses will, therefore, quite naturally look to price on funding. As long as the ECB maintains that position, DCM funding will struggle.

The cost behind structuring a first DCM transaction can be prohibitive. And there is always the chance that a bond issue will not attract investors.

Yet given the cautious lending criteria from domestic and international banks and the demands of private equity, DCM funding is set to increasingly form a key role in funding the growth and success of mid-market corporates.

The borrower's perspective - Link Lease

Linklease was established in 2014 to help SMEs across the Middle East secure the finance they need to secure major pieces of equipment.

Working across a broad range of industries across the Middle East, Linklease offers both conventional and Sharia-compliant leasing products so that no matter how specialised an industry or piece of equipment it can provide the right leasing answer.

The team behind Linklease has so far delivered deals exceeding US$1 billion across 3,500 transactions. Linklease is quite simply keeping the engines of the Middle East economy moving.

"There is an outrageous demand for credit in the SME sector and short availability," says Steve Williams, CEO at Linklease. "That is largely because the appetite for local and international banks to extend credit facilities to small businesses is not keeping up with demand – managing lots of small transactions is prohibitive. SMEs in the Middle East find it very tricky to raise anything more than US$250,000 without substantial collateral."

"Middle East businesses have little choice but to turn to cash in their own business, which is in short supply, which then puts the onus on equipment manufacturers or the distributor to fund what they are providing. It is a phenomenal opportunity for us as an equipment leasing company."

Despite an experienced lender, it was a chance encounter that led Linklease to the debt capital markets.

"Whilst traditional commercial bank funding would have been cheaper it just wasn't available to us as a relatively new company," says Steve. "The risk appetite from the banks [in the Middle East] is just not in the right space for this type of transaction."

Linklease was able to create a ringfenced portfolio of assets, structured to appeal to investors.

"There are a number of sectors which we gravitate towards – such as manufacturing, healthcare and construction," explains Steve, "but it is not just the fact that they need equipment, it is how resaleable the equipment is. We look at equipment as a commodity which if it doesn't work in the company where it is, we pick it up and deploy it elsewhere."

DCM funding also sits more comfortably with Linklease's own business model, as Steve explains.

"As a leasing company, we don't ideally need all of the cash on day one. We have to source underlying client leases and a pipeline – we're talking about building our book over the coming years. We don't want to arrange US$200m in one go. DCM allows us to take an amount that we know we can deploy in good order to keep the metronome of funding from swinging too far in either direction."

"Yet it is not something to be entered into lightly," says Steve. "The obligations are significant, and as a listed company there is a high degree of transparency."

Linklease has, however, found DCM to be "transformational". "It has," says Steve, "been a momentous milestone."

Visit link-lease.ae to learn more.

Euro medium-term note (EMTN)

Corporate borrowers are not limited to raising debt in their own jurisdiction, they can also make use of a euro medium-term note (EMTN) programme. EMTN enables a borrower to raise funds in multiple currencies (not just in Euros) and opens the bond issue to investors outside their own country.

An EMTN programme comprises a set of master documents containing standard terms and conditions and other contractual provisions that can be used to make any number of bond issues over a given time frame (each issue being a 'series'), subject to a maximum programme limit. The programme documents are typically governed by English law.

The bonds issued under an EMTN programme are called 'notes' but are the same in substance and form as stand-alone bond issues. EMTN programmes are typically more expensive to set up than stand-alone bonds issues, but are ultimately much cheaper. Once the programme documents are in place, each further series of notes issued involves the production of small supplemental documents that identify the relevant provisions of the master documents and set out the specific commercial terms of the further series.

The negotiation of the principal terms will already have been done when the programme was initially established, and the necessary disclosure by the issuer will already have been made and have been verified by the initial due diligence.

EMTN programmes are typically listed on the world's major stock exchanges and borrowers will often seek an investment grade rating from a recognised ratings agency for each series.

DWF's London office has acted as issuer counsel on six EMTN programmes in 2019.

The borrower's perspective - The JLG Group PLC

The JLG Group was established in 2012 with the aim of providing a real alternative to business bank lending. It has built a robust, scalable and anti-money laundering compliant process for corporate borrowers across the UK. It has European borrowers firmly in its sights as it continues to grow.

"Ours is a simple business," says Robert Boot, its Finance Director. "We borrow money and lend that money to SMEs, making a margin in between."

"Customers can borrow and repay, borrow and repay as many times as they wish within the facility's timeframe – typically 12 months. The product is devised to help manage peaks and troughs of cash flow."

The average facility is about GB£40,000 with currently just over 2,000 customers of which around 1,800 are active at any given time.

When raising funds to support the business, JLG Group turned to DCM with a series of retail bonds, later issuing institutional bonds.

"We didn't have a large capital base to start off with, so we had to look where we were going to raise funds," explains Robert. "We considered everything – equity and even preference shares. Bank loans to our type of business were just not available. In terms of private equity and venture capital – we didn't have the track record that would be attractive to them."

"Issuing equity is either very cheap or very expensive, depending which way you look at it. It's cheap because you don't pay interest, but expensive because at the end of the day you lose control of your business and the loss of capital growth. We viewed it as expensive."

Right now, JLG Group's loan book is increasing at around GB£5m a month and shows no sign of slowing. DCM funding allows JLG Group to match as closely as possible its funding and lending requirements, minimising the cash drag of interest payments on funds not currently utilised.

The strength of the business and the management team at JLG Group has been key to its DCM funding success.

"Obviously, you need a good team to run the business," says Robert. "But you need a good team because investors and the exchange where you list will look closely at them too. They need to be savvy and have experience. You can't do it from scratch."

Learn more by visiting thejust-group.com

The journey to DCM

DWF has led DCM transactions for many companies around the world over the past decade, acting for both arrangers, issuers, investors and borrowers.

Our report highlights a knowledge gap amongst businesses on DCM and particularly the process borrowers need to follow to secure funding.

Whilst each transaction will be very different, they all follow the same basic model:

- the Issuer (borrower) issues the bonds (basically an 'I owe you') which are purchased by investors;
- the bonds may be listed on a stock exchange and may be rated by a credit rating agency (if required by the investors);
- the Issuer will use the proceeds of the bond for the purpose it requires (e.g. to build a new factory, to expand a business line, working capital etc), as detailed in the prospectus and other transaction documents;
- the Issuer may grant security (where required) to investors to secure the repayment of the bonds. If the proceeds of the bond are loaned to another company, security from that other company is passed back up to the Issuer for the benefit of the investors;
- the Issuer will pay interest (a 'coupon') on the amounts received from investors (this is typically monthly or quarterly); and
- the Issuer will repay the entire amount received from investors on the expiry date of the bond (or earlier if the bond amortises) and can typically finance the repayment with a new bond issue if required.

To help companies looking to access DCM for the first time we have produced the following question and answer guide.

Will I get the money?

Whilst there is no guarantee that investors will buy a bond, we aim to structure every bond issue so that it is attractive to potential investors including structuring asset security to guarantee repayment of the bond, working closely with credit rating agencies to ensure that the bonds are eligible for 'investment grade' ratings (which many investors will require), and liaising closely with the relevant stock exchange to ensure that the bonds are eligible for listing, which will increase liquidity for the bonds.

How long will it take?

Most bond issues can be completed in a three to four month timeframe, although our record is just four weeks from instructions to listing. For bonds which are backed by particular assets, those assets will need to be chargeable, so companies should give prior thought to ensuring that the assets are free from existing security, or existing security can be easily released at the time of the bond issue.

What security and covenants will we need to give?

This depends on the type of bond. For an 'asset backed' bond, there needs to be underlying assets that can 'back' the bond. As a general rule of thumb, the value of the bond should be not be more than 70% of the value of the asset. For corporate bonds, investors will focus more on the historical business of the company and the future business plan.

Will I need to get a rating?

Not necessarily, but some investors will require an investment grade rating to invest in the bonds.

What are the different types of structure?

This will depend on the individual company, the amounts required, the availability of audited accounts or availability of assets to be used as collateral. DWF can provide initial advice on the most appropriate structures on a case by case basis.

What documentation will I need to get ready?

Again, this will depend on the structure of the bond, but a prospectus or other form of investment memorandum will be required. It will need to include full details of the company, its directors, the business in general and what the proceeds of the bond will be used for. Any corporate documents pertaining to the company, audited accounts, ownership documents of assets to be used as collateral etc will need to be made available.

What information will I need to gather?

The prospectus or investment memorandum will also contain broad information on the company's industry sector and any risks associated with the company, business, sector or related to investments in the bonds in general. Accordingly, in addition to the documentation to be provided (see above), the company will need to provide this wider information.

The DWF approach

As we hope you can see from this report, DCM can be an accessible and flexible funding option for a business.

Whilst we have sought to explain the process in simple terms, we appreciate that for many companies this will be your first foray into the world of DCM and you will likely still have a number of questions. The good news is that we are here to help and we use our experience and expertise to ensure that the process is as smooth and pain-free as possible.

DWF's international team is experienced in advising on all aspects of DCM transactions, acting for arrangers, issuers, borrowers and investors. Our experienced team regularly advise on DCM issues from EMTN programmes listed on major stocked exchanges, to mini bonds and sovereign bonds, both conventional and Shariah compliant.

As 'issuer counsel' we will help guide your business through the process:

- making recommendations for the various transaction parties who will be involved (such as trustee and arranger);
- helping you through the listing process and rating process (if required);
- carrying out the verification process; and
- preparing the prospectus or investment memorandum and other transaction documents, tailored for your business.

In 2019, DWF has assisted a multitude of companies in DCM transactions involving a large number of countries, including UK, France, Italy, Poland, UAE, Sweden, Estonia, Malta, USA, The Netherlands, Australia, Spain, Democratic Republic of Congo, India and the Kingdom of Saudi Arabia.

Wherever your business is based, DWF can assist in bringing your company to the DCM market.

If you are eager to learn more about DCM and the opportunities and options it could provide for your business, please contact one of our experts below:

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Beyond borders, sectors and expectations

DWF is a global legal business, connecting expert services with innovative thinkers across diverse sectors. Like us, our clients recognise that the world is changing fast and the old rules no longer apply. That's why we're always finding agile ways to tackle new challenges together. But we don't simply claim to be different. We go beyond conventions and expectations.

Join us on the journey.

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