HANSA PODCAST – EPISODE 001: GET BETTER AT THINKING ABOUT CAPITAL

Today we will be discussing about capital decisions in companies and the common mistakes that companies make. To structure this topic we will look at the main reasons why companies look for capital and in each of those situations we will share with you the lessons we have learnt.

There are 3 reasons why SMEs (small and medium enterprises) need capital:

1. To support GROWTH
2. To resolve OWNERSHIP matters
3. Turning around a DISTRESS situation

There are about 8 sources of capital:

1. Debt from banks
2. Debt from other lenders (we call them NBFC's)
3. Shareholder Loans
4. Mezzanine Debt
5. Equity from shareholders
6. Equity from friends and family
7. Equity from private equity
8. Equity from an IPO

Lets look at the first point which is GROWTH capital. There are 6 reasons we have identified on why companies look for capital:

1. To fund WORKING CAPITAL

2. INCREASING CAPACITY – setting up new factories, offices or stores

3. SALES & MARKETING – adding more salespeople and doing more marketing campaigns

4. INTERNATIONAL GROWTH

5. NEW PRODUCT DEVELOPMENT

6. ACQUISITIONS

You will find all this information in the show notes on our website www.hansapartners/podcast

Lets look at each of the six in detail and share some of our observations in companies:

- **Working capital is mainly used to fund receivables and inventory.** Funding of working capital is a constant struggle for companies

    - **The best source for funding working capital is debt** from banks. It's the cheapest source of capital. There are various types of instruments available with banks to fund working capital. Some are fund based like working capital limits and some are non-fund based like letter of credits and bank guarantees. As your business grows secure more working capital from banks. In India most banks require security even for working capital. At some point lack of security becomes a constraint to get access to more funding from banks

    - **In most commodity businesses, the more working capital you can get the more you can grow – this is what we see in most companies.** They have been securing contracts just because they are able to fund the working capital. Soon they realize that most of their receivables are of poor quality and inventory is obsolete and the company is in trouble. This is not theoretical. This is a case we recently reviewed.

- **You can use 3rd party consultants for raising WC but be very involved**: We were looking at a company where the accounting team (not even the CFO) was in discussions with the Banks. The owners never get to understand the banks criteria and never took the time to build a relationship with the bank. Negotiating with the owners or the CEO gives the banks a different level of confidence.
- **Hire a good CFO.** In most of the companies the biggest talent gap is in the accounts department. The reasons are understandable - well qualified CFO's are difficult to get and cost a lot. But its worth the effort. The CFO's salary cost can be justified by the savings in WC and other cost savings.
- **Don't fund working capital with Equity.** Equity is expensive and use equity for initiatives like investing in sales and marketing and new product development. Most SME's tie up significant portion of their capital in working capital and so sales and new product development /R&D remain underinvested.

- Second reason for growth capital is – increasing capacity (setting up a new factory, office or store). Banks are open to lending to such initiatives through term loans. But in most cases they require a security or a collateral. If the owners reach a limit with the collaterals, getting such loans is a challenge. They equity options will have to be explored. Our observations here are as follows:
  - **Be involved in creating the business case and test all the assumptions –** Just around the city where we are based there are several projects where the land was acquired, factory was built and commissioned but there was not a day of production. Because the project plans were faulty. Use 3rd party consultants to build project plans but be involved in validating the critical assumptions. Most often the project reports are prepared as compliance documents to secure debt.
  - **Evaluate make vs. buy**: If there is enough capacity in the market then outsource the production to 3rd parties. We recently reviewed a plant where someone wanted to set-up a battery plant. On discussing with a few sectors experts, we realized that there were atleast 10-15 such projects being initiated by large companies.
  - **Expand in stages:** Design projects where capacity can be increased in stages. This will minimize the upfront funding needs and also reduce the risks of any project delays or faulty assumptions. We looked at a case where a company wanted to increase it capacity by 5 times. Our suggestion was to expand more gradually and also in different locations.
- The next 3 growth needs, **sales and marketing, international growth, invest in new product development**. Banks are usually not open to lending for such initiatives. Its best to fund such initiatives with operating cashflows and if that's not sufficient then shareholder debt or finally equity.
  - **Secure your existing cashflows:** We worked on a case where aggressive growth plans were prepared and the focus of the senior management shifted to supporting the new initiatives. Soon the sales from the core business started declining and there were liquidity issues.

- **Constraints here are usually people and not capital**: Professionalizing the sales team or securing a sales team in other countries is challenging because most SME's struggle to find good people. Usually they approach such growth plans through partnerships.
- **Control is key**: Before embarking on an aggressive growth plan, have the necessary controls in place. This includes cost controls and also the ability to measure the profitability from each sales initiative. In most SMEs the OPEX is lumped into one single bucket and if you want to see the profitability of the new initiatives, there is no way of doing that.
- **Private equity can be a good source if the scalability is proven.** If it is an unproven area or product, its best to go slow and pilot test using operating cashflows. Raising a lot of capital to enter into new and unproven areas is not advisable.

- The last and 6th option why capital is required for growth is to **make acquisitions**. In case of SME's most owners are thinking about organic growth. Acquisition is almost never in the plan. We have seen SME's making small acquisition which are mostly distressed sales by people they know. Banks are most likely not going to fund such transactions. Equity can be a good source of capital to fund acquisitions. More than capital, most investors come with M&A experience. In addition to capital also use their knowledge to structure the transaction and plan for post-acquisition integration.

We have covered the GROWTH capital needs of companies on how they should think about it and how they should fund them. Next lets look at capital needed to resolve ownership issues. Sometimes an inefficient ownership structure is the bottleneck for growth. We have identified 4 such scenarios. When you need to resolve an ownership situation, you will most likely need equity.

1. You have a shareholder who wants to sell his stake
2. There is a generational change in the company
3. Current owners want to sell 100% of the company (buyout)
4. Current management team wants to become owners of the company – we don't see this case often in India

Some of our observations here are:

1. In one or our companies an existing shareholder wanted to sell his stake. The current owners were willing to buy his stake but they valued the company low. Don't do that. Always get a fair market valuation done for the company
2. We are currently working on a generational change case where the father wants to dilute a small stake as a retirement fund and leave the rest of the company to the children. We don't see many owners thinking like that.
3. **If you want to sell a company 100% - prepare the company for that**. Build a good management team in the company. This takes a few years. We looked at a majority stake case where the factory was totally underinvested, there was no middle management and employee morale was very low. You will only find distressed buyers for such cases
4. Most reputed investment bankers will do a good job in raising equity – but keep your valuation expectations realistic. We recently saw a case which had sales of $3m USD and was valued at $100m. **Avoid investment bankers who set unrealistic valuation expectations.**
5. **Don't go for an IPO too early.** We have reviewed several cases that have filed for IPO's but they were not really ready for that. Build a scalable business model and organization and governance model (which is truly working) before you can file for an IPO.

Finally lets speak briefly about turnaround situations. There are hundreds of companies in India which are currently in distress. Turnaround situations arise when a company was growing aggressively and took on a lot of debt to fund that. But due to some external or internal reasons the growth plans did not materialize and the company was left with too much debt burden and is now struggling to service that.

Real Estate, Power and Infrastructure sectors in India are full of such companies.

There is a new law in place in India called "the Bankruptcy Law" for quick resolution of such cases. But having reviewed about 10 distressed cases in the last year here are our inputs to business owners:

For companies that are currently healthy there are several lessons that you can learn by looking at companies in distress:

1. **Cyclicality** – If you are in a cyclical business like Infrastructure, let the upward cycle not fool you into taking too much debt. Once the cycle turns you will not be able to service the debt and the equity gets wiped out. Most SME's are not aware of the risks that come from cyclicality.
2. **Invest in financial control / risk management** – don't view them as process overheads. You may be a small company so keep the processes light. Keep tight control of your profitability and working capital.
3. **Don't bite more than what you can chew** – We looked at a company that was executing projects worth a few million. Suddenly because of their long track record they took on 1 project worth a few hundred million. The margin of error with cash flows is very less and then you get caught in the debt trap if things don't go as planned.

In case you are heading towards distress, there are few things you can do:

1. **Cut costs very aggressively, sell assets** to replay your debts – show a sense of urgency. We understand that these can be very difficult decisions. Many of the companies we have reviewed had 5-6 years before the banks took over.
2. There are special situation investors in the market – **distressed debt investors**. Identify them and work out a turnaround solution with them. Don't be over optimistic. Create a win-win deal with such investor. Remember that key is to survive.

In case you are in distress and the bank has taken over the company. Things are no longer in your hands. There are several participants in the process – the resolution professionals, the ARC's (Asset Recovery Companies), consortium of banks to deal with. The process is well defined but what we have experienced is that it still takes a long time and gets complicated due to involvement of many parties. Most of the times its an opportunity for another industry player to take over the company.

EPISODE SUMMARY:

In this episode we gave you a quick overview of the situations in which companies need capital and how they can address them. In the future episodes we will discuss each of these situations in more details and also give you a more holistic approach to growth which includes strategy, capital, execution, and impact.