EXPERT Q&A

Heading off issues before they appear is one of the keys to engaging with the SME market and you can only do that if you have scars born of experience, insists Alex Schmid of ESO Capital

The problems you won't find on the balance sheet

Q How do you define an SME?
Everyone's got their own definition. SMEs can be backed by large asset managers at the top end of the spectrum and P2P platforms at the bottom. There is a huge difference between large, sophisticated private companies with access to great resources, international capital markets mindsets, a really good grip on reporting and good resources when it comes to financial systems and so on, and, on the other side, someone who runs a travel agency using QuickBooks and doesn't have the slightest clue of what seniority means within the capital structure.

For us, the market is that smaller SME that hasn't had exposure to capital markets, sophisticated financial structuring or sponsor-type situations where the sponsor would bring those skills. We tend to be the first non-bank financial partner in a business. We work more closely with companies than our traditional credit peers, so we behave a bit like private equity even though we do debt. We are effectively their financial sponsor.

A deal becomes less our world and more the brokered world if the business has the resources to put together a well-qualified pitch with accurate information that allows people to decide from afar, instead of us having to find where the information is.

SPONSOR
ESO CAPITAL

€1.1bn
The total amount ESO Capital has invested since its inception

Q Where is the white space in the market today?
The white space is where the business says it needs money to make a certain event happen rather than saying it wants senior secured debt at 3x and then 2x mezzanine. We are driven more by the opportunity cost of not doing something versus competitive pricing for capital. That's really the issue.

Where someone has tried to get traditional sources of capital – typically from banks but occasionally from family offices – firms like us find it very hard to compete in terms of pricing. I'm a big believer that if you have a plain vanilla easy deal, it will get done by banks. However, if it's just slightly out of the ordinary – it's not business as usual or there is some kind of business transition – and the SME has not opted to go down the private equity route then we may be the only port of call.

Q What is the key to effectively balancing risk and return?
To put it bluntly, by putting huge resource against it. It doesn't come for free. There could be lots of risk that may not express itself in financial figures. You find it in the scar tissue that builds up over the years when you deal with entrepreneurs at this end of the market, which can be tough. It's not something that you can necessarily project from the balance sheet or in the financial statements. You really have to have your downside case worked out at underwriting and you have to spend a lot of time trying to foresee issues. The key is to anticipate and plan for them before they happen; then you're a good few steps ahead if problems do occur.

Q How much competition is there?
At the lower end of the market, the issue is more about the continued building of trust with capital takers. I'll give you an example. My family owned a business and it was a typical German Mittelstand business. My dad would never have dealt with firms like us because he was traditional, ran a very good business and the whole notion of debt providers that weren't banks would have been very uncomfortable for him.

The biggest thing we hope for is that financing solutions of all kinds become an everyday thought process for these small companies. So they actually think 'I've got a bank, I've got a debt fund, I've got these asset finance guys and these receivables finance guys and I can choose. I'm going to do my due diligence and I'm going into this marketplace with a positive attitude'.

Q What are the biggest challenges in the SME market?
It's hard to stay true to your colours because the investment management business incentivises you to think about fund management fees and asset management fees as the drivers to firm value. When that guides you, you automatically gravitate to doing more deals, quicker deals and putting the fund size up, which will at some point put you in a spot where your definition of SMEs will change.

If you're a good marketer you will still say you do SMEs but you have migrated from the more difficult ones to the easier ones in order to scale. Staying focused on your core market means asking what you are good at; but staying in that box becomes harder and harder.

Q How do you go about building the team you need?
It's hard on the senior side, less so on the junior side. On the senior side I have met a number of people that have worked in big shops who are really good at the technical aspects of the job. But my conviction is that if you put them into a role working with SMEs and you take away that calling card, it becomes a hard thing to do.

The biggest issue is that many people who are in the SME space now have come out of the large institutional market and I have not met many who I would say have a true entrepreneurial heart. To have the cultural awareness to know how it feels for someone to build a business is important. I'm proud of the fact that here we do have that DNA across substantially all decision-makers. We come from families that owned businesses, built our own businesses, got whacked a few times, made mistakes and we understand how owners of businesses feel over the long term.

"The biggest thing we hope for is that financing solutions of all kinds become an everyday thought process for these small companies"

Q What do you mean when you talk about process risk?
I like process risk over asset risk or business risk. I don't mind working hard to evaluate assets and conclude there is probably less actual than perceived risk, rather than take the asset risk where you go upmarket and do higher leverage ratios and so on. At the lower end you have to be careful because a small business is a very different animal to a bigger one. It has less time to restructure and react to things. It may not have the wherewithal in the economic cycle to stick around.

Q What's the key to managing assets and adding value?
The key is to have people in your team dedicated to it. We have always had a strong asset management team, with deep experience of working with companies and managing assets. We ensure they are involved from the beginning of a deal, when we start to conduct due diligence and discuss structure.

I've learned over the last couple of years that it's important for us to truly contribute value rather than just being the guys who write the cheques and monitor covenants. That's probably the eureka moment I had: to use a private-equity approach to working with our portfolio companies as a downside protection mechanism that enhances our credit risk position. Many people would, in downside markets, give up and walk away.

That's also the difference between a person with a natural entrepreneurial mindset and someone from the transaction and financing markets: the notion that 'it might be hard for two years so we'll give up', which doesn't occur to us. We work hard from the due diligence phase to anticipate problems. When they happen, we commit considerable resources to work through them. ■