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# TOWARD ADVISING SMES ON STACKED FUNDING<sup>1</sup>

Kirsten Rauwerda<sup>2</sup>, Lex van Teeffelen<sup>3</sup>, Frank Jan de Graaf<sup>4</sup>

**This paper addresses new funding issues faced by SMEs. Over a period of nine months, the authors conducted a preliminary study into the problems surrounding stacked funding faced by SMEs and their financial advisers. The study includes a short literature review, the outcomes of three round table discussions and the identification of problems and possible solutions.**

Borrowing has become a complicated process for SMEs as a result of the credit crunch and SMEs financial advisers - whether they are controllers or accountants - are currently flying blind. Banks have traditionally been the greatest source of funding for SMEs, but are now operating stricter financing control. This has seen the growth of a number of new forms of financing. Loans from banks are increasingly combined with other forms of funding; in other words, they are stacked. Alternative forms of financing such as crowdfunding, online working capital, and factoring and leasing are becoming more popular, but a combination of forms of financing is often needed to meet the total credit needs of entrepreneurs. The combination of these different types of financing is called stacked funding and this requires SMEs to operate a different policy. Some might have finance departments, but many make use of independent advisers. SMEs need financial advisers who are aware of the sources of funding available, who can recommend an effective mix, and who can set the application process in motion. This means the financial adviser, controller, or accountant needs to have extensive knowledge of financing tools. There are currently more than 40 different forms of financing and they all have their own terms and conditions.

In the following paragraph we provide an outline of the problems identified during the three round table discussions with advisers from SMEs. In order to provide an answer to these problems, we first provide an outline of the current financing structure of SMEs. Once this has been positioned within the theory, we will provide an outline for possible solutions. Once SME financing specialists succeed in standardizing their processes, it will become easier for SMEs to source funding. In this article we will focus on the financial adviser working for or hired by an SME. This can be a controller, accountant, or other financial specialist.

## **SMEs lack experience and advice**

SMEs have very little experience with new forms of financing. This was illustrated by research conducted by the Dutch Chamber of Commerce and HU University of Applied Sciences Utrecht (Van der Veen et al., 2015) at SMEs and self-employed workers without employees. Dutch Chamber of Commerce chairperson Claudia Zuiderwijk, quoted in *Het Financieele Dagblad*, 5 November 2015, says: "Entrepreneurs tend to opt for traditional

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sources of funding and, if they are unsuccessful there, they usually stop looking.” What also became clear is that entrepreneurs are often knocking on the wrong doors. They could make more frequent use of factoring, leasing, and crowdfunding but are often unfamiliar with these forms of financing (Snoei et al., 2013; Braaksma and Smit, 2014).

Up until the financial crisis, banks and accountants were the traditional advisers for SMEs and financing was organized through the local bank. The accountant was then responsible for providing accurate financial data while, in larger SMEs, the controller also had a role to play. The relationship between the bank, accountant, and the SME has since become more complex due to stricter capital demands placed on banks and new forms of financing. Financial specialists, who often have their own SMEs, are advocates for stacked funding but tend to lack the required knowledge to answer the constant influx of new questions. There is no good and efficient step-by-step plan for combining different forms of funding and this means that successful implementation of stacked funding is limited.

During three round table discussions held in Amsterdam on 13 May 2016 and 7 September 2016 and in Utrecht on 23 May 2016 and which were attended by 35 SME financial advisers, accountancy firms, grants consultancies, and financial advisers affiliated with financing parties, it became clear that SME accountants and other specialized financial advisers often had limited knowledge of new financing tools and of stacking these forms of funding. In the stacked funding process, questions arise about topics such as duty of care, collateral, maturities, and risks. Stacked funding is not simply the combination of different forms of financing. The complexity of a stacked finance mix is that different forms of financing influence one another. This creates new problems in terms of maturities, collateral, interest costs, and other related aspects. Advisers find it problematic to:

- coordinate the termination of maturities
- coordinate repayment periods
- correlate the required securities and collateral
- meeting the various financial criteria of financiers at the same time
- balancing different cost structures and forms of financing.

To explore on these issues, we first address the current financing and capital structure of SMEs.

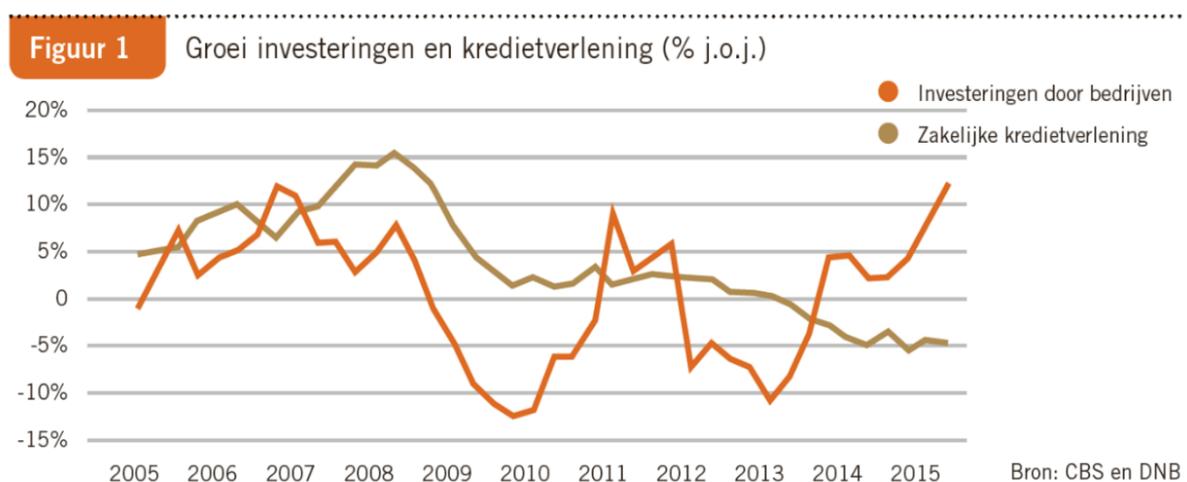
### **Financing Dutch SMEs**

SMEs have severely limited access to public financial markets for equities and corporate bonds, due to their limited need for capital and the costs for listings. Thus SME entrepreneurs are, by definition, restricted to using banks or alternative forms of financing. An important reason for the reduction in the possibilities for external financing for SMEs is the costs banks incur for funding. The costs of small loans at banks are just as high as larger amounts. It is well-known that banks work with complex and non-standardised IT and software systems, have high compliance costs, and pay relatively high salaries. They can't make sufficient margins on smaller loans. The relatively small financing needs of SMEs, which often concern amounts in the range of €50,000 to €250,000 (Van der Veen et al., 2015, Span and Verhoeven, 2015), makes them unattractive to banks. As a result, Qredits, the largest Microfund supplier in the Netherlands, was established for starter financing and

capital provision up to €250,000. Companies such as Spotcap and many crowdfunding platforms are providers of alternative fundings, although they offer loans at much higher interest rates than banks.

From a total outstanding amount of 135 billion euros on SME loans in mid-2015, banks have been reducing financing by 5% every year (DNB / CPB Netherlands Bureau for Economic Policy Analysis, 2015). This means that since economic growth set in at the end of 2013, banks have been lending seven billion euros per annum less to SMEs (DNB Dutch National Bank/CBS Netherlands Bureau for Statistics, 2015).

Figure 1: Growth y.o.y. of SME investments (orange) and provided bank capital (brown)

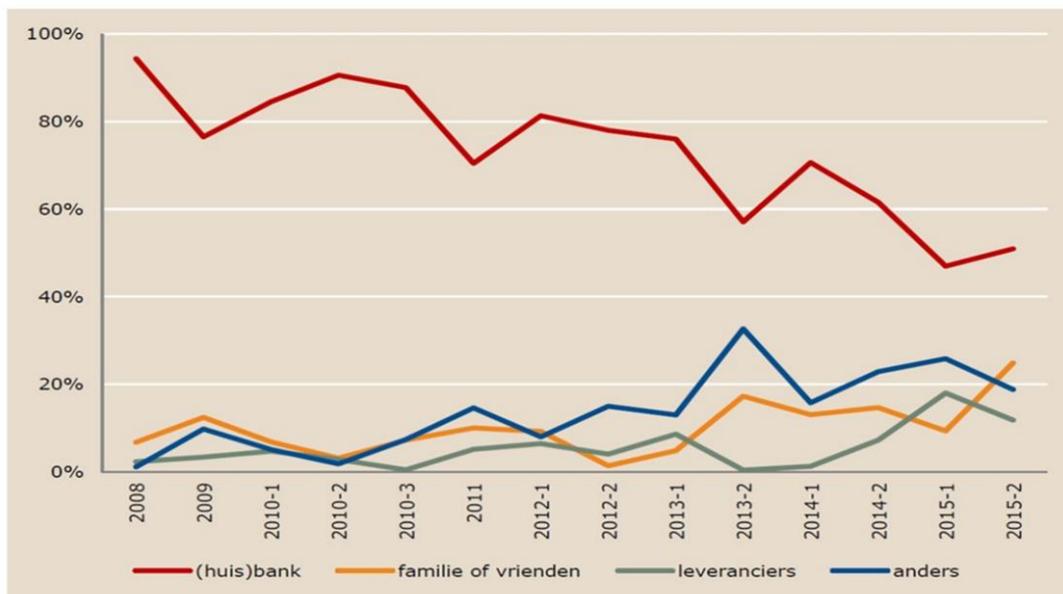


This decrease in external financing in times of economic growth is unique, especially if the demand for financing is on the rise. The Netherlands has significantly dropped in the World Bank's financing rankings and is number 71 for access to finance for SMEs (The World Bank, 2015) Within the EU, it is SMEs in the Netherlands that have the largest chance of being rejected in their application for financing (SAFE, 2014). In 2015, the ECB indicated that lending is recovering in Europe with the exception of the Netherlands where the criteria for SMEs is becoming increasingly strict.

### The capital structure of Dutch SMEs

The pecking order theory suggests that if businesses want to reduce information and financing costs, they should finance their investments with retained profits (cash). If this is not possible, then it should be financed with loans, and if that is not possible either, then by issuing shares (Myers & Majluf, 1984). The smaller the business, the harder any of these three options becomes, as cash flow is still limited and there is little collateral to secure loans. Issuing shares is also difficult, as SMEs are often unable to issue shares on the public capital market or through private placements with institutional investors. This makes them more dependent on their own money or that of family, friends, and banks. This is clearly illustrated in the following diagram which shows that money from family, friends, supplier credit, and other sources now makes up 50% of SME financing (Span et al., 2015).

Figure 2: Use of different types of SME financing 2008-2015  
 Lemma of colours: **banks**, **family/friends**, **supplier credit**, **other forms**



Bron: Panteia o.b.v. de Financieringsmonitor, 2015. Bij beantwoording van de vraag waren meerdere antwoorden mogelijk, percentages kunnen dus optellen tot boven de 100%.

In response to the restricted financing possibilities, several different commercial and non-commercial parties have created virtual platforms such as Fundwijzer, Fundipal, the Nationale Financieringswijzer, and FactoringVergelijken. These platforms range from describing a few forms of financing to providing concrete advice and consultancy based on algorithms for a select number of forms of financing. In addition to these virtual platforms, an increasing number of service providers - who are often small firms themselves - are specializing in one type of credit. This includes crowdfunding platforms such as Colin Crowdfund, Kapitaal op Maat, Funding Circle, and online working capital provider Spotcap. There are also trade finance companies that are introducing new forms of online factoring such as Pro Quidity, Trefi and FactuurVoldaan. These financial parties also provide forms of financial advice, but seem to be just one switch in the full chain of lending and credit management processes.

Recently Dutch banks as Rabobank, ABN Amro and ING also actively entered this new sphere with *new financing* and *retail banking*. Through regional sessions and digital portals clients were able to contact different financiers and investors. Acting as intermediaries or *matchmakers*, these banks have found a way to embrace their changing role in this process. As a result of the large offer and complexity of the topic, accountants and financial advisers are often unable to make considered decisions when determining a combination of forms of financing. The figures on the next page contain the different forms of financing that are available to SMEs divided into equity and debt.

Figure 3: Different forms of SME equity financing (partially based on Baker Tilly Berk, 2016)

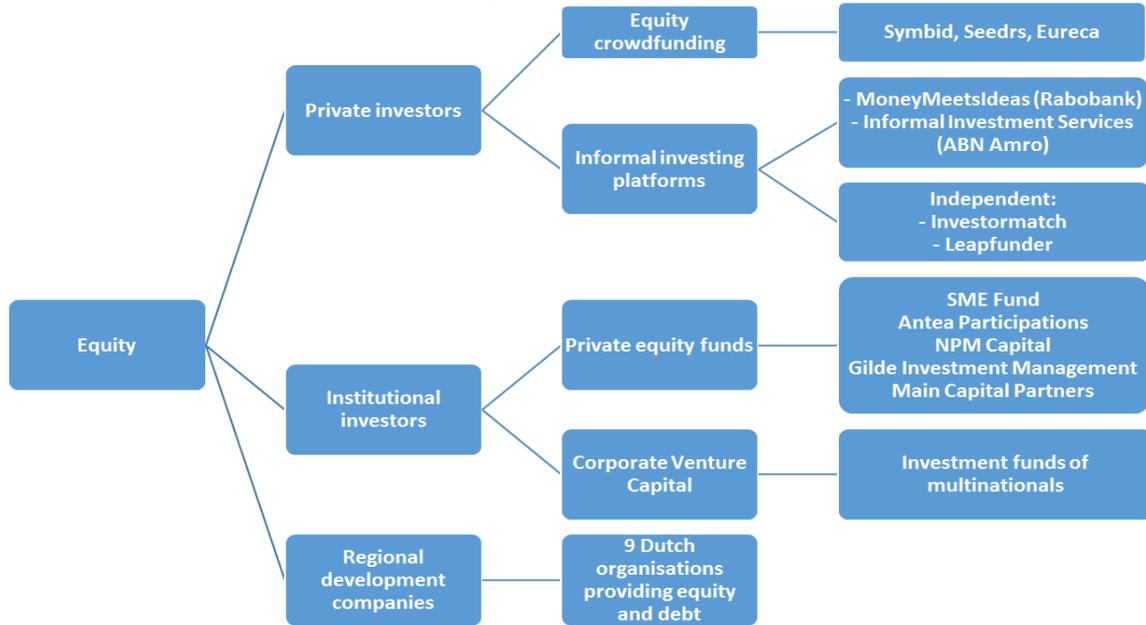
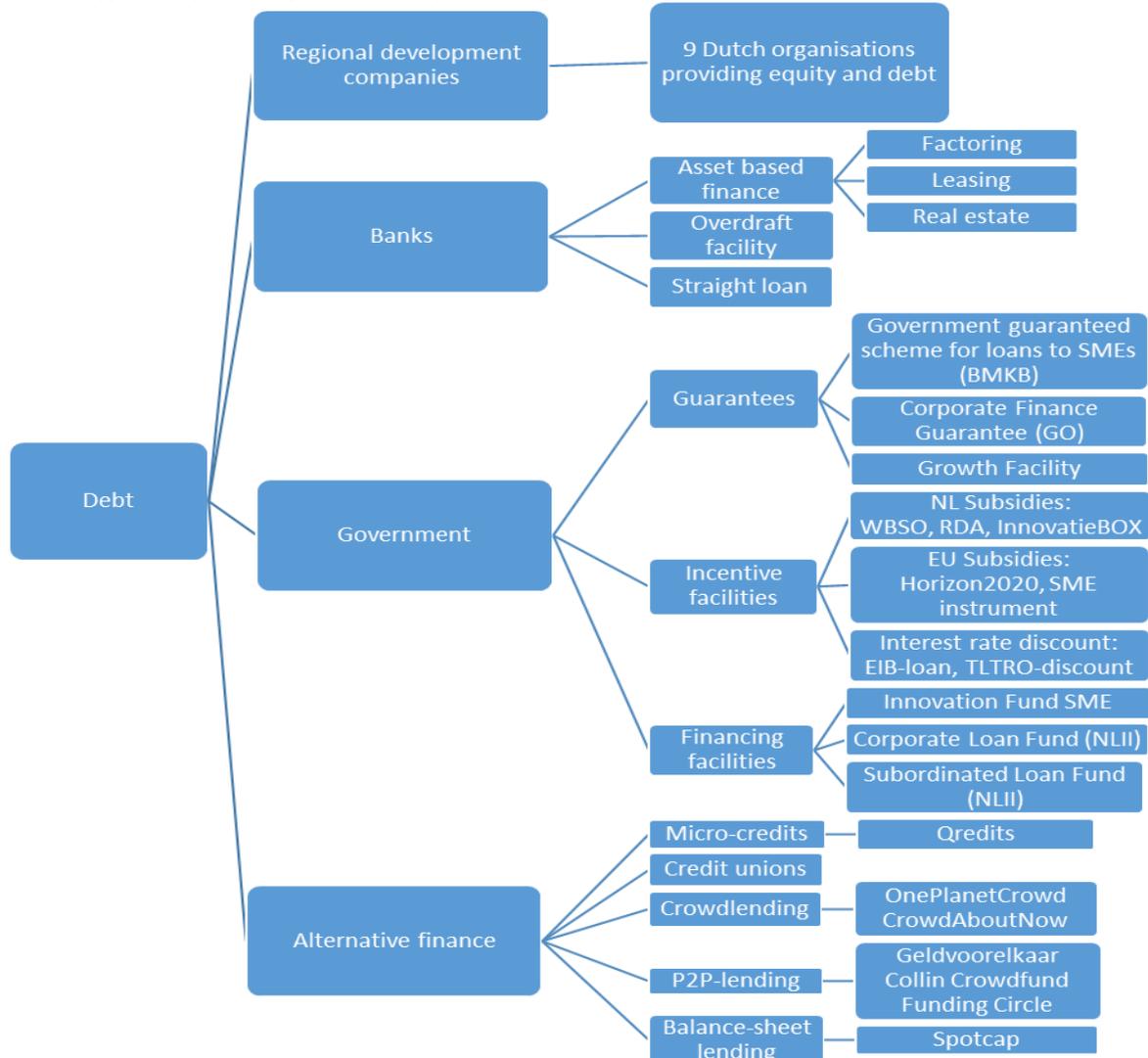


Figure 4: Different forms of SME debt financing (partially based on Baker Tilly Berk, 2016)



## Stacked funding: Towards a standardisation of the process

The information above demonstrates that stacked funding requires a process that reduces the complexity, that is cost-efficient for the adviser and financial departments, and that brings together the available offers. The financial adviser require knowledge of combining funding possibilities and a method or step-by-step plan for arranging financing. Figure 5 below presents a step-by-step plan that can resolve the gap in the knowledge and complexities of conduct and the steps that the financial advisers would need to take.

*Figure 5: Possible step-by-step plan for stacked funding for SMEs*



To realise structured advice for stacked funding it is important to first identify the issues experienced when providing advice about stacked forms of financing for SMEs. In addition, increased transparency and coordination between different financiers contributes is needed. The complications that might arise when following this step-by-step plan are described below.

The first step - the request protocol with the objective of obtaining financing - is impeded by problems regarding knowledge as well as the conduct of SME financial advisers. First of all, accountants and advisers do not possess the required knowledge of all the different forms of financing and, secondly, they have insufficient understanding of how those different financing tools affect one another. Thirdly, they have too little cognizance of which financing tools are successful in specific situations and which are not. This knowledge gap also affects the conduct of the adviser. Due to this lack of knowledge, advisers have a tendency towards a restricted number of financing forms based on habit rather than informed decisions based on the rational consideration of all possibilities. Lack of time and cost considerations also play a role here.

The second step that the accountant or other type of adviser would need to take, is to create a short business analysis for the presentation of the financing structure to possible financiers. However, this is also hampered by several issues. The specialist does not have a complete overview of all the demands that financiers might place on stacked funding proposals and does not know how these financiers handle stacked funding proposals in their processes. This makes it difficult for the specialist to determine the best method of presenting the SME finance structure to financiers to give them a positive impression of the financing application.

The third step is to decide on the optimal finance mix. A matrix should be developed that specifies the business situation and appropriate forms of credits. The issue here is that a large part of SME funding is currently processed digitally with a significant number of

established lines and demands. The online help centres are designed to deal with single funding and not stacked funding. Financial specialists at SMEs are unsure of how to deal with this. It is also often unclear what should be mentioned in a contract for one financing instrument about the other forms of funding used. Lastly, it is also often unclear how they should express the choice for a stacked funding mix in such a way that it is attractive for potential financiers.

The fourth step - checking the assessment and knock-out criteria of the different financiers - contains the greatest problem faced by advisers in this step-by-step plan. This is because it is often unclear for the adviser how the application of different financing tools in a finance mix for SMEs impacts the assessment and knock-out criteria of financiers. The financial specialist does not know if the utilization of multiple financing tools results in different criteria being used by financiers in terms of security, repayment options, maturities, and other requirements.

The last step in the step-by-step plan - providing advice to an SME about an appropriate finance mix - is also subject to issues similar to those encountered in the fourth step. It is unclear for the adviser how the different financing tools impact one another. This results in the adviser not having a clear understanding of the points about which agreements need to be reached between the SME and the different financiers. The adviser also lacks understanding of what needs to be reported about stacked funding during the maturity of the finance mix and the role that the adviser plays in this. Finally the question arises about when the adviser needs to be proactive - whether it is about financial management or cash management - when something changes in the situation of the SME and the optimal finance mix changes as a result.

## **Conclusion**

It is clear that stacked funding is an attractive option for SMEs, as it expands the financing options in comparison to the traditional bank loans that SMEs would have taken out before the advent of the credit crunch. However, financial advisers have insufficient knowledge of stacked funding which means that stacked funding is not implemented successfully at SMEs. The financial adviser requires knowledge of combining funding possibilities and a method for arranging financing for their SME clients. The step-by-step plan proposed in this article can help the adviser. However, this requires further explication of the steps that are to be taken and research into the gaps of knowledge and complexities of conduct. To address this need, the authors have started a two-year research project in the spring of 2017, together with the 18 parties advising on and providing for different types of finance.

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