TDC TOSCA DEBT CAPITAL

TDC Insights:

UK Regional SME Lending

The Regional Contribution

Home to almost two thirds of the UK's 5.7 million private sector businesses and responsible for over 60% of economic output, the regional economy and the SMEs operating within it are a significant driver of UK prosperity[1]. The North West has demonstrated particular impetus over recent years, with the highest business birth rate of any UK region in 2017 and an annual growth rate of 3.8%[2].

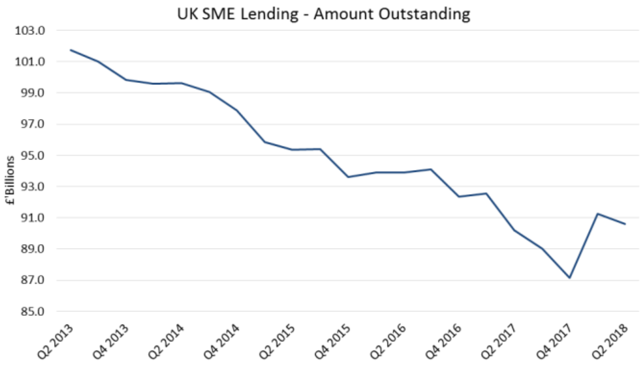
From an SME perspective, the regions continue to refute the perception that aspirational businesses need to be based in London and the South East, with almost half of the Sunday Times Fast Track 100 companies based outside of this area. With policymakers increasingly aware of the need to address imbalances within the UK economy, it is vital that there exists the financial firepower and funding to support growing, ambitious businesses right across the country.

Since its launch in 2015, Tosca Debt Capital ('TDC') has seen a raft of these dynamic regional businesses first hand, having invested over £200m of capital across over 20 transactions through the funding of positive transactional events. As a Northern based organisation with a focus on regional businesses, TDC has provided a differentiated funding offering at a time when the lending options available to SMEs can be limited.

The SME Finance Gap

Despite the prevalence of regional SMEs, appetite for lending into this space from traditional sources has never truly recovered from the Global Financial Crisis, which saw the well documented retrenchment of bank lending as organisations undertook a "flight to headquarters", driven by the need to address their balance sheets.

Compounded by greater capital requirements and increasingly complex regulatory regimes, there remains a "liability of distance" when its comes to the ability of regional SMEs to access bank and other sources of funding. With innovative companies in so called "peripheral" regions more distant from decision makers, lending becomes less based on relationships and local discretion, instead skewed in favour of more automated and process driven credit appraisal. The solution to this issue would appear to be a rebalancing of financial infrastructure away from the London-centric status quo.



Source: SME Lending Data: UK Finance

"Regions with a richer and more varied financial ecology, including locally headquartered financial institutions and a more diverse array of alternative funding sources, may be less prone to restrictions in accessing credit [3]."

TDC has demonstrated that there is significant appetite from investors to support regional corporates, having attracted over £320m of institutional capital with the specific purpose of, although not limited to, investing in SMEs in the North, Midlands and wider regions.

[1] BEIS: Business Population Estimates for the UK and Regions 2018
[2] ONS: Business Demography, UK: 2017
[3] Lee, Neil and Brown, Ross (2017) Innovation, SMEs and the liability of distance: the demand and supply of bank funding in peripheral UK regions. Journal of Economic Geography

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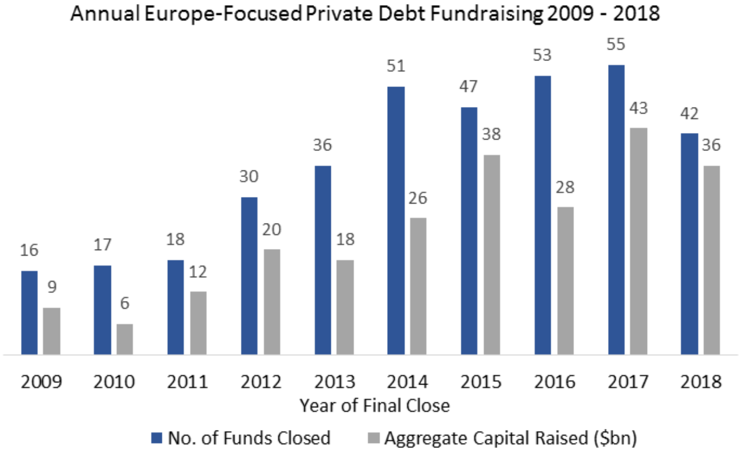

Source: 2019 Preqin Global Private Debt Report

The Rise of Private Credit Funds

Partly in response to the retrenchment of bank lending, the increase in European focused direct lending funds over the last decade has been prodigious, both in terms of the core number of funds and amount of capital raised. A consequence of this influx of capital has been a trend of ever larger transaction investment size as funds look to differentiate through hold size in an increasingly competitive market.

This can often render regional markets too inefficient for these funds to deploy capital into, with the typical financing quantum being sub-threshold and business too geographically remote.

The race to the top in terms of investment hold size is exacerbated by the higher search costs associated with identifying and appraising lending opportunities in the regions, especially those without private equity backing. This means that there remains a natural propensity for direct lenders and other financial investors to focus on the more traditional corporate communities in which they are often based, with the result that capital is often allocated more readily to businesses in London and the South East.

"Banks, as well as investors active in the leverage loans and high-yield bond markers are typically not as active in the SME end of the market."
Preqin, 2019

The result of these trends is that these larger corporates have access to a broader array of funding sources than ever, from syndicated bank facilities through to these internationally diversified direct lenders, as well as the public bond markets.

SME Funding Options

Despite Mid and Upper Mid-Market corporates being well served, the availability of funding options and the pool of capital providers can quickly drop off when the funding requirement or size of enterprise falls below a critical threshold – typically less than £100m of revenue and/or £10m of EBITDA. This quandary is likely to be exacerbated by recent private debt fundraising trends that saw more capital committed to the largest fund managers in 2018 than ever before[4]. With vast amounts of capital to deploy, these so called "mega lenders" have a natural focus on transactions where the financing requirement meets their sweet spot of £25m+ with a "bigger is better" approach to lending.

The risk is that SME regional borrowers become orphaned; stuck between lower lending appetite from mainstream lenders, and without access to the wider array of funding sources available to larger corporates. TDC have found this especially to be the case where corporates are seeking funding packages of between £10m - £25m. Key to supporting the SME market and broader UK regional economy is a range of funding options from capital providers that are accessible locally and have a comprehensive understanding of the marketplace that they serve, with the contacts and business networks to match.

"A strong relationship and good communication between lender and borrower can facilitate more constructive long-term success."
Preqin, 2019

The process of choosing a funding partner is a significant decision for any business, and an ability to reference an organisation with local advisors and other corporates is naturally an important part of the selection process for any potential borrower. In TDC's experience, being based in the North and therefore geographically distinct provides a real differentiator in terms of quickly establishing strong communication and relationship between borrower and lender.

Short lines of communication and an ability to respond decisively have proved to be an important distinction for TDC in providing certainty of decision making when appraising a funding requirement. All portfolio monitoring continues through the same regionally based team after initial transaction completion, ensuring continuity from the original investment process in terms of relationships and business understanding.

[4] Preqin Global Private Debt Report, 2019

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Supporting the Regional Business Community

As the UK's only regionally based direct lender, TDC's ethos extends beyond purely funding the growth of SME corporates without the shareholder dilution of an equity investment. Accumulated through years of experience acting in the local business community, the TDC team has extensive contacts and networks across the market that can ultimately be of benefit to investee companies.

Associated with this concept of providing more than capital is the credibility, guidance and disciplines that TDC as an institutional investor brings to investee companies. This can consist of corporate governance recommendations, financial reporting improvements, and 'best-in-class' behaviours from across the portfolio.

The benefits of a supportive funding partner has been particularly evident in TDC's realised investments to date, with investee companies having achieved step-change growth. This growth has resulted in these businesses subsequently attracting investment and support from a range of private equity, international corporates and 'big 4' banks as they continue on their growth trajectory.

Case Study

de Poel

First Lien Facility

Invested: September 2016
Realised: January 2018

- Based in Knutsford, Cheshire, de Poel Group is the UK's leading independent and vendor neutral expert in non-permanent staffing solutions
- TDC provided a first lien facility to allow the existing principal shareholder to realise value whilst bringing the Management Team into the equity structure via a vendor-supported MBO
- TDC backed the business as it entered a transformational phase of growth, with a capital structure that incentivised the executive management team
- In January 2018, the group was sold to Geometric Results Inc. (GRI), a portfolio company of Bain Capital Private Equity in a deal that realised c.60% growth in equity value over a 16 month investment tenure
- Key factors that TDC brought to the transaction:
  - Local decision making and empowerment providing speed and certainty of execution
  - Relationship-led team of experienced investment professionals
  - Commercial approach to inter-creditor drafting and negotiations with the working capital provider

"The TDC team worked closely with management and shareholders to develop a funding solution that allowed management to participate in the equity as they delivered the future growth strategy and at the same time crystallising value for the principal shareholder. Their flexibility and local presence allowed us to complete a complex deal in a timely manner."
John Walker,
Executive Chairman, de Poel

BVCA Member Firm

insider DEALMAKERS AWARDS 2018 WINNER

THE LLOYDS BANK NATIONAL BUSINESS AWARDS UK 2018

Signatory of: PRI Principles for Responsible Investment

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