Growth Strategies

for

Exporting SME’s

A Financial Perspective

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Dublin March 14th, 2012

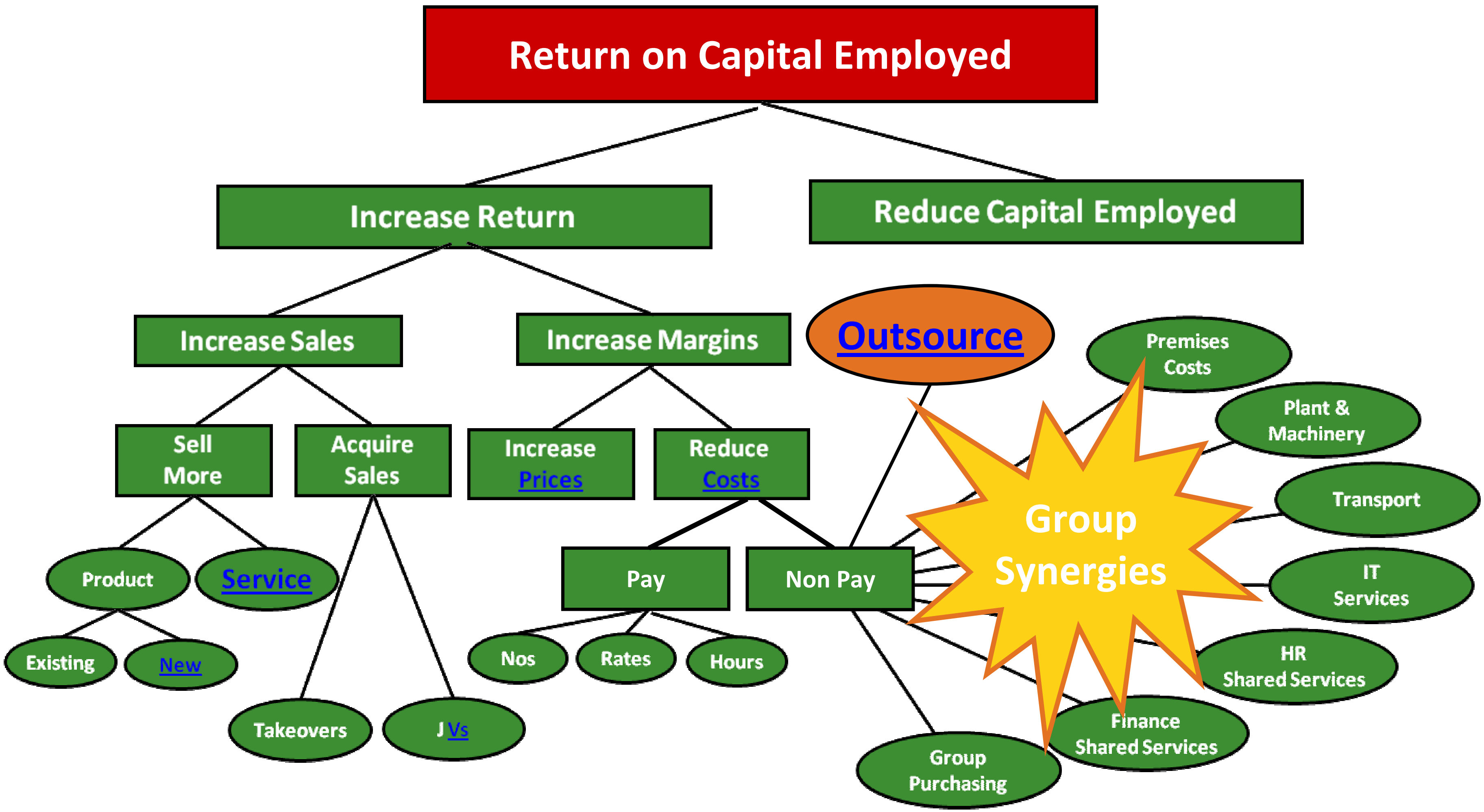
Growth ?

- Why are we in Business?
  - To make money!

- One way of making more money is to grow the business
  - But only if its profitable , sustainable growth

- Growth for Growth's sake should never be an objective

- Ultimate aim is to grow the profit/profitability of the business
  - This converts to Maximising Return on Capital Employed
  - And there are only two ways in which you can do this


Return on Capital Employed
Increase Return
Reduce Capital Employed
Increase Sales
Increase Margins
Outsource
Premises Costs
Plant & Machinery
Transport
IT Services
HR Shared Services
Finance Shared Services
Group Purchasing
Group Synergies
Sell More
Acquire Sales
Increase Prices
Reduce Costs
Pay
Non Pay
Product
Service
Existing
New
Takeovers
J Vs
Nos
Rates
Hours

Sell More Product

- Existing Products
  - Can be difficult to grow organically
  - Innovative ways to grow volume
    - Change packaging size
    - Learn from FMCG sector

- New products
  - Most new products are minor variations on old products
    - Learn from FMCG sector again[Slide 3]

Service vs Product

- *'The Servitisation of the Product Industry'*
- Slide 6 Rolls-Royce
- Huge advantages to service rather than product
  - Only cost is labour cost of provision
  - No capital investment
  - No or reduced working capital
    - No inventory
    - Sometimes payment in advance
  - Usually renewable every year
  - 16 to 1 usage rule!!!Slide 3

TotalCare®

TotalCare is a flexible approach to achieving an engine support service

TotalCare® is a flexible approach to achieving an engine support service that has the correct fit and scope of services to meet the operator's specific needs.

It provides a single source solution ensuring "peace of mind" for the lifetime of the engine,
from the time the engine is delivered to the customer until the engine goes out of service. This is achieved through our sharing of knowledge, expertise and experience. [Slide 5]

Growing by Acquisition

- Much easier to grow by acquisition than organically
  - 'Horizontal Integration' can give immediate access to
    - volume increases of similar products/services
    - to similar or even the same customers
  - ' Vertical Integration' can open up
    - new but familiar markets and protect routes to market
    - or give greater control over the supply chain
- But beware the pitfalls
  - In excess of 50% of acquisitions fail to deliver expected value
  - On average the share price of acquirers goes down by between 1 and 3%
  - On average acquirers returns are 5% lower than peers for at least 5 years after acquisition!

Key Success Factor

- All takeovers and mergers need to generate ***synergies*** to create shareholder value
- Synergy means   **2 + 2 = 5**
- Must be identified before doing the deal
  - If not then the pricing is a ‘shot in the dark’
- Can only be delivered with much effort and pain to both parties
- First 90 days essential!
  - change is expected straight away
  - after 90 days troops will have regrouped and built up defences

When is Value Created

- Logically value is only created for the Acquirer when the value received is greater than the price paid

- Assuming that the market Value of the target is the same as its stand alone value this can be further defined as

Value Created = Value of Improvements–Premium Paid

- This requires delivery of the benefits of Synergy

Premiums

- On average premiums paid are around 30%
- The premium appears on the balance sheet as Goodwill in Intangible Assets
- If you look at the balance sheets of companies that have been active in the acquisitions market you'll find that in many cases Goodwill is the single largest asset they have
- This brings great pressure to deliver the synergies to justify the prices paid
- Look at Diageo

ENTERPRISE IRELAND

Finance 4 Growth

DIAGEO

Consolidated Balance Sheet

(At 30th June)

				2010 £million's	2009 £million's
Fixed Assets					
	Tangible Assets			2404	2,326
	Intangible Assets			6726	6,215
	Other Fixed Assets			3372	3,410
Total Fixed Assets				**12,502**	**11,951**
Current Assets					
	Cash & Bank Balances			1551	1,012
	Debtors (Receivables)			1495	1,568
	Stock (Inventory)			3281	3,078
	Other Current Assets			625	409
Total Current Assets				**6,952**	**6,067**
Total Assets				**19,454**	**18,018**
Current Liabilities					
	Short term Debt			773	1,110
	Creditors (Payables)			843	655
	Current Taxes			391	532
	Other Current liabilities			1937	1,689
Total Current Liabilities				**3,944**	**3,986**
Term Liabilities					
	Term Loans			8332	7,784
	Provisions for Liabilities & Charges			318	314
	Deferred Tax			744	606
	Retirement & Other Obligations			1254	1,424
	Trade & Other Payables			76	30
Total Term Liabilities				**10,724**	**10,158**
Shareholders' Funds					
547	Share Capital	2803		797	797
	Share Premium			1342	1,342
	Retained Profits			-1377	-2,200
	Other Reserves			3245	3,282
	Minority Interests			779	715
	Treasury Shares				
	FX Translation Reserve				
Total Shareholders Funds				**4,786**	**3,936**
			C/E	15,510	14,094
Total Liabilities & Shareholders' Funds				**19,454**	**18,080**

Diageo Ratios

Profitability		
Gross Profit	58.09	58.19
Operating Profit	26.32	25.97
PreTax Profit	22.89	21.37
Net Profit	18.02	18.30
Return on Capital Employed	16.60	17.16
Return on Total Assets	9.06	9.46
Return on Equity	36.82	43.29
Net Asset Turnover	0.63	0.66
Liquidity		
Current Ratio	1.76	1.52
Quick Asset Ratio	0.93	0.75
Collection Period	56	61
Inventory Period	292	289
Payments Period	75	61
Leverage		
Overall	3.06	3.59
Bank	1.90	2.26
Long Term Debt	1.74	1.98
Profit Cover for Interest	2.75	2.86
Price Earnings Ratio		13.68

Top Premiums over last 10 years

Pricey Deals

The 10 largest premiums paid for a U.S. company during the past decade.

Announced	Deal	Value in billions	Premium pre bid 1-week
1/12/09	Abbott Laboratories/Advanced Medical Optics	$2.97	218.8%
11/7/08	AT&T/Centennial Communications	2.83	138.8
12/1/08	J&J/Mentor Corp	1.12	105.0
5/18/07	Microsoft/aQuantive	5.92	91.4
7/22/09	Bristol-Myers Squibb/Medarex	2.37	83.5
6/16/05	Pfizer/Vicuron Pharmaceuticals	1.78	78.6
4/4/11	Texas Instruments/National Semiconductor	6.49	74.3
8/13/10	Seawell/Allis-Chalmers Energy	1.09	66.8
12/6/01	Millennium Pharmaceuticals/COR Therapeutics	1.25	64.0
2/22/01	Siemens/Efficient Networks	1.39	54.9

Source: Dealogic

Value Creation vs Premium Paid

Premium paid as % of stand-alone value

	10	20	30	40	50
0	10	20	30	40	50
10	0	9	18	27	36
20	-8	0	8	17	25
30	-15	-8	0	8	15

Value of performance improvements as % of stand-alone value

Reasons for failure

- Wrong strategy
- Too high a price
- Misjudged the market
- Did not understand the business model of target
- Over-estimated the value of synergies
- Poor negotiation
- Bad planning
- Unexpected event (e.g. interest rate up)
- Personnel walk-out – loss of key skills in acquiree
- Culture clash
- Invalid assumption (e.g. divestment of unwanted activities that cannot in fact be sold)
- Time bomb not identified – legal, environmental…
- Cash injection underestimated
- Failure to recognise importance of first 90 Days

Increasing Prices

- Difficult in a competitive market
  - Find innovative ways of doing it
  - Learn from the FMCG sector
    - Change packaging
    - Change volumes
    - Change product mix
- Go green/organic and get a premium
  - Shell
  - Environmentally friendly petrol/diesal Slide 3

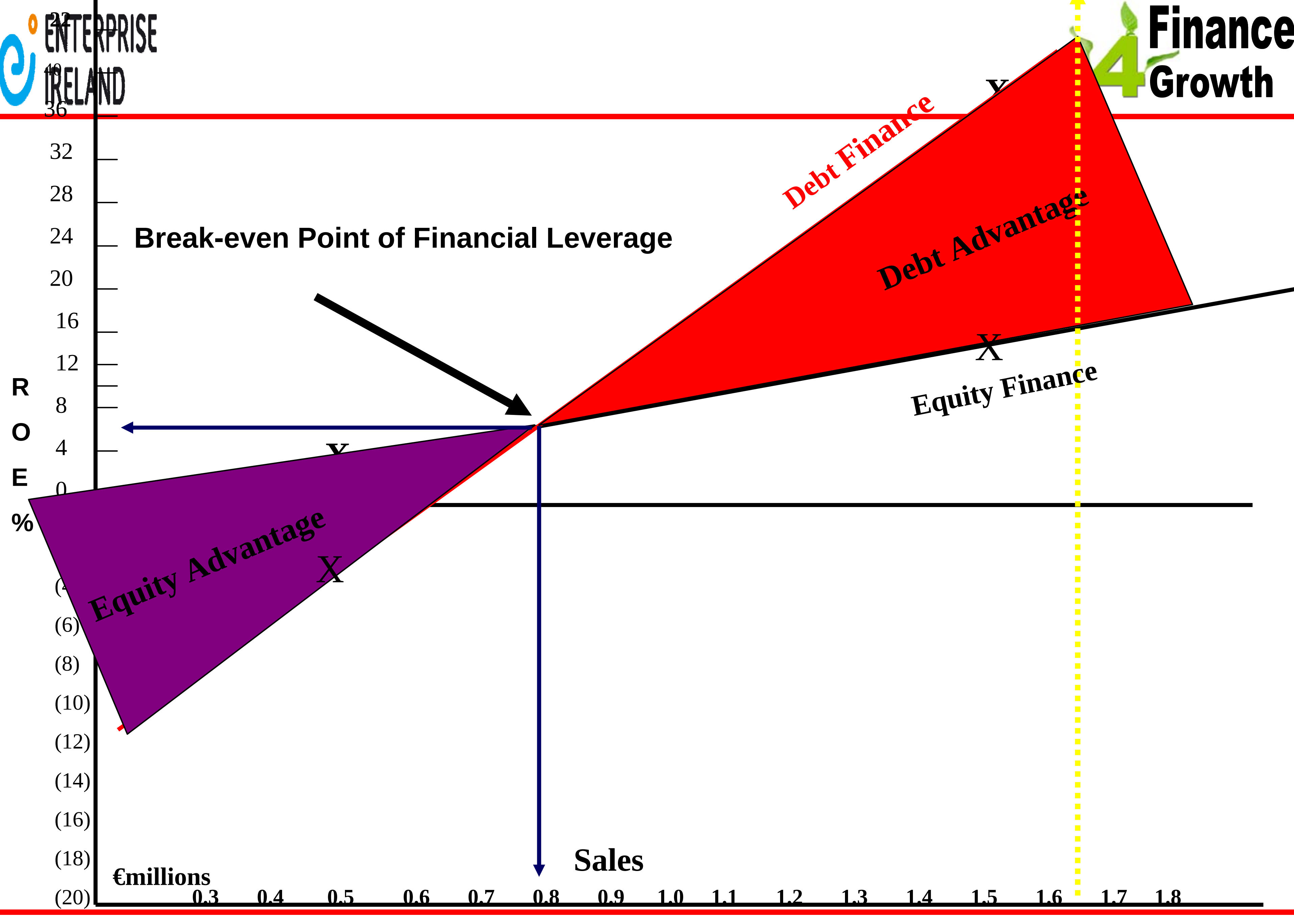
Bottom Line Impact of Profitability vs. Growth

	Now	*5% Cost Savings* *	*30% Revenue Increase*
Sales Rev.	100	100	*130*
COGS	60	*57*	*78*
Margin	40	43	52
VC	30	30	*39*
FC	8	8	8
Op. Inc.	**2**	**5**	**5**
Operating margin (%)	*2%*	*5%*	*4%*

Conclusion: a 5% Cost Savings Improvements Internal focus has the same bottom-line impact as a 30% Revenue Increasing external focus ***Slide 3***

The Right Capital Structure for Growth

- Capital Structure has a major impact of the return to equity investors/owners
  - Getting it right can help generate very attractive returns
  - Getting it wrong is one of the most common causes of business failure!
- Its important to get it right for every stage of development …. Not just start up


Break-even Point of Financial Leverage
Debt Finance
Debt Advantage
Equity Finance
Equity Advantage
X
X
X
X
R
O
E
%
36
32
28
24
20
16
12
8
4
0
(6)
(8)
(10)
(12)
(14)
(16)
(18)
(20)
0
Sales
€millions
0.3
0.4
0.5
0.6
0.7
0.8
0.9
1.0
1.1
1.2
1.3
1.4
1.5
1.6
1.7
1.8

Trade Off Between Business & Financial Risk

- Capital structure should reflect reasonable balance between Business & Financial risk
  – If Business Risk is high then the business will not be able to take on high Financial Risk
  – If Business Risk is low then the Business can afford to take higher Financial Risk
- The irony is that low business risk businesses probably don't need debt but banks are constantly trying to lend to them !
- High business risk businesses usually need lots of debt but banks are very reluctant to lend to them!

Business Risk

- Normal day to day business risks
  - Management
  - Marketing
  - Competition
  - Production
  - Industrial relations
- Economic factors
- **Manifested in volatility and vulnerability of earnings**
- High Business Risk
  - Wide variety of things that can go wrong
  - One big risk factor that could be very damaging
- Low Business Risk
  - Very few things can go wrong
  - Limited impact if they do
  - Stable market
- Lets look at Suretech Solutions

Suretech Solutions

Balance Sheets at 31/12

€000's				
Year	**2011**		**2010**	
Fixed Assets				
Tangible				
Equipment	381	381	406	406
Current Assets				
Cash	0		109	
Trade Receivables	4,172		3,547	
Accrued Income	2,464		2,156	
Other Receivables	636	7,272	674	6,486
		----------		----------
Total Assets		**7,654**		**6,892**
Current Liabilities				
Overdraft	276		351	
Trade Creditors	153		128	
Other Creditors				
Provisions & Accruals	1,679		1,427	
Taxation	917	**3,025**	539	**2,445**
Term Liabilities				
Bank Loans	2,800		2,600	
Shareholder Loans	100		150	
Provisions	0	**2,900**	379	**3,129**
Shareholders' Funds				
Share Capital	50		50	
Retained Earnings	1,679		1,268	
Minority Interests		**1,729**		**1,318**
		---------		---------
		7,654		**6,892**
	C/E	**4,629**		**4,447**

Suretech Solutions

Income Statements for years ended 31/12

€000's			
Year		**2011**	**2010**
Sales		**25,600**	**21,638**
less			
Cost of Sales	***(a)***	20,081	16,988
Gross Profit		**5,519**	**4,650**
S G & A Expenses	***(b)***	4,969	4,235
Operating Profit		**550**	**415**
Interest Charges		128	100
Profit before Tax		**423**	**316**
Taxation		11	13
Profit after Tax		**412**	**303**

(a)		
Cost of Sales:		
Permanent Staff	*7,291*	*6,182*
Contract Staff	*12,278*	*10,373*
Chargeable Expenses	*512*	*433*
Total	***20,081***	***16,988***
(b)		
S, G & A Expenses		
Employee Costs	*3,453*	*2,919*
Travel & subsistence	*451*	*381*
Depreciation	*128*	*121*
Admin Expenses	*937*	*814*
Total	***4,969***	***4,235***

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Suretech Solutions

Ratios

Finance 4 Growth

	Year 2011			2010	
Profitability					
Gross Profit	21.56	%		21.49	
Operating Profit	2.15	%		1.92	
PreTax Profit	1.65	%		1.46	
Net Profit	1.61	%		1.40	
Return on Capital Employed	11.89		11.89	9.34	
Return on Total Assets	5.38	%		4.40	
Return on Equity	23.80	%		23.01	
Net Asset Turnover	5.53			4.87	
Liquidity					
Current Ratio	2.40			2.65	
Quick Asset Ratio	2.19			2.38	
Collection Period	59		***95***	60	***96***
Payments Period	3		***33***	3	***33***
Working Capital Ratio	25%		19%	26%	19%
Leverage					
Overall	3.43			4.23	
Bank	1.78			2.24	
Profit Cover for Interest	4.31			4.17	

Business Risk

- Gross Margin >>>>>>>>>>> OK
- Operating Margin>>>>>> ???
- Net Margin >>>>>>>>> Too low

- ***Suggests need for 'Low' Financi Risk***

- But Overall Leverage High
- Bank Leverage high but improving
- Good Profit Cover for InterestSlide 3

Implications of Inappropriate Capital Structure

Too much Debt relative to Equity

or

Correct mix of Debt/Equity but too little overall funds

=

Overtrading

Causes of Overtrading

- Initial Undercapitalisation
  - Most common cause
- Depletion of Working Capital
  - Over-investment in fixed assets
  - Premature repayment of term debt
  - Diversion of cash to non trading activities
  - Profit shortfalls
  - Excessive profit distribution
- Over-Expansion
  - Gives it its name

Consequences of Overtrading

- Liquidity Problems
  - Difficulty meeting day to day payments
  - Often perceived as normal but it shouldn't be

- Decline in Profitability and Efficiency
  - Diversion of management time to non productive activities
  - Increased interest charges
  - Inability to buy in bulk
  - Loss of cash and early payment discounts
  - Inability to shop for best price and quality
  - Obsolescence of plant & machinery
    - > increased maintenance
    - > technologically uncompetitive
  - Loss making sales

While the competitor with the well balanced Capital Structure gets on with making and selling product at a profit

- **Receiver/Liquidator**

Remedies for Overtrading

- Increase Capital

  - Extra equity >>>>>> more cash >>>>>>greater debt capacity

- Increase Margins

  - Difficult because of impact of liquidity problems on profitability

- Reduce Investment in Fixed Assets

  - Lease and rent
  - Sale & leaseback etc

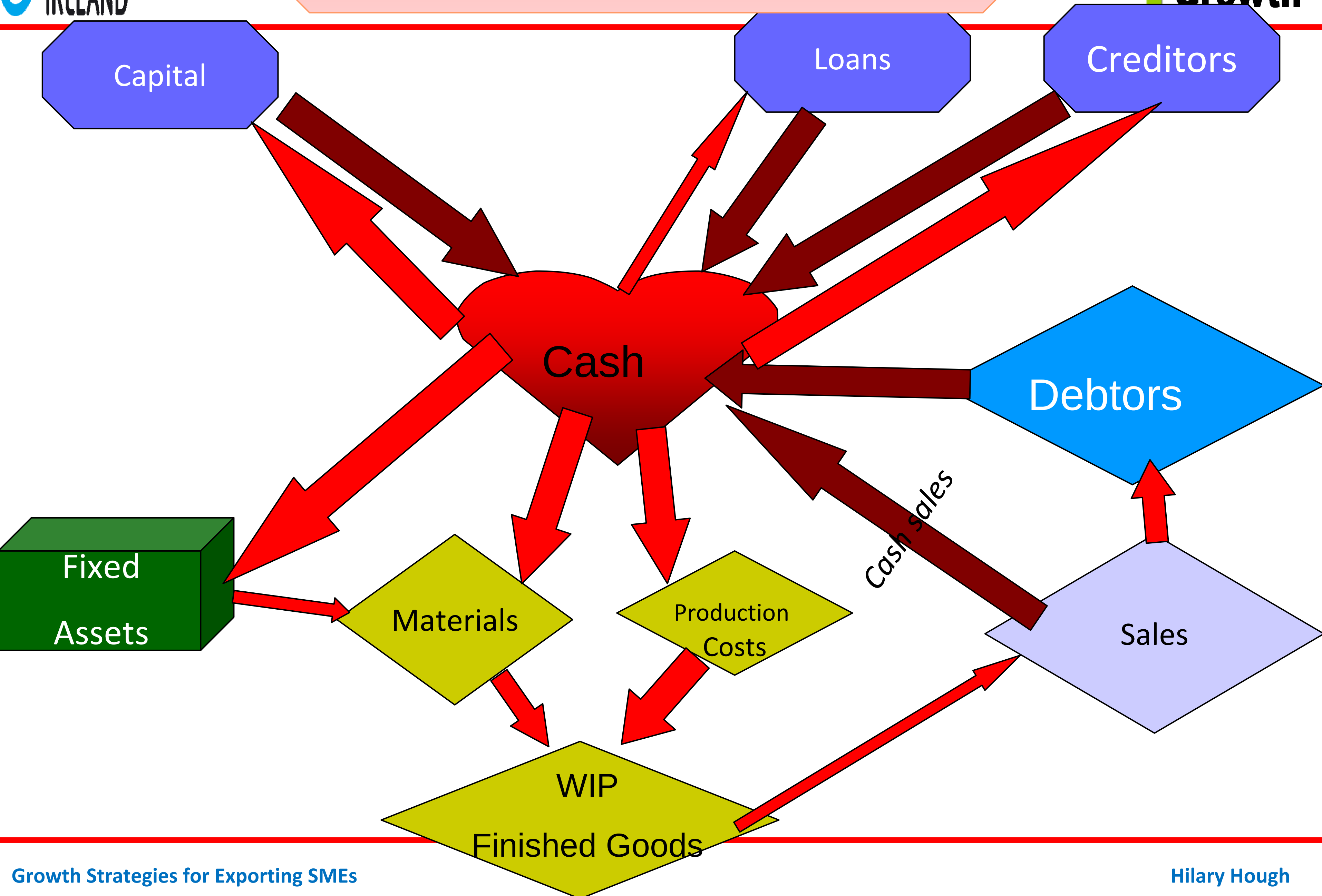
- Improve Working Capital Control

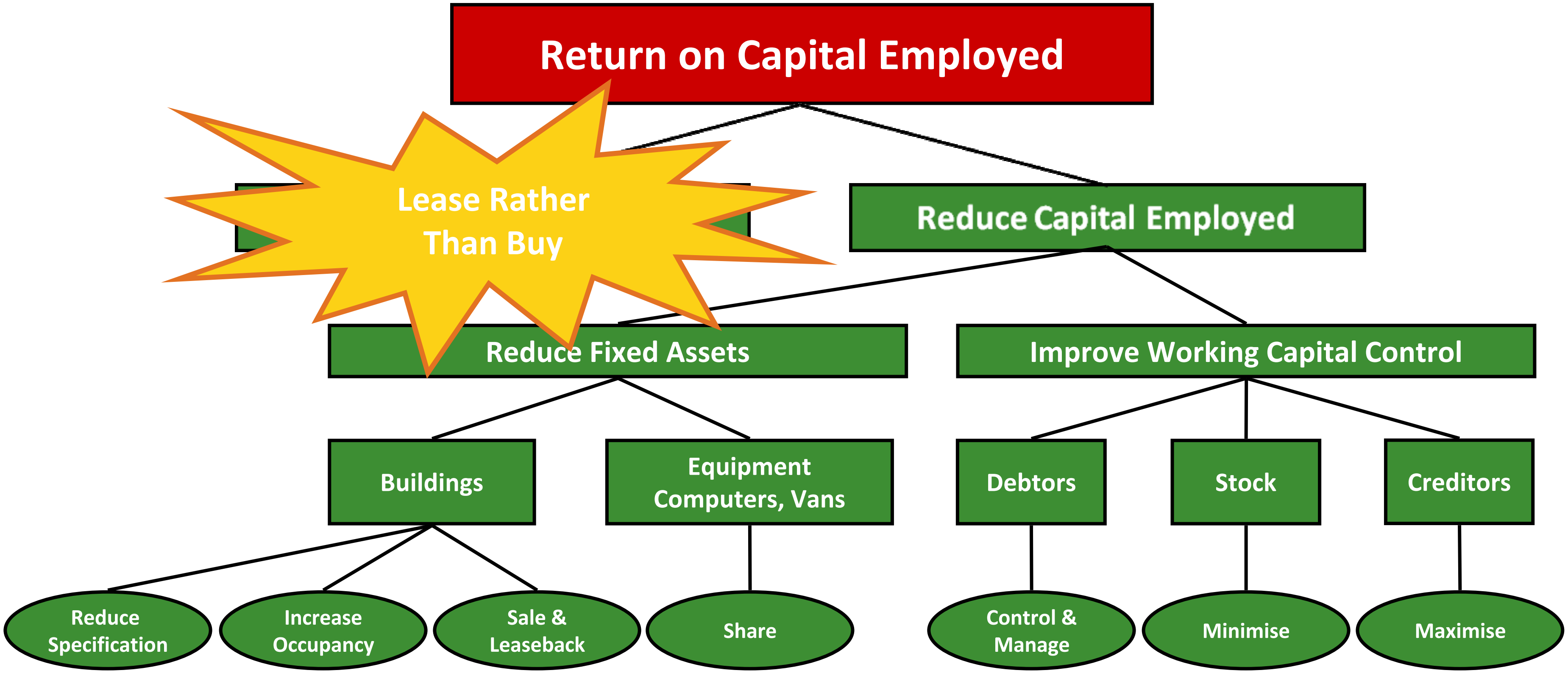
  - Difficult while under liquidity pressure

- Reduce Level of Activity

  - Last resort but may be essential for survival

Cash Flow Diagram




Return on Capital Employed
Lease Rather Than Buy
Reduce Capital Employed
Reduce Fixed Assets
Improve Working Capital Control
Buildings
Equipment Computers, Vans
Debtors
Stock
Creditors
Reduce Specification
Increase Occupancy
Sale & Leaseback
Share
Control & Manage
Minimise
Maximise

Reducing Fixed Assets

- Sell off unwanted assets
- Sale and Leaseback
- Lease & rent rather than buy
- Sub-contract and outsource
- Sell off unprofitable departments

We'll now look at each of these individually

Sell off unwanted assets

- Unproductive
- Tie up scarce cash resources
- Negative impact on ROCE and EVA
- Always opportunities to improve space utilisation
- Sale decisions often made too late

Sale and Leaseback

- Normally land and buildings
- Large assets
- Sold to investor and then leased back
- Releases significant funds for use in the operations of the business
- To add value business return must be higher than property investment return
- Used to be viewed negatively but now seen very positively eg Microsoft
- If funds cant be used in the business they should be given back to the shareholders

Lease and Rent rather than buy

- Business needs use rather than ownership of assets
- Suitable for machinery, motor vehicles, office equipment
- Frees up cash and credit lines for working capital
- Asset can be put to immediate use and generate cash to meet the lease payments
- Need to differentiate between Finance and Operating leases

Subcontract and Outsource

- Enables business focus on core activities
- Main benefit is Flexibility
- Reduces investment in fixed assets and working capital
- Even if cost is higher it can increase ROCE because of the reduced investment
- Benefits from the specialisation and single focus of the outsourcer
- Modern outsourcing moves operations to low cost locations
- Financially justified but can create social problems

Sell off Unprofitable Departments

- Definition of profitable must take into account investment in fixed assets and working capital
- Divisions that ‘make a contribution’ may still warrant closure if they tie up excessive investment in assets
- Every division must be assessed on a ROCE basis rather than bottom line

Problems

- Security for banks
  - Applies to SMEs rather than major organisations
- Balance sheet Impact
  - Ratios may improve but could be misleading
  - Substance over form has changed the accounting treatment of leasing
- Inflationproof value of property
  - Owners pension fund!

Asset Management

Working Capital

Minimise the Working Capital Cycle

Working Capital Cycle

Collection Period

+

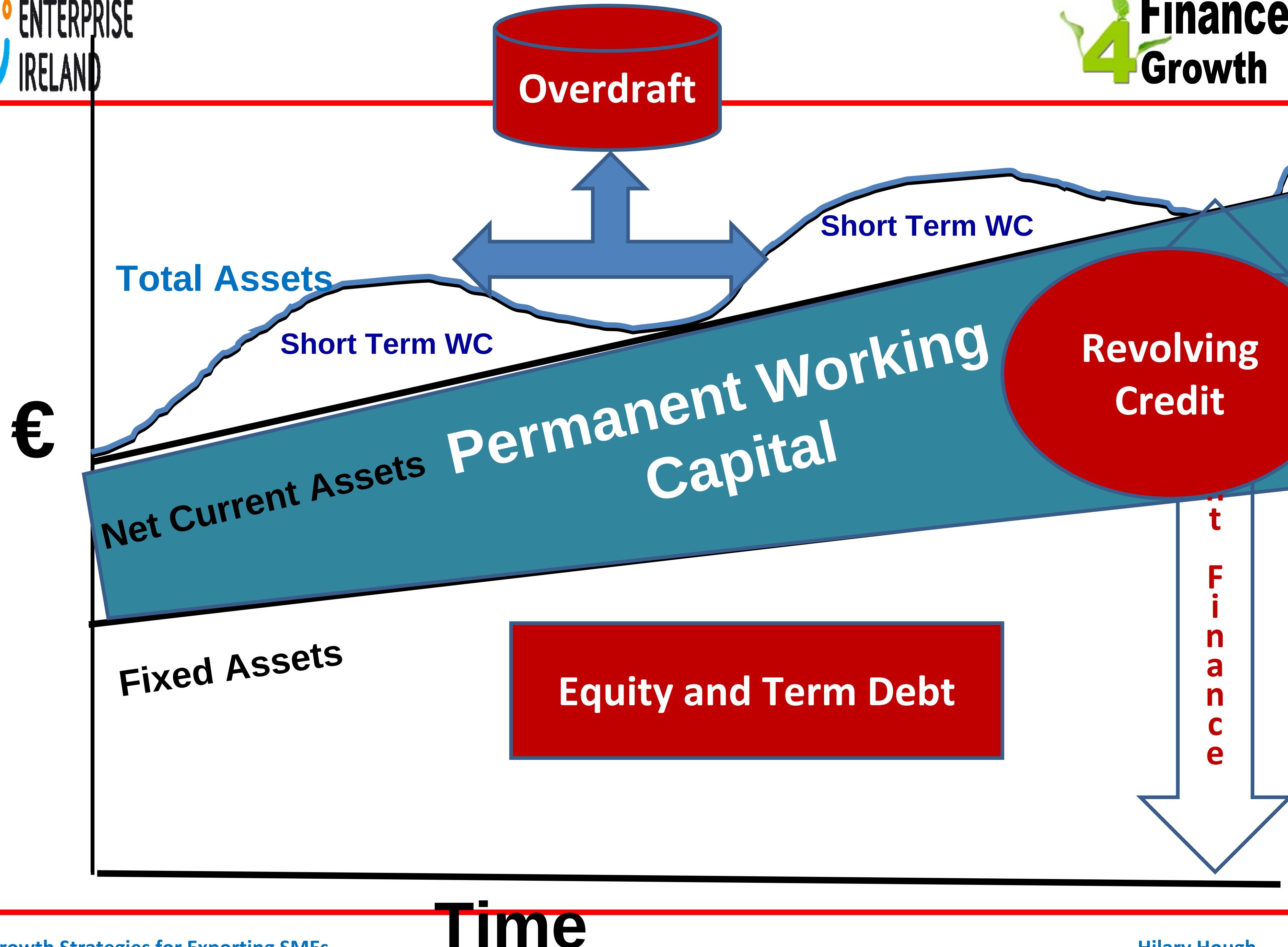
Stock Period

-

Payments Period

=

Working Capital Cycle


Overdraft
Total Assets
Short Term WC
Short Term WC
€
Net Current Assets
Permanent Working Capital
Revolving Credit
t
Finance
Fixed Assets
Equity and Term Debt
Time

Getting the 'Right' Type of Finance

- Essential to match the use with an appropriate debt type
  - **Fixed Assets**
    - Equity and term debt
  - **Permanent Working Capital**
    - Revolving credit
  - **Fluctuating Working Capital**
    - Overdraft

Lets apply this to Suretech Solutions

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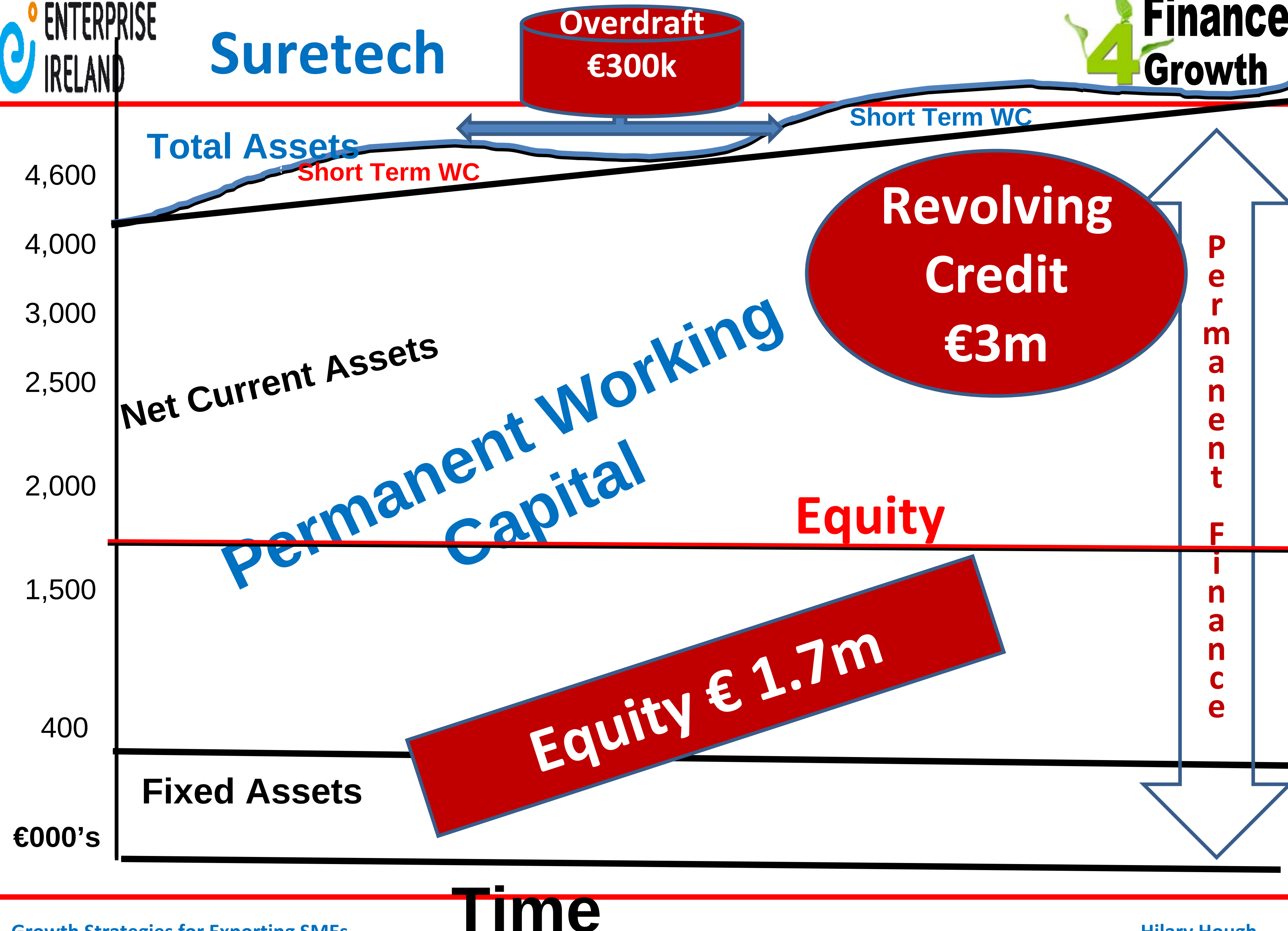
Suretech



Overdraft
€300k
Total Assets
Short Term WC
Short Term WC
4,600
4,000
3,000
2,500
2,000
1,500
400
€000's
Revolving Credit €3m
Permanent Finance
Net Current Assets
Permanent Working Capital
Equity
Equity € 1.7m
Fixed Assets
Time

Suretech ‘Right’ Type of Finance

- For Suretech matching use with an appropriate debt type works out as follows:
  - **Fixed Assets**
    - Fixed assets €380k relatively low
    - Fully Equity financed with €1.3m still available
  - **Permanent Working Capital**
    - Largest requirement €4.3m
    - €1.3m Equity
    - €3m Revolving credit
      - Commercial Finance (Discounting) facility
      - 80% of Debtors = €3.3m
  - **Fluctuating Working Capital**
    - Effectively standby facility
    - Overdraft €300k

Funding Suretechs UK Contract

UK Contract	€000's	
Sales	7,200	
Cost of Sales	5,832	0.81
Gross Margin	1,368	0.19
Expenses (say 10%)	720	0.10
Pre Tax profit	648	
Tax	65	0.10
Net Profit	583	0.08
Working Capital Ratio	19%	
WC Requirement	1,368	
Receivables	1,164	59

- Gross Margin fixed at 19%
- Expenses assume some economies of scale
- Applying the 2011Working Capital Ratio of 19% shows a W/C Requirement of €1.368m
- This could be financed as follows:

Debtor Finance	931	0.80
Profit	437	
	1,368	

- This is about the same ratio of Equity to Debt as in the overall Co financing

Managing Exchange Rate Exposure

- Essential to minimise or eliminate exchange risk
  - You are not in the FX risk business
  - You need to know what a sale is worth when you make it
    - It makes no sense to have to wait anxiously for the exchange rate on the day the debtor pays you to know whether you've made a profit or not
    - As far as possible the rate should be fixed on the day the sale is made and any related costs taken into account in determining profit and/or pricing
    - *'A bird in the hand is worth two in the bush'*

Minimise/Eliminate Risk

- Invoice in €'s
  - Let your customer take the exchange risk
  - Very often not acceptable to UK customers
- Match inflows and outflows by currency
  - Requires careful management
- Borrow in foreign currency to match inflows
  - Can be very effective
  - Needs tight management
- Forward exchange contract
  - Buy or sell forward to fix the expected income or expense
  - Safest way to do it
  - *Ignore 'profits' you would have made by not fixing!!!*
- Hedge contract
  - Variation on the FX contract
- Bill discounting
  - Just another way of borrowing in currency

Suretech Exchange Risk

	Suretech UK Contract			
		€000's	£000's	
Todays Rate	0.83871	7,200	6,039	
Average Rates	***2011***			
January	0.845838		7,139	0.84%
February	0.846297		7,135	0.90%
March	0.866533		6,969	3.21%
April	0.882947		6,839	5.01%
May	0.877877		6,879	4.46%
June	0.887448		6,805	5.49%
July	0.884759		6,825	5.21%
August	0.876685		6,888	4.33%
September	0.871723		6,927	3.79%
October	0.870360		6,938	3.64%
November	0.857395		7,043	2.18%
December	0.844055		7,154	0.63%

- The €7.2m value is based on todays exchange rate giving a sterling value of just over £6m
- If we applied the monthly rates for 2011 to this we see that the potential differential ranged from 0.8% to 5.5%
- At worst it could have wiped out almost 70% of the profit on the contract.
- Suretech cannot live with that uncertainty in 2012

Accessing Bank Credit

- Why are banks in business?
  - To make money
- If banks don’t lend then they don’t make money!!!
- To access bank credit you have to get into the mind of the lending banker!
- They base their decisions on an analysis of two key factors
  - Risk
  - Repayment capacity

Risk Analysis

- In analysing risk the bank looks at four key factors:
  - Environment --- external and internal
    - How is the current economic environment affecting your business
  - Market
    - Local, national, international
    - Consumer or wholesale etc
  - Management
    - How have you responded to the downturn
    - HIT (Honesty, Integrity, Track Record)
  - Security
    - Land & Buildings
    - Personal guarantees …………………..thorny issue!!

Repayment Capacity

- When a banker extends credit he gives you cash
  - He therefore needs to evaluate your ‘cash generating ability’ to establish if you will be able to service and repay the amount borrowed.
- From the bankers point of view the best indicator of future cash generating ability is past ability to generate cash!
  - This will involve detailed analysis of the accounts of the business over the past two to three years.
- You will need to provide a Business Plan which will show the lender
  - how you are going to use the credit being sought and
  - most importantly how you are going to generate the cash to service and repay the facility.
  - Free Cash Flow