EQUITY FINANCE
OUTLOOK

THE IRISH EQUITY CHALLENGE

Most Irish SMEs rely on traditional forms of finance to grow their business according to research carried out for AIB by Ipsos MRBI.

The proliferation of alternative sources of capital for Irish small and medium enterprises (SMEs) in recent years, has led to the creation of a vibrant funding ecosystem with a wide variety of key stakeholders providing a range of funding options for companies at all stages of their development.

Increased investment from agencies like Enterprise Ireland and the Irish Strategic Investment Fund with the establishment of a number of equity funds, together with the introduction of alternative financial products like Mezzanine Finance, have all played a significant role in broadening the depth and breadth of the capital pool available to Irish SMEs.

Despite the increased availability of capital, however, the vast majority of Irish SMEs continue to rely on bank debt and retained profits to fund their day-to-day operations and their growth plans according to a research report, Equity Finance for SMEs, which was carried out by Ipsos MRBI on behalf of Allied Irish Banks (AIB), p.l.c..

The research, Equity Finance for SMEs, shows that 71% of the SMEs surveyed said they were partly financed by the reinvestment of profits from the business while 56% also rely on traditional bank debt in the form of a business loan or an overdraft.

In addition, 26% of those surveyed said that their business was funded by equity investment from the founders while just 6% indicated that they had received a grant from a semi-state body like Enterprise Ireland or the Local Enterprise Board.

When it came to alternative forms of equity finance, however, just 1% said that they had secured investment from either a venture capital firm or an equity fund to help them grow and expand.

Despite this, 6% of the companies surveyed indicated that the prospect of raising equity finance was very appealing with another 23% indicating that it would be "fairly appealing."

Although this compares with the 70% of SMEs that indicated that equity finance did not appeal to them, it does offer opportunities for providers of equity finance to explore and reach out to Irish SMEs.

Indeed 13% of the SMEs surveyed said that they had already been approached about the possibility of raising equity finance while 4% said they had initiated a discussion with a third party about equity finance, according to the Ipsos MRBI research.

When it came to the perceived benefit of equity finance to Irish SMEs, 24% of the respondents said it would allow them to grow and expand, with 6% saying it would help them with working capital and cash-flow requirements.

Overall, the research highlights the degree of uncertainty about what equity finance entails and some of the misconceptions SMEs have about the nature of it.

As the survey noted, some 62% of those surveyed were either not that familiar or not at all familiar with equity finance. This compares with the 12% that said they were very familiar and another 26% that were fairly familiar with it.

Of the companies that indicated that they had no wish to use equity finance, 77% cited the possible loss of control of their business while 69% indicated that they preferred to use debt finance. Another 61% believed that they would have to sell some or all of the business in order to pay back the equity investor while 60% believed maintaining ownership was more important than achieving growth.

While the majority of SMEs were forecasting growth – future access to finance, whether it was equity or debt – was deemed to be a factor in limiting potential growth by 20% of those surveyed, just behind economic factors, which were cited by 24% of respondents. >>

HOW SMES FINANCE THEIR BUSINESS

71%	REINVEST PROFITS
56%	BANK FINANCE
26%	FOUNDERS EQUITY
10%	FRIENDS AND FAMILY
6%	EQUITY FROM INSTITUTIONAL/ INDIVIDUALS
6%	GOVERNMENT GRANTS

EXPECTED USES OF EQUITY FINANCE IN BUSINESS GROWTH

27%	INVEST IN PREMISES
25%	INVEST IN PLANT/ EQUIPMENT
14%	NEW MARKETS
13%	LAUNCH NEW PRODUCTS
13%	INVEST IN MARKETING/ SALES
8%	RECRUIT MORE STAFF

Base: All respondents: 300 *Ref: Equity Finance for SMEs, Ipsos MRBI, 2016*

The findings of the research clearly indicate that some challenges lie ahead for all the stakeholders involved in the funding ecosystem, particularly when it comes to the educational message that needs to be disseminated amongst Irish SMEs (including the different equity providers and State agencies like Enterprise Ireland).

As the development agency charged with helping Irish businesses to grow and expand into overseas markets, Enterprise Ireland has led the way in the development of the equity finance market in Ireland.

As one of the biggest European providers of equity finance, both directly and indirectly, to Irish companies at all stages of their development, its investment in a range of different Irish equity funds has led to the growth of a vibrant market that serves Irish SMEs.

"For years, Enterprise Ireland has supported the venture ecosystem with seed funds and we have played a significant role in creating bigger funds which in turn are invested in Irish companies," says Donnchadh Cullinan, Manager Growth Capital & Banking Relations, Enterprise Ireland.

"Over the last 20 years we have probably invested in over 45 different funds and for us it's about trying to create an appropriate array of funding options and ensuring that companies have access to these at all stages of their development. It's not a one-size-fits-all, because companies have different requirements when it comes to debt and equity, depending on where they are in their life-cycle," he says.

"The reality is that for many companies, equity is the only option available to them, particularly in their early stages of growth.

He points out, however, that there is growing

Donnchadh Cullinan
Manager, Growth Capital & Banking Relations, Enterprise Ireland

acceptance of equity as a form of capital amongst Irish SMEs.

"For many companies, especially in the software and high tech space it starts with equity and often ends with equity and maybe somewhere along the line they take on debt. But these Intellectual Property (IP)-backed companies are used to equity and understand the need for it and the role it can play in helping them grow. While of course there will always

> *"From Enterprise Ireland's point of view, the message that equity can complement and expand on the existing range of funding sources available to Irish SMEs is one that needs to spread."*

be haggling over valuations and dilutions, for the vast majority of them there has never been an issue with the concept of equity," he says.

"In the past, more traditional companies looked the other way and opted for pure debt to fund their growth. Companies got used to funding their balance sheet with 100% debt, often secured against a property.

"Things have changed and it will never go back to the way it was. So it's really important that companies realise that they now should explore other forms of capital, including equity, and that an over-reliance on debt is not a good thing," he says.

"The Ipsos MRBI research, carried out on behalf of AIB, says it all really but it is encouraging to see it also shows nearly 30% respondents are open to equity finance. But the 70% who are not is something of a concern, especially in the context of Brexit and the longer-term economic strategy which requires we grow more indigenous companies of the scale needed to reach new export markets.

"We have launched a new marketing initiative called Global Ambition to get that message out. While the UK is, and will remain, our biggest export market for some time to come, we need to diversify our export base and for many, this will require additional finance for investment in projects that may take some time to deliver a return. Equity finance is an excellent option in this context," he says.

"The research also shows that finance was considered to be a factor in limiting potential growth by 20% of those surveyed. This strongly suggests a need for a cultural shift in our business community.

"From Enterprise Ireland's point of view, the message that equity can complement and expand on the existing range of funding sources available to Irish SMEs is one that needs to spread.

"We are seeing it changing for the better as people and companies become more aware of the range of funding now available and we see it with our client base more and more," he says.

"The amount of deals and interactions companies are having with the different equity funds in which we have invested has also picked up considerably over the past year. While this is a good thing, there's still a huge education piece to be done around equity and its potential benefits to help companies reach their potential," Cullinan concludes.

PERCEIVED CONCERNS ABOUT EQUITY FINANCE

LOSS OF CONTROL	NONE	NO REQUIREMENT	PAYING IT BACK	DON'T KNOW ENOUGH	COST OF FUNDS
26%	18%	10%	9%	7%	6%

TYPICAL AMOUNT OF EQUITY FINANCE REQUIRED

NOT SURE	UP TO €100,000	>€100,0000-€200,000	>€200,000-€500,000	>€500,000-€1 MILLION	>€1 MILLION-€2 MILLION	>€5 MILLION
14%	26%	13%	22%	10%	7%	2%

Base: All who would consider equity finance: 250 *Ref: Equity Finance for SMEs, Ipsos MRBI, 2016*

HELPING IRISH COMPANIES GROW

Through its Corporate Finance and Specialised Finance unit, AIB is playing a leading role in providing bespoke and specialised financing and advisory solutions to Irish start-ups, SMEs and corporates.

One of the most significant developments in the Irish financial services sector in recent years has been the growth in alternative sources of finance for Irish companies seeking to expand their business, while bank debt continues to account for the lion's share of finance provided by the banks to SMEs – as evidenced in the Ipsos MRBI research carried out for this Outlook report – the growth in the equity finance market over the last ten years has led to the creation of a vibrant ecosystem with numerous venture capital and private equity firms now operating in the Irish market.

The Government's *Action Plan for Jobs,* which was first published in 2012, identified the development of a strong and vibrant equity finance market as one of several steps towards ensuring that Irish companies have access to a broad range of finance options at all stages of the corporate life-cycle, including peer-to-peer, seed capital, venture and growth equity capital and Mezzanine Finance.

Subsequent reports on the equity market by Forfás and InterTrade Ireland in 2013, also underlined the importance and availability of private equity to help SMEs and larger firms that are seeking to expand.

Ray Fitzpatrick
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"Ten years ago, there was seed funding available to the right companies but later stage equity finance was very difficult to get. A number of these companies have matured and are now seeking growth capital to expand and this market has developed to meet this demand." says Ray Fitzpatrick, Head of Equity Investment Unit, AIB.

"The State, in particular, has played a significant role in helping to develop the equity finance market in Ireland, and this has been important to its recent development."

"Both the Ireland Strategic Investment Fund and the various Seed and Venture Capital (VC) Schemes run by Enterprise Ireland, have had an impact on the overall market; not only by helping businesses to grow, but also by enabling a number of VCs set up new funds to invest in Irish businesses. This has contributed to the development and growth of the overall market," he says.

In addition, he points out that the Irish banks have played an important role in supporting this growth, while the European Investment Fund, as well as a number of

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Irish pension funds, have also played a role in helping Irish private equity funds achieve sufficient scale.

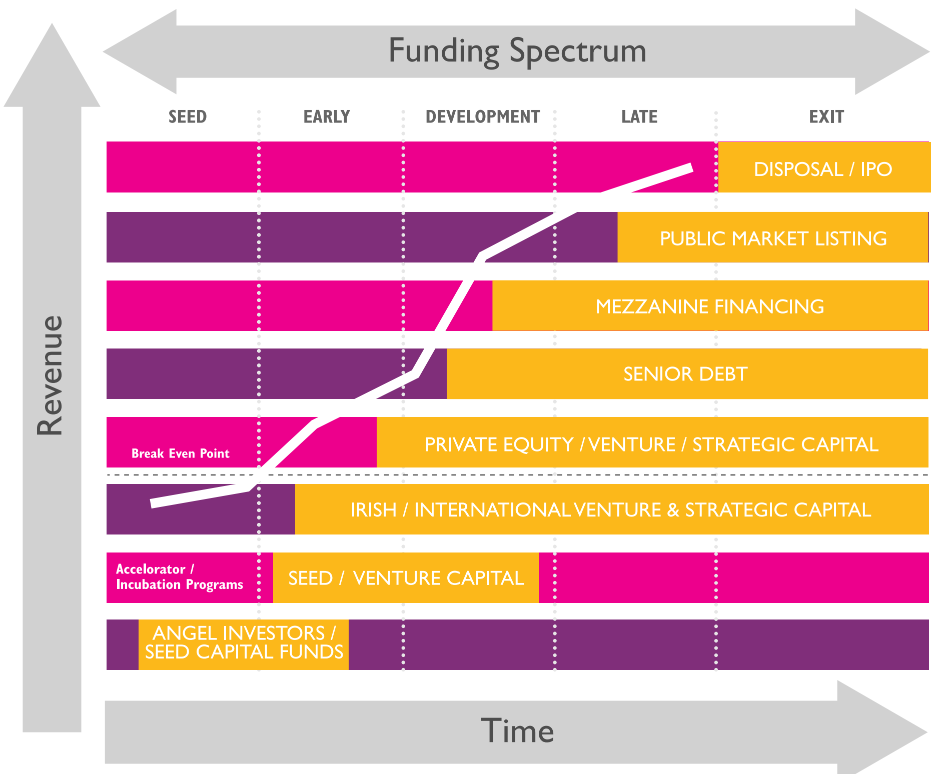
"AIB, for example, has committed €130m to ten active funds since 2007. These include the likes of our own AIB Seed Capital Fund, Frontline Ventures, ACT, Causeway Capital Partners, Fountain Healthcare, Atlantic Bridge and MML. Between the various funds that we have committed to, they have raised around €692m which has been invested in c. 150 companies to date and between them these firms have created c. 3,600 jobs," he says.

Today the private equity ecosystem in Ireland is buoyant with numerous large Irish and international equity funds operating in the marketplace.

"Last year venture-backed companies in Ireland raised approximately €522m. This was a significant increase on the €400m that was raised in 2014. In the first half of 2016, a record amount of c. €485m has been raised," says Ray.

"I see significant potential over the next few years for Irish start-ups and SMEs to scale internationally and the equity finance marketplace is growing to meet the demand. The Irish Venture Capital Association, for example, predicted in 2014 that the demand for equity between 2014 to 2019 would be around €1.65bn, or €330m per annum, but now I believe this will exceed €2bn," he adds. >>

FINANCING OPTIONS ACROSS THE CORPORATE LIFE CYCLE



Ref: Equity Finance for SMEs, Ipsos MRBI, 2016

John Fogarty

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By its very nature, equity finance expands the sources of capital available to a business so that larger transactions can be contemplated, says John Fogarty, Managing Director, AIB Corporate Finance Limited.

"The reality is that only so much can be financed from cash-flow, and unlike bank debt, which is the starting point for companies when they want to expand, equity helps maximise the range of other finance options that they can bring on board. And it also offers a degree of comfort to lenders when they see that a company has taken the steps to raise private equity" he says.

A common misconception amongst business owners contemplating equity finance as an option is that they will end up ceding control of their business to the equity provider, something which is also borne out by the Ipsos MRBI research, according to John.

"Naturally, there is a fear of the unknown

"Last year venture-backed companies in Ireland raised approximately €522m. This was a significant increase on the €400m that was raised in 2014."

and owners may have concerns about giving up control. The idea of bringing another shareholder into a business which the owner has spent decades building can be difficult at first but in practice the new equity investor is not trying to take over the business.

"The reality is that they are investing in the business and the management because they believe it has a profitable future ahead and they see the potential. Generally, new equity investors are not seeking to come in and run the business, rather they are backing the owner and management team; and they will work with them, to grow the business and to generate returns for the benefit of all shareholders," he says.

"From the outset, however, it's also important that the interests of the equity investor and the business owner are aligned and that they share the same view of the company's future and the direction it should take. If their respective interests are not aligned, it can be disastrous.

"So it's imperative that all the redline areas in terms of valuations, the percentage of the shareholding the owner is prepared to give over, the structure of the board and the voting rights are all agreed upon well in advance. It's also important that owners of the business take advice or appoint specialist advisers to help them through the process," says John.

"It should also be remembered that private equity investors are not going to be there for the long term either. Typically, they might have a four to six-year horizon before they want to exit because they too have their own shareholders and investors to return capital to. Family offices or private high net-worth individuals, on the other hand, might take a slightly longer term view, depending on the company," says John.

Ronan Burke

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While the availability of institutional equity has played a significant role in boosting the pool of capital available to Irish businesses, it is by no means the only option available. In recent years, the availability of Mezzanine Finance, for example, has played an increasing role in the capital mix at the disposal of businesses, says Ronan Burke, Head of Mezzanine Finance, AIB.

"Mezzanine Finance is not new and it's quite a common debt instrument in other more mature markets. Post the economic downturn in Ireland and with the improved economic circumstances, it's beginning to take off and AIB is currently the only Irish bank that has a dedicated Mezzanine Finance unit within it," he says.

"Mezzanine Finance essentially bridges the gap between debt and equity in a company's capital structure. It is a second ranking security instrument and is subordinate to senior debt but more senior in terms of its ranking to equity. As such, it's an attractive and cheaper alternative to equity for some companies as it allows a business reduce its cost of capital and boost its return on equity," he says.

In effect, Mezzanine debt is cheaper than equity and is not shareholder dilutive, which are both very important to Irish business owners.

Mezzanine Finance is also suitable for established companies that have strong cash flows and can demonstrate an ability to maintain both senior and mezzanine interest and principal obligations in addition to the terms set out by the mezzanine provider.

"It's not suitable for start-ups or companies

"The reality is that they are investing in the business and the management because they believe it has a profitable future ahead and they see the potential."

in the early stages of their development," says Ronan. "Apart from having good cash-flows and a stability in its earnings profile, the company generally has to have a strong market position within its sector in addition to a strong management team and committed shareholders who are likely to have a defined exit strategy," he says.

Typical sectors where Mezzanine Finance may be deployed include the hospitality sector (including hotels and pubs), nursing homes, pharmacies and other asset-backed sectors like prime commercial real estate, wind-farms and solar energy projects.

"Generally it's used by companies to fund growth opportunities like acquisitions or leveraged management buy-outs," says Ronan.

"But the reality is that it's not suitable for every business and we would always advise that any company considering Mezzanine Finance as an option to seek advice from their specialist advisors so as to understand the nature of Mezzanine Finance and the implications it has on the company's capital base," he says.

As increasing numbers of good businesses have funding requirements beyond the confines of senior bank debt, through its Corporate Finance and Specialised Finance departments, AIB seeks to work with its Corporate and SME customers to provide bespoke and innovative financing solutions and specialised advice on raising capital (both equity and debt) to assist businesses in achieving their growth objectives.

CASE STUDY: A FAST FOOD PHENOMENON

David Maxwell of the burrito restaurant chain Boojum talks about how private equity has played a key role in the growth of the business.

David Maxwell, Director, Boojum

When the opportunity to acquire the successful and popular Boojum chain of burrito restaurants arose in 2015, David Maxwell and his brother Andrew thought it was too good an opportunity to pass on.

The two brothers were on the look-out for their next venture, having chalked up considerable expertise in the restaurant business in the USA. This time, however, they wanted something closer to their native Belfast.

"We looked at a few businesses and then HNH, the Belfast corporate finance firm, suggested we take a look at Boojum. We knew the business well, having eaten there, and we liked it," says David Maxwell.

"The idea of fast-casual dining, which uses good quality ingredients, prepared well and served as quickly and at a reasonable price, is here to stay because it suits people's busy lifestyles. From the outside looking in, we thought it was a great business with a bright future and when we looked at the numbers, we realised just how successful it was and we made the decision to go for it, subject to getting the finance in place," he says.

"When we got down to doing the deal, there was a gap in terms of what our bank, First Trust, part of the AIB Group, could lend us and the asking price. Rather than let the deal go, it was suggested that we look at introducing more equity into the business," he adds.

"From the outset, we knew that if we were going to take on an equity partner, it would have to be somebody who could bring something to the party and help us push the business on.

"We pitched the idea to several private equity businesses and as part of that process we were also privately vetting them to see if they were suitable and what more they could bring to the business other than just money. Ultimately we felt that Renatus Capital Partners fitted exactly the profile we were looking for," says David.

Renatus Capital Partners was founded two years ago by Brendan Traynor and Mark Flood. It typically invests €1m-€3m in ambitious, profitable, mid-market companies and is an active supporter of management buy-outs, management buy-ins and platform businesses looking to consolidate or expand through acquisition. Flexible capital, strategic support and commercial insight to successfully grow and develop businesses are the core foundations of what Renatus offers, according to David.

"It was important that they understood the business better than most. They were aware of the brand in Dublin and they had also done their research, so it was a good fit for us. We met them in the morning and by the afternoon a deal was done and since then, they have been great to deal with," he says.

"From the outset, we knew that if we were going to take on an equity partner, it would have to be somebody who could bring something to the party and help us push the business on."

"We are left to run the business on a day-to-day basis and Renatus helps us make high-level decisions, but they have also pushed us on and made us better operators, while they have also opened doors that we probably couldn't have," he says.

"In addition, First Trust was behind us from the very start and was very supportive. It backed the deal because it believed in the management team and the company's plans for growth. With private equity backing, it probably gave the bank a little bit more confidence in the business than if we were just writing the cheque ourselves because the private equity due diligence would have been similar to the one that the bank would have carried out," says David.

"But we are also fortunate that the business has good strong cash-flows, a good business model and what we believe is a strong management team driving the business," he adds.

Choosing to go down the private equity route is something that he has no regrets about. "Quite simply, this deal wouldn't have happened for us if we hadn't got private equity. I know some people might have mixed views about it and might be concerned that a private equity investor would come in and try and take over the business. Once you understand the role private equity can play in growing your business and feel comfortable about it, then it really makes sense. Personally, I couldn't speak highly enough about private equity," he says.

With the support of First Trust and Renatus, the company has been able to expand. "When we bought the business there were five outlets, now we are about to open our eighth and we intend to open more over the next few years. We have a great team in place to make all this happen," he says.

"In terms of our expansion plans, obviously organic expansion is the preferred route, but we have also been presented with possible acquisition targets and we will look at them, but only if they make sense for Boojum. Ultimately, we would love to take the Boojum brand into the UK as we genuinely believe it has considerable potential to grow beyond the island of Ireland," he says.

CASE STUDY: EDUCATING THE WORLD

Equity finance allowed the educational publisher Prim-Ed grow by way of acquisition according its CEO **Seamus McGuinness.**

A €15m deal to acquire the Australian company RIC Publications earlier in 2016 has reinforced the reputation of Prim-Ed as a global force in the educational publishing market.

Headquartered in New Ross, Co. Wexford, Prim-Ed Publishing acquired its global partner in a deal that gave it a physical presence in five different countries, markets in another twenty-two countries and a staff of over one hundred.

The deal was supported by MML Growth Capital Partners, which is backed by both Enterprise Ireland and AIB, as well as AIB Corporate Banking.

Founded in 1994 by Seamus McGuinness, Prim-Ed publishes a wide range of resources for teachers, with over 1,000 different titles, covering every part of the curriculum, published to date.

"I always envisaged that we would need an equity partner; it was on the cards from the outset and I couldn't see any other way of doing it."

For its part, RIC Publications – a partner of Prim-Ed since the mid-2000s – was set up in Australia and grew into the New Zealand, South African and Malaysian markets.

"We had a close working relationship with RIC for a number of years," says Seamus McGuinness, CEO of Prim-Ed.

"The company was originally established in Australia 30 years ago by two teachers and they had been thinking about selling out for a while. I think they knew they had grown it as much as they could. Fortunately, we were also looking at opportunities at a global level," he says.

"The market is very competitive internationally and there is always a lot of movement in terms of M&A activity. Many of the big educational publishers are always trying to grow by buying up other businesses to add to their existing portfolio," says Seamus.

Seamus McGuinness, CEO, Prim-Ed Publishing.

"We engaged PwC to explore the various options open to us. Realistically, we knew we would have to borrow if we were going to invest, but to borrow we would also have to raise a deposit. That's why we decided to look at equity finance.

"I always envisaged that we would need an equity partner; it was on the cards from the outset and I couldn't see any other way of doing it, particularly if we wanted to achieve the kind of growth and opportunity we were looking for while maintaining the value in the business that we had already built up," he says.

"From day one, PwC worked very hard with us to ensure that our interests were taken into account and that it wasn't going to be a case of working with any equity partner. They advised us on which ones we should be talking to, set up the meetings and helped us with the negotiations.

"There's any number of equity companies in the market and there's plenty of funding available. However, each of them will offer different things, so it's important to settle with the one that's best suited to the company's needs as opposed to the needs of the equity provider. Some wanted larger shareholdings than others, but for us it was about getting the best deal, not just any deal," he says.

"When it came to dealing with MML, we were able to structure a deal that matched

"There's any number of equity companies in the market and there's plenty of funding available."

our expectations with theirs and although they are passive investors in the business, they do engage with us on a regular basis, not only because they are secondary lenders and are keen to see the numbers, but they want us to do well, and if we do well, the shaeholders benefit", says Seamus.

Being able to broaden its capital base by way of equity also provided a degree of comfort to the company's main lender AIB says Seamus.

"Having an equity finance provider like MML gave the bank a great sense of comfort and it made the whole lending process fairly straight forward. Apart from the strong management team and the good business case, the bank were aware that MMLwas also working hard in the background. We don't do deals like this one every day, but the equity finance people do and their expertise and knowledge was great when it came to dealing with the bank, structuring the loan and working out a repayment schedule that would work," concludes Seamus.