The Credit Review Office provides some information for SMEs considering funding a Capital Project from 'Own Funds' or working capital

Over the past 5 years the demand for bank credit from SMEs has been declining in a straight line from 40% in Q1 2013 to 26 % in the latest Department of Finance Bi-annual SME Demand Survey. A similar pattern has been observed in the European Investment Bank Group survey on Investment and Investment Finance, where credit demand is found to be low across the EU; however, another finding from the survey is that 75% of Irish firms are using internal funds to finance their investment activities. This is higher than the EU average of 60%. When I meet the main banks here to discuss lending performance, they also cite that there is a high level of self-funding taking place in the economy which is constraining their ability to grow their lending books.
A separate piece of research is being commissioned by the Credit Review Office to explore whether changes in banks' physical distribution networks is adversely affecting demand for credit.

With the economy growing strongly, many SMEs are planning to grow capacity, and/or replace ageing capital equipment. The above research indicates that many of these projects will be self-funded. Self-funding is of course the cheapest form of finance available to SMEs and this should always be considered as an option, there are however some pitfalls in pursuing this option which we have observed from previous credit appeals. Remember, cash is king in terms of business survival.

The main danger is in running out of working capital for your existing core business, either through an unexpected increase in the capital cost of the project, or an unexpected shock to the core business's finances, say from a late paying or defaulting debtor; or more dangerously reliance on creditors as a source of funding. When such shocks happen, you risk having cheques bounced on your core business account, with all the reputational damage with creditors, and the impact on the business's credit records on which future financing decisions by banks will be made. A core business which is struggling to meet its own operating bills, will have little surplus cash to complete the capital project.

In such cases presented to the Credit Review Office we have been able to successfully show the lending bank the strength of the core business, and to identify the sunk costs in the capital project together with the projected costs to finish it out; and then show that there would be enough cash generated by both the core business and the eventually the project itself to cover term loan repayments. But bear in mind, before the Credit Review Office had been involved the lending bank had already said 'NO' twice to the borrower's application – the process to get credit may have taken over two months, and some businesses may not be able to survive that long.

A secondary aspect that has been observed in the Credit Review Office is that when applying for credit, banks will look back at the financial performance of the business over the past three or more years and will give little or no recognition for the funds which have been self-invested. The performance of the business may be better than the financial accounts suggest if profits are being used to fund investment projects.

Some things to consider if you are contemplating using ‘own funds’ to finance a project.

a. When planning the project, think about a funding plan for the project, which should reflect the costs and duration of the Project, and how much and when it will generate its own cash. This will be an input to your overall cashflow planning – if you don’t have a cashflow for at least the duration of the project, then it is a scary prospect to commit own funds to any project.
b. Assuming you have a cashflow, this should reflect the funding plan outlays on the project, and you should carefully consider buffers for any financial shocks mentioned earlier which may occur along the way, to your core business or to the project.
c. SMEs historically have relied too heavily on overdraft funding for working capital, and in some cases capital expenditure purposes. Any funding plan should have an appropriate loan structure for the nature of the project. Overdrafts are not a suitable vehicle for long term credit needs.
d. If the business is self-funding a project it may be that part of the overall funding requirement, are relying more on creditors than it should be. Any change in relationship or goodwill with creditors can jeopardise a good business.
e. It is easier to get credit before the event than if you subsequently encounter difficulties; even if that is just to agree a suitable overdraft limit with your bank to cover cashflow contingencies. You will only have to pay interest if the facility is required.
f. If you decide to go ahead and fully self-fund, it may be at the least advisable to meet with your bank’s relationship manager to let them know what you are doing and show them the funding plan, and ask them to record the meeting on your file – just in case you need to get some help during the project.
g. From the funding plan/cashflow, you may feel that you can partially self-fund the project but will also need some bank finance – bearing in mind that banks will now typically fund only up to 70% of a project costs. The term of the loan will reflect the nature of the project and the expected cashflows from it.
h. If you have self-funded previous projects that are now part of the core business, make sure that you advise the bank of the prior outlays and the outcomes of the project. If the bank isn’t told this, they are unlikely to recognise the self-funding from your financial accounts and may underestimate the performance of your business.

And if all else fails, contact the Credit Review Office and we will do our best to secure credit for viable SMEs.