SME Access to Finance

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- *No change to current arrangements.*
- *Facilitate development of an SME finance database to reduce information asymmetries between lenders and borrowers.*

The Inquiry seeks further information on the following areas:

- *To what degree will technological developments resolve issues related to information asymmetries in SME lending?*
- *What are the best options to narrow the informational gaps between lenders and SME borrowers?*
- *Could the use of certain loan covenants be reduced, while still providing SMEs with adequate access to finance and lenders with appropriate protection?*
- *What are the prospects for a market for securitised SME loans developing?*
- *What are the main barriers to greater broker activity in SME finance? Are these barriers transitional or structural in nature?*
- *What are the best options for improving the tax treatment of VCLPs?*

Funding through loans is not available to SMEs because few have the asset base against which a loan can be secured. Equity funding is problematic because the number of investors who are permitted to invest is limited and because the market in equity are illiquid and complex.

In two other submissions I have made to this inquiry recommendations were made for governments to provide Tradeable Claims for Infrastructure and Tradeable Claims for Public Housing through PrePayments with Discounts.

This submission outlines PrePayments with Discounts as a liquid tradeable claim for SME Capital Projects with well defined outputs of measurable value resulting from the investments.

PrePayments with Discounts is a variation of Crowd Funding and is a variation of Funding widely used by governments when involved with Nation Building. Examples from Nation States are the Commonwealth Bank's early years when the bank funded infrastructure projects, during and after the First World War, the nation building exercises from the reconstruction of Japan and Germany, and the funding of China since the late 1980's.

Modern Crowd Funding funds projects by people buying goods and services before they are produced. This submission combines these ideas and creates a liquid tradeable claim over goods and services to be produced by an enterprise. The claim is in the form of a transferrable PrePayment with Discounts where the Discount depends on the length of time the claim has been held. The PrePayment may or may not be adjusted for inflation and the Discount depends on the risk associated with the investment. The laws and regulations surrounding these claims are covered under the regular contracts for the sale of goods and services.

The submission outlines why this form of Crowd Funding is a better alternative than Equity Funding or Loans as the way to finance innovations .

Funding Innovations with Prepayments for Services

There are many ways the Australian Government can assist fund innovation. The methods can be classified under the broad headings,

- Equity
- Loans
- Grants
- sales.

The challenge with sales is that it happens after the innovation occurs. This proposal presents a way that investors can pre-purchase the output of innovation, to let pre-sales be used to fund innovation.

Equity has been tried through various mechanisms where funds are directed through intermediaries such as VC funds. It is difficult to measure the effectiveness of this approach and it depends to a large extent on the skills of the VC funds. Anecdotally it appears the major beneficiaries of this approach are the VC funds not the innovators. There is growing interest in equity crowd funding but this is not suitable for small investors as it highly volatile. It is recognised that governments and financial institutions should not take ownership of the means of production.

Non Recourse Loans have been tried and we are told has resulted in few loan repayments and many defaults. Loans from financial institutions are not available to fund innovations. Organisations have to use other assets as collateral to fund innovation.

Grants are a common method but typically result in a large amount of paper work due to governments having to be careful with the distribution of funds. Grants also suffer from the same problems as equity as being dependant on the skills of the grant assessors. Grants work well in very early stage projects where there are no products for sale.

PrePurchasing Output (Sales) from innovative organisations is a largely untried method but has the potential to give good results, become self sustaining, and be a method of leveraging Crowd Funded Innovation. It can be easily implemented because it is based around tangible product of goods and services. It can be trialled quickly because it does not require any special legislation or extra due diligence over normal purchase arrangements. It does not apply to all innovations but it does apply to those who have made their first sale.

Prepayments with Discounts

One mechanism for providing Funds for Innovations is Prepayments with Discounts to purchase Goods and Services resulting from the Innovation at some time in the future.

A Prepayment is purchased from an organisation with the promise that the organisation will supply goods and services produced at some time in the future in exchange for the Prepayments. An advantage of this approach is that all buyers become investors and investors become potential buyers. The mechanics of investing in the organisation and of buying goods and services are the same. This reduces costs as there is a single system for investing and buying. It also ensures that the interests of investors and buyers are aligned and focussed on producing goods and services.

The value of goods and services supplied for exchange of a prepayment is determined at the time of delivery and is calculated as follows:

1. The Prepayment amount is adjusted for inflation over the period from the purchase to the use of the prepayment.
2. The Prepayment value is adjusted by a discount applied over the period from the purchase to the use of the prepayment.

3. The value of the prepayment is then used to purchase goods and services at the price at the time of use.

One method of discounting is to calculate the discount as a Discount Rate per unit of time.

With a Discount Rate of 7% per year and with no inflation the value of a prepayment of $100 is as follows:

Year	Value
0	100
1	107
2	114
3	121

With inflation of 3% and a Discount Rate of 7% the value of a prepayment of $100 is:

Year	Inflation Adjusted	Value
0	100.00	100.00
1	103.00	110.21
2	106.09	120.94
3	109.27	132.22

If we assume that prepayments are used an equal amount every year then we can compare the cost of prepayments with loans where the loans are repaid at a fixed amount each year.

Comparison in the cost per year for prepayments and loans assuming a 30 year repayment time.

Initial Amount	$100.00					
Rate	7%					
Years	30					
		Loan	**Loan**	**Prepayments**	**Prepayments**	
Rate		**Per Year**	**Total**	**Per Year**	**Total**	**Extra Cost**
	5%	$6.51	$195.15	$5.83	$175.00	20.15%
	6%	$7.26	$217.95	$6.33	$190.00	27.95%
	7%	$8.06	$241.76	$6.83	$205.00	36.76%
	8%	$8.88	$266.48	$7.33	$220.00	46.48%
	9%	$9.73	$292.01	$7.83	$235.00	57.01%
	10%	$10.61	$318.24	$8.33	$250.00	68.24%

Inflation has been ignored because with prepayments the price of goods and services is likely to rise with inflation. If the price drops then the buyer gets more goods and services.

PrePayments as a Liquid Tradeable Claim

Transferrable PrePayments provides a liquid tradeable claim that can be used to finance any Capital Investment where the Investment results in a saleable product or service.

Once an Innovation has shown that there is a market for its products then finance for commercialisation and further development can be financed through PrePayments with Discounts.

Early stage companies can have a high Discount Rate that reflects the risk of the investment. PrePayments can be of any size and are easily implemented as they are a variation on normal purchasing arrangements. The laws, regulations and accounting practises surrounding existing payments and discounts all apply. Profits made from the sale of PrePayments are treated as Capital Gains if held for more than a year. This means that PrePayments are a way of Crowd Funding the Commercialisation of Innovations. The Government can be part of the Crowd and can use the same criteria as any other member of the public in evaluating whether the Investment is sound or otherwise. This will reduce compliance and allocation costs of government funds.

PrePayments gives the buyer the right to purchase goods and services supplied by the Seller at a Discount at any time in the future. Buyers buy PrePayments at different times and can be under different conditions. This means each PrePayment purchase is treated as an entity and its value is different from PrePayments purchased at different times and with different conditions.

PrePayments are not fungible as they can only be used for specified goods and services and because each PrePayment has a different value. However, PrePayments can be transferred between Buyers so they can be sold. Because they can be transferred they are a liquid investment as there are always future Buyers of services of an enterprise producing goods or services.

The value of PrePayments should be increased to account for inflation. This is because the goods and services offered by the seller will normally increase with inflation.

PrePayments can be for any amount and are simple and easy to sell because they are not a financial product but are payment for a service. The same accounting systems are used for investing as is used to purchase services.

PrePayments appear on the books as a long term unsecured liability. Discounts are not treated as income and so are not taxable. However, if PrePayments are sold the value of the Discounts is treated as a Capital Gain if the PrePayments are held for a period of time.

The Government can use PrePayments as a sustainable way of funding Innovation.

The companies that are successful get further investment while those that are not successful get less or no further investment. This reduces losses and increases gains because the winners pick themselves.

For illustration purposes let the Prepayments have a discount of 30% annually. That is $100 worth of Prepayments can purchase $130 worth of goods or services in one years time. Let the funding body have the right to continue to fund development of the organisation up to ten times the initial Prepayment and let the Prepayment be required to be used within ten years. Let us assume that 50% of innovations fail, that 40% return the Prepayment investment and that 10% are successful and require further funding. Let us start with 10 organisations which all receive $100K. After one year another $1M is invested in the successful Company.

Companies	10
No return	5
Return Investment	4
Successful	1
Discount	30%

	Investment	Investment	Returns from	Returns from

Year	in all	in successful	Successful	Breakeven	Balance
1	1000000				-1000000
2		1000000	330000	120000	-1550000
3			330000	120000	-1100000
4			330000	120000	-650000
5			330000	120000	-200000
6			330000		130000
7			330000		460000
8			330000		790000
9			330000		1120000
10			330000		1450000

As can be seen the system can be made self sustaining with extra investments in the successful company funding the other not so successful companies.

Successful companies will be able to get funds at lower Discount Rates which is why it is important that the agreement is to allow further investment at the high Discount Rate but to limit the amount that can be invested at the high rate. Early stage funding people and organisations will be able to sell the high Discount Rate Prepayments for a substantial capital gain if the Discount Rate on new Prepayments drop.

Comparison of transferrable Prepayments with Loans

Loans require regular payments and take money out of the Company because interest payments are on demand. This makes it difficult to handle cash flows where the cash flow comes years after the investments. Interest on Loans compounds so that at high interest rates means interest is an unsustainable burden. Loans are a relatively illiquid investment and the value of the investment changes arbitrarily with changes in interest rates.

Prepayments output from investments is a stable investment. When there are sales the liquidity of the investment is high. The investment returns are known. The investment returns are as Capital Gains not as income. Funds are not taken out of the Investment. This makes for stability in cash flows.

Loans are unavailable to Innovations without asset backing. PrePayments allow for Crowd Sourcing and for the future buyers to fund development.

Comparison of transferrable Prepayments with Equity

Equity returns are potentially unlimited with very high returns possible. Equity returns are uncertain and variable. For small companies equity is an illiquid investment. For large companies with stock market listings returns are highly variable and depend on external factors as well as the performance of the investment. Equity returns are relatively easily changed and lead to inequities in distribution of value.

Prepayments are liquid. The returns are fixed and known and hence are much lower risk. Prepayments are lower risk than Equity as they are treated as unsecured loans in the event of a company failure.

Evidence of PrePurchasing Funding Investments

There is a growing body of evidence that Crowd Funding new products and services is successfully funding innovations. There are examples of crowd funded companies becoming large very quickly. These products have been predominantly consumer products where people pre buy the products or some other benefit. PrePurchasing with Discounts broadens the products that can be funded and allows investors to invest in the products without finally purchasing them.

Recommendation

It is recommended that the Government support Innovation with a $500M self sustaining Prepayment system for funding Innovation Commercialisation. The Government funds will only be used for projects that have other matching investors using the same PrePayment vehicle.