Engineering and
Machinery Alliance

Engineering and Machinery Alliance – Financing a Private Sector Recovery

1 Background to the Alliance

The Engineering and Machinery Alliance (EAMA) represents the following trade associations:

- Agricultural Engineers Association
- British Automation and Robot Association
- British Paper Machinery Suppliers Association
- British Plastics Federation
- British Turned Part Manufacturers Association
- Confederation of British Metalforming
- Gauge and Toolmakers Association
- Manufacturing Technologies Association
- Printing, Papermaking and Converting Suppliers Association
- Processing and Packaging Machinery Association
- UK Industrial Vision Association

They represent 1,600 firms in the mechanical engineering sector with sales of £8 billion.

- Based on the Office of National Statistics (ONS) new criteria for the sector they represent a third of the UK's mechanical engineering output.
- Using HM Customs' data, sector exports account for about 70% of sector sales.
- And again according to ONS comparisons, mechanical engineering is one of only two manufacturing sectors to regularly contribute a positive trade balance to the UK economy -- over £3 billion in 2008.

Typically our companies supply 'enabling technologies' to other sectors (e.g. automotive, aerospace, medical, power and food industries) in the form of machinery or packages combining services and products.

This is the preserve of small and medium sized niche or specialist companies (SMEs). Important, large companies are also involved, as are many innovative entrepreneurial SMEs, all pushing the boundaries of factory performance, extending the envelope of the physically feasible to new levels in terms of speed, precision and migration into novel technologies and materials.

2 How these views were assembled

In the second half of 2009, EAMA invited the British Bankers Association to co-operate in a series of joint Round Table meetings, where individual EAMA SMEs and representatives of the banks would be able to ventilate their issues and through this improved communication find a better way forward to resolve issues.

The views expressed here are based on the exchanges that took place in the three Round Table discussions we have had so far. The next is scheduled for October.

3 Our Views on the Questions Posed in the Consultation Green Paper

General Evidence Base

1. Do you agree with the evidence base as set out in this paper? Are there any additional issues that should be considered?

We agree with the evidence as far as it goes. But believe that the base is too narrow. It's written from a financial supply side perspective, not from the users' points of view.

It therefore needs to extend much further to get under the real economic impact of the recession and what's needed in terms of financing. We appreciate that it cannot do this in detail but we believe it should at least give some indication that it recognises there are different needs across different sectors and that more than a one-size-fits-all approach will be needed.

Some examples:

- There's a fundamental difference in how the 'overnight' changes in existing financing arrangements imposed by the banks hit labour intensive firms (typically services) compared to capital intensive companies.

  (i.e. according to ABI 15 June 2010, companies average annual capital investment in the Professional, Scientific and Technical Activities sector was £13,600 compared with £85,400 in Manufacturing, so changes in financial terms have vastly different impacts between sectors.)
- The relative impact on confidence and the measures needed to bolster confidence so that firms invest (please see attachment A summarising how a cross section of member firms were hit).
- The speed with which new manufacturing technologies are being introduced, cutting typical replacement periods from ten years to five or even three and in doing so eroding residual machinery values.

There's more below on all these issues.

Certainty over Frameworks

2. Do you think greater certainty over future tax and regulation would have a significant impact on current demand for or supply of business finance?

An EAMA survey indicates that regulation costs each SME firm over £33,000 a year. A recent EEF study shows manufacturers rated tax and regulation as the two worst aspects of the UK business environment.

So if it's certainty in terms of cutting the size, complexity and impact of tax and regulation then yes, it will have an impact on demand.

However, the impact on manufacturers may be more muted, unless the financial environment responds in a supportive way to the sort of issues raised as examples in answer to 1 above. (There is also the question of the loss of certain measures that encourage investment, e.g. plans to withdraw the annual investment allowance and reduce the depreciation rates for capital allowances, both will have a knock-on impact.)

In manufacturing, retained earnings are by far the most common source of investment finance. So sustained Government action on tax can have a direct impact on firms' ability to invest.

Equity Markets

3. Are there any regulatory obligations that may disproportionately deter SMEs from listing on exchange-regulated markets such as AIM and Plus Quoted? What can be done to address this?

4. Are there any additional barriers to corporates (of any size) accessing equity markets and how could these be addressed?

5. How can Government ensure that the best small businesses in all parts of the UK are visible to publicly backed venture capital funds? Should Government intervention to address the equity gap focus on the best firms regardless of geography, or seek explicitly to address

regional economic disparities? The Government would be particularly interested in views on regional stock exchanges.
6. How can publicly-backed equity schemes and the Growth Capital Fund make more use of private capital in future? How could the scale and reach of publicly backed funds be improved? Are there any gaps within the portfolio? Does the potential model for the Growth Capital Fund meet the objective of filling a gap in the availability of funding for growth companies? Are there ways in which the potential model could be developed to improve its appeal to investors or its ability to make a material contribution to the funding of growth companies?
7. How could more high-net-worth individuals be encouraged to become Business Angels and participate in larger deals through syndicates? Are there specific issues impeding business angel activity that the Government should address, such as investor readiness or the structure of publicly-backed venture capital funds?

No comment

8. How can eligible businesses help themselves to become 'investment ready' for equity finance? Where should this be done by private sector, market-led solutions? What role is there for Government in supporting this, and should intensive Government support be focussed on businesses high growth potential?

There are four basics that SME manufacturers need to follow to become 'investment ready':

- Full and thorough application of lean manufacturing practices.
- Produce completely unencumbered financials (e.g. no personal links, clean cost structures, balance sheet).
- Ensure a succession plan is in place so that the future is not dependent on any one individual.
- Develop a broad customer base to reduce vulnerability to the loss of one contract so that the firm is more attractive to invest in.

9. How effective are current tax incentives for equity investment in small businesses, such as the Enterprise Investment Scheme or Venture Capital Trusts?

Our experience is limited, but the view is that the current offer is pretty good.

Debt Capital Markets
10. Are there any steps that industry, financial institutions or Government could take to promote access to debt capital markets for a greater number of UK businesses?

No comments

Competition
11. What more could be done to promote greater competition in the provision of business finance?
12. What other actions could be taken to help businesses (of all sizes) access a wider range of different finance options?

There is some inertia amongst SMEs about changing their bank so they may not respond to normal recommendations and briefings. A local or mutual provider or bank may overcome this, but so might 'nudges' through business groups and trade associations highlighting the more competitive deals achieved by peer businesses.

Our experience is that SME owners/MDs are often experts or 'technicians' in the products and processes they use. They may not be experts in finance. For that they rely on third parties (e.g. accountants) whom they may see only three or four times a year (having to pay for the privilege) and that these advisers/consultants may not know the business that well.

If the bank that the firm has been with for many years turns a request down or imposes somewhat stiffer charges, the SME tends to take it for granted that since this is the bank that knows the business best, this is the best offer that's going to be available and that other banks will only offer tougher conditions.

Addressing Future Risks
13. Looking ahead, what are your views on future risks to the provision of business finance, in particular bank lending? If you have concerns, do these reflect transitional factors in the wake of the financial crisis, or structural factors? Are there steps that the banking sector, regulators or policy makers should be taking to mitigate these risks?

There are several important considerations here.

First, the structural.

Structural
The banks hold the whip hand when it comes to their dealings with SMEs.

From the SMEs point of view, in 2008/09 the banks imposed new, arbitrary, one-sided conditions. Finance dried up over night. The risk of that happening again is very real to SMEs. They want a sustainable banking relationship, but are doubtful whether it's achievable.

Some firms are already reporting that some banks are insisting on their taking out payment protection insurance with their loan. (Another way for the banks to keep apparent interest rates low, but the added insurance cost cuts further into companies' cash flow.)

UK – EU comparisons on access to finance and associated costs
Eurobarometer's *Access to Finance Report* (published in September 2009) covers many industries (60%), such as manufacturing, construction, distributive trades and logistics, as well as services (40%) with a particular focus on SMEs (92% of all responses).

The report indicates that banks play a more central role as supportive business partners in Germany, France and Italy than they do in the UK, where firms use a greater variety of sources placing perhaps a greater demand on cash flow.

Survey results

1. Compared to companies in Germany, France and Italy, use of trade credit has been far more popular in the UK. (Note this refers to 'trade credit', the period between delivery and when payment must be made for the goods, not 'trade credit insurance'.) On the other hand, a far smaller proportion of UK firms accessed a bank loan in the first two quarters.

Used over the last 6 months:	UK	Germany	France	Italy
Bank loan	19	28	26	32
Internal funds	60	67	50	39
Grants, subsidised loans	9	7	10	16
Bank overdraft	36	30	31	38
Trade credit	35	5	9	10
Leasing, hire purchase, factoring	18	33	14	19

2. Banks are more involved in providing loans to business in other countries than in the UK.

Provider of most recent loan over the last 2 years:	UK	Germany	France	Italy
Bank	72	86	94	94
Private individual	14	9	1	3
Other (micro finance, government etc)	14	5	5	3

3. While over half UK firms say that the cost of financing (other than interest rates) has increased in the last six months, half of French and German firms say that the cost has remained unchanged. And in Germany more than one in eight say charges have fallen.

Charges other than interest rates in last 6 months:	UK	Germany	France	Italy
Increased	53	17	37	46
Unchanged	33	58	48	35
Decreased	7	13	3	8

4. While half of firms in all four countries say that the size of their loans remained unchanged over the last six months, far more UK firms report decreases in the amounts they could borrow than in the other three countries.

Available size of loan over the last 6 months:	UK	Germany	France	Italy
Increased	10	24	14	20
Unchanged	52	54	54	55
Decreased	30	16	18	11

5. UK firms are equally likely to use a loan as working capital or for fixed investment, whereas fixed investment dominates French, German and even Italian use. Also far more UK companies use loans to help finance R&D or training.

Use of most recent loan (over last 2 years):	UK	Germany	France	Italy
Working capital	**57**	**44**	**20**	**35**
Fixed investment	**50**	**60**	**69**	**42**
R&D	**13**	**8**	**6**	**9**
Training	**10**	**2**	**1**	**2**

Conclusions

1. UK suppliers may have had more pressure on their cash flow than their competitors in France Germany and Italy. Standard payment terms are much shorter for example in Germany.
2. Banks are much more closely involved with their business clients, with bank loans far more prevalent in the other three countries than in the UK.
3. French and German companies are more likely to be benefiting from financing terms that have been maintained at pre-crisis levels. Terms for UK and Italian firms are much more likely to have got tougher.
4. One of the key changes for UK companies was the cut in the amount they could borrow. German, French and Italian firms were not hit to the same degree.
5. Loans in Germany, France and Italy are more likely to go on fixed investment, where the plant can be used to pay off the loan. UK companies are more likely to spend it on running the business, with more than two in ten using it for R&D and training.

Investment

Companies supplying into innovative or high value added markets have to keep investing to innovate and upgrade performance in plant and skills. If they don't they fail. And where they fail they threaten the supply chain that depends on them all the way up to the original equipment manufacturer (OEM).

So banks must be encouraged to step up as partners to facilitate investment not just with the OEMs but with these crucial supply chain link SMEs. Without that investment UK firms and the supply chains that depend on them will be lagging competitors who are installing the latest equipment now.

Already there is a danger of sliding back into the era of the two speed economy, as the banks come roaring out of recession with the benefit of public backing, while manufacturers face the invidious choice in uncertain times of husbanding resources for cash flow and survival (but not growing) or taking on more expensive risks to grow.

Reluctantly we have come to the conclusion that UK manufacturing SMEs are unlikely to benefit from the sort of supportive relationship with their banks that similar size firms enjoy in Germany and France or the USA.

- We therefore support the idea of an Infrastructure and Industrial Investment Bank. This would change perceptions about the UK as a place to run a manufacturing business.

Technology

Looking forward, the economy and the manufacturing sector both face a period of considerable change. For manufacturing this includes rapid technological innovation in the various production processes and associated machinery.

Technology life cycles are shortening. Machines that have a fully functional life of 25 years may only be fully competitive for a much shorter period, so technological advance is actually eroding machinery's residual value. As a result:

- Leasing is becoming more important.
- Ownership is not such an issue.
- Business models are changing/need to change.

It's important to understand how banks are going to go about this changing model when Government policy will provide less favourable terms for manufacturing investment (i.e. withdrawal of investment allowances) -- what criteria will the banks use in the assessment platform on which sound judgment will be made.

If the UK is to promote high-tech industry and exports then it's crucial that the financing framework is able to tackle these changes on an internationally competitive basis.

A recent four-country EAMA automation survey found that the other countries (Germany, Spain and Sweden) all offered a wider menu of financial support for example.

Personal guarantees

Another apparently 'structural requirement' of the banks is their strong preference for personal guarantees (see also under Question 15 EFG below). Their view is that statistically they get a much better outcome on loans where the main protagonist has put up some personal guarantees as collateral. This is a fact of life for most SME owners. But of course putting your family's home on the line may simply be too much for many, particularly in uncertain times and so goes to undermine confidence and increase wariness and caution, particularly when the banks can so easily change your arrangements overnight (please see attachment A).

Now on to the transitory.

<u>Transitional</u>

SMEs' report and accounts for 2009 are likely to look pretty bad. But these figures are about the past. Banks have details of current trading and can see how companies are being managed. Current information is far more important than the past.

During the next three years, industry and the banks are going to be working in a new environment. We have not so far suffered the white collar recession that was talked about in late 2008. But manufacturing has been hit again.

Even successful SMEs have had to adjust to big falls in business, even up to 50% in some cases. This has required dramatic cost reduction. Managements have been sorely tested to maintain skills and morale for the upturn while still reducing employment numbers and maintaining (perhaps depending on the technology sector even increasing) investment. And all of that with additional demands from the banks.

Banks and industry need to be clear about what is going to work best under these changing circumstances.

Banking Sector Environment
14. What steps can banks, industry or Government take to strengthen bank's relationships with their customers and ensure businesses are not discouraged from seeking finance? What steps can the banking sector and others take to improve the financial readiness of business?

SMEs are adamant that the banks would get a much better reception if they put greater focus on 'building' their relationships with SME manufacturers. For them everything that is wrong with the current situation is wrapped up in the title 'Relationship Manager'. Developing relationships with SMEs (as opposed to managing the relationship) requires different skills, attitudes and criteria for assessing success in the role.

EAMA members believe that banks have forgotten how to do business with manufacturers. Manufacturers are good sources of business for banks because they typically have longer term requirements across a wide variety of services (e.g. deposits, overdraft, transmission and investment).

In the past OEMs used to show their (SME) suppliers what they needed to do develop a successful relationship with them. If the banks' approach is one of relationship building (rather than management) then they should offer guidance in a similar vein.

This could help in several ways bridging some inevitable communication gaps.

- Many manufacturing SME owners' difficulties with their banks stem from the owners' backgrounds. Very often they are technicians with a perfect understanding of the technologies and processes used in the manufacturing business rather than of finance. (Please see comments to questions 11 and 12 above)

15. What options might Government consider to support increased lending to business (including possible expansion of the EFG or of payments to part of the supply chain)? How effective is the EFG in increasing access to debt finance for small businesses? What could be done to improve it and can more cost be borne by users?

The Enterprise Finance Guarantee is a well designed scheme. As of April 2010 it had helped nearly 10,000 firms through the recession. But it is also the refuge of last resort. A company is only eligible if all personal guarantees are used up in the loan process. So it's not going to stimulate investment. Nor will it help firms take advantage of opportunities as they arise.

One of the reasons why the EFG works in this way relates to the 'sliding scale' that's applied to the 75% Government-backed guarantee.

As we see it, there is quite understandably pressure on the banks to make sure that they don't provide loans to 'failing' companies. One of the mechanisms to achieve this in the EFG is through the conditions agreed with the banks whereby, if it turns out to that a bank's portfolio of loans includes some that turn sour, that bank will find its 75% guarantee from public funds reduced so that the bank takes some of the knock for its poor analysis and decision-making. As a result banks ask firms for a personal guarantee that 'occasionally' extends beyond the 25% that is not covered by Government.

There are a couple of ways to improve take-up:

- Drop the personal guarantee requirement and raise the interest rate from 2% above bank interest (which would increase the cost borne by EFG users).
- Extend cover so that it can be used to support firms that are heavily export oriented.

16. What steps would be beneficial in making securitisation more attractive to investors and a stable form of funding for lenders? Are there particular sectors or products that this should be focused on?

No comment

International Trade
17. Are there significant constraints on access to trade finance for UK exporters? What measures could banks, industry or the Government take to increase the availability of trade finance?

<u>Invoice discounting and factoring</u>
Invoice discount houses and factors refuse to make payment on goods as they leave the country for the export customer if there is no credit insurance cover. Last year, trade credit insurers withdrew cover from sectors such as automotive but also from companies that supplied into those sectors. The trade insurance top-up didn't cover exports either. This caused problems for the suppliers and exacerbated their difficulties with their banks.

As we make progress in ramping up our exports, the UK will need to have a more robust system in place. (At one point there were unsubstantiated rumours that one of the insurers was simply blacklisting UK exporters, but not those in other countries.)

The Export Credit Guarantee Department may be doing an excellent job for the larger companies on big contracts, but it is not considered to be up to the mark for SMEs, even among specialist niche companies that are leaders in their field world-wide.

- ECGD's service to SMEs should be reviewed and benchmarked to match or better the standards set by Export-Import bank in the USA and the services available to exporters in Germany and France.

<u>Guaranteeing the customer's deposit and the Enterprise Finance Guarantee</u>
In mechanical engineering it is standard practice for a customer to pay a 25-30% deposit to confirm their order. It happens all over Europe and in the USA. In return for the deposit, the customer expects to receive a guarantee, normally from a bank, that they will receive the machine they have ordered or their money back.

If the company making the machine is any good, this is all very low risk, for which the banks make a charge.

Whereas French, German and US banks provide the guarantee for a small charge, UK banks often deduct the deposit guarantee sum from the company's overdraft at the bank, so that the manufacturer is no better off for having received the deposit. There's no benefit to company cash flow.

And now some banks have doubled the interest they charge (to 3½%) and increased their administration charges. Others have placed ceilings on the total amount they will guarantee for any one manufacturer, effectively slapping a cap on the size of the firm's order book, or forcing them to forego the benefit of the deposit, which opens them up to increased risk.

Faced with so much uncertainty, some companies report trying to use the Enterprise Finance Guarantee Scheme, which was conceived to help improve the availability of working capital for SMEs.

However, despite its conception to help innovative firms, the terms specifically exclude support for 'individual export orders'. If a firm is over 70% export, in practice all their activity is excluded. In mechanical engineering the average for the sector is 70% export.

Apparently such difficulties do not arise in other countries, because they run a 'Bond Support Scheme' with Government backing, so that any orders where the deposit may be too big to be handled by the usual channels, can be covered competitively.

- If the UK is to develop a strong offer internationally it must be able to compete in the provision of such guarantees without putting its own manufacturers at a disadvantage.

Attachment A
Company reports on banks' treatment in late 2008/early 2009

Birmingham
We were forced down the factoring route (due to a weakened balance sheet): our overdraft charges increased from £8k to factoring costs of £18k+!

In answer to your email I must state that my bank (HSBC) have been very supportive (over recent months in particular), but at a price. We have experienced cash flow problems, so have been placed on their 'watch list', imposing a monthly management charge for this privilege! Also, I have recently (February 2009) discussed applying for a loan supported by the Enterprise Finance Guarantee Scheme (?), but was told ... *'As I mentioned on Tuesday Cliff, you must consider that if you as a director are unwilling to provide any guarantees into the business then the Government will not be prepared to do so in your place. Please bear this in mind ....'* I'm not sure if this is accurate, but was told point blank that the bank would not support my application.

Nottinghamshire
I bank with 'us/the Government (RBS)', my feeling is that the banks are at last doing their jobs properly, in that they are scrutinising all their customers carefully. My experience is that for 20 years I have always returned a profit, I have always been up front with the bank, and at all times kept them fully informed as to what I am doing. The downside of that is that once my business started to experience serious problems as of August 08, they suddenly wanted considerably more from me. Question is, had I not have been so forward with them in the first place would I have attracted so much attention.

My advice, don't give them more than the bare essentials, keep well within your limits, do not be afraid of using that very difficult word with your customers 'NO. Clear your account and you can have the goods'.

North West
We required a temporary facility to finance a large tooling project which was given but the amount was 60% of the amount needed to produce the order, which we then had to move intercompany monies around to finance the project, which cost us time and monies, and had a knock on effect on our sister company's plans for new machinery procurement and job creation.

We are also in the midst of trying to purchase our own factory for the tool room, and have found things have changed. The Government have bailed the banks out and saved their necks, and the SMEs are still out in the cold. The banks should be instructed to support the country's manufacturing industries that actually work very hard and produce something positive for the country.

North East
My only grievance is that having allowed themselves to get us all in the position we recently found ourselves in, the banks have now introduced a factor on any loans or overdrafts which is driven by OUR cash flow based on a debtor and creditor register, which is incredible considering that the banks themselves and just as importantly the Government allowed the financial sector to operate totally unregulated during the recent downturn.

West Midlands
Case1
We had our bank manager in this week and without any warning he has given us 2 weeks to reduce our overdraft by 50%. He has told us to take a bank loan for the remaining 50% at

9% interest charge. Well you can imagine we are not happy and are looking to change our bank.

Case 2
A company banking with Barclays recently extended his overdraft facility by £218,000 (approximately 10%). The cost to him was:

- an increase of 1% in his interest rate (to 3.5%);
- a 513% increase in his arrangement fee (to £23,000);
- the bank demanded a personal guarantee for almost the full value of the loan.

South East
Company in South East has raised their concern at the increase in bank charges and the high disparity in the percentage increases being charged. They question whether their usage is the reason why the percentage on Autopay payments is related to their volume monthly of 237 transactions whereas 'cheques paid in' accounts for only 5 transactions.

Activity	Current Charges	New Charges	%
BACS Direct Debits	0.38	0.40	**5.3%**
Standing Orders	0.40	0.42	**5%**
Cheques & Other Debits	0.60	0.63	**5%**
Automated Credits	0.16	0.18	**12.5%**
Manual Credits	0.67	0.70	**4.48%**
Cheques paid in – Branches	0.25	0.26	**4%**
Autopay Payments	0.28	0.50	**78%**
Internet Faster Payment	0.00	0.40	**100%**

Manufacturer
Our bank (BoS) have cut our overdraft facility by > 30%, increased charges on the remaining portion, **and** the removed portion should we need it!

Control of our bank has been strong in recent years - but times are different. In percentage terms we're now paying more for less.

On loans for equipment, e.g. rotary tables, they have displayed a complete lack of interest, forcing us to fund the purchase from cash.

Tool Supplier
As a company we have not noted any change with our bank, Lloyds TSB. The probable reason is that we do not borrow from them; we only use them as a finance route to run our business.

We are noting however that our customers are having major difficulty in getting decisions from underwriters for their finance applications. When questioned the finance source is saying that they have to be very careful now who to and what they lend.

The other issue relates to the rates of interest they are being asked to pay, circa 4% in most cases, which is higher than they were paying 3/4 years ago when investment interest was much higher. They see no correlation between current bank rate and what they are being asked to sign up too.

These actions are NOT going to aid early investment.

Manufacturer
In our experience we have found banks that have received Government money to be the worst offenders in their unwillingness to support manufacturing companies in the UK.

Example: We had a meeting with our Lloyds TSB bank manager last year, July 2008 seeking a commercial mortgage for our new premises. He could see no reason at the time looking at our finances and the valuation of the premises in question that we would not get the mortgage.

He told us that we would get a decision within two weeks. Solicitors were informed; the agents selling the property were also informed.

After three weeks and having heard nothing from our bank, I began to worry and could not get hold of our bank manager to update us on progress.

With this in mind I contacted another Bank, Santander Group. They came down to meet us and within a week we had the mortgage.

After all the legal issues were completed and after the discussion with Lloyds TSB re their unwillingness and dithering they decided to freeze our account whilst substantial funds belonging to us were being held.

They deemed a letter of 1st legal charges to Santander as a debenture.

Santander told us that they were in breach of the Banking Code of Conduct.

We have since moved our banking business to the Santander Group, due to the pathetic treatment by Lloyds TSB which nearly cost us our business.

Not good for maintaining our domestic manufacturing infrastructure,

We are profitable company in our 9th year.