Capital markets update

When it comes to capital markets, all is rosy. However, winter is around the corner, and it's only a matter of time before interest rates rise. So while Ireland is once again awash in capital, is this money fit for purpose?

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It wasn't long ago that "raising capital" meant a trip down to the local Bank of Ireland or AIB. That's simply how Irish businesses were financed. And for a long time, that suited everyone just fine.

But the world is different now. Today, the evolution of Irish capital markets continues at pace, with new players and new forms of capital entering the market seemingly every day. In fact, this influx of money has prompted some to question whether there might be too much capital chasing Irish companies.

But this thinking is misguided. It's not a matter of how much capital is chasing Irish companies today – it's whether the right type of capital will be chasing them tomorrow.

Paving the way

Capital flows generally follow economic cycles, with a stripe and a variety for every occasion.

Distressed debt funds, the so-called "vulture funds", were the first form of new capital to arrive in Ireland, stepping into the breach created by the collapse of the banking system, at the very bottom of the economic cycle, and profiting from our misfortune.

In this way, these funds served an invaluable function (yes, you read that correctly). By investing in the Irish economy when no one else would (or could), they facilitated the banks in ridding themselves of bad debts, thus freeing them to lend again and paving the way for our eventual economic recovery.

Chasing growth

Victims of their own success, vulture funds have since been displaced by a new type of investor: this time, chasing growth.

These funds – largely traditional private equity funds – form a large component of the supposed surplus of capital that has critics so worried. They need not be concerned.

In the main, these funds are here to capitalise on the growth of Irish companies and the upward trajectory of the Irish economy.

Their arrival and success mark a significant step in the evolutionof Ireland's capital markets, as the monies they invest afford business owners enhanced optionality with respect to selling their business, planning for succession, and pursuing new growth opportunities.

But the fact remains that the primary mission of these funds is to acquire growth companies, which begs the obvious question – what if your company is not for sale?

Or worse again, what if it's not growing?

No sale!

It's an important distinction. Most Irish businesses are family-owned. The notion of selling even a small interest to an outsider is anathema to them.

And even if it weren't, not every company fits the criteria of private equity, which include a bevy of superlatives (in addition to growth), foremost among them that a company has the requisite size to warrant consideration in the first place (here's a hint: it skews more towards the "M" side of the SME spectrum).

That's a tall order by the standards of most SMEs, particularly now that the recovery has largely run its course and the growth profile of most companies has levelled off.

And there's the rub. The pool of non-bank capital available today is deep, but not broad. It is targeted at a certain type of company, at a specific stage of development, at particular point in the economic cycle. This hardly constitutes a surplus.

What's next?

Meanwhile, the next form of capital, for the next part of the cycle – the downward part – has yet to reveal itself. That's not to say that it won't, but it's unlikely to come from the existing funders in the market. Equity chases companies up, not down.

No, the next evolution in Irish capital markets will likely come from debt investors given the lower returns expected in a down market. Unfortunately, Irish debt capital markets have yet to see the same influx of funding as the equity side of the ledger, at least not in any scale. And it's questionable whether they ever will.

The reasons for this are manifold, but in short can be ascribed to two factors: size and presence.

Ireland's size limits the appetite of large, institutional lenders to enter the market. The start-up costs are prohibitive relative to the amount of capital they'd be able to deploy and the profit they could conceivably generate.

Because of this, most debt funds merely dip their toes in the Irish market, sending over representatives from time to time, but never establishing a permanent presence, and as a result never gaining much traction.

Indeed, the most successful non-bank lenders operating in the market today all have local operations. This is not surprising. Brass plate lenders with no local presence don't figure prominently in the list of financiers with which family businesses want to transact.

Of course, this leaves the average SME with only one obvious alternative.

Old faithful

Commercial banks will never be fully displaced by non-bank lenders. They are the first and most trusted partners of any business, and are safely ensconced in the capital structure of every SME.

But ubiquity is not a panacea. Bank debt is fundamental, but it can be constraining, with operating restrictions and security requirements often disproportionate to the actual risk being borne. As such, it's not always the most practical form of capital.

That said, in defence of the banks, that's not their problem. They are senior lenders. They are not in the business of taking equity risk.

And that's fine. For now.

But the funding requirements of Irish SMEs are likely to change as the economy invariably cools.

Winter is coming

Though it might feel like our economic recovery has only just begun, make no mistake – winter will come again. It always does.

Indeed, with most of the Western world experiencing seven consecutive years of economic growth and equity markets reaching dizzying new heights, it's only a matter of time before the cycle turns, interest rates begin to rise, and growth begins to slow.

These conditions will require a commensurate form of capital. Broadly speaking, this means longer-dated, more flexible funding than is currently available from banks or growth funds.

This capital – typically some form of mezzanine funding – is not meant as a wholesale replacement for bank debt or traditional equity, but as a tactical supplement thereto that can facilitate investment in long-term capital projects irrespective of the prevailing economic headwinds.

Fit for purpose

Though nascent, this type of funding is becoming increasingly available to Irish SMEs via a new generation of funds, further evidence that capital flows follow economic cycles.

It also suggests that the conventional wisdom is wrong: there is no capital surplus. To the contrary, Irish SMEs are only just now beginning to be offered capital that is fit for all seasons.

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