

WHY INVESTORS SHOULD INVEST INTO SME'S



Whenever we talk about the terms “**Investments**” the first thing that comes to mind are **Multinational companies, or Public Listed Firms**. However the major market that has the true potential for being *perfect vessels for investment are the Small Medium Enterprises*. They actually carry a far better innate value in some ways than their larger counterparts.

The most important question for an investor looking into a small business is where do they focus their attention??. With the many Small Businesses out there, what makes one company more fascinating than the other?

Based on the statistical report from *The Companies Commission of Malaysia (SSM) in 2017 there were reported over 1,251,190 Registered Companies in Malaysia*.

However, due to the lack of Consultancy firms that can research and present the potential value of these companies to the mass market, these SME's don't receive the proper help they need. Especially in terms of *Corporate Loans, Business Loans, Contract Financing, Trade Line Facilities, Branding, Marketing Systems, Investor Relations, Etc.*



What we as Investors and Management Consultants have failed to realize is that, this provides great opportunities for above-market returns. In fact, some of the industries within *the SME Framework are doing far better than their larger counterparts in terms of "Profitability"*.

However this also means **investors** like us **must have an approach system for determining** which companies are worth focusing our efforts and financing on.

After many years of investing in private companies, we at SKB have developed an initial framework—the first five things that we look at when we see a new company or *Investment Potential*.

Valuation and deal structure, for example, are still the critical areas (Which we will be touching on in other articles).

The principles behind this list could apply to many industries, but they are especially relevant to consumer and retail businesses, the industries in which I have the most experience.

Please note that this list is not intended to be all-inclusive comprehensive system. It's intended only to serve as an analysis point for us to begin our appraisal of the said company or enterprise:





1. THE PROMOTER

Believe it or not, it all begins with the Promoter/Owner of the company when it comes to evaluating a small business, you are investing as much in the leadership of the company as you are in the product or company.

Thus, invest behind a Promoter who knows what's best for the company. As part of your initial diligence, reference checks and third-party background checks are a must. Another aspect is to ensure that you are Comfortable working with the individual(s) that you are investing into.

In my personal experience, there has been times where my analyst had done the necessary Due Diligence and had found the company to be sound and marketable with a promising margin. However when the meeting was set between me and the said promoter, the deals fell through.

Unfortunately, many Promoters once called for an Investor meeting, suddenly seem to get the impression that they are all too great and arrogance sets in. Suddenly, figures and profit margins change completely without rhyme or reason.

My advice! *Investors are NOT STUPID!!!* When we are meeting you, we already know your business inside out!

Why is that?? We need to be very precise as to what the company needs not only in Finance but supplementary resources in order for the expansion process to happen.

As without the Expansion Plan! How would we recoup our investment and make money on it?? Therefore it is good to be Confident but never be Cocky nor Arrogant, as for one moment if I find that I cannot trust the person running the company that I am investing into... *I walk away!! No if's No buts, No Explanations required.* This is something that Business people in ASIA should really look into, as put yourself in our shoes. If you did not trust someone, would you invest your money in them??

Besides that, I can't think of any specific formula for evaluating a good leadership talent but you should do what every investor does, which is spend a lot of time asking questions!

Set meetings and investigate on issues you think are important to you and your investment decisions. Does this person understand their business, have a passion for the product, and have what it takes to persevere?

2. MARGINS

The Key area that I always look at is the Gross Margin! This is the percentage difference between what a product sells for in the market which dictates your actual revenue and the production costs of that product, which translates into cost of goods sold, or COGS.

The calculation of this particular ratio is critical, as it is what allows an Investment company like SKB to invest in all the other areas needed to get the product or service to market through channels such as marketing and distribution.

Gross margins will definitely vary in different industries and even by categories of business within an industry.

What an Investor has to be savvy about is that razor-thin gross margins leave no room for error in operations of the company.

In private equity financing, I focused on investing in categories that have higher gross margins and thus could sustain increased costs more easily. Examples of higher gross margin categories include The Food and Beverage Industry, Cosmetics, Electronics, and natural and organic products. **(Please look out for our case studies in the issues to come)**

Gross margin expansion is very difficult as it comes back to the existing flow of the Business enterprise. Focusing on creating products with better margins, is not necessarily based on cost cutting measures? Though lower prices for raw materials can help, but how and where the business can create an improvement in the gross margin comes to completely thinking outside the box.

3. BRANDING

Though Branding is the Key Factor that we need to look at when investing into a company, this is often the toughest thing to assess in a small company. However an investor needs to ask themselves **"Does this brand offer something unique?"** An example of this is Method is lets look into Cosmetic Product company like say *"Body Shop"*.

Now as an Investor you are well aware of the market awareness and market share held by "Body Shop" Assuming there is this smaller manufacturing company that has products similar to Body Shop with a 100% organic ingredient structure and supposedly better than products at the Body Shop.

What would you do? Well the first thing that I would do is look at the **Branding**. If there is relatively minimum to No Exposure on the company and its products then my personal preconceptions would kick in as **how do they sell the products that No One Knows EXISTS???**

You see the common misconception by most businesspeople is that my Product is superior! Its great to have the confidence! But always remember that no matter how good your product is, without proper Branding you are gone before you even start!



As an Investor we need to see how well the Product can sell within the creation of the Brand Image of the company and product and costs that will be derived for the said exercise. If that is feasible against the Margins explanation in area number 2 as mentioned above, only then we would consider the said Investment Viable.

Another example in the consumer packaged goods (CPG) world, there are countless energy drinks. But there's a reason why **Red Bull** has been huge successes while other products with similar recipes and formulas have failed: *formulas can be copied, brands cannot; an important lesson to remember.*

4. REPETITIVE INCOME

Repetitive income is the portion of the revenue that is going to continue in the future. It provides a nice base (ideally a growing base) of revenue on which management can rely while focusing on ways to grow the business. It's especially valuable because the cost of acquiring a new customer is typically about six times the cost of keeping an existing customer.

For example cosmetics, in consumer products recurring revenue comes from repeat purchases.

Maybe you bought the product once because you liked the packaging, you buy it again because the product performed better than or as anticipated, like say Sunsilk Shampoo, once you have used it and it feels good after using, then the Packaging has worked in prompting you the customer to pick up the product and be a recurring customer for the product.



It's not enough, of course, to look to recurring revenue; the question is how frequently that revenue will recur.

At another Investment that we undertook, we invested in a Women's Day and Night Cream Company with a beautifully designed bottle that dispensed the cream in the exact proportions the average woman needed every day.

The problem was that the average woman usually uses a lot more night and day cream than is needed. As a result, consumers took 12-18 months longer than normal to use up our cream. Sounds great for the consumer, but it was problematic for the company because it delayed the repeat purchase cycle.

We got burned on this deal as we formulated all the systems from Margins to branding but making the product so effective we screwed ourselves on the long term repetitive business margins that hurt the company's innate value in the long run.

5. EXIT STRATEGY

For an Investor the Exit Strategy is one of our key factors that we look at. As this strategy determines the time frame and mode of when and how we invest our funds, therefore recouping the said investment(s) and making the prescribed profit(s) are purely determined by the scheduled Exit Strategy.

Most Business owners think that if they build a great company there will always be a home for it, but in certain or rather most industries that's definitely not the case. When we come into a company as an Investor we look at the Exit Strategy being done in either of the 3 ways prescribed below:



a) AN IPO OPTION – Dependent of the company's turnover and nature of business, we would primarily look into taking the company listing and cashing out at the IPO. It is our Job at SKB to build and maintain the company for this exercise.

b) A BUYOUT OPTION - If the company has visions of selling to a strategic acquirer, it should be able to 1) identify who these likely “strategic” are, 2) determine what their acquisition strategies have been, and 3) be able to explain why that business should be attractive to a strategic acquirer.

We would also prepare the said company for a Strategic Merger and Acquisition process if that is the required option agreed by all parties.

c) THE R.O. I MODEL – This Model of Investment is whereby a certain rate of returns has been determined by the Promoters and SKB and upon the achievement of benchmarks set by both parties, the Exit Strategy used would be based on how we have recouped our Investment and Profit as predetermined at time of initial investment structure as agreed by all parties.

I sincerely hope that I have been helpful in enlightening you as to what we Investors should look into Investing in SME Companies. I hope that I have been able to help show you the challenges that are being faced by us the Investors and how to make your business more applicable and Investor friendly. I wish you all the Best and Hope this article helps you get the necessary investment(s) required for your company for its growth and expansion.

