The Struggle of Local Businesses

by Adhurim Doci & Madalina Samoila

- Death Valley
- The Phenomenon of Revenue Illusion
- The Rusty Gearshifts of Leverage

The Struggle of Local Businesses

There is a 60% chance that your business will not make it past 5 years (ONS 2017). This article explores why so many businesses fail and how you can avoid the same fate.

Assuming that your product/service is needed in the market, there are 3 common traps that businesses fail to overcome :

- *Managerial Gaps and Resource Limitations*
- *Rusty Gearshifts of Leverage*
- *Revenue Illusion*

Executive Summary

In analyzing the high failure rates of SMEs within the UK, it becomes clear that the survival dilemma stems from three interconnected challenges:

Managerial Gaps and Resource Limitations: The core issue here is the inadequacy of management expertise and the scarcity of resources. Many SMEs struggle with developing effective management practices due to limited access to skilled personnel and resources. This gap often results in inefficient operations and decision-making, emphasizing the need for enhanced managerial capabilities and resource optimization.

Revenue Illusion: This factor highlights the misinterpretation of revenue forecasts as an indicator of financial health, often neglecting the critical importance of cash flow management. The optimism bias towards projected revenues can mask the urgent need for meticulous financial planning and control, leading SMEs into precarious financial positions.

The Rusty Gearshifts of Leverage: SMEs' reluctance to engage with external financing reflects a misunderstanding of how debt can be strategically used for growth. This 'broken gearbox' limits their ability to leverage financial instruments effectively, stunting potential expansion and innovation due to a preference for internal funding.

To succeed in today's competitive market, small businesses must prioritize innovation, streamline their cash flow by maintaining high cash reserves, and manage their receivables and payables efficiently. Strategic use of debt, coupled with rigorous risk management, enables them to fund promising projects effectively. Implementing advanced forecasting methods and formal management practices is recommended for SMEs.

This fairy tale explores several themes, such as

Introduction

Small to Medium Enterprices

SMEs are defined by the Organization for Economic Cooperation and Development (OECD) (2004) as independent non-subsidiary firms that have less than a given number of employees (<250). They are divided into Micro, Small, and Medium sizes based on the number of employees, revenue, and total assets on their balance sheet.

	Micro	Small	Medium
Number of employees	1 - 9	10 - 49	50 - 249
Turnover	Up to £632,000	Up to £10.2 million	Up to £36 million
Balance sheet	Up to £316,000	Up to £5.1 million	Up to £18 million

Figure 1: The Categories of SMEs

SMEs represent 99.2% of all businesses in the UK, emphasizing their crucial role in the economy. They also account for 61% of employment and 52% of private sector turnover, marking their substantial economic contribution.

Managerial Gaps and Resource Limitations

One of the most multi-dynamic problems that affects all the functional areas of the business is the presence of “Resource Limitations”& “Managerial Gaps”.

This is highly common in Micro-Enterprises which are businesses with an annual turnover of up to £632,000 (Figure 1). This is because most of them are run by owners who are not qualified for managerial positions. We believe that those businesses significantly suffer from imperfect information due to oversimplification of the decision-making process (Mendy, 2021). The findings indicated a need for a more innovative environment and inter-departmental collaboration to enhance overall company performance. It suggested that changes in employee learning and development can be critical resources for performance improvement, alongside managerial efforts.

Additionally, a study by NIESR found that small businesses benefit significantly from formal management practices, especially those related to human resources. Such practices lead to growth and better productivity, counteracting the potential harm from oversimplified decision-making (Bryson & Forth, 2018).

This fairy tale explores several themes, such as

The Phenomenon of Revenue Illusion

In conversations with various local business owners, I've sensed a common trend: they tend to focus only on their sales, costs, and total profit. This narrow perspective often overlooks critical aspects such as the efficiency, timing, and flow of cash through the company's operational channels. At Mapogos Capital, we recognize that this omission can be fatal for businesses; it contributes to what we refer to as the "Revenue Illusion." This is due to overly optimistic revenue projections, rooted in inadequate forecasting that skews the perception of financial health.

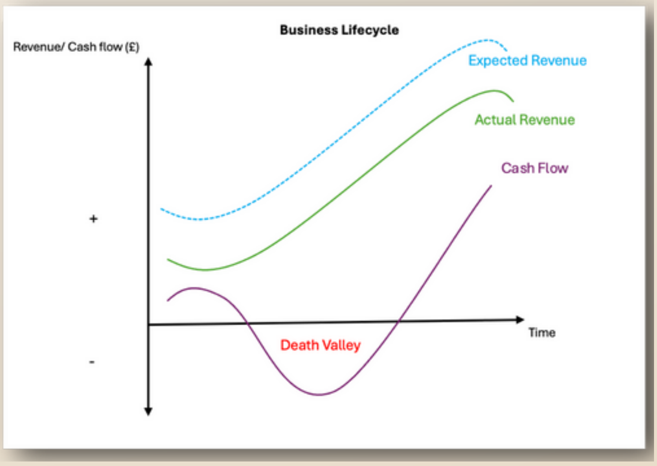


Figure 2 : The Early Business lifecycle

The illusion of a successful business often arises from a focus on sales volume without accounting for the timing differences between accounts receivable and accounts payable. While a growing number of orders may indicate robust sales, it does not guarantee immediate cash flow. Three in five UK businesses are owed money from late payments, fuelling stress and cash flow problems (Barclays 2022) .

Conversely, expenses often require immediate payment. This mismatch creates a deep compounding problem. Figure 2 simplifies this concept by illustrating the early stages of a business lifecycle. Cash flow will initially decrease before following the same behaviour as Revenue. Therefore, businesses find themselves operating in the “Death Valley” zone. This zone will expose and rigorously test the company's financial resilience by stretching the elasticity of total liquidity. To navigate this zone, a mere surface-level assessment of net working capital is insufficient. A more nuanced analysis is required, one that examines the ratio of cash reserves to total current assets, thereby ensuring a comprehensive understanding of the company's true liquidity position.

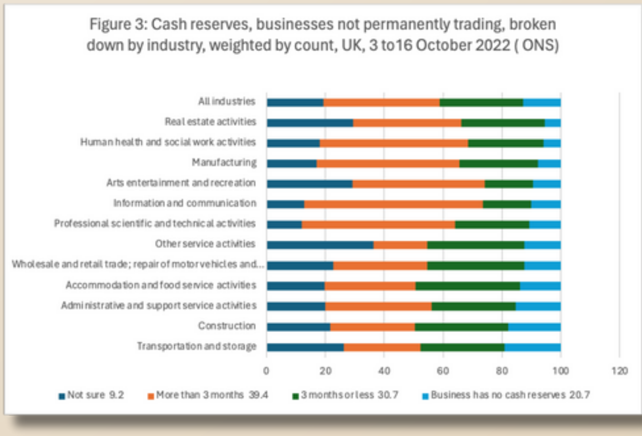


Figure 3: Cash Reserves of businesses in the Uk, weighted by count.

This risk of bankruptcy drastically increases when the businesses are operating with low cash reserves (Figure 3). The Office of National Statistics clearly states this issue: “In early October 2022, 41% of businesses reported they had either no cash reserves (13%) or had three months or less (28%); this is the highest percentage reported since late June 2021". This demonstrates that businesses

suffer from imperfect information when it comes to the importance of cash reserves.

The Rusty Gearshifts of Leverage

At Mapogos Capital, we often describe the misconception that business owners have about debt using the metaphor "The Rusty Gearshifts of Leverage." This metaphor highlights how leverage, like the gearshift in a vehicle, is crucial for translating financial capital into expanding projects and experiencing internal economies of scale.

Yet, many businesses regard debt solely as 'bad debt', associating it with undue risk and potential financial trouble, much like a car stuck in first gear due to a rusty gearshift, unable to accelerate.

Reasons for not applying for a loan.

Main reason for not applying for new loans or new lines of credit	Freq.	Percent
Don't know	619	1.17
Refuse to answer	34	0.06
No response	7	0.01
Still in process	749	1.42
Skip	3	0.01
No need for a loan	28,742	54.53
Application procedures for loans are complex	5064	9.61
Interest rates are not favourable	7562	14.35
Collateral requirements are too high	3666	6.95
Size of loan or maturity are insufficient	976	1.85
It is necessary to make informal payments	1617	3.07
Did not think it would be approved	3290	6.24
Other	384	0.73
Total	52,713	100

Figure 4. Reasons for not applying for a loan

Figure 4 shows how 54.53% of SMEs are not applying for a loan because they believe that there is " No need for a loan" (Wang, 2016). This evidence further supports the asymmetric information between banks and SMEs. Apart from the misconception that business owners have about debt, interest rates have also become a disincentive over the years. As we can see from Figure 5 the EIR has risen over the years. Typically the average interest rate charged by UK banks for small and medium business loans is about 7%.

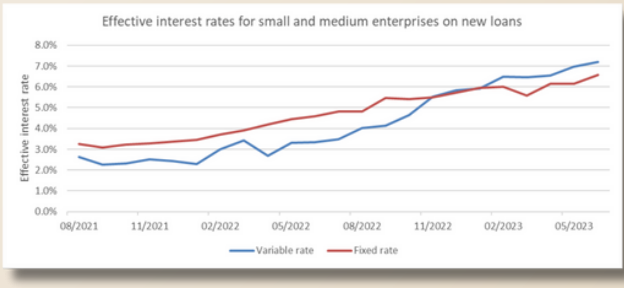


Figure 5. Effective Interest rates (E for small to medium enterprises on new loans

Among the SMEs which need external financing, it is evident that the financing difficulties usually result from the following reasons: (1) high-interest rate; (2) complex application procedures; (3) high collateral requirements; (4) perception of SMEs that the application would not be approved; (5) informal payments (Wang,2016). High requirements for collateral and lack of confidence imply a lack of credit guarantees in institutions. The consequences are similar to the observations made by Beck and Demirguc-Kunt (2006) who concluded that asymmetric information between borrowers and lenders plus the high transaction costs are the two leading constraints that exacerbate the financing available for SMEs.

Let us help you with your business

Mapogos Capital offers the support to fine-tune your financial strategy, delivering tailored consultation services to refine cash flow management and ensure accurate forecasting.

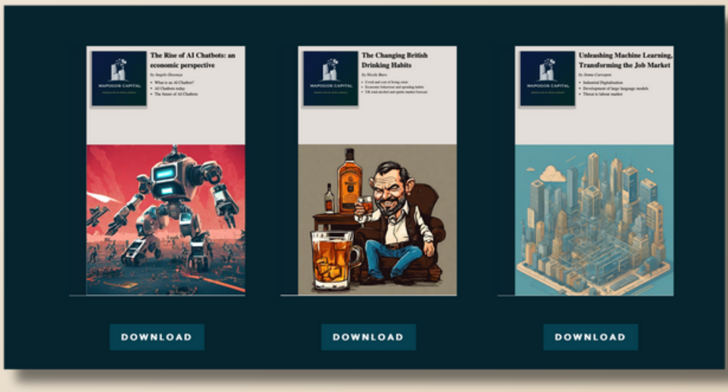
We are here to support your pursuit of market opportunities and facilitate the procurement of external financing. With our guidance, your business will navigate the complexities of growth and secure a robust financial standing.

For further inquiries: :
Email: contact@mapogoscapital.co.uk
Phone number: +44 (0) 2045112570
Website: mapogoscapital.co.uk
Linkedin : Mapogos Capital

Start Now

Stay ahead of the curve with Mapogos Capital's weekly insights! By subscribing to our articles, you're not just staying informed—you're gaining a competitive edge.

With each article, you dive into a world of expert knowledge, exclusive content, and thought-provoking perspectives that can't be found anywhere else. Don't miss out on the opportunity to expand your horizons. Subscribe now and join a community of discerning readers who demand nothing but the best in financial intelligence.



Our Mission

Our mission is to combat financial illiteracy on a global scale and contribute to the betterment of our society. To fulfil this purpose we concentrate our efforts on the backbone of our economy - assisting business owners in making more informed and intelligent decisions.

References

1. Wang, Y. (2016) 'What are the biggest obstacles to growth of SMEs in developing countries? – An empirical evidence from an enterprise survey', Borsa Istanbul Review, 16(3), pp.167-176.
2. Bryson, A. & Forth, J. (2018) 'The Impact of Management Practices on SME Performance', National Institute of Economic and Social Research (NIESR).
3. D. Clark (2022) 'Survival rate of new enterprises in the United Kingdom from 2007 to 2020, by years survived', Statista.
4. Barclays (2022) Three in five UK businesses are owed money from late payments, fuelling stress and cash flow problems
5. Zoom (2019) 'Adoption of remote technology in the UK', Committees Parliament.
6. Mendy, J. (2021), 'Performance management problem of four small and medium-sized enterprises (SMEs): towards a performance resolution', Journal of Small Business and Enterprise Development, 28(5), pp. 690-710. DOI: 10.1108/JSBED-06-2019-0201.
7. Census (2021) 'Business birth and death rates, 2016 to 2021', Office for National Statistics
8. Sukkar, A. 2022, The Future Path of SMEs: How to Grow in the New Global Economy, 1st edn, Business Expert Press, New York.
9. Crisis management for small and medium-sized enterprises (SMEs): strategies for external crises, 2022, Springer, Cham, Switzerland.
10. Falahat, M., Ramayah, T., Soto-Acosta, P. & Lee, Y. 2020, "SMEs internationalization: The role of product innovation, market intelligence, pricing and marketing communication capabilities as drivers of SMEs' international performance", Technological forecasting & social change, vol. 152, pp. 119908.
11. Industry 4.0 in SMEs across the globe: drivers, barriers, and opportunities, 2021, First edn, CRC Press, Place of publication not identified

The content provided on this website, including but not limited to articles, analysis, news, and general information, is for informational purposes only and does not constitute financial, legal, or other professional advice. Mapogos Capital Limited does not recommend or endorse any specific investments, investment strategies, financial products, or services, and the content is not intended to be a substitute for professional financial advice. Visitors should not use the site's content as the sole basis for any investment decisions. While we strive to provide accurate and up-to-date information, Mapogos Capital Limited makes no representations or warranties of any kind, express or implied, about the completeness, accuracy, reliability, suitability, or availability with respect to the website or the information, products, services, or related graphics contained on the website for any purpose. Any reliance you place on such information is therefore strictly at your own risk. Mapogos Capital Limited, its affiliates, and its employees are not liable for any losses or damages arising from the use of the content provided on this website, including but not limited to direct, indirect, incidental, punitive, and consequential damages. The copyright of this privacy policy and all content on the website is owned by Mapogos Capital Limited and is protected by UK and international copyright laws. Unauthorized use, reproduction, or distribution of this material without express and written permission from Mapogos Capital Limited is strictly prohibited.