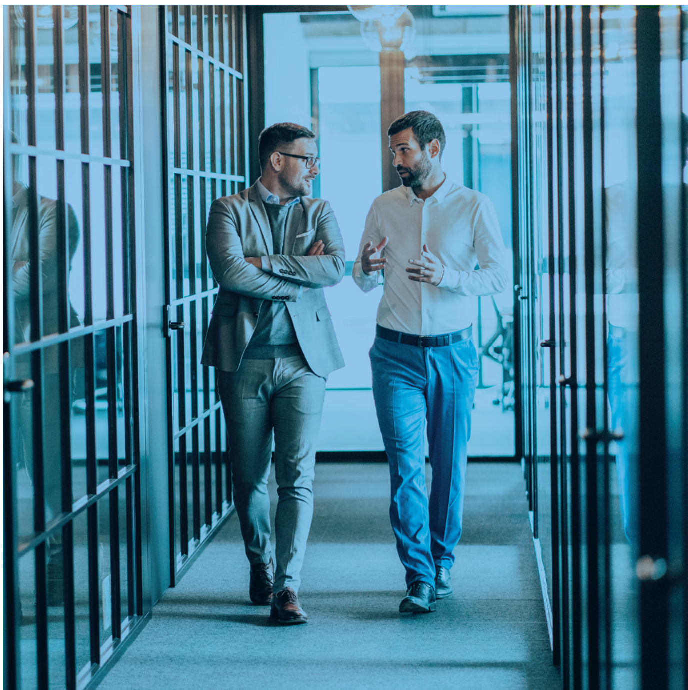
Guidebook
SME Financing

A road to an investment of institutional investors



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Introduction

This guidebook outlines the demands and preferences of Dutch institutional investors. Its purpose is to serve as a guideline for Dutch Small and medium enterprise (SME) financing funds to ensure that they meet the organisational requirements of institutional investors. As most of the demands and preferences of Dutch institutional investors overlap with those of foreign investors, this document may also be of value to SME financing funds seeking investors in foreign markets. To attract funding from institutional investors, SME financing funds have to invest a lot in terms of cost, time (to wait), knowledge, effort. These efforts are not one-off . The company needs to be open to structural changes in the organisation and transparency for due diligence and reporting processes.

This handbook by AIF is made possible in part by Invest NL and Stichting MKB Financiering and paves the way to institutional funding for SME funds and describes the possible bumps in the road involved when obtaining institutional funding.

Advantages of institutional funding

Obtaining institutional funding requires significant efforts; however, substantial benefits may be gained for maturing SME funds who are ready to make the next step. Most importantly, there are certain limits to how far a fund or company can grow under the umbrella of private investors. Institutional funding alleviates these limits since institutional investors manage the largest pool of money in the total investor landscape. Furthermore, the requirements imposed by institutional investors ensure a more robust and professional organisation going forward.

The landscape of institutional Investors

The common denominator of institutional investors is generally understood as all institutions that invest common money. This means that institutional investors do not invest their own funds but the money of participants or clients. Therefore, they are subject to strict regulations that limit unwarranted risk taking and have policies in place to protect the best interests of their clients or participants. Institutional investors must be able to substantiate any investment decision they make thorough documentation about the risks and rewards of the investment strategies that are considered.

In this guidebook, particular emphasis is placed on the two largest types of institutional investors in the Netherlands: pension funds and insurers. Due to the sheer amount of money they invest, these investors can be an important source of funding for SMEs (via SME funds) and, thus, a good alternative to the traditional source of bank funding. In addition, this report also discusses regional development centres (ROMs) and family offices as a possible source for SME financing.

In general, institutional investors include the following parties:

- Pension funds
- Insurance companies
- Sovereign wealth funds

Further distinction between institutional investors can be made based on the ultimate beneficiary of the investments. Pension funds invest money on behalf of their participants, they are accountable towards these participants and must justify their investment decisions to them. The investment framework for pension funds is strict because of their accountability to their participants. Insurers and family offices are asset owners and invest for their own balance sheets, having an investment framework that is less strict than that of a pension fund. The tight restrictions that pension funds face may limit certain investments by prioritizing participant interests, social responsibilities, public scrutiny, costs, or liquidity requirements.

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In the Netherlands, a total capital of around EUR 2 trillion is invested by institutional investors. The annual amount that SMEs need in funding is only a small part of this. Nevertheless, it is not self-evident that institutional investors can play a major role in the funding of SMEs. Like banks, institutional investors have the goal of achieving a suitable return given a certain risk profile. However, they have a different framework in which they operate. While banks must keep their funding within the global regulations of the Basel Convention and are accountable to their shareholders, each institutional investor has their own set of regulations and stakeholders. Institutional investors must be able to justify to their regulations and stakeholders why a particular investment has been made and, therefore, have a strict decision-making process in place for investments.

This section first describes the types of institutional investors, including their typical investment profile and preferences It is followed by a description of the investment process, including the various considerations that need to be made.

Types of investors

In this guidebook, pension funds, insurers, ROMs, and family offices refer to potential institutional investors.

Selection of institutional investors

> Increasing organisational complexity and effort

Family Offices	Regional Development centres	Insurers	Pension funds
Anthos Amsterdam Clavis Commenda De Hoge Dennen Capital HAL Investments HB Capital Kaya Capital Navitas Providence Capital Reggeborgh	Brabantse Ontwikkelings Maatschappij BOM LIOF Innovation Quarter / investeren & innoveren in Zuid-Holland Impuls Zeeland NOM oost nl	achmea AEGON Allianz a.s.r. CZ de Goudse verzekeringen menzis nationale nederlanden VGZ ATHORA	ABN·AMRO Pensioenfonds ABP bpfBOUW Stichting pensioenfonds ING pensioenfonds PGB Pensioenfonds Vervoer Pensioenfonds Zorg & Welzijn pme pensioenfonds PMT pensioenfonds Metaal & Techniek Stichting Shell Pensioenfonds

Dutch pension funds

Dutch pension funds are the largest institutional investors. A total of EUR 1,449 billion was invested in portfolios comprising various asset classes. The number of pension funds has been gradually decreasing due to consolidation. Currently, the number of pension funds is less than 200 in total.

Pension funds determine their own investment policy and are organised in two ways. Either (1) the investments are selected and managed by the pension fund itself, or (2) the pension fund outsources these services.

1. The pension fund selects and manages its own investments. It manages a network of professionals, including the administration of pensions and parties who advise the administrative office on investments.

2. A pension fund chooses to outsource the selection and management processes of its investments to a pension provider, also known as a fiduciary manager. An external organisation is used to implement the investment policy, set up by the pension fund, and select the investments within a certain framework set by the pension board. A small number of fiduciary managers manage the investment portfolios of many pension funds in the Netherlands. These can be non-commercial fiduciary managers, such as APG, Blue Sky Group, MN, or PGGM (owned by the largest pension funds), but can also be commercial fiduciary managers, such as Achmea, Aegon, BlackRock, BMO, Kempen or NN Investment Partners (owned by insurers/ commercial owners or the public through a listed company).

Social initiatives, such as investing in SME financing funds, are regularly addressed by pension funds themselves. The board of the pension fund then instructs the fund’s fiduciary manager to consider a particular initiative.

Pension funds fall under the Dutch Pensions Act and, therefore, must act in accordance with a regulatory framework, ‘Financieel Toetsingskader’ (FTK). The FTK sets conditions for the financial health of a pension fund and is built around the principles of market valuation, risk-based financial requirements, and transparency. It also indirectly provides an additional dimension to the desirability of investment categories by dictating a risk premium per investment category. Pension funds are under the supervision of De Nederlandsche Bank (DNB).

Pension funds are a non-profit entity and, therefore, have no shareholders; however, they have various stakeholders, such as employers who pay pension contributions, employees who pay pension contributions and accrue pension, and retirees who receive pension benefits. The board of the pension fund, which is formed by representatives from each of these stakeholder groups, is ultimately responsible for the investment policy. Therefore, the board is also responsible for deciding whether to invest in SME financing funds as part of the investment portfolio.

Insurers

Insurers are the second largest category of institutional investors. All Dutch insurers together have more than EUR 450 billion in assets under management. Insurers can be divided into different types. Life or pension insurers have the most assets under management as they invest the life insurance and pension premiums of their customers. Due to consolidation, only a limited number of life and pension insurers are active in the Netherlands. Achmea, Aegon, Allianz, a.s.r., Nationale Nederlanden and Athora Nederland together make up most of this sector. Non-life insurers, health insurers and other insurers have considerably smaller investment portfolios.

A life or pension insurer offers commercial life insurance and retirement products. The premiums deposited by the purchaser of the product are invested by the insurer on their own balance sheet or within a separate (pension) product. This makes the customers of the insurer an important stakeholder in the choice of investments. For some pension products, the choice of investments can be made by the customer (within a certain selection by the insurer), whereas for other products, the insurer makes the investment decisions. The insurer’s shareholders determine the insurer’s risk attitude and, indirectly, the insurer’s investment policy. The investment policy may be an important source of profit and loss for the insurer, in addition to the participant premiums.

Insurers are covered by the European Solvency Directive. Analogous to the Basel Convention for banks and the FTK, this regulation determines the desirability of investment categories by dictating a risk premium per investment category.

Family offices

Family offices are a third, relatively small category of institutional investors. The traditional family office supports one or more generations of one wealthy family in the management of their assets: a single-family office. In recent years, the segment of multi-family offices has substantially grown. The scope of the multi-family office is essentially the same as that of a single-family office but includes several families and individuals. There is no such thing as an organisational template for a family office. The design and services of a family office are dictated by the preferences of the family.

These organisations often originate from successful entrepreneurs. The entrepreneurial spirit influences the management of the accumulated capital: a relatively large portion of the assets are used for private investment in other companies. For equity investments, this translates to private equity and venture capital investments. Entrepreneurial investments in fixed income are in direct lending or mezzanine loans.

Family offices have limited supervision when no external customers are served. The most important and often the only stakeholder is the entrepreneur and/or his family. Their activities are thus largely hidden from view. This is by design; privacy and discretion are crucial conditions for a family office. Family offices may be an important player for Dutch SMEs due to their (entrepreneurial) investments.

Regional Development centres

Regionale Ontwikkelingsmaatschappijen

ROMs are semi-governmental organisations that were created to strengthen the regional economy by, for example, investing in innovative and fast-growing regional companies and restructuring business parks. In addition, they provide venture capital to entrepreneurs and may become shareholders in these companies. They also guide entrepreneurs in their business operations and encourage entrepreneurs to establish themselves in the region. A total of 10 ROMs are currently active in the Netherlands, with more than EUR 260 million joint direct investments.

Stages of funding for SME Funds

Stages funding process

> Increasing complexity and effort

1. Private investors	2. Family offices or (semi) governmental funds	3. Pension funds and insurers	4. Public investors (via equities and bonds)

Four stages in the funding process of SME funds can be distinguished. Each of these provide new organisational requirements and challenges that should be overcome as the organisation of the SME fund matures and grows. It is not strictly the case that each of these levels must be completed in order to arrive at level 3, institutional funding.

Newly established SME funds usually do not begin with institutional funding but look for private investors within their direct and indirect surroundings through friends, acquaintances, and networking activities. These investors are wealthy individuals with no formal investment framework and can base their investment decisions upon the personal trust they have in the entrepreneur behind the SME fund. When the minimum investment in the fund is 100,000 Euro the funding stage is not regulated by the Dutch financial market authority. Certain private investors with a high-risk appetite are willing to take on high risk and can make a fund viable in the initial phase of the SME fund by investing in it.

With the backing of private investors, an SME fund can begin building a track record and prove it is viable. Having a track record provides the fund with credibility and reduces the risk of the fund's strategy being overlooked by other investors. Family offices and/or (semi) governmental funds may be approached and when the organisation is presented in a professional manner, may be enticed to invest in the fund. At this stage, it is important for the SME fund to prove it is capable of executing its strategy and operations on a larger scale before moving on to the next stage of funding.

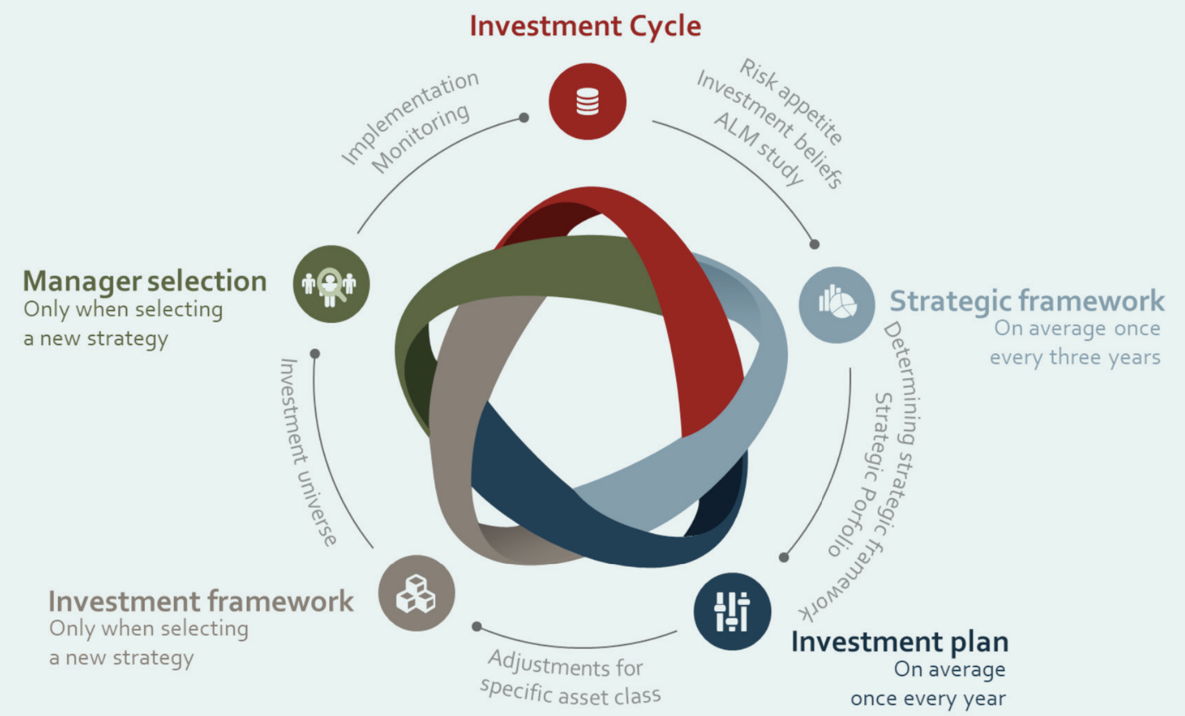
When the fund has the ambition to raise a minimum of €50 million, it can decide to take the next step and approach institutional investors. All the detailed steps involved are further explained in the next sections of this guidebook.

Investment decision-making process

Institutional investors are held accountable for their investment decisions. Regulatory pressure ensures that this investment process is as strong and transparent as possible. As shown in the investment cycle on this page, this often leads to a rigorous and strict investment policy regarding investment selection. These selection processes for institutional investors demand high organisational standards from managers who do the selection for the institutional investors. Retail and private investors face no such pressures and are not subject to the same restraints. Their decision-making process is faster and more opportunistic. Private investors do not require a high level of detail in their due diligence process and have no formalized decision-making framework or demanding reporting standards. Before deciding to enter the road of institutional investments, a manager must be aware of these organisational requirements.

On the next pages there is a generic description of the different steps that a new investment must go through before it is accepted or rejected by an institutional investor.

Investment cycle



Investment cycle

The processing time for all the phases in a complete investment cycle typically takes 6 to 12 months for institutional investors with extensive investment policies and processes. If an investor has already invested in private debt or SME funds, the lead time can be significantly shortened. These investors only have to complete the last two phases of the investment cycle: investment framework and manager selection.

Risk appetite

Determining the fundamental principles of the institutional investor is very important, especially when investing on behalf of the participants. The risk attitude, together with the current investment portfolio, forms the input for the ALM study.

Since the risk appetite concerns the general risk attitude of the institutional investor, SME financing-related elements do not yet play a role.

Investment beliefs

The investment beliefs form the basis of the investment policy and determine the investment universe and investment conditions. All new investment proposals should be assessed against these principles.

A potential limiting investment belief for SME funds is that the board must be able to understand the investment. Because it is a relatively new investment category, little knowledge has been built up in the organisation regarding investment in SME loans.

Asset-Liability Management (ALM) study

An ALM study supports strategic decision-making by providing insight into how the most important risk factors affect the balance sheet and the degree to which the strategic policy can achieve the strategic objectives. Such studies are typically conducted over a three-year cycle and are aimed at reconciling the organisation's assets and liabilities. For a pension fund, the pension liabilities must be aligned with the capital in investments, so that the mismatch between these two factors is minimized. For insurers, payments to the insured are aligned with the income from investments.

The ALM study conducts scenario analyses based on the risk attitude and the investment strategy (assets) along with actuarial modelling based on life expectancies (liabilities). The results are then used as the basis for determining the investment policy. The ALM study uses capital market assumptions per investment category. This mainly concerns expectations of return, risk, and correlation with other investment categories in different market conditions. Because the SME loan market is a new investment category and therefore an immature market, data about this market is limited.

Strategic framework

From the ALM study, a long-term investment strategy is established in which macroeconomic expectations and expected returns are discussed among the investment committee. Subsequently, the asset classes that form the basis of the portfolio construction are determined. Since it is a long-term strategy, the strategic framework is set up once every 3 years.

For SME financing, the same issue applies as in the ALM study: the lack of accurate historical data makes it more difficult to include SME loans as an investment category in the strategic framework. If comparable investment categories with sufficient data and track records are available, they may be considered as more viable options for inclusion into the strategic framework.

Investment plan

The investment plan sets out and substantiates the investment policy for the coming period (usually one year) based on the results of the strategic framework. If this shows that the current investments need to be adjusted or expanded, a plan is drawn up and forms the basis for a manager selection trajectory.

Again, regarding SME loans, the same issues arise regarding experience, accurate historical data, and the availability of existing and proven comparable investment categories.

Investment framework

After it has been established that investments can be made in a particular investment category, a framework is set. The framework sets out the preconditions and guidelines for the specific investment category.

Because SME financing is very diverse, fragmented, and not standardized, drawing up a detailed framework is important. Limited data availability is, again, a challenge for creating a detailed framework.

Manager Selection

After the framework has been established, the search for the right investment product and manager begins. For small(er) investors, the selection process is often guided by an external advisor, while large institutional investors usually have in-house expertise to facilitate a selection process. During the selection process, several investment products and their managers within an investment category are compared to each other and tested against various criteria. The focus is on, among other things, the risk-return profile, the governance in the product, its manager, and the liquidity. A recommendation for a specific manager is the result of the selection process.

For manager selection, different investment strategies and their managers are weighted against each other. It is important for SME financing funds to be on the radar of institutional investors in this phase of the investment cycle when they are selecting an SME fund manager.

Implementation

The new (or modified) investment is implemented in the investment portfolio.

An important consideration when implementing an investment in SME financing is the lead time of building the portfolio. The speed at which SME financing is provided is an important factor.

Monitoring

The investments are continuously monitored by the manager on behalf of the investor, so that the investor remains in control of his investments.

The lack of available and standardized reports makes the monitoring of investments in SME financing more complex and laborious.

The SME fund perspective

The asset class private debt, which includes SME funds, has become increasingly popular among all types of investors. In a survey by Preqin, private debt funds were asked what they thought the most important source of capital would be in 2023.

The results are presented in Figure *Preqin private debt survey* on page 13. Family offices and insurance companies are expected to fulfil an important role in the provision of capital. Although there are fewer insurance companies that can provide funding compared to family offices, they can still be a larger source of funding because they deal with much larger ticket sizes in their investment decisions.

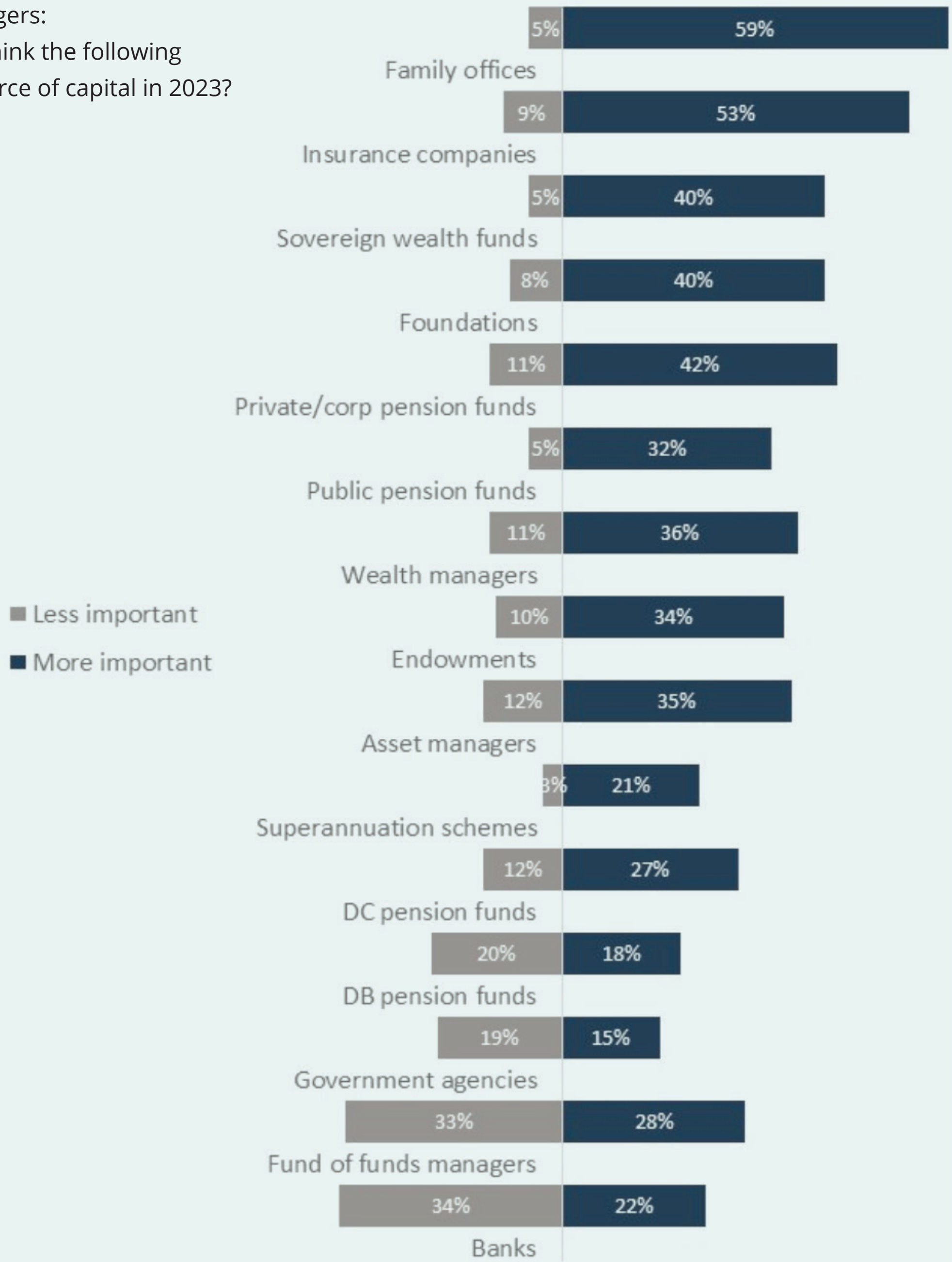
Pension funds are expected to be less inclined to provide funding for the private debt asset class. This is in line with the stringent investment framework that is applicable to pension funds, as described earlier.

Before an investment in Dutch SMEs is considered, the characteristics of that investment must match with the total investment framework of an institutional investor. The level of thoroughness in the section above greatly depends on the size, type, and sophistication level of an investor.

In general, family offices are regarded as more opportunistic compared to formalized institutional investors, such as insurers and pension funds. Before the market for SME funds matures, family offices may be the first stop on the institutional funding road.

Preqin private debt survey

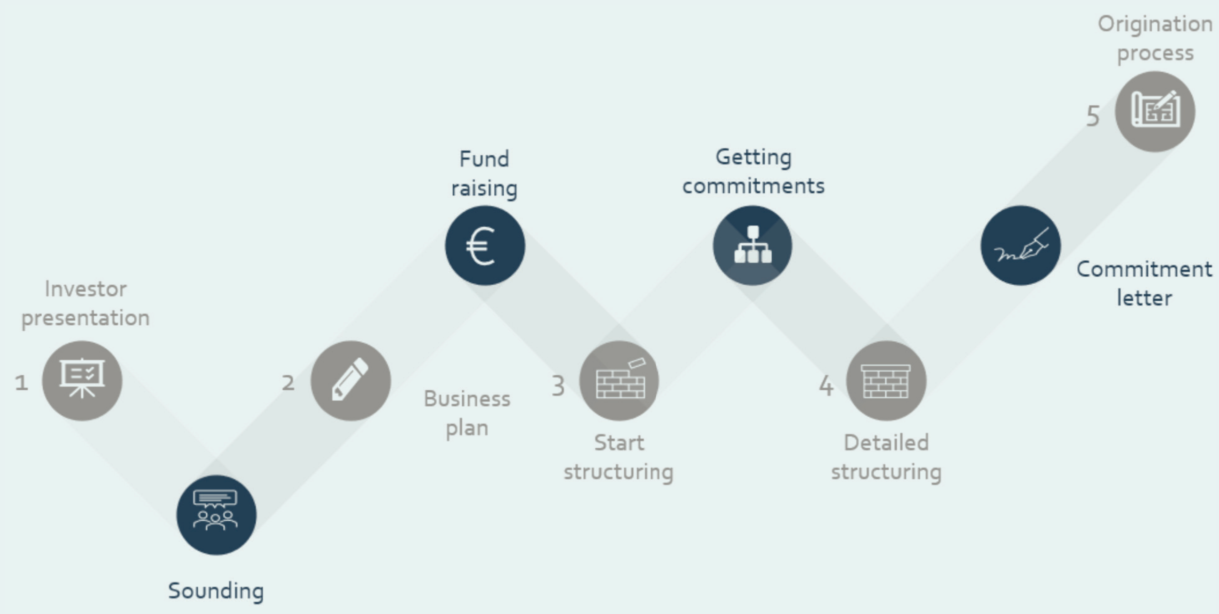
Question asked to managers:
How important do you think the following investors will be as a source of capital in 2023?



Roadmap

The visual below represents a roadmap of all the main steps involved in obtaining (institutional) funding from the perspective of an SME financing fund. It is a high-level overview that marks several milestones a fund achieves on its way to receiving funding. The road from one milestone to the next is not always equally time consuming, intensive, or costly. The table below the roadmap indicates these differences. A fund manager should evaluate the time and costs involved in achieving the next milestone when considering whether to continue the road to institutional funding. Ensuring an organisation is ready for the next step can prevent starting a costly process and having to quit halfway through. Below the table, a few go/no-go moments are highlighted to help the manager with their considerations. The blue milestones represent actions, and the grey milestones represent the creation of documentation or processes.

Roadmap



Considering the intensity of some of the other milestones, for certain some other moments in the process may be considered go/no-go moments. Despite high intensity and costs related to the general structuring and the detailed structuring phase, these are not chosen as go/no-go moments. After sounding the investor presentation and writing the business plan, the strategy should be interesting enough to investors and worth the future costs that will be made further down the road. Managers are advised to consider the costs associated with the milestones that are down the road when they are at the go/no-go moments.

Go/no-go moments

1. **Investor presentation:** Creating the investor presentation is the first go/no-go moment. It is at the beginning of the roadmap and is a costly process. The presentation requires nearly all aspects of an organisation to be put on paper in a presentable format. It is used to inform investors about the strategy and should instil confidence in the organisation's governance and capabilities.

2. **Business plan:** The second go/no-go moment is creating the business plan, which comes after sounding the investor presentation with potential investors. The sounding round should provide insights as to whether the strategy is interesting to investors, and if so, a decision can be made to work it out in detail in the business plan.

Steps	Time consuming	Intensity	Costs
1. Create investor presentation	Average	Average	High
Sounding investor presentation with investors	High	Low	Low
2. Create business plan	Average	High	Average
Start fundraising	High	Average	Low
3. Start general structuring	Average	Average	High
Getting commitments	Low	Low	Low
4. Start detailed structuring	Average	High	High
Signed commitment letter	Low	Low	Low
5. Start origination-servicing	Average	Average	Low

The table above describes the intensity that is paired with achieving each milestone on the roadmap. The requirements and details for these milestones are presented in the next section of this document.

This section is meant to indicate moments when the fund manager should carefully consider whether to continue the road to institutional funding so that unnecessary costs can be avoided.

Making the Leap

The guidebook thus far has provided an explanation of what the investment decision framework of institutional investors looks like, a description of the landscape they operate in, and the consequences for SME financing funds. This of the guidebook provides SME financing fund managers with practical insights into fundamental aspects of an organisation that institutional investors examine when considering an investment strategy. The manager needs to be able to convince any potential investor that these organisational aspects are covered and that all documentation and policies are in place. The fund's requirements differ by law, depending on the regulatory regime the fund is subject to. The possible regulatory regimes for SME financing funds include AIFMD (in this case, a licence is required) or the AIFMD light-regime (registratie regime).

The headline topics are generally in time sequence for a fund, taking into consideration that a fund may attract non-institutional funding before eventually receiving institutional funding. The chapter numbers correspond to the milestones in the roadmap.

1. Investor presentation

An investor presentation simply and compellingly tells the story of a fund to potential investors. A strong investor presentation should at least address the topics presented in this chapter. It is important to note that these topics are worked out in detail in the business plan. In the investor presentation, these topics should be presented in a simple and concise manner. The topics are presented in an order that is common for an investor presentation.

Investment process - Investment strategy
The term investment strategy refers to a set of principles designed to reach investment goals. This plan is what guides a manager's decisions based on goals and risk tolerances which can vary from conservative (following a low-risk strategy where the focus is on wealth protection) to highly aggressive (seeking rapid growth by focusing on capital appreciation).

Investment process - Deal sourcing
Deal sourcing refers to the process through which the fund can discover, evaluate and potentially select various loan opportunities.

Investment process - Debt strategy
The debt strategy should elaborate in as much detail as possible on the types of loans the fund is targeting. This should include, but is not limited to, the minimum and maximum loan size, type of debt instrument, collateral arrangements, the level of seniority, projected LTV, and projected defaults. The pricing strategy is naturally an important part of the debt strategy.

Investment process - Sector focus (if applicable)
It is common practice to present a brief overview of the current debt market, where the funding gaps lie, and the competitors that are currently serving that segment of the market.

Investment process - Geography
The geography refers to the region in which the fund is attracting borrowers.

Investment process - Risk adjusted expected returns
Well-informed investors want to know the expected return of the fund. It is the anticipated performance and the overall profit that is expected to be made. Expected return is just that: expected. It is not guaranteed, as it is based on historical returns and or predicted based on loan projections. It is used to generate expectations, but it is not a prediction.

Governance and organisation - Governance
This refers to governance related to the management, the code of conduct and the supervision of the fund. It essentially involves balancing the interests of a company's many stakeholders, such as investors, borrowers, management, the regulator, financial market supervisors and the community. For investors, it is also important that the financial interests of the manager are aligned with those of the fund. This can be realized, for example, through co-investing by the manager or can be expressed in the fee structure.

Governance and organisation - Legal entities and their functions
Present the legal structure of the fund.

Governance and organisation - Teams and organisational chart

Provide an overview of the structure of a company and its key personnel and decision makers as well as an overview of their experiences. Distinguish between the organisational structure that is placed under 'Governance and organisation' and the investment team including experience, which should be a part of 'Track record, experience and team'.

Governance and organisation - Risk management

Risk management in investment decisions is the process of identifying, analysing, and accepting or mitigating uncertainty. Essentially, risk management occurs when a fund manager analyses and attempts to quantify the potential for losses in an investment, such as a moral hazard, and then takes the appropriate action given the fund's investment objectives and risk tolerance. Risk management of a fund can be described according the three lines of a defence model. In this, standard portfolio monitoring is the first line of defence, an independent risk management function such as the investment committee services is the second line of defence, and independent assurance is the third. Each of these levels play a distinct role within the organisation's wider governance framework. The three lines of defence model is further explained in the detailed structuring section.

Governance and organisation - Track record

Track record, a financial term lent from track racing, commonly refers to a fund's past performance. This section also relates to the investment team and their experiences. Funds under the same firm with other investment strategies or sector focuses can be mentioned under the track record even if they are not strictly comparable. In this case, it should be clearly stated how the track record is related (within the current team, within the fund).

Investment structure (funds or mandate vs. origination only)

While this entire guidebook is focused on SME funds to attract institutional investors, it is possible to focus the organisation on just the origination of loans. In practice, this means that origination and management are split between two organisations. The loans are transferred after origination, and most of the fund's requirements are managed by another institution. However, in this scenario, an investor presentation is still required to convince institutional investors on origination capabilities. An example of this kind of setup is the Dutch Mezzanine Fund who originates loans; the Privium Fund Management is the AIFM manager of the fund. FundIQ is an example of a fund that performs both origination and management. Under investment structure, the setup and the regulatory regime that is applicable to the fund is explained. Examples include MiFID/ AIFMD.

Fee-structure

A fee structure is a chart or list highlighting the rates and costs of the SME fund. A fee structure lets potential investors know what to expect when investing in the fund. All types of costs should be visible in a clear and concise format.

Environmental, social, and governance

The way the fund involves environmental, social, and governance (ESG) in their operation should be included in the investor presentation at both the investment (loans) and company levels. There are various ESG strategies and criteria that are used in practice, with some strategies focusing more on avoiding negative impacts (also called 'socially responsible investment'), others paying most attention to the identification of investment risks and opportunities stemming from sustainability issues (ESG investing or sustainability investing) and a third group focusing mostly on the creation of a positive impact (impact investing). Credible ESG integration embedded in an ESG policy (or responsible investment policy) is increasingly important for investors and should be seen as a unique and valuable opportunity for differentiating and standing out as a fund. Reversely, not being able to demonstrate how the fund considers ESG factors will make the fund less attractive to investors. Environmental criteria consider how investments contribute to climate change through greenhouse gas emissions, along with waste management and energy efficiency. Social criteria examine how it manages relationships with employees, suppliers, customers, and communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls, business ethics and shareholder rights. In addition, there is increasing attention for diversity and inclusivity; it is recommended to incorporate these topics as well.

Term sheet

A term sheet is a list of the features and terms and conditions of the fund. The terms and conditions contained in this document are not binding to any of the parties, as they are subject to modification through further negotiations before the final agreement is prepared and signed.

A term sheet is an important document because it is an essential step to signing the final agreement. It contains a list of indicative terms and conditions and displays the intentions of entering into a funding arrangement.

Partners

A partner is an entity with which the fund has some form of cooperation. This relationship may be a contractual, exclusive bond in which both entities commit not to ally with third parties. Alternatively, it may be a very loose arrangement designed largely to impress potential investors and competitors with the size of the network the fund belongs to. In the partners section, it is substantiated which processes are insourced and outsourced. Administrative activities, such as fund accounting, reporting, net asset value calculation, capital calls, distributions and investor communications, are commonly outsourced.

2. Business plan

A fund's business plan can be generally described as an 'investor presentation worked out more in detail'. Therefore, the described investor presentation serves as a basis in terms of topics for the business plan. The most common format is a document so that there is more room for details and explanation. In addition to the topics addressed in the chapter Investor Presentation, the topics below should be worked out in detail. In addition to the format chosen for the plan, it is useful to include common questions and answers in a due diligence questionnaire (DDQ) / request for proposal (RFP) database for effortless filling of investors' own formats.

DDQ
DDQs are essentially the highlights of the firm's most frequently asked questions. Many funds utilize a standard question format. A popular one is prepared by the Alternative Investment Management Association (AIMA). Regardless of the format employed, many investors require a fund to complete their own DDQ, called an RFP.

Operations
The fund's operations concern the design and control of all the business processes in the SME fund. It involves the responsibility of ensuring that operations are efficient in terms of using as few resources as needed.

3. Start general structuring

Fund structuring is the legal, fiscal, and economic configuration of a fund that considers the features and requirements of the fund company (manager requirements) and the principles of the potential fund investors (investor requirements).

Legal documentation platform

The legal documentation platform constitutes all legal documents that are produced during or before general structuring. These documents are associated with the creation of the fund (constitutional documents and terms and conditions) or are specifically related to the internal business operations and setup (information memorandum and service agreements).

Information memorandum or private placement memorandum

A memorandum serves to provide buyers with information on the offering. The memorandum is essentially a thorough business plan intended for investors to use in their due diligence.

Funds under the AIFMD regulation [1] have requirements regarding the information to be provided to investors prior to their investment. The information memorandum, or the private placement memorandum, serves the same purpose as the prospectus. Under certain circumstances, it is not required to present an information document to investors. However, even in such situations, we recommend funds to create an information memorandum because institutional investors require an information memorandum or an equivalent in their due diligence processes.

Subscription form or agreement

A subscription agreement is a document formalizing the investor's application to join a limited partnership and become a fund's investor. The fund agrees to sell a certain number of shares at a specific price, and in return, the subscriber promises to buy the shares at the predetermined price.

1. Alternative Investment Fund Managers Directive (https://www.afm.nl/nl-nl/professionals/onderwerpen/aifm-int-wet)

4. Detailed structuring

This concerns the final version of the manual including all accompanying appendices: AOIC and policy documents. In addition to writing policy documents, it is also about putting the documentation into practice.

The basis is a handbook–business manual, which is drawn up for employees to present the structure and operation of the company. It also concerns the code of conduct that employees must adhere to and other employee-related policies, such as the screening policy and a policy for personal investment transactions.

An overview can be included in the business manual of how processes are set up with reference to an operating manual in which they are elaborated in more detail. An operating manual is sufficient without a AIFMD license, but otherwise an AOIC is preferred. Detailed structuring is the final stage before the fund starts operating.

Operating manual and policies

An operating manual describes all the relevant operational processes of a fund and refers to the relevant policies used for each of these processes. This document is important to institutional investors to ensure that the fund conducts its business in a professional manner and can instil confidence in the fund's capabilities. The operating manual should cover several topics:

- Onboarding investors (including KYC)
- Investment management
- Portfolio management
- Capital calls
- Distributions, redemptions & secondary trades
- Loan servicing
- Administration, valuation, and reporting
- Risk management
- Governance

It may be that some operations are outsourced to an external party. In this case, it is important to enter a service level agreement to ensure the external party adheres to the requirements, guidelines, and outsourcing policy. In the end, the fund remains responsible for the quality delivered by outsourced parties.

In addition to the operating manual, it is required to write up several policies. These include, but are not limited to:

- HR policies (code of conduct)
- Client policies (complaints management)
- Investment policies (Risk management policy and Responsible Investment Policy)

Valuation - Loan and portfolio valuation

Valuation is the analytical process of determining the current (or projected) worth of an asset. There are many techniques used for performing a valuation. Public debt involves continuous pricing: mark-to-market. As the loans of SME funds are not exchanged on a secondary market, these assets are valued according to a mark-to-model method. This is a pricing technique based on financial models where assumptions and calculations are used to approximate the value. There are companies, such as valuation consultants and accountancy firms, to which the development of a valuation framework and the continuous organisation of portfolio valuation operations can be outsourced. Using this method, all future cash flows are discounted back to the current value using the interest rate. The valuation of the total fund is different than the valuation of just the loan portfolio as the total fund also includes non-invested money. This is cash from recent capital calls or funds that will be distributed to investors. Valuation is less important for closed-end funds because the investor cannot enter or exit the fund at any desired moment. Institutional investors, however, demand monthly valuation reports.

Valuation - Performance Measurement

The goal of performance measurement is to ensure a full disclosure and fair representation of the fund's investment performance. The time-weighted rate of return (TWR) is a measure of the compound rate of growth in a portfolio. The TWR is often used to compare the returns of investment managers because it eliminates the distorting effects on growth rates created by inflows and outflows of money. Closed-end funds often make use of internal rate of return and multiple of money calculations. The same applies to loan and portfolio valuation, which are excellent external parties that can help with setting up performance measurement.

Reporting - Investor reporting

Typical investor reporting consists of the following statements/reports at a minimum.

- Monthly investment statement: with cash flows, net asset value, value difference, spread movements, number of loans outstanding, etc. Institutional investors will demand these monthly. The quarterly statement should be sufficient for non-institutional investors.
- Quarterly investment statement: Same as monthly statement but includes more details and a statement about the past quarter.
- Annual report approved by external accountant

Reporting - Legal reporting

Depending on the regulatory regime, the fund is subject to certain levels of legal reporting. Annual reports are typically the cornerstone of legal reporting. AIFMD requires alignment with all marketing and legal documentation, as they must be consistent with all other documents (e.g., prospectus, term sheets, etc.). Furthermore, increasing requirements for transparency from regulators impacts the content of reports by requiring additional and more detailed disclosures:

- Report key data of the fund, the manager, and the investment strategies to the AFM.
- Periodically report to the Dutch National Bank (DNB) on the main financial instruments (generally unavailable for SME funds) that are traded in and the main risk positions and main concentrations of the funds (these two are relevant for SME funds)

Reporting - Assurance reporting

Financial institutions such as institutional investors are obliged by law to demonstrate that processes are controlled in the case of outsourcing. This means that a financial institution will require a service organisation control report from its suppliers before the suppliers can provide services to the institution. The financial institution demonstrates, by means of a ISAE 3402 [2] report, that all outsourced processes are controlled. This certification can be a requirement of institutional investors in case their outsourcing policy defines their investment managers as an outsourced supplier. An ISAE 3402 audit is regarded as a quality criterion for funds.

Reporting - Supervisory and regulatory reporting for institutional investors

Supervision, legislation, and regulations have become more and more extensive for institutional investors over the past years. The implication of this development is that the reporting pressure has also become increasingly extensive. The reporting requirements for SME funds differ depending on the types of institutional investors it serves. Institutional investors require reporting standards that are in line with then new financial framework (Nieuwe Financieel Toetsingskader), in case of pension funds, and solvency reporting, in case of insurers. SME funds are to be reported in line with these regulatory standards to enable institutional investors in their reporting. Reporting standards are less strict when the SME fund does not serve institutional clients.

2. Alternative Investment Fund Managers Directive (https://www.afm.nl/nl-nl/professionals/onderwerpen/aifm-int-wet)

Reporting - ESG reporting

Investors are increasingly incorporating ESG metrics in their investment decision-making processes as described under the ESG section of the investor presentation. This trend is becoming less voluntary as legislators are pressuring transparency on asset owners. A concrete legislative example is the Sustainable Finance Disclosure Regulation (SFDR), which requires sustainability information in periodic reports. As a result of the SFDR, financial market participants must check what type of products they offer and, on that basis, what transparency obligations they must comply with. To comply with regulations is the minimum requirement of ESG reporting. When ESG improvements is a specific goal of the fund, reporting on more metrics such as the impact on the UN Sustainable Development Goals should be considered.

Operations - Fund administration

Typical fund administration includes:

- Record of cash flows
- Record of assets
- Participant register
- Reconciliation: accounting for discrepancies between two sets of records for example between the custodian's records and the fund's books).

Operations - Registrar & transfer agency

Registrar transfer agencies are required for large funds with many investors. These institutions register and maintain detailed records of transactions of investors for funds. A registrar is an institution responsible for keeping records of shareholders. When a fund needs to make an interest or dividend payment to a fund's shareholders, the fund refers to the list of registered owners maintained by the registrar. A transfer agent is assigned to maintain an investor's financial records and track each investor's account balance. The transfer agent records transactions, cancels and issues certificates and processes investor mailings. Transfer agents work closely with registrars to ensure investors receive their interest or dividend payments in a timely manner.

Operations - IT

IT operations refers to anything related to technology, such as networking, hardware, software, or the people that work with these technologies. In the financial sector, processes are increasingly digitized and, when possible, automated. During the detailed structuring phase, all IT systems and automated processes are defined and communicated. Business continuity planning in case of disrupting incidents should be considered.

Risk management and compliance

Risk management relates to the control of financial and non-financial risks within the organisation. Non-financial risks for the organisation can relate to operational risks and other organisation-related risks (e.g., reputation, processes, IT systems or (un) qualified employees). Fund-specific risks are monitored using the three lines of defence mentioned earlier. The first line of defence is the portfolio manager, the second line of defence is the investment committee, and the third line of defence is the audit. They manage, among other things, credit risk, market risk, liquidity risk and leverage risk.

The compliance function within an organisation ensures that a business adheres to external rules and internal controls. In financial markets, compliance departments work to meet key regulatory objectives to protect investors and ensure that markets are fair, efficient, and transparent. They also seek to reduce system risk and financial crime. These objectives are designed to support confidence in the financial system. Funds are subject to regulations that govern advertising, communications, conflicts of interest, customer understanding and suitability and prevention of money laundering.

Risk management - Portfolio monitoring (first line of defence)

The first line of defence is executed when the deal is analysed, which includes a risk assessment.
The risk of the deal should be in line with the risk appetite of the fund and should complement the risk of the overall portfolio.

Risk management - Investment committee (second line of defence)

The deal analysis is presented to the investment committee, who will form an opinion about the deal. The committee needs to be independent of the deal originator to mitigate any conflicts of interest. The investment committee may consist of external parties to emphasize independent decisions and gain additional expertise.

Risk management - Accountant (third line of defence)

The accountant performs account analysis and reviews the financial statements and other reports to ensure they contain accurate data. Large organisations may have an internal audit department that provides an independent, objective assurance and consulting activity designed to improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Risk management - Limit monitoring

The limits of the fund are contractually fixed during detailed structuring. These limits are continuously monitored by the fund when it is launched. These limits may concern the following areas: credit quality, geography, loan sizes, sector exposures, concentration limits, and liquidity levels.

Risk management - Leverage

Leverage results from using borrowed capital as a funding source while investing to expand the asset base of the fund and generate higher returns on capital. At the same time, leverage will also multiply the potential downside risk in case the investment result is negative. Therefore, leverage increases risk. As such, proper risk management of the level of leverage is the highest priority in case the fund is planning to use leverage. The amount of leverage also has an impact on the AIFMD license due to the 'De minimis exemption'. In general, Dutch institutional investors have an explicit preference for non-leveraged funds because of the increased complexity and risk involved with these strategies.

Risk management - Liquidity

Two types of liquidity are generally considered for funds. One is position liquidity, and the other is fund liquidity. Position liquidity relates to how readily the instruments used in the strategy can be converted into cash at a known value. Concerning SME funds, loans are generally not converted into cash before they are redeemed by the borrower. Hence, this kind of liquidity is not relevant as the fund is very illiquid in this perspective. How quickly stated terms allow an investor to exit a fund investment is the so-called fund liquidity. This question needs to be answered during the detailed structuring phase.

5. Start origination and servicing

Congratulations, the fund has made the leap. Now the loan origination and servicing phase begins. All the processes in this phase operate as described in the operating manual that was fabricated during the detailed structuring phase.

Investor processes
Drawdowns, or capital calls, are issued to limited partners (the fund's shareholders) who had committed in earlier phases. This capital should be used for new investments (loans), and a portion of the committed capital is required to fund those new loans. The fund will start fabricating and sending out the earlier described reports so that investors can monitor their investment in the context of their total portfolio.

Deal sourcing, screening, and selection
Deal sourcing is a process used by finance professionals to identify investment opportunities in the market. In the case of this guidebook, SME firms seeking funding. The goal of deal sourcing is to ensure that many deals are obtained in a given period to maintain a viable deal flow in line with the outlined investment strategy in earlier presentations and documents. Most SME lenders are shifting towards an electronic version of loan applications that makes this stage paperless. New technologies allow for the application to be completed online through a website or mobile app and collected data to be tailored to specific loan products. At this stage, the application is reviewed for accuracy, genuineness and completeness. This process of application review is also the start of the loan origination process, which continues until the deal is executed.

Deal analysis
After the application is completed, the underwriting process or deal analysis begins. The lender takes a variety of components into account. Many lenders generate their own unique criteria for scoring that can be unique to their business or industry. This process is typically partly automated with the help of a rule engine and IT integrations with other systems that provide information on creditworthiness.

Investment decision making
Depending on the results from the deal analysis process, an application will be approved, denied, or sent back for additional information. If certain criteria do not match, there can be a change in the parameters, such as reduced loan amount or adjusted interest rates.

Investment Committee
The final loan approval is commonly performed by an (internal) investment committee as described earlier under the second line of defence of risk management. The members of this committee should guarantee a level of independence from the deal sourcing and credit analysis teams as they present their investment case to the committee.

Deal execution
Most loans fund shortly after the loan documents are signed. This marks the end of the loan origination process.

Loan servicing and special management
Loan servicing refers to all the administrative aspects of a loan from the time the proceeds are dispersed to the borrower until the loan is paid off. Loan servicing includes, among other things, collecting monthly payments, maintaining records of payments and balances, and following-up on any arrear payments. Funds can decide to implement special management activities if arrears persist or borrowers default. Such activities may consist of more intensive internal guidance, restructuring, or hiring an external party. Knowledge of these processes must be demonstrated, as these operations are of great importance in the selection processes by institutional investors.

About Stichting MKB Financiering

The Stichting MKB financiering was founded by pioneers and representatives of the SME funding market with the aim of improving access to alternative (non-bank) financing options for entrepreneurs. Collaboration between alternative financiers is a step towards greater visibility and strength of the sector.

The interest of the entrepreneur is paramount, which is why the foundation is connected to a central complaint register and the Code of Conduct for SME Financing is drawn up in collaboration with entrepreneurs and advisers.

About AF Advisors

This guidebook has been made in collaboration with AF Advisors. AF Advisors is a leading consultancy boutique that services the investment industry by combining industry knowledge and expertise with a practical, multi-disciplinary approach. Many type of (SME) funds and institutional investors are among their clients, and they are supported by AF Advisors in their organisational, product, structuring, investment, or regulatory challenges. AF Advisors can provide guidance to funds on any of the topics described in this document. This guidebook was commissioned by the ministry of Economic affairs and Climate change and Invest-NL.

About Invest-NL

Invest-NL is an impact investor focused on making the Netherlands more sustainable and more innovative. This guidebook has been commissioned by Invest-NL in relation to the Dutch Alternative Credit Instrument (DACI), a collaboration between the Dutch Ministry of Economic Aff airs, the European Investment Fund, and Invest-NL. DACI is a fund of funds investing in SME debt funds, and thus, providing access to alternative sources of fi nancing for Dutch SMEs.

Questions?

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