Financing Circular Business Models - Risks and Opportunities

Circular economy and circular business models:
As a result of the linear "take-make-waste" economy, today in Sweden we live as if there were 4.7 planets. The global average is 1.7. This is an unsustainable situation, where circular economy is increasingly mentioned as a possible solution. Circular economy is a concept and a framework that is based on the idea that materials, resources and products that are used at their highest possible value. To accomplish this, circular business models, especially product-as-a-service models, are considered to be one of the strongest drivers. When the ownership of the products stays with the producer instead of being sold to a final customer or consumer, the incentives for the manufacturing company shift from making money from the flow of material to making money from material preservation.

The Problem in brief:
In our survey, we have seen that when companies shift to circular business models, their are consequences that do not normally arise when applying traditional linear business models. The factors that give economic, and thus financial, consequences are:

- The company binds more capital in a stock of products to be rented out.
- In the long term, the cash flow will be more stable, but in the short term worse than with linear sales.
- Rental models require a different pricing model, and perhaps new second-hand markets.
- The products that will be kept longer by the company and rented out require better quality and circular - perhaps even future-adaptive - design.

All of the above factors entail a new view of the capital requirement. In the short term, more capital is needed for the transition to a circular business model. Everything indicates that companies necessitate a higher degree of solvency in the future, i.e. more own financing than before in order to be more resilient at fast changes. Loan capital is also needed, and thus the financial sector becomes an important player in the transition.

About the project:

The project "Financing circular business models - risks and opportunities" has being financed by Vinnova and has being carried out by the research institute RISE in collaboration with the product companies Kinnarps AB, Modul-System HH AB, and Clean Motion AB, as well as the finance companies Sparbanken Sjuhärad, Ekobanken and JAK Member Bank. Susanne Olofsson and Thomas Polesie participated as consultants. The project was mainly developed as an interview-based study during the period January 2018 to May 2019. In addition to participating parties, another 10 product companies and 9 financial actors (of which 3 major banks in the Netherlands) were interviewed. The study is the first of its kind - a scientific study that examines the role of funding for a transition to circular business models.

Read more:
ri.se/vad-vi-gor/projekt/finansiering-av-cirkulara-affarsmodeller-risker-och-mojligheter

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Recommendations for product companies:
Financing is perhaps not the first problem that arises when you, as a manufacturing company, want to switch to selling service, but when the need for flexible access to loans and capital arises, the following aspects are important to think and act on:

- A financier will always conduct a credit check based on a combination of assessment of the risk in the business, collateral and person. For you as a company in need of capital, you have to convince the lender that your business model is sustainable in the long term, not only environmentally and socially but also financially. Financing will always be dependent on a good "business case" with sound revenue streams. Both pricing, contract times, cost calculations for maintenance, repair and service etc. must withstand detailed evaluation.
- The offer must show greater benefit for the customer, and thus have a potential for higher profitability than the corresponding linear model. It is therefore important to include the comparison with the existing linear model in the presentation of the business. Demonstrate why the existing linear model is not long-term sustainable!
- When the financier finds it difficult to find suitable benchmarks and benchmark numbers (because your model is new in the industry), think about how this can be fixed. Can you look outside Sweden? Can you actively involve your customers and their repayment ability in the assessment?
- If your products are low-value and normally cannot be taken as collateral, how can you and the lender find a suitable form of security? Is there a secondary market where a residual market value can be found? Is it better that contracts and future revenue streams are considered as collateral? If so, who can take over the contracts if the business needs to be liquidated?
- As there is an increased perceived risk to the financier when financing circular models, we believe that it is very important for a financier to know that the owners of the company also take their share of the risk. In other words, such a situation is about sharing the risk. This means that owners and boards must also understand the new models and the issues that arise. Potentially, this can also strengthen the ties between companies and financiers as well as create more collaborative conditions than today.
- One of the biggest financial challenges with the conversion to circular business models is that when the balance sheet changes, the conditions for important key figures are also changed. Current assets may need to be redefined to fixed assets, working capital as well as capital employed is affected, and key ratios such as return on capital employed (ROCE) and inventory turnover need to be revalued. In practice, this can mean that it becomes very difficult to control the company's two activities (the linear and the circular) within the framework of the same financial model and governing principles. This can be solved by placing the circular business in a separate business area, or even in a separate company.

Recommendations aimed at banks and other financiers:
Circular economy is a megatrend that affects structures, models and opportunities throughout the economy. Banks and financiers, like other players in the economy, must relate to and consider this. One of the most obvious and concrete examples of situations that require new ways of working and a partly new view of risk is when the need for increased capital during the transition to circular business models has to be financed by loans. Here are some advice and tips for financiers, based on collected data in the project.

- You as a financier, are central to the success of the transition to circular business models! As the one who decides on which projects are funded, you decide which projects will be implemented. You are a very important player in the transition to a radically more resource-efficient society.
- See the circular journey as a business opportunity for you as a financier! By learning more about your customer's business, you can position yourself not only as a financier, but also as a strategic adviser. This increases your opportunities not only to take right credit decisions, but also to broaden your offerings and strengthen your business.
- Act long-term! In circular business models, there is an inherent sustainability thinking and a long-term perspective in revenue streams, which must also reflect on the financial market and access to capital. Long-term capital will be an essential part of the restructuring, both on the ownership and loan financing side.
- Act as part of a business ecosystem! When it comes to both the evaluation of repayment ability and the evaluation of collateral, you need to look broader than usual on the challenge. If you cannot easily understand whether the customer's forecasted revenue is credible and relevant - talk to the customer's customers. If there does not seem to be a simple way of realising contract values for a possible bankruptcy - talk to actors in similar industries, look outside Sweden's borders, set up collaborations with other financiers and try to create a knowledge base about this.
- It may be necessary to take a slightly higher (perceived) risk initially to build the new knowledge needed to secure future business. There is also a risk of remaining in existing linear models, and at some point, it is a greater risk to remain with exposure to customers in existing models than to shift.
- Affect how you want this new market to work! Collaborate with other banks and financial actors, and act for the changes in rules and policies that you consider necessary for the financing situation to work well and be an opportunity and not an obstacle for companies that want to switch to circular models. Look at risks in another way. As a financier, you have the same responsibility to develop business models that are sustainable and that meet the product companies and their customers' demands for sustainability.

Recommendation to policy makers:

- If Swedish companies should be able to switch to circular models and Sweden be a role model in the transition to a more circular economy, clear national goals are a must.
- Government funding in any form (guarantees, conversion loans or similar) could increase the pace of the transition to more circular business models.