

MSME & Asset Based Finance

Creating Jobs & Competitiveness Through Finance

5th Regional Competitiveness Event – Sarajevo
USAID|RCI|PFS

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May 19, 2010



Background

- Over 1.3 billion people live on < \$1/day
- Another 1.6 billion people live on < \$2/day
- Poverty and social unrest are increasing, not decreasing
- Most people in the world are workers and not entrepreneurs
- Most poor & MSMEs do not have urban real estate to use as collateral
- MSMEs account for the majority of companies and employment in most countries
- To dramatically increase employment and decrease poverty, innovative and effective ways to support MSMEs and their growth are needed

MSME Access to Finance: Obstacles

- Financial Institutions (FIs) view MSMEs as more risky, especially rural & agricultural businesses
- FIs view MSME lending as more costly
- FIs often depend on urban real estate collateral and historical financial statements in credit assessment
- Therefore MSMEs and high growth potential enterprises have difficulty obtaining finance from FIs
- Lending, if available at all, is often mismatched in purpose, type, tenor and required collateral
- Ironically, once MSMEs obtain finance from FIs, further growth is often impeded, putting them in a straightjacket

MSME Access to Finance: Objectives

- Innovatively finance MSMEs by filling gaps in the market
- Increase sales and profitability
- Increase equity through retained earnings
- Create new employment, maintain employment and increase incomes
- Support farmers and other small suppliers
- Support women, minorities and entrepreneurs
- Increase local production and manufacturing, thereby improving the trade balance
- Support all sectors including agriculture and all regions
- Improve quality, competitiveness and sustainability

Types of Finance for MSMEs

- Traditional bank lending
- Capital markets
- Asset-based finance

Traditional Bank Lending

- ***Overdraft financing:*** short term financing (< 1 year)
 - Overdrafts
 - Lines of credit
- ***Term loans/installment loans:*** medium to long term financing (> 1 year)

The underwriting of traditional bank lending often makes it beyond the reach of many farmers and MSMEs – but it is the main source of liquidity. Liquidity is usually not the main impediment to increased lending.

How can we unleash this liquidity to catalyze growth?

Capital Markets

Public capital markets: securities (mainly stocks/equities and bonds) offered to the investing public.

Private capital markets: securities issued in private markets

- Venture Capital/Private Equity
- Strategic Investment
- Buy-outs

Capital market instruments are usually more expensive to develop and labor intensive to manage, and require stronger legal and enforcement regimes for protecting investors. Careful consideration needed for the exit strategy.

Asset-based Finance

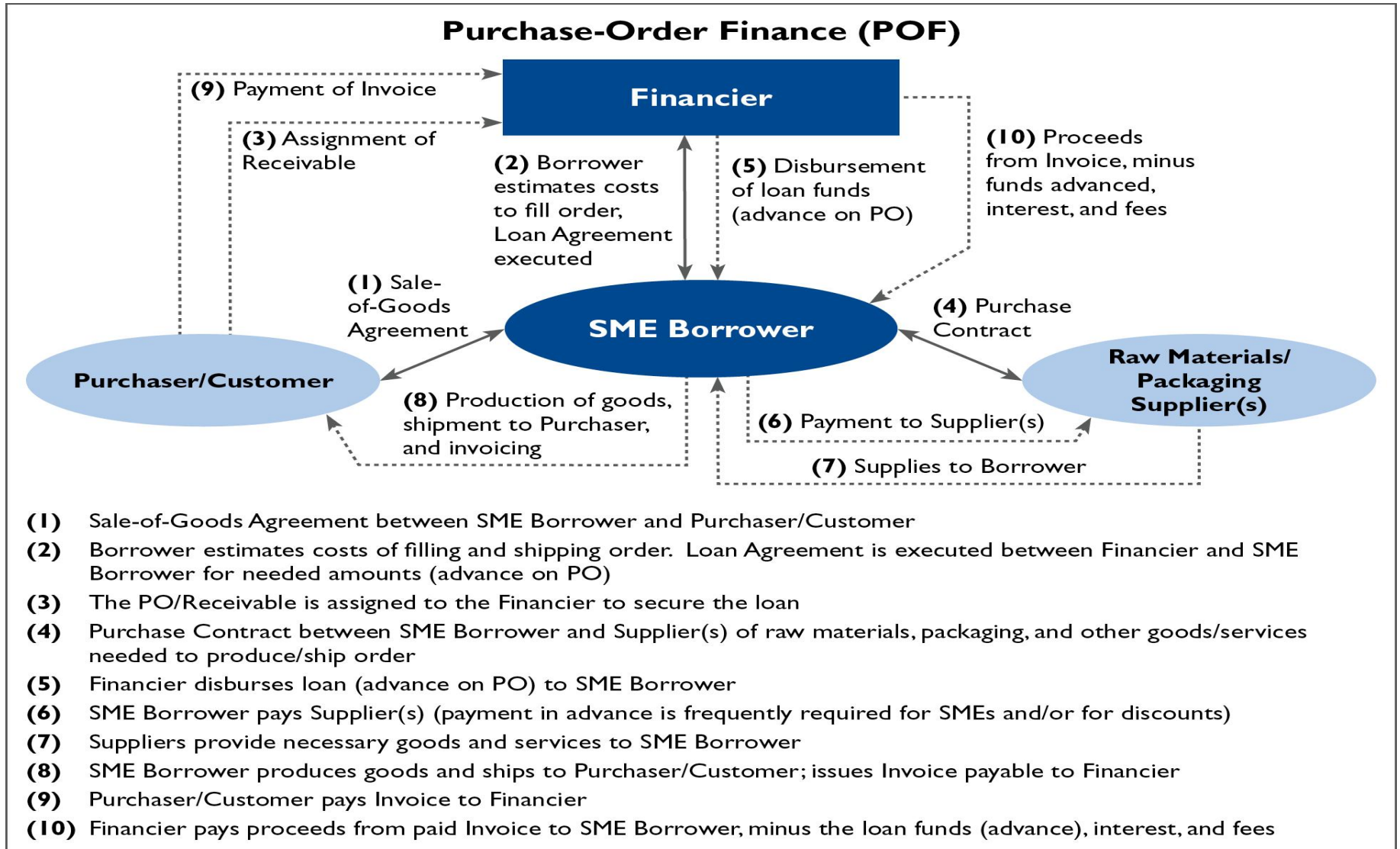
Asset-based finance provides structured working capital and term loans secured by a specific asset. It can open financing for MSMEs that either cannot qualify for traditional bank/MFI loans or whose lending needs exceed what they can obtain from traditional products at a given point in time.

- ***Purchase Order Finance (POF)***
- ***Accounts Receivable (A/R) Financing***
- ***Factoring***
- ***Leasing***
- ***Warehouse Receipts (WHR)***
- ***Documentary Credit / Guarantees***

Purchase Order Finance (POF)

- Short term working capital finance to fill orders
- Pre-shipment / pre-export
- Transaction linked (not general line of credit or loan)
- POF does not require real estate/mortgage as collateral, leaving long term assets as security for long term lending
- Loan amount typically from 10,000 – 100,000 € for MSMEs
- Tenor of 15 – 365 days
- Extremely efficient instrument to create sales and jobs
- Effective throughout the value chain (from input and equipment suppliers, to producers, processors, distributors, traders, wholesalers, and retailers. It is a powerful tool for unlocking the value-chain's potential)
- “The Places They Go When Banks Say No”
 - <http://www.nytimes.com/2010/01/31/business/smallbusiness/31order.html?pagewanted=1&th&emc=th>

POF Structure



Accounts Receivable - A/R

What it is: *Accounts Receivable (A/R)* financing is a revolving line of credit advanced against the A/R, with the amount of credit based on the A/R collection history. Usually offered by banks.

Requires: efficient lien registration and bankruptcy systems, economies of scale and verifiable sales relationships between producers and buyers.

Applicability: Usually more suited to large, corporate enterprises with large volumes of A/R than to MSMEs.

Factoring

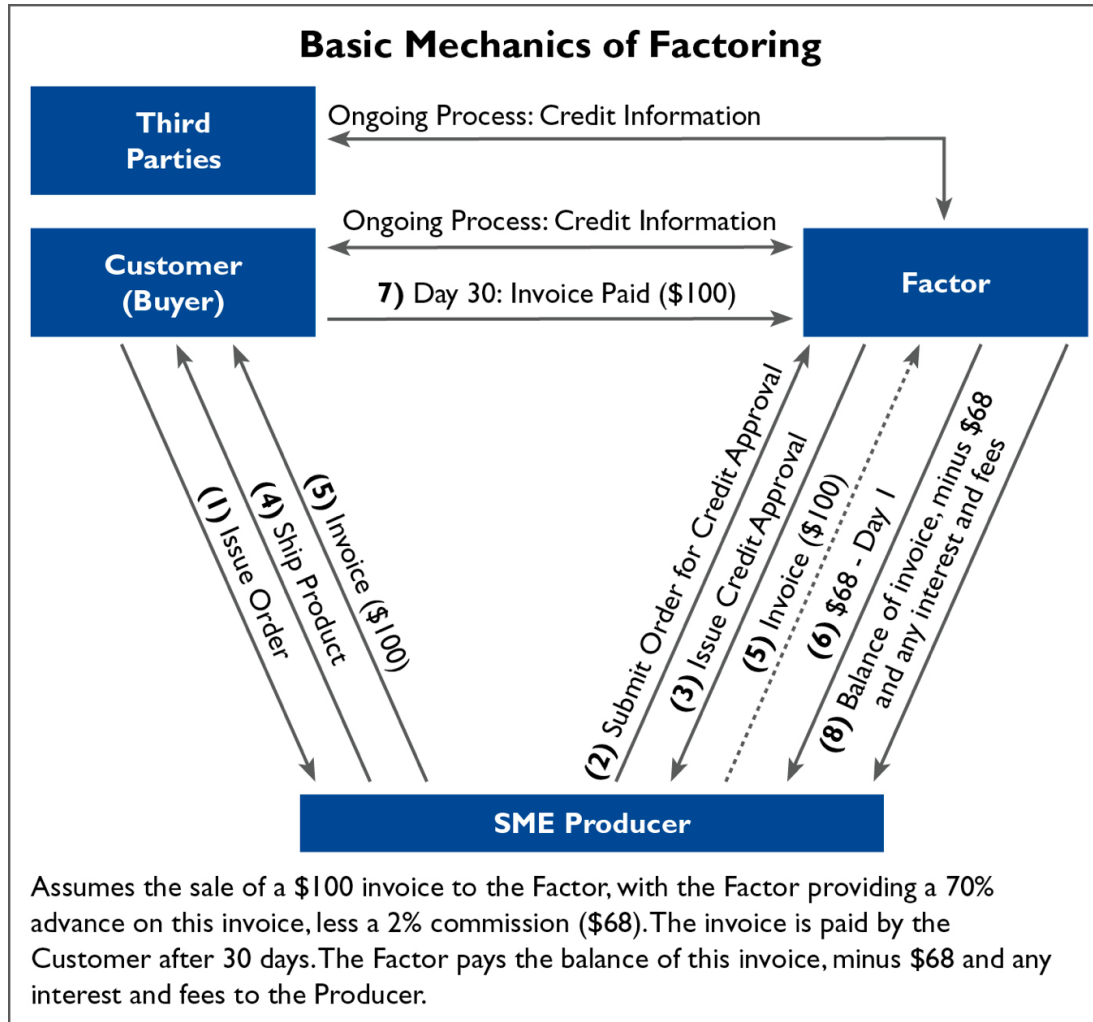
What it is: *Factoring* provides financing post-shipment, and basically accelerates payment. The enterprise sells its invoice(s) to the financier (called the “factor”). The factor then pays the enterprise a percentage of the invoice face value and takes over responsibility for collection. Usually offered by specialized finance companies, not banks.

Requires:

- Some economies of scale to be profitable
- Access to reliable credit information

Applicability: Can be applied with weaker insolvency regimes, but requires excellent access to reliable credit information and certain economies of scale. Generally can be profitably applied to larger enterprises.

Factoring



Reverse Factoring

A variant of factoring known as “reverse factoring” has been effective in broadening MSME access to finance. In ordinary factoring, because the factor purchases many invoice from a limited number of MSMEs, it must collect credit information and calculate credit risk for a large number of buyers. In reverse factoring, the factor pools and purchases receivables payable from only a few high-quality and/or international buyers and it needs to collect credit information and calculate the credit risk for only a few large, transparent, well-rated firms.

Leasing

What it is: A contract where the provider (the **lessor**) owns the asset and grants the client (the **lessee**) the use of the equipment in exchange for periodic payments.

- ***financial leasing:*** the lease period extends for the asset's useful economic life, and the lessor recovers the full asset value plus interest/fees through regular lease payments.
- ***operating leasing:*** the term of the lease is shorter than the economic life of the asset and only a percentage of the asset's value is recovered over the lease term. More complicated/risky than financial leasing.

Applicability: Excellent instrument for financing equipment. Lower risk than term/installment loans. Proper tax treatment important.

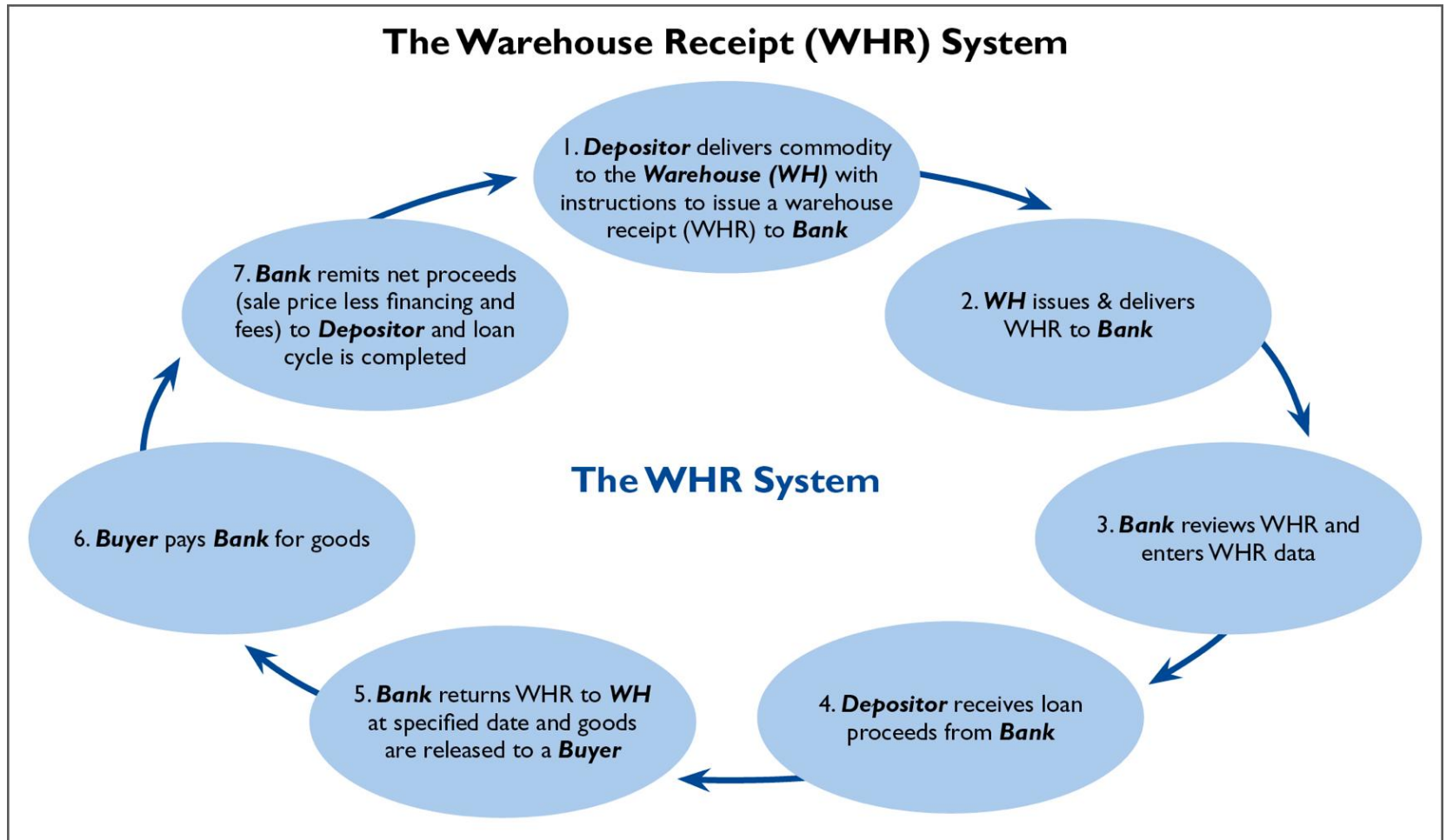
Warehouse Receipts (WHR)

What it is: A warehouse receipt (WHR) is a document certifying the ownership, existence and availability of a particular quantity, type and quality of commodity in a designated facility, such as a bonded warehouse.

Requires: (1) Reasonably well-developed banking system that recognizes the WHR certificate as collateral; (2) System of warehouses with adequate regulation and commodity protection that is trusted by banks; and (3) Accessible, accurate market information.

Applicability: Difficult for small-scale producers and MSMEs to access. Capital investment and operating costs require economies of scale.

Warehouse Receipts (WHR)



Documentary Credit

Letters of Credit (L/C): An obligation taken on by a bank to make a payment for a specific commodity on a customer's behalf once specific conditions are met.

Letters of Guarantee (L/G): A letter from a bank guaranteeing a sum of money to a specific beneficiary (the seller) if the opposing party (the buyer) does not meet specified conditions under the contract.

Documentary Collections (D/Cs): the exporter (seller) provides his bank with the shipping and collection documents for a specific commodity. The importer's (buyer's) bank then presents the seller's the bank with shipping and title documents in exchange for payment (note that in the case of D/Cs neither the buyer 's nor the seller's bank is guaranteeing payment).

Guarantees

A **financial guarantee** is an assurance given by an outside party to compensate a financier, in whole or in part, if a borrower does not fulfill contractual obligations under a credit agreement.

USAID offers four core types of credit guarantees through the **Development Credit Authority (DCA)**, but **loan portfolio guarantees (LPGs)** are the most common form for expanding finance to MSMEs. All DCA guarantees are legally binding commitments backed by the full faith of the US Government to share in up to 50 percent of a private lender's realized losses. DCA guarantees help alleviate market imperfections by reducing the perceived risk of lending to targeted sectors and borrowers, including farmers, agribusinesses and MSMEs.

Examples of MSME Finance

Several illustrative examples of MSME and Asset Based Finance programs in developing countries are highlighted in the following slides.

Macedonia – SME Finance Fund

- SME Finance Fund founded in 2003 to finance underserved MSMEs in Macedonia. USAID and Crimson Capital provided the original operational and lending capital. The Fund is structured as a Macedonian foundation.
- Norfund subsequently provided a long term loan for on-lending.
- Primary instrument is POF. Fund will introduce A/R financing and leasing.
- Over \$17 million lent to MSMEs in 233 loans, and more than 2,095 new permanent jobs created, of which 1,039 are for women and 268 for minorities. This does not include the thousands of farmers and MSME suppliers that are also beneficiaries.
- Almost 50% of the loans are to women and minority owned firms, over 30% of the loans are to agriculture/agribusiness, and 7 startups have been financed
- Created over \$62 million in new exports
- The Fund is self-sustaining from interest and fee income
- The Fund is a large generator of new employment per dollar

Kosovo – SME Finance Fund

- SME Finance Fund founded in 2008 to finance underserved MSMEs in Kosovo. The Norwegian Ministry of Foreign Affairs and Crimson Capital provided startup and initial operational support. Norfund and USAID provided lending capital. The Fund is structured as a Limited Liability Company (LLC).
- Primary instrument is POF. Fund will introduce A/R financing and leasing.
- Non-bank Financial Institution (NBFI), registered, licensed and supervised by the Central Bank of Kosovo.
- In first 16 months of operation over \$3 million in loans to MSMEs, stimulating more that \$31 million in sales. Lent out USAID funds 2.27x in 16 months.
- 227 direct new jobs created, several hundreds of small farmers and suppliers supported.
- Created 54 jobs for women and minorities and 7 loans to women and minority owned firms.
- All funds continuously lent out.
- 0% defaults (for banks and MFIs, bad loans = 4.3% in 2009).
- Fund is now self-sustaining on interest and fee income from its lending operations

Examples of MSME Finance

- **Azerbaijan:**
 - USAID Private Sector Competitiveness Enhancement Program (PSCEP). Introduced POF to 6 banks, expanding the use of Letters of Credit, Letters of Guarantee and Documentary Collection, and expanding the use and availability of leasing. Generated over \$26 million in new MSME financing, including POF, in one year.
 - USAID Trade and Investment Reform Support Program (TIRSP). Improving the enabling environment for leasing and making recommendations for banks/leasing companies to increase utilization of leasing.
- **Bolivia:** USAID Bolivia Rural Competitiveness Activity (ARCo). Assisted the micro-finance institution “FIE” to open 5 full service branches in the rural coca-growing regions of Yungas and Chapare and to develop and introduce MSME lending products, including POF (first introduction of POF to Bolivia).
 - With total technical assistance funds of just \$0.5 million, this innovative program resulted in over \$18.5 million in loans to more than 6,500 clients.
 - In addition, rural clients opened more than 9,400 savings accounts with deposits totaling over \$4.7 million.
 - Project won the USAID 2009 Award for Innovations in Value Chain Finance.

Examples of MSME Finance

- **Kosovo:** USAID Cluster and Business Support (KCBS). Developed documentation for a USAID DCA Loan Portfolio Guarantee (LPG) and implemented a series of training programs in agricultural lending to build the capacity of the partner bank's loan officers. The partner bank made 914 loans to farmers and agribusinesses, fully utilizing the DCA LPG for \$10 million in lending in just two years. The partner bank also added agricultural loans to its core product profile.
- **Peru:** USAID Promoting Integrated Development (PDA). Assisting nine financial institutions to introduce a savings-linked credit product which helps rural agricultural producers obtain much needed access to finance in the rural, alternative development regions of Peru. Over \$5.9 million in credit has been extended to more than 2,600 agricultural producers in the target areas. More than 2,400 savings accounts have been opened, totaling over \$2.7 million.

Examples of MSME Finance

- **Moldova:** USAID Competitive Enhancement and Enterprise Development (CEED). Introduced POF to five partner banks. To date, the five partner banks have made loans totaling over \$5.5 million to Moldovan MSMEs, enabling more than \$12 million in new sales. Expanded the utilization of leasing.
- **Armenia:** USAID FS Share Financial Sector Stability Pilot (FSSP). Introducing POF to two partner banks to provide finance to MSMEs in agriculture, food processing, information & communications technology (ICT), energy, pharmaceuticals, and tourism. First POF loan made -- \$15,000 to assist a pharmaceutical company produce eye drops for export to Russia -- just three months into the program. Analyzing the potential use of hedging mechanisms in SME lending to overcome the currency mismatch (dollarization of deposits – need for lending liquidity in drams).

Examples of MSME Finance

- **Macedonia:** USAID Agribusiness Activity (AgBiz). Helping Macedonian agribusinesses source capital to enable them to expand and improve production as well as to increase sales. Assisted agribusinesses to access over \$14.5 million in financing to expand their operations and complete trade deals. Also working with fresh fruit producers and marketers to install more efficient drip irrigation systems, upgrade storage facilities and enhance their export marketing capabilities.
- **South Africa:** USAID Financial Sector Project (FSP). Assisted a major commercial bank to introduce two new loan products -- Invoice Clearing and Vendor Finance -- designed specifically for the SME market. These products are analogous to factoring and POF respectively. Also supported capacity building of the National Credit Registry (NCR), which is responsible for monitoring the availability of credit, pricing and market conditions, trends in access to credit and indebtedness, and market conduct and competition.

Summary

Access to finance for MSMEs can be increased by:

- Introduction/adaptation/utilization of appropriate financial instruments at existing FIs, including asset based lending products and guarantees.
- Creation of special purpose companies or funds to lend to/invest in MSMEs
- Technical assistance and training to FIs – particularly on the use of specific financial instruments with “live” MSME borrowers on real transactions
- Technical assistance and training to SMEs to increase their capacity to qualify for loans and manage their finances
- Improvements in the legal, regulatory, and policy framework and capacity of institutions (registries, bureaus, supervisory agencies, etc.)
- Some additional information on MSME & Asset Based Financing:
 - <http://www.fsshare.org/content/fs-series-4-enabling-small-and-medium-sized-enterprise-access-finance-primer>
 - <http://fsshare.qedgroupllc.net/SME-finance/player.html>