Raise the anchor

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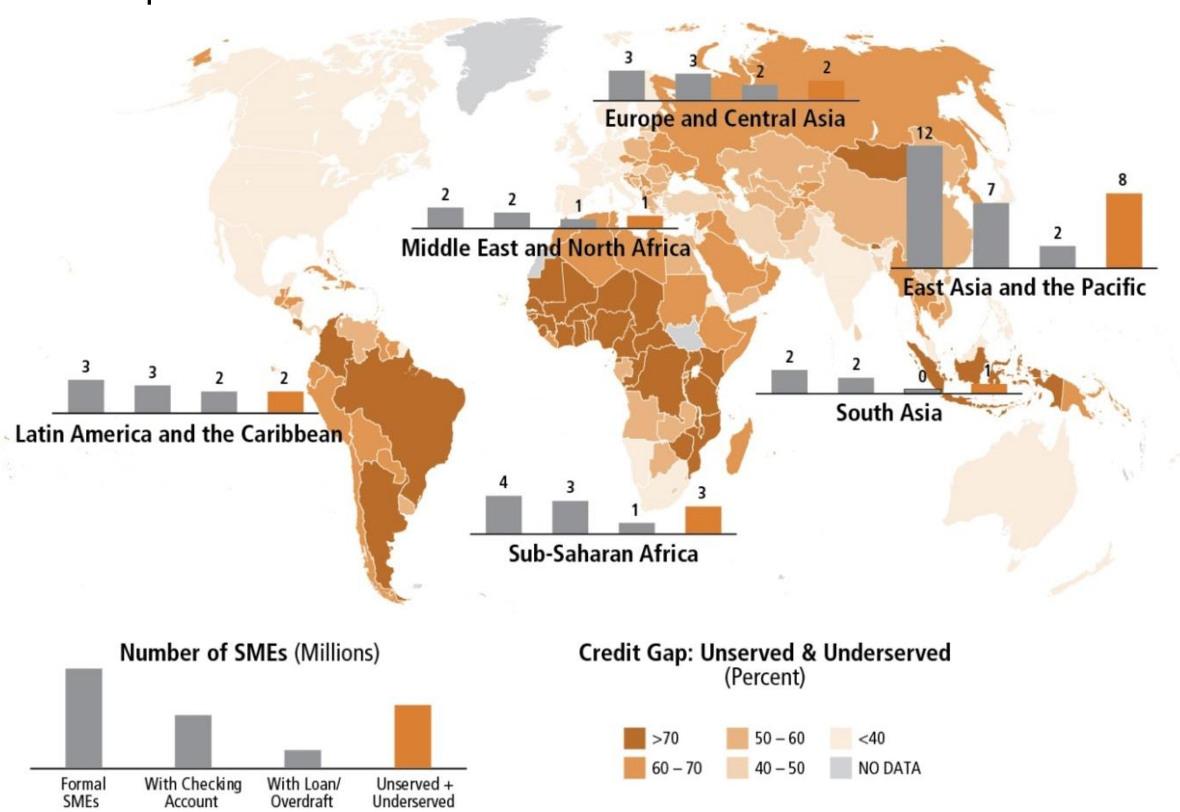
One of the most reliable growth stimuli for SMEs is value chain financing. Qamar Saleem, Martin Hommes and Aksinya Sorokina explain how this works and why it is good business for banks

Basic credit-oriented products or financial services provision that resembles corporate banking are the usual approaches adopted in banking offerings for small and medium-sized enterprises. However, this approach is likely to have limitations in terms of scalability and portfolio risk profile.

While value chain financing is typically seen as a solution for corporate clients, winners in SME banking demonstrate that it can be a vehicle for significant growth and help foster a more sustainable business. The most important thing is to set up the value chain finance mechanism correctly, particularly in terms of people proficiency, process optimization, proposition bundling and seamless corporate and SME onboarding.

SMEs often supply to or buy products and services from large corporations (anchors), directly or indirectly, yet are often unable to leverage these business linkages to obtain financing. Estimates have shown that between 14 and 20 million SMEs are either unserved or underserved in developing countries, amounting to a credit gap of nearly US$1trn (See Figure 1). SMEs also face problems meeting the loan requirements of banks to obtain financing, given their lack of acceptable collateral, land registry certificates, credit histories, and audited financial statements. **Of the sizeable credit gap, nearly one third is estimated to be linked to value chains, creating a significant market opportunity for enterprising financial institutions.**

FIGURE 1: Credit Gap for Formal SMEs



Source: IFC, Closing the Credit Gap for Formal and Informal MSMEs

A win-win proposition for all stakeholders

Due to their small scale, SME suppliers tend to face cash flow challenges, especially at contract inception and while work is in progress. At the other end of the value chain, if SME buyers rely on the anchor to provide financing, they can be affected by the risk of supply disruptions and higher product costs. From the lender's perspective, banks often find it difficult to assess the risk of SMEs given the lack of information, financial transparency and SME specific credit assessment tools. **However, many banks have been using value chain finance products to overcome these problems and have rapidly developed specialized product and service offerings**. The benefits are summarized in Figure 2.

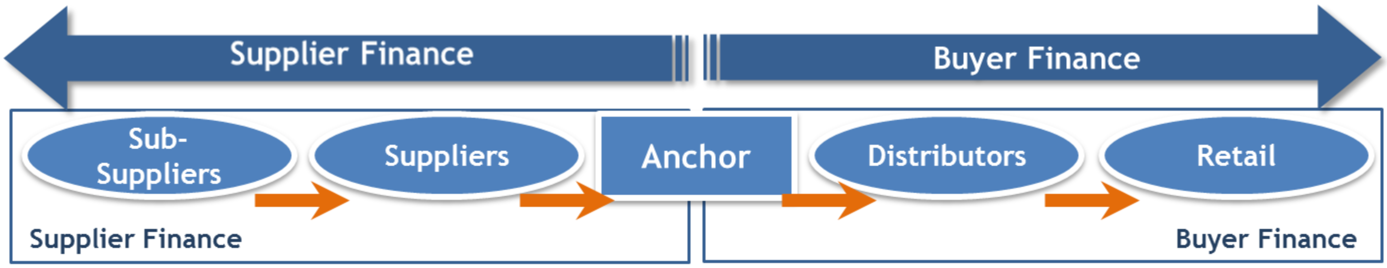
FIGURE 2: Benefits of VSF for Corporate and SME Banking

	Benefits for SME Banking	Benefits for Corporate Banking
Market	New segment opportunities	Competitive differentiation
	Market distinction	Key corporate access
Business	Faster scalability	Increased revenue share
	Sales effectiveness	More business opportunities
Risk	Better portfolio risk profile	Better risk management
	Access to data and information	Cash management mandate
Relationship	Stronger relationships	Increased retention
	Enhance transactional business	Increased limit utilization

Source: IFC analysis

Value chain finance (VCF) also renders multiple benefits to the SMEs themselves. The advantages are not limited to financing but also related to transactional efficiencies and business strengthening (see Figure 3). In general, VCF enables banks to provide financing to SMEs that would have been difficult through traditional financing channels, as it leverages the relationship and transaction flows with other parties in the value chain, rather than relying purely on the limited financial strength of SMEs.

FIGURE 3: Benefits for SMEs



Suppliers to the Anchor are financed	Buyer/Distributors to the Anchor are financed
Key Benefits for small supplier:	***Key Benefits for small buyer:***
➢ Better financing terms	➢ Access to bank finance
➢ Improved trade terms and instruments	➢ Strengthening of relationships with Anchor
➢ Improved liquidity	➢ Better financing and trade terms
➢ Minimized cost of collections	➢ Assured funding linked to business
➢ Timely payments receipt	➢ Strengthened bank relationship
➢ Match funding based on orders	➢ Streamlined transaction management

Source: IFC analysis

Importantly, the anchors gain clear benefits from engaging in value chain financing arrangements with the help of the bank. Large multinationals have traditionally been involved in value chain finance solutions through international financial institutions. The large regional and local corporates are now increasingly getting interested in domestic value chain financing solutions through local banks, which provide local market expertise and access to the specialized platforms. These arrangements often maximize efficiencies and overall performance across the value chain. See Figure 4.

FIGURE 4: Benefits for Anchors (large corporates)

Supplier Finance	Buyer Finance
Where suppliers to anchor companies are financed	Where distributors of anchor companies are financed
Key benefits for Anchor	**Key benefits for Anchor**
Reduce hassle of multiple payments	Balance Sheet de-risking
Lower administrative costs	Reduce transaction costs
Reduce the cost of purchase	Increased sales push
Extended credit terms to the suppliers	Reduce cash discounts
Ability to integrate with ERP systems	Minimized collection hassles
Minimized advance payments	Enhanced channel loyalty

Source: IFC analysis

Thus, all key stakeholders stand to benefit from VCF provided they have "a skin in the game". Banks can build such programs across multiple anchors with a homogeneous approach, creating economies of scale. However, there are four key challenges that must be confronted. Further detail is set out in Figure 5, but in summary these are how to:

- Maximize the bank's revenue from the value chain financing;
- Minimize costs;
- Mitigate inherent risk; and
- Engage and manage the anchor.

(Individual components of these challenges are illustrated in Figure 5.)

FIGURE 5: Key challenges for building a high performance value chain finance solution

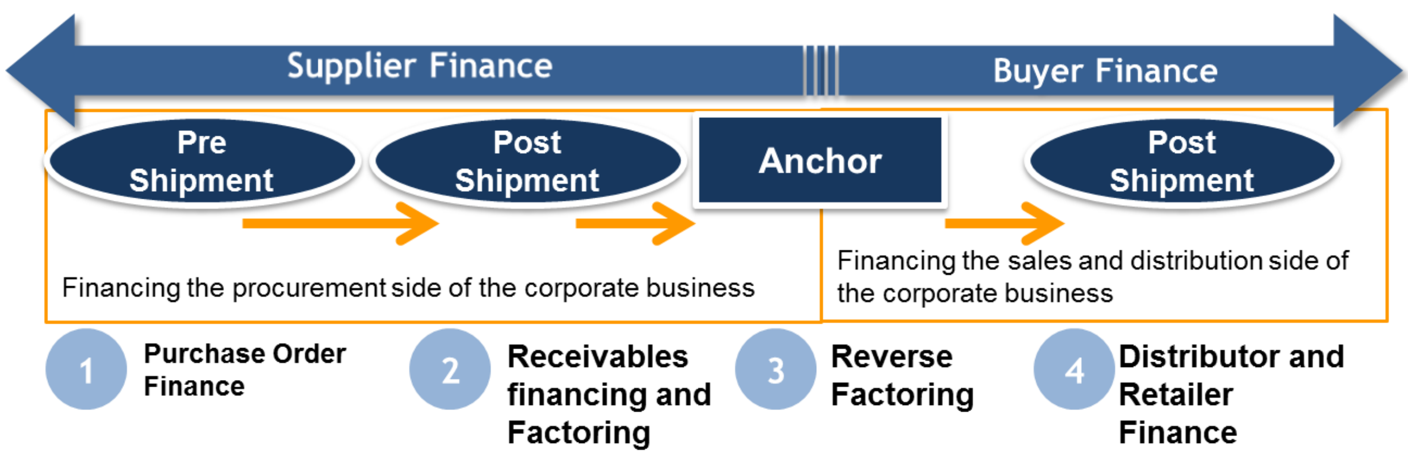
Revenue	Cost	Risk	Anchor
Market size complexities	Skill gap bridging	Policy and program	Sensitivities
Sales methodologies	Sales outfit	Assessment tools	Selection mechanism
Building for scaling	Operational burden	Portfolio management	Technology usage
Product structure	Channel usage	Collections framework	Engagement plan

Source: IFC VCF Advisory Services Toolkit

Tapping the potential and leveraging best practices

Value chain finance mechanisms can be developed under four main product groups (see Figure 6). The most commonly and widely used provide financing to SME suppliers of the anchors. These include pre-shipment finance to SME suppliers, which can be done on the strength of a purchase order, and post shipment finance, which is provided through invoice discounting or factoring. Reverse factoring solutions are where the anchor initiates the program, supports supplier selection and onboarding with process automation and technology platforms. Where SMEs are purchasing from the anchor, distributor and retailer finance programs build upon mutual trade linkages for financing.

FIGURE 6: Four key value chain finance product programs

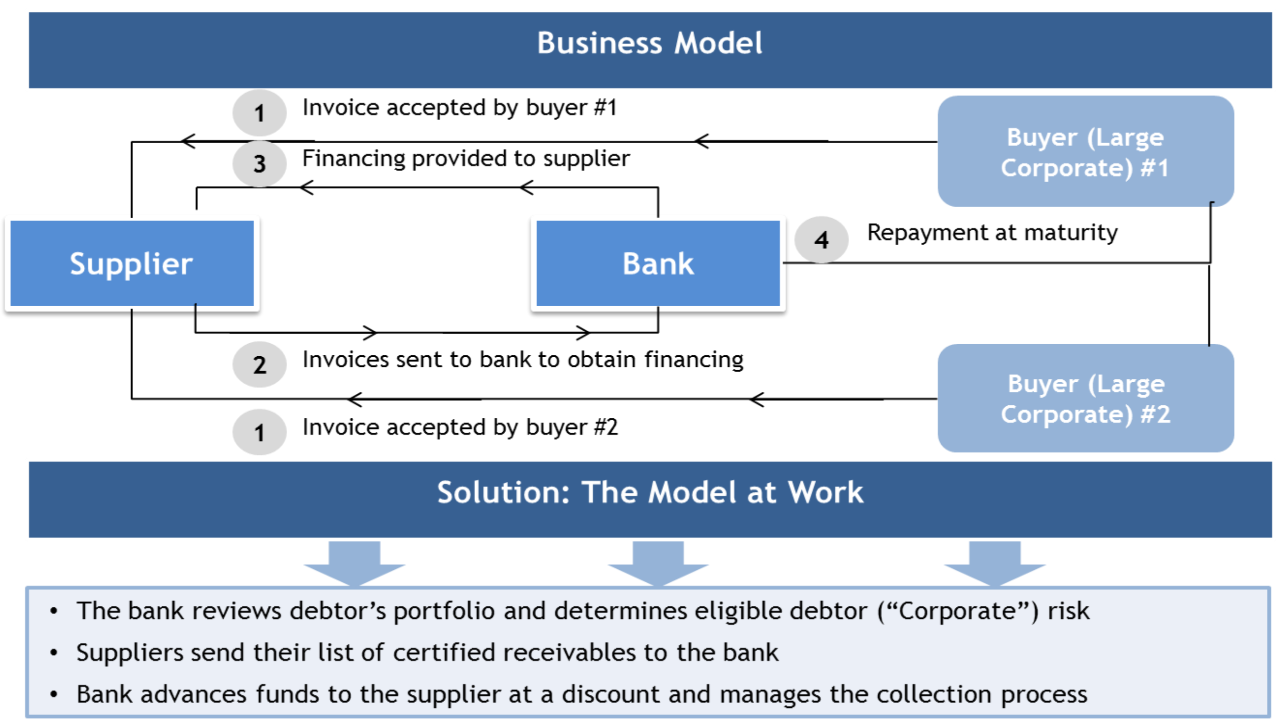


Source: IFC analysis

Purchase order or pre-shipment finance solutions aim to support the purchase and inventory management stages. A large emerging markets bank in East and South-East Asia, a large bank in the US, and one of the largest banks in Kenya, have all developed programs to help SMEs access capital at a very early stage of the production process, enabling them to take on large orders. For example, a leading commercial bank in Africa, with a presence in Kenya, set up a short-term financing scheme (up to 180 days) through a work order, or contract-financing product. This was made up of a contract-based leasing financing product, commercial vehicle financing, invoice discounting and dealer finance solutions.

In the post-shipment phase, factoring and receivable finance models are the most commonly used, as these best mitigate SME performance risk. These solutions provide SMEs with a flexible way to finance their working capital at lower cost, since it leverages the credit risk of the anchor, while managing their receivables risk. To structure a factoring scheme, the bank reviews an SME's receivable portfolio and determines the risk profile of the debtors (the anchors), then selects an approved list of debtors, and manages the collection process from the debtors. A large international bank in Brazil, for example, has a leading factoring program that allows SME suppliers to access cheaper finance, augment their turnover, and better negotiate sales terms with their debtors. See the factoring model in Figure 7.

FIGURE 7: Factoring illustrative example

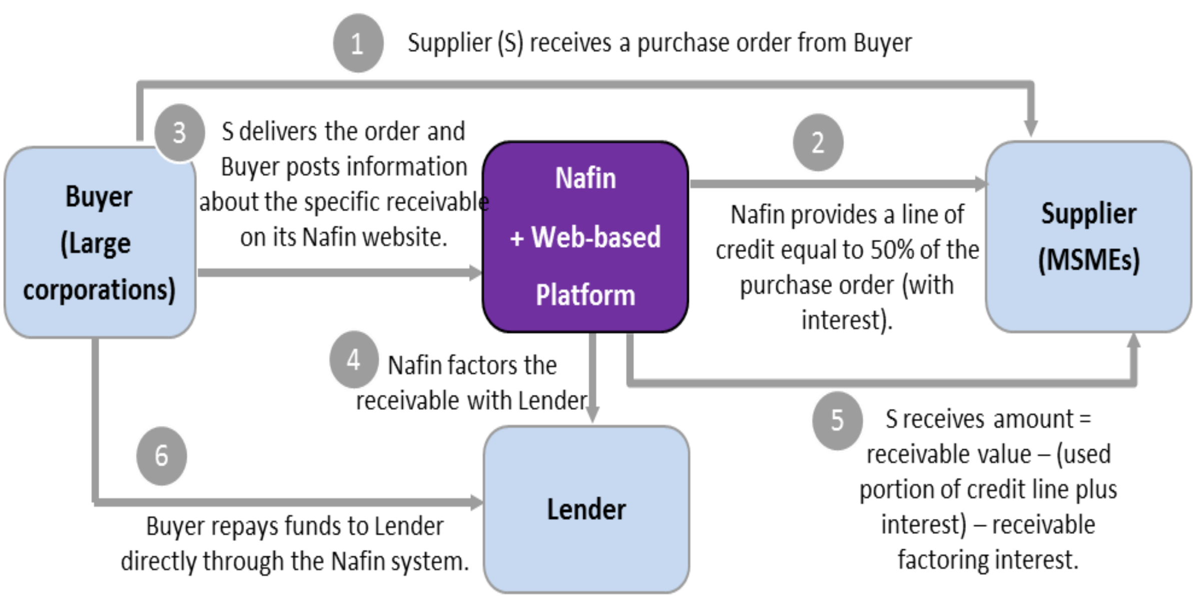


Source: IFC analysis

Reverse factoring, which is slightly less common, is typically driven through the anchor. Selected by the bank based on their business risk and current credit limits, the anchors upload the approved invoices, most suitably through an electronic platform, while the SME supplier chooses the respective invoices to be discounted and financed by the bank. Examples of such multibank platforms are GT Nexus and PrimeRevenue, which partner with IFC on multiple VCF engagements. On the maturity date, the bank debits the anchor account. A large international bank in Africa and NAFIN in Mexico (Figure 8) offer examples, of reverse factoring product. NAFIN is a top development bank in Mexico and has a leading reverse factoring and purchase order financing scheme. It offers financing to SMEs for up to 50% of confirmed contract orders from NAFIN-subscribed buyers, without recourse or collateral, and at variable adjusted rates. The financing scheme was a leading source of SME funding during the financial crisis of 2008, at a time when most Mexican banks retrenched their lending in the domestic market.

Dealer and distributor finance programs have been launched by banks, but retailer finance programs are rare. A distributor finance program can be built for a select group of dealers with some level of dependency on the anchor (to minimize risk for the banks). This is done by establishing, for example, overdraft accounts for the dealers to facilitate a quicker off-take of the merchandise from the anchor company. Optimally, and as one of the largest banks in India has done, an electronic platform can be set up to automatically generate the invoices based on unutilized overdrafts and keep track of the transactional flow. A leading example of dealer and retailer finance is Tribanco in Brazil. Tribanco, established in 1990 by Grupo Martin, offers several credit (for example, working and investment loans and credit cards) and non-financial services (such as capacity building and business training to retailers) to serve more than 37,000 SMEs across the 9,000 retail outlets in its national distribution chain.

FIGURE 8: Nacional Financiera NAFIN Mexico (reverse factoring)



Source: Scaling up SME Access to Financial Services in the Developing World, IFC 2010

A promising future for value chain and SME finance

Targeting value chains offers banks an excellent opportunity to also target SMEs in a scalable and risk mitigated manner. But while it seems simple, the solution is complex to design and challenging to execute. Winners have demonstrated how successful this approach can be, but we have also seen many examples of banks unable to design it right and failing to achieve the desired scale and profitability, not to mention portfolio weaknesses and fraud issues. Important considerations are:

- **Due diligence of the anchor.** This is a key building block. For any VCF program to work, it is vital that the bank obtains the buy-in and partnership of the anchor. There must also be alignment between the finance/treasury and sourcing/procurement departments of the anchor to make sure that both business units gain from the new product to be introduced.
- **Conducting due-diligence on suppliers.** There is a need to ensure that the suppliers being targeted through the program have been carefully selected. Optimally the bank should segment the suppliers and, through sound market knowledge, modify the financing rate depending on the supplier's segment.
- **Understanding the scalability of the process and the program.** It's also important to determine the best ways to automate the process, which involves several steps. First, a proper on-boarding program needs to be established for the anchor, the suppliers, and/or distributors. Second, the bank benefits by introducing an IT solution for the VCF program. Building an internal IT platform can be costly and a demanding strategy in the long term, especially for banks focused on the domestic market without an international presence. But several IT service providers offer specialized and widely used VCF platforms, from which the bank can choose the most optimal and cost-effective. Furthermore, a dedicated sales force is needed, with proper incentive mechanisms to ensure the bank is able to effectively market and communicate the new program upon launching to reach scale and recuperate the investments made. Finally, cannibalization tests must be introduced to ensure that if the VCF program is introduced, it will not cannibalize important revenues stemming from other product offerings.
- **Legal considerations must be made.** These include looking at the local assignment law to minimize the risk of suppliers selling the receivables to multiple parties. Fraud prevention is also another area of concern and can be reduced by implementing separate functions that upload invoices and make payments, as well as proper mechanisms to monitor the anchors and suppliers to make sure no collusion agreements have been made to defraud the bank.
- **Pilot-testing the VCF program with two or three anchor companies and their suppliers and distributors.** It is imperative to understand if the VCF is working well or needs adjustment. To refine the program, the bank will need to review the volumes and the usage rates by either the suppliers or the distributors.

This last point is really important and there are various potential barriers to take up. These could include the program's structure, such as pricing, or its IT platform. There could be a cultural or character-based issue where, for example, the supplier is adverse to change. And for supplier-based programs, the supplier may have ample liquidity, which means the bank will need to convince the anchor to extend the payment terms.

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