

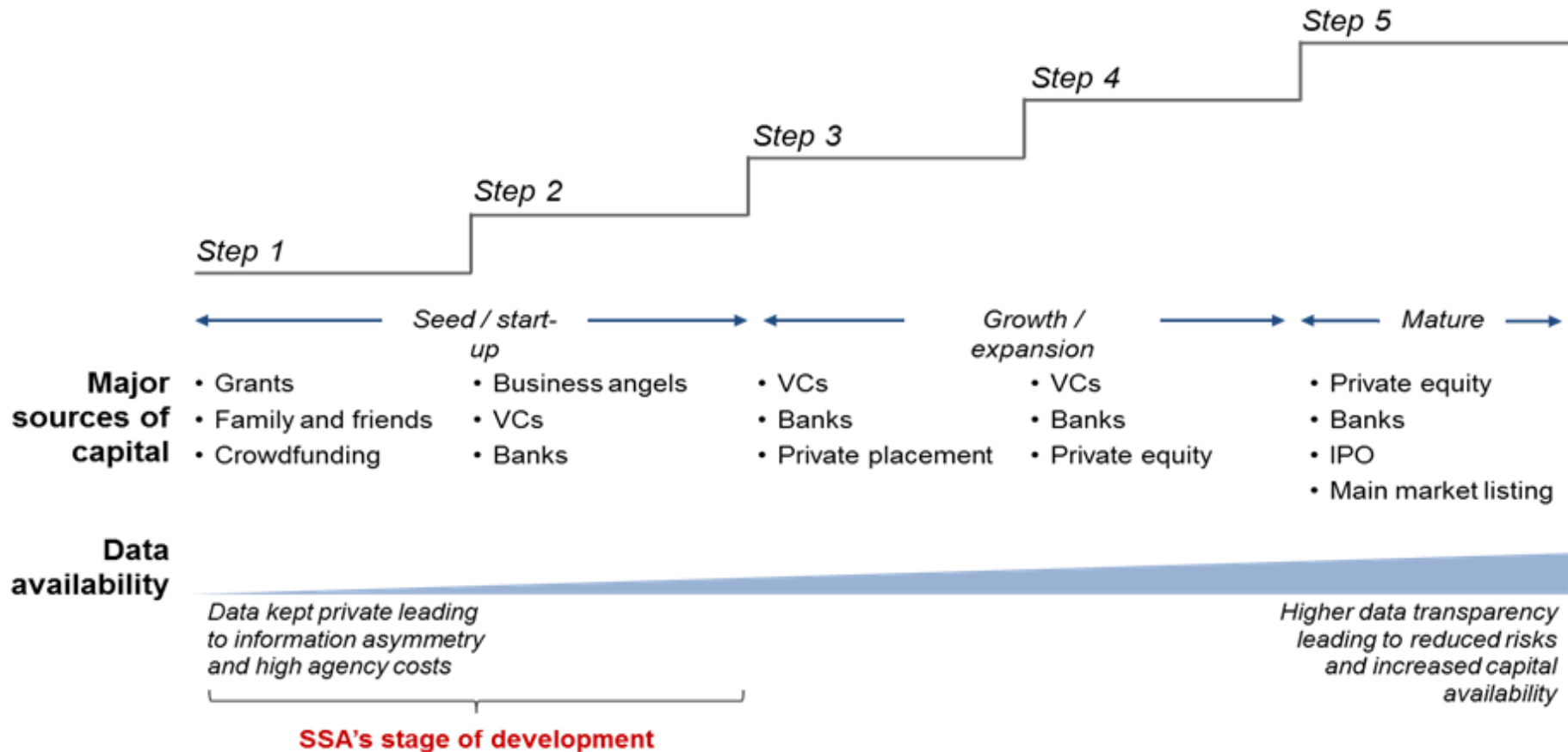
Augmenting SME access to third-party finance

Michael Fuchs

Maputo, December 11th, 2018

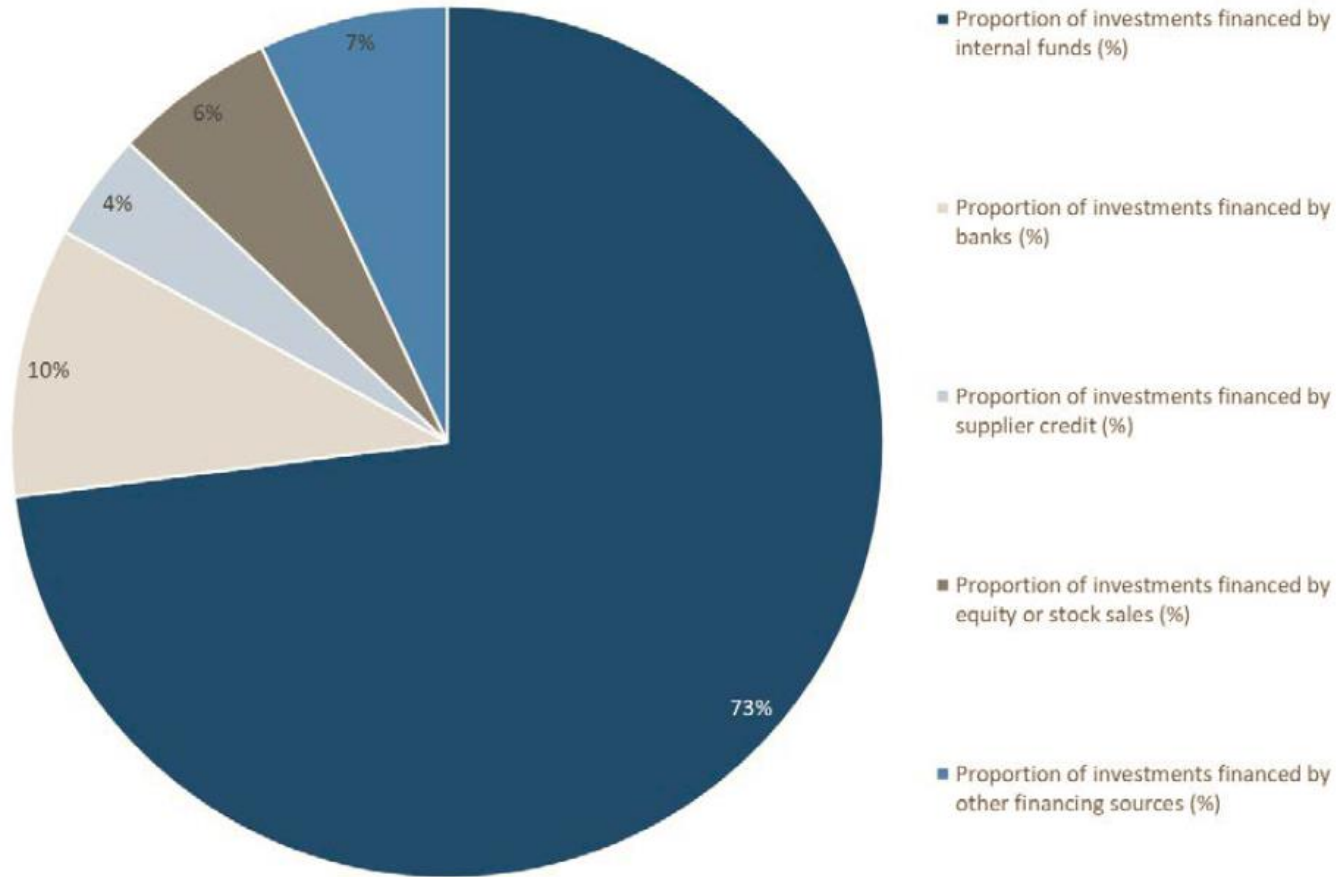
Recognizing the options for deepening markets for enterprise finance

The Enterprise Funding Escalator



Current sources of SME financing – external financing is the exception

Enterprise Surveys for SSA (2011-2017)



High costs of transparency associated with exchange listings

Market conduct: “the widows and orphans syndrome”

Direct costs:

- Costs of preparing for the listing – documentation, change in legal status, preparation of relevant documents;
- Costs of sponsor and advisor fees – initial and ongoing;
- Costs of ensuring ongoing compliance (audit fees);
- Admission and ongoing fees paid to the exchange.

Indirect and more intangible costs:

- Establishment of requisite governance structures;
- The opportunity cost of management time spent on ongoing compliance and investor relations;
- Loss/diminution of company control;
- Greater public visibility (accountability);
- Perceived market short-termism translating into share price volatility.

Issuance tends to gravitate towards larger enterprises, as these costs are similar irrespective of the issuance size.

Specialized SME exchanges offer advantages, but very few are successful

- Focus on growth SMEs (in need of external capital)
- Reduce entry requirements (performance, number of shareholders, free float)
- Reduce governance requirements (number of independent directors)
- Reduce costs (lower fees, electronic reporting)
- Reduce frequency of required information disclosure
- Allow unlisted private placements targeting institutional investors

Why is this not working well (except in a few cases) even on more advanced markets?

- For many institutional investors, SME issues are too small and lack the liquidity, reputation, access to information, governance, and risk profile they need.
- Retail investors can be scared off by the potential risks of investing in SMEs.

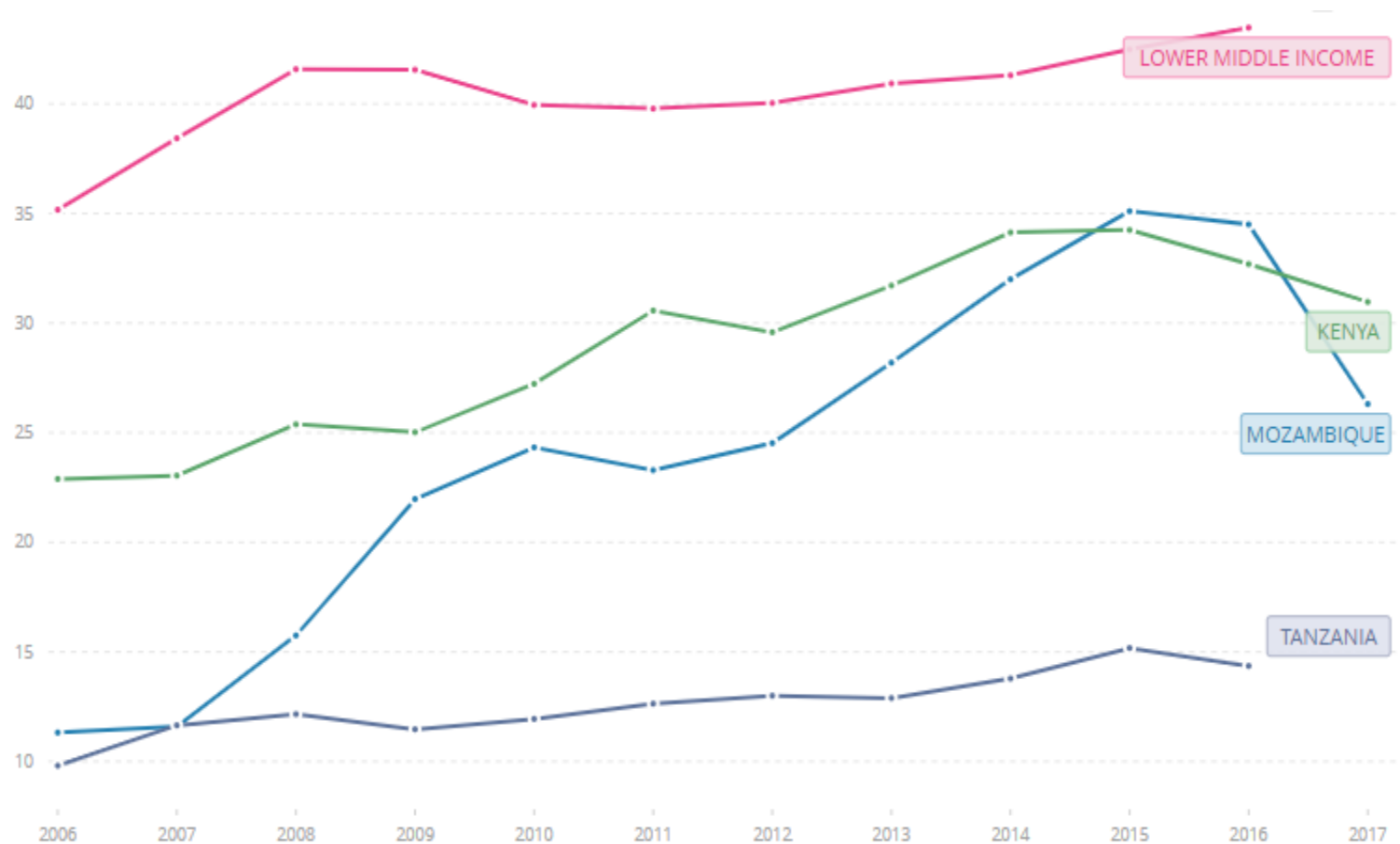
Credit from banks insufficient and possibly inappropriate

- Typically very short-term
- Expensive both in terms of interest rates and fees charged, and collateral requirements
- Banks have limited risk appetite for SMEs: prefer “risk-free” government securities (crowding out)
- Banks restricted by more onerous regulatory requirement (e.g. as regards maturity mismatches)

What are the options for SMEs to access more patient and affordable finance?

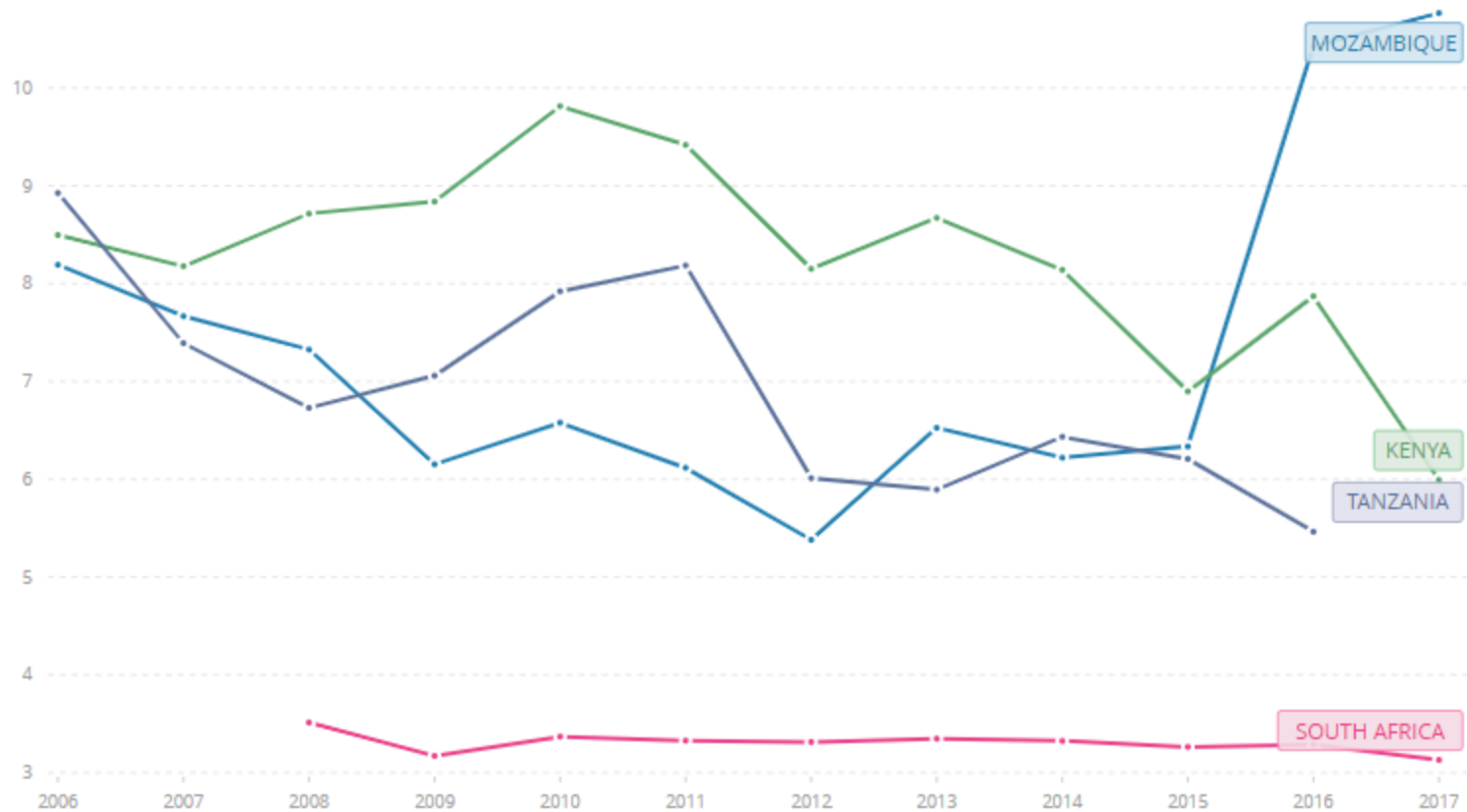
Shallow banking system:

credit to the private sector as % of GDP is declining



High cost of bank finance:

sharp increase in NPLs results in increasing interest rate spreads



Three possible remedies

Three possible remedies that could augment financing to SMEs are considered in the following:

- Asset-based lending
- Subordinated debt
- Reverse factoring

Implementing any of these approaches would require championing and sponsorship

SME asset-based lending

- Based on a revolving pool of collateral, such as receivables – requires close monitoring of borrowers' receivables
- Credit risk reduced through over-collateralization and accumulation of liquid reserves
- Important that commercial law allows lenders to file claim against the pool of a borrowers' receivables
- Availability of a mechanism by which a Special Purpose Vehicle issues notes to capital market investors against the pool of assembled receivables

Case study: Cofina funding SMEs in Senegal and Côte d'Ivoire
Issues 18 month revolving notes yielding 7.5% so far for \$20 million -- oversubscribed. Over-collateralized 130%. Reserve account equivalent to 6% of value of receivables.

Subordinated debt fund targeting SMEs

Focus of traditional PE has focused on larger enterprises: owners of SMEs reluctant to relinquish equity stakes. Advantages of subordinated debt:

- *Self-liquidating investments:* regular income provided by longer-term debt funding
- *SME owners retain their equity:* owners of SMEs unwilling to share the upside on the equity they have built in their enterprises
- *Regular income stream for investors:* allows issuance of securities that provide regular returns to investors quite similar to fixed income securities
- *Local domicile advisable:* regular income stream encourages investment by institutional investors, but may require local domicile (partnership legal framework and processing capacity)

Focus on SMEs may necessitate higher remuneration (than standard 2% of invested capital to fund manager), as fund managers need to evaluate and monitor a larger number of smaller enterprises to achieve their investment targets.

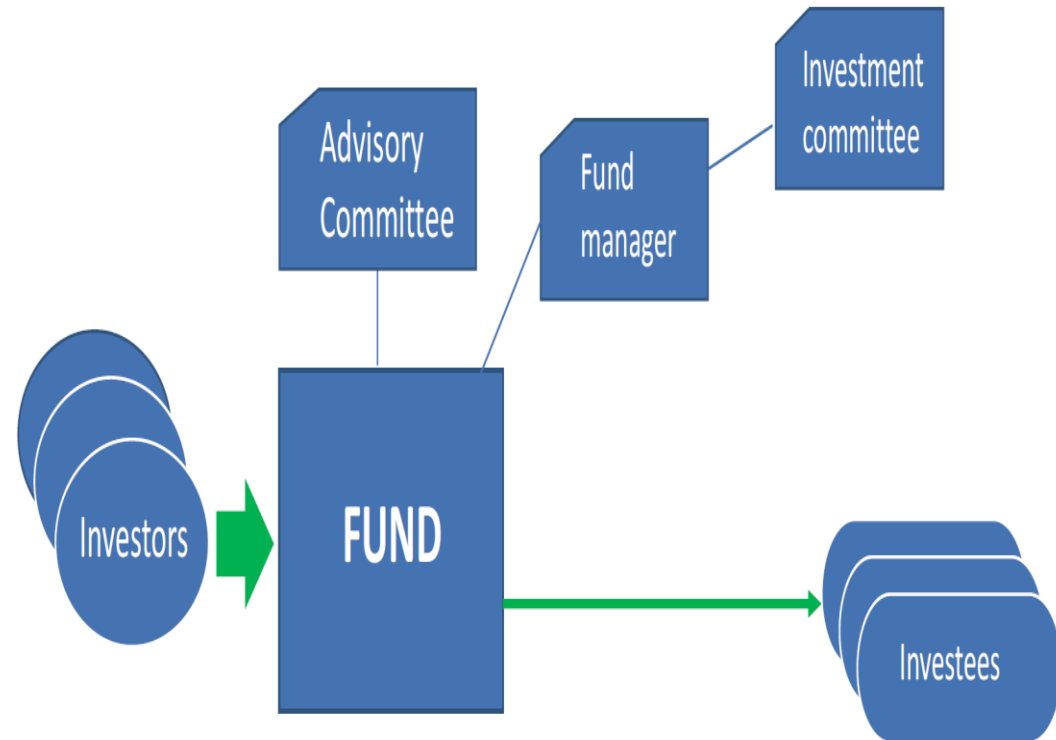
Subordinate debt funds: examples and possible structure

Business Partners:

- Flexible choice of instruments (ranging from equity and royalties to term loans)
- Built cadre of mentors to support implementation

Grofin:

- Preference for self-liquidating term loans
- May also require collateral



Reverse factoring as a means to build supply-chain financing

- **Factoring:** a specialized institution, the factor, buys the right to collect a firm's invoices from its customers, by paying the firm the face value of these invoices, less a discount.
- As factors assume credit risk of their client's customers, factoring only works well where *availability of credit information* is well-developed.
- **Reverse factoring:** the factor purchases accounts receivables, but only when accounts receivable are due from well-regarded larger firms. Credit information needs are considerably reduced by focusing on large firms purchasing goods from a number of smaller supplier.
- Reverse factoring is a means for creditworthy buyers to facilitate favorable financing options for their suppliers.
- **Importance of conducive legal framework:** in the event of the seller's bankruptcy, the factored receivables are not part of the bankruptcy estate, but are recognized as property of the factor on which other creditors cannot advance claims.

Examples of factoring arrangements

- **COFIDE**, a Peruvian development bank, pools the invoices from many small buyers allowing the package of invoices to be financed on better terms than each individual invoice. Because of the close relationship between large suppliers and their MSE customers, the suppliers can provide a substantial amount of credit to MSEs at relatively low risk and low cost. In the medium term, once a track record has been established and it is possible to ascertain the risk associated with the invoices being discounted, the aim is to source bond financing.
- **NAFIN**, a Mexican development bank, pays the SME immediately at a discount and later collects the full outstanding amount directly from the large buyer. In this way small firms use the receivables from their larger clients to obtain loans. NAFIN reduces costs by operating on an automated platform, thereby also allowing suppliers to build their credit histories.