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## EXPORT FINANCING FOR SMEs: THE ROLE OF FACTORING

A challenge for many small exporters is access to financing. In particular, many exporters find it difficult to finance their production cycle, since after goods are delivered most buyers demand 30 to 90 days to pay. For this duration, sellers issue an invoice – recorded for the buyer as an account payable and for the seller as an account receivable – which is an illiquid asset for the seller until payment is received. Factoring is a type of supplier financing in which firms sell their credit-worthy accounts receivable at a discount (generally equal to interest plus service fees) and receive immediate cash. **Factoring is not a loan and there are no additional liabilities on the firm's balance sheet, although it provides working capital financing.** In addition, factoring is often done "without recourse": the factor that purchases the receivables assumes the credit risk for the buyer's ability to pay. Hence, factoring is a comprehensive financial service that includes credit protection, accounts receivable bookkeeping, collection services and financing.

Factoring can be a powerful tool in providing financing to high-risk, informationally opaque sellers. Factoring's key virtue is that underwriting is based on the risk of the receivables (i.e. the buyer) rather than the risk of the seller. Therefore, factoring may be particularly well suited for financing receivables from large or foreign firms when those receivables are obligations of buyers who are more creditworthy than the sellers themselves.

***Factoring can provide important export services to SMEs in both developed and developing countries***

Like traditional forms of commercial lending, factoring provides small and medium enterprises (SMEs) with working capital financing. However, factoring involves the outright purchase of receivables by the factor, rather than the collateralization of a loan. In traditional lending relationships, the decision to extend credit is primarily based on the creditworthiness of the seller rather than the value of the seller's underlying assets and the lender looks to collateral only as a secondary source of repayment. The primary source of repayment is the seller itself and its viability as an ongoing entity. In the case of factoring, the seller's creditworthiness, though not irrelevant, is only of secondary underwriting importance.

In some countries, borrowers can use receivables as collateral for "asset-based" loans. The difference is that the lender secures the receivables as collateral, rather than taking legal ownership of the assets. Therefore, this type of financing requires good secured lending laws, electronic collateral registries, and quick and efficient judicial systems which are often unavailable in developing countries. However, factoring only requires the legal environment to sell, or assign, receivables and depends relatively less on the business environment than traditional lending products.

Another merit of factoring in a weak business environment is that the factored receivables are removed from the bankruptcy estate of the seller and become the property of the factor. In this case, the quality and efficacy of bankruptcy laws are less important.

Factoring is used in both developed and developing countries. In 2005, total worldwide factoring volume was over US$1 trillion – including over US$5 billion in China, Mexico, Turkey and Brazil – an impressive five-year growth rate of over 50%. This included over US$90 billion in international, cross-border receivables of exporters in 2005, an annual growth rate of over 25%. On average, about 15% of total receivables in emerging markets were international, as compared to over 20% in developed countries[1]. Although absolute factoring turnover (and relative to GDP) is smaller in emerging markets than in developed countries (see Table p.6), factoring might play a relatively more important role for SMEs and new firms in emerging markets that often have difficulty accessing bank financing.

Factoring can provide important export services to local SMEs. For example, an obstacle for firms in emerging markets to sell into export markets is overseas customers' reluctance to work on letters of credit. Firms in developed countries often refuse to pay on receipt to firms in emerging markets since they need time to confirm the quality of the goods. They also know that it could be very difficult to receive a refund on returned or damaged goods from firms in countries with slow judicial systems.

However, firms can arrange to factor their future foreign receivables prior to overseas sales. This can protect local exporters with credit covers that allow them – also as a competitive gesture – to sell on open account terms without the fear of bad debts and provide them with immediate cash flow against their export sales. Factoring companies can provide exporters with credit protection, working capital financing, and collection services. These pooled services might also allow local exporters to enter new, riskier markets.

There is strong evidence in previous literature that the use of trade credit and the potential for factoring services is higher in countries with greater barriers to SME financing, particularly during periods of financial distress. For example, a study by Demirguc-Kunt and Maksimovic (2001) finds that in 39 countries around the world, trade credit use is higher relative to bank credit in countries with weak legal environments, which makes bank contracts more difficult to write. Fisman and Love (2003) highlight the impact of inter-firm financing by showing that industries with higher dependence on trade credit financing exhibit higher rates of growth in countries with relatively weak financial institutions. Love, Preve and Sarria-Allende, 2006) find that trade credit is an important source of financing, relative to bank lending, during periods of financial distress. Van Horen (2004) studies the use of trade credit in 39 countries and finds that trade credit is used as a competitive tool, particularly for small and young firms. McMillan and Woodruff (1999) study the use of trade credit in Vietnam and find that small firms are more likely to both grant and receive trade credit than large firms. This empirical evidence suggests that SMEs in emerging markets are likely to provide trade credit and hold illiquid accounts receivable on their balance sheets.

However, factoring may still be hampered by weak contract enforcement institutions and other tax, legal, and regulatory impediments. For example, factoring generally requires good historical credit information on all buyers; if unavailable, the factor takes on a large credit risk. In general, a small firm sells its complete portfolios of receivables in order to diversify its risk to any one seller. In fact, many factors require sellers to have a minimum number of customers in order to reduce the exposure of the factor to any one buyer and to the seller's ability to repay from receipts from other buyers, in the case that a buyer defaults. However, this diversified portfolio approach requires factors to collect credit information and calculate the credit risk for many buyers. In many emerging markets the credit information bureau is incomplete (i.e. may not include small firms) or non-bank lenders, such as factors, are prohibited from joining. In the case of exporters, it might be prohibitively expensive for the factor to collect credit information on firms around the world.

Fraud also represents a big problem in this industry (e.g. bogus receivables and nonexistent customers) and a weak legal environments and non-electronic business registries and credit bureaus make it more difficult to identify these problems. An alternative usually used in emerging markets is for the factor to buy receivables with "recourse", which means that the seller is accountable in the event that a buyer does not pay its invoice and the seller of the receivables retains the credit risk. However, this may not successfully reduce the factor's exposure to the credit risk of the seller's customers, since in the case of a customer's default, the seller may not have sufficient capital reserves to repay the factor.

Empirical tests confirm these hypotheses. Klapper (2006) uses a sample of factoring turnover as a percentage of GDP for 48 countries around the world and finds that creditor rights are not significant predictors of factoring. However, access to historical credit information, which is necessary to access the credit risk of factoring transactions and enforce factoring arrangements, does matter. This paper also finds evidence that factoring is relatively larger in countries with weak contract enforcement, which suggests that factoring may substitute for collateralized lending.

### *"Reverse Factoring" allows SMEs to receive more financing at lower costs*

One solution to these barriers to factoring is the technology often referred to as "Reverse Factoring". In this case, the lender purchases accounts receivables only from specific high-quality buyers and the factor only needs to collect credit information and calculate the credit risk for selected buyers.

Reverse factoring can mitigate the problem of weak information infrastructures if only receivables from high quality buyers are factored (such as foreign, internationally accredited firms). In addition, the reduced risks associated with reverse factoring makes it possible for firms to factor without recourse, which can reduce firms' exposure to the credit risks of its customers.

Another advantage of reverse factoring is that it provides benefits to both lenders and buyers. In many countries banks offer factoring. In this case, factoring enables lenders to develop relationships with small firms (with high quality customers). This may provide cross-selling opportunities and allow lenders to build credit histories on small firms that can lead to additional lending (for fixed assets, for example). The large buyers may also benefit: by engineering a reverse factoring arrangement with a lender and providing its customers with working capital financing, the buyer might be able to negotiate better terms with its suppliers. For example, buyers may be able to extend the terms of their accounts payable from 30 to 60 days. In addition, the buyer benefits from outsourcing its own payables management.

Reverse factoring can also aid the development of local bond markets, by pooling securities from a large number of sellers to one or more creditworthy buyers. This pool of receivables could be securitized with a credit rating equal to that of the underlying high-quality buyer(s).

**Case Study: The Nafin Factoring Program in Mexico**

A successful example of reverse factoring in a developing country is the case of the National Financiera (Nafin) development bank in Mexico, which offers on-line factoring services to SME suppliers. The program is called *Cadenas Productivas* or "Productive Chains" and works by creating 'chains' between 'Big Buyers' and small suppliers. The Buyers are large, credit worthy, and often foreign firms that are low credit risk.

What makes Nafin special is that it operates an electronic platform that provides on-line factoring services, which reduces costs and improves security. Over 98% of all services are provided electronically, which reduces time and labor costs. The electronic platform also allows all commercial banks to participate in the program, which gives national reach, via internet, to regional banks. This technology has allowed successful economies of scale – Nafin grew from a 2% market share of factoring in 2001 to 60% of the market in 2004.

There are a number of additional characteristics that make the Nafin program unique. For example, all factoring is done on a non-recourse basis, which lets small firms increase their cash holdings and improve their balance sheets. Also, Nafin has a 'multi-bank' approach, which allows lenders to compete to factor suppliers' receivables. In addition, Nafin pays for the costs associated with their electronic factoring platforms and all legal work, such as document transfers, preparing and signing documents, etc., so that banks charge only interest and not service fees. Nafin covers its own cost with the interest that lenders pay for Nafin's refinancing capital or service fees.

Nafin has succeeded in providing financial services to Mexican SMEs. As of mid-2004, Nafin had established Productive Chains with 190 Big Buyers (about 45% in the private sector) and more than 70,000 SMEs (out of a total of about 150,000 participating suppliers). About 20 domestic lenders participate, including banks and independent finance companies. Since the program's inception in September 2001, Nafin has brokered ever 11 million transactions – 98% by SMEs – at a rate of about 4,000 operations per day.

In addition to factoring services, Nafin capitalizes on its information on the sales and payment history of small sellers to also offers contract financing. This provides financing up to 50% of confirmed contract orders from buyers with Nafin supply chains, with no fees or collateral, and a fixed rate.

Many suppliers that participate in the Nafin program have no other sources of financing. In discussions with suppliers, many reported that they had no access to external financing before receiving financing from Nafin and most previously depended on internal funds and credit from their own suppliers. In addition, suppliers stated that Nafin financing is preferable to bank financing, since banks are slow to make credit decisions, would offer less credit and charge higher rates.

An additional advantage of the Nafin platform is that it prevents fraud, which is systemic in the factoring business in the US and other developed countries. Since only large buyers are able to enter new receivables, sellers cannot submit fraudulent receivables. Moreover, since the bank is paid directly by the buyer, suppliers cannot embezzle the proceeds.

The success of the Nafin program highlights how the use of electronic channels can cut costs and provide greater financial services to SMEs. The Nafin factoring program is used as a model in Mexico for the automation of other government agencies and service providers. For instance, on-line banking services also allow lenders to penetrate rural areas without banks and provide incentives for firms in the informal sector to register and take advantage of financing opportunities. The success of the Nafin program depends on the legal and regulatory support offered in electronic Signature and Security laws that could be a model for other developing countries.

## Conclusion

**Reverse factoring has the potential to be an important source of working capital financing for exporters in countries with poor credit information.** In particular, factoring is an ideal source of financing in countries with small, risky suppliers and large foreign buyers. Whereas ordinary factoring requires lenders to have timely and comprehensive credit information, reverse factoring only requires complete credit information on one or more creditworthy firms. Exporters could particularly benefit from factoring services – which might allow firms with foreign, creditworthy buyers to sell on open account terms and expand into new markets. An example of reverse factoring is the Nafin factoring program in Mexico, which highlights how the use of electronic channels and a supportive legal and regulatory environment can cut costs and provide greater financing opportunities for exporters and SMEs in emerging markets.

[1] Data is from Factor Chain International: www.factors-chain.com

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## Average Factoring Turnover By Country, 1994-2005 (in Millions of EUR)

| Countries | Factoring Turnover (millions Euro) | Factoring as a Percentage of GDP (millions Euro) | Growth Rate of Factoring Turnover since 2000 |
|---|---|---|---|
| Argentina | 275 | 0.15% | -83.97% |
| Australia | 23,130 | 3.30% | 215.98% |
| Austria | 4,273 | 1.40% | 87.82% |
| Belgium | 14,000 | 3.84% | 75.00% |
| Brazil | 20,050 | 2.52% | 66.92% |
| Canada | 3,820 | 0.34% | 69.33% |
| Chile | 9,500 | 8.24% | 258.49% |
| China | 5,830 | 0.26% | 2,650.00% |
| Cuba | 210 | . | 94.44% |
| Czech Republic | 2,885 | 2.36% | 187.06% |
| Denmark | 7,775 | 3.06% | 91.98% |
| El Salvador | 80 | 0.47% | . |
| Estonia | 2,400 | 18.31% | . |
| Finland | 10,470 | 5.42% | 46.84% |
| France | 89,020 | 4.22% | 69.72% |
| Germany | 55,110 | 1.98% | 134.68% |
| Greece | 4,510 | 2.11% | 200.67% |
| Hong Kong | 7,700 | 4.33% | 220.83% |
| Hungary | 1,820 | 1.67% | 429.07% |
| India | 1,990 | 0.25% | 323.40% |
| Ireland | 23,180 | 11.80% | 256.62% |
| Israel | 325 | 0.26% | -29.35% |
| Italy | 111,175 | 6.45% | 1.07% |
| Japan | 77,220 | 1.71% | 32.06% |
| Lebanon | 61 | 0.27% | . |
| Lithuania | 1,640 | 6.43% | . |
| Malaysia | 532 | 0.41% | -9.06% |
| Mexico | 7,100 | 0.92% | 41.15% |
| Morocco | 430 | 0.83% | 855.56% |
| Netherlands | 23,300 | 3.92% | 46.54% |
| New Zealand | 250 | 0.23% | 150.00% |
| Norway | 9,615 | 3.39% | 93.85% |
| Panama | 240 | 1.55% | 9.09% |
| Peru | 95 | 0.12% | . |
| Philippines | 141 | 0.14% | . |
| Poland | 3,700 | 1.24% | 77.46% |
| Portugal | 16,965 | 9.80% | 88.60% |
| Romania | 550 | 0.56% | 816.67% |
| Russia | 2,540 | 0.33% | . |
| Singapore | 2,880 | 2.47% | 37.14% |
| Slovakia | 830 | 1.79% | 418.75% |
| Slovenia | 230 | 0.68% | 253.85% |
| South Africa | 5,580 | 2.32% | 0.54% |
| South Korea | 850 | 0.11% | 639.13% |
| Spain | 55,515 | 4.94% | 184.69% |
| Sri Lanka | 201 | 0.86% | 103.03% |
| Sweden | 19,800 | 5.59% | 60.84% |
| Switzerland | 1,900 | 0.52% | 46.15% |
| Taiwan | 36,000 | 10.41% | 886.30% |
| Thailand | 1,640 | 0.93% | 29.34% |
| Tunisia | 226 | 0.79% | 276.67% |
| Turkey | 11,830 | 3.26% | 85.13% |
| U.S.A. | 94,160 | 0.76% | -7.93% |
| Ukraine | 333 | 0.41% | . |
| United Kingdom | 237,205 | 10.82% | 91.65% |
| Vietnam | 2 | 0.00% | . |
| *Average middle-income countries* | 2,624 | 1.89% | 341.94% |
| *Average high-income countries* | 37,172 | 4.12% | 126.04% |
| *Average (total)* | 17,777 | 2.89% | 227.10% |