Supply chain finance support facility

Project Briefing Note




Unlocking working capital – Lessons learned about stimulating supply chain trade finance

PURPOSE OF THIS BRIEFING NOTE

Inclusive Growth is one of FSD Kenya's four theme areas. The objective of the Inclusive Growth programme is to enhance financial inclusion of SMEs in Kenya. One of its first projects was the Supply Chain Trade Finance (SCTF) Facility, which started in 2009 and will soon be merged into the new GrowthCap Programme.

This briefing note is based on experiences gained in the Supply Chain Trade Finance project. Its aim is to communicate how to successfully introduce Supply Chain Finance.

ACCESS TO WORKING CAPITAL THROUGH INVOICE DISCOUNTING

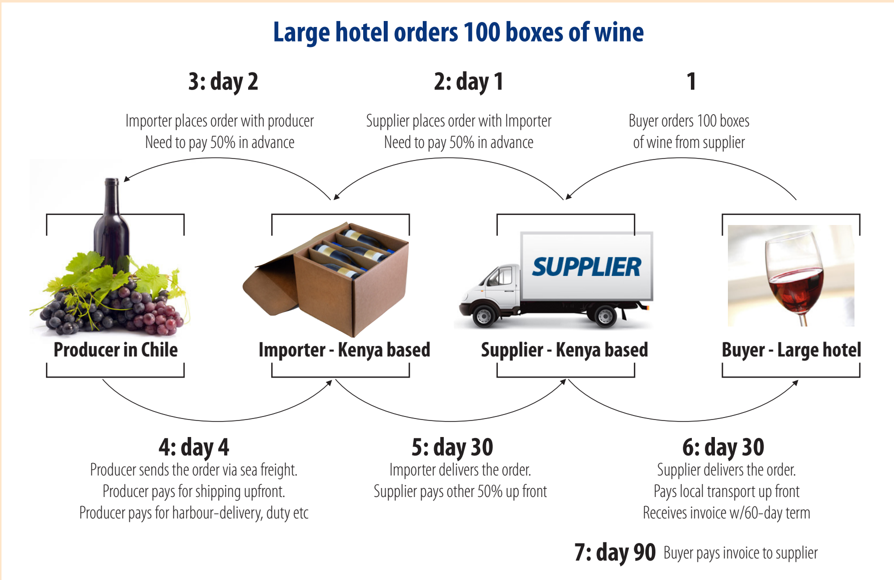
"Insufficient working capital" is the number one complaint of Kenyan SMEs, and is particularly common among traders and suppliers. While their typically large corporate clients expect 60-day payment terms, these small companies cannot secure payment terms for their inputs, such as goods or labour, and lack the assets to access collateral-based credit. Their inputs may require immediate payment or even pre-payment. In practice, the working capital of traders and suppliers is "locked in" for much of the time.

Most of suppliers' working capital is lying idle in deliveries pending payment. They are only left with the certified invoices....

These invoices are exactly where the opportunity lies: as they are for goods delivered to and certified by large corporate buyers, their payment is guaranteed by entities (the corporate buyers) more creditworthy than the supplier. These invoices can serve as collateral for credit. This type of credit is called 'invoice discounting finance' (IDF).

> *"Invoice discounting allows a business to draw money against its sales invoices before the customer has actually paid. To do this, the business borrows a percentage of the value of its sales ledger from a finance company, effectively using the unpaid sales invoices as collateral for the borrowing."*[3]

Box 1: Example of duration that supplier working capital is locked in



In this case, to supply 100 boxes of wine, the supplier must pre-finance 50% of its costs for 30 days, estimated at 35% of total sale value[1]. During that period, this working capital is locked in and cannot be used for anything else. When the wine is delivered, the supplier must pay the remaining 50% for the wine (i.e., finance another 35% of sales value on the wine costs) as well as an estimated 50% of its own personnel, administration and transport costs, representing about 5% of sale value). The hotel only pays its invoice after 60 days. This process locks in 75% of the sale value for 60 days. For the supplier, this is the equivalent of a total of 92%[2] of the sale value locked in for two months.

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1 Assuming the supplier spends 70% of the total sale costs to purchase the wine.
2 35% is locked in for 30 days, which is equivalent to 17.5% locked in for 60 days.

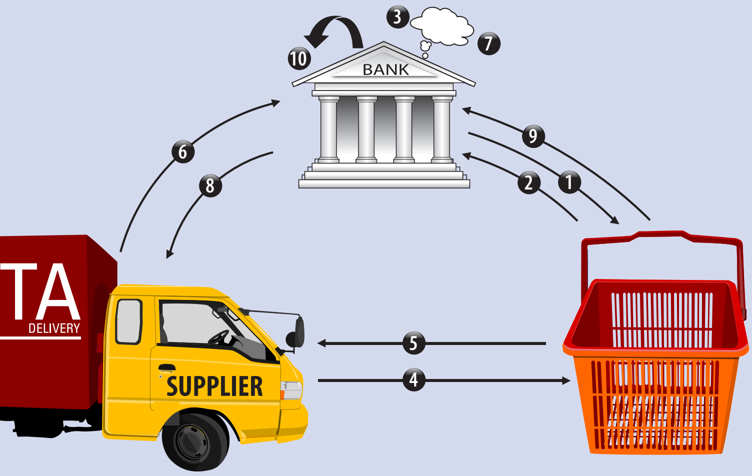
3 http://en.wikipedia.org/wiki/Invoice_discounting (October 14th, 2012)

A typical grocery shelf in a supermarket. "Insufficient working capital" is the number one complaint of Kenyan SMEs, and is particularly common among traders and suppliers.

When FSD's Supply Chain Trade Finance Facility was started, the few banks in Kenya that offered any invoice discounting only had small IDF operations. However, several banks showed interest in starting invoice discounting finance and this is what the SCTFF focused on.

HOW INVOICE DISCOUNTING FINANCE WORKS

The invoice discounting finance process is summarized in the following diagram:



1. Bank (or supplier) requests buyer cooperation
2. Buyer agrees to cooperate and pay into supplier's account at bank
3. Bank assesses and approves buyer
4. Supplier delivers goods
5. Buyer signs receipt of goods note (recognising invoice)
6. Supplier submits signed invoice for IDF at bank
7. Bank approves individual IDF
8. Bank pays supplier 70% of invoice value
9. Buyer pays into supplier's bank account
10. Bank transfers advance + fee + interest from supplier's account to own account
11. Process finished

Invoice discounting finance is substantially different from other credit products

After FSD Kenya's three years' experience, it is clear that invoice discounting is very different from the credit products with which banks are familiar, requiring a distinct approach and different skills. In invoice discounting:

- credit cycles are short, about 60 days long
- amounts per invoice can be small, but there are often numerous 'repeat' invoices
- the supplier applies for the credit, but the risk depends on the buyer.
- These differences imply that successful IDF requires:
- very fast turnaround to the client, and quick decisions for each invoice
- capture of the 'repeat' invoices issued to the same buyer over time
- risk assessment and due diligence performed on the client's business partner (the buyer), and not on the bank's client (the supplier).

FAST TURNAROUND

The lesson in Kenya so far is that banks require a turnaround in thinking and doing in order to become successful in IDF. Crucial to this is fast decision-making processes. Rather than each invoice going through the full risk-assessment and approval process which takes at best several days, banks need to approve 'lines', rather similar to overdraft facilities. For example, each supplier-buyer combination could be assessed for a maximum IDF line lasting six months. Once created, suppliers could use such lines to submit invoices for discounting up to the approved maximum. These invoices could be approved directly by the responsible IDF in a matter of hours without being approved by the risk-management section.

The line's validity could be extended through a shortened approval process that considers its past performance.

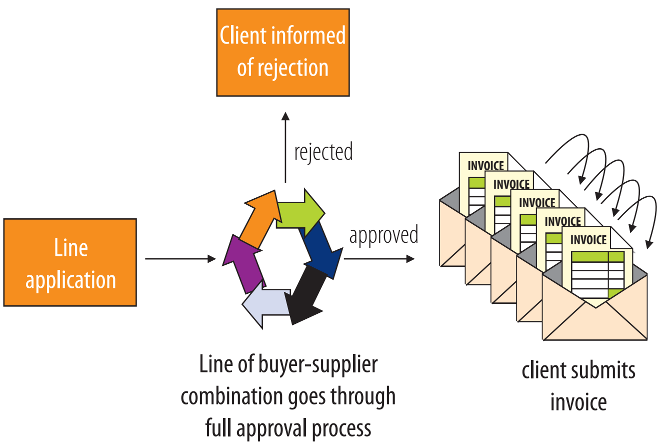
Wakulima SACCO's Banking hall. Several banks showed interest in starting invoice discounting finance and this is what the SCTFF focused on.

CAPTURING REPEAT INVOICES

Participants in the SCTF Facility experienced challenges in getting clients to submit repeat invoices. There was a high drop-out rate after clients had submitted their first invoice..Banks had required that the first invoice to be discounted go through the lengthy full approval process, discouraging clients that did not want to go through the same process again. The solution lies in making a clear distinction between the approval of a line and access to it. New IDF clients will explicitly apply for a line of a certain amount for a certain buyer. The proposed line will go through the full approval process with an invoice that is more of an example than the real IDF application. Once the line is approved, client invoices will require just hours for approval within the IDF section.

Fast turnaround goes hand-in-hand with the capture of repeat invoices.

Bank makes explicit that full approval process done once for a period



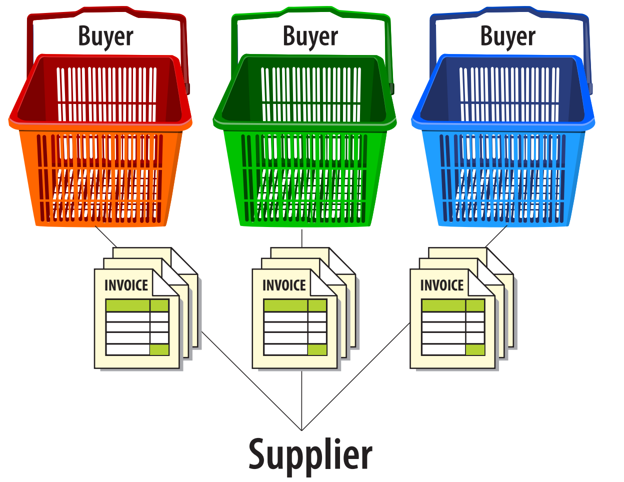
FOCUS ON BUYER RATHER THAN SUPPLIER

The hat-trick of IDF is completed by successfully focusing on the buyer.

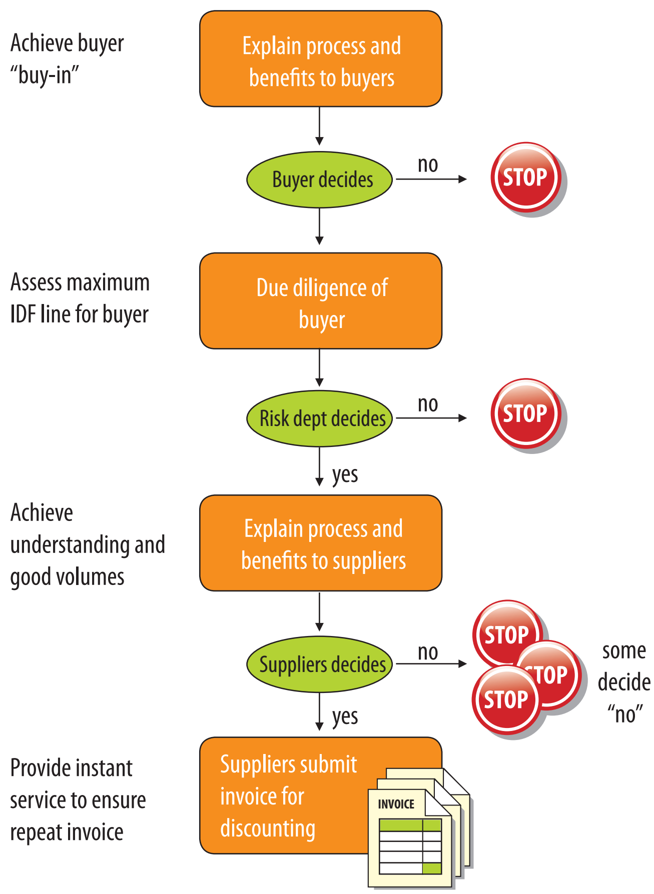
Most participant banks in FSD Kenya's SCTF Facility required time to get used to assessing one party (the buyer) for creditworthiness while serving another party (the supplier) as their client. Once this was embraced, things started moving.

At first, all banks took the suppliers as their departure point and served these according to their needs. This typically resulted in IDF assessing several buyers for each supplier, requiring a lot of effort for small volumes.

IDF without buyer-focus results in serving one supplier and all his/her buyers



Over time it was realized that the departure point should be the buyers, and that buyers ideally introduce suppliers, rather than the other way round. In fact, the ideal process for successful IDF is as follows:



Buyers do not automatically see the benefits of IDF for their business. Their first reaction is often mistrust. Many view it as charity to their suppliers and added risk and uncertainty for themselves.

IDF DEMAND-SIDE ISSUES – LOW AWARENESS AMONGST BUYERS AND EVEN SUPPLIERS

Suppliers' weak demand due to lack of awareness

Demand for IDF required a lot more attention and effort than expected. While overall, suppliers mention shortages of working capital and cash flow as their main problem, they do not necessarily know about IDF as an appropriate solution. They rarely request IDF, only becoming clear about the opportunities through in-depth discussions with the bank.

Buyers' unwillingness to cooperate

Buyers do not automatically see the benefits of IDF for their business. Their first reaction is often mistrust. Many view it as charity to their suppliers and added risk and uncertainty for themselves.

Buyers require well-considered, dedicated awareness raising that demonstrates benefits to their bottom line.

Box 2. How IDF contributes to buyer profits

A buyer's business is only as good as the products they are supplied. Suppliers' cash-flow issues put pressure on quality. A buyer with sufficient working capital can:

- order goods on time
- deliver on time
- hold some reserves
- deliver varying quantities on short notice
- select providers according to quality rather than payment schedule

A needy supplier negatively impacts a buyer's business. One precarious link results in an ailing supply chain.

Buyers hesitant due to fraud

Fear of fraud is another factor preventing buyers from cooperating in IDF. Buyers worry that when their certified invoices are passed on to third parties, multiple (and therefore fraudulent) invoices may be presented and accidentally honoured, leaving buyers responsible to pay for the originals. This is a legitimate fear, and IDF providers must carefully ensure that such practices are impossible.

IDF providers can address this through carefully developed procedures. The simplest method is for buyers to sign and certify (with a seal) a specific form, together with the original invoice, in which the buyer approves the transfer of the invoice to a specific IDF provider. The invoice can only be granted when the original is presented together with the attached paper authorizing the transfer. The IDF provider will also send an email to both the original issuer of the invoice (the supplier) and the buyer confirming the submitter and submission date of the original invoice. Such procedures should deal with most buyer concerns of fraud.

The IDF provider should carefully draw up terms and conditions to safeguard against any risks on the buyers' side.

ORGANISATIONAL SET-UP – THE MOST APPROPRIATE LEGAL FORMS

In Kenya, invoice discounting is primarily provided by banks. There are also two dedicated non-bank institutions, one fully concentrating on invoice discounting finance and another with a significant portion of its SME finance portfolio in invoice discounting.

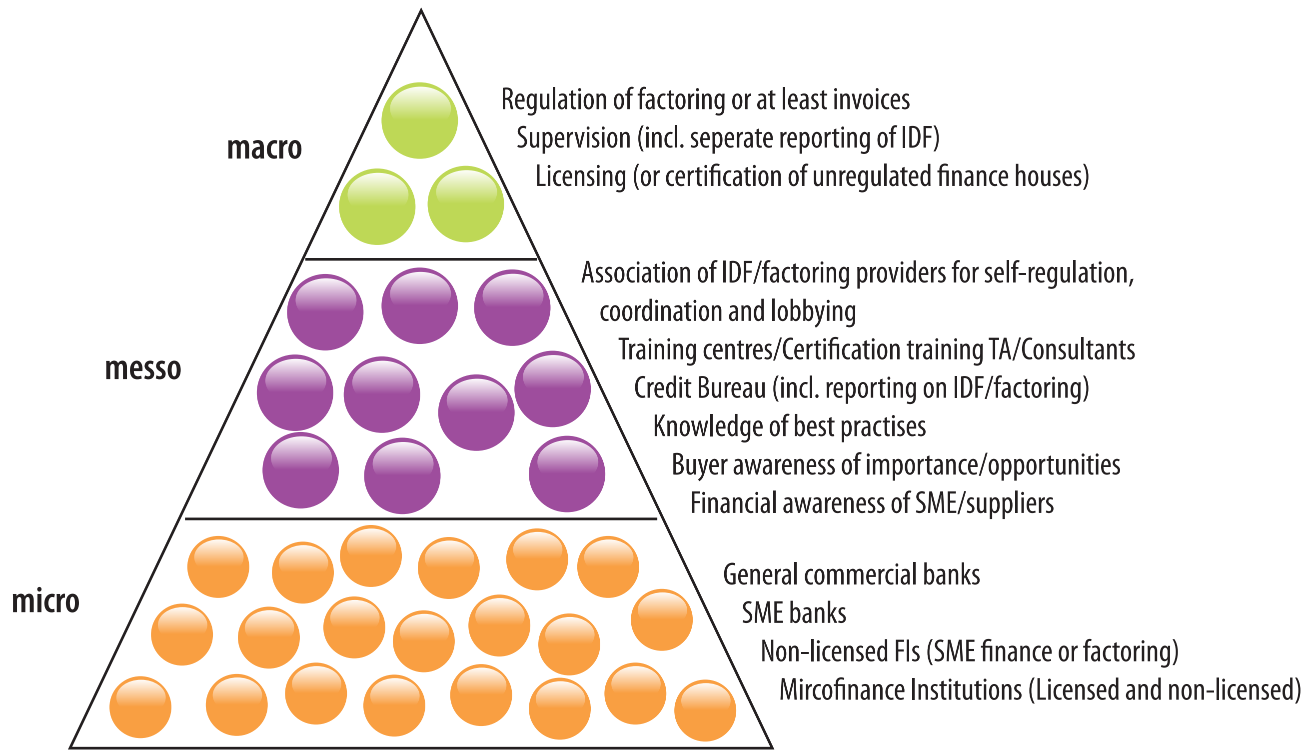
A SECTORAL DEVELOPMENT APPROACH IS REQUIRED FOR IDF TO THRIVE

IDF proves to be another financial product that requires balanced development of the different levels of service provision. A healthy sector could be presented with the following graph:

The advantages and disadvantages of the different legal forms can be summarized as follows:

legal form	Advantages	Disadvantages
general commercial bank	▪ often good liquidity position ▪ corporate client base that could provide entrance to corporate buyers ▪ seen as most trustworthy by corporate buyers ▪ access to low-cost funds (deposits)	▪ often strongly risk-averse ▪ often bureaucratic ▪ difficult to introduce new products with distinct requirements ▪ possible need for high capital adequacy rate
specialized SME bank	▪ good understanding of needs of final client, the supplier ▪ often more flexible processes, quicker to adopt new products ▪ somewhat less risk-averse than general banks ▪ regulated, hence trustworthy ▪ reasonable access to low-cost funds (deposits)	▪ no access to corporate buyers within own portfolio ▪ possible need for high capital adequacy rate
non-bank SME financial house	▪ good understanding of needs of final client, the supplier ▪ most flexible processes, quicker to adopt new products ▪ high risk appetite	▪ no access to corporate buyers within own portfolio ▪ usually unsupervised, so less trustworthy ▪ higher fund costs than deposit-taking banks/more difficulty accessing funds
specialized IDF/ factoring house	▪ good understanding of needs of final client, the supplier ▪ fully specialized in specific product, with dedicated sales force ▪ most flexible processes, and ability to introduce new related cash flow products ▪ high risk appetite	▪ no access to corporate buyers within own portfolio ▪ usually unsupervised, so less trustworthy ▪ higher fund costs than deposit-taking banks/more difficulty accessing funds ▪ more vulnerable to seasonal fluctuations of IDF demand
deposit-taking microfinance institutions	▪ good understanding of needs of final client, the smaller supplier ▪ proficiency in quick, efficient processes for high volume/low margin ▪ high risk appetite ▪ regulated, so trustworthy ▪ access to funds: deposits and international investors	▪ no access to corporate buyers within own portfolio and probably high threshold for MFIs ▪ clients are generally micro enterprises, if pursued ▪ possible need for high capital adequacy rate

A healthy IDF - enabling environment has mature and functioning micro-, meso- and macro-level components



Kenya's SCTF Facility first concentrated on the micro-level of the enabling environment (i.e. the supply side of IDF). However, it soon became clear that meso-level and macro-level equally require attention.

At the macro-level, lack of regulation is a current obstacle to IDF. As invoices are not recognized as legal title papers, they cannot be sold. As a result, buyers are under no obligation to pay an invoice presented by an entity other than the original issuer. This means that IDF can only function when the buyer cooperates. In countries with regulations, buyers are legally bound to pay whoever presents the original invoice. If such regulation existed, IDF would likely grow faster.

Provision of IDF might also be enhanced by separate reporting of IDF finance (and/or factoring), as this would help those active in the sector to monitor its growth and development.

At the meso-level, the sector would benefit from a number of interventions. If all those active in providing IDF or factoring organized themselves into an association to represent their interests and work on self-regulation, IDF could gain better standing and become better known. Such an association would provide a joint voice to influence government regulations. Credit bureaus should receive separate reporting on IDF, including data on both the buyer and supplier per invoice. Credit bureaus should also receive reports from unlicensed entities which may represent a substantial portion of IDF/factoring. Awareness-raising among both buyers and suppliers may prove another valuable intervention.

At the micro-level it is important to look at the full spectrum of IDF/factoring providers. These explicitly include dedicated IDF houses, which may be the typical first movers in countries with an underdeveloped IDF sector. Commercial banks are unlikely to step into IDF before it is a proven business opportunity. Microfinance institutions (MFI) may also be important for a flourishing supply of IDF. Since these institutions commonly deal efficiently with low-margin, high-volume processes, they are well placed to provide IDF. However, they may have more challenges building relationships with buyers. They can be expected to specialize in both smaller suppliers and smaller buyers.

ABOUT FSD KENYA

Established in early 2005, FSD Kenya aims to support the development of inclusive financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry our goal is to significantly expand access to services among lower income households and smaller scale enterprises. FSD operates as an independent Trust under the supervision of professional trustees, with policy guidance from its programme investment committee. Finance is provided by a number of development partners including the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA), Agence Française de Développement (AFD) and the Bill and Melinda Gates Foundation together with the Government of Kenya.

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FSD Kenya
Financial Sector Deepening

info@fsdkenya.org • www.fsdkenya.org
FSD Kenya is an independent Trust established to support the development of inclusive financial markets in Kenya
4th Floor Kenya KMA Plaza • Off Ragati Road, Upper Hill • P.O. Box 11353, 00100 Nairobi, Kenya
T +254 (20) 2718809, 2718814 • **M** +254 (724) 319706, (735) 319706