

HOW TO ACCESS TRADE FINANCE

A GUIDE FOR EXPORTING SMEs



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Guide dealing with the processes involved in obtaining finance for exporting SMEs – explains the credit process of financial institutions from pre-application to loan repayment; examines the SME sector and barriers to finance, as well as the risks in lending to the SME sector as perceived by financial institutions; addresses SMEs' internal assessment of financial needs, determining the right financing instruments, and finding the appropriate lenders and service providers; discusses how to approach and negotiate with banks; tackles cash flow and risk management issues; includes examples of real-life business plans and loan requests; includes bibliography (p. 134).

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Foreword

This book addresses one of the critical needs of business: access to trade finance.

Even in the best of economic times, small exporters single out trade finance as a major challenge. In the current economic downturn, trade finance for small exporters in developing countries has all but dried up. Uncertainty from investors and consumers has led to a massive contraction in demand: a 60-year low in world trade, a fall-off in foreign direct investment, a drop in commodity prices and a contraction in remittances. The world's poorest countries have suffered most from the global trade slump, with their export earning slashed by up to 50% in the first half of 2009 as compared to the same period in 2008.

Trade finance has a critical role in accelerating economic recovery, and to help developing countries fulfill their aspirations. A commitment from governments, in partnership with the banking sector, is essential to the maintenance of credit flows.

It is in this context that ITC offers this very practical guide to help small and medium-sized exporters in developing countries tap into trade finance. The guide provides an overview of financing issues from the perspective of small exporters, offers understanding of which financial instruments are most suitable, which service providers are most relevant, and how to approach them.

Ten years ago, ITC issued a forerunner of this guide, entitled *How to Approach Banks*. This new guide, *How to Access Trade Finance: A Guide for Exporting SMEs* reflects an evolution in the trade development sector. There is growing understanding of the partnership needed between the banking sector and governments to boost SME exports. Consequently, ITC has worked with banks, development funds, chambers of commerce, trade promotion organizations and financial associations to develop this guide. It is our hope that these institutions, along with small exporters, will use this guide to help make trade finance more accessible, and build a stronger trade platform to support small businesses around the world.



Patricia R. Francis
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Introduction

The current global economic and financial crisis is not conducive to the business development of small firms, especially those with international markets. Millions of these enterprises, considered the backbone of an economy, have collapsed. Small and medium-sized enterprises (SMEs) in developing countries have been hardest hit, with export markets cut by an average of 40%–50% and resulting increases in unemployment and poverty.

International Trade Centre (ITC) has decided to publish this Guide as part of a package of short-term responses to help SMEs in these times of crisis.

SME managers often cite access to finance as a major obstacle to creativity, entrepreneurship and growth. The crisis created an immediate scarcity of funds for lending. As an after effect, a tightening of exposure levels has further affected SMEs, which financial institutions already considered as representing increased risk.

This Guide provides the SME manager with key advice on how to understand bank requirements, prepare a bankable proposal and a solid business plan, conduct better negotiations with banks, and use banks to boost their competitiveness. The publication also describes how to develop a relationship between a new breed of bankers and SME managers. These are bankers who are ready to work closely with the SME community to understand their needs and provide new solutions.

For SME managers to develop a beneficial relationship with banks, they must understand the mission of the banks and their exposure limitations. They must be proactive in their search for sustainable business ideas. Together, banks, trade support institutions and firms must develop clear benchmarks and early warning systems to minimize non-performing loans. They must also establish a climate of dialogue and trust.

This Guide complements several other ITC trade finance publications and software applications to help these managers improve their access to finance and subsequently enable them to take advantage of new export markets.

Written in accessible language, this publication is divided into six sections, taking the user through each step needed to understand the process of obtaining finance. The Guide draws upon examples from development banks and microfinance networks, and includes real-life business plans and loan requests.

How to Access Trade Finance: A Guide for Exporting SMEs will be particularly useful for SME managers. It will also be useful for trade support institutions, and business trainers and coaches. Sector associations will find a number of useful answers for their members. We also hope that bankers will find this Guide helpful in developing a better understanding with SMEs.

ITC hopes this publication will contribute to bridging the gap of knowledge between financial institutions and small firms in developing countries, leading to successful and sustainable development impact.

Trade finance: a lifeline for trade

Trade finance refers to a wide range of tools that determine how cash, credit, investments and other assets can be used for trade. Typical trade-related financial services include letters of credit (L/Cs), import bills for collection, import financing, shipping guarantees, L/C confirmation, checking and negotiation of documents, pre-shipment export financing, invoice financing, and receivables purchase. Trade finance instruments can be structured to include export credit guarantees or insurance.

Trade finance facilitates trade by helping overcome the information asymmetry between buyers and sellers, enabling them to trust a system whereby sellers will be paid under certain conditions and buyers will get the products they paid for. Trade finance contributes to international trade in four areas: payment facilitation, risk mitigation, and financing and the provision of information about the status of payments or shipments. Every trade finance transaction involves some combination of these four elements, adjusted to suit the circumstances of a particular market or of a trading relationship.

Trade finance is the lifeline of trade because more than 90% of trade transactions involve some form of credit, insurance or guarantee. The financial crisis is striking at the heart of the global economic system. Many normally stable banks are wary of capital depletion and are consolidating balance sheet positions, often in response to regulatory imperatives, thereby limiting the amount of money available to be lent against the reduced capital base. Trade finance is not exempt from this liquidity crunch. It is estimated that the trade-financing gap (between funds needed and funds available) has exceeded US\$ 300 billion, with the result that trade flows are directly and adversely affected. The gap in trade finance has resulted in a substantial reduction in the movement of goods between producer and consumer markets, and is threatening to stall the trading system.

When banks are extremely risk-averse, small- and medium-sized enterprises (SMEs) are likely to be more affected than larger ones. With banks allowing a lower amount for loans, SMEs, normally among the last in a pecking order, would have even more problems competing for fewer funds at higher costs. In ordinary times SMEs face difficulties accessing finance; the current extraordinary financial crisis multiplies this difficulty. By some accounts, SMEs in developing and emerging markets are doubly impacted, as financiers tend to retreat from higher-risk markets at the same time as credit shifts further from SMEs and towards larger corporate clients.

Challenges for SMEs

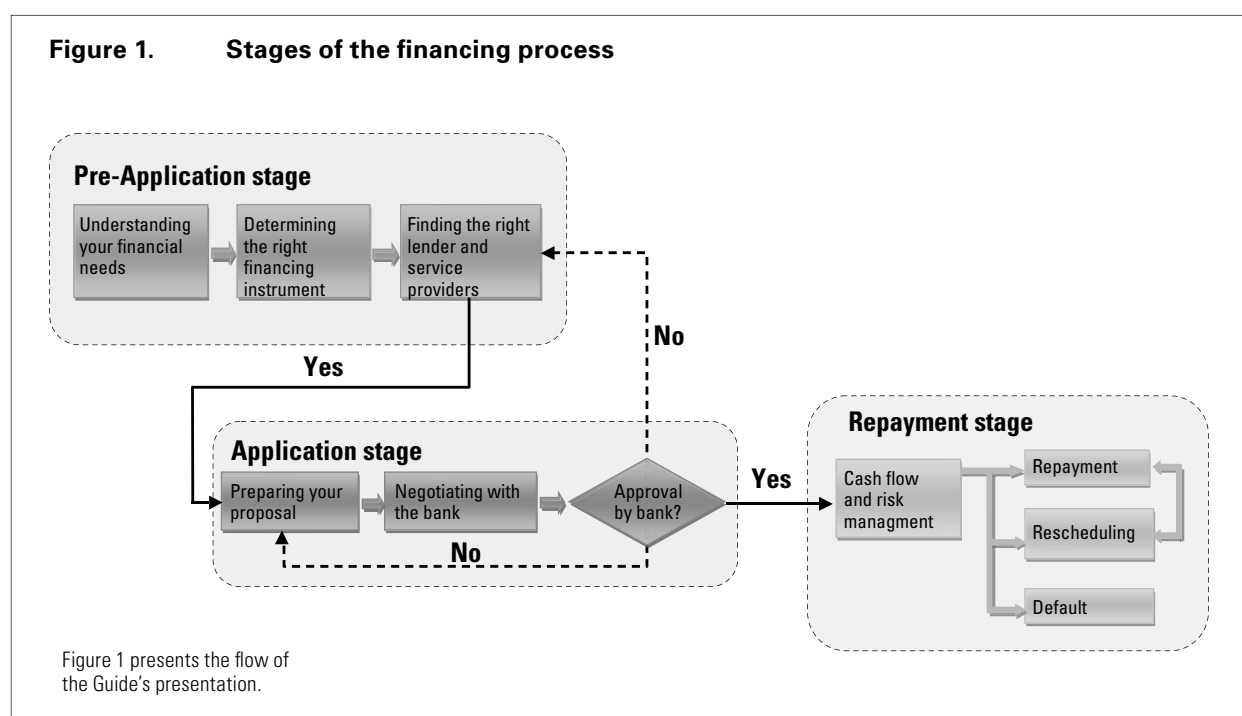
SMEs comprise the great majority of registered companies in developing and developed countries. They play an important economic role by generating employment and income, and by contributing significantly to export earnings. But banks tend to prioritize lending to large companies because of higher risks and high transaction and monitoring cost of SME lending activities.

Some banks have succeeded in maintaining and increasing SME portfolios, by differentiating their approaches for different borrowers without deviating from

the principles of good credit. In many cases, access to capital for SMEs must be accompanied by capacity building through management training, business and strategic planning, marketing, accounting and technology upgrading. The approach to SME lending is markedly different from traditional corporate banking and requires a paradigm shift for many financial institutions.

SMEs that intend to access financing must have an effective knowledge of the types of financial institutions, the various products and services available, and credit policies and procedures. SMEs, especially those involved in exports, must inform themselves of alternative credit sources, including non-bank providers, as well as alternative financing options. Such options include credit guarantees, insurance, leasing, and other more recent innovations as discussed later.

This Guide is meant for start-up and expanding SMEs with special focus on exporting SMEs. With illustrations from different countries, this Guide is a how-to manual for SMEs in accessing finance by understanding the credit process of financial institutions from pre-application to loan repayment.



For SME borrowers and financial institutions to understand each other's perspectives, Chapter 1 discusses the SME sector and barriers to finance, as well as the risks in lending to the SME sector as perceived by financial institutions.

The pre-application stage will cover SMEs' internal assessment of their financial needs (Chapter 2), determining the right financing instrument (Chapter 3), and finding the right lenders and service providers (Chapter 4). Next, the Guide discusses how to approach and negotiate with the bank or financier during the application stage (Chapter 5). Finally, the Guide tackles cash flow and risk management – both critical in ensuring repayment of the borrowed financing (Chapter 6).

Chapter 1

Overview of SME finance

Increasing access to finance by SMEs is important because SMEs are the engine of economic development, they constitute the majority of business enterprises, and they are vital for employment generation and poverty alleviation. However, financial constraints – high cost and lack of access to finance – impede SME growth. Indeed, these problems rank top among perceived obstacles by SMEs in surveys across the globe. Without sufficient capital SMEs are unable to develop and take advantage of business opportunities.

There is anecdotal evidence that SMEs are more adversely affected by the deleveraging, lack of liquidity, and increase in risk aversion by banks.¹ If in normal times SMEs already have a difficult time accessing finance, periods of liquidity squeeze would naturally compound SMEs' financial constraints.

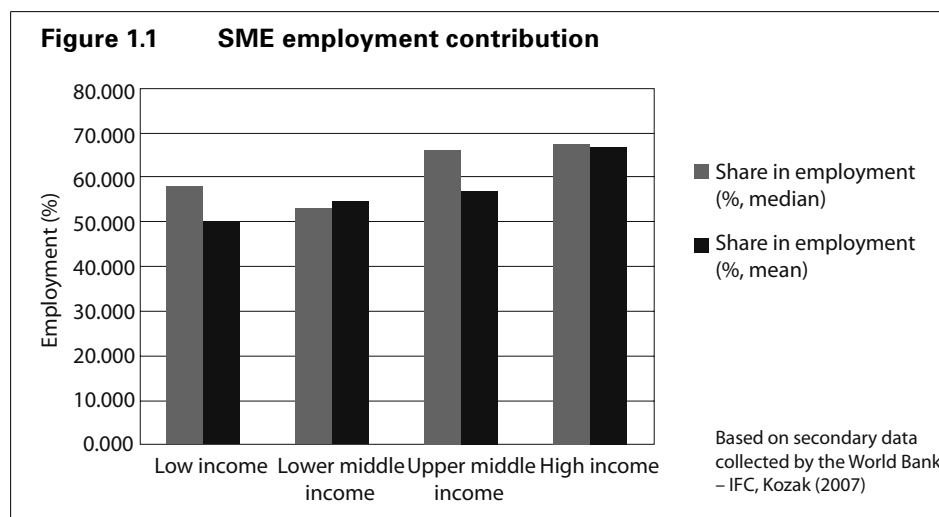
Importance of SMEs

Some governments and institutions define SMEs based upon annual turnover (revenues), and others do so based upon the size of the enterprise. In many countries, SMEs are defined as those with roughly between 10 to 250 employees. Firms with more than 250 workers are considered large, although in some cases firms with 100 employees are considered large firms.

SMEs account for 95% to 99% of registered businesses depending on the country. They contribute more than 60% of employment in developed economies and more than half in middle- and low-income economies (see Figure 1.1). The contribution of SMEs to GDP ranges from less than 20% in poor countries to about half of GDP in rich economies.

Many developing-country SMEs have inserted themselves into vertical production networks as component suppliers to big multinational companies, increasing their contribution in export receipts. SMEs, as major employers especially in rural areas, make valuable and necessary contributions to poverty alleviation. SMEs can be a significant source of innovation often dramatically altering an industry. Think, for example, of Microsoft or Apple Inc. before they became behemoth multinationals: they revolutionized not only their industry, but also our way of life. In both developed and developing economies, the organic growth of small enterprises is a vital source of wealth creation.

¹ For example, fruit growers in Costa Rica were unable to obtain pre-shipment financing in late 2008 from the domestic banking system. Had their importer not extended further credit to their suppliers, on top of advance payments, the crops would not have been brought to the market (Humphrey, 2009).



Finance: a key constraint to SME growth

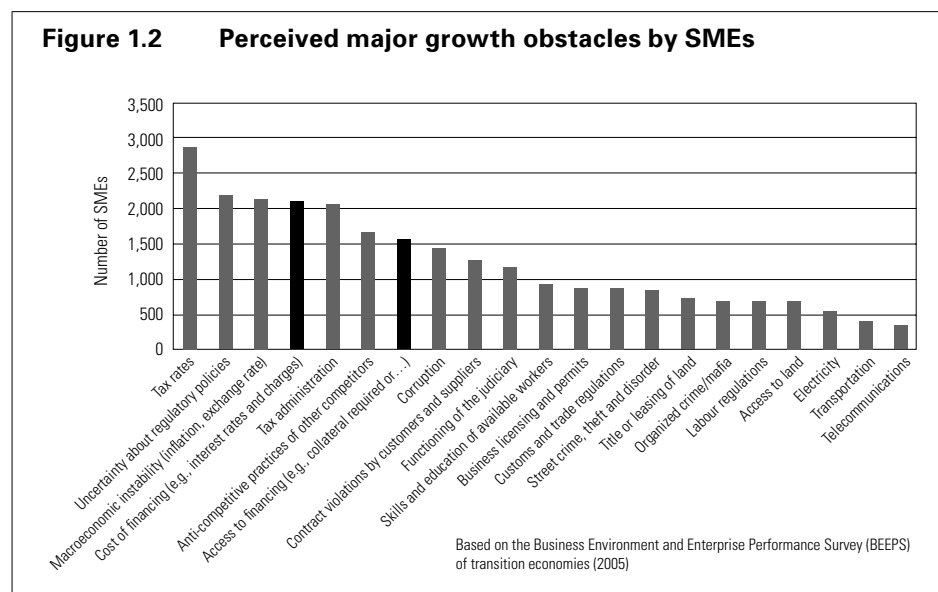
Studies show that in developed economies where institutions (political, economic, legal, etc.) are stable and mature, SMEs grow faster than in countries where the business environment is less conducive. Studies also show that the effect of growth constraints on small enterprises is more adverse than on medium and large firms. Since poor institutions are more prevalent in less developed economies, it is common to see in these countries a greater proportion of small enterprises that have stayed underdeveloped and unproductive than in more advanced economies. Similarly, the average size of firms tends to be larger in countries with more developed financial institutions, rapid judicial conflict resolution mechanisms, and better property right protection.

The importance of business environment and institutions explains why – instead of size-focused public policies, such as SME subsidies – more government and development agency efforts have steered towards helping provide efficient contractual and informational frameworks, better regulatory frameworks, and market-friendly institutions and policies. Business environment reforms, for example, better bankruptcy laws and credit reporting, help financial institutions reach out more to SMEs, and hence close the gap between firms of different sizes.

The cost of, and access to, finance ranks among the crucial factors shaping the business environment worldwide. Surveys show that SMEs consider financial constraints as among the top barriers to growth. Figure 1.2 shows that many SMEs consider cost of finance (4th) and access to finance (7th) as among the major obstacles to growth. This perception is shared in many other developing countries, even at times ranking these two obstacles higher.² Studies also show that younger and smaller firms face higher financing obstacles than older and bigger enterprises. Furthermore, these financing obstacles have greater effect on growth of small firms – twice the effect of the same obstacles on the growth of larger firms.³

² For example, see the World Bank study by Beck (2007).

³ Beck (2007) provides an excellent survey of various empirical studies on finance and SME growth.



Most SME financing comes from internally generated funds, supplemented by borrowings from family and friends as well as informal sources or moneylenders. Banks and other formal finance sources have a very small share. For example, while banks account for about 20% of the financing for new investments of large firms, they contribute less than 10% of the amount that small firms need for the same purpose.

Grey market funds,⁴ in contrast, are important for SMEs. They are more expensive⁵ than the formal fund sources but they are more flexible and quicker to obtain. They rely less on project viability and more on personal networks and relationships for loans screening.

Barriers to formal finance: financial institutions' perspective

A recent World Bank study⁶ shows that banks overwhelmingly consider the SME segment as a big market with great prospects and high profitability. If so, why are SME loans a small percentage of total bank portfolios? SMEs are not the preferred borrowers of many financial institutions. This sub-section explores a few reasons for the reluctance of banks to lend to SMEs despite their perceived potential.

High transaction costs

What drives the difference in access to finance between small, medium, and large firms? Research attributes this variation to transaction costs and information asymmetries. Banks, like all enterprises, incur costs to do business. They incur costs to assess credit, process and monitor loans, implement and maintain technology, establish branches, as well as costs for capital provisioned

⁴ Grey market funds are issued from informal though legal financial markets.

⁵ Rates from the grey market may be up to 30% per month on a short-term monthly loan, and between 5% and 10% a month for loans with a one year maturity (Wattanapruttipaisan, 2003).

⁶ Beck, Demiguc-Kunt, and Peria (2008), present very interesting survey results of banks all over the world on their perception of SME lending.

for loans required by regulators. In other words, banks incur costs related to the safekeeping and management of funds: money costs money.

Banks make money by taking deposits, some portion of which they are then permitted to lend or invest. The difference between what banks pay out in deposit interest, and what they collect on loans and investments must cover all costs and generate a profit.

Transaction costs are directly related to profitability. The higher the cost of processing a transaction, the lower is the return. This is particularly critical because banks maintain a variety of lines of business – some of which are less expensive (and therefore more profitable). Banks can and should make careful choices about where to apply their capital resources to generate returns. Lines of business within a bank compete for capital. The more profitable a business is, the more capital will be directed to it.

The totality of costs, including transaction costs, incurred by banks drives a wedge between the funding cost (deposit rates) and the lending rate banks charge borrowers. The higher these transaction costs, the higher will be the cost of borrowing for businesses. In turn, the higher will be the probability that some set of borrowers will face restrictions on access to funding. The competition for capital within financial services firms contributes to the cost-profit-access dynamic that is so challenging for SMEs.

SME loans are high-cost lending transactions because they are typically small, compared to loans to big firms. Compounding the problem, SME loans are often more time consuming to assess, monitor and manage. Many bankers perceive that small businesses require much more advisory support – handholding – than mid-market or large corporate clients.

Banks are increasingly process and technology-driven. Small companies often cannot or do not provide lenders with the basic inputs required to facilitate what banks perceive to be an efficient risk assessment process. Audited financial statements, formal business plans or funding proposals, credit reports and verifiable biographies of company executives are inputs to conventional credit assessments that banks often find difficult to gather for SMEs. The diversity and opaqueness of SME businesses further contributes to the view among bankers that SME lending is challenging, risky and generates lower returns than other transactions.

Imperfect information

Bank outreach to SMEs is also constrained by default risk. Banks generally do not lend to whoever would be willing to pay higher interest rates because doing so would attract riskier borrowers with higher default probability.⁷ One way for banks to circumvent the asymmetric information problem is to screen out borrowers through non-interest rate devices such as requiring collateral or demonstrated capability based on audited financial information. The lack of audited financial statements that banks can assess tends to exclude SMEs from

⁷ The information asymmetry literature posits that there are two sources of risk: adverse selection and moral hazard. Adverse selection refers to the difficulty of choosing a good borrower, while moral hazard refers to the difficulty of enforcing the agreed credit contract. The risk of adverse selection prevents banks from giving out loans to the highest interest rate bidder and allowing the market to clear that way. Rather, credit rationing takes place accommodating those projects having what are deemed to be the optimal balance between rate of return, and probability of default.

consideration by prudent lenders. The opaqueness of SMEs makes it difficult for banks to determine if they have the capacity and/or the willingness to pay. This opaqueness results partly from conscious decisions on the part of small business owners not to disclose more information than absolutely necessary, and partly from a lack of understanding among SMEs about the importance of communicating openly and regularly with their bankers.

The lack of public information and credit histories, particularly in countries where credit bureaus do not exist, adds to the difficulty banks have distinguishing SMEs with really good potential from those that only appear so. As a result, banks tend to either reject SMEs with good prospects or put all SMEs in the same lot, charging high interest rates to all, thereby discouraging the good ones.

High default risk of SMEs

During economic downturns, SMEs tend to experience bankruptcies more than large firms because they have fewer resources to fall back on. SMEs also tend to have weaker management skills to anticipate and respond to adversity. The greater probability of defaults by SMEs is another reason for bank reluctance to loan to this sector.

Limited collateral

Collateral – security in the form of assets – is a way for banks to recover money in the event of default. Without adequate collateral, banks have limited or no ways to protect their loaned assets. SMEs' lack of collateral is another dissuasive factor for financial institutions. Even if collateral is available, in countries where there is no reliable registry for mortgages, liens and other encumbrances, the quality of the collateral may not be what it seems because it might have already been pledged for other loans. Legal systems in countries where it is difficult for banks to enforce rights to collateral also contribute to bank caution in SME lending.

These factors explain why banks, in dealing with SMEs, usually have numerous requirements and tedious procedures to verify collateral and available financial statements. Some large banks do relatively sophisticated credit ratings (discussed later in this Guide), using qualitative and quantitative information to screen out the uncreditworthy borrowers. The ratings become a basis for risk analysis and for the decision to approve or reject the loan application. After the rigorous pre-approval processes, banks also incur time and resource costs to monitor loans. Some banks have early warning systems to anticipate problems that can crop up during the loan cycle. In addition to these internal procedures, banks often require government guarantees or other government support to mitigate their risk⁸ and to augment the limited collateral available from SMEs.

Banks take these precautionary measures to safeguard their capital and meet their responsibilities to keep their investments safe while generating competitive returns. Risk management policies and practices of banks are meant to prevent default and ensure loan repayment. A prudent lender will prefer not to extend

⁸ In some countries, governments provide regulatory subsidy for SME loans, usually in the form of lower capital requirement or lower loss provisions.

loans, even at higher interest rates, if it is unsure of the real costs, the risks or the expected return.

Risk and return are positively related: the higher the risk (of lending to a SME, for example), the higher the return that will be demanded by the lender. There is a point, however, where the risk is so high (the probability of repayment so low), that no target return justifies the loan.

Box 1.1 illustrates how uncertainty from a financial crisis affects the availability of financing.

Box 1.1 The Asian crisis and access to trade finance by SMEs: the case of documentary credits

The more difficult the macroeconomic environment and the more precarious the situation of the financial institutions, the more risk averse they become. In this sense, an unstable macroeconomic environment is an additional barrier for SME access to finance. The experience during the Asian crisis of the late 1990s illustrates this difficulty, which is now being experienced in other countries.

For trade finance instruments that rely on banks, such as letters of credit (L/Cs), financial crises that affect trust among financial counterparties can have a paralyzing effect on trade. L/Cs are important in enabling trade in certain markets, and their proper functioning depends on a level of trust between financial institutions. L/Cs represent a payment undertaking, and all parties to a transaction must trust such undertakings for the process to function. In higher-risk markets, a second level of undertaking, referred to as confirmation of an L/C, requires even greater trust between financial institutions. Confirmation of an L/C has similar effect to a guarantee in that the confirming bank accepts to make payment, trusting it will be able to recover funds from the issuing bank.

But when financial institutions do not have confidence in the stability of the importer's country or in the standing of the financial institution issuing the L/C, confirmed letters of credit become very difficult and expensive – sometimes impossible – to obtain. During the Asian crisis, Indonesian banks had difficulty getting foreign counterparties to confirm the L/Cs they issued on behalf of Indonesian importers because of doubt over the stability of the entire Indonesian financial system.

In times like these, national or multilateral support in terms of export credit guarantees can help break the logjam. In the case of Indonesia, the central bank had to step in to guarantee Indonesian bank-issued L/Cs by depositing US\$ 1 billion of its foreign reserves offshore and using it as guarantee. Some relatively stable Indonesian banks, likewise, made deposits in foreign banks and used those deposits as cash collateral for their L/Cs. Without these steps, foreign banks would not confirm L/Cs from Indonesian banks. Without confirmed L/Cs, Indonesian importers could not import needed raw materials.

Barriers to formal finance: SME perspective

In the previous section, we discussed the bank perspective on the difficulties in providing financing to SMEs: 1) small loans are more costly to monitor and administer; 2) SMEs are diverse and more opaque than large firms, thus their risk profile is less favourable; and 3) with limited collateral, their ability to offset higher levels of risk with security for the bank is very limited.

In addition to these challenges, SMEs, by their own actions, can compound the problem. SMEs often fail to address the concerns of lenders; their behaviours can inadvertently reinforce those concerns and perpetuate restricted access to financing.

For example, SMEs may not be interested in approaching banks because they do not want anyone looking over their shoulders. When SMEs do approach financial institutions, they may not properly describe their borrowing needs – even basics such as amount and timing/duration of the loan required. At times, SMEs do not know that alternative forms of finance and supporting mechanisms exist, which can be more appropriate and cheaper than loans. Sometimes, SMEs simply lack confidence to approach banks.

Lack of technical capacity to prepare and present convincing business plans and bankable proposals further frustrates SMEs' potential bank access. To compensate for lack of adequate collateral and credit history, a good SME business plan should identify strong compensating elements in the proposal. Few SMEs, however, know how to prepare effective requests for financing.

In addition, financial difficulties are not uncommon among SMEs, particularly in the early stages of a start-up or project. For businesses where such difficulties have included delays in repayment, defaults or other derogatory information in credit reports, the challenge in accessing financing is further amplified. In such instances, preparing compelling funding proposals is all the more critical.

External factors also make it difficult for SMEs to borrow from financial institutions. During economic crises, formal sources of finance are overly cautious about dealing with SMEs. The very high cost of borrowing discourages many SMEs. The lengthy loan application process, and in some transition economies, the overly bureaucratic procedures dampen SMEs' interest in applying for loans.

Chapter 2

Understanding your financial needs: do you really need to borrow?

All businesses require financing. This is particularly true if they are engaged in international trade. The trade cycle or transaction (including the time to collect receivables) is usually longer than that of domestic trade. International trade requires that firms not only have more available capital, but are also sufficiently liquid. The equipment for export-oriented production may be costly, while the working capital needed to pay for the employees and material inputs can be equally, if not more, burdensome. Additionally, unexpected expenses can arise, and they can be substantial – from delays in transport and customs clearance to expensive dispute resolution or legal proceedings in foreign jurisdictions, to unexpected turmoil in foreign markets.

This chapter will lead you through an assessment of whether you need to tap external financing. There are four conventional sources of external finance: equity, debt, trade financing, and grants or government aids. External financing can significantly help SME businesses, but it may not be the first best source of finance. If you look closely at your business and operations, you may find ways to raise funds without resorting to borrowing or reduce the amount you need from external sources.

Cost and benefit of external finance

Why do you need to limit the amount sourced from outside your company? Because, whether it is equity or debt or trade financing or government grants, these sources of financing entail costs.

Borrowing funds requires the payment of interest, a cost that can be substantial, depending upon the source. Some small businesses finance their initial phases through credit card debt, which is extremely expensive everywhere. Borrowing often requires the pledging of some type of asset in some proportion to the amount borrowed. If you cannot service the debt by paying interest and repaying the principal when due, you could lose the pledged assets.

Judicious borrowing is often logical and necessary. However, borrowing is not always the best option for raising capital. As a general rule, the less leveraged your enterprise is, the lower your risk in difficult times. Prudent and sustainable borrowing is linked directly to the health and financial wherewithal of the business. There is a limit to the amount that can be borrowed, and at least some of that borrowing capacity ought to be reserved for inevitable times of difficulty.

Borrowing can provide advantages. Even if you have started your business without debt, at some point you might need to borrow money to expand your

business and take advantage of specific opportunities. Moreover, it can be less costly to finance some business assets and operations using debt rather than equity because the cost of borrowing is chargeable against profits and there are tax deductions. Financing through equity entails giving away some ownership in the business, and entrepreneurs often resist this option. The crucial thing is to have a balance between liabilities and equity, or in academic parlance, to have an optimal capital structure.

Besides the financial considerations, borrowing from banks helps many SMEs improve operational efficiencies, develop better corporate governance, and enhance their management systems. This happens because SMEs try to cultivate good management behaviour to become more eligible for bank loans and because lending banks normally monitor their activities. Bank monitoring may curtail the creativity of some entrepreneurs, but in many cases it helps improve the operations of the business. Borrowing from a financial institution can result in useful discipline, serving the enterprise over the long term in ways that extend beyond the financial benefits of a loan.

Tapping external equity also has its cost – the dilution of ownership in favour of outsiders. If entrepreneurs find bank monitoring intrusive, giving equity up to outsiders, such as new partners, venture capitalists, or business angels, results in substantial or even total loss of management control, depending on the amount of equity raised. On the other hand, equity investment provides important benefits to SMEs in the form of advanced business knowledge and management skills. Equity investors have an interest in the success of the enterprise, arguably to a greater degree than lenders. Owners profit in direct relationship to the success of the venture, whereas lenders are focused on earning an agreed return and recovering the principal.

Even government grants that appear to have little or no cost involve transaction costs in the form of (typically) bureaucratic, process-intensive, time-consuming application procedures and, in some cases, monitoring, reporting and post-grant audits. Reliance on government aid arguably involves a long-term cost in that such aid does not help SMEs build long-term relationships with financial institutions. Moreover, unlike outside equity, government grants do not facilitate the transfer of management knowhow.

Trade finance is typically short term and transaction-based. It is intended to meet the financing requirements of importers and exporters, and can be an excellent, cost-effective alternative to borrowing from other bank facilities. It can be attractive in that it need not directly impact the capital structure of an enterprise the way that debt or equity-based financing will.

The SME manager should consider the pros and cons of each type of financing (debt, equity, grant, trade credits) to determine how much money the company will raise from specific sources. The final solution is likely a mix of debt- and equity-based sources.

Efficient financial management

As there are costs in obtaining external finance, your company should know how to manage its finances efficiently. There are things you can do to generate funds internally through effective management of resources.

Box 2.1 will help you make an assessment of your operations and financial situation. It may reveal untapped sources that can minimize the amount you need from external sources. In the checklist, if you answer many questions ‘yes’, it is likely that there is a lot you can do to improve your internally generated finance. Analyze the items answered ‘yes’ to determine how you can improve the use of your financial resources.

You may have excess cash. Your enterprise may be too lenient on collecting receivables. You may be able to negotiate delayed payment terms with your suppliers, or pay in instalments without additional cost. There may be fixed assets that are no longer necessary and can be sold, or sold and leased back. You may be maintaining too much inventory of raw materials or finished products in relation to your turnover leading to unnecessary restriction of cash flow. Appendix I provides more detailed tips on how to save cash or extract cash flow from internal sources.

The exercise of checking on whether your business efficiently uses financial resources is good management practice and should be done continuously, not only when you are considering whether to borrow. You can use Box 2.1 to regularly check on your financial resource management.

In addition, established measures and techniques, such as financial ratios, can serve as valuable guidelines in assessing the health of your enterprise. Financial ratios can be compared or benchmarked against other small businesses in your industry. They are an important indicator used by lenders and investors in determining whether your business is a good risk. Understanding such measures and incorporating them into your management practices will assist in positioning your business for when you will decide to approach lenders or investors.

Box 2.1 Looking inside your own kitty: a test

	YES	NO
Reducing assets to raise funds		
<i>Cash.</i> Is there cash lying in deposit accounts with the bank?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Marketable securities.</i> Are there treasury bills, stock, and bonds that can be sold?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Accounts receivable.</i> Can debtors be made to pay up more quickly?	<input type="checkbox"/>	<input type="checkbox"/>
Can bad debts or written-off receivables be recovered through a collecting agency?	<input type="checkbox"/>	<input type="checkbox"/>
Will a bank discount receivables such as invoices, post dated checks, or promissory notes?	<input type="checkbox"/>	<input type="checkbox"/>
Will a factor or forfaiter buy invoices with or without recourse?	<input type="checkbox"/>	<input type="checkbox"/>
Will customers be willing to pay interest on trade credit given?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Stock and inventories.</i> Can stocks of raw materials and commodities be reduced?	<input type="checkbox"/>	<input type="checkbox"/>
Should production be cut or rescheduled to avoid stockpiling of finished goods?	<input type="checkbox"/>	<input type="checkbox"/>
Can you secure raw materials from suppliers on consignment?	<input type="checkbox"/>	<input type="checkbox"/>
Do you keep stock of raw materials that you no longer use?	<input type="checkbox"/>	<input type="checkbox"/>

Box 2.1 Looking inside your own kitty: a test (cont'd)

	YES	NO
<i>Prepaid expenses.</i> Can insurance premiums and other prepaid services be settled in instalments without extra cost?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Advances to third parties.</i> Can loans be called in?	<input type="checkbox"/>	<input type="checkbox"/>
Raising funds by reducing fixed assets		
<i>Land and building.</i> Are there any lands or building spaces that can be sold and leased back?	<input type="checkbox"/>	<input type="checkbox"/>
Are there any unnecessary lands or building space that can be disposed off?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Machinery and equipment.</i> Are there any machinery and equipment that can be sold and leased back?	<input type="checkbox"/>	<input type="checkbox"/>
Are there any unnecessary machinery and equipment that can be disposed of?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Investments in subsidiaries, other business.</i> Do you have investments in subsidiaries or other businesses that do not bring in returns? Can you dispose of these investments?	<input type="checkbox"/>	<input type="checkbox"/>
Raising funds by increasing current liabilities		
<i>Trade creditors.</i> Will creditors extend trade credit either with interest (but lower than bank rates) or without interest?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Taxes.</i> Can taxes and permits be deferred or paid in instalments without penalty?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Short-term borrowings.</i> Can grace periods be extended?	<input type="checkbox"/>	<input type="checkbox"/>
Can instalments be rescheduled?	<input type="checkbox"/>	<input type="checkbox"/>
Raising funds by increasing equity		
<i>Distribution of profits.</i> Will shareholders or partners be willing to defer or suspend dividend payments?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Share capital increases.</i> Are shareholders or partners willing to put in fresh funds?	<input type="checkbox"/>	<input type="checkbox"/>
Can you bring in new shareholders or partners into the business?	<input type="checkbox"/>	<input type="checkbox"/>
<i>Income notes, bonds, preferred shares.</i> Are there investors prepared to invest in these instruments?	<input type="checkbox"/>	<input type="checkbox"/>

Assessing your financial need

How do you know how much financing you need and when do you need it? It is important to get the right answers to these questions. If you underestimate your firm's needs, you may run out of financial resources at a critical time, putting your business at risk, or being forced to forego a profitable opportunity. However, if you overestimate them, you can end up with more debt than you intended, or giving up more business ownership than you desire. In some cases, early repayment of debt carries a penalty, and buying back equity that has been given in exchange for financing will involve paying a premium to the equity holder. In either case, overestimating financing needs will involve cost.

Lack of clarity about the amount of financing needed (whether you ask for too much or too little) will be apparent to skilled lenders and savvy investors. Either approach reflects negatively on your management skills and the viability of the business, and will raise the risk associated with your business, likely translating to a higher cost of funding.

There are several components of financial need that you should consider to estimate the funding you need. These include 1) working capital (i.e., your day-to-day operating costs); 2), fixed assets (land, building, equipment, etc.); 3) marketing costs (advertising, promotional programmes, etc.), and 4) financial cushion or contingency (some reserved amount for changes in business circumstances).

Box 2.2 Components of financial need: an example

Radiocar, a company producing radios and CD players for cars, found that it needed US\$ 2,000,000 to finance its projected growth, including the introduction of a new product line. Radiocar's needs are broken down as follows:

Working capital	US\$ 200,000
Fixed assets	US\$ 1,525,000
Marketing costs	US\$ 225,000
Financial cushion	US\$ 50,000

Total	US\$ 2,000,000

In the example in Box 2.2, the calculations used to produce the amount needed are based on careful analysis of financial statements and projections. Thus, to make a good assessment of your financial need, the first step is to put your financial statements (i.e., the income statements, balance sheet, and statement of retained earnings)⁹ in order. Based on your financial statements, you can identify the amount of money you currently require in key areas. Then, based on your business objectives and plans, which will determine the fixed asset expenditure you need as well as the amount of marketing effort you will expend, you can forecast the amounts you will need. Let us consider the individual components of financial need.

Working capital

Working capital is the difference between current assets and current liabilities. Current assets consist of cash and other assets that are expected to convert into cash within a year. On the company's balance sheet current assets are presented in order of their liquidity – in other words, according to the time it takes to convert each of them into cash. Important current assets are cash, equivalents of cash, marketable securities, accounts receivables and inventories.

Current liabilities are short-term debts and obligations that must be paid in cash within that operating year. Current liabilities include accounts payable, payable expenses such as accumulated wages and taxes, and notes payables. In assessing current liabilities keep sight of the committed cash outflows such

⁹ Income statements show a breakdown of total sales and total expenses. Statement of Retained Earnings show retained earnings accumulated since the company began operations. Retained earnings are important for businesses since this money (internal sources of funds) is used to fund growth (working capital) and buy fixed assets (equipment, machinery, etc.). Balance sheets show what a company owns (assets) and what it owes to lenders, supplier, employees, tax authorities, etc. (liabilities) and shareholders (owners' equity).

as amortization or principal repayment of medium- and long-term loans, lease payments, and other financial obligations.

Businesses must manage their working capital efficiently to ensure that they are able to continue operations and can satisfy both maturing short-term debt and upcoming operational expenses. Managing working capital means being able to meet day-to-day cash flow needs, pay wages and salaries when they are due, pay suppliers, pay taxes and pay providers of capital, etc. This involves managing inventories, accounts receivable and payable, and cash. Some techniques for efficient working capital management are contained in Box 2.1 above. The goal of working capital management is to receive cash as soon as possible while legitimately delaying cash payout as long as possible.

For example, firms use just-in-time (JIT) inventory systems to avoid paying for inventory until it is needed while avoiding carrying costs on the inventory. The idea is that sales projections (timing and volumes) are aligned to the acquisition of inventory so that the company does not pay too soon for inventory and does not hold inventory for too long. Working capital management involves identifying the cash balance that allows for the business to meet day-to-day expenses, but reduces cash holding costs. Excess cash can profitably be invested in short-term investment without affecting day-to-day operations. In international business and trade, cash management can involve the management of multiple currencies and foreign currency accounts, and careful control of receivables (or payables) involving international jurisdictions. This is one reason for the increasing integration of trade and cash management services in many financial institutions.

Applied to debt management, working capital optimization involves appropriate credit policy, i.e., credit terms that will attract customers without unduly affecting cash flow. Generally, this involves a trade-off between increased revenue and the delayed collection of receivables from extending credit to buyers. Businesses normally want to offer credit to attract more sales, but quality of customers – as well as the timing of payments – is equally if not more important. Poor credit management leads to bad debts and write-offs. Credit policies and the payment behaviours of your customers must be monitored regularly and revised (you may choose to extend more credit or longer terms to some clients, or cut others off from credit entirely) as needed.

There is no one formula for determining working capital requirements. The needs of companies vary depending on factors like the nature of their business, production policies, size of business, length of operating cycle, fluctuations of supply and seasonal variations, credit policy, business fluctuations, and other factors.

For example, if your business is in trading, you will need more liquid cash compared to a manufacturing firm. Among manufacturing firms, working capital requirements depend on the type of products they sell, technologies, and marketing policies. If the operating cycle, (from the time the firm receives raw materials to the time it is paid by the consumer), is long, the larger the working capital requirement.

Seasonal industries that produce only at specific times of the year require more working capital during the active season. If supplies of raw materials are irregular, you might want to stock up on them when they are available, hence requiring higher working capital. Larger businesses require higher working capital than smaller ones. Likewise, if you do not enjoy liberal credit from suppliers, or if you have liberal credit policy towards your customers, you will need more working capital.

An increase in working capital means either that your current assets have increased or your current liabilities have decreased. Box 2.3 shows an example of working capital increasing due both to an increase in assets and a reduction in payables.

Continuous working capital (or cash flow) management is critical to the ongoing operation of a business because the relationship between current assets and current liabilities is dynamic.

Box 2.3 *Change in working capital: an example*

Radiocar identified the following increases in accounts receivable, inventory, accounts payable, and other working capital accounts.

Accounts receivable	US\$	100,000
Inventory	US\$	75,000
<i>Subtotal</i>	<i>US\$</i>	<i>175,000</i>
Less: Accounts payable	US\$	50,000
<i>Net working capital</i>	<i>US\$</i>	<i>125,000</i>
Other Working Capital Accounts	US\$	75,000
Net change in working capital	US\$	200,000

Fixed assets

Fixed assets can be tangible, such as real property, plant and equipment; or intangible, such as copyrights, patents, trademarks and goodwill. These assets are usually important for the long-term operation of your company. As a result, they must be evaluated over a long period. They are characterized by the amount required to obtain them.

Before investing in a fixed asset, it is essential to have a capacity plan. This means an estimate of how much the asset will be utilized in, for example, a production or manufacturing process. If the amount of capacity required is far below the capacity created through acquisition of the new asset, the fixed asset will be underutilized and not generating amount of profit desired.

Similarly, a new asset that does not provide the level of capacity required perpetuates a situation where the company is producing at lower levels than it profitable could. Revenues are lost in this situation.

Any exercise requiring projection into the future, including estimates of capacity, involves risk of inaccuracy. This is an inescapable reality of longer-term evaluations. We can minimize those errors by combining both qualitative and quantitative forecasting methods to calculate sales projections. Alternatively, instead of a large, one-off investment, you can consider investing in phases, shortening the period over which projections must be made, and reducing the amount of capital at risk.

Marketing cost and financial cushion

Marketing costs – advertising and promotional programmes – are discretionary (or optional) costs. These costs are not absolute necessities for ongoing operation. They can be curtailed or eliminated during hard times without materially affecting the company's short-term performance or survival.

The financial cushion, or contingency, is a reserve to take care of possible discrepancies between plan and reality. It is very difficult, for example, to find yourself not having enough cash to pay for the current portion of some long-term debt because the cash payment you had relied on is delayed for 30 days. Financial reserves are there so that some emergency situations can be handled with relative ease.

Useful planning tools for such discrepancies are the scenario analysis technique (also referred to as a “what if” analysis), and sensitivity analysis. Scenario analysis looks at various “what if” situations to assess how the company’s financial health and targets may be affected by changes in circumstances. Sensitivity analysis indicates the variables that will have greatest impact on your company’s financial situation. These techniques are not error-proof because you need to make forecasts based on assumptions of different variables. Errors on these assumptions will have impact on the resulting scenarios.

Chapter 3

Understanding various financing instruments

After you have computed your financial needs, it is necessary to know whether you require short- or long-term financing to be able to decide where to source your funding and what financing instruments are most appropriate. There are formal and informal sources of finance. Informal sources are money-lenders, friends and relatives. Formal sources include banks; equity sources such as stock exchanges, venture capitalists and business angels; trade credits usually from suppliers or from purchasers; and government grants and aid. There are also a number of financing instruments that an SME can choose.

Some important differences between domestic and international transactions

This chapter discusses various financing instruments for domestic and international transactions. Before considering available instruments, however, it is important to emphasize that domestic and international transactions differ in many respects. International transactions involve risks not present in domestic ones. Every element of a commercial transaction is complicated by the realities of cross-border interaction.

These challenges begin at the earliest stages of a new international venture when a business initiates market analysis, feasibility assessments and in-market activities. The challenges unique to international business include higher travel expenses, complications from operating in a new environment, and the need for intercultural effectiveness. Complications continue as a business attempts to conduct due diligence on prospective partners – financial and commercial information is not always available (or trustworthy) –, and considers options for dispute resolution, including recourse against a foreign business partner, which can be expensive and complex.

International business involves macro-issues such as political instability, foreign currency exposure, complications related to logistics, and transport of goods to overseas markets. The list of issues that differentiates domestic from international business is long and varied, and specific challenges vary by market.

Those very challenges and complications are the factors that can increase profitability for successful, well-managed international ventures. They also tend to discourage timid or conservative businesses and, therefore, may reduce competition in some markets. At the very least, international business involves a change in the competitive landscape.

Unique risks and challenges exist at the transactional level. SMEs have to consider exchange rate fluctuations in sales and profit projections. Depending on the currency in which buyer and seller agree to do business, exchange rate fluctuations can work for you, or work against you. If you are a net exporter, you benefit from depreciation in your home currency against the currency of the importing market because you improve your competitiveness abroad through reduced pricing, as well as obtaining more local currency equivalent of your international sale, once you convert foreign currency receipts to domestic funds. As a net importer, you will tend to benefit from an appreciation of the domestic currency because you will spend less to purchase the same foreign products.

Doing business internationally involves less tangible, but equally or more important elements. International transactions require the creation, development and ongoing management of commercial relationships from a distance. There is relatively less face-to-face contact than in domestic ventures. To the extent that face-to-face interaction helps in developing mutual trust, lessen the number of unknowns, and thus reduce the riskiness of business transactions, then international transactions tend to be riskier than domestic ones. While advances in communication technology have mitigated this challenge to some degree, it remains an important issue, particularly when either or both trading partners originate from cultures, where personal relationships are more important than contractual covenants. In developing and emerging markets, the information and communications technology may not be as effective in supporting long-distance contact and relationship management.

Disputes arising from domestic transactions generally are more easily resolved than those arising from international transactions. The former normally can be more easily litigated in the local courts of law. In international trade disputes, unless the parties have agreed in advance which court and legal system will have jurisdiction over the dispute, complicated jurisdictional and choice of law questions can arise protracting resolution of the dispute. Even non-judicial dispute resolution options, such as arbitration, are more complicated by an international element.

The distance and the length of the payment period can affect the financing needs of the firm engaged in international transactions. Longer payment periods may be required due to long shipping periods plus the time needed to complete all the necessary paperwork that usually accompanies international shipments. In addition, the increasing leverage exercised by large retailers against small suppliers/exporters has forced exporters to extend generous terms, and to accept settlement on open account terms. This development puts pressure on the working capital requirement of many SME exporters.

Besides differences in risk levels and financing requirements, the sources of finance can also vary for international and domestic transactions. While international transactions tend to be riskier, they have greater possibilities to tap financial institutions that are more oriented towards foreign markets. Some of these financial institutions, such as export credit agencies or export insurance facilities, are specifically suited to firms engaged in international business. These specialist firms and service providers are discussed in this chapter.

We also describe the most commonly used methods of payment and the types of short-term credit facilities best suited for each method. These methods are generally applicable for both domestic and international transactions.

Not all of these may be available in all developing countries since either the legal framework for particular financial transactions does not yet exist or the financial institutions lack the necessary sophistication. The discussion here only serves as a guide to the different possibilities of finance.

Various financing transactions

Trade credit, promissory notes and bills of exchange

In most businesses, goods and services are invoiced by the seller and paid for by the buyer at the end of the month or with a credit of 30, 60, 90 days or more. The period between the date of delivery and the actual receipt of the payment by the seller is the most prevalent form of credit. Trade credit, as it is called, is a facility based on a pre-agreed arrangement between the buyer and the seller. It is the simplest, quickest to arrange and often the cheapest method for the buyer.

Trade credit does not normally involve pledging assets as security or drafting legal documentation. It is based on commercial practices and trust between parties. The extension of credit, including trade terms, is often an important element of the sales process in that the option to delay payment can make one product or service more attractive than another, all other things being equal. The competitive importance of trade credit is even more pronounced in international transactions, where attractive financing options often determine whether an international sale is concluded or not.

A fundamental concept in finance is that money costs money. Generally, when credit is extended there is compensation (cost, from the borrower's perspective) in the form of interest, or perhaps an arrangement of exclusive dealing. Suppliers may offer a discount on the invoice value for early payment; the buyer foregoes the discount and pays interest on the amount due in the event that extended payment terms are granted.

Instead of paying by check or bank transfer, the buyer, with the seller's consent, may issue a promissory note or a post-dated check. A promissory note is a contract where one party (the maker or issuer) makes an unconditional promise in writing to pay a sum of money to the other (the payee), either at a fixed or determinable future time or on demand of the payee, under specific terms. Promissory notes differ from IOUs in that they contain a specific promise to pay, rather than simply acknowledgment of a debt.

When the seller and the buyer are less well known to each other, or the seller is less sure of the buyer's creditworthiness, the seller may prefer to issue a bill of exchange¹⁰ to the buyer. The bill of exchange specifies a payment date and, if the seller so requires, may need to be guaranteed by the buyer's bank in the form of an aval.¹¹

10 A bill of exchange is an unconditional written order from one person (e.g. seller) to another (e.g. buyer), requiring the person to whom it is addressed to pay on demand or at a future time date a sum of money to, or to the order of, a specified person, or to the bearer.

11 An aval is a form of guarantee on a bill of exchange.

Cash advances

Your customers may be a source of financing. Competitive dynamics may provide you with the leverage to obtain a cash advance from your buyers. If your product or service is urgently needed, financing options favourable to you – including a cash advance – may be negotiated.

While you are unlikely to reveal to your buyers that you lack funds or are otherwise financially distressed, there are ways to communicate to buyers that favourable financing terms are required to facilitate timely sourcing of inputs for production, and therefore timely delivery of the promised goods. A solid basis of trust will be needed for such transaction. In return for providing a down payment, buyers may require you to offer them more competitive prices.

Outgrower schemes

An outgrower arrangement is a partnership between growers or landholders and a processing company for the production of commercial agricultural products. Outgrower partnerships vary considerably in the extent inputs, costs, risks and benefits are shared between growers/landholders and companies. Partnerships may be short or long-term (e.g., 40 years), and may offer growers either only financial benefits or a wider range of benefits. Growers may act individually or as a group in partnership with a company, and use private or communal lands. The specific terms of outgrower partnerships tend to be detailed in formal contracts.

Outgrower partnerships may include arrangements such as joint ventures and contract farming. In conventional outgrower schemes, the landholder is contractually responsible for the supply of agricultural produce to the contracting company at harvest. Under the contract, the company may provide inputs and/or technical support to the grower, and guarantees a market for the product. An example of such arrangement is provided in Box 3.1.

Box 3.1 Example of outgrower scheme

An Asian paper manufacturing company sourced its wood pulp from concession forests. As the forests were becoming depleted, the company developed an outgrower scheme for local landholders in order to seek additional plantation resources to partially supply pulpwood. The company was motivated by the opportunity it would provide to strengthen its relationship with local communities through the sharing of benefits.

The company began to encourage farmers to grow trees on eight-year rotations on marginal lands for pulpwood. Under the outgrower scheme, it agreed to provide farmers with planting stock and technical advice, and assured a market for the product at a guaranteed minimum price. The company developed the necessary road infrastructure and a strong extension service. In return, the growers agreed to give the company first right of refusal of the trees.

Discounting receivables

Many forms of commercial and financial documentation are negotiable – that is, they can be sold in the market. This mechanism is often critical to the effective conduct of business, both domestically and internationally.

If you, as a seller, granted credit to your buyers (allowing an agreed amount of time for payment) but need cash to finance business activities, you can sell those invoices, promissory notes, post-dated checks, or bills of exchange at a discount to a discount house or a bank for cash, while continuing to extend credit to your buyers. The bank or discount house pays you some amount less than the face value of the instrument, and later collects the full amount when due from your buyer, keeping the difference as compensation for providing you with cash earlier.

The discount rate varies from one bank to another and depends on such factors as the amount of the invoice, the creditworthiness of your buyer, the duration of the credit period, etc. This is why it is important to grant supplier's credit only to creditworthy customers. The discounter becomes the owner of the receivable, promissory note, or bill of exchange. If the discounter takes on full responsibility for collection (including the risk of non-payment), your receivable is discounted without recourse. However, if the discounter looks to you for reimbursement in case the debtor defaults on payment, then your receivable is discounted with recourse. Discounting with recourse will generally be less expensive, as it provides the discounter with additional security in collecting funds should a dispute arise or the buyer fail to pay.

Accounts receivable discounting is flexible, quick, simple, and does not involve security or special legal documentation. However, the potential drawback is the high cost of the discount rate. In some places, the discount can go as high as 20% to 30% of the invoice value, particularly for non-recourse discounting.

Term loans

Instead of obtaining trade credit or discounting receivables, you may decide that you need longer-term and sustained sources of outside credit. This is especially true if, in your normal operating activities, the flows of cash in and out of your business do not match perfectly leaving you with periods when you run short of money.

Provided your overall performance and income flow are satisfactory, you can apply for short-term credit from banks, financing houses, and other financial institutions (discussed in Chapter 4). The bank may grant you a bank overdraft that allows you to overdraw your business bank account up to an agreed maximum amount beyond what you have on deposit. The overdraft facility has very high charges. The advantage, however, is that you pay only for the amount overdrawn, which is within your control. Unlike trade credits and receivable discounting, some security and other legal documentation (contracts, debentures) may be required. Banks will typically require a minimum deposit to the overdrawn account within an agreed period, and may require that the overdraft be paid in full once per month (the overdraft need only be repaid overnight, and the funds can be available again the next day). Specifics vary, but this type of facility is intended for short-term use, and the lenders look for continuing flow of funds into the account as a means of managing risk.

Banks and other institutions may offer other short-term credit facilities in different forms. Basically, however, they consist of one or more disbursements by the lender with a fixed or variable repayment schedule over the year (monthly, quarterly, payment at the end of the period, etc.). Security is nearly always required, together with legal documentation.

Whether it is overdraft or other short-term loans, lenders can make the facility revolving. A revolving credit line is an agreement with the bank to extend or renew a loan – with or without changes in its level or terms – with few, if any, changes to the security or contracts.

Leasing

Leasing is a transaction in which a firm can obtain the use of certain fixed assets (e.g., real estate, equipment, machinery) for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the lessor and the lessee can be for a fixed or an indefinite period of time (called the term of the lease). The payment for the lease is called rent.

For SMEs that lack the resources to purchase business assets like manufacturing equipment or production space, leasing is an attractive option that facilitates management of capital. In some cases, it offers the only practical option in acquiring access to the required assets, and in managing the financial obligation. Leasing provides more flexibility in the event a company wishes to move to a new location or use more modern equipment. The lessee has the option not to renew the lease at the end of its term.

Leasing is subject to favourable tax treatment in many jurisdictions. Effective tax planning is an important, often overlooked, dimension of financial planning and management. For tax purposes, lease payments are considered expenses, which can be set off against revenues. Because capital assets fluctuate in value, leasing shifts risks to the lessor, in that the lessor retains ownership of the asset. On the other hand, particularly in the case of real estate markets, if property prices have grown steadily over time, a business that depends on leased property may be forgoing capital gains. Another disadvantage of leasing is the uncertainty of the rent when leases come up for renewal. Lessors may demand a higher price, especially if they see that they have the upper hand in negotiations, as for example, when the value of the business is tied to the use of the particular asset.

Grants and subsidies

Many governments provide financing to support expansion, research and development, training initiatives, and acquisition or upgrade of business assets. Such assistance is frequently available to SMEs. Government support can be cash, assistance in finding investors, or expert technical assistance.

In many developing countries, the availability of grants and subsidies depends on whether the type of business is in a priority sector (i.e., an economic sector that has large economic linkages, great employment generation, export potential, etc). It sometimes depends on the location (whether urban or rural). Good quality grant applications are important. Timing is also important, as some grants only last for a certain period or until the funding has been committed and disbursed.

A disadvantage of grants is that there are usually conditions the applicant must meet, and the audit obligations of granting institutions can be intrusive. Grant amounts are often insufficient to cover all costs of business ventures or initiatives, and matching contributions from applicants are usually required.

Equity finance (stock shares, venture capital and business angels)

SMEs can raise equity. Equity is the ordinary share capital of a business, which entitles the holders to all distributed profits following certain priority of payments.¹² Equity can be raised from retained profits or by issuing shares through public offerings. Public offerings, however, are difficult for SMEs for several reasons. They can be complex, time-consuming and expensive to complete, and the requirements for listing shares on stock exchanges can be daunting.

Listing a stock involves extensive financial disclosure. The challenge of maintaining the stock price and ensuring that minimum listing requirements are met on an ongoing basis can be difficult for SMEs. Capital markets are unforgiving; very often, business success – even profitability and solid returns – is secondary to meeting short-term market expectations. The same problems of opaque financial reports and insufficiency of collateral assets that curtail SMEs' access to loans also prevent their access to public stock exchanges.

There are, however, private equity sources willing to stake risk capital on particular businesses and projects. This risk capital usually comes from venture capitalists and business angels. Both invest money, not as a loan, but in exchange for shares (equity) in the business. These investors often demand a significant role in the management of the business, as well as in the setting of strategic direction. It is common for investors to demand representation on the board of directors. They require higher rates of return to compensate for the risk associated with this type of financing.

The return can be earned from ongoing operations, or when the investors exit from the business through sale of their shares. Thus, their profit is highly dependent on the growth and success of the SME. This explains why venture capitalist and business angels are interested only in companies with high growth prospects and experienced, ambitious management.

Typically, venture capitalists fund long-term and large investments, while business angels provide medium-sized amounts. Angels usually want hands-on involvement in management without necessarily exercising day-to-day control. If the SME entrepreneur is open to this arrangement, the relationship with a business angel with the right skills can strengthen a business by, for example, offering marketing and sales experience. Box 3.2 provides some examples of these innovative forms of equity financing.

¹² Ordinary shareholders usually receive dividends after creditors and the holders of debentures and preference shares have been paid.

Box 3.2 Selected innovators' business models

Agora Partnership (US)

Agora combines non-profit consulting with for-profit venture funding. For the consulting part, it partners with business schools in the United States or Nicaragua (where it is active) by matching a team of students from these schools with potentially high growth entrepreneurs who normally run a small business. The entrepreneur is selected on the basis of the quality of his business plan, product viability, financial opportunity, social and environmental value, and management team. The matching idea is for the business school students to help entrepreneurs analyze their constraints to growth, and assist them in solving a strategy or marketing problem. After being coached by student-consultants, Agora Venture provides grants to the most promising funding in the range of US\$ 25,000 to US\$ 250,000. Funded companies are closely monitored and continue to receive education and technical assistance.

Business Partners of South Africa

Business Partners of South Africa (BP) couples technical assistance with a variety of equity and quasi-equity instruments that allows it to reap the upside of its investments and allow borrowers to enjoy low initial payments on financing. Its investments range between US\$ 50,000 and US\$ 1 million. BP has successfully employed debt and royalty schemes that allow lenient repayment terms on the debt for the first months of the loans, after which royalty-sharing kicks in. It compares the internal rate of return that a prime loan would generate against the realistic ability of the business to pay; the difference is then covered with a revenue-sharing agreement lasting until the gap is filled. In a few cases, BP uses a debt/royalty/equity model with the equity stake ranging between 25% and 35%. BP provides technical assistance and support that is subsidized but not free.

SME Bank of Thailand

The SME Bank of Thailand runs for its clients an entrepreneur health-check programme called the SHINDAN programme. It aims to help small businesses improve their operations. Under the programme, companies will ascertain the quality and effectiveness of their business processes. As a diagnostics and consultancy service, the SHINDAN programme helps SME Bank clients to know or anticipate problems in their businesses, identify possible solutions, and seek support from the bank and its partners. The areas of diagnosis include marketing, production, finance and accounting, and human resources. The service is provided free.

Business Development Bank of Canada

The Business Development Bank of Canada (BDBC) provides Internet access financing for SMEs' business requirements, e.g., starting a business, upgrading or replacing equipment, purchasing new production space, or obtaining working capital. The online site walks the interested borrower through the loan cycle. The borrower begins by completing a request form and submitting a business plan with all the templates provided online. Financing is based on the applicant's needs, resources, and project viability. The online site also provides a diagnostics section that assesses the entrepreneurial preparedness of the online visitor. In tandem with financing are consulting services for business planning, market research, human resource management, efficiency improvement and innovation, among others. BDBC also provides a post-loan facility called Business Continuity Guide to help ensure the continuing survival of an enterprise going through difficult times.

Source: Yago, Roveda, and White (2007); www.smebank.co.th.

Financing international transactions

In this section we consider how exporters normally get paid, how importers pay for international transactions, and what financing options and risk mitigation possibilities are available for international traders.

Methods of payment in international trade

Importers and exporters usually need to resort to trade payment and financing mechanisms, coursed through third parties such as banks or specialized financial institutions that help guarantee both the payment to exporters and the delivery of products to importers. Exporters and importers can also directly transact, for example through cash advances or trade credits (open account). These methods, however, are generally used only after a long, repeated and stable buyer-seller relationship has been established. Typically, the use of such methods also requires a certain level of comfort related to the risks associated with doing business with a particular country or region. The most trusted commercial relationship offers limited comfort if the country in which the trading partner is based erupts in violence or implodes economically as a result of a sudden devaluation of the currency.

Trade finance mechanisms provide some combination and degree of support in four areas:

- ❑ Payment facilitation, enabling secure and timely payment across borders, for example through proven communications methods such as SWIFT (a secure bank-to-bank messaging system used to transmit bank instruments such as letters of credit, as well as payments between financial institutions).
- ❑ Financing to one or more parties in a trade transaction, whether it be the importer, exporter, or one of the banks.
- ❑ Risk mitigation, either directly through the features available in a trade financing mechanism, or indirectly through insurance or guarantee products designed to meet the needs of importers and exporters.
- ❑ Providing information on the movement of goods and/or the status of the related financial flows.

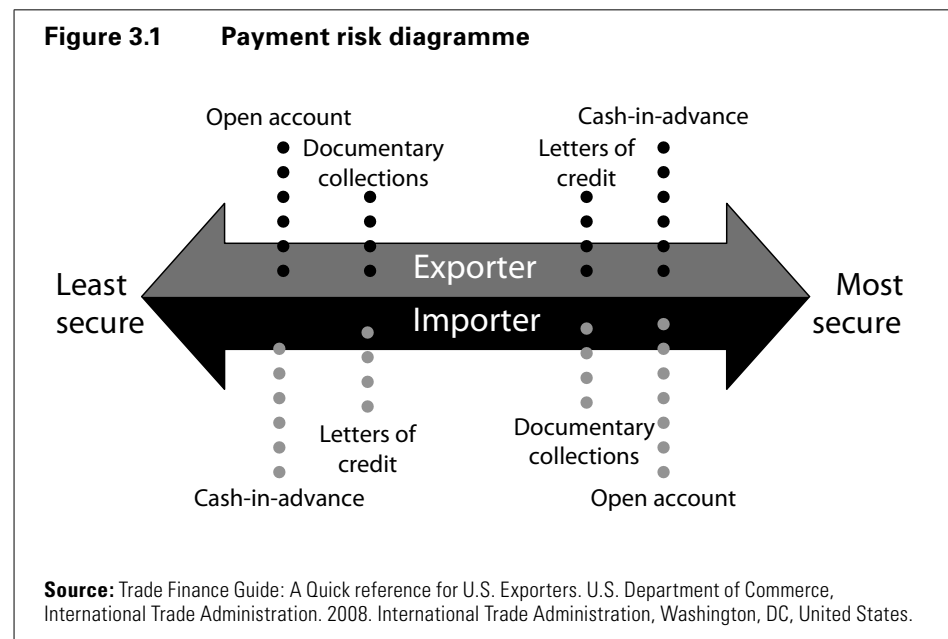
While the following section discusses trade finance in terms of payment methods, each method is best viewed in terms of its characteristics and features across the four dimensions of trade finance listed above.

There are four common methods of payment available to firms engaged in international trade: cash-in-advance, letters of credit (L/Cs), documentary collection and open account. As discussed below, each method has its own merits and drawbacks from the point of view of the exporter or importer. Each can be assessed in terms of whether it secures the interests of importer, exporter or both trading partners.

For example, an exporter will prefer cash-in-advance as the safest and most secure mode of payment, followed by L/Cs or documentary credits, documentary collection, and open account in that order. An exporter faces virtually no risk under a cash-in-advance payment while the importer takes on all the risk (i.e., of not receiving the desired product he has paid for).

In contrast, in an open account arrangement, the exporter takes all the risk because he ships the product to the importer and must wait some period before receiving payment. The exporter takes the risk of default by the buyer. By the same token, an importer will find cash-in-advance the most risky mode of payment and open account the safest. In the former, the importer faces the risk that the exporter will not deliver and not getting back his advance payment. In the latter, however, the importer has all the leverage in the transaction. Table 3.1 summarizes the relative risks of each payment option.

The four modes of payment have implications for the cash flow management of exporters and importers. Exporters receive cash payment at the earlier phase of the trade cycle through cash-in-advance, while their capital is tied up longest under the open account mode. The converse is true for importers: its cash outflow is earliest with cash-in-advance while in an open account system it is allowed to delay payment.



Cash-in-advance or customer's deposit

If a seller is unsure of a buyer's creditworthiness, or there are other circumstances that cast doubt on the certainty of getting paid, such as political instability in the buyer's country, one sure and safe option is to ask for cash-in-advance. Cash-in-advance is a facility in which payment in full is made prior to the shipment of goods. It is ideal for Internet-based businesses.

With this payment method, the exporter is exposed to virtually no risk. All risk is placed on the importer since payment is made before shipment, eliminating the risk of non-payment. The buyer can use international wire transfer, credit card or check to pay in advance. Payment by check is least attractive to the exporter as it may take several weeks or months to collect especially if it is drawn from a non-local bank, defeating the intention of receiving payment before shipment. There is also a risk that the buyer's check may be returned due to insufficient funds. Cash-in-advance provides security to the exporter and improves the exporter's working capital position. The early payment might be applied to the sourcing of components or producing the goods being exported.

While getting cash in advance is most favourable to the exporter, it is the least attractive payment option for the buyer. First, it can create cash flow problems for buyers. Second, the buyer faces the risk that goods ordered and paid for will not be delivered on time or at all, or will not meet the agreed quality or technical specifications. Thus, unless the exported goods are somehow unique or especially made for a client, market competition prevents many exporters from demanding cash-in advance lest they lose out to other suppliers over payment terms.

Documentary credit

Documentary credits, commonly known as Letters of Credit (L/Cs), are financial instruments that represent an independent undertaking – typically by a bank – that the bank will make payment to the exporter on behalf of a customer (the importer), provided that the terms specified in the L/C are fully met. Letters of credit are recommended for new or less established trade relationships because the buyer's bank is there to guarantee for both exporters (that payment will be made) and importers (that the terms of the contract are met).

While the importer is a client of the bank issuing the L/C, the payment undertaking provided by the bank is independent. The bank's credibility in international markets motivates it to honour the payment promise. In practice, the importer's bank may be inclined to interpret the outcome of a transaction in favour of its customer. Therefore, the exporter should ensure that the financial institution issuing the L/C is credible and respected.

With L/Cs, the issuing bank's creditworthiness and stability are crucial. Figure 3.2 shows how the financial institution intermediates between the exporter and importer. The L/C has the effect of replacing the payment promise (and therefore the credit standing) of the importer, with that of the bank issuing the L/C. This is referred to as credit enhancement, since it improves the credit and risk profile of the transaction.

The usual L/C transaction can be summarized as follows: 1) an exporter and an importer agree on a sales transaction; 2) the importer (buyer) applies for an L/C from a bank (called the issuing bank); 3) the issuing bank assesses the creditworthiness of the importer, approves the application, and then forwards the L/C document to a bank in the exporter's (seller's) country (called the advising or confirming bank); 4) the advising bank confirms that the L/C is in order; 5) if the L/C is confirmed, the exporter ships the goods; 6) the exporter submits the shipping documents¹³ to the confirming bank to be processed for payment; 7) the confirming bank examines documents for compliance with the terms and conditions of the L/C, then forwards documents to the issuing bank; 8) importer pays the issuing bank; 9) the issuing bank releases the documents so the importer can claim the goods; 10) the money is transferred from the issuing bank to the advising bank; 11) the advising bank transfers the money to the exporter.

Letters of Credit are versatile instruments with a variety of features that can be added or revised to address the requirements of various transaction types and markets. The basic flow in a documentary letter of credit transaction involves three phases:

¹³ Commercial or shipping documents usually include, among others: invoices, export declarations, bills of lading, shipping receipts and commercial certificates. In practice, documentary requirements vary depending on the perceived risk involved in dealing with a particular company, or the import requirements in the buyer's country.

- Issuance and advising of the instrument;
- Examination of documents and determination of compliance;
- Payment and settlement as per the terms of the L/C.

Issuance and advising

An exporter and an importer agree on the terms of a sales transaction and sign a sales contract. A purchase order is issued. The importer (buyer) applies for a L/C from its bank (the issuing bank). The importer must typically have an account relationship and a line of credit with the issuing bank, which reviews the application against the account status (including the creditworthiness of the importer). The issuing bank also reviews the L/C application to ensure the terms are consistent and workable since the L/C, once issued, becomes a payment undertaking for the issuing bank.

If all is in order, the bank approves the application, issues the L/C and then forwards the instrument to a selected bank in the exporter's (seller's) country. Generally, this is the exporter's bank, and it is referred to as the advising bank. The role of the advising bank is to authenticate the L/C, and to 'advise' it to the beneficiary of the L/C, the exporter. Authentication by the advising bank involves verification of the origin/source, completeness and integrity of the instrument.

The exporter then reviews the terms of the L/C to ensure all is as agreed, and proceeds to prepare the shipment as per the terms of the L/C. Several instruments are referred to as documentary credits because compliance with the terms of the L/C is demonstrated through a series of documents that are required in order to trigger payment.

Document examination

The exporter prepares and presents documents for payment. These documents evidence that the exporter has produced, loaded and shipped the goods, and no longer has control of them. Documents are typically presented for verification at the advising bank, which, if it accepts the role, is often also the negotiating bank.¹⁴ The documents include commercial invoices and bills of lading – documents of title which represent control and ownership of the goods shipped. The importer typically cannot clear the goods without presenting these documents to customs authorities at the port of delivery.

Settlement

If all is in order and in strict compliance with the terms of the L/C as confirmed by the negotiating bank, the payment can take place, according to the exact place and timing as determined in the terms of the L/C. The paying bank, which is often the same as the advising / negotiating bank, will pay the exporter for compliant documents, and seek reimbursement from the issuing bank. The ultimate payment promise remains with the issuing bank.

In this transaction, security is provided to both importer and exporter by the intermediate roles played by the issuing and advising/negotiating banks. In effect, payment is not authorized unless and until full compliance with the L/C terms is validated. Similarly, the documents are not turned over for delivery to the importer until payment is triggered. In the settlement of L/C transactions, the

¹⁴ The negotiating bank is the bank that accepts the documents for examination and, if these are found in order, authorizes the payment to the exporter.

exporter receives payment (or a promise of payment at an agreed future date), and the importer receives the documents, which are then used to claim the goods.

L/C confirmation

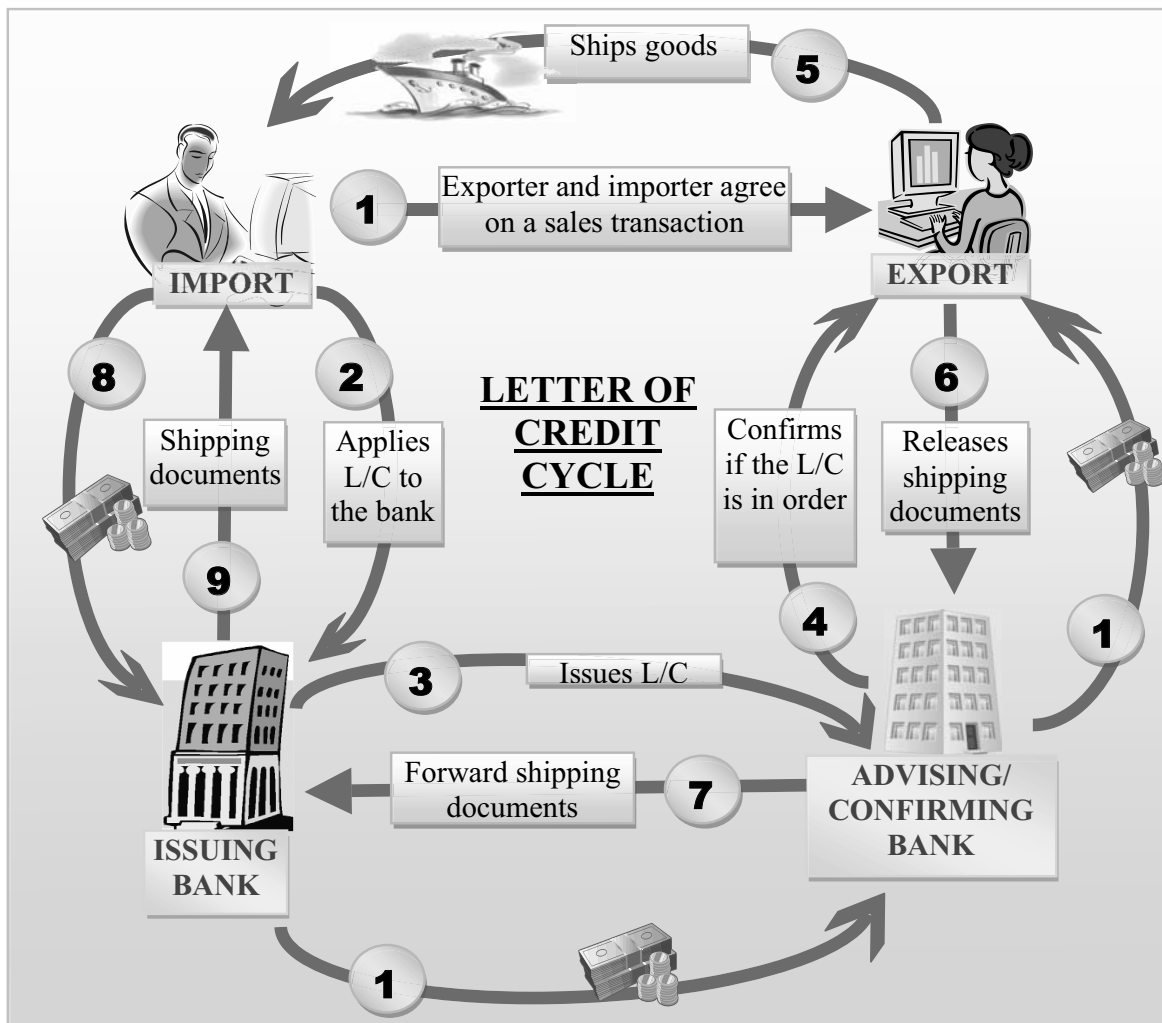
An important feature of a L/C, which can be used if needed, is a confirmation. In cases where the exporter is uncomfortable with the payment undertaking of the issuing bank, or with the stability of the country in which the importer resides, the exporter can request that the L/C be issued with the option to confirm the instrument. This may be deemed necessary if the issuing bank does not have credible standing in international markets, if the political or economic stability of the importing country is in doubt, or if some specific characteristic of the market or the transaction raises the risk of non-payment. Even with the best and most ethical intentions on the part of the importer, the sudden imposition of exchange controls can substantially delay or prevent payment.

In such cases, a L/C can be confirmed by another bank, typically in the exporter's country, and most commonly the advising bank, and generally the exporter's bank. A confirmation is a separate and independent payment undertaking by the confirming bank to the exporter. The confirming bank must determine that the terms of the L/C are acceptable, and that the risks of non-payment by the issuing bank – as well as the risk associated with the importing country – are acceptable or can be adequately mitigated through insurance.

The exporter can then present documents to the confirming bank, and will be paid in full for compliant documents, regardless of any defences to the payment obligation that might otherwise exist. The confirming bank makes its own, independent determination about the compliance of documents, and is bound to settle with the exporter directly as per the terms of the L/C.

Confirmation requires the confirming bank to take on a financial risk, and therefore requires the payment of a fee to the confirming bank. The higher the assessed risk, either at the level of the importing country or the issuing bank, the higher the confirmation commission paid by the exporter.

Figure 3.2 Letter of credit transaction process



Source: Duval, Y. "Challenges of Research on Trade Finance". Presentation at WTO/ESCAP/ARTNeT Capacity Building Workshop for Trade Research. Bangkok. June 22, 2009.

Box 3.3 details the different types of L/C transactions. There may be many other types of transactions involving L/Cs as they can be tailor-fitted to particular transaction risks. This flexibility in accommodating various commercial contracts is one of the major advantages that L/Cs offer to international traders. L/Cs also have near-universal recognition, as payment or finance instruments, governed by widely recognized international rules published by the International Chamber of Commerce (ICC) in Paris. The rules currently used to guide the use and interpretation of documentary credits are contained in the Uniform Customs and Practice (UCP 600), which is the latest iteration of rules first published in the 1930s. The UCP 600 is widely accepted, and has influenced legal jurisdictions across the globe.

The major drawbacks in using documentary credits are that they tend to be relatively expensive, complicated and labour-intensive. Moreover, if the terms of the L/C are not strictly complied with, the exporter may lose the protection for which the L/C was utilized to provide. Documentary credits are not foolproof. They will not protect the parties from outright fraud or bank failure. Dealing with reputable financial institutions with a good network of international affiliates is recommended.

Box 3.3 Features of letters of credit

A commercial L/C is a payment and financing mechanism used to facilitate international trade. L/Cs can be tailored to meet the needs of a variety of trading relationships and contexts, through a series of features that can be included in the terms of the L/C instrument.

Revocable and irrevocable L/Cs

A revocable L/C may be cancelled (revoked) or modified for any reason at any time by the issuing bank without notification. An irrevocable L/C may not be amended or cancelled unless the issuing bank, the confirming bank and the seller agree. In the latest version of UCP 600, the ICC has eliminated revocable L/Cs.

Confirmed and unconfirmed L/Cs

A L/C is confirmed when a second bank, usually in the locale of the exporter, has added its obligation (confirmation, guarantee or assurance of payment) to that of the issuing bank. An unconfirmed L/C is one that has been advised to the beneficiary solely by the advising bank without adding its confirmation. An exporter should consider confirming an L/C if there is uncertainty about the credit standing of the issuing bank or if the buyer is located in a country where political unrest, economic instability, currency devaluation or exchange controls put payment at risk.

Straight and negotiable L/C

With a straight L/C, the obligation of the issuing bank to honour drafts is limited solely to the beneficiary, and not to any other endorser, negotiator, or bona fide holder of the drafts. With a negotiable L/C, the issuing bank is obligated to pay the beneficiary or any bank nominated by the beneficiary.

Restricted and unrestricted

Under a restricted L/C only a specific bank, which is usually the advising bank, can purchase a bill of exchange from the exporter. In the case of unrestricted L/C, the purchasing bank is not specified. Hence, the exporter can present the bill of exchange to any bank and receive payment.

Term (Usance) versus Sight L/C

A term or usance L/C involves a payment undertaking at a future point in time, as agreed between the buyer and seller. A term L/C can specify, for example, that payment will be made 30 days after the shipment date, or 60 days 'sight' (60 days after the documents are 'seen' by the bank and determined to be compliant). A 'Sight L/C', or an 'L/C available at Sight', provides for payment after presentation of the draft and documents, and after verification that the documents conform to the terms of the L/C.

Documentary collection

Under a documentary collection (D/C), the exporter presents the shipping and collection documents to his bank (remitting bank), which sends them to its correspondent bank in the importer's country (collecting bank). The latter gives shipping and title documents to the importer in exchange for payment. The payment can either be at sight (document against payment) or can be made on a specified later date (documents against acceptance). When funds are received from the importer, they are remitted to the exporter through the banks.

D/Cs therefore offer more protection to the exporter than open accounts because his payment goes through the banking system, as in the case of L/Cs. In the case of the D/Cs, however, the role of the bank is more limited than in L/Cs. First, the bank does not guarantee payment to the exporter. While in L/C transactions, the bank has the responsibility to pay the exporter according to the terms of the contract whether the importer defaults or not, in D/C transactions, the exporter retains the risk of the importer default. This

is the reason why the use of D/C is recommended only in established trade relationships and in stable export markets. Second, the bank only collects documents on the account of the exporter, without being required to verify said documents. D/Cs therefore offer less security to the exporter than L/Cs.

In summary, D/Cs are simpler and cheaper than L/Cs but the corresponding risk is higher for the exporter. Still, through the bank, the exporter has the guarantee that the buyer will not get the title and gain physical custody of the goods unless the buyer endorses the draft. The risk is that if the buyer does not accept the goods, the exporter has no guarantee of payment and might end up either seeking another buyer on short notice and at a significant discount, or shipping the goods back, a very costly alternative.

Open account

Under the open account method of payment, goods are shipped with the necessary documents directly to the importer who agrees to pay the exporter at a future date, usually 30 to 90 days. This payment method favours importer while presenting the highest risk option for the exporter. It is generally recommended for use in low-risk trading relationships, usually parent-subsidiary trade, or companies that are in a vertical production network, or in very stable, repeated trade relationships. In terms of market share and particularly in North America and Europe, open account had come to dominate the financial trading landscape. To win customers in a competitive market, exporters tend to agree to an open account mode but combine it with other trade financing techniques to mitigate their risk. These instruments (credit insurance, export guarantees, etc.) are discussed later in this chapter.

Open account is inexpensive because it does away with bank charges and other costs under the documentary credit or documentary collection system. The seller simply sends the buyer the pertinent documents. The buyer then pays by bank transfer upon receipt, or after an agreed period. It is, however, the least secure of the different payment methods from the point of view of the exporter.

Recent trends

In recent years, use of L/Cs and documentary collections has declined in favour of trade on open account terms, particularly as large global retailers have demanded favourable payment terms from suppliers. This trend was evident in the pre-crisis trading environment, even in markets previously considered too risky for open account trade. The current financial and economic crisis has slowed this trend with major trade financiers across the globe indicating that L/C-enabled trade volumes have increased.

In certain regions, the reliance on L/Cs and other traditional instruments of trade finance has remained relatively significant. The Middle East and parts of Africa continued to make use of traditional instruments as many other markets shifted to open account terms, and the use of L/Cs with related risk mitigation features, has remained important through the current crisis.

The financial crisis of 2008-2009, precipitated by exposure to low-quality mortgage loans in the United States, eventually raced across many parts of the globe. As banks were uncertain about ultimate exposures due to the complex and opaque nature of the financial instruments involved, a crisis of confidence

developed among banks. Critical bank-to-bank lending (interbank lending) evaporated, and the financial crisis became a full-scale global economic crisis.

The seizing up of interbank lending, caused by banks hesitant to lend to other banks for fear of losing funds, led directly to a crisis in the facilitation of international business and trade. Top-tier financial institutions in the United States and Europe became unacceptable risks, and their financial undertakings – including documentary credits they issued – were deemed untrustworthy.

Banks that were considered solid prior to the crisis were forced to seek confirmation of their L/Cs by banks previously deemed to be of lower standing. The evaporation of pre-export finance forced shipping companies to refuse to load shipments, drove shipping rates to 10% of pre-crisis levels, and led to an increase of 300%–400% in trade finance costs across the globe.

Because of the high volume of trade via L/Cs, when a financial crisis affects the credibility of bank counterparties, trade is severely affected. If the exporters do not trust the viability and solvency of the issuing bank from the importer's country, or if no bank is willing to confirm an L/C, then trade cannot take place. This was what occurred in some countries in 1998-1999 during the Asian and Russian financial crisis: foreign banks refused to confirm L/Cs issued by banks from crisis-affected countries without government and international guarantees (see Box 1.1).

However, relative to other mode of payments, many more exporters and importers trust the use of L/Cs during financial crises. For example, in the current financial crisis, the International Chamber of Commerce (ICC) noted the drop in the use of open account system of payment among its members in favour of L/Cs. When there is greater uncertainty, more exporter-importer partners who have used other instruments return to the use of L/Cs because of their relative security. The exporter has greater assurance that the importer will be able to claim the goods only after payment has been made; and the importer is assured that the exporter will only be paid if he has complied with the L/C conditions and has presented all the stipulated documents.

Table 3.1 provides a summary of the four different modes of payment discussed above.

Table 3.1 Methods of payment in international transactions

Method of payment	Definition	Applicability	Risk distribution	Pros/cons for exporting SMEs
Cash in advance	Full payment prior to shipment	Recommended for high-risk export markets	Exporter is exposed to virtually no risk; burden is greatest on the importer	Pros: Payment before shipment, eliminates risks of non-payment Cons: May lose customers to competition over payment terms
Letter of Credit	A commitment by a bank on behalf of the buyer that payment will be made to the exporter when the terms and conditions of the L/C are met	Recommended in new and established trade relationships; exporter should be confident of the creditworthiness of buyer's bank	Evenly spread between seller and buyer if conditions are adhered to	Pros: Transaction is secured by a third party. Goods against payment. Cons: Complex and labour intensive process. Relatively expensive.

Table 3.1 Methods of payment in international transactions (cont'd)

Method of payment	Definition	Applicability	Risk distribution	Pros/cons for exporting SMEs
Documentary collection	Exporter entrusts the collection of payment to a bank with payment instructions	Recommended in established trade relationships and in stable markets	Riskier for the exporter but cheaper than L/Cs	Pros: Payment is made with the assistance of a bank. The process is simple, fast and less costly than a L/C Cons: Bank role is limited and payment is not guaranteed
Open Account	Payment by importer after receiving the goods, usually within a timeframe of 30 to 90 days	Recommended for use in a low-risk trading relationships or in a competitive market to win new customers (should be combined with one or more trade finance techniques)	Significant risk to exporter because buyer could default on payment after goods are shipped	Pros: Boosts competitiveness in the global market; helps establish and maintain a successful trade relationship Cons: Significant risk of nonpayment. Additional costs associated with risk mitigation measures

Box 3.4 Pitfalls in trade transactions: a case study

An Asian supplier met a prospective importer of components for a new product at a trade fair. They agreed that the supplier would produce the goods, ship them and forward the shipping documents directly to the importer, including the invoice for payment 30 days from its issuance date. The component to be exported needed to meet specific requirements to comply with the importing country's safety standards. The two parties verbally agreed to slight changes to the contract to cover these requirements.

The invoice and bills of lading were received directly from the Asian supplier. But payment was not made on the due date because the goods had not yet arrived. The ship arrived six weeks later (from the invoice date) but the goods, which had not been inspected prior to shipment, did not meet the safety standard requirements in the destination country. The importer refused to pay and the exporter was left to dispose of the goods.

How could the exporter have protected itself? First, with respect to the non-payment after the goods have been shipped but not yet received within 30 days after invoice date, the exporter had overlooked the long transport time to ship goods overseas. If the exporter had wanted a more timely payment, a better agreement would have involved an L/C. In this way, regardless of whether the goods had arrived or not, as long as the exporter had the documents to show that it had satisfied the terms of the L/C, it might have been paid through the bank. The L/C provides security on when the exporter can receive payment (assuming it had satisfied all the requirements) and even the opportunity to receive the payment in advance of the due date through non-recourse discounting of the receivable (discussed in the next section).

Even if the importer had paid in full at a later date, delays in payment can cost the exporter money. For example, if the exporter had been counting on the money to cover costs on a certain date, it may have had to seek emergency funding at a higher interest rate. If the exporter had been counting on the money to honour a forward currency contract, late receipt may preclude it from honouring the contract.*

Second, since the exporter and importer do not know each other well, it was not prudent to engage in a direct trading arrangement. A L/C or D/C would have provided additional guarantee to the exporter. Third, the agreement should have stipulated clearly the certification requirement to ensure that the safety standards were met. Fourth, the exporter could have also tried to obtain trade insurance to cover the risk of non-payment by the importer.

On the importer's side, the L/C could have required that the goods be tested prior to shipment to ensure compliance with its country's safety standard. The exporter would have been required to provide an inspection certificate to satisfy this condition of the L/C.

* A forward contract is a financial contract that obligates the purchaser to either buy or sell a financial asset (in this case a currency) at a specific price, quantity, and a date in the future.

Trade financing options

The financing needs of enterprises involved in international trade can be categorized into pre-shipment and post-shipment finance. Pre-shipment finance is needed to support pre-export costs such as wages, production inputs and working capital. Post-shipment finance is meant to ensure adequate liquidity for the exporter until the purchaser receives the products and the exporter receives payment. Common methods used to obtain pre- and post-shipment financing are explained below.

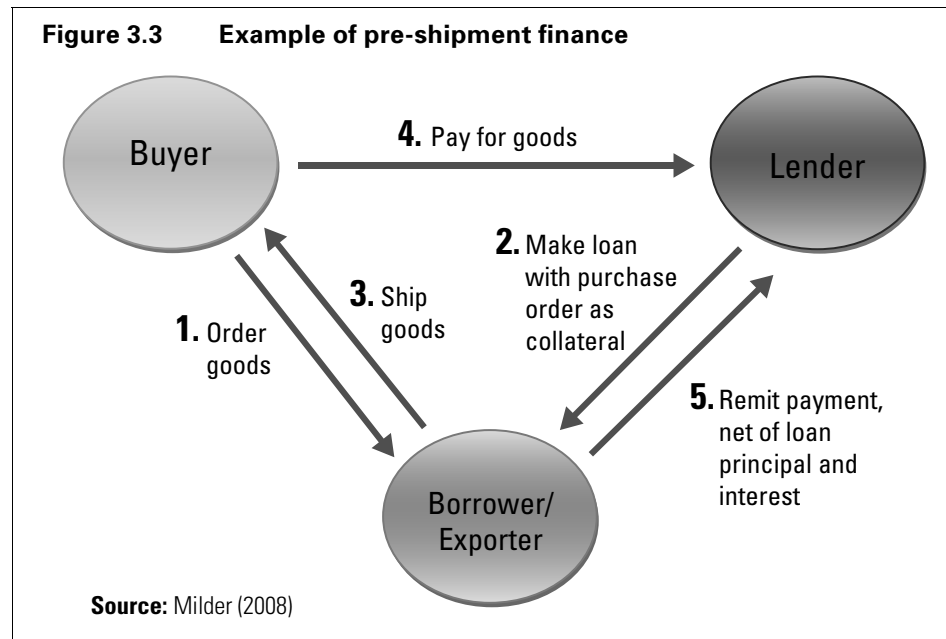
Pre-shipment finance

Once the exporter has shipped the goods and has prepared the invoice, bills of exchange or similar documents, there are ways to convert the documents into immediate cash as discussed later in this section. However, many companies need financing before they ship the goods to pay for the inputs and other production costs. Exporting SMEs can negotiate for lines of credit from a relationship bank with the corresponding documentation and collateral requirements. Other structured trade finance include: 1) export receivables-backed financing, 2) inventory/warehouse receipt financing, and 3) pre-payment financing.

Export receivables-backed financing

The lender provides pre-export loans or advance payment facilities to the exporter with repayment obtained from the sale of the pre-financed exported goods. The lender takes a security interest in the physical goods and an assignment of the receivables under the export contract. The risk in this arrangement is that the exporter may not be able to supply the goods as envisaged in the export contract. Hence, banks perform due diligence to verify the potential of the exporter to deliver, or require personal guarantees (e.g., rights to the borrower's assets).

A typical mechanism for this type of financing is illustrated in Figure 3.3. Here, the lender provides the exporter financing so it can produce the goods, using the purchase order as collateral. Usually, lenders fund up to 60% of the export sales value. The lender also acts as the collector on behalf of the exporter and remits the proceeds of the sale to the exporter, after deducting the principal and interest payment for the exporter's loan.



Inventory/warehouse receipt financing

This model entails the use of securely stored goods as loan collateral. The exporter places the goods in a secured warehouse under the control of an independent third party (the warehouse operator) in exchange for a warehouse receipt. The receipt issued by the warehouse, certifying the deposit of goods of particular quality and quantity, is then used as collateral by the borrower. The operator keeps the goods in good condition and is answerable to the bank. Unlike export-receivables-backed financing that relies on the exporter's promise that the proceeds of their sale will be used to pay the creditor, in warehouse receipt financing, the lender already has the produced goods as collateral.

This form of financing may not be available in most developing countries, as it requires an adequate physical infrastructure. For example, there must be high standards to ensure that the quality of the goods in storage is maintained. In addition to good physical infrastructure, countries also need recognized assessing bodies that can assess the value of the goods. Finally, warehouse financing requires a legal system that recognizes and enforces the value of the receipts.

Pre-payment financing

In this model, the buyer purchases goods by paying the seller in advance, thanks to a loan raised from a bank for that specific purpose. Normally, for this financing, either the goods are already in a warehouse or about to be assembled. With the pre-payment, the buyer obtains the title to the goods and then transfers its rights under the pre-payment contract to the bank that provided the loan. The bank gets paid once the supplier fulfils its export contract. This mechanism enables a bank to share key financing risks with the buyer while at the same time reducing the risk of non-payment.

Post-shipment finance: factoring

Once the goods have been shipped, the exporter can advance receipt of payment or facilitate cash inflow in a number of ways. First, the exporter can negotiate a L/C that requires payment once the goods have been shipped and the documents

have been submitted to the issuing bank. The exporter is paid by the negotiating or confirming bank upon the determination of full compliance of the documents with the terms of the L/C, while the goods are still in transit to the importer. Second, the export account receivable document can be used as collateral for a bank loan. Third, the exporter can sell the invoice or account receivable at a discount. This latter method is called factoring if the account receivable is short-term and recurrent. It transfers the risk of non-payment from the exporter to the factor that bought the asset. Factoring is an asset sale, not a loan, i.e., there is no debt repayment and no additional liabilities on the exporter's balance sheet. Factoring transactions tend to be volume sale transaction as well as regular or recurrent arrangements, not one-off transactions. The drawback in factoring for the exporter is that the cost (the discount) may be expensive.

There can be variations of factoring. In ordinary factoring, the factor generally purchases many accounts receivables from a limited number of sellers and collects credit information on a large number of customers (the buyers). Since the factors' risk rests with the buyers, not with the sellers of the accounts receivables, especially if the factoring is done without recourse,¹⁵ factors need to ensure that the customers are creditworthy. There is also an alternative, called reverse factoring, whereby the factor pools or purchases receivables only from a few high-quality and/or international customers, but owing to many sellers (typically, the many suppliers of these high quality customers). Reverse factoring minimizes the factor's credit risk as well as the effort that it expends on credit information collection (see Box 3.5).

Box 3.5 Example of reverse factoring

Heller Financial factors for all account receivables by Walmart in Mexico. The Mexican suppliers that sell their accounts receivable from Walmart can receive immediate payment of 80% of the export sales value from Heller. After Heller receives payment from Walmart, it pays the Mexican suppliers the other 20%, less interest and service charges.

The advantage for Walmart is that it is able to negotiate extended credit with its suppliers, usually on open account terms. Likewise, instead of paying multiple suppliers, it only needs to pay a bill to Heller, thus minimizing transaction costs. The advantage for the suppliers is that they are able to obtain immediate payment of 80% of the sales.

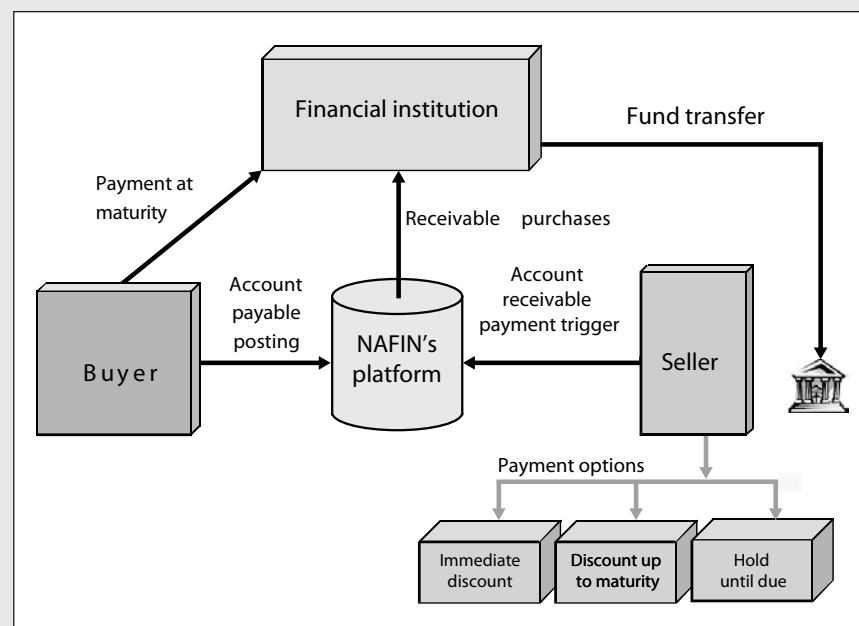
Box 3.6 gives another example of reverse factoring using Mexico's NAFIN SA, a government-owned development bank that helps solve the liquidity problem of SMEs through reverse factoring. Though the current set-up is described for domestic sales, the model is instructive and can be applied to international transactions.

¹⁵ Factoring without recourse means that all the risk has been taken over by the factor. The seller of the receivable has no liability if the buyer fails to pay the factor. Factoring with recourse means that, in the event that the buyer does not pay, the factor can go back to the seller to be repaid. Naturally, while the former is more favourable to the exporter, the cost is also higher.

Box 3.6 Mexico's NAFIN

Nacional Financiera (NAFIN), a development bank in Mexico, has an online system to provide reverse factoring services to SMEs. The online platform allows the factoring, by financial institutions that are clients of NAFIN, of the account receivables (A/Rs) from large, creditworthy buyers. Once a supplier delivers goods to the big buyer and issues an invoice, the buyers (among the biggest in Mexico) post an online negotiable document of the factorable amount on the NAFIN webpage. Interested financial institutions can post the quotes for the A/Rs in the system, and the supplier can choose the best quote. Once the supplier has decided on the factor, the discounted amount is transferred to the supplier's bank account. The factor receives the payment from the buyer directly when it is due (see Figure 3.4).

Figure 3.4 NAFIN's reverse factoring



In three years of operation (2001-2004), NAFIN has 190 large buyers, more than 150,000 suppliers (about 70,000 are SMEs), and about 20 domestic lenders (bank and other financial companies) that participate in the programme. But the due diligence necessary is not on the 150,000 suppliers but on the fewer number of buyers. NAFIN has brokered 1.2 million transactions, almost all by SMEs which previously had no access to external financing before the programme.

Source: De La Torre, Gozzi, Schmukler (2006).

Globally, growth in factoring had been fastest in Europe, Australasia and Asia. Table 3.2 shows how big the factoring business has become, although the majority of the factoring volume transactions are domestic.

Table 3.2 How big is the factoring business?¹⁶

In million euros	Domestic volume (2008)	International volume (2008)	Per cent International (2008)	Per cent change (2002-2008)	Total volume 2002/GDP 2002
Europe	774,882	113,651	12.8	69.9	5.4%
Americas	142,050	12,400	8.0	33.9	1.0%
Africa	12,910	353	2.7	113.8	1.3%
Asia (Incl. Middle East)	185,901	49,718	21.1	237.3	1.0%
Australasia	33,200	46	0.14	232.73	2.2%
World	1,148,943	176,168	13.3	82.98	2.5%

Source: Factors Chain International, www.factors-chain.com (2008).

Supply chain finance

Supply chain finance (SCF) is a new and evolving value proposition being developed for businesses engaged in international trade. It represents significant innovation in international trade. Some aspiring providers, including top-tier financial institutions, have invested heavily in related technology and development and marketing of supply chain programmes.

The concept of SCF is to provide financing options that take into account the various relationships, different levels of creditworthiness and different market contexts that make up an international supply chain. While SCF concepts apply equally well to domestic transactions, the unique dynamics of cross-border business lend themselves well to the notion of providing financing based upon a holistic view of international supply chains.

The cost of financing is directly related to the risk profile of a transaction, which includes considerations such as the creditworthiness of buyer and seller, the stability of the markets involved, the mobility of capital and the security of transportation – along with a host of other factors.

If one market or one trading partner is assessed as lower-risk than the other, the cost of securing financing becomes lower for one party than another. For example, if an African exporter proposes to export to a French buyer, generally, the supplier side of the transaction will be seen as involving higher risk, and the cost of financing will be higher when compared to the buyer side of the transaction. These realities offer an opportunity for risk arbitrage: if the transaction can be financed based upon the lower-risk of the French buyer, the cost of funding will be reduced to the benefit of all concerned.

One advantage of SCF programmes is the holistic view they take on trading relationships: the more mature incarnations of SCF can offer the African supplier an opportunity to secure financing on the basis of the creditworthiness of the buyer arranged in and through the more stable, less risky French market. The risk profile of the transaction is reduced accordingly, and the cost of financing is lowered to reflect the adjusted risk profile.

Such arrangements require transparency and trust between the parties involved. They also require at least one of the financial institutions involved

¹⁶ Select countries per region. Africa: Egypt, Morocco.

to take a holistic view of the supply chain and offer a financing solution based upon that view of the trading relationship and the supply chain underpinning the transaction.

SCF solutions take into account both the receivables (exporter) and the payables (importer) side of the transaction. The SCF services provided by a financial institution can include:

- ❑ Early cash conversion of inventory, either by removing the inventory from the supplier's balance sheet through monetization mechanisms (e.g., inventory receipt financing) or by structuring the transaction to allow a forward sale and a just-in-time delivery of the inventory to the purchaser.
- ❑ Faster payment of receivables through on-line discounting of eligible invoices.
- ❑ Longer payment terms for purchasers' payables by financing prepayments and on-line discounting of eligible payables.

Pure financing options are supplemented with complementary cash management, foreign exchange and other solutions that are aimed at both importer and exporter. If effectively structured, these have the potential to enhance the efficiency of the overall supply chain.

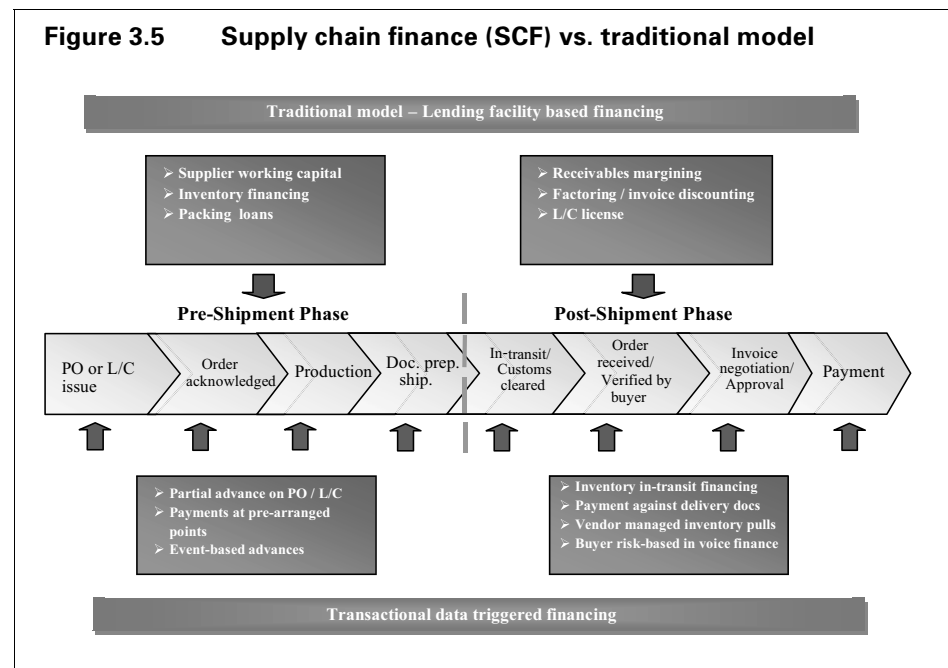


Figure 3.5 represents the SCF concept from pre- and post-shipment perspectives. The light-blue arrows identify a series of potential trigger events to which a financing solution may be applied. These events range from the issuance of a purchase order or letter of credit, through customs clearance at the port of receipt, to payment by the importer. Provided that the technology platform supporting the SCF programme gives full visibility to financiers – most commonly banks – of each event, a bank can offer the buyer or seller and offer a type of financing suited to the particular stage of the transaction.

The financing will often involve a link to some form of asset or document of title (e.g., an invoice or a negotiable transport document). One illustration of the importance of technology in enabling flexible, responsive supply chain

finance involves the transmission of a communication that advises goods have been cleared through customs – meaning, typically, that the importer has taken possession and control of the shipment, and therefore might be approached about financing on the basis of that transactional trigger.

Supply chain finance is in its early stages of development and evolution. A variety of offerings labelled SCF solutions can be found in the market. At the basic end of the spectrum, banks may offer a single-product solution. At the opposite extreme, financial institutions invest in advanced technology platforms that may be purchased from a provider or developed in-house on a highly customized basis. Those platforms can support a portfolio of product offerings, transaction and advisory services, as well as complementary commercial banking products, which will often cross traditional financial product boundaries.

Typically, supply chain programmes are initiated when a bank attracts a large buyer as a client. The buyer will tend to be a large organization relative to its suppliers. The bank may count on leverage in the buyer/supplier relationship to bring the suppliers into an SCF programme as members of the buyer's supply chain. The larger entity is often referred to as the anchor client. SCF programmes can involve anchors on either the buyer or seller side.

Financial institutions will approach the development of their SCF business in different ways. These differences can determine whether certain SMEs will be offered financing or not. Some financial institutions will selectively finance only certain partners of the anchor client; others prefer to take an “all-or-nothing” approach. The reality for SME exporters is that the SCF model is still under development. The best opportunity to participate in a SCF programme is to join as a supplier to a large buyer (often a retailer).

Certain financial institutions have developed the SCF model to highlight demonstrable financial returns to both buyer and seller. Improvements to key performance and financial measures such as DSO (days sales outstanding) and DPO (days payment outstanding), calculable improvements to the cost of financing, and direct impact on performance measures such as earnings per share are elements a holistic, evolved SCF programme.

Local and regional banks may be involved in SCF activities. However, the providers of advanced SCF programmes tend to be large international banks with the necessary technology infrastructure and a strategic commitment to trade and supply chain finance. Certain international financial institutions and development banks may support or enable the delivery of SCF programmes and solutions in emerging or developing markets.

SMEs looking for trade and export financing options may find that SCF programmes provide a source to reasonably priced financing through solid international institutions on the basis of the credit standing of their buyers overseas. It will be increasingly advantageous for SMEs to become familiar with the supply chains within which they operate.

Box 3.7 Example of supply chain finance

Chinese Taipei launched the supply chain model to serve the liquidity needs of sub-suppliers associated with the main manufacturer that anchors the global supply chain within the nation's economy. The project gives financial institutions access to online information (like date of order, goods receipt, invoice issuance, account payable postings, etc.) with the supply chain management (SCM) system associated with specific supply chains, so that they can issue funds to the sub-suppliers. The costs of this facility follow a declining price structure as transactions progress from origination to fulfilment.

In comparison to traditional lending, the success of the project is shown in the incremental increase in disbursed funds, especially in the extension of new credit (pre-purchase order), cheaper cost of funding and lower default rates. But the real innovation of this project, according to a 2007 Asia-Pacific Economic Cooperation (APEC) report, is that the banks are willing to issue funds without collateral because of the transparency, timeliness and accuracy of the information provided by the SCM system.

Other types of finance

In addition to the pre- and post-shipment financing and SCF, SMEs can rely on other types of finance available for domestic and international transactions. These are the forms of finance discussed. For exporters, however, there are special financing facilities such as export working capital financing (EWCF), and special grants and aids from government or international donor institutions.

EWCF allows exporters to purchase goods and services needed to support export sales. It can be used to purchase raw materials, supplies, and equipment to fulfil export sales orders. It can involve transaction-specific short-term loans and revolving lines of credit. However, EWCF is generally available only to SMEs with strong personal guarantees, assets, or high-value receivables. For discussion of government grants and subsidies, please refer above.

Table 3.3 summarizes the various financing instruments for international transactions.

Table 3.3 Trade financing options

Financial instrument	Definition/Mechanism	Risk for financial institution
Pre-shipment finance		
Export-backed finance	Loan is backed by a pledge assigning receivables from export contract in favour of lender	Exporter may not deliver
Warehouse receipt/inventory financing	Inventory is the collateral for the loan; proof is warehouse receipt	Quality of inventory must be safeguarded
Pre-payment financing	Importer borrows to advance payment to exporter; usually applicable when goods are ready to be shipped or assembled; importer transfers the title of the purchased goods to the bank as collateral	Importer may not pay
Post-shipment finance		
Factoring	Sale of export receivables at a discount (usually from few suppliers/exporters, many buyers)	Non-payment of receivables by importer/buyer
Reverse factoring	Sale of receivables at a discount (from many suppliers, few buyers)	Non-payment of receivables by importer/buyer
Supply chain finance	Combination of different financing schemes applied at different points of supply chain	Technology-intensive

Understanding and managing risks

International trade has more risks than domestic trade. International trade entails traversing cultural, linguistic and legal differences. It involves more paperwork and requires an in-depth understanding of international commerce, such as customs procedures, negotiation with logistical intermediaries, searching for business partners, adjusting to foreign markets, etc. Goods that must travel greater distances are subject to greater possibility of damage or theft.

These risks fall into four categories: 1) economic or commercial risk; 2) exchange rate risk; 3) transport risk; and 4) political risk. This subsection discusses the nature of the different risks in international trade and the financing instruments that can be used to mitigate them.

Risks in international trade

Commercial/economic risks

This risk refers to non-payment by importers/buyers or collecting payment late and insufficiently. The reasons may include buyer insolvency, misunderstanding over the quality of the goods (as Box 3.4 illustrates), or simple bad faith. Commercial risk may also refer to exporters' inability to deliver the product on time and according to agreed quality. Finally, commercial risk may also be due to the bank's insolvency or inability to honour its commitments. Other economic risks may relate interest rates when, for example, there is an increase in the benchmark interest rate, such as LIBOR, on which a loan is based. The risk of fraud is one area where trade finance mechanism cannot fully protect importers and exporters.

Exchange rate risks

Fluctuations in exchange rates may be favourable or unfavourable depending on whether you are a net importer or a net exporter. Major movements in exchange rates can eliminate projected profits in an international sale.

Transportation risks

Goods may be damaged, lost or stolen during transit.

Political risks

These are risks stemming from the political and economic circumstances of the country where your trading partner resides, or where goods are sourced or delivered. Political risks vary by country and at different points in time. They can range from the outbreak of war or conflict, to trade embargoes, to changes in government regulations. Examples are exchange control regulations or cancellation of trade licenses. A balance of payment crisis that affects the availability of foreign exchange is another example of political risk.

Figure 3.6 summarizes these four types of risks.

Figure 3.6 Risks in international trade and mitigation methods

Risk category	Economic (commercial) risks related to the trading partner	Exchange rate risk	Transportation risk	Political risks		
				Foreign policy	Domestic policy	Economic policy
Examples	Importer is not willing or unable to pay Importer does not accept merchandise. Exporter does not deliver on time or products agreed.	Floating exchange rates: variations in exchange rates. Fixed exchange rates: risk of devaluation.	Damaged or Loss of goods	War Embargo restrictions	Revolt Civil war	Prohibition on foreign exchange transfer Currency declared non-convertible
Methods to mitigate risks	Private insurance or public export credit agencies; Letter of credit; Bank guarantees.	Bank provides hedging facilities; Public exchange risk insurance.	Private insurance	Export credit agencies or private insurance		

Source: WTO, "Trade Finance and Financial Crises", Special Studies 3.

Risk-mitigating financing instruments

The evaluation of risks in international trade plays a major role in determining the method of payment that can be used for settlement between buyer and seller. Below are some of the commonly used financing instruments that take various risks into account.

Forfaiting

Forfaiting is the discounted sale of accounts receivable, usually without recourse. Under this facility, all risks are eliminated from the exporter/seller while the forfaiter assumes all the risk of non-payment. It is usually used with sales of capital goods, bulk commodities, or large projects. It is also usually a medium term credit (180 days and up), and can be arranged on a one-time, rather than recurring basis. Banks or some specialized financial institutions are usually involved in forfaiting. Because of the nature of the goods that lend itself to this type of instrument, forfaiting is not widely used by SME exporters.

Factoring

Besides being a source of post-shipment financing, factoring can also be considered a risk-mitigating instrument. If used without recourse, factoring transfers the non-payment risk to the factor, much like in forfaiting. It is different from forfaiting because the transactions tend to be recurrent instead of one-off, short term instead of medium term, and products are other than capital goods and bulk merchandise.

Export credit insurance

Credit risk insurance covers commercial and political risk of non-payment in international trade transactions. Insurance policies generally cover portions of the commercial risks (say, up to 85% of the export sales value) and typically include insolvency of the buyer, failure to pay within four months of due date,

and refusal by the buyer to fulfil the terms of the contract provided there is no breach of contract by the exporter. Political risks that are covered include changes in import/export regulations, cancellations, hostilities, expropriation, and other factors that affect payment that are outside the control of the buyer and the exporter.

Export credit insurance may be insurance purchased by and for the benefit of the exporter. The exporter may keep an insurance award or assign the award to a bank. In some cases banks, themselves, choose to purchase export credit insurance to protect their own loans or financing transaction.

Export credit guarantee

Export credit guarantees are a form of security for financing transactions. Banks and some government institutions usually provide this security for a fee. While insurance is generally meant for exporters, export credit guarantees, on the other hand, are meant for banks. Guarantees safeguard export-financing banks from losses related to trade transactions. Public institutions provide export credit guarantees to facilitate export transactions. Without these guarantees, banks are usually loath to provide financing for very risky transactions such as pre-shipment financing to enterprises that do not have sufficient track records. Export finance guarantees are particularly interesting for small and first-time traders who are not yet sufficiently known to the financial sector and do not have the collateral to satisfy the banks. These guarantees to banks and other financial institutions enable exporters to obtain pre-shipment and post-shipment short-term credit.

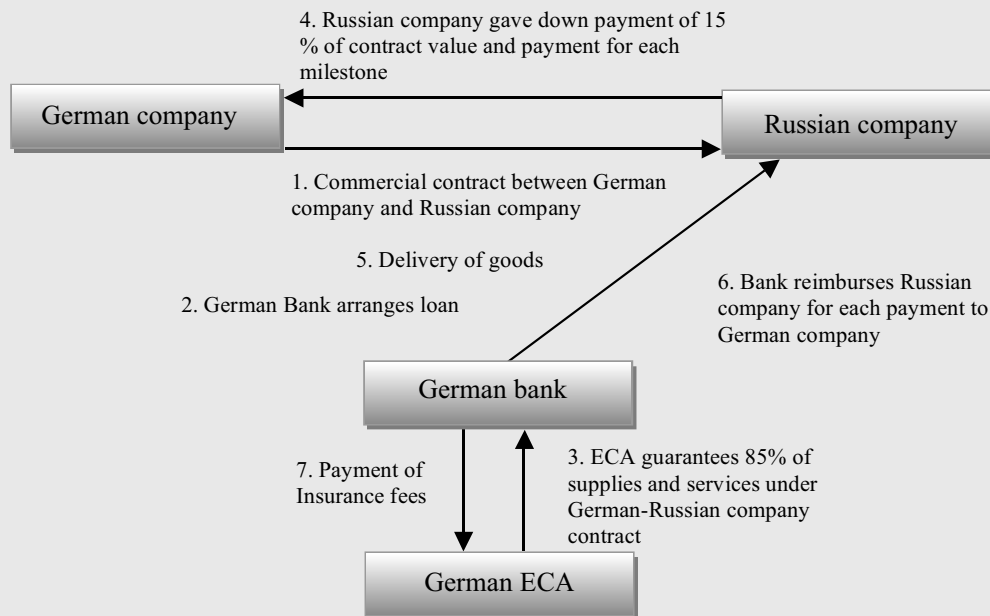
Export credit agencies (ECA) are the usual providers of these guarantees although some banks also sell credit guarantee services.¹⁷ Banks are usually keen to provide facilities backed by export guarantees (from an ECA or another bank) as the guarantees greatly reduce the risk of the transactions. Box 3.8 illustrates how some of these guarantee transactions can become quite complex, while Box 3.9 shows the developmental impact of credit guarantees.

In times of financial stress, ECA help keep trade going in affected economies. During the Asian financial crisis, when commercial financing had dried up ECA were the only source of trade-related financing. Governments had to step in to provide trade credits and maintain credit lines through guarantees.

¹⁷ A standby letter of credit that banks offer likewise acts as a guarantee. A bank will issue a standby letter of credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between applicant and beneficiary. The credit normally has an expiration date, but may include an automatic renewal clause.

Box 3.8 Example of export transaction with buyer's credit guarantee

In this example, the exporter (German company) won a contract worth €4 million in the Russian Federation. The Russian company was able to obtain financing for the transaction from a German bank. The German ECA backed 85% of the credit.



Box 3.9 Philippines – Asparagus case (credit guarantee for indirect exporters)

An association of small farmers in South Cotabato, Philippines with landholdings ranging from three to five hectares wanted to enter into a contract to grow asparagus for Dole Philippines Inc. The farmers were beneficiaries of the government's Agrarian Reform Program that distributed rice and corn farm lands.

Dole identified the area as suitable for planting asparagus, and offered the farmers a contract growing scheme whereby Dole would provide the farming technology and inputs such as asparagus seedlings. Dole planned to export fresh asparagus to Japan. Under the growing agreement, pricing was subject to a floor price with an escalation should the export market price increase.

This was a start-up project and the first commercial-scale production of asparagus in the country. No commercial banks would lend to the farmers association. The farmers' only assets were their small agricultural lands titles that were not yet perfected.

A government bank, the Development Bank of the Philippines (DBP), was willing to finance the project under its Window 3 Program, which charged less-than-commercial rates for developmental projects. The bank determined that the asparagus production was developmental as it involved a new agricultural industry, agrarian reform beneficiaries and foreign exchange earnings.

DBP, however, needed a guarantee for the loan. The guarantee was provided by the Guarantee Fund for Small and Medium-scale Enterprises (GFSME), a quasi-government agency (now the Small Business Corporation, a government-owned financial institution). The GFSME provided an 80% guarantee and Dole Philippines issued a commercial guarantee for 10% for a total of a 90% guarantee on the PHP 30 million loan to the farmers from DBP.

Beginning with 90 hectares first planted with asparagus on a commercial scale, more than 3,000 hectares of asparagus have since been planted in South Cotabato and other provinces. Foreign exchange earnings from the export of asparagus mainly to Japan and Europe have made asparagus a major cash crop in the country. Income and employment effects on the local economies have been substantial.

Hedging

Another risk exporters and importers face is exchange rate volatility or currency risk. This risk occurs because currencies do not have fixed rates; rather, they vary everyday (often by the moment) depending on many factors: supply, demand, monetary movements, political-economic conditions, speculative movements, etc. You have to evaluate exchange rate risk for your operations and decide whether or not you need cover. In general, it is good to cover for exchange rate risk especially if you anticipate huge fluctuations that can severely affect your expected profitability. The aim is to protect the profit and cash flow in domestic currency from fluctuating due to exchange rate movements. In this way, your cash flows can be predicted and your obligations and commitments can be met.

The way to protect yourself from currency movements is through hedging, i.e., offsetting a currency position by another so that whatever is lost or gained on the original currency exposure is offset by a corresponding gain or loss on the currency hedge. Hedging is a technique that serves to offset the risk of loss due to future and unpredictable fluctuations of exchange rates. A perfect hedge is one in which all possibility of loss or gain is eliminated.

Exchange insurance (also known as forward contracts) and currency options are the two main mechanisms of cover offered by financial entities. The exporter, for example, can hedge by arranging a forward contract with its bank under which the bank agrees to exchange the foreign currency that will be received (say in six months) at an agreed exchange rate. Alternatively, the exporter can buy a futures contract from an organized exchange to lock in the expected future value of its foreign income. Many developing countries, however, do not have organized exchanges for futures contracts.

Another important instrument for financial risk coverage is the currency option, which gives you the right to buy or sell a currency amount on a certain date at a pre-established rate. If you expect prices to increase, you purchase a right to buy the currency, this is known as a *call option*; if instead you expect prices to fall, you purchase a right to sell the currency, which is known as a *put option*.¹⁸ The use of options is recommended for currencies that are volatile and hard to predict. If, at the date specified in your contract, the spot rate (i.e. current rate) is less favourable than the pre-established rate, it is wise to exercise your option. If, on the contrary, the spot is more favourable than the pre-established rate of your contract, it is better not to exercise your option and instead benefit from the current conditions. In such a case, bear in mind that you lose the value of your premium, i.e. the price you paid for acquiring the option. Therefore, the purchase of an option guarantees that you will benefit from conditions that are at least as good as the pre-established rate specified in your contract. For more stable currencies, the forward exchange is more appropriate. The forward contract obligates the purchaser to either buy or sell the currency at a specific price, quantity and at a date in the future. Under such a contract, enterprises can “lock in” an exchange rate today for a specific time in the future, which enables them to plan and budget business expenses with more certainty.

¹⁸ The financial organizations that make options available usually charge a premium for the facility.

Effects of the crisis on lending and trade finance

The global financial crisis of 2008-2009, created a crisis of confidence in the bank-to-bank lending markets. It precipitated a global economic crisis that resulted in a shortfall of hundreds of billions of dollars in trade financing across the world. While many markets struggle under the weight of enormous financial liabilities and bailout programmes, some argue that in many developing countries, the current global financial crisis has not led to widespread restriction on credit. Several informal surveys show that most banks in developing countries have not restricted lending to companies. However, anecdotal evidence suggests that the financial crisis has affected access to finance of some firms.

Despite the absence of widespread restriction of bank lending, the cost of borrowing has increased as a result of the tightness in liquidity. With the overall rise in borrowing cost, discounts on accounts receivables and other factorable assets also rise. Likewise, given the general shortage of credit, companies tend to reduce credits to each other. It is logical to think that in times of tight liquidity, suppliers prefer cash transactions over than sales on credit to protect their own cash flows and to lessen their risk should more companies run into financial difficulties.

Perhaps the more adverse effect of the global crisis on finance is indirect. Sluggish demand, particularly in the export market, is affecting the creditworthiness of not only direct exporters but also firms that do business with exporting companies. With a widespread decline in borrowers' creditworthiness, the loan market tightens even more.

Finance for international transactions has also been impacted by the crisis. There has been an increased risk perception among traders. First, traders that used to deal on open account or D/C terms have shifted to safer L/Cs. Even long-time trading partners have started to ask for bank guarantees on their open account transactions.

Second, because of tightening liquidity, banks have noted some difficulties in getting confirmation of L/Cs.¹⁹ In addition, the acceptability of L/Cs from developed and developing countries are receiving more careful scrutiny. Recently, there has been a higher rejection of trade documents on the basis of minor discrepancies.

Third, syndicated loans, which are usually used to back up international trade transactions of emerging countries, have dropped. The deleveraging trend among international banks has also led to difficulties in rolling-over foreign loans. Fourth, demand for risk-mitigating instruments such as trade credit insurance and guarantees have increased.

The crisis appears to be impacting traders differently depending on whether or not they operate in well-established value chains. For example, garment manufacturers in developing countries like South Africa and Bangladesh have had no problem sourcing their raw materials because parent firms have taken responsibility for sourcing. Likewise, horticulture producers with links to wholesale markets in Europe with established lines of trade finance have

¹⁹ A similar event took place before during the Asian crisis as documented in Box 3.1 when foreign banks were rejecting L/Cs issued by Indonesian banks until the central bank of Indonesia provided cash guarantees.

experienced no liquidity problem. On the other hand, a subsidiary in South Africa with a parent company tied to a Middle East investor experienced a squeeze in liquidity because financing problem of the parent spilled over to its subsidiary.

Table 3.4 summarizes the links between a financial crisis and some financing instruments both domestic and international.

Table 3.4 Trade finance and potential impacts of a financial crisis

Trade finance	Potential impacts of a crisis
<p><i>Letters of credit (L/Cs)</i> Importers use L/Cs issued by their banks (the issuing bank) as a means of assuring exporters that they will be paid. If the exporter submits the required documentation (invoices, bills of lading, etc.) to its bank (the advising or confirming bank), payment is made to the exporter.</p>	<ul style="list-style-type: none"> – The creditworthiness of the importer is undermined in the crisis and the issuing bank will not assume the risk. – The issuing bank does not have sufficient funds to extend credit to the importer. – The advising/confirming bank does not have confidence in the issuing bank. – Trade finance institutions reduce their overall exposure or exposure to particular countries during a financial crisis, reducing trade credit across the board to firms and banks in those countries.
<p><i>Domestic bank lending</i> Domestic banks provide credit to exporters to cover pre-shipment or post-shipment costs. Such funding is similar to provision of working capital in general, although it may be less risky to the extent that it is loaned against specific purchases and assets.</p>	<ul style="list-style-type: none"> – Financial outflows reduce liquidity in the domestic banking system. – International banks operating in the domestic market reduce credit in order to cut the exposure of parent banks. – Shortages of foreign currency prevent banks lending the foreign exchange needed for import of inputs or export freight charges.
<p><i>Trade credit</i> Companies extend trade credit to each other when buyers delay or advance payments to suppliers. Open account trade involves importers paying invoices once goods are received. Importers can extend credit to exporters if they pay for goods (all or in part) in advance.</p>	<ul style="list-style-type: none"> – General shortage of credit prevents importers and exporters extending credit to each other. – As credit become scarce, banks reduce lending to their customers, and more creditworthy firms reduce lending to less creditworthy ones as their own access to finance is reduced – Firms reduce credit to suppliers or buyers because of the increased risk of non-repayment as more companies get into financial difficulties.

Source: Humphrey (2009).

Chapter 4

Choosing the right service provider

It is important to match your needs with the right type of lender. Choosing the best lending institution can save you unnecessary fees, mismatched needs and services, and other financial headaches. Before choosing a financial institution, it is prudent to know about the different kinds of lenders, who they are and the types of financial services they normally offer.

An importer is frequently locked in to doing business with a bank where it maintains accounts. An exporter, in a documentary credit or documentary collection transaction, has the option to deal with any bank that provides trade processing and trade finance services. The export transaction depends on the creditworthiness of the issuing bank, not that of the exporter. Because export transactions, especially those where a confirmation is requested, are very profitable, most banks will accept export documents presented for payment provided they can complete basic due diligence to address their regulatory obligations.

Types of service providers

There are various providers of financing each with their own specialties. Some are banking institutions whose resources are mostly obtained from deposits; they usually need a license to operate and are heavily regulated. Non-bank financial institutions, such as insurance companies, draw their resources not from deposits but from other private and public savings. Other specialized financial institutions, offering specialized products in trade finance include factor houses and leasing companies. Non-conventional sources of financing, particularly for equity, include venture capitalists and business angels. This section discusses each of these financial services providers.

Commercial banks

Small business owners and individual depositors and borrowers usually turn to banks for their financial needs. Banks come in different sizes: some are huge multinational, universal banks; others are large; but domestic, while others are small, niche banks.

In terms of resources, universal commercial banks represent the largest single group of financial institutions in most countries. They have the biggest capitalization and offer a wide variety of banking services. These services include trade financing activities (i.e., accepting drafts and issuing letters of credit; and discounting and negotiating promissory notes, drafts, bills of exchange and other

debt instruments), accepting savings and demand deposits, buying and selling foreign exchange, and lending money against personal security and property

Bank subsidiaries or branches of large foreign multinational banks offer a wide range of financial services. Usually, they have the advantage of international recognition that is useful in trade finance. For example, if you open a L/C with a foreign bank subsidiary, there may be no need to incur the extra cost of having the L/C confirmed by another bank. However, it is important to understand the distinction between a branch and a subsidiary and to appreciate the associated risks and costs. A branch can rely upon the financial standing of the parent, whereas a subsidiary must stand on its own financially and in terms of credibility.

A local commercial bank may offer the same services but because its name is not recognized abroad, your foreign counterpart might request another bank to confirm the local bank's L/C, adding to the cost of the transaction. The disadvantage for SMEs in dealing with large universal banks is that transactions are usually done at arm's length using strict procedures and processes to analyze the credit risk through impersonal risk-rating technology like credit scoring (discussed in Chapter 5).

Small, domestic commercial banks usually have a limited menu of services. For SMEs, however, they are usually easier to transact business with. They often offer more competitive terms than their larger competitors. Smaller banks are usually more flexible and prompt in making decisions. Large global banks may not develop the same intimate knowledge of local commercial and financial practices, and may be less disposed to supporting SMEs.

Development banks are special types of commercial banks, usually providing targeted forms of financing. Most development finance institutions provide medium- to long-term finance typically to industrial, agricultural and mining projects in keeping with their developmental mission. Some development banks have expanded their lending portfolios to include trade finance, especially short-term working capital for exporters. Some specialized institutions are offshoots or subsidiaries of development finance institutions. Many development banks offer loans on concessionary terms, which is a plus for SMEs. Box 4.1 give examples of development banks.

Box 4.1 Examples of development banks

Plantersbank (Philippines)

Planters Development Bank (Plantersbank), is the only private bank in the Philippines exclusively focused on lending to SMEs. Plantersbank provides a wide range of products for SMEs. Among its facilities are short-term working capital lines, term loans, standby letters of credit, check discounting facilities, and project financing under government-administered SME lending programmes funded by multilateral and bilateral institutions.

SIDBI (India)

The Indian financial system caters to the needs of small-, medium- and micro-enterprises (MSMEs) through an institutional network. Small Industries Development Bank of India (SIDBI), established by the Indian Parliament in 1990, provides three main types of assistance: 1) direct finance to the MSMEs sector; 2) indirect finance or resource support to primary level institutions, such as commercial banks, state financial corporations and other specialized institutions, catering to the needs of MSMEs; and 3) promotional and business development services. SIDBI offers financial and non-financial schemes, including project finance, bills discounting, export finance, equity finance, venture capital, marketing finance, finance for technology upgrading and R&D and credit rating. It also offers developmental support for cluster development, entrepreneurship and skill development and rural industrialization programmes.

Multilateral development banks are like domestic development banks, but have far wider reach. They are usually a good source of concessionary loan financing. During financial crises, they often inject confidence in international trading system by providing trade credit insurance and guarantees. However, they do not normally deal with retail financing for individual SMEs. Rather, they direct their financing through governments and banking institutions. Box 4.2 gives some examples of multilateral development banks.

Box 4.2 Multilateral development banks

PTA Bank (Africa)

The Eastern and Southern African Trade and Development Bank (PTA Bank), recognizes that SMEs are a critical catalyst to economic growth. As in other parts of the world, most businesses in the region are SMEs. Most exports in Africa are generated by SMEs and they provide support to big industries.

PTA Bank has strategies targeting SME needs by:

- Providing lines of credit to national and multinational financial institutions and commercial banks that lend to SMEs;*
- Participating in organs of the Common Market for Eastern and Southern Africa that promote research and know-how dissemination for the SME sector; and*
- Participating in private equity funds that target SMEs.*

PTA Bank has a loan/guarantee scheme to empower women entrepreneurs. The mechanism provides seed capital to spur growth. Its main objective is to provide collective borrowing power and resource mobilization to finance individual projects.

CABEI (Central America)

The Central American Bank for Economic Integration (CABEI) promotes the integration and economic and social development of the Central American countries. CABEI seeks to improve the quality of life of the Central American people, playing a regional leadership role in the design of financial solutions for poverty reduction, regional integration and the competitive integration of Central America in the global economy.

CABEI has specialized units in agribusiness, energy and environment, science and technology, infrastructure, housing, and small-, medium- and micro-sized enterprises (SMMEs). Resources from CABEI and other development agencies are channelled through the SMME programmes.

Specialized financial institutions

These financial institutions provide specialized services and assistance to specific client groups in response to their unique demands or requirements. Export-import (exim) banks usually receive support from governments, multilateral development banks and industry associations. They give short-term credit on concessionary terms and take reasonable risks that other private financial institutions may not consider. SMEs should explore the services of exim banks as they can be a source of cheap credit. Exim banks can provide the guarantees necessary for SMEs to approach commercial lenders for trade financing. SMEs can also benefit from the experience and advice of exim banks, usually provided free of charge. Box 4.3 gives examples of exim banks in developed and developing countries.

Box 4.3 Exim banks in developed and developing countries

Export-Import Bank of India

In India, SMEs often have limited knowledge about obtaining formal financing. Exim Bank of India has a SME group to address this sector. Because of their size, SMEs generally are risk averse and require a safe mode of non-recourse financing. With this objective in mind, Exim Bank of India extends lines of credit to overseas entities, which provide a safe mode of non-recourse financing to Indian SMEs, in addition to serving as a market entry mechanism. It offers credit to buyers and suppliers for exports on deferred payment terms.

Exim Bank of India has pioneered international factoring and forfaiting services in India. In addition, it has implemented a number of innovative programmes focusing primarily on SMEs. A programme on structured export-marketing support was developed through a World Bank funded project with Exim Bank of India as an executing agency, in which several SMEs were financed for their overseas marketing activities. Exim Bank of India has also operated an agency credit line for the International Finance Corporation for lending to SMEs.

Exim Bank of India, with ITC, launched an IT toolkit, Loan.Com, which enables SMEs to develop bankable business plans thereby enhancing their access to finance. This is a new and pioneering initiative for supporting select export oriented SMEs. The pilot project, successfully tested in India, will be replicated by ITC and Exim Bank of India in other developing countries. Exim Bank of India received the ‘SME Development Award – 2008’ from the Association of Development Financing Institutions in Asia and Pacific for this pioneering work with ITC.

Philippine Export-Import Credit Agency (PhilEXIM) (Philippines)

To address the financial needs of SMEs, PhilEXIM has the following programmes:

- Short Term Direct Lending Program grants short-term loans, purchases export bills and extends any form of receivable financing to SME exporters to finance their pre-shipment working capital requirements and post-shipment arrangements.*
- SME Unified Lending Opportunities for National Growth (SULONG) is a financing scheme for SMEs. Through an alliance of government financial institutions, SMEs are given access to financing not previously available to them. SULONG has simplified and standardized lending procedures and guidelines, fee structures, interest rates, application forms, financial ratios and other lending parameters.*
- Wholesale Lending Program for SME Exporters is a response to the export sector’s need for government assistance to provide immediate credit to exporters and their sub-contractors who have no or limited access to regular credit facilities of banks. The programme gives value to private sector participation in delivering government credit and capacity building services to exporters. PhilEXIM makes available wholesale funds exclusively dedicated to lending to exporters and their sub-contractors.*

Microfinance institutions provide loans, savings and other basic financial services to the poor who traditionally lack access to financial services. They range from non-profit organizations to large commercial banks. Examples of microfinance institutions (MFIs) are provided in Box 4.4.

Box 4.4 An example of microfinance institution (MFIs)

India: Small Industries Development Bank of India (SIDBI)

Over 100 MFIs have been established by SIDBI's Foundation for Micro Finance. To ensure their suitability SIDBI screened each of them using its well-established rating procedure. These MFIs are subsequently provided with capacity building assistance through a national institution specially set up for this purpose.

Seven branches have been opened by the SIDBI to deliver microfinance services through intermediaries. Three are in major hubs of microfinance activity in the country. The other four centres provide microfinance programmes in underserved areas.

Normally, the amount loaned by the MFIs to an individual borrower must not exceed INR 25,000. In exceptional cases, particularly for enterprise and housing, the amount per borrower may be increased to INR 50,000. The repayment period (including moratorium) ranges from 15 months to four years.

Mongolia

In Mongolia, 31% of total loans of the banking system are related to MSMEs (an equivalent of MNT 790.5 billion or US\$ 559.4 million). This indicates the extent to which the MSMEs play an important role in Mongolia's financial system.

XacBank, founded in 1998, is a community development bank and microfinance institution in Mongolia. It was created as the result of the merger between two of the largest non-bank financial institutions in Mongolia and has been operating to provide a full range of financial services aimed at MSMEs in remote rural areas. It was a runner-up in the "European Microfinance Awards 2006" in recognition of the bank's work to reduce poverty through rural outreach and its contribution to creating an inclusive financial sector.

Another institute that is actively engaged in the microfinance sector is the Microfinance Development Fund (MDF), which was established within the framework of the microfinance outreach project, jointly implemented by the Government of Mongolia and the International Development Association of the World Bank. It aims to expand the outreach of sustainable financial services to poor and vulnerable households in Mongolia. Since 2003, MDF has loaned around 35 million MNT to 32,400 people through 10 commercial banks, with 68% of the total loans disbursed in rural areas. Currently, there are 3.6 billion MNT of outstanding loans. The average interest rate on loans disbursed by the MDF through MFIs is 2.36%. This rate is lower by 0.84% than the rate at which MFIs, themselves, access finance.

Another type of specialized institution is the factoring house that purchases account receivables at a discount. SMEs can approach factoring houses without being concerned about collateral requirements and other monitoring that commercial bank loans usually entail. The important consideration is that the clients (from whom the account receivables are due) must be creditworthy.

Leasing companies lease various assets, e.g., commercial properties, equipment, machinery, vehicles, etc. These institutions help free up capital by dividing an otherwise large investment, say on capital equipment, into multiple rent payments rather than one large purchase payment. For start-ups and small businesses, leases for capital equipment can be a lifesaver. SMEs should consider the lease option, but should be aware of potential drawbacks, including future increase of rental prices, appreciation of real estate property, etc., as discussed in Chapter 3.

Non-bank financial institutions

Non-bank financial institutions (NBFIs) do not draw their resources from public deposits. Their business is usually to facilitate bank-related services such as investment, risk pooling and market brokering. Examples of NBFIs

include insurance agencies, credit unions, pawnshops, currency exchanges, and microfinance institutions. NBFIs can be a good source for SME financing. We will discuss three types of NBFIs: export credit guarantee and insurance companies, credit unions, and government-run programmes.

Export credit guarantee and insurance companies provide coverage for trade risks in exchange for premiums. These guarantees and insurance are useful for securing larger financing from commercial banks. Many of these institutions are government-sponsored institutions set up principally to promote exports. Thus, it should be relatively easy for exporting SMEs to approach these institutions. The premium these institutions charge is usually based on their perception of risk of the country where the export goods are destined. If the risk is unreasonably high, your export may not be eligible for guarantee or insurance coverage. Box 4.5 illustrates how export credit agencies help during financial crisis.

Box 4.5 Global crisis-related initiatives of selected export credit agencies

As the crisis deepened and exporters complained of the dearth of export trade financing and working capital funding, export credit agencies introduced new initiatives, some of which are described below.

UK Export Credits Guarantee Department (ECGD)

The United Kingdom has recently introduced a letter of credit guarantee scheme to assist UK exporters by boosting the availability of short-term export finance.

Under this programme a bank in the UK guarantees payment to its exporting customer, provided documents stipulated in the letter of credit issued by the buyer's overseas bank are presented to it. In this way, the UK exporter is able to mitigate the risk of non-payment by its buyer.

By sharing with banks the credit risks associated with confirmed letters of credit, ECGD aims to increase the amount of short-term export finance the banking sector can make available to UK exporters. This is particularly important at a time when the overall risk appetite of the trade market has been reduced due to the recent difficulties in the financial sector.

This scheme will cover 282 overseas banks in 36 export markets. More banks and export markets are expected to be added.

India

The Reserve Bank of India increased the limit on export credit re-finance available to banks, to release extra liquidity of about US\$ 4.5 billion into the banking system. It also extended the repayment window from six to nine months.

Brazil's BNDES

Banco Nacional de Desenvolvimento Econômico e Social (BNDES), the Brazilian export credit agency, has a new working capital credit facility worth R\$ 6 billion. The maximum amount granted by each credit facility is R\$ 50 million.

Source: *Trade Finance Magazine.*

Credit unions are financial institutions formed by groups of people with common interests. Members of credit unions pool their assets to provide loans and other financial services to each other. SMEs can easily access financing from credit unions of which they are members, but the services credit unions offer are severely limited. Generally, international banking and trade finance are not focus areas for credit unions. However, credit unions are a good source of short-term loans.

Governments place significant importance on exports since export receipts fuel national economies. Government ministries, therefore, introduce policies and develop programmes and incentives to promote and encourage exporters especially those involving non-traditional goods and commodities. Many of these measures and programmes provide funding available to SMEs. This funding is usually coursed through banks. Thus, it is worthwhile to ask your banks about the availability of special concessionary loans from your government. Box 4.6 gives an example of government support through trade fair financing.

Equity sources

As discussed in Chapter 3, equity financing may be available for major funding needs. One way to raise equity is through the sale of shares listed on a stock exchange to the public. To make of public offering of shares, your company should have had a few years of operation and track record of solid growth. All your financial records should be in order as stock exchanges have strict disclosure requirements of financial and other relevant information.

There are two other sources of equity, venture capitalists and business angels, which look for SMEs with high growth potential. These types of investors usually have large resources contributed by rich individuals who are willing to take risks in new businesses in exchange for high returns. In the past, they have been mostly interested in businesses such as Internet-based businesses, biotech and high-tech ventures that had strong potential of growth and high profitability.

Equity financing can come at a cost – the dilution of your own ownership in the business. In some cases, there is also a loss of management control because business angels usually want to involve themselves in strategic decisions. Thus, SMEs are advised to approach this source of financing with caution.

To summarize, SMEs can choose from a number of financing sources. Some of them are affordable sources of funds, others are more costly; some offer one-stop shopping for financial services, while others have specialized products. Some require collateral while others do not. These sources are summarized in Table 4.1.

Table 4.1 Different financial institutions

Sources	Products/Services	Condition of access	Availability of SME services
<i>Commercial banks</i>			
Universal/Foreign	Wide array of domestic and international financing	Relatively tough: borrower needs to pass credit-scoring and risk-rating	Usually has dedicated units for SMEs
Small/Local	Limited	Easy through relationship lending; flexible	Generally available; highly motivated to get SME business
Development banks	Medium to long-term finance; trade finance	Relatively easy because of developmental interest	Usually has special unit for SMEs
Multilateral development banks	Wide array of banking services plus credit guarantee and insurance at cheaper rates	Usually deals with governments and financial institutions	None
Investment and merchant banks	Fee-based services, e.g., loan syndication for large transactions	Very select clientele	Hardly
<i>Specialized institutions</i>			
Export-Import banks	Wide range of trade payment and finance possibilities on advantageous terms	Varies. Some big exim banks only cater to large transactions	Usually has special programmes for SME exports
Factoring houses	Discounted purchase of receivables	Easy with creditworthy receivables	Has facility for small recurrent transactions
Leasing companies	Leasing	Easy	Some services are for SMEs, e.g., equipment leasing

Table 4.1 Different financial institutions (cont'd)

Sources	Products/Services	Condition of access	Availability of SME services
<i>Non-bank Institutions</i>			
Credit unions	Limited; mostly loans	Easy if SME is a member	Services are usually for SMEs and individuals
Export credit guarantee and insurance agencies	Credit guarantees and insurance	Usually accommodating to SMEs because of developmental interest (especially if government owned)	May have special units/ programmes for SMEs
Government and trade associations	Limited; usually special financing for particular projects	Easy because of developmental considerations	Will seek SMEs
<i>Equity sources</i>			
Stock exchange	Extensive source of equity from the public	Tough disclosure requirements	Usually not available for SMEs.
Venture capitalist	Good source of equity for start-up and expansion	Only for SMEs with fast growth and high potential	Usually seek SMEs with growth potential
Business angels	Same as venture capitalist but management involvement	Same as venture capitalist but smaller transactions are possible	Usually seek SMEs with growth potential

Choosing the right financial institution

We have discussed how you can analyze your financial needs. We have learned that your financial needs may be for working capital, fixed asset acquisition, a financial cushion, or meeting committed cash outflows. Then we talked about how to fill the financing gap, whether through debt, equity or trade finance. We also discussed different types of financing instruments, especially for trade finance, as well as different possible sources of financing. The next question is how to decide which financial institution to approach to obtain your required funding.

The previous section talked about the many types of financial institutions that offer different financing. In developing markets not all these financial institutions or financing instruments exist because of lack of proper infrastructure facilities and conducive legal environments. Hence, developing country SMEs may have less choice than their developed country counterparts. In all events, the type and terms of credit you seek should be closely linked to the method of payment you use to settle your trade transactions and to your firm's cash cycle.

From among the available financial institutions in your country, make a list of potential financial institution you can approach. You can get this information by asking friends and colleagues that have dealt with these financial institutions. Find out their preferences, priorities and the type of borrowers' profile that they prefer. Financial institutions have different criteria for borrowers, different tolerances to risks and different likes and dislikes. Determine whether your company fits an institution's borrower's profile, and whether you can comply with the institution's requirements regarding collateral, covenant articles, loan duration and grace period as well as interest rates and other fees.

When choosing a financial institution, consider building a long-term relationship. Sometimes, both the SME borrower and the lending institution focus on short-term concerns such as maximum loan amount at affordable interest rates and convenient repayment schedule with little regard for continuous and repeat business. In choosing the right financial institution, remember that the cheapest may not necessarily be the best one for you over

the long term. The bank's attentiveness to the needs of its clients and quality of its service should be paramount.

Several issues are important. Is the lender concerned about your continued business viability? Does the lender provide good service and advice? What has been the experience of others with this financial institution? Does it suggest alternatives, in case it cannot meet your financing needs?

Start-ups should contact a financial institution at an early stage. Even if their initial applications are rejected, they can keep in touch with the bank and build trust over time. In this way, the next time they need funding they will already be known by the bank and will have easier access to finance.

Once you have chosen a bank, work to build mutual trust. For example, it is not advisable to continue shopping around for lenders after you have had serious discussions with one bank and that bank's loan approval process has progressed to a considerable extent.

SMEs should understand that banks must follow certain processes for each financing. Some may have simpler evaluation and approval procedures than others; some may require more documentation and collateral, etc. SME managers must understand the perspective of banks in granting or denying financing and the processes they follow to guard against the credit risk. Understanding the bank's perspective should help SMEs better prepare for and succeed in financing applications.

While a relationship approach is advisable, SMEs can (and arguably should) consider multiple sources of financing. An exporting SME can have a long-term relationship with its core bank, and a transactional approach with one or two other providers whose specific services match specific needs of the SME. The reasons a SME will select a trade financier may vary significantly from the reasons it will select a domestic financial institution.

Chapter 5

Securing finance

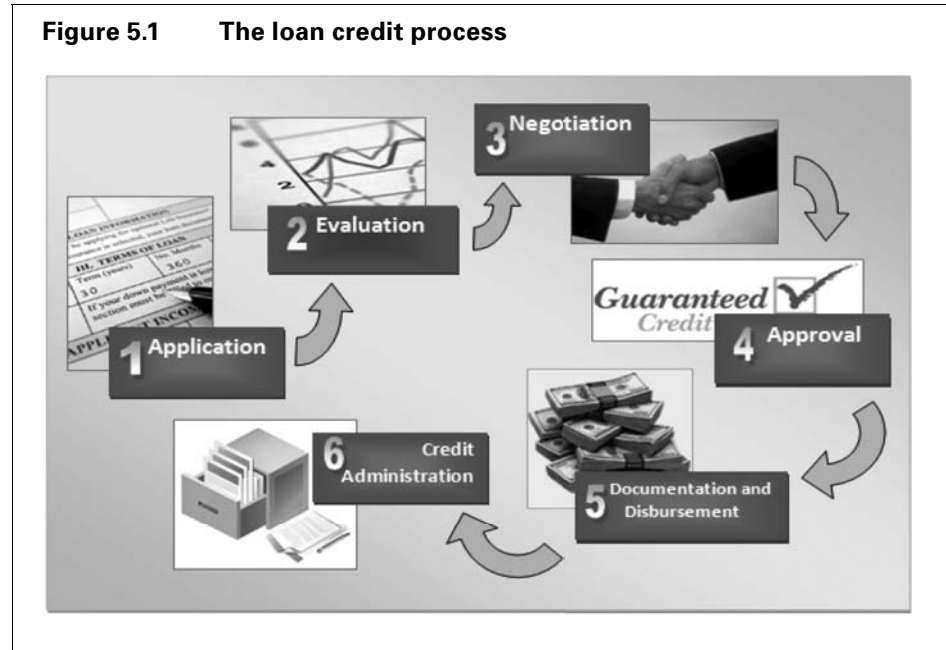
Once you have selected the bank or financial institution to approach, you must prepare for the lending institution's credit process. Every lender has its own set of guidelines, criteria, document requirements, etc., on the basis of which it decides to grant or deny a financing application. Some banks are conservative with very high thresholds for safety. Others are willing to take on more risk. Some of the latter are development banks or development financing institutions mostly owned by governments. Even these institutions follow certain procedures and impose various requirements for loan applications.

Lenders have different guidelines and procedures for different types of financing facilities. For instance, a short-term loan for a relatively small amount will likely require less review and investigation than a long-term loan for a large amount. There are financing facilities other than traditional loans such as account receivable and inventory financing. The application for such financing facilities will have procedures and requirements different from standard loans.

Borrowers must have a working knowledge of the loan or financing facility they seek. They should also have a good understanding of the financial institution's culture, philosophy and reputation. These factors shape the way the institution conducts business. With knowledge about the institution and its credit processes, the borrower is prepared to apply for financing.

The procedures and guidelines of a financial institution exist to safeguard its interests and resources against the risks in financing transactions. As part of the credit process, banks first and foremost look to your business' profitability or potential, the prospect of making money and your competence to operate and manage your business. To increase the likelihood that they will not lose in the transaction, financial institutions usually ask for security, known as collateral. Collateral is a claim on an asset that the banks can seize and sell in the event of your failure to repay the loan.

This chapter explains the credit process for a loan. Because other forms of financing follow different processes, we highlight some of those differences. Generally, however, the basic steps of application, evaluation, negotiation, approval, disbursement, and monitoring are applicable to almost all financing transactions (see Figure 5.1). We describe these basic steps in detail.



Application

Applying for a loan

The credit application is the primary step that drives the credit process. It provides the historical information the bank uses for credit risk assessment and measurement (discussed in the next section). It is at this stage that banks get to know you, the borrower. It is critical to provide truthful information about yourself and your business. The quality of the business plan you present is also critical. Spend enough time and effort on the business plan that it will convince the lender of your viability and worthiness as a borrower. Another important element of your application is the list of collateral you are willing to pledge to the bank.

Preparing a successful business plan

A good business plan must convince the banker that: 1) your business idea is sound; 2) you have the ability to implement the business plan (operational plan); and 3) you have the ability to raise enough resources (financial plan). A business plan can be used for various audiences (not just for bankers). Different audiences may require varying degrees of emphasis on individual plan components, but the major components will be the same. A typical business plan contains certain basic elements, including:

- ❑ A description and definition of the people and entities involved, the saleable product or service, and the market environment for the product or service.
- ❑ An analysis and plan for how the product or service will be produced or performed and sold.
- ❑ A quantification of what is needed to achieve the plan and when it is needed, accompanied by a summary of anticipated results (financial plan).

More specifically, a business plan usually contains the following: 1) company description and history; 2) description of the product; 3) market analysis; 4) marketing and sales plan; 5) operational plan; 6) management plan; 7) financial plan; and 8) financial statements and analysis.

Description of the company: In the introduction of your company, you need to highlight your company's vision for the future and record of achievement, thus underscoring your own qualities, abilities, and vision for the business. For the financiers to fully appreciate what your company can become, they need to understand what it has been. They should have an appreciation of your personal qualities as the owner because they are a strong predictor of business success. As you describe your vision for the company, the goals you set must be seen as realistic and achievable.

Description of the product: This section defines what the product is, does and how it works. Pictures and drawing can be useful. Be clear about who can benefit from the product and why, thus laying the groundwork for detailed market analysis by indicating the universe of potential users. Note that potential users are normally, but not always, buyers. Whether the product is ready to be marketed should be discussed.

Marketing and sales plan: This section draws attention from bankers because the reliability of the whole business plan will depend much on the reasoning process of the marketing and sales plan. A marketing plan should start with the definition of the target market, identifying what market segment and market position you will assume. It should describe thoroughly the establishment and management of the sales force. Avoid overoptimistic scenarios in your sales projections. The key is to give realistic estimates based on good market research. Pricing should be realistic: overconfidence on the perceived value of your product can lead to unreasonably high prices and unrealistic predicted margins.

Operational plan: In the operational plan, you should discuss the production method and process, the facilities needed for production, and the required materials and other resources. If the materials are not commonly available, you should explain how you are going to obtain them. Some good business ideas turn out to be untenable because they rely on very special production processes or materials that cannot be easily acquired on commercial basis. Other times, the failure is in not foreseeing the difficulty in hiring employees with the skills required.

Management plan: Your plan should describe the following issues: operational functions; key skills required; and key personnel or source of skills. You should show full recognition and understanding of the key functional areas and responsibilities for a venture, and how these areas and responsibilities relate, interact, and communicate to accomplish a stated purpose. Address possible conflicts of interest in any incentive scheme that you intend to give to your employees. In this section, you must establish management's integrity, skills, and depth at all levels of the business organization.

Financial plan: The financial plan will show the total financial resources necessary to get the business or project up and running. It should sum up the resource requirements from the previous plans (marketing, operational and management plans) along with the timing. It should show, to the extent known, the source of this financial support. The assessment of financial need, as discussed in Chapter 2, should be reflected in the financial plan.

Financial statement and analysis: This section should show the projected profit that the business can generate and how long it will take before the business starts recouping its investment. The analysis will include: 1) projected income statement; 2) projected balance sheet; 3) projected statement of cash flows; and 4) computation and analysis of key financial indicators.

Box 5.1 Organization of a business plan

1. *Cover sheet*
2. *Table of Contents*
3. *Executive Summary*
4. *Company description – history, vision, mission statement, business philosophy*
5. *Product – usefulness, benefits, potential users and buyers*
6. *Market analysis – analysis of customers, competitors, target market*
7. *Marketing and sales plan – including distribution and sales schedules*
8. *Operational plan – technical and engineering details of production process*
9. *Management plan – description of functional areas; incentive schemes*
10. *Financial plan – total resources needed and possible sources*
11. *Financial statements and analysis – how much profit can be made; length of period before the investment is expected to pay off*
12. *Appendices*

In addition to the business plan, other materials and documents should be prepared and presented to the bank. A letter of introduction from someone respected in the community who can vouch for your character and abilities is useful, especially if you are new in the business. You should prepare a curriculum vitae highlighting your professional achievements. A brochure of your business, proof of ownership and registration are also documents that banks usually require. You can present detail of booked orders with the corresponding proofs like correspondence, quotations from suppliers, draft contracts from buyers, etc. Box 5.2 lists these useful documents.

Box 5.2 Documents to accompany your business plan

- Letter of introduction – from someone respected by other business people*
- Curriculum Vitae – to include name, personal details, education and qualification, professional experience (stating principal achievements), references (names of people who can vouch for your professional capabilities and integrity)*
- Business brochure*
- Proof of company ownership and registration*
- Banks and other business references*
- Balance sheet, profit-and-loss, and cash flow statement*
- Budget for the current year*
- Details of booked orders – with documents, corresponding quotation from suppliers, and draft contracts with buyers and suppliers*

Business plan preparation is one of the most important steps in obtaining financing. Many SME applications fail because of poorly prepared and unconvincing business plans. Typical errors are:

- ❑ The goals and plans of the company are unrealistic given its past history and current economic environment. For example, if you own a simple ‘mom and pop’ store, it is unrealistic to propose to have a chain of supermarkets in five years.
- ❑ The marketing analysis is poor because it is not based on good marketing research.
- ❑ Sales estimates are over-optimistic because the product is overpriced, the economic environment is difficult, or the usefulness and benefit of the product is overestimated.
- ❑ The technical and operational requirements of the plan are not feasible because the materials are not commonly available, the production process is complicated, or the skilled human resources are lacking.
- ❑ Succession plans for management, especially in enterprises owned by a sole entrepreneur, are unclear causing financiers to have doubts about the continuity of the business once the original entrepreneur is gone.

Sometimes applications fail simply because of missing documents or incomplete application materials. The lesson is to take business plan making very seriously. Be prepared with all the necessary supporting materials. Be realistic. Be truthful. This exercise is useful for you as the manager, whether or not a financial institution eventually approves your application.

Collateral

When you approach an institution for financing, it is useful to have a list of the assets you are prepared to pledge as security for the loan. If these are fixed assets (land, property, machinery, equipment, vehicles, etc.) you own, have copies of the titles to show the bank. If you have marketable stocks of raw or finished products, or internationally quoted stocks of commodities not yet sold, bring warehouse receipts or inventory lists with you. If you do not have warehouse receipts, delivered by a third party and attesting to the quantities or values of the commodities stored, you can usually obtain a certificate from an inspection company evidencing the quantity and quality, sometimes even the price or value, of the goods. Your list of receivables is also useful, because your bank may be willing to buy them at a discount, rather than lend you money. Inventories and receivables are examples of movable collateral. A proper legal and institutional framework is necessary to use these assets as collateral.

Investments are sometimes acceptable to lenders as collateral, particularly if they can be easily sold. Share certificates of companies listed on stock exchanges, bonds, debentures, treasury bills, etc., are examples of investment collateral. Cash deposits can be used to secure loans. Other forms of collateral are insurance policies for the benefit of the lender, or an undertaking (guarantee) by a third party (e.g., another bank or government agency) to repay the loan if you should default.

Financial institutions rarely lend the full value of the security taken. The reason is that, should they need to sell the security because of a default in payment, the price they obtain may be less than the value of the loan. The amount of cover needed for loans varies from country to country and asset to asset. In some cases you may have to pledge assets worth two or more times the amount of the loan.

Applying for other sources of finance

There are sources of financing other than loans. If you have outstanding receivables (also called invoices), you can sell them to a third party at a discount. As discussed in Chapter 3, the amount you can get from selling receivables depends mainly on their quality. The quality is determined by several factors the most important of which is the age of the receivable. The rule is the more current your receivable, the greater its value. Thus, the longer the term of the receivable, say, 90 days or more, the less likely you will get financing. The quality of a receivable also depends on the reputation of the company that owes the money. The more established that company, the better the chances that you will get receivable financing and at a better value.

Receivables financing is a quick way of raising cash. The process and requirements for a loan application, discussed above, do not apply. The only consideration is the quality of the receivables. The speed and convenience that receivables financing offers can be very attractive, especially to businesses encountering cash flow shortages or the need to expand their business by filling new orders. But there are disadvantages the most important of which is the cost. The discount rate can be so deep and the service fee so expensive that the cost of receivables financing may be higher than the interest of a standard loan.

A good business plan will help establish if receivables financing is a good strategy, and its impact on the profitability and sustainability of your business. Receivable financing is a short-term, stopgap measure until you are able to obtain a regular credit facility from a bank. As discussed in Chapter 4, you may approach a bank or a factor for receivables financing. The critical documents are the proofs for the receivables, e.g., invoices, sales contract, etc.

Related to receivables financing is inventory financing, also known as warehouse financing. It is essentially a credit line from a bank with inventory as collateral. Like receivables financing, the process in obtaining inventory financing is faster than a loan because the main consideration is the quality of the inventory. This financing requires substantial inventory of ready for sale goods. Like receivables financing, this is a short-term solution to cash flow problems, not a prudent long-term financing strategy. The important papers for the financial institution provide proof that the inventory exists, either from an accredited inspection company or through warehouse receipts. At times, it is necessary to provide information on your accounts payable, especially for inventory financing, because in many legal jurisdictions suppliers have prior liens on inventories.

Unlike the above two alternatives to loan financing, the procedure for documentary credits transactions can be meticulous and involves considerable documentation. This is so due to the need to protect the interest of all parties to the transaction. Fortunately, many of the documents have been standardized to a great extent by the International Chamber of Commerce (ICC). The ICC publishes helpful guidelines on documentary credit operations and develops what are known as Incoterms (international commercial terms), which are trading expressions used worldwide in international sales contracts and are governed by precise rules and regulations. You have the option to adopt the ICC terms or not, but because of their wide international application, adopting them facilitates mutual understanding, especially if foreign counterparties with different laws and commercial usage are involved.

The documents listed below are those most frequently referred to in documentary credit transactions. Specimens of some of these documents are presented in the Appendix. The documents are:

- Draft or bill of exchange.
- Commercial invoice.
- Certificate of origin.
- Insurance certificate.
- Inspection certificate.
- Transport documents.

Application evaluation

Loans

Once all the documents have been submitted, the lender undertakes a credit risk assessment to identify and control its risks. The lender performs a standard credit analysis from the income statement, balance sheet, and cash flow statements, along with an analysis of the character and capacity of the borrower. It also identifies the primary source of debt repayment and evaluates the availability of secondary sources, such as collateral. Lenders place paramount emphasis on the quality of collateral.

Typically, the bank prepares an appraisal report that summarizes: the background and history of the enterprise; the business and its prospects in relation to the business cycle and regulatory vulnerability; the product lines and target market; management structure and competence (for SMEs, succession is an important element); continuing viability; financial condition, and previous dealings with the bank. The bank evaluates the collateral, all possible risks related to the financing requested, credit structure, and special conditions (i.e., whether the bank needs to exercise special controls over the collateral). Most of this information should be presented in your business plan.

For relatively sophisticated banks, the evaluation exercise is usually summarized in a credit scoring process. Credit scoring is a credit risk assessment tool that translates credit evaluation analysis into an alphanumeric code. This process assesses the probability of default and, if defaults occur, the risk of loss by the bank. The probability of default is assessed from the borrower's risk rating (BRR), which is usually based on the borrower's financials, management, and market, independent of the credit structure or collateral.

Various lenders may give different weights to each of these three major criteria. Under financials, banks consider standard financial ratios for credit assessment, cashflow/cash drivers, as well as projections. Under management, lenders consider management integrity, court records and credit checking, business experience, management skills, and succession. Under market conditions, lenders analyze the enterprise's stage in the business cycle, industry prospects, economic outlook, state of competition, and government regulation. This subjective assessment by the loan officer, which is like a rating on the submitted business plan, is then translated into an alphanumeric grade as shown in Table 5.1. The subjective assessment of your financials, management,

market and product prospects may be triple A (i.e., very low probability of default, highly desirable borrower) or double B (higher probability of default) or B, C or D grades, which likely will result in denial of the loan application.

The risk of loss is determined from the loan exposure risk (LER), which is composed of the facility transaction risk and collateral risk. LER is an assessment of the amount of loss that the bank is exposed to if you default. The facility transaction risk is the probability of a loss associated with the transaction. This, usually, depends on the size of your loan and the term/maturity of the transaction. For example, a small working capital loan has lower transaction risk than a large multi-year project finance facility.

Another factor that affects the exposure risk of the bank is the collateral risk, i.e., the risk that the collateral's value will deteriorate over the term of the loan. Because different types of collateral have varying degrees of risk based on marketability and the degree of the lender's control over the asset, the bank assesses the security you offer. For example, real estate in a prime locality presents lower risk of loss than equipment and machinery that may depreciate quickly. A loan guarantee from the government provides solid cover for the bank for any potential loss. As illustrated in Table 5.1, an LER rating of 1 means the loan is considered very low risk. With a rating higher than 5, the bank considers your loan as posing significant risk and will likely deny your application.

Table 5.1 Borrower risk rating and loan exposure risk

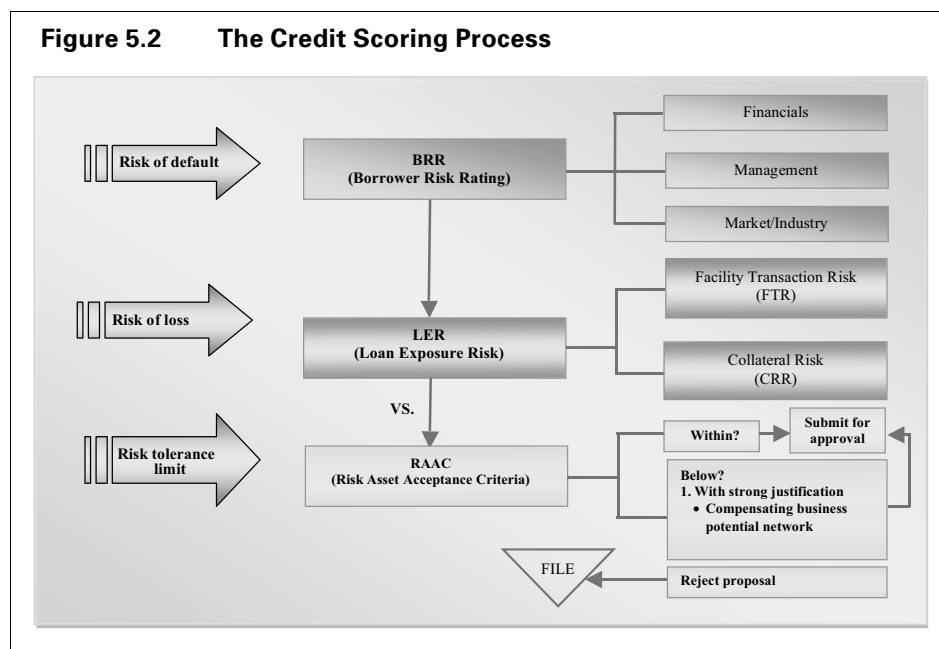
	BRR	Points	Description	LER	Risk
Acceptable	AAA	91-100	Excellent, prime, highest quality	1	Low Risk
	AA	81-90	High quality. Low probability of default	2	Low Risk
	A	71-80	Good. With many favourable attributes of a good credit	3	Low Risk
Liste de surveillance	BBB	61-70	Satisfactory. With adequate debt service capacity within normal business cycle but with probability of default in case of disruptions to normal business cycle	4	Medium Risk
Non acceptable	BB	51-60	Below satisfactory. May still be acceptable, but any prolonged unfavourable economic period may result in deterioration and impairment of repayment capacity	5	Medium Risk
	B	41-50	Marginal. Credit lacks desirable characteristics	6	Medium Risk
	CCC	31-40	Below standard	7	High Risk
	CC	21-30	Below standard	8	High Risk
	C	11-20	Below standard	9	High Risk
	D	1-10	Below standard	10	High Risk

Source: ADFIAP- member bank internal documents.

On the basis of the BRR and LER scores, the bank decides whether the overall risk falls within limits the bank can tolerate. Banks usually combine the BRR

and LER scores to determine whether the borrower is within its risk asset acceptance criteria (RAAC). If it is within the bank's tolerance limit, the loan is submitted for approval. If not, the loan is either disapproved or submitted for approval, subject to strong justification.

Figure 5.2 summarizes the credit scoring process.



Has the Economic crisis impacted the loan evaluation process? As previously discussed, though no widely spread lending restriction has taken place, many banks have become stricter in the evaluation of loans. The risk assessment has become tougher. Banks have also enhanced their scrutiny of borrowers' backgrounds, returning to the old banking adage: "know your customers well."

As an SME manager, understanding how banks evaluate you and your proposal should help you prepare more adequately for the entire credit process. Knowing that business plan and collateral quality are important, you will know how to highlight your strengths and minimize attention to your weaknesses. For example, since you will likely not have sufficient collateral, you will invest more in preparing a convincing business plan. Knowing that your reputation is often the key to getting financing, you will likewise safeguard the your company's reputational capital. (We will discuss this more in the next chapter).

Other financing schemes

In accounts receivables financing, the evaluation takes account of the financial condition of your borrower, i.e., the entity that owes you money. The analysis of repayment capacity focuses not on cash flow from operations but on cash flow from receivables and inventory. Whereas typical loan borrowers have their balance sheets and financial statements analyzed, for A/R and inventory financing, the relevant analysis is on the quality and value of the receivables or inventory. The bank will also assess its ability to control and monitor the pledged assets, e.g., how trustworthy is the warehouse management that is taking care of the inventories, as well as its capacity to dispose of the assets in distressed situations.

Negotiation

To be competitive in business, one must minimize costs. To the extent that you need to borrow, you should try to get the best terms possible. If the financial charges and related costs of borrowing are not advantageous and risk putting you into a situation where you are no longer competitive, it would be better not to borrow. The goal of negotiation is to obtain a favourable price (cost of the loan), including non-interest costs, fees and charges (see Box 5.3). Furthermore, you should negotiate for terms that are most convenient for you. Avoid, for instance, tying up fixed assets for a small short-term loan if you know you will need them as security for a medium- to long-term loan in a few months.

Box 5.3 Checklist of commissions, fees and charges

Loans

- ❑ *Appraisal fee (or front-end fee). This fee is a percentage of total loan facility, paid up front, often as a deduction from principal disbursed. Amounts vary from one institution to another.*
- ❑ *Commitment fee. This is a fee paid on undisbursed portion of a loan facility. It is often waived. The rate is usually between ½% and 1%.*
- ❑ *Interest on outstanding principal, expressed as a per annum rate. Rate may reflect lender's assessment of risk. Low rates may be available through incentive schemes for exporters or for development components considered of special economic benefit to the country. (The method of calculation varies from one institution to another. You should make sure this method is thoroughly explained to you. For instance, interest may be calculated on day-to-day balances, or on monthly overdraft ceilings, on a 360-day year, and so on.)*
- ❑ *Legal costs and charges.*
- ❑ *Disbursement fees. Amounts charged by the lender as a flat fee on each disbursement if there is more than one.*

Trade finance

- ❑ *Charges for payment facilities, services. Fees and commissions charged for opening and confirming L/Cs, collection and other sundry services rendered by banks.*
- ❑ *Discount rates, forfaiting rates. The percentage charged by the discounter or the forfaiter for discounting or forfaiting receivables.*

In loan negotiations, lenders aim to get a good rate of interest on their money at little risk. They will try to obtain the best collateral possible. They will probably prefer the types of facilities and payment methods with which their staffs are most familiar, and which do not require too much back-office effort or time. As their time is precious, lenders will try to obtain fees for services rendered.

Negotiations should benefit both parties and each should feel satisfied with the outcome. The relationship may develop into a long-term one, with the bank growing to appreciate and trust you as transactions develop and your business expands. Bankers are keen to keep good customers. Banks work in a competitive environment and will vie with one another to obtain business. If your bank is pleased with the way your transactions are conducted and there is a feeling of mutual satisfaction and loyalty, your negotiating position will be strengthened and concessions will be eventually granted in your favour. At the start of the relationship, however, do not be surprised to be offered less favourable terms than the bank's more tested borrowers.

Below are a few tips to help you prepare for negotiation with the bank.

1. **Prepare before the negotiation.** Unless you have previously dealt with the bank, learn all you can about the institution: its business philosophy, affiliations, shareholders and directors, lending rates, schedules of charges and fees for services. Brochures and annual reports, normally freely available, provide information about structure, organization and services. Colleagues and other business people who have previously done business with the bank can also provide useful information.
2. **Come well prepared for your presentation.** Make sure that you submit all the relevant documents (see Box 5.2 above). State clearly what you intend to do with the funds you want to borrow. If your intention is to finance the purchase of goods or services for manufacturing products or the purchase of commodities for export, tell your banker the whole story: from whom you are buying, to whom you are selling, how you intend to pay and get paid. Speak to your bank about these matters before you sign contracts or agreements with your suppliers and customers or make payment arrangements.
3. **Seek advice.** The negotiation can be a good opportunity to explore options. You may have in mind one payment method, but an experienced banker can advise you of alternatives. He can advise you of the risks and dangers of various payment methods, on the most suitable ways to finance your transactions and on the security you should provide as a guarantee. You should remember to ask about hedging possibilities to cover or reduce risks of currency and price fluctuations.
4. **Be cautious.** In considering the bank's advice, resist borrowing more than you need, or for too long, or at too high an interest rate. Banks sometimes propose the types of credits or payment methods with which they are most familiar, or that are the most remunerative or least risky for them. Before you seriously pursue a financing application at one bank, get information on the alternatives. Ask about costs. Remember there are costs, fees and charges in addition to the interest rate. What about front-end fees? (These are payments deducted from the loan at disbursement to cover the lender's cost of evaluating your request, assessing the risk or opening the loan account.) What are the back-office fees? Ask about the bank's standard or sliding scale of rates for its services and how these rates will affect your transaction. Include in your consideration the legal fees for drafting a loan agreement, which may be part of your cost.
5. **Show loyalty and professionalism.** Avoid giving the impression that you are talking to other financial institutions after negotiations have reached the stage where the agreement is finalized and awaiting management or board approval. There is nothing wrong in trying to get to know various alternative sources and wanting the best deal, but this should be done at an earlier phase of the process. If you tell bank managers that you have found a better deal elsewhere after they have spent hours with you, drawn up documentation and obtained clearance from their loans committee, senior management or board, they will feel that you have wasted their time.

There are many ways of arranging a trade finance package. Always inquire into the cost of the facility offered and compare it to the cost of the alternatives. If you are able to show the bank that it would be cheaper for you to obtain the same result using another method, point this out tactfully but firmly. But

know your facts. If, for instance, the bank's interest rate is higher than the rate your supplier is prepared to accept for trade credit, tell the bank of this alternative and be prepared to show a letter from your supplier to that effect. As with loans, you need to understand the other fees and charges that can increase your cost.

Reputation and mutual trust are the keys to a good borrower-lender relationship. You should project confidence in yourself and your business during negotiations with the financial institution. Try to gain the confidence of your bank with the view towards a long-term business relationship. Low cost is important, but the cheapest lender may not also prove to be the best in the long run.

Approval, loan documentation and disbursement

Bank consultation and approval process

Lenders take their loan-making business seriously. No loan is disbursed without having been studied, and approved by many people. A typical loan approval has the following steps.

1. The account officer (AO), primarily responsible for obtaining all the supporting documents to the credit proposal, assesses the application's creditworthiness and the sufficiency and enforceability of the bank's claims in the event of default
2. After the AO's preliminary assessment, the manager forwards a credit proposal to the next level of approving authority depending upon the amount of credit requested. Usually, there are different committees for approving different types of loans. For example, a relatively small loan may only need approval by a credit sub-committee and not need to go through the credit committee that is usually comprised of the bank president plus other members. For medium size loans, the credit committee has to approve. For very large loans, the board of directors must approve. Each financial institution has its own threshold on what constitutes a small, medium or large loan. If the bank uses credit scoring, it will send the rating to the approving authority.
3. The approving authority evaluates the credit proposal based on the documents forwarded by the AO and a credit memo written by the AO's immediate superior and decides whether or not to grant the financing. Normally, the evaluation is based on your creditworthiness, the quality of the collateral, the purpose of the facility, repayment terms, etc., taking into consideration both subjective and objective evaluation that may be summarized in the credit scores.
4. If the approving authority decides positively, the AO coordinates with the legal department in ensuring that the collateral will protect the lender's interest. The legal department prepares loan documents and sends them to the AO.
5. A senior executive officer of the bank and the borrower sign the loan documents in the presence of witnesses.

Knowing that banks follow particular processes before a loan is approved, you are forewarned that the financing may not come quickly, assuming it

is approved. Thus, foresight and planning are important in applying for a loan. You must allow sufficient lead-time for the bank's approval process. For example, even a short-term loan is rarely approved in just a week's time.

The account officer and bank manager with whom you deal directly are important to your application. However, there are other bank officers who have a say on your application. Unlike the account officer and bank manager who know you personally through your application and negotiation, the other bank officers will evaluate you impersonally and mostly only on the basis of the documents and written proposals you submit.

If you hope to deal with the bank for subsequent financing, it is important to understand that your loyalty and diligence in fulfilling your terms of the loan will help the manager and account officer in their careers. As they rise to higher level of responsibilities, you will gain additional allies on bank credit committees.

Loan documentation and disbursement

The loan agreement may be documented in a formal contract or in a simple letter to be acknowledged by the other party. In general, loan documents have the following elements (especially for short-term facilities):

- ❑ A definition or description of the contracting parties.
- ❑ Recitals stating that the lender agrees to grant a loan or other facility to a borrower for specified reasons.
- ❑ A description of the facility, including:
 - Amount.
 - Currency.
 - Duration.
 - Interest rate.
 - Due dates for interest payments and instalments on principal (a schedule showing instalment dates and amounts may be appended).
 - Grace period (if any).
 - Fees or commissions payable up front (i.e., when the loan is disbursed).
 - Penalties for late payment (additional interest).
- ❑ The conditions preceding disbursement (i.e., the conditions which the borrower must fulfil before the bank releases the money).
- ❑ The security arrangements.
- ❑ The obligations of the borrower. (These are covenants the borrower undertakes to honour. They spell out what the borrower may not do and what he or she is obliged to do after the loan has been disbursed.)
- ❑ Events of default. These are the circumstances that will give the lender the right to call in the loan.
- ❑ Who is responsible for settling costs such as legal expenses, collection costs, etc.
- ❑ The rules for the settlement of disputes.
- ❑ The national law applicable to the agreement.
- ❑ Date and signatures of lender and borrower.

Examine the agreement carefully before signing. Be cautious, particularly with the covenants, because they may appear harmless but if breached, the bank can use the breach to call in the loan. Exercise the same caution with the security documents. These documents concern assets you pledge as collateral and may contain provisions with which you may not wish to agree, e.g. when your assets can be seized and sold. As with most legal documents, it is best to consult a competent lawyer to advise you before you sign a loan agreement.

If a previously signed agreement needs to be amended, this can be done either by appending a letter signed by both parties, or drawing up a supplemental agreement containing the additional clauses and amendments.

What to do if your application is rejected

If your application for financing is rejected, do not worry. Not all first time loan applicants are approved. Creativity and persistence are keys to success. Funding applications require skills that improve with practice. Learn from each experience and use that knowledge to enhance funding success in the future.

To maximize the lessons you can learn, ask the bank for an explanation of its decision so you can strengthen the weak points in your application the next time you apply. Re-application is an available option, especially if you find that the cause of rejection is something that can easily be remedied. Perhaps you did not supply an important document; procure it for your re-application. Perhaps the bank felt that your sales projections were overestimated; present alternative scenarios to show that even at lower projected sales, you still could afford the repayment terms. Perhaps, as is often the case, your collateral is deemed inadequate; ask a third party (private or government) to guarantee your loan. There are a host of things you can do to enhance your chances of being approved.

Alternatively, you can always explore alternative sources of financing. If the bank you approached was worried about the high risk of your application, you can approach other banks whose risk tolerance may be higher. You can try approaching government-owned banks or development banks that may have developmental interest in your project. You can approach wealthy investors, venture capitalist and business angels who are willing to take on higher risks.

Chapter 6

Being a responsible borrower: repayment stage

If you want a long-term partnership with your lender, you must establish your reputation as a good payer, abiding by your loan agreement and paying on time. In this way, subsequent requests for financing will cost less because you will have additional collateral: your good reputation.

Borrowers experience repayment problems and default on their loans for a variety of reasons. SMEs often default due to bad cash flow management – not considering specific cash payment obligations to suppliers, utilities, tax authorities, landlords or banks. Sometimes SMEs have difficulty separating personal from business finances. Business working capital ends up being used for family consumption or emergencies. Proper cash flow management can prevent these problems. First, you must separate money belonging to your business from personal money. Second, you must have the discipline to match your business cash outflow to your cash inflow to avoid a lack of liquidity.

Another common problem is that many SMEs tend to think of loan grants from government as dole, that is charity that need not be paid back. Sometimes they use borrowed funds for other than the original intended purpose. For example, money meant for the purchase of machinery and equipment gets diverted to buying vehicles, real estate property or other items unrelated to the project for which the loan was given. This can put a strain on the capacity of the SME borrower to pay back the loan, particularly if the money was not used for productive business purposes. Box 6.1 presents one bank's analysis of various factors contributing to loan defaults during the Asian financial crisis.

One adverse consequences of a loan default is a damaged reputation with your creditor bank. Because credit references are usually requested each time one applies for a loan and because financial institutions communicate with each other, your reputation is also tarnished before other potential lenders. In countries with functioning credit bureaus where the creditworthiness of firms and individuals can be checked, one loan default will stain your record for a long period.

Even if you obtain another loan elsewhere after a default, it most likely will have a higher interest rate than those given to favoured and trusted customers. Financial institutions will not be as flexible in the terms they will grant as they are with borrowers of good standing. Defaults can also lead to loss of your collateral assets, which, in many cases, cost more than your outstanding loan.

The bottom line is that once you enter into a financing arrangement you should take the repayment obligation very seriously. This means planning your cash flows carefully, abiding by the covenants, anticipating potential repayment problems, and keeping the bank informed, especially of adverse developments.

This chapter discusses how you can be a borrower valued by lenders and how to manage your business risks.

Box 6.1 Study of loan default experiences

After the 1997 Asian financial crisis, one bank conducted a study of borrowers in its loan portfolio that went bankrupt or were in distress during and after the crisis. Below are the typical characteristics of these enterprises.

- ❑ *Diversified into areas outside core competencies. Most of the enterprises in crisis were those that expanded into businesses that were outside of their core business competencies.*
- ❑ *Inadequate project planning skills. Most of these firms lacked the planning skill to successfully execute the business conceptualization and implementation phases.*
- ❑ *Lacked of financial discipline. After achieving profitable operations, instead of reinvesting profits to improve business operations, these entrepreneurs invested into non-business related assets such as expensive cars, houses and other high-ticket consumer products.*
- ❑ *Low capital reserves. When the crisis started to affect their business operations, management could not provide sufficient extra capital to tide them over the crisis.*
- ❑ *Mismanagement of receivables. Enterprises failed to aggressively collect accounts receivable.*
- ❑ *Poor business records and general management weaknesses. They went into default because of poor records management, general management weaknesses and their inability to efficiently and effectively handle a hostile operating environment.*
- ❑ *No diversification strategy. Others faded in the crisis because they put all their eggs into one basket or they concentrated on one specific market. This ultimately led to declining sales and ultimately business failures. They were not able to diversify into other markets or areas where it would be more profitable or at least recover their losses in one area from another winning area.*

Source: ADFIAP member-bank interview.

Satisfying contractual obligations

Your obligations as a borrower are typically set forth the loan agreement. These obligations usually consist of the duty to make timely payments and specific actions related to the drawdown of the loan. The borrower often is obligated to provide the lender periodically with accurate financial statements and information about the condition of the firm and the project for which the loan proceeds were intended.

If, during the loan period, you change your enterprise's legal form of ownership, management, etc., you should notify the lender in advance of the new organizational structure. Similarly, if you wish to transfer obligations under the loan contract to a third party, you must obtain the lender's consent in writing.

The lender will take steps to ensure that the load will be repaid. This may entail monitoring your operation and ensuring that the value of the collateral does not deteriorate. A representative from the bank may regularly call or visit to check on your business and monitor whether the loan proceeds are spent for the purposes for which the loan was granted.

Borrowers should inform their lenders in advance of potential difficulties. In this way, if payments need to be rescheduled or loans need to be restructured,

the lender has adequate information to make the necessary decision in a timely manner. To avoid occasions when you need to make late payments, reschedule your loans, or restructure them, it is important to monitor your cash flow and efficiently manage risks. We next discuss risk management.

Managing operational risks

Enterprise risk management

Many SMEs grow into successful corporations. There are also many failures. Thousands of SMEs all over the world start operating and make profits, but then fail to grow, stop operating and declared bankruptcy. Many SME businesses closed even before they make profits. Closure or bankruptcy are the result of many factors classified as business risks. These risks pertain to marketing, production, financing, labour, acts of nature or even politics. If not managed properly these risk can cause failure. Risks are inherent in any business; they can be both threats and opportunities.

An entrepreneur is creative and innovative with a healthy appetite for risk-taking. Successful entrepreneurs are those able to combine creativity and innovation in business with prudence and acumen in risk management. Risk management analysis is an important management tool that should be done on a continuous basis. It involves identifying risks and knowing how to handle or manage them.

Risk management analysis includes:

- Description of the risk (internal/external?)
- What event(s) can trigger the risk?
- Who/what will be affected if the risk occurs and what will be the speed of the impact? (For example, how will a foreign exchange risk affect the domestic value of your foreign sales or the cost of your imported materials? How will your cashflow budget change?)
- What is the probability of the risk occurring (high, medium, low)?
- What would be the impact (high, medium, low)?
- What actions can be taken by your company a) to prevent the risk from occurring; or b) mitigating the impact if the risk does occurs? (For example, is there a way you can transfer part of the risk to others, e.g., through hedging or insurance)?

Box 6.2 *Step-by-step ways of managing business risks*

1. *Risk identification: identify the risks that your business is exposed to.*
 - External risks: beyond your control or influence.*
 - Internal risks: operational risks within your control or influence.*
2. *Risk analysis: determine the significance of each risk. In so doing, you will be more prepared in handling a risk if or when it occurs. There are several activities that can help you do a good risk analysis (on your own without engaging the services of a consultant). These include:*
 - Get information from your lender-bank about current developments relating to your business and industry. Such developments may include trends and updates in management, marketing, finance and technology. Most banks provide this as part of their customer service. This information is also available on the Internet.*
 - Join trade or business associations as they are good sources of information and also provide networking opportunities.*
 - Analyze strengths, weakness, opportunities and threats (SWOT).*
 - Engage in business planning and brainstorming.*
3. *Risk ranking: ranking the risks you have identified in terms of probability of occurrence and impact will help you prioritize the allocation of resources such as capital, systems and personnel.*

Broadly, business risks are external or internal. External risks are those beyond the control or influence of the enterprise. Examples of external risks are the political environment, government regulations, natural disasters, industry changes, and financial risks involving credit, interest rates and foreign exchange.

Internal risks are business risks that are within the control or influence of the company. These are operational risks that you, as the SME manager or owner, can anticipate and plan for in order to prevent them from happening. If their occurrence cannot be prevented, steps can be taken to minimize or mitigate their impact. Examples of internal risks are business strategies, employees and personnel, systems and procedures, cash flow and liquidity.

Managing these risks properly may determine the success or failure of your business. The process of anticipating and managing risk should be continuous, particularly during an economic recession when profits decrease, threatening your ability to meet your obligations.

Examples of risks and how to deal with them

We discuss below some types of risks that are particularly relevant to your capacity to repay your loans.

- Compliance risks pertain to meeting government laws, standards and regulations. Today, when both domestic and foreign markets are particularly attentive to safety and health issues, SMEs should be on the look out for changes in laws, regulations or policies that could affect the design, specifications and use of their products. These are called non-tariff measures that can affect your product's entry into foreign markets. Enterprises must try, as far as their resources permit, to make market

dictated changes in product design and specifications to improve and enhance product quality.

Risks such as these can lead to your export products not being accepted in the destination market, as in the example in Box 3.4. Product rejection can adversely impact your projected sales. You will have to come up with other ways to dispose of those products while still being able to repay the money you borrowed to produce and ship them.

- ❑ Manpower risks include labour strikes and loss of key personnel. As the entrepreneur, you should understand the sentiments of your workforce. Monitor your turnover rate; if it is higher than the industry standard, determine the reasons why. Does the company have a reasonable policy in terminating the services of undesirable employees? Is there low or inconsistent productivity?

Employee strikes impose costs on the company. You might need to hire additional labour to make up for lost production, or require non-striking employees to work overtime. This means extra cash outflows. The risk of not being able to deliver products to your customers can affect your sales and hence your cash inflows. Your bank should know of your potential short-term illiquidity arising from labour problems so it can help you adjust your repayment schedule, if necessary.

- ❑ Temporary business interruption and natural calamity risks include unpredictable power outages, adverse climatic conditions, earthquakes, fires, floods and infestations that can threaten the firm without prior notice. Firms should develop business continuity plans to deal with business interruptions and obtain business interruption insurance if feasible.

Planning for contingencies should not have major adverse consequences for your cash flow unless the contingency measure would cost a significant amount. For example, if you plan to buy a generator to protect against power outages, you need to consider how this expenditure would impact your projected cash flow.

A disruption resulting from a flood, earthquake or storm could seriously damage or destroy inventory, production space, machinery or business records. If you are not able to resume operations quickly, the cash flow impact could be severe and even cause you to default on your loan.

- ❑ Security risks include intrusion into company premises and facilities, vandalism and theft. Security breaches can have a direct impact on the financial position of the firm. Theft of equipment, goods and money is a constant problem for small enterprises. Strict monitoring of inventory and financial transactions at the end of each day helps prevent security risks.

The extent to which a security breach could affect cash flow and cause difficulty in paying your loan will depend on the amount of monetary loss and how crucial the lost or damaged equipment is for your operation. Loss of important and expensive equipment that must be replaced immediately can have significant impact on cash outflow.

- ❑ Market risks arise from exposure in stocks, commodities, foreign exchange markets and use of derivatives for hedging purpose. For SMEs that export and import products abroad, exchange rate risk is a constant feature of their business. It is important to take the necessary training on how to deal with this risk.

Adverse changes in exchange rates can have considerable effect on cash flow. If your domestic currency appreciates, for example, your export earnings in foreign currency will have a diminished value in local currency. This can impact your capacity to pay in the short term, unless you have been able to transfer some of your risks through insurance policies, hedging, and other risk-mitigating instruments, as discussed in Chapter 3.

- There are certain risks that arise from exporting. Difficulties in obtaining export documentation, such as specific standards and quality certifications, sometimes represent a major payment risk for exporters. The effect can be similar to those of non-tariff measures discussed above.

These are just a few examples of risks that can threaten the financial position of your business and your ability to meet your obligations to your creditors. It is important, therefore, to update your risk management analysis regularly.

What to do in case of default

Good risk management can minimize your chances of failure, but will not entirely eliminate them. When misfortune hits your business you are still be obligated to repay your loan. If there are signs that you will not be able to meet your obligations – in other words that you are going to default – you should speak to your banker about it as soon as possible.

The best solution for the bank is usually to first try to help you solve your problems before seizing your assets or other pledged collateral. It is expensive and time consuming to call guarantees or put your company into receivership. If there is a good probability that you will overcome your problem and return to liquidity if granted new terms for your loan, banks may be willing to do so.

Rescheduling loans

One option is to reschedule your payout. This usually consists of extending the loan duration by a number of instalment periods.²⁰ A grace period may be given to allow the borrower more time before resuming payments. The advantage of rescheduling is that the original loan agreement or security arrangements do not need to be changed. The bank merely draws up a supplemental agreement that modifies the original terms where needed. There are, however, additional fees, charges and possible legal expenses that will be at the borrower's expense.

Restructuring loans

Loan restructuring is usually more complex than rescheduling. It can involve rescheduling plus other changes in the loan agreement, such as converting part of the remaining unpaid principal into another type of facility or into equity in the borrowing company. For banks, restructuring is often a last resort before putting the borrower into receivership.

²⁰ Some variations are possible. Rescheduling may involve not only an extension of the payment schedule but also an increase in principal and corresponding security. It may also involve a reduction of interest and principal payments over an extended period of time.

Summing up, you can enhance your reputation with the bank by keeping your payments current, or else giving advance warning of difficulties or delays. To be able to do this, you need to monitor your cash flow and manage the risks of your business. As your business grows, your borrowing requirements increase. You will be able to negotiate for better terms with the bank for these new financing requirements as your good debt-servicing record enhances your business reputation.

Appendix I

Tips on how to raise funds from internal sources

Cut down on unproductive current assets

Working capital involves your firm's current assets and current liabilities. It covers your inventories, accounts receivable, accounts payable and cash. By efficiently managing your working capital, you will be able to tap the cheapest and best sources of cash within your business.

A large portion of your funds may be sitting idle in the form of accounts receivable and inventories of raw materials, finished goods, and goods-in-process.

Time is money. It will be to your advantage if you can get your funds to move faster (e.g., speed up collection of receivables) or reduce the amount of money tied up in inventories. If you succeed in doing these things, you will have less need to borrow money to fund your working capital requirements. If you can negotiate better terms with your suppliers – for instance, longer credit terms or increased credit limits – you effectively create free financing. Consequently, you will not have to borrow money and take on additional interest expenses.

Improve inventory management

Reduce your stocks of raw materials, consumables and commodities to the minimum possible to reduce the funds tied up on these goods. All businesses, particularly exporters, must carry a variety of raw materials, finished goods, and supplies inventory, but too much can be costly. In addition to the acquisition cost of inventory items, there are other costs associated with keeping goods in stock, such as transportation, handling, storage, insurance, spoilage, pilferage, losses and the opportunity cost of capital.

Some tips on managing inventory:

- Take advantage of bulk discounts. Compute the amount of interest you are paying on stocks between the time they are paid for and the time they are consumed or used. Do the same calculating for small amounts purchased frequently, but without discount. Does the discount exceed the cost of borrowed funds?
- If you import materials, think twice before buying in bulk. Timing is crucial when you have to pay in another currency. Is your currency depreciating or appreciating against the foreign currency of your trading partner? Of course, you have to factor in potential delays in future imports of these products that can affect your own production.
- Counter inflation risks. Compare expected price increases with the current or forecasted inflation rate. Is the rate of increase higher or lower than the interest rate on loans or the yield you can obtain from a short-term investment?
- If you rent warehouse space, calculate how much less space you would need if you reduce your levels of stocks.

- Do your stocks take up space that could be used more profitably for production?
- Identify the fast and slow stock movers and establish the optimum stock levels of each finished good. By how much can you reduce your stocks without running the risk of shortages? Determine what would be the cost of a day's or a week's delay in supplying a customer or in shipping goods compared with the cost of storing finished products. When you reduce your stocks, you likewise prevent possible losses arising from theft, pilferage, spoilage and deterioration.

Speed up work-in-progress

The faster you are able to get your goods off the production floor, the sooner you will be able to sell them and earn money. Think of ways to reduce the time it takes to manufacture your products or prepare your goods for export. If it requires extra labour to speed things up, compare the additional costs to the potential additional revenues .

Reduce your debtors and receivables

If you extend credit, keep in mind that slow payments and poor collections can have a crippling effect on your business, especially if your working capital position is tight.

Set clear credit policies and make sure that your staff and customers understand them. Check out your customers thoroughly before you offer credit. Establish credit limits for each customer.

It is usually better to allow your customers to pay for purchases using their credit cards rather than issuing you a post-dated check. With the former, the burden of collection is borne by the credit card company, not by you.

Regularly review your receivables, especially your ageing schedules. The longer an overdue account remains uncollected, the greater the chance you will never get paid. Check if customers settle their invoice on time. If not, establish procedures for collecting overdue receivables.

Calculate the cost of granting customers credit. Is it higher than your sales margin? Is it worth granting credit? Would you lose your customers if you do not extend credit, reduce the credit period, or charge interest?

Reduce prepaid expenses

Certain prepaid expenses, like insurance premiums, cannot be avoided. If you can pay in instalments, but at a marginally higher rate, compare the additional cost with the interest expense of a loan.

Exchange your marketable securities for cash

If you have marketable securities, you may be better off selling them instead of paying interest on borrowed funds. Compute for the yields you get on these types of investments and compare them with the existing interest rates. If computed yields are lower, you would be better off selling your investments to raise needed capital.

Dispose of your unproductive fixed assets

Unproductive fixed assets tie up capital and can cost money if they need to be maintained or if you are paying rent and taxes on them. Such assets include unused building space, land and

equipment. You may be using these assets, but do you need to own them? Delivery vehicles, can be hired or leased; premises can be rented rather than owned. Production or storage areas can be allocated to more profitable activities, or even dispensed with, through subcontracting or through the use of common services facilities.

If you need funds, compare the cost of renting, leasing, subcontracting or hiring with the cost of tied-up capital, using current bank loan interest rates as your benchmark. Also compare your cost of production or warehousing with the costs of subcontracting. However, before you dispose of fixed assets, make sure that they are not pledged to your creditors.

Increase your current liabilities at little or no extra cost

Negotiating delayed payment terms from suppliers and tax authorities can help improve your company's financial position. From your suppliers, you can negotiate a mutually beneficial arrangement. Granting you a trade credit will help your business expand and consequently allow you to purchase more from them. You are more likely to obtain concessions by explaining these potential benefits than by threatening to find another source of supply. If need be, you can agree to pay interest on deferred payments.

Most businesses accept payment by credit cards. However, credit cards are among the most expensive source of financing. It is better to obtain trade credits than to use credit cards. Trade credits are cheaper and less complex than borrowing from financial institutions. Agreements can be reached faster and, more importantly, there is usually no need to put up collateral or prepare costly legal documentation. Reputation capital is often sufficient. Thus, it is important that you establish yourself as a customer of good credit standing. Once you have proven yourself to be a good payer, your suppliers may consign raw materials to you without financing charges.

From the government, you can try to obtain extensions on tax payments. If your accounts are audited and you have a good record of growth, you can show your financial statements as well as your cash flow projections and try to agree upon a payment schedule that improves your liquidity. It is in the interest of tax authorities to have companies trade profitably and grow.

Appendix II

Typical shipping documents required for L/Cs

An L/C is a distinct and separate transaction from the contract of sale on which it is based. In documentary credit transactions, the parties are not concerned with fulfilling the terms of the sales contract. They deal solely with documents, not goods. The issuing bank's obligation to the importer is to examine all documents to ensure that the terms and conditions of the credit are met. The advising bank is responsible for sending the documents to the issuing bank. The exporter sees to it that all conditions of the agreement have been complied with.

The documents are the buyer's proof that the goods shipped are what it expects. An L/C transaction can require an array of documents. The most common documents include:

- Commercial invoice. The commercial invoice is a bill for the goods transferred from the seller to the buyer. It contains a description of the merchandise, price, point of origin, names and addresses of the buyer, seller and shipper, and the delivery and payment terms. The buyer needs the commercial invoice to prove ownership and arrange payment. Some government agencies use the invoice to assess customs duties.
- Bill of lading. A bill of lading is a written account of the goods shipped and a promise to deliver the goods safely to their destination.
- Certificate of origin. This is a signed statement attesting to the origin of the goods that some countries require for purposes of import tariffs and quotas.
- Inspection certificate. Some buyers and countries require a certification of inspection attesting to the specifications of the goods. Inspection is usually performed by an independent testing organization.
- Insurance certificate. This document is issued and signed by an insurance company, agent or underwriter. It states the type and amount of coverage.
- Packaging list. This list itemizes the materials in each individual package with net, legal tare, and gross weights. It is attached to the outside of the package in a clearly marked waterproof envelope.
- Warranty title. This warranty, which is given by a seller to a buyer, states that the title being conveyed is good and that the transfer is correct.

Appendix III

Special L/Cs

- ❑ Standby L/C. A standby L/C serves as a secondary payment mechanism. With a standby letter of credit, an exporter trades as if settlement were on open account. On the exporter's request, a buyer instructs its bank to issue a standby L/C. With a standby L/C, an exporter is able to obtain payment from the bank in case the buyer defaults.
- ❑ Revolving L/C. With a revolving L/C the issuing bank restores the credit limit to its original amount once it has been drawn down. This special type of L/C is commonly used when the importer anticipates a regular flow of merchandise from an exporter.
- ❑ Transferable L/C. A transferable L/C can be transferred by the original (first) beneficiary to one or more secondary beneficiaries. It is normally used when the first beneficiary does not produce the merchandise himself, but he is a trader who wishes to transfer part or all of his right and obligations to the actual suppliers. This special type of L/C can be transferred only once.
- ❑ Red clause L/C. The unique feature of this special L/C is that it authorizes the advising bank to make advance payment to the exporter before the actual shipment of goods to the buyer. The advance may be up to 100% of the export contract value and may be used by the exporter to buy inputs for manufacturing or shipment. Negotiation of red clause credits are limited to the bank making the advances in order to assure that revenues from the shipment are used to repay the advances made.
- ❑ Green clause L/C. An L/C with a green clause enables a seller to receive pre-shipment advances against collateral represented by warehouse receipts. A green clause L/C differs from a red clause L/C in that the goods must be warehoused. It is commonly used in the export of agricultural commodities, where the exporter may raise funds to harvest new crops for export by pledging available stocks as collateral.

Appendix IV

Approaching financial institutions: some practical tips

Below are guidelines to help you select the right financial institution with appropriate services for your financing requirements:

- Before visiting any financial institution, talk to friends, associates, suppliers and fellow members of civic organizations or industry associations about their experiences with the institution. You can get useful tips on how to approach financial institutions. Make a list of referrals from these discussions.
- From these referrals, make a short list of those institutions that understand your business and industry, have developed fruitful ongoing relationships with your friends or associates, and show interest in their customers as a partner rather than simply as a moneylender.
- Contact the financial institutions on your referrals short-list. It may be best to first contact the head office because it is most likely that the head office will have comprehensive financing programmes and services for small entrepreneurs. You may transfer your account later to the branch office nearest you.
- Make an appointment. Advise the institution that you seek financing for your business and make sure you will be meeting the right person on the appointed date.
- First impressions count. Dress properly for the meeting and come to the appointment on time.
- During the meeting, be candid about your needs and expectations from the prospective relationship.
- Ask about lending requirements and approval criteria. Different financial institutions have different lending styles. Some are more conservative than others. Some financial institutions may require three years of financial statements showing profitability before they are to deal with you.
- Find out about the experience of the financial institution in handling accounts similar to your business and those in your industry. Not all financial institutions are comfortable financing transactions in certain industries or for small, development-stage enterprises.
- Ask about the bank's turnover rate of employees. It will be difficult to nurture a long-term relationship with a financial institution if you must deal with a different account officer every three months or so.
- Look for online cash management for easy invoicing, payment collection and payroll services. Online banking is quicker than needing to go to the financial institution in emergencies.
- Hand out your brochures and business cards. Even at this early stage of your search for financing, you may have to contact at least two people from the financial institution: the credit manager and his or her assistant or a senior account officer. It never hurts to know more than one contact during your search for credit.

Apply these pointers with the financial institutions on your short-list. After completing your inquiries, create a matrix highlighting the advantages and disadvantages of seeking the financing you need from each of the institutions. Compare your prospects then choose the financial institution that best meets your business requirements.

Appendix V

Letters of credit documentation

Example of an application for irrevocable documentary credit

Documentary credit number
(to be assigned by the bank)

I/We hereby authorize the Development Bank of the People to open an Irrevocable Documentary Credit set forth below:

Please check the relevant box

Type of documentary credit		Form of documentary credit		Confirmation instructions		Date and place of expiry	
<input type="checkbox"/> Foreign <input type="checkbox"/> Standby <input type="checkbox"/> Domestic		<input type="checkbox"/> Irrevocable <input type="checkbox"/> Transferable		<input type="checkbox"/> Confirmed <input type="checkbox"/> Unconfirmed			
Applicant's name				Beneficiary's name			
Address, tel. No. and fax no.				Address, tel. No. and fax No.			
Contact person/s							
Currency code and amount		In words:					
		In figures:					
Percentage credit amount tolerance							
Credit available by <input type="checkbox"/> Sight payment <input type="checkbox"/> Deferred payment: terms _____ <input type="checkbox"/> Acceptance _____ No. of days ____ after <input type="checkbox"/> sight <input type="checkbox"/> bill of lading date <input type="checkbox"/> Negotiation (sight or usance)				Credit available with <input type="checkbox"/> _____ (Restricted/nominated bank) <input type="checkbox"/> Any bank <input type="checkbox"/> _____ (To be filled-up by fi)			
Payment instructions <input type="checkbox"/> Check payment <input type="checkbox"/> Debit applicant's FI A/C No.: _____ Bank name _____ Check number _____ Branch: _____							
Partial shipment <input type="checkbox"/> Allowed <input type="checkbox"/> Not allowed		Transshipment <input type="checkbox"/> Allowed <input type="checkbox"/> Not allowed			Latest date of shipment		
Place of taking in charge/dispatch from./ Place of receipt				Port of discharge/ airport of destination			
Port of loading/Airport of departure				Place of final destination/ for transportation to./ Place of delivery			
Description of goods							
PSCC code		Incoterms <input type="checkbox"/> EXW <input type="checkbox"/> FAS <input type="checkbox"/> FOB <input type="checkbox"/> CFR <input type="checkbox"/> CIF <input type="checkbox"/> Others: _____					

Documents required

Domestic letter of credit	Standby letter of credit
<input type="checkbox"/> Beneficiary's signed sales invoice <input type="checkbox"/> Signed delivery receipt <input type="checkbox"/> Beneficiary's signed draft/s at sight drawn on us <input type="checkbox"/> Duly signed inspection and acceptance report issued by the applicant as required under R.A. 9184, as amended <input type="checkbox"/> Other documents (please specify) _____	<input type="checkbox"/> Beneficiary's signed draft/s drawn on us <input type="checkbox"/> Beneficiary's signed sworn certification duly notarized in duplicate stating (applicant) has failed to pay/perform (obligation) pursuant to (agreement) Original standby letter of credit <input type="checkbox"/> As per attached format which will be an integral part of this application <input type="checkbox"/> Other documents (please specify) _____

Import letter of credit

- Full set of original/s clean on board ocean bills of lading One original air waybill plus two (2) non-negotiable copies made out/consigned to the order of the Development Bank of the People marked freight Prepaid Collect
- Notify Applicant Others (please specify) _____
- Signed commercial invoice in triplicate
- Packing list in triplicate Duly signed inspection and acceptance report issued by the applicant as required under R.A. 9184, as amended
- Marine Air insurance policy or certificate issued to the order of the Development Bank of the People including institute cargo clauses (all risks) strikes, riots and civil commotions, war, theft, pilferage and non-delivery clauses, warehouse to warehouse for 110% of total invoice value
- Other documents (please specify) _____

Additional conditions

- | | |
|--|---|
| <ul style="list-style-type: none"> <input type="checkbox"/> All documents including <input type="checkbox"/> Bill of lading (BL)/ <input type="checkbox"/> Air waybill (AWB) must legibly contain the L/C number pertaining to the shipment <input type="checkbox"/> Shipping documents dated prior to L/C opening not acceptable <input type="checkbox"/> Drafts drawn under this credit must be marked "Drawn under Development Bank of the People Irrevocable Letter of Credit No. _____ dated _____." Draft must be presented on or before the expiry date of L/C. <input type="checkbox"/> Cable negotiation required (for sight L/Cs only) <input type="checkbox"/> Presentation period: Documents must be presented within _____ days after <input type="checkbox"/> B/L date <input type="checkbox"/> AWB date <input type="checkbox"/> Indicate the net and gross weight on the Packing List or Commercial Invoice <input type="checkbox"/> The words "Entered Duty and Tax Free Under Local Government Code _____" shall be printed conspicuously on the equipment, in which case beneficiary's certificate to this is required | <ul style="list-style-type: none"> <input type="checkbox"/> Shipment must be made on <input type="checkbox"/> Philippine flag vessel/ <input type="checkbox"/> Air carrier unless a prescribed waiver is secured from the nearest Philippine consulate at the Port of Origin by the seller and/or from the <input type="checkbox"/> Country Shippers Bureau/ <input type="checkbox"/> Civil Aeronautics Board (CAB) by the buyer ten (10) days prior to shipment. No payment shall be made unless this condition is complied with. <input type="checkbox"/> Shipment must be in wooden crate <input type="checkbox"/> Before loading, subject wood packaging materials for fumigation as per ISPM No. 15 (International Standard Phytosanitary Measures) <input type="checkbox"/> Others (please specify) _____ |
|--|---|

TO BE FILLED UP BY FI TRADE OPERATIONS

- Advising bank _____ Confirming bank _____
- Advise thru bank _____ Reimbursing bank _____

DETAILS OF CHARGES

- All bank charges outside the country are for the account of Beneficiary Applicant Except _____
- A charge of US\$ 65.00 for discrepant documents presented shall be deducted from the proceeds of any drawings

L/C subject to Uniform Customs and Practice for Documentary Credits, 2007 Revision ICC Publication 600 MFO#01107

In consideration of your issuing the documentary credit, the undersigned hereby declare/s that i/we have read and fully understood the terms and conditions appearing on the reverse side hereof and hereby agree to be bound thereto.

Authorized signature/s over printed name/s

Signature verified by:

Example of a security agreement

In consideration of your issuing the Credit according to the Application appearing on the reverse side hereof, I/we hereby jointly and severally agree as follows:

1. To accept, when requested and/or required by you, any and all time drafts drawn under, or purporting to be drawn against, the said Credit, or against any extension, renewal, or increase thereof applied for by me/us.
2. To pay you, at your office, on demand, in legal tender of the Country, the face amount, if drawn in Philippine Currency, or if drawn in foreign currency, its equivalent in Philippine Currency, at the rate of exchange that you may fix, of all drafts, receipts or any other evidences of disbursement of funds, drawn under, or purporting to be drawn against the Credit, or against any extension, renewal or increase thereof applied for by me/us; it being understood and agreed that I/we will pay on demand all such drafts, receipts or any other evidences of disbursement of funds, irrespective of the fact that the merchandise represented or purported to be represented by the relative shipping documents, if any, whether or not released to me/us under a Trust Receipt, may not have arrived at its final destination and/or may not have been received by me/us, owing to causes beyond the control of the Bank, whatever the nature of such causes may be.
3. I/We also hereby agree, to pay you, at your office, on demand:
 - a. Interest at the rate of _____% per annum, calculated from the date of evidence of disbursement of funds until the date of complete payment by me/us, to you at any other higher rate that you may fix owing to the delay in payment of the draft/s, receipts or other evidences of disbursement of funds, or owing to any extension granted thereon from date of first presentation until final payment.
 - b. Your commission at the rate which you may stipulate at the time of the opening of the Credit as well as all commission charges and other expenses charged to you by your correspondent/s. In the event the Credit will not be used in full, I/we hereby agree not to claim from you a refund of such commission.
 - c. Any and all other charges, expenses and taxes which may be paid or incurred by you in connection with the Credit.
4. In case I/we incur in default on any or all foreign currency denominated obligations related to this Credit, you shall have the right to convert the amount of obligation to a peso obligation following the prevailing exchange rate on the day of conversion and subject the converted obligation to the prevailing interest rate applicable to peso obligations.
5. In case of my/our absence, or for failure on my/our part to effect payment on demand or after a reasonable time from date of first presentation or if for any other reason you may deem it convenient, you are hereby authorized, at your option, to debit from my/our current account in your Bank the amount of your liquidations for the drafts, receipts, or any other evidences of disbursement of funds issued in accordance with the said Credit, including the interest, commissions, and all other charges mentioned in Section 3 above; or should you deem it still more convenient you are also hereby authorized to deduct such amount from whatever funds belonging to me/us which may be at anytime in your possession, regardless of their nature. If I/we have no sufficient funds with you, all our obligations with you under this credit facility and on other notes, accounts or evidence of indebtedness shall at your option and without need of any act or deed (i) become immediately due and payable (ii) if not paid on due date, be subjected to a penalty equivalent to 2% per month; and (iii) together with said penalty, bear interest at prevailing market rates from the time the obligation/s become due and payable.

6. I/We hereby recognize and admit your ownership in and unqualified rights to the possession and disposal of all property shipped under or pursuant to with the Credit, whether or not released to me/us on trust or bailee receipt, or otherwise, and also in and to all shipping documents, warehouse receipts, policies or certificates of insurance and other documents accompanying or relative to drafts drawn under the Credit and in and to the proceeds of each and all of the foregoing, until such time as all the obligations and liabilities of mine/ours, or any of us to you at any time existing under or with reference to the Credit or this Agreement, or any other credit or any other obligation or liability to you, have been fully paid and discharged. And I/we also agree, that, in case of need, you shall be at full liberty to sell the said property and to apply the net proceeds (including any amount recoverable under the Insurance Policies or Certificates covering the said property, and after deducting freight and insurance, if effected by you, as well as all other charges due to you, including the usual merchants commission to which you shall be entitled) towards the full payment of the relative draft or of any other draft/s drawn under the said Credit. You shall have the right of recourse against me/us for any deficiency resulting in your favour. Upon the sale of said property I/we will indemnify and hold you harmless from and against such and every claim, or action or suit which may arise against you or any such correspondents by reason thereof.
7. I/we agree, at any time, on demand, to deliver, transfer, or assign to you, as security for any and all of my/our obligations and liabilities hereunder, absolute or contingent, due or to become due, additional security of a value and character satisfactory to you, or to make such payments as you may require. I/we agree, that upon my/our failure at all times to keep a margin of security with you, satisfactory to you, or upon the making by me/us of any assignments for the benefit of creditors, or upon the filing of any petition for bankruptcy by or against me/us, or upon the application for the appointment of a receiver of any of my/our property, or upon any act of bankruptcy or state of insolvency of me/us, all such obligations and liabilities shall become, and be immediately due and payable without demand or notice. In any such event, or upon my/our failure to pay any of such obligations or liabilities when it or they shall become due, I/we, as to property in which I/we may have any interest, expressly authorize you to sell immediately, without notice to me/us or any of us, any and all such property, at private sale or at public auction at such time and at such place and for such price and upon such terms and conditions as you may deem proper, and to apply the net proceeds of such sale or sales, together with any balances of deposits and any sums credited by or due from you to me/us in general account or otherwise, to the payment of any and all of my/our obligations or liabilities to you, however, arising.
8. I/We will procure any necessary import, export, or other licenses for the transport of the property shipped under or pursuant to the Credit, and will comply with all foreign and national government regulations in regard to the shipment of such property, and will furnish such certificates in that respect as you may at any time require. Furthermore, I/we hereby undertake to insure the goods/merchandise/machinery for their total value against loss from fire, theft, pilferage or other casualties through the F Risk and Insurance Management Department.
9. It is hereby understood and agreed that in case the said Credit should expire without having been availed of, in whole or in part or extended, my/our liability therefore appearing on your books shall be automatically cancelled sixty (60) days after expiry date of the Credit without need of notice to me/us. It is hereby understood and agreed that in case the said Credit should have been issued in foreign currency and its equivalent in Philippine Currency should have been paid to you at the time of its issuance or at any time thereafter, any unused balance remaining on the said Credit will be refunded by you to me/us, at such time after its expiry date as you may fix, at your buying rate for bankers demand drafts in the currency in which the Credit may have been used.

10. It is hereby further understood and agreed that if after having availed of the Credit, a residual value exists, such residual value shall be cancelled at such time after my/our submission to you of the due confirmation from the shipper/vendor that all shipments have been made and no further shipment is forthcoming, or after receipt by me/us of your notice of cancellation after the lapse of sixty (60) days from expiry of the facility, whichever comes first.
11. That except as instructions may be given you by me/us in writing to the contrary and prior to the opening of the Credit: a) You and/or any of your correspondents will receive and accept as Bills of Lading only such Bills of Lading which show that the goods are loaded on board as may be evidenced by an On Board Bill of Lading, or by means of a notation to that effect, dated and signed/initialed by the carrier or his agent, whatever the specific provision of such document/s. The date of the Bill of Lading or date indicated on the reception stamp or any other document evidencing shipment or dispatch will be taken as the date of shipment of the goods; b) Part shipment/s and/or shipment/s in excess of the quantity called for in the Credit may be made and you may honour the relative drafts, my/our liability to reimburse you for payments made being limited to the amount of the Credit. Shipments made on the same ship and for the same voyage, even if Bills of Lading evidencing shipment “On Board” bear different dates, will not be regarded as partial shipments; c) If the Credit specifies shipment by installment within given periods and any installment is not shipped within the period allowed for that installment, the Credit ceases to be available for that or any subsequent installment and you are released from any obligation under the Credit to honour the relative drafts.
12. The users of the Credit shall be deemed my/our agents and I/we shall be accountable for any and all of their acts of omission. Neither you nor your correspondents shall be responsible for: a) the existence, character, quality, quantity, condition, packing, value or delivery of the property purporting to be represented by the documents; b) any difference in character, quality quantity, condition, or value of the property from that expressed in documents; c) the form, validity, sufficiency or genuineness of documents, even if such documents should in fact prove to be in any or all respects invalid, insufficient, fraudulent or forged; d) the time, place, manner or order in which shipment is made; e) partial or incomplete shipment, or failure or omission to ship any or all of the property referred to in the Credit; f) the character, adequacy, validity or genuineness of any insurance, or the solvency or responsibility of any insurer, or for any other risk connected with insurance; g) any deviation from instruction, delay, default or fraud by the shipper or anyone else in connection with the property or the shipping thereof; h) the solvency, responsibility or relationship to the property of any party issuing any documents in connection with the property; i) delay in arrival or failure to arrive at either the property or any of the documents relating thereto; j) the delay in giving or failure to give notice of arrival or any other notice; k) any breach of contract between the shippers or vendors and myself/ourselves or any of us; l) failure of any draft to bear any reference or adequate reference to the Credit, or failure of documents to accompany any draft at negotiation, or failure of any person to note the amount of any draft on the reverse of the Credit or to surrender or take up the Credit or to send forward documents apart from drafts as required by the terms of the Credit, each of which provisions, if contained in the Credit itself, may be waived by you; m) any and all consequences arising out of delay and/or loss in transit of any message(s), letter(s) or document(s); n) errors, omissions, interruptions or delays in transmission or delivery of any message, by mail, cable, telegraph, wireless or otherwise, whether or not they be in cipher, or any error, neglect, or default, of any of your correspondents, or errors in translation or interpretation of technical terms; o) any consequences arising beyond your control and none of the above shall affect, impair, or prevent the vesting of any of your rights or powers hereunder. I/We shall protect you and any other drawee in paying any draft dated on or before the expiration of the Credit regardless of when drawn

and when or whether negotiated. I/We are responsible to you for all obligations imposed upon you with respect to the Credit or the relative drafts, documents or property. I/we further agree, that any action taken by you or by any correspondent of yours under or in connection with the Credit or the relative drafts, documents or property, if taken in good faith, shall be binding on me/us and shall not put you or your correspondent under any resulting liability to me/us, and I/we make like agreement as to any inaction or omission, unless in breach of good faith. I/we agree, jointly and severally, to indemnify and hold you harmless from any claim, loss, liability or expenses arising by reason of any such failure to pay or accept.

13. In the event of any change or modification with respect to a) the amount or duration of the Credit; b) the time or place of shipment of any relative property; c) the drawing, negotiation, presentation, acceptance, or maturity of any draft or document; or d) any of the other terms or provisions of the Credit, such being done at my/our request, this Agreement shall be binding upon me/us in all respects with regard to the Credit so changed or modified, including any action by you or any of your correspondents relative thereto.
14. You shall not be deemed to have waived any of your rights hereunder, unless you or your authorized agent has signed such waiver in writing. No such waiver, unless expressly as stated herein, shall be effective as to any transaction which occurs subsequent to the date of such waiver nor as to any continuance of a breach after such waiver.
15. In the event the Bank shall hire the services of counsel to enforce any of its rights or remedies under this obligation, I/we undertake to pay as for attorney's fee, a sum equal to twenty per cent (20%) of the amount sought to be recovered which in no case shall be less than ten thousand (P10, 000.00) in addition to the costs of suit and all other fees and incidental expenses of collection incurred by the Bank.
16. Except as otherwise expressly stated herein, the Credit is subject to the Uniform Customs and Practice for Documentary Credits (1993 Revision) the International Chamber of Commerce Publication No. 500.
17. This Agreement shall be binding upon me/us, my/our heirs, my/our executors, administrators, successors-in-interest, and assigns, and shall inure to your benefit of and be enforceable by you, your successors, transferees and assigns.
18. You shall have the absolute right to assign or transfer your right hereunder in favour of any party.
19. I hereby authorize the representative/examiner of the Bangko Sentral ng Pilipinas (BSP) to inspect the merchandise covered by the Credit.
20. This application shall constitute as my/our certificate of indebtedness to FI, without need for me/us to execute another PN or any other instrument, whether at the time of the opening or negotiation of the L/C, or at the time of the acceptance of the drafts, or at the time of the execution of the TR.

AUTHORIZED SIGNATURE/S OVER PRINTED NAME/S

Example of a certification

REPUBLIC OF _____

PROVINCE OF _____

MUNICIPALITY/CITY _____

“Payment for the cargo and/or the sea/air transport cost of this
importation covering _____

(state brief description of importation, name of

exporter and invoice number)

by the _____

(name of importer)

is or will be directly or ultimately financed, partly/wholly, by a domestic/foreign loan or credit granted
by _____

(name of financial institution)

and/or guaranteed by the _____

(name of financial institution)

and that it shall be shipped in the Philippine flag vessel/air carrier pursuant to P.D. 1466
unless the prescribed waiver is secured.” (N.B. if prescribed waiver has been secured,
state also: True/Xerox copy of the prescribed waiver is attached.)

A F F I A N T

SUBSCRIBED AND SWORN TO BEFORE ME in the _____ this _____ day of
_____, _____ affiant exhibiting to me his/her Community Tax Certificate
No. _____ issued at _____ on _____.

Notary Public

Doc No. _____

Page No. _____

Book No. _____

Series of _____

Example of an export transmittal letter

DATE: _____

The Head, Trade Operations
Development Bank of the People
Address

Gentlemen:

We enclose the original check/draft and documents described below for outright/purchase/collection drawn against L/C No. _____ issued by _____ of _____.

Draft/check no.	Date:	Tenor:	Amount:
Drawer: Address:		Drawee: Address:	

DOCUMENTS

(Please indicate number of copies of each)

AWB/BL	Invoices	Certificate of origin	Consular invoice	Insurance policy	Packing list	Mailing certificate	Others

(Please handle in connection with Instructions marked "X")

- Deliver documents against acceptance/payment/collection
- Advise non-acceptance by cable/airmail giving reasons.
- Advise non-payment by cable/airmail giving reasons.
- Protest for non-acceptance/non-payment
- Do not protest
- After acceptance ask your correspondent to advise due date by air mail and collect the item at maturity
- Credit proceeds to CA/SA A/C No. _____ maintained with you under advice to us.
- Credit proceeds to out CA/SA A/C No. _____ maintained at _____ Branch.
- Issue your checks in our favor for the net proceeds.

Please mail documents via: DHL Registered airmail Parcel post Airfreight

Where this item serves as collateral for an advance obtained from you, you may modify or change the instructions given and above exercise your discretion in the collection of this item to the same effect as though you were the only one having an interest therein, without altering or modifying your right of recourse against us for the amount advanced. All items are at our risk and subject to final payment and we agree that you are not to be held responsible for failure or negligence of your correspondents, loss of documents in the mails or for any other cause or causes beyond your control. You are authorized to charge our account for your commission, postage and other charges.

Mail to:

Very truly yours,

Name of company

Authorized signature over printed name

Additional instructions:

Example of a letter of indemnity

EB No. _____

DATE: _____

The Head, Trade Operations
Development Bank of the People
Address

Dear Sirs:

In consideration of your negotiating my/our draft for _____
drawn under revocable/irrevocable Letter of Credit No. _____, issue in my/our
favor on _____, by _____

(date)

(Name of issuing bank)

of _____, I/we hereby undertake and bind myself/ourselves to hold you free and
harmless from any loss or responsibility arising out of the fact that contrary to the provisions
of the aforementioned letter of credit _____

_____.

If for any reason, my/our draft is not finally honored or retired by the drawee, I/we hereby
further undertake and bind myself/ourselves to refund to you, on demand, the full amount
of this negotiation, together with the corresponding interest thereon as well as yours or your
correspondent's charges and expenses thereon, if any; and to compensate you fully for any
damages that might be instituted by the buyer or importer on the ground of lack of faithful
performance of the contract between said buyer or importer and myself or ourselves. Likewise,
should my/our draft be dishonored for any cause whatsoever, I/we hereby authorize you, at
your discretion and without any responsibility on your part, to sell, or cause to be sold either
publicly or privately, the underlying goods, wherever they may be found, and from the proceeds
thereof, I/we hereby empower you to collect all expenses incident thereto, together with your
commission, interest, and other charges, as well as to reimburse yourself there from the full
amount of this negotiation, interest, charges and other expenses thereon, returning to me/us
only whatever amount that may remain thereafter; and, should there be any deficiency still
in your favor, notwithstanding the sale made as herein authorized, I/we likewise bind myself/
ourselves to pay the said deficiency to you upon demand.

If there is delay in the payment of my/our draft due to discrepancies in the documents
presented to you, I/we undertake to pay your interest at _____% p.a. from the date the bill
was originally due up to the actual date the draft is ultimately paid by the drawee.

Very truly yours,

Name of company

Authorized signature over printed name

Appendix VI

Sample business plan

COMPANY X

YEAR:

Table of contents

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<i>Business description</i>	100
<i>Business roadmap</i>	101
<i>Target markets</i>	102
<i>Production description</i>	103

Executive summary

Company X requests a credit facility from Bank Y. The details of the requested facility are as follows:

Amount: CUR²¹ 14,771,776 medium term loan.

Purpose: The medium term loan will finance development costs for upgrading a hatchery²² that will enhance productivity and reduce cost of production.

Project: Subject of upgrading is an integrated 20 hectares hatchery located in district E. The project has been in operation for the last eight years.

Tenor: Seven years for the medium term loan with three quarters grace period in principal after full release of the amount.

Repayment: Equal quarterly amortization with three quarters grace period in the payment of principal portion of the obligation and three quarters grace on the payment of interest.

Collateral: Immovable and movable assets on the project site including future improvements thereon partially financed from the proceeds of the loan.

Other conditions: Company will not declare or pay any dividends to the stockholders until such time that the loan is fully liquidated. Excess funds at the end of the second year may be invested in allied undertakings but with prior consent of the bank.

Repayment source: Primarily from the incremental net cash flows generated from the hatchery upgrading.

Detailed estimates of the project cost	The new technology will cost the company a total amount of CUR 28.62 million for fixed improvements and the upgrading of the broodstock. Specific areas where the improvements are introduced and the specific costs thereof are as follows:		
Improvements and upgrading affecting the whole facility	Total cost	Cost sharing	
		Equity	Loan
Fencing and water treatment facilities upgrading	CUR 6,446,250	CUR 2,578,500	CUR 3,867,750
Upgrading of the artificial incubation and other hatchery facilities	CUR 18,173,377	CUR 7,269,351	CUR 10,904,026
Total project cost	CUR 24,619,627	CUR 9,847,851	CUR 14,771,776
Working capital	CUR 4,000,000	CUR 4,000,000	
Grand total	CUR 28,619,627	CUR 13,847,851	CUR 14,771,776
Sharing		48.39%	51.61%
Effects on the project being financed	The upgrading of the hatchery can generate the necessary profitability and cash flows to service the obligation. In addition, the incremental effect of the upgrading can substantially enhance the overall financial performance of the company.		
Drawdown	Requested loan drawdown schedule is as follows:		
	Upon compliance with documentary requirements		CUR 15,000,000
	Upon completion of the hatchery upgrading		CUR 13,619,627
	Total		CUR 28,619,627

²¹ In the sample no specific national currency will be used. Instead “CUR” will appear in front of all the amounts.

²² A facility designed to raise fish. It provides an optimum environment for fish eggs to develop and hatch by maintaining proper water temperature and oxygen levels, and providing adequate food supplies and safety from predators. A fish hatchery works to raise baby fish and prepare them for release in another environment for various reasons, as well as for food.

Business description

General information

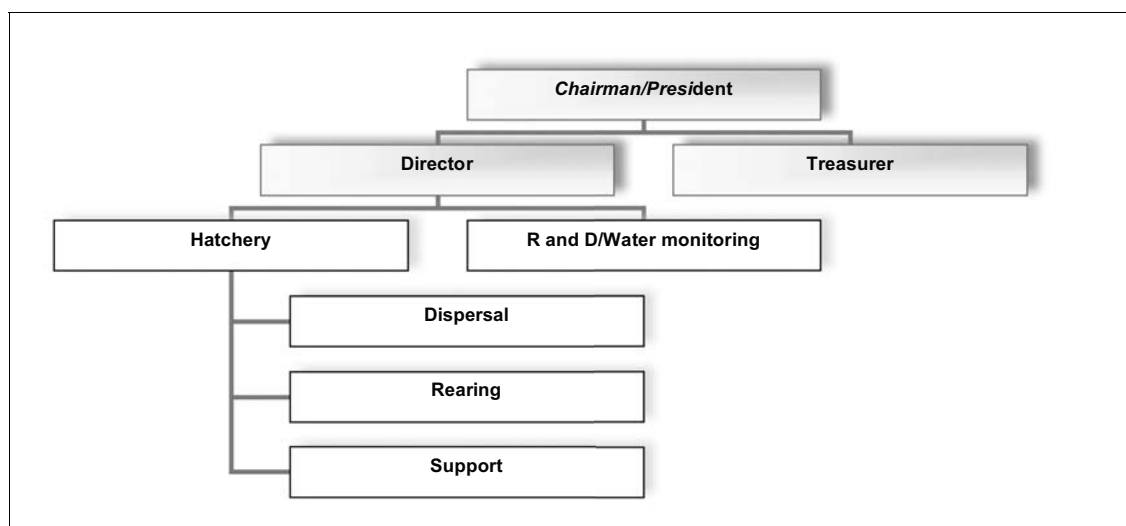
Company name	X
Legal structure (e.g. company, sole trade, partnership)	Limited liability
Date incorporated	1998
Registration No.	*****
Address	*****
Operations	Company has been in operations since 1998.
Authorized/Nominal capital	
Controlling stockholder(s)	Family of F, Jr.
Core business	Company is the biggest fish hatchery in the region in terms of facilities and production capacity
Facilities	Structures, facilities and equipment on a company owned land with total area of 20 hectares
Development roadmap	<ul style="list-style-type: none"> • Continuous development and upgrading of the breeding stocks to improve genetics and ultimately profitability of the fish growers • Upgrading of the hatchery facilities to support the genetic improvement

Company information

Key people in the company are as follows:

Names	Designations
Mr F. Jr	Chair operating officer
Mr KK	Director
Ms GG	Treasurer

Organizational chart



The management team and the organizational framework

Company X's management team has the experience, strength and capability to execute this business plan and achieve the desired outcome.

Core strategies

- Cost leadership – Maintaining cost effective and efficient management and operating systems;
- Superior science – Using new technologies in processing to bring down cost and new products to enhance value of the product of the company.

Financial brief as of 31/12/Y-1

Total assets	CUR 69,728,267.97
Total current assets	CUR 5,296,909.84
Total fixed assets	CUR 64,431,358.13
Total liabilities	CUR 17,947,160.54
Total current liabilities	CUR 1,915,957.37
Total non-current liabilities	CUR 16,031,203.17
Bank loans	0
Total equity	CUR 51,781,107.43
Total sales	CUR 16,493,452.76
Net income	CUR 51,849.07

Business roadmap

Roadmap	Bringing down cost of production per kilo to enhance competitiveness and profitability	
Purpose of the loan	<p>The project involves upgrading the fish farm, which will involve the following:</p> <ul style="list-style-type: none"> • Upgrading the facilities to improve the production of saleable fingerlings from 4 million pieces to 12 million pieces per month • Conversion of the open spaces into fish pond and a test laboratory. <p>Artificial Incubation will enhance productivity and effectively reduce unit cost of fingerlings produced. Comparison between the existing technology and the upgrading to artificial incubation technology is as follows:</p>	
Particulars	With upgrading	Before upgrading
Fish hatchery production		
Fingerlings production/month	CUR 15 million	CUR 5 million
Survival rate	80%	50%
Effect of change in temperature	Minimal increase in mortality	Increase in mortality at a range between 10% to 30%
Number of employees	16 (4 additional for handling and delivery)	12

Project description

Detailed estimates of the project cost	The new technology will cost a total amount of CUR 28.62 million for fixed improvements and upgrading of the broodstock. Specific areas where the improvement are introduced and the specific costs thereof are as follows:		
Improvements and upgrading affecting the whole facility	Total cost	Cost sharing	
		Equity	Loan
Fencing and water treatment facilities upgrading	CUR 6,446,250	CUR 2,578,500	CUR 3,867,750
Upgrading of the artificial incubation and other hatchery facilities	CUR 18,173,377	CUR 7,269,351	CUR 10,904,026
Total project cost	CUR 24,619,627	CUR 9,847,851	CUR 14,771,776
Working capital	CUR 4,000,000	CUR 4,000,000	
Grand total	CUR 28,619,627	CUR 13,847,851	CUR 14,771,776
Sharing		48.39%	51.61%
Effects on the project financed	The upgrading of the hatchery can generate the necessary profitability and cash flows to service the obligation. In addition, the incremental effect of the upgrading and expansion can substantially enhance the overall financial performance of the company.		

Target markets

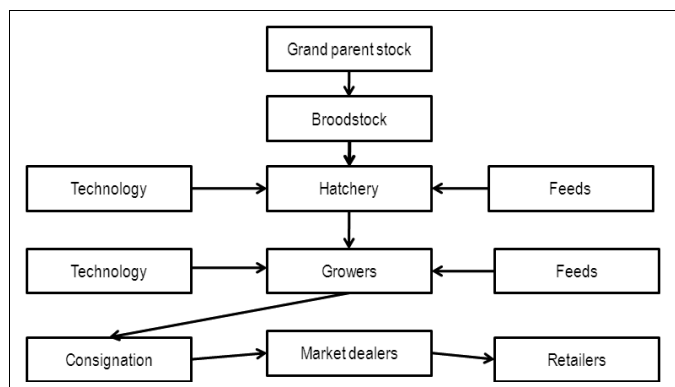
Marketing aspects

Product	Fish fingerlings with different sizes		
Marketing territory	Surrounding three regions		
Major customers of the company			
Name of customer	Quantity requirement	Supplied by company X	Percentage
1. Customer A	5,000,000	1,000,000	20%
2. Customer S	3,500,000	1,000,000	28.57%
3. Customer D	3,000,000	500,000	16.67%
4. Customer F	1,000,000	500,000	50%

Marketing strategy

Target market	Large buyers of the fish	
Pricing	Pricing dependent on supply/demand, currently at CUR 0.38 per kilo	
Promotion	Periodic sales visits to customers and potential customers. Attendance at trade shows	
Coverage	Focused on nearby areas	
Delivery	Company's vehicle	
After sales service	Regular communication with customers	
Production capacity	15 million per month	
Capacity utilization	80% to 90%	
Technology employed in the operations		
Area of operations	Company X technology	Traditional technology
Breeding	Artificial incubation	Fry collection
Tanks	With liner	No liners
Sex reverse	100%	Partial
Aeration	Blowers	None
Key success factors		
1. Water management	There is a need to manage the water parameters so that they are within the range that is beneficial to the productivity of the broodstock and the male and female parent fish. For the company to effectively manage water parameters, it is important to set up sea water intake, a laboratory and a large reservoir.	
2. Quality of broodstock	There is a need to maintain a large broodstock to enable the company to choose only the broodstock best fit for the reproduction process. There is also a need for continuing development of broodstock so that the broodstock with less than optimum productivity can be culled.	
3. Nutritional requirement and disease prevention	Company will add food supplement to enhance the nutritive value of the commercial feeds and probiotics to enhance food absorption and increase the resistance of the fish against stress.	
4. Optimum feeding and quality of feeds	Company will regularly test the quality of feeds purchased from suppliers. Feeding protocols will be strictly implemented.	

Production description



Input/Raw material requirement

Tabulation of the input/raw materials requirement

Particulars	Source	Other information
Broodstock	Internally developed	Company selects the best species from the grow-out
Natural food	Internally developed	Company has its own protocol for the development of natural food.
Commercial feed	Different suppliers	Company has stand-by generators

Labour requirement

	Number of employees
1. Production	37
2. Managerial	3
Total	40

Quality control system

Quality assurance takes two forms: First, there must be correct counting. Second, steps must be taken to insure that the fingerlings are healthy and free of parasites and diseases. For correct counting, company uses a counting process that is transparent and provides continuous training of people on accuracy in fingerlings counting. Through laboratory equipment, the company provides assurance on quality.

Operation strategy

Company aims for cost leadership through implementation of cost control measures and through technology innovations.

Without environmental manipulation²³, the hatchery is productive for only 8 months a year.

²³ Environmental manipulation is a process that aims at providing conditions that are sufficiently close to optimal or natural conditions to induce the majority of fish to complete maturation and spawning. Environmental manipulations can be used to achieve two purposes: 1. Adjust aspects of the naturally changing captive environment to ensure that fish proceed to maturation and spawning during the natural spawning season or 2. To provide the complete cycle of environmental changes required to induce the full cycle of maturation outside of the natural spawning season and thereby obtain out-of-season egg production. *Methods in reproductive aquaculture: Marine and freshwater species*, 2009.

Appendix VII

Loan documentation

Example of a pro-forma term loan agreement

This TERM LOAN AGREEMENT (the “Agreement”), by and between:

The _____, a government financial institution created and operating pursuant to the provisions of Executive Order No. ___ dated _____, as amended by Republic Act No. ___ dated _____, with address at _____ Makati City, Philippines, hereinafter referred as to the “**Lender**”.

– and –

Ms. _____, married to Mr. _____, (doing business under the trade name and style “_____ POULTRY FARM”), of legal age, Filipino, with residence and postal address at _____, Philippines, hereinafter referred to as the “**Borrower**”.

W I T N E S S E T H: THAT

WHEREAS:

1. The Borrower has requested the Lender to assist in the financing of the Project as defined in this Agreement.
2. The Lender, having been satisfied as to the feasibility and priority of the Project, has agreed to extend the Loan to the Borrower on the terms and conditions set forth in this Agreement.

NOW, THEREFORE, the parties hereto hereby agree, as follows:

ARTICLE I *Definitions; References, Headings*

Section 1.01. *Definitions*

The terms which are not expressly defined herein shall have the meanings ascribed to them in the “General Conditions Applicable to Term Loan Agreement under the Bank’s Retail Lending” (the “General Conditions”), incorporated herein as Annex “A”, and the following additional terms shall have the following meanings:

- a. “Advance” shall mean the advance by the Lender to the Borrower pursuant to Section 2.01 or, as the context may require, the amount of such advance from time to time outstanding.
- b. “Commitment” shall mean the principal amount of Pesos: _____ (**Php** – – – – –), or, as the context may require, the obligation of the Lender to lend up to such amount in accordance with the terms of this Agreement.
- c. “Commitment Period” shall mean the period from the date hereof to and including the earliest of (a) the date the Commitment is fully availed of by the Borrower, or (b) the date the Commitment is terminated or cancelled in accordance with the terms of this Agreement or (c) within one (1) year from date of advice of approval.
- d. “Interest Payment Date” shall mean the last day of an Interest Period.
- e. “Interest Period” shall mean the period commencing on the date of the initial Borrowing and having a duration of one (1) quarter, and each period thereafter commencing upon the expiry of the immediately preceding Interest Period and having a duration of one (1) quarter, provided, that (a) the first Interest Period with respect to a Borrowing subsequent to the initial Borrowing shall commence on the date of such subsequent Borrowing and shall end on the last day of the then current Interest Period as established above, and (b) if any Interest Period would, otherwise, end on a day which is not a Banking Day, that Interest Period shall be extended to the next succeeding day which is a Banking Day.
- f. “Loan Obligation” shall mean: (i) the aggregate principal amount of the Advances made by the Lender to the Borrower; (ii) all interests due on the Advances, including Capitalized Interests and Other Charges (CIOC); (iii) all fees, costs and expenses payable by the Borrower under the terms of this Agreement and such other agreements of the Borrower with the Lender; and (iv) all other obligations and liabilities of the Borrower to the Lender now existing or hereafter incurred either as a new loan or as extension, renewal or restructuring of the existing loan/s. The term shall include all advances made by the Lender for insurance premiums and realty taxes.

Section 1.02. *References*

Except where the context otherwise requires, references in this Agreement to Article or Section are to Article or Section of this Agreement.

Section 1.03. *Headings*

The headings of the Articles and Sections hereof are inserted for convenience of reference only and are not to be construed as modifying the substance of this Agreement.

ARTICLE II *The Loan*

Section 2.01. *Advance*

- a. The Lender agrees, upon the terms and subject to the conditions hereinafter set forth, to make the Advance to the Borrower during the Commitment Period in the aggregate principal amount up to, but not in excess of, its Commitment.
- b. The Advance shall be denominated in Philippine Pesos, (other currency) and Philippine Pesos shall be the currency of account, disbursement, and any payment to be made by the Borrower under this Agreement.
- c. The Loan shall be funded under any available funding program for SME projects.

Section 2.02. *Procedure for Borrowing*

- a. The Borrower shall deliver a Notice of Borrowing and a Certificate of Borrowing, substantially in the form of Exhibit “A” and Exhibit “B”, respectively, at least five (5) Banking Days (or such shorter period as may be agreed upon) prior to the date of any proposed Borrowing hereunder. Such Notice of Borrowing, once delivered to the Lender, shall be irrevocable and shall commit the Borrower to avail of the amount stated therein on the proposed date of Borrowing.
- b. Subject to the fulfillment of all applicable conditions set forth in this Agreement, the Lender shall make available the amount of the Advance not later than 11:00 a.m. on the proposed date of Borrowing specified in the Notice of Borrowing. All releases shall be subject to the Lender’s Operating Guidelines.

Section 2.03. *Use of Loan Proceeds*

The Borrower agrees that the proceeds of the Loan will be used to partially finance not more than eighty per cent (80%) of the acquisition/installation cost of a tunnel-ventilated climate control equipment system, the construction/retrofitting cost of a tunnel-ventilated building, and pre-operating costs (the “Project”).

Section 2.04. *Note*

Each Advance by the Lender shall be evidenced by a Note dated on the date on which such Advance is made and payable to the order of the Lender in the amount of such Advance, provided, however, that the maturity of all promissory notes shall coincide with the maturity of Note covering the initial drawdown.

Section 2.05. *Repayment*

The Borrower shall repay the Loan in seven (7) years, inclusive of the two (2) quarters grace period on principal, repayable in twenty six (26) equal quarterly installments to start at the end of the third (3rd) quarter from date of initial release.

Section 2.06 *Prepayment*

- a. Provided that the Borrower is not in default in payment of any sum due under this Agreement or under the Note, the Borrower may, at its option, prepay the Loan in part or in full, together with accrued interest thereon to the date of prepayment, and, if so required by the Lender under its approval, subject to the payment of prepayment penalty as provided in Section 2.06 (b) and to the following conditions: (i) each prepayment shall be made on an Interest Payment Date; (ii) the Borrower shall give the Lender written notice not less than thirty (30) days prior to such proposed prepayment, which notice shall be irrevocable and binding on the Borrower; (iii) each partial prepayment shall be applied against the repayment installments of the Loan in the inverse order of their maturity; and (iv) any amount prepaid may not be reborrowed hereunder.
- b. In addition to the conditions specified in Section 2.06 (a), the Borrower shall pay to the Lender a prepayment penalty equal to three per cent (3%) of the amount prepaid; provided, that in case of partial prepayment, the prepayment penalty shall be based on the portion of the outstanding principal prepaid.
- c. In the event of prepayment, the Gross Receipts Tax (GRT) shall be recomputed and the corresponding Statement of Account shall be issued and furnished the Borrower within one (1) week from date of full payment. The Borrower shall be billed separately for any deficiency tax or any applicable taxes computed on the pre-terminated accounts after the actual full payment, in view of changes in tax rates (GRT) when the repayment schedule is shortened.

Section 2.07. *Interest*

- a. The Borrower agrees to pay interest on the Advance based on the Lender's prevailing rate at the time of loan release plus one per cent (1%) minimum spread and the applicable premium for fixed rate depending on the fund source.
- b. If the Borrower fails to pay any principal or interest payable under the Note when due, or any sum payable by the Borrower under this Agreement (including, but without limitation, fees, charges, costs, and expenses), the Borrower shall, on demand by the Lender, pay a default charge at the rate of twenty four per cent (24%) per annum over and above the basic interest rate.
- c. All payments of interest pursuant to this Section shall be computed on the basis of a year of 360 days for the actual number of days elapsed (including the first day but excluding the last day) accruing to the period for which it is payable.
- d. Gross Receipts Tax (GRT) or any other applicable tax shall be for the account of the Borrower.

Section 2.08. *Payment*

- a. All payments to be made by the Borrower hereunder or under the Note shall be made in immediately available funds at the office of the Lender, not later than 11:00 a.m., Philippine time, on the relevant date when they are due (each such payment made after such time on such due date to be deemed to have been made on the next succeeding Banking Day).
- b. Any payment made to the Lender hereunder or under the Note shall be applied in accordance with the following order: (i) against costs, expenses and indemnities due hereunder; (ii) against default charge on advances; (iii) against advances; (iv) against default charge on past due interest and/or past due principal; (v) against past due interest; (vi) against past due principal; (vii) against current interest; and (viii) against current principal.
- c. Notwithstanding anything in this Agreement to the contrary, the Lender may apply any payment received from the Borrower or for its account to the payment of any or all existing accounts of the Borrower in the order of priority that the Lender may prescribe from time to time.

ARTICLE III *General Conditions*

Section 3.01. *Integration of General Conditions; Modifications*

The General Conditions, herein incorporated as Annex "A" with the additional condition and modification set forth below, constitute an integral part of this Agreement.

- a. A new section is added under Article III of the General Conditions as Section 3.02 (d), to read:
- b. "In case the Single Borrower's Limit (SBL) set by the Bangko Sentral ng Pilipinas (BSP) is exceeded at any time during the term of the Loan, the Lender shall have the right to require either to withhold the unreleased balances of the Borrower's loan or demand the prepayment of any portion thereof in order to bring the Borrower's outstanding balance within the SBL."

ARTICLE IV Particular Covenants

Section 4.01. *Security Document*

The following are specified to constitute the Security Document for the purpose of Section 5.01 of the General Conditions:

- a. A registered first real estate mortgage on one (1) parcel of land covered by TCT No. _____, of the land records for the Province of _____, registered in the name of the _____, married to _____, together with all the buildings and improvements existing or which may hereinafter exist thereon.
- b. Memorandum of Agreement between the Lender and _____.
- c. Assignment of Deposits with Hold Out equivalent to one (1) quarterly loan amortization.
- d. Endorsement in favor of the Lender of the insurance policy/ies covering the mortgaged assets, the insurance to be placed by the Lender through its appointed broker for the account of the Borrower.

Section 4.05. *Fees*

The following is specified as the fee payable by the Borrower to the Lender for the purpose of Section 4.01 of the General Conditions:

- a. A front-end fee of up to one-half of one per cent (0.5%) based on the Commitment, payable on or before the first Loan release.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their respective duly authorized signatories as of the day and year first written above.

DEVELOPMENT BANK OF THE PEOPLE

By:

Borrower

Senior Vice President **With my marital consent:**

SIGNED IN THE PRESENCE OF:

ACKNOWLEDGMENT

COUNTRY)

CITY) S.S.

Before me, this _____ day of _____ 2009, personally appeared:

Name	Comm. tax cert. No.	Place/Date issued

known to me and to me known to be the same persons who executed the foregoing instrument and who acknowledged to me that the same is their free and voluntary acts and deeds as well as those of the principal _____. represents. This instrument, which consists of six (6) pages, refers to a Term Loan Agreement with Exhibits A, B and C and Annex A consisting thirteen (13) pages, providing for a loan in the aggregate principal amount of Pesos: Php _____, and signed by the parties and their instrumental witnesses on each and every page thereof.

IN TESTIMONY WHEREOF, I have hereunto set my hand and affixed my notarial seal at the place and on the date first above written.

Doc. No. _____;

Book No. _____;

Page No. _____;

Series of 2009.

Checklist of requirements

The company

- Company background, corporate mission/vision, highlights of past achievements and/or corporate milestones
- SEC Registration/Articles of Incorporation (3 copies certified correct by Corporate Secretary)
- Board of Investments (BOI) Registration, if applicable
- Accomplished Customer Information Report (Form A)
- Accomplished Confidential Information Sheet by Principal Officers (attached form can be photocopied)
- Board Resolution authorizing the borrowings and designating the authorized signatories (include specimen signatures)
- Management and organization structure write-up
- Current members of the company's board of directors and senior executives with a description of their education and professional background

Operations

- Description of present operations to include facilities and system capacity
- Others _____

Financial aspect

- Financial statements for the last 3 years (Audited and In-house). Kindly detail components of cost of sales, operating expenses, fixed assets and depreciation
- Balance Sheet
- Income Statement
- Cash Flow
- Financial projections over the life of the loan, including detailed assumptions
- Diskette/CD/DVD copy of financial projections
- Hard Copy of financial projections
- Financial statements of related companies (affiliates and/or subsidiaries) for the last 3 years
- Others _____

Marketing aspect

- Present and projected demand and supply condition
- Position in the industry
- Copy of study by independent marketing consultants
- Discussion on target market
- Discussion of competition within and outside of the Country (i.e., in terms of comparable products, companies offering similar products, etc.)

- Marketing and sales strategies (method, pricing, sales terms, incentives, special arrangements, etc.)
- Copy of product purchase agreement/memorandum of understanding/contract, if any (to include profile of each company and expected sales volume)
- Others _____

The project

- Description of company's medium and long term plans
- Description of project to be financed including fund source and uses (amount of equity contribution and debt); timetable by phases, and current project status
- Copy of Supplier's Agreement/Contract/Memorandum of Understanding
- List of required government approvals and status of compliance (i.e., environmental clearance certificate, permit to sell, BOI/EPZA approval, etc.)
- Others _____

Collateral

- Proposed collaterals to be mortgaged with FI. In case of real estate mortgage
- Copy of TCT authenticated by the Register of Deeds
- Latest Tax Receipt
- Tax Declaration
- Standard Lot Plan with Vicinity Map, duly certified by a Geodetic Engineer, blue print, standard size. The vicinity map should show the name of street/s and distance from one point of the lot to the nearest street intersection or landmark
- Road right of way (if land is an interior lot) or document to show proof that the lot is with established access
- Appraisal Report of proposed collaterals by any of the FI-accredited appraisal companies
- Others _____

Credit/relationship with banks

- List of banks with current dealings with the company and its major shareholders
- Types of bank accommodations
- Others _____

Others

- Identified risks to which the project is sensitive to, and its proposed mitigants
- Developmental Impact Assessment – benefits of the project to the Philippine economy in general and to the specific location of the project in particular
- Others _____

Please note that during processing of your loan it may be inevitable that additional documents inherent to your project will be required. This will be promptly communicated to you by our Marketing Unit to avoid delay.

Model of a confidential information sheet

(For individual applicants, partners and corporate officers and/or principal)

Personal data

Name of individual	First name	Middle initial:	Surname:	Age:
Name of spouse	First name	Middle initial:	Surname:	Age:
Residence:			Tel No.:	
Business address:			Tel No.:	
Citizenship:		No. of children:	Number of still dependent:	
Other dependents			Relationship	
1.				
2.				
3.				

Educational attainment

	Applicant	Spouse
School/s attended and year		
Degree/s obtained		
Profession or trade		
Place and Date of birth		

Experience (Applicant)

Year	Position	Company	Salary	Investment

Experience (Spouse)

Year	Position	Company	Salary	Investment

Assets (Real Estate)

TCT/TD No. and location	Area and improvements	Income	Assessed value	Market value	Encumbrances

Other assets

TCT/TD No. and location	Area and improvements	Income	Assessed value	Market value	Encumbrances

Liabilities

Name and address of creditors	Amount	Date		Security	Balance	Remarks
		Granted	Due			

References

(Past credit dealings with banks, trade firms or private parties)

Note: Attach latest income tax return and personal balance sheet (If space is not adequate, use another sheet)

Interviewed by:

Date:

Applicant's Signature

Model of a customer's information report

Branch/Department

Name		Trade name					
Office address		Date established					
Plant address		Number of years in operation					
Business line							
OWNERSHIP/OFFICERS AND STOCKHOLDERS							
Legal status: <input type="checkbox"/> Single proprietorship <input type="checkbox"/> Partnership <input type="checkbox"/> Corporation							
Officers/Directors							
Partners/Major stockholders							
STOCKHOLDER'S EQUITY		Original	Present				
Capital							
Authorized							
Paid-up							
Retained earnings							
Surplus							
Revaluation surplus							
PRODUCT LINES							
Product(s)	% to total sales	Selling price/Unit	Quantity produced	Profit contribution			
				Gross pesos	%	Net pesos	%

Customer's information report

Branch/Department

Sales organization

Principal markets (state domestic/export, product/category, peso/dollar sales volume, regional/foreign distribution)					
a. Domestic:					
b. Export:					
Market share per product/ category:					
Principal customer (based on peso/dollar sales volume):					
Selling terms (COD, L/C, O/Q, 60, 90, etc. days credit):					
Method of distribution (wholesale/retail, no. of salesmen, dealers, distribution, branches, outlets):					
Competitors:					
Receivable level policy (No. of days /months level of annual sales, quarterly aging of receivables):					
SUPPLIERS					
Imported purchases				% to total purchases	
Local purchases				% to total purchases	
Major suppliers	Product	Peso/Dollar volume	% to total purchases	Purchase terms	Frequency/Amount of average purchase

Customer's information report

Branch/Department

INVENTORY POLICY (No. of days/months level of annual purchases)			
Finished products		Raw materials/Supplies	
Semi-products		Obsolete/Inventory for write-off (if any)	
Special arrangement with suppliers (exclusive distributionship, franchise, dealership, arrangements, etc.			
Restrictions/Availability of supplies			
PLANT FACILITIES			
No. of shifts		No. of employees	
Rated unit per shift		Actual unit capacity	
Owned		Machinery used	
Leased from			
FACILITIES			
Business cycle (purchase of supplies up to cash conversion) in terms of time			
Historical performance			
Latest available financial figure		Projections	
For financial year ending 20		For financial year ending 20	
Gross sales		Domestic purchases	
Net income		Imported purchases	
Gross sales		Domestic purchases	
Net income		Imported purchases	
Strategy (marketing, financial, etc.)			
During the period		Strategy (marketing, financial, etc.)	
EXPANSION PLANS (if any)			
Plant capacity		Sales network	
New products lines		Total cost	
		Source of financing	
Borrowing level plants			

Customer's information report

Branch/Department

CREDIT RELATIONSHIPS (Ranked as to size of credit facilities)						
Banks/Financial institution	Credit accommodation		Security/Guaranty			
COLLATERAL BUSINESS						
	Total		With FI		FI % share to total	
	Projected	Actual	Projected	Actual	Projected	Actual
P Deposits (ADB. 12 mos.)						
Foreign remittance business (\$)						
Import (\$)						
Export (\$)						
AFFILIATED COMPANIES AND RELATED BUSINESS						
Name	% ownership	Account with FI				
		H.O.	Branch	None		
		Date	Prepared by:	Noted by:		
		Signature over printed name		Signature over printed name		

Model of a credit proposal

Borrower name			CP date	CP No.
CREDIT EVALUATION SHEET				
I. Loan purpose:				
II. Background of business				
Principal officers:			Ownership structure:	
Position	Name	Age	Name of stockholder	% ownership
				%
				%
				%
				%
			TOTAL	%
Sources of revenue				
III. Management				
IV. Credit investigation	CIR date:		<input type="checkbox"/> No adverse findings	<input type="checkbox"/> With adverse findings
Exposures with other banks and FIs			Non-borrowing accounts with other banks	
BANKS/FIs	TOTAL EXPOSURE	EXPERIENCE	BANKS	DEPOSIT ADB
TRADE CHECK	Satisfactory dealings			
CMAP	No adverse findings			
NFIS	No adverse findings			

Credit proposal

Borrower name					CP date	CP No.			
V. Financials audited	(Specify auditor)	Unaudited	In-house	Reconstructed	Consolidated				
Financial highlights									
Date/Year	2006	2007	2008	Proj 2009	Date/year	2006	2007	2008	Proj 2009
Sales					Current ratio (x:1)				
Net income					D/e ratio (x:1)				
Current assets					Cashflow coverage (x:1)				
Total assets					Gross profit margin (%)				
Current liabilities					Net profit margin (%)				
Total lt liabilities					Financing gap days				
Total liabilities					Days receivable				
Equity/net worth					Days inventory				
C A D A					Days payable				
					Asset turnover (x:1)				
Borrower risk rating:					Satisfactory – with adequate debt service capacity within normal business cycle but with probability of default in case of disruptions to normal business cycle.				
Negative/declining indicators/ratios and threshold items are due to the following:									
VI. Market / industry/project risk:									
VII. Weaknesses / vulnerabilities									
Weaknesses:									
Vulnerabilities / worst case scenario:									
Remedies / risk mitigants / strategies									
Recommending approval:						Reviewed by			
Account officer date: _____			Sbd head date _____		Sbg head date _____		Csg date _____		

Glossary of terms

Account

A record of financial transactions for an asset or individual, such as at a bank, brokerage, credit card company, or retail store. More generally, an arrangement between a buyer and a seller in which payments are to be made in the future.

Accounts receivable (A/R)

Accounts for which payment is still to be received. These include invoices, bills, and promissory notes. Such items can be sold to a factor or used as collateral in securing a loan.

Accrued debts

Debts that have accumulated during a given period.

Administrative expenses

These are expenses that are not as easily associated with a specific function as are direct costs of manufacturing and selling. They typically includes expenses of the headquarters office and accounting expenses.

After sight

Term used in a bill of exchange to indicate the period for which the bill is to be calculated from the date the drawer presented it to the drawee for acceptance.

Amortization

The liquidation of a debt over a period of time.

Assets

In business and accounting an asset is anything owned, whether in possession or by right to take possession, by a person or a group acting together, e.g., a company, the value of which can be expressed in monetary terms. Assets may be classified in many ways. The principal distinction normally made for business purposes is between fixed assets and current assets. Fixed assets are purchases for continued and long-term use in earning profit in a business. Examples: land, buildings, machinery, etc. Current assets are assets continually turned over in the course of a business during normal business activity. Examples: accounts receivable, stock, cash and work in progress.

Back-to-back documentary credit

When an exporter obtains an ordinary documentary credit from the importer's bank, he can use this as security with his own bank. With this documentary credit serving as collateral, the exporter's bank can then issue a second documentary credit in favour of the exporter's suppliers.

Bad debt

An unpaid account that will likely remain uncollectible and be written off.

Balance sheet

An itemized statement that lists how much a business owns and owes at a given moment of time. It is called a balance sheet because the value of what the company owns must equal the total of its debts and net worth.

Bill of exchange

An unconditional written order by one party, the drawer, requiring another party, the drawee, to pay the drawer or a third party—the payee—a specified sum of money on demand or at a pre-determinable future date.

Bill of lading (B/L)

A document setting out the terms of the contract between the exporter of the goods and the carrier, under which the freight is to be transported from the port of shipment to that of destination. The B/L serves as a document of title, a contract of carriage and a receipt of goods. Its holder has the right to gain possession of the shipped goods.

There are two main types of B/L:

- 1) Straight bill of lading: a non-negotiable B/L, under which the goods are handed directly to the stipulated consignee.
- 2) Negotiable or Shipper's order bill of lading: This can be bought, sold or traded while the goods are in transit, or used to support a Letter of credit transaction. To take possession of the shipped goods, the final holder of the B/L needs the original or a copy as proof of ownership.

Bond

A debt issued for a period of more than one year. A bond investor is effectively lending money. The seller of the bond agrees to repay the principal amount of the loan at a specified time. Interest-bearing bonds pay interest periodically.

Budget

An estimate of the revenues and expenditures for a future a period of time, usually one year.

Business plan

A document prepared for the purpose of determining the technical feasibility (i.e., project is possible using a proper complement of specific methods and machines and equipment) and financial viability (i.e., will earn profit) of planned activities or business transactions.

Buyer's credit

A financial arrangement by which a bank, financial institution or export credit agency in the country of the exporter extends a loan, either directly to the foreign buyer of the exported goods, or indirectly through a bank in the buyer's country acting on his behalf. The credit is thus meant to enable the buyer/importer to make payments due to the supplier/exporter under the contract. It is typically a medium-to long-term loan.

Buying forward

The act of buying foreign currency for a future value date at a price quoted at the present.

Capital

Resources that will yield benefits and create wealth over time. The term is related to investments. It may be divided into physical and financial, fixed and working, etc.

Cash against documents

A collection procedure where the exporter asks its bank to forward the firm's shipping documents to the buyer's bank with instructions to release the goods upon payment of the invoice.

Cash flow

The flow of cash payments to or from a firm during a given period of time. Expenditures are sometimes referred to as "negative" cash flows.

Cash flow statement

A document that reflects the amount of cash that comes in (e.g., equity, loan proceeds, cash collection on receivables, sales, other revenues) and goes out (fixed capital expenses, production expenses, selling and administrative expenses, payment of dividends, etc.) of a business. It analyzes how much cash is needed and when that money is required by the business within a period of time.

When assessing the financial condition of a business, credit analysts consider the cash flow statement a better basis for judgment than the traditional income statements. The lender uses it as a basis for determining whether the borrower is in a position to repay the loan being applied for.

Central Bank

A central bank, reserve bank, or monetary authority is a banking institution granted the exclusive privilege to lend a government its currency. Like a normal commercial bank, a central bank charges interest on the loans made to borrowers, primarily the government of whichever country the bank exists for, and to other commercial banks, typically as a 'lender of last resort'. However, a central bank is distinguished from a normal commercial bank because it has a monopoly on creating the currency of that nation, which is loaned to the government in the form of legal tender.

Certificate of origin

A document stating the country where the export items originated.

Collateral

Asset pledged as security for a credit, lease or other commitment or liability and forfeited to the lender if the borrower fails to honour its obligation. They include marketable properties, such as real estate, chattel, stocks, and bank deposits.

Collection turnover

The average time it takes a business to receive payment for receivables.

Commercial bank

Privately owned financial institution that provides a wide variety of banking services, including trade financing, accepting savings and demand deposits, buying and selling foreign currency, and lending money against personal security or personal property.

Commercial invoice

A bill that reflects the transfer of goods from seller to buyer.

Consular invoice

A special form of invoice issued by the consulate of an importing country. This is often required by customs to confirm the country of origin.

Contract

A legally binding agreement between two or more parties.

Cost and freight (CFR)

A pricing term used in the foreign trade of goods through ocean shipment. It indicates that all the expenses for shipment and freight up to the port of destination are included in the quoted price of the goods. The cost of insurance however is left to the buyer's account. When the export is conducted through modes other than ocean shipment, the term used is Carriage paid to (CPT).

Cost, insurance, and freight (CIF)

Under this term, the price of the goods quoted by the seller includes the cost of insurance, transport and other miscellaneous charges sustained until the point of debarkation from the vessel. When the goods are transported through modes other than ocean shipments, the term used is Carriage and insurance paid (CIP).

Cost of production

The sum of the costs of materials, labour, and overhead that went into the manufacture of goods or fulfilment of a service.

Credit

This is another word for debt. Credit is given to customers when they are allowed to make a purchase with a promise to pay later. A bank gives credit when it lends money.

Currency

Refers to the money used in exchanges, which has an assigned value and is authorized by law.

Creditworthy

An entity in which the risk of default on a debt obligation is considered low.

Customer's deposit

The amount advanced by the buyer to the seller to finance the manufacture of the buyer's order.

Current assets

Valuable resources or property of a company that will be turned into cash within a year, or used up in the operation of the company within one year. They include cash, government bonds, marketable securities, notes and accounts receivable, inventories, and prepaid expenses.

Current liabilities

Any liability which must be honoured within one year (e.g.: dividends, taxes, accounts payable, payroll).

Debenture

A term indicating a fixed-interest bond secured against the issuing company's assets (these may consist either of specific assets of the company or of its assets in general). Debenture bonds are distinct from ordinary bonds, the latter being unsecured. Debentures will be paid whether the issuing company makes a profit or not and, in case of liquidation, debenture holders have priority over ordinary bondholders on the company's remaining assets. Debentures can be bought and sold on a stock exchange.

Debt

Duty or obligation to pay money, deliver goods, or render service. The use of debt to finance a firm's activity implies the repayment of principal and interests. Because the interest paid on debt can be written off as an expense, debt is normally the cheapest type of long-term financing.

Debt-to-equity ratio

The proportion, expressed in percentage, that indicates how much of the total company funds are supplied by creditors. This is determined by dividing total debt by total asset.

Default

Failure to pay loan interest or loan principal on schedule. When a borrower defaults on its loan obligation, its loan account is said to be delinquent or in arrears.

Deferred tax

A liability of a company resulting from income that has already been earned from an accounting perspective but is not yet considered for tax purposes.

Discount

The amount of money that is deducted from the face value of a negotiable instrument. It is expressed as a percentage of the face value of the instrument. The individual or institution that discounts negotiable instruments is called discounter.

Delinquency

Failure to make payment on a loan obligation on the due date.

Documents against acceptance

A form of payment for the exported goods. The shipping documents attached to a draft for a specific sum are sent to a bank or agent in the port of destination. The documents are released to the consignee when he accepts the draft.

Documentary credit arrangement

A method of financing trade whereby a bank (the issuing bank), acting on the request of a client, is instructed to pay, accept or negotiate drafts following certain terms and conditions stipulated in the draft.

Draft

A written agreement or order from one party (the drawer) to another (the drawee) to pay a specified sum to a third party or payee on a specific date.

Duty

A tax imposed by the customs authority of a country on imported goods.

- 1) Ad valorem duty: a duty calculated on the monetary value of the imported goods.
- 2) Specific duty: a duty calculated on the weight or quantity of imported goods, without any reference to their monetary value or market price.
- 3) Compound duty: a duty based on the combination of the goods' monetary value and other factors.
- 4) Drawback: the total or partial refund of a duty paid on imported merchandise at the time of re-exportation, where the exported goods may have the same form or a different form than at the time of import.

Encumbrance

A claim against a property held by another party. An encumbrance can take several forms: mortgages, claims by other parties, court judgments, pending legal action, unpaid taxes, restrictive deed or loan covenants, easement rights of the neighbours, or zoning ordinances.

An encumbrance usually impacts the transferability of the property. Also known as a lien.

Equity

In accounting:

Ownership interest or claim of a holder of common stock (ordinary shares) and some types of preferred stock (preference shares) of a firm. On a balance sheet, equity represents funds contributed by the owners (stakeholders) plus retained earnings or minus the accumulated losses

Net worth of a person or firm computed by subtracting total liabilities from the total assets. In the case of cooperatives, equity represents members' investment plus retained earnings, minus losses.

Escrow account

Accounts held in offshore banks, outside the country of a debtor, through which a portion of his export revenues are channelled in order to cover future debt-service payments. The beneficiaries of the escrow accounts are the creditors who will obtain extra security for their loans and priority in debt service.

Exports

Refers to all goods leaving a country that are properly cleared by Customs.

Export credit guarantee

An assurance usually provided by a government agency that safeguards banks against losses that could arise from financing export transactions. It therefore facilitates exporters' access to pre/post shipment credit from a banking institution and is thus a powerful incentive to exporting. It should be noted that export credit guarantees do not involve the actual provision of funds to exporters.

Export credit insurance

A policy to cover some of the riskier areas faced by exporters i.e., non-payment due either to insolvency of the importer (commercial risk) or political events (political risk). Export credit insurance is frequently mentioned in connection with export credit guarantees. While guarantees cover bank export loans, insurance policies are issued directly in favour of the exporters. In many developing countries this type of insurance is either not available or is too expensive.

Several types of export credit insurance are available. These differ from country to country according to the needs of the local business community. The most widely used types of export credit insurance include the following:

- 1) Short-term export credit insurance: generally covers credit periods not exceeding 180 days. Pre-shipment and post-shipment export stages are covered and protection may be provided against political and commercial risks.
- 2) Medium- and long-term export credit insurance: issued for credits extending for periods over 12 months. It provides cover for exports of capital goods, construction or special services.

- 3) Investment insurance: issued to companies investing in foreign countries. The Multilateral Investment Guarantee Agency (MIGA), affiliated with the World Bank, offers this type of insurance.
- 4) External trade insurance: applies to goods not shipped from the originating country. It is not available in a number of developing countries.
- 5) Exchange risk insurance: covers losses arising from the fluctuation of the respective exchange rates of the importer's and exporter's national currencies over a determined period of time.

Ex quay

A contract for the sale of goods wherein the exporter bears all the costs, consisting of duties, taxes, freight, and other charges, incurred in the course of delivering goods. It also includes the costs of loading and unloading goods from the quay at the port of destination to the road vehicles. The buyer assumes all subsequent charges.

Ex ship

An Incoterm that denotes the exporter's obligation to deliver the goods to the buyer at the named port of destination.

Ex works

A contract for the sale of goods wherein the exporter makes the goods available to the buyer at the exporter's premises.

Factor

A financial institution that purchases accounts receivable at a discount. The factor can administer the receivables, buy them outright, and advance cash payment before collection.

Factoring

A technique that allows businesses (including trading companies) to discount accounts receivables or other assets to obtain cash. In factoring, the accounts receivable or other assets are sold at a discount on a daily, weekly or monthly basis to a factoring house. Such an organization will assume title to the receivables or assets and will also bear all commercial and political risks connected with the transaction, without the right of recourse to the exporter in the event of default of the foreign buyer. In practice, the factoring house purchases the trade credits of its client and handles the collection on the receivables on its own behalf. Factoring may thus be a convenient option for firms without an effective collection department or which often discount their receivables. Factoring houses usually require that they handle a large percentage of an exporter's business. They tend to work with short-term receivables (up to 180 days), linked mostly to sales of consumer goods.

Feasibility study

A detailed examination of the comparative costs and benefits of a project proposed for funding. It ascertains the project's potential for commercial success before a loan is approved.

Financial viability

The earning capacity of a project to generate acceptable returns to equity holders and to service its debt on time and in full.

Finished goods inventory

Goods for sale that are held in stock.

Fixed asset

A term indicating tangible assets such as real estate, buildings, land, plant and machinery, bought by the firm for long-term use rather than for resale or immediate consumption. Increasingly, fixed assets include intangible assets such as patents, trademarks and customer recognition. Fixed assets are retained in the business for long periods and a portion of their original cost will be written off (amortised) against profits to reflect their diminishing value over time. In the firm's balance sheet fixed assets are therefore usually shown at cost, less depreciation charged to date. It should however be noted that certain fixed assets, such as property, can appreciate in value.

Forfait discounting

A method of discounting without recourse where the exporter sells its receivables to a forfaiter who takes over the risk of non-payment.

Free alongside ship (FAS)

An export contract that makes the seller responsible for the cost of delivering the goods to the quay at the port of shipment but not for the cost of loading them onto the ship.

Free on board (FOB)

Under this term, the price of the goods quoted by a seller includes transport, insurance and loading costs incurred until the merchandise is loaded on board the ship. The seller fulfils his obligations when the goods are boarded (i.e., have passed over the ship's rail) at the named port of shipment. The buyer has to bear all costs and risks of loss or damage arising from the point of loading. The term FOB can only be used for sea or inland waterway transport. When the ship's rail serves no practical purpose, such as in the case of roll-on/roll-off container traffic, the term "free carrier" is more appropriate. FOB values also serve as a reference for import and export valuation.

Freight forward

A shipment wherein the freight is payable at the port of destination.

Foreign exchange rate

The rate at which a unit of one nation's currency is converted into another nation's currency.

Foreign exchange risk

Probability of loss occurring from an adverse movement in foreign exchange rates. It can affect both importers and exporters as well as investors.

Front-end fees

Fees charged by financing institutions for the services rendered in assessing a loan application or opening the loan account. These fees are deducted from the loan proceeds upon disbursement.

Gearing

See debt-to-equity ratio.

Grace period

In the context of a loan, it is the period during which no repayments of principal (sometimes principal plus interest) are due from the borrower to the lender.

Green clause

A clause inserted in the letter of credit requiring the exporter to provide some form of guarantee, such as a warehouse receipt or warrant, evidencing existence of the goods being pledged in favour of the bank.

Guarantee

A promise or assurance by a person or institution to pay a loan in the event that the borrower fails to meet its obligation. With a guarantee cover, risks are minimized on the part of the lender.

Hedging

Activities undertaken to eliminate exposure or minimize losses that may arise as a result of fluctuations in foreign exchange rates.

Hurdle rate

The minimum return on investment necessary to cover all costs associated with a project. If the expected rate of return is below the hurdle rate, the project is abandoned or should be modified to increase return.

Import

All goods entering into the seaports or airports or by land from another nation properly cleared through Customs or remaining under Customs control, whether such goods are for direct consumption, for trading, for warehousing, or for further processing.

Incoterms

Incoterms or International Commercial Terms are a series of international sales terms, published by the International Chamber of Commerce (ICC). They standardize international trade practices, facilitate trade and minimize misunderstandings over commercial terminology and are therefore widely used in international commercial transactions. They divide transaction costs and responsibilities between buyer and seller. In particular, they define which parties incur the costs and at what specific point the costs are incurred.

Inspection certificate

A certification that attests to the specifications of the goods. The inspection is performed by an independent testing organization.

Interest

A charge paid by a borrower to a lender for the use of the lender's money. It is expressed as a percentage rate over a period of time.

Interest rate

The amount of interest charged for borrowing a particular sum of money over a specified period of time.

Insurance certificate

A document signed and issued by an insurance company stating the amount and type of insurance coverage.

Irrevocable letter of credit

See Letter of credit.

Just-in-time method

A manufacturing system that minimizes inventories by arranging that components and parts be delivered as they are needed in the production process.

Letter of credit (L/C)

A financial document issued by an issuing bank at the request of a buyer (applicant) to a seller (beneficiary), which guarantees payment to the seller if the terms and conditions specified in the L/C are fulfilled. It usually contains a brief description of the goods, the documents required, shipping date and an expiry date after which payment will no longer be made. There are different types of L/C, according to the level of security they grant the beneficiary (seller/exporter).

- 1) **Irrevocable Letter of Credit:** This can neither be modified nor cancelled without the agreement of all the parties concerned. The payment by the issuing bank is guaranteed provided that the beneficiary (seller/exporter) satisfies all the terms and conditions of the L/C.
- 2) **Revocable Letter of Credit:** This may be modified or cancelled by the issuing bank at any time and without notice to the beneficiary. However, payments or drafts negotiated within the terms of the credit before receipt of the revocation or amendment notice from the issuing bank remain validly binding for all parties. Negotiability is restricted to the advising bank and confirmation is usually not available. The revocable letter of credit gives maximum flexibility to the buyer but involves risks for the seller.
- 3) **Confirmed Irrevocable Letter of Credit:** A L/C in which the responsibility of another bank (the confirming bank, which is usually the same as the advising bank) has been added to that of the issuing bank, upon authorization or request of the latter. The confirmation represents a definite undertaking by the confirming bank, which obligates itself in the same manner as the issuing bank. It is used to back up the credit standing of the issuing bank and to mitigate risk by replacing a foreign bank risk with a domestic bank risk.
- 4) **Irrevocable Unconfirmed Letter of Credit:** A L/C which has been advised through an advising bank, acting as an agent of the issuing bank, without however assuming any responsibility towards the beneficiary except for taking reasonable care to check the apparent authenticity of the documentary credit which it advises.
- 5) **Revolving Letter of Credit:** A type of L/C issued only once and through which the money made available to the seller, after being drawn within a stated period of time, will again become available in the future, usually under the same terms and without another L/C being issued. This type of credit is used in connection with regular and ongoing purchases from a foreign supplier. Revolving L/Cs may be revocable or irrevocable, and the revolving element may be linked to time and/or value.
- 6) **Documentary Letter of Credit:** A L/C where the issuing bank stipulates that certain documents should accompany the draft. These documents assure the applicant (buyer/importer) that the merchandise has been shipped, is in good condition and that title to the goods has been transferred to the importer.
- 7) **Negotiable Letter of Credit:** A L/C issued in such form that it allows any bank to negotiate the documents.

Liability

An amount owed (i.e., payable) by an individual or entity for goods or services received, expenses incurred, assets acquired, and amounts received but not yet earned.

Lien

A legal claim against an asset that is used to secure a loan and must be removed before the property is sold. Also known as encumbrance.

Liquidity

A company's ability to meet its current obligations (or debts that must be paid within one year) using its current assets.

Line of credit

The commitment of a financial institution to a borrower to extend credits under certain conditions up to an agreed amount for a specified period of time, renewable at the discretion of the lender.

Loan

Money lent with interest.

Loans outstanding

The unpaid balance of loans as of a certain date.

Marketable

Fit for sale and in demand from buyers.

Market risk

The risk that the value of an investment will decrease due to moves in market factors. The four standard market risk factors are:

Equity risk, the risk that stock prices will change.

Interest rate risk, the risk that interest rates will change.

Currency risk, the risk that foreign exchange rates will change.

Commodity risk, the risk that commodity prices (e.g., corn, copper, crude oil) will change.

Mortgage

A long-term loan that involves the pledge of an asset, such as real estate, as collateral for the loan.

Negotiable instrument

A financial instrument that may be transferred from one owner to another without informing the original issuer. It provides evidence of the debt, and the holder of the instrument acquires legal title to the goods or property regardless of whether the previous holder had a defect in his title. Negotiable instruments include bank notes, bearer bonds, cheques, certificates of deposit, etc.

Open account

A means of payment whereby the exporter extends credit directly to the importer. The goods are delivered and payment is provided for at some specified future date, without the buyer issuing any negotiable instrument evidencing his legal commitment. The final payment by the buyer is via cheque or money transfer, with the bank's role being limited to moving the funds from the buyer to the seller. In some cases, the open accounts receivable may be discounted with a financial institution. An open account transaction requires the seller to have absolute trust in the integrity of the buyer, since the seller assumes all the risks of the transaction, as opposed to cash in advance. Open account is thus common in markets characterized by long-standing commercial relationships between the two parties.

Opportunity cost

Potential benefit that is lost or sacrificed when the selection of one course of action makes it necessary to forgo a competing course of action.

Packing list

Sometimes called the manifest, it is an enumeration of the contents of a particular pack or crate indicating the quantity, weight and measurements of the contents.

Payback period

The length of time required for the recovery of an investment or a loan.

Pledge

A item of value that is given or held as security for the fulfilment of a debt or obligation.

Post-shipment finance

Credit covering the company's financial needs for the period following the shipment, to ensure sufficient liquidity until the shipped products have reached the purchaser and payment has been received. Post-shipment financing is generally of a short-term nature (less than twelve months).

Post-dated check

A check bearing a date in the future that can only be cashed on or after that future date.

Pre-shipment finance

Financing advanced to the exporter to support the costs of activities undertaken prior to shipment of the goods (i.e., purchase of inputs and components, payment of salaries, wages and overhead, etc.) and to provide it with additional working capital. Pre-shipment financing may take the form of a short-term loan, an overdraft, a cash credit, etc.

Preferred shares

Shares of a company that have some priority over the other shares in terms of the payment of dividends or the distribution of assets upon liquidation.

Prepaid expense

Goods or services that are paid in advance.

Prepayment

The payment of all or part of a debt prior to its due date.

Principal

In lending, the total amount of money being borrowed or lent, on which interest payments are calculated.

Profit and loss statement

A financial statement that summarizes the revenues, costs and expenses incurred during a specific period of time – usually a fiscal quarter or year. These records provide information that shows the ability of a company to generate profit by increasing revenue and reducing costs. The P&L statement is also known as a “statement of profit and loss”, an “income statement” or an “income and expense statement”.

Promissory note

An unconditional written promise, issued and signed by the debtor, to pay on demand or at a fixed or determinable future date a stated amount of money to the order of a specified person or to the note's bearer. Promissory notes are transferred by endorsement.

Receivable

The money owed by customers to a business that the business expects to collect on some future date.

Red clause

A clause (originally typed in red) added to a letter of credit authorizing the advising/negotiating bank to make an advance payment to the beneficiary (exporter) before the actual shipment to the buyer. The advance may be up to 100% of the export contract value and may be used by the exporter to buy the inputs for manufacturing or shipment. Red clause credits are used primarily when the buyer (importer) has an agent in the exporting country. To finance its purchases, the importer may arrange for the opening of a red clause letter of credit. Negotiations of red clause credits are limited to the bank making the advances in order to assure that revenues from the shipment are used to repay the advances made.

Rescheduling

The process of drawing up a new principal repayment schedule, thereby readjusting the terms of the loan, either by a reduction of interest rates and/or an extension of the duration of the loan.

Restructuring

The combined process of rescheduling and converting all or part of the existing loan into another type of financing facility.

Return on equity

The percentage of earnings on the capital invested by the owners.

Revocable letter of credit

See letter of credit.

Revolving facility

A credit facility that allows a company to finance its current needs by borrowing from the bank, on a short-term basis, up to a certain specified maximum amount. The borrower is privileged to borrow, repay, and borrow again during the specified period.

Risk

It can be defined as "the threat or probability that an action or event will adversely or beneficially affect an organization's ability to achieve its objectives". In simple terms risk is 'uncertainty of outcome', either from pursuing a future positive opportunity, or an existing negative threat in trying to achieve a current objective.

Security

- 1) Financing or investment issued by a firm or government agency that denotes an ownership interest and provides evidence of a debt, a right to share in the earnings of the issuer, or a right in the distribution of a property. Securities include bonds, debentures, notes, options, shares (stocks), and warrants but not insurance policies, and may be traded in financial markets such as stock exchanges.
- 2) Collateral used to guarantee repayment of a debt.

Self-liquidating

Providing enough income to pay off the amount borrowed from financing.

Selling forward

The practice of selling foreign currency for a future value date at a price that is fixed and quoted at the present.

Short-term loan

A loan that comes due in one year or less.

Supplier's credit

A financing arrangement under which an exporter extends credit to a foreign importer to finance its purchase. Usually the importer pays a portion of the contract value in cash and issues a promissory note or accepts a draft as evidence of his obligation to pay the balance over a period of time. The exporter thus accepts a deferred payment from the importer, and may be able to obtain cash payment by discounting or selling the draft or promissory notes created with his bank.

Telegraphic transfer

A means of remitting money where the bank, at the request and risk of its customer, sends a cable with the necessary particulars to its foreign agent who will act on the instructions. The transfer is usually made in the currency of the payee's country.

Trade credit

Credit given by the supplier to the purchaser. Compared to a bank loan, a trade credit is easier to arrange and is often the cheapest form of credit for the buyer since it is based primarily on mutual trust and interest.

Transferable documentary credit

A documentary credit where the seller allows the paying bank to pay all or part of the proceeds of the sale to another beneficiary.

Unsecured

A situation when the lender has no security other than a legally enforceable commitment by the borrower to repay the loan.

Working capital

The difference between a company's *current assets* and *current liabilities*. It is the capital needed to finance the operating cycle of a business (e.g., pay employees, suppliers, tax authorities, etc). More precisely, it is the part of the current assets that are not financed by the resources generated by the operating activities.

Yield

The income produced by an investment. This could be expressed as a percentage and can be paid at fixed intervals (yearly, semiannually or quarterly).

- 1) **Current Yield:** The ratio of the coupon (interest) to the market price of a security. It is expressed as a percentage and neither the maturity nor the number of interest payments made are taken in consideration.
- 2) **Yield to Maturity:** The percentage rate of return paid on a bond, note or other fixed income security which is purchased and held up to its date of maturity. This is calculated on the basis of the coupon rate, the length of time to maturity and the bond's market price. It is assumed that the coupon interest paid over the life of the bond will be reinvested at the same rate.

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