Advance Global Capital

Receivables Finance in Emerging Markets

How financial innovation can enhance social and economic development




Executive Summary

Andy Davis and Peter Chen
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In the White Paper, the authors examine the use of factoring and related services to finance cross-border trade between the Emerging and Developed Markets, and assess its potential to strengthen SMEs in Emerging Markets while providing attractive returns to those that invest in this alternative asset class.

For the full paper, please contact Advance Global Capital at info@advanceglobalcap.com

About the Authors

Andy Davis is a UK-based writer on investment, finance and business. He spent 15 years as a journalist on the Financial Times, where he held a series of senior roles including Development Editor and most recently editor of FT Weekend. Andy writes for a range of newspapers and magazines and is the author of several research reports on alternative sources of finance for small businesses including the first Beyond the Banks report, published by the National Endowment for Science, Technology and the Arts; Seeds of Change, published by the Centre for the Study of Financial Innovation; and innovations in Access to Finance for SMEs, published by the Association of Chartered Certified Accountants' Global Forum for SMEs. He is associate editor and investment columnist for Prospect, the monthly current affairs magazine, and in May 2012 was named Personal Financial Journalist of the year in the Wincott Awards on the strength of his columns for Prospect.

Peter C. Chen is a doctoral student in Finance at the University of Chicago, Booth School of Business. His primary fields of interest are international finance and asset pricing with asymmetric information. Prior to attending Chicago Booth, Peter was a research fellow at the McKinsey Global Institute (MGI), the research arm of the consulting firm. At MGI, his research focused on the movements of global financial markets and the influences to the regional economies. Before joining McKinsey, Peter was a research assistant at the Federal Reserve Board of Governors, where he facilitated staff economists in maintaining macroeconomic models and policy making. He received his BA in Mathematics and MA in Economics from the University of California, Los Angeles.

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The global market in trade receivables finance encompasses a variety of related services – the most familiar of which is Factoring – that are founded upon a central concept: that one can accelerate the flow of cash to companies that supply goods and services to corporate and public-sector customers by advancing short-term funding backed by these suppliers' outstanding invoices. This enables companies with weak credit ratings to access funding based on the value of their receivables and (in some cases) the credit rating of their end-customers, rather than on basis of their own balance sheet strength.

Although the transactions can be structured in different ways, in their most basic form a supplier that has issued an invoice will either pledge or sell it outright to a finance provider for an agreed percentage of its full face value and in return will receive immediate funding up to that level. This provides a rapid injection of working capital for the supplier that enables it to finance its ongoing operations without having to await final settlement of the invoice by its end customer, which frequently takes 90 days or more.

The financing of cross-border trade receivables is now the fastest growing form of trade finance, easily outstripping growth in more traditional form such as Letters of Credit. Between 2008 and 2012, cross-border factoring showed compound annual growth of 16.8% a year, while separate figures show that other forms of cross-border trade finance, including Letters of Credit, grew 1.2% between the same period (see Figure 1).

The potential for [trade receivables finance] to grow is therefore very significant indeed since it has very low penetration of a very large pool of potential assets.

The reasons for this shift include changes in bank regulation that make traditional forms of trade finance such as letters of credit more capital intensive to provide because they involve bank-to-bank exposure, as well as the shrinking of balance sheets among European banks, formerly leading providers of trade finance globally.

Although a huge market, worth more than $2.8 trillion a year, distribution of receivables finance around the world is very uneven and is overwhelmingly concentrated in developed markets. Many emerging markets have little or no access to working capital via factoring or other forms of invoice finance. There is a widespread lack of access to this form of finance in emerging markets, where services such as these could have hugely beneficial effects in terms of social and economic development. Africa and South Asia are prime examples of this. Therefore we observe a big overlap between the least developed countries and those that have little or no access to receivables finance as a means of financing working capital.

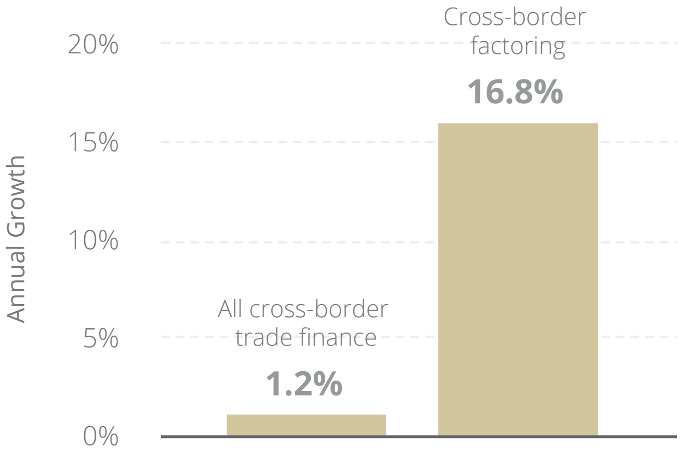
If factoring in emerging markets were to rise to the global average of 4.18% of GDP, market turnover in emerging markets excluding China could be expected to increase from $292 billion in 2012 to over $533 billion (see Figure 2).

The absence of this type of funding is usually attributed to a paucity of credit information on debtors and borrowers in emerging markets, as well as doubts over the legal framework for this type of transaction. However, these need not be obstacles to reverse factoring or supply chain finance (SCF), where large, established companies, ultimately domiciled in the developed world, approve invoices from their SME suppliers for payment and these "approved payables" are then financed at a discount by banks or non-bank finance providers. In this case, credit information on the debtors is freely available and investors can readily assess their credit risk exposures.

Figure 1

Cross-border trade receivables is the fastest growing form of trade finance

Annual growth between 2008 and 2012



Source: Factors Chain International

The opportunity to advance lending secured by high quality receivables offers one of the best ways to improve these small companies' access to finance and so their ability to expand and create jobs and social wellbeing.

Conventional SCF is predicted to grow very quickly over the remainder of this decade, with annual growth rates of up to 40% expected. In practice, however, SCF programmes tend not to penetrate very far down supply chains due to the difficulties of putting such programmes in place. Therefore, alternative methods are needed to bring the benefits of SCF to smaller suppliers. Notably the Cadenas Productivas programme run by Nafin in Mexico, clearly demonstrates how this technique can be used to increase SME access to finance, particularly when it can be delivered via a secure and easy-to-use technology platform.

Research by the International Finance Corporation (IFC) found that although very significant trade flows from emerging markets were suitable for "reverse factoring" because the ultimate end-debtor was an "investment grade" company domiciled in an OECD country, very little of this trade was in fact financed via reverse factoring. For example, just 5 per cent of the $20 billion of suitable exports each year from Turkey went through a SCF programme.

In markets where the financial system remains under-developed and SMEs' access to collateral to secure their loans is limited or non-existent, the opportunity to advance lending secured by high quality receivables offers one of the best ways to improve these small companies' access to finance and so their ability to expand and create jobs and social wellbeing. The ability to address a larger social and developmental agenda by encouraging the adoption of this form of trade finance represents one of its most important potential benefits.

The opportunity therefore exists to provide an innovative financial product that can bring benefits both to SMEs and to their larger corporate customers. SMEs gain more rapid access to cash flow, while their large customers can ensure their supply chain is better financed and at the same time improve their own working capital position by extending their payment terms.

Finally, investors that allocate capital to a well-diversified portfolio of cross-border trade receivables of this kind can reasonably expect attractive rates of return coupled with relatively low levels of risk exposure. Trade receivables finance represent an asset class with a number of attractive characteristics:

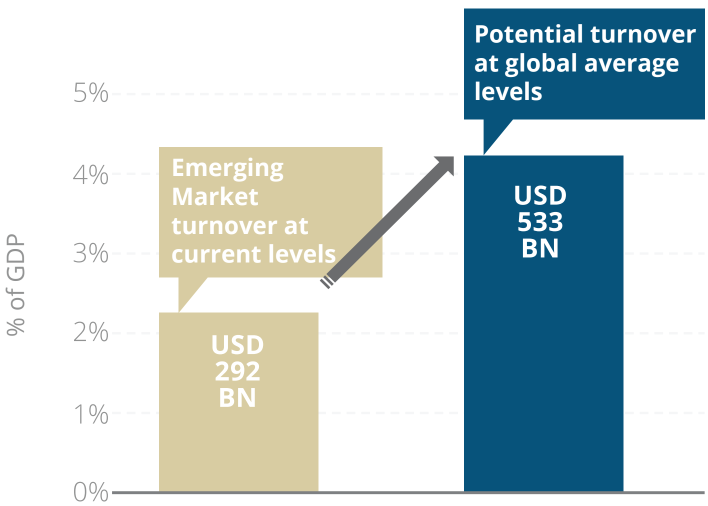
- Low levels of correlation, even during periods of financial crisis, with other more traditional asset classes
- Low levels of loss on default (significantly below 0.5% even through the worst periods of the financial crisis), thanks to the balance sheet strength of the large corporate customers to whom these invoices are issued
- Very significant capacity for the asset class to expand, particularly in emerging markets. This is both because of the low current penetration of receivables finance in these markets and because of the likelihood that volumes of cross-border trade from these markets will grow significantly as their economic development proceeds.

Trade receivables finance represents an asset class that offers attractive, consistent and uncorrelated returns at modest levels of risk.

Figure 2

Potential size of market for emerging markets trade receivables finance

Total turnover of emerging markets, excluding China (2012)



Source: AGC estimates

About Advance Global Capital

Advance Global Capital (AGC) is an international firm founded in 2012. We specialise in alternative investments which not only deliver attractive financial returns, but demonstrate significant social and economic impact.

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