USAID
FROM THE AMERICAN PEOPLE

FS SHARE
FINANCIAL SECTOR KNOWLEDGE SHARING

# FS SERIES #4: ENABLING SMALL- AND MEDIUM-SIZED ENTERPRISE ACCESS TO FINANCE

## PRIMER, DIAGNOSTIC CHECKLIST, AND MODEL SCOPE OF WORK

**SEPTEMBER 2009**

This document was produced for review by the United States Agency for International Development. It was prepared by Chemonics International Inc. for the Financial Sector Knowledge Sharing Project, delivery order number EEM-E-03-05-00006-00.

# FS SERIES #4: ENABLING SMALL- AND MEDIUM-SIZED ENTERPRISE ACCESS TO FINANCE

## PRIMER, DIAGNOSTIC CHECKLIST, AND MODEL SCOPE OF WORK

The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

# CONTENTS

Acronyms ........ i
Introduction ........ ii
Executive Summary ........ iii

Primer ........ 1

A. Importance of SMEs in Emerging Markets ........ 1
- A1. Definition and Role of SMEs ........ 1
- A2. Distinctive Challenges of SME Access to Financing ........ 2
  - A2a. General Challenges of SME Financing ........ 2
  - A2b. Special Problems Associated with Lending to SMEs in Emerging Markets ........ 3
- A3. Sources of Finance ........ 4
- A4. Capital Markets ........ 6
  - A4a. Public Capital Markets ........ 6
  - A4b. Private Capital Markets ........ 7
- A5. Traditional Bank Lending ........ 8
  - A5a. Traditional Bank Lending: Assessing SME Credit Risk ........ 9
  - A5b. Overdraft Financing and Term Loans ........ 10
- A6. Asset-Based Finance ........ 10
  - A6a. Accounts-Receivable Finance ........ 11
  - A6b. Warehouse Receipts ........ 11
  - A6c. Factoring ........ 13
  - A6d. Purchase-Order Finance ........ 15
  - A6e. Leasing ........ 17
- A7. Guarantees, Including USAID DCA Guarantees ........ 18
- A8. Designing Demand-Driven Programming ........ 20

B. Case Studies ........ 21
- B1. Case One: Purchase-Order Finance in Bolivia ........ 21
- B2. Case Two: DCA Loan Guarantees to Promote SME Lending in Kenya ........ 24
- B3. Case Three: The Agricultural Cooperative Bank of Armenia Leasing Company ........ 27
- B4. Case Four: An Innovative SME Fund in Macedonia ........ 31

Annexes
- Annex A. SME Finance Diagnostic Checklist ........ 34
- Annex B. Model Scope of Work ........ 36
- Annex C. Glossary ........ 53
- Annex D. Bibliography ........ 58

## ACRONYMS

| | |
|---|---|
| A/R | accounts receivable |
| ACBA | Agricultural Cooperative Bank of Armenia |
| ADB | Asian Development Bank |
| AfdB | African Development Bank |
| ARCo | Rural Competitiveness Activity |
| ASME | Agribusiness SME Market Development Program |
| BDS | business development services |
| BEI | Business Environment Index |
| BG | bond guarantee |
| CAMEL | capital, assets, management, earnings, and liquidity |
| CMS | Credit Management System |
| COTR | contracting officer's technical representative |
| DCA | Development Credit Authority |
| EBRD | European Bank for Reconstruction and Development |
| EGAT | Bureau for Economic Growth, Agriculture and Trade |
| EU-TACIS | European Union's Technical Aid to the Commonwealth of Independent States |
| FSD | Financial Sector Deepening |
| IDB | Inter-American Development Bank |
| IFC | International Finance Corporation |
| IFI | international finance institution |
| IPO | initial public offering |
| KARF | Kenya Access to Rural Finance |
| KCB | Kenya Commercial Bank |
| KCBS | Kosovo Cluster and Business Support |
| KEMCAP | Kenya Microfinance Capacity Building Program |
| LLC | Lebanon Leasing Company |
| LPG | loan portfolio guarantees |
| MBRC | Macedonian Business Resource Center |
| MSME | micro-, small-, and medium-sized enterprise |
| MSOW | model scopes of work |
| NBFI | non-bank financial institution |
| NGO | nongovernmental organization |
| NPL | non-performing loan |
| POF | purchase-order finance |
| PPP | public-private partnership |
| SBEF | Superintendency of Banks and Financial Institutions |
| SEED | Support for East European Democracy |
| SME | small- and medium-sized enterprise |
| SOW | scope of work |
| TA | technical assistance |
| USG | United States government |
| VAT | value-added tax |
| WHR | warehouse receipt |

# INTRODUCTION

The United States Agency for International Development (USAID) Bureau for Economic Growth, Agriculture and Trade (EGAT) created the Financial Sector Knowledge Sharing Project (FS Share) to collaborate with USAID missions to develop effective and efficient financial-sector programs that increase access to financial services and develop well-functioning markets worldwide. USAID awarded Chemonics International, Inc. the FS Share delivery order under the Financial Sector Blanket Purchase Agreement. FS Share has a three-year period of performance, July 2008 through July 2011.

Through the FS Share Task Order, USAID EGAT and Chemonics proactively collaborate with missions to identify financial-sector priorities and develop strategies and programs for growing the financial sector. FS Share identifies financial-sector best practices and aggregates them through model scopes of work (MSOW), primers, diagnostic tools, best-practice case analyses, and other tools. These deliverables are disseminated to USAID missions for use in financial-sector programs. FS Share can assist with implementation and connect mission staff to external resources on best practices. In response to mission demand, FS Share delivers presentations and other knowledge-sharing endeavors.

### Objective of This FS Series

The objective of this FS Series is to provide U.S. government (USG) program designers with a basis of technical understanding of approaches to enable access to financing for small- and medium-sized enterprises (SMEs) in emerging markets. The FS Series includes a Primer, Diagnostic Checklist, and a Model Scope of Work. The Primer identifies the challenges that SMEs face in accessing finance and discusses financing solutions available to them, including traditional bank-lending approaches and more progressive asset-based financing techniques. The diagnostic checklist is designed to assist USG programmers with evaluating the preconditions and options available to enable access to financing for SMEs. Finally, the model scope of work in Annex B provides sample language to integrate into effective programming.

This FS Series was developed by FS Share consortium member Crimson Capital, with input from ShoreBank International Ltd. The Series was reviewed and edited by Chemonics International.

### FS Share Rapid Response Hotline

For assistance identifying resources and addressing questions about SME finance, contact FS Share Project Manager Roberto Toso at 202-955-7488 or rtoso@chemonics.com, or Deputy Project Manager Melissa Scudo at 202-775-6976 or mscudo@chemonics.com.

To access the FS Share task order and EGAT assistance on any mission financial-sector program, scope of work (SOW), or procurement questions, contact:

| | | |
|---|---|---|
| FS Share COTR: William Baldridge | wbaldridge@usaid.gov | 202-712-1288 |
| FS Share Activity Manager: Mark Karns | mkarns@usaid.gov | 202-712-5516 |
| FS Share Activity Manager: Christopher Barltrop | cbarltrop@usaid.gov | 202-712-5413 |
| FS Share Activity Manager: Anicca Jansen | ajansen@usaid.gov | 202-712-4667 |
| Supervisory Team Leader: Gary Linden | glinden@usaid.gov | 202-712-0128 |
| EGAT/EG Office Director: Mary Ott | mott@usaid.gov | 202-712-5092 |
| Contracting Officer: Kenneth Stein | kstein@usaid.gov | 202-712-1041 |

# EXECUTIVE SUMMARY

Analysts and policymakers increasingly recognize the importance of SMEs in economic development. SMEs are critical because they account for large shares of total output and employment, and are especially important for the strategic objective of overcoming poverty.

SMEs frequently identify inadequate access to finance as a major impediment to investment and growth. The objective of this primer is to provide recommendations on how SMEs in emerging markets can improve their access to financing. This primer discusses the challenges that SMEs face in gaining access to finance and the opportunities for overcoming these obstacles in order to make finance more readily accessible in developing countries.

After discussing capital markets and traditional banking, the primer demonstrates how innovative financing techniques (e.g., factoring and leasing) can be used to make credit available to companies that have good potential but have difficulties accessing traditional bank financing. A common characteristic of these techniques is that the provider of finance relies less on collateral and historical performance and more on claims against a company's specific short- and medium-term assets and the future cash flows that these assets will generate from business activities. These techniques can often be used in environments where traditional credit products have inadequate or limited utility for a large number of SMEs.

The primer then considers how USAID Development Credit Authority (DCA) credit guarantees can be used to enlarge SME access to finance. To date, DCA guarantees have been useful in encouraging banks and other financial institutions to lend to SMEs in emerging markets. Additionally, guarantees can play an expanded role in increasing SME access to asset-based[1] finance.

In the second part of the primer, we present four case studies that illustrate ways in which financing techniques, including DCA guarantees, have been used in emerging markets. The cases are purchase-order finance (POF) in Bolivia; DCA guarantees in Kenya; leasing in Armenia; and an innovative SME finance fund in Macedonia.

A diagnostic checklist on SME finance is provided in Annex A. It is intended to give programmers a quick reference of SME finance options. Annex B provides a model scope of work (MSOW) for undertaking a comprehensive analysis of SME finance markets in a specific USAID-assisted country.

---

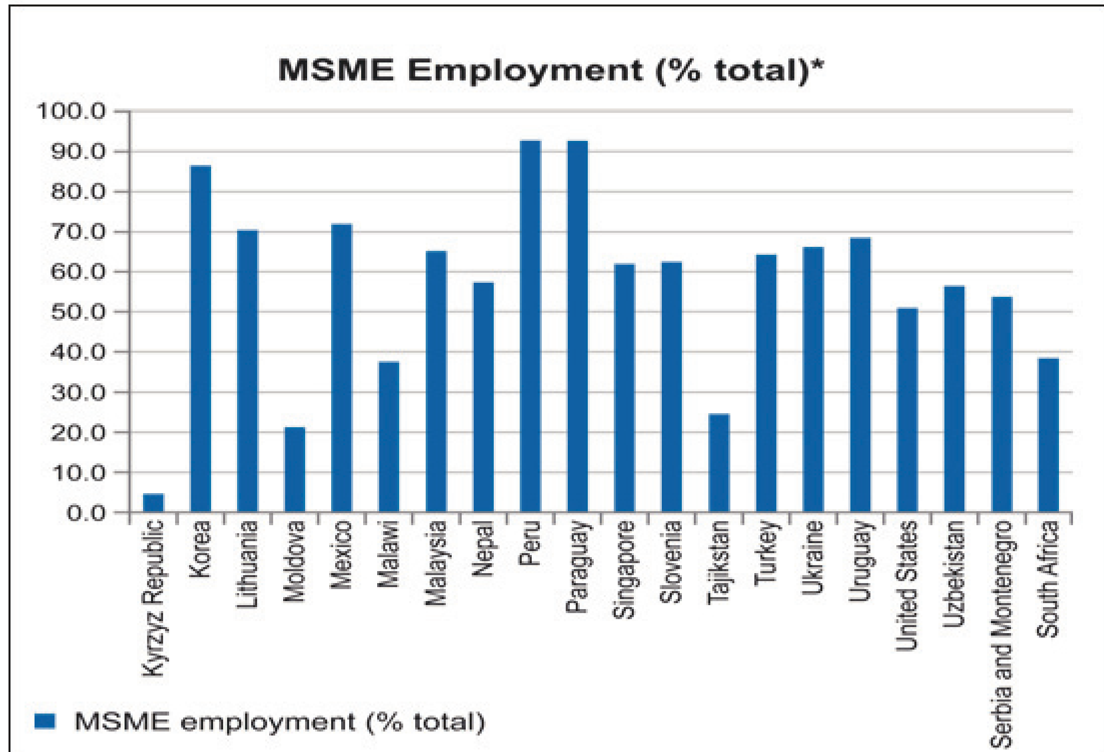
[1] Asset-based finance is a specialized type of financing that provides structured working capital and term loans secured by an "asset" such as a purchase order, contract, accounts receivable, invoice, letter of credit, inventory, machinery, or equipment (and in some cases, real estate). Asset-based finance is discussed further in Section A6.

# PRIMER

## A. Importance of SMEs in Emerging Markets

### A1. Definition and Role of SMEs

Analysts and policymakers increasingly recognize the importance of SMEs[2] in economic development (Beck, Demirgüç-Kunt, and Peria, 2008; Organization for Economic Cooperation and Development [OECD], 2006, p. 9). SMEs are critical because they account for large shares of total output and employment and are thus key to the strategic objective of overcoming poverty. A 2007 World Bank survey found that for 76 developed and developing countries, SMEs accounted for the largest number of companies and, in most countries, more than half of all non-agricultural employment and close to 60 percent of manufacturing employment (Beck, Demirgüç-Kunt, and Peria, p. 3).




The graph depicts microenterprises and SME employment as a percentage of total employment in 16 countries — a breakout for SMEs only was not disaggregated. Compiled using data from Kozak, 2007.

---

[2] There is no universally accepted definition of SMEs based on specific criteria (e.g., number of employees). SMEs are generally considered to have a maximum of 250 employees (with a smaller number in Africa). According to Gibson (2008, pp. 18-29), definitions of SMEs should be adjusted to the size of their home country's national economy and, further, should be based upon functional attributes rather than size. The dividing lines between SMEs and large enterprises, and between SMEs and microenterprises, are discussed further in Annex B, MSOW.

### A2. Distinctive Challenges of SME Access to Financing

Inadequate access to finance is frequently identified as a serious impediment to SME growth (OECD, 2006, p. 10; Bakker, Klapper, and Udell, 2004, p. 7). SMEs in emerging markets have difficulties gaining access to the formal financial system (i.e., banks and capital markets). The formal financial system may mobilize sizable volumes of domestic savings, but these are generally channeled to other sectors of the economy, such as larger enterprises, governments, or government-affiliated enterprises.

#### A2a. General Challenges of SME Financing

Virtually all governments, international organizations, and donors assign a high priority to the SME sector and to facilitating SME access to finance. Nevertheless, the record of actually expanding access to finance has been mixed in all countries. This is partly because the financing of SMEs presents specific challenges for prospective financiers,[3] who must make special efforts to operate in this market segment.

First, SMEs have a much higher rate of failure than larger firms (Evans, 1987, pp. 657-674). Numerous studies show that the variance of profitability and growth decreases with size. Financiers can minimize losses by dealing with larger and more established firms. SMEs are also typically more opaque than larger companies.[4] SMEs usually do not produce audited financial statements that yield credible financial information and have no obligation to make public disclosure. In smaller enterprises, the line of demarcation between the personal finances of the owner(s) and the business is usually blurred (e.g., automobiles and homes used for both personal and business purposes and the use of family labor within the business). Moreover, unlike established public companies, which are expected to observe standards of corporate governance with clearly defined roles for shareholders, managers, and other stakeholders, SMEs tend to reflect the idiosyncrasies of their owners and their informal relationships with stakeholders. Finally, the risk of the principal/agent dilemma,[5] which is inherent in all financing operations, is particularly acute with SMEs (OECD, 2006, p. 19).

In addition to these risks of SME lending, many financiers consider it to be more costly — and therefore less profitable — to lend to SMEs. Financiers often state that it takes about the same amount of time and resources to source, evaluate, approve, and monitor a loan to an SME as it does to a large company. However, because the loans are smaller,

---

[3] In this primer, the term "financier" refers to any entity that provides financing in any form (e.g., a bank, investor, or supplier of asset-based finance).

[4] Asymmetric information is a more serious problem in SMEs than larger firms. The SME entrepreneur has better access than the financier to information concerning the operation of the business and has considerable leeway in sharing such information with outsiders. Therefore, it may be difficult for the financier to determine if the entrepreneur is making erroneous decisions or to adequately understand the business. The entrepreneur may also have incentives to remain opaque, not only in dealings with financiers but with other outsiders such as regulators and tax authorities.

[5] The principal/agent dilemma refers to an instance in which a borrower uses borrowed funds for purposes other than those for which they were intended.

the ratio of costs to the loan amount is proportionately higher (while the revenue generated from the loan in interest and fee income is proportionally lower).

In order to lend successfully to SMEs, financiers must learn how to reduce risks and share risks with the borrowers, and to reduce the costs relative to the size of the loans. There are many strategies to reduce risk. One solution is to require prospective borrowers to contribute a significant amount of their own money as equity in the company or into the specific transaction. Other techniques include the use of mortgages[6] and other forms of collateral to secure the loan, or the use of guarantees, insurance, or principal and interest payments tied to the company's cash flow.[7] A third method is to develop appropriate risk-rating and evaluation systems for SMEs. (This method is discussed in more detail in Section A5).

### A2b. Special Problems Associated with Lending to SMEs in Emerging Markets

The discussion so far applies to SME finance in all countries. Additional problems are found in emerging markets, where flaws and gaps in the legal, institutional, and regulatory environment represent further disincentives to banks and financial institutions to undertake SME lending. First, SMEs in emerging markets typically lack acceptable forms of collateral to secure bank loans. Second, weak legal systems often prevalent in emerging markets and the corresponding weak enforcement of claims against borrowers inhibit banks from lending.[8] Third, in many emerging markets, SMEs often shun the formal economic and regulatory framework and operate in the informal economy (International Labour Organization, 2007).[9] Fourth, high rates of taxation, complex tax regimes, and regulations that seriously increase the cost of doing business (e.g., complex business registration processes) do not encourage the use of formal financial markets.

Another impediment is government policy affecting the allocation of financial resources (OECD, 2006, p. 11). Banks may be under pressure to purchase certain assets, such as government or quasi-government bonds. In some emerging markets, private banks operate as part of industrial-financial groups, often controlled by elites with close ties to government, that tend to lend on the basis of personal relationships or special interests. When entrepreneurs perceive a lack of willingness on the part of financial institutions to deal with SMEs or recognize that the process is not fair and transparent, this removes an

---

[6] A mortgage is the transfer of an interest in real estate property (e.g., land, buildings) to a lender as a security for a debt, with the condition that this interest will be returned to the owner when the terms of the loan have been satisfied. A secured loan is a loan in which the borrower pledges some asset (e.g., real estate, vehicles, inventory) as collateral for the loan. If the borrower defaults, the creditor may ultimately take possession of the asset and sell it to satisfy the outstanding debt.

[7] These techniques are effective because borrowers do not want to lose their own money or assets. In addition to mitigating the financiers' own losses in case of default, these mechanisms prevent situations in which the borrower can transfer nearly all of the risk of his activity to the lender while maintaining all of the "upside."

[8] This is often embodied by difficulty enforcing contracts and judgments, and a lack of alternative dispute resolution mechanisms and quick settlement procedures for small claims.

[9] For example, the International Labour Organization (2007, p. 1) estimates that the informal workforce share of non-agricultural employment is as high as 72 percent in Sub-Saharan Africa, 52 percent in Asia, and 48 percent in Latin America and the Caribbean.

incentive for firms to move into the formal economy (i.e., to gain access to formal finance).

Bank regulators also play a role in enabling or discouraging commercial banks to lend to SMEs. Lack of or inadequate collateral may be a significant deterrent for banks to lend if the regulator severely penalizes them by requiring additional reserves for loans that are not adequately collateralized — no matter how good the cash flow, management, and other creditworthiness variables of a specific SME borrower may be. Excessive conservatism on the part of regulators may discourage cash-flow or "relationship" lending. Therefore, an SME with limited or no collateral may become ineligible for bank borrowing, even if its business has been successful.

Finally, well-intentioned policy or lending programs have sometimes actually discouraged banks from developing SME lending. A lack of loanable funds (liquidity) in the banking system and/or the high cost of credit were often perceived as the main obstacle to SME finance. In response, donor-funded programs provided liquidity to commercial or government-development banks through specialized credit lines; the banks could then on-lend these funds to SMEs. In many cases, interest-rate ceilings were imposed that made it difficult to price credit to reflect the risks and costs of lending to SMEs. These programs often distorted the market, and default rates were high (U.S. Agency for International Development [USAID], 2006a, p. 3; International Monetary Fund [IMF], 2007, p. 24).

### A3. Sources of Finance

This section of the primer discusses the three basic sources of finance that are accessible to SMEs through financial intermediation:[10]

> a) the capital markets (public and private) where entities in need of finance issue securities (debt, equity, or a debt/equity hybrid) that are purchased directly by investors or indirectly through investment funds or brokers;
> b) traditional lending (overdrafts, lines of credit, term loans), primarily provided by commercial banks;
> c) asset-based financing[11] (POF, factoring, leasing, etc.) that can be offered by banks, finance companies, and other specialized non-bank financial institutions (NBFIs). The banking system and asset-based finance generally deal in debt instruments, and capital markets deal in both debt and equity instruments.

The range of financial products available in most financial systems is summarized in Table 1. Under the three basic types of SME finance, the table lists the most commonly used finance instruments within each category, the principal suppliers, and summary comments on applicability and potential for development by USAID missions. The table

[10] Financial intermediation is the process by which those people and other entities with excess savings place those funds in the financial market, and where people and entities that require external financing obtain funds.
[11] Under asset-based lending, loan transactions are structured to overcome many of the difficulties that SMEs usually face in qualifying for traditional lending products.

rates the degree of institutional and regulatory development and degree of business environment development needed for each listed financial instrument on a scale of 1 to 5, with 5 being the most developed and sophisticated level and 1 being the lowest level of sophistication and development required. The subsequent sections provide detail on each of the three sources of finance.

**Table 1: Options for Financing of SMEs in Emerging Markets**

| Type of Finance & Finance Products | Suppliers of Funds | Degree of Institutional & Regulatory Development Needed | Degree of Business Environment Development Needed | Applicability and Potential for Development by USAID Missions |
|---|---|---|---|---|
| ***Capital Markets*** | | 5 | 2-5[12] | |
| Debt<br>Corporate Paper<br>Convertible Bonds | Specialized Retail[13] & Institutional Investors, IFIs[14] | 5 | 3 | Large enterprises are primary target of investors. Limited applicability to SMEs. |
| Equity<br>Stock Shares<br>Venture Capital | Specialized Retail & Institutional Investors, IFIs | 5 | 5 | Large enterprises are primary target of investors. Limited applicability to SMEs. |
| ***Bank Credit*** | | | | |
| Working Capital<br>Short-Term Credit<br>Overdrafts<br>Lines of Credit | Banks,<br>Savings & Loan Cooperatives,<br>Finance Companies | 2-3 | 2-3 | Very high demand by SMEs. Increased access can be expanded through capacity-building programs, DCA guarantees. |
| ***Bank Credit*** | | | | |
| Fixed Capital<br>Medium-Term Loans | Banks,<br>Savings & Loan Cooperatives,<br>Finance Companies | 3 | 3 | High demand by SMEs. Supply can be expanded through capacity-building programs, DCA guarantees. |
| ***Asset-Based Finance*** | | 2 | 2 | Expanded use of DCA guarantees should be explored for all products. |
| Accounts Receivable (A/R) Finance | Banks, Finance Companies | 3 | 3 | Potential for development in emerging markets, but requires an efficient lien-registration system, certain economies of scale, and established, verifiable sales relationships between producers and the buyers. Purchase-order finance (POF) is a good precursor product. |

[12]Note that a poor business-enabling environment does not preclude functioning capital markets; however a securities markets-enabling environment must be present.
[13] High-net-worth individuals, venture capital companies
[14] International Finance Institutions (IFIs): International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), Asian Development Bank (ADB), Inter-American Development Bank (IDB), African Development Bank (AfdB), etc.

| Type of Finance & Finance Products | Suppliers of Funds | Degree of Institutional & Regulatory Development Needed | Degree of Business Environment Development Needed | Applicability and Potential for Development by USAID Missions |
|---|---|---|---|---|
| Factoring | Specialized Bank Subsidiaries, Finance Companies | 3 | 3 | Potential for development in emerging markets. Can build on value chain relations for companies that supply creditworthy customers. Requires certain economies of scale. Well-suited to jurisdictions with weak contract enforcement but requires access to reliable credit information. |
| Warehouse Receipts (WHR) | Banks | 3 | 3 | Mixed record for successfully opening SME finance. Typically requires very large economies of scale. |
| Purchase-Order Finance (POF) | Banks, Finance Companies | 2 | 2 | Many instances of successful introduction in emerging markets. Substantial potential for further development, particularly for SMEs in value chains. |
| Leasing | Specialized Bank Subsidiaries, Finance Companies | 2 | 2 | Many instances of successful introduction in emerging markets. Substantial potential for further development. |
| ***Informal Finance***[15] | | | | |
| Supplier and Customer Credit<br><br>Informal Loans | Suppliers and Customers<br><br>Money Lenders | 1<br><br>0 | 1<br><br>0 | Common in value chain relations. Can be the basis for use of more formal financing techniques. High cost, but accessed by SMEs. Depending on source can be dangerous. |
| ***Self-Finance*** | | 0 | 0 | Spontaneous when SMEs have significant equity (owner funds), and/or financial support by family members. |

### A4. Capital Markets

The defining characteristic of capital markets is direct intermediation. The entity seeking finance issues a security (e.g., debt, equity, or a combination of both) that is purchased by an investor. The investor may be an individual or an institution (e.g., a pension fund or mutual fund), and assumes all of the risks and rewards inherent in those securities. The discussion of capital markets can be further subdivided by public capital markets in which securities are offered to the broad investing public and are subject to capital-markets regulation and private capital markets that are not offered publicly or subject to the full range of regulation.

### A4a. Public Capital Markets

Public capital markets are those markets in which securities — mainly equities and bonds — are offered to the general investing public and are subject to the full jurisdiction of the germane regulatory body. The capital market comprises a primary market in which new

[15] Encouraging SMEs to move from informal to formal finance should be a primary objective of development efforts.

securities are issued and a secondary market in which outstanding securities are traded. Securities are frequently traded on regulated exchanges.

In general, the degree of institutional and legal sophistication required for effective intermediation through the public capital markets is higher than for all other forms of finance. Because investors, not banks, make the final decisions about where financial resources are allocated, the system requires a highly advanced information infrastructure to provide investors with reliable information through public disclosure. Transparency and public-disclosure requirements are especially stringent. Rules regarding the supply of information disseminated through prospectuses and regular reporting must be formulated and enforced; supporting institutions such as rating agencies and the research arms of investment houses also inform investors. The legal system should be capable of detecting and sanctioning misconduct (e.g., improper disclosure, insider trading, or market manipulation). In most countries, capital markets are the most sophisticated component of the financial system, and only large, established companies regularly access them.

Some countries have established specialized stock exchanges[16] for smaller companies in which listing and disclosure requirements are less rigorous than on the main boards.[17] The record of such exchanges is mixed, and there is no compelling reason to press emerging markets to introduce such exchanges at this time. Most SMEs cannot afford to list on *any* board; even if they could, it is unlikely that investors would purchase their securities.

### A4b. Private Capital Markets

In private capital markets, operations take place among small groups of qualified investors and are not always subject to full regulation. For example, some countries have laws that allow companies to issue debt or equity as private placements to small groups of qualified professional investors without observing all the rules for public securities offerings. Private capital markets are open only to certain categories of institutional investors and very-high-net worth individuals; securities issued in private markets are not publicly traded or listed.

In private equity (i.e., the provision of equity capital without a public offering or listing of that equity), investors plan to hold their positions in the company for a limited time, to transform the company in some way, and to realize a profit by an exit. Private equity can be divided into two broad categories: **buy-outs**, which are the purchase of existing companies with the goal of restructuring and realizing a profit by re-selling, and **venture capital**, which is a private-equity investment in a relatively new company with high potential or in an existing company with new opportunities for growth. The objectives of venture-capital investment are to find companies that provide better-than-average returns;

[16] A stock exchange is an institution, organization, or association that hosts a market where stocks are traded. Exchanges impose rules and regulations on the firms and brokers involved with them. If a particular company is traded on an exchange, it is referred to as “listed.”
[17] A board is a subdivision of an exchange where certain categories of stock are traded under a specific set of rules. An exchange may have more than one board.

make an early investment; assist in its transformation into a market leader; and exit with a large profit.

Private-equity investors typically take minority stakes in the company, and their financial rights are more limited than those of lenders. Their investment is inherently longer-term, usually with no return until a successful exit. A minority stake in an SME, even a successful one, has a very limited market. Initial public offerings (IPOs) are very expensive and quite rare, and usually provide limited exit options (usually the sale of the company to a strategic buyer and/or investment group, or sale back to the original owner). Equity investors also have limited recourse in the case of bankruptcy. Equity investing is usually very labor-intensive, requiring in-depth monitoring and oversight, and sometimes takeover of management of the company. Therefore, equity investment is the most risky and the least-applicable source of finance for SMEs[18] (Lin, 2009, p. 76).

**Enterprise Funds**

The enterprise funds that operated in transition economies after 1989 are an example of private equity. Funded via the Support for East European Democracy (SEED) Act of 1989, USAID established the enterprise funds to support the private sector in then-nascent market economies of Central and Eastern Europe.

The funds invested $1.2 billion in more than 500 enterprises in 19 countries. By pairing USG funds with other resources, the funds raised an addition $5 billion. The records of individual funds were mixed. Some made major gains in investment and enterprise success and several funds became self-sustaining with private capital. In other cases, major management and accountability issues arose, and some funds were closed out at a near total loss.

### A5. Traditional Bank Lending

The financing techniques discussed from this point onward will concern debt instruments. Unlike equity investors, who share in a company's residual profits, providers of debt finance earn income by lending at predetermined interest rates or margins; they earn income only if the borrower services (i.e., repays) the debt. They also face asymmetric risk: they derive only limited benefits if a borrower becomes very profitable but are at great risk if the borrower cannot repay its debt.

Although the underwriting of traditional bank lending often makes it beyond the reach of many SMEs, it is still the primary source of finance for SMEs. Banks usually control the largest share of financial assets in emerging markets and they often have widely distributed branch networks.[19] While sometimes not represented in the most remote areas of some countries, their geographic reach is wider than that of other financial institutions,

[18] In addition, because equity investment is long-term with little or no interim reflows, only a limited number of companies can be financed with a given amount of funds. Debt financing turns over much more rapidly; it can be lent over and over, and help many more companies.
[19] Other suppliers of traditional lending include savings-and-loan cooperatives and finance companies. Cooperatives are a major player in many countries. Their clients are a mix of SMEs and microenterprises; they rarely lend to large enterprises.

except possibly microfinance institutions. Banks also have a strong tradition of involvement in local communities.

### A5a. Traditional Bank Lending: Assessing SME Credit Risk

In traditional bank lending, credit is extended to the borrower and the lender accepts the risk of lending to that borrower.[20] It is essential for banks to understand what constitutes creditworthiness and to structure its dealings with borrowers based on a thorough risk assessment. To assess a borrower's ability to repay a loan, a bank might analyze the borrower's **financial statements**, use **relationship management**, and/or conduct **credit scoring**.

Traditionally, banks have made credit decisions based on analysis of a borrower's historical **financial statements** (i.e., balance sheet, cash flow, and income statement). Borrowers are usually required to provide financial statements — ideally, audited statements prepared by a reputable accounting firm in accordance with accepted accounting standards — which are used to determine their historical financial performance.[21] It is often difficult for SMEs to provide the types of historical financial information required for this type of risk assessment.

Banks active in the SME sector often augment their analysis of financial statements with **relationship management**. Relationship management is well-suited to banks willing to lend to SMEs with good growth potential but no traditional forms of collateral. Here, a bank accumulates qualitative information about the borrower (e.g., its managerial skills, business strategy, and relationship with the community) as it provides financial services over time. However, this information can take a long time to gather and represent an added cost for the bank, at least in the short term (Bakker, Klapper, and Udell, 2004, p. 9). Further, because this information is not always easy to observe, verify, or communicate, it should be supplemented with risk-rating systems that emphasize analysis of the SME's profit and loss statement, cash flow, and cash-flow projections.

Recognizing that it is difficult to separate a firm's finances from those of its owner(s), many banks and financial institutions now use some form of **credit scoring** to assess the risk of lending to SMEs. Credit scoring analyzes data about the firm's owner (as if the owner were applying for a consumer loan) and the firm itself; statistical methods predict future credit performance. The resulting "hard" information is primarily personal consumer data (e.g., income, net worth, personal assets, available credit, prior delinquencies, and prior bankruptcy) obtained from consumer credit bureaus, asset registries, data collected by the financial institution (e.g., financial ratios, such as profitability and leverage, and past credit problems), and in some cases data from commercial credit bureaus.

[20] Banks must manage risk conservatively to protect depositors' and shareholders' funds, which are lent to approved borrowers. Banks are licensed and supervised by a central banking authority, and are subject to strict regulation and oversight.
[21] Historical financial statements, however, often do not give a good picture of an SME's growth potential.

### A5b. Overdraft Financing and Term Loans

Bank credit to SMEs is usually either **overdraft financing**[22] or a **term loan**. Overdraft financing functions much like a credit card, allowing the SME client to borrow periodically as the need for short-term working capital arises; it is revolving and sometimes renewed on a year-by-year basis. In emerging markets, banks often require real-estate collateral, which many SMEs do not have. Although overdraft financing can be useful for financing short-term working capital, it can also put SMEs in a financial straightjacket in which all its collateral is tied up in the borrowing on the overdraft, making it impossible to get additional financing. The SME must also pay interest on the outstanding balance, which keeps getting rolled over.

A term loan is granted for a longer period (usually not less than two years) and enables the SME to make longer-term investments in equipment (e.g., machinery that will increase productive capacity). Repayment of principal usually takes place in accordance with a predetermined schedule over the life of the loan (e.g., payments every month, quarter, or six months). The interest rate may be fixed for the life of the loan or variable (floating) with respect to a reference rate such as Libor. Like overdraft financing, term loans usually require significant real-estate collateral — a requirement many SMEs are unable to meet.

To help banks in emerging markets better understand SMEs and move into the SME sector, USAID has provided technical assistance (TA) such as training and capacity-building programs. Continued donor support is needed to assist bank personnel to develop appropriate SME risk-rating systems and educate them about lending in new sectors. We should also consider ways to help banks develop and market new SME products (such as the asset-based products discussed below) that have both sound risk mitigation and reduced collateral requirements.

### A6. Asset-Based Finance

Asset-based finance is a specialized type of financing that provides structured working capital and term loans secured by an asset (e.g., a purchase order, contract, accounts receivable, invoice, letter of credit, inventory, machinery, equipment, and in some cases real estate). It is attractive because it creates a source of funding for SMEs that either cannot qualify for traditional bank loans or whose lending needs exceed what they can obtain from traditional products.

This section of the primer covers five types of asset-based financing: accounts-receivable (A/R) finance; warehouse receipts (WHR); factoring; purchase-order finance (POF); and leasing. In A/R finance and WHR, financing is generally provided by banks; the other

[22] Overdraft financing can take the form of a formal line of credit or an arrangement by which the bank allows a client to periodically overdraw their deposit or checking account. Overdraft financing is typically for less than one year.

products[23] are often provided by an NBFI, which might be a subsidiary of a bank that separates this type of lending from the deposit side of its operations.[24]

### A6a. Accounts-Receivable Finance

Companies active in production and trade will normally have A/R, prospective revenues from sales already made and invoiced but for which the buyer has yet to pay. The lender will open a revolving line of credit based on the pattern of A/R and the payment history of the buyer of the company's goods. The amount of credit extended under an A/R loan is explicitly linked by formula to the liquidation value of the assets used as collateral (Bakker, Klapper, and Udell, 2004, p. 1). Outstanding A/R is continuously monitored to ensure that the value of the assets always exceeds the amount of the loan.

A/R lending is a common source of small-business financing in the United States, Australia, Canada, and the United Kingdom; its use in emerging markets has been limited but is expanding. A/R lending requires an efficient lien-registration system that clearly defines when liens are filed, and a bankruptcy system that preserves lender priority and minimizes time in bankruptcy.[25] It also requires certain economies of scale and established, historically verifiable sales relationships between producers and buyers. POF, which is discussed in section A6d below, can be a good precursor product to introducing A/R finance.

### A6b. Warehouse Receipts

WHR financing is another type of asset-based lending that has been introduced in emerging markets with some success. A WHR is a document certifying the ownership, existence, and availability of a particular quantity, type, and quality of commodity (e.g., grain, copper bars) in a designated facility, such as a warehouse.

Through a WHR system, producers or traders deposit commodities at a warehouse, which offers secure storage and issues a receipt certifying that it is in possession of a specified quantity of a commodity that meets specified standards. The depositor can then use that receipt as a pledge to secure a loan from a bank (generally 50-80 percent of the stored commodity's value). The bank places a lien on the commodity so it cannot be sold without proceeds first going to repay the loan. The advantage of WHR finance is that it allows producers, processors, and traders to use their commodities as collateral and determine the best time to sell them — when grain prices rise, for example.

---

[23] Recent trends indicate that traditional banks are crowding specialized leasing companies out of the market due to the cheaper cost of funding through their client-depositor base.

[24] A bank separates asset-based activities from its main institution because a large volume of non-banking assets on its balance sheet creates risk and might lower its credit rating. Furthermore, different skill sets are needed to perform these activities.

[25] For example, financial institutions receiving assistance to introduce trade finance as part of a USAID-funded TA project in Azerbaijan recently stated that they do not feel it is feasible to add A/R financing to their product portfolio at this time. Currently in Azerbaijan, a bank cannot take a formal pledge or lien against A/R and even if a bank uses an informal collateral agreement in a court proceeding, the bank would be unable to sell or liquidate the A/R (Crimson Capital, personal communication, August 2009).

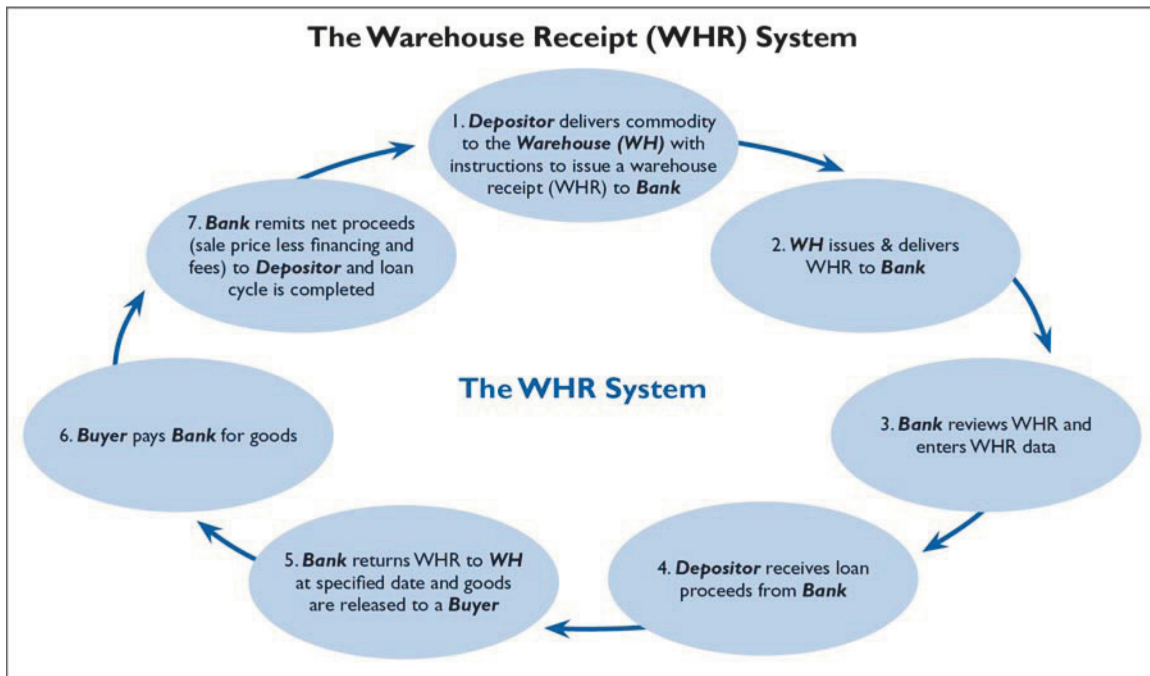



Chart developed based on a WHR System chart that originally appeared in a Support for Private Enterprise Expansion and Development (SPEED) project report. USAID, 2006c, p. 3.

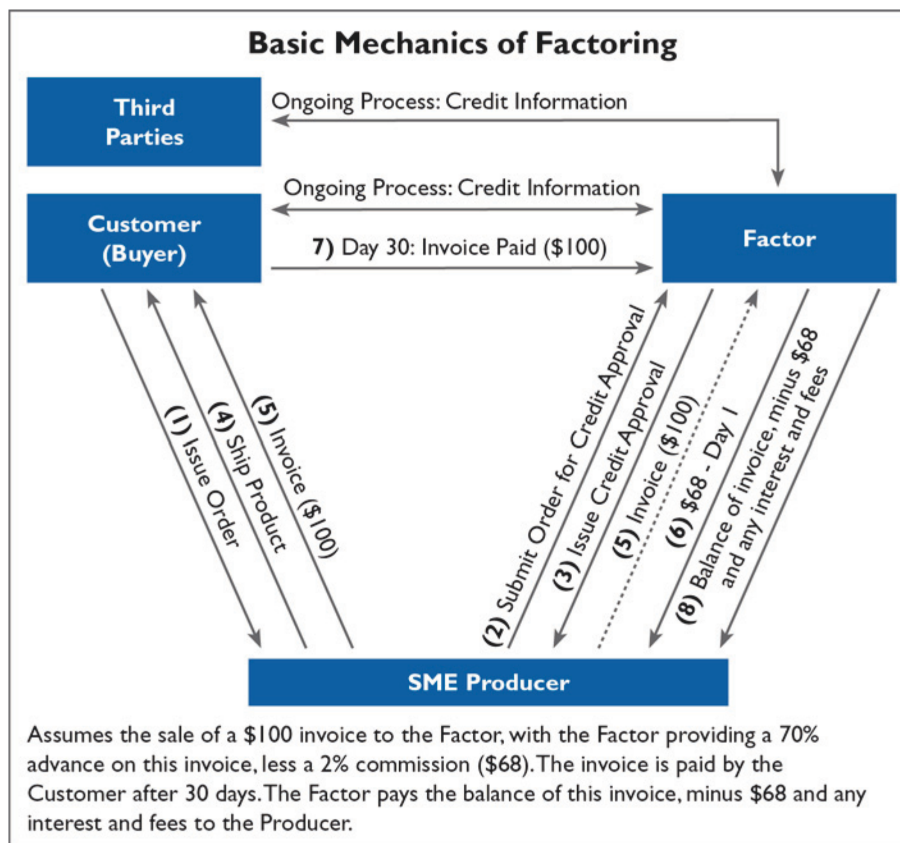
This system requires a reasonably well-developed banking system that recognizes the WHR certificate as collateral. Banks will require a high level of protection for the collateral, enforced by sound management practices at a licensed and bonded warehouse, with adequate supervision by a regulatory agency. Accessible, accurate market information must be available (so that depositors can make an informed decision about the best time to sell their stored commodity) and certain economies of scale are also required,[26] which can make it difficult for small-scale producers to successfully participate in WHR systems. Capital investment and operating costs for WHR systems are generally high.

Several transition economies, including Bulgaria and Hungary, have introduced WHR systems that appear to be operating well (European Bank for Reconstruction and Development, 2002, pp. 13-35). In Argentina, WHR systems account for a significant portion of agricultural lending, and total receipts issued now exceed $1 billion (Giovannucci, Varangis, and Larson, n.d., p. 6). However, recent experience suggests it may be difficult to include smaller-scale farmers or SMEs, even in countries with established WHR systems (Miller, 2008). The system has potential, but it may not be the best vehicle to increase financing for SMEs. Program designers should proceed with caution.

[26] SMEs and small farmers typically would have to efficiently pool their commodities to use WHR systems.

#### A6c. Factoring

Like A/R, factoring provides financing to an SME producer during the collection phase of its activity: after it has delivered goods and issued an invoice to the buyer, but before it has received payment. Through a factoring transaction, the SME sells its invoice or invoices[27] to the financier (called the "factor") outright. The factor then pays the SME a percentage of the A/R value — which can range from 50 percent to 80 percent — and takes over responsibility for collection. Factoring is generally undertaken by specialized companies rather than by banks and is usually best-suited to rapidly growing companies experiencing cash-flow difficulties due to overtrading.[28]




Bakker, Klapper, and Udell, 2004, p.6, obtained from Worthy, 2003.

Factoring relies on legally separating an SME from its assets (i.e., should the borrower become insolvent, the assets would not be considered part of the estate and would not be subject to bankruptcy proceedings). Therefore, unlike A/R, factoring is well-suited to

---

[27] Factoring generally requires some economies of scale to be profitable (i.e., usually the borrower will sell a pool of invoices from established customers to the factor). Factoring is rarely conducted on an invoice-by-invoice basis.

[28] Overtrading refers to a situation in which the SME takes orders that it is unable to support with its current working capital or assets.

jurisdictions with weak insolvency regimes.[29] However, because the factor's decision turns on the creditworthiness of the buyer (of the SME producer's goods), access to reliable credit information is required,[30] which can limit its applicability in emerging markets[31] (Klapper, 2005, pp. 15-16).

Factoring can be disclosed or non-disclosed. In the former, the factor assumes responsibility for collection with full disclosure to the buyer. In the latter, the SME continues to collect his book debts, but credits the proceeds directly into a special factoring account in the name of the factor.

In some emerging markets, a variant of factoring known as "reverse factoring" has been effective in broadening SME access to finance. In ordinary factoring, because the factor purchases many A/R from a limited number of SMEs, it must collect credit information and calculate credit risk for a large number of buyers. In reverse factoring, the factor pools and purchases receivables payable from only a few high-quality and/or international buyers and it needs to collect credit information and calculate the credit risk for only a few large, transparent, well-rated firms.

**Reverse Factoring**
Heller Financial, a subsidiary of GE Capital, and Wal-Mart have a reverse-factoring arrangement in Mexico in which Wal-Mart offers its Mexican suppliers the option of having their accounts factored by Heller and receiving immediate payment for 80 percent of the sale. The additional 20 percent, less interest and service charges, is paid upon Heller's receipt of Wal-Mart's payment. Although the sellers may not have any relationship with Heller, they can receive short-term financing because they are borrowing on Wal-Mart's credit risk. By providing short-term financing, Wal-Mart is able to negotiate better terms with its suppliers and reduce its transaction costs by paying one bill to Heller rather than to a large number of suppliers. (Bakker, Klapper, and Udell, 2004, p. 15, obtained from Klapper and Vittas, 2003).

The factoring industry is fairly well-developed in some transition economies of Central and Eastern Europe, including Russia. Some emerging Asian countries such as China and Taiwan have significant factoring industries. Latin America, Brazil, Chile, and Mexico also have comparatively large factoring industries. The industry has made only sporadic progress in other emerging markets. The fact that factoring has been successfully established in countries where the legal and regulatory infrastructure is not very robust

[29] A country's tax structure can also affect the size of its factoring industry. Stamp duties on factored invoices and other levies on factoring can impede the growth of the industry. Value-added taxes (VATs) may also have an effect, depending on the structure of the tax system. For example, although the services fee associated with factoring is typically subject to VAT, the financing should be exempt to create a level playing field between factors and other lenders.
[30] To augment information available from credit bureaus, factors generally develop and maintain specialized, proprietary databases on the credit profiles of buyers.
[31] One way that factors can reduce risk is by requiring that the factored transaction be executed on a recourse basis: If the buyer does not pay, the SME remains liable for the full amount of the loan, plus applicable interest and fees. Non-recourse factoring, conversely, is riskier to the factor, which will, accordingly, advance a lower percentage of the value of the invoice and charge higher interest and fees.

suggests that there is unexploited potential. USAID may work with financial institutions to launch factoring as a new product.

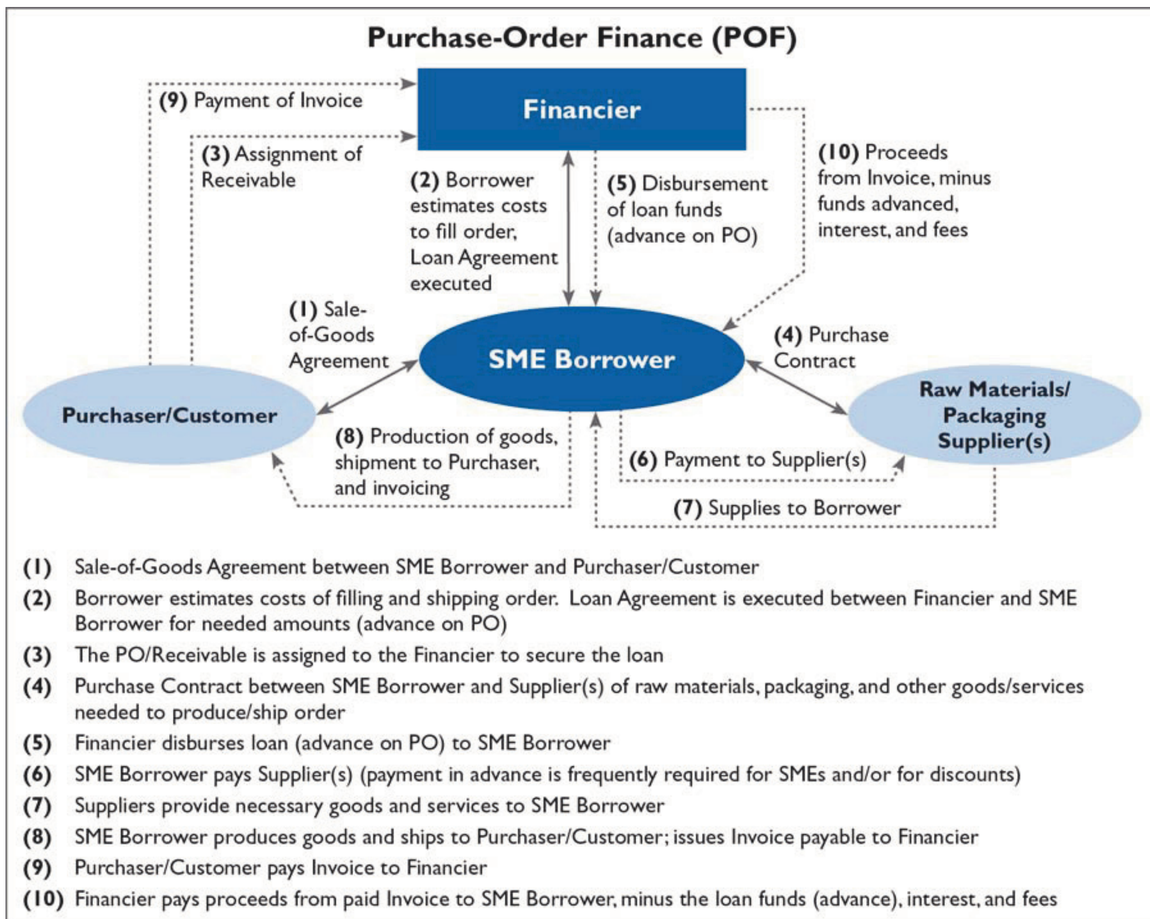
### A6d. Purchase-Order Finance

A/R and factoring finance the collection phase of an SME's activities; POF funds the production phase. As an SME develops, it commonly receives orders that are larger than it can fill (e.g., it does not have adequate resources to buy the raw materials, packaging, etc., to produce, package, or ship the good). Such large or frequent orders are a growth opportunity for the SME. POF can provide the working capital an SME needs to take advantage of such opportunities.

In POF, the SME obtains a verified purchase order from a buyer and estimates[32] the direct costs (e.g., raw materials, packaging, labor, shipping, insurance) required to produce and to deliver the product. The financier reviews the order, the cost breakdown, and the SME's operating record. The financier bases the credit decision on whether the purchase order is from a creditworthy customer or is backed by an irrevocable letter of credit from a reliable bank and on whether the SME can produce and deliver the product according to the terms of the contract. If the loan is approved, the financier advances a percentage of the of total order value to the SME;[33] the advance is typically lower than in factoring (generally not exceeding 75 percent), but is the exact amount the SME needs to produce and ship the order and issue the invoice. The SME then produces the good, delivers it, and bills the customer. The receivables are either assigned to the financier and the customer is instructed to pay the financier directly or the payment is directed into an account under the financier's control. When the financier receives payment, it deducts the amount advanced and interest or fees,[34] and remits the balance to the SME.

---

[32] Formal price quotes are required to back up these estimates.
[33] To further mitigate risk, the financier may pay the producer's suppliers directly to preclude the use of funds for other purposes.
[34] The fees include the financier's cost of collecting on the receivable, an interest charge for the period of the invoice's term of payment, a profit margin, and a risk premium associated with potential losses from uncollectible receivables and/or from the supplier's inability to produce and ship the order.




POF graphic reprinted with permission of Crimson Capital, © 2009.

POF is different from factoring and A/R in several ways. First, it requires more intensive monitoring of an SME's operations. In the case of factoring and A/R, the product has already been produced and delivered; POF requires the financier to accept the risk that the order will not be filled. POF, therefore, typically has higher interest rates and fees than other asset-based products. However, there are ways the financier can mitigate this risk and profitably finance the growth of SMEs, usually without requiring real estate as collateral. The financier relies heavily on projected cash flows and can take guarantees and other collateral such as inventory and bills of exchange. By advancing a smaller percentage of the order value, taking assignment of the invoice, and other methods, risk can be satisfactorily managed.

POF has been used in the United States with great success, helping SMEs grow dramatically. In recent years, it has been introduced in emerging markets such as Armenia, Azerbaijan, Bolivia, Kosovo, Macedonia, and Moldova, both through banks and stand-alone specialized NBFIs. Because POF finances individual transactions, it does not require the same level of legal and market sophistication as A/R and factoring, making it well-suited for emerging markets. POF is proving to be one of the most effective financial instruments for generating rapid growth in sales, profitability,

employment, and exports for SMEs. See the Bolivia and Macedonia case studies in Section B.

### A6e. Leasing

SMEs must acquire capital equipment (e.g., buildings, vehicles, fixtures, and machinery) to increase production capacity, improve quality, and/or raise efficiency levels. A lease is a contractual arrangement between two parties, where the provider (the **lessor**) owns the asset (usually capital equipment) and agrees to grant the client (the **lessee**) the use of the equipment in exchange for periodic payments. In practical terms, leasing allows enterprises without access to bank financing to get the capital equipment they need.

There are two primary types of leasing, financial and operating. This primer focuses on the financial lease.[35] In **financial leasing**, the lease period extends for the equipment's useful economic life, and the lessor recovers the equipment costs plus interest through regular lease payments. The lessee usually bears all the costs of maintenance, damage, and insurance, and the lease generally cannot be canceled. At the end of the lease, the lessee usually has the option to purchase the asset for a nominal amount or return it to the lessor. (The lessee almost always takes over the title of the asset at the end of the lease period.) In contrast, in **operating leasing**, the term of the lease is shorter than the economic life of the asset and only a percentage of the asset's value is paid over the lease term. The lessor earns income from multiple, shorter-term leases and the final sale of the asset. Unlike financial leases, operating leases may sometimes be canceled, and the lessor, not the lessee, usually bears all the costs of maintenance, insurance, and damage. Because operational leases are riskier for the lessor and the transaction is more complicated, financial leases should be introduced first in any new market.

The lessor's credit decision is based partly on the lessee's ability to generate cash flow from business operations to make lease payments. In many instances, cash flow is generated by the use of the leased asset; this makes the lessor's underwriting decision easier. Leasing is well-suited to SMEs, which often lack credible credit information, formal financial statements, or long records of profitability. For the financier, the funding it provides goes directly toward the purchase of equipment without passing through the hands of the lessee, averting the risk that the funds might be used for other purposes.

Leasing offers important advantages in countries with weak business environments, particularly those with weak property rights, creditors' rights, and collateral laws. In principle, secured lending and leasing should be about the same in terms of risk, but experience has shown that legal ownership through leasing is recognized by all parties, including courts, more consistently than secured lending. A leasing transaction has advantages if the lessee declares bankruptcy. Under bankruptcy rules, lease payments

---

[35] Financial leasing is stressed because the risks are much lower and the transaction is less complicated. The full value (or very close to it) plus financing costs are recovered during the term of the lease, which corresponds to the economic life of the asset. In operating leasing, less than the full value of the asset is paid for over the term of the lease and the lessor accepts a much wider range of business risks, such as whether the equipment will actually be leased sufficiently and whether lease payments will be sufficient to cover maintenance expenses.

have priority over loan payments, and the lessee is usually allowed to continue making lease payments. Also, even if the lessee is not permitted to make its lease payments, the lessor can usually repossess the equipment. (Lenders have to wait for a decision from a bankruptcy court before they can take possession of the collateral.) However, leasing can be difficult to implement in countries without a national asset register or with weak (or no) laws on repossession. The former makes the illegal on-selling of leased assets easier; the latter undermines the lessor's ability to repossess leased equipment in the case of default. Further, when considering supporting leasing initiatives, programmers should give attention to the country's tax code, to ensure that leased equipment is not double-taxed.[36]

Lessors are usually specialized private leasing companies or subsidiaries of banks or financial institutions. Manufacturers and equipment suppliers sometimes offer leasing as part of their marketing/sales activities, usually through a finance subsidiary. Some lessors offer a standard range of items, preferring equipment with which they have experience, and purchased from suppliers on whom they can rely.

Worldwide, enterprises use leasing to finance vehicles, machinery, equipment, and sometimes even buildings. It is estimated that in advanced economies, up to one-third of private investment is financed this way. Largely due to improvements in the legal and regulatory environment for leasing, the leasing industry in emerging markets experienced spectacular growth during the 1990s, with large- and medium-sized enterprises accounting for most activity (Deelen, Dupleich, Othieno, and Wakelin, 2003, p. 3). In the past 15 years, smaller companies and farmers have begun to use leasing as means to invest in agricultural equipment. See the Armenia case study in Section B.

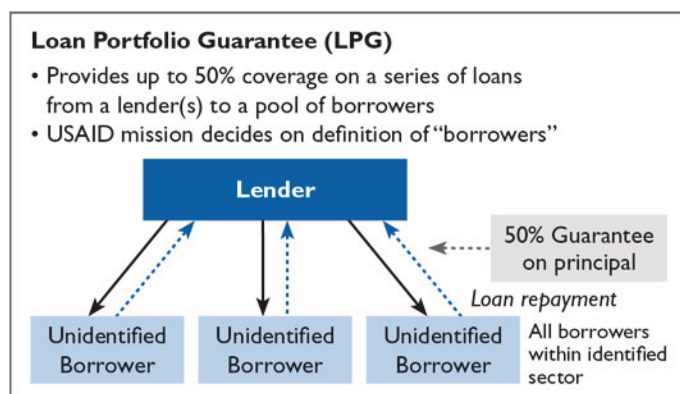
### A7. Guarantees, Including USAID DCA Guarantees

A **financial guarantee** is an assurance given by an outside party to compensate a financier, in whole or in part, if a borrower does not fulfill contractual obligations under a credit agreement. There are two basic types of guarantees. Mutual Guarantee Associations are established by groups of SMEs, business foundations, or chambers of commerce, often in collaboration with banks. Official Loan Guarantee Funds are mostly funded by regional or national authorities, aid donors, or international organizations.

USAID offers four core types of credit guarantees through the DCS: **loan portfolio guarantees** (LPGs), loan guarantees, **bond guarantees** (BGs), and portable guarantees. LPGs and BGs are best-suited to expanding finance to SMEs. Though each type of guarantee is structured slightly differently from the others, all are legally binding commitments backed by the full faith of the USG to share in up to 50 percent of a private

[36] In some countries, tax authorities essentially double tax the leasing operations by taxing the purchase of the leased item and then fully taxing the lease itself as if it were a separate purchase, without refunds or credit to the lessor. The case study on leasing in Armenia in section B illustrates an instance where a leasing company and TA providers worked together to successfully remove such a double tax burden on leasing.

lender's realized losses. USAID's guarantees cover all risks of payment associated with the credit.




USAID, n.d.a.

An LPG involves one lending institution and multiple borrowers that are part of a borrower group specified by USAID. The purpose of an LPG is to encourage a lender to extend credit to areas that are underserved by financial institutions. In most cases, LPG agreements are made with local commercial banks that agree to undertake expanded lending in the SME sector. In some cases the agreement with the bank simply stipulates that lending should be to SMEs, but in other cases the agreement specifies the targeted sector or region in greater detail. A BG ensures investors in corporate and/or sub-sovereign bonds of both recovery and repayment. The guarantee often enables the issuer to obtain a higher credit rating and, consequently, access less expensive and longer-term financing. DCA BGs can be issued by local institutions to fund term lending to SMEs. These operations enable banks to raise funds competitively and to match longer-term assets with long-term liabilities while spurring development of the local capital market.

When combined with a broader assistance package, the DCA guarantee can be a powerful tool to partner with commercial banks. For example, in the case of a DCA LPG designed to encourage banks to go into SME lending, other program elements might include capacity-building/training in SME lending for bank personnel in how to develop appropriate risk-rating systems for SME clients; how to lend to a new sector, such as agriculture; capacity-building programs to raise SMEs' financial literacy (e.g., developing cash-flow projections and profit-loss statements); assistance marketing new products to SME clients; or opening branches in underserved regions. The ultimate objective is to encourage spontaneous financial intermediation at market conditions. DCA guarantees should alleviate market imperfections by reducing the perceived risk of lending to small businesses.

To date, DCA guarantees have mainly been used to guarantee bank credits or bank bond issues based on those credits. There has been relatively little use[37] of DCA facilities to support asset-based financing, but these techniques offer substantial potential to expand financing for SMEs. For example, DCA guarantees could be given to factoring companies in cases where the credit standing of purchasers whose receivables held by factors is marginally acceptable, but where credit enhancements would encourage greater activity. See Kenya case study in Section B.

---

[37] DCA guarantees have been used to support leasing in Sri Lanka and POF received by agricultural producers in East Africa.

### A8. Designing Demand-Driven Programming

Successful program design aimed at increasing SME access to finance should begin with supply- and demand-side analyses of the market for financial services in the market sector targeted by the program. The target sector may be a country's entire SME sector or a narrower subset, such as SMEs involved in agricultural processing in a specific region.

A supply-side analysis looks at the supply of SME finance and the factors that influence it, including a review of the legal, regulatory, and institutional environment and the financial institutions and markets. It determines to what extent parties can obtain efficient and equitable treatment from the legal and regulatory system, including legislation covering bankruptcy, secured transactions, and creditor rights, and to what extent the legal system enforces these laws and rights.[38] It also determines the availability of reliable information needed to conduct business, including the availability and quality of collateral registries and credit registries. It considers relevant laws and regulations for the provision of financial services, including banking laws and relevant specific financial product laws (e.g., leasing law), and assesses the capability of financial supervisors (e.g., central banks and banking superentendencies). The supply analysis should specify the number, size, and geographic coverage of the financial institutions active in the market, their professional and institutional capacity, and their range of product offerings.

The demand-side analysis considers the demand for SME finance and the extent to which that demand is being met. It should indicate the number of SMEs in the targeted region or sector and the number of people employed. It should also address the size of enterprises, sectoral specialization, annual sales, and the degree of concentration. The relationships among SMEs inside the value chain and discernible patterns in trade credit among enterprises are important considerations, as is the level of financial sophistication among the entrepreneurs in the target sector and region. The demand-side analysis should express the exact nature of SME financing needs; it should consider whether the SMEs need working capital for items such as raw materials, packaging, and transportation, or whether investments in capital equipment would be useful.

Annex B includes a MSOW that elaborates the elements of supply- and demand-side analysis.

[38] In assessing the total environment for conducting business, the World Bank has constructed a Business Environment Index (BEI) in which countries are scored for a) property right protection, b) contract enforcement, c) cost of entry regulations, and d) efficiency of the bankruptcy system.

### B. Case Studies

### B1. Case One: POF in Bolivia

### B1a. Background and Environment

Bolivia is one of the poorest countries in Latin America, with sharp regional inequalities in income. Bolivia has the highest rate in the world of the informal sector as a share of GDP.[39] The World Bank's BEI ranks the country near the bottom for the region.

Bolivia has experienced bouts of hyperinflation and severe recession over the past two decades, and more than half its assets are denominated in dollars rather than Bolivian currency (boliviano). Partly reflecting unstable financial conditions, the formal banking system has remained fragile and cautious. Much of the formal financial system is in decline due to unstable domestic conditions and capital flight. Deposits in the formal financial system declined from 52 percent of GDP in 2000 to 44 percent in 2005. During the same period the assets of the banking system (mainly loans) fell from 63 percent of GDP to 35 percent (Beck, Demirgüç-Kunt, and Levine, 2000, pp. 597-605).

The tendency to avoid formal markets is exacerbated by highly profitable, illicit coca farming. Some farmers find it more profitable to grow the illicit crop; for financial institutions, this increases perceived risk and discourages lending. Many products offered by traditional financial institutions are ill-suited for legitimate SMEs, because they have strict collateral requirements (Ortega, 2008, p. 1). The absence of financial institutions' branches in rural areas also creates a major problem for SMEs in search of capital. Some informal financing within the value chain does occur, but it is often not flexible enough to meet demand, while short-term working loans from buyers bind producers to specific buyers rather than allowing them competitive choices (USAID, 2006a, p. 14).

In this context, the USAID-funded Rural Competitiveness Activity (ARCo) project was designed to improve licit productive activities and access to financial services in the coca-growing Yungas and Chapare regions of Bolivia.

### B1b. Approach

In 2005, the financial services component of the ARCo project began its work by conducting supply- and demand-side analyses of the financial sectors in Yungas and Chapare to determine SME finance needs and available financial services.

The ARCo demand-side analysis found substantial demand for working capital to produce more value-added products (e.g., products made from bananas, coffee, palm hearts, pineapples) and to expand the tourism industry. Small producers in this region had value-chain relations with wholesalers, cooperatives, foreign purchasers, and distributors that could facilitate access to finance. With working capital, producers could improve

[39] A World Bank report (2008, p. 7) estimated that 80 percent of employment in Bolivia is informal.

productivity and quality with fertilizers, new plantings, improved maintenance, harvesting, and increased sales (USAID, 2006a, pp. 3-13).

Project staff determined that working capital should be the first priority, possibly followed by rural leasing and WHR. Based upon orders for sales to actors higher up the value chain, ARCo concluded POF could be used to expand SME access to finance. Banking supervisory bodies, including both the Superintendency of Banks and Financial Institutions (SBEF) and the central bank, responded positively to this idea.

The analysis also sounded some cautionary notes (USAID, 2006a, pp. 9-13). Many rural producers had become accustomed to below-market interest rates; one task would be to overcome attitudes toward repayment stemming from concessionary lending and periodic debt forgiveness.

ARCo's supply-side analysis showed that Bolivian banks remained reluctant to lend outside of major urban centers and usually required urban real estate as collateral, imposing high collateral-to-value ratios (USAID, 2005b, pp. 25-32). Moreover, with the banking system in a period of crisis and contraction, banks were wary of entering untested market segments.

ARCo decided that developing the relationships needed to introduce and sustain a viable POF program would require capacity-building with an existing financial institution. Staff solicited expressions of interest from 13 lending institutions that had some history of activity in the targeted regions; three institutions responded positively. ARCo selected FIE, a private financial fund and a leading Bolivian microfinance institution, to implement the POF pilot project. FIE is a financially sound institution and at present has a very strong domestic credit rating of AA.

The agreement with FIE provided for a small subsidy for it to open branches in Yungas and Chapare and to receive TA from ARCo to train financial-institution staff. FIE agreed to use its own funds for the loan pool and issue $2.2 million in POF credits in two years. With these commitments in place, work started to develop a POF product tailored to local needs. This included developing prototype loan contracts, tracking systems, and costing/pricing policies. ARCo conducted training programs for more than 100 FIE staff in identifying clients with need of and interest in new working capital loan arrangements; assessing potential borrowers' needs; structuring POF loans to meet the needs of small farmers and members of producer cooperatives and associations; assessing POF loan risk and structuring deals to reduce chances of default; and marketing the POF product (R. Ortega, personal communication, March 2009).

The project gave FIE strong incentives to commit the necessary time and resources to designing and implementing the POF product. FIE could expand its client base with a new product that could compete in Bolivia's saturated microcredit markets. TA deepened FIE's overall capacity in credit evaluation, risk assessment, loan management, and international trade. The performance-based subsidy incentives tied to four specific lending targets lowered FIE's financial risks in launching a new product with a new client

group. ARCo's approach to creating incentives and reducing risks resulted in a set of conditions that enabled FIE to successfully launch POF and understand its profit potential (R. Ortega, personal communication, March 2009).

### B1c. Results

One of the first POF operations under the program involved transactions between Cooperativa Agropecuaria Integral Noreste, a 260-member association of small coffee producers, and A. van Weely BV, a well-known Dutch trading company specializing in organic foods. Integral Noreste had received a purchase order from A. van Weely for a full container (nearly 20,000 kg) of washed Arabic organic Bolivian coffee, but they needed financing to process and ship the order (Ortega, 2008, pp. 5-6).

In October 2007, FIE issued a $30,000 POF loan to Integral Noreste for 90 days at a 12-percent annual rate. Integral Noreste used this financing to purchase coffee beans from producers and for post-harvest packaging. Integral Noreste officially transferred its A/R from A. van Weely to FIE, which kept control of the funds and paid suppliers for bills incurred by the cooperative. For further security, Integral Noreste deposited $10,000 in cash into a special FIE account. No other fees or collateral were used (Ortega, 2008, pp. 5-6).

**Project Impact**

The POF pilot project continues to grow throughout the target regions, with FIE disbursing more than 280 POF loans totaling $2.5 million in just a little more than two years. Owing to its positive experience with this project, FIE is exploring opening additional branches at its own expense in other rural areas and expanding the use of POF throughout the country. It is also introducing POF in larger urban markets to finance SMEs. FIE's success has had a demonstration effect on other financial institutions: Prodem, an NBFI operating in Bolivia, now offers a POF product (R. Ortega, personal communication, March 2009).

Previously, Integral Noreste could pay its members (i.e., coffee suppliers) only after it received payment from the buyer — usually three to four months after delivery. As a result, producers often sold their higher-quality coffee to other intermediaries for immediate payment, albeit at lower prices. The POF loan allowed Integral Noreste to pay suppliers upon delivery of the coffee, providing an incentive for members to sell their coffee to the cooperative. In the future, this will allow the cooperative to negotiate higher purchase prices for premium coffee, benefiting the small growers (Schiff and Stallard, 2009, p. 5).

### B1d. Key Findings and Lessons Learned

Several important lessons emerge from the ARCo model (R. Ortega, personal communication, March 2009):

- The financier's risk was reduced by creating an A/R mechanism based on demand from creditworthy clients.
- Targeted subsidies were introduced to lower costs of entering the market and encourage long-term sustainable interventions by financial institutions.

- Buyers, sellers, and financial intermediaries established links of trust and cooperation through increased information-sharing.

We can also draw several other lessons for implementing similar projects (Schiff and Stallard, 2009, pp. 5-6):

- Take time to determine the type of product required.
- Initiate interventions based on well-functioning relationships within the value chain.
- Due diligence is necessary on both ends of the transaction. The financial institution should obtain character references about both the seller and the buyer (e.g., how serious the entity is about the business, its payment records, and length of time in business).
- Training the financial institution's staff in marketing is important to project success.
- Devise products tailored to the results of the demand survey. No single product is appropriate for every need.
- Carefully choose the best institutional delivery mechanism (e.g., a credit union with strong local links, a commercial bank, an NBFI, an SME-financing institution, or a microfinance institution).
- Adjust the product to the financial institution's culture, procedures, rules, and regulations to minimize resistance to change. Make sure the leadership is fully aware of the process and buys in. Spend ample time on training and TA to middle management and loan officers.
- Work through the process step-by-step with the financial institution toward a successful first operation. Early success is essential for demonstrating the benefits of the arrangement.
- Build in incentives to make the intervention sustainable.
- Design an exit strategy to avoid creating dependency. Empower the institution to continue the operation after the project's exit.

### B2. Case Two: DCA Loan Guarantees to Promote SME Lending in Kenya

#### B2a. Background and Environment

Although the Kenya financial sector is relatively well-developed compared with other countries in the East Africa region, access to finance remains a major obstacle for SMEs. (USAID, n.d.a, p. 1). For more than two decades, USAID has been a leading donor supporting the effort to build a competitive microfinance industry (USAID, 2008, p. 5). At the turn of the century, USAID made the decision to focus on promoting an industry-level enabling environment in Kenya with the goal of opening channels of finance to micro-, small-, and medium-sized enterprises (MSMEs). This case study considers three

DCA LPGs that were designed to support USAID Kenya's overall goal of improving MSME access to finance. The three DCA LPGs considered are a $1.6-million LPG to K-Rep Bank to encourage lending to women-owned SMEs (2005-2010); a $3.95-million LPG to Kenya Commercial Bank (KCB) to promote SME lending (2006-2011); and a $2.5-million LPG to Fina Bank, also to promote SME lending (2006-2011).

### B2b. Approach

Based on experience gained through implementation of earlier DCA guarantees, USAID Kenya decided to embed DCA support activities in select TA-provider programs to maximize the potential benefits of the DCA guarantee programs.[40] The USAID-funded Kenya Microfinance Capacity Building Program (KEMCAP) operated from 2004-2008 and was designed to support the Association of Microfinance Institutions and to provide TA to the Central Bank of Kenya in developing appropriate microfinance regulations. KEMCAP's knowledge of and engagement with the microfinance sector made it a good fit to support to DCA guarantee programs designed to facilitate MSME lending.[41] KEMCAP's support to the three DCAs discussed in the case study included developing a SME market-sector assessment that was used to develop necessary DCA documentation; training to partner banks on using the DCA's Credit Management System (CMS); and monitoring to ensure that partner bank loan disbursements complied with the DCA agreements. In addition, KEMCAP's work with the Association of Microfinance Institutions and the Central Bank of Kenya fostered a business and regulatory environment more favorable to the microfinance industry as a whole.[42]

### B2c. Results

*K-Rep Bank: $1.6-Million LPG to Promote SME Lending to Women-Owned Businesses*. K-Rep was established as an intermediary organization in 1984 to provide funds to nongovernmental organizations (NGOs) that were on-lent to microenterprises. A subsidiary organization, K-Rep Bank, was formed and licensed as a commercial bank in 2000.

K-Rep applied for a DCA guarantee because many of its clients were growing and requiring additional capital. The bank sought a DCA guarantee to mitigate risk during a learning period to adjust to these growing SME clients.

In 2005, K-Rep received a DCA LPG of $1.6 million (to support $3.2 million in lending), earmarked to encourage lending in agriculture, tourism, and merchandise to SME businesses that were at least 50 percent women-owned (USAID, 2005a, pp. 2-7). To date, the K-Rep DCA LPG has guaranteed 172 SME loans with a total value of nearly $2.25

---

[40] A 2007 USAID-funded review of Kenya's DCA programs recommended that USAID move to an active management approach, working one-on-one with banks to realize greater gains from its DCA guarantees (USAID, 2007a, p. 10).
[41] Part of KEMCAP's technical SOW explicitly included support to the development and implementation of DCAs to support MSME lending.
[42] With KEMCAP's support, the Microfinance Bill was passed into law in 2007 (USAID, Kenya Microfinance Capacity Building Program Final Report, 2008, p. 4).

million. The guarantee is on track to be fully utilized by the targeted end date of September 2010.

*Kenya Commercial Bank: $3.95 Million to Promote SME Lending*. KCB was initially established as a government-owned bank; the government subsequently reduced its shareholdings to about 25 percent. KCB has the widest network of branches in the country and is Kenya's largest bank by assets.

KCB applied for a loan guarantee to reduce collateral requirements (previously set at more than 100 percent of the loan value) for select SMEs and to focus on building its understanding of individual SME businesses, their cash flow, and select economic sectors (USAID, 2006b, pp. 8-9; M. Rostal, personal communication, July 2009).

To date, the KCB $3.95-million DCA LPG has guaranteed 216 SME loans totaling $3 million. KCB has developed and introduced two new loan products in the market that are backed by the DCA guarantee: Biashara Working Loans, which target SMEs, and Grace Loans, targeted to women-owned businesses. The LPG is anticipated to be fully utilized by the targeted end date of September 2011.

*Fina Bank: $2.5 Million LPG to Promote SME Lending*. Fina Bank, a relatively small commercial bank in Nairobi, was established as an NBFI. It became a fully licensed commercial bank in 1995.

Fina had traditionally served Kenya's Asian community but decided to broaden its target market to the larger SME community in Kenya and East Africa. It undertook a major restructuring effort to do this, including applying for a DCA loan guarantee to reduce risk during the transition period (USAID, 2006b; M. Rostal, personal communication, July 2009).

To date, the Fina $2.5-million DCA LPG has guaranteed 172 SME loans totaling $2.7 million. The LPG is anticipated to be fully utilized by the targeted end date of September 2010.

In addition to the support provided by KEMCAP described above, Fina received considerable TA support via financing from the Financial Sector Deepening (FSD) Trust, including an embedded credit advisor in SME lending from ShoreBank. The SME lending resulting from the combined TA package and the DCA guarantee was a highly successful model for Fina, which has transformed itself into a major player in the SME lending arena in Kenya and has expanded its SME lending activities into Rwanda. In 2007, Fina Bank was voted the No. 1 SME lending bank in the country by the Kenya Bankers' Association.

### B2d. Key Findings and Lessons Learned

KEMCAP provided support to the three DCA LPGs in developing relevant background studies, providing training in using the DCA's CMS and monitoring to ensure that loan disbursements complied with DCA agreements. In addition, KEMCAP's work with the

Association of Microfinance Institutions and the Central Bank of Kenya fostered a business and regulatory environment more favorable to the microfinance industry as a whole. In other instances, USAID TA providers have provided support to DCA guarantee design and implementation through trainings to support improved bank lending policies and practices, through the design of new loan products and through customer referrals. For example, the USAID-funded Kosovo Cluster and Business Support program (KCBS) provided support in developing DCA documentation (design phase); in developing and implementing a series of training programs in agricultural lending to build the capacity of loan officers (implementation phase) to lend to the target sector; and in working with its established network of farmer's associations to market the new agricultural loans. The impact of this technical support was significant: The partner bank made 914 loans to farmers and agribusinesses, fully utilizing the $5 million DCA LPG (to support $10 million in lending) in just two years. The partner bank also added agricultural loans to its core product profile and is continuing to lend to the agricultural sector. In Peru, the USAID-funded Alternative Development Program (known by its Spanish acronym, "PDA") has provided support in preparing background documentation for two proposed DCA LPGs to support lending in rural areas. PDA has also worked with the two selected partner financial institutions to develop a working-capital loan product specifically designed for rural farmers, which will be marketed through the two proposed DCAs.

As illustrated above, embedding a DCA support component in a USAID TA program can be an effective way to increase the impact and success of DCA guarantees. Timing the complementary TA can often be the key factor in achieving impact through a credit guarantee. Training and other TA should be planned well in advance of structuring a DCA in order to ensure that the market is sufficiently able to utilize the benefits of a risk-sharing guarantee. The on-the-ground presence, financial-sector expertise, and knowledge of key financial-sector players offered by USAID TA providers can be critical in:

- identifying the demand for a DCA guarantee;
- identifying market imperfection(s) and an approach(es) for overcoming it/them;
- providing training to the selected financial institution(s) to move into a new market, to market new loan products, or to implement appropriate SME risk-rating systems;
- building the enabling environment for SME lending through TA to promote improved banking supervision and regulation;
- referring new clients to the selected financial institution(s)

### B3. Case Three: The Agricultural Cooperative Bank of Armenia Leasing Company

#### B3a. Background and Environment

The Agricultural Cooperative Bank of Armenia (ACBA) was founded in 1998 as part of an EU-TACIS[43] initiative to address the agricultural credit needs of Armenia's rural

[43] The European Union's Technical Aid to the Commonwealth of Independent States is the EU's TA program in all independent countries of the former Soviet Union (except the three Baltic countries).

community. Although ACBA's short-term seasonal loans to the rural agriculture sector did much to address Armenian farmers' working capital needs, farmers had difficulty accessing longer-term credit to procure productive equipment. Armenian banks offered only short-term loans of one year or less; collateral-to-loan requirements were so high that access to even short-term credit was out of the reach of many SMEs (Hakobyan and Miller, 2006, p. 1).

ACBA believed it could help SMEs meet their needs for productive equipment by introducing leasing. Discussions began among ACBA, Credit Agricole,[44] and other key players, including the IFC[45] and USAID/Armenia. It was decided that ACBA would provide an operating platform for the proposed leasing company through its established network of branches, and that the leasing company would operate as a for-profit entity with leasing transactions conducted at market (i.e., non-subsidized) rates. The new ACBA Leasing Company was formally incorporated in 2003 (International Finance Corporation, 2003).

**B3b. Approach**

Several steps were necessary before ACBA Leasing Company could be incorporated. First, Credit Agricole conducted market research to determine the demand for leasing in Armenia. The study concluded that demand in the agriculture and agribusiness sectors was not sufficient to support a leasing company, but that there was potential demand in other productive sectors that could sustain the investment (USAID, 2007b, p. 2). The company charter stipulated that the company would support agribusiness and non-agricultural sectors, and would focus on financing productive equipment and vehicles, including automobiles, not consumer goods.

**Addressing Double Taxation**

At the time when ACBA was established, it was charged VAT when equipment was leased *and* on interest earned from the lease, amounting to double taxation. ACBA successfully lobbied to change the law on VAT to remove payment of VAT on interest earned on leased equipment (USAID, 2006, p.4).

Second, inadequacies in the legal framework had to be resolved, and ACBA, Credit Agricole, and the IFC began to lobby for change. In 2002, the Civil Code was amended to broaden the scope of equipment that could be legally leased (USAID, 2007c, p. 23). A new Law on Credit Organizations was also adopted, designating the Central Bank of Armenia as the regulator for leasing companies (Law on Credit Organizations, 2002, p. 9).

Third, USAID, through its Agribusiness Small- and Medium-Sized Enterprise Market Development Program (ASME),[46] supported the development of Armenia's movable

[44] Through its consulting arm, Credit Agricole Consultants, Credit Agricole provided TA to establish ACBA. Credit Agricole eventually became the major ACBA shareholder.
[45] The IFC has invested in more than 100 leasing companies in 50 different countries (35 in Europe, the Middle East, and Central Asia). It initiated the establishment of the first leasing company in 25 countries, including Armenia.
[46] Much of ASME's interest in the project stemmed from the needs of its agribusiness clients, who had been unable to access capital through the banking system.

*cadastral* (collateral) registry, which allows lessors and lenders to record ownership and liens on movable property, such as equipment. This was an important precursor to establishing a leasing company, because it reduced the risk of a lessee attempting to sell leased productive equipment.

With the market assessment completed and the appropriate legal-regulatory groundwork laid, the ACBA Leasing Company was established in 2003. ACBA, the IFC,[47] Credit Agricole, and the Lebanese Leasing Company (LLC) were the initial shareholders. The IFC and Credit Agricole also provided lines of credit to the new company. USAID's ASME program provided an embedded, full-time technical advisor for two years, covering the pre-start-up phase and the first 16 months of operations, as well as additional grant funding for purchases of agricultural equipment for leasing (Hakobyan and Miller, 2006, p. 1).

The main goals of the ACBA Leasing Company were to help the agricultural economy and SMEs in the industrial and service sectors obtain medium-term financing for equipment and manufacturing facilities; develop leasing as an instrument in the Armenian financial market; assure viability of the leasing company through sound risk-management practices; and enable Armenian enterprises to renew their stocks of fixed assets.

Because leasing was almost entirely new in Armenia, it was important to educate stakeholders about its nature and uses. To market leasing to new clients and industry partners, ACBA held presentations at industry seminars and workshops, participated in donor-sponsored agribusiness industry sessions, and provided training materials to potential suppliers, distributors, and importers (Hakobyan and Miller, 2006, p. 4-5). Capacity-building inside the ACBA group itself was also addressed. Workshops were conducted to explain leasing to branch managers and training in leasing was provided for credit officers at ACBA branches. A credit officer was assigned to coordinate leasing activity in each branch, and compensation practices were adjusted so branch personnel shared in commissions for new leases.

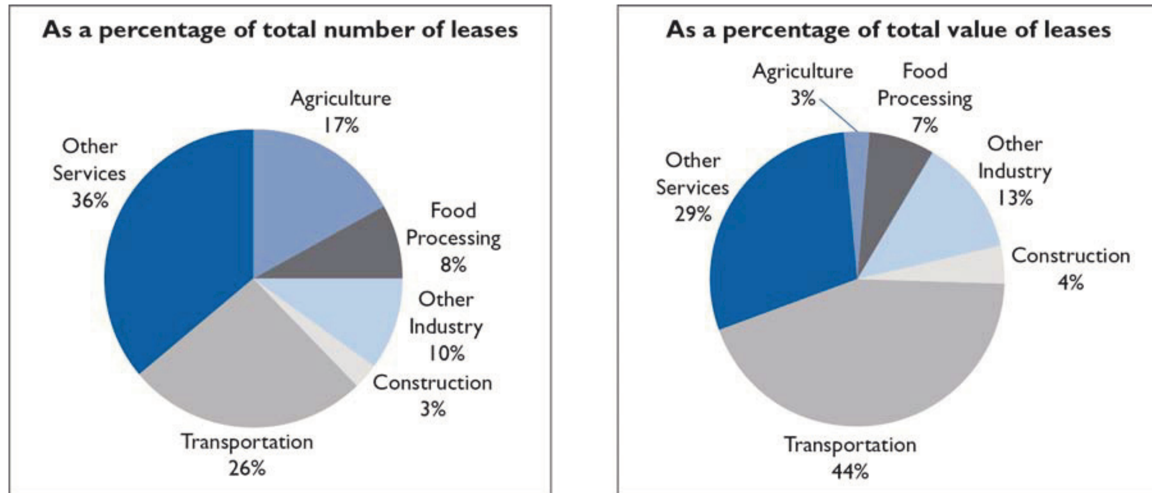
Leasing professionals must not only have knowledge of finance but also expertise in the sectors for which equipment is being purchased and leased. ACBA Leasing created an asset manager position to ensure sufficient knowledge about the equipment being leased and maintain relationships with distributors. More than 70 suppliers have signed cooperation contracts. The close relationships with distributors often result in price discounts: For example, ACBA Leasing receives a 5-percent discount on the purchase of both KamazTrucks (Russia) and Heidelberg printing equipment (Germany), which, in turn, is passed on to the lessee. Furthermore, having knowledge of the leased equipment helps ACBA Leasing appropriately estimate risk and maintenance costs (Hakobyan and Miller, 2006, p. 5).

---

[47] The IFC sold its shares to the other shareholders in 2007 as part of a scheduled buy-out.

### B3c. Results

Leasing activities have expanded considerably since the company was founded in 2003. By the end of 2008, 654 lease agreements had been made and the volume of leasing had reached $27.5 million (A. Bazikyan, personal communication, July 27, 2009).[48] The charts below show the breakdown of leased equipment by sector as a percentage of total leases and as a percent of the total value of leases for 2008.




Charts compiled from data provided by ACBA Leasing Company Deputy General Manager, Arsen Bazikyan, July 2009.

By serving targeted market sectors and offering Armenian SMEs access to needed capital equipment, ACBA Leasing has become profitable. Income from leases has risen steadily. In 2008, the company signed an agreement with the European Bank for Reconstruction and Development (EBRD) that will provide $8 million for future lease operations. Importantly, there has also been a demonstration effect. Other financial institutions[49] have begun to realize the attractions of leasing as a financing vehicle and have begun leasing operations in competition with ACBA Leasing, further opening access to finance for SMEs.

### B3d. Key Findings and Lessons Learned

Several important lessons emerge from the ACBA Leasing Company case.

First, the approach taken to establish the ACBA Leasing Company is a successful model for replication. Its private-sector founders made significant financial contributions and offered much-needed expertise; they were highly motivated from the outset to ensure the company's viability and commercial success.
Second, during the early implementation phase, care was taken to educate potential clients on the leasing product (demand-side) and train ACBA Bank and ACBA Leasing

[48] This includes $15 million in outstanding leases at the end of 2008.
[49] Cascade Credit, Agroleazing Leasing, and Ameriabank offer financial leasing in the Armenian market.

Company staff (supply-side). Efforts were made to develop strong relationships with equipment distributers and importers, which not only allowed ACBA Leasing to appropriately estimate risk and maintenance costs, but have resulted in occasional reductions in equipment costs.

Finally, the demonstration effect merits consideration. It appears that a viable leasing finance market is now developing spontaneously in Armenia, with multiple suppliers entering the market based on the pioneering initiative led by ACBA. USAID support (TA and grant funding for equipment purchases), though substantial, was justified by market-development objectives in a situation where a market was being created from scratch. Care should be taken, in other contexts, to determine that USAID interventions do not provide unbalanced support to a single company and to avoid market distortions where there may already be active suppliers.

### B4. Case Four: Innovative SME Fund in Macedonia

#### B4a. Background and Environment

The Macedonian Business Resource Center (MBRC) was a seven-year, USAID-funded project designed to help Macedonian businesses strengthen their competitiveness, financial management, operations, service delivery, and marketing. The project achieved significant results, facilitating more than $95 million in trade and investment deals for businesses over the life of the project. Despite success facilitating trade and investment, however, MBRC's SME clients continued to report that they needed access to working capital to grow their businesses — something that was not offered in the country's financial-services market at the time.

In response to this need for working capital, MBRC's implementing partner, Crimson Capital, began to look for ways to fill the finance gap. In early 2002, Crimson Capital approached USAID Macedonia with a project concept to launch an innovative fund that would provide short-term working capital to Macedonian SMEs through POF. USAID provided $1.1 million to launch the fund and an additional $1.5 million loan funds to Crimson Capital to be on-lent to Macedonian SMEs.

#### B4b. Approach

Initial work to establish the Macedonia SME Commercial Finance Fund (the Fund) included developing the POF product, including drafting appropriate credit policies, procedures, and loan agreements. Because both the Fund and POF were new to the Macedonian market, Fund staff carried out intensive marketing to SMEs to explain the particulars of each. In July 2003, the Fund made its first loan — $52,000 — to Univerzal Promet, enabling it to purchase raw materials it needed to fill orders for vinegar, antifreeze, and canned vegetables. The company's annual profit margin increased 20 percent; Univerzal Promet repaid the loan in five months and added 10 new seasonal employees (Crimson Capital, personal communication, July 2009).
As discussed earlier, POF can require more intensive monitoring of the SME's operations than some other asset-based products due to the risk that the order will not be filled. In

order to mitigate this risk, the Fund staff conducts mandatory visits to potential SME borrowers' places of business. This fosters a thorough understanding of each potential client's business and production cycle. Prospective borrowers must demonstrate that they can produce and deliver the goods on time and meet quality standards set in the purchase order; they must also demonstrate sufficient cash flow to sustain healthy business operations over the life of the POF loan.

Because the Fund is not a bank, its developers had to determine how to execute loan operations in Macedonia.[50] The Fund entered into an agreement with a licensed Macedonian bank and opened an account there. To execute a POF loan, the Fund gives wire instructions and loan agreements to the partner bank, which then wires loan funds from the Fund's account to the borrower. When a buyer pays for the borrower's goods, its money sometimes goes directly into the Fund's account at the partner bank. The Fund then deducts loan funds, interest, and fees and remits the reminder to the borrower. In cases where the buyer remits directly to the borrower, the Fund collects from the borrower. The Fund uses numerous techniques to ensure repayment and to mitigate risk.

### B4c. Results

The provision of working capital through the Fund has had a substantial impact on the growth of Macedonian's SME sector. To date, the Fund has made more than $15 million in loans to SMEs, resulting in the creation of more than 2,000 new, permanent jobs. Loans have been made to 39 women-owned and 42 minority-owned businesses, and to seven startups. The Fund's loans have stimulated an average yearly increase of 25 percent in revenues and 780 percent in profits for client SMEs, and have generated more than $58 million in new exports. The Fund's default rate has been less than 1 percent (Crimson Capital, personal communication, July 2009).

From its conception, the Fund was structured as a market-driven entity designed to address a critical gap in SME financial services. Its initial design allowed it to successfully make the transition from a donor project to an independent commercial entity. Today, interest and fees generated by the Fund's activities have made it totally self-financing. It has also registered as a local, Macedonian organization. The Fund's loan pool continues to be re-lent to SMEs on an ongoing basis, and it provides donors[51] with a sustainable legacy that has already leveraged initial donor loan-pool funds 50 times over. Based on its success, the Fund's founders have been able to double the loan capital available for lending, which will further accelerate sales, profits, exports, and employment. The Fund will be transformed to an LLC-form of a NBFI by the end of 2009. The Fund's founders successfully launched a sister fund in Kosovo in 2008.

[50] There was no NBFI law in place in Macedonia when the Fund was established.
[51] Norfund and Crimson Capital have also contributed to the Fund to increase its lending capital.

### B4d. Key Findings and Lessons Learned

Several important lessons emerge from the Macedonian SME Commercial Fund model:

- A thorough understanding of the market is key. Previous work implemented under the USAID-funded MBRC project demonstrated that SMEs had a pressing need for working capital. Work under MBRC also provided solid background knowledge of existing financial institutions' product lines.

- Designing the Fund to operate at commercial, market rates and on a cost-covering basis allowed it to transfer to an independent, self-sustainable institution.

- Time and care were taken to fully understand — and ensure adherence to — Macedonian banking, company, tax, and registration laws.

- The new POF product was successfully introduced to the market in tandem with a substantial marketing and outreach program to targeted borrowers.

## ANNEX A. SME FINANCE DIAGNOSTIC CHECKLIST

This diagnostic checklist is a quick reference for USG program officers when considering SME finance options. The checklist contains a non-exhaustive series of questions relevant to three sources of SME finance. It is designed to help programmers identify and compare opportunities for SME finance market development or a package of interventions to incorporate in a unified SME finance project. The checklist is designed for use in conjunction with the more detailed information presented in the primer and the MSOW in Annex B.

| Key Questions | Yes | No | Comments/ Responses |
|---|---|---|---|
| **Capital Markets** | | | |
| 1. Do SMEs seek either equity or debt finance in the capital markets? | | | |
| 2. If yes, does the country have a competent securities regulator who can enforce rules concerning shareholder and bondholder rights? | | | |
| 3. Are there credit-rating agencies and a credit-rating system applicable to SMEs? | | | |
| 4. Have local banks used the domestic bond market as a source of liquidity to fund their SME portfolios? | | | |
| 5. Are there domestic investors prepared to invest in shares or bonds of individual SMEs or bonds issued by financial intermediaries that lend to SMEs? | | | |
| **Traditional Banking** | | | |
| 1. Are banks well-capitalized, prudentially sound, and adequately supervised (e.g., BASEL II compliant)? | | | |
| 2. Do banks lend to SMEs on a significant scale? If not, what are the major obstacles cited? | | | |
| 3. Does the country have effective collateral laws and registries, an efficient bankruptcy regime, and credit-recovery procedures that protect lenders, supported by reliable commercial courts? | | | |
| 4. Is reliable credit information on SMEs available from public credit registries and/or private credit bureaus? | | | |
| 5. Do banks have plans to increase activity in the SME sector through expansion of branch networks, development of new SME finance products, or other initiatives? | | | |
| **Asset-Based Finance** | | | |
| ***A/R Finance, Factoring & POF*** | | | |
| 1. Do local SMEs have significant sales to clients with established credit ratings? | | | |
| 2. Does the legal system recognize SME assets underlying asset-based finance as separate from the other assets of the SME in case of bankruptcy? | | | |
| 3. Does the country have a collateral registry and lien system on which asset-based finance providers can rely? | | | |

| Key Questions | Yes | No | Comments/ Responses |
|---|---|---|---|
| ***WHRs*** | | | |
| 1. Does the country have a system of warehouses with adequate regulation that is trusted by banks? | | | |
| 2. Do SMEs/small-scale farmers have adequate access to market information to make informed decisions on the optimal time to sell their commodities? | | | |
| 3. Is there a system in place that allows SMEs/small-scale farmers to pool their commodities efficiently? | | | |
| ***Leasing*** | | | |
| 1. Do SMEs regularly use capital equipment that is suitable for leasing? Are there a sufficient number of potential users of the instrument to support an ongoing program? | | | |
| 2. Are financial institutions prepared to consider the use of leasing? | | | |
| 3. Does the country have an adequate leasing law? Can leased assets be legally repossessed? | | | |
| 4. In case of bankruptcy, does the legal system recognize leased assets as separate from the borrower's other assets? | | | |
| 5. Does the country have well-functioning collateral registry and lien system? | | | |
| ***DCA Guarantee Facilities*** | | | |
| 1. Are there SME finance market imperfections and risks that could be mitigated by a DCA guarantee? Which SME finance product(s) are most likely to merit consideration? | | | |
| 2. Is there a financial intermediary committed to expanding SME finance that has the solvency, liquidity, and management commitment to undertake a DCA guarantee agreement with USAID? | | | |
| 3. Is it reasonable to believe that the use of guarantees will provide "additionality" (i.e., not simply replace unguaranteed financing that would have occurred in any case)? | | | |

# ANNEX B. MODEL SCOPE OF WORK

This section provides a generic MSOW for undertaking a comprehensive analysis of SME finance markets in USAID-assisted countries. It complements and draws upon information in the primer and case studies and it can be used in conjunction with the SME Finance Diagnostic Checklist (Annex A) to ensure that all relevant points related to SME finance programming are covered.

The purpose of the MSOW is to offer a tool to USAID missions to help determine how best to proceed with the design of effective SME finance programs. It covers a generic supply- and demand-side analysis that addresses all dimensions of the existing SME finance market in a given country, identifies the impediments in the market, and prioritizes feasible market-development interventions that missions might undertake in collaboration with assisted-country partners. It also includes special consideration of the application of DCA credit enhancements to accelerate market expansion.

The MSOW has been prepared for flexible use, adaptable to the needs of individual design teams. Some missions may be further advanced than others in the analytical process, and may need to undertake only parts of the analysis. Design requirements may also vary by the geographic scope of the contemplated SME finance initiative (e.g., countrywide or different regions) and/or the targeted SME sectors (e.g., all-inclusive, urban vs. rural, selected industries, SMEs linked to specific value chains). In all cases, the MSOW will serve as a starting point for program designers, who will then construct the specific SOW needed for their particular requirements. Depending on the complexity of the effort, USAID missions may complete the analysis internally and/or via contracts with external consultants.

The MSOW has five sections, adaptable to the specific objectives of individual missions:

1. Purpose: analysis of the SME finance market in (country/region/sector)
2. Supply-side analysis
3. Demand-side analysis
4. Conclusions and recommended market interventions*
5. Next steps

*DCA guarantee possibilities are included in the recommended interventions.

In practice, we assume actual SOWs will include an executive summary, table of contents, and annexes, as determined by the authors. The MSOW does not include any of the other elements of a contract, such as staffing, timing, budget factors, or other contract boilerplate.

<u>Distinctions between Supply and Demand</u>

In the MSOW, the supply-side analysis is separate from the demand-side analysis and is covered first. In practice, SME markets function on the basis of mutually agreed

transactions between suppliers (sources of finance) and borrowers (demand). Prices, terms, and conditions of credit, equity, or other financing transactions are equally important for both supply and demand analysis, as are most of the elements of the legal and regulatory regime (which affect SME borrowers and financial institution providers). There can therefore be somewhat arbitrary distinctions, when analyzing SME finance markets, between topics that are addressed under the supply side or the demand side. As a basic principle, demand is primary; viable markets are demand-driven and supply responds to demand. On the other hand, creative suppliers can and do develop and market financial products that may not have been previously explicitly demanded, but which uncover latent demand and drive new markets.

It is usually more convenient to treat the supply side first, although it can be done either way. Keeping the two categories intact facilitates and helps generate a common understanding of how markets are working — or failing. Another reason for starting with supply is that statistical data on SME credit volumes, disaggregated by financial products, are more reliable than demand data. Demand calculations must rely on multiple assumptions (e.g., the percentage of targeted SMEs that are deemed "bankable" and the average size of credit likely to be demanded). Regardless, the SOW's principal conclusions should be an accurate-as-possible estimate of viable "unmet demand." The estimate should be given in absolute terms (i.e., U.S. dollar equivalent volume) and in percentage of viable credit subjects (per the categories addressed by the SOW) receiving vs. not receiving credit.

## MODEL SCOPE OF WORK

### 1. PURPOSE

[Suggested text in quotations, with comments]

"The purpose of this scope of work (SOW) is to provide comprehensive information and recommendations for the development of the small- and medium-sized (SME) finance market in (insert country, region within country, targeted SME sectors, other considerations explicitly describing the focus of the SOW)."

"The SOW comprises a detailed supply and demand analysis of the existing SME finance market (per first paragraph), identifies the impediments in the market, and ends with conclusions and recommendations that prioritize feasible market development interventions that USAID/(insert country) might undertake. (Optional) It also includes special consideration of the application of Development Credit Authority (DCA) credit enhancements to accelerate SME market expansion."

The Purpose section should be short. Additional short paragraphs could be added citing USAID mission strategy, programming, and other concerns that place the content of the SOW in broader contexts and highlight special expectations of the exercise.

## 2. SUPPLY-SIDE ANALYSIS

**Overview**

We suggest that the supply-side analysis section start with an "overview" statement explaining what comprises a supply-side analysis. A generic overview statement (from the Primer, Section A8) reads:

"A supply-side analysis looks at the supply of SME finance and the factors that influence it, including a review of the legal, regulatory, and institutional environment and the financial institutions and markets. It determines to what extent parties can obtain efficient and equitable treatment from the legal and regulatory system, including legislation covering bankruptcy, secured transactions, and creditor rights, and to what extent the legal system enforces these laws and rights.[52] It also determines the availability of reliable information needed to conduct business, including the availability and quality of collateral registries and credit registries. It considers relevant laws and regulations for the provision of financial services, including banking laws and relevant specific financial product laws (e.g., leasing law), and assesses the capability of financial supervisors (e.g., central banks and banking superentendencies). The supply analysis should specify the number, size, and geographic coverage of the financial institutions active in the market, their professional and institutional capacity, and their range of product offerings."

A short overview statement drawing from this generic text should be tailored to refer to the specific overall content and objectives of the supply-side analysis in the SOW. It serves the purpose of summarizing the work to be done and can end with a sentence such as, "The detailed tasks to be undertaken are specified below."

**Detailed Tasks**

The actual supply-side analysis tasks will include a mix of the generic tasks/activities presented in the following list. In the more comprehensive SOWs, it is possible that most or all of the subject matter covered in the list will need to be included. More narrowly focused scopes will have a shorter list. In all cases, the specific subject matter to be included, and the actual text of each of the detailed tasks, can draw from the generic information provided below. As required and known, sources of data to be consulted, relevant reference documents, and other information to be consulted should be indicated.

The generic tasks for the supply-side analysis are divided into four sub-sections:

(A) The Financial System
(B) Financial Intermediaries and SME Finance Products
(C) Legal and Regulatory Environment
(D) SME Finance Supply-Side Market Impediments

[52] In assessing the total environment for conducting business, the World Bank has constructed a Business Environment Index (BEI) in which countries are scored for property-right protection, contract enforcement, cost-of-entry regulations, and efficiency of the bankruptcy system.

(A) The (insert country) Financial System

- Task: Provide an overview of the financial system in (country). Factors to be considered and described should include most or all of the following:

  (1) The degree to which the system is dominated by government-owned vs. private financial intermediaries
  (2) Restrictions on foreign ownership of bank shares
  (3) The degree to which there are government policy controls on interest rates and fees (e.g., usury laws) or allocation of finance (e.g., directed credits to defined economic sectors, financial repression) vs. no government restrictions
  (4) The overall sophistication of the financial sector in terms of diversity of financing instruments (the three principal categories being traditional bank lending, asset-based finance, and equity capital)
  (5) The overall level of competition in the system (e.g., number of intermediaries, profit margins, presence of foreign firms)
  (6) The geographic reach of financial services (e.g., savings, credits, equity) (i.e., Are they concentrated in one or two cities or present in all regions?)
  (7) The overall status of the financial regulatory system and the stability of the system in recent time (e.g., incidence of bank failures, systemic financial crises, capital flight)
  (8) Whether Basel II is in place or planned to be in place
  (9) Currencies used in financial transactions (e.g., strictly local currency, mix of currencies — dollarization, use of euro, etc.), currency stability (e.g., foreign exchange regime, inflation, devaluation frequency)
  (10) The degree to which financial services are being delivered to different categories of enterprises by size (e.g., large enterprises, SMEs, and microenterprises)
  (11) Previous/existing interventions in specific financial institutions by donors/technical assistance (TA) providers in the area of SME lending enhancement

  In the actual SOW, this task should highlight the most relevant information needed by program designers to provide a concise overview of the financial system. Many of the elements of the system are fully detailed in the tasks that follow.

(B) Financial Intermediaries and SME Finance Products

- Task: Specify the number, size (deposits, other indicators), ownership, geographical coverage, and the financial intermediaries currently operating in (country), using the following categories:

  - Commercial Banks
  - Community Banks

- Savings and Loan Cooperatives
- Specialized Financial Institutions
- Equity Finance Institutions

This task provides a map of finance providers (universe of suppliers) in the country. Other categories can be added or titles of categories changed to best reflect country situations. Lists of the individual intermediaries should be placed in an annex, in tables showing size by deposits, total loan portfolio, total equity investment portfolio, or other key portfolio indicators.[53] Ownership (i.e., government or private, national or foreign) and geographic reach within the country should be recorded. "Specialized Financial Institutions" are intended to include finance companies, leasing companies, and other entities that are not authorized to take deposits. "Equity Finance Institutions" are intended to include venture capital companies and other private equity investment entities. *Note:* Many countries have specialized microfinance institutions that operate legally as commercial banks, with a separate legal status, or as NGOs. If needed, these institutions could be listed in an additional category.

- Task: Specifically for SMEs, specify and elaborate upon the SME finance products currently offered by the financial intermediaries, using the following categories:

  - Traditional Lending (e.g., short-term credit lines/overdrafts and medium-term loans)
  - Asset-Based Lending
  - Equity Capital
  - Guarantee Facilities

  For each of these categories, this task will define and describe the products offered in the existing market. It will then provide information about which financial intermediaries are engaged in each type of SME finance, quantify the volume of SME lending or SME equity investment that is currently registered, and describe the typical terms and conditions of the SME finance being provided (e.g., interest rates, tenor, collateral requirements, gearing ratios). For traditional lending, the intermediaries will include commercial banks and cooperatives. For asset-based lending, defined as "alternative" finance (including accounts receivable [A/R] lending, warehouse receipts [WHR], factoring, purchase-order finance [POF], and leasing) the intermediaries will include commercial banks (directly or through subsidiaries), cooperatives, and specialized financial intermediaries. For equity capital and guarantee facilities, the intermediaries will be entities dedicated exclusively to those objectives.

[53] Consideration should also be given to undertaking a capital, assets, management, earnings, and liquidity (CAMEL) ratio analysis of the banks and financial institutions, taking care to compare only those institutions that are similar.

In this task, it is particularly important to provide data on the quantity of SME finance being provided, in terms of dollar-equivalent volume and numbers of SME clients. Finance for SMEs needs to be carefully defined to exclude finance provided to large enterprises or microenterprises. The output on this part of the task (finance volume) will be compared with the estimate of total demand by SMEs for each type of SME finance (again by finance volume) to derive overall estimates of unmet demand for each type of SME finance product.

With regard to terms and conditions, this task will also identify the typical features of each type of currently transacted SME finance product, including as relevant: (1) interest rates (monthly, annualized); (2) overdraft financing vs. term loans; (3) tenor (length of credit agreement); (4) collateral requirements (real property, pledged assets, other guarantees); (5) special features of asset-based finance; or (6) specific conditions of equity capital finance. In the case of guarantee facilities, if these exist in the market, their specific terms should also be recorded (e.g., percentage of credit covered, fee rates).

This task should conclude with an assessment of the current profitability of the SME finance products. How interesting is this business for the intermediaries? Some intermediaries may be way ahead of others (market setters) and be highly successful (profitable). Others may be engaged only marginally in a given product market. How much competition is there, by finance product and geographic markets? Are there intermediaries who are expressing interest in entering markets? If so, why? This information will help determine recommendations for market development.

(C) Legal and Regulatory Environment

Two dimensions of the legal and regulatory environment affect the supply-side analysis: the financial sector and the commercial law regime.

- Task: For each of the following entries, describe and provide a summary assessment, as relevant, covering: (a) the quality of current laws/policies; identification of gaps in the legislative framework; (b) implementation of the laws/policies, identifying the institutions charged with implementation, their effectiveness, and gaps in essential institutional capacities; and (c) the enforcement of the laws/policies (i.e., the effectiveness of judicial/court systems in carrying out timely, transparent, and fair enforcement actions.[54])

  (1) Financial Sector Laws and Regulatory Institutions

    - Banking Law
    - Asset-Based Financial Product Laws

[54] With regard to commercial courts, do such courts exist and how effectively do they operate? What is the average time frame from instituting legal proceedings against a defaulting borrower and obtaining judgment? Is the court system inherently or marginally corrupt?

- Capital Market Laws
- Bank Regulation and Supervision
- Capital Market Laws and Regulation Institutions
- Credit Bureau Law and Institutions
- Rating Agencies

(2) Commercial Law Regime[55]

- Company Law and Registries
- Property Law
- Contract Law and Enforcement (including Credit Recovery)
- Collateral (Secured Transactions) and Collateral Registries
- Bankruptcy Law
- Competition (Anti-Monopoly) Law
- Accounting and Auditing Services

In this task, the actual SOW would include only those entries relevant to the SME finance analysis being conducted. For each entry chosen, the scope should specify, as known, the existing laws/policies, implementing institutions, any specific concerns that need to be addressed, and other background information to be consulted by design teams.

(D) SME Finance Supply-Side Market Impediments

Based on the data and analysis prepared in (A), (B), and (C), above, the macro factors of the financial system, the volumes of SME finance currently in place and disaggregated by finance product, and the status of the key legal and regulatory laws and institutions will be identified. Interviews and information collected in the above tasks, and further surveys/interviews with banks and other intermediaries, will provide the basis for Task (D).

- Task: Identify and elaborate upon the key supply-side market impediments in the current (insert targeted SME market). Describe how the mitigation or removal of the impediments could solve obstacles to commercial bank lending, asset-based lending, and equity finance for SMEs and lead to potential significant expansion of the market. A non-exhaustive list of commonly cited impediments, drawn from the Primer, case studies, and other experience, is given below, but should be used, modified, or supplemented depending on the design team's analysis:
  - Limited prior involvement of intermediaries in SME finance (sector, urban-rural distinctions, if relevant); high costs of SME lending (real or perceived) vis-à-vis lending to large enterprises; consequent wariness to enter new markets

[55] The financial-sector laws/institutions are most specifically tied to the supply side. The commercial law regime is treated here, but it is equally important for both the supply and demand analysis because it directly affects decisions by lenders, investors, and clients (SMEs seeking debt and/or equity finance).

- Lack of credible financial information, particularly for smaller SMEs; opaque information, no audited financial statements or obligations to make public disclosure; blurred line of demarcation between personal and business finances
- Lack of or unreliable credit bureaus (distinguish between government credit registries and private credit bureaus)
- High collateral requirements, resulting in underserved markets due to lack of sufficient real collateral among potential SME borrowers
- Lack of understanding of alternative asset-based lending products; need for new product development and testing; better understanding of value-chain financing, opportunities for POF, lending based on cash flows, A/R, factoring, etc.
- Need for strategies to mitigate risk in SME finance: soft collateral; payments tied to cash flows; direct payments to suppliers; gearing ratios (debt/equity); enhanced risk-assessment methodologies; special efforts to enlighten intermediaries on managing risk; expanding finance portfolios and profitability
- Weaknesses in the legal/regulatory environment: need for new or improved laws/policies; structural reforms of implementing institutions, such as collateral registries, bankruptcy/commercial courts and trustees, competition agencies, bank supervision, capital market institutions, etc.
- Weak or arbitrary enforcement mechanisms (e.g., lack of capacity in legal system to enforce claims against borrowers via effective credit-recovery laws; absence of alternative dispute resolution mechanisms or quick settlement procedures for small claims)
- For relatively newer asset-based lending, need for new or improved legislation/policies/implementation for leasing, WHRs, factoring, and other alternative financing mechanisms
- Lack of sufficient liquidity for SME finance, via deposits and/or other funds sourced by intermediaries; correct match between short-term/medium-term assets and liabilities; potential for tapping new depositors through linking savings accounts and new credit products
- Is the government distorting market liquidity through the issue of treasury bills and bonds?
- Insufficient physical bank infrastructure (geographic reach in targeted regions) and technological infrastructure (software, hardware applied to SME finance operations)
- Insufficient competition in the overall financial sector, lack of incentives to enter new markets/gain market share
- Problems arising from earlier policy mistakes, in particular, overuse of subsidized government credit programs that historically have led to market distortion, high default rates, and a culture of non-payment

For this task, it will be useful to indicate, if possible, the differing degree of importance of the impediments, and how their mitigation should be prioritized and sequenced.

## 3. DEMAND-SIDE ANALYSIS

**Overview**

We suggest that the demand-side analysis section start with an "overview" statement explaining what comprises a demand-side analysis. A generic overview statement (from the Primer, Section A8) reads:

"The demand-side analysis considers the demand for SME finance and the extent to which that demand is being met. It should indicate the number of SMEs in the targeted region or sector and the number of people employed. It should also address the size of enterprises, sectoral specialization, annual sales, and the degree of concentration. The relationships among SMEs inside the value chain and discernible patterns in trade credit among enterprises are important considerations, as is the level of financial sophistication among the entrepreneurs in the target sector and region. The demand-side analysis should express the exact nature of SME financing needs; it should consider whether the SMEs need working capital for items such as raw materials, packaging, and transportation, or whether investments in capital equipment would be useful."

A short overview statement drawing from this generic text should be tailored to refer to the specific overall content and objectives of the supply-side analysis in the SOW. It serves the purpose of summarizing the work to be done and can end with a sentence such as, "The detailed tasks to be undertaken are specified below."

**Detailed Tasks**

The actual demand-side analysis tasks will include a mix of the generic tasks/activities presented in the following sub-sections. In the more comprehensive SOW, it is possible that most or all of the subject matter will need to be included. More narrowly focused scopes will have a shorter requirement. In all cases, the specific subject matter to be included and the actual text of each of the detailed tasks can draw from the generic information provided. As required and known, sources of data to be consulted, relevant reference documents, and other information to be consulted should be indicated. Formal surveys can also be commissioned.[56]

The demand-side tasks are divided into four sub-sections:

(A) Importance of SMEs in the Economy
(B) SME Finance Needs
(C) Legal and Regulatory Environment
(D) SME Finance Demand-Side Market Impediments

---

[56] For example, a 2005 SME market study was commissioned in Ecuador and conducted by Habitus Investigacion, S.A., a local firm. The comprehensive study and survey reviewed data from the superintendency of companies and the small business chambers to estimate the size of the SME sector and demand for different SME finance products, with a focus on Quito and Guayaquil. The study was inspired by the potential to apply successful microfinance techniques to the lower end of SMEs.

## (A) Importance of SMEs in the Economy

- Task: Define as precisely as possible the number of SMEs in the economy, including definitions of SMEs, share of GDP output, share of total employees, disaggregation by industry sector, participation in exports, and other features such as linkages to larger enterprises through value chains, sub-contracting, franchising, out-grower arrangements, and other transactions. *Note:* The information collected and analyzed will be for the country as a whole, for regions within the country, and/or targeted industry sectors, depending on the specific SOW.

  Definitions of SMEs must be clear, and they will vary by country contexts (i.e., the size and complexity of the overall economy) and macroeconomic data used by different countries. The design team will determine and explain the definition used, considering and drawing from the following parameters, as relevant:

  - Dividing lines between SMEs and large enterprises, and between SMEs and microenterprises. Whatever the key criterion or criteria used for the definition, the higher end will mark the demarcation line with large enterprises, and the lower end will mark the demarcation line with microenterprises.[57]
  - Key measures: The most frequently used criterion in defining SMEs is the number of employees (the numbers often used are a minimum of 10 and a maximum of 200). Another frequently cited measure is total sales revenue (turnover), using figures that relate to the size of the economy in question. Other approaches that are especially instructive in SME finance projects use average size of SME credits, a common starting point being no lower than $20,000 and rising to a high-end amount of up to $250,000.[58] None of these criteria is fully satisfactory, but a definition must be chosen and adhered to, and ideally should be identical to or not deviate significantly from definitions used in central bank or other statistics within the country.[59]

  With regard to the share of SMEs in total GDP output, total exports, and total employment, these statistics should be available in government macroeconomic databases and/or World Bank/regional development bank databases. If not, best estimates need to be made and the methodology explained.

---

[57] In actual SME market-development activities performed by a USAID mission, these lines can and likely will be crossed at the edges, but the basic distinctions separating SMEs from large enterprises and microenterprises will remain. A survey of individual banks' definitions of SMEs should be conducted.

[58] Using the credit-size measure, a further distinction often becomes apparent between small-scale SMEs and larger SMEs. Small-scale SMEs are not microenterprises but require relatively low amounts of credit (under $50,000), which tend to be less available than higher average credit amounts for the larger SMEs.

[59] See the work cited in the Primer by Gibson and Van de Vaart, *Defining SMEs*: *A Less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries*, The Brookings Institution, 2008.

With regard to the other features, it is suggested that one or more of the following sets of disaggregated information be presented, again depending on the focus of the SOW.

- Breakout of SME numbers/data by industry sector (i.e., standard sectors such as agriculture, manufacturing, construction, retail, tourism, and professional services) or further disaggregated within a standard sector (e.g., leather products within manufacturing, coffee or cacao production within agriculture)
- Value chain breakouts (e.g., SMEs acting as subcontractors, out-growers, franchises, or other suppliers providing similar goods to larger enterprises such as processors and exporters)
- Formal vs. informal SMEs — an important consideration, especially for SME finance projects where the objectives are to increase access to formal financial intermediaries

(B) SME Finance Needs

Three tasks are recommended in analyzing specific finance needs. The first considers needs by type of finance product and factors affecting demand. The second looks at ancillary business development (non-finance) services and how needs for business development services (BDS) interplay with demand for finance. The third task involves the quantification of potential demand, using assumptions on percentages of SMEs that can (or should) seek formal external finance and estimated average amounts of finance solicited per SME.

- Task: Debt and Equity Finance Needs by Product: Analyze and describe SMEs' needs for external finance, for each of three categories of SME finance products.

  - Traditional Short-Term Credit Lines/Overdrafts and Medium-Term Loans
  - Asset-Based Lending
  - Equity Capital

For this task, reference should be made to the figures provided in sub-section (B) of the supply-side analysis, which show the actual amounts of credit and/or equity finance currently transacted between SMEs and financial intermediaries. The levels of current SME finance should be interpreted in terms of SME needs vs. actual access to finance. With regard to traditional loans, which factors diminish credit requests and/or credit approvals? Examples that might be cited in the SOW, depending on country situations, include high real collateral requirements, high interest rates and other fees and commissions, concern by SME owners about the risks of indebtedness, loss of ownership control (equity investments), or costs associated with accepting formal sector finance (taxes, employee benefits, etc.). SMEs may also lack knowledge of finance products, particularly asset-based finance in the form of leases, A/R discounting, factoring, or finance tied to purchase orders. How can orientation to the advantages of the alternative finance

products stimulate higher demand? With regard to equity capital, most SMEs start with their own savings or investments by family members and other individuals. In what circumstances are SMEs at the higher end of the scale likely to consider seeking external venture capital investments to finance business expansions?

This task should also report on evidence of other forms of credit currently being used by SMEs. Two examples are (1) trade credits among enterprises (e.g., supplier credit by providers of equipment purchased by SMEs, buyer credit [advances] for delivery of products against purchase orders) and (2) loans by informal money lenders. These sources of finance tend to be less reliable and may carry substantially higher costs than formal sector credit.

- Task: Business Development Services (BDS): Describe the availability and use by SMEs of ancillary BDS, and their interplay with demand for SME finance.

  This topic is treated separately; there is a long history of linkages between financial and non-financial services for SMEs. What is the status of the BDS industry for SME clients? Are SMEs using and paying for BDS services (full-cost basis, subsidized basis via government or donor programs)? Do BDS providers help link SMEs to sources of formal SME finance (e.g., in connection with business plans developed with BDS assistance)? What other professional non-finance services are being accessed by SMEs, including lawyers and accountants?

  This task should also cover SME business associations, as well as SME chapters within national or regional chambers of commerce and industry. These associations often play key roles in informing and educating SME members on the availability of finance products and how to take advantage of them.

- Task: Quantification of Demand: Provide an accurate-as-possible estimate of total potential demand by SMEs (nationwide or a targeted group of SMEs) for the three principal SME finance products (i.e., traditional bank loans, asset-based loans, and equity investments).

  The methodology for these calculations should begin with the total number of SMEs being considered. Of this number, a judgment (assumption) will be made regarding the percentage of the SMEs that will, given mitigation or removal of the market impediments presented in sub-section (D) below, become "bankable" subjects of credit or equity investments. Experience suggests that no more than 60 percent of the SMEs will, or should, become credit subjects under favorable circumstances. Perhaps no more than 5 percent would be subjects for equity investments. Then, a second assumption will be made on the average amount of credit (by product, traditional loan, or asset-based product) or equity investment that the SMEs will need and seek. As indicated earlier, it is likely that average credit amounts will be at least $20,000 per SME. It is more difficult to project likely average equity investment amounts. Multiplying the bankable SME investors by the average amounts will yield the total potential demand in dollar

terms. It is prudent to consider high and low assumptions for the two principal variables, and to end with a range of lower and higher potential demand estimates. Actual potential demand is likely to be close to the middle of the two estimates, although it is best to err on the low side.

(C) Legal and Regulatory Environment

- Task: Analyze SMEs' perceptions of the legal and regulatory environment affecting their ability and decisions to seek finance.

  SMEs, like suppliers of finance, need to have confidence in the financial sector and commercial law regimes that affect the SME finance markets. Both supply and demand participants in the markets need to rely on the quality of the laws, policies, implementing institutions, and judicial enforcement on all of the 14 legal and regulatory subjects listed in sub-section (C) of the supply-side analysis (not re-listed here but to be included in this task). Each side needs to be ensured and believe that the laws are understood, fair, effectively implemented, and impartially enforced. Without these assurances, the SME finance markets will be compromised and will not be expandable consonant with USAID mission objectives. In this task, the actual SOW should cite the subjects among the 14 listed that are relevant to the demand side of the market and the degree to which SMEs are well-protected or to which structural reforms of the laws, policies or institutions need to be undertaken.

(D) SME Finance Demand-Side Market Impediments

Based on the data and analysis prepared in (A), (B), and (C) above, the importance of SMEs in the economy, SME needs for finance disaggregated by product and other factors, and the status of the key legal and regulatory laws and institutions will be identified. Interviews and information collected in the above tasks, and further surveys/interviews with SMEs, will provide the basis for Task (D).

- Task: Identify and elaborate upon the key demand-side market impediments in the current (insert targeted SME market). Describe how the mitigation or removal of the impediments could solve obstacles to commercial bank lending, asset-based lending, and equity finance for SMEs, and lead to potential significant expansion of the market. A non-exhaustive list of commonly cited impediments, drawn from the Primer, case studies, and other experience, is given below but should be used, modified, or supplemented depending on the design team's analysis:

  - Disincentives among SMEs to seek formal finance and become formal sector companies required to pay taxes and employee benefits, incur other costs, and be subject to other regulations
  - Disincentives linked to illegal but profitable activities in the informal sector (e.g., coca production)

- High collateral requirements that are beyond the reach of SMEs (e.g., urban real estate valued several times a loan amount)
- Wariness, often justifiable, of taking on debt, including concerns on hidden fees, lawsuits, and protections of borrower rights. This is also informed by awareness, in certain countries, of prior subsidized SME credit programs that led to non-payment behavior, which honest SMEs want to avoid.
- Perceived high cost of credit (interest rates plus fees and commissions)
- Lack of easy access to financial providers' bank branches and offices, especially in rural areas, and related transaction costs (e.g., travel time)
- Lack of flexible, agile short-term credit products that have reasonably low cost (interest rates), meet SME working capital requirements, and are understood and easily administered. Such products include both traditional credit lines and alternative asset-based lending products.
- Absence of complementary savings services from deposit-taking institutions, offering reasonable income on term deposits. Savings products are frequently as important as credit products in responding to demand by SME owners and their families.
- Underutilized advice on SME finance options that could be provided by SME business associations (e.g., orientation on the advantages of asset-based loans, facilitating contacts with financial intermediaries, and monitoring new financial services initiated with SME members)
- Regarding equity finance, need for orientation and knowledge among SMEs ready to seek equity partners on rules, regulations and protection mechanisms, distinctions between private equity and shares listed with stock exchanges, etc.

For this task, as for the supply-side analysis, it will be useful to indicate, if possible, the differing degree of importance of the impediments and how their mitigation should be prioritized and sequenced.

## 4. CONCLUSIONS AND RECOMMENDED MARKET INTERVENTIONS

### Conclusions

The conclusions drawn from the analysis should include the following three parts:

- Task: Determine and state, as accurately as possible, the current market coverage of viable (bankable) demand. The measure should be in U.S.-dollar terms. The denominator in the equation is the viable *demand*, using the result of the quantification of demand task in Section 3. The numerator is total current *supply*, using the result of the tasks completed in Section 2. The resulting ratio is the percentage of market coverage.

  The market coverage ratio will be estimated for the individual SME financial products under consideration, and can be aggregated for all SME finance. They

will be countrywide or limited to selected geographic regions (or urban vs. rural zones), and be all-inclusive in terms of industry sectors or limited to selected sectors, depending on the USAID mission's needs. Finally, while these ratios are for SME credit (or equity) volumes in dollar terms, data on numbers of clients receiving finance (supply) vs. total numbers of viable clients (demand) can be used to produce ratios based on clients.

The unmet demand will be analyzed to determine degrees of market saturation and market failure. Particularly in cases where a reasonable percentage (30 percent or more) of viable demand is already being met, the analysis will also inform program designers on where and how the SME markets are functioning well. In these cases, special care should be taken in designing market expansion initiatives to avoid disruptions or distortions of the existing markets.

- Task: Spell out the exact nature of SME financing need(s) that the USAID mission should address, and the results in terms of market expansion that might be accomplished via a concerted market-development initiative. The needs will include traditional debt finance (short-term credit lines and medium-term loans for working or fixed capital), alternative asset-based lending, and/or equity finance.

  For this task, the mission may have predetermined certain SME finance products and markets that are to be addressed in the SOW. These needs should be directly addressed in the conclusions. Other needs that have emerged from the analysis but that may not have been previously identified should also be included.

- Task: Prioritize the SME financing needs in terms of impacts that can be anticipated through implementation of a concerted initiative, and indicate the most critical supply-side and demand-side market impediments that should be tackled (indicate sequencing of actions as relevant).

  This task should answer the key questions centered on potential market expansion impacts. In general, the volume of finance, and the numbers of clients served, should increase significantly in absolute and percentage terms.

  This task, by specifying the most critical impediments to be mitigated or removed, will also lead directly to decisions on the mix of interventions to be included in the contemplated market development initiative.

  The conclusions presented should also present relevant interconnections between the impacts of the initiative and broader USAID strategic objectives in the country.

## Recommended Market Interventions

- Task: From the conclusions, as well as the detailed supply-side and demand-side analyses, briefly outline the possible content for one or more USAID SME finance initiatives.

  No suggested content for this sub-section is offered. The actual SOW, however, should provide the detailed instructions to designers on what the USAID mission requires in terms of detail and elaboration. Where it is planned to proceed almost immediately to the full-scale design of one or more projects, the information to be included may be much more substantial, including recommendations on inputs for a project (e.g., specific technical assistance, training, study tours) as well as outputs. At a minimum, however, the SOW should ask for a list of the highest-priority SME finance market interventions deemed to be feasible and achievable within a defined timeframe.

## Development Credit Authority

- Task: Identify possible uses of DCA credit enhancements and guarantees as a means to remove market impediments and accelerate the expansion of new SME finance markets.

  DCA facilities are very often an additional mechanism that USAID missions apply to SME finance market initiatives. They take multiple forms, including:

  - Loan portfolio guarantees for financial intermediaries that provide SME finance using their own funds (liquidity) to extend credits to a large number of SME clients
  - Loan guarantees for financial intermediaries that lack sufficient liquidity for SME finance operations and utilize the DCA guarantee to access finance from third-party lenders
  - Bond issue guarantees for similar liquidity-need purposes, involving DCA guarantees of bonds issued in the local market
  - Other DCA guarantee products

  As a rule, DCA guarantees cover no more than 50 percent of the risk of default on SME credits extended by the financial intermediaries. They usually cover up to five years of activity, and require origination and utilization fee payments by the intermediaries. The fees are not onerous, and intermediaries approved for DCA guarantees use the guarantee cover in calculating their overall risk in entering new and relatively untested SME finance markets. The availability of a DCA guarantee can be a decisive factor for intermediaries in making final decisions to enter a new market and to do so at a pace and intensity consistent with USAID impact expectations. Finally, two of the principles governing DCA approval decisions (by DCA/Washington as well as USAID missions) are (1) *additionality*, meaning assurances that the SME finance activities supported by the guarantee

would not have gone forward without the DCA guarantee and (2) *utilization*, meaning an expectation that the amount of DCA guarantee cover provided will be as fully utilized as possible by the recipient intermediary.

## 5. NEXT STEPS

**(Optional)**

If included in an actual SOW, this section will briefly lay out the next steps involved in proceeding to full-scale design of a SME finance initiative. It will include activities to be undertaken, calendars, levels of effort, budgets, and other elements as required.

# ANNEX C. GLOSSARY

## Terminology

**Accounts Receivable (A/R) Finance.** The selling of a company's A/R, at a discount, to a factor, who then assumes the risk of the account debtors and receives cash as the debtors settle their accounts. A firm that sells its A/R may not be confident of its ability to collect those debts or might think that the cost of collecting that debt is more than the discount that must be provided to the factor when off-selling their receivables. Also called A/R financing.

**Bond.** A debt instrument that certifies a contract between the borrower (bond issuer) and the lender (bondholder) as spelled out in the bond indenture. The issuer (company, government, municipality) pledges to pay the loan principal (par value of the bond) to the bondholder on a fixed date (maturity date) as well as a fixed rate of interest (usually paid twice a year) for the life of the bond. Alternatively, some bonds are sold at a price lower than their par value in lieu of the periodic interest; on maturity, the full par value is paid to the bondholder. Bonds are issued in multiples of $1,000, usually for periods of five to 20 years, but some government bonds are issued for only 90 days. Most bonds are negotiable, and are freely traded over stock exchanges. Their market price depends mainly on the rating awarded by bond-rating agencies on the basis of issuer's reputation and financial strength. Investment in bonds offers two advantages: (1) known amount of interest income and, unlike other securities, (2) considerable pressure on the company to pay because the penalties for default are drastic. The major disadvantage is that the amount of income is fixed and may be eroded by inflation. Companies use bonds to finance acquisitions or capital investments. Governments use bonds to keep their election promises, fund long-term capital projects, or raise money for special situations, such as natural calamities or war.

**Capital.** The measure of the accumulated financial strength of an individual, firm, or nation, created by sacrificing present consumption in favor of investment to generate future returns above investment costs.

**Collateral.** A security or a guarantee (usually an asset) pledged for the repayment of a loan or bond in the case the borrower or issuer is not able repay.

**Convertible Bond.** A bond that can be exchanged for the issuing company's other securities (e.g., common stock or ordinary shares) under certain terms and conditions.

**Corporate Bond.** A debt instrument issued by a private corporation; different from a government or sub-sovereign bond.

**Credit Bureau.** A credit-reporting agency.

**Debt.** An obligation to pay money, deliver goods, or render service under an express or implied agreement. The one who owes is a *debtor* or *debitor*; the one to whom the debt is

owed is a *debtee*, *creditor*, or *lender*. Use of debt in a firm's financial structure creates financial leverage that can multiply yield on investment as long as returns generated by debt exceed its cost. Because the interest paid on debt can be written off as an expense, debt is normally the cheapest type of long-term financing.

**Development Credit Authority (DCA) Bond Guarantee.** A USAID DCA guarantee offering bond holders up to 50 percent guarantee of principal repayments. A bond guarantee ensures investors in corporate and/or sub-sovereign bonds of both recovery and repayment. A DCA bond guarantee often enables the issuer to obtain a higher credit rating than it would have without the guarantee, allowing the issuer to obtain less expensive and longer-term financing.

**DCA Loan Portfolio Guarantee (LPG).** An LPG provides up to 50 percent coverage on net principal losses by a private-sector lender to a borrower group specified by USAID. The purpose of an LPG is to encourage a lender to extend credit to borrowers, such as local governments, which are underserved by the financial sector.

**Equity.** (1) Ownership interest or claim of a holder of a firm's common stock (ordinary shares) and some types of preferred stock (preference shares). On a balance sheet, equity represents funds contributed by the owners (stockholders) plus retained earnings or minus the accumulated losses. (2) Net worth of a person or firm computed by subtracting total liabilities from the total assets. In case of cooperatives, equity represents members' investment plus retained earnings or minus losses.

**Factoring.** A type of supplier financing in which firms sell their creditworthy A/R at a discount (equal to interest plus service fees) and receive immediate cash. Factoring is not a loan. It is a comprehensive financial service that includes credit protection, accounts receivable bookkeeping, collection services, and financing (Klapper, 2005, p. 1).

**Islamic Banking.** Activities of Islamic financial institutions differ from those of standard commercial depository corporations in that predetermined interest on financial transactions is prohibited. The non-payment of interest on liabilities does not in itself preclude instruments from being classified as external debt.

The classification of Islamic banking instruments as external debt, or not, can be determined by the following general guidance.

Islamic instruments:

- Deposits include conventional and transferable deposits, such as Amanah and Qardhasan deposits, as well as investment participation certificates that are not investments in the permanent capital of a financial institution and do not have the characteristics of tradable securities.
- Debt securities consist of various investment participation certificates that have the characteristics of tradable securities and are not permanent capital of an institutional

unit. Included in this category are a financial corporation's most tradable investment certificates recorded as liabilities.
- Loans cover arrangements in which a financial institution makes prepayments for clients, finances ventures or trade, or supplies working capital to clients. The arrangements may include short-term or other partnerships in which a financial institution is not making permanent, equity-type investments (OECD, Glossary of Statistical Terms).

**Leasing.** Leasing is an asset financing method in which an asset, such as equipment or a building, owned by one party is provided to another party for productive usage in exchange for periodic payments (International Finance Corporation). Whereas traditional asset financing provides capital up front to the borrower to purchase an asset and requires periodic payments with interest until the loan is fully repaid, leasing does not transfer ownership to the lessee but rather allows them to use the equipment for a fee.

There are two main types of leasing arrangements. *Finance leases* typically extend for most or all of the useful life of the equipment. They require regular lease payments throughout the lease term, which allow the lesser to recover the cost of the asset, as well as interest payments. Finance leases usually cannot be cancelled, and typically provide the opportunity for the lessee to purchase the then-depreciated asset at the end of the lease period for a nominal price. This type of leasing is similar to traditional term loans for equipment, but the distinction is that the ownership of the asset is not transferred to the lessee during the lease period (Rozner, 2006, p. 2).

*Operating leases* are typically shorter in duration and can be cancelled by the lessee. Because the leases do not typically extend beyond the useful life of the equipment, the lessor is able to recover the initial investment through the short-term rental payments and the final sale of the slightly used asset once the lease period expires (Ibid).

**Line of Credit.** The extent to which a seller will extend credit-payment terms to a buyer or bank. It is the total of the amounts of (a) unpaid invoices, (b) goods in transit, and (c) orders confirmed but yet to be shipped or loans.

**Non-Bank Financial Institution (NBFI).** An NBFI is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFIs facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and market brokering. Examples of these include insurance firms, pawn shops, cashier's check issuers, check-cashing locations, currency exchanges, and microloan organizations.

**Overdraft Financing.** Overdraft financing is provided when businesses make payments from their current business account that exceeds the available cash balance. An overdraft facility enables businesses to obtain short-term funding, although in theory the amount loaned is repayable on demand by the bank. Overdrafts are generally meant to cover short-term financing requirements; they are not generally meant to provide a permanent source of finance. Depending on the size of the overdraft facility, the bank will generally

require the SME to provide collateral (e.g., by securing the overdraft against tangible fixed assets).

**Public-Private Partnership (PPP).** A particular form of private-sector participation in the financing and provision of municipal services and infrastructure. A PPP is characterized by private-sector management of the project company but with a public entity or municipality retaining a significant stake (and sometimes the majority) of the share capital of the project company.

**Purchase-Order Finance (POF).** POF refers to a type of short-term, pre-delivery financing in which companies pledge purchase orders for goods as partial collateral to secure working capital or trade financing to complete the order. The financing is transaction-specific and is not to be used for general cash-flow purposes, but rather for costs associated with filling the specific order, such as purchasing raw materials and inputs, direct labor and overhead costs, packaging, and shipping (Gold and Jacobs, 2007, p. 20). The lender either provides the seller with funds for specific purposes or can purchase the required inputs and materials directly from the supplier for the borrower's use. In POF arrangements, the seller submits a purchase order to the lender in exchange for a partial advance to cover the costs of filling the order. Once the goods or services are produced, the A/R is transferred to the lender, who receives payment from the buyer, deducts the amount of the advance plus interest and fees, and remits the remaining balance to the seller (Ibid).

**Registry.** A government agency that maintains a public register of certain items of information, such as company records and land titles (e.g., a collateral registry or credit registry).

**Retail Bonds.** Bonds targeting individual retail investors who will buy bonds on their own behalf, not for an organization. Retail investors typically buy bonds in much smaller quantities than institutional investors and are therefore often charged slightly higher commissions than institutional investors.

**Revenue Bonds.** A bond on the debt service that is payable solely from the revenue generated from the operation of the facilities being financed or from other non-tax sources

**Reverse Factoring.** The lender purchases A/Rs from only high-quality buyers. The lender needs only to collect credit information and calculate the credit risk from the buyer. The credit risk is equal to the *customer's* default risk, not the SME's. This arrangement allows creditors in developing countries to factor "without recourse" and provide low-risk loans to high-risk SMEs (Klapper, 2005, p. 16).

**Term Loan.** An asset-based short-term (usually for one to five years) loan payable in a fixed number of equal installments over the term of the loan. Term loans are generally provided as working capital for acquiring income-producing assets (e.g., machinery, equipment, inventory) that generate the cash flows for repayment of the loan.

**Value Chain Finance.** As stated by Fries and Stallard (2009), "value chain finance is neither a separate subset of finance, with unique or distinct products, nor is it a complex new field." The term simply refers to the finance that flows to or among value chain members, including the smallest microenterprises and the largest multinational companies. Value chain finance may be direct or indirect. Direct value chain finance refers to financial flows between value chain actors. For example, a processor may provide cash or in-kind credit to a small farmer producing mangoes for the company. The credit is repaid when the mangoes are delivered to the processor. Indirect value chain finance refers to lending by a financial institution (whether a non-governmental organization[NGO], credit union, or bank) to a value chain member. Some successful value chain financing approaches are actually a hybrid of the two. For example, a bank may lend to small producers *through* a processor. The processor, with its established relationship with the producers, may take responsibility for ensuring repayment of the individual loans to the bank, thereby reducing the costs to the bank of analyzing the credit risk of each borrower and monitoring the individual loans.

**Venture Capital.** Startup or growth equity capital or loan capital provided by private investors (e.g., the venture capitalists) or specialized financial institutions (e.g., development finance houses or venture capital firms). Also called risk capital.

**Warehouse Receipt (WHR).** A document that provides proof of ownership of commodities (e.g., bars of copper) that are stored in a warehouse, vault, or depository for safekeeping.

## ANNEX D. BIBLIOGRAPHY


Bakker, M., Klapper, L., & Udell, G. (2004). *Financing small and medium-size enterprises with factoring: Global growth in factoring – and its potential in Eastern Europe.* World Bank.

Beck, T., Demirgüç-Kunt, A., & Levine, R. (2000). *A New Database on Financial Development and Structure.* World Bank Economic Review 14. Revised January 2009.

Beck, T., Demirgüç-Kunt, & A. Peria, M.S. (2008). *Bank Financing for SMEs around the World: Drivers, Obstacles, Business Models, and Lending Practices.* The World Bank Development Research Group Finance and Private Sector Team. Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1312268

Deelen, L., Dupleich, M., Othieno, L., Wakelin, O., & Berold, R. (Ed). (2003). *Leasing for Small and Micro Enterprises. A guide for designing and managing leasing schemes in developing countries.* International Labour Organization.

European Bank for Reconstruction and Development. (October 2002). *Lithuania: Financing of warehouse receipts Legal review*. (2002). Report Series N.1-October 2002.

Evans, D. (1987). Tests of Alternative Theories of Firm Growth. *Journal of Political Economy. Volume 95.*

Fries, B., & Stallard, J. (2009). *Finance in the Value Chain Framework Briefing Paper.* US Agency for International Development. Retrieved from http://www.microlinks.org/ev_en.php?ID=34299_201&ID2=DO_TOPIC

Gibson, T., & Van der Vaart, H. J. (2008). *Defining SMEs: A Less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries.* The Brookings Institution. Retrieved from http://www.brookings.edu/papers/2008/09_development_gibson.aspx

Giovannucci, D., Varangis, P., & Larson, D. (n.d.). *Warehouse Receipts: Facilitating Credit and Commodity Markets.* Retrieved from http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTARD/0,,contentMDK:20439054~pagePK:210058~piPK:210062~theSitePK:336682,00.html

Gold, M., & Jacobs, G. (2007). Analysis of the Potential for Development of SME Purchase Order Finance Products. Unpublished.

Hakobyan, A., & Miller, M. (2006*). Lessons Learned from ACBA Leasing*. Unpublished. Development Alternatives, Inc.

International Finance Corporation. (n.d.). *Summary of Project Information: Armenian Leasing Company*. Retrieved from http://www.ifc.org/ifcext/spiwebsite1.nsf/1ca07340e47a35cd85256efb00700cee/30692AC6421A205885256B8B007F47C7

International Finance Corporation. 2003 Press release. Retrieved from http://www.ifc.org/ifcext/eca.nsf/Content/SelectedPR?OpenDocument&UNID=9AE21EDD7C60088E85256D1300660352

International Labor Organization. (2007). *The information economy: enabling transition to formalization.*

International Monetary Fund. (2007). *Bolivia: 2007 Article IV Consultation*.

Klapper, L. (2005). *The role of factoring for financing small and medium enterprises*. World Bank Policy Research Working Paper No. 3593. Retrieved from http://econ.worldbank.org/external/default/main?pagePK=64165259&piPK=64165421&theSitePK=469382&menuPK=64216926&entityID=000090341_20050515140836

Kozak, M. *Micro, Small, and Medium Enterprises: A Collection of Published Data* [Data File]. (2007). International Finance Corporation. Retrieved from http://www.ifc.org/ifcext/sme.nsf/AttachmentsByTitle/SMEDatabase.xls/$FILE/SMEDatabase.xls

Lin, J. (2009, July 11). Walk, don't run. *The Economist, 76.*

Miller, M. (2008). *Warehouse Receipts in "Less than Ideal" Conditions*. Unpublished. US Agency for International Development.

Organization of Economic Cooperation and Development. (2006). *The SME Financing Gap, Volume I, Theory and Evidence.*

Ortega R. (2008). *Value Chain Financing in Rural Bolivia: Introducing Purchase Order Financing*. Paper presented at the Innovations in Financing Value Chains Competition.

Republic of Armenia Law on Credit Organizations. (2002). Retrieved from http://www.cba.am/CBA_SITE/legal/orenkner.html?__locale=en

Rozner, S. (2006). *RAFI Note #11, Rural Leasing*. US Agency for International Development.

Schiff, H., & Stallard, J. with assistance from Falvey, M., & Ortega, R.L. (2009). *Purchase order Finance in Bolivia: Innovations in Financing Value Chains*, US Agency for International Development microREPORT #151. Retrieved from http://www.microlinks.org/ev01.php?ID=39079_201&ID2=DO_TOPIC

*U.S. Government Assistance to Eastern Europe under the Support for East European Democracy (SEED) Act.* (2004). Bureau of European and Eurasian Affairs. US Agency for International Development. Retrieved from http://www.state.gov/p/eur/rls/rpt/37005.htm.

US Agency for International Development. (2005a). *Action Memorandum: CRB Recommendations for Approval of Development Credit Authority Activity in Kenya: K-Rep Bank SME Facility.* Unpublished.

US Agency for International Development. (2005b). *The Bolivian Financial System: A Supply Side Analysis*. Unpublished.

US Agency for International Development. (2006a). *Access to Finance Value Chain Financing in Chapare and Yungas*. Unpublished.

US Agency for International Development. (2006b). *Action memorandum: CRB Recommendations for Approval of Development Credit Authority Activity in Kenya: Fina Bank SME Facility and KCB SME Facility.* Unpublished.

US Agency for International Development. (2006c). *Warehouse Receipts Financing – A Banking Perspective.* Unpublished.

US Agency for International Development. (2007a). *Assessment of Development Credit Authority Guarantees in Kenya*. Unpublished.

US Agency for International Development. (2007b). *Coping with the "Unexpected" – The Experience of ACBA Leasing in Armenia*. MicroNote. Hakobyan, A. Retrieved from http://www.microlinks.org/ev02.php?ID=15496_201&ID2=DO_TOPIC

US Agency for International Development. (2007c). *Armenia Financial Sector Deeping Project: Leasing. Presentation to Partner Banks and CEOs.* Unpublished. Retrieved from http://www.fsdp.am/upload/files/Leasing_CEO_Round_Table_Presentation_English.pdf

US Agency for International Development. (2008). *Kenya Microfinance Capacity Building Program Final Report*, Unpublished.

US Agency for International Development. (n.d.a). *Co-operative Bank of Kenya LPG - Activity Description*. Unpublished.

US Agency for International Development. (n.d.b). *USAID Development Credit Authority*. Retrieved from http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit/types_loan_portfolio_guarantee.html

**U.S. Agency for International Development**
1300 Pennsylvania Avenue, NW
Washington, DC 20523
Tel: (202) 712-0000
Fax: (202) 216-3524
**www.usaid.gov**