

## Structured sales finance: funding international sales growth for small to medium enterprises

BY JOHN R. RICE III

Small to medium sized businesses, (SMEs), account for a significant portion of the world's business volume. For China, about 50 percent of GDP is generated by the SMEs. A good portion of the SMEs must compete internationally and SME owners taking on international businesses require intelligence, bravery, and optimism. In the Book of Genesis we read that there was a time when "giants roamed the earth". Well in the world of international business that time is now! Just take a look at this list:

Company	Revenue
Wal-Mart Stores	\$287bn
Royal Dutch Shell Group	\$268bn
General Electric	\$193bn
CitiGroup	\$108bn
Home Depot	\$73bn
Sony	\$66bn
Target	\$49bn

They are just a very few of many companies, which may not be giants in the biblical sense but, if you are an SME seeking your fortune doing international business these giants must be acknowledged because their substantial power sets the conditions for how business is done.

### International competition: working capital demands

Today, small to medium sized businesses competing in the international markets are up against some fearsome challenges, including competition for sales and meeting the variable costs for delivery which often

pose the most difficult obstacles.

The requisite working capital to meet overhead, sales, and production costs is found in two forms: equity and debt. Equity is wonderful if and when it is available, but most SMEs are not that attractive to equity investors. SME equity principally comes from owners and it is usually limited to the funds needed to get the company up and running. Debt secured by real estate, equipment, inventory, and receivables is the next source, (also very limited), and surprisingly, unsecured debt in the form of credit card lines is one of the primary sources of working capital for small businesses. These sources of working capital are typically inadequate to support significant growth for the following reasons:

1. An SME often has limited credit and must pay suppliers before or at the time of delivery.
2. Delivery to the actual buyer occurs after production, international shipment, customs clearance, warehousing, repacking, and local delivery.
3. International buyers increasingly want payment terms which call for payment after the product is received and accepted by the buyer and payment terms are usually 30 to 60 days from the date of acceptance.

Consider an SME receiving a purchase order in the amount of \$500,000. It is issued from a large retail chain to a US company which is buying from a large Chinese manufacturer where the cost of goods is \$350,000. The Chinese manufacturer requires a Documentary Letter of Credit (LC) to start production. The shipping date is 30 days from the date of the confirmation of the LC, transit time is 20 days and customs clearance is five days. After clearing the container, the merchandise will go directly to the retail chain's distribution centre in approximately two days. The US distributor (SME) will invoice the retailer two days later. The payment terms given by the retailer are 30 days, but this

retailer actually pays in 45 days. Therefore the US company's \$350,000 of capital will be out approximately 166 days from the date the US (SME) opens the LC.

If this company is to continue selling \$500,000 per month under the same conditions after five months, it will need working capital of \$1.75m just to pay for the cost of goods before their first invoice is paid. Accordingly, with a \$90,000 monthly overhead, the carry increases by \$450,000 to \$2.2m. If the company's sales are increasing each month, the working capital demands will, of course, increase as well.

In this example, the main asset of the US distributor is the receivable, but the receivable is created 121 days after the LC is opened. How does this SME finance the LC for its foreign manufacturer? The simple answer would be that it has cash or a bank line. But in general most companies have some cash to carry the operation's overhead and perhaps a bank receivable line which advances a percentage of the invoice up to a designated amount based on the bank's credit formula. If the company's sales are growing this will not be enough. Should either or both of these working capital resources not be available, the order(s) would have to be reduced or refused. Moreover, this working capital dilemma is compounded if a foreign manufacturer is selling directly to the US retailer, (which is increasingly the case), because then the working capital carry period increases.

### Obstacles; quality control and buyer credit risk

There are many other such issues to be solved by SMEs engaging in international transactions, certainly too many to be identified in the context of this article. However, the most significant in my view are the quality control and buyer credit risks. For example, assuming the LC is opened and delivery is made, the buyer will require that the goods conform to his order. If the shipment does not meet the required standards, ▶▶

it will be rejected or at the time of settlement there will be charge backs to adjust for nonconforming goods. In addition, there are significant examples of goods that are delivered and accepted and then the buyer defaults. The rigorous challenges of sourcing working capital, maintaining high levels of quality control and credit risk management are among the most critical issues facing SMEs, as they venture out into the global market, thus competing with the giants of today's international business.

Of course, many financial products have been created over the years to support sales growth. However, in the international arena most are aimed at larger and well-capitalised borrowers. The development of structured products such as the International Trade Alliance Program (ITAP) have been created for SMEs.

Such programmes focus directly on supporting sales growth for small and medium sized companies without relying on the SMEs' credit. This program is highly structured and asset-based. But the structure is built around the sales transaction and the assets are mainly those within that transaction itself. SMEs need working capital to pay for the cost of goods, a complete quality control management system, logistical and warehousing support, and a full guarantee of the buyers' credit.

Structured sales finance is applicable to any finished goods transaction at any point in the supply chain. Key requirements are; the company has experienced management, the company produces well made products with commercial value, and the company has a buyer for its products which is worthy of credit in the amount of each purchase. With this approach, there is no specified credit limit tied to the SME, thus it can grow as rapidly as sales are created. This is very important for an SME which is selling to national and international distribution chains where sales can increase by several hundred percent in a very short time.

#### Global business support structures

Advances in political, financial and technological areas have helped structured sales finance programs mature and offer SMEs a viable plan of action with which to increase their sales. The most significant advances include:

1. Letters of Credit
2. Freight Containerisation

#### 3. Silicon Chips "Personal Computers"

Briefly, the Letter of Credit is the outgrowth of the Draft (first recorded in Genoa about 1100 AD), which evolved into a Trade Acceptance and finally into a Documentary Letter of Credit. This instrument came into its own in the US in the 1960s and allowed for the creation of an international bank controlled settlement system and the "assurance of payment" for commercial transactions between buyers and sellers doing business almost anywhere in the world.

The containerisation of freight as conceived by Malcolm Mclean in the 1930s led to the creation of the Sea Land Corporation in the 1970s. This company created a system where freight could be placed in a standardised steel container, which could then be easily transferred from a truck, train, ship, and airplane. Thus creating a cost-effective, efficient, worldwide, interlinked freight handling, logistics, and delivery system, which permitted the rapid and safe movement of vast quantities of goods anywhere in the world within a few weeks.

Finally an invention we all depend upon – the microprocessor – was developed in the early 1970s and this led to the creation of low cost ubiquitous digital computing and telecommunications. This technology has linked the entire world and nearly everyone in it by cable or wireless transmitters and receivers at the speed of light and sound. Now with the internet and cell phone, information may be instantly received almost anywhere in the world.

Together these innovations have allowed the creation of global business support structures in finance, freight movement, and communications. For the SME, conforming to the financial and management requirements of these monumental international business support structures is not an option; it is a requirement of doing international business today. While they are truly complex, expensive and a bit daunting for an SME, the benefits are enormous. Imagine having the largest of financial institutions, freight assets and computer systems at your company's disposal with no significant capital investment. In fact ITAP allows SMEs of nearly any size to take full advantage of this mega, international business support structure, while costing only a small percentage of the transaction profit.

#### US importer/distributor: a closer look

For example, in March an SME (US importer distributor) had an \$8m order from a multi billion dollar retailer. At the time, the SME did not have sufficient capital or credit to complete the order. The SME had experienced managers and an experienced manufacturer in China to produce the order. The manufacturer wanted an LC payable FOB China. The buyer wanted 60 day terms, excellent quality control, and the SME to have EDI inventory and billing capabilities. Under a proprietary structured finance program, it was determined that the buyer was creditworthy and the lender agreed to issue Letters of Credit to the manufacturer in China covering the cost of goods. A quality control management program implemented, and the lender agreed to factor the account, and guarantee the retailer's credit.

This structured sales financing:

1. insured payment to the manufacturer through the international banking system (LC), removed the risk of quality failure (third party inspections),
2. provided logistical support (an international shipping company and bonded warehouse with EDI systems was arranged),
3. created working capital for the SME based on the order (LC/s and factoring receivables), and
4. managed the credit risk to the SME by providing a guarantee of payment in the event of buyer default.

During the six months of this structured sales financing, nearly \$5m of goods have been delivered, invoiced, and paid for with less than one percent of charge backs for quality control issues. Sales to the SME's buyer for the balance of the year will exceed \$14m. The SME is optimistic that sales to the buyer for 2006 will be in excess of \$20m.

Structured sales finance is an extremely effective tool for SMEs which have rapidly expanding sales. Taking on the giants of international trade certainly has its risks but with faith, strong leadership and a good slingshot full of working capital, anything is possible. ■

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