SARONA

# TRADE FINANCE

## IN FRONTIER & EMERGING MARKETS

Mobilizing Capital for Impact at Scale

**MAY 2018**

# Trade Finance: Addressing a Vexing Problem for Development

Across emerging markets, access to finance is a persistent obstacle to sustainable growth. Nowhere is this more true than trade finance. In our work, we see first-hand that small and medium-size enterprises (SMEs) often cannot optimise growth because they cannot get the funding they need to buy materials to fill orders, finance unpaid accounts receivable, smooth cash flows, and pay employees. Without access to trade finance, many SMEs would simply die.

And while trade finance is a thriving global industry comprising myriad public and private players, in frontier and emerging markets it remains a nascent and fragmented sector with large funding gaps – gaps that severely curtail private-sector development and socio-economic prosperity.

Sarona – a global leader in emerging market impact investing – set its sights on this crucial problem. With funding support from MEDA[1] and Global Affairs Canada, we engaged Mbuyu Capital to examine this issue. Our conclusions are presented herein, and the Full Report can be sourced here.

# Overall Findings

Trade finance is crucial to SMEs and to the broader economy. Otherwise, many SMEs simply cannot make a sale, or must halt production until payment is received – these can be fatal blows.

There is massive unmet demand for trade finance by SMEs across developing markets: Of the $1.3 trillion credit gap, some $150 billion is readily serviceable by trade finance.[2]

The supply-demand gap is greatest in Latin America in overall dollar amount, while Africa has the greatest relative supply-demand deficit.

**Among key factors preventing SMEs from moving up sector value chains, *lack of access to business/trade/supplier finance* is the factor most cited by:**

**60%** **of agri-food sector SMEs**

**60%** **of tourism sector SMEs**

**50%** **of apparel sector SMEs**

***World Trade Report 2016: Levelling the Playing Field for SMEs, World Trade Organization***

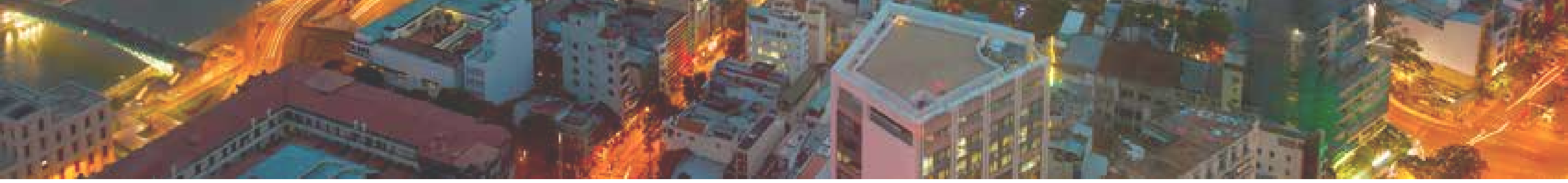
The addressable global (excl. China) market gap for SME trade finance in 32 frontier & emerging market SMEs is $112 billion, including:

**10** **markets over $1B**

**21** **markets over $500M**

**$37B** **in low, lower middle income and least developed countries**

[1] Mennonite Economic Development Associates
[2] All figures: Frontier and Emerging Markets, excluding China



# Sarona's Journey Into Trade Finance: A Note From the CEO

Imagine running a small company and landing a contract to supply Walmart with your product. It must feel pretty intoxicating when the largest global retailer signs you up as one of their suppliers. Thirty days after your first shipment, reality slowly sinks in – your big client doesn't pay when invoiced. Rather, they'll wait 90, 120, or perhaps even 180 days before replenishing your aching bank account. Fairness aside, it simply isn't possible to run your business like that. And if you're in South America, it's not very likely that a bank will fill the gap for you. Big problem.

A few years ago, Sarona became a partner in solving this issue for small to mid-market companies in Colombia. By purchasing a position in the Kandeo PE Fund in Colombia, we became a shareholder in GFO – Grupo Factoring de Occidente – a firm that has created an innovative model of providing financing to such companies.

GFO is both a financier and an information channel between large buyers and smaller producers. Seventy of the top 100 Colombian companies list their payables on GFO's web platform, showing who they owe money to, and when their supplier can expect payment. On the other side, the suppliers – many of which are small businesses – can log into the website to see whether their invoice has been approved and when payment might be coming. If the payment date is too far off, the supplier can simply click on a link and trigger immediate payment from GFO, which then awaits payment directly from the large debtor company.

This kind of financial innovation improves lives and livelihoods in a powerful, scalable way. That's why Sarona is helping chart bold news ways to solve persistent trade finance challenges.

Gerhard Pries
*Chief Executive Officer*

# Key Insights – Trade Finance Supply

**The supply of trade finance is very small compared to the demand and the opportunity**

» Banks remain the largest suppliers of credit, but they serve larger corporations and commodity traders, hence the credit gap

**Larger, established non-bank trade finance providers are growing in size – as a result:**

» They are serving larger SMEs with larger deals, while the supply to smaller SMEs has been reduced

» They are shifting to longer term lending vs trade finance

» Their returns decreasing due to asset growth, which forces larger deal sizes and lower rates

**New suppliers are arising to fill the gap, and are growing quickly**

» Many are focused on non-exchange traded commodities, lower volumes and niche routes to achieve higher margins

**Deal flow continues to be a problem, suggesting an information gap that must be addressed before the credit gap for SMEs can be closed**

**Investors focused on ESG and Impact is growing**

» This results in increased awareness of social and environmental issues by trade finance providers

# Bridging the Divide Between Capital and Deal Flow

Large established players have capital, but not SMEs, while smaller local players have SMEs (and risk), but not capital. We need more capital flow to SMEs

**Established, international trade finance suppliers are able to attract capital from a variety of sources, but:**

- To retain SME focused they need to be able to access more deal flow which they can transact efficiently
- Mechanisms to mitigate risk and reduce transaction costs for smaller deals need to be developed
- Quality new entrants doing smaller deals need to be provided with capital

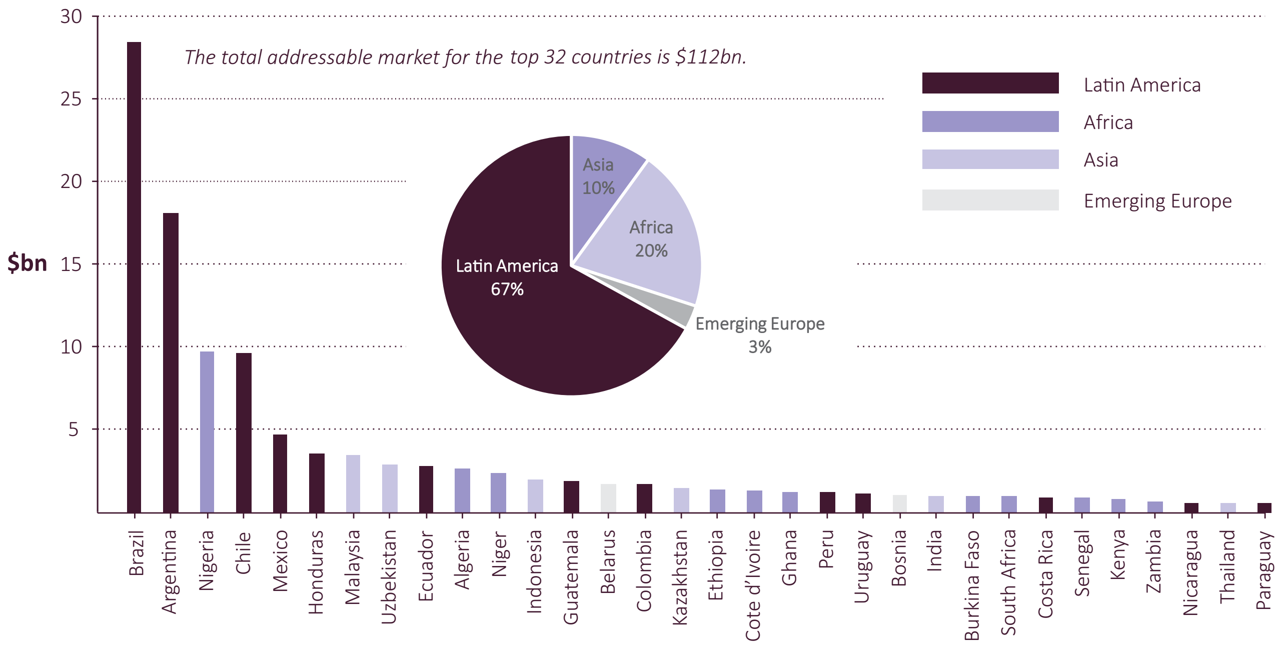
**Local, smaller trade finance suppliers in frontier and emerging markets have strong SME deal flow and often innovative technology solutions, but:**

- They need capital, generally on-balance sheet in small $1-$5 million allotments initially
- They are often small, early-stage businesses with associated risks
- Investor transaction and monitoring costs are high

# The Solution? Targeted Capital to Connect Supply and Demand

- Innovative development initiatives to unblock the pipeline between demand and supply - such as improving connectivity between SMEs and suppliers of trade finance, technology to reduce transaction costs and supply chain solutions
- Innovative development finance for risk-mitigating solutions
- Investable products with identifiable impact and risk-return profiles to mobilise commercial capital at scale
- Trade finance focused on impact offers significant potential to create positive outcomes at the system, supply chain and individual SME level

# Addressable Market Gap by Country




*Source: Mbuyu Capital analysis, IFC SME Enterprise Finance Gap Database, McKinsey 'Two Trillion and Counting' 2010*

## About Sarona

Sarona invests in private companies in frontier and emerging markets, targeting strong financial returns, and positive ethical, social and environmental impact.

The firm, based in Canada and Netherlands, is a leader in innovative development finance, working with private and public partners to structure blended finance vehicles that achieve both financial goals and the Sustainable Development Goals.

Sarona's mandates include direct and fund investment strategies focused on both debt and growth equity for private companies.

*"Trade finance is an investible asset class at an early stage. The universe of funds is small, the depth of the asset class is low, and there is very substantial scope for growth."*

***Mbuyu Capital***

## About Our Partners

**MEDA** is an international economic development organization whose mission is to create business solutions to poverty. Founded in 1953 by a group of Mennonite business professionals, the organization partners with the poor to start or grow small and medium-sized businesses in developing regions around the world.

**Mbuyu Capital** opens up private markets in Africa to institutional investors by creating customised portfolios across private equity, real estate and credit. Both financial returns and impact are targeted using a research-driven, operationally-focused and disciplined approach, integrating primary, secondary and co-investments.

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