

# “COALITION” A PROPOSAL FOR FINANCING SME’s, 2001

by

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## ABSTRACT

Many have been the approaches on financing small and medium enterprises in developing countries, but most of them do not seem to solve the great problem that lies beneath those good intentions: SME’s don’t fit in the risk analysis patterns that financial institutions require in order to grant their loans.

## INTRODUCTION

The traditional route small and medium sized companies had to take for the purpose of obtaining loans was going to a Bank or a Government office to request. Then, they had to leave part of their assets as a guarantee either on a signed paper or physically at a warehouse.

The problem has been going all along and, although most businessmen can prove their business plans have good perspectives, and present sound financial projections, they usually don’t have the kind of assets that financial institutions are requesting in order to lend them the money they need to start their business engines.

The spread of new technology over the emerging nations enterprises, namely Internet and wide area networks, has developed innovative approaches that are being taken using old financial instruments as the base for these schemes.

The proposed model in this paper requires the interaction of several players of the modern market economy, predominant in most countries. We call this strategy “Coalition”, a word coined in 1612.

## PLAYERS

This business model requires the participation of at least four kinds of entities, each with it’s own role, obligations and, of course, financial benefits.

1. Banks: Although this is a new model, these financial institutions are still the centerpiece of SME financing, and as such, they hold the highest recognition and trustworthiness in developing countries.

Since their inception, these organizations have been the intermediary between lenders and investors, and their role in this proposal has not changed at all. The only thing that will differ is how they accomplish one of their main tasks.

2. Government: There has to be someone who defines all of the financial rules in a country, and it usually is a government office such as the Central Bank or a Banking Commission. They are responsible for designing and implementing legislation when needed, and regulating the fulfillment of existing laws between the interested parties.
3. Guarantor: In this case, it is a big and solid enterprise that has enough means to certify that it will pay for the debts it may acquire with a Bank.

In the coalition model, the 'Guarantor' can even be a local or federal government, all it takes to play this role is to be recognized as a trusty debt payer because, as we explain in this paper, trust is the central axis around which financing rotates in Mexico and, generally, worldwide.

All an organization requires for taking part in the Coalition is having, at least, one small or medium company as a provider of raw material, services or products, and having bill payment policies in which cash is delivered afterwards.

4. Guarantee: This role is represented by a small or medium sized company in need of a loan. Guarantees should have an agreement with a Guarantor for delivering materials, services or products.

## THE MODEL

The whole coalition strategy is based on the traditional Factoring service. This means that there has to be a Guarantee selling its services or products to a Guarantor, and who is waiting for a specified period of time in order to receive money for the products and invoice he has already handed over.

Given the game players and needs above, the Guarantor has an account payable, owing the Guarantee a certain amount of money over a time lapse, and since it is a big company who usually has very important business with the Bank in other aspects (treasury, investment instruments, stocks, etc.), it already has a business history with the financial institution.

As a provider for the Guarantor, the Guarantee has some signed documents (generally, accounts receivable) that he got from his client at the time of the products or services delivery, and that he can take to the Bank in order to cash them in advance of their due date.

The Bank already trusts the Guarantor, so it can easily grant the money to the guarantee in exchange of the signed documents before the maturing date.

Once the transaction is performed, the Guarantee has enough money to continue operating, and is no longer hand-tied until he gets a loan.

## FAILURE OF FACTORING AS A CASH FLOW ENABLER IN MEXICO

The main principle for the scheme to work properly is trust, which can be a very rare adjective in developing countries.

In the early 80's factoring was considered to be an innovative tool for financing all kinds of companies in Mexico, specially because it was seen as a credit with a natural guarantee, so most Banks decided to start discounting documents to provide its clients with enough funds to continue their business.

Soon, the reality showed the financial institutions that factoring had a flaw. They learned that it was not enough guarantee to have a signed invoice or account payable in order to secure the payment.

There was an important number of 'ghost companies' which were created for the sole purpose of acting as clients of several small providers, and who soon went legally broke by Mexican laws. The Banks never got to collect the debt so they stopped to provide Factoring without recourse services.

Some years later, factoring with recourse, the only kind then available, was either too expensive, too limiting, or non functional, so it was discontinued from all of the bank's services catalogs and, therefore, burried inside another of the unsuccessful financial instruments dark tombs.

## WHAT IS NEEDED IN ORDER TO REACTIVATE FACTORING

In this coalition, entities who already know each other transmit their trust to the other participants, so the last member of the chain (the Bank) can issue a credit to the first one (the Guarantor), relying on the trust he already has on the one in the middle (the Guarantor).

Another of the main premises for coalition to reactivate factoring is that there must be existing chains of production, suppliers or services, because in that way, trust can be passed from the first link to last one, reactivating, by this manner, this kind of financing for all of the members of that chain.

## PUTTING THE "E" INTO COALITION

Technology can be one of the key factors to make this proposal known and successfully used by the members of a commercial chain. It simply makes the process of discounting accounts receivable easier by allowing suppliers to consult via websites the status of all of their pending invoices, and by facilitating them to request the factoring from the bank.

On the guarantor's perspective, an electronic coalition means that they will be able to keep the products and services coming without worrying about their suppliers going broke because of a cash flow lack. They won't even have to worry about the document discounting at all, because the Bank takes charge of all of the process.

For the Banks, it is a new service which will attract new customers or that will make existing ones extend business with them. The services they provide will generate commissions on the guarantor's side, and interests from the guarantee's side, and the best part is that it can mostly be an automated online process, so it means less expenses on mortar and workforce.

The only human interaction needed from the Bank's side, in this strategy, is when interest rates have to be negotiated, which can be done via chat, thus eliminating the need of opening new branches in towns and pueblos that don't justify doing so in order to attend just a few clients.

The guarantee's main benefit is that he'll be able to access funds without having to stop by a bank's office and having to present all of the traditional documents and guarantees. All he has to do is log into the Bank's systems, select the documents he wishes to discount, and if he agrees on the default discounting rate, wait for the transaction to be cleared and the money deposited to his account.

## VALUE ADDED SERVICES

One of the most attractive uses of technology for the Coalition proposal is its ability to let Guarantees play with variables in order to achieve certain objectives. This is easily done with the use of calculators.

Some value added services that a financial institution can offer on their coalition related website are:

1. A program that is able to tell the Guarantee the exact amount of money he will receive by selecting a document for factoring at any specific date until its maturing date.
2. Based on a given need of money, an interactive website that lets the user select different account receivable documents (previously registered by Guarantors), and that depending on their due date and discount rate, shows the user the total amount of money he would receive if he cashed the documents at that time.
3. A routine that sorts all of the user's receivables by a number of different views: Date, Issuer, Amount, Due date, Discount Rate, etc.
4. A program based on an given amount of money that automatically selects the documents to discount meeting specified criteria: The oldest documents, discounting the fewest invoices, discounting the most receivables from a specified issuer, etc.
5. An interactive functionality in order to let the users contact bank executives so that they can negotiate discount rates and ask questions without the need of using

telephone lines. Furthermore, this could be achieved in a number of ways, including chat, messaging systems, and even video conference.

It is important to note that a well designed system should let the Guarantee view from a single login all of his account receivables from different clients and in the different chains that he is a member of.

In order to have more people using this system, and less attending branch offices or using call centers, the factoring website should be planned in a manner such that navigation is very simple and , yet, satisfies all of the user's needs, including all of the data manipulation routines possible that add value to the service.

## LIMITATIONS

Coalition is a solution for financing certain types of Small and Medium sized Enterprises, and it's limited to aiding those who integrate a part of a supply chain. This case represents around one fifth of all SME's in Mexico, that nevertheless play an important role in the generation of Gross National Product.

This proposal is also limited to the level of technology in a Country. If the Internet or at least modem technology is not present at this time, the effort will have less impact, since it would have longer response times, perhaps also influenced by the bureaucracy of some institutions.

Another possible problem is actual legislation. If a nation has limitations in the possibility of making financial transactions via electronic media, the proposal would be less attractive.

Coalition facilitates short-term financing, and in no way is a solution for the long-term debt problem in emerging countries, but it settles the pavement for SME's by helping them start a trustable relationship and banking history with credit organizations, which might eventually be an important factor when requesting other kinds of loans.

## WHAT IS BEING DONE IN MEXICO

Since the election of President Vicente Fox, the country has been going through numerous changes in the ways of conducting business with the government, who usually was inefficient and bureaucratic.

Last year, a project called "E-Mexico" was launched by the head of the country, with the intention of modernizing all the processes that in one way or the other have a relationship with either persons or enterprises, and the country's main developing bank (NAFIN) hasn't been an exception.

The concept of "Productive Chains" has already been adopted by that Bank, and with the **coalition** with some big enterprises, it has developed factoring services for SME's.

Moreover, some of those corporations include international commercial chains such as Walmart, Important government owned institutions, including the Federal Electricity Commission (CFE) an electricity generation and reselling monopoly, The health Institute for State workers (ISSSTE), and some big national enterprises.

Other commercial Banks have already envisioned the high profits and controlled risk they can have with this approach, and have started developing functionalities on their websites that will enable them to do E-Finance in a short term.

## WHY E-FINANCE IS AN IMPORTANT STEP IN FINANCING SME'S IN MEXICO

Since the main problem with financing non corporate enterprises in the country was their lack of assets in order to guarantee the credits, coalition brings new hope to middle and small sized companies, because this factor is solved when the big players act as guarantors.

Furthermore, even when SMEs had enough resources in order to properly back a loan, most of them didn't have a credit history because they hadn't had a credit before, and in Mexico, very few companies are trusted from the beginning of their business relation. Coalition empowers trust from Important Enterprises to their business partners, because the scheme permits the bank to trust an SME by trusting the big corporation at the end of the chain.

## CONCLUSIONS

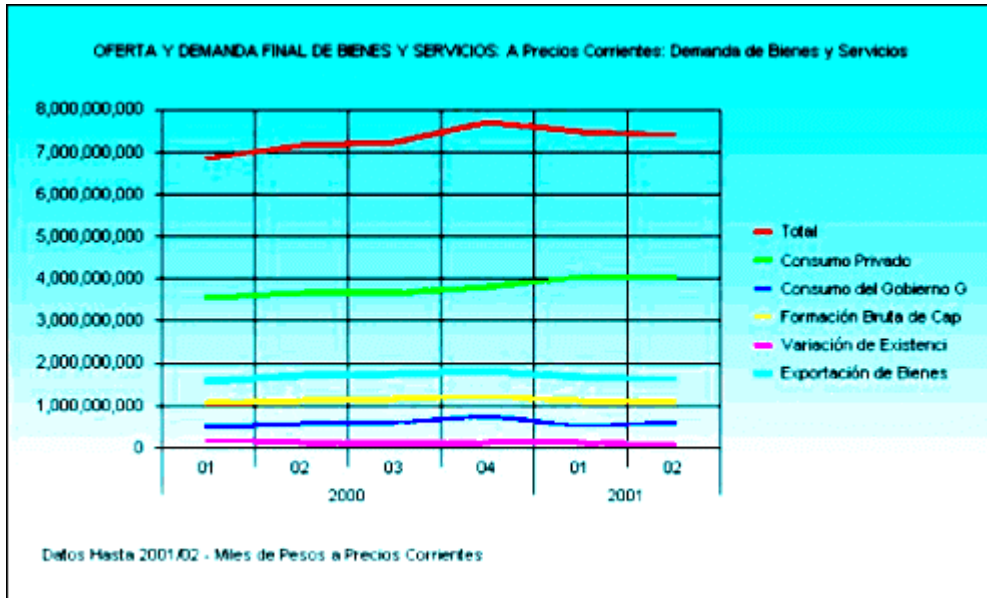
- Each day the interest of corporations who depend on supply chains, in participating in these coalitions is growing more and more, because it is helping them to develop their suppliers by facilitating them to have enough cash flow when the market conditions demand more production, and because it simplifies the administrative tasks of paying supplier by supplier when the Bank takes charge of that part of the business.
- We can expect a big growth of these programs in the short term as members of a productive chain (or Guarantees) get to know their existence, and when they understand the benefits they can obtain from using them.
- With the merging of Mexico's main Banks and foreign institutions, we can expect a growth in the financial entities efficiency. This will only make them to look at new ways of making money, new products to offer, and new clients to gather, and E-Financing is a very solid first step they can take into the 21<sup>st</sup> century business models.
- Universities are key participants in making coalition a reality. At least in Mexico, technology knowledge is very limited in people older than 30 years, and therefore, Colleges can participate in two ways:

1. Educating existing Executives and Managers: So that they will learn how to use the new age tools to do E-Banking and obtaining E-Financing.
  2. Preparing Students: So when they enter the labour market they have all the necessary knowledge to start using these tools, and thus pushing existing executives making them use the 'New Market' E-products.
- If E-Mexico really proves to be supported by the government itself, it will surely change the way the country works in, and in that transition we will be able to see how E-Financing gets more attention, and perhaps one day it will help improving the situation of the currently shrinking middle class, who owns most the small and middle sized enterprises in the nation.

## ADDENDA

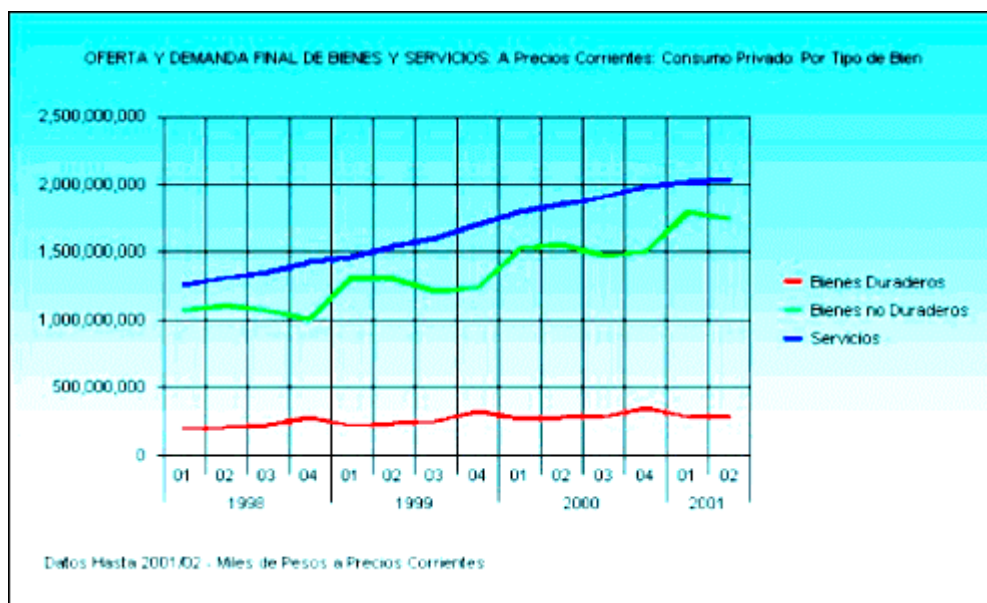
Below is a graphic that shows the growth of demand on goods and services in Mexico (information until Q2 2001) where we can see the importance of Private Industry demand (green line) as well as the relevance that exportations have for the country (light blue line).

Source: <http://www.inegi.gob.mx/estadistica/espanol/economia/feconomia.html>



Below: Growth of the internal demand on Fixed Assets (red line), Standard assets and products (green line) and services (blue line), where we can see the importance of the service Industry demand over the other two kind of products, which helps us understand how relevant will the service-chain will eventually be in the country.

Source: <http://www.inegi.gob.mx/estadistica/espanol/economia/feconomia.html>



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