Chapter 13

Capital Requirements and Private Sources of Financing

Many small and medium-sized businesses suffer from undercapitalization and/or poor management of financial resources, often during the first few years of operation. Typically, the entrepreneur either overestimates demand for the product or severely underestimates the need for capital resources and organizational skills. Undercapitalization may also be a result of the entrepreneur's aversion to equity financing (fear of loss of control over the business) or the lender's resistance to provide capital due to the entrepreneur's lack of credit history and a comprehensive business plan (Gardner, 1994; Hutchinson, 1995).

Large corporations have an advantage in raising capital compared with small businesses. They have greater bargaining strength with lenders, they can issue securities, and they have greater access to capital markets around the world. However, major changes are taking place in small/medium-sized business financing due to three important factors: technology, globalization, and deregulation. Information technology enables the financial world to operate efficiently, to decentralize while improving control. It also provides businesses seeking capital to choose from a vast range of financial instruments (Grimaud, 1995). Globalization allows businesses to turn increasingly to international markets to raise capital. With a touch of a button, businesses will have access to individual or corporate sources of finance around the world. With deregulation, in many countries, competition in financial products is allowed across all depository institutions. The distinction between investment and commercial banking is quite blurred, and both sectors now compete in the small business financing market.

It is important to properly evaluate how much capital is needed, in what increments, and over what time period. First are the initial capital needs to start the export-import business. Start-up costs are not large if the exporter-importer begins as an agent (without buying for resale) and uses his or her own home as an office. Initial capital needs are for office supplies and equipment—telephone, fax, computer—and a part-time assistant. The business could also be started on a part-time basis until it provides sufficient revenues to cover expenses, including the owner's salary. However, when the business is commenced with the intention of establishing an independent company with products purchased for resale (merchant, distributor, etc.), a lot more capital is needed to prepare a business plan, travel, purchase, and distribute the product, and exhibit in major trade shows. Second, capital is needed to finance growth and for expansion of the business. It is thus critical to anticipate capital needs during the time of growth and expansion as well as during abnormal increases in accounts receivable, inventory levels, and changes in the business cycle.

The capital needs and financing alternatives of an export-import business are determined by its stage of evolution, ownership structure, distribution channel choice, and other pertinent factors. A very small sum of money is often needed to start the business as an agent because no payments are made for merchandise, transportation, or distribution of the product. However, initial capital needs are substantial if a person starts the business as a merchant, distributor, or trading company with products available for resale. This entails payments for transportation, distribution, advertising and promotion, travel, and other expenses.

Capital needs at the start-up stage may be smaller compared to those needed during the growth and expansion period. However, this depends on the degree of expansion and the capital needed to support additional marketing efforts, inventories, and accounts receivable. The ownership structure of an export-import firm tends to have an important influence on financing alternatives and little or no influence on capital needs. Studies on small business financing indicate the following salient features:

- Incorporated companies are more likely to receive equity (and other nondebt) financing than debt financing because lenders perceive the incorporated entity as having a greater incentive to take on risky ventures due to its limited liability (Brewer et al., 1996).
- Younger firms are more likely to obtain equity (nondebt) than debt financing. The probability of receiving debt financing increases with age. This is consistent with standard theories of capital structure, which state that such businesses have little or no track record on which to base financing decisions and are often perceived as risky by lenders.

- Firms with high growth opportunities, a volatile cash flow, and low liquidation value are more likely to finance their business with equity than debt. In firms with high growth opportunities, conflicts are likely between management and shareholders over the direction and pace of growth options, and this reduces the chances of debt financing. However, businesses with a good track record and high liquidation value (with assets that can be easily liquidated) have a greater chance of financing their business with debt rather than equity (Williamson, 1988; Stulz, 1990; Schleifer and Vishny, 1992).

CAPITAL SOURCES FOR EXPORT-IMPORT BUSINESSES

Capital needs to start the business or to finance current operations or expansion can be obtained from different sources. Internal financing should be explored before resorting to external funding sources. This includes using one's own resources for initial capital needs and then retaining more profits in the business or reducing accounts receivables and inventories to meet current obligations and finance growth and expansion. Such reductions in receivables or inventories should be applied carefully so as not to lead to a loss of customers or goodwill, both of which are critical to the viability of the business.

External financing takes different forms and businesses use one or a combination of the following:

- *Debt or equity financing:* Debt financing occurs when an export-import firm borrows money from a lender with a promise to repay (principal and interest) at some predetermined future date. Equity financing involves raising money from private investors in exchange for a percentage of ownership (and sometimes participation in management) of the business. The major disadvantage with equity financing is the owner's potential loss of control over the business.
- *Short-term, intermediate, or long-term financing:* Short-term financing involves a credit period of less than one year, while intermediate financing is credit extended for a period of one to five years. In long-term financing, the credit period ranges between five and twenty years.
- *Investment, inventory, or working capital financing:* Investment financing is money used to start the business (computer, fax machine, telephone, etc.). Inventory capital is money raised to purchase products for resale. Working capital supports current operations such as rent, advertising, supplies, wages, and so on. All three could be financed by debt or equity.

Several sources of funding are available to existing export-import businesses that have established track records. However, financing is quite limited for initial capital needs, and the entrepreneur has to use his or her own resources or borrow from family or friends. It is also important to evaluate funding sources not just in terms of availability (willingness to provide funding) but also in regard to the capital's cost and its effect on business profits, as well as any restrictions imposed by lenders on the operations of the business. Certain loan agreements, for example, prevent the sale of accounts receivable or equipment, or require the representation of lenders in the firm's management. The following is an overview of possible sources of capital for export/import businesses.

Internal Sources

This is the best source of financing for initial capital needs or expansion because there is no interest to be paid back or equity in the business to be surrendered. Start-up businesses have limited chances of obtaining loans so self-funding becomes the only alternative. Internal sources include the following:

- Money in saving accounts, certificates of deposit, and other personal accounts
- Money in stocks, bonds, and money market funds

External Sources

Family and Friends

This is the second-best option for raising capital for an export-import business. The money should be borrowed with a promissory note indicating the date of payment and the amount of principal and interest to be paid. As long as the business pays a market interest rate, it is entitled to a tax deduction and the lender gets the interest income. In the event of failure by the business to repay the loan, the lender may be able to deduct the amount as a short-term capital loss. Such an arrangement protects the lender and also prevents the latter from acquiring equity in the business.

Banks and Other Commercial Lenders

The largest challenge to successful lending is the turnover rate of small businesses. In general, fewer than half of all small businesses survive beyond the third-year mark. However, the survival rate for export-import businesses is generally higher than that of other businesses. Due to the level of risk, banks and other commercial lenders tend to avoid start-up financing without collateral. A 1994 IBM consulting group survey of small businesses revealed that bank credit was the most popular primary source of capital in the United States, followed by internally generated funds. Credit cards were not a significant source of financing. Of the businesses, 58 percent maintained a working capital line of credit, followed by term loans (42 percent). Only 3 percent of the businesses used Small Business Administration (SBA) loans (Anonymous, 1995).

Banks remain the cheapest source of borrowed capital for export-import firms as well as other small businesses. To persuade a bank to provide a loan, it is essential to prepare a business plan that sets clear financial goals, including how the loan will be repaid. Banks always review the ability of the borrower to service the debt, whether sufficient cash is invested in the business, as well as the nature of the collateral that is to be provided as a guarantee for the loan. Bankers always investigate the five Cs in making lending decisions: character (trustworthiness, reliability), capacity (ability and track record in meeting financial obligations), capital (significant equity in the business), collateral (security for the loan), and condition (the effect of overall economic conditions) (Lorenz-Fife, 1997). Even though it is often difficult to obtain a commercial loan for start-up capital, a good business plan and a strong, experienced management team may entice lenders to make a decision in favor of providing the loan. The following are different types of financing.

Asset-based financing. Banks and other commercial lenders provide loans secured by fixed assets, such as land, buildings, and machinery. For example, they will lend up to 80 percent of the value of one's home minus the first mortgage. These are often long-term loans payable over a ten-year period. Business assets, such as accounts receivable, inventories, and personal assets (savings accounts, cars, jewelry, etc.), can be used as collateral for business loans. With accounts receivable and inventories, commercial lenders usually lend up to 50 percent and 80 percent of their respective values. Use of saving accounts as collateral could reduce interest payment on a loan. Suppose the interest on the savings account is 4 percent and the business loan is financed at 12 percent. The actual interest rate that is to be paid is reduced to 8 percent.

Lines of credit. These are short-term loans (for a period of one year) intended for purchases of inventory and payment of operating costs. They may sometimes be secured by collateral such as accounts receivable based on the creditworthiness and reputation of the borrower. A certain amount of money (line of credit) is made available, and interest is often charged on the amount used. Certain lenders do not allow use of such lines of credit until the business's checking account is depleted.

Personal and commercial loans. Owners with good credit standing could obtain personal loans that are backed by the mere signature and guarantee of the borrower. They are short-term loans and subject to relatively high interest rates. Commercial loans are also short-term loans that are often backed by stocks, bonds, and life insurance policies as collateral. The cash value of a life insurance policy can also be borrowed and repaid over a certain period of time.

Credit cards. Credit cards are generally not recommended for capital needs for new or existing export-import businesses because they are one of the costliest forms of business financing. They charge extremely high interest rates and there is no limit on how much credit card issuers can charge for late fees and other penalties (Fraser, 1996). If financing options are limited, credit cards could be used if the probability of the business succeeding is very high (if you have made definite arrangements with foreign buyers, etc). One should shop for the lowest available rates and plan for bank or credit union financing at a later date, if the debt cannot be retired within a short time period, possibly with an account receivable or inventory as collateral. A survey of small and medium-sized businesses by Arthur Anderson and Company in 1994 showed that 29 percent of businesses use credit cards for capital needs (Field, Korn, and Middleton, 1995).

Small Business Administration (SBA)

The SBA has several facilities for lending that can be used by export-import businesses for capital needs at different stages of their growth cycle (see Table 13.1).

Small business investment companies (SBICs). SBICs are private companies funded by the SBA that were established to provide loan (sometimes equity) capital to small businesses. Even though they prefer to finance existing small businesses with a track record, they also consider loans for start-up capital. Members of a minority group could also consider a similar lending agency funded by the SBA that is intended to finance minority start-up or existing businesses.

The SBA guaranteed loan (7(a) loan guarantee program). The guarantee by the SBA permits a lending institution to provide long-term loans to start-up or existing small businesses. Export-import businesses can use the money for their working capital needs, for example, to purchase inventory and help carry a receivable until it is paid, to purchase real estate to house

TABLE 13.1. SBA Funding for Export-Import and Other Small Businesses

Program	Brief Overview
1. The 7(a) Loan Guarantee: Start-up/ expansion/ working capital	Loans made by private lenders are guaranteed up to $2 million, which could cover up to 50 percent of the loan. Funds could be used to buy land and buildings, to expand facilities, to purchase equipment, or for working capital.
2. Certified Development Company (CDC)/ 504 Loan	CDCs are nonprofit economic development agencies, certified by the SBA. The owner is to contribute a minimum of 10 percent equity in the business. The loans are available up to $750,000. Loans can be used to purchase land, for improvement or renovation of facilities, and to purchase machinery or equipment. Project assets are often used as collateral. It cannot be used for working capital. (Up to 40 percent cost of fixed assets.)
3. Small Business Investment Companies (SBICs)	They are licensed by SBA and lend their own capital as well as funds borrowed through the federal government to small businesses, both new and already established. SBICs make either equity investments or long-term loans to companies with growth potential. Investment is not to exceed 20 percent of its private capital in securities or guarantees in any one concern. (Loans for start-up or expansion.)
4. Low Documentation	Designed to increase the availability of funds under $100,000 and to expedite the loan review process. (Loan guarantees for start-up or expansion/working capital.)
5. International Trade Loan	Used for businesses preparing to engage in, or already engaged in, international trade, or for those adversely affected by competition from imports. Used to develop and expand export market or for working capital. Loans are guaranteed up to $2,000,000. (Loan guarantees to expand market/working capital.)
6. Fast track	This was designed to increase capital available to businesses seeking loans up to $250,000. It is currently offered as a pilot with a limited number of lenders. (Loan guarantee for start-up/expansion/working capital.)
7. Export Working Capital	This was designed to provide short-term working capital to exporters. Maximum loan guarantee is $750,000. Loan requests above $833,333 are processed by Ex-Im Bank. (Loan guarantee.)
8. Microloans	These range from $100 to $25,000. Funds available to nonprofit intermediaries, who in turn make loans to small business borrowers. Collateral and personal guarantee are required. Loan maturity may be as long as six years. (Loan for start-up/expansion/working capital.)

the business, and for acquisition of furniture and fixtures. The SBA guarantee is available only after the business has failed to obtain financing on reasonable terms from other private sources. It is considered to be a lender of last resort.

The Certified Development Company. The Certified Development Company (CDC 504) program assists in the development and expansion of small firms and the creation of jobs. This program is designed to provide fixed-asset financing and cannot be used for working capital or inventory, consolidating or repaying debt. (For an overview of SBA loans, see International Perspective 13.1)

Finance Companies

The following are different ways of raising capital from finance companies to start or expand an export-import business.

Loans from insurance companies and pension funds. Life insurance policies can be used as collateral to borrow money for capital needs. Pension funds also provide loans to businesses with attractive growth prospects. Pension funds and insurance company loans are intermediate and long-term

INTERNATIONAL PERSPECTIVE 13.1.
SBA Loans and Their Features

1. **Guaranty Loans:** The loans are made and disbursed by private lenders and guaranteed by SBA up to a certain amount. This means that if the borrower defaults on the loan, SBA will purchase an agreed-upon percentage of the unpaid balance. Direct and participation loans (loans made jointly by SBA and other lenders) are quite few and have even decreased over the years.
2. **Interest Rates:** Unless otherwise stated, maximum rates for guaranteed loans are 2.25 percent above prime for a loan greater than $50,000 with maturity of less than seven years and 2.75 percent above prime for loans from seven to twenty-five years. Rates on loans under $50,000 may be higher.
3. **Guarantee Fee:** Payment of a guarantee fee is required for all guaranteed loans. Loans are to be secured by a collateral and personal guarantee.
4. **Guarantee of Last Resort:** SBA loans are provided as a matter of last resort, that is, when borrowers cannot obtain credit without SBA guarantee. The borrower is expected to have some personal equity to operate the business on a sound financial basis.

credits (five to fifteen years). Banks often introduce such lending agencies to their clients when the funds are needed for longer than the banks' maximum maturity period.

Commercial finance companies. These companies grant short-term loans using accounts receivable, inventories, or equipment as collateral. They can also factor (buy) accounts receivable at a discount and provide the export-import firm the necessary capital for growth and expansion. Factoring is a way of turning a firm's accounts receivable into immediate cash without creating new debt. The factoring company will collect the accounts receivable (A/R), assume credit risks associated with the A/R, conduct investigations on the firm's existing and prospective accounts, as well as do the bookkeeping with respect to the credit. In most cases, a factoring company will advance 50 to 90 percent of the face value of the receivables and later pay the balance less the factor's discount (4 to 7 percent of face value of receivables) once the receivables are collected. An export-import firm could easily factor its receivables so long as it sells to government clients or to major companies that have good credit. The disadvantage with this method is that it is expensive and could absorb a good part of the firm's profits.

Equity Sources

For many export-import businesses, the ability to raise equity finance is quite limited. Although such funding provides the owner with initial capital needs, money for expansion, or working capital, it means some dilution of ownership and control. Finding compatible business partners and shareholders is always difficult. There are three sources for equity funding:

- Family and friends
- *Business angels (invisible venture capitalists):* Business angels provide start-up or expansion capital and are the biggest providers of equity capital for small businesses. They can be found through networking advertisements, newspapers, or the World Wide Web. This segment is estimated to represent about 2,000 individuals or businesses investing between $10 billion to $20 billion each year in over 30,000 businesses (Lorenz-Fife, 1997).
- *Venture capitalists:* Venture capitalists provide equity capital to businesses that are already established and need working or expansion capital. The Small Business Administration (SBA) estimates that 500 venture capital firms are currently investing about $4 billion a year in some 3,000 ventures. They may not be suitable for small export-import firms because (1) their minimum investment is about $50,000

to $100,000; (2) they seldom provide funding for start-up capital because they are interested in companies with a proven track record and market position; and (3) they expect high returns (10 to 15 percent) on their investments over a relatively short period of time.

PRIVATE SOURCES OF EXPORT FINANCING

In many export transactions, the buyer is unable or unwilling to pay for the goods at the time of delivery. This means that the seller has to agree to payment at some future date or that the buyer should seek financing from third parties. The seller may seek financing from the buyer or third parties for purchasing goods from suppliers, to pay for labor, or to arrange for transportation and insurance (preshipment financing). The exporter may also need postshipment financing of the resulting account or accounts receivable or both (Silvester, 1995).

Competitive finance is a crucial element in export strategies, especially for small and medium-sized companies. Exporters should carefully consider the type of financing required, the length of time for repayment, the loan's effect on price and profit, as well as the various risks that may be associated with such financing.

In extending credit to overseas customers, it is important to recognize the following:

1. Normal commercial terms range from 30 to 180 days for sales of consumer goods, industrial materials, and agricultural commodities. Custom-made or high-value capital equipment may warrant longer repayment periods.
2. An allowance may have to be made for longer shipment periods than are found in domestic trade because foreign buyers are often unwilling to have the credit period start before receiving the goods.
3. Customers are usually charged interest on credit periods of a year or longer and seldom on short-term credit of up to 180 days. Even though the provision of favorable financing terms makes a product more competitive, the exporter should carefully assess such financing against considerations of cost and risk of default.

Financing by the Exporter

Open Account

Under this arrangement, an exporter will transfer possession or ownership of the merchandise on a deferred-payment basis (payment deferred for an agreed period of time). This can be done in the case of creditworthy customers who have proven track records. In the case of customers who are not well-known to the exporter, such arrangements should not be undertaken without taking out export credit insurance.

Consignment Sales

Importers do not pay for the merchandise until it is sold to a third party. Exporters could take out an insurance policy to cover them against risk of nonpayment.

Financing by the Overseas Customer

Advance Payment

The buyer is required to pay before shipment is effected. The advance payment may comprise of the entire price or an agreed-upon percentage of the purchase price. An importer may secure the advance payment through a performance guarantee provided by a third party. Export trading or export management companies, for example, often purchase goods on an advance-payment or cash-on-delivery basis, thus eliminating the need for financing. They can also use their vast international networks to help the exporter obtain credit and credit insurance.

Progress Payment

Payments are tied to partial performance of the contract, such as production, partial shipment, and so on. This means that a mix of advance and progress payments meets the financing needs of the exporter.

Financing by Third Parties

Short-Term Methods

Loan secured by a foreign account receivable. An exporter can borrow money from a bank or finance company to meet its short-term working capital needs by using its foreign account receivable as collateral. In most cases, the overseas customer is not notified about the loan. As the customer makes payment to the exporter, the exporter, in turn, repays the loan to the lender. It is also possible to notify the overseas customer about the collateral and instruct the latter to pay bills directly to the lender. This may, however, put to question the financial standing of the exporter in the eyes of the overseas buyer.

An exporter can usually borrow 80 to 85 percent of the face value of its accounts receivable if the receivables are insured and the exporter and overseas customer have good credit ratings.

Most banks are reluctant to lend against receivables that are not insured. The bank's security is effected through assignment of the exporter's foreign accounts receivable. Documentary collections are easier and less expensive to finance than sales on open accounts because the draft in documentary collections is a negotiable instrument (unlike open account sales, which are accompanied by an invoice and transport documents) that can easily be sold or discounted before maturity. Although most lenders are interested in providing a loan against foreign receivables, it is not uncommon to find some that would purchase them with full or limited recourse. In both cases, most banks require insurance. (Once the receivables are sold, the exporter will be able to remove the receivables and the loan from its balance sheet.)

Trade/banker's acceptance. This arises when a draft drawn by the seller is accepted by the overseas customer to pay a certain sum of money on an agreed-upon date. The exporter could obtain a loan using the acceptance as collateral or discount the acceptance to a financial institution for payment. In cases in which the debt is not acknowledged in the form of a draft, the exporter could sell or discount the invoice (invoice acceptance) before maturity. In both cases, the acceptances are usually sold without recourse to the exporter and the latter is relieved from the responsibility of collection.

A draft drawn on, and accepted by, a bank is called a banker's acceptance. Once accepted, the draft becomes a primary obligation of the accepting bank to pay at maturity. This occurs in the case of documents against acceptance (documentary collection or acceptance credit), whereby payment is to be made at a specified date in the future. The bank returns the draft to the seller with an endorsement of its acceptance, guaranteeing payment to the seller (exporter) on the due date. The exporter may then sell the accepted draft at a discount to the bank or any other financial institution. The exporter could also secure a loan using the draft as collateral. The marketability of a banker's or trade acceptance is dependent on the creditworthiness of the party accepting the draft.

Letter of credit. In addition to the acceptance credit discussed previously, the letter of credit could be an important instrument of financing exports:

1. *Transferable letter of credit:* Using this method, the exporter transfers its rights under the credit to another party, usually a supplier, who receives payment. When the supplier presents the necessary documents to the advising bank, the supplier's invoice is replaced with the exporter's invoice for the full value of the original credit. The advising

bank pays the supplier the value of the invoice and will pay the difference to the exporter.

2. *Assignment of proceeds under the letter of credit:* The beneficiary (exporter) may assign either the entire amount or a percentage of the proceeds of the L/C to a specified third party, usually a supplier. This allows the exporter to make purchases with limited capital by using the overseas buyer's credit. It does not require the assent of the buyer or the buyer's bank.
3. *Back-to-back letters of credit:* A letter of credit is issued on the strength of another letter of credit. Such credits are issued when a supplier or subcontractor demands payment from the exporter before collections are received from the customer. The exporter remains obligated to perform under the original credit, and if default occurs, the bank is left holding a worthless collateral.

Factoring. Factoring is a continuous arrangement between a factoring concern and the exporter, whereby the factor purchases export receivables for a somewhat discounted price (usually 2 to 4 percent less than the full value). The amount of the discount depends on a number of factors, including the kind of products involved, the customer, the factoring entity, and the importing country. Factoring enables exporters to offer terms of sale on open account without assuming the credit risk. Importers also prefer factoring because by buying on open account, they forgo costly payment arrangements such as letters of credit. It also frees up their working capital. In the case of importers that have not yet established a track record, banks often will not issue letters of credit and open account sales may be the only available option.

In export factoring, the exporter receives immediate payment and the burden of collection is eliminated. Factors have ties to banks and financial institutions in other countries through networks such as Factors Chain International, which enables them to check the creditworthiness of an overseas customer, to authorize credit, and to assume financial risk.

Increases in global trade and competition have resulted in the search for alternative forms of financing to accommodate the diverse needs of customers. In highly competitive markets, concluding a successful export deal often depends on the seller's ability to obtain trade finance at the most favorable terms for the overseas customer.

International factoring has grown by about 500 percent during the past ten years, amounting to $20 billion in 1994. In the United States, the factoring industry handles about $2 billion in foreign trade (Ioannou, 1995). The export factoring business grew by 14 percent in 1991, compared with a 9 percent increase in domestic factoring (Ring, 1993). It is now available in about forty countries, mostly concentrated in North America, Western Europe, and Asia. Even though export factoring has been traditionally associated with the sale of textiles, apparel, footwear, or carpets, it is now used for a host of diversified products.

A typical export factoring procedure includes the following steps: Upon receipt of an order from an overseas customer, the exporter verifies with the factor, through its overseas affiliate, the customer's credit standing and determines whether the factor is willing to authorize credit and to assume financial risk. If the factor's decision is in favor of authorizing credit to the overseas customer, then the parties follow the procedure described in Figure 13.1.

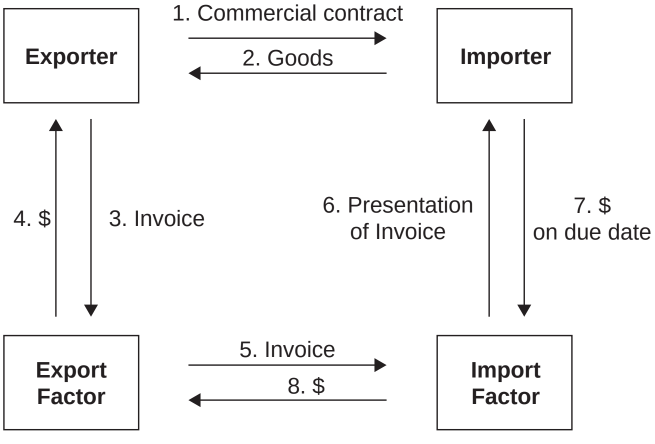

FIGURE 13.1. Export factoring: (1) the exporter and importer enter into a commercial contract and agree on the terms of sale (i.e., open account), (2) the exporter ships the goods to the importer, (3) the exporter submits the invoice to the export factor, (4) the export factor provides (cash in advance) funds to the exporter against receivables until money is collected from the importer. The exporter often receives up to 30 percent of the value of the receivables ahead of time and pay the factor interest on the money received, or the factor pays the exporter, less a commission charge, when receivables are due (or shortly thereafter). The commission often ranges between 1 and 3 percent, (5) the export factor passes the invoice to the import factor for assumption of credit risk, administration, and collection of the receivables, (6) the import factor presents the invoice to the importer for payment on the agreed-upon date, (7) the importer pays the import factor, and (8) the import factor pays the export factor. In cases where the export factor advanced funds up to a certain percentage (e.g., 30 percent) of the exporter's receivables, the remaining portion (70 percent of receivables less interest or other charges) is paid by the export factor to the exporter.

Arrangements with factors are made either with recourse (exporter liable in the event of default by buyer or other problems) or without recourse in which case a larger discount may be required since the exporter is free of liability. (For advantages and disadvantages of this financing method, see Table 13.2.)

Intermediate- and Long-Term Methods

Buyer credit. Some export sales, such as those involving capital equipment, often require financing terms that extend over several years. The importer may obtain credit from a bank or other financial institution to pay the exporter. The seller often cooperates in structuring the financing arrangements to make them suitable to the needs of the buyer.

Forfaiting. Forfaiting is the practice of purchasing deferred debts arising from international sales contracts without recourse to the exporter. The exporter surrenders possession of export receivables (deferred-debt obligation from the importer), which are usually guaranteed by a bank in the importing country, by selling to a forfaiter at a discount in exchange for cash. The

TABLE 13.2. Advantages and Disadvantages of Export Factoring

Advantages	**Disadvantages**
• Factoring allows immediate payment against receivables and increases working capital.	• Factoring is not available for shipments with value of less than $100,000. It is appropriate for continuous or repetitive transactions (not one-shot deal). Factors often require access to a certain volume of the exporter's yearly sales.
• Factors conduct credit investigations, collect accounts receivable from importer, and provide other bookkeeping services.	• Factors do not work for receivables with maturity of over 180 days.
• Factors assume credit risk in the event of buyer's default or refusal to pay (nonrecourse).	• Factors generally do not work with most developing countries because of their inadequate legal and financial framework.
• Factoring is a good substitute for bank credit when the latter is too restrictive or uneconomical.	• Exporter could be liable for disputes concerning merchandise (quality, condition of goods, etc.) and contract of sale.

deferred debt may be in the form of a promissory note, bill of exchange, trade acceptance, or documentary credit, which are unconditional and easily transferable debt instruments that can be sold on the secondary market.

The origins of forfaiting date back to the 1940s, when Swiss financiers developed new ways of financing sales of West German capital equipment to Eastern Europe. Since Eastern European countries did not have enough hard currency to finance imports, they sought intermediate-term financing from their suppliers. The leading forfait houses are still located in Europe.

In a typical forfaiting transaction, the overseas customer does not have hard currency to finance the sale and requests to purchase on credit, usually payable within one to ten years. The exporter (or exporter's bank) contacts a forfaiter and provides the latter with the details of the proposed transaction with the overseas customer. The forfaiter evaluates the transaction and agrees to finance the deal based on a certain discount rate and other conditions. The exporter then incorporates the discount into the selling price. Discount rates are fixed and based on the London Interbank Offered Rate (LIBOR), on which floating interest rates are based. The forfaiter usually requires a guarantee or aval (letter of assurance) from a bank in the importer's country and often provides the exporter with a list of local banks that are acceptable as guarantors. The guarantee becomes quite important, especially in cases of receivables from developing countries. Once an acceptable guarantor is found, the exporter ships the goods to the buyer and endorses the negotiable instruments in favor of the forfaiter, without recourse. The forfaiter then pays the exporter the discounted proceeds.

Although export factoring and forfaiting appear quite similar, there are certain differences in terms of payment terms, products involved, continuity of transaction, and overall use:

1. Factors are often used to finance consumer goods, whereas forfaiters usually work with capital goods, commodities, and projects.
2. Factors are used for continuous transactions, but forfaiters finance one-time deals.
3. Forfaiters work with receivables from developing countries whenever they obtain an acceptable bank guarantor; factors do not finance trade with most developing countries because of unavailability of credit information, poor credit ratings, or inadequate legal and financial frameworks.
4. Factors generally work with short-term receivables, whereas forfaiters finance receivables with a maturity of over 180 days. (See Table 13.3 for advantages and disadvantages of this financing method.)

TABLE 13.3. Forfaiting

Advantages

1. Forfaiters purchase receivables as a one-shot deal without requiring an ongoing volume of business, as in the case of factoring.
2. Financing can cover 100 percent of the sale. Improves cash flow and reduces transaction cost for the exporter since responsibility for collection is assumed by the forfaiter. Forfaiter also assumes all of the payment risk (i.e., credit risk of the guarantor bank, the interest rate risk as well as the buyer's country risk).

Disadvantages

1. It is not available for short-term financing (less than 180 days). Terms range from one to ten years.
2. Transaction size is usually limited to $250,000 or more.
3. Interest and commitment fees (if advance payment is required by exporter) may be high.
4. Exporter is responsible for quality, condition of goods, delivery, overshipment, and other contract disputes.
5. Exporter is responsible for obtaining a bank guarantee for the buyer.

The following are some examples of forfaiting transactions:

- The Bankers Association for Foreign Trade (BAFT) arranged with a cotton machinery company to sell over $500,000 worth of cotton lint removal machinery payable eleven months from the date on the bill of lading. A Greek commercial bank issued the letter of credit, which called for acceptance drafts. Bankers Trust of New York confirmed the letter of credit, and Midland Bank undertook the forfaiting transaction.
- Morgan Grenfell Trade Finance Limited purchased receivables from U.S. exporters to Peru. The finance company required the guarantee of one of the large Peruvian banks and accepted a repayment period of up to five years.
- Morgen Grenfell also financed the down payment in cash (forfaiting) of the sale of electric turbines to Mexico, which was financed by Ex-Im Bank. The Ex-Im Bank required a 15 percent down payment.
- The Export Development Corporation (EDC) of Canada purchases accounts receivable from Canadian exporters provided the promissory notes issued by the overseas customer are guaranteed by a bank acceptable to the EDC, the transaction complies with the Canadian content requirement, and the promissory note does not exceed 85 percent of the contract price.

Export leasing. This is a financing scheme in which a third party, be it an international leasing entity or a finance firm, purchases and exports capital equipment with a view to leasing it to the importer in another country on an intermediate to long-term basis. This arrangement is suitable for the export of capital goods. The lessor could be located in the exporting or importing country. Whether it is an operating or finance lease, the legal ownership of the asset remains with the lessor and only possession passes to the lessee. Under the operating lease, the lease rentals are not intended to amortize the capital outlay incurred by the lessor when the equipment was purchased. Instead, the capital outlay and profit are intended to be recovered through the re-leasing of the equipment and/or through its residual value on its eventual sale. It is not a method of financing the acquisition of the equipment, but a lease for a specified period. The lease is reflected in the balance sheet of the lessor and not the lessee. Under the finance lease, the lease rentals are intended to amortize the capital costs of acquisition as well as to provide profit. Usually, the lessee chooses the equipment to be leased and bears the cost of maintenance and insurance. The lease is reflected in the balance sheet of the lessee and not the lessor.

For businesses that need new equipment but lack the necessary resources or hard currency to purchase, leasing becomes an attractive option. It requires little or no down payment, and the equipment can be bought at the end of the lease agreement for a nominal price. Lease payments are tax deductible in many countries. Since such payments do not appear as liabilities in the financial statements, they preserve the lessee's financial position and do not reduce its ability to borrow for other reasons. Other advantages of leasing are that (1) one can lease up-to-date equipment that may be too expensive to purchase, and (2) the lessee can always trade in the old equipment in the event of obsolescence and obtain new even before the end of the lease. There are, however, certain disadvantages: (1) it may attract adverse tax consequences in certain countries, and (2) the cost of leasing is often higher than other financing methods.

CHAPTER SUMMARY

Major Changes in Small Business Financing

Technology, globalization, and deregulation.

Determinants of Capital Needs and Financing Alternatives

Stage of evolution, ownership structure, and distribution channels.

Internal Financing

Using one's own resources, retaining more profits in the business, and reducing accounts receivable and inventories.

External Financing

Forms of External Financing

Debt or equity financing; short-term/intermediate/long-term financing; investment, inventory, or working capital financing.

Sources of External Financing

Family and friends, banks (asset-based financing, lines of credit, personal and commercial loans, credit cards), Small Business Administration, finance companies, and equity sources.

Financing by the Exporter

1. *Open account:* Payment is deferred for a specified period of time.
2. *Consignment contract:* Importer pays after merchandise is sold to a third party.

Financing by the Importer

1. *Advance payment:* Payment is before shipment is effected.
2. *Progress payment:* Payment is related to performance.

Financing by Third Parties

Short-Term Methods

1. *Loan secured by a foreign accounts receivable:* Account receivable used as collateral to meet short-term financing needs.
2. *Trade/banker's acceptance:* A draft accepted by the importer is used as collateral to obtain financing.
3. *Letter of credit:* Transferable letter of credit (L/C), assignment of proceeds under an L/C, and a back-to-back L/C used to secure financing.
4. *Factoring:* An arrangement between a factoring concern and exporter whereby the factor purchases export receivables for a discount.

Intermediate- and Long-Term Methods

1. *Buyer credit:* Importer obtains a credit from a bank or financial institution to pay the exporter.
2. *Forfaiting:* Purchase of deferred debts arising from international sales contracts without rcourse to the exporter.
3. *Export leasing:* A firm purchases and exports capital equipment with a view to leasing.

REVIEW QUESTIONS

1. What are the major changes taking place in small and medium-sized business financing?
2. What factors determine capital needs and financing alternatives in export-import trade?
3. State the common external sources of financing for export-import businesses.
4. Describe the following: SBICs, Certifed Development Company, CDC/504 loan program, International trade loan.
5. Discuss the various methods in which a letter of credit can be used to finance exports.
6. What is export factoring? How does it differ from forfaiting?
7. State the typical steps involved in export factoring.
8. What are the disadvantages of factoring?
9. Is venture capital generally suitable for export firms?
10. What is the various loan facilities provided by the SBA to export businesses?

CASE 13.1. TADOO'S SALES TO BELGIUM

Tadoo, Inc. is a chemical company incorporated in the state of Tennessee and engaged in the production and sale of various chemical products used to kill harmful insects or strip leaves from trees. Since the company was established in 1980, it has generated gross sales of over $60 million largely from sales in the United States and west European countries. Its sales agents and distributors are located in over a dozen countries.

In September 2000, the Belgian government advertised for a purchase of $20 million chemical products. The winner of the bid was required to provide financing for a period of two years. Given Tadoo's inability to secure private or public financing for the sale, it decided to contact a forfaiter to explore the possibility of financing the deal. Tadoo provided the forfaiter with important details to establish the viability of the transaction including its delivery date, repayment terms (four semiannual repayments over a two-year period), interest rate (payable by buyer), and a letter of credit instrument to be opened in favor of Tadoo through a Belgian bank.

The forfaiter calculated the expected costs (discount rate, commitment fees, etc.) necessary to sell the receivable and added it to the commercial contract so that Tadoo will be able to receive 100 percent of the required cash value. This helped Tadoo to submit a contract price that will include financing expenses. The forfaiter also examines the structure of the transaction to ensure that it has maximum liquidity. This includes the financing period, country risk, and credit risk. The forfaiter is expected to resell the transaction in the market.

Prior to the submission of the bid, Tadoo entered into a detailed contract with the forfaiter. The contract required Tadoo to sell the receivable to the forfaiter and stated the terms and conditions of the contract. It also provided Tadoo with the option to cancel the contract with no liability in the event that Tadoo fails to win the bid. A month after the submission of the bid, the Belgian government informed Tadoo that it has been awarded the contract.

Tadoo began to manufacture the product and supplied the product to the buyer in special shipping containers in accordance with the terms of the contract. Four bills of exchange were accepted by the Belgian Bank and later endorsed by Tadoo to the forfaiter without recourse and provided to the latter with supporting documentation. The forfaiter received and verified the documents and paid $20 million to Tadoo. Tadoo is required to honor all its contractual commitments pertaining to product support and warranty but the financial risk associated with the bill of exchange maturing over a two-year period had been sold to the forfaiter without recourse.

Questions

1. Would Tadoo encounter problems if it was exporting to a developing country?
2. Is this method more beneficial to Tadoo than other forms of financing?