Theme 1: Helping SMEs in Doing Business

Good morning, ladies and gentlemen,

There is no doubt that SMEs nowadays face an increasingly broadened scope of challenges. When we look at the group of manufacturers and traders with whom we do business with on a daily basis, we can see the threats coming to them from all directions. The market for traditional products is shrinking. The speed of new products coming on stream sometimes makes it difficult to recoup investment or development costs. Technology obsolescence is demanding extremely fast reaction from the manufacturers. For electronic goods such as mobile phones, product cycle is now reduced to six months or less and the continuous rolling-out of new models becomes necessary to sustain sales. For garment manufacturing, a 9-month lead time for delivery would have become one month or less for some. Manufacturing bases which offer low production costs are getting fewer and are farther away. Factory owners often have to move their production like nomads searching for water and pasture, often at high costs and great inconvenience. There is no room for mediocre performers.

Similarly, for traders and trading firms, the consolidation of major buyers through M & A activities, integration of the global supply chain and the extensive regional sourcing activities by the major buyers have created a very strong threat of disintermediation. It has been the wake-up calls for many otherwise stable businesses in the past years. The positive outcome of this phenomenon is that it drives many SME trading firms into niche businesses, creating brands to differentiate and optimize product designs and service features to add value, so as to survive.

The external environment is also less friendly. In addition to sporadic anti-dumping legislations being passed, regulatory and compliance rules are getting tougher. Such rules could cover anything from environmental protection to product safety and operational risks, such as the SOX certification. The cost of compliance for a smaller firm may, for some businesses, be disproportionate to the sales turnover and annual profit.

Nevertheless, as a group, the SMEs are still thriving. With each downturn in the business or economic cycle, there is always the inevitable, and rather sad, elimination of many less efficient and therefore uncompetitive players. Yet there are successful ones who have changed with the tide, adopted new business models, ventured into new markets and indeed prospered with renewed energy. These are the companies who have overcome adversities, created solutions and rather than asking for solutions, and, with some timely support, could mature and grow into large enterprises of the future.

The profiles of the successful survivors have changed over time. Taking HK as an example, the previous group of successful SMEs are entrepreneurs who are industrious, versatile, keen to learn, have a strong survival instinct, skilful in replicating and modifying products/services and typically carry a local or regional mentality.

Although it is not mutually exclusive, the newer breed of SMEs is typically managed by better educated owners who are aggressive, flexible, keen to achieve in a shorter time span, tends to be more creative and innovative and carries a more global mentality.

However, regardless of which profiles they take up, the SMEs are not a homogenous group. Although they are broadly classified by definitions for the purpose of identification, statistics or sometimes administration, they could be vastly different - not only in sizes and the types of businesses they are in, but also in terms of their competitiveness and capabilities. Each of the SMEs could be in a different stage of development. Similarly, each region's SMEs could also be in different stages of development. This generates a wide range of needs indeed. However, the problem of financing seems to be rather common amongst SMEs in many places.

In an annual regional survey conducted by UPS and as reported in the UPS Asia Business Monitor for 2007, they identified the top three problems encountered by SMEs in financing businesses as:

1. Bureaucracy and red tapes in processing applications.
2. Lack of institutions willing to lend to small businesses.
3. Insufficient collateral.

This is hardly surprising as these are typically the collective perception of those obtaining financing for the SMEs.

However, it is worth noting that in this regional study, they also give the percentage of those responding parties saying that none of the above is experienced, i.e. the "no problem" responses. These "no problem" responses are highest in Japan and HK (56% & 52% respectively), followed by Taiwan, Singapore, Korea and Australia (all 30%+). There seems to be a correlation of these higher percentages with the maturity of the SME markets and the characteristics of the local banking markets in these regions. It is therefore possible that with the sharing of some best practices, exchange of experience and avoidance of past mistakes, considerable mileage can be gained in speeding up development in this area.

I would now like to take a few moments to talk through the different stages of the SMEs' funding needs and focus on how the banking market has evolved to meet some of these needs in the past few years.

Let's begin with the start-ups in the SMEs. Very likely, they are owned by entrepreneurs with an idea or a product, some key contacts and an abundance of entrepreneurial spirit. They are in need of "seed money" or the initial capital to allow them to commence business. This is the most difficult stage for SMEs because this is also the stage which involves the highest level of uncertainty and the greatest business risks.

Intensive debate has taken place as to who should be giving support to this group and for how much. I do not wish to propose a perfect commercial solution here except to say that there will always be an element of exchange for providing the “seed money”, depending on whichever party is willing to provide it and there should always be a concept of balance for such exchange.

For example, from a strictly commercial point of view, entrepreneurs should find the first batch of their seed money from their savings or from a willing family member or their close friends. Outside of this inner circle, the element of exchange becomes more evident.

SMEs will need to find a suitable platform or establish the right contact to identify the right investor for putting in the money. It may be a venture capital/”angel” fund or an enterprising investment fund which is willing to take higher business risks in return for a stake in the company and for good return over time or to yield an exceptional profit upon a successful listing in the stock market. The owner will have to give up certain flexibility in accepting the investment, which may include adhering to a rather strict financial discipline and reporting structure plus releasing some degree of management control of the company.

Another alternative is a strategic partner who may be interested in the unique product, service or positioning of the company, which complements theirs, and is willing to enter into a contract under certain exclusive terms with the company, or additionally to take a stake in the company, with or without an option to eventually taking it over. The owner will perhaps have to form a binding strategic alliance with the partner, with an associated restriction on its business model, in return for the equity injection. If it carries an option to sell the company eventually, then it would be the ultimate condition of exchange.

Outside of investors, the government is often regarded as a natural source of obtaining subsidies for financing start-ups given the weight of the SMEs in the commercial segment within the society. For example, as at Dec 2006, there were 276,000 SMEs in HK which accounted for 98% of the total business units and provided 1.19 million jobs. This represents about 50% of the total employment. I don’t have the percentage of the start-ups but I believe it is in the small minority and this is one factor that the government will be looking at.

I would leave the governments to explain their positions and options. However, there will always be a balancing of priorities for the government when the tax payers’ money is used.

Finally, commercial banks – they are not investors in the SMEs and therefore do not share either the ownership or the commercial profit of the company. As such, they are inclined to accept only commercial risks which are justified by the overall return on funds provided – that is, having an acceptable risk/reward ratio. As a rule, they are more interested in financing short to medium term working capital with visible repayment ability, but are not interested in financing direct capital injection.

Most commercial banks in fact measure the borrower's own equity against borrowed funds as an indication of the commitment of the owner and the stability of their business – so called the gearing of the business. This is in fact part of the good risk management discipline for which they are accountable to their regulators.

Commercial banks are therefore generally not a good source of "seed money".

The opportunity for a SME to obtain funding improves substantially when it has been in business for two to three years. With an audited and more reliable financial track record, banks are usually more prepared to take risks on SMEs.

To facilitate administration and risk management, SMEs are commonly put into different groups within commercial banks.

Normally, the smaller companies are grouped into the Mass Market segment and the larger companies are grouped into the mid-market or larger companies segment. For the customers in the Mass Market segment, simple, packaged products for smaller amounts are developed and offered. Simplicity and convenience are often the main considerations. For customers in the mid and larger markets, individual proposal is evaluated and tailor-made facility packages, often for larger amounts, are provided. Relationship management is the key driver for marketing, achieving understanding and reducing risks in the mid and larger markets.

To facilitate the above segmentation process, the use of more efficient risk assessment tools like credit scoring is now common for the mass SME market. With behavioral patterns measured statistically and using past business experience, this type of tools allows a bank to take a portfolio risk within certain selected parameters. Coupled with an enlarged direct sales force or web-based e-banking channels, a bank can more effectively build and manage a much larger SME customer base. It also allows them to be more proactive rather than reactive in seeking their potential customers.

The establishment of local credit bureaus, like the Commercial Credit Reference Agency or CCRA, which is founded in HK in 2004, enhances the application of credit scoring. Banks can more effectively eliminate candidates with undesirable track records by simply adding acceptable CCRA reports as one of the parameters.

Banks also provide packaged products such as special purpose-driven loans for a specific target market with terms designed to achieve an estimated rate of return under certain risk assumptions. For example, profit tax loans are offered to profitable, tax-paying firms against their tax returns and short-term repayment ability.

For larger companies, commodity-based inventory loans with control of goods vested in the banks are sometimes designed to support companies with a need for maintaining a stable supply of raw materials at all times (and to counter short-term price inflation).

Other examples include the vendor financing model whereby banks rely on the financial strength of a major buyer and its high standard of vendor selection, as good risk mitigating factors to lend to their SME sub-contractors.

The sub-contractor model is important to the SMEs. With the right partner, SMEs can obtain relatively stable orders while continue to acquire valuable technology and process upgrades, R & D support and staff training. For this reason, the sub-contractor model has been cited as a bridgehead to competitiveness in the June 2002 publication of the Asia-Pacific Development Journal.

In the same way, collaborative financing packages between banks and equipment manufacturers with good knowledge of their customers are being introduced to the market. Leveraging on the manufacturers' internal purchase and usage records, banks can expedite their risk assessment process and prepare suitable financing packages with significantly less difficulties. This type of packages is increasingly common in the equipment finance market.

Account receivable finance is another product which is getting popular with SMEs. Its growth coincides with the gradual decline of the use of traditional documentary credits as an international means of payment. On an international scale, tailor-made account receivable finance package can ride on the global supply chain to link up the payments between the ultimate buyers and the remote suppliers. With the help of web-based channels, factoring agents in the buyers' country can factor the receivables and make speedy payments to the suppliers' bank upon receipt of confirmation of shipment. This will significantly shorten the financing cycle and reduce both the risk and costs of the suppliers.

On the domestic front, banks can combine account receivable financing with credit scoring to generate a risk-weighted product for the mass customers. The knowledge and experience built up in this type of product helps to better define the target customer segment and assist in future product modification.

Lastly, government-sponsored financing projects are available in some areas as another source of funding. Projects such as the SME funding scheme in HK is equivalent to a JV between the banks and the government whereby SMEs are provided with loans partially guaranteed by the government for financing business installation and equipments, as well as for working capital and accounts receivables.

The more proactive manner in which banks tackle the SME market enhances the opportunity for eligible SMEs to obtain short to medium term finance. Based on factors including business considerations, banks are now a willing partner in the financing of SMEs and are actively looking for tools which would allow them to achieve their commercial aspirations, while providing acceptable risk mitigation in the process. Products and processes are developed along the way and the delivery channels are enhanced for this purpose.

I would like to conclude by saying that while the commercial reality and challenge of funding for the SMEs will always remain, the market has evolved to provide a better environment for those SMEs which can demonstrate their ability to conduct business and have acquired a reasonable track record.

The financing institutions have generally regarded the SME market as one which can provide reasonable returns notwithstanding the higher risks. Risk mitigation tools, product packages and increasingly, strategic partners, will be coming into the picture to allow banks to tap into this market with more confidence and determination.

Thank you very much for your attention.

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