Verité insights

The exporting problem of SMEs: finance is one solution

September 2015

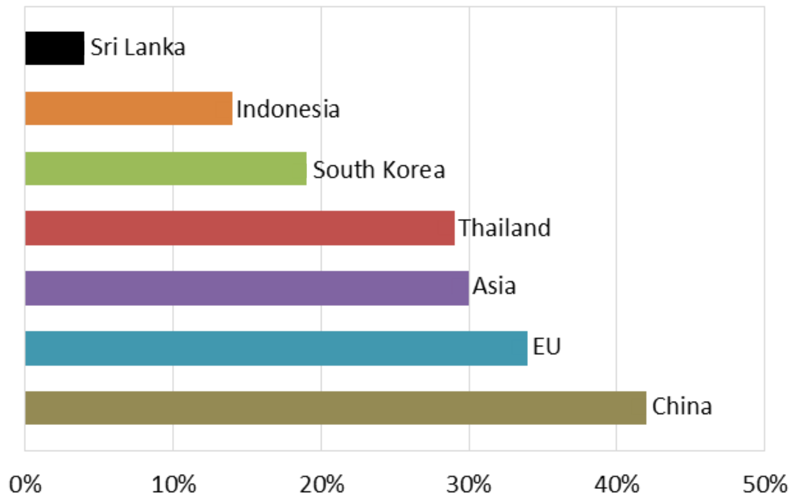
Since the turn of the century, not only have Sri Lankan exports declined as a share of its GDP, but also in terms of its global share. Sri Lanka had a larger global share of exports at Independence, than at present. There are several reasons for falling behind, but one in particular has received too little attention: The exporting weakness of Sri Lankan SMEs.

This *Insight* sets out that small and medium enterprises (SMEs) are hampered by credit terms of buyers and that export financing solutions are a critical aspect of support for SMEs. The government has an important role to play in realising this solution

Low participation of SMEs in exports

Sri Lanka's export performance depends too much on a few large firms and too little on its SME sector. Sri Lanka has 3,027 SMEs (firms with a turnover of less than LKR 150 million) registered as exporters. They collectively contribute to less than 5% of Sri Lanka's exports. China for instance has over 40% contribution by SMEs and the average in Asia is 30%. Exhibit 1 provides some key comparisons against Sri Lanka's SME export performance. The fact that countries differ on how they define an SME makes the comparisons inexact, but the conclusion remains robust – the export contribution of Sri Lankan SMEs is unusually low.

Exhibit 1: SME share of exports: Sri Lankan SMEs are weak



Source: Annual Report 2014, Central Bank of Sri Lanka, Export Performance Indicators 2004-2013, Asia SME Finance Monitor 2013, ADB

The low export participation of SMEs in Sri Lanka means that Sri Lankan exports are over dependent on the performance of a few large firms. 81% of the export revenue is brought in by just 235 firms, each with an export turnover exceeding a billion LKR. A significant difference between the SMEs and large firms is their access to affordable financing to offer credit to buyers – which is critical to succeeding in exports.

Financing exports is a problem for SMEs

In the current context of international trade, buyers tend to have greater bargaining power. Therefore, in trying to secure orders, exporters compete not just on price, quality and reliability, but also on the terms of payment. Buyers prefer to delay payment until goods are received (or, sometimes, even sold). The exporter, therefore, incurs the full cost and must wait anywhere from one to three months (sometimes even longer) to receive payment.

The short term cash flow crunch created by the delay between shipping the goods and receiving payment generally poses greater difficulties for SMEs than larger firms. The result can be the inability to purchase raw materials and services required to fulfil parallel export orders and loss of customers. The fact that SMEs tend to face high risk premiums on short term financing is what makes this problem acute.

SMEs are typically treated as high risk borrowers and face a high cost of borrowing for at least two reasons: (1) lack of collateral, (2) lack of risk related information about their buyers and markets. In this context the risks tend to be overestimated and the cost of borrowing becomes unreasonably high. Therefore, financing exports becomes a problem for SMEs, which are then pushed to reduce their ambitions on exports.

Solving the export financing problem

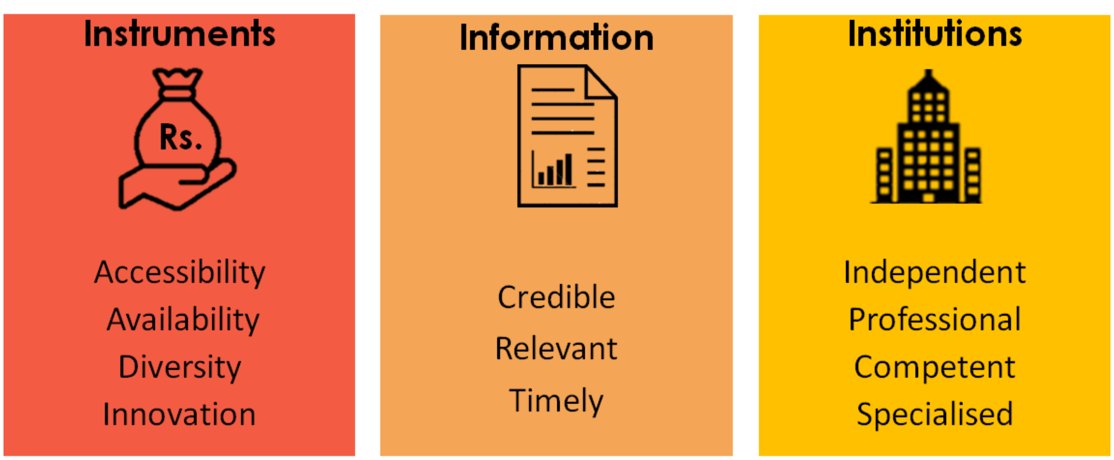
Most other countries have well recognized financing mechanisms that are designed to solve this export finance problem of SMEs. However, at present, such mechanisms are non-existent or under-developed in Sri Lanka. Establishing such mechanisms will require both the government and private sector to take intentional measures towards improving the instruments, institutions and information that relate to export finance.

Instruments: creating instruments to meet the needs of SMEs will require both facilitation and provision of services by the government. For example, in terms of facilitation the government can, through regulations and policy, encourage value chain financing. This means that downstream SMEs can gain access to financing using the credibility of the aggregator or association that is at the top of the value chain. In terms of provision, the government can enter and assist the underdeveloped export finance risks market through the partial provision of insurance and credit guarantee schemes on export financing.

Information: Poor quality and access with regard to information creates higher risk estimations, and gathering information is also costly and time consuming. The government has a role in this area as well. For example, using the existing infrastructure of commercial sections in Sri Lankan embassies in export destinations the government can provide buyer and country information to help mitigate the distortions created by lack of information. It will help reduce search costs and lower the price of export finance instruments.

Institutions: Institutions such as Export Development Board (EDB) and Sri Lanka Export Credit Insurance Corporation (SLECIC) have existed for over 35 years, but have failed to invest in the development of institutional capacity and competency. Currently the services and instruments provided by these institutions with regard to export finance, lack the necessary scope and effectiveness. In the present day Sri Lanka may also need to add a specialized export credit agency such as an EXIM bank, to match the support provided to exporters by competing countries, especially in the early stages of export development.

Exhibit 2: Solutions to the export finance problems of SMEs



The government has announced an ambitious target: that Sri Lankan export revenue should rise from the present 15% of GDP to a 100% of GDP. Sustainably steering the country towards that target will require careful attention to supporting the exporting ability of SMEs. Export financing is a critical part of that support, and government engagement is needed in order to improve all three aspects of the export finance problem: Instruments, Information and Institutions.