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Growing Prosperity Through Trade

Opportunities to enhance trade finance in the textile and garment sector across East Africa and the Horn of Africa

Focus note

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UKaid from the British people

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In this focus note, we set the scene by identifying the main bottlenecks constraining the provision of trade finance to textiles and garments companies across the region, before outlining two key opportunity areas – namely, factoring and the introduction of flexible collateral requirements – which have the potential to unlock the power of trade finance to boost sector growth.

Key challenges

Square pegs and round holes: Collateral requirements in the textile and garment industry

The textile and garment industry in East Africa and the Horn of Africa largely comprises small-scale businesses which often rely upon imported raw materials for garments and apparel production. Most of these firms have movable assets such as machinery and inventory, which cannot be collateralized in many geographies (such as Tanzania, Burundi, Somaliland and South Sudan) due to regulatory restrictions. Even in countries like Rwanda where inventory can be collateralized, local banks may be unwilling to accept inventory as collateral, given their preference for more traditional collateral in the form of immoveable assets such as land. This renders lack of collateral one of the biggest barriers to accessing trade finance within the sector.

Using machinery as collateral is also a challenge for SMEs because banks attribute a very low value to machines: this is partly attributable to SMEs' purchase of used rather than new machinery. In this case, banks may provide trade financing worth up to 75% of the valuation, which significantly limits the amount of financing provided.

Timing mismatch: Long business cycles for textiles and garments manufacturers

Our consultations with textiles and garments operators revealed that there is a general lack of trade finance products available for the sector. For example, given the industry's longer business cycles – often between 180 and 240 days – importers would require longer loan tenors compared to businesses that source for raw materials locally, which have shorter processing cycles of 90 days. However, banks providing trade finance instruments – such as inputs financing and purchase order financing – largely base their provision on the shorter cash conversion cycles of local-sourcing businesses, thus posing a huge repayment challenge to textiles and garments importers.

Lack of formalization and awareness of trade finance products

Textiles and garments SMEs therefore mainly leverage traditional financing solutions such as overdrafts and advance payments for their trading activities, due to limited awareness of existing trade finance instruments. Indeed, most textiles and garments stakeholders mentioned that they were not very familiar with trade finance instruments in general.

Moreover, most textiles and garments SMEs operate in the informal or semi-formal sector, within highly fragmented value chains, and tend to compete with illegal imports which are much cheaper and therefore erode their competitiveness. For example, in Ethiopia, textile firms operate at 40-45% efficiency, with lengthy production processes that take 45-60 days longer than other countries, undermining their commercial viability and limiting access to trade finance.

Heightened risk perceptions

These factors, coupled with Financial Service Providers' limited understanding of how textiles and garments businesses operate, given the lack of in-house sector advisory teams, contribute to a high-risk perception regarding the sector. The lack of adequate risk-sharing facilities exacerbates this view, resulting in high interest rates on trade finance instrument such as distributor finance.

COVID-19 has intensified the challenges faced by textiles and garments SMEs further. For example, supply chain disruptions have occurred due to COVID-19 induced movement restrictions (causing difficulties in accessing inputs from key import destinations such as China, or cancellation of orders given the reduced business activity at retail stores in key export markets in Europe, the USA and elsewhere). A second challenging impact of COVID-19 has been slowing production of non-essentials, with a shift towards production of essential products such as PPE. These additional constraints imposed by the pandemic have widened the already-sizable trade finance gap within the sector.

Opportunity areas

Against the relatively challenging backdrop outline above, we identify two specific opportunity areas with strong potential to resolve the traditional barriers to uptake of trade finance solutions by textiles and garments companies and their lenders:

Opportunity 1

Opportunity to boost supply chain finance by supporting factoring and reverse factoring

A key opportunity to transform trade finance in the sector lies in the provision of support for factoring and reverse factoring across the region. There are opportunities to promote supply chain finance by leveraging buyer relationships to facilitate SME financing without banks having to take the associated risk. Reverse factoring enables SME suppliers to get paid the value of their invoices before the end of the credit period by leveraging the credit standing of their off-taker. This type of product is already offered by several banks across the region; however the following opportunities exist to significantly increase uptake:

Capacity building to build awareness and develop understanding within the market amongst both large corporates and SMEs through marketing, so that corporate clients can offer it as a payment option to their suppliers, and SMEs can request it from buyers that they have a good relationship with. SMEs could be targeted through industry associations and larger corporates could be targeted by partnering with banks to ensure that relationship managers are informing corporate clients of the availability of this financing instrument.

Supporting bank partnerships with intermediaries who can process reverse factoring transactions in order to have large uptake. Both NCBA Bank Kenya Plc and Kenya Commercial Bank (KCB) have partnered with fintechs (such as ECap and eBiashara) to rollout their reverse factoring programs in Kenya, for example. Fintech partners are needed to provide the online platform through which SME suppliers can trade their invoices. Using technology facilitates the simultaneous processing of hundreds of invoices at low cost, which is key as large volumes are typically needed for reverse factoring to be commercially viable for banks.

Support in the adaptation of the factoring model law developed by Afrexim bank to country-specific contexts by providing technical assistance on policy design to regulators. This would require close collaboration between lawmakers, regulators, the financial services sector and the private sector to translate the model law into a legal framework which addresses the country's specific needs and challenges. Creation of a centralized factoring register would also be needed to enable factors to register and protect their interests, which would also serve the dual purpose of reducing the information asymmetry faced by factoring companies.

Procurement teams of large corporates may be resistant to reverse factoring because they can't keep payables to banks outstanding for a long time, as they would a local SME. However, this potential challenge could be mitigated by adapting the marketing for corporates to highlight the benefits of reverse factoring for buyers – namely, reduced risk of supplier non-performance, improved supplier relationships, and increased competitiveness in the market. For TradeMark East Africa (TMEA) and Financial Sector Deepening (FSD) Africa, specific intervention opportunities include:

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FSD Africa can provide technical support to banks to assist them in targeted marketing of factoring and reverse factoring products to build awareness and develop understanding within the market.

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FSD Africa can provide technical support to banks to help them identify fintechs to partner with that can serve as intermediaries for processing reverse factoring transactions.

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TMEA can facilitate collaboration between FSPs, regulators, lawmakers, and the private sector through joint workshops in order to get the input needed to adapt the factoring model law to country-specific contexts. It can also conduct a review of the current legislative framework and highlight gaps.

Opportunity 2

Opportunity to support sector firms through a working capital and trade finance facility

A second key opportunity area lies in the creation of a COVID facility to support textiles and garments firms. In light of market disruptions due to the COVID-19 pandemic, there's an opportunity to support textiles and garments companies by creating a facility to provide working capital and trade finance to address the immediate challenges of falling revenue and cashflow constraints in order to help them sustain operations. The following considerations need to be considered when structuring such a facility to help ensure that it is as impactful as possible:

Tailoring the facility to address the specific concerns of textile and garment SMEs around collateral requirements and tenors. Borrowing from the example of the facility recently launched by the Indian government, it would be worthwhile for both TMEA and FSD Africa, in collaboration with partners such as Mastercard Foundation, to explore the establishment of a collateral-free facility targeted at textile SMEs. Inclusion of a slightly longer tenor (4 years, for example), as well as a one-year moratorium on principal repayments, would greatly enhance the capacity of the SMEs to navigate the immediate challenges posed by cashflow constraints during the pandemic.

Support businesses with reviewing their operations and making them resilient, with a focus on lowering variable costs as this would reduce cash outflows faster than focusing on fixed costs. This could be a prerequisite for accessing the facility, as 'leaning out' operations would reduce each businesses' financial needs, meaning that the same amount of funds could be used to support more businesses, or to support the same number of businesses for a longer period.

Leverage existing government support and help build awareness of these measures. In many countries, governments have provided economic stimulus packages such as financial support for paying workers' wages, and tax reliefs. For the full impact of these stimulus packages to be felt, companies need to be aware of them. There is therefore an opportunity for FSD Africa, through its facility, to build awareness of these COVID-19 related reliefs, and perhaps even require companies that want to access the facility to take advantage of these other available reliefs.

Provide technical assistance to firms to help them upskill their workforce during this time. Stakeholder consultations revealed that a key challenge in the textile and garment sector is a skill gap within the workforce. Therefore, businesses could take advantage of reduced operating capacity and use the extra time to upskill their workforce. Using this time to train workers not only helps to close the skill gap and reduce reliance on imports from China and India, but also increases production efficiency, which in turn reduces costs, helps businesses become globally competitive, and leads to increased profits in the long term.

For FSD Africa, specific intervention opportunities include:

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FSD Africa can partner with a transaction advisor to design a facility to provide working capital and trade finance support for textiles and garments firms across the region and to determine how much funding is needed, in addition to providing funding for the facility and partnering with organizations like Msingi East Africa to create the criteria for firms to access the fund.

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FSD Africa can also partner with Msingi to deliver the additional support needed for textiles and garments companies seeking to access funds from the facility (such as capacity building to help them develop a business resilience plan, technical support to make their operations leaner, information on existing government support, and technical assistance to upskill their workforce).

Report developed by:

Open Capital
contact@opencapital.com
@OCA_Africa
www.opencapital.com

FSD Africa, Nairobi, Kenya
info@fsdafrica.org
@FSDAfrica

www.fsdafrica.org

TradeMark East Africa
info@trademarkea.com
@TradeMarkEastA

www.trademarkea.com

Foreign, Commonwealth
& Development Office, London, UK
@FCDOGovUK

www.gov.uk