The financing and information needs of smaller exporters

By Stuart Cooper and Inke Nyborg of the Bank's Business Finance Division.

This article outlines the key structural issues facing smaller firms seeking to enter or remain in export markets. It finds that effective access to focused advice and information is the most important enduring issue facing smaller exporters, especially those new to exporting. Access to finance does not appear currently to be a major difficulty for firms with some experience of exporting, though they may not be fully aware of all the alternative sources of finance. There is also some evidence that smaller exporters are less active than larger exporters in taking steps to manage their foreign exposure, possibly making them more vulnerable to the risks arising from fluctuations in foreign exchange rates and the failure of foreign buyers. The final section of the article notes the likely impact of the single currency on smaller exporters.

During the past five years, the Bank has devoted considerable attention to issues relating to the financing of small firms with turnover of up to £1 million. This work, under the direct leadership of the Governor, has aimed to consider ways of improving the financing of the small business sector in the United Kingdom. In addition to an annual review,(1) the Bank has recently targeted more specific areas of interest and concern. One of these has been the issues facing smaller exporters with total turnover of up to £10 million, on which the Bank published a report in February 1998.(2) The report drew on a range of sources: recent discussions with the providers and users of finance, relevant government departments, and others with a particular knowledge of the subject; and data and surveys carried out by other bodies. This article summarises the main findings of the report on the financing and information needs of smaller exporters.

Numbers of small exporting firms

The most recent data published by the Department of Trade and Industry (DTI) suggest that there are 3.72 million active businesses in the United Kingdom, of which 3.69 million (more than 99%) are classified as small businesses.(3) There are no official statistics on how many small businesses are exporters, but on the basis of VAT registrations and other HM Customs and Excise data, the DTI estimated that the total number of exporters was between 110,000 and 115,000 in 1995. It is likely that this figure underestimates the actual number of exporters in the United Kingdom, because Customs and Excise data include shipping agents, which are likely to represent a number of exporting customers that are too small to be registered for VAT purposes.

In the absence of official data, surveys can be used to gain an insight into the population of small exporting companies, but analysis is often hindered by the different ways in which they measure and group small firms. Some survey estimates are based on the number of employees, whereas others are based on total turnover. Survey conclusions about smaller firms' propensity to export also vary, as one would expect, according to the period under review, how exporting is defined, or any bias of the sample towards a particular region or sector.

Despite methodological difficulties, some general themes emerge. A number of surveys show that smaller firms, regardless of which definition is used, are less likely to be experienced exporters and more likely to export only occasionally. Smaller firms are also less likely to export a large proportion of total turnover. One survey found that only 21% of smaller exporters exported more than half of their total turnover,(4) whereas in another survey about 50% of all exporters claimed to export more than half of their turnover.(5)

It appears that the export record of UK small and medium enterprises (SMEs) is not as strong as that of other European countries. According to a survey by Grant Thornton,(6) the United Kingdom is thirteenth in the European Union in terms of the proportion of SMEs that exports. The DTI has suggested that the small proportion of exporting SMEs in the United Kingdom might partly reflect the United Kingdom's geographical position.(7)

(1) Since 1994, the Bank has published an annual report entitled *Finance for Small Firms*. The fifth report was published in January 1998. Copies can be obtained from the Bank's Public Enquiries Group (tel 0171–601 4878; fax 0171–601 5460).
(2) Copies of the report, entitled *Smaller Exporters—A Special Report*, can be obtained from the Bank's Public Enquiries Group.
(3) The DTI classifies small businesses as those employing between 0 and 49 employees. In 1996, sole traders or partners without employees accounted for more than 2.5 million businesses. Source: DTI (July 1997), *Small and Medium Enterprise (SME) Statistics for the United Kingdom, 1996*.
(4) Barclays Bank (1996), *Realising your Export Potential*, based on a survey of 400 businesses with sales turnover of up to £10 million, undertaken in April 1995.
(5) NatWest (1996), *The NatWest Triannual Survey of Exporters*, (Vol 4, No 1).
(6) Grant Thornton (Spring 1997), *European Business Survey*.
(7) DTI (1997), *Competitiveness UK: Our Partnership with Business. A Benchmark for Business*.

Sources of information and advice

There are many similarities between how firms sell goods to overseas buyers and how they operate in the domestic market. Both processes involve identifying potential markets, setting prices, manufacturing and transporting the goods, and receiving payment. Where the processes differ, apart from the potential exposure to exchange rate fluctuations, is that some aspects of selling overseas may be more complex, especially for firms exporting to a market for the first time.(1) Indeed, a survey undertaken by the British Chambers of Commerce (BCC)(2) identified poor research and lack of preparation as a reason for failure among 30% of businesses that had experienced unsuccessful export ventures. New exporters may not be experienced enough to be able to identify all of the complexities when they start exporting. This awareness of potential pitfalls, or fear of the unknown, may lead some firms to decide against exporting potentially profitable products or services. So access to relevant information and advice is critically important to potential, new and experienced exporters, and inexperienced exporters are also likely to require some degree of 'hand-holding' during their initial forays into export markets.

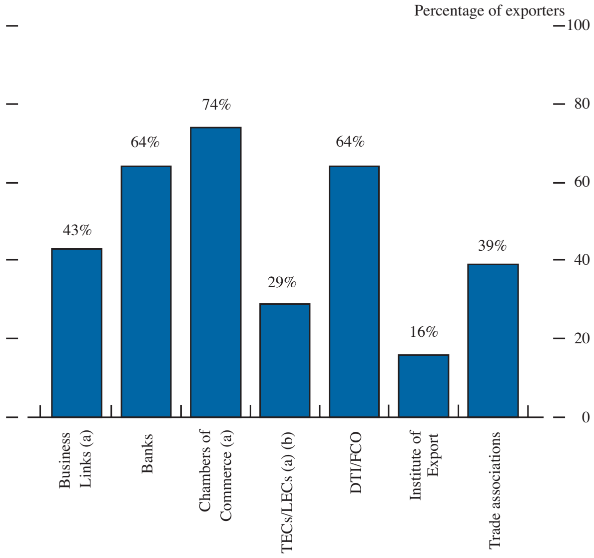
There is no shortage of potential providers of information and advice. A recent study of export support, undertaken at Durham University Business School,(3) identified four main providers of exporting services and advice in the United Kingdom:

- public and semi-public agencies, such as Business Links (see below), the DTI/FCO Overseas Trade Services, local authorities, and Training and Enterprise Councils (TECs);
- Chambers of Commerce, trade associations, and other professional institutions such as the Institute of Export;
- private institutions, including banks, consultants, lawyers and freight forwarders; and
- other businesses, including export clubs, overseas customers and suppliers that are willing to share information and experience.

But the existence of such a large number of potential providers of support, and unfamiliarity with the services that they offer, can result in a bewildering choice, particularly for firms with no previous exporting experience. Even when identified, sources may not always tailor information and advice to suit the needs of the individual exporter. Indeed, the Bank's work suggests that the non-availability of focused information and advice is currently the most important structural issue facing smaller exporters, especially those new to exporting.

As Charts 1 and 2 show, the use made of the main providers of assistance with export procedures currently varies considerably among smaller exporters. Data from the same survey, on how users rate the services provided, suggest that many exporters are missing out on potentially useful services because of their low levels of awareness of some providers and products. Also, even when exporters know about a provider, they may not be aware of the full range of products on offer.

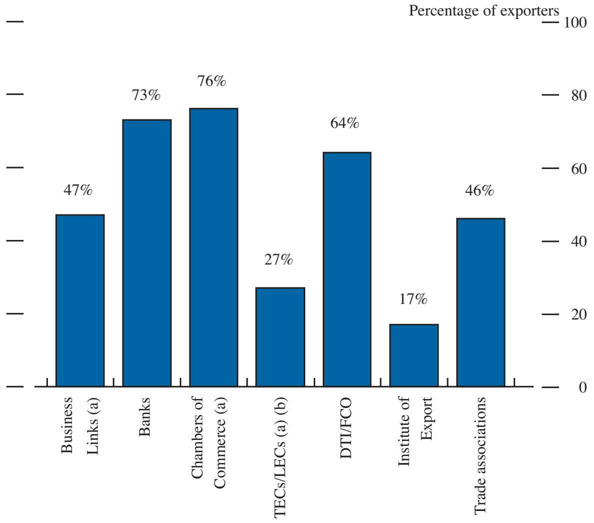
Chart 1
Usage of service providers: £0–1 million turnover band



Source: Major Issue Limited (1997), *The Fifth Survey of International Services Provided to Exporters*.

(a) Though listed separately, Chambers of Commerce and Training and Enterprise Councils are partners in individual Business Links.
(b) LECs are Local Enterprise Companies.

Chart 2
Usage of service providers: £1–10 million turnover band



Source: Major Issue Limited (1997), *The Fifth Survey of International Services Provided to Exporters*.

(a) Though listed separately, Chambers of Commerce and Training and Enterprise Councils are partners in individual Business Links.
(b) LECs are Local Enterprise Companies.

(1) There may also be some sizable upfront costs, eg obtaining local regulatory approval.
(2) British Chambers of Commerce (May 1997), 'Exporting', *Small Firms Survey*.
(3) Atherton, A and Sear, L (1997), *Support for the Exporting SME: Current Configurations of Provision in the North-East of England*, Durham University Business School.

The diversity of sources of assistance and specific products available to smaller firms more generally, combined with low awareness of these among firms, was a key factor in the decision in 1992 to initiate the Business Link network. Each Business Link is intended to act as a 'one-stop shop', able to provide firms with, or signpost them to, the service most appropriate for their particular needs. The presence of Chambers of Commerce and TECs as partners in individual Business Links has helped to focus expertise within a single umbrella organisation. The special needs of exporters were further recognised by the appointment of Export Development Counsellors (EDCs) within Business Links.

Based on the Bank's discussions with market participants, there appears to be a broad consensus that, through EDCs, Business Links are probably the best current means of providing initial advice, as well as the 'hand-holding' role desired by some new or less experienced exporters. Nevertheless, many of those involved in exporting or the provision of finance to exporters continue to voice concerns about the inconsistency of service provision across the Business Link network. But it should be noted that 1998 is the first year of full operation of the completed EDC network, so it is too early to judge the true potential of EDCs and Business Links.

Though Business Links are intended to be the first port of call for exporters and SMEs more generally, many smaller exporters still rely on their bank for initial advice and assistance. But it is unrealistic to expect branch managers to provide detailed advice to firms about aspects of exporting that are not directly related to financing or payment (though where a bank's policy is to focus its expertise in regional or central locations, wider information may be available to customers). So it is important that bank staff have sufficient knowledge to enable them to direct exporters effectively to a suitable source of information or advice on the wider or more technical issues of exporting, as and when appropriate. This also applies to other parties, such as accountants, that are often targeted by smaller firms with initial queries.

The Export Forum

The report of the Export Forum, which arose from a commitment in the Government's pre-election business manifesto to improve the effectiveness of government support for exporters by bringing together the relevant Whitehall departments and business representatives, concluded that a number of improvements needed to be made to government support for exporters.[1] Many of those involved in exporting have endorsed the findings of the Export Forum—in particular, the highlighting of weaknesses in the branding and marketing of government services, which are not widely known and used.

The Internet

The Internet is potentially a very important development for exporters. A number of websites have been set up by support providers to allow 24-hour access to information and advice on a wide range of business issues. They are also being used to promote UK businesses abroad—for example, the *Trade UK* website's exporter database. There are encouraging signs that exporters are beginning to use the Internet. One survey[2] indicates, for example, that 40% of exporters with turnover up to £1 million are using the Internet, and 46% of those with turnover between £1–10 million. Smaller exporters appear to use the Internet largely for marketing, whereas other exporters use it more widely (for example, for company information and to explore new business opportunities). This may reflect differences in resources, but it is important for small exporters to be aware of the possible benefits of the Internet, particularly time and cost savings.

Sources of external finance and protection

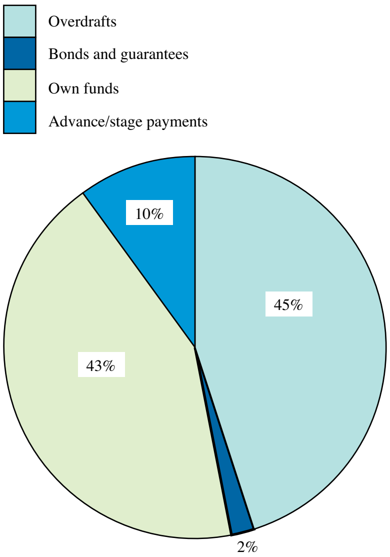
Firms involved in exporting require working capital in the same way as firms producing solely for the domestic market. They require finance to fund the manufacturing process, transportation and the period between shipment and payment, and will often need to seek some proportion of this from an external source such as a bank. Finance providers, however, often regard the risks associated with lending to exporters as greater than those involved in lending to firms selling only in the domestic market. For example, lenders may take a more cautious view of the value of receivables in an exporter's balance sheet, since some will relate to foreign buyers about whom they are unwilling or unable to form credit judgments, or they may be uncertain about an exporter's ability to produce goods that conform to potentially different specifications and standards.

Charts 3 and 4 suggest that own funds and bank overdrafts are the predominant means of funding receivables for exporters in both the £0–1 million and £1–10 million turnover categories. The original survey shows that this is broadly in line with the funding of exporters in general, irrespective of size. Research by Barclays Bank[3] also found that the commonest form of external finance was an overdraft facility, but that internal funding was much more important. Both surveys indicate that smaller exporters make little use of other sources of finance.

In some respects, it is not surprising that bank overdraft facilities appear to be the commonest form of external finance used by smaller firms to finance export receivables. Overdrafts are commonly used as the primary source of working capital for domestic businesses, and so are a form of finance that businesses find familiar and can understand. Moreover, neither survey data nor the Bank's work has suggested that there is currently a major gap in the overall

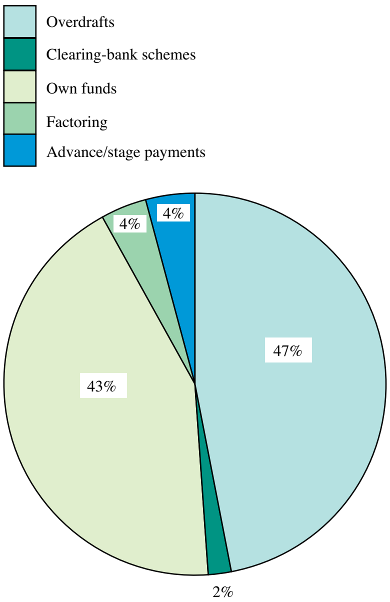
(1) A full list of the recommendations can be found in *Towards an Export Initiative—a Report by the Export Forum*, DTI (November 1997).
(2) Major Issue Limited (1997), *op cit*.
(3) Barclays Bank (1996), *op cit*.

Chart 3
Usual method of financing export receivables: £0–1 million turnover band



Source: Major Issue Limited (1997), *The Fifth Survey of International Services Provided to Exporters*.

Chart 4
Usual method of financing export receivables: £1–10 million turnover band



Source: Major Issue Limited (1997), *The Fifth Survey of International Services Provided to Exporters*.

availability of bank finance to smaller exporters, though discussions with market participants suggest that the availability of finance to firms seeking to export for the first time may be less certain. But many exporters may be unaware of, or have limited information about, alternative financing arrangements that may be more appropriate in practice. For example, this might account for the perceived under-utilisation of factoring by smaller exporters (see below). It is also possible that providers of finance may be less willing to offer alternative forms of finance, since they may feel that exporting—particularly in the case of new exporters—involves additional risks in the event of default or non-performance, to which they do not wish to be exposed. Examples of these products may be clearing-bank trade-finance schemes and pre-shipment finance (see below). Nonetheless, it is important that firms have enough information to be able to make rational and informed choices about the forms of finance that match their individual requirements most closely. This highlights the importance of access to sound and comprehensive advice on finance, and of finance providers making sure that information about their products is widely available.

Factoring

The cautious approach that many lenders take towards the value of overseas receivables in the balance sheet of firms seeking to develop their exporting business may mean that fast-growing exporters have insufficient working capital as orders increase.[(1)] This shortage may be a particularly acute problem if there are no additional fixed assets that the firm can pledge as security against new borrowing facilities, or if the firm is unable (or unwilling) to strengthen its balance sheet via an external equity injection. A potential solution, and also a source of working capital for exporters more generally, is export factoring or invoice discounting (though invoice discounting, both domestic and export, is unlikely to be available to firms with turnover of less than £1 million). These products also offer additional services, such as non-recourse finance, advice on trading terms, protection against exchange risk, and expert knowledge of overseas buyers' creditworthiness, which can help to resolve some of the uncertainties that are said to dissuade smaller firms from becoming active exporters.

The minimum turnover for access to export factoring and invoice discounting has fallen substantially in recent years because of improvements in technology, the information available to factoring companies and strong competition for business within the industry. But the limited evidence available indicates that few smaller exporters are currently using these services.[(2)] This may reflect a lack of awareness, both among exporters and their advisers, of the full benefits that these products can offer. In addition, factoring is perceived by many as being unduly expensive, though costs should be at least partly offset by lower overheads as a result of the factor taking over management of the sales ledger.

Clearing-bank trade-finance schemes

Smaller exporters make little use of clearing-bank trade-finance schemes at present, as Charts 3 and 4 show. Banks providing these products to exporters need to take into account two particular risks: first, whether the exporter will successfully deliver the goods to the contractual specifications: and second, whether the overseas buyer will pay for the goods supplied. In the case of new and smaller exporters, there is generally no track record of performance,

(1) This can, of course, also be an issue for rapidly growing smaller firms operating solely in the domestic market.
(2) For example, Charts 3 and 4 above and *Barclays Bank* (1996), *op cit*.

and little or no evidence of success in negotiating disputes with overseas buyers.[1] Though banks can try to overcome these informational deficiencies to some extent, this invariably requires the use of additional resources, and so schemes can become disproportionately expensive for banks to provide to smaller exporters and for firms to use. For the smallest exporters, such schemes have so far simply not proved practical for banks for these reasons.

Pre-shipment finance

There are particular occasions when exporters in certain lines of business or in particular situations may require pre-shipment finance. The most common examples of this include:

- a step increase in orders;
- a particularly large order, or one with a large production run for which it is not possible to negotiate advance or stage payments; and
- an order with a long lead time (for example, bespoke capital goods) or consisting of several components, where payment is not forthcoming until receipt of the final component.

However, banks and others providing pre-shipment finance believe that they are assuming greater risk than for normal trade-finance services, because of the additional risks arising in the pre-shipment period (for example, buyer or manufacturer going out of business, or the manufacturer failing to provide goods of the contracted quality or specification). They are therefore unlikely to be willing to provide such finance if they cannot satisfy themselves that the risks are acceptable, or in the absence of credit insurance or an irrevocable letter of credit. So pre-shipment risk is another area where lenders are hindered by a lack of information about smaller exporters without a track record. In such circumstances, smaller exporters will probably need to use an alternative source of finance.

Credit insurance

A recent survey by the BCC[2] found that 29% of firms that had experienced an unsuccessful export venture cited inability to obtain payment as a cause of failure. These figures highlight the difficulties that many exporters face in securing cross-border payment, and perhaps suggest scope for new and existing exporters to investigate the use of credit insurance as part of a comprehensive export strategy. In addition, a commonly cited reason for firms choosing not to export is a fear of the unknown. Credit insurance can help to overcome this by adding greater certainty to this very important aspect of exporting. Many smaller exporters do not use, or are unaware of, the existence of credit insurance. For example, a recent Lloyds Bank Commercial Service survey[3] of companies with turnover of up to £100 million found that only 14% of exporters used credit insurance.

Credit insurance can have additional benefits for policyholders, such as access to substantial databases of information on overseas buyers. Exporters may also find that credit insurance improves their access to export finance, since banks are likely to derive greater comfort from the value of insured receivables in an exporter’s balance sheet. But as mentioned above, smaller exporters are often less able to devote resources to credit management. So before banks provide additional finance facilities, they will need to be fully satisfied that a firm is able to manage its credit insurance policy.

The development of schemes specifically tailored for smaller exporters has tended not to be particularly remunerative for credit insurers, for three main reasons:

- the start of any policy involves an upfront cost in addition to continuing operating costs for the insurer. Most of these costs do not reduce proportionately in line with insurable turnover;
- smaller exporters often have insufficient resources or expertise to enable them to manage their debtors as effectively as larger exporters. As a result, the claims ratio for smaller exporters tends to be higher than the average for all exporters; and
- the combination of the above has meant that the appropriate premium for smaller exporters has needed to be set at a level that exposed the insurer to the risk of adverse selection—the exporters willing to pay high premiums have tended to be those that were expecting to claim on a more frequent basis, with those less likely to claim tending not to take out insurance.

Recently, however, some insurers have managed to reduce the costs of providing services to smaller exporters with simpler policies and lower administration costs, and a number of new products from the major credit insurers are aimed specifically at smaller exporters. A challenge for credit insurers is to raise awareness of their products and of these improvements, in order to overcome ingrained perceptions of credit insurance as an expensive and scarce service for smaller exporters. Some responsibility for increasing awareness of the benefits of credit insurance must also lie with those involved in advising smaller exporters.

Risks arising from foreign exchange movements

The exchange rate risks facing exporters are significant, as even major currencies can move sharply against one another during the 60–90 days’ credit period that exporters commonly allow. Exporters have faced a considerable strengthening of sterling since the second half of 1996. Setting prices and receiving payment in the buyer’s currency

(1) Smaller firms also tend to have less influence over buyers than their larger compatriots do.
(2) British Chambers of Commerce (1997), *op cit*.
(3) The survey was undertaken in June 1997 by Lloyds Bank as part of its *Business in Britain* economic review.

has the advantage to the exporter that the product should appeal more to the buyer. The disadvantage is that the exporter rather than the buyer bears the exchange risk. For example, a UK exporter signing a sales contract on 23 April 1997 worth DM 56,000 would have been able to convert this to £20,000 had he received payment on the day. But if the exporter had granted a credit period and received payment three months later, the same Deutsche Mark receipts would have yielded only £18,000. If the exporter had been working to a 10% profit margin, his profit would have been eliminated.

There is evidence that larger firms are more active in taking measures to protect themselves against currency risks. For example, a NatWest business survey carried out in mid 1997[(1)] found that larger firms taking part in the survey made greater use than smaller firms of each of the suggested measures. A survey by Barclays Bank[(2)] has suggested that fewer than half of smaller exporters protect themselves against currency exposure. It is unclear whether this reflects a deliberate choice by smaller exporters or lack of awareness of products.

Exporters can use a number of products to reduce the uncertainties arising from foreign exchange rate movements, including forward foreign exchange contracts, foreign exchange options and opening a currency account with a bank. Some of the more sophisticated products that banks provide may be targeted mainly at larger customers, because of their complexity or high upfront costs. But some hedging products are potentially of great benefit to smaller exporters. Forward exchange rates are a good example, because they are not especially complicated and banks are often able to offer attractive rates even on smaller transaction amounts (for example, £10,000 and above) by batching smaller transactions. So there may be some scope for advisers and providers to ensure that smaller exporters are made fully aware of products, and of the advantages and disadvantages of each.

To some extent these findings are unsurprising, because larger firms are likely to have more resources to identify, understand and manage their currency risks. Larger firms are also more likely, by virtue of their size and complexity, to have the scope to offset parts of their cross-currency cashflows against one another. Smaller exporters may have few—if any—natural offsets, and are less likely to be able to take advantage of intra-group hedging, which is an important (and often cost-efficient) way of managing foreign exchange risk.

Single currency

The European Union is the key market for British firms currently exporting.[(3)] However, a firm's size appears to have an impact on where it prefers to trade. Traditionally, smaller firms have been more likely to export to Europe than to other parts of the world, attracted by the proximity and fewer barriers to trade. Of small businesses with turnover of less than £1 million, 88% regard the European market as important for their export activities. This preference is less pronounced for larger companies, which are more attracted to the North American market and the Middle East.[(4)]

The level of preparation for the single currency among smaller businesses generally appears to have been limited—external consultancy and IT resources are already under pressure from issues stemming from the Year 2000 problem. Businesses may also be unsure about what exactly is required from them. One survey suggests that 65% of smaller businesses have made no plans to deal with EMU.[(5)] It is unclear, however, from survey evidence whether businesses that export are further ahead in their preparations for the single currency. According to another source, 61% of exporting businesses with turnover of up to £1 million, and 59% of those with turnover of £1–10 million, have made no plans to deal with EMU.[(6)]

There is no room for complacency for UK firms involved in the financial markets of, or exporting directly to, countries that will adopt the euro from the start. Their competitors in those countries are actively preparing their businesses for the new environment; some companies have already announced that they will prefer to deal in euros from 1999 onwards. Many smaller UK firms are likely to be either suppliers or subcontractors to such firms; a survey of 3i companies[(7)] suggested that 30% of firms employing fewer than 19 staff, and 43% of firms employing between 20–49 staff, produce goods that are sold to other UK companies for subsequent export. The importance of the euro as a major international currency may mean that some smaller firms may experience more pressure to invoice and accept payment in euros than they now do to handle existing foreign currencies. This would mean bearing increased foreign exchange risk or, in some cases, bearing exchange risk for the first time. Such firms will need to prepare themselves to manage this extra risk.

Response to the report

This article has summarised the findings of the Bank's research into the issues faced by smaller exporters. The initial findings were presented at the Governor's annual seminar on finance for small firms in January 1998, alongside the Bank's fifth annual report on finance for small firms, and were discussed by a large group of senior representatives from the major finance providers, small firms representative organisations, academics and

(1) NatWest (1997), *NatWest Triannual Survey of Exporters* (Vol 5, No 2).
(2) Barclays Bank (1996), *op cit*.
(3) This section draws partly on *Practical Issues Arising from the Introduction of the Euro*, a guide prepared by the Bank. Copies may be obtained from Public Enquiries Group, Bank of England, London EC2R 8AH (tel 0171–601 4878; fax 0171–601 5460).
(4) Barclays Bank (1996), *op cit*.
(5) Barclays Bank (October 1997), *Barclays Business Banking Survey*.
(6) Major Issue Limited (1997), *op cit*.
(7) Bannock Consulting (November 1997), *3i Enterprise Barometer*.

Government officials. Seminar participants welcomed and endorsed the Bank's conclusions, emphasising the mutual responsibility of finance providers and smaller exporters in maximising export market opportunities. During 1998, the Bank will continue to monitor these developments through its continuing work on small firms.