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PO Financing for SMEs in Saudi Arabia and beyond the Middle East Region

The new Playing Field in Trade Finance

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Executive Summary

Small and medium-sized enterprises (SMEs) are key contributors to economic growth and job creation. The current market conditions are affecting in particular small businesses with little access to third-party financing. In light of the increasingly pessimistic market conditions, small businesses are particularly affected with little to no access to financing from banks.

Improving financial inclusion for SMEs could boost annual economic growth by 1% per year, and lead to a potential 16 million jobs by 2025 in the Middle East and Central Asia regions.[1] As a result of the coronavirus pandemic, millions of SMEs are looking for new ways to get funding. It is crucial now more than ever to close the gap in financial inclusion for SMEs in the Middle East.

The good news is that the emergence of technology for the provision of financial services (Fintech) is driving innovative financing alternatives for SMEs. Such crowdfunding peer-to-peer platforms have the potential to alleviate some of the financing constraints faced by SMEs and provide more inclusive financing mechanisms for small businesses.

This report examines the current challenges for SMEs, their funding options available in the market as well as the unique opportunities in the Kingdom of Saudi Arabia. The evolution of Fintechs focusing on SMEs is reviewed, highlighting the example of leading Fintech provider Ta3meed and its Purchase Order (PO) financing solution.

SMEs Challenges & Opportunities

Small and medium enterprises (SMEs) account for the majority of businesses worldwide and are important contributors to job creation and global economic development. They represent about 90% of businesses and more than 50% of employment worldwide.[2] In Saudi Arabia, SMEs form 90% of businesses in the Kingdom, yet contribute only 22% to the Gross Domestic Product (GDP) - slightly below average in the region, ahead of only Kuwait and Oman.[3]

Access to finance is one of the biggest obstacles facing the development of SMEs. Research shows that the growth and development of the SME sector are strongly linked with sustainable access to financial resources. The SME sector has received increased global attention due to its growing importance in terms of income generation, source of employment, and contribution to GDP. However, SMEs are less likely to be able to obtain financing from banks than large firms; instead, they rely on internal funds to run their enterprises. The International Finance Corporation (IFC) estimates that 65 million firms, or 40% of SMEs in developing countries, have an unmet financing need of $5.2 trillion every year.[4]

SMEs rely on external financing for a number of business activities, including:

- maintain short-term cash flow
- replace or purchase equipment or machinery
- pursue expansion opportunities, or
- ensure the survival of the business.

As a result, many governments and countries all over the world have begun to direct more attention to SMEs to ensure that they are provided with appropriate access to financial liquidity.

In Saudi Arabia, the government took an active role and successfully implemented several policies to support SMEs as part of its efforts to diversify its economy and reduce the country's dependence on oil as part of the Saudi Vision 2030. To help achieve the goal, the government established the SME Authority encouraging businesses and entrepreneurs with business-friendly regulations, easier access to funding, and a greater share of national procurement and government bids.[5]

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However, despite the Saudi government's efforts to enhance and support the bankability of SMEs, many companies still struggle to obtain financing in Saudi Arabia and remain under-served by banks. Given the nature and size of these businesses as well as high levels of risk and transaction costs involved, banks and other financial institutions are often reluctant to lend them money. Research shows that the proportion of loans from commercial banks to SMEs in Saudi Arabia is approximately 6%.[6]

This situation is not just unique to Saudi Arabia but across other markets. In the region, SMEs account for only 7% of total bank lending - the lowest level in the world. According to a study by the IFC, there are 365 to 445 million enterprises in emerging markets and approximately 85 percent of these companies suffer from credit constraints. In addition, if financing is available, interest rates for loans from banks are high due to the level of risk involved in lending direct money to SMEs.[7]

Working Capital is Key to SMEs

With more than $900 billion in trade exchange, the Gulf Cooperation Council (GCC) region ranks number eight among the most active countries in global trade flows.[8]

Although the general economic prospect is sound, the region has been equally impacted by the recent global downturn. The disruption in global value chains and capital flows had a weigh on domestic production and demand. Current uncertainties in the global economy and financial markets are putting unprecedented pressures on SMEs and their cash reserves in the region.

Managing working capital has never been as important to SMEs in the Middle East as it is in today's market environment. Working capital is the ongoing source of funds that a company needs to grow its business, invest in equipment, and hire employees.

***"Financing working capital is taking more importance** among CFOs, treasurers and supply chain top executives"*

Today SMEs in the Middle East that are successful managers of liquidity, working capital, and risks in their supply chain, do not extend beyond their financial debt-servicing capabilities and are better prepared for the current market. As a result, financing working capital is becoming more important among CFOs, treasurers, and supply chain top executives, as it offers significant potential to generate bottom-line improvements and create competitive advantages.

Financing working capital bridges the need of a corporate to maintains its working capital, but at the same allowing its SME counterparty to receive early payment form a third-party financier. It solves the conflicting objectives between a buying organization looking for ways to maintain its Days Payable Outstanding (DPO) and reduce the risk of supply chain disruptions and on the other side the SME's goal to reducing its Days Sales Outstanding (DSO).

This is where Financial Technology (Fintech) comes to play changing the financing of working capital with innovative solutions like PO financing. The developments in recent years demonstrate the possibilities of Fintech as an additional source of financing for Middle Eastern SMEs.

How Fintech can help ensure the Survival of SMEs

The financial sector in the Middle East is not immune to this digital disruption. Today, in Saudi Arabia and throughout the region, there is a new generation of Fintech entrepreneurs who are gradually reshaping the economic environment. They are focusing on SMEs supporting their government's current plan to develop frameworks for sponsoring SMEs in order to drive their economic growth to contribute more to GDP.

Saudi Arabia's Fintech SME lending sector is still young. But recent growth indicates that it has the potential to develop into a strong and healthy alternative to traditional bank lending to the SME sector.

Fintechs in the Middle East region are combining the latest digital-delivered financial solutions with Islamic Financing. The solutions are sharia-compliant allowing for millions of Muslim investors to fund through Islamic Fintech, while providing funding to SMEs. These private and institutional investors are crucial in offering financing to SMEs - they are usually faster than traditional financial institutions due to their willingness to be open to new technology platforms when seeking superior returns.

Besides, Fintech solutions with a digital approach baked into their DNA, are innovative when it comes to funding opportunities. They allow for transparent risk mitigation with a new type of user experience to make SME borrowing straightforward.

Broadly, Fintech SME lenders can be characterized as either balance sheet lenders or peer-to-peer (P2P) marketplace lenders. Such P2P funders are especially of great interest in Saudi Arabia as they establish a direct economic relationship between a borrower and an individual, or institutional investor.

P2P marketplaces are using Fintech platforms that allow investors to fund underlying transactions and monitor their investments through interactive dashboards. Investors are entitled to payments of principal and profit from the borrowers to whom they have been matched. The Fintech typically levies a fee on returns as compensation for operating the marketplace platform.

One P2P marketplace focusing on SMEs and gaining recognition in the Fintech market is Riyadh-based Fintech company, Ta3meed. The Fintech company is operating a platform for financing government-backed Purchase Orders (PO) and is in a unique position to disrupt the SME lending space in the Middle East region and beyond.

Ta3meed Financing Platform

Ta3meed (PO in Arabic) is the first PO financing platform in the Middle East providing funding based on government-issued and guaranteed POs. The company, managed by a team of leading trade and financial technology experts, offers unique investment opportunities and support of SMEs in the region by focusing on Trade Finance and PO as the underlying asset. The financing opportunity of Pos for SME resellers is substantial.

In Saudi Arabia alone, government entities have issued 57,000 POs representing over SAR 84 billion (USD 22.4 billion) in the first Half of 2020.[9]

To access the POs, Ta3meed's digital platform connects via APIs (Application Programming Interface) to the government-owned entities. Based on the POs, SMEs resellers can access affordable, on-demand financing from crowdfunding investors who are looking for superior returns.

What is PO Finance?

PO financing is a short-term commercial finance option that provides capital to pay suppliers and/or resellers upfront for verified POs. SME avoid depleting cash reserves or declining an order because of cash flow challenges. It allows companies to accept POs and adjust quickly the financing facility in order to meet their needs. If order volume drops, there is no long-term commitment so they can stop using it at any time.

Who qualifies for PO Financing?

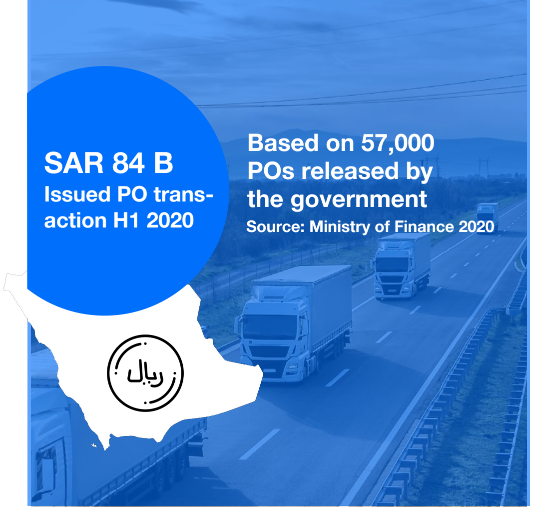
PO financing is designed for growing businesses with limited access to working capital or irregular cash flow. Usually PO financing is geared towards SME-type companies, however, it can be offered to any type of businesses in various industries such as telecommunications, healthcare, and the construction sector. Financing is backed by POs based on revolving, ongoing trade flows of manufactured goods with average payment terms of 90 to 120 days.

How much does it cost?

Ta3meed PO financing starts at SAR 0.5 million (USD 130 thousand). The cost of financing POs varies for each transaction starting as low as 1% per month based on the individual PO rating.

How long does it take?

From the time you submit the application and due diligence materials, it takes approximately one business day to get initial approval. For an individual or institutional investor it takes up to 24 hours to sign up and fund your POs.



The Ta3meed Platform is regulated by the Saudi Central Bank (SAMA)

Ta3meed offers Sharia-compliant investment solutions that provide the market with competitive alternative asset-class investments focused on the real economy. The financing solutions are offered with credit enhancements at competitive returns to other available comparable instruments. The superior returns depend on several factors, including the credit rating of the government entity the duration of financing, and the degree of the underlying credit risk.

This type of peer-to-peer lending, also known as crowd lending cuts out the middleman - traditionally a bank allowing companies to borrow directly from investors. Investors funding PO-backed trade finance transactions earn competitive yields for their short-term investments based on self-liquidating assets with little to no volatility.

The revolving revenue streams are based on investment-grade risk as POs are issued by governments in the regions. Throughout, the whole process, the investors can control returns to fit their investment strategy and distribute their investments to borrowers with different loan sizes as well as different profit margins and risks.

The Ta3meed Platform is regulated by the Saudi Central Bank (SAMA).The Platform has been tested and implemented successfully with the Saudi government, SME resellers, and multinational manufacturers.

Risk is mitigated by applying adequate credit screening and KYC checks conducted on all participants. It includes PO and payment history checks via API to the Ministry of Finance entity, Etimad and to the credit bureau, Bayan. In addition, prior to funding, all POs are confirmed by government-entities representing a payment guarantee. This makes the financing solution a unique opportunity to support SMEs and generate great returns for investors.

How does PO work?

You are reseller receiving a PO from a customer such as a government-owned entity. Your supplier needs payment within 30 days, but your customer invoice won't be paid for 120 days after shipment is received. This creates a working capital gap and financing opportunity. Upon your request for financing, Ta3meed will verify the PO and immediately make an advance with up to 100% of the PO amount and pay your supplier directly. The financing is based on crowd-funding from individual investors and institutional financiers.

Based on purchase contract, your supplier will sell the goods to Ta3meed. You will enter into a Murabaha contract with Ta3meed issuing a Promissory Note and we will issue the payment to the supplier, who will deliver the underlying goods directly to your customer.

At maturity, your customer wires payment to escrow account, created and controlled by Ta3meed, who settles accounts with your company and transfers the profit to the investors.

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Ta3meed Platform is permitted by the Saudi Central Bank (SAMA) to test its innovative products under the Regulatory Sandbox.

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