Trade finance as a barrier to SME internationalisation: Special reference to African trade with China

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Dissertation submitted in partial fulfilment of the requirements for the degree Magister Commercii in International Trade at the Potchefstroom Campus of the North West University

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2010

Potchefstroom

ABSTRACT

The importance of small and medium-sized enterprises (SMEs) in the economy should not be overlooked. The main function of SMEs is to contribute to the economic activities in a country, through the provision of goods and services to the public or other firms. These goods and services could be traded internationally, thus increasing a country's export performance. It is important for economic growth that SMEs grow within their respective economies. One way that SMEs can achieve growth is through internationalisation. Firms are internationalising faster than ever before (because of advances in telecommunications and transportation) and internationalisation theories that can provide practical guidance to firms are more important today than in the past.

A firm's ability to internationalise no longer only depends on the quality of the product, the delivery terms and competitive prices. Internationalisation increasingly depends on the ability and willingness of financial institutions to grant credit. Obtaining trade finance has become a major hindrance to SME internationalisation, especially in Africa. By overcoming the difficulties in obtaining trade finance, African SMEs will be able to expand into foreign markets.

The purpose of this study is to determine how African SMEs can overcome trade finance barriers to internationalisation. SMEs can do so by mitigating the risks involved in every international transaction and by becoming "trade finance ready".

A trade finance facility that is well suited for African SMEs (because it revolves around identifying and mitigating the risks involved with their international transactions) is structured trade and commodity finance. In trading with China, African SMEs can obtain structured trade and commodity finance from a specialist financial institution that focuses on the Chinese market (which is the focus of this study). China Construction Bank (Johannesburg branch), through their association with Rand-Asia Trade Finance, provides structured trade and commodity finance to African SMEs. The key to receiving structured trade and commodity finance is that these SMEs, together with China Construction Bank (Jhb) and Rand-Asia Trade Finance have to mitigate the

risks involved with their international transactions so that the SMEs can become “trade finance ready”.

The aim of the empirical research is to investigate how African SMEs can obtain structured trade and commodity finance from a specialist Chinese bank located in Africa. Empirical evidence was obtained through a weeklong visit and interviews with personnel at Rand-Asia Trade Finance and China Construction Bank Johannesburg. This study presents two cases of how successful SMEs were able to mitigate the risks involved with their international transactions.

Both of the SMEs used in the case studies were able to mitigate the risks involved with their international trade transactions and by doing so were able to obtain structured trade and commodity finance. Apart from the risks that SMEs have to mitigate in order to obtain structured trade and commodity finance, there are other factors that SMEs can consider to overcome trade finance as an internationalisation barrier. By doing so, they will become more “trade finance ready” before applying for credit. This makes it easier for any bank to approve a credit application.

SMEs with an established but low turnover and profit record are more likely to obtain finance. SME managers should plan in advance and show an understanding of the dynamics of developing a business. SMEs must have realistic expectations and must be committed to their international transactions. It is essential that the manager/owner of the SME knows his/her business well. The SME must be able to outline the structure of the organisation and shareholders to the bank. All of these factors will encourage the bank to provide the SME with structured trade and commodity finance.

Keywords: Internationalisation, SME, trade finance, structured trade and commodity finance, China, Africa, risk mitigation

OPSOMMING

Die belangrikheid van klein en medium-grootte ondernemings (KMO's) binne die ekonomie behoort nie oorgesien te word nie. Die hoof funksie van KMO's is om 'n bydrae te lewer tot die ekonomiese aktiwiteite van 'n land deur die verskaffing van goedere en dienste aan die publiek of ander ondernemings. Hierdie goedere en dienste kan internasionaal verhandel word, en kan dus 'n land se uitvoerprestasie verbeter. Dit is belangrik vir ekonomiese groei dat KMO's binne hul onderskeie ekonomieë groei. Een wyse waarop KMO's ekonomiese groei kan bewerkstellig, is deur internasionalisasie. Ondernemings internasionaliseer vinniger as ooit tevore (weens vooruitgang in telekommunikasies en vervoer) en internasionalisasie-teorieë wat praktiese riglyne aan ondernemings kan bied, is vandag belangriker as in die verlede.

'n Onderneming se vermoë om te internasionaliseer is nie meer slegs afhanklik van die kwaliteit van die produk, die afleweringsvoorwaardes en mededingende pryse nie. Internasionalisasie is toenemend afhanklik van die vermoë en bereidwilligheid van finansiële instellings om krediet toe te staan. Om handelsfinansiering te bekom het 'n ernstige belemmering ten opsigte van KMO-internasionalisering geword, veral in Afrika. Deur die moeilikhede om handelsfinansiering te bekom te oorkom, sal dit vir Afrika KMO's moontlik wees om na buitelandse markte uit te brei.

Die doel van hierdie studie is om te bepaal hoe KMO's in Afrika handelsfinansieringshindernisse tot internasionalisasie kan oorkom. KMO's kan dit bewerkstelling deur die risiko's betrokke in elke internasionale transaksie te mitigeer en deur "handelsfinansiering-gereed" te word.

'n Handelsfinansieringsfasiliteit wat goed gepas is vir Afrika KMO's (omdat dit handel oor die identifisering en mitigering van die risiko's betrokke by hul internasionale transaksies) is gestruktureerde handels- en kommoditeitsfinansiering. Deur handel te dryf met Sjina, kan Afrika KMO's gestruktureerde handels- en kommoditeitsfinansiering vanaf 'n spesialis finansiële instelling, wat fokus op die Sjinese mark, bekom. China Construction Bank (Johannesburg-tak), deur hul assosiasie met Rand-Asia Trade Finance, verskaf gestruktureerde handels- en kommoditeitsfinansiering aand Afrika KMO's. Die sleutel tot die ontvang van gestruktureerde

handels- en kommoditeitsfinansiering is dat hierdie KMO’s, tesame met China Construction Bank (Jhb) en Rand-Asia Trade Finance, die risiko’s betrokke in hul internasionale transaksie moet mitigeer, sodat die KMO’s “handelsfinansiering-gereed” kan word.

Die doel van die empiriese navorsing is om te bepaal hoe KMO's in Afrika gestruktureerde handels- en kommoditeitsfinansiering kan verkry vanaf 'n spesialis Chinese bank wat in Afrika geleë is. Die empiriese bewyse is ingesamel deur ’n weeklange besoek en onderhoude met personeel by Rand-Asia Trade Finance en China Construction Bank Johannesburg. Hierdie studie bied twee gevallestudies aan van hoe suksesvolle KMO’s in staat was om hul risiko's betrokke by hul internasionale transaksies te verminder.

Beide van die KMO’s wat in die gevallestudies gebruik is, kan die risiko’s betrokke in hul internasionale handelstransaksies mitigeer, en deur dit te doen kon hulle gestruktureerde handels- en kommoditeitsfinansiering bekom. Behalwe vir die risiko’s wat die KMO’s moet mitigeer om gestruktureerde handels- en kommoditeitsfinansiering te bekom, is daar ander faktore wat KMO’s kan oorweeg om handelsfinansiering as internasionaliseringshindernis te oorkom. Deur dit te doen, sal hulle meer “handelsfinansiering-gereed” word voor hulle vir krediet aansoek doen. Dit maak dit makliker vir enige bank om ’n kredietaansoek goed te keur.

Dit is meer waarskynlik dat KMO’s met ’n gevestigde maar lae omset en winsrekord finansiering sal bekom. KMO-bestuurder behoort vooruit te beplan en behoort begrip te toon ten opsigte van die dinamiek betrokke by die ontwikkeling van ’n besigheid. KMO’s moet realistiese verwagtinge hê en moet toegewyd wees tot hul internasionale transaksies. Dit is essensieel dat die bestuurder/eienaar van die KMO sy/haar besigheid goed ken. Die KMO moet die struktuur van die organisasie en aandeelhouers aan die bank kan uitstippel. Al hierdie faktore sal die bank aanmoedig om die KMO van gestruktureerde handels- en kommoditeitsfinansiering te voorsien.

Sleutelwoorde: Internasionalisasie, KMO, handelsfinansiering, gestruktureerde handels- en kommoditeitsfinansiering, Sjina, Afrika, risiko-mitigering

ACKNOWLEDGEMENTS

During the course of my study I received encouragement and support from a variety of people whom I would like to thank, in no specific order:

- To my parents and my sister for their unconditional love and encouragement. Thank you for believing in me and encouraging me to be the best I can be.
- To Dawie Maree, thank you for your love, support and encouragement throughout this year. You bring out the best in me.
- To my supervisor Dr. Marianne Matthee, thank you for your patience, advice and constructive criticism. Without her, my study would not have been possible.
- To my friends, especially Karien, Emma, Anèl and Marnel, for their moral support and encouragement. I will always be grateful.
- To my grandparents, thank you for believing in me.
- To Mrs. Cecile van Zyl, for language editing and translation.
- To the personel at Rand-Asia Trade Finance, especially Michael Brandon, for providing assistance and valubale information during my visit at Rand-Asia Trade Finance.

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Chapter 1: Introduction

1.1 Background

The importance of small and medium-sized enterprises (SMEs)[1] in the economy should not be overlooked. Aris (2007) states that SME activities contributed significantly to economic growth in developed countries such as Japan, Korea and Taiwan. SMEs account for over 95% of firms and generate a large share of new jobs in OECD countries (OECD, 2000). However, SMEs are not just important in developed countries, they also have a significant role in developing countries. According to Fan (2004), SMEs play a very important role in developing countries and are important for economic growth. SMEs are also necessary for competitive and efficient markets and they also help to reduce poverty (Fan, 2004).

SMEs are important for economic growth for the following reasons. Firstly, because they are the sector that provides the largest number of employment opportunities. Secondly, they are a major source of technological innovation in a country (Fan, 2004). For example, during 1997, SMEs contributed to half of the total employment as well as one third of total output for the manufacturing sector alone in South Africa (Gumede & Rasmussen, 2002). Thirdly, SMEs increase the competitiveness of certain markets if there are a lot of firms in one market and through the ease that SMEs can enter and exit a market, thus making the economy more flexible, leading to more innovative skills and ideas (Fan, 2004). Lastly, SMEs can also assist with poverty reduction, as they tend to employ low-income workers. In some cases, SMEs are the only source of employment in certain regions, thus making them the only source of income for the poor in that region (Fan, 2004). The main function of SMEs is to contribute to the economic activities in a country through the provision of goods and services to the public or other firms.

[1] The World Bank categorises SMEs as Micro-enterprises, Small enterprises and Medium enterprises. Micro-enterprises have fewer than 10 employees, less than US$100 000 in assets and their total annual sales are less than US$100 000. Small enterprises have 10-50 employees, their total assets are between US$100 000 and $3 million and their annual sales are between US$100 000 and $3 million. Medium enterprises have 50-300 employees, their total assets are between US$3 and US$15 million and their annual sales are also between US$3 and US$15 million (Fan, 2004).

These goods and services could be traded internationally, thus increasing a country's export performance (Berry *et al.*, 2002).

It is important for economic growth that SMEs grow within their respective economies. One way that SMEs can achieve growth is through internationalisation. Internationalisation includes both the inward and outward operations (imports and exports) of a firm into international markets (Nummela, 2002). SMEs contribute to between 25 and 35% of world exports and also account for a small share in foreign direct investment (OECD, 2000). The OECD finds that internationally active SMEs are growing faster than their domestically active counterparts (OECD, 2000). Trading internationally is important for all SMEs because not only does it stimulate economic growth through spillovers in knowledge and technology, but it creates opportunities to enter new markets and enhance domestic competitiveness. Companies that export can also gain a global market share, reduce their dependence on the domestic market and stabilise seasonal market fluctuations (ANON.a, 2009). When comparing SMEs to larger firms, it is evident that SMEs can better respond to changing market conditions and shorter product life cycles than larger firms, which is why SMEs are becoming more active in joint ventures (OECD, 2000).

The focus of this study is on African SMEs. SMEs in Africa represent 90% of businesses, contribute to over 50% of GDP and account for 63% of employment (UNEP FI, 2007). Despite all this, SMEs in Africa are finding it hard to grow, because of bad governance, lack of foreign investors and poor infrastructure (UNEP FI, 2007). African economies can therefore benefit greatly from the growth in their SME activities. As mentioned above, SMEs contribute significantly to poverty reduction and economic growth through job creation as well as creating an innovative competitive environment within the respective economies. Internationalisation provides an avenue for SME growth. Internationalisation would not only contribute to more and better employment in Africa, but trading internationally can also enhance economic development because of the increase in domestic competitiveness through the benefits that are obtained from spillovers in knowledge and technology. Internationalisation of African SMEs can therefore play a vital role in the economic development of the continent.

There are many opportunities for African SMEs to enter the international market today. One such an opportunity is with China. African exports to China have increased from US$ 3,8 billion in 2001 to US$ 51,4 billion in 2008 (TradeMap, 2010). China signed the first official bilateral trade agreement with Algeria, Egypt, Guinea, Morocco and Sudan in 1961 and today it is known as the Sino-Africa agreement (Uchehara, 2009). The Sino-Africa agreement aims to strengthen traditional relations, rediscover strategic opportunities for deepening investment, trade, economic, educational, technological, and scientific cooperation for hopefully mutual benefits between Africa and China (Opondo, 2007). According to Opondo (2007), Chinese President Hu Jintao announced that China would be doubling assistance to Africa (from the 2006 level). They would also provide $3b of preferential loans and $2b of preferential buyer's credits to Africa. Hu also stated that a China-Africa development fund worth $5b would be established to encourage Chinese companies to invest in Africa (Opondo, 2007). China also agreed to increase the number of export items that receive a zero-tariff treatment from the least developed countries in Africa from 190 to 440 (Opondo, 2007). China further promised to create specialisation in skills and productivity to enhance competition in the global marketplace by establishing three to five trade and economic zones in Africa (Opondo, 2007). During 2008, Sino-African trade reached the US$106.8 billion mark and China's cumulative investment in Africa between 2000 and 2008 was more than US$5 billion. Today, China already levies no import tariffs on 478 products imported from 31 African countries (Qin, 2009). African SMEs would thus greatly benefit if they chose to trade with China because it is one of the fastest growing markets in the world.

1.2 Problem statement

The internationalisation of Africa's SMEs is vital for economic development through providing the countries with more and better employment opportunities as well as the benefits of the spillovers in knowledge and technology from China. The internationalisation processes of SMEs are greatly influenced by barriers, which slow down the speed of expansion into foreign markets. Export barriers refer to constraints that hinder a firm's ability to operate successfully in a foreign market (Leonidou, 1995). These barriers to trade could be both internal and external. Internal barriers are barriers associated with the company's own capabilities and organisational resources. External barriers originate from the environment in which the firm operates (Leonidou, 1995). Internal barriers consist of informational, functional and marketing barriers. Informational barriers include the limited information to analyse the foreign market, identify business opportunities as well as the inability to contact their foreign customers. Functional barriers include the shortage of working capital to finance exports, lack of production capacity and untrained personnel. Marketing barriers consist of product, price, promotion, logistics and distribution barriers (Leonidou, 2004). External barriers consist of technical, governmental, task and environmental barriers. Technical barriers include unfamiliar paperwork/procedures, challenging communication with foreign customers and the slow collection of payments from abroad. Governmental barriers include the lack of assistance/incentives from the home government and unfavourable regulations/rules. Task barriers include the different attitudes and habits of foreign customers as well as aggressive competition in the foreign market. Lastly, environmental barriers consist of economic, political-legal and socio-cultural barriers in both markets (Leonidou, 2004).

This study focuses on trade finance as a barrier to internationalisation. Mitigwe (2005) lists export barriers in order of their importance to African SMEs and found that the lack of finance is the most important barrier to internationalisation in Africa. According to Gumede and Rasmussen (2002), 25% of small exporting enterprises in South Africa find it difficult to obtain finance. Insufficient export finance was also identified as a major barrier to the success of Ghana's growth strategy and is ranked as the number one barrier to exporting in Ghana (Buatsi, 2002).

Trade finance is therefore a major barrier for African SMEs. Corruption as well as political unrest, poor infrastructure and bad governance in some African countries are greatly affecting foreign investment in African countries (UNEP FI, 2007). This has a negative effect on SMEs that want to obtain trade finance and enter foreign markets. African SMEs therefore cannot reap the benefits of internationalisation, because of the difficulties of obtaining finance.

1.3 Motivation

One of the key barriers is the lack of working capital to finance international trade (Leonidou, 2004). African SMEs must therefore be able to exploit the opportunities that trading with China holds by enabling them to obtain trade finance. African SMEs' access to finance will ultimately determine whether they will be able to grow or not. According to Prusky and Klein (2010), financial institutions recognise the need to provide stable financing to SMEs, but have difficulties in supplying it because SMEs have special requirements (it is necessary for financial institutions to develop credit models that include collateral structures). This, in turn, causes financial institutions to focus on deal structures for SMEs (Prusky & Klein, 2010). A Chinese specialist bank that focuses on deal structures for African SMEs is the China Construction Bank (CCB) in collaboration with Rand-Asia Trade Finance. This study therefore examines how African SMEs can overcome trade finance barriers and so be able to trade with China, through the facilitative role of the CCB and Rand-Asia Trade Finance.

1.4 Objectives

This study has primary and secondary objectives:

The primary objective is to determine how SMEs can overcome trade finance barriers to internationalisation.

The secondary objectives are to:

- provide an overview of the internationalisation process of SMEs;
- provide an overview of trade finance risks, methods and facilities;
- provide a description of trade between China and Africa;
- explain how CCB Jhb in collaboration with Rand-Asia Trade Finance facilitates trade between Africa and China through the provision of structured trade and commodity finance;
- compile two case studies on how SMEs were able to obtain trade finance through mitigating the risks involved with their international transactions; and
- explain how SMEs can become “trade finance ready”.

1.5 Method

This study consists of two parts out of which one would be making use of primary data research and the other secondary desk research.

The first part of the study was compiled by making use of secondary desk research. To achieve the first three objectives, the following were done: a literature overview of the internationalisation process of SMEs was undertaken, an overview of trade finance methods and facilities was also given as well as a description of trade between Africa and China.

The second part of the study involved obtaining primary data that was used to achieve the last three objectives. China Construction Bank Johannesburg and Rand-Asia Trade Finance assisted in this regard. The data was used to compile an empirical study that flowed from the literature study. It focused on 1) the role of CCB Jhb as a facilitator to trade finance and 2) the process of obtaining such finance from CCB Jhb/Rand-Asia Trade Finance. Two case studies were compiled of SMEs that have obtained trade finance from CCB Jhb/Rand-Asia Trade Finance by mitigating the risks involved with their international transactions and becoming “trade finance ready”.

1.6 Delimitation (Chapter overview)

The delimitation for the study is as follows:

Chapter 1 serves as the introduction.

Chapter 2 explains the literature on the internationalisation of SMEs.

Chapter 3 contains the literature on trade finance.

Chapter 4 discusses the process of obtaining structured trade and commodity finance from the China Construction Bank/Rand-Asia Trade Finance and contains the research method.

Chapter 5 concludes and makes recommendations.

Chapter 2: Literature review

2.1 Introduction

Traditionally, exporting has been considered the main approach to becoming an internationalised enterprise (European Commission, 2004). Internationalisation, however, entails more than only exporting. It includes both the inward and outward operations (imports and exports) of a firm into international markets as well as the ability of being competitive in an international business environment (Nummela, 2002).

SMEs in all sectors face increasing competition because of internationalisation and they have to respond to these challenges (European Commission, 2004). SMEs can overcome these challenges by trading internationally. Trading internationally is important for all SMEs because not only does it stimulate economic growth through spillovers in knowledge and technology, but it also creates opportunities to enter new markets and enhance domestic competitiveness (Dhungana, 2003). Internationalisation thus provides an avenue for SME growth. According to Nummela (2002), the number of small firms that operate in international markets have been growing steadily and the time lag of SME internationalisation (the time of the establishment from the firm to the first export delivery) has also become shorter. Because SMEs internationalise faster than in the past, they need to acquire the resources and skills (which accompanies an outward movement) faster than before.

The aim of this chapter is to provide an overview of the internationalisation process of firms, by describing different internationalisation processes, motivations why SMEs enter foreign markets as well as the barriers that hinder internationalisation. This chapter is divided as follows: section 2.2 provides an overview of internationalisation theories and processes. Section 2.3 examines born global firms. Section 2.4 discusses the internationalisation of SMEs and consists of motivations and empirical evidence. Section 2.5 discusses the barriers to internationalisation with the focus on trade finance and section 2.6 concludes.

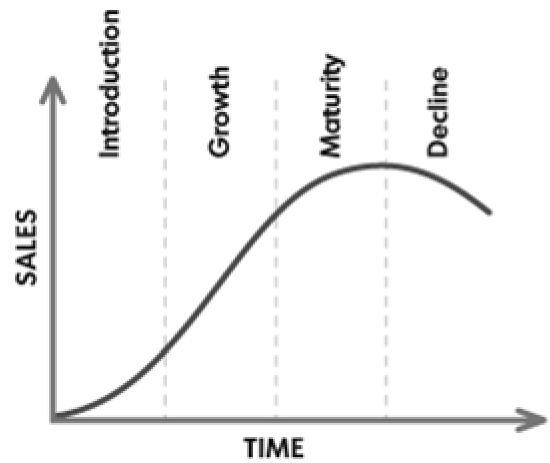
2.2 Internationalisation theories and processes

The internationalisation process of a firm is complex and multidimensional (Fletcher, 2001:26). Firms are internationalising faster than ever before (because of advances in telecommunications and transport) and internationalisation theories that can provide practical guidance to firms are more important today than in the past (Axinn & Matthyssens, 2002). There are a number of theories that explain the internationalisation of a firm. This section provides an overview of the following theoretical explanations of internationalisation: the product life cycle concept for international trade, the Uppsala School approach, the transaction cost approach, Dunning's eclectic approach, the network approach as well as the resource-based theory.

2.2.1 The product life cycle concept for international trade

The product life cycle concept was developed by Raymond Vernon in 1966. It states that all products have product life cycles. This means that all products go through certain stages from the development stage to the point at which the product is withdrawn from the market (Fox, Rink & Roden, 1999). Figure 2.1 below illustrates the product life cycle curve. From the curve it is clear that the product life cycle has four phases. A new product is introduced into the market in the first phase. As time goes by and more consumers become aware of the product, sales will increase, which leads to the growth phase. The product will then reach its mature phase on the product life cycle. This is the point where sales no longer increase (turning point) and decline thereafter. The life cycle of a product is dependent on the time that the product has been on the market as well as the sales of the product. For example, sales will reach a maximum point at the mature phase of the cycle where it will saturate and then decline (Fox *et al*., 1999).

Figure 2.1: The product life cycle curve



Source: Newly Corporate (2010).

Vernon's product life cycle theory is based on the concept above. Vernon (1966) indicated that a firm's mode of entry into a foreign market depends on the stage at which the product is in the product life cycle. It can either be at the introduction phase (new product), growth phase (where modifications can still be made to the product) or matured phase (where the product is more standardised) (Olafsson, Hermannsdóttir & Islands, 2009).

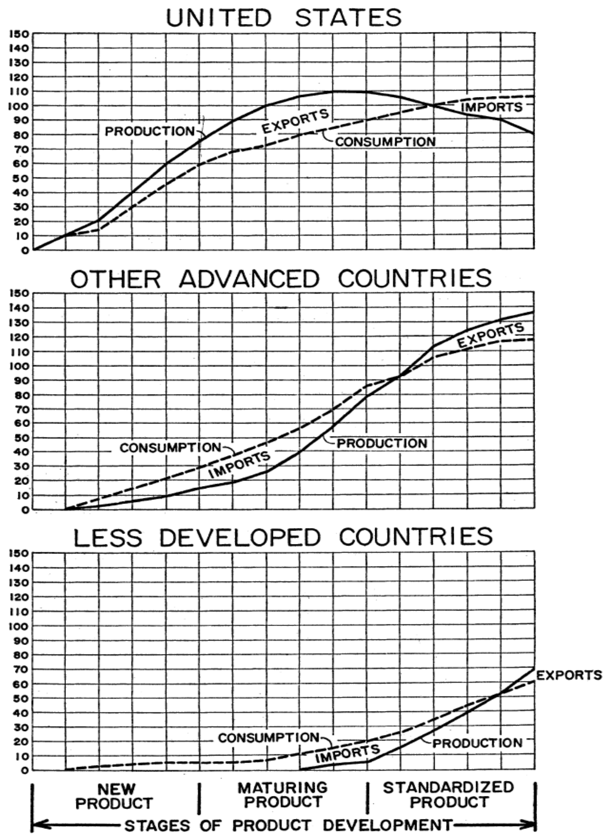
The theory is based on the assumption that firms in advanced countries, such as the USA, are similar in terms of their knowledge of their home market. Firms in the USA, for example, have the same knowledge of the demand and needs of the consumers in their domestic market because they are located in close proximity to their consumers. By communicating with the domestic consumers, the producers in an advanced country can then develop new products according to the needs in the market. The new product is then manufactured and sold in the domestic market, this is the introduction phase. This then implies that products are developed in those countries where the need first arises, which is in countries with high income levels and high labour costs (also known as advanced countries) (Johanson & Vahlne, 2003).

After this new product has been introduced into the domestic market of an advanced country, consumers in other markets (foreign markets) become aware of the new product. A need for the new product arises in developing countries. The firm will then decide to export the product to these markets, because they do not have the knowledge or skills to develop the new product in their domestic market. This is the growth phase of the product life cycle concept – where a firm in an advanced country would first export its new product to other markets. It is important to note that production stays in the home market at first (Vernon, 1966; Johanson & Vahlne, 2003).

As the techniques of production become more standardised, the manufacturing plant of the firm will shift to developing countries because of the lower labour costs there (Segerstorm, Anant & Dinopoulos, 1990). The products are then exported back to the advanced countries. This is known as the maturing phase. An example of the product life cycle concept is Mexico's Maquiladoras (assembly plants in Mexico for American firms). It is a well-known fact that America is an advanced country. It was easier for firms located in America to identify the needs and demands of the US consumers and develop new products accordingly. These products that were developed and manufactured in America were then exported to other countries with the same needs, for example Mexico. Later on, when the NAFTA trading agreement was signed, the American firms decided to move their production plants to Mexico (the Maquiladoras) where production costs were very inexpensive. The firms then exported the finished goods back into America and sold it domestically. The clothing firm Levi's is one example of such a firm (Bair, 2001).

Figure 2.2 below illustrates the trend in the product cycle theory as explained above. A new product requires highly skilled labour and countries with the required resources (the USA is used as an example in Figure 2.2) tend to exploit their advantage when trading internationally. As the product reaches its maturing stage, the product becomes more standardised. This means that it can be mass produced without any highly skilled labour. At this point, the advantage shifts to the developing countries because of the lower production costs, who then export the finished goods back to the developed countries (MacDonald, 2001).

Figure 2.2: Vernon's product life cycle concept



Source: Vernon (1966:199).

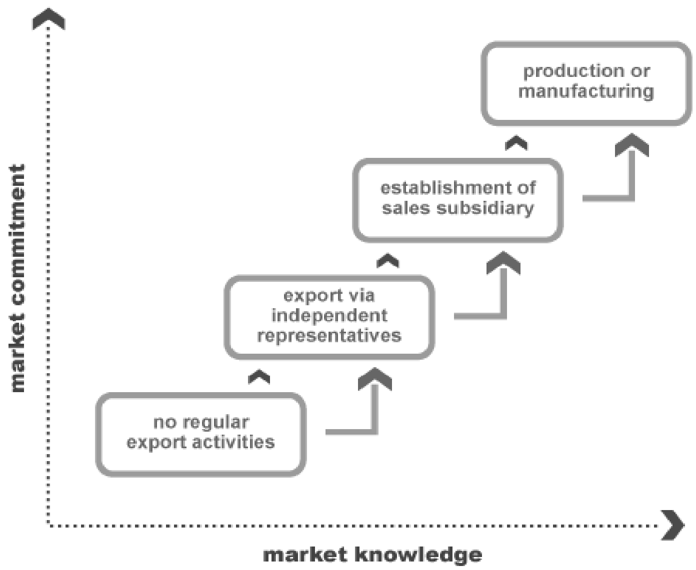
In the next section, the Uppsala school approach to internationalisation is discussed. The Uppsala model is a very well-known model of internationalisation. Where the product life cycle concept of internationalisation stated that a firm will enter a foreign market dependant on where the product is in its life cycle, the Uppsala model states that a firm will choose to enter a foreign market if it is familiar with the market and if the foreign market is located near the domestic market (Forsgren & Hagström, 2006).

2.2.2 The Uppsala school approach

According to Pedersen and Petersen (1998), the Uppsala model is very general and thus applicable to different firms in different situations. The model seeks to explain two aspects of internationalisation. Firstly, firms go through stages of internationalisation as their international experience and commitment increases (Szabò, 2002). Secondly, the expansion of firms across international markets as they move from markets that are located closer to them to markets that are located further away (Clark, Pugh & Mallory, 1997).

The first aspect of the model suggests that firms internationalise by moving gradually from low commitment/risk to high commitment/risk as their knowledge of and experience in foreign markets increase. This occurs in the following four stages. In stage 1, the firm does not engage in exporting, nor does the firm interact with a foreign market. In stage 2, the firm starts to enter international markets through indirect exporting, with the help of trading houses, export agents and resident foreign buyers. In stage 3, the firm engages in direct exporting. Here the firm is responsible for marketing its product in the foreign market as well as all the transport arrangements. The final stage (stage 4) indicates that a firm will set up its own production facilities in the foreign market after gaining all the experience and knowledge required (Griffiths, Klingebiel, Wall & Zimmermann, 2007:17). Figure 2.3 below indicates the Uppsala stages model.

Figure 2.3: The Uppsala stages model



Source: Provenmodels (2010).

From the stage model above, it is clear that firms tend to enter international markets first through indirect exporting. Indirect exporting (lowest risk/commitment) is where the company sells its products to a trading house or distributor in the home market who then undertakes to sell the products in a foreign market (ITRISA, 2009:76). Firms then move on to establish their own sales subsidiaries in foreign markets. This can be done through direct exporting. Direct exporting involves more commitment and risk than indirect exporting, but it exposes the company to the practical realities of doing business in foreign markets, which could prove to be beneficial in the long run. If a company decides to enter foreign markets by means of direct exporting, they are responsible for the marketing and shipment of their products (ITRISA, 2009:76).

Lastly, the stages model indicates that firms will eventually establish their own production facilities abroad. The safest method of such a mode of entry into foreign markets is through competitive alliances. "*A competitive alliance refers to an arrangement between two companies whereby each agrees to collaborate in producing a product and to share one or more of its strategically important assets (competitive advantages) with the other, in order to enhance the perceived value of the output*" (ITRISA, 2009:78). Competitive alliances carry a fair amount of risk/commitment and include licensing, franchising and joint ventures. Figure 2.3 indicates how a firm’s mode of entry into a foreign market will differ when the market knowledge of the foreign market and the market commitment to them increases.

The second aspect of the model states that firms start to invest in countries that are closer to them, for example neighbouring countries such as South Africa and Botswana, because of their perceived knowledge of the countries that are closer to them (Forsgren & Hagström, 2006). Firms tend to think it is safer to invest in countries that they are familiar with and that are closer geographically. Later on, when the firm is settled in the neighbouring country, it will consider looking at markets that are further away (Forsgren & Hagström, 2001). Psychic distance is an important concept in the second part of the model. Evans and Mavondo (2000: 311) define psychic distance as: *“the distance between the home market and a foreign market resulting from the perception and understanding of cultural and business differences.”* This means that all firms view the distance to foreign markets differently, because of their own perceptions of the foreign market. For example, an Australian firm may view Japan as a foreign market that is very “far away”, because of the language barriers and cultural differences, while the same firm may view South Africa as a market that is closer to them because of some cultural similarities (Evans & Mavondo, 2000).

The most important assumption of the Uppsala school model is that a major obstacle to internationalisation is the lack of knowledge of foreign markets. A firm can, however, overcome this by learning about the foreign market conditions and gaining experience in the foreign market (Forsgren & Hagström, 2001:4). According to Forsgren (2002), the more a firm knows about the foreign market, the lower the risk might be and the actual investment made by the firm may be higher. Knowledge is unfortunately difficult to transfer to other individuals, thus one individual’s experience cannot be transferred to another.

There are, however, critical views of the Uppsala school model. For example, the model is criticised in not taking into account the effects of globalisation (that the wants in different markets are becoming similar). Another criticism is that firms today have easier access to knowledge than in the past, because of better technology, and firms will tend to enter foreign markets that are located further away, rather than markets that they are familiar with (which contradicts the model above) (Anon.b, 2010).

The Uppsala school model along with the Innovation-Related Internationalisation model forms part of the Incremental Internationalisation Models (IIM). Both the Incremental Internationalisation Models are based on the fact that internationalisation takes place through a firm's entry into a foreign market at different stages (the only difference is the number of stages) (Cavusgil, 1980). The Innovation-related model is where each subsequent stage of the internationalisation process of a firm is considered as innovation of the firm; this is based on Vernon's product life cycle concept (see figure 2.2) (Gankema, Snuif & Zwart, 2000). This means that firms will start to internationalise when it has developed a new product and the product is in its maturing phase (see section 2.2.1). Both of the Incremental Internationalisation Models focus on the export development process of SMEs (Ruzzier, Hisrich & Antoncic, 2006).

From the above it is clear that the Uppsala school model focuses on internationalisation based on geographical as well as psychic distance, where the transaction cost theory suggests that a firm will try to balance the advantages of internationalisation with the additional costs of entering a foreign market. In the following section, the transaction cost approach to internationalisation is discussed.

2.2.3 The transaction cost approach

There are two types of costs that are associated with the transaction cost theory, namely market transaction costs and control costs (Brouthers & Nakos, 2004). The transaction cost theory combines elements of industrial organisation as well as contract law in order to weigh the tradeoffs that are made in vertical integration[2]. Vertical integration incorporates the desirability of various modes of entry at different levels of control (Anderson & Gatignon, 1986). In other words, firms will establish their own company in a foreign market if it is difficult to transfer

[2] Vertical integration is defined as: *"A form of business organization in which all stages of production of a good, from the acquisition of raw materials to the retailing of the final product, are controlled by one company. A current example is the oil industry, in which a single firm commonly owns the oil wells, refines the oil, and sells gasoline at roadside stations"* (Encyclopaedia Britannica, 2010).

knowledge to other organisations across international borders (Choi, Eriksson & Lee, 2003). However, the internal control costs of a firm would be higher if a firm had to control the operations of a new company in a foreign market. Therefore, the transaction cost theory suggests that a firm will try to balance the advantages of integration with the additional costs of control by selecting an appropriate mode of entry (Brouthers & Nakos, 2004). In this balancing act, firms are mainly concerned with minimising transaction costs (Madhok, 1998).

The transaction cost theory is based on the assumption that markets are competitive, i.e. there must be many suppliers or manufacturers in a firm's potential market. It is better if the firm has an operating system that is easier to control. If a firm is too opportunistic (takes too many risks), it could be replaced by its competitors in the market (Whitelock, 2002).

The transaction cost theory examines three issues (Rugman & Verbeke, 2005). Management must first determine the firm's boundaries (financially as well as resources). This has two key components, namely the choice of geographic scope of the firm's activities and the entry mode that the firm will choose. For example, will the firm enter the foreign market on its own, or will it collaborate with a foreign partner? Management must secondly decide whether or not the interaction with their suppliers and customers will be managed differently in the foreign market. And the third issue is whether or not managers must engage in the firm's internal design. The firms' management must decide if structural change is needed (Rugman & Verbeke, 2005). All of the above-mentioned factors will have an effect on transaction cost. For example, the choice of an entry mode will affect how much the firm will spend in order to reach their new market and whether or not management will want to visit the foreign market.

From the above it is evident that firms must try to balance the advantages of entering a foreign market with the costs of internationalisation. Dunning's eclectic approach argues that there are three sets of advantages that explain why firms choose to enter foreign markets. In the following section, Dunning's eclectic approach to internationalisation is discussed.

2.2.4 Dunning's eclectic approach

According to Axinn and Matthyssens (2002), Dunning aimed to explain why firms produce and invest in foreign markets. He combined elements from the transaction cost theory and industrial organisation theories. The eclectic approach argues that there are three sets of advantages that explain the involvement and production of a firm in a foreign market.

These include ownership advantages, location attractions as well as internalising advantages. The theory is also referred to as the OLI theory (Melin, 1992). Brouthers, Brouthers and Werner (1996), Lu and Beamish (2001) and Olafsson, Hermannsdottir and Islands (2009) explained the three advantages as follows. Ownership advantages (O) are the competitive advantages that a firm possesses and they are created through the firm's international experience, size, etc. An example of ownership advantages is superior products or products that are technologically advanced. These include patents, branded products as well as products that cannot be easily duplicated (Dunning, 1980). This compensates for the "liability of foreignness" that is generally associated with international companies as well as the competitive domestic rivals in the target market (Olafsson, Hermannsdottir & Islands, 2009). This liability means that an international firm may have higher costs than their domestic competitors, because they are not located in the target market (Lu & Beamish, 2001).

Location attractions (L) have to fit in with the firm's strategy and implies that a firm will choose a target market that will best suit the firm's overall goals (Dunning, 1980). These locational advantages are country-specific factors related to the target market, for example market risk and market potential (Brouthers *et al.*, 1996). Some firms can increase their competitive advantage in that market by better exploiting the location advantages. By offering low cost labour, for example, would imply a cost advantage for that firm. Measures of location advantage include cultural, economical as well as political similarities (Brouthers *et al.*, 1996).

Lastly, internalising advantages (I) focus on keeping assets and skills in the company rather than renting it out through licensing and franchising (Dunning, 1988; Olafsson *et al.*, 2009). There are opportunity costs involved with internalising advantages. The firm has to compare the costs of operating the international venture on its own with the costs of finding and maintaining an external relationship to perform the same function, for example a joint venture or franchise (Brouthers *et al.*, 1996).

In the next section, the network approach is discussed. Where Dunning's eclectic approach to internationalisation is based on the three sets of advantages (OLI theory), the network approach is based on the development of relationships.

2.2.5 The network approach

The network approach attributes internationalisation to the development of networks of relationships over time, as international buyers and sellers build up knowledge about each other (Fletcher, 2001). The network approach is therefore most often applied to vertical relationships, i.e. the relationship between buyers and sellers. Travelling to the foreign market, learning about their cultures etc. may give a firm's management the experience and courage to initiate an outward activity into the foreign market (Forsman, Hinttu & Kock, 2002).

According to Chetty and Holm (2000:80), through internationalisation the firm can create and maintain relationships with counterparts in other countries and this can be done in three ways. Firstly, by forming relationships with counterparts in countries that are unfamiliar to the firm. Secondly, by increasing the firm's commitment in already established foreign networks, and finally by combining the firm's position in different networks in various foreign countries.

From the above it is evident that the network approach to internationalisation is based on building relationships in foreign countries, where the resource-based theory is based on internationalisation because of a firm's available resources. In the following section, the resource-based theory is discussed.

2.2.6 Resource-based theory

The resource-based theory is based on the assumption that a firm's expansion into a foreign market depends on the firm's available resources as well as market opportunities in the foreign market (Peteraf, 1993; Anderson & Kheam, 1998). Penrose (1980) as well as Ibrahim (2004) indicated that a firm consists of resources, for example financial and technological resources. If a firm has plenty of resources available, the possibility of the firm entering international markets is much greater (Almeida, Sapienza & Michael, 2000; Ibrahim, 2004).

Resources also play two important roles in a firm's decision pertaining to which market entry mode to choose. An SME will firstly choose exporting, because they have few resources, while a large firm with plenty of resources would rather set up a production plant in the foreign market (Ibrahim, 2004). According to Ucbasaran, Westhead and Wright (2001), SMEs can also be opportunity driven when entering international markets. This means that they will look for critical resources in other markets that are not available in their home market.

SMEs can adopt a more global focus from their launch (Rennie, 1993). This differs from all the above-mentioned internationalisation theories. The focus now shifts to SMEs that enter international markets from early on, sometimes without the necessary knowledge of the foreign market. The following part of the study will focus on born global SMEs.

2.3 Born Global SMEs

Born global firms along with international new ventures (INV) form part of the rapid internationalisation model (Madsen & Knudsen, 2003). An international new venture is defined as "*a business organisation that, from inception, seeks to derive significant competitive advantage from the use of resources and the sale of outputs in multiple countries"* (Oviatt & MacDougall, 1994:49). According to Ray (2009:1), international new ventures include firms that, within their first eight years, want to create a competitive advantage from the usage of resources obtained from multiple countries. Born global firms, however, means that the resources needed to create the venture are obtained from only one country, but the firm intends to do business in multiple countries (Ray, 2009).

The born global concept is a fairly new concept of business and globalisation in the world (Bals, Berry & Hartmann, 2008). Born global firms are evident in most countries across the globe (Nummela, 2004). They are important because, according to the European Commission (2004), a study among new enterprises in Finland found that one in ten enterprises were born global and these enterprises were all dependent on their exports for their survival. The advancement of born global firms can be attributed to the following three factors, the new market conditions globally (which make it easier to enter foreign markets), technological development (advancements in telecommunications, transport and production processes) and the capabilities of people (workers, managers, entrepreneurs etc.) (Madsen & Servias, 1997; Nummela, 2004).

Researchers of born global firms have found that there are several ways in which a born global firm can be defined (Gabrielsson & Kirpalani, 2004). First, Fan and Phan (2007) define a firm as a born global based on the number of foreign sales made at the commercial launch. Secondly, Andersson and Wictor (2003) state that a born global is a firm that, within three years of its launch, has reached a foreign sales mark of 25%. Thirdly, Moen and Servais (2002) define a born global as a firm that started to export to foreign markets early after its establishment. Despite these different views, Holtbrügge and Enßlinger (2006) found that there are two characteristics of born global firms that remain the same. The first is the speed at which internationalisation takes place and the second is the geographical scope of the firms' international ventures. It is evident that born global firms enter international markets much faster than other firms and they also tend to enter more foreign markets that are further away from their home market (Holtbrügge & Enßlinger, 2006).

Globalisation has made it much easier for entrepreneurs to launch born global firms. Take for example the increase in transport efficiency worldwide, information and communication channels are without delay, which increases people's knowledge of foreign cultures, economies as well as market potential (Luostarinen & Gabrielsson, 2004). On the other hand, however, the rise of born global firms can be seen as a response to more competitive markets because of the negative effects of globalisation (Nummela, 2004).

Liesch, Steen, Middleton and Weerawardena (2007) state that the majority of born global firms are small firms. How is it then that small firms enter international markets faster than larger firms? According to Yeoh (2004), a firm's ability to enter international markets depends on the flexibility of a firm's production methods as well as the flexibility of the product itself (in order for the product to be accepted in foreign markets). As mentioned in Chapter 1.1, SMEs are more flexible than larger firms and this makes it easier for a small firm to become a born global firm. The ability of a small firm's top management to deal with uncertainties as well as difficulties in international markets is also vital for the firm's survival (Yeoh, 2004; Liesch *et al.,* 2007).

Rennie (1993) examined the difference between born global firms and domestically based firms in Australia (higher-value-added manufacturers). Figure 2.4 below indicates that born global firms' export propensity (based on their percentage of sales) is 76%, while domestic based firms' is only 20%. It is also clear that born global firms tend to export much faster after their launch (2 years) than domestically based firms (27 years). However, their average export sales (in millions of dollars) are the same at 12 years. Born global firms also tend to have less experience in foreign markets, but their average growth rates are 5% higher than other firms (Rennie, 1993).

Figure 2.4: Higher-value-added manufacturing firms, the difference between born global and domestic based firms

Source: Rennie (1993: 45).

Although born global firms tend to be SMEs, they are very competitive and they manage global business systems more effectively and efficiently than their larger counterparts. Rennie (1993:47) states that *"born global firms are the most extreme example of the potential significance of small and medium-sized enterprises for a nation's export growth".* The role of born global firms in economic growth should not be overlooked (Rennie, 1993).

The subsequent part of the study focuses on the importance of SME internationalisation. As mentioned in the introduction (see section 2.1), SMEs in all sectors face increasing competition because of globalisation and they have to respond to these challenges (European Commission, 2004). One way to respond to these challenges is by internationalising and by doing so, an SME can grow (Matthee & Finaughty, 2010).

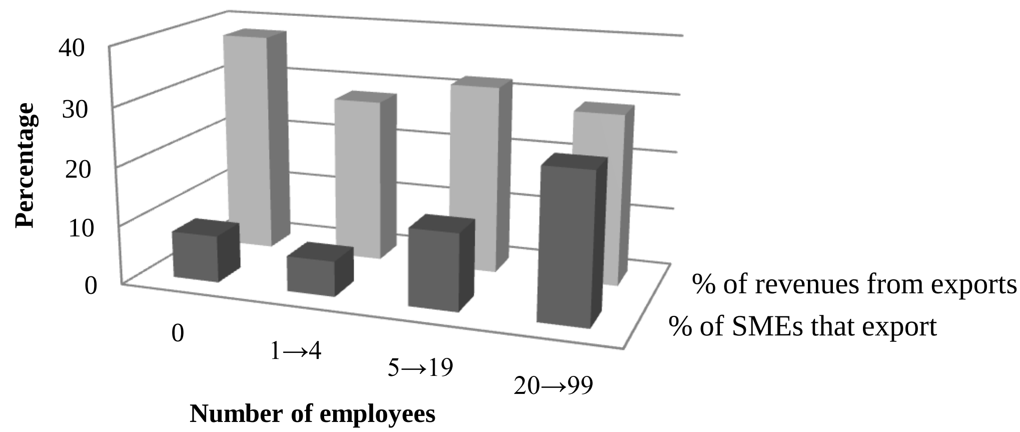
2.4 Internationalisation of SMEs

SMEs are vibrant and innovative and can easily adapt to a changing environment to become a driver of economic growth (Lesakova, 2004:1). SME growth is also important for economic growth as SMEs contribute to between 25 and 35% of world exports (OECD, 2000). This study focuses on the internationalisation of SMEs through exporting (see section 2.2.2). It is evident that SMEs in developed nations overshadow the exporting community; 90% of SMEs in Canada, Italy, Norway and Korea are exporters and they account for over 50% of all export sales (Calof & Viviers, 1999). However, SMEs in developing nations also make a significant contribution to the countries' total exports. For example, the exports of SMEs in Pakistan account for 80% of their total exports and in the Philippines, 90% of their exporters are SMEs (Dhungana, 2003). It is clear that SMEs play an important role in the growth of a country's exports.

Dhungana (2003:14) indicates that the importance of SMEs in the export community has taken on a new dimension. SMEs in developing countries during the early stages of exporting focus more on exporting labour intensive goods. As the SMEs start to modernise, their focus shifts to light engineering goods as well as simple machinery.

According to Lesakova (2004:4), SMEs can greatly benefit from internationalisation. There are opportunities such as larger markets and product diversification, the labour force and the company's facilities can be used more effectively. SMEs can also benefit from the availability of certain resources that are not available in the domestic market, for example cheaper labour. There could be risks involved (see section 2.5), such as unfair competition and the potential of suffering a great loss (Lesakova, 2004:4). A survey conducted by Statistics Canada in 2004 indicates the export propensity and intensity of SMEs in Canada. This is illustrated in Figure 2.5 below. From the figure it is evident that the smallest businesses gain the highest percentage of revenue from their exports.

Figure 2.5: Export propensity and intensity of SMEs



	0	1→4	5→19	20→99
% of SMEs that export	8	6	13	25
% of revenues from exports	38	28	32	29

Source: SME Financing Data Initiative (2010).

From section 2.2, it is clear that SMEs can choose to enter international markets in many different ways. According to Pietilä (2007:27), SMEs with a more specific consumer base are more likely to use a dual-concentration strategy. In other words, an SME concentrates its efforts only in certain market segments in a small number of countries. Czinkota and Ronkainen (2002) indicate that initially, most SMEs are not interested at all to enter international markets and they will not even consider an unsolicited export order if one is received. As time elapses, an SME would become more interested and they would start to export to countries and markets that are familiar to them. SMEs will gradually begin to take more risks and increase their commitments to other foreign markets.

The Observatory of European SMEs (2004) illustrates that SMEs in Europe can be grouped into four categories. Firstly, SMEs that import all of their goods, relying on a foreign supplier. Secondly, SMEs that are currently active in exporting. Thirdly, SMEs that have subsidiaries, branches and joint ventures abroad. And fourthly, SMEs that are not active in international markets at all (European Commission, 2004). The European Network for SME research (ENSR) in 2002 found that indirect exporting is a very important contributor to SME growth in Europe (Griffiths *et al.*, 2007).

From the above it is clear that exporting (direct or indirect) plays an important role in SME growth and because SMEs are more flexible, internationalisation occurs easier. According to Numella (2004), SMEs will begin to internationalise because they react to unexpected opportunities. The following section focuses on the motivations or triggers that drive SMEs to internationalise.

2.4.1 Motivations for SMEs to internationalise

There are both proactive and reactive motivations that affect an SME's decision to internationalise. Proactive motivations involve the strategic change of a firm. This usually occurs when a firm wants to enter international markets and adapts its strategies accordingly, while reactive firms expand internationally because they have to. Reactive motivations are environmental motivations that a firm cannot control (Czinkota & Ronkainen, 2002). According to Albaum, Duerr and Strandskov (2005), SMEs primarily choose only one main motive for internationalisation and the rest is considered as secondary motives. Table 2.1 below indicates the different proactive and reactive motivations that cause SMEs to enter foreign markets.

Table 2.1: Major internationalisation motivations of SMEs

PROACTIVE	**REACTIVE**
• Profit advantage • Unique products • Technological advantage • Exclusive information • Managerial urge • Tax benefit • Economies of scale	• Competitive pressures • Overproduction • Declining domestic sales • Excess capacity • Saturated domestic markets • Proximity to consumers and ports

Source: Czinkota & Ronkainen (2002).

2.4.1.1 Proactive motivations for entering international markets

Profit advantage is where an SME's management will see large international sales as a potential source of more and better profits for the SME. Therefore, the more they sell in the foreign market, the more profit they will make (Pietila, 2007:12).

An SME would also choose to enter international markets if they have a *unique product* or a *technological advantage.* If an SME has a product that is not widely available, it could provide the firm with a competitive edge in the foreign market (Czinkota & Ronkainen, 2002). According to Hollensen (2007), the issue with this type of product is that it is not clear for how long the product will stay unique or technologically advanced in order to provide the firm with a competitive edge.

Exclusive market information is another proactive stimulus for SMEs. This includes knowledge about the foreign market, their consumers and their market situations, which is not commonly shared by competitors. Such knowledge could be obtained through the firm's own market research in foreign markets or through special contacts a firm may have in a foreign market (Pietila, 2007:13).

Managerial urge is the fifth proactive motivation to internationalise. It involves the eagerness, desire and determination of the firms' management to enter foreign markets. This could be because they want to travel internationally, be part of a business that operates internationally or it could be because of their entrepreneurial intuitions (Hollensen, 2007).

The advantages of a *tax benefit* are also a big driver towards internationalisation. Tax benefits are more commonly known as subsidies. Governments offer tax benefits to SMEs to encourage exports. This allows an SME to sell its products at a lower price in the foreign market (Krugman & Obstfeld, 2008). The World Trade Organisation (WTO), however, prohibits the subsidies of exports in all countries except the poorest (Czinkota & Ronkainen, 2002).

Finally, *economies of scale* as a proactive motivation to internationalisation; a firm experiences economies of scale when the cost of producing one unit declines as production increases (Mohr & Fourie, 2008).

2.4.1.2 Reactive motivations for entering international markets

Competitive pressures are the main reactive motivation for SMEs to internationalise. Competitive pressures in the firm's domestic market may drive the firm's decision to internationalise because of the fear of losing their market share in the domestic market (Pietila, 2007:14).

Secondly, SMEs can decide to enter foreign markets because of *overproduction.* SMEs can sell their abundant products in a foreign market when the domestic market's demand for that product is saturated (Hollensen, 2007).

Declining domestic sales is the third reactive motivation. SMEs can enter foreign markets if the product life cycle has reached its declining point, as indicated by Figure 2.1. The firm can prolong the product life cycle by expanding their sales into foreign markets. Consumers in the foreign market may not be familiar with the product and this would cause the product life cycle to enter a growth stage again (see Figure 2.1).

The fourth reactive motivation is *excess capacity.* If the firms' space or equipment for production is not fully utilised, they may decide to enter foreign markets in order to achieve broader distribution of their fixed costs (Czinkota & Ronkainen, 2002). The concept of *saturated market sales* is similar to a decrease in domestic sales. SMEs can again use the international markets to prolong the product life cycle (as mentioned above).

The final reactive motivation is the *proximity to consumers and ports.* This entails that trading internationally would be easier for an SME that is located near international ports or international consumers. This means that when a firm is located near a country's border, for example a firm that is located in Durban (near a port) or Nelspruit (near foreign consumers at a border, Mozambique), it would be easier for that firm to enter international markets (Czinkota & Ronkainen, 2002; Hollensen, 2007; Pietila, 2007).

From the above it is clear that an SME can choose to enter a foreign market because of several reasons. In the following section, empirical evidence is provided of SMEs that have grown through exporting.

2.4.2 Empirical evidence

It is important to look at some SMEs in different countries that choose to enter foreign markets compared to SMEs that are not active beyond their domestic borders. When compared to each other, the importance of internationalisation on SME growth becomes evident. This section contains empirical evidence of how SMEs have grown since engaging in exports.

Firstly, the importance of SMEs to a country's growth must be indicated. Dhungana (2003) reported the performance of SMEs in the Asian and Pacific region in his study. The Republic of Korea has focused on making their SMEs more competitive, not only domestically, but internationally as well. Policies were set in place to provide SMEs with access to finance, particularly for the Asian financial crisis, and also to promote exports. Korean SMEs contribute to 41.8% of total exports. In China, SMEs account for roughly 60% of total exports, SMEs in the Philippines make out 90% of all the exports, while Indian SMEs contribute 40% of total exports. From the latter it is evident that SMEs can contribute significantly to a country's exports and growth. It is also important to look at how SMEs were able to grow through engaging in exports.

Forsman, Hinttu and Kock (2002) examined Finish SMEs and indicated that the most important motivation for SMEs to enter foreign markets was the interest of the firm's managers in internationalisation, inadequate demand in the domestic market (because the market is so small) and enquiries from foreign consumers. The majority of Finish SMEs prefer to internationalise through direct exporting followed by indirect exporting. Around 72% of Finish SMEs are active in direct or indirect exporting (Pietila, 2007). The average turnover gained from operating in foreign markets was 38,6% (more than non-exporting SMEs) and more than 50% of the SMEs are international new ventures (started to export within three years of birth) (see section 2.3) (Forsman, Hinttu & Kock, 2002). SMEs in Finland can thus use the turnover gained by exporting to grow.

SMEs in Canada make up the majority of the firms that are active in international trade and play a significant role in Canada's export performance. Canadian SMEs choose to enter foreign markets through the stages model (see section 2.2.2) and started to export because the managers were interested and they were considered to be innovative firms (Orser, Spence, Riding & Carrington, 2008). SMEs in Canada that engaged in exports received more revenue than SMEs who only focused on the domestic market. Exporter SMEs in Canada made $1.2 million (Canadian dollar), while non-export SMEs' revenue was a mere $505 761 (Canadian dollar). Exporter SMEs in Canada were more profitable and have more assets and total equity than their non-exporting counterparts (Orser, Spence & Carrington, 2006). It is clear that SMEs in Canada that are active in foreign markets are able to grow more than SMEs that focus on the domestic market.

Calof and Viviers (1999) examined the export society of Southern Africa. They found that less than 3% of all SMEs in Southern Africa were exporters in 1999 (compare this to Italy's 80%), and that South African SMEs accounted for less than 1% of total exports during 1999 (compare this with China's 60% above). This study, however, was conducted in 1999, just a couple of years after the sanctions were lifted against South Africa. A more recent study conducted by Mitigwe (2005) also focused on South African SMEs. Mitigwe (2005) states that there is a high population of SMEs in South Africa and 86% of the SMEs used in the survey preferred exporting to other forms of internationalisation. SMEs in South Africa choose to enter foreign markets because the risks associated with trading were minimised, they want to utilise their capacity and received unsolicited orders from abroad. It is also clear that the SMEs will continue to internationalise once they adopted an international mindset. The SMEs choose to enter markets that are geographically but not psychically close (see section 2.2.2). According to Van der Walt (2007), exporter SMEs in South Africa receive much higher turnovers per year than non-exporter SMEs. Fewer than 8% of non-exporter SMEs receive more than R50 million turnover per year, while approximately 35% of exporter SMEs receive more than R50 million turnover per year (Van der Walt, 2007).

Table 2.2: Summary of empirical evidence

Country	Internationalisation method	Reason for internationalisation	Did the SME perform better after internationalisation?
Finland	Direct exporting	• Interest of management • Inadequate demand in home market	Yes, gained a revenue of 38,6% through exporting
Canada	Exporting through stages model	• Interest of management • Innovative firms	Yes, made Can$694 239 more than non-exporters
South Africa	Exporting through stages model	• Risks were minimised • Utilise their capacity • Received unsolicited orders	Yes, exporter SMEs receive much higher turnovers per year than non-exporters

Source: Compiled by author using data from Forsman, et al. (2002); Mitigwe (2005); Orser, et al. (2006); Van der Walt (2007) Orser et al. (2008).

It is evident from the above that when an SME is active in foreign markets, its revenue is much higher than non-exporter SMEs. SMEs can also make a significant contribution to a country's total exports and ultimately a positive trade balance. However, barriers to internationalisation can hinder the growth of SMEs into foreign markets (see section 1.2). The following part of the study discusses the barriers that hinder SME internationalisation.

2.5 Barriers that hinder internationalisation

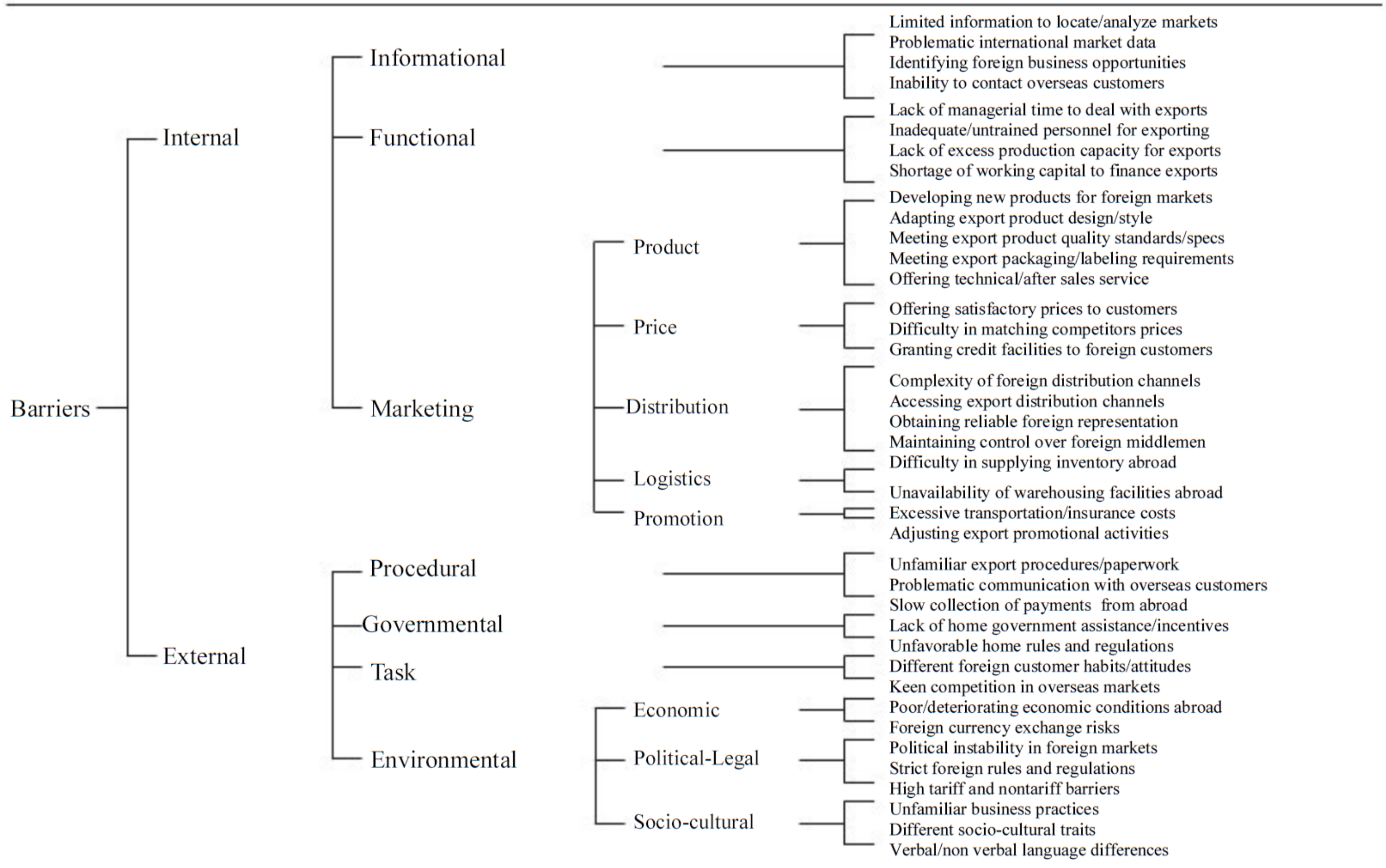
2.5.1 General barriers

Why do some SMEs export and others do not? There is a simple explanation for this, namely export barriers (Ahmed, Julian, Baalbaki & Hadidian, 2004). Export barriers refer to all of the constraints that hinder an SME's ability to operate in a foreign market (Ali, 2006). Export barriers relate to SMEs that have never exported before, as well as SMEs that are currently exporting and experiencing progression problems in their target market (Fillis, 2002).

From Figure 2.6 below, it is clear that export barriers could be both internal and external. Internal barriers consist of informational, functional and marketing barriers. Informational barriers include the limited information to analyse the foreign market, identify business opportunities as well as the inability to contact their foreign customers. Functional barriers include the shortage of working capital to finance exports, lack of production capacity and untrained personnel. Marketing barriers consist of product, price, promotion, logistics and distribution barriers (Leonidou, 2004).

External barriers consist of technical, governmental, task and environmental barriers. Technical barriers include unfamiliar paperwork/procedures, challenging communication with foreign customers and the slow collection of payments from abroad. Governmental barriers include the lack of assistance/incentives from the home government and unfavourable regulations/rules. Task barriers include the different attitudes and habits of foreign customers as well as aggressive competition in the foreign market. Lastly, environmental barriers consist of economic, political-legal and socio-cultural barriers in both markets (Leonidou, 2004).

Figure 2.6: Export barriers



Source: Leonidou (2004:283)

Hollensen (2004) reported the most critical factors that affect a firm's internationalisation initiation. These critical factors can be divided into three main groups, namely general market risks, commercial risks and political risks. From Table 2.3 below, it is evident that difficulties in obtaining export finance are the number one commercial risk that affects the internationalisation process of a firm.

Table 2.3: Barriers hindering the process of internationalisation

General market risks	Commercial risks	Political risks
• Comparative market distance • Competition from other firms in foreign markets • Differences in product usage in foreign markets • Language and cultural differences • Difficulties in finding the right distributor in the foreign market • Differences in product specifications in foreign markets • Complexity of shipping services to foreign buyers	• **Difficulties in obtaining export finance** • Exchange rate fluctuations when contracts are made in foreign currency • Failure of export customers to pay due to contract dispute, bankruptcy, refusal to accept the product or fraud • Delays and/or damage in the export shipment and distribution process	• Foreign government restrictions • Foreign exchange controls imposed by host governments that limit the opportunities for foreign customers to make payment • Lack of governmental assistance in overcoming export barriers • Lack of tax incentives for companies that export • National export policy • High value of the domestic currency relative to those in export markets • High foreign tariffs on imposed products • Confusing foreign import regulations and procedures • Complexity of trade documents • Civil strife, revolution and wars disrupting foreign markets

Source: Hollensen (2004:43).

The following section discusses the lack of trade finance as well as the difficulties in obtaining trade finance as a barrier to internationalisation.

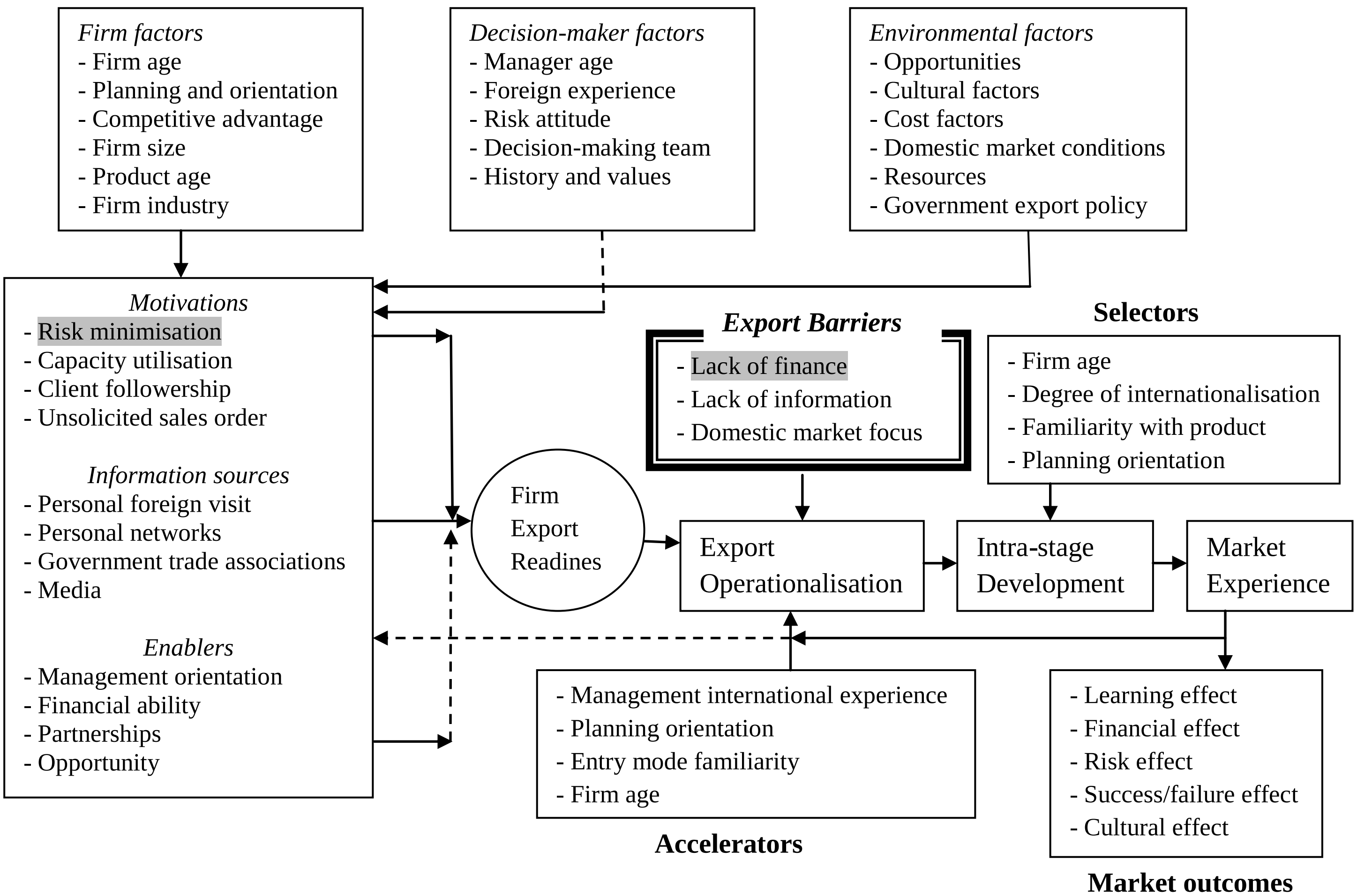
2.5.2 Trade finance as a barrier

Suárez-Ortega (2003) group export barriers in the following categories (the barriers are similar to that of Leonidou, 2004): knowledge, resource, procedural and exogenous. Trade finance is listed under resource barriers, and according to Suárez-Ortega (2003), are very significant export barriers for SMEs. Resource barriers consist of the lack of finances for market research, the lack of capital to finance export sales, the lack of local banks with international expertise as well as the unwillingness of banks to fund SMEs. Through the latter it is evident that a lack of finance is a great barrier for SME internationalisation and ultimately SME growth. Pissarides (1999) also states that a lack of finance is the main obstacle to SME growth.

A firm's ability to internationalise no longer only depends on the quality of the product, the delivery terms and competitive prices. Internationalisation increasingly depends on the ability and willingness to grant credit (Branch, 1995; Buatsi, 2002). According to Buatsi (2002), who studied export financing in Ghana, Ghana's growth strategy to become a middle income country by 2020 depends on the growth of Ghana's exports. Insufficient export finance is a major constraint on Ghana's growth strategy. Ghana implemented the Export Development and Investment Act in 2000 to overcome the problem. Despite this, a lack of finance is still ranked as the number one export constraint in Ghana, with 53% of micro-firms and 45,5% of small firms indicating that a lack of finance is the biggest constraint (Buatsi, 2002). In a study of the internationalisation barriers of manufacturing SMEs in Nigeria, Okpara and Koumbiadis (2010) find that lack of export finance is ranked as the second largest barrier for these firms. Similarly, Gumede (2000) study small firms in the KwaZulu-Natal province in South Africa. He reports that the majority (94%) of small firms in this area feel that lack of export finance is a hindrance to exporting.

Figure 2.7 below indicates the internationalisation process of African SMEs (Mtigwe, 2005). There are certain firm factors, decision-maker factors and environmental factors that play a role in an African SME's decision to internationalise. Firm age, planning and orientation, competitive advantage, firm size, product age and firm industry are all firm factors. Decision-making factors consist of the managers' age, their foreign experience, their risk attitude, the decision-making team themselves as well as their history and values. Environmental factors include opportunities, cultural factors, cost factors, the domestic market conditions, resources as well as the government's export policy. All of these factors contribute to the export readiness of African SMEs. Export barriers, on the other hand, have a negative effect on SMEs' decision to export. Mtigwe (2005) lists export barriers in order of their importance to African SMEs and find that a lack of finance is the most important barrier to internationalisation in Africa, followed by a lack of information and domestic market focus.

Figure 2.7: *Internationalisation process, listed in order of importance*



Source: Mtigwe (2003: 367).

Not only is the lack of trade finance important for African SMEs, but obtaining trade finance is also a hindrance to SME internationalisation (see Table 2.3 above). According to Gumede and Rasmussen (2002), 29% of very small exporting enterprises, 33% of small enterprises as well as 16% of medium-sized exporting enterprises in South Africa find it difficult to obtain finance (see Table 2.4 below).

Table 2.4: Percentage of South African enterprises finding it difficult to obtain finance

	Very small	**Small**	**Medium**	**Large**
Exporters	29	23	16	11
Non-exporters	24	25	30	21

Source: Gumede and Rasmussen (2002:167).

From the above it is evident that trade finance is a major barrier for African SMEs' growth. The SME sector in developing countries, such as Africa, has been neglected by their governments in terms of access to finance (Dhungana, 2003). According to Kauffmann (2005), African SMEs' main sources of trade finance are their informal savings, retained earnings as well as loan associations, which are very unpredictable. It is very difficult for African SMEs to receive export finance because of their uncompetitive market position, small size, uncompetitive financial results and the volatile country risk associated with Africa (Sha, 2009). Corruption as well as political unrest, poor infrastructure and bad governance in some African countries have a significant impact on foreign investment in African countries (UNEP FI, 2007). This has a major negative effect on SMEs that want to obtain trade finance and enter foreign markets. African SMEs thus cannot reap the benefits of internationalisation, because of the difficulties in obtaining finance. Chapter three contains the literature on the financing of international trade.

2.6 Conclusion

It is evident that SMEs in all sectors face increasing competition because of internationalisation (see section 2.1). One way to respond to these new challenges is through exporting. This chapter examined the different internationalisation theories, born global SMEs and international new ventures, motivations for SMEs to internationalise as well as the barriers that hinder internationalisation. There are a number of theories that explain the internationalisation of a firm. The product life cycle concept for international trade states that all products have product life cycles. According to the product life cycle concept, a firm's mode of entry into a foreign market depends on the stage at which the product is in the product life cycle (see section 2.2.1). The Uppsala school approach to internationalisation states that a firm will choose to enter a foreign market if the foreign market is located near the domestic market. Geographical as well as psychic distances are two important concepts of the Uppsala model (see section 2.2.2). The transaction cost approach states that a firm will establish its own company in a foreign market if it is difficult to transfer knowledge to other organisations across international borders (section 2.2.3). Dunning's eclectic approach, also known as the OLI theory, explains internationalisation according to three advantages, namely ownership advantages, locational advantages and internalising advantages (section 2.2.4). The network approach to internationalisation, on the other hand, attributes internationalisation to the development of relationships over time as international buyers and sellers build up knowledge about each other (section 2.2.5). Finally, the resource-based theory is based on the assumption that a firm's expansion into a foreign market depends on the firm's available resources (section 2.2.6).

SMEs can also adopt a more global focus from the moment of their conception. The concept of a "born global firm" is a fairly new concept in international trade. Born global firms have a significant impact on how people perceive the effects of globalisation. It is clear that born global firms tend to enter international markets much faster than other firms. The majority of born global firms are SMEs. SMEs are vibrant and innovative and can easily adapt to a changing environment. SMEs play a significant role in the growth of the economy and can greatly benefit from internationalisation.

There are both proactive and reactive motivations that affect SMEs' decisions to enter international markets (see section 2.4.1). However, export barriers hinder the expansion of SMEs into foreign markets. General export barriers include both internal and external export barriers (see section 2.5.1). Obtaining trade finance is a major barrier to SME internationalisation in African countries (see section 2.5.2), which leads to a barrier for African SME growth. Chapter 3 contains the literature on the different methods of trade finance and facilities.

Chapter 3: Financing international trade

3.1 Introduction

It became evident in Chapter 2 that internationalisation is very beneficial for SMEs, as it provides an avenue for SME growth (see section 2.4). There are, however, barriers that hinder the expansion of SMEs into foreign markets and therefore SME growth (see section 2.5). According to Hollensen (2004), the difficulty in obtaining trade finance is a critical barrier to internationalisation for SMEs (see section 2.5). By overcoming the difficulties in obtaining trade finance, SMEs will be able to expand into foreign markets.

Nkini (2005:2) defines trade finance as *"the provision of any form of financing that enables a trading activity to take place and which may be made directly to the supplier, to facilitate procurement of items for immediate sale and/or for storage for future activities, or it could be provided to the buyer, to enable him to meet contract obligations"*.

According to Auboin (2009), 80 to 90% of world trade relies on some form of trade finance. Trade finance is very important for international trade and the success of a firm's exports depends on the availability of trade finance (US Comptroller of the Currency, 1998). Trade finance can fill the trade gap (difference between the exports and imports). This is because the income generated from exports is used to pay for the imports (Abegglen & Hout, 1978). Obtaining trade finance leads to more exports, which in turn decreases the trade gap. Trade finance offered by financial institutions can fill the gap. Trade finance can vary in terms of the length of credit. There is short-, medium- and long-term[3] finance available along with pre- and post-shipment finance[4].

[3] Short-term finance is usually for periods up to one year, but in practice manufacturers prefer a maximum of 180 days. Medium-term finance is for periods between one and two years, and long-term finance is for periods between two and five years (Grath, 2008). Long-term finance is much more difficult to obtain than short-term finance (Berry, Von Blottnitz, Cassim, Kesper, Rajaratnam & Van Sventer, 2002).

[4] Pre-shipment finance is financing for the period prior to the shipment of the goods (Jinn, 2004). Pre-export finance helps to support pre-export activities such as manufacturing, paying wages, packing the goods, obtaining insurance,

Chauffour and Farole (2009) found that trade finance involves risk mitigation (traders need facilities to minimise the risk of trading internationally) and liquidity (firms need some form of protection against non-payment). If exporters had to wait to receive the full payment from abroad, the manufacturing process will not be able to continue, because payment could take a long time and they need the working capital. Receiving some sort of external finance will reduce this risk (Baker, 2003).

Because of the negative effects of the global financial crisis in 2008 and first quarter of 2009, the availability of trade finance has experienced some difficulties and has therefore become scarcer. In order to promote trade in this difficult time, leaders of the G20 agreed to ensure $250 billion of trade finance support for two years in April 2009 (Chauffour & Farole, 2009). However, SMEs (especially in developing countries) find it even more difficult to receive trade finance, because banks perceive them as unprofitable and risky (International Trade Centre, 2002).

The aim of the chapter is to provide an overview of the risks involved with trade finance as well as trade finance methods and facilities. This chapter is divided as follows: section 3.2 provides an overview of the financial risks involved with international trade. Section 3.3 examines the methods of payment used in international trade. Section 3.4 discusses the other methods of trade finance with the focus on structured trade and commodity finance and section 3.5 concludes.

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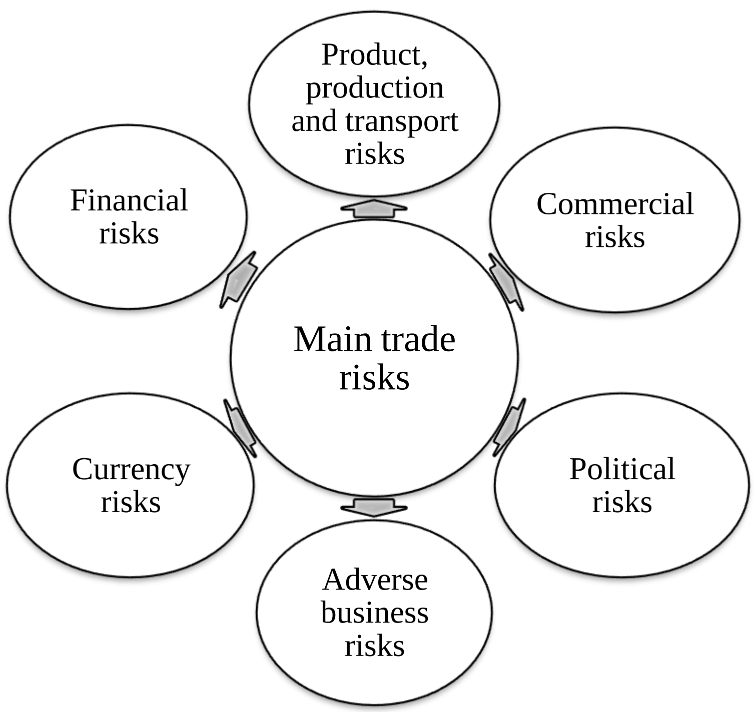
export duties and the shipment of the goods (SME Finance, 2010). Post-shipment finance assists the exporter between the date that the consignment is shipped and the date that the final payment is due (ITRISA, 2007).

3.2 Financial risks involved with international trade transactions

When an exporter SME explores the possibilities of entering foreign markets, there is one issue that requires the most attention, namely whether or not the exporter is going to get paid accordingly. Apart from the transactional risk[5] that the SME faces, there are other major financial risks involved with international trade (ITRISA, 2007:5). Figure 3.1 indicates the main risk structure involved with international trade. The risks are product, production and transport risks, commercial risks, political risks, adverse business risks, currency risks and financial risks. The risks involved with international trade differ with each individual transaction and depend to a large extent on subjective evaluation (Grath, 2008).

Figure 3.1: Different forms of risk in international trade



Source: Grath (2008:11).

[5] *"Transaction risk is the current and prospective risk to earnings and capital arising from fraud, error, and the inability to deliver products or services, maintain a competitive position, and manage information*"(Bankersonline, 2010).

3.2.1 Product, production and transport risks

Product risks are risks that are involved in the product itself. For example, if a different climate or environment will affect the product's performance and if there is quality insurance or maintenance that needs to accompany the product. Whether or not the product can be used in the manufacturing of other products and also the stage at which the product is on its product life cycle (see Figure 2.1) can affect the sales in the foreign market (IOSH, 2002; Grath, 2008).

Product risks can also include some form of manufacturing/production risks (Grath, 2008). Production risks can occur when the product is tailor-made or has unique specifications. The latter can be risky to manufacture because if the importer fails to accept the product (or fails to make a payment), it will be difficult for the exporter to sell the products to someone else (Grath, 2008).

Transport risks are the risks involved with the physical movement of the goods from the exporter to the importer (Grath, 2008). Examples of transport risks are that the goods can be stolen or damaged (due to bad infrastructure or political unrest in a country) on-route to the importer (ByGalacia, 2010). In the case of the goods being stolen or damaged, it is important to know who is responsible for the costs related to the damage/loss (Grath, 2008).

How the costs and risks are split between the exporter and the importer in terms of the delivery of the goods is clarified by the Incoterm 2010 (ICC, 2010). There are eleven different Incoterms that can be divided into four groups (ICC, 2010). Group E is where the goods are made available to the importer at the exporter's premises. Group F is where the exporter delivers the goods to a carrier/named place appointed by the importer. With groups E and F, the exporter's risk and obligations are minimal (UNDP, 2008). Group C is where the exporter is responsible for contracting the carriage of the goods, without assuming the risks after shipment. With group C, the exporter's obligations become more extensive, but the importer is still responsible for the risks (SITPRO, 2007d). Group D is where the exporter has to assume most of the costs and risks associated with delivering the goods to the place of destination. With group D, the importer is responsible for arranging import customs clearance and the costs/risks of un-loading the goods at the place of destination (SITPRO, 2007d; ITRISA, 2008; UNDP, 2008). Adequate insurance is very important to protect the interests of both the exporter and importer when they have goods in transit (Branch, 2006).

Transport risks can be covered by cargo insurance. According to SITPRO (2007c), cargo insurance covers any loss or damage to goods when in transit at the cost of a premium. The basic principles of cargo insurance are insurable interest, utmost good faith, indemnity and subrogation (ITRISA, 2008). The insurable interest of the cargo owner is not the goods itself, but his financial interest in the goods. The owner will benefit from the safe arrival of the goods or be negatively affected by loss/damage (Branch, 2006). A breach of the principles of utmost good faith can be in the deliberate withholding of relevant facts (ITRISA, 2007). Honesty is always important. With indemnity, the insured goods will be placed in the same position as before the loss/damage occurred (Branch, 2006). Subrogation is where the credit insurer of the exporter will attempt to recover an outstanding amount in the case of non-payment by the buyer (ITRISA, 2007). Cargo insurance consists of three cargo institute clauses, A, B and C. Cargo institute clause A provides the most cover (at the highest premium) with B and C providing less coverage at lower premiums (SITPRO, 2007c). War and strike clauses can also be added as additional clauses, if necessary. Additional clauses are usually added to provide cover against the risks of wars, strikes, riots and social/political unrest (Branch, 2006).

3.2.2 Commercial risks

Commercial risks are also known as buyer risk. Buyer risk is the risk that the buyer is not going to pay for the goods that they received or decides that he/she no longer want the goods. According to Guruswani (2008), there are two elements of buyer risk, namely their willingness to pay and their creditworthiness.

The buyer’s willingness to pay includes whether the importer/buyer was willing to pay for previous transactions, in other words, were there any cases where he failed to make the payment. SMEs should also look into the aspect of a buyer’s willingness to pay, which could be done through consulting with trade references, the Department of Trade and Industry (DTI), chambers of commerce etc. (ITRISA, 2007). An importer’s creditworthiness is reflected in their ability to pay. An SME exporter can consult banks as well as credit bureaus to confirm an importer/buyer's creditworthiness (ITRISA, 2007).

According to Jinn (2004), risks can be minimised through acquiring export credit insurance. "*Export credit insurance is the branch of insurance which offers protection to exporters (in return for the payment of a premium) against the risk of non-payment by foreign buyers"* (ITRISA, 2007:99). Export credit insurance covers both political as well as commercial risks (Baker, 2003). Export credit insurance is provided by export credit agencies. Major credit export agencies in Africa include the following: the African Export Import Bank (Afreximbank), Export Credit Insurance Corporation of South Africa (ECIC) and Credit Guarantee Insurance Corporation (Afreximbank, 2007; Credit Guarantee Insurance Corporation, 2010; DTI, 2010).

3.2.3 Political risks

Political risks are also known as country risk. Country risk occurs when political as well as economic instability of the foreign market poses a threat to non-payment (Eaton, Gersovitz & Stiglitz, 1986). According to ITRISA (2007), political unrest that could cause non-payment includes a coup, a revolution or evidence of corruption.

On the economic front, however, delays in payment could arise from a shortage in foreign exchange as well as low per capita income and a high level of unemployment. It is clear from the above that developing countries pose a bigger threat than developed countries (ITRISA, 2007). Information about a country's political and economic environment can be found at the CIA's World Factbook, Coface and the World Bank (ITRISA, 2007; Garth, 2008). Export credit insurance can also be used to minimise the risks involved with political risks (see section 3.2.2).

3.2.4 Adverse business risks

Adverse business risks include all business practices of a negative nature and refer to the risks associated with fraud, corruption, bribery and money laundering (Garth, 2008). Fraud is a major issue in international trade today. Boland (2010) states that there are many forms of fraud, for example insurance scams, cargo theft, piracy, counterpart fraud, etc. A global fraud survey indicated that 72% of companies in Japan have experienced bribery or corruption in the past two years and that the majority of those were with their international operations (Ernst & Young, 2008).

3.2.5 Currency risks

Currency risks are also referred to as exchange rate risk. ITRISA (2007:17) defines the exchange rate as "*the price of one currency expressed in terms of another*". Exchange rate risks arise because the exchange rate can fluctuate over time. This is because the exchange rate is agreed upon when the sales contract is set in place, but payment is not made until the due date specified on the contract (Arize, Osang & Slottje, 2000). For example, if a South African exporter enters into a contract with a German importer, the value of the Rand is likely to weaken or strengthen against the Euro between the date that the contract was signed and the date on which the payment is due. If the Rand weakened against the Euro, the exporter will receive more and if the Rand strengthened against the Euro, the exporter will receive less (ITRISA, 2007). The party that is vulnerable to this risk is the party that is receiving payments or making them in a currency other than his own (ITRISA, 2007:21).

The risk associated with a fluctuating currency is minimised through a forward exchange contract (Humphrey, 2009). A forward exchange contract (FEC) is used to secure an exchange rate for the settlement of a contract on a future date. When entering into an FEC, it is necessary to state the amount, the two currencies involved and the date at which the exchange will take place (Travelex, 2010). FECs allow traders to fix exchange rates and through this mitigate the risk of fluctuating currencies (Travelex, 2010).

3.2.6 Financial risks

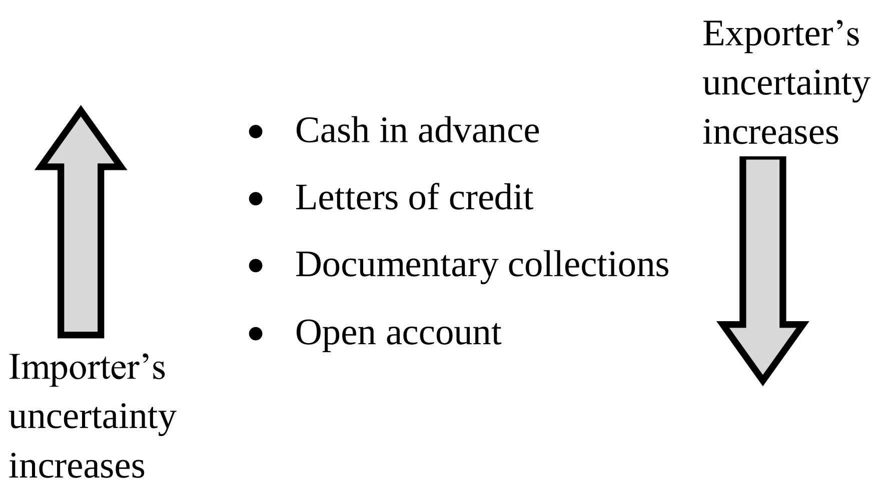
Financial risks include bank risks. Bank risk is the risk of non-payment through the instability of certain banks in the foreign market (Boland, 2010). Banks can sometimes collapse, and because of the financial crisis, banks are more unstable than before. Bank failure is not restricted to third world countries. Examples of failed banks include Saambou (SA), Washington Mutual (USA) and Bradford and Bingley (UK) (ITRISA, 2007; UK House of Commons Treasury Committee, 2009). Exporters can consult with their own banks in order to get a credit rating of the foreign bank in question (ITRISA, 2007).

From the above it is evident that there are certain risks involved when trading internationally. Using the correct method of payment can help to mitigate the risks involved when trading internationally and ensure payment to the exporter. The following section discusses the methods of and terms of payment used in international trade.

3.3 Methods of payment used in international trade

There are four main payment categories available in international trade, namely open account, bank collections, documentary credits (letters of credit) as well as cash in advance. The four methods of payment offer different degrees of risk and uncertainty to both the importer and exporter (ITRISA, 2007).

Figure 3.2: Methods of payment



Source: Humphrey (2009:4).

Figure 3.2 above illustrates how the importer and exporter's risk and uncertainty vary with the different methods of payment. An importer's uncertainty/risk is very low with an open account and increases as they move to cash in advance; while an exporter's uncertainty is the opposite and he/she bears the most risk with an open account and the least with cash in advance.

According to Herger (2009), the four methods of payment can be divided into two groups, namely direct and indirect methods of trade finance. Direct methods of trade finance are where the importer and exporter handle the trade finance directly with each other. Direct methods of trade finance include cash in advance and open account. Indirect methods of trade finance include bank collections and letters of credit; there is thus a third party involved. Direct methods of trade finance have certain disadvantages in the sense that they can result in liquidity risks for both the importer and exporter (it could affect their cashflows and ultimately their business activities). Because of this, SMEs that do not have sufficient liquidity would be reluctant to trade when only direct methods of trade finance are used (Herger, 2009).

3.3.1 Direct methods of trade finance

Direct methods of trade finance include cash in advance and open account.

Cash in advance is the least secure method of payment for the importer and the most secure method of payment for exporters. Cash in advance is where the importer has to pay for the goods before the exporter sends the consignment. The importer will not be able to sell the goods until he receives it from the exporter, which in turn creates a cashflow problem (US Department of Commerce, 2007). Cashflow can be a problem for the importer, because he has to pay for goods that he has not yet received. It is, however, a desirable method of payment if the exporter does not know the credit standings of the importer and by doing so he avoids the risk of non-payment (Baker, 2003).

On the other hand, according to the US Department of Commerce (2007), an open account transaction entails that the goods are shipped and delivered before the payment is made by the importer. With an open account transaction the exporter faces the most risk and because of this, it is not the most desirable method of payment for SMEs.

Export factoring is a type of short-term facility that is used for sales under open account (US Department of Commerce, 2007). With export factoring the exporter sells his receivables or invoices to a finance company (the factor). Through this, the factor assumes all of the credit risks (for example, the risk of non-payment) (Grath, 2008). Export factoring has several benefits to exporters. For example, the exporter receives immediate cash and has no export administration costs. According to Baker (2003), the interest rate charged by the factor may be higher than other forms of trade finance, because of the risks that the factor has to bear.

Export factoring is mainly used in industrialised/developed countries and by exporters that are interested in trading with open account (Grath, 2008). Although the risks involved in the transaction are on the factor, it is clear that this is not the ideal method of trade finance for African SMEs (it is not widely used in developing countries because it is too risky). African SMEs need trade finance that mitigates the risks involved with developing countries (Afreximbank, 2007). One such a method of trade finance is structured trade commodity finance (see section 3.4).

SMEs would therefore prefer to use indirect methods of trade finance. Indirect methods of trade finance are offered by financial institutions, for example banks. This enables SMEs to partly bridge the time between incurring costs and receiving the payment in order to prevent liquidity risks. Indirect methods of trade finance include bank collections and letters of credit (Herger, 2009).

3.3.2 Indirect methods of trade finance

Indirect methods of trade finance include bank collections as well as letters of credit.

3.3.2.1 Bank collections

A bank collection is where the bank has to collect the payment from the importer on behalf of the exporter (ITRISA, 2007). There are two types of bank collections, namely clean and documentary collections. With a clean collection the exporter has to submit the draft and collection order (unaccompanied by any other documents) to the exporter's bank and send the additional documents directly to the importer. The exporter's bank then sends the documents to the corresponding bank in the importer's country. The importer's bank presents the draft and thereafter debits the importer's account. The payment is then sent to the exporter's bank where the exporter's account is credited (ITRISA, 2007).

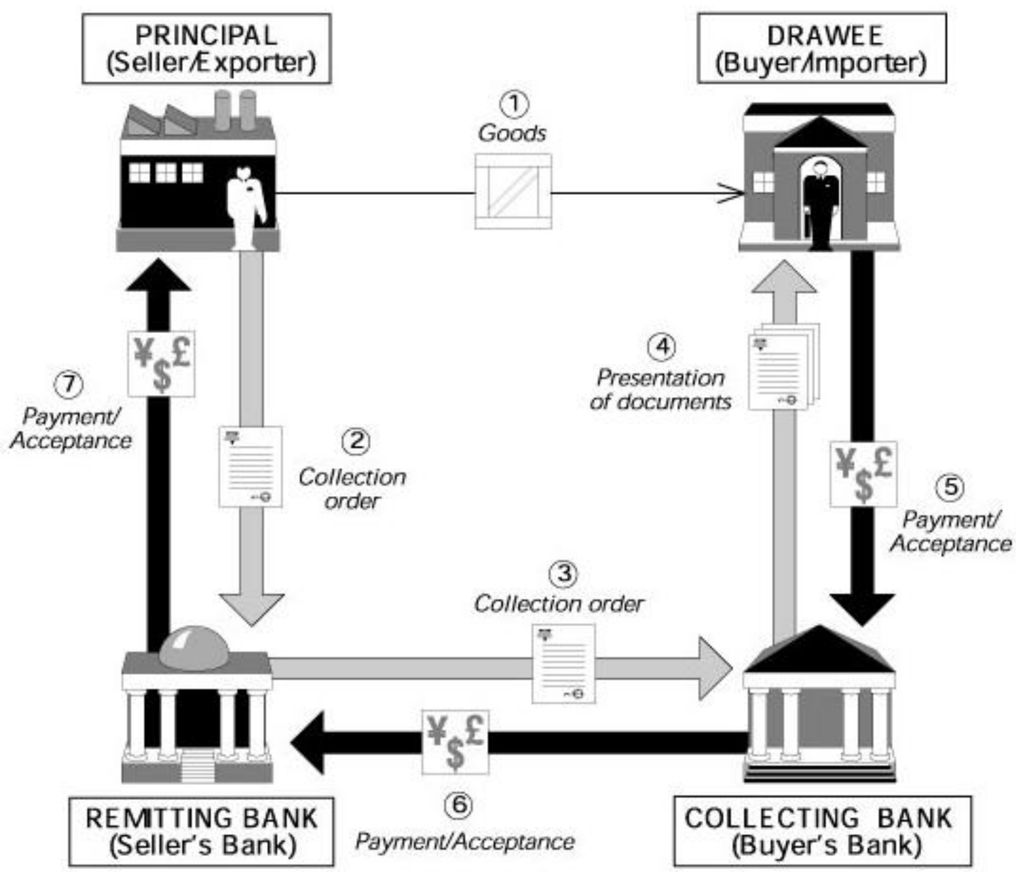
A documentary collection, on the other hand, is where the draft is attached to all the transport and commercial documents when sent to the importer's bank. In exchange for these documents, the payment is transferred from the importer's bank to the exporter's bank (US Department of Commerce, 2007). There are two different types of documentary collections, namely documents against payment (D/P) and documents against acceptance (D/A) (SITPRO, 2007b).

Documents against payment (D/P) are used when the exporter needs the payment immediately (SITPRO, 2007b). A typical D/P transaction is as follows. The exporter ships the goods to the importer and hands the documents over to the remitting bank[6]. The remitting bank forwards the documents to the collecting bank[7]. Only after the payment is made, the collecting bank will then release the documents to the importer. The collecting bank will then transmit the funds to the remitting bank for payment to the exporter (HSBC, 2006; US Department of Commerce, 2007; Standard Bank, 2010a).

[6] "*In a draft collection transaction, the first bank in the chain of collection, i.e. the sellers bank*" " (Baker & Dolan, 2008: 147).
[7] "*Any bank other than the remitting bank involved in the collection of a draft and/or documents*" (Baker & Dolan, 2008: 140).

Documents against acceptance (D/A) are used when a credit period between the exporter and importer has been agreed upon (SITPRO, 2007b). A typical D/A transaction is as follows. Only upon the acceptance of the time draft (date of future payment), the documents are released to the importer. The importer is now legally obligated to pay on the future date. The collecting bank will contact the importer when it is time to make the payment, and will then transmit the funds to the remitting bank for payment to the exporter (HSBC, 2006; US Department of Commerce, 2007; Baker & Dolan, 2008; Standard Bank, 2010a; World Trade Reference, 2010).

Figure 3.3: Documentary collection procedure



Source: World Trade Reference (2010).

Figure 3.3 above indicates the collection procedure of both documents against payment and documents against acceptance. The steps are as follows:

1. The exporter ships the goods to the importer.
2. The exporter hands the collection order over to the remitting bank.
3. The remitting bank sends the collection order to the collecting bank.
4. The collecting bank presents the documents to the importer.
5. The importer makes the payment and the documents are released to him.
6. The collecting bank transfers the payment to the remitting bank.
7. The remitting bank will then make the payment to the exporter.

3.3.2.2 Letters of credit (documentary credits)

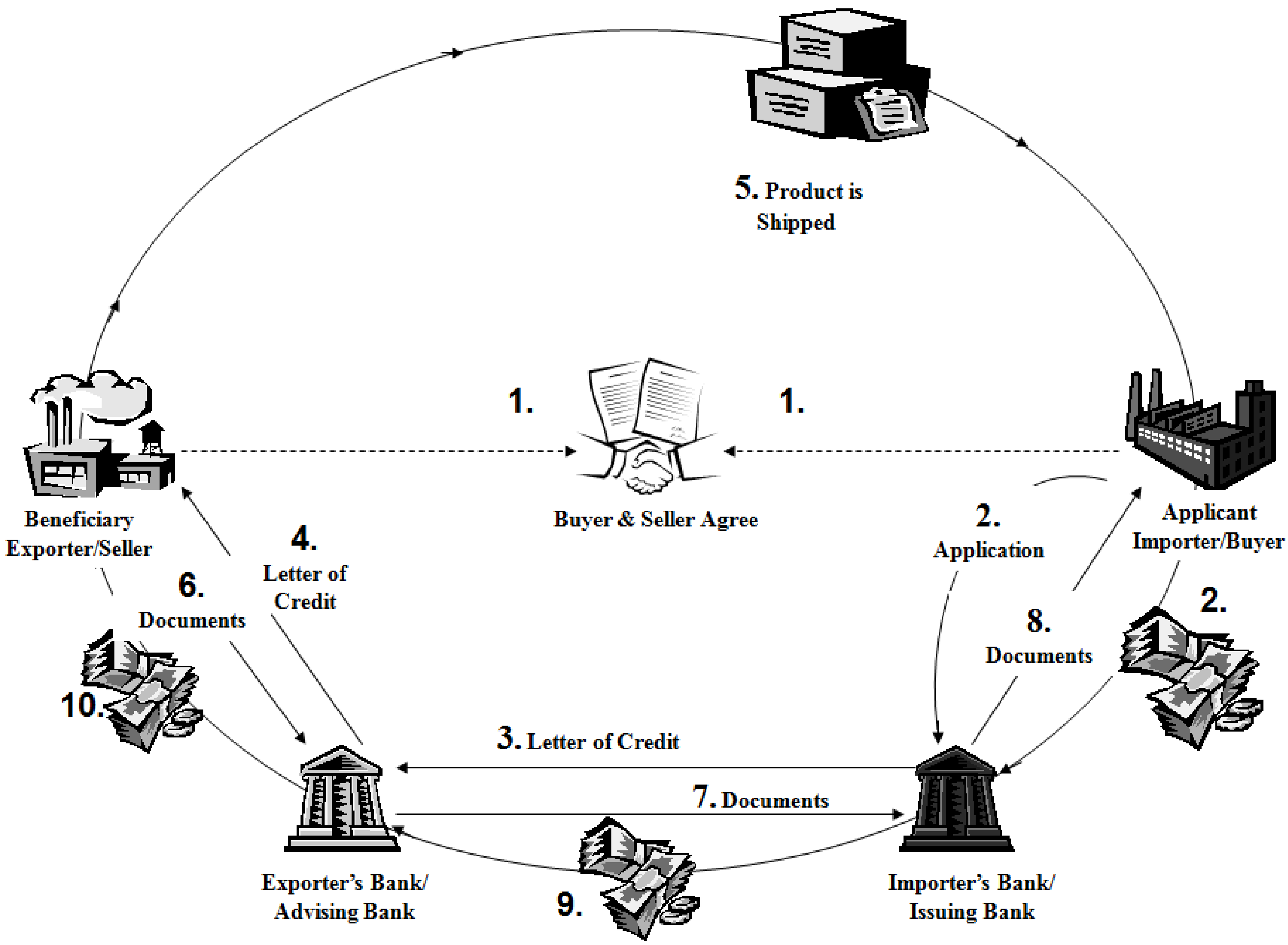
Letters of credit differ from all of the other methods of payment because the exporter is no longer only dependant on the importer to make the payment (ITRISA, 2007). This makes letters of credit the most secure method of payment available to traders today (US Department of Commerce, 2007).

Letters of credit are requested by the exporter and the importer’s bank will guarantee payment if the importer fails to do so. The goods are then available to the importer, after the payment is made (Baker, 2003). Letters of credit are governed by a set of rules from the ICC, called “Uniforms, Customs and Practice”. The latest version of this set of rules is known as UCP600 (SITPRO, 2007b). According to Humphrey (2009), letters of credit provide finance and they assure the exporter of payment. Chuah (2009) finds that the letter of credit system assists the importer and exporter in three ways. Firstly, not only does it help to mitigate the risk of non-payment to the exporter, but it also reduces the risks of facing different jurisdictions, by letting the exporter choose a bank in the exporter’s country. Secondly, it is beneficial to the importer in such a manner that it allows him to decide which documents he wants to see prior to making the payment (for example, quality certificates, inspections, etc.). Letters of credit, thirdly, assist both the importer and exporter with the financing of the transaction. The importer may obtain an advance from the bank to finance the purchase by a pledge of shipping documents (bill of lading). The exporter, on the other hand, may use the letter of credit to finance the transaction by using a back-to-back letter of credit in favour of his suppliers (Chuah, 2009).

According to ITRISA (2007), there are three main types of letters of credit available to traders. They are, revocable, irrevocable and irrevocable and confirmed letters of credit. A revocable letter of credit is where the importer can ask his bank to cancel the letter of credit at any time. Under UCP600, revocable letters of credit are no longer accepted (SITPRO, 2007b). An irrevocable letter of credit can only be cancelled if all the parties agree, i.e. importer, exporter and all the banks involved in the transaction. Irrevocable and confirmed letters of credit are when the issuing bank[8] is not able to pay the exporter, the confirming bank[9] will do so (ITRISA, 2007, SITPRO, 2007b). Figure 3.4 below illustrates the process of how a letter of credit works.

[8] The importer's bank that issues the letter of credit (ITRISA, 2007).
[9] The bank authorised by the issuing bank to add its confirmation (ITRISA, 2007).

Figure 3.4: *Letter of credit*



Source: Michigan State University (2007).

The steps below explain Figure 3.4 above.

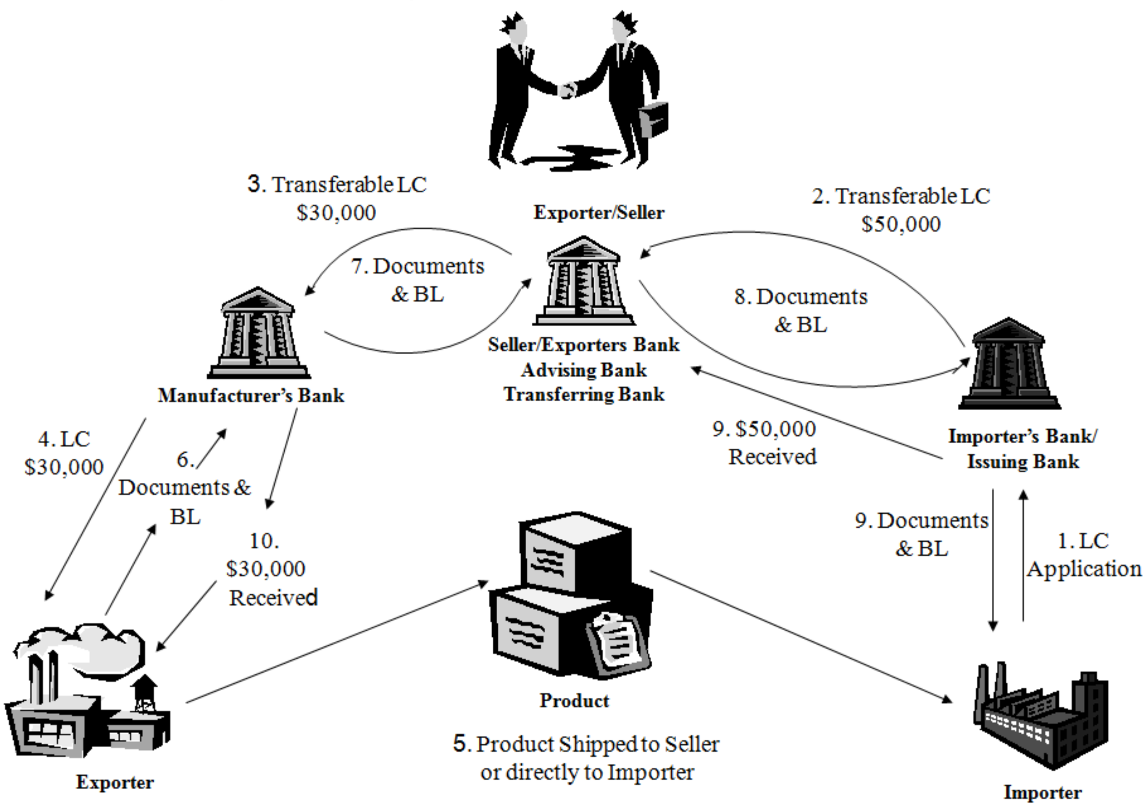
1. Importer and exporter agree on the terms of the contract (letter of credit).
2. The importer sends the application for a letter of credit to the issuing bank and payment is made.
3. The issuing bank sends the letter of credit to the advising bank.
4. The advising bank then sends the letter of credit to the exporter.
5. The exporter then ships the goods to the importer.
6. The exporter sends the necessary documents to the advising bank.
7. The advising bank sends the documents to the issuing bank.
8. The issuing bank hands the documents over to the importer.

9. The issuing bank then transfers the payment to the advising bank.
10. The advising bank makes the payment to the exporter.

Sub-varieties of letters of credit include the following:

- *A transferable letter of credit* is where the exporter (beneficiary) can transfer all his rights to another party (see Figure 3.5) (ITRISA, 2007). Through this he can act as a middleman between the supplier and the importer (SITPRO, 2003). This will enable the exporter to use the issuing bank's credit to avoid having to use his own funds or borrow money in order to pay his supplier (Exporthelp, 2010). The letter of credit can only be transferred once and the transferable letter of credit must be specifically marked as such by the issuing bank (Scotiabank, 2010).

Figure 3.5: Transferable letter of credit



Source: Michigan State University (2007).

The following steps explain Figure 3.5 above.

1. Importer completes letter of credit application at issuing bank.
2. Issuing bank sends transferable letter of credit worth $50 000 to advising bank.
3. Advising bank sends transferable letter of credit worth $30 000 to manufacturer's bank.
4. The manufacturer's bank sends the letter of credit worth $30 000 to the exporter.
5. Exporter ships the goods to the importer.
6. Exporter hands the necessary documents over to the manufacturer's bank.
7. Manufacturer's bank sends the documents to the advising bank.
8. The advising bank sends the documents to the issuing bank.
9. The issuing bank releases the documents to the importer who makes the payment.
10. Payment is transferred to exporter.

- *Red clause is a letter of credit* that enables the exporter to receive a portion of the payment before the presentation of the documents is made (prior to the shipment of the goods). This amount is then subtracted from the amount due to be paid when the documents are presented. This was traditionally written in red ink on the letter of credit (ITRISA, 2007; Scotiabank, 2010).

- *A back-to-back letter of credit* can be used instead of a transferable letter of credit. The letter of credit may be used to get a second credit for a lesser amount (ITRISA, 2007). Therefore, it involves two letters of credit. In other words, rather than transferring the original letter of credit to the supplier when received by the issuing bank, the exporter may request that his bank opens a letter of credit in favour of his supplier. These letters of credit are seen as back-to-back, because the one is issued on the security of the other (SITPRO, 2003; SITPRO, 2007a; Exporthelp, 2010; Scotiabank, 2010).

- According to SITPRO (2007a), *revolving letters of credit* are used when there is a frequent shipment of the same goods to the same buyer. The letter of credit must always state that it is revolving. After each payment made against the letter of credit, the amount payable is reinstated without any changes needed to be made to the credit (SITPRO, 2003; Exporthelp, 2010).

- According to the Credit Research Foundation (1999), a *standby letter of credit* serves a different function than the commercial letter of credit. It protects the exporter against non-payment because it is used as a secondary payment mechanism when a non-secure method of payment is used (for example open account etc.). It is issued in favour of the exporter to back-up certain obligations of the importer (SITPRO, 2003). If the importer fails to perform according to his obligations indicated on the standby letter of credit, the exporter can claim under the letter of credit (Exporthelp, 2010). The exporter, however, needs to present certain documents in order to claim from the standby letter of credit. These documents include the standby letter of credit itself, a sight draft, proof of dispatch as well as a written demand for the payment (Scotiabank, 2010).

Indirect methods of trade finance are better for SMEs because they help the exporter to receive more secure payments at an earlier stage (Herger, 2009). In order to utilise the indirect methods of trade finance, SMEs should have collateral and strong balance sheets. However, SMEs do not have enough collateral or strong balance sheets and are perceived as risky by financial institutions (Zavotta, 2008). This is a major hindrance to accessing finance by SMEs. According to Zavotta (2008), SMEs experience more variable rates of return and higher rates of failure. SMEs have less capital and resources to withstand the negative effects of trading (see section 3.2) than their bigger counterparts. Financial institutions would therefore use financing facilities to finance international trade transactions that mitigate the risks involved with SMEs and do not require strong balance sheets. One such a facility to provide trade finance to SMEs is structured trade and commodity finance (Jinn, 2004). The following section discusses structured trade and commodity finance as such a facility.

3.4 Structured trade and commodity finance

Grath (2008:149) defines structured trade finance as the "*prearranged or tailor-made trade financial techniques or structures, designed for individual transactions or projects, arranged by, or in cooperation with, specialized financial institutions*". In other words, all structured trade finance deals differ from each other, as they are tailor-made for each specific transaction.

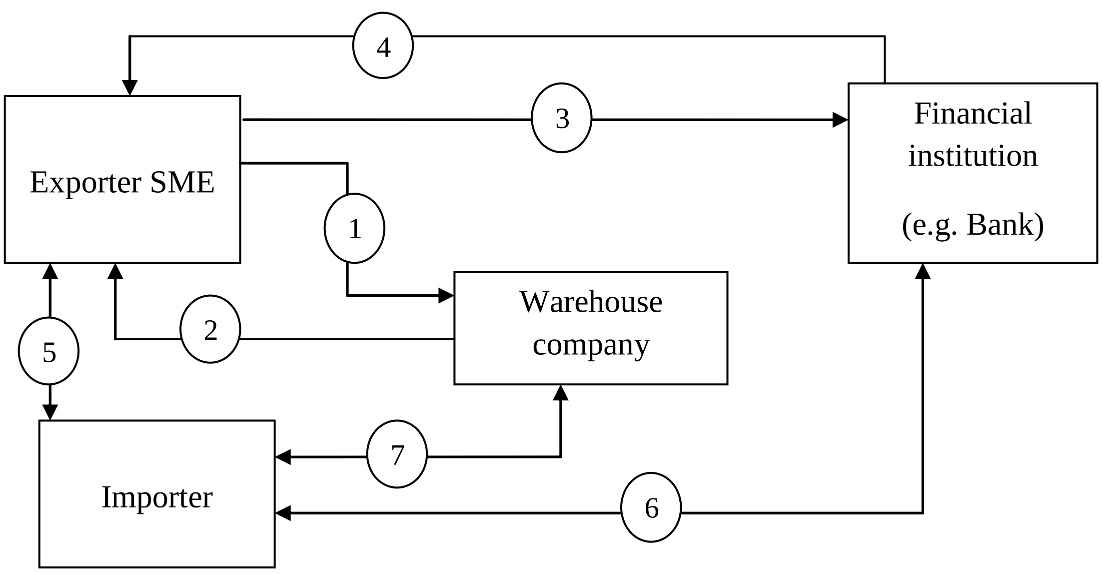
Stauffer (2004) states that structured trade and commodity finance are the actions of financing trade, while taking security over the goods (as they are part of the trade flow). With structured trade financing, the lender will take the goods (the finished product) as collateral. Only a portion of the total worth of stock is financed as additional security for the lender. This can vary between 70 and 80% or be calculated, taking into account the risk factors involved with the transaction (Trade finance magazine, 2010). The lender will take possession of the goods and sell them in order to realise the outstanding amount, if something went wrong with the transaction (Trade Finance Magazine, 2010). Structured trade and commodity finance are self-liquidating. In other words, finance is provided on transactional basis and the finance provided is repaid by the proceeds from the sale (bank is automatically reimbursed) (Matthee & Finaughty, 2010).

Because structured trade and commodity finance differ for each transaction and different risk factors are taken into account, there are a number of factors that affect the nature of structured trade and commodity finance. These include the nature of the product, the volatility of product prices, location of the warehouse, value of the contract, terms and conditions of the contract, country and currency of transaction as well as the nature and profile of the end user (ABSA, 2010).

Although structured trade and commodity finance deals are tailor-made, they can be divided into three models, namely export-receivables backed financing, inventory/warehouse receipt financing and pre-payment financing (Hew, 2000; UNESCAP, 2005). Export-receivables backed financing is where a pre-export loan is provided to the exporter and repayment is obtained from the exporter's receivables resulting from a sale (UNESCAP, 2005). Financing is thus based on the due-payment to be made. Pre-payment financing, on the other hand, is structured as a purchase of the goods where payment is made in advance (Hew, 2000). The buyer can obtain a loan from a bank and use it to effect the pre-payment. Through this the buyer has the title for the goods. Under the contract, the buyer has to transfer all his rights to the bank (Hew, 2000; UNESCAP, 2005).

Inventory/warehouse receipt financing entails the use of securely stored goods as loan collateral (USAID, 2000; UNESCAP, 2005). With warehouse receipt financing, the goods are placed under the control of an independent third party who will look after the goods (it is important that the goods stay in a good condition) and assures the financial institution (bank) it is secure[10]. When the warehouse receives the goods, the warehouse manager issues a receipt[11]. The exporter can use this receipt to get a loan. The receipt issued by the warehouse is accepted by the bank as a guarantee against non-payment (Trade Finance Magazine, 2002; UNESCAP, 2005). In other words, the bank has control over the goods until they are sold, and can sell them in the case of default by the exporter. The process of warehouse receipt financing is illustrated in Figure 3.6 below.

Figure 3.6: Warehouse receipt financing



Source: UNESCAP (2005:41).

[10] It is important that the financial institution has the rights on the goods and that the exporter cannot give it to someone else (UNESCAP, 2005).
[11] The receipt indicates the quantity, quality, grade, value etc. of the goods (UNESCAP, 2005).

The following steps explain Figure 3.6 above.

1. Exporter SME deposits goods at warehouse.
2. Warehouse issues receipt for goods.
3. Exporter SME lodges receipt with bank.
4. Bank provides credit.
5. Exporter SME and importer sign a sales contract.
6. Importer reimburses credit and in return bank transfers the receipt for goods.
7. Importer delivers the receipt and the warehouse makes the delivery.

There are a number of financial institutions that provide structured trade and commodity finance in Southern Africa. ABSA, Standard Bank and Nedbank, among others, are well-known banks in Southern Africa that provide this service (ABSA, 2010, Standard Bank, 2010, Nedbank, 2010).

In summary, structured trade and commodity finance revolves around identifying and mitigating the risks involved with transactions. This makes it well suited for African SMEs (because every transaction is self-liquidating, it minimises the risks of the bank, making it ideal for SMEs) (UNESCAP, 2005). Utilising structured trade and commodity finance has certain advantages for African SMEs. It can enhance their competitiveness in the sense that they are able to utilise trade finance to obtain international transactions and thus make profit (Sha, 2009).

The focus of this study is on African SMEs trading with China (see section 1.1). In trading with China, African SMEs can obtain structured trade and commodity finance from a specialist financial institution that focuses on the Chinese market. China Construction Bank, through their association with Rand-Asia Trade Finance, provides structured trade and commodity finance to African SMEs. The key to receiving structured trade and commodity finance is that these SMEs, together with China Construction Bank and Rand-Asia Trade Finance, have to mitigate the risks involved with their international transactions. Chapter 4 illustrates how the risks are mitigated for SMEs as well as the bank by presenting two case studies.

3.5 Conclusion

It is evident that trade finance is very important for international trade as it plays an important role in the cashflow of exporters. Trade finance offered by financial institutions can vary in terms of the length of credit and can either be pre- or post-shipment (see section 3.1). Exporters face different financial risks when trading internationally and it is important for them to mitigate these risks (see section 3.2).

The methods and terms of payment used in international trade play a vital role in mitigating the risks of the exporter. There are four main payment categories available with international trade, namely open account, bank collections, letters of credit and cash in advance (see section 3.3). The four methods of payment offer different degrees of risk and uncertainty to the exporter SME and can be divided into two groups, namely direct and indirect methods of trade finance. Direct methods of trade finance include cash in advance and open account. Export factoring is a type of short-term facility that is used for sales under open account (see section 3.3.1). Indirect methods of trade finance include bank collections and letters of credit (see section 3.3.2). SMEs would prefer to use indirect methods of trade finance because they enable them to partly bridge the time between incurring costs and receiving the payment in order to prevent liquidity risks.

It is very difficult for African SMEs to receive export finance because of their uncompetitive market position, small size, uncompetitive financial results and the volatile country risk associated with Africa. Financial institutions would therefore use financing facilities that mitigate the risks involved with SME transactions. One such a facility of trade finance is structured trade finance (see section 3.4). Structured trade and commodity finance deals are tailor-made for each individual transaction, but can be divided into three models, namely export-receivables backed financing, warehouse receipt financing and pre-payment financing. Structured trade finance is used with risky transactions, for example companies in Africa and is particularly well suited for higher risk companies such as SMEs.

China Construction Bank, through their association with Rand-Asia Trade Finance, provides structured trade and commodity finance to African SMEs. The key to receiving structured trade and commodity finance is that these SMEs, together with China Construction Bank and Rand-Asia Trade Finance, have to mitigate the risks involved with their international transactions. Chapter 4 illustrates how the risks are mitigated for SMEs as well as for China Construction Bank/Rand-Asia Trade Finance by presenting two case studies.

Chapter 4: China Construction Bank Case Study

4.1 Introduction

It became evident in Chapter 3 that African SMEs are perceived as risky because of their uncompetitive market position, small size, uncompetitive financial results and the volatile country risk associated with Africa (Sha, 2010). Furthermore, SMEs experience more variable rates of return and higher rates of failure. SMEs also have less capital and resources to withstand the negative effects of trading than their bigger counterparts. The lack of collateral is also a major hindrance in accessing finance by SMEs (Zavotta, 2008).

Banks are often accused of not understanding SMEs and their trading activities because of the above-mentioned factors. It is thus essential for financial institutions along with the SMEs to mitigate the risks involved with SME financing (see section 3.2) in order for them to provide trade finance for SMEs. One such facility that financial institutions can provide, which can mitigate the risks involved with SME financing is structured trade and commodity finance (see section 3.4).

African economies can greatly benefit from SME internationalisation, as SMEs make up 90% of businesses in Africa (UNEP FI, 2007). There are many opportunities for African SMEs to enter the international market today. One such an opportunity is with an emerging economic giant, China (see section 1.1). It is important for African SMEs to obtain structured trade and commodity finance from a financial institution that understands the Chinese culture and market. One such a financial institution is the China Construction Bank Corporation (CCB) working in collaboration with Rand Asia Trade Finance.

In order for SMEs to overcome trade finance as a barrier, they need to mitigate the risks involved with their international transactions. Once they have mitigated the risks involved, and have taken other considerations into account (being “trade finance ready”), SMEs will be able to obtain structured trade and commodity finance. This will enable them to engage in internationalisation (especially exports) and through exporting they will show signs of growth.

The aim of this chapter is to explain how CCB Jhb (in collaboration with Rand-Asia Trade Finance) facilitates trade between Africa and China through the provision of structured trade and commodity finance and how they mitigate the risks involved with the financing of SMEs' trading activities. This chapter also contains the case studies of two successful SMEs who both received structured trade and commodity finance from CCB Jhb/Rand-Asia Trade Finance. The case studies illustrate how both the SMEs, by being "trade finance ready", were able to mitigate the risks involved in their international transactions.

This chapter is divided as follows. Section 4.2 provides an overview of China-Africa trade. Section 4.3 contains the research methodology and provides an overview of the China Construction Bank Corporation and Rand-Asia Trade Finance as well as the case studies. Section 4.3.4 provides an overview of how to become trade finance ready and section 4.4 concludes.

4.2 China-Africa trade

Trade and investment have increased rapidly between China and Southern Africa since 1998 (Bowker, 2008). According to Matthee and Finaughty (2010), China sees South Africa as the gateway to investing in Africa. China signed the first official bilateral trade agreement with Algeria, Egypt, Guinea, Morocco and Sudan in 1961 and today it is known as the Sino-Africa agreement (Uchehara, 2009). The Sino-Africa agreement aims to strengthen traditional relations, rediscover strategic opportunities for deepening investment, trade, economic, educational, technological, and scientific cooperation for hopefully mutual benefits between Africa and China (Opondo, 2007).

According to Michel (2008), trade between China and Africa has increased from \$10 billion in 2000 to \$70 billion in 2007, while China's imports from Africa have increased from \$13 billion in 2004 to \$51 billion in 2008 (see table 4.1). Today, China levies no import tariffs on 478 products imported from 31 African countries. This is a major benefit for African SME exporters

(Qin, 2009). China's domestic market demand for commodities is continuing to grow significantly. According to Roy (2010), the top commodity products demanded by China's domestic market include rubber, soybeans, wheat, copper, iron ore (steel) as well as crude oil. This is reflected through China's imports from Africa, which include mineral fuels, oils, ores, copper, iron, steel etc (see Table 4.1 below).

Table 4.1: Bilateral trade between China and Africa in USD thousand

Number	Product label	China's imports from Africa				
		Value in 2004	**Value in 2005**	**Value in 2006**	**Value in 2007**	**Value in 2008**
	All products	13 287 897	18 471 711	27 831 838	32 760 947	51 397 435
1	Mineral fuels, oils, distillation products etc.	10 597 982	15 195 669	23 223 603	26 014 539	40 413 854
2	Ores, slag and ash	753 020	976 636	1 731 131	2 617 430	5 624 578
3	Wood and articles of wood, wood charcoal	345 896	433 058	494 809	824 568	921 141
4	Copper and articles thereof	67 980	132 872	27 1171	498 140	911 830
5	Iron and steel	344 290	298 445	34 4507	872 894	610 375
6	Other base metals, cermets, articles thereof	37 557	32 568	70 649	23 393	359 259
7	Pearls, precious stones, metals, coins, etc	15 877	18 973	36 656	46 288	321 721
8	Electrical, electronic equipment	8 141	18 580	24 295	23 598	314 132
9	Cotton	312 446	389 214	552 769	400 768	262 470
10	Fertilizers	43 315	36 344	52 696	29 086	167 984

Source: TradeMap (2010).

Table 4.2 below indicates the bilateral trade value between China and South Africa for the period between 2005 and 2009 (measured in USD 1000) as well as the top 10 South African products imported by China. The total value of all the South African products imported by China was USD 3,4 billion in 2005 and increased to USD 8,6 billion in 2009. The top 5 product groups that China imports from South Africa includes ores, slag and ash, pearls, precious stones, metals and coins, iron and steel, other commodities as well as plastics and articles thereof.

Table 4.2: *Bilateral trade between China and South Africa in USD thousand*

Number	Product label	China's imports from South Africa				
		Value in 2005	**Value in 2006**	**Value in 2007**	**Value in 2008**	**Value in 2009**
	All products	3 443 052	4 085 358	6 618 094	9 234 973	8 693 253
1	Ores, slag and ash	967 100	1 257 453	1 927 265	4 034 264	4 024 625
2	Pearls, precious stones, metals, coins, etc	955 899	1 185 921	1 339 327	1 704 928	1 706 777
3	Iron and steel	427 074	298 751	826 990	904 057	1 017 543
4	Commodities not elsewhere specified	461 727	461 625	578 212	1 551 561	901 879
5	Plastics and articles thereof	33 327	34 950	38 192	73 535	113 385
6	Nickel and articles thereof	52 097	96 687	46 439	103 010	112 635
7	Wool, animal hair, horsehair yarn and fabric thereof	19 483	38 618	67 832	80 954	107 225
8	Aluminium and articles thereof	91 607	120 102	86 891	71 877	99 070
9	Copper and articles thereof	34 548	51 189	168 311	155 852	97 119
10	Pulp of wood, fibrous cellulosic material, waste etc	12 925	3 106	40 462	40 849	78 413

Source: TradeMap (2010).

The South African product group with the highest annual growth value between 2005 and 2009, under the top 10, is pulp of wood, fibrous cellulosic material, waste etc. (with a growth percentage of 86%). The South African product group with the lowest annual growth value between 2005 and 2009, under the top 10, is aluminium and articles thereof (with a growth percentage of -4%). This could be because of the 2008/09 commodity market downturn.

From the above, it is evident that African exports to China have increased significantly over the past five years. African SMEs must reap the benefits of China's growing interest in Africa, through exporting. Exporting is made possible for African SMEs through obtaining a trade finance facility that is able to mitigate the risks involved (see section 3.2), namely structured trade and commodity finance (Sha, 2010).

The aim of this study is to investigate how African SMEs can overcome trade finance as a barrier (especially obtaining trade finance) in order to reap the benefits from trade with China. A specialist Chinese bank in Africa, aimed to facilitate bilateral trade between Africa and China, was used to obtain the necessary information. It is useful for African SMEs to use a specialist bank because of their knowledge and understanding of the differences between the African and Chinese markets and cultures. The following section discusses the investigation of how African SMEs can obtain structured trade and commodity finance from a foreign bank, located in South Africa, to facilitate international relations and trade between Africa and China.

4.3 Research method

The aim of the empirical research is to investigate how African SMEs can obtain structured trade and commodity finance from a specialist Chinese bank located in Africa (see section 4.2). The China Construction Bank (along with Rand-Asia Trade Finance) was chosen for this study because it is a specialist foreign bank, located in Africa, which provides structured trade and commodity finance for SMEs and has a good understanding of the Chinese market.

The information needed to compile the case studies was obtained through a weeklong visit and interviews at Rand-Asia Trade Finance (in collaboration with China Construction Bank) from 14 to 21 July 2010. Interviews were conducted with Eric Finaughty (CEO), Kevin Lovell (Marketing Director) and Michael Brandon (Marketing Officer). Questions asked included how Rand-Asia Trade Finance manages to mitigate the risks involved with SME financing as well as the process of obtaining trade finance from Rand-Asia Trade Finance. This study focuses on the joint venture between CCB Jhb and Rand-Asia Trade Finance.

4.3.1 China Construction Bank Johannesburg

The China Construction Bank Corporation is one of the leading banks in China and one of the largest banks in the world (Matthee & Finaughty, 2010). China Construction Bank (CCB) is a state-owned commercial bank with their headquarters located in Beijing China. The newest edition to CCB is their branch in Johannesburg (CCB Jhb), which opened on 2 October 2000. CCB chose to open a branch in South Africa because they wanted to promote bilateral trade between Africa and China. The branch is located in Sandton, Johannesburg, because it is in close proximity to South Africa's heart of trading, namely City Deep, OR Tambo, and other major trading companies, for example Mediterranean Shipping Company (MSC).

CCB Jhb offers merchant, wholesale and investment banking products/services to the South African business community. CCB Jhb's corporate banking products/services include the following: 1) Loans in the form of call loans, fixed loans, structured finance as well as customer foreign currency accounts; 2) Telegraphic transfers, both inwards and outwards; 3) Trade finance is offered through import letters of credit, export letters of credit, import and export collections, guarantees (performance guarantees, bid / tender bonds, shipping guarantees, demand guarantees and payment guarantees) and lastly; 4) structured trade and commodity finance.

CCB Jhb has a unique understanding of China, which in turn facilitates a unique understanding of China-African trade. More than 150 firms have benefited from CCB Jhb's provision of trade and commodity finance. The majority of the companies that CCB Jhb has financed since its operations began in South Africa are SMEs.

When trading with China, there are several benefits for an SME in obtaining structured trade and commodity finance from CCB Jhb. These benefits include their knowledge and understanding of the differences between the African and Chinese cultures. CCB Jhb understands how complex the Chinese culture (language, communication methods etc.) may be for the African entrepreneur wanting to trade with China and manages the cultural gap efficiently (through staff that can speak and write Mandarin). CCB Jhb also has a great understanding of emerging markets and the problems/risks associated with them. This is a distinct advantage for SMEs to trade with the help of CCB Jhb.

It is important that the SME is located in a country that is accepted and approved by CCB Jhb. CCB Jhb will lend to SMEs located in South Africa, Hong Kong, Singapore and Mauritius. CCB Jhb will also lend to SMEs whose trade flows are through countries with stable political jurisdictions. Because CCB Jhb has a better understanding of emerging markets and their difficulties, they will also give finance to SMEs trading with the DRC, Rwanda and Zimbabwe. This is a major advantage for African SMEs seeking finance from CCB Jhb. CCB Jhb finances a wide range of products. 20% of the products financed by CCB Jhb are finished goods (intermediate products), which include specialised steel products for manufacturing purposes, galvanised steel coils, modems for GSM communication, solar heating panels and tyres. Commodity finance, as stated above, is the core focus CCB Jhb's finance facilities (80% of products financed are commodities). Commodity finance products include metals and minerals in various forms (ore, concentrates and refined), for example copper, zinc, aluminium, cobalt, chrome, manganese, stainless steel and coal. Agricultural commodity products include palm oil, sunflower seed oil, maize, wheat, and tobacco.

With the help of the Chinese government, CCB Jhb promotes bilateral trade and investment between the Southern African Development Community (SADC) and China. CCB Jhb facilitates China-African trade through building important relationships. These relationships all support CCB Jhb's trade and commodity finance provisions and are dedicated to promoting bilateral trade between Africa and China. They have built three important relationships. Firstly, CCB Jhb has built a relationship with Grindrod Bank Ltd and secondly, with FirstRand Bank Ltd. Thirdly, CCB Jhb has built an important relationship in the form of a joint venture with Rand-Asia Trade Finance, who is a specialist in structured trade and commodity finance. This study focuses on the joint-venture between CCB Jhb and Rand-Asia Trade Finance because Rand-Asia Trade Finance is a specialist in structured trade and commodity finance.

With the joint venture, CCB Jhb is responsible for issuing the facility and finance to the client. They also handle the administration of the transaction (including their cashflow) and they are responsible for the exchange control of the transactions.

4.3.2 Rand-Asia Trade Finance

Rand-Asia started in November 2000 and has been working with CCB Jhb since March 2001. Rand-Asia Trade Finance mainly operates in Sub-Saharan Africa. The dynamic hubs (countries in which they do the most business) are dominated by South Africa, Nigeria, the DRC, Tanzania as well as Mauritius. English is Rand-Asia Trade Finance's main operating language, but because they are working in collaboration with CCB Jhb, some of the staff members are able to speak and write Mandarin. This is a major advantage for SMEs wanting to export to China, because they (CCB Jhb and Rand-Asia Trade Finance) help each other to understand both the Chinese and the African market.

The objective of the joint venture is to use the combined experience and resources of both the companies to optimise the commercial opportunity in China-African trade. Rand-Asia Trade Finance is the arranger and manager of structured trade and commodity finance for CCB Jhb. Rand-Asia Trade Finance is responsible for the marketing and business origination (in other words, obtaining clients). Rand-Asia Trade finance, along with the SME, is responsible for mitigating the risks involved with transactions through the provision of credit reviews (see Appendix A) and helps to set up the best possible structured trade and commodity finance facility for each individual SME. Rand-Asia also handles the implementation of a lending relationship with the clients and they manage the collateral (stock and debtors). Rand-Asia is therefore pro-active in the life cycle of the facility / deal.

The joint venture mainly focuses on financing commodities, but they also handle certain finished goods, in the sense that finished goods are essentially intermediate products or products that can be used for other purposes as well. Commodity finance is, however, the core focus of the joint venture and commodity products (see Table 4.2, top 10 South African products imported by China) include agricultural products (maize, grain, tobacco, vegetable oils etc) as well as metals and minerals (in various forms, oil, copper, tin, cobalt, chrome, zinc and manganese), chemicals and fertilisers. This mitigates the risk for CCB Jhb/Rand-Asia because it is easier to sell these products if they need to (in the case of contract default by Rand-Asia Trade Finance's client when Rand-Asia Trade Finance takes possession of the collateral).

Structured trade and commodity finance from CCB Jhb/Rand-Asia are explained below:

- Each facility is specially structured for the client and the products traded.
- The facility is transactional, but of a revolving nature (once-off deals are not considered because they tend to be more risky).
- Secured and self-liquidating finance (collateralised lending). Secured in the sense that Rand-Asia Trade Finance uses the underlying product as security (collateral) (see section 3.4). This is calculated through for example, for every eight rand that CCB Jhb lends the

SME there must be at least one rand's collateral, in other words eight to one. Self-liquidating finance means that the finance is provided on a transactional basis (see section 3.4).

- The tenor (term of the finance) is typically 180 days or less, but no longer than 360 days. For example, agricultural products' tenor is typically 270 to 360 days.
- Finance facility could also be post-production. For example, with agricultural products after harvesting and copper after mining.
- Finance can be both pre- and post-shipment (see section 3.1) and can include the processing and shipping of the client's product.

From the above it is evident how Rand-Asia Trade Finance structures their trade and commodity finance facilities for their clients. It is important for SMEs to know how Rand-Asia Trade Finance's credit application process works in order for them to obtain structured trade and commodity finance.

4.3.2.1 Application process

When an SME applies for credit, CCB Jhb/Rand-Asia will take the following process into account when conducting a credit application (see Appendix A):

1. The client's details, including contact details, address and any other loans from other banks.
2. The SME's marketing information. This includes the reason/motivation for the facility, the background of the SME, the nature of the business, their client base as well as their competition.
3. Utilisation of the facility. This applies when CCB is doing a credit review of an already existing client, and looks at how the facility was used during the last period. They look at the limit of the facility, transactional costs and how much of the facility the SME used.
4. Pricing. The pricing concept is divided into two groups. Firstly, the income of the facility as reflected through a bank as well as Rand-Asia Trade Finance's income from the facility. CCB Jhb/Rand-Asia Trade Finance will firstly look at the average funding per

year, the turnover per year, etc, in order to calculate the SME's total earnings. Secondly, CCB Jhb/Rand-Asia calculates the SME's net earnings.

5. A description of the facility. This includes the amount of the facility, the currency, tenor days, interest margin, fees, foreign exchange forward cover, which amount is approved and what the proposed amount of the facility is.
6. Structure of the facility. This includes explanatory notes to the facility schedule, the general process of the facility as well as an overview of the client's debtors.
7. A facility flowchart is also provided to explain how the facility works (see Figure 4.1 below).
8. An overview of the proposed covenants and securities is also conducted. The proposed covenants include the client's position in stock, cashflow management, title and ownership of the goods, foreign currency exchange risk, exchange control approval, debt/equity ratio (gearing) and the financial statements audited at year end. Securities include cession in security, cession of insurance policies, subordination of shareholders' loans, pledge of shares, pledge of stocks and other securities.
9. An organisational chart of the client is also included.
10. A financial analysis is then conducted. This includes an overview of the client's income statement, balance sheet as well as a cashflow statement.
11. Risk analysis is the most important part of the credit application form for SMEs. This indicates which risks are involved with the transaction and how they can mitigate these risks.

More than 90 % of all credit applications are approved by CCB Jhb, because they were all able to mitigate the risks involved with their international transactions. Understanding the client is very important for both CCB Jhb and Rand-Asia Trade Finance (as it is part of the Chinese culture to get to know their prospective business partners before entering into a contract). CCB Jhb, along with Rand-Asia Trade Finance, will visit a potential new client and assess whether or not it is feasible to engage in a relationship. If found that it will be possible to engage in the relationship, the facility request is sent to CCB Jhb's lending committee. On approval of the facility, the necessary documents, securities and structures are implemented by CCB Jhb.

It is important to note that no money can be withdrawn until all the securities are in place. Therefore, SMEs must be prepared to wait at least 90 days for the latter to be implemented and everything to be finalised. Each facility is reviewed every year (with a three-month fiscal and performance overview). The amount of each facility depends on the products traded, the SME's activities as well as the risks involved with the transaction. The value of each facility is also linked to a gearing ratio. A gearing ratio is the ratio of liabilities (current and long term) to the shareholder's funds (equity) of the SME, for example 5:1 (five times liabilities to capital). The tenor also depends on the commodity as well as the nature of the business (as mentioned above).

4.3.2.2 Analysis of risks

The most important part of structured trade and commodity finance for SMEs is to understand the risks involved with the transaction (see section 3.2) as well as the mitigating factors that can be used to reduce the risks. If SMEs are able to mitigate these risks, their chance of obtaining structured trade and commodity finance are better than it otherwise would have been.

Rand-Asia Trade Finance conducts a business risk analysis when an SME applies for structured trade and commodity finance (see Appendix A). Here they look at the impact of the various risks on the SME. Firstly, if the international transaction can cause the SME to become insolvent (credit risk) and secondly if the risks involved with the transaction can affect the business or put the SME's activities under strain (business risk). Rand-Asia Trade Finance, in collaboration with the SMEs, also states how each individual risk can be mitigated. The risk assessment process is performed by Rand-Asia's team of marketing officers. The facility is structured according to CCB Jhb and Rand-Asia's understanding of the SME, the product traded, sales contract as well as the risks involved. The different risks are measured on a scale of 1 to 5, where 1 is low risk and 5 indicates a high risk**.** The business risk analysis looks at the following risks involved with SMEs.

Industry risk forms part of product risks (see section 3.2.1). This is the risk that occurs in the field of industry in which the SME operates, for example if he/she is a commodity trader. Rand-Asia will look at the following: if the product traded by the SME is a scarce product (if he/she is a niche player) or if the product traded is readily available. They will also consider the impact of the climatic conditions on the specific commodity and what the global demand for the product is.

Geographical position risk forms part of commercial risks (see section 3.2.2). Rand-Asia Trade Finance assesses in which areas the SME operates. Here they look at the location of the SME's buyers and their suppliers.

Supplier risk is part of production risks (see section 3.2.1). This is applicable if the SME is dependent on their suppliers in order to manufacture the goods/ provide the commodities that are traded. The risks include the SME's suppliers' performance capability (if he/she is able to send the goods on time), the history of their relationship (has there been any cases of default by the supplier), the mutual dependency between them (how dependent the SME is on his supplier and vice versa) as well as their previous agreements.

Buyer risk forms part of commercial risks (see section 3.2.2) and includes the performance capability and the history between the SME and their clients. Here Rand-Asia Trade Finance also looks at the mutual dependency between the SME and their clients (how dependent the SME is on his clients and vice versa) as well as their previous agreements.

Environmental risk is part of product and production risks (see section 3.2.1). A question asked when evaluating the environmental risks of the SME is whether or not the SME's operations pose any danger to the environment, e.g. toxic emissions or waste.

Competition risk is the risk that potential or existing competitor/competitors pose to the SME applying for a structured trade and commodity finance facility. If there are too many competitors in the market, or one competitor that attracts most of the potential clients, the international transaction will be too risky because of the lack of clients in that market.

Demand risk looks at the relevance of the SME's products to its markets, whether or not there is a demand for the product in the foreign market, as well as the consumers' willingness to purchase the product. Demand risks fall under product risks (see section 3.2.1).

Concentration risk also forms part of product and production risks (see section 3.2.1). Concentration risk consists of two perspectives: Firstly, from the bank's perspective, and secondly, from the SME's perspective. From the bank's perspective, concentration risks can occur in their lending profile (the percentage of their clients trading in agricultural products, mining and metal products polymers, etc.). The risk here is that, for example, 90% of the bank's clients are trading agricultural products and that their client base is not more spread out. Rand-Asia Trade Finance will look at the client's business mix and exposures. If they only trade in one commodity (as SMEs most likely do), they will have a higher risk profile than if they trade in several commodities. From the SME's perspective, on the other hand, Rand-Asia Trade Finance evaluates the SME's risks relative to their business spread. Rand-Asia Trade Finance will look at which part of the production chain the SME concentrates on as well as the geographic location of the SME and their clients. For example, are they all located in the same area or are their clients spread over a wider area?

Commodity price risk is the risk that is associated with changes in the product's price (see section 3.2.1), for example gold, platinum, oil and agricultural commodities. In order to mitigate the risks involved with price volatility, SMEs should fix the prices of the product in the contract.

Exchange rate risk is also known as currency risk (see section 3.2.5). It occurs when the volatility of foreign currencies affects the value of assets and earnings related to the transaction. Rand-Asia Trade Finance will assess the SME's transaction and see whether losses due to volatility have occurred. Rand-Asia will furthermore determine whether the SME has a hedging policy in place.

Settlement risk. Here Rand-Asia Trade Finance looks at the tenor of the facility and the performance of the parties involved (the SME's suppliers and clients). In the case of a trader, the SME should consider using back-to-back L/Cs in order to pay for the goods that they have received from their suppliers (see section 3.3.2.2).

Payment risk falls under financial risks as well as commercial risks (see sections 3.2.2 and 3.2.6). Payment risks are the risks associated with the repayment of the borrowings/facility and how the

SME will mitigate these risks, for example, through the use of indirect methods of payment (see section 3.3.2).

Operational / performance risk is the SME's ability to execute the transaction successfully so that he/she can repay Rand-Asia Trade Finance. Here Rand-Asia Trade Finance looks at the SME's ability to manage his/her business processes in order to perform as specified in the contract.

Key management risk. Rand-Asia Trade Finance assesses the SME's business sustainability relative to their key management (whether or not the SME can maintain their business under the key management). In order for them to do this, they look at the management's ability (what they can achieve), their experience with trading internationally and their commitment to the business.

Production & off-take risk falls under production risks (see section 3.2.1). Here Rand-Asia Trade Finance discusses the adequacy and maintenance of the processing plants. For example, the amount of skilled labour, the supply of power and water to the production plant as well as adequate storage for the goods manufactured/traded (if the SME does not have enough storage space, they will have to rent storage at another premises).

Transportation risk (see section 3.2.1). This includes, for example, all the risks involved with the method of transport used, the carriers involved as well as the collection process used (for example the Incoterms that are used, see section 3.2.1).

Quality/quantity analysis (QQA). The QQA has to do with the quality and quantity of the goods traded under the structured trade and commodity finance facility. The risk that an SME can face here is that their client will not accept the QQA processes and certificates that were presented to them. It is therefore important that the QQA is conducted through an internationally acceptable third party, who ensures that the goods traded are up to standard.

Sovereign risk is where a foreign bank can alter their foreign-exchange regulations if the foreign government has implemented such strategies. The risk here is that assets or earnings in a foreign country could be frozen or there could have been an increase in the SME's international debt (because of new regulations).

From the above it is evident that Rand-Asia Trade Finance identifies all the possible risks involved with each individual transaction/facility. Through identifying and mitigating the risks involved, it will ensure the repayment of the facility to Rand-Asia Trade Finance. Many of the above-mentioned risks could apply to one transaction/facility. The following section discusses how Rand-Asia Trade Finance, in collaboration with the SMEs, was able to mitigate the risks involved of two SMEs that receive structured trade and commodity finance from Rand-Asia Trade Finance.

4.3.3 Case studies

This section presents two cases of how successful SMEs were able to mitigate the risks involved with their international transactions. For each of the following case studies, an overview of the description of the facility, a facility flowchart as well as their risk analysis are provided (these are three sections of the credit application process, namely 5, 7 and 11, see section 4.3.2.1). For confidentiality reasons, the two SMEs used in this case study remain anonymous.

4.3.3.1 SME A (Rivonia – Johannesburg – Trader)

SME A has been in business for approximately 10 years (although the owner of the business has been involved with trading for almost 20 years) and a client of CCB Jhb since 2005. SME A employs approximately five people in South Africa and has been exporting since their inception (in other words a born global firm, see section 2.3). SME A has been trading with China since their operations began. SME A's business, financed under CCB Jhb, has included the finance of copper and cobalt exports from the DRC. All DRC operations and investments by SME A have been put on hold because of the financial crisis of 2008. SME A is currently active in the exports of chrome and to a lesser extent manganese from South Africa to China.
SME A has been adversely affected by the commodities market collapse in 2008/09, which in turn caused a decline in their growth during that period. However, as the markets recovered,

business also started to pick up again in 2010. It is likely that they will have improved conditions for growth going forward with the help of a structured trade and commodity finance facility.

The structured trade and commodity finance facility that Rand-Asia Trade Finance is currently providing for SME A, is structured as follows. Structured trade and commodity finance is provided on metals and minerals, including chrome and manganese. These are the commodities that SME A is exporting to China. The amount of SME A's first facility was USD 5 million in 2005 and is still USD 5 million today. SME A's gearing (debt/equity) ratio is 4:1. This means that they have four times more debt than equity.

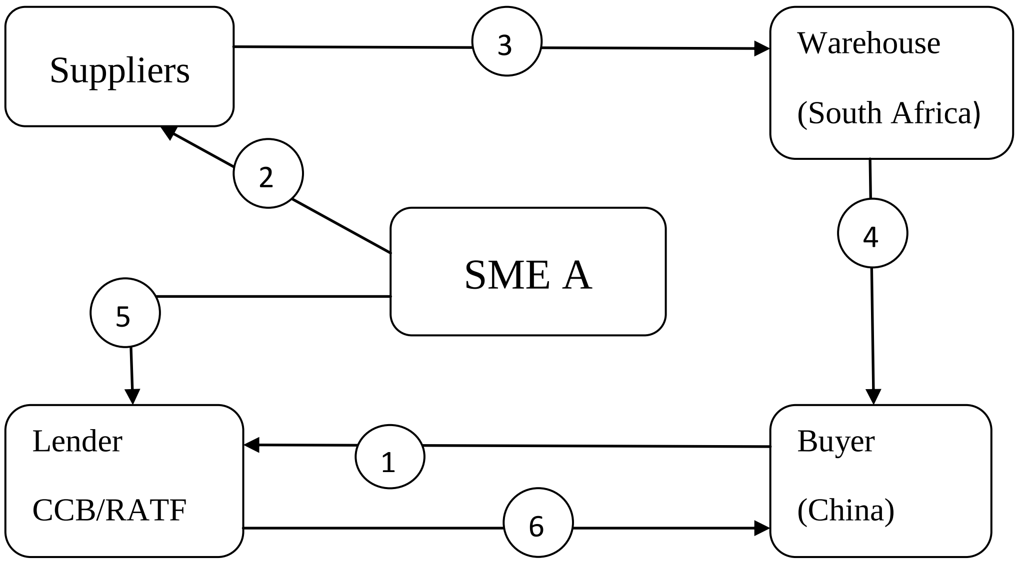
Because SME A is a trader, Rand-Asia Trade Finance structures SME A's facility according to the international transaction, where commodities are sourced and ultimately sold. For payment of their suppliers (payment is made in ZAR), SME A uses either an L/C or pays upon the delivery of the stock at a South African warehouse (with Incoterm FOB[12]) (see section 3.2.1). With this facility, Rand-Asia Trade Finance provides pre-shipment finance (see section 3.4) that is supported by a back-to-back L/C (see section 3.3.2.2) (because SME A is a trader, they need to obtain finance in order to pay for the goods that they have received before exporting the goods to China and receiving payment). The L/C always has to be accompanied with an acceptable independent QQA (quantity/quality analysis) certificate.

SME A also uses letters of credit when dealing with their Chinese buyers. On these L/Cs, the prices of the product (metals and minerals) are fixed in order to minimise the risk of losses occurring. Here, SME A must pay 30% in advance before Rand-Asia Trade Finance will give the L/C to SME A, after which the goods are shipped to the warehouse (see section 3.4). The goods are only released for shipping if all of the documents are finalised. SME A's transactions with their buyers are concluded on a matching sales basis (using only the same currencies), for example US$ to US$ (this eliminates exchange rate risks). All transactional cashflow from SME A's buyers is to be paid directly to Rand-Asia Trade Finance.

[12] "*FOB (FREE ON BOARD) is where the risks and costs of transportation passes to the buyer once delivered on board the ship by the seller"* (VEDP International Trade , 2010).

Figure 4.1 below illustrates the facility flowchart of SME A (Number 7 of the credit application process).

Figure 4.1: Metals and minerals exports trade flow of SME A.



The steps in Figure 4.1 above are explained below.

1. CCB Jhb receives L/C in favour of the buyer from China.
2. SME A makes a pre-payment (if required) to the producer for procurement of material against third party QQA (Quality, Quantity Analysis) or CCB Jhb opens a back-to-back/supporting L/C (see section 3.3.2.2) to the supplier on behalf of SME A.
3. Supplier ships the goods to the warehouse in South Africa.
4. Goods boarded on vessel to China (either by SME A or supplier).
5. SME A submits the documents for L/C negotiation to CCB Jhb.
6. L/C is negotiated and the proceeds of the payment go to the settlement of SME A's outstanding loan with CCB Jhb.

Before SME A was able to obtain structured trade and commodity finance, they needed to mitigate the risks involved with their transactions (see section 4.3.2). Risks inherent to this transaction, as identified through the risk analysis (number 11 of credit application form), is as follows.

Industry risk. The industry risk involved with SME A is the limited supply of the commodity, chrome, in the global market, which SME A exports. Because South Africa is the world's biggest exporter of chrome, this mitigated the risk of SME A.

Exchange risk. Here there was the risk of Forex losses occurring when dealing with their suppliers, because SME A bought the goods in ZAR and the loan settlement is in US$. SME A was able to mitigate the risk by entering into a Forex contract to cover the currency exposure.

SME A also faced *demand risk.* Demand risk is the possibility of reduced global demand for copper and cobalt. SME A was able to mitigate this risk by diversifying their product spread to include chrome and manganese.

Settlement risk. The settlement risk that SME A faced was the risk of non-payment as well as unacceptable supply terms from their supplier. However, SME A was able to obtain all of their goods through obtaining pre-shipment finance accompanied by an L/C. The transactions are also all self-liquidating and pre-sold deals, which mitigated the settlement risks involved.

Quality/Quantity Analysis (QQA) risks. The risk that SME A faced here was that their clients will not accept the QQA processes and certificates that SME A has presented to them. SME A mitigated this risk through only making use of an internationally acceptable third party that conducts the QQA.

4.3.3.2 SME B (Springs – Manufacturer)

SME B has been in business for approximately 50 years and manufactures and distributes steel products to the mining, industrial as well as agricultural markets. The company employs 50 people, most of whom are experienced steel traders. SME B has its own production facilities where they produce value-added products, for example steel strips, cut to size steel sheets, traffic signs, steel furniture, etc. The company's clients are spread through several geographical markets from Africa, South America and Asia. The Asian market consists of China and Indonesia. Rand-Asia Trade Finance provides trade and commodity finance facilities that are back-to-back (L/C) and self-liquidating in nature (see section 3.4).

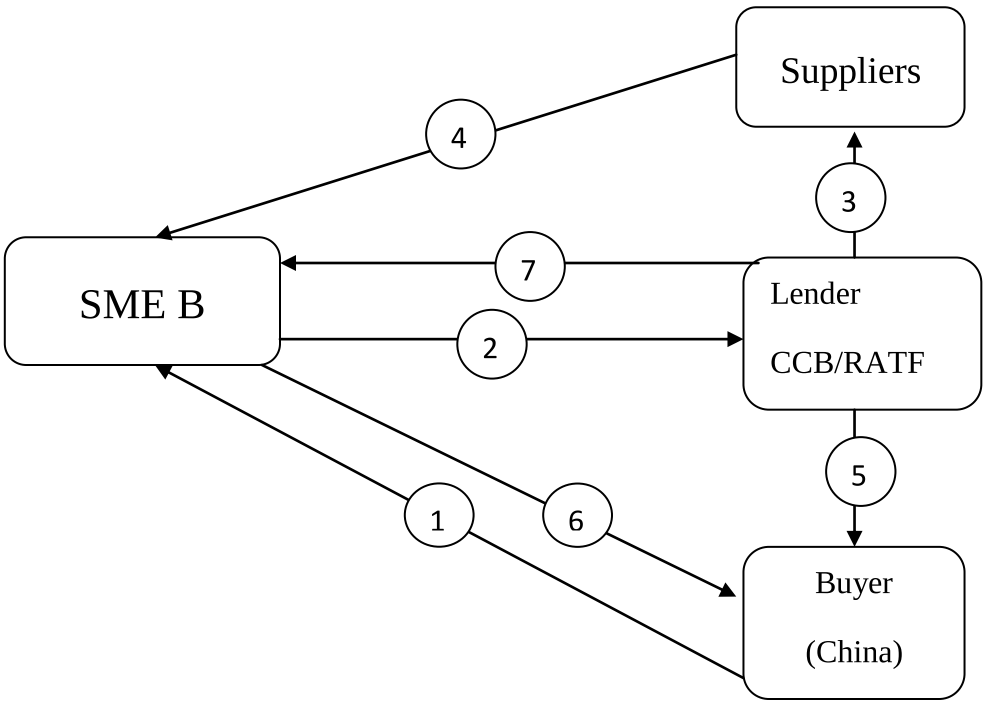
The structured trade and commodity finance facility that Rand-Asia Trade Finance is currently providing for SME B, is structured as follows. Structured trade and commodity finance is provided on metals and minerals, including steel. SME B exports steel products (in various forms) to China. With this facility, Rand-Asia Trade Finance provides back-to-back L/Cs (see section 3.3.2.2). The L/Cs are issued in favour of the suppliers on the back of the incoming L/Cs from the buyers (they need to repay their suppliers for the raw materials obtained). The amount of SME B's first facility was USD 10 million, while the amount of their facility today is USD 5 million.

SME B has also been adversely affected by the commodities market collapse in 2008/09, which in turn caused a decline in their growth during that period. However, as the markets recovered, business also started to pick up again in 2010. It is likely that they will have improved conditions for growth in the future.

With the sales contract, all of SME B's transactions are concluded on a matching sales basis (see section 4.3.3.1), for example US$ to US$. SME B is not allowed to have any unsold stock, therefore all of their stock must be 100% pre-sold. SME B is in charge of the shipping documents up until the point of sale. SME B's gearing (debt/equity) ratio is 10:1. This means that they have ten times more debt than equity. Because SME B, unlike SME A, is not a trader, it is not necessary for them to make use of warehouse receipt financing (see Figure 3.6).

Figure 4.2 below indicates the facility flowchart of SME B (Number 7 of the credit application process).

Figure 4.2: Facility flowchart of SME B.



The steps in Figure 4.2 above are explained below.

1. Buyer issues an L/C in favour of SME B.
2. SME B then applies for finance as well as a back-to-back L/C to be issued in favour of their supplier.
3. CCB Jhb/Rand-Asia Trade Finance then issues the back-to-back L/C for SME B's supplier.
4. The supplier then ships out the raw materials to SME B.
5. CCB Jhb submits the documents to the buyer's bank.
6. SME B ships the goods to the buyer in China (CFR[13] terms).

[13] CFR (Cost and Freight) is where the risks passes to the buyer when seller delivers the goods on board of the vessel. Seller arranges and pays for freight up until the named port of destination (VEDP International Trade, 2010).

7. On completion of the transaction and when the payment on the incoming L/C has been received, the profits are given to SME B.

The structure of SME B's facility differs from the structure of SME A's facility in the following manner. Where SME A is a trader, SME B is a manufacturer in the value-adding process of steel. SME A can either make a pre-payment to their supplier or CCB Jhb can open a back-to-back or supporting L/C in order for SME A to receive the goods from their suppliers. While SME B only has to apply for finance in the form of a back-to-back L/C, SME A's supplier sends the goods to a warehouse before SME A can take possession of the goods. SME B's supplier, on the other hand, sends the raw materials directly to SME B (no warehouse is needed). The proceeds of SME A's transactions go to the settlement of SME A's pre-shipment finance loan at CCB Jhb/Rand-Asia Trade Finance. With the completion of SME B's transactions, Rand-Asia Trade Finance will deduct their fees, after which the profits are given to SME B.

Before SME B was able to obtain structured trade and commodity finance, they needed to mitigate the risks involved with their transactions (see section 4.3.2). Risks inherent to this transaction, as identified through the risk analysis (number 11 of credit application form), are as follows.

Industry risks faced by SME B. The steel industry plays a critical role in infrastructural as well as overall economic development of a country. Global steel production grew enormously in the 20th century from a mere 28 million tonnes (in the beginning of the century) to 1343 million tonnes by the end of 2007. The economic boom in China and India has led to a massive increase in the demand for steel. However, steel prices fell by 50 to 70% because of the economic downturn in 2008 (which is why the amount of SME B's facility has decreased). Because the product financed (steel) is sellable in the market in the event of payment default, this mitigated the risks involved for Rand-Asia Trade Finance. Rand-Asia Trade Finance also has other steel traders among their clients to which they could sell the products to.

Transportation risks involved the unavailability of reliable transport for the financed goods (steel) as well as the lack of contracts (that SME B has) with logistics companies. SME B was able to mitigate the risk through mostly making use of marine transport. As all of their goods are procured from China and India and shipped internationally, SME B's deals are mostly conducted on CFR terms (see section 3.2.1). Only reputable international logistics companies are used by SME B.

It is evident from the case studies that SMEs can obtain structured trade and commodity finance through mitigating the risks involved with their international transactions. Because of receiving trade finance, both of the SMEs were able to expand their businesses through trading with China. However, both of the SMEs involved in this case study were adversely affected by the economic downturn and commodity market collapse of 2008. Both of the SMEs are set to make continuous use of structured trade and commodity finance in order to mitigate their risks and enhance growth for both of them in the future.

Now that it is apparent that there are risks involved with financing SMEs, it is important for SMEs to know how they should become "trade finance ready" in order for them to obtain structured trade and commodity finance.

4.3.4 Becoming "trade finance ready"

Apart from the risks that SMEs have to mitigate in order to obtain structured trade and commodity finance, there are other factors that SMEs can consider to further overcome trade finance as a barrier. These factors are:

1. to first establish their businesses. Financial institutions seldom provide trade finance to start-up businesses. Therefore, SMEs with an established but low turnover and profit record are more likely to obtain trade finance;
2. that SME managers should plan the international transaction in advance and show an understanding of the dynamics of developing a business;
3. to have realistic expectations (the SME should not take on deals that will cause them to exceed their production possibilities). Once-off deals are dangerous to finance (because

they are too risky) and SMEs should rather not consider deals that are unrealistic (too good to be true);

4. that the SME is willing to back the deal with as much collateral as possible. They must therefore be committed to make sure that the transaction is successful. This, in turn, will encourage the bank to provide credit;
5. that the manager/owner of the SME has a thorough understanding of his/her own business;
6. that the company should be registered as a (Pty) Ltd[14] or Ltd rather than a CC[15], because the SME must be able to express the structure of the organisation and shareholders to the bank and
7. to have approximately three years' audited financial statements, financial discipline and equity. (The gearing ratio is also used to determine whether or not to provide the credit).

If all of the above-mentioned factors are in place, it will encourage financial institutions to provide structured trade and commodity finance to SMEs (which is less risky, as mentioned in section 4.1). These factors, together with risk mitigation, make it less risky for a financial institution to provide trade finance to SMEs. By doing so, an SME can become "trade finance ready".

[14] With privately own companies (Pty) Ltd, it is evident who is responsible for making the decisions and how the directing mind of the company may be elected (Business owner, 2010).

[15] Close Corporations (CC) do not require audited financial statements and the members of the CC are only liable for debts under a number of specified circumstances (Business plan, 2010).

4.4 Conclusion

African economies can greatly benefit from SME internationalisation, as SMEs make up 90% of businesses in Africa. There are many opportunities for African SMEs to enter the international market today. One such an opportunity is with an emerging economic giant, China (see section 4.1). China-African trade has increased by approximately US$60 billion between 2000 and 2007, and today China levies no import tariffs on 478 products imported from 31 African countries (see section 4.2).

The aim of this study was to investigate how African SMEs can obtain structured trade and commodity finance from a specialist Chinese bank located in Africa (see section 4.2). The China Construction Bank (along with Rand-Asia Trade Finance) was chosen for this study because it is a specialist foreign bank, located in Africa, which provides structured trade and commodity finance for SMEs and has a good understanding of the Chinese market (see section 4.3).

The China Construction Bank Corporation is one of the leading banks in China and one of the largest banks in the world. The newest edition to CCB is their branch in Johannesburg (CCB Jhb). More than 150 firms have benefited from CCB’s facilitation of trade and commodity finance and the majority of the companies that CCB Jhb has financed are SMEs. CCB facilitates China-African trade through building important relationships. The joint venture with Rand-Asia Trade Finance is a very important relationship for CCB Jhb. There are several benefits to obtaining structured trade and commodity finance from CCB Jhb/Rand-Asia. These benefits include their knowledge and understanding of the differences between the African and Chinese cultures as well as their understanding of emerging markets. This is a distinct advantage for SMEs to trade with the help of CCB Jhb (see section 4.3.1).

Rand-Asia acts as the arranger and manager of structured trade and commodity finance for CCB Jhb. The focus of the joint venture is mainly on financing commodities, but they also handle certain finished goods, in the sense that finished goods are essentially intermediate products or products that can also be used for other purposes. This mitigates the risk for CCB Jhb/Rand-Asia, because it is easier to sell these products if they need to (see section 4.3.2).

The following factors need to be considered when applying for a structured trade commodity finance facility at CCB Jhb/Rand-Asia. Understanding the client is very important for both CCB Jhb and Rand-Asia. It is important to note that no money can be withdrawn until all the securities are in place. Therefore, SMEs must prepare to wait at least 90 days for the latter to be implemented. Each facility is reviewed every year. The amount of each facility depends on the products traded, the SME's activities as well as the risks involved with the transaction. The value of each facility is linked to a gearing ratio. The tenor also depends on the commodity as well as the nature of the business. The SME must be located in a country that is accepted and approved by CCB (see section 4.3.1).

CCB Jhb/Rand-Asia takes the following factors into account when conducting a credit application (see section 4.3.2.1): The client's details, the SME's marketing information, utilisation of the facility, pricing, description of the facility, structure of the facility, facility flowchart, the proposed covenants and securities, an organisational chart, financial analysis as well as a risk analysis (see Appendix A). Analysing the risks is the most important part of the credit application form for SMEs (because SMEs are perceived as risky). This indicates which risks are involved with the transaction and how they should mitigate these risks.

Both of the SMEs used in the case study (see section 4.3.3) were able to mitigate the risks involved with trading internationally and through doing so were able to obtain structured trade and commodity finance. Both of the SMEs have been adversely affected by the commodities market collapse in 2008/09 and were not able to show signs of growth during that period. It is likely that they will have improved conditions for growth forwarding future, as the market is starting to pick up again.

Apart from the risks that SMEs have to mitigate in order to obtain structured trade and commodity finance, there are other factors that SMEs can consider to overcome trade finance as an internationalisation barrier (see section 4.3.4). By doing so, they will become more "trade finance ready" before applying for credit. This makes it easier for any bank to approve a credit application. SMEs with an established but low turnover and profit record are more likely to obtain finance. SME managers should plan in advance and show an understanding of the dynamics of developing a business. SMEs must have realistic expectations and must be committed. It is essential that the manager/owner of the SME knows his/her business well. The SME must be able to outline the structure of the organisation and shareholders to the bank and must have a good track record. All of the latter will encourage the bank to provide the SME with structured trade and commodity finance (see section 4.3.4). Chapter 5 concludes the study and provides recommendations.

Chapter 5: Conclusions and recommendations

5.1 Introduction

The internationalisation of Africa's SMEs is vital for economic development by providing the countries with more and better employment opportunities as well as the benefits of the spillovers in knowledge and technology. This is also true in the case of trading with China. The internationalisation processes of SMEs are greatly influenced by barriers, which slow down the speed of expansion into foreign markets. These barriers to trade could be both internal and external. Internal barriers are barriers associated with the company's own capabilities and organisational resources. External barriers originate from the environment in which the firm operates.

This study focused trade finance, which is a resource barrier. More specifically, it focused on the difficulties in obtaining trade finance as well as the lack of trade finance as a barrier to internationalisation. Lack of finance is the most important barrier to internationalisation in Africa. For example, 25% of small exporting enterprises in South Africa find it difficult to obtain finance. Insufficient export finance is also identified as a major barrier to the success of Ghana's growth strategy and is ranked as the number one barrier to exporting in Ghana. African SMEs therefore cannot reap the benefits that internationalisation holds, because of the difficulties they experience in obtaining trade finance.

China's domestic market is increasingly demanding more commodities, such as wheat, steel and soybeans. African SMEs must therefore be able to exploit the opportunities that trading with China holds by enabling them to obtain trade finance. Although financial institutions recognise the need to provide stable financing to SMEs, they still have difficulties in supplying it to SMEs because they are perceived as risky and have special requirements. In providing trade finance to SMEs, financial institutions need to focus on deal structures for SMEs. A Chinese specialist bank that focuses on deal structures for African SMEs is the China Construction Bank Johannesburg (CCB Jhb). They operate in collaboration with Rand-Asia Trade Finance. This study therefore examines how African SMEs can overcome trade finance barriers and so be able to trade with China, through the facilitative role of CCB Jhb and Rand-Asia Trade Finance.

5.2 Conclusions

The primary objective of this study was to determine how SMEs can overcome trade finance barriers to internationalisation. This objective was achieved through the following sub-objectives.

The first sub-objective was to provide an overview of the internationalisation process of SMEs. Chapter 2 achieved this objective by examining the different internationalisation theories, born global SMEs and international new ventures, motivations for SMEs to internationalise as well as the barriers that hinder internationalisation. There are a number of theories that explain the internationalisation of a firm. The product life cycle concept for international trade states that all products have product life cycles (see section 2.2.1). The Uppsala school approach to internationalisation states that a firm will choose to enter a foreign market if the foreign market is located near the domestic market (see section 2.2.2). The transaction cost approach states that a firm will establish their own company in a foreign market if it is difficult to transfer knowledge to other organisations across international borders (section 2.2.3). Dunning's eclectic approach explains internationalisation according to three advantages, namely ownership advantages, locational advantages and internalising advantages (section 2.2.4). The network approach to internationalisation attributes internationalisation to the development of relationships over time as international buyers and sellers build up knowledge about each other (section 2.2.5). And the resource-based theory is based on the assumption that a firm's expansion into a foreign market depends on the firm's available resources (section 2.2.6).

SMEs can also adopt a more global focus from the beginning. It is clear that born global firms tend to enter international markets much faster than other firms. It also became evident that the majority of born global firms are SMEs. There are both proactive and reactive motivations that affect SMEs' decisions to enter international markets (see section 2.4.1). However, export barriers hinder the expansion of SMEs into foreign markets. Obtaining trade finance is a major barrier to SME internationalisation in African countries (see section 2.5.2), which creates a barrier for African SME growth through internationalisation. The aim of Chapter 2 was to provide an overview of the internationalisation process of firms, by describing the different internationalisation processes, motivations why SMEs enter foreign markets as well as the barriers that hinder internationalisation (with a special focus on trade finance as a barrier).

The second sub-objective was to provide an overview of trade finance risks, methods and facilities. Chapter 3 achieved this objective by examining the different risks involved with international trade as well as the different methods of payment, including direct and indirect methods of payment along with their facilities. From Chapter 3 it became evident that exporters face different financial risks when trading internationally and it is important for them to mitigate these risks (see section 3.2). The methods and terms of payment used in international trade play a vital role in mitigating the risks of the exporter. There are four main payment categories available with international trade, namely open account, bank collections, letters of credit and cash in advance (see section 3.3). The four methods of payment offer different degrees of risk and uncertainty to the exporter SME and can be divided into two groups, namely direct and indirect methods of trade finance. Export factoring is a type of short-term facility that is used for sales under open account (see section 3.3.1). SMEs would prefer to use indirect methods of trade finance because it enables them to partly bridge the time between incurring costs and receiving the payment in order to prevent liquidity risks.

Financial institutions would rather use financing facilities that mitigate the risks involved with an SME's international transactions. One such a facility of trade finance is structured trade finance (see section 3.4). Structured trade finance is used with risky transactions (for example companies in Africa) and is particularly well suited for higher risk companies such as SMEs. The aim of Chapter 3 was to provide an overview of the risks involved with trade finance as well as trade finance methods and facilities with the focus on structured trade and commodity finance.

The third sub-objective was to provide a description of trade between China and Africa. Chapter 4 achieved this by examining China-African trade. In section 4.2 it became evident that China sees South Africa as the gateway to investing in Africa. The Sino-Africa agreement aims to strengthen traditional relations, rediscover strategic opportunities for deepening investment and strengthen trade for mutual benefits between Africa and China. Section 4.2 also highlighted that trade between China and Africa has increased from $10 billion in 2000 to $70 billion in 2007, while China's imports from Africa have increased from $13 billion in 2004 to $51 billion in 2008. China's imports from Africa include mineral fuels, oils, ores, copper, iron and steel.

The fourth sub-objective was to explain how CCB Jhb, in collaboration with Rand-Asia Trade Finance, facilitates trade between Africa and China through the provision of structured trade and commodity finance. Chapter 4 achieved this objective by examining the China Construction Bank Johannesburg branch, Rand-Asia Trade Finance, the credit application process as well as the analysis of risks involved with SMEs' international transactions. CCB Jhb facilitates China-Africa trade by building important relationships in Africa. The joint venture with Rand-Asia Trade Finance is a very important relationship for CCB Jhb. Rand-Asia Trade Finance acts as the arranger and manager of structured trade and commodity finance for CCB Jhb. The focus of the joint venture is mainly on financing commodities, but they also handle certain finished goods. This mitigates the risk for CCB Jhb/Rand-Asia Trade Finance (see section 4.3.2).

The following factors need to be considered when applying for a structured trade commodity finance facility at CCB Jhb/Rand-Asia Trade Finance. Understanding the client is very important for both CCB Jhb and Rand-Asia. It is important to note that no money can be withdrawn until all the securities are in place. Therefore, SMEs must be prepared to wait at least 90 days for the latter to be implemented. Each facility is reviewed every year. The amount of each facility depends on the products traded, the SME's activities as well as the risks involved with the transaction. The value of each facility is linked to a gearing ratio. The tenor also depends on the commodity as well as the nature of the business. The SME must be located in a country that is accepted and approved by CCB Jhb (see section 4.3.1).

With the credit application, Rand-Asia Trade Finance considers the following factors (see section 4.3.2.1): the client's details, the SME's marketing information, utilisation of the facility, pricing, description of the facility, structure of the facility, facility flowchart, the proposed covenants and securities, an organisational chart, financial analysis as well as a risk analysis (see

Appendix A). Analysing the risks is the most important part of the credit application form for SMEs (because SMEs are perceived as risky). This indicates which risks are involved with the transaction and how they must mitigate these risks.

The fifth sub-objective was to compile two case studies on how SMEs were able to obtain trade finance through mitigating the risks involved with their international transactions. Chapter 4 achieved this through providing the case studies. The two case studies illustrated how both the SMEs, by being "trade finance ready", were able to mitigate the risks involved in their international transactions. Both of the SMEs used in the case studies (see section 4.3.3) were able to mitigate the risks involved with trading internationally and through doing so were able to obtain structured trade and commodity finance. Both of the SMEs have been adversely affected by the commodities market collapse in 2008/09 and were not able to show signs of growth during that period. It is likely that they will have improved conditions for growth in future, as the market is starting to pick up again.

The sixth sub-objective was to explain how SMEs can become "trade finance ready". Chapter 4 achieved this by providing other factors that SMEs can consider to overcome trade finance as an internationalisation barrier (see section 4.3.4). Apart from the risks that SMEs have to mitigate in order to obtain structured trade and commodity finance, there are other factors that SMEs can consider to further overcome trade finance as a barrier. These factors are:

1. to first establish their businesses. Financial institutions seldom provide trade finance to start-up business. Therefore, SMEs with an established but low turnover and profit record are more likely to obtain trade finance;
2. that SME managers should plan the international transaction in advance and show an understanding of the dynamics of developing a business;
3. to have realistic expectations (the SME should not take on deals that will cause them to exceed their production possibilities). Once-off deals are dangerous to finance and SMEs should rather not consider deals that are unrealistic (too good to be true);

4. that the SME is willing to back the deal with as much collateral as possible. They must therefore be committed to make sure that the transaction is successful. This in turn will encourage the bank to provide credit;
5. that the manager/owner of the SME has a thorough understanding of his/her own business;
6. that the company should be registered as a (Pty) Ltd or Ltd rather than a CC, because the SME must be able to demonstrate the structure of the organisation and shareholders to the bank and
7. to have approximately three years' audited financial statements, financial discipline and equity. (The gearing ratio is also used to determine whether or not to provide the credit).

These factors, together with risk mitigation, make it less risky for a financial institution to provide trade finance to SMEs. By applying these factors, an SME can become "trade finance ready". The aim of Chapter 4 was to explain how CCB Jhb (in collaboration with Rand-Asia Trade Finance) facilitates trade between Africa and China through the provision of structured trade and commodity finance and how they, in collaboration with the SME, mitigate the risks involved with the financing of SMEs' trading activities.

Therefore, the primary objective was to determine how SMEs can overcome trade finance barriers to internationalisation. SMEs can do so by mitigating the risks involved in every international transaction and by becoming "trade finance ready". This will enable them to engage in internationalisation (especially exports) and through exporting they will show signs of growth.

5.3 Recommendations

The following recommendations can be made for SMEs and for African governments in general.

Recommendations for SMEs:

- Before an SME applies for structured trade and commodity finance, they must make sure that they are "trade finance ready" (see section 4.3.4). In order for them to become even more trade finance ready, the SMEs should, in collaboration with the financial institutions, mitigate the risks involved with their international transactions as far as possible.

Recommendations for African governments:

- Governments should make more African SMEs aware of the benefits that trading with China holds for African SMEs. This goes hand-in-hand with making SMEs aware of the top African commodities that are in demand from China through export promotion. Governments should continue to promote and maintain international relations with China.
- Both of the SMEs used in the case studies experienced difficulties due to the commodity market collapse in 2008 (SME B was more severely affected by this than SME A). Governments could intervene and prevent this, through for example the use of an Import-Export bank.
- To make SMEs aware of the availability of structured trade and commodity finance when trading internationally (see section 1.1 for benefits of SME internationalisation) through the use of export councils, export promotion agencies, etc.

This study indicated how trade finance as a barrier to internationalisation can be overcome through risk mitigation and "trade finance readiness". One limitation of this study is that trade finance data is not readily available. Another limitation, however, is to provide a detailed guideline for SMEs that specifically indicates how they can mitigate all the possible risks involved with their international transactions, as identified by their trade finance provider. This is a proposed topic for further research.

Other recommendations for further research are to examine the availability of structured trade and commodity finance for African SMEs wanting to trade with other countries, for example with the other three BRIC countries (Brazil, Russia and India). These nations are showing signs of rapid growth and African SMEs can use this as an opportunity to internationalise. Another recommendation for future research is to consider whether or not the establishment of an Import-Export bank in South Africa, in particular, is viable.

APPENDIX A

中国建设银行
China Construction Bank

rand-asia
TRADE FINANCE

New Credit Application

[Insert Client's Name (Pty) Limited]

[Insert TCF reference no.]

Presented By: [Insert Marketing Officer's Name]

CLIENT NAME: [INSERT CLIENT NAME]

Registration No. ###

Physical Address		**Postal Address**	
[INSERT PHYSICAL ADDRESS]		[INSERT POSTAL ADDRESS]	
Contact Details		-	
Client Contact person		**Rand-Asia Contact person**	
[INSERT NAME & DESIGNATION]		[INSERT NAME & DESIGNATION]	
Telephone Number/s		**CCB Contact Person**	
Office: ###		[INSERT NAME & DESIGNATION]	
Cell: ###			
Fax: ###			
Capital Provision		**Auditors**	
Amount: Date:	[INSERT AMOUNT] ###	[INSERT NAME OF AUDITOR]	
Interest Reserve		**Reviews**	
Amount: Date:	[INSERT AMOUNT] ###	Last Annual Review as per:	[INSERT DATE]
		Last Interim Review as per:	[INSERT DATE]
Exchange Control Approval		**Exchange Control Approval**	
Bank:	[INSERT BANK'S NAME]	Bank:	[INSERT BANK'S NAME]
Branch:	[INSERT]	Branch:	[INSERT]
Excon No.:	[INSERT]	Excon No.:	[INSERT]
Expiry Date:	[INSERT]	Expiry Date:	[INSERT]
Total Approval:	[INSERT]	Total Approval:	[INSERT]
Purpose:	[INSERT]	Purpose:	[INSERT]

Shareholding		
Name	**%**	**Domicilium**

Other Banks

Bank	**Type of facility**	**Amount**	**Utilisation** [Insert Date]	**Security**

Comment

MARKETING INFORMATION

Introduction

Reason/Motivation for the Facility

The purpose of this application is [insert]

- Text…
-

Text…

- Text…

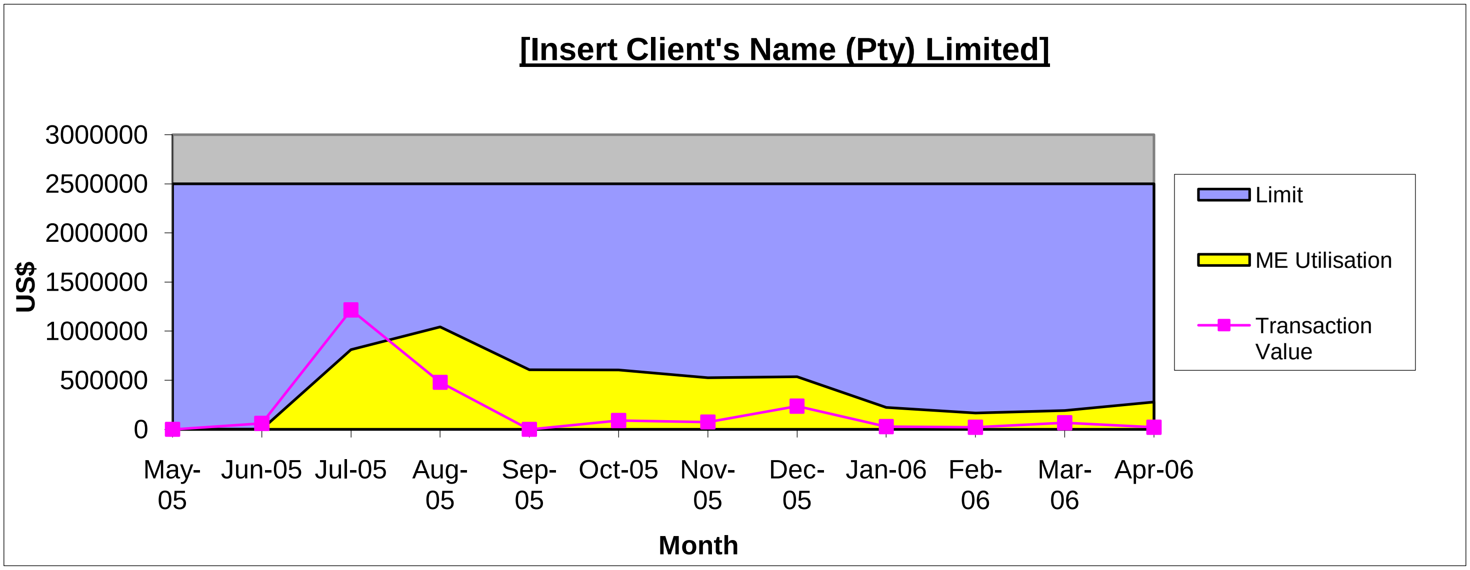
Background

Nature of Business

Client Base

Competition

UTILISATION



Comments

PRICING

BANK: INCOME ON THE FACILITY AS REFLECTED THROUGH A BANK								
Key:	Enter Text/Text			Determine the basis, if any, for calculating Interest &/or Fees				
Facility Description	Forex	Rand	Average Funding p.a.	Turnover p.a.	Interest Margin p.a Net of COF	Fee on Turnover	Income Forecast Interest	Income Forecast Fees
	USD '000	7.2000 '000	/ by 2 times Estimate Ave Util' '000	4.0 times '000	360-days % pa	% flat	* 1,000	* 1,000
A) Bridge Finance & LC		R 0	R 0	R 0	2.500%	1.000%	R 0	R 0
B) [insert]	0	R 0	R 0	R 0	0.000%	0.000%	R 0	R 0
Totals	0	R 0	R 0	R 0			R 0	R 0
TOTAL EARNINGS								R 0

ROC Calculation			Capital Used		Weighting			Gross RAROC
			R 0		15.000%			#DIV/0!

RAND-ASIA TRADE FINANCE: INCOME ON THE FACILITY ANTICIPATED FOR RATF								
Facility Description	Forex	Rand	Average Funding p.a.	Turnover p.a.	Interest Margin p.a Net of COF Profit Share	Fee on Turnover Profit Share	Income Forecast Interest	Income Forecast Fees
	USD '000	7.2 '000	/ by 2 times '000	4.0 times '000	10.000% % pa	40.000% % flat	* 1,000	* 1,000
A) Bridge Finance & LC	0	R 0	R 0	R 0	0.250%	0.400%	R 0	R 0
B) [insert]	0	R 0	R 0	R 0	0.000%	0.000%	R 0	R 0
Totals	0	R 0	R 0	R 0			R 0	R 0
RAND-ASIA NET EARNINGS								R 0

CCB/SYNDICATED PARTNERS NET EARNINGS	RAROC	#DIV/0!	R 0

HISTORY OF FEES & INTEREST MARGIN EARNED								
CLIENT	[Insert]							
	Prior year:	1-Mar-06	to	28-Feb-07	Current Year	1-Mar-07	to	28-Feb-08
	Total CCB				Total CCB			
Fee Income								
Interest Margin *(estimate)*								
Total CCB	R 0				R 0			

DESCRIPTION OF FACILITY

DESCRIPTION OF FACILITIES Sub-limits shown in (brackets)	Tenor Days	Interest Margin	Fees	Outstanding (Sub Limit)	Approved (Sub Limit)	Proposed (Sub Limit)
CURRENCY				US$	US$	US$
DATE OF INFORMATION				[dd.mm.year]	[dd.mm.year]	[dd.mm.year]
COMMODITY FINANCE FACILITY [Amend as required] **Uncommitted, secured & self liquidating Commodity Finance Facility for:** - Import Letters of Credit - Procurement Financing - Bridge Finance of Receivables - Documentary Collections - Shipping Guarantees (linked to approved transactions) - Bid/Performance Guarantees	[xxx Days]	<u>RAND</u> **Prime plus [x.xx]%** (RATF Margin: #.##%) <u>FOREX</u> **LIBOR plus [x.xx]%** (RATF Margin: #.##%)	x.xx% Flat	[insert amount]	[insert amount]	[insert amount]
FOREIGN EXCHANGE FORWARD COVER [20%] risk weighted Limit UN-MATCHED deals	[xxx Days]	-	Points per market	[insert amount]	[insert amount]	[insert amount]
TOTAL FACILITY / RISK	-	-	-	**[insert amount]**	**[insert amount]**	**[insert amount]**

FACILITY

Explanatory Notes to the Facility Schedule

Structure of the Facility

General Process

Merchanting Transactions

Food Security (African) Transactions

DEBTORS

Name	**Country**	**Terms of Payment**
[insert]	[insert]	[insert]

All other Debtors with respective terms outside above mandates require pre-approval.

FACILITY FLOW CHART

Notes

Insert copy of flow chart

PROPOSED COVENANTS & SECURITIES

Covenant	**Sub-category**	**Comment**
Advance Rate	**General:** **Debtors:** **Profits:**	[Insert] [Insert] • • • [Insert]
Margin		[Insert] • • •
Position in Stock		[Insert]
Contracts with Buyers		[Insert]
Buyers / Debtors to be pre-approved		[Insert]
Cash Flow Management	**Rand:** **Forex:**	[Insert] [Insert]
Title and Ownership of Goods		[Insert]
Foreign Currency Exchange Risk		[Insert]
Exchange Control Approval		[Insert]

Debt/Equity Ratio (Gearing)		[Insert]
Management Accounts	**Term:**	[Insert]
Financial Statements Audited Financial Year-end	**Term:**	[Insert]

SECURITIES

Cession in Security		
Cession of Insurance Policies		
Suretyship Personal		
Suretyship by Company		
Subordination of Shareholders Loans		
Pledge of Shares		
Pledge of Stocks		
CGIC Debtor Insurance		
Other securities (add)		

ORGANISATIONAL CHART [insert/amend]

Notes

<u>Shareholding</u>		
Name	**%**	**Domicilium**
<u>Directors & Management</u>		
[insert name - title]		
[insert name - title]		

Interest Cover			
Interest Cover	#VALUE!	#VALUE!	NEG OP PROFIT
INTEREST COVER COMMENT	#VALUE!	#VALUE!	OK

CASH FLOW STATEMENT

	31-Dec-08 Audited		**31-Dec-07 Audited**		**31-Dec-06 Audited**	
[ZAR]	**Months**	12	**Months**	12	**Months**	12
	Quoted to	-	Quoted to	-	Quoted to	-
Cash Generated - Operating Activities			-			
Cash Flows from Investment Activities			-			
Cash Flows from Dividends Paid			-			
Cash Flow from Financing Activities			-			
(Decrease)/Increase in Cash or Cash Equivalent	0		0		0	
Cash and Cash Equivalent at beginning of the Year	0		0			
Cash and Cash Equivalent at the end of year	0		0		0	

FINANCIAL ANALYSIS

[COMPANY'S NAME]

Financial Analysis Conducted and Completed by:	Michael Wang

Marketing Officer Comments (where applicable) by:	Eric Finaughty

INTRODUCTION

Financial Analyst
Text…

Text…

Text…

Text…

Marketing Officer (if applicable)
Text …

Text…

COMMENTARY ON INCOME STATEMENT

Financial Analyst

REVENUE
Text…

COST OF SALES
Text…

FINANCE COSTS
Text…

OPERATING EXPENSES
Text…

Text…

Marketing Officer (if applicable)
Text…

Text…

COMMENTARY ON BALANCE SHEET

Financial Analyst
EQUITY
Text…
Text…
Text…

LONG TERM LIABILITIES
Shareholders Loans …

Other…

Text…

CURRENT LIABILITIES
Where is our / Trade Finance exposure recorded

Text…
Text…

FIXED ASSETS
Text…
Text…

CURRENT ASSETS
Inventory…

Debtors…

Cash at Bank…

Text…
Text…

CONTINGENT LIABILITIES
Text…
Text…

PROVISIONS
Text…

Text…

BAD DEBTS
Text…

Text…

GENERAL
Text…
Text…

Marketing Officer (if applicable)
Text…

Text…

COMMENTARY ON KEY RATIO ANALYSIS AND CASH FLOW STATEMENT

Financial Analyst LIQUIDITY … GEARING … DEBTOR / CREDITOR DAYS … INVENTORY … INTEREST COVER … CASH FLOW … Text … Text … Text …

Marketing Officer (if applicable) Text … Text…

FINANCIAL RISK (GENERAL/SUMMARY)

Financial Analyst	Risk Weight:	**# / 5**
Text… Text…		

Marketing Officer (if applicable	Risk Weight:	**# / 5**
Text… Text…		

BUSINESS RISK ANALYSIS 1=Low Risk 5=High Risk

The key risks identified are as follows:

INDUSTRY RISK *Field of Industry in which the customer operates e.g. commodity trader.* *Is the customer a niche player or more general? Impact of climatic conditions on commodity (if applicable); Availability of product; Global Demand*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

GEOGRAPHICAL POSITION *In what geographical areas does your client operate including location of Buyer/Supplier and Commodity Source/Consumption*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

SUPPLIER RISK *Performance capability/History of relationship. Agency Agreements. Mutual Dependency*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

BUYER RISK *Performance capability/History of relationship. Agency Agreements. Mutual Dependency*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

ENVIRONMENTAL RISK *Does the company's operations pose any danger to the environment e.g. toxic emissions or waste?*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

COMPETITION *Evaluate the risk that potential / existing competitors pose to your client / facility*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant				

Text …

DEMAND RISK *Relativity of your client's products to its markets*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

CONCENTRATION RISK *Evaluate your client's risks relative to business spread i.e. Commodity/Products – Supply/Sale (Client/Geographic location)*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

COMMODITY PRICE RISK *Price volatility; are prices fixed in contracts with sellers & buyers? Pre-sold?*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

EXCHANGE RATE RISK *Volatility affecting the value of assets & earning relating to foreign currencies, Transaction - losses due to volatility and Translation Risk – mismatch between assets & liabilities. Hedging Policy?*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

SETTLEMENT RISK *Tenor, non-simultaneous performance of the parties to deal, facility self-liquidating? Back-to-back deals?*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

PAYMENT RISK *Risks associated with the repayment of borrowings and how does your client mitigate these*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

OPERATIONAL / PERFORMANCE RISK *Your client's ability/vulnerability to execute on transactions and to manage his business processes/failure to perform*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**

Risks Identified: Text …
Mitigant Text …

KEY MANAGEMENT *Business sustainability relative to Key Management in terms of management's ability, experience and commitment and global network*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

PRODUCTION & OFF-TAKE RISK *Discuss adequacy & maintenance of processing plants; skilled labour; supply of power & water; adequate storage (for example)*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

TRANSPORTATION RISK *Method of transport; carriers involved; collection process (if applicable)*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

QUALITY/QUANTITY ANALYSIS *What are the processes and risks relevant to your client/facility*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

SOVEREIGN RISK *Assets or earnings in a foreign country could be frozen or expropriated/increased default of international debt*	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

[RISK TITLE]	Credit Risk Weight:	**# / 5**	Business Risk Weight:	**# / 5**
Risks Identified: Text …				
Mitigant Text …				

RECOMMENDATION & SIGN OFF

… … … …

PREPARED & RECOMMENDED BY:

…
Marketing Dept

FINANCIAL ANALYSIS BY:

…
Risk Management

RECOMMENDED BY:

Eric Finaughty
CEO - Rand-Asia Trade Finance

ANNEXURES

Audited Financial Statements for FYE dd-mmm-yyyy
Management Accounts for ## Months for Period Ending dd-mmm-yyyy
Statement of Assets and Liabilities for:
> …
Text…
Text…

SECURITY

\- - - -
\- - - -
All security documentation relating to this facility are in place, the originals lodged with CCB.

[Delete items that are not applicable and add items not included in list]

Security Documents	**Reference**				**Comment [BRIEF]**
	SEC	**Client**	**No.**	**Date**	
Facility Documentation					
Facility Letter	SEC		0001		
Term Sheet	SEC		0002		
Cession in Security	SEC				General or Specific
Rand Denominated Account Opening Form	SEC				
Customer Foreign Currency Account Opening Form	SEC				
General Terms and Conditions for Guarantees	SEC				
General Terms and Conditions for Documentary Credits	SEC				
General Agreement for Foreign Exchange Transactions	SEC				
Signature and Currency Dealing Mandate	SEC				
Declaration of Cession of Insurance Policies	SEC				
Indemnity for Documents Surrendered	SEC				
Power of Attorney - SARB Form	SEC				
Power of Attorney - Trade Finance	SEC				
Power of Attorney - Rand-Asia	SEC				
Indemnity Electronic Communications	SEC				
Suretyship Personal	SEC				Unlimited or Limited
Suretyship by Company	SEC				Unlimited or Limited
Subordination of Shareholders Loans	SEC				[Insert Name]
Pledge of Shares	SEC				
Pledge of Stocks	SEC				
Test Key Arrangements	SEC				
Resolution by the Board of Directors	SEC				Acceptance of the Facility
Insurance					
Insurance Policy Marine and Stock Loss	SEC				[Noted or Ceded]
CGIC Debtor Insurance	SEC				Domestic Policy No. ____________
CGIC Debtor Insurance	SEC				Export Policy No. ____________
Shares					
Original Share Certificates	SEC				**[if Personal Suretyship Held]**
(if lodged (CM24 signed but not dated))	SEC				

General					
KreditInform report (and code)	SEC				
Client Information Form (completed and signed)	SEC				
Statutory Document					
Memorandum and Articles of Association	SEC				
Certificate of Incorporation	SEC				
Certificate to Commence Business	SEC				
Certificate of Name Changes (if applicable)	SEC				

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