



DEVELOPING WIN-WIN STRATEGIES FOR CHINA'S SMALL ENTREPRENEURS

HOW NANYUE BANK IS INNOVATING LENDING

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By identifying and overcoming financial hurdles in local business cycles, China's regional banks are playing an increasingly critical role in moving China's domestic economy forward. Yilong Xu, in charge of Nanyue Bank's microfinance operations, is a pioneer in this respect, especially when it comes to identifying loan opportunities that may aid small entrepreneurs often overlooked by more conventional banks.

The key to Yilong Xu's success is an intense focus on the business cycle. The idea is to identify "pain points" or gaps in financing and liquidity that keep small business owners from functioning effectively. By focusing on the business process itself rather than on the credit history of individual borrowers, Xu has been able to largely automate the lending process, while reducing risk and eliminating the need for experienced loan officers.

An innovative feature of Xu's approach is to make payments directly to suppliers, rather than to the borrowers, thus eliminating any temptation to divert funding to other purposes.

An example where Xu's strategy has proved exceptionally profitable is China's retail tobacco and cigarette industry. Tobacco is generally sold through small shops and street stalls, most often by women in their fifties. The whole of China has a single supplier, which operates as a legal monopoly. Licenses are granted to individual vendors, who are required to maintain a minimum level of 10,000-50,000 RMB (US\$1,523-7,617) cash reserves before making new orders.

The usual cycle from ordering cigarettes to actually selling them is around 7 to 14 days. The "pain point" is the tobacco monopoly's requirement that a vendor must make the full payment of the order's amounts before deliveries can be made. If not, deliveries are automatically declined. In the case of a special holiday or an event such as a wedding, the lack of cash means a substantial loss in revenue.

Nanyue Bank's innovative solution is to offer 7-14 day loans to cover the missing amount. For a one-week period, the interest on the loan is a minimal 0.35%. The profit margin for selling tobacco is 7% to 13%. Since the loan is paid directly to the Tobacco monopoly rather than to the individual borrower, the risk of default is low. If the borrower fails to pay, he or she is effectively prevented from doing future business. The license to sell tobacco is extremely valuable so there is a powerful incentive to make certain that loans are repaid on time.

Since the process is largely automated, the cost to the bank of processing the loan is practically non-existent, yet once a sufficient flow of loans is created, the annual return on investment (ROI) for the aggregated loans constitutes a hefty 18% a year.

Since the bank launched the plan in 2015, it has been averaging 7,000 loans a week in just one province. The default rate has been zero. Individual tobacco vendors clearly profit from the plan, but the tobacco monopoly also wins. Since vendors have increased, profits are substantially up all around. Before Xu and Nanyue Bank launched the plan, the default rate was roughly 20%, meaning that only around 80% of the vendors could manage to meet the 10,000-50,000RMB minimum. Today, the transaction success rate stands at 99%.

Another sector successfully targeted by Xu and the Nanyue Bank is transportation. China has roughly 2.8 million trucks operating on national highways. The usual process for moving goods is to contact a logistics company, which then subcontracts the order to a truck owner, who usually has one or two trucks and may drive the truck himself, or hire someone else as a driver.

The standard business cycle, from receiving an order to actually being paid, is roughly 60 to 90 days. During that time, the owner needs to advance the total cost of purchasing fuel, hiring a driver, wear and tear on the truck and paying for highway tolls. Gasoline or diesel fuel usually accounts for around 20% of the total cost. Hiring a driver and paying tolls may account for another 25%.

Xu identified highway tolls as the "pain point" which the bank could contribute to resolving. Instead of advancing money to the owner of a truck, the bank makes payments directly to the company managing the highway. The bank is then reimbursed at the end of two months, at an interest rate of around 3%. The annual rate, once all the loans are aggregated, is 18%.

So far there have been no defaults. In any case, there is almost no risk since failing to pay back a loan would effectively block the truck owner from the country's major highways. Even more important, however, is the fact that Nanyue bank has managed to facilitate the growth of commerce by advancing the credit needed to make the system function.

A third sector that is profiting from Nanyue Bank's innovative approach is the growing of bananas in Hainan. Banana growers are required to buy insurance against natural disasters. The government pays 75% of the amount, and the grower is responsible for the remaining 25%. The cycle usually lasts from five to six months. Bananas are planted in February, and for the first four months, the process is virtually risk free. In the last two months of the growing cycle, however, there is a high risk that a crop will be destroyed by rain, hail or some other unexpected event. To protect against damage, the growers cover the plants with plastic bags, which cost roughly 0.50 RMB (US\$ 0.076) per bag. Traditionally, each grower needs to purchase around 10,000 bags in advance. That means fronting at least 5,000 RMB (US\$760) until the crop is sold and payments are received.

Nanyue Bank identified the purchase of the bags as the key "pain point" in the business cycle. Again, payment is made directly to the suppliers of the bags. The bank is reimbursed by the grower after payment for the crop is finally received. While the interest in this case adds up to 3% during the period when the bags are needed, the amount is still small enough to be easily affordable. The total interest for a two-month loan is roughly 150 RMB (US\$22.85). The large number of loans and the quick turn-around make the plan especially profitable.

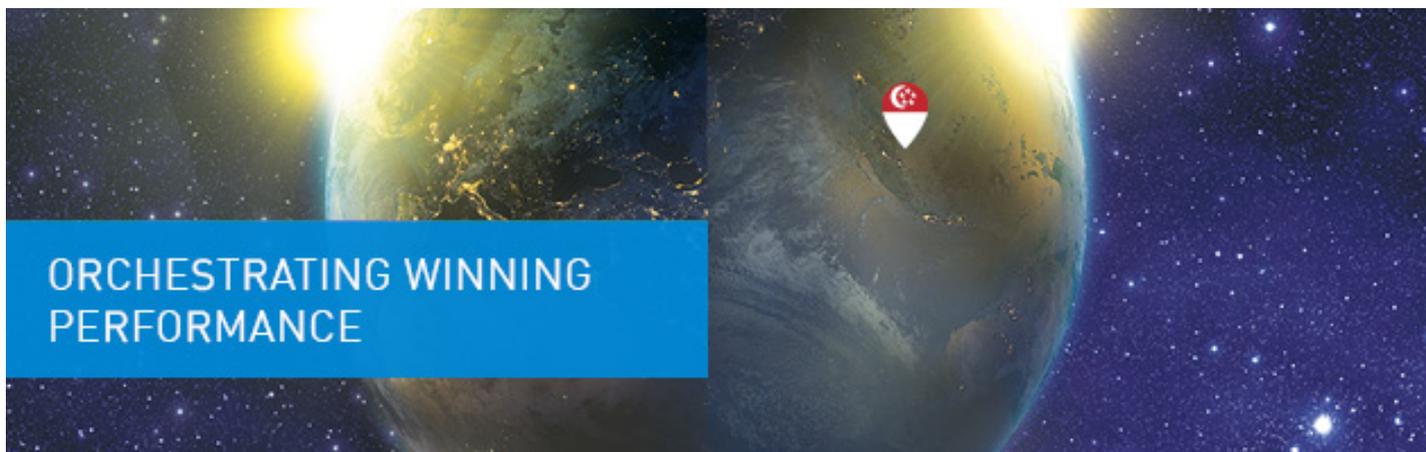
The largely automated loan process, combined with the elimination of the need to establish a credit rating for borrowers, means that the entire operation can be run by a small number of bank personnel. In contrast to traditional loan operations which have an over 10% default rate, Nanyue Bank's default rate is only around 0.3%.

Whether it be in tobacco, transportation, agriculture or other industries, this new style of banking works because it focuses on the business process rather than on an individual client's credit history.

An interesting footnote is that Xu is able to run Nanyue's microfinance operations with a skeleton staff of only six people. Three are dedicated to credit modeling based on big data. The other three handle sales and developing new clients. The process is otherwise highly automated. The genius is in the design.

Winter Nie is a professor of operations and service management and is Regional Director for IMD Southeast Asia & Oceania. She teaches in [Orchestrating Winning Performance \(OWP\)](#) Singapore, taking place November 28 to December 02, 2016.

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