Discussion Paper

Third International Conference on Financing for Development

Addis Ababa, Ethiopia

13-16 July 2015

Financing Small and Medium Sized Enterprises for Sustainable Development: A View from the Asia-Pacific Region

WP/15/05

July 2015

UNITED NATIONS ESCAP

Economic and Social Commission for Asia and the Pacific

Working Paper Series
Macroeconomic Policy and Development Division

FINANCING SMALL AND MEDIUM SIZED ENTERPRISES FOR SUSTAINABLE DEVELOPMENT: A VIEW FROM THE ASIA-PACIFIC REGION

This discussion paper was prepared for ESCAP by Nick Freeman, Independent Economic Development Consultant.

The author gratefully acknowledges the contributions made by Masato Abe, Sailendra Narain, Michael Troilo and J. S. Juneja.

For more information, contact:

Macroeconomic Policy and Development Division (MPDD)
Economic and Social Commission for Asia and the Pacific
United Nations Building, Rajadamnern Nok Avenue, Bangkok 10200, Thailand
Email: escap-mpdd@un.org

Series Editor
Dr. Aynul Hasan
Director
Macroeconomic Policy and Development Division

Please cite this paper as:
Freeman, Nick (2015). Financing Small and Medium Sized Enterprises for Sustainable Development: A View from the Asia-Pacific Region. MPDD Working Paper WP/15/05. Available from www.unescap.org/our-work/macroeconomic-policy-development/financing-development.

CONTENTS

1. SMES' VARYING FINANCIAL NEEDS: THE POLICY-MAKER'S PERSPECTIVE... 1

1.1. SME ACCESS TO FINANCE: A SUBREGIONAL COMPARISON.................................. 1
1.2. THE SME BUSINESS LIFE-CYCLE.. 8
1.3. WORKING CAPITAL: FUNDING DAY-TO-DAY OPERATIONS 9
1.4. FIXED CAPITAL: FUNDING INVESTMENT... 10
1.5. BEYOND COLLATERAL: SUPPORTING THE GOOD AND RECYCLING THE BAD.............. 11

2. MAPPING OUT SME FINANCE: DEBT PRODUCTS AND SERVICES......... 14

2.1. SME DEBT-FINANCING OPTIONS.. 14
2.2. THE ATTRACTIONS AND RISKS OF SME DEBT FINANCE (AND CREDIT GUARANTEE SCHEMES) 18
2.3. SECURED TRANSACTIONS, CREDIT REPORTING AND THE USE OF 'BIG DATA'........... 23

3. MAPPING OUT SME FINANCE: EQUITY PRODUCTS AND SERVICES...... 27

3.1. ADVANTAGES AND DISADVANTAGES OF EQUITY FINANCING OF SMES.. **27**

3.2. FORMS, ATTRACTIONS AND RISKS OF SME EQUITY FINANCE............................ **28**
3.3. BUSINESS DEVELOPMENT SERVICES, AND BALANCING DEBT WITH EQUITY **31**

4. SPECIALIST SME-FOCUSED BANKING: HELP OR HINDRANCE? 33

4.1. AN OVERVIEW OF SPECIALIST SME-FOCUSED BANKING IN THE REGION................. 33
4.2. INTRODUCING A FOUR-TIER NATIONAL SME FINANCE SYSTEM........................... 36
4.3. FINANCIAL SUPPORT DURING ECONOMIC DOWNTURNS.................................... 38
4.4. A BRIEF NOTE ON THE IMPACT OF SOCIETY, CULTURE AND TRADITION.................. 41

5. CONCLUSIONS AND POLICY RECOMMENDATIONS.............................. 43

1. SMEs’ VARYING FINANCIAL NEEDS: THE POLICY-MAKER’S PERSPECTIVE

1.1. SME access to finance: a subregional comparison

> “Small and medium-size enterprises account for the largest share of employment in the developing world. They are also more likely than large firms to be credit constrained. These businesses need working capital to operate, to grow and to compete in the marketplace. So access to finance is crucial to their success.”
>
> World Bank, *Doing Business 2015.*

As the above quotation intimates, limited access of SMEs to even the most basic financing tends to be a relatively generic issue, whether they are located in less developed, developing and developed countries. It is a generic problem across the globe, and no less valid in the Asia-Pacific region. The differences between countries and regions tend to lie in the degree of intensity of this constraint, which can vary significantly. For example, SMEs in less developed countries typically have a much more difficult time accessing finance than their counterparts in developed countries. This is due to a number of factors, including their own risk profiles and suitability for external funding (ie. demand side weaknesses), as well as the relative strength and capacities of the banking and finance sector (ie. supply side inadequacies). In addition, the capacities and resources of government agencies in developed countries tend to be greater, which then allows for larger and more effective policy interventions to try and overcome market failures or address regulatory constraints. There can also often be greater market and regulatory failures at work in less developed and developing economies, compared with more developed countries.

Indeed, developed countries tend to have a more developed financial and regulatory support structure that serves to reduce the risk and costs of lending to SMEs, and thus allows the market to be a more efficient provider of such finance. These can include stronger ownership rights, their adjudication and enforcement, which makes it easier for banks to foreclose on assets pledged as security for loans that have defaulted, for example. They will also more likely to host private credit bureaus that provide credit history for almost all firms that have ever taken a loan, again reducing the risk entailed for the finance provider. A good personal borrowing history by an individual that needs a loan to start a business venture may encourage a bank to provide the finance, based more on his/her credit history than whether or not collateral is available. Ratings agencies and secured transaction registries can also be useful in this regard. And with recent advances in ICT, the use of ‘big data’ allows financiers to forecast with greater confidence on the likelihood of an applicant’s credit standing. But in countries where such ‘big data’ do not exist, or are fragmented or go unshared (for whatever reason), these kinds of support structures, so useful in mitigating SME risk, cannot be implemented so easily, or require substantial efforts and cost to be developed.

Just as not all countries are the same in their ability to provide SME finance, it is similarly the case that not all SMEs are the same. And thus, not all SMEs’ financing needs are the same. As a consequence, SME financing should ideally span a range of activities, products, services and mechanisms for funding the development of SMEs.

SME financing is not wholly divorced from other kinds of banking and finance, but it does tend to have its own special characteristics intended to serve the particular needs of SMEs. One is the ability to mobilize capital relatively quickly, in response to start-up or growth opportunities, and market windows, that can rapidly arise (and equally rapidly close). Another salient characteristic is one of complementarity, with SME financing augmenting more traditional sources of financing in many contexts. But the precise financing needs and expectations of SMEs (whether in the form of debt and/or equity) tends to vary, depending on (but certainly not limited to) such factors as:

(a) Home country profile;
(b) Industrial, agricultural or services sector in which the SME is operating;
(c) Perceived business risk of the SME and its business venture;
(d) Asset structure of the SME (e.g. tangible versus intangible, capital-intensive versus less capital-intensive, high or low labour content);
(e) Debt-to-equity ratio of the SME (i.e. how 'leveraged' the business is);
(f) Anticipated future growth rate of the SME;
(g) Profitability of the business;
(h) A range of social and cultural factors;
(i) The wider macro-economic health of the country (and even the global economy) at a particular time, influencing the SMEs' business prospects; and
(j) Current size, stability and complexity of the financial sector, influencing the propensity to lend to SMEs and other high risk sectors.

The principal SME finance instruments can be broken down into the six broad categories, namely: informal, internal, debt-based products and services, equity-based funding avenues, non-collateralized debt products, and government grants or subsidies. Each of these instruments will be briefly discussed:

- Informal finance refers to all financial transactions, between two parties, that occur outside the regulatory framework and enforcement of a central banking and finance authority. Such funds may come from personal savings, borrowing from relatives or 'loan sharks'. The primary concern with this kind of financing is that it is beyond the regulatory body's ability to regulate and enforce the process, such as protecting users and prosecuting abusers (such as usuries), as well as inhibiting its ability to enact its fiduciary, monetary and systemic banking sector responsibilities.

- Internal financing is the method of generating funds through a company's core business, such as through withheld profits and using working capital. In developing countries, including those in Asia and the Pacific, informal and internal financing typically dominates SMEs' financial sources, particularly for start-up ventures and micro and small enterprises.

- Debt-based financing, which is also a major (and formalized) source of funding for SMEs, typically takes the form of credit lines, term loans, rolling overdrafts and other debt products that must be fully repaid over time, with interest. Most debt financing is provided by commercial banks. This is typically the most common (and therefore most important) form of financing that SMEs -- and others -- think of when they consider access to finance. The most common form usually entails the borrower providing some kind of collateral as security against the loan, should he/she be unable to service the loan, as stipulated in the loan contract. There may also be various supporting services, such as credit guarantee schemes, used to encourage (by mitigating some of the risks of) lending to SMEs and other eligible businesses.

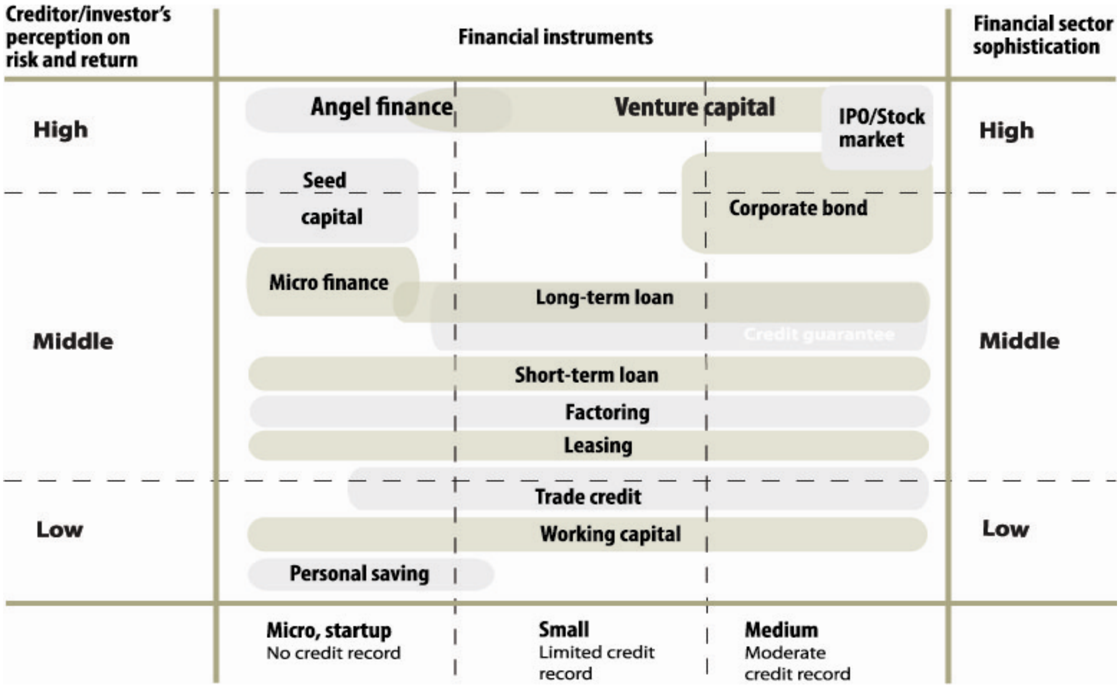
- Equity-based financing spans a range of activities whereby investors provide funds (and sometimes also non-financial assistance also) in exchange for an ownership share or other interest in the business. It includes a wide range of financing sources such as business angel networks, venture capital, private equity, and even share issuance through initial public offerings (IPOs). There are also debt-equity hybrid instruments, such as convertible loans, whereby a loan is converted into shares at a later date, if contractually agreed by both parties.

- Non-collateralized debt products are typically a way of issuing financing while circumventing the need for collateral, which can often pose a problem for SMEs. The most common types of asset-based financing are factoring, invoice discounting and inventory financing. Financial leasing is another common method of financing the acquisition of equipment by SMEs.

- In some countries, the public sector sometimes actively promotes the development of SMEs by providing grants, subsidies, or guarantees. These are often provided through devoted state agencies or through commercial financial institutions, with clear criteria that establish which SMEs are eligible to apply. The efficacy of using such instruments to overcome or mitigate market failure tend to be controversial, given the use of public funds and the risk of losses to the state budget, but are popular with policymakers that wish to support SME sector development.

Figure 1 seeks to depict much of this in graphic form, focusing on the relative risk and return expectations attached to each SME financing form (see the left-hand column, from high to low), the degree of sophistication (and therefore likely transaction costs) depicted in the right-hand column, also from high to low. The central area depicts the differing SME finance products and services in a matrix that combines both the risk/ reward/sophistication/transaction cost expectations mentioned before, combined with the typical needs and financing options of (a) micro and start-up, (b) small and (c) medium sized enterprises. Thus, for a start-up venture, probably angel financing comes with the highest degree of risk and need of investor sophistication, relative to the ease of using some personal savings of the entrepreneur concerned (if he or she should have some) to get the business going. For larger SMEs, investment by a private equity/venture capital investor, followed by an initial public offering (IPO) is probably as sophisticated a form of financing that one might consider, relative to getting a short-term loan for use as working capital.

Figure 1. Stylized representation of the various SME finance options



Source: Abe and others (2012).

Further details and discussion on all of these SME finance instruments are explored later in the paper, with an emphasis on providing an Asia-Pacific perspective. At this stage it is already evident that the potential range of SME financing options available in some countries is quite substantial, with an aim of meeting the specific needs of SMEs at different stages in their development, and seeking to do different things with the funding on offer. Needless to say, in some less developed and developing countries, not all these options are available - for a wide range of reasons - whether they be regulatory, market-influenced, historical, and/or capacity related.

Turning to Asia and the Pacific, a recent joint study by the ADB and OECD (2014) on 'Enhancing Financial Accessibility for SMEs' notes the following broad profile in Asia's access to finance for SMEs, as compared with other regions of the globe (table 1):

(a) Enterprises in Asia have less access to credit and overdraft facilities than their counterparts in other regions.

(b) SMEs in Asia have lower access to credit than large firms in Asia.

(c) SMEs in Asia were only slightly more likely to report financial constraint than larger Asian firms, though much less than in other regions.

(d) SMEs in Asia were least likely to have made recent investment, and most were reliant on retained earnings for both investment and working capital.

(e) SMEs in Asia were least likely to apply for a loan.

(f) SMEs in Asia were more likely to be required to provide collateral for loans and were more likely to be financed by state-owned banks.[1]

Table 1. Enterprise characteristics and access to financial services (%), Asia and non-Asia compared.

	Non-Asia			Asia		
Item	Small	Medium	Large	Small	Medium	Large
Exporter	9.7	22.4	35.4	9.3	24.3	45.7
Investment - fixed assets	34.9	34.9	35.8	54.1	60.3	60.4
Female owners	41.2	61.1	77.4	24.9	49.2	64.6
Financially constrained	55.8	60.0	59.2	26.1	25.9	25.0
Banking access						
Checking	83.5	93.3	95.7	79.4	94.9	97.4
Overdraft	40.7	64.0	72.8	12.2	29.5	37.9
Credit	31.8	51.5	71.0	15.4	34.5	49.7
Sources of credit for most recent loan						
Private commercial banks	79.3	77.9	84.6	28.3	27.0	27.9
State-owned banks	14.8	18.5	13.5	59.1	65.5	70.2
Nonbank financial institutions[a]	5.2	2.8	1.3	8.6	6.9	1.6
Other	0.7	0.7	0.6	3.9	0.5	0.4

[a] Nonbank financial institutions include microfinance institutions, credit cooperatives, credit unions, or finance companies.

Source: ADB-OECD (2014), p. 31.

The World Bank's latest 'Doing Business' survey also provides some revealing data pertaining to the Asia-Pacific region (World Bank, 2015). One of the ten metrics used to measure the relative ease of doing business in the 189 territories covered is access to credit (the most basic form of finance). Tables 2 and 3 show the rankings of East Asian & Pacific countries and South Asian countries by this particular metric based on the 2015 survey.[2] Surprisingly perhaps, Cambodia ranks first in the former subregion, ahead of (less surprisingly) Singapore and Hong Kong, China; and Malaysia. At the other end of the spectrum, Myanmar, Papua New Guinea and Timor-Leste rank lowest on access to credit. In the South Asian subregion, India ranks top-most for access to credit,