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Private equity and SMEs: an instrument for growth

Jean-Michel Severino *Chairman – IP*

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Stabilising growth in Africa – growth which is real but fragile – depends partly on the dynamism of SMEs, which receive little in the way of private equity support. Funds' profitability can be enhanced, in particular by developing local teams. The levels of funding invested need to be scaled up and the full spectrum of technical support resources should be utilised. Finally there needs to be considerable emphasis on additional investments targeting social objectives.

We're hearing it everywhere: Africa is back on track; its time has come. Growth rates prove it, and the impressive forecasts are stacking up. A booming population combined with GDP increases look set to propel the continent to the equivalent of China's current position, measured in terms of absolute economic value, by 2050. And you can almost hear what comes next: development has happened, aid can be scaled back, case closed – Africa must now become private-sector terrain. A good deal of this description is indeed accurate – the recovery in African growth rates is raising hopes of a renaissance. A middle class is emerging. Civil society is transforming, and exhibiting increasingly democratic values.
Yet this growth is both fragile and unevenly distributed. Fragile, because the African economies are still small, vulnerable to external turbulence, confronted with immense environmental challenges. Their public finances are exceedingly constrained, as evidenced by the recent return to state indebtedness. Unevenly distributed, because not all of the continent's regions are reaping the fruits of this growth to the same extent; nor do the different social categories have fair access to the same opportunities. Africa will struggle to contend with these constraints and challenges on its own.

An ecosystem of responsible SMEs for sustainable growth

Achieving sustainable growth in Africa partly depends on developing responsible small and medium-sized African enterprises (SMEs). Expansion in this sector – in terms of the number and size of the companies involved – is in itself a driver of growth. A dynamic SME sector has a balancing effect on society through the "middle class effect" it brings about; it creates jobs, spreads wealth, and anchors economic activity locally. Of course it is also necessary that these SMEs genuinely promote sustainable growth – environmental issues are especially crucial here: SMEs are less able to bear the costs involved in managing environmental impacts and their social practices can prove to be less beneficial than those of large corporations.

Nonetheless the role of SMEs is widely celebrated and growing this sector features among the official objectives of all the bilateral and multilateral cooperation programmes. Many development banks have set up ad-hoc programmes and European financial development institutions have been intervening in this area on a regular basis for many years. Even so the support systems in place for SMEs have remained unambitious in number and limited to a handful of instruments: comprising on the one hand public technical support (or "upgrading") programmes, on the other refinancing or guarantee instruments offered to the primary banks. These instruments are useful and important and should be reinforced. Yet however impressive they sound, they do not provide a means of tackling the endemic problem of capital financing for SMEs.

This problem has been so well known for so long that most countries in the Organisation for Economic Cooperation and Development (OECD) have set up dedicated state support schemes benefiting their own SMEs in order to address it. In the vast majority of cases these SMEs find themselves in a tight situation in terms of their equity capital: they can be suffocated by their own growth, limited by their owners' financial capabilities or effectively barred from accessing the long-term external financing typically provided by the private equity industry. In France for example, there are schemes to support innovation (FIPs1), and local SMEs (FCPIs2) – all supported by fiscal expenditure. Then there are OSÉO's3 interventions in the form of quasi equity and debt, backed by the substantial funding available to this financial institution and facilitated by the triple-A rating it owes to its public status.

Africa's private equity boom has not benefited the continent's SMEs. International and continental funds have focused mainly on the telecommunications sector and major infrastructures (primarily energy), and have concentrated on the more highly developed nations to the north of the continent and on South Africa. This trend is even more pronounced for small SMEs (with fewer than 100 employees). And the situation is even worse for start-ups – companies established within the last five years, which play a key role in driving economic dynamism. It is these newly formed, small-scale SMEs that constitute the core of future development: they will be the engine driving African growth in the future, its central ignition system. And yet they are entirely neglected, absent from collective concerns – and from the interventions of private equity.

Improving investment profitability

Low levels of savings, the inadequacies of the banking system and the limitations of the entrepreneurs themselves make the challenges of accessing private equity familiar to SMEs in other parts of the world even more acute in Africa. The same is true with regard to accessing private equity funds. We might assume that investment funds' lack of interest in small companies derives from their lower profitability compared with that of large corporations. However, neither claims levels nor profitability differentiate the potential performance levels of instruments dedicated to large corporations or to SMEs. What makes the difference is management costs. In Africa, front-end and management costs are exceptionally high compared with the unit values of the transactions, in an industry where fixed costs are the rule. This has an automatic knock-on effect on net profitability for investors. Moreover, when the investment objectives are innovative profitability may be limited – resulting in extended investment periods or higher losses compared with the portfolio average. Which explains investors' relative disinterest in this target category – and, in consequence, the low number of management teams dedicated to this sector.

The profitability of equity or quasi equity investments in African SMEs could improve given two scenarios: more local teams operating with lower charges within a local market; or the development of teams of a significant size capable of industrialising the process and spreading their structural costs over a substantial portfolio. The former scenario is realistic and is already starting to happen. Yet the process is very slow, because of the low levels of human resources available (which are therefore expensive) and the scarcity of local capital – which means that these teams need to find international backers, who are difficult to identify and persuade.

The second scenario is also possible, taking as a basis the international teams already in place or some national teams – like those currently emerging in South Africa or north of the Sahara, for example. Yet here too the process will take time; the market's natural processes will not of themselves offer any shortcuts. Developing a strong SME sector certainly involves the provision of more long-term financing, among other things; yet it also requires a dedicated programme of initiatives. This needs to be one of the general interest objectives of development policies if we wish to accelerate the growth process in a meaningful way.

Promoting the growth of private equity

As was the case for microfinance, accelerating the growth of private equity to benefit African SMEs involves deploying a range of complementary strategies. First of all the funds made available to private equity teams targeting SMEs need to be increased. Too many public finance institutions supporting the private sector continue to have excessive financial requirements with regard to this category. Like FISEA, the Investment and Support Fund for Businesses in Africa set up by the Agence Française de Développement (AFD), it is important that bilateral or multilateral private-sector finance institutions establish "patient investment" categories which can benefit social business4 in general and SMEs in particular. Some bilateral co-operations could take on the role of subsidising the instruments with the most socially beneficial objectives.

Private individuals also represent significant potential contributors. They could be further encouraged, in France, by extending the fiscal measures relating to income tax and the solidarity tax on wealth ("impôt de solidarité sur la fortune" or ISF) which benefit the FPI and FCPI schemes – and by equivalent measures in other countries. These tax schemes' yield in development terms could prove significantly higher than that of traditional tax-funded development aid. Admittedly these tax schemes are not very popular in France, but these investors could be given additional or alternative encouragement by insuring their investment risk using a mechanism like the ARIZ scheme5 or by setting up schemes to cover initial losses. The fact that such mechanisms incorporate an element of indirect subsidy should not be a deterrent, if the aims and outcomes of these funds do serve the general interest and if the returns achieved by investors are clearly below market expectations: what is happening here, effectively, is the co-financing of public policy. The same arguments can apply to the final category of potential investors: industrial and financial businesses implementing a social and environmental responsibility strategy involving the creation of investment funds designed to have an impact.
The second category of resources needing rapid deployment is technical support. Small and very small businesses have only very recently started to gain access to this resource. Private equity funds can use this instrument efficiently to benefit the companies in which they are investing. The larger the intervention the greater the tangible impact it can have: alongside ad-hoc technical expertise it is also possible to finance medium-term management positions during the start-up phase, to provide training and to facilitate evaluations. This final point is very important: capitalisation, formalisation and feedback are crucial to drive progress in a sector which is feeling its way forward, laying down new pathways for development policy. It is also important to help the fund management teams themselves progress: often young and facing significant professional challenges, almost all of them need strengthening, particularly in relation to the quality of environmental and social management. Building African teams focused on small businesses is an objective in its own right, involving a commitment to developing this profession and taking the risk of supporting emerging, relatively inexperienced teams. There must be a willingness to accept potential losses – relatively easy here because the sums involved are limited – and to support training in universities and higher education institutions.

Greater environmental awareness

Supporting African SMEs, it must be emphasised, involves more than just developing a private equity industry adapted to the context. The legal and fiscal business environment, the quality and cost of infrastructures and essential services, the availability of human resources, openness and the international commercial context, the performance of public services, etc. are all factors which can boost – or impede – the dynamism of SMEs.

Nonetheless the development of impact investment – using financial instruments which combine social objectives with targeting a financial return – will play a crucial role in the major battle to stabilise African growth which has been under way for a decade or so, following the long and depressing period of structural adjustment. In order to ensure that this era is firmly consigned to the past it is vital that sufficient energy and resources are devoted to this objective, especially by public organisations and private development institutions.

Footnotes

1 FIPs (Fonds d'Investissement de Proximité – local investment funds) were created by the Dutreil Law in 2003, supplementing the SME support system already provided by FCPIs (Fonds Communs de Placements dans l'Innovation – innovation investment funds).
2 FCPIs (Fonds Communs de Placements dans l'Innovation – innovation investment funds) were created by the 1997 Finance Law to support the growth of high-potential innovative companies.
3 OSÉO is a French state-owned company whose primary objective is to help SMEs and medium-sized businesses secure funding, supporting their ability to drive innovation and growth.
4 This new kind of business was defined by Nobel prizewinner Muhammad Yunus: an enterprise which devotes its profits to reducing costs and producing social benefits, returning no more than the initial investment to investors.
5 ARIZ is a guarantee scheme created by the Agence Française de Développement to make it easier for private SMEs and microfinance institutions to access financing.