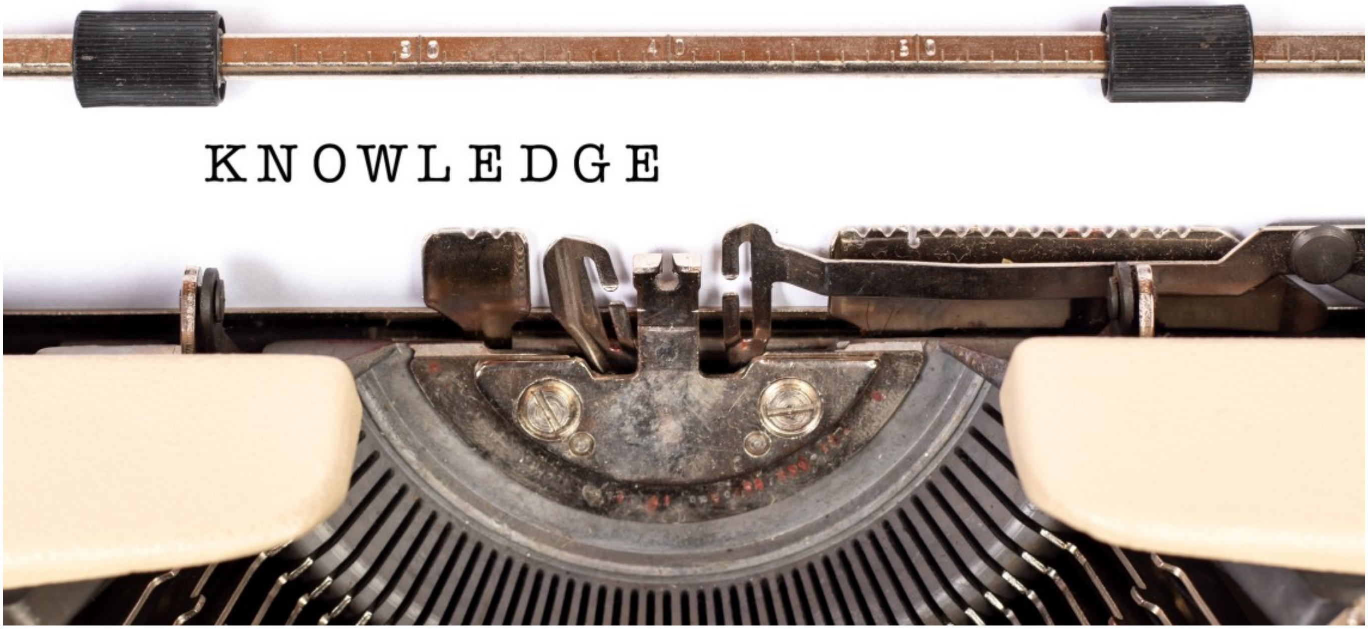
Private Sector & Development

A blog coordinated by Proparco

Understanding SMEs in developing countries to meet their needs more effectively

Bertrand Savoye *Senior Economist – AFD*

September 23 2019



There is now universal agreement on the crucial role of SMEs – which comprise the bulk of businesses in developing countries – particularly in creating jobs. Nevertheless, there are many different – sometimes erroneous – interpretations concerning their financing requirements. The goals of SMEs are not the same as those of big corporations and it is only by understanding these goals more effectively that we can deploy the instruments and processes that will help SMEs to access the funds they need more easily.

PS&D

This article is an excerpt from Issue 32 : SME finance in Africa: what's new?

Dynamic, flexible, innovative and more human in scale… Small and medium-sized businesses (SMEs) are now credited with every virtue. While economists and decision-makers do not always agree on how exactly to define them, notably in developing economies, they are unanimous in recognizing the role they play together with their qualities. So the question is no longer one of how to promote them but how to do this as effectively as possible.

When the shortcomings of SMEs become advantages

Financial backers have a perfect right to wonder what they can realistically expect from this population of diverse businesses which are generally fairly small in size. For industries in developing and emerging countries alike, economies of scale and capital intensity increase with size. The same goes for apparent labor productivity and average wages for people with similar qualifications.
So big business seems to have everything going for it.
In fact, the contributions of SMEs and large corporations cannot be treated in isolation: the strengths of one become the weaknesses of another. So SMEs are more flexible – but working conditions are often precarious and wages lower. They are innovative but their innovations are generally of a peripheral nature and – given the amount of R&D required – radical innovation generally remains the preserve of large corporations. On the plus side, while working conditions are often more difficult in SMEs, their local presence helps to forge valuable social ties that are only appreciated when small shops are forced out of urban centers for example. And above all, while they are in effect less productive than big companies, their extensive growth pattern helps create much more jobs. In general, the bigger the company, the less jobs they create on average. Indeed, beginning in the 1980s, very large corporations even began suffering from negative employment elasticity and productivity gains were accompanied by job cuts as part of intensive growth strategies.

> *In fact, the contributions of SMEs and large corporations cannot be treated in isolation: the strengths of one become the weaknesses of another.*

Within any production system, SMEs and large companies play largely complementary roles and we have even observed increasing financial concentration and a decrease in average business size linked partly to decisions by big business to reorganize around smaller structures. The popularity currently enjoyed by SMEs can partly be attributed to the rise in unemployment being driven by fluctuating oil prices, increasing awareness of the major contribution of SMEs to employment and the boom in market services. Because economies of scale and capital intensity play a far smaller role in most service activities, size is less of a barrier to entry and a medium-sized business may be optimal in terms of combining competitiveness and flexibility. This is the reason why large corporations predominate in industry and over three-quarters of SMEs are present in trade and services.

From the “missing middle” to the “missing large”?

In industrialized countries, interest in SMEs dates from the early 1970s with the publication of Small is Beautiful as part the backlash against the preoccupation with economic productivism. In Africa, the interest is more recent and came in the wake of the focus on the informal sector in the 1970s and 80s. SME’s first became a topic of interest as part of efforts to understand why there were so few of them, summarized by the notion of the “missing middle”. This notion has since been challenged: the bulk of SMEs are in the service sector where they escape statistical detection in studies that often focus on only one industrial sector.

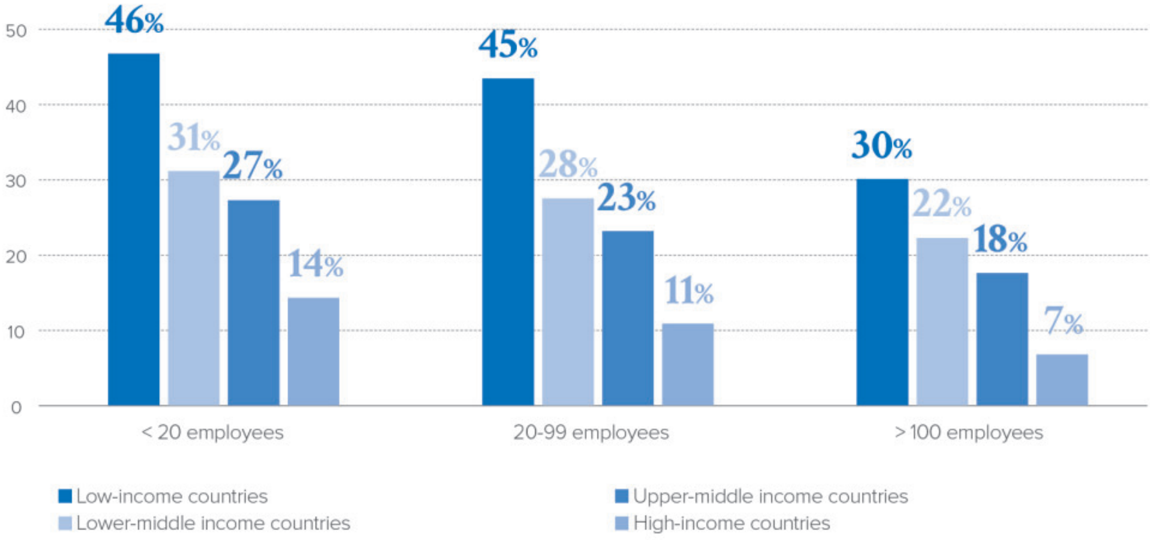
This remark on statistical data raises the tricky question of estimating the number of SMEs and their weight in African economies. It also highlights the need to use precise definitions of size and thresholds (upper and lower limits) and what the notion of a business actually refers to , otherwise variances between estimates can be quite considerable (in the order of 1 to 100 in Senegal, for example). Ideally, there should also be a standard official definition between African countries – just like there is in the EU – instead of different national definitions: SMEs are defined as companies with less than 100 employees in Cameroon, less than 200 in Morocco and Côte d’Ivoire, less than 300 in Tunisia, with turnover of less than two billion CFA francs in Senegal, etc.

In the absence of accurate statistics, we may advance figures that are more or less comparable with those found in other parts of the world. In most developed countries, companies without employees – when they are actually included in statistics – generally account for a little over half of companies while microbusinesses with less than 10 employees account for nine-tenths of all businesses. The less developed the economy, the higher this figure tends to be. In Africa, enumeration difficulties are accentuated by the notion of the informal sector which can lead to the exclusion of units that would be considered microbusinesses in other regions due to their numerous similarities with this type of business. The proportion of microbusinesses exceeds 95% and microbusinesses and SMEs taken together account for virtually all businesses in existence.

> *In most developed countries, companies without employees – when they are actually included in statistics – generally account for a little over half of companies while microbusinesses with less than 10 employees account for nine-tenths of all businesses.*

SME access to external financing

Average % of SMEs who consider access/cost of financing to be a major constraint on their business activities.



Source: Dalberg, 2011.

Objectives, strategies and constraints on SMEs

SMEs come in all shapes and sizes (self-employed contractors, small- and medium-sized businesses, microbusinesses, etc.) but they also differ in terms of their objectives and the strategies they deploy in pursuit of these. While large businesses have little alternative other than to increase their profitability or win new market share, the aims of SMEs are extremely varied and are often indissociable from those of the head of the business or the family that owns it. Consequently, most SMEs are focused more on perpetuating the business than on accumulation or growth strategies. Many are reluctant to hire people and expand – even though their business is experiencing considerable growth – because the owners prioritize non-economic objectives, prize their independence or quite simply because they just want to do a job instead of growing a business. These objectives illustrate why certain public policies are inadequate or much too ambitious. For example, you cannot automatically assume that job support measures will create more jobs.

They also color the perception of the difficulties encountered by SMEs. When developing country businesses are questioned about their problems, the most frequently cited worries relate to the business environment, the effects of corruption and different forms of unfair competition. Next comes instability and unclear taxation guidelines, poor security for production facilities and land, insufficient and volatile demand, poorly trained labor and of course tight credit and high interest rates charged together with the collateral required and the term of the guarantee.

Major financing difficulties but needs are probably overestimated

Unlike other concerns, financing difficulties are considerable and the smaller the size of the business the greater they are (see diagram). In the Worlds Bank’s 2010 World Business Environment Survey, these problems were ranked second in order of importance by SMEs but only in fourth place by larger businesses.

While companies the world over generally find banks to be extremely cautious, the banks themselves insist that “bankable” investment projects will always find a financial backer. The truth probably lies somewhere in between. In the first special report of this magazine – written on the same topic 10 years ago – Paul Collier sensibly pointed out that the financing of African SMEs combines two difficulties: lending to the African private sector is riskier than in the rest of the world and financing a small business is riskier than financing a larger one. However, in the same edition, Paul

Derreumaux, who was CEO of BOA at the time, recognized that banks had not earmarked the resources needed to meet the financing requirements of these customers. This reluctance was due in large part to the yields on government bonds.

> *While companies the world over generally find banks to be extremely cautious, the banks themselves insist that "bankable" investment projects will always find a financial backer. The truth probably lies somewhere in between.*

Just like estimates of the number of SMEs and their contribution to employment or value added, the amount of financing requirements not met by the financial system should be treated with extreme caution. These are taken from macroeconomic estimates of potential financing demand that are underpinned by many assumptions. If we adopt a macroeconomic perspective, a number of questions need to be addressed, notably concerning the whole area of investment credit. The first apparently trivial question is whether the company actually feels a need to invest. While a large company will always have an annual investment programmer that needs to be funded, this is by no means the case for an SME. Once the initial investment has been made, very few entrepreneurs actually reinvest because the way the business is run – we're usually talking about small retail operations, building or personal services or handcraft production – does not require this and the business owner is not necessarily focused on accumulation or growth. And, supposing the business does wish to invest, does it need an external source or can it self-finance? Because interest rates are high – especially for micro loans for microbusinesses – and the activities in question are often highly profitable, owners are frequently able to self-finance their investment. If this is the case, they prefer this solution. Next, if the business feels it needs outside finance in the form of a bank loan, it needs to apply for this and to submit a valid loan application. If the application is accepted, the project must be "bankable" in terms of its quality and the financial strength of the business. Applying these different filters ultimately produces financing estimates that are lower than those generated using macroeconomic methods [3].

In conclusion, SMEs make an invaluable contribution to employment which is without doubt the key challenge facing Africa's economies. While access to funding represents one of their key difficulties, their expectations and the estimates of their financing requirements are often disproportionate and this is where it becomes useful to define policies and instruments that reflect realistic objectives.

> *knowledge of policies that seek to improve SME access to bank funding is still fairly sketchy and further study is required.*

It remains to be seen whether technical and financial partners4 can come up with financial instruments (concessional loans, risk sharing mechanisms, venture capital, etc.) that will have a real positive impact on access to financing and the performances and health of businesses. Most studies focusing on the links between finance and growth have found a positive correlation between financial development and growth precisely due to the lessening of constraints on the external financing of businesses. However, as scientific impact assessments are more difficult to carry out in meso-finance than in microfinance for a number of methodological reasons, knowledge of policies that seek to improve SME access to bank funding is still fairly sketchy and further study is required to ensure that these supports are not limited to windfall effects for financial institutions.

Footnotes:

1 This question arises in developed countries (should we include contractors and self-employed people, companies without employees, etc.?) and to an increasing extent in developing countries in relation to informal production structures (that do not keep accounting records).

2 The IFC estimates these at USD 330 billion.

3 According to an AFD study on the industrial sector in Madagascar, 40% of sole-trader businesses and 55% of companies said they needed a loan; 13% and 25%, respectively had applied for a loan, and 3% and 14% respectively, were actually granted the loan. Of those businesses who were refused, one-third were in a loss-making situation. If we consider that all profitable businesses should have been granted a loan, the percentage rises from 3% to 7% of sole-trader businesses and from 14% to 17% of companies, i.e., disparities that correspond to a relatively low level of solvent financing requirements not being met by the banking system (see http://bit.ly/2JbSn65)
4 Such as the French Choose Africa initiative which will invest €2.5 billion to help 10,000 businesses grow between now and 2022.

References

Cadot, O., Disdier, A-C., Gourdon, J., Héricourt, J., Suwa-Eisenmann, A., 2014. "Évaluer l'impact des instruments financiers en faveur des entreprises", Document de travail n°137, AFD, Paris.
Chauvet, L., Ehrhart, H., 2015. "Aid and growth. Evidence from firm-level data", Working paper n°563, Banque de France, Paris.
Collier, P., 2009. "Repenser le financement des petites entreprises en Afrique", Secteur privé et développement, n°1, Proparco, Paris.
Derreumaux, P., 2009. "Les difficultés de financement des PME en Afrique : à qui la faute ?", Secteur privé et développement, n°1, Proparco, Paris.
Hsieh, CT. et Olken, B., 2014. "The missing "missing middle", Journal of economic perspectives, vol. 28, n°3, Pittsburgh.
IFC, 2017. "MSME Finance Gap, assessment of the shortfalls and opportunities in financing micro, small and medium enterprises in emerging markets", World Bank Group, Washington.
Quartey, P., Turkson, E., Abor, J., Iddrisu, A., 2017. "Financing the growth of SME's in Africa : what are the constraints to SME financing within ECOWAS ?", Review of Development Finance, Vol. 7, Issue 1, 2017.
Savoye, B., 1996. "Analyse comparative des microentreprises dans les pays en développement et dans les pays industrialisés", Revue Tiers Monde, vol. 37, n°148, Paris.