MAKING CAPITAL MARKETS WORK FOR SMEs in AFRICA

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The 21st century is being touted as Africa's century. This is because since the beginning of this decade, African growth rates have finally exceeded those of the world in general- a very welcome and positive development. Since the mid 1990s, the percentage of the population living with less than US$1 per day and less than US$2 per day has declined[1]. Between 2001 and 2008, growth in gross domestic product (GDP) on the continent averaged 5.9 percent annually. This growth was accompanied by significant flows of FDI into the region, leading to a near doubling of FDI stocks between 2003 and 2007 according to UNCTAD. In 2008, Africa grew by an impressive 5.2 percent; the sub-Saharan African (SSA) region grew even faster, at 5.5 percent. While this growth has allowed African countries to reduce poverty in recent years, income levels remain low and there is still much to be done in order to realize the MDGs by 2015. The African growth rates also continue to be much lower than those of the group of developing countries from Asia, a region that has raised the living standards of its citizens significantly over recent decades. The financial crisis around the world also played a part by halting and worsening a lot of the progress that has been achieved.

Nonetheless, recovery from the crisis is currently under way across the continent. We have seen the results of prudent macroeconomic policies over the last decade. This was one of the main reasons why the issues arising from the financial crisis were curtailed. The next step we have to take is to focus on other necessary reforms that will lead to economic development. One such is to create the enabling environment that will support the real sector, such as small and medium-sized enterprises (SMEs). Our growth story needs to continue and this can be facilitated through the diversification of our economy. An excellent channel is through the development of our financial systems. Our financial systems are currently dominated by the banking system which means there is an urgent need to develop our financial markets. Financial deepening especially helps those industries more dependent on external finance and also helps to reduce financing constraints, particularly for smaller firms. SMEs are the backbone of an economy and therefore one of the key roles the financial markets can play is in the provision of finance to SMEs.

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[1] Regional Economic Outlook, *Sub-Saharan Africa- Back to High Growth?* April 2010

The paper is organized as follows: Section **2** discusses the definition and characteristics of SMEs as well as the value they bring to an economy. Section **3** mentions the constraints faced by SMEs in Africa. Section **4** analyzes the reasons why financing SMEs is important and the constraints they face when accessing finance. Section **5** discusses the role of capital markets in economic development. Section **6** considers capital markets as an alternative form of finance for SMEs in terms of equity financing and venture capital and the constraints they can face. Section **7** highlights key intervention in promoting SME development and looks at what various jurisdictions are doing. It also looks at the role of government and international finance institutions in developing SMEs. Section **8** makes some recommendations before the conclusion in section **9**.

What are SMEs?

The definition of SMEs varies depending on the region/country and the threshold that is used. Definitions in use today define thresholds in terms of employment, turnover and assets[2]. In the United States, small businesses that are defined by the number of employees, refers to those with fewer than 100 employees, while medium-sized business often refers to those with fewer than 500 employees. In the European Union (EU), companies with fewer than 10 employees are defined as "micro", those with fewer than 50 employees as "small", and those with fewer than 250 as "medium". For developing countries, small-scale enterprises would generally mean enterprises with less than 50 workers and medium-size enterprises would usually mean those that have 50-99 workers.

In Nigeria, for example, the criteria of employment and paid up capital is used. Small enterprises are defined as those employing less than 50 people with assets (excluding land and buildings) below N50m ($328, 947) and a 'medium' enterprise in Nigeria is seen as one which employs less than 200 people with assets less than N500m ($3,289,473). In Uganda, a small-scale enterprise is an enterprise or a firm employing a maximum of 50 employees, with the value of assets, excluding land, building and working capital of less than Ug.shs 50 million (US$ 30,000), and the annual income turnover of between Ugshs.10-50 million (US$6,000-30,000). A medium-sized enterprise is considered a firm which employs between 50-100 workers[3].

SMEs are a very heterogeneous group. As Kristine Hallberg describes it, they include a wide variety of firms—village handicraft makers, small machine shops, restaurants, and computer

[2] Causes for SME Financing Difficulty, International Journal of Business and Management, Vol.4, No.6, June 2009
[3] Louis Kasekende and Henry Opondo (2003) *Financing Small and Medium-Scale Enterprises (SMEs): Uganda's Experience*, Bank of Uganda Working Paper

software firms—that possess a wide range of sophistication and skills, and operate in very different markets and social environments. Their owners may or may not be poor. Some are dynamic, innovative, and growth-oriented; others are traditional "lifestyle" enterprises that are satisfied to remain small[4].

SMEs are the main source of employment in developed and developing countries alike. In the US for example, the SME sector is said to provide 67% employment and 61% manufacturing sector output. In Korea, there are over 30 million SMEs constituting about 99.9% of the enterprises and employing over 88.1% of the labour force. Similarly, in Africa, SMEs comprise over 90% of African business operations and contribute to over 50% of African employment and GDP. In Nigeria, SMEs account for some 95 per cent of formal manufacturing activity and 70 per cent of industrial jobs. The real sector of the economy, comprising manufacturing, solid minerals and agriculture sectors- is where most SMEs fall into. They employ an average of 50 percent of the working population as well as contributing up to 50 percent to Nigeria's industrial output. In Morocco, 93 per cent of all industrial firms are SMEs and account for 38 per cent of production, 33 per cent of investment, 30 per cent of exports and 46 per cent of all jobs[5]. These examples confirm that SMEs are an integral part of society and that they are critical to economic development.

The Value of SMEs in an Economy

Entrepreneurial activity is crucial to fostering economic and social progress on the continent. The Global Entrepreneurship Monitor, a research program aimed at assessing the national level of entrepreneurial activity in selected countries, conducted an entrepreneurship and economic growth study on 37 countries in 2002. According to the study, the economic growth of a country is directly correlated to its level of entrepreneurial activity. In particular, there is a high correlation between economic growth and entrepreneurial activity in industrialized countries. For instance, the American economy is well known for its flexibility, adaptability, and grasping of opportunity partly because of a prevalence of entrepreneurial culture in the United States. According to the report, countries that are able to replenish the stock of businesses and jobs and have the capacity to accommodate volatility and turbulence in the entrepreneurial sector are best placed to compete effectively.

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[4] Kristen Hallberg, A Market-Oriented Strategy for Small and Medium-sized Enterprises, IFC Discussion Paper No.40
[5] *Source: African Development Bank and OECD Development Centre, African Economic Outlook (2004-2005)*

Looking at a specific country, in 2003, Uganda was ranked the most entrepreneurial country in the world amongst the Global Entrepreneurship Monitor countries with a Total Entrepreneurial Activity [TEA index] of (29.2) signifying that 29 out of 100 Ugandans – almost every third Ugandan is engaged in some kind of entrepreneurial activity[6]. This index was extraordinarily high in both men and women. Entrepreneurship in Uganda is inspired by both "necessity" and "opportunity". Of the 41 countries in the study, Uganda came first followed by Venezuela, Thailand and Mexico. Countries such as Croatia, Hong Kong, Japan and Belgium were ranked at the bottom. This was a remarkable achievement because Uganda outperformed many countries that are more developed and known for their entrepreneurship, including the United States which came 12th. Entrepreneurs and SME development can play a key role through their contributions to economic advancement and social empowerment. They also play a part in poverty reduction, thereby contributing to the realization of the MDGs.

SMEs add value because they are the emerging private sector in developing countries and thus form the base for private sector-led growth. Economically, the presence of SMEs stimulates markets. Entrepreneurs create new enterprises, new commercial activities and new economic sectors which have a positive multiplier effect on the economy. They generate jobs for others; increase research and development; produce goods and services for society; introduce new technologies and improve or lower cost outputs; and they earn foreign exchange through export expansion or the substitution of imports. Their presence is crucial not only for improving the number of employment opportunities for the poor but also the variety and quality. SMEs are the brains of an economy and providing them with an environment to flourish helps foster a knowledge economy. SMEs are also said to be more innovative than larger firms. In developed countries, SMEs often follow "niche strategies," using high product quality, flexibility, and responsiveness to customer needs as means of competing with large-scale mass producers.

For many developing countries, the promotion of SMEs has also been a powerful engine of wealth creation. It helps create wealth for individuals seeking business opportunities and provides them with the chance to pursue entrepreneurial aspirations. Both a new business and the wealth the owner can obtain will help boost the economy by providing new products as well as the spending power created for the entrepreneur. It is also often said that SMEs contribute to a more equal distribution of income or wealth. To the extent that SME owners and workers are in the lower half of the income distribution, promoting the growth of SMEs may lead to a more equitable distribution of income. Socially, self employment serves to empower people and

[6] Global Entrepreneurship Monitor, 2009

generates innovation and changes mindsets. Therefore the promotion of SMEs is a necessary component in trying to achieve economic and social advancement in Africa.

Supporting SMEs will also encourage and enhance the participation of women in the economy since most SMEs are owned by women, especially in the agricultural and informal sectors. Available data shows that they grow up to 70% of the food produced on the continent. We are seeing a growing class of determined women who own their small businesses and they are increasingly being engaged in formal employment and entrepreneurship. They also play substantial roles in micro and small scale businesses and trade and they make up about 60% of the informal sector. **Table 1** shows the share of micro, small and medium scale enterprises (MSMEs) owned by women in six Sub-Saharan African countries[7]. The table clearly shows that most of the countries have a majority female ownership of MSMEs which has in turn led to a majority of female workers in the enterprises.

Table 1: Share of MSMEs Owned by Women in Selected African Countries

	Botswana	Kenya	Lesotho	Malawi	Swaziland	Zimbabwe
% of MSMEs owned by women	75	46	73	46	84	66
% of women workers	67	40	76	40	78	57

Female entrepreneurship can be a driving economic force to spearhead job creation, increase production, boost market innovation as well as augment human resources and skills development. World Bank research has established that women are more likely than men to contribute additional income to household poverty reduction, meaning that giving more women access to credit and increasing their economic power is likely to translate into improved livelihoods for a higher proportion of society[8].

Entrepreneurship and business creation are also a growing alternative for young people whose age group often faces a labour market with high unemployment rates. Traditional career paths and opportunities are gradually disappearing and many young people are taking up the challenge of starting their own businesses as an alternative form of employment. Many countries and several international donors and institutions have identified entrepreneurship as

[7] AfDB-UNIDO report on Promoting SMEs in Africa (2002)
[8] African Development Bank (2009). African Women in Business Report, Private Sector Department.

a key priority in the promotion of youth livelihoods and employment[9]. Indeed, according to the International Labour Office (ILO) in the last decade or so, most new formal employment has been created in small enterprises or as self employment. Youth entrepreneurship is also on the rise not just out of necessity but also because of identified opportunities as well as young people's desire for independence and flexibility in their working lives. In other words, entrepreneurship and self-employment can be a source of new jobs and economic dynamism in developed countries, and can improve youth livelihoods and economic independence in developing countries.

Constraints Faced by SMEs in Africa

Notwithstanding the widely acknowledged role of SMEs in fostering economic growth and development, they have continued to face a variety of constraints. Some of the challenges they face are inadequate infrastructural facilities, shortage of skilled manpower, high rate of enterprise mortality, low level of entrepreneurial skills, lack of a conducive operating environment, restricted market access and cumbersome regulatory requirements. One of the major difficulties SMEs come across, however, is the issue of access to finance. SMEs, especially in developing countries, suffer from lack of access to appropriate (term and cost) funds from both the money and capital markets. This is due in part to the perception of higher risks resulting in high mortality rate of the business, information asymmetry, poorly prepared project proposals, inadequate collateral, absence of, or unverifiable history of past credit(s) obtained and lack of adequate historical records of the company's transaction.

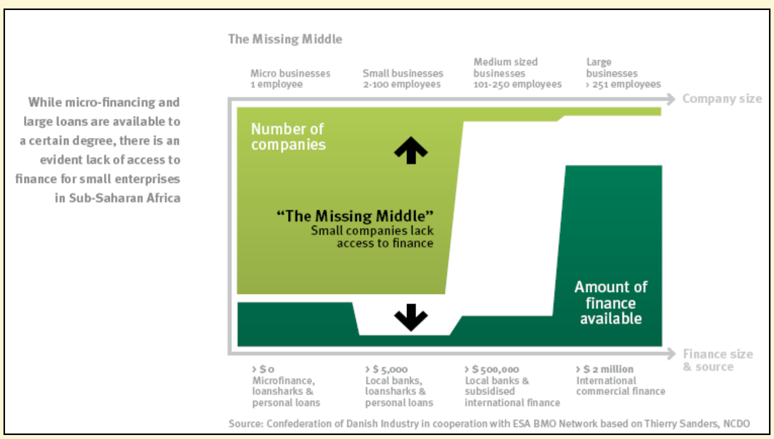
In some cases, there is a virtual absence of capital market facilities and instruments that SMEs can access. For instance, the financial systems in most African countries are underdeveloped and provide few financial instruments. Capital markets are still evolving while other conventional sources have no confidence in the credit worthiness of the SMEs. Non-bank financial intermediaries, such as micro credit institutions, could play a greater role in lending money to the smaller SMEs but do not have the resources to monitor their customers when they expand. The main source of capital for SMEs are their retained earnings and informal savings and loan associations, which are unpredictable, not very secure and have little scope for risk sharing because of their regional or sectoral focus. The many problems SMEs face when accessing finance will be discussed in more detail later on and the subsequent section will highlight the key reasons why access to appropriate finance is of critical importance to SMEs.

[9] OECD 2001; Africa Commission 2008; ILO 2009

1. ***Why is Financing SMEs so Important?***

4.1 SMEs are vital for economic growth and development in both industrialised and developing countries, by playing a key role in creating new jobs. Small and medium-sized enterprises need adequate financing to meet needs at each stage of their life cycle, from creation through operation, development, restructuring, recovery and beyond. Financing is necessary to help them set up and expand their operations, develop new products, and invest in new staff or production facilities. Many small businesses start out as an idea from one or two people, who invest their own money and probably turn to family and friends for financial help in return for a share in the business. But if they are successful, there comes a time for all developing SMEs when they need new investment to expand or innovate further.

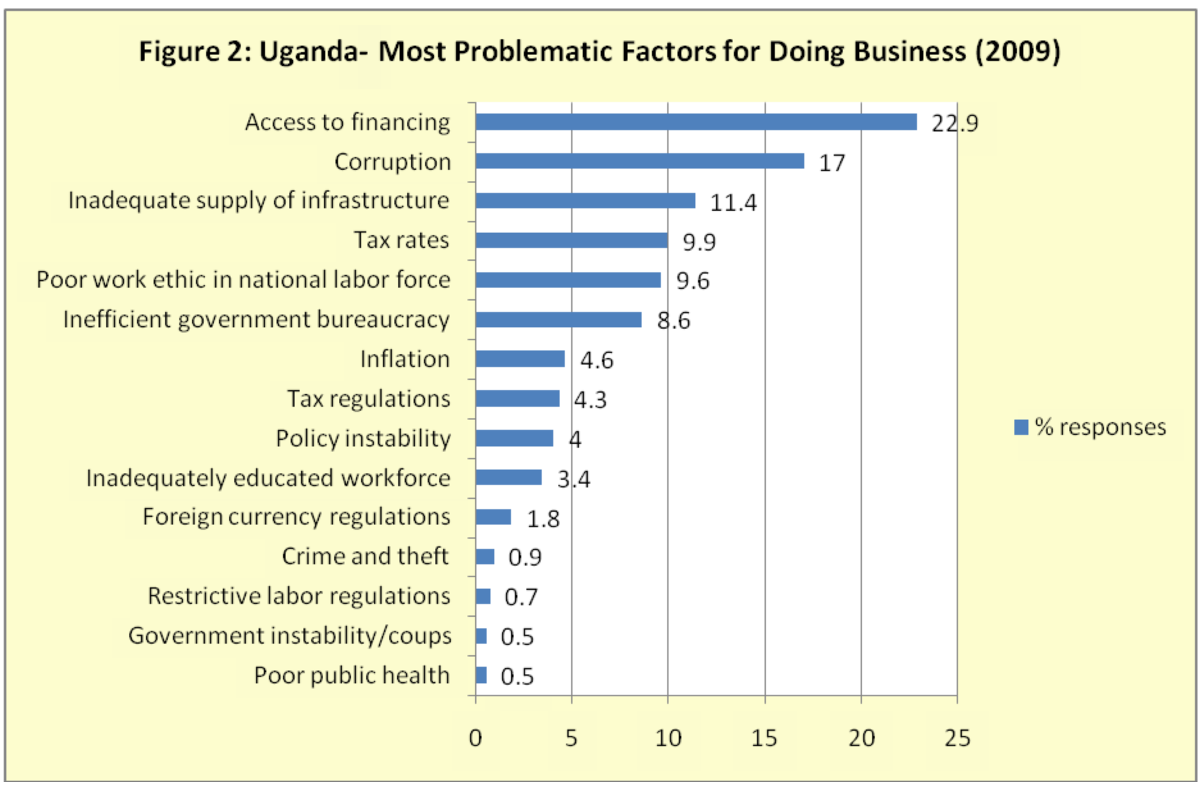
Figure 1
"The Missing Middle"



That is where they often run into problems, because they find it much harder than larger businesses to obtain financing from banks, capital markets or other suppliers of credit. Many African countries have to deal with this chasm between the role of micro credit institutions and that of larger financial institutions. This is the space where SMEs operate and referred to in the Africa Commission's Report as 'the missing middle' and as shown in **Figure 1**. This 'missing middle' or 'financing gap' is all the more important in a fast-changing knowledge-based economy because of the speed of innovation. Innovative SMEs with high growth potential, many of them in high-technology sectors, have played a pivotal role in raising productivity and maintaining competitiveness in recent years. Nonetheless, innovative products and services need investment to flourish, however great their potential might be. If SMEs cannot find the financing they need, brilliant ideas may fall by the wayside and this represents a loss in potential growth for the economy. In some cases, the financing is available but only for a particular sector or type of SME.

Financing Constraints for SMEs

As mentioned previously, SMEs face numerous difficulties during their life cycle. One of the main challenges they have to deal with is the issue of financing constraints. This is because the conditions for financing for SMEs are inferior to that of large enterprises. The lack of access to credit is a major factor in the underdevelopment of SMEs in Africa. **Figure 2** shows the most problematic factors for doing business in Uganda in 2009[10].



[10] Africa Competitiveness Report, 2009

Note: From a list of 15 factors, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

The table shows that access to finance was identified by the respondents (22.9%) as the most significant constraint in doing business in the country. This is quite common in many African countries, including Nigeria, where access to finance was the second most important constraint to doing business (22.3 % of respondents), after inadequate supply of infrastructure. Despite their dominant numbers and importance in job creation, SMEs traditionally have faced difficulty in obtaining formal credit or equity. Banks have also been quite reluctant to service SMEs for a number of well-known reasons, which include the following:

(i) SMEs are regarded by creditors and investors as high-risk borrowers due to insufficient assets and low capitalization, vulnerability to market fluctuations and high mortality rates;

(ii) Information asymmetry arising from SMEs' lack of accounting records, inadequate financial statements or business plans makes it difficult for creditors and investors to assess the creditworthiness of potential SME proposals. SMEs are less structured than large scale organizations and are usually dominated in terms of management style and other characteristics by the promoter. They are therefore perceived as higher risk.

(iii) High administrative/transaction costs of lending or investing small amounts do not make SME financing a profitable business. Since banking credit is a scale economy, it is typically more expensive on a unit cost basis to lend to SMEs compared to larger organizations.

As a result, commercial banks are generally biased toward large corporate borrowers, who usually provide better prepared business plans, have credit ratings, more reliable financial information, better chances of success and higher profitability for the banks. When banks do lend to SMEs, they tend to charge them a commission for assuming risk and apply tougher screening measures, which drives up costs on all sides. Borrowers are typically required to demonstrate that they have sufficient equity to contribute to their businesses, which many small business owners usually lack. Entrepreneurs also tend to lack traditional collateral (such as land) and the credit history needed to qualify for loans. Banks also tend to regard SMEs as unprofitable because of the high transaction costs involved in providing many small-sized loans as opposed to fewer large loans. Even when SME owners are able to access bank financing, the maturities of commercial bank loans are often too short to pay off any substantial investment.

Another problem is that entrepreneurs also tend to have less information about financial products and services because of their higher financial illiteracy rate. The actual cost of finance is also an issue. The lengthy and costly procedures involved in starting and exiting a business often serve as huge deterrents for them. High interest rate payments are also a significant barrier.

This means that not only do SMEs have difficulty accessing finance, they also have to deal with the higher cost of finance relative to the charges larger firms face. This provides a strong rationale for the exploration of alternative sources of funding for entrepreneurs.

Capital Markets and Economic Development

The capital market is a crucial component of a good working financial system and a critical vehicle for a nation's development. The development of a strong capital market is imperative because theoretical and empirical literature have shown that there is a strong, positive correlation between capital market development and economic growth. Stock markets can lower the cost of mobilizing savings and thereby facilitate investment in the most productive technologies. They link those who have the resources to invest with those who could use this capital to turn new ideas into businesses, generating jobs, improving living standards and contributing to the economy. The impact on economic activity also occurs through the creation of liquidity. A well functioning, liquid and broad capital market is crucial to the operation of any emerging economy. Research has shown that countries that have relatively liquid markets tend to grow much faster than countries with illiquid markets. Among other things, liquid markets make it possible to obtain financing for capital intensive projects with long financing horizons. They can therefore lead to faster rates of capital accumulation and general productivity gains. In African countries, improvements in the capital market are essential because they also also facilitate the diversification of their economies.

Looking at how stock markets have evolved, the number of stock markets in sub-Saharan African countries has risen from 5 in 1989 to 16 today. Between 2002 and 2007 their value (market capitalization) nearly doubled to 153 percent of GDP before dropping to 83 percent of GDP in 2008 as a result of the global financial crisis[11]. **Table 2** shows some stock market development indicators for some selected SSA countries. The table shows that except for South Africa and Nigeria, the markets are generally small. Most of the countries have only a small number of listed companies and the average ratio of market capitalization to GDP (about 20%)

[11] Regional Economic Outlook, SSA- Back to High Growth? April, 2010

is lower than in most emerging markets. Market liquidity is less than 10 percent of the value of shares actually traded each year which is considerably low. Low business volumes and small market size present difficulties when attempting to create a world class market and also serves to discourage foreign investors. One potential solution to this is to encourage small markets to move towards integration and create a regional market or cross-border alliances. While there are constraints to this such as the difficulties in creating uniform regulatory standards, a significant advantage would be that larger markets are better able to provide the needed liquidity. It would also increase efficiency and lower transaction costs if implemented successfully.

Table 2:Stock Market Development Indicators for Select Markets (2007)

	Number of Listed Companies	**Stock Market Capitalization**	**Stock Market Capitalization**	**Value Traded**	**Turnover**
		(% Of GDP)	*(billions of US$)*	*(% of GDP)*	
Botswana	18	41.9	5.9	0.9	2.2
WAEMU*	40	32.0	8.4	0.8	2.5
Ghana	32	18.6	2.4	0.7	4.5
Kenya	51	42.2	13.4	4.5	9.8
Malawi	n.a.	12.9	1.8	2.4	0.5
Mauritius	41	73.1	5.7	5.8	7.9
Namibia	9	9.3	0.7	0.3	3.3
Nigeria	**202**	**35.9**	**86.3**	**10.1**	**19.4**
South Africa	401	280.8	833.5	153.4	51.1
Tanzania	n.a.	4.0	1.3	0.1	2.1
Uganda	**n.a.**	**1.2**	**0.1**	**0.1**	**5.0**
Zambia	n.a.	15.6	2.3	0.6	3.1
Emerging Markets					
Argentina	103	31.9	52.3	4.1	9.5

Brazil	392	79.3	589.3	44.5	42.6
Chile	244	118.9	132.4	27.1	22.8
Mexico	131	42.0	232.6	12.9	30.8
Malaysia	1027	156.0	187.1	83.0	53.2
Thailand	476	68.9	102.6	45.1	55.1

*WAEMU- West African Economic and Monetary Union

Source: Financial Structure Database; and World Bank, World Development Indicators.

This means we do have some more to do with respect to our capital markets before they will pave the way for our economic development. Most capital markets in Africa are not sophisticated enough to play the developmental role they need to play. Our rapidly developing economies require a modern financial system that increases the efficiency of investment and contributes to sustainable economic growth. One of the key ingredients to a good working capital market system is an effective regulatory framework governing the markets. This is where the input of a Capital Market Authority comes in. We must strive hard to provide the enabling environment to allow capital markets to grow and become a viable source of finance for all types of businesses.

Capital Markets as an Alternative Form of Finance

The use of the capital market is one such alternative. Capital markets foster entrepreneurship and innovation which in turn, creates job opportunities. This means like SMEs, they have a major role to play in the economic development of a nation. Capital markets are a viable way of increasing financing options to SMEs and would ultimately serve to develop the SMEs. The ability of companies in their early stages of development to raise funds in the capital markets is beneficial because it allows these companies to grow very quickly. This growth in turn speeds up the dissemination of new technologies throughout the economy. Furthermore, by raising the returns available from pursuing new ideas, technologies, or ways of doing business, the capital markets facilitate entrepreneurial activities. However, most African capital markets currently do not have the depth and liquidity to support financing of SMEs. Nonetheless, efforts are being made to increase the sophistication of securities markets all over the continent.

What is the Role of Capital Markets in SME Development?

For entrepreneurship and innovation to thrive, not only does credit need to be accessible, but there needs to be different types of financing. Capital markets are an important source of long term finance, especially since SMEs have been primarily dependent on banks for financing. A financial system that is built on the two pillars of banking and securities markets is stronger than a system that is built solely on banking credit since a well -functioning system would be comprised of various sources of finance. The choice of banks or the market would then depend on the needs of the SME. They are both crucial components of an economy, and it is impossible to say unequivocally which of the two systems is better for economic growth[12]. The capital market can and should compete head on with banks in the supply of debt finance to businesses including those to SMEs. From a regulatory viewpoint, it is necessary for the competition between the banks and capital markets to take place on a level playing field[13]. Therefore, capital markets should be actively promoted as an important alternative source of finance for SMEs, particularly long term finance through equity financing. Equity and debt financing can be made available as well as venture capital funds.

Equity Financing

Equity investors primarily seek growth opportunities, so they are often willing to take a chance on a good idea and provide the needed capital. Equity financing is a strategy for obtaining capital that involves selling a partial interest in the company to investors. The equity, or ownership position, that investors receive in exchange for their funds usually takes the form of stock in the company. This provides small business owners with a broader scope in terms of financing as they gain access to multiple funding sources. In contrast to debt financing, which includes loans and other forms of credit, equity financing does not involve a direct obligation to repay the funds. Instead, equity investors become part-owners and partners in the business, and thus are able to exercise some degree of control over how it is run. As the only way for equity investors to recover their investment is to sell the stock at a higher value later, they are generally committed to furthering the long-term success and profitability of the company. Many equity investors in startup ventures and very young companies also provide managerial assistance to the entrepreneurs and are often good sources of advice and contacts.

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[12] Levine and Zervos (1998) *The American Economic Review*
[13] The Economist, “A survey of global equity markets”, May 2001

While there are many benefits that can be derived from equity financing, there are also a few reasons why there has traditionally been a lack of equity investment in SMEs. The primary reason is that equity investors seek highest return consistent with the risk of investment; SME investments are difficult to evaluate; SME investments take time to mature; and they are often difficult to liquidate. One of the major disadvantages of equity financing is that the founders must cede some control of the business. If investors have different ideas about the company's strategic direction or day-to-day operations, they can pose problems for the entrepreneur. In addition, initial public offerings can be very complex and expensive to administer because of onerous listing rules and other disclosure requirements. Such equity financing may require complicated legal filings and a great deal of paperwork to comply with various regulations put in place to provide credible information to investors. For many small businesses, therefore, equity financing may necessitate enlisting the help of attorneys and accountants. Nevertheless, the benefits tend to outweigh the disadvantages. This is primarily because equity finance raised by an SME provides additional equity cushion for more credit that can further fund growth and expansion.

Venture Capital

Venture capital, on the other hand, refers to the next round of finance in companies that have achieved stability and have strong growth potential. A venture capital fund would typically invest in an SME in a high-growth sector looking to expand its operations. Venture capital can also play a role in buy–outs of more established companies. The involvement of a venture capitalist is usually from two to four years, after which the venture capitalist will typically either sell the shares of the company on a stock exchange, e.g. an initial public offering (IPO), or sell the whole stake in the company, for example, to a more established competitor. Venture capital firms can be key financing vehicles for SMEs and venture capital funds value the possibility of monitoring the performance of the invested business, giving advice when needed and following-up on such advice. Capital markets provide important exit opportunities for venture capital firms enabling them to put their capital at risk to finance other SME opportunities. Specifically, the capital markets provide initial public offerings and other opportunities for venture capital firms to exit an investment in an SME.

Venture capital has the potential of offering a valuable source of finance complementing the more traditional credit finance provided by commercial banks. Some of the fundamental reasons hindering SMEs from obtaining credit from commercial banks and other credit institutions are less important in attracting venture capital. The advantages of venture capital are therefore:

(i) Venture capitalists are willing to accept higher risks than traditional banks in exchange for potentially large gains from the sale of shares in the company.

(ii) Venture capitalists do not require collateral from borrowers.

(iii) Operating costs are lower due to the absence of high interest rate payments

(iv) Venture capital, by nature, is long-term or at least medium-term capital, in contrast to short-term loans from banks.

(v) The managerial know-how provided by venture capitalists can in some cases be more valuable to the start-ups of SMEs than the actual financing received.

However, there are also a number of drawbacks:

(i) As in traditional bank lending, operating costs associated with lending a small amount may discourage investors.

(ii) The need for highly liquid markets is not as pressing compared to open-end funds or mutual funds, since venture capital funds have a long-term involvement in the companies they invest in. Nevertheless, an exit mechanism is necessary for venture capitalists to attain capital gains.

Constraints SMEs Face When Accessing Capital Markets

While SMEs have the opportunity to leverage the capital markets in terms of financing, they unfortunately face relatively high entry barriers to the capital market. In attempting to improve SME access to capital markets, there are several issues that need to be understood and addressed. The first hurdle to overcome is having an adequately developed capital market in terms of depth and liquidity. Second, SMEs, in essence, have relatively high credit risk. While SMEs have high growth potential, they are also more vulnerable to sudden changes in the economic and competitive environment. Third, there exists severe information asymmetry in this segment of enterprises. SMEs' corporate information is often nonexistent, or comes with very high access costs in many economies in the region. Fourth, SME financing is inherently associated with a higher unit cost when compared with that of large corporations. The relatively smaller size of funding, as well as higher information and monitoring costs, leads to higher implementation costs per deal when processing finance in capital markets. Moreover, financial instruments related to SMEs in the capital market are often illiquid, partly because the total amount of the instrument itself is relatively small and because the investor base with matching risk profiles in the market is shallow.

There are also several practical barriers they face when accessing capital markets. The common problems faced by SMEs in raising resources are well known and begin with the initial public offer itself. As a share offering by a medium enterprise cannot obviously be large, the high issue expenses become particularly burdensome. Certain pre and post issue expenses are fixed in nature and do not vary with the issue size. Furthermore, merchant bankers who generally get their fees as a percentage of the issue size, are naturally less enamoured of the SME business. Even after listing a smaller company's stock will more likely be illiquid. In fact a smaller company may have to spend proportionately more on advertising and publicity to gain 'visibility'.

Nonetheless, even with all these hurdles, capital markets can still be an excellent source of funding for some SMEs. Listing on a stock exchange is a transparent and beneficial strategy which provides an exit mechanism for investors, including venture capital firms and the providers. A listing also brings visibility and credibility to the firm further supporting its brand. A stock market quotation, in any case, is an invaluable benchmark.

Interventions in Promoting SME Development

SME's have played a vital role in raising productivity and maintaining competitiveness in recent years. SME's provide brilliant ideas but in some cases, these ideas are never developed due to lack of funding. Due to the developmental advantages SMEs bring to an economy, many governments, international financial institutions (IFIs), NGOs and the private sector are supporting African countries in their efforts to promote the development of SMEs and overcome the financing hurdles they have to deal with.

In Uganda, for example, the government supports the ILO's SME initiative, the Expand Your Business Programme (EYB). It is an integrated business training and support package for small to medium scale enterprises that have growth objectives in mind. The EYB programme in Uganda is coordinated by Enterprise Uganda. Enterprise Uganda is an institution designed to support the government in realizing its objective of promoting the development of SMEs to become the main vehicle for expanding production, providing sustainable jobs and enhancing economic growth. It was established under a framework of the UNDP Enterprise Africa regional initiative. A consortium of local and international donors including UNDP Uganda, Enterprise

Africa, UNCTAD and the Government of Uganda is promoting it. Its concept is based on the Empretec Programme model currently operating in 25 countries in Africa, Eastern Europe and Latin America. The Empretec model is designed as one-stop programme, which provides an integrated and comprehensive range of business support services for SMEs using a hands-on approach. **Box 1** provides some more detail on the objectives of the EYB programme.

Box 1: EYB programme and Enterprise Uganda

The mission of Enterprise Uganda is to develop a new generation of dynamic Ugandan entrepreneurs by actively providing support to the SMEs to enhance their productivity, growth and competitiveness.

The objectives of Enterprise Uganda are to:
-create general entrepreneurial awareness, enhance indigenous entrepreneurship skills and develop an effective entrepreneurial and management training capacity in Uganda;
-develop bankable proposals for business expansion, new ventures and to assist sponsors negotiate for financing;
-enhance the operational efficiency and competitiveness of SMEs to assist companies to diversify into new products;
-develop subcontracting linkages between SMEs and large local private companies as well as government procurement agencies; and
-promote and develop productive, stable and equitable linkages between SMEs in Uganda and foreign companies.

The Bank of Uganda also operates a number of credit schemes and support programmes on behalf of itself, the government and the donors. The credit schemes provide loans to small and medium size enterprises in the private sector through licensed banks while the support programmes are for building the capacity of financial institutions, including MFIs. The credit schemes include: *Apex Private Sector Loan Scheme (Apex)*, which was designed to support small and medium scale private sector enterprises in manufacturing, agro-processing, and services, including tourism and the *Export Refinance Fund (ERF)*, which was designed to provide working capital in support of export of non- traditional exports.

Alternative Stock Exchanges

One answer to the problems SMEs face when attempting to tap into the capital markets is the creation of exclusive stock exchanges for SMEs. There are many SMEs which are excluded from the listed category in spite of having a good track record of growth because they do not meet the listing criteria. A SME-focused stock exchange is likely to boost the confidence of SMEs planning to tap the capital market to raise low cost capital.

Table 3: Differences between AltX and Main Board (Johannesburg)

Listing Requirements	**Main Board**	**AltX**
Minimum Share Capital	R25 million	R2 million
Profit History	3 Years	None
Pre-tax Profit	R8 million	N/A
Shareholder Spread	20%	10%
Number of Shareholders	300	100
Sponsor/DA	Sponsor	Designated Adviser
Publication In The Press	Compulsory	Voluntary
Number Of Transaction Categories	2	2
Special Requirements	N/A	Appoint Financial Directors
Annual Listing Fee	0.04% of average market capitalisation with a minimum of R26,334 and a maximum of R121,700 (including VAT)	R22,000 (including VAT)
Education Requirements	N/A	All directors to attend Director's Induction Programme

Source: Johannesburg Stock Exchange

Some examples of SME dedicated stock exchanges include AltX, Africa's first alternative exchange for SMEs, a partnership between the Johannesburg Stock Exchange Ltd. and the Department of Trade and Industry. AltX allows smaller companies to float shares with a more flexible regulatory system as compared to the main market. **Table 3** shows some of the major differences between the listing requirements for the AltX market and the Main board. It shows how the requirements for the AltX market have been relaxed to cater to SMEs. The creation of an SME stock exchange will also help in bridging the gap between private equity players, venture capitalists and the SMEs whilst providing them with a platform to raise funds in the capital markets.

Another successful SME dedicated market is the **Alternative Investment Market (AIM**), a self-regulated, sub-market of the London Stock Exchange (LSE). Although most AIM-listed companies are not start-ups, most are small and highly risky. AIM combines the benefits of a public quotation with a flexible regulatory approach and allows smaller companies to float shares with a more flexible regulatory system than that which is applicable to the main market. Launched only in 1995, AIM has raised well over £25 billion for more than 3000 companies to date. Flexibility is provided by less regulation and no requirements for capitalization or number of shares issued. Some of the other characteristics of the market include: no minimum shares to be in public hands; no trading record requirement; no prior shareholder approval for transactions (except to reverse takeovers); currency for and easier rules on acquisition; nominated adviser required at all times; no minimum market capitalization; eligibility for a range of tax benefits.

TechMark is another alternative exchange and like the AIM, is a division of LSE. They have the same rules but TechMark is for technology-based companies. There are actually no rules on trading period, public ownership, or capitalization but two sets of lawyers and a corporate broker are required in the process. AIM and Techmark suit companies with a clear intention and prospect of progressing onto the main London Stock Exchange market. Both processes also engage a financial PR firm to ensure the issue is well publicized and achieves its minimum subscription. Each company applying to join AIM must appoint a nominated adviser, popularly known as a 'nomad'. Nomads are responsible, amongst other duties, for warranting that a company is appropriate for AIM. Once admitted to AIM, a company has ongoing disclosure requirements and must retain a nominated adviser.

Ofex is another independent market catering for smaller issues in the UK. The process is quite similar to the AIM and TechMark but slightly less involved. The market is less liquid (sales of shares are infrequent and made amongst a relatively small number of buyers) compared to AIM. There are no minimum trading, capitalization, public ownership, or other requirements other than the basic public limited company requirements. There is a 'sponsor' company and a firm of external auditors and lawyers whom together will undertake an independent audit of the accounts and produce a report and prospectus on the company.

The following are examples from India and Korea which further illustrates what other jurisdictions are doing to encourage SME development through the use of capital markets.

***The Indian Experience*[14]**

In India, policy makers, alive to the special needs of SMEs, created a niche market/ separate exchange for them and also simplified the procedural requirements, thereby reducing certain costs. The OTC Exchange of India (OTCEI) set up in 1990 was the first exchange to deal exclusively with smaller sized companies. It had as its twin objectives helping smaller companies raise capital in a cost effective manner and providing the investors with an efficient and transparent method of trade. The OTCEI has been a pioneer in introducing screen-based trading and market making. Yet it failed to take off, probably because it was ahead of its time.

Securities Exchange Board of India (SEBI) is now addressing the issue by exempting companies listed on the SME exchanges from eligibility norms applicable for IPOs. SME companies for the purpose of these new regulations will have a paid-up capital of not more than Rs. 25 crore (US $5,617,975). They can list on the main boards of National Stock Exchange of India/Bombay Stock Exchange with a minimum paid-up capital of Rs. 10 crore (approx. $US 2,247,190). In what is by far the most noteworthy of the current measures, the minimum IPO application size will be Rs. 1 lakh (approx. US$2250). This way the regulator hopes to have informed financially sound and well-researched investors with some risk taking ability. However, the high minimum requirement will shut out many small investors and will also reduce the number of shareholders. How far that will impact on liquidity of the company's stock remains to be seen. Merchant bankers have been given special responsibility in market making (for a minimum period of three years) and underwriting the issue. Guidelines have been laid down for procedures to be followed when the paid-up capital of the listed company exceeds Rs. 25 crore (US $5,617,975) and when an investor's holding falls below Rs. 1 lakh ($ 2250).

***The Korean Experience*[15]**

[14] Ayan Banerjee, *Capital Market Access to SMEs in India*, Available at: http://ssrn.com/abstract=962033

Capital markets provide an opportunity for loans of banks to SMEs to be securitized. The Korean government introduced the primary collateralized bond obligation (P-CBO) program in order to smooth out liquidity constraints and support SMEs. Started in 1999, the P-CBO program was expanded to include venture firms in 2001. A P-CBO is a type of asset-backed security (ABS) with newly-issued corporate bonds as the underlying asset. SMEs issue new corporate bonds and sell them to a special purpose vehicle (SPV) as an underlying asset. The SPV then issues the CBO based on the pool of SMEs' newly-issued corporate bonds, and sells the CBO to investors in the market. Credit enhancement is provided through various channels, including banks and credit guarantee funds. The SPV issues both senior and junior tranche bonds, with senior tranche usually at AAA grade. From 2000 to 2006, about 17,334 billion won (US $ 15,493,385) was raised for financing SMEs through P-CBO.

P-CBOs offer more fundraising opportunities to SMEs that have low credit ratings. In fact, the distinguishing feature of the P-CBO program lies in facilitating the issuance of corporate bonds to help finance SMEs. Because P-CBOs pool bonds with different levels of risk, the overall risk of default decreases. Also, because the P-CBOs are issued through strict surveillance by credit rating agencies, they are a relatively safe and fairly attractive investment. Furthermore, P-CBOs can offer higher yields than general corporate bonds. In short, P-CBOs can be a useful instrument that can resolve the credit mismatch problem that exists between investors and SMEs, thus filling the financing gap of SMEs.

Government Actions

In order to facilitate active SME financing through capital markets, our government must pay attention to the development and growth of the capital market and come up with ideas to tackle obstacles inherent in SME's, such as sources of funding. The government can play an essential role in alleviating SME's financing gaps in the capital market. In Nigeria, for example, the government introduced the Small and Medium Industries Equity Investments Scheme (SMIEIS), which requires banks to set aside 10% of their profits before tax to improve availability of funds to SMEs. They believe that supporting groups in entrepreneurship is crucial for opening up economic resources and entrepreneurial potential critical to long-term economic prosperity. Nigeria has also taken steps to address the other challenges faced by SMEs as the UN ECA study notes that the Nigerian government has formulated special policy measures and

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[15] Jae-Ha Park, Byung-Chul Lim, Jung-Han Koo (2008) *Developing the Capital Market to Widen and Diversify SME Financing: The Korean Experience*, Korea Institute of Finance.

programs to encourage the development of SMEs including the enactment of favorable laws and regulations on contracts, leasing, and corporate tax, as well as fiscal and export incentives for SMEs.

Government support programmes can complement and support policies directed towards SME development. Government support schemes for business development should be targeted to SMEs and existing programs should be constantly evaluated and revised based on experience, research and best practices around the world. Additionally, governments can promote entrepreneurship through information programmes, which can build awareness of the opportunities afforded through entrepreneurship. Furthermore, they can introduce people to existing economic incentives for entrepreneurial activities and motivate people to take advantage of these. Also, since small businesses often do not meet the conditions for bank loans, governments can endeavour to create an environment that is conducive to entrepreneurial activities, through supportive legislature for example.

International Financial Institutions (IFIs)

One IFI that is greatly involved in the development of SMEs on the continent is the **International Finance Corporation (IFC)**. The IFC has SME Solutions Centers, which are a key component of IFC's support for small and medium sized enterprises in Africa. The centers promote access to finance for small and medium sized enterprises in the region complemented by specific capacity building services. They support small and medium sized enterprises at different stages of business development to enable them to improve their business processes, human resources, structures, and products and services.

The IFC has recognized that smaller businesses generally struggle to attract finances, whether in the form of debt or equity. Traditional long-term bank finance is generally inaccessible to small and medium sized enterprises because they lack the required collateral. To address these challenges, IFC has engaged Business Partners, a fund manager to set up the Business Partners International risk capital fund as the access to finance component of the SME Solutions Centers. Business Partners International (BPI) is a wholly owned subsidiary of Business Partners, a leading South African provider of risk capital to small and medium enterprises. So far, BPI has raised $14.1 million in Kenya and $10 million in Madagascar. IFC contributed 32 and 35 percent of the capital of the BPI risk capital funds for Madagascar and Kenya, respectively. Other international investors include the European Investment Bank, Commonwealth

Development Corporation, Norfund, and Doen Foundation. A number of regional and local institutions have invested in the funds as well, including the Assurance Reassurance Omnibranche in Madagascar, and Trans Century Ltd and the East African Development Bank in Kenya. Using the funds raised, support is extended to qualifying small and medium sized enterprises in the form of equity, quasi equity, and debt financing. Repayment and exit (where equity is provided) is generally achieved from the cash flow of the investee companies.

The SME Solutions Centers commenced operations in 2005, initially concentrating on providing business information and capacity building support to small and medium sized businesses. The BPI risk capital funds for Madagascar and Kenya were launched on September 2006 and January 2007, respectively. More than 450 small and medium sized businesses have received enterprise level support to improve their processes. Over 3,000 employees from these businesses have participated in training provided by the centers. Currently, 16 companies are part of the in-house incubation facilities. More than 170 business plans have been received, out of which a good number are being considered for possible investment.

The European Investment Bank (EIB) is also involved in helping SMEs with their financing problems and has established venture capital funds in Africa. The funds have been used to acquire an equity share in small enterprises and to provide business guidance to these enterprises. The objective was to realize commercial returns by participating in profits and capital gains. All in all, in 2000 the EIB made available 215 million Euros in risk capital to African and some other developing countries.

Another major initiative is the US$ 500 million African Guarantee Facility launched by the **Africa Commission** in conjunction with the **African Development Bank** in May 2009. This facility is intended to provide guarantees and capacity building support for financial institutions and SMEs. The US$ 500 million which will be leveraged three times and will provide risk sharing coverage of 50%, is expected to mobilize US$ 3 billion of loans and US$ 20 billion of SME investments, representing 1.5 per cent of Africa's GDP.

Recommendations

After reviewing the importance of SMEs to the economy, the challenges they face, the various initiatives of governments and stakeholders to foster the SMEs and the outcomes of those initiatives, it is important that a comprehensive approach in resolving the problems of the SMEs sub-sector be adopted. It is clear that SMEs, especially in the developing economies, face numerous challenges, with finance being a major constraint. The following are some recommendations that countries, policy makers and SMEs can consider:

- **Improve on the management expertise and financial reporting of SMEs**: Promoters of SMEs should endeavour to improve the management capabilities required for preparing profitable business plans and effectively managing their businesses. They must also prepare timely, transparent and acceptable financial reports of their companies which would be acceptable to regulators, investors and other stakeholders. Financial reporting is one of the burdens that SMEs face and to address this, the International Accounting Standards Board (IASB) created a simplified version of International Financial Reporting Standards (IFRS) for SMEs. It is shorter than the full IFRS, less complex, easier to comply with and contains greatly reduced disclosure provisions. However, SMEs that are listed are unable to use the IFRS for SMEs and are subject to the full IFRS. Such financial reports will be important in attracting debt and/or equity finance from lenders and investors. Developing an adequate information disclosure regime by adopting clear accounting standards and establishing credit bureaus would also go a long way to encouraging lending to SMEs.

- **Governments in developing economies should consider harmonizing initiatives for supporting the SME sub-sector.** This is very important because there are instances where for instance, a number of government agencies are found to be duplicating efforts in this direction. This was the case in Nigeria until the Federal Government merged three different agencies (NBC, NIDB and NERFUND) into the Bank of Industry (BOI). Harmonizing efforts could lead to greater efficiency and perhaps lead to an improvement in their supportive capacity.

- **Adequate infrastructure**: The governments of developing countries need to ensure the provision of necessary infrastructure such as power, education, water, roads, transportation etc. These are absolute minimum requirements for the SMEs to flourish. Capital markets provide a financing gateway by enabling governments and private firms to raise the funds for infrastructure through the issuance of government and corporate bonds, for example.

- **Fostering the development of innovative instruments and risk sharing arrangements**: Some African countries are already experimenting with innovative financial instruments. For instance, warehouse-receipt financing is helping to guarantee loans with agricultural stocks in South Africa, Kenya and Zambia. Other financial instruments, such as leasing can reduce risk effectively for credit institutions. In addition to innovative financing mechanisms, innovative measures can also be put in place to share risk. Credit associations that reduce risk by sharing it are more common. They help financial institutions choose whom to lend to, by guaranteeing the technical viability of projects and sometimes providing guarantees.

- **Promotion of Venture Capital Companies through Competitive incentives**: Venture Capital funds nurtured the Silicon Valley in the United States. In 2000 alone in Korea, venture capital invested was about 2 trillion won (US $ 1,787,629,603). Venture capitalists can be encouraged through comprehensive and competitive incentives such as tax breaks/holidays. Viable and diverse exit strategies must also be put in place for the venture capitalists. Above all, a key success factor for venture capital is the provision of a conducive operating environment throughout the entire life cycle.

- **Funding through the Capital Market**: It is important to find ways of easing the processes and costs of SMEs sourcing of funds from the capital market as well as getting listed. The following options could be considered:

  a. **Creation of platforms on the Stock Exchanges for SMEs:** The example of the Alternative Investment Market ((AIM) in London is instructive, considering the amount of money so far raised on the AIM (about 25 billion pounds for about 3000 companies across the globe). Our SMEs can benefit greatly from these types of initiatives. It should be noted however, that a number of countries already have such platforms. For instance, Nigeria has the second-tier securities market which is meant for companies in this category, though it is still yet to be operational. What needs to be done is a thorough review of the listing requirements of this market as well as vigorous public enlightenments and support policies to get the companies to move to the market.

  b. **Develop Asset Backed Securities (ABS): -** This could take the form of the P-CBO of Korea. The SMEs could sell corporate bonds which will be the underlying assets to some special purpose vehicle (SPV) This SPVs will pool the different corporate bonds sold to them by the SMEs and in turn, sell to investors. In this way, even SMEs with low credit ratings will be able to raise money while the weighted risk of the bonds in the pool will minimize the risk exposure of the investors.

Conclusion

SMEs in Africa are the catalysts of economic growth and development, as well as the backbone of the nation. They are a very important component of an economy, especially in Africa where they make up the majority of enterprises. SMEs are increasingly taking the role of the primary vehicles for the creation of employment and income generation through self-employment, and therefore, have been tools for poverty alleviation. SMEs also provide the economy with a continuous supply of ideas, skills and innovation necessary to promote competition and the efficient allocation of scarce resources.

Access to finance for SMEs is a key challenge to supporting sustainable growth in Africa. Many policymakers agree that in order to increase SME access to finance, alternative sources of funding must be explored. Capital markets are a viable way of increasing financing options for SMEs and would ultimately serve to develop both the SMEs as well as the capital markets. The financial support that capital markets could provide them will increase economic development in the continent.

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