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Small and Medium Enterprises as Tools in International Development

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Small and Medium Enterprises as Tools in International Development

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Abstract

Small and Medium Enterprises as Tools in International Development

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This report analyzes Small and Medium Enterprises and their use as a development tool. There is evidence to suggest that Small and Medium Enterprises can create jobs and offer wage premiums to employees. Because of these development benefits, in the last ten years, there has been a substantial industry built around supporting Small and Medium Enterprises in developing countries. The report examines the theory of change surrounding Small and Medium Enterprises and then explores the three main challenges that affect their growth and success: financing, human capital, and the enabling environment. For each challenge, the report examines how it affects Small and Medium Enterprises, solutions to the challenges, and the solutions' level of impact. Ultimately, the report offers a research agenda as well as policy recommendations for Small and Medium Enterprises in international development.

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Introduction

Small and Medium Enterprises (SMEs) have increasingly become a focus in the international development field over the last five to ten years.[1] SMEs are seen as valuable development tools because of their job creation, wage premium, and GDP effects. To encourage and assist SMEs, a support sector has developed. The support sector works to address some of the challenges that inhibit SMEs from being the development tool they could be. These challenges include: financing, human capital constraints, and the enabling environment.

The focus on SMEs in development is still relatively new, and there does not seem to be a review of the SME support industry's impact. This paper is designed to fill that gap: given that SMEs are a viable development vehicle and there are challenges to their operation, how are these challenges being addressed and what is the impact?

In writing this paper, there was an extensive literature review of development organizations' publications, academic publications, and SME support sector publications. With that research base, Chapter Two will examine both debt and equity SME financing markets and discuss how impact investing and innovative debt practices address the financing issue. Of the three challenges, there has been the most attention on securing financing for SMEs. Chapter Three will analyze the lack of human capital, both managerial capital and in the general workforce; it will also assess organizations that have developed to support human capital development. Chapter Four will look at the enabling environment for SMEs and the difficulty in addressing this issue. Finally, Chapter Five will offer research and policy suggestions to further develop the industry.

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[1] International organizations' and countries' definitions vary, but the most common definition is that SMEs are businesses with a maximum of 250 employees.

Chapter One: SMEs

In the last ten years, there has been an increased focus on Small and Medium Enterprises (SMEs) as an international development tool. This is apparent in the increase in development organizations' SME involvement, the number of players in the SME industry, and the push for industry wide coordination and standardization.

Nearly all of the main development players have shown interest in SMEs. Since 2007, many bilateral and multilateral development organizations have begun SME initiatives. These organizations include the International Finance Corporation (IFC), the UK Department for International Development (DFID), the United States Agency for International Development (USAID), the Inter-American Development Bank (IDB), and the Japan International Cooperation Agency (JICA) as well as others, and donor support to SMEs is likely between $0.5 and $1.5 billion, although this number does not take into account substantial loan support.[2] The International Finance Corporation (IFC), a member of the World Bank Group and the largest global development institution focused on the private sector, says that SMEs "are key engines of job creation and economic growth in developing countries."[3]

The number of impact investing funds and SME accelerators/incubators has rapidly increased in the past few years.[4] Impact investing is defined as, "investments

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[2] Kurt Dassel, Dan Grimm, and Curtis Cannon, "Growth and Opportunity: The Landscape of Organizations that Support Small and Growing Businesses in the Developing World," *Monitor Deloitte and the Aspen Network of Development Entrepreneurs* (2013): 7.

[3] "IFC and Small and Medium Enterprises," *The International Finance Corporation* (2012): 1.

[4] Throughout this paper, the SME support industry will be discussed. This refers to all organizations whose goal is to assist SMEs in their growth because they believe that SMEs are effective tools for international development. The two main types of support organizations are impact investing funds and accelerators/incubators (further discussed in Chapters Two and Three). However, the support sector also includes industry trade association groups like the Aspen Network of Development Entrepreneurs and the Global Impact Investing Network. It also includes groups that regularly fund SME development work like foundations.

made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return."[5] Accelerators/incubators are selective organizations (non-profit or for-profit), usually run by experienced entrepreneurs, that offer a package of services to assist aspiring entrepreneurs in their venture.[6] Between 2003 and 2007, 75 impact investing funds launched globally with an average target assets under management of $45 million. Between 2008 and 2012, 145 funds launched with an average target assets under management of $53 million.[7] In terms of accelerators/incubators, an estimated 73% are less than five years old.[8] The number of players in the industry is growing quickly.

As the number of players increase, there have been movements to coordinate and standardize as an industry. The Aspen Network of Development Entrepreneurs was founded in 2009 to act as a trade association for SME support sector organizations.[9] In 2009, the Aspen Network of Development Entrepreneurs had 34 members, and today, it has over 200. The Global Impact Investing Network was also founded in 2009 as a representative group for impact investors, a subset of those involved in the SME support sector.[10] In 2011, the Global Impact Investing Network launched the Impact Reporting

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[5] "About Impact Investing," *Global Impact Investing Network*, accessed 9/15/13, http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html.
[6] For a more detailed discussion, please see the 'How the Challenges are Being Addressed' section in Chapter Three.
[7] "Engines of Prosperity: Impact Report 2012," *Aspen Network of Development Entrepreneurs* (2012): 14.
[8] Ross Baird, Lily Bowles, and Saurabh Lall, "Bridging the 'Pioneer Gap': The Role of Accelerators in Launching High-Impact Enterprises," *The Aspen Network of Development Entrepreneurs and Village Capital* (2013): 3.
[9] "About ANDE," *The Aspen Network of Development Entrepreneurs*, accessed 12/16/2013, http://www.aspeninstitute.org/policy-work/aspen-network-development-entrepreneurs/about-ande.
[10] "About Us," *The Global Impact Investing Network*, accessed 1/23/2014, http://www.thegiin.org/cgi-bin/iowa/aboutus/history/index.html.

and Investment Standards which was developed to facilitate the measurement of impact investing activity and to assess impact investing's impact.[11]

Between the increased institutional focus and the activity in the field, it is clear that there is a consensus around, and momentum for, supporting SMEs as a development tool. To understand why, it is important to delve into the SME Theory of Change and unpack the evidence for it.

SME THEORY OF CHANGE IN INTERNATIONAL DEVELOPMENT

The SME theory of change is that SMEs contribute to development in three main ways: they create jobs, offer higher wages, and increase countries' GDPs. SMEs have great capacity to grow as they move from small business to medium business to large business, and as they move, they generate more jobs for the community. In addition to job creation, SMEs offer jobs with higher pay than jobs in the very common informal sector. This is critical because the World Bank (2013) says that changes in wages are a main contributor to poverty reduction.[12] Finally, as a number of reports (such as Ayyagari, Beck, and Demirguc-Kunt, 2007; Dalberg, 2011; and the IFC, 2010) have stated, SMEs contribute substantially to GDP.[13] While lack of data is a problem in development research, enough has been published about SMEs to arrive at a reasonable conclusion about their development impact, especially related to their job and wage effects.

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[11] "Data Driven: A Performance Analysis of the Impact Investing Industry," *Impact Reporting and Investment Standards* (2011): i.
[12] "World Development Report 2013: Jobs," *World Bank* (2013): 9.
[13] Meghana Ayyagari, Thorsten Beck, and Asli Demirguc-Kunt, "Small and Medium Enterprises Across the Globe," *Small Business Economics* 29 (2007): 419.
"Report on Support to SMEs in Developing Countries," *Dalberg* (2011): 13.
"Scaling-Up SME Access to Financial Services in the Developing World," *The International Finance Corporation* (2010): 9-11.

Jobs and Job Creation

Over 600 million jobs need to be generated in the next 10 years to ensure that the global unemployment rate does not grow; because of this, jobs are often at the center of national and international strategic plans.[14] Currently, SMEs provide the majority of private sector jobs worldwide. Over 95% of OECD enterprises are SMEs and these businesses account for roughly 60% of private sector employment in OECD countries. Globally, SMEs account for about 90% of businesses and are responsible for 50% of employment.[15]

In addition, research has shown that SMEs' offer superior job growth rates (ones that significantly exceed the average GDP growth rate and job growth rate of the countries where the SMEs operate). Nichter and Goldmark's (2009) study of Micro and Small Enterprises (defined as firms with up to 50 workers) in Africa and Latin America showed that these firms demonstrate employment growth of 17% a year. This was over double the GDP growth rate of most countries in the sample.[16] Analysis done on World Bank Enterprise Surveys (by Beck, Demirguc-Kunt, and Maksimovic in 2005) show that small firms (which they defined as firms with five to 19 workers) had 18.6% job growth over two years in developing countries; this is again about double the general job growth. Even when countries had net job losses, small firms had net job gains.[17] SMEs both create and lose more jobs than large firms do (in developed and developing countries). Yet overall, the job creation outweighs the loss, and net job creation is higher for SMEs.[18]

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[14] "IFC Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction," *The International Finance Corporation* (2013): 3.
[15] "IFC and Small and Medium Enterprises," *The International Finance Corporation*, 1.
[16] Simeon Nichter and Lara Goldmark, "Small Firm Growth in Developing Countries," *World Development* 37, No. 9 (2009): 1453.
[17] "IFC Jobs Study," *The International Finance Corporation*, 3.
[18] "Scaling-Up SME Access to Financial Services in the Developing World," *The International Finance Corporation*, 13.

Wages and Benefits

Not only do SMEs create jobs but these jobs offer wage premiums over informal employment and microenterprise employment, both of which are common types of employment in developing countries. Companies with between 10 and 50 employees offer wage premiums of 10%–30% over micro-enterprises that have less than 10 employees; the premium increases to 20%–50% if the business has over 50 employees.[19] A Small Enterprise Assistance Fund (SEAF) study compared SME wages to national average wages and found that SME wages were typically 37% higher.[20] This indicates that not only are SMEs agents of job creation, they can also improve livelihoods.

GDP and Economic Development

SMEs are substantial contributors to GDP and account for 49% of GDP in high income countries and 29% in low income countries.[21] A study by Ayyagari, Beck, and Demirguc-Kunt has shown that having a large share of SMEs is a characteristic of a successful economy.[22] SMEs directly contribute to GDP growth by increasing output, adding value, and generating profit. Indirectly, SMEs are said to impact GDP through increased innovation. They also contribute to a diversified economy that has decreased vulnerability to sector specific shocks.[23] When the SEAF study mentioned above tried to estimate a multiplier effect, they found that for every dollar invested in SMEs, SMEs

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[19] Dassel, Grimm, and Cannon, "Growth and Opportunity," *Monitor Deloitte and the Aspen Network of Development Entrepreneurs*, 5.
[20] " From Poverty to Prosperity: Understanding the Impact of Investing in Small and Medium Enterprises," *Small Enterprise Assistance Fund* (2007): 13.
[21] "Scaling-Up SME Access to Financial Services in the Developing World," *The International Finance Corporation*, 11.
[22] Ayyagari, Beck, and Demirguc-Kunt, "Small and Medium Enterprises Across the Globe," *Small Business Economics*, 416.
[23] "Report on Support to SMEs in Developing Countries," *Dalberg*, 13.

generated $12 in the local economy (please see Footnote 22 for study design notes).[24] GDP might have less of a day-to-day impact on citizens of developing countries than more job opportunities or higher wages, but it is an important measure of overall development and economic vitality.

Data Considerations

The research on SMEs mostly uses general SME data. In the data, there is no common definition of SMEs, and it usually does not distinguish between types of SMEs. First, looking at definitions of SMEs, they differ between organizations and countries. Definitions use both different measures and different numerical cutoffs. Frequently used measures are number of employees, total net assets, sales, and investment level.[25] Number of employees is the most common of the metrics, and a number of sources define SMEs as having a maximum of 250 employees.[26] The IFC found that 35% of the 132 economies reviewed defined SMEs as having a cut off of 250 employees.[27]

However, while there are some definitional similarities, there is a substantial level of variation. For example, the World Banks' definition of a SME would include businesses that are three times larger (by number of employees) than the largest SME under the Inter-American Development Bank definition. The definitions also do not take into consideration country differences in typical SME size. In some countries, the typical firm is smaller and most SMEs have far less than 250 employees. In these cases, having

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[24] "From Poverty to Prosperity," *Small Enterprise Assistance Fund*, 26. The SMEs analyzed in this study were all members of the SEAF Portfolio. The report states that SEAF attempted to select a SME group reflective of their portfolio, but the companies that they accept into their portfolio are all companies likely to excel.

[25] "Report on Support to SMEs in Developing Countries," *Dalberg*, 6.

[26] Ayyagari, Beck, and Demirguc-Kunt, "Small and Medium Enterprises Across the Globe," *Small Business Economics*, 416.

[27] "Micro, Small, and Medium Enterprises Around the World: How Many are There, and What Affects the Count?," *The International Finance Corporation* (2010): 2.

close to 250 employees would actually make the firm one of the larger firms in the country. For example, in Ghana, the UNDP and World Bank SME definitions would include both the Nestle and Unilever manufacturing subsidiaries. Clearly subsidiaries of multinational corporations are not SMEs, but because the SME definitions do not currently take into account country context, this type of error can occur. To address these issues, a Brookings paper argues for replacing the numeric cutoff with a formula that takes the individual country context into account.[28] However, at the moment, major players still use numeric markers (such as number of employees). When reviewing the literature, it is important to note that the non-standard SME definitions could impact the research.

In addition to the definitional confusion, the data does not usually distinguish between types of SMEs.[29] SMEs are a diverse group of firms with varying growth intention and potential. Many firms in the SME category include enterprises that are not intended to scale. This might include, for example, small convenience stores or market stands. While these are small businesses, they are very different small businesses than ones that are looking to grow and expand, such as businesses bringing a new technology to market. And of those that are looking to grow, there are likely some better suited to scale than others. The data available tends to group all SMEs and not parse out those with

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[28] Tom Gibson and H.J. van der Vaart, "Defining SMEs: A Less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries," *Brookings* (2008): 3.

[29] While the data does not always distinguish between types of SMEs, those working in the SME industry do. Because of this, there is somewhat of a misalignment between academic research data and practioner research data. For example, the Aspen Network of Development Entrepreneurs uses the term Small and Growing Businesses (SGBs) to delineate firms with the intention and potential to scale. The Aspen Network of Development Entrepreneurs focuses its research on these types of firms. Their definition of SGBs is "[c]ommercially viable businesses, with between five and 250 employees, that have strong potential for growth and thus for creating social and economic benefits in the community and the economy."

growth intention or potential. This paper follows the practioner trend, and SMEs refers to the subset of SMEs that have both the intention and potential to grow.

ARGUMENTS AGAINST SME DEVELOPMENT EFFICACY

Not everyone is convinced by the SME Theory of Change. The main point of contention is the lack of causal evidence proving SME development impact. The current evidence supporting the theory is correlational. Additionally, some have argued that large firms have more potential to achieve development goals than small firms. For example, Ayyagari, Demirguc-Kunt, and Maksimovic cite evidence showing that large firms are more productive than small firms.[30] Another argument is that wage premiums for large firms are likely even higher than the premiums SMEs achieve. A final argument is that research has not shown that the size of the SME sector is related to poverty reduction for the poorest in society (the bottom 20% or those who live under $1 a day).[31] While these are valid arguments, they point to evidence that large firms provide stronger poverty alleviation mechanisms than SMEs. Large firms go through a development process; they do not begin as large. The SME support sector's goal is usually to provide the infrastructure necessary to facilitate the growth of SMEs into larger firms. Keeping in mind that there are differing points of view, the rest of this paper will be based on the emerging consensus that SMEs are a valuable development tool due to their job creation, wage, and GDP effects.

[30] Meghana Ayyagari, Asli Demirguc-Kunt, and Vojislav Maksimovic, "Small vs. Young Firms Across the World: Contribution to Employment, Job Creation, and Growth," *The World Bank* (2011): 17.
[31] Thorsten Beck, Asli Demirguc-Kunt, and Ross Levine, "SMEs, Growth, and Poverty: Cross-Country Evidence," *Journal of Economic Growth* 10 (2005): 224-227.

Challenges Facing SMEs

There are a number of challenges for SMEs that are muting their potential development impact. The three main ones are access to financing, access to human capital, and the enabling environment. This becomes clear through examining SME information from two leaders of SME information collection: the World Bank and the Aspen Network of Development Entrepreneurs.[32]

The World Bank Enterprise Surveys show that access to finance, electricity, practices of the informal sector, tax rates, political instability, an inadequately trained workforce, and corruption are the main obstacles in developing countries. These largely fall into the finance, human capital, and enabling environment buckets. Of the obstacles, SMEs (5-99 employees) listed access to finance as their top obstacle. The Aspen Network of Development Entrepreneurs membership surveys suggest that while access to finance might be the number one obstacle overall, the intensity of the three constraints fluctuates depending on the region of the world.[33]

Assuming that SMEs are an engine for development, what are the challenges facing SMEs, how are the challenges being addressed, and what is the impact? The subsequent chapters in this paper will explore these questions at a global level.

[32] The World Bank Enterprise Surveys offer some of the most comprehensive company level data available. The Aspen Network of Development Entrepreneurs does substantial research based on data available from its member groups who comprise many of the leaders in the SME international development industry.
[33] Dassel, Grimm, and Cannon, "Growth and Opportunity," *Monitor Deloitte and the Aspen Network of Development Entrepreneurs*, 12-13.

Chapter Two: Financing for SMEs

CHALLENGES AROUND FINANCING

Chapter One asserts that supporting SMEs is a viable way to achieve international development goals. However, as mentioned in Chapter One, securing debt and equity financing is the top problem for SMEs in developing countries. Traditionally, microfinance provided funding under $25,000 and commercial banks or private equity groups provided funding over $2 million, but in the area between, it is difficult to secure funding.

This gap is a critical problem because research has shown that SME financing obstacles have a disproportionate effect on their growth: financing obstacles reduced large firm growth by about 6% yet reduced small firm growth by about 10%.[34] When that is coupled with a difficult enabling environment (such as confusing regulation and corruption) then small firms show three times slower growth than large firms. This is likely because small firms are less able to navigate an unequal enabling environment with transaction costs and information asymmetries.[35]

Looking at debt financing, it is clear that there is SME demand. Of SMEs, 70% do not use external debt financing from financial institutions, although they would like to, and another 15% of firms are underfinanced, bringing the total to 85% of firms experiencing credit constraints.[36] A McKinsey report (2012) attempted to evaluate the credit gap and found that there is an unmet need (for both formal and informal MSMEs)

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[34] Cross country firm level databases were used to run regressions exploring the effect of financing, legal, and corruption related obstacles on firm growth. Researchers used dummy variables for small, medium, and large firms and controlled for other firm and country characteristics.

[35] Thorsten Beck and Asli Demirguc-Kunt, "Small and Medium Size Enterprises: Access to Finance as a Growth Constraint," *Journal of Banking & Finance* 30 (2006): 2938.

[36] "Why Banks in Emerging Markets are Increasingly Providing Non-Financial Services to Small and Medium Enterprises," *International Finance Corporation* (2012): 6.

of $2.1 to $2.5 trillion worldwide. Regionally, McKinsey found that the credit gap is most severe in East Asia, South Asia, and Sub-Saharan Africa.[37]

Banks' high returns, the administrative costs associated with SMEs, a mismatch of capital timing, and lack of data have all been identified as barriers to SMEs obtaining debt financing in developing markets and each will be discussed below. For many years, banks in countries with growing financial systems were not threatened with competition and could be profitable just by lending to major, established players. Additionally, SMEs are generally considered less attractive loan recipients since they incur higher administrative costs for banks. As loans vary in size, transaction costs per loan, such as due diligence, stay fairly constant. A certain level of research must be done for every client and this takes employee time. Because SME clients require the review but take out smaller loans, they offer lower profit margins than clients who require the review but take out larger loans and pay more in interest.

Moreover, there is a mismatch in timing. Banks in developing countries are largely dependent on liquid funds, such as deposits. They have to be especially careful to keep enough capital to service the withdrawals that come with bank deposits. Because they need higher levels of capital available day-to-day, there is less capital available for long-term loans. In developed countries, there are entities that provide long-term funds to banks (for example, pension funds). Because banks know that these funds will not be withdrawn for a certain number of years, they can loan out long-term capital to interested parties, like SMEs. In developing countries, if banks try to provide long-term capital to

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[37] Peer Stein, Tony Goland, and Robert Schiff, "Two Trillion and Counting: Assessing the Credit Gap for Micro, Small, and Medium-Sized Enterprises in the Developing World," *McKinsey & Company and The International Finance Corporation* (2012): 1-2. The report's goal was to offer a comprehensive assessment of the global micro, small, and medium sized enterprises' credit gap. The report used data from a variety of sources but relied most heavily on the World Bank's Enterprise Surveys, the IFC MSME Database, and McKinsey's proprietary knowledge.

SME borrowers, they have a maturity mismatch between liquid deposits and long-term loans.

Finally, in developing countries, banks have a lack of data about their potential SME customers. Many countries have weak accounting standards, and SMEs often do not have financial statements. Additionally, there is not usually market data, such as information on default rates, for the SME market and sub-sectors. Without this information, it is difficult to build models predicating loan risk. The lack of information limits the possibility for lending based on financial statements or credit scores. Because of these issues, banks often engage in collateral based lending or charge extremely high interest rates. Generally, there is a lack of market infrastructure that disproportionately affects SMEs.

Turning to the equity, developing countries' equity markets have traditionally been underdeveloped. Banks handled funding for SMEs, although as just discussed, banks had little engagement with SMEs.[38] The reasons for the limited equity capital are similar to the reasons for limited debt capital in that there are constant administrative costs, and there is a lack of information about SMEs. However, there are some additional barriers, for example, difficulty exiting investments. Venture capitalists are reluctant to offer funding without a clear timeline for an exit. In many countries, there is not the necessary financial infrastructure to support Initial Public Offerings (IPOs). Since it is difficult to exit through the public avenue, other options would include finding a third party buyer or having the entrepreneur buy back venture shares. Given the substantial capital this requires, it is hard to find an interested buyer.[39] This lack of liquidity is not

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[38] "Report on Support to SMEs in Developing Countries," *Dalberg*, 17-19.
[39] "Engines of Prosperity," *Aspen Network of Development Entrepreneurs*, 17.

conducive to a thriving equity sector. Also, entrepreneurs in developing countries are often not familiar with the equity model which can reduce demand.[40]

HOW CHALLENGES ARE BEING ADDRESSED

Despite the barriers mentioned above, in the past five years there has been increased bank interest in and activity around financing SMEs in developing countries. Studies have found that banks are interested in systematically lending to SMEs and are finding them profitable.[41] Some early results even suggest that serving SMEs can be more profitable than serving large companies. A 2010 Boston Consulting Group survey showed that for emerging market banks, the average return (pre-tax) was between 41% and 44% for SMEs but 33% for large companies.[42] In banks' experimentation with different types of SME lending, they found that SMEs are profitable when they are consumers of a combination of services. Table 1 shows both sample services and the percentage of banks offering these services in four countries under study.[43]

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[40] "Report on Support to SMEs in Developing Countries," *Dalberg*, 19. The venture capital and private equity fields are still relatively new and are only beginning to expand into the developing world. Their deals can be complex with numerous requirements for SMEs to meet. Given the novelty and complexity, some entrepreneurs could be hesitant to enter into a legally binding deal.

[41] Augusto de la Torre, Maria Soledad Martinez Peria, and Sergio L. Schmukler, "Bank Involvement with SMEs: Beyond Relationship Lending," *Journal of Banking & Finance* 34 (2010): 2281.

[42] "Redefining the Emerging Market Opportunity: Driving Growth through Financial Services Innovation," *World Economic Forum* (2012): 31.

[43] Torre, Peria, and Schmukler, "Bank Involvement with SMEs," *Journal of Banking & Finance*, 2281.

Banking products	Percentage of banks			
	Argentina (%)	Chile (%)	Colombia (%)	Serbia (%)
Deposit or savings products				
1. Checking or savings accounts	84.6	66.7	83.3	75.0
2. Investments	76.9	88.9	83.3	0.0
Financing products				
3. Term loans	84.6	100.0	100.0	100.0
4. Credit cards	84.6	88.9	83.3	100.0
5. Factoring	15.4	55.6	33.3	0.0
6. Leasing	76.9	77.8	16.7	0.0
7. International trade financing	76.9	77.8	16.7	0.0
Services and other products				
8. Foreign exchange	15.4	55.6	0.0	25.0
9. International payments and collection	69.2	77.8	33.3	75.0
10. Payment to employees	84.6	77.8	83.3	25.0
11. Payment to suppliers	100.0	77.8	66.7	25.0
12. Tax payments	23.1	66.7	50.0	0.0
13. Collection of receivables	76.9	77.8	83.3	25.0
14. Insurance products	46.2	33.3	0.0	0.0

Table 1: Banks' product offerings for SMEs.[44]

As banks' interest in SME engagement has increased (due to SMEs' potential profitability), there have been innovative methods of engagement that reduce transaction costs and make SME clients more attractive. Some of these approaches discussed below include using technology, capitalizing on point of sale machines, and taking advantage of the security of supply chains.

First of all, some providers have begun implementing remote relationship management using technology-focused outreach (emails and texts) to follow up with clients. By communicating with lower revenue SME clients automatically, banks can focus their in-person resources on higher revenue SME clients and become more cost efficient. For example, ICICI Bank in India uses phones calls and text messages to communicate with its SME customers. Both delinquency rates and the onset of delinquency fell significantly. The bank found that remote follow-up was almost as effective as in-person follow-up.[45]

[44] Ibid., 2286.
[45] As a note, all the examples used in this report were chosen both by their applicability and how relatable they were. In this case, 'how relatable' means that, when possible, those highlighted in the examples were major organizations in the SME field or the examples came from documents by major organizations in the SME field.

Another method is to adapt point of sale machines and ATMs to deliver SME financing.[46] For example, Garanti (the second largest bank in Turkey) offers high-speed loan approval for SME clients through machines around the country. Clients enter a desired loan amount (between TRY2,000 and TRY9,000) and repayment terms (between three and 12 months) into the nearest machine and are approved within five minutes. Garanti does this through an automatic scoring model where it considers client risk and business complexity. Garanti also offers sector specific loan packages. These packages are based on SME sector (agriculture, manufacturing, tourism, etc.). The packages have set repayment schedules and collateral obligations that are flexible and incorporate the sector's business cycle and growth stage.[47]

Finally, some banks are providing loans to SMEs integrated into large corporations' supply chains. The corporations are involved in the loan process and therefore split some of the risk with the bank.[48] In addition to offering a combination of financial services and new methods of engagement, banks have begun to offer SMEs non-financial services such as capacity building services.[49] Banks are increasingly offering one-on-one guidance, information dissemination, and trainings. The majority of these services are free or given at a reduced rate.

For example, Standard Chartered Bank (SCB) is a global bank that offers non-financial services to its SME clients because it believes that SMEs are an important customer class, especially in Africa, Asia, and the Middle East. Their non-financial services have been training and information dissemination. One service was to provide

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[46] "Redefining the Emerging Market Opportunity," *World Economic Forum*, 35-36.
[47] Ibid., 107-108.
[48] Ibid., 35-36.
[49] "Why Banks in Emerging Markets are Increasingly Providing Non-Financial Services to Small and Medium Enterprises," *International Finance Corporation*, 11.

business training to SME clients in Pakistan and Kenya. There was a two-day training that covered basic finance, accounting, and customer service. A main part of this was preparing basic financial statements (income statements, balance sheets, and cash flows). Another SCB initiative was developing the Women in Business Resource Center. This center is geared towards female entrepreneurs and addresses specific challenges such as a lack of a female role model and access to financial education. The center offers learning modules on business planning and finance as well as leadership skills. In the planning and finance section, the center offers lessons on analyzing balance sheets and controlling cash flow. In the leadership skills section, it has lessons on management style and negotiation.[50]

A few other financial approaches have become more common. Factoring, one of these financial approaches, has become an important source of working capital. Factoring is when a lender makes a credit assessment based on the liquidation value of SME's short-term assets, such as accounts receivable or inventory. In some types of factoring, the lender will actually purchase a firm's accounts receivables and then collect them. Reverse factoring is also a prominent tool. With this, financial institutions purchase receivables from high credit buyers. By doing this, they can offer low risk loans to high risk suppliers like SMEs. The lender focuses on financing many SMEs that sell to one major buyer so the lender is able to simplify the credit assessment and processing.[51] Lastly, leasing is a useful approach; leasing allows firms to use their cash flow from operations to make payments and avoid problems that are associated with lack of credit history.[52]

[50] Ibid., 40-48.
[51] "Redefining the Emerging Market Opportunity," *World Economic Forum*, 37-38.
[52] "Scaling-Up SME Access to Financial Services in the Developing World," *The International Finance Corporation*, 18.

All this information suggests that the debt market is expanding for SMEs; however, it is still not meeting the global SME credit need discussed above. And, although there is activity in the debt market, the bulk of the SME support work is being done in the equity market.

In the equity market, impact investing is the main tool. As mentioned above, impact investing is defined as, "investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return."[53] Impact investing is a subset of a larger category, social investing. Social investing refers to investing that considers social and environmental issues.

There are a number of actors involved in impact investing including high net worth individuals and families (who want to add a social aspect to their portfolio), development finance institutions, and foundations.[54] A Global Impact Investing Network sponsored paper (2013) cited a survey of 47 organizations with $143 billion (GBP) under management that found that 47% of respondents expected to have some impact investments in their portfolio within the next two years.[55]

An example of an impact investment would be the Acumen Fund's investment in Sproxil. Acumen is a well known, non-profit with the goal of "working to create a world beyond poverty by investing patient capital in breakthrough ideas, emerging leaders, and social enterprises that deliver critical, affordable goods and services to the world's

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[53] "About Impact Investing," *Global Impact Investing Network*, accessed 9/15/13, http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html.

[54] "From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors," *World Economic Forum* (2013): 6.

[55] Maximillian Martin, "Making Impact Investible," *Impact Economy Working Papers* 4 (2013): 25.

poor."[56] Since 2001, Acumen has invested over $60 million in SMEs in South Asia and East Africa.

In 2011, $1.79 million of the $60 million was invested in Sproxil. Sproxil's goal is to reduce the presence of counterfeit drugs in developing countries. It offers a mobile product authentication service where consumers text the pharmaceutical code (which is on all pharmaceuticals) to Sproxil. Sproxil's system is able to analyze the pharmaceutical number and respond immediately telling the consumer if the drug is counterfeit or not. Sproxil's revenue comes from pharmaceutical companies. Companies are motivated to pay for Sproxil's service to decrease the presence of illegitimate drugs in the marketplace. By alerting consumers to counterfeit drugs, manufacturers are able to increase their own market share. Pharmaceutical companies also are likely also motivated by the reputational harm that counterfeit drugs can cause. If counterfeit drugs do not work or cause a consumer to become sicker, the legitimate manufacturer's brand is damaged.[57]

Another impact investing example is Pearl Capital Partners, which is an investment firm that invests in East African SME agribusinesses. Pearl Capital invests between $250,000 and $2.5 million per firm, and they evaluate investments equally on their social and financial benefits.[58] One of their investments is Bee Natural Uganda. Bee Natural purchases honey from farmer cooperatives and then processes, packages, and sells it all over East Africa. Pearl Capital's 2008 investment allowed Bee Natural to purchase processing equipment and increase their working capital. Now Bee Natural is

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[56] "Impact Investment Profile," *Global Impact Investing Network*, accessed 4/6/14, http://www.thegiin.org/cgi-bin/iowa/resources/profile/19.html.
[57] Ibid.
[58] "About Us," *Pearl Capital Partners*, accessed 4/6/14, http://www.pearlcapital.net/about%20us.php.

the largest honey processor in East Africa.[59] The information above shows that there is proven activity in both the debt and equity financing markets; however, the impact of this activity is less clear and should be examined.

LEVEL OF IMPACT

Impact information is scant, especially in the debt market. The field would benefit from research surrounding the amount of debt assigned and repayment success. Even better would be to measure what entrepreneurs were able to achieve by their increased access to debt capital. With impact investing, there is more information, although, impact data is still lacking. One major issue with impact investing is that it is unclear how success is defined.

Impact investing success could be measured on a number of variables, all of which will be expanded on in the paragraphs below: number of funds and assets under management, number of entrepreneurs matched with funding, stages of SMEs supported, rate of return, presence of non-philanthropic investors, or impact benchmarks. If success is defined as an increased number of funds and increased assets within them, then there has been a fair amount of success. All assessments of impact investing show growth in the number of funds and in the pool of money, although the numbers vary. As mentioned earlier, from 2003 to 2007 there were 75 funds launched while from 2008 to 2012 there were 145 launched.[60] A Dalberg study (2011) found 192 private equity funds involved in SME investment in developing countries with capital worth $7 billion. The funds have largely begun in the last five years, and the majority, 60%, focus on Sub-Saharan Africa.[61] A Global Impact Investing Network study (2013) found that impact investing

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[59] "Our Investments," *Pearl Capital Partners*, accessed 4/6/14, http://www.pearlcapital.net/our%20investments.php.
[60] "Engines of Prosperity," *Aspen Network of Development Entrepreneurs*, 14.
[61] "Report on Support to SMEs in Developing Countries," *Dalberg*, 19.

has grown to a $36 billion worldwide industry in the past few years. Their estimates suggest that the industry could grow to $400-$1000 billion by 2020.[62]

If success is not measured by number of funds and assets but rather by matching current entrepreneurs with funding, success has not been achieved. Impact investing assessments show that while there are an increasing number of funds and amount of capital available, one of the most critical challenges to the continued growth of impact investing is the lack of quality investment opportunities. There still seems to be a gap between SMEs' riskiness and investors' risk tolerance.[63]

Furthermore, some of this gap is likely related to the stage of investment available (some is also likely related to human capital, discussed in Chapter Three). Investors are generally most interested in growth stage investments, largely because investments at that stage have a track record of success and are therefore less risky. Growth stage companies have positive earnings before interest, taxes, depreciation, and amortization (EBITDA). After that, the next preferred size would be venture stage: companies with established operations but not yet positive EBITDA.[64] In the Aspen Network of Development Entrepreneurs' most recent Impact Report, they conducted a survey of fund managers. In developing countries, just over 95% of funds focused on more developed stage SMEs with the average deal size ranging from $789,000 to $1.45 million while just under 5% funds focused on start ups with an average deal size of $106,000.[65] Village Capital also conducted an industry survey and found that less than 1% of impact funds invested in deals under $250,000.

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[62] Maximillian Martin, "Making Impact Investible," *Impact Economy Working Papers*, 4.
[63] Dassel, Grimm, and Cannon, "Growth and Opportunity," *Monitor Deloitte and the Aspen Network of Development Entrepreneurs*, 13-14.
[64] Yasemin Saltuk, Amit Bouri, Abhilash Mudaliar, and Min Pease, "Perspectives on Progress: The Impact Investor Survey," *J.P. Morgan and Global Impact Investing Network* (2013): 8.
[65] "Engines of Prosperity," *Aspen Network of Development Entrepreneurs*, 20.

Impact investing evolved to remedy the funding gap discussed earlier in the chapter, and with the substantially increased activity in equity markets, there is now a new gap for financing between $25,000 and $200,000, which is where many entrepreneurs fall. Monitor calls this the pioneer gap phenomenon. Firms pioneering new business models have increased barriers to overcome. They must both educate consumers and convince investors to fund them.[66] Securing funding in the range just above micro through start up funding remains a gap in the field and makes it more difficult to assess impact.

Looking at measuring success by returns, early evidence indicates that impact investing can achieve competitive returns. A J.P. Morgan study (2010) showed that the expected returns of impact investments were 8-11.9% for debt and 20-24.9% for equity. Developed market return expectations are 5-7.9% for debt and 15-19.9% for equity.[67]

To mainstream impact investing beyond those with substantial philanthropic goals, there will need to be competitive returns. So another potential marker of success is that more institutional and mainstream investors are involved. By this measure, impact investing has not yet achieved success. While there is interest in the field, it is unclear if that will translate into more generalized investment by non-philanthropic parties. So far, institutional investors have not been very active in the impact investing arena.[68]

Finally, there is little, if any, information about the impact that these entrepreneurs have had on their community due to the funding they received. As the field develops, there will likely be impact assessments that delve into the community impact of SMEs that receive funding.

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66 Harvey Koh, Ashish Karamchandani, and Robert Katz, "From Blueprint to Scale: The Case for Philanthropy in Impact Investing," *the Monitor Group* (2012): 10.
67 Maximillian Martin, "Making Impact Investible," *Impact Economy Working Papers*, 5.
68 Ibid., 25.

Omidyar (2013) published one of the largest overview studies that attempted to identify funds with exceptional performance, defined as meeting or exceeding financial and social returns promised; an explicit impact objective; at least five years of operation; financial returns; and a system of accountability for impact objectives. Of a list of 350 funds across the globe, 30 funds met the criteria.[69] This could be largely because the 'at least five years of operation' criteria is a major exclusion factor; however, it is an important data point that so few funds met the requirements.

Reviewing the actors in the debt and equity space, traditional banks are moving into the space as discussed above. There are also SME support organizations working in the debt space, typically working with smaller banks and advising them how to serve SME clients. In impact investing, there are a large number of actors, both non-profit and for-profit. The bulk of equity work seems to be done by non-profit entities, and the work is still largely funded by foundations or development aid organizations, such as the IFC. If institutional investors put money into impact investing, there will be a funding mix, but until that occurs, NGOs will likely continue to facilitate and foundations and aid programs continue to fund.

What we can conclude from the research cited above, the increased number of players, and the increased amount of money going into the field is that organizations with a social bent have interest and have begun providing financing for SMEs in developing countries. The exact impact of this funding is unclear, but it does appear that financing is ceasing to be the main SME constraint. As impact investors look for appropriate investments, the main constraints seem to be with the SMEs: the level of SME development (i.e. the number of pre-venture stage SMEs) and the level of human capital.

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[69] Cathy Clark, Jed Emerson, Ben Thornley, Daniel Brett, Christopher Cox, Coldby Dailey, and Brenna McCallick, "Impact Investing 2.0: The Way Forward – Insight from 12 Outstanding Funds," *Omidyar Network* (2013): 5.

Chapter Three: Human Capital

CHALLENGES AROUND HUMAN CAPITAL

The IFC Jobs Study (2013) said, "[t]here are not enough workers for high-skilled jobs, not enough jobs for low-skilled workers, and not enough business owners and managers who have the required skills to manage their business."[70] This is the crux of the human capital issue in developing countries. The issue can be considered both through managerial capacity and through the general employee pool.

Managerial capital is key for SMEs because it is linked to the ability to run a business efficiently. Firms with better managerial capital can improve the marginal productivity of their inputs. For labor inputs, skilled managers can motivate workers and retain them; they can also allocate them more wisely. Additionally, managerial capital is important to determine the amount and type of non-labor inputs that a firm purchases. For capital outlays, managers must forecast the capital needs of the firm as well as plan and understand the acquisition process. Finally, strong managers are better able to identify productive marketing and pricing strategies, often through their experience and training.[71]

Lack of managerial capital can increase financial barriers for SMEs. Low financial literacy can prevent SMEs from understanding financing options. Also, strong accounting and financial statements are crucial for working with partners and attaining financing, and managers are often central to building these.[72] If financing becomes more available through the initiatives discussed in Chapter Two, it is important for the firm to have the human capital to use it effectively.

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[70] "IFC Jobs Study," *The International Finance Corporation*, 96.
[71] Miriam Bruhn, Dean Karlan, and Antoinette Schoar, "What Capital is Missing in Developing Countries?" (paper for presentation): 4.
[72] "Scaling-Up SME Access to Financial Services in the Developing World," *The International Finance Corporation*, 16.

Attracting and retaining the managerial capital talent currently present in the labor market is difficult for SMEs. In an Omidyar and Monitor study, they found that SMEs usually compete with established firms for managerial talent in Africa. Since established firms generally have more means and more job security to offer employees, educational systems prioritize training students for employment in those established firms. African entrepreneurs said that there are insufficient resources going towards cultivating skills that are needed to start, manage, and work in entrepreneurship.[73] Without well-trained human capital, SMEs' potential to grow, and therefore create more jobs, will be limited.[74]

Considering human capital in terms of the general employee pool, there is a mismatch between the labor skills that are supplied and demanded in countries. In lower income countries, lower skilled worker are needed to work in sectors such as agriculture. In higher income countries, advanced skill workers are needed for manufacturing, finance, and businesses services. However, even in developed countries where advanced skills are more prevalent, the supply of workers with needed skills has not kept pace with demand. The IFC estimates that by 2020, there will be a surplus of 90 to 95 million low skilled workers around the world.[75] In the SME sector, this impacts SMEs' ability to find workers to hire. SMEs often have cash flow limitations, especially during the start up phase, and might not be able to offer competitive salaries if there is a limited supply of skilled workers available.

The human capital gap is recognized; however, it has not received the same level of focus that the financing gap has. Nonetheless, there are some common ways of improving human capital.

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[73] "Accelerating Entrepreneurship in Africa," *Omidyar Network and the Monitor Group*, 8-9.
[74] "IFC Jobs Study," *The International Finance Corporation*, 98.
[75] Ibid., 96.

How Challenges Are Being Addressed

A popular way of addressing the lack of human capital is through accelerators/incubators. As mentioned above, these are selective organizations (non-profit or for-profit), usually run by experienced entrepreneurs, that offer a package of services to assist aspiring entrepreneurs in their venture. They typically offer business development support (such as consulting on business models), infrastructure support (like access to office space), network support (introductions to key players, funders, and customers), and sometimes also financial support (either grants or investments). They often connect entrepreneurs with other advisory professionals such as lawyers and accountants. While the majority provides the same set of basic services, only about half provide financial support. The central idea is that accelerators/incubators help build human capital through their business advising and training functions.

Incubators and accelerators are often confused; traditionally, incubators focus on early stage enterprises and accelerators focus on later stage enterprises with revenue streams and customers. Those differences tend to be blurred internationally, and in this paper, the term accelerator will refer to both accelerators and incubators.

Accelerators usually spend one to two months recruiting their companies. Many accelerators work with SMEs at different stages, although, some specialize in one stage. In general, about 40% of accelerators work with SMEs in the idea stage (ventures without a prototype, product, or customer), 75% work with SMEs in the prototype stage (ventures with a minimum viable model of their product or service but pre-revenue), 65% with post-revenue stage SMEs (ventures with customers but not positive cash flows), and 25% with growth stage SMEs (ventures with positive cash flows).

In terms of subject matter, 20% of accelerators focus on one sector, 40% focus on a number of sectors, and 40% are not sector specific. Of those that do have a focus, the three most common are health, clean energy, and agriculture. Typically, accelerators operate either nationally or regionally; however, some do accept companies from around the world or work in more than one country or region. Figure 1 shows what an Aspen Network of Development Entrepreneurs and Village Capital study (2013) found regarding geographic focus (note that accelerators were allowed to identify all the areas where they operate so percentages do not equal 100).

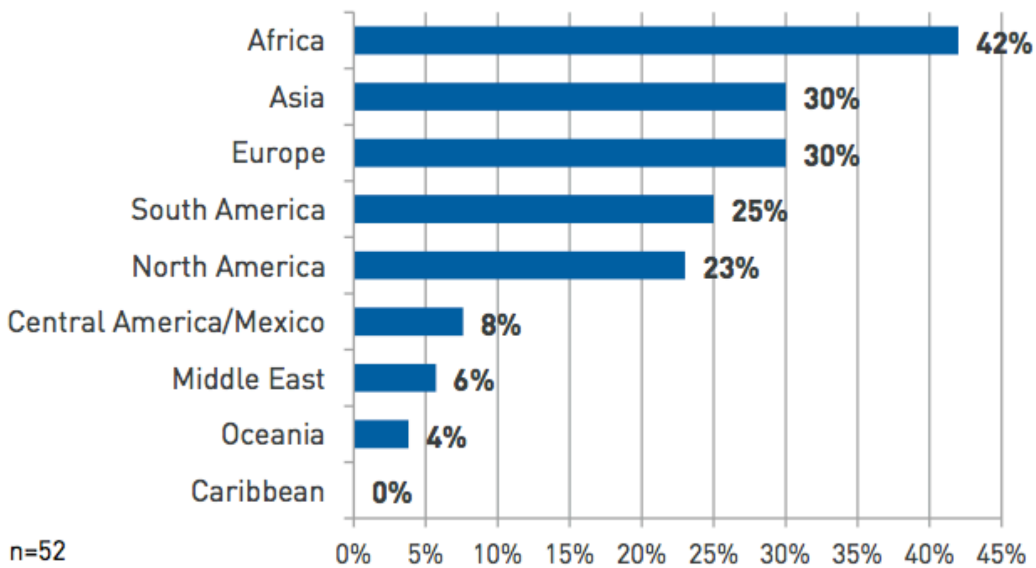

Figure 1: Accelerators' geographic focus.[76]

As an example, Agora Partnerships is an accelerator that focuses on early stage companies in Latin America. Agora emphasizes business advising and network building both before and while SMEs seek funding. Pre-funding support often includes refining the entrepreneurs' business models and creating financial history documents that

[76] "Bridging the 'Pioneer Gap': The Role of Accelerators in Launching High Impact Enterprises", *the Aspen Network of Development Entrepreneurs and Village Capital* (2013): 7.

investors require (such as financial statements). Agora also assists entrepreneurs who are in the process of receiving investor funding. They help entrepreneurs create cash flow models and due diligence documentation. For network building, they match entrepreneurs with mentors as well as potential funders. One of Agora's clients was CO2 Bambu. CO2 Bambu constructs sustainable housing using guadua bamboo for marginalized populations in Nicaragua and in post disaster regions. With Agora's assistance, they have begun to build a customer base of governments, NGOs, and private clients that need sustainable housing built quickly at a competitive price point.[77]

Another example is Endeavor which works to achieve long-term economic growth by accelerating high impact entrepreneurs around the world. They work with entrepreneurs in 20 countries in Latin America, the Middle East, Asia, Europe, and Africa. One of their entrepreneurs is Lito Rodriguez who leads a Brazilian company called DryWash. DryWash manufactures vehicle cleaning products and supplies them to a network of franchises. DryWash's competitive advantage is that their products clean vehicles without water, do not pollute the environment, and use 99% less electricity than traditional car washes. After accepting DryWash into their program, Endeavor helped it to produce a business plan. Endeavor also introduced it to strategic partners as it explored franchising. Finally, Endeavor provided connections to local legal support and marketing and branding consultants.[78]

Moving from looking at how accelerators operate to how they are funded, an Aspen Network of Development Entrepreneurs and Village Capital study showed that

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[77] "CO2 Bambu," Agora Partnerships, accessed 4/6/14, http://agorapartnerships.org/accelerator-2/for-entrepreneurs/by-class/co2bambu.
"How it Works," Agora Partnerships, accessed 4/6/14, http://agorapartnerships.org/accelerator-2/accelerator-recruitment#businessConsulting.
[78] "Our Entrepreneurs: Lito (Jose) Rodriguez," *Endeavor*, accessed 4/6/14, http://www.endeavor.org/entrepreneurs/lito-josé-rodriguez/155.

over 53% of accelerator funding comes from philanthropies.[79] Of the accelerators sampled, 75% of them rely on some level of philanthropic support. In addition to the philanthropic funding, many charge the entrepreneurs for accelerator services. They often have a stake in the SMEs' returns, either from acquisition deals closing or from SMEs that successfully scale.[80] While about half of accelerators take equity in enterprises, returns from those investments comprise only 8.2% of their revenue. See Figure 2 for a more detailed funding breakdown.

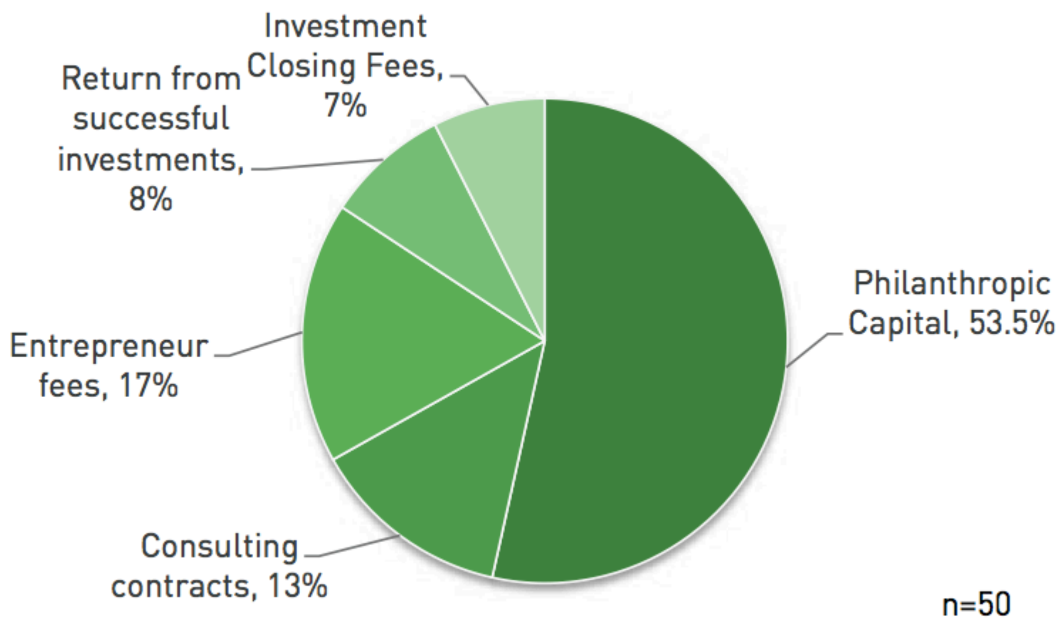

Figure 2: Accelerators' budgets by funding source.[81]

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[79] "Bridging the 'Pioneer Gap,'" *the Aspen Network of Development Entrepreneurs and Village Capital*, 10-11.

[80] Dassel, Grimm, and Cannon, "Growth and Opportunity," *Monitor Deloitte and the Aspen Network of Development Entrepreneurs*, 14.

[81] "Bridging the 'Pioneer Gap'", *the Aspen Network of Development Entrepreneurs and Village Capital*, 8.

The lack of revenue from equity could be due to how many accelerators have been started in the last five years. Like with impact investing funds, the pool of accelerators has greatly expanded in the past five years; the Aspen Network of Development Entrepreneurs and Village Capital found that 73% of active accelerators were less than five years old. Considering the underdeveloped equity markets in many developing countries, exits could have yet to occur.[82]

Level of Impact

There has not been much research into accelerators' effectiveness as tools in emerging markets. Even in developed markets, there is not a consensus on how to evaluate accelerators' effectiveness. Different ways of measure could include: the survival and growth of the businesses, number of companies that have become public, number of companies that were acquisition targets, or other metrics like sales growth, employee growth, cash flow, and assets. Of these, the most straightforward is to look at the number of companies that have survived, and this is a common measure. However, the number of companies that have survived and grown (maybe defined as a certain percentage in a certain number of years); have become public; or were acquired would offer better information. Growth, going public, or being acquired show a higher level of success than staying in business. The likelihood of those three actions should be enhanced by accelerator programs.

Even if there was agreement on the definition of effectiveness, evaluation is complicated by the lack of data to study. The Aspen Network of Development Entrepreneurs and Village Capital found that about one fourth of the accelerators did not collect data from their clients that graduated their program. While many other

[82] Ibid., 3.

accelerators do collect financial data about their client firms, about one third do not collect social indicator data. Despite this, the study found that there are a number of practices that seem to be correlated with success. In this case, success is defined as accelerators with above average enterprise success rates and enterprise survival rates.[83] Factors leading to success include: entrepreneur selection, quality of/access to services, and networks. Even though accelerators are in place to increase human capital and technical skills, selectivity is closely linked with accelerator performance. When the selection process includes assessing managerial, product, and financial characteristics, as well as market dynamics, accelerators show the best results. Both the quality of services and the period of engagement are important to the success of an accelerator. And finally, it is crucial for an accelerator to offer a strong network of advisors, contacts, and investors.

It is worth noting that although accelerators work to increase the number of viable SMEs, just under half of impact investors say they have not found any companies meeting their criteria from accelerators. This suggests a disconnect between investors' criteria and the companies that accelerators choose to support.[84]

A major accelerator advantage is that they offer business advising and training which is thought to build human capital. Since there is limited information on accelerators' effectiveness, it is useful to review studies on the impact of entrepreneurial training. So far, there is somewhat positive evidence. A number of studies found that basic management training improves business practices and performance. Karlan and

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[83] The enterprise success rate is the percentage of graduate SMEs that are operating profitably and/or have raised a major amount of capital; the enterprise survival rate is the percentage of graduate SMEs that are operating profitably and/or have raised a major amount of capital or are still operating but are not profitable.

[84] Ibid., 23.

Valdivia (2011); Drexler, Fischer, and Schoar (2010); and Bruhn et al. (2010) conducted RCTs examining the effect of management training or consulting provided to SMEs in Latin America. They found rudimentary management training does improve business practices.[85] Interestingly, while the training and consulting had a substantial dollar impact on sales and profits, statistically, the result was weak.[86] In another meta-analysis, they found that four of five studies under review showed that training programs for managers and business owners had a positive impact on business practices and productivity. The one study that did not find an impact was reviewing the shortest training program (implemented for two days).[87]

At the moment, most accelerators are non-profit entities and funding often comes from foundations. Other general business skills training also seems to be aid funded. Private sector actors could move into the field if accelerators' SMEs begin making successful exits; however, the difficulty exiting investments was touched on in Chapter Two. Until there is a financial incentive, human capital building seems likely to remain a non-profit dominated segment.

It is still early, but accelerators are a promising option to address the human capital need. Even though both the number of financing options and accelerators have grown in the past five years, financing has been more of a focus. It seems the market is nearing a point where there will be more financing than there are viable investments. When that occurs, there will likely be a greater influx of organizations that work to

[85] These business practices include keeping accounting records, calculating monthly revenues, and separating business and home financial transactions.
[86] Yukichi Mano, Alhassan Iddrisu, Yutaka Yoshino, and Tetsushi Sonobe, "How Can Micro and Small Enterprises in Sub-Saharan Africa Become More Productive? The Impacts of Experimental Basic Managerial Training," *World Development* 40, No.3 (2012): 458.
[87] "IFC Jobs Study," *The International Finance Corporation*, 100-101.

address the human capital and pipeline issue. At that point, hopefully data from the early accelerators will be available for evaluation.

Chapter Four: The Enabling Environment

CHALLENGES AROUND THE ENABLING ENVIRONMENT

The enabling environment, somewhat of a catchall phrase for how a country's governance impacts business and commerce, is often a hurdle for SMEs.[88] World Bank data shows that the five top difficulties of the enabling environment in low and middle income countries, each of which will be elaborated on below, are: lack of electricity, heavy regulation, high tax rates, practices of competitors in the informal sector, and corruption.[89] In addition, access to markets, a specific set of difficulties within the enabling environment, will be discussed after the five obstacles.

SMEs cite electricity as the main obstacle; 52% named it as a significant issue. When electricity fails, SMEs lose productivity because SMEs are less likely than large firms to have access to alternative sources of electricity. Between 22 and 35% of SMEs have access to generators compared to 51% of large firms.[90]

In terms of heavy regulation, SMEs often struggle because they encounter both burdensome regulations and vague rules confusingly applied. This can occur at many steps in the business creation process such as construction permits, registering property, paying taxes, trading across borders, and enforcing contracts. Large firms are typically better able to navigate complex procedures because they can afford to devote staff to working through the process. Large firms also generally go through regulatory issues

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[88] The World Bank says that governance, "can be defined as the rule of the rulers, typically within a given set of rules. One might conclude that governance is the process – by which authority is conferred on rulers, by which they make the rules, and by which those rules are enforced and modified." "Governance-What is Governance?," *The World Bank*, accessed 4/7/14, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/EXTMNAREGTOPGOVERNANCE/0,,contentMDK:20513159~pagePK:34004173~piPK:34003707~theSitePK:497024,00.html.

[89] "Scaling-Up SME Access to Financial Services in the Developing World," *The International Finance Corporation*, 14.

[90] Ibid., 15.

more than once, and through exposure, gain institutional knowledge and form relationships.[91] They also have capital to support any extra fees that arise.

In terms of taxes, the IFC (2010) said that median tax rates are higher in lower and middle income countries than high income countries (20% vs. 14%). Not only do SMEs have a high tax rate on average, the taxes they pay usually do not contribute significantly to increased revenue.

Additionally, countries' informal sectors are tightly linked to their tax rates. In order to bring in revenue when there is a large informal sector, governments tend to impose significant taxes on the formal sector. As they do, the high tax rate acts as an incentive to operate in the informal sector rather than move to the formal sector. Informal competitors are also able to offer lower prices since they do not have the tax expense that formal SMEs do. Given this, a system that incentivizes informality is highly problematic for SMEs.

Finally, in terms of corruption, SMEs are somewhat more likely to pay a bribe to facilitate a transaction than large firms are. This could be either because they lack bargaining power and connections that would allow them to avoid paying bribes or it is possible they are easier targets because they do not comply with all regulations.[92] These difficulties are an overview of what SMEs face in low and middle income countries; for a breakdown of the regional variation in obstacles, see Figure 3.

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91 "Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises," *The World Bank* (2014): 1.

92 "Scaling-Up SME Access to Financial Services in the Developing World," *The International Finance Corporation*, 15-16.

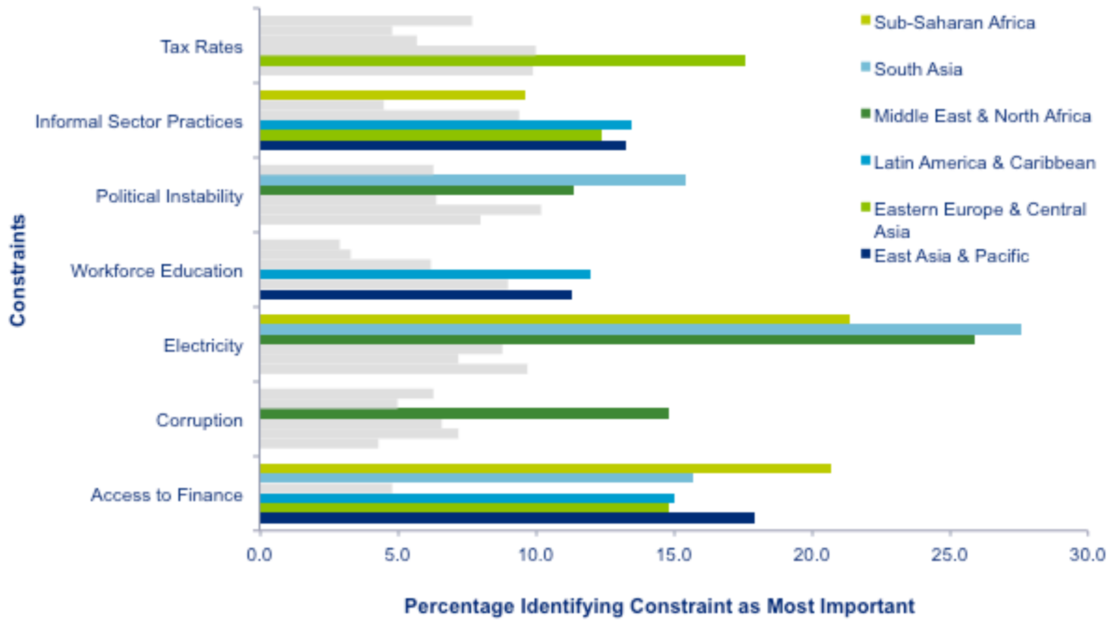

Figure 3: Percentage of firms identifying each constraint as most important by region (the top three constraints for each region are highlighted).[93]

Access to markets is an issue for many SMEs. It includes hurdles that make it difficult for entrepreneurs, and any vendor, to strategically participate in markets. The first hurdle is typically market information. Basic information about market size and scope is often not available, and market segmentation is either also unavailable or quite expensive. Typically, in more developed markets, agencies provide market information to SMEs. Additionally, in developing markets, information on pricing, exporting, and production quantity and quality can be difficult to obtain.[94] Access to market problems have direct effects on entrepreneurs' ability to obtain funding. To reduce risk, funders are more likely to invest in entrepreneurs with multiple product channels. Without multiple

[93] "Enterprise Surveys," *The International Finance Corporation*, accessed 7/15/13, http://www.enterprisesurveys.org.
[94] "Access to Markets: Making Value Chains Work for Poor Rural People," *International Fund for Agricultural Development* (2012): 1-2.

channels, revenues and profits have greater potential to stall, increasing investing risk.[95] Given the operational and funding implications, access to markets is a critical part of the enabling environment.

The IFC (2013) cited long-term studies that have shown increases in quantity and quality of infrastructure alone reduce poverty and inequality.[96] Although it is a key SME challenge, the enabling environment is difficult to address given the many issues and stakeholders. Because of the complexity, there are not strategies to address it in the way impact investing works to increase available financing. Given this, the next section of the chapter will focus more on trends in enabling environments worldwide and less on specific enabling environment building work.

How Challenges are Being Addressed

Parsing out enabling environment reforms and comparing best practices across countries would go beyond the scope of this paper. However, the World Bank's yearly Doing Business reports give a picture of the overall trends. The World Bank produces reports analyzing regulations that affect private sector firms (especially SMEs) around the world. To do so, they track 11 indicators for 189 economies. They group the 11 indicators into those that relate to regulatory processes and those that relate to the strength of legal institutions. See Table 2 for a list of the 11 areas tracked. By doing this yearly, they are able to detect patterns and offer insight into common characteristics of countries that score well on the measures.[97]

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95 "Accelerating Entrepreneurship in Africa," *Omidyar Network and the Monitor Group*, 6.
96 "IFC Jobs Study," *The International Finance Corporation*, 61.
97 "Doing Business 2014," *The World Bank*, V.

Complexity and cost of regulatory processes	
Starting a business	Procedures, time, cost and paid-in minimum capital requirement
Dealing with construction permits	Procedures, time and cost
Getting electricity	Procedures, time and cost
Registering property	Procedures, time and cost
Paying taxes	Payments, time and total tax rate
Trading across borders	Documents, time and cost
Strength of legal institutions	
Getting credit	Movable collateral laws and credit information systems
Protecting investors	Disclosure and liability in related-party transactions
Enforcing contracts	Procedures, time and cost to resolve a commercial dispute
Resolving insolvency	Time, cost, outcome and recovery rate
Employing workers	Flexibility in the regulation of employment

Table 2: World Bank Doing Business indicators.[98]

The 2013 Doing Business report found that, globally, there has been progress in simplifying and reducing the cost of regulatory processes. Business regulation practices have gradually converged toward more efficient practices seen in higher income countries. Of the 2,000 types of reforms recorded in the last 10 years, two thirds were targeted at improving regulatory processes. For examples of this convergence across four measures, see Figure 4. However, there has been less convergence in the strength of legal institutions across countries. The report also found that countries with the weakest regulatory institutions and the most costly regulatory processes engage in regulatory reform less often; however, when they do, they address the worst of their regulatory structures and often adopt international best practices.

[98] Ibid., 22.

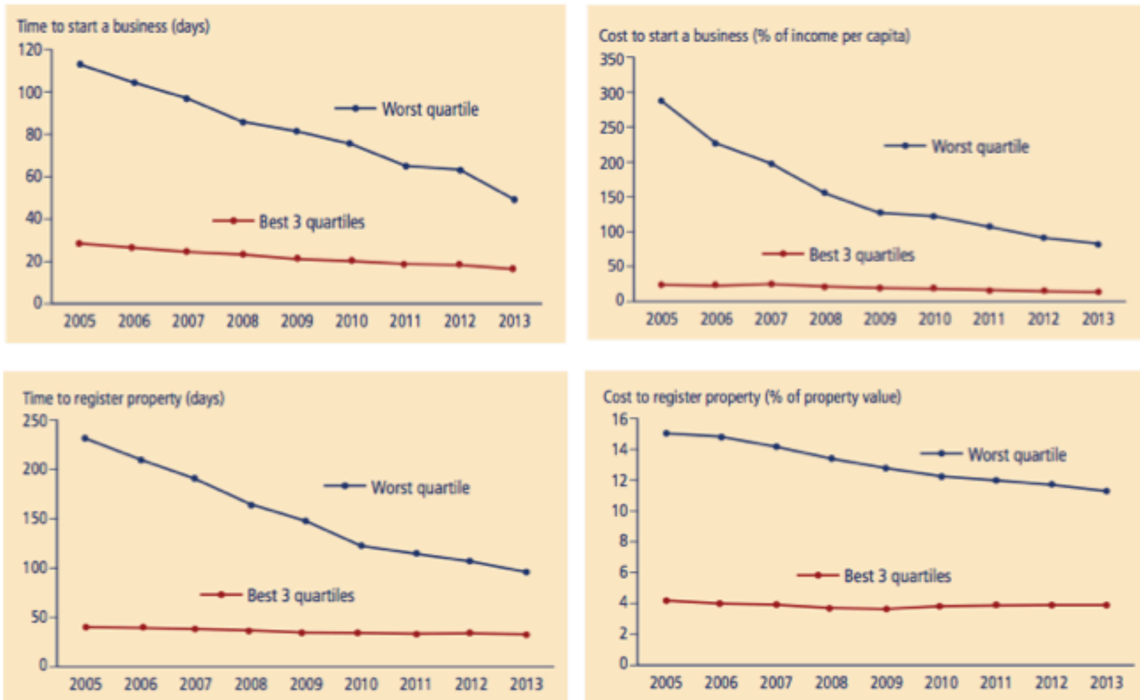

Figure 4: Convergence of practices towards those seen in the best performers' economies.[99]

For example, Rwanda made reforms specifically to promote entrepreneurship. The government decided a priority was to accelerate Rwanda's development to become a middle income economy by 2020. To achieve this, they created a Doing Business Unit to spearhead economic initiatives. Since the creation of the unit, Rwanda has made 26 regulatory reforms. One reform was increasing the number of notaries available. Before 2006, there was one notary in the country which meant that entrepreneurs had long waits when they tried to register their new business. In 2006, Rwanda introduced hundreds of new notaries. In addition, Rwanda set up one-stop shops so that business registration was

[99] Ibid., 14.

streamlined. With changes like these, the time required to start a business fell from 18 days to three.[100]

As another example of regulatory reform, Malaysia has made significant progress on reducing the complexity of their tax system and moving towards an electronic system. In the past, companies and taxpayers had to send their forms by mail or take them to a tax office; after the reform, they were able to complete forms and provide payment details online. The online system allows entities to input their tax information and has safeguards to ensure that deductions are done correctly to save time and avoid penalty charges. Finally, the reforms automated refunds to get money back to companies and citizens as soon as possible.[101] This type of streamlining would assist SMEs who often do not have the funds to hire a full time accountant. The online filing method would make the process more flexible and reduce errors that can be costly in time and money. To get a sense of the number of reforms by geographic area, see Figure 5.

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[100] "Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises," *The World Bank* (2013): 37-41.
[101] Ibid., 56-59.

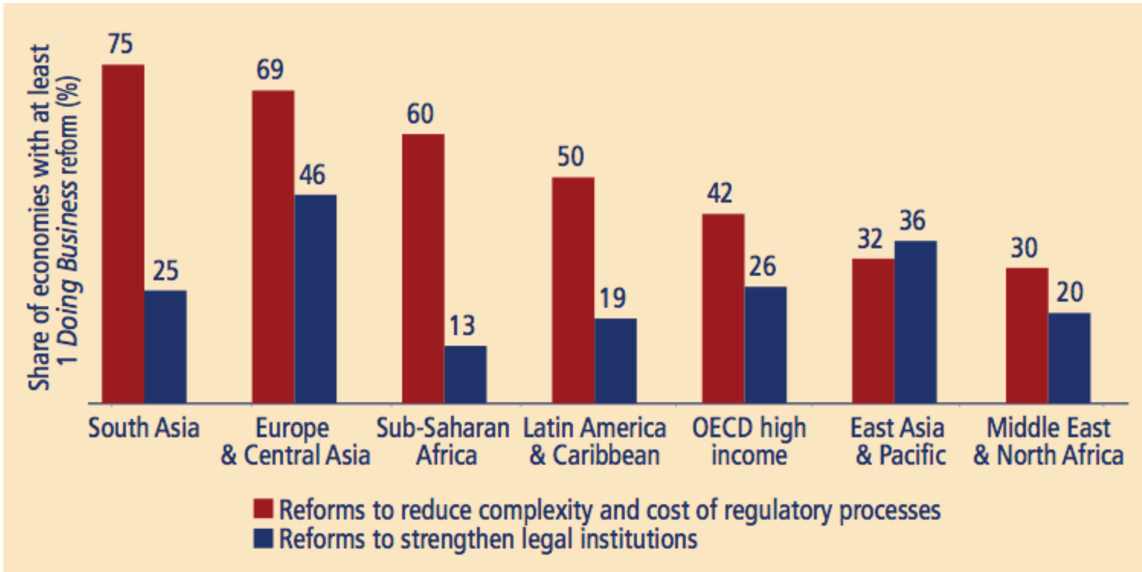

Figure 5: Regulatory and legal reforms by geographic region (2012 and 2013).[102]

Reviewing commonalities among countries that lead the Doing Business indicators, they generally have bigger governments (measured by government expenditure as a percent of GDP). High performing countries also have small informal sectors because more people have access to formal employment and the associated benefits. Finally, the countries are more likely to have legally protected gender equality.[103]

Clearly, there will be significant variations from country to country on if and how they engage in enabling environment reform. As a whole, there are generally agreed upon practices that improve business environments, but with the number of stakeholders and the different economic ideologies involved, the enabling environment can prove difficult to address.

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[102] "Doing Business 2014," *The World Bank*, 9.
[103] Ibid., 4-5.

Level of Impact

Given some of the improvements summarized above, the next step is to examine the impact. The impact would theoretically manifest on a number of levels including an increase in the number of new/newly registered business as well as in the country's growth rate. Within country studies have found a positive correlation between reforms in business regulation and the registration of new firms. The World Bank Doing Business studies found between a five and 17% increase in the number of newly registered businesses after reforms. Figure 6 shows the effect of reforms in six countries.

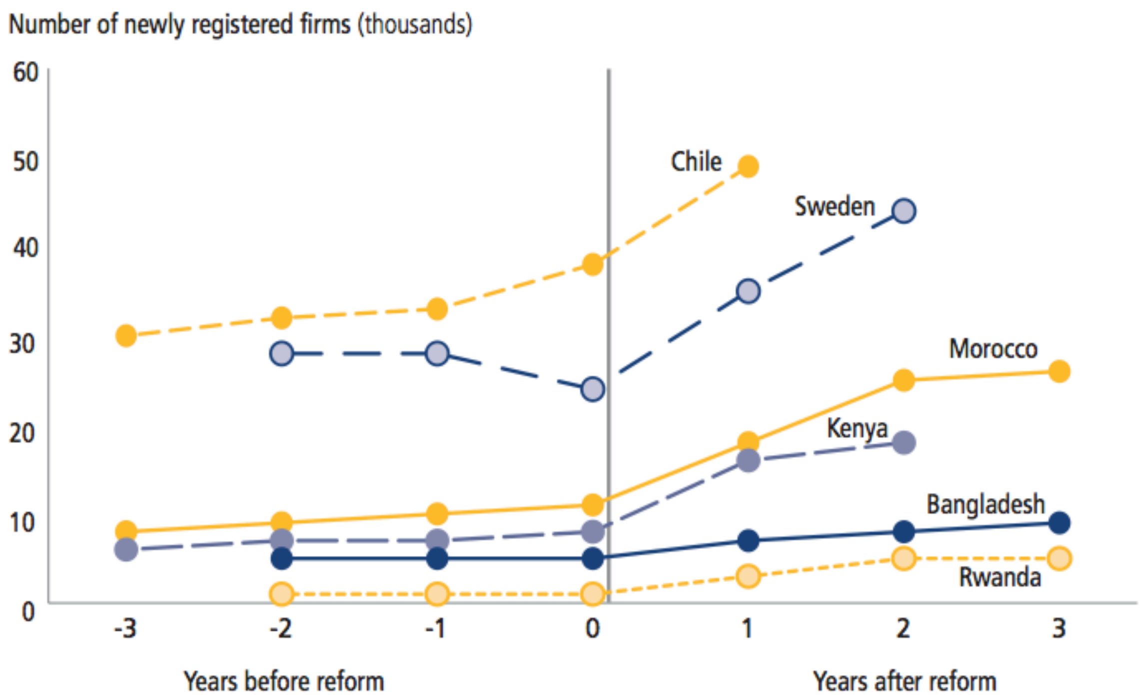

Figure 6: Number of newly registered firms before and after regulatory reform.[104]

When analyzing if this was due to informal businesses registering or the creation of new businesses, Bruhn (2011) found that reform increased the number of registered

104 "Doing Business 2013," *The World Bank*, 14.

businesses by 5% because former wage employees started businesses and not because informal businesses registered.[105] Looking at the relationship between regulation and countrywide growth, Eifert (2009) found that low income countries that engaged in reform increased their growth rate by .4% the following year.[106]

At the moment, there do not seem to be groups addressing the enabling environment. Some SME support sector organizations advocate for certain issues, but addressing the enabling environment does not seem to be a core focus. Thus far, enabling environment change has involved the country's government and sometimes an international organization like the World Bank. This dynamic impacts some of the policy suggestions in the next chapter. Particularly, because of the national specificity of the changes necessary, there needs to be strong SME support sector groups at the national level.

Looking at progress on access to market issues, a number of SME support organizations work to address access to markets as part of their agriculture initiatives or as part of other SME support work (typically financing and technical assistance related). Additionally, organizations are working on incorporating SMEs into large firms' supply chains. However, this is an area that could use a more targeted focus.

Despite improvements, entrepreneurs in developing countries still have difficulty with the regulatory processes in their country's environment. Organizations working in the SME support sector often have an interest in enabling environment change, but that is not their primary purpose. Given the enabling environment issues, as well as the

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[105] Miriam Bruhn, "License to Sell: The Effect of Business Registration Reform on Entrepreneurial Activity in Mexico," *Review of Economics and Statistics* 93, no. 1 (2011): 382-386, in "Doing Business 2014," *The World Bank*, 31.

[106] Benjamin Eifert, "Do Regulatory Reforms Stimulate Investment and Growth? Evidence from the Doing Business Data, 2003-07," *Center for Global Development* Working Paper 159 (2009), in "Doing Business 2013," *The World Bank*, 11.

financing and human capital ones discussed in previous chapters, Chapter Five will offer a number of research and policy recommendations.

Chapter Five: Research and Policy Recommendations

While there are policy recommendations to make, the lack of research proving the SME theory of change in development is a significant challenge. There is also space for a research agenda related to human capital and the enabling environment. As mentioned in Chapter Two, there has been a substantial amount of literature on the financial limitations that SMEs face, and there are a number of innovative approaches in both the debt and equity spaces that have seemed to improve the financing environment. The same cannot be said for the literature in and approaches to human capital and the enabling environment. The research agenda proposed below addresses the overall field gap related to proving SMEs as a development tool and specific gaps in the human capital and enabling environment research. After discussing the research agenda, this chapter will discuss policy recommendations in light of the missing research.

First of all, for the field, it is critical to prove the efficacy of SMEs as a development tool. SMEs and the SME support sector would greatly benefit if the conversation moved from asking if SMEs are effective development tools to asking how best to support and encourage SMEs. Showing effectiveness will pave the way for more financial resources to be dedicated to the field. Development organizations that fund SME focused projects, such as the World Bank or the United Nations Development Program, want to know that their initiatives are efficient ways of using limited resources. Proving effectiveness would be a strong argument for increasing SME project funding. If the SME support sector decides to fund that research itself, the Aspen Network of Development Entrepreneurs already acts as a trade association for all those in the SME support sector. As an organization, they publish research and host a yearly conference where main SME support sector actors engage on industry topics. Additionally, its members include some of the organizations that have worked in SME development the longest and are well respected. The Aspen Network of Development Entrepreneurs would be well placed to coordinate the proving the theory of change effort.

Turning from the overall theory of change question to the human capital question, there is a vast body of literature on human capital and the effects of training. However, there is very limited literature examining human capital in the context of development and SMEs. Thus far, there are indications that rudimentary business training does improve SMEs' business; however, that is a far cry from understanding the types of training that are effective, what training is appropriate for what kind of SME, and the exact impact of training on SME growth. There is also evidence that more robust entrepreneurship-applicable education would be useful; however, it is unclear where that should take place (at the primary level or secondary level) or how much and what should be taught (critical thinking or more logistical running-a-business skills). A better understanding of how programs and training help develop entrepreneurship skills is important. Essentially, the body of literature on human capital and the body of literature on SMEs have yet to meet.

In terms of the enabling environment, there is also much to be done. Literature has identified characteristics of strong enabling environments (low impediments to starting businesses, legal protections, etc.) yet there is no comprehensive studies or guide on how to attain those. While the roadmap will vary based on country dynamics, there could be a more clear synthesis of lessons learned. A careful study of specific SME applicable regulations and legal structures would benefit the field. Additionally, an understanding of how distinct sectors are impacted by the enabling environment is important. How can countries cultivate an industry specialty? For example, to support building a SME agriculture sector, countries need to consider food safety standards as well as general regulatory and legal environment questions while, to build a SME pharmaceutical sector, countries need to consider intellectual property and medical testing regulations as well as the general regulatory and legal environment questions.

Moving from the research agenda to policy recommendations, there is a main policy recommendation for the SME field as a whole then specific recommendations related to financing, human capital, and the enabling environment.[107] The main policy recommendation is to build robust local SME support sector groups that are connected to an overarching international structure. In this case, local would mean building a strong country level SME industry group. Although, in the future, if a country's SME sector is strong and well supported, having city or state level groups would be valuable.

Some issues require industry-wide coordination. For example, proving the SME theory of change is best done by an international group that includes well-known, long-standing actors in the field. However, some issues are best addressed locally. Not only do financing and human capital challenges vary in severity depending on the country, enabling environment challenges are almost guaranteed to be locally dependent. Local groups are well placed know what needs to change and to advocate for it. Given the dual needs (industry wide coordination and country level advocacy), it is important to have both international and local structures.

A 'local SME support sector group' sounds vague, but the formation and affiliation is less important than the group including entities and organizations that are closely linked to the SME sector. The appropriate members are critical to the groups' knowledge and advocacy clout. However, having the local group linked with the international SME infrastructure would be a strong move to ensure that there is local and

[107] The SME field refers to all actors in the field: SMEs themselves and the SME support sector.

international communication. Given this, the local group could be affiliated with the Aspen Network of Development Entrepreneurs or the Global Impact Investing Network. The Aspen Network of Development Entrepreneurs has regional affiliates so it would be natural to expand that network. However, the local group could also be affiliated with a chamber of commerce or any group tightly linked to the SME community.

Once these local groups are active, an initial item of business should be a map of the country's (or at least the major cities') SME landscape that notes SME support organizations, active SMEs, and generally provides an overview of actors and resources.[108] A clear sense of all the available resources would be very valuable to entrepreneurs who are planning to launch or have recently launched a SME. Additionally, such a document would act as a network builder. Those in the SME support sector would have a clear idea of others working in the area and their interests. If an impact investing group focusing on health came across an entrepreneur with a carbon reducing technology, they could refer the entrepreneur to impact investors that work in environmental technology rather than just decline to fund the entrepreneur.

Moving to consider some of the challenges discussed in the paper, financing is the challenge that has been best addressed thus far. However, there is a substantial amount of work that remains to be done. Areas to focus on include building a body of information about SME's, their patterns, and needs. Research has shown that credit information sharing has a positive effect on the credit available to SMEs. Building credit information and then ensuring that information is shared is critical to getting SMEs access to funding.[109] Analysis of SME information can allow institutions, both financial and SME

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[108] Dassel, Grimm, and Cannon, "Growth and Opportunity," *Monitor Deloitte and the Aspen Network of Development Entrepreneurs*, 19.
[109] Beck and Demirguc-Kunt, "Small and Medium Size Enterprises," *Journal of Banking & Finance*, 2940.

support related, to segment and better serve the heterogeneous SME group. Banks would be best placed to gather this information as SMEs come to them to seek financing. However, to ensure the information is open to all those interested, development institutions or groups that work with banks to assist them in serving SMEs might be a better choice.

In terms of the human capital challenge, development organizations should consider incorporating entrepreneurial and general business skill classes into the initiatives they fund. There are many programs targeted at the post secondary education level, both technical training schools and university programs. Donors should include funding specifically for entrepreneurial education. This could also be an opportunity for private educational institutions. Since there is a gap in the market, a private school could begin offering a curriculum tailored to entrepreneurship. If the private school finds significant demand, then entrepreneurship could be integrated into aid programs.

To address the enabling environment challenge, there is a need for a strong regulatory and legal framework. All SMEs would benefit from contract enforcement, property rights, reliable legal recourses, and clear and consistent processes for business creation. Of course, this is far easier said than done. Given that, some less comprehensive options include offering subsidies to scale proven socially beneficial businesses and prioritizing transparency.

Governments should offer subsidies to scale proven SMEs that have a social benefit. Initially, the burden is on the provider to show their model successfully offers a social good. In this situation, the SME incurs the costs of beginning the program and sustaining it to the point of creating a track record of success. Once success is demonstrated, governments should assist in bringing the social benefit to a wider population. It is an efficient use of resources because the risk and cost of failure is initially on the SME; the government purchases a proven model and assists with expansion. For example, in India, public ambulances are often slow and overburdened. Because of this, there was a SME that offered an ambulance system guaranteeing speedy arrival times. It used a tiered pricing system so that no customer was turned away. It makes sense to contract with the ambulance system to either supplement or replace the public system.

Governments should also make significant investments in transparency. For SMEs or smallholders to engage in the market, there must be equal information available. The government can be a strong player in offering information about market prices, export procedures, the quality of goods on the market, and the quantity of goods. For example, interested citizens could get texted prices of a representative basket of goods daily.

The SME and SME support industry is at a very promising point. There has been accelerating interest in the last five to ten years and a proliferation of actors. To ensure that the industry is able to deliver as a development tool, it will be critical to pursue an aggressive research agenda; address the financing, human capital, and enabling environment barriers; and have international and local structures dedicated to supporting SMEs. The suggestions above would provide initial steps towards furthering SMEs as a key development tool.

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