

infoDev Study on Addressing the Financing Gap for Technology Entrepreneurs in Developing Countries

Preliminary Findings & Recommendations from the *infoDev* Study

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(general SME vs. ICT/ICTE small businesses)
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INTRODUCTION

Study Focus

Existence, origins and nature of “**financing gap**” faced by SME in the ICT/ICTE industry

➔ **Shortage of capital to meet demand** (but not necessarily an “absolute lack” of capital)

➔ **Obstacles also on the demand side** (namely, “control aversion”)

Study Coverage

Small and Medium Enterprises (SME) as defined by the World Bank Group:

- ➔ Micro (up to 10 workers and US\$ 100,000 turnover)
- ➔ Small (up 50 workers and US\$ 3 million)
- ➔ Medium (300 workers and US\$ 15 million)

i.e. widely different business models

Study Coverage

Firms operating in:

➔ **ICT activities** (software development, IT-related consulting, production, sale & servicing of IT equipment)

➔ **ICT-enabled activities** (Business Process Outsourcing – BPO, remote testing, design and R&D activities)

Study Coverage

➔ **Latin America** (Argentina, Brazil, Peru, Dominican Republic)

➔ **Sub Saharan Africa** (Kenya, Senegal)

➔ **Asia** (India, Philippines)

➔ **North Africa** (Morocco)

➔ **Eastern Europe** (Ukraine)

i.e. widely different countries

Study Coverage



OBSTACLES TO SME FINANCING

Informational Asymmetries

Always present in any enterprise financing decision, but **more severe for SME** (e.g. inadequate financial reporting)



Problem magnified in ICT/ICTE by the **high tech nature** of the business (but more literate promoters)

Risk Profile

SME have a **higher risk profile** (“one man band”, limited market power, more exposed to adverse changes in the external environment)



Problem exacerbated in ICT/ICTE by the **innovative character** of activities, with high risk of failure

Transaction Costs

SME financing is an **expensive business** (high fixed costs for a *faible ticket*; raising interest or fees is only a partial answer)



In ICT/ICTE the problem is more severe because of the **specialized expertise** required to appraise initiatives (not available to traditional financiers)

The Issue of Collateral

More a symptom than the original cause, as it serves to mitigate problems with “moral hazard” and high risk profile



In ICT/ICTE the problem is aggravated by the **intangible nature of assets** (but in some segments trade receivables can serve the purpose)

Impact of Institutional Factors

Problems are exacerbated in Developing Countries:

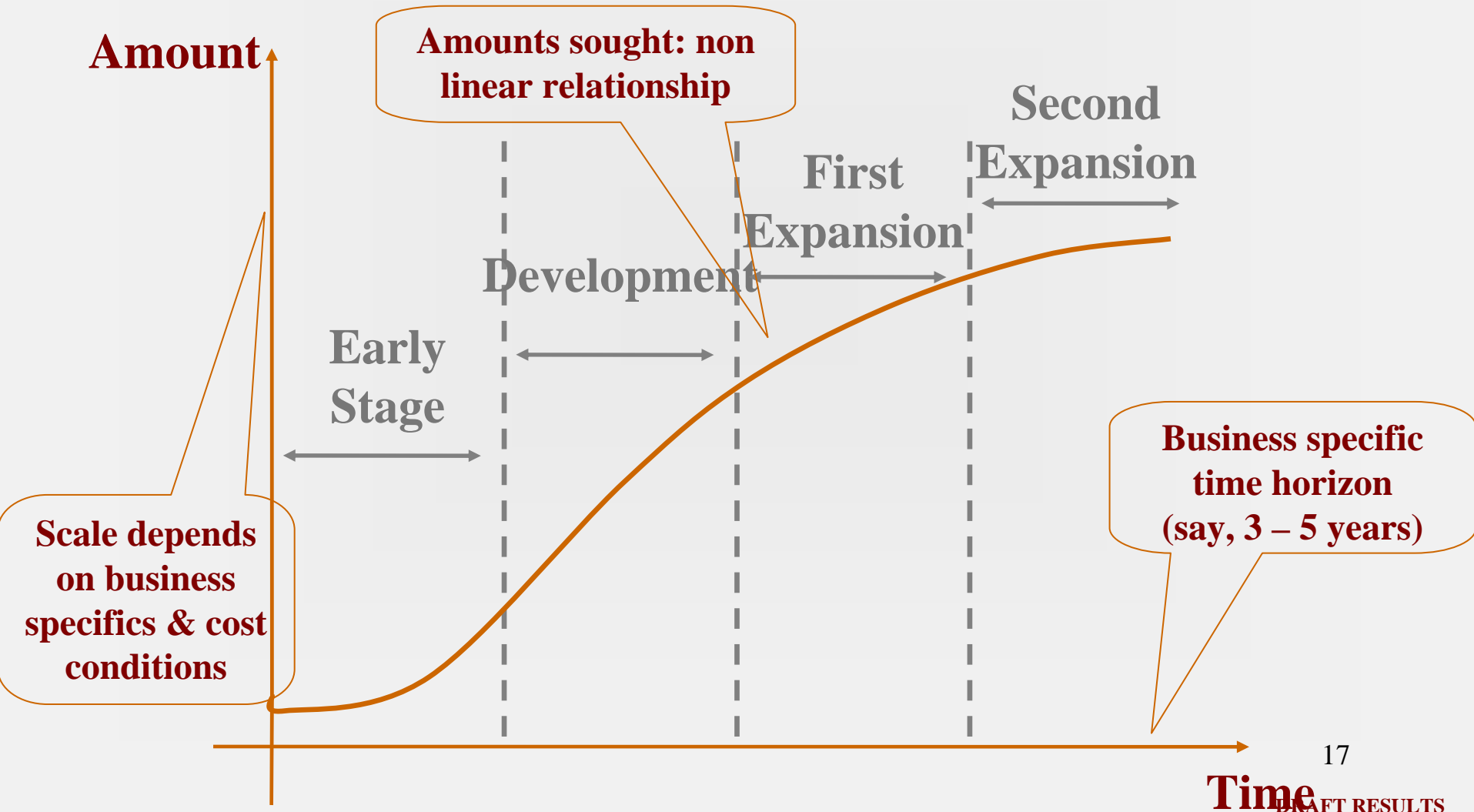
- ➔ undeveloped **financial systems** (concentrated banking sectors, thinly traded stock markets)
- ➔ inadequate **legal systems** (problems with collateral and, sometimes, quasi equity instruments)
- ➔ undeveloped **information infrastructure** (e.g. no credit bureaus)
- ➔ **taxation** often skewed in favor of debt financing

EVIDENCE FROM COUNTRY STUDIES

Approach

- ➔ Overview of the **ICT/ICTE sector** (size, key traits)
- ➔ **Financing needs** identified (sort of “financing life cycle” model)
- ➔ Review of **existing instruments** (debt and equity financing)

Financing Needs: Life Cycle Model



Definitions:

➔ **Early Stage:** includes pre seed, seed and start up phases (from business idea to commercialization)

➔ **Development:** firm may or may not trade profitably and needs refer to capacity increase, market development & working capital

➔ **1st Expansion:** significant change in operations (second version or product diversification)

➔ **2nd Expansion:** financing needs often related to an internationalization drive

Comments

➔ in **simpler activities** (e.g. web designing and IT services), the distinction between early stage and development becomes blurred

➔ the **non linear relationship** between development stages and amounts required may not apply to some ICTE activities (e.g. call centers)

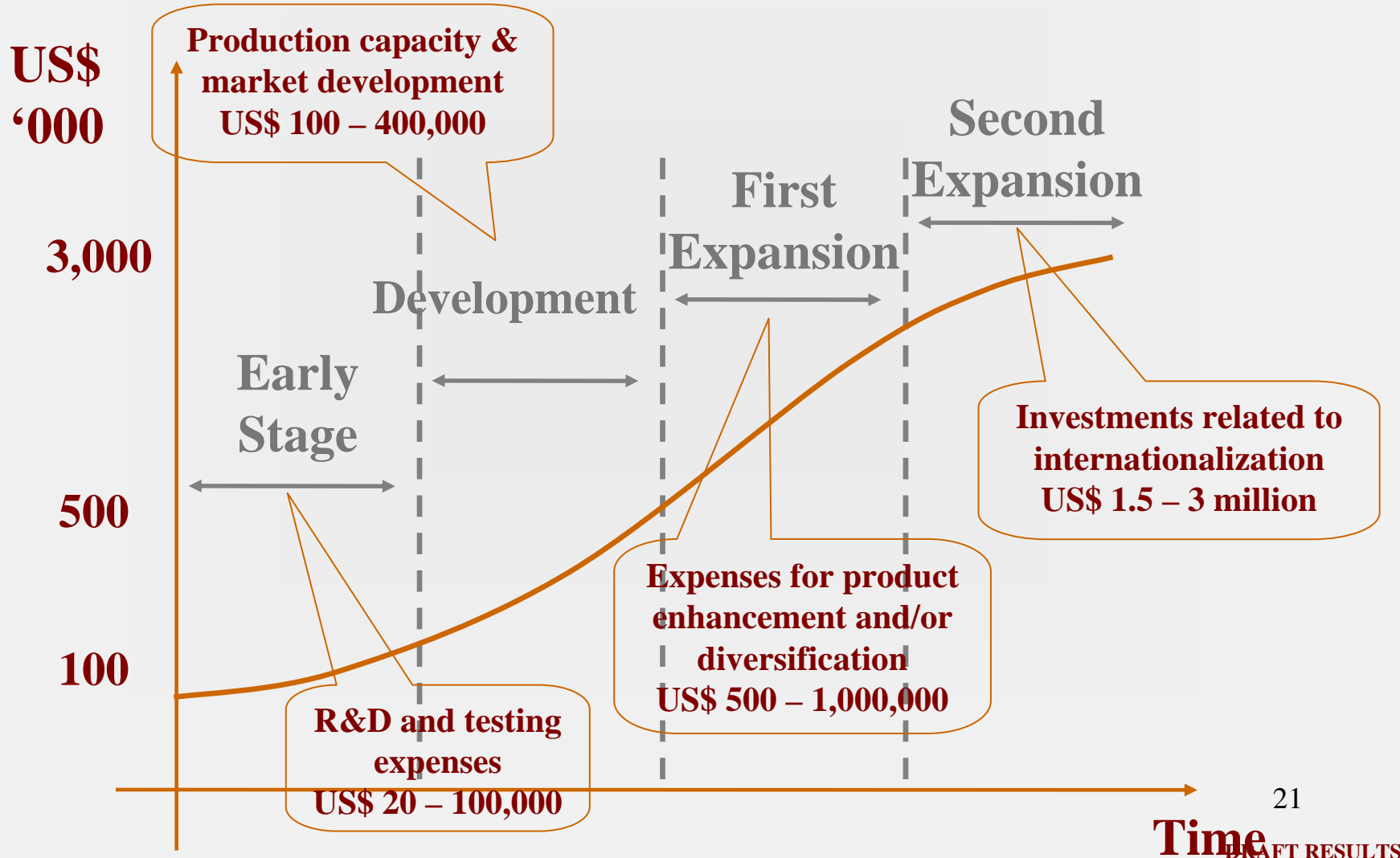
Morocco – ICT/ICTE Sector

➔ Medium sized **ICT sector** (US\$ 580 M, 1,000 firms of which 200 “real ICT”, 7,400 jobs), with strong position in applications for payment systems (some world players)

➔ **ICTE** activities rapidly growing (60 call centers, US\$ 80-100 M, 8-10,000 jobs), thanks to increasing decentralization from France & Spain

➔ Emerging **regional – sub-regional role** (Senegal, Mauritania, etc.)

Morocco – Financing Needs



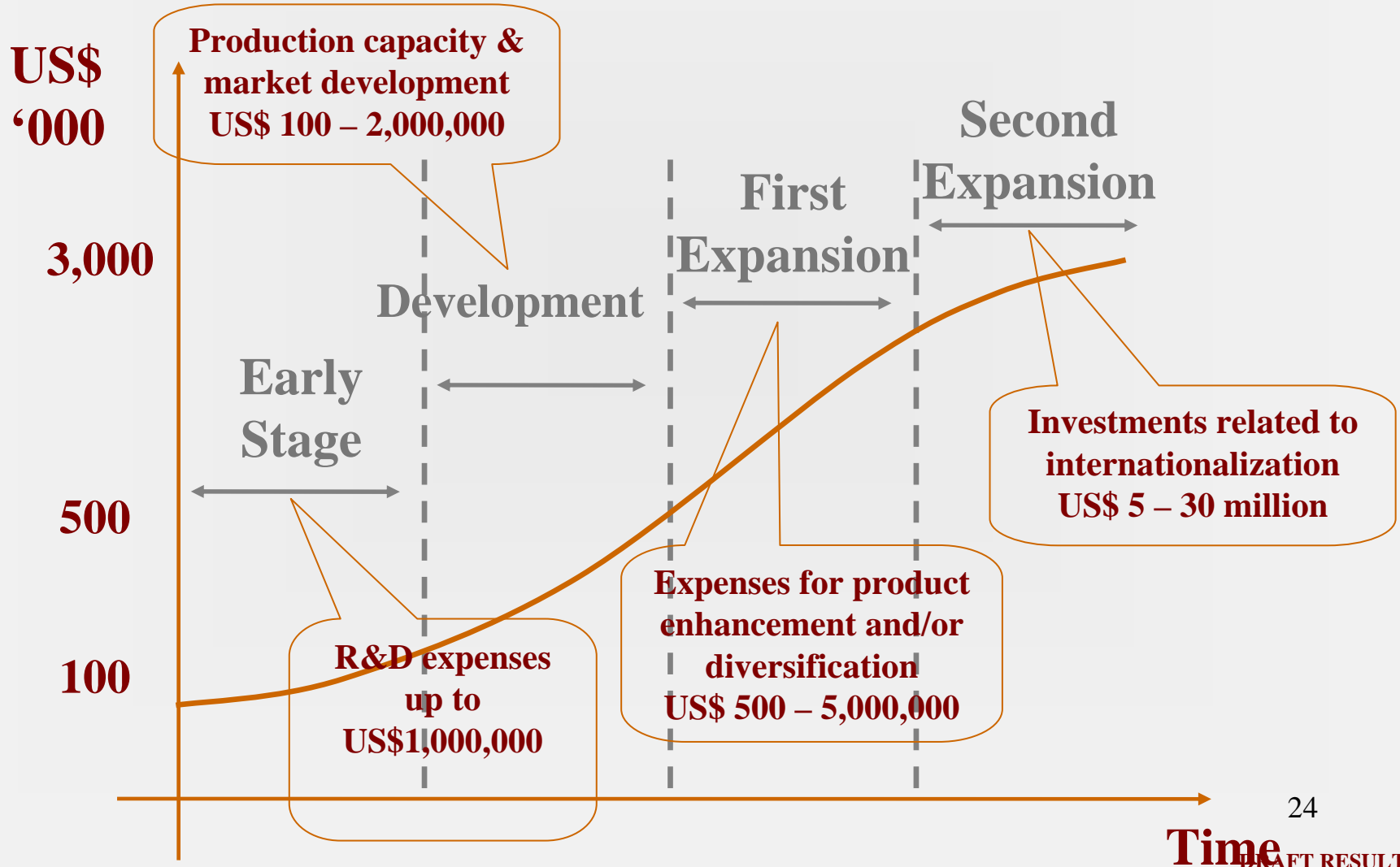
Morocco – Sources of Financing

- ➔ **Banks** admit knowing little about ICT and lending remains limited and fully collateralized)
- ➔ Talks of an **ICT guarantee fund** (proposed by the ICT sector association - APEBI)
- ➔ Generalist **equity funds** did invest in ICT (1/4 – 1/5 of deals), but they rarely go below US\$ 500,000
- ➔ Only one **seed financing facility** (*Fonds Sindibad*, with funds from CDC PME and EIB), plus some **grant financing** through NGO/government schemes

India – ICT/ICTE Sector

- ➔ Very dynamic **ICT sector** (US\$ 30 billion million, 70% export), with strong positions in services industry and emerging products industry (some world leaders – *Infosys*, *TCS*)
- ➔ **ICTE** rapidly growing, thanks to decentralization from US
- ➔ Fairly developed **infrastructures** STPI, STEP, Incubators

India – Financing Needs (new products)



India – Sources of Financing

➔ **Private investors are attracted by India:** money is still coming in, Bombay stock exchange +50% in less than six months

➔ **Equity funds** keep investing in ICT, but they rarely go below US\$ 2,500,000

➔ Some **grants**, up to US\$ 50,000, and **guarantee schemes** through government initiatives

➔ A strong need to **develop Public Private partnership** for **attracting private investors to get involved in the early stage phase**

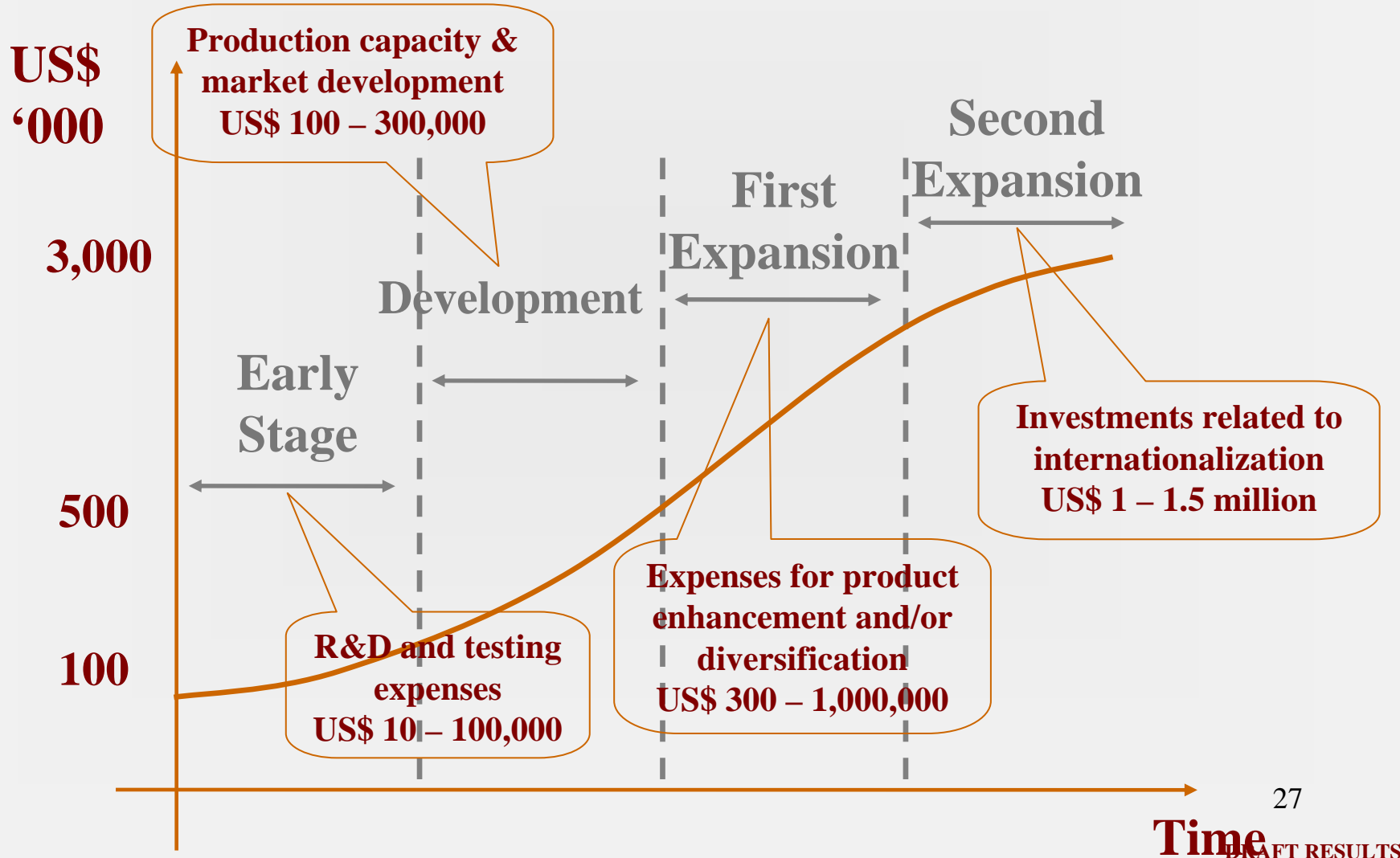
Ukraine – ICT/ICTE Sector

➔ Very dynamic **ICT sector** (US\$ 6 billion, 1,300 software related companies, 900 hardware, 400 ISP – 50,000 jobs), focus on software development and outsourcing, significant R&D, innovative

➔ **Competitive advantage** in highly skilled programmers and low labor cost

➔ **Problems:** low IP protection, uncertain legal framework, business practices not transparent, black economy

Ukraine – Financing Needs



Ukraine – Sources of Financing

- ➔ Most SME rely on **self-financing**
- ➔ **Equity funds** and **bank loans** are currently not accessible for SME, all the more in the ICT sector.
Credit guarantee schemes could play an important role
- ➔ There are no grants and **public intervention is needed** to cover the early stage and first expansion
- ➔ **Foreign Investors are discouraged** by uncertainty and lack of transparency

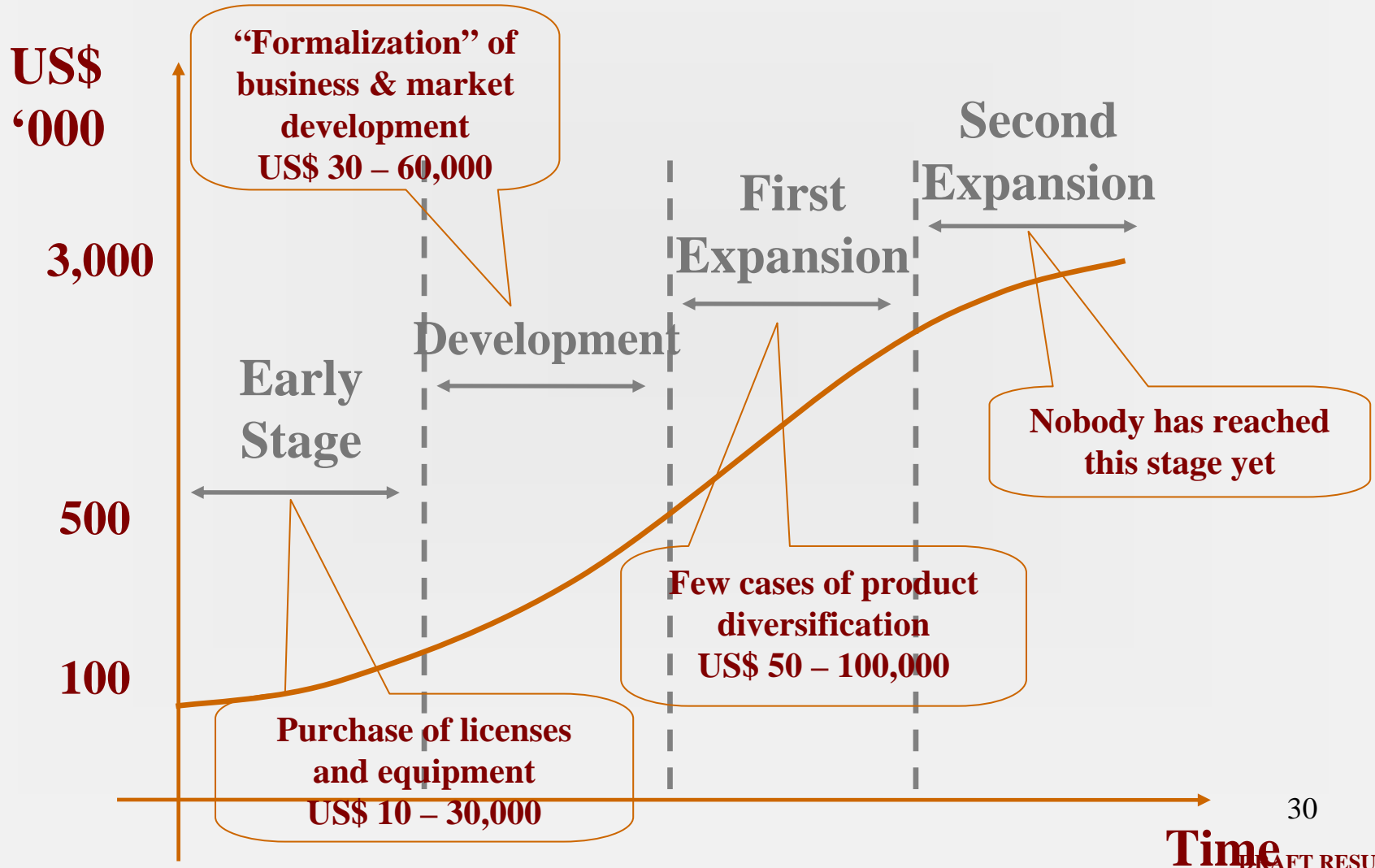
Kenya – ICT/ICTE Sector

➔ Small **ICT sector** (less than US\$ 50 M), with some 30-40 IT firms (web-designers, developers of business applications, and “software localizers” – i.e. translation in Kiswahili)

➔ **ICTE** is emphasized in the brand new ICT strategy, but development is prevented by high cost of connectivity (3 call centers licensed, only 1 active)

➔ **Regional hub**, with significant presence of leading corporations (*Microsoft, HP*)

Kenya – Financing Needs



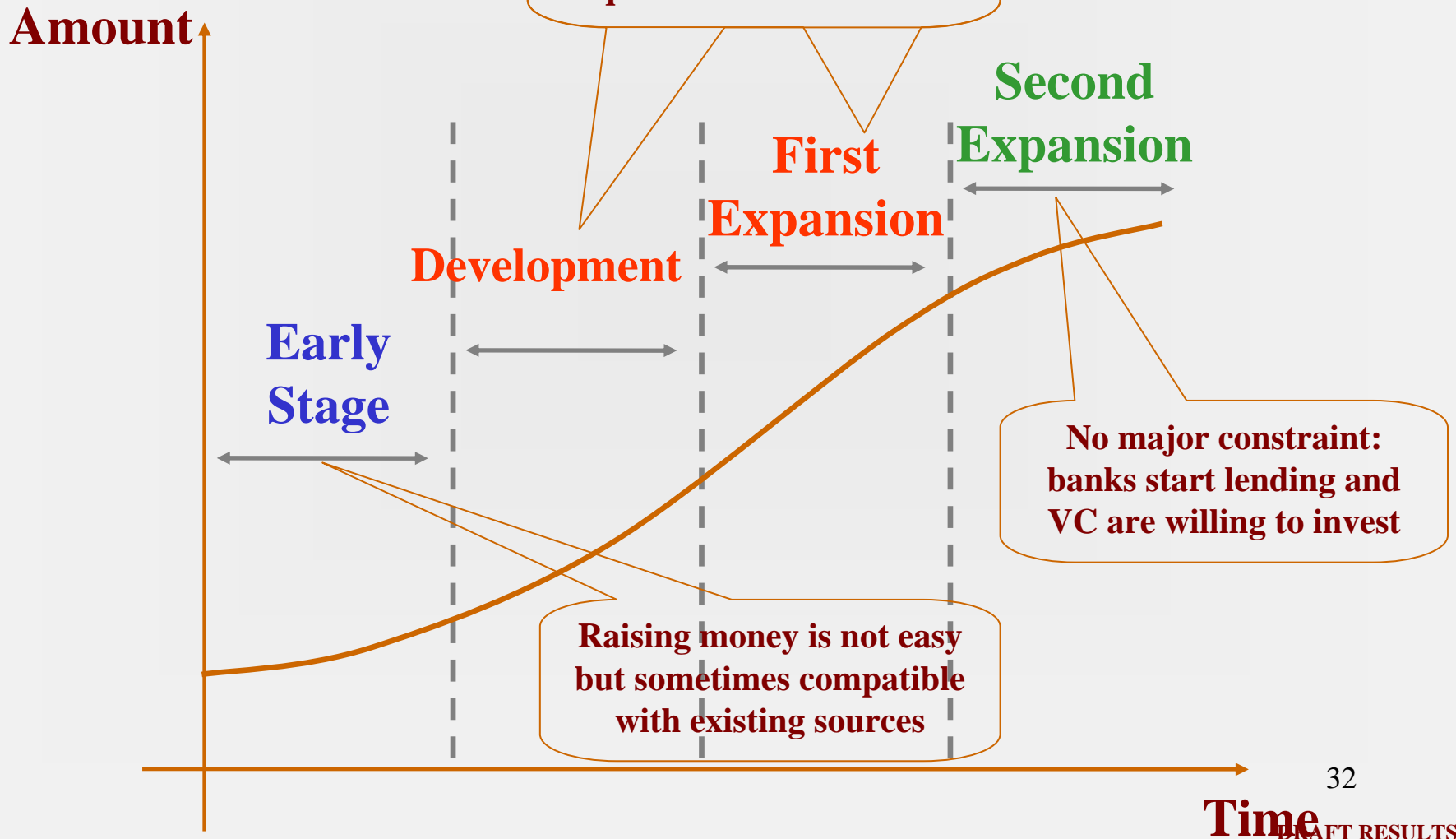
Kenya – Sources of Financing

➔ **Banks** are wary of SME in general, but *K-Rep Bank* financed some 10 small ICT operations (seemingly going well)

➔ **Equity funds** have not invested in ICT so far (*Aureos* is targeting larger deals and *Business Partners* is still in the process of setting up)

➔ *East Africa Capital Partners* tried to establish a fund with no success, and is assisting deals on a case by case basis (now targeting large deals)

Summing Up



Constraints also on the demand side

➔ **“Wrong” expectations** from promoters (do not understand or accept the risk premium required by providers of equity financing)

➔ Inability to **build a working relationship** with banks and other sources of financing (do not have time or skills)

SUPPORTING MEASURES

SME financing has been a top priority for donors and IFI for more than a decade



- ➔ Policy measures to improve the **overall business environment**
- ➔ Technical assistance to enhance **SME capabilities**
- ➔ and, especially, a wide range of **interventions in financial markets**

Interventions in Financial Markets

- ➔ **SME credit lines** (used by all donors & IFI, large number, possibly more than 400)
- ➔ **Leasing** (IFC alone supported the establishment of over 150 leasing companies)
- ➔ **Equity financing schemes** (possibly, 70-80 SME funds in operation)
- ➔ **Credit guarantee schemes** (especially in East Europe and Middle East, promoted by EU)

The Record

- ➔ **Credit lines** were certainly useful in a number of cases (no liquidity/forex), but sometimes have become too expensive and remained un-disbursed
- ➔ **Leasing** is doing well and the same applies to **credit guarantee funds** (in more advanced countries)
- ➔ **Equity funds** sometimes paid a price for their novelty (and average size of deals seems to be increasing .. once more the *faible ticket* problem)³⁷

**Most initiatives target SME “in general”,
only few devoted to ICT/innovative firms**

➔ A dozen donor/IFI-participated **investment funds** (typically less than US\$ 10 million each), mostly in Latin America, India and South Africa

➔ Few cases of credit lines with **“special windows”** for innovative enterprises (but more often support is given to the use of ICT by SME in general)

RECOMMENDATIONS

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**Promote
Credit
Guarantees**

**Increase Supply
of Equity
Financing**

Financing Gap

**Enhance
Understanding of
Financing Options**

**Enhance
Understanding
of ICT Sector**

**Promote Flexible
Investment
Instruments**

Increase Supply of Equity – New Facilities

ICT equity funds targeting **deals below US\$ 1 million** are still rare. Interest is particularly strong in India (need to feed new deals in the VC pipeline)



➔ Assistance to design ICT dedicated facilities **combining public and private money**, along the lines of schemes used in the US (revised “SBCI model” and EU (ETF Start Up)

➔ **Co-financing** would be appreciated

Increase Supply of Equity – Existing Funds

Existing “generalist” equity funds are not a priori against small deals or ICT, but are often deterred by **transaction costs**



- ➔ “TA facility” to cover **preparation & monitoring costs** incurred by fund managers for smaller deals (below US\$ 1 million)
- ➔ **Tactical approach**, trying to make the most out of what already exists

Promote Flexible Investment Instruments

Increasing recognition that investments in smaller companies require an **imaginative approach**, with use of instruments that go beyond standard equity and can be easily understood and accepted by SME



➔ Consolidate and disseminate **best practices on quasi equity financing** (royalty schemes, loans with performance related interest, etc.)

➔ Assist in **creating conditions** for more widespread use (legal framework & profession)

Enhance Understanding of ICT Sector

In many countries bankers have a limited understanding of the **fundamentals of the ICT/ICTE sector**, which is still largely regarded as a sort of “black box”



➔ Assist ICT sector associations and business incubators in compiling and disseminating information on **basic economic and financial parameters** (current proposal for a *Centrale Financière TIC* in Morocco)

Better Understanding of Financing Options

Smaller entrepreneurs need to be assisted in their initial approach to banks and other sources of financing



- ➔ **Build capacity** within ICT sector associations and business incubators to advise and support members
- ➔ More than just “business planning” and “application filling”: **real coaching is needed**

Promote Credit Guarantees

For small investments (US\$ 25 – 100,000) credit guarantees could be an **alternative to seed financing**. In countries with a weak equity culture (Ukraine), could work also for larger operations



➔ Technical assistance for the establishment of **ICT credit guarantee schemes**

➔ Where sector associations are strong (e.g. India), the **mutual credit guarantee model** could apply

**THANK YOU FOR YOUR
ATTENTION**