

VII. EXTENT AND SEVERITY OF THE FINANCING GAP

VII.1 INTRODUCTION

The previous chapters examined the financing needs and the various sources of financing available to small ICT/ICTE firms. Chapter VII looks at the financing gap faced by these firms, from three different angles. First is a discussion of the constraints faced by firms at different stages of development. Second is an analysis of financing conditions in the main segments/lines of business. Third is a discussion of the conditions prevailing in the different countries surveyed. This is followed by some concluding comments.

VII.2 FINANCING GAP & STAGES OF DEVELOPMENT

As firms go through the various stages of development—from early stages (seed and start up) to later expansion phases—their financing needs evolve. Study results indicate that the financing constraints faced by ICT/ICTE firms are comparatively more severe in the development and first expansion phases. The situation is more nuanced in the other phases.

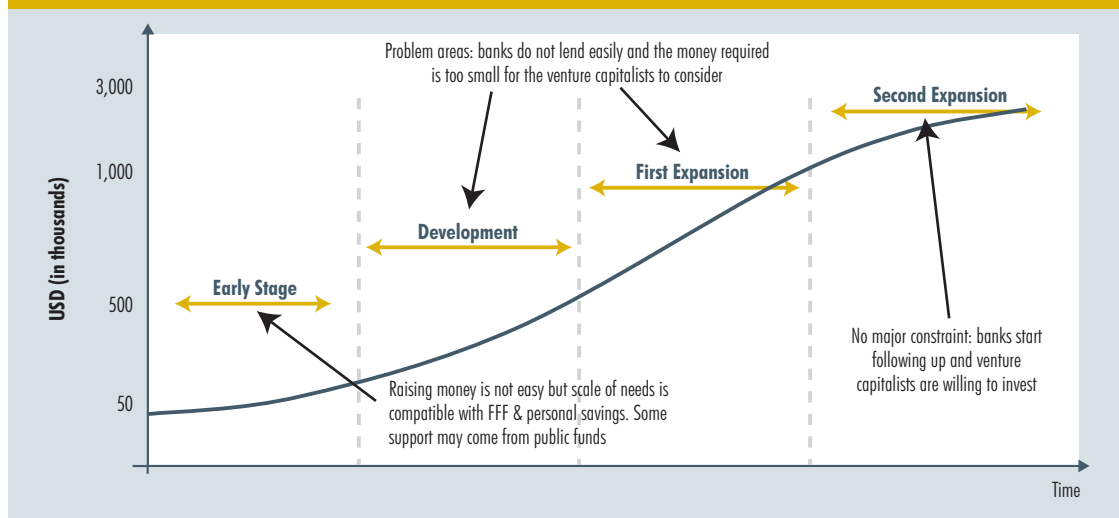
In the *early stage*, financing needs may vary significantly, depending upon the specific nature of the business and the cost conditions prevailing in different countries. In middle-income countries, financing needs are often in the US\$50–100,000 range. These amounts are often compatible with the recourse to the usual ‘FFF channels’, complemented with some personal loans and with some financing from public schemes. In lower-income countries, the amounts at stake may be even lower, and are

sometimes compatible with funds accessible through: (i) micro-enterprise banks and MFI facilities (e.g. Kenya’s *K-Rep*, Senegal’s *Pamecas*, and Peru’s *Edpymes*); or (ii) government or donor supported schemes. More problematic is the situation of promoters of ‘high profile’ innovative SME, such as the export-oriented innovative projects sometimes found in India. The financial requirements of those initiatives usually exceed these informal or traditional sources. Therefore, promoters may turn to government-led seed funds established at the federal or state level, or to a few other private high-tech funds (such as *IndiaCo*). However, the volume of resources available through these facilities is often limited to coping with the demand. For example, India seed funds operating at the state level typically have a capital of not more than US\$5 million.

In the *development and first expansion stages*, financing needs rapidly escalate from US\$100,000 to US\$1,000,000 and beyond. Enterprises at these stages of development do not have a sufficient track record to be accepted as credible borrowers by commercial banks. This despite the fact that they are already in business and are often trading profitably. On the other hand, venture capitalists regard the amounts sought by SME as too small to justify the high ‘transaction costs’. Under these conditions, ICT/ICTE enterprises may try their luck with government schemes. However, more often than not, they are forced to rely predominantly on self-financing. In developing countries, this means taking recourse to unorthodox practices, such as delaying the payment of social security and taxes. This may well result in a significant slow down in the development process, which in a fast moving business such as ICT, may ultimately jeopardize the future chances of success.

If and when an enterprise manages to reach the *second expansion stage*, then conditions for accessing financing improve significantly. Banks may still wary of lending large sums to companies involved in a business that they do not understand well, but the volume of money flowing through the bank account is a powerful factor in mitigating this skepticism. Much more importantly, investment

Figure VII.1. Nature and Severity of Financing Gap



deals above US\$2–3 million can more easily attract the interest of venture capitalists.

The considerations above are summarized in Figure VII.1.

VII.3 FINANCING GAP & LINES OF BUSINESS

From a line of business perspective, financing gap problems are most severe in the case of small enterprises active in software development and IT services. In other sectors, the situation is more favorable, although significant constraints may be faced by firms active in specific segments.

Software and IT Services. As indicated earlier, this sector is highly diversified, and encompasses heterogeneous business models that are sometimes hardly comparable. However, one element in common to most enterprises in this sector is the extreme unpredictability of results, which translates into low survival rates. On the other hand, this is also the kind of business where tremendous achievements are recorded from time to time. Like all other businesses based on immaterial assets, access to finance depends largely on the capability of

promoters to attract capital on the basis of pure business ideas. This is often an uneasy and largely useless exercise when it comes to commercial banks. Unless promoters can offer substantial collaterals in the form of private properties, bankers are extremely unlikely to put any money into an immaterial business that many do not understand well. The situation improves somewhat when an enterprise can maintain a constant cash flow for a certain period through side-activities¹⁷, or when a more established firm can leverage on their own patented applications¹⁸. On the other hand, software development and IT services are the favorite domain for tech-savvy VC, especially those who follow enterprises from the cradle and are ready to accept a high incidence of small losses in order to achieve a few stunning gains. However, these players are not present in all the countries, and they have a very hands-on approach that some promoters dislike. The same applies to business angels, whose involvement is very limited or non-existent in most of the countries surveyed. As a result, firms active in these

¹⁷ A typical example is that of the small early-stage software development firm providing web-design, IT-consultancy and other 'basic' services to finance the R&D necessary to develop more sophisticated and valuable ERP applications and alike.

¹⁸ A critical mass of 'IP-based companies' can be found only in countries with an advanced IT industry, like India and Brazil. In such contexts, it is also possible to find banks willing to accept IPR as collateral. This is rarely the case with SMEs.

sectors face significant problems—and, as seen in the previous section, the financing gap is more acute in the development and first expansion stage, when financing needs normally exceed the opportunities offered by informal sources, MFI and bootstrapping.

Internet Services. Operators connected with telecom companies, media concerns and international ISP providers are increasing dominating the ISP business. The relatively few independent ISP still in operations are often firms that have been in business for several years. Most of them also managed to survive a first wave of market consolidation. However, despite their relatively well-established character and the existence of a credit history, independent ISP often face serious problems in accessing funds. These problems relate to two aspects: (i) the increasing capital intensive character of the business, which increases financing needs compared with existing levels of turnover (ability to repay); and (ii) the intense competition brought about by large operators, which drives down profits and casts doubts on the long-term prospects of these firms. The situation is more positive in the case of the other typology of internet access providers, i.e. cybercafés and internet public points. The financing needs are often very modest—in most countries one can start a cybercafé with less than US\$10,000—and they are normally compatible with FFF channels or small personal loans from local banks. The financing needs are obviously higher in the case of the more structured chains of cybercafés that are increasingly common in various countries. However, by the time firms reach the point at which they can venture into this type of business, they have normally established good relations with commercial banks, who are attracted by the highly liquid nature of the business. Telecenters and cybercafés in rural areas, is a segment where access to finance remains difficult. Promoters' savings are normally lower than in urban areas, and access to bank lending much more difficult. In certain cases, rural ICT activities can get support from socially-oriented donor and NGO programs aimed at 'alleviating the digital divide'. However, promoters are still left struggling with issues related to the justification and eligibility of cost items, and the demonstration of positive social impact.

BPO and Other ICTE Activities. In general, enterprises active in the BPO sector face relatively mild problems in accessing financing. This is due to two main factors. First, many operations are simply

subsidiaries of large international companies, or, increasingly, of powerful domestic groups. In these cases, mobilization of financing obviously does not pose any real problem. Second, even independent BPO providers normally can count on long-term contracts at the start of operations, which permits a certain financial stability. Payment conditions are better when the function outsourced is regarded as 'crucial' by the client, as it is often the case for payment services. However, working capital needs generally remain within reasonable limits, and banks are often willing to open discounting facilities. The situation is more problematic in the case of higher value-added ICTE activities. In these cases, the launch of activities often requires the purchase of expensive software and equipment (e.g. for 3D graphics and animation studios), and mobilizing external financing is not easy.

Sale of IT Equipment and Packaged Software.

In this sector, financing needs are similar to those found in other trading activities, and they are normally of a short-term nature. Working capital needs may increase beyond normal levels if sales to 'bad payers' (such as the government) account for a significant share of turnover. However, this is often compensated by higher margins. Under these conditions, banks are normally willing to open discount facilities, although this often carries a high interest. Working capital needs are higher in the case of specialized and expensive products, such as WiMAX equipment. However, well-established firms often handle these items. Therefore, this does not translate into any significant problems.

Hardware Manufacturing and Assembly. As indicated above, in the countries surveyed, this line of business is the preserve of large companies. Only a handful of small-scale firms active in the assembly of PC and other equipment are in operation. In these cases, financing needs are not too different from those of other light manufacturing companies. Getting money from banks may not be easy, but at least firms do not face any specific 'ICT bias'.

VII.4 FINANCING GAP IN SURVEYED COUNTRIES

Conditions for access to finance vary greatly across the ten countries surveyed. Those differences mainly

reflect the different level of sophistication of financial systems, but, again, demand-side considerations also play a role.

In **India**, ICT professionals widely lament the existence of a significant financing gap for deals of US\$1–2 million. Following the wave of failures that occurred in the early 2000s, many venture capitalists became extremely skeptical about early-stage deals. As a result, the market for small deals (i.e. below US\$3 million) went through a severe recession during the period of 2000–2003. The annual number of small investments shrank from some 140 to less than 20. In parallel, the average size of all VC deals increased from US\$4 million in 2000, to over US\$8 million in 2003. However, signs of a reversal of this negative trend have recently emerged. To begin with, the years 2005 and 2006 witnessed the launch of several funds (*Erasmic Venture Fund*, *SeedFund*, *Upstream Ventures*, etc.) that deliberately targeted deals in the US\$0.5–1 million range. Second, the trend toward large deals has somewhat slowed down due to the overvaluation of more established enterprises. Even some mainstream VC have started to turn toward smaller companies where they can find cheaper investment opportunities. Finally, the closer cooperation between business incubators and some high-tech funds (mainly government-led) has started to bear some fruit—for example, the two incubation finance deals finalized in early 2007 by the *Gujarat Venture Fund*. The positive impact of these factors has yet to be felt in its entirety. Nevertheless, in 2006 the number of small deals has already soared to 50, up from the 20–30 deals per annum recorded in the previous two years. Certainly, this number is insufficient, but at least things are moving in the right direction.

Similar considerations exist in **Brazil**. Again, ICT operators widely lament serious problems in the financing of smaller initiatives—this has been acknowledged by authorities and financial institutions alike. However, there are signs that the situation is improving. A new generation of funds focused on small enterprises—with a total capitalization in excess of US\$50 million—has been established since 2004–2005, and more initiatives of this type are expected to materialize in the near future. These funds—as well as the launch of dedicated credit facilities for the ICT—have just begun to make their impact felt, but in due course they are expected to significantly alleviate the gap.

In **Senegal** and **Kenya**, the financial system is still rather undeveloped, and SME face serious limitations in accessing finance. Weaknesses in the financial system are mirrored by the modest investment opportunities offered by a small and unsophisticated ICT/ICTE industry. Therefore, whatever financing gap may exist, it cannot be described as ‘industry specific’. The situation is similar in **Peru**. Its ICT/ICTE industry is bigger and marginally more diversified, but investment opportunities related to truly innovative activities remain limited. Under these conditions, the constraints faced by small ICT/ICTE operators are not all that different from those affecting SME in general.

The financing gap appears to be comparatively more severe in the **Philippines**, **Vietnam**, and **Ukraine**. These countries already have a sizeable ICT/ICTE industry, and the potential for further growth remains substantial—although in different segments in each country (BPO in the Philippines; software development in Ukraine; hardware and software development in Vietnam). However, the financial systems in these three countries have clear difficulties in following-up. Recently, there have been some improvements, such as the launch of a first high-tech fund in Vietnam, but these improvements are insufficient. All indications are that the demand for investments of less than US\$1 million is still largely unsatisfied.

Morocco and **Argentina** are intermediate cases. In both countries, the ICT industry has some potential—although not as much as in the Asian countries. The financial sector still displays a relatively conservative attitude. However, the government authorities take an activist stance—they have launched dedicated schemes, sometimes with support from donors. In Argentina, there is a new generation of equity investors that are largely focused on early-stage SME. Overall, a financing gap certainly remains, but the number of well-deserving initiatives that get rationed is not huge.

VII.5 CONCLUDING REMARKS

Overall, results from the study confirm the existence of a financing gap, in the sense that many

seemingly well-deserving ICT/ICTE operators have limited or no access to external financing. The gap is particularly severe for companies at an intermediate stage of development—those that seek amounts from US\$100,000–1,000,000. However, this finding cannot be generalized to the whole industry or to all of the countries. Firms involved in software development and in the provision of IT services

face the most stringent constraints—operators in other lines of business are less affected. The financing gap is most severe in countries where the growth of the ICT/ICTE sector has outpaced developments in the financial sector. In other countries, the constraints that ICT/ICTE firms face are not distinguishable from those affecting SME in general.