IV ISSUES IN SME FINANCING

IV.1 INTRODUCTION

The development literature focuses a good deal of attention on issues faced by SME in accessing finance. Traditionally, the focus is on obstacles created by commercial banks or equity funds, or on imperfections in the broader institutional environment. However, SME also make decisions about financing and display attitudes that have an important bearing on financing decisions. Therefore, constraints may also appear on the ‘demand side’ of the financing marketplace.

Section IV.2 provides a brief overview of obstacles faced by SME in general. Section IV.3 provides a brief overview of obstacles faced by ICT/ICTE small businesses. Section IV.4 briefly discusses ‘demand side’ constraints.

IV.2 OBSTACLES TO SME FINANCING

The economics literature on enterprise financing has identified three main obstacles that may prevent SME from obtaining adequate financing\(^4\). These obstacles are as follows:

- The existence of marked informational asymmetries between small businesses and lenders, or outside investors;
- The intrinsic higher risk associated with small-scale activities;
- The existence of sizeable transactions costs in handling SME financing.

A fourth problem very often cited in the literature (and loudly lamented by small entrepreneurs) is the lack of collateral that typically characterizes SME. In developing countries, these problems are often exacerbated by institutional factors. These aspects are briefly dealt with below.

Informational Asymmetries

Informational asymmetries are always present in enterprise financing transactions. Entrepreneurs typically possess privileged information on their businesses that cannot be easily accessed—or cannot be accessed at all—by prospective lenders or outside investors. This leads to two problems. First, the lender/investor may not be able to differentiate adequately between ‘high quality’ and ‘low quality’ companies and projects. In that case, price variables (i.e. interest rates) may not work well as a screening device, because high interests may lead to an excessively risky portfolio (the ‘adverse selection’ problem). Second, once the lenders/investors have supplied the funding, they may not be able to assess whether the enterprise is utilizing the funds in an appropriate way (the ‘moral hazard’ problem). To mitigate these problems, bankers and outside investors may adopt precautionary measures, such as requiring that financing be collateralized. Ultimately, they may simply turn down the request for financing (‘credit rationing’). Informational asymmetries tend to pose more severe problems for SME, than for larger business. The information that SME can realistically provide to external financiers (in the form of financial accounts, business plans, feasibility studies, etc.) often lacks detail and rigor. This problem is often aggravated by the low level of education of small entrepreneurs, who may not be in the position to adequately articulate their case. This problem is particularly acute in developing countries. The information supplied to bankers and outside investors by family-owned SME is often not

4 The literature on obstacles to SME financing is enormous. The theme was extensively discussed at two conferences organized by the World Bank, namely: the Conference on Small and Medium Enterprises held in October 2004 and the Conference of Access to Finance held in March 2007. The analysis presented in this section owes much to the ideas put forward in two papers presented at the 2004 conference, namely: Berger Allen and Greg Udell, A More Complete Conceptual Framework for SME Financing, and Cull Robert, Lance Davis, Naomi Lamoreaux, and J. L. Rosenthal, Historical Financing of SMEs. These papers (as well as the other papers presented at the two conferences) can be accessed through the Finance research program website (http://econ.worldbank.org/).
fully accurate and realistic, and opaque behavior may prevail. Under these conditions, outside financiers tend to adopt a very cautious attitude towards SME, and either reduce the amount of financing sought or refuse it altogether.

Risk Profile
Another approach ascribes the difficulties faced by SME in accessing finance to their higher risk profile. Suppliers of external funds regard SME as riskier enterprises for a number of reasons. First, SME face a more uncertain competitive environment than larger companies—they experience more variable rates of return and higher rates of failure. Second, SME are comparatively less equipped in terms of both human and capital resources to withstand economic adversities. Third, there is the problem of inadequate accounting systems, which undermines the accessibility and reliability of information concerning profitability and repayment capacity. In developing countries, there is the added problem of a more volatile operating environment, which has a negative impact on the security of transactions. There is a greater risk that lenders/investors will not get paid, or that assets will not be properly registered.

Transaction Costs
Irrespective of risk profile considerations, the handling of SME financing is an expensive business. The cost of appraising a loan application—or of conducting a due diligence exercise in view of a possible equity investment—is largely independent from the size of the financing under consideration. For all practical purposes, the following costs are fixed: (i) administrative costs; (ii) legal fees; and (ii) costs related to the acquisition of information, such as the purchase of a credit profile from a specialized agency. In the case of smaller loans or investments, it is more difficult to recoup these costs. Similar considerations apply to the costs that outside financiers must incur after disbursement, when conducting field inspections, or attending board meetings. Again, the problem is more severe in developing countries for the following reasons: (i) the lack of adequate management information systems in financial institutions; (ii) the undeveloped state of the economic information industry; and (iii) the poor state of certain public services, such as the registration of property titles and collaterals. To some extent, the problem can be solved by raising the cost of financing through a higher interest rate or closing fee. This is indeed the approach adopted by many micro lending schemes, but it is possible only up to a certain point.

Lack of Collateral
In the case of debt financing, lenders typically request collateral in order to mitigate the risks associated with the ‘moral hazard’. The lack of collateral is probably the most widely cited obstacle encountered by SME in accessing finance. The amount of collateral required in relation to the loan size is a measure frequently adopted to empirically assess the severity of the financing gap. In some cases, the enterprise may be unable to provide sufficient collateral because it is too new—because it is not firmly enough established. That problem is closely related to the ‘higher risk’ argument presented above. In some cases, the lender may deem the collateral insufficient in view of the size of the loan requested. In other words, the proposed expansion project may be too large in comparison with the current size of the firm. Again, this is an issue related to the ‘higher risk’ argument presented above. In other cases, the collateral may be insufficient simply because the managers-owners tend to siphon off resources from the company for personal or other purposes. Again, this is closely related to the risk profile and the moral hazard issues. Lack of collateral can be viewed more as a symptom than as a direct cause of the difficult relations between SME and providers of finance. Whatever the sequence of causes and effects, it is widely acknowledged that in developing countries the issue of collateral is comparatively much more severe. The following section examines how the undeveloped state of institutional and legal frameworks, prevents the possibility of pledging the owned assets as collaterals.

Institutional and Legal Factors
In the case of many developing countries, the above-mentioned obstacles to SME financing are exacerbated by institutional and legal factors.

First, many developing countries still have highly concentrated and uncompetitive banking sectors. This is often the result of restrictive government regulations. This reinforces the tendency to adopt very conservative lending policies or to charge high interest rates. If banks can thrive with a stable pool of well-established clients, they have no real incentive to improve the range of financial products—and, in particular, no incentive to go down market, to meet the needs of small businesses. The
same is true if banks can make hefty profits simply by buying government debt—as is often the case in Latin American countries—which results in the ‘crowding out’ of small-scale lending.

Second, insufﬁciently developed legal systems effectively prevent the development of certain ﬁnancing instruments, including the use of collateral as a risk-mitigating element. For instance, legal provisions regarding security interests (how the collateral is protected, how the collateral priority is determined, etc.) are of crucial importance in determining the efﬁcacy of collaterals. Likewise, if company laws offer only limited protection to minority shareholders, the development of venture capital and angel ﬁnancing is inevitably negatively affected. These problems were particularly severe at the beginning of the transition period in former socialist countries, when even the memories of certain fundamental market institutions had disappeared.

Third, even when adequate legislation is available, there are often problems with enforcement. Today, transitional and developing economies often have cadastres and registers of movable assets. Nevertheless, their functioning is often less than ideal. Records are frequently missing or misplaced. There are lengthy procedures for ﬁling mortgages and pledges, and for ascertaining the status of certain assets. There are often cases of corruption among personnel.

Fourth, the “information infrastructure” is still largely undeveloped. There is a lack of credit bureaus and other mechanisms for collecting and exchanging information on payment performance. This inevitably exacerbates the informational asymmetries between enterprises and lenders/ investors. While some of the above institutional constraints apply to all enterprises, it is clear that small businesses are likely to suffer disproportionately from their presence.

IV.3 SPECIFIC OBSTACLES AFFECTING SME IN THE ICT/ICTE INDUSTRY

In the ICT/ICTE sector, industry speciﬁc aspects often limit access to ﬁnance for SMEs.

Informational Asymmetries and Transaction Costs

In the case of ICT activities—somewhat less so for certain ICTE businesses—the informational asymmetries that characterize any lending or investment decision are magniﬁed by the high-tech nature of the business. This is particularly true of commercial banks, which can rarely count on loan ofﬁcers with substantial experience in the variegated aspects of ICT. This inevitably increases transaction costs, because the economics of high technology firms are more difﬁcult to evaluate than the fundamentals of ‘brick and mortar’ businesses. Similar considerations apply to equity investments. Venture capitalists are, by deﬁnition, better equipped than loan ofﬁcers to understand and capture the upside of a variety of different businesses. Still, the due diligence process of ICT/ICTE deals may require the deployment of specialized expertise that is not normally available to generalist venture capital funds.

Risk Proﬁle

ICT/ICTE are widely perceived as high risk activities, characterized by a skewed distribution of returns and by a high probability of failure. This adds to the generally unfavorable risk proﬁle of SME in general, resulting in a peculiarly unattractive picture for more conservative ﬁnanciers. In reality, only a minority of ICT businesses are involved in the development of new products and in the use of new processes in untested markets, while many ﬁrms perform activities that are not riskier than many brick and mortar businesses. This is especially the case of simple IT services (e.g. the customization of software) and of several ICTE activities (e.g. the performance of remote accounting and transcription services). However, many providers of ﬁnance are largely unfamiliar with the fundamentals of the ICT/ICTE business, and therefore are often unable to differentiate between different categories of risk.

The Issue of Collateral

In the case of ICT/ICTE, the issue of collateral is made more severe by the intangible nature of innovation activities and of assets generated through

---

5 A recent review of issues related to the ﬁnancing of SME in the ICT/ICTE industry is provided in OECD, Financing Innovative SMEs in A Global Economy, Paris, 2004. Useful elements are also presented in the already mentioned OECD study on ﬁnancing gap (see above).
such innovation. Indeed, not only are innovation-related assets difficult to value in monetary terms, but they also have little salvage value in the event of commercial failure. Therefore, innovation activities have limited collateral value in obtaining a loan. However, the severity of the problem obviously depends upon the specifics of different lines of business. Firms involved in software development and IT-consulting are in a comparatively more difficult position, whereas companies working on contract for foreign firms (as is often the case for firms in the BPO segment), may rely on high-grade accounts receivable as collateral. This may facilitate access to various forms of trade finance, such as factoring and forfeiting.

Institutional Factors
The presence of institutional and legal obstacles that have a special bearing for ICT/ICTE activities compound the fundamental problems examined above. Two of the largest of these obstacles are as follows:

- Initial public offerings (IPO) are by far the preferred exit mechanism for venture capitalists. However, in most developing countries stock markets are still undeveloped and thinly traded while SME-oriented stock markets of the NASDAQ variety are largely non-existent. Such a limitation in exit mechanisms inevitably has a negative impact on venture capital operations;
- In several countries, taxation is skewed in favor of debt financing. This results in a powerful brake on the emergence of business angel activities, and on the fundraising capabilities of venture capitalists. In some developed economies (e.g. the UK), tax legislation is formulated to encourage the involvement of wealthy individuals in high risk investment activities, but similar schemes have been adopted by only a handful of emerging and developing countries.

IV.4 DEMAND-SIDE CONSIDERATIONS

The behavior of financial institutions is not the only reason that SME have problems accessing financing. Constraints on the ‘demand side’ also have an impact. Indeed, while SME advocates loudly lament the inaccessibility of external finance, bankers and venture capitalists often decry the shortage of ‘bankable’ or ‘investable’ firms. In this connection, the following three factors play a significant role:

- The poor quality of projects submitted for financing;
- The inability of SME to make the best possible use of available sources of funding;
- The negative attitude displayed by SME toward equity financing.

These aspects are briefly analyzed in the following section.

Poor Quality of Projects
One ‘demand side’ constraint has to do with the quality of projects submitted for financing, which is often well below minimum standards. This also applies to the ICT/ICTE industry, where more than a few business ideas do not meet the basic standards for receiving any serious consideration by financiers. Needless to say, the poor quality of projects is frequently invoked as an excuse by conservative bankers, but the problem is often acknowledged also by ‘independent parties’, such as members of the scientific community. Indeed, as it will be shown later in this Report, in certain countries the pipeline of potentially viable projects is extremely limited, at least in the more ‘advanced’ segments, such as software development and IT services. In part, the issue of the quality of projects is a problem of perception.

Inability to Exploit Existing Opportunities
A second constraint is that promoters are often unable to make the best use of available opportunities, irrespective of the intrinsic quality of the projects. This relates not only to their limited ability to convincingly articulate business ideas, but also to the unwillingness of many small entrepreneurs to ‘waste time’ in dealing with financial institutions. In this respect, the ICT/ICTE industry is not much better than more traditional sectors, despite the higher than average level of education of entrepreneurs. Certainly, there are examples of promoters who have been able to cultivate a strong relationship with venture capitalists or business angels, and who have been able to gradually build a relationship of trust and familiarity that could compensate for other factors. However, in many cases, high tech promot-
ers tend to concentrate exclusively on technical aspects and are not inclined to invest time in creating financing opportunities. Even in the case of well-established businesses, there are indications that knowledge of financial instruments is limited. Business associations and incubators can sometimes help in overcoming this attitude, but so far, this has not always been the case.

**Negative Attitude towards Outside Investors**

A third problem has to do specifically with equity financing and relates to the unwillingness of enterprises to relinquish control over the company to outsiders. This attitude is referred to as ‘control aversion’ in the literature. It is quite widespread among SME, and the ICT/ICTE industry is no exception. The problem is found in several countries. That includes countries with a more advanced ICT industry and a well-developed financial sector, such as India, where references to the ‘51% syndrome’ were quite common in conversations with industry experts. Somewhat at odds with conventional wisdom, there are indications that control aversion may be more widespread among firms at the very early stages of development (“those believing that they will become another Bill Gates”, as one of our interlocutors put it), than among more established firms (“those who have already faced the reality of business life”). In the Philippines, focus groups were run with enterprises at different stages of development. The more established companies displayed great interest in accessing equity financing, whereas promoters of initiatives at the seed stage—many of which were still hosted in a business incubator—proved much less enthusiastic, if not outright negative. This aspect has non-negligible implications in terms of the financing gap at the various stages of development.

6 For instance, during field work in Morocco, we came across a fairly successful company active in the development of payment solutions. Despite the fact that the company had already been operating in several export markets (including some risky ones), the management was totally unaware of the possibility of protecting their export sales through export credit insurance. Even the recourse to letters of credit appeared to be limited. 7 An early treatment of the ‘aversion control’ issue is found in Cressy R. and Olofsson C., “European SME Financing: An Overview”, Small Business Economics, Volume 9, 1997. A more recent empirical study is Berggren B., Olofsson C. and Silver L., “Control Aversion and the Search for External Financing in Swedish SMEs”, Small Business Economics, Volume 15, 2000.