Attracting Additional Funding For Entrepreneurial Ventures: Challenges and Suggestions

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What Is Addressed in this Presentation?

- Why SMEs (including entrepreneurs) and what is our focus?
- What happened in the 2007 global financial crisis?
- What were the governmental responses?
  - I spend disproportionate time on the above two: this is where the lessons lie.
- What do we take from this and what is missing?
- What do we need?
- Opportunity.
- Why do we not have the missing elements?
- How de we get them?
- Conclusions.

Why SMEs and What is Our Focus?

- SMEs important for:
  - Growth
  - Jobs
  - Social cohesion
- Our focus issue: access to finance, which impacts three stages (we will have to consider finance with respect to each stage):
  - Creation
  - Survival
  - Growth

What Happened?

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- Global financial crisis has exacerbated the financing constraints
  - Enormous decrease in demand for the goods and services provided by SMEs (exporters, in particular, were devastated)
  - Credit crunch
- Financings to SMEs much lower than their contribution to GDP
- SME financings decreased more than loans to large enterprises (measured against contribution to GDP)
- ❑ Large entities could access capital markets (bonds) [develop equivalent capabilities, multi-issuer sukuk and private equity pooled sukuk]
- ❑ Large entities could access non-bank financial institutional financing [develop equivalent capabilities]
- Some countries targeted increased financing to SMEs

What Happened?

- Effects on SMEs:

  - Reduced cash flows and liquidity (declining revenues, greatly increased payment delays)
  - Bankruptcies - globally
  - Unemployment
  - Inability to get financing
  - Adverse effects greater in emerging markets

What Types of Financings are Used?

- Overdrafts
- Lines of credit
- Short-term loans
- Long-term loans
- Leasing
- Factoring
- Trade credit
- Government and multi-lateral loan guarantees
- Private equity (venture capital, growth capital)

- Cannot really determine what stage is being financed

What Happened?

- Increased SME demand for short-term financing (working capital to offset decreased revenue and payment delays)
  - Characteristic for economic downturns: the share of short-term loans usually increases relative to long-term or investment loans
- There was a decline in short-term loans.
  - May be due to government policies as well as tighter credit standards
  - Increases in government guarantee programs
  - But those usually go to long-term financings, which was true during the crisis
- ❑ SMEs increased use of overdrafts and lines of credit

What Happened?

- SMEs faced more severe credit conditions than did large enterprises:
  - Higher interest rates (rate spread between SMEs and large entities increased)
  - Evaluated as having poorer business prospects
  - Shortened maturities
  - Increased collateral demands (more SMEs had to post collateral, and at higher percentages)
- Demand versus supply of financing
  - Credit conditions much stiffer
  - Decreased SME demand: historic lows
  - Fewer SME applications for financing
  - No expansion financings
  - SMEs response: tried to cut external borrowing
  - Terms were tougher for those SMEs that did get financing

What Happened?

- Overdraft and credit line usage increased as percentages, even into recovery (2010 rankings)
- Much country variation (e.g., Eurozone entities rely on banks (74%) as compared with the United States (24%))
  - Overdrafts and credit lines
  - Bank loans (all tenors combined)
  - Trade credit:
  - Leasing, factoring:
- Most matters have to be studied on a jurisdiction-specific basis
- Study alternative financing sources, conditions facilitating use of alternatives

What Were the Government Responses?

- Government responses:
  - Support demand side (sales)
  - Prevent the depletion of working capital
  - Enhance access to credit

- In considering government response capabilities:
  - ❑ Public debt has increased dramatically through financial crisis
    - 100% of GDP and higher at end of 2011
    - 30-60% higher than 2007

❑ Limits the ability of governments to respond to the SME segment [utilize what governments offer, but expand non-governmental component and urge modifications to government programs to accommodate non-governmentals]

What is the Status of Equity Financings?

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- Venture capital: sharp decline
- Growth capital: later stage expansion (not buy-outs, turnarounds, replacement capital): sharp decline
- Some countries tried to address and promote early stage and expansion capital
- ❑ Very few SMEs even approach – or even entertain approaching - venture capital sources or other external equity sources
- ❑ Educate the SME population to consider private equity, and other non-loan capital and financing

What Were the Government Responses?

- Governments were sensitive

- ❑ Injected money into both loan guarantee programs and direct lending programs

  - total amount available
  - percentage of loan guaranteed
  - number of eligible entities
  - new instruments

- ❑ Work with governments to apply similar principles to equity capital, Islamic finance arrangements and other alternative arrangements

- ❑ Same for "new instruments" on next slide

What Were the Government Responses?

- New instruments:
  - Guarantees of guaranteeing short-term loans and counter-cyclical loans
  - Get-started loans (guaranteed loans with business advice and consulting services)
  - Increased coverage of guarantees, sometimes to 100%
  - Postponements of repayment of guaranteed loans
  - Use of pension funds to augment loan guarantees
  - Guarantees of equity capital
  - Assistance to mutual and cooperative guarantee associations and arrangements
  - Increased co-financing by public agencies and banks.

What Were the Government Responses?

- SME-specific (e.g., often time-bound, although many have been extended):
  - Deferrals of tax payments
  - Capping of interest rates
  - Roll-overs of SME loans
  - Conversions: short-term t long-term
  - Conversions: overdrafts into loans
  - Decreased defaulting
  - Credit mediation systems
- Adapt the foregoing to apply to equity, Islamic and other alternatives

What Do We Take From This? What is Missing?

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- The focus, globally, is on lending, particularly interest-based lending
- There is an acknowledgement of the equity role, but …
- Not the historical or current focus
  - Cannot get much hard data (voluntary surveys of private equity associations is primary source)
- Shift the focus (we will come back to this): equity and Islamic finance

What Do We Need?

- More capital into the Islamic finance system

- More capital into the SME segment

- To think of both of these issues from a global-to-local perspective

  - Global funding and expertise involvement
  - Global returns
  - Global risk sharing
  - Local business

- Build global alliances and global cooperation arrangements

Opportunity

- Islamic finance, as equity-based finance, with longer-term horizons, is especially well situated to:
    - make a contribution and
    - shift the focus
    - shift the emphasis
    - shift the approach
- Islamic finance has the tools

What Do We Not Have?

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- Equity
  - Private equity (I focus on just this aspect today)
    - First in, high risk, high return expectations
  - Capital markets equity (many possibilities here that I would like to discuss, but not enough time in this presentation)
- In terms of fundamental principles, private equity (particularly venture capital and growth capital) is compatible and synergistic with Islamic finance, although they also use considerable leverage
- More Islamic finance in as equity induces private equity: there is less senior debt finance above the equity
- More equity (combined Islamic and private equity) makes it easier to obtain whatever leverage is ultimately needed

Why Do We Not Have It?

- Why do the private equity investors not flock in to these SME markets?
  - they have the tools
  - they the interest
  - they are willing to invest in high risk ventures
  - at least in some markets (e.g., US and UK)
- Lack of awareness of Islamic finance and its capabilities and methods
- Perceived inability to achieve rates of return; situational perception
- Legal and regulatory disincentives
  - Global taxation of US entities
    - Thus local tax incentives often do not help
  - Foreign investment restrictions (e.g., the most successful SMEs have foreign investment in numerous studies)

How Do We Get It?

- Education of SME providers regarding Islamic finance alternatives (e.g., the IFC-IBM toolkit.com that is widely used)
  - Directly
  - Through governments and multi-laterals that have SME initiatives
  - Through businesses such as IBM that contribute to the SME educational process
- Education of global private equity community

How Do We Get It?

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- Alter the risk profile (governments, Islamic finance, etc., especially via equity infusers)
- International tax treaties to address some of the tax problems
- Trade treaties to decrease export – import restrictions
- Relax local impediments, some examples:
    - Foreign investment restrictions
    - Foreign expertise
    - Domestic tax impositions
    - Funds repatriation and currency convertibility
    - Legal reforms to enhance predictability of outcomes (disputes)

Conclusions

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- Study ways in which to expand private equity involvement
  - Global perspective
  - Want high-end, world-class involvement (expertise)
- Facilitate greater international cooperation
- Integrate Islamic finance into the mix
- Study capital markets possibilities for SMES along the same principles
- Further modify existing governmental response methods and modalities from these perspectives
- Think integratively, cooperatively and creatively

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What is the Effect of Basel III?

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- One of the major bank issues during financial crisis: bank liquidity
- Focus: minimum capital requirements and the design of new rules for liquidity management (rules revisions and new rules)
- Basel III Objective: improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill-over from the financial sector to the real economy
- What are the implications for SMEs?

What is the Effect of Basel III?

- If Basel III positively impacts growth, it will increase SME lending
- Argument is:
  - SMEs are affected more by financial instability than large firms or households
  - SMEs are less able to hedge against a financial crisis than large firms
  - SMEs cannot rely on public safety nets as households do
  - SMEs are highly dependent on external finance
  - Thus, their prosperity might be relatively more dependent on economic and financial stability

What is the Effect of Basel III?

- Critics:
- Loans and other banking services will become more expensive and harder to obtain under Basel III
- SMEs hit hardest by this