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ISSUES @ PECC

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PACIFIC ECONOMIC COOPERATION COUNCIL

Financing Small and Medium Enterprises: Challenges and Options

ISSUES@PECC presents the current work of PECC's three Forums on Trade, Finance and Community Building and collaborative work with other groups. Complimentary copies are available upon request from the PECC International Secretariat. It is also available on line at http://www.pecc.net.

About this Issue

This **ISSUES@PECC** is the summary report of the discussion at the 2nd Annual Conference of the PECC Finance Forum held in Hua Hin, Thailand, on July 8-9, 2003, on the topic of *Financing SMEs: Issues and Options*.

The PECC Finance Forum serves as an open forum for a tri-partite dialogue among the academia, government, and business sector, on the financial policy issues facing the Asia-Pacific region. The purpose of the dialogue is to assess the international environment for financial stability and development in the region, to assess progress in the promotion of financial reforms, integration and cooperation in the region, and to develop the desired vision of regional financial and monetary cooperation. For the purpose of these assessments, the Finance Forum undertakes survey-based task force studies on specific issues as well as convenes an annual conference of experts drawn from the member economies and the international financial institutions. For more information, visit www.pecc.net/finance.

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The Pacific Economic Cooperation Council (PECC) is a unique partnership of senior representatives of business, government and research from 25 Asia Pacific economies, who work on practical policy issues to enhance trade, investment and economic development in the region. It is the only non-government, independent Official Observer organization of APEC.
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The Definition and the Role of SMEs

The definition of SMEs varies from country to country. The classification can be based on the firm's assets, number of employees, or annual sales. The International Finance Corporation defines SMEs as firms with less than 300 employees and total assets less than US$15 million. In smaller economies, SMEs are defined as less than 20 employees.

Whatever the definition, and regardless of the size of the economy, the growth of SMEs throughout the region is crucial to regional growth.

SMEs play a critical role in providing job opportunities, enhancing the quality of human resources, nurturing a culture of entrepreneurship, fostering creativity and opening up new business opportunities.

The Critical Challenge of Funding

Flexibility as well as low start-up and operating costs have enabled SMEs to spring up, to reposition and adjust themselves quickly in response to market and economic changes. Moreover, they easily expand or contract in a short time. SMEs have not only survived the impact of big enterprises and the law of economies of scale but have carved out niches for themselves, which enable them to coexist with big enterprises.

However, the most common problems for SMEs are the lack of access to market information and technology, the low quality of human resources and the lack of access to capital. Despite efforts by financial institutions and public-sector bodies to close funding gaps, SMEs continue to experience difficulty in obtaining risk capital.

These funding gaps relate to firm size, risk, knowledge, and flexibility. SME borrowing requirements are small and frequently do not appeal to financial institutions. More collateral may be required than SMEs can pledge. Financial institutions may lack expertise in understanding small and medium knowledge-based business. The flexibility in terms and conditions of financing that SMEs require may not be available.

Funding Options

The PECC Finance Forum considered a range of funding options: credit unions, leasing companies, private equity and venture capital as well as the traditional sources such as banks.

Credit Unions, Leasing Companies

Options for funding at the start-up stage include credit unions, leasing companies, personal finance and contributions from family relations.

Private Equity and Venture Capital

The venture capital in the United States has developed without any official government policy and to finance high-technology firms that are "informationally opaque," often without tangible assets and established products and markets.

In the United States, venture capital accounts for only a small part of SME financing (under 2%) concentrated in certain industries.

The size of venture capital declined in 2001. In the United States, venture capital rose from $20 billion in 1998 to $100 billion in 2000 but dropped to $38 billion in 2001.

Private equity funds from institutional investors (primarily pension funds and wealthy individuals) are typically structured as limited partnerships with fixed lives (usually around ten years) and general partners responsible for making investments with incentive-based compensation schemes.

To respond to issues raised by investors, venture capital funds typically demand board representation and play an active management role, which may not be acceptable to some (family-owned) firms.

There has been rapid growth in venture capital and private equity in Asia since the Asian financial crisis. Venture capital and private equity are concentrated in Japan and Korea. Hong Kong and Singapore are also centers of the regional venture capital activities.

Taxes, the regulatory framework, and funding policies differ greatly across economies, which affect the efficiency of transfer of capital.

There is evidence that private equity in economies like Korea and Japan is used to replace sources of funding not available from traditional institutions. Private equity is not used to finance high-tech firms, but rather to finance the restructuring of established firms in the traditional industries. Venture capital in Chinese Taipei is concentrated in high-tech investments and started from fund managers with experience in the U.S. venture capital industry

Banks

Traditional industries with tangible assets and well-run businesses can often raise funds from traditional sources like banks. Bank Rakyat Indonesia demonstrated to the PECC Finance Forum how traditional credit-granting institutions with funds could finance SMEs effectively with carefully tailored packages to suit small business. Analysis of SME financing in the U.S. suggests that banks and traditional credit-granting institutions still provide the largest source of outside financing.

However, the PECC Finance Forum recognized that for some banks financing SMEs may be very difficult due to lack of accurate reliable information on the financial condition and performance; unconvincing and weak business plans; weakness in SMEs management, market links, governance and information technology. There can be a lack of training for banks' staff, who might not be sufficiently informed about lending to growing, high-risk companies. Banks' weaknesses in identifying the characteristics of SMEs often lead to unsatisfactory lending arrangements. The banks often resist due to the higher overhead cost resulting from a high number of customers with smaller loan size.

The banks must adopt appropriate lending technologies and operation systems to enable them to realize the market potential and to lend profitably to small businesses.

Bank Rakyat Indonesia: A Case Study

In Indonesia, the government implemented policy to encourage banks to have at least 20% of its portfolio in SMEs. The Bank Rakyat Indonesia (BRI) has developed its own approach to the provision of financial assistance to SMEs. The bank developed uniquely tailored lending programs. Administrative procedures and collateral systems were simplified. Technical assistance was provided through SME Centers. Loan guarantee were provided and micro credit insurance. BRI established SME Centers to provide growing businesses access to information technology with which to access a global market information system.

BRI concluded that the development of SMEs is not only a bank responsibility but requires commitment from financial institutions, large-scale companies, central and regional governments and other bodies such as the Chambers of Commerce, and NGOs. The government needs to develop an integrated and comprehensive policy in order to achieve this goal.

SME Funding from Capital Markets

SMEs may choose to fund growth by raising equity on the Stock Exchange to access funds outside traditional funders such as banks. They can spread and share the risk of high growth strategies by sharing equity ownership. The Stock Exchange facilitates marketable shares to acquire other companies. It provides an exit strategy for the founding family members. Listing on the Stock Exchange can increase corporate profile.

However, the capital markets geared to small companies have not proved successful. The cost of listing to raise a small amount of funds has proved to be as costly as raising large amounts of funds. The Prospectus and Investment Statements have demanded as much detailed information and forecasting. The increasing pressure for continuous disclosure places great pressure on small management teams.

Small business markets have not attracted investors; the costs of listing and ongoing compliance costs combined with requirements for continuing disclosure have been a disincentive to small growing companies with limited management skills. The high-risk nature of these small businesses and the limited information they can provide has not attracted support from the broking community.

Disclosure is essential for confidence in public securities markets. Best business practice is crucial to underpin disclosure. Track record is important when investors are comparing options. At the start-up stage, growth and the revenue are important – the demands of listing too soon may inhibit growth.

The Role of Government

Government can affect the supply of funding for SMEs. It can do so by *introducing rules and regulations to encourage banks, venture capitalists and capital markets to create uniquely tailored programs, for example, directing venture capital to seed firms in growth sectors and supporting pension funds participation in venture capital funds and tax incentives.*

Impacts of globalization such as global competition, rapid changes in technology and the evolving market conditions add to the high risk of funding fast-growing small businesses. R&D costs are rising. Strategic alliances are increasing, particularly, cross-border alliances. Mergers and acquisitions cross borders. Information networks are becoming more sophisticated, for example, through development of clusters.

Policy Recommendations

The following recommendations have emerged from the Finance Forum discussion of the issue of how to finance the growth of SMEs in the region:

- *Promote a flexible environment for the venture capital specific to SMEs to flourish;*
- *Tailor credit in banks and other similar institutions to the need of small firms;*
- *Give a greater emphasis on training programs to help banks' staff understand the unique requirements of SMEs better;*
- *Harmonization of the financial policy framework across economies will promote cross-border strategic alliances including SMEs and facilitate transfer of experiences between the regional economies.*

References

The Finance Forum discussion of the problem of financing SMEs at its 2nd Annual Conference held in Hua Hin on July 8-9, 2003, was based on the following papers presented at the Conference:

"Financing Challenges of SMEs from the Policy Perspective: the Experience of the Bank Rakyat Indonesia in SMEs Financing", by Rudjito, President Director, Bank Rakyat Indonesia

"Capital Markets for Small and Medium Enterprises: Evaluation of Recent New Zealand Experience", by Juliet McKee, Finance Forum Coordinator, New Zealand PECC

"Venture Capital in APEC Economies: Report to APEC", by Kimball Dietrich, University of Southern California.

These papers are available on-line at http://www.pecc.net/finance/forum2003.