Global Landscape for MSMEs

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Global Landscape for MSMEs

"The backbone of the euro-zone economy is its small and medium-size firms. These account for 99% of euro-zone businesses, two-thirds of employment and have historically been the main engines of innovation and growth. They also rely overwhelmingly on banks for their funding. Europe's economic fortunes hinge on healthy businesses being able to secure the funding they need to expand." -- Wall Street Journal

"Euro-zone policy makers acknowledge that SME funding is now their single biggest policy challenge. The headline data make for grim reading. Bank loans to businesses contracted 2.1% from a year earlier in October following a 2% drop in September, according to the European Central Bank. In Spain, business lending fell by an annualized rate of 10%. Small firms in the southern periphery continue to pay significantly higher interest rates than firms in core countries." -- Wall Street Journal

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"But the biggest prize lies in simplifying—or better still harmonizing—bankruptcy rules and improving the functioning of justice systems. In Italy, many businesses cite the inadequacies of the justice system as the single biggest impediment to investment. Portuguese entrepreneurs complain that while the government has made it easy to start a business, it remains difficult to close one; venture capitalists encourage Portuguese startups to incorporate in London." – Wall Street Journal

Source: Wall Street Journal article, "What Europe Really Needs Is a Bankruptcy Union", (December 8, 2013)

The Importance and Prevalence of MSMEs

1) No standardized **definition of MSMEs**. Based on European Commission Recommendation 96/280/EC:
   - **SMEs** : <250 employees
   - **MSMEs** : 5-10 employees

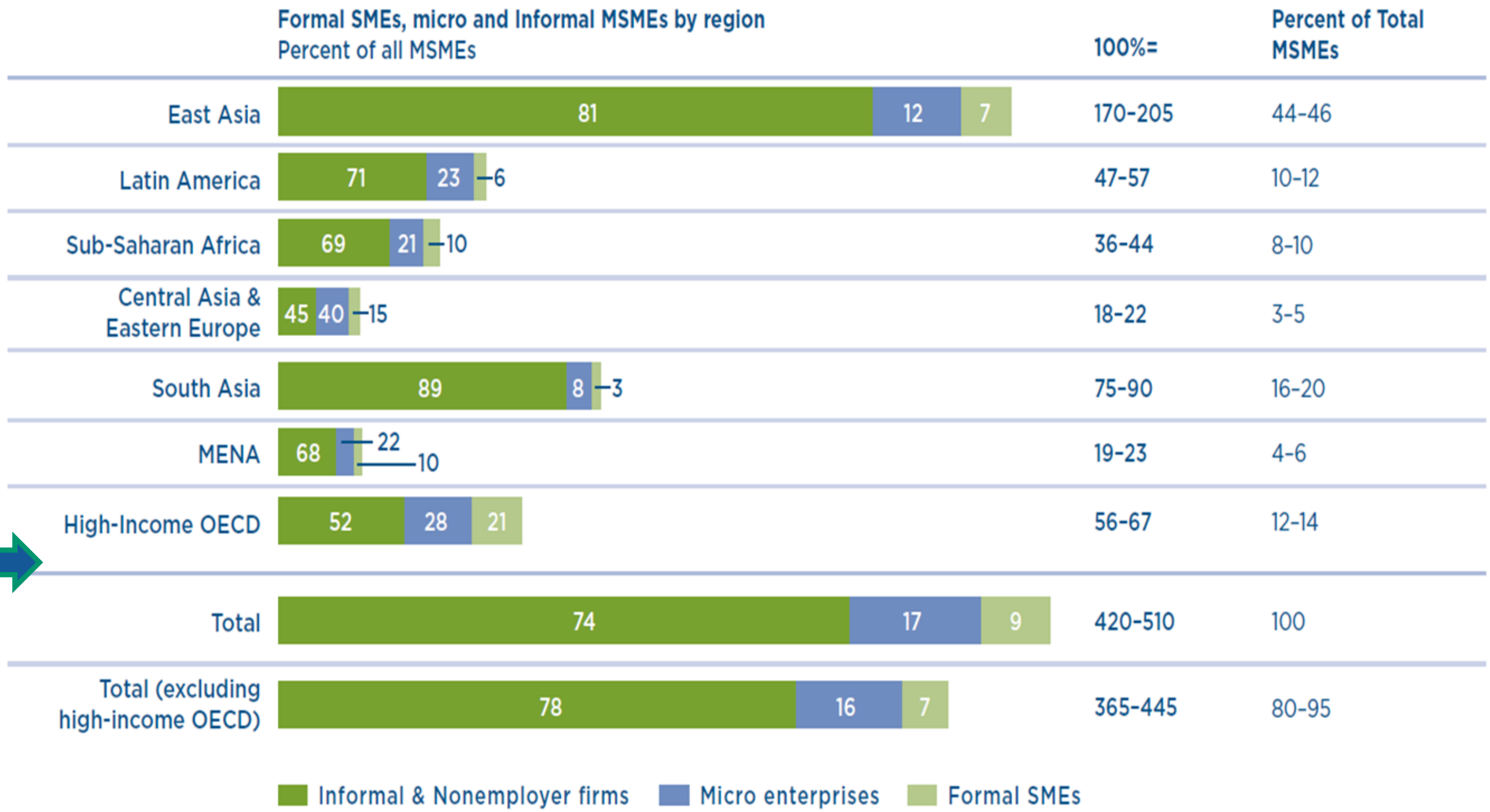
2) **SMEs** account for at least 95% of registered firms worldwide.

3) Globally, there are estimated 420-510 million **MSMEs**, of which only 9% are formal.

4) In emerging markets, there are close to 365-445 million **MSMEs** (80-95% of global average)
   - 25-30 million formal **SMEs**
   - 55-70 million formal **micro enterprises**
   - 285-345 million **informal enterprises** and **non-employer firms**

Source: G-20 report using IFC-McKinsey data

Informal and non-employer firms represent the majority of MSMEs globally, but the proportion is notably higher in East and South Asia, Latin America and Sub-Saharan Africa



Source: G-20 report using IFC-McKinsey data

Some of the key challenges faced by MSMEs

1) Reduced access to capital
2) Greater vulnerability to financial distress and barriers in enforcing contracts
3) Reduced access to markets, skills, infrastructure (e.g. electricity) and government services

Reduced access to capital – global findings

In **developing economies**:

-The likelihood of a small firm having access to a bank loan is **about a 1/3 of what it is for a medium-sized firm**

-Only **1/2 of formal SMEs** (11-17 million) have access to formal institutional loans or overdrafts

-Only 30-35% (8-10 million) of the formal SMEs which already have a banking relationship via deposit/checking accounts have access to credit

-The **finance gap is far bigger between micro and informal enterprises**, especially in Asia and Africa: 65-72% lack access to credit.

Source: G-20 report using IFC-McKinsey data

Reduced access to capital

Equity financing-- less common for SMEs than bank financing and lending services in developing economies

Negative growth impact of financial constraints is 2/3 greater on small firms than on large firms

Source: G-20 report; IFC/A2F SME Banking Knowledge Guide

Reduced access to capital

<u>Findings in Sub-Saharan Africa</u>

"The financial enabling environment in SSA presents greater obstacles than in other regions of the world" -- IFC Integrated Access-to-Credit Matrix draft using IFC Evaluation 2000 findings

–Only 11% of SSA micro entrepreneurs and ~5% of small enterprises obtaining credit to sustain their businesses

–Less than 1% in agribusiness

<u>MSME lending in Africa has been inhibited by:</u>

- challenging market factors: adverse supply, demand, and cost conditions
- sub-standard quality of financial infrastructure
- Lack of data to conclusively establish current lending rate in the region

Source: IFC A2F data

Reduced access to capital

Reasons for poor access to finance

1)Intrinsic weaknesses related to scale of business

2)Flaws in provider delivery models

3)Lingering deficiencies in the enabling environment for financial services: financial infrastructure (accounting and auditing standards, credit reporting systems, and collateral and insolvency regimes), and legal and regulatory framework for financial institutions and instruments

Source: G-20 report using IFC-McKinsey data

Reduced access to capital

Proposed solutions

1)**Reduce service costs** through intensive use of technology and/or the adoption of cost-effective client-relationship models;

2)**Combine offerings** of savings, transactional, equity financing and credit products, with a view to increase generated income

3)**Use advanced risk management technology** to maximize risk/reward balance; and,

4)**Achieve strong focus** on the small and/or medium enterprise segment to help implement excellent execution capabilities in the above areas.

Source: G-20 report

Studies show that MSMEs are also more vulnerable to financial distress and encounter more barriers in enforcing contracts

SMEs are:

1)**more likely to fail in a bad economy** *(Jovanovic 1982; Hopenhayn 1988)*

2)**as susceptible as any business to debt disputes**

a) cannot afford collection procedures

b) do not have resources to go after debts (Example: Peru Study)

3) **more vulnerable to nonpayment of debts** (lower cash flow; do not have effective personal discharge in bankruptcy)

4)**at a disadvantage in disputes with larger companies with more resources, or the State** (Small Business Commissioners through the Small Business Commissioner Act 2003)

Differing views in literature on the relative importance of the various costs and benefits of informality

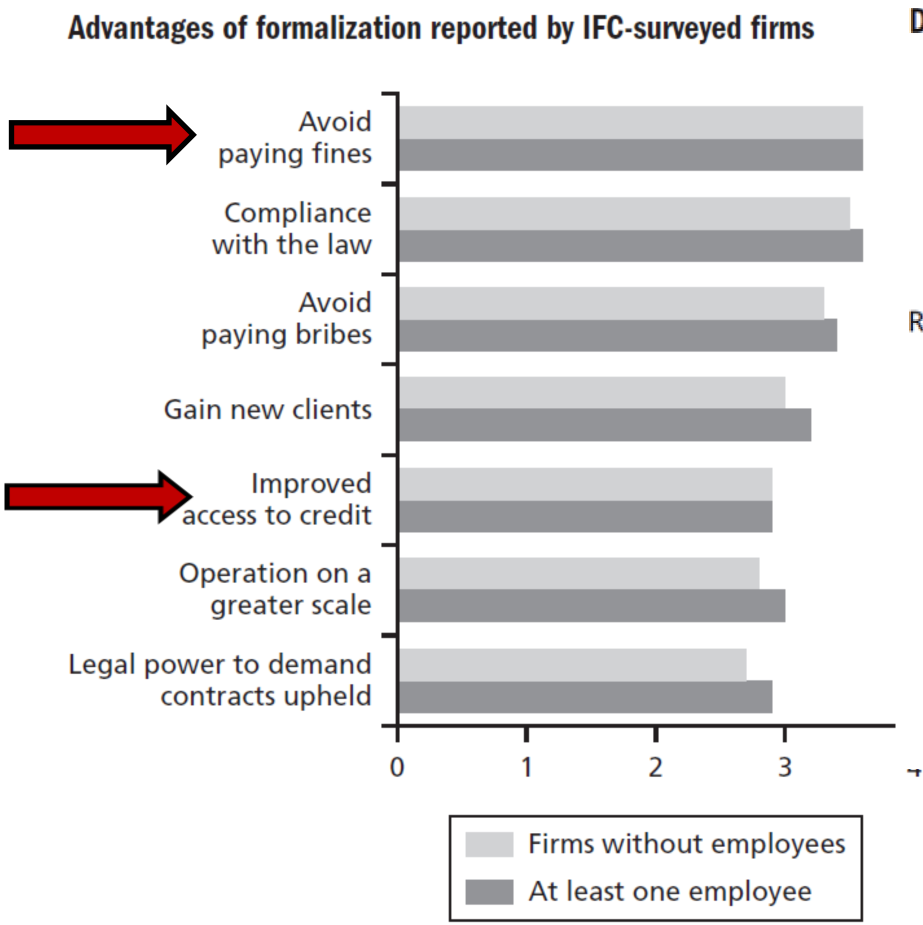
1)Informal firms would like to formalize, but are prevented from doing so by costly regulations and bureaucracy

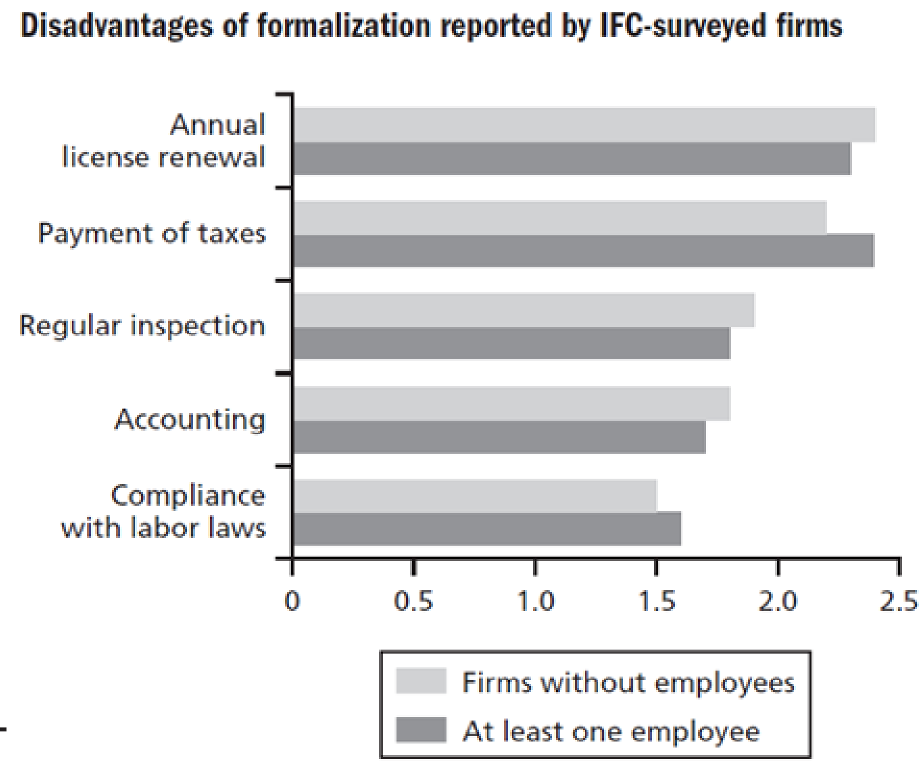
2)Smaller and less productive firms rationally opt-out from the formal sector since there are little benefits from formalizing

3)Segmented labor market perspective: informal sector caters to individuals who would rather be in employment, but are unable to find formal wage jobs

Source: de Soto, 1989; Maloney et al., 2004; Fields, 2004

Evidence on the relative importance of the various costs and benefits of informality





Thank you

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Investment Climate, Debt Resolution and Business Exit:

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