

Investing in the heart of emerging markets

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Small and medium-sized enterprises with access to finance trigger strong development effects on the local economy: job creation, formalization of the economy, a broader tax base and better institutions. An outstanding innovation in this field comes from Switzerland and was awarded by the G-20.



Small and medium-sized enterprises are the primary driver of job creation in developing countries. (Picture: small shops in La Paz)

Even in Switzerland, small and medium-sized enterprises (SMEs) have reported difficulties when it comes to finding capital to fund their growth. So imagine how problematic it must be for SMEs in developing countries and emerging markets to gain access to equity and debt capital. Yet, these emerging markets are full of rapidly growing, promising small businesses. However, such enterprises have a measurable social impact in addition to generating financial returns.

SMEs long neglected

Not a great deal of economic research has been done into SME financing so far, primarily because there is no generally applicable definition of the term «SME». Every country, and every multilateral organisation, chooses

its own definition according to different total asset, sales and headcount figures. In South Korea, for example, any enterprise with fewer than 3000 employees is deemed to be an SME, while many African countries have set an upper limit of 20. This lack of clarity is one of the reasons why SME financing has remained a blind spot, stuck between large companies benefiting from global flows of capital, and the high profile microfinance industry. The result is that SMEs, whether they seek to raise equity or debt capital, now have to contend with a finance gap.

Numerous obstacles

First of all, SMEs face pronounced asymmetry of information between investors and the company. Because they are subject to less

stringent transparency requirements than large companies reporting in accordance with international standards, SMEs are burdened with a risk premium. Secondly, investors demand collateral, which is harder to provide and evaluate in developing economies as opposed to industrialized nations. Thirdly, emerging market financial sectors tend to be less developed, thus implying a lack of products geared to small and medium-sized enterprises.

Completing the bridge

As a result SMEs lack not only debt capital to fund ongoing operations, but also equity to enable and safeguard long-term growth. Investment is scarce, even though emerging markets have enjoyed rapid growth at unprecedented levels of stability over the last ten years (something that has been particularly apparent since the advent of the financial and debt crisis in the developed world). How can investing in SMEs in countries like this be made attractive and feasible for private investors? The notion of bridging the gap between Swiss investors and SMEs in developing economies appears less improbable once you realize that the second half of the bridge has already been built. This applies to both equity and debt financing.

Risk capital from diversified umbrella fund

There are a considerable number of private equity fund managers in emerging markets who have in-depth knowledge of their home markets and have gained the necessary business and financial background in the West. Over the last 15 years these regional fund managers have been nurtured as part of private sector development programmes run by multilateral organizations. In most cases this has enabled managers to set up their first investment fund. Yet despite the success of many of these funds, private investment has not been found to take the place of multilateral funding, with investors put off by the lack of name recognition and fund diversification, as well as the high transaction costs involved.

The fund-of-funds structure created by responsAbility (as recognized by the G-20) addresses this problem by allowing diversification over several private equity funds. Regional fund managers use capital inflows to acquire minority interests in promising SMEs. They share their know-how by playing

an active role in developing the target business. This helps create a greater degree of professionalism, which among other things is reflected in improved transparency and exemplary corporate governance. The growth that an SME is able to achieve as a result of this support triggers significant development effects in the local economy: job creation, formalization of the economy, a broader tax base and better institutions.

Refinancing via longer-term debt capital

Meanwhile a growing number of financial institutions in emerging markets are targeting the SME credit business. Given the success of certain SME banking pioneers, it comes as no surprise that entering the SME segment is an increasingly popular option both for larger banks (downscaling) and microfinance banks (upscaling). Basically, banks are replicating a model pioneered by the Raiffeisen and cantonal banks in Switzerland more than one hundred years ago. However, these SME banks do have an Achilles heel: refinancing. Established banks refinance their lending via short-term savings and time deposits. SMEs, on the other hand, require loans which last for several years. The resulting discrepancy between asset and liability maturities prevents banks from refinancing SME loans. Taking into account both the issues and social impact of SME financing, the Global Microfinance Fund allocates up to 20 per cent of its investments to SME banks, provided they meet the same financial and social criteria as their microfinance counterparts.

Latin America: the most important region

Despite a significant increase in loans to the private sector in the last five years, financial sectors in Latin America are still trailing behind the developed nations or even other emerging markets. responsAbility manages assets of USD 924 million. Latin America is its most important region with an investment share of 40 per cent. Its largest single SME position is Procredit, a banking group dedicated to financing small enterprises. Procredit has a loan portfolio of USD 833 million in seven Latin American countries. The average size of these loans varies from country to country. In Mexico, for example, loans average USD 17,000, compared with the USD 400 typical for a microloan in that country.