KfW Development Bank

››› Materials on Development Financing

No. 2, February 2017

SME Financing: Successful Cornerstone of Financial Cooperation

Authors: Dr. Carmen Colla and Carmen Kühn

Bank aus Verantwortung

Contents

1. Introduction	**3**
2. Relevance of SME financing	**4**
3. FC initiatives to improve access to financial services for SMEs	**8**
4. Effects of the KfW commitment in the SME sector	**10**
5. New FC approaches	**12**
6. Outlook	**16**
7. References	**17**

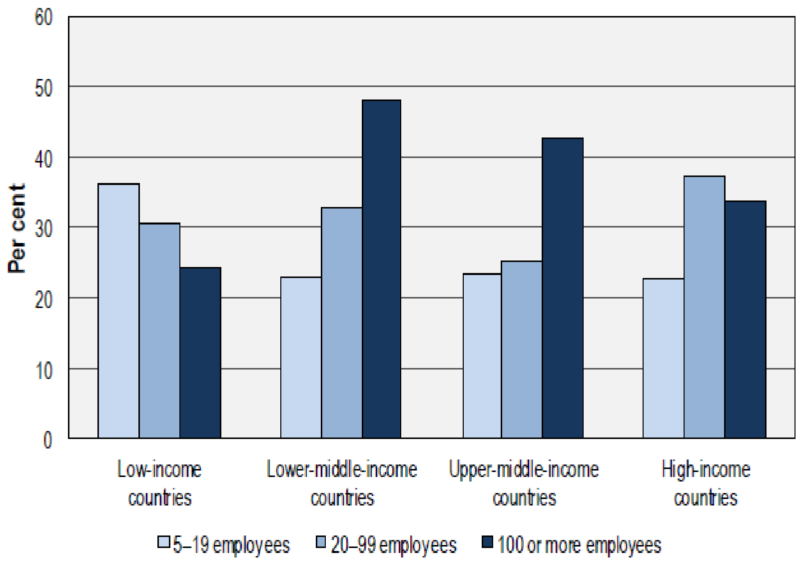
1. Introduction

The financing of small and medium-sized enterprises is traditionally a significant focus of German Financial Cooperation (FC). At present, it represents 40% of the total financial-sector portfolio in FC and so plays by far the greatest role ahead of micro, as well as energy and environmental financing (27% and 18% respectively of the total volume). There is also considerable general interest in this sector, because of its major significance in terms of the development and stabilisation of national economies. With regard to the resilience of national economies, the promotion of the SME sector is also a topic for the G20 Presidency in 2017. This provides an opportunity to highlight the commitment of KfW Development Bank in the field of SMEs and to demonstrate both the effects and the successes achieved.

2. Relevance of SME financing

The essential significance of the SME sector for growth, employment, productivity, and innovation is well-recognised. Empirical data shows that the majority of existing and newly created jobs both in industrial countries as well as in developing countries and emerging economies are attributable to SMEs. Indeed, the contribution of the SME sector to newly created jobs in developing countries is particularly high, at over 60%[1]. Data from an IFC study in 2014 also demonstrate a clear link between the density of SMEs and the per capita income of a country[2]. In this context, it is worth noting the significant role of the local SME sector with regard to combating the causes of refugee migration and also the potential of a strong SME sector for mitigating the economic consequences of migration in host countries.

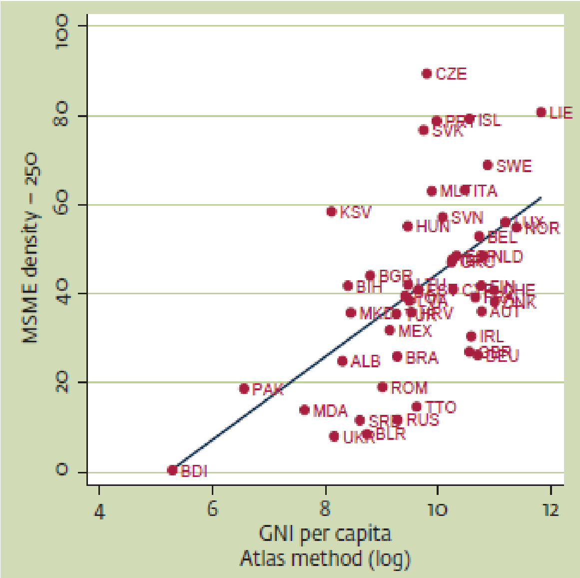
Share of SMEs in the creation of new jobs (median values)



Source: De Kok et al. (2013), based on Ayyagari et al. (2013)

[1] ILO (2015)
[2] Gonzales et al. (2014) http://smefinanceforum.org/sites/default/files/analysis%20note.pdf

MSME density and national income per capita

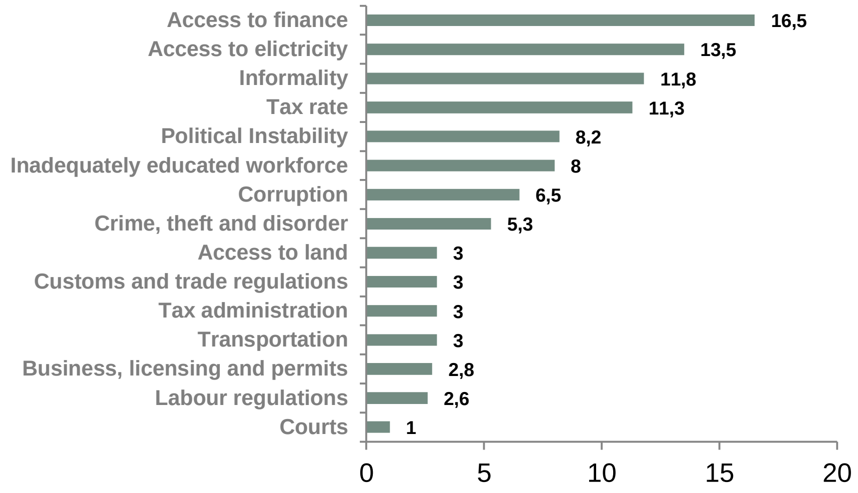


Source: Gonzales et al. (2014)

Accordingly, one key to economic growth is the strengthening of the SME sector and/or the elimination or reduction of existing barriers to investments by SMEs. In less developed countries, in particular, SMEs have outstanding potential to play their part in adding value to the local economy. One of the largest obstacles to investment remains a lack of access to (adequate) financial services. This fundamentally applies to all countries, levels of development, and industries, but particularly to small companies and the “missing-middle” segment in less developed countries, which is often too large to apply for microloans and not large enough for an adequate access to financing through commercial banks. According to the “World Bank Group Enterprise Surveys Data”, well over 30% of all SMEs in low-income countries specified the lack of access to financing as one of the three main obstacles preventing growth[3].

[3] World Bank Group Enterprise Surveys Data

Percentage share of companies that identified the following factors as main obstacles preventing growth



Source: World Bank Group Enterprise Surveys Data

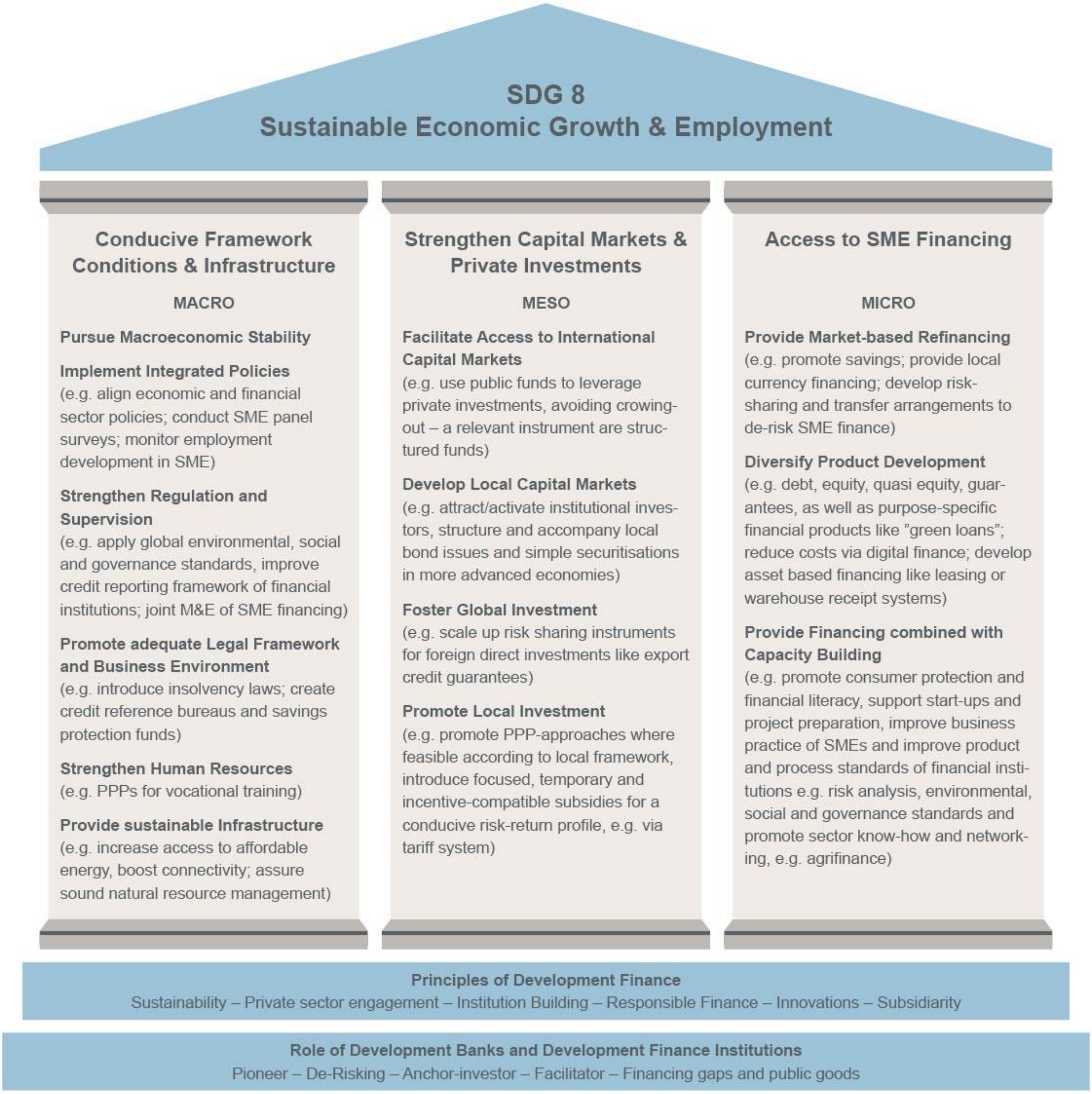
Impediments in SME Development

Apart from the often under-developed financial systems in developing countries and industrialising countries, especially in rural areas, a conservative and restrictive lending policy is one of the main reasons for the restricted access to finance. The focus of risk-averse banks is often on simple financing products for borrowers with a successful credit history and/or connected with high collateral requirements. In Nigeria, for example, the proportion of loans that require collateral and the level of collateral in relation to the loan amount stand at 85.5% or 234% for medium-sized enterprises, which is far above the OECD average (64.2% or 137.3%). In addition, at 61.4%, almost 15 times more loans are rejected here than the OECD average (4,2%)[4]. It is therefore not only the high requirements for the collateral to be provided, but also a pessimistic attitude about a loan commitment being awarded, generally complex application procedures, and high interest rates that deter SMEs from even submitting a loan application[5].

Conceptual Framework on Long Term SME Financing

In order to tackle the different obstacles impeding an adequate access to SME financing the German development cooperation applies a multi-level approach in the promotion of sustainable and long-term SME financing. According to the Sector Strategy on Sustainable Economic Development and Financial Sector Development[6] a comprehensive strategy for promoting long-term SME financing is based on three pillars: (i) creation of a conducive framework and infrastructure, (ii) strengthening of capital markets and promotion of private investments, (iii) improvement of the access to financial services including capacity development for financial institutions and SMEs. In order to apply this strategy effectively all activities related to the three pillars at the macro, the meso and the micro levels have to be well coordinated and integrated.

[4] World Bank Group Enterprise Surveys Data
[5] International Labour Conference (2015)
[6] BMZ (2016)



Source: Internal presentation

The main focus of the KfW activities presented in the following sections is on the third pillar (access to SME financing) plus some aspects of the second pillar (strengthening of local structures and leveraging of private capital for investments).

3. FC initiatives to improve access to financial services for SMEs

In light of the various reasons for a lack of access to financial services, the efforts of KfW are focused on several levels.

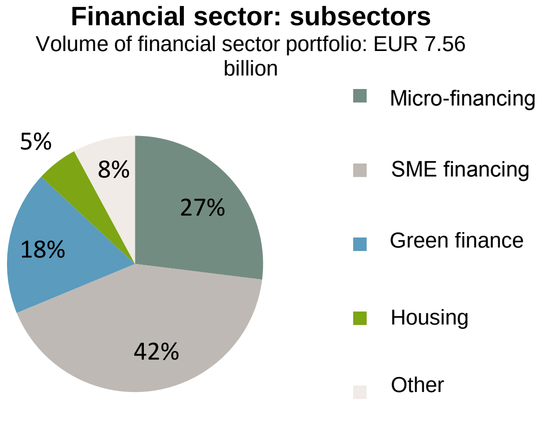
KfW offers long-term refinancing and participations that allow for needs-oriented lending, e.g. even to small SMEs and startups. Among other projects, KfW is involved in the *Small and Growing Business Fund (GroFin)*, which was founded in 2014 and has so far been operating in 14 countries in Africa. The risk capital is used for the financial support of small startups and strongly growing SMEs in particular, but also to establish local contact points for the fund and so to intensify the strategic advice for SMEs. Apart from numerous other existing projects in this area, a *credit line in Nepal* is also being prepared which is designed to finance companies in the “missing-middle” segment, especially in rural areas. An accompanying measure will be put in place to support the partner bank(s) in developing and launching this credit product.

Another important approach is risk hedging by the financial intermediaries using credit guarantee funds, in order to hedge at least part of the lending risk faced by the partner financial institutions. For example, KfW finances together with the EU the *European Palestinian Credit Guarantee Fund (EPCGF)*, a revolving credit guarantee facility that provides partial guarantees for investment and operating loans from banks to micro, small and medium-sized enterprises (MSMEs). The aim of this initiative is to permanently mobilise the existing liquidity of the local banking sector to provide long-term financing for the clearly under-supplied MSMEs in Palestine.

In addition, KfW promotes the introduction of modern lending technologies within the scope of accompanying measures. Apart from teaching know-how through the training of management and staff, the structural adjustment of the banks to suit the needs of the SME business and the simplification of application procedures also play a crucial role. For example, the aim is to accelerate application procedures and to increase the number of commitments on the basis of optimised application evaluations. Accompanying measures at the executing agency also play an important part in a number of ways, including in the introduction of cash flow-based loan products instead of products that rely on the provision of collateral. For example, KfW has granted a credit line consisting of *primary loans and one subordinated loan to Sekerbank, Turkey*. It was also possible to counter the lack of loans in particular to young SMEs without a credit history by providing accompanying advisory services to the bank, which now provides adequate credit products for the existing MSEs (micro and small enterprises) and even MSE startups. The executing agency is the only private bank on the Turkish market so far which is addressing the segment of MSE startups and is applying a cash flow-based credit technology.

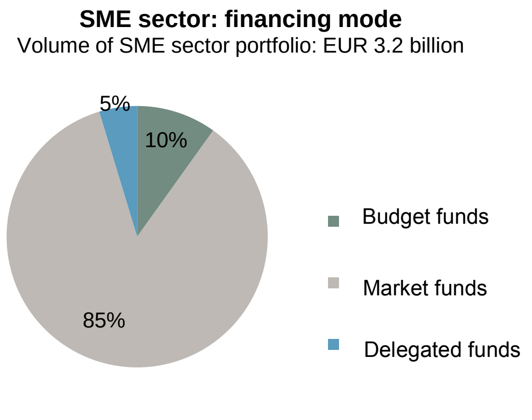
The current SME portfolio of KfW Development Bank in figures

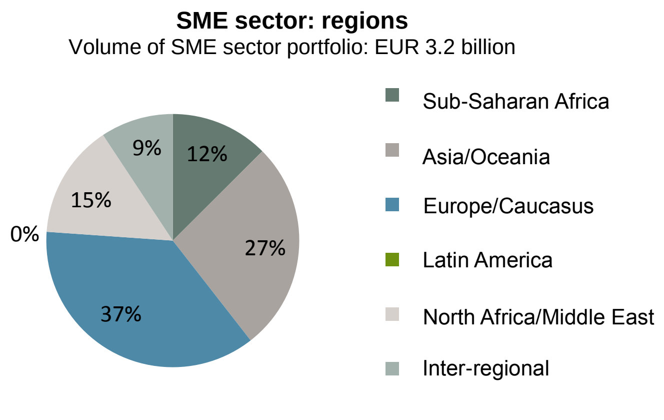
At present, the SME portfolio of KfW Development Bank has a total volume of EUR 3.2 billion, representing the largest financing segment in the financial sector[7].



Source: Internal presentation

More than 60 projects in 25 countries and nine cross-border funds are financed primarily (85%) with KfW's own funds, while budget funds and delegated funds make up the remaining 15% of the investment volume. With a current portfolio volume of over EUR 800m, India is the country that is supported most by KfW in the field of SME financing, ahead of Turkey with over EUR 600m and Morocco with over EUR 400m. Serbia and Nigeria are two other recipient countries with fund commitments of over EUR 100m.





Source: Internal presentation

Source: Internal presentation

The development in new commitments has been significant over the last years. The volume of investment in new SME projects, which was EUR 159 million in 2010, rose to more than EUR 861 million in 2015. Accordingly, the part of SME financing in the global financial sector portfolio increased considerably during the same period: Whereas SME projects accounted for almost 21% of the portfolio in 2010, their percentage had risen to over 42% in 2016. This sharp increase is the result of the growing number of high-volume projects in emerging economies such as India, Turkey and Morocco. Taking into account the development progress made in these countries, the enhanced absorption capacity of their markets and the rising number of well-established local financing partners, high-volume projects are on the rise in sectors that are more challenging, such as the financing of innovations or environmental technology.

[7] In fact, the SME portfolio is even larger, as many SME projects tend to be classified in different subsectors such as green finance.

4. Effects of the KfW commitment in the SME sector

Projects in the financial sector always have a systemic effect, i.e. they are designed to develop and expand the financial infrastructure of the country and so to give final borrowers and SMEs the possibility to receive local, needs-oriented and affordable financing on a sustainable basis. The results of a number of exemplary and already completed projects show that the KfW commitment is making a significant contribution toward achieving this goal.

- For example, in Macedonia there were hardly any credit products for the MSME sector on the market at the beginning of the KfW commitment, which involved a participation in the development of the Pro Credit Bank and the credit line to the German-Macedonian Fund (GMF) to name two in particular. By the end of the GMF project, 80% of the MSMEs had access to loans and almost all banks in Macedonia are now offering appropriate products. In addition, the supporting introduction of modern credit systems ensured that cash-flow based credit technologies and alternative collateralisation have now become a current practice in the Macedonian banking sector. The KfW commitment played a significant part in these developments.

- In the context of a similar line of credit via the German-Rumanian Fund, many SMEs in Rumania gained access to the formal financial sector for the first time as well. Banks with SME-adapted financial services set up a total of 73 branches and all the partner banks that were refinanced in Phase II of the project have introduced SME business on a permanent basis.

- Within the scope of a credit line to the Small Industries Development Bank of India (SIDBI), loans were awarded to 366 SMEs in ten different Indian states within one year. Moreover, in the period from 2006 (the beginning of the project) through 2014, the SME portfolio of SIDBI quadrupled in size. In the context of an impact study, it was also shown that the share of investments in production expansions and/or technology improvements in the companies that were questioned in an evaluation (100 out of 366) had increased from 2% to 30%.

- The evaluation of the EPCGF/Palestine project showed that additional SME financing was provided by the fund which would not have been available without the credit guarantee fund: In particular, more than half of all the guaranteed loans were awarded to borrowers without any credit history, which indicates that the guarantee fund has dramatically improved the access to needs-oriented SME financing for Palestinian companies. It was also discovered in a case study that the risk involved in the guaranteed loans was actually far lower than had been initially anticipated. This suggests that access to financing for borrowers even without a guarantee has also improved.

- Thanks to the provision of equity-like, long-term subordinated loans to SMEs via the Peruvian promotional bank COFIDE it was possible to achieve quality improvements and an expansion of SME lending even with other providers, particularly private banks, which meant that the project had positive effects far beyond the scheme itself (demonstration effect).

Considering the effects that are most important for the SME sector, namely growth and increases in employment and income, the assessment also leads to positive results. Although suitable methods for a standardised impact measurement are not yet developed, figures are already available especially for the employment impact of several KfW projects. The European Fund for Southeast Europe (EFSE) has already reached approx. 790,000 final borrowers, where the loan made it possible to retain over 660,000 jobs and to create more employment. Moreover, a recent impact study on the employment and income effects of SME financing in Serbia showed significant positive effects in terms of employment and growth in companies financed via five KfW promotional loans. On average, the SMEs achieved employment growth of 7.8% and an average increase in sales of 8.21%, or an average increase in the operating result of 27.11%. In the course of the GroFin project, 62,450 jobs in the financed SMEs have been retained or created so far, and an added value of USD 469m per annum was achieved in the local economies. An impact study about SANAD with a final customer survey by two MFIs (approx. 1,000 MSMEs) in Jordan and the Lebanon also reveals positive income and employment effects: 51% of the participants confirmed that the access to financial services had increased their income and 27% of the companies were able to create additional jobs thanks to the access to financial services.

5. New FC approaches

These exemplary results alone emphasize the significance of SME support and financing in developing countries. A great deal has already been achieved in the SME sector in recent years. The depth of the financial sector in developing countries has increased considerably in the last 10 years, measured by the number of bank branches. In addition, the IMF Financial Access Survey analysed that, between 2010 and 2015 in the 25 surveyed developing and emerging countries[8], the number of SMEs as borrowers increased from 5.72 million to 9.19 million. Reforms concerning insolvency proceedings and improvements in the framework conditions for the provision of credit information have also borne positive fruit. More and more new technologies and methods are available so that it is now possible to overcome traditional obstacles that impede access to finance in the SME sector.

Nevertheless, the SME sector still faces huge challenges. In less developed countries, still only 20 to 30% of all companies on average have a loan (in Latin America and Europe/Central Asia, the value is slightly higher), whereas in high-income countries the figure is far above 50%[9]. There is still a need for action especially in the offering of customised financing. The promotion of the integration of SMEs into (global) added-value chains is becoming more and more important for the economic development of a country. Globalisation and an increasing regional economic integration have intensified the competition in both local and global markets. Integrating SMEs into global value chains improves their competitiveness and so makes a positive contribution to both employment levels and integrative growth. KfW is therefore focusing increasingly on the integration of SMEs into (global) value chains. One example is the *participation of KfW in the Fair Trade Access Fund for Africa and Latin America*, which finances and advises small-scale farmers and agricultural workers who are part of the Fair Trade producer groups and also other actors along the Fair Trade value chain. As well as an improvement in the financing possibilities and information, the fund should also facilitate access to sales markets for the target group and so improve their integration into international value chains. Moreover, at the end of 2016, KfW awarded a *credit line combined with a credit guarantee to the Export Growth Fund of the Development Bank of Rwanda*. The low-interest subloans are intended to strengthen trade financing in this country marked by a severe trade balance deficit and also to support the integration of local SMEs in international value chains.

[8] Bangladesh, Bosnia-Herzegovina, Brunei, Burundi, Cameroon, Chad, Chile, Dominican Republic, Equatorial Guinea, Georgia, Gabon, Guinea, Colombia, the Comoros, Kosovo, Latvia, Libya, Madagascar, Macedonia, Mexico, Myanmar, Namibia, Pakistan, Peru, Qatar, Romania, Thailand, Turkey, West Bank and Gaza.

[9] World Bank Group Enterprise Surveys Data

Export Growth Fund, Rwanda

The aim of the project is to improve the offering of financial services to growth- and export-oriented SMEs in Rwanda. At present, the country is facing a deepening trade balance deficit, and it is still far from the target of the Rwandan government of achieving 28% export growth. The objective of the fund is to provide finance for the development of the export business and the expansion of individual companies into new export markets. In particular, the fund finances SMEs that export more than 40% of their production and generate sales between USD 50,000 and 1 million. In parallel, an accompanying measure is intended to support the project executing agency and the partner financial institutions in the development of a corresponding range of products.

Financing instrument: Line of credit
Conclusion of contract: 2016
Project executing agency: Development Bank of Rwanda
Financing volume: EUR 8.5m

In addition, new approaches are generating positive effects in terms of development policy above and beyond direct employment and growth effects by setting selective incentives for SMEs, e.g. for creating training places, energy-efficient investments or for more risk-friendly innovation measures. With its *participation in the Asia Social Entrepreneurship Fund*, KfW is supporting – for example – innovative social entrepreneurs by providing the required equity combined with intensive, technical support. This project is improving the provision of affordable offers of suitable quality for the target group and is supporting the overall development of market structures for equity financing. Another example from India is the *credit line to the Small Industries Development Bank of India (SIDBI)* for the financing of innovative MSMEs in the key areas of climate and the environment. The financing offering of the SIDBI includes financing instruments that are tailored to the specific financing situation of MSMEs – in particular, risk capital instruments and/or financing that has risk-capital characteristics (e.g. subordinated loans). In addition, KfW is a co-founder of the *eco.business Fund*, which allows companies and cooperatives in Latin America to afford financing for investments that make a contribution to preserving biodiversity or the sustainable use of natural resources.

Eco.business Fund

The eco.business Fund enables SMEs and cooperatives in Latin America to finance investments that contribute to preserving biodiversity or to the sustainable use of natural resources. This includes, in particular, enterprises involved in sustainable farming, fishing, forestry, and eco-tourism. In this context the eco.business Fund focuses in particular on companies that have obtained an environmental certification from an independent body, or which operate in conformity with the fund's biodiversity objectives. Alongside existing bank clients, new clients who want to reorganise their production processes are also a target.

Parallel to credits for investment purposes, the fund also offers its clients advisory services. Here, the emphasis is placed on the support of partner banks in developing “green credit products”, on aiding end clients (e.g. with obtaining environmental certifications) as well as on building and transferring know-how related to environmental funding.

Approach: Structured fund
Conclusion of contract: Dec. 2014
Founders: KfW, Conservation Internationel and Finance in Motion
Fund volume: USD 54.9m
Federal Ministry for Economic Cooperation and Development (BMZ) funds: Approx. USD 21m
KfW funds: USD 25m

The refinancing of local currency and the development of local capital markets are increasingly significant for the sustainable promotion of financial systems. Projects aimed at developing capital markets have a particular long-term effect because they strengthen the local and private financing capacities and also make the relevant countries less dependent on international (development) financing. The lacking development of bond markets in local currencies in many states represents an essential barrier to growth, as it prevents savings and pension balances from being released to the real economy to the necessary degree in the form of local-currency loans. In this relatively challenging area, too, KfW has concluded initial projects, and others are under preparation. At the end of 2013, KfW founded the *African Local Currency Bond Fund (ALCBF)*, which invests in bond issues of local financial institutions and acts as an anchor investor to allow the issuer to carry out further currency-congruent financing and to allow access to local-currency loans for MFI and bank customers. This fund is one of a kind. Another current example is the African fund *“Lending for African Farming Company” (LAFCo)*, which was co-founded by KfW and offers direct local-currency financing for SMEs to promote local and regional value chains and to increase the production of food.

Energy Efficiency Credit Line, SIDBI

The FC measure resolved in 2016 includes the financing of energy-efficiency investments in the commercial sector in India. The aim of this measure is to increase the energy efficiency of SMEs through needs-oriented access to investment loans, and to reduce the greenhouse-gas emissions of the Indian SME sector. Within the scope of the project, investments that improve energy efficiency and save energy are being financed, primarily in the following four areas:

- Industry-specific technological solutions,
- Industry-independent technical devices and process optimisations,
- Modifications to the energy supply and
- Energy-efficient industrial buildings.

The aim is to achieve structure-forming effects in the financial sector through the sustained expansion of the financing instruments of the SIDBI and through the strengthening of the SIDBI in its supportive activities as an environmental bank. The project follows directly on from the project “Funding of energy-efficiency measures in SMEs” submitted to final appraisal in February 2016, and is designed to enhance the existing funding approach and to establish it on the Indian market.

Financing instrument: Interest reduction
Conclusion of contract: 2016
Project executing agency: SIDBI
Financing volume: EUR 111.5m

6. Outlook

The key now is to transfer this selection and other innovative approaches to further countries and regions. In view of the challenges involved in the introduction of new financing products and/or the financing of new target groups, however, pure financing measures are barely sufficient to eliminate the deficits in the financial sector. The successes of the above-mentioned examples also depended and still continue to depend largely on the supporting consultant measures from the financing partners. Achieving significantly positive effects in the area of access to finance, employment, and growth and generating other indirect, positive effects, such as in the area of the environment, will be easier if development financiers coordinate their projects more intensively. Numerous existing platforms and networks such as the Global Partnership for Financial Inclusion (GPFI) or the SME Finance Forum already provide opportunities for this.

.

7. References

Ayyagari, M., Demirgüç-Kunt, A., Maksimovic, V. (2011): “Small vs. young firms across the world: Contribution to employment, job creation, and growth”, World Bank Policy Research Working Paper No. 5631, 2011.

BMZ (2016): “Sektorstrategie Finanzsystementwicklung“, 2016.

De Kok, J., Deijl, C., Veldhuis-Van Essen, C. (2013): “Is small still beautiful? Literature review of recent empirical evidence on the contribution of SMEs to employment creation”, Eschborn and Geneva, GIZ and ILO, 2013.

Gonzales, E., Hommes, M., Mirmulstein, M. L. (2014): “MSME Country Indicators 2014 – Towards a Better Understanding of Micro, Small and Medium Enterprises”, IFC, World Bank Group.

ILO (2015): “Small and medium-sized enterprises and decent and productive employment creation”, International Labour Conference, 104th Session, 2015.

International Labour Conference (2015): “Provisional Record, Fourth item on the agenda: Small and medium-sized enterprises and decent and productive employment creation. Reports of the Committee on SMEs and Employment Creation”, International Labour Conference, 104th Session, 2015.

World Bank Group Enterprise Surveys Data: „Enterprise Surveys (database), International Finance Corporation and World Bank”, Washington, DC, http://www.enterprisesurveys.org.

Imprint

Publisher
KfW Group
KfW Development Bank
Palmengartenstrasse 5-9
60325 Frankfurt am Main
Germany
Phone +49 69 74310
Fax +49 69 7431 2944
info@kfw-entwicklungsbank.de
www.kfw.de

Editor
Competence Centre Sustainable Economic Development, Education, Health

Photos
Source: KfW Photo Archive, Copyright: photothek.net