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Addressing the Financing Gap for Technology Entrepreneurs in Developing Countries

Findings & Recommendations from the *info*Dev Study

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Study Focus

Existence, origins and nature of **"financing gap"** faced by SME in the ICT/ICTE industry

➡**Shortage of capital to meet demand** (but not necessarily an "absolute lack" of capital)

➡**Obstacles also on the demand side** (namely, "control aversion")

INTRODUCTION

Study Coverage

Small and Medium Enterprises (SME) as defined by the World Bank Group:

- ➡Micro (up to 10 workers and US$ 100,000 turnover)
- ➡Small (up 50 workers and US$ 3 million)
- ➡Medium (300 workers and US$ 15 million)

i.e. widely different business models

INTRODUCTION

Study Coverage

Firms operating in:

➡**ICT activities** (software development, IT-related consulting, production, sale & servicing of IT equipment)

➡**ICT-enabled activities** (Business Process Outsourcing – BPO, remote testing, design and R&D activities)

INTRODUCTION

Study Coverage

- **Latin America** (Argentina, Brazil, Peru, Dominican Republic)
- **Sub Saharan Africa** (Kenya, Senegal)
- **Asia** (India, Philippines)
- **North Africa** (Morocco)
- **Eastern Europe** (Ukraine)

i.e. widely different countries

INTRODUCTION

Study Coverage

ACTIVITIES
(from very basic to very advanced)

ENTERPRISES
(from micro to small MNC)

COUNTRIES
(low & middle income small & huge)

Diverse universe, with widely different business models and financing needs

OBSTACLES TO SME FINANCING

OBSTACLES TO SME FINANCING

Informational Asymmetries

Always present in any enterprise financing decision, but **more severe for SME** (e.g. inadequate financial reporting)

Problem magnified in ICT/ICTE by the **high tech nature** of the business (but more literate promoters)

OBSTACLES TO SME FINANCING

Risk Profile

SME have a **higher risk profile** ("one man band", limited market power, more exposed to adverse changes in the external environment)

Problem exacerbated in ICT/ICTE by the **innovative character** of activities, with high risk of failure

OBSTACLES TO SME FINANCING

Transaction Costs

SME financing is an **expensive business** (high fixed costs for a *faible ticket*; raising interest or fees is only a partial answer)

In ICT/ICTE the problem is more severe because of the **specialized expertise** required to appraise initiatives (not available to traditional financiers)

OBSTACLES TO SME FINANCING

The Issue of Collateral

More a symptom than the original cause, as it serves to mitigate problems with "moral hazard" and high risk profile

In ICT/ICTE the problem is aggravated by the **intangible nature of assets** (but in some segments trade receivables can serve the purpose)

OBSTACLES TO SME FINANCING

Impact of Institutional Factors

Problems are exacerbated in Developing Countries:

➡undeveloped **financial systems** (concentrated banking sectors, thinly traded stock markets)

➡inadequate **legal systems** (problems with collateral and, sometimes, quasi equity instruments)

➡undeveloped **information infrastructure** (e.g. no credit bureaus)

➡**taxation** often skewed in favor of debt financing

EVIDENCE FROM COUNTRY STUDIES

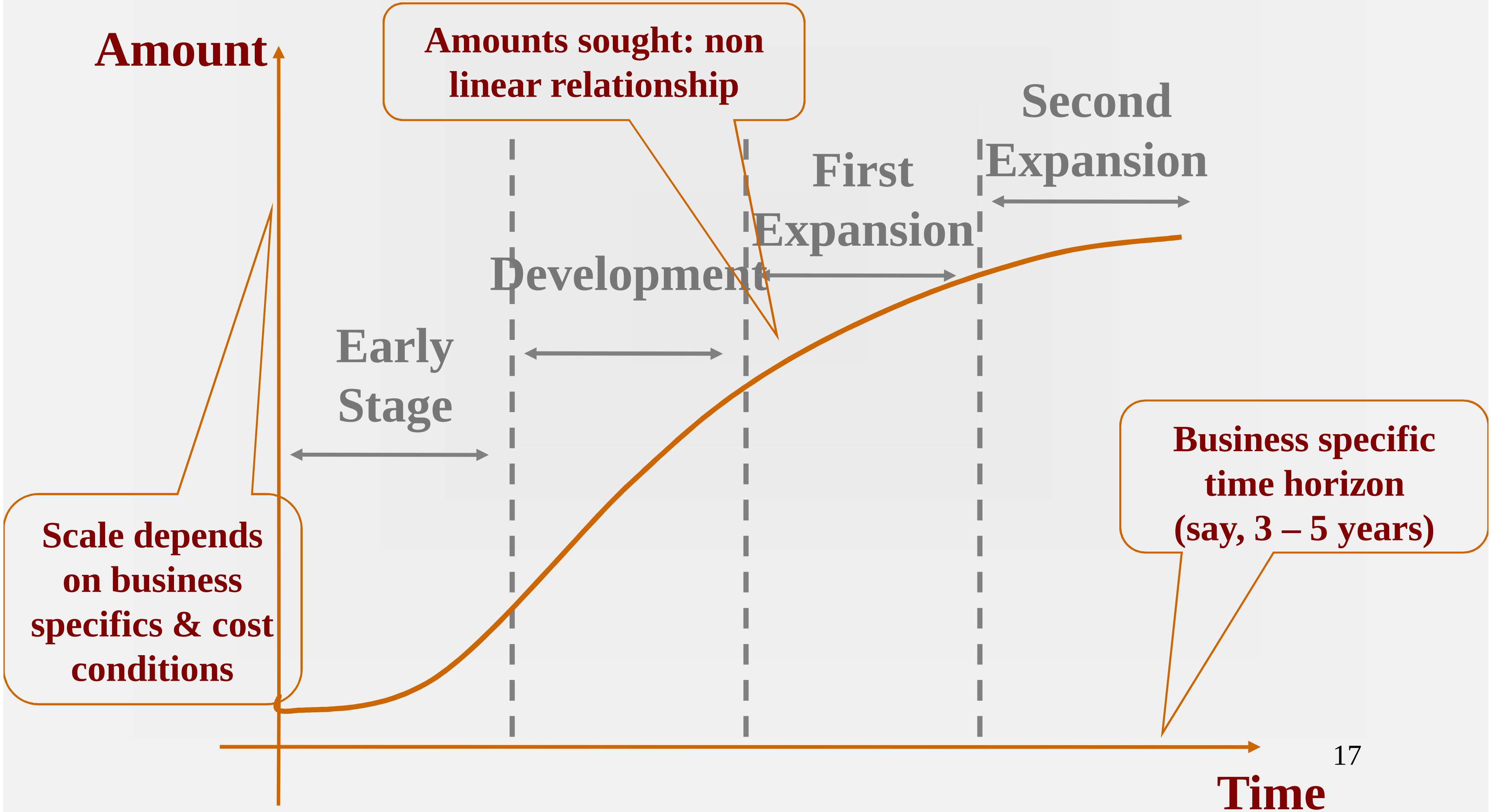
EVIDENCE FROM COUNTRY STUDIES

Approach

- Overview of the **ICT/ICTE sector** (size, key traits)
- **Financing needs** identified (sort of "financing life cycle" model)
- Review of **existing instruments** (debt and equity financing)

EVIDENCE FROM COUNTRY STUDIES

Financing Needs: Life Cycle Model



EVIDENCE FROM COUNTRY STUDIES

Definitions:

- **Early Stage**: includes pre seed, seed and start up phases (from business idea to commercialization)
- **Development**: firm may or may not trade profitably and needs refer to capacity increase, market development & working capital
- **1st Expansion**: significant change in operations (second version or product diversification)
- **2nd Expansion**: financing needs often related to an internationalization drive

EVIDENCE FROM COUNTRY STUDIES

Comments

- in **simpler activities** (e.g. web designing and IT services), the distinction between early stage and development becomes blurred

- the **non linear relationship** between development stages and amounts required may not apply to some ICTE activities (e.g. call centers)

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Morocco – ICT/ICTE Sector

➡Medium sized **ICT sector** (US$ 580 M, 1,000 firms of which 200 “real ICT”, 7,400 jobs), with strong position in applications for payment systems (some world players)

➡**ICTE** activities rapidly growing (60 call centers, US$ 80-100 M, 8-10,000 jobs), thanks to increasing decentralization from France & Spain

➡Emerging **regional – sub-regional role** (Senegal, Mauritania, etc.)

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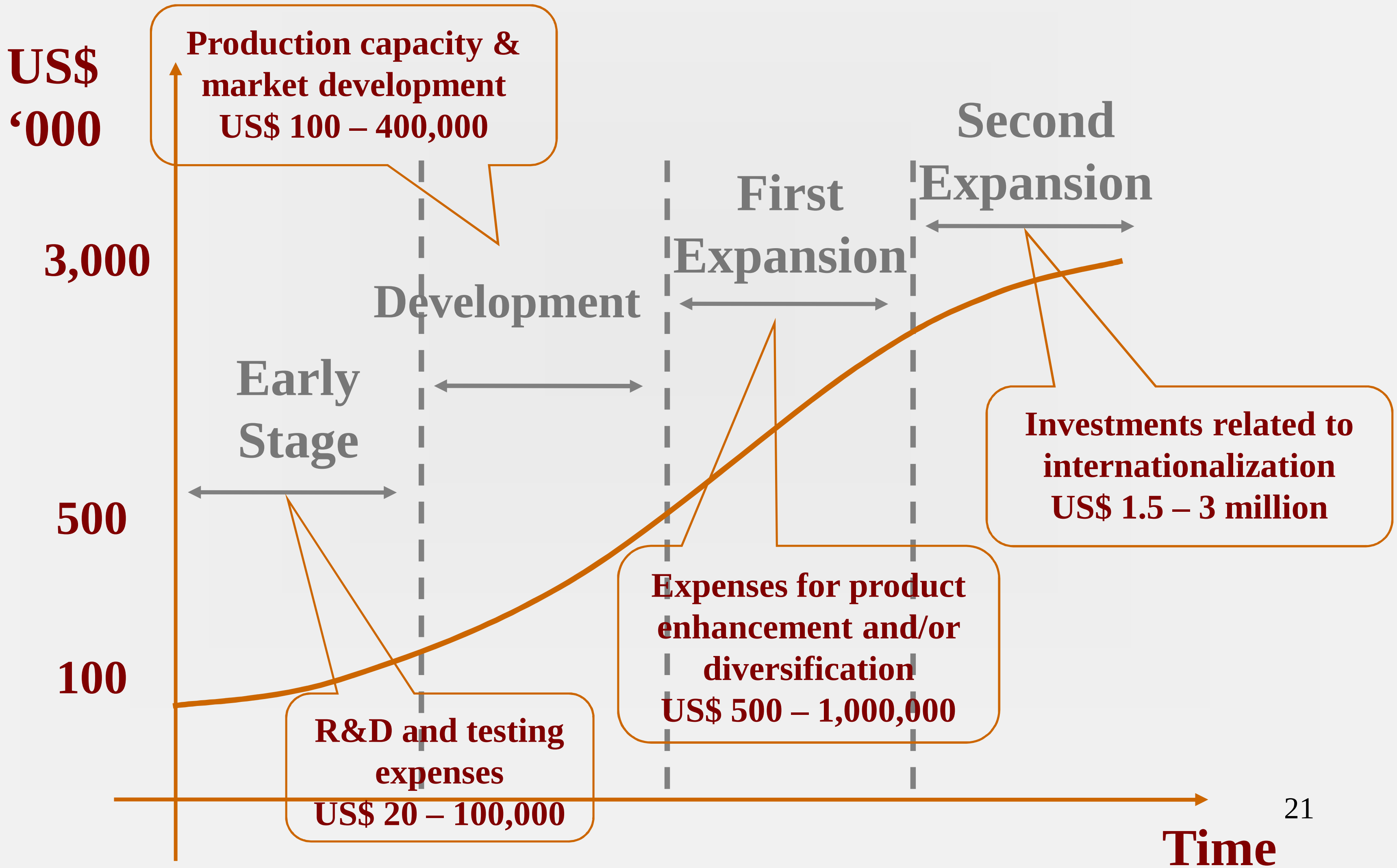
Morocco – Financing Needs



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Morocco – Sources of Financing

➡**Banks** admit knowing little about ICT and lending remains limited and fully collateralized)

➡Talks of an **ICT guarantee fund** (proposed by the ICT sector association - APEBI)

➡Generalist **equity funds** did invest in ICT (1/4 – 1/5 of deals), but they rarely go below US$ 500,000

➡Only one **seed financing facility** (*Fonds Sindibad*, with funds from CDC PME and EIB), plus some **grant financing** through NGO/government schemes

EVIDENCE FROM COUNTRY STUDIES

India – ICT/ICTE Sector

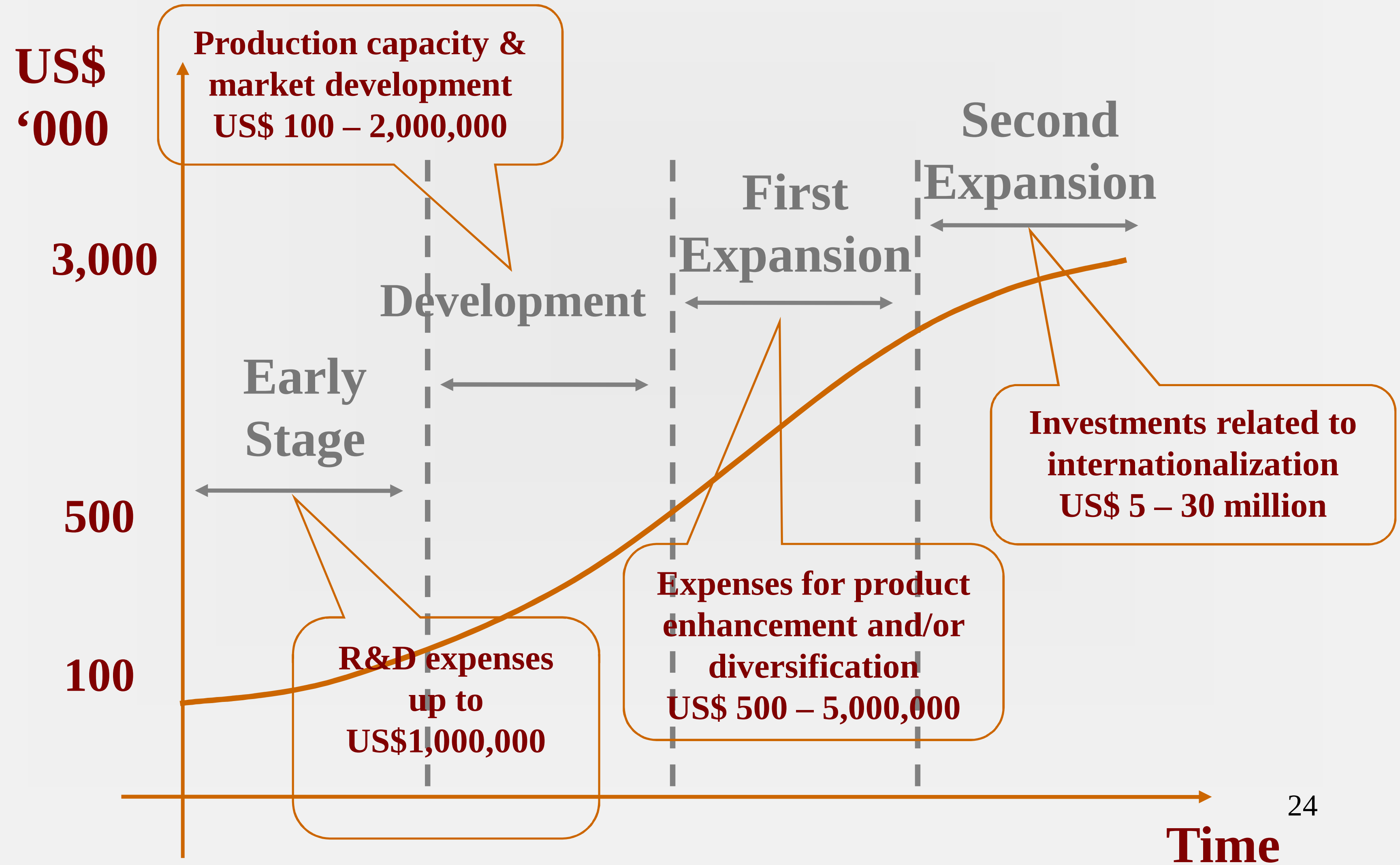
➡Very dynamic **ICT sector** (US$ 30 billion million, 70% export), with strong positions in services industry and emerging products industry (some world leaders – *Infosys*, *TCS*)

➡**ICTE** rapidly growing, thanks to decentralization from US

➡Fairly developed **infrastructures** STPI, STEP, Incubators

EVIDENCE FROM COUNTRY STUDIES

India – Financing Needs (new products)



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India – Sources of Financing

- **Private investors are attracted by India**: money is still coming in, Bombay stock exchange +50% in less than six months
- **Equity funds** keep investing in ICT, but they rarely go below US$ 2,500,000
- Some **grants**, up to US$ 50,000, and **guarantee schemes** trough government initiatives
- A strong need to **develop Public Private partnership** for **attracting private investors to get involved in the early stage phase**

EVIDENCE FROM COUNTRY STUDIES

Ukraine – ICT/ICTE Sector

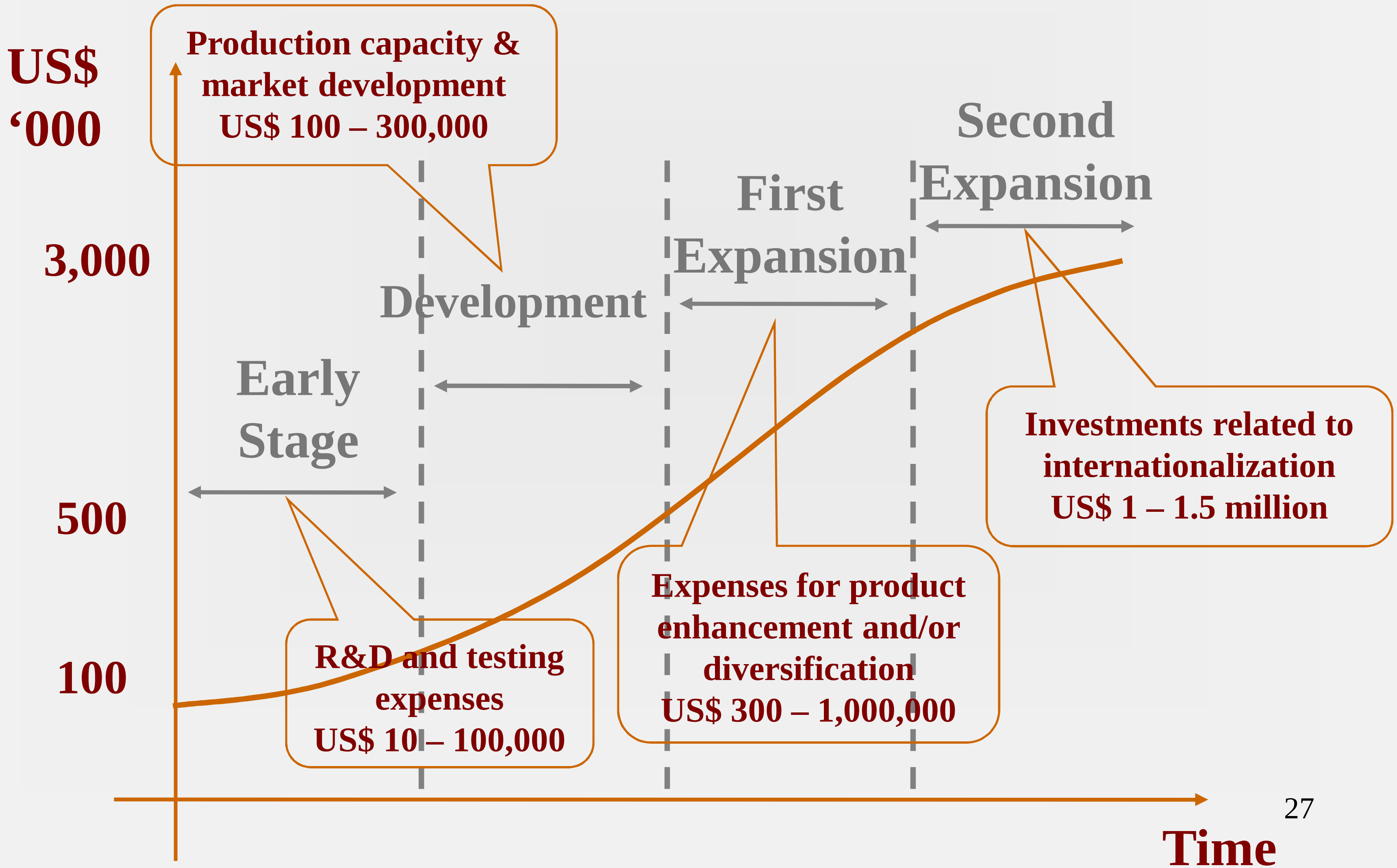
➡Very dynamic **ICT sector** (US$ 6 billion, 1,300 software related companies, 900 hardware, 400 ISP – 50,000 jobs), focus on software development and outsourcing, significant R&D, innovative

➡**Competitive advantage** in highly skilled programmers and low labor cost

➡**Problems**: low IP protection, uncertain legal framework, business practices not transparent, black economy

EVIDENCE FROM COUNTRY STUDIES

Ukraine – Financing Needs



EVIDENCE FROM COUNTRY STUDIES

Ukraine – Sources of Financing

- Most SME rely on **self-financing**
- **Equity funds** and **bank loans** are currently not accessible for SME, all the more in the ICT sector. **Credit guarantee schemes** could play an important role
- There are no grants and **public intervention is needed** to cover the early stage and first expansion
- **Foreign Investors are discouraged** by uncertainty and lack of transparency

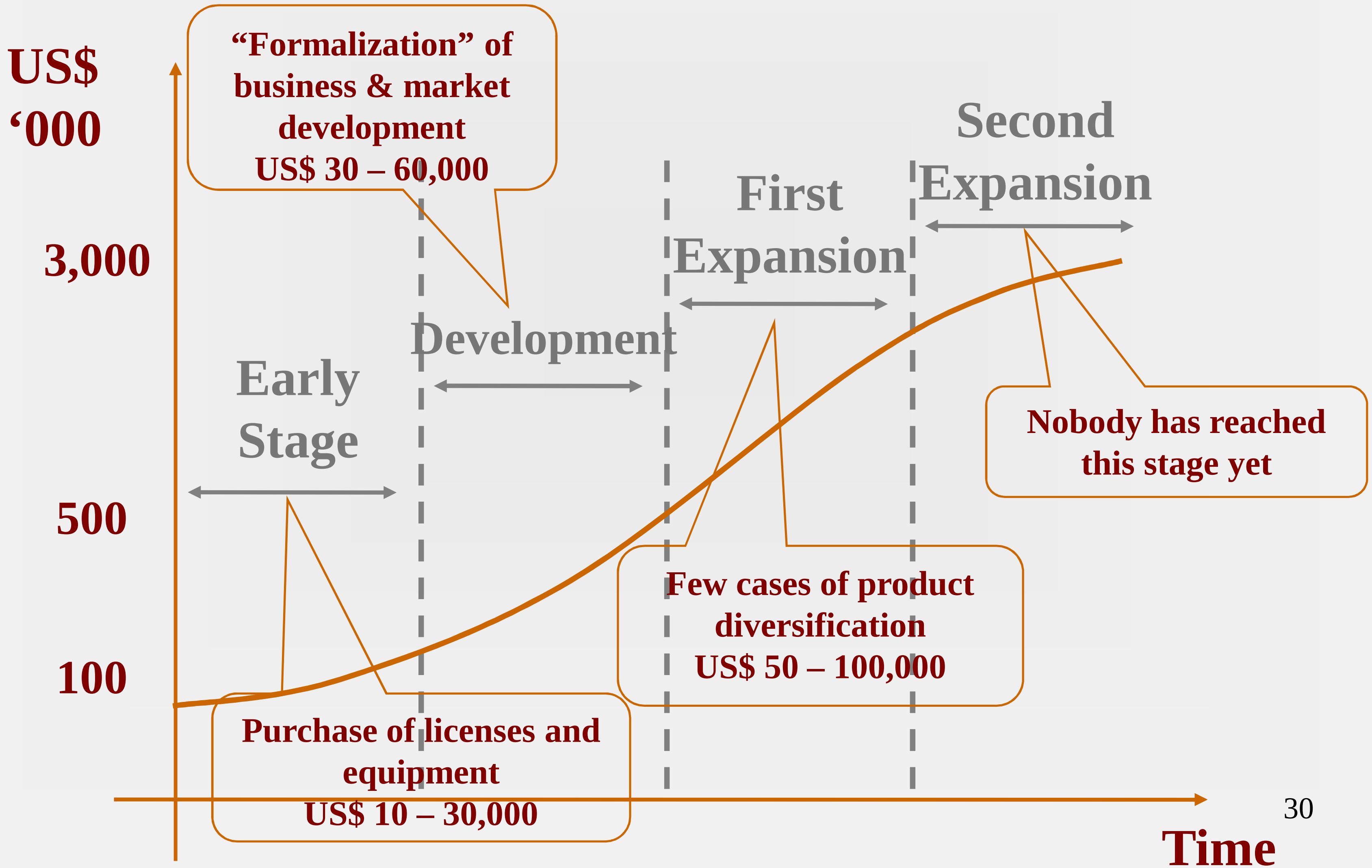
EVIDENCE FROM COUNTRY STUDIES

Kenya – ICT/ICTE Sector

- Small **ICT sector** (less than US$ 50 M), with some 30-40 IT firms (web-designers, developers of business applications, and "software localizators" – i.e. translation in Kiswahili)
- **ICTE** is emphasized in the brand new ICT strategy, but development is prevented by high cost of connectivity (3 call centers licensed, only 1 active)
- **Regional hub**, with significant presence of leading corporations (*Microsoft*, *HP*)

EVIDENCE FROM COUNTRY STUDIES

Kenya – Financing Needs



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Kenya – Sources of Financing

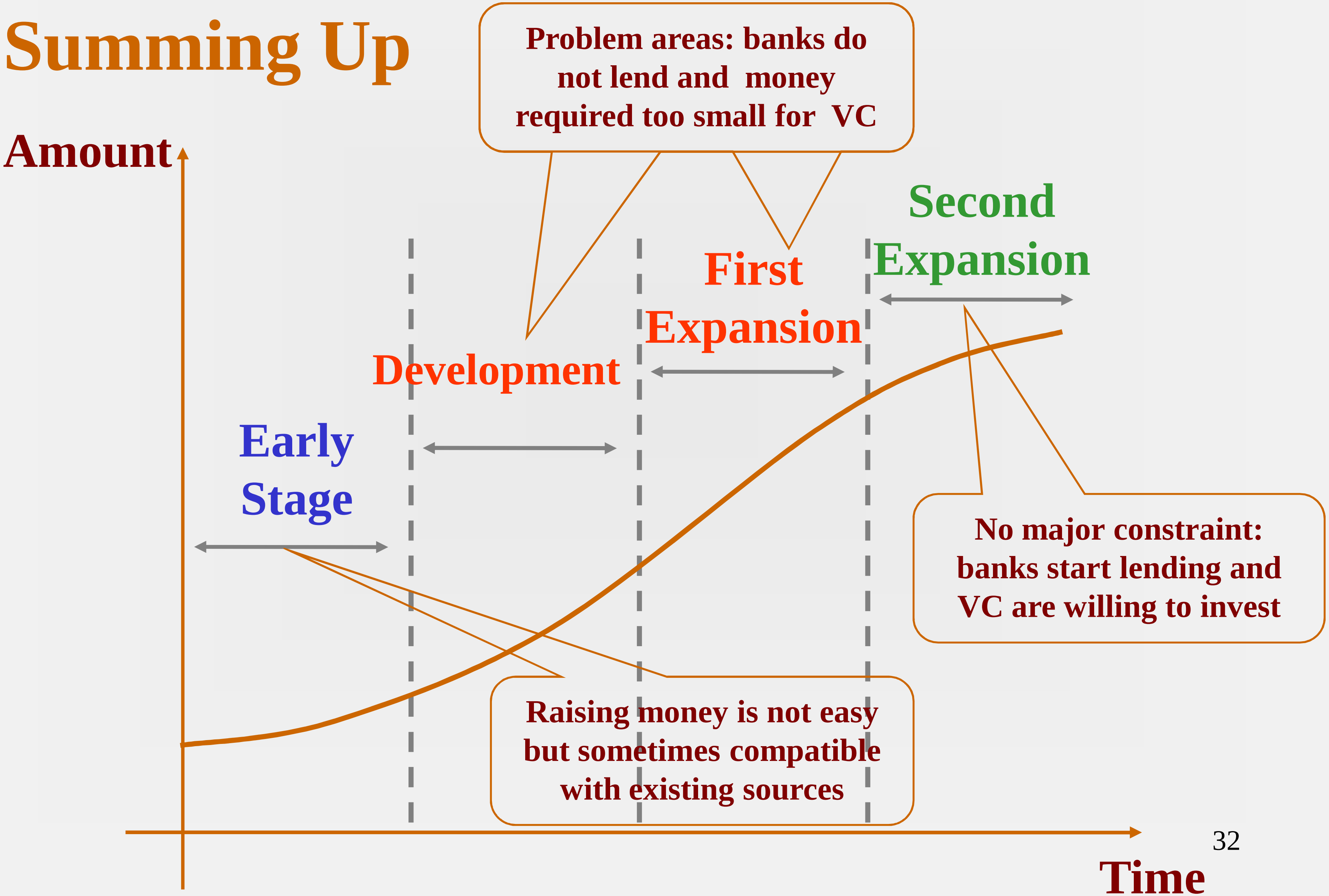
➡**Banks** are wary of SME in general, but *K-Rep Bank* financed some 10 small ICT operations (seemingly going well)

➡**Equity funds** have not invested in ICT so far (*Aureos* is targeting larger deals and *Business Partners* is still in the process of setting up)

➡*East Africa Capital Partners* tried to establish a fund with no success, and is assisting deals on a case by case basis (now targeting large deals)

EVIDENCE FROM COUNTRY STUDIES

Summing Up



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Constraints also on the demand side

➡ **“Wrong” expectations** from promoters (do not understand or accept the risk premium required by providers of equity financing)

➡ Inability to **build a working relationship** with banks and other sources of financing (do not have time or skills)

SUPPORTING MEASURES

SUPPORTING MEASURES

SME financing has been a top priority for donors and IFI for more than a decade

- Policy measures to improve the **overall business environment**
- Technical assistance to enhance **SME capabilities**
- and, especially, a wide range of **interventions in financial markets**

SUPPORTING MEASURES

Interventions in Financial Markets

➡**SME credit lines** (used by all donors & IFI, large number, possibly more than 400)

➡**Leasing** (IFC alone supported the establishment of over 150 leasing companies)

➡**Equity financing schemes** (possibly, 70-80 SME funds in operation)

➡**Credit guarantee schemes** (especially in East Europe and Middle East, promoted by EU)

SUPPORTING MEASURES

The Record

➡**Credit lines** were certainly useful in a number of cases (no liquidity/forex), but sometimes have become too expensive and remained un-disbursed

➡**Leasing** is doing well and the same applies to **credit guarantee funds** (in more advanced countries)

➡**Equity funds** sometimes paid a price for their novelty (and average size of deals seems to be increasing .. once more the *faible ticket* problem)

SUPPORTING MEASURES

Most initiatives target SME "in general", only few devoted to ICT/innovative firms

➡A dozen donor/IFI-participated **investment funds** (typically less than US$ 10 million each), mostly in Latin America, India and South Africa

➡Few cases of credit lines with **"special windows"** for innovative enterprises (but more often support is given to the use of ICT by SME in general)

RECOMMENDATIONS

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Promote Credit Guarantees

Increase Supply of Equity Financing

Financing Gap

Enhance Understanding of Financing Options

Enhance Understanding of ICT Sector

Promote Flexible Investment Instruments

RECOMMENDATIONS

Increase Supply of Equity – New Facilities

ICT equity funds targeting **deals below US$ 1 million** are still rare. Interest is particularly strong in India (need to feed new deals in the VC pipeline)

➡ Assistance to design ICT dedicated facilities **combining public and private money**, along the lines of schemes used in the US (revised "SBCI model" and EU (ETF Start Up)

➡ **Co-financing** would be appreciated

RECOMMENDATIONS

Increase Supply of Equity – Existing Funds

Existing “generalist” equity funds are not a priori against small deals or ICT, but are often deterred by **transaction costs**

- ➡“TA facility” to cover **preparation & monitoring costs** incurred by fund managers for smaller deals (below US$ 1 million)
- ➡**Tactical approach**, trying to make the most out of what already exists

RECOMMENDATIONS

Promote Flexible Investment Instruments

Increasing recognition that investments in smaller companies require an **imaginative approach**, with use of instruments that go beyond standard equity and can be easily understood and accepted by SME

➡ Consolidate and disseminate **best practices on quasi equity financing** (royalty schemes, loans with performance related interest, etc.)

➡ Assist in **creating conditions** for more widespread use (legal framework & profession)

RECOMMENDATIONS

Enhance Understanding of ICT Sector

In many countries bankers have a limited understanding of the **fundamentals of the ICT/ICTE sector**, which is still largely regarded as a sort of “black box”

➡Assist ICT sector associations and business incubators in compiling and disseminating information on **basic economic and financial parameters** (current proposal for a *Centrale Financière TIC* in Morocco)

RECOMMENDATIONS

Better Understanding of Financing Options

Smaller entrepreneurs need to be assisted in their initial approach to banks and other sources of financing

- **Build capacity** within ICT sector associations and business incubators to advise and support members
- More than just “business planning” and “application filling”: **real coaching is needed**

RECOMMENDATIONS

Promote Credit Guarantees

For small investments (US$ 25 – 100,000) credit guarantees could be an **alternative to seed financing**. In countries with a weak equity culture (Ukraine), could work also for larger operations

- Technical assistance for the establishment of **ICT credit guarantee schemes**
- Where sector associations are strong (e.g. India), the **mutual credit guarantee model** could apply

THANK YOU FOR YOUR ATTENTION