Financing Small and Medium Enterprises in the Republic of South Africa

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Acknowledgments

The project team would like to thank the national authorities of Republic of South Africa, all participants in the surveys, and individuals from other institutions who provided valuable inputs relating to the study during discussions in May and November 2010, and in May 2011. In particular, we would like to thank representatives from the Absa Bank, The Banking Association South Africa, Business Partners, Compuscan, Department of Trade and Industry, Economic Development Department, Finmark Trust, First National Bank, Gauteng Department of Economic Development, Industrial Development Corporation, Khula Enterprise Finance, National Credit Regulator, National Empowerment Fund, National Treasury, Nedbank, Sasfin, Standard Bank, and USAID Financial Sector Program.

Additionally, we would like to thank Irina Astrakhan, Claus Astrup, Ingrid Goodspeed, Thomas Losse-Mueller, Inessa Love, Maria Soledad Martinez Peria, and Chunlin Zhang for helpful comments and suggestions on earlier drafts of this report. The study was carried out under the overall guidance of Marilou Uy (Sector Director, Finance and Private Sector Development, African Region, the World Bank) and Ruth Kagia (Country Director, Botswana, Lesotho, Namibia, South Africa and Swaziland, Africa Region, the World Bank). Naturally, all errors remain our own.
## Acronyms

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<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>ANC</td>
<td>African National Congress</td>
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<tr>
<td>BDS</td>
<td>Business Development Support</td>
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<td>BEE</td>
<td>Black Economic Empowerment</td>
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<tr>
<td>DFI</td>
<td>Development finance institution</td>
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<tr>
<td>dti</td>
<td>South African Department of Trade and Industry</td>
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<td>ES</td>
<td>Enterprise Survey</td>
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<td>ICA</td>
<td>Investment Climate Assessment</td>
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<tr>
<td>IDC</td>
<td>Industrial Development Corporation</td>
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<tr>
<td>JSE</td>
<td>Johannesburg Stock Exchange</td>
</tr>
<tr>
<td>LAC</td>
<td>Latin America and Caribbean Region</td>
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<tr>
<td>LE</td>
<td>Large enterprise</td>
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<tr>
<td>MENA</td>
<td>Middle East and North Africa Region</td>
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<tr>
<td>MI</td>
<td>Microenterprise</td>
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<tr>
<td>MSE</td>
<td>Micro- and small-sized enterprise</td>
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<tr>
<td>NEF</td>
<td>National Empowerment Fund</td>
</tr>
<tr>
<td>NPL</td>
<td>Nonperforming loan</td>
</tr>
<tr>
<td>P&amp;L</td>
<td>Profit and loss</td>
</tr>
<tr>
<td>PERC</td>
<td>Policy and Economic Research Council</td>
</tr>
<tr>
<td>SAMAF</td>
<td>SA Micro-Finance Apex Fund</td>
</tr>
<tr>
<td>SARB</td>
<td>Reserve Bank of South Africa</td>
</tr>
<tr>
<td>SARS</td>
<td>South Africa Revenue Service</td>
</tr>
<tr>
<td>SEDA</td>
<td>Small Enterprise Development Agency</td>
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<tr>
<td>SME</td>
<td>Small- and medium-sized enterprise</td>
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<tr>
<td>UYF</td>
<td>Umsobomvu Youth Fund</td>
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Executive Summary

Small and medium-sized enterprises (SMEs) make an important contribution to employment, income and economic growth. Numerous studies worldwide have highlighted that SME growth requires external financing. Constraints to accessing credit consistently are rated as one of the greatest barriers to the operation and growth of firms. Moreover, credit constraints affect SMEs more severely than large firms. Traditionally, the performance of the South African financial sector in providing access to finance to medium-sized and large firms in the formal sector was seen to be satisfactory. In actuality, many micro and small enterprises in the informal economy were facing more severe constraints. This report assesses the impact of South Africa’s economic downturn on the provision of finance to those SMEs that previously had good access. The report also reviews policy options to secure a stable supply of finance for the SMEs that have more difficulties accessing credit now, as well as those not served by the financial sector at all.

Due to the low level of disaggregation of publicly available credit data, many questions regarding the pattern of formal SME financing remain unanswered. In this context, one is often reliant on perceptions. The demand side (SMEs) perceives that financing the formal financial sector is scarce, expensive and short term. The supply side (financial institutions) perceives that opportunities of acceptable quality are too rare and that too many obstacles must be overcome.

This report presents findings from two surveys relating to access to finance for small- and medium-sized enterprises (SMEs) in South Africa. The first is a survey of formal SMEs (demand-side survey) in which 234 of 1,057 firms originally surveyed in late 2007 as part of the World Bank’s South Africa Enterprise Survey of 2008 were revisited to assess their access to financial services and to investigate the effects on them of the economic downturn of 2007–09. Of the 234 firms interviewed in 2010, 194 were SMEs. Of these, just over 50 percent were Black or Asian owned. Most of the rest were White owned. The second is a survey of commercial banks and other financial institutions involved in lending to SMEs (supply-side survey) to better understand their involvement with SMEs and their business models for serving this segment. Linking both surveys in this report presents a complete picture of access to finance for SMEs in South Africa, including both demand and supply-side issues, in the presence of an important exogenous shock. This report enables cross-checking conclusions and perspectives from the
two sides of the survey. Additionally, based on the survey results, as well as a discussion of the recent performance of development finance institutions, the report outlines a range of policy considerations.

Key findings from the surveys and the review of government policy approaches are:

1. The economic downturn negatively affected SME finance, and banks view macroeconomic risk as a key obstacle to expanding SME finance.
   - Worsening macroeconomic conditions during 2007–09 negatively impacted SME financing, due to both the reduced demand for goods and services sold by SMEs and the tightened credit conditions. In South Africa, a sharp rise in interest rates in 2007 saw the end of the consumption-led growth of much of the 2000s. The interest rate rise negatively impacted bank profits from 2008 onward in the form of significantly higher impairment charges. The effects of muted domestic demand were compounded by weaker international demand as a result of the global financial crisis. These results reflect both the character of the economic boom that ended just as the financial crisis unfolded and the nature of the SME market in South Africa, which was oriented toward consumer spending.
   - As a response to the economic downturn, over 70 percent of the surveyed banks did change their SME credit management practices. Actions included tighter origination standards and closer monitoring of high-risk loans.
   - Banks reported a reduction in loan applications between 2007 and 2009 and a proportionally even greater reduction in loan approvals. Based on available data, on average, applications declined by 23 percent and loan approvals by 43 percent, indicating a relatively large reduction in loan approval rates (from 61 percent to 45 percent).
   - As a result, compared to 2007, in 2010 more firms perceived access to finance as an obstacle to their business and growth. One in three of the surveyed SMEs now considers access to finance to be “a major or very severe” obstacle to its business. By contrast, the 2007 ratio was nearer one in ten.
   - SMEs are finding it harder to obtain longer term financing, for example, for investment, from commercial banks.
   - By contrast, SMEs found working capital loans provided by banks to be easier to obtain. The evidence suggests that SMEs prefer to source working capital from commercial banks rather than from trade suppliers or customers, as was the case historically. Of the formal
SMEs surveyed in the demand survey, a slightly higher percentage of firms applying for loans in 2010 had their applications rejected than in 2007. On the other hand, fewer loans in 2010 required collateral than in 2007, perhaps due to better “on-boarding” processes within banks whereby it is easier for an SME to qualify for a loan once it has successfully passed through a “get-to-know-you” period.

- There was unanimous agreement among the surveyed financial institutions that macroeconomic factors were a significant or very significant obstacle to their engagement with SMEs. Among the factors cited were macroeconomic instability, unemployment, over-indebtedness, high interest rates, falling demand and the impact of reduced government spending in certain areas.

2. Beyond macroeconomic risks, in the view of commercial banks, significant information gaps constrain the ability to expand SME finance.

- Other obstacles mentioned by survey respondents include significant information gaps (inadequate or absent business plans and financial statements), lack of business and financial skills among entrepreneurs and limited coverage of SMEs by the credit bureaus. Finally, a number of institutions noted the perennial difficulties associated with small enterprise lending—namely, the high fixed costs per transaction, and the difficulty of achieving economies of scale and of standardizing products and procedures.

- Generally, regulatory factors, whether affecting financial institutions or SMEs directly, do not seem to constrain financial institutions’ engagement to any great extent. However, certain concerns were raised by the industry: for example, the cumbersome nature of the judicial processes required to recover a debt and the low Small Claims Court limit of R7,000, and the potential implications of the business rescue provisions of the new Companies Act.

3. Large commercial banks are by far the largest suppliers of SME finance and continue to view the sector as an important segment for future business growth.

- The large commercial banks (“the Big 4”) constitute a very large proportion of the market for SME lending, and were perceived by all institutions to be major players in the market. The public sector accounted for only 2.5 percent of lending to SMEs in 2009. However, other institutions in specific market segments, such as niche banks, nonbank financial institutions and public financial institutions, also were named as important participants.
Small enterprise units generally have provided the large commercial banks with a relatively robust income stream through the downturn. For example, net income contribution from small enterprise units as a proportion of total bank net income rose from 5.4 percent to 5.7 percent from 2007 to 2009. Similarly, the results point to the differing credit experiences of small and medium enterprises. Between 2007 and 2009, nonperforming loans for small enterprises remained flat, at an average percentage of 3.9 percent. In contrast, nonperforming loans for medium enterprises tripled over this period to 4.9 percent, albeit from a lower base of 1.5 percent in 2007.

In terms of determinants of banks’ involvement with the segment, SME banking is seen as a feeder for future business and as an attractive and profitable business in its own right. Government policies appear to matter only marginally in motivating commercial bank engagement with the SME sector.

Expected profitability is the most commonly cited factor as to how banks target SMEs. Three-fifths of institutions employ a sector-specific approach, with franchises, in particular, being targeted by various institutions. Additionally, institutions recently have had to take a more proactive approach to marketing to attract enough applications of sufficient quality.

However, commercial bank SME business models vary significantly and focus more on deposits and transaction services than on providing credit to SMEs.

Organizationally, among the large commercial banks, there does not appear to be industry-wide consensus as to where within the bank the SME unit is best placed. In some banks, the SME unit is located in the retail banking division; in others it is within the business or commercial banking division.

Among the large commercial banks, deposits from SMEs tend to be noticeably larger than lending to SMEs, with an average ratio of loans to deposits of 58 percent for SMEs and 49 percent for small enterprises. This result shows that the SME units are less focused on providing credit.

The large commercial banks generate a significant proportion of their revenues from noncredit products and services. As an illustration, on average, in 2009, 73 percent of revenues were generated from deposit, account management and other transaction and fee based services.
• On the credit side, a large proportion of SME loan books are made up with traditional asset-backed lending. Other lending products, such as factoring, leasing and trade finance, constitute a small proportion of the lending book in the typical universal bank.

• Almost all institutions surveyed offered free business training and coaching services to SMEs. Business training and support offer benefits to both the lender and borrower, with effective support believed to increase the probability of loan repayment.

• Credit scoring is widely utilized across the sector as an input in credit decisions, and there is evidence of innovation taking place in this field. However the industry is generally quite far from full automation even for small enterprises, with scorecards not yet developed for certain product areas. Given the challenge of limited financial history for start-ups, banks are looking more at the financial position and characteristics of the business owners. Similarly, after taking on a new client, banks may require a “get-to-know-you” period of from 6 to 18 months before extending credit.

5. Overall, public policy interventions to support SMEs through the economic downturn and to expand SME finance were ineffective. However, if public policy instruments are reformed, commercial banks see a clear role for government in supporting further outreach.

• Government has established an extensive institutional and organizational infrastructure for SME financing, including wholesale and retail financing as well as credit guarantees, and other ancillary services, such as business development services and implementation of special sector schemes. The primary organizations involved include Khula Enterprise Finance, the Industrial Development Corporation (IDC) and the National Empowerment Fund.

• Despite having relatively large capital endowments, these organizations have had marginal impact on SME development and growth. The Big 4 banks, plus other private sector players such as Business Partners and Sasfin, have much greater exposure in the SME market.

• In terms of government response to the economic crisis, some support, albeit small in comparison to the size of the overall lending market for SMEs, was quickly made available to distressed SMEs. For example, the IDC launched a R2 billion fund targeted at distressed firms, 15 percent of which was distributed to SMEs.
• Banks did not increase use of the Khula indemnity product scheme (provided through the commercial banks) during the downturn, the time when government support would have been most important because existing SME financing was reduced. Khula is nominally the lead parastatal in the area of SME lending. Its mandate is to provide financing to the SME market through intermediaries as a wholesale financier. However, in recent years, the volume of its indemnity product has dwindled to a low point.

• In view of the extent of banks’ current commitment to SMEs, the development finance institutions’ (DFIs’) primary focus should be on deepening their collaboration with private sector intermediaries and providing more streamlined service to them, rather than pursuing strategies likely to result in DFIs’ competing with the financial industry, as would Khula’s direct credit scheme.

• Financial institutions surveyed were positive about the ability of government to make a positive impact on SME lending. A large proportion of financial institutions felt that the government could increase the appeal of SME lending through regulatory reforms, and through guarantees and subsidies. A sizable proportion also was positive about other potential reforms, including judicial, legal, and credit bureaus.

• Although not a focus of this study, viewing the South African economy as a simple two-economy model, with an advanced economy working in parallel with a much poorer, less developed economy, can be a useful framework for defining an appropriate policy to promote access to finance. Given South Africa’s entrenched economic divisions, there remains an important role for government in taking an active, market-leading policy stance to address structural obstacles and to ensure access to finance for all entrepreneurs.

6. A number of promising potential policy directions can be identified:

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<th>Potential policy direction</th>
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| 1. Improve effectiveness and uptake of partial credit guarantee scheme | • Importance of “incentive features of operational design, especially for intermediaries.”
• Key features of Khula’s indemnity scheme that appear to be influencing uptake are higher guarantee rates, conditional payouts only when all collateral recoveries have been exhausted, strict eligibility criteria, and dual credit assessment processes.
• We believe that all these factors, in combination, can be flexed to produce a more attractive scheme from the perspective of financial intermediaries, while ensuring they have enough of a stake in the loan to act in the interests of the guarantor. |
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<th>Potential policy direction</th>
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| 2. Review cost effectiveness and objectives of existing direct credit schemes, and restructure/reform where necessary | • Direct credit schemes can be used to overcome market failures in which certain borrowers are excluded, or can be used to kick-start SME lending to certain areas (for example, through demonstration effects or by developing market information).  
• Achieving well-performing and sustainable schemes is not straightforward. Credit assessment and operational efficiency are critical success factors.  
• To ensure cost effectiveness, it is important to review the performance of existing schemes, and, where necessary, close down or restructure the schemes as appropriate. |
| 3. Support development of Business Development Support (BDS) through public research       | • BDS can help to address some of the intrinsic weaknesses in SMEs that cannot be addressed through financing tools alone.  
• The survey indicates that banks are increasingly focused on the provision of BDS; however, they remained vexed as to how to do it efficiently and how to ensure that BDS is appropriate and of a high enough standard.  
• The government has a role in this market as a provider of BDS, mainly in the form of the Small Enterprise Development Agency (SEDA) and Khula's mentorship program.  
• In addition to ensuring that these institutions are performing and meeting their objective, government should consider ways to promote good practice and efficient use of the money being spent on BDS by the private sector (research, industry fora, and the provision of technical assistance, among others). |
| 4. Support development of market credit information for SMEs                                | • While comments generally were positive about information from the credit bureaus, it was noted that coverage is limited and does not necessarily include all financing received by SMEs.  
• Credit bureaus are innovating in this space but face challenges (for example, how to capture all credit information from trade suppliers).  
• There appear to be two potential areas for government to consider: (1) refinements to the legal and regulatory framework to improve incentives to share information among lenders, and (2) an educational campaign promoting the value of credit bureaus among SMEs. |
| 5. Subsidize R&D regarding lending technologies to overcome the information gap            | • Around the globe, certain commercial banks have applied lending practices developed in the microfinance sector to overcome the issue of high transaction costs and high-risk profiles of potential borrowers.  
• South African banks are innovating technologies to better serve SMEs, and the sector is still experimenting.  
• Case studies and lessons from other markets and workshops to cross-fertilize ideas may be useful to banks.  
• It may be worth government considering financing the establishment of a new “window” of credit guarantees specifically to stimulate the use of automated scoring techniques. |
### Potential policy direction

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<th>6. Review impact of identified regulatory and judicial issues identified in the survey</th>
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<td><strong>Description</strong></td>
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<td>• While many institutions did not feel that regulatory issues were significant obstacles to their SME lending business, they were unanimous that regulatory initiatives could improve the attractiveness of lending to SMEs, for example, for registering and enforcing collateral.</td>
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<tr>
<td>• The important objectives are for existing legislation to be continually and transparently reviewed and for upcoming legislative and regulatory changes to be assessed objectively, based on solid evidence, for possible unintended consequences.</td>
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Introduction

Numerous studies worldwide have highlighted the important contribution made by small and medium-sized enterprises (SMEs) to employment, income and economic growth. In a study of 76 developed and developing economies, Ayyagari and others (2007) found that SMEs account for more than 60 percent of total manufacturing employment and that SMEs contributed significant proportions of GDP. While there is debate in the literature as to the causal link between SMEs and economic growth, studies have shown a positive association (Beck and others 2005). SME growth requires external financing, but constraints to accessing credit, consistently rated as some of the greatest barriers to the operation and growth of firms, affect SMEs more severely than large firms (Beck and Demirguc-Kunt 2006; Beck and others 2006).

The purposes of this report are to:

1. Analyze the availability of bank finance to SMEs in South Africa and how availability might be enhanced in the context of the economic downturn
2. Offer concrete policy recommendations on how to lessen obstacles to bank SME financing and reduce the negative effects of the economic downturn (or of a similar downturn in future) on access to finance.

Prior to the economic downturn, access to finance by SMEs in South Africa offered a heterogeneous picture. Overall, most formal small and medium enterprises did not perceive access to finance to be a significant constraint. However, micro and small enterprises in the largely informal economy already had reported insufficient access to finance. The Investment Climate Assessment of South Africa, based on results of a 2008 Enterprise Survey, established that, prior to the downturn, “as a rule, formal-sector firms in South Africa do not see access to finance as a major problem, but a large proportion of microenterprises and a sizable segment of formal small businesses do.” Seventeen percent of microenterprises used credit products, compared with 49 percent of small, 69 percent of medium and 82 percent

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1 For manufacturing in South Africa, the value is over 80%, one of the highest in the sample.
2 This phenomenon is not restricted to developing countries or a particular region. For instance, many European SMEs consistently consider access to finance a problem (see European Commission 2003); and 38% of European SMEs in the European Union’s new member states do not have sufficient financing to see projects through (European Commission 2006).
of larger firms; and credit rejection rates were higher for smaller firms. The 2010 FinScope South Africa Small Business Survey confirmed these findings for small and microenterprises. Forty-two percent of owners did not use any form of financial service for business purposes, formal or informal, whereas 52 percent were formally included. Forty-seven percent were banked (for example, had savings or checking accounts); 22 percent used insurance products; and only 8 percent used credit products.

These results reflect the dual economy character of the South African economy. The firms that were part of the advanced formal economy benefitted from the highly developed financial sector, while the majority of firms outside the formal economy did not. According to the Investment Climate Assessment, the access gap between SMEs and larger firms is greater in South Africa than in most of its peer group countries. For example, in South Africa, only 59 percent of SMEs have any credit products, compared to 82 percent of large firms—a difference of 23 percent. In a group of peer countries, including Argentina, Brazil, Malaysia, and Thailand, the gap ranges from 10 percent to 14 percent.

It is commonly assumed that the financial and economic crisis of 2007–09 exacerbated the problems of SME financing due to both reduced demand for goods and services sold by SMEs and tightening credit conditions (OECD 2009). Features of SMEs, such as lower levels of diversification compared to large enterprises, a high dependence on credit and fewer financing options, may make SMEs more vulnerable in times of crisis. Consequently, a number of countries put packages in place to support SMEs, including the creation and extension of loan guarantee schemes for SMEs, and measures to stimulate demand in the wider economy. However, given the proximity of the downturn, few empirical studies have analyzed the impact of the downturn on the supply and demand of finance for SMEs.

There are also particular domestic economic circumstances predating the global financial crisis that should be considered. Throughout most of the 2000s, strong consumption-led growth was fuelled by historically low interest rates and a boom in residential property prices. These factors led to a sharp hike in interest rates in 2007, negatively impacting bank profits from 2008 onward in the form of significantly higher impairment charges, especially in segments relating to consumer lending such as mortgages. The effects of muted domestic demand were compounded by the global economic downturn. For example, reduced demand for commodities led to job shedding in the mining industry. While government spending on infrastructure, partly in anticipation of the 2010 World Cup, partially compensated for the reduced demand, 2009 saw the lowest real growth rate since 1992 (minus 1.8 percent according to SARB figures). Despite the economy having started to grow
again, challenges remain. For example, since the beginning of the global crisis, the country has seen the loss of over 870,000 jobs. The unemployment rate rose from 26.7 percent at the end of 2008 to 32.4 percent in first quarter of 2010 and peaked at 50 percent among young people. Furthermore, following the World Cup, there are concerns as to the impact of a reduction in government demand on SMEs serving the construction industry.

To assess the impact of the downturn on the demand side for SME financing, this study follows on the 2008 Enterprise Survey (ES) of South Africa, which surveyed over 1,000 SMEs. For this survey, a subset of the previously surveyed firms was revisited, providing a panel of firms with data pre- and post-crisis. Additionally, the new survey included specific questions on the “real” and financial effects of the crisis to provide additional insights on the impact of the downturn. In total, 234 firms were re-interviewed between March and June 2010.

Data on banks’ involvement with SMEs and their perceptions of potential public policy approaches to enhance SME access to finance were collected via a specially designed questionnaire administered to selected banks during May 2010. Institutions were chosen both to represent the major players actively involved in SME finance and to reflect the broader banking sector in South Africa. The institutions included the major private sector commercial banks, niche banks focused on the SME sector, and other institutions with broader development mandates. In total, 8 institutions were surveyed, representing 89 percent of assets in the banking sector in 2009. The former included all 4 major commercial banks, 2 development finance institutions, 1 niche bank, and 1 nonbank financial institution focused on SME clients.

The supply-side survey used in this report shares many features of previous World Bank surveys on bank finance to SMEs, including the quantitative focus applied in Beck and others (2008) and Rocha and others (2010). However, the current supply-side survey has been tailored to take into account local considerations, for example, by including questions on specific government programs; and to directly focus on the impact of the global crisis.

The advantage of linking both surveys is that it enables us to gain a complete picture of access to bank finance for SMEs in South Africa, including both demand and supply-side issues, in the presence of an important

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3 The latest growth figures show a year on year increase of 2.6% from Q3 2009 to Q3 2010.
4 These figures include “discouraged workers,” not actively seeking employment.
5 The full list of surveyed institutions is as follows (in alphabetical order): Absa Bank, Business Partners, First National Bank, Industrial Development Corporation, National Empowerment Fund, Nedbank, Sasfin, and Standard Bank. Detailed discussions also were held with Khula, although as a wholesale funder, this institution was not asked to complete the full written survey.
6 Bankscope database and authors’ calculations.
exogenous shock. It also enables us to cross-check conclusions and perspectives from the two sides of the survey.

The results of both surveys indicate that policymakers should not be complacent with regard to access to credit for SMEs and even less so after the economic downturn. The past three years have been challenging for both SMEs and banks. The demand-side survey shows that firms’ perception of finance as an obstacle to growth has worsened following the downturn, for both small and large firms; and this worsening of perception is supported by the quantitative data. For example, there is evidence of a decrease in financing of investment projects through commercial banks, and financing working capital through customers and/or suppliers has clearly declined between 2007 and 2010. Evidence from both surveys indicates a reduction in loan approval rates, reflecting both a worsening of the financial position of firms and lack of appropriate collateral (‘lack of effective demand’ from the supplier perspective), and reduced risk appetite on the part of providers of finance. The perception on the part of financial institutions persists that smaller firms are more risky, more costly to serve and less profitable than larger firms. This perception has been reflected in an increase in “pricing for risk” over the crisis.

As well as summarizing the evidence found in the surveys, this report discusses policy considerations based on the survey results and international experience. While not exhaustively reviewing all potential policy actions, it suggests a number of areas in which government involvement may be fruitful. These include refinements to the existing partial credit guarantee scheme to increase uptake, transparent assessment of the effectiveness of existing programs, collaboration with the private sector around skills development and BDS, and assistance to improve market credit information.

The report is structured in 5 sections:

• Section 2 provides a short overview of existing studies and data on SME finance in South Africa
• Section 3 presents the main results of the surveys
• Section 4 provides policy considerations
• Section 5 concludes.

7 An historical overview of key policy issues relating to the SME sector and survey methodologies are presented in appendices 1 and 2 respectively.
2 Insights from Existing Studies and Data Sources

Before discussing the methodologies employed and results of this survey, it is important to reflect on existing recent information on SME financing in South Africa. Various studies, focusing on either the demand side or the supply side (but not combined), have been published. Additional insights can be gained by analyzing the publicly available data collected and aggregated by the Reserve Bank of South Africa.

2.1 Enterprise Survey of South Africa, 2008

In 2008 the Enterprise Survey of South Africa, on which the demand side of this survey builds, surveyed 1,057 businesses in 4 urban locations, with two-thirds drawn from selected manufacturing industries. The survey considered 4 categories of SMEs: microenterprises (fewer than 5 employees), small (5 to 19 employees), medium (20 to 99 employees) and large (over 100 employees). Of the 1,056 businesses surveyed, only 120 were microenterprises and thus biased toward formally registered SMEs with at least 5 employees.

As well as analyzing a range of business environment issues, the survey highlights firms’ perceptions regarding access to finance. The key finding of the Investment Climate Assessment of South Africa (2010), based on results of the Enterprise Survey, is that “as a rule, formal-sector firms in South Africa do not see access to finance as a major problem, but a large proportion of microenterprises and a sizable segment of formal small businesses do.” Seventeen percent of microenterprises use credit products, compared with 49 percent of small, 69 percent of medium and 82 percent of larger firms; and credit rejection rates are higher for smaller firms. Additionally, the access gap between SMEs and larger firms is greater in South Africa than in most of its peer group. For example, in South Africa, only 59 percent of SMEs have any credit products, compared to 82 percent of large firms—a difference of

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8 The following is not an exhaustive list of all studies on SME finance in South Africa. For example, the Task Group of the Policy Board for Financial Services and Regulation extensively reviewed the profile of SMEs and their contributions to the economy, access to equity capital and debt, and access to other bank services. However, it is not an empiric study, as the cited studies are.
9 Conducted by the survey firm, EEC Canada, on behalf of the World Bank.
10 See methodology appendix for additional details.
23 percent. In a group of peer countries, including Argentina, Brazil, Malaysia and Thailand, the gap is 10 percent to 14 percent.

### 2.2 FinScope South Africa Small Business Survey, 2010

To develop a more comprehensive understanding of the small business sector, and highlight the specific challenges faced by small business owners and the capacity they have to deal with these challenges, FinMark Trust developed the FinScope Small Business Survey. The survey has broad objectives to describe the size and scope of the small business sector. It also has specific financial inclusion objectives, namely

“…to determine the levels of financial access (formal and informal) for the small business sector, to describe the landscape of financial access (that is, type and extent of financial product usage), and to identify the barriers to financial access.”

In regard to financial inclusion of SMEs, the FinScope survey has similar objectives to the current study (especially the demand-side). However, the scope of FinScope is broader with a universe of all business owners in South Africa, 16 years or older, that employ fewer than 200 employees. The definition thus includes informal and microenterprises, and this should be taken into account when considering the results of the survey. The study surveyed 5,676 small business owners.

The study found that there are 5.6 million small business owners in South Africa, equating to 1 in 6 of the population who generate an income through small business activity. Of these, only 17 percent have registered businesses. Thirty-nine percent of owners cite money-related matters (such as sourcing money and cash flow) as the main obstacle faced when starting up their businesses, compared to 34 percent who cite strategy issues (such as not enough customers and too many competitors). The survey found that 42 percent of owners do not use any form of financial service for business purposes, formal or informal, while 52 percent are formally included. Forty-seven percent are banked (for example, have savings or checking accounts); 22 percent use insurance products and 8 percent use credit products. The survey also found emotive barriers to credit access. For example, 36 percent of owners claim not to believe in borrowing money, and 35 percent regard borrowing as too risky. Additionally, poor record-keeping was found to be an important area for skills development.

The study revealed interesting gender insights. Although more small businesses were owned by women than by men, only 43 percent of female
small business owners had a bank account, compared to 52 percent of male small business owners.

### 2.3 USAID Financial Institutions’ Hurdles to SME Financing, 2010

In the last quarter of 2009, in partnership with the Banking Association of South Africa, USAID undertook a survey of financial institutions to identify hurdles for the financing of SMEs and to propose solutions to facilitate the provision of business development services. The methodology employed by this survey was to randomly select senior executives, credit managers and loan officers from within participating financial institutions. Eighteen of 27 institutions approached, including a mix of banks, and other private and public financing entities, participated in the survey. From a universe of 2,977 candidates identified by their institutions, 683 were randomly selected. Of these, 179 individuals, or 26 percent, completed the survey.

Employing a 4-category definition of SMEs,\(^{11}\) with turnover of up to R20 million per annum, the survey found that successful financing is greater among SMEs with a higher turnover. In contrast, firms at the lower end of the SME market require greater ancillary support prior to becoming candidates for finance. The study argues that financial institutions

> “…are working with a financing model that is inappropriate for this market of largely previously disadvantaged entrepreneurs. These entrepreneurs are unsophisticated when it comes to financial and business matters, and have limited resources, although they could very well be greatly qualified and potentially successful in their chosen field.”

The report therefore suggests that there is a need for financial institutions to develop both more appropriate risk evaluation models and products tailored to this market segment.

### 2.4 Reserve Bank Data

While there are no “perfect” data sources on SME lending in South Africa preceding and extending over the crisis period, the Reserve Bank publishes a

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\(^{11}\) (1) Annual turnover less than R500k per annum, (2) between R500k and R2.5 million per annum, (3) between R2.5 million and R10 million per annum and (4) between R10 million and R20 million per annum.
rich set of data on the banking market, providing information on individual banks’ balance sheets, and aggregated income statements, balance sheets and information related to other areas, such as credit risk.\textsuperscript{12} These data are released on a monthly basis, and in general go back to January 1994, although there was a break in the series at the start of 2008. In most cases, it is possible to reconstruct consistent series back beyond the break in 2008, although this is not possible for aggregate exposures to SMEs. This data point was introduced only in January 2008.

For the purpose of this study, the benefit of considering Reserve Bank data is that submissions to the Reserve Bank are a regulatory requirement and are made in a standardized way for all banks. The data should therefore be reliable and comparable across institutions. The drawback is that not all desired items are available for the business segment under consideration. Additionally, banks may need to report in a way that does not naturally fit their organizational structure, for example, if “SME retail” spans the microenterprise, small business and business banking units.

Using these data sources, the following subsections will consider aspects of the market for SME lending in South Africa.

\textbf{2.4.1 Size of the market for SME lending}

There are both a range of definitions of SMEs and a range of potential sources from which to estimate the size of the market for SME lending. Therefore, at best, it is possible to define only a range for the potential size of the market dependent on the definition and the data source used.

Perhaps the most obvious source for the size of the market is the BA200 (Credit risk) form from the Reserve Bank. This form publishes aggregate gross credit exposures for both SME retail and SME corporate.\textsuperscript{13} Unfortunately, the BA200 has been available only since June 2008, and its predecessor, the DI500, does not contain the same data fields. However, to measure the market, the BA200 provides a useful marker. As of December 2009, the gross credit exposure to SME retail was R172.7 billion and to SME corporate was R238.5 billion. These figures gave a combined market size of R411.2 billion for a very broadly defined SME market (that is, including companies with up to R400 million in turnover). The BA200 does not further

\textsuperscript{12} www.reservebank.co.za/internet/publication.nsf/WLPSV/SARB+activities~Statistical++economic+info?opendocument

\textsuperscript{13} According to The Banks Act (94/1990): Regulations relating to Banks’, a retail SME exposure is defined as an exposure to a small business, which must be less than 0.2% of the retail portfolio, and, in aggregate, be less than R7.5 million. A corporate SME exposure is defined as any exposure to a corporate entity or institution of which the aggregate annual turnover amount is less than R400 million.
split this data into detailed asset classes, such as mortgage lending and term loans.

The BA900 (individual banks’ balance sheets) returns do provide a split by asset class but do not segment the client base in the same way as the BA200. Nevertheless, data on overdrafts, loans and advances (excluding mortgage lending) to unincorporated household (HH) business enterprises is provided. According to the Reserve Bank:

“Unincorporated business enterprises of households comprise households engaging in market production as one-[person] businesses or sole proprietorships and partnerships. They are legal entities but are not organized in the form of a company and the household and business accounts cannot be separated. The one-[person] business or sole proprietorship can be with or without employees with the latter being own-account workers.”

This definition is relatively narrow and is likely to encompass only the very smallest of firms classified by banks as small enterprises. Nevertheless, the aggregated value in the BA900 returns for loans to this segment amounted to R16.5 billion in December 2009. While mortgage lending is not separated out in this way, it is likely that, if it were included, the aggregate value of credit would rise considerably.

2.4.2 Historical trends

Since 1994, loan volumes in South Africa have grown rapidly in both real and nominal terms. Based on Reserve Bank data from the BA100 and D100 (Balance sheet), from 1994 to 2009 total customer loan volumes grew at a compound annual growth rate of 14 percent in nominal terms and 8 percent in real terms. However, as highlighted in Figure 1, there was a 3.1 percent nominal decline in total customer loans in 2009 (10.2 percent in real terms), the first decline since data was first available in 1994. Given the maturity profile of a typical lending book, this represents a significant decline in the flows of total customer loans. Almost 40 percent of lending goes to private households, overwhelmingly in the form of home loans, which on December 31, 2009 accounted for R786 billion of total lending of R2,205 billion.

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15 Inflation adjusted according to the CPI, available at Stats SA.
17 SARB BA100 returns December 2009.
In terms of lending to SMEs specifically, long-run data is not yet as readily available as it is for total loans. Nevertheless, using the same data sources as we used to estimate the size of the market for SME lending, it is possible to observe some recent trends. First, as shown in Figure 2, the BA200 returns show a decline in SME lending over 2009. This decline was more pronounced for the smaller SMEs. In nominal terms, this decline amounted to 3.4 percent for SME Retail and 2.6 percent for SME Corporate. Furthermore, while the data goes back only to June 2008, the decline in credit to SMEs appears to have started earlier for smaller businesses than for larger ones.

At the smaller end of SMEs and/or microenterprises, the data on unincorporated business enterprises of households in the BA900 demonstrate a similar, but more pronounced, decline. In 2008 and 2009, loans to this sector (excluding mortgage lending) declined by 12.0 percent and 11.0 percent, respectively. What is particularly interesting about this data is the absence of development in this segment. Over the period 2001 to 2009, nominal total customer loans grew at a compound annual growth rate of over 10 percent, whereas loans to unincorporated businesses declined. In real terms, the decline in loan volumes is more severe, ending the period 44 percent lower than at the start.

Conclusively, all sources paint a consistent trend of the decline of lending to businesses since 2008. The results also are consistent with analysis shared by the National Credit Regulator, which indicates contraction in flows of corporate credit extended by monetary institutions through 2009. For SMEs in general, this decline has been in

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18 The results also are consistent with analysis shared by the National Credit Regulator, which indicates contraction in flows of corporate credit extended by monetary institutions through 2009.
the region of 3 percent. However, it appears that the effects of the crisis were even greater for smaller businesses, which showed declines of up to 11 percent in nominal terms. Moreover, there appears to be a lack of long-term growth in volumes for the smaller SMEs. Finally, declines in lending volumes occurred earlier in this segment.

In addition to lending volumes, it is important to consider the impact of the crisis both on credit quality and on the income and profitability of banks active in the SME sector. Aggregate market data on credit impairments or nonperforming loans relating to SMEs is not readily available. However, for banks in general, income statement impairments demonstrate a clear deterioration of credit quality over the past few years. Data from the BA120/DI200 (income statement) shows that credit impairments in 2008 and 2009 were many times higher than those experienced in the earlier years of the decade (Figure 3). For example, impairments increased by 142 percent in 2008 and by an additional 19 percent in 2009.

More specifically related to SMEs, some insight can be gained by considering FNB Commercial’s public segmental reports (relating to all business banking clients, including SMEs). However, these reports relate to the experience of only one institution and may not fully reflect the market as a whole. Income statement impairments increased from R59 million in 2005 to R389 million in 2009, an increase of almost 700 percent. Similarly, nonperforming

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19 It would be very valuable if a process to capture such data on a regular basis could be initiated.
loans increased by over 400 percent, from R402 million in 2005 to R1,623 million in 2009.

Evidence thus points to a marked deterioration in credit quality in 2008 and 2009, but it should be noted that this deterioration started prior to this date. While aggregated evidence on SMEs is limited, case evidence from the experience of one lender suggests that there were similar trends in lending to businesses as a whole. Furthermore, analysis of the BA100/DI100 shows that the ratio of balance sheet impairments was higher in 2009 than at any time since 1994. Nevertheless, if one considers the fast growth of the balance sheet discussed earlier, by historical standards, this ratio was actually very low in the mid-2000s. Thus, when looking at the raw data, 2008 and 2009 are not such outliers as they appear.

From a profitability perspective, even though South African banks have been impacted by the decline in credit quality and increase in impairments, the banks remain comfortably profitable overall. Figure 4 presents implied profits after tax from the BA120/DI200 since 2001. Profits did decline in both real and nominal terms in 2009 (by 16.5 percent and 23.6 percent, respectively), but in the context of the decade are still favorable. Thisfavorability is true both in absolute terms and as a return on assets, which was higher than all years prior to 2006. While there was a decline in net interest income due to a reduction in the balance sheet, noninterest revenue growth remained largely unaffected by changes in the credit environment.

Source: SARB BA120 & DI200 returns.
Figure 4: Aggregate Profits After Tax of South African Banking Sector

Source: SARB BA120 & DI200 returns.
3 Survey Results

This section presents the key results from the surveys, focusing first on the demand side (survey of SMEs), followed by the supply side (survey of banks and other financial institutions).

3.1 Demand Side

The demand-side component of the survey is based on face-to-face interviews with managers of 234 of the 1,057 firms originally interviewed in 2007 in the World Bank’s South Africa Enterprise Survey of 2008. Of the 234 firms interviewed in 2010, 194 were SMEs. Of these, just over half were Black or Asian owned, and most of the rest were White-owned.

Because not all of the firms interviewed in 2007 were re-interviewed in 2010 (many could not be located, and a number had closed), there is the possibility of survivorship bias in the sample that was interviewed. The report draws comparisons between those firms that survived to 2010 and those classified as “exits” (for example, could not be traced). The firms that survived tended to be more established and more export oriented than those that did not. Surviving firms also tended to have more employees, although in general the size of the firm was not a predictor of whether it was likely to survive or not.\(^\text{20}\)

Significantly, the firms that in 2007 had considered access to finance to be a major obstacle were more likely to have exited by 2010.

3.1.1 Firms’ perception of access to finance over the downturn

*Firms’ perception of finance as an obstacle to business and growth has worsened after the crisis.* Previous surveys conducted by the World Bank Enterprise Survey team showed that overall (both small and large) South African firms did not consider access to finance a major obstacle to their business operations, especially when compared to other African countries or countries at a similar stage of development (World Bank 2010). However, Figure 5 shows that, during the last 3 years, firms’ perception regarding how lack of access to finance obstructs their operations and growth has changed. While in 2007 66 percent of SMEs reported that lack of access to finance was

\(^{20}\) Survivorship analysis is presented in appendix 3.
no obstacle to growth, in 2010 this figure was only 25 percent. To the contrary, in 2010 approximately 32 percent of SMEs considered lack of access to finance a major or very severe obstacle to their businesses.\(^{21, 22}\)

Similarly, summary statistics in Figure 5 seem to suggest that the crisis had a differential impact on small and large firms. The proportion of SMEs reporting that finance was no obstacle to growth decreased by 41 percent from 65.8 in 2007 to 24.7 in 2010. However, for large firms, the decrease was even larger at almost 48 percent—from 85.4 to 37.5.\(^{23}\)

\(^{21}\) A test for mean differences across years and size categories revealed that mean changes in the percentage of firms reporting finance as a major obstacle to growth in 2007 and 2010 were statistically significant. Similarly, mean changes in the percentage of firms stating that finance was no obstacle to growth in 2007 and 2010 also were statistically significant.

\(^{22}\) While the perception that access to finance has worsened as a result of the crisis, this perception is actually not high compared to peer countries. For example, in Brazil, for which an Enterprise Survey was undertaken in 2009, only 15\% of firms reported that access to finance was no obstacle to growth compared to 49\% of firms that reported that finance was a major or severe obstacle.

\(^{23}\) A basic correlation analysis showed that the probability of firms reporting in 2010 that finance was no obstacle to growth was lower for larger firms relative to SMEs. In particular, we estimated for firm \(i\), in sector \(j\) at time \(t\), \(\Delta \text{NoObstacle}_{i,j,t} = \beta_1 \text{Large}_{i,j,t-1} + \alpha_j + \epsilon_{i,j,t}\), where \(\Delta \text{NoObstacle}\) is the change between 2010 and 2007 on whether the firm reported finance as an obstacle to growth or not. \(\beta_1\) is negative and significant at the 10\% level. When we controlled for other firm characteristics such as foreign ownership or export status, the coefficient was no longer significant, suggesting that the result might not have been driven by size per se but by other firm-specific characteristics.
3.1.2 Analysis of the quantitative survey results

The worsening in perception of finance as an obstacle to business detailed above was supported by analysis of the quantitative data. First, there was a decrease in the financing of investment projects through commercial banks. The percentage of firms applying for loans did not change drastically between 2007 and 2010. Therefore, this decrease in the financing of investment projects through commercial banks could have been driven mainly by the reluctance of commercial banks to lend to SMEs. Given that SMEs’ activities usually are considered riskier than larger and more established firms’ operations, banks faced with a more volatile environment may have chosen to fund fewer SMEs investment projects.

Firms finance most of their investment projects through internal funds although financing through commercial banks is the second and, in most cases, only other option. Figure 6 shows that, between 2007 and 2010, there was a substantial drop in the share of investment projects financed through banks for SMEs. This drop was particularly severe for medium enterprises (from 32 percent in 2007 to 20 percent in 2010). The decline was milder for small firms, which in 2007 financed on average 27 percent of their investment projects through commercial banks. In 2010 this figure was only 21 percent.24

Figure 6: Main Forms of Financing Investment by Size: Panel

![Figure 6: Main Forms of Financing Investment by Size: Panel](image-url)

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24 However, this difference is not statistically significant.
All SMEs use either internal resources or banking credit, or both, to finance the purchase of fixed assets. In 2010, 14 percent of SMEs used owners’ contributions or issued equity as an alternative or complementary method of financing. This was a considerable increase with respect to the situation in 2007 when only 1 SME reported using this type of financing. On average, in 2010 small firms financed 11 percent of investment through equity compared to almost none in 2007. This difference is highly statistically significant.

Second, financing of working capital through customers and/or suppliers clearly declined between 2007 and 2010... at the same time that financing of working capital through commercial banks significantly increased.

Surveyed firms financed most of their working capital through internal funds. Financing working capital by customers and/or suppliers was an important source of financing in 2007 whereas on average only 6 percent of working capital was financed through bank credit. Interestingly, between 2007 and 2010, the relative importance of these two forms of financing reversed. The proportion of working capital financed through commercial banks more than doubled while the proportion financed through customers/suppliers decreased by half. Various reasons may account for this reversal. From the demand side, the cost of financing working capital through banks can be cheaper than financing through suppliers/clients, especially as the bank rates declined tracking the prime rate. From the supply side, the capacity of banks to price more carefully for risk may have lowered the cost of short-term finance (finance for working capital) vis-à-vis an increase of the cost of longer term finance (finance for investment). Finally, the reversal could have been a consequence of the disruption of the value-chains relationships in the aftermath of the adverse demand shocks due to the global crisis.

Figure 7 shows some heterogeneity across size categories. The majority of working capital is financed through internal funds irrespective of size category. However, in 2007 financing through customers and/or suppliers was a relevant alternative, especially for SMEs. Both medium and large firms chose to finance between 10 percent and 13 percent of their working capital through banks while small firms only financed 5 percent in the same way. This financing pattern changed considerably in 2010. SMEs witnessed a statistically significant average 10 percentage point decline in the share of working capital that they financed through customers and suppliers. For large firms, the decline was more moderate and not statistically significant. At the same

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25 We have data for only 69 of 194 SMEs regarding the different methods used to finance the purchase of fixed assets.
time, financing working capital through commercial banks increased significantly, especially for small firms.

In sum, South African firms rely mainly on internal funds to finance both working capital and investment. Customers and/or suppliers were cited in 2007 as the second largest funding source for working capital. Nevertheless, during the last 3 years, it seems that SMEs have started to switch to commercial banks, and away from customers and/or suppliers, as the providers of working capital. In fact, of the 60 firms that reported using bank credit to finance working capital in 2010, 40 reported obtaining working capital from customers and/or suppliers in 2007 but no longer were doing so. More than half of the firms that switched their preference were SMEs.

Various hypotheses might explain the switch from customer/supplier funding of working capital to commercial bank funding and the decline in longer term investment projects by commercial banks. First, bank credit might be cheaper. Bank rates declined as the prime rate declined but to a much lesser extent than the decline in the prime rate, which could indicate that the banks were charging a high risk premium. Second, the decline in customer/supplier funding could have been the result of an overall increase in uncertainty as a result of the global financial crisis. Faced with tougher economic conditions and lower liquidity, customers and suppliers could not afford to provide financial services. Between 2007 and 2010, practices such as
payment of inputs after delivery or payment of sales before delivery experienced a clear drop. Finally, the financial products offered by banks could have become more user-friendly for certain types of credit involving low-risk products. For example, some products required simpler documentation or lower collateral requirements.

Why did firms rely so much on internal funds? Were their credit applications rejected, or did they simply not apply for credit? In the case of firms that opted not to apply for credit, what were the main reasons?

The percentage of firms that applied for a loan in 2010 compared to the same figure in 2007 decreased slightly from 21 percent to 17 percent, respectively. However, most of this decline was due to an increase in the number of firms that did not know whether the company had applied for a loan or not. Therefore, the percentage of firms that did not apply for a loan between 2007 and 2010 remained constant at 79 percent. Regarding the reasons not to apply for a loan, most firms of all sizes pointed to the lack of need (Table 1). 26

| Table 1: Reasons for No Loan Application (by Firm Size) (%) |
|-----------------|-----|-----|-----|-----|-----|-----|-----|-----|
| Reason                        | Small | Medium | Large | Small | Medium | Large | Small | Medium | Large |
| Skipped          | 17.87 | 15.57 | 25.14 | 25 | 23.47 | 35 |
| No need          | 44 | 67.21 | 54.1 | 62.5 | 66.33 | 52.5 |
| Complex application procedures | 11.2 | 2.46 | 4.37 | 4.17 | 3.06 | 0 |
| Unfavorable interest rates  | 13.07 | 6.56 | 9.29 | 1.39 | 3.57 | 0 |
| Unattainable collateral requirements | 4.27 | 1.64 | 1.37 | 1.39 | 0.51 | 0 |
| Insufficient size of loan and maturity | 1.6 | 0.82 | 0.27 | 0 | 0 | 0 |
| Did not think it would be approved | 5.6 | 4.1 | 2.73 | 1.39 | 0.51 | 0 |
| Other            | 2.4 | 1.64 | 2.73 | 4.17 | 2.55 | 12.5 |

Furthermore, while there was not a big overall drop in the percentage of companies applying for bank finance, the results showed a notable increase in the percentage of SMEs firms not applying for loans because they argued they had no need for one. We do not have data on the purposes of the loans.

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26 This relates to the perceived lack of need for finance. It is, of course, possible that firms are missing potentially profitable opportunities due to weak capacities or problems with complementary inputs, such as business development support, entrepreneurial skills, and rigidities in other market factors such as the labor market.
However, it seems plausible that, given the general slowdown in business activity as a result of the economic downturn, firms had less need to undertake investment projects. On a positive note, the decrease in the percentage of firms that reported complex application procedures or high interest rates as deterrents to credit application was remarkable.

Do firms that need external financing and apply for loans actually obtain them? The percentage of applications rejected increased slightly from 18 percent in 2007 to 22 percent in 2010. This finding is consistent directionally with the results of the supply-side survey, which found an increase in rejection rates, although one may have expected both higher rejection rates and a larger increase in rejections based on the data provided directly from the banks.

The 2010 survey did not include questions regarding the nature of the rejection. However, data from 2007 points out that the main reason for banks to reject loan applications was lack of appropriate collateral. In addition, a 2009 FinMark Trust report highlighted that the greatest challenge faced by lenders to micro and small enterprises was the high cost of doing business in relation to loan size. In particular, lenders complained about the cost of “collateral perfection and realization.” Ultimately, these difficulties translated into either a cost of borrowing prohibitive to the client or, in most cases, a general lack of interest in lending, creating a concerning financing gap.

In fact, in 2007 68 percent of the loans required some form of collateral. However, in 2010 only 45 percent of loans required collateral. This result might have resulted from “on boarding” processes within banks. The nature of the survey guarantees that if one was interviewed in 2010, one also had been interviewed in 2007. This connection means that firms that had stable relationships with banks or new firms that were just starting to do business with banks in 2007 could have continued those financial links to 2010. By that time, firms new in 2007 and banks would have passed successfully through their “get-to-know-you” phase, which varied between 6 month and 18 months according to banks. Therefore, the lower collateral requirements could have indicated better information available to banks.

In addition, in 2010 the percentage of large firms required to produce collateral was higher (52 percent) than the percentage of SMEs (41 percent) required to produce collateral. Also in 2010, the collateral requirements for

27 Although of lower concern than collateral requirements, financial institutions highlight SMEs’ lack of financial education as a major deterrent to providing credit. In 2009 USAID published the report, “Development of Strategy Options for SME Financial Literacy.” Its objectives were to identify the current level of financial literacy among SMEs, current educational programs, and especially SMEs’ financial educational needs.
larger firms were higher (averaging 92 percent of the loan) than the value of the collateral requested from SMEs (averaging 67 percent of the loan). However, if collateral were a burden and a deterrent to SMEs’ applying for credit, this reality might explain the lower collateral figures observed among the firms that actually did obtain credit. Similarly, firms included in the 2010 survey were firms that had operated successfully between 2007 and 2010 and therefore might represent lower risk than the average firm in the population.

The size of the collateral required often was substantial and, in most cases, reached 100 percent of the value of the loan or line of credit required. Compared with the 2007 surveyed data, collateral requirements were lower in 2010. In 2007 the median collateral represented 100 percent of the value of the credit while in 2010 the median collateral was 80 percent. Again, these lower collateral requirements could result from better screening processes on the part of financial institutions, from introducing novel financial instruments such as leasing and factoring with no collateral requirements, and/or from focusing on surviving firms for which the bank already would have had some past information on performance and loan repayment history.

To summarize, (1) loan application procedures to banks had become simpler and more user friendly, and (2) banks required less collateral (even if it was still substantial). These results could be explained by an evolving banking model more focused on SMEs (as described in the supply-side section of this document) and/or through some selection bias in the sample due to the fact that we observed only better performing firms that were surveyed both in 2007 and 2010.

### 3.2 Supply Side

This section summarizes the results of the supply-side survey of banks and other financial institutions involved with lending to SMEs. The section analyzes both the type and extent of banks’ involvement with SMEs and the business models used to serve these clients.

Results would be expected to vary according to institution type. For example, the response of private sector and development institutions could differ during a downturn. The private sector institutions could seek to maintain profitability while, depending on their mandates, development institutions could seek to expand lending to offset the effects of credit contractions elsewhere. Therefore, while maintaining anonymity, this section will make it clear to which institution types the results pertain and highlight major differences in impacts of the crisis.
The supply-side survey feeds into a growing body of studies by the World Bank aiming to better understand banks’ involvement with SMEs. Starting in the Latin America and Caribbean (LAC) Region with an onsite survey of banks in Argentina and Chile (World Bank 2007a), similar studies were undertaken for Serbia (World Bank 2007b) and Colombia (Stephanou and Rodriguez 2008). De la Torre and others (2010) combined the survey results for Argentina, Chile, Colombia, and Serbia with a number of other sources, including data collected by the International Finance Corporation (IFC) and surveys of SMEs conducted in seven Latin American countries. Subsequently, Beck and others (2008) developed their own survey, using elements of the previous IFC and World Bank studies. Beck and others (2008) also placed more emphasis on obtaining quantitative data on the extent, type, and pricing of bank financing to SMEs; and covered many more countries to compare developed and developing economies. In total, they surveyed 91 banks in 45 countries. Recently, Rocha and others (2010) utilized a similar survey instrument across 139 banks in 16 countries in the Middle East and North Africa (MENA) Region.

While the results of these surveys do depend on the particular market and country circumstances to which they are applied, some conclusions appear generalizable across the countries studied.

1. The conventional wisdom is that large banks are not interested in serving SMEs and small banks have an informational advantage in their lending relationships with SMEs. To the contrary, large banks do view the SME sector as a profitable segment and a core strategic focus, and the intensification of banks’ involvement is not dependent on relationship lending. Rather, large banks may have advantages of scale, being able to offer a wide range of products and apply new technologies and risk management systems. To serve this core segment, banks have established dedicated units.

2. The share of SME lending in developing countries is lower than that in developed countries. According to Beck and others (2008), the average share of SME lending in developing countries is 16 percent compared to 22 percent in developed countries, and the reported share is even lower in the MENA Region.

3. Macroeconomic instability in developing countries is cited as a major obstacle to increased lending to SMEs (Beck and others 2008).

4. Large banks’ involvement with SMEs may not have been derailed by the global financial crisis of 2007–09 (De la Torre and others 2010). However, some increases in pricing and reduction in average loan maturity were observed, as banks viewed the SME sector as increasingly risky.
### 3.2.1 Involvement with SMEs

This section analyzes the extent of banks’ involvement with SMEs and the key determinants of this level of involvement.

**Assessing banks’ involvement with SMEs**

Commencing with the structure of the market for SME lending, all institutions perceived that the main players in SME finance were the large banks. Some institutions also named the niche banks, nonbank financial institutions and public financial institutions as important market participants (43 percent of respondents in all cases). These perceptions are not unexpected given the concentrated nature of the banking market in South Africa, with the Big 4 representing almost 85 percent of assets in the banking sector in 2009. Seventy-one percent of respondents stated either that a small number of financial institutions dominate or that the market is segmented (that is, there are a small number of banks with national reach and a large number of regional or sector-specific players). Only development finance institutions (DFIs) and nonbank financial institutions perceived the market to be “atomized,” or, in other words, that there are many active players targeting similar SMEs.

From a pure scale perspective, analysis of the quantitative survey results does support the view that the larger banks constitute a very large proportion of the market for SME lending. Other participants represent important players in specific market segments. To illustrate, the Reserve Bank BA200 return gave gross credit exposures to SME retail of R172.7 billion in December 2009. The surveyed niche banks, nonbank financial institutions, and DFIs (including Khula) had an aggregate exposure of just over R8 billion on this date, or almost 5 percent of the total market. For 2 of the Big 4 for which we have appropriately disaggregated data, the value was R91.8 billion, or 53 percent of the total market. There well may be definitional issues in these figures because institution-specific definitions of SMEs are employed, but the results do indicate clearly the relative size of the Big 4 in this market.

Furthermore, when considering only the size of the development sector, institutions with a development mandate provide a relatively small, albeit noticeable, proportion of lending to SMEs. In 2009 this proportion amounted to 2.5 percent of all lending to SMEs, as measured by SME retail in the BA200.

Regarding the size of SME units within the larger universal banks, lending to SMEs represents on average 7.8 percent of total loans;\(^\text{28}\) and lending to

\(^{28}\) Note that this value was considerably lower than average share of SME lending found by Beck and others (2008): 16 percent for developing countries and 22 percent for developed countries.
small enterprises represents 1.6 percent of total loans, and just 5 percent of residential home loans. Given that business banking tends to be a net provider of deposits to the system, SMEs contribute a higher proportion of deposits than loans: roughly 14.5 percent of total deposits from SMEs and 2.2 percent of total deposits from small enterprises. Additionally, the survey results indicate that SME units employ a low percentage of the total staff, at approximately 2 percent. Of course, in SME specialists and institutions with a development objective, SMEs may represent considerably higher proportions, in some cases making up 100 percent of the business.

Both the survey data and the interview discussions confirmed two aspects of the crisis experience: a reduction in loan applications and a proportionally even greater reduction in loan approvals. Based on available data, average loan applications declined by 23 percent and loan approvals by 43 percent, indicating a relatively large reduction in loan approval rates (from 61 percent to 45 percent). A number of respondents pointed out the difficulty of obtaining accurate data on loan approval rates due to the issue of “prescreening,” whereby potential applicants may not even put in a loan application because it is clear that they would not meet the lending criteria. However, if prescreening increased during the crisis, as indicated during the discussions, our estimates of crisis loan approval rates were overly optimistic. Discussants indicated that this reduction in loan approval rates was due partly to tightened lending standards but also to the deterioration in the underlying financial condition of firms, if lending standards were held constant.

The survey results indicated that deposits from SMEs tended to be noticeably larger than lending to SMEs, with an average ratio of loans to deposits of 58 percent for SMEs and 49 percent for small enterprises. These ratios show that the focus of banks’ SME units was not purely on providing credit. On average, only 25 percent of revenues came directly from credit products, whereas 75 percent came from deposits, account management, and other transaction- and fee-based services.

For SME specialists and institutions with a development mandate, the picture was somewhat different. Some institutions focused exclusively on providing credit or equity investments and were not deposit taking. Others did take deposits but had a ratio of loans to deposits closer to two.

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29 According to the BA100, total customer loans were R2,205 billion in December 2009. This value was consistent with responses given in the survey.

30 The number of approved loans would not change (since, by definition, prescreened loans would not be approved should they go through the full approval process), but the number of applications would be higher.
As such, credit tended to constitute a far higher percentage of revenues (90 percent–100 percent) for these institutions than for the universal banks. In terms of profitability, the survey results indicated that SME banking typically contributed a larger amount relative to its size. For example, in 2009 small enterprises contributed an average of 5.7 percent of net income to the universal banks surveyed. As discussed above, the relative size of small business banking as measured by loans and employees is closer to 2 percent. Thus, small enterprises contributed more in net income than the size of small business banking would imply. In 2007 small enterprises contributed a lower percentage of net income, on average 5.4 percent, implying that profits in small business banking remained robust over the downturn. Furthermore, between 2007 and 2009, nonperforming loans for small enterprises remained flat, averaging 3.9 percent. In contrast, nonperforming loans for medium enterprises tripled over this period to 4.9 percent, albeit from a lower base of 1.5 percent in 2007.

In addition to a decline in volumes and loan approvals from 2007 to 2009, we observed a relative increase in pricing for risk. From December 2007 to December 2009, the prime rate decreased 4 percentage points from 14.5 percent to 10.5 percent. Over the same period, the best interest rate available to the lowest risk customer decreased from an average of 15.8 percent to 14.9 percent for small enterprises, from 16.4 percent to 13.3 percent for medium enterprises, and from 13.3 percent to 11.1 percent for large enterprises. These results showed that a lower proportion of the decrease in the prime rate was passed on to small enterprises than to medium and large enterprises. This result indicated that banks placed more emphasis on pricing for risk and that the perceived risk of lending to small enterprises was higher.

**Determinants of involvement with SMEs**

So what determines the degree of involvement with SMEs? Figure 8 presents the percentage of institutions naming certain drivers (top panel) or obstacles (bottom panel) as either significant or very significant.

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31 When interpreting these figures, looking at average values masked that considerable heterogeneity of experience existed across institutions and that the measure was highly sensitive to business experience in other units, such as retail.

32 Data from http://www.reservebank.co.za

33 There could be alternative explanations for this observation, such as differential lags between movements in the prime and repricing small-enterprise credit facilities compared with larger firms. However, discussions generally acknowledged that emphasis on pricing for risk had increased during this period.
These results provided useful insights, although it was important to bear in mind the context of the survey when interpreting the results. For example, all institutions cited the economic development of the country as either significant or very significant—a higher percentage than named financial returns as being at least significant. Similarly, the importance of Black Economic Empowerment (BEE) and the financial charter to lend to SMEs was the second most cited factor and, again, was cited more than financial returns. While these ratings may have reflected reality, open discussions during the face-to-face sessions indicated that the key drivers of the engagement of universal banks in small business banking were mainly still commercial. In other words, SME banking was seen as a feeder for future business but also as an attractive and profitable business in its own right. Political economy considerations mattered only marginally.
Feeder for future business
All of the Big 4 spoke of the small business segment as being a feeder for future business. Small business banking is a very small part of their overall activities, generating roughly 1.6 percent of their total loans and employing 2 percent of total staff. Nevertheless, they acknowledged that the size of the market (sheer number of businesses) meant that it was a market they could not ignore. Although estimates varied widely as to exactly how many small businesses were in the country, the number was thought to be close to 6 million, the vast majority of which (perhaps more than 75 percent) were microenterprises. Twenty-five percent of all small businesses were in Gauteng province, the country’s economic powerhouse, which includes Johannesburg and Pretoria.

Above all, the banks recognized the need to build up a reasonable market share of smaller, growing businesses to develop a healthy pipeline of medium-sized enterprises to lend to in the future. This recognition implied that banks were ready to take a long view of the profitability of their small enterprise clients. One banker suggested that banks’ “lifetime value calculations” were becoming more sophisticated. It was unlikely that these calculations played an especially decisive role in deciding whether to take on a new client, but evidence suggested that such considerations did play a role in softening the way banks handled their smaller clients who were getting into difficulties during the downturn. Government issued a call for banks to treat sympathetically small businesses that were getting into difficulty. Nevertheless, banks appeared willing to take these risks because they wanted to ensure having incurred the upfront cost of establishing a relationship with their clients. They wanted to ensure that these small businesses survived until they became more profitable in the future.

A profitable and resilient business in its own right
As has been indicated, the banks’ small enterprise business units performed relatively well during the downturn, staying profitable despite sharply lower loan applications and approvals. Although nonperforming loans (NPLs) to small enterprises generally increased, the increase was negligible compared to the extent seen in medium enterprise lending. Accordingly, as a proportion of the banks’ total net incomes, the contributions made by their small enterprise units actually grew. A number of banks remarked that it took the downturn to demonstrate the fundamental resilience of small enterprise banking, despite the real and continuing challenges that small firms face.

34 FinScope South Africa Small Business Survey 2010.
The reason was that small banking business among most of the larger banks was sharply skewed toward deposit-taking and transaction banking and away from credit. Deposits from small enterprises sometimes exceeded the credit extended to them by a factor of five times. This meant that non-interest revenue (that is, fees, especially on regular banking transactions) was high and, in some cases, well in excess of net interest income. Deposit-taking and transaction banking therefore represented a good quality income stream for the banks, contributing meaningfully to group profits, and meant that NPLs, to the extent that they occur, were low and containable—approximately 5 percent of outstanding loans.

A number of banks also spoke of the opportunities from cross-selling products from elsewhere in the bank (such as from retail, banc assurance, and personal banking) to the small enterprises. Some banks considered these opportunities very significant: 83 percent of institutions surveyed named cross-selling as a significant or very significant driver.

**Public policy considerations matter to a very limited degree**

In contrast to the economic drivers, political economy considerations appeared to play only a marginal role in determining bank strategies toward the small enterprise sector.

For example, most banks said that in the absence of the Financial Sector Charter (FSC), under which the banking industry agreed to lend R5bn to Black- and women-owned SMEs\(^{35}\) between 2003 and 2008, their lending to SMEs would stay the same.\(^{36}\)

Their response does not suggest that banks were unaware of the developmental importance of small enterprises in South Africa but, rather, that the market-based incentives shaping bank strategies were comparatively stronger. Banks generally were well attuned to the opportunities generated by the structural changes taking place in the country’s economy and responded accordingly—but in a commercial way rather than out of any sort of societal or political obligation.

This commercial orientation is borne out by the fact that banks’ utilization of the Khula guarantee scheme was very low. In most cases, less than 5 percent of their total small enterprise loan book was covered by a Khula indemnity. It could be surmised that if the banks felt the political pressure to

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\(^{35}\) With a turnover between R500,000 and R20m.

\(^{36}\) The Financial Sector Charter technically is no longer in force. Its provisions were largely subsumed by the generic BEE Codes. However, the BEE Codes do not contain the specific provisions relating to the so-called targeted investments (which included bank commitments to lend to Black- and women-owned SMEs and for low-cost housing) or access. Consequently, the banking industry is proceeding as though the charter were still in force, at least regarding these provisions.
lend more to small enterprises, they would have made more active use of the Khula indemnity scheme, even if they had felt it needed reform and did not operate efficiently.

As mentioned above, the banking industry generally was happy to go along with government calls for them to adopt a more lenient stance toward small businesses that were struggling during the downturn. The banks did react more leniently, not because they wanted to please the government but because it made business sense for them to do so.

Obstacles

Macroeconomic factors
Moving on to the obstacles to lending (Figure 8, bottom panel), while the institutions that participated in the survey weighted most of the obstacles highlighted rather differently, there was unanimous agreement that macroeconomic factors were a significant or (according to most respondents) very significant obstacle to their engagement with SMEs. Among the “macroeconomic factors” cited were macroeconomic instability, unemployment, over-indebtedness (among consumers and in small businesses themselves), high interest rates, falling demand, and the impact of reduced government spending in certain areas. These responses reflect both the:

- Character of the economic boom that ended just as the global financial crisis unfolded—consumption led on the back of historically low interest rates and accessible consumer credit
- Nature of the SME market in South Africa—very oriented toward consumer spending, which slowed in the wake of a sharp rise in interest rates through 2007–08, and rising job losses, especially in the mining sector.

The restaurant trade (with the exception of fast food franchises) and suppliers to the mines, construction, and manufacturing were particularly badly hit as the economy headed toward recession. As one bank remarked, just as the barriers to entry in many of the markets that SMEs serve are low (for example, retail businesses), so the barriers to exit are also low, adding to the risk of lending in the sector.

However, as suggested above, because macroeconomic factors appear to be by far the most serious set of obstacles to banks’ engagement with SMEs, one can surmise that as the economy picks up, banks will be willing to return to more normal levels of activity quite quickly. Indeed, a number of

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37 This finding is consistent with findings from the demand-side survey (Section 3.1).
institutions suggested that sectors that were hit badly early in the downturn are looking much more robust, while others are seeing “green shoots” of recovery across their entire small enterprise banking business.

**Regulatory factors**

Generally, regulatory factors, whether affecting financial institutions or SMEs directly, did not seem to greatly constrain financial institutions’ engagement with SMEs.

Not surprisingly, given the profound political changes in the country, since the African National Congress (ANC) took office in 1994, the financial industry has had to contend with numerous pieces of new legislation or regulation. These include Black Economic Empowerment regulation in its various forms (including the Financial Sector Charter and the BEE Codes); anti-money-laundering legislation in the form of the Financial Intelligence Centre Act; and market conduct legislation in the form of the Financial Advisory and Intermediary Services Act, National Credit Act (NCA), and compliance with Basel 2.

Despite the reshaping of the regulatory landscape and the compliance burden, current financial sector regulation does not appear to be a serious impediment to banks’ engagement in the sector. In some respects, it has made it easier. For example, the 2006 National Credit Act contains reckless lending provisions that allow a court to set aside a loan if it was made without due attention to whether the borrower could repay it. However, these provisions also impose an obligation on the borrower to disclose fully his or her financial circumstances (including loans to other financial institutions). Consequently, banks felt that they were getting better information from borrowers than they used to. Banks also claimed that, in the current climate, they already were using more stringent affordability assessment criteria than the National Credit Act required.

This additional transparency from which banks are now benefitting when they are considering making a loan appears to outweigh the inconvenience of having to accommodate the new debt counseling or alternative dispute resolution processes required by the Act prior to enforcing a debt.

The only kind of small businesses that the National Credit Act applies to are sole proprietorships and so-called close corporations. However, these are quite numerous so the Act does play a significant role in the SME arena as well as in consumer credit. It is also standard practice for most banks to credit-score the business owner (the “jockey”) as part of the overall credit assessment process for the business. Thus, the Act has considerable influence even when the SME concerned is a limited company (“Pty Ltd”).
Limited companies are covered by the Companies Act, which has been revised and came into law in 2011. At the time of the survey, lenders raised concerns about the so-called business rescue provisions. While facilitating enterprise restructuring, stays on creditors would make it harder for lenders to recover outstanding debts in the event of a business failure. The operational implications of the revisions to the Act were being considered in detail by the banks.

The cumbersome nature of the judicial processes required to recover a debt (that is, contract enforcement), and the cost thereof, concerns financial institutions. The problem is expected to get worse once the revisions to the Companies Act become law. The Small Claims Court has a claims limit of R7,000, which is far too low to be of any real benefit as an alternative to a full court process.

BEE legislation has had a profound impact on the racial composition of financial institutions’ staffing and on ownership and may have nudged financial institutions toward servicing Black- and women-owned small enterprises. However, BEE has not caused a radical shift in banks’ general appetite for the small enterprise sector.

Overall, therefore, insofar as it directly affects financial institutions, the regulatory environment can be said to be reasonably conducive toward small business banking, or at least benign.

As regards the regulatory environment’s effects on small enterprises, besides the cumbersome nature of judicial processes already mentioned, several respondents cited the tax regime for small enterprises as problematic, suggesting there is room to streamline it.

In many ways, this suggestion is surprising. For some years, the South African Revenue Service (SARS) has introduced reforms to simplify tax compliance processes for small business as well as increase qualifying tax thresholds. The objective has been to encourage informal businesses to formalize. The reason was that formal businesses tended to perform more strongly because they found it easier to access finance and other services that benefited their businesses. In 2009 SARS introduced a micro-business tax for businesses with under R1 million turnover per year. The tax was optional and exempted these businesses from other taxes. To simplify assessment, it was calculated based only on turnover but so far has been slow to gain acceptance. One banker suggested that the R1 million turnover cap might encourage small businesses to forgo growth in the interest of staying below the cap.

Of course, the full social costs and benefits of any such regulatory change should be considered.
From the lenders’ perspective, forgoing growth clearly was not desirable. However, this view that small enterprises would choose to forgo growth was not widespread.

Other business-level legislation cited as obstacles by financial institutions included inflexible labor laws as well as onerous administrative processes such as company registration.

**Bank-specific factors: Supply-side constraints affecting banks’ lending to SMEs**

While a number of respondents were reluctant to suggest that their own institutions constrained their engagement with small enterprises, a number were prepared to suggest that they were held back by their own rules, for example, concerning collateral that small enterprises were not able to provide. The difficulty of having to assess the skills of the entrepreneur was referred to as well. One smaller institution suggested it was constrained by its own physical reach, which was not able to access small enterprises operating in some parts of the country.

Interestingly, a number of institutions suggested that they lacked enough of a skill set to be able to effectively assess small enterprises. In general, these institutions lacked experience in the small enterprise sector. This is a capacity constraint that increased automation should help to address—at least up to a point. As one banker said, “Intuitive lending is very expensive in the small business environment.” Thus, innovation in credit scoring should have the dual effect of simplifying the process of taking on a new client, while reducing the scope for expensive errors of judgment. The important issues here are that some institutions acknowledge that (1) the historic approach of trying to apply the same credit assessment techniques used in the banks’ more traditional business to small enterprise lending will not work so (2) loan officers with different skills and new lending technologies are needed.

As mentioned, the officials responsible for completing the questionnaires generally (and understandably) were reluctant to acknowledge constraints to their engagement with SMEs that were self-created or self-imposed—that is, that came from their own organizations. The survey responses were somewhat thin in this area. From this fact, it would be easy to construe that most of the problems that prevent banks and SMEs from engaging satisfactorily with each other emanate from the SMEs, not the banks. However, supply-side constraints, which tend to be organizational or procedural, almost certainly are more extensive than the survey results would indicate.
SME-specific factors: Demand-side constraints

The survey explored the extent to which demand-side constraints (business owner’s lack of business skills, absence of a credible business plan or other financial information, absence of collateral) barred engagement with SMEs.

The various institutions had distinct differences of opinion as to how much of an impediment demand-side factors represented. Nevertheless, there was reasonable consensus that significant information gaps made lending to small enterprises very risky. Inadequate or absent business plans and financial statements were a major concern to financial institutions.

While generally positive about the information provided by the credit bureaus, a number of respondents suggested that a lack of coverage of SMEs was a constraint. Although South Africa is well served by personal credit bureaus, they do not capture the credit behavior of small businesses, even though the financial relationship between an entrepreneur and his or her business may be very close.

A more intractable concern mentioned by a number of institutions was that entrepreneurs often lack basic business and financial skills, partly due to poor schooling.

In view of the above, it is no surprise that most financial institutions compensate for these SME deficiencies (whether real or perceived) by providing business support services as part of their relationship with their small enterprise clients. Some institutions, such as Business Partners, offer business support as an explicit part of their financing activities. Other institutions are exploring ways of streamlining their access to good quality business advisory capacity and even looking internationally for it. This topic is explored later in this report.

Finally, a number of institutions noted the perennial difficulties associated with small enterprise lending—namely, the high fixed costs per transaction, and the difficulty of achieving economies of scale and of standardizing products and procedures.

When asked whether certain obstacles had worsened as a result of the crisis (Figure 9), unsurprisingly, the majority of institutions pointed to macroeconomic factors, and half of the institutions named lack of adequate demand. Encouragingly, these are not long-term structural factors but are directly affected by the macroeconomic situation. Forty percent of the institutions noted that bank-specific and SME-specific factors also had deteriorated, presumably due to the increased pressures both internally on banks and on their clients brought about by the difficult economic circumstances.

The perception among the commercial banks surveyed was that it is more difficult to lend to SMEs than to large enterprises (LEs). In other words,
the vast majority of banks felt that it was both more costly and riskier to lend to SMEs than to LEs and that, overall, SME lending was less profitable (Figure 10). This perception is not necessarily supported by recent financial results, which point to the SME business as a robust generator of income (although this result is perhaps driven more by nonlending revenues and costs).

**SME Market**

Market participants appeared optimistic about the size and prospects of the SME market in general. Eighty-six percent of respondents stated that the SME market is big and the prospects are good. One institution noted that the market is big but below its potential and hampered by the recession.
The Big 4 appeared less pessimistic about the impact of the crisis on the long-term prospects for the SME market (Figure 11), with some of the banks stating that the crisis would have a positive effect. In contrast, the other respondents thought that the crisis would have a negative impact.

### 3.2.2 Business model

This section analyzes banks’ business models for the SME segment. An overview of organizational models observed, marketing, products offered, and credit risk management follows.

#### Organization

All of the universal banks surveyed had separate business units for SMEs, although there were differences in where these units were located organizationally within the banks. In some of the surveyed banks, the SME unit sat within the retail division based on commonalities with the other retail areas, such as a shared branch network and the link between personal and small business borrowing (for example, by using a customer's personal residence as collateral for a loan used for business purposes). In other banks, the SME unit sat within the business or commercial banking division to provide a consistent experience as clients grew, and to share knowledge and reduce duplication in areas such as system and credit risk model development. *Significantly, there did not appear to be industry-wide consensus as to where the SME unit should be best placed organizationally, and certain banks recently had changed organizational structures.* The decision appeared to be influenced considerably by internal factors such as the overall structure and organization of the bank as much as by long-term strategic decision-making.
Additional differences were observed among institutions regarding the degree of decentralization. Some banks employed a “federal” model, with largely autonomous units responsible for their own profit and loss (P&L), in some cases, even at the regional level. Other banks employed a more centralized model. However, to a large extent, these differences were just a matter of degree.

**Marketing**

Institutions employed different approaches to determine which SMEs to target. Sixty percent of institutions employed a sector-specific approach. Franchises (such as fast food), in particular, were targeted by various institutions, but so were other industry sectors. Fewer institutions employed a geographic focus, although major commercial areas are, unsurprisingly, more attractive to lenders.

Among all institutions surveyed, when asked to list their top three factors, Figure 12 presents the relative frequency of factors that they used to target SEs. The most commonly cited factor was expected profitability (26 percent of factors mentioned), followed by company size and credit quality. Development return was the equal fourth most commonly cited factor, although this result was driven largely by the DFIs in the sample. Commercial factors (such as expected profitability), company size, and industry sector typically were the most important factors for the Big 4. BEE was relatively insignificant as a factor to target SEs. To target MEs, similar factors were used, although expected profitability was relatively more important and development return less important.

Institutions recently had to take on a more proactive approach to marketing. Where previously word of mouth may have been sufficient, now banks

![Figure 12: Factors Banks Used to Target Small Enterprises](image-url)
need to market more actively. Despite strong demand, 88 percent of institutions felt that they had to undertake a fair amount of marketing, or market aggressively, to attract enough applications of sufficient quality.

Considerable differences were observed between the commercial banks and the DFIs/nonbank financial institutions with regard to the distribution channels employed. While the commercial banks employed a wide range of distribution channels (Figure 14), other institutions exclusively employed a branch distribution model.

**Products**

In terms of products and services offered, it is important to distinguish between the credit and noncredit side. In general, the large commercial banks
generated a significant proportion of their revenues from noncredit products and services. In contrast, banks with a SME-sector-specific focus and those with a broader development mandate focused more heavily on credit. For example, on average, the large commercial banks generated 27 percent of their revenues from credit; and 73 percent from deposits, account management, and other transaction- and fee-based services. For other institutions, the average split was 95 percent to 5 percent for credit versus noncredit products.

Focusing first on the lending side, a large proportion of the SME loan books of the big commercial banks was made up of traditional asset-backed lending. Typically, the large commercial banks had similar proportions of asset-based and property loans (30 percent–50 percent), working capital loans (30 percent–40 percent), and investment loans (20 percent–30 percent). However, the exact product mix does vary considerably by institution. One bank in particular had a very large proportion of asset-based and property loans, and a lower proportion of loans for working capital.

Other lending products, such as factoring, leasing, and trade finance, constitute a far smaller proportion of the lending book in the typical universal bank (for example, ~1 percent). One niche bank was successfully employing a different business model: a relatively large leasing book and significant volumes of trade financing, factoring, and investment loans. Its lending offerings were complemented by a range of nonfinancial service products (discussed below).

To mitigate the cost of SME loans, institutions noted that the cost was taken into account in the pricing. As discussed earlier, the average interest rate applied to the lowest risk SE client was 14.9 percent (or prime + 4.4

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39 Due to the accounting of revenues from deposits, this split does not necessarily reflect the split between net interest income and noninterest revenue.
percent), compared to 11.1 percent (or prime + 0.6 percent) for the lowest risk LE client. In addition to risk differentials, the higher interest rate for SMEs likely was applied to take into account higher administrative and other costs for servicing SEs. Other factors used to control the costs included the use of good systems and standardized documents and agreements. The ability to cross-sell to SMEs also was deemed an important factor.

When asked to qualitatively assess the impact of the crisis on SME lending, the institutions were divided. Twenty-five percent of them stated that SME lending had not varied significantly in real terms (that is, taking inflation into account). Another 25 percent of institutions stated that lending had increased in real terms. This difference was due in part to the differing remits of the institutions in the sample. The DFIs had increased their exposure during the crisis to counter the effects of the perceived private sector credit contraction. The majority of the Big 4 claimed that lending either had not varied significantly in relative terms (that is, relative to other parts of the bank), or had decreased.

Turning to the noncredit side, all of the major banks offered a range of savings and transaction- and fee-based products. However, there were differences in the specific product range offered and noticeable differences in the scope of products offered by the Big 4 compared to the other institutions. As shown in Figure 17, all of the major commercial banks offered business training and coaching to SMEs, foreign exchange services, and payment services. Additionally, the majority offered cash management and payroll services.

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In the interviews with the banks, they confirmed that small business banking was a small but efficient way to garner liquidity for the bank and that banks tended to offer small enterprises little by way of interest on their deposits.
Only one institution reported offering outsourced back-office services to SME clients. By contrast, the other institutions in the survey offered far fewer transaction and fee products, providing only business training and coaching (75 percent) and foreign exchange (25 percent). Similarly, the public finance institutions did not offer any savings products to SMEs. They were focused on credit and the provision of business training and coaching.

Almost all institutions surveyed (87.5 percent) offered a free service to SMEs. Typically, this service was business training and coaching. Business training and support offered benefits to both the lender and the borrower because effective support was likely to increase the probability of loan repayment. Therefore, it was perhaps not completely altruistic that the banks provided such services free of charge, although respondents did rate social responsibility (“contributing to the economic development of the country”) as an important factor in serving the SME sector.

Typically, banks viewed checking accounts as their most profitable nonlending product, followed by internet banking, savings, and investment products.

By and large, the major commercial banks offered standardized products to both small and medium enterprises, although some banks said that they also offered tailored products to medium enterprises (Figure 18). Specialist SME lenders and banks with a development mandate were more likely to offer solutions tailored to SMEs.

The banks were split on the impact of the economic crisis on the products and services they offered to SMEs. Roughly 40 percent stated that the crisis did not have an impact on the products that they offered. The rest

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*Business Development Support (BDS) is detailed in Section 5.4.6.*
responded that the crisis had motivated them to offer new products to SMEs, such as business coaching to provide support in downturn conditions and a free transaction account. Other impacts of the crisis commonly reported included the perceptions that the risk of SME lending had increased (100 percent of respondents) and that the demand for SME borrowing had increased. The banks were split on the impact of the crisis on both international trade financing and demand for SME nonlending products.

Before specifically considering the risk management practices of the surveyed banks, the responses showed that, for SEs, many aspects of the business, with the exception of product sales, typically were centralized in the head office or regional head office (Figure 19). As discussed, some banks employ a more decentralized model that enables decision making at the branch level, especially in the area of loan assessment. For MEs, more of the business typically is decentralized to the branch level, especially in the area of loan assessment.
Credit risk management process

In all of the commercial banks surveyed, credit risk management was separated from sales, and the risk management and sales teams were separated (Figure 20). Credit risk management typically was centralized at headquarters, where risk management was undertaken by a dedicated credit analyst (80 percent of respondents).

The surveys showed that credit scoring was widely utilized across the sector as an input in credit decisions, and there was evidence of innovation taking place in this field. However, the industry generally was quite far from full automation even for small enterprises. For example, score cards had not yet been developed for certain product areas. Given the challenge of limited financial history for start-ups, banks were looking more at the financial positions and characteristics of the business owners, and their personal property typically comprised an important component of the collateral. Similarly, after taking on a new client, banks might require a “get-to-know-you” period ranging from 6 months to 18 months before extending credit. Behavioral scoring models, which utilized the full set of information available from other accounts, were other important components of the credit process, and were used widely across the major banks in the small enterprise space. In general, banks recognized that “intuitive lending” in the SME environment could be very expensive. In other words, they recognized that automation is necessary for making the right decisions as well as reducing administrative costs associated with lending.

In contrast, credit decisions for medium enterprises generally were made case by case based on factors such as the viability of the specific business plan and the ME’s relationship with the bank.

**Figure 20: Organization of Credit Risk Function (Commercial Banks)**

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42 A small number of institutions did use automated scoring to approve loans in the small enterprise segment but only for limited loan limits and only in certain products.
Looking at the details of the credit assessment process, typically both the owner and the SME were scored, using information from credit bureaus, and public and private sources. All of the major banks made use of a range of both qualitative and quantitative factors. These included rating the quality of the SME management; Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis of the SME; viability of the business plan; assessment of market size and potential; entrepreneurial character of the owner; financial analysis of the SME; projected sector trends; financial projections for the SME; and financial analysis of the SME owner. However, the importance that each individual bank assigned to various factors differed widely. For example, in the aggregate, collateral, the financial assessment of the business, the firm’s credit history with the bank and from a credit bureau, and the owner’s characteristics were equally important in making lending decisions to small enterprises. However, different banks assigned quite different weightings to these factors.

The majority of respondents (87.5 percent) required collateral for SME loans, and roughly 70 percent of loans required collateral. Over 75 percent of respondents allowed the use of movable collateral. For overdrafts and term loans, collateral requirements typically were at least 75 percent of the value of the loans, although this could depend on the risk assessment and the structure of the deal. Approximately only 50 percent of banks reduced the interest rate for secured lending. However, as noted above, the provision of collateral was an important factor for determining whether loans could be granted. Table 2 shows the average importance of different collateral types for the commercial banks to lend to small enterprises. Unsurprisingly, cash was rated the highest, followed by real estate. Equipment and livestock were not valued highly.

**Table 2: Importance of Collateral Types for SE Lending**

<table>
<thead>
<tr>
<th>Collateral type</th>
<th>Average importance (on scale of 1 to 8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2.3</td>
</tr>
<tr>
<td>Real estate</td>
<td>2.8</td>
</tr>
<tr>
<td>Guarantees</td>
<td>3.3</td>
</tr>
<tr>
<td>Land</td>
<td>3.5</td>
</tr>
<tr>
<td>Equipment</td>
<td>4.0</td>
</tr>
<tr>
<td>Livestock</td>
<td>6.0</td>
</tr>
</tbody>
</table>

SME collateral requirements that were higher than those for large enterprises most commonly were due to a lack of financial information about the
SMEs (100 percent of respondents) and because SMEs were harder to evaluate (80 percent of respondents). Other reasons given were that SMEs were more informal, had worse management, and could be harder to prosecute. Respectively, 57 percent and 50 percent of respondents reported difficulties enforcing and registering collateral.

As a response to the economic downturn, over 70 percent of surveyed banks did change their SME credit management practices. Actions included tighter origination standards and closer monitoring of high-risk loans. Even banks that did not explicitly tighten credit standards acknowledged that, given the deterioration of the underlying financial positions of firms, fewer applicants could reach the existing credit standards.
In South Africa, support for the SME sector has been a policy priority for the government since the end of apartheid in 1994. Targeted financial support has been directed through initiatives such as Khula Enterprise Finance and the SA Micro-Finance Apex Fund (SAMAF). A plethora of nonfinancial support schemes have been promoted, in recent years under the overall umbrella of the Small Enterprise Development Agency (SEDA). Given the country’s history, a core focus has been to promote Black- and women-owned small businesses. The regulatory and tax burden for small business has been eased. For example, VAT procedures have been streamlined and qualifying tax thresholds for small business raised. Policy support has targeted a number of priority sectors, including export, tourism, construction, and ICT; and population segments, such as young people. Recent legislation gave equity investors in small businesses a tax rebate to address a perceived “equity gap” afflicting this segment. The development of small businesses, especially so-called Second Economy businesses, was given particular emphasis in the Accelerated Shared Growth Initiative for South Africa (ASGISA). This initiative was launched by the country’s Presidency in 2006 to halve poverty and unemployment by 2014.

The expansion of financing for Black SMEs is reported as one of the success stories of the Financial Sector Charter. By end-2007, the financial sector had extended more than R8.8bn (US$1.2bn) of new finance (mainly loans) to Black SMEs, well in excess of the target of R5bn ($670m) of new finance by end-2008. However, the Financial Sector Charter defines SMEs as having annual turnover in the range R500,000 to R20m, which does not map easily to the National Small Business Act definitions. Furthermore, although a majority of small businesses as a whole are Black owned (in many cases, beneficiaries of Black Economic Empowerment policies), it is estimated that a majority of larger small businesses may be White-owned. Lending to such entities would not be picked up in the Charter figures.

The February 2011 National Treasury Policy Document, “A Safer Financial Sector to Serve South Africa Better,” emphasizes access to finance by small businesses as a policy priority. The strategy highlights the reduction in SME lending volumes during the economic downturn and the need to
support small businesses, especially in the informal economy. Furthermore, the New Growth Path and the 2011 State of the Nation address announced a restructuring and rationalization of development finance institution support to small and micro businesses.

Based on the analysis of the survey responses, and the assessment of the performance of existing government programs, this section advises on potential directions of future SME finance policy in South Africa.

4.1 Considerations for Policy Design

The key goal of SME finance policy is to push out the access frontier for SMEs (Figure 23). The survey results indicate that not all potentially credit-worthy SMEs are receiving credit. In an efficient market with perfect information, theory would suggest that all credit-worthy SMEs should have access to credit. Therefore, policy that removes obstacles should increase lending to SMEs. The surveys highlighted a number of potential regulatory and judicial issues that could obstruct lending, although in general such regulatory factors were not highlighted as significant concerns to the banks in South Africa. Furthermore, institutions consistently highlighted potential entrepreneurs’ lack of relevant skills and the resulting poor quality of loan applications. If we assume that an entrepreneur has an inherently credit-worthy idea (one that will produce stable cash flows) and sufficient own resources, but is unable to formulate this idea in a way that will be approved by the credit assessment process, improving the skill set of the entrepreneur could lessen the constraint.\textsuperscript{45}

However, in a world of asymmetric information in which the lender knows less about the credit-worthiness of the borrowers than do the borrowers themselves, this lack of information can act to ration credit, regardless of the interest rate charged (Stiglitz and Weiss 1981). Policies and technologies that improve the information set available to lenders may reduce this lending constraint. Credit bureaus supply credit information to lenders, improving the information available in making credit decisions. Similarly, credit technologies that better use currently available information (such as scoring) can improve the information position of the lender.

The structure of South Africa’s financial sector is an important parameter in determining successful policy approaches. As opposed to that of other countries, the sector is dominated by four large banks that have established

\textsuperscript{45} Alternatively, one can think of increasing entrepreneurs’ skills as increasing the pool of potentially credit-worthy SMEs because more highly skilled entrepreneurs are more likely to succeed in their businesses.
themselves in the advanced economy but have limited knowledge and information access to the sphere outside the traditional formal sector. There is an absence of financial institutions that can leverage relationships and linkages in the informal economy to overcome information asymmetries. Nevertheless, even though their approach to lending to the sector is relatively cautious, these four private sector commercial banks provide the large majority of credit to formal SMEs in South Africa. In the absence of good information access, SMEs are higher risk and more costly to serve than larger enterprises. Thus, banks have adopted correspondingly conservative business models (such as requiring long “get-to-know-you” periods prior to lending). Despite this conservatism, given the relatively larger scale of commercial to public sector lending in this segment, if policy interventions are to have a significant impact, they need to be directed at leveraging the existing commitment of the private sector.

Thus, in the short term, overcoming the risk hurdles to enhance the large commercial banks’ credit provision to SMEs is a priority. Private sector commercial banks are likely to enjoy a comparative advantage over public sector institutions in areas such as credit risk assessment, and this factor should be taken into consideration when determining how the public sector should direct support to SMEs. Although there may be political sensitivities about supporting already profitable banks, commercial institutions will channel resources where they perceive returns to be greatest. Without appropriate interventions, moving banks from the status quo will be challenging. For example, the majority of banks reported that the Financial Sector Charter (FSC) targets did not impact their level of lending to the sector. It is critical that policy interventions not merely support the existing business level but lead to additional lending.

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46 Absa Bank, First National Bank, Nedbank and Standard Bank (in alphabetical order).
In the medium term, more competition and the entry of financial institutions with a focus on the SME segment will be additional options. The impact on the retail credit market of the entry of new commercial banks with specialized business models will be important in informing government policy. The government would be well advised to review options to incentivize investments in innovative business models outside the established banking sector. However, the historic performance of public direct credit schemes has been mixed at best, with issues relating to unclear mandates and portfolio quality. For this reason, the government would be ill advised to try to engineer more competition through direct interventions.47

The following sections present an overview of existing government programs relating to SME finance, then discuss potential policy interventions. In theory, government can take on a wide range of regarding SME finance, from being an active participant in the market to setting and implementing policies that enable the market to function efficiently and competitively. This report advocates that government policy focus on providing a conducive environment for market-based solutions to address the challenge of SME financing and to provide instruments that leverage the expertise and involvement of commercial institutions. Nevertheless, this report also acknowledges that there may be cases in which market failures may be so severe that market-based solutions will not be effective. In this case, there should be explicit discussions of the appropriate intervention, considering a broad range of potential actions that will sustainably increase the access frontier, and the relative cost benefit of such actions.

4.2 Assessment of Existing Government Programs

The Government of the Republic of South Africa has established an extensive institutional and organizational infrastructure for SME financing, including wholesale and retail financing as well as credit guarantees; and other ancillary services, such as business development services and implementation of special sector schemes. The three primary organizations involved are Khula Enterprise Finance, the Industrial Development Corporation (IDC), and the National Empowerment Fund (NEF). To a lesser extent, the Umsobomvu Youth Fund (UYF),48 South African Microfinance Apex Fund (SAMAF), and Land Bank have played their own roles in SME finance—in the former two

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47 A number of discussants raised the issue that public loans may be perceived as grants by potential borrowers, with the associated problems relating to repayment.

48 Now subsumed into the National Youth Development Agency and Khula.
cases, at the lower end of the market, with micro to small enterprises; and in the latter case, with rural and agriculturally oriented SMEs.\textsuperscript{49}

Despite having relatively large capital endowments (totaling roughly R85 billion among the three primary institutions, albeit for mandates broader than simply SME finance), these organizations have marginally affected SME development and growth. The Big 4 banks, plus other private sector players such as Business Partners and Sasfin, have much greater exposure to the SME market.\textsuperscript{50} In one sense, it may be argued that development finance institutions (DFIs) should not have a primary or major role in the market, especially in a country with a private sector as large and diverse as that of South Africa. On the other hand, an open question remains as to how far the DFIs should push risk frontiers and encourage the innovation and deepening and broadening of markets. Within the key government ministries, the consensus is that the DFIs can and should be playing a much more extensive role in the SME financing market, especially given the apparent extent of unmet demand among smaller and Black-owned SMEs, and the perceived reluctance on the part of the banks to engage more fully with the sector.

Performance across the various institutions varies greatly. Nonetheless, they all have challenges, and some under-perform significantly in many respects. Generally, all of the DFIs suffer from unclear or too broadly defined mandates, combined with substantial overlap among them. Compounding their mandate muddle, many of the DFIs also vacillate between the influence and effective control of at least 2, and sometimes 3 or 4 different ministries. None of them pushes the edge of the risk envelope as far as it should or could. As an example, many hold substantial deposits instead of investing their capital in the SMEs that they were designed to serve. Management and technical skill and capacity vary, but overall the DFIs demonstrate a real lack of qualified human capital. Financially, these large organizations tend to show operating profits, but these profits often derive from noncore activities (such as funds held on deposit or in money market investments). In addition, in many of the organizations, portfolio quality is poor.

On the positive side, in terms of government response to the economic and financial crisis, it appears that some support was quickly made available to distressed SMEs, albeit small in comparison to the size of the overall lending market for SMEs. By not being constrained in the same way as private

\textsuperscript{49} Subsequent to the analysis undertaken in this study, it has been announced that Khula, SAMAF and the small business activities of IDC are to be merged, creating a new institution focused on the funding of SMEs. This may potentially have a significant impact on the future institutional environment for supporting SME finance, but is too recent a development for extensive analysis here.

\textsuperscript{50} As noted in Section 3.2.1, in 2009 the main DFIs combined accounted for only 2.5% of exposures to SMEs.
sector institutions and by having an explicit development mandate, the DFIs were able to provide credit counter-cyclically over the crisis at a time when SME clients required most support. Data from the supply-side survey shows that, in contrast to the commercial banks, the DFIs were able to increase their lending to SMEs both in terms of total number of loans outstanding (up roughly 20 percent between December 2007 and December 2009) and total exposures to SMEs (up over 30 percent over the same period). Furthermore, it appears that the DFIs response to the difficulties faced by SMEs was swift, both in restructuring loans and in instigating programs to assist distressed firms. For example, the IDC launched a R2 billion fund targeted at distressed firms, 15 percent of which was distributed to SMEs.

Nevertheless, as noted above, the relative size of DFIs’ exposures is small compared to that of the private sector. Accordingly, the size of the counter-cyclical support provided by the DFIs was small in comparison with movements in the overall market. For example, the IDC’s intervention amounts to only 2.7 percent of the reduction in credit to SMEs from commercial banks from June 2008 to December 2009 and 0.2 percent of total exposures to SMEs.\(^{51}\) Recounting these facts is not to downplay the significance of DFIs’ support for distressed firms in particular. However, we do not have enough data on the destination of the DFIs’ loans during this period to determine the extent to which they actually served as a kind of safety net—that is, provided financial support to distressed firms that the market would not target. This is an important potential role that clearly would complement ordinary bank lending.

Khula is the lead parastatal in the area of SME lending, with a mandate to provide financing to the SME market through intermediaries as a wholesale financier. Khula’s two principal products for SME financing are the Khula Credit Indemnity Scheme and Non-Bank Retail Financial Intermediaries (RFIs). The purpose of the indemnity scheme is to share risk with commercial banks through partial credit guarantees (PCGs). Finance is approved directly by the bank, which can apply to Khula for a guarantee. The guarantee provides essentially insurance cover for up to 90 percent of the irrecoverable portion of loans granted by the participating banks. RFIs are independent organizations accredited by Khula to lend money directly to SMEs. RFIs receive funds from Khula to lend to SMEs according to their own lending policies.

\(^{51}\) As discussed in Section 4.2, the level of overall exposures to SME retail was R172.7bn in December 2009. The level had declined by 6.1% between June 2008 and December 2009, a reduction of R11.2bn.
Khula, therefore, provides the government’s PCG scheme to SMEs. However, there are concerns that this scheme has not been working effectively. Volumes of new indemnities (both in value and volume) have dwindled and are now very low. What is more, banks did not increase their usage of the scheme during the downturn, at a time when government support would have been most important.

Banks noted that the Khula scheme can be complicated to administer and excludes potential borrowers based on unnecessarily stringent conditions. Moreover, although the guarantee provides banks with a high level of cover (50 percent–90 percent, but typically at the higher levels), its economic attractiveness is eroded by long recovery processes. These typically last over a year, and payouts are made only after all recovery attempts have been completed. Together with the banking industry, Khula is aiming to address some of these operational challenges and has been implementing changes to its processes. Khula is piloting a portfolio indemnity in two provinces. Recently, the parastatal’s mandate was broadened to include direct lending—through Khula Direct. This change puts Khula directly into competition with its wholesale clients and raises considerable operational and capacity issues within the institution as well as risks as to the soundness of Khula’s eventual lending decisions.

The economic crisis provides government with a fresh opportunity to examine the effectiveness of existing programs—both the ease with which users (including the banking sector) could access concessional funding or guarantees in normal conditions, and whether the programs were an effective
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instrument through which government support could be delivered in times of economic crisis.

In view of the extent of banks’ current commitment to SMEs (which dwarfs DFIs’), a key recommendation of this report is that the DFIs’ primary focus should be on deepening their collaboration with private sector intermediaries and providing a more streamlined service to them, rather than on pursuing strategies likely to result in their competing with the financial industry. There is a range of appropriate incentives that could be considered. They could include potential interventions, such as credit guarantees, wholesale lending, and support for the provision of business development services (discussed next).

### 4.3 Potential Policy Directions

A positive aspect of the survey was that the institutions were relatively positive about government’s ability to make a positive impact on SME lending. A large proportion of financial institutions felt that the government could increase the appeal of SME lending through regulatory reforms and through guarantees and subsidies (Figure 23). A sizable proportion of institutions also was positive about other potential reforms.

#### 4.3.1 Improve effectiveness and uptake of partial credit guarantee schemes

Partial credit guarantee (PCG) schemes are widely seen as mechanisms through which the public sector can risk-share with the private sector and increase lending, especially when the private sector is risk averse. The latter

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**Figure 23: Could Government Improve the Appeal of SME Lending through the Following?**

<table>
<thead>
<tr>
<th>Percentage of Institutions</th>
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</thead>
<tbody>
<tr>
<td>Legal</td>
</tr>
<tr>
<td>Regulatory</td>
</tr>
<tr>
<td>Institutional</td>
</tr>
<tr>
<td>Guarantee</td>
</tr>
<tr>
<td>Subsidies</td>
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<tr>
<td>Credit bureaus</td>
</tr>
<tr>
<td>Judicial</td>
</tr>
</tbody>
</table>

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factor is relevant in South Africa, where the private sector appears rather cautious about lending to small businesses. Furthermore, the advantage of utilizing a well-designed PCG scheme is that it builds on the scale and commitment of the private sector, while utilizing its risk assessment capacities, distribution networks, and operational efficiencies.

As noted in Honohan (2010), the prerequisites for a PCG scheme to achieve improvements in social welfare include “clear and precise goals, against which performance is regularly monitored, realistic pricing verified by consistent and transparent accounting, and attention to the incentive features of operational design, especially for the intermediaries.”

Clear and precise goals and (given the potential liability that the government takes on when it writes large guarantees) transparent accounting clearly are important in ensuring that the PCG scheme achieves its goals (as they are for direct credit programs). Nevertheless, it is the incentive features for intermediaries that particularly resonate with the current workings of the Khula indemnity scheme.

Although it protects the state from potential gaming by the financial intermediaries, in its current form, the PCG scheme does not provide appropriate incentives so is under-utilized. The key features that appear to be influencing the performance of the scheme are:

- High guarantee rates of up to 90 percent of unrecovered loss
- Conditional payouts by Khula only when financial institutions have exhausted all recoveries of collateral
- Khula’s own strict eligibility criteria
- Dual credit assessment process by the financial institutions and Khula.

As well as serving as collateral for asset-poor borrowers, another attraction of utilizing a credit guarantee scheme is that the government can leverage the risk-assessment expertise of the private sector, and increase lending transparency and operational efficiency. When the government takes on a very large proportion of the outstanding credit risk, the intermediary has less incentive to undertake independent creditworthiness assessments, diminishing the advantage of the PCG for the state. In addition, the intermediary would have less incentive to maximize the recoveries it gets from the sale of collateral because the intermediary knows that, ultimately, the majority of the outstanding loss will be covered by a payout under the guarantee scheme. Therefore, to protect itself, Khula has instigated a policy of paying out only after all recoveries have been completed. This policy has the negative effect

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52 Italicics are authors’ own.
of reducing the economic desirability of the scheme from the perspective of the intermediary due to the time value of money and the administrative burden. Furthermore, given the lower incentive for the intermediary to undertake independent credit assessments, Khula also undertakes a credit assessment, creating a double hurdle and longer administrative delays.  

We believe that all of these factors, in conjunction can be flexed to produce a more attractive scheme from the perspective of the financial intermediaries, while ensuring that they have enough of a stake in the loan to act in the interests of the guarantor. Following Honohan (2010), the following paragraphs provide international perspectives on two questions:

1. “Should the guarantor undertake its own credit assessment?”
2. “What proportion of the guarantee should be offered?”

According to Honohan (2010), “…some of the best-regarded schemes do not carry out such retail [credit risk] assessments, instead relying on an assessment of the intermediary.” More than 50 percent of the guarantees offered by the US Small Business Administration (SBA) are to lenders who make loans without the prior approval of the SBA, as is the case with Chile’s FOGAPE. Borrowers still must meet eligibility criteria, but they are assessed afterward. One justification for the guarantor to undertake risk assessment would be if it has an informational advantage. If there is no justification, the additional risk assessment likely will not be cost effective. In terms of the rate of the guarantee, “…many practitioners argue that the lender should retain a significant part of the risk (no less than 20 percent but preferably 30–40 percent)” so that there is sufficient incentive for the lender to appropriately undertake risk assessment. In practice, most schemes guarantee slightly more (for example, 85 percent in the case of SBA), and rates less than 50 percent tend to not attract the intermediaries. Various innovative approaches can be observed, including auctioning guarantee amounts and scaling guarantee rates according to risk and claims experience.

Beck and others (2010) reviewed statistical evidence on 76 PGC funds in 46 countries, both developing and developed economies. They found “an important role for government in the funding and management of PGC

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53 According to Khula, the vast majority of applications are rejected due to missing eligibility criteria or mistakes on the application form, not to tighter risk criteria.
54 Khula is piloting a portfolio guarantee to address these issues.
55 Subsequent to the first draft of this report, Khula has been addressing a number of these concerns and intends to launch a portfolio guarantee shortly.
56 The distinction is between “loan-level” guarantees and “portfolio” guarantees. In the former, the guarantor typically reviews both eligibility criteria and risk profile. In the latter, the guarantor leaves these reviews to the discretion of the intermediary.
57 Fondo de Garantía Para Pequenos Empresarios.
funds, but less so in risk assessment and recovery, roles that are mostly confined to the private sector." Seventy-two percent of PCGs used a loan-level guarantee, 14 percent a portfolio guarantee, and the remainder a combination. Surprisingly, the study found that 40 percent of schemes offered guarantees of up to 100 percent, with a median coverage ratio of 80 percent. Approximately 50 percent of the schemes in the sample had an absolute guarantee amount; 40 percent had a maximum guarantee period (with a median of 10 years). The study also found a large variation in the time after default that the guarantor paid the intermediary, ranging from very short periods to over one year (in Germany). In only 14 percent of cases did payout happen after the intermediary had written off the loan. In 76 percent of schemes, payout happened either when the borrower defaulted (34 percent) or when the intermediary initiated recovery (42 percent).

The results of the Beck and others study do indicate that, in many respects, the Khula scheme is not an outlier among schemes found globally. Nevertheless, Khula may not be designed optimally for South Africa. In particular, while a 90 percent guarantee rate appears high from the perspective of incentive compatibility mechanisms, this rate is matched by many other schemes. However, Khula’s recovery time is longer than in almost all guarantee schemes in the sample. Additionally, many of these schemes are applied in country circumstances very different from South Africa’s and may not be applicable or effective in a different geography. For example, the ease (or difficulty) of collateral collection may impact the intermediary incentives; and, to be effective elsewhere, the scheme may require that intermediaries share a larger proportion of risk. While the study does not provide clear guidance on the optimal design of a PCG scheme, it seems reasonable to argue that the design of the scheme is an important element in both uptake and performance.

As noted in Honohan (2010), the design of PGC funds should be undertaken with clear objectives against which performance is monitored regularly, pricing set realistically and supported by transparent accounting, and incentives of intermediaries taken into account.

### 4.3.2 Review cost effectiveness and objectives of existing direct credit schemes, and restructure/reform where necessary

As discussed in Section 4.2 above, the performance of the DFIs involved in direct credit provision (to varying degrees, IDC, NEF, UYF, SAMAF, and Land Bank) varies greatly.

The potential justifications for direct government credit schemes are similar to the justifications for subsidies and for partial credit guarantees and can
be used to overcome market failures in which certain borrowers are excluded from the free market. For example, where there are large inequalities in collateral endowments, certain borrowers may be excluded from borrowing from private sector institutions. Alternatively, government lending can be used to kick-start SME lending to certain market segments, either through demonstration effects or by developing market information (for example, credit histories for SMEs), thus enabling private sector institutions ultimately to enter the market. Furthermore, government lending can be justified in offsetting a credit crunch in which a sudden increase in uncertainty could exacerbate information asymmetries.58

The political advantage of using direct credit schemes is that they are easier and faster to control than lending through market mechanisms. Thus, in terms of distribution objectives, governments will find it easier to claim success. Nevertheless, achieving well-performing and sustainable schemes (that is, not needing recapitalizations) is not as straightforward. In particular, credit assessment and operational efficiency are critical success factors. As with PCG funds, it is important to have clear objectives against which performance of direct credit funds is monitored, supported by transparent accounting and reporting. To ensure cost effectiveness, it is important to review the performance of existing schemes and, where necessary, close down or restructure the schemes as appropriate.

Additionally, it may be worth the government’s considering alternative financing schemes. For example, an important message from the demand-side survey is that, over the downturn, banks have become increasingly reluctant to provide longer term investment finance and prefer to provide only working capital. This message implies that banks are less willing to take on term risk. The provision of term funding (either as a credit line or a liquidity facility) could encourage banks to provide term loans to SMEs.

4.3.3 Support development of Business Development Support market through public research

Complementing the risk-sharing mechanisms, such as the lending and guarantees by DFIs, risk-mitigation mechanisms are another critical component of the SME financing landscape. These Business Development Support (BDS) services can help to address some intrinsic weaknesses in SMEs that cannot be addressed through financing tools alone. BDS embraces a wide range of interventions, including counseling, training, mentorship, technical assistance, market-entry assistance, legal advice, business process, and

58 These and additional justifications regarding PCG funds are provided in Honohan 2010.
managerial coaching. Public and private individuals and organizations offer these services broadly or in specific niches. In most cases, some subsidy is required to bridge the real cost of providing the BDS and the SME’s ability to afford those services.

The supply-side survey indicated that banks were increasingly focused on the provision of BDS, and reviewed the delivery channels and effectiveness of their programs. The majority of institutions surveyed, including all of the Big 4, offered business training to their clients, with most providing it as a free service. The financial crisis may have had positive effects in this regard by motivating some institutions to improve their nonfinancial support offerings.

All of the banks and other financial institutions expressed full appreciation for the value of good quality BDS. At the same time, they remained vexed as to how to provide it efficiently and how to ensure that it is appropriate and of a high enough standard over the long term to actually realize its potential benefits. For example, 1 of the Big 4 banks would like to totally outsource BDS, as it does not see it as a competence of the bank and is concerned about the potential conflicts of interest that may arise between playing the dual roles of business advisor and business funder. Nonetheless, even after having looked at international providers of such services (where it presumed it would find greater quality), that bank has yet to see a viable way of implementing the model. Another of the Big 4 takes a hands-on approach to credit appraisal, which in effect, facilitates BDS in the targeted areas of need per application but also is costly and time consuming. A third of the Big 4 banks seems to depend substantially on an external, international business support network, which again seems more effective than the generalized BDS available in the market, but is perhaps not so efficient at or capable of substantial scale.

The BEE codes include a levy of 2 percent–3 percent on before-tax profits (earnings before income tax, depreciation and amortization) to be used for the development of qualifying enterprises. The levy has come under greater scrutiny over the past year, since most major corporations have already done their BEE equity deals and now must look for other areas of the scorecard to maintain or improve their BEE ratings. Even if applied by only a few of South Africa’s leading companies, the values that could be directed to BDS through the enterprise development window could be enormous. These funds would

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59 The relative success of banks lending to franchises indicates the value of lending strategies packaged with BDS. Banks and nonbank financial institutions alike commented on the value that the systems, procedures, training, market identification, branding, and all manner of other elements included in a quality franchise bring, particularly in mitigating the business and entrepreneur risks that stifle funding other SMEs.
dwarf any other amount of money dedicated to this realm, especially considering that it is meant as an annual, not once-off, contribution. At the same time, very few companies seem to know how to effectively and efficiently spend these monies.

New models should start to emerge, as more money comes into the sector and more corporations take part. However, regardless of how substantial a role the banks play in this emerging corporate-sponsored BDS space, the 3 percent levy appears likely to contribute to the development of a more attractive lending environment for banks and others seeking to increase their SME financing activities.

The government has a role in this market both as a provider of BDS, mainly in the form of the Small Enterprise Development Agency (SEDA) and in Khula’s mentorship program.60 In addition to ensuring that these institutions are performing and meeting their objectives, the government should consider ways to promote good practice and efficient use of the money being spent on BDS by the private sector. This promotion could involve research, industry fora, and the provision of technical assistance.

4.3.4 Support development of market credit information for SMEs

As discussed above, survey respondents generally were positive about the availability of market information through the credit bureaus, with 86 percent responding that they considered the credit bureaus effective. However, comments also were received that coverage of businesses was limited61 and did not necessarily include all financing received by the SMEs. Information was incomplete, in part, because the Credit Act did not oblige banks to share information on which credit exposures their SME clients had. However, the main reason is that much of the credit to SMEs came from trade suppliers. Clearly, if information on SMEs’ repayment behavior to their suppliers were available to lenders, this information would provide useful insights into the reliability of a potential SME borrower and would give existing lenders an earlier signal of financial difficulties.

Collecting information on trade suppliers is challenging for the credit bureaus because of the diversity and number of suppliers and systems. However, there is evidence that the credit bureaus are trying to fill this gap by working with suppliers and working on technological solutions to record repayment information. While better information will make it easier for firms

60 See appendix for details of SEDA and Khula’s mentorship program.
61 Start-ups, of course, would not be included. In this case, banks use the personal credit bureau.
to borrow, SMEs themselves tend to be suspicious of sharing their information with a third party.

Given the importance of market information to overcome the problems of asymmetric information and facilitating lending, the government should consider ways it can support the development of the SME credit bureaus. The private sector serves the market well so there does not appear to be a need for a public credit bureau in this space. Nevertheless, there are two potential avenues to consider: (1) refinements to the legal and regulatory framework to improve incentives to share information among lenders and (2) an education campaign to promote the value of credit bureaus among SMEs.

4.3.5 Subsidize R&D on lending technologies to overcome information gaps for SME lending

Around the globe, certain commercial banks have applied lending practices developed in the microfinance sector to overcome the issue of high transaction costs and high risk/low collateral profiles of potential borrowers. The innovations have involved primarily providing small uncollateralized loans and lending larger amounts based on repayment behavior. As discussed in Malhotra and others (2006), Bank Rakyat Indonesia was one of the early adopters of microfinance techniques and achieved good success in scale and reduced costs.

The following are characteristics of commercial banks that successfully apply microfinance technologies to serve SMEs (Malhotra and others 2006):

- Approach is relationship based: relationship-lending model based on qualitative information with emphasis on owner characteristics when sufficient data not available.\(^\text{62}\)
- Initial small, short-term loans are ratcheted up based on repayment performance.
- Loan monitoring and credit risk control mechanisms are intensive.
- Loan officers’ incentives are tied to loan portfolio performance.
- Transaction costs are lowered in several ways: for example, devolved initial screening to village associations (Armenia), and standardization and efficiency benchmarks by branch (BRI).
- Full-cost pricing in the form of interest rates and fees is adopted to achieve sustainability.

\(^{62}\) Wells Fargo is an example of the successful application of credit scoring. Making 67\% of its loan decisions for SMEs automatically, Wells Fargo kept its loan-processing costs among the lowest in the industry.
• Other credit analysis and risk management techniques are used, including:
  • Emphasis on cash flow analysis to determine clients’ ability to pay: for example, ShoreBank in Azerbaijan and Georgia
  • In-depth knowledge of clients and their businesses
  • Credit scoring.

Factoring and leasing are two products that can be used to finance SMEs that lack collateral and/or credit histories. Since it is based on accounts receivable, factoring depends on the credit-worthiness of the buyer. Leasing is based on the ability of SMEs to generate sufficient cash flow to service their lease payments, with their assets working as collateral.

As discussed in Section 3.2, South African banks are innovating and developing new technologies to better serve SMEs. These technologies include development of credit-scoring models and increased automation, analysis of owner characteristics, a “get-to-know-you” period (although this is usually not credit led), and a focus on standardization to keep costs low. The provision of free business development support to SMEs is an additional tool being used to reduce risk.

Since the sector is still developing and experimenting, case studies and lessons from other markets may prove valuable in supporting banks in their innovations. In particular, public support should sponsor potential new entrants with innovative business models to foster competition. In many cases, local banks have received high-quality technical assistance from various organizations to help these banks build up their SME lending businesses. Additionally, workshops to cross-fertilize ideas (for example, with successful microfinance organizations) and provision of information to support innovation may be of use to the SME units of the major banks.

Finally, the government may find it valuable to consider financing the establishment of a new “window” of credit guarantees (distinct from Khula) specifically to stimulate the use of automated scoring techniques. Such a facility, to be used exclusively to guarantee loans that were scored on an entirely automated basis, could be quite modest in scale and, in view of its experimental nature, time limited. This new facility could yield valuable insights into the effectiveness of automated credit scoring.

4.3.6 Review impact of identified regulatory and judicial issues identified in the survey

Many institutions did not feel that regulatory issues had been significant obstacles to their SME lending business and, in some cases, actually had
helped (for example, the National Credit Act, or NCA). Furthermore, the surveyed institutions were unanimous in saying that regulatory initiatives could improve the attractiveness of lending to SMEs. The institutions’ positive expectation implies that government should keep reviewing where improvements can be made and obstacles removed. For example, the respondents did note that there were problems registering and enforcing collateral. Additional concerns were raised about the business rescue provisions of the new Companies Act.

Although individually these issues may not prove to be major constraints, collectively they contribute to create a climate that may be less conducive to SME financing than it needs to be. There are two important objectives. The first is for existing legislation and regulation to be reviewed continually and transparently, for which ongoing research, conducted on a reasonably frequent basis, is an absolute necessity. Second, upcoming legislative and regulatory changes must be assessed objectively based on solid evidence, to avoid possible unintended consequences.
5 Conclusions

Using the results of two surveys, the one a survey of banks and other lending institutions and the other of SMEs, this study makes a number of important observations regarding the provision of bank finance to SMEs in South Africa.

First, lending to SMEs declined over the economic downturn. This decline can be ascribed in part to falling demand for bank loans. Indeed, banks reported that the lack of creditworthy demand was a key obstacle to lending. Nevertheless, there also was evidence of banks that applied tighter credit standards because of an increase in perceived risk of lending to SMEs, which are considered especially vulnerable in recessionary economic conditions. As a result, loan approval rates declined markedly.

Second, firms themselves feel financially more constrained today than they did in 2007. While in 2007 finance was not considered a major obstacle, it was considered so in 2010. Firms thus identified access to finance as a key issue. Moreover, smaller firms that did secure credit were likely to face higher interest rates due to “pricing for risk.” The demand-side survey also indicated that it was harder for SMEs to secure longer term investment financing.

However, the research has also produced some positive findings. The commercial banks appear to be very committed to the SME sector, seeing it as a profitable business in its own right and as a strategically important feeder for future business. Positively, the primary motivation for the banks to engage in this sector was commercial, not driven by public policy priorities. Lending volumes from the large commercial banks to SMEs were considerably larger than from public institutions.

Regulatory constraints, on the side of both banks and SMEs, did not appear hold back SME financing to any great extent. Given that banks have continued to develop their SME lending activities through the downturn, once economic conditions improve, the outlook for the SME sector can be expected to improve. Banks themselves view the prospects for the SME sector to be good and largely unaffected by the downturn, at least in the long term. Banks also are investing in their credit risk technologies and considering appropriate organizational models to better serve the sector.

Nevertheless, there did appear to be more potential to support SME finance. The demand-side survey identified a large unfulfilled appetite for finance from SMEs, especially for longer term finance, which appeared particularly hard to access. On the supply side, the perception among banks was that SMEs were both higher risk and more costly to serve. Consequently, the
banks remained cautious in lending to the sector, for example, by employing long “get-to-know-you” periods prior to lending. Additionally, the robust profitability of SME units in banks resulting from a focus on nonlending products and deposits suggested additional scope for lending to this market segment.

Government programs, especially the Khula guarantee scheme, provided incentives for banks to lend to some untapped parts of the market. However, in the context of the market as a whole, volumes were very low and declined considerably in recent years. Banks commented on the complex and time-consuming nature of the program and the low effective guarantee coverage provided, which undermined Khula’s economic attractiveness. Lending volumes in other government programs also tended to be low in comparison to the private sector. These programs were not necessarily systematically targeting the SME sector and often had high rates of nonperformance, calling their sustainability into question.

While there have been considerable developments in the provision of BDS in both the public and private sector domains, challenges remain in how to effectively provide this key nonfinancial support mechanism.

There appeared to be considerable potential for government to strengthen support and provide appropriate incentives to the private sector banks and financial institutions, which have shown themselves committed to serving the SME sector. Government should be prepared to transparently assess the effectiveness of existing programs and consider ways to capitalize on the private sector’s commitment to SMEs. Government could initiate a range of potential interventions, such as credit guarantees, wholesale term lending that could be funded by a credit line or liquidity facility, support for the provision of business development services, and support to develop a market for credit information. In particular, government should take into account ways to address some of the themes identified in the surveys, especially the difficulties faced by SMEs in accessing longer term investment loans.

While regulatory factors were generally not perceived as a hindrance to SME lending, some respondents noted that there were problems registering and enforcing collateral. Concerns also were raised about the impact that the Companies Act could have on the ability of lenders to recover outstanding debts in the event of a small business failure. While the financial sector is considering the operational implications of the legislation, the impact should be carefully monitored.

In addition, a number of obstacles to lending due to demand-side factors were identified. Chief among these was the perceived lack of business skills of SME owners applying for loans. While this lack speaks to the
major developmental issue of education policy, government also has a role to encourage the effective delivery of BDS. The performance of existing BDS schemes has been variable due in part to the difficulty of finding consistently high-quality BDS service providers. On the other hand, there does not appear to be consensus on what constitutes a “best practice” model of BDS provision.

The focus of this study was predominantly access to finance for formal sector SMEs. Other studies, such as the FinScope Small Business 2010 survey, have indicated that access to finance for smaller and informal businesses can be considerably more challenging than for formal SMEs. Viewing the South African economy as a simple two-economy model, with an advanced economy working in parallel with a much poorer, less developed economy, can be a useful framework for thinking about the challenges of defining appropriate policy to promote access to finance. If banks are able to generate stable and profitable business within the advanced sector, what drives them to compete in the less developed sector? Nevertheless, in the long run, the biggest opportunities lie in the less developed sector.

Given the “green shoots” in the macroeconomy, the prospects for the SME sector certainly look brighter than they did 12 months ago. Moreover, South Africa’s private financial sector looks well placed to serve the financing needs of many SMEs. Nevertheless, given South Africa’s entrenched economic divisions, there remains an important role for an active, market-leading policy stance to address structural obstacles and to ensure access to finance for all entrepreneurs.
Appendices
Historical Overview of the SME Sector in South Africa: Key Policy Issues

When the ANC assumed power in 1994, it inherited an economy that was not only overwhelmingly owned by the minority White population but also dominated by a small number of monopolies and oligopolies whose existence made life extremely challenging for independent small businesses. In 1992 the top 6 conglomerates controlled 85.7 percent of the market capitalization of the Johannesburg Stock Exchange (JSE).\(^62\) By 2002 the top five still represented 59.8 percent of the JSE.\(^63\) Concentration of market power, as well as ownership, in the hands of a few large firms was a significant problem in South Africa at that time. Despite the passage of the Competition Act in 1998, which gave government the powers to force the break-up and restructuring of conglomerates, these concentrations remain today. They have contributed to a particularly hostile environment for SMEs, especially in the start-up phase, and are a major reason why SMEs in South Africa contribute a lower share of both employment and output than comparable countries.\(^64\)

This uneven playing field was the backdrop against which the ANC quickly sought to provide broad-ranging support to SMEs. Competition policy was part of the response.

The ownership imbalances were addressed through a range of Black Economic Empowerment (BEE) initiatives that cut across the entire economy and had particular significance for SME development.\(^65\) A broad-based Black Economic Empowerment Act was passed only in 2004 following a Black Economic Empowerment Commission, which reported in 2001. Nevertheless,


\(^{63}\) Anglo, Sanlam, Mutual, Liberty, Rembrandt.

\(^{64}\) However the estimates vary considerably and depend on whether microenterprises are included in the percentages. For example, one government-supported research study (SMEs’ Access to Finance in South Africa—a Supply-Side Regulatory Review, (Falkena and others 2002) suggested that SMMEs (that is, including microenterprises could account for 50%–60% of employment.

\(^{65}\) It should be noted that BEE was about much more than just ownership. It was about a broad range of additional factors including skills development, procurement and access to financial services.
BEE principles had informed industrial and economic policy from the moment that the ANC had assumed power. New legislation emerged covering, for example, employment equity and preferential procurement and the creation of the National Empowerment Fund. NEF aimed to give previously disadvantaged South Africans access to funding to enable them to take advantage of emerging economic opportunities, such as privatizations. A number of important industry empowerment charters also predated the BEE Act, all containing important provisions regarding SMEs.

Given the ownership structure of South Africa’s economy and the market dominance enjoyed by a few large firms, it is easy to see how government policy toward SMEs and BEE became so closely intertwined. The theory went that, to build capital, talented Black or women entrepreneurs had little choice but to establish their own businesses. Government could tilt the balance in favor of Black or women entrepreneurs by creating incentives for large corporations to buy from them and for financial institutions to lend to them. It put White owners of small businesses in a peculiar position—theoretically, at least, able to benefit from a more competitive economy but generally, and perhaps justifiably, denied access to the preferential treatment enjoyed by their Black and female competitors. Most small enterprises were of course White-owned at the time the ANC came to power and research indicates that a majority of larger small enterprises are in fact still White-owned.

Since 1994, there has been no shortage of government-led activity in support of SMEs. Key milestones were as follows:

- A White Paper was published in 1995, following a Presidential Conference on Small Business in March of that year.
- A number of new institutions also were established in 1996. These included Khula Enterprise Finance, set up to provide wholesale funding and guarantees to SMEs through retail intermediaries and the Ntsika Enterprise Promotion Agency, set up to provide nonfinancial support to SMEs.
- The National Empowerment Fund Act was passed in 1998.
- The Umsobomvu Youth Fund, set up to provide finance and business development services to young people in business, was set up in 2000.
- The Financial Sector Charter was signed in 2003.

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66 White-owned business in fact can benefit from the Khula indemnity program.

67 FinScope Small Business 2005—63% of businesses in BSM7 (the uppermost segment identified in that survey) were White-owned.

68 Being a private sector initiative, this is not strictly a government policy measure but had a similar effect.
• The Small Enterprise Development Agency (SEDA) was formed in 2004 to merge together the main government providers of nonfinancial support to SMEs, including Ntsika.

• The South African Microfinance Apex Fund (SAMAF), set up to provide finance to microenterprises via retail intermediaries, was launched in 2005.

• The Accelerated and Shared Growth Initiative for South Africa (ASGISA) was launched in 2006. ASGISA was a set of initiatives that aimed to accelerate South Africa’s growth rate and halve unemployment and poverty by 2014. It aimed to tackle the binding constraints on growth including, explicitly, the problem of red tape for SMEs.

• The National Credit Act (NCA) was passed in 2006, affecting the way credit providers lend to sole proprietorships and close corporations (but not limited companies).

• A new Companies Act was passed in 2009, introducing new provisions surrounding the rescue of businesses in distress and the phasing out of close corporations.

There has also been emphasis on SME development in economic and industrial policy statements, not least within GEAR\(^69\) itself, the core economic policy framework adopted in 1996 and still essentially in force today, but also, for example, in the Department for Trade and Industry’s Manufacturing Strategy (2001) which identified key industry sectors for SME development including tourism and agro-processing.

Various other funding schemes for SMEs became available, including through the parastatal Industrial Development Corporation (IDC) and, at a regional level, through provincial government.

There has also been a sustained effort to ease the regulatory and tax burden for small business—for example, VAT procedures were progressively streamlined and qualifying tax thresholds for small business increased. In 2009, tax administration for small businesses with a turnover of less than R1m was simplified by the introduction of a single turnover tax to replace all the other taxes with which small business were required to comply. Legislation has also been passed giving equity investors in small businesses a tax rebate to address a perceived “equity gap” afflicting this segment.

Unfortunately, despite the activity and undoubted policy commitment, many of the higher profile initiatives have not been successful, although there is some evidence that the Khula indemnity program is drawing some bank finance into parts of the market that the banks would otherwise avoid.

\(^{69}\) Growth, Employment and Redistribution: A Macro-Economic Strategy
As the BEE Commission report itself said in 2001: “Government initiatives have ... suffered from a lack of institutional support, poor co-ordination, insufficient focus, unclear mandates and insufficient outreach.” Later research found that many business owners are simply unaware of government SME support services and as a consequence these are underutilized. The government’s institutional response to SME development is considered in more detail later in this report.

The core of the ANC’s economic policy GEAR was its emphasis on fiscal deficit reduction and maintaining a consistent monetary policy to keep inflation under control. Despite being caricatured as “neo-liberal,” GEAR in fact explicitly referenced the need to enhance support to industry and also acknowledged the various SME-related initiatives which were by then well under way. Nonetheless, over the years that followed, GEAR attracted criticism from the political left for being insufficiently redistributive and in particular for its failure to deliver on job growth. As a result there was sustained pressure from community groups and indeed from the ANC’s own alliance partners, especially in the early years of the new millennium, for more government intervention to support priority areas that were considered likely to have a direct and beneficial impact on the poor. This included SME development.

Under the overall stewardship of the National Treasury, the policy stance toward the financial sector has consistently tended toward facilitating market-based approaches, rather than coercive measures or direct government provision—this, notwithstanding a view that is shared across government, including within National Treasury, that there are significant market failures that perpetuate financial exclusion, including the exclusion of small enterprises. While the market-leaning language that characterizes mainstream economic and financial sector policy seems to contrast with some of the rhetoric surrounding SME policy specifically, it is fairly clear that the more interventionist policy statements are directed at microenterprise development with the expectation that market provision would take care of larger small businesses. And, in fact, if one considers that Khula-guaranteed loans account for less than 5 percent of the small enterprise lending books of the major banks, it is clear, overwhelmingly, that this is what has happened. Private sector lending has dominated—with specialist players such as Business Partners and GroFin, specifically targeting smaller businesses (although not micro-businesses),

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70 FinScope Small Business (2005) found that only 28% of small business owners in Gauteng province were aware of any government SME support schemes—and of these only 43% were aware of Khula, the main provider of government finance and guarantees for SMEs.

71 The South African Communist Party and the Congress of South African Trade Unions (COSATU).
often with an innovative blend of finance and business advisory support. There have also been SME-related interventions from companies in the industrial sector as well, such as Anglo American, Barloworld and Sasol.

Against this background, the recent extension in Khula’s mandate to allow it to offer loans directly to clients (Khula Direct) is a clear departure. The initiative requires that Khula itself be recapitalized and this is yet to happen.

As political tensions grew over the pace with which economic inequalities were being addressed, there was particular attention on microenterprise development following a speech by former President Thabo Mbeki in 2003 on the duality of South Africa’s economy (“two parallel economies”) and the need to tackle the country’s largely underdeveloped and informal “Second Economy.” The existence of a Second Economy was “a reflection of both the legacy of apartheid colonialism and market failures which render the First Economy incapable, on its own volition, from contributing to the elimination of the “two economies”72. This presaged more government intervention vis-à-vis microenterprises with the eventual launch of a new microfinance apex, SAMAF. As with many of the other supply-led, government initiatives, SAMAF’s performance has been pedestrian.

One very visible sign of mounting dissatisfaction with the direction of economic policy was the Red October Campaign, led by the SA Communist Party and others which started in October 2000. These were nationwide street protests against discriminatory bank lending policies, nominally directed at the banks but clearly aimed to influence government policy too. The Campaign led eventually to a Financial Sector Summit in 2002 involving banks, labor, government and civil society, at which the banks agreed to certain commitments around access to finance, and initiated a process that ultimately led to the Financial Sector Charter.

Whilst the Charter can be seen as a pre-emptive strike by the financial industry against the possibility of unpalatable legislation (a draft Community Reinvestment Bill was being actively considered at the time), it is a nevertheless a voluntary commitment by the industry to transformation and BEE and contained very specific provisions relating to Black- and women-owned small businesses. Specific commitments included:

- New lending to Black- and women-owned small businesses (“Black SMEs”) of R5bn by 2008. Black SMEs were defined as having a turnover of between R500,000 and R20m

• 50 percent of procurement to come from BEE-accredited companies by 2008

• Support to Black SMEs to enable them to take advantage of preferential procurement

• Support for second and third tier financial organizations (whose clients were expected to be small businesses).

The initial period of the Charter ran from 2003 to 2008. By 2007 already, the financial industry had met its procurement target for 2008 and easily exceeded the R5bn target for loans to Black SMEs, promoting critics to suggest the targets were too easy. Today, the major banks say that if the Financial Sector Charter were to disappear73 it would have no impact on their lending to small enterprises, that is, it would not result in them lending less to small enterprises. This would seem to suggest that the indirect policy push behind the Charter was not especially effective in moving the banks into areas they were not already comfortable with. This interpretation may be too cynical: a formal impact review would probably conclude that the Charter has had a positive impact on Black SMEs in terms of their access to finance and business development. Government’s view, however, seems to be that the Charter has played only a limited role in tackling the broader challenges of SME development.

Toward the end of the Mbeki Presidency, and as the Charter was at its half-way point, the role of small enterprises was given further prominence with the launch, in February 2006, of the Accelerated and Shared Growth Initiative for South Africa (ASGISA). This was portrayed not as a strategy but as a set of initiatives that aimed to accelerate South Africa’s growth rate and halve unemployment and poverty by 2014. Not only did ASGISA aim to “eliminate” the Second Economy, but it also identified the burden of the regulatory environment on small and medium businesses as a binding constraint on the country’s growth. While some of ASGISA’s proposed initiatives were rather vague, others, including those relating to regulatory reforms intended to benefit SMEs, were much less vague.

However, ASGISA’s timing was unfortunate: soon after its launch, the country was heading for much more difficult economic conditions and there was a change of administration with the recall of President Mbeki, the appointment of President Kgalema Motlanthe and eventually the election of

73 Technically, the Charter is no longer operative as it has not been gazetted under the BEE Codes. Nevertheless, the financial industry claims to be continuing to operate as if the Charter were still in force, which is indicative of its political significance.
President Jacob Zuma. With these political changes, ASGISA, as a formal policy, lost its traction and is no longer core government policy.

Under the Zuma administration, the core tenets of economic policy remain largely unchanged and, with the economic downturn, the government does not have the financial flexibility to embark on more interventionist policies toward SMEs, even if it chose to do so. There is still some uncertainty about which ministries are to assume responsibility for the main governmental institutions that have a bearing on SME development (namely, Khula and IDC) although it is reported that the new Department for Economic Development will play a significant role one way or another in SME development in the future, alongside the Department for Trade and Industry. The Department for Economic Development is still not operational, however, and so it is too early to tell what the new policy implications of the move (if any) might be.

In conclusion, therefore, policy toward SME development since 1994 has been very largely shaped by considerations of competitiveness and Black Economic Empowerment. Much of the poverty alleviation rhetoric surrounding SME policy has clearly been aimed at supporting microenterprise development: government’s track record in promoting institutions to support small businesses, including microenterprises, has been generally quite patchy. On the other hand, there has been solid progress toward creating a more conducive enabling environment for small business, through, for example simplified tax administration and new companies’ and credit law. Government remains concerned that the banking sector is still not doing enough to support small businesses and, as a consequence, the impetus toward direct government intervention remains. Since the formal end of apartheid, small business development has always been a politically charged issue in South Africa and seems likely to remain so.
A2 Survey Methodologies

A2.1 Demand Side

This demand-side component of the study is based on a sample of firms interviewed in the World Bank’s South Africa Enterprise Survey of 2008. In other words, firms were re-interviewed in 2010 to assess how the global economic crisis and the worsening domestic economic environment had affected those firms specifically.\(^{74}\)

The survey instrument for both the 2008 and 2010 surveys was a written questionnaire that was conducted through face-to-face interviews with the firm managers. The surveys collected information on four broad areas: managers’ ratings on a common scale of different aspects of their business environment; objective indicators of the various dimensions of the business environment; financial, production, employment, assets, sales and technological information; and key business characteristics such as age and form of organization.\(^{75}\)


The Enterprise Survey of 2008 covered a sample of 1,057 establishments sampled from four locations: Johannesburg (68 percent), Cape Town (14 percent), Port Elizabeth (6 percent), and Durban (12 percent). About two thirds of the sample was drawn from selected manufacturing industries. The rest of the sample was drawn mainly from the retail sector that accounted for almost 22 percent of the final sample. Most importantly for our analysis the breakdown by size category shows that 47 percent of the sampled firms were small enterprises (5–19 workers; 495 firms), 35 percent of the sampled firms were medium enterprises (20–99 workers; 366 firms) and 18 percent of the sampled firms were large firms (over 100 workers; 196 firms).\(^{76}\) Firms were selected using a stratified random sampling scheme, with strata defined by employment size. The full distribution of the 2008 sample is presented in Table A1.

\(^{74}\) These datasets are maintained by the Enterprise Survey Unit of the World Bank which provides standardized surveys for over 100 countries (www.enterprisesurveys.org).

\(^{75}\) The questionnaire can be downloaded online (www.enterprisesurveys.org).

\(^{76}\) Notice the classification into small, medium and large firms done on the demand side differs from that made by banks on the supply side of the document.
### Table A1: Distribution of 2008 Sample by Industry

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<th>Number</th>
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<td></td>
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<td>Food</td>
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<td>Plastic and rubber</td>
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</tr>
<tr>
<td><strong>Services (339)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale</td>
<td>14</td>
<td>1.32</td>
</tr>
<tr>
<td>Retail</td>
<td>229</td>
<td>21.67</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>65</td>
<td>6.15</td>
</tr>
<tr>
<td>Transport</td>
<td>2</td>
<td>0.19</td>
</tr>
<tr>
<td>Information Technology</td>
<td>4</td>
<td>0.38</td>
</tr>
<tr>
<td>Other Services</td>
<td>25</td>
<td>2.37</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>4</td>
<td>0.38</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1057</td>
<td>100</td>
</tr>
</tbody>
</table>

### A2.1.2 The World Bank Enterprise Survey of South Africa, 2010

To analyze the impact of the global financial crisis on firm performance, and evaluate changes in terms of access to finance for SMEs in South Africa, a number of the firms sampled in the Enterprise Survey of 2008 were re-interviewed in 2010. In addition to the standard questions included in the 2008 survey, the 2010 survey collected specific information about the economic environment and conditions in the aftermath of the global financial crisis.77

The 2010 survey attempted to interview all companies surveyed in 2007 however, only a proportion could eventually be interviewed. Out of the 1,057 firms interviewed in 2008 only 234 firms (that is, over 20 percent) were successfully interviewed. We classify the remaining 78 percent of the firms that

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77 The questionnaire can be downloaded from www.enterprisesurveys.org.
failed to be interviewed as either exits from the sample (165 firms) or other (658 firms). Table A2 provides a summary of the reasons for firm disappearance from the 2010 sample.

**Table A2: The 2010 Survey Follow-Up**

<table>
<thead>
<tr>
<th>Status</th>
<th>Freq</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Re-interviewed (234)</td>
<td>234</td>
<td>22.14</td>
</tr>
<tr>
<td>Could not be re-interviewed (823)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exit (165)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business has closed down</td>
<td>14</td>
<td>1.32</td>
</tr>
<tr>
<td>Cannot trace the address</td>
<td>68</td>
<td>6.43</td>
</tr>
<tr>
<td>Company discontinued business</td>
<td>8</td>
<td>0.76</td>
</tr>
<tr>
<td>Company is not active</td>
<td>1</td>
<td>0.09</td>
</tr>
<tr>
<td>New company located at site, but refused to participate</td>
<td>1</td>
<td>0.09</td>
</tr>
<tr>
<td>No business located at this address</td>
<td>2</td>
<td>0.19</td>
</tr>
<tr>
<td>No such street number or company in this address</td>
<td>1</td>
<td>0.09</td>
</tr>
<tr>
<td>Not a business: a private household</td>
<td>23</td>
<td>2.18</td>
</tr>
<tr>
<td>Went bankrupt</td>
<td>2</td>
<td>0.19</td>
</tr>
<tr>
<td>Wrong address/moved away and cannot get new address</td>
<td>9</td>
<td>0.85</td>
</tr>
<tr>
<td>Other 1</td>
<td>36</td>
<td>3.41</td>
</tr>
<tr>
<td>Other (658)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business was bought out by another company</td>
<td>15</td>
<td>1.42</td>
</tr>
<tr>
<td>Company has moved abroad</td>
<td>1</td>
<td>0.09</td>
</tr>
<tr>
<td>Company has relocated</td>
<td>21</td>
<td>1.99</td>
</tr>
<tr>
<td>Duplicate</td>
<td>13</td>
<td>1.23</td>
</tr>
<tr>
<td>Have tried on numerous occasions, but are continually asked to call back</td>
<td>149</td>
<td>14.10</td>
</tr>
<tr>
<td>Have visited address but respondent not there</td>
<td>1</td>
<td>0.09</td>
</tr>
<tr>
<td>No address, suburb, street</td>
<td>21</td>
<td>1.99</td>
</tr>
<tr>
<td>Outside of the regions covered</td>
<td>4</td>
<td>0.38</td>
</tr>
<tr>
<td>Owner away until end June</td>
<td>8</td>
<td>0.76</td>
</tr>
<tr>
<td>Refusal to participate in survey</td>
<td>300</td>
<td>28.38</td>
</tr>
<tr>
<td>Other 2</td>
<td>125</td>
<td>11.83</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1057</td>
<td>100</td>
</tr>
</tbody>
</table>

1. No street number provided and no such company in the street; Business no longer in operation; Company no longer there; Construction site; Empty building; Empty Field; New company there; Not a business: a private household; Premises empty.
2. Could not get appointment before cut off; Could not make an appointment; Same address as other company in the survey.
It is worth noting that the failure to re-interview the full 2008 sample results in a nonrepresentative sample for 2010. However, the overall sample composition of firms in the 2010 survey is very similar to that of 2008. The main characteristics of the 2010 sample are summarized in Table A3.

Regarding size distribution, the composition of the sample in 2010 is similar to the one in 2008, and in both surveys approximately 80 percent of the surveyed firms are SMEs. The breakdown by size category shows that 52 percent of the sampled firms were small enterprises (5-19 workers), 31 percent of the sampled firms were medium enterprises (20-99 workers) and 17 percent of the sampled firms were large firms (over 100 workers). The median firm has 14 employees with great variation between SMEs and large firms, the former employing on average 11 workers while the latter over 400 on average. The majority of firms belong to the “Food,” “Other manufacturing” and “Retail” sectors. In fact, almost 40 percent of SMEs included in the survey operate in the Retail sector. A quarter of the firms are direct exporters, especially among larger firms where more than half of the sample reports some nondomestic sales. Only 5 percent of the sampled firms are foreign owned and, similar to exporters, foreign ownership is more prevalent among larger firms. Finally, in half of the sampled firms the main owner is White or Caucasian with great variation across firm size. In only 5 percent of large firms is the main owner Black.

**Table A3: Characteristics of the 2010 Sample**

<table>
<thead>
<tr>
<th>Measure</th>
<th>All Firms</th>
<th>SMEs</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of Firms</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Firms</td>
<td>234</td>
<td>194</td>
<td>40</td>
</tr>
<tr>
<td><strong>Number of Employees</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>14</td>
<td>11</td>
<td>163.5</td>
</tr>
<tr>
<td>Mean</td>
<td>86.31</td>
<td>18.99</td>
<td>412.80</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>510.13</td>
<td>22.43</td>
<td>1191.78</td>
</tr>
<tr>
<td><strong>Industry (percentage)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food</td>
<td>10.26</td>
<td>7.73</td>
<td>22.50</td>
</tr>
<tr>
<td>Textiles</td>
<td>2.14</td>
<td>2.06</td>
<td>2.50</td>
</tr>
<tr>
<td>Garments</td>
<td>4.27</td>
<td>3.61</td>
<td>7.50</td>
</tr>
<tr>
<td>Chemicals</td>
<td>3.85</td>
<td>3.61</td>
<td>5.00</td>
</tr>
<tr>
<td>Plastic and rubber</td>
<td>3.42</td>
<td>2.58</td>
<td>7.50</td>
</tr>
<tr>
<td>Non metallic mineral products</td>
<td>0.43</td>
<td>0.52</td>
<td>0.00</td>
</tr>
</tbody>
</table>

(continued)
<table>
<thead>
<tr>
<th>Measure</th>
<th>All Firms</th>
<th>SMEs</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Metals</td>
<td>0.85</td>
<td>1.03</td>
<td>0.00</td>
</tr>
<tr>
<td>Fabricated metal products</td>
<td>6.41</td>
<td>5.15</td>
<td>12.50</td>
</tr>
<tr>
<td>Machinery and Equipment</td>
<td>2.56</td>
<td>2.58</td>
<td>2.50</td>
</tr>
<tr>
<td>Electronics</td>
<td>1.71</td>
<td>2.06</td>
<td>0.00</td>
</tr>
<tr>
<td>Other Manufacturing</td>
<td>14.96</td>
<td>15.98</td>
<td>10.00</td>
</tr>
<tr>
<td>Construction</td>
<td>3.42</td>
<td>1.55</td>
<td>12.50</td>
</tr>
<tr>
<td><strong>Services</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale</td>
<td>6.84</td>
<td>7.73</td>
<td>2.50</td>
</tr>
<tr>
<td>Retail</td>
<td>34.62</td>
<td>39.18</td>
<td>12.50</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>2.14</td>
<td>2.58</td>
<td>0.00</td>
</tr>
<tr>
<td>Transport</td>
<td>0.85</td>
<td>0.52</td>
<td>2.50</td>
</tr>
<tr>
<td>Information Technology</td>
<td>0.85</td>
<td>1.03</td>
<td>0.00</td>
</tr>
<tr>
<td>Other Services</td>
<td>0.43</td>
<td>0.52</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>Percentage of Exporters</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indirect</td>
<td>12.39</td>
<td>12.37</td>
<td>12.5</td>
</tr>
<tr>
<td>Direct</td>
<td>25.64</td>
<td>19.59</td>
<td>55</td>
</tr>
<tr>
<td><strong>Percentage of Importers of Materials</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct</td>
<td>32.48</td>
<td>27.84</td>
<td>27.84</td>
</tr>
<tr>
<td><strong>Ownership—average percentage of capital owned by</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic</td>
<td>92.35</td>
<td>93.71</td>
<td>85.85</td>
</tr>
<tr>
<td>Foreign</td>
<td>5.34</td>
<td>4.03</td>
<td>11.59</td>
</tr>
<tr>
<td><strong>Ethnicity of Major Shareholder</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Don’t know</td>
<td>2.14</td>
<td>1.55</td>
<td>5</td>
</tr>
<tr>
<td>Not applicable</td>
<td>5.56</td>
<td>2.58</td>
<td>20</td>
</tr>
<tr>
<td>African</td>
<td>20.94</td>
<td>24.23</td>
<td>5</td>
</tr>
<tr>
<td>Indian</td>
<td>13.68</td>
<td>15.98</td>
<td>2.5</td>
</tr>
<tr>
<td>Lebanese or Middle Eastern</td>
<td>0.43</td>
<td>0.52</td>
<td></td>
</tr>
<tr>
<td>Other Asian</td>
<td>1.28</td>
<td>1.55</td>
<td></td>
</tr>
<tr>
<td>European</td>
<td>50</td>
<td>46.91</td>
<td>65</td>
</tr>
<tr>
<td>Other</td>
<td>2.56</td>
<td>2.58</td>
<td>2.5</td>
</tr>
</tbody>
</table>

Out of the 194 SMEs interviewed in 2010, 93 percent were drawn from Town/City while the 7 percent remaining were located in smaller urban centers. Regarding the location of SMEs, the majority (61 percent) were located in Johannesburg, 16 percent in Cape Town, 15 percent in Durban and 8 percent in Port Elizabeth.
Forty-seven percent of the surveyed SMEs adopt the legal form of sole proprietorship, followed by 37 percent of SMEs that are organized as privately held, limited companies. Publicly listed companies are only 5 percent of the sampled SMEs.

In addition, 30 percent of SMEs report females among the owners of the firm.

### A2.2 Supply Side

Data on banks’ involvement with SMEs was collected via a specially designed questionnaire, administered to selected banks during May 2010. The questionnaires were completed and returned to the World Bank in advance of on-site discussions with the project team. At the outset, it was made clear to the participating institutions that the results of the survey would remain anonymous or be aggregated, and as such the institutions should not have an incentive to withhold potentially sensitive information about their SME businesses.

Institutions were chosen both to represent the major players actively involved in SME finance, and to be broadly reflective of the broader banking sector in South Africa. The institutions included the major private-sector commercial banks, niche banks focused on the SME sector, and other institutions with a broader development mandate. In total, eight institutions were surveyed,\(^78\) representing 89 percent of assets in the banking sector in 2009.\(^79\)

Overall, the questionnaire comprises 72 questions. It is focused on credit to SMEs, with the intention of addressing four broad areas: (1) the extent of the bank’s involvement with SMEs, (2) determinants of SME bank financing, (3) the bank’s SME business model (including products and credit risk management), and (iv) the effect of the international financial crisis of 2008–2009 and the domestic economic downturn that began in 2008. The questionnaire was loosely structured around work undertaken in previous World Bank studies across the globe (as discussed in the Introduction), but was updated and adapted to reflect local market conditions and give particular attention to the impact of the economic downturn on financing for SMEs in South Africa.

While the questionnaire is broadly focused on SMEs, institutions were asked to separate out responses by small enterprises (SEs), medium enterprises (MEs), and, where applicable, microenterprises (MI) and large

\(^{78}\) The full list of surveyed institutions is as follows (in alphabetical order): Absa Bank, Business Partners, First National Bank, Industrial Development Corporation, National Empowerment Fund, Nedbank, Sasfin, and Standard Bank. Discussions also were held with Khula, although as a wholesale funder, this institution was not asked to complete the full written survey.

\(^{79}\) Bankscope database and authors’ calculations.
enterprises (LEs). Respondents were asked to provide their own definitions of these categories, and therefore also provided data according to their own definitions. While this may make the analysis of cross-institution data more challenging, there are benefits in terms of understanding how different banks approach this market segment. Additionally, practical considerations meant that it would not be possible for institutions to restate their data according to a standardized definition within the timeframe required and at limited cost.

Table A4 shows the median turnover ranges for microenterprises, small enterprises and medium enterprises for the banks surveyed, and compares this to the median ranges from national definitions. For micro and small enterprises, the banks do employ a definition close to that implied by the national definitions. For medium enterprise, the national definitions are considerably lower.

**Table A4: Definitions of SME According to Turnover Limits (R million)**

<table>
<thead>
<tr>
<th></th>
<th>Surveyed Banks</th>
<th>National Small Business Act</th>
<th>Financial Sector Charter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Microenterprise</td>
<td>0–0.4</td>
<td>0–0.2</td>
<td>0–0.5</td>
</tr>
<tr>
<td>Small enterprise</td>
<td>0.4–8.75</td>
<td>0.2–13</td>
<td>0.5–20</td>
</tr>
<tr>
<td>Medium enterprise</td>
<td>8.75–100</td>
<td>13–26</td>
<td></td>
</tr>
</tbody>
</table>

It should be noted that given participation in the survey was voluntary for the banks, a full set of responses was not necessarily received for each question. This was especially the case in the quantitative sections, when banks may not have had the information readily available in the format required. The analysis of the results is therefore supplemented with information provided during the face-to-face discussions. The public information discussed above provides a useful cross-check to the survey results, although the survey questions are more specifically targeted at the experience of units specifically serving small enterprises.

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80 It should be noted that at a feedback session with representatives of the Big 4 suggested that the following turnover ranges were becoming the industry norm: Micro (R0–5 million); Small (R5–35 million).
Given the failure to interview all sampled firms on the demand side from the 2008 survey we acknowledge the potential sample selection bias arising from interviewing the surviving firms and therefore studied the determinants of exit from the sample paying particular attention to the role played by access to finance.

Table A5 shows the main characteristics of the firms that completed the interview in 2010 and those that went out of business. On average firms that exited the sample are smaller and younger. In fact, 50 percent of the exiting establishments had less than 20 employees. Exiting firms were on average less export oriented than survivors and approximately 16 percent of the failures were foreign owned. Regarding access to finance, 22 percent of exiting firms considered finance as a major or severe obstacle to growth, as opposed to 9 percent of surviving firms. In fact, while 35 percent of the surviving firms had a line of credit or loan in 2007, only 28 percent of the exiting firms had access to this type of financial instruments. However, on average, both exiting and surviving firms financed approximately 11 percent of their investment projects through bank financing.

Table A5 presents basic characteristics of the surviving and exiting firms and although the data seems to point to a positive correlation between financial obstacles and firm exit, the data do not allow us to rule out the possibility that firms that did not have a line of credit or loan in 2007 might have acquired one in the consecutive years before going bankrupt, or that other firm specific characteristics correlated or uncorrelated with access to credit explain firm survivorship. A basic study of determinants of firm survivorship (Table A6) shows that the probability of exit is not correlated to firm size; however, more established firms are more likely to survive. Most importantly, the analysis shows that firms that, in 2007, considered finance a major obstacle to growth were more likely to exit. However, this measure of access to finance is based on the subjective perceptions of the firm and might not

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81 As already suggested in Table A2, we define exit as those situations in which the firm was not interviewed because the business had closed down, the business went bankrupt, the business no longer had a telephone line, there was no reply after 12 or more attempts to contact the business, there was no such company in that street, the telephone number did not exist and there was no listing on internet, when there was a wrong number and it was not possible to locate the firm, and when the address corresponded to a private household.
correspond to quantitative measures of access to finance. In other words, if finance is a problem for survivorship what are the main channels?

**Table A5: Characteristics of the Survivor and Exiting Firms**

<table>
<thead>
<tr>
<th>Measure</th>
<th>Completed</th>
<th>Exitd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Firms</td>
<td>234</td>
<td>165</td>
</tr>
<tr>
<td>Average (Median)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size (number of employees)</td>
<td>121.75 (24)</td>
<td>43.02 (19)</td>
</tr>
<tr>
<td>Age</td>
<td>18.66 (14)</td>
<td>13.32 (9)</td>
</tr>
<tr>
<td>Percentage of the value of the loan required as collateral</td>
<td>102.28</td>
<td>114.47</td>
</tr>
<tr>
<td>Percentage of working capital financed through banks</td>
<td>8.62</td>
<td>7.01</td>
</tr>
<tr>
<td>Percentage of investment financed through banks</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Value Added per Employee</td>
<td>246309.3</td>
<td>252159.2</td>
</tr>
</tbody>
</table>

**Percentage of Firms ...**

... with less than 20 employees | 41% | 50%
... that export | 25% | 19%
... foreign owned* | 10% | 16%
... that report Finance as a major or severe Obstacle | 9% | 22%
... with a Line of Credit and/or Loan | 35% | 28%
... with a Loan that were required to provide Collateral | 73% | 74%

*Foreign: A company is defined as foreign if a foreign national owns 10 percent or more of the company shares.

We explore the role of two different measures of access to finance on the probability of exit: whether the establishment had a line of credit/loan and collateral requirements (Table A7). We find that once we control for firm specific characteristics, factors such as having a line of credit or whether the establishment was required to provide collateral are not significant predictors of the probability of exit. However, once we allow for a nonlinear effect of size, firms holding a line of credit or loan are less likely to exit. In other words, large firms holding a line of credit or loan are less likely to exit; however, having a line of credit does not significantly affect the probability of exit in the case of SMEs.

Therefore, firms that report a worsening perception in access to finance are more likely to exit the sample but having a line of credit or loan or collateral requirements does not seem to be the only mechanism. We proceed by exploring the impact of different financial options for working capital and investment respectively on the probability of exit. The main finding is that...
firms with higher levels of their working capital financed through customers and suppliers have a higher tendency to exit the sample, while other forms of financing do not significantly affect the probability of exit (Table A8). Contrary to the different methods of financing working capital in the case of investment the different options have no differential impact on the probability of exit (Table A9). One possible explanation for this result is that while investment in fixed assets might reflect business opportunities and a desire on the part of the firm to expand, financing of working capital is required for daily operations. Therefore, given the increased uncertainty in the business environment provoked by the economic downturn, customers and suppliers might have been more reluctant to finance working capital. This would have ultimately translated into a higher probability of exit of those firms that were more reliant on this type of financing and that could not substitute it with other means of financing.

**Table A6: Basic Determinants of Firm Survivorship**

<table>
<thead>
<tr>
<th></th>
<th>(1) maxexit b/se</th>
<th>(2) maxexit b/se</th>
<th>(3) maxexit b/se</th>
<th>(4) maxexit b/se</th>
</tr>
</thead>
<tbody>
<tr>
<td>SME</td>
<td>0.013</td>
<td>0.065</td>
<td>0.055</td>
<td>0.068</td>
</tr>
<tr>
<td></td>
<td>(0.08)</td>
<td>(0.08)</td>
<td>(0.08)</td>
<td>(0.09)</td>
</tr>
<tr>
<td>Age</td>
<td>−0.005**</td>
<td>−0.005**</td>
<td>−0.004**</td>
<td>−0.004*</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Exporter</td>
<td>−0.023</td>
<td>0.004</td>
<td>0.030</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.07)</td>
<td>(0.07)</td>
<td>(0.08)</td>
<td></td>
</tr>
<tr>
<td>Foreign</td>
<td>0.178**</td>
<td>0.166**</td>
<td>0.184*</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.08)</td>
<td>(0.08)</td>
<td>(0.10)</td>
<td></td>
</tr>
<tr>
<td>Finance Major Obstacle</td>
<td>0.203**</td>
<td>0.203**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.07)</td>
<td>(0.08)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(value added per employee)</td>
<td>0.000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
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</tr>
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<td>396</td>
<td>285</td>
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</tbody>
</table>

*p < 0.1  **p < 0.05

Note: All specifications include sectoral dummies. Marginal effects are reported. Results from estimating a probit model where the dependent variable equals one if the firm exited the sample in 2010 and zero if the firm completed the interview.
### Table A7: Basic Financial Determinants of Survivorship

<table>
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<th>(2) maxexit b/se</th>
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<td>Age</td>
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<td>-0.003</td>
<td>-0.006</td>
<td>-0.005**</td>
<td>-0.003</td>
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<tr>
<td>Sme</td>
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<td>0.150</td>
<td>-0.020</td>
<td>0.068</td>
</tr>
<tr>
<td></td>
<td>(0.08)</td>
<td>(0.15)</td>
<td>(0.15)</td>
<td>(0.10)</td>
<td>(0.31)</td>
</tr>
<tr>
<td>Exporter</td>
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<td>-0.151</td>
<td>-0.005</td>
<td>-0.176</td>
</tr>
<tr>
<td></td>
<td>(0.07)</td>
<td>(0.11)</td>
<td>(0.14)</td>
<td>(0.07)</td>
<td>(0.11)</td>
</tr>
<tr>
<td>Foreign</td>
<td>0.168**</td>
<td>0.206</td>
<td>-0.001</td>
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<td></td>
<td>(0.08)</td>
<td>(0.21)</td>
<td>(0.32)</td>
<td>(0.08)</td>
<td>(0.21)</td>
</tr>
<tr>
<td>Establishment had line of credit/loan</td>
<td>-0.045</td>
<td></td>
<td></td>
<td>-0.231*</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.06)</td>
<td></td>
<td></td>
<td>(0.14)</td>
<td></td>
</tr>
<tr>
<td>Establishment was required to provide collateral</td>
<td>0.055</td>
<td>0.078</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.11)</td>
<td></td>
<td></td>
<td>(0.32)</td>
<td></td>
</tr>
<tr>
<td>Percentage of the value of the loan required as collateral</td>
<td>0.001</td>
<td>0.001</td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>(0.00)</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Establishment had line of credit/loan * sme</td>
<td>0.230</td>
<td>0.230</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Establishment was required to provide collateral * sme</td>
<td>0.028</td>
<td>0.028</td>
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</tr>
<tr>
<td>LR_chi_square</td>
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<td>9.509</td>
<td>15.151</td>
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<tr>
<td>pseudo_R2</td>
<td>0.053</td>
<td>0.065</td>
<td>0.116</td>
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<td>396</td>
<td>116</td>
<td>86</td>
<td>396</td>
<td>116</td>
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</tbody>
</table>

*p < 0.1  ** p < 0.05

Note: All specifications include sectoral dummies. Marginal effects are reported. Results from estimating a probit model where the dependent variable equals one if the firm exited the sample in 2010 and zero if the firm completed the interview.
Table A8: Determinants of Survivorship: Does Method of Financing Working Capital Matter?

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<th>(6) maxexit</th>
</tr>
</thead>
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<td>b/\text{se}</td>
<td>b/\text{se}</td>
<td>b/\text{se}</td>
<td>b/\text{se}</td>
<td>b/\text{se}</td>
</tr>
<tr>
<td>Age</td>
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<td>-0.005**</td>
<td>-0.005**</td>
<td>-0.005**</td>
<td>-0.005**</td>
<td>-0.005**</td>
</tr>
<tr>
<td></td>
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<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Smaller</td>
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<td>0.049</td>
<td>0.072</td>
<td>0.049</td>
<td>0.049</td>
<td>0.045</td>
</tr>
<tr>
<td></td>
<td>(0.09)</td>
<td>(0.09)</td>
<td>(0.09)</td>
<td>(0.09)</td>
<td>(0.09)</td>
<td>(0.09)</td>
</tr>
<tr>
<td>Exporter</td>
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<td>-0.010</td>
<td>-0.013</td>
<td>-0.015</td>
<td>-0.024</td>
</tr>
<tr>
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<td>(0.07)</td>
<td>(0.07)</td>
<td>(0.07)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>Foreign</td>
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<td>0.200**</td>
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<tr>
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<td>(0.10)</td>
<td>(0.09)</td>
<td>(0.09)</td>
<td>(0.09)</td>
</tr>
<tr>
<td>Value Added per Employee</td>
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<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>percent Working</td>
<td>-0.003</td>
<td>-0.002</td>
<td>-0.007**</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Financed</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>through Banks</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>percent Working</td>
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<td>0.004**</td>
<td>0.005**</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Financed</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>through Customers/</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Suppliers</td>
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<td></td>
</tr>
<tr>
<td>percent Working</td>
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<td>0.001</td>
<td>-0.005**</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>through Internal</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Funds</td>
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<td>(0.00)</td>
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<td>0.077</td>
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</tr>
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<td>285.000</td>
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</tr>
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</table>

*p < 0.1  ** p < 0.05

Note: All specifications include sectoral dummies.
Marginal effects are reported.
Results from estimating a probit model where the dependent variable equals one if the firm exited the sample in 2010 and zero if the firm completed the interview.
Table A9: Determinants of Survivorship: Does Method of Financing Investment Matter?

<table>
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<th></th>
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<th>(3) maxexit b/se</th>
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<th>(6) maxexit b/se</th>
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<td>−0.005**</td>
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<td>−0.005**</td>
<td>−0.004*</td>
<td>−0.005*</td>
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<tr>
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<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Less than 20 employees</td>
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<td>0.070</td>
<td>0.071</td>
<td>0.067</td>
<td>0.070</td>
<td>0.064</td>
</tr>
<tr>
<td></td>
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<td>(0.09)</td>
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</tr>
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<td>0.005</td>
<td>0.004</td>
<td>0.011</td>
<td>0.005</td>
<td>0.014</td>
</tr>
<tr>
<td></td>
<td>(0.07)</td>
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<td>(0.07)</td>
<td>(0.07)</td>
<td>(0.07)</td>
<td>(0.08)</td>
</tr>
<tr>
<td>Foreign</td>
<td>0.185*</td>
<td>0.191*</td>
<td>0.196**</td>
<td>0.186*</td>
<td>0.197**</td>
<td>0.185*</td>
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<tr>
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<td>(0.10)</td>
<td>(0.10)</td>
<td>(0.10)</td>
<td>(0.10)</td>
<td>(0.10)</td>
</tr>
<tr>
<td>Value Added per Employee</td>
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<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Capex per Employee</td>
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<td>−0.000</td>
<td>−0.000</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>percent Investment</td>
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<td>−0.001</td>
<td>−0.001</td>
<td>−0.001</td>
<td>−0.001</td>
<td>−0.001</td>
</tr>
<tr>
<td>Financed through Banks</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>percent Investment</td>
<td>−0.002</td>
<td>−0.002</td>
<td>−0.001</td>
<td>−0.002</td>
<td>−0.001</td>
<td>−0.001</td>
</tr>
<tr>
<td>Financed through Suppliers / Suppliers</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
</tr>
<tr>
<td>percent Investment</td>
<td>−0.001</td>
<td>−0.001</td>
<td>−0.001</td>
<td>−0.001</td>
<td>−0.001</td>
<td>−0.001</td>
</tr>
<tr>
<td>Financed through Internal Funds</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Log_likelihood</td>
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<td>−181.802</td>
<td>−181.066</td>
<td>−181.517</td>
<td>−181.054</td>
<td>−180.496</td>
</tr>
<tr>
<td>LR_chi_square</td>
<td>22.547</td>
<td>22.618</td>
<td>23.314</td>
<td>22.887</td>
<td>23.515</td>
<td>27.793</td>
</tr>
<tr>
<td>pseudo_R2</td>
<td>0.066</td>
<td>0.064</td>
<td>0.068</td>
<td>0.066</td>
<td>0.068</td>
<td>0.071</td>
</tr>
</tbody>
</table>

*p < 0.1  ** p < 0.05

Note: All specifications include sectoral dummies. Marginal effects are reported. Results from estimating a probit model where the dependent variable equals one if the firm exited the sample in 2010 and zero if the firm completed the interview.
Overview of Main Development Finance Institutions Involved in SME Lending

The next few pages briefly profile the DFIs with a role in the SME space. Most of the discussion focuses on Khula, since it is nominally the lead government parastatal in this area, although IDC and NEF come under some scrutiny, with lesser mentions of UYF, SAMAF, and Land Bank.

A4.1 Khula Enterprise Finance

Khula was created in 1996 as a major outcome of the government’s SME strategy and policy. Part of that strategy necessitated the creation of SME-focused financing institutions. These institutions were regarded as essential for the type of lending where the risk and transactional costs are too high for conventional commercial banking practice. Khula Enterprise Finance Limited was established under the Companies Act as an independent limited liability company to provide financing to the SME market through intermediaries as a wholesale financier.

Table A10: Selected Financial Metrics for Khula (R million, FY to March)

<table>
<thead>
<tr>
<th>Item</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>P&amp;L</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income from loans</td>
<td>40.6</td>
<td>26.1</td>
</tr>
<tr>
<td>Impairments</td>
<td>7.9</td>
<td>2.7</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>32.8</td>
<td>70.1</td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans and advances</td>
<td>349.7</td>
<td>249.5</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,315.2</td>
<td>1,258.8</td>
</tr>
</tbody>
</table>


Khula’s two principal products for SME financing are the Khula Credit Indemnity Scheme and Non-Bank Retail Financial Intermediaries (RFIs). The purpose of the indemnity scheme is to share risk with commercial banks
through credit guarantees. Finance is approved directly by the bank, which can apply to Khula for a guarantee when there is inadequate collateral. The guarantee provides what is essentially insurance cover for up to 90 percent of the irrecoverable portion of loans granted by the participating banks. RFIs are independent organizations accredited by Khula to lend money directly to SMEs. RFIs receive funds from Khula to lend to SMEs according to their own lending policies.

As Khula’s SME target market cuts across a number of traditional sector based boundaries, there is potential for both co-operation and duplication of efforts with other DFIs. Khula has been innovative in exploring products to exploit synergies with other DFIs, and has devised informal inter-DFI boundaries based on loan size.

Considerable effort has gone into establishing risk management processes and systems. However, Khula is still in the process of finalizing and implementing some of these. Accordingly, new initiatives aimed at increasing its impact, such as by expanding into more difficult sectors of the target market, by adding delivery channels such as retail, or by varying key risk control measures such as risk pricing will increase pressure on risk management.

Khula needs to carefully assess the conflicting requirements of using risk management techniques to control losses within acceptable levels whilst not unduly restricting its development impact. Government needs to give Khula clear guidance on its risk appetite balanced against those development goals, and there has to be a clear linkage to the financial consequences of those decisions and the consequent financing implications.

To date, Khula has done a good job in addressing the goals set for it by the dti. Khula has met its targets for financial sustainability, development impact and specific goals relating to job creation, lending to BEE companies and women groups. It has been creative in its approach, establishing a number of complementary products and channels to assist SMEs. Progress over recent years has been good, with significant improvements in loan and indemnity volume whilst maintaining solid financial performance. However, the targets that have been set for Khula have been made in isolation of any estimate of the gap for funding in the SME sector.

Khula is working on two major strategic initiatives in particular: 1) establishing equity stakes in selected RFIs to facilitate improvements in their throughput and management; and 2) establishing Khula Direct, a retail outlet.

Both initiatives have logic, but there are some significant unresolved questions and potential problems areas, including possible overlaps with

82 Although, as with other institutions, there was an increase in credit losses over the crisis.
other DFIs, a major change in the number and type of RFI operating in the market, and maintaining financial sustainability. In addition it is not clear how the requisite investment will be funded from Khula’s existing balance sheet. The initiatives are Khula centric and do not allow for the “crowding in” of private sector capital, which could be critical if the financing gap for SME is as big as perceived.

Khula is financially sustainable at present, largely because it has limited its exposure to developmental lending and because it has kept a significant proportion of its balance sheet in noncore assets, held purely for investment. In fact, Khula currently enjoys a reasonable return on its developmental loans and kept its losses on the indemnity product within manageable level. Both which product lines could be expanded to achieve more development impact but would require additional funding which would have to come from redirecting investment funds into either activity.

The supply-side survey has revealed that loans guaranteed by Khula typically comprise less than 5 percent of banks’ small enterprise portfolios. It is an open question as to whether the cost of this marginal lending is justifiable on purely developmental grounds. Although it is fairly clear from the survey returns that in the absence of a Khula indemnity some of this lending would simply not take place at all, the modest scale of Khula-backed lending gives rise to the criticism that neither the banks nor Khula have made a serious effort to make the partnership work. Currently, less than 15 percent of guarantee fund capacity is utilized.

As mentioned, it is not clear how the capital investment and operating costs of the major initiatives are to be funded—still less the ongoing financial cost of increased exposure to developmental risk. Khula’s capitalization is currently being reassessed by government in light of the proposal to establish Khula Direct. However, the level of loans and indemnities already authorized but not drawn and the rate of lending growth are likely to put the current balance sheet under strain within the next three years, even prior to the demands of the new initiative.

The most pointed criticisms of the Khula credit guarantee scheme revolve around the recovery and claiming process. Recently, this has actually become more onerous and more risky for the banks, in that they must not only secure judgment, but must now also exhaust the entire loan recovery procedure. This may only become worse if the contentious aspects of the proposed new Companies Act come to fruition, where, in effect, businesses will be able to delay liquidation through a form of debt review and counseling, similar to the regulations in place under the National Credit Act.

Banks interviewed for this survey complained about the restrictiveness of Khula’s own rules. For example, in order for a business to qualify for
Khula guarantee, the business owner must not have more than one business interest, and yet some of the most productive and successful SME entrepreneurs often run multiple operations.

Another criticism of the Khula process is the fact the lending bank and Khula both have to vet each loan before it can be placed under the guarantee. Especially for smaller loans, there is a serious question as to whether such intense scrutiny is really necessary and whether the costs of this duplicative process outweigh the benefits.

If Khula were to reduce its cover to say, 50 percent (rather than 70 percent–90 percent), and complement that with less cumbersome administrative processes, then overall costs may reduce, and Khula could then rely more on banks taking credit assessment seriously and applying their own processes, instead of trying to fit into Khula’s rules.

The counter argument to this is that a generous guarantee, even if it is costly, is necessary to get banks to lend into this space at all. However, there is limited evidence from the literature to suggest that high levels of guarantee have been effective at encouraging banks to lend at scale to new market segments. In other words, other constraints matter more than whether a guarantee is on offer or not.

**A4.2 Industrial Development Corporation**

IDC has undergone many changes since its creation in 1940, and though its original purpose was to act as financier in the promotion of new industries and the development of existing industries, the war-induced shortages forced the then government to amend the mandate to allow IDC to establish as well as operate industrial enterprises. As a result it became instrumental in the financing of basic industries such as paper (Sappi) and fertilizer (Foskor), but also in import-substitution industries like Sasol (synthetic rubber), before branching out into mining, steel and aluminum. A foray into SME development was terminated with the transfer of its book to the Small Business Development Corporation in the mid-1980s. However, since 1994 IDC’s focus has shifted back to small business, Black empowerment, supporting economic growth and employment, re-distribution of wealth, and spatial development. In doing so, the mandate today is closely aligned to the government’s current social and economic priorities.

Despite the nominal post-1994 policy shift for IDC to play a more substantial role in SME financing, its operational structure is not geared for SME and so it has set itself a minimum direct funding level of R1m. This is exclusionary for many SMEs. Nevertheless, it does on-lend funds (often to other DFIs) for franchising sub-sectors and microfinance.
 IDbIDC defines an SME as any firm that has two out of three of the following characteristics: 1) < 200 employees; 2) < R50m turnover per year; and/or 3) < R55m assets. In practice, it lends to those SMEs at the middle to upper range of these parameters.

IDC’s basic operational structure is sector-based. However, in the realm of SME financing, it has accommodated an array of schemes that are supposed to respond to specific issues, areas of development, and crises, although this approach appears to be somewhat unsystematic. It also would seem that IDC’s relatively strong governance, financial standing, and management ability, as compared to the other DFIs, makes the IDC an attractive place for government and donors to allocate funds that they want disbursed for particular purposes. Examples of these funds and schemes include:

- Transformation funds: BEE, women and entrepreneurship, community (1BN)
- Pro-orchards and pro-forestry (200m and 100m)
- Township and rural (500m).

In keeping with its episodic, scheme-based approach to financing SMEs, IDC established a R2 billion rescue and recovery fund for distressed businesses, in the aftermath of the financial crisis and economic recession. This fund covered mostly larger firms, and many of them had not been clients of IDC previously, but rather clients of the major banks. IDC launched the distressed fund in April 2009, and in the first financial year disbursed R450m, followed by R1.4 billion in the second year. Of these amounts, roughly 15 percent went to SMEs. Other clients, both SMEs and larger firms, did not receive new financing, but did benefit from restructuring of existing debt. IDC claimed that many of the distressed businesses waited too long to come

### Table A11: Selected Financial Metrics for Industrial Development Corporation (R million, FY to March)

<table>
<thead>
<tr>
<th>Item</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>P&amp;L</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NII</td>
<td>1,165</td>
<td>1,307</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>2,229</td>
<td>5,621</td>
</tr>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans and advances</td>
<td>10,374</td>
<td>8,820</td>
</tr>
<tr>
<td>Total assets</td>
<td>88,631</td>
<td>73,377</td>
</tr>
</tbody>
</table>

*Source: Annual Report 2010.*
to IDC for help, and were already practically out of business, as shown, for example, by their already having been evicted from their places of business.

Of a total loan book of over R10bn, approximately a quarter is committed to SMEs. Within IDC’s equity portfolio, which is valued at about R60bn, it is estimated that only about 5 percent or less is dedicated to SMEs. Average loan terms are 5 to 7 years; and IDC estimates that it currently services about 1,300 SME clients across all of its schemes, portfolios, and products.

IDC claims to have a different mandate to commercial banks in respect of SME financing, in that it is prepared to assume a greater level of risk, and does not expect the SME to provide security. In addition, IDC allows the SMEs to contribute less equity, while not basing a credit decision on historic performance, but rather projections of future cash flows and other tests of potential viability. IDC cited its track record in franchise markets as a good example of how IDC has demonstrated the potential profitability of lending to emerging entrepreneurs.

IDC’s posture toward SME finance is dependent on movements in government and on the other DFIs. Given continuing uncertainty about which ministry will take the lead on SME development and have responsibility for IDC, and indeed Khula, it is difficult to assess what the medium- to long-term strategic direction of the two major DFIs for SME finance may be. Clarifying the strategic direction, and ensuring effective and clear coordination across the DFIs, should be a priority.

A4.3 National Empowerment Fund

The roots of National Empowerment Fund (NEF) can be found in the National Empowerment Fund Act No. 105 of 1998 that set out a wide range of objectives for the first DFI dedicated to the promotion and facilitation of Black economic equality and transformation. NEF’s objectives can be summarized under three principal thematic areas according to the following:

- **Transformation**
  - “(a) providing historically disadvantaged persons with the opportunity of, directly or indirectly, acquiring shares or interest in State Owned Commercial Enterprises that are being restructured or in private business enterprises”

- **Enterprise Support**
  - “(c) promoting and supporting business ventures pioneered and run by historically disadvantaged persons; and

  - (f) contributing to the creation of employment opportunities”
• Widening Savings and Investment
  • “(b) encouraging and promoting savings, investments and meaningful economic participation by historically disadvantaged persons;
  • (d) promoting the universal understanding of equity ownership among historically disadvantaged persons; and
  • (e) encouraging the development of a competitive and effective equities market inclusive of all persons in the Republic.”

By 31 March 2007, NEF had received a total of R 1.2bn in cash funding from government. State owned shares in two companies (MTN and Uthingo) for subsequent retail distribution also were transferred to NEF shortly after its establishment. Such stakes are shown on NEF’s balance sheet and boost the capital base. The 2003 BBBE Act and the 2007 Codes of Good Practice are useful for NEF in that they help it to ensure that its investment and other activities are fully aligned and consistent with government policy.

**Table A12: Selected Financial Metrics for National Empowerment Fund (R million, FY to March)**

<table>
<thead>
<tr>
<th>Item</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>P&amp;L</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest received from*</td>
<td>106.6</td>
<td>103.0</td>
</tr>
<tr>
<td>Impairment of*</td>
<td>171.3</td>
<td>89.1</td>
</tr>
<tr>
<td>Surplus for the year</td>
<td>199.0</td>
<td>104.0</td>
</tr>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Originated loans and preference shares</td>
<td>898.3</td>
<td>688.6</td>
</tr>
<tr>
<td>Total assets</td>
<td>5,000.3</td>
<td>4,638.2</td>
</tr>
</tbody>
</table>

_Source: Annual Report 2010._

_Note: * = Originated loans and preference shares._

As a framework, the risk management system is appropriate. However, it appears that much of the value so far achieved in risk management has been in identifying and flagging risks rather than mitigating them. This is in large part due to the demands of the mandate that requires NEF to undertake high risk investments in start-ups and very small enterprises. The absence of detailed portfolio concentration and exposure limits is a significant weakness, particularly as NEF is expected to greatly increase its investment operations.

NEF’s operational activities are carried out in two divisions, Fund Management and Asset Management whose activities are very different and therefore should be considered separately.
FMD is headed up by the chief investment officer, CIO, and is the biggest division in NEF. There are two separate funds:

- iMbewu Fund that is designed to promote the creation of new businesses and the provision of expansion capital to early stage businesses;
- Corporate Fund that is designed to improve access to BEE capital and has three products, acquisition finance, project finance and expansion finance.

The sustainability of NEF is dependent on it being able to square the circle of making early stage investment and supporting very small enterprises without incurring losses that threaten its financial viability. Despite only having built up the portfolio recently, according to the 2010 annual report, nonperforming loans constituted 45 percent of the total originated loan book for the financial year ending March 2010, up from 28 percent in the previous year. This is a marked deterioration in loan book quality, from a starting point of already high NPLs. From a sustainability perspective, the situation should be monitored closely going forward.

iMbewu consists mostly of term loans of 6 year maturity (12 months of no repayment in which interest is accrued, followed by 60 months of repayments). This compares to the typical market duration of 36 months maturity.

During the crisis, the iMbewu portfolio had to be restructured due to economic difficulties of borrowers, especially in the transport portfolio (trucks). Prior to the crisis, rates were Prime -1. The new rates were fixed at 8 percent (currently Prime -2) for 80 percent of the loan. This initiative was applied to the whole portfolio.

One innovative approach has been to develop master agreements with franchisors to provide financing for franchisees. These loans are typically in the region of R3m.

Two strategic decisions have been made to increase outreach. First, there was commitment to have more transactions go through the loan approval process faster. Second, the NEF will increase its footprint nationally.

In terms of linking with commercial banks, it was felt that the mandate of the NEF differed significantly with the objectives of the commercial banks, rendering links very difficult. For example, NEF does not require the owners of the companies to which it lends to subscribe high levels of their own equity, and as such businesses are highly geared from day one. Banks have far stricter collateral requirements and are less patient when/if the borrower experiences difficulties.

NEF does not want to do all things for all people or to attain massive size, but to do what it does well. It posits that if in 5 years it could have
created 100 viable SMEs creating many job opportunities in the economy, this would have been a success.

### A4.4 Other Development Finance Institutions in SME Finance

In addition to Khula, IDC, and NEF, three other DFIs have a minor or tangential, but nonetheless important role in SME finance. These other DFIs include Umsobomvu Youth Fund (UYF), the South African Microfinance Apex Fund (SAMAF), and Land Bank.

UYF had a portfolio similar to NEF’s iMbewu fund, which also had high impairments. More successfully, it operated jointly funded SME portfolios with FNB and Business Partners, which those institutions actually managed. Whatever the eventual outcomes of these initiatives may have been, the question is perhaps moot now. The organization has effectively been folded into the National Youth Development Agency, which would appear to want to focus on more grant-based types of support to individuals and microenterprises.

SAMAF is a fledgling institution that aims to wholesale funds to nonbank financial intermediaries for on-lending to microenterprises. To the extent that it has provided a way for Khula to focus more keenly on small and medium enterprises, it is helpful. However, the microfinance sector has some of the most intense needs and intractable challenges, which go far beyond SAMAF’s capacity. In turn, SAMAF has been tempted to continue playing in the small enterprise space, where it perceives relatively less risk and better financial and economic returns. SAMAF’s mandate puts it squarely in a market that the banks dare not touch (except through unproven and sporadic attempts, such as Standard Bank’s Community Banking division); but if it were effective, SAMAF could facilitate the linkages into the banks for both the nonbank financial institutions and some of the microenterprises that may grow in size and maturity over time. However, since its inception, SAMAF has made slow progress.

Two years ago, Land Bank was insolvent and in the midst of a major governance and managerial crisis. Sharp and decisive action from National Treasury, including secondment of one of its senior officials as Land Bank’s acting CEO, has rescued the institution. However, it still has a long way to go to secure long-term sustainability and viability. In the aftermath of the 1997 Strauss Commission Report, the Land Bank tried to shift its major focus from large, commercial farmers to new clients, especially the beneficiaries of land reform, namely, Black emerging farmers—effectively, its version of SMEs.
However, Land Bank’s attempts to service that market have been beset by governance problems, which have been a partial cause of the wider malaise in the institution. A scheme designed specifically to support new farmers who received land through the land redistribution process suffered NPLs of 50 percent and more. Despite these obvious shortcomings, Land Bank will likely have to remain a part of government’s SME financing approach. The other DFIs have shown little capacity or interest in funding rural enterprises, much less farming. Nevertheless, the rural and periurban areas remain some of the most important areas to develop and to push the frontiers of SME finance.
A5 Overview of Institutions Involved with Business Development Support

A5.1 Small Enterprise Development Agency

The Small Enterprise Development Agency (SEDA) is an agency of the South African Department of Trade and Industry (dti). SEDA was established in December 2004 through the National Small Business Amendment Act, Act 29 of 2004.

SEDA is mandated to implement government’s small business strategy; design and implement a standard and common national delivery network for small enterprise development; and integrate government-funded small enterprise support agencies across all tiers of government. SEDA’s mission is to develop, support, and promote small enterprises throughout the country, ensuring their growth and sustainability in coordination and partnership with various role players. The agency is the government’s primary vehicle through which nonfinancial support is given to SMEs and does not engage in financing activities.

Government perceives SEDA’s interventions as critical in alleviating poverty in South Africa, because the small enterprise sector has a significant and valuable contribution to make in sustainable and equitable social and economic development, as well as in employment and wealth creation. SEDA is committed to build the sector through the development of SMEs, including cooperatives. To this end, it offers SMEs advice, counseling, mentorship, guidance and access to vital contacts through its nationwide network of 9 provincial offices, 40 district branches, 4 mobile units, 46 Enterprise Information Centres and 29 Technology Incubators. In the financial year ending March 2009, SEDA incurred annual expenses of R482.2 million. Despite this level of outreach and investment SEDA’s contribution is marginal. One survey from 2006, found that only 5 percent of small businesses surveyed were aware of SEDA. This result is mirrored in the recent FinScope South

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83 FinScope Small Business (Gauteng pilot) 2006.
Africa Small Business Survey 2010, which found that only 4 percent of small businesses were aware of SEDA.84

Products and services to which entrepreneurs have access include, among others, information and advice, training and mentoring, business planning and registration, incubation and technology transfer as well as sector specific training and development programs.

At best, the performance and quality of SEDA-facilitated BDS have been highly variable. Most independent commentators in the market cite poor quality of BDS service providers as a major reason why the services do not deliver the benefits promised. Poor selection of BDS providers, as well as haphazard selection and matching of the SMEs with those service providers tend to diminish the efficiency and effectiveness of service delivery. SEDA faces pressure to be seen to be assisting the most disadvantaged and smallest enterprises, which often does not match well with the relatively high-touch and intensive modes of one-on-one BDS that SEDA normally advocates.

Particularly in the context of facilitating or mitigating the risk of bank finance, SEDA has had little impact. Most of the businesses that SEDA would prefer to service are below the size threshold of interest to the banks, and many of them are microenterprises or start-ups, for which the banks have little to no interest. In other instances, the banks routinely complain that the ‘business plan for a fee’ orientation that epitomizes the approach to BDS service delivery and the attitude of many of the consultants used, mean that the proposals presented are not credible and are of a poor quality.

A5.2 The Khula Mentorship Program

Khula provides both pre and post loan mentorship to SMEs. The actual provision of mentorship services is done by independent mentors/business advisors that are skilled in their respective areas of specialization.

Khula sources its business mentors from a database that is maintained by the Institute of Business Advisors of South Africa (IBASA). IBASA specializes in the selection and accreditation of mentors/business advisors. Both Khula and IBASA have entered into a service level agreement with the primary purpose of regulating and managing the provision of business advisory services to the SME sector. Khula’s Regional Offices have the authority

84 The 2010 survey also found that 76% of small business owners were unable to name any organization that gives help and/or advice to small businesses, and that only 6% of small business owners had used any support organizations. While 10% could name the National Youth Development Agency (which incorporates the Umsobomvu Youth Fund) only 1% had actually used its services.
to enter into service level agreements with individual bona fide IBASA members.

Khula’s BDS has seen slightly more success than the SEDA BDS initiatives, particularly in respect of facilitating and mitigating bank financing. The program is focused very much on improving access to Khula’s guarantee scheme and the banks that lend under it, and thus has a direct intent and design for financing, as opposed to SEDA’s broader objectives. Outsourcing of the recruitment and selection process to a third party, namely IBASA, has helped to improve the quality of BDS service providers, although maintaining standards remains a concern among SMEs and banks alike. Also, both IBASA and Khula actively manage the BDS delivery process, which SEDA rarely does. The sustainability and scalability of the Khula BDS scheme are questionable in that most of the SMEs continue to come from the smaller end of the spectrum, thereby raising questions as to whether such businesses could ever afford the full cost of such a service, no matter how high quality it may be.

### A5.3 Other Business Development Support Services

A 2005 Genesis Analytics report neatly summarized the scope and performance of the BDS market in South Africa, specifically:

- **Subsidized government and private sector programs** (*Umsobomvu, Sizanani, Thuso, SEDA*). The subsidized schemes generally have shown poor outreach and performance.

- **Commercial** (*Business Partners, FNB*). These schemes have been successful, but are limited to the SMEs that can afford to carry the cost of the support services or provide the required return.

- **Corporate sponsored programs** (*Anglo Zimele, SAB Miller, Nurcha, Eskom*). These schemes have been successful in supporting SMEs, but their success may be limited to opportunities where the SMEs can be integrated into the value chain of the corporate sponsor and where corporate social investment can contribute to the cost.
References


