

ENTREPRENEURSHIP, ACCESS TO
CAPITAL & SMES IN MENA:
SUPPLY? DEMAND?
THE ISSUES:

OECD – MENA

5th SME Working Group

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22 February 2011, Casablanca, Morocco

- Problem: funds not flowing as desired to Entrepreneurs, & Small & Medium Sized firms.
- Frequent observation in region:
 - Banks are not taking risk
 - Venture investors are not taking risk.
- First reactions: find ways to move more funds to SMEs.
 - But are we asking the right questions and enough questions?
 - Re Risk & Funding: To the extent true (and not always), we need to ask WHY? What drivers, fundamentals?

- Access to Capital:
 - Demand: Entrepreneurs / Enterprises
 - Supply: Financial Institutions (credit/debt, equity)
- Challenge: *sustainable* access to funding for investment for SMEs, and particularly entrepreneurial SMEs in early stages.
- Known:
 - Relative to apparent demand, appears to be problem of access.
- Assumptions? Where is the problem?

- **Gazelles: High-Potential SMEs / SME Champions**
 - Outstanding SME focused on growth, with high prospects, usually highly innovative (e.g. IKEA in early days)
- **Entrepreneurial SME**
 - An SME that generates good profits, but may not seek growth (e.g. small traditional packaging firm).
- **Lifestyle SME**
 - An SME that is more focused on the owner's lifestyle (e.g. small boutique hotel with no desire to grow).
- **Ordinary SME / Traditional SME**
 - A small enterprise with minimal profits to its owner, usually very traditional. (e.g. Traditional textile exporters, individual artisans)
- **“Hobby” or Casual Business (Very small enterprise)**
 - A very small business operated on the side; not as main activity, no serious intention to make the business grow.
- **Craft, Traditional Very small enterprise**

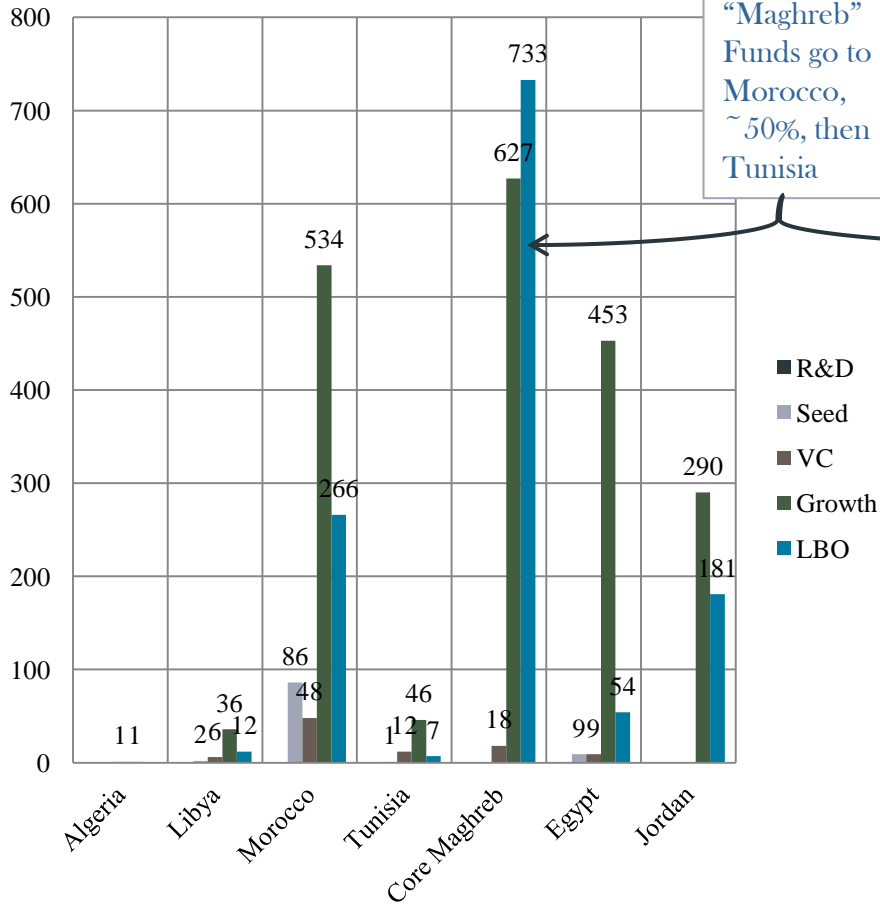
- Reflect on Access to Finance on Demand side via the lens of Equity Financing (VC, etc).
 - Why VC as lens?:
 - Equity Funding (Risk Capital) neglected component in Policy Discussions.
 - Equity cares more about internal quality of SME / quality of Entrepreneur(s).
 - Focused on high-impact Entrepreneurs seeking to build firms that will drive competitiveness, the key need in region.
 - In Maghreb decent level of Venture Capital available.

Developing MENA Funds (2008)

Capital Raised Fund Stages

(Select Countries, NA & Comp)

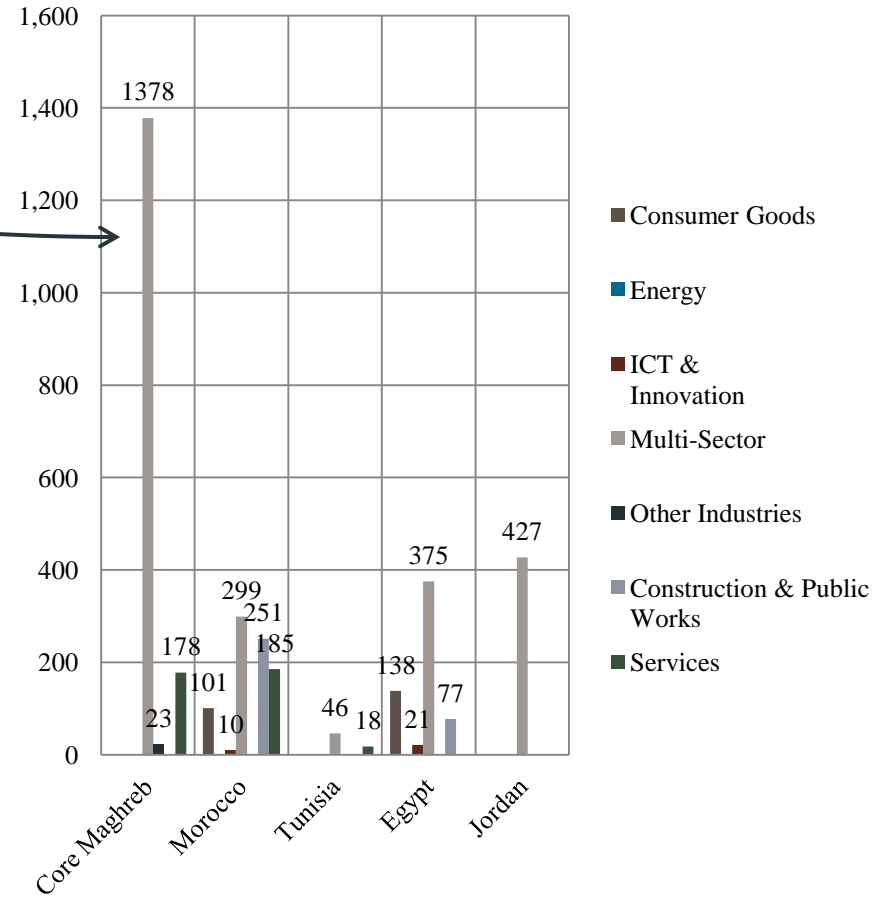
Millions US\$, 2008



Funds in North Africa

(Select Countries)

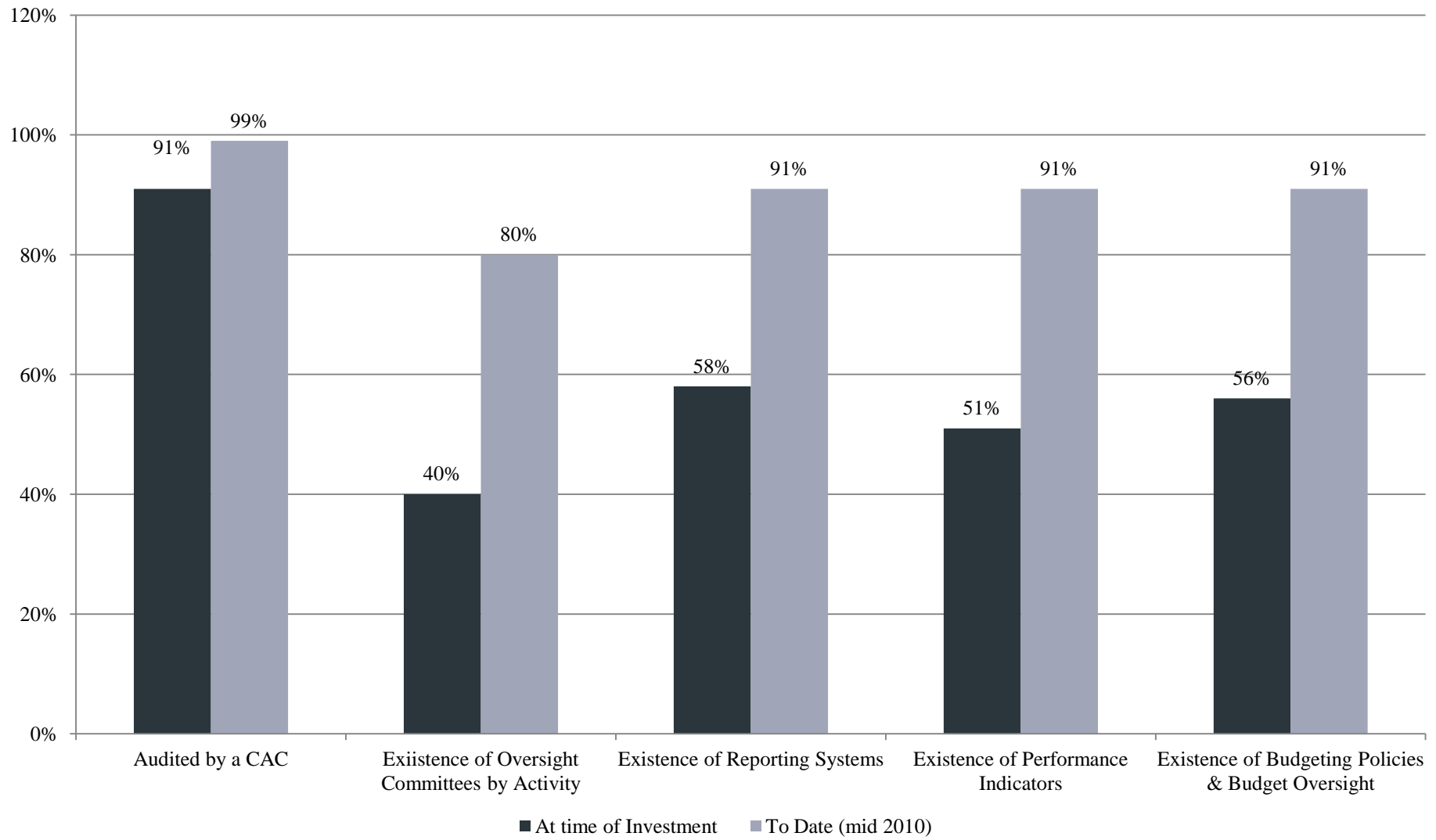
Millions US\$, 2008



- Assumption: Provide the capital and Entrepreneur Access to Capital/Finance problem solved.
 - Good evidence that this is not true.
 - Moroccan regional risk capital funds experience
 - Negative returns in venture funds
 - Arguments to lower standards
 - Do we have the capital to waste?
 - If Quality of SMEs is low, there will be high levels of losses.
 - For Example: High level of Bad Credit in Banks
 - How “eligible” (i.e. sustainable) is the SME demand?
 - All Evidence says SMEs need serious upgrading, especially in Human Resources (Management).

- Limited social capital (TRUST & UNDERSTANDING of PRACTICE)
- Limited Entrepreneur networks & skill sets in Mgmt, and limited connections with financing
- Limited and outdated legal forms for structuring investments to meet both Venture Investors (Angels, VCs, etc) & Entrepreneur expectations
- Lack of RETURNS on Capital.
 - Early stage losing substantial money.
 - Why?
 - Weaknesses in firms, weakness in gmt w entrepreneurs
 - Tough business climate, investment not enough.

SME Quality, VC Impact, Morocco



- **“A key reason that financing funds’ flows to emerging-market SMEs are insufficient—especially for investments in the range of \$100,000 to \$1.5 million—is that returns are not fully risk-adjusted.”**

- Milken Institute, *“Stimulating Investment in Emerging-Market SMEs, Financial Innovations Lab Report”* 2009

- Translated from Finance Speak:

Overall Profits / Returns to Investors in SMEs & Entrepreneurs from venture investments are not covering the losses or are not attractive enough to pull money away from “more certain bets” like Real Estate (perception of RE as a safe & sure thing quite common, despite the 2008 crisis!).

WHY POOR PROFITS, POOR QUALITY.

- Without an ability to make good profits... capital simply will not be sustainably invested in Entrepreneurs.

“ Entrepreneurs often need a great deal of technical assistance in putting their companies’ financials in order, marketing, and other initiatives that could make their businesses successful.

This increases a fund’s ... expenses and lowers net returns to investors.

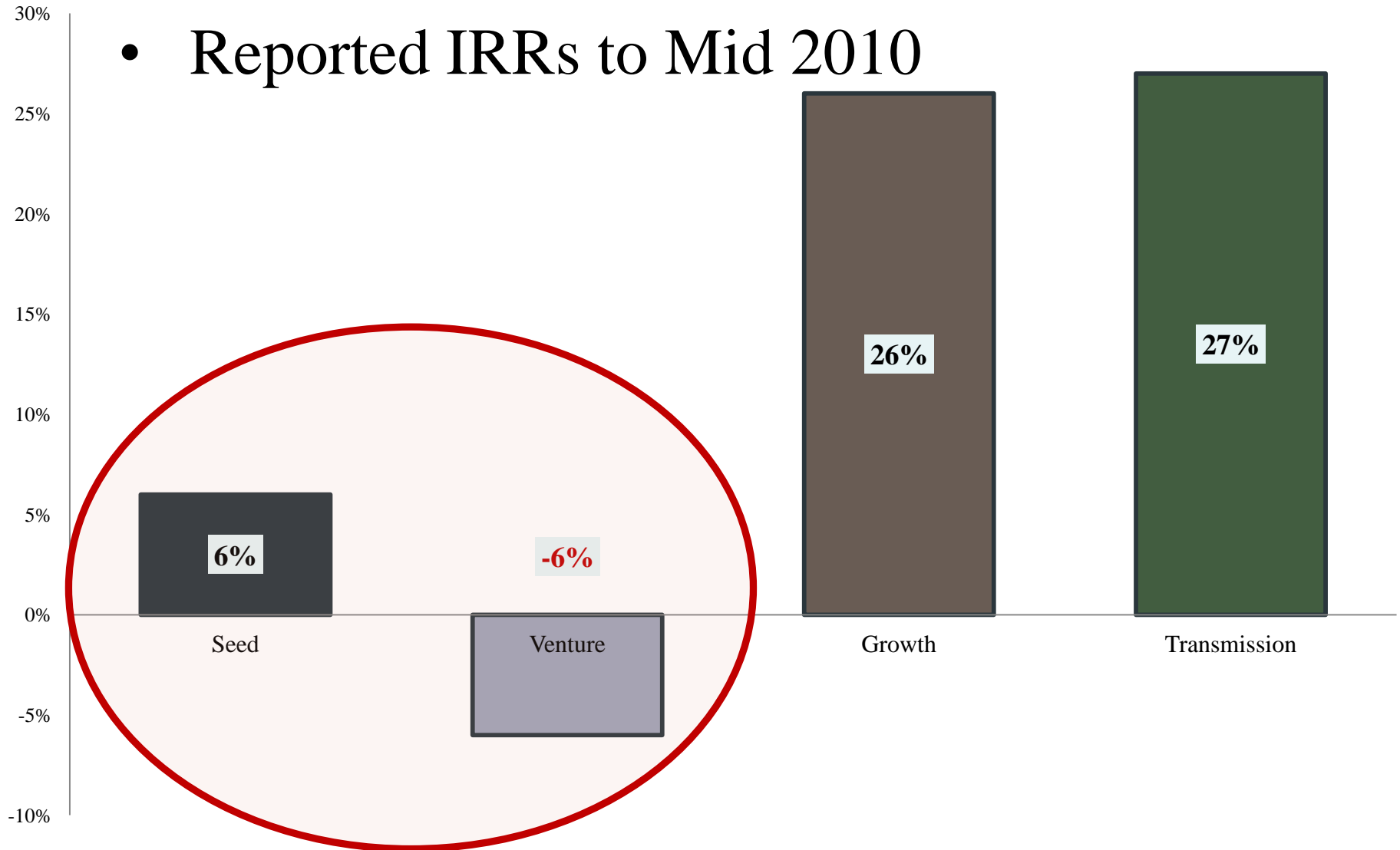
Because they are not fully compensated for the risk, investors have not embraced the opportunities.”

The capacity constraints faced by risk funds in developing markets across the globe are similar:

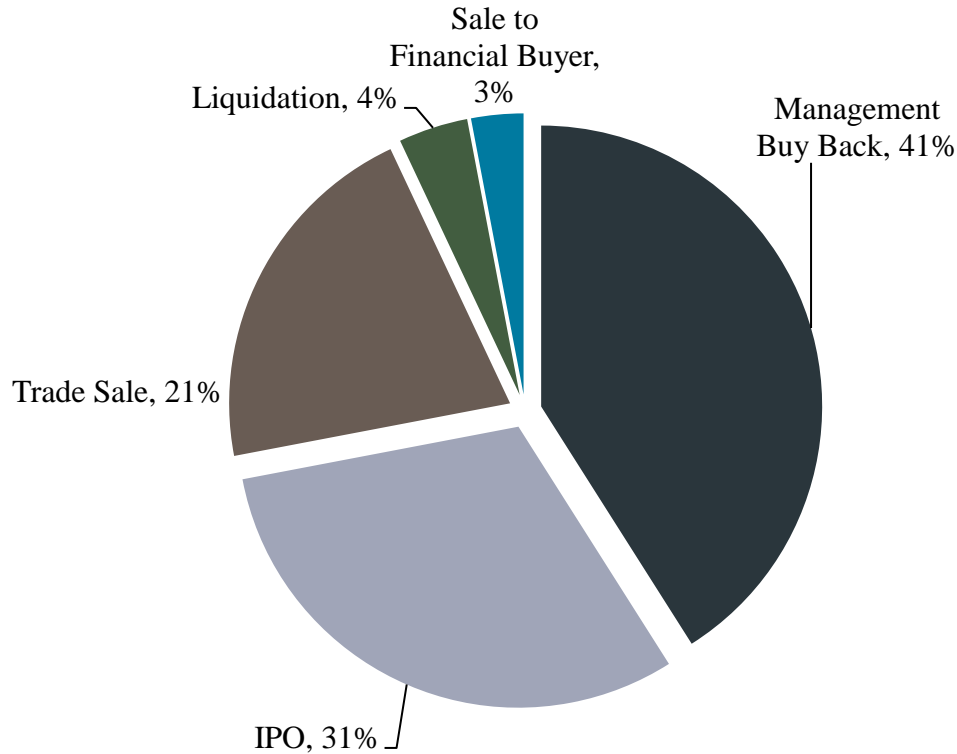
- Lack of good legal / investment structures to manage risk, find common ground with Entrepreneurs
- Challenge to get good deal flow creation: eligible SMEs / Entrepreneurs
 - Too many 1 entrepreneur shows... not enough teams.
- Lack of good “hands on” investor skills (VCs need to upgrade too)
- Not enough resources in Funds to add value relative to needs of SMEs
- Lack of profitable returns (exits) on SME investments .

Adapted from : Capacity Constraints Facing Risk Fund Managers - Final report, Financing for Growth, 2008

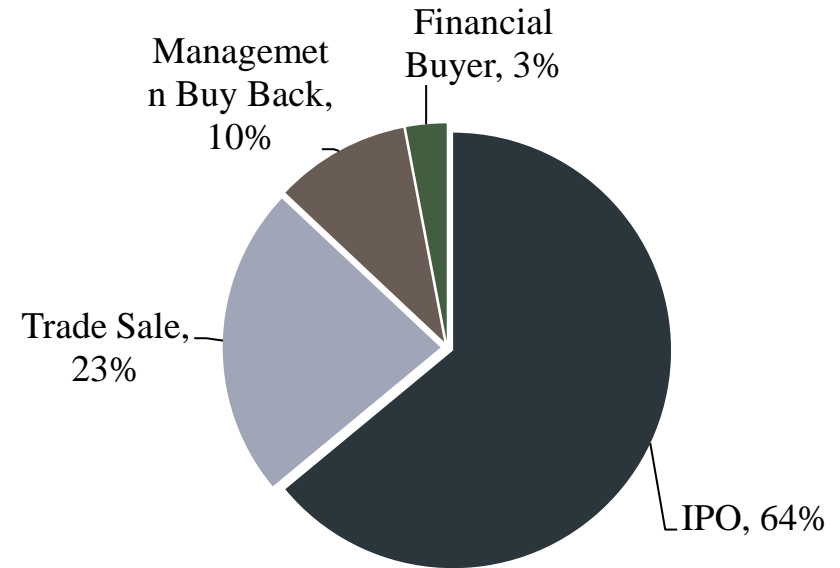
- Reported IRRs to Mid 2010



Exits by Type (No.)



Perc. Capital Returned by Exit Type



- Less-than-ideal management practices prevalent in region to overcome environment
- Acceptance of Role of Outside Investors:
 - Sharing ownership, high level governance controls
- Acceptance of *Applied* Good Governance
 - Old school family forms reality
 - Modernized mgmt styles needed

VC/Equity Investor Objectives

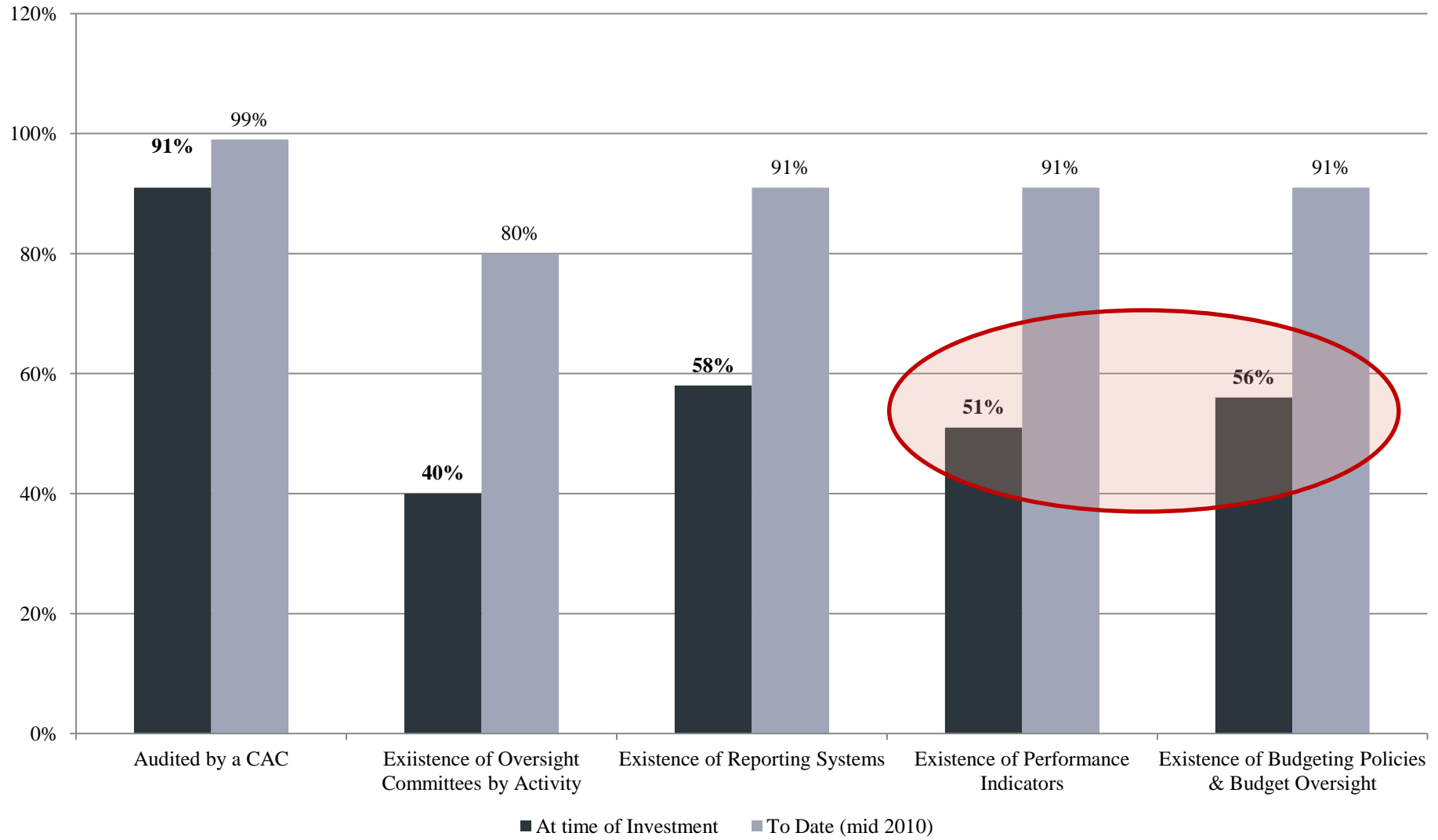
Objectives of Equity Investors

- Maximum Return (IRR; X return)
- Large Equity participation
- Liquidity
 - IPO
 - Merger or Trade Sale
 - Put back to the Company
- Hedge Risk

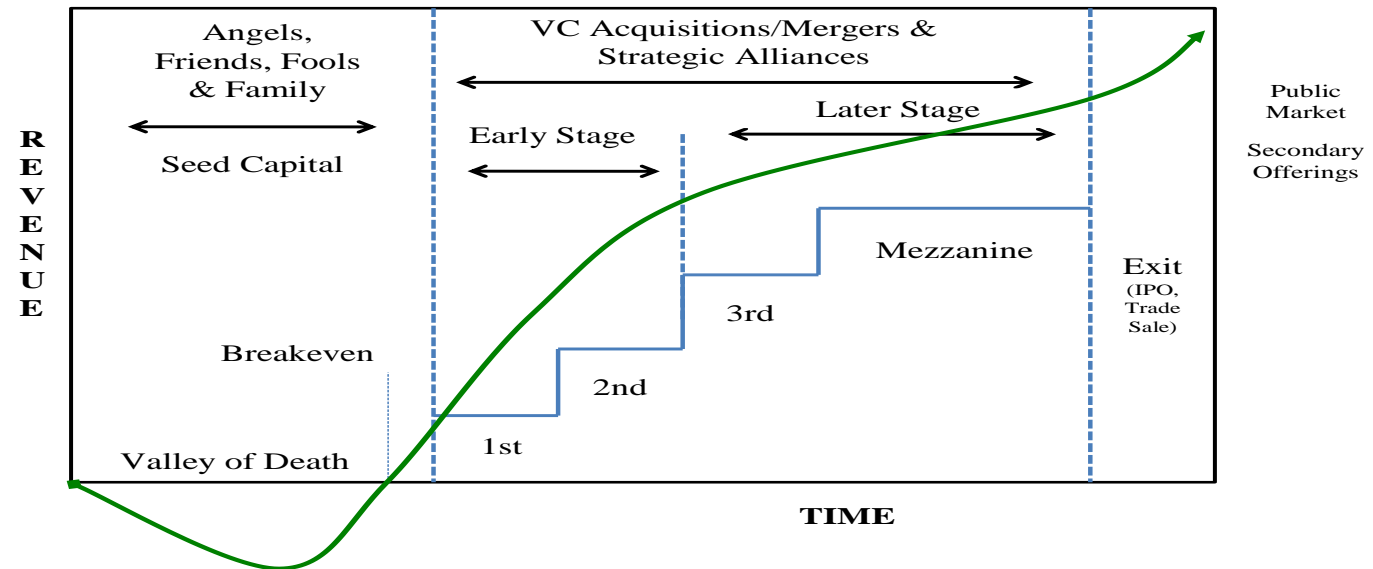
Entrepreneur Objectives

- Keep as much equity as possible
- Keep control of operations
- Incentives for founders (& key employees)
 - MENA very weak in providing incentives, sharing control internally with non-founders & especially non-family
- Keep restrictions to a minimum
- Keep in the Family (MENA)

SME Quality, VC Impact, Morocco



Venture Financing Cycle



The Enterprise & Funding Sources over Time

Owner
Capital

Angels

Family & Friends

Banks

Venture Capital/PE

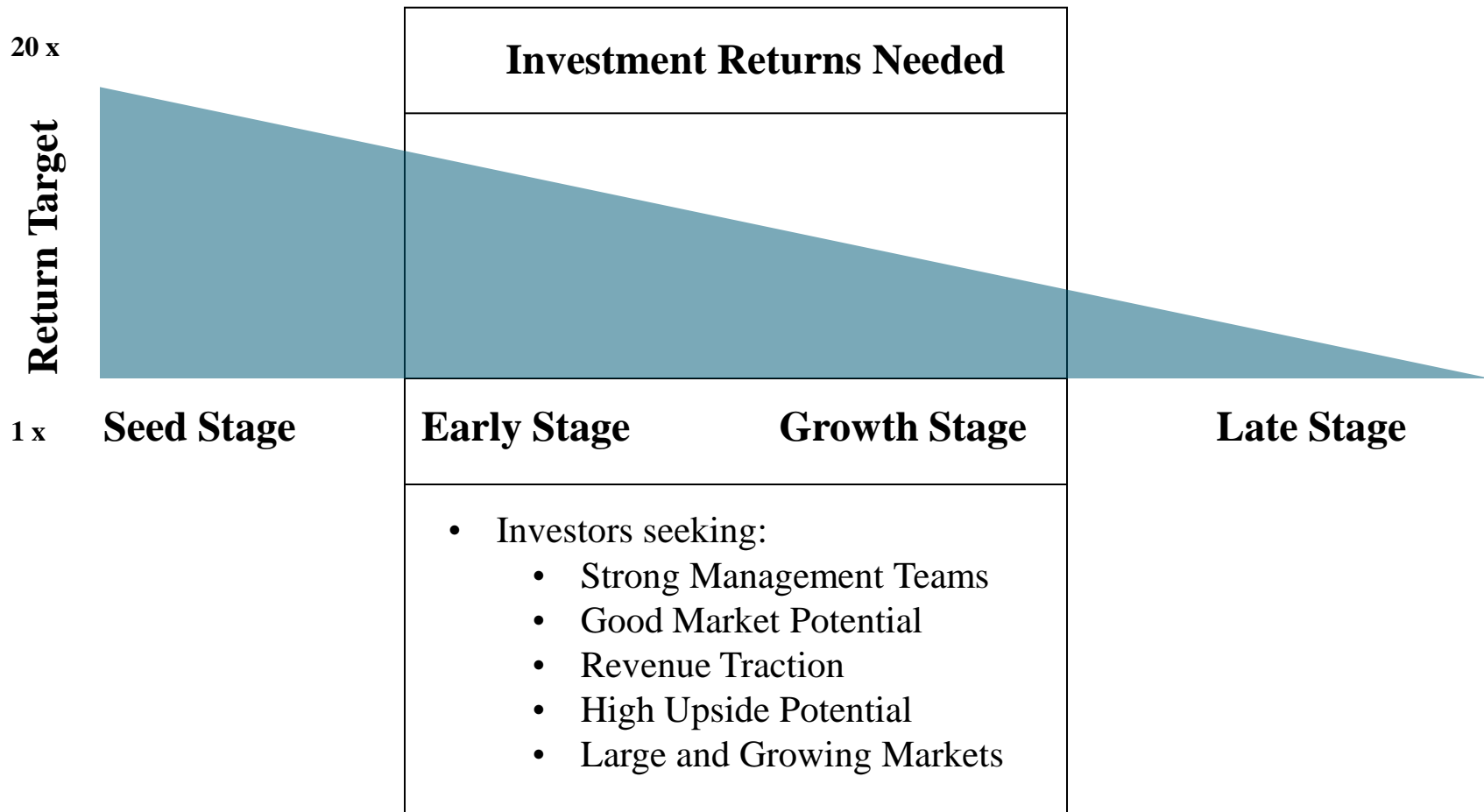
Buyout
IPO
Sale

- Angel Capital?
 - Good concept, however, requires (to be real sustainable solution):
 - Good Social Capital:
 - Understanding of the
 - Acceptance of outside investors on standard terms
 - And outside investors who are also playing the game
 - Legit worries by Entrepreneurs re ‘Faux Angels’ taking over the enterprise
 - But what is the core motivation for promoting?:
 - Increase funding to high-value start-ups, small-firms? (or small firms generally?)

- Positive role to play, **but** issues undermining venture capital funds also hit Angels:
 - Limited and outdated legal forms for structuring investments to meet both Venture Investors (Angels, VCs, etc) & Entrepreneur expectations
 - Limited social capital (TRUST & UNDERSTANDING of PRACTICE)
 - Limited Entrepreneur networks & skill sets in Mgmt, and limited connections w venture financing
 - Lack of RETURNS on Capital.

- After all, investors are rich, right?
 - Many funds are investing *your* retirement money.
- Investment in Entrepreneurs, SMEs competing against other capital uses.
 - EG: Real Estate (particular challenge in MENA)
 - As one Angel told me, he hears all the time “Why fund a risk enterprise when you can get 50% in RE speculation.”
 - Without good returns, SMEs will be starved of capital
 - Good returns also indicative of **competitiveness** and MENA region needs more competitive enterprises, more higher value, non-traditional enterprises.

The Risk, Profitability / Return Trade Off & Financing Entrepreneurs / SMEs



Stage Of SME	Expected Annual Investment Return	Expected Increase on Initial Investment
Start-up SME (idea stage)	60% +	10–15 × investment
First-stage financing (new SME (1-3 years))	40%–60%	6–12 × investment
Second-stage financing (development stage (some profit record))	30%–50%	4–8 × investment
Third-stage financing (expansion stage)	25%–40%	3–6 × investment
Turnaround	50% +	8–15 × investment

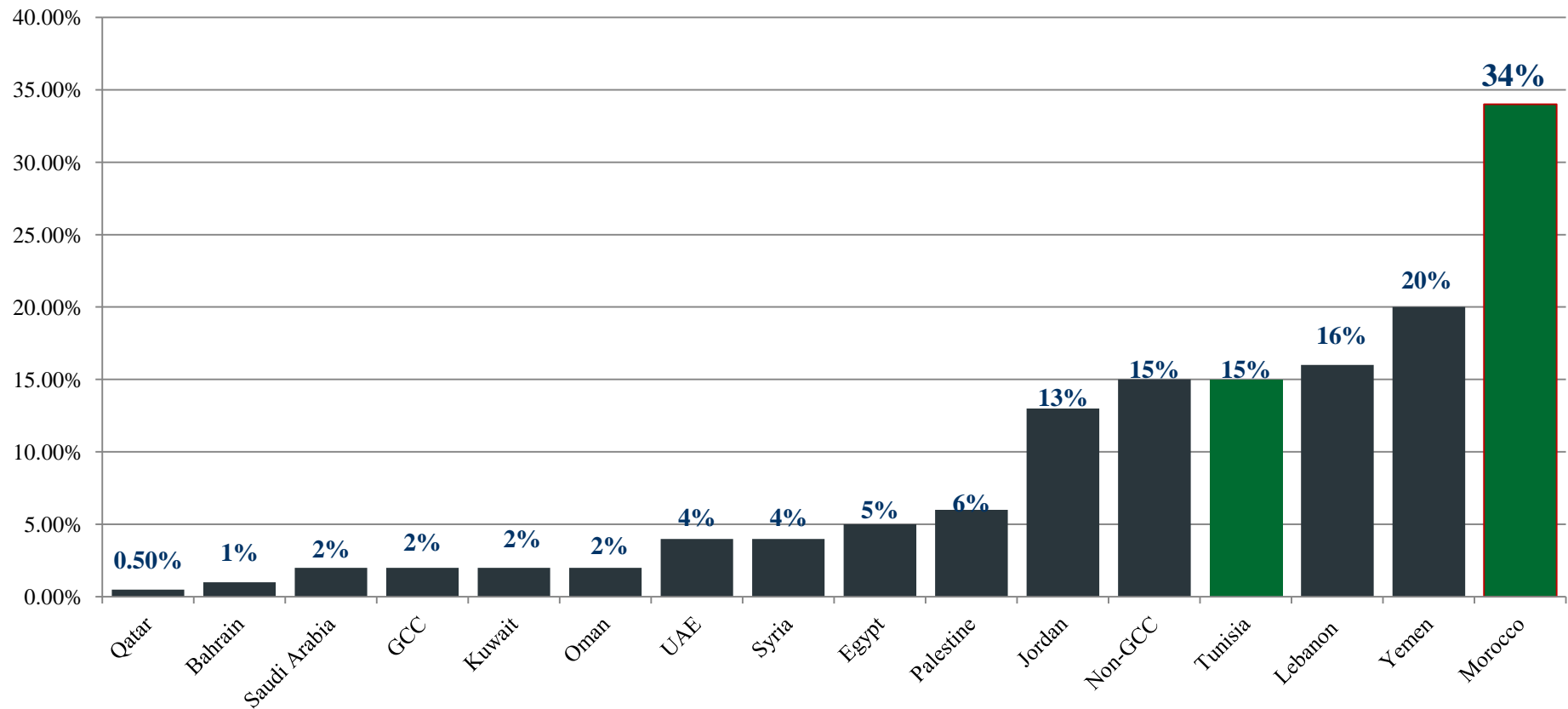
- We can't jump over these problems but how to render them digestible:
- Enviro / Framework
 - Need to look at breaking out into the key barriers to Improve Returns to investing in SME from the Private POV
- SME Quality
 - How to help. Technical Assistance frequently wasted if behind closed doors obs...
 - And the volume of SMEs is huge!

- Review Regulatory to remove barriers, follow best practice:
 - Enable investment & flexibility for CHANGE, do not impose hard requirements
 - Hard handcuff requirements are failures (See Lerner, Josh. Boulevard of Broken Dreams (2010))
 - Legal vehicles / Forms for Entrepreneurs & Investors:
 - Reform and modernize to make EASY & Cost Effective to use (e.g. Delaware LLC, France's reformed SAS);
 - Restrictions on issues like Preferred Share structures, Quasi Equity funding

- Improve Returns to financing of Entrepreneurs / SMEs? (That is make more attractive)
 - Improve SME bottom-lines (profits) by improving their competitiveness
 - Targeted business development services to higher potential SMEs (coming back to this)
 - Improved overall business environment
 - Improve investment tools
 - Better corporate vehicles / forms for entrepreneurs & investors
 - Improve liquidity tools (exits)
 - Alt approaches
 - Better public markets / alt markets

- Bad Money drives out good
- Strong standards bring in better practice, money.
 - Moroccan banking case as an example

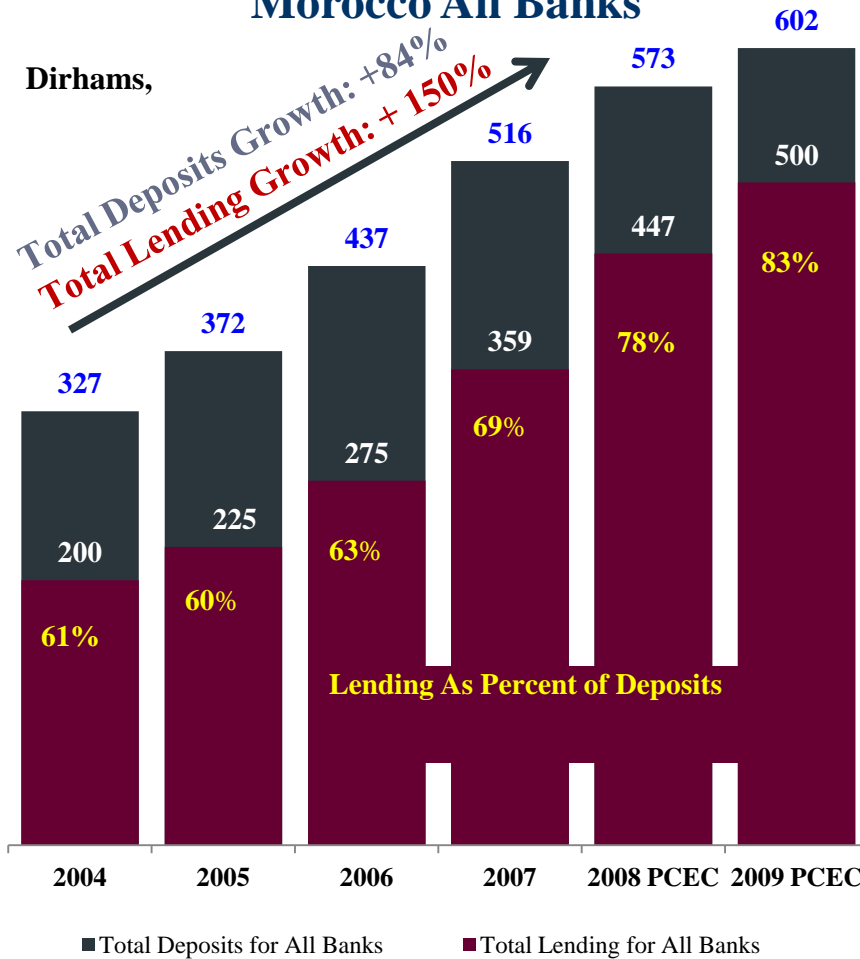
Bank Funding to SMEs (WB & Union of Arab Banks)



SME Loans as percent of total lending.

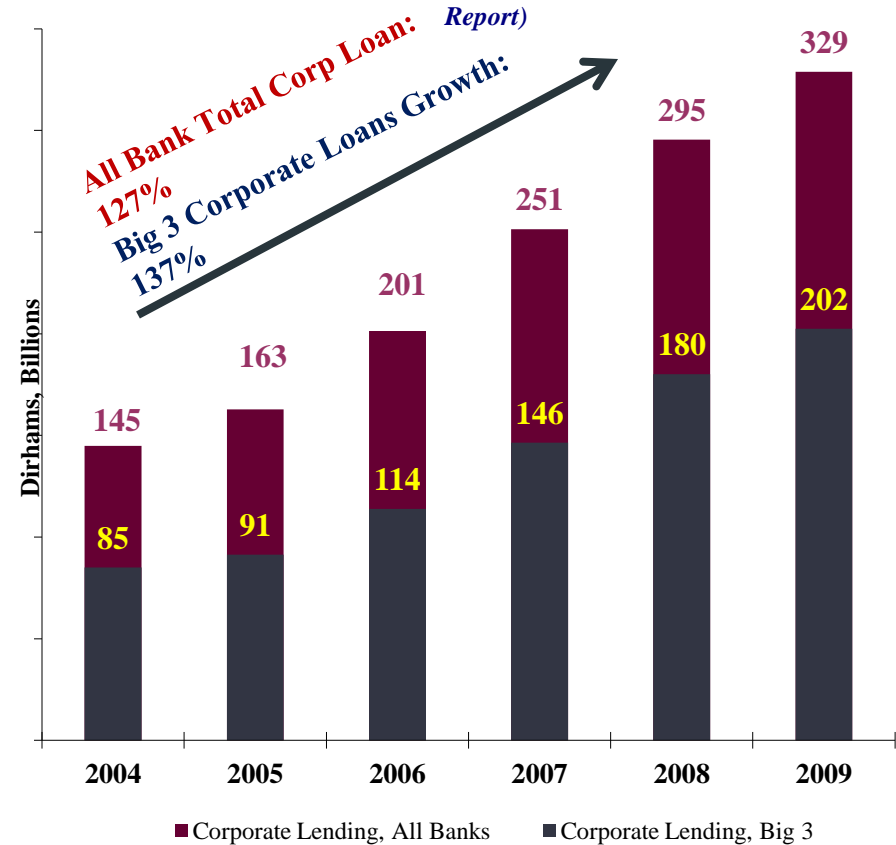
Funding availability to smaller firms in the Maghreb has significantly improved, making raising debt for smaller-sized investments more attractive, although regulators are watching leverage ratios.

Deposits vs Lending Growth Morocco All Banks

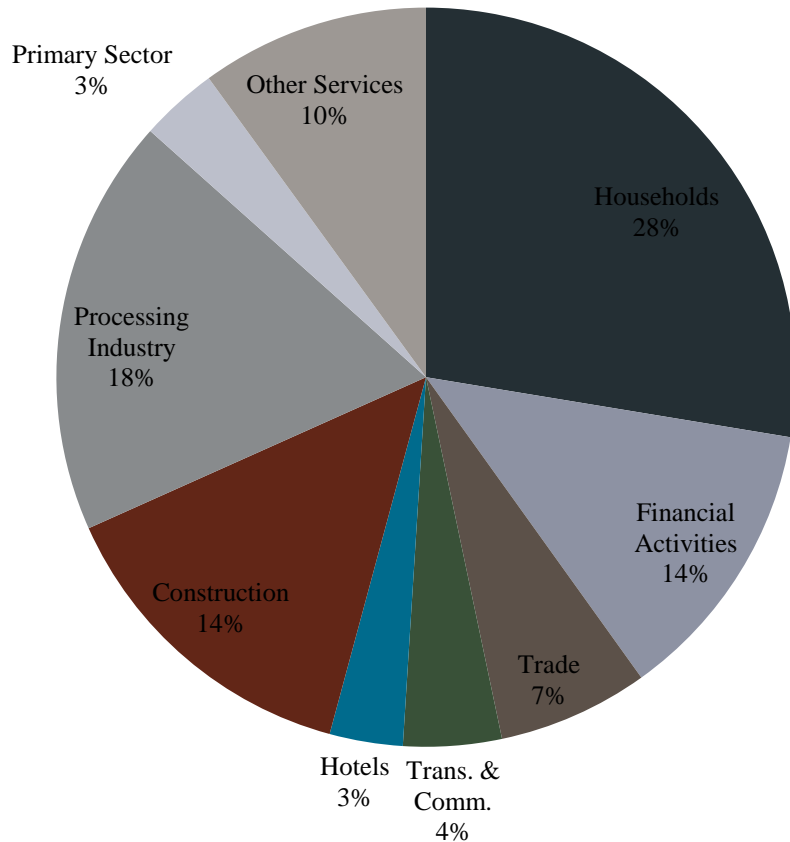


Moroccan Bank Lending Significant Increase in Corporate (2004-2008)

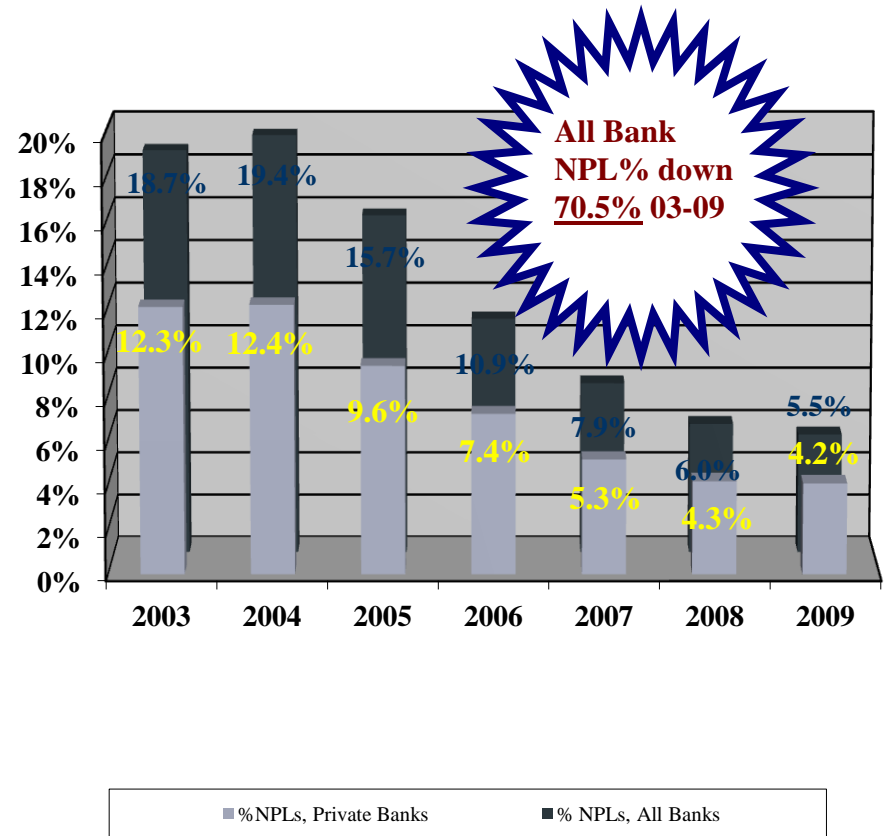
(sources: Bank Annual Reports, BAM Supervision Annual Report)



Morocco Bank Lending By Sector (2009)



Morocco Bank Non Performing Loans Improving Credit Management



“Technical assistance—consulting an individual or group that has business or finance experience on how to improve various aspects of a business—is critical to emerging-market SMEs and can help enhance a company’s value. Although the cost of technical assistance can be substantial, it is one of the best ways to mitigate investment risk. To prevent technical assistance from draining a commercial SME fund of its revenue, investors can work with development institutions, governments, foundations, and NGOs to create grant-based pools of funding to pay for technical assistance to portfolio investees.

The net return on the investment in such a fund should be higher because of the associated cost reductions for the fund itself and the improved performance of portfolio businesses. As a result, more commercial investors would be attracted to these funds while helping philanthropic organizations meet their objectives. Public institutions can use their capabilities to leverage greater private capital for SME investment funds.”

Source: Milken Institute: *Stimulating Investment in Emerging-Market SMEs* Financial Innovations Lab Report, 2009

- “Mechanisms are needed to match investors with projects that need funding. ...
- ...such mechanisms would move beyond ad hoc, project-by-project investments to create a more efficient marketplace. This need is especially great given the information asymmetries in developing countries.
- Investors find it difficult to identify appropriate investments, and entrepreneurs have trouble locating sources of capital. Making opportunities more visible would reduce investors’ transaction costs and increase the availability of capital for SMEs.”

Source: Stimulating Investment in Emerging-Market SMEs, Financial Innovations Lab Report, 2009

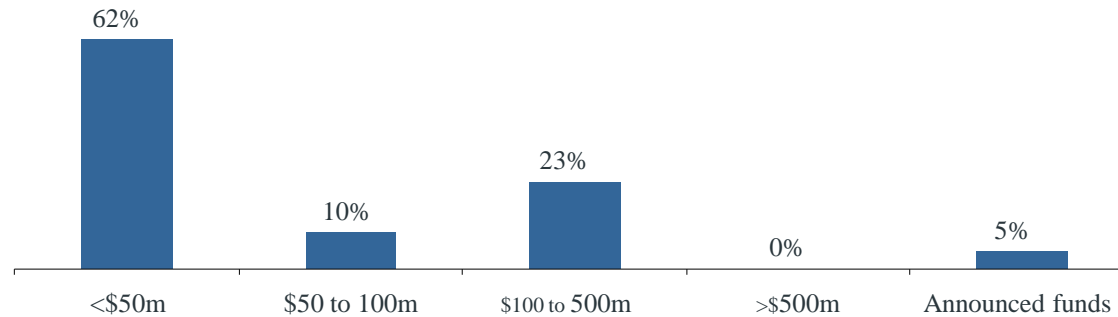
End of Presentation.

TIME FOR DISCUSSION

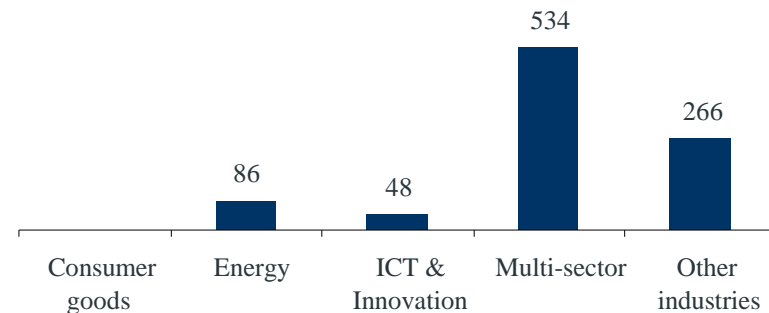
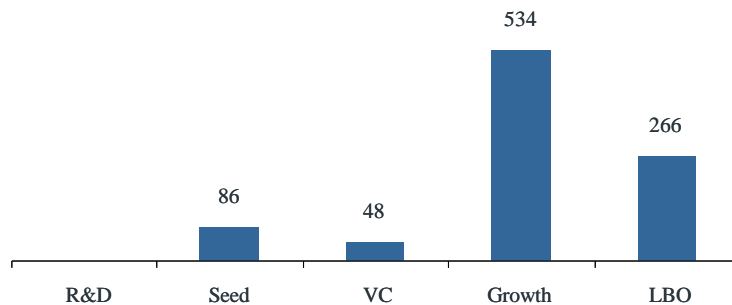
Maghreb & North Africa VC & PE
(excluding Real Estate & Infrastructure) Reference Slides

**ENTREPRENEURS & RISK
FINANCING: VENTURE FINANCING
LANDSCAPE IN NORTH AFRICA,
THE CONTEXT FOR ACCESS TO CAPITAL**

Moroccan PE/VC Funds by Size

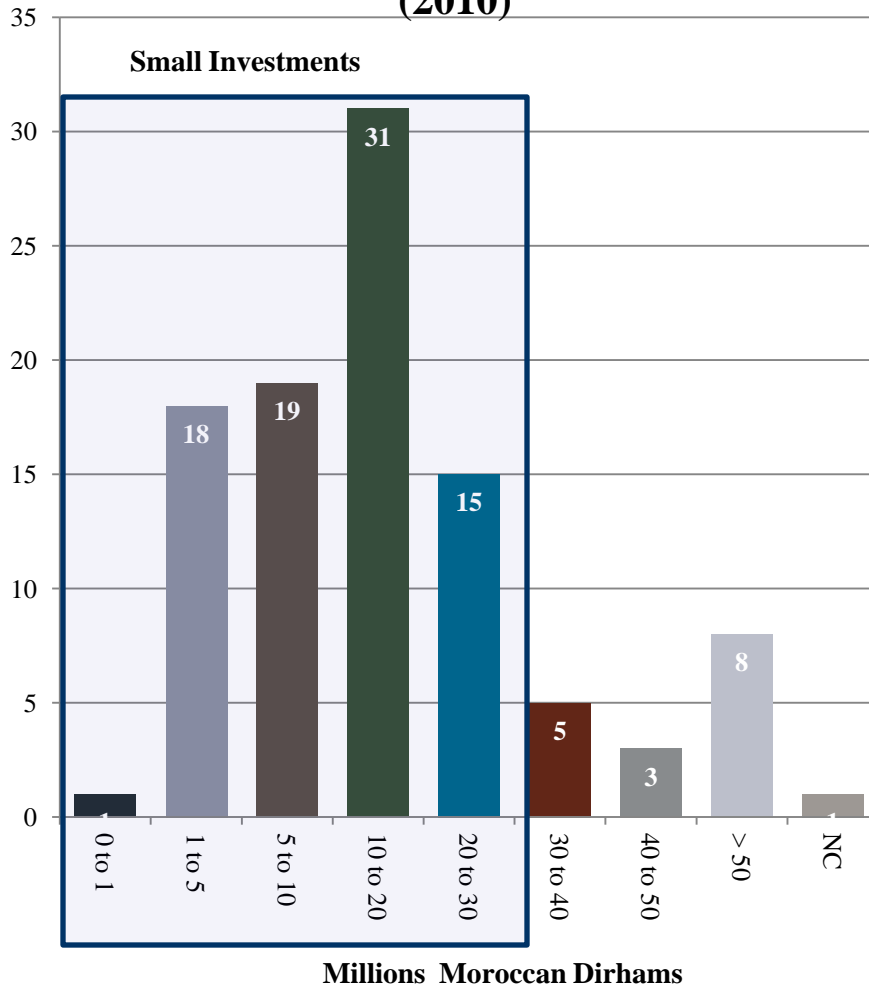


Funds announced by Investment Stage (in \$USm)

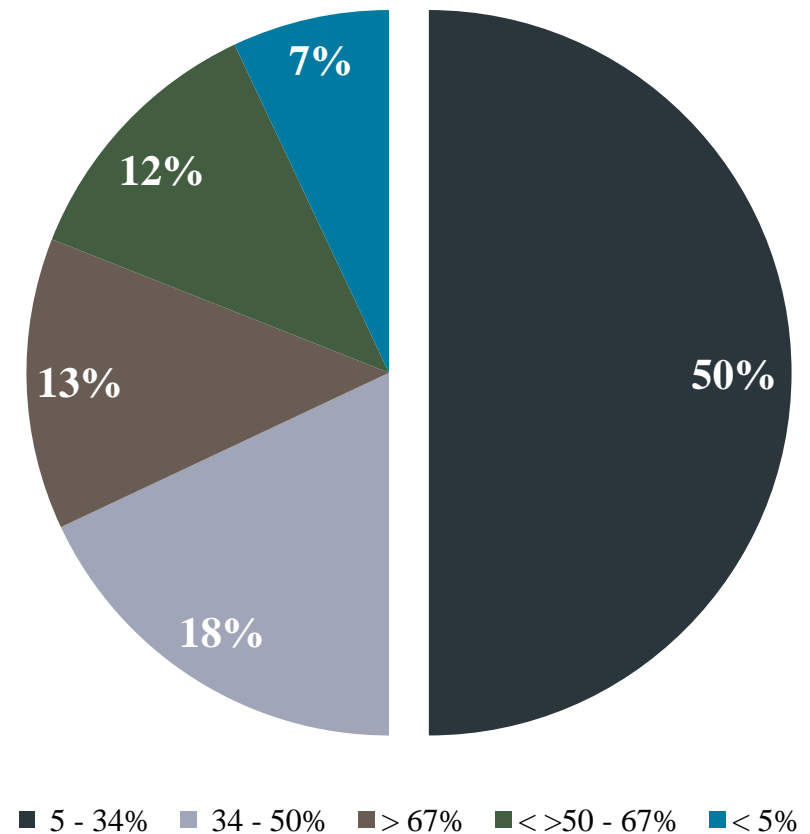


Maghreb Investment Style: Diversified & Small

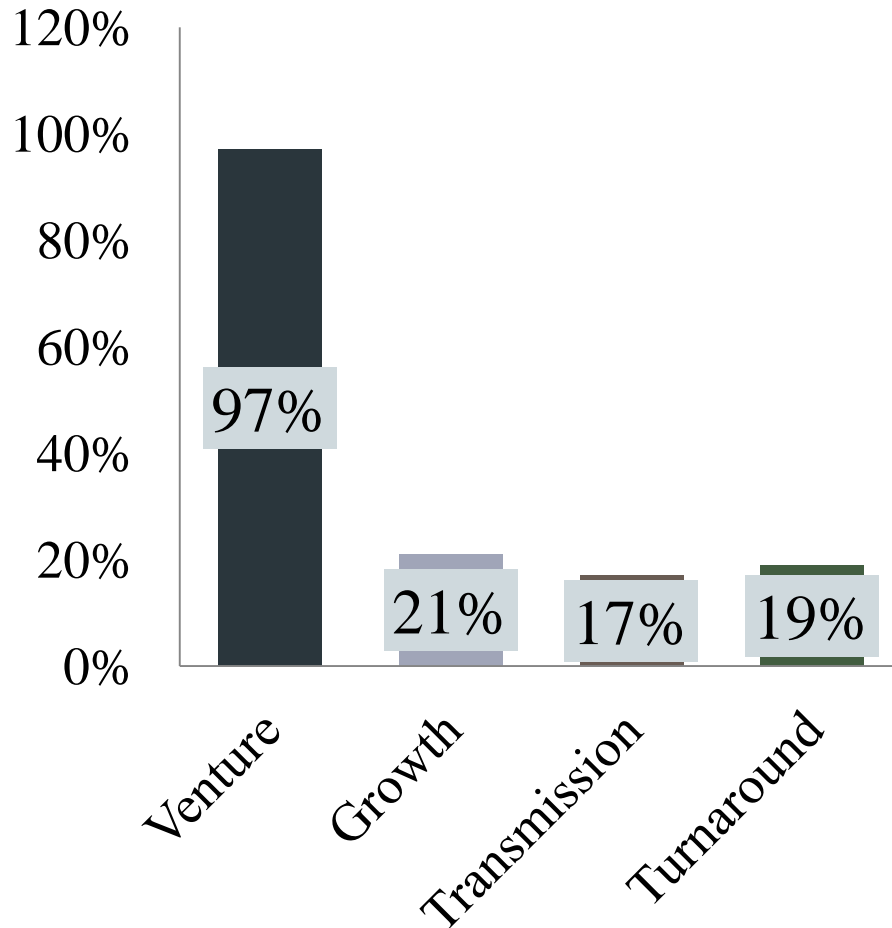
Number of Deals by Capital Invested (2010)



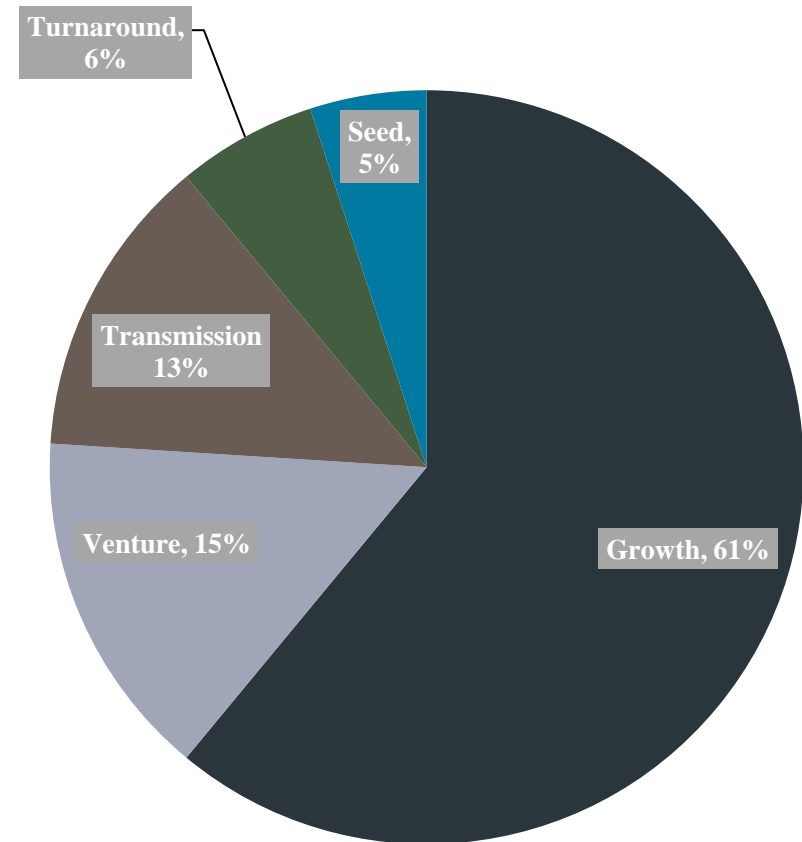
Invested Companies by % Capital Acquired (2010)



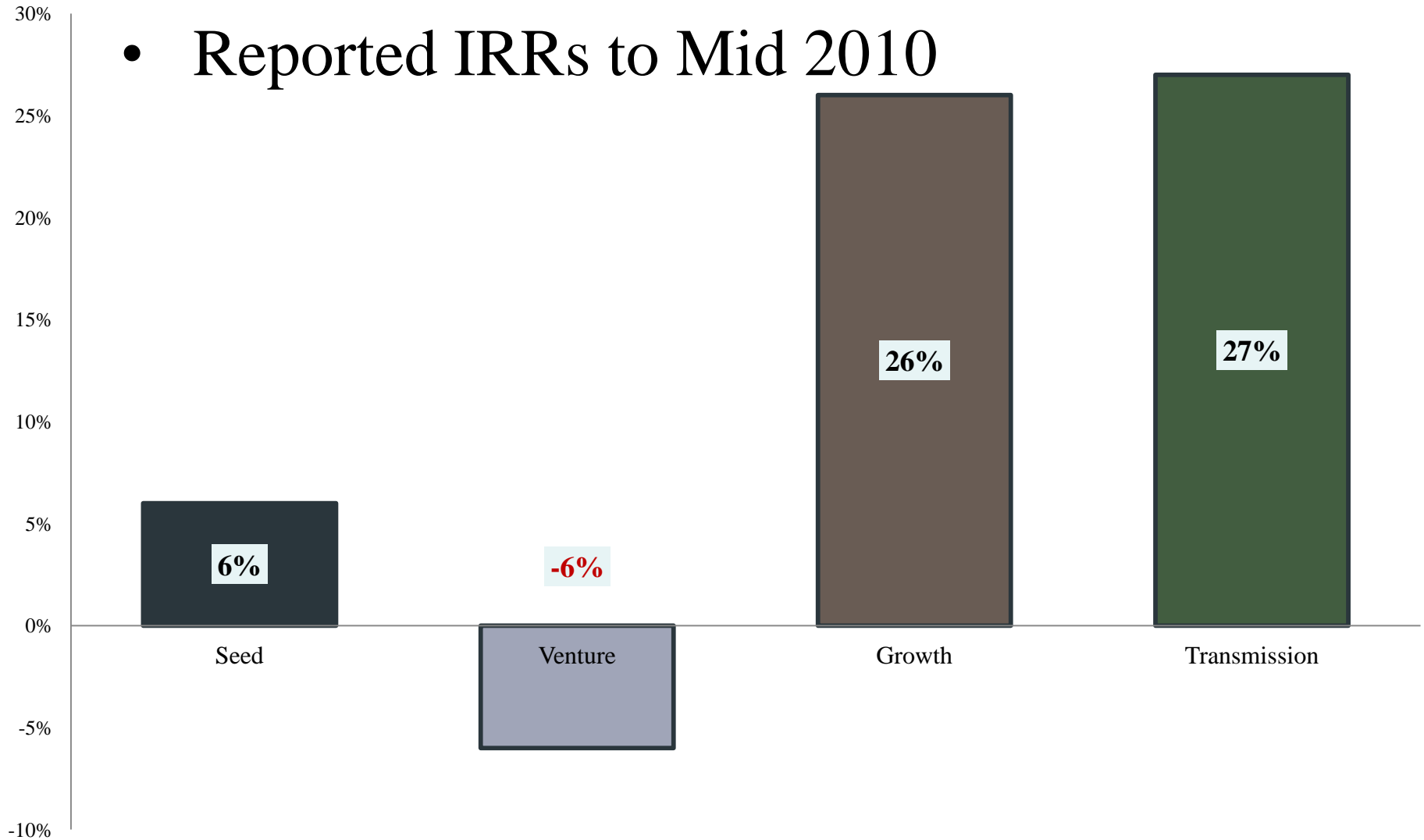
Revenue Growth, Invested Cos, by Invest Stage



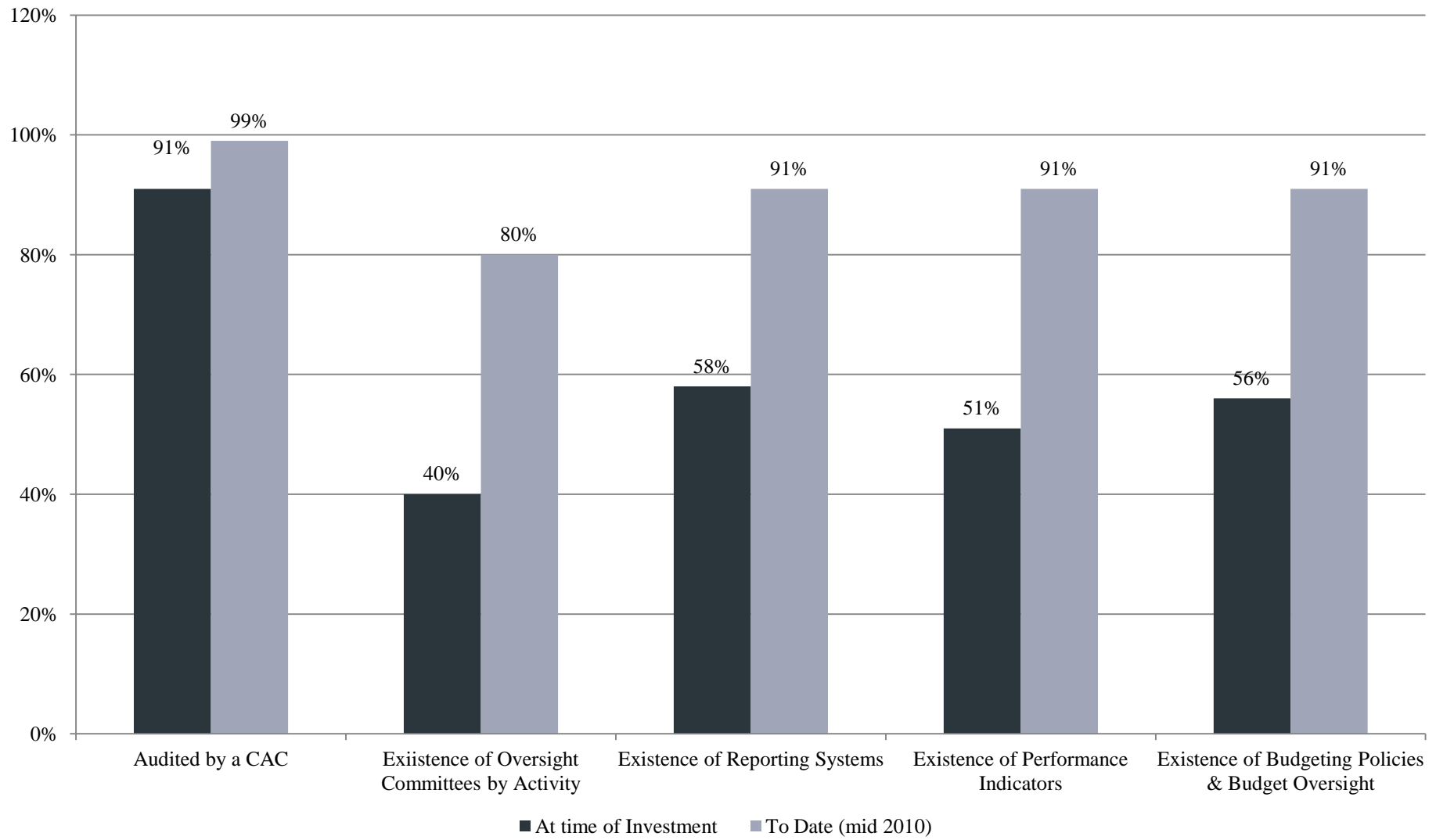
Investment Stage Shares of total portfolio.



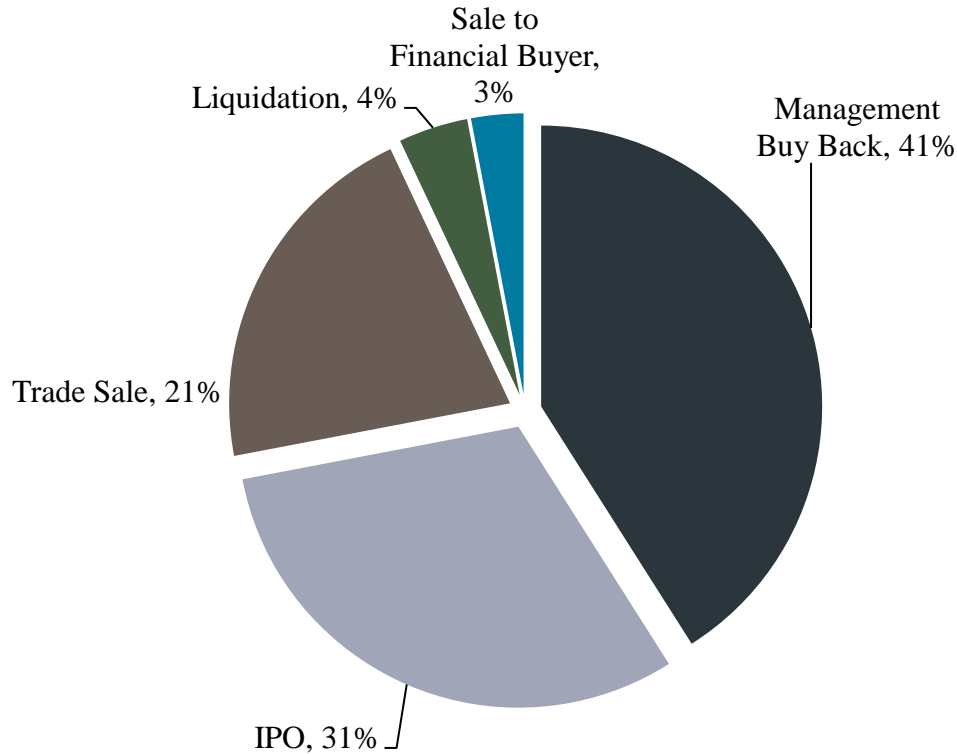
- Reported IRRs to Mid 2010



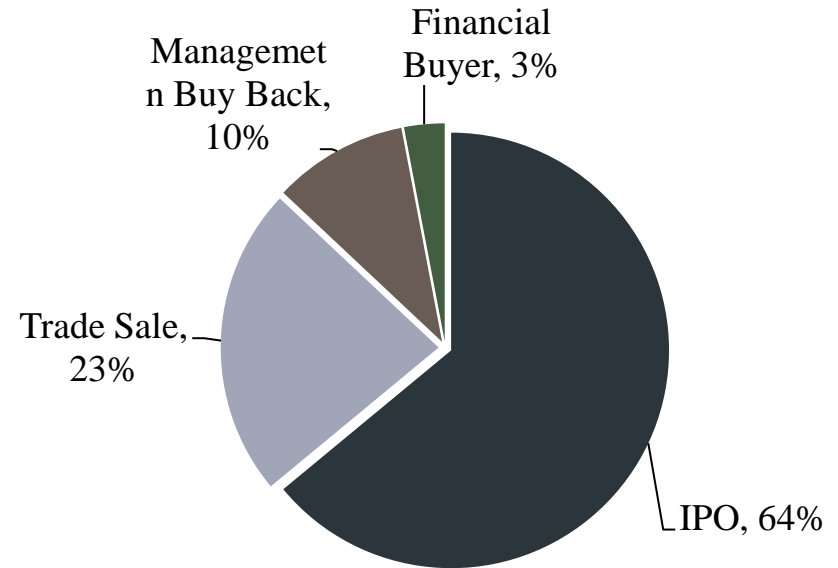
SME Quality, VC Impact, Morocco



Exits by Type (No.)



Perc. Capital Returned by Exit Type



- “As downward protection acts against the investor’s targeting the maximum yield, it tends to promote the survival of venture capital investors instead of enhancing the success of their investments. Hence the clearly observable tendency that the more advanced the venture capital industry of a given country, the more unlikely that downward protection play a major part in encouraging venture capital. In the USA and in the United Kingdom, venture capital programmes supported by the state tend to focus on raising the returns to private sector investors. On the other hand, in Continental Europe, every one of the more significant countries (France, Germany, Sweden, the Netherlands, Denmark) has public programmes including the direct guarantee component.” Karsai, Judit. “Can The State Replace Private Capital Investors? Public Financing of Venture Capital In Hungary.” Discussion Papers MT–DP. 2004/9, Institute of Economics Hungarian Academy of Sciences Budapest June 2004, p. 7
- Mason, Colin. “Public Policy Support For The Informal Venture Capital Market In Europe: A Critical Review” Working Paper 08-07 Hunter Centre for Entrepreneurship, University of Strathclyde Business School, December 2008, p. 10

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