SMEs AND SDGs:

Supporting small and medium enterprises to achieve the sustainable development goals

– Insights from a BlueOrchard Survey | November 2017

BlueOrchard *is a leading global impact investment management firm dedicated to fostering inclusive and sustainable growth while providing attractive returns for its investors. BlueOrchard offers premium multi-asset class solutions and is an expert in innovative blended finance and public-private-partnership mandates. With a major presence in emerging and frontier markets and offices on four continents, BlueOrchard helps its partners around the world make profound investment decisions and meet their objectives.*

Founded in 2001 by initiative of the UN, BlueOrchard was the first commercial manager of microfinance debt investments. The firm has utilized its know-how and experience to steadily expand into asset classes including credit, private equity, and sustainable infrastructure. To date, BlueOrchard has invested more than USD 4bn across 70 emerging and frontier markets, enabling fundamental social impact. BlueOrchard Finance is a licensed Swiss asset manager authorized by the FINMA. Its Luxembourg entity is a licensed alternative investment fund manager (AIFM) authorized by the CSSF. For additional information, please visit: ***www.blueorchard.com.***

BlueOrchard
Impact Investment Managers

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EXECUTIVE SUMMARY

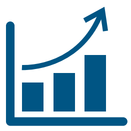
As an impact investment manager focusing on the developing world for more than 15 years, BlueOrchard has participated in the evolution of the inclusive finance sector as it has expanded beyond the financing of traditional microfinance institutions to include a broad range of lenders to small and medium enterprises (SMEs). Contributing to the growth and development of the SME sector has both important economic and social impacts, and these businesses, both formal and informal, have a critical role to play in the achievement of the Sustainable Development Goals (SDGs). Their impact is particularly strong through employment creation, providing significant opportunities for populations in developing countries.

The 17 SDGs, ratified by the United Nations General Assembly in September 2015, were presented as "a universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity". Not surprisingly, strengthening the capacity of SMEs – typically, though not exclusively, through greater access to finance – is identified as a key target in specific SDGs. In addition, SMEs involved in specific sectors can also make a significant contribution to the achievement of other SDGs. These sectors include in particular agriculture, affordable healthcare, education, clean energy and water & sanitation.

Nevertheless, the SME sector faces significant challenges: While SMEs in emerging markets do contribute to job creation, their contribution to overall economic growth, even when accounting for the weight of the informal sector in emerging markets, lags behind the examples of OECD economies. Access to financing sources for SMEs in their respective local markets is still a challenge for many companies. In addition, financing needs are only a piece of the puzzle of a number of challenges and policy responses required to develop the SME sector looking at both the demand and the supply sides.

BlueOrchard conducted a survey on a sample of financial institutions (FIs) lending to SMEs across different regions with the objective to identify differences and commonalities of SME markets across various countries and the needed improvements in terms of services and financing for SMEs in emerging and frontier markets. The main findings of the survey show that

credit remains the main source of SME financing, with loan sizes and maturities varying by region and being almost always collateralized



SMEs are impacted by commodity prices and the development of natural resources sectors

when financing is combined with business advisory services and capacity building the impact of financing can be enhanced and credit risk mitigated

credit unions, cooperatives and microfinance institutions tend to have greater outreach to informal sector SMEs compared to banks

legal, regulatory, market and political stability is required and in some regions supersedes other requirements for further developing

start-ups and those SMEs that operate in the informal sector are most limited in the access to credit

Understanding the key challenges and opportunities helps to point to the most effective means to provide support to the SME sector. Leveraging on its longstanding experience, BlueOrchard's action plan to support the development of the SME market pivots around a threefold approach:

1. innovative product structuring with the enhancement of portfolio securitizations of specialized SME lenders and financing companies;
2. combination of tailored funding for SMEs with advisory services and capacity building to multiply the benefits achievable with the financing; and
3. technological focus to achieve sustainable development and inclusive solutions across sectors.

In accordance with BlueOrchard's mission and vision an important role is envisaged for BlueOrchard's current mandates under management and future new initiatives to contribute to fulfill the SME financing agenda in emerging and frontier markets ensuring that this is responsible, inclusive, and sustainable.

INTRODUCTION

The recognition of the key role played by small and medium enterprises (SMEs) has been increasingly acknowledged by public policy makers and a range of initiatives, policies and policy frameworks – at both the national and supranational level – have been elaborated in order to support, promote and grow this segment. In the preface to the World Bank's 2017 "What's Happening to the Missing Middle?: Lessons from Financing SMEs" report, the authors remarked on how following the dislocation of the 2008/2009 global financial crisis, policy makers worldwide – in the EU, the G20, the OECD and the World Economic Forum, to name a few – focused increasing attention on strengthening the SME sector in order to build greater economic resilience worldwide.[1] Among these initiatives, in 2010, the G20 launched its "SME Finance Challenge," and published its policy paper on "Scaling-Up SME Access to Financial Services in the Developing World"[2] and the World Bank's Finance and Markets Global Practice developed its "SME Action Plan".[3] In 2017, the UN General Assembly, recognizing the importance of these enterprises, decided to declare 27 June the "Micro-, Small and Medium-sized Enterprises Day" to raise public awareness of their contribution to sustainable development.[4]

As an impact investment manager focusing on the developing world for more than 15 years, BlueOrchard has participated in the evolution of the inclusive finance sector as it has expanded beyond the financing of traditional microfinance institutions to include a broad range of SME-lenders. Microfinance institutions have grown with their clients and

have diversified their financial offering, while also enlarging their focus segment from micro businesses and micro entrepreneurs to include the so-called "missing middle." Many banks, meanwhile, have often moved from lending to large corporates to servicing the missing middle and SMEs. Leasing companies and innovative fintech companies have also become increasingly involved.

Contributing to the growth and development of the SME sector has both important economic and social impacts, and these businesses, both formal and informal, have a critical role to play in the achievement of the Sustainable Development Goals. In this paper, we explore how these impacts can be achieved, the challenges and opportunities that SMEs face, and how their further development can be supported.

1 Alibhai, S., Bell, S., Conner, G. (2017). *What's Happening in the Missing Middle?: Lessons from Financing SMEs.* [pdf] Washington, DC: World Bank. Available at: http://hdl.handle.net/10986/26324 [Accessed 4 Sept. 2017].

2 International Finance Corporation. (2010). *Scaling-Up SME Access to Financial Services in the Developing World.* [pdf] Washington, DC: World Bank. Available at: http://www.ifc.org/wps/wcm/connect/bd1b060049585ef29e5abf19583b6d16/ScalingUp.pdf?MOD=AJPERES [Accessed 4 Sept. 2017].

3 Gloria, E., Gandolini., (2015). *SMEs finance leapfrogs through fintech innovation. [pdf] World Bank.* Available at: http://blogs.worldbank.org/psd/smes-finance-leapfrogs-through-fintech-innovations [Accessed 5 Sept. 2017].

4 United Nations. (2017). *Micro-, Small and Medium-sized Enterprises Day 27 June.* [online] Available at: http://www.un.org/en/events/smallbusinessday/ [Accessed 4 Sept. 2017].

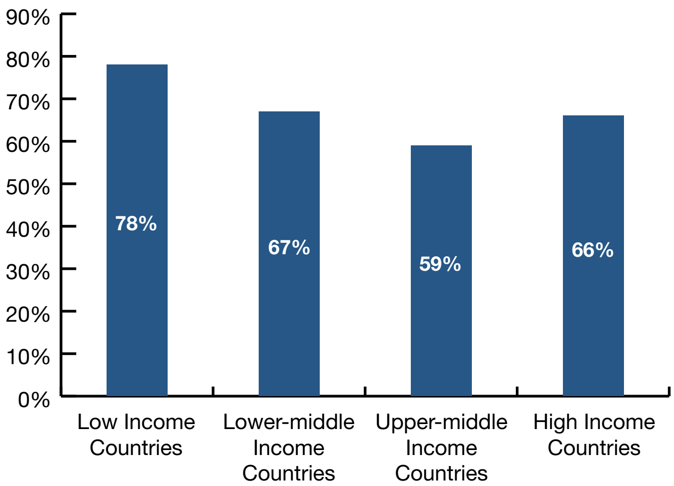
THE SME SECTOR: ECONOMIC CONTRIBUTION AND EMPLOYMENT GENERATION

In frontier and emerging market economies, the SME sector contributes significantly to both employment and gross domestic product (GDP). While estimates vary based on various definitions of what constitutes an SME, the numbers are impressive.[5] A 2015 World Bank brief reported, for instance, that formal SMEs contribute up to 60 % of total employment and up to 40 % of GDP in emerging economies, while creating four out of every five new jobs.[6] Direct effects on GDP growth come from increased output,

"SMEs create four out of every five new jobs in emerging economies."

value added and profits, while GDP is impacted indirectly through increased innovation and greater macroeconomic resilience of the overall economy. Critically, job creation is one of the most significant effects by SMEs, having strong social as well as economic implications. An in-depth study on employment generation was conducted by the World

Table A: Employment contribution by SMEs



Bank in 2011, looking at data from 104 developing countries over a two-year time horizon. As shown in Table A, smaller enterprises (here, defined as those with less than 100 employees) contributed the majority of new jobs in low income countries, at a striking 78 %.[7] It is worth noting that this analysis did not include informal (that is, unregistered) businesses, which as shown in data from the IFC (Table B) account for an even greater share of GDP in lower income countries.[8]

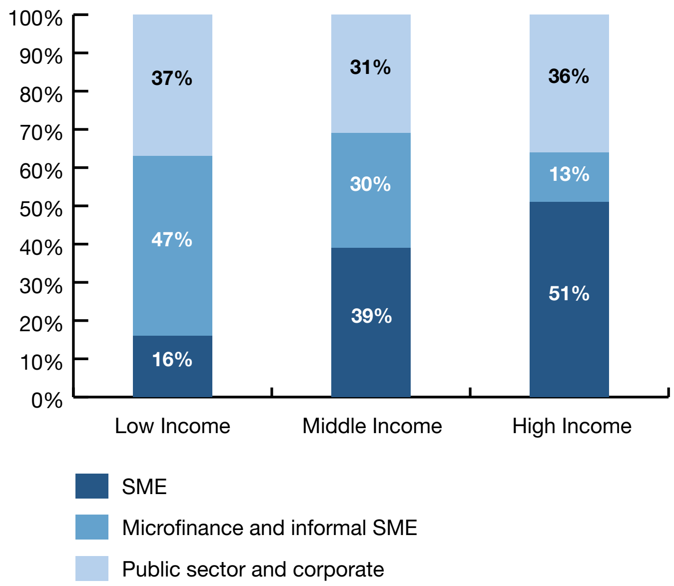
5 Enterprise size is typically defined based on number of employees, assets and/or annual sales, but thresholds vary. For example, the European Union defines micro, small and medium enterprises (MSMEs) as enterprises with up to 250 employees, EUR 50 million in sales and/or EUR 43 million in assets, while the World Bank typically uses significantly lower thresholds in sales and assets (USD 15 million). In the World Bank study *"Small vs. young firms across the world: contribution to employment, job creation, and growth"* referenced below small firms are those with less than 100 employees.

6 The World Bank. (2015). Brief: *Small and Medium Enterprises (SMEs) Finance.* [online] Available at: http://www.worldbank.org/en/topic/financial-sector/brief/smes-finance. [Accessed 3 Sept. 2017].

7 Ayyagari, M., Demirguc-Kunt, A., Maksimovic, V., (2011). *Small vs. young firms across the world: contribution to employment, job creation, and growth.* [pdf] Policy Research working paper. Available at: http://documents.worldbank.org/curated/en/478851468161354807/pdf/WPS5631.pdf [Accessed 4 Sept. 2017])

8 Ayyagari., Beck., Demirgüç-Kunt., (2003) *IFC SME Banking Knowledge guide 2010.* [pdf] Available at: https://www.ifc.org/wps/wcm/connect/b4f9be0049585ff9a192b519583b6d16/SMEE.pdf?MOD=AJPERES [Accessed 4 Sept. 2017]

Table B: SMEs' contribution to GDP



The data also revealed that in comparative terms, in lower income countries, smaller enterprises account for comparatively more employment than in their richer counterparts, with more than half of jobs in lower income economies coming from such firms.

Table C: Percentage of jobs by companies by size (medians)[9]

	Company size (by # of Employees)		
	5–19	20–99	100+
Low Income	22,52	28,32	44,20
Lower-Middle Income	17,89	25,61	51,06
Upper-Middle Income	12,06	25,91	60,65
High Income	13,83	31,53	54,34

When looking at recent job creation, the evidence is even stronger. Among the countries that experienced overall job creation, less than 5 % of this job creation in low income countries (and slightly more than ¼ in low-middle income countries) came from enterprises with more than 100 employees.

Table D.1: Percentage of jobs created by companies of different sizes (medians) in countries with net job creation

	Company size (by # of Employees)		
	5–19	20–99	100+
Low Income	58,34	30,36	4,57
Lower-Middle Income	40,70	26,10	27,48
Upper-Middle Income	40,69	31,68	29,75
High Income	39,84	58,79	6,31

For those where employment levels declined, job losses were all from such larger enterprises, while companies employing 99 or fewer workers experience net increases in employment.

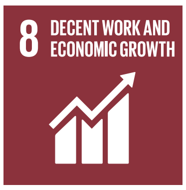
Table D.2: Percentage of jobs created by companies of different sizes (medians) in countries with net job losses

	Company size (by # of Employees)		
	5–19	20–99	100+
Low Income	66,90	0,81	–180,20
Lower-Middle Income	12,96	0,13	–104,88
Upper-Middle Income	90,43	131,74	–328,70
High Income	22,30	22,48	–144,77

9 Source for Tables C-D.2: Ayyagari, M., Demirguc-Kunt, A., Maksimovic, V., (2011). *Small vs. young firms across the world: contribution to employment, job creation, and growth.* [pdf] Policy Research working paper.

SMEs AND SDGs: A MUTUALLY REINFORCING RELATIONSHIP

The 17 Sustainable Development Goals (SDGs), ratified by the United Nations General Assembly in September 2015, were presented as "a universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity". Not surprisingly, strengthening the capacity of SMEs – typically, though not exclusively, through greater access to finance – is identified as key target in specific SDGs. These include:



SDG 8 – Decent Work and Economic Growth: Given the employment-generating role of SMEs, allowing these businesses to thrive and prosper is clearly a critical area for achievement of this goal. Target 8.3 is to "Promote development-oriented policies that support productive activities, decent job creation, entrepreneurship, creativity and innovation, and encourage the formalization and growth of micro-, small- and medium-sized enterprises, including through access to financial services."

> "Strengthening the capacity of SMEs is identified as key target in specific SDGs."

SDG 9 – Industry, Innovation and Infrastructure: Innovation and hard work is the hallmark of an SME: all business owners start with an idea, and develop it to create a viable business that meets the needs of its customers. But SMEs, like all businesses, require support to allow those ideas and innovations to materialize in a successful venture. These supports include access to financial services and the ability to access markets.

Target 9.3 identifies the importance of access to financial services and is to "Increase the access of small-scale industrial and other enterprises, in particular in developing countries, to financial services, including affordable credit, and their integration into value chains and markets." This target again points to the importance of providing funding to SMEs, but it also includes the idea of strengthening the ability of SMEs to access markets and expand their businesses through value chains, thus going beyond pure credit. By offering business development services and networking opportunities to their clients, SME lenders can facilitate the further development of these enterprises.

One example of such a lender is the organization Idepro in Bolivia that has a specific "Procadenas" lending product aimed at providing financing across the value chain of specific sectors and connecting various businesses along this chain with one another. Starting in various agro-forestry products, such as quinoa, grapes, castañas and forestry products Idepro has now also expanded its value chain financing into textiles, transport and construction.

SECTOR-SPECIFIC AREAS

SMEs involved in specific sectors can also make a significant contribution to the achievement of other SDGs. These sectors include in particular agriculture, affordable healthcare, education, clean energy and water & sanitation.

SDG 2 – Zero Hunger: Target 2.3 explicitly points to the important role played by smallholder farmers and agricultural-focused SMEs in creating and maintaining a sustainable food supply. This target is to "By 2030, double the agricultural productivity and incomes of small-scale food producers, in particular women, indigenous peoples, family farmers, pastoralists and fishers, including through secure and equal access to land, other productive resources and inputs, knowledge, financial services, markets and opportunities for value addition and non-farm employment."

SDG 3 – Good Health and Well-Being: In many developing countries, healthcare SMEs fill the gap left by the inability of the public sector to meet health care needs of the population. SMEs, noted the authors of one study "are progressively taking the leading role as innovators of low-cost, high-volume delivery models."[10] Though again, limited access to capital was cited as an impediment to the further development of these enterprises, in addition to the challenges of proper quality control and accreditation.

In a 2015 survey conducted by the AXA Group and the United Nations Environment Programme Finance Initiative's Principles for Sustainable Insurance (UNEP FI PSI) on the impacts of climate change on SMEs, 9 % of the 1,104 SMEs surveyed were involved in the healthcare sector showing a relatively high number of SMEs in this area.[11]

SDG 4 – Quality Education: Likewise, public funding alone in many developing countries is insufficient to provide the breadth and the quality of education services needed to reach the ambitious goals laid out in SDG 4. In many regions of the developing world, low cost private schools have been identified as a key means to provide the necessary educational services to the population, and can be considered essentially "educational SMEs."

The Center for Education Innovations (CEI) tracks, among other innovations, the development of low cost private schools worldwide and in a recent study noted that the number of low cost private schools had more than doubled in India since 1993, while in Kenya, low cost private school enrollment has tripled since 1997.[12] Of 40 profiled programs, 31 were launched after 2005 and most are located in Sub-Saharan Africa and South Asia (especially

10 Kholi, J., Wanjiru, R. (2013). Private Sector Opportunities in Developing Country Healthcare. [online] *Private Sector Development* – Proparcos Magazine Available at: http://blog.private-sector-and-development.com/2013/08/12/private-sector-opportunities-developing-country-healthcare/ [Accessed 4 Sept. 2017]

11 AXA. (2015). *Business Unusual: Why is the climate changing the rules for our cities and SMEs?* [online] AXA. Available at: https://www.axa.com/en/about-us/business-unusual-29-october [Accessed 5 Sept. 2017]

12 Center of education innovations. (2017). *Low-cost private schools.* [online] Available at: http://www.educationinnovations.org/topics/low-cost-private-schools [Accessed 5 Sept. 2017]

Kenya and India). BlueOrchard manages a tailored mandate to support affordable and good quality private schools in Africa. This is the Regional Education Finance Fund for Africa (REFFA) initiated by the German Federal Ministry for Economic Cooperation and Development (BMZ) and the German Development Bank, KfW.[13] REFFA's objective is to further support the development of private education providers in Africa via dedicated financing and technical assistance.

"There is a potential USD 1.2 trillion market for SMEs in the area of 'clean technology'."

SDGs 6 and 7 – Clean Water and Sanitation and Affordable and Clean Energy: A report by the World Bank in 2014 identified a potential USD 1.2 trillion market for SMEs in the developing world in the area of "clean technology" for the decade ending in 2023.[14] The greatest opportunities identified were in waste management, followed by small hydro, water treatment, onshore wind power, solar photovoltaic, geothermal and bioenergy. SMEs are considered to be particularly well-placed to operate in this sector due to the various value-chain areas involved that are suited to small-sized enterprises – construction, installation, operations and maintenance – and the connection that SMEs have to local markets. The study reports that in the UK, up to 90 % of clean technology businesses are SMEs, and this could be replicated in the developing world. An example from Sub-Saharan Africa is AbzeSolar in Burkina Faso. Namely, an SME committed to empowering local communities via the provision of high quality solar energy products and solutions installed and maintained by locally trained people.

13 For more information visit: www.reffa.org

14 World Bank. (2014). *Building Competitive Green Industries: The Climate and Clean Technology Opportunity for Developing Countries.* [online] Available at: http://documents.worldbank.org/curated/en/837201468165876160/Building-competitive-green-industries-the-climate-and-clean-technology-opportunity-for-developing-countries [Accessed 4 Sept. 2017]

MEET OUR INVESTEES: ACLEDA BANK

A FASCINATING UPSCALING EXPERIENCE

ACLEDA (Association of Cambodian Local Economic Development Agencies) started in 1993 as a national non-governmental organization (NGO) specialized in micro and small enterprise development and credit operations with the support of the United Nations Development Program (UNDP) and the International Labor Organization (ILO). Today ACLEDA is the largest full-service bank in Cambodia and offers loans, savings products, trade financing, online banking and a wide range of banking services. It employs more than 12’000 people and has 259 agencies across the country. ACLEDA has remained focused on micro and SME entrepreneurs. Loans for income generating activities contribute close to 85 % of its USD 2.8 billion portfolio in volume terms as of March 2017.

One of ACLEDA’s clients are Mrs. Channy and her husband, who in 2011 decided to take their first loan for USD 35,000 to start a laundry shop. Their customers are hotels and guesthouses in Phnom Penh. Since then, the couple has been borrowing loans from ACLEDA to expand their business including supplying toiletries to their customers and selling clothes. Being a so-called 5th cycle client, they borrowed their last loan in the amount of USD 83,000 in September 2016 to increase their supplies and buy new washing machines.

Another client of ACLEDA is Mrs. Ratana. She has been with the bank since 2011 and used her first loan in the amount of USD 30,000 to construct rooms on her spare plot of land and then rent them to garment workers. In this way she complemented her income from her rice trading business. Mrs. Ratana is currently in her 6th loan cycle with ACLEDA and borrowed her last loan amounting to USD 120,000 in December 2016. She used this loan to further expand her rice trading business. With the loans from ACLEDA Mrs. Ratana was able to expand her businesses and increase her income. She and her husband are optimistic about their future and plan to buy more land and thereby to increase their rental activities.

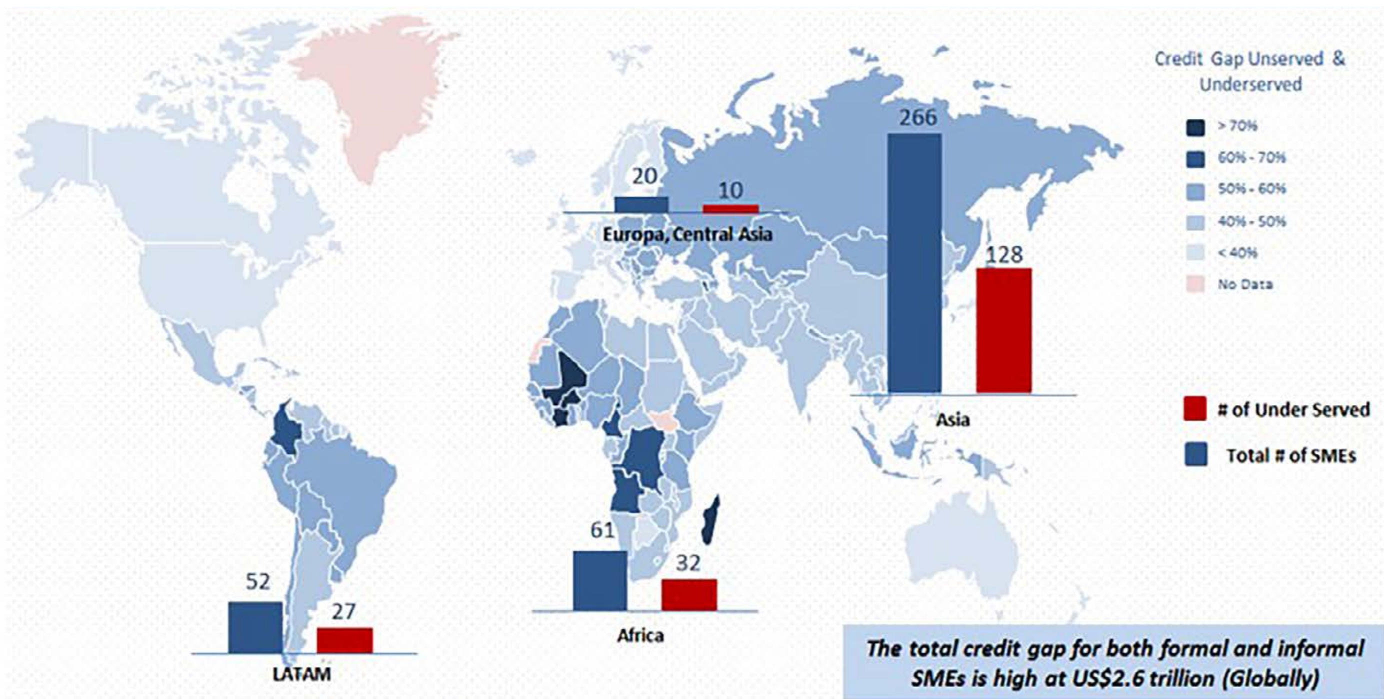
CHALLENGES AND OPPORTUNITIES FOR SMEs IN EMERGING MARKETS: THE FOUR-KEY AREAS

The literature on the SME sector is quite extensive and there is generally a clear consensus on the main areas to focus on for the further development of the SME sector.

1 The first consensus is that SMEs in emerging markets do contribute to job creation but their contribution to overall economic growth, even when accounting for the weight of the informal sector in emerging markets, lags behind the examples of OECD economies. The 2017 OECD study "Small, Medium, Strong. Trends in SME Performance and Business Conditions" for instance, shows a direct correlation between the SME growth and improvement of the employment environment. [15] But it also indicates that despite the higher proportion of employment in lower-income countries, SMEs do not contribute a greater proportion of economic growth in these countries than they do in developed countries.

2 The second is that in order to achieve the SDGs a stronger and more productive SME sector is required. SDG 8 "Decent Work and Economic Growth" articulates many targets that boil down to productivity, efficiency, innovation, in addition to inclusiveness and sustainability. [16]

Table E: SMEs affected by the credit gap in millions of enterprises



Source: IFC Enterprise Finance Gap Database 2011.(Including formal and informal SMEs)

15 OECD. (2017). *Small, Medium, Strong. Trends in SME Performance and Business Conditions.* [online] Available at: http://www.oecd.org/industry/small-medium-strong-trends-in-sme-performance-and-business-conditions-9789264275683-en.htm [Accessed on 4 Sept. 2017]
16 Kamal-Chaoui., L. (2017), *Unlocking the potential of SMEs for the SDGs.* [online] OECD. Available at: https://oecd-development-matters.org/2017/04/03/unlocking-the-potential-of-smes-for-the-sdgs/ [Accessed on 4 Sept. 2017]

3 The third is that access to financing sources for SMEs in their respective local markets is still a challenge for many companies. The IFC Enterprise Finance Gap database 2011 for formal and informal SMEs has estimated an overall USD 2.6 trillion credit gap globally for SMEs in emerging markets, confirming the large unmet financing needs of formal and informal SMEs.[17] In some parts of Africa, Latin America and Asia more than 60 % of SMEs are affected by the credit gap.

4 The fourth point of agreement is that financing needs are only a piece of the puzzle of a number of challenges and policy responses required to develop the SME sector looking at both the demand and the supply sides. The OECD presents them in a comprehensive manner indicating the policy obstacles on both demand and supply side, the main areas of concerns, and the potential policies required to address them (see Table F below).[18]

> "There is an overall USD 2.6 trillion credit gap globally for SMEs in emerging markets."

Table F: Challenges and policy responses for developing non-bank finance instruments for SMEs

Policy obstacle	Main area of constraints	Potential policy action	Structural measures
Demand-side	Lack of awareness, negative perceptions and inabilty to access alternatives to bank finance	• Consider a national strategy to foster financial literacy, ideally with a specific focus on SMEs • Develop financial education programmes for entrepreneurs and would-be entrepreneurs, including through incubators • Develop investor-readiness programmes	• Address the fragmentation of SME financial markets • Improve the liquidity and scale of markets (thin markets problem) • Help to develop an SME finance ecosystem • Create links and matchmaking services between (potential) investors, entrepreneurs and large companies • Monitor and evaluate public policies in this area
Demand-side	Lack of financial skills and vision	• Enhance SME financial skills and strategic vision by offering advisory services to improve accounting, financial management and overall business development • Complement the provision of financial support to SMEs with non-financial elements such as counselling and monitoring	
Demand-side	Disadvantageous tax treatment of equity instruments	• Encourage tax neutral regulation • Support a range of financing instruments for SMEs, e.g. via tax deductibility for innovative start-ups that participate in entrepreneurship trainings or in incubator programmes	
Supply-side	Opacity of the SME market	• Improve transparency and provide targeted information, e.g. by credit registries or bureaus for SMEs and rating services going beyond collateral and historical financial information • Identify SME financing needs and gaps and improve the evidence base	
Supply-side	Regulatory ambiguity or barriers to entry in the SME market	• Design regulation that supports a range of financing instruments for SMEs, while ensuring financial stability and investor protection	
Supply-side	Limited exit stops	• Lower the costs of IPOs • Introduce measures that reduce the length of time between investing and exiting • Considering the needs of equity investors when designing regulation	

17 World Bank. (2015). *Small and Medium Enterprises (SMEs) Finance.* [online] Available at: http://www.worldbank.org/en/topic/financialsector/brief/smes-finance [Accessed on 5 Sept. 2017]
18 OECD. (2017). *Financing SMEs and Entrepreneurs 2016: An OECD Scoreboard.* [online] Available at: http://www.oecd-ilibrary.org/industry-and-services/financing-smes-and-entrepreneurs-2016_fin_sme_ent-2016-en [Accessed on 5 Sept. 2017]

BLUEORCHARD SURVEY: OBJECTIVES AND FINDINGS

Over its past 15 years of activities in the field of financial inclusion and impact investing, BlueOrchard has provided more than USD 4 billion in funding to micro, small and medium enterprises (MSME) across 70 frontier and emerging markets. The intermediary financial institutions that BlueOrchard finances are highly diverse and range from local commercial banks and specialized SME/microfinance banks to Tier III NGOs, credit cooperatives, credit unions, and sector specific financing companies (e.g. schools, agriculture value-chain financers).

In order to build on the BlueOrchard portfolio and on the evolving nature of its investees and of their portfolio composition and types of products and services provided, an in-depth survey was carried out over the past six months by the BlueOrchard investment team. The objective of the BlueOrchard survey was to:

i) identify both the differences and commonalities of SME markets across various countries of operations; and
ii) identify the needed improvements in terms of services and financing for SMEs in emerging and frontier markets.

The BlueOrchard survey was conducted on a sample of financial institutions (FIs) lending to SMEs across four different regions: Caucasus, East Asia, Sub-Saharan Africa, and Central and South America.

The results of this survey provide an opportunity to understand better the local SME markets through the eyes of their bankers while also get a first-hand perspective of the SMEs' needs, requirements and challenges.

The main observations of the survey are as follows (refer also to Table G):

CHARACTERISTICS OF FINANCING

Credit remains the main source of SME financing, with loan sizes varying by region in the USD 20,000 – USD 800,000 range. Loan maturities typically go out to 36-48 months but some longer-term financing (84 months) is also available in some regions and SME loans are almost always collateralized.

Short-term financing is also important since credit lines and overdraft facilities partly compensate for the limited supplier financing available across all regions.

Banks play an important role in terms of volume but other FIs (e.g. credit unions, cooperatives, microfinance institutions) are crucial to meet the financing needs of SMEs. The latter tend to have greater outreach to informal sector SMEs and being less regulated have more flexibility on some lending terms (e.g. type of collateral).

LEGAL, REGULATORY, POLITICAL AND MARKET STABILITY FACTORS

In the regions surveyed, there are no specific regulatory limits that impede the financing of SMEs (though it should be mentioned that such limits do exist in other countries, such as, for example, India and Bosnia). Interest rate caps have seriously damaged the SME sector in some Latin American markets, however, and have only partially resulted in the sought after operational cost-effectiveness (by forcing lenders to be more efficient in order to be profitable) in some Asian markets.

Collateral enforceability linked to long legal processes and political influence is raised by FIs in some regions as a concrete bottleneck, though in other regions this does not seem to hinder business and portfolio recoveries.

With respect to the potential to grow the SME market further, many FIs are positive as long as the incentives are right (tailored funding sources, good return perspectives, etc.). However, the importance of market and political stability was highlighted, particularly in Africa, where it supersedes all other requirements for further developing the SME sector. SMEs are impacted by commodity prices and the development of natural resources sectors even if indirectly in some markets. SMEs also require a stable environment to ensure their growth plan and investments for the future.

"SMEs need more than financing."

ADVISORY AND CAPACITY BUILDING CAN MULTIPLY THE IMPACT OF FINANCING

An important feedback received from some of the FIs surveyed is that SMEs need more than financing. When financing is combined with business advisory services (e.g. strategic and business planning, market and competitive analysis, review of MIS and accounting systems, among others) the impact of financing can be enhanced and the potential credit risk is mitigated by a tailored product and services mix. FIs recognize, however, their limitations in providing such services to SMEs.

PORTFOLIO AND SECTOR DIVERSIFICATION

FIs are eager to grow their SME portfolio as long as this is combined with a diversification across a range of sectors as opposed to concentrations in the same industry.

Experience from some Central American markets where FIs had more than 75 % of their portfolios dependent on only one sector have provided unforgettable examples of the disastrous effects of portfolio concentration.

START-UP FINANCING STILL THE EXCEPTION

The SMEs that are most limited in the access to credit are start-ups and those that operate in the informal sector. Lack of track-record, sufficient or appropriate collateral, and accounting records weaken their chances when seeking 1st time financing. Incentives for the financing of start-ups have proven valuable in Eastern Europe and could enhance the development of the SME sector in innovative industries and new technologies (e.g. renewable energy, energy efficiency companies, and fintechs).

Table G: Summary of BlueOrchard Survey Results on Financial Institutions

REGION:	Caucasus	East Asia	Latin America	Africa
What is the typical structure of an SME loan? (Amount, collateral level, rates, term, bullet/ amortizing)	Loan amounts range between USD 40K and USD 800k. Up to USD 400k is small, and above is medium. Tenor 1-84 months. Revolving of funding is bullet, while investment is usually amortising. Collateral is 1 time of loan amount.	Loan amounts range between USD 40K and USD 800k. Up to USD 400k is small, and above is medium. Tenor 1-84 months. Revolving of funding is bullet, while investment is usually amortising. Collateral is 1 time of loan amount.	SME loans have very different amounts depending on the country (Peru & Costa Rica up to USD 120k, Ecuador small loans up to USD 250k, medium loans above USD 250k). Exposures are secured by real estate mortgages. Collateral coverage is usually above 100% of the credit limit. The debt to equity is capped at a max. of 200%. Short-term financing facilities (i.e credit lines or overdrafts) are for working capital needs and for up to 36 months. Funding for fixed assets (business expansion) is for 60 months.	Loan amounts for SMEs are above USD 15k and up to USD 30k. Loan terms are up to 36 months. Collateral is 100% for small loan amounts and 150% for larger loans. Collateral is tpically: vehicles, land and buildings.
How are local SMEs typically financed? (equity, credit, other)	SMEs are typically financed by Credit. Equity in fewer cases.	SMEs are typically financed by Credit. Equity in fewer cases.	SMEs are typically financed by credit from the formal financial sector and suppliers. Loans are for working capital and fixed assets.	Mainly from credit. Suppliers finance is limited and equity is also a source of funding in some cases.
What are the main lending sources for local SMEs (banks, MFIs, other)? Is there any specific market leader?	Local commercial banks and MFIs.	Local commercial banks and MFIs.	The main financing sources are local banks. In some markets there are fund guarantees, financing from MFIs, and from municipal banks and credit unions.	– Commercial banks, mostly in terms of overdraft – MFIs, with amortized loans, and – Cooperative associations informal lending. There is no real specific market leader in terms of financing local SMEs. MFIs are also a lending source as their requirements are less strict than banks (e.g. more flexibility in terms of collateral).
Are there any legal or regulatory limits or other restrictions for lending to SMEs?	None, other than single borrower limits.	None, other than single borrower limits.	Regulatory requirements on single borrower exposure apply, as well as limitations in terms of maximum loan amount in certain markets.	No specific regulation with the exception of sinlge borrower limits (different for secured and non-secured loans) and in some countries interest rate caps.
How much could you grow your SME loan portfolio if you could either lend to SMEs or have a way of managing total exposure to the SME sector through sale?	There is still a potential in the market to grow the SME portfolio. With funding at attractive pricing, and subject to a less conservative risk approach and higher returns, the SME portfolio could grow.	There is still a potential in the market to grow the SME portfolio. With funding at attractive pricing, and subject to a less conservative risk approach and higher returns, the SME portfolio could grow.	A mixed feedback from the respondents: 1) not interested in growing this segment, 2) interested in growing the SME portfolio with invoice discounting, project finance, and working capital, and 3) reasonable growth is expected.	Funding is not the main bottleneck at this stage. Market and political stability are the main considerations.
Are securitizations a common or occasional feature of the local credit market?	Securitization is a common feature of the local credit market.	Securitization is a common feature of the local credit market.	There are some cases but remains uncommon.	Not common.
How would you rate the enforceability of claims in your country?	Enforceability is good.	Enforceability is good.	A mixed feedback from the respondents: 1) ok in Peru, 2) very long legal recovery periods in Costa Rica, 3) medium in Ecuador.	Mixed feedback depending on the country: good in Ghana, below average in Ivory Coast, and very slow and unreliable in Nigeria and Congo DRC.
For SMEs, is the access to credit a problem?	Credit products from financial institutions are vastly available. If SMEs have a track-record, collateral is available and they have up and running cash flows credit is accessible. For Start-up SMEs it is less accessible.	Credit products from financial institutions are vastly available. If SMEs have a track-record, collateral is available and they have up and running cash flows credit is accessible. For Start-up SMEs it is less accessible.	Overall access to credit for SMEs is more difficult than for corporates, especially when these are newly established SMEs. Limitations are due to the complexity of analysiy linked to the informality of SME businesses. The quality of services is a bottleneck: most of the services are not designed for SMEs (i.e. analysis based on collateral instead of cash-flow) and the lack of advisory services for SMEs hinders their further growth.	Yes, this is mainly due to lack of formal documentation and structures in place. Nigeria being an exception given the high competition in the financial market. SMEs complain about unsatisfactory product features (e.g. interest rates or collateral requirements) and lack of business support and adequate information.

MEET OUR INVESTEES: ARARATBANK

AN SME LENDING CHAMPION

ARARATBANK is the tenth largest bank in Armenia with an approximate 4 % market share in assets and deposits. It was established as a result of the reorganization of Haykap Bank, operating in the Armenian financial market since 1991. In 2008 the European Bank for Reconstruction and Development (EBRD) purchased 25 % of ARARATBANK shares and supported the bank through technical assistance. The bank today has a clear focus on micro and small business lending with its 903 employees and its 65 branches. Business loans contribute close to 60 % of the loan portfolio in volume terms, and MSME loans close to 25 % as of March 2017. Micro business loans are defined as business loans under the amount of USD 42'000 and 20 employees, whereas small business loans do not exceed the loan amount of USD 125'000 and 50 employees.

Ms. Sarukhanyan, one of ARARATBANK's clients, has been engaged in the production of pancakes and cakes since 2016. Her company, ARMEN-SARGIS LLC, based in Yerevan, offers over 41 varieties of pastry, such as cakes, pancakes and other similar pastries. The pastries are sold under the trademark "ERIKAS SWEET" in various supermarkets and shops in the city of Yerevan. In May 2017 she borrowed a loan of USD 43,000 from ARARATBANK to purchase delivery cars and stoves as well as to renovate a number of production rooms. With the loan she was able to create 5 new jobs. At present, the company has 12 employees: 2 dough makers, 1 dough rolling-out person, 2 bakers, 4 cake designers, 2 packers and 1 accountant.

Mr. Torchyan has been engaged with his company UINWEB Co. Ltd in the café business in Yerevan for about 7 years. In his café, "Tom Collins", he employs nine employees— 3 waiters, 2 barmen, 1 manager and 2 cooks and 1 accountant. In August 2016 he got a loan amounting to USD 20,000 from ARARATBANK to acquire new tables, chairs, kitchen utensils, tableware and air-conditioners and for renovation purposes. With the help of another loan from ARARATBANK he opened a second café, the "EPICURE", in January 2017 and was able to create 10 new jobs (waiters, barmen, managers, cooks and dishwashing persons).

SUPPORTING THE GROWTH AND DEVELOPMENT OF THE SME SECTOR

Identifying the key challenges and opportunities helps to point to the most effective means to provide support to the SME sector. In this, both the public and private sector have important roles to play.

PUBLIC SECTOR: FOCUS ON ENABLING PRIVATE ACTORS

The public sector's principal role is to enable a healthy development of the SME sector. To be most effective, such efforts should encourage and catalyze, but not crowd out or impede private sector involvement in order for the sector to remain sustainable over the longer term. There are many initiatives at the national and supranational levels, and in order to harmonize such efforts, draw on shared lessons and identify best practices, a specialized SME Finance sub-group under the G20's Global Partnership for Financial Inclusion developed general Policy Guidelines under the report "Scaling up SME Access to Financial Services in the Developing World' in 2010. [19] This report draws on 164 case studies, with a focus on three key areas: legislation, regulation and supervision; financial market infrastructure; and public intervention and support mechanisms.

While it is beyond the scope of this paper to analyze these policy guidelines in depth, the key takeaway is that these guidelines encourage developing countries to fully develop credit infrastructure for SMEs, while improving SME financial capability through targeted learning and support interventions and promote competition through an enabling regulatory environment. Key areas where public support can be most effective include:

- Enabling framework for alternative SME finance products like leasing and factoring
- Consumer protection legislation including financial literacy for clients
- Credit bureau
- Effective collateral registry and insolvency procedures
- Accounting and auditing standards for SMEs
- Promoting capacity building programs (both for SMEs themselves and SME lenders)

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19 World Bank. (2010). *Scaling-Up SME Access to Financial Services in the Developing World.* [pdf] Available at: http://documents.worldbank.org/curated/en/669161468140035907/pdf/948300WP0Box385443B00PUBLIC00ScalingUp.pdf [Accessed 5 Sept. 2017]

RESPONSES FROM THE PRIVATE SECTOR: FINANCING INSTRUMENTS

Given the extensive funding gap outlined above, it is clear that there is significant need for additional funding to further develop the SME sector. Traditionally, hurdles to greater financing involve a lack of understanding of the market by investors, perceptions of high risk and, while the aggregate amounts needed are large, individual transactions are generally too small, idiosyncratic and administratively burdensome for capital market investors to take on direct exposures. Indeed, SMEs are generally best-suited for secured local bank funding due to their small scale, limited or incomplete information and what is often a lending relationship that involves more personalized attention and monitoring. As such, most funding to SMEs comes from local institutions, which are in turn financed by international investors and local banks, as well as development or public agencies.

SME Bonds

To fill the funding gap, however, a greater range of mechanisms is needed to expand the funding available to this growing sector. In the developed world, there is a niche market of SME bonds, particularly in Germany, where approximately 110 companies have raised funds via SME bonds since 2010.[20] For the reasons outlined above, however, the market for such bonds is quite limited, and even more so in developing countries given country risk issues layered on top of credit considerations. It should be noted as well that the German experiment has not been without its problems and high rates of default in 2016 have led the regulator to put in place higher transparency requirements and qualitative prerequisites to improve the quality of placements and increase the sector's appeal to investors.

> "To fill the funding gap a greater range of mechanisms is needed."

SME Loan Securitizations

Various financing structures can provide greater scale and, in some cases, risk pooling to overcome such hurdles. These include SME loan securitizations and various credit guarantees schemes. In loan securitizations, an SME lender can effectively arrange more financing to local SMEs than its balance sheet would allow it to take on on its own, in effect by originating loans and then selling them on as a basket of exposures to local and international investors. It is also a way for foreign investors to provide funding through secondary markets in countries where the regulation may have limitations such as interest rate or exchange controls that could limit the access to the local capital markets. Credit risk to investors can be reduced by including conditions that defaulted loans, up to a certain level, must be replaced by performing ones, while the originator also continues to actively monitor exposures in the portfolio.

20 The Wall Street Journal. (2017). *German Exchange Aims to Revive Market for SME Bonds by Tightening Rules.* [online] Available at: https://www.wsj.com/articles/german-exchange-aims-to-revive-market-for-sme-bonds-by-tightening-rules-1488355204 [Accessed on 3 Sept. 2017]

An example of a successful securitization in the SME sector was by ProCredit Ecuador in 2013: a USD 70 million, 5-year SME securitization. ProCredit Ecuador, established in 2001 as member of the Frankfurt-based ProCredit Group, lends to SMEs and has a strong reputation for its robust credit and risk methodology. Most of ProCredit Ecuador's medium-term funding was sourced from abroad; hence the bank was looking to diversify its source of funds by tapping the local securities market via the issuance of securitizations. In the end, both foreign (including BlueOrchard managed funds) and local investors participated in this successful transaction.

Digital finance and crowdfunding platforms

Technological innovations have also spurred the development of the fast-growing area of digital finance platforms and crowdfunding platforms both for debt and equity. With respect to digital finance, M-Pesa in Kenya, B-cash in Bangladesh and G-cash in the Philippines are all examples of mobile money platforms that have enabled SMEs not only to facilitate funds transfers but also provide market information and business opportunities. NeoGrowth in India is another case in point: NeoGrowth makes working capital loans to SMEs that receive non-cash payment sales, with loans are repaid as customers of the SMEs pay for their products/services on NeoGrowth approved Point of Sale (POS) machines. Interestingly, this non-cash model served the institution very well during the recent demonetization crisis in India, when various cash denominations were rendered invalid, causing significant disruptions in cash-based businesses.

Crowdfunding has become an interesting tool for SMEs in both developing and developed countries. With over 800 online platforms worldwide, this mechanism also provides access to equity in addition to debt. The Cambridge Center for Alternative Finance has performed benchmarking exercises on crowdfunding in various regions – including Asia-Pacific, where such financing mechanisms have grown most dramatically and East Africa, where it remains in a relatively nascent state.[21] Their research shows that excluding China (the largest crowdfunding market globally with a staggering USD 100 billion in annual activity), USD 430 million of projects in the developing world were funded via crowdfunding platforms in 2015. While the majority (80 %) of these projects were donation-based, a growing proportion are commercial peer-to-peer lending or equity crowd-funding. In developed countries, by contrast, 90 % of crowdfunding is commercially oriented, showing interesting potential for this market.

21 University of Cambridge Judge Business School. (2016). *Harnessing Potential: The East Pacific Alternative Finance Benchmarking Report.* [pdf] Available at: https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/harnessing-potential.pdf [Accessed on 3 Sept. 2017]
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MEET OUR INVESTEES: PROMERICA GROUP

SHIFT FROM RETAIL TO SME AND GREEN FINANCE

The Promerica Group is made up of nine commercial banks with a particularly strong footprint in Central America, including banks in Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, Panamá, Dominican Republic, Cayman Islands and Ecuador. The consolidated assets of these banks are more than USD 12.6 billion, and the group's strategy includes increasing its emphasis on lending to the SME sector within the various countries of operations. The Guatemala affiliate, for example, aims to have 30 % of its projected USD 1.5bn loan portfolio dedicated to SMEs by 2020; other affiliates like Costa Rica and Nicaragua have already more than 30 % of their portfolio outstanding to SMEs.

Several of the Promerica banks have developed green loans for SMEs, with a particular focus on energy efficiency, reduction of environmental impact, and renewable energy (such as wind energy, biomass, photovoltaic, among others). Promerica Costa Rica (PMCR)'s SME green loan program, for example, has grown from less than USD 3 million in 2010 to more than USD 50 million currently. A requirement on these loans is for clients to achieve a 20 % saving in energy, water, or reductions in carbon dioxide emissions, thus quantifying the positive environmental impact. The bank also aims at designing products specific for financing hybrid and electric cars, sustainable cities, sustainable agriculture and green housing.

One of PMCR's SME green loan clients is a furniture manufacturer in the town of Palmares, in the province of Alajuela: Na lakalu. Na lakalu uses wood from renewable sources and took a USD 410,000 loan from PMCR to finance a solar panel generator. The family behind Na lakalu is very entrepreneurial minded, environmentally conscious, and their products are designed by professional furniture designers.

Sometimes the business produces more energy with the solar generator than it requires. In these cases, the surplus energy will be stored on the company's electricity grid. According to Costa Rican law, any generation in excess of consumption can be stored during a specific time period.

KEEPING SIGHT OF THE SDGs: RESPONSIBLE LENDING

Lenders to SMEs can also play a critical role in assessing for and promoting strong social and environmental practices. By financing an SME that uses child labor or otherwise abuses its workers, dumps toxic chemicals in local water sources or cuts down vulnerable forests for its own use clearly does not contribute to the social good, nor advance any of the SDGs articulated above. On the contrary, such abuses clearly contribute to deepening the problems we should be working to solve. These are extreme examples, which would seem to involve malicious intent, but there are also more nuanced situations where negative consequences can be the result of simply lack of knowledge or lack of resources.

In order to address these concerns, both lenders to SME-finance organizations and SME financers themselves have developed both screening tools to identify environmental and social risks and educational tools to provide to SMEs to improve their performance when weaknesses or harmful practices are identified. Many development finance institutions – the Dutch development bank FMO, for example, as well as the private sector arm of the World Bank, the International Finance Corporation (IFC), in particular – have developed detailed tools that identify specific risks per sector: Leather tanning, for example, involves the risk of dangerous exposures to chemicals by workers and inappropriate disposal of such chemicals; for enterprises in carpentry, it is important to check the source of wood products. In order to be effective, these tools need ultimately to be used by SME lenders themselves with the companies that they finance, both to spread awareness and improve practices on the ground.

Exclusion lists are used by most lenders to SME finance institutions that clearly spell out which types of companies may not be financed (those that use child or forced labor; weapons manufacturers; those that use chemicals and pharmaceuticals subject to international phase-outs or bans, etc.).

CONCLUSION

In agreement with the G20/OECD High-level Principles on SME Financing, a number of actions are required to enable SMEs to access a broader range of effective financing sources: "Tapping into a wide range of financing instruments across the risk-return spectrum would help SMEs obtain the forms of finance most suited to their needs at different stages of their life cycle, be more resilient in the face of crisis, and enable them to contribute to economic growth that is more inclusive and sustainable". [22]

BlueOrchard's action plan to support the development of the SME market pivots around a threefold approach:

i) innovative product structuring with the enhancement of portfolio securitizations of specialized SME lenders and financing companies;
ii) combination of tailored funding for SMEs with advisory services and capacity building to multiply the benefits achievable with the financing; and
iii) technological focus to achieve sustainable development and inclusive solutions across sectors.

In accordance with BlueOrchard's mission and vision an important role is envisaged for BlueOrchard's current mandates under management and future new initiatives to contribute to fulfill the SME financing agenda in emerging and frontier markets ensuring that this is responsible, inclusive, and sustainable.

22 G20., OECD. (2015) *High Level Principles on SME Financing.* [pdf] Available at: https://www.oecd.org/finance/private-pensions/G20-OECD-High-level-Principles-on-SME-Financing-Progress-Report.pdf [Accessed on 3 Sept. 2017]

ABOUT THE AUTHORS

Maria Teresa Zappia, Chief Investment Officer, has been focusing on the financing of SMEs and micro and small businesses in emerging and frontier markets for over 20 years. Prior to joining BlueOrchard she has worked for several development banks and financial institutions (EBRD, Asian Development Bank, Overseas Development Institute, OECD Development Centre, among others) based mostly in the field across several regions (South East Asia, Eastern Europe and Central Asia, Africa). Maria Teresa contributed to the development of dedicated financing instruments for local commercial banks entering the SME sector and also managed technical assistance programs to accompany credit line financing with capacity building. She holds a Master of Philosophy in Development Studies from the University of Sussex (Distinction), and a Degree in Economics (1st Class Honors) from the University of Florence (Italy).

Lisa Sherk, Head of Social Performance Management, has worked for nearly a decade in the microfinance sector and has more than 15 years of experience in emerging markets finance. She currently heads BlueOrchard's social performance management efforts and was previously the Director of BlueOrchard's investment team, with expertise in the areas of financial and credit analysis. Lisa has worked as a microfinance consultant with international funders and donors in microfinance, as well as with MFIs in Bolivia, Peru and Mexico. Lisa started her career in emerging markets asset management at Swiss Bank Corporation before becoming a Vice President at Wasserstein Perella Emerging Markets and then serving as Managing Director at Atlantic Advisors LLC. She holds a Master in International Affairs from Columbia University.

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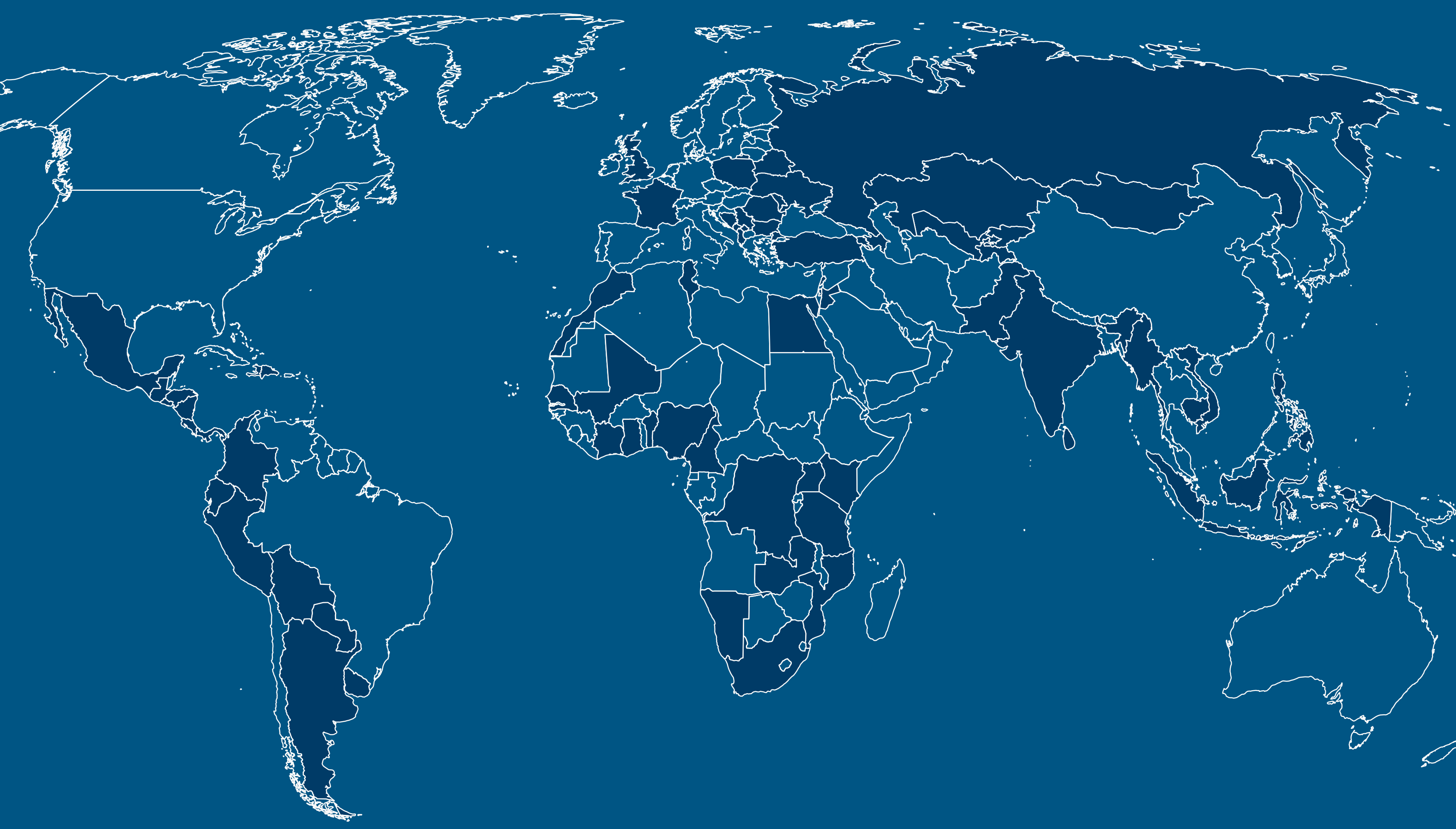

Zurich, Geneva, Luxembourg, Lima, Phnom Penh, Tbilissi, Nairobi

BlueOrchard Finance Ltd
Seefeldstrasse 231 · 8008 Zurich · Switzerland · T +41 44 441 55 50
Rue du Commerce 9 · 1204 Geneva · Switzerland · T +41 22 596 47 77