How the state and private sector can partner to boost support to SMEs: Lessons from Chile & Malaysia

Stephen Timm

A report for the Department of Trade and Industry ***(the dti)*** *and TIPS*

Executive Summary

June 2012

Executive Summary

For South Africa, the promotion of small businesses remains key to creating jobs and a more equitable economy. Evidence from Chile and Malaysia – both countries with similar emerging economies as South Africa – reveals that by partnering to provide finance and business support, the government and the private sector can boost support to small businesses. This report builds on key findings by this author in other emerging countries in a 2011 TIPS report, by the same author, titled "How South Africa can boost support to SMEs: Lessons from Brazil and India".

This report looks at how state and private sector can partner to:

- Provide incubation services.
- Improve access to finance – through credit guarantees, the promotion of angel investment networks and venture capital.
- Promote innovation by attracting foreign entrepreneurs.

The report also considers e-procurement as an alternative to set-asides, when it comes to boosting state procurement from small and medium enterprises (henceforth SMEs).

Performance and policy

Small, micro and medium enterprises make up 99% of all businesses in Chile and Malaysia, accounting for 741 430 such firms in Chile (in 2009) and 548 267 in Malaysia (in 2005). In Chile the sector accounts for 20% of gross domestic product (GDP) and 60% of jobs, while in Malaysia SMEs contribute 31% of the GDP and 56% of employment.

Figures on the number of small businesses in South Africa remain sketchy. While FinScope's 2010 South Africa Small Business Survey reveals that there are close to six million small businesses in the country, the Department of Trade and Industry's Annual Review of Small Business 2006-2008, held there to be 2.43 million small enterprises in 2007. Small and micro enterprises contribute between 27% and 34% of South Africa's GDP and for about 55% of all jobs.

The percentage of workers employed by small businesses in Malaysia and Chile is on the rise. In Chile the proportion of persons working in SMEs rose from 54.5% of employees in the February-April 2010 quarter to 56.4% in February-April 2011. Small firms also create the highest number of jobs in Chile. A 2011 study by the Research Division of Chile's Ministry of economy revealed that of the 262 430 new salaried jobs created in the February-April 2011 quarter compared to the same period in 2010, 90% were generated by micro, small and medium enterprises companies with 200 employees or fewer. In the last decade, the contribution of SMEs to Malaysia's total employment has been increasing – from the sector employing 56.4% of the workforce in 2003 to 59.5% in 2010. In South Africa, between 1985 and 2005, 90% of all new jobs were created by small, micro and medium firms.

Both Malaysia and Chile are targeting innovation as a key cornerstone of economic growth. Much of South Africa's small business policies are based on promoting black small enterprises. The dti is also looking to roll out more incubators, largely to help mentor more black business owners to get into the supply chains of large companies. However up till now the government's support to small businesses remains lack lustre. In many instances awareness of schemes also remains low.

Incubation

Incubators in South Africa are largely funded by the government. There are also a few privately-funded incubators. The dti, in partnership with its Small Enterprise Development Agency (Seda) is now looking to roll out 250 incubators. However incubators are expensive to set up and run and the government will have to rely on partnering with the private sector to roll out more incubators. The government is also faced with questions of how to both help incubatees find market access and source funding. As well as helping businesses to serve local demand, incubators must also assist businesses to produce goods that have an international demand, if the economy is to grow.

The governments of Chile and Malaysia both view business incubators as important tools to drive innovation and create more sustainable economies for their respective countries. Although many incubators are funded by the government in Chile, these are often set up by universities. In this way a partnership exists between the state, businesses and universities. Less of a partnership exists however in Malaysia, where the state plays a much more active role and in many instances both sets up and funds incubators.

While in Chile the state wants to use incubators to move away from its resource-dependent economy, the Malaysian government deploys incubators to foster certain high-tech sectors and to improve the competitiveness of SMEs. The Chilean government also hopes to use incubators to create more entrepreneurs. Just like South Africa, Chile is on a drive to create more incubators, and in 2011 the Chilean government launched an initiative that includes a public-private investment of $7.3bn (R59.6bn) aimed at supporting over 76 000 entrepreneurs through the launch of 13 new incubators.

How have incubators performed?

South Africa's Seda incubators are behind incubators in Malaysia and Chile's ChileIncuba members when it comes to the number of jobs created per incubatee (in the enterprise assisted by the incubator). The number of jobs created per incubatee is greatest in Malaysian incubators (3.5 jobs on average per incubatee) – similar to jobs per incubatee in the US and Korea – compared to less than a single job created by each incubatee in Seda's incubators. Incubatees in ChileIncuba incubators create on average 2.5 jobs. Each incubatee from ChileIncuba incubators also turns over almost 10 times more revenue on average than an incubatee based in a Seda incubator. It is clear that the kind of businesses created by Seda incubators are micro endeavours with little scalability, compared to Malaysia and Chile's promotion of high growth, high-impact entrepreneurs.

South Africa

In South Africa Seda's incubators have grown from 23 in 2007 to 31 in 2011. These incubators represent various sectors from steel in Mpumalanga, and ICT in Gauteng, to sugar-cane in KwaZulu-Natal and furniture manufacturing nationwide. During the 2010/11 financial year Seda's 31 incubators supported 958 businesses (about 58% of these were in the agricultural sector). Seda's incubators also helped incubatees increase their collective turnover from R129 million in 2008/9 to R206 million. In all, 893 jobs were created by incubatees. This however translates to less than one new job created by each incubatee that Seda assisted in 2010/11.

Chile

Chile has between 25 and 30 incubators. A snapshot of Chile's incubators is provided by ChileIncuba, the country's incubator association, which represents 13 incubator organisations (which account for 70% of the incubation projects supported by the government). In 2011 these 13 incubators were incubating 600 businesses. This is an average of 46 businesses per incubator, with 66% of incubatees undergoing virtual incubation. In 2011, 234 enterprises graduated from the 13 incubators (an average of 18 per incubator). Incubatees each record average annual sales of 132 million Chilean pesos (R2.2 million). Between 2004 and 2007 incubators helped launch 700 new companies, of which 390 or 56% were operational during this time. One reason these incubators produce quality businesses is that the application process is fairly strict – only 9% of the 2 575 applications incubators received for incubation in 2010, were approved.

Malaysia

Malaysia's 106 incubators together house about 2 650 tenants, at an average of 25 tenant companies per incubator (ranging from 10 to over 250). Companies remain in incubation for an average of four years. Many of the first incubators in Malaysia were focused more on providing real estate than on providing effective business development services. It was only from 1999 that services such as funding and mentoring and coaching were provided to incubatees by certain incubators.

Lessons from Malaysia and Chile

Lesson 1: Picking winners

The experience in Chile and Malaysia shows that incubators that focus on fostering innovative ideas to solve problems that society or companies face, may have a better chance of helping incubatees reach the market, source finance and will inevitably have a higher growth potential and survival rate. Malaysia, Brazil and Chile focus on picking the best and on creating world-class businesses.

Lesson 2: Use incentives that will incubate high-growth businesses

Chile's incentive for incubators is linked to seed funding channelled through incubators to recipients; this way both incubators and incubatees receive funding – solving two central problems in business incubation. Firstly the incentive is given to incubators only if they assist incubatees. But secondly and most importantly, the new incentive places more emphasis on the quality of the business supported than was previously the case. Only by supporting good businesses to grow, will incubators be able to get funding from the government to finance their operations and the incubation of clients.

South Africa may have a number of funds that help finance innovative businesses, but none of these offer *small seed grants* in the same way as Chile's Corfo does. This may be something to consider as the South African government looks to expand its incubation network.

Lesson 3: Other ways to fund incubators: royalties, equity, consulting

Incubators in South Africa are poorly funded, meaning the government will have to allow incubators to source funding from other means. Enterprise development and a mooted matching grant incentive may cover some of the costs, as would the above proposed incentive Chile uses, but other financing must not be excluded.

In Chile the private sector is quite involved in funding incubators. In fact 50% of ChileIncuba's 13 members are not funded by Corfo, in total Corfo funding accounts for 28% of the 1.8 billion pesos (R30 million) in funding to the association's members. These incubators rely on various forms to draw funding, such as taking royalty fees and shares in incubatees, charging for consulting services and getting funding from corporate sponsors:

Royalty fees and equity

Chile's GestaMayor does not rely on funding from Corfo instead it takes a 7% to 15% royalty from products and services developed by incubatees. The incubator opts for a royalty share rather than equity, as it would only make sense to take equity in firms that it assists that grow to a very big scale.

Consulting services

Chile's virtual incubator Incubatec draws about 25% of its funding from the consulting services it offers incubatees. In Malaysia incubators draw most of their funding from government, but incubators also net some revenue through running training programmes and consulting.

Corporate sponsors

Another funding option is to get corporate sponsors to host challenges and competitions from which potential incubatees are then chosen. This is what incubator 3IE does in Chile.

Lesson 4: Partner more with universities

University involvement in Chilean incubators is very strong and all major incubators in the South American country are either funded by, or work closely with universities. There are several advantages in having a business incubator located on a campus. These include access to in-house technology development and commercialisation, the benefit of making available experiential learning for students, faculty engagement, fostering innovation and thus contributing to economic development and society at large, partnerships with government and industry, and finally, media attention.

In this, South Africa must build more incubators on university campuses and in partnership with tertiary institutions. There is also an opportunity for the Technology Innovation Agency's (TIA) 12 technology stations and three tooling stations (as well as 14 biotechnology platforms) based at universities and universities of technology to help mentor these businesses, while attracting more innovative entrepreneurs.

Lesson 5: State, business can partner to access the market

Helping incubatees access the market is one of South African incubators' biggest challenges. Incubators in Malaysia and Chile use various methods to help their businesses to market their products and services. These include fairs, showrooms, market-linkage programmes and linking high-tech firms with the needs of particular customers by having companies run ideas calls (to for instance develop applications that address certain needs).

Driving innovation

The state and private sector can also partner to boost innovation, with the state co-investing in privately-managed venture capital funds and helping to set up angel investment networks. A novel scheme started in Chile in 2010 involves the government funding foreign entrepreneurs to come to the country and set up there for a short time, in the hope of stimulating the creation of more local innovative entrepreneurs.

Creating a venture capital industry

The Malaysian government has five government-backed venture-capital (VC) funds and a private equity fund which invest in innovative businesses in the country, while there are between 10 and 30 private equity and VC funds in the private sector. The state, through Malaysia Venture Capital Management (Mavcap), has since 2001 contributed RM450 million (R1.2bn) to 11 private sector venture capital funds. These funds have sourced a further RM205.5 million (R542m) to bring the total investment in private-sector venture capital funds to RM655.5 million (R1.7bn). In all 39 firms received a total of R264 million in funding from the first round of funding between 2001 and 2006.

In Chile, the government's small business support agency Corfo has since 1996 invested in 14 venture capital funds managed by private managers. The investment by the state is in the form of loans to leverage private investments. Corfo invests at a ratio of three to one and has also structured incentives to boost investments in technology-related businesses. Another Corfo vehicle allows private investors to reduce their risk, by allowing them to purchase Corfo's shares at the halfway point of the duration of the fund. By March of 2009, there were 14 venture capital investment funds in Chile, of which 10 had made investments – in 42 companies.

Yet despite Chile in 2011 being rated the most attractive country for venture capital in Latin America, VC investments in the South American companies still remain rather insignificant. Significantly, experiences in Canada and the US show that interest in venture capital increases when there are tax incentives, as does investment in technological innovation.

The government's TIA could co-invest with private-sector funds to finance small businesses and seek assistance from the private sector in managing investments. The government needs to champion funding in innovative businesses and be pro-active in talking to the private sector to co-invest.

Stimulating angel funding

In Chile and Malaysia the state is also helping to roll out angel investment networks by funding the setting up of platforms through which angel investors can engage one another to invest in deals together, and in so doing mitigate the risks of investing in the start-up sector.

South Africa, like other emerging countries, also lacks an angel-investing environment. Attempts have been made to get high-net-worth individuals to invest in small businesses by amendments to the Income Tax Act which effectively overhaul the SJ12 venture capital tax incentive. The current VC tax incentive should be modified to allow tax rebates for those that place their investments directly in small businesses, rather than have them invest in a VC company (which in turn invests in a small enterprises) to qualify for a rebate.

Importing entrepreneurs to drive innovation: Start-up Chile

Start-Up Chile, run by the state's small business agency Corfo, helps create a strong entrepreneurial system in Chile and attempts to get entrepreneurs in Chile to think globally. Foreign entrepreneurs (including Chileans outside of the country) are individually offered $40 000 (R324 000) in financial support if they set up in Chile for at least a six-month period. In supporting the scheme government has spent $40 million (R324m) over four years to back 1 000 foreign entrepreneurs who may leave Chile after six months. So far from the pilot group of 24 companies that arrived in Chile in November 2010, 12 were still in the country a year later and three had, as of November 2011, been able to raise capital of over $4 million (R32.4m). As part of the programme, entrepreneurs are expected to visit universities and schools and give talks and mentor locals.

Finance: Credit guarantees

The government and the private sector can also partner together when it comes to financing small businesses. One of the most effective ways to do this is for the state to set up a credit guarantee scheme. Banks and lending organisations that are members of the scheme then advance loans to small businesses, but because the risks of lending to this sector are very high, the state provides a guarantee to these organisations that should the loan go bad the banks will be compensated by the state. Worldwide there are more than 2 250 credit guarantee schemes in operation. Countries with the strongest policy and fiscal support for small businesses also have the highest proportion of SMEs serviced by guaranteed loans.

Small firms in Chile and Malaysia have relatively good access to finance, according to recent research figures. In Chile in 2007, almost 93% of micro enterprises and 100% of small enterprises that operated in the formal sector had a bank loan. Malaysia has been ranked by the World Bank and others as one of the world's leading countries when it comes to access to finance for SMEs and between 2000 and 2010, SME bank financing increased from 31.1% to 38.5% of all business loans.

Although South Africa shares the top World Bank ranking when it comes to access to finance for businesses, just under half of small businesses are banked (46.7%). In the 2010 GEM Report, South African entrepreneurship experts as well as business owners reported that financial support was one of the biggest challenges to entrepreneurs in the country.

While Chile's Fogape and Malaysia's CGC (Credit Guarantee Corporation) have lent millions of rands in loans through their respective schemes to thousands of business owners, South Africa's Khula guarantee scheme (which now falls under the Small Enterprise Finance Agency) ground to a near halt in the 2009/10 financial year. There had been a slight recovery by 2010/11 for Khula's scheme, when it reported lending out 81 new loans to the value of R36.5 million in that period. But, the loans disbursed remain *very* low. Since its inception in 1996, guarantees disbursed by Khula have never topped 800. In 2009 when Khula lent out 53 guarantees, Fogape gave out over 52 510 guarantees and CGC 14 073 guarantees. Khula also notched up an average default rate of 42.15% between 2006 and 2010. This means that more than four in every 10 loans lent out by banks through the scheme were defaulted upon. In comparison, both Fogape and the CGC have relatively low default rates – both at 4%.

Lessons from Malaysia and Chile

There are several lessons that South Africa's Khula guarantee scheme can learn from Fogape and CGC; these include ways to drive lending through innovative measures (such as an auction system), the reduction of red tape in the claims process and the improvement of training at banks and trust between banks and the credit guarantee scheme.

Lesson 1: A unique auction system can lower the coverage rate

Fogape's auction system has led to decreasing coverage rates – average coverage rates have fallen from 80% when initiated in 2000, to 62.2% in 2010. Bidding takes place four to six times per year, and only supervised financial institutions can participate. In all, 16 financial institutions and 10 mutual guarantee societies participated in an auction in September 2011.

Lesson 2: Use equity and quotas to drive banks to adopt a scheme

When Malaysia's CGC was set up in 1972 banks owned over 70% of the organisation, while the remaining stake was held by the central bank (Bank Negara). The adoption of the scheme by banks was driven, in the beginning, by a central bank provision which required banks to lend 3% of their total deposits to SMEs. This was then increased to 5% and then to 10% in the years following this. By 1981 the government stipulated that 12% of banks' total lending had to go to SMEs, with 5% to be taken up by lending under the CGC. In 1994 the central bank began increasing its share in the CGC through a number of equity injections, the central bank today holds about 80% of the corporation.

Lesson 3: Ensure a fast claims process

Speedy payments of claims by a credit guarantee scheme to member banks is vital if a scheme is to garner confidence from participating banks and lending organisations. This is especially pertinent for Khula, where over two in five loans were defaulted upon by businesses between 2006 and 2010. Khula requires a bank to first seek a default judgment against a business owner before it can lodge a claim, which can take between one to three months to obtain or up to five years. But while it can easily take a year for Khula to settle a claim with banks, at Chile's Fogape (where banks only needs proof that legal proceedings are under way in court) it can take less than one month for a claim to banks to get paid out. At Malaysia's CGC claims are typically settled within three months of an application for claim settlement.

Lesson 4: Use systems to reduce risk when lending

The use of credit-risk systems can also help schemes, such as Khula, to mitigate risks. The CGC makes use of three important systems to mitigate risk and make it easier for credit providers to make a decision about whether to grant SMEs loans or not. These three systems are:

- The Central Credit Reference Information System (CCRIS): banks must supply the central bank with data on loans in order for the system to calculate the risk of lending to SME clients.
- The Credit Tip-off System (CTOS): reports on any legal proceedings lodged against businesses or individuals in Malaysia.
- SME Credit Bureau: provides SME lenders with accurate credit ratings which will help in accessing finance from CGC.

Lesson 5: Strong bank-scheme relations

In South Africa, Khula can do well to increase communication between ordinary bankers and the scheme's officials. South African banks noted in a 2011 study that the number of meetings between its staff and Khula staff had dwindled in recent years. In Chile, Fogape sponsors an advisory committee with representation from the four banks, the nation's largest three employers' associations of small and micro businesses, the Ministry of Economy and Supervisor Fund that meets quarterly.

Public e-procurement portal

The government can open state procurement to more small businesses if it uses privately developed IT systems as a platform to buy the goods and services it needs. Chile's e-procurement system, ChileCompra, was adopted by the government to help it to improve the management of public resources allocated to buying goods and services from private suppliers and at the same time offer a more open and transparent tender system. Since 2004 to 2011, the percentage of procurement from small and micro enterprises through ChileCompra has increased from 23.8% to 41%.

In South Africa efforts to put set-asides in place to promote state procurement of goods and services from small enterprises, have been blocked by the National Treasury over concern that set-asides for specific entity types are unconstitutional. It is why a 2008 cabinet-approved plan to allocate 85% of spend on 10 key goods and services to small businesses never took off. E-procurement might be the answer for the state it if intends boosting SME procurement.

Conclusion

The dti has already outlined its intent to partner more with the private sector and to incentivise both its small business support agencies and the private sector to develop innovative and high-impact support programmes for small businesses. However the state should also take the lead in devising clear plans to partner with the private sector in the areas of incubation and business support, access to finance and market access.

In taking the lead the state can boost business and incubation support to SMEs by:

- Partnering with business support agencies and incubators by setting up matching funds to crowd in the private-sector. The state must also use monetary incentives which encourage the private sector to support high-growth businesses that grow their sales, create jobs and are able to attract private investment.

In improving access to finance for SMEs, the state can:

- Partner with banks by recapitalising the Khula guarantee scheme (now under the Small Enterprise Finance Agency) and adopting techniques to get buy-in from banks (such as cutting red tape in claims processes, holding workshops with ordinary bankers, getting banks to take equity in the guarantee scheme, holding auctions among banks which require a certain amount of funding to be disbursed or finally implementing priority lending targets).
- Partner with business angels by funding angel investment networks (through for example the Technology Innovation Agency) and ensuring that the revised venture capital tax incentive of 2011 (12J of the Income Tax Act) is effective in seeing venture capital companies being set up and lending to small businesses.
- Partner with private venture capital companies by co-financing investments (through for example the Technology Innovation Agency) with such funds being invested in high-impact innovative companies.

The dti together with the National Treasury should also explore the benefits of setting up an e-procurement system for the buying and selling of state goods and services. This should be coupled with the rollout of internet access points across the country.

Together the state and the private sector can help to create more focused and effective support for SMEs.