



APEC Framework for Innovative SMME Financing Mechanisms

Prepared by the SME Finance Forum



The SME Finance Forum

The SME Finance Forum works to expand access to finance for small and medium enterprises—a critical engine of job creation in emerging economies.

The Forum brings together financial institutions, technology companies, and development finance institutions to share knowledge, spur innovation, and promote the growth of SMEs.

Managed by IFC, the SME Finance Forum was established by the G-20 in 2012.

The APEC Business Advisory Council (ABAC)

The APEC Business Advisory Council (ABAC) was created by the APEC Economic Leaders in November 1995 to provide advice on the implementation of the Osaka Action Agenda and on other specific business sector priorities, and to respond when the various APEC fora request information about business-related issues or to provide the business perspective on specific areas of cooperation. ABAC comprises of up to three members of the private sector from each of the 21 APEC economies. ABAC members are appointed by their respective Leaders, and represent a range of business sectors, including small and medium enterprises. The ABAC International Secretariat based in Manila. For more information, visit www.abaconline.org



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Foreword

On behalf of the APEC Business Advisory Council (ABAC), I am pleased to present this report on one of the greatest challenges facing many small, medium and micro-enterprises (SMMEs) in the Asia-Pacific region today: access to financing. This is critical for the growth and survival of many SMMEs, but many enterprises continue to face difficulty to secure capital needed to realize their potential. Ultimately, this affects their ability to contribute to the job creation, innovation, and economic growth so vital to the lifeblood of many economies in the region.

Since its foundation, ABAC has been committed to examining issues and contributing solutions to build a robust and sustainable environment for the growth of SMMEs. While bank financing remains the main source of financing for most SMMEs, this report comes in a timely manner to assess emerging innovative financing mechanisms that are fostering a more dynamic and diverse landscape for SMME financing. Technology is beginning to bridge the gap for many SMMEs looking for new financing sources and it is one of the exciting areas that this report explores.

Governments play a vital role to support and incentivize private sector to address the credit gap that hinder the growth of many SMMEs in the region. We hope this report will inspire new thought and action, especially in emerging areas, where governments can consider regulatory review and reform to enable the growth of alternative mechanisms that may be more suitable for nascent and establishing SMMEs.

We are grateful to the SME Finance Forum and ABAC Canada for their leadership and vision for the report. We also thank all the ABAC members for their contributions.

We hope you enjoy this report and we look forward to receiving your feedback.



Ning Gaoning
ABAC Chair

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Executive Summary

The growth of small, medium, and microenterprises (SMMEs) is held back by limited access to finance. Traditional banks fail to meet the full needs of SMMEs. But innovative mechanisms are emerging that promise to broaden the range of financing options available.

This report highlights the growing range of alternative and innovative financing mechanisms available to small, medium, and microenterprises. It considers what governments can do to expand the range of financing mechanisms in their economies, and in particular, what policy and regulatory reforms encourage the development of new financing models.

Traditional bank finance plays and always will play a major role in financing SMMEs. But the higher end of the market, lower-risk profitable companies with good marketable assets for collateral, is better served than the lower end. Lack of bank debt financing has a bigger impact on SMMEs than on larger enterprises, which can launch public offerings for debt and equity. The narrow set of financing sources typically available to SMMEs makes them more vulnerable to the changing conditions in credit markets. Even in countries where bank financing is more robust, the finance options generally fall short, and fail to satisfy the full demands of the more dynamic, fast-growing firms in those economies.

SMMEs play a valuable role in job creation and make significant contributions to economic growth in both developed and developing economies. They stimulate domestic demand through job creation, innovation, and competition. Small firms have the highest level of employment and highest rate of job creation in developing countries.

Even so, SMMEs are typically much more credit-constrained than large firms in developing economies, and this affects their ability to grow. In more developed economies, a small number of fast-growing

SMMEs account for the majority of jobs created. The global financial crisis dampened the macro environment, especially for SMMEs in the Asia-Pacific Economic Cooperation (APEC) region. Sharp declines in external demand, and a credit crunch has made financing more difficult, and caused more SMMEs in the region to go into liquidation.

The vulnerability of small businesses was also revealed during the recent economic crisis, when banks tightened their lending guidelines and lines of credit dried up for SMMEs. With stricter Basel-governed risk-weighted capital allocations, banks began to take a more conservative approach to lending to SMMEs.

This report **encourages APEC leaders to increase financing alternatives for SMMEs by exploring innovations within the SMME financing landscape, and reviewing the regulatory framework and environment required to enable these new models to be introduced successfully. APEC governments should provide an enabling environment that can support a diverse range of financial institutions and products.** Facilitating the entry of new, specialized market participants will broaden the range of financing options for SMMEs at their different life cycles. This report outlines the range of emerging financing options for: (1) early stage SMMEs still in the prerevenue stage; (2) SMMEs that have achieved revenues but are not yet profitable; and (3) growing SMMEs that have achieved profitability.

This report calls for:

- *more government action with regard to equity-based financing mechanisms for SMMEs, such as support for business angels, seed capital, and venture capital;*
- *regulatory review to remove barriers to SMME access to new, Internet-based trade and supply chain financing platforms (including cross-border platforms);*

- *regulatory review to facilitate new SMME access to crowdfunding facilities;*
- *regulatory review to encourage small-cap exchange and exchange window development more suited to SMMEs; and*

- *regulatory review to ensure that major financial participants that have a longer term outlook and higher risk profile, including high net worth individuals, family trusts, insurance companies, pension funds, and other endowments, are not discouraged from participating in investment vehicles based on well-documented SMME loan and other pooled SMME finance assets.*

Need for Support: SMME Financing Gap and Barriers to Financing

Within Asia's highly bank-centered financial systems, SMMEs face greater financing obstacles than large firms. Higher interest rates, stricter collateral guarantee requirements, and exclusion from credit ratings all make it harder for SMMEs. In addition, collateral frameworks based only on immovable assets, such as land and property, often unduly penalize SMMEs in credit ratings.

IFC (2010) estimates the total unmet need for credit by SMMEs globally in the range of US\$2.1 trillion to US\$2.5 trillion. Of the estimated 365 million to 445 million SMMEs in the developing world, almost 70 percent are not able to access external financing from financial institutions, even though a need was indicated. East Asia faces a credit gap estimated in the range of US\$900 billion to US\$1.1 trillion, while South Asia faces a credit gap of US\$310 billion to US\$370 billion.

While new start-ups find it hard to access traditional debt and equity financing, women entrepreneurs face even higher barriers relative to their male counterparts. Women-owned small enterprises face a credit gap of more than US\$1 trillion. Women entrepreneurs control some 40 percent of formal microenterprises, 36 percent of small firms, and 21 percent of medium-sized firms, but receive a far smaller share of the total credit going to such enterprises.

Women-owned enterprises face additional problems due to legal and cultural barriers that vary by country, but exist everywhere.

While many central banks worldwide are increasing their activities in SMME credit markets through direct capital injections into the banking system and through guarantee

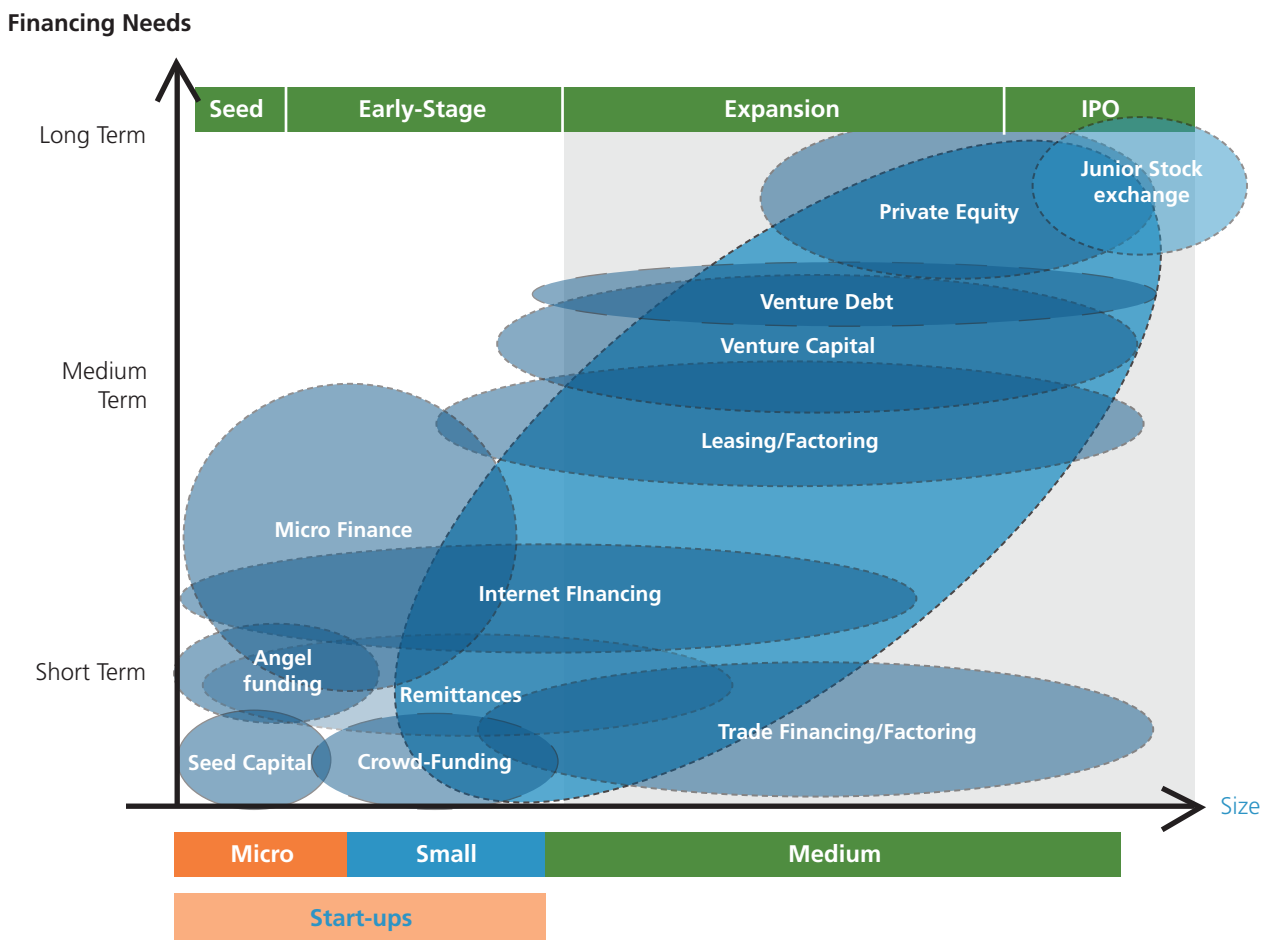
funds and other risk-sharing instruments, the financial crisis has led to more discussion on broadening the range of financing instruments including more innovative financing mechanisms and about the role of government in creating the legal and regulatory environment to support the growth of those instruments.

SMME Financing Landscape

While banks still play the main role in financing SMMEs, other innovative financing mechanisms are emerging to create a far more diverse financing ecosystem. Chart 1 below illustrates innovative financing mechanisms according to the size, financing need, and development stage of the firm. The main lifecycle stages of a firm include a prerevenue start-up stage, early commercialization, where the SMME is in its early revenue stages, and a more established stage, where the SMME is finally profitable.

Banks are typically less exposed to SMMEs than to larger firms, experience more defaults on SMME loans, and charge higher fees and interest rates for SMME products. The share of bank loans to small and medium firms averages 11 percent and 13 percent respectively, while banks' exposure to large firms averages 32 percent. Fees on small and medium business loans average 1.11 percent and 0.96 percent, while they average just 0.76 percent for loans to large firms. The share of nonperforming loans for small and medium business loans is 7.4 percent and 5.7 percent respectively, while it averages close to 4 percent on loans to large firms.¹

Chart 1: Financing Mechanisms for Each Life Cycle Stage of an SMME



Source: Authors have slightly modified original design by William Haworth, IFC 2013

SMME Ecosystem: Overview Pre-revenue Stage

Personal, Family and Friends

Financial capital provided via personal funds, or funds of friends and family members.

Start-Up Labs and Accelerators

These are intensive business programs that include mentorship, educational components, and networking, and aim to accelerate the business. The accelerator gets a stake in the company's equity in exchange for expert mentoring, exposure to investors, and help with securing future capital investment. Such programs can be politically high profile and very resource intensive. The 4th ABAC meeting in 2011 recommended that APEC governments strengthen the information transparency regarding government assistance in this area, so that costs and benefits could be analyzed more thoroughly, successful models replicated, and unsuccessful ones terminated. Experienced and successful incubators and accelerators provide significant mentoring; networking with other entrepreneurs; access to talent; training and information on emerging technological trends; introductions to potential customers; and marketing to venture capital funds.

Convertible Debt

This is an investment in the form of a company borrowing money with the intent that the debt incurred and interest accrued will later be converted to equity in the company at a later valuation. This allows companies to delay valuation while raising funds in its early stages.

Seed and Angel Funding

SMMEs in early stages are often self-funded and receive funds from friends or family or from angel investors.

Seed funding refers to the primary capital of a business. It is often provided by an angel investor, who is an affluent, high net worth individual, in exchange for equity or

other equity-like instruments. Business angels use their personal disposable finance and business or professional experience to invest in the growth of a small business, usually at the conceptual stage where the start-up is yet to generate any revenues. Thus, this form of capital is often used for research and development to cover operating expenses. It comes at high risk due to the fact that the technology, business model, and potential customers are still unproven, as well as the lack of existing cash flows that could be used for evaluation.

Angel investors can make investments on their own or as part of a group (syndicate), usually led by a lead angel investor. Angel investors normally not only make an investment into a company but also share their knowledge, experience and networks to guide and add value to their investee companies. Angel investments bear extremely high risk and are usually subject to equity dilution from future investment rounds.² Angel funding represents an alternative to formal equity funds, with investments in the United States ranging from US\$100,000 to US\$250,000. Generally, business angel investments are limited, as they tend to invest in sectors where they have gained direct experience.

ABAC has made the following recommendations regarding angel investment (2013):

- *Identify and mobilize angel investors to support SMME growth across different sectors.*
- *Catalyze angel investments and venture capital through effective support programs that encourage investments in small businesses by:*
 - *offering tax credits;*
 - *initiating matching funds to qualified angel investments; and*
 - *providing an optional buy-out program.*
- *Provide an enabling legal and regulatory environment for the entire chain of financial activities that support companies across various stages of innovation.*

- *Create, maintain, and enhance fundamental conditions for entrepreneurship and innovation, especially at the incubation by:*
 - *supporting the development of a cadre of good fund managers and human capital;*
 - *promoting good corporate governance and sound risk management; and*
 - *supporting research and development, tie-ups between university and industry, and foreign investment and international trade.*

Few APEC economies have policies to develop and leverage local angel investment. Yet government programs are critical for such early stage funding, as venture capitalists generally target SMMEs closer to the commercialization phase. Angel investors typically invest locally, in areas that they are familiar with and can help with connections. Canada (Province of British Columbia) offers tax credits for angel investments in strategic sectors. There is a 30 percent refundable tax credit available for individuals up to US\$200,000 investment and a 30 percent nonrefundable tax credit for corporations in a qualified eligible small business. Any unused tax credits can be carried forward up to five years. New Zealand operates a matching funds program with local angels with an option for angels to buy out the government for added upside leverage.³ In order to encourage the proliferation of business angels, the government of Malaysia offered a tax incentive for individual angel investors in 2013 that would allow them to get a personal tax deduction of up to RM 500,000 per annum, after two years of shareholding, known as the “Angel Tax Incentive.” To qualify for the deduction, business angels must be tax residents in Malaysia and either high net worth individuals (personal assets of RM 3 million and above) or high-income earners (gross total annual income of not less than RM 180,000).

Venture Capital

Venture capital is a form of private equity financing that is suited to privately held innovation-based, early-stage technology firms with high potential for growth, but also with high investment risk. Venture capital-backed

firms demonstrated superior performance with stronger growth in sales revenues and assets than similar stage firms without venture capital support.⁴ SMME clients of “mid-cap” funds supported by IFC from 2000 to 2010 grew jobs at an average rate of 18 percent per year.⁵

High-technology funds in developing countries so far are primarily found in India with few examples in Brazil, Morocco, Philippines, Ukraine and Vietnam. They include *private initiative*, *government-financed funds* and *mixed schemes*. Often private and government funds are supplemented by financing provided by international financial institutions (IFIs) or bilateral donors. Only mixed schemes consider early-stage investments. Private funds tend to concentrate on later-stage and larger deals (i.e. above US\$2-3 million).⁶

Venture capital support for SMMEs in emerging markets represents only a small fraction of the overall quantity of private equity fund investment.⁷ There are several reasons for this. Despite the vast differences in the enabling environments between developed and emerging markets, fund structures that were developed in advanced economies have been transplanted to emerging markets without making adjustments to reflect these differences. Although these structures seek to implement industry best practices, they do not contemplate the specific needs of funds operating in places such as Latin America, Asia, and Africa.

Second, financial markets differences, ranging from shallow capital markets to fundraising challenges, inhibit the development of robust local capital markets.

Third, capacity constraints of SMMEs often prevent them from seeking venture capital investment.⁸

Finally, data collection for venture capital also encounters particular problems related to inconsistent definitions and sources across countries. There is a need for greater standardization of venture capital data reporting, in terms of both the definition used for the different stages of investment and the methodology employed to collect data.

Additional regulatory issues inhibit venture capital flow to emerging markets, as investors gravitate to economies where doing business is easier, and where strong commercial rule of law prevails. Regulators should ensure that enabling legal and regulatory environment encourages the flow of more private sector resources into venture capital. These include the legal environment (laws governing bankruptcy, technology transfer, foreign investment, and company organization), tax policies and incentives, and protection of minority investor rights, among others. Due to the higher risks involved in financing of venture capital, governments and regulators need to provide an environment that does not discourage informed risk-taking, while ensuring the soundness of the financial system. Exit mechanisms are also important, for which strong local capital markets that allow exits through initial public offerings and local companies that are attractive to strategic buyers must exist.

As many emerging economies in Asia look to accelerate growth in innovation sectors, venture capital plays a critical role in enabling an environment conducive for

innovation. It encourages private sector investments in early-stage risk capital and helps ensure that high-potential innovative firms have access to financing. Government seeding is necessary to kick-start a country's venture capital industry. Every successful venture capital market has had government support in its early days including Silicon Valley, Boston, Singapore and Israel. Government programs can be an important source of funding, as venture capitalists tend to invest closer to the commercialization phase of SMMEs.

Example: ABAC 2013 – Canada's Venture Capital Action Plan

Canada's Venture Capital Plan represents an initiative to attract institutional and other private sector investors to the venture capital asset class to create a sustainable venture capital ecosystem. The plan called for US\$250 million to support two new large-scale private sector led national funds of funds, US\$100 million to top up existing provincial funds of funds, and US\$50 million to top up venture funds that had recently raised money

Chart 2: Overview of SMME Ecosystem

Prerevenue Stage	Early Revenue Stage/ Early Commercialization Stage	Established/ Profitable Stage
Personal, Family & Friends	Supply Chain Financing	Bank Debt
Start-Up Labs & Accelerators	Internet Trade/Value Chain Financing	Trade Financing – Letters of Credit
Convertible Debt	Bank Line of Credit	Junior Stock Exchange & Venture Exchange
Seed/Angel Funding	Subordinated Debt	Public Market IPO
Venture Capital	Venture Debt	Bond/Capital Markets
Crowdfunding	Equipment Leasing	Private Equity
Microfinance	Venture Capital	-
-	Financial Capital Crowdfunding	-
-	Islamic Financing	-
Areas of Innovative Growth		
Seed/Angel Funding	Internet Trade/Value Chain Financing	Junior Stock / Venture Exchange
Microfinance	Venture Capital	
Venture Capital	Equity Crowdfunding	
Crowdfunding		

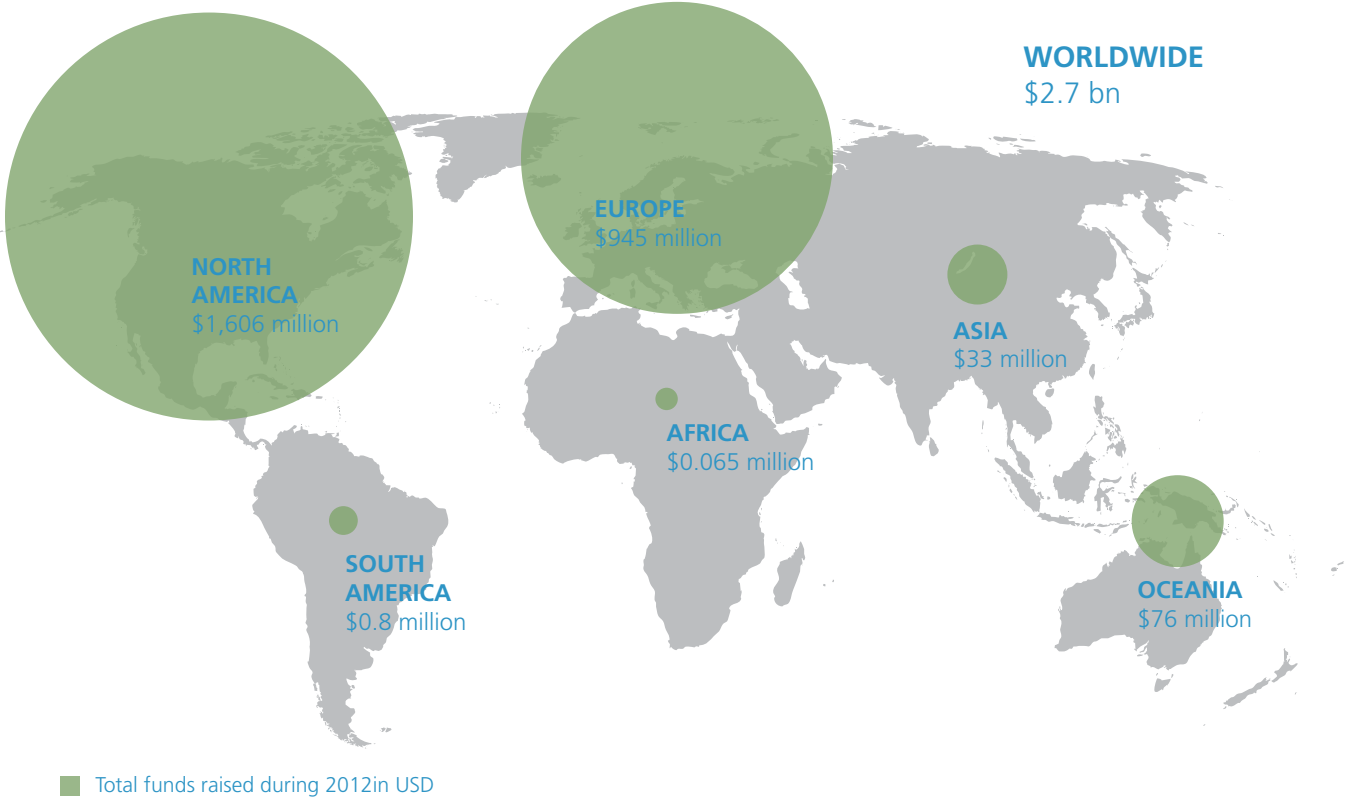
Source: Authors

to help them meet fundraising targets and reach scale. Through this program the government hopes to act as a catalyst in the development of a sustainable venture capital ecosystem led by private sector investments that include broader participation by existing institutional and corporate entities, increasing the number of successful Canadian companies by encouraging investment in high potential innovative firms with better access to financing, and contributing to a deeper pool of experienced fund managers by attracting foreign expertise and capital to Canada's venture capital market. Canada's encouragement to the private sector comes in the form of matching funds and taking the first losses, if any, for the fund of funds, thus providing some downside protection for the overall investment.

Crowdfunding

Crowdfunding refers to any kind of capital formation where both funding needs and funding purposes are communicated broadly, via an open call, in a forum where the call can be evaluated by a large group of individuals. It is an Internet-enabled way for businesses and/or other organizations to raise money for their projects or for financial capital in the range of US\$1,000 to US\$1 million. Projections for the size of the crowd-funding investing market vary broadly from US\$3.98 billion to US\$300 billion.⁹ While lending-based crowdfunding grew 111 percent to US\$1.2 billion, equity-based crowdfunding is still rather small with growth rates of 30 percent to US\$116 million¹⁰ (see also Figure 1 below).¹¹ Crowdfunding has four subcategories: *Donation or presales*

Figure 1: Total Funds Raised During 2012



Source: Massolution, Crowdfunding Industry Report, 2013

crowdfunding, reward crowdfunding, peer-to-peer lending, and financial capital crowdfunding.

Crowdfunding carries the sorts of risks that might be expected of such “low touch” Internet financing processes, but to date levels of fraud in the larger, older platforms are quite low. The risk of default remains, and a key differentiating factor among platform operators should be their ability to present firms to investors in more transparent and comprehensive ways that can make risks easier to assess. Most lending and financial capital crowdfunding platforms to date have been limited to “qualified investors,” high net worth individuals who demonstrate sufficient assets and financial acumen to gain entry to platforms, with (for the most part) only the more donation and reward-based schemes open to the general public. This has enabled many regulators to adopt a relatively hands-off approach to crowdfunding so far, on the assumption that high net worth individuals can protect themselves. As the industry has grown and pressure has mounted to open the platforms to institutional investors and to the general public, regulators have had to adopt a more hands-on approach, as exemplified by the Jumpstart Our Business Startups (JOBS) Act and ensuing (in progress) regulations in the United States.

The market share of crowdfunding in Asia Pacific was only 1.2 percent in 2012. Investors in Asia tend to be more conservative, and adaptation to innovative financial models is slow. Until July 2012, the first crowdfunding platform in China called “Demo Hour” had completed only 281 projects, and successfully collected funding of ¥6.37 million (around US\$1 million); from this, there were 76 design-type projects. There were also 27 film-and-TV-type projects, which collected funding of ¥2.22 million.

The bulk of crowdfunding today is in donation or preselling crowdfunding. Platforms, such as Kickstarter in the United States, are examples where companies are selected and approved to offer innovative products, still in the design phase, for sale to the public. If there is enough interest, the company would then be able to use the money raised to fund the development of the

product. This can conflict with consumer protection laws so many of the campaigns are designed as donations. This is particularly attractive to new innovative companies as it allows them to raise nondilutive funding to develop their product; provides a clear assessment of the consumer interest in their product, and often leads to venture capital interest for those companies with strong presales interest. A number of successful companies have now been formed through crowdfunding of their product ideas.

There are two forms of financial capital crowdfunding: those that are equity based and those that are debt based. While the market is still in its infancy, most of this market tends to be in equity. Equity crowdfunding allows individual investors seeking to invest for an eventual financial return in the business. In debt-based crowdfunding each investor can bid an amount to loan and receives an interest rate associated with that amount. Disclosures include the type of debt, the interest rate, and the term of the instrument.¹² Once a campaign is successfully funded, the issuer’s average interest rate is the weighted average of all accepted bids.

Equity crowdfunding platforms still represent only a small fraction of financial crowdfunding platforms, compared to presales crowdfunding, due to regulatory restrictions. While there are different equity-based platforms, certain general standards have emerged. Required information typically includes information about:

- the business;
- the owners;
- the company’s business plan;
- the type of equity security being offered;
- the percent of the company being sold in the offering;
- the amount of time remaining in the offering; and
- the minimum amount required to be raised to complete the offering.

Investors and issuers often share the same exit strategy: a sale, merger, or initial public offering (IPO), and also share the same risks including dilution and illiquidity.

Businesses seeking funding on these platforms tend to be early-stage firms with limited access to other forms of funding. They have a high risk of default within their first year of existence, posing a high risk for equity holders.¹³ So far, equity-based crowdfunding platforms have launched in the Netherlands; Italy;¹⁴ United Kingdom; France; Austria; Germany; Australia; Hong Kong SAR, China; and Russia.¹⁵ They are legal but not yet effective in the United States. Since 2007, investors in companies listed on U.K.-based Funding Circle have completed financing totalling over £156 million, receiving an annualized return of 5.8 percent.

The JOBS Act was signed by U.S. President Barack Obama in April 2012. A relevant element of the US\$447-billion bill is its proposition to loosen regulations on small businesses that wish to raise capital, including through crowdfunding, while retaining investor protections.¹⁶ In terms of crowdfunding, the JOBS Act allows nonaccredited investors to invest through a new exemption to crowdfunding. As soon as the United States fully implements the JOBS Act, companies will be able to raise US\$1 million during a 12-month period, without registration, prospectus, or strong reporting regimes. The amount that any investor may invest in such a campaign depends upon individual income, which also acts as protection for investors.¹⁷

Microfinance

Microfinance is a general term to describe financial services to low-income individuals or those who do not have access to typical banking services. It is especially applicable to women entrepreneurs and entrepreneurs from ethnic or religious minorities who feel particularly unwelcomed in many banks, but who have proven excellent clients for many specialist microlending nonbank financial institutions. On the assumption that low-income individuals are capable of lifting themselves out of poverty if given access to banking services, these financial services usually provide small amounts of money for short periods of time. The World Bank estimates that approximately 160 million people in developing countries are served by microfinance. Legal and institutional reforms, along with some government support to create incentives for microfinance, can improve the operating environment for both microfinance providers and their clients. For example, easing market entry of nondeposit-taking institutions; broadening recognition of nonmortgage collateral; reducing the cost and time for movable asset registration; and strengthening commercial dispute resolution mechanisms can reduce barriers to microfinance institution formation and growth.

Early Revenue Stage/Early Commercialization

Supply Chain Financing

Supply chain finance is an age-old practice vital to the financial management of many SMMEs that cannot obtain working capital from banks. Instead, they turn to their buyers, who arrange advances based on their knowledge of the firm and its abilities. This system is widespread in APEC today and will remain a critical component of the SMME ecosystem for some time to come. Its disadvantage for the SMME is that it increases dependency on the buyer, who can extract quite stringent terms for the financing without any regulatory oversight. Its disadvantages for the buyer include tying up capital that might be more productively deployed, and increasing financial management complexity in a nonfinancial institution.

A new development in this area, as more supply and value chain transactions move from cash to electronic payments, is the development of third-party supplier finance services, often Internet-based. These new platforms link various transaction parties through technology-based financing processes to lower transaction costs for buyers, sellers, and financing institutions. This new type of supply chain finance provides short-term credit that optimizes working capital for both buyer and seller. Using online platforms automates transactions and allows integration for all stages of the transaction. Through these services, Internet platforms act like agents. The merchants apply for a loan on the platform, which will transfer the loan applications to the banks after authentication and verification. Then the banks complete the loan release process.

The assessment of the financial transaction information in Internet financing is mainly based on the sales record of the e-merchant, number of visitors on the online store, customer feedback, product pricing, inventory, or customer comments on various rating sites. The transactional information is digitalized and becomes an important asset, driving a more direct model between lenders and borrowers, which helps decrease

operational costs through automation and economies of scale. Technologies change the way data is generated, transmitted, processed, and utilized. Therefore, the cost of data collection, data processing, and information completeness should continue to decrease.

The market for such e-commerce financing in the year 2013 is estimated to be around US\$40 billion. The average loan amount is less than US\$6,500, with SMMEs making up the overwhelming majority of users for such services. E-commerce financing provides working capital to merchants on e-commerce platforms as a value-added service, based on Internet supply chain financing models. These e-commerce platforms can work with banks, other financial institutions and/or even pier-to-pier (P2P) lending platforms together to offer the loans.

Example: Loan through P2P Platforms – DHgate China Micro Loan

DHgate started to offer service to its online merchants in 2010, in cooperation with some quality P2P lending platform partners. The merchants apply for the loan on the e-commerce platform. Assessments are made based on historical data, and the merchant is notified of the assessment including the credit line. Qualified merchants can apply online on the DHgate e-commerce platform. The DHgate platform communicates with the partner P2P platform, exchanges necessary data, and provides endorsement. After that, the applicants can follow up on the partner P2P platform. The P2P platform invites matching investors for the loan. The endorsement from the e-commerce platform becomes a trusted identity, and the merchants can enjoy lower interest rates and much faster matching approvals. After investors are matched, the loans are released. Repayments are normally in instalments. This kind of loan is suitable for specific tiers of customers. The platform will prequalify and endorse the merchants before they apply for the loan. No collateral or third party guarantors are needed.

Example: DHgate, Instant Credit Loan from Bank

In 2014, DHgate in cooperation with China Merchants Bank started a credit line loan service. DHgate platform customers apply for the bank debit card. Cardholders interested in the financial loan service can make a preliminary inquiry on the DHgate platform for prequalification, subject to certain specified conditions. Only business organizations with formal registration or private merchants with specific transaction experience are eligible. After that, prequalified merchants can apply for the credit line loan through an online application form, and the platform will perform a formal identity verification and historical data assessment. Data is then sent to the bank for real-time approval. The loan released is credited to the bankcard account of the merchant directly and automatically within 5 minutes.

Subordinated Debt

This is debt that ranks after other debts should a company fall into liquidation or bankruptcy. This debt is owed to an unsecured creditor that can only be paid, in the event of liquidation, after the claims of secured creditors have been met and paid in full. Therefore, subordinated debt is much more risky than unsubordinated debt.

Asset-Backed Financing/ Venture Debt

This is another type of debt financing for emerging venture-backed companies, by specialized banks or nonbank lenders, to fund growth, working capital, or capital expenses. It is available to early-stage growth companies that do not have positive cash flows or significant fixed assets to use as collateral.

Venture debt exemplifies a debt financing option, available for enterprises that already have obtained equity financing from an outside investor. Most venture debt includes a charge for interest along with some form of equity participation, usually in the form of warrants. The payment terms tend to allow for the deferral of the interest payments until such time as the company's projected cash

flow would allow for that payment. Within the wider gamut of venture debt, there are a few different types of loans available based on the different stages of companies:

- Accounts receivable-based line of credit is useful for companies that generate revenues in the form of accounts receivable and compensates for the working capital gap between issuance and collection of accounts receivables.
- An equipment-backed term loan allows an enterprise to purchase equipment without significant additional collateral charges.
- A nonformula line of credit looks and feels in many ways like equity in the short term, with the obvious caveat that it's debt will have repayment terms associated with the note. Term loans typically have multi-year terms (3 years is the norm, though some are longer) while nonformula lines of credit, not tied to accounts receivable, typically have a one-year term and specific repayment terms associated with the note.¹⁸

Equipment Leasing

Typically SMMEs may need capital equipment, but banks would not be willing to lend funds to purchase the equipment due to the company's credit rating or lack thereof. With leasing, the financial leasing company purchases the piece of equipment and keeps ownership, but permits the SMME to use the equipment under a leasing contract while getting payment, close to the leasing company's cost of borrowing the funds plus a credit risk spread.

The advantages for the lessor are improved risk management with the asset as collateral, increased sales focus with a specialization on a standard and simple product. SMMEs have the advantage of unsecured term lending to leverage a down payment and finance a productive asset, and the benefit of the flexibility to match lease expenses and cash flow generation. Thus, leasing allows the SMME to overcome problems of poor creditworthiness by offering the provider of funds an asset that is independent of its own credit standing. However, many tax regimes unintentionally impose additional charges on leases (not

being able to deduct lease payments, as opposed to interest payments, for example), making leasing less affordable in some countries. Policy makers should strive to level the fiscal playing fields for comparable financial instruments bearing comparable risks, giving leasing a chance to develop as an important alternative for SMMEs.

Islamic Financing

Islamic financing is compliant with Sharia principles and can be extended to anyone, not just Muslims. There are five key elements that must be avoided in Islamic finance: interest (*riba*); speculation (*maisir*); uncertainty (*gharar*); unjust enrichment/unfair exploitation; and unethical purpose. In practice, this means that businesses that provide goods and services deemed to be contrary to Islamic principles, such as those involved with armaments, pork, tobacco, drugs, alcohol, or pornography, would not be eligible. They also tend to invest in real assets, not financial instruments that are based on speculation. Central to Islamic finance is the fact that money itself has no intrinsic value; it is simply a medium of exchange. And while this might mean that earning interest is not allowed, accounts are structured such that lenders profit by buying and selling of approved goods and services. The principle means of Islamic finance are based on trading, and it is essential that risk be involved in any trading activity. Lenders can profit by being rewarded for the risk that is assumed.

The Brunei government's Small and Medium Enterprises Financing Program, administered through the Ministry of Industry and Primary Resources, shows that Islamic instruments can support a wide variety of business needs. Bank Islam Brunei Darussalam (BIBD) is one of two banks in Brunei to administer this program. Its SME Islamic financial services assist in business expansion, contract implementation, bridging cash flow requirements, and payments intermediation. BIBD offers small enterprise loans up to US\$4 million equivalent, and microloans of under US\$40,000 under this framework. Its Islamic-certified products include pre-and post-delivery export finance across the full trading cycle, lines of credit (cash lines), term financing, hire purchase, trade lines, and bank guarantees, as well as export refinancing.

Development-Oriented Venture Capital Funds

Generalist venture funds consist of diversified portfolios, rarely investing in early-stage equity deals, with deal sizes typically between US\$1.5 and 3 million. There are also obstacles to smaller deals.¹⁹ *Development-Oriented Venture Capital Funds* are primarily operated by IFIs or donors, such as the Small-Enterprises Assistance Funds (SEAF, U.S.), and Business Partners (South Africa). Investments are generally in line with a development mandate and there is a tendency to invest in medium-sized firms.

ABAC has identified several measures that policy makers can take to support the development of these categories of alternative SMME finance services. It recommends the following steps to encourage the growth of these new third-party platforms:

- Provide an enabling legal and regulatory environment that will encourage the flow of more private sector resources into private equity through such measures as laws governing bankruptcy, technology transfer, foreign investment, company organization, tax policies and incentives, and the protection of minority investor rights.
- Encourage closer public and private sector collaboration: Undertake policy dialogue involving relevant government agencies, international institutions, and the private sector to examine best practices in facilitating the development of private equity, use of public resources and tax policy.
- Develop funds of funds: ABAC recommends the development of an APEC-oriented fund of funds to be established as a catalyst in the development of a sustainable venture capital ecosystem. A fund of funds offers broad diversification through asset allocation with investments in a variety of venture funds diversified across several different economic sectors that are combined into one fund. It would require:
 - collaboration with interested economies and multilateral institutions such as the Asian

Development Bank, World Bank Group, and the International Monetary Fund.

- government incentives to encourage private enterprises, institutions, and banks to participate such as:
 - tax incentives;
 - first in-last out by government for downside protection; and
 - potential buyout of government at preestablished rates of return to leverage upside.

Example: ABAC 2014 – The New Zealand/Chinese Taipei Co-Fund

The New Zealand/Chinese Taipei Co-Fund exemplifies a cross-border initiative in venture capital development to help SMMEs gain access to finance and markets by investing in high growth companies from New Zealand and Chinese Taipei. Chinese Taipei's National Development Fund (established in 1973) and New Zealand Venture Investment Fund (established in 2002) jointly provide US\$160 million for investment over five years. Portfolio

investments are equally made into both New Zealand and Chinese Taipei companies, including private companies at seed, start-up, or early expansion stage and up to US\$40 million or 60 percent of the capital of an eligible venture capital fund.

At the same time, governments can inhibit the development of the venture capital industry by poorly designed interventions that crowd out private initiative. In the examples given above, government was supporting private initiative, rather than replacing it with government-controlled efforts. Furthermore, legal and regulatory reforms promoting responsible investment must accompany initiatives supporting the creation and operation of venture capital funds. These include protection of minority shareholders' rights; facilitating the transfer of share ownership; and the speedy and equitable settlement of commercial disputes. They should be buttressed by fiscal reforms creating tax regimes that ensure a transparent and equitable treatment of company profits, dividends and capital gains, and the tax-free passthrough of returns to a venture capital fund and its investors.

Established Stage

Bank Debt

An established profitable company that needs external financing to meet operating needs can borrow from a financial institution or engage in securities exchange transactions such as stock, bond, or preferred share issuance. In many instances, the first form of debt is bank debt, secured or unsecured lending from a major bank. The global financial crisis and resulting regulatory changes have impacted the ability of many banks to provide the same level of lending as before the crisis. As these banks have cut back, the impact has been significant on the smaller, less-established companies, particularly SMMEs. A popular measure for governments has been the provision of loan guarantees to secure lending to SMMEs. It is important that these programs continue and that increasing regulatory burdens do not significantly impact bank lending to SMMEs.

Trade Financing – Letters of Credit

These are letters from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase. Letters of credit are often used in international transactions to ensure payment will be received.

Junior Stock Exchange/Venture Exchange

A stock exchange is a market in which securities, commodities, and derivatives are traded, giving companies and governments a platform to sell securities to the investing public. An exchange can be a physical location where traders meet or an electronic platform. Junior exchanges are new markets, or windows within existing markets, that use different rules of conduct that lower costs of entry and compliance for smaller firms. These rules can involve technological innovation to lower transactions costs, or reductions in disclosure and other requirements, as noted in the examples below.

SX Ignite. TSX Venture is a Canadian stock exchange that trades electronically and launched TSX Ignite with Toronto Stock Exchange (TSX). TSX Ignite is a new initiative designed to support the growth and development of Canadian SMMEs by providing information about building a successful business through various stages of the company's growth. Information is offered through events or Learning Channels.²⁰

NASDAQ. The Nasdaq stock market in the United States is the world's second-largest stock exchange. It has been boosting its efforts to support capital-raising for European SMMEs. NASDAQ's Swedish exchange, for example, has published a White Paper, which includes new rules, among others, of companies no longer needing to have 500 shareholders who must each own shares worth €1,000 in order to list. According to the White Paper, the exchange seeks to support economic growth and the creation of new jobs by helping SMMEs access financing on the capital markets.²¹

Alternative Investment Market (AIM). AIM, an exchange in London, gives companies the opportunity to raise funds and trade securities on a capital market at an earlier stage in their business development, as it maintains a more flexible regulatory structure. This is particularly the case for companies seeking to achieve corporate growth through acquisitions or disposals as there are reduced disclosure requirements. Shareholder approval is only required for reverse takeovers and transactions that result in fundamental change of business.

ABAC recommends that governments consider the promotion of new, junior stock exchanges oriented toward smaller companies that may not be able to meet the listing requirements of the more established public stock market exchanges. It also recommends the government to review listing requirements that may enable smaller companies to list on those exchanges in such a way to clearly identify the higher risks involved in such companies. Regionally operating exchanges could help smaller market countries reduce costs of developing these alternative capital markets.

However, making these exchanges effective requires prior regional agreement on cross-border trade and investment rules and regulations.

Bond/Capital Markets

A bond market is where issuance and trading of debt securities takes place. It includes government-issued securities and corporate debt securities, and facilitates the transfer of capital from savers to issuers or organizations requiring capital for business expansions or ongoing capital.

A capital market is for buying and selling equity and debt instruments; it channels savings and investments between capital suppliers and businesses. There is substantial ABAC work being done through the Asia Pacific Financial Forum to develop a more robust capital market for Asia. As part of that, it is important that government consider regulations that allow for capital market funds to be used toward SMME financing. For example, it would be important that regulations allow for the creation of funds of funds for venture capital, institutional financial capital crowdfunding, funding for microfinance companies, and other such pooled instruments that could enhance the participants in the SMME financing ecosystem.

Public Market IPO

This is a type of public offering where the first shares of stock by a private company are sold to the general public in a regulated stock exchange. A company selling shares is never required to repay capital to its public investors. After the IPO, when shares trade freely in the open market, money passes between public investors. The costs of these

processes generally are beyond the means of all but the largest of SMMEs. Listing requirements for companies also limit the ability for all but the larger firms to meet the requirements to be able to list on such exchanges. In fact, in many exchanges, if the company were to fall below certain of those requirements, it would be delisted and no longer able to trade its securities on those exchanges.

Private Equity

In general, private equity is a broad asset class consisting of equity securities and debt in operating companies that are not publicly traded on a stock exchange. Private equity investments are generally made by a private equity firm, a venture capital firm, or an angel investor. There are many forms of private equity, including angel and seed investments, as well as venture capital, already discussed in this paper. In practical jargon, private equity today often refers to:

- a more narrow focus on growth capital in the form of equity investments in relatively mature companies looking for capital to expand or restructure operations, enter new markets or finance a major acquisition without a change of control of the business;
- leveraged buyouts of a company, a business unit, or business assets with the use of financial leverage; or
- distressed and special situations to rescue established companies undergoing operational or financial challenges.
- Given these priorities, it is not surprising that only older, more medium-sized SMMEs take much of the tiny share the sector obtains from the mainstream private equity industry.

Conclusions

SMMEs make significant contributions to social and economic welfare by stimulating domestic demand through employment opportunities, innovation, and competition. Although traditional bank finance is, and will continue to be, a major player in financing SMMEs, it is clear that the restrictions on alternate access to finance is the most crucial obstacle to SMME growth.

Governments and their policies play a crucial role in removing the barriers to accessing financing for SMMEs. Subsequently, it is important for APEC leaders to explore the broader spectrum of innovations within the SMME financing landscape, in order to better meet their needs. Key areas of innovation are microfinance, seed and angel funding, venture capital, crowdfunding, Internet trade financing, and venture-oriented stock exchanges.

There is no single solution for financing SMMEs and while this report explores innovative mechanisms, traditional bank financing needs continued attention. National policy makers need to develop a comprehensive suite of policy options that support innovative and diversified financing models. These models should broaden the range of financing options through specialized market participants to serve the financing needs of SMMEs at different stages of growth, while at the same time encouraging banks to maintain an active presence in SMME markets.

Some specific ABAC policy recommendations include: *SMME Ecosystem Review.* This report outlines some of the various financing mechanisms that have proven successful in helping fund successful SMME's. It would be useful for each economy to review against this list its SMME financing ecosystem to determine what mechanisms are generally available and to encourage a broader range of these financing mechanisms to flourish.

Regulatory government review. If governments were to regularly review policies and actions surrounding SMME financing, this might identify unintended barriers to emerging innovative financing options that

can spur the growth of SMMEs and their respective economies. Regulatory review can ensure an increase in SMMEs' abilities to access microfinance; seed/angel funding; venture capital; increased trade financing options enabled by the Internet; crowdfunding through financial capital or presales of future products; and public markets through early-stage, venture-oriented stock market offerings. The participation of major institutional participants such as insurance companies, pension funds, and endowment funds can help develop the systems needed to more effectively assess the risk profile of various pooled investment funds to enable the development of specialized products that broaden the SMME financing ecosystem in a market-driven way. Regulations often are designed for short-term oriented financial players, such as banks, and discourage these longer-term oriented players from participating in the development and investment of products designed to help meet the financing needs of SMMEs.

Angel, seed, and venture capital. APEC governments and their leaders can play a valuable role in building an environment conducive for equity based financing options. Government programs and initiatives can include the adoption and maintenance of legal and regulatory frameworks to support small ticket equity funding, protection of minority shareholder's rights, easier transfer of share ownership, and equitable settlement of commercial disputes. Equity financing is a critical part of a robust financing ecosystem for SMMEs. Successful, equity-backed SMMEs generate significantly outsized benefits in employment and other aspects of economic growth. No small ticket equity/venture capital market has developed without government playing a key role in seeding its initial development. Specifically, governments can provide tax credits or matching funds to angel investors to spur investment, and encourage pension funds, sovereign wealth funds, insurance companies, and endowment funds to enter the market, or seed fund of funds as a catalyst in the development of a sustainable venture capital ecosystem. Other government initiatives

that encourage investments in small businesses include investment tax credits, matching funds and optional buy-out programs.

Economy-specific framework for the responsible growth of crowdfunding. Crowdfunding regulations should balance the need for consumer or investor protection with capital formation. A country-specific framework for crowdfunding investing should be created to encourage, in its first phase, high net worth individual and institutional investment in start-ups and small businesses, and to attract diaspora remittances for such vehicles. It is important to enact regulations that are not too burdensome, accepting that these are more educated, sophisticated investors, and to learn from this initial phase in designing more specific legislation to enable broader institutional investors and the general public to enter the second phase of growth.

Blended public-private financing vehicles. Many OECD governments have already formed special investment funds alongside private investors in SMMEs through blended fund structures. The public entity joins other public and private entities and provides equity, debt, quasi-equity to SMMEs, or funds-of-funds structures that the public entity allocates funding to several funds that provide financing to SMMEs. Risks and rewards are different depending on the tolerances of the different participants in the fund structures. A key challenge in this area is finding the right, enabling role for government, crowding in, rather than crowding out nascent private sector interests.

Footnotes

1. Beck, Demirguc-Kunt, Peria, 2008.
2. ABAC, 2014: Malaysia Angel Investment.
3. ABAC, 2010.
4. Industry Canada, 2013.
5. IFC Jobs Study, 2013.
6. Ibid.
7. Divakaran, 2014: From 2009-2011 SMME investing in Latin America exceeded US\$600 million but represented less than 5 percent of overall capital invested by VC and PE firms in the region. In 2011 there were about 16 active funds dedicated to East Africa, with 20 large-scale deals (average transaction value of more than US\$10 million) representing a total investment of US\$188 million.
8. Ibid.
9. Best, Neiss, Stralser, and Fleming, 2013.
10. Massolution, 2013.
11. Ibid.
12. Infodev, 2013.
13. International Organization of Securities Commissions (IOSCO), 2014.
14. Only start-ups labeled as innovative by the Chamber of Commerce are eligible to raise capital through equity crowdfunding platforms. Further requirements are previous investments in R&D, a professional investor that subscribes at least 5 percent of the capital offered and a guarantee to investors to withdraw from investment at any time. The maximum amount that can be raised is €5 million.
15. Massolution, 2013.
16. OpenCongress: H.R.12 – American Jobs Act of 2011.
17. Massolution, 2013: Maximum 5 percent of income/net worth or US\$2,000 or maximum 10 percent of income/net worth or US\$100,000, respectively.
18. See Venture Banker website for more detail at <http://venturebanker.tumblr.com/post/413505375/understanding-venture-debt-part-i-what-is-venture>.
19. Ibid.
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