TIPS FORUM 2024

SMALL BUSINESS, INCLUSIVE GROWTH AND INDUSTRIAL POLICY IN SOUTH AFRICA

LEVERAGING CORPORATE ECOSYSTEMS TO DRIVE SMALL BUSINESS DEVELOPMENT AND INCLUSIVE GROWTH

July 2024

Dumisani Mkhonza, COO - Absa Corporate Funds Management

Paper presented at the TIPS Annual Forum 2024

The Annual Forum 2024 is being hosted by Trade & Industrial Policy Strategies (TIPS) in partnership with the DSI/NRF South African Research Chair in Industrial Development (SARChI), the Department of Trade, Industry and Competition (the dtic) and Absa Bank

About the author

As the Chief Operating Officer, Dumisani Mkhonza, "Dumi" is responsible for the effective functioning of what he calls the "engine room" of non-traditional finance. He has played various roles in Absa for the last 20 years including Finance, Treasury, Product Control, Commercial Property Finance, Private Equity This current role in Developmental Finance consolidates his passions and technical abilities.

He is passionate about leveraging the banks and corporates ecosystems as catalysts for building inclusive economies. Banks play a transformative role in the economic lives of individuals and businesses. The socio-economic challenges in our beautiful continent require new solutions and partnerships. As Absa, together with our corporate clients, we are in a great position to empower Africa's tomorrow. Dumi uses his wealth of banking experience and extensive knowledge to create innovative finance solutions with impact and this enhances the transformative role that Absa plays in our society.

About the paper

This paper is based primarily on the extensive experience of Absa Corporate Funds Management and Enterprise Development. It is premised on insights drawn from the access Absa Corporate Funds Management has to inhouse data, subject matter experts and systems. It is a thought leadership paper inspired by our learnings and leading-edge practices observed over time that we seek to leverage in building Africa's stories and growth potential.

One of Absa's strategic imperatives is to be an active force for good in everything we do. This is a crucial pillar of the organisation's strategy. To achieve this, Absa is embedding ESG principles and SDG aspirations in its core business strategy, which are key to delivering long-term value linked to its purpose.

Absa promotes just and equitable societies by actively influencing public policy and regulation and strengthening trust by way of *inter alia* thought leadership in various mediums.

"We don't have to engage in grand, heroic actions to participate in change. Small acts, when multiplied by millions of people, can transform the world." Howard Zinn

1. Executive summary

A thriving small business ecosystem is integral to inclusive growth and job creation in the fight to reduce poverty and inequality, especially in South Africa.

The paper presents key challenges in **access to finance**, recommends solutions and details approaches in **building an enabling SME ecosystem** as a solution for growth and sustainability.

The focus is on fostering inclusive growth through strategic financial and non-financial interventions, leveraging the banking ecosystem and embracing Environmental Social Governance (ESG) and B-BBEE scorecard principles to drive sustainable development.

> *"Inclusive growth is fostered through strategic financial and non-financial interventions, leveraging the ecosystem within financial sector, embracing ESG and B-BBEE principles to drive sustainable development."*

The solution to the growth of small businesses, involves intentional and increased participation of small businesses in the value chain of corporate and public sector entities and collaboration with diverse stakeholders such as business development support partners.

2. Access to finance and the role of the financial sector

Small businesses face barriers in accessing finance from the financial sector due to several and multifaceted challenges and constraints, including traditional lending approaches. We highlight some of the challenges we see as crucial and suggest possible solutions.

In instances where small businesses obtain funding, funds received are generally insufficient and at higher interest rates with the result that SMEs are not able to fulfil the following objectives:

- set up costs,
- ongoing operational costs;
- expansion costs;
- ability to create meaningful wealth; and
- creation of employment opportunities.

The sustainability of the small businesses is naturally compromised in light of the above, with the result that they sometimes adopt desperate measures to "survive". To this end, in order to access additional working capital for operational, growth and other business expenses, SMEs often approach informal lenders that provide loans at unaffordable rates, which in turn reduces the margins and often results in financial losses.

The above-mentioned constraints limit the SMEs from growing sustainably and from optimising their potential and result in the unintended consequence of reducing the meaningful role SMEs can play in job and wealth creation.

The barriers that SMEs encounter are addressed below with proposed solutions:

- **Limited cashflow and lack of own capital (equity gap)**

  Problem statement

  Most SMEs struggle to get off the ground (start-up capital) or to keep going (working capital) or move to the next level (growth capital) due to the current nature of funding instruments and business terms. Loans received by SMEs are usually not suitable for start-up capital as the business is not expected to generate positive cashflow in the initial stages. Working capital remains a major constraint because suppliers are not prepared to provide credit terms to SMEs and customers do not pay on time or pay at all. In instances where customers are also SMEs, there is a systematic risk as they might be waiting for payments from their customers as well. VAT on sales is due when the invoice is issued and not when the payment is received. These are the integrated problems that SMEs face.

  Possible solution

  <u>Pre-performance</u>: This can be addressed through lending-based grants, advance payments and affordable (soft) loans from corporates (including public sector entities and financial institutions). These soft loans are interest free or at low interest rates to maintain purchasing power of the available capital and are at extended repayment period. This has the potential of improving the working capital and overall cashflow position of the SME.

  <u>Post-performance</u>: SMEs can receive payments early to fund operations by discounting their invoices through Supplier Finance products from financial institutions and corporates. Through B-BEEE codes, corporates are incentivised to make early payments especially on purchase orders.

- **Poor or no credit profile**

  Problem statement

  In traditional financing, a bad credit records prevent SMEs from obtaining further credit. SMEs often have poor or no credit profiles as a result of the issues elaborated on above relating to limited cash flow and limited equity contributions. Given that lenders and creditors are paid by way of net revenue generated by the SMEs, these stakeholders are entitled to list SMEs in credit bureaus, if there are no repayments.

  Possible solution

  A negative credit record should be imposed when successive efforts to ensure compliance with credit terms are willingly disregarded. There should be clear indications of neglect and negligence in this scenario. A negative credit record should not automatically prevent an SME from obtaining credit, but there must an assessment of whether there was willingness but no ability to pay as opposed to ability to pay but no willingness. The SME management's true intention, integrity and character must be tested. There must also be a demonstration that the SME is in control of their debt situation by providing valid reasons for the default and plausible repayment plans.

- **Lack of security and weak balance sheet**

  Problem statement

  SMEs ordinarily need financing earlier than lenders are prepared to provide, mainly because of risk of volatility associated with still being in an emerging stage. At this stage, the balance sheet is not yet strong enough and there is usually insufficient security even when cashflows are positive.

  Possible solution

  New funding products that allow for intermittent advances, high and low given the project or cycle of the business ought to be made available by the financial services and corporate sector. Such products should allow the SME to obtain finance when there is profitability and affordability. Banks can collaborate and share the risk with corporates and DFIs by entering into risk sharing agreements for development purposes. For example, use of guarantee funds and special purpose vehicles focused on SME funding.

- **Limited or no track record and trading history**

  Problem statement

  SMEs do not qualify for credit even where the SME shows profit history, recurring contract revenues, verifiable trade references, and banking history. All this might not be sufficient. There is normally an expectation for the SME to be in operation for 2 to 5 years to be considered worthy of credit under the traditional approach. Non-bank lenders are prepared to look at shorter periods but will often price that risk by implementing higher interest rates which reduces profit margins.

  Potential solution

  It is generally accepted that credit risk is high in the SME lending space but a holistic and empathetic approach to SMEs provides the context and ensures fit for purpose solutions. The credit approach should be forward looking (empowering the future of SMEs) based on cashflows from the contracts and/or commercially viable business plans. More emphasis must be placed on positive cashflow generation ability and management's integrity than on historic financial statements and current financial position of the SME.

  Banks do provide funding to start-up businesses however lending is not normally viewed an appropriate instrument at the commencement of business when there is no trading history. There is scope for equity providers at this stage. Start-ups can qualify for funding if owners have expertise in a particular product or service and this can be verified independently. Generally, a grant or equity might still be required to manage the financial leverage and to ensure SME is not set up to fail. Extending the availability of reasonably priced funding will improve the probability of SME success

In recognition of the role that financial institutions can play in supporting SMEs, Absa has developed a non-traditional lending approach, orientated towards financial inclusion, through focusing on the SME's ability to generate cashflows to make loan repayments. The lending approach is underpinned by a deliberate intention to collaborate with other entities in the formal economy, such as corporates and DFIs.

3. Building an enabling SME Ecosystem

Two African proverbs are relevant here. "It takes a village to raise a child" and "if you want to go fast, go alone, if you want to far, go together". Growth and success of most SMEs depend on the support of and collaboration of diverse stakeholders that bring experience, knowledge and expertise into SME Ecosystem. While banks, DFIs and non-bank lenders can play a significant role in extending finance to SMEs, funding alone is not sufficient for growth and sustainability. SMEs also need access to markets, access to information and knowledge and access to business development support. No single stakeholder can solve all the problems, all the stakeholders are crucial in the ecosystem to work for a common good.

Improving access to Markets and to Information

Private sector and public sector entities can diversify their value chains by opening up opportunities to smaller suppliers and distributors. Absa has a wide range of annual events that provide networking, visibility opportunities and procurement opportunities with Absa corporate clients. For example, Smart Procurement is an event that facilitates connections between small businesses and corporates. These events allow for information sharing and business connections to be made. The aim is to increase participation of small businesses in value chains.

Artificial Intelligence (AI) driven analytics can play a crucial role in identifying partnership opportunities within corporate and public sector value chains. By analysing extensive datasets, AI can help corporates, public sector entities and financial institutions identify viable SMEs within their environment and help them align their products and services with market demand whilst observing data privacy requirements. This will enhance market competitiveness for the benefit of customers.

Growth of social enterprises in the SME ecosystem is likely to disrupt most industries as they often focus on benefiting those that are excluded by using a commercial approach to address unmet needs. Democratisation facilitates easier access to information and tools, breaking down barriers to participation. It reduces costs, improves risk management and experience of the players within the ecosystem.

Embracing digital transformation and AI

- **Reducing administrative burden**

The credit application process can be cumbersome for SMEs with documentary, compliance and diligence requirements. The synchronization and centralisation of various administrative and compliance processes using digital solutions will facilitate better and effective on-boarding and application journey. With an ID and mobile number of an individual and their consent, financial institutions can validate independently from golden sources (CIPC, Credit Bureaus, SARS, Home Affairs, and Banks) without need for SMEs to provide such documentation. This form of sourcing documentation independently reduces the risk of fraud and improves credibility. Considerations must always be given to data privacy requirements to ensure that personal information is only used for intended purposes.

- **Improved turnaround times on credit applications**

Banks are in a unique and favourable position to assist SMEs quicker because they are privy to various sets of information and data that is not ordinarily available to other players. This information, when consolidated or viewed holistically, can help with a more accurate and quick credit assessment of an SME.

For example, transactional data on the SME business bank account combined with the owner's personal bank account information, credit bureau information, POS (Point of Sale) information can be reviewed together. This can help determine a credit outcome by using this data instead of relying on historical financial statements and management accounts, which do not reflect future potential and SMEs often lack.

This consolidated view of the owner and the business is an area where AI can play a role by predicting future revenues and expenses based on historical transactions from the bank accounts, thus providing a forward-looking perspective on an SME's ability to repay its debts. AI algorithms can assess an SME's cash flow patterns, identify potential risks, and forecast repayment ability enabling financial institutions and corporates to make better informed lending decisions. They can also assess the owner's ability to manage personal expenses that may have a bearing on their salary need.

- **Improved compliance and reporting**

There are benefits for using AI in the SME ecosystem. For example, automated business diagnostic tools could lower costs of providing and procuring services like accounting, tax and advisory services.

Digital accounting and business management tools can be introduced and integrated with the SME's business accounts resulting in enhanced and quality financial reporting by the SMEs. Data generated from these solutions can enhance lending decisions where historical information traditionally used in lending decisions is lacking.

Additionally, this compliance and financial reporting provides credibility to Impact Reporting that this normally used by corporates for ESG and Sustainability reporting.

- **Inclusion of micro and informal sector**

The existence of this market is necessary, but solutions are different. Physical cash is king and is still pretty much the norm in the township, rural and informal sectors and there has been a cultural issue around distrust of the banking system. Creation of a credit profile is important for future growth prospects. Digital transformation and FinTechs assist in "decashing" the economy. This is important because it improves business safety and reduces risks of financial crimes such as heists and money laundering. It helps to formalise small businesses whilst developing a credit profile. FinTechs play a significant role and in their ability to decash the environment whilst improving data in order to improve the credit environment. Socio-economic development (SED) funds, Global Development Organisations (GDOs), community trust funds and other social impact funds can play a shaping role here by being a source for innovative finance instruments.

Enabling access to Business Development Support (BDS) partners

Absa has a Business Development Risk Management Platform, where mentors and experts, who are themselves small businesses can provide bespoke business development support to funded SMEs. The platform extends Absa's reach and the appropriateness of the support provided and helps avoid cultural and language barriers when engaging with SMEs. Support provided includes funding readiness, financial and legal management support, financial modelling, strategy execution, and mentorship. The purpose is to improve the funded SMEs' ability to repay their loans, grow their businesses, and access additional finance.

Collaboration with universities and funding specific PHD projects is proposed for research on applying AI innovations. This could inform development finance policies and products into the future.

Collaboration with audit firms will assist SMEs improve understanding of financial management incorporating internal controls, budgeting, retention and growth needs, working capital management improving financial controls, and compliance with various legislation e.g. labour laws, income tax , VAT Act etc. An informed business owner reduces the business continuity and going concern risk as well as the credit risk by managing the business better.

Monitor , Evaluate and Learn

To ensure the success of any collaboration for the benefit of SMEs, a robust monitoring and evaluation (M&E) framework is necessary. This framework will track the progress of the initiatives against set objectives and key performance indicators (KPIs). Regular impact reports must be provided to all stakeholders, highlighting achievements, challenges, and recommendations for improvement. The M&E framework also facilitates learning and adaptation, ensuring that our collaboration remains effective and responsive to the needs of SMEs

Corporate Social Responsibility (CSR)

Citizenship is being redefined by corporates in the new post pandemic era. It is no longer an event or side of the desk exercise, it is firmly embedded in how corporates do business to stay relevant and sustainable. Customers are discerning, good quality and price are no longer sufficient. Socially and environmentally responsible products and services are firmly in the equation of customer decisions.

Employees in corporate environments through colleague volunteering or prescribed engagements in an area of their choosing (i.e. part of an employment contract includes 40 hours of SME coaching) can provide SMEs with guidance and access to knowledge in areas where they may be lacking, such as sales, procurement and legal. Financial support can be used to incubate SMEs, ensuring that skills gaps within these businesses are addressed, and enable the management teams to gain the right tools and knowledge to become successful. This is the risk mitigation required by lenders especially banks and it is at the heart of banking.

Possible enhancements in legislation

- **National Credit Act (NCA)**

Problem statement

The National Credit Act aims to protect borrowers from being exposed to reckless lending, to limit cost of credit and to encourage financial inclusion. The act is primary aimed at individual consumers but it also extends protection to small businesses that meet certain criteria, ensuring they are not subjected to unfair lending practices. This can however be a deterrent for non-bank lenders as they face higher operational and regulatory risks due a requirement to be registered credit providers. This comes with administrative and compliance burden to adhere to the NCA legislation.

As a result, non-bank lenders prefer to lend at higher amounts (greater than R250 000) or to SMEs that are already in business and generating revenue in excess of R1m per annum. This unfortunately means start-ups are excluded and SMEs looking for small loans less than R250 000 are excluded.

Possible solution

The NCA legislation may need to be reviewed and harmonised with the B-BBEE legislation. SME borrowers that qualify for Enterprise and Supplier Development (ESD) under B-BBEE codes should be excluded from the NCA given that the lending is on generous terms. The NCA already excludes certain entities as borrowers, and this can just be an extended to ESD borrowers.

- **B-BBEE legislation on ESD**

Problem statement

When it comes to loan funding of ESD borrowers by corporates, there is currently an opportunity to include shorter term loans in addition to outstanding balances at financial year of the corporates (measured entities) for B-BBEE points calculation. Any loans provided during the year and repaid during the year are not currently recognised. This means that purchase order financing or short-term loans are not preferred by corporates which excludes start up entities, township and rural businesses, smaller suppliers or distributors who need this kind of funding.

Possible solution

This funding is currently provided by FinTechs but can be augmented should the legislation be tweaked and this will further stimulate this enviroment. For example, points should also be awarded to corporates advancing money to the FinTechs, aggregators or SPVs and claim points award on 80% utilisation of the funding and reduction say over 5-year period on a straight line basis as this should be sufficient time to show impact of such initiatives. This should increase the funding pool at the lower end of the market.

4. Conclusion

The commercial imperatives of corporates remain its primary obligation. Corporates can only create jobs, support SMEs and the community when they are themselves profitable. By optimally integrating ESG principles which recognise the positive correlation that exist in commercial, social and environmental outcomes with B-BBEE principles and using ecosystem thinking, value is created for all stakeholders.

The biggest challenge and call to action is the mindset shift needed within the corporate culture.

The challenges facing SMEs are multifaceted, but with the right blend of financial support, ecosystem partnerships and collaboration, we can build an inclusive and sustainable economy. It is important to view the development of SMEs through a holistic approach i.e. both from a commercial and social perspective. The possible solutions outlined in this paper hopefully provides a roadmap for leveraging corporate value chains and ecosystems to drive transformation and to ensure the financial inclusion of SMEs.

Abbreviations

B-BBEE	Broad-Based Black Economic Empowerment
DFI	Development Finance Institution
GDO	Global Development Organisation
ESD	Enterprise and Supplier Development
ESG	Environmental Social and Governance principles
SDG	Sustainable Development Goals
M&E	Monitoring and Evaluation
KPI	Key Performance Indictors
SPV	Special Purpose Vehicle

References

- Absa's internal policies and data
- Material from Sustainability Leadership course
- National Credit Act 34 of 2005
- B-BBEE Act 53 of 2003, Empowerment Amendment Act, 2013 (Act No. 46 of 2013
- B-BBEE Codes of Good Practice, Sector-Specific Codes of Good Practice
- Avanthika Santhee - BCom Honours in Management Accounting (UKZN), The Impact of Artificial Intelligence on the Future of the Accounting Profession, Honours thesis
- Mleni, AOK (2021). The importance of access to finance for SMEs and their ability to export: The case for South Africa [unpublished master's thesis]. University of Stellenbosch