The Small and Medium Enterprise (SME) Sector —

Catalyst for Growth in South Africa

J.P. Morgan (JPM), through the JPMorgan Chase Foundation, is launching a new initiative focused on small and medium-sized enterprise (SME) growth in collaboration with three core partners: Dalberg Global Development Advisors, Aurik and Raizcorp. Through this partnership, JPM is supporting the provision of business development support (BDS) services to selected entrepreneurs, with the aim of directly stimulating broader job creation and economic growth while gathering evidence on the value and impact of BDS services.

This report was commissioned by JPM and developed in collaboration with Dalberg. It aims to share lessons gleaned from a combination of publicly available data and in-depth interviews with experts on SMEs. It provides the context and rationale for J.P. Morgan's "SME Catalyst for Growth" pilot programme, which is being formally launched in February 2012.

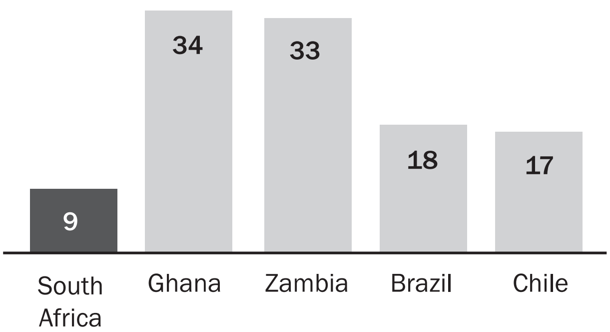
Dalberg J.P.Morgan

Amid debate about the role of small business as actual drivers of economic growth, there is strong evidence that small and growing businesses are critical for job creation and employment in developing economies.

South Africa is facing an unemployment crisis; at least 25 percent of the population is jobless, with the number increasing to nearly 40 percent if one includes those that have given up the search for work. At the same time, the level of entrepreneurial activity is low in South Africa when compared to other emerging markets. According to the Global Entrepreneurship Report, the level of early-stage entrepreneurial activity is directly related to per capita income. In 2010, South Africa ranked 35th out of 54 profiled countries, ranging in income levels and regions, in terms of total entrepreneurial activity and was below the average for all participating countries. The report shows that the level of early-stage entrepreneurial activity is strongly related to per capita income. It was well behind countries such as Ghana, Zambia, Brazil and Chile in its ability to foster successful new businesses[1].

South Africa ranked 35 / 54 countries, and was below the average rate of 11.7 for all participating countries.

Total early stage entrepreneurial activity (TEA[2])
Percentage, 2010

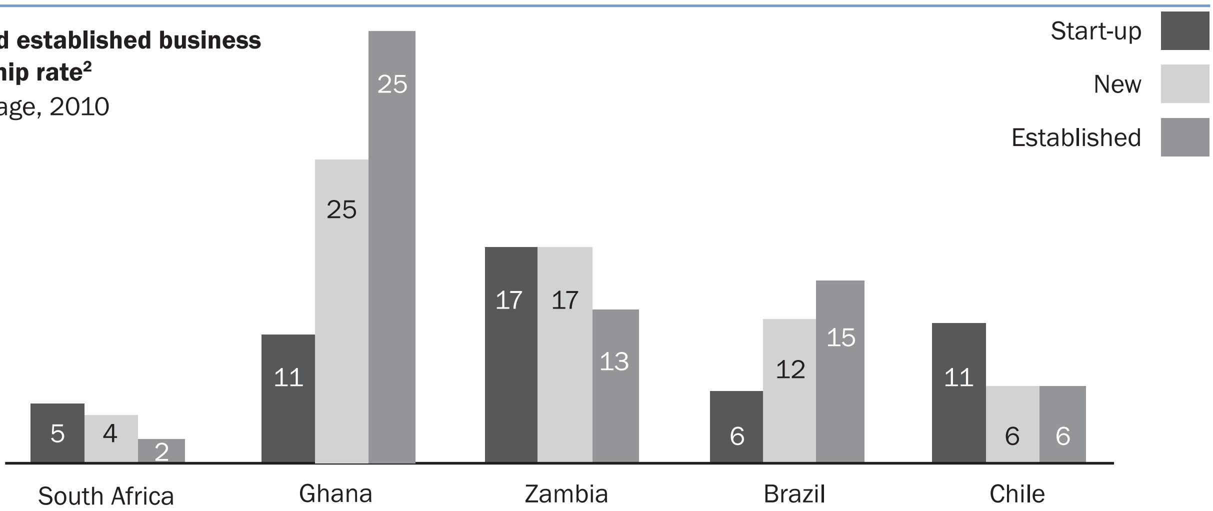


Source: Global Entrepreneurship Monitor (GEM) Report 2010

In his 2011 State of the Nation address, President Zuma stated that "the small business sector is a critical component of the job creation drive". The New Growth Path released in December 2010 by Ebrahim Patel, the Economic Development Minister, set job creation as a priority, with a target of creating five million additional jobs in the next ten years. It aims to

South Africa is well behind Ghana, Zambia, Brazil and Chile in its ability to foster successful new businesses.

New and established business ownership rate[2]
Percentage, 2010

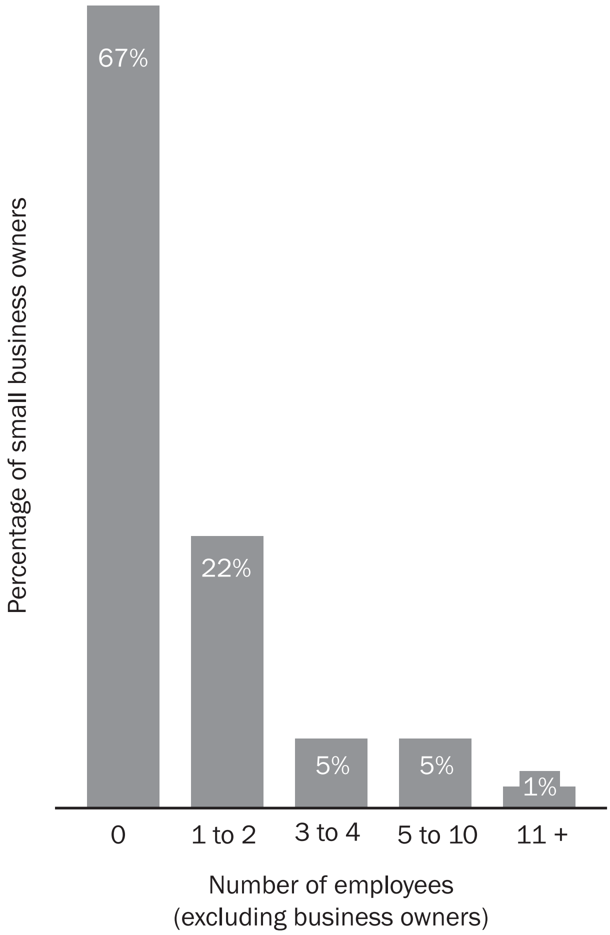


Source: Global Entrepreneurship Monitor (GEM) Report 2010 reduce unemployment from 25 percent to 15 percent, largely through the development of small businesses.

In the absence of a national census, and for the purposes of this report, data is drawn from existing studies, including the Finscope Small Business Survey (2010), as well as the SBP SME Growth Index (2011). According to the Finscope 2010 study, the SME sector has an estimated 5.6 million small businesses operating in South Africa, creating 11.6 million total employment opportunities – that is six million jobs excluding the small business owners themselves. However, the sector is heavily skewed towards micro-enterprises, with 82 percent of South African enterprises being micro or very small (as defined by the National Small Business Act). These businesses are often 'survivalist' or 'lifestyle' businesses. Two in three business owners operate their own businesses and do not have any employees. Only 300,000 of the country's businesses employ five or more employees. While medium-sized firms may not produce the bulk of output or production, they generally hire most people in an economy[3]. Micro and small businesses in South Africa are not achieving the growth required for increased job creation, due to a number of challenges.The focus of this report is the 'small and growing' business sector i.e. small and medium-sized enterprises with the potential for job creation.

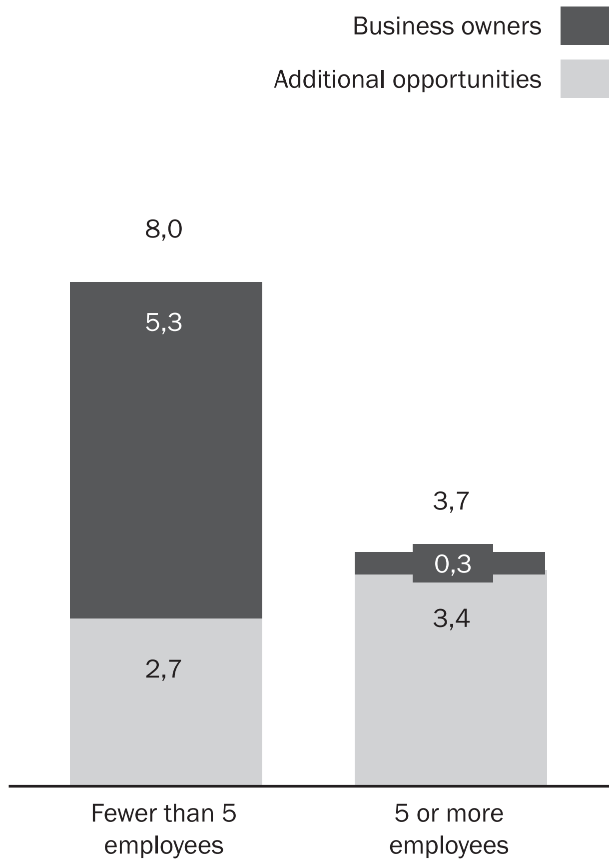
Businesses with fewer than five employees represented 94% of small businesses in South Africa.

Size of small businesses in South Africa



Only 6% of small businesses had 5 or more employees, but contributed 26% more to jobs.

Number of employment opportunities created



Source: Finscope Small Business Survey 2010

> **To fully realise the potential of SMEs, the sector needs to be approached with a fresh perspective attuned to the challenges it faces. There is a need for the focus to shift from the available collateral in the business to the viability of the business and the ability of the entrepreneur. Each business needs finance tailored to their unique challenges. In addition to this, the business owner needs access to the expertise and market knowledge required to make their business a success.”**
>
> **— Guido Boysen, CEO of GroFin Africa** (2010)

SMEs face numerous challenges in terms of access to finance, market access, skills and networks, and the enabling environment. Many businesses face financial constraints and cash flow uncertainty. Businesses often lack the collateral and financial records (e.g. audited financial statements) required for loans from commercial banks. Application processes tend to be bureaucratic. There are high transaction costs and a lack of awareness about the procedures involved in gaining financing. These challenges are evident in the fact that 75 percent of applications for credit by new businesses are rejected and only two percent of new SMEs are able to access loans[4], whilst only only 2% of businesses seeking private equity are successful[5].

Among actors seeking to promote SME growth, there has been much attention focused on providing debt and equity financing for businesses to succeed and achieve scale. The banking system remains the main source of capital to start and grow businesses. Finscope estimates that 47 percent of business owners are formally banked through commercial banks. There are also a number of publicly funded entrepreneurial support instruments that provide grants and debt and equity solutions to SMEs. In 2011, Finance Minister Pravin Gordhan stated that government support to businesses would include R600 million for enterprise investment incentives. Support for small businesses would be provided through the South African Micro-finance Apex Fund (R282 million over three years) and Khula Enterprise (R55 million). Patient capital is available through development finance institutions (DFIs), micro-finance institutions, Corporate Social Investment Grants and foundations. The venture capital (VC) space is growing with an estimated R2.6 billion invested in the VC asset class between 2000 and 2010, 50 percent of which went to businesses in the start-up phase[6]. EEnterprise Development (ED) is one of the elements contained within the Black Economic Empowerment (BEE) scorecard, and has a target contribution of 3% net profit after tax per annum. Corporations contribute a large amount to the sector through enterprise development. For example, Standard Bank South Africa contributed R35 million in 2010.

While it is true that capital is essential and plays a key role in the ability of a business to progress, it is not the only necessary ingredient for success. There are non-financial barriers for SMMEs in South Africa which hinder growth.

The **enabling environment** is a key barrier to growth. Crime and theft ranked as the third highest obstacle to growth for business owners in the Finscope survey. Labour regulations are inflexible, impose a high minimum wage for staff and often result in difficulties with unions and strikes. Poor infrastructure is often a constraint, with issues such as high energy costs and lack of consistent electricity supply, high cost and/or limited availability of transport. In Finscope, competition is ranked as the third greatest obstacle to growth for businesses[7]. This shows that businesses are unable to deal with natural market competition by finding defensible niche markets and products. The economic slowdown has had a negative impact on business growth, with 40 percent of businesses surveyed for the SBP "SME growth Index 2011" highlighting this as the primary barrier to growth.

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Also, businesses often lack the necessary **knowledge and networks** required to be successful in a particular market or industry. They are unsure of what product or service should be sold in the market, and do not know how to attract and retain a sufficient customer base. Financial constraints hinder enterprises' ability to grow management capacity and staff base. The Finscope study highlights this, particularly in start-up businesses. When starting up, 44% of business owners cite money-related matters and 50% cite business strategy as their main obstacles[8]. Even the "money-related" challenges are less a problem of availability of capital, and more to do with entrepreneurs' lack of awareness of financing instruments and limited skills and knowledge on who to approach. Without support, the likelihood of these entrepreneurs creating competitive and sustainable businesses is slim.

SME experts identify business support as a priority focus area for the South African SME sector, and a range of individuals and organisations have responded by providing a range of services broadly referred to as business development support (BDS). These organisations have the potential to address the barriers to SME growth.

> **"In reality, it is the ability of the entrepreneur to identify the factors that dictate the conditions and circumstances under which a business should thrive and take appropriate courses of action that ultimately leads to the success of the business. In short, it is a matter of skill and aptitude."**
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> — The Entrepreneurial Dialogues: State of Entrepreneurship in South Africa. 2010. GIBS, Endeavor, FNB.

Business Development Support as a Catalyst for Small Business Growth

In South Africa, BDS providers have the potential to provide small businesses with much needed skills to address these challenges. They can help address management and strategic challenges through provision of training and ongoing advice to business owners. However the market itself faces some constraints.

On the demand side, the high cost of BDS services can discourage business owners from using them. There is also a strong perception of limited value for money for all these services, which affects uptake for even high quality providers. This is likely linked to experiences with the poor quality interventions available in the market. Businesses face diverse challenges and have differing needs, and as such require tailored services. Some businesses may require short-term technical support on a specific system, while others need broader strategic support. On the supply side, the market is fragmented, with multiple players varying in size, scope and quality. No national quality controls or standards exist in the current market. There is limited data availability on the outcomes of BDS provision, due largely to weak monitoring and evaluation systems to track BDS relative strengths and weaknesses. There is a lack of transparency in the sector, with providers and financiers hesitant to share results. Businesses have limited knowledge of these services, often resulting in low uptake. The asymmetry of information is clear in the Finscope survey, wherein 75 percent of small business owners stated that they were not aware of business support organisations, and 94 percent have not made use of these services. Small business owners who did make use of support organisations were most likely to get support and advice relating to starting up a small business[9].

New Initiative to Help Address These Issues

Based on these findings, the SME Catalyst for Growth programme was designed to help drive employment generation and economic growth in South Africa by improving access to effective BDS. It seeks to increase the amount of funding available for high-quality providers of BDS that will be used to provide support for growing South African enterprises. Simultaneously, it aims to introduce greater transparency and awareness of the potential benefits as well as the relative merits of different types of BDS offerings available in the market.

The programme design began with the identification of 35 leading organizations that provide support to small businesses through a total of 62 individual interventions. This subset of the broader market of providers was selected to be representative of the market in terms of type of services, scale, quality and stage of business growth served. The organizations were segmented into four categories of support: (1) access to finance, (2) market access, (3) BDS and (4) enabling environment. Across all categories, 53 percent of interventions were focused on the start-up phase, and 68 percent on micro to small enterprises[10].

Given the importance of capacity for business growth, the analysis focused primarily on BDS. Within BDS, services ranged from shorter-term management and business training courses to mentoring and coaching to technical skills training, with almost 50 percent of the interventions focused on start-ups[11]. Through desk research and expert input, seven high-potential partners were short-listed, based largely on their strong reputations and track records within the space. These providers were then evaluated according to four criteria:

- **Early to growth stage focus:** Based on the gap identified in the research - that this stage of entrepreneurs is both underserved in terms of BDS provision and critical for job creation.
- **Reputation for high quality intervention:** Organisations should be well-known in the sector, and regarded by experts and practitioners as high quality BDS providers.
- **Holistic offering:** Providers should have interventions that combine: business development support (BDS), access to finance and access to markets (i.e. services should be comprehensive vs. short-term training).
- **Track record of success:** BDS providers should have a track record and reach in the sector, with a proven / successful model. Ability to absorb additional financing to increase scale.

Two reputable providers were identified as immediate partners: Raizcorp and Aurik. J.P. Morgan and Dalberg held in-depth discussions with these providers to explore opportunities for investment. Subsequently, a detailed programme of support has been designed:

- **Short to medium term:** The objective is to support the provision of BDS to a set of early-stage enterprises. The programme will fund 20 entrepreneurs in the Gauteng province in the first two years, with at least

50 percent being black-owned enterprises. A core focus of this will be the development of a strong monitoring and evaluation framework, with clearly defined impact metrics, to measure success of BDS provision by Aurik and Raizcorp. J.P. Morgan and Dalberg will share the analysis and results of the pilot programme to help the SME community sharpen its understanding of BDS support, and its impact on job creation and economic growth. This pilot programme is being launched in February 2012.

- **Longer-term vision:** The partners will build a public platform to share comprehensive information on the performance of BDS providers in this market. This should allow for a more transparent comparison between different BDS providers, a tool which should help both financiers and enterprises invest wisely in the sector to contribute more effectively to South Africa's growth targets. The specific intervention will be refined and tested through the course of the pilot programme.

End Notes

[1] Herrington, M., Kew, J., Kew, P. Tracking Entrepreneurship in South Africa: A GEM Perspective. 2009., GEM Global Report 2010.

[2] TEA rate measures prevalence of business start-ups and new businesses in the adult population (18 – 64 yrs). New = percentage of adult population who are owner-managers for < 3.5 years, Established = paid wages for >3.5 yrs. Discontinuation: the number of individuals who have discontinued a business in the last 12 months.

[3] National Planning Commission. 2011. Economy Diagnostic. Available: http://www.npconline.co.za

[4] Finscope. 2010. South Africa Small Business Survey.

[5] http://www.investorsnetwork.co.za

[6] South African Venture Capital & Private Equity Association.2010., Venture Solutions - Venture Capital Survey.

[7] Finscope. 2010. South Africa Small Business Survey.

[8] Finscope. 2010. South Africa Small Business Survey.

[9] Finscope. 2010. South Africa Small Business Survey.

[10] Dalberg analysis, 2011.

[11] Dalberg analysis, 2011.

Get Involved

J.P. Morgan is excited to launch this new initiative and to work closely with partners in South Africa to realise its vision and support job creation and economic growth. Should you be interested in getting involved in this initiative, please contact:

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Aurik Business Incubator ('Aurik') is a virtual business incubator established in 2001. It provides a range of business service to early-stage entrepreneurs to build their businesses into assets of value. Aurik has been directly involved in 12 start-up ventures as an active venture capital investor and has worked with more than 600 entrepreneurs over the last 8 years. www.aurik.co.za

Raizcorp is Africa's only unfunded for-profit business incubator model, which provides full-service business support programmes that guide entrepreneurs to profitability. Raizcorp was founded in 2000, and has since become Africa's premiere business incubator model. Raizcorp has developed a rigorous selection process that ensures that those who make it into the various programmes are indeed those with the highest potential to succeed. Once selected, the entrepreneurs are exposed to a high touch support programme that continues to produce excellent results. Raizcorp has worked with over 800 businesses and currently supports excess of 240 companies in 8 locations in South Africa and Angola. Approximately 86% of Raizcorp's partner companies have a growth rate in excess of 15% per annum. Over a period of 1 to 2 years, Raizcorp has managed to increase the turnover and profitability of over 95% of its partner companies. www.raizcorp.com

Dalberg Global Development Advisors is a strategic consulting firm that works exclusively to raise living standards in developing countries and address global issues like climate change. Dalberg is for-profit but not profit-maximizing; it only takes projects that will advance its social mission. The firm's work helps governments, foundations, international agencies, non-governmental organizations, and Fortune 500 companies to make sustainable improvements in the lives of disadvantaged and underserved populations around the world. Founded in 2001, Dalberg now has more than 120 people from 30 nationalities working in 11 offices around the world, including Copenhagen, Dakar, Geneva, Johannesburg, London, Mumbai, Nairobi, New York, San Francisco, Santiago and Washington, D.C. They bring expertise gained in the private sector to bear on problems commonly dealt with in the public and non-profit spheres. The firm takes a holistic approach to global development, touching topics from access to finance and energy policy, to public health and human rights. www.dalberg.com

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