Webinar

Brief 68:2021

CATALYZING CAPITAL

for fast Growth SMEs

Pakistan Institute of Development Economics

IN THE YEAR OF 2021

Preamble

This webinar raises the four questions;
1: Current Capital Deployed: What is the amount of capital supporting SMEs in Pakistan?
2: **Promising Approaches**: Which are the most promising approaches to increasing capital?
3: **Potential New Capital Sources:** Which institutions would provide a step-change in finance?
4: **Requirements for Unlocking Capital:** What is required to see asset owners invest more capital?

Webinar also suggests promising approaches to have any chance of addressing the stubborn challenge of sustainable financing for SMEs in Pakistan and how to spur significant scaling up of investment in small and medium enterprises in Pakistan over the coming three to five years. The main focus of this webinar is on approaches and initiatives that best serve the needs of fast-growth SMEs in Pakistan.

Key Points

- Small and Medium Enterprises (SMEs) are essential to the progress of the nation; countries all over the world associate their national development with a strong, thriving SMEs sector. The importance of the SME sector can be gauged from its contribution to the world's leading and emerging economies. Countries such as Japan, China, Brazil, India, Malaysia, and Sri Lanka are relying on SME development for economic growth, through the adoption of intensive policies and strategic private sector development. In most countries, SMEs constitute more than 90% of all enterprises and significantly contribute towards inclusive economic growth.
- There is a range of opportunities for startups in the digital economy, emerging technologies, or even in traditional sectors with significant demand and supply gaps classified as fast-growth SMEs. However, access to finance is a constraint for SMEs' growth across most emerging markets and Pakistan in particular. The lack of financing options is particularly problematic for SMEs that are too big for microfinance institutions and too small as too risky for banks and private equity firms.
- SMEs that are commercially viable with five to 250 employees and have potential and ambition for growth. The framework is developed to monitor the segment of enterprises, that is helpful to target markets within the broad range of SMEs: Blueprint, Validate, Prepare and Scale because they are at once deemed to be poised for growth.
- Our Target market of SMEs requires different types of capital at different stages. Market realities are such that not all of these types of capital are available to them. There is capital deployment to SMEs in Pakistan in terms of debt, equity, mezzanine, and grant capital. There are supply and demand-side data gaps such as (the amount of AUM of debt, the amount of debt the target market of SMEs requires to grow and on what term, etc.)
- Some promising approaches are highlighted that could help to achieve this additional financing for SMEs in Pakistan and how each of these approaches could contribute to the additional capital deployment. In this discussion, we identified the five most promising approaches (the commercial bank with a SMEs unit channel-specific, investment fund providing mezzanine multi-channel, Asset back financing multi-channel, Flexible debt instrument multi-channel, Tailor private equity fund) in order of absorptive capacity and investor appetite in current market conditions.

- **Impact and challenges of these approaches**

  Approach 1
  - If commercial Bank with SMEs is scaled then SMEs will become part of the mainstream financial sector, building a track record with financial institutions and opening opportunities and financing, bringing broader financial intermediation benefits to local economies.
  - There is a need to be a stronger demonstration of the business case for commercial banks, especially juxtaposed to comfortable risk-free returns. There will need to be a resolution of any risk-weighting capital issues deriving from regulatory oversight.

  Approach 2
  - If the Investment Fund providing Mezzanine is scaled it meets the needs of the enterprises, particularly as they grow. Commercial banks could invest in and acquire these non-bank financial institutions and approach that more SMEs funds use to deploy the capital.
  - Mezzanine instruments tend to be highly tailored and highly structured compared to others. It needs to be as standardized as possible. A standardized mezzanine would enable the easier rollout against lower costs.

  Approach 3
  - If Asset-Backed financing is scaled then we can have standardized asset back financing as a specific product especially if it is applied by sector, especially applicable to the often targeted agriculture sector.We need to choose our sector and verticals carefully to ensure sufficient volume and market risks complicate residual asset valuations.

Approach 4

- If the Flexible debt approach is scaled then it meets the needs of the investor, as there is more flexibility of how to pay back, and the entrepreneurs are not forced to give up equity prematurely, etc.
- There is a need for shared documentation to overcome some of the early movers' costs and to begin to standardize the approaches.

Approach 5

- If Tailored Private Equity is scaled, it improves the balance sheet structure and financial prospects for SMEs. It provides the potential to build leading firms in the key-value chain and generate downstream commercial benefits to smaller firms.
- There is a need to be currently below the return expectations of many asset holders. It is expensive and time-consuming to build local investment teams.
- It is important to note that we need a combination of approaches delivered by a variety of actors to meet the needs of our target market. There is no single approach that alone will achieve an increased scale and reach of investment capital.

- Current asset owners and managers include an array of commercial, quasi-commercial, donor actors, and the overwhelming majority of capital for our targeting market has come from development finance institutions. There are barriers to increased investment in our target market especially among the largest investors and many, but the reason is underperforming financial returns of current investment in SMEs. For both current and new investors coming into the target market, there is a need to recalibrate finance return expectations to accurately reflect the performance and operating environment in Pakistan.
- To move asset owners to deploy more capital, we must be creative and courageous and redefine the risk-return liquidity impact paradigm for investing in our target market. To progress the quantum and distribution of financing for SMEs in Pakistan to any meaningful degree from asset owners we need to focus effort at two levels. 1: work to bridge the expectation gap at a transaction and operational level. And Galvanize action to tackle or at least chip away at systematic barriers.
- We anticipate that Development Finance Institutions will remain the source of just over half the additional capital with donors and foundations stepping up to provide about a quarter of that capital, and corporates and impact investors providing the remaining quarter.

Way Forward

- There is a need to be moving from diffuse and fragmented transactions to more strategic, smart, and systematic investment. Furthermore, focusing on real economy SMEs that produce tangible goods and services that meet people's real needs, accepting that basic business that must be solid.
- To reflect the total return from investing in productive SMEs, reframe the value proposition, rather than seeking the home run of finding the next Steve jobs, economic and social returns such as relative contribution to GDP and employment should become part of the investment thesis and part of the value proposition attracting funders to purchase impact.
- Identify and galvanize source of grant and sub-commercial capital, recognizing these sources as critical in achieving ambition for scale and reach while demonstrating how the need for the grant and sub-commercial capital will decline overtime at the transactional and operational level as SMEs investment opportunities mature and scale, particularly with the use of technology to drive cost down.
- It is recommended that the following specific actions such as building a data set (rather than data points), focusing on one country as a community actor, unlocking domestic capital markets, and building local talent and local content offer a tangible and critical way forward to ensure that SMEs in Pakistan receive the capital they need to scale, create jobs and contribute to the comprehensive national development goals.

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