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EXPLORING ALTERNATIVE SOURCES OF FINANCING SMALL AND MEDIUM ENTERPRISES (SMES) IN MALAWI: LESSONS FROM ELSEWHERE

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ABSTRACT

Small and medium enterprises are the backbone of any economy and Malawi is not an exception. However, there are many structural, institutional and regulatory challenges bedeviling SMEs and these are more pronounced in developing countries like Malawi. One major area challenging the survival and growth of SMEs in Malawi is access to finance. The only readily available market for financing has been the commercial banks whose interest rates have always been exorbitantly high. This article tries to undertake a review of other alternative financing mechanisms that Malawi can explore to promote the SME sub-sector. This was done by reviewing practices from other jurisdictions. Available options include equity guarantee schemes, equity investment schemes and capital markets approaches that done not involve listing.

Introduction

Evidence about the critical role played by the micro, small and medium enterprises (MSMEs) and the contribution they make to the socio-economic development of economies has been well documented. Peterholf, Romeo & Calvey (2014) reported that small and medium enterprises account for 90% of all businesses globally. In addition, SMEs generate 60% of employment worldwide and provide jobs to roughly 80% of workforce in the developed world. Another important finding was that 50% of global Gross Value Added (GVA) is contributed by small and medium enterprises.

In Malawi, the findings by the comprehensive 2012 Fin Scope MSME survey that 1,050,320 people were employed by just around 41% of the country's MSMEs also attest to the pivotal role of SMEs in our domestic economy. The contribution of small and medium scale businesses to socio-economic growth and development of nations takes many forms including boosting public revenue collections through various forms of taxation, provision of goods and services to the general public and, more importantly, poverty alleviation through creation of employment and economic empowerment of citizens.

Sadly, financing has been identified as one single factor that challenges the survival and growth of MSMEs, not only in Malawi, but also the rest of the other parts of both the developed and developing world, albeit with varying magnitudes. The Fin Scope study revealed that '59% of MSMEs were excluded from financial services, as opposed to 31% that are formally served by some sort of financial system, with the balance relying on informal services. Only 22% are banked. Over three quarters do not borrow funds, primarily because they doubt their ability to repay loans. Of those who borrow, informal credit systems tend to be the primary source of credit'. Much as other studies done across time and space (Kazooba, 2006; Chirwa, 2008; World Bank, 2009, etc.) have revealed that poor transportation, inadequately educated workforce, unreliable power supply are among a host of factors inhibiting the growth and survival of SMEs, access to finance has led the list, at least according to the available evidence.

The World Bank Enterprise Survey (2009) revealed that out of the many obstacles to their business growth which included poor transportation, unreliable power supply, exorbitant tax rates, inadequately educated workforce, crime, complicated business licensing procedures, corruption and limited access to land, 45.6% of SMEs recounted limited access to finance as the main obstacle. This evidently shows how counterproductive financing challenges have become in defining the survival and growth of most MSMEs in Malawi.

Access to finance gives MSMEs the chance to develop their businesses and to acquire better technologies for production, therefore ensuring their competiveness. Despite this acknowledgement, there still exists a huge challenge for MSMEs in Malawi pertaining to access to initial and expansion capital funds from traditional commercial banks. This is also exacerbated by the fact that the majority of commercial bank loans offered to SMEs are often limited to a period far too short to pay off any sizeable investment. In addition, banks prefer to lend to the Government rather than private sector borrowers because the risk involved is lesser and higher returns are offered. It is such apathy for the SMEs that has crowded out most private sector borrowers and increased the cost of capital for them.

The challenges of access to financing, coupled with persistently high cost of borrowing provides the basis to understand whether promoting the altering of capital structure of MSMEs, which has been biased towards debt, can mitigate the capital access challenges.

It is on account of the given brief background that this paper aims at providing an understanding of various financing options for SMEs that have been pursued elsewhere. This will provide food for thought for policy making as stakeholders are trying to improve the economic and operating environment for SMEs in Malawi.

Brief situational analysis of MSME landscape in Malawi

The dividing line as regards to which businesses fall into the micro, small and medium enterprises category is not universal, but varies from economy to economy depending on prevailing circumstances. This implies that what might qualify as a medium enterprise in Malawi might be micro or small especially when fitted in a developing country context. From the findings of the 2012 MSME FinScope survey, the draft MSME Policy proposes the following categorisations according to the number of employees: micro enterprises (1-4 employees), small enterprises (5 to 20 employees) and medium enterprises (21 to 100 employees) (GoM, 2012). It has also been the convention for many countries to extend the definitions by including turnover thresholds. However, the susceptibility of such definitions to currency and inflationary dynamics renders it unstable for comparisons over time. In additions, categorisations become blurred in instances where the business earns high turnovers but with a very small number of employees as is typical with the service sector.

Maintaining up to date data on MSMEs in Malawi has been a challenge due to the nature of the sector involved. Since most of the businesses are informal (not registered), there is no system to track which new enterprises are sprouting up, how many are folding as well as the number and nature of businesses graduating from micro to small, small to medium and medium to large. At institutional level and owing to the nature of the sector as already alluded to, conducting a comprehensive exercise and setting up the system and database, has also been a challenges as well. Hitherto, the FinScope MSME Survey (2012) remains the comprehensive single major study that was conducted in the sector and provides a reference point on main highlights and landscape of MSMEs in Malawi. The findings unearthed very important statistics that re-enforces the pivotal role of the SME sector in driving the development agenda of the country through promotion of sustainable economic growth and development is. It also provides the need and justification for policy to focus the efforts in developing the sector as well as channeling the corresponding financing to promote SMEs in Malawi.

The findings showed that Malawi has 987,480 MSMEs with 758,118 business owners. As of 2011, the sector generated K326 billion worth of income and was an employer of 1,050, 320 people. It was found that 87% of the businesses are retailers and mostly involved in trading within the agricultural sector. Geographically, it was found that 85% of the businesses are located in the rural areas and most of these are micro enterprises. The important finding to be noted as well is that profit levels are generally very low.

The second generation of the Malawi Growth and Development Strategy fully recognizes the importance of the private sector and businesses in driving the overall development agenda of the country. Under its first theme on Sustainable Economic Growth, the MGDS II recognizes the need to create an enabling environment for private sector participation and development as well as fostering job creation (GoM, 2006). It also spells out specific sectors of the economy upon which private sector development efforts will be prioritized with agriculture being one of them.

The National Export Strategy further re-enforces the position of MGDS II by setting out a prioritized roadmap to developing the country's productive base 'to allow for export competitiveness and economic empowerment'(GoM, 2012). This inevitably entails that for the private sector to grow, there is need to address the obstacles that inhibit their birth and threaten their development. Challenges confronting MSMEs in Malawi are well documented. But financing ranks highly amongst the many. The FinScope MSME Survey reported a 59% financial exclusion rate and this relates to access to financing as well as the use of commercial banks for management of business finances.

SMEs and access to finance

The challenges of access to finance by SMEs are not generally unique to developing countries, nor are they to Malawi specifically. However, the degree of financial exclusion varies according to the level of development of the economy as well as the size of the business (i.e. either micro, small and medium). A closer analysis on most stumbling blocks to accessing financing by SMEs shows that various players in the SME sector have their share of the blame. The players include policy makers, SMEs themselves, and at times, commercial banks. Practically though, commentators and analysts are always tempted to concluding that access to finance challenges are a creation of commercial banks and the problem can be solved by commercial banks themselves by their mere action of just reducing the lending rates and softening loan access conditions. However, commercial banks do not operate in a vacuum, rather, they do in the general economy amidst all regulatory and institutional challenges and restrictions. This implies that the general macroeconomic environment and lack of infrastructural facilities play a decisive role in an economy as regards how financial institution charge interest rates on their funds. Under macroeconomic environment, high interest rates are a discouragement to small businesses to obtain lines of credits from commercial banks. This is due to the fact that profits are undermined as a result of high cost of funds.

A brief analysis of commercial bank interest rates in Malawi shows that the policy rate as set by the Reserve Bank of Malawi is currently at 25 percent. Further, commercial bank interest rates are all generally above 32 percent, making our market one of such with high lending rates in the region. This situation is not unprecedented as interest rates in Malawi have generally averaged

25.97 percent from 2001 until 2015, reaching an all-time high of 75.53 percent in February of 2001 and a record low within the decade of 13 percent in August of 2010. As can be seen, the volatility and unpredictability of the interest rates over time as well as the interest levels pose a huge challenge to both business planning and profitability as a whole, and more significantly, to small scale businesses.

Further, foreign exchange rate system management disparities in Malawi have also posed another big challenge to small and medium-sized enterprises. The exchange rate effect is mainlyfelt via procurement and importation of raw materials and the constraint on the availability of trade credit for small businesses by commercial banks. Institutionally, weaknesses in the legal framework in such aspects as guarantees' enforcements make it very hard for financing institutions to recover bad loans. Resultantly, it forces lenders to impose stiffer conditions for financing to small and medium scale businesses.

The general macroeconomic and policy issues discussed above constitute some but not all of the challenges complicating the access to credit puzzle for micro, small and medium enterprises. Structural organization and nature of SMEs themselves also carry a fair share of the blame. As reported by Lemuel (2009), there are a myriad of internal structural and organizational problems within the SMEs that are of huge concerns to banks and financing institutions. According to his findings, most SMEs tend to be disorganized in such aspects as internal control functions, accounting and human resource management. In his study on SME financing in sub-Saharan Africa, Derreumaux (2009) concludes that internal controls in the management of small scale businesses play second fiddle. As such detection and correction of weaknesses becomes harder. Resultantly, banks lose trust in SMEs as they try to minimize risks and comply with central bank regulatory requirements on risk management. This state is a result of the universal reality that most MSMEs are owned by individuals or families who are themselves decision makers in all aspects of the business without having any professional checks, a scenario that increases chances of committing errors in the running of the business hence eroding confidence from the lenders.

The draft MSME Policy and strategy for Malawi also concedes the existence of inherent characteristics of MSMEs that hinder their growth and increases risk perception to lenders. Cultural and lifestyle behaviours including poor repayment practices, substandard customer service, flooding of entrepreneurs trading in the same product or service due to lack of creativity, lack of collaboration amongst small businesses to leverage their available resources as well as weak investment and saving culture are documented as the most prominent.

Defining the problem

The debate on increasing access to financing by small scale businesses has always converged on the understanding that access can be boosted by ensuring that commercial banks and other financial institutions should offer capital at affordable cost. However, it should be fair to assert that macroeconomic conditions and the associated policy objectives of Government has and shall remain at most times in conflict with the ideal expectation of lower market cost of capital. This therefore calls for innovativeness and diversification in generating viable ways of dealing with the challenge in our midst.

Secondly, literature has presented enough on the inherent issues and nature of SMEs where, even in the presence of affordable capital, organizational issues bordering on financial reporting, record keeping and personalized nature of businesses, especially in the micro and small category, shall still remain an impediment. Innovations in diversifying sources of financing, among others, entail that our businesses should be opened to the reality of embracing equity as an alternative or complementary source of financing to debt. It is on this understanding that this paper brings to fore some of the financing mechanisms other countries have adopted in order to widen the capital sources for small and medium enterprises. Upon exposing the alternative sources, it is incumbent upon various players having a stake in the SME sector to undertake a detailed study as to which ones are feasible in the current context. This involves careful analysis and brainstorming by financial and capital market regulators, central government policy makers and agencies responsible for implementing programmes and interventions.

Approach of the discussion

The paper undertakes a desk review of financing practices that have been proposed and adopted elsewhere. In the cause of reviewing the relevant literature on SME financing, one element that comes out clear is that access to bank funds by small businesses is a challenge, though in relative terms, in most parts of the globe, regardless of the levels of interest rates. It is on this realization that policy makers have come up with tailor-made non-banking solutions to solve the small scale businesses financing puzzle.

Owing to the pecking order theory, this paper strongly feels that the alternative financing options discussed therein can best suit the medium category of the MSMEs, and may still not practically appeal to the micro and small enterprises. Nevertheless, if successful, then the fight would be declared to be in the course of being won. The pecking order theory as propagated by Myers (1984) asserts that when making decisions on the source of financing their needs, firms do it in a hierarchical order. They use internally available funds in the early stages, followed by debt in the middle stage. It is in the latter stage of operations and existence that they consider external equity as a source of financing.

The complexities of institutionalizing these alternative financing sources do exist, but the reality of acknowledging that net importing economies like Malawi can realistically enjoy a sustained period of low interest rates without inflationary pressures and hence inducing a cycle of policy undoing should provide an impetus to explore the alternatives. These alternatives are discussed in the subsequent sections.

Credit guarantee schemes

In his discussion paper on financing small and medium enterprises in Myanmar, Kyaw (2008) presents credit guarantee schemes as one of such array of initiatives to overcome the inherent unwillingness within the financial system to extend credit to SMEs. It can take slight variations from country to country depending on its design. In Japan, there was formed what is called a Credit Guarantee Association (CGA). The CGA provides credit guarantees to SMEs in exchange for financial information. The business information provided by the guarantees is compiled by the CGA and made available to financial institutions as a basis for credit provision to SMEs. Apart from Japan, credit guarantee schemes have been successfully implemented in many other ASEAN countries including Singapore, Malaysia, Philippines and Thailand.

Import and export trade financing facility

Under the import trade financing facility, for instance, an individual financial institution or group of financial institutions undertake to purchase imports needed for use and on behalf of small and medium-scale enterprises. The SMEs, in turn, purchases the desired imported goods and services for business operations from the commercial banks at a pre-determined profit margin to the banks.The payments terms with SMEs are then made in a flexible manner, i.e. payments can be made either as a lump sum, in installments or on a deferred basis. The same arrangement also applies to imports whereby a commercial banks buys from local SMEs willing to imports their goods and services, resells the services or commodities to foreign companies at a determined profit margin. Malaysia is one such economy to have practiced this arrangement.

Results from the review of studies and practices on alternative financing mechanisms for small and medium enterprises bring into fore one main finding that should not be ignored by policy makers if the efforts are to make a difference. The degree of sophistication of a particular economy is directly correlated to the success of a particular mechanism such that a one-size-fits-all approach may be a faulty experiment. Discussed below are some of the alternatives:

Capital market financing

Arguably due to the challenge of high market interest rates and other risk considerations by commercial banks, most SMEs financial their long term investments through such facilities as lines of credits and overdrafts which are short term in nature. Yet 'such sources can be valuable in the start-up stage but they do not provide the long-term financing required as companies mature or seek growth' (Peterhoff, Romeo & Calvey, 2014). Ideally, capital markets provide an alternative solution to long term financing puzzle faced by SMEs. However, there is a host of complex legal, regulatory and high transactional requirements that firms must fulfil, a scenario that proves to be a tall order for most, if not all, small businesses thereby leaving the issuing of debt or equity the preserve of large and well established companies. Owing to this realization, most economies have established SME platforms as second tiers of the main stock exchanges and these are characterized by flexible listing requirements and costs with a view to make them affordable and beneficial to SMEs, whom they are intended to serve.

The notable successful platforms in the world include Alternext in Europe, AltX in South Africa, Alternate Investment Market in London and Mothers in Japan. The documented limitations with this arrangement are that most of the SMEs issues tend to be small and hence become unattractive to institutional investors. Again, this platform practically favours large SMEs and can, therefore, not realistically serve the needs of the micro and small categories.

The experience with Malawi is not encouraging at all. The Malawi Stock Exchange has ever championed the introduction of an alternative counter for small and medium enterprises. However, no single SME has been interested to transact business. This state of affairs should not be strange at all considering that even on the main counter, it has been around 6 years now since that last company was listed. Much as we may jump to conclusions that SMEs have not welcomed the MSE initiative, it might be a misplaced generalization since much has not been done to publicise the benefits of having an SME platform in a country where literacy on financial and business issues is on the lower side.

Alternate listing venues that do not involve trading

Most economies that have promoted and embraced the capital market as a platform for SME financing have still experienced the same problems that one would anticipate. Just as mainstream capital markets appear properly suited for well-established companies with robust corporate governance structures, capital market financing platforms still display the same discrimination. It is a well-known fact that MSMEs or SMEs cover a broader category of firms at various levels or stages of development. This implies that much as these firms are grouped together for the sake of policy interventions and programming, their needs are unique as they move from micro, small to medium. As a result, pure capital market modelled on a conventional market favour bigger SMEs (medium category) implying that the micro and small enterprises remain excluded, despite the alternate counter having relaxed regulatory listing conditions and formalities.

The continued search for more affordable financing platforms that cater for the needs of SMEs at varying levels of development and capital requirements has led to the emergency of platforms that enables non-bank institutions, entities and individuals to provide direct lending to firms and individuals alike. The loan matching platforms take various forms but the overall objective is to enable the flow of funds from willing investors to small businesses who are in dire need of financing but cannot compete for resources in the traditional/mainstream market due to various policy, structural and economic issues as already discussed.

Under these platforms, the lending process can take various forms including peer to peer (P2P), investor to business (B2B), peer to business (P2B) and investor to peer (B2P). What makes these platforms unique and more SME-friendly is the fact that there is minimal screening involved before lending is effected. The most common models associated with these platforms include:

The marketplace model: An interest rate at which lenders fund borrowers is pre-defined. It can be done via lending clubs or other arrangements.

The auction model: Loan bidding is conducted by lenders. Those who finally offer the lowest interest rates become successful.

The pure match model: Direct contact between borrowers and investors characterize this model

The crowd-funding model: This model is premised on the understanding that an investor undertakes to fund agreed start-up project(s) on the understanding that he/she gets unlisted equity share. Understanding the commitments expected is one of the key elements for success in using crowd funding (Beesley, 2013).

Small and medium enterprises equity investment schemes

Equity investment schemes may take various forms and shapes. But specific to this paper, we look at the Nigerian case where the Central Bank of Nigeria took an initiative to pool resources from commercial banks' profits for the cause of small and medium enterprises in Nigeria in promoting industrialization, poverty alleviation and creation of employment. Through the initiatives, commercial banks undertook to set aside 10% of their profit after tax for investment in small and medium enterprises as loans, equity or a combination of both. The banks effectively become equity owners in the businesses and are normally expected to exit after a period of three years (Gbandi, Amissah, 2014). If the investment was through debt, the same could be converted to equity. The interest rates were predetermined and lower than the ruling market interest rates. Through this, SMEs were assured of lower cost of capital at preferential rates. On the other hand, lenders were assured of the safety of their investment through equity ownership thereby bringing risk levels to almost zero.

Conclusion and policy implication

This paper tried to discuss in brief, some of the alternative sources of financing other than the conventional bank lending. The intention is not substitute, but rather, complement. The need to initiate this debate comes from the realization that there always tends to be conflicts in general macroeconomic policy decisions goals which results in conflicting outcomes. For instance, the desire to contain inflationary pressures in the economy convinces monetary policy makers to restrict bank lending by maintaining interest rates too high to the detriment of small scale businesses' growth. In this case, the short to medium term intention of policy is not out of ill but to ensure some degree of stability in all sectors of the economy.

On the other hand, financial institutions tend to offer high interest on loans as a response to macroeconomic conditions as well as risk assessments considering the nature and attendant organizational challenges of the MSME sector. But in all this, the reality is that these bottlenecks have to be surmounted. There is always need to find ways and means of providing affordable capital to our small scale businesses, more so with overwhelming evidence pointing to the SME sector as an employers and significant contributor to economic growth of not only Malawi, but world over. An economy can, therefore, not afford to ignore the need to provide adequate policy, institutional and logistical incentives towards growing the sector. Hence the need is to widen the horizon with regard to exploring affordable sources of financing. Low and affordable interest rates should always remain the ultimate goal of policy as anything short of that is counter-productive in the pursuit of long term sustainable economic growth. It is imperative, therefore, to seriously consider developing other non-formal banking avenues for our SMEs to access the much needed financing. This should take into consideration issues of feasibility and acceptability amongst the beneficiaries considering the level of sophistication and development of the Malawi economy.

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