

Surviving the drought

Access to finance among small and medium-sized enterprises

A report from the Economist Intelligence Unit
Sponsored by ACCA (Association of Chartered Certified Accountants), the Certified General Accountants Association of Canada and CPA Australia.





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About this report

In August 2009, the Economist Intelligence Unit conducted a survey of 730 senior executives from small and medium-sized companies (SMEs) around the world about their perceptions of finance conditions. The survey and paper were sponsored by ACCA (Association of Chartered Certified Accountants), the Certified General Accountants Association of Canada (CGA-Canada) and CPA Australia.

Survey respondents represent a range of industries, including financial services, professional services, manufacturing and information technology. All respondents represent companies with annual revenue below US\$100m. Over 40% of respondents are CEO or managing director level, and the remainder are other managers and senior executives.

Our editorial team conducted the survey and interviews, and wrote the paper. The author was Christopher Watts and the editor was Rob Mitchell. The findings expressed in this paper reflect the views of the Economist Intelligence Unit.

Our thanks go to the survey respondents and interviewees for their time and insight.



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Executive summary

SMEs continue to grow in spite of the downturn. Despite the current gloomy environment, many SMEs continue to grow revenue—albeit at a slower pace than in 2007 or 2008. In all, 54% of executives expect revenue growth in the next two years; just 15% expect a decline. Respondents in Asia-Pacific, the Middle East and Africa are most optimistic about the future.

Access to finance for SMEs has been squeezed. Just as the pace of growth in net profit and cash flow generated by operations slows, executives say that financing has also been constrained. Just over one-half of those companies questioned for this research have seen a deterioration in the availability of finance over the past two years—especially bank lending and private equity funding. At the same time, around one-half of these executives believe these funding sources have become more costly.

To preserve cash, SMEs are postponing investment. Executives at SMEs expect a lack of funding to be the main constraining factor on their businesses over the next two years. One-half of the executives say that the financial crisis had a significant impact on their ability to invest in assets for growth. A similar proportion say that the financial crisis has had a significant impact on their ability to invest in innovation and research and development.

SMEs are cutting costs and improving cash management. Some SMEs expect to survive the downturn without external finance by improving cash management and working capital. In all, seven out of ten survey respondents are reducing costs to preserve cash. The worse a company's revenue outlook, the higher the likelihood it will turn to such measures. More than one-half of the businesses interviewed have sought advice on accessing financing in the past year.

SMEs expect conditions to improve by 2011. A slim majority of respondents expect a broad return to pre-crisis levels of availability of finance in 2011 or before. Whether their own firm's access to finance will improve depends not only on their views of the broader market, but also on their perception of their firm's own prospects. In general, those that are more optimistic about the future tend to have fewer concerns about access to finance.

Some firms are poised for a new growth phase. According to some in-depth interviews with executives at SMEs, their firms are poised to reinvest in growth when conditions become more favourable. Many are planning to dust off plans for acquisitions, for example, or geographical expansion, including recruiting staff. Some executives have seen the first signs of a rebound in growth in their businesses; in anticipation, a few are already positioning themselves for their next growth phase.



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Section 1: The SME perspective

Facing the new business environment

There have been few times in the past few decades when growing a business has been more challenging. Companies are faced with declining output in many countries around the world, a slump in trade and foreign direct investment, a reluctance among customers to spend and a highly austere environment for obtaining finance.

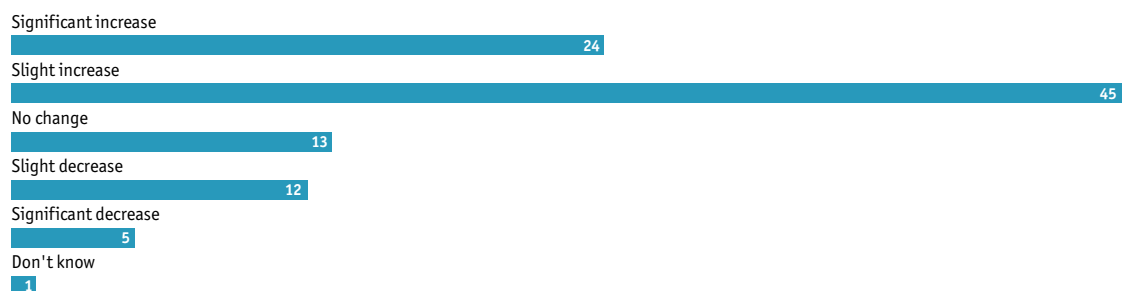
Despite these difficulties, the survey and interview programme conducted for this report indicate that many small and medium-sized enterprises (SMEs) are optimistic about their growth prospects. Almost seven out of ten respondents expect an increase in demand for their products and services over the next two years. At the same time, 54% expect revenue growth, with only 15% sufficiently pessimistic to expect a decline. Most positive among the respondents are those from Asia-Pacific, where 66% expect an increase in revenue, and the Middle East and Africa, where 58% expect growth. Executives in eastern Europe are the most gloomy overall, with just 46% expecting a revenue increase and 21% expecting a decline over the next two years.

Eastern Storage Systems (ESE), a UK shelving supplier, is one company that has been able to record revenue growth despite the tough operating environment. “We are yet to be affected by the recession, and continue to exceed our record sales figures of 2008,” confirms Simon Francis, the company’s managing director. “We have only had one project fail to materialise, because our customer could not raise the finance for the work.” Another is Content Syndicate, a Dubai-based media content firm. Its founder, Maddy Reddy, reports that deals take longer to get off the ground, and customers are pushing for a hard bargain. But overall, he says, “the numbers haven’t taken a hit”.

Despite these positive reports, growth among SMEs appears to be slower than it has been in the past—and perhaps less than it could have been but for the current unfavourable financial climate. Asked about their revenue in 2007, 20% of respondents say that they recorded growth of 20% or more. But as difficulties started to emerge in 2008, the proportion posting this level of growth fell to 18% of respondents. Looking ahead to the end of 2009, just 11% of the sample expect revenue growth of 20% or higher, although this number rebounds to 17% in 2010.

What change do you expect in demand for your products and services between now and the end of 2010?

(% respondents)

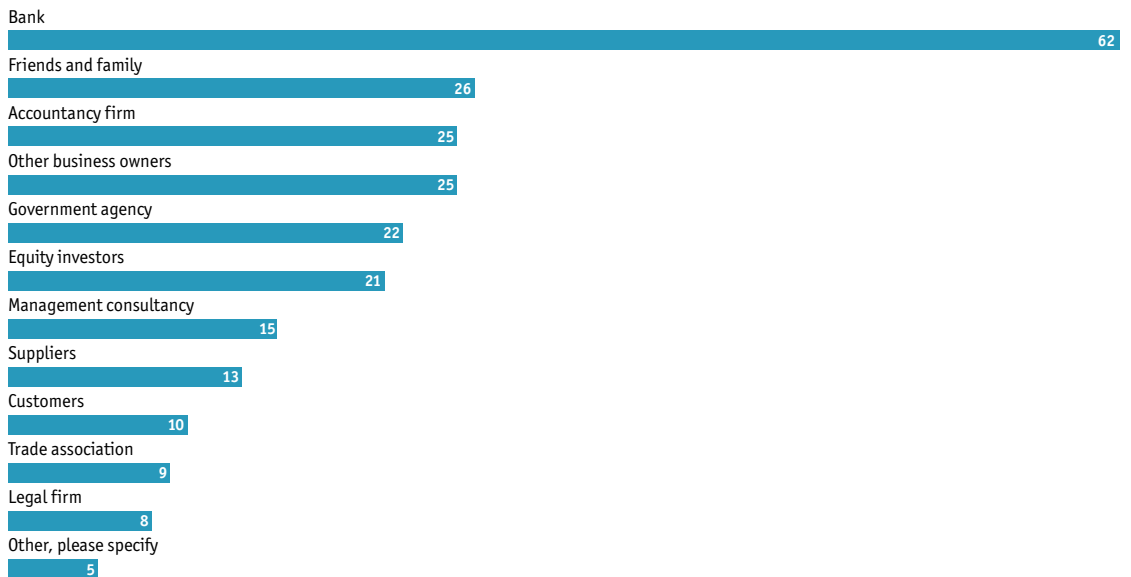




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Which of the following have you approached for advice about access to finance in the past year? Please select all that apply.
(% respondents)



Access to finance is undoubtedly a main contributing factor to this changing picture of growth. Excluding the 5% of respondents who say that availability of finance does not affect their business, 54% of firms report that they have seen a deterioration in the availability of finance over the past two years. This sentiment is strongest in Europe, where 65% of respondents report a decline in availability.

Bank lending, which is among the most important sources of finance for SMEs, is the area that has been cut back most severely. Stripping out those respondents for whom the question is not applicable, it is clear that unsecured lending is the area that has been most squeezed, with 53% pointing to a reduction; secured loans also feature highly, with 37% pointing to a decline in availability. This may reflect the general tightening of financial market conditions worldwide; it may also reflect expectations of more stringent regulatory and risk management frameworks that could affect approaches to credit risk.

One company that is feeling the effects of tighter bank conditions is Unkasoft, a Spanish developer of software for mobile devices. According to Jaime Lanchares, a co-founder, the company occasionally approaches its bank for a short-term loan of up to €50,000. “But for the past eight months, it’s almost impossible to negotiate with them,” he says. Another is A Le Coq, an Estonian brewer. For several years, the firm has negotiated leases for its delivery trucks with banks. But that has changed, according to Peep Akkel, the company’s financial manager. “In autumn 2008, I noticed a huge difference compared with earlier years,” he says. “Getting them even to fix margins—let alone rates—was impossible.”

When asked how their relationships with their banks have changed, executives at SMEs offer a wide range of responses. While many say their banking relationships have changed little, some say their banking ties have become stronger as the financial and economic climate has worsened. One is Jason Judkins, CFO and general manager at Yealands, a winery founded in New Zealand in 2008. “The bank



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has been fully supportive of our business plan, even though it has evolved, and we didn't meet the targets we initially thought we were going to meet," he says.

Indeed, 62% of respondents say that they have approached their bank for advice on accessing finance in the past year. "Our banks' financial advice is vital for us to diversify our financing sources," says Emmanuel Peña Sanchez, the owner of Compañía Peña Sánchez, a Mexican construction firm. At the other end of the spectrum is Mahtani Fashion, an Indian retailer, whose founder, Vinayak Mahtani, says that, for his firm, "the banks are not even an option any more". (See box.)

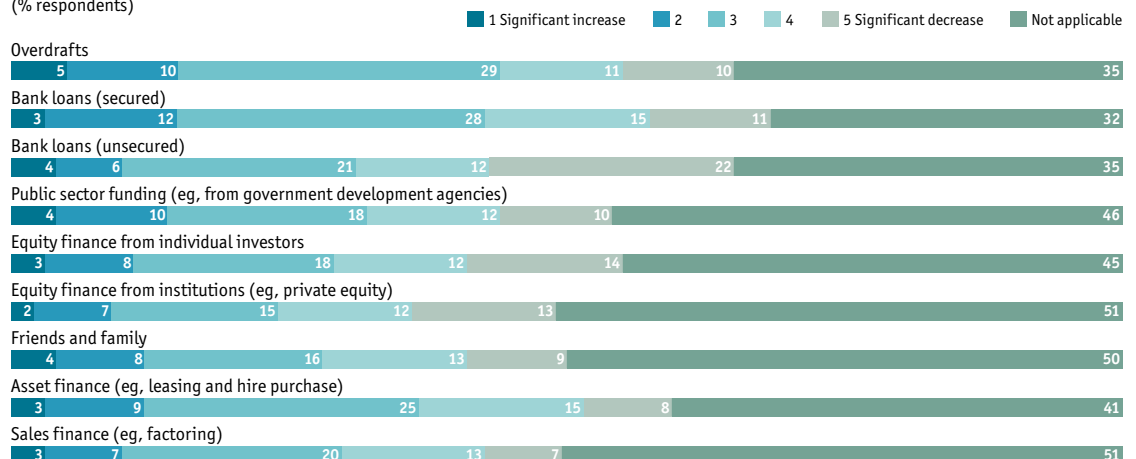
Beyond bank lending, executives say that there has been a squeeze on private equity from institutions and individuals, with 50% of respondents reporting a decline in the former and 47% in the latter. Similarly to banks, many venture capital providers are finding their own balance sheets under strain. It is likely that some providers are holding back cash for companies that are already in their portfolios. "We are probably investing in fewer and fewer new deals," confirms Anne Glover, co-founder and chief executive of UK-based Amadeus Capital Partners. "More of the capital is going to companies that we've [previously] chosen to support." She adds, however, that Amadeus continues to invest similar amounts of capital today as it did before the financial crisis.

In addition to becoming more difficult to access, finance is becoming more expensive, according to the executives questioned for our survey. Almost 55% of respondents for whom the question is relevant report that the cost of debt finance has risen in the past two years. Mr Judkins of Yealands says that even though his firm has a good working relationship with its bank, the cost of taking out loans has risen. "Margins have increased," he says. "There have been extra margins placed on some of our swaps. They are under one per cent—but extra margins nonetheless."

Cashbox, an operator of bank-independent ATMs in the UK, provides another example. Its chief executive, Ciaran Morton, notes that the firm used to take on straight debt from its bank at an annual interest rate of 8%. "No one does that any more," he says. His company's most recent funding has been in the form of convertible bonds. "Now, we are paying a higher interest rate on the convertibles than we were paying on straightforward debt just two years ago."

What change has there been to the availability of the following types of finance for your business over the past two years?
Please rate 1 to 5 where 1 is significant increase and 5 is significant decrease.

(% respondents)





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Mahtani Fashion: A collateral conundrum

Mahtani Fashion of India, which runs a chain of five shoe stores under the Vi-Ge brand, has struggled to find finance during 2009. In December 2008, the firm's bank abruptly told the founder, Vinayak Mahtani, that his credit lines had been cut—despite prompt repayment of previous loans and healthy bank accounts. Now, according to Mr Mahtani, finance is the biggest obstacle to his growth strategy. “We were going to expand at a much faster rate than we have been,” he says.

Why the sudden closure of the bank's credit facilities? Mr Mahtani has never received an explanation. But he says that one of the biggest difficulties in India is that collateral is needed to get a loan from a bank, or from a non-bank lending firm—and his company had not invested in any hard assets that could be put up as collateral.

The main alternative, according to Mr Mahtani, is to approach personal lenders. These are individuals who lend money on a peer-to-peer basis, with three-, six- or 12-month terms, and monthly interest payable of around 2%. But, according to Mr Mahtani, “these people are not concerned about the company. They are concerned about who the CEO is. And if we borrow from them, I have to give them my personal guarantees.”

With expansion in mind, Mr Mahtani has found a way to skirt round the problem of collateral. Now, to fund the opening of further stores, he plans to turn to franchising. “We have decided that, instead of opening up our own stores, we are going to franchise out. So we have franchisees who invest in the interior of the store, while we invest in the stock, in partnership with them,” he explains. “We plan to open six or seven stores in the coming year using this approach.”

Preserving cash as funding is squeezed

Inadequate access to finance is having a direct impact on many companies' investment plans. One-half of the executives questioned for this survey say that the financial crisis has had a significant impact on their ability to invest in assets that are required to grow the business. Investments in innovation and new product development, and in sales and marketing, are also coming under pressure, with 52% of those who consider the question applicable saying the financial crisis has had a significant impact on their ability to invest in the former, and 48% in the latter.

While it is only natural for businesses to rein in investment in a difficult economic environment, the long-term consequences can be severe. Sales and marketing can seem an obvious candidate for streamlining when demand is weak, but companies that shed jobs here, or rein in research and development (R&D) spending, can find themselves at a disadvantage when better times return.

The crisis is also having an impact on the expansion plans of many SMEs, with 52% of respondents who indicate the question applies to them reporting that their market expansion plans have been significantly affected, and 51% saying that their geographical expansion plans have been affected. At first glance, this may seem inconsistent with the finding that companies expect demand for their products and services to hold up well. However, this may well be a result of a mismatch between supply and demand. On the one hand, customers may continue to demand a company's products and services. On the other, the crisis is preventing investment on the supply side—through R&D, sales and marketing, and distribution to customers.

In some cases, it is financial backers that are putting pressure on companies to halt their expansion plans. Before the downturn, Unkasoft planned to open offices in San Francisco and New York. Recently, however, its venture capital backer halted all investment in expansion among companies in its portfolio. “Although we are improving our revenue, we can't execute our plans,” says Mr Lanchares.

In addition to putting expansion plans on hold, the majority of SMEs are also seeking to reduce their operating expenses. Asked about the steps they are taking to improve their cash position, 70%



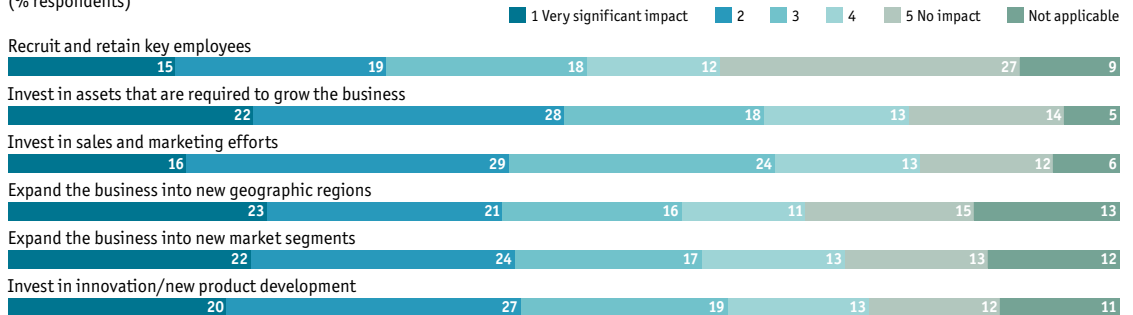
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What impact has the financial crisis had on your ability to carry out the following strategic and operational activities?

Please rate 1 to 5 where 1 is very significant and 5 is no impact.

(% respondents)



of survey respondents say that they are reducing costs. This has been the approach taken by the four partners behind a US restaurant chain, Wahoo's Fish Taco, who were seeking to cut costs but did not want to compromise on quality, nor raise prices. "We started to work a lot harder with our vendors to find some efficiency," explains Mingo Lee, one of the co-founders. "We signed some longer-term contracts to reduce our prices." And Orka Group, a fashion producer and retailer in Turkey, has lowered its costs by making use of growing numbers of idle production lines in the country's textile factories. "Because of that [spare] production capacity, they give us very, very competitive prices," says Süleyman Orakcioglu, the company's founder.

As firms seek to keep costs under control, some, inevitably, have shone the spotlight on personnel costs. Around 32% of respondents have cut pay and benefits, perhaps in a concerted effort to avoid cutting back on staff, and 29% have laid off staff. Transport, travel and tourism, and construction and real estate are among the sectors most likely to have cut staff. In the case of Unkasoft, redundancies among the firm's 20 employees were avoided, according to Mr Lanchares. Instead, he says, "we talked with some of our staff and offered them to [go freelance if they wished]".

In order to preserve cash, executives at many SMEs are also fine-tuning their cash management. In fact, 62% of respondents say that, by improving cash management and working capital, they can survive the current downturn without recourse to external finance. "Those private businesses that have managed cash, and continue to manage cash, are the ones that will succeed," confirms Suzi Woolfson, a partner at PricewaterhouseCoopers in the UK. Unsurprisingly, a relatively high number of respondents with a positive revenue outlook feel that they can weather the storm without external funding, if they tighten their cash management. By contrast, relatively few among those with a very negative outlook believe that they are well positioned to do so.

When tackling their cash management practices, executives turn first to working capital management. Some recognise that there is scope to renegotiate payment terms with suppliers and customers in order to reduce pressure on cash flow. Just over four out of ten respondents say that they are discussing payment terms with suppliers, while 39% are tightening payment terms with customers.

For Mr Francis of ESE, which has cash in the bank, and no debt, the focus has been on the customer and minimising the risk of extending credit to customers. "Our only concern is getting paid for the work we do," he says. "We have taken steps to minimise the risk, by doing credit checks, and taking



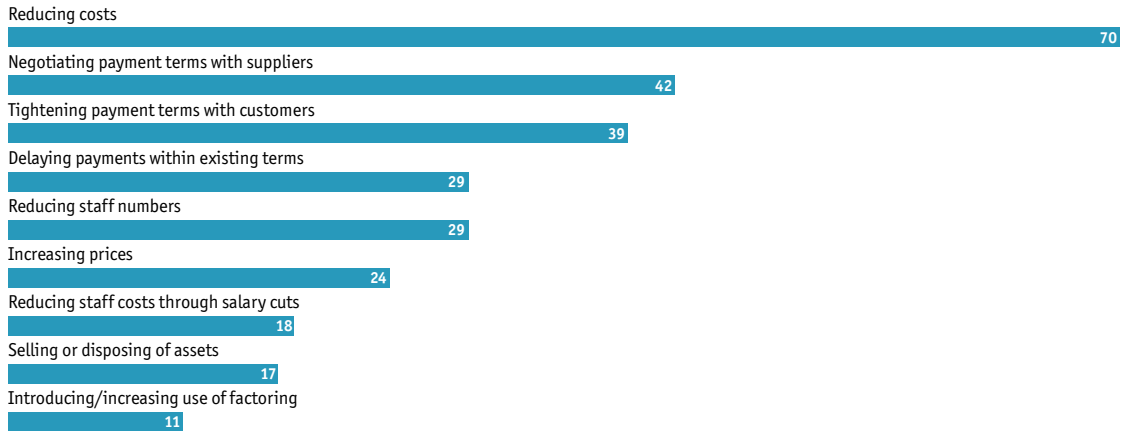
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Which of the following steps is your company taking to improve its cash position in the current environment?

Select all that apply.

(% respondents)



deposits upfront, and payment on delivery for customers we are not certain about.”

As a result, SMEs with a negative revenue outlook are therefore more likely to push through cost reduction and cash management measures than firms with a positive revenue outlook. Notably, the one exception to this is tightening payment terms with customers. While 40% of SMEs with a positive revenue outlook are seeking to tighten customer payment terms, the figure among SMEs with a very negative revenue outlook is just 25%. This may reflect fear of further eroding revenue that is already dwindling. (Mr Francis of ESE confirms that his firm has turned away some work as a result of its tighter cash management practices.)

For many young, high-growth companies, this is the first time that executives have been forced to turn the spotlight on cost efficiency and cash management in this way. “A lot of businesses have not been through these problems before,” says Huw Morgan, head of business banking at HSBC in the UK. In response to this demand, Mr Morgan says that HSBC has beefed up training programmes for its business lending staff, with a focus on cash flow. The bank has also turned to the Internet to offer advice to SMEs.

Getting ready for the upturn

Although the economic indicators remain somewhat mixed as this report goes to publication in October 2009, there are signs that the worst of the downturn may be over. Among the executives we interviewed for this research programme, there appears to be further anecdotal evidence of a rebound in growth. Mr Lee of Wahoo’s Fish Taco is one executive who believes that conditions may at last be improving. “Restaurants are the first ones to get hammered heading into the recession—and we’re also the first ones to recover, as the bounce starts occurring,” he says. “I think that’s what we’re seeing now. In the past three months, we have seen a steady increase in our traffic, and a return to the numbers we’re accustomed to at this time of the year.”

Even if Mr Lee is right that the real economy is picking up, it may take longer for credit conditions to ease. Just over one-half of survey respondents expect to see a broad return to pre-crisis levels of

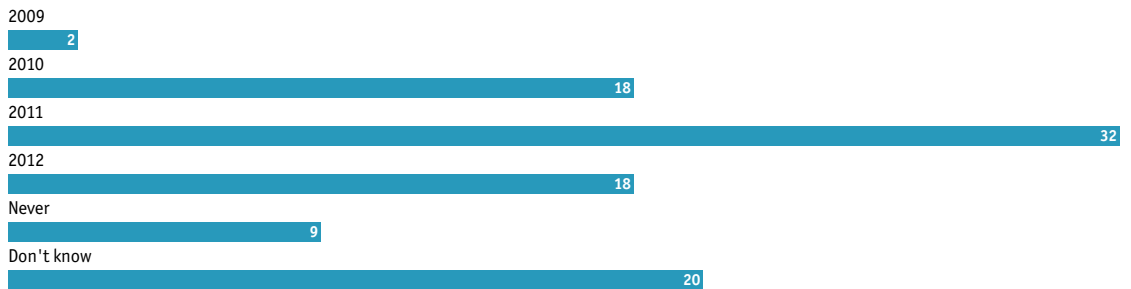


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When do you expect availability of finance to return to 2007 levels in your domestic market?

(% respondents)



availability of finance by 2011 or before. Executives in Latin America and Asia-Pacific are much more likely to expect availability of finance to return to 2007 levels by 2011 than other executives, especially those from North America and western Europe. Even so, many executives are reluctant to be drawn on the topic, or remain rather pessimistic. One-fifth say that they do not know when conditions will ease, while 9% say that there will never be a return to the availability of finance seen in 2007. In North America, that figure climbs to 13%, perhaps reflecting perceptions of a severe regulatory clampdown in the financial services sector.

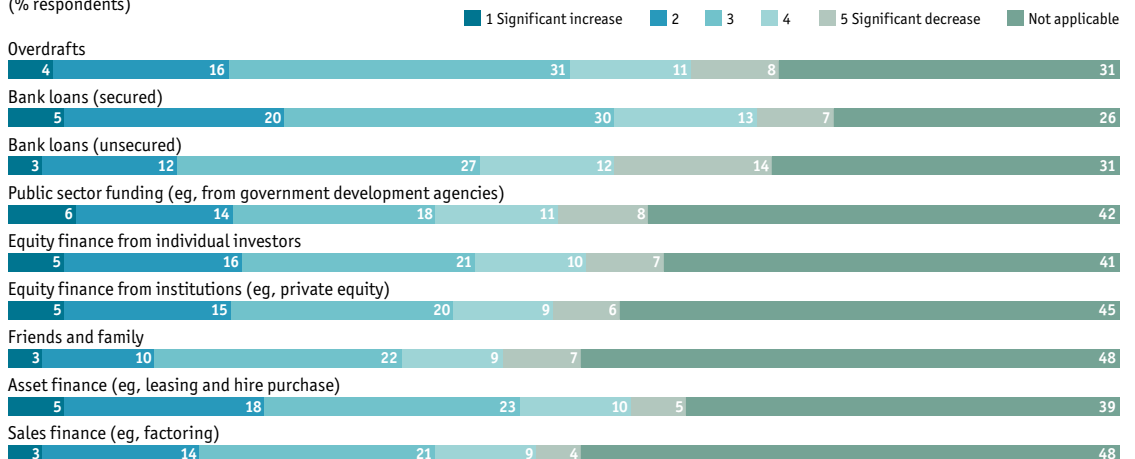
Still, many more executives at SMEs are optimistic that finance will become available to their own firms in the next two years than are pessimistic—although this is gauged from a low base. For example, for those executives for whom the question is applicable, 37% expect an increase in the availability of asset finance (such as leasing and hire purchase) in the next two years, where just 24% expect availability to shrink. A further 38% expect availability to remain at current levels.

A similar picture emerges for availability of private equity from institutions: 36% expect availability of private equity to grow; just 27% think it will decline; and 37% say it will stay flat. For his part, Mr Lanchares of Unkasoft says that he noticed some venture capital firms becoming more active again around June 2009. As a result, he approached his firm's venture capital backers in the hope of securing

What change do you expect to the availability of the following types of finance for your business over the next two years?

Please rate 1 to 5 where 1 is significant increase and 5 is significant decrease.

(% respondents)





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€1.5m of fresh capital. “We expect to close the next funding round in March 2010,” he says.

More broadly, respondents who expect bank lending to bounce back over the next two years narrowly outnumber those who think it will shrink. For example, one-third expect growing availability of secured bank lending and 29% anticipate better availability overdrafts, while in both cases 26% of respondents foresee declining availability. (Executives are not optimistic about access to unsecured loans, however, with just 22% expecting an increase in availability and 38% anticipating a decrease.) It is worth noting that these opinions appear to reflect executives’ perceptions of their own firms’ fortunes, as well as those of the market in general. Respondents’ expectations that funding will be available to their firms is markedly higher among those who expect to record revenue growth in the next two years. By contrast, executives who are less confident in the outlook for their firm’s revenue tend to be doubtful that more funding will be available.

Once favourable operating and financial conditions return, many firms say that they are poised to pick up where they left off. For example, many executives interviewed for this research indicate that postponed plans for investment and expansion will be dusted off. In anticipation of fresh capital, Unkasoft is already planning its expansion into the US, which had been on hold. “We are thinking about returning to our expansion plans in the US next year, from about March, April or May 2010,” confirms Mr Lanchares.

Wahoo’s Fish Taco is also planning its next steps. Over the next five years, the firm plans to invest in the infrastructure it needs to add another 100 outlets to its existing 55. According to Mr Lee, in the current market many prime sites are becoming available that would normally be beyond the reach of a smaller operator such as Wahoo’s. “We are going to take advantage of that and look for higher-quality locations at much reduced rates,” he says. “We are talking to our banks to get ready.”

Ten tips from a venture capital firm

For entrepreneurs and start-up firms pitching to venture capital firms for funds, the process has become considerably more difficult in the past two years. Unfavourable economic conditions mean that venture capital executives are spending more hours of the day nurturing their existing investments, rather than looking for new deals. Moreover, the tough climate means that venture capital firms are keeping a closer eye on funds and allocating them to their portfolio companies, rather than new firms.

Nevertheless, some deals are still being done. Anne Glover, co-founder and chief executive of Amadeus Capital Partners, a venture capital firm based in the UK, gives her ten top tips for entrepreneurs seeking funding from venture capital providers.

Try to get a personal introduction to a venture capital provider.

Send ahead a short introduction to yourself and your company. Engage with providers well in advance of needing cash—at least six months if possible.

Recognise that venture capital providers vary in focus, and may not match your company.

Take references, and approach the meeting as if you were building a long-term relationship.

Don’t assume that venture capital providers must invest—they can sit and wait for the best propositions.

Don’t overwhelm providers with data until you are asked for it.

Don’t sell all the time; venture capital houses need to understand the company, and its risks.

Don’t assume that venture capital providers have nothing to contribute but cash.

Don’t fail to respond to follow-up requests after an initial meeting—it leaves a lasting impression.



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Section 2: The regional outlook for finance

In this section, regional analysts from the Economist Intelligence Unit give their assessment of the outlook for finance across key regions of the world, with a particular focus on the funding climate for SMEs.

Sub-Saharan Africa

SMEs contribute significantly to the economies of the African continent, representing around 90% of all businesses, and providing the main source of jobs and income for African people. But for many SMEs, raising finance for their business is both costly and challenging. Fees charged on loans to businesses in Africa average almost 2% of the amount of the loan for small firms and 1.8% for medium-sized businesses, according to Finscope, which is almost double the cost in other developing economies. Interest rates for SME clients in Africa are some 5-6 percentage points higher on average than elsewhere in the developing world, with “prime” SME borrowers in Africa typically paying 15.6% for loans, compared with 11% in other regions.

Bank lending to SMEs in Africa has been hindered by the high degree of perceived risk associated with such loans and the banking sector’s focus on larger enterprises as key drivers of their revenue. Similarly, SMEs are largely unable to raise funds on local stockmarkets, although the Johannesburg, Nigerian and Mauritian stockmarkets have second-tier boards to cater to medium-sized businesses. Small firms at the top of their size range (that is, close to an annual sales threshold of US\$2.5m) can usually access working capital from banks, albeit at great expense, but their smaller peers are often left out in the cold.

Private equity funds have been increasing their African exposure in recent years. Nevertheless, private fund inflows to Africa remain marginal at just US\$3bn in 2007 or contributing 0.6% of the 7% of global capital inflows to emerging markets as a whole. Over one-half of the private equity placed in Africa in 2007 went to South Africa, followed by Nigeria (19%) and Zambia (12%). The bulk of the funds flowed to large businesses in three main sectors—distribution (27%), finance (25%) and telecommunications (12%).

Relatively limited linkages with the financial sector have done little to spare African economies from the global financial crisis. Demand for African exports (commodities, as well as manufactured and processed goods) has slumped and capital flows to the continent have slowed.

It would appear that the worst of the global financial crisis is now over, but one lasting impact in the short to medium term is likely to be the persistence of greater risk aversion among international investors and financial institutions, compared with the five years before the global financial crisis. These factors will present many companies with financing difficulties, particularly in 2009-10, in terms of servicing existing debt and securing new credit lines. SMEs appear particularly exposed, with many lenders focusing on core and possibly less risky business ventures, which tend to be larger and more strategically important organisations.



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In the short term, SMEs will continue to face financing difficulties through reduced access to capital from sources such as private loans, bank loans, term financing or equity investments. However, improving economic conditions from 2010 onwards and the continued focus of governments in many African countries on supporting SMEs should lead to an improvement in financing options in the medium to long term, as will targeted international development finance initiatives. African governments will continue to focus on building stronger financial regulations and the development of finance options for SMEs.

Many reforms that governments could initiate to roll back a number of obstacles to SME financing are minor, but political expediency will ensure that progress will be slow, if any, in some of the key areas such as the removal of needless red tape and bureaucracy. Moreover, the continent's overall operating business environment will continue to suffer from a number of constraints, including weak enforcement of property rights and rule of law, which will undermine efforts to improve SME access to finance. Also, a lack of reliable data and information will be another major stumbling block for both lenders and borrowers.

North America

Across North America's three economies—Canada, Mexico and the US—SMEs seeking financing will face more difficulties than in the recent past. In Canada and the US, which offer broadly similar financing conditions although different supervisory systems, companies will encounter more stringent conditions on loans. Fewer small firms will qualify for credit, and borrowers may in the short term have to pay higher real rates. Meanwhile, equity financing in the form of venture capital or private equity will remain scarce. According to our survey, only 15% of respondents expect an improvement in the availability of institutional equity finance over the next two years.

Even in good times, Mexico's financial system provides only limited credit to SMEs. In the current slump, financing will constrict further and remain available only for large, creditworthy and exporting firms.

More than one-half of respondents to our survey say that there has been a decline in availability of finance over the past two years. Looking ahead, only a small minority expect a further deterioration across overdrafts, unsecured loans and other vehicles, with a higher proportion expecting the situation to remain the same.

Following a boom in business credit in all three North American Free Trade Agreement (NAFTA) economies that lasted until late 2008, lending has dipped more recently. The pattern is the same in all three economies, although the precise timing differs between them. In the US, whose banks were at the origins of the financial crisis, outstanding business loans reached a peak in October 2008. Lending continued to fall month on month to July 2009, by which time volumes stood at 2.8% below their peak in nominal terms¹.

The pattern is similar in Canada, where business lending crested in December 2008, then fell in six of the seven subsequent months, and stood at 8% below its peak in July 2009². In Mexico, credit expanded until February 2009, and then fell in every month to June, dipping 4.5% below its peak. Business lending crept up marginally in Mexico in July³.

¹ Federal Reserve System, Assets and Liabilities of Commercial Banks in the United States, August 28th 2009, table H.8.

² Bank of Canada, Weekly Financial Statistics, August 26th 2009, page 5: Chartered Bank Assets.

³ Banco de Mexico, Custom download from the database "Financiamiento e información financiera de intermediarios financieros", lines SF210, SF211 and SF212.



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Senior loan officer surveys, published quarterly in Canada and the US, provide some reasons for optimism (Mexico's central bank does not conduct this type of survey). Surveys from July found that the majority of banks were still tightening standards for business loans, but these majorities were less hefty than in previous quarters. If historical trends prevail, and barring another crisis event, current sentiment should turn to loosening in the coming quarters.

Nevertheless, business lending remains in the doldrums across the continent and, in early September 2009, it was too early to declare a turnaround in any of the three markets. In line with current data, the Economist Intelligence Unit forecasts that overall bank lending will fall in all three economies across 2009. Recovery will appear first in Canada in 2010, and extend to Mexico and the US in 2011. We do not expect that business lending in any of the three North American economies will return to the double-digit growth rates enjoyed in the middle of the current decade. Survey respondents feel similarly about their own revenue growth. For example, 19% believe that they will experience growth of more than 10% in 2009.

Large and creditworthy firms are likely to retain better access to financing than their smaller rivals, although there is considerable variation in this regard across the region. According to a recent central bank survey, large-company bias is particularly strong in Mexico, where SMEs have chronic difficulties in obtaining financing. Surprisingly, however, US loan officer surveys do not reveal any systematic slant against small companies, either in standards or pricing.

According to surveys, banks have widened their spreads over their own cost of funding in the US and Canada since late 2007, although this trend has begun to reverse in recent quarters across both countries. Anecdotal evidence indicates that this is the case in Mexico as well. The Economist Intelligence Unit forecasts, however, that any increase in spreads will not prove enduring, and margins will return to pre-crisis levels, or even below them, by 2011. Abundant government liquidity, competition among lenders and the easing of extraordinary levels of risk aversion will combine to push down spreads.

Companies will find little shelter in the coming years in equity financing. Although the global drought in initial public offerings appears to be coming to an end in the third quarter of 2009, few companies are expected to come to market in 2010-11. Angel investors, stung by losses elsewhere in their portfolios, will be reluctant to serve as major sources of finance for individual firms.

Private equity and venture capital (PE/VC) was a limited alternative even in the boom years: in 2007 it provided US\$105.7bn in new funds in the US and a much smaller US\$1.4bn in Canada, according to PricewaterhouseCoopers in its *Global Private Equity Report* (a separate study estimated US\$1.2bn in investment in Mexico in that year).

Since the credit crunch intensified in 2008, equity financing has shrunk precipitously. Although strictly comparable figures are not available, national sources show that PE/VC capital investments fell by 38% in Canada and 62% in the US. Deal volumes continued to fall in the first two quarters in the US, according to the Private Equity Pitchbook.

Central banks in all three countries have now cut rates to historical lows in an effort to counteract the economic contraction. Official interbank target rates currently stand at 0.25% in Canada, 4.5% in Mexico and 0-0.25% in the US. They are likely to remain this low in the near future; central bankers



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in both Canada and the US have vowed in recent statements to hold them down for an extended period. In addition, the US Federal Reserve and, to a lesser extent, the Bank of Canada have pursued quantitative-easing policies.

These efforts have succeeded in reversing the crisis conditions of late 2008 and early 2009. However, they will not dispel the current gloom in business financing conditions, which is likely to persist for several years.

Asia

Asia's export-oriented economies, which were hit hard by the global economic crisis, are now showing strong signs of recovery. But given that export growth is unlikely to return to its pre-crisis rate in the near future, the region will still need to find a new growth model that focuses more strongly on supporting domestic demand. One way of achieving this would be to provide more support to small businesses, which account for the majority of employment in most Asian countries, and are also typically the most dynamic sector of the economy.

Historically, however, the SME sector has frequently had poor access to credit. If SMEs are to thrive over the next two years, and play a major role in reorienting economies away from their traditional dependence on exports, it is essential that this situation improves. This, in turn, will depend on the overall health of the financial sector in Asia, as well as the efforts of policymakers to ensure that SMEs do not continue to be frozen out of credit markets.

Compared with two years ago, 45% of respondents to the survey from Asia-Pacific say that the availability of finance has deteriorated. Over the next two years, less than one-quarter expect the availability of overdrafts to improve, and only 21% expect the availability of unsecured bank loans to improve.

Most banks in Asia have emerged from the crisis in a stronger position than their counterparts in the rest of the world, largely because they have had little exposure to toxic US sub-prime debt. Despite this, access to credit remains more difficult for SMEs to come by than before the crisis began. Indeed, lending to the sector has fallen much more sharply than lending to larger companies, according to the IMF's *World Economic Outlook* report. This suggests that, as the crisis has intensified, banks have become much more risk-averse in their lending decisions.

Another reason SMEs can lack access to credit is that it is normally much more risky lending to an SME than either an individual wanting a mortgage loan (who can use the property as collateral), or a bigger company, which typically has a plant or some machinery to use as a loan guarantee. In Thailand, for example, which set up a special bank in the aftermath of the Asian financial crisis to support the sector, 22% of the loans to SMEs became non-performing at their peak, compared with 17% of loans from the financial sector as a whole, according to the Asian Development Bank.

Since the start of the downturn, a number of governments in the region have been introducing measures to support the SME sector, in recognition of the role it can play in helping economies to rebalance. These measures range from credit guarantee schemes in India and South Korea, to a rule for banks in the Philippines that mandates them to allocate at least 10% of total lending to the SME sector.

The state-owned banks in China have also been encouraged to increase lending to SMEs, while the



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government in Singapore has begun investing directly in innovative start-up companies by matching the investments made by the private sector. In addition, central banks across the region have been cutting interest rates sharply since the crisis began, and although there are doubts about the extent to which these cuts have been passed on to borrowers, the cost of new loans has typically fallen.

There are various reasons why SMEs have suffered from poor access to credit. In China, for example, big state-owned enterprises (SOEs) are given much more favourable access to credit. In addition, the government has been actively encouraging the biggest firms to expand abroad and become world-beating national champions. This means that SMEs may not get the attention that they require.

Overall, SME access to credit is likely to improve significantly over the next two years as the region's financial sector continues to stabilise and government measures to support lending to the banking sector take effect. However, despite the strong support of governments, SMEs will continue to find their access to credit hampered by a banking sector that is fearful of lending to what remains a relatively risky sector and an official policy bias, which favours big, often state-owned, enterprises.

Western Europe

Almost without exception, the government bailout packages unveiled to prop up ailing banking systems feature stern demands for lenders to boost credit for SMEs. Unfortunately, the severity of the credit crunch has resulted in the staggering amounts of capital poured into the banking system trickling out as loans to small businesses only gradually, if at all.

Respondents to the survey from western Europe are particularly downbeat about the availability of finance. Six out of ten say that there has been a deterioration over the past two years. More than one-third expect a further deterioration in the availability of overdrafts, while a similar proportion expect a continued decline in the availability of unsecured loans.

To unblock the flow of credit, some governments, such as in France and Belgium, have appointed credit mediators with a mandate to intervene on behalf of companies that are having difficulty coaxing credit from lenders. From its launch in late 2008 until August 2009, the mediator in France released €1.4bn in loans that were initially refused to firms. But in its latest communication, the mediator's office noted that requests for arbitration from firms with less than ten employees were still rising.

Large banks are also doing their smallest customers no favours. "SMEs often lack face-to-face contact with bank managers who understand their business," lamented the OECD in a report earlier this year. "It is the large, troubled banks that are now refusing to lend ... under local branch banking these SMEs might have been judged as viable." More than ever, banks are being encouraged—or in the case of nationalised institutions, forced—to refocus their businesses on the simple, relationship-based lending to local firms that was once banks' *only* business.

Although the limited exposure of SMEs to international capital markets shielded many from the worst of the initial credit crisis, increasingly integrated supply chains mean that big companies' problems are "eventually passed down the supply chain and hurt SMEs", according to BusinessEurope, a regional employers' federation, in a recent communiqué. Pressure on SMEs' working capital has been particularly acute during the recent downturn, with large companies delaying payments to smaller suppliers as a form of free financing. In response, the UK's Federation of Small Business



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launched a “name and shame” campaign against large companies that unilaterally extended terms to small suppliers, in some cases delaying payments for up to four months. The scaling back of cover by risk-averse credit insurers has also put many SMEs’ balance sheets under pressure, leaving them dangerously exposed if important customers default on promised payments.

There are encouraging signs of a thaw in previously frozen credit markets. In the latest survey of loan officers by the European Central Bank (the euro area’s central bank), the net percentage of lenders who expected to tighten credit for SMEs in the third of quarter of 2009 halved, to 21%, from 42% in the previous quarter’s poll. Six months ago, nearly two-thirds of loan officers were cutting back on credit to small businesses. Survey respondents also expected terms and conditions on loans to relax in the euro zone relative to previous quarters.

The Bank of England (the UK’s central bank) does not provide specific data on SMEs, but in its latest survey of loan officers, for the first time in more than two years a net positive balance said that the share of approvals of loan applications from medium-sized non-financial companies was growing. Maximum credit lines also saw growth, but unlike in the euro zone, spreads widened and covenants grew stricter (although by a smaller degree than in previous quarters).

A smaller but broader survey of SMEs across Europe drew similar conclusions to the central banks. UEAPME, a trade group, polled SME managers in ten countries between May and June 2009, concluding that “access to finance for SMEs was significantly worse than a year before, but slightly better than earlier this year”. In general, businesses also found that their banks were asking for more collateral and information to help them assess the risks of borrowers, according to UEAPME.

Whether through government cajoling, public pressure or improving economic conditions, lenders appear to be cutting the cost and boosting the availability of finance for SMEs. For the EU’s 23m small businesses—and the 100m staff employed by them—these signs, however mixed, are being welcomed with open arms.

Middle East and North Africa

Access to finance for SMEs across the Middle East region is generally limited and expensive.

Respondents to the survey from the slightly broader regional group of the Middle East and Africa are fairly downbeat about the change in availability of finance in their region over the past two years, with 54% reporting a deterioration. Looking ahead, they are slightly less pessimistic, with around one-third expecting an improvement in the availability of overdrafts, for example, and 22% expecting a further deterioration.

There are a number of reasons for the scarcity and high cost of credit in the region. These include a legacy of state control over the economy and a comparatively underdeveloped banking sector, which lacks the risk management tools and expertise to extend loans to smaller corporate borrowers with a shorter track record.

As might be expected, there are large variations across the region. In the poorer, non-oil-exporting states of the region, such as Egypt, SMEs account for a greater proportion of economic activity and international development organisations are active. For this reason, financing options tend to be somewhat greater than in the wealthy Gulf Co-operation Council (GCC) states. This may yet change,



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particularly because the burgeoning young populations in the more populous Gulf states are forcing governments to promote entrepreneurship as a means of job creation, since SMEs are generally far more labour-intensive than the mainstay hydrocarbons industry.

In the World Bank's annual Doing Business survey for 2009, no Middle Eastern country ranked among the top 50 in the "Getting Credit" category. Saudi Arabia was best placed at 59th, pushing the more open, service- and trading-oriented UAE into second place at 68th. Bahrain and Kuwait—alongside Egypt and Lebanon—ranked joint 84th overall, while the remainder fell outside the top 100 of the 181 states included in the study. Despite having relatively well-developed banking and legal systems, Oman and Qatar came in at only 123rd and 131st respectively. A survey published in August by Standard Chartered Bank found that in Egypt, Jordan, Lebanon and the UAE commercial banks operated a virtual blanket refusal to lend to firms established for less than one year, predominantly SMEs.

Central bank interest rate cuts have failed to ease the pain for SMEs, as banks in the region have either failed to pass them on to lenders or have continued to refuse loan requests regardless of a prospective borrower's willingness and ability to pay a higher servicing cost. Even during better times, data collated by Dun & Bradstreet, a global credit and risk consultancy, on the UAE found that 50-70% of loan requests from SMEs were rejected.

The economic and financial market downturn in the region has led to soaring levels of non-performing loans (NPLs), especially in the UAE as a result of the Dubai property market slump. This has made the region's banks far more reluctant to lend to all but the most creditworthy borrowers. The situation is expected to improve as economic recovery sets in from mid-2010 onwards. But even then, deficiencies in risk management at many banks are likely to result in greater caution than in pre-crisis days, while rising interest rates will increase the cost of borrowing for all.

Across the region, efforts are slowly being made to instil more risk management practices in credit assessment. This could ultimately benefit financially and economically sound SMEs that previously suffered from a blanket rejection of credit.

Of all the major Middle Eastern economies, Egypt is the most reliant on SMEs as contributors to economic growth. With the assistance of the International Finance Corporation, the soft-loan arm of the World Bank, the Egyptian central bank has created the Egyptian Credit Bureau (I-Score). It hopes that this new entity will help to address the long-standing risk aversion of the country's mainstream banks, which has its origins in NPL problems stretching back to the 1990s. In 2007 Egypt also created the Nilex bourse, the first in the region aimed specifically at allowing smaller companies to list and seek capital market funding.

In the GCC, however, banks remain virtually the only source of SME finance. The bond and sharia-compliant *sukuk* markets in the GCC are currently dominated by sovereigns, government-affiliated companies, banks and the region's corporate heavyweights. Over time, and as economic conditions improve in the region, it is hoped that debt capital markets will also start to encompass smaller firms, as they have elsewhere in the world.



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Conclusion

Many SMEs continue to grow, despite broadly unfavourable economic conditions. For some, however, expected growth in 2009-10 is not what it might have been—or, indeed, what it was in 2007-08. In many cases, lower growth means lower earnings. At the same time as internal cash resources are shrinking, external funding such as bank lending, and private equity, is being squeezed.

As a result, SMEs are holding back on investment in future growth. In addition, to survive the current conditions, many are cutting costs and renegotiating with suppliers in an effort to preserve cash in the short term. Companies with a negative revenue outlook are paying closer attention to these measures. For some executives, it may be the first time they have faced an unfavourable financing and operating environment.

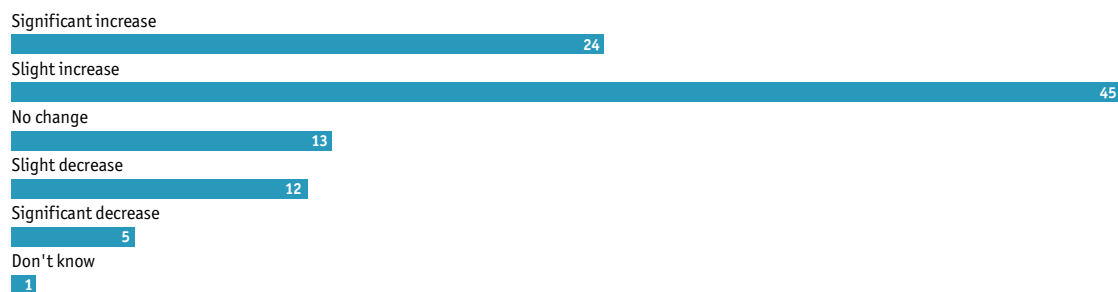
Most executives at SMEs expect a return to pre-crisis levels of availability of finance for their firms in 2011, or before. Here, the level of optimism depends not only on respondents' views of the broader market, but also on their perception of their firms' own prospects. When conditions become more favourable, many firms are poised to reinvest in growth, dust off plans for acquisitions, or reignite their market or geographical expansion plans.

Appendix

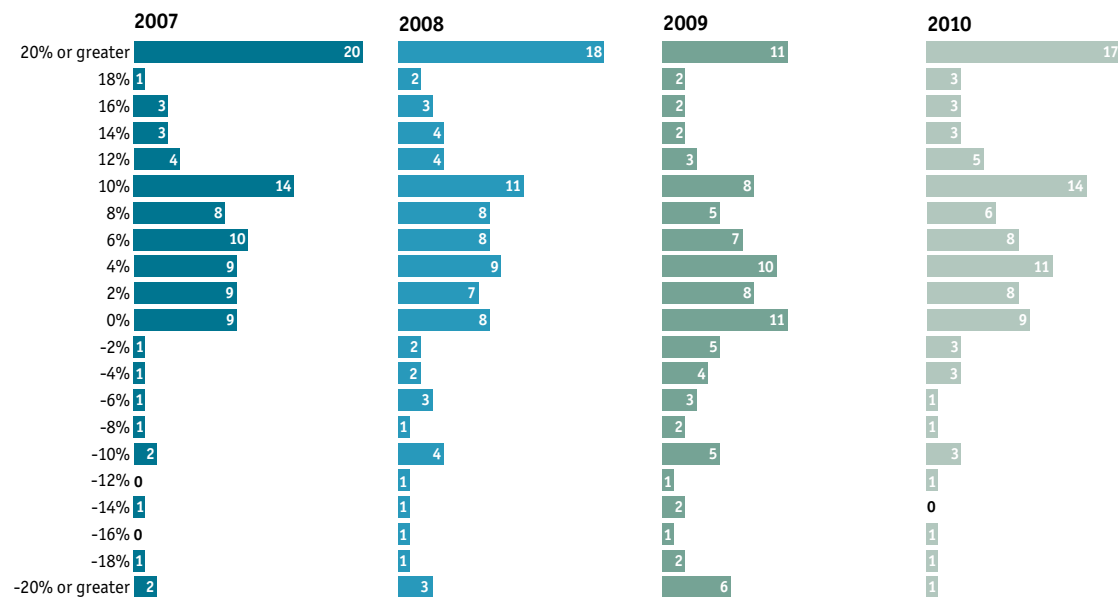
What is your company's global annual revenue in US dollars? (% respondents)



What change do you expect in demand for your products and services between now and the end of 2010? (% respondents)



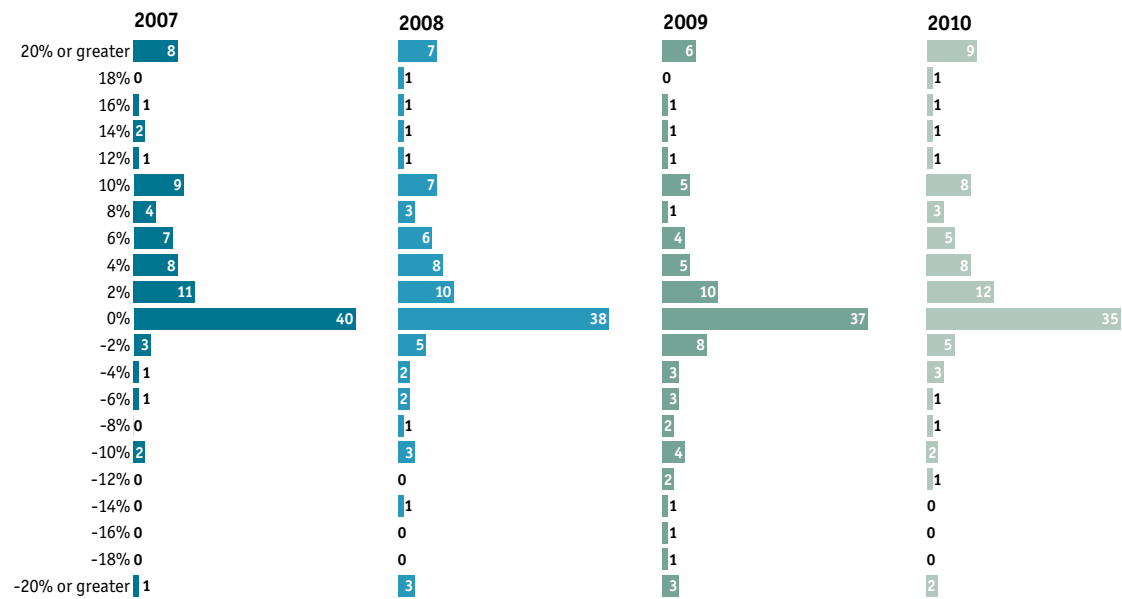
What were your annual gross revenue growth levels in 2007 and 2008 and what do you expect them to be in 2009 and 2010? (% respondents)



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What change has there been to the number of employees in your business in 2007 and 2008, and what change do you expect there to be in 2009 and 2010?

(% respondents)

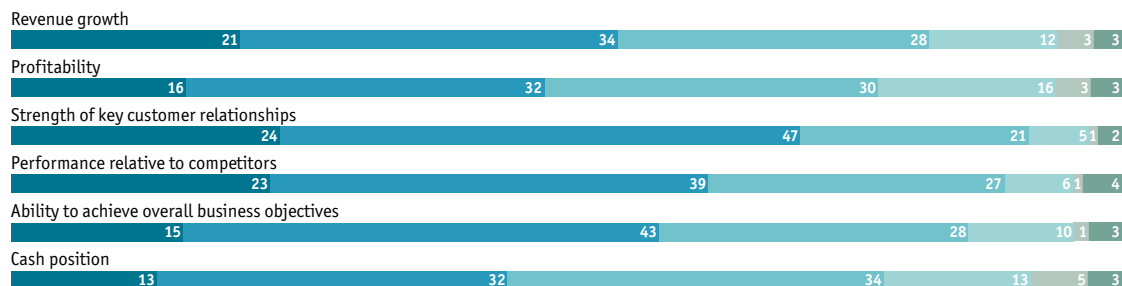


Over the next two years, how do you view the prospects for your company across the following measures?

Please rate 1 to 5 where 1 is very positive and 5 is very negative.

(% respondents)

1 Very positive 2 3 4 5 Very negative Don't know

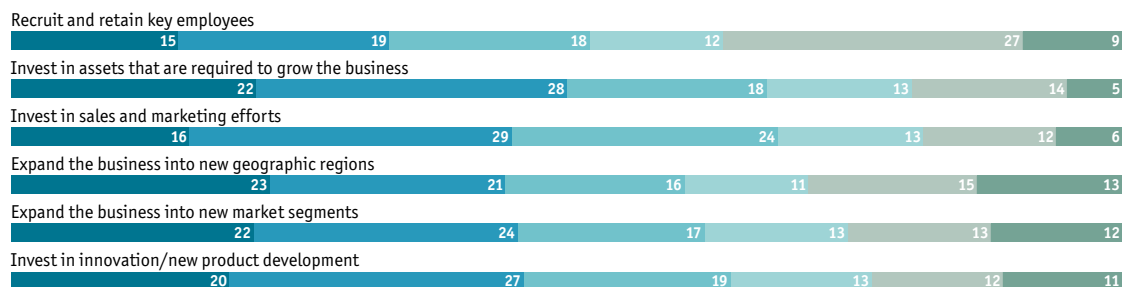


What impact has the financial crisis had on your ability to carry out the following strategic and operational activities?

Please rate 1 to 5 where 1 is very significant and 5 is no impact.

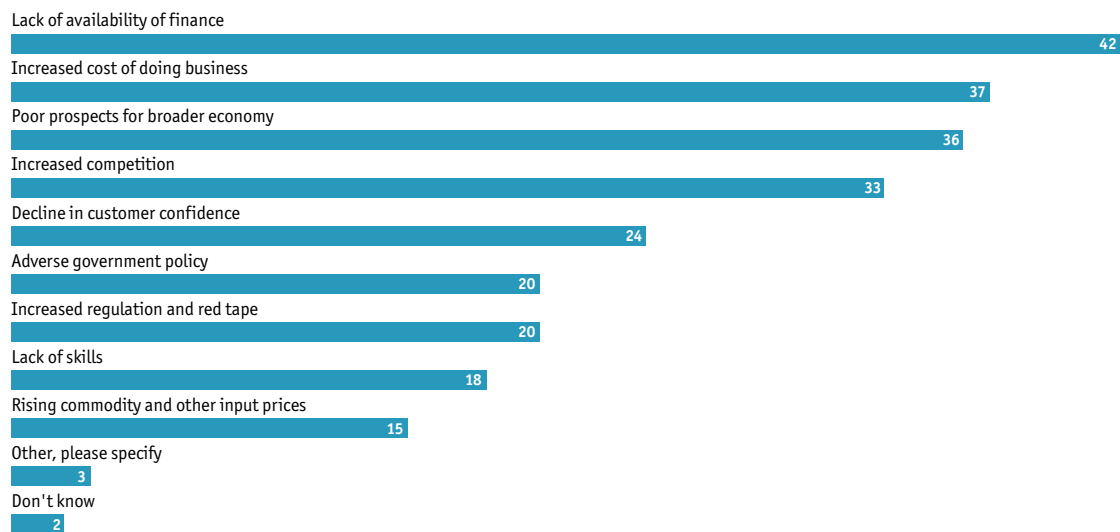
(% respondents)

1 Very significant impact 2 3 4 5 No impact Not applicable

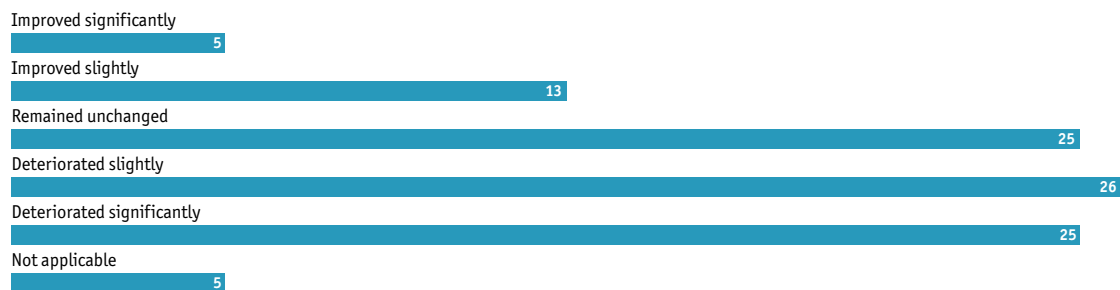


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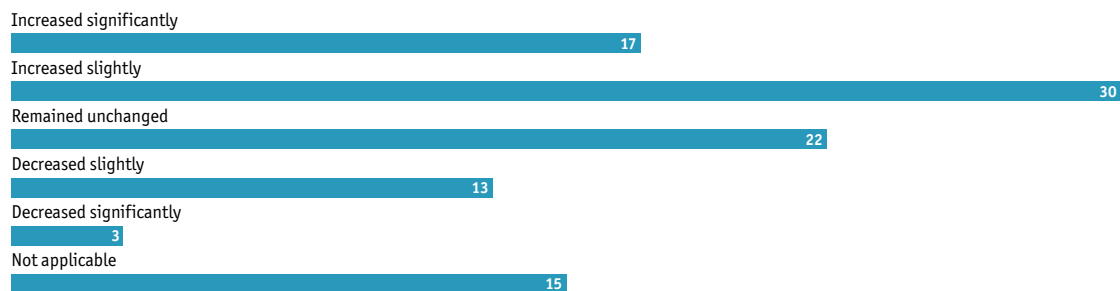
Which of the following factors are most likely to constrain your business over the next two years? Select up to three.
(% respondents)



Compared with two years ago, has the availability of finance for your business...
(% respondents)



Compared with two years ago, has the cost of debt finance for your business...
(% respondents)

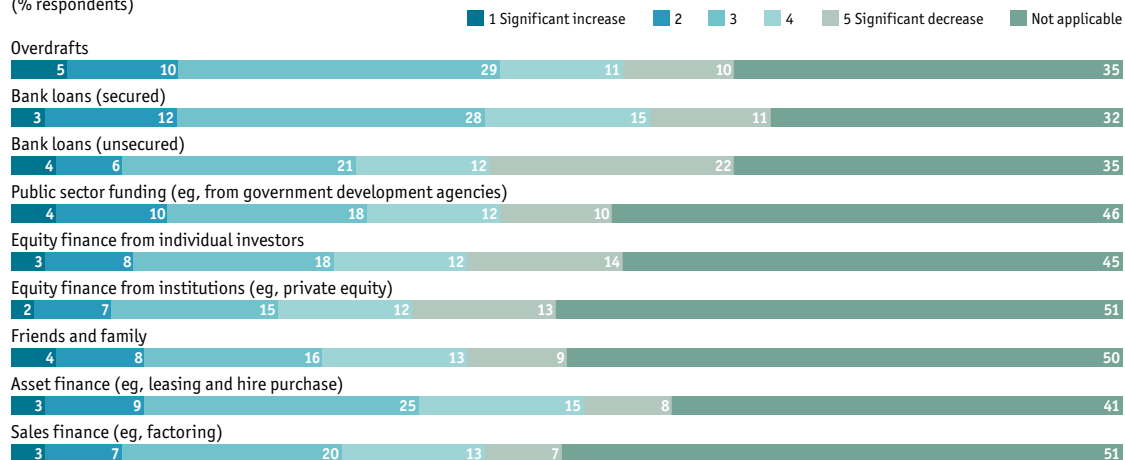


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What change has there been to the availability of the following types of finance for your business over the past two years?

Please rate 1 to 5 where 1 is significant increase and 5 is significant decrease.

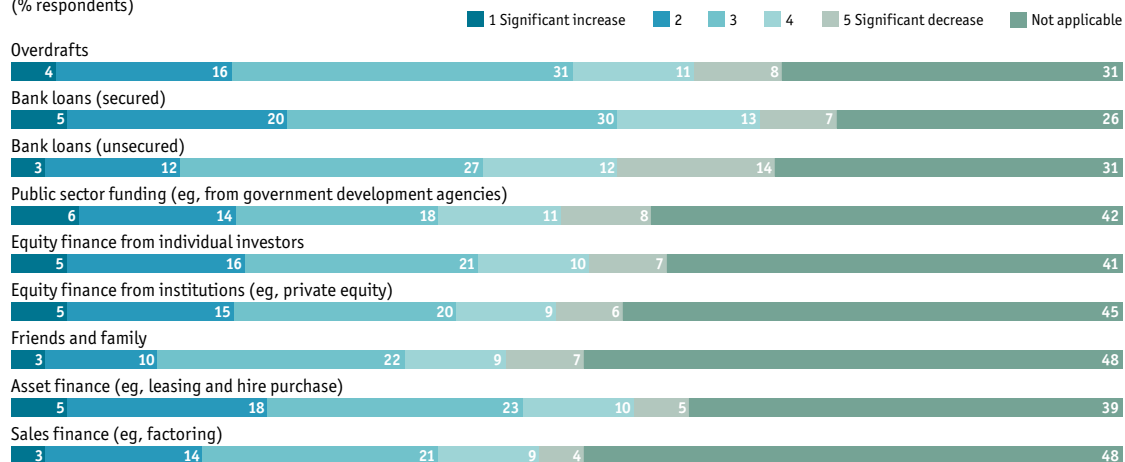
(% respondents)



What change do you expect to the availability of the following types of finance for your business over the next two years?

Please rate 1 to 5 where 1 is significant increase and 5 is significant decrease.

(% respondents)

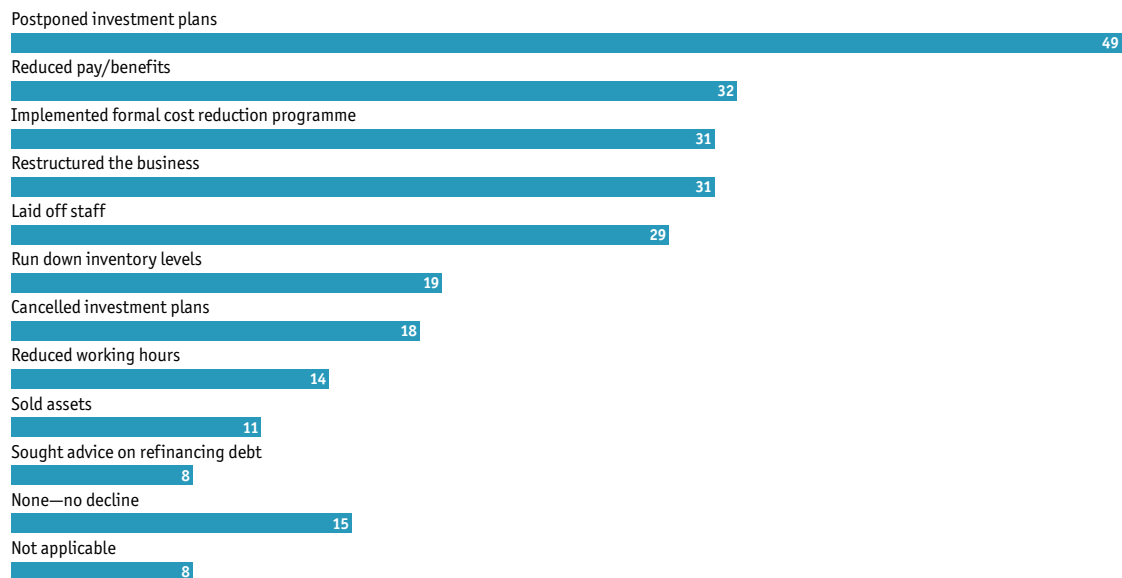


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Which of the following steps has your company been forced to take as a direct result of a decline in availability of finance?

Please select all that apply.

(% respondents)



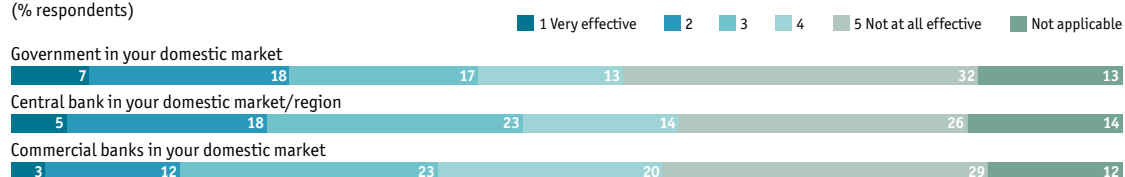
What changes have you made to the level of debt in your company over the past three years?

(% respondents)



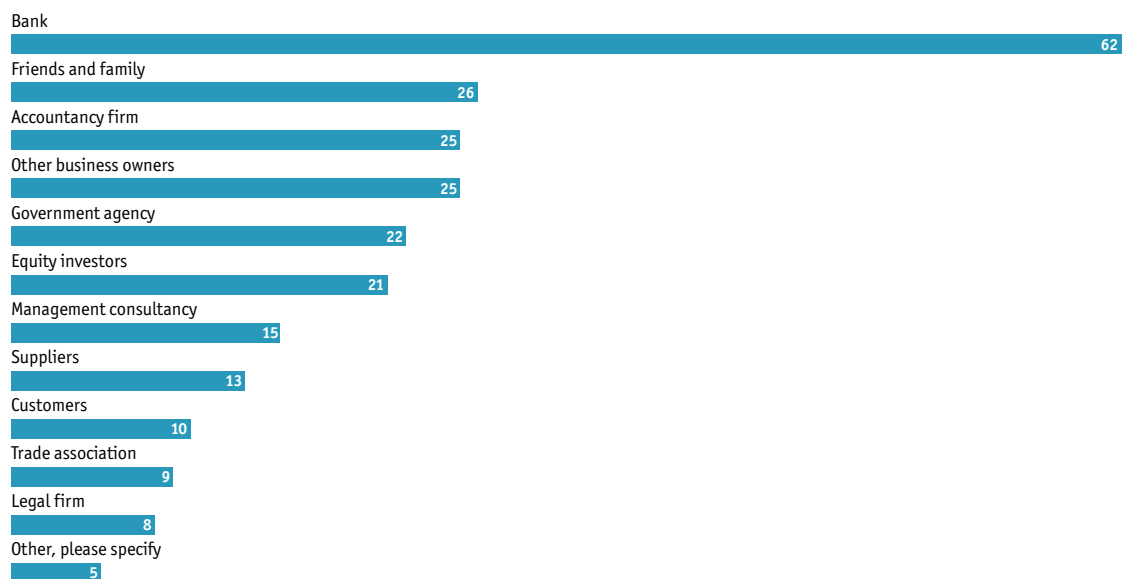
Since the credit crisis began, how effective do you think intervention by the following has been in helping to ease access to finance? Please rate 1 to 5 where 1 is very effective and 5 is not at all effective.

(% respondents)

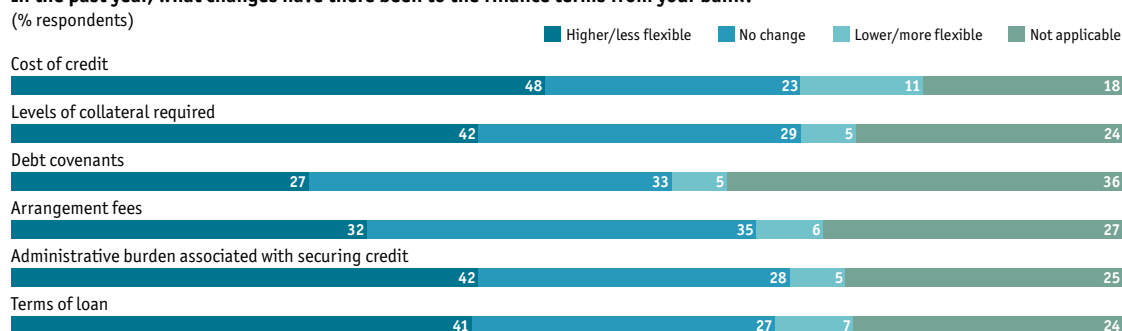


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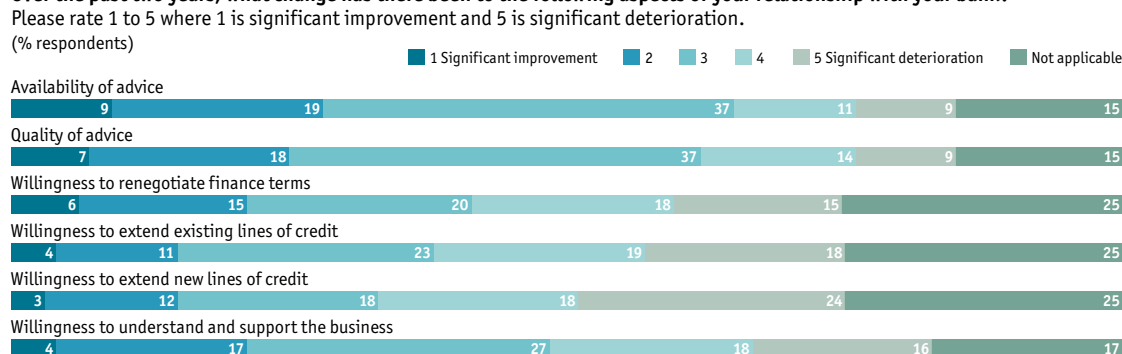
Which of the following have you approached for advice about access to finance in the past year? Please select all that apply.
(% respondents)



In the past year, what changes have there been to the finance terms from your bank?

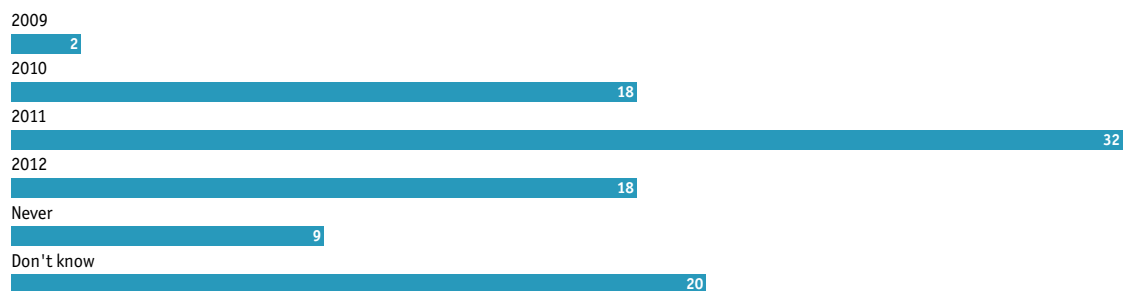


Over the past two years, what change has there been to the following aspects of your relationship with your bank?

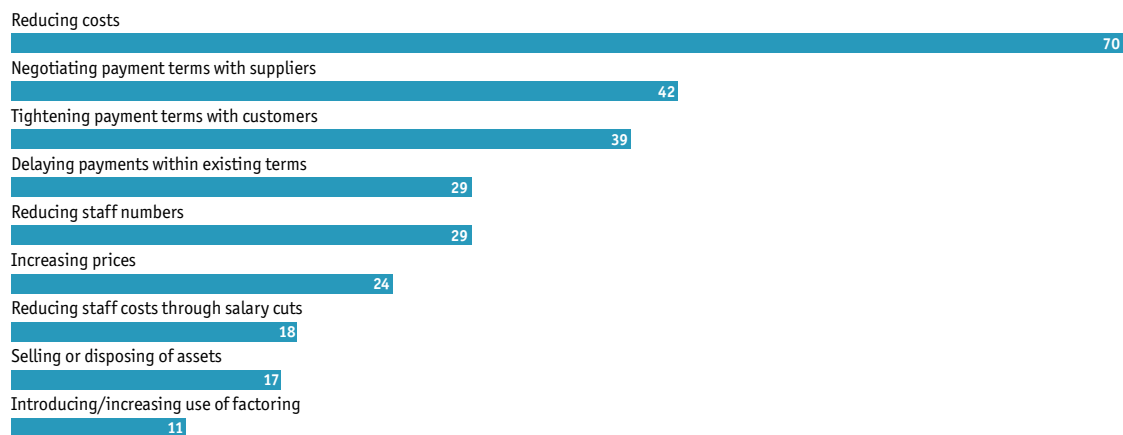


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When do you expect availability of finance to return to 2007 levels in your domestic market?
(% respondents)



Which of the following steps is your company taking to improve its cash position in the current environment?
Select all that apply.
(% respondents)

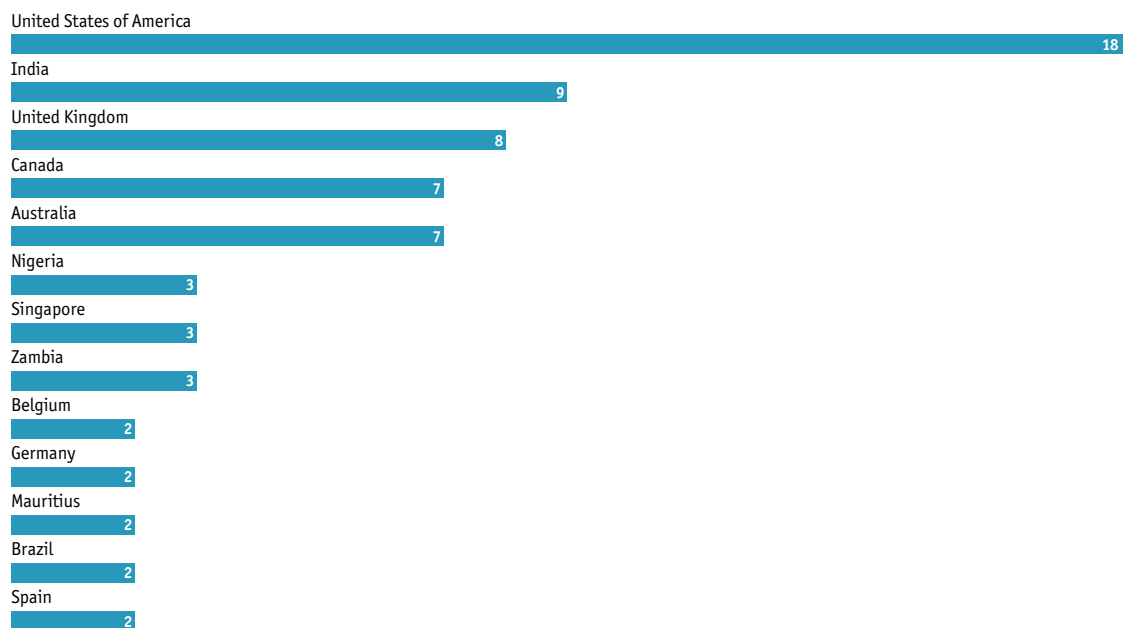


Please indicate whether you agree or disagree with the following statements.

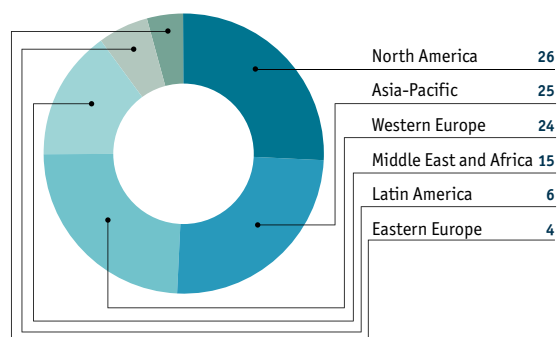


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In which country are you personally located?
(% respondents)



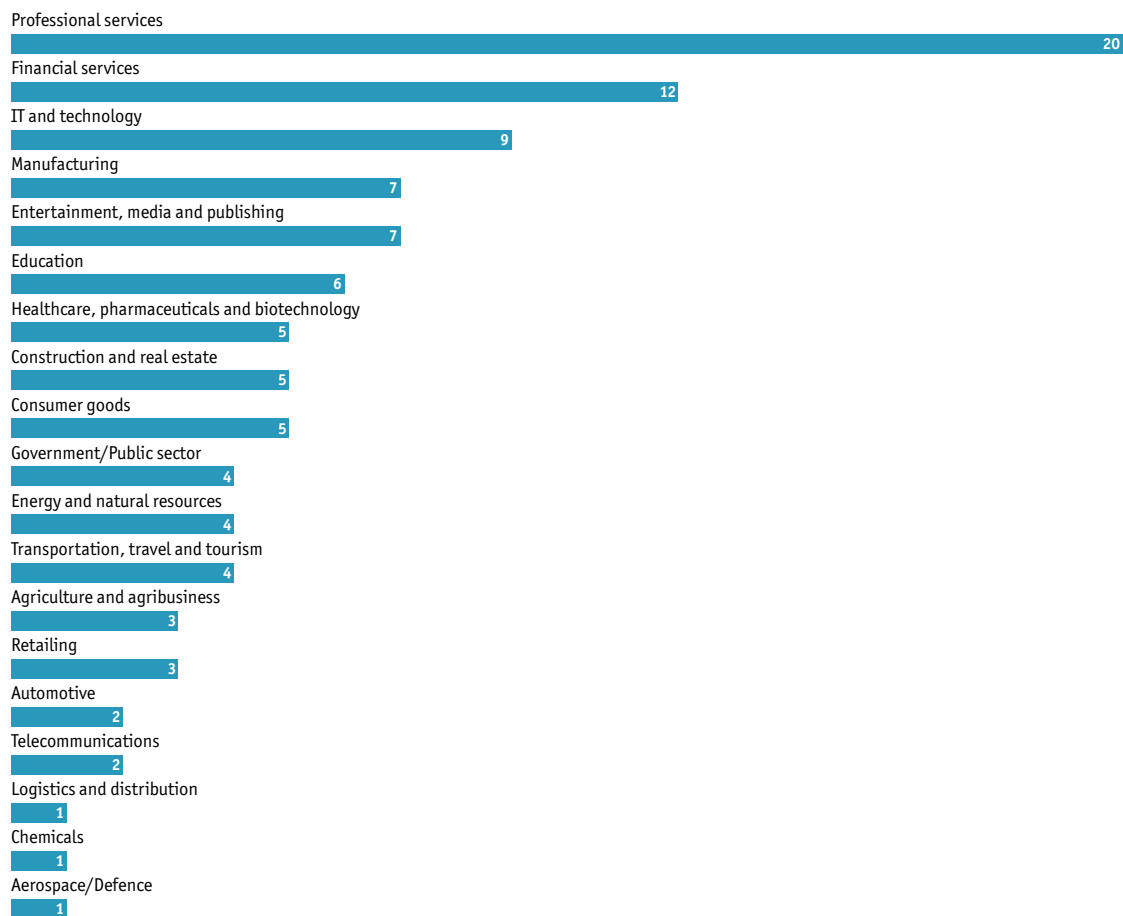
In which region are you personally based?
(% respondents)



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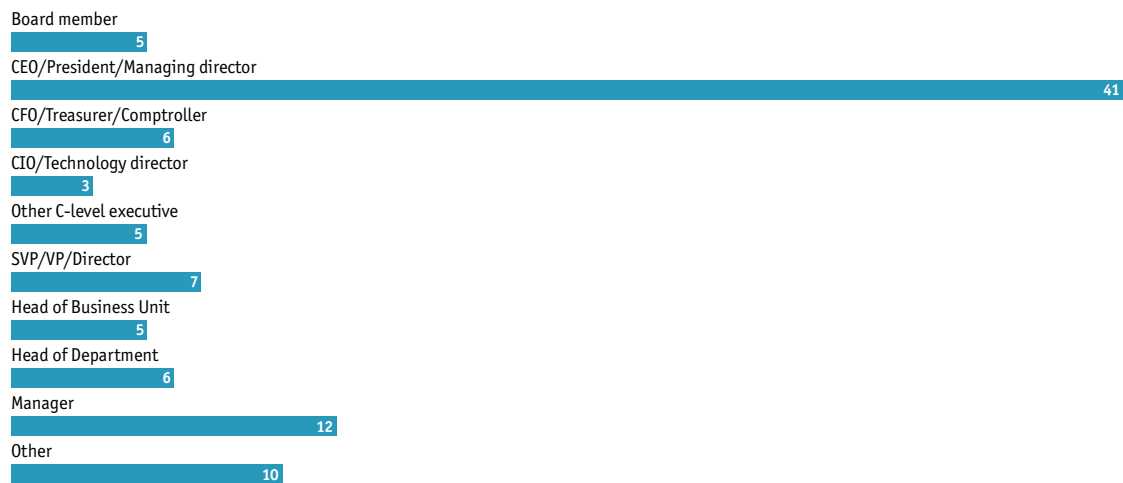
What is your primary industry?

(% respondents)



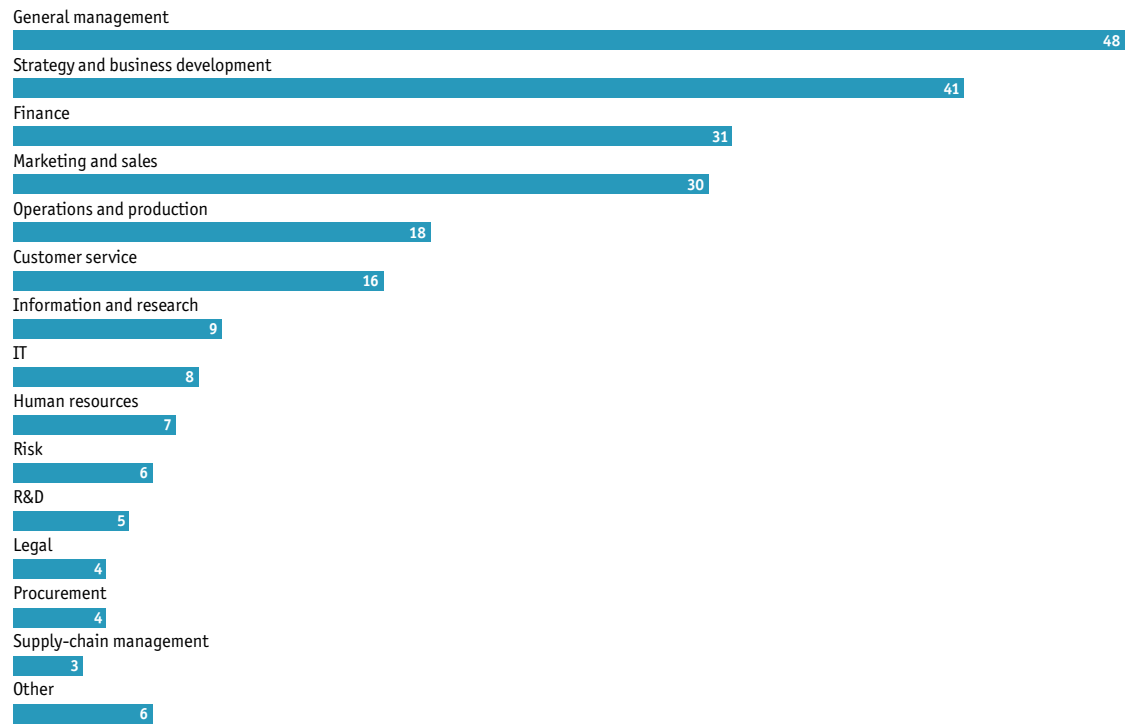
Which of the following best describes your job title?

(% respondents)



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What are your main functional roles? Please choose no more than three functions.
(% respondents)



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LONDON

26 Red Lion Square

London

WC1R 4HQ

United Kingdom

Tel: (44.20) 7576 8000

Fax: (44.20) 7576 8476

E-mail: london@eiu.com

NEW YORK

111 West 57th Street

New York

NY 10019

United States

Tel: (1.212) 554 0600

Fax: (1.212) 586 1181/2

E-mail: newyork@eiu.com

HONG KONG

6001, Central Plaza

18 Harbour Road

Wanchai

Hong Kong

Tel: (852) 2585 3888

Fax: (852) 2802 7638

E-mail: hongkong@eiu.com