TITLE
What funding model will foster SMME development in South Africa?

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LIST OF ABBREVIATIONS

SMME	Small, Medium and Micro Enterprise
DFI	Development Finance Institution
MFI	Microfinance Institution
SEF	Small Enterprise Foundation
DSBD	Department of Small Business Development
IDC	Industrial Development Corporation
GDP	Gross Domestic Product
HDSAs	Historically Disadvantaged South Africans
SDGs	Sustainable Development Goals
SBI	Small Business Institute
RRB	Regional Rural Bank
MFRC	Microfinance Regulatory Council
NCR	National Credit Regulator
MFT	Market Failure Theory
FFT	First Fundamental Theorem
NGO	Non-Governmental Organisation
CEPD	Council for Economic Planning and Development
EPB	Economic Planning Board
KPI	Key Performance Indicator
LLP	Larger Loan Programme
DTI	Department of Trade and Industry
SEDA	Small Enterprise Development Agency
SEFA	Small Enterprise Finance Agency
JSE	Johannesburg Securities Exchange

ABSTRACT

Literature suggests that the Small, Medium and Micro Enterprise (SMME) sector is important to local economic development. SMMEs can alleviate the problem of unemployment while being efficient and flexible by serving segmented consumer markets. First, this study investigates whether SMMEs have been the key drivers of economic development in South Africa. Second, the role of Development Finance Institutions (DFIs) in the financing of SMMEs and their funding models. Finally, the research presents a case study of a small private financial institution, the Small Enterprise Foundation (SEF), a Micro Finance Institution (MFI) in South Africa and its significant contribution to the SMME sector and economic development. The study found that the SMME sector remains largely under-serviced by the traditional financial institutions and DFIs, due to the reluctance to grant loans as a result of the lack of knowledge on the borrowing behaviour of SMMES. The case study of the SEF also showed significant funding gaps experienced by microenterprises that receive funding from it. The study concludes by making recommendations that the role of DFIs needs to be enhanced by using a key governmental department such as the Department of Small Business Development (DSBD) to be a key coordinator of SMME programmes among DFIs such as the Industrial Development Corporation (IDC).

Keywords: SMMEs, DFIs, Funding

CHAPTER 1: INTRODUCTION

South Africa's transition into a democratic dispensation in 1994 brought hope and expectations of an inclusive economy, particularly for the Historically Disadvantaged South Africans (HDSAs). The economy grew at average Gross Domestic Product (GDP) growth rate of 2.25 percent between 1994 and 2020 (StatsSA, 2021). Before the impact of the Covid-19 pandemic were even recorded, statistics showed that more than 30 percent of the people were unemployed (Le Pere, 2021). By the first quarter of 2021, the unemployment rate was at a staggering 32.6 percent (Le Pere, 2021), with the worst affected group being women in active employment having lost their jobs in the first 2 months in which the government introduced strict lockdown measures as a result of the pandemic. Furthermore, globally, South Africa has been rated as one of the most unequal societies with a Gini coefficient of 0.63 (World Bank, 2021). This inequality is maintained by the legacy of apartheid which excluded many historically disadvantaged groups in society, particularly black people, from participating in the economy.

Moreover, the structure of the South African economy does not create enough job and employment opportunities and tends to disadvantage the poor (Goga, Bosiu, & Bell, 2019). At the heart of these adversities is the failure to restructure an economy that thrives on the capital-intensive and resource-based industries (Goga *et al.*, 2019).

Integrating into the global economy has provoked an argument of whether the South African economy has potential to grow significantly by creating competitive advantage for domestic industries. Kesper (2000) argues that the experience of successful Small, Medium and Micro Enterprises (SMMEs) in industrialised economies, particularly in Japan and Europe, implies that the SMME sector is important to economic development of countries. This sector is believed to alleviate the problem of unemployment while being efficient in flexibility by serving consumer markets that are segmented. This debate has therefore been taken up in the South African context where the SMME sector constitutes a large majority of businesses and is expected to play a key role in driving South Africa's economic development. In South Africa, SMMEs make up 91 percent of formal entities, which provide approximately 60 percent of employment and contribute approximately 51 percent to GDP (FinMark Trust, 2021). However, research has revealed a gap in the policies for SMME development and the reality faced by these enterprises. For example, the International Finance Corporation (2019) in its study found that 85 percent of the SMMEs in South Africa are survivalist and informal businesses. It also found that SMMEs struggle to grow and graduate to large businesses due to the business environment in which they operate in that does not necessarily support their growth. This is exacerbated by the regulatory red tape that stifles growth and the uncoordinated support for SMME development. These challenges therefore result to poor business sustainability and poor rates of business formalisation.

The SMME sector in South Africa is also not homogenous, therefore it requires a set of policy tools that are fine-tuned rather than the broad forms of assistance that are available to these enterprises (Kesper, 2000). It should also be acknowledged that only a small portion of dynamic enterprises show potential to create employment, while the survivalist enterprises, which result from 'enforced self-employment', constitute a majority of the country's SMME economy. Moreover, the performance of SMMEs does not only depend on the removal of barriers to entry or the removal of other restrictions such as public regulations. Instead, they also depend on organisational and industrial structures, the aspirations and capabilities of the entrepreneur, as well as the adaptiveness of the firm.

At the heart of these challenges faced by SMMEs, the lack of funding for this segment of the economy remains a major obstacle. Capital and financial markets allocate resources to businesses for the purpose of achieving economies of scale in order to gain competitive advantage by creating markets through prospects for diversification and capabilities expansion. However, SMMEs are often undercapitalised as commercial banks are reluctant to grant loans to start-up ventures without significant monetary commitment from the entrepreneurs, due to the risk associated with start-ups (Musacchio, Lazzarini, Makhoul, & Simmons, 2017). In the South African context, Ngema (2011) found that lack of knowledge and information on the borrowing patterns, experiences and preferences of SMME owners in accessing funding from the traditional banking system is a barrier for banks to finance these groups as they usually fall under the low income segment.

In order to address the issue of commercial banks underserving start-up ventures, complementary and specialised financial institutions such as microfinance institutions (MFIs) and development finance institutions (DFIs) have been created in many economies where the traditional financial system has been found lacking in providing the necessary funding for industrialisation and development.

The study will therefore review the microfinance industry as one of the prevailing financing models for SMMEs. It will also review the role of DFIs as important role players in contributing strategically to South Africa’s economic development agenda as they have been identified by the government to be key levers for supporting SMMEs.

During the apartheid era, the development finance system and the national industrial policy prioritised large scale capital-intensive projects. DFIs were a crucial tool to the state’s plan of a government-led industrialisation. DFIs were involved in shaping the enterprise sector with the main aim of providing cheap access to network infrastructure and public finance as well as lowering strategic costs for businesses (Le Pere, 2021). This choice of using DFIs by the apartheid government as means of growing its presence in the economy was a result of the increased international isolation, pressure and the devastating effects of sanctions. The regime also wanted to control the highly concentrated private sector. DFIs were therefore an important component for the state to successfully develop a racially-based industrial economy that cushioned against the devastating effects of sanctions (Le Pere, 2021).

This study seeks to argue that, even though financial intermediaries such as MFIs exist, they fail to provide the necessary funding and support needed by SMMEs to grow. The paper concludes by arguing that in order for the national objectives to be met, the role of DFIs needs to be significantly enhanced through using a governmental department or agency to coordinate with all relevant sectors and stakeholders.

1.1 Research question

This study evaluates the current funding models available for SMMEs by investigating the funding challenges experienced by SMMEs in South Africa. The study seeks to address the following questions:

1. What funding models currently exist for SMMEs in South Africa and what are the characteristics, benefits and challenges of these models?
2. What is the role of DFIs in SMME development?
3. Do they crowd-in or directly compete with private institutions?
4. How should the state intervene and address the financing and funding gap of SMMEs in order to achieve economic development?

1.2 Research methodology

This study evaluates the predominant financing models used to fund micro enterprises in South Africa by exploring the contribution of the Small Enterprise Foundation (SEF), an MFI in South Africa, providing finance to SMMEs. The study undertakes a case study approach which is considered as a useful approach to examine data at the micro level by researchers and can be used as an important tool when a large sample size is challenging to obtain (Mishra & Rasundram, 2017). The authors assert that even though case studies provide better insight on the behaviours of the subject of interest and present data of real life situations, they are criticised for their inability to generalise results. However, Flyvbjerg (2006, p.228) argues "one can often generalize on the basis of a single case, and the case study may be central to scientific development via generalization as supplement or alternative to other methods." Therefore, in order to address this concern and to prevent any potential bias that could result from using a single type of methodology, primary data through interviews and secondary data through a desktop research will be assessed. Interviews will be semi-structured, open-ended interviews with a sample of 15 SMME owners financed by SEF. The questions will be open-ended to allow participants to elaborate and offer in-depth details to questions. Furthermore, a sample of 15 SMME owners who have not received any finance from the traditional financial institutions have been targeted through a survey and in person interviews in order to compare their experiences with those funded by SEF. The interviews are conducted to supplement the desk top research by obtaining empirical evidence. The study had no funding and therefore had to limit the number of participants to 30 SMME owners within the Johannesburg and Tshwane Metropolitan Municipalities. Various sources of secondary data including official documents from SEF, scientific journals within the SMME context, reports from Statistics South Africa, private and public agency reports and previous studies were assessed. Responses were analysed and evaluated using techniques such as tabulation and graphs.

1.3 Overview of chapters

The paper is structured as follows: chapter 2 reviews the overall literature on SMMEs and challenges in access to finance and then narrows down the focus by reviewing the SMME sector in the South African context and how it contributes to economic development. Chapter 2 then concludes by reviewing the literature critiquing the SMME-led approach. From the challenges, particularly funding challenges, faced by SMMEs that have been noted in chapter 2, chapter 3 provides an overview of the prevailing financing models by firstly reviewing the conventional financing models and their pitfalls; the microfinance model, used to fund SMMEs, and how it has played a role in SMME development and its pitfalls. Given these challenges, chapter 3 then discusses the developmental finance institutions that were established by the government in order to provide financial services to SMMEs, particularly in the South African context. Chapter 4 discusses the survey methodology from the case study conducted at SEF whereby a comparison regarding the experiences for SEF-funded microenterprises and self-funded microenterprises are be made. Lastly, chapter 5 provides a conclusion and policy recommendations for SMME funding in South Africa.

CHAPTER 2: LITERATURE REVIEW

In this chapter I review the literature on the role of SMMEs and their contribution to economic development particularly in Africa. I then discuss the role of SMMEs in the South African context by examining its contribution and importance in the economy, how it is segmented in the different credit ecosystems and the different challenges, especially funding challenges faced by SMMEs in South Africa. Lastly, I review the critiques of the SMME-led approach by bringing in literature from different scholars who have noted shortcomings in the arguments in favour of SMMEs.

2.1 The role of SMMEs for development

According to Duarte (2004), in development literature, the role of SMMEs is important not only because they are defined as engines of growth but also because they are the largest of firms in the economic activity. Small firms have an important role for many economies and their weight in the industrial fabric of most industrialised economies is above 80% and they are much easier to describe than to define (Duarte, 2004). Moreover, these small firms have an important role on many aspects such as employment, taxes or innovation that most times are regarded as the responsibility of large firms. Duarte (2004) argues that in "The Theory of Economic Development" Shumpeter (1934) emphasises the role of the entrepreneur as a prime cause of economic development and that this development is achieved through innovation. This means that if the entrepreneur has an important role to play in economic development, the role is achieved through the institution that the entrepreneur represents which is the firm. The firm therefore can be a small, medium or micro enterprise.

There is no standard definition for SMMEs and according to FinMark Trust (2021), there are more than 200 definitions used by organisations across 155 economies. The definitions for SMMEs can comprise of more than one variable and the three common variables used are: number of employees (which is the most commonly used variable); the value of total assets, and annual turnover (International Finance Corporation, 2019; FinMark Trust, 2021). Almost in all economies, SMMEs comprise of the following number of employees: micro (1 to 9 employees on average); small (10 to 49 employees on average); medium (50 to 100 employees on average) (FinMark Trust, 2021). The size of SMMEs is an important factor on their success because it allows some flexibility, which is difficult to find on the large firms. Duarte (2004) argues that through their flexibility and their potential for employment creation, SMMEs can play a major role in regional development. This is because SMMEs are more flexible, adaptable and are speedier than larger organisations. Moreover, small firms typically rely on flexibility and timely responsiveness to customer needs to create and serve profitable niche markets and this quick response to market signals is vital for the survival of small firms. On the other hand, SMMEs can also be understood to play a dynamic role. From this point of view, small firms might enter the market in order to provide a fairer income distribution among the firms operating in a certain business to bring innovation using their knowledge either with a new idea or from past experiences. This suggests that small firms, at least in some situations, are not smaller clones of the larger incumbents, but rather agents of change through innovative activities (Duarte, 2004).

It is said by Kongolo (2010) that based on the “small is smart” phrase, successful businesses are those that continuously introduce new or improved varieties of products. Moreover, SMMEs have the ability to produce goods and services at lower costs and can therefore sell at lower prices. As a result, they play an important balancing role at the micro and macroeconomic level. Chimucheka (2013) argues that the middle class in society therefore corresponds well with SMMEs and as a result counter-balance oligopolies and monopolies by reducing their capacity to control the market. This results to benefits for society as more people have access to goods and services they would not ordinarily have access to without SMMEs providing them at more favourable prices.

It is further argued by Duarte (2004) that SMMEs all over the world have a very representative weight for economies and for local development. SMMEs are considered as the ‘back-bone’ of local economies in Europe while in the Asian financial crisis they were depicted as ‘an army of ants’ for Taiwan to fight the financial crisis. With regards to Africa for example, Duarte (2004) points out three main categories of local economic development initiatives that act as policy instruments, namely: community economic development; enterprise development; and locality development. On the community economic development initiative, SMMEs are perceived to contribute to housing improvements and settlement upgrading for basic service delivery as a way to stimulate the economy in the community.

On enterprise development initiative, the clustering and specialisation of firms may contribute to the emergence of agglomeration economies. This agglomeration might bring to local producers knowledge spill-overs, spin-off activity advantages, and the creation of new start-ups (Duarte, 2004). Rogerson (2003) further argues that small enterprises were successful in developed countries because of the development of industrial or enterprise clusters. An enterprise cluster can be defined as a collection of entrepreneurs who are involved in creating similar or the same products while being in the same location which enables them to be close to each other (Rogerson, 2003). One of the key aspects of this close working relationship between enterprises is the possibility for positive imitation and learning effects as well the possibility for technology diffusion among small enterprises. Even though having numerous producers in one location increases access to markets, which is important to small enterprises, the benefits realised by these enterprises is not adequate to bring about progressive enterprise cluster development. Instead, these enterprises must intentionally be pro-active around issues of common concern and pursue joint achievements (Rogerson, 2003). These joint achievements therefore imply that because of the closeness of these enterprises, they should be able to assist each other in terms of suppliers and customers and share information on issues of common concern. This makes clusters to enjoy the flexibility and efficiency gains which individual producers hardly attain. Finally, the locality development initiative corresponds to the management of the entire local territory and includes all the local planning, infrastructure development and the creation and expansion of socio-economic overhead capital (Duarte, 2004).

According to Rogerson (2003), the SMME sector is prioritised in Africa's policy agenda for economic development. This is because the main contributions of SMMEs are in creating employment, alleviating poverty and contributing to economic growth. This has therefore made SMMEs to no longer be side-lined but to rather play a key role in development planning for Africa. It is said by Endris and Kassegn (2022) that entrepreneurial activity is important to the achievement of multiple Sustainable Development Goals (SDGs), including SDG 1: "End poverty in all its forms everywhere"; SDG 8: "Promote inclusive and sustainable economic growth, employment and decent work for all"; and SDG 10: "Reduce inequality within and among countries". SMMEs can therefore be said to play an important role in job creation, providing two-thirds of all formal jobs in developing countries and 80% in low-income countries (Endris & Kassegn, 2022). The sustained success of SMMEs therefore depends on local conditions, such as public services, good corporate law and access to finance. Moreover SMMEs contribute more than 50% of most of African GDP and an average of 60% of employment (Endris & Kassegn, 2022).

Endris and Kassegn (2022) in their study emphasised the role SMMEs have played in employment creation in Africa. The authors noted that the informal sector has been a growing source of employment for a large section of the African youth, as well as for older workers trying to seize entrepreneurial opportunities. The authors argue that SMMEs contribution to GDP and poverty reduction has been substantial, and has become a major point of entry into the labour market. Moreover, the promotion of SMMEs has been a key area of intervention in recent years in view of the major employment challenges. For that reason, the employment share of the self-employed in low-income countries is almost five times (54%) the share in high-income countries (11%) (Endris & Kassegn, 2022). SMMEs have also embraced technological innovations in creating new opportunities as well as expanding their businesses. In particular, high mobile phone penetration has brought opportunities to SMMEs in rural and urban areas of Africa.

Endris and Kassegn (2022) argue that although SMMEs in Africa generate a large percentage of new jobs, they also account for most lost jobs. Kesper (2000) and Rogerson (2003) argue that the SMME economy in Africa is dynamic and is in a constant state of change and influx, with new enterprises being established and existing enterprises closing down. Furthermore, there are no scarcity of SMMEs as new firms are started at a fast rate, however, the vast majority of these tend to be operated by one person, which is usually the owner. Endris and Kassegn (2022) found that there is a large concentration of enterprises in sub-Saharan Africa, with 44 million SMMEs, of which 97% are micro-enterprises. Even though SMME start-ups may occur as a consequence of supply-push and demand-pull circumstances, in the African experience, this may not always be the case. Evidence suggests that a large number of enterprises in Africa have been established due to enforced entrepreneurship instead of market opportunities. For example, the International Finance Corporation (2019) found that a significant amount of SMME start-ups are driven by necessity, largely from unemployed individuals with no source of income. While FinMark Trust (2021) also noted that more than 60% of individuals who start businesses in South Africa do so because of unemployment.

Endris and Kassegn (2022) have also noted that entrepreneurial activity in low-income countries dominated by individuals who are forced into starting their own business due to unemployment are typically not highly productive. This therefore limits the SMME sector in contributing to employment needs in a sustainable and real way and limits their chances of scaling. These types of businesses in Africa are also typically the least remunerative and the least efficient. In general, they also tend to be established in large quantities, particularly in markets with the least barriers to entry and low returns (Kesper, 2000; Rogerson, 2003). Essentially, SMMEs in the continent are in a state of excess supply of unskilled and unorganised labour, which transmits the problem of unstable markets to workers and bases competition on reducing labour costs instead of upgrading technology. This is unlike in the example of the Asian giants such as South Korea where large enterprises function as catalysts for growth.

While the debate for improving the policies for SMMEs in Africa was mainly centred around and influenced by the discussion of the 'Asian Miracle', however, in the African context, the miracle has been somewhat different. This is because the conditions faced by many SMMEs in Africa mainly restrict them to being survivalists (Rogerson, 2003). This is to say, the issue for SMMEs in Africa is to turn enterprises from being survivalist into dynamic enterprises of growth. This can be achieved by accepting that SMMEs can play an important role in growth and change, however, achieving this on their own is a challenge. Therefore, if policy tools are to be applied in order to support SMMEs, the first critical step is to recognise their dynamics in how they change and grow over time.

2.2 The role of SMMEs in the South African context

In Sub-Saharan Africa, the country with one of the highest levels GDP per capita is South Africa, however despite this, the country is one of the most unequal societies (International Finance Corporation, 2019). The high unemployment rate, particularly among the youth and the previously disadvantaged communities, has contributed to the inequality. Therefore, SMMEs make a substantial contribution to reducing the unemployment levels (International Finance Corporation, 2019). It can also be argued that the government has made great strides in supporting SMME development in South Africa. The significance of SMMEs is recognised within the National Development Plan and a number of institutions were created in support of SMMEs (International Finance Corporation, 2019). After creating an Integrated Small Business Development Strategy in 1995 and legislating the Small Business Act in 1996, the South African government in 2014 created a new department to channel additional funds and consolidate public sector support for SMMEs.

The Department of Small Business Development (DSBD) was therefore established under the Department of Trade and Industry (DTI). The mandate of the DSBD is to lead and coordinate an integrated approach to the promotion and development of entrepreneurship, SMMEs and cooperatives, and to ensure an enabling legislative and policy environment to support their growth and sustainability (Department of Small Business Development, 2023). The DSBD has two implementing agencies which are the Small Enterprise Finance Agency (SEFA) which provides financial products and services to qualifying SMMEs and cooperatives and the Small Enterprise Development Agency (SEDA) which provides non-financial support to small enterprises and cooperatives (Department of Small Business Development, 2023).

The International Finance Corporation (2019) found that the degree to which the South African government prioritises SMMEs within local and national government policies is satisfactory. However, the follow-through and the execution of these programmes is poor because there is lack of information available on the support services available to SMME owners and how they can access them, meaning that the owners are not making use of them. The International Finance Corporation (2019) also noted that because the DSBD is a relatively small department with only 0.2 percent of departmental budgets back in 2019, it is constrained and unable to deliver its large mandate. Moreover, the department's broad coverage scatters information and makes it difficult to measure the effectiveness of policies, together with the lack of data available for the results of support programmes for SMMEs. Regardless of this, SMMEs are still regarded as important for South Africa's economic development and below are the reasons.

Employment creation: According to Kesper (2000), SMMEs address the issue of high unemployment rates as they have a high labour absorption capacity. The FinMark Trust (2021) found that in South Africa, SMMEs employ approximately 60 percent of the work force.

Economic growth and development: According to Chimucheka (2013), SMMEs are the vehicles by which those in low income households in South Africa are able to gain access to economic opportunities. Moreover, they are seen as one of the major drivers in economic development as they enhance entrepreneurial development and private business growth. The FinMark Trust (2021) found that SMMEs contribute approximately 51 percent to South Africa's GDP.

Poverty alleviation: According to Chimucheka (2013), SMMEs are identified by the South African government to be the key to poverty alleviation as they combine resources to produce goods and services efficiently for the society in which they operate in.

Equity and participation: The SMME sector has also been observed to be the main absorber for marginalised segments of the population, such as poor communities, women, and the youth (FinMark Trust, 2020). Kesper (2000) also argues that SMMEs redress past inequalities that were inherited from the apartheid regime in terms of restricted career opportunities for black employees and patterns of economic ownership.

Social stability: SMMEs play a vital role in the efforts to meet society's basic needs in the absence of social support programmes, which refers to South Africa's SMME market and the survivalist activities characterised by low barriers of entry for job seekers that are inexperienced (Kesper, 2000).

Competition: It is said by Kesper (2000) that SMMEs promote competition by creating niche markets in which they grow in domestically in order to be able to respond to changes in demand and be able to compete internationally due to their flexibility. Furthermore, they are considered to adjust at short notice and are adaptable to dynamic market demand and supply; while also broadening economic activity by increasing employment and contributing to international trade (Gyimanh & Agyeman, 2019). When SMMEs compete with each other, consumers also benefit in terms of price and quality (Chimucheka, 2013).

Even though it can be said that the SMME sector has been growing and contributing to the South African economy, the International Finance Corporation (2019) argues that these numbers do not tell the full picture. This is because there are major differences across business size and whether they are characterised as formal or informal. Moreover, the International Finance Corporation (2019) in its study found that the SMME sector in the country has been stagnant with findings from StatsSA back in 2017 showing that there were 2.309 million enterprises in that year compared to the 2.019 million back in 2008 (International Finance Corporation, 2019).

Since there is no set definition for SMMEs, the Small Business Institute (SBI) in its 2018 analysis of formal SMMEs, set out to apply a clear definition of SMMEs, since they are defined differently in policy documents, statistical studies and legislation. The SBI used size definitions determined by the number of persons associated with a firm. Figure 1 below shows the SMME sector size by number of employees.

Figure 1: SMME size by number of employees

Category	Employees	Fraction of total	No of businesses
Microenterprise	**0 to 10**	84.8%	2 219 026
Small enterprise	**11 to 50**	14.4%	375 809
Medium enterprise	**51 to 250**	0.8%	20 916

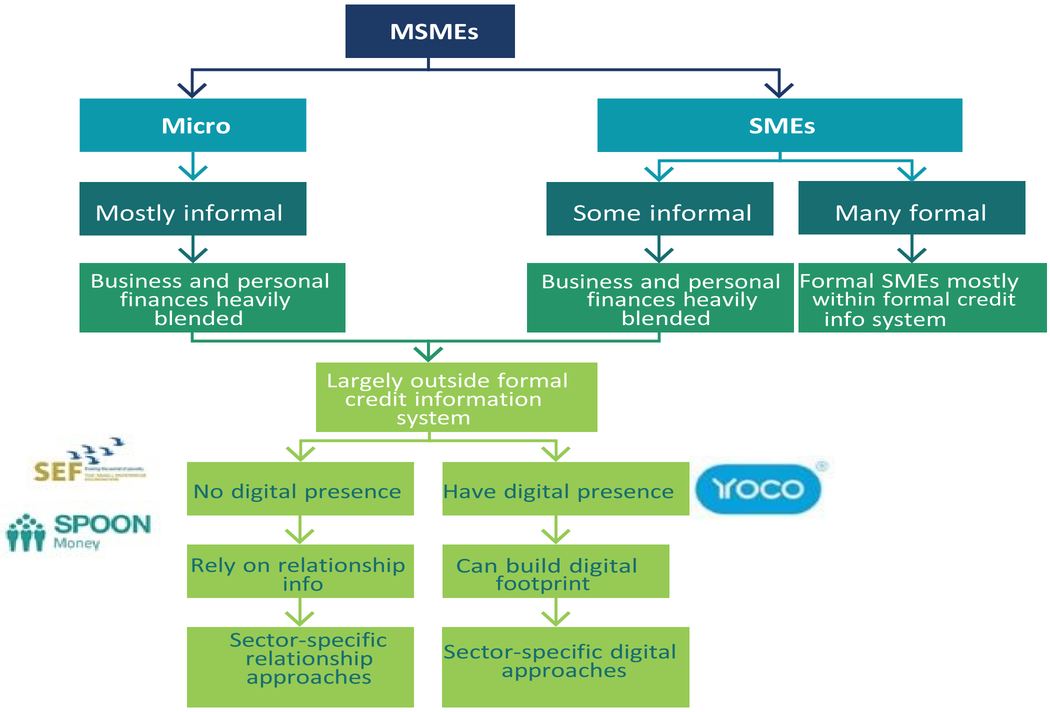
Source: FinMark Trust (2020)

From the figure above, it can be observed that the definition for SMMEs is linked to the number of employees employed in the firm. However the measure used for this definition does not provide enough context and it might be unsuitable in distinguishing the different requirements for the different types of SMMEs. For example, according to FinMark Trust (2021), a highly specialised services enterprise may only have a few personnel working for it, therefore making it to be regarded as a microenterprise. However, the same enterprise may have special financial requirements, while an enterprise employing numerous personnel may still struggle with the issue of being survivalist. Therefore, carefully thought out approaches are required in considering the funding needs of SMMEs.

When it comes to the provision of finance to SMMEs in South Africa, formality is an important segmentation factor, as it defines the extent to which SMMEs have integrated into the credit information system particularly with regards to their size (FinMark Trust, 2021). For example, large enterprises are likely to be registered, have a business bank account, have higher annual turnovers, a tax number and a licence or permit to run operations. These are often the prerequisites required by commercial institutions in order to provide funding to SMMEs, and this consequently makes formal businesses to be incorporated into the formal credit information system. In the case of informal enterprises, there is no difference between business finances and the personal finances of the entrepreneur. Therefore, when finance is provided to these informal businesses, financial institutions regard the credit as individual loans.

The formal and the informal SMME spaces in South Africa are different and they typically access credit from different sources, thereby making them to participate in different credit ecosystems (FinMark Trust, 2021). The SMME category a firm falls under, determines the information systems that the firm will be captured under as well the lending approaches available to the enterprise. Figure 2 below outlines the different systems.

Figure 2: SMME credit approach and information type segmentation.



Source: FinMark Trust (2021)

Figure 2 above shows that there is hardly any information-sharing between the informal sector of micro financing and the formal credit segment. This makes enterprises to function in one of the credit ecosystems and only overlap temporarily before they grow and move to formal credit (FinMark Trust, 2021).

Rogerson (2008) found that in terms of demand-side research, studies have shown that lack of access to finance is a constraint to SMME development. Moreover, issues of poor access to credit and high interest rates were underpinnings of low usage of formal bank loans and were exacerbated by complex application processes, lack of collateral and credit history (Rogerson, 2008). While Fatoki and Odeyemi (2010) found that the failure rate of SMMEs in South Africa was 75%, which was one of the highest in the world, due to lack of finance as a result of about 75% of all applications for bank credit being rejected. Across different phases in SMME development, different financing requirements have been observed. According to Rogerson (2008), there is a distinction between the financial needs of the minority or traditional white-owned enterprises on the one hand, which enjoy access to finance through family or friends or equity in property, and, on the other hand, of the larger group of emerging enterprises from previously disadvantaged communities, which present the biggest challenge in SMME development. The majority of the disadvantaged group have neither their own or friends or relatives resources; no possible collateral and no access to traditional debt due to their fragility and risk of failure (Rogerson, 2008).

The two primary sources of external finance for new SMMEs are equity and debt. However, external equity in the form of the stock exchange or venture capital is usually not available for SMMEs (Fatoki & Odeyemi, 2010). Furthermore, the lack of venture capital funds makes new SMMEs dependent on bank loans and suppliers of credit for their early stages of financing. Despite this dependence on debt finance, SMMEs in South Africa have very limited access to commercial bank loans because commercial banks hesitate to lend to SMMEs. Endris and Kassegn (2022) found that 79% of informal businesses in South Africa have never obtained a loan, and only 21% utilised bank loans. From this, only 19% of formal businesses used a bank loan to start their business (Endris & Kassegn, 2022). On the supply side of financing, it was revealed that banks are servicing only the upper end of the small business market because of the high risk of default when banks grant credit, high cost of screening, and low returns associated with the lower end of the market (Rogerson, 2008).

SMMEs in South Africa also face several challenges that affect the environment in which they operate in. Firstly are the regulatory and legal barriers which include challenges relating to the labour law requirements that are restrictive; the business insolvency regime; and property rights issues. Secondly there are issues related to the business environment and these include complying with the tax system and the burdensome business registration process. Thirdly, there are challenges relating to entrepreneurial competency which include limited training programmes for enterprise development and inadequate business capability. Fourthly, there are challenges relating to access to infrastructure which include access to and the cost of ICT infrastructure as well as physical infrastructure bottlenecks such as electrical supply. Fifthly, there are challenges relating to access to markets, which include government procurement compliance standards and the opportunity to partake in downstream and upstream commercial value chains (International Finance Corporation, 2019). Lastly, Mutezo (2005) found that SMMEs fail in South Africa due to lack of education and lack of entrepreneurial culture. Fatoki and Odeyemi (2010) point out that lack of education and training has reduced management capacity in SMMEs in South Africa and is one of the reasons for their high failure rates. This suggests that managerial competency will have an impact on access to finance by new SMMEs.

2.3 Critique of SMME-led approaches

Castel-Branco (2003) has argued that in development literature, SMMEs have had a privileged treatment. This is mainly attributed to the fact that there have hardly been arguments against SMMEs, even if policies related to development do not favour them necessarily. Moreover, the importance and the role of SMMEs is highlighted in almost all corners of economic programmes and development literature, especially in developing economies where the role of SMMEs is largely emphasised even if the results are different to what is regarded as the norm. This therefore makes the SMME rhetoric to be a favoured policy tool within literature (Castel-Branco, 2003). However, there are major problems related to this debate that this literature review will explore.

Firstly, the definition of SMMEs varies significantly across the board and is typically related to the degree of development and the scale of the economy. SMMEs can be defined with regards to the scale of operations of the enterprise or according to the amount of personnel employed. Defining SMMEs with common indicators is difficult and raises problems because the definitions are also dependant on other economic indicators. For example, the definition can be different for studies discussing SMMEs in countries of different structures but of similar status - such as studies about South Korea and Taiwan, Mozambique and Kenya. The definition of SMMEs is very different in these studies because what is small and medium in each country, is dependent on issues that are exogenous to the definition of an SMME (Castel-Branco, 2003). Furthermore, the author argues that there is also no universal concept of SMMEs, which therefore makes SMMEs an inadequate tool for policy making and economic evaluation.

Secondly, since SMMEs are defined very differently, this can result in many challenges in setting common policies and analytical tools that are aimed at successfully addressing the SMME issue. Moreover, there can never be policies to adequately address the issue of SMMEs. Instead, policies need to be aligned with development goals such as the nature of industrialisation, the skills to be developed, and the type of markets and technology to be addressed (Caste-Branco, 2003). Thirdly, the difference in the definition of SMMEs depends on economic and social processes. These differ between creating and mobilising the informal sector and creating and mobilising the domestic capital, while also differing between technological innovation dynamics and the labour market dynamics. This therefore makes the problems aimed at addressing SMME issues to be very different, too many and not clear as to whether they are the best tool in solving and understanding such dynamic processes (Castel-Branco, 2003).

Under these above mentioned conditions, it can therefore be said that the list of arguments for SMMEs is almost endless for development practitioners and scholars to deal with. These include, for example: market flexibility; employment creation; market proximity and fragmentation; rent-seeking and political and economic power; accessibility to domestic capital; controversial debates about economies of scale and scope; the creation and mobilisation of entrepreneurial spirit; and the exploration of factor endowment based comparative advantages, amongst others. Therefore, it can be argued that the kind of challenges that SMMEs are expected to solve are almost infinite and are, in itself, a problem because while they are presented as a solution to solving the issues of development, they are rarely seen as having potential pitfalls and shortcomings (Castel-Branco, 2003). It also appears as though an enterprise being small would make it less hazardous and more able to solve and avoid the harm created by bigger enterprises. However, there is no single policy or institution that can address all the problems in an economy.

From the arguments presented above, it can therefore be argued that the main problem of having one unclear policy tool is that it can result in many conflicting goals in SMME approaches. For example, SMMEs are commonly defined by the number of small employees, which suggests that, possibly, they are capital intensive. This could conflict the goals of creating employment, promoting national entrepreneurship, exploring factor endowment led comparative advantages, and adapting to market demands and conditions. Being capital intensive would also undermine the goal of factor market flexibility as it would raise a question on the problem of labour skills (Castel-Branco, 2003). Moreover, unlike Rogerson's (2003) argument that favours enterprise clusters, it can be said that numerous small enterprises within the same industry are likely to result to unproductive rent-seeking. Kesper (2000) has stated that while the enterprise clusters in the Latin American experience proved the dynamism associated with SMMEs, in the African context, there is lack of evidence of micro enterprises graduating into large corporations. Gyimah and Agyeman (2019) also argue that even though SMMEs in developing countries tend to create more jobs, large corporations typically create sustainable jobs, offer higher wages and training, and are usually more productive. Moreover, larger companies usually support multiple direct jobs through their distribution networks and supply chains. Another problem of SMMEs is that, many exit the markets and therefore the job creation argument yields low job creation returns in the long term.

Even though the benefits (and shortcomings) of SMMEs have been documented, the willingness of traditional and commercial banking institutions to provide finance to microenterprises has been limited. Providing finance in the economy, particularly for the historically excluded is intertwined with improving and alleviating the problems of unemployment, poverty and inequality. There is therefore a need for 'patient capital' for new businesses to develop. The next section will discuss the financing models available to SMMEs.

CHAPTER 3: PREDOMINANT SMME FINANCING MODELS

In this chapter I discuss the financing sources available to SMMEs particularly the conventional financing models used by traditional banks. I then review the microfinance model as well as its pitfalls. Thirdly, I review literature on development finance institutions and how they have been agents of economic development for countries, particularly South Africa. This section also highlights the different types of DFIs in the country and how they have contributed to SMME development since their inception. Lastly, this section will draw from international experiences on the role of DFIs in the economy and provide an overview of the critiques noted by scholars regarding the presence of DFIs.

3.1 Equity

Start-up capital for SMMEs can be in the form of debt or equity financing. According to Mutezo (2005), debt financing is a method that involves a loan, the repayment of which is only directly related to the sales and profits of the business. Debt financing requires that some asset such as a house, land or a car be used as collateral. Equity financing on the other hand does not require collateral and offers the investor a form of ownership position in the business (Mutezo, 2005). Equity can come in the form of the owner's contribution, and contribution from friends and family which are an important source of SMME financing (Leroy, 2012). According to Mutezo (2005), equity can be divided into internal and external equity where internal equity enhances the credibility of the SMME when sourcing external funding. Moreover, equity provides long-term financing with minimum cash flow challenges that are usually associated with debt financing. However, there exists a trade-off between debt and equity financing for the SMME owners with regards to potential financial risks, profitability and voting control. Mutezo (2005) argues that while equity funds have been seen as a way to stimulate the growth and development of SMMEs, particularly those owned by the previously disadvantaged, the preferred investment ranges are too high to significantly reach these enterprise sectors.

3.2 Bank finance

According to Mutezo (2005), commercial banks are the most frequently used source of short-term finance by the entrepreneur when collateral is available. The funds provided by commercial banks are in the form of debt financing, and as such, require some tangible guarantee or collateral. Collateral can be in the form of business assets such as land, building, equipment or personal assets such as the entrepreneur's car or house (Mutezo, 2005). In general banks have two main loan products for SMME financing namely term loans and overdrafts.

Leroy (2012) defines a term loan as a form of finance which creates a fixed obligation to make cash payments and requires the payment of interest for its use. A term loan is usually classified into short and long term with short term loans usually being less than three years and being repaid in monthly instalments from the business cash flow, while long term loans usually run for between three to ten years (Leroy, 2012). Overdrafts on the other hand according to Leroy (2012) also assist SMMEs with short term working capital in order to meet their day to day expenses. When banks grant overdraft facilities, they enable SMMEs to overdraw and use funds which are over and above the funds available on the businesses' account. However, a bank overdraft is an expensive source of finance for SMMEs in South Africa and increases their risk (Leroy, 2012).

The shortfall to bank finance is that banks are not optimally configured to provide finance to SMMEs and this is due to the fact that they developed in an economy dominated by large enterprises (Ngema, 2011). Commercial banks lack the set of skills necessary for assessing and mentoring start-ups and small enterprises. As a result their assessment and decision making, and consequently their products are not tailored to the specific needs of entrepreneurs. Commercial banks in most cases refuse to grant loans to SMMEs for the following reasons (Mutezo, 2005):

- There is a high risk that the SMME owner will default on loan repayments due to insufficient cash flow
- Due to the limited resources and poverty conditions experienced by most SMME owners, they may not have adequate collateral to secure their loans
- The administrative costs involved in screening applications is too high

- Commercial banks receive low returns when investing in the SMME sector
- SMME owners, particularly the previously disadvantaged, experience cultural and language barriers when accessing banks

Despite this dependence on debt finance, SMMEs in South Africa have very limited access to commercial bank loans because commercial banks hesitate to lend to SMMEs. Endris and Kassegn (2022) found that 79% of informal businesses in South Africa have never obtained a loan, and only 21% utilised bank loans. From this, only 19% of formal businesses used a bank loan to start their business (Endris & Kassegn, 2022). Mutezo (2005) also found that many SMMEs in South Africa have no access to certain sources of finance due to barriers of entry. For example, most SMMEs are automatically excluded from certain financial forms, such as public sources like the Johannesburg Securities Exchange (JSE) (Mutezo, 2005). They also face difficulties raising certain types of finance such as long term loans because of the high risk associated with their businesses which have little equity in the form of share capital.

3.3 Microfinance Models

Most SMMEs all over the world experience problems of access to finance due to the low risk propensity of financial institutions and this is due to the fact that most SMMEs owners especially in the informal sector, are poor and do not have any form of collateral as security (Mutezo, 2005). Microfinance provides an important source of funding for those SMMEs excluded from the formal financial institutions (Mutezo, 2005). Microfinance can be defined as providing credit to the poor groups in society, not served by the traditional banking system, through using poverty-focused financial providers namely Microfinance Institutions (MFIs) (Ngema, 2011). The next section will assess literature on three developing economies which have similar characteristics to South Africa and are facing similar socio-political and economic challenges as South Africa. These are namely India, Brazil, and Kenya. There are many economic and socio-political similarities that India and Brazil share with South Africa, an example being the income distribution gap between the rich and the poor is amongst the largest in the world for South Africa, India and Brazil (Ngema, 2011). Meanwhile, in Kenya, microfinance models for SMMEs are taken seriously. These economies therefore serve as a base in exploring the contributions of microfinance to SMMEs.

3.3.1 Microfinance models in developing countries

India

According to Ngema (2011), historically, poverty alleviation and microfinance were linked, as institutional credit was regarded as an important tool to enhance production and productivity in India. The models selected to extend credit to the poor in a sufficient and timely method were traditional banks, cooperatives and Regional Rural Banks (RRBs). However, there were gaps between the objectives of these institutions and the reality in India due to policy design flaws, weaknesses in implementation and the inability of the government to stop resorting to measures such as loan waivers. As a result, the traditional banking system was unable to lend to the poor as a profitable and a viable activity, but rather as a social obligation (Musacchio *et al.*, 2017; Ngema, 2011). The financial system had to therefore wait for a number of years for the microfinance model to be considered as credible. During this time, policy makers were in search of products and services for the rural and poor population that would be provided for by the financial markets. At the time of this search by policy makers, it was revealed that the poor tend to come together through various informal ways by combining their savings and providing unsecured small credit to group members (Thorat, 2006). It is then, the microfinance industry in 1980 was established, with an attempt to form financial institutions that provided access to credit services and savings mobilisation. The sector has since grown tremendously in India in the past decades.

According to Ngema (2011), the most successful MFI in India is SKS Microfinance, established in 1998 to provide finance to the poor. This MFI only serves women and employs the group-lending model, adopted from the Grameen Bank, as collateral. Using the Grameen model, the women apply for loans in groups of four or five. This model lowers the rate of repayment default as none of the group members can apply for a new loan until all members of the group pay back the loan. SKS, for its profitability and self-sustainability, also implemented a new technologically advanced microfinance model. It also transformed into a fast growing institution by reducing costs. SKS achieved this by preventing waste during the loan process, introduced an efficient management system and used innovative technology (Musacchio *et al.*, 2017).

Brazil

Brazil has one the largest population in the world and is the largest economy in South America with a GDP of USD 1608.98 billion in 2021 (World Bank, 2021). Despite Brazil's wealth, the country has the highest number of poor people in South America. This provides a conducive environment for the microfinance industry to thrive. However, despite this, the microfinance industry in Brazil experienced slow growth rates since its first inception in 1973. The reasons for this slow-take off was the harsh economic climate experienced by the country in 1994; inadequate regulatory framework; and the strong presence of subsidised credit initiatives (Ngema, 2011). These barriers therefore limited the emergence of sizeable MFIs and created numerous challenges within the industry. In recent years however, the microfinance industry has grown substantially and the notable MFI to contribute to this growth is the Banco do Nordeste which is a public regional bank. The most successful product from the Banco do Nordeste is the CrediAmigo which is aimed at providing microcredit to microbusinesses. One of the main reasons the CrediAmigo product is a success is because the bank spent a considerable amount of resources on researching and understanding the needs of the microenterprise sector before developing and launching the programme (Ngema, 2011).

The bank in its research discovered that most microenterprises do not borrow from commercial banks and those that use credit depend more on family, suppliers and moneylenders. This is despite the fact that the interest charged by these groups of moneylenders is far higher than the interests charged by commercial banks. The main reasons for not borrowing from commercial banks were that microenterprises face challenges in meeting credit guarantee and documentation requirements (Ngema, 2011). After taking these factors into consideration, the bank then innovated the CrediAmigo programme. Even though the CrediAmigo is part of a regulated financial institution, the programme has its own customised repayment and disbursement window while other programmes offered by NGOs in Brazil disburse money through cheques which are cashed at banks. Moreover these other programmes focus on specific geographic locations, based on the municipalities they operate in, however, CrediAmigo takes a wider regional approach, thus enjoying the benefits of economies of scale provided by its parent company.

Ngema (2011) argues that although Banco do Nordeste is not open about its best practice approaches, there are several lessons to be learned from the CrediAmigo programme. The important lesson is that state-owned banks or commercial banks can play an important role in the microfinance sector especially if they offer tailor made microfinance products to SMMEs and the poor.

Kenya

Just like in many other African countries, providing funding to the poor has remained a challenge in Kenya. The countries' rural environment is characterised by low literacy levels, high risk and low profitability economic activities, as well as undiversified economies (Ngema, 2011). These conditions have made it unattractive for MFIs and commercial institutions to operate. Like other developing economies, the Kenyan financial services environment is characterised by traditional commercial banks being reluctant to provide financing to microenterprises. This is because microenterprises hardly have any credit history or assets to use as collateral. Other reasons cited are that there are no financial institutions located in rural Kenya due to the perceived risk and high transaction costs and majority of the people living in rural Kenya do not have the money or time for a trip to the banks that exist in town. As a result of these challenges, MFIs such as K-Rep have been regarded as hope for Kenyans in rural areas to have access to credit as they have ventured into developing credit products designed for microbusiness. Some of the approaches used by the MFIs include group lending versus individual lending models and minimalist versus integrated approaches.

Even though these approaches have been a success, it was discovered that clients had some objections regarding the lending practices used by MFIs. Clients claimed to be against the group lending model as it failed to take into account the different characters and behaviours of group members. Others claimed to not like the weekly mandatory meetings due to the sessions taking long to conclude. Other clients stated that they would prefer to have an input or control over the conditions of the loans in terms of the interest rates, the loan size and the loan term (Ngema, 2011).

3.3.2 Microfinance industry in South Africa

Microfinance in South Africa was established in the 1980s with several key role players with different objectives, such as government agencies, for-profit organisations and NGOs, contributing to its growth. The microfinance industry has four phases namely: Pioneer, Break-out, Consolidation and Maturity phase.

The Pioneer phase which occurred from 1980 to 1994 included commercial lenders and NGOs who advanced microfinance products and resulted in their initial success. However, these lenders were operating illegally and were usually charging extreme interest rates (Ngema, 2011). The next phase which was the Breakout phase which occurred from 1995 to 1999, was characterised by rapid growth within the microfinance industry. This was prompted by the exemption in 1992 to the Usury Act of 1968 that eliminated the cap on interest rates on short-term loans. As a result of this move, the microfinance sector was effectively legalised, thus attracting large capital flows from the legal financial sector (Ngema, 2011).

The Consolidation phase which took place from the 2000s onwards was characterised by major tough competition among MFIs due to the excessive growth of the microfinance industry which led to reduced profit margins and increased risks to these institutions (Ngema, 2011). Moreover, the government established a regulatory council namely the Micro Finance Regulatory Council (MFRC) in order to outlaw the payroll lending used as a collection mechanism by MFIs. As a result of the loss of a stable collection mechanism, low profit margins and increased compliance, many MFIs went bankrupt. In 1997, it was estimated that there were approximately 3,500 formal MFIs, however by the year 2000, approximately 1,334 MFIs remained registered (Ngema, 2011).

The Maturity phase is characterised by the establishment of the National Credit Regulator (NCR), which replaced the MFRC as well as the introduction of the National Credit Act of 2007 which removed the previous R10 000 loan size cap. The NCR focuses on increasing access to micro loans for the low end of the market, however, even though the rate of microloans issued continues to increase, the rate of increase has been lower (Ngema, 2011).

The South African financial industry is comprised of formal and informal service providers. The formal financial service providers are key industry players who abide by the regulations and law requirements for operating. Examples of formal financial service products include credit cards, insurance products and savings accounts. While the informal providers are those that do not operate within the legal regulatory framework. This means that informal financial providers provide whatever the market requires and if the products they offer do not gain traction, they abandon them (Ngema, 2011). Examples of informal financial products are burial societies, stokvels and loan sharks. Microfinance activities are usually conducted in areas with marginalised groups in suburban areas with high percentages of low income groups and to a lesser extent rural areas (Moloi & Ntshakala, 2016). Forms of microfinance in South Africa include: NGOs, micro lenders, community or group savings, and informal money lenders.

Non-governmental organisations (NGOs): According to Mutezo (2005), NGOs serve as a network for donor funding and they provide a limited range of products and services. However, NGOs do not have the infrastructure to reach a significant number of SMMEs, hence they only serve a minority of SMMEs (Mutezo, 2005). Moreover, SMME owners are usually not aware that they can receive finance through NGOs and therefore do not pay attention to their role (Mutezo, 2005).

Micro lenders: Micro lenders provide micro loans averaging R1600, over a period of one month, which do not require any form of collateral (Mutezo, 2005). Micro lenders focus on providing relatively short-term, personal loans to salary earners and this therefore limits the loans to only those who are employed. The majority of the loans are for household needs and for balancing income fluctuations, while a small percent of these funds are utilised for business purposes (Mutezo, 2005).

Community or group savings: In South Africa, loan schemes and community or group savings are an important source of microfinance for SMMES although they do not necessarily provide loans. These groups are known as Stokvels. Group savings occur when individuals come together in a group and contribute specified amounts on a rotational basis each month with each member getting a chance to take home the month's collected cash (Mutezo, 2005). In recent years, many of these schemes have used banking services for the safe keeping of their funds. This creates an important link through which they can gradually evolve into specialised banking services and loan facilities.

Informal money lenders: In townships in South Africa, informal money lenders are known as Matshonisa – the term which loosely means "making you poorer" – where loans are provided to blacklisted individuals (Mutezo, 2005). The interests attached to the loans are usually extremely high and borrowers often fall into the debt trap. As soon as borrowers receive their monthly incomes, they are expected to repay their loans and interest (Mutezo, 2005).

It can be said that entrepreneurs use and demand a mixture of financial products that include savings and credit offerings. However, receiving these products from the commercial financial players is a main problem for these households. Ngema (2011) argues that there are few financial institutions that serve the very poor (who supplement government grants with survivalist microenterprises); the economically active poor (who participate in microenterprises in the informal economy) and the destitute poor. There is therefore a debate regarding the role of developmental MFIs in providing financial services to the poor in South Africa. The questions that arise from this debate are whether microfinance should be best directed at the economically active poor, as they are already participating and engaged in some form of microenterprise, with hopes that these microenterprises will grow into formal businesses and thus contribute to job creation and economic development. Or whether MFIs should focus on the destitute poor in order to alleviate poverty and build assets that can minimise economic exclusion and vulnerability. The next section will therefore explore the challenges faced by MFIs in South Africa.

3.3.3 Challenges facing MFIs in South Africa

There are various challenges faced by MFIs. Some of the external variables and obstacles cited as a barriers to their growth are: formal competition; informal competition; economic dualism; higher loan size; cost of regulation; banking fees; urbanisation and immigration; and limited entrepreneurial training (Ngema, 2011).

- Formal competition: MFIs compete with commercial banks (although they serve different market segments) that are well resourced and who provide credit to borrowers with a good credit record.
- Informal competition: In certain cases, borrowers are reluctant to resort to MFIs for funding and still rely heavily on stokvels and loan sharks for credit, even though MFIs might offer better credit terms.
- Economic dualism: MFIs are expected to pay high salaries to skilled employees while they receive their revenue from third-world loan sizes. As a result, they have the highest salary burdens due to the employment cost to loan size differences.
- Higher loan size: Loan amounts in South Africa must be greater than other developing markets in order to account for the high operating costs. Therefore, MFIs in the country tend to issue less loans and are unable to diversify risk as compared to the other developing markets.
- Cost of regulation: Due to the country's first-world regulatory framework, the compliance costs imposed on these institutions are higher than in those countries with less formal government regulations.

- Banking fees: Banks in South Africa charge minimum fees rather than fixed percentages when accepting cash deposits. This results to reduced profitability for MFIs as there are usually high volumes of small loan repayments.
- Urbanisation and immigration: The significant demographic shifts to urban areas results in highly transient populations in many cities. These individuals therefore lack the associated bonds of trust, through which to secure the group solidarity based loans.
- Limited entrepreneurial training: During the apartheid era, operating small enterprises was prohibited and this was done to ensure an inexpensive large labour force for those in power. As a result, emerging entrepreneurs, particularly those previously disadvantaged, lack role models those from whom to learn business skills.

3.3.4 Critique of the microfinance industry

The provision of micro-credit over the recent years has had support as the most suitable tool for poverty alleviation and SMME development. There have been therefore attempts by MFIs to duplicate the success of the Grameen Bank by adopting the methodology of group lending (Rogerson, 2003). The principles for sustainable lending used by the successful MFIs to SMMEs are: offering small initial loans with short repayment terms; diversifying portfolios and specialising in financial services; concentrating on providing finance to business with a track record; recognising that the poor do save; and motivating repayments through joint liability and group solidarity.

The microfinance model has however been criticised. Rogerson (2003) found that one of the criticisms for microfinance is that there is lack of evidence to suggest any major impacts for SMMEs in terms of them growing into more sophisticated big enterprises which increase the rate of employment or income flows. Bateman and Chang (2009) also argued that the microfinance model ignores the crucial role of scale economies. By definition, microfinance produces microenterprises which means that enterprises are very small and almost always operate below minimum efficient scale. However, it is accepted that for all enterprise sectors there remains an identifiable minimum efficient scale of production, and operating below this level makes it virtually impossible for any enterprise to survive and prosper in a competitive business environment (Bateman & Chang, 2009).

Literature notes that microfinance is rarely associated with enterprise specialisation or technical innovation. Bateman and Chang (2009) argued that the microfinance model helps to deindustrialise and infantilise the local economy because given the high interest rates and short maturities demanded by most MFIs, it is generally only the most simple and unsophisticated microenterprises that can service a microloan. Furthermore, these microenterprises are very simple trading, retail and service operations with small production-based operations. Furthermore, the employment impact is seen as weak and tending to preserve or diversify the self-employment of entrepreneurs, rather than to create new employment opportunities (Rogerson, 2003). Gyimah and Agyeman (2019) found that MFIs usually do not have long-term funds and this inhibits the efficient offering of financial services to SMMEs. Moreover, approximately 60% (Gyimah & Agyeman, 2019) of the loans disbursed to SMMEs by MFIs have short repayment terms of less than a year and these MFIs often do not have efficient systems and access to information in order to monitor and evaluate SMME projects.

Given the challenges discussed above faced by MFIs, it can be argued that there are other programmes that provide funding to SMMEs in South Africa. They include state initiated institutions created to finance SMMEs; private sector programmes involved in SMME financing; and community-based or non-commercial institutions involved in financing SMMEs (Ngema, 2011). In spite of the efforts made by various governments to strengthen and improve the contribution of SMMEs in their economies, SMMEs continue to face significant funding challenges (Gyimah & Agyeman, 2019). Given the difficulties and challenges for SMMEs to access the necessary funding from traditional financial institutions, the role of the state thus becomes important (Bell, Goga, Mondliwa & Roberts, 2018). The state therefore has an important role to play in order to boost economic development and industrialisation through a DFI. The next section will discuss the state initiated institutions or developmental finance institutions that were established by governments in order to provide funding for SMMEs.

3.4 Development Finance Institutions Model

The orthodox economics perspective that justifies the role of DFIs in the economy is the market failure theory (MFT) which takes the “First Fundamental Theorem” (FFT) of welfare economics as a starting point (Mazzucato & Penna, 2016). The FFT states that markets are efficient allocators of resources under three conditions: (1) There is a complete set of markets so that all demanded or supplied goods and services are traded at known prices; (2) all agents are price-takers; (3) an equilibrium exists. Therefore, under these conditions, the allocation of resources is ‘Pareto optimal’ meaning, there is no allocation of resources that will make a producer or a consumer better off without making someone else worse off (Mazzucato &

Penna, 2016). Under this framework, market failures occur when condition (1) and/or (2) are violated, resulting in the resource allocation by markets being inefficient. Mazzucato and Penna (2016) assert that if markets are not Pareto-efficient, efficiency can be achieved through public policies however, under this mainstream economics view, market failure is only a necessary but not sufficient condition for public policy or governmental intervention.

Mazzucato and Penna (2016) find that the market failure framework is limited in understanding the enhanced roles that DFIs have had to play due to the increased speculation and short-termism of private finance, because it ignores the role that the state has played in the shaping and creation of markets. Investing in new ventures such as SMMEs has been the focus of some DFIs since the 1950s and the main reason for this focus is the fact that SMMEs face challenges in securing external funding due to lack of collateral, guarantees or lack of a track record of profitable investments (Mazzucato & Penna, 2016; Goga *et al.*, 2019; Gyimah & Agyeman, 2019). The MFT justification for investing in new ventures is thus related to market inefficiencies at the micro level.

Literature notes that financial and capital markets have been found wanting in funding industrialisation. For example, Goga *et al.* (2019) found that in some countries, banks protected existing firms and the stability of their profits, instead of financing new and innovative firms. Mondi and Roberts (2005) also noted that financial institutions play a crucial role in economic development as they channel financial resources from firms where there is a surplus to those where there is a deficit. This therefore means that the financial sector selects groups of economic activities and enterprises which will receive investment and act as catalysts for structural change in the economy. However, the financial sector tends to follow rather than lead developments in the real economy (Mondi & Roberts, 2005). This is mainly because it relies on information in order to assess risks and this means that the financial sector will therefore tend to fund enterprises that are well developed, where information is available and where there are readily available examples. This implies a bias against groups of agents or undeveloped product such as small, medium and micro-run and black-owned business, where there is little information available due to these groups being historically excluded by banks (Mondi & Roberts, 2005).

Mazzucato (2016) and Mazzucato and Penna (2016) showed the limitations of the market failure justification – which is based on orthodox perspectives - in explaining the role of DFIs and developed an alternative framework that is based on the heterodox perspectives, which have critiqued the market failure theory and provided real insights on the role of DFIs. Mazzucato and Penna (2016) argue that DFIs have had to play enhanced roles due to the increased speculation and short-termism of private finance and the market failure framework ignores the role the state has played in creating and shaping markets. Even though activities such as investment in public goods like infrastructure may be explained by the market failure theory, Mazzucato and Penna (2016) argue that in fulfilling this developmental role, DFIs do more than just providing financial capital to fix failures. Instead, they provide social capital for the development of social capabilities, and coordinate public-private partnerships. Therefore, the developmental role of DFIs also underlies with the roles of promoting challenge-led investments and supporting new ventures.

Instruments for promoting development finance for industry have played a very important role in industrialisation for many countries (Chang, 2002). Even though much attention has been focused on the experiences of the East Asian industrialised countries, countries such as the USA implemented proactive industrial policies including finance. To this day, the USA has provided high levels of financing for priority industries and areas such as defence, research and development, and pharmaceuticals. The challenge of ‘catching up’ by countries in industrial development point out greater returns from effective financing for industrial development (Chang, 2002). Mondi and Roberts (2005) argue that, instead of pushing back technological frontiers, rapid industrialisation can be accomplished by adopting existing technologies together with accumulating human and physical capital. What is crucial for this process is the flow of finance to areas with potential growth, which could lead to the ‘rise of the rest’ (Mondi & Roberts, 2005). For example, the extraordinary success and growth of the East Asian countries has been credited to the publicly coordinated method to industrial development that ensures developing targeted industries and investing in building production capabilities. The success of East Asia is characterised by strategic coordination by institutions to govern the market or various bodies. For instance, in Taiwan, there was the Council for Economic Planning and Development (CEPD), while in Korea there was the Economic Planning Board (EPB) (Mondi & Roberts, 2005). These institutions had the same goal of achieving industrial catch up.

The difference between the late industrial countries in East Asia and those in Africa and Latin America was that the goal of rapid industrial growth and development was moved to a national priority. This extended to the state acting autonomously from competing interests of the elite by ensuring wide distributed economic development, which was different from the unequal distributions that characterised the process of industrialisation (Mondi & Roberts, 2005). The developmental state therefore acts as an economic catalyst that plays an aggressive and an active role in industrialisation by mobilising both foreign and domestic finance and by targeting this finance towards investment that raises productivity. Despite the move to trade liberalisation in the 1990s, the development finance institutions and the financial sector continued to be important in providing support to targeted industries; in disciplining large firms to make sure that their behaviour was in line with the industrial development goals of the government; and in setting performance requirements. Their role epitomised the model of a developmental state, meaning, they were strong technocratic institutions that were fulfilling the long-tern developmental agenda (Mondi & Roberts, 2005).

3.4.1 DFIs as agents of economic development?

Development finance institutions have formed an integral part of most countries' developmental trajectories and are regarded as an important key to solving market imperfections (Musacchio *et al.*, 2017; Goga *et al.*, 2019; Gyimah & Agyeman, 2019). In countries with capital limitations, these institutions promote entrepreneurial action and alleviate capital scarcity to improve existing or new industries by providing long-term credit, credit guarantees, subsidised interest rates, technical assistance and equity. From the body of literature discussing the methodologies employed by these DFIs and the motivation behind them, Musacchio *et al*. (2017) identified three main roles and purposes of DFIs: the industrial policy view, political view, and social view. The industrial view holds that DFIs were formed in response to failure by the capital markets in providing finance necessary for industrialisation and entrepreneurial activity. The political view portrays DFIs as instruments serving politicians' personal objectives or as channels for rewarding the politically involved industrialist, while the social view holds that governments intervene in capital markets to address social issues such as unemployment (Musacchio *et al*., 2017). On the other hand, Mazzucato and Penna (2016) identified four roles DFIs have played: providing capital to under-serviced sectors; providing countercyclical funding during economic downturns; new venture support; and responding to specific challenges.

In terms of new venture support role, DFIs have been investing in SMMEs and innovation development since the 1950s but this initiative has been intensified in recent years due to the fact that SMMEs face challenges in securing external funding due to lack of collaterals, guarantees and track records of profitable investments (Mazzucato & Penna, 2016). In industrialised economies, DFIs were found to have played an important role in addressing the SMME funding gap whereby small enterprises in their start-up phases lacked internal and external sources of finance for innovative project (Mazzucato & Penna, 2016).

Literature has also documented the implications of the short-term nature of the financial markets in providing industrial finance and how the market has been linked to seeking profit-maximisation instead of investing in productive assets. The role of DFIs is therefore important in directing finance towards productive opportunities, where the financial markets have been found lacking in providing finance to these opportunities. Gyimah and Agyeman (2019) in their study found that DFIs also play other roles in the economy. Their literature notes that DFIs in many economies have prevented the incidence of a credit crunch with their counter-cyclical role by expanding their activities when the private sectors increase their risk aversion. Moreover, the services that DFIs provide vary between providing loans or guarantees to entrepreneurs and investors or funding state infrastructure projects. DFIs also take lead in industrial projects in economies where collateral requirements stall access to credit from commercial banks and also support micro loans and finance to SMMEs. Gyimah and Agyeman (2019) argue that it is in these cases that DFIs often find themselves with first-mover advantage in markets with strong growth potential. It can therefore be argued that the goal for DFIs is to graduate SMMEs into the formal banking sector and maximise the participation of local capital in financing projects.

SMMEs are often undercapitalised as commercial banks are reluctant to grant loans to start-up ventures without significant monetary commitment from the entrepreneurs, due to the risk associated with start-ups (Musacchio *et al.*, 2017). In order to address the issue of commercial banks underserving start-up ventures, complementary and specialised financial institutions have been created in many economies where the traditional financial sector has not provided sufficient finance necessary for industrialisation and development. In South Africa for example, the Industrial Development Corporation (IDC), serves as a DFI providing finance for industrialisation. Goga *et al.* (2019) defines development finance as the provision of finance to market segments that are not well served by the capital and the financial markets, and whose social benefits exceed commercial benefits. These market segments are usually high-risk low-returns or low risk low returns segments (SMMEs), making it unattractive for the financial markets to service them (Goga *et al.*, 2019; Gyimah & Agyeman, 2019). Moreover, the contribution of SMMEs to South Africa's GDP is lower compared to Asian and Latin American countries as South Africa is perceived to be less entrepreneurial than other developing countries and other African counterparts (Ngema, 2011; International Finance Corporation, 2019). Reasons for this low level of entrepreneurship include: limited access to capital; bureaucratic red tape and misdirected government support (Ngema, 2011; International Finance Corporation, 2019).

Given the crucial role SMMEs play in the South African economy, DFIs have a significant role to play in increasing investment rates to SMMEs by lending where the private sector will not extend finance (Mondi & Roberts, 2005). Moreover, since private institutions only consider private returns rather than the wider development impacts or the positive externality effects of projects, the 'insider' position of DFIs may itself improve the prospects of certain projects. This can be achieved by ensuring appropriate connections with other sectors of government.

3.5 Government initiatives to support industry in South Africa: The role of DFIs

During the apartheid era, the development finance system and the national industrial policy prioritised large scale capital-intensive projects. DFIs were a crucial tool to the apartheid government's project of state-led industrialisation. DFIs were engaged in shaping the enterprise sector with the main aim of providing cheap access to network infrastructure and public finance as well as lowering strategic costs for businesses (Le Pere, 2021). This resort to using DFIs as means of increasing the state's presence in the economy was a result of the increased international pressure, isolation and the devastating effects of sanctions because the apartheid regime wanted to tightly control the highly concentrated private sphere. DFIs were therefore an important component for the state to successfully develop a racially-based industrial economy that cushioned against the devastating effects of sanctions (Le Pere, 2021).

Since 1994, however, the role of DFIs has been reoriented as part of the state's developmental agenda of addressing the deprivations of the apartheid era and improving social welfare. Le Pere (2021) states that there are two categories of DFIs post 1994 and they are namely those that provide equity and loan financing as part of their developmental agenda; and those that provide grant-based funding and other forms of non-financial assistance. It can therefore be said that the ethos of DFIs have evolved in line with the government's developmental priorities. Moreover, the mandate for DFIs are based on three principles: their first mandate is to be catalysts for job creation, accelerated industrialisation, human capital development and economic growth; their second mandate is to be active in sectors and activities where private sector capital sources are found lacking; and their third mandate is to sustainably bridge investment gaps (Le Pere, 2021).

There are 16 DFIs in total in South Africa which are equally split between provincial and national levels. These DFIs confirm to the rationale of serving the economically marginal sections and the disadvantaged population by supporting job creation, improving access to financial services, improving infrastructure and industrial development, and improving small business development. They are therefore the government's tool of promoting a quasi-welfare state through the benefits they derive from receiving concessionary financial sources in order to uplift the standards of living for those affected by inequality, unemployment and racialized poverty (Le Pere, 2021).

The next section provides a brief overview of the main DFIs in South Africa.

The Industrial Development Corporation (IDC)

In South Africa, the IDC is one of the oldest development finance institutions for industry. The IDC was established in 1940 and it has played a crucial role in shaping the country's industrial development since then (Mondi & Roberts, 2005; Le Pere, 2021). During the apartheid regime, the IDC directed finance to strategic industries such as basic chemicals, fuels and basic metals. As a result, the IDC was an important public institution in the minerals energy complex, an industry that has dominated the country's industrial development. The IDC was also key to the state's strategy for manufacturing as it supported mega projects and also held equity stakes in big companies including former state-owned enterprises such as Iscor and Sasol (Mondi & Roberts, 2005).

Amongst the noticeable investments made by the development finance system was the development of Iscor, the steel giant (Roberts & Rustomjee, 2010). Iscor was developed through subsidies, which came with very little conditions from the state. Iscor supplied the mines with steel in the process of development and it remains one of the biggest suppliers of steel even post-democracy (Roberts & Rustomjee, 2010). As a result, the post-apartheid government inherited an economy which was resource based with high levels of concentration (Goga *et al*., 2019). There has therefore been a strong continuity in the structure of the economy in that, the sector that thrived as a result of state support during the apartheid era, has continued today to dominate the economy and the apartheid legacies have left an economy that is still characterised by the minerals energy complex industries (Bell *et al.*, 2018). Moreover, the economy grows in line with the traditional resource base as a result of the development finance system funding model remaining largely oriented towards large and established enterprises in less diversified and upstream industries (Bell *et al*., 2018).

As described previously, the IDC has historically played a powerful role in implementing and designing industrial policies. However, its role has diminished in recent years due to the industrial policy being differently oriented. Instead, the IDC has been a driver for the management of the numerous incentive programmes. Engaging with the development trajectory and increasing emphasis on a more activist policy agenda of the South African economy, implies a need for the IDC to play a bigger but different role. The IDC has thus been focused on promoting and developing skills transfer, black entrepreneurship, and gender and employment equity in competitive industries such as heavy manufacturing, agro processing and metal products and minerals. According to Mondi and Roberts (2005), other major developments in the IDC include: the design and implementation of Customised Sector Programmes by the DTI; provincial development and growth plans which include developing industrial clusters; government's capital expenditure programme; and the Department of Science and Technology's Advanced Manufacturing Technology Strategy, which is aimed towards new subsectors, industries, and activities. The IDC's position and knowledge of industry is therefore vital for capitalising on the positive returns from these activities (Mondi & Roberts, 2005).

<u>The Development Bank of Southern Africa (DBSA)</u>

The DBSA was established in 1983 to coordinate and promote the development and growth of the homelands. It has mainly focused on financing and investing in economic, social, and physical infrastructure since 1994. The mandate of the DBSA has been extended to the entire continent. As a result, the DBSA has taken on multiple roles such as providing opportunities for joint ventures and partnerships, providing advisory services and implementing and managing projects (Le Pere, 2021). The DBSA is self-financing, enjoys good domestic and international credit ratings and has retained a strong balance sheet.

<u>The Land and Agricultural Development Bank of SA</u>

This DFI was created in 1912 for the purpose of financing agricultural and rural development, mainly for white commercial farmers. Its mandate however has changed since 1994 to that of encouraging and empowering the historically disadvantaged groups to enter agri-processing sectors and commercial farming through the Special Mortgage Bond (Le Pere, 2021). Small-scale cooperatives and farmers were financed via the Micro-Agricultural Finance Initiative. The Land and Agricultural Development Bank is one of the country's largest DFI and has disbursed over R200 billion in loans from 2011 to 2016 (Le Pere, 2021).

Khula Enterprise Finance (KEF)

The DTI established KEF in 1996 in order to promote the sustainability and the development of small, medium and emerging businesses. This DFI does not provide direct finance, but provides finance through banks and financial intermediaries by providing guarantees and collateral for its clients who apply for loans from commercial banks (Le Pere, 2021). However, this mandate changed in 2009 when KEF set up Khula Direct as a result of growing demand for capital for SMMEs. KEF therefore had a capital base of R3 billion for providing direct loans to SMMEs (Le Pere, 2021). In addition to this, it provides low rental start-up premises for its clients as well as mentorship services.

The National Housing Finance Corporation (NHFC)

The NHFC was established in 1996, with the Department of Human Settlements (DHS) performing the oversight function. The NHFC provides affordable finance and housing to low and middle income groups who have a regular source of income (Le Pere, 2021). The NHFC's mandate is to also provide finance for home improvements for these groups with the Breaking New Ground programme aimed at providing finance for upgrading and eradicating informal settlements. The NHFC was changed into a fully-fledged bank in 2006 since it is a wholesale funding and risk-managing corporate entity. The NHFC has also built partnerships with the DBSA and the private sector in pursuit of its goals of addressing the housing backlog in South Africa (Le Pere, 2021).

Rural Housing Loan Fund (RHLF)

The RHLF also falls under the Department of Human settlement and its main mandate is to provide loans through intermediaries and generate social venture capital to low income households for what is called 'incremental housing purposes' (Le Pere, 2021). This is a people-driven process - although the RHLF provides strategic guidance – to empower low-income households in rural areas in order for them to acquire ready access to credit. This ready access to credit is aimed at unlocking and developing the potential of beneficiaries for savings, selfhelp and for building and improving their own houses over time. The NHFC and RHLF were merged in October 2018.

National Urban Reconstruction and Housing Agency (NURCHA)

NURCHA was created to initiate programmes aimed at ensuring the sustainable flow of finance to build affordable and low-income housing and infrastructure in peri-urban and urban areas. Its mandate is to extend the housing market for the poor and contribute to the emergence and development of black-owned construction firms, amongst other things (Le Pere, 2021). NURCHA was also merged with the NHFC in October 2018.

National Empowerment Fund (NEF)

The NEF falls under the DTI and was established in 1998 by the NEF Act. The mandate for the NEF is to innovate solutions and promote BEE for greater economic inclusion. The NEF provides non-financial and financial support to its clientele. The financial support is provided by means of financing models which include women's empowerment fund and rural and community development fund (Le Pere, 2021). While the non-financial support is provided by means of pre and post-investment, asset management and socio-economic development.

The SA Micro-Finance Apex Fund (SAMAF)

SAMAF was created in 2006 in order to provide affordable and accessible financial services to benefit micro and small business owned by the poorest of the poor. This is achieved through sustainable financial intermediaries that help the poor in growing their own asset bases and income, and thereby reduce unemployment and alleviate poverty (Le Pere, 2021). Moreover, SAMAF facilitates capacity building and training for micro enterprises and ensures effective financial intermediation by making markets work for the poor.

Le Pere (2021), however, notes that there have been concerning trends about the financial performance of DFIs in South Africa. The author argues that their financial performance has been characterised by poor loan recovery, mounting losses, and continued dependence on the government to underwrite their operational costs, despite disbursing R275 billion annually (Le Pere, 2021). Furthermore, DFIs have hardly helped to mitigate market failure but have rather allocated their resources in an inefficient manner. If standard indicators such as return on assets, return on equity, and non-performing loan ratios are used, it can be said that DFIs have underperformed when it comes to advancing their defined social purposes and objectives. To quote Le Pere (2021, p.11) "In short, the self-sustainability of DFIs has been their Achilles heel and a major source of their institutional and financial vulnerability".

3.6 DFIs from other developing countries

Examining the role of DFIs and how they can play an important role in the economy can be based on the principles of their contribution to economic growth, accelerated industrialisation and human capital development in the context of the current economic crisis in the country (Le Pere, 2021). The Brazilian Development Bank, BNDES, is the model that is often referred to. After the Chinese Development Bank, the BNDES which was established in 1952, is one of the largest in the world that supports investment in commerce and industry, SMMEs, agriculture, health, education and mass transportation. The BNDES has also been involved in the green economy and renewable energy initiatives in recent years (Le Pere, 2021). The BNDES has played a major role in the growth and development of the Brazilian ethanol sector.

Other notable countries where DFIs have been crucial in steering long-term industrialisation include Mexico, India, South Korea and Japan. In Mexico, the Nacional Financiera has exclusively focused on financing SMMEs whose start-ups face supply chain risks, particularly from big buyers. In India, the Industrial Development Bank has focused on the long-term financing and development of the ICT sector in India. The Korea Development Bank has focused on providing industrial capital and services in investment, corporate, and consumer banking. While the Industrial bank of Korea is mainly focused on funding SMMEs. Lastly, the Development Bank of Japan and the Japan Bank for International Corporation have also been financial drivers of infrastructure development including developing private sector partnerships, providing consulting services, implementing and managing projects, and providing export credit (Le Pere, 2021).

3.7 Concerns about the actions of DFIs. Do they crowd-in or directly compete with private institutions?

There have been concerns about the actions of DFIs. The first concern is bureaucratic inertia. Once the DFI is established, they can have a life of their own, regardless of their impact and the role they play (Musacchio *et al.*, 2017). Moreover, they are supposed to have autonomous technocracy that evaluates the tools that are best in addressing market failures. This therefore means that the benefits and salaries of DFIs are above the mean for state-owned enterprises and governmental organisations. Secondly, DFIs usually have key performance indicators (KPIs) that are not related to their objectives. For instance, most DFIs use total loan disbursements per year as their KPI. Therefore, if the main objective of DFIs is to solve market failure, they should have KPIs related to the alleviation of market failure (Musacchio *et al.*, 2017).

Another concern about the actions of DFIs is that they will stifle the emergence of private banks. This is because DFIs tend to cater to large enterprises that would be able to borrow using private sources of capital. By targeting these enterprises, DFIs may create a problem of credit misallocation as they will be channelling subsidised funds to enterprises that are not necessarily financially constrained. Additionally, by focusing on established big enterprises, DFIs may also cherry-pick the enterprises in the economy with a high capacity to repay their loans. This would mean that private banks are left with riskier clients, therefore making private banks to be reluctant to provide enterprises with loans. In other words, the presence of a DFI may crowd out the development of a private credit market (Musacchio *et al.*, 2017).

However, according to the European Development Finance Institutions (2021), DFIs are mandated to provide sustainable long-term finance that are market-based in order to crowd in rather than crowd out private credit providers. The European Development Finance Institutions (2021) recommended that in order to achieve this, DFIs should aim to offer market-based prices through benchmarking against commercial market factors. Secondly, DFIs should respect the Enhanced DFI Principles for Blended Concessional Finance when offering subsidised funding. Blended finance is the strategic use of development finance for the mobilisation of additional finance towards addressing the SDGs. The rationale for using blended concessional finance is that DFI's support for the private sector should make a contribution that is beyond what is available or that is otherwise absent from the market, and should not crowd out the private sector. Therefore, blended concessional finance should address market failures (European Development Finance Institutions, 2021). Another principle is to crowd-in private institutions by catalysing market development and mobilising private sector resources.

The Global Impact Investing Network (GIIN) (2016) also supports the notion that DFIs seek to crowd in private sector investors by listing four strategies used by DFIs to achieve this. First by catalysing underserved markets; second by offering syndicated loans that include third-party private-sector financial institutions as co-lenders in their investment; third by launching asset management products in an effort to mobilise more private sector funding for development finance objectives; and last by making investment conditional on third party co-financing to encourage private-sector investors to join deals that would not otherwise fit their risk profiles.

The next section will discuss the survey from the case study conducted at the Small Enterprise Foundation, an MFI offering loans to SMMEs in South Africa and makes comparisons of the experiences from microenterprises funded by SEF as well as those that are self-funded.

CHAPTER 4: SURVEY METHODOLOGY

Data collection for this study was achieved through conducting semi-structured, open-ended interviews with a sample of 15 clients from Small Enterprise Foundation (SEF) and interviews with staff members at SEF to get background information. Furthermore, a sample of 15 micro entrepreneurs who have not received any finance from the traditional financial institutions have been targeted through a survey and in person interviews in order to compare their experiences with those funded by SEF. The Ethics Committee approved the study and an Ethical Clearance form was granted. The next section will discuss the business types of these microenterprises, the number of employees, the challenges they face as well as the support they need. Further data analysis from the interviews is included in the appendices.

The Small Enterprise Foundation is a non-profit, pro-poor organisation founded in the Limpopo province in 1992 and currently operates in seven of the nine provinces (excluding the Western Cape and Free State). SEF was initially focused on providing microcredit to the poor in rural areas, but it later focused on providing microcredit to rural women. SEF uses a group-based lending methodology adopted from the Grameen Bank. Members form themselves into groups of five and they undergo group training and testing before they are officially recognised and given a group recognition certificate. Once groups are recognised, they are eligible to apply for loans and the loans are collectively guaranteed by all group members. While SEF does not accept deposits or savings facilities, it requires its members to make savings of a minimum of 2 percent of the loan amount fortnightly through the Post Office and Nedbank group savings account. The loans are also disbursed into these group accounts. The savings accumulated by members are not used as a security or collateral but rather as means to motivate members to build up funds which they can fall back on during emergencies. SEF also offers non-financial services every fortnight through the Thutopele financial education programme to assist and equip clients with business skills.

SEF has over 170 000 clients (as of January 2023 according to SEF's monitoring file), the vast majority being women. In seeking to offer better financial support to SMMEs, SEF also has developed the Larger Loans Programme (LLP) in 2018 which offers individual liability loans and has over 500 clients. Both men and women are allowed to join the LLP programme. The LLP programme, just like the general programme, also offers non-financial business development services aimed at providing assistance to clients by helping them access market opportunities and to grow their businesses. Figure 3 below shows SEF's loan structure.

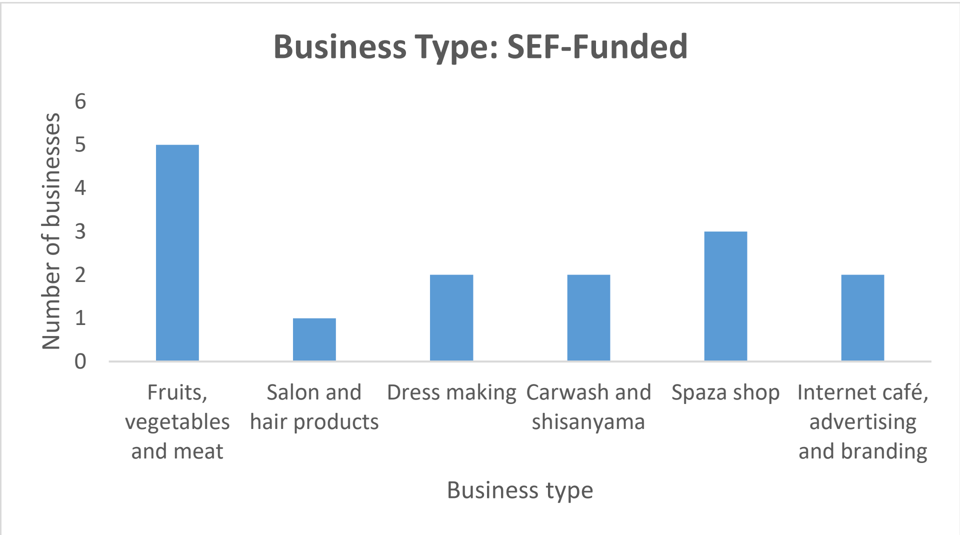
Figure 3: SEF's loan structure

Programme	**Average loan size**	**Min and Max Loan terms (months)**	**Minimum loan amount**	**Maximum loan amount**
General Programme	R4 266	4, 10	R1 000	R25 000
Larger Loan Programme	R50 440	4, 24	R30 000	R250 000

Source: SEF monitoring file (January 2023)

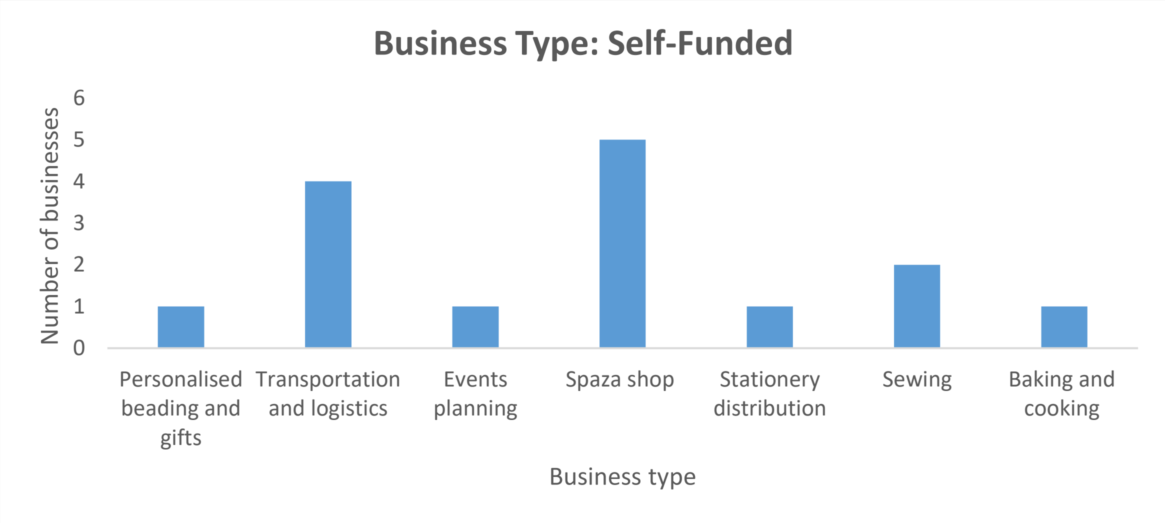
Results from interviews conducted:

Figure 4: Business Type - SEF-Funded Micro Enterprises



Source: Author's own calculations

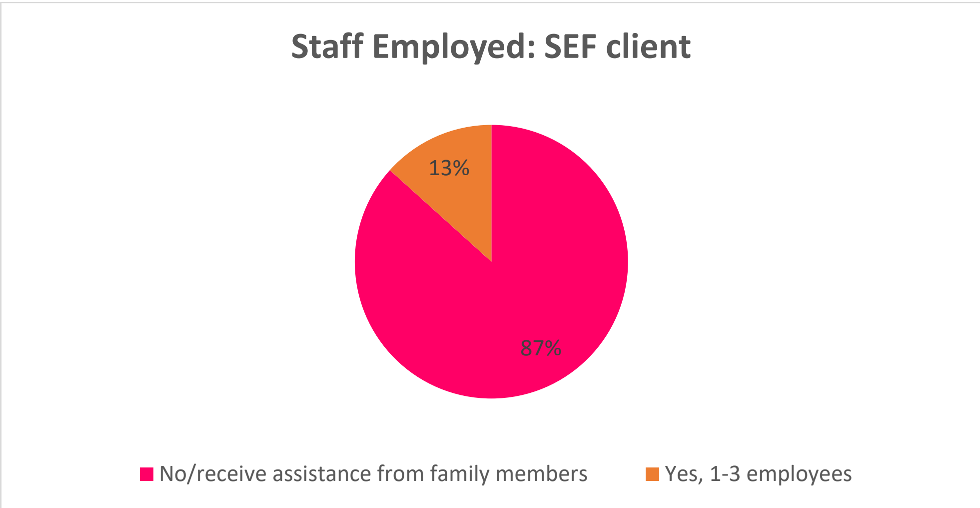
Figure 5: Business Type - Self-Funded Micro-Enterprises



Source: Author's own calculations

From figure 4 and 5 above, it can be observed that the business types of these microenterprises are spaza shops and fruit and vegetable street vendors which are mostly in retail services and are classified as micro. These types of businesses typically fall under the informal sector as they are not registered or paying any taxes. Even for the micro-enterprises who receive loans from SEF, it was found that they fall under the informal segment with low labour skills.

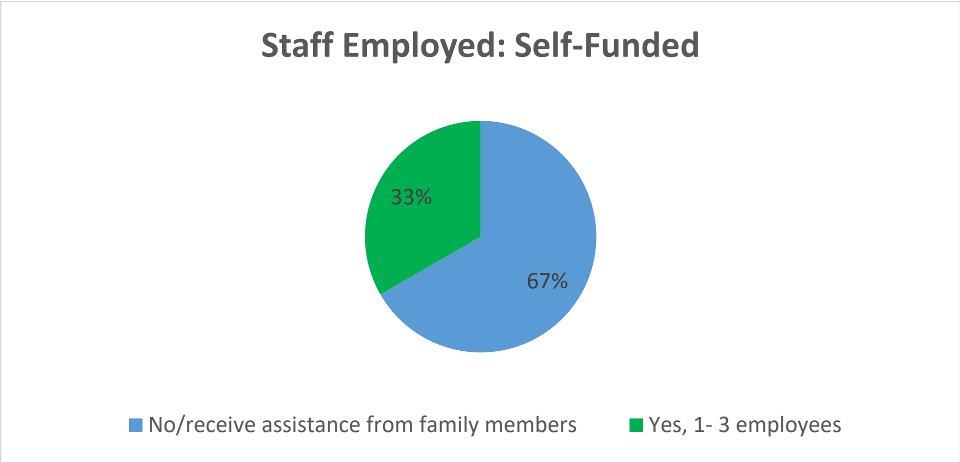
Figure 6: Staff Employed - SEF-Funded Micro-Enterprises



Source: Author's own calculations

From figure 6 above, when asked about the number of employees that work in their businesses, 87 percent of the interviewees responded that they have no employees, they either operate the business alone or receive assistance from family members. The interviewees also noted that they do not pay wages to family members, but rather give them inconsistent amounts for them to buy items such as clothes and toiletries since most of the income generated from the business is directed towards household expenses such as groceries and electricity that benefit everyone. Of the 13 percent who responded that they have employees, all of the interviewees employed between 1 to 3 employees. They noted that even though they have employed people to assist in their businesses, there is no formal wage structure and wages are dependent on the performance of the business for that particular month. The wages range from R1000 to R2500 per month.

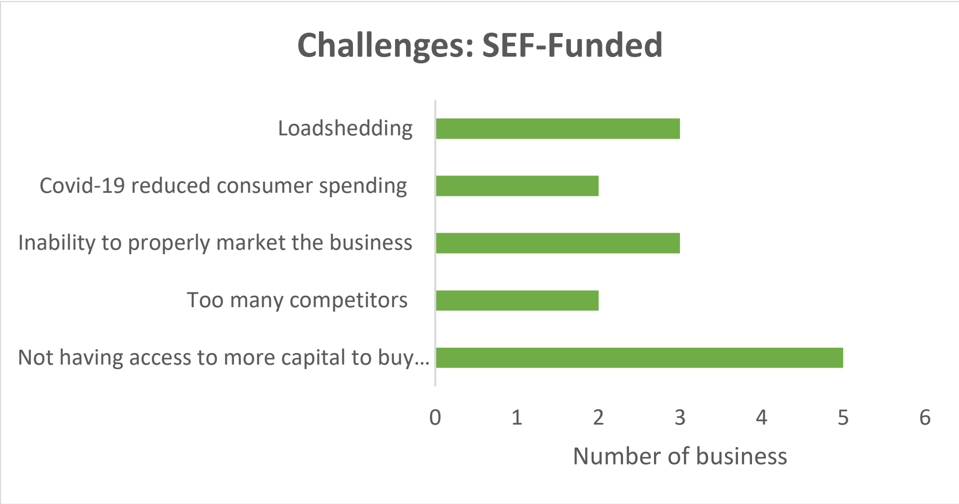
Figure 7: Staff Employed - Self-Funded Micro-Enterprises



Source: Author's own calculations

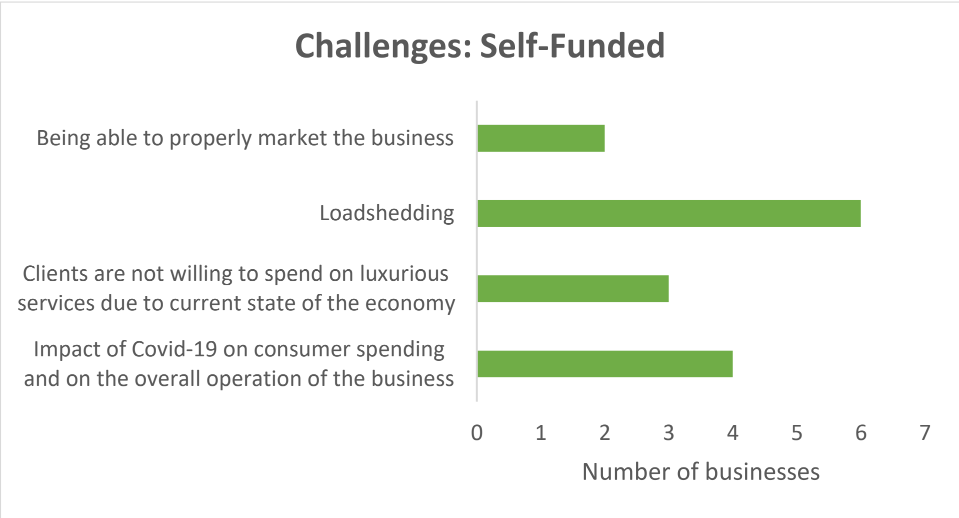
From the data presented in figure 7 above, 67 percent of the self-funded interviewees responded that they operate their business alone or receive assistance from family members. While 33 percent responded that they employ between 1 to 3 employees. With the evidence from both figure 6 and 7 presented above for SEF funded business and those that are self-funded, it can be observed that one-person enterprises are a majority of the SMMEs. This sparks the debate about the wages and working conditions in microenterprises as these factors are usually poor for both the owners and the employees, thus placing a question mark on the sustainability and the quality of the employment created. Moreover, the data supports Kesper's (2000) claim that most of these SMMEs are started out of necessity rather than choice. The data shows that 47 percent of the respondents, both those that are funded by SEF and those self-funded, started their business because of unemployment (see appendices 1 and 2).

Figure 8: Challenges Faced by Micro-Enterprises: SEF-Funded



Source: Author's own calculations

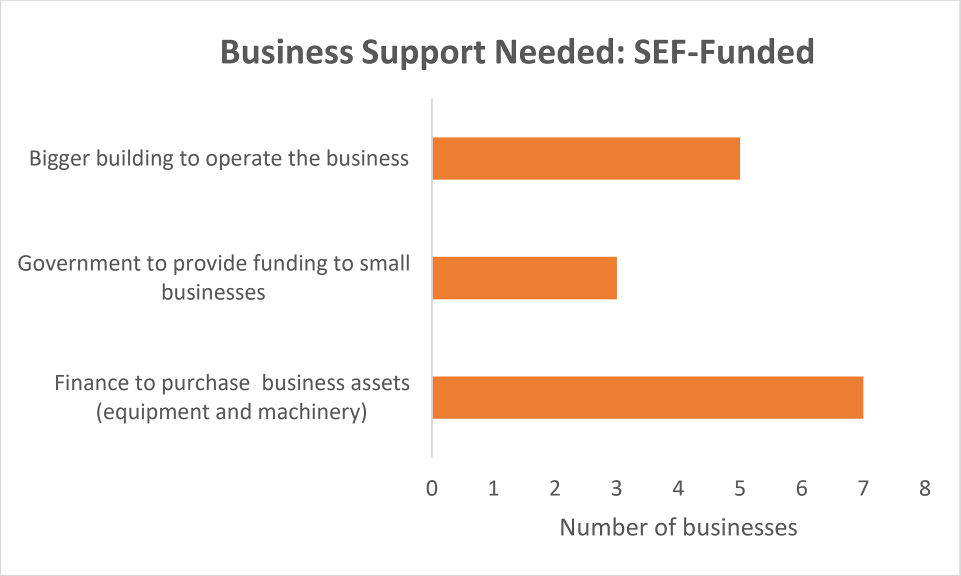
Figure 9: Challenges Faced by Micro-Enterprises – Self-Funded



Source: Author's own calculations

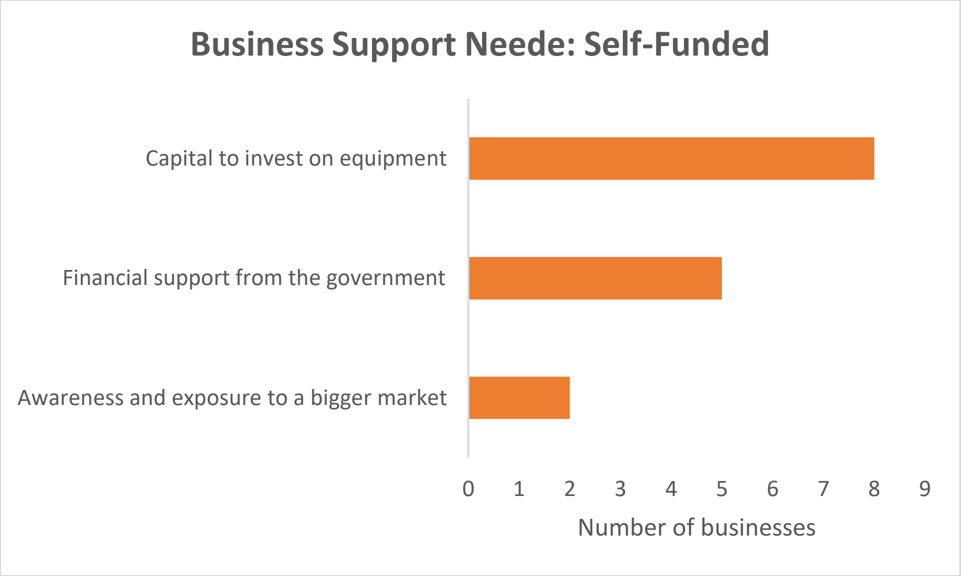
When both the SEF funded and the self-funded enterprises were interviewed about the challenges they face, the common themes were that load-shedding has contributed significantly in terms of the businesses experiencing loss in profits as load-shedding reduces productivity. For businesses involved in cooking and baking, and salons the effects of load-shedding are worse as productivity comes to a complete stop, potential clients turning away and products being wasted. The other common theme was that consumer spending has reduced significantly since the Covid-19 pandemic, coupled with the worsening economic climate and consumers willing to spend less on luxury items. These conditions have made it difficult for these microenterprises to recover post-pandemic, with most noting that they are usually operating at a loss. Another common theme was that these enterprises are unable to properly market their businesses. When engaging with SEF clients, it was noted that the clients do attend the financial education sessions (Thutopele) offered by SEF every fortnight which include topics on business marketing. However, it seems as though these clients are not applying the lessons learned practically. Another issue that was noted was that some of the SEF clients found the Thutopele sessions to be time wasting and are therefore reluctant to attend meeting during days which Thutopele is being delivered. This explains the gap that these microenterprises are experiencing (funded by SEF) since the owners see little to no value in business skills development.

Figure 10: Business Support Needed - SEF-Funded Micro-Enterprises



Source: Author’s own calculations

Figure 11: Business Support Needed – Self-Funded Micro-Enterprises



Source: Author’s own calculations

The common theme from both groups of microenterprises interviewed was that they need business support in the form of capital to invest on business assets such as equipment and machinery. One of the internet café enterprises funded by SEF noted constraints with accessing the appropriate amount for the machinery needed for their business. The owner noted that they wanted to buy branding machinery, which costs over R300 000, used to create billboards and corporate identity items. However, the maximum loan offered from the SEF LLP programme is R250 000, meaning that they would have to find other means to finance the shortfall. One of the owners from the self-funded group of enterprises noted that they needed to buy industrial sewing machines in order for their business to operate efficiently to meet the market demand. However, due to no funding being available for their informal business, it will take years for them to save in order to procure the equipment needed. Another common response was that the enterprise owners felt there was a need for government to provide funding to SMMEs in order for them to grow. The owners felt the government would offer a better funding model than the one currently offered by private financial institutions.

The interesting findings from the study were from SEF-funded enterprises whereby a majority of business owners part of the general programme noted that the maximum loan amounts of R25 000 offered by SEF in the general programme is sufficient to grow their businesses and that they would not consider accessing more funds due to them being reluctant to take on more debt. Only the microenterprises that are part of the LLP programme felt the R250 000 maximum loan was insufficient. These differences could also be due to the fact that the latter can potentially graduate and grow into more formal businesses due to the entrepreneurial spirit demonstrated by the owners.

The data illustrated above has shown that the SMMEs interviewed are survivalist and are micro enterprises, mostly in retail activities, with very limited signs of growth. Furthermore, the SMME sector is unlikely to fulfil all of its roles such as creating employment and contributing to economic growth because only a small section of the SMME sector will develop the capacity to improve growth and create employment at socially desirable levels. The effects of the Covid-19 pandemic have also highlighted a great need for a more active role from the government in guiding the economy towards recovery.

This chapter highlighted the experiences faced by SMMEs in South Africa and even though the sample size was too small to make some generalisations, it gave some insights on the challenges faced by SMME owners. Empirical evidence from this study showed that regardless of the enterprises being funded by an MFI or being self-funded, they face similar experiences in terms of the funding gap. This has highlighted the need for the government to intervene and provide a funding model that will ensure SMMEs grow and contribute in a meaningful way in the economy. The next chapter will provide a conclusion and policy recommendations on how the government can play this role in SMME development.

CHAPTER 5: CONCLUSION AND POLICY RECOMMENDATIONS FOR SMME FUNDING IN SOUTH AFRICA

In this study I sought to evaluate the current funding models available for SMMEs by investigating the funding challenges experienced by SMMEs in South Africa. The study aimed to answer the research question by reviewing literature on the funding models that currently exist for SMMEs in South Africa. The study further explored the role of DFIs in SMME development and whether they crowd-in or directly compete with private institutions. Empirical evidence on the funding challenges faced by SMMEs was gathered through using the SEF as a case study and by comparing experiences from microenterprises funded by the SEF and those that are self-funded. Though the interview sample size is small and not a representative of the SMME sector, the sample and the responses, to some degree, reflects the structure of the national SMME sector in South Africa which consists largely of micro-enterprises. Evidence from the interviews conducted with these microenterprises supports literature in that there is a funding gap and that the government needs to intervene. This study thus argues that, even though financial intermediaries such as MFIs exist, they fail to provide the necessary funding and support needed by SMMEs to grow. The government therefore has an important role to play in creating an enabling environment for SMMEs to thrive in the country. The government’s role is multifaceted with responsibilities for supportive regulation, policy coordination and providing capacity building and financing for SMMEs.

The government has a direct role to play in supporting SMME growth by strengthening the institutions that provide support to these enterprises through DFIs which will deploy blended financial instruments to reduce the private and public risk of lending to this sector. Thus, the funding model that will foster SMME development in South Africa is through DFIs because the participation of DFIs in SMME financing can lead to sustainable economic growth and reduce the problem of access to finance. This is because, DFIs have both financial and non-financial programmes to address the issue of SMME financing. Furthermore, literature has noted that SMMEs fail to access credit due to lack of collateral and information asymmetry.

However, the study has shown that DFIs are able to eliminate this obstacle as they provide grants and asset finance, which eliminates the lack of assets. DFI loans eliminate the problem of lack of track record and credit guarantee schemes. The IDC could play a very important role in this regard as an already existing DFI. The combination of the IDC as a development financer, as an actor in industrial policy formulation and implementation, and as the centre of information and knowledge on industrial development places it in an important role as a development agency. Moreover, the ongoing development of the IDC's links and knowledge base across the private sector and government will enable it to realise its developmental role.

In order to ensure that capital from government institutions such as DFIs does not crowd out private capital markets, the government could consider a gradual transition towards a hybrid system by working together with private financial providers. This means that a good government intervention should crowd in the private sector by: providing financial support to alternative financing models such as microfinance institutions, whose scale is limited by small balance sheets; by providing credit guarantees to banks; and by offering loans to SMMEs that include these third-party private-sector financial institutions as co-lenders in their investment.

Additionally, there is a need for a single point of contact between business owners and the government, which will enable the government to stretch administrative capacity less thinly and enable entrepreneurs to easily find support from the government. Therefore there is an opportunity for the government to achieve this through using the Department of Small Business Development (DSBD). The mission of the DSBD is to coordinate, integrate and mobilise efforts and resources towards the creation of an enabling environment for the growth and sustainability of SMMEs and co-operatives. Therefore, the DSBD can be a key coordinator of SMME programmes among government stakeholders such as the Small Enterprise Development Agency (SEDA), the Small Enterprise Finance Agency (SEFA) as well as DFIs such as the IDC in order to expand access to financial and non-financial support to new and existing SMMEs.

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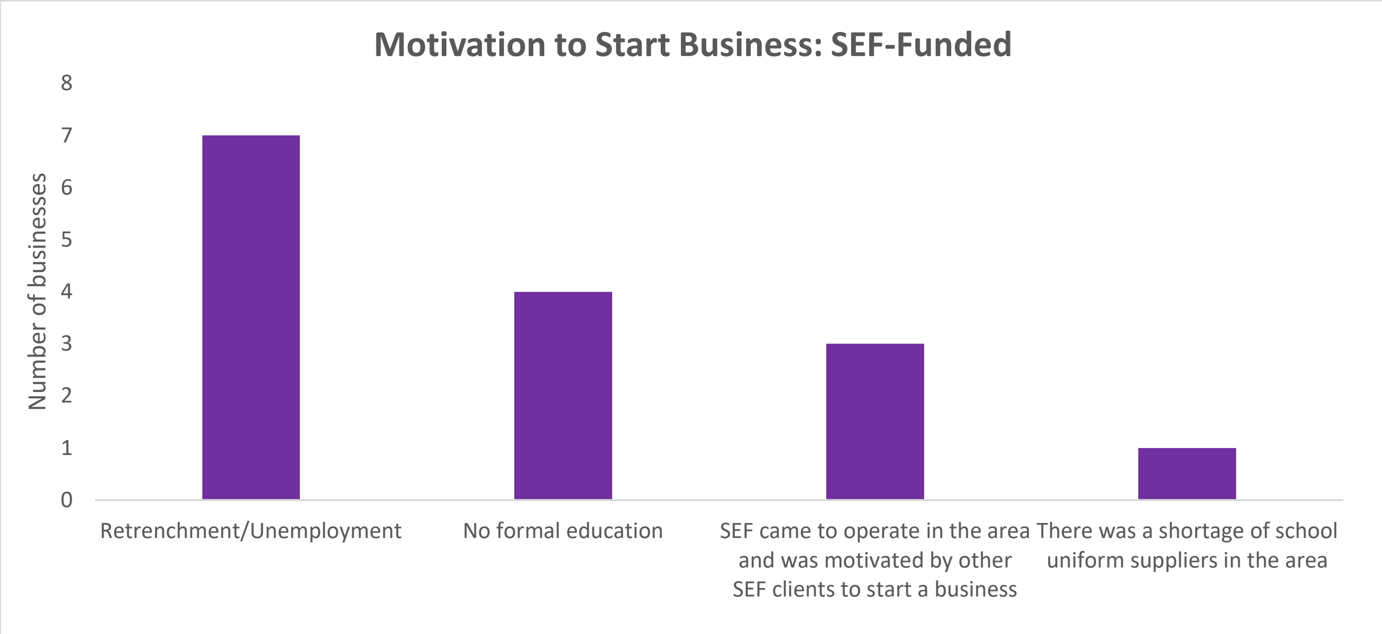
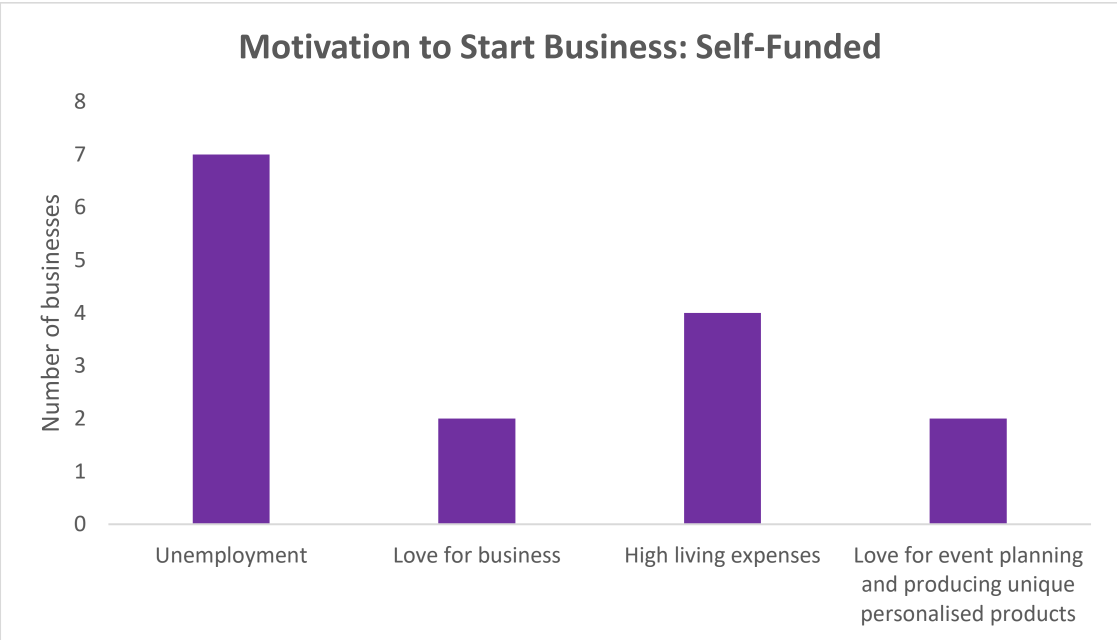
APPENDICES

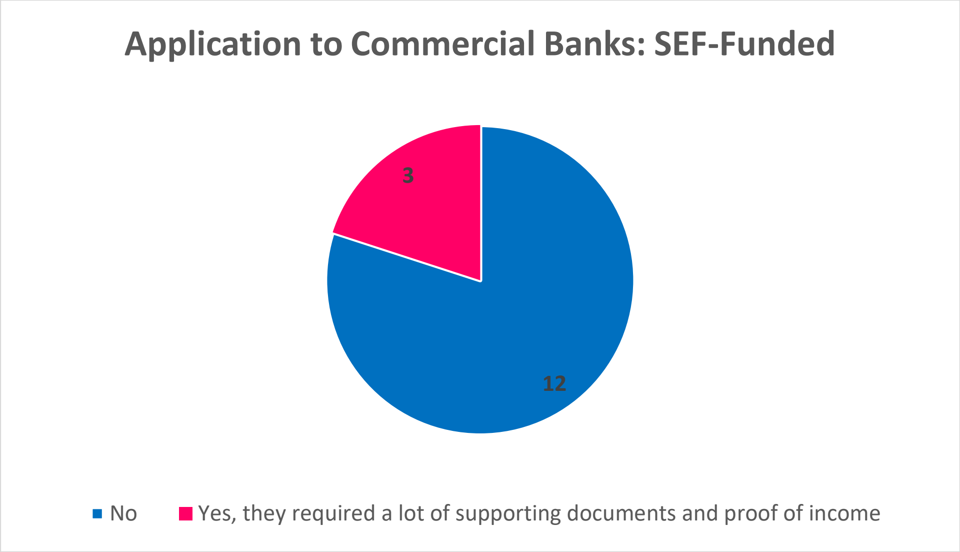
Appendix 1: Motivation to start business – SEF-Funded



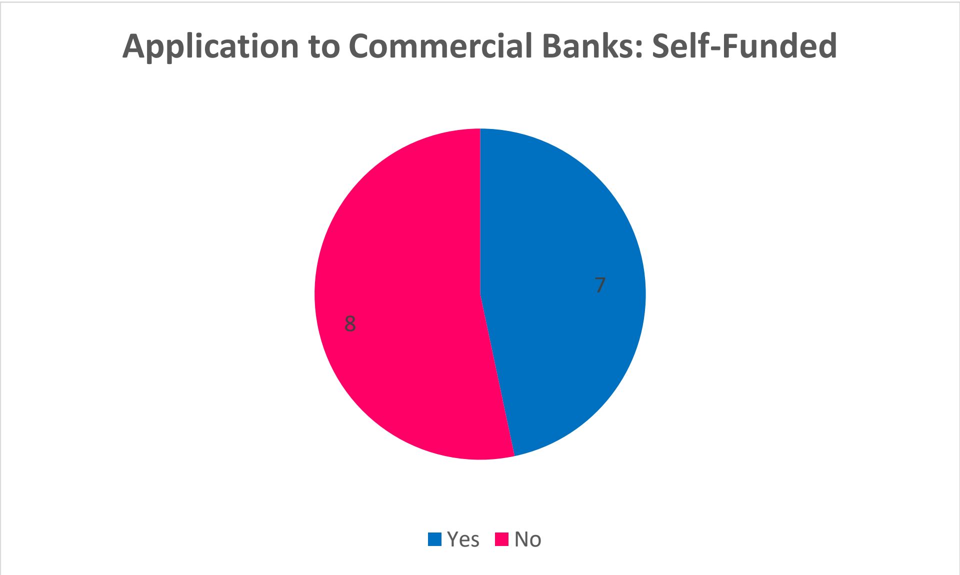
Appendix 2: Motivation to start business – Self-Funded



Appendix 3: Application to Commercial Banks – SEF-Funded



Appendix 4: Application to Commercial Banks – Self-Funded



Appendix 5: Interview Responses: SEF Funded Micro Enterprises

Question	Response	Number of respondents
1. Can you please explain the type of business you are owning	Fruits, vegetables and meat	5
	Salon and hair products	1
	Dress making	2
	Carwash and shisanyama	2
	Spaza shop	3
	Internet café, advertising and branding	2
2. What motivated you to start your business?	Retrenchment/Unemployment	7
	No formal education	4
	SEF came to operate in the area and was motivated by other SEF clients to start a business	3
	There was a shortage of school uniform suppliers in the area	1
3. What would you describe as the challenges you faced when you were starting your business?	There were no challenges	2
	Business was initially self-funded	5
	Business was slow, there were no funds to invest into the business	8
4. Do you have any employees that work for you? If so, how many?	No/receive assistance from family members	13
	Yes, 1-3 employees	2
5. How would you describe the performance and experience of your business before becoming a client of the Small Enterprise Foundation?	Business was performing well	4
	Business was not performing well as there was no money to buy stock and to match competitors' product offerings	6
	Business performance was weak with very low profit margins	5
6. How would you describe the performance and experiences with your business since becoming a client at SEF?	Business is performing well, there is more money to invest into the business and buy stock	7
	Business has been stagnant, SEF only allows small loan increases	4
	Business is weak, low consumer spending due to Covid-19	4
7. Do you think the maximum loan amount that SEF is currently offering to their clients is sufficient to grow their businesses?	Yes, afraid to take more debt	5
	No, not enough to buy stock or invest in the business	4
	No, SEF only allows small loan increases	2
	No, the group programme makes it difficult to receive loan increases as a result of poor repayments from other members	4
8. Do you feel the loan terms and interest rate are favourable for your business?	Yes, it is better than what is offered by loan sharks	7
	Yes, depending on the loan term - lobger loan terms have higher interest rates	3
	Yes, shorter loan terms are favourable	5
9. Would you consider other financing options with larger amounts if another financial institution were to offer you financing for your business?	No, banks have a lot of strict requirements and require many supporting documents such as payslips and bank statements	7
	Yes, if the requirements are accommodating to the poor	2
	Yes, if only it is the government providing funding and not a loan	6
10. Have you ever applied for business finance at a commercial bank? If so, how was your experience?	No	12
	Yes, they required a lot of supporting documents and proof of income	3
11. What would you describe as the challenges in running your business currently?	Not having access to more capital to buy stock or invest in the business	5
	Too many competitors	2
	Inability to properly market the business	3
	Covid-19 reduced consumer spending	2
	Loadshedding	3
12. What kind of support do you feel your business needs in order for it to grow?	Finance to purchase business assets (equipment and machinery)	7
	Government to provide funding to small businesses	3
	Bigger building to operate the business	5

Appendix 6: Interview Responses: Self-Funded Micro-Enterprises

Question	Response	Number of respondents
1. Are you 18 years or older?	Yes	15
2. What type of business do you own?	Personalised beading and gifts	1
	Transportation and logistics	4
	Events planning	1
	Spaza shop	5
	Stationery distribution	1
	Sewing	2
	Baking and cooking	1
3. What motivated you to start your business?	Unemployment	7
	Love for business	2
	High living expenses	4
	Love for event planning and producing unique personalised products	2
4. What would you describe as the challenges you faced when starting your business?	Could not keep stock, orders became more complex, building clientele and adapting to the new styles of personalised items	1
	Marketing and customer retention	4
	Having no access to capital or sponsers to start the business	6
	Clients failing to pay on time	4
5. Do you have any employees that work for you. If so, how many	No/receive assistance from family members	10
	Yes, 1- 3 employees	5
6. How would you describe your experience with accessing funding for your business?	Difficult and tough to get funding especially from government. Business is self-funded	15
7. Have you ever applied for business finance at a commercial bank or any other financial institution	Yes	7
	No	8
8. How would you describe your experience with applying for business finance at a commercial bank or financial institution?	Have not tried to apply	5
	The interest rates offered were extremely high	3
	No response from financial institutions after applying for funding	2
	Difficult as banks require a lot of documents and have strict requirements that make it hard to qualify	5
9. What would you describe as your challenges with running your business currently?	Impact of Covid-19 on consumer spending and on the overall operation of the business	4
	Clients are not willing to spend on luxurious services due to current state of the economy	3
	Loadshedding	6
	Being able to properly market the business	2
10. What kind of support do you feel your business needs?	Awareness and exposure to a bigger market	2
	Financial support from the government	5
	Capital to invest on equipment	8