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Fuel Growth of Small and Medium-Sized Enterprises

Introduction

In the developing world, small- and medium-sized enterprises (SMEs) are critical for inclusive economic growth. These vibrant businesses broaden opportunity, increase productivity, create jobs, and help alleviate poverty. In developed countries, SMEs represent more than half of GDP and account for nearly 2/3 of employment.[1] But they are largely absent from the formal economies of poor countries, which are often able to sustain micro-enterprises and huge conglomerates but are missing mid-sized firms. Fueling SMEs - and demonstrating their profitability - could help these businesses become a powerful engine of growth in the developing world.

Today, there are trillions of investment dollars chasing returns around the globe. For SMEs in the developing world, however, although they are a potentially high-impact and high-return investment, only a trickle of capital reaches them. Large businesses have access to formal, bank-based credit and (in some markets) private equity and public markets. At the other end of the spectrum, over the last 30 years the microfinance movement has made substantial strides in making capital available to households and micro-entrepreneurs. SMEs, on the other hand, remain underserved and lack access to the tools and finance necessary for rapid expansion: they are the “missing middle.”

While there are indications that SMEs could generate high returns on invested capital, today these investments are expensive to find, execute, and manage relative to their size – and the investment returns often do not match the expense. Because the costs of sourcing and completing deals are high, it is often difficult to gather and verify important information, and investments can also be difficult to exit. This initiative aims to increase the capital available to high-growth SMEs by tackling some of the root causes that limit their growth prospects.

The Problem

The lower-income segments of developing countries benefit when SMEs have better access to finances because they alleviate poverty by creating more jobs and better wages. And as a recent World Bank report noted, “The bulk of evidence suggests that developing the financial sector and improving access to finance are likely not only to accelerate economic growth, but also to reduce inequality and poverty.”[2]

But there are a number of barriers to investing profitably in these growth opportunities. Local financial institutions are reluctant to lend to SMEs because of higher perceived risks, lack of collateral and prohibitive transaction costs. Equity investors share these concerns and also struggle with illiquidity, particularly because they lack viable exit options. And many SMEs operate outside of legal and regulatory systems, characterized by widespread informality, low productivity, and lack of firm governance and reliable information (including normal accounting procedures). Today, in all of Africa and South Asia, less than $1 billion in actively managed investment funds specifically target the SME sector.[3]

Our Approach

Google itself started off as a small enterprise. We want to extend the kind of opportunities that existed for us in Silicon Valley to places like the Great Rift Valley. The instruments that gave Google a chance to grow – well-developed capital markets and financial products – don't exist in many parts of the world right now . . . but they can.

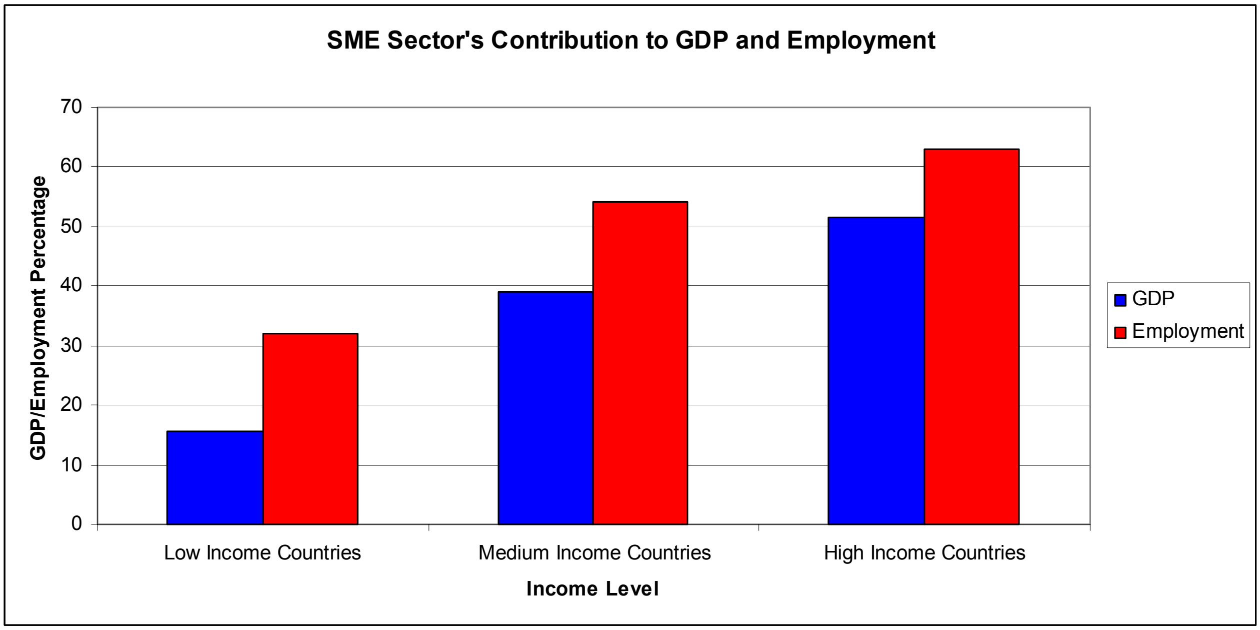
Google.org aspires to combine innovation, information, and technology in an effort to transform the way SMEs are linked to sources of finance. We will bring a combination of grant money, investment capital, and hands-on engagement to attempt new approaches. We are pursuing a three-pronged approach to increase the flow of finance to the missing middle.

First, we will focus on lowering transaction costs, making it easier and cheaper for investors to find and make investments in SMEs. Transaction costs are prohibitive right now because investors lack the information they need to make investments, and where information does exist, it is often expensive to get or in a non-standardized format. Since investments in SMEs are so costly to source, make and monitor, investors often put their money elsewhere. We hope to improve transaction structures, so that each deal is, on average, lower cost and higher return. We also will work to improve the informational basis for deals, so that investors can make better deals at a lower cost. Specifically, we – together with our partners - will develop and invest in the tools and systems that make it easier for growth capital to flow to SMEs. For instance, we will look for opportunities to enable investors to find entrepreneurs. We will work to create technologies or methodologies to provide an improved informational basis for investment decision (e.g. better ways to standardize business information such as credit histories). Our work in this area will often be done in partnership with banks and other financial institutions in the local markets.

Google.org will also work to deepen capital markets. Our goal is to lower the cost capital, manage risk, and create innovative ways to use capital markets. In addition, since there are few opportunities today to exit successful SME equity investments (which means investors are often less likely to make them in the first place), our work in this area will also be designed to increase liquidity. As a first step, we will invite capital markets partners to evaluate current options and invest in creating information tools and mechanisms to increase liquidity in the market for risk capital.

Finally, we will invest in the SME market ourselves. By becoming active participants, Google.org will also become a user of the tools we are creating and refining, and will work to improve them and more accessible. We want to demonstrate that it is possible to make a profit by investing in SMEs. We also want to foster new investment mechanisms. These might include peer-to-peer investment tools, distributed models of finance, micro-franchising, and aggregator or other network models. We will consider a wide variety of approaches, from investing in funds or partnering with financial institutions, to directly supporting SMEs to make the business case for this sector and catalyze the market for new financial products and instruments.

To the extent that there is an opportunity for collaboration, we will partner on Google.com projects in this area. This will often happen in the developing world, but will also occur in the developed world where Google's workforce and technical expertise can play a role in helping to grow the missing middle.



World Bank, Asli Demirguc-kunt, December 2002, Presentation: New Technologies for Small and Medium Sized Enterprise Finance

[1] The Brookings Institution, Policy Brief 159, "Beyond Microfinance: Getting Capital to Small and Medium Sized Enterprises to Fuel Faster Development," March 2007.

[2] World Bank. 2008. *Finance for All? Policies and Pitfalls in Expanding Access.* Washington, DC.

[3] International Finance Corporation. 2007. *List of SME Funds.*