THE JOBS FUND

South Africa Siyasebenza

Learning Series

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Lending to those Lending to SMEs: Job Creation Lessons from the Jobs Fund's On-Lending Projects

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The Jobs Fund is a R9 billion fund established by the South African Government in 2011. It was established to encourage innovation and give greater impetus to initiatives with potential to generate sustainable employment. The Fund aims to catalyze innovation in job creation through structured partnerships with the private and public sectors as well as NPOs by awarding once-off grants to organisations through a competitive process. The Jobs Fund operates on challenge fund principles and aims to incentivise innovation and investment in new business approaches that directly contribute to long term sustainable employment creation.

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The Jobs Fund supports a portfolio of Enterprise Development Projects that offer innovative commercial approaches to sustainable job creation. These initiatives stimulate the demand for labour, that is, new jobs are created in the market as a result of the expansion of the Small, Medium and Micro Enterprises (SMMEs) supported. Within this portfolio is a variety of On-lending Projects.

On-lending is a funding instrument utilised by many developmental projects. On-lending refers to the practice of an organisation borrowing funds with the aim of lending these funds to public/private/SMME entities to support specific developmental goals. The rationale of On-lending is to support the implementation of important investment projects by offering SMMEs, who would generally not qualify for loans or credit to expand.

Access to finance, coupled with business operational assistance by the on-lenders, can improve business success of the SMMEs, thereby creating jobs and positively contributing to the economy.

1. Introduction

South Africa is facing what has been termed as the "Triple Challenges" which are unemployment, inequality and poverty. Since the world economic crisis in 2008, economic growth has been slow, with the country falling into a technical recession in the first quarter of 2017 and unemployment reaching 27.5% in the third quarter of 2018. Job creation has been identified as one of the important means to address these challenges.

It is widely publicised that Small, Medium and Micro Enterprises (SMMEs) are important creators of new jobs. Various stakeholders, including the private sector and the Government, believe that SMMEs are an important contributor to the growth of jobs in an economy. As at 2015, the National Statistics Agencies and Endeavor Insights calculated that it would take 49,000 scalable SMMEs growing at a rate of 20% per annum to meet the National Development Plan's target of creating 11 million jobs by 2030 (SME South Africa, 2015). However, SMMEs find it difficult to survive and achieve sustainability, particularly due to a lack of skills and access to capital.

The high failure rate of small businesses, particularly start-ups, within short periods of time, is well documented. Lenders are often reluctant to give SMMEs funding because of the high risk that they can go out of business before loans are repaid. Yet cash flow, in addition to necessary experience and knowledge to guarantee success, is among chief reasons for the high failure rate of SMMEs.

Often, when customers find it difficult to access services or goods, intermediaries are needed as an integral part of the value chain. In the commercial lending space, on-lenders are some of the important intermediaries striving to make it easier for borrowers to access finance. An on-lender is an entity that borrows funds from a commercial lender and then lends these funds on to those borrowers who find it difficult to access funds directly from a commercial lender. Some of the reasons which make it relatively easier for an on-lender to access finance from commercial lenders are:

- An existing long track record in the business of on-lending and consequently a long credit history,
- Using their relatively large scale and financial ability to access finance from lenders, and
- Experience in lending to borrowers which are seen to be too risky from lenders' point of view.

The Jobs Fund has partnered with On-lenders (referred to as Jobs Fund Partners) by extending grant funding to them on condition that they successfully raise additional funding elsewhere, the practice is termed "matched funding". The Jobs Fund Partner (JFP) would then use the grant and matched funding to invest in one or more projects to create jobs in a financially sustainable way. An important factor is the use of the Jobs Fund's limited funding to leverage additional funding from elsewhere through the matched funding mechanism so that there are *more* funds available to invest in SMMEs and create jobs.

2. Method

2.1 General Research Design and Approach

In 2017 an Evaluation was commissioned by the Jobs Fund to review three On-lending Projects that provide support to Small and Medium Enterprises (SMEs). These On-lending Projects focused on assisting the "missing middle" – SMEs that are too large to secure micro-loans but too small or considered to be too risky to secure a loan through traditional commercial means. The Study utilised a combined Evaluation and Case Study approach. The Evaluation was used to assess how well the Projects had performed and the Case Studies were used to determine how the Projects achieved the results that they did. Case Study findings have been articulated in the form of Cross-Case Comparisons and Good Practice drawn from each of the Projects.

2.2 Method of Data Collection

Data collection included:

- Desktop research,
- Interviews with JFPs, SME beneficiaries and Jobs Fund team,
- Focus groups with SME beneficiaries,
- Workshops for Jobs Fund team and JFP, and
- Surveys with Jobs Fund Partners and SME beneficiaries.

3. Results and Findings

3.1 Utilising grants in innovative ways

The On-lenders have utilised grants in innovative ways which include -

- Use of grant to improve financial security and access more finance:
    - Using the grant as additional financial security to raise more finance from commercial lenders and investors at a lower interest rate. These additional funds were used to extend loans to additional SMEs who typically do not meet commercial lenders' stringent requirements to access finance.
- Use of grant as partial security to attract investor funds into SMEs:
    - Using the grant as an investment to attract private investors' funds to extend additional lending to SMEs. The grant would be used as a partial guarantee against possible credit losses that the investors could suffer.
- Use of grant to attract additional funding from the private sector and therefore sharing risks:
    - Using the grant to share risks with commercial lenders when extending funds to SMEs.

3.2 Using non-traditional assessment methodologies

On-lenders were willing to go beyond the traditional approach of simply assessing an individual or company according the level of financial security they possess or prior track record.

Some of the non-traditional approaches used by the on-lenders include -

- Using their specialised knowledge of the industry they service (niche lending):
  - An example here is a property on-lender which extends loans to property entrepreneurs who are usually unable to access funding from commercial lenders due to their perceived or actual high risk.
  - The lack of entrepreneur's personal track record in the property development industry and the risks associated with running SMEs does not deter the property on-lender from extending finance to inner-city areas, but these factors chiefly count negatively towards obtaining finance from a commercial lender.
  - In addition to providing finance, the on-lender is able to provide business support to the SMEs due to their long successful track record in the sector. The business support also serves as a risk management tool minimising risks of business failure and thus maximising chances of loan repayments back to the on-lender.
- Using non-traditional ways of calculating loan repayments:
  - Some of the on-lenders focus on SMEs and other firms looking for short-term cash flows or experiencing problems stemming from cyclicality of the sectors in which they are based, e.g. restaurants, hotels etc.
  - The loan repayments to the on-lender are expressed as a percentage of firms' credit or other cards sales.
  - Repayments will be high when card sales are high and low when card sales are low. Thus, the firms make higher repayments when they are doing well and lower repayments when times are tough, a flexibility that is a value-add to these businesses.
  - This model is relatively new in South Africa but quite common in the US.
- Exploiting additional levers more extensively than traditional lenders to manage risk:
  - Some on-lenders cater for SMEs facing difficulties by actively offering them repayment flexibility in the form of repayment holidays.
  - Other options include converting loans into shares in the businesses or sharing revenue, although the on-lender will look to only hold the shares for a limited period and not in perpetuity.
  - On average, the On-lending Jobs Fund Partners have managed defaults to a low rate of 1.5% of the total funds employed.
- In addition to finance, provide business support to maximise SME potential success
  - Some on-lenders make available specialised business support to the SMEs they finance.
  - These include formal programmes into which entrepreneurs participate, assignment of the so-called "supercoaches" who have successfully run businesses themselves, suggesting solutions in terms of resources which seem to be lacking in the business and insisting on proper governance structures necessary for business success.
  - Both SMEs and on-lenders are aligned in that a SME is looking for business success and the success of the SME means the on-lender can successfully receive loan repayments.
- Use of group lending to minimise defaults
  - The use of group schemes is widespread in life insurance. This model has been replicated in lending which requires lending to a group of people or business owners where the participants in the group are jointly and severally liable.

- It is the joint responsibility of the group of borrowers to ensure that each one of them repays their portion of the loan.
- This practice has seen significant reductions in defaults and one of the reasons cited has been that borrowers are less willing to default on, or let down, someone they are familiar with i.e. other participants in the group.

3.3 On-lenders are not created the same

Some on-lenders are niche on-lenders and provide finance within the space they really know very well. Other on-lenders consider a range of SME borrowers from different sectors of the economy. It is expected that there is more coverage of SMEs when considering a wider range, but this comes with a lack of focus and higher expected default rates. This would require funders that are willing to lend over the long term, with results only being seen after extended periods of time.

3.4 Differing objectives for investment

Jobs Fund Partners have a mandate which consists of objectives which can be conflicting at times. The mandate is typically the creation of jobs, effecting systemic change and sustainability. It is very difficult to find projects that tick all three objectives. The evaluation study established that a portfolio approach is required. Ideally, the Jobs Fund Partner should not require every investment in an SME to tick all the objectives. Rather, SMEs that an on-lender invests in should tick at least one of three objectives but, at a portfolio level, there should be sufficient spread of all three objectives being met.

3.5 Return to fiscus

When implementing projects in partnership with the Job Fund Partners, the financial sustainability requirement maximises the chances that the same grants can be used over multiple periods for different projects and creating additional new jobs (recycling of grant funding). In addition to the self-sustaining nature of this type of government support, there are also other benefits. One way to think about the economic and social benefits of these projects is to consider return to fiscus.

3.5.1 Definition

The fiscus consists of government income and expenditure. Financial benefits of the projects by a way of return to fiscus are the provision of additional income to the fiscus. The additional income to the fiscus is mainly through taxes from, among other sources:

- Personal income taxes (PAYE and associated taxes such as UIF and SDL) paid by the beneficiaries of the new jobs created;
- Company taxes on profits that the new supported SMEs would pay if successful;
- Value Added Tax (VAT) paid on spending by the beneficiaries of the new jobs created.

Social benefits of the projects by a way of return to fiscus include the opportunity for the job beneficiaries to fund their own consumption and sometimes ceasing to rely on government provision and therefore reducing the expenditure side of the fiscus. Examples of these benefits include:

- Job beneficiary being empowered to fund their own consumption,
- One job being able to support more people in a household and therefore improving social conditions,
- Beneficiaries of the new jobs created to improve their living conditions so that the problems associated with being poor can be eliminated and more opportunity to plan life better e.g. educating their own children, having plans to improve future prospects etc.

3.5.2 Return to Fiscus (RTF) for the projects reviewed

In order to assess how the investment into the three projects performed based on this matrix and to ascertain whether the investment of public funds had yielded a return to the fiscus based on the jobs created, the On-lending Projects evaluated were reviewed using the RTF matrix (measured in terms of PAYE only).

The approach considers the return to fiscus of a set salary at varying levels of job creation. Due to the types of jobs created by the 3 projects and the average salary ranges of those jobs, a salary of R15,000 per month was utilised. This translates to a PAYE amount of R1,575 per job created and represents the RTF for every job created from the grant amount invested.

The table below summarises the findings:

	Partner 1	Partner 2	Partner 3	Total
Grant utilised	R99,6 m	R157.4 m	R50.2 m	R307 m
Permanent jobs created	1,460	1,996	9,025	12,481
RTF measure per Job per month	R1,500	R1,500	R1,500	R1,500
Av. months in employment per job created	18	18	18	18
RTF (R millions)	R39.4 m	R53.8 m	R243.4 m	R336.9 m
Return on Public Funds Invested	40%	34%	485%	110%

The table above demonstrates that at an individual project level, partner 3 has yielded the highest return on the public funds invested. The jobs that have been created will yield a significant return to fiscus (485%) from a PAYE perspective. Overall the On-lending portfolio has to date already returned more than the initial funding invested (110%).The Jobs Fund will look to add to the already existing value for money criteria to select future projects to be funded.

4. Conclusions & Recommendations

This Evaluation identified issues that obstruct and practices that promote job creation and access to funding for SMEs. Whilst some of these issues and opportunities may be addressed through the natural evolution of business practice over time, others will require active intervention, whether it be from private sector, civil society and government. It is also anticipated that some of these interventions will need to be effected through policy and regulatory instruments; primarily at national and regional level. Outlined below are the good practice and policy intervention recommendations identified by the Evaluator.

4.1 Good practice recommendations

4.1.1 Market in which an on-lender operates

- Identify a niche market of SMEs to lend to.
- Have intimate commercial knowledge of the targeted market.
- Utilise various platforms to source lending opportunities e.g. formal ways through credit applications, industry gatherings

4.1.2 Operations of an on-lender

- Adjust lending practices to be appropriate for the targeted market. These can include non-traditional ways of assessing credit applications.
- Appropriate, and often innovative, risk management practices provide the on-lender with competitive advantage.
- Providing business support and mentoring to SMEs are forms of risk management and can minimise default rates.

4.1.3 Sources of funding for the lender

- Diversifying sources of finance can reduce on-lender's cost of finance.

- On-lender needs to think broadly about where to source finance. While established on-lenders can source finance from commercial lenders, others need to also consider public programmes, development finance institutions, appropriate industrial programmes, capital markets and overseas providers of development finance.
- Other forms of funding should be considered e.g. guarantees, subsidised operations, subsidised mentoring etc. Need to have form and level of funding appropriate to the stage where the on-lender is at in its lifecycle.

4.1.4 Risk Management

- Risk management should be applied at all critical areas of the business.
- Helping borrowers (SMEs) to formalise their businesses e.g. instilling governance, offering mentorship and training, putting in place controls to manage risk.
- Flexible lending terms e.g. flexible forms and level of repayment terms can give SMEs space and opportunity to survive and minimise permanent loss of funds through defaults.

4.1.5 Relationships

- Relationships are key. There is a need to build relationships with current and future borrowers (investees) and funders.

4.2 Policy considerations

4.2.1 Create an enabling environment

Policy intervention is required to create the enabling environment within which existing on-lenders will be willing to extend into niche SME markets, and which encourages new on-lender entrants. This policy intervention is required in particular to address the following:

- High costs of entry, given initial anticipated losses; which may be addressed through funding support.
- Limited loss experience data (which may be addressed through support for industry-wide databases, as is currently in place for life insurance underwriting).
- The need for a safety net to encourage investment in the on-lenders (such as the guarantees).

With regard to the second point above, it should be noted that commercial lenders will characteristically not lend to markets in which there is little to no loss history. It is expected that by building a database of loss and default history in specific SME sectors, it will be possible to encourage more lenders to lend to SMEs as they will feel confident that there is sufficient data in order to price their products correctly.

With regard to the third point above, partial credit guarantee mechanisms will encourage funding of unproven businesses where there is insufficient data to formulate a loss history. This will crowd in institutional investors into untested and underserved markets.

4.2.2 Commercial bank lending flexibility

Policy could be introduced to encourage commercial banks to be more flexible in their lending practices, in particular their conservative security-based approach to lending. Policy could also support the education of SMEs regarding how to access funds. SMEs often do not keep accurate records, governance systems and up to date financials. Keeping these records may help the SME to access funding, be it from a conventional source or a niche lender.

4.2.3 Institutional structures that support collaboration

Policy could mandate the creation of institutional structures to support active collaboration within the funding industry, with particular regard to SME funding, for example:

- Funders and entrepreneurs connecting with each other, and

- Funders and commercial banks sharing lessons learnt and experience in dealing with default in new markets.

4.2.4 Provision of business development support

Policy intervention is required to encourage the provision of business development support for SMEs that is effective in mitigating the risks that limit SME access to finance.

The support provided needs to follow a more intensive business development model, when compared to the type of support currently offered by government.

4.2.5 Skills development

Policy focused on skills development (e.g. National Skills Development Strategy [NSDS] III) could be revised (viz. through the NSDS IV currently being developed) to include a focus on the development of SME skills that are seen by funders as jeopardizing business success through their absence.

4.2.6 Centralised coordinating support agency

Policy could be promulgated to establish a centralised coordinating support agency whereby SMEs requiring technical support can be directed to the correct public and private initiatives where they can find this support. A central database, not dissimilar to the Central Supplier Database (CSD), could be established in this regard.

4.2.7 Support for the "missing middle"

Policy focused on SME development merits revision (given lack of success of current policy instruments) to ensure more focused government funding support for SMEs in the "missing middle".

4.2.8 Safety nets

Through policy intervention, government could create safety nets for innovative funding businesses struggling to survive periods of protracted systemic risk. Policy could help establish special funding options for this purpose, in a similar fashion to bailouts provided to banking institutions that are deemed "too big to fail".

4.2.9 Portfolio approach

For the Jobs Fund it will be important to encourage a portfolio-based approach to its funding decisions. This will allow certain projects to focus purely on a job creation agenda. Other projects could focus on establishing innovative funding models, whilst some could focus on ensuring sustainable commercial returns. A similar philosophy would also benefit Jobs Fund Partners that themselves fund other ventures.