Economic Systemic Capitalism vs. Occupy Wall St.: The Financing of Small and Medium Enterprises

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What is hindering high- growth entrepreneurship: Culture, institutions, or the environment?

- Is LAC missing truly innovative entrepreneurs?
- One way to shed light on these questions is to look back at history. At the beginning of the 20th century, insufficient entrepreneurial spirit reflected the institutions and attitudes toward entrepreneurship.
- Indeed, census data for 1910 in Argentina show that 7 out of 10 businesses registered in Argentina were owned by foreigners.
- In Mexico in 1935, the share of establishments directed by people born abroad was 35 percent, while some 90 percent of the workers in the same sectors were Mexican

Startup Chile!

- In August 2010, the Chilean economic development agency, CORFO, launched an innovative initiative with the aim of enhancing the country's competitiveness through technology, innovation, and entrepreneurship.
- The program, Start- Up Chile, aims to create a new entrepreneurial environment by enhancing international connections and removing the barriers faced by entrepreneurs: limited access to credit, low adoption of new technologies, and the lack of international customers.
- Early- stage, high- potential entrepreneurs received seed capital of $40,000, which they had to match with at least $4,000 of their own resources.

Startup Chile!

- The pilot launched a modest 22 start- ups from 14 countries.
- By June 2012, 323 start- ups had been hosted; more than $8 million had been raised from investors in the United States, Argentina, and Mexico; and projects had achieved sales of $550,000 and employed 228 people.
- The goal is to reach 1,000 projects by 2014.

Does financial underdevelopment explain the innovation gap?

- Innovation is a risky activity; if markets fail to share some of these risks, entrepreneurs may find it difficult to innovate.
- Financial development, in terms of both the depth and the diversification of financing instruments, appears to exert a disproportionately positive effect on small firms, which tend to find it more difficult to raise funds,
- Because small firms tend to operate locally, local financial development has also been found to be an important determinant of the economic success of an area.

LAC Financial Markets

- They find that access to external financing is associated with greater firm innovation.
- LAC financial markets developed substantially in the last two decades, as de la Torre, Ize, and Schmukler (2012) document. Bond and equity markets have gained ground, institutional investors now play a central role, new markets and instruments have sprung up, maturities have lengthened, and dollarization has been reduced.
- However, many of these gains are benefitting only larger firms; significant gaps remain in the financing of smaller ones, as manifested by the depth and efficiency (as measured by interest rate margins) of banking intermediation and the liquidity of domestic equity markets.

What is Lacking?

- These gaps are of concern because they coincide with some of the financial indicators that have been shown to be the best predictors of future output growth and because, except for bank margins, there is little evidence of convergence toward benchmark levels consistent with the economic development of the region and its basic structural characteristics.
- The lack of depth of the banking sector, an important financing avenue of small firms, may in particular hurt the innovation potential of emerging fi rms.
- Another area of concern is the limited capacity of institutional investors to expand their portfolios beyond the safest and most liquid investments.

Is it Across all LAC countries?

- These features are not identical across countries. There is substantial heterogeneity in financial development within the region, with smaller, lower- income countries generally lagging behind.
- The innovation potential of firms in LAC— in particular small ones— may also be hindered by the dearth of private equity and venture capital financing options.

A Continuous Challenge!

- Overall, start- up financing remains a challenge in the region: venture capital accounts for less than 10 percent of total PEVC investments.
- Moreover, venture capital typically does not finance young, innovative firms.
- The dearth of financing opportunities for young, innovative firms may be hindering the region's entrepreneurial potential. But the problem may not necessarily be solved by simple supply-side interventions.

A Vicious Cycle!

- The region may be trapped in a vicious cycle of low innovation leading to too little demand for a healthy private equity and venture capital investments in industry to flourish. It may be possible to break such a cycle stems with government-led supply side interventions—but without a larger mass of young, innovative firms, supply- only interventions are likely to fail.

- the facts that LAC has underdeveloped capital markets and that venture capital appears to chase big deals in traditional industries do not by themselves imply that the region's innovation gap is caused by lack of access to finance. Young rather than small firms drive growth and employment generation in the long run.

- Hence, it is worthwhile to explore the link between firm age and access to finance.

The difficulties continue.

- Narrow range of financing instruments available or accessible to start-ups and SMES
- Limitations of traditional debt finance:
  - Thin capitalisation of the SME sector
  - Seed, early stage and growth capital gap
  - Lack of funding for major transitions
- Regulatory reforms and banks' deleveraging
  - Credit constraints as the "new normal"

Missed opportunities

- Wider use of alternative instruments hampered by lack of awareness, understanding and skills on the part of SMEs, financial institutions and governments.

How to Fix and Improve!

- **Improve understanding** about opportunities and challenges of alternative instruments to address ***diverse* needs and SME types**, in different economic and regulatory environments
- **Explore policies to foster** broader development and use
- Derive policy recommendations and **encourage discussion** among all stakeholders

External financing instruments alternative to traditional debt …

Low Risk/ Return	*Low Risk/ Return*	*Medium Risk/ Return*	*High Risk/ Return*
Asset-Based Finance	**Alternative Debt**	**"Hybrid" Instruments**	**Equity Instruments**
• Asset-based lending • Factoring • Purchase Order Finance • Warehouse Receipts • Leasing	• Corporate Bonds • Securitised Debt • Covered Bonds • Crowdfunding (debt)	• Subordinated Loans/Bonds • Silent Participations • Participating Loans • Profit Participation Rights • Convertible Bonds • Bonds with Warrants • Mezzanine Finance	• Private Equity • Venture Capital • Business Angels • Specialised Platforms for Public Listing of SMEs • Equity Derivatives • Crowdfunding (equity)