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# EQUITY FINANCING OF SMALL-SCALE INDUSTRY 1/

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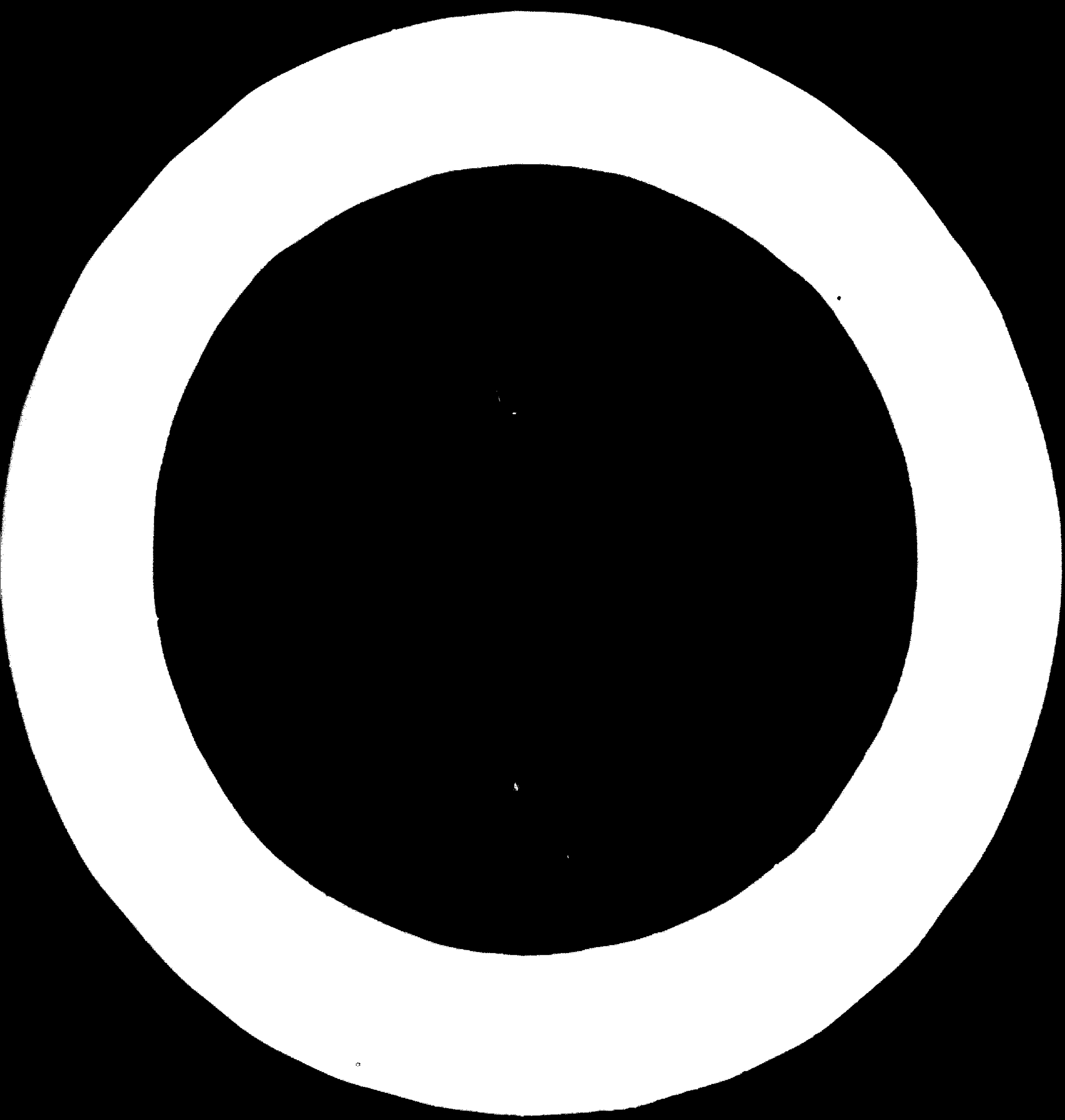

## Equity Financing of Small-scale Industry

One of the important problems in the financing of small-scale industry is the insufficiency of the owned capital. In developing countries, this problem does not affect only small enterprises. All enterprises suffer from the lack of well organized capital markets but small undertakings feel more acutely the scarcity of capital - especially of "risk-capital". Small investors are reluctant to risk their savings in becoming part-owners of small enterprises in spite of hopes of better returns. They normally prefer to invest in fixed deposits and government bonds, which yield lower profits, but allow funds to be withdrawn at short notice. Another problem is the lack of adequate information on investment opportunities in profitable small undertakings. In most developing countries, small savings are invested in public issues of share capital but this takes place only for issues from large firms with established standing and repute, and small-scale industries have no access to this source of financing.

Most development financing organizations extend term loans and few have attempted to provide equity financing to small enterprises.

One way of meeting the difficulty is to set up special investment institutions of adequate size and standing, able to attract public issues of shares. Small enterprises needing additional capital can apply to these investment institutions and, if found creditworthy, can obtain equity capital through granting ownership or against the transfer of shares.

In the United States, the history of such institutions is fairly old-privately sponsored civic corporations for the development of new enterprises and the modernization of existing ones date back to 1911. Some of them managed to obtain funds by asking a group of prominent citizens to subscribe to their capital or to underwrite a public issue. Small enterprises can obtain capital out of such funds if the entrepreneurs are considered to be sound businessmen and if the project is attractive. However, the activity of such institutions has been limited - one of the oldest and most soundly managed corporations has on an average given assistance to not more than 10 firms each year over a period of forty years. They have also been very selective - a case is recorded in which more than 1000 applications were received in one year, of which only 58 were considered deserving close investigation.

In 1958, the United States Small Business Administration (SBA) began a programme of establishment of Small Business Investment Companies (SBICs) with the objective of meeting the "equity gap" faced by small firms. The Small Business Investment Act of 1958 provided for the establishment of a Small Business Investment Division in the SBA, having responsibility for the implementation of this programme. The SBA licenses, regulates and helps finance privately organized and operated SBICs. According to the law, a SBIC must be incorporated and have a minimum of three stockholders. A company which meets the statutory and regulatory requirements can obtain a license from the SBA. The SBICs can receive a large infusion of capital from the Federal Government. Under the Act, a SBIC should have a paid-in capital and surplus of at least $ 300,000 before it would be eligible for a license, The SBA can supply up to half of this amount ($ 150,000) by purchasing subordinated debentures of the SBIC. These subordinated debentures, purchased by the Government, are considered part of the "statutory capital" of the SBIC. Additional loans from the SBA can amount to as much as 50 per cent of the "statutory capital" of the SBIC. Therefore a SBIC can be started with as much as two-thirds of its capital provided by the Government. 1/

1/ For example, if private funds provide $ 150,000, the SBA matches it by buying $ 150,000 worth of the SBIC's subordinated debentures, and then makes a loan to the SBIC of 50 per cent of the $ 300,000 of "statutory capital", that is, another $ 150,000. In this example, the SBIC gets started with $ 450,000, in which there are 2 government dollars for each private dollar.

The SBIC can provide equity capital and long-term loans to small firms.

The Act sought to broaden the ownership of the SBICs and eventually to reduce their reliance on Government financing. It provided that a small firm receiving capital from a SBIC had to buy stock in the SBIC equal to at least 2 per cent, but not over 5 per cent of the capital supplied. The Act permitted SBICs to make long-term loans to both incorporated and unincorporated small firms. It also allowed SBICs to provide consulting services for a fee. To encourage the formation and profitability of the SBICs, the Act gave tax advantages to both SBICs and to their stockholders.

The Act has been amended several times (1960, 1961, 1963, 1966 and 1967). The original provision that equity capital provided by the SBIC to a small firm could only be in the form of convertible debentures proved to be too restrictive. The initial requirement that the small firms receiving SBIC financing had to purchase stock of the SBIC was eliminated, since many small firms considered this as an additional charge for the funds received. 2/ The amount of statutory capital was raised from $ 150,000 to $ 400,000 and subsequently to $ 700,000, subject to the condition that matching funds were invested in the SBIC from private sources. The original Act had permitted SBA to make loans to SBICs up to 50 per cent; this was amended by limiting the amount of such loans to $ 4 million of 50 per cent, whichever was less.

Commercial banks had originally been permitted to invest in an SBIC an amount not to exceed one per cent of the bank's capital and surplus; this was subsequently increased to 2 per cent in order to obtain bank support. Through further amendments, SBA was given additional authority to regulate SBICs and suspend their licenses. The most recent amendments provide for a further increase in the amount of money an SBIC may draw from the SBA, an additional increase (to 5 per cent) in the percentage of the capital and surplus a commercial bank may place in a SBIC, and for

2/ The amendment made it possible for small firms to buy stock in a SBIC but did not require them to do so.

the establishment of an SBIC Advisory Board. The SBA can now match private funds on a two-for-one basis up to $ 7.5 million.

Yet after a decade the record of the SBICs is not very impressive.

Through the first quarter of 1967, SBICs made almost 27,000 separate financings to small firms, totalling $ 1.2 billion. As of that date, the assets of the SBICs were $ 672 million, but it should be noted that a large portion of these assets were provided by the Government. During this period, the SBA purchased $ 184 million of subordinated debentures and lent the SBICs over $ 173 million to add to their capital. Profits have been meagre. Not until the year ending March 1967 did the SBICs show an over-all profit.

The profit was modest: $ 10.7 million for the 600 odd companies incorporated in SBICs - a return of only 2.4 per cent on invested capital, which is hardly attractive for investors getting 6 per cent or more from government issues.

An analysis made by the SBA of the profitability of SBICs shows that the majority of SBICs with modest capitalization were unlikely to have profitable operations. In the SBA study, SBICs were broken down into four size categories: less than $ 325,000, $ 325,000 to $ 1,000,000, $ 1 million to $ 5 million, and $ 5 million and above. The rate of return on invested capital of companies in these size categories in 1966 was, respextively, a loss of 2.3 per cent, a profit of 0.3 per cent, a profit of 4.4 per cent, and a profit of 3.3 per cent. As a result of this study, the SBA has advocated that the minimum capital of an SBIC be $ 1 million.

As stated in Addison Parris' recent book,

"It is also likely that the average size of SBIC equity financing and loans to small business will also become larger and larger simply because larger financings are more profitable. And the larger loans are given to firms somewhat larger than "the little fellow", whose needs are more modest.

It is undeniable that SBICs can be made profitable, given the proper mix of government subsidy and encouragement of larger and larger SBICs and larger and larger outlays by SBICs. We shall then have large SBICs making long-term loans and providing equity financing for what are in effect medium-sized firms. The little fellow will be lost in the shuffle again simply because there is not much money to be made out of him." 3/

Another disappointing aspect of the SBIC experiment is the low proportion of equity financing provided by the SBICs to small firms. Out of $ 522 million of investments and loans outstanding by the SBICs in March 1966, $ 279 million (54 per cent) were in long-term loans; $ 180 million (29 per cent) in debt securities and $ 93 million (17 per cent) in capital stock - only 17 per cent were actually in equity capital.

It is unlikely that SBICs would be adequate tools for generating industrial development in the developing countries. Their experience in the United States, where small firms represent one of the most productive small industry sectors in the world, has not been promising. The formation of SBICs requires heavy capital inputs, both from the private and the public sectors - and capital is one of the scarcest factors in the developing countries. SBICs, to be successful, require excellent management and a rational selection of recipient small firms; such management is also very scarce in developing countries. The tendency of SBICs to finance medium-sized companies rather than small enterprises is another factor restricting their use in the developing countries.for the promotion of small-scale industry.

In Japan, small business investment companies were authorised by legislation in 1963, which provided special government assistance to companies extending equity financing to small enterprises under government regulations. Three companies differing in ownership and in regional coverage were formed between 1963 and 1965, one each in Tokyo, Osaka

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3/ Addison W. Parris, The Small Business Administration (Washington: Praeger, 1968), page 166.

and Nagoya. The Tokyo company is the largest, with a capital of ¥ 2.5 billion (US $ 7 million), the Nagoya company is the smallest, with a capital of ¥ one billion (US $ 2.8 million).

The Government may provide up to one-third of the capital of such companies in the form of 6.5 per cent 15-year redeemable non-voting preference shares. However, in the case of the above-mentioned three companies, the Government subscribed shares amounting to only 10 to 12 per cent of their capital. The local governments provided an additional 17 to 20 per cent capital in common shares. Private financial institutions own the majority of shares in all three companies and the remainder of the shares are held by associations of dealers in securities and by industrial companies.

The investment companies may finance only enterprises with a capital (before company financing) of less than ¥ 50 million (US$ 139,000), purchasing not less than 15 per cent nor more than 50 per cent of the shares issued. To be eligible, firms must also have paid dividends of at least 10 per cent per annum over the past 18 months; show promise of growth; and be unable to raise capital from other sources. Initially, the investment companies were only authorized to provide finansing by the purchase of the newly issued shares, but regulations were amended in 1965 to permit them to purchase debentures bearing maximum interest of 10 to 11 per cent convertible to equity within four years. By the end of 1965, the three companies had together made a total of about 75 investments in a wide variety of enterprises. The shareholders of the companies and private banks assist the companies in identifying promising clients.

In the Netherlands two equity financing companies have been in operation since 1960. One, administered by the Middle-class Bank, takes minority participations in companies on a temporary basis in amounts up to the equivalent of US$ 27,000; the second, administered by the National Investment Bank, takes participations ranging from US$ 27,000 up to about US$ 7,000,000. These operations are based on rather ingenious arrangements.

The two financing companies obtain their funds from long-term deposits of financial institutions. Both the depositors and the financing companies are guaranteed against any loss by an Industrial Guarantee Fund of about US$ 8 million, established by the Netherlands Government. The financing companies purchase shares in firms at values determined on the basis of the firms' assets and earnings. The firms have an option to repurchase such shares within a certain period at par, plus 10 per cent annual appreciation, less the amount of dividends paid in the period on the shares.

Thereafter, the financing companies may sell the shares at market value or at an "appraised fair market value" determined by two auditors, one appointed by the financing company and one by the firm. Although these provisions would appear to meet most of the usual objections to financing small firms on an equity basis, neither the potential recipients nor the bank administers of the Dutch equity financing operations have shown much enthusiasm for the arrangements. Up to the end of 1965 the company administered by the National Investment Bank had made ten investments, while the other company had not made any. 4/

Equity financing has not been attempted yet with any success in developing countries. One organization, which has experimented unsuccessfully with equity financing of small enterprises in a developing country, is the Orissa State Finance Corporation, India.

The Orissa State Government began an experiment in 1959 under the provision of its State-Aid-to-Industry Act to extend equity financing to industrial enterprises. By 1961, it had invested the equivalent of about $ 800,000 in 37 companies. Private share-holders were required to put up a minimum of at least 10 per cent of the total investment, with the state contributing the rest. The private owners were given the opportunity to repurchase the government shares. They assumed the managerial responsibilities of the enterprises subject to the authority of the board of directors, on which the government was represented.

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4/ Davenport, Robert W. Financing the small manufacturers in Developing Countries, 1967, p-197 (Mc Graw-Hill, New York, 1967)

Deficiencies in the management of these enterprises became a serious problem. In 1960, an evaluation conducted by the Government concluded that "these stemmed largely from the indifference of entrepreneurs who had little at stake in the enterprise, and from a lack of supervision". On the other hand entrepreneurs complained that effective management was blocked because decisions on operational matters could not be obtained from government directors who had little experience of commercial small industrial enterprises. Other deficiencies, as stated in a recent report 5/ are "lack of care in the selection of entrepreneurs and the saddling of the management with government supervision (sometimes interfering with managerial tasks)". As a result, the Orissa government had to suspend this operation.

Experiments holding somewhat better prospects of success have been carried out by the Maharashtra Small-scale Industries Development Corporation and by the State Industrial and Investment Corporation of Maharashtra (SICOM), India. 6/

In Senegal the National Society of Industrial Studies and Promotion (SONEPI) recently established with UNDP (Special Fund) assistance has proposed the establishment of an equity participation fund with a view to providing part of the capital of small-scale and medium-sized industrial enterprises, so that entrepreneurs could have at their disposal "own capital" which would enable the banks to grant them rediscountable medium-term loans. The proposal makes adequate safeguards against possible misuses. Access to the equity participation fund would be subject to the following conditions:

(a) Business success of the applicant in his previous activities;
(b) A feasibility study of the project to be carried out by SONEPI;
(c) A commitment to convert the applicant enterprise into a limited company (or give it some other specific legal status), to keep proper accounts and to engage a firm of chartered accountants acceptable to the lender bank;

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5/ and 6/ For more details, see the paper "Extension Service and Development Finance for Small Industry, an International Comparative Analysis prepared for UNIDO by M.C. Shetty - ID/WG.17/14 August 1968 - p.12

(d) Participation in a seminar for training heads of enterprises, organized by SONEPI, and dealing with modern management methods;

(e) The equity participation fund's investment in the capital of the new enterprise must not exceed 3 per cent of the fund's total holdings nor 40 per cent of the loan requested;

(f) Enterprises benefiting from equity participation should be under an obligation to buy out the participation on completion of repayment of the medium-term bank loan.

SONEPI has estimated that about 75 million frs. CFA (US$ 270,000) would be required for financing of about 50 small-scale enterprises during the Third-Four-Year Plan. It proposed to request the Caisse centrale de coopération économique (Central Economic Co-operation Bank) to grant the state of Senegal a loan of this amount on a long-term basis at a reduced rate of interest for allocation to the equity participation fund on a permanent and non-repayable basis.

It is proposed to create a separate department within SONEPI "the Equity Participation Fund Department" for the management of the fund. The department would be assisted and supervised by an Equity Participation Fund Management Committee, whose decisions will be executed through the Director General of SONEPI. The members of the committee would be the Ministers of Planning and Industry and of Finance; the Director General of SONEPI (Chairman); the Directors of the Central Economic Cooperation Bank and Directors of the five main Senegalese banking institutions.

The Committee would have two main functions:

(a) Examining applications for fund participation and deciding whether to grant or refuse them;

(b) Supervising the management of the fund on the basis of the documents submitted to it.

The fund would participate only in industrial investment programmes requiring medium-term bank credit submitted by Senegalese entrepreneurs wishing to establish new industries or expanding existing ones. Equity participations would be subscribed by SONEPI, since the fund would have no status as a legal entity in its own rights. Equity participation by the fund in industrial enterprises would be subject to the granting of the medium-term bank credit justifying such participation.

The recipient would have to sign a contract with SONEPI to buy out the funds' participation in his enterprise within a maximum of two years of the last repayment due on the medium-term loan obtained from the banking establishment.

The total resources of the Fund (75 million frs. CFA) would be distributed among all the five main credit institutions of Senegal. SONEPI would be responsible for the preparation of a feasibility study and for supervision of the operations connected with the utilization of the amounts obtained from the fund. The purpose of this supervision would be to prevent misuse of the fund's participations or of the bank loans granted and to enable prompt action to be taken against defaulters.

The proposed equity participation scheme of Senegal seems to be worth studying by other developing countries. Its main features - preparation of sound projects and supervision of operations including training of the management - seem to offer hopes for success.

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