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FINANCING OF SMALL BUSINESS AND PRIVATE ENTREPRENEURSHIP

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Abstract

This article examines the economics of financing small business in private equity and debt markets. Firms are viewed through a financial growth cycle paradigm in which different capital structures are optimal at different points in the cycle. This study and study of the specifics of the financial and credit mechanism in foreign countries is an important factor in determining the optimal directions of financial and credit support for small businesses and private entrepreneurship in the Republic of Uzbekistan. The purpose of the study of the financial and credit mechanism for supporting small business in foreign countries is to formulate the main directions for improving small support based on the analytical data.

Keywords: small business, private entrepreneurship, foreign experience, credit, financing, state support, financial incentives.

INTRODUCTION

One of the important areas of research on the problem of bank lending to small businesses is the study of the positive experience of a number of foreign countries that have achieved the best result in this aspect. When studying foreign lending models for small businesses, undoubtedly, the main accent is made on the experience accumulated in the US, Germany, France, that is, the countries that are the main participants in international assistance programs in developing countries. The role of the entrepreneurial enterprise as an engine of economic growth has garnered considerable public attention in the 1990s. Much of this focus stems from the belief that innovation – particularly in the high tech, information, and bio-technology areas – is vitally dependent on a flourishing entrepreneurial sector. The spectacular success stories of companies such as Microsoft, Genentech, and Federal Express embody the sense that new venture creation is the sine qua non of future productivity gains. Other recent phenomena have further focused public concern and awareness on small business, including the central role of entrepreneurship to the emergence of Eastern Europe, financial crises that have threatened credit availability to small business in Asia and elsewhere, and the growing use of the entrepreneurial alternative for those who have been displaced by corporate restructuring in the US.

Accompanying this heightened popular interest in the general area of small business has been an increased interest by policy makers, regulators, and academics in the nature and behavior of the financial markets that fund small businesses. At the core of this issue are questions about the type of financing growing companies need and receive at various stages of their growth, the nature of the private equity and debt contracts associated with this financing, and the connections and substitutability among these alternative sources of finance. Beyond this interest in the micro-foundations of small business finance is a growing interest in the macroeconomic implications of small business finance. For example, the impact of the US “credit crunch” of the early 1990s and the

effect of the consolidation of the banking industry on the availability of credit to small business have also been the subject of much research over the past several years. Similarly, the "credit channels" of monetary policy – mechanisms through which monetary policy shocks may have disproportionately large effects on small business funding – has generated considerable analysis and debate. Other key issues, such as the link between the initial public offering (IPO) market and venture capital flows, prudent man rules regarding institutional investing in venture capital, and the role of small firm finance in financial system architecture are just beginning to attract research attention.
The private markets that finance small businesses are particularly interesting because they are so different from the public markets that fund large businesses. The private equity and debt markets offer highly structured, complex contracts to small businesses that are often acutely informationally opaque. This is in contrast to the public stock and bond markets that fund relatively informationally transparent large businesses under contracts that are more often relatively generic.
Financial intermediaries play a critical role in the private markets as information producers who can assess small business quality and address information problems through the activities of screening, contracting, and monitoring. Intermediaries screen potential customers by conducting due diligence, including the collection of information about the business, the market in which it operates, any collateral that may be pledged, and the entrepreneur or start-up team. This may involve the use of information garnered from existing relationships of the intermediary with the business, the business owner, or other involved parties. The intermediary then uses this information about the initial quality of the small business to set contract terms at origination (price, fraction of ownership, collateral, restrictive covenants, maturity, etc.). Contract design and payoff structure are chosen on the basis of the financial characteristics of the firm and the entrepreneur as well as the firm's prospects and the associated information problems. High risk-high growth enterprises whose assets are mostly intangible more often obtain external equity, whereas relatively low risk-low growth firms whose assets are mostly tangible more often receive external debt for reasons explored below. Finally, in order to keep the firm from engaging in exploitive activities or strategies, the intermediary monitors the firm over the course of the relationship to assess compliance and financial condition, and exerts control through such means as directly participating in managerial decision making by venture capitalists or renegotiating waivers on loan covenants by commercial banks.

LITERATURE REVIEW

The papers in this special issue were drawn from a conference held at New York University in May 1997 sponsored by the Berkley Center for Entrepreneurial Studies and the New York University Salomon Center. They consist of full-length research papers, discussants' comments on these papers, and shorter contributions based on panel discussions. The topics span a wide variety of key issues, including venture capital and going public (Trester, 1998; Thakor, 1998; Bergemann and Hege, 1998; Lerner, 1998b; Benveniste et al., 1998; Flannery, 1998), angel anance (Lerner, 1998a; Prowse, 1998; Acs and Tarpley, 1998), the impact of anancial institution consolidation on small business lending (Peek and Rosengren, 1998; Strahan and Weston, 1998; Rosen, 1998b; Goldberg and White, 1998; DeYoung, 1998), relationship lending (Berlin and Mester, 1998; Houston and James, 1998; Pagano, 1998; Angelini et al., 1998; Kashyap, 1998; Cole, 1998; Duca, 1998), issues in credit availability (Hancock and Wilcox, 1998; Eisenbeis, 1998; Avery et al., 1998; Mann, 1998), the availability of new data sources for research on small business (Wolken, 1998; Fenn and Liang, 1998; Dunkelberg, 1998), and the future of small business anance (Gompers, 1998; Rosen, 1998a; Meyer, 1998). This special issue and the conference on which it is based have several motivations. The arst is to provide as complete a picture as possible of the nature of the private equity and debt markets in which small businesses are nanced based on currently available research and data. The second is to draw connections between various strands of the theoretical and empirical literature that have in the past focused on specic aspects of small arm anance but often have not captured the complexity of small business nance and the alternative sources of funding available to these ®rms. The third goal is to extend research in key areas related to the markets, contracts, and institutions associated with small arm nance. Finally, we wish to highlight important issues for future research and the relatively new data sources available to address these issues. It serves to compensate the losses of members of the company, as well as credit risk to the bank. The Society of Mutual Guarantees provides a dossier to its clients in the bank. Without a dossier, the bank does not essentially consider the issue of granting a loan. But before submitting a dossier to the client to the bank so that he can receive a loan, the Company itself assesses the risk of a particular financial transaction and decides whether it is advisable to obtain a loan. A mutual guarantee company distributes the risk of one client to many. If the Company does not have enough funds from the guarantee fund, then it can use its initial capital, which was formed at the time of the creation of the company. The main company for insurance of credit risks in France is Sofaris (State Joint Stock Company for Insurance of Credit Risks of Small and Medium Enterprises). At the same time, the state, participating in its own funds in credit risk insurance, does not interfere in the activities of the bank that works with small business, nor in the activities of Sofaris. Sofaris does not have direct links with the enterprise, but only with banks. Sofaris is a mixed economy society: 34% state contribution, 46% banks and other institutions. The amount of Sofaris in the capital is 19%. Sofaris shares responsibility for credit risk between the state, banks and insurance companies. Sofaris does not analyze credit risk, but delegates this work to banks. Banks are preparing a file on clients, whose credit risk is insured by Sofaris. If the risk is not justified, then Sofaris does not compensate for the damage that may lead to bankruptcy. If a small business does not return a loan on time due to its insolvency, the bank notifies Sofaris of this and asks to cover the insured risk. In turn, Sofaris asks the bank to make certain reimbursement of damage on the insured loan at the company's expense (use of the lien, sale of a part of the enterprise's values, etc.). SOFARIS compensates only those losses, it is impossible to compensate by other methods. At the same time, the interest on the loan is refunded. Usually for investments SOFARIS compensates for the loss when approximately 50% of the capital is lost. Another important aspect of supporting small businesses is the experience of France in establishing partnerships with clients and providing them with consulting and training services. In the practice of banking services for small enterprises in a country where there is clearly a tightening of competition in connection with the unification of the European Union, there is a formation of long–term bank relations with small business representatives, even in the case of a transition to a new higher level of economic activity. In our opinion, this approach is very useful for Russia, since consulting and training services of banks are poorly developed in our country, this can give domestic banks additional benefits, increase the loyalty of entrepreneurs to the bank and its bank status. Such a bank may later become a "home" bank, where small businesses will store savings and savings. Comparing politics and attitude to small business in industrialized countries, it is rather difficult to make clear and clear generalizations. An analysis of foreign experience of lending to small businesses shows that when choosing the means of financing their business they can use the funds of investors or creditors. But with the money of the creditors, we must give certain promises to return the borrowed amount taking into account the value of interest, as an irrational payment for the use of another people's money.

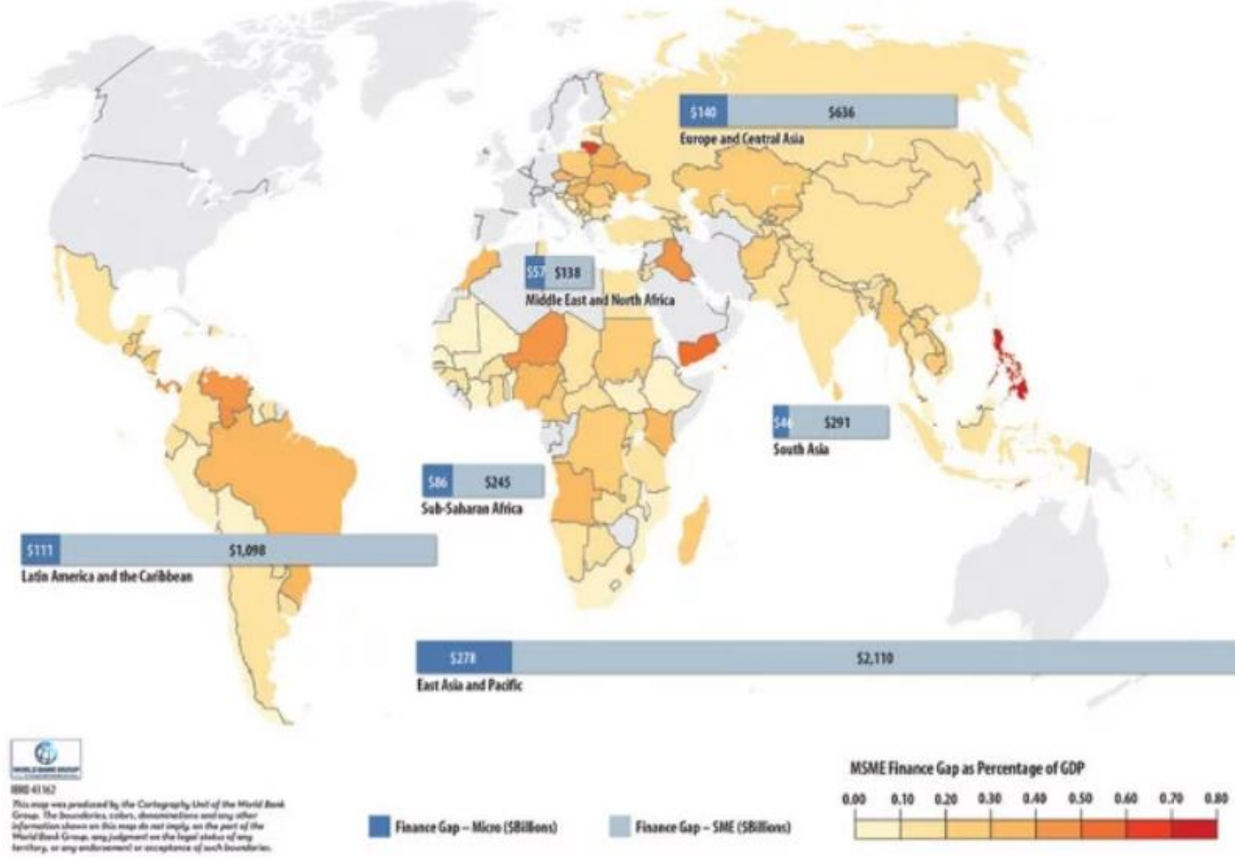
RESEARCH METHODOLOGY

The methodological basis of the research was the use of legal and regulatory documents, presidential decrees and decisions in the field of small business and private entrepreneurship development. Also, the methods of induction and deduction were widely used in the analysis of views and opinions related to the research work. Statistical data grouping, comparative analysis, sample observation methods were used in the analysis of the data of the Statistical Committee of the Republic of Uzbekistan. Scientific abstraction and other methods were used to enrich the content of the work and give it concluding thoughts.

ANALYSIS AND RESULTS

Small and Medium Enterprises (SMEs) play a major role in most economies, particularly in developing countries. SMEs account for the majority of businesses worldwide and are important contributors to job creation and global economic development. They represent about 90% of businesses and more than 50% of employment worldwide. Formal SMEs contribute up to 40% of national income (GDP) in emerging economies. These numbers are significantly higher when informal SMEs are included. According to our estimates, 600 million jobs will be needed by 2030 to absorb the growing global workforce, which makes SME development a high priority for many governments around the world. In emerging markets, most formal jobs are generated by SMEs, which create 7 out of 10 jobs. However, access to finance is a key constraint to SME growth, it is the second most cited obstacle facing SMEs to grow their businesses in emerging markets and developing countries.

SMEs are less likely to be able to obtain bank loans than large firms; instead, they rely on internal funds, or cash from friends and family, to launch and initially run their enterprises. The International Finance Corporation (IFC) estimates that 65 million firms, or 40% of formal micro, small and medium enterprises (MSMEs) in developing countries, have an unmet financing need of $5.2 trillion every year, which is equivalent to 1.4 times the current level of the global MSME lending. East Asia And Pacific accounts for the largest share (46%) of the total global finance gap and is followed by Latin America and the Caribbean (23%) and Europe and Central Asia (15%). The gap volume varies considerably region to region. Latin America and the Caribbean and the Middle East and North Africa regions, in particular, have the highest proportion of the finance gap compared to potential demand, measured at 87% and 88%, respectively. About half of formal SMEs don’t have access to formal credit. The financing gap is even larger when micro and informal enterprises are taken into account.



1-Figure. Formal MSME Finance Gap in Developing Countries

A key area of the World Bank Group's work is to improve SMEs' access to finance and find innovative solutions to unlock sources of capital.

Our approach is holistic, combining advisory and lending services to clients to increase the contribution that SMEs can make to the economy including underserved segments such as women owned SMEs.

Advisory and Policy Support for SME finance mainly includes diagnostics, implementation support, global advocacy and knowledge sharing of good practice. For example we provide;

Financial sector assessments to determine areas of improvement in regulatory and policy aspects enabling increased responsible SME access to finance

Implementation support of initiatives such as development of enabling environment, design and set up of credit guarantee schemes

Improving credit infrastructure (credit reporting systems, secured transactions and collateral registries, and insolvency regimes) which can lead to greater SME access to finance.

Introducing innovation in SME finance such as e-lending platforms, use of alternative data for credit decisioning, e-invoicing, e-factoring and supply chain financing.

Policy work, analytical work, and other Advisory Services can also be provided in support of SME finance activities.

Advocacy for SME finance at global level through participating and supporting G20 Global Partnership for Financial Inclusion, Financial Stability Board, International Credit Committee for Credit Reporting on SME Finance related issues.

Knowledge management tools and flagship publications on good practice, successful models and policy frameworks

The challenges to sustainable financing for MSMEs have become even more pronounced with the onset of the Covid-19 pandemic, as government authorities are severely constraining their operations. A survey of Ugandan firms in April 2020 reported that 58 percent of micro-enterprises would have to close if pandemic-driven restrictions were maintained for three months; among small firms, a majority said they would have to close if the status quo remained unchanged for up to six months. If current trends continue, the worst may be yet to come, and the hardest-hit victims will be those employed by MSMEs. Since 60 percent of African households report informal sector earnings as their primary source of income, the average worker is less likely to have a social safety net to rely on if they lose their job. Moreover, in the most impoverished settings, workers face the harrowing dilemma of having to either miss work and risk food insecurity or go to work and risk catching the virus.

CONCLUSION

Relatedly, the pandemic has also worsened one of the more ubiquitous challenges of financing MSMEs in Africa: the high information costs for formal sector lending. Commercial financial institutions have a fiduciary responsibility to protect themselves from high-risk exposure. They do this by undertaking due diligence and making risk assessments on potential borrowers. However, the costs of undertaking credible risk assessment have increased significantly with Covid-19; consequently, local commercial lenders have pulled back on their financing in general, given the higher-risk environment.

- SME Lines of Credit provide dedicated bank financing – frequently for longer tenors than are generally available in the market – to support SMEs for investment, growth, export, and diversification.
- Partial Credit Guarantee Schemes (PCGs) – the design of PCGs is crucial to SMEs' success, and support can be provided to design and capitalize such facilities.
- Early Stage Innovation Finance provides equity and debt/quasi-debt to start up or high growth firms which may otherwise not be able to access bank financing.

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