SME Loans and Equity Instruments as a Means of De-risking SME Finance and Increasing Market Liquidity.

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Introduction

It is well known that loans from traditional banks such as Deposit Money Banks (DMBs) and other lenders are usually associated with high interest rates and collaterals. Likewise, investors often tilt their investments toward more established business entities with large assets and robust financial books characterized by heavy cash inflow and outflow. This is to ensure that their dividend of investment is at least assured since from a large company perspective, business interests are properly aligned than in a small company or a Micro, Small, and Medium Enterprise (MSME). In Nigeria, MSMEs cater to the employment of over 80% of Nigerians and contribute to more than half of the country's GDP.[1] Though SMEs contribute largely to economic growth in Nigeria, they suffer access to adequate financing from investors both retail and institutional. This is because financiers, banks, and investors largely believe that SME finance is highly risky due to their lack of ownership of sophisticated assets that can be used as security for loans.

Therefore, some investors prefer to offer loans to the SME as opposed to equity investment due to a lack of confidence, uncoordinated business model, and perception. SME loans are a specialized form of finance made available to SMEs to augment their working capital. They are usually tailor-made to suit the specific needs of the business. Similarly, in exchange for capital, some business owners give up a portion of ownership through equity instruments and mezzanine finance which offer the investor an option to convert debt to equity if the loan offered to the business is not paid within the agreed period or is not paid in full.

Recent market practices have shown that SME loans and equity instruments are veritable ways to reduce the high risk associated with SME finance and increase market liquidity. Venture Capital (VC) investments increased in the first half of 2024 with Startups securing significant equity and debt finance from foreign and local investors. In August 2024, Waza, a Y Combinator-backed B2B payment and liquidity provider for emerging market businesses secured $8 million in equity and debt funding, which consists of a $3 million seed equity round and a $5 million in debt funding.

SME Financing In Nigeria; Importance & Risks

SMEs are generally regarded as businesses with an asset base that is between N5 million (Five Million Naira) to N500 million (Five Hundred Million Naira), and a staff strength that is between 11 (eleven) and 100 (one hundred) employees.[2]

SME finance is the funding of small and medium-sized enterprises and represents a major function of the general business finance market in which capital for different types of firms is supplied, acquired, and priced.[3]

Importance of SME Finance

Like every other business, finance is critical to the growth of SMEs, particularly to expand their operational capacity, achieve business objectives, and improve competition. Some of the importance of SME Finance include:

1. Business Expansion:

Adequate financing allows SMEs to increase production capacity, hire more employees, and invest in new technologies. This enhances the business's ability to serve a larger market and positions it for regional and international expansion.

2. Operational Efficiency:

Financing enables SMEs to streamline operations by investing in productivity-enhancing technology, raw materials, or inventory. Efficient processes lower costs, which helps improve profitability and ensures a stable cash flow, enabling SMEs to compete more effectively.

3. Innovation and Product Development:

With access to finance, SMEs can invest in research and development (R&D), enabling them to introduce new products and services tailored to evolving consumer demands. This capability drives innovation and allows SMEs to differentiate themselves in the marketplace.

4. Employment and Economic Impact:

The scaling of SMEs has a multiplier effect on the economy. As SMEs grow, they create employment opportunities, contribute to income distribution, and stimulate local economies through increased purchasing power and demand for goods and services.

Risks Associated with SME Finance in Nigeria

SME Finance comes with unique challenges, particularly for lenders, who face numerous risks when extending credits or investing in SMEs. Traditionally, SMEs are high-risk businesses. They lack acceptable collateral securities such as tradeable securities, first-class mortgages, and high-grade bonds. Some of the associated risks with SME Finance include:

1. Credit Risk: One of the primary risks lenders face is the possibility of default. Many SMEs in Nigeria operate in highly volatile sectors with fluctuating revenues and uncertain cash flows. Lack of financial stability increases the likelihood that an SME cannot repay its loans. Limited credit histories, inaccurate or incomplete financial records, and inadequate credit ratings further amplify this risk, as lenders lack the necessary data to make informed lending decisions.

2. Collateral Risk: Unlike large corporations with substantial assets, SMEs often lack the collateral that banks require as security for loans. Without collateral, DMBs and other institutional and retail lenders are exposed to higher risks in case of default. The absence of adequate collateral also means that lenders cannot recover significant losses if the borrower defaults. For many lenders, collateral serves as a risk mitigation tool in accordance with customary lending practices. When SMEs do not offer adequate collateral, lenders face a direct increase in risk exposure.

3. Market Risk: SMEs in Nigeria operate in a challenging economic environment characterized by inflation, currency devaluation, and regulatory changes. Market volatility negatively impacts SMEs' revenue streams and ability to service debt. Additionally, SMEs are highly sensitive to economic downturns, which may reduce consumer spending and impact business performance. Lenders are consequently wary of these external factors, which can affect the stability of SME operations.

4. Operational Risk: Many SMEs lack structured management systems, and their operations may depend heavily on the business owner, making them vulnerable to operational disruptions. A lack of sound corporate governance limited financial literacy, and inadequate business planning can result in operational inefficiencies. For lenders, this translates to a higher risk of business failure.

Structuring SME Loans and Equity Instruments

SME Loans can be structured in many ways that can accommodate both lenders' and borrowers' interests. To address the general conclusion that SME finance is associated with high risks as previously highlighted, the government, financial institutions, and investors are increasingly adopting various structures tailored to SMEs' needs and lenders' interests. These structures not only improve accessibility to finance and market liquidity but also reduce the risks associated with SME lending and investment. Some of the innovative structures SME loans and equity instruments may adopt include:

1. Public Credit Guarantee Scheme: Credit Guarantee Schemes provide third-party credit risk mitigation to lenders through the absorption of a portion of the lender's losses on the loans made to SMEs in case of default, typically in return for a fee.[4] Public Guarantee Schemes are designed to reduce collateral problems for business owners and increase access to SME finance. This involves a synergy with public institutions and agencies by providing a guarantee for a portion of the loan amount. The Development Bank of Nigeria[5] provides structures like this by introducing risk-sharing facilities that encourage banks to extend loans to SMEs. The transfer of some of the risk to the government encourages SME finance and improves market liquidity.

2. Syndicated Loan: Syndicated loans have emerged as a strategic financial structure, providing SMEs with unique advantages in navigating the complexities of modern business and funding environments. A syndicated loan structure involves multiple lenders coming together to provide a loan to a borrower. This structure involves a lead arranger who organizes the syndicate and facilitates communication among participating lenders.[6] A syndicated loan structure spreads the risk across the various lenders. However, it is usually used for large projects. In July 2024, FMO, an international entrepreneurial development bank provided a USD 295 million loan facility to support SMEs in Nigeria.[7]

3. Blended Finance: Blended Finance plays a pivotal role in alleviating some of the real and perceived risks associated with SME finance. Blended Finance structure combines concessional funds from development finance institutions or philanthropic sources with commercial funding. This structure mitigates the risk to private investors and incentivizes them to lend to SMEs. For example, international organizations working with local financial institutions provide concessional loans that help reduce the overall risk profile of SME financing.

4. Convertible Debt Structure: Convertible debt structure offers a hybrid solution that combines debt and equity features. It allows lenders to convert debt into equity at a later stage, typically once the SME achieves specific growth targets or milestones. Convertible debt provides SMEs with access to funding without the immediate pressure of repayments, while giving lenders an option to benefit from the company's future growth by converting debt into shares.

Structuring SME Loans and Equity Instruments cont.

5. Peer-to-Peer Lending (P2P): P2P lending allows SMEs to raise capital from a large pool of small investors, spreading the risk across a wider base. By tapping into these platforms, SMEs can secure funds without meeting the stringent requirements of traditional banks, while individual investors can support high-potential businesses.

Conclusion

While financing is essential for the growth and development of SMEs in Nigeria, it also exposes lenders to substantial risks that require careful management. However, implementing a loan structure that combines investors' and lenders' interests through equity and debt is sacrosanct in de-risking the SME finance landscape. This not only makes financing more accessible and manageable for SMEs but also helps lenders and investors mitigate their risks, making SME finance a more viable and attractive option which translates to market liquidity. As more lenders, financial institutions, and investors adopt these strategies and as supportive policies continue to emerge, SMEs can be propelled to their full potential driving job creation, innovation, and sustainable economic growth. However, securing appropriate transaction advisory is necessary to ascertain the suitable structure that best fits a proposed project.

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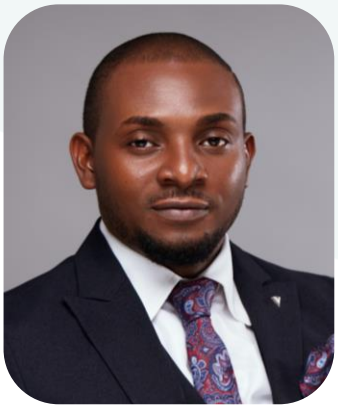
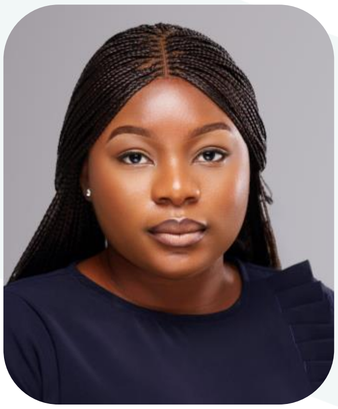


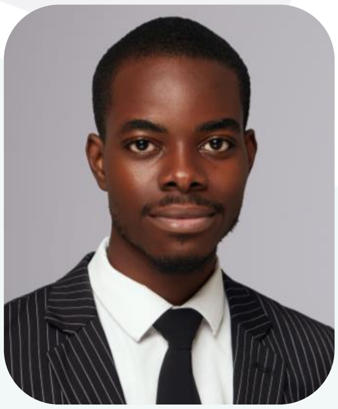
Noble Obasi
Team Lead

NobleObasi
@strenandblan.com



Ibitola Akanbi
Associate

IbitolaAkanbi
@strenandblan.com



Michael Afuye
Associate

MichaelAfuye
@strenandblan.com