

**ECONOMIC DIVERSIFICATION IN THE REPUBLIC OF KAZAKHSTAN
THROUGH SMALL AND MEDIUM ENTERPRISE DEVELOPMENT:
INTRODUCING NEW MODELS OF FUNDING FOR SMES**

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LIST OF ACRONYMS

ADB:	Asian Development Bank
BPI:	Business Partners International (South Africa)
CGC:	Credit Guarantee Corporation (Malaysia)
CIS:	Commonwealth of Independent States
CMAR:	Center for Marketing and Analytical Research (Kazakhstan)
DFI:	Development Financial Institutions
DTI:	Department of Trade and Industry (United Kingdom)
EBRD:	European Bank for Reconstruction and Development
ECU:	European Currency Unit
ExIm:	Export-Import Bank of the United States
FY:	Fiscal Year
GoK:	Government of Kazakhstan
ICT:	Information Communication Technology
IFC:	International Finance Corporation
IMP:	Industrial Master Plans
IT:	Information Technology
JSC:	Joint Stock Company
KMC:	Kazakh Mortgage Company
KSBP:	Kazakhstan Small Business Program
KUF:	Ministry of Education, Research and Church Affairs (Norway)
KZT:	Kazakhstan Tenge
LLC:	Limited Liability Company
LLP:	Limited Liability Partnership
LP:	Limited Partnership
MCTF:	Multicurrency Trade Finance
MIDF:	Malaysian Industrial Development Finance Berhad
MCO:	Microcredit Outlet (South Africa)
NBK:	National Bank of Kazakhstan
NEP:	New Economic Policy
NF:	Research Council of Norway
NIF:	National Innovation Fund (Kazakhstan)
NPL:	Non-Performing Loan
OCF:	Oblast Capital Fund (Kazakhstan)
R&D:	Research and Development
RFI:	Retail Financial Intermediaries
RM:	Malaysia Ringgit
RVCF:	Regional Venture Capital Fund (United Kingdom)
SBA:	Small Business Association (United States of America)
SBIC:	Small Business Investment Company (United States)
SEAF:	Small Enterprise Assistance Funds
SEGF:	Southeast Growth Fund (United Kingdom)
SIF:	Small and Medium Enterprise Investment Fund
SME:	Small and Medium Enterprise
SMEF:	Small and Medium Enterprise Development Fund (Kazakhstan)
SND:	Industrial and Regional Development Fund (Norway)
SVO:	Government Consultative Office for Investors (Norway)
SWOT:	Strengths, Weaknesses, Opportunities and Threats
USD:	United States Dollar
VC:	Venture Capital

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EXECUTIVE SUMMARY

In order to counter natural resource dependence and encourage entrepreneurial development in Kazakhstan, the Government of Kazakhstan (GoK) has embarked upon a multi-faceted approach to small and medium enterprise (SME) creation in the non-oil sectors of the economy. Under the onus of the sustainable development fund Kazyna, the government has tasked two governmental agencies, the Small and Medium Enterprise Fund (SMEF) and the National Innovation Fund (NIF), to remedy deficiencies in capital access for growing SMEs. Despite government efforts, access to capital is still inefficient due to inchoate developmental aims, procedural imperfections and bureaucratic restrictions.

This report is the product of collaboration between Columbia University School of International and Public Affairs, Economic and Political Development concentration and the Center for Marketing and Analytical Research, Government of Kazakhstan to identify bottlenecks to SME development. In particular, the focus of the report is on streamlining existing SME financing programs and the provision of additional sources of financing as methods to enhance SME access to capital.

In addition to analyzing the SME environment in Kazakhstan, a benchmark analysis was conducted, looking specifically at Malaysia, Norway, the United States and the United Kingdom for examples of successful SME finance enhancing policies. Findings from the benchmark analysis will provide background information for recommendations on the applicability of international practice to address the funding needs of SMEs in Kazakhstan.

Based on research findings, the following policy recommendations have been put forward:

- **Recommendation 1:** Streamline access to debt financing through the restructuring of SMEF operations.
- **Recommendation 2:** Provide regional technical assistance and support services via existing SMEF regional branch networks.
- **Recommendation 3:** Introduce models of equity financing through the establishment of SME Investment Funds (SIFs).
- **Recommendation 4:** Designate some of the newly established SIFs as Oblast Capital Funds.

In order for these recommendations to be effectively implemented, the following conditions must exist:

- High-level government support to SME development
- Long term government commitment to financing and supporting SME programs

INTRODUCTION

Small and Medium Enterprises (SMEs) are recognized as the sine qua non of economic growth in the industrialized nations of the developed world. In the United States, SMEs account for 60-80 percent of the net new jobs created over the past decade and nearly half of the real GDP¹. Now, focus has turned to the applicability of government-assisted SME development to deliver greater prosperity to the widest cross-section of people in the developing world. Both the World Bank and the International Finance Corporation (IFC) have understandably placed considerable importance on SMEs in the developing world, both as a source of job creation and an engine of economic growth.

The Government of Kazakhstan has also recognized SME growth as a long-term priority, specifically focusing on exports in the non-oil sectors, to counter a possible onset of Dutch disease and provide economic opportunities for a greater number of citizens. Currently, the Kazakhstan national economy is inordinately dependant on the extractive sector for foreign currency reserves, employment and exports. Unless new oil and mineral reserves are located and viably developed, Kazakhstan will likely endure a pullout of foreign consortia and corporations. It will face a challenging dilemma in the next decade unless other sectors of the economy are robust and competitive.

The GoK as well as multilateral and bilateral institutions have recognized three primary obstacles to growth in the entrepreneurial sector: a less-than-optimal regulatory and legal framework for conducting business, a lack of basic business knowledge among possible entrepreneurs, and finally, a lack of access to start-up and mezzanine level financing, especially among poorer regions and disadvantaged populations in the country. Kazakhstan will face great challenges in its efforts but these obstacles are not insurmountable.

In this report, the research team will tackle the third but perhaps most salient problem in the long term, lack of capital access funds in Kazakhstan. As the regulatory and business environment, currently the focus of most international assistance and local efforts, improves, lack of adequate models of equity financing will dampen future progress. Fortunately, several countries, which are heavily resource endowed today or have been in the past, provide models of successful government assistance to SME's allowing them to continue to grow in non-extractive sectors and become centers of both high and low technology sectors. The Columbia University Project Team looked at the examples of four countries, Malaysia, Norway, the United Kingdom, and the United States to identify best practices in easing access to capital to allow for good ideas to take hold and have space to grow.

¹ Moutray, Chad, The Small Business Economy for Data Year 2005. US Government Printing Office, Washington, 2006

METHODOLOGY

The research was conducted over a six-month period, with background research conducted in New York City and on the ground research conducted during two one-week trips to Almaty, Kazakhstan.

In January 2007 a fact-finding mission to Almaty was conducted to identify the problems faced by SMEs in Kazakhstan. The research team identified key government and non-government agencies responsible for supporting SME development. The government agencies interviewed included the Center for Marketing and Analytical Research (CMAR), the National Innovation Fund (NIF), Almaty Business Incubator and the Small and Medium Enterprise Fund (SMEF). As the primary executive agency of the State Programs for SME support SMEF alone was responsible for managing 29 billion tenge (235 million USD) of government funds allocated towards SME support. International agencies interviewed included USAID/Pragma Corporation, World Bank, International Finance Corporation and the American Chamber of Commerce. The private agencies interviewed included Kazkommertsbank, the largest bank in Kazakhstan, managing US \$12.3 billion and Alliance Bank, the largest SME bank in Kazakhstan, managing US \$5 billion with SMEs. These interviews were semi-structured interviews and the interviewees were provided information on the purpose of the interview and proposed research study for which the interview was being conducted.

In March of 2007, a second fact-finding mission was conducted with a narrowed focus on SME financing. During this trip, the team re-interviewed certain government and non-government agencies and identified new agencies of interest for the project. The organizations interviewed again include SMEF, CMAR, Kazkommertsbank, and Alliance Bank. The new government agency interviewed was the National Innovation Fund, which directly supports ten venture funds. International organizations interviewed included the European Commission Delegation and EBRD contractor KSBP. Since inception in May 1998 EBRD SME program credited 211 308 projects that amounted to 1,66 billion USD of program funding. Private sector agencies interviewed included Small Enterprise Assistance Fund (SEAF), which manages a venture fund valued at US \$12.8 million and the Federation of Entrepreneurs.

Between November 2006 and April 2007, the team conducted research and interviews while based in New York City. Internet research, semiformal in-person, phone, and internet interviews were conducted. All sources used are duly cited in the report.

BACKGROUND

General

From 2003 to 2007 Kazakhstan GDP grew at rates higher than 9 percent buoyed by high world crude oil prices.² But the issue on the development agenda for the country today is whether these extractable resources will be a guarantee of the country's future sustainable development, or on the contrary, it will follow the same path to the resource addiction quagmire experienced by the majority of resource exporting countries.

Under the current official scenario, oil production is expected to double by the beginning of the next decade, and triple over the next 10-15 years, reaching 3.5 million barrels per day.³ The government's oil revenue is expected to grow from \$4.2 billion in 2005 to about \$16 billion between 2015- 30.⁴ The dependence on the energy sector will increase tremendously if no effective and rigorous measures are taken to develop the non-oil sector. The Government of Kazakhstan (GoK) created the National Fund as a special arrangement in the field of macroeconomic policy to cope with negative consequences of the oil windfall. As of September 2006 the National Fund has accumulated US \$11.5 billion.⁵ The declared goal of this fund is to suppress inflation and avoid pressures on the exchange rate by diverting oil income away from the country, thus minimizing its influence on the national economy. The Sustainable Development Fund "Kazyna" was created by decree of the President of the Republic of Kazakhstan on March 16, 2006 with the purpose to increase and stimulate investment and innovation activities.⁶

Financial Sector

Kazakhstan's access to capital has improved substantially in the past two years. Reflecting a buoyant economy underpinned by high commodity prices and prudent macroeconomic policies, all international credit rating agencies rate Kazakhstan's sovereign currency at investment grade.⁷ Improvements in the economic and operating environment of Kazakhstan's financial sector have resulted in rapid growth during the past 5 years, leading to enhanced creditworthiness and commercial profiles for domestic banking. Encouraged by this improving macroeconomic environment and robust growth, Kazakhstani banks have increased lending volumes by an average of more than 40 percent per year while maintaining healthy asset quality and profitability. This is especially true for the top performers in the first two tiers of the banking system.⁸ One of

² The World Bank, <http://www.worldbank.org/kz/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/KAZAKHSTANEXTN/0,,contentMDK:20212143~menuPK:361895~pagePK:1497618~piPK:217854~theSitePK:361869,00.html>

³ The Economist Intelligence Unit, http://store.eiu.com/country/KZ.html?ref=country_list

⁴ International Monetary Fund, Republic of Kazakhstan: Selected Issues. No. 05/240, July 2005

⁵ National Fund Kazakhstan, www.nationalfund.kz

⁶ Kazyna, www.kazyna.kz

⁷ The Economist Intelligence Unit, see Fn. 2.

⁸ Bank Tech, Almaty, <http://www.banktech.kz/en/2007/>

the key challenges facing the financial sector is the development of the nascent capital markets (debt and equity).⁹

In September 1995, the National Bank of Kazakhstan (NBK) introduced strict prudential requirements for the operation and capital adequacy of banks. Following legislative changes in July 2003, the Financial Markets Supervisory Agency was formed. As of January 2004, it took responsibility for most of the supervisory and regulatory functions in the financial sector, which had previously been performed by the NBK. The agency's main task is to regulate and supervise the financial markets and institutions in Kazakhstan.¹⁰

Domestic pension funds have increasingly emerged as important investors in the local bond market since the launch of pension reform in 1998. The steadily accumulating pension funds provide a supply of long-term capital that is lacking in most emerging markets, including many other former Central Asian and Commonwealth of Independent States (CIS) countries. However, Kazakhstan has no meaningful private equity market with the standards expected by international institutional investors. Similar to most developing countries, venture capital does not play a major role in the Kazakhstani financial market.¹¹

SME Sector

Current Conditions

Kazakhstan's high dependence on oil exports poses a potential threat to the economy, given potential volatility in the international oil market. SMEs and manufacturing are currently underrepresented in the national economy. Low productivity and underdeveloped securitization force SMEs to operate in the sector of tradable goods and services. More than 60 percent of gross SMEs revenues are from the service sector.

Due to the fact that the SME sector is relatively more labor-intensive and provides for approximately 40 percent of total employment, SME growth is significantly more inclusive and pro-poor in nature. In its efforts to diversify the economy via SME sector development, the GoK has established an institutional framework of agencies to implement the major state policy strategies that will also benefit SMEs and has promulgated the latest Law on Entrepreneurship dated 31 January 2006

SME development is hampered by the difficulty in accessing capital, especially debt financing, at sustainable market rates and the banking sub-sector's lack of confidence in SME entrepreneurs. Estimates suggest that banks currently lend to SMEs at annualized interest rates of 18 percent or more. In an economy where access to capital is constrained

⁹ EBRD, Strategy for Kazakhstan, November 21, 2006, p. 10.

¹⁰ National Bank of Kazakhstan, <http://www.nationalbank.kz/?uid=2918191A-802C-E8FB-306B5BC51E34622D&docid=127>

¹¹ EBRD, Strategy for Kazakhstan, November 21, 2006, p. 10

and banks have a legacy problem of attracting customers, serious negative consequences can arise. On the other hand, banks and other financial intermediaries are reluctant to address these needs because of high risks, including the absence of appropriate collateral coverage; these risks are mitigated through higher interest rates. These hurdles must be overcome if Kazakhstan wants to move out of its heavy dependence on oil exports and to diversify the SME segment.

SME incubators provide SMEs with legal expertise and facilities. Within the aforementioned, the Kazyna Fund and SMEF address the issue of SME development. Formidable obstacles, such as lengthy procedures at SMEF, affect efficient access to capital. It can take up to two months for a business to obtain a loan from SMEF (as compared to two weeks at a private bank). In addition, SMEF's work is hampered by strict banking regulations, particularly on the part of capital requirements. These restrictions prevent the Fund from assuming its role as a development engine for SME growth. Second tier banks increasingly fill the gap by providing loans to SMEs at interest rates higher than those of the Fund.

Additional info on the state of SME in Kazakhstan, as of 01/01/2007

- There are 823,156 officially registered SMEs, 76 percent of which are currently operational. This figure represents 639,185 operating enterprises and has grown during the period 2002 to 2005 by 18 percent annually.
- SMEs account for the employment of 1.653 million people, who constitute 21.8 percent of the labor force. On average, this figure has grown by 8 percent annually.
- The SME share in the overall GDP of Kazakhstan is 24.4 percent.

Legal Framework

The Law of the Republic of Kazakhstan “On Private Entrepreneurship” (dated January 21, 2006) defines the main legal, economic and social guarantees of SME liberties. One of the features of the new law is that it systematizes the legal terms and codifies the required norms into a single legal act. Another important feature is the law's provision of clearer definitions on the subject of regulation – drawing clear lines between small, medium and large businesses based on the number of employees and average annual asset value.

According to the law, a small enterprise is defined as a legal entity with an average annual number of employees at 50 persons or less, and an average annual asset value not exceeding 60,000 conventional units. A medium enterprise is a legal entity with an average annual number of employees at 250 persons or less, and an average annual asset value not exceeding 125,000 conventional units. Important features of the law¹² include an obligation on the part of the government to finance consultancy and training services from the state budget and to create a network of business incubators, industrial zones and centers of SME support.

¹² According to this, preliminary overview.

Since 1991 there were six state programs on the *Support and Development of Small Entrepreneurship* (including the current one for 2005-2007 program cycle). The major directions of the state policy towards business sector today are shaped with the 2003 enactment of the Strategy on Industrial-Innovative Development for 2003-2015 and 2006 Address of the President to the People of the Republic of Kazakhstan On the Strategy to Enter the World's 50 Most Competitive States.

Support Organizations

Kazyna

The first stage: The Kazyna Fund for Sustainable Development was established on March 16, 2006 to address the objectives of the Industrial and Innovative Development Strategy of the Republic of Kazakhstan, i.e. the stimulation of investment into innovation projects to ensure Kazakhstani economic diversification and to further Kazakhstan's integration and competitiveness in the regional and global marketplace. Kazyna's strategy is to identify and implement long-term (5-20 year) investment projects in non-extractive sectors through the combination of capital, technology, know-how and management of these following national development institutions: 1) the Development Bank, 2) the Investors Fund, 3) the National Innovation Fund, 4) the State Corporation for insuring export loans and investments, 5) the SME Fund (SMEF), 6) the Center for Market and Analytical Research (CMAR), and 7) "Kazinvest." The structure and roles of all of the institutions under Kazyna are still under development, so as to eliminate internal competition and redundancy of tasks and duties.

Kazyna's role is to identify and implement, through Government and private sector cooperation, new results-oriented break-through projects that have high socio-economic value and provide administrative support and long-term financing in the form of debt and equity. Kazyna's Charter Capital amounted to US \$ 1 billion.

The second stage of the Kazyna Fund's development, following its inception in 2006, is marked with the March 12, 2007 Presidential Address to the People of the Republic of Kazakhstan "The New Kazakhstan in The New World". In addition to its role as a corporate manager for development institutions, these new directions for Kazyna were announced as priorities:

- Ensuring the provision of modern services to develop the competitiveness and export capacities of prospective enterprises and manufacturers – from financing applied research to promoting Kazakhstan's goods at local and international markets. The Fund shall become the state operator on issues of export support
- Identifying the integration of new technologies and the development of applied sciences in the economic priority sectors
- Facilitating access to export markets for leading enterprises in non-production industries via structured finance, export credits, export insurance, etc.

- Studying and implementing the aspects of venture financing on a competitive basis for manufacturing and production industries, which could find a niche and maintain a strong position on the international markets
- Attracting international companies to participate in joint ventures with Kazakhstani businesses that have export potential
- Promoting local and foreign investment into special economic and industrial zones, as well as export-oriented techno-parks
- Establishing a Fund of Funds with the participation of international financial institutions

In light of the above, Kazyna's investment budget increased up to US \$10 billion for projects in 2007-2010 within the following priority sectors: chemicals, petrochemicals, metallurgy, machinery, biofuels, energy, construction materials, transport and logistics, oil and gas machinery and related services, food production, and other non-extractive industries.

Small and Medium Enterprise Development Fund (SMEF)

Created in 1997 by the Governmental Decree, SMEF was originally under the direction of the Ministry of Industry and Trade. As mentioned above in 2006, oversight of SMEF was transferred to Kazyna¹³.

The structure of SMEF includes headquarters in Almaty with regional branches in each of the 14 oblasts (administrative-territorial units or regions).

Currently, according to the Law on Entrepreneurship, SMEF is obliged to pursue the following tasks:

- Project financing – which implies financial support for SMEs through the provision of financial resources for projects, but not financing enterprises as a whole
- Development of a micro-credit enterprise network with the participation of SMEs
- Development of a guarantee system to facilitate the extension of commercial bank loans to SMEs
- Development of leasing for SMEs
- Provision of training and consultancy services
- Development of a grant system for co-financing the operations of SME quality control systems

From its creation up until now, SMEF has undergone the following development stages:

During the first stage of its development (1997-2001) SMEF acted as a government agent for managing credit lines extended by international financial and development institutions (US \$50 million ADB Agricultural Sector Program Loan, US \$77.5 million from the EBRD for Technical Assistance Programs). SMEF also oversaw the implementation of

¹³ State owned fund and sole stakeholder for other 6 state owned national development institutions responsible for their efficient management in line with the Strategy of Industrial-Innovative Development.

national programs in the field (US \$22.7 million Program on the Support of Domestic Produce). During this period, financing was conducted through private financial institutions in Kazakhstan.

The Second stage (2002-2004) was characterized by the creation of a network of regional branch offices. SMEF started to extend direct loans to SMEs (12 percent annual rate, decreased to 10 percent after five years) from its own budget as well as from the funds available through a number of government credit lines.

The goal of the Third (Current) Stage (as per 2005-2007 Memorandum of SMEF Activities approved by Kazyna) and the strategic directions for the Fund in 2007-2011 aim to create a financial supermarket that would provide a whole range of financial products (loans, insurance guarantees) for SMEs. SMEF's capital is to be increased by up to KZT 30 billion (approximately US \$250 million), of which US \$166.5 million has already been provided.

The main sources of funding for SMEF are from the capitalization of government budget funds for the subsequent financial year as well as credit lines from international financial institutions.

SMEF's loan portfolio is comprised of the following programs (as of October 2006):

- The EBRD Small Business Program in Kazakhstan (211,308 projects financed in the amount of US \$1.66 billion)
- The Second Tranche of the ADB Agricultural Sector Program Loan (95 projects financed in the amount of US \$54,600)
- The Government-funded Program on the Measures of Domestic Producer Support (14 projects financed in the amount of US \$22.72 million. The program is almost finalized and the returns are to be used to increase SMEF's capitalization)
- The Small Business Loan Extension Program (including women entrepreneurship) from funds provided by the budget in the amount of US \$2.5 million, starting in 2002. (By the beginning of October 2006, the total project value increased to the amount of US \$5.86 million)
- The Government-funded Program on the Development of Small Towns for 2004-2006 drawn from capital earmarked for SMEF. By October 2006, 272 projects were financed in the amount of US \$12.1 million
- Extending Loans from SMEF Funds (1371 projects were financed in the amount of US \$136.9 million)
- A Co-financing Program with the Akmola Oblast Governorship on a 50:50 basis, with capital provided by the Akmola Oblast Budget and SMEF (21 projects financed in the amount of US \$1.7 million)

As of October 2006, SMEF's assets totaled US \$291.6 million, with SMEF's own capital making up more than US \$233.3 million.

According to SMEF management, the main obstacles to the proper functioning of the Fund are as follows:

- Absence of a proper and comprehensive strategy for SME development in Kazakhstan, which is due to the declining importance of the regulatory body in the hierarchy of state institutions (from a separate agency to a subcommittee of the ministry, from a separate fund to an affiliate of the Kazyna fund)
- Rigorous regulations from the part of the Financial Supervisory Agency. The prudential regulations on SMEF's capital and the requirements on reserves that are created on losses from credit activity are directly borrowed from banking regulations. This is not the best policy towards venture and development oriented institutions due to their higher credit risk exposure.
- Requirements for profit orientation by the State Development Fund, Kazyna. This requirement does not seem to be relevant for the management and directly conflicts with SMEF's efforts to provide training and consultancy services to SMEs (per its government mandate)

The Center for Marketing and Analytical Research (CMAR)

The Center for Marketing and Analytical Research (CMAR) was created in response to the need to implement the *Strategy on Industrial-Innovative Development for 2003-2015*, which was introduced in August 2003. CMAR, founded as a wholly owned state institution, works under the Kazyna Fund. It supports Kazakhstan's industrial and innovation strategy by providing marketing information and analytical research to boost economic diversification and Kazakhstan's competitive environment in both regional and global markets.

Among its goals, CMAR aims to be both a reliable source of information and a networking point between Kazakhstan's industrial and business sectors. Staffed with western educated and trained personnel, CMAR acts as a strategic idea generator for the economic development of Kazakhstan, using the most modern and advanced methods of research.

Through its activity, CMAR provides consistent policy analysis to a wide range of clients. In particular, it serves both the private and public sectors, including governmental bodies, representatives of SMEs, large enterprises and international consulting companies. Taking Michael Porter's Cluster theory as a model for development, CMAR aims to address the creation of an industrial base to enhance the country's competitiveness. It supports the GoK in its state policy formulation on all matters concerning the macroeconomic environment, trade, and financial infrastructure. Through its research, CMAR also contributes to economic diversification by studying the challenges facing the non-extractive sector.

Through analyzing value chains, potential barriers and external and technological factors that can influence the full implementation of a competitive sector, CMAR aims to create

policy recommendations that are able to investigate and assess Kazakhstan's market potential.

In line with its mission to contribute to economic diversification, CMAR has recently been assigned a major position in the development of the Kazyna-supervised National Export Strategy (NES), which was announced last fall. Addressing the need to enhance the non-extractive sector's export capacity, CMAR will play a crucial role in assessing the structural framework related to the project "A New Kazakhstan in a New World." CMAR will essentially act as a base for the creation of an agency that can support the non-extractive business sector's export activity. It will identify potential establishments - exporters and enterprises having export potential. Furthermore, the analysis will address any type of research and analysis activity that can support promotion to external markets.

National Innovation Fund (NIF)

The National Innovation Fund (NIF JSC) Joint Stock Company was established in May 2003 through a GoK Resolution. The resolution detailed that the government would provide 100 percent of the organization's authorized capital. The NIF was mandated to assist in the growth of innovation activity and the development of high-tech and science intensive production facilities within Kazakhstan. NIF's primary activities include creating venture funds, financing innovation projects both in Kazakhstan and abroad, developing innovation infrastructure and financing research and development through grants. Innovative sector focuses include information technology, pharmaceuticals, oil and gas technological services and food processing.

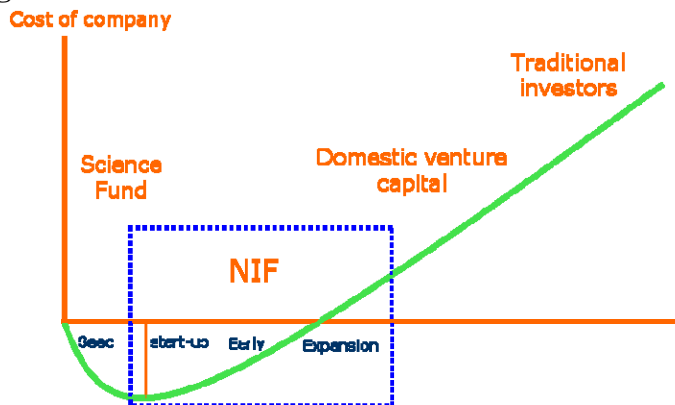
NIF serves as both a venture capital fund and a fund of funds. The main purpose of the organization's venture funds is to support innovation activity in Kazakhstan. To date, the NIF has invested over US \$182 million in programs worth US \$792.5 million, including US \$92 million in eleven equity investment projects, and US \$75 million in ten venture funds.

Investment projects: the NIF funds projects across a wide range of stages, starting with early seed companies to companies in early expansion phases. The overall priority in project investment is to develop technology and know how through R&D, with movement away from an emphasis on the oil sector. Companies receiving equity funding from the NIF must be financially sustainable and be working in innovative areas. Generally, the NIF is willing to invest between US \$50,000 and US \$15 million into any single project. NIF invests in shares that make up 49 percent or less of the company and looks for an internal rate of return (IRR) of at least ten percent. Other project criteria include the requirement that the project is innovative, increases employment, and properly hedges risk. Geographically, NIF can invest in both Kazakhstan and abroad, with many potential projects from neighboring Central Asian and former Soviet countries.¹⁴

¹⁴ Interview with Arman Moldakhmetov, Deputy Chairman of NIF JSC. March 12, 2007.

Venture Capital Funds: Currently, NIF invests in ten funds – five local and five international. Foreign funds include funds from Central Asia, the United States, Germany, Malaysia/Japan, and Israel. Funds obtaining capital from NIF are required to invest at least 30 percent in innovation projects. The ideal fund obtaining capital from NIF would be approximately 20 percent owned by a foreign company, 40 percent owned by a Kazakh Company, and 40 percent owned by NIF.¹⁵

Figure 1: Role of NIF in overall investment environment¹⁶



Currently, the NIF operates with three main subsidiaries, the Engineering and Technology Transfer Center JSC (responsible for analytical research, transfer and commercialization of technologies, and innovation infrastructure development), KazSat JSC (responsible as the financial operator of the project aimed at creating a telecommunications satellite and its ground control structure) and Alatau Managing Company LLP (responsible for the management of the Alatau Technical Park, including the development of the park's infrastructure).¹⁷

NIF has also forged partnerships with organizations from Europe, Singapore, Malaysia, the United States, and India.

¹⁵Interview with Arman Moldakhmetov, Deputy Chairman of NIF JSC. March 12, 2007.

¹⁶ Moldakhmetov, Arman. Presentation: "Innovations and Technologies Development to Replace Oil Dependence." Amsterdam, 2007.

¹⁷ Ibid.

ISSUES

The SME sector in Kazakhstan makes up a significantly smaller portion of the economy than in developed economies. SME output contributes only 20 percent of GDP and only 40 percent of total employment (whereas in developed economies, these numbers can be as high as 60-80 percent). In addition, the sectoral and geographical distribution of SMEs in Kazakhstan lacks diversity. According to the latest information of the Statistics Agency of Kazakhstan dated 1 January 2007, 25.4 percent of the total SMEs output is generated in the import/retail trade sector, while 22.7% of all SMEs are located in either Almaty or Astana.

In order to diversify its economy, the Government of Kazakhstan should emphasize the need to further expand and diversify its SME sector. In order to accomplish this two-pronged agenda, the government needs to address the following issues that exist in the market:

- **High cost of finance:** According to the National Bank of Kazakhstan the average nominal interest rate at the end of Q1 2007 was 13 percent.¹⁸ Looking specifically at SME loans, this number increases to somewhere between 15-18 percent and above.¹⁹
- **Limited Access to Finance:** SMEs in fast turnaround and high-profit sectors such as retail trade obtain loans relatively quickly, but high-risk and capital intensive sectors such as manufacturing or telecommunications are less likely to obtain loans or can obtain only risk-adjusted high interest rate loans. These latter sectors are important to Kazakhstani economic diversification.

In addition, SMEs do not have access to long-term finance, which increases enterprise stability and encourages entrepreneurs to work in manufacturing and other industries with high fixed costs. It is reported that second tier banks provide credit for three years. "Today, three years is not enough for SMEs to have good turnover and become sustainable."²⁰

Regions outside of major urban areas such as Almaty and Astana have limited access to finance. In addition to limited competition between banks, oblasts lack alternative sources of finance, such as equity capital.

- **Lack of Information:** Although the Law on Entrepreneurship tries to address the information gap that exists for SMEs, the current structure prevents analytical market information from being produced and disseminated efficiently. Currently, akimats are designated as the centers of SME support. Given the extensive responsibilities of akimats, SME development is low on the priority list.²¹ As a result, SMEs do not receive needed advisory services and educational training.

¹⁸ Interview with SME Fund Chairman Gosman Amrin on April 11, 2007

¹⁹ Interview with representatives of Alliance and Kazkommertsbank, March 13 and March 16, respectively

²⁰ Interview with SME Fund Chairman Gosman Amrin on April 11, 2007

²¹ Ibid

- **Lack of Management Skills:** Given its relatively young entrepreneurial culture, Kazakhstan lacks individuals with the skills required to make a business successful. These include planning and management skills.

This paper will present policy recommendations that specifically address these issues.

BRIDGING THE FUNDING GAP: BENCHMARKING ANALYSIS

Overview of the SMEs in the Economy of Malaysia

Background

One of the Malaysian Government's major strategic priorities is to develop and strengthen the infrastructure that enables SME growth and global competitiveness. According to the Small and Medium Enterprise (SME) Annual Report 2005, SMEs accounted for 99.2 percent of all establishments, accounted for 65.1 percent of the total workforce and contributed 47.3 percent to the GDP/total value added.²²

SME development in Malaysia became a priority with the launch of the New Economic Policy (NEP 1971-1990) aimed at reducing and correcting economic imbalances.²³ However, real efforts towards encouraging and recognizing the importance of SMEs occurred during the 1980s with the Government's effort toward encouraging closer linkages between SMEs and larger enterprises. The Malaysian Government has proven sustained interest in establishing a strong and dynamic SME sector that will stimulate the economy and fulfill its long-term development objectives. Establishment of the National SME Council was one of the recent institutional initiatives to "spur the development of SMEs into globally competitive enterprises"²⁴. The Malaysian government put greater effort into strengthening SME performance by initiating programs and incentives that provide for an integrated approach to the development of industrial areas and opportunities for SME growth.²⁵

Spotlight on the Malaysian SME definition by priority sectors:

1. Manufacturing, Manufacturing-Related Services and Agro-based industries

SMEs in manufacturing, manufacturing related services and agro-based industries are enterprises with full-time employees not exceeding 150 or with annual sales turnover not exceeding RM 25 million.

Category	Micro-enterprise	Small enterprise	Medium enterprise
Manufacturing, Manufacturing-Related Services and Agro-based industries	Sales turnover < RM 250,000 OR full time employees < 5	Sales turnover between RM 250,000 and RM 10 million OR full-time employees 5 – 50	Sales turnover between RM 10 million and RM 25 million OR full-time employees between 51 – 150

²² Small and Medium Enterprise (SME) Annual Report 2005

²³ Ching, P.W. "The Development of the Malaysian Economy." Pearson, Malaysia, 2004.

²⁴ SMI Development Plan

²⁵ MITI 2005

2. Services, Primary Agriculture and Information & Communication Technology

SMEs in the services, primary agriculture and Information & Communication Technology (ICT) sectors are enterprises with full-time employees not exceeding 50 or with annual sales turnover not exceeding RM 5 million..

Category	Micro-enterprise	Small enterprise	Medium enterprise
Services, Primary Agriculture and Information & Communication Technology (ICT)	Sales turnover of less than RM 200,000 OR full time employees < 5	Sales turnover between RM 200,000 and RM 1 million OR full time employees 5 - 19	Sales turnover between RM 1 million and RM 5 million OR full time employees between 20 and 50

SME Policy Highlights: National Institutional Developments Designed for SMEs

The National SME Development Council was established in June 2004 to provide strategic direction to government policies on SME development. This ensured a more cohesive and coordinated approach in promoting the development of competitive and resilient SMEs. The Council is chaired by the Prime Minister and represents the Government's top-level commitment to properly formulate and effectively implement government SME policies. The Council coordinates inter-Ministry and Agency efforts on SME development and provides strategic policy frameworks for the industry going forward. It has more than 12 Ministries and 38 Agencies, which support the Government's SME development efforts. Each of these organizations was tasked with specific development objectives aimed at particular target groups. Since its establishment the Council has adopted a three-pronged strategy of strengthening the infrastructure for SME Development, building the capacity of domestic SMEs and enhancing access to financing.

To ensure that the infrastructure is conducive for SME development, the Council approved:

1. A common definition of SME for target development and establishment of the comprehensive National SME Database - for better identification of SMEs and for the effective targeting of SMEs in the design of policies and programs in manufacturing, primary agriculture, the manufacturing-related services sector, as well as for relevant, timely and accurate data collection on SMEs for better policy formulation.

2. Priority sectors for enhanced capacity and capability of SMEs

The National SME Development Council supports building the capacity of SMEs in seven areas: marketing and promotion, advisory services, entrepreneur development, technology development, product development, training and human resources development, and awareness and outreach. Comprehensive support offered in these areas is necessary for strengthening SME competitiveness and resilience.

3. SME policy formulation and evaluation framework

This framework also covers the identification of broad strategic priorities and targets for SME development as well as the establishment of comprehensive key performance indicators to monitor and evaluate the effectiveness of all ministries and agencies involved in SME development.

To enhance SMEs access to finance the Malaysian Government has undertaken the following new institutional developments:

- Establishment of the SME Bank to provide SME-specific loans and advisory services.
- Transformation of the Credit Guarantee Corporation Malaysia Berhad (CGC). An important initiative to strengthen the SME financing infrastructure has been the transformation of the CGC in terms of expanding its role and the range of products and services it offers. The CGC provides a wider range of credit enhancement products and advisory services on financial and business credit ratings aimed at facilitating greater lending to SMEs while promoting sound financial management.
- Small Debt Resolution Scheme. This was established in November 2003 to facilitate the restructuring of viable SMEs burdened by non-performing loans. Under this mechanism, a committee undertakes an independent assessment on the viability of the business and the loan restructuring and financing requirements for SMEs. The performance of this scheme has demonstrated that the restructuring of loans is more important than the provision of new financing to ensure the viability and sustainability of financially distressed SMEs
- Introduction of new trade financing products for SMEs to encourage the export of goods and services to non-traditional markets.

SME Bank (Bank Perusahaan Kecil & Sederhana Malaysia Berhad) started its operations on October 3, 2005 as a development financial institution (DFI) to nurture and meet the unique needs of small and medium enterprises. As a one-stop financial center responding to the funding and business growth needs of Malaysian SMEs, the Bank complements existing products and services offered by commercial banks through comprehensive and integrated financial and business advisory services. Its primary role is to contribute towards the growth of a more robust entrepreneurial community in Malaysia. A wholly owned subsidiary of Bank Pembangunan Malaysia Berhad, the Bank operates through its head office in Kuala Lumpur and via 16 branches nationwide.²⁶

Financial Services of the SME Bank: Depending on the business stage at which there is interest, there are SME Start-Up, SME Franchise, SME Procurement and/or SME Global services.

²⁶ <http://www.smebank.com.my/>

SME Classification	Micro	Small	Medium
Type of Financing	▸ Conventional and Islamic	▸ Conventional and Islamic	▸ Conventional and Islamic
Facilities	▸ Term Loan ▸ Revolving Loan ▸ Leasing ▸ Bank Guarantee / Letter of Credit	▸ Term Loan ▸ Revolving Loan ▸ Leasing ▸ Bank Guarantee / Letter of Credit ▸ Loan Stock	▸ Term Loan ▸ Revolving Loan ▸ Leasing ▸ Bank Guarantee / Letter of Credit ▸ Loan Stock
Limit of Financing	▸ Up to RM 500,000 (for priority programs only)	▸ Up to RM 5 million	▸ Up to RM 10 million
Interest Rates	▸ Competitive rates subject to terms of funds and risk ratings where applicable		
Tenure	▸ Up to a maximum of 15 years subject to assets financed ▸ Working capital up to 5 years, subject to annual review ▸ Up to a maximum of 3 years grace period		
Method of Repayment	▸ Monthly, Quarterly, Fixed or Contract Terms		
Processing Fee	▸ 0.25percent of approved loan		

Support Services: The SME Bank and its services network enhance entrepreneurship across the five product groups and offer evaluation expertise and resources to all Malaysian SMEs. Among the many that are mention-worthy:

- Business Assessments: Auditing and tracking the competitiveness of small businesses through quantitative financial and qualitative market analysis of product, market and customer potential.
- Business Matching: Matching small enterprise product/service capabilities with medium enterprises, government-linked companies, national and international chambers of commerce and other 'buyers' of products and services.
- Business Dialogue / Conference: Organization of meetings and seminars with successful SME customers, strategic partners, ministries, agencies and other financial institutions supporting SME development in the country.
- Research and Knowledge Management: Links to Government research and development units, universities, research institutes, professionals, consultants and subject matter experts.

Overview of the SMEs in the Economy of Norway

Background

In Norway, an SME is defined as an enterprise that has fewer than 250 employees, an annual turnover not exceeding ECU 40 million, or an annual balance-sheet total not exceeding ECU 27 million. More specifically, a 'small' (as opposed to 'medium')

enterprise is defined as one that has fewer than 50 employees, an annual turnover not exceeding ECU 7 million, or an annual balance-sheet total not exceeding ECU 5 million. The average aggregate data showed that between 1990-1999, the Norwegian SME sector accounted for 61 percent of total domestic employment.²⁷ SMEs in Norway account for the vast majority of the business population, as less than one percent of Norwegian firms have more than 100 employees.²⁸

Priorities / Target Group of SME Policy

Norway is the world's third largest exporter of oil. As such, Norway's SME development policy aims to diversify the economy away from oil dependence, in preparation for when the supply of natural resources depletes. In terms of public sector business support, the government prioritizes small enterprises of less than 100 employees and focuses on these five areas:

- Development of competence in SMEs
- Innovation, restructuring and the establishment of enterprises
- Less developed regions of the country
- Projects involving women
- Environmental issues and initiatives

SME Policy Highlight: Innovation Norway

The Norwegian government invests heavily into economic diversification away from oil dependence, including funds allocated for SME debt/equity financing and tax abatements for expenditures in priority development sectors. In 1993, the Norwegian Government established two entities targeted toward economic diversification and SME development: The Research Council of Norway (NF) and the Norwegian Industrial and Regional Development Fund (SND). The NF promoted cooperation and coordination among research institutes in Norway and also served as a strategic advisor to the Norwegian Government on science and technology issues.²⁹ The Industrial and Regional Development Fund (SND) was the vehicle for the public funding of Norwegian industrial and innovative development, by disbursing VC equity investments, grants, loans and guarantees for organizations that engaged in innovative activities, capital restructurings (turnaround) and high tech ventures. The main mission of the SND was to provide public support for and to address and close any financing gaps that fledgling SMEs and promising ventures faced. The rationale behind the SND's financing program is that the government can and should absorb more risk than capital markets will tolerate.

In 1999, the Norwegian Government determined that national investment into R&D lagged behind the European average and therefore formed The Hervik Commission,

²⁷ Meghana Ayyagari, Thorsten Beck and Asli Demirgüç-Kunt. Small and Medium Enterprises across the Globe, March 2005

²⁸ Beate Rotefoss, Eirik Pedersen, Sverre Are Jenssen, and Lars Kolvereid, The Case of Norway

²⁹ European Trend Chart on Innovation, Country Report: Norway, European Commission, Directorate General Enterprises "Innovation and SME" Programme

which investigated policies that would stimulate private sector investment into R&D. The result of this commission favored the implementation of an R&D tax credit to be added to preexisting forms of SND financial support.³⁰ The Norwegian Government therefore established SkatteFUNN, which is a tax deduction scheme to subsidize private sector R&D expenses incurred by small and larger sized businesses. This tax credit was established in 2002, in the form of a percentage credit for qualified R&D expenditures: 20 percent deduction of corporate income tax, wealth tax and national insurance tax for small enterprises and 18 percent for large enterprises. Early evidence indicates that this program is widely used and that the credit accounts for a significant portion of an enterprise's expenses.³¹

On January 1, 2004, the Norwegian Government established Innovation Norway, a state owned company, which combined and consolidated the activities of The Norwegian Trade Council, The Industrial and Regional Development Fund (SND), The Norwegian Tourist Board and The Government Consultative Office for Inventors (SVO). Innovation Norway employs over 700 people and maintains offices in over 30 nations, all 18 counties in Norway and a main office in Oslo. It aids in the innovation, internationalization and promotion of companies in different districts and regions of Norway. Its core group of clients is Norwegian SMEs.

The Norwegian Government also provides non-financial business support for SMEs via the network of Innovation Norway offices as well as free online information services. The Norwegian Government is also involved in labor related issues for SMEs. The Mobility-Program and SME-Competence, both under the Research Council of Norway, are designed (respectively) to facilitate the transition of academic, university-based researchers into the private sector and to encourage recent graduates to seek employment in the SME sector for at least three years.³²

Supporting SME Exports

Innovation Norway's international presence is designed to promote the export of its clients' consumer products, services and intellectual property and to offer would-be tourists more information on Norway and Scandinavia in general. In the United States alone, Innovation Norway has five offices: the New York office focuses primarily on tourism but also provides consulting services for Norwegian enterprises looking for customers in the US. The San Francisco office focuses on IT, energy and innovation/entrepreneurship. The Boston office is principally engaged in biotechnology/pharmaceuticals, the Houston office specializes in oil extraction technologies and the Washington, DC office serves as the political center for all Norwegian economic interests in the United States.

³⁰ European Trend Chart on Innovation, Country Report: Norway, European Commission, Directorate General Enterprises "Innovation and SME" Programme

³¹ Jan Nill, Design and use of fiscal incentives to promote business RDI in CREST countries – an overview, Contribution for the CREST OMC 3percent 2nd cycle expert group on fiscal measures, European Commission Joint Research Centre - Institute for Prospective Technological Studies (IPTS), 2005

³² STI Outlook 2000: Norway Case, <http://www.oecd.org/dataoecd/9/40/2754469.pdf>

Innovation Norway SME Support Program

Innovation Norway's New York City office is currently working with a Norwegian company that designed, patented and manufactures a device that tracks a performer's location on a theater stage, balancing his or her voice on the sound system accordingly. In this instance, Innovation Norway is performing a market scan and is contacting theater organizations to gauge interest in this product.

Promoting Rural Industrialization

Consistent with one the SND's priority sectors, which focuses on less developed rural regions, Innovation Norway maintains an office in each of Norway's 18 counties, with the express purpose of funding and growing SMEs. The Ministry for Local Government and Regional affairs along with the ministries of industry, energy, agriculture and fisheries are responsible for economic innovation outside the cities and urban centers. The theory of economic clustering has taken hold in Norway and development in the less populated areas tends to follow (or is encouraged to follow) this theory. In addition, Europrise Norway (as a part of the Europrise project) provides incentives for rural youth.

Training in Entrepreneurship: Skills and Management

In 1997, the Norwegian Ministry of Education, Research and Church Affairs (KUF) developed and presented a plan for its program "Entrepreneurship in Education and Training". This plan was to make entrepreneurship an educational objective throughout the formal educational system. Certain counties launched their own educational initiatives, forming partnerships between schools and local enterprises. Some of these programs involved students as young as elementary school-aged.

As the development of competence was one of the priority sectors of the SND, in 1999, Euro 40 million was earmarked for SME competence development programs. For example, The FRAM Program emphasizes management and strategy competence in SMEs with less than 100 employees. Over a period of 15 months, 12 companies come together for six two-day structured workshops, in which senior management and key employees exchange practices, network with one another, etc. Over 85 percent of the graduating SMEs meet or exceed FRAM's profitability targets.³³

One Stop Shop Model

One of the major features of Innovation Norway's business model is to provide a one-stop shopping experience for its Norwegian SME clients. This includes fee-based consulting services, such as market scans for exports as well as exploring partnership possibilities with the SND, larger companies, or both, for enterprises in rural areas. Much of Innovation Norway's business activity is done via public/private partnerships:

³³ http://ec.europa.eu/enterprise/enterprise_policy/best-directory/en/education/norway.htm

there is public funding earmarked for fee-based consulting, either within Innovation Norway (50/50 public/private payment structure) or with outside consultancies (public subsidy covers much less). There are occasional instances when a Norwegian SME produces a product or technology that is so promising that the establishment of a market would benefit the nation as a whole. In these instances, consulting services in the form of market scans and brokering are provided on a wholly subsidized, or free, basis.

Overview of the SMEs in the Economy of The United States

Background

The United States defines the SME sector rather broadly as businesses with less than 500 employees.³⁴ As a subcategory, micro enterprises are defined as businesses with five or fewer employees, which require \$35,000 or less in startup capital and lack access to the traditional commercial banking sector.³⁵ However, under the Small Business Act, the Small Business Administration (SBA) has the explicit right to “specify detailed definitions or standards” depending on the industry in which the small business operates.

SMEs represent 99.7 percent of all employer firms in the US and employ half of all private sector employees. They account for 44.3 percent of the total U.S. private payroll and have generated 60 to 80 percent of net new jobs annually over the last decade. SMEs created more than 50 percent of the non-farming private GDP. American SMEs enjoy a two-thirds likelihood of surviving (as a new firm) for at least two years and a 50 percent likelihood of surviving four years. Additionally, they produce 13 to 14 times more patents per employee than large patenting firms and employ 41 percent of high tech workers (such as scientists, engineers, and computer technicians).

Priorities / Target Group of the SME Policy

Via the Small Business Act of 1953, Congress created the Small Business Administration, whose function was to "aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns." The Investment Company Act of 1958 established the Small Business Investment Company (SBIC) Program, under which the SBA licensed, regulated and helped provide funds for privately owned and operated venture capital investment firms. They specialized in providing long-term debt and equity investments to high-risk small businesses.³⁶ In the 1960s anti-discrimination initiatives were introduced to create a more level playing field for ethnic minorities. In particular, community development finance initiatives focused on delivering products and services to low-income communities, which are not served or underserved by private financial markets.

³⁴ As defined by the U.S. Small Business Administration (SBA) Office of Advocacy for the purposes of research. www.sba.gov/advocacy

³⁵ As defined by the Association for Enterprise Opportunity (AEO), trade association for the U.S. Microenterprise Industry. www.microenterpriseworks.org

³⁶ <http://www.sba.gov/aboutsba/history/index.html>

SME Policy Highlight: Small Business Investment Company Program

Besides its three separate loan programs the Small Business Administration provides equity financing for small businesses through the SBIC Program.

The government itself does not make any direct investments and does not target any specific industries. SBICs, licensed by the Small Business Administration, are privately owned and managed investment firms. The SBIC program is a “fund of funds”, meaning that portfolio management and investment decisions are left to qualified private fund managers. The SBA has very minimal direct involvement in a SBIC’s portfolio management operations.

The SBA licenses professional venture capitalists, who form SBICs, either in the form of limited partnerships (LPs) or limited liability companies (LLCs). The SBA then facilitates the leverage of the SBICs’ private funds through loan guarantees. SBICs make equity or debt/equity investments in small businesses and help the businesses grow. Once the businesses “exit” successfully, the SBICs repay the SBA with the profits. The funding period usually lasts from seven to ten years. There is no budget “tax” money used to finance SBICs. Funds are drawn from the market through the issuance of SBA Guaranteed Certificates. Proceeds from the issuance are used to finance the SBA’s purchase of SBIC’s pooled debentures (see Figure 2).

Even though the SBA does not directly interfere with investment decisions, investments are regulated. One hundred percent of the portfolio should be invested into Small Businesses, of which, 20 percent must be “Smaller Enterprises”. Not more than 20 percent of the “regulatory” capital can be invested in a small business and its affiliates without prior SBA approval. SBICs are prohibited from investing in project finance (real estate, motion pictures, etc.), foreign or passive investments, re-lenders/re-investors and businesses whose activities are deemed contrary to the public interest.

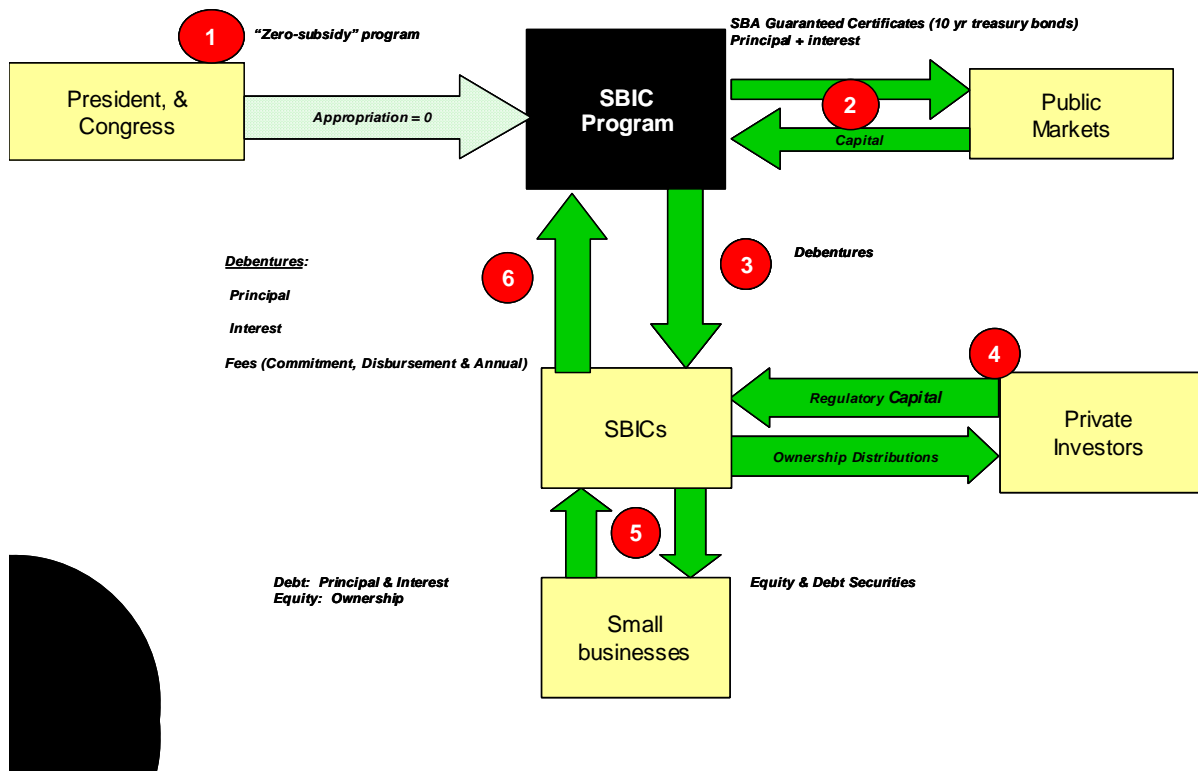
SBICs may control small businesses for up to seven years, which can be extended with SBA approval. This requirement prevents funds from abusing their position as a financial source, gives recipient SME a long time horizon for improvement of its efficiency and enforces some degree of capital turnover.-

In Fiscal Year (FY) 2005, the SBIC Program produced \$2.9 billion in equity and debt capital investments. Licensed SBICs made approximately 4,000 investments in approximately 2,300 small businesses.³⁷

By the end of FY 2005, the SBA had over \$6.3 billion invested in 418 funds (venture capitalist entities, called Small Business Investment Companies (SBICs)), plus another \$5.1 billion in outstanding commitments. Together, with private capital topping \$12 billion, the program totals over \$23 billion in capital resources dedicated to entrepreneurs.

³⁷ <http://www.sba.gov/INV>

Figure 2: SBIC Program Map



Overview of the SMEs in the Economy of The United Kingdom

Background

Small and medium enterprises play an important role in driving economic growth through innovation and employment. In the United Kingdom, 99 percent of the 4.3 million enterprises are considered small. An SME, according to the standard European Commission definition, is generally any business that has less than 250 employees and has either a turnover of less than 50 million Euros or balance sheet net assets of less than 43 million Euros. Further narrowing the definition, small enterprises are defined as those with between 0 and 49 employees. Approximately 0.5 percent are classified as medium (between 50 and 249 employees).³⁸ The overwhelming majority (71 percent) of SMEs in the UK are privately owned companies with no employees, while 24 percent have fewer than ten.³⁹ Despite the large presence of single person companies, SMEs still account for 58.7 percent of employment in the UK. Within each region, SME employment ranges from 47 percent (London) to over 70 percent (South West, Wales, and Northern Ireland).⁴⁰

³⁸ Department of Trade and Industry Statistical Press Release. December 2006.

³⁹ Small Business Service Annual Survey of Small Businesses, 2005, p xi

⁴⁰ Department of Trade and Industry Statistical Press Release. December 2006.

Priorities / Target Group of SME Policy

Because of the important role SMEs play in the economy, the United Kingdom developed a Small Business and Government Strategy in December 2002, which outlined the government's SME development strategy. This strategy includes a focus on building the capacity for small business growth, improving access to finance for small businesses, and developing entrepreneurship in disadvantaged communities. Geographically disadvantaged regions have been a particular focus of UK SME policy, promoting the creation of government supported regional venture capital funds.

SME Policy Highlight: Regional Venture Capital Funds

The UK government issued a "Competitiveness White Paper" in December 1998, outlining policy initiatives aimed at creating a competitive, knowledge-driven economy SME sector. A key program introduced in the paper was the £270 million Enterprise Fund, which would be a public-private partnership between the government and financial service institutions, to address the funding needs of SMEs by enhancing alternate sources of finance. The Enterprise Fund program included four elements: the Small Firms Loan Guarantee Scheme, Regional Enterprise Funds (later dubbed Regional Venture Capital Funds), the UK High Tech Fund, and Early Growth Funding.⁴¹

The Regional Venture Capital Funds (RVCF) initiative is designed to be the minimum necessary to stimulate private sector investors to provide small-scale risk finance for SMEs with growth potential. Supported by the Department of Trade and Industry (DTI), the program establishes at least one commercial fund in each of the nine English regions. The funds, managed by experienced venture capital professionals, are commercially focused and receive investment funding from both the government and the private sector (with the government limited to minority ownership).

RVCFs can invest in companies at any stage of development, from seed to management buy out, and are mandated to consider a broad range of sectors. All RVCFs must invest in SMEs in their region and act as the first institutional investor with initial investments limited to £250,000. After six months or more, the investment can be followed up with a further £250,000. Each fund can also invest in a company at subsequent rounds to prevent dilution.

In addition, RVCFs must:

- Principally operate in the appropriate region of England as defined by the DTI
- Not fall into any DTI restricted sectors. RVCFs can invest in most sectors, however there are a few restricted sectors such as banking, insurance, agriculture and property development among others.

⁴¹ "Closing the Regional Equity Gap? A Critique of the Department of Trade and Industry's Regional Venture Capital Funds Initiative. *Regional Studies*, Vol. 37.8, pp. 855–868, November 2003"

- Have not previously received funding from a recognized institutional venture capital fund. RVCFs may invest either after or alongside angels, angel networks, corporate venturers and certain seed funds. They may also invest alongside other venture capital funds in certain circumstances during subsequent funding rounds.

Investee Company Spotlight: Southeast Growth Fund (SEGF)

The Southeast region currently has 20 funds, one of which is wholly and two of which are partially backed by the public. The total available venture funding in the region is estimated at £211.1 million. As of 2005, 408 investment projects received equity funding, with the average investment valued at £340,000.⁴²

The Southeast Growth Fund is capitalized at £30 million and is the fifth largest RVCF. The UK government is the largest investor in the fund with a 25 percent holding. Other investors include the European Investment Fund, Barclays, Royal Bank of Scotland, Windsor & Maidenhead Pension Fund and West Midlands Enterprise.⁴³

In looking for investment projects, SEGF targets companies with significant growth potential. By taking an equity stake in such companies, SEGF ensures that returns to investors are maximized. The company management team should demonstrate commitment to the business financially as well as in terms of ambition, competence and enthusiasm. Growth potential is usually demonstrated by the existence of a combination of barriers to entry for competitors such as intellectual property protection, unique selling propositions, previous revenue growth and a management team with a track record of success.

While the process for making investments in each company will vary, SEGF has a fairly consistent approach to the process of making each investment. There are seven major stages, which include:

- Submission and Review of Business Plan
- Initial Meeting
- Indicative Terms
- Initial Due Diligence
- Investment Panel Meeting
- Legal Process and Independent Due Diligence
- Completion

It normally takes between 3 to 6 months from the point at which a business plan is submitted until completion, although it can take longer, and in certain circumstances the

⁴² DTI Commissioned Study: “A Mapping Study of Venture Capital Provision to SMEs in England” October 2005. p84

⁴³ Regional Venture Capital Policy UK and Germany Compared. Ron Martin, Christian Berndt, Britta Klage, Peter Sunley and Stephan Herten. 2003. p 34.

process can be expedited. The major factors that influence the amount of time taken to make investments are the complexity of the target company and the responsiveness of its directors and advisors to requests from SEGF.

SEGF looks to make investments from which they can exit in the medium term, typically three to five years post-investment. Essentially, the firm realizes the major component of return on investments by selling their stake in the business. Though they will consider selling back the stake to management shareholders in exceptional circumstances, such a strategy is not entertained at the onset.

POLICY AND LEGISLATION PROPOSAL

Recommendation 1: Streamline Access to Debt Financing Through the Restructuring of SMEF's Operations.

Currently, Kazakhstan's SME Fund (SMEF) extends loans both directly and through private banks. We will argue that SMEF would be able to reduce its operational expenses and improve the effectiveness of its other offered services if it delegated all of its money lending operations to private banks. SMEF's current practice of extending loans directly to SMEs is inefficient given the existing network of private banks. SMEF should outsource this function to private banks, which have the expertise and human resources to quickly disburse funds to applicants.

In order to ensure that sector-specific SMEs receive these loans, SMEF should define the client selection criteria and include those loan conditions in the negotiated bilateral agreement. As an extra incentive to banks, SMEF will pay a nominal service fee for every SMEF-funded SME loan disbursed. Any financial returns from these SME loans will be reinvested into the original SMEF loan funds pool. The private banks will maintain the loan portfolio while SMEF performs regular audits to ensure the funds are being disbursed as stipulated by the agreement. If the percentage of non-performing loans in the SME portfolio becomes excessive, the contract between SMEF and the bank should be terminated.

An approximate set of measures that are needed to implement the suggested changes to SMEF loan operations.

- Establishment of a set of criteria that clearly defines which SMEs are eligible to receive SMEF financed private bank loans.

Within these criteria the following (inclusive but not exhaustive) types of SMEs should be prioritized:

- SMEs in priority sectors including manufacturing, telecommunications, transportation, and logistics
- SMEs expanding their businesses in preparation for export
- SMEs being established in low income or disadvantaged areas
- Define the reporting procedures by which participating banks will have to abide.
 - Banks should report loan and repayment activities related to SMEF funds on a regular basis
 - SMEF should conduct scheduled and unscheduled audits to ensure proper use of the funds
- Establishment of an auditing body that will oversee the contracts between SMEF and the private banks
- A Bank Survey should be conducted to determine the minimal service fee that would provide banks with enough incentive to participate in the program.

SMEF currently provides loan guarantees for SME private bank loans. This process is convoluted and requires *both* the private bank and SMEF to conduct separate due diligences on the applicant. SMEF should streamline this burdensome process by eliminating the required SMEF due diligence.

An approximate set of measures that are needed to implement the suggested changes to SMEF's loan guarantee operations.

- Establishment of a set of due diligence criteria that defines which SMEs are eligible to receive the SMEF guarantee loans from private banks.
- Establishment of an auditing body in SMEF who will oversee the contracts between SMEF and the private banks and ensure that only loans that meet SMEF criteria are being granted government guarantees.

Recommendation 2: Provide Regional Technical Assistance and Support Services Through Existing SMEF Regional Branch Networks.

The one-stop shop model is advantageous in that the regional offices act as information nodes, training centers and deal sources/brokers. This is pivotal to creating a fluid network between both potential investors and SMEs and between SMEs themselves. Effective access to capital in Kazakhstan cannot be considered fully implemented if the business system is not supported by mechanisms that allow the demand and the supply sides of capital to easily meet. There may be supply/demand equilibriums in the large urban centers and surrounding areas, but the same cannot be said for the other regions of the country. Also, being far away from the most advanced universities, regional entrepreneurs face limited access to appropriate and relevant financial and technical knowledge resources.

In this respect, the presence of a regional office in each oblast, similar to the Norwegian model, could help to fill the information, training and networking gaps that plague these regions.

Characteristics of the Model and Necessary Implementation Measures:

Regional presence should be guaranteed by an organization modeled after 'Innovation Norway', under Kazyna, which combines the equity/debt/guarantee functions of NIF and SMEF with business incubator-like services that provide a one-stop-shopping experience for priority-sector enterprises in all 14 Kazakhstani Oblasts and Almaty and Astana (for a total of 16 regional offices). To reduce costs and take further advantage of other government office synergies, these functionalities could be established within the current regional SMEF offices.

Each office should ensure three main services related to research, training and networking:

- Each office should periodically analyze its region's current business environment, paying particular attention to economic trends and potential opportunities that are not

yet exploited (considering geographical factors, available infrastructure and human capital). The analyses should aim to highlight not only the strengths but also the weakness of the territory (the proverbial SWOT analysis), while providing an adequate response to the problems.

- Based on the available economic opportunities in their regions, each office should organize workshops and training courses that provide the necessary skills to develop local human resources potential. Acting as local training points, the offices can provide entrepreneurs with access to proper training and knowledge, which is often a scarce resource in rural areas that are far away from colleges and universities.
- In addition to serving as training centers, these offices should be provided with budgets to allow them to hire teams of short-term professional consultants and/or longer-term graduate student interns. These individuals would work at the regional centers for a specified period of time (three to ten weeks) to perform the aforementioned economic analyses and/or to develop entrepreneurial training materials for the office staff.

One of the offices' major functions would be to act as a contact point between local entrepreneurs and non-bank sources of capital, such as national or foreign investment funds. In addition to providing information related to the alternative capital sources (such as angel and seed investors) these offices should also be able to create a networking environment and forum among the SMEs themselves. In this respect, a formalized communications scheme should be established between SMEF's regional offices, the NIF and CMAR. In light of CMAR's new role as the future creator of a database of Kazakhstani export-oriented SMEs, systematic communication would be critical to developing export deals and domestic and/or international partnership agreements.

SME Financing Mechanisms

While SMEF's regional offices are involved with debt financing at reduced interest rates for priority sector SMEs, The NIF (equity investing arm of Kazyna) maintains neither a liaison nor a marketing presence in any region outside of Almaty. Kazyna should earmark some of NIF's equity investing capital for SMEF's regional clients. Combining equity and debt financing options for entrepreneurs will allow for the reduction or elimination of the need for loan collateral assets and the reduction of the need to make high-interest loan payments. Equity securitization also opens up the possibility for the financial restructuring of poorly performing companies – an intervention that may actually reduce the number of bankruptcies in the Kazakhstani SME sector. Because of the risks involved with equity investment, a careful due diligence will be necessary before any investment is made. Consistent with the Norwegian model, however, the Government of Kazakhstan would be in a better position to take on risky investments that capital markets would otherwise reject.

Recommendation 3: Introduce Models of Equity Financing Through the Establishment of SME Investment Funds (SIFs).

As outlined above, the Small Business Investment Program has been highly successful in the United States. We will argue that Kazakhstan would benefit from a similar program. Moreover, we will demonstrate that such a policy recommendation could be implemented in Kazakhstan without encountering major difficulties, due to the country's positive experience in the field of asset securitization. Kazakhstan currently has a mortgage financing system that allows banks to refinance their mortgage portfolios via a special semi-governmental entity – the Kazakh Mortgage Company (KMC).

The link between mortgage securitization and equity participation in SME financing is straightforward: Banks that issue mortgages pool a certain number of loans that meet certain requirements and offer them to the KMC. If the pool of mortgages offered by the bank matches the KMC's requirements, the seller-bank is refinanced; otherwise the bank is required to replace the pool's non-standard loans and re-offer the pool for refinancing. Since the KMC cannot legally tap into the state budget as a means of financing its operations, the KMC issues securities on the open market to replenish its liquidity needs. Banks securitize their loans and get access to liquidity, the KMC ensures liquidity and the stable functioning of the system and in the end, investors are presented with open market low-risk securities as a means of diversifying their assets.

The SBIC refinancing system is essentially the same. SBICs that are licensed by the SBA are able to refinance their expenditures up to certain level by issuing obligations, or debentures, to the SBA. The SBA, which is denied access to taxpayer money for the purposes of the SBIC program, finances its expenditures by issuing SBA certificates to open market investors. One small difference between these two systems is that liquidity to the funds is provided by the SBA in advance, i.e. before actual commencement of operations since it is participation in the capital of the fund.

An approximate set of measures that are needed to implement the SBIC scheme in Kazakhstan.

- The establishment of a separate law or amendments to current legislation that would introduce SME Investment Funds (SIFs) into the legal framework.

Within the law the following points (non-exhaustive) should be observed:

- Definition of the overall system including licensing, refinancing terms and each party's responsibilities
- Establishment of a separate entity or division within SMEF (both referred to hereafter as 'the Agency')
- Status of the securities issued by the Agency to refinance its participation in the SME Investment Fund (SIF), and the degree to which they are or are not guaranteed by the state
- Requirements for the SIFs in terms of investment limits (sectors of financing apart from SMEs, investments for liquidity purposes), reporting and accounting, sources of financing

- Definition, in principle, of what types of financing (debt financing, equity participation) the Agency should provide in order to avoid unnecessary competition (extrusion effect) between the Agency, which is better positioned to access financial resources from the market, and the private sector (particularly banks). In this regard, equity participation as a sole principal would be recommended.

Since the goal is to provide financing to economic sectors in which the private sector is generally uninterested, a balance between the need to provide investment while avoiding the creation of unfair competition and the misallocation of resources should be observed.

- Definition of a licensing process and a licensing authority.

Taking into account the specifics of the Kazakhstani market where the licensing authority for financial markets is traditionally divided between the National Bank and the Agency of Financial Supervision. It would be possible to delegate some measure of SIF licensing authority to the Agency, such as having it create a list of pre-approved SIF.

The depth of licensing requirements and the general mode of regulation should also be defined, depending on the balance between solvency requirements and the need to observe the tightness of regulation for SIF:

The importance of solvency is defined by the degree of non-institutional investor participation in SIF capital and/or refinancing through the purchase of Agency securities. In principle, this category of investor requires protection, as this is one of the main objectives of the financial market's regulatory bodies. It also depends on the level of protection provided by the Agency (to mitigate the risky nature of investments). The importance of fine-tuning regulatory tightness is needed in order to avoid creating disincentives to the establishment of SIF. In this regard, a study of the NIF-funded innovation funds should be commissioned in order to explain the lower-than-expected success of Kazakhstani innovation funds. Since upper-level legislative regulation was nearly non-existent, the only regulations were the ones established by the NIF.

- Study the viability of commercial banks' participation in SIF, with regard to complying with the "Chinese Wall" principle that would prevent banks from holding equity stakes in non-financial entities. If allowed, participating banks should be restricted in terms of the amount of money (in absolute and relative terms) allocated into SIFs, terms and other conditions that would prevent actions that might jeopardize the stability of the banking system (i.e. depositors money drained through SIFs as a channel)
- Define an overseeing body for SIFs. This measure correlates with the choice of regulatory method. The choice should be made with respect to the issue of possible conflicts of interest with the primary objectives of a regulator.

In order to set up these funds, a bidding and open tender process should be established where all funds that meet the investment criteria established by the government can bid on government investment funding. Government criteria should mandate that:

- Each fund be managed by experienced investment professionals
- Each fund be commercially focused and be commercially viable
- Each fund be able to raise capital from non-government sources so that government investment will not exceed 49 percent of the total capital managed by the fund
- Each fund must limit its investments to projects geographically located in one specific oblast
- In addition to providing funding, each fund must have a managerial training component embedded in its investment schemes, which would provide business training to investees.

In order to ensure that non-government investors receive market competitive returns, the government should cap the returns on its investment at the rate of inflation, with any percentage returns exceeding that to be distributed to other investors. The NIF should be placed in charge of organizing the bidding process and making final recommendations on venture capital funds. The office of the President should be in charge of making final decisions as to which funds win the bid.

Recommendation 4: Designate Some of the Established SME Investment Funds (as per Recommendation 3) as Oblast Capital Funds. At Least One OCF Should be Located in Each of Kazakhstan's 14 Oblasts.

Currently, the five NIF-supported venture funds are located in and around Almaty and Astana. In order to support the economic development of all regions in Kazakhstan, we will argue that the government must ensure that each oblast has access to both debt and equity financial market tools. The Government of Kazakhstan should develop Oblast Capital Funds (OCFs) aimed at providing risk capital finance to small and medium enterprises. The framework (legislative basis) should be the same for OCFs as for SIFs. OCFs should not be granted more favorable conditions than SME Investment Funds (SIFs) with private participation (just SIFs with government participation). On one hand it would provide a transparent process that is the same for all SIF investors, including the government. On the other hand it would allow the government to exit from an OCF without changing its legal status. Among the special clauses for an SIF with government participation (an OCF), legislation should stipulate the following (non-exhaustive):

- Caps on the amount of losses
- Requirement for OCFs to have managing boards of independent directors with appropriate qualifications
- Restriction on the geographic spread of investments within a specified oblast or region
- Possibility for private investors to participate in an OCF-SIF along with the government and a requirement for the government to exit an OCF at the moment it reaches specified requirements or after certain number of years
- Establishment of favorable conditions for OCFs, given they possibility that investors may find them less attractive due to their geographic restrictions

Program objectives:

- Establish a capital fund in each oblast targeted at providing alternative sources of equity capital to SMEs in the region. These funds must not displace existing equity markets in the specific geographic locale.
- Continue to develop the entrepreneurial culture in each oblast by giving SMEs access to equity and the managerial know-how of venture capital firms.
- Increase the amount of finance, in particular, equity risk finance available to SMEs.
- Provide incentives for fund managers to develop operations in the 14 oblasts and for investors to invest in these regions.

Example of Existing SME Fund: The Business Partners-Khula Start-up Fund

Organizational Overview

The Fund was created to enable entrepreneurs to establish new enterprises and drive early phase business expansion. Khula Enterprise Finance Limited is an agency of the Department of Trade and Industry of South Africa established in 1996 to facilitate access to credit for SMEs through various delivery mechanisms. These include commercial banks, retail financial intermediaries (RFIs) and micro credit outlets (MCOs). Khula also provides mentorship services to guide and counsel entrepreneurs. Notably, Khula is a wholesale finance institution, thus Khula does not provide entrepreneurs financial assistance directly but acts as a contact point to the aforementioned institutions. As part of its new strategic approach, Khula conceptualized the establishment of a start-up fund that would offer entrepreneurs not already in business an opportunity to enter the business arena.

Target market

The fund plays an economic equality function as the government tries to level the playing field for previously disadvantaged populations. It exclusively targets black owned, managed, or empowered SMEs in addition to a special focus on female entrepreneurs and rural provinces. Due to the limited resources in the local indigenous communities the fund does not require any contribution from the beneficiary. The primary focus and determining factor is the business's viability and sustainability.

Investment Structures

Investments made by the Fund are structured using equity, royalties and term loans or any combination of these. Individual solutions are structured after having assessed the venture's potential risk and return. The Fund is capitalized at South Africa R150 million and has been structured as a Venture Capital Fund that will primarily provide equity and quasi-equity risk capital for start-up and early stage businesses. Khula is the anchor investor in the Fund, contributing an amount of R120 million. Business Partners invested R30 million and will have the added responsibility of managing the fund.

Product Features

Services offered include free initial proposal evaluation, free initial consultation on options for business development, independent strategic advice, risk capital, finance for restructuring of family ownership, divisional spin-offs, management buy-outs and management buy-ins, listing the enterprise on a stock exchange, arrangement of trade sales and assistance with mergers and acquisitions. Another key facet of the scheme is technical assistance which is provided to guide entrepreneurs in starting, planning and running their businesses. A separate fund was established to fund these activities.

Deal Sourcing

BPI uses a referral mechanism to obtain business plans for review. Referrals come from industry sector journals and relationships with intermediaries such as accounting firms, legal firms, forums, and other organizations that have an impact on SMEs.

Due Diligence Process

Through its experience, BPI has streamlined its due diligence process by establishing an extensive in-house database of investments and by following a standard due diligence task list. The total process takes about 4 weeks, but is dependent on the deal, the quality of the proposal and the extent to which information is readily available. An initial seven-day prescreening includes a financial analysis, an industry analysis, a company profile, and a preliminary deal structure. This efficient due diligence process has improved accuracy, decreased costs, and decreased bad debt in the overall portfolio.

Risk Mitigation

To mitigate risks, BPI relies on its efficient due diligence and evaluation process to look for businesses that: Conform to good corporate governance; Operate in politically stable countries; Operate in a country that has is home to at least one large local investor; Operate in industries in which BPI has a sound understanding of the investment climate; Are led by an entrepreneurs who have good standings within their communities; Are backed by strong technical support.

Example of Existing SME Fund: Small Enterprise Assistance Fund (SEAF)

Organization Overview:

Born as the private investment division of CARE in 1989, SEAF became independent in 1995, focusing on the sponsorship and management of investment funds that address small businesses, especially in emerging markets, which do not have easy access to capital financing. The funds SEAF manages and sponsors are considered commercially sustainable and have a for-profit orientation. The Funds, under the supervision of SEAF, provide targeted small and medium enterprises with financial support, in the form of structured debt and equity growth capital. They also follow up with post-investment business development assistance and train the enterprise on how to increase sales and improve operational assistance. The types of investors involved in the Funds range from economic development organization such as the International Finance Corporation (IFC) and European Bank for Reconstruction and Development (EBRD) to multinationals, private foundations, pension funds, insurance companies and other financial institutions. In Kazakhstan, the NIF is an investor in SEAF's Central Asia Small Enterprise Fund.

Product Features

The Funds invest around US \$2 million per investment. The investments are usually made to locally registered, private companies that retain at least 51 percent ownership interest. The Fund usually controls 15 to 49 percent of the portfolio company. SEAF policy outlines three main exit strategies: through a strategic sale to a third party, sale of interest to the current partner, or spin-out. Before pursuing the investment, the Fund notifies the investee of the exit strategy. The deal is pursued only when an exit agreement is reached.

Product Advantages

SEAF investments allow capital flows and enterprise growth in environments where access to funds is limited or traditional sources of capital are not yet fully developed. All of SEAF's investors agree to socially responsible financial returns. In addition to financial support, the Funds can also bring skills and know-how. Through its activity, SEAF has contributed to job creation, increased exports and developed the comparative advantages of the countries involved. SEAF projects aim to be environmentally responsible and respect the anti-corruption codes of both the US government and the multilateral organizations.

Deal Sourcing

SEAF is active in finding potential investees. Its investment officers are committed to identifying potential clients. Clients also take initiative, proposing new ideas based on existing business plans with financial models that demonstrate positive cash flow. Entrepreneurs, existing small companies and start-ups come to SEAF if they want to expand operations.

Due Diligence Process

The Funds invest a considerable amount of time into properly investigating potential clients. The due diligence process must satisfy a consolidated checklist that covers business opportunities, company plans, financials, management and legal assessment. According to SEAF criteria, the client must meet the not only financial but also social criteria.

Technical Assistance Strategy

One of the major social benefits of SEAF is brought by the fact that it does not act purely as an investor but also provides consultation and training for staff, brings in management expertise and establishes development links between funds in different countries/regions. Before SEAF disburses funds, it usually puts aside a certain amount of money to train the target company's staff. This preliminary training involves the general manager of the company and includes a background check on candidates, the establishment of a supervisory board, the organization of weekly meetings to discuss issues and regular audits. The management looks over the qualifications of the personnel and determines what training is needed.

Sources: Website, the Executive Summary and Due diligence checklist provided by SEAF and Interview on March 14, 2007.

Enabling Environment

Despite the Government's continuous efforts to create favorable conditions for SMEs and increase employment in the SME sector, slow progress is observed. The fact that the SME Fund's direct disbursement of loans constitutes only three percent of all loans and credits obtained by SMEs indicates the need for improvement in the institutional framework, policies and regulations that affect the SME sector in general.

To date, public assistance for SME access to financing and business support is limited to the provision of some tax incentives and preferential loans to priority sectors approved under government schemes. Such financial assistance was primarily conducted via implementation of certain laws and many ad-hoc government programs. To name recent few:

- The 2006 Law on Entrepreneurship
- The Program on Accelerated Measures to Support SMEs in 2005-2007
- The Concept of SME Fund JSC Development for 2005-2007 approved by the GoK Resolution dated August 22, 2005, as well as the recent SME Fund strategic development directions for 2007-2011
- The Concept for the Establishment of Social Entrepreneur Corporations (SECs) dated May 31, 2006
- The Program for Establishment of the Microfinance System for the Rural Population;
- The Program of Small Towns Development in 2004-2006
- The Concept for the Development of a Network of Micro-Credit Organizations for Rural Goods Manufacturers of the Republic of Kazakhstan dated April 28, 2006

These ad-hoc programs result in misaligned priorities, undermining overall SME development. Establishment of uniform medium and long-term state strategies and the creation of the National Council for SME Support and Development is the key to a sustainable government commitment for enhancing SME capacity.

Development of a comprehensive medium and long-term strategy for SME sector support is crucial to promoting the sustainability and competitiveness of Kazakhstani SMEs at the regional, national and global levels. SME access to funds, especially in rural areas, deserves priority attention. The GoK should therefore pay more attention to restructuring the existing government agencies involved in SME support and monitoring those agencies' impact on SME operations. A strong political will for enhancing policy development is required for easing regulations, relaxing strict internal procedures of SME support agencies and introducing both tax and non-financial incentives for SMEs at the state and regional levels.

High-level Government Support for SME Development

In addition to the existing Entrepreneurs Council⁴⁴, the GoK shall consider setting-up the National SME Sector Development Council/Inter-Agency Working Group under the Prime-Minister of Kazakhstan to accelerate real measures that support SMEs. Such a governmental umbrella-structure is vital to introducing and implementing cross-agency SME capacity development programs. Examples of such cross-sectoral programs to be included under this umbrella organization are (non-exhaustive):

- Technical Entrepreneurship Development, SME Export Promotion and Franchise Development Assistance to facilitate SME expansion in domestic and international markets, Agricultural SME Development
- Technology Acquisition by SMEs via feasibility studies and programs targeted to assist SME adaptation to new technical advancements
- SME Goods Delivery/Transportation Services
- Entrepreneurship Training schemes to assist SMEs in obtaining new ideas, skills and human resources
- Enhancing Marketing of SMEs (brand promotion, product/service design) to improve product quality and enhance product presentation, promotion and export to the global market

Introduction of a comprehensive approach to addressing SME development and financing concerns at the high-government level will result in positive advancements in the SME sector.

Long-term Government Commitment to Financing and Supporting SME Programs

With all the above-mentioned considerations necessary to create an enabling environment for SME sector growth, it is suggested that the GoK:

- Draft a comprehensive long-term state strategy for SME development and support addressing solutions to current SME issues, with roles assigned to all SME-related stakeholders
- Amend entrepreneurship and SME-related laws in line with international best practices to ease SME access to financing. The Republic of Kazakhstan's bank laws should be amended with regard to financial services diversification and the improvement of current requirements for SMEs at favorable conditions (interest rates, loan terms). The administrative procedures for loan approval should be reconsidered with regard to the limits in loan amount and tenure
- Monitor the work of entrepreneur expert councils within local executive agencies to draft normative legal acts that can further enhance legislative and policy developments with regard to SMEs
- Consider a step-by-step introduction of the following amendments to the Code on Taxes and Other Obligatory Payments to the Budget (Tax Code), similar to the

⁴⁴ The existing consultation body of entrepreneurs, established by Presidential Decree #1560, April 23, 2005.

experience of many successful SME-supporting countries, in order to further boost financial incentives for SMEs

Through the National Council for SME Development and Support and in line with the state strategies the GoK should enhance the speed of forthcoming reforms, particularly the provision of additional monetary benefits and other incentives for SMEs, which may include:

- Direct and indirect tax incentives aimed generally at stimulating investments in the priority sectors of the economy (partial/total relief from income tax, exemption from import and excise duties and sales tax, double deduction of brand advertising expenses incurred, export promotion and export credit insurance)
- Grant assistance, which forms the basis of many SME or special purpose programs in five main areas: access to markets, access to technology, updating skill sets and information and infrastructure support (industrial sites and business incubators)
- Debt and equity provision (direct provision of loans through private banks, credit guarantees for SME borrowers, equity financing and venture capital).

In addition, we suggest that the government establish a two pronged strategy in SME development:

- Financial discipline: Programs providing services which directly compete with the private sector in competitive markets should be required to exercise financial discipline and perform according to market based standards. Through the establishment of effective procedures and institutions, the government can efficiently achieve state priorities through market driven initiatives. Examples of programs that would be required to exercise financial discipline are the SMEF loan program executed through private banks and the Small Business Investment Funds.
- Government subsidized services: The Government should be committed to bearing expenses of non-revenue generating government support programs which are necessary to reach stated SME objectives. To ensure the availability of funds to support these programs, the medium term budgetary planning process should include procedures which earmark a certain percentage of funds to financing these programs. An example of this type of government subsidized program would be the one-stop-shop model.

The strategy should be aimed to attain a desirable balance between these two goals: financial discipline and government commitment to undertake financial responsibility for SME sector development.

CONCLUSION

The Government of Kazakhstan has identified SME growth as a long-term priority. Through the creation of Kazyna and organizations such as the SME Fund and NIF, the government has initiated a mechanism for SME development support. Despite the existence of these government organizations, SMEs in Kazakhstan remain underdeveloped in key sectors, largely as a result of a less-than-optimal regulatory and legal framework for conducting business, a lack of basic business knowledge among possible entrepreneurs, and finally, a lack of access to start-up and mezzanine level financing, especially among poorer regions and disadvantaged populations in the country.

This paper argues that in order to address existing SME development bottlenecks, the GoK should strengthen the role of the SME Fund as the key government body serving as an intermediary between state and private financial institutions. In line with its mission and strategic goals of SME support, the SME Fund shall enhance existing support mechanisms for SMEs in the priority sectors. In addition to developing projects for SME promotion, the SME Fund should initiate or continue to support:

- Disbursement of preferential loans through private banks for priority sector SMEs, especially for first-time entrepreneurs, who lack capital and a positive bank credit rating
- Credit guarantee schemes based on the Framework Agreements between the SME Fund and private banks to address the problem of lack of collateral
- Establishment of Norwegian style “one-stop shops” for infrastructure support services or SME support services such as information centers, business advisory services, quality certification consulting services, HR pools etc.
- Development of training programs to help SMEs, government agencies and SME-support institutions to develop new attitudes concerning leadership, decision-making, risk taking, markets literacy and the development of entrepreneurship
- Creation of an environment conducive to the establishment of SME Investment Funds and oblast capital funds to provide equity to SMEs and promote transparent and effective mechanisms to transfer state funds according to the aforementioned model

In addition to enhancing the services provided to SMEs through the SME Fund, the establishment of uniform medium and long-term state strategies and the creation of the National Council for SME Support and Development is the key to a sustainable government commitment for enhancing SME capacity.

The GoK has expressed its commitment to economic diversification through SME development. In order to effectively nurture the growth of SMEs in all sectors in the economy, the government must create an enabling environment that provides incentives for SMEs to enter into non-traditional sectors. By ensuring cooperation between all SME-related stakeholders and through maintaining consistent medium and long term strategies, the GoK will effectively foster diversification in Kazakhstan’s economy.

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