

SMEs and poverty reduction



findings from four case studies

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Established in 1979 as the Corporation for Enterprise Development, CFED is a nonprofit organization that expands economic opportunity. We work to ensure that every person can participate in, contribute to, and benefit from the economy. We identify promising ideas; test and refine them in communities to find out what works; craft policies and products to help good ideas reach scale; and foster new markets to achieve greater economic impact. CFED works nationally and internationally through its offices in Washington, DC; Durham, North Carolina; and San Francisco, California.



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Introduction

In early 2004, the Ford Foundation's Affinity Group on Development Finance (AGDF)'s Small and Medium Enterprise (SME) Committee asked CFED to conduct a desktop review of the current literature on the SME sector and its links to poverty reduction strategies in the United States and internationally. The review provided a wealth of information and examples, and illustrated that SMEs are essential components of economic growth, employment and wealth creation in economies both large and small. Specifically, available research showed that the SME sector forms a larger share of GDP as country income increases, and that the SME sector generates a larger percentage of employment in higher income countries. However, the data stopped short of proving a causal link between SME vitality and economic growth. It was not possible to say whether SME vitality is a cause or effect of healthy economic growth, or if they are both outcomes of some other factor. In addition, the evidence directly linking SMEs and poverty reduction was considerably less robust than that linking them to economic vitality, even where SMEs represent the largest number of businesses in the economy (as, for example, in the United States).

Strategies in support of the SME sector have often been assumed to have an implicit poverty reduction effect, yet there are limited data and few examples that demonstrate this effect. For this reason CFED, with continued support from the Ford Foundation, launched a Small Grants Program in 2006, designed to explore the linkages between SME strategies and poverty reduction. Four innovative strategies in support of SMEs in four different countries were chosen to receive funding for the creation of case studies – guided by independent researchers and evaluators – that would document the theories of change, program components, and outcomes for poor individuals throughout the value chains of the SMEs supported. Of the four programs selected, three have an explicit and intentional pro-poor focus, while the fourth focuses on improving business competitiveness. All four initiatives focus on increasing the profitability and growth of the enterprises as a needed foundation for their overall goals.

CFED selected a qualitative case study methodology for this research to allow for a more nuanced exploration of the ways in which SMEs might reduce poverty. The goal was to better understand the mechanisms through which SMEs might benefit poor individuals and to explore whether an intentional focus on the poor in program design made a difference in poverty reduction outcomes *vis a vis* program designs that do not explicitly have a pro-poor focus.¹ This is an important question. To our knowledge, intentionality in program design has not been addressed in this way before, and based on 40+ proposals for funding that were submitted for the Small Grants Program, it appears that many practitioners still seem comfortable assuming a pro-poor impact from any kind of SME support strategy.

This summary paper provides a brief overview of the four interventions, the key findings from the case studies, and a brief discussion of the challenges inherent in the simultaneous, integrated promotion of SME business vitality and poverty reduction. For access to the full case studies, as well as the desktop review, please visit www.cfed.org/go/sme.

1 Program design could focus intentionally on the poor in one of two ways: Either by choosing to work only with SMEs whose business model, activities, and/or location clearly includes poor employees, suppliers, or customers, or by encouraging or requiring some kind of poverty reducing activity on the part of the SME in exchange for participation in the program.

Theories of Change

In each case study, which follows detailed guidelines developed in cooperation with CFED, the practitioners articulate the intended outcomes of their interventions, as well as the mechanisms through which they hypothesized the interventions would benefit poor individuals – i.e. each program’s “theory of change.” These analyses illustrate fascinating variations, as each program identifies different groups of primary beneficiaries targeted for poverty reduction – SME employees, suppliers, or customers – and different mechanisms for reaching them. The common thread connecting all of them is the belief that SME company health and growth are necessary preconditions for poverty impact. No matter what the theory of change, each intervention assumes that SMEs cannot be an engine of opportunity and poverty reduction unless they are healthy, competitive and successful.

Pacific Community Ventures, San Francisco, California, USA

Pacific Community Ventures (PCV) is a Community Development Venture Capital Fund that focuses on investing in small businesses that provide quality jobs in low and moderate income (LMI) communities throughout California. It defines “quality” jobs as those that pay a living wage and provide health benefits and opportunities for skill and asset building. In other words, these are jobs which allow relatively low skilled workers from LMI communities to build wealth and move out of poverty. PCV’s target for poverty reduction is the employees of its portfolio companies. It believes that “having a constant store of quality employment opportunities is the only sustainable way to lift local communities out of poverty.”

Consistent with its theory of change, PCV provides expansion capital and free business advisory services through a hybrid profit/non-profit model in order to strengthen and grow the kinds of businesses that provide quality employment opportunities in poor communities. PCV believes that not all SMEs provide quality jobs, and therefore screens its potential investments for their ability and willingness to provide quality jobs for LMI employees. In order to maximize the social return on its investment, “PCV seeks companies where investing in the workforce is part of the business model and integral to business success.” In addition, PCV provides its portfolio entrepreneurs with encouragement and guidance on how to provide their employees with opportunities for upward mobility.

Aavishkaar Micro Venture Capital Fund, Mumbai, India

Like PCV, Aavishkaar is also a socially motivated venture capital fund which provides investment capital and management advice to SMEs. The fund has a wide service footprint in rural and semi-urban India, and its pro-poor business strategy is to invest in entrepreneurial start-ups and SMEs that create products and services that provide economic opportunities and benefits to the poor. Its primary target for poverty reduction is the customers of its portfolio companies. Aavishkaar portfolio companies provide the rural and semi-urban poor with products and services that improve economic productivity and profitability, lower the costs of both business and personal activities, and provide access to previously unavailable or unaffordable health, financial or energy services.²

For these reasons Aavishkaar sees its SME investments as leading to both economic benefits for individual poor customers as well to the more general social development of rural and semi-urban areas in India. Aavishkaar screens its investments for potential social impact and only works with companies it deems

² More detailed descriptions of the portfolio companies and their products and services can be found in Aavishkaar’s case study.

to be “socially relevant, commercially viable, and environmentally friendly.” Once it invests in a company it is totally focused on supporting the company’s success and commercial viability through the provision of flexible financing and mentoring support, and does not offer advisory services explicitly in support of the company’s social outcomes. Aavishkaar operates as a for-profit and earns management fees from its portfolio companies. A key requirement for its own sustainability and growth is to convince its investors of the commercial viability of its business model.

FUNDES Argentina, Buenos Aires, Argentina

FUNDES works to develop and strengthen the competitiveness of SMEs throughout Latin America through branches in ten countries. The intervention documented in FUNDES Argentina’s case study aims to increase the competitiveness and sustainability of SME subcontractors to large cement and ceramic producers in the municipality of Olavarría in Buenos Aires Province. The program provides intensive management consulting as well as business networking support to the SMEs, and by doing so aims to improve business practices and competitiveness among SMEs in its program over the medium term. FUNDES’ support is also designed to strengthen the vertical relationships between the SMEs and large producers and the horizontal relationships among the SMEs themselves.

The FUNDES program provides an important counterpoint to the other three interventions. The long term goal of this program is the development of a stronger SME sector in Olavarría, one better able to withstand economic fluctuations and crises (this program was created in the context of the Argentine economic crisis), and therefore able to support a vibrant local economy and maintain its workforce during economic downturns. As such, it aims to prevent poverty. The theory of change for this intervention includes increased competitiveness, profitability, and growth for the targeted SMEs, as all the interventions do, but it does not specifically target poverty. Therefore this case study provides an opportunity to see what poverty reducing outcomes might naturally flow from interventions that support SME growth and competitiveness, but do not have poverty reduction as an intentional goal.

Center for Human and Economic Development Studies, Peking University, Beijing, China

Established in 2005, the Center for Human and Economic Development Studies (CHEDS) is a non-profit research institution based at the School of Economics, Peking University. CHEDS researchers have been particularly interested in economic development and poverty reduction in rural areas, including the role SMEs play in increasing farmers’ income, reducing poverty, and mitigating income inequality in China. In order to combine their research with the practical promotion of development programs, they work closely with local officials in Xiji County who have implemented multiple, interlocking programs and policy interventions – which constitute an agricultural industrialization strategy – in support of SMEs in the region’s potato processing sector.

Xiji, an extremely poor area in Western China, has a long history of potato cultivation. But it was not until the 1980’s that potato processing enterprises began to flourish, offering the opportunity to add significant value to the sector. And it was not until 2003 that a set of interventions in support of potato processing SMEs, known as the Potato Industrialization Strategy (PIS), was put into action. These government policies and services include: (1) Funding potato-related R&D and agricultural extension services; (2) Favorable taxation policy; (3) Marketing services; (4) Encouraging the expansion of potato cultivation; and (5) Promoting the establishment of potato-related cooperatives. This represents a regional development strategy, which aims to reduce absolute poverty in Xiji County as a whole. The primary target for poverty reduction in this program is the poor potato farmers – the suppliers to the SMEs. Their income is expected to increase based on higher prices

for raw potatoes (due to greater demand as the potato processing SMEs grow larger and stronger), and the farmers' ability to increase their production and yields (due to the R&D and agricultural extension system). In addition, the growth of the SMEs is expected to produce an increase in wage earning opportunities (expanded non-agricultural employment) available to the farmers.

Methodology

The case study research designs combined interviews and surveys of key stakeholders (such as intervention founders and staff, local officials, SME owners and managers, SME employees, and SME suppliers) with the collection and analysis of existing quantitative data. Although each case study was researched and written by different and autonomous teams of researchers, the teams were all asked to address the following five key questions as the basis of inquiry for their studies, in order to provide a unifying framework for investigating and organizing the research from each site:

- 1) What is the program strategy to both support SME development/growth and reduce poverty? What specific aspects of both does the program target?
- 2) How did these strategies evolve over time? What opportunities facilitated these efforts, and which barriers hindered them?
- 3) What is the interaction (trade-offs, synergies, conflicts, etc.) between the program's business promotion and poverty alleviation goals?
- 4) What are the outcomes of the intervention for businesses and their owners?
- 5) What are the outcomes for other stakeholders – e.g. employees, their families, other businesses, the community?

A lack of available baseline data on many variables of interest limited the scope of the outcomes research, but a number of interesting themes were nonetheless suggested by the mix of qualitative and quantitative data that the case study researchers obtained.

Findings

As mentioned previously, each of the SME support organizations, regardless of differences in their theories of change, share a fundamental hypothesis that SMEs cannot be an engine of opportunity and poverty reduction unless they are healthy, competitive and successful. As such, we first examine the case study findings related to business outcomes to explore if and how success was achieved in terms of strengthening the SMEs. We turn our attention next to examining the nature of the evidence that organizations were able to document regarding their achievement of poverty-reduction outcomes for poor members of the SME's value chain. For each intervention, we consider whether or not observed poverty reduction outcomes are consistent with the intervention's theory of change, and look to see whether a secondary unintended or alternative group of poor beneficiaries emerged who were not part of the original theory of change.

Business Outcomes

The four case studies all had differing access to data on business outcomes, so their results are not

comparable across interventions. However, it seems clear that all four did succeed to at least some extent in developing and strengthening the competitiveness of their target SMEs. The key business outcomes cited in the case studies are highlighted below:

PCV

- PCV's portfolio companies have increased their annual sales at a median compounded growth rate of 28% since PCV's investment in them.
- 76% of PCV-advised companies report tangible impact as a result of their business advising experience.

Aavishkaar

- Aavishkaar's portfolio companies typically take 2-3 years of investment and management guidance before they show increased sales and profitability, and a number of their investments were not this old at the time of research.
- The three portfolio companies that were interviewed for the case study have experienced strong growth in sales and profitability and cited Aavishkaar's mentoring and networking support as key factors in their success.

FUNDES Argentina

- 80% of the participating SMEs adopted new management tools as a result of their participation in the program, and 60% internally restructured their businesses to improve efficiency. 75% felt that the program improved their ability to take advantage of the improving Argentinean economy.
- As a result of the program's efforts to create horizontal linkages among the SMEs, a number of them have begun to work together to enter new markets and negotiate larger contracts than they could access on their own.
- The least successful component of the intervention was the attempt to strengthen vertical ties between the SMEs and the large companies they supplied. One of the explanations provided in the case study for the relative lack of success of this component is differing interests between the two groups.

CHEDS

- The economy of Xiji Country grew at annual rates of over 13% during the first three years of the PIS (2002-2005). Potato processing enterprises clearly played a lead role in this growth, as by 2005 they accounted for close to 60% of gross industrial output and value added from industry.
- Potato industry employment (in both processing enterprises and potato related co-ops) grew from around 40% to more than 55% of Xiji's non-agricultural employment during the first three years of the PIS (2002-2005).
- Based on the available data, the PIS appears to have strengthened potato processing SMEs, as well as potato-related cooperatives, which are themselves SMEs, and which have played a key role in developing the market for fresh potatoes.

Poverty-Reduction Outcomes

Across the board, the three poverty focused interventions were able to demonstrate poverty reduction outcomes in line with their theories of change. In addition, Aavishkaar's case study found poverty reducing effects outside the key group (customers) identified in its theory of change, but not for all portfolio companies. Instead, Aavishkaar's support for its portfolio companies resulted in expanded wage employment and other livelihood opportunities for poor individuals when the portfolio company's activities and business model inherently called for lower-skilled labor. In contrast, because the SMEs that FUNDES Argentina worked with demanded an increase in only skilled labor, no direct poverty reducing outcomes were found. A final factor that emerged as relevant to the poverty reduction potential of an SME sector intervention is the overall poverty level of the area where the SME support program is active.

PCV

PCV is at the forefront of social outcomes measurement for an SME practitioner. Since 2000 it has conducted annual surveys of its portfolio companies in order to track the quality of jobs they provide to their LMI employees, who make up the majority of their workforces. PCV's case study provides a wealth of detailed information on these jobs, which all pay average hourly wages that exceed local living wage ordinances and provide health benefits and almost all of which provide skill-based training. However, PCV has noticed a variation in job quality that is positively related to company age and size. This only underscores PCV's philosophy that to provide quality employment to LMI Californians they must work to create solid business outcomes for their portfolio companies.

In addition to supporting quality jobs, PCV has provided direct wealth building opportunities to LMI portfolio employees by negotiating equity set-asides for employees³ and connecting employees with PCV's Individual Development Account (IDA)⁴ program. As of 2006, PCV had created over \$1 million of wealth for LMI employees through equity sharing mechanisms, and enrolled 56 LMI employees in IDA programs, where they are saving roughly 3% of their gross monthly income toward an asset purchase.

PCV focuses its poverty reducing goals and activities on the LMI employees of its portfolio companies, and it has certainly succeeded in providing them with significant economic opportunities. Since PCV does not track outcomes for any other stakeholders, outcomes for any additional or unanticipated poor constituencies are not available.

Aavishkaar

Aavishkaar does not have a history of tracking the social outcomes of its work, so for this case study several portfolio companies were chosen for closer examination. The following two examples demonstrate how Aavishkaar's portfolio companies have improved the economic well-being of poor customers, in line with Aavishkaar's theory of change:

- Customers of the Servals kerosene stove burners (over 250,000 sold) save 30% on their kerosene (cooking fuel) costs. These customers are predominantly rural farmers and low income households.

3 The story of one such deal – PCV's successful exit from its investment in Timbuk2 Designs, which resulted in a cash bonus of up to two times annual pay for the company's factory workers – is included in PCV's case study.

4 As described on CFED's website www.cfed.org, Individual Development Accounts (IDAs) are matched savings accounts that enable low-income American families to save, build assets, and enter the financial mainstream. IDAs reward the monthly savings of working-poor families who are building towards purchasing an asset - most commonly buying their first home, paying for post-secondary education, or starting a small business.

- The SKEPLS technology product (a computerized milk collection and analysis system) benefits poor rural dairy farmers. It saves time and increases trust between farmers and their dairy collection cooperatives. Outcomes for the farmers have included increased numbers of animals owned, an 88% increase in amount of milk sold to the dairy collection center, and an increase in the year-end bonus paid to members of the cooperative.

In addition, although employees of its portfolio companies are not the main intended beneficiaries of Aavishkaar's activities, in some cases job creation for the poor has been an outcome when the company's activities and business model inherently demand less skilled labor. For example, the case study research revealed that in addition to providing a cost saving product to poor customers (the efficient kerosene burner), portfolio company Servals had also expanded and stabilized wage employment opportunities for women and semi-skilled workers. New small-scale rural production units employed women and men who, prior to their employment with Servals, were working inconsistently or not at all. Rural women members of self-help groups also received training in marketing and then bought the products wholesale and earned money re-selling the products to others in their communities.

FUNDES Argentina

According to the case study, the Local Development Program achieved success in increasing the competitiveness and strength of the participating SMEs. This was its goal. While the participating SMEs did expand their employment (less than 5%), the new hires were mostly people with more education (university or higher) and professional skills than previous employees, which represented a positive increase in the SMEs' competitiveness and professionalism, but cannot be seen as increasing opportunity for poor workers. No other poverty reducing outcomes were suggested by the case study research, which implies that direct poverty reducing outcomes cannot be assumed from all SME support programs that succeed in improving business outcomes. The long term or indirect impact of the program on poverty via local economic development could not be assessed given the methodology and time frame of the case study.

CHEDS

The CHEDS case study finds evidence that the PIS has resulted in increased income for poor potato farmers through several different mechanisms:

- Greater volume of output;
- Increased demand and prices for raw potatoes;
- Dividends earned through co-op membership; and
- Increased seasonal wage employment opportunities in either potato processing SMEs or potato related co-ops.

Thus, the PIS appears to have had not only its primary impact on poor farmers as suppliers of SMEs, but also through the wage employment generated through improved SME business outcomes, as hypothesized in the theory of change.

According to CHEDS' case study, the PIS has been largely successful as a regional development strategy for Xiji County. Because the county is so poor – its 2000 per capita income was only 40% of the national average and in 2001 a quarter of the county's population lived below the national absolute poverty line of approximately 75 cents a day – it seems intuitive that a policy of widespread support for SMEs, if successful

in achieving positive business outcomes and therefore generating local economic activity, would have a regional poverty reducing impact.

Challenges in Market-Based SME Poverty Reduction Strategies

Three of the four case studies provide a good panel of evidence that it is possible to pursue the dual goals of growing SMEs and reducing poverty. Having said that, the pursuit of both objectives is not without tradeoffs and tensions, some of which are highlighted below:

Challenges to simultaneously maximizing social and business outcomes of SMEs

Both Aavishkaar and PCV, as venture capital funds, want to invest in companies with the greatest growth and profit potential. However, many such companies don't meet their social impact screens. According to the case study, "PCV has found it must pass up promising financial investment opportunities with SMEs when the social return potential is limited." For example, SMEs that outsource their lower-skilled positions do not meet PCV's social investment criteria. In addition, some companies with appropriate poverty impact potential may not represent sufficient commercial return. However, passing up investment deals with potential for community development impact but which are too financially risky presents less of a concern for PCV, since "if a company is unsuccessful financially, it also fails to serve as a means of continued economic opportunity for its employees." PCV has also managed to work with a fairly wide spectrum of businesses by shifting its investment focus to later stage companies and supporting riskier start-ups through its non-profit Business Advisory Service, which provides technical assistance but not financial investment.

Challenges to maximizing poverty and business outcomes at multiple levels in a value chain

The tension inherent in sometimes opposing interests for different members of a supply chain came up in several of the case studies. In the case of the PIS in Xiji County, the processing SMEs and the poor potato farmers have opposite goals with regard to the price of raw potatoes. In order for the processing SMEs to survive and thrive as businesses, they need access to a steady supply of raw potatoes at a relatively low price. However, poverty reduction for the farmers hinges on a higher price for their raw potatoes as a key source of increased income. In addition, the FUNDES case study cites differing interests between the SMEs and the large companies they supplied as one source of the relative lack of success its program had in strengthening those vertical relationships.

Challenges to financial sustainability of "high touch" SME support strategies

Three of the four documented interventions – PCV, Aavishkaar, and FUNDES Argentina – involve quite extensive and expensive management coaching for the SMEs served. PCV provides its advisory services and employee wealth building programs through a sister non-profit that is grant-funded. Though it has been able to attract philanthropic dollars to grow its advisory services, "PCV remains frustrated by the lack of capital available for its non-profit organization." Aavishkaar, which does not accept grant funding, has struggled with the experience that, "Investments with strong social agendas often have not focused on maximizing profitability due to the lack of business skills, networking and marketing. Therefore, Aavishkaar spends more time (which costs money) on improving the commercial viability of strong socially based organizations." Finally, a key finding of the FUNDES case study was that very intensive consulting, practically

embedded in the company, is more effective for strengthening SME competitiveness than conventional business management training.

Conclusion

Considered together, these four case studies present compelling evidence that strong and vibrant SMEs can be a powerful and important conduit to economic gains for poor people. However, they also suggest that while healthy growth of the SME (as an enterprise) is a necessary precondition for social impact, poverty reduction cannot simply be assumed to result from all programs or policies that support SMEs. The following aspects of program design are important to consider when gauging a program's potential for poverty reduction:

- Which SMEs are served, how are they supported, and what poverty reducing actions are companies encouraged or required to take;
- Where along the SMEs' value chain are poor individuals positioned to benefit (e.g. does the theory of change target employees, suppliers, or customers);
- What are the mechanisms that translate SME growth or stability into benefits for poor individuals; and
- Where is the program operating (e.g. are the SMEs located in broadly poor areas)?

CFED's experience through the RFP process, and the questions generated by the case studies, also underline the need for further work on how social returns can be tracked and measured in the SME sector. Some of the most commonly used metrics, or shorthand, such as "dollars invested in SME sector," "number of SMEs served," or even "jobs created and preserved," fall short of capturing results and impacts in the SME sector.

These findings reinforce the value of supporting SMEs as a poverty reduction strategy. But to be effective, donors, investors and policy makers must have an intentional and strategic focus on social outcomes. Those interested in investing in this sector to increase economic opportunity and security for the world's poor need to ask questions about who a given program targets for poverty impact, its approach, theory of change, and evidence of social impact.



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