

INCREASING SME ACCESS TO FINANCES THROUGH THE SECURITIES MARKET

Nargiz Ahmadova

SUMMARY

This policy paper is dedicated to the problem of access to finances faced by small and medium-sized enterprises (SME) in Azerbaijan. The study points to weak access to financial resources as the main factor that hampers the role of SME in the Azerbaijani economy. Specifically, the policy paper is dedicated to increasing SME access to the bond market as a solution to this problem. First of all, the reasons for the poor involvement of enterprises in the bond market were determined and then, based on these factors, three alternatives were offered for increasing SME access to the bond market. The first alternative is to keep the current situation, ensure transparency on the capital market and increase the financial literacy of enterprises. To this end, a proposal was made to create a centralized rating base and increase the efficiency of existing organizations that support SME. The second alternative recommends selling bonds through banks. And the last alternative proposes creating an alternative stable income platform at the Baku Stock Exchange. Considering the required institutional and legislative changes, it is recommended that the first alternative should be implemented first and the second and third alternatives after that.

1. INTRODUCTION

Given that small and medium-sized businesses play a major role in promoting innovation and technology in the country, we can easily see the crucial role of SMEs in economic development. For example, on the example of 45 countries, Beck (2005) found a strong positive relationship between SMEs and GDP per capita. Additionally, SMEs contribute to the development of the state budget by creating new jobs and expanding the tax base. According to a survey of 76 developed and developing countries, SMEs are responsible for 60 per cent of employment. Even during a crisis, SMEs contribute to employment and economic growth; During the Asian financial crisis, SMEs were called an army of ants for Taiwan, which was fighting the crisis. However, our research showed that the contribution of SMEs to the Azerbaijani economy is not at the appropriate level. Compared with other similar economies, the low share of SMEs in the country's economy shows that there are significant obstacles in this area. The study revealed that access to finances was the main obstacle to SMEs among these barriers. Taking into account the potential support of SMEs for the development and diversification of

Azerbaijan's economy, this policy document addresses the issue of increasing SME access to the securities market in order to use alternative sources of funding.

2. SOURCES OF FUNDING FOR SMES IN AZERBAIJAN AND EXISTING PROBLEMS

The contribution of small and medium-sized enterprises to the country's economy is not at the appropriate level despite their growing number in Azerbaijan. The main reason for this is that the economy depends on the oil sector.

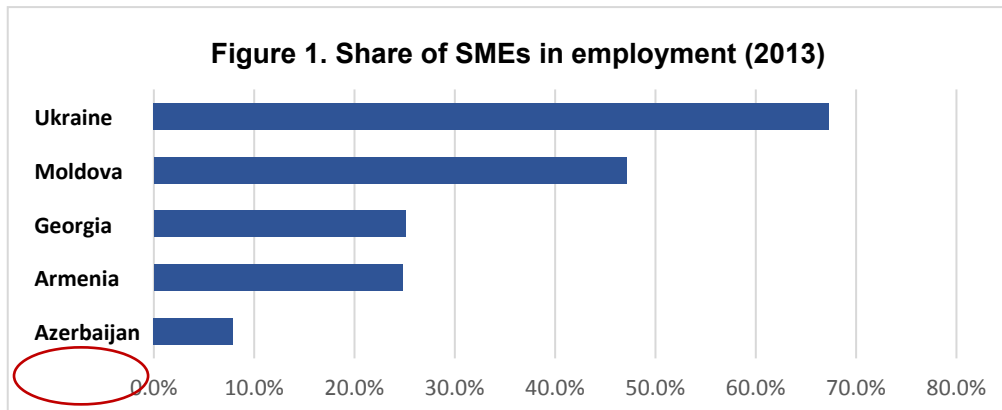
Table 1

Indicator (per cent)	2015			2016		
	General	Small	Medium	General	Small	Medium
1. Added value	7.5	5.9	1.6	6.4	5.2	1.2
Non-oil sector	10.9	8.6	2.3	9.9	8.1	1.8
2. Number of employees	18.7	5.8	12.9	18.4	6.6	11.8
Non-oil sector	19.1	5.9	13.2	18.9	6.8	12.1

Source: EU4 Business Report

In general, as shown in Table 1, the share of SMEs in the economy is lower in terms of their value and number of employees. In other words, the fact that the added value created by SMEs in the economy is below 10 per cent shows that there are serious problems in this area. Moreover, if we look at the trend from 2015 to 2016, we can see that the value created by SMEs in the non-oil sector declined during these years, which, in turn, creates an unsatisfactory picture. As for the share of SMEs in employment, there is a declining trend from 2015 to 2016, and the main reason is the decline in the number of employees in medium-sized enterprises.

Additionally, if we look at the share of SMEs in general employment, we can see that Azerbaijan is in the last place among the Eastern Partnership countries (**Figure 1**).



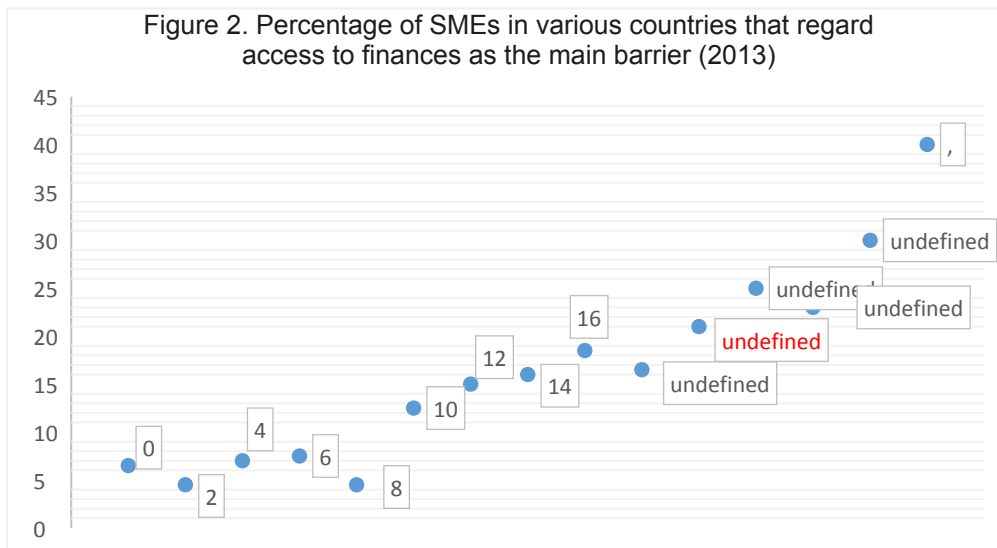
Source: SME Policy Index Eastern Partner Countries 2016

It is clear from Figure 1 that in 2013, the share of SMEs in employment in the country was only 8%, while this figure was 24% in Armenia, 25 in Georgia, 48 in Moldova and 67 in Ukraine.

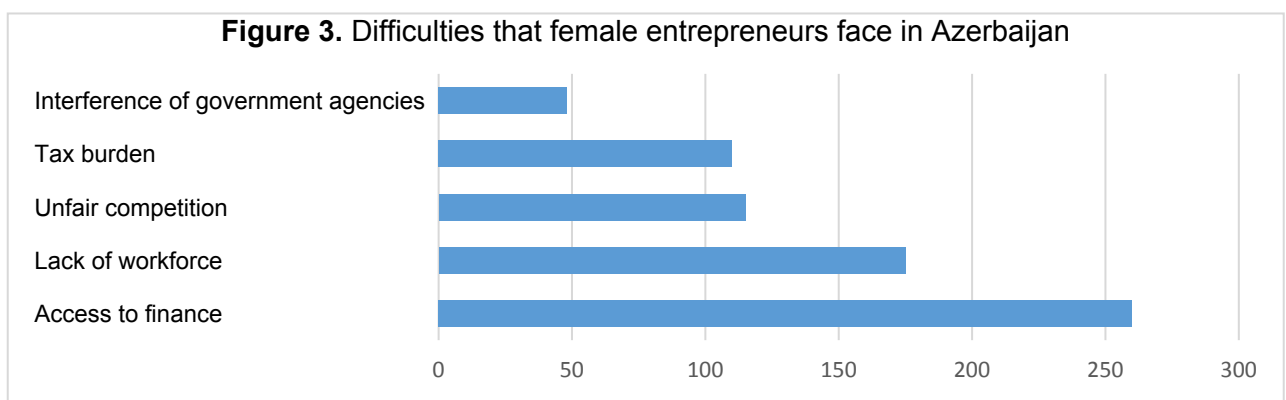
It should be noted that 97.8% of SMEs operating in Azerbaijan are small and only 2.2% belong to medium-sized businesses. Such a small share of medium-sized businesses can actually be regarded as a factor that contributes to SMEs' limited contribution to the economy and employment.

According to the results of the Business Environment and Enterprise Performance Survey (BEEPS) carried out by the European Bank for Reconstruction and Development (EBRD), 21.7% of small businesses and 21.6% of medium-sized businesses operating in Azerbaijan consider access to finances as the main problem. In addition, compared to other developing countries, the share of SMEs that regard access to finances in Azerbaijan as a major problem is higher (Figure 2).

Source: World Bank



At the same time, the results of a face-to-face survey conducted by the Centre to Assist the Development of Entrepreneurship and Market Economy and the Centre to Assist the Development of Small and Medium Entrepreneurship among 500 (five hundred) women entrepreneurs in Azerbaijani regions in 2018 showed the lack of finances as a major obstacle to entrepreneurship (Figure 3).



Source : SME Policy Index Eastern Partner Countries 2016

As we can see, more than 50% of the 500 respondents noted access to finances as a major problem. Despite the fact that this survey was conducted among women, it is clear that a survey among male entrepreneurs will also create a similar picture.

The SME Policy Index: Eastern Partnership Countries 2016 report of the Economic Cooperation and Development Organization says that, like in other Eastern Partnership countries, the issue of SME access to finances in Azerbaijan is a problem. According to the report, the position of Azerbaijan in terms of SME access to finances was 2.70 on a 5-point scale, which is the worst indicator among the Eastern Partnership countries (Table 2). Thus, if in 2016 the average indicator is 3.28, this figure is 2.7 in Azerbaijan. The fact that the index for both years is below average shows that access to finances remains a major obstacle to the business environment in the country. According to the methodology of the organization, this level indicates that there are good bases for the implementation of the policy in this field, but in practice it is not being implemented.

Table 2. Access to finances index (for SMEs)

Years	Armenia	Azerbaijan	Belarus	Georgia	Moldova	Ukraine	Average
2016	3.53	2.7	3.08	3.76	3.4	3.22	3.28
2012	3	2.74	2.5	3.52	2.65	2.59	2.83

Source: SME Policy Index Eastern Partner Countries 2016

Additionally, as we can see from **Table 2**, more than 85% of the loans provided to small and medium-sized enterprises (85.7% - small, 97.2% - medium-sized) are warranted. The value of the collaterals that provide this guarantee is more than twice the value of the loan, which makes it difficult for SMEs to use bank loans, which are a major source of external funding. More precisely, the share of the collateral in the loans received by small enterprises is 259.1%, and in the medium-sized enterprises - 201.2%. In addition, more than 20% of entrepreneurs refused to apply for a loan, which turns the lack of finances into one of the major barriers to SMEs.

Tables 3

Indicators	Size of enterprises	Specific share %
Bank land/Share of enterprises with a loan	Small	14.7
	Medium-sized	14.6
Share of loans that require a guarantee (%)	Small	85.7
	Medium-sized	97.2
Share of the pledge required for receiving a loan (loan amount %)	Small	259.1
	Medium-sized	201.2
Share of enterprises that had their last loan application rejected	Small	23.6
	Medium-sized	23.6
Share of enterprises that point to access to	Small	21.7

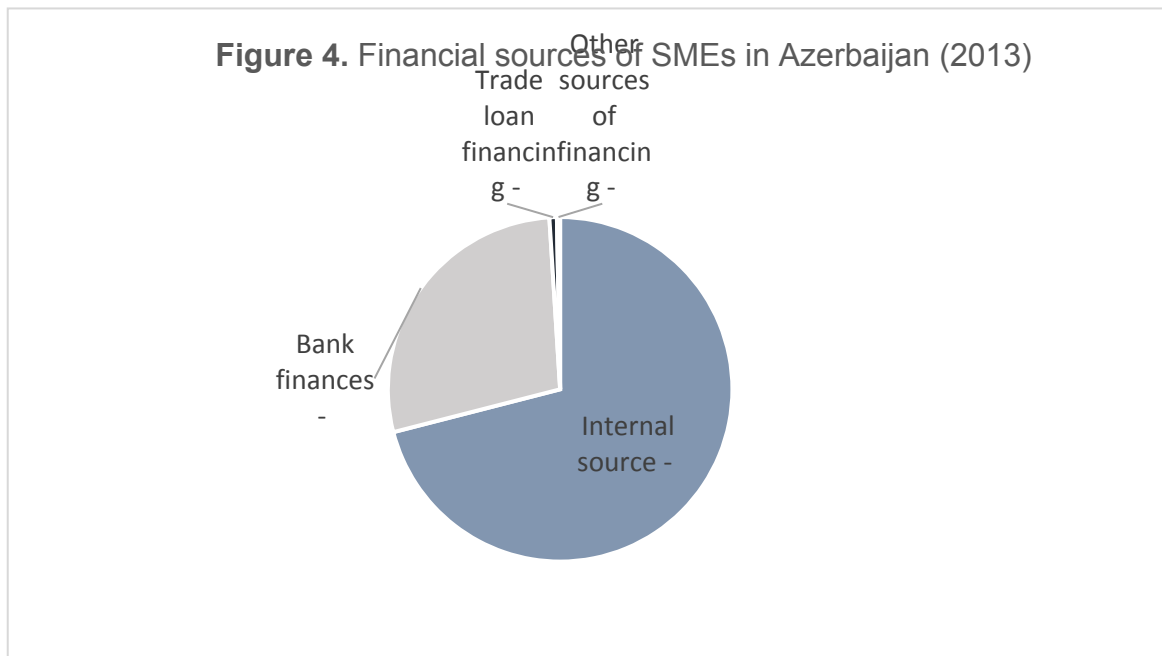
finances as the main problem

Medium-sized

21.6

Source: <http://www.enterprisesurveys.org/data/exploretopics/finance>

A report prepared by the World Bank Group notes that most of the SMEs' investment capital in Azerbaijan comes from domestic financing. Among external funding sources, bank loans are prevalent.



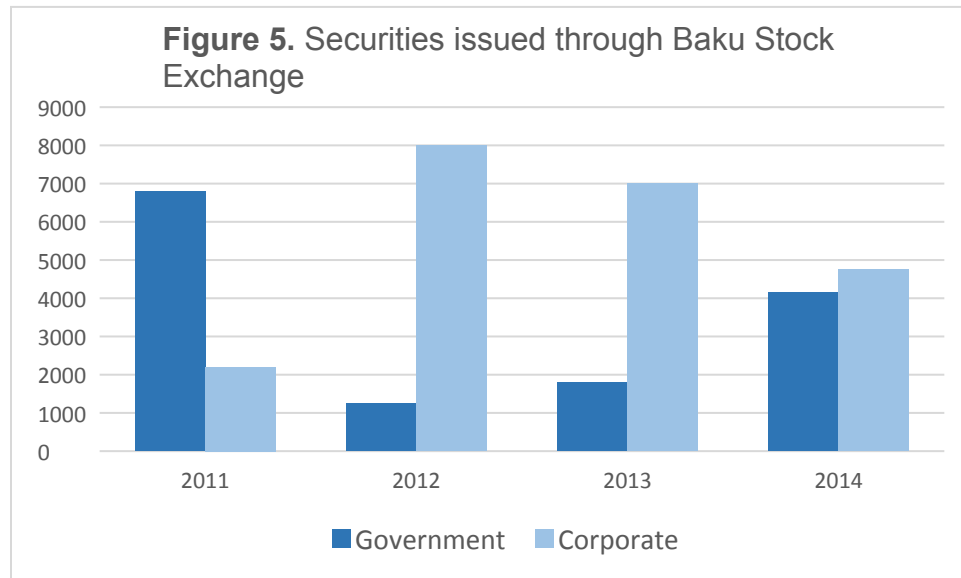
Source: World Bank

It is apparent that although SMEs have extensive financing mechanisms around the world, the small and medium-sized enterprises in Azerbaijan are more focused on banks and non-bank credit institutions. In addition, according to the results of a survey conducted by the Qabus Research and Consulting Company and the Centre for Media and Public Initiatives among 200 small and medium-sized enterprises in order to study the level of SME access to loans in Azerbaijan, entrepreneurs mainly apply to credit organizations as an external source when they need financial resources. 45% of SMEs said they use loans from banks and 5% from non-bank credit organizations. The share of entrepreneurs who ask friends, acquaintances or relatives for interest-free funding is 42.5%. A small number of respondents (2.5%) were forced to seek funding either from pawnshops or usurers who have the highest interest rates in the country.

International financial institutions are another financial source for SMEs. For example, EU4Business, established by the European Union, implements measures aimed at the development of SMEs in Azerbaijan. Specifically, EU4Business focuses on the development of SME access to finances in the country. So far, the organization has provided loans worth 207 million euros to 348 enterprises. In addition, the European Bank for Reconstruction and Development (EBRD) and the Asian Development Bank (ADB) provide financial support to SMEs within the framework of various programmes.

Like in international practice, there are a **number of institutions in Azerbaijan that provide state support** to the development of SMEs, including funding. Unlike other credit organizations, these institutions allocate funds on favourable terms to SMEs. These institutions include the *Entrepreneurship Development Fund, the State Agency for Agricultural Loans, the State Fund for Information Technology Development and the Mortgage and Credit Guarantee Fund*. The main feature of these funds is that their credit resources are secured at the expense of funds allocated from the state budget.

In international practice, one of the sources of funding for SMEs is the securities (capital) market. Our research has shown that SMEs in Azerbaijan are not interested in this market. Official data indicate that the growth of the securities market has taken place mainly due to the increase in the share of government securities. A growth on the market of corporate bonds was ensured for the first time in 2014, which happened thanks to commercial banks. The demand of the Central Bank to increase the banks' aggregate capital to 50 million manats forced the banks to enter the market and increase their capital. On the other hand, the bonds placed by the Mortgage Fund and the Southern Gas Corridor CJSC to acquire more finances affected the increase **(Figure 5)**.



Source: State Securities Committee

At present, there are only 19 large enterprises that have their bonds in circulation at the Baku Stock Exchange. It seems that SMEs do not participate in the securities market, although the average interest rate on loans in national currency in the country is 14.17% and approximately 11-12% of funds are involved in bonds. In addition, unlike bank loans, the bond market does not require a collateral, and this can turn bonds into a financial source for SMEs that cannot afford a collateral. At the same time, the bond market provides a longer-term financial resource that can further facilitate SME investment in long-term projects and ultimately help them to grow.

Taking into account the potential role of SMEs in the development and diversification of Azerbaijan's economy, this policy document aims to increase the ability of SMEs to use alternative sources of financing by providing them with access to the bond market.

3. LEGISLATIVE ACTS REGULATING THE SECURITIES MARKET

The main law regulating the activities of the securities market in Azerbaijan is the Law of the Republic of Azerbaijan "On the Securities Market" adopted on 15 May 2015.

Under the legislation of the Republic of Azerbaijan (either the Civil Code of the Republic of Azerbaijan or the Law of the Republic of Azerbaijan "On the Securities Market"), there is no restriction on SME access to the capital market.

So legal entities willing to be financed by the capital market may do so by issuing stocks or bonds. OJSCs can easily participate in the stock and bond market, while LLCs can easily participate in the bond market. In contrast to the issue of shares, the law envisages certain restrictions on the issue of bonds.

According to Article 3.8 of the Law "On the Securities Market", the issuer's maximum bond issuance requirements are determined by the Financial Market Supervisory Chamber (FMSC). These limits can be found in the Rules of the Chamber "On the maximum volume of bond issue". According to the rules, an entity wishing to issue a bond may release bonds in line with its international credit rating and the amount of its capital. If the issuer does not have a credit rating, then it may issue bonds double the amount of its capital. On the other hand, SMEs can also easily invest in capital markets. For this purpose, the law provides for activities either in the stock exchange or outside the stock exchange. Investors willing to trade at the stock exchange can do this through investment companies. Investment companies are participants who have received a special licence to participate in the securities market, and they engage in financial mediation (brokerage and dealer services) on the market.

In order to participate in a regulated market (stock exchange), issuers must first put the securities they want to sell at the exchange on the listing of the Baku Stock Exchange (BSE). The latest amendment to the BSE listing was brought in line with international standards in accordance with the State Programme on the Development of the Securities Market in the Republic of Azerbaijan for 2011-2020 and facilitated investors' access to this market. Currently, measures have been identified on the basis of the Strategic Road Map on Financial Services Development to further facilitate and stimulate investors' participation in this market, and it is planned to digitalize investors' access to the capital market in the coming years (ensuring investors' direct access to the stock market through electronic platforms). This will further stimulate investors' participation in financial markets and contribute to the development of the secondary securities market.

4. FACTORS THAT HINDER SME ACCESS TO THE BOND MARKET

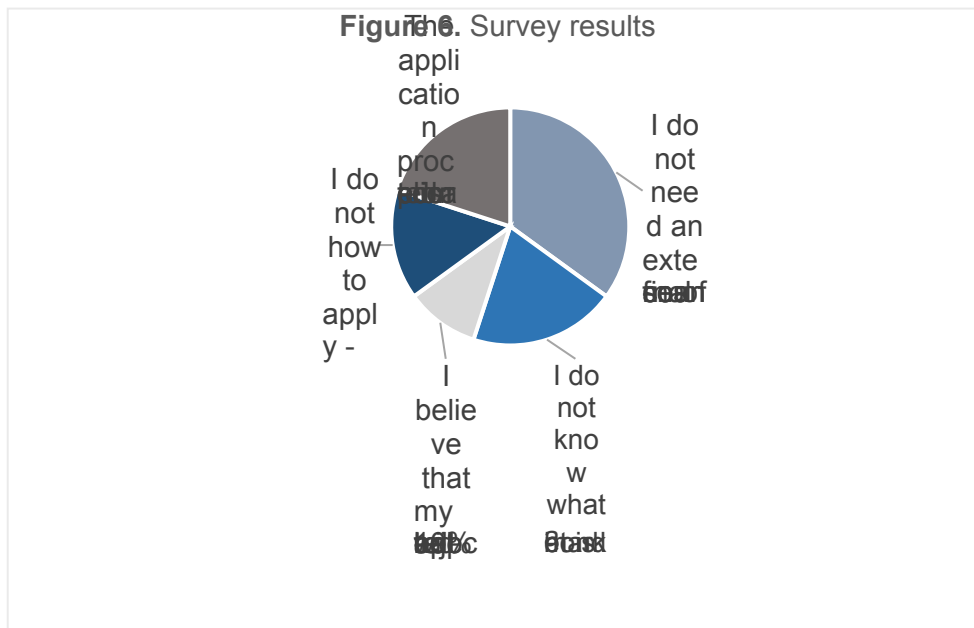
After analyzing the legislative acts that regulate the securities market, we can see that legislation is not the reason for the poor involvement of SMEs in the bond market. That

means that there are other factors at the root of the problem. For this purpose, a survey was conducted among 30 entrepreneurs operating in Baku and Sumgayit. The purpose of the survey was to study the level of businesses' awareness of the capital market and to assess their access to this market. To ensure impartiality, the anonymity of participants was secured.

The following questions were put to the entrepreneurs during the survey:

- Do you use the bond market? If the answer is "no", "What is your reason for not using it?"
- Do you know that bonds are a cheaper financial source than banks?
- Do you know what is required to be listed on the Baku Stock Exchange?
- Do you also have any other ideas that are not covered by the questions on this subject?

We can group the results of the survey as follows (Figure 6).



In fact, if we analyze the answers better, we will see that the main root of the problem is insufficient financial literacy among SMEs. The responses show that respondents are either totally unaware of this financial mechanism or have limited access to information. The fact that they do not know how to apply or consider the procedure to be complicated in fact stems from this reason. The fact that many SMEs know banks as the only external source of funding is, in fact, one of the graphic examples of this.

When looking at this issue from investors' point of view, we can say that the main problem is that SMEs are not interested in accountability. Non-standard financial statements prevent SMEs from using of the bonds market. The absence of proper financial reporting stems either from the financial illiteracy of SMEs or the fact that they want to avoid transparency.

According to Jafar Ibrahimli, director of Texnika Kapital Management LLC, weak corporate governance in companies, the lack of transparency in companies and failure to meet the criteria required for participating in the capital market reduce their interest in the securities market.

5. PROPOSED ALTERNATIVES TO INCREASE SME ACCESS TO THE BOND MARKET

- **Alternative 1. Facilitating SME access to the capital market through transparency and increased financial literacy**

First of all, it is expedient to establish **a *centralized rating base (CRB) for SMEs*** to ensure transparency for investors. The CRB is created under the Small and Medium Business Development Agency (SMB), and information on SMEs is collected by the Agency. An Appraisal Council, which includes independent experts and entrepreneurs, is set up at the SMB. The Council develops standard risk methodology (SRM) to evaluate SMEs and analyzes the financial status of SMEs using SRM. By posting this information on the SMB's website, we can help investors to quickly analyze and evaluate potential investments. Thus, more investors will be involved in the bond market, which means more financial resources for SMEs. In addition, the rating base will strengthen competition on the market and competition between SMEs. In turn, increasing transparency and competition will increase the efficiency of the market.

In addition, it is important to increase the ***effectiveness of consulting services*** to increase the financial literacy of SMEs. Currently, there are a number of organizations that support SMEs in the country with a number of well-known organizations such as the Business Training Centre (BBTC) and its seven regional offices, the Entrepreneurship Development Fund, the Export and Investment Promotion Foundation, and ASK. At the same time, the ABAD centre was established in 2016 by the State Agency for Public Service and Social Innovation under the President of the Republic of Azerbaijan. The Centre provides small businesses with planning, marketing, branding and design, financial accounting and legal assistance services. Among these, we can point to the ASK and ABAD centres that provide active consultation services. However, the main problem is the lack of sufficient training and counseling services. Although there is no information about the number of attendees in the events, we can say that the number of attendees is not very high, considering that the events are only announced by a personal website. Whether entrepreneurs are aware of the centres providing such services is questionable. For example, when looking at the list of businesses that are members of ASK and always use their services, we see that there are only 11 businesses, which is a very small figure. In order to address the existing problem, it is important for organizations supporting entrepreneurship to promote their activities through television and radio programmes. Although the internet is currently being used as a major advertising tool, commercials on television and radio programmes in developing countries, as well as Azerbaijan have a greater scope of coverage. In addition, the extent to which training sessions are relevant to the needs of SMEs is an important factor. For this purpose, it is expedient to conduct a survey among entrepreneurs when selecting

the subject matter. This will not only help meet the needs of the events, but also promote training among entrepreneurs. Finally, coordination between institutions is crucial to enhancing effectiveness. For example, an advisory programme has been created within the Baku Stock Exchange, and in order to join the programme, it is necessary to submit information about a business plan, a statement by the company manager, financial statements and the company's management structure. Based on our research, no organization has held an event on these subjects over the past year. So, it is necessary to establish coordination among these institutions so that they touch upon issues that may be useful for entrepreneurs. In other words, training sessions held at separate centres will be more effective for entrepreneurs if they are coordinated.

- **Alternative 2. Ensuring SMEs access to the capital market through banks**

In practice, SMEs use banks as a major source of external funding and already know how to work with them. From this point of view, the mechanism for the sale of bonds through banks (underwrite) increases the demand for these financial instruments. At present, 12 commercial banks in China issue financial bonds, and experience shows that the reliability of bonds sold through banks is higher in the eyes of investors, which increases the demand for bonds issued by SMEs. Additionally, banks gain a new source of income in this way, which contributes to the diversification of banks' income. But bearing in mind that banks do not normally sell bonds, the sale of bonds can increase their risks, which may not be favourable for the entire financial system. In order to avoid this situation, the right to sell bonds must be given to banks that have a solid financial position. At the same time, criteria should be determined as to what SME bonds they can sell. In other words, the sale of bonds through banks should be regulated by relevant rules.

- **Alternative 3. Facilitating SME access to the capital market through the creation of an alternative fixed income platform**

In world practice, an alternative fixed income platform was created to facilitate access to markets for both issuers and investors. A number of German regional stock exchanges used this experience, and as a result, more than 50 SMEs earned capital worth 2.7 billion euros. These platforms are focused on institutional investors who want to diversify their portfolios with fixed-income securities from medium-sized companies that are not listed and have good business prospects. These platforms, which allow direct non-bank lending to corporations and individuals, provide substantial financial support to SMEs. In recent years, Spain has also started to create fixed income platforms, the main purpose of which is to help SMEs to acquire capital. Additionally, given the importance of alternative fixed income platforms, the New York Stock Exchange said it would take measures to increase the sales of bonds issued by SMEs through alternative platforms. These platforms facilitate the borrowing and lending process by establishing links between businesses and investors. These market entry requirements are more flexible compared to officially regulated markets and bond issue can be faster. In this way, companies that use platforms can benefit from the simplification of the process and low costs.

6. CONCLUSION AND SUGGESTIONS

First of all, increasing the financial literacy of SMEs in Azerbaijan and ensuring transparency on the capital market are a prerequisite for all proposals; i.e., as long as there is no financial literacy and transparency, changes to the capital market will not be effective at the appropriate level. In this regard, the effectiveness of existing consultation services should be increased and a centralized rating base for SMEs should be established at the SMB Agency.

In addition, the sale of bonds through banks may be a successful step for Azerbaijan. Specifically, since the sharp fall in oil prices in 2015, banks have been looking for new sources of income, and bonds sales could be one of those sources. Considering that investors trust banks as the most reliable financial institution in the country and that SMEs use only banks as an external funding source, we will see that this proposal can be quite effective. In other words, both the issues and investors regard banks as the most trusted financial institutions in Azerbaijan, which can create demand and supply on the bond market. According to existing banking legislation, banks' bond sales are not illegal, indicating that the proposed supply is accessible. However, as mentioned above, the right to sell bonds must be given to banks with solid financial indicators. Specifically, considering that the banking sector is vulnerable in Azerbaijan, it is important to implement and monitor the sale of bonds with strong legislation.

References

1. B. (2005). SMEs, Growth, and Poverty [PDF].
2. Investing in SMEs in the Eastern Partnership [PDF]. (n.d.). EU4Business.
3. The Key Enablers of Business Success and the Economic Rationale for Government Intervention[PDF]. (2013, December). Department for Business Innovation & Skills.
4. OECD. (n.d.). New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments (Publication).
5. "Qadın sahibkarlığı" (Working paper). (n.d.). Bakı: Sahibkarlığa və Bazar İqtisadiyyatının İnkişafına Yardım Fondu Kiçik və Orta Müəssisələrin İnkişafına Yardım Mərkəzi
6. Samadov, A. (n.d.). Azərbaycanca kiçik sahibkarlıq. Retrieved from <https://www.stat.gov.az/source/entrepreneurship/>