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How South African SMEs can survive and thrive post COVID-19

Providing the right support to enable SME growth now and beyond the crisis

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The ongoing COVID-19 pandemic is causing untold human suffering across Africa and is likely to leave an indelible impact on the continent's small and medium-sized enterprises (SMEs). We define SMEs as "a separate and distinct business entity, together with its branches or subsidiaries, if any, including cooperative enterprises, managed by one owner or more predominantly carried on in any sector or subsector." Specifically, our focus is on businesses with a turnover of more than R15m and less than R500m.[1] These businesses play an outsized role in economies and employ an estimated 80 percent of the continent's workforce in both the formal and informal sectors, but during times of crisis they are often the least resilient. This is because typically they have limited cash reserves, smaller client bases, and less capacity to manage commercial pressures than do larger companies.[2, 3]

For South African SMEs, already having to contend with a contracting economy, additional shocks from COVID-19 are putting further pressure on their operations. Lockdown measures have caused revenues in many SMEs to fall precipitously and the majority report that they are being forced to cut back on business spending to survive.[4]

For some, this may not be enough; analysts are predicting that around 60 percent of SMEs may close before the crisis is over.[5]

In this report, we draw on our experience working directly with SMEs in South Africa to provide insights into the headwinds that they are facing at this time, along with best practice examples and recommendations for how to address some of these challenges. We also offer a view on what the public and private sector can do to support this important business segment.

Because of their critical role in job creation and growth, protecting and enabling SMEs during this period of economic turbulence is important not least because their survival and recovery is likely to be a bellwether for the economy as a whole.

1 The lower threshold is based on a rough extract of the latest thresholds published by National Small Business Act with the upper thresholds including some larger SMEs. The reason for this classification is that this group of SMEs represent a significant portion of the total employment within the landscape beyond sole proprietors as highlighted in our recent survey where the majority of this group employed >100 and <500 employees.
2 How to rebuild and reimagine jobs amid the coronavirus crisis, McKinsey & Company, April 2020
3 Setting up small and medium-size enterprises for restart and recovery, McKinsey & Company, June 2020
4 COVID-19 South Africa SME Financial Pulse Survey conducted on SMEs in South Africa between R15mn and R500mn in turnover spread across sectors and geographies (n=100)
5 Sme.africa and Sasfin survey of ~1000 SMEs

SMEs are the lifeblood of South Africa's economy—and also the most at risk

SMEs across South Africa represent more than 98 percent of businesses, employ between 50 and 60 percent of the country's work force across all sectors, and are responsible for a quarter of job growth in the private sector. And while the GDP contributions from South Africa's SMEs lag other regions—39 percent compared to 57 percent in the EU—there is no doubt that this sector is a critical engine of the economy (Exhibit 1).

Coming into the COVID-19 crisis, small enterprises in the country were already facing significant headwinds. A sluggish economy coupled with several ratings downgrades have negatively affected SMEs year on year and the economic impact of the coronavirus is likely to exacerbate these trends.[6] During the global financial crisis of 2008, SMEs bore the brunt of job losses and revenue declines globally and analysts expect this to be the case in this crisis too.[7]

Many SMEs have already experienced a dramatic drop in demand. A McKinsey Consumer Pulse Survey carried out at the end of March 2020 found that more than 80 percent of respondents were looking to decrease spending across all retail categories and more than 70 percent were looking to cut back on transport and travel-related costs.[8] Sectors worst affected include the services sector (for example, private accounting and legal firms), tourism, hospitality and retail. While these are some the fastest growing SME sectors in the country, the majority of businesses in them were not able to operate during the 35-day lockdown and their activities continue to be curtailed under level 3 and 4 restrictions."

Not surprisingly, business disruptions are signalling a strong decline in revenue and profitability of SMEs. Business confidence has fallen, too. In a flash survey we conducted in April 2020, just over a third of businesses surveyed expressed that they are pessimistic about the economy and economic outlook and more than 30 percent indicated that they expected revenues to fall by between 5 and 50 percent over the next six to 12 months leading to negative profits in excess of -5 percent.[9]

98.5%

Percentage of businesses in South Africa that are SMEs

6 The unseen sector: A report on the MSME opportunity in South Africa, International Finance Corporation, November 2018

7 The Impact of the financial crisis on job creation potential of SMEs, European Parliament Report, September 2012; https://www.brookings.edu/blog/the-avenue/2020/03/25/what-the-great-recession-can-tell-us-about-the- covid-19-small-business-crisis/

8 These data are from McKinsey & Company's COVID-19 Consumer Pulse Survey, March 2020

9 These data are from McKinsey & Company's COVID-19 South Africa SME Financial Pulse Survey, April 2020

Exhibit 1

SMEs are a vital component of economies, creating jobs and enabling inclusive growth

	Majority of businesses	Create private sector jobs	Meaningful share of the GDP	Enable inclusive growth
EU	99.8%	68%	57%	30%
G2	99%	65%	46%	25%
SA	98.5%	25.8%	39%	38%
	SMEs' share of total no. of businesses	SMEs' share of private sector workforce	SMEs' share of national GDP	SMEs owned by women

Source: Eurostat, Individual SME Authorities, Institute of Regional & Global Studies; European Commission - SME Performance Review (2015-16), IMF GDP Rankings (2015); Annual report on European SMEs; Small Business Institute South Africa

SMEs in South Africa face distinct challenges in navigating the crisis

McKinsey & Company has worked with a number of SMEs across 12 industries within South Africa over the past two years. In this time we have observed several common challenges across these businesses which include the following:

Limited access to low- and medium-cost funding is constraining business growth.

A recent report highlighted that only 6 percent of SMEs surveyed received government funding and only 9 percent had sourced funding from private sources.[10] Additionally, the majority of private equity funding has largely been focused on mature businesses with around 90 percent of funding going to businesses that are more than five years old.[11] We have seen first-hand how this lack of access to funds is hindering business growth. For example, a local high-end furniture manufacturer, which had successfully grown the business to generate more than R10 million in revenue p.a., was unable to secure an additional R4 million in capital funding to sustain this growth. This was largely due to a lack of knowledge of available funding options as well as challenges in managing cashflows and earnings before interest, taxes, depreciation, and amortization (EBITDA) to deliver sufficient results to secure funding.

Even when funding is available, low awareness of opportunities and a lack of financial knowledge remain major barriers to SMEs accessing the required support.

In a recent survey we conducted on the impact of COVID-19 on SMEs, 36 percent of respondents said that they were not receiving government loans or support and a quarter were not making use of payment reliefs such as UIF and PAYE. The top two reasons for not accessing such support, other than not qualifying, included that entrepreneurs were not aware of the opportunities or did not know where to find the information needed to apply (Exhibit 2).

[10] An assessment of South Africa's SME landscape, SME South Africa, 2018
[11] The Impact of Venture Capital & Private Equity in South Africa, SAVCA, February 2020

This was also evident prior to the crisis. For example, an SME within the agricultural sector that had created a plan to significantly expand the capacity of its operations by modernising facilities and creating additional storage facilities, was hampered by a lack of experience in developing a minimum viable plan. The expansion plan required funding, which was around 50 percent higher than annual revenue. However, only a few sources had been explored to secure this because the business owners did not know where to look or how to make the pitch to investors.

Slowing demand has led to SMEs having to limit expansion plans and identify alternative channels to sell products.

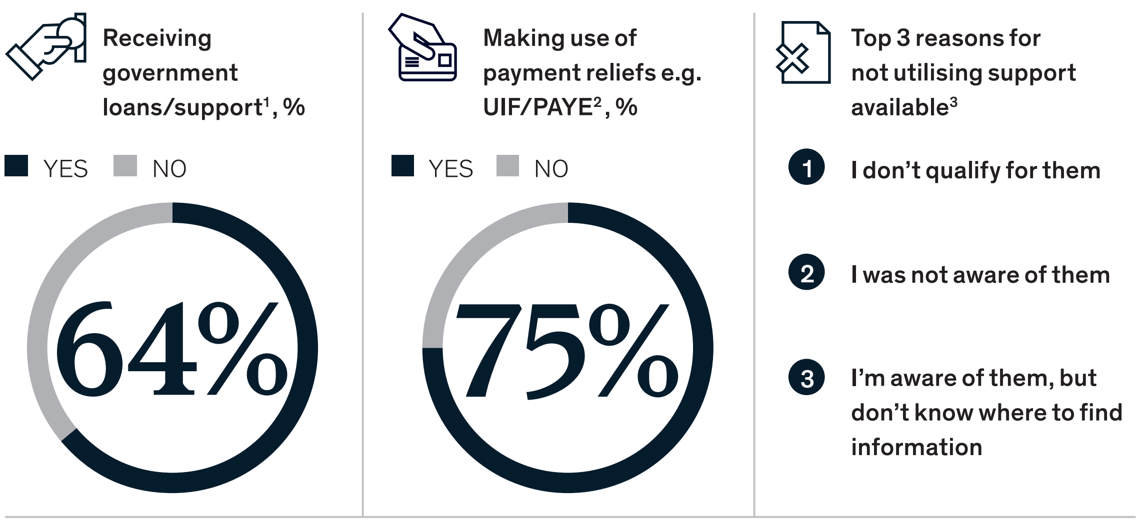
Between 40 to 60 percent of small business respondents to our survey reported that they expect to make a loss of more than 5 percent for the current financial year as a result of the crisis (Exhibit 3). Even before COVID-19 struck, many SMEs were having to scale back and look for new ways to get their product to market. Some examples include a coffee roasting business, that, due to lack of local demand from the private sector was exploring opportunities to expand internationally and partner with large corporates in these markets. And an SME in the recycling industry that generated 50 percent of its revenue from processed recycling resale was reviewing its business plans and outlooks in the medium term. The business it derived from corporates was expected to decline as a result of the contracting economy and this will likely be accelerated as corporates operate limited office capacity during the crisis.

Exhibit 2

Low awareness of opportunities is preventing SMEs from accessing public sector funding

Flash survey conducted with ~100 SMEs in the South African market

Public sector



1. **Q:** To support the economic fallout from coronavirus, the Government announced recently that it is to support lending to eligible small-and-medium sized businesses through institutions such as the Small Enterprise Development Agency (SEDA) and the Industrial Development Corporation (IDC) - Would you be interested in availing this kind of loan (i.e., loan partially guaranteed by the government) for your business?
2. **Q:** There are several programmes available to support in paying employees, providing relief from UIF and PAYE - are you currently utilizing any of these?
3. **Q:** What is the reason that you are not making use of these programmes?

Source: McKinsey & Company COVID-19 South Africa SME Financial Pulse Survey, n=100, date collected: April 17 - April 20, includes SMEs >R500mn in annual revenue

Accessing the right markets in order to sell products is a challenge.

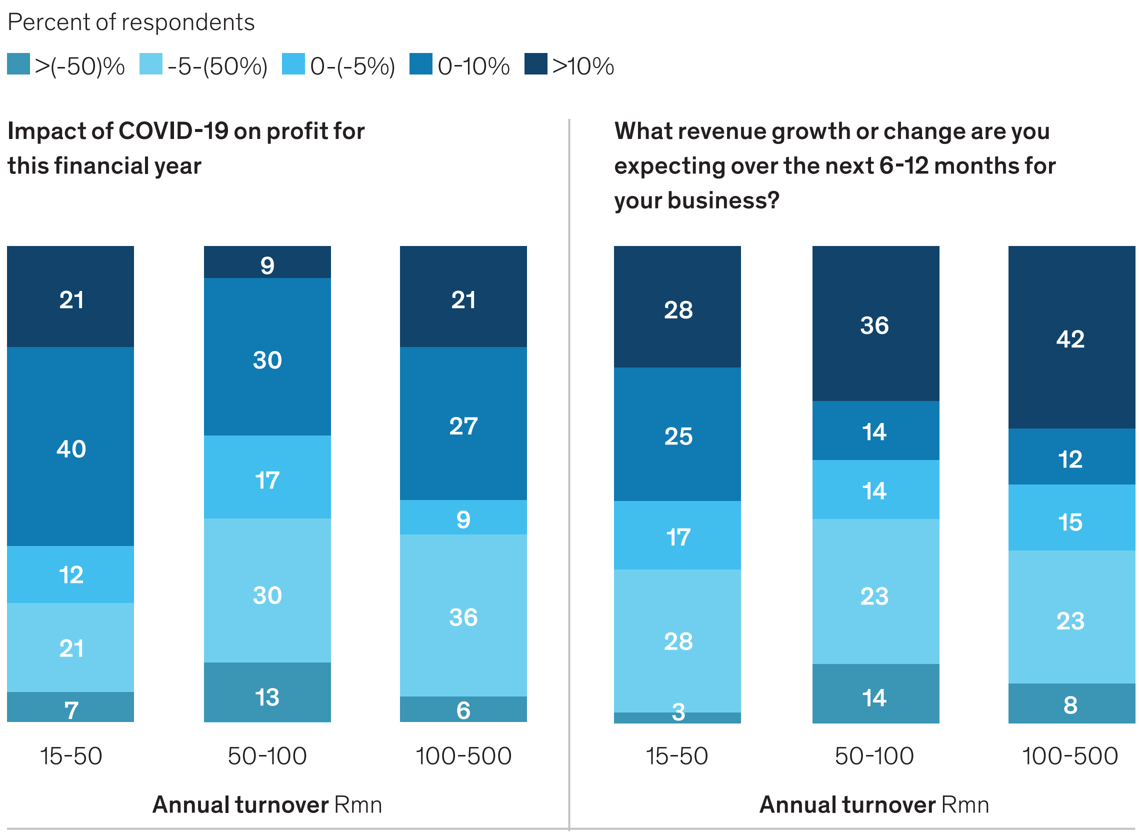
Several SMEs highlighted an ongoing struggle to connect with potential buyers. Very often, SMEs are overly dependent on a small number of clients; in some cases an entire business can be concentrated in a single local redistributor. The emergence of online marketplaces and micro sales platforms that allow manufacturers to access new markets is one way of helping to overcome this challenge. For example, Thola Africa, an online platform we developed in partnership with ICT-works, offers African artisans and designers—who mostly have a limited or regional customer base—access to a global market looking for products of this nature. The platform now has 17 suppliers and more than 225 products listed to date.

Owners and founders struggle to empower staff to lead and drive the business.

Many SMEs are struggling to break free from a restrictive owner mindset and assume a more strategic role largely because small enterprises often lack sufficient performance management systems, clear day-to-day operating models, and management structures with well-defined roles and responsibilities, Key Performance Indicators (KPIs), and designated decision-making. For example, one Business Process Outsourcing (BPO) provider was delivering coaching on customer management but not driving strong performance management on key client Service Level Agreements (SLAs). Another manufacturing SME owner struggled to extract himself from production and manufacturing and hire in key skills to take over these roles, even though he was scaling the business.

Exhibit 3

Between 40 and 60 percent of SMEs expect to make a loss of more than 5 percent as a result of the crisis



Source: McKinsey & Company COVID-19 South Africa SME Financial Pulse Survey, n=100, date collected: April 17 - April 20, includes SMEs >R500mn in annual revenue

Liquidity and cashflow management are limited.

Many low maturity and new SME businesses lack the financial, operational, and strategic structures that are common in larger businesses. This hinders them from making the best use of available capital to scale their operations. This may be because they have limited cashflow and are highly dependent on clients paying their invoices on time or because they have little knowledge and insight into how to effectively set up and run the business, and the associated key metrics to be tracked. For example, an agricultural client that had an ambitious growth plan to expand their facilities in core and non-core areas struggled to obtain the required funding because the business was not in a financial position to meet stringent funding requirements.

A lack of prioritisation and financial planning that would have allowed them to focus on core areas to finance and build out, meant that rather than growing sustainably, the scale of their ambitions and poor internal management combined to ensure that they did not grow at all.

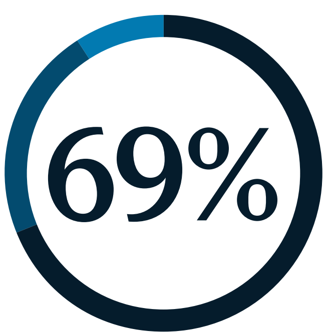
Liquidity and cashflow management are likely to come under even further pressure during the crisis. Our recent survey highlights that SMEs are taking drastic actions to hedge against future risk with 70 percent saying they have reduced business spending already. The largest area of impact is likely to be on employment (Exhibit 4).

Exhibit 4

70% of SMEs say they have reduced business spending already and despite government efforts, the largest area is employee layoffs

Impact on business spending[1]
percent of respondents

- Significantly/ Somewhat reduced
- Kept it the same
- Significantly/ Somewhat increased



Reason for reduced spending[2]
percent of respondents

~51%

Due to current reduction in revenues

~49%

Being cautious and preparing for the worst

Top 3 ways in which businesses are reducing spending[3]
ranking based on number of times response was selected

1. **I am laying off employees/workers**
2. **I am taking a look at my entire business spend & reducing where I can**
3. **I am reducing the number of hours my business is open daily to reduce expense**

1. **Q:** To what extent have you changed your business spending in the past month? n=1004
2. **Q:** What is the main reason you are reducing your business spending? n= 616
3. **Q:** How are you reducing business spending? Please select all that apply: I am taking a look at my entire business spend & reducing where I can, laying off or furloughing employees/workers, reducing the number of hours my business is open daily to reduce expense, postponing spending on items where possible, buying the same things I used to buy but buying lower cost items, buying less quantity of most things

Source: McKinsey & Company COVID-19 South Africa SME Financial Pulse Survey, n=100, date collected: April 17 – April 20, includes SMEs >R500mn in revenue

Four areas where SMEs can take action to mitigate these challenges during the crisis

In working directly with SMEs we have encountered a number of innovative responses to overcome these challenges and grow during the COVID-19 crisis and beyond. Broadly speaking, SMEs are pursuing several common strategies to support their success at this time in the following domains: financial stability; access to new markets and customers; a stable supply chain; strong customer engagement; a healthy workforce; and a robust post-crisis strategy. Most of the examples cited here relate to one or more of these domains.

1. **Leverage technology to reach new customers or provide a distinctive value proposition**

   Digital and new technologies create an opportunity for SMEs to enhance their reach and efficiency at lower costs, overcoming the scale disadvantage they have relative to larger players. SMEs can focus on key areas of competitiveness in their value chain, product, and/or operations and identify the best technology levers to enhance competitiveness.

   For example, a local BPO SME leveraged widely available technology—a Virtual Private Network (VPN)—to transfer their systems onto a custom-made platform, which could be quickly modified as their needs shifted. This allowed them to rapidly move their call centres to remote working in the wake of a nationwide lockdown in South Africa. In less than five days, they moved more than 80 percent of their operations to a remote working model. The remaining capacity was not needed due to scaled-back customer demand during the crisis. The company was subsequently able to employ this unused capacity to generate additional business by supporting state initiatives aimed at reducing the spread of the coronavirus. A strong technology position helped this BPO player be more agile in the face of significant market uncertainty and disruption to their operations.

2. **Develop clearer market access strategies**

   SMEs can be more structured and holistic in developing their go-to-market strategies to increase their market share and also reduce the risk inherent in concentrating their sales with one to three large customers. For example, one agricultural processing player rapidly assessed the market conditions to identify areas that would drive demand for their product.

Digital and new technologies create an opportunity for SMEs to enhance their reach and efficiency at lower costs, overcoming the scale disadvantage they have relative to larger players.

A better understanding of, for example, shifting demand, potential new client bases, and local substitutes for their product enabled them to shift their focus to new target markets to sustain demand. Access strategies allow SMEs to focus on their core value proposition that can be leveraged to clearly position themselves in a new market. For example, a BPO provider developed a discrete niche offering to take to new markets instead of adapting the business to any new demand as they had done in the past. This allowed them to more effectively prioritise scarce business development opportunities as well as investment resources.

3. **Drive efficiency as well as sales**

   Most SMEs we have worked with focus on increasing sales and managing cash as priorities. SMEs that also focus on operational efficiencies can drive further competitiveness to support sales, while also potentially creating increased capacity in the business. For example, a manufacturing SME used basic visualisation tools such as management boards to optimise operations. By tracking tasks in progress and KPI dashboards, they managed to achieve a 25 percent improvement in scrap reduction which had a resultant EBITDA impact of roughly 100 percent. This was primarily driven by improved visibility into areas of leakage as well as a better ability to focus team efforts on solving problems.

4. **Develop team skills and capabilities and empower leadership**

   SMEs on a fast growth track can struggle to scale up growth, particularly when founders are still actively involved in the business. By investing in capability building, particularly at a leadership level, SMEs can create more capacity for senior leaders to focus on growth and strategy to ensure sustainability. For example, a BPO player formed a shadow Manco with delegated roles and responsibilities supported by the existing, experienced Manco team. This allowed the leadership team to distribute the workload during the COVID-19 crisis more effectively as they transitioned to remote working and freed them up so that they could focus on sourcing new business and developing continuity plans. The company also supported their team with training on adopting a leadership mindset. Additionally, they empowered their top team by making more financial data available to them so that they could better understand and take ownership of the results of the business.

SMEs that focus on operational efficiencies can drive further competitiveness to support sales, while also potentially creating increased capacity in the business.

All hands on deck: The right support to enable SME growth

Our SME Financial Pulse Survey carried out in April 2020 revealed the concerning reality that 52 percent of SMEs are considering having to close down parts of their business and reduce capacity as a result of the COVID-19 crisis (Exhibit 5). More than 40 percent of all SMEs have already reduced capacity, laid off employees or may need to lay off employees, including larger businesses with revenues in excess of R100 million. Compared to 51 percent pre-crisis, only 21 percent of respondents are optimistic that the South African economy will recover quickly.[12]

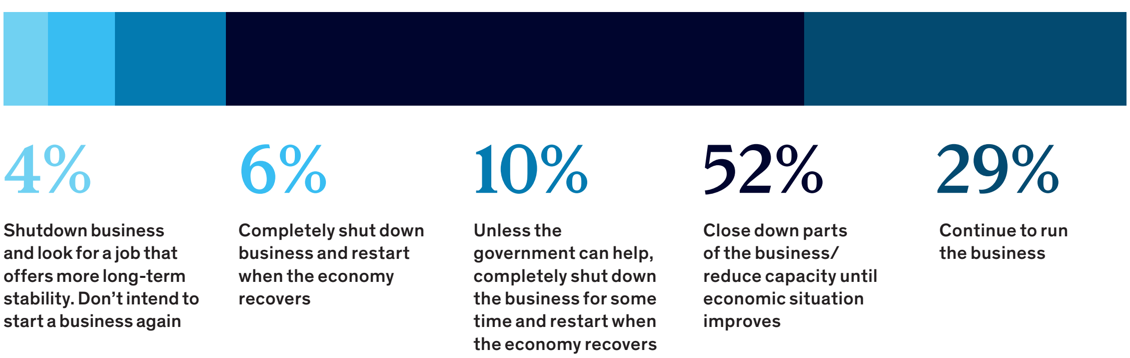
In addition to taking steps to innovate and pivot their businesses in response to this new reality, the vast majority of SMEs are going to need broader support if they are to emerge stronger from the crisis. Many may lack the in-house skills and business advisory services they need to get the right advice on structural business changes and to help them reimagine their business at this time.

More than 50 percent of SMEs are currently receiving support from financial institutions for payments and more than 60 percent are taking advantage of relief being offered by government despite low awareness regarding what relief is available at this time.[13] But to prevent a widespread contraction of the sector, more will need to be done. Both government and the private sector have a special role to play here.

Exhibit 5

Of all the SMEs that report a pessimistic outlook, a majority believe they will need to close down or reduce capacity entirely

Most likely outcome of COVID-19 for their business (for business owners with a pessimistic outlook)[1], Percent of respondents, with pessimistic economic outlook n=464[2] (somewhat pessimistic, very pessimistic about economic conditions)



1. **Q:** Given you are fairly pessimistic about the overall economic condition your business is likely to operate in over the next few months due to COVID-19, please choose which out of the below options may be the most likely outcome for your business (only includes responses of those that have selected somewhat pessimistic, pessimistic or very pessimistic about post COVID-19 economic conditions)
2. 36% of survey respondents had a pessimistic economic outlook

Source: McKinsey & Company COVID-19 South Africa SME Financial Pulse Survey, n=100, date collected: April 17 – April 20, includes SMEs >R500mn in revenue

[12] These data are from McKinsey & Company's COVID-19 South Africa SME Financial Pulse Survey, April 2020
[13] Ibid.

Government support is key to galvanising SMEs post COVID-19

Government is undoubtedly a key player in the SME ecosystem, and post COVID-19 there will be new pressures, forcing them to be even more careful about ensuring that scarce funds are effectively deployed and utilised. Their role can be viewed through two lenses; as an enabler of SME growth and through the delivery of targeted support, especially to high-growth businesses. We have identified four key areas where government support could be critical.

1. **Boost the national entrepreneurship ecosystem**

   Governments can enhance the national entrepreneurial culture by promoting programmes that prioritise SMEs as preferred suppliers. They can also work to identify and bridge gaps in business enablement which could hinder SME growth. In addition, they could provide outsourcing support for back office services, something that small SMEs typically struggle with. Government could also focus on raising awareness amongst SMEs as to what support—financial or otherwise—is available to them.

2. **Invest in the skills and capabilities that SMEs need at this time**

   Government can continue to ensure that entrepreneurs are supported with the skills and capabilities they need to rebuild and grow their business after the crisis. Most would benefit from additional training, for example in business scenario planning or managing scarce financial resources. This would be particularly relevant where relief funding is provided. Government could also work with industries and sectors that are most under threat from COVID-19 to develop resilience strategies and to help them reimagine their business models going forward.

3. **Drive innovation, research, and development**

   Research and development are key requisites for innovation and growth and successful entrepreneurship ecosystems recognise this. For example, Malaysia's national commercialisation platform—PlaTCOM Ventures—helps entrepreneurs turn their ideas into successful products and services. In South Africa, more will need to be done to identify and fund high-growth businesses and support innovation even where current financials do not support this.

4. **Provide targeted and sector-specific support for SMEs now and post crisis**

   There is a significant opportunity for government to work with entities such as the Small Enterprise Development Agency (SEDA) and the Small Enterprise Finance Agency (SEFA) to provide nuanced, sector-specific interventions to help SMEs get back on their feet post-crisis. Some sectors, for example, will need initial financing, while others may need more sustained support. As far as is possible, given that this support will impact the government's financial position, this could extend to continuing initiatives such as PAYE deferments and tax breaks instigated during the crisis. All these support mechanisms need to be clearly and rapidly accessible to ensure that SME leadership is not having to spend too much time managing financing processes while also managing the crises in their business.

   Government can also drive specific support to unlock growth. For example, government could support export-focused companies in agriculture and BPO by setting up an export office for all SMEs to help reduce bottlenecks. In addition, they could support manufacturing and consumer goods businesses that have the potential to compete with larger players and offer alternatives to imported goods. This might include creating cooperatives.

Private sector support can boost the viability and sustainability of SME partners

The private sector has several levers it could pull on to support SME growth—especially those with high potential—post the COVID-19 crisis, depending on the business area.

Banks and financial institutions have already driven a significant number of initiatives globally and in South Africa to support SMEs, including through the suspension of loan repayments or the reworking of principal repayments; the provision of resources and communication tools to clients; interest and fee waivers; relief loans; and pre-approved or expedited loan approvals. For example, a leading South African bank is providing instant short-term deferral on credit products for up to three months and another is offering a similar programme for SMEs with a turnover of less than R20 million.

Financial institutions can also play a significant role in driving uptake and capability-building in new channels and payment methods. The recent consumer survey conducted by McKinsey highlighted that post the COVID-19 crisis more than 65 percent of payments will be done using cards or means requiring POS devices; a significant drive from financial institutions can help drive uptake and readiness in businesses.[14]

Corporates more generally could enable SMEs by focusing their supplier development for longer-term scale and competitiveness. We recommend five elements for private sector players to consider as part of their supplier development processes to both serve their needs and ensure the viability and sustainability of their SME partners as a business imperative, and not just for social responsibility purposes.

1. Develop a clear selection criteria for suppliers upfront. For example, by defining the categories in which to develop suppliers. This could be based on ownership structures, business performance, or other criteria.
2. Assess the capability gaps that exist within suppliers upfront and develop plans to help them close these.
3. Build funding and capability requirements into the contract to create sustainability.
4. Simplify contractual terms and conditions and required paperwork for SMEs which often do not have large/dedicated commercial teams.
5. Establish regular check-ins and course correction sessions throughout the lifecycle of the suppliers.

Corporates more generally could enable SMEs by focusing their supplier development for longer-term scale and competitiveness.

[14] These data are from McKinsey & Company's COVID-19 Consumer Pulse Survey, March 2020

SMEs are a vital engine in the South African economy. They drive growth, create employment— especially amongst the youth— and spearhead innovation. SMEs are also customers to larger companies across the supply chain and supply vital goods and services to companies and households, helping to keep the wheels of the economy in motion. Furthermore, they can leverage their agility to design and incubate new technologies and business models to build a better future. Many of South Africa's SMEs have the potential to become tomorrow's large corporations, the African unicorns that this continent needs to continue on its path to growth and prosperity.

When the pandemic will peak in South Africa is uncertain. It is imperative therefore that efforts to protect SMEs move with speed and decisiveness not only to cushion the worst of the impacts of the crisis on livelihoods but to help ensure a swifter recovery for the broader economy.

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