Supporting Innovation in Small and Medium Enterprises in Lebanon

The Development Challenges

Lebanon is a high-middle-income country with a population of around 4.5 million and, in 2010, a per capita GDP of US$9,262. Unemployment, which stood at 9 percent in 2007, and high migration of young, educated Lebanese are significant challenges for the government. Private sector–led growth is thus a crucial factor for the country and constitutes a core pillar of the national development agenda.

The private sector in Lebanon is dominated by small firms where more than 99 percent of all private enterprises have fewer than 50 employees, of which 93 percent have fewer than 5 employees. Lebanon has also established itself as a creative hub for the Middle East and North Africa (MENA) region. In 2011, services accounted for 79.7 percent of GDP and 70 percent of the labor force.

Relative to other countries in the MENA region, Lebanon does well in terms of lending to small and medium enterprises (SMEs). These results are largely due to the multiple incentive programs and support to SME lending provided by the government of Lebanon and the central bank—Banque du Liban—since 2000. These initiatives include subsidizing interest payments of SME borrowers, extending special guarantees to SMEs, and granting exemptions on compulsory reserves of creditors. Initially focusing on projects in agriculture and industry, these schemes were gradually expanded to include other sectors such as information and communication technology, environment and energy-efficient projects, and tourism and housing industries.

However, the banking sector remains strongly conservative in its lending with loans given to primarily large companies. Loan dollarization is still high and banks’ loan to deposit ratio is only 33 percent—much of which is attributed to the high levels of deposits.

The current financial environment leaves three substantial gaps in Lebanon’s innovation system. The first gap is funding at the early concept stage where entrepreneurs need to develop their ideas into a viable concept and product; the second and third gaps are related to the absence of seed and early stage venture finance, respectively.

Highlights

In mid-2011, the World Bank Middle East and North Africa Finance and Private Sector Unit, jointly with the government of Lebanon, launched the preparation of the Supporting Innovation in Small and Medium Enterprise (iSME) in Lebanon Project. The Capital Markets Practice and the Entrepreneurship, Technology, and Innovation Practice provided technical assistance and support designing the project. The project will be launched at the end of 2012 by the government of Lebanon; the World Bank MENA region; the Capital Markets Practice; and the Entrepreneurship, Technology, and Innovation Practice.

The objective is to encourage the equity investment market to increase the supply of early stage investment finance for financially viable, new, and existing innovative firms. This, in turn, will generate a more robust risk-taking culture, stimulate entrepreneurship, and, over time, enhance the potential for additional private sector jobs.

The project funding will finance the following two components:

- The iSME funding program that will have two project subcomponents providing two types of financing to enterprises:
  - Development grants to stimulate ideas generation and concept development (total US$2.5 million)
  - Equity investment to support the early stage growth of a firm (total US$25 million)

- Project management and implementation that will include outreach, training activities, and establishing a project implementation unit (total US$2.5 million)

The World Bank’s Response

To fill the gaps, the World Bank Middle East and North Africa Regional Office, with technical support from the Capital Markets Practice and the Entrepreneurship, Technology, and Innovation Practice has been working with the government of Lebanon to launch the Supporting Innovation in Small and Medium Enterprise (iSME) in Lebanon Project. This project will establish and finance a funding program, the iSME Fund, to stimulate innovation by entrepreneurs, encourage more start-ups, and increase the availability of equity funding for young, growing firms until they reach the stage where they can be attractive to later-stage venture capital (VC) funds.
The iSME Fund will be the first of its kind, a public–private innovation support and equity financing mechanism in Lebanon and the MENA region. The iSME Fund will allow the government of Lebanon to demonstrate the effect of leveraging public funding with private investment to create a critical mass of innovative and high-growth SMEs that are important for economic growth and job creation. Later, this model can be expanded or replicated elsewhere in Lebanon and the MENA region.

The overarching objective is to develop a stronger, more dynamic and competitive private sector by filling in the funding gaps to support innovation of private sector enterprises and by addressing a market failure in start-up and early stage equity funding. This, in turn, would help to create spillover effects to attract foreign investment and bring in more VCs, to create additional business and growth to the broader supply chain, and to build the investment ecosystem—all of which can help grow confidence in the economy and ensure sustainability and growth of the local private sector for higher job creation.

The key beneficiaries of the project will be potential and existing entrepreneurs with new commercial ideas, many of whom would otherwise seek opportunity abroad (early stage and new start-up enterprises), and existing SMEs that are on the verge of expansion. Both groups would otherwise operate in the “Valley of Death” because of a lack of access to funding.

The project seeks to fill in the funding gaps faced by these firms because of the nature of the products or services they offer (such as mobile applications, software, or services), which cannot be collateralized and are seen as too risky by commercial banks. The project has also integrated an outreach and mentorship framework to help link the project beneficiaries to mentorship programs, diaspora networks, and other entities inside and outside Lebanon that are critical in ensuring the success of start-ups and SMEs.

Project results indicators that will be measured are as follows:

- **Increase in access to finance for SMEs**
  - Total number of firms receiving equity financing leveraging investors and the iSME fund
  - Total volume of financing generated by leveraging investors only (as a result of a grant activity)

- **Level of innovation**
  - Number of new and improved products and processes offered
  - Number of new start-ups created under the project

- **Growth of beneficiary SMEs**
  - Growth in sales and turnover of beneficiary SMEs
  - Number of new jobs created in beneficiary firms

The project funding will finance the following two components:

- **The iSME funding program** will have two project subcomponents providing two types of financing to enterprises as follows:
  - Development grants are to stimulate ideas generation and concept development (total US$2.5 million). Under these grants, potential entrepreneurs with a new business idea will be invited to apply for a small grant to help them develop an innovative concept. KAFALAT, a publicly subsidized loan guarantee scheme and the implementing agency for the project, will screen all proposals with a grant committee of technical experts to decide on the winner.
  - Equity investment is to support the early stage growth of a firm (total US$25 million). This subcomponent will provide equity investment in an enterprise alongside another VC investor. Equity investment from the social investment fund program will take the same risk as the VC investor and can be made at three stages of risk finance—seed capital, venture capital, and growth capital.

- **Project management and implementation** will include providing outreach, delivering training, and establishing a project management unit (total US$2.5 million).

**Figure 1: Institutional and Oversight Arrangement**

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**How to Follow Up**

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