

Small business finance landscape and a finance gap in South Africa

INTRODUCTION

Small and medium-sized enterprises (SMEs) play a critical role in South Africa's economic development and job creation. Nevertheless, small businesses often face obstacles to growth and sustainability due to various factors, including limited access to formal financing. Funding institutions, particularly banks, are reluctant to finance SMEs due to information asymmetries, insufficient collateral such as land and property, and low levels of financial literacy, among other reasons. These challenges contribute to the perception that SMEs are high-risk borrowers, resulting in SMEs being given lower priority compared to large corporations and bank consumer clients. To bridge this financing gap, state development institutions like the Industrial Development Corporation (IDC) offer support through targeted financial mechanisms, although less resourced than private banks. In recent years, the government has implemented a credit guarantee scheme aimed at enhancing SME access to finance, but the uptake remains low. This continues to exacerbate the issue of the missing middle financing gap that hampers small businesses securing the capital necessary for growth.

This policy brief examines the funding gaps for small to medium enterprises in South Africa: the sustainability of SMEs requires better access to formal financial services. It first provides an overview of SMEs in South Africa, comprising information about the size of both the formal and informal small business sectors, their production structure, income contribution to various economic sectors, and employment contribution. This is followed by a look at access to funding for formal small businesses, particularly loans obtained by SMEs. It then examines government-backed financial support options available to SMEs, including credit and loan guarantee schemes. In conclusion, the policy brief outlines findings and recommendations.

BACKGROUND

Small and medium-sized enterprises have made significant contributions to the economy and are globally recognised for their roles in driving economic growth, creating employment, and advancing social development, serving as a fundamental foundation for industrialisation (Rankhumise and Letsoalo, 2019). In South Africa, formal small businesses are estimated to contribute about one-third of the value added to the economy, while informal enterprises contribute around 5% (TIPS, 2023). Additionally, SMEs have grown in number in tandem with overall economic growth over the past two decades (TIPS, 2023). SMEs have also been instrumental in generating employment opportunities within the labour market. In the last quarter of 2022, formal waged employment in SMEs stood at 3.8 million workers, while 1.4 million self-employed individuals contributed to job creation in the informal sector (TIPS, 2023). According to the key findings of the FinScope MSME South Africa 2024 Survey (FinMark Trust 2024), micro, small, and medium enterprises (MSMEs), with an estimated turnover exceeding R5 trillion, account for approximately 80% of the workforce.

Finance is essential for the sustainable growth and viability of small and medium-sized enterprises (Msomi and Olarewaju, 2021; Levin, 2023). Access to external funding is crucial for boosting start-up businesses, and new SMEs are an important vehicle for tackling challenges such as equitable distribution of income and unemployment (Fatoki, 2014). Despite their potential contributions to sustainable economic development, small businesses often struggle to secure the necessary financing for expansion and seize new opportunities. Furthermore, credit access for SMEs remains limited, particularly in developing countries (Demirgüç-Kunt et al., 2018, as cited in Huang et al., 2020). Limited access to credit for small and medium-sized enterprises is influenced by a combination of supply and demand factors. On the supply side, market imperfections, like information asymmetries, are prevalent.

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SMEs secure considerably less external funding compared to large corporations, leading to a financing gap. Preliminary bank lending data show that SMEs collectively obtained only 13% of total credit.

For instance, SMEs often lack the comprehensive financial documentation required by banks for credit applications, making it difficult for lenders to evaluate their creditworthiness (Abraham and Schmukler, 2017). Traditional lending procedures generally require collateral to help banks assess and manage credit risk, but many SMEs lack sufficient collateral (Jaabi, 2018; Abraham and Schmukler, 2017; Huang et al., 2020). Moreover, SMEs often lack high-quality financial data (Huang et al., 2020). In South Africa, key obstacles preventing the formal financial sector from extending credit to SMEs include insufficient investment capital, inadequate collateral, and inadequate financial records (Asah, Louw and Williams, 2020). Demand-side factors include the low financial literacy commonly found among SME owners, as noted by Fatoki (2021). Other demand factors involve internal challenges that contribute to the failure of newly established micro-entrepreneurs, such as limited management experience, insufficient staff training, and a lack of operational skills (Fatoki, 2014).

In addition, SMEs secure considerably less external funding compared to large corporations (Abraham and Schmukler, 2017), leading to a substantial financing gap. In South Africa, preliminary bank lending data show that SMEs collectively obtained only 13% of total credit. In contrast, corporations received 51%, and bank consumer clients received 36%. This disparity indicates that banks prioritise larger corporations and consumer clients over SMEs. Approximately 33% of small businesses in South Africa reported having access to credit (UNDP, 2024). Beyond financial constraints, SMEs also encounter other obstacles, i.e., restricted access to markets, insufficient technological capabilities, and skills, which further impede their growth and expansion. The COVID-19 pandemic had a detrimental impact on small businesses, and persistent external challenges such as the energy crisis, crime, political instability, and corruption continue to hinder growth and development within the sector.

To tackle market failures and the funding gap for SMEs in South Africa, institutions like the IDC and the Small Enterprise Finance Agency (SEFA) provide financial support through loans and credit guarantees. The COVID-19 pandemic highlighted the vulnerability of small businesses, leading to many closures. In response, the government partnered with commercial banks to establish the Loan Guarantee Scheme (LGS) aimed at supporting SMEs in the formal sector that were impacted. In addition, the Department of Small Business Development introduced the Township and Rural Entrepreneurship Programme (TREP) and the Small Enterprise Manufacturing Support Program (SEMSP) to provide blended finance and non-financial support to informal micro and small enterprises as well as small-scale manufacturers in townships and rural areas. Despite these efforts, funding for small businesses from the IDC has declined in recent years, coinciding with the establishment of SEFA, which has also seen reduced funding. Furthermore, private banks have shown minimal participation in credit guarantee schemes. As a result, these institutions have not effectively addressed the funding gap for small businesses.

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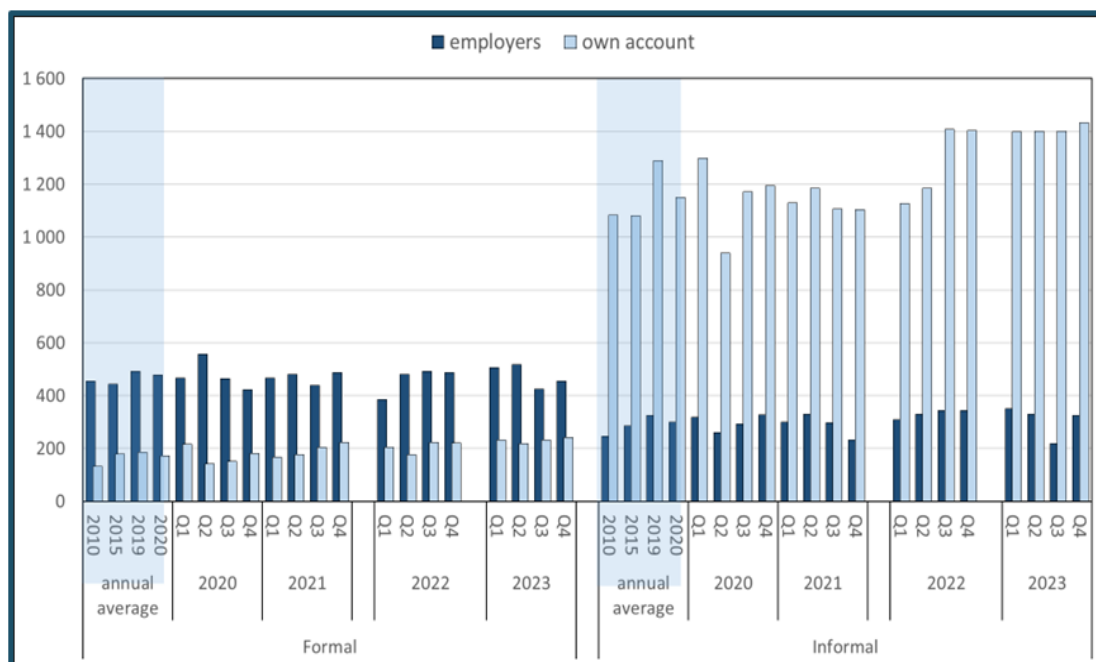
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Graph 1: Number of formal and informal small businesses (a), 2010 to 2020 and quarterly from 2020 to 2023



Source: Calculated from Statistics South Africa. Labour Market Dynamics Surveys for 2010 to 2020, and Quarterly Labour Force Surveys for the first quarter of 2020 to the fourth quarter of 2023. Electronic datasets. Datasets downloaded from Nesstar facility at www.statssa.gov.za. Note: (a) Defined as the number of employers with under 50 employees plus own-account workers.

SME OVERVIEW

The number of small businesses, both formal and informal, fluctuated from the early 2010s to the early 2020s. Formal employer businesses and self-employed informal businesses are dominant in the small business sector. In terms of production, formal businesses mainly operate in construction, business services, and trade, while the majority of informal businesses are in trade. The agriculture and manufacturing sectors have the smallest number of SMEs. In addition, SMEs contribute less income to the mining and quarrying sectors, as well as the electricity and water supply sectors – these industries are typically dominated by large enterprises. Job creation in the sector slightly increased in the post-COVID-19 period. A more detailed analysis is provided in the following sub-section

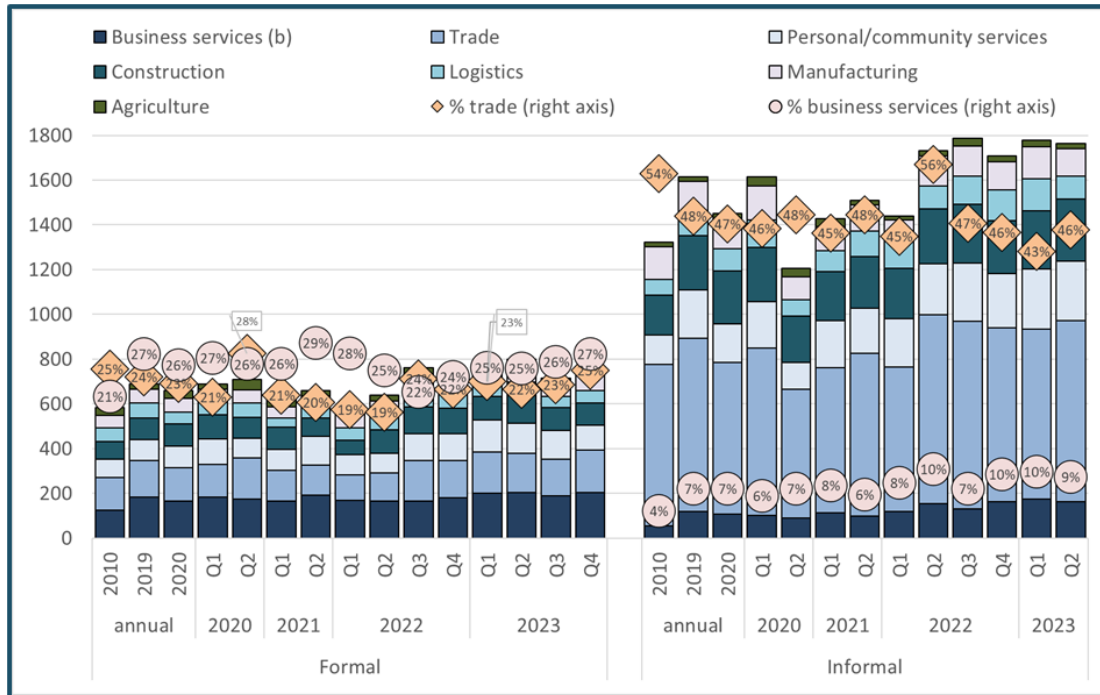
The number of small businesses (SMEs) in South Africa

Graph 1 indicates that formal businesses, including both employers and self-employed individuals, have grown. From 2015 to 2019, the number of small businesses that are employers (excluding self-employed individuals) increased by 11%. This number declined by 3% in 2020 due to the impact of the COVID-19 pandemic. While there was a brief recovery in the post-COVID period, the number dropped again in the fourth quarter of 2023, coinciding with the worst loadshedding period in South Africa that year (TIPS 2023a). In contrast, self-employed or own-account businesses constitute a significant portion of the small informal business sector. The COVID-19 pandemic had a severe impact on these businesses, leading to the closure of 28% between the first and second quarters of 2020 during the hard lockdown. Despite this setback, they have since recovered, reaching a peak of 1.4 million in the last quarter of 2023.

SME production structure

Formal small businesses primarily operate in the services sector, particularly in business services and trade. During the fourth quarter of 2023, 27% of formal businesses were engaged in business services, which includes finance, while 25% operated in trade (refer to Graph 2 on page 4). In contrast, only 9% of SMEs are involved in manufacturing. In the informal sector, trade accounts for the largest proportion of small businesses, at 47%. In comparison, the agricultural sector has the lowest representation, with only 1% of informal small businesses engaged in this field during the same period.

Graph 2: Number of small businesses (a) by sector and industry, annually in 2010, 2019 and 2020, and quarterly from the first half of 2021 to the fourth quarter of 2023

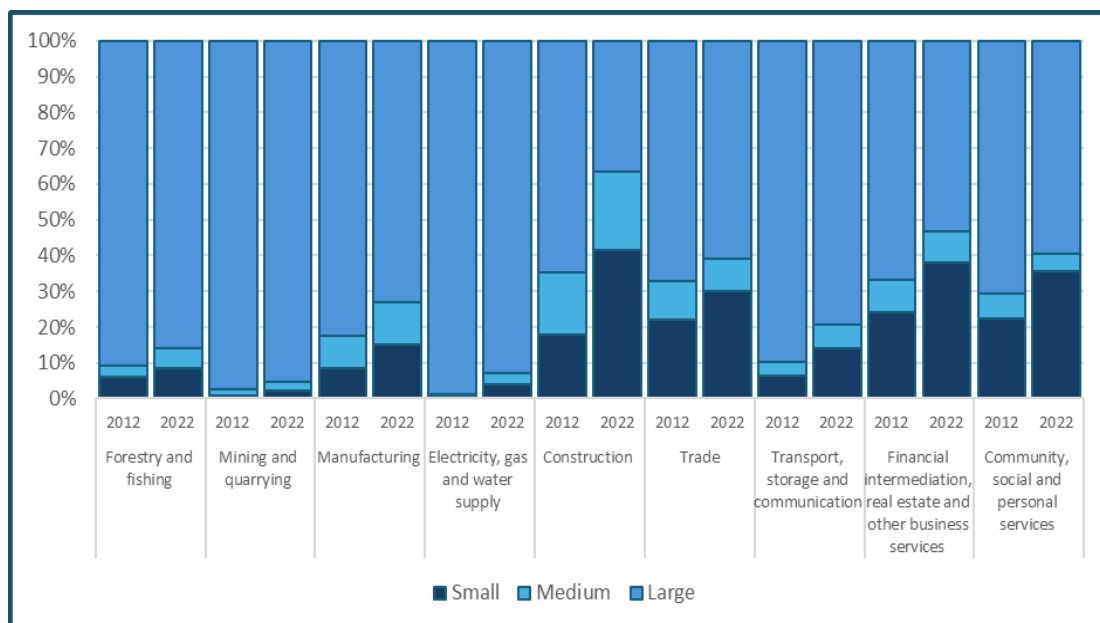


Source: For 2010 to 2019, calculated from Statistics South Africa. Labour Market Dynamics for relevant years. Electronic databases. For 2020 to 2023, calculated from Statistics South Africa. Quarterly Labour Force Surveys. Electronic databases. Downloaded from Nesstar facility at www.statssa.gov.za. Note: (a) Measured by the number of people saying they are employers or self-employed. (b) Includes finance.

SME turnover contribution by industry

The role of small businesses in the domestic economy grew across all sectors over the decade from 2012 to 2022. Notable contributions in 2022 were in construction (41%), financial and other business services (38%), communication and personal services (36%), and trade (30%). Small businesses contributed less than 5% in the mining and quarrying, and electricity and water supply, sectors which are typically dominated by large enterprises (see Graph 3).

Graph 3: Turnover contribution by enterprise size in all industries, 2012 to 2022, in constant 2022 rands

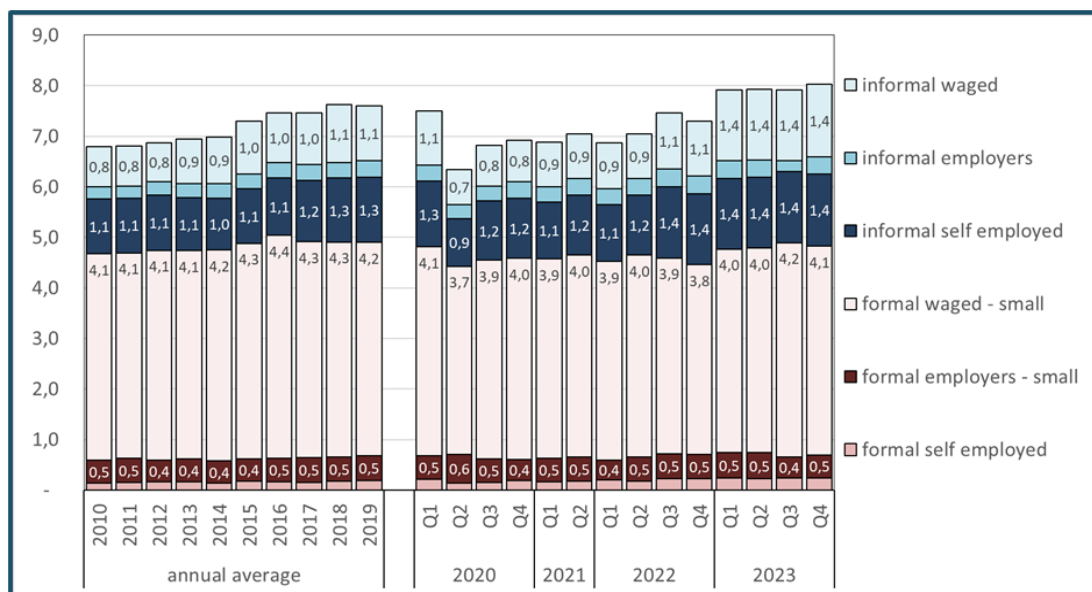


Source: Calculated from Statistics South Africa. Annual Financial Statistics 2021. Accessed at www.statssa.gov.za in May 2024. Note: The authors grouped micro and small enterprises. According to Stats SA, micro-enterprises are those businesses with turnover below or equal to R35 million. Small enterprises as those with a turnover ranging from R35 million to R91 million.

SME employment contribution

Employment in the small business sector is primarily driven by formal waged employment, with an annual average of around four million workers since 2010 (see Graph 4). This figure remained relatively stable, except during the COVID-19 pandemic. During this period, many informal self-employed businesses and waged employment opportunities were significantly affected. The number of self-employed businesses dropped by 28%, from 1.3 million in the first quarter of 2020 to 900 000 in the second quarter. Similarly, informal waged employment saw a 34% decline, decreasing to 700 000 workers in the second quarter of 2020 from 1.1 million in the first quarter. These businesses have recovered, and employment levels in waged positions have now exceeded pre-pandemic levels.

Graph 4: Employment in millions by sector, type, and size of employer, annual averages for 2010 to 2019 and quarterly 2020 to 2023 (a)



Source: Calculated from Statistics South Africa. Labour Market Dynamics for relevant years from 2010 to 2019, and Quarterly Labour Force Survey for 2020 to 2021. Electronic databases. Accessed at Nesstar facility at www.statssa.gov.za. Note: (a) Quarterly figures are not seasonally adjusted. Surveys for the third and fourth quarters of 2021 had a very low response rate and are therefore excluded.

ACCESS TO FINANCE

The following sub-section looks at access to funding for formal small businesses from both government development institutions and the private sector (with a focus on banks). As outlined, small businesses in both the retail and corporate sectors receive the least credit from banking institutions in South Africa. Moreover, the IDC has significantly reduced its funding to SMEs over the past decade, from 2013 to 2023, highlighting a persistent lending gap. Similarly, SEFA has seen a decline in SME funding since reaching its peak in 2022.

Loans to SMEs by banks

Graph 5 highlights a significant disparity in lending by South African banks, with small and medium-sized enterprises receiving less credit compared to other categories of lending. Over the past six years, retail and corporate SMEs have been allocated 13% of loans, whereas corporate entities have received 51%, and bank consumer clients have received 36%. Small businesses in the banking retail lending category are the least funded, with lending to these SMEs dropping by 11% from R290 billion (constant rands) in 2020 to R259 billion (constant rands) in 2023. Larger small businesses in the bank lending category, specifically the SME corporate sector,¹ had better access to credit, with an average of R466 billion in constant rand from 2019 to 2023. Corporate entities in South Africa continue to dominate the credit landscape, with an average of R2.8 trillion in constant rand over the six years, while bank consumer clients received approximately R2 trillion (constant rand) on average. While lending to corporates has been increasing, in constant rand, small businesses received less credit in 2023 than in 2012 (constant rand).

¹ SMEs corporate: SMEs turnover of less than R400 million, and SMEs retail: SMEs with credit exposure equal to or below R12.5 million.

Corporate entities continue to dominate the credit landscape, with an average of R2.8 trillion over the past six years. Small businesses received less credit in 2023 than in 2012.

Graph 5: Gross credit exposure by banks to different market segments, 2019-2023

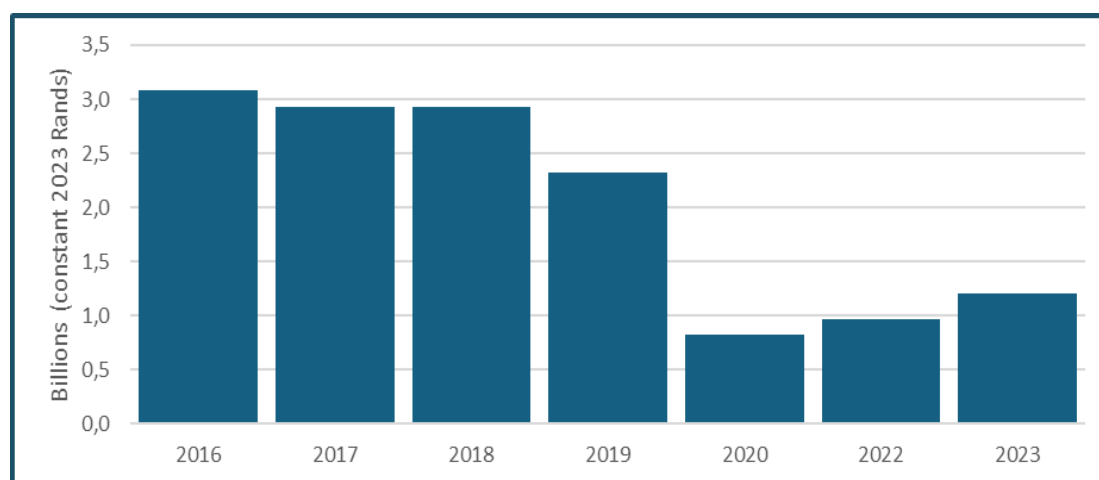


Source: Gross Credit Exposure BA 200 in December of each year, constant 2023 rand. The author has deflated with the StatsSA CPI index. Categories are from SARB Data BA 200. Note: SMEs corporate (SMEs turnover of less than R400 million) and SMEs retail (SMEs with credit exposure equal to or below R12.5 million). Consumer retail includes revolving credit and residential mortgage loans.

Loans to SMEs by Development Finance Institutions

Funding to small and medium-sized enterprises from the IDC has declined (see Graph 6). Since 2016, SMEs received an average of about R2 billion annually from the IDC (in constant rand). The highest level of funding occurred between 2016 and 2019, averaging approximately R3 billion. However, funding from the IDC to SMEs has since declined and has not returned to pre-COVID-19 levels. This decline coincides with the establishment of the government Small Enterprise Development Agency (SEDA), a dedicated Development Finance Institution (DFI) focusing on small business lending. This shift enabled the IDC to concentrate on larger, capital-intensive projects, while SEFA focused on small business loans, leading to a reallocation of resources and a reduction in direct SME funding from the IDC.

Graph 6: Funding provided to SMEs by IDC in constant billions of rands, 2016 to 2023



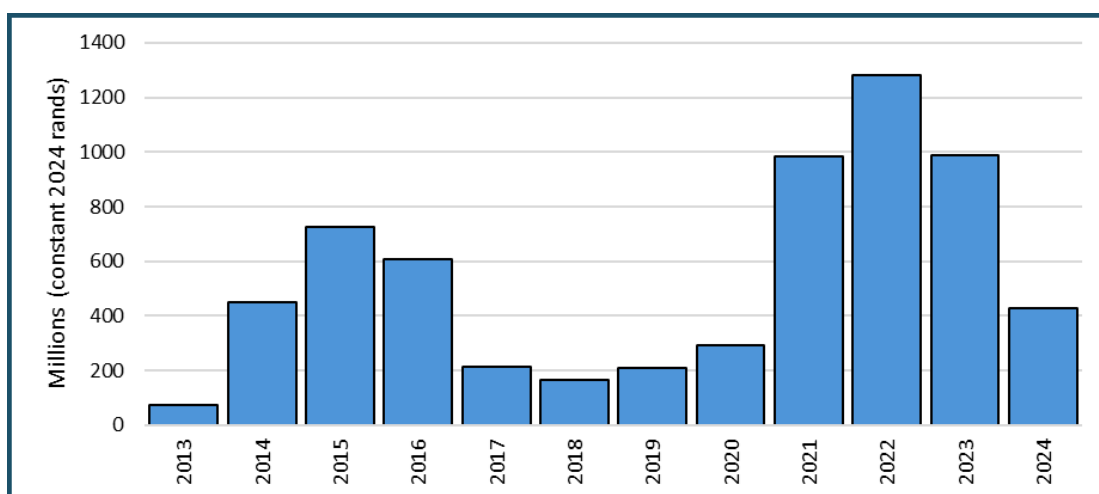
Source: Industrial Development Corporation Integrated Annual Reports 2020, 2022, and 2023. Funding from 2013-2020 excludes funding by SEFA. Accessed on www.idc.co.za in July 2024, deflated using CPI.

Funding from the IDC to SMEs has declined and has not returned to pre-COVID-19 levels. This coincides with the establishment of the government Small Enterprise Development Agency (SEDA).

Opportunities for increased local procurement throughout the state exist. More so as the state looks to spend almost R1 trillion in infrastructure programmes across a number of sectors and levels of government.

Graph 7 depicts SME funding from SEFA, which initially followed an upward trajectory after its establishment in 2012. Following this growth, funding fell by 65%, dropping from R608 million (constant rands) in 2016 to R212 million (constant rands) in 2017, primarily due to fewer approvals and stringent credit conditions (SEFA, 2017). Funding remained relatively stable with minor fluctuations through 2019 and 2020. In 2021, there was a sharp 236% increase, with funding reaching R984 million (constant rands), largely driven by COVID-19 relief programmes. Despite this boost, SEFA's funding to SMEs has declined since the peak in 2022. The reduced funding available in 2024 is presumably driven by challenges in direct lending, onboarding issues, and high impairment rates, particularly affecting township and rural businesses (SEFA, 2024).

Graph 7: Payments (a) to SMMEs by SEFA in constant million rands, 2013 to 2024



Source: Small Enterprise Finance Agency (SEFA). Annual Reports 2013-2024. Direct Lending: Disbursements. Accessed on www.sefa.org.za in March 2025, deflated using CPI. *Note (a)* Payments are measured by disbursements from direct lending to SMMEs and Cooperatives from a minimum of R50 000 to a maximum of R15 million. Direct Lending mainly provides debt funding and, in certain programmes, offers blended financing instruments, (combination of loans and grants).

GOVERNMENT FINANCIAL SUPPORT MECHANISMS FOR SMES

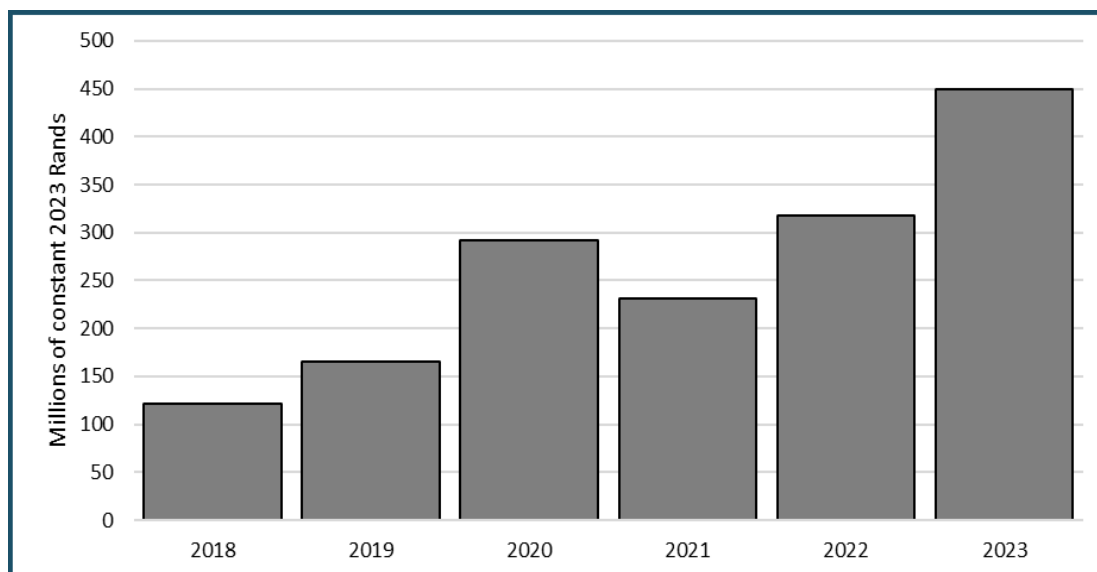
Small businesses in South Africa and globally struggle to secure funding due to insufficient collateral, property ownership, or credit history, hindering their growth and discouraging investment. To overcome these barriers, credit and loan guarantees, along with blended finance mechanisms, enhance access to finance by offering alternatives to traditional forms of collateral and reducing risks for lenders. The COVID-19 pandemic further exposed the vulnerability of SMEs, leading to closures and prompting government interventions, including loan guarantees and blended finance initiatives to support small businesses, particularly those located in townships and rural areas. This section explores government-backed financial support for SMEs, focusing on credit guarantee schemes, COVID-19 loan guarantees, and blended finance initiatives.

The Khula Credit Guarantee Scheme (KCG), part of SEFA, provides credit guarantees to small businesses through third-party intermediaries such as banks and trade credit providers. Over the past six years, the average value of these guarantees, in real terms, has been R263 million (Graph 8). In response to the COVID-19 pandemic, the credit guarantees surged by 77%, increasing to R292 million (constant rands) in 2020, up from R165 million (constant rands) in 2019. These KCG credit guarantees reached a peak in 2023. Despite this significant growth, the total credit guarantees still account for only 0.06% of approximately R717 billion (constant rands) in loans provided to small businesses by South African banks.

Small businesses in South Africa and globally struggle to secure funding due to insufficient collateral, property ownership, or credit history, hindering their growth and discouraging investment.

In 2020, in response to the COVID-19 pandemic, National Treasury and South African Reserve Bank launched the COVID-19 Loan Guarantee Scheme to enhance credit access for formal small businesses.

Graph 8: The total value of credit guarantees, from 2018 to 2023



Source: Small Enterprise Finance Agency annual reports 2022-2023. Accessed on www.sefa.org.za in July 2024, deflated using CPI. Note: Khula Credit Guarantees (KCG) is the total value of guarantees taken up.

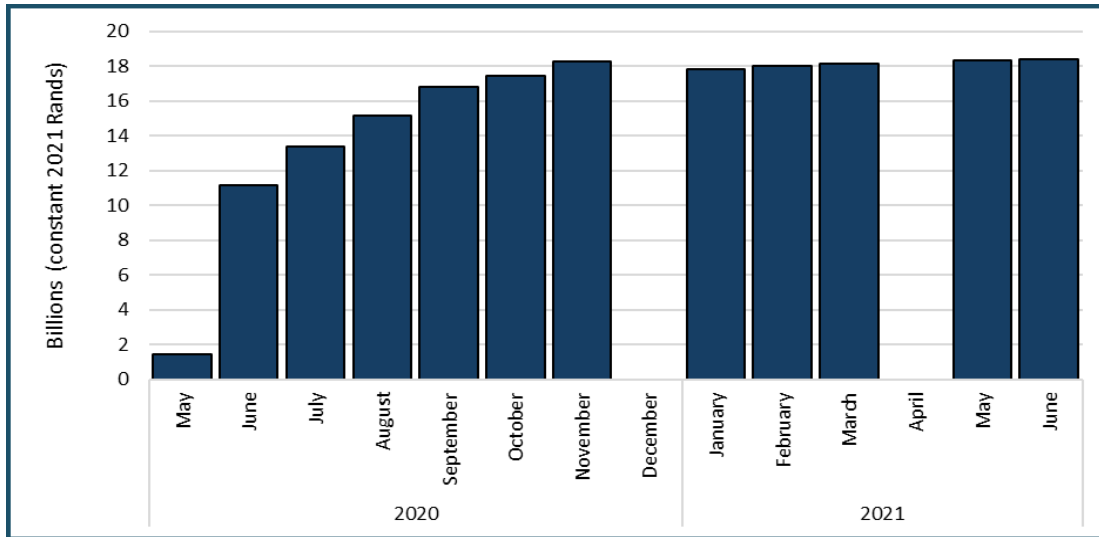
In May 2020, in response to the COVID-19 pandemic, the National Treasury and the South African Reserve Bank launched the COVID-19 Loan Guarantee Scheme to enhance credit access for formal small businesses with annual turnovers below R300 million. This initiative was designed to support SMEs experiencing financial strain due to dampened demand and lockdown restrictions. Similar to the 2008/09 global financial crisis, the pandemic threatened significant contractions in credit markets, which would disrupt business liquidity. The loan guarantees provided by banks were intended to assist eligible businesses in covering operating expenses such as rent, salaries, and lease agreements (SARB, 2020).

As shown in Graph 9, loans extended by banks increased in real terms during the initial months following the announcement. In 2021, the LGS saw a 1% monthly growth, though the uptake of these guaranteed loans remained low relative to the total loans provided to small businesses. It is likely that businesses were uncertain about the economic outlook, which would have impacted their ability to repay the loans. Other factors include weak business and consumer confidence, and load-shedding (BASA, 2020). Although initially intended as a temporary intervention, the scheme has since been revised by the National Treasury following the pandemic.

As part of its blended finance strategy to support small businesses, the Department of Small Business Development, in partnership with its agencies SEFA and SEDA, launched programmes to assist businesses in township and rural areas in response to the financial challenges caused by the COVID-19 pandemic. One such programme is the Township and Rural Entrepreneurship Programme, introduced in 2021. Managed by SEFA, TREP provides blended finance (i.e., loans and grants) and business development services to small businesses in sectors like clothing and textiles, arts and crafts, retail, and automotive, among others. Similarly, in 2020, the department introduced the Small Enterprise Manufacturing Support Programme, which focuses on expanding the economies of townships and rural areas. Through SEFA, this programme also provides blended finance and non-financial support to small-scale manufacturers, helping them acquire equipment, working capital, and obtain product testing and accreditation, among other forms of assistance (SEFA, 2024).

The Department of Small Business Development, with SEFA and SEDA, launched programmes to assist businesses in township and rural areas in response to financial challenges caused by the pandemic.

Graph 9: Covid-19 Loan Guarantee Scheme, monthly from May 2020 to June 2021



Source: The Banking Association South Africa. Accessed from www.banking.org.za in July 2024. Note: The value of LGS for December (2020) and April 2021 months is unclear on the Banking Association South Africa (BASA) website; therefore is excluded.

CONCLUSION

Small businesses, whether formal or informal, significantly contribute to economic growth, job creation, and enhance productivity across a range of sectors, including business services and trade. SMEs are particularly important in sectors such as construction, finance, personal services, and trade. The data from this policy brief underscores the importance of small businesses in domestic industries, highlighting the sectors where they are most dominant and their considerable contribution to job creation. However, despite these contributions, South Africa still faces a job crisis, which small businesses can help to address. Increasing access to finance for small businesses is a vital intervention that could promote the growth of the SME sector. This would not only encourage expansion and new investments by existing enterprises but also support the establishment of new start-up firms.

In addition, the lending data reveals a significant financial gap in SME financing, with both private banks and public lending institutions, including DFIs, unable to meet the demand. Bank lending to SMEs is notably lower than lending to large enterprises and consumer bank clients. Furthermore, funding from the IDC has decreased by 61%, from approximately R3 billion (constant rands) in 2016 to around R1 billion (constant rands) in 2023. Similarly, SEFA's funding to SMEs has dropped by about 67%, from a peak of R1.28 billion (constant rands) in 2022 to roughly R426 million (constant rands) in 2024. These trends highlight the discrepancies in the domestic financial landscape.

To bridge financial gaps, the government has introduced various tools to support SMEs, including credit guarantees, loans, and blended finance options. These initiatives are complemented by efforts to promote financial inclusion, particularly through strategies aimed at expanding small informal businesses through blended finance programmes and non-financial assistance, such as the Township and Rural Entrepreneurship Programme and the Small Enterprise Manufacturing Support Programme. However, there is a critical need to enhance the resources available to national and provincial DFIs and encourage greater collaboration between them and financial institutions to increase SME lending. Moreover, credit guarantees should be broadened and streamlined, as their uptake remains low, especially in addressing challenges like collateral and credit history. Access to finance is essential in fostering the growth and establishment of small businesses. However, several other challenges persist. These include providing support for market access, developing management and business skills, improving financial literacy, and enhancing infrastructure. This involves securing appropriate business premises and ensuring consistent access to electricity and water. Tackling these aspects can foster a more supportive environment for the long-term success of small businesses.

Small businesses contribute to economic growth, job creation, and enhance productivity. SMEs are particularly important in sectors such as construction, finance, personal services, and trade.

Access to finance is essential in fostering the growth of small businesses; however, several other challenges persist. These include support for market access, developing management and business skills, improving financial literacy, and enhancing infrastructure.

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