NIGERIAN BANKING SECTOR EQUITY INVESTMENT SCHEME IN SMALL AND MEDIUM-SCALE ENTERPRISES: ARE THERE LESSONS TO LEARN?

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Abstract
As small and medium-scale enterprises (SMEs) are perceived as engine for economic growth in any economy, various government regimes in Nigeria have initiated a number of financing schemes and policies to ease SMEs’ access to investment funds. Whilst these government-led initiatives have been implemented through banking sector intermediation, they have largely failed to achieve their purpose for a number of reasons. In an effort to complement government’s initiatives, the Nigerian banking sector introduced the small and medium enterprises equity investment scheme (SMEEIS) for the purpose of rendering financial, managerial and technical support to SMEs. Like government-led initiatives, this scheme largely failed to achieve its purpose and has since been scrapped. This paper examines SMEEIS as a venture capital and provides plausible causes of its failure namely, banks’ lack of requisite skills to manage venture capital, apparent bias of banks towards SMEs and regulatory challenges. Whilst the scheme was profoundly important, the outcome suggests that its initiation and implementation were rather plausibly poorly articulated.

Keywords: SMEs, venture capital, banking sector

Introduction
As SMEs have the potential to accelerate economic growth and provide employment opportunities (Sanusi, 2003), various government regimes in Nigeria have initiated several financing schemes or policies to assist these firms. However, those schemes have failed to achieve their policy thrust for a number of reasons, amongst which are unstable macroeconomic policies, poor credit guarantee policy, challenges of foreign currency dominated loans, lack of transparency of the agencies assigned to manage those schemes, lack of risk protection for the participating banks (Eigbe, 1995). Although the stock market was also used to incentivize SMEs via less stringent listing requirement into the Second-Tier Securities Market (SSM) window, the scheme experienced low patronage from SMEs. Despite the poor performance of the various schemes aimed at stimulating the growth and development of SMEs in Nigeria, the government initiatives to support the financing of SMEs are apparently motivated by government expectation that these firms can promote job creation, economic growth and the realization of local content policy of the government.

With the poor performance of the various SMEs financing schemes initiated by the Nigerian government, the Bankers’ Committee launched the Small and Medium Enterprises Equity Investment Scheme (SMEEIS) in 1999 albeit taking effect from June 2001. It was stated in SMEEIS guidelines that the scheme was initiated by the banking industry to complement the Federal Government’s efforts in stimulating economic growth, developing local technology and generating employment. The scheme, among other things, was aimed at providing financial support to SMEs through banks’ equity participation in the SMEs instead of through the conventional loan platform. Whereas the rationale behind this scheme was laudable and promising as an emerging venture capital financing option that would make banks to share the risk of budding entrepreneurs, the scheme failed to achieve its expectations (Egbon, 2005) and was ultimately scrapped in 2008. Whilst any efforts to assist SMEs are commendable, this paper seeks to examine the
SMEEIS project in the light of why it failed and to highlight lessons that could be learned in order to forestall failure of any current and future financing policies aimed at supporting SMEs in Nigeria. The remainder of this paper is organized as follows. Whilst Section 2 provides some conceptual issues of venture capital, Section 3 provides a brief review of SMEEIS as an effective pioneer venture capital in Nigeria. In addition, Section 4 analyses challenges of SMEEIS while Section 5 discusses the causes of poor performance of SMEEIS, its abrupt demise as well as informed lessons to be learnt. The last section provides some conclusions.

Some conceptual issues
The nature of SMEEIS as an equity form of financing to support emerging and potentially viable SMEs in sharing their risk of ownership supports the view that SMEEIS is nothing but a venture capital (VC). According to Akingbohungbe (1991, p. 2), VC involves “Capital investment in the form of equity or equity-convertible subscription to any start-up company and to its phases of development. Or that vital financing assistance that enables the translation of uncertainties into realities perhaps in short time than envisaged by entrepreneurs.”

As the literature suggests, VC is usually associated with start-ups, firms that are highly innovative and potentially high-growth (Ross, Westerfield & Jordan, 2013). Whilst these firms have the potential to earn high returns, they equally have high risk of failure (Gompers & Lerner, 2001). Essentially, adequate professional expertise is needed by the investor to mitigate this high risk tendency. According to the literature, banks lack the expertise to manage VC as it falls outside their areas of professional expertise (Becker & Hellmann, 2002; Egbon, 2005). The literature also identifies a number of complexities associated with VC as a financing option that apparently make VC management incompatible with banks’ expertise.

First, VC is equity-based participation involving the purchase of shares or equity-linked investments such as convertible debts, preference shares tied to equity. This participatory investment platform apparently confers partnership status on the venture capitalist. Second, such investment is illiquid as it is held for a long time before it can be liquidated. Van Horne (2001), for example, regards VC investment as letter stock because it is an illiquid investment as the investor cannot sell it except at the time of exiting the portfolio through initial public offering (IPO) or other form of sell out. Third, VC requires the investor to participate in the investee firm, which suggests that the VC must have expertise in the management of the investee (see Becker & Hellmann, 2003, Hellmann, 1998; Hellmann & Puri, 2000; Sanusi, 2003). The failure of the first German VC formed by German banks, according to Becker & Hellmann (2003), was attributed to the divorce of the venture capitalist from the management of its portfolio companies. Beck & Hellmann (2003) corroborated this assertion by the narratives provided by various beneficiaries and benefactors of the scheme. According to Hellmann (1998) and Hellmann & Puri(2000), the success of VC in the US are attributable to the extensive control held by the venture capitalists over the investees as the former could replace the entrepreneurs with professional managers when the need arises, different to the approach of the German venture capitalist even though many of the entrepreneurs were evidently rookies. The rationale for the venture capitalist to have professional expertise to provide hands-on management support to the investee is apparently supported by Hamm’s (2002) argument that a well-performing entrepreneur may have problem of scaling up his management capability to fit a growing business.

A fourth complexity involves the selection of potentially viable investees, which are also high-risk by nature. For example, Bygrave & Timmons (1992) and Gompers & Lener (1999) identify the process of selecting promising entrepreneurial companies, helping them to develop their potential and participating in the rents generated by successful companies as the heart of VC. If the process is not properly understood, the investor or bank might allow promising SMEs to be crowded out. In addition to these potential complexities affecting the effectiveness of venture capitalism, other issues have been identified as necessary condition for effective venture capital operations. For example, Back & Gilson (1997) argue that active stock market is profoundly essential for VC to thrive (see also Akingbohungbe, 1991); however, Becker &Hellmann (2003) see this as
necessary rather than sufficient condition for the development of VC industry. Another issue of relevance involves control rights namely, the legal protection of the contractual rights of the VC investor. As Becker & Hellmann (2003) argue, VC firms will fail where the contractual restrictions and governance arrangements apparently favour the entrepreneur over the investor. Adequate legal or regulatory framework is essential to incentivize constant VC inflow (Akingbohungbe, 1991). Moreover, VC investors daringly delve into promoting the commercialization of research findings (Zhang, 2007). Zhang cited several firms that were promoted by professors and researchers especially in Biotech and Internet Industries in the US.

Lastly, on the part of the investees, entrepreneurship must thrive to sustain VC financial support to those investees. Entrepreneurship is almost always associated with innovativeness, although it has been classified in the literature in a number of ways. For example, Smith & Miner (1983) classify entrepreneurs into craftsman and opportunistic. Whilst the craftsman builds a rigid organization, he is not interested in losing control and so does not seek elaborate expansion. Consequently, this entrepreneur cannot attract VC funds as such business is a mere source of prestige or employment for the entrepreneur. In contrast, the opportunistic entrepreneur builds a flexible, adaptive organization with great quest for growth and strategic planning. As there is no evidence that Nigeria lacks innovative entrepreneurs in industry, commerce and academia, VC industry has the potential to profitably develop in Nigeria in supporting SMEs.

**SMEEIS and venture capital in Nigeria**

**SMEEIS and venture capital financing**

As earlier mentioned, SMEEIS was initiated in 1999 by the Bankers’ Committee to financially support SMEs through equity participation. The initiative came about due to the perceived inability of SMEs to meet banks’ stringent lending requirements and the problematic of adequate immediate liquidity to service loans. SMEEIS financing arrangement provides a window for SMEs to conserve cash flow for operations, except to the extent that those SMEs declare dividend. According to SMEEIS guidelines, the investing banks are to seek more of capital gains during divestment, which usually takes place not less than three years of investment (see also Cumming & Johan, 2014). SMEEIS by nature lends itself to VC financing option. The implementation of SMEEIS apparently suggests that banks would not be bias in extending this facility to SMEs compared to loan schemes in which they appear to discriminate against these firms. As noted earlier in Section 2, banks lack the essential professional expertise to manage VC. According to Sanusi (2001), the banks have to manage the fund, or authorize venture capital specialists/fund managers to manage the fund on their behalf. Another possible means for banks to administer the fund is by the establishment of subsidiary VC firms.

VC is an emerging form of financing window for highly risky ventures with high-growth potential. It is one of the financing options adopted by fledging innovative entrepreneurs besides conventional sources of funding such as personal savings, loans, and so on. Whilst budding entrepreneurs appear to have their products’ concept in the form of ideas and unproven commercial development, they are rarely appealing to banks for financing. VC financing becomes helpful under this context as many innovative ideas have been promoted and realized through VC assistance (Hellmann & Puri, 2000). But it is not clear how banks could manage VC fund which they apparently seem not to understand its nitty-gritty.

Moreover, the definition of VC by Gompers & Lerner (2001) suggests that banks lack the skill-set to manage VC. According to Gompers & Lerner (2001, p. 146), VC is an “independent, professionally managed, dedicated pools of capital that focus on equity or equity-linked investments in privately held, high growth companies.” Apparently, this corroborates Sanusi’s (2003) observation that equity investment requires skill-set different to what banks are familiar with in credit appraisal and management. In addition, Anyanwu, Adebusuyi & Okafor (2003) also acknowledge that SMEEIS office [within banks] lacks the required manpower and facilities to meet the task of midwifing and nurturing the scheme.
The interest of Nigeria in VC apparently predates the Bankers’ Committee’s initiative as the Nigerian Government in 1993 promulgated Venture Capital (incentives) Decree. This Decree led to the establishment of the first private VC firm in Nigeria known as National Risk Fund (NRF). However, not much has been heard or documented about the NRF. With the apparent lack of success of this VC agency, it is not clear why the banking sector picked interest in VC as manifested in the ideology behind SMEEIS as a scheme to support the financing of SMEs.

SMEs and SMEEIS in Nigeria

SMEs do not have any universal definition (see, for example, Anyanwu, 2001; Rogers, 2002). Some of the reasons attributed to the diverse definitions of SMEs are the state of development of the economy, time period, and technology employed. Essentially, the definition varies across countries. SMEs are also defined according to a particular policy programme aimed at providing financial support to them as far as the Nigerian experience has shown. In this regard, the Bankers’ Committee under the auspices of SMEEIS in 1999 defined SME as an enterprise with maximum asset base of ₦200m (excluding land and working capital) and the number of employees ranging between 10 and 300. The Committee reviewed the definition in 2005, perhaps to accommodate a larger number of SMEs within the funding framework by increasing the asset base of qualifying SMEs to ₦500m. According to SMEEIS guidelines, banks were required to set aside 10% profit before tax (PBT) towards SMEEIS fund annually. However, this was later changed to 10% profit after tax (PAT) and further reduced to 5% PAT. At least two reasons could be adduced to the reduction in contribution towards SMEEIS fund. First, the evidence of large amount of undisbursed accumulated SMEEIS fund which apparently makes reduction of such contribution intuitively rational. For example, whereas about ₦40b of SMEEIS reserve was created in 2005, only less than ₦9b was disbursed to SMEs from it. However, Fiakpa (2008) stated that SMEEIS reserve and disbursement were ₦43b and ₦29b respectively in September 2008. Second, by hindsight, events in the banking sector suggested that the banks were making only paper profits which also have implications for the cumulative amount of SMEEIS fund. Moreover, banks’ lack of understanding of the management of venture capital appear to be one of those challenges that encouraged the large amount of undisbursed SMEEIS fund to potentially viable SMEs.

With the understanding that SMEEIS is a venture capital genre of financing SMEs, some of the banks established subsidiary VC firms. For example, First Bank of Nigeria established First Funds Limited, while Union Bank of Nigeria in conjunction with four other banks established Unique Venture Capital Management Limited (see Ajekigbe, 2004; Oboh, 2004). However, the performance of these VC firms appears not to be obvious. Other banks appeared to have assigned the operation of SMEEIS to a unit within the banks. Such in-house administering of SMEEIS would certainly be fraught with the hangover bias of banks in their lending to SMEs. According to Inegbenebor (2005), there is the existence of mutual mistrust between banks and SMEs’ entrepreneurs. Whilst the SMEs’ entrepreneurs perceive the banks as unfavourably disposed to granting them credit facilities, the banks on the other hand perceive the SMEs as risky investment. Consequently, the SMEs might be reluctant to fully embrace any financing initiatives established by banks, whether it be SMEEIS, equity financing, or loan. The poor performance of SMEEIS as banks’ financing initiative to support SMEs may not be a surprise. Becker & Hellmann (2003) provided empirical evidence that banks are not competent to manage VC, which equally corroborates Sanusi (2003) who observes that the management of equity financing falls outside the banks’ areas of core competence. Usually, short-term securities and loan portfolios are banks’ areas of core competence, which are managed differently to VC.

One of the challenges banks will normally face in managing VC lies in the fact that VC financing have thrived in the high-tech industry. The complex technical and risky nature of this industry makes it difficult for banks to be able to provide the technical and managerial support to the firms. For example, the literature suggests that VC industry could not thrive in Germany because it is a bank-based economy (see Becker & Hellmann, 2003). A former German parliamentarian (Joschka Fischer) was quoted in The Economist (1995) as
saying that if Bill Gates were a German there 
would be no Microsoft. The above does suggest 
that banks’ inability to effectively manage VC is 
not peculiar to Nigeria.

The challenges of SMEEIS

During the life time of SMEEIS, it faced a myriad 
of challenges that apparently curtailed its 
performance and plausibly led to its abrupt demise. 
As we have already highlighted, SMEEIS is a VC 
and potentially difficult for banks to manage 
because it is outside their areas of core 
competence. SMEEIS guidelines specified that 
banks are to give financial advisory, technical and 
managerial support to benefitting SMEs under the 
scheme. An apparent implication of this is that the 
banks will elect to invest in SMEs that are 
operationally less complex. Consequently, many 
potentially viable firms risked being crowded out 
by those firms the banks could reasonably provide 
financial advisory, technical and managerial 
support according to the obligations specified in 
SMEEIS guidelines. A second challenge of 
SMEEIS is banks’ risk-averse behaviour towards 
SMEs, whereas SMEEIS fund as a VC financing 
option is a risk-fund. Although the banks’ risk- 
averse behaviour is due to their prudence in 
safeguarding customers’ deposit, SMEEIS reserve 
is part of the shareholder fund (but it apparently 
provides some cushion for customers’ deposit).

A further challenge faced by SMEEIS is in the 
establishment of subsidiary VC companies to 
manage the SMEEIS fund. Whereas the banks and 
the Central Bank of Nigeria (CBN) were aware 
that banks lacked the expertise to administer VC, 
the CBN and the SMEEIS guidelines did not 
permit banks to utilize SMEEIS fund as part of VC 
companies’ formation expenses. This position of 
the CBN and SMEEIS guidelines was apparently 
discouraging in establishing subsidiary VC 
companies, which in all probability favoured the 
management of SMEEIS in-house by the banks 
despite their inherent lack of expertise. Another 
challenge faced by SMEEIS is the apparent failure 
of government to articulate a regulatory framework 
to protect the rights of the contracting parties. As 
earlier mentioned in Section 2, robust regulatory 
and governance framework is necessary for the 
effectiveness of VC. Without the legal codification 
of the rights of the different contracting parties, it 
will be difficult for financiers to invest in SMEs 
under such atmosphere. An important aspect of the 
legal framework necessary for the effective 
running of VC is control right. Do the financiers 
have controlling power during the period their 
investment is held? Do they have the right to 
remove and replace management (including 
founders) of the investee SMEs when necessary? 
The absence of such rights accounted for the 
failure of German VC companies (Hellmann, 
1998; Hellmann & Puri, 2000). Lastly, the 
unwillingness of SMEs’ entrepreneurs to share 
their ownership with the banks was a plausible 
challenge of SMEEIS. In addition to the above 
challenges, our survey prior to 2010 gave further 
insights into the likely reasons for the failure of 
SMEEIS as a financing, technical and managerial 
window to support SMEs in Nigeria. The next 
section presents and discusses the survey data.

Causes of the poor performance of SMEEIS 
and lessons to be learnt

In order to find out the rationale for the poor and 
delayed distribution of accumulated SMEEIS fund 
to potential SMEs, we surveyed thirty three (33) 
respondents from Commercial banks, CBN and 
Securities and Exchange Commission (SEC). We 
chose these organizations because they were 
implicated in the effective administration of 
SMEEIS to varying degrees. For example, whereas 
the banks owned and were to manage the fund, the 
CBN regulated the activities of those banks 
including how they should manage SMEEIS. 
SEC’s inclusion was thought relevant as IPOs 
(usually regulated by SEC) were plausible means 
of banks’ divestment from the SMEs.However, 
only fifteen (15) of these respondents answered the 
questions to which our immediate concern relates. 
They were requested to rank in order of priority the 
likely causes of banks’ slow disbursement of 
SMEEIS fund to SMEs (Table 1).
Table 1: Ranking of causes of delay in disbursing SMEEIS (poor performance)

<table>
<thead>
<tr>
<th>Causes</th>
<th>Ranking</th>
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<th>4</th>
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<th>6</th>
<th>7</th>
<th>Total</th>
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<tr>
<td>The bias of banks that investments in SMEs are</td>
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<td>No adequate government framework for regulating</td>
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<td>Management of equity scheme is outside the core</td>
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<td>5</td>
<td>6</td>
<td>4</td>
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<td>competence of banks</td>
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<td>Low level of awareness of the scheme among promoters</td>
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<td>3</td>
<td>-</td>
<td>-</td>
<td>3</td>
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<td>7</td>
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<td>of SMEs</td>
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<td>Slow pace of registration of venture capital firms</td>
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<td>-</td>
<td>-</td>
<td>3</td>
<td>9</td>
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<td>to administer the scheme</td>
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<td>Insufficient number of growth SMEs capable of</td>
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<td>-</td>
<td>3</td>
<td>-</td>
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<td>2</td>
<td>-</td>
<td>10</td>
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<td>utilizing the fund</td>
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<tr>
<td>Unwillingness of SMEs to share ownership with others</td>
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<td>2</td>
<td>-</td>
<td>8</td>
<td>5</td>
<td>-</td>
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<td>15</td>
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</table>

Based on the seven (7) plausible factors we adduced to the slow disbursement of SMEEIS fund, we asked the respondents to rank them according to the order they thought these had affected the performance of SMEEIS. Whereas 1 represents the most significant reason for the poor performance of SMEEIS, 7 represents the least significant reason. However, we further grouped ranks 1-3 as ‘significant’, 5-7 as ‘not significant’, and 4 as ‘neither significant nor not significant’. Using the Significant (1-3), neither significant nor not significant (4) and not significant (5-7) ranking scales, the ranking in Table 1 is now presented.

The respondents almost unanimously agreed that the bias of banks that investment in SMEs is high-risk investment as 14 (93%) of the respondents made this allusion, whereas only 1 (7%) has a contrary view. Following this in rank two is 11 (73%) responses that inadequate governance framework inhibited the performance of SMEEIS, while 4 (27%) ranked this as not significant.

Moreover, the respondents apparently ranked banks’ lack of competence to manage equity scheme in the third position, representing 11 (73%) ranking this as significant while 4 (27%) considered it as neither significant nor not significant. An awareness of SMEEIS to SMEs’ entrepreneurs was ranked in fourth position for the poor performance of the scheme. Whereas 5 (33%) respondents accepted this option as significant, 10 (67%) held that this reason was insignificant in assessing the poor performance of SMEEIS. The slow pace of registering VC companies and insufficient number of growth SMEs to utilize the fund were ranked fifth and sixth respectively. Whereas 3 (20%) respondents alluded that the registration of VC companies and insufficient growth SMEs were significant to the poor performance of SMEEIS, 12 (80%) respondents considered them not significant. Lastly, the unwillingness of SMEs’ entrepreneurs to dilute ownership was ranked least by the respondents (only 2 (13%) ranked it as significant, 5 (33%) ranked it as not significant, whereas 8 (54%) ranked it in the neither/nor bracket).

As the survey results show, the prominent reasons respondents adduced to the poor performance of SMEEIS were the bias of banks towards investing in SMEs, banks’ lack of competence to manage equity scheme and the absence of adequate governance framework to regulate SMEEIS as a VC form of financing SMEs. On the other hand, the respondents were of the view that VC companies’ registration, insufficient potential SMEs, awareness of SMEEIS among SMEs and unwillingness of entrepreneurs to dilute ownership were considered as not significant factors that affected the poor performance of SMEEIS.
However, one of the limitations of the above survey is the non-inclusion of SMEs respondents to find out their level of awareness of the scheme as well as how those who were aware would equally rank those factors raised as the perceived causes of the poor performance of SMEEIS. Lessons could be learnt from the above findings with regard to the performance of SMEEIS as a financing initiative to support SMEs. The above findings have implications for policy to the extent that future financing schemes (private or public) aimed at assisting SMEs should thoroughly anticipate potential challenges as well as articulate strategies to mitigate them. Another lesson to be learnt is the need to evolve financing initiatives that are compatible with our environmental peculiarities rather than importing initiatives that appear to be alien to the managers of such initiatives. Alternatively, imported initiatives could be modified to suit local peculiarities. Whilst SMEEIS and other government-led initiatives that failed have been mediated through the conventional banks, specialized institutions that understand the complexities and challenges of SMEs should handle the financial, managerial and technical supports to SMEs. In addition, adequate regulatory framework that explicitly codifies investor-investee rights and relations in the context of SMEs financing needs to be clearly articulated.

Conclusion
We conclude that the establishment of SMEEIS as a VC financing initiative to financially, managerially and technically support SMEs in Nigeria was not only profoundly essential, but also timely. However, the consistent built-up of undisbursed funds apparently led the banks to consistently reduce their contributions to the fund, and to ultimately scrap the scheme. The high tempo at which the banks embraced SMEEIS by creating a huge amount of SMEEIS fund and the ultimate poor performance of the scheme apparently suggest that the potential challenges of the scheme were not properly thought out prior to its implementation. As the findings suggest, the banks lack the professional expertise to manage VC adequately, which has implications for the abrupt scrapping of SMEEIS. However, the decision to scrap the scheme prematurely appears to have overlooked the likely relationship benefits (if any) that might accrue to the banks and investee SMEs in the long-run (see, for example, Hellmann, Lindsey & Puri, 2008).

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271