Unlocking the True Potential of SME Digital Transformation in the MENA Region

A whitepaper by investopia

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INTRODUCTION

In the Middle East and North Africa (MENA) region, Small and Medium Enterprises (SMEs) are increasingly acknowledged as vital drivers of economic development. The sector plays an important role in the economy, contributing to the GDP and job creation. The World Bank highlights that formal SMEs account for up to 60% of total jobs and nearly 40% of GDP in emerging economies. These figures would be significantly higher if informal SMEs were included.

In the MENA region, SMEs account for 60% of the GDP, thus being critical drivers of the economy, with the IMF estimating that SMEs contribute upto 50% to employment while accounting for almost 90% of the region’s businesses. Yet, in many parts of the region, SMEs face challenges due to restricted access to credit, unfavorable business conditions, and talent shortages.

The development of the SME sector has become the focal point of many national strategies for inclusive growth. The COVID-19 pandemic added to the challenges faced by SMEs in MENA and threatened to exacerbate already high levels of unemployment in the region. The sectors where SMEs were concentrated, such as trade, tourism, and transportation, were also severely affected by measures to contain the virus's spread. Additionally, as most SMEs had not digitalized their business models, the "great lockdown" led to a sudden halt in operations for many of them.

In this regard, a strong digital infrastructure is essential to support the development of the SME sector and the critical role it plays in the economic diversification plans for many countries in the MENA region. With digitally savvy millennials making up a significant portion of the population, consumer expectations have evolved to prioritize not only the utility and cost of goods and services but also the speed and convenience of their delivery. As a result, SMEs must embrace digitalization to meet these expectations and stay competitive. There is significant potential for digitalization levels to rise among SMEs in the MENA region, with almost three out of four SMEs still using manual processes and basic communication tools to engage with customers and suppliers in the UAE, which is, in fact, one of the more digitalized countries in the region.

Amid the digital transformation of the SME sector, the Investopia ecosystem emerges as a proactive advocate for investments into developing a more digitalized ecosystem for SMEs in the MENA region. This will result in productivity benefits, cost savings, job creation and sustainability improvements, ultimately pushing the SME sector to become an engine of growth for the economies in the region.

CURRENT LANDSCAPE OF SMES IN MENA AND CHALLENGES FOR DIGITALIZATION

Micro, Small and Medium Enterprises (MSMEs) make up the majority of enterprises in the MENA region, accounting for 80-90% of total businesses in most countries.

Within the SME sector, there's a growing recognition of the importance of digitalization, with many SMEs beginning to adopt new technologies to enhance efficiency and customer engagement. Businesses in MENA have generally been slow to adopt the internet to enhance productivity, despite various government initiatives aimed at promoting digitalization. The digitalization process in this region has not followed the typical trajectory seen in other markets, where consumer adoption of online services leads businesses to follow suit, fostering a gradual development of the digital ecosystem. In MENA, widespread internet adoption, particularly in the GCC, began around the mid-2000s, but businesses only started to digitalize after 2010. The internet is still primarily used for entertainment and communication, with much less emphasis on transactions or innovation, resulting in businesses lagging behind both governments and consumers in internet usage.

SMEs in the MENA region are expanding their digital presence, but their overall impact remains limited. Despite a rise in internet usage among the population, only 15-25% of SMEs in MENA had an online presence by the end of 2012, and recent surveys suggest that these figures have changed only slightly since then.

Some of the major challenges hindering the digitization of SMEs include a strong preference for cash transactions, limited awareness of technology and digital solutions, and an emerging funding gap. Access to finance is one of the biggest challenges confronting MSMEs worldwide, especially in the MENA region, where nearly 63% of MSMEs lack financial access. The total financing gap for MSMEs in MENA is estimated to be between $210 billion and $240 billion, with the formal MSME finance gap accounting for approximately $160 billion to $180 billion. Some surveys estimate that only 8% of lending is directed towards SMEs across the MENA region, with the figure being even lower at 2% in GCC countries. This is significantly lower than the lending averages of 18% for middle-income countries and 22% for high-income countries.

Universal broadband internet access is essential for the transition to a digital economy. It serves as the backbone for digital services, applications, and business models, and is a prerequisite for adopting other digital technologies for SMEs. For these digital dividends to be realized, a labor force with the necessary digital skills, digital platforms to connect businesses with consumers and suppliers and digital financial services need to be available alongside the availability of affordable high-speed internet. Other crucial elements include digital identities (IDs), interoperable digital payment systems to enable transactions, digitally literate consumers, affordable devices, and a supportive entrepreneurial culture. Additionally, a reliable electricity supply, efficient e-commerce logistics, and digital identification along with data centers for cloud computing are essential. A strong regulatory framework is also necessary to foster innovation while addressing risks such as cyber threats, data protection and privacy, consumer protection, fraud, and money laundering.

BENEFITS OF DIGITAL TRANSFORMATION FOR SMES

Start-ups and small business owners recognize that emerging digital technologies can greatly benefit their operations. A survey by YouGov, targeting decision-makers in small and medium-sized enterprises, indicated that digital transformation initiatives can enhance operational efficiencies and improve customer experiences through technology. Digital technologies offer new avenues for businesses to accelerate their growth. Emerging technologies and broadband internet can enhance operational efficiencies, foster innovation, provide access to markets and financing, and allow companies to operate remotely during lockdowns. The flexibility of remote work can also facilitate the inclusion of women and youth in the SME sector.

The primary advantage of adopting digital technologies, specifically cashless payments, is the ease of accessing revenue and transferring budgets, such as payments to suppliers. Additional research, including Arthur D. Little's 2021 survey of 240 UAE-based SMEs, has demonstrated that digitization has significantly benefited SMEs by helping them attract new customers, reduce costs, and enter new markets, particularly with the increased ease of cross-border transactions. Digitalized SMEs have also been found to have 26% higher revenues in comparison to non-digitalized ones.

Digital technologies can also enhance SMEs' access to credit, addressing a major barrier to their growth. Electronic payments generate a digital record of transactions, allowing banks to lend to SMEs based on cash flows when audited accounts and collateral are not available. Digitizing payments within supply chains can help SMEs optimize accounts receivable and improve cash flow for working capital. Big data strengthens banks' credit risk assessment capabilities and enhances AML/CFT compliance, which can reduce wholesale de-risking that has disproportionately affected SME lending, enabling banks to develop products specifically designed for SMEs.

Additionally, blockchain technology facilitates faster cross-border payments and creates reliable electronic registries for leased and movable assets, allowing SMEs to pledge movable collateral. Digital innovations like crowdfunding and P2P platforms also provide alternative funding sources.

Technologies such as hyperscale cloud, defined as cloud computing ecosystems designed to protect scalable and flexible cloud resources, contribute to increased employee productivity especially across geographically dispersed operations as SMEs expand. Cloud-enabled analytics and advancements from hyperscalers, such as Artificial Intelligence (AI) and Machine Learning (ML), enhance decision-making and cost efficiencies across organizations. Migrating to hyperscale clouds can reduce average IT infrastructure spending by over 27% compared to on-premises IT. Additionally, IT employees can be freed up to focus on more innovative and productive tasks, benefiting from streamlined IT environments and improved system administration efficiency.

With access to the innovative tools and capabilities offered by hyperscalers, SMEs and start-ups can leverage the agility and scalability of cloud computing. This enables them to identify new business opportunities, rapidly iterate on product development, and swiftly launch their products and services at scale across various regions, benefiting from a global infrastructure and unlimited computational power.

IMPACT ON ECONOMIC GROWTH AND INNOVATION

SMEs are crucial for job creation within the MENA economies, and governments can encourage the industry by accelerating their digital transformation through the formulation and implementation of national strategies that tackle both supply and demand constraints hindering digitalization.

Youth unemployment, which currently stands at about 25% in the MENA region and exceeds the rate in the rest of the world, severely affects economic growth in the region and needs to be addressed. SMEs can also help improve female entrepreneurship levels in the region, with women in the region having the lowest rates of Total Entrepreneurial Activity (TEA) at only 4% of the population. The digitalization of SMEs can help improve both these outcomes.

The use of digital technologies such as hyperscale clouds enable SMEs to achieve their growth potential by facilitating global expansion, government policy goals, and the wider technology ecosystem. The impact of these is signified by the fact that in the UAE alone, the potential economic benefits for SMEs and startups from hyperscale cloud adoption are estimated at $ 10.1 billion between 2022 to 2030. At the same time, it is expected to create 133,000 jobs and result in $ 7 billion in potential economic benefits for local technology partners and resellers in the ecosystem during the same period. It is also expected to support the development of a wider innovation ecosystem in the region, while future-proofing its data needs.\

Digitalization offers not only financial benefits, but also supports better resilience through improving the adaptive capacity of SMEs and reduces carbon footprints.

Three key forms of digitalization that contribute to product and process innovations are big data analytics, digital interconnection in production and logistics, and digital value chains. Each of these digital transformation strategies offers significant advantages for SMEs, the wider economy and ultimately, innovation. Big data analytics enhances decision-making and provides valuable customer insights that can drive new product development. Digitalizing production processes can boost productivity and flexibility, increasing the likelihood of innovation. Additionally, digital value chains improve production efficiency by streamlining operations and enhancing collaboration throughout the supply chain. Overall, these advancements in data analysis, production, logistics, and value chains are expected to positively influence firms' innovation efforts, while increasing revenues and thus contributing to increased economic growth.

FUTURE OUTLOOK AND RECOMMENDATIONS FOR INVESTORS AND POLICY-MAKERS

The public and private sectors in the MENA region have been developing programs to catalyze the growth of SMEs, including startups. As we delve into the transformative landscape of digitalization in SMEs, one segment that warrants special attention from investors and the government is "scale-ups." These are SMEs with established business models that are experiencing rapid growth. Scale-ups make up about 5% of SMEs and can originate from any sector or age group, with their founders having the potential to make significant contributions to their respective ecosystems. With the appropriate support to digitalize, scale-ups can expand quickly and create a substantial economic impact.

While digitizing businesses through marketplaces and portals remains an area of focus in the future, government organizations across the MENA region can spearhead digital transformation and technology adoption, generating demand that can be met by local SMEs, start-ups, and technology partners. This necessitates harmonizing and simplifying digital and data regulations at both national and regional levels, alongside implementing a risk-based data classification system to enhance data security and facilitate technology adoption.

Second, MENA governments can collaborate with the private sector and technology firms to address the digital skills gap through training and upskilling programs, laying the groundwork for a digitally proficient workforce capable of driving innovation and entrepreneurship. On the demand side, the digital usage gap – the disparity between people who live in areas covered by broadband but not using the internet – is multiple times the coverage gap. In fact, this gap in the MENA region is the second highest in the world and needs to be addressed. To boost demand for digital services, governments should implement digital literacy and awareness programs while also enhancing consumer trust by strengthening frameworks for cybersecurity, digital identification, data privacy, and consumer protection.

Macro and regulatory policies require careful calibration to ensure a coherent policy mix and reduce unintended consequences. Interest rate caps can deter bank lending to SMEs by limiting the ability to price risk effectively, so a relaxation of these caps is necessary. Policies aimed at promoting bank lending to SMEs must strike a balance to ensure that financial inclusion goals do not come at the expense of financial stability. Public sector wages should be assessed with competitiveness in mind. Additionally, government borrowing to cover fiscal deficits should consider the risk of crowding out the private sector, particularly SMEs.

Finally, there is significant potential to foster collaboration between regulators and technology companies to ensure that existing and future regulations do not impede widespread technology adoption. Technology firms can offer valuable insights into emerging technologies and the regulatory impacts they may face.

CONCLUSION

SMEs in the MENA region are at various stages of digital transformation, but in many countries, the necessary conditions for effectively utilizing new technologies are lacking. These SMEs encounter substantial supply-side constraints, while demand factors also significantly contribute to the slow pace of digitalization.

Multi Stakeholder collaboration are necessary to help SMEs overcome barriers by facilitating connections with other sectors to access skills and new technologies, share best practices, and navigate regulatory challenges related to data management. Additionally, partnerships with technology providers and educational institutions can provide valuable, cost-effective tools and support capacity building. Cross-sector collaboration is crucial, as SMEs serve as important partners and intermediaries within supply chains.

In conclusion, the digital transformation of SMEs in the MENA region is essential for fostering innovation, enhancing competitiveness, and driving economic growth. By addressing existing barriers and promoting access to digital tools, skills, and supportive policies, stakeholders can create an environment conducive to SME success. Collaborative efforts among governments, private sector entities, and educational institutions will be vital in facilitating this transformation. Ultimately, empowering SMEs through digitalization will not only benefit individual businesses but also contribute significantly to the region's overall economic resilience and prosperity.

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