Access to Finance for SMEs

By the World Bank, Ghana office

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Access to Finance for Small and Medium Enterprises in Africa

By the World Bank Ghana Office

Why African Entrepreneurs are key to Creating Jobs
The private sector is the key engine of job creation accounting for 90 percent of all jobs in the developing world. Small and medium Enterprises (or SMEs) account for the vast majority of these jobs.

It is estimated that 122 million new jobs will be needed in Africa by 2020 to absorb a growing workforce and address unemployment.¹ Most jobs, including for women and the youth, are expected to come from SMEs that form over 95% of businesses in Africa. At present, Africa accounts for just 1% of global manufacturing. Despite having 27% of the world’s arable land, many African countries import food and agricultural products from outside the continent.²

Governments play a vital role by ensuring that the conditions are in place for strong private-sector led growth, and by alleviating the constraints that hinder the private sector from creating good jobs for development. However, access to finance is often cited by firm owners as one of the key determinants of growth and expansion.

It is essential for Africa to have a vibrant private sector by providing SMEs with adequate support to access finance, markets and improve their productivity and competitiveness. Experience from other parts of the world show that SMEs are capable of creating productive jobs, which is critical for Africa to achieve its human capital potential, improve the performance of real sectors, strengthen domestic markets and exports, and achieve food security.

Job creation in emerging markets is stunted by lack of finance, lack of adequate electricity, poor business environment and investment climate with skills mismatch from lack of coordination between industry and all forms of tertiary education. In 71% of countries, SMEs cite access to finance as the biggest obstacle. In Africa, Access to Finance is identified by over 20 percent of SMEs to be the BIGGEST constraint (see Figure 1). Traditional Banks find it difficult to meet the needs of SMEs, particularly start-ups and innovative enterprises – the very firms which appear most likely to create the greatest number of jobs. Data from Zambia shows that while 95% of SMEs have bank accounts, only 16% had loans or lines of credit (6% of small and 25% of medium enterprises). In addition, virtually all loans (93%) required collateral, which on average amounted to 146% of the loan amount.

Commercial banks largely avoid lending to SMEs who they see as difficult to serve with current business models. Constraints include issues relating to the availability of credit information, the

¹ McKinsey Global Institute, Africa at work: Job creation and inclusive growth, 2012.
registration and enforcement of collateral, the verification of documents and identification, and low levels of business skills and training. The microfinance industry focuses on payroll based lending and traditional microfinance institutions are very small. Leasing companies lend to SMEs but expansion is hampered by a lack of funds and lack of clarity regarding taxation. Nevertheless, servicing SMEs is a profitable line of business for commercial banks who generate a large proportion of revenues from non-credit related activities (e.g. fees and low interest-rate deposits).

**Figure 1: Percent of SMEs citing biggest obstacle (SMEs between 5 -100 employees)**

<table>
<thead>
<tr>
<th>Obstacle</th>
<th>AFR</th>
<th>EAP</th>
<th>ECA</th>
<th>LAC</th>
<th>MNA</th>
<th>SAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to finance</td>
<td>21.4</td>
<td>15.2</td>
<td>14.2</td>
<td>15.3</td>
<td>18.6</td>
<td>14.1</td>
</tr>
<tr>
<td>Bankruptcy</td>
<td>19.2</td>
<td>10.0</td>
<td>9.4</td>
<td>10.0</td>
<td>15.3</td>
<td>17.3</td>
</tr>
<tr>
<td>Tax rates</td>
<td>7.3</td>
<td>4.9</td>
<td>2.8</td>
<td>3.7</td>
<td>11.7</td>
<td>6.1</td>
</tr>
<tr>
<td>Professional ability</td>
<td>6.5</td>
<td>7.8</td>
<td>7.8</td>
<td>12.8</td>
<td>11.0</td>
<td>6.1</td>
</tr>
<tr>
<td>Practices of Competition in the internal sector</td>
<td>10.6</td>
<td>12.2</td>
<td>12.5</td>
<td>15.3</td>
<td>14.1</td>
<td>18.1</td>
</tr>
<tr>
<td>Corruption</td>
<td>4.3</td>
<td>4.3</td>
<td>7.2</td>
<td>7.1</td>
<td>4.7</td>
<td>3.6</td>
</tr>
<tr>
<td>Inadequately educated workforce</td>
<td>2.7</td>
<td>10.4</td>
<td>5.3</td>
<td>9.1</td>
<td>10.0</td>
<td>6.4</td>
</tr>
<tr>
<td>Access to land</td>
<td>5.5</td>
<td>5.3</td>
<td>1.2</td>
<td>1.4</td>
<td>5.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Crime, Theft, and Disorder</td>
<td>3.8</td>
<td>5.1</td>
<td>2.3</td>
<td>4.1</td>
<td>1.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Transport</td>
<td>3.5</td>
<td>3.3</td>
<td>3.0</td>
<td>4.3</td>
<td>2.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Costumes and Trade regulations</td>
<td>7.6</td>
<td>9.7</td>
<td>10.5</td>
<td>9.7</td>
<td>8.4</td>
<td>8.5</td>
</tr>
<tr>
<td>Other</td>
<td>9.7</td>
<td>9.7</td>
<td>10.5</td>
<td>9.7</td>
<td>8.4</td>
<td>8.5</td>
</tr>
</tbody>
</table>

**Figure 2: Average percentage of revenues by product type**

- Nigeria
- South Africa
- Developing

Which SMEs create jobs?
Although the literature is not conclusive, evidence from the USA, Canada, western European countries, India, and other developing countries such as Lebanon and Tunisia, suggest that most NET new job growth comes from firms less than five years old. Data from the USA shows that virtually all net new jobs come from young firms – which almost by definition are small firms. However, start-ups and new firms will find it very difficult to access financing from commercial banks as they do not have a track record and are considered “too risky”. As a result, commercial banks generally will NOT provide financing to start-up enterprises or a young firm – resulting in a serious financing gap in most emerging countries. This stunts growth or puts young firms out of business.

Beyond financing, at the early stages of development, SMEs also face other challenges, including:

- Lack of advisory support services
- Weak corporate governance
- Mentoring skills and talent development
- Incubation support
- Research centers
- Networking
- Market access

In addition, there is a lack of affordable professional services (consulting, law, accounting, etc.) and other support programs including governmental, formal and informal business networks. A well-functioning network of Credit Bureaus can alleviate this problem if properly set up with sustainable funding.

Many countries also have weak enabling environment for SMEs, such as regulatory constraints, complicated tax laws, complex process for permits & registration, insolvency and creditor rights, and often unfavorable secured transaction laws. In some cultures if Africa, entrepreneurship is sometimes not seen as a valuable career, with bankruptcy and failure considered to be a taboo.

The Life Cycle of Firms (Equity and Debt)
Developing pre-bank financing infrastructure to help start-up firms through the investment stages is therefore key to supporting employment generating firms. In general, firms go through several stages of development with various types of financing sources:

<table>
<thead>
<tr>
<th>Firm/Product Development Stage</th>
<th>Financing Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic/Applied Research</td>
<td>R&amp;D Grants, Friends, Family, Founders</td>
</tr>
<tr>
<td>Proof of Concept/Prototype</td>
<td>Angel Investors, Friends, Family</td>
</tr>
<tr>
<td>Engineering / Production Prototype</td>
<td>Venture Capital</td>
</tr>
<tr>
<td>Production &amp; Marketing</td>
<td>Private Equity, Project Finance</td>
</tr>
<tr>
<td>Revenue Growth</td>
<td>IPO, Mergers, Acquisition</td>
</tr>
</tbody>
</table>

Firms need different types of financing – which evolve as they grow. For instance, most SMEs commence operations with “own funds” – or money from friends, family and “fools”. Locked out of bank financing, many SMEs die unless equity support, trade finance, or even small amounts of bank (or other financial institution) finance is made available.

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3 The Kauffman Institute (USA)
The charts in Figure 4 show the share of funding types used globally by SMEs – taken from the Enterprise Survey data (for both investment and for working capital). The reliance on internal or “own” funds is significantly higher in developing countries – a factor which, in the absence of alternative funding modalities, stunts their growth and overall economic development.

**Figure 4: Global Funding Sources for SMEs**

![Chart 1: Financing of Investments for All Countries](chart1.png)

- **Internal funds**: 72%
- **Banks**: 14%
- **Supplier credit**: 5%
- **Equity or stock sales**: 4%
- **Other sources**: 5%

![Chart 2: Financing of Working Capital for All Countries](chart2.png)

- **Internal funds**: 74%
- **Banks**: 11%
- **Supplier credit**: 11%
- **Other sources**: 4%

**SME Finance Strategy**

A strategy to support SMEs should comprise several components ranging from the provision of basic financial information to the provision of funds for growth and expansion. Many countries are still working on getting the basic financial infrastructure in place to support increased lending to SMEs through a broad range of systems:

- **Credit Information Bureaus**: SMEs generally suffer from asymmetry of information and lack of basic financial literacy. Tailored training on fundamentals of financial management with robust credit information systems – containing both positive and negative information from a wide variety of sources – helps address this asymmetry;

- **Secured Transactions Registries**: Most SMEs do not have traditional forms of collateral (i.e. fixed assets). Secured Transaction Laws and Registries for Moveable Property better serve SME borrowers by reducing the risk perception of lending to SMEs.

- **Insolvency and Creditor Rights Reform**: When bankruptcy proceedings are uncertain and court systems are slow – banks will be less willing to lend to SMEs – given the uncertainty of speedy resolution in the event of default;

- **Payment Systems**: Efficiently functioning and increasingly electronic payment systems can greatly support SME activity in many countries (more later).

In addition, while not necessarily innovative, many countries still have not developed systems for trade finance, particularly leasing, factoring, and credit guarantees.
Funding Sources

IFC SME Ventures Program

The IFC SME Ventures Program was set up to invest in fragile, post-conflict states, low income countries and frontier regions of developing countries. It provides Risk Capital and Advisory services to primarily fund managers and SMEs. The SME Venture has so far established 4 funds in 6 countries (DRC, CAR, Liberia, Sierra Leone, Bangladesh and Nepal), with US$46 million invested in 61 firms through the 4 funds, 58 of which are performing to expectations. The venture program has sufficient potential deals to find viable investments and thereby grow. There are expansion plans to scale up in other markets, with the objective of reaching 20 funds in the upcoming 5 years with an expected investment funds of US$500 million. The focus has been to provide capital through equity, quasi-equity and loans to high growth potential SMEs (post startup stage with 2-3 years in business) that range from US$ 100,000 up to US$ 2 million. The venture program is scalable and has a transformative approach through adequate investment and advisory offerings as first time SME fund managers generally need training to help them quickly move up the learning curve.

The World Bank has begun to establish co-investment financing vehicles with Angel networks. These projects provide equity and debt – frequently on a 50-50 basis – with an Angel investor who is relied upon to make sound investment decisions. Recent examples include:

- **Lebanon**: Early Stage Project co-investment equity worth $30 million;
- **India**: $550 million project for early stage debt and franchise financing;
- **Croatia**: Early Stage financing of EUR 20 million;
- **Morocco**: project under preparation

African Business Angel Network (ABAN)

The World Bank is supporting the development of Angel investors and networks in Sub-Saharan Africa. The African Business Angel Network (ABAN) is a pan African non-profit association founded to
support the development of early stage investor networks across the continent and to get many more (early stage) investors excited about the opportunities in Africa. ABAN seeks to promote a culture of Angel investing across Africa. There are networks emerging across the continent, but there is yet a conversation in place that connects them. There is a sincere need to collect/develop best practices and to make this knowledge available. To create a resource and contact point for promoting new networks and/or supporting other stakeholders looking to get involved in building the ecosystem. Also to engage private sector investors and to offer some guidance on investing into African born innovations. In turn, ABAN seeks to further build the industry and improve the climate for startup entrepreneurs.

ABAN began as a consortium of independent investor networks including the Lagos Angels Network (LAN), Cameroon Angel Network (CAN), Ghana Angel Network (GAIN), Venture Capital for Africa (VC4Africa), Silicon Cape and supported by the European Business Angel Network (EBAN), the LIONS Africa Partnership and DEMO Africa. In the interest to connect these African networks, support new investors and new networks, to maximize their impact and to connect African investors to their global counterparts, the need was established to form a pan-African association of angel investor networks and other early stage investors – hence the creation of ABAN.

**Diaspora Funds**

Mobilization of diaspora investments is possible through the issuance of a diaspora bond, a retail saving instrument marketed to the diaspora. A developing country government (or a reputable private corporation) can tap into the wealth of migrants by selling such bonds even in small denominations (from $100 to $1,000). The bonds could be sold in larger denominations to wealthier migrants, diaspora groups, or institutional investors. Diaspora bonds can tap into the emotional ties of the diaspora—the desire to give back—and potentially help lower the cost of financing for development projects in their country of origin. Since the diaspora savings are mostly held as cash “under mattress” or in low-yielding bank accounts in the diaspora host countries, offering an annual interest rate of 3 to 5 percent on diaspora bonds could be attractive. Diaspora bonds have several advantages, both for the issuer and for the emigrant who buys the bond: (i) through retailing at small denominations, ranging from $100-$10,000, issuers can even tap into the wealth of relatively poor migrants; (ii) in certain cases a confident issuer could issue in local currency terms as migrants may have local currency liabilities in the issuing country and hence less aversion to devaluation risk; (iii) migrants are expected to be more loyal than the average investors in times of distress, and they might be especially interested in financing infrastructure, housing, health, and education projects; and (iv) a diaspora bond would offer a higher interest rate than the rate diaspora savers earn from bank deposits in their country of residence.

The African Diaspora could be developed as an important source of Angel financing and mentoring support for new and young African entrepreneurs – in much the same way that Endeavor originally started out as providing support to Latin American entrepreneurs, based upon Latin Americans living in the United States. Some prior work would need to be done to address:

- **Policy:** Working with governments to obtain improvements in enabling policy and institutional environments for engaging Diaspora;
- **Financial:** Working with development partners and the African Union on the cost of remittances and approaches for leveraging and securitization of remittances;
- **Human:** Working with countries, Diaspora professional networks and hometown associations for human capital development and start-up capital.

**Other Innovative Financing**

The World Bank is exploring potential for other more innovative forms of financing to meet the needs of start-up SMEs (see Figure 5). Finally, as part of investment climate work and regulatory
reforms, the World Bank will continue to support countries to improve the overall business environment.

Figure 5: Potential Innovative Sources of Financing for SMEs

Examples from other countries
China and Turkey provide two good examples that countries in Africa could follow. In both cases, it is recognized that commercial bank lending to MSEs is a low margin business with high costs involved in making small loans. This requires many good loans need to be made and the interest charged has to allow for cost recovery. In addition, SME have little traditional collateral and weak or no financial statements. Therefore, commercial banks have to build capacity in relationship-based lending with little or no traditional collateral with risks assessed based on cash flow. This requires moving from a “hands off” lender to a “hands on lender” to generate business and monitor performance. The successes from China and Turkey show that SME lending can be a higher margin business than lending to micro-enterprises, but is still lower than lending to corporates. Improvements to efficiency are still required and interest rates have to allow for cost recovery.

In both countries, the World Bank (IBRD) with other state or international development partners, provided financial support to state owned wholesale banks with influence and commitment to develop the MSME lending market. Both projects ensured that there were sufficient number of participating financial institutions leading to competition and innovation, which brings down interest rates for MSMEs. Incentives for banks to participate included long term funding and freedom to set interest rates for borrowers. Technical Assistance was provided to the banks more intensively to serve MSE than SME segment, to ensure profitability of MSME lending.

The lessons from China and Turkey show that sufficiently high pricing can be justified provided it does not kill the SME borrower. In general, interest rate caps tend to discourage SME lending by banks. Reliable and comprehensive credit information system is beneficial providing both positive and negative credit information. Bank provisioning rules should not penalize unsecured lending if risks are analyzed and managed well. Clients without financial statements can be served, provided their cash flows are understood and monitored. The costs and time of transactions matter – these depend on: (i) branch networks available to SME; (ii) centralized registration of collateral and the cost and time it takes; (iii) types of registrable collateral; and (iv) capital requirements.
China

Key facts:
- $145 million IBRD and KfW Loan for on-lending
- $5 million KfW grant for Technical Assistance
- Participating Financial Institutions (PFIs): 11
- Period: 2007-2011

Results:
- Cumulative number of MSE borrowers: 205,372
- Volume of MSE loans disbursed: $2.3 billion
- Average loan size: $11,199 (twice the GDP per Capita)
- NPLs: < 1%
- Profitability: 11% (i.e. difference between lending rate charged by PFIs and total cost of providing micro loans)

Figure 6: China Micro and Small Enterprises (MSE) Finance Project

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¹World Bank: Enhancing access to finance for underserved MSEs in China (Technical Note), 2014.
Turkey

<table>
<thead>
<tr>
<th>Key facts:</th>
<th>Results:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• $1.7 billion IBRD loans for on-lending (about 20% of total IFI financing)</td>
<td>• Cumulative number of SME borrowers: 506</td>
</tr>
<tr>
<td>• 22 PFIs</td>
<td>• Average loan size: $1.2 M for leasing companies and $2.6M for banks (119 times and 258 times the GDP per Capita respectively)</td>
</tr>
<tr>
<td>• Period: 2000-2011</td>
<td>• NPLs &lt;2%</td>
</tr>
<tr>
<td></td>
<td>• Export by sub-borrowers grew by 117% between 2003 and 2006 and 95% between 2005 and 2008 (vs. 85% and 80% for exporting firms in same sector)</td>
</tr>
<tr>
<td></td>
<td>• For every $1 loan, exports increased by $ 7.1</td>
</tr>
</tbody>
</table>

Figure 7: Turkey Export Promotion Project

Note: Participating Financial Institutions (PFIs) included commercial banks and leasing companies

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5 World Bank: Expanding export capacity of Turkish companies (Technical Note), 2014.
Key Challenges
Global lessons confirm the view that the challenges faced by SMEs in Africa can be overcome through a combination of focused activities. Increasing access to finance for SMEs in Africa will therefore require addressing the following:

- How to increase resources available (i.e. capital increase) to both private venture funds, Angel investor, and state-owned development banks that target on-lending to SMEs finance
- Providing public support for investments that bring innovations and new technologies including non-bank financing into African markets (e.g. internet backbone and other infrastructure)
- How to mitigate risk perception by Financial Intermediaries (FIs) and commercial banks for financing SMEs, and ensure scale for them to reach SMEs profitably
- Strengthening SME capacity through development of business management skills, financial literacy, information systems and availability of skilled workforce
- Reducing reliance on fixed collateral by introducing secured transactions register that includes moveable assets
- Implement government policies that promote access to markets for SME products, particularly improving the investment climate and business environment by streamlining regulations and procedures.

Issues to be addressed

Access to Finance
- Capitalizing Financial Intermediaries, national development banks, etc., and private sector investors
- Early-stage and innovative finance; Financing Research and Development
- Risk mitigation and guarantee instruments
- Trade/Supply chain finance (factoring, leasing, etc.)
- Financial sector infrastructure (payment systems, collateral registry, etc.)

Enabling Environment
- Registration and licensing reforms
- Property rights protection; Efficient judiciary system
- Competition and trade policies
- Lower compliance costs throughout the business lifecycle of SME firms

Firm-Level Capabilities
- Firm level training & Skills development
- Management capacity building
- Acceleration and Incubation support
- Innovation and Upgrading technology

Access to Markets
- Supply chain development
- Investment policy
- Trade logistics & infrastructure