Discussion note

Finance in Africa: stimulating growth finance

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There is a widely held perception that investing in new and growing businesses is inherently risky, yet the evidence suggests that SMEs who receive advice and support are likely to survive and prosper. This is as true in Africa today as it is in the UK. But the support must include access to finance – and microfinance can only partly fill the gap. And then there is the challenge of scale. **David Irwin** poses some ideas to stimulate debate…

I set up one of the first local enterprise agencies in the UK – in 1980 – and created one of the UK's first micro-finance schemes. We assisted clients to develop their business skills, to write business plans and to access finance from the banks and others and often assisted with a loan from our loan fund. We helped growing businesses as well - to raise finance from the banks, from seed and venture capital funds, and elsewhere, typically packaging support of £50,000 to £500,000.

There were two key factors in our success – we assisted clients to write compelling business plans and we instilled confidence in commercial investors that we had lowered the risk. This required effort to appraise clients' ideas, to develop a relationship and to support them to prepare business plans – and, when we were lending, to do so based on cash flow forecasts and not on balance sheets.

I now spend much of my time in Africa – working on enterprise support and regulatory reform. For example, I did much of the preliminary work to set up the Abuja Enterprise Agency. I have worked with the Gatsby Trusts which, despite their name, are business support organisations in Cameroon, Kenya, Tanzania and Uganda.

Business development makes an important contribution to economic growth and poverty alleviation in developing countries. Economic growth is closely associated with reductions in poverty (World Bank, 2004a, UNCTAD, 2008). In common with other international donors, the World Bank (2004b) argues that an important driver of economic growth is a vibrant private sector. Balunywa (1998) asserts that "it is now generally agreed that small businesses are one of the key engines of growth in many developing countries by contributing to employment creation". The Commission for Africa (2005) stresses that growth will drive down poverty more rapidly if poor people are better able to participate in society and the economy. They suggest that poverty reduction through growth requires a focus on supporting and growing indigenous private businesses.

The informal economy in sub-Saharan Africa is estimated to account for 78 per cent of non-agricultural employment and 92 per cent of new jobs. But informal businesses have limited access to finance, so there are limits to how much they can grow. And larger firms create jobs faster than smaller firms, provided that they can secure the resources that they need.

For understandable reasons, banks in most developing countries are reluctant to lend to aspiring entrepreneurs, so most businesses rely on micro-finance institutions (MFI).

In 2008, some 160 MFIs participated in Microfinance Information Exchange's annual benchmarking. They provided some $2.5bn in loans to 5.2m borrowers. However, the highest penetration rate (that is, the ratio borrowers to the population) is only 2.6 per cent (Kenya) with most less than two per cent. The average loan is $317. Average financial self-sufficiency of the MFIs is 95 per cent, but return on equity is negative: -1 per cent, so they are not sustainable without continuing grant aid.

Considerable effort has been expended on supporting and growing the reach of micro-finance, but they do not support businesses once they really start to grow – perhaps making the mistaken assumption that they have become attractive to commercial finance institutions.

Growing beyond micro-finance

The consequence is that there is a gap – a missing middle where businesses have grown to employ 20 or 30 people and have good prospects – that is not filled by commercial sources.

Cameroon Gatsby Foundation lends to women through credit circles. They support some 35,000 beneficiaries through 550 groups and provide limited business development support alongside their loans. When they last undertook a strategic review, they identified a need to provide a ladder of support that enabled borrowers to progress from group micro-loans, perhaps a number of times, through individual micro-loans guaranteed by the group, to individual loans, to commercial loans guaranteed by CGF, to fully commercial loans or even equity. Even with a leading banker as their Chairman, they have struggled to find the resource to move beyond group micro-loans.

I undertook much of the early work for the establishment of the Abuja Enterprise Agency. I was anxious that this should not raise expectations by providing business development support but then fail to assist clients to raise finance, so AEA created a micro-loan fund alongside – and persuaded a couple of the banks to provide three staff on secondment to manage the fund. They have been modestly successful. But, even with bankers assisting them, businesses find id it difficult to raise further support as they grow. Nominally there are schemes in Nigeria to support businesses raise larger loans from the banks; in practice, however, it is very difficult for businesses to access this money.

The Africa Finance Corporation, a private sector led investment bank and development finance institution, estimates that there could be up to $130bn of investment opportunities across Africa in the next five years.

The problems

As in the UK 25 years ago, the major problem is that the banks do not understand how to assess risk in small and growing businesses. The assumption seems to be that the only way to deal with risk is to take high levels of collateral. It is rare that banks refer clients to small business support organisations and equally rare that business support organisations refer clients to the banks, so they don't gain experience or build trust in working with each other. There is no creativity, either, in the way that investment finance is provided.

The solution

I think that there are three requirements:

- There is an opportunity for more non-bank investors to provide finance to businesses that need significantly more than a few thousand dollars;
- There needs to be experimentation with investment mechanisms, including quasi-equity, to identify what works well and what can be grown to scale;
- Businesses need good mentoring and support with management development, networking and marketing.

It is also important, as Honohan & Beck (2007) stress, that donors do not drive out commercial investors by subsidising credit that is then provided to businesses who would probably have secured it anyway.

References

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Biographical note

David Irwin consults in enterprise and economic development. He works with business support initiatives, social enterprises and regulatory reform programmes, mainly in Africa and the UK. Clients include the Department for International Development, Danish International Development Agency, World Bank, Esmee Fairbairn Foundation, Gates Foundation and Sainsbury Family Charitable Trusts.

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