SME Finance in Sub-Saharan Africa:
How do we achieve significant scale & reach?

Executive Summary & Call to Action

31 August 2017

Enclude
PEOPLE. PRINCIPLES. PROSPERITY
Aspen Network of Development Entrepreneurs
Shell Foundation

Small and medium enterprises (SMEs) form a crucial part of the economies in emerging markets, and contribute significantly to employment and income at the household level. However, access to finance is a key constraint for SME growth. The lack of financing options is particularly problematic for the 'missing middle' SMEs that are too big for microfinance institutions and too small or perceived as too risky for traditional banks and private equity firms. Generally, there is an under-appreciation and lack of interest in financing moderate growth SMEs in emerging markets, which are considered to be the backbone of emerging market economies.

In response to this critical gap, **the Shell Foundation commissioned Enclude and the Aspen Network of Development Entrepreneurs (ANDE) to conduct research on how to spur significant scaling up of investment in and reach to SMEs in Sub-Saharan Africa over the coming three to five years**. For this study, the target SME market was identified as those in the "validate" and "prepare" stages of growth[1], which are seeking $250,000 to $1 million in capital located within Sub-Saharan Africa (referred to throughout as our "Target Market").

The research and resulting calls to action of this study are grounded in four driving questions:

1) What is the current amount of capital supporting SMEs in Sub-Saharan Africa?
2) Which are the most promising approaches to increasing capital?
3) Who/which institutions would provide a significant increase in finance?
4) What is required to see asset owners invest more capital?

This study is based on research conducted from late 2016 to mid-2017, with **generous participation from leading providers of SME finance globally through roundtable discussions, surveys and interviews.** The findings in this report highlight both individual approaches and systemic interventions necessary to achieve significant scale.

Roundtable Discussion - 16 Participants (November 2016)

Survey and Interviews Conducted - 14 and 10 Participants Respectively (April and May 2017)

And more

Research Reports Reviewed- 30+ Reports

And more

[1] As defined in, "From Blueprint to Scale: The Case for Philanthropy in Impact Investing", Monitor Group (2013)

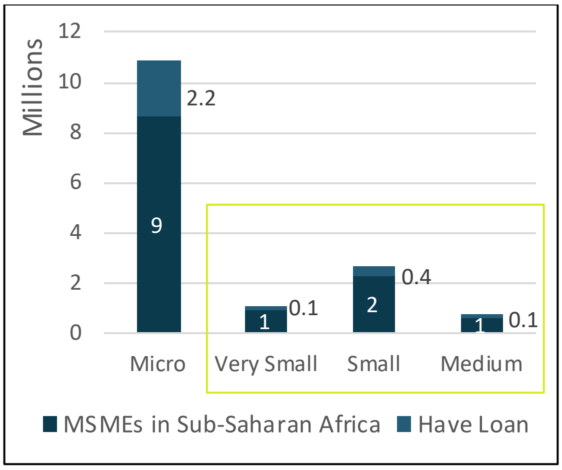
Workshop - 11 Participants (March 2017)

Enclude, rootcapital, CapPlus, Open Capital Advisors, European Investment Bank, Smallholder, Aspen Network of Development Entrepreneurs, Triple Jump, USAID, I&P Investisseurs & Partenaires, Shell Foundation

Question 1: What is the amount of capital supporting SMEs in Sub-Saharan Africa?

There is generally a lack of data about SMEs in emerging markets, and specifically on our Target Market.

Nonetheless, based on the best available data, we estimate that there are 9.4 million formal and informal SMEs in our Target Market. Moreover, we estimate that there is currently $25.7 to $30.7 billion in debt outstanding to these SMEs, and around $0.53 billion in equity and mezzanine financing under management targeting those SMEs – leaving a total capital gap reaching upwards of $70 billion.[2] It is reasonable to assume that of the estimated 9.4 million SMEs, at best 1 in 3 have access to a loan; it seems evident that even fewer have access to an appropriate equity or mezzanine instrument. **There is no doubt that the capital gap for our Target Market is significant**.



A stretch goal would be both an increase in the quantum of financing, with a goal of **an additional $3 billion in financing in the next three to five years,** as well as better distribution of debt, mezzanine and equity financing within our Target Market, moving **from 1 in 3 SMEs having access to debt financing to 2 in 3, and expanding the amount of equity and mezzanine instruments available to our Target Market.**

Question 2: Which are the most promising approaches to increasing capital?

The research team **evaluated a total of 10 approaches** that had the potential to significantly increase the quantum and distribution of financing, and reach the stretch goal highlighted above. The solutions considered represent a combination of "instrument" (e.g. debt, equity, grant) and "distribution channel" (e.g. fund, licensed financial institution, NBFI, etc.). For some recommended approaches, the instrument was effectively channel neutral meaning that it could be distributed by a range of

[2] *Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises. IFC Advisory Services (2011)*

operating entities (referred to as a "multi-channel" solution); in other cases the instrument was channel specific.

1) Accelerator linked fund
2) Asset-backed financing
3) Commercial bank with an 'SME unit'
4) Crowd-funding models
5) Flexible debt instrument
6) Investment fund providing royalty-based or convertible loans (mezzanine)
7) Licensed deposit-taking microfinance institution
8) Non-Bank Financial Institution (NBFI) providing flexible debt
9) Recoverable grants
10) Tailored private equity fund

While evaluating the above approaches, we **considered both the requirements of asset owners and SMEs**, to ensure that the approaches were both 'investable' and grounded in local realities.

Specifically, key criteria included the demonstrated strategic, operational and financial viability of the approaches, the ability to serve the needs of our Target Market, the possession of central archetypal features, and prominent mentions from those interviewed and surveyed.

In terms of the central archetypal features, our research found that the most successful models possess high degrees of: (i) nimbleness, (ii) improvement of risk management and operational efficiencies, (iii) a modified approach to collateral, and (iv) digital front- or back-end components.

Based on these criteria, we identified the five most promising approaches (listed in order of absorptive capacity and investor appetite in current market conditions):

- **Commercial bank with an 'SME unit' (channel specific)**: this should be an important source of debt financing for our target SMEs, and banks have the infrastructure for financing at scale; the regulated financial institution structure provides a solid operating platform that, when used effectively, has significant potential for scale and reach
- **Investment fund providing mezzanine (multi-channel)**: especially important for higher growth SMEs that cannot or will not offer equity; this can be a product that can be standardized and is increasingly popular among specialist funds
- **Asset-backed financing (multi-channel):** critical for large asset procurement by SMEs, although often constrained by inadequate legal and regulatory regimes; distribution can be effected through a range of channels, from regulated financial institutions to non-bank financial institutions to funds
- **Flexible debt instrument (multi-channel)**: there is growing recognition that standard financing products do not necessarily meet the needs of our Target Market, so flexible instruments are essential; distribution of this instrument has application across a range of financial intermediaries, from regulated financial institutions, non-bank financial institutions to funds

- **Tailored private equity fund (channel specific with design variety)**: equity financing for our Target Market is scarce, but equity is necessary to strengthen SME balance sheets, crowd in local financing, and provide long-term growth capital; a fund structure as the primary channel for distribution is highlighted as familiar to investors, although a growing trend is exploring whether a fund should be open-ended for an unlimited duration or closed-ended with a fixed term

It is important to note that **we need a combination of approaches delivered by a variety of actors to meet the needs of our Target Market** – there is no single approach or solution that alone will achieve the stretch goal of an increase in scale and reach of investment capital. Additionally, a variety of capital types – debt, equity, and mezzanine – are required to support the 'building blocks' of the SME balance sheet.

Across all of these approaches, three themes emerged to enhance the efficacy of the solution: (i) the critical need for well-structured subsidies and/or concessional capital for these approaches to be viable, (ii) the primacy of business development services for the target SMEs, recognizing that effective business development services also require subsidy, and (iii) the advent of technology as a potential catapult to scale. Firstly, subsidies and concessional capital played a key role in building the microfinance industry, and similarly, this type of capital will be critical in building the industry for SME financing in Sub-Saharan Africa. Secondly, funding for and effective delivery of business development services has proven challenging and the costs of delivery often weigh on returns generated for investors; yet these services remain critically important to the success of our Target Market. Thirdly, various applications of technology – across the prioritized approaches – are not yet tapped; these technology applications are positioned to dramatically improve core functions, such as credit risk management, as well as lower the costs of transacting for SMEs and intermediaries.

Thus, to achieve the stretch goal in financing our Target Market with the amount and type of capital they need as they grow, we believe **increased focus should be given to all five promising approaches, while recognising the critical importance of subsidies, business development services and technology**.

Question 3: *Who/which institutions would provide a step change in finance?*

Current asset owners and asset managers include an array of commercial, quasi-commercial, and donor actors, including Development Finance Institutions, foundations, family offices, corporations, development banks, high-net worth individuals, and governments. That being said, **the overwhelming majority of capital for our Target Market has come from Development Finance Institutions**, and more recently from foundations, albeit at more modest levels.

Barriers to increased investment in our Target Market, especially among the largest investors – Development Finance Institutions and foundations – are many, but the chief reason cited is the **under-performing financial returns of current investments in SMEs in Sub-Saharan Africa (relative to expectations), most acutely impacted by exchange rate volatility and depreciation**. When considering returns, it should be noted that nearly all private equity and venture capital funds in Sub-Saharan Africa have underperformed relative to financial expectations, whether or not those funds were focused on SMEs. The Global Impact Investing Network (GIIN) found that market-rate expectations are 16.5% on equity in emerging markets (across regions and sectors).[3] However, Cambridge Associates found that net IRRs of private equity and venture capital funds in Sub-Saharan Africa were generally in the single digits for the period between 2012 and 2016, and in the low single digits in each of 2015 and 2016.[4]

Other serious barriers to increased investment in our Target Market include lack of skilled investment management talent in many markets in Sub-Saharan Africa, high costs of underwriting and transaction structuring, and limited access to sub-commercial and donor funding.

For both current and new investors coming into the Target Market, there is a need to re-calibrate financial return expectations to accurately reflect the performance of the underlying SMEs and the operating environment of Sub-Saharan Africa. Perhaps, more importantly, **there is a need – and an opportunity – to reframe return expectations to explicitly reflect the positive impact results to be realized at the enterprise, sector, and country levels**. On average, it is estimated that formal SMEs contribute up **to 60% of total employment and 40% of national income (GDP) in emerging economies**, with much higher numbers when informal SMEs are also included. In these countries, this segment of firm also creates **4 out of 5 formal jobs**.[5]

Even with well-structured subsidies, recalibrated and reframed return expectations, the risk/return profile of our Target Market of SMEs suggests that large scale, highly commercial players, such as pension funds, are not likely to be a major source of new near-term capital. For now, **we need more quasi-commercial, sub-commercial and donor capital to be deployed.** While Development Finance Institutions and foundations have been the main supporters to date, and we believe they will need to continue to be the main supporters for the years to come, impact investors have largely stayed on the sidelines. Recognizing this is

[3] 2017 Annual Impact Investor Survey 2017. Global Impact Investing Network. 7th Edition

[4] Cambridge Associates pooled end-to-end returns, net of fees, expenses and carried interest. 2016

[5] Small and Medium Enterprises (SMEs) Finance Brief, World Bank, 2016

a niche community with limited capital, we believe this group should and could become more active in financing our Target Market. Another group that to date has hardly provided any capital to our Target Market of SMEs is corporations. This group could be responsive to a business case tied to financing SMEs within their supply chains, and more generally helping to achieve the Sustainable Development Goals in emerging markets.

Question 4: *What is required to see asset owners invest more capital?*

Building on Question 3, in order to move asset owners to deploy more capital, **we must be creative and courageous, and redefine the risk-return-liquidity-impact paradigm for investing in our Target Market**. The investment opportunity, which is both large and vitally important for local economies, cannot be ignored. At the same time, we need to recognize that there is a gap between expectations and the current reality.

To progress the quantum and distribution of financing for SMEs in Sub-Saharan Africa in any meaningful degree from asset owners – whether they already provide funding and investment or are still on the side lines – **we need to focus efforts at two levels**:

1. Bridge the expectation gap at a **transaction and operational level**
2. Galvanize action to tackle, or at least chip away at, **systemic barriers**

At the transaction and operational level, we need to consider blended finance structures as time-bound tools that can address – in specific situations – financial return issues, foreign exchange exposure, track record, and performance duration. During the period of building markets and proving performance, **well-structured blended finance solutions are essential "wheels" to move us on the road** to sustainable SME financing at scale. We also need to build into deal structures sustained delivery of business development services with demand-driven relevance of the support services shaped by the SMEs.

At the systemic level, we need to focus on: (i) lack of data on the profile and performance of our Target Market to set realistic risk / return expectations for investors, (ii) constraints of accessing and building local talent, (iii) foreign exchange fluctuations in emerging markets, and Sub-Saharan Africa specifically, and (iv) stimulation of the domestic capital markets.

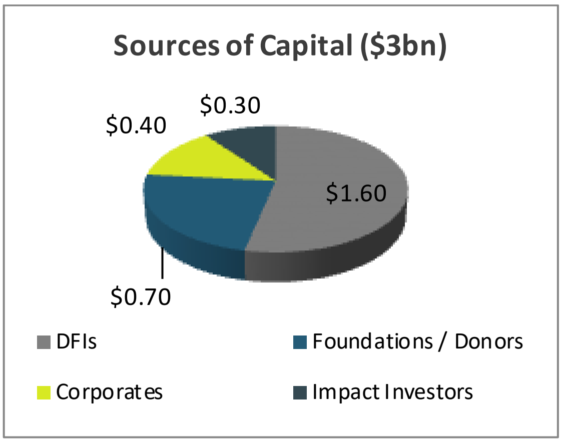
Lowering the barriers at both levels – transaction/operational and systemic – will require not only thoughtful, well-designed interventions coordinated among many actors, but will also need targeted subsidization using grant and/or concessional capital support. **Grant support is material, not marginal, to address these barriers and to create the**

necessary enabling environment for financing of SMEs in Sub-Saharan Africa.

Recognizing the importance of subsidy, we believe it is vital to sharpen its "use case" – what is the entry point of subsidy and what can we expect to change as a result, with clarity about who benefits. Overtime, we can – and should – expect to see a migration of the application of subsidy **moving from interventions at the transaction and operational level to the systemic level**, suggesting that there is a **time-bound nature to the level of subsidy needed at the transaction and operational level** of SME activity.

In considering the need for subsidy, it is instructive to keep in mind the role of subsidy – at scale – in building comparable market activity. The microfinance market has benefited from decades of assistance and billions in subsidy, where the levels and amounts followed a similar trajectory of **increased focus and migration from transaction level to systemic level support.** We should learn from this experience as we update the subsidy map for support of our Target Market.

As highlighted in Question 1, we believe $3 billion in additional capital over the coming three to five years represents a reasonable stretch goal towards beginning to fill the financing gap in our Target Market. We anticipate that **Development Finance Institutions will remain the source of just over half the additional capital,** with donors and foundations stepping up to provide about a quarter of that capital, and corporates and impact investors providing the remaining quarter.



In terms of uses (deployment) of the additional capital, we anticipate that **solutions linked to commercial banks will command the greatest portion of capital (40-50%), given their absorptive capacity and potential for scale.** Commercial banks that embrace fintech solutions, most effectively through smart partnerships, will outperform. Mezzanine funds will also be able to absorb a significant portion of that capital (20-30%), both because of the demand for such financing from SMEs and the growing interest amongst investors in that approach. Asset-backed financing solutions will closely trail (10-15%), with equity funds and flexible debt instruments absorbing the remaining (5-10%) each, not because there is less demand for those products, but because they are generally perceived as more risky by investors.

Call to Action

We need to embrace a strategic and systemic 'action framework' as anchored in three dimensions: (i) capital providers funding (ii) promising solutions, enabled through (iii) collective action initiatives.

Before offering specific action steps, it is important to re-emphasize several broader messages that are critical for the suggested promising approaches to have any chance of addressing the stubborn challenge of sustainable financing for SMEs in Sub-Saharan Africa. At a collective level, key stakeholders should:

- move from diffuse and fragmented transactions to more **strategic, smart and systemic investments**
- focus on **real economy SMEs**, those that produce tangible goods and services that meet people's real needs, accepting that basic business may not be 'sexy', but it's solid
- have honest dialogue that is grounded in **real data**, not hyperbolic dialogue that underestimates the challenges and masks the potential solutions
- **recalibrate return expectations** to recognize the perhaps more modest, but steady financial returns that SMEs can deliver, including those with more modest growth profiles
- reframe the value proposition to reflect **the 'total return'** from investing in productive SMEs, rather than seeking the 'home-run' of finding the next 'Steve Jobs in Ethiopia'; economic and social returns, such as relative contributions to Gross Domestic Product (GDP) and employment, should become part of the investment thesis and part of the value proposition attracting funders to 'purchase' impact
- identify and galvanize **sources of grant and sub-commercial capital**, recognizing these sources as critical in achieving the ambition for scale and reach, while demonstrating how the need for grant and sub-commercial capital will decline over time at the transactional and operational level as SME investment opportunities mature and scale, particularly with the use of technology to drive costs down
- more **'doers' than 'talkers'** joining the community of committed actors with targeted efforts to invite local governments and funders with appetite for 'purchasing' development outcomes generated by SMEs

With the action framework in mind, as well as the key messages, we believe that the following specific actions offer a tangible and critical way forward to ensure that SMEs in Sub-Saharan Africa receive the capital they need to scale, create jobs and contribute to the comprehensive development goals set out by the United Nations through the Sustainable Development Goals.

Collective Action Initiatives

ACTION 1:

Building a data set (rather than data points)

Fundamental to achieving scale and reach is having a robust data set that tracks and enables analysis and sharpens insights of size, distribution, trajectory, returns and other data in comparable ways. We need a collective commitment to **open and honest sharing of investment data** – financial and non-financial – both to inform and guide capital allocations, and also to establish an impact benchmark that will motivate new actors seeking impact returns. To achieve this we must:

- encourage Development Finance Institutions (and other key actors) to **share their data**
- invite ANDE or a similar industry actor, together with academic institution(s), to be the **repository of SME data,** and take ownership of data collection, distribution, and warehousing
- **provide funding**, mainly through Development Finance Institutions and foundations donating $100,000 per institution per year for collecting, analysing, and disseminating the data

ACTION 2:

Focus on one country as a community of actors

Going deep into one country as a community of actors would help demonstrate the viability of the five most promising approaches, and potentially help catalyse quantum steps in capital mobilization. To achieve this we must:

- build a coalition of funders that **commits to a strategic financing plan for a specific country** (e.g. Uganda as a relevant example) to show what can be done with a density of funders financing promising approaches simultaneously, pursuant to **a smart, strategic plan for scale and reach**
- encourage a Development Finance Institution or foundation to **fund a 'blue print for action'** in the target country to address macro environment issues that enable transaction-level activity
- provide incentives and guidance to a **diversity of financial and advisory intermediaries** to facilitate capital distribution into existing and new initiatives in the target country

ACTION 3:

Unlock Domestic Capital Markets as the only viable solution to FX issues

Unlocking domestic capital markets is the only viable solution to foreign exchange (FX) issues. We have seen the consistent and serious effect caused by FX issues, both volatility and depreciation. In the near-term, we need to create structures and solutions using blended finance. To achieve this we must:

- encourage Development Finance Institutions, impact investors, and foundations to participate in structures that use **different layers of capital** to mitigate FX exposure in order to keep the cost of capital appropriate for the SME
- encourage Development Finance Institutions to **embolden domestic institutional investors** to participate in structured blended deals, that will be grounded and guided by Development Finance Institutions' expertise and willingness to sit in the higher risk chair in the capital structure
- establish a track record through these blended capital structures that will stimulate domestic investment activity that is not dependent upon FX mitigation

ACTION 4:

Build local talent and local content

Ultimately, reliable support for our target SMEs requires local quality resources. We should ensure that every technical assistance program and investment vehicle is structured and managed with an eye to building these local resources. To achieve this:

- Development Finance Institutions and foundations should prioritize technical assistance expenditures that focus on **developing local skills, capabilities, and ownership**
- all actors should ensure that any country-level 'blueprint for action' as proposed in Action 2 **connects local organizations that strengthen talent** (e.g. universities and accelerators)

Capital Providers

In sum, each of the actor groups has a key role to play in addressing the urgent financing gap that plagues the 'missing middle' SME market in Sub-Saharan Africa. Below we outline where each stakeholder should take the lead in this effort:

Development Finance Institutions…

- will need to continue to be the **primary financier** of these SMEs over the next three to five years, **re-calibrating their return expectations** to reflect the investee risk/return profiles, as well as the local market environment

- **strengthen the analysis of the positive impact return** realized by investing in our target SMEs
- **lead in making the case for SMEs** through (i) data and track record, (ii) increased investment, (iii) mobilization of local capital, (iv) development of local talent, to crowd-in other capital providers, and (v) develop and demonstrate the case for declining amounts of subsidy and sub-commercial capital as SME investment intermediaries mature and scale

Foundations…

- should continue supporting **more innovative approaches** to SME financing (e.g. explicit participation in blended finance transactions), and help finance the building of the **SME financing ecosystem** (e.g. grant funding for SME, Intermediary, and market-level capacity building)

Impact investors…

- are **encouraged to step up** and start providing financing to SMEs through existing approaches, as well as invest in the development of more innovative solutions
- seem particularly well suited to push the **business development services and technology** frontiers and should proactively pursue and encourage incorporation of these important delivery elements across all SME investment approaches

Corporates…

- **need to be engaged** through data sharing and track record, as well as business cases linked to the Sustainable Development Goals and/or their own value chain requirements, to provide capital down the line

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