Financing Small and Medium Enterprises in Africa

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Overview

The development of the private sector varies greatly throughout Africa. SMEs are flourishing in South Africa, Mauritius and North Africa, thanks to fairly modern financial systems and clear government policies in favour of private enterprise. Elsewhere the rise of a small-business class has been hindered by political instability or strong dependence on a few raw materials. In the Democratic Republic of Congo, for example, most SMEs went bankrupt in the 1990s – as a result of looting in 1993 and 1996 or during the civil war. In Congo, Equatorial Guinea, Gabon and Chad, the dominance of oil has slowed the emergence of non-oil businesses.

Between these two extremes, Senegal and Kenya have created conditions for private-sector growth but are still held back by an inadequate financial system. In Nigeria, SMEs (about 95 per cent of formal manufacturing activity) are key to the economy but insecurity, corruption and poor infrastructure prevent them being motors of growth.

Africa's private sector consists of mostly informal micro enterprises, operating alongside large firms. Most companies are small because the private sector is new and because of legal and financial obstacles to capital accumulation. Between these large and small firms, SMEs are very scarce and constitute a "missing middle." Even in South Africa, with its robust private sector, micro and very small enterprises provided more than 55 per cent of all jobs and 22 per cent of GDP in 2003, while big firms accounted for 64 per cent of GDP.

SMEs are weak in Africa because of small local markets, undeveloped regional integration and very difficult business conditions, which include cumbersome official procedures, poor infrastructure, dubious legal systems, inadequate financial systems and unattractive tax regimes. Many firms stay small and informal and use simple technology that does not require great use of national infrastructure. Their smallness also protects them from legal proceedings (since they have few assets to seize on bankruptcy) so they can be more flexible in uncertain business conditions.

Large firms have the means to overcome legal and financial obstacles, since they have more negotiating power and often-good contacts to help them get preferential treatment. They depend less on the local economy because they have access to foreign finance, technology and markets, especially if they are subsidiaries of bigger companies. They can also more easily make up for inadequate public services.

Restricted Access to Finance

Africa's SMEs have little access to finance, which thus hampers their emergence and eventual growth. Their main sources of capital are their retained earnings and informal savings and loan associations (tontines), which are unpredictable, not very secure and have little scope for risk sharing because of their regional or sectoral focus. Access to formal finance is poor because of the high risk of default among SMEs and due to inadequate financial facilities.

Small business in Africa can rarely meet the conditions set by financial institutions, which see SMEs as a risk because of poor guarantees and lack of information about their ability to repay loans. The financial system in most of Africa is under-developed however and so provides few financial instruments. Capital markets are in their infancy, shareholding is rare and no long-term financing is available for SMEs. Non-bank financial intermediaries, such as microcredit institutions, could be a big help in lending money to the smallest SMEs but they do not have the resources to follow up their customers when they expand. Improving business conditions, boosting the capacity of SMEs, expanding the financial sector and strengthening links between firms will permanently increase SMEs' access to finance.

Improving business conditions

Proper information, a key to deciding whether to make a loan, would be helped by adopting clear accounting standards, setting up independent, competent and reputable accounting firms and creating more credit bureaux supplying data on the solvency of firms.

An impartial legal system that can help settle contract disputes, commercial law reform and drafting and clarifying land titles, as well as effective bankruptcy procedures, are vital for growth of the business sector.

A country's tax laws can either coax small businesses into the formal sector of the economy or keep them out of it.

Governments should also make sure that they pay SMEs promptly, since public contracts are vital to the financial security of these firms.

First published in Policy Insights No. 7, a joint publication of the African Development Bank and the OECD Development Centre (www.oecd.org/dev/)

Helping SMEs meet the requirements of formal financing

Apart from the need to boost SME capacities, some financial instruments can help provide missing information or reduce the risk stemming from some SMEs' lack of transparency.

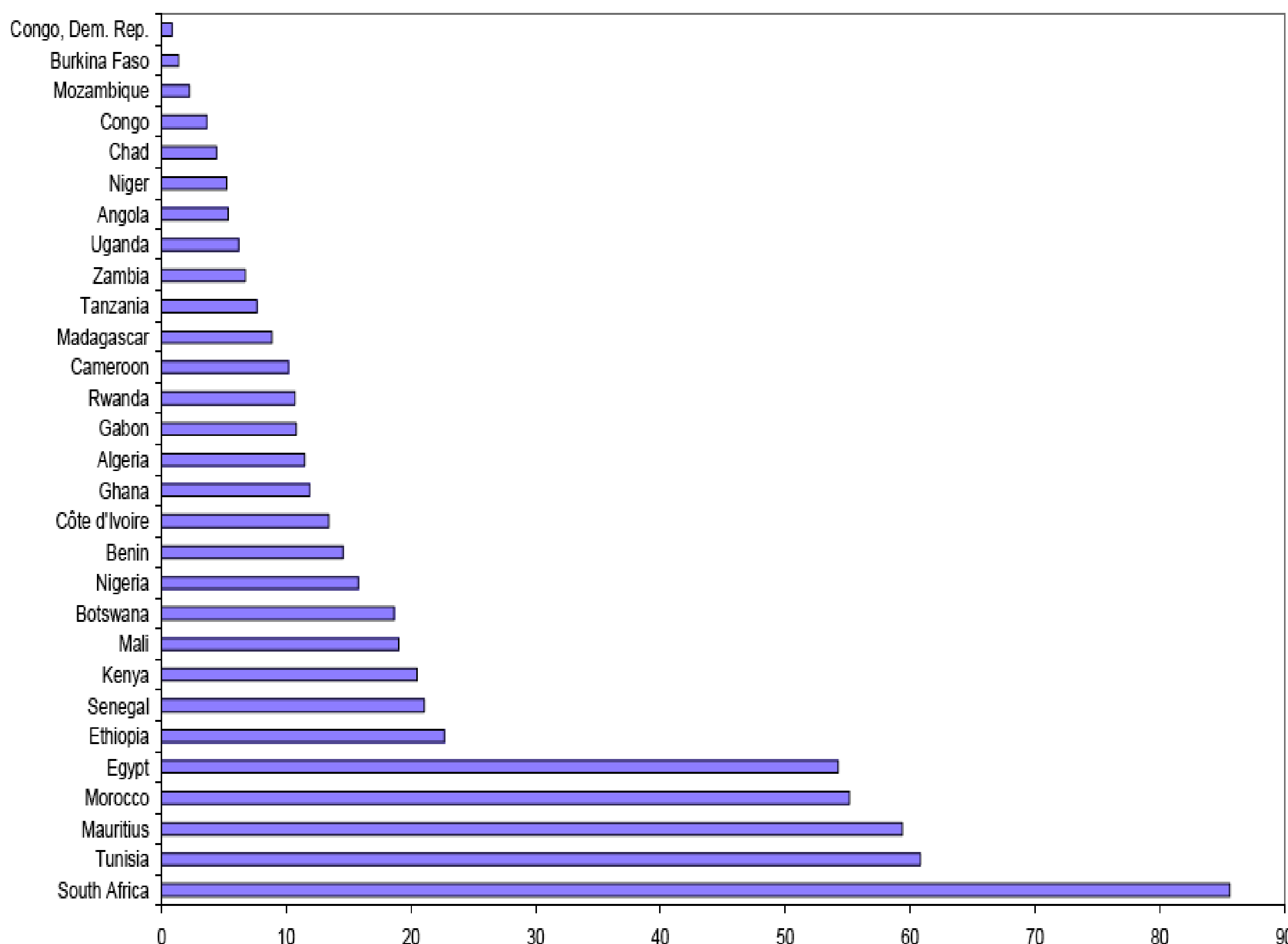
Franchising, which is very popular in Southern and East Africa with the encouragement of South Africa, allows use of a brand name or know-how that reduces the risk of failure. Warehouse-receipt financing (in South Africa, Kenya and Zambia) guarantees loans with agricultural stocks.

Other financial instruments, such as leasing and factoring, can reduce risk effectively for credit institutions but are still little used in Africa. Credit associations that reduce risk by sharing it are more common. They help financial institutions choose to whom to lend, by guaranteeing the technical viability of projects, and sometimes providing guarantees. But growth of these bodies is limited by the lack of organisation among SMEs in Africa and by their focus on certain sectors and geographical areas.

Governments and donor sources have thus preferred creation of guarantee funds to ensure repayment in case of default. In several countries, especially in Central Africa, this has not worked since provision of a guarantee has meant less rigorous choice of investment projects and a lower rate of debt recovery. Elsewhere, notably in Mozambique, borrowers and financial institutions have worked together to maintain a good rate of recovery and to reduce interest rates.

Making the financial system more accessible to SMEs

Most African financial systems are fragmented. The "missing middle" in the pattern of size of firm is matched by one in the range of financing available. Lack of funding for SMEs has partly been made up for by micro-credit institutions, whose growth is due to the flexible loans they offer small businesses. In Angola, Novobanco provides loans free of bank charges, without a minimum deposit and with informal guarantees (property assets and a guarantor), as well as permanent contact with loan managers. Though adapted to local needs, however, micro-credit institutions remain fragile and modest-sized.



Facts about SMEs in Africa

Very few countries have working definitions of SMEs, except some members of UEMOA/WAEMU and Mauritius and Morocco. So data on this is hard to compare, though patterns can be seen and countries can be ranked by extent of SME activity:

Nearly 80 per cent of firms in Congo have fewer than five workers. The country has 2 100 firms in the formal and 10 000 in the informal sector.

A 1997 survey in Benin showed that of the 666 SMEs counted, half were in commerce and the rest were mostly in construction, or were pharmacies and restaurants. Only 17 per cent were in manufacturing.

SMEs in Kenya employed some 3.2 million people in 2003 and accounted for 18 per cent of national GDP.

SMEs in Senegal contribute about 20 per cent of national value-added.

Nigerian SMEs account for some 95 per cent of formal manufacturing activity and 70 per cent of industrial jobs.

In Morocco, 93 per cent of all industrial firms are SMEs and account for 38 per cent of production, 33 per cent of investment, 30 per cent of exports and 46 per cent of all jobs.

Micro and very small businesses in South Africa provided more than 55 per cent of total employment and 22 per cent of GDP in 2003. Small firms accounted for 16 per cent of both jobs and production and medium and large firms 26 per cent of jobs and 62 per cent of production.

Source: African Development Bank and OECD Development Centre, African Economic Outlook (2004-2005).

Entrepreneurs are inventors of businesses. These SMEs are playing their role in feeding Ghana. But who would lend them money and technical support to improve their service, working environment and generate more incomes?

Source: AllAfrica.com

As well as lacking trained staff, micro-credit institutions face limited expansion because of their limited funds. Their mainly short-term finance means they cannot easily turn the savings they collect into medium or long-term loans.

They are also up against the cost of refinancing through the formal banking sector and have no access to refinancing either by the central bank or by venture capital. Microcredit institutions could be put on a firmer financial footing by developing and adapting long-term savings products that exist elsewhere, such as life insurance and home-saving plans, and encouraging the setting up of specialized refinance banks such as Mali's "solidarity bank" (Banque malienne de solidarité), or working more closely with the formal banking sector (Benin's SME support organization PAPME and the local Bank of Africa).

Some countries (such as Kenya) have dealt with the lack of funding by supporting growth of smaller commercial banks or (in Ghana) of rural banks, so as to bring traditional banks and SMEs closer geographically and business-wise. South Africa passed two laws in early 2005 to expand the banking system to include savings and loan institutions (second-tier banks) and co-operative banks (third-tier banks) while easing banking regulations so the newcomers could still be flexible in providing loans. In many countries, commercial banks are also setting up their own micro-credit services.

Removing the obstacles to access for SMEs' to finance requires that commercial banks, micro-credit institutions, community groups and business development services (BDS) work closely together. Pushing for agreements between financial bodies and BDS suppliers will help make up for lack of capacity and reduce costs by more efficient division of labour. The BDS supplier makes the

initial choice of projects on a purely technical basis and the credit institution looks at financial viability.

Making loans to intermediaries (NGOs and federations of SMEs) with the job of allotting funds to members can also help cut administration costs. Solidarity between banks, especially setting up inter-bank financing to (as in Nigeria) pool money to be invested in SMEs, reduces the extra risk of lending to SMEs, as well. Working with banks boosts the financial viability of micro-credit institutions and can also help informal financial bodies to move towards the formal sector.

Expanding the supply of finance through the non-financial private sector

Financial institutions are not the only source of money for SMEs. Apart from remittances by nationals working abroad, which are a key boost to private-sector growth, the interdependence between SMEs, large firms and sectoral "clusters" is a major potential source of finance, as shown in Asia and Latin America.

Big firms can do a lot to help SMEs get finance more easily by transferring resources (money and factors of production) and guaranteeing SME solvency with financial institutions. Links with major companies can also help SMEs get export credits, which are especially important in countries with weak institutions, since commercial partners are better informed than other creditors (especially financial institutions) about the ability of their customers to repay debts. Export credits have been proved useful in Zambia's agro-food industry. Subcontracting is still uncommon in Africa, but has grown rapidly in South Africa since 1998, though there is increasing scepticism about it because it may confine SMEs to low-skill informal activities.

Clusters of SMEs, which are very active in Asia, enable member firms to seek finance together, provide collective guarantees or even set up their own financial body. The threat of expulsion from the cluster ensures that promises are kept, which allows the network to overcome shortcomings in the legal system.

Frequent interaction with financial authorities, as well as the role that reputation plays in the cluster, can greatly increase confidence between firms and financial institutions and thus make it easier to get loans and lower rates of interest.

Working together also means firms can get supplier credits and can borrow from each other when necessary, which reduces general costs. Such clusters, however, are very little developed in Africa and are concentrated in South Africa, Kenya, Nigeria, Tanzania and Zimbabwe.

A CHANGING CONTINENT: THE AFRICA YOU NEVER SEE

Carol Pineau

Producer and director of the film "Africa: Open for Business,"

In the waiting area of a large office complex in Accra, Ghana, it's standing room only as citizens with bundles of cash line up to buy shares of a mutual fund that has yielded an average 60 percent annually for the past seven years. They're entrusting their hard-earned cash to a local company called Databank, which invests in stock markets in Ghana, Nigeria, Botswana and Kenya that consistently rank among the world's top growth markets.

Chances are you haven't read or heard anything about Databank in your daily newspaper or on the evening news, where the little coverage of Africa that's offered focuses almost exclusively on the negative -- the virulent spread of HIV/AIDS, genocide in Darfur and the chaos of Zimbabwe.

Yes, Africa is a land of wars, poverty and corruption. The situation in places like Darfur, Sudan, desperately cries out for more media attention and international action. But Africa is also a land of stock markets, high rises, Internet cafes and a growing middle class. This is the part of Africa that functions. And this Africa also needs media attention, if it's to have any chance of fully joining the global economy.

Africa's media image comes at a high cost, even, at the extreme, the cost of lives. Stories about hardship and tragedy aim to tug at our heartstrings, getting us to dig into our pockets or urge Congress to send more aid. But no country or region ever developed thanks to aid alone. Investment, and the job and wealth creation it generates, is the only road to lasting development. That's how China, India and the Asian Tigers did it.

Yet while Africa, according to the U.S. government's Overseas Private Investment Corp., offers the highest return in the world on direct foreign investment, it attracts the least. Unless investors see the Africa that's worthy of investment, they won't put their money into it. And that lack of investment translates into job stagnation, continued poverty and limited access to education and health care.

Consider a few facts: The Ghana Stock Exchange regularly tops the list of the world's highest-performing stock markets. Botswana, with its A+ credit rating, boasts one of the highest per capita government savings rates in the world, topped only by Singapore and a handful of other fiscally prudent nations. Cell phones are making phenomenal profits on the continent. Brand-name companies like Coca-Cola, GM, Caterpillar and Citibank have invested in Africa for years and are quite bullish on the future.

The failure to show this side of Africa creates a one-dimensional caricature of a complex continent. Imagine if 9/11, the Oklahoma City bombing and school shootings were all that the rest of the world knew about America.

I recently produced a documentary on entrepreneurship and private enterprise in Africa. Throughout the year-long process, I came to realize how all of us in the media -- even those with a true love of the continent -- portray it in a way that's truly to its detriment.

The first cameraman I called to film the documentary laughed and said, "Business and Africa, aren't those contradictory terms?" The second got excited imagining heart-warming images of women's co-ops and market stalls brimming with rustic crafts. Several friends simply assumed I was doing a documentary on AIDS. After all, what else does one film in Africa?

The little-known fact is that businesses are thriving throughout Africa. With good governance and sound fiscal policies, countries like Botswana, Ghana, Uganda, Senegal and many more are bustling, their economies growing at surprisingly robust rates.

Private enterprise is not just limited to the well-behaved nations. You can't find a more war-ravaged land than Somalia, which has been without a central government for more than a decade. The big surprise? Private enterprise is flourishing. Mogadishu has the cheapest cell phone rates on the continent, mostly due to no government intervention. In the northern city of Hargeysa, the markets sell the latest satellite phone technology. The electricity works. When the state collapsed in 1991, the national airline went out of business. Today, there are five private carriers and price wars keep the cost of tickets down. This is not the Somalia you see in the media.

Obviously life there would be dramatically improved by good governance -- or even just some governance -- but it's also true that, through resilience and resourcefulness, Somalis have been able to create a functioning society.

Most African businesses suffer from an extreme lack of infrastructure, but the people I met were too determined to let this stop them. It just costs them more. Without reliable electricity, most businesses have to use generators. They have to dig bore-holes for a dependable water source. Telephone lines are notoriously out of service, but cell phones are filling the gap.

Throughout Africa, what I found was a private sector working hard to find African solutions to African problems. One example that will always stick in my mind is the CEO of Vodacom Congo, the largest cell phone company in

that country. Alieu Conteh started his business while the civil war was still raging. With rebel troops closing in on the airport in Kinshasa, no foreign manufacturer would send in a cell phone tower, so Conteh got locals to collect scrap metal, which they welded together to build one. That tower still stands today.

As I interviewed successful entrepreneurs, I was continually astounded by their ingenuity, creativity and steadfastness. These people are the future of the continent. They are the ones we should be talking to about how to move Africa forward. Instead, the media concentrates on victims or government officials, and as anyone who has worked in Africa knows, government is more often a part of the problem than of the solution.

When the foreign media descend on the latest crisis, the person they look to interview is invariably the foreign savior, an aid worker from the United States or Europe. African saviors are everywhere, delivering aid on the ground. But they don't seem to be in our cultural belief system. It's not just the media, either. Look at the literature put out by almost any nongovernmental organization. The better ones show images of smiling African children -- smiling because they have been helped by the NGO. The worst promote the extended-belly, flies-on-the-face cliche of Africa, hoping that the pain of seeing those images will fill their coffers. "We hawk poverty," one NGO worker admitted to me.

Last November, ABC's "Primetime Live" aired a special on Britain's Prince Harry and his work with AIDS children in Lesotho. The segment, titled "The Forgotten Kingdom: Prince Harry in Lesotho," painted the tiny nation as a desperate, desolate place. The program's message was clear: This helpless nation at last had a knight -- or prince -- in shining armor.

By the time the charity addresses came up at the end, you were ready to give, and that's good. Lesotho needs help with its AIDS problem. But would it really have hurt the story to add that this land-locked nation with few natural resources has jump-started its economy by aggressively courting foreign investment? The reality is that it's anything but a "forgotten kingdom," as a dramatic increase in exports has made it the top beneficiary of the African Growth and Opportunity Act (AGOA), a duty-free, quota-free U.S.-Africa trade agreement. More than 50,000 people have gotten jobs through the country's initiatives. Couldn't the program have portrayed an African country that was in need of assistance, but was neither helpless nor a victim?

Still the simplistic portrayals come. A recent episode of the popular NBC drama "Medical Investigation" was about an anthrax scare in Philadelphia. The source of the deadly spores? Some illegal immigrants from Africa playing their drums in a local market, unknowingly infecting innocent passersby. Typical: If it's a deadly disease, the scriptwriters make it come from Africa.

Most of the time, Africa is simply not on the map. The continent's booming stock markets are almost never mentioned in newspaper financial pages. How often is an African country -- apart, perhaps, from South Africa or Egypt or Morocco -- featured in a newspaper travel section? Even the listing of worldwide weather includes only a few African cities.

The result of this portrait is an Africa we can't relate to. It seems so foreign to us, so different and incomprehensible. Since we can't relate to it, we ignore it.

There are lots of reasons for the media's neglect of Africa: bean counters in the newsroom and the high cost of international coverage, the belief that American viewers aren't interested in international stories, and the infotainment of news. There's also journalists' reluctance to pursue so-called "positive stories." We all know that such stories don't win awards or get front-page, above-the-fold placement. But what's happening in Africa doesn't need to be cast in any special light. The Ghana Stock Exchange was the fastest-growing exchange in the world in 2003. That's not a "positive" story, that's news, just like reports on the London Stock Exchange. I imagine a lot of consumers would have found it newsworthy to learn where they could have made a 144 percent return on their money.

My independent film was made possible by funding from the World Bank, for which I am extremely grateful. But the bank wouldn't have had to step in if the media had been doing their job -- showing all Africans in all facets of their lives. In a business that's supposed to cover man-bites-dog stories, the idea that Africa doesn't work is a dog-bites-man story. If the media are really looking for news, they'd look at the ways that Africa, despite all the odds, does work.

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