



Policy Insights No. 7

Financing SMEs in Africa

by Céline Kauffmann

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SMEs in Africa: the "Missing Middle"

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 micro-credit 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.

Increasing SME Access to Finance: A Four Pronged Approach

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.

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.

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. Micro-credit 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 specialised 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 organisation 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.

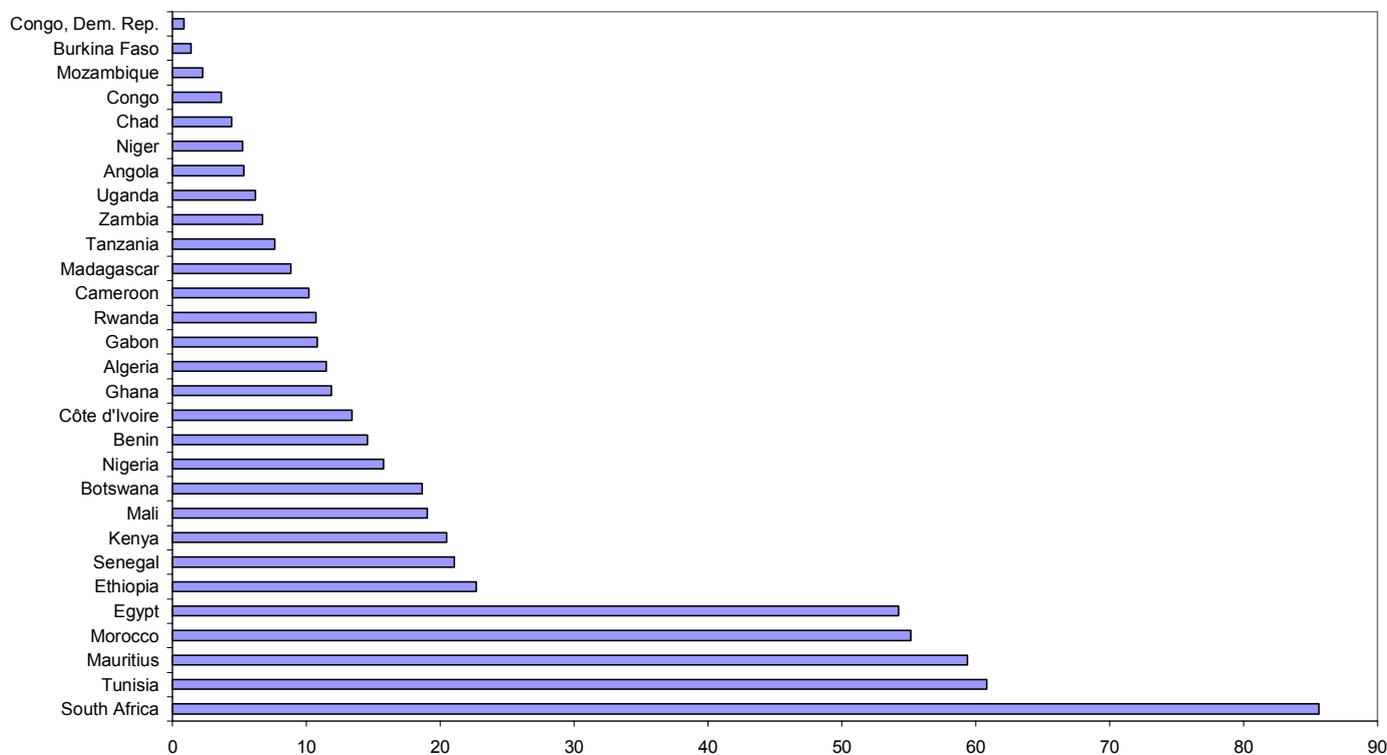
Expanding the supply of finance through the non-financial private sector

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 inter-dependence 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.

Figure 1. **Share of Credit to the Private Sector in 2003** (percentage of GDP)



Source: IMF, *International Financial Statistics*.

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)*.

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OECD Development Centre "Le Seine St Germain"
12 boulevard des Iles
92130 Issy-les-Moulineaux, France
Tel: 33 (0)1 45.24.82.00
Fax: 33 (0)1 44.30.61.49
E-mail: cendev.contact@oecd.org