London
Stock Exchange Group

LSEG Africa Advisory Group

Report of Recommendations

The challenges and opportunities of SME financing in Africa

AFRICA ADVISORY GROUP
LONDON STOCK EXCHANGE

Our thanks

We extend our thanks to the participating students from the University of Cambridge for their contributions to the research, carried out as part of the Cambridge Judge Business School MBA Students Project, GCP 2018.

Foreword

Welcome to the launch of a series of report recommendations from London Stock Exchange Group (LSEG). They were conceived nearly three years ago with the founding of our LSEG Africa Advisory Group (LAAG), which was designed to provide a platform for regular and collective dialogue through which to develop stronger relations with senior decision-makers, regulators and business leaders across the continent. I'm honoured to have been LAAG's Chairman for the past year and to have seen at first hand its commitment to provide thought leadership on the direction of policy and activity.

Let me start by offering my personal gratitude to its members, who continue to work (on a pro bono basis) to identify ways in which African capital markets could be expanded and enhanced, with our help and support. The work was carried out in conjunction with academic input from Cambridge Judge Business School and the involvement of many other stakeholders in London and across Africa, so this has been a genuinely collaborative effort with one key objective in mind: to create mutually beneficial situations, in partnership with local market infrastructures, by which to increase global investment flows and create deep and sustainable capital markets for Africa.

I believe we all share that same mission and hope that by sharing these recommendations, we offer not only practical advice and constructive solutions, but can also, ultimately, influence policy through shared engagement – with your help.

Three years ago, LAAG started to look at some of the specific challenges (and opportunities) associated with structural and capacity constraints to growth in African markets. Based on prominence and urgency, five key topics and workstreams were shortlisted, and these now form the basis of these papers. In summary, they address capital raising challenges for SMEs, developing the green bond market for infrastructure projects and developing offshore local currency bond markets, as well as focusing on the importance of country market classification and corporate information dissemination.

We should be clear from the outset that, while no effort has been spared to ensure empirical grounding, our research and conclusions are not intended to be either exhaustive or all-inclusive. In many cases, the most appropriate actionable suggestions and policy recommendations are also not new. But we do see value in pulling them together and presenting them in this usable format.

In conclusion, our intention is that these reports should initiate discussion and of course, LSEG remains ready and able to play its role. We look forward to bringing you on board too and we will appreciate all further interest and feedback.

Suneel Bakhshi
Chairman, International Advisory Groups
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1. Executive summary

Small and medium-sized enterprises (SMEs) account for around 90% of Africa's businesses and are viewed as the engines to drive forward the continent's economic development.

Despite their vital role, many African SMEs experience a shortage of financing at all levels. Over the years, this has hindered their ability to grow and innovate, in turn preventing African economies from reaching their full potential.

The key challenges SMEs face in raising capital that are identified in this paper include:

- **Inefficiency of African capital markets in supporting SMEs**
- **Low capacity and the need for upskilling and training**
- **Minimal visibility to a broad investor base**
- **Absence of government-led SME strategy to develop the ecosystem.**

Based on these challenges, the following recommendations have been suggested:

- **Implement internationally recognised capacity building programmes for SMEs and the creation of SME hubs**
- **Raise the visibility and awareness of leading African private businesses**
- **Establish a public registrar for African businesses**
- **Government policies should support and aid SME development.**

2. Overview of the African SME landscape

Small and medium-sized enterprises (SMEs) comprise the backbone of Africa's economy, accounting for approximately 90% of all companies and providing nearly 80% of the region's employment. In Nigeria, the example is more extreme; SMEs comprise 96% of the country's businesses, compared with 53% in the US and 65% in Europe.

40%

The proportion of SMEs in Africa that say accessing finance is the primary factor constraining their growth

SMEs are therefore fundamental to the future success of the African continent, with the potential to establish a new middle class and boost the demand for local goods and services. Their role in driving innovation, creating employment opportunities and therefore contributing to domestic wealth creation routes is critical for sustained economic development.

Despite their crucial role in driving the continent's economic development, evidence suggests that SMEs in Africa experience a severe shortfall in financing which has historically hindered their growth. A study conducted by Investisseurs & Partenaires found that 40% of SMEs in Africa identified the primary factor constraining their growth as accessing finance. Some estimates put the current funding gap at more than US$140bn.

Ultimately, the lack of funding results in millions of SMEs being forced to go out of business within a few months of beginning operations and significantly inhibits the ability of SMEs to reach their full growth potential and become the future 'blue chips' within their respective economies. Recent estimates suggest that in Kenya alone, almost half a million small enterprises fail annually as a result of the tough business environment.

> "The lack of funding results in millions of SMEs being forced to go out of business within a few months of beginning operations"

3. Barriers to accessing finance for African SMEs

3.1. The function of capital markets in serving the needs of SMEs

The lack of funding for SMEs in Africa calls into question how well domestic capital markets are serving the needs of these companies, who form the bulk of the business universe in African countries. In general, the purpose of capital markets is to promote growth in the economy by providing capital for companies to innovate, expand and create jobs. Therefore, for an economy to work, capital must flow from investors to businesses, ranging from the largest blue chips to SMEs and entrepreneurs, instead of being concentrated on the large and well-established firms.

However, primary research conducted within Africa's capital markets suggests that there is a significant lack of awareness of the variety of financing options available to these SMEs to support their growth trajectory. These range from microfinance and angel investing to venture capital, private equity and potentially listing on growth segments of local exchanges. This unfamiliarity has resulted in low levels of domestic participation for these companies, leaving local equity markets underdeveloped. This contributes to the lack of depth and liquidity within domestic capital markets, which eventually results in a smaller Initial Public Offering (IPO) pipeline for local exchanges.

SMEs seeking to raise capital have traditionally relied on short-term debt, which is commonly viewed as the only viable option. The result is excessive dependence on the banking sector – specifically, on bank loans and other forms of high-yield debt. As such, the financial sector has continued to grow around this common notion, with banks and other stakeholders focusing their operations on bank loans and debt financing.

The type of financing (equity or debt) that would best suit a company's needs is heavily dependent on a company's stage of development. Debt is a tax-deductible form of capital raising that would suit a well-established blue-chip corporation. That said, the same would not apply to a high-growth SME where funding is required in order to finance expansion. Bank loan financing would therefore leave a small company prioritising loan repayments or face risking default. Debt is thus fundamentally ill-suited to enabling SMEs to fund the innovation and long-term projects that ultimately drive economic growth and create new jobs.

In the context of Africa, the existing business environment poses further obstacles to debt-financed SMEs. Interviews on-site with various stakeholders have helped uncover the following issues:

- **Onerous credit checks from foreign banks restrict SME participation:** foreign banks are more likely to use sophisticated scoring models when assessing creditworthiness, but SMEs often lack the track record and meaningful data inputs required
- **Relationship-based lending leads to non-performing loans:** local banks may not use credit scoring and prefer to focus on relationship-based lending. A consequence of this is that local banks experience higher rates of non-performing loans
- **Negative reinforcement tools:** credit bureaus have predominantly served as a negative reinforcement tool as a result of the harsh measures they take in the case of delayed payments. Smaller companies run the risk of being 'blacklisted' if a single loan repayment is delayed
- **Prohibitive collateral requirements:** lenders seek collateral to mitigate the high, and often unquantifiable, credit risk associated with lending to SMEs. According to studies, it takes multiple years to recover bad loans, which forces lenders to demand prohibitively high collateral amounts.

It is therefore crucial for Africa to unleash the potential of equity capital to support these companies that are so vital to the future of the continent's economies. With the right combination of advice and support, SMEs can navigate the challenges, identify the right forms of equity capital raising and drive growth to support the economic development of the continent. While the launch of SME growth segments within domestic exchanges may be beneficial, without the right training and a supporting advisory community, these market segments are likely to be left untapped.

The challenges and opportunities of SME financing in Africa

Barriers to accessing finance

3. Barriers to accessing finance for African SMEs (continued)

1 in 3

It is estimated
that one in every three Kenyan citizens is a member of a chama – informal group investments where individuals pool their savings together

Evolving culture
There is, however, evidence that some African countries are already trying to evolve from a culture focused on high-yield informal debt and bank loans to equity financing.

This trend has become engrained in Kenyan culture over the years. Chamas (the word 'chama' means 'group' or 'association' in Kiswahili) are informal group investments where individuals pool their savings together. Typically formed by individuals with close social ties, Chamas traditionally invest in property, but may also lend to groups or SME owners who they know and trust. It is estimated that one in every three Kenyans is a member of one of the 300,000 Chamas in the country, which between them control an estimated 300bn Kenyan shillings (approx. US$3bn).

Another example of an African country that has recognised the precedence of equity over debt is Rwanda. The Rwanda Stock Exchange (RSE) started the small and medium enterprise market segment in 2014, and this is seen as a practical way to enable SMEs to tap into capital markets and raise long-term funds to grow their businesses. RSE carried out a three-month awareness campaign that was intended to take the capital market to the doorsteps of the SME sector in the country. The campaign aimed to improve the financial literacy of Rwandan SMEs and other corporates through public education and outreach. Other countries in Africa to launch an SME segment include Nigeria (AseM), Kenya (GEMS) and South Africa (AltEx).

3.2. Lack of capacity
Lack of experience and knowledge among African SMEs in the successful running of a business has led to diminishing trust among stakeholders who could potentially provide much needed equity capital, leading to those stakeholders rejecting financing options for African SMEs. Some of the key Africa-specific capacity gaps that SMEs face include:

— **Fear of control loss:** one major concern SMEs have regarding equity financing is the loss of control. Many SMEs are unwilling to accept external investment and bring in new partners, as they fear relinquishing control of their company. According to a major African investor: "Entrepreneurs would rather own 100% of one than 10% of a hundred." Additional observations show that this culture is starting to change, albeit slowly, as SMEs are becoming exposed to the international success stories of peer companies that have benefited from external investment

— **Governance for growth:** many SMEs are unaware of the importance of strong governance, and hence lack access to expertise that could improve their management structures and practices. In many cases, company boards are lacking altogether, with no substitute structures in place to provide sound input, hold management accountable, oversee independent audit or remuneration decisions, or perform other traditional board functions. Government-sponsored bodies sometimes help train and advise SMEs on the importance of following best governance practice. The International Finance Corporation is working to institutionalise the corporate governance scorecard, having trained over 2,000 companies in East Africa on its implementation

— **Lack of transparency:** many SMEs do not have anti-bribery safeguards for their operating and financing processes which preserve the integrity and transparency of the national funding space and ensure that deserving SMEs receive their fair share of financing

— **Financial reporting:** many SMEs in Africa do not have audited financial information to provide to lenders or potential investors. This is particularly apparent in countries where this is not an enforceable legal requirement. Entrepreneurs also often lack the resources to prepare accurate records, or access to an external service provider that can produce records on their behalf. Regardless of legal obligations, many SMEs will continue to struggle to produce accurate, useful financial information without increased access to financial education and awareness of the value of this information

— **Sustaining growth:** lacking a strategic vision for how to grow the business is preventing many small African companies from scaling up. Even when a temporary revenue boost presents itself, it is almost never sustainable. A growth strategy plan is often not present, restricting long-term success

— **Retaining talent:** growth SMEs often underestimate the importance of managing talent by seeking to attract, develop and retain individuals who are valuable to the organisation. This ultimately restricts the company's performance and also serves as a warning to future employees

— **Branding:** African SMEs are vulnerable to avoidable branding and marketing errors that cost them business. Branding is a key enabler in helping a company differentiate itself from the competition and ensure its business and product offer reflects the company's culture and values

— **Entrepreneurship:** according to data from the Global Entrepreneurship Monitor, South Africa reports a high fear of failure when it comes to entrepreneurship and innovation. Innovation in Africa is generally led by large firms that enjoy structural advantages, such as economies of scale, compared with SMEs

— **IPO:** finally, there is a general lack of familiarity with the IPO process, from listing requirements to the benefits of being a public company. Regarding this as unachievable or too complicated, African SMEs would not seriously consider public markets. Becoming a public company is, however, a significant contributor not only to the development of a company, but to the further robustness of the local capital markets.

Existing support providers – benefits and limitations
In recent years, the supply of service providers that offer business support has significantly improved across the continent. In the past few years, innovative, commercial-based service providers have emerged to support SMEs with business and legal advisory services, financial management services and incubation and acceleration services. In Kenya alone, there were 28 incubator-like organisations as of 2016.

One positively performing organisation is the SME Development Authority in Nigeria, which provides resources such as networking, collaboration and training sessions and helps them access external grants. Another, the Lagos State Employment Trust Fund (LSETF), supports SMEs by helping them formulate clear business models by using the value proposition canvas, without focusing heavily on the figures and forecast financials.

Regional accelerators play a key role in identifying innovative SMEs by providing mentoring and coaching services to SMEs that want to strengthen their business model. Through their programmes and competition events, incubators and accelerators help SMEs to identify market opportunities, build and refine business models, develop expansion strategies and pitch effectively to potential investors. In addition, accelerator programmes help enterprises build investment readiness. Based on interviews with start-ups, co-working spaces (a common feature of accelerators) enable peer-to-peer learning, build networks and strengthen the entrepreneurial culture of companies based there.

Yet a closer look into some of these programmes and the overall landscape has identified several associated limitations:

— **Demand from high-growth SMEs exceeds supply:** the growth in the SME sector calls for more diverse, accessible and cost-effective business support services. Interviews with accelerators and assessment based on publicly available information suggest that such incubators support around 20 SMEs per year on average. This is only a small fraction of the SMEs that could benefit from these services. Moreover, the ecosystem has focused on more IT-related sectors rather than agriculture or healthcare, where more patient capital is needed

— **Lack of quality services:** traditionally, the majority of the business support ecosystem for SMEs in Kenya, for example, has been made up of donor-funded programmes, government/university programmes, and initiatives by non-governmental organisations (NGOs). These programmes provide training and technical assistance but tend to lack a commercial mindset

— **Lack of trust between SMEs and support providers:** although business support providers are emerging throughout Africa, a lot of SMEs aren't using them because of a lack of knowledge and trust between the service provider and the SMEs. Recent interviews with non-profit incubators and start-ups suggest that this is because the quality of service and mentorship needs to be improved.

3.3. Minimal visibility to investors, leading to a 'missing middle' financing gap
A closer look into African SMEs enables the differentiation of a category that could be best described as the 'missing middle': African businesses employing between five and 250 people, with capital needs ranging from US$20,000 to US$2m. SMEs in the missing middle are too big for microfinance organisations, but too small or risky to access sufficient growth capital from conventional debt and equity investors. These companies have been identified as facing unique challenges in accessing finance, talent and markets.

3. Barriers to accessing finance for African SMEs (continued)

40

There are now
more than 40 angel investor groups, networks and initiatives across 25 African countries – up from 20 at the end of 2015

In Kenya, for example, angel investors fund just 2% of start-ups, focusing mostly on the IT sector. The most active angels have invested a total of only US$10m in Kenya since 2008, spread across 82 investments.

There is a positive trend, with the number of visible angel investor groups, networks and initiatives having recently grown to more than 40 across 25 African countries (up from 20 at the end of 2015). However, capital remains scarce and the industry-specific knowledge and mentorship of these angels is limited. Therefore, while there is significant venture capital money available for technology and energy, it is unlikely to create spillover into other sectors because the limited partners are reluctant to invest in sectors that lack strong track records of exits.

The existence of this profound financing gap preventing efficient deployment of private capital in Africa can be largely attributed to a lack of visibility of these companies to early-stage investment. Many of these investors do not feel comfortable investing in SMEs on the grounds of unestablished credibility and lack of trust. Many entrepreneurs are therefore forced to finance the growth of their businesses independently.

One of the most prominent forms of investment within Africa is impact investing, where institutions require funding candidates to fulfil certain criteria, forcing them to bootstrap their business and potential growth. Significant impact investment is available to early growth-stage companies, but this investment is predominantly reserved for SMEs that hit certain social metrics and risks entrepreneurs and SMEs losing focus on commercial viability. Based on interviews, it was identified that some high growth-potential start-ups in the missing middle are adjusting their business models to fit the impact investing criteria to get financing from impact investors, rather than focusing on their core competencies.

3.4. Absence of government SME strategy to develop the ecosystem
There is evidence that African governments do recognise the important role SMEs play in the local economy. Nevertheless, certain areas exist where SME strategy has not been placed at the heart of government policies:

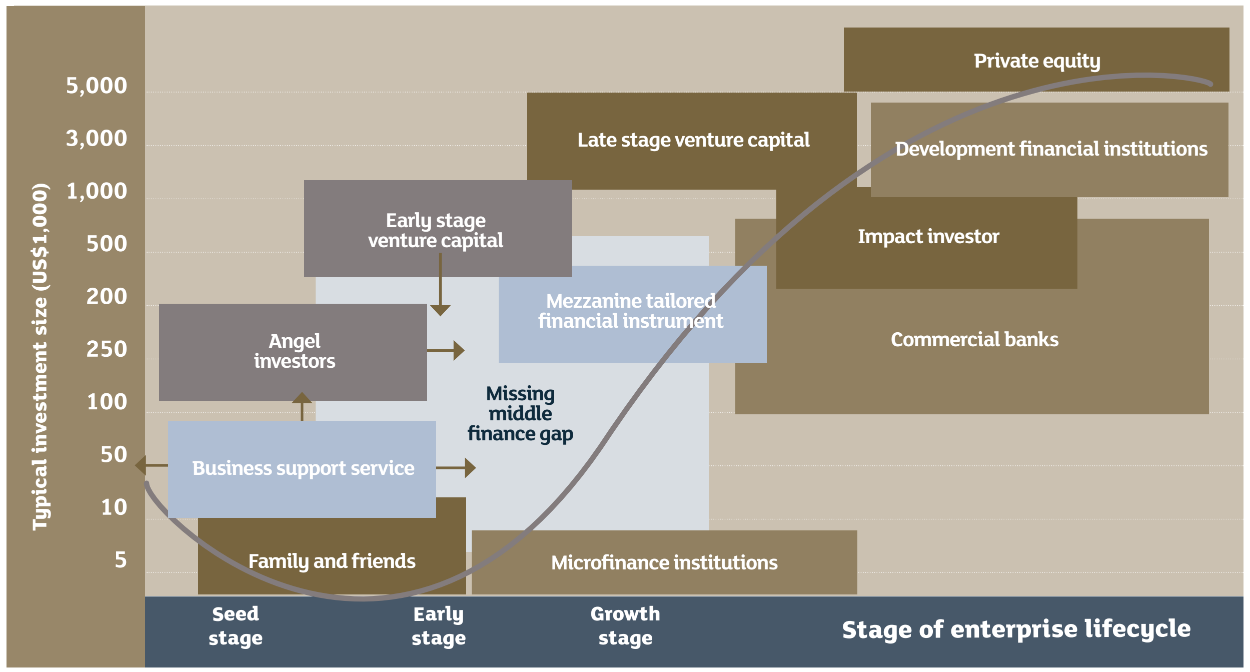
- **Tax/regulation regimes that are not supportive to SME development:** research revealed a lack of tax benefits, both on the SME and the investor side. For instance, Nigeria's SME sector revealed that some start-ups had paid taxes since their incorporation and did not draw any tax benefits or breaks from the government. Likewise, private investors and institutions received no tax incentives for their risky investments with this sector – the kind of incentives that are often prevalent in other economies and promote SME development in their countries
- **Administrative factors hinder SME growth:** a long setup time for SMEs in Africa is not unusual – it takes about two months for any SME to set up a business in Nigeria, for example. This is corroborated in the World Bank's 'Ease of Doing Business 2018' report, where Nigeria is ranked 130 and Kenya 117 (out of 190 markets surveyed) in terms of the ease of starting a business

"Significant impact investment is available to early growth-stage companies, but this investment is predominantly reserved for SMEs that hit certain social metrics"

- **Non-transparency and corruption:** non-transparent practices revolving around nepotism and corruption often starve SMEs of financing opportunities that may better come from foreign investors. For instance, in Transparency International's recently published 'Corruption Perceptions Index', Nigeria ranks 148 and Kenya 143 (out of 180 countries). An interesting application to curtail corruption and nepotism was observed in Nigeria, where PwC was used as a third-party application evaluator for an LSETF lending (and training) programme.

FIGURE 1

Missing middle financing gap in Africa



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4. Recommendations

4.1. Implement internationally recognised capacity building programmes for SMEs and the creation of SME hubs

As mentioned above, business support programmes already exist in Africa. However, there are several limitations that need to be addressed:

— **Current supply cannot meet the high demand**

— **The support ecosystem outside major cities such as Nairobi or Lagos is still limited**

— **Existing incubators lack a commercial mindset**

— **Financing is skewed towards the IT sector.**

There is thus a need for more private and publicly funded training and support programmes to handle the demand in an affordable manner. Such programmes should involve experienced trainers and enhance awareness of alternative funding tools in addition to bank lending. These training programmes should also aim to cover the wider continent, as well as a broad spectrum of industries.

A study by Venture Capital for Africa reveals that "ventures that participate in sector events, or join an incubator or accelerator, secure on average 23% more than their counterparts who do not participate in such programmes."

4.2. Raise the visibility and awareness of leading African private businesses

As was established during the research, many SMEs are in need of early-stage finance, falling into the missing middle financing gap. African companies lack visibility and credibility, which are crucial factors for accessing this stage of funding.

One solution is for African governments to support initiatives aimed at showcasing Africa's leading private companies to the public. Such initiatives could involve publications from credible sources, providing key information about companies such as the business model, KPIs and governance.

4.3. Establish a public registrar for African businesses

The development of a domestic or regional online registrar where key information about companies is publicly available is crucial for African businesses. This would generate credibility, allow quick access and facilitate investor participation. An example of such an establishment is Companies House, the UK's registrar of companies. All registered limited companies must file annual financial statements. By filing public records, the registered company signals trust.

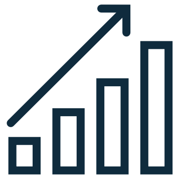
4.4. Government policies should support and aid SME development

As mentioned above, the regulatory environment in some African countries has not been fully aligned with supporting SME development and growth. Governments should therefore aim to embed SME development strategies in their broader national development and growth strategy. This could be done by:

— **Fostering an SME advisory community:** governments should foster an ecosystem designed to support African SMEs by developing an SME advisory community, including brokers, lawyers and financial consultants, that specialises solely in SME corporate finance

— **Strengthening SMEs' role in the ecosystem:** African governments are encouraged to work alongside blue chips and create a strategy where SMEs could be further included in the ecosystem through preferential involvement in value chains or governmental projects

> "African companies lack visibility and credibility, which are crucial factors for accessing this stage of funding"



23%

A study found that
SMEs that take part in sector events or join an incubator or accelerator programme secure 23% more funding, on average, than those that don't participate in such activities

— **Creating a centralised help portal:** in order to further promote a supportive environment, governments are encouraged to create a centralised portal, helping SMEs navigate the support they need. A government-run portal would serve as a trusted resource

— **Adopting technological solutions, allowing for leapfrog advancements:** African countries are extremely well positioned to benefit from leapfrog opportunities thanks to the speed with which new and disruptive technology is entering the continent. Local regulators should therefore support new technology initiatives such as artificial intelligence and blockchain. This would make it possible for African markets to unite their mechanisms and even establish a capital markets union

— **Providing and promoting a regulatory and administrative environment:** policymakers should introduce an enabling legal, regulatory and administrative environment for SMEs to facilitate and encourage their growth. Transaction costs in setting up and doing business should be minimised through fair, simple and less costly taxation, customs, licensing, registration, financial, judicial and other governance systems and procedures. In addition, tax incentives for investing in SMEs would encourage higher investor participation and offset investors' view of SMEs as risky investments

— **Working with stock exchanges to facilitate the creation of SME segments:** African governments are encouraged to cooperate with their local stock exchanges in the creation of special SME segments for easier listing. As discussed earlier, having a tier-based listing process would support SMEs' potential in qualifying for more relaxed listing requirements, after which they could progress to the exchange's main market.

> "There is a need for more private and publicly funded training and support programmes... Such programmes should involve experienced trainers and enhance awareness of alternative funding tools in addition to bank lending"

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