Looking for African solutions to the SME financing gap

By St John Bungey

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Unrealised growth potential and positive demographics continue to make Africa an attractive long-term investment destination, despite the SME funding gap.

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Africa has 400 companies with more than $1bn in revenue and 700 companies with more than $500m in revenue. Over the past five years, debt transactions totalling $110.2bn have been placed in African debt markets or by African companies on international markets, [the majority of which were US dollar-denominated](). Taking all of this into account, the size of the corporate loan market across sub-Saharan Africa (excluding South Africa), is estimated to be greater than $150bn. While at face value these nominal sums may seem impressive, they mask a massive shortage of finance.

Africa's massive credit gap

Baker & McKenzie estimate that $90bn per annum of spending on infrastructure is required to enable the continent to catch up to the developed world. According to the African Development Bank, Africa faces a trade finance funding gap of about $120bn, as a result of underserving by financial institutions. Finally and most importantly, the International Finance Corporation (IFC) estimates that the SME credit gap in sub-Saharan Africa is between $70bn to $90bn. This implies a requirement to increase bank advances by threefold to this sector, if there is any hope of closing that gap.

The lack of access to capital is by no means unique to sub-Saharan Africa. Several continents and countries globally suffer from a similar fate. It is the concentration of that funding gap in specific areas and the economic reasons why, that make for interesting reading. When delving deeper, there is almost a "preferred habitat" phenomenon which, in this case, appears to be not loading on term structure or duration, but rather loading on type of counterparty and size of borrower.

While both still underfunded, the large long-term infrastructure projects are dominated by development finance institutions (DFIs) and, as noted above, multi-nationals and regional corporate players are serviced by the larger international banks and have limited access to capital markets. With the exception of South Africa, real access to finance for small and medium enterprises (SMEs) is almost non-existent.

The role of SMEs in Africa

There are many studies that point to the role that SMEs can play in creating employment and reducing poverty. This varies substantially across countries, from as low as 16% of GDP in low-income countries to 51% of GDP in high-income countries. Notably, the contribution of SMEs is considerably higher in South Africa.

The estimated 91% of formal business entities that are SMEs contribute 52 to 57% to GDP. Looking to the continent, in Ghana SMEs are even more prominent, representing about 92% of Ghanaian businesses and contributing about 70% to Ghana's GDP. Furthermore, almost all studies agree on a further point; that in order for this economic-flywheel to begin to turn there needs to be reasonable access to capital, in the form of both equity and debt.

As we know, capital is fluid and has a habit of moving to meet demand, particularly where the risk and reward-skew is attractive. So what is causing this funding mismatch and why does it persist? The obvious question is, are most African SMEs a bad credit risk or do they offer sub-par investment prospects? The macro-economic backdrop of generally high GDP growth rates, a demographic dividend and the most rapid urbanisation rate in the world, is mostly positive.

If one zooms out to place African SMEs in a global context, their equity would be in the global micro-cap category and the debt in the very high yield or mezzanine space. Both asset classes, particularly given the drivers of where these businesses operate, should offer very attractive returns.

The risk return continuum

The key is that as a collective, high yield and micro-cap investing works extremely well in a portfolio context. The predictability of risk and return rises with spread or diversification of exposures. Herein lies the problem of funding SMEs in Africa. While the attractive returns tend to be at the lower end of the market cap spectrum, SME deals on the continent tend to be very small, difficult and time-consuming to originate.

The result is that to create a portfolio of assets takes time on the ground and a serious amount of effort. During the building phase, while there are few exposures, the risk and return experience can be more extreme which often colours investors' perceptions of the space. The net result is that capital often heads back up the market-cap spectrum toward the lower risk corporate deals, where origination is easier, deal size warrants the cost of due diligence and, most importantly a spread of assets can be achieved relatively quickly.

So what can be done to facilitate investment into the SME space?

The not-so-obvious answer is communication. Providers of capital need a marketplace to assess businesses that require funding. This would allow relative evaluation, some level of standardisation and the ability to create a portfolio of small loans or equity investments relatively quickly.

A mere pipe-dream? Using a parallel example, the continent jumped fixed telephony to becoming the world's fastest growing mobile market. That in turn enabled the success of businesses like M-Pesa which means that Kenya now accounts for a third of the world's mobile money users. Could sub-Saharan Africa lead innovation and use mobile connectivity to improve on the peer-to-peer or online lending platform models such as Lending Club, Prosper or Avant?

Digital technologies facilitate the establishment of efficient matching. A result is the ability to aggregate and match the market with a level of efficiency and speed that was not possible in the past. Several contenders have tried to create lending bridges or origination platforms, others like PesaYetu in East Africa and Pollen Finance in South Africa continue to innovate.

Who will win and how the model will evolve is unclear, but that Africa will solve it SME funding gap in a unique way is almost certain.

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