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SmartLessons
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SME Solutions Center—Kenya: Developing Alternative Financing Solutions for Small and Medium Enterprises

ABOUT THE AUTHORS

KIRAGU MAINA
heads the SSC program in Kenya. He was involved in development of the SSC program since its inception, including refining the strategic plan, fundraising for the BPI Kenya fund, establishing the mechanics for the SME risk capital and TA funds, launcing of the SSC and the BPI Kenya SME funds, designing and rollout of the various SME products/services provided via the SSC, and advising new SME risk capital fund managers in the region. Kiragu has nearly 20 years of corporate, entrepreneurial, and private sector development experience.

SCHOLASTICA BUTOYI
the Program Assistant for the IFC's SME Solutions Center in Kenya, has over 20 years' experience in IFC, working with SMEs in Kenya. Her role is to leverage institutional memory in IFC's continued quest to address the challenges faced by SMEs.

NKATHA MICHIRA
is a Business Development Officer at IFC's SME Solutions Center in Kenya. Her experience and understanding of the micro and SME sectors in the Kenyan market support the SSC in developing viable and lasting solutions to the challenges faced by entrepreneurs.

APPROVING MANAGER
Eme Essien, Africa SME Initiatives Corporate Portfolio Management Department.

Small and medium enterprises (SMEs) in Africa have been hailed as the engine of economic growth. They are at the heart of developing countries' entrepreneurship, the source of most new employment and productive investment, and the basis for growth and poverty reduction. Despite the economic potential of SMEs, they face severe constraints related to access to resources, finance, and services, as well as procedural barriers—all of which limit their potential to invest, innovate, and improve productivity and sustainability. To address these constraints, IFC developed the SME Solutions Centre (SSC) Pilot Program in Kenya. The SSC value proposition centers on four key pillars: Access to Finance, Access to Advisory Services/Technical Assistance (now SME Management Solutions), Access to Reliable Market Information, and support for an enhanced Business Enabling Environment. This SmartLesson details the lessons learned from the SSC's experience with the Access to Finance *pillar.*

Background

In September 2004, IFC undertook a market study—the Kenya SME Country Study—whose findings provided insights into the SME space in Kenya and corroborated what IFC had learned and understood of the SME market from two previous programs focusing on SME development in Africa: the Africa Project Development Facility and the Africa Enterprise Fund.

The SSC developed its "one-stop shop" model with the aim of promoting a holistic and integrated approach to helping meet SME finance, management capacity, and information needs. Part of IFC's Strategic Initiative for Sub-Saharan Africa, the model allows IFC to innovate with new services targeting SMEs to achieve greater developmental impact.

One of the key value-added services of the SSC's Access to Finance pillar is the incorporation of a $14.1 million risk capital fund—which received equity from IFC, European Investment Bank, Commonwealth Development Corporation, East African Development Bank, and Transcentury, a local private equity investment group—and a separate $2.5 million technical assistance fund, provided by IFC and the World Bank through

Kimemia Engineering Ltd, a midsize road and infrastructure contractor, is a beneficiary of SSC Kenya's finance and advisory services. (Photo from SSC Picture Gallery).

the International Development Association (IDA). Both funds are managed by a third-party fund manager, Business Partners International Kenya Ltd (BPI). The long-term objective was to provide an alternative to the stringent and often unattainable collateral requirements for SME lending. This new source of growth capital for SMEs fills the gap left by the market failure of mainstream financial institutions to provide cash-flow/viability-based SME finance.

Through the three other pillars, the program also aimed to address other market failures arising out of lack of access to reliable market information, underdeveloped access to business development services, inadequate management capacity within SMEs and business associations, and an onerous licensing, legal, and regulatory environment. Another area of focus was the development of business incubators supporting start-up enterprises for demonstration, with a view to encouraging both the public and private sectors to embrace business incubation as a growth strategy for private sector development. (See box.)

Program Performance: Access to Finance Results to Date

SME access to finance delivered via the in-house risk capital fund managed by BPI has experienced growth as follows:

- $12.873 million in SME commitments in the last three years, representing 91 percent of the total $14.1 million BPI Kenya SME Fund; $7.3 million has been disbursed.
- The commitments represent 62 SME investments, averaging $208,000 per investment. Minimum/maximum investment: $50,000 to $500,000.
- Forty of the SMEs have received advisory assistance, amounting to $500,000, through the IDA funds.
- Over 1,000 jobs have been created, and over 950 jobs sustained.

Lessons Learned

1) Jumping the first hurdle: Plan for fund-raising.

IFC partnered with BPI, a leading South African SME investment fund manager, to establish Business Partners Kenya, and then led the fund-raising efforts to establish Kenya's first SME risk capital fund, targeting SME deals in the $50,000 to $500,000 range. Fund-raising for the SME Fund took much longer than anticipated. The fund aimed to raise $15 million but closed at $14.1 million in December 2006, two years after commencement of the SSC program. Reasons for the delay:

- *Internal expectations about the ability to raise a new SME risk fund in Kenya targeting investments as low as $50,000 were overly optimistic and not in synch with the market reality at the time. To date, BPI is one of only two fund managers that make investments as low as $50,000 to SMEs. Other funds invest in the range of $100,000 to $1 million, and their fund-raising does not take less than two years.*
- *Kenya was just emerging from a long period of economic recession characterized by massive defaults and nonperforming loans in the commercial banking sector—a large proportion of them attributable to SME lending—thus scaring investors away from the proposed fund.*
- *IFC's credit/investment policy limited its ability to commit more than 20 percent in equity to the new fund, given its greenfield status. This meant IFC was proposing to establish a new fund in an area relatively unknown to the market, but was not willing to take a proportionately larger risk in seeding the fund, making it difficult to fill the gap, even where there were investors willing to match IFC's commitment. Eventually, IFC's Funds Department and senior management received board approval to increase IFC's exposure to 40 percent, which not only raised the appetite of other institutional investors but also reduced the funding shortfall, given the commitment by some investors to match IFC's investment.*

The delay in closing the fund presented a major credibility risk for the nascent SSC, which required careful management of expectations both internally and externally, especially since its high-profile launch had been hailed by the government as a major boost to SME access to finance. Nonetheless, the SSC team turned this "imminent crisis" into an opportunity to further market the program, educate stakeholders countrywide, create partnerships with private and public entities, roll out advisory assistance and capacity building projects, and develop a pipeline of deals to be considered for financing, once the fund was in place.

Programs replicating this one should factor in the time it takes to raise risk capital funds for SMEs in Africa—and put off public launches until after fund-raising is successfully completed!

2) Does your target market understand the new product? Develop a communication plan to educate potential clients.

The SME market had limited knowledge of how alternative, noncommercial bank financial products, specifically risk capital, worked—and who the target market was. Consequently, numerous noneligible SMEs that applied to the fund were subsequently rejected or declined the financing structure, leading to the initial negative perception that the SSC's Access to Finance pillar did not actually address SME financing needs, and was after all not the panacea to *all* of the SME market's financing gaps, as was widely touted by various public entities. (The average approval rate for risk capital investments is about 10 percent). Further, the association with the World Bank led some SMEs to imagine that financing would be on a grant or concessionary basis, and it took a lot of awareness creation to debunk this myth.

Although initially there was no plan to educate the target market on risk capital, the gap was immediately evident. In

2008, SSC developed a communication strategy that involved media outreach, joint road shows with BPI, and collaboration with other SME stakeholders such as SME business associations and government agencies—to raise awareness and understanding of the product and, ultimately in 2009, run countrywide workshops that reached about 1,000 SMEs, training them on risk capital financing and other IFC products, such as the SME Toolkit.

It's vital to develop a comprehensive ongoing communications plan for educating the SME market about how risk capital funds work, what they look for in an ideal SME investment, how they structure their investments, why they take a share of "ownership" via equity in an SME's closely held business, and why they require an SME to sign up for an in-depth technical assistance package to mitigate its risk. For the SSC, an early communications plan would have gone a long way toward minimizing the initial negative perception.

3) Partner selection is critical: Determine the criteria to be used.

Before embarking on the SSC program, IFC spent significant time searching for the ideal partner with whom to launch the Access to Finance pillar of the SSC—not a simple task, given the novelty of the product, combined with the ever-present risk of providing SMEs with finance without the traditionally mandated 100-plus percent security cover to access commercial bank loans. Lending IFC's name to such a new venture and asking institutional investors to partner in it—in frontier countries, with all the risks they portend, especially in view of the high SME attrition rates—was a clear demonstration of IFC's commitment to innovation in support of SME development in Africa.

The ideal partner would have a track record in SME risk capital investment and the right blend of commercial and developmental business ethos. Business Partners Ltd, a South African financier providing quasi-equity financing and technical assistance support to SMEs in South Africa, had made over 30,000 investments in SMEs since its establishment in 1981. It had developed a unique set of products tailored specifically to the needs of SMEs and a set of operating systems and procedures that maximize the efficiency of making smaller-scale investments. Business Partners Ltd set up a subsidiary company, BPI.

A potential issue with BPI was its "dark horse" nature, being in the market with no experience in SME investment outside a much more sophisticated South African market. Also, as a fund manager and general partner, BPI was not investing its own capital in the fund, as the limited partners would be required to do. However, BPI brought the rigor, experience, and credibility that not only attracted other institutional investors such as the European Investment Bank, but also sparked a "revolution" in the growth of SME funds in the region, given BPI's success in Kenya.

4) More than just financing: It is critical to link loans to technical assistance.

IFC supports the BPI fund by facilitating its access to a

Heritage Foods Kenya Ltd, a small manufacturer of pet food, is a beneficiary of SSC Kenya's finance and technical assistance services. (Photo from SSC Picture Gallery).

separate technical assistance fund (IFC/IDA TA fund)—a singularly important lynchpin in tying the concept and emergence of SME risk capital in East Africa to good business practices. The TA component provides access to services such as business planning, financial management, sales and marketing, corporate governance, environmental and social safeguards, quality management, systems integration and process automation, legal advice, and market linkages.

SSC developed and continually updates a database of experienced business development service providers, many of whom have undergone SSC-organized training courses. The SSC leverages these service providers to design and deliver TA interventions to SMEs, thus increasing the SSC's reach countrywide. The SSC undertakes the monitoring and evaluation (M&E) to ensure quality and consistency of TA delivered.

Via the BPI fund, **the SSC pioneered the concept of structuring TA as subordinated non-interest-bearing debt,** not only obligating the SME to sign an interest-free TA loan agreement, but also ensuring that the TA applied is mutually agreed between the SME client and BPI, and that the SME participates in ensuring successful application of the TA intervention in its business by the TA service provider. **The SME's commitment to repay the TA funds**

(at zero interest) ensures that the SME fully buys into the process and has a stake in maintaining the new business practice or process.

When structuring TA, it is important to bear in mind that the bulk of TA funds will not necessarily be absorbed by the SME at the beginning, but rather, as the business grows, increases its cash-burn rate, and runs into new challenges, the uptake of TA funds may increase in tandem—to support projected growth in a challenging economic/business environment.

We have also learned that a large injection of capital is not necessarily a panacea for SMEs' growing pains at start-up, early-stage, or growth phases. Frequently, such enterprises require more hand-holding, mentorship, and other capacity-development assistance *before* they can effectively absorb new capital. **This tends to further debunk the myth that money is the cure-all for all SME problems.** We have seen SMEs that realize they do not need to take on new capital immediately if they can seal revenue hemorrhage, streamline working capital management, aggressively manage costs, improve management systems, and increase effectiveness of their business development initiatives and quality of their products and customer relationships. Saddling such SMEs with debt only compounds their financial woes.

And finally, we have **learned that SMEs are more willing to take up and pay for TA when it's linked to either access to finance or access to markets/contracts,** since it leads to increased capital or revenue for the SME. And in time SMEs appreciate the value of TA as a risk mitigant and sustainability builder, as opposed to its just being a "nice thing to do" for their businesses.

Conclusion

SSC has provided significant demonstration effect by showing that a combination of risk capital financing and technical assistance for SMEs can facilitate viable investment opportunities. As a result, a robust emergence of new SME-oriented risk fund managers is deepening SME access to finance in Kenya. Eight new funds targeting SMEs have benefited from guidance and market information from SSC Kenya. Such funds/fund managers include Grofin Kenya Ltd, TBL Mirror Fund, Acumen Fund, Care Enterprise Partners (now Africinvest), Root Capital, Investeq, In-Return Capital, Enablis, and Fanisi, wielding close to $400 million in equity targeting SME investments. IFC's Funds Department has subsequently invested in a number of these funds. In addition, banks have introduced new and flexible SME lending products, premised on viability of free SME cash flows, with a significant impact on their SME loan portfolios over the last three years.

The SSC program's Access to Finance pillar has thus acted as a catalyst in the SME market, demonstrating increased awareness and appetite for cash-flow–based lending among traditional providers of SME finance. The SSC also has made concerted efforts to work with other financial institutions (local banks) to make alternative types of viability-based finance available to their clients.

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