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SUPPORTING PRIVATE INDUSTRY

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Financing of Private Enterprise Development in Africa

Private Sector Development Branch
Investment Promotion and
Institutional Capacity Building Division

United Nations Industrial Development Organization

PSD Technical Working Papers Series

The PSD Technical Working Papers Series is a series of occasional papers arising from the work of the Private Sector Development Branch of the Investment Promotion and Institutional Capacity Building Division (IPC/PSD) of UNIDO. It is intended as an informal means of communicating important insights and findings from the technical cooperation and research activities of the Branch to a wider public of interested development practitioners, policy-makers and academics. The Branch would welcome comments and suggestions on the issues raised in these papers, which may be addressed to:

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FINANCING OF PRIVATE ENTERPRISE DEVELOPMENT IN AFRICA

The need for a wider range of financial instruments and interfaces with business development services for SMEs

by

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Private Sector Development Branch
Investment Promotion and Institutional Capacity Building Division

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ACRONYMS

ACEP	Alliance de Crédit et d'Epargne pour la Production
ADB	African Development Bank
AMINA	African Development Fund Microfinance Initiative for Africa
APDF	African Project Development Facility
BCEAO	Banque Centrale des Etats de l'Afrique de l'Ouest
BOAB	Bank of Africa-Benin
BDS	Business Development Services
BRAC	Bangladesh Rural Advancement Committee
BRI	Bank Rakyat Indonesia
BRVM	Bourse Régionale des Valeurs Mobiliers
CIDA	Canadian International Development Agency
CDC	Commonwealth Development Corporation
CGAP	Consultative Group to Assist the Poorest
DFI	Development Finance Institution
DFID	Department for International Development (UK)
ECOWAS	Economic Commission of West-African States
FDI	Foreign Direct Investment
FS	Financial Services
GVCF	Ghana Venture Capital Fund
IFC	International Finance Corporation
ILO	International Labour Organization
KPED	Kenya Private Enterprise Development Project
K-Rep	Kenya Rural Enterprise Development Programme
MF	Micro-Finance
MFI	Micro-Finance Institution
NGO	Non-Governmental Organization
OHADA	Organisation pour l'Harmonisation en Afrique du Droit des Affaires
ROSCA	Rotating and Savings & Credit Associations
SAP	Structural Adjustment Programme
SME	Small and Medium Enterprise
TVCF	Tanzania Venture Capital Fund
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
UNDP	United Nations Development Programme
USAID	US Agency for International Development
VCCZ	Venture Capital Company of Zimbabwe

EXECUTIVE SUMMARY

The present paper reviews *experiences and lessons learned* in the financing of private enterprises in Africa. Focus is on the financial burden faced by different categories of entrepreneurs when starting, operating, rehabilitating or expanding their business. The paper does not address the need for 'the basics', i.e., a properly functioning banking system.

The business community in Africa is heterogeneous, from micro-businesses to large corporations, located in large urban centres, in rural areas and in the formal and informal sectors. Financing needs are therefore of varying nature. In describing experiences, a link is made between size of enterprises, financing schemes/instruments and typical delivery channels. Different types of financial services (FS), implemented through a range of institutional systems (NGOs, development finance institutions, commercial banks etc.) are reviewed, covering micro-finance, SME credit, venture capital and other forms of financing.

When referring to enterprises in this paper, focus is predominantly on businesses, both existing and potential, in the *manufacturing sector and related services*. This is in line with the mission of UNIDO, as well as recognizing the fact that for the manufacturing sector, be it micro, small, medium or large enterprises, securing finance is more difficult, as they typically require medium-term or long-term loans. Also, attention is particularly on the availability of finance for indigenous investors, considered of paramount importance for the creation and retention of wealth. This does not ignore the importance of attracting foreign investors to Africa. These will benefit from a healthy local business community and, in turn, will create market opportunities for local enterprises.

The paper also addresses the need for non-financial or business development services (BDS), such as information, training, counseling, marketing assistance, highlighting the interface required between the two fields of support. It is argued that financial services are necessary but not sufficient conditions for successful performance of enterprises. The paper stresses the need for synergy (‘where FS and BDS meet’) and how their complementarity can improve the health of both the financial and non-financial support infrastructure available to entrepreneurs.

This paper does not claim to undertake an exhaustive review of studies carried out and efforts undertaken in particular in Africa. The topic of finance is too vast. It aims, rather, to present an overview of what can be learned from experience, what is the focus of current efforts and which are some general principles to bear in mind. By inserting summaries of good practice and listing some interesting references (including web sites), it is hoped this paper will have practical use for donors, policy makers and practitioners alike working on the issues covered.

CHAPTER I:

Introduction

A. The context

Africa has opportunities to offer beyond natural resources. Data indicate that the share of manufacturing and services in Foreign Direct Investment (FDI) flowing into Africa is increasing in absolute terms, albeit from a low level. On profitability of investment, Africa scores higher than other regions. New African entrepreneurs are emerging, encouraged by changes in the political and macro-economic landscape in most African countries, in which private initiative is now encouraged. Yet there is also bad news: the continent has fallen behind in terms of its share in total FDI flows to developing countries which have shown a substantial increase over the last 15 years. The gap has grown: Africa accounted for only 4 percent of total FDI inflows to developing countries in 1996-1997 (compared to 9 percent in 1981-1985), and these flows are concentrated in a few countries (UNCTAD, 1999). Regional co-operation is slow in developing. Total investment as a share of GDP has declined, and in terms of its distribution, public investment still takes too high a share. Private investment has increased but remains limited (ECA, 1999). This reflects that there still is a lack of confidence in investment in Africa and, unfortunately, a disproportionate amount of African private wealth is held abroad.

Key challenge for African countries thus remains how to stimulate private investment. Central to this are entrepreneurs and their ability to identify opportunities, supported by a favourable policy, legal, regulatory, and institutional environment, as well as an improved physical infrastructure. This reflects the paradigm that markets are at the center of economic activity, with governments playing a facilitating and catalytic role (Stiglitz, 1998). Entrepreneurs are the do-ers, while the policy environment and meso-level support institutions provide the supporting framework. Good governance is a necessary condition for both the do-ers and supporters to succeed in achieving their objectives.

B. Access to finance

When an entrepreneur is asked his[1] major problem, he will almost certainly reply: "shortage of finance". He may indeed have a serious cash flow problem so that he has difficulties in paying his employees or financing purchase of materials. It would be a mistake, however, to believe that in all cases this is the predominant problem. Still, there is no doubt that lack of access to formal finance can be a major element crippling the ability of a business to operate effectively, to

[1] For the sake of simplicity, all pronouns throughout the text indicate both genders

maintain or replace machinery, to purchase materials and services most economically and to modernise or expand. When starting a new business, most small enterprises, often beginning as micro-businesses, are unable to obtain loans, or any form of financing from formal institutions. They start their business by investing their own savings and/or using funds obtained from relatives or friends. This might be supplemented by loans from informal lenders or by credit from suppliers of materials.

It is only when the business has been operating for some time, usually as a micro-enterprise or on a small scale, that an attempt is made to seek financing from a bank for further development and expansion. Only then is there any likelihood of obtaining access to funds from such financial services, although it will never be easy (see also Box 1).

Box 1: Problems in small enterprise financing

Obstacles in access to finance by small enterprises typically include (*inter alia* Fisher, 1995):

i. High transaction cost for financial institutions to provide many small size loans as opposed to fewer but larger loans;
ii ‘Riskiness’ of borrowers due to lack of credit history, lack of adequate collateral, uncertainty about entrepreneurial ability and repayment capacity linked to market constraints, deficiency in the legal system in case of loan delinquency etc.;
iii. Cost of lending (including the time factor) as compared to the profitability of the business opportunity for which a loan is sought;
iv. Inadequacy of investment projects submitted to banks;
v. Weakness or limited outreach of financial institutions and of instruments focused on raising capital such as stock exchanges, investment funds etc.;
vi. Macro-economic instability and policy bias such as interest rates controls, preferential treatment of larger/state-owned customers;
vii. Difficulties in access due to e.g., cultural barriers (gender, disadvantaged groups), remoteness (rural areas).

An additional problem in finance for smaller businesses in the African context is the interweaving of the finances of the owner, his family and that of the business operated. It is often difficult to separate these two elements and to be able to present the financing institution with the clear justification for the sum requested, based on the accounts available of the business operation. Also, there is a tendency for owners and their families to extract more funds for the personal use of the family members than the business can actually bear. This may strip the business of the funds it needs to cover operating expenses and impedes the building up of resources. It also impedes the creation of contingency funds for difficult periods that may arise and makes it virtually impossible to build up reserves for future investment and development of the business.

There are other forms of finance for businesses, apart from credits made available through the banking system. Part of the working capital can certainly be financed from supplier credits and, in some situations or sectors, by advances from customers. Working capital is often financed by small businesses by bank overdraft facilities. All these may be acceptable ways of financing current needs of small businesses but must be under control and it is important that those who manage these businesses know exactly what their cash flow commitments are and how they intend to cover these.

As to the fixed assets, entrepreneurs quite often over-estimate their proposals for investments in business premises and equipment which can result in poor utilisation of facilities. It can also call for debt repayments at an unsustainable level. For lack of adequate accounts and figures, working capital is usually underestimated, which may be linked to a desire to obtain the maximum amount for acquisitions of fixed assets and to over-optimism as to how much time might elapse before the income of the business will be able to pay for its operational expenses and service debt. Inexperienced staff in African banks may compound the problem by accepting, without questioning, data submitted by SMEs in applying for loans. Advisory services can contribute significantly to avoiding these problems by demonstrating to owners of SMEs how to prepare a realistic business plan.

It is important both to be realistic in assessing that the financial resources sought by an SME can create the revenue in a reasonable time to cover the expenses (both direct and indirect), and, at the same time, that the debt servicing burden incurred is manageable. This may require adjustment of business plans to a scale - not in every case the optimum - that can ensure that the debt burden will not strangle the business in the future.

There is no doubt that the cultures and politics of some societies breed a belief that friendship with powerful and politically controlling individuals can both ensure success in access to funds and will protect businesses, if a point is reached where there are arrears or defaults in payment of debts. This is a dangerous view of the linkages of business and political power, all too frequent also in African countries. Financial institutions that allow themselves to be the subject of such political influences sooner or later will face major financial crises themselves. The existence of such influences, particularly prevalent in countries in which banks are under state control, inevitably leads to incompetent and inefficient businesses and institutions that cannot be sustained for long.

CHAPTER II:

Experiences in enterprise financing

A. Micro-finance for micro-enterprises

i. The micro-finance movement: a new fashion or an old habit?

Micro-finance (MF) is not a new subject: it was practiced well before the word micro-finance was invented. Informal savings and credit schemes are widespread and carry different names in different African countries (tontine, susu, stokvel etc.). Over the past years, MF has become a 'growth industry', when measuring the resources that have gone (and will continue to go) into this field. Some much publicised institutions in the developing world (Grameen Bank in Bangladesh, the Unit Desa operations of Bank Rakyat Indonesia and BancoSol in Bolivia are examples) have shown that if small sums are available to poor people engaged in micro-business, they are likely to repay their loans. These initiatives have illustrated that lending to this sector is, in reality, no more risky than lending to other groups, if proper procedures and approaches are used and that -to have durable impact-, the social and business objectives of MF need to be combined. The results in terms of outreach and financial sustainability of the above MF efforts led to a wave of attempts to replicate such experiences, with varying performance.

The Microcredit Summit held in Washington DC in 1997 estimated that there were 500 million poor people throughout the world engaged in micro-enterprises but that less than 2% of them had access to credit or any financial services. The Summit put as objective to ensure that 100 million of the world's poorest families will be receiving credit for self-employment by 2005.

There is no doubt that in the last few years, the idea of micro-finance, the lending of small amounts to those with micro-businesses, has caught the imagination of both the multi-lateral and the bilateral donor agencies as creating new hope of alleviating widespread poverty in low-income countries. The poor, who have been typically excluded from the formal banking system in the past, are now, through the micro-finance movement, benefiting from small uncollateralised loans.

The donor community now believes that if suitable approaches, procedures, controls and institutional frameworks are introduced, micro-finance may actually be profitable, although it may take some time before this is achieved and the profit will never be high. Key donors are part of the Consultative Group to Assist the Poorest (CGAP), a donor consortium co-ordinated by the World Bank to promote micro-enterprise lending, including the US Agency for International Development (USAID), other bilateral donors, the United Nations Development Programme (UNDP), and NGOs. In addressing the fifth Consultative Meeting of CGAP (June 1998), the UN Deputy Secretary General, Louise Frechette, stated that lack of capacity is a bigger obstacle to growth of micro-finance institutions (MFIs) than lack of capital, highlighting the need for diffusing good practice standards with a view to building a sound, vibrant and growing MF industry.

ii. The principle of micro-finance

Micro-finance consists of lending very small amounts of money both to individuals and to groups for very short periods of time. The amounts range from as low as US$50 to US$ 1,000, although there is now a tendency to go higher in repeat loans and some MFIs are lending as much as US$2,000 - 5,000 as well. Micro-finance means lending without requiring traditional forms of collateral. Based on the experience of the successful and larger MFIs, micro-finance programmes have found that personal knowledge of the borrowers, the creation of small groups that apply peer pressure to prevent the development of arrears or defaults, and incentives to offer larger loans on the basis of good repayment records, have achieved high levels of loan recovery. Although there are some exceptions, several of the more successful MFIs have achieved loan recovery rates of over 90%. Even the less successful ones, including some in Africa, can claim recovery rates of over 80%, which is substantially higher than the early micro-lending projects.

It is an interesting observation that the clientele receiving micro-credits includes an increasing number of women beneficiaries. Most donors and governments regard this as an additional success as women have generally been excluded previously from access to any credit. There is increasing evidence that small loans offered to women have a greater social and development impact in alleviating poverty and that women appreciate their increased access to credit by paying back more regularly than their male counterparts. One should recognize, however, that the users of the loans are not necessarily women borrowers. A study carried out in a rural community in Bangladesh highlights the influence of the husband or other males encouraging women borrowers to join a Grameen Bank loan group (Rahman, 1999).

Whereas there are no fixed success characteristics, there are guiding principles and diagnostic/rating tools as regards performance of the institutions, covering their financial strength, operational efficiency and impact on the target group. Examples are the guidelines issued by the Donors' Working Group on Financial Sector Development (Committee of Donor Agencies for Small Enterprise Development, 1995); good practice principles compiled and diffused by the MicroFinance Network and by CGAP; rating tools used by donors and practitioners such as the Inter-American Development Bank, USAID, UNDP’s Micro-Start Programme and various international NGOs. The key challenge of MFIs is to reach the maximum number of borrowers, build up a quality portfolio, maintain the value of assets, keep costs down and maximize income.

Prior to the burgeoning growth of the new MFIs, credits for small and micro enterprises were based on the misconceived idea that these enterprises could not afford to pay the full cost of institutional lending and needed to be subsidised. The ironic feature of this argument is that a substantial number of such enterprises actually paid, and still pay, exorbitant interest rates to money lenders to obtain rapid access to funds and are quite happy to pay higher real interest rates to cover the cost of credit. The idea that the poor may have to pay market rates of interest to obtain access to finance is often considered socially and politically unacceptable. In the end, however, it is access to funding that counts and less the cost of the finance.

Experience of the past has shown that subsidised credit does not reach the poor but usually ends up with well connected political groups who are able to get a share of lending being offered cheaply. Subsidised loans can thus become used as a form of corruption by governments and may be offered as the price of political support. Quite apart from this aspect, low interest loans have encouraged borrowing more than is needed and more than can be reasonably serviced by the borrowers. It also encourages the purchase of under-utilised, relatively expensive equipment, making it cheaper in relation to the employment of labour.

iii. Who are the micro-finance intermediaries?

a) NGOs

As part of their programmes, many foreign and local NGOs aiming to support women groups, rural communities etc., have included a micro-business dimension. They began with projects in training, counseling and other services (social NGOs) but many found, over time, that credit delivery had a greater impact on poverty and that they were more effective in enhancing standards of living when focusing on financing. They have been generally dependent on donor funding or help from local or international foundations for the resources they on-lend. In some cases, small amounts of funding have been obtained from the deposits and savings of the borrowers themselves.

As their involvement in micro-lending increases and they acquire more experience, NGOs have gradually adapted their social orientation. Such NGOs, many with religious backgrounds, have initially frowned on business-like approaches, focusing on profitability and financial sustainability. However, these NGOs have learned from experience that they have to be run efficiently to prevent erosion of funds and that it is in the long term interests of both the lenders and the borrowers to charge rates that will ensure the sustainability of the lending.

Much thought has been given by donors to how the formal financial institutions might be brought into funding micro-finance and greater lending to SMEs. Approaches to achieving this include cutting down transaction costs by relying on NGOs to screen would-be borrowers, by NGOs monitoring and supervising the use and repayment of loans, and having NGOs deposit their funds in commercial banks so that these institutions will have to use less of their own deposits for lending to small borrowers.

The move of some larger NGOs in different countries (Bolivia, Peru, Kenya, Tanzania) to develop into micro-finance banks should be given more serious consideration. Only NGOs that have the institutional experience and financial structure with adequate capitalisation, should consider such moves. There is the factor that NGOs have proved more effective than commercial banks in providing micro-finance because of their informality and flexibility. There is a danger that becoming banks will reduce the benefits of informality, will bring them into the orbit of direct supervision of the central bank, will push these micro-lenders towards larger borrowers and may divert them from their main role – lending to very small borrowers who cannot obtain access to services from the formal sector institutions.

b) Development banks

Recognizing the importance of appropriate financial services for micro-enterprises, the African Development Bank (ADB) approved in September 1997 the AMINA programme (African Development Fund Micro-finance Initiative for Africa), a pilot scheme of US$ 20m. The programme is currently in its two-year pilot phase, and focuses on strengthening the capacity of existing MFIs. AMINA will also focus on the building of appropriate regulatory frameworks of

MF delivery. It will collect and disseminate relevant information among MF practitioners in Africa. Ten countries have been included in the pilot phase, based on *inter alia* their ongoing initiatives and regulatory framework pertaining to MFIs, namely: Burkina Faso, Cameroon, Cap-Verde, Chad, Ethiopia, Ghana, Malawi, Mauritania, Mozambique, and Tanzania. Some efforts focus on promoting linkages between the monetary authorities and decentralized financial systems at the grassroots level. ILO's Social Finance Unit is operating a programme in partnership with the Central Bank of West African States (BCEAO) in support of village banks, women's savings groups, etc. in seven participating Francophone countries (Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal and Togo). Replication of the programme in Central and East Africa is planned. Similarly, the UN Capital Development Fund (UNCDF) operates a micro-finance activity with the *Banque Ouest Africaine de Développement*.

c) Commercial banks

The early supporters of micro-finance maintained that 'the poor are bankable'. This was the basis of the formation of the Grameen Bank in Bangladesh in the mid-80s. The problem has been to get the commercial banks to accept this. In Panama a commercial bank, Multi Credit Bank, saw business opportunities in MF. In 1998 the 3,000 MF loans generated 18% of profits while comprising only 8% of the loan portfolio. The percentage of defaults was also reported to be lower than for other loans handled by this bank (Btesh, 1998). A private bank in Sri Lanka, the Hatton National Bank, has successfully operated a MF credit programme. BankoSol, which evolved from the NGO, Prodem, became a profitable commercial bank in Bolivia, and actually attracted other local banks to enter into MF-type lending, leading to competition in the Bolivian MF market. Examples of commercial banks in Africa that use their own resources towards the provision of MF services are few, although the new generation of African commercial banks is a promising trend (see Box 4 below). These banks recognize that financing of SMEs and micro-enterprises is an important part of their market that can, in the course of time, generate new clients and profitable lines of business.

iv. Outreach of micro-finance in Africa

In Africa micro-finance is still considerably less developed than in regions such as Asia and Latin America. As can be seen from Table 1 reflecting the operations of some African MFIs at the end of 1997, the value of lending and the number of borrowers are small compared to organisations such as the Grameen Bank, the Bangladesh Rural Advancement Committee (BRAC) and BRI Unit Desa in Indonesia. BancoSol in a small country such as Bolivia, had 75,755 borrowers in 1997. Even K-Rep (the Kenyan Rural Enterprise Programme), one of the foremost MFIs in Africa, reached only 7,078 at the end of 1997, compared with 1.7 million for BRAC in Bangladesh and over 2 million borrowers for Grameen.

K-Rep in Kenya is the first NGO in Africa that has been licensed recently as a fully-fledged bank. K-Rep started in 1984 as a USAID-funded project to support NGO credit programmes, and evolved later into an umbrella organization involving a small number of NGOs operating credit programmes. It gradually transformed into an MFI with a minimalist (finance only) approach. In Senegal, the *Alliance de Crédit et d'Epargne pour la Production* (ACEP) started in 1985 and has now 24 outlets spread across the country (ACEP, 1998). Notwithstanding these encouraging developments across the African continent, if micro-finance is to have a significant impact on alleviating poverty and stimulating the micro-business sector, it has to have a much wider outreach.

However, sometimes certain government institutions, without experience in the field of MF, have tried to become MFIs, claiming that 'others' do not reach these target groups. This is usually not very effective.

Table 1
Figures of some Micro-finance programmes in Africa (as at 31.12.97)

Network Member	No of Borrowers	Annual Growth Rate	% Female	Average Loan Size (US$)	Portfolio at Risk	Outstanding Portfolio (M US$)	Value of Deposits (M US$)
ABA *(Egypt)*	14,443	12%	12%	$ 841	1.6%	$ 11.3	n.a.
ACEP *(Senegal)*	5,506	- 1%	30%	$ 526	5.2%	$ 10.3	$ 2.0
CERUDEB (*Uganda*)	6,683	14%	27%	$ 1,110	10.1%	$ 7.8	$ 11.4
City Savings And Loans *(Ghana)*	3,040	543%	80%	$ 363	32.0%	$1.1	$ 1.8
Get Ahead *(South Africa)*	17,239	65%	92%	$ 192	7.1%	$1.9	n.a.
K-Rep *(Kenya)*	7,078	- 17%	58%	$ 878	n.a.	$ 4.1	$ 1.7

Source: 1998 membership survey, MicroFinance Network, July 1999 (www.bellanet.org/partners/mfn)

v. Regulation of micro-finance institutions

Government policies for the financial sector obviously influence the development of micro-finance. It has been common in the past for financial policies to introduce stringent controls on the banking sector, governing the level of interest rates for both lending and deposits and, in some cases also, controlling the amount of credit. Attempts were made to supervise the liquidity of banks by stringent regulations on reserve requirements and the debt-equity ratio of lending institutions. In some countries there have even been legislative requirements on the collateral that the banks have to take from borrowers, in relation to loan sizes.

All this has, in the past, restricted the freedom of the financial sector for micro-finance to cover its costs. Lending institutions must be free to set higher interest rates to cover increased transaction costs in making small, and even uncollateralised loans. Only if ways can be found to charge more for such loans and to find ways of reducing the transaction costs does micro-finance become feasible for any organisation unless heavily subsidised (see Box 2 below).

Box 2: Regulation and co-ordination

A financial institution usually becomes regulated, when it is raises funds for on-lending through savings or deposits. It remains a 'non-bank', as long as deposit taking is limited to members of the institution, and not to the public at large (as in the case of a bank). Regulation and supervision of MFIs has been an issue of debate. First, an NGO that operates as an MFI typically needs to register and have statutes describing the conditions of operation, target group eligibility etc. Such procedures should be clearly laid down. Secondly, there are the regulations regarding lending, such as pertaining to interest rate setting, taxation etc. (enabling regulations). Thirdly, there are the issues of governance and supervision by owners, financial strength, management efficiency, portfolio and delinquency management (Ogada en Grozel, 1998). The above determine the rules of operation, enforced through strict monitoring in practices against fixed standards (capital adequacy, portfolio quality, management, earnings and liquidity requirements).

It is argued that regulation is not required, if no deposits are taken and if the integrity of the financial system is not at stake. Others stress that MFIs are lenders and one should apply the regulations and controls applicable to banks to the MF market, the main difference being the minimum capital requirement. Correspondingly, the regulatory framework varies from country to country, from simply pursuing good practices and self-regulation to specialized regulations specific to MFIs.

In South Africa, the development of codes of conduct for micro-lending is achieved through bringing together representatives of the main stakeholders (Berenbach and Churchill, 1997). Similar efforts have been undertaken elsewhere in Africa to create consensus among MF institutions and to influence policymaking (Women's World Banking, 1998).

Experience has shown that the lack of a regulatory framework for MFI has resulted in duplications and contradictions. At times donors go faster than recipient countries as regards the creation of MFIs. It has been reported that the establishment of institutions financed from donor funds has often created 'financial service islands' totally separated from the local financial infrastructure (Ministry of Foreign Affairs, the Netherlands, 1996).

vi. Savings

Savings mobilisation has now become an element in several micro-finance programmes for various reasons. First of all, savings provide a relatively inexpensive source of capital for re-lending. In the medium or long term, savings may develop into assets that may be used by borrowers as collateral in dealing with commercial banks. Nevertheless, problems can arise when subsidised programmes force borrowers to save a small percentage of the borrowed money as a hedge against the possibility of repayment difficulties. Micro-finance programmes may derive more benefit from mobilising voluntary, rather than compulsory, savings (Robinson, 1995). In the mobilisation of savings it is also important to offer attractive interest rates on deposits and flexibility for the saver to obtain easy access to the money deposited. Too little attention may have been paid in the past to the appropriate deposit rates to be offered in saving programmes to borrowers of micro-finance.

In many countries NGOs are not entitled legally or by charter to hold savings deposits. The interests of savers must be protected and it is therefore not advisable to allow any organisation the privilege and responsibility of holding savings, without ensuring that the saver is protected either legally by guarantees (such as deposits insurance), or by the financial soundness of the institution where the deposit is made. The desire to collect more savings and deposits has, in fact, been a major factor in impelling the larger NGO micro lenders to wish to transform themselves into major chartered banks.

vii. Challenges

In the field of MF, donors, policy makers and practitioners face a number of challenges, including:

- *increase outreach:* the target set by the Microcredit Summit is ambitious and will require significantly increased resources. In addition to tapping traditional sources of financing (through multi- and bi-lateral donors) to support the expansion and upgrading of new and existing MF initiatives, the formal financial sector in Africa will have to take a bigger role in the development of MF. If Africa's MFIs improve performance, expand outreach and adhere to good practice, this may lead to more donor resources, commercial lending, increased savings and earnings from lending.

- *improve MF delivery:* the popularity of MFIs and corresponding availability of donor resources in this field should focus more attention on improved MF delivery. This includes the exchange of information, experiences, the diffusion of tools, training and advice. Performance measurement should focus on key ratios and indicators related to financial health of the organisation, operational efficiency and portfolio quality with the aim of sustainability. An effective management information system (MIS) is crucial to analyze the institution's strong and weak points. In this context the use of Internet as envisaged by the newly established Paris-based international NGO PlaNet Finance, reflects an innovative approach to MFIs (Attali, 1997).

- *recognize that MF is not a panacea for but can help reduce poverty:* MF it is claimed to be one of the roads to alleviate poverty, through income generation. MF has to combine social objectives with good banking principles but it can be argued that those that can pay the higher rates are not necessarily the poorest of the poor. Measurement of impact on the target population is important, albeit keeping in mind a proper balance between rigorous impact measurement in terms of effects on clients and the wider environment and the cost of such in-depth evaluation. Efforts have been made to make these more cost-effective. Examples are to be found in the work of USAID's Micro-enterprise Best Practices project and in research initiated by the Ford Foundation.

- *accept that 'larger than micro businesses' need more financial help:* MF is the only financing available to micro-enterprises and is crucial for starting and expanding such basic economic activities, but MF is an inadequate instrument for most manufacturing and related services that typically require larger amounts for investment and working capital. To illustrate, the World Bank reported on a pilot project in Madagascar, in which 54 Savings and Loans associations have been set up in the period 1993-1997, with average loan size of $132, and repayment rates of some 96% (World Bank, 1998). In spite of the preliminary success in this pilot phase, the limitations of loans of this size for stimulating business development and creating employment are evident. Similarly, in ACEP's portfolio the average loan size was $526 (MicroFinance Network survey, 1998); not surprisingly more than 60% of the loans were in the trading sector, compared to only some 6% in manufacturing (ACEP, 98). Growing SMEs need loans in the US$ 3,000 – US$ 50,000 range which MF cannot provide. Only the formal banking sector can fill the gap.

It is clear that micro-finance is still in an early stage in Africa. If it is to have an impact towards stimulating the growth of micro-businesses into small enterprises, MFIs in Africa will need to expand considerably the number of borrowers served and the total amount lent. Apart from this, more needs to be done in Africa to help micro-enterprises grow into formal small businesses (graduation). Undoubtedly micro-finance fulfils an important role and has a significant impact on the relief of widespread poverty in Africa. However, in the end it is the growth of businesses into SMEs (covered in the next section) that will make the contribution towards wider business development and creating more employment and ultimately raising living standards in Africa. Micro-finance alone will not be able to achieve this.

B. Financing for small and medium enterprises (SMEs)

i. SMEs and the formal financial sector

SMEs constitute a vital element of the development process and their contribution in terms of production, employment and income in both industrialized and developing countries is widely recognised. Limited access to the required financial resources to start, survive and grow is one of the challenges faced by SMEs, a heterogeneous group of businesses with varying needs at different stages of enterprise development. Reference is made in this respect to paragraph 1.2 in which the problems in accessing investment and working capital are described.

A healthy formal financial sector is one of the ingredients of an environment conducive to enterprise development and growth. It represents the sum total of all the intermediary institutions offering financial services to the business community and the population at large. Unfortunately, in many African countries the financial sector is not yet well developed, although macro-economic reforms and bank restructuring have in recent years led to healthy changes in the financial sector landscape across the continent, in the form of improved regulatory framework, reduction of direct control over interest and exchange rates, less interference in directing bank lending etc. (see Box 3 below). Pursuance of such reforms including privatisations of state-owned banks and development of credit rating are expected to make African banks stronger and more competitive and enable them to access global capital markets.

ii. Who are the financial intermediaries?

Apart from central banks, other institutions that make up the financial sector in developing countries generally include: commercial banks, investment banks, development finance institutions, rural and people's banks, insurance companies, different types of equity finance groups, sectoral or specialised banks, and credit and saving unions. Stock exchanges and capital markets are either non-existent or only in their infancy in most African countries. Some do have operating capital markets and relatively more developed financial sectors. South Africa, Zimbabwe, Kenya, and Ghana may be quoted as examples. As far as finance for SMEs is concerned, commercial banks, development finance institutions, leasing organizations, credit unions and some venture capital companies are the main providers

Box 3: Financial sector restructuring

Aware of the problems afflicting the financial sector in African countries, the World Bank developed a programer of financial sector adjustment to restructure the ailing financial system of African countries. This included the re-capitalising of sick financial institutions and bringing interest rates in line with prevailing market conditions (as many of the loans offered tended to be subsidised -including the credit lines and loans offered by foreign donors to all sizes of firms). The aim of the World Bank was to end loan subsidies, to revise all systems for licensing new financial institutions, to promote more competition between financial institutions, and change the rules of operation of some of the state-owned institutions, particularly development banks, in an effort to make these institutions operate on a more commercial basis. Other reform measures involved the liberalisation of exchange rates, import/export and in some cases of overall control measures on the granting of credit.

Structural adjustment programmes (SAP) began in Africa in the late 1980s or early 1990s. There is debate on the actual impact of SAP: there are claims that countries improved their macro-economic policies, but there are also views challenging the results in terms of increase in investment and degree to which growth rates can be explained by macro-economic policies versus other variables (Okonkwo, 1996). A new set of beliefs is evolving, considering earlier prescriptions based on 'the Washington consensus' incomplete and *inter alia* highlighting the role of government in undertaking actions that make financial markets work better (Stiglitz, 1998). This puts a demand on the quality of institutions in building up and supervising the performance of a healthy financial infrastructure.

Inevitably, the structural adjustment measures initiated by the World Bank, led to a difficult transition period, as credit controls and interest rate rises imposed hardship and problems on businesses dependent on loans. Exchange rate changes made foreign loans more difficult to service and increased substantially the costs of imported materials and equipment, which led to increased inflation and higher interest rates. Trade liberalisation created situations where local SMEs could not compete with cheaper imported goods. All these problems have imposed special hardships on the formal SME sector and significant numbers have gone out of business in African countries since structural adjustment began. Micro-businesses, being less dependent on imported materials, less subject to foreign competition and interest rate changes, have fared somewhat better.

a) Central banks

The degree of independence of central banks differs from country to country; some were less independent in their relationships with the Treasuries and Finance Ministries and were unable to introduce the necessary legislation on the operation of banks and the standards required for setting up a formal financial institution. This led, in a number of countries, to the setting up of banks without a sound financial structure, with far too low capitalisation and high indebtedness right from the start. This indebtedness only grew as some of the banks were unable to recover a dangerously high proportion of the loans they issued.

b) Commercial banks

Commercial banks are the main formal providers of financial services to the business community. They act as financial intermediaries by mobilising deposits and savings and then on-lending these resources for personal and business loans. Larger commercial banks offer varied financial services– not only savings, deposits, credits but also foreign transfers and exchange transactions, as well as insurance, bill payments, handling investments and advising on investment portfolios, factoring and leasing.

The commercial banking sector in many African countries used to be dominated by foreign banks and, following independence, state-owned commercial banks were set up. Since around the mid-1980s, following the recognition of ineffective performance of public-owned banks, a number of privately owned banks have developed in some countries such as Ghana, Kenya, Nigeria, Uganda and Zimbabwe, among others. Most of them, however, were acutely under-capitalised and made ill-advised loans.

The main lending of commercial banks in most countries relates to the provision of short-term working capital, since the deposits they use for their funding are, in turn, also of a short-term nature. The extent to which they are willing and able to provide longer term loans depends, to a great extent, on the character of the deposits which they are using as funding. As in most parts of the world, small business is perceived as risky, since the failure rate is high. The lack of documentation available makes it difficult to obtain a clear picture on the financial situation and prospective success of such businesses. The transaction costs of lending to SMEs is high in relation to the size of loans, making such lending in many cases unprofitable, especially if the interest rates are controlled and loan recovery entails costly collection efforts. It is not surprising, therefore, that most commercial banks in Africa – both state owned and private (almost without difference) – prefer dealing with larger trading companies, rather than with small struggling manufacturing enterprises.

One of the requirements for banks to engage in lending to riskier categories of businesses, is recourse to a correctly functioning judicial system. In this respect, the establishment in 1993 of a unified commercial law covering (part of) francophone Africa (*Organisation pour l'Harmonisation en Afrique du Droit des Affaires* -OHADA), constitutes an improvement, defining the basic guidelines for a common judicial framework and providing for a recourse (a Supreme Court in Abidjan) in case of non-satisfactory settlement of disputes at the national level.

Donors agencies have played a significant role in offering credit lines to African commercial banks, mostly state-owned, but lately also to some private and even foreign owned financial institutions. Donor funding to commercial banks in Africa for lending to SME has resulted often in imposing more stringent conditions for screening of borrowers and debt recovery proceedings and portfolio management. Foreign advisers were posted to help and advise in the management of donor credit lines, to ensure that the beneficiaries conformed to the original target group laid down when the donor loans were approved and to the terms and conditions on which the credit was approved. Donor support and intervention have also resulted in staff training and upgrading, thus contributing to improving the operation of some commercial banks (Webster, 1991).

Some of the services offered by commercial banks are highly profitable and can subsidise others which produce less/slower net income such as lending to SMEs. In a similar way, larger urban branches that serve bigger populations can cross-subsidise smaller branches in rural towns that hardly break-even. In some cases banks are only allowed by the government or central bank to set up new branches in urban centres, when at the same time they set up an equivalent branch or branches in rural areas. The larger branch networks that commercial banks have makes it easier for smaller and medium enterprises to gain access. The cost of making a journey to visit a bank, together with the preparation of data and documentation, may be out of proportion to the volume of financial help sought if it involves travelling a few hundred kilometers to a capital city to discuss a small transaction. At the same time, it can take considerable time and effort for smaller branches to break even.

In countries with larger financial sectors, competition between banks may play a major role in widening outreach but this is less so in Africa. However, promising new initiatives, particularly in new banks, have started, as illustrated in Box 4 below. It is likely that existing banks will be influenced to follow.

Finally, there is a tendency to lump all commercial banks together but, in reality, this category of financial institutions encompasses a broad variety of different types of organisations. Within the title of commercial banks can be included cooperative banks, and people's banks or *banques populaires*. Also, there are credit unions such as the Rotating and Savings & Credit Associations (ROSCA) which combine savings and lending to a relatively small number of participating members. Credit unions created by specific trades, such as garment makers, carpenters etc., do play an important role since they can be organised for bulk purchases by members and for joint marketing activities. In addition, new types of banks have developed over the last years, such as Islamic banks, which are governed according to Islamic religious beliefs, which do not permit the charging of interest on lending. The lending mechanism developed by Islamic lending banks is based on the bank and clients sharing the financial risk and success in a form of profit sharing. It can be considered a variation of venture capital, discussed below.

Box 4: A new generation of African banks

In Benin, financial sector reform in the early 1990s led to the establishment of new private banks, majority-owned by domestic private investors. Bank of Africa-Benin (BOAB), reported to be largely the brainchild of one entrepreneur, has become the largest commercial bank in the country since it started its operations in 1990. The bank focuses on providing modern banking services to households and firms. Partners include Proparco, FMO, BOAD and IFC. Its loans and investments increased from 3 per cent of total assets in 1990 to 52 per cent in 1995. BOAB is currently focusing on developing its medium- to long term refinancing. It established branch offices, also diversified by creating the country's first leasing company and by becoming shareholder in the country's first private life insurance company. The Bank participates in the financial restructuring and expansion of larger scale enterprises and participates in credit programmes focused on SMEs and micro-enterprises (G. Pfeffermann, IFC, 1999).

In the neighboring country Togo, Africa's first locally owned regional bank holding company, Ecobank Transnational , was established in 1988, reflecting the driving force of the private sector in promoting regional integration. Ecobank had difficulties in the beginning, but is reported now to be profitable. Outside Togo, it has subsidiaries in Benin, Burkina Faso, Côte d'Ivoire, Ghana, Nigeria and Mali and intends to open additional ones in 3 other West African countries soon. It plans ultimately to be present in all 16 ECOWAS countries. Partners are ECOWAS Fund, Kingdom Holdings Africa and IFC. The mission is to provide first-class corporate and consumer finance and focus on 'doing basic banking well' in the ECOWAS region according to its CEO, former Citibank staff member. ECOBANK co-operates with the African Management Services Company (AMSCO) as regards staff training and improving banking practices. To reduce the cost of training abroad, it is to establish the first regional school of banking in West-Africa, expected to be launched in early 2001 (IFC, Impact, 1999).

c) Development banks

The earliest examples of development banks were in the 1960s/70s when the first such bank was set up in Africa with a World Bank loan in Ethiopia. Subsequently, development banks were set up in most African countries under state ownership, including, in several of them, separate sectoral development banks, e.g. rural development bank, agricultural banking institutions and housing banks.

To illustrate, of the World Bank's US$ 3bn lending to SMEs in the period 1973-1989, the largest number of projects was in Africa - all of which were channeled through public sector banking institutions. Unfortunately none of the cases reported as successful were in Africa. The average repayment rate of the credit lines in Africa was reported as 61 per cent (Snodgrass and Biggs, 1995).

Most development banks, like their commercial counterparts, have suffered from severe under-capitalisation which has only been rectified by continuous international multilateral and bilateral loans to the point where more than half of their capital on the balance sheet was owed to international institutions such as the World Bank.

Development banks have usually operated from single, large headquarters in the capital, which made it difficult for them to provide access to smaller firms in the provincial/rural areas. The staff are generally trained for lending to larger enterprises and are unsuited to lending to SMEs. In most cases, they have been prohibited from taking deposits from the public which made them reliant on government and international donor funding, Not surprisingly, as time went on, they were subject to considerable government pressure in both the granting of loans and in their recovery. Some of their major clients were loss-making para-statals, producing losses in the development banks and making them more and more reliant on 'bail outs' from donors or government, or from both. In most cases, to become profitable, such institutions need to restructure themselves, to be re-capitalised and to broaden the range of financial services they offer. They will also have to become more independent of governments.

Although privately owned development banks are few, at least in Africa, there are a number of African countries, where development banks and corporations in donor countries (examples are France, Germany, the Netherlands and Sweden), became equity partners in the creation of Development Finance Institutions (DFIs). By the 1990s, it has become increasingly evident that many special donor-supported DFIs were unable to achieve sustainability.

iii. Credit guarantee schemes

Credit guarantee schemes aim to share risks with lending institutions so that the lender will be compensated for all or part of the loss on a loan default. Such schemes are intended to help those entrepreneurs who have sound viable projects but cannot offer satisfactory collateral to meet the requirements of a lending bank to obtain credits. Experience has shown that such guarantee systems must be designed and implemented so that claims can be made and settled against default without undue delay or bureaucratic problems. For a guarantee scheme to be attractive to a bank, it should not increase the costs of loan processing for the lender. Usually, credit guarantee schemes create a special fund to be used to meet claims, although there are some successful schemes in developed countries where no specific funds exist, but only a commitment by the government that the loss guaranteed will be paid if there is a default.

The creation of a guarantee fund has the added advantage that it can be invested in some relatively liquid form and so earn income for the organisation managing the scheme. Furthermore, a guarantee fund need only be at a level to cover the anticipated default of loans and so can be leveraged, possibly five or ten times. This means that for each US$1m in the fund, a volume of US$5m or US$10m in credits to SMEs can be guaranteed, or possibly higher, depending on *inter alia* financial discipline in repayment.

A common criticism of credit guarantee schemes is that of 'moral hazard'. The scheme may weaken the will and commitment of both borrowers and lenders to repay the loan or collect payments vigorously when they know that a significant part of the loss will be paid back by the guarantor. A good guarantee scheme will take steps to reduce the degree of 'moral hazard', first by requiring those who obtain credit to offer whatever collateral they can, even when this is appreciably less than would normally be required by the lender to approve the loan. Also, the lending institution must assume a proportion of the risk involved. Here, best practice seems to indicate that lenders should assume at least 25% - 40% of the risk and not less than 20%.

Of late there have been moves by guarantee schemes to overcome reluctance of banks to participate and to reduce delays by authorising participating banks to approve a guarantee without reference to the guarantor, once the bank has been "accredited" by the guarantor. This "accreditation" is usually based on recognition of soundness of the bank's financial structure and capitalisation, the quality and number of its staff, their competence to screen SME loan applicants and to appraise their projects, and acceptable levels of loan portfolio performance. The lender may then be allowed to approve a guarantee for a lower percentage.

Fees charged for the guarantees to the bank -but mostly passed on to the borrowers- are the main source of income; the most usual level of fees is between 1% and 2% of the loan amount on application. In most cases part of the fee is not returned, even if a guarantee is not approved and is considered a levy paid to cover the cost of screening and approving the borrower and appraising the project for a guarantee. An annual fee of 1% - 3% is then levied for the repayment period of the loan on the actual amount of the guarantee. Too high a level, either for the front-end fee or for annual payments would tend to act as a deterrent in the use of the guarantee scheme (Levitsky, 1997).

In Africa guarantee schemes have had a poor record. Where they have been tried, the banks have generally not had confidence that the guarantee organisation, usually the central bank, would settle claims quickly and without dispute. Only in South Africa, and some years ago in Ghana, have there been some relatively successful guarantee schemes but in the latter case, only for a limited period. This should not lead to the conclusion that guarantee schemes have no applicability in the African context. Schemes must be designed carefully, tested after consultation with the banks that use them and revised where necessary with due care to try to avoid misuse.

C. New developments in private enterprise financing in Africa

i. Leasing/hire-purchase

Leasing and renting refers to a form of financing whereby premises, equipment, vehicles etc. are made available against a regular, usually monthly, payment. In agriculture and construction, such arrangements are quite common. In recent years, computers have been leased out too. In leasing, there is no transfer of ownership, but usually the lessee is entitled to buy the goods at a low price after the termination of the lease contract – usually after around 5 or 6 years.

The monthly fee on leasing is usually quite high since it has to cover the depreciation, maintenance, insurance and, possibly, an allowance for financing or inflation, as the case may be. In general, goods that are leased, particularly factory equipment, are of a fairly general nature as they have to be easy to sell if the client business fails or falls into arrears in the payment of the monthly leasing fee.

The advantage of leasing to small scale entrepreneurs is that it can reduce the need for collateral to obtain a loan. It can also help the business to react more flexibly to fluctuations in changes for demand in certain products as in the obsolescence of certain types of equipment. Leasing also allows businesses to free a larger part of resources for working capital finance. In the case of short-term leases or rentals, this can solve the problem, particularly with mobile equipment, for peak demands or contract work where the period in which one will use machinery can be relatively short and would not justify the outright purchase.

Leasing is to be encouraged as a means of solving shortages of equity finance and difficulties of obtaining loans for smaller firms. In some countries, in South America and South East Asia as well as in some of the more developed countries, some major equipment suppliers engage primarily in leasing out their products rather than selling them. Banks or other financing institutions sometimes have leasing subsidiaries. There is need, however, for legislation to protect lessees, particularly against high down-payment requirements or exorbitant leasing fees.

Leasing arrangements are few in Africa, except possibly in construction. Only in the Maghreb region of North Africa are leasing arrangements more widespread; they have played a significant role in Morocco, enabling small firms to equip their businesses when they lack access to the capital to buy the equipment they need, or where for special reasons it would not be economically viable to buy.

ii. Venture capital

Venture or risk capital is the name given to equity investments in businesses by outsiders who are not the main owners. Venture capital investments participate in the risks of success or failure of the business and, because they face such risks, it is to be expected that they will look for high returns (high risk – high return; see Box 5). Venture capital 'nurtures' enterprises in their early stages, typically when the marketing of new products is launched. In the early stages of a business, there is little prospect of significant income return and the venture capitalist foregoes the continuous assured income that might be derived from lending the capital sum, in favour of increased returns through capital gains in later years and when the investment is finally sold.
At the institutional level, Venture Capital Funds (VCF) make available equity investments in smaller businesses that are considered to have strong potential for significant growth. It is considered that in the course of time, they will yield satisfactory financial returns in relation to what might be obtained through depositing the money in a fixed interest account.

As indicated above, some of the venture capital may come from family links. Sometimes, some larger firms or corporations in an industry may provide some capital to new, smaller firms who may be suppliers of materials, components or services or may be just new firms who they consider as offering innovative products and special promise. The latter type of arrangement between large and smaller firms has been evident in the last years in South Africa, where some of the large corporations in the country have made available relatively small amounts of capital (for them) to help enterprising persons - often former and existing employees from the disadvantaged populations - start a business. Another source are 'business angels', rich individuals who have sold off some of their business interests and are looking for new, favourable investments that they might take an interest in. However, nowadays the primary source of capital are institutional investors such as pension funds, insurance companies, development agencies, merchant or investment banks.

In Africa, there is little experience of venture capital although there has been a start in some countries. Most previous attempts of donor agencies to launch venture capital projects in Africa have had mixed, though predominantly relatively poor results. Foremost among these has been the US Agency for International Development (USAID) which has made some efforts in Africa among its 13 worldwide projects in this field. One was the Kenya Private Enterprise Development Project (KPED) in the 1980s. USAID found that there was little interest in the provision of venture capital and that most of the owners of small and medium sized businesses that were targeted by the project had no desire to reduce their debts in exchange for partial ownership in the company. Moreover, many companies either were unwilling or did not have the financial documentation needed by venture capitalists to assess realistically the potential for investment. In the report of this project, it is stated that 17 of the 18 firms asked if they would submit proposals for possible venture capital investments showed no interest. (Fox, USAID, 1996).

Apart from USAID's efforts, there have been some other more recent attempts to develop venture capital in African countries. Some of these were the initiative of the Commonwealth Development Corporation (CDC) of the U.K. The CDC had some experience in other countries in Asia and Latin America and the Caribbean. Since 1990 it has tried to focus more venture capital efforts in Africa. The first was the setting up of the Venture Capital Company of Zimbabwe (VCCZ) in 1991, capitalised at the then equivalent of US$ 14m. The International Finance Corporation (IFC) of the World Bank provided 20% of the share capital while DFID (then ODA) contributed some technical aid. The first years were difficult; VCCZ was faced with a flood of over 500 applications, with only about 2% of the applications resulting in deals. This is similar to the experience of venture capital companies in other countries.

By 1996 VCCZ had effected over 20 investments but of these two had already failed. As ‘start ups’ were considered to be most risky, VCCZ looked for some existing firms that wanted to expand but these were hard to find. A major problem faced by the VCCZ was that the income from dividends was slow to come, nor was it possible to sell off any of the investments; as a result, the share capital invested by donors was gradually used to cover operating costs. As has been found in other developing countries, donor supported funds had social and development objectives which made it difficult for VCCZ to choose investments to maximise financial returns. Inevitably, VCCZ started to lend more than invest in equity, as had happened in some of the USAID examples in other venture capital cases.

CDC has also helped to develop, with USAID, the Ghana Venture Capital Fund (GVCF) and the Tanzania Venture Capital Fund (TVCF). Both are now in operation. Based on the experience of the VCCZ, and to safeguard against the erosion of the capital through excessive management costs, in Tanzania as in Ghana there is a similar arrangement of two companies (the venture capital fund and the venture fund management company), with an annual fee to cover the management of investments. The CDC-assisted venture capital projects in Zimbabwe, Ghana and Tanzania have moved slowly and have faced a paucity of high return projects in which to invest, exacerbated by a reluctance of local entrepreneurs to accept outside investors and partners.

The African Development Bank organised in 1992 and 1994 seminars on the subject, to discuss the preconditions for promoting VC in Africa. Experiences were described, such as of FIARO

(*Financière d'Investissement ARO*) in Madagascar, established in 1988 and reported to manage a portfolio of 30 VC projects by the end of 1993. FIARO's partners include *inter alia* PROPARCO (Subsidiary of Caisse Centrale) of France and IFC (private finance affiliate of the World Bank). In Tunisia, the *Société de Participations et de Promotion des Investissements* (SPPI), which started in 1990 and constitutes a venture bringing together 10 commercial and 7 development banks, had approved a total of 41 VC projects by end 1993. The obstacles mentioned to venture capital operations in Africa included factors such as scarcity of high-yielding investment opportunities and inability to cover in the long-term operating cost of VC structures (ADB, 1994).

As stated above, venture capital investors expect their main return through the sale of the equity share after a number of years of growth. In Africa, many entrepreneurs expect that they will be able to buy out outside investors for close to the sum of money that was originally invested. This is, of course, totally unacceptable to venture capitalists as it would mean that they would share in the risk of failure but would not benefit from the capital gains from success and growth.

Without developed capital markets, as is the situation in most African countries, there is little chance of a flotation of the company, which would test the capital worth through the share price and demand for shares. It is also unlikely that more than a few firms would reach that level of growth within 5 to 10 years to be able to be floated on the stock exchange. Takeovers, or as is sometimes called 'trade sales' to other companies or to other investors in the country, are also rare in Africa. In the end sale to the main owners is the major form of 'exit'. It has to be laid down in the original agreement how this will be done and how the company will be valued.

Usually venture capital firms find 20-40% the optimum level of equity participation. Below 20% is too low for the venture capital firm to influence major management decisions and 40% - perhaps up to 49% in special cases – is as high as one can expect an entrepreneur to give over to an outsider.

Most venture capitalists in Western countries do not become involved in the daily management of the firms in which they invest. They do sit on a Board of Directors and try to control such items as further significant investments or purchases, development of new products, significant reorganisations and, management remuneration, arrangements for bookkeeping and auditing of the firm's accounts. They may want to be informed of and to control all other business activities of the partners.

Most venture capital companies also lend funds in addition to the equity investment made. This provides some income in interest and debt repayment and often helps to balance the high risk of making only an equity investment, which would leave the venture capitalist waiting for dividends while the enterprise's debts are being serviced.

As can be seen from the above examples, the cost of screening proposals and of negotiation of shareholder agreements is high and there is a protracted period before there is any financial return in dividends. It is not unusual therefore in Africa, for venture capital firms to be offered a management fee in the range of 2-3% of the total investment amount involved. So far, such management payments have been generally covered by donor funds.

Box 5: Equity investment - looking for the right projects and partners

The provision of equity capital has a place in the financing of small businesses in Africa but it can only fill a financing 'niche' which might be called 'the equity gap' to generate an adequate balance between debt and equity. Most venture capitalists will not invest principally in small enterprises, since high-return opportunities are relatively few, risks are high and 'exits' very difficult. In western countries, such investments take place in smaller companies, to finance the initial concept of a business, product development, expansion or to prepare a company for a public offering, typically in innovative or 'high-tech' fields. In the African context, it is hard to find such cases, though competitive advantages in the low(er)-technology and service sectors with export potential could provide VC opportunities. Agro-business projects might also offer opportunities.

As an indication of the risky nature of venture capital in smaller firms in developed countries, the statistics usually quoted are that 20-30% of investments end in total losses, around 40% are survivors but with little growth prospects or hopes of profitable assets sales. Only about 20% (at the most 30%) are successes in which substantial returns and profits are made, often enough to cover the losses sustained in the others.

There is potential demand and market for venture capital in Africa. However, the conditions for offering risk capital (high value-added and high returns in a relatively short period in return for high level of risk) as well as for accepting such participation (need to share ownership) are likely to limit the outreach of such schemes in the near future.

Because of the difficulties faced by venture capitalists in making equity investments in smaller firms in Africa, there is a strong case for special tax concessions or treatment to encourage venture capital investment. As an example, one may quote the case of the Republic of Korea, which has special legislation to encourage venture capital activities. Companies in which venture capital firms have invested, benefit from full exemption from corporation tax in the first four years of operation and a 50% reduction for the following two years. Up to 50% of the venture investments made each year can be set against taxable profits (Yung Yoon Park, 1992).

iii. Other trends on the African capital market

The development of capital markets and stock exchanges is the final and most sophisticated phase in the evolution of the financial sector. A number of Africa-specific emerging market funds have been established, with a combined worth of US$ 1 billion (of which the Morgan Stanley Africa Investment Fund –US$250 million) is the largest. Some are country-specific, such as Mozambique's first private equity fund Minco, launched in September 1998; others are regional or pan-African.

On the African continent, only in South Africa is there a larger active capital market. The stock exchange of South Africa accounts for about 70% of the total of US$ 280 billion Africa’s stock exchanges’ capitalisation (end 1997). Including South Africa, there are 15 active stock markets in Africa. Next to South Africa, the largest markets in Sub-Saharan Africa are in Zimbabwe, Nigeria (US$ 2 billion each) and Kenya (US$1.9 billion), but even in these exchanges, the number of listings is still low and markets regulations are in their infancy. The other 11 stock markets are even less effectively regulated and have even shorter listings. Most have been in existence for only a relatively short period of time and have low trading volumes. There is always a danger of such markets being strongly dominated by a few of the larger companies who manipulate trading to suit their purpose. There is need for more precise investment regulation and foreign technical assistance to develop acceptable trading standards and practices. At the same time, the number of instruments trading on the new capital markets has to be expanded to suit the needs of the African countries. As the process of privatisation of utilities and other large companies, previously in the public sector, gains pace, there is need for a market in bonds as well as shares.

Other instruments need to be developed and traded on the markets to bring in listings of smaller (possibly more technologically advanced) companies with high growth potential. Such instruments might include Mutual Funds or Unit Trusts where smaller investors can buy into these growing firms through managed share portfolios. In addition, consideration might be given to special mini exchanges for trading in the shares of smaller companies, something similar to the Nasdaq in New York, Easdaq in Brussels, AIM in London, Neuer Markt in Germany and Nouveau Marché in France, although these exchanges concentrate more specifically on high technology firms.

In view of the small domestic markets of most African economies, there is need for regionalisation and linking of different exchanges as are under preparation in Southern, Eastern and Central Africa. There are many difficulties in such an arrangement but only such linkages can be expected to give adequate scope in volume and range of activities for the operation of successful exchanges and sufficient to use a 'state of the art' quotation system. A regional exchange for the Francophone countries of West Africa started operations in Abidjan in September 1998 (Bourse Régionale des Valeurs Mobiliers, BRVM), providing a common exchange for Benin, Burkina Faso, Guinea Bissau, Côte d'Ivoire, Mali, Niger, Senegal and Togo. Listings and trading volumes are still very low but there is hope that they will grow in the course of time.

In 1996, the African Capital Markets Forum was established, bringing together African institutions associated to the capital markets with a view to exchanging information and expertise, and acting as a multi-country advocacy group of institutions involved in raising capital for private sector endeavours in Africa.

CHAPTER III:

Financial services and business development services

A. Limitations of purely financial schemes

As indicated in the introduction of this paper, financial services alone will not be able to produce sustained enterprise development, although increasingly MFIs are finding it more effective to concentrate on offering finance alone. In such cases non-financial support services are expected to be offered by other service providers. Although there may be differences of opinion on the subject, there is no doubt that a suitable synergy between financial services and business development services (BDS) can make credit schemes more effective and can produce a more successful outcome in lending programmes.

An organisation approached to finance an investment in an enterprise must recognise that the key to success lies in the feasibility of the project and the quality of the entrepreneur. Institutions in Africa complain of a dearth of good investment proposals. There is undoubtedly some validity in this comment but no clear conclusions as to the reasons. It may be that there is not really a shortage of projects but a lack of well-presented proposals in a bankable form.

The majority of entrepreneurs in Africa, whether contemplating a start-up or an expansion, need some help to convert ideas into a technically and financially acceptable business plan. There are many imperfections in the flow of information in African countries and effective BDS can assist in reducing business failure by filling this gap. There is an element of risk in all business undertakings – in fact there is a well-known, accepted relationship between reward and risk in the business world. When information and data are available, undue risk can be minimised, although not eliminated entirely. BDS can also facilitate possible partnerships with foreign investors or venture capitalists but only if there is sufficient data, records and information on the business and the investment proposal. General statements are not effective in negotiations on potential partnerships. 'The devil is in the details' and, to present such a detailed proposal, most entrepreneurs need advice and assistance.

Some banks have tried to solve this problem by organising their own advisory and consultancy services. Inevitably, this is costly but apart from the cost, there is a potential conflict of interest between those who help draw up the business plan and the loan approval process which has to remain objective and independent. The real help that BDS can give is often before an approach is made to the financial lender. It is then that the entrepreneur can be helped to prepare a convincing business plan, undertake some market studies and improve business records; all of which may help towards a loan being approved. The African Project Development Facility (APDF) of IFC based in Abidjan gives considerable support to those preparing project financing proposals. APDF is assisted by a CIDA programme in Ghana to provide BDS to those that have received financing. Advisory services developed by banks understandably tend to focus on clients and to follow-up on non-payment of loans.

There is a technological element that is important in all investment proposals. Technological capacity (as defined in a World Bank study quoted by Dawson and Jeans, 1997), is the ability of producers to identify product opportunities, to source, install and operate the right equipment and to have the knowledge and technical experience to implement changes in the production process, as well as to innovate to meet changing market conditions. These complex factors can be vital in determining the success or failure of a project and it is this field of capacity building that generates clear synergies between financial and non-financial services.

The above reflects the argument that much sought after progress in terms of technological deepening, innovation, quality improvements are unlikely to come from *credit alone*. Financial services are necessary but not sufficient. If focus is on expansion of business activities rather than upgrading production techniques and improving productivity, there is a risk of gradual market saturation and, accordingly, of SMEs moving into a low technology, low quality production trap (Dawson and Jeans, 1997).

B. Complementary non-financial services

Financial intermediaries and BDS providers need to work together for the following reasons:

- The chances for a credit approval is enhanced if the business plan convinces the lender. As has been pointed out, when banks provide the advice and help to prepare such a plan there are problems and it is costly. Some banks successfully operate a very small unit to discuss requirements to satisfy the bank and some loan officers are equipped to undertake such discussions. Generally, the borrower has to go elsewhere to find a BDS provider – private consultants, a business association or some private or public business centre. It is rare that NGOs can provide such services effectively. Working with BDS providers can reduce the transaction costs of a bank in handling loan requests. This makes such lending financially more attractive.

- Credit schemes may benefit from working together with BDS providers in recommending enterprises to obtain outside advice when encountering problems resulting in poor loan repayment. However, BDS providers must not become debt collectors.

- Loan officers can benefit from networking with BDS providers as partners when needing to become more familiar with data on the sector involved and identifying the risk involved in new product development or expansion projects. Cooperation with BDS providers can also help loan officers become more familiar with the personality and background (and credit-worthiness) of the entrepreneur seeking the loan.

In the early years of support for SMEs, emphasis was placed on the creation of public SME support institutions. These are now more rare. Many have disappeared after becoming ineffective with poor staffing, minimal outreach and little impact (UNIDO, 1996). Concerned about the result of BDS-related interventions, the Committee of Donor Agencies for Small Enterprise Development has worked starting 1995 on good practice guidelines on the development of BDS for SMEs, which were published in 1998.

Strengthening BDS capacity of a variety of service providers is a core feature of many of the projects in, *inter alia,* Africa in which UNIDO is involved (UNIDO, 1999). These BDS may include information and referral, general business counselling, specialized advisory services such as facilitation of business linkages, technology acquisition and use, enterprise restructuring etc.[1] The challenge is to install and maintain a business-like orientation of the service provider to enable survival on fees generated from services delivered to SMEs combined with some degree of subsidisation. Whereas in a market economy most BDS is expected to be provided by the market, public support is called for when the market is not addressing the problems faced by existing and potential entrepreneurs.

There have been interesting non-government and private sector efforts in the field of BDS. For example, in Benin public support is stimulating access of SMEs to the services offered by selected private consultancy firms that are providing them with business planning, and enterprise restructuring/rehabilitation support. Efforts are undertaken to link such SMEs clients with local banks. In this process also the partner consultancy firms receive guidance, with a view to strengthening their capabilities as BDS providers. In Lesotho, co-operation among public and private institutions, supported by donor agencies, resulted in training and advisory services, as well as improved access to credit of small, predominantly rural entrepreneurs. Technical and entrepreneurial training of Tanzanian women resulted not only in individual enterprise improvements and development of new products to be marketed, but also contributed to networking among entrepreneurs in associations and to the formation of small credit schemes by such associations.

In addition to UNIDO, most bi- and multilateral donors and agencies are active in the field of private sector development, including BDS. In Ghana EMPRETEC has now become a large, integrated foundation, offering training, consultancy, information and business linkages support to an increasing number of SMEs. Efforts are being made to build on the experience of EMPRETEC Ghana in other African countries through the creation of a new programme - Enterprise Africa. Some more specialised institutions have also developed with support from the private sector including AMKA, an export promoting institution for SMEs in Tanzania, and KMAP (Kenya Management Assistance Programme) - an organisation seeking to build business linkages between SMEs and large corporations, whereby the latter offer advice and assistance. In South Africa and Zimbabwe there are interesting developments of private sector BDS helping SMEs through large corporations, universities and business associations. These are only a few examples which show the movement in Africa towards more innovative, commercially-based, fee-paying consultancy programmes of BDS for SME.

There are, however, still many challenges that remain in this field of non-financial assistance, to help the financial intermediaries offer more effective financial services for SMEs:

- Rather than financial intermediaries building up their own BDS, it is more effective for these institutions to build up linkages between themselves and BDS providers. More networking is called for between the financial services and BDS providers;

- BDS providers must be conscious of their respective role, as distinct from the financial institutions. They cannot force financial institutions to approve loans. Financial intermediaries have to remain their own masters in deciding when and how much to approve for a loan. BDS providers, for their part, have to think more commercially and build up

[1] See also the paper *Capacity-building for private sector development in Africa* prepared by UNIDO for this Conference

their own outreach, impact and cost-effectiveness and find suitable cooperative relationships with financial institutions;

- SMEs have to seek BDS providers from as wide a range of sources as feasible. These may include both formal and informal sources - consultants, universities, business centres and associations, and possibly also suppliers, distributors, research institutes and large corporations – whoever in fact can help them improve their performance;

- There must be a recognition of payment for BDS. This may be full or partial payment and at times there may be subsidies, but enterprises who benefit from BDS help must recognise that they have to make some contribution to the cost of such services. In turn, the enterprise will learn to appreciate the value of such services and use them only when they are of benefit.

CHAPTER IV:

Conclusions and recommendations

Several important conclusions and recommendations emerge from this paper, which may be summarized as follows:

1. **Challenge to increase the volume and range of finance:**
   It is clear from this paper that increasing the volume of finance available and the delivery of such funds in various appropriate forms, to support enterprises in Africa, is a difficult challenge. The weak financial sectors and the reluctance of the formal banking system to become more involved in direct financing of SME-based private sector development, especially for provision of long-term loans for equipment acquisition, persist as major obstacles and it will take time for the situation to improve. More has to be done by governments and communities to press the commercial banks who are the main sources of financial flows to the business community, to recognise the importance and value of the SME business sector as an expanding clientele for their services.

2. **Need for active role of central banks:**
   Central banks have to be given more independence, strengthened with qualified, experienced personnel, able to fulfil adequately the role of supervising and monitoring the performance of commercial banks in the provision of loans to those enterprises able to make effective use of them. Although introducing regulations mandating commercial banks to allocate a fixed percentage of their loan portfolio to SMEs may be controversial and difficult to administer, central banks may still exert pressure for such banks to increase their lending to this sector. Tax and other incentives may be offered (rather than penalties for non-performance) as regards easing reserve requirements and the encouragement of channeling government business to those banks that show a greater willingness to lend to small businesses. The central bank might offer those commercial banks lending more to SMEs the opportunity to expand their branch networks in highly populated urban areas, a move much sought after by such institutions.

3. **Need to regulate NGOs:**
   The relationship between NGOs and the formal banking system should not be adversarial. NGOs can function as MFIs with primary responsibility for lending to micro-businesses but should be governed by regulations controlling their activities and access to funds. Such NGOs should be discouraged from retaining clients for too many repeat loans after having offered the maximum amount of credit permitted to those micro clients who have successfully paid back the loans they have been given, just to retain good, growing clients by increasing upper limits and so keep 'star' performers in their

portfolio. Experience shows that the process of offering smaller loans, possibly around US$500 as a first step, to be followed by higher loans of US$ 1,000 – 3,000 has proved an effective method of encouraging the repayment of loans in the expectation of obtaining increased access to finance. There is a strong case not to set the upper limit of loan sizes of NGOs too low but at the same time, NGOs should have an appropriate upper limit (perhaps around US$ 3,000 – 5,000) with the purpose of then transferring successful, growing clients with good repayment records to borrowing from banks for their further financial needs.

NGOs have shown their ability to reach higher collection rates on their loans, often in the upper 80s or above 90%. Serious consideration should be given to limiting the lending of those NGOs that do not reach such recovery levels after a period of two to three years and not to allow them to mobilise savings from clients. Such NGOs could also be restricted in their access to donor or public funds until they attain acceptable standards of loan recovery.

Despite improvements in recovery levels of some NGOs, there is still more to be done in the improvement of monitoring systems on borrowers and loan portfolios and in reacting quickly to non-payment. It is also important for NGOs, and indeed formal banking institutions as well, to maintain a rigid stance on refusing any further borrowing by 'wilful' defaulters (that is those who have no serious cause for their non-payment of loans and for falling into arrears). Black-listing of borrowers who do not pay their loans, when they are able to do so, is most important in building up the long-term health of all the financial institutions and the financial sector as a whole.

4. Need for NGOs and formal banks to cooperate:

Formal financial institutions such as commercial banks and, in a few cases, development banks, have to be encouraged and pressed to make appropriate loans to those who have proved themselves by paying off a number of loans they have received from NGOs or from formal financial institutions. This is most important when a small or micro business is about to make a quantum leap to expand and modernise the enterprise. This may require an injection of finance, several times greater than previous borrowings which they have repaid. Bank staff have to be ready, experienced and given the authority to approve such loans on the basis of the past track record of the borrowing enterprises, the quality of their business planning, combined with the credit-worthiness of the entrepreneur, accepting whatever collateral or personal guarantees may be offered, even when they may fall somewhat short of the bank's usual requirements. Only in this way will there be success in enabling small and micro businesses to grow into mainstream SMEs.

5. Diversification of SME finance required:

There is also a need, on many occasions, to explore the possibilities of non-banking credits from suppliers, customers or contractors and to consider such options as leasing or hire purchase of equipment and premises. Venture capital and leasing arrangements may grow quicker, if given favourable treatment from the tax authorities but it will take time for them to become a major factor in the financing of SMEs in Africa.

Donor agencies should give more consideration to help setting up equity funds and leasing organisations. There has been too much emphasis in the past on provision of credit lines and loan funds, developing a misguided belief that enterprises can rely exclusively on loans to fund growth. This is not the indicate that credit facilities have been available in abundance; simply that financing for SMEs should be provided in different forms.

6. **Opportunities for business linkages:**
There are other approaches that have been successful and should be given more consideration in African countries. Larger firms should be encouraged to establish foundations or special funds for the small business community and particularly for small enterprises who are their sub-contractors. South Africa has several successful examples of such arrangements.

7. **Credit guarantees may help:**
As indicated earlier, credit guarantees may help to increase bank lending for SMEs but will not prove 'panaceas' if the financial sector as a whole and the various banking institutions are not in a sound state to use such schemes properly. All guarantee schemes must pass the test of loan additionality, namely that the introduction of the guarantees has resulted in an increase in lending to SMEs and that those who have not previously had access to finance are able to obtain credit. There is little value in a guarantee scheme that only results in risky loans of the banks' regular clients being given guarantees. Credit guarantee schemes can only solve the problem of lack of suitable collateral on the part of SME borrowers with good business projects.

8. **Banks and BDS should work together:**
It is usually inadvisable for banks to invest greatly in developing their own advisory services which tend to focus on clients. It is preferable for banks to work with independent BDS providers. The latter, for their part, have to maintain a high quality and objectivity of work, with a commercial orientation. They should also aim at a substantial outreach in their activities.

9. **More than finance:**
Finally, access to financial services is only one ingredient for sustained enterprise development, albeit an important one. The minimalist credit approach has clear limitations, and for credit schemes to be effective and have impact, complementary services are needed. Access to suitable business development services is also important for enterprises to support the upgrading of their production techniques, products and services, with a view to being able to adapt to changing market conditions, and to moving into the production of goods and services that meet the demands of domestic and foreign markets in terms of price, quality, design etc.; in other words: to making the enterprises more competitive.

ANNEX:

SOME USEFUL WEB SITES

Site name (in alphabetical order)	Organization
www.accion.org	ACCION Intl.
www.afdb.org	African Development Bank/general
www.afdb.org/about/amina-overview	African Development Bank/Amina
www-agecon.ag.ohio-state.edu/ruralfinance	Ohio State University/rural finance programme
www.bellanet.org	Bellanet (international initiative focused on fostering inter-agency collaboration)
www.bellanet.org/partners/mfn	MicroFinance Network
www.bellanet.org/sed/performance	Record of virtual conference on performance measurement in BDS
www.bus.utexas.edu/~talbotb/microcredit	University of Texas; microcredit/microenterprise resources
www.colorado.edu/EconomicsInstitute/bfmft/mbb	University of Colorado, Ec. Institute, microbanking bulletin
www.eib.org	European Investment Bank/general
www.enterweb.org	many linkages to sites concerning *inter alia* micro-finance , finance and banking, advisory services, gender (some of which are included in this table)
www.grameen-info.org	Grameen Bank
www.iadb.org	IADB/general
www.iadb.org/sds	IADB/sustainable development department (sme, micro-enterprise, finance)
www.idrc.ca	IDRC (Canada)
www.ifad.org	IFAD/general
www.ifc.org	IFC/general
www.ifc.org/abn/index	IFC/Africa Business Network
www.ilo.org	ILO/general
www.ilo.org/public/english/65enterp	hosting BDS guidelines (Donor Committee on Small Enterprise Development)
www.ilo.org/public/english/65entrep/finance	ILO Social Finance Unit
www.oecd.org/activities	OECD/general
www.mbendi.co.za	Business information/Africa
www.mip.org	USAID's Microenterprise Program
www.partners-bsbdc.org	Social banking
www.planetfinance.org	Planet Finance (international NGO)
www.sba.gov	Small Business Administration, USA
www.soc.titech.ac.jp/icm	Virtual library on micro-credit related issues of Mr. Hari Srinivas, Tokyo Institute of Technology (comprehensive)
www.unctad.org	UNCTAD/general
www.undp.org/sum	UNDP/micro-finance
www.undp.org/uncdf	UNDP/UNCDF (special unit on micro-finance)
www.unido.org	UNIDO/general
www.unido.org/doc/online	UNIDO/online resources
www.worldbank.org	World Bank/general
www-esd.worldbank.org/html/esd/agr/sbp	World Bank, Sustainable banking with the poor
www.worldbank.org/html/cgap	CGAP home page
wwb@igc.apc.org	e-mail address of Women's World Banking

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