British International Investment

Insight

How and why we finance SMEs

Practical thinking on investing for development

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Foreword

BII sees opportunities for impact in firms of all sizes. Sole-traders, microenterprises, small, medium, and large firms are all sometimes unable to find the financing they need, to the detriment of society. The growth of firms is at the heart of development. Countries escape poverty as people move out of informal employment into wage-paying jobs at larger and more productive firms. There is a striking absence of large firms in many of the countries where BII invests.

The lack of suitable finance is a well-known constraint on the growth of small and medium enterprises. The answer seems obvious: increase supply. But the persistence of this problem over time and across countries tells us that it is not so easily solved. This paper tells the story of BII's efforts to close the SME financing gap, tries to explain why the gap exists, and examines what the evidence has to say about the development impact of improving access to finance for SMEs.

Banks are a big part of our story. In the past, in less developed financial sectors, our priority was often simply to strengthen and grow banks. As banks mature, our support can become more targeted, helping them shoulder the risks of SME lending and expand into more impactful areas, such as green lending.

Bank lending practices are evolving, often in response to opportunities created by digital technologies and new sources of information about borrowers. The arrival of new digital lenders, offering borrowers quick decisions without asking for collateral, has shaken up the market. We often support these new entrants via fund managers who specialise in financial technologies.

But digital credit typically serves the smaller end of the SME spectrum. Larger SMEs sometimes want larger loans, on flexible terms that are better suited to financing investments for growth. To meet that need, we often turn to SME financing specialists with more hands-on business models. The latest milestone in our SME financing journey is Growth Investment Partners, a business that BII has founded in Ghana to provide patient and flexible risk-bearing finance to larger SMEs, based on careful assessments of the borrower's growth prospects. It is a model we hope to replicate elsewhere.

There is no single answer to the problem of SME financing. Our approach is to support continued innovation and diversity in the financial sector. The needs of SMEs are varied, and the solutions must be varied too. We want to keep learning, and we hope you will learn something from our journey so far.

Paddy Carter
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1

Executive summary

The single largest contributor to poverty reduction is better paid work, and most people living in poverty either work for themselves, for microenterprises, or for small and medium-sized enterprises (SMEs). This is the foundation of the impact case for investing to improve the supply of finance to SMEs. By giving support to SMEs with the potential and desire to grow, while also helping other SMEs to become more productive and resilient (even as they remain SMEs), low-income economies will start to look more like high-income economies – benefitting from higher wages, better working conditions, and more goods and services at lower prices. There are several constraints holding SMEs back, and access to finance is one of their most pressing problems. If development finance institutions (DFIs) can help to solve that problem, the development consequences will be enormous.

SMEs are diverse in their size and nature, and their financing needs differ accordingly. Equity can be important, especially for firms with growth ambitions, but the focus of this paper is on lending. While British International Investment (BII) has 65 years of experience in supporting SME finance in developing economies, we focus here on the evolution of our approach to SMEs since 2012, and how our journey has led to our latest innovation: Growth Investment Partners (GIP), a new specialist SME financing business we have created in Ghana.

This paper looks primarily at Africa, although our experience in South Asia also offers some lessons for how the African market might develop. It also focuses on access to finance that enables SMEs to invest and grow. Other areas – such as insurance and payments, for example – are critical elements of SME financial services, but are outside the scope of this paper.

The need for GIP and other innovations is evidenced by the vast and widely reported SME 'financing gap'.[1] This gap reflects mismatches between what lenders are willing to provide and what borrowers are willing to accept. Lenders want to easily assess credit risk, protect themselves with collateral, and prefer short tenors. Borrowers are often risk averse and want flexible repayment terms, lack well-documented track records, and want longer tenor loans for growth investments. Finding commercially viable solutions that work for both is critical to unlocking SME financing and therefore SME potential.

These structural challenges reveal a set of principles that underpin effective approaches to SME financing:

1) The fundamental problem in SME finance is information – lenders find it too costly to both gather information and use it effectively to accurately assess borrowers' prospects. Finding new ways to address this problem can be transformative.

2) Approaches to SME financing must respond to the needs of SMEs. The financing gap is not just a lack of supply, but the lack of *suitable* supply.

3) The diversity of SME needs means there is never going to be a single model that 'fixes' the SME financing gap.

Closing the financing gap therefore demands different products offered by different types of institutions to different types of borrowers. BII's experience across countries and regions, both successes and failures, has taught us how to bring innovative solutions to underserved market segments.

1 See the SME Finance Forum – MSME Finance Gap

Banks remain the cornerstone of SME financing and over the years we have worked with banks to extend their SME lending. Our initial approach was often to provide core capital to support the bank's overall growth, including geographic expansion. We then shifted towards targeted risk-sharing facilities for SME lending, and more recently have begun using instruments that are more tightly-targeted at impact themes, such as climate lending and women-owned businesses, for instance. The overall pattern is that as markets and lending institutions mature, our support can focus on helping them expand in more impactful directions. But despite the continuing importance of traditional banks (those that offer a range of financial products to many customer segments), they are not the complete solution to the SME financing problem. We have learned that:

- The financing offered by most banks will only satisfy the needs of a segment of SMEs.
- Lending products are not targeted to different types of SMEs in a way that prices risk appropriately.
- As a result, some banks regard expansion into SME lending as too risky and not particularly appealing from a commercial perspective.

To extend our reach beyond banks, we are also increasingly working with specialist lenders that are dedicated to overcoming the challenges inherent in SME finance, many of which do so by exploiting emerging digital technologies. Innovation – such as harnessing alternative sources of data to assess credit risk in an efficient, low-cost way – is central to the future of SME finance, although currently lenders using these technologies are mostly providing smaller and shorter-tenor loans.

Our market research found that many SME owners are risk averse and, when contemplating investment for growth, value flexible finance with risk-bearing characteristics complemented by business support services. Equity finance can offer that but, along with the challenging economics of traditional private equity funds for SMEs, the owners of SMEs do not always want outside shareholders. GIP, our latest SME financing innovation, has been carefully designed with all these lessons in mind. It is a permanent capital vehicle, initially financed with patient equity from BII, to provide flexible growth capital to SMEs over long time horizons. By providing innovative financial products that differ from the standard market offering, GIP will tailor its financing to the needs of borrowers based on long-term earning potential, not just on short-term track record and collateral.

We believe GIP is a scalable solution that can deliver impactful financing to a critical SME segment and become an integral part of the SME financing toolkit, while also providing an attractive risk-return to investors such as local pension funds. We hope to replicate GIP in other countries across Africa.

2

Introduction

From the African Union to the European Union, helping SMEs gain better access to finance is a strategic priority.[2] Governments, impact investors, and non-governmental organisations (NGOs) see healthier SMEs as instrumental to prosperity, poverty reduction, and more inclusive societies.

Why so much attention for SMEs? While they may, by definition, be small, their collective role is large. Quite how large is difficult to pin down – definitions, typically based on employee headcount, assets, and revenues, vary across countries and organisations. A full discussion of what counts as an SME is beyond the scope of this paper, and, unless noted otherwise, we use the International Finance Corporation (IFC) definition throughout. The IFC estimates that SMEs account for about 90 per cent of businesses and more than 50 per cent of employment *worldwide*.[3]

The relevance of SMEs is not limited to any region or stage of development.[4] However, in lower income countries, SMEs contribute a larger share of employment – in the poorest countries they account for seven out of every ten jobs on average (see Figure 1).

In the poorest countries, SMEs account for seven out of every ten jobs on average.

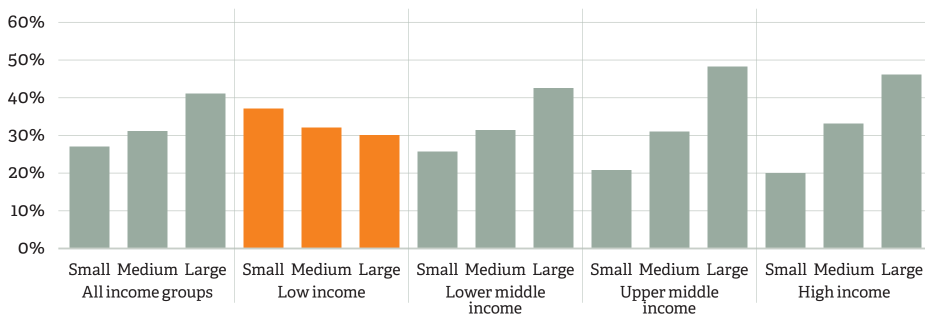


Figure 1: Share of employment by firm size and country income group[5]
Source: World Bank Enterprise Surveys

2 African Union SME Forum; European Commission – SME Strategy.

3 See World Bank - SME finance. To note, SMEs are often thought of as part of a wider group that includes 'micro' businesses – i.e. MSMEs. Microfinance is equally an important part of BII's toolkit, but for the purpose of this report, the focus is SMEs only.

4 In the UK, Germany and US, large businesses account for less than 1 per cent of total enterprises (IFC MSME Economic Indicators, accessed 25 May 2023).

5 To note, in Figure 1, large firms are classified as 100+ workers, medium firms 20-99 workers, and small firms 5-19 workers, as per the data presented by IFC here.

Because they dominate economies in terms of their number, SMEs are often referred to as the 'engine' of growth and poverty reduction. But as countries get richer, average firm sizes get larger. What we want to see is more large firms. That will happen as some small firms grow large and displace their smaller, less productive competitors, and because of the entry of large firms that are 'born large' (not all large firms grow from small beginnings).[6]

This does not mean that SMEs disappear as economies develop. In fact, the economic contribution of *formal* SMEs to gross domestic product (GDP) actually increases, because those remaining SME firms become much more productive (see Figure 2) (Ayyagari, et al., 2007). In short, as countries get richer, the SME contribution as employers falls and their contribution to overall output grows.

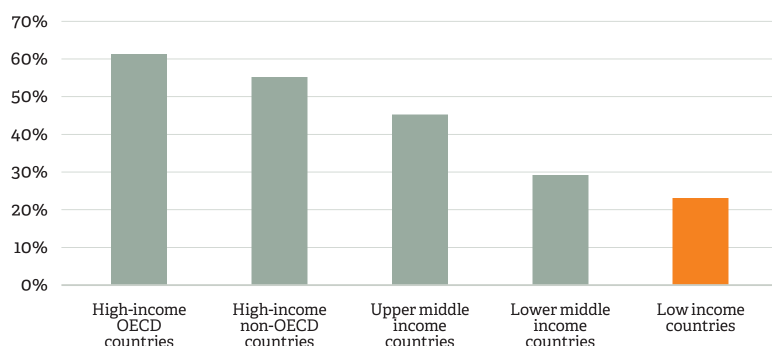


Figure 2: Value added share of MSMEs by income level
Source: IFC – MSME Country Indicators (2014)

Access to finance has been identified by SMEs in many developing countries as their single largest obstacle, inhibiting their growth in both size and productivity.[7] Despite decades of effort, and some notable success stories, the SME financing problem has not been entirely solved. There remains a need for innovation to reach SMEs that still cannot find financing on the terms they need.

This paper will dig into the SME financing problem and share some of what we have learned over the years, culminating in GIP, our latest SME financing innovation in Ghana. GIP is a new platform that will provide flexible growth capital over long horizons based on long-term earning potential, not short-term track record and collateral.

This section provides a brief introduction to two of the questions that are fundamental in understanding the gaps in SME financing and BII approaches to filling them. Why do financial intermediaries struggle to address the needs of SMEs? And what has BII learned through its recent efforts to solve this problem?

The fundamental barriers to SME financing

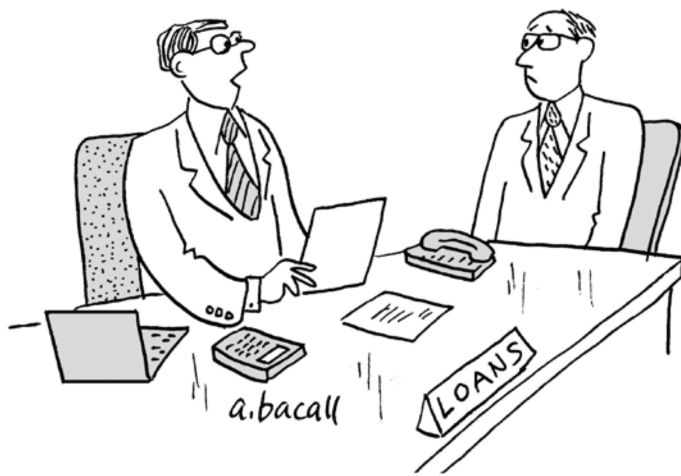
Broadly speaking, it is difficult to target financing at SMEs for two reasons:

1) The nature of the SMEs and their needs; and
2) The commercial requirements of financial intermediaries serving SMEs.

The challenge is finding solutions that work for both borrower and lender. A young growing firm often cannot provide evidence of consistent revenue and profits, but lenders may consider a business with no proven track record as too risky. A services SME with no owned premises might lack the type of assets that are acceptable as collateral, but an unsecured loan is outside creditors' risk appetites. A small manufacturing business might take three to five years to start generating sufficient earnings from a new factory to service a loan, but the short-term nature of most banks' liabilities means that the market only offers one- to three-year loans for SMEs.

6 Almost half of the large firms in low-income countries were born large, compared with less than 30 per cent in high income countries (Ciani, et al., 2020).

7 See World Bank Enterprise Survey data.



"We are prepared to make you a loan, but first you have to prove that you really don't need it."

The total potential demand for SME finance in developing countries is estimated at $7.7 trillion.

Aggregating all these mismatches between what lenders provide and what borrowers seek ends up with a major shortfall in investment and growth. The total potential demand for SME finance in developing countries is estimated at $7.7 trillion, yet financing provided meets less than half of this.[8] The gap in sub-Saharan Africa is roughly equivalent to the GDP of the 30 smallest economies combined.[9]

The SME financing gap is calculated as the difference between the potential demand for finance ($310 billion in sub-Saharan Africa) and current supply ($68 billion).[10] Financing gap estimates should not be interpreted as the volume of credit that could be supplied sustainably to SMEs in economies as they are today. Some estimate of demand come from economic models benchmarked against more developed economies, others may be based on SME surveys. Both differ from actual unmet demand. An SME owner might tell a researcher they would ideally like a $50,000 loan to grow their business, but this is not the same as actively seeking that loan by going to a bank and submitting an application. The key difference between estimates of potential and actual demand is that the latter requires the business owner to accept the financial products on offer in the market, which our research shows cannot be taken for granted. But even if these numbers may somewhat exaggerate the immediate gap between supply and demand, there is little doubt that a significant gap remains which, whether you look at things from the borrowers or lenders' perspective, is difficult for either party to bridge.

So, how might other actors step in to help bridge the gap?

This question has been on the radar of DFIs and others for decades. Our own history in SME financing stretches back to the 1950s, because it has always been a fundamental part of what we do. This paper covers the period since 2012, when CDC Group (as BII was then known) was restructured and started making direct investments again.[11] DFIs invest in financial services not to expand banks, non-bank financial institutions (NBFIs), and capital markets for its own sake, but to get money to smaller businesses in a way that creates markets, jobs, and social impact.

8 'Potential' demand in Bruhn, et al., (2017) expresses the amount of financing that MSMEs would need, and financial institutions would be able to supply, if they operated in an improved institutional, regulatory and macroeconomic environment. It is calculated by estimating equilibrium demand for credit by SMEs in developed economies and then applying that benchmark to developing countries. However, that method is an estimate of sustainable demand for credit by SMEs in an economy that looks quite different to the reality today. Other estimates of financing gaps may use a different approach. The concept of equilibrium is important – if one restaurant takes out a loan to open a new branch, it might have a reasonable chance of success, but if every restaurant in town does that, it would very likely end badly. If you just ask firms how much they might like to borrow and add that up to estimate total demand, the number will exceed the sustainable volume of lending.

9 Based on most recent available MSME Finance Gap Database data (2018) and comparable GDP figures from IMF World Economic Outlook Database, both accessed 10 July 2023.

10 IFC MSME Finance Gap Database, accessed 11 July 2023.

11 Between 2004 and 2012, CDC Group had operated a 'fund of funds' model. This paper also touches upon some pre-2012 investments that were important steps in our SME financing journey, such as Access Holdings and Advans (see Section 5.4).

Many different approaches to SME financing have been attempted over the years, including by BII. The typical story has been one of partial success. Success in the sense that these efforts have often increased the supply of credit to many SMEs; partial in the sense that SME lending has not always flourished commercially and has hence sometimes been difficult to scale. This has left many SME financing needs unmet, and not all types of SME equally well-served. That more than 3.5 billion people still live in some form of poverty attests to the fact that, when it comes to ending poverty, finding solutions that succeed at scale is the key.[12]

Box 1. Debt and equity financing options for SMEs

BII provides both debt and equity to SMEs, usually via intermediaries. This paper is about lending, with a focus on Africa. A forthcoming BII Insights paper will look at private equity.

Equity is risk-bearing. It does not create financial obligations on a business, because dividends need only be paid when the business is able to do so. Growth equity investors are also often looking to make capital gains when they sell their shares, not by taking cash out of the company as dividend (or by a combination of the two). But from the perspective of an SME owner, raising equity from outside investors can be unappealing because it gives them a share in the business and its profits, and complicates governance. It can mean that owners give up control of their business. Equity growth capital is typically only sought from outsiders to finance particularly ambitious or risky business plans, where the owners want to share the risks and are willing to share the rewards (and for which sufficient debt may be hard to come by).[13] Additionally, finding equity investors interested in investing in SMEs can be challenging due to size, scalability, governance and exit potential.

The attraction of debt is that it is relatively simple, and beyond sometimes imposing some performance covenants on the business, lenders do not interfere with management. When a business performs well, it generates returns for its owners when cash generated exceeds the debt service payments required by lenders. Higher debt levels – higher leverage – amplifies the returns on equity when things go well, because those earnings are generated from a relatively smaller equity base. But leverage also amplifies risk. A highly-leveraged business can only tolerate a small downturn in performance before it becomes unable to service its debts. And while simple, the timeframes and covenants associated with debt finance can be rigid, regardless of the company's performance.

One of the lessons we have learned is that some SMEs need access to debt on terms that share the characteristics of equity – flexible repayment terms – that respond to how the business is performing.[14] See Section 6 about GIP.

12 World Bank Poverty and Inequality Platform, based on total global population living under $6.85 per person, per day (the typical national poverty line in upper-middle-income countries), accessed 11 July 2023.

13 There are other motivations for raising equity. Sometimes lenders want firms to reduce their leverage, to increase their chances of repayment. Sometimes owners want to sell fully or partially, to realise cash.

14 We are not the only development finance actors reaching that conclusion. There is increasing interest in the possibility of offering microfinance on more flexible terms – see Cordaro, et al., (2022) for an introduction. For larger businesses, venture debt is a well-established commercial lending product tailored for early-stage companies, and various 'mezzanine' products that sit between senior debt and equity are increasingly common. See Peter (2021) and Hossein Dad (2023) for evidence on the importance of risk-bearing equity to nationwide productivity and inequality.

Our approach to SME financing and what we have learned

Our long history in SME finance has yielded many important lessons. The following is an overview, with details and examples in Section 5.

Following CDC's 2012 restructuring, SME financing efforts were partially focused on large banks. Through both debt and equity investments, we sought to strengthen financial systems and increase lending to local SMEs, including through the expansion of banks' geographic footprint into underserved areas of our markets. The scale these banks operate at meant our core capital injections, once leveraged, would result in credit supplied in volume to SMEs. However, such an approach can have a limited effect on the underlying problem: banks have their strengths, but their loans often do not meet the needs of SMEs, and their appetite for SME lending can be relatively low.

We have therefore increasingly considered how to 'de-risk' the SME segment using instruments like longer-term credit, guarantees, and risk-sharing facilities. By assuming a proportion of the credit risk associated with a bank's SME portfolio, we have been able to support banks to deploy greater volumes of SME-focused credit. Targeting lending to where it is most impactful has also grown in relevance to our approach. We have progressively worked more with banks and other financial intermediaries to establish directed lending lines with a defined use of capital, supporting the flow of finance to the most underserved and impactful SMEs, for example those with climate outcomes and/or those led by women.

Working with, and through, banks remains an important element of our financial services strategy, but over time it has come to be increasingly complemented by investments in NBFIs (see Section 5.2.2). By supporting the growth of specialised SME lenders, we have helped expand and diversify the products and support offered to SMEs while also continuing to drive geographical expansion. Fintechs offering unsecured lending have enabled us to reach segments of the SME market that were previously harder to access, for example. Newly emerging technologies have shown promise in allowing lending decisions to be based on alternative data, such as financial transaction history from mobile apps, thereby improving risk management and reducing costs.

We have made use of specialist fund managers to make impactful investments in the SME financing ecosystem that would have been harder for us to make as direct investments. This has included investments in businesses that build financial infrastructure (such as payments) and those providing technology-enabled products and services. The expertise and networks of these fund managers enable us to access high impact opportunities and create value through better understanding of markets and business models relative to investing directly or via generalist funds. We, in turn, have been able to shape the practices of these funds – in terms of environmental, social and governance (ESG) issues, business integrity, and impact management – to the benefit of their underlying portfolio.

Our approach to SME financing also has an important countercyclical motivation. When crises hit, banks and other lenders tend to shrink the supply of credit to SMEs; our support can help counteract that (see Gambacorta & Marques-Ibanez, 2011). Our responses to the 2016 Ebola crisis in Sierra Leone, and later the COVID-19 pandemic across our markets, highlighted the importance of supporting banks to maintain the supply of finance to SMEs, particularly in the form of working capital loans, and especially at times when others are withdrawing their support.

The past decade of investing to reach SMEs in South Asia and Africa has been a learning journey for BII. The focus of this paper is largely on sub-Saharan Africa, where the micro, small and medium-sized enterprises (MSME) financing gap is double that of India as a share of GDP.[15] The more developed South Asian market has important lessons that may apply to Africa.

Figure 3 depicts the ingredients of a successful strategy towards SME financing, drawn from our experience. These lessons are discussed in depth in Section 5.

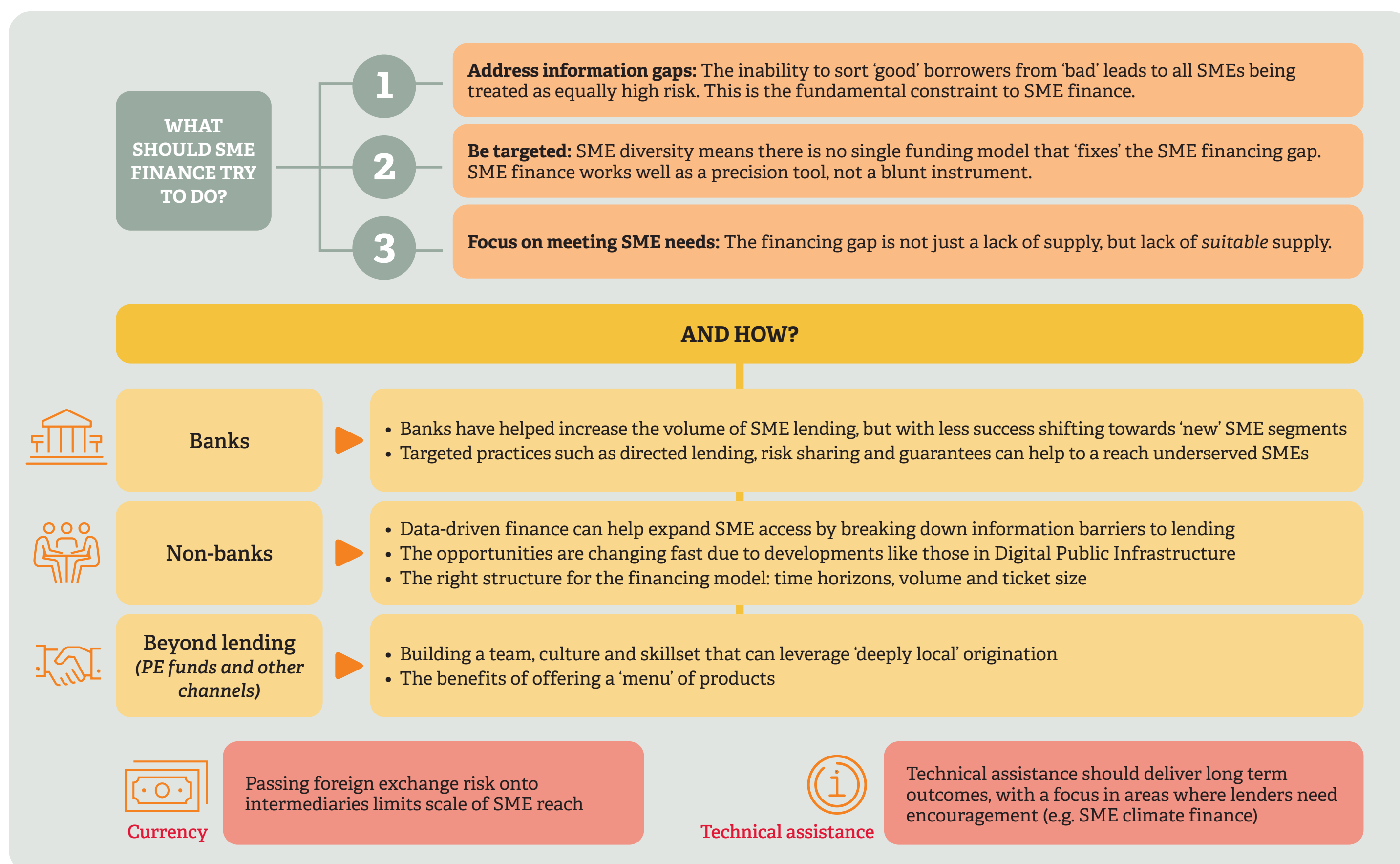


Figure 3: The 'what' and 'how' of SME financing: BII's lessons learned

The most important lesson is that an effective SME financing strategy cannot be delivered through any single approach. This means our efforts must be spread across helping banks to grow and evolve their approaches to SME lending, working with specialist SME lenders to leverage and scale new technologies, and finding ways to deliver alternative types of capital.

In some countries there are market segments whose needs are not being met by existing financial service providers. We created something new to address one of these segments, in Ghana. GIP is an innovative new approach designed to serve larger SMEs that want risk-bearing capital for growth. GIP is therefore a new solution for an old challenge. It is a permanent capital vehicle that will provide innovative and differentiated growth capital to SMEs. Its loans have flexible terms that differ from the standard market offering and are tailored to the needs of borrowers. GIP will lend based on long-term earning potential, not solely on short-term track record and collateral. It will also push beyond a purely financial offering through support services to strengthen business performance.

It is our belief that rethinking and harnessing the best of traditional approaches can redefine best practice in SME financing and make a material contribution to economic development and poverty reduction by helping to close the SME financing gap.

15 IFC MSME Finance Gap Database and definitions, accessed 11 October 2023.

The remainder of this paper expands on these themes in greater detail and describes how we arrived at the conclusion that we wanted GIP to be a new type of lending institution. But before then, Section 3 summarises the impact case for investing in improving SME access to finance, and some of the nuances around job creation and growth, where there is a risk of unrealistic expectations. Section 4 returns to the topic of mismatches between what SMEs want and what lenders are willing to supply, and Section 5 outlines some of what BII has learned as our Financial Services Group's investment strategies have evolved over the years. We then present the key features of GIP and why we see it as having transformative potential in Section 6, followed by brief conclusions in Section 7.

3

The impact of supplying finance to SMEs

To many development actors, the impact case for financing SMEs is self-evident. People living in poverty often own or work for small firms which struggle to access finance to grow their businesses or to improve the livelihoods of their owners and employees.[16] This is the basic impact case for investing to improve access to finance for SMEs. But questions remain about the role of SMEs in development. Not all SMEs are alike – some may have a greater positive impact on development than others. From another perspective, developing countries need fewer SMEs and more large firms (see Section 3.1). For impact investors and DFIs thinking about where to allocate their capital and origination efforts, an important question is how the impact of supporting SMEs compares to the alternatives of targeting microenterprises or large firms.

This section will largely discuss the impacts of providing finance to SMEs in comparison to large firms. The evidence shows that while microfinance does unlock growth for a small set of entrepreneurs, it mainly serves to help households manage their finances, and to help microenterprises – often grouped together with SMEs as MSMEs – manage working capital and cashflows.[17] Microfinance providers that target business owners, rather than lending to householders for consumption, sometimes report significant effects on borrower incomes.[18] We approach microfinance largely from a household wellbeing perspective, and also work with some microlenders that specialise in business lending. However, from an economic transformation and growth perspective, the more relevant comparison is between SMEs and large firms.

16 We have a more expansive definition of poverty in mind here than extreme poverty.

17 The evidence is well-summarised in the VoxDev live literature review, which is periodically updated. The Handbook of Microfinance, edited by Hartarska & Cull, looks more closely at household vulnerabilities and financial health. CGAP (2011) discusses the issue of over indebtedness. The 60 Decibels microfinance index is valuable because it draws on a much larger set of lenders than the academic literature. Banerjee, et al., (2021) "Can microfinance unlock a poverty trap for some entrepreneurs?" shows that business revenues more than double for 'gung ho' entrepreneurs when given access to microfinance.

18 See the recent independent evaluation of Arohan Financial Services, part of the broader FCDO-BII Evaluation and Learning Programme.

SMEs undeniably need greater access to more suitable forms of finance, and so finding better ways to get growth capital into the hands of SMEs remains a priority for us. At the same time, we do not regard firm size in itself to be a useful indicator of impact. The category of SME covers everything from the lowliest backstreet workshop or retailer to upscale consumer services, professional services, and technology firms. SME lenders target different segments of the population, different geographic regions, and different sectors. Even just in terms of size, by the IFC definition, SMEs range from having ten employees with as little as $100,000 annual revenue, to 300 employees with $15 million annual revenue. This means that just as we need a suite of tools, rather than having a single approach to SME financing, we must also understand how impact changes with context rather than having a single view on the impact of SME financing,

3.1 Development means larger firms

Large firms tend to be more productive and pay better wages, with this large firm 'wage premium' higher in poorer countries.[19] In Niger, it was found to be 100 per cent, meaning the wages of workers in large firms are double that of workers in MSMEs (Ciani, et al., 2020). Historically, the process of development has involved more people having a salaried job. Bandiera, et al., (2022) document how this transformation has happened everywhere but Africa, where young workers are today no more likely than their parents to hold a salaried job, which the authors attribute to the absence of large firms.

The size distribution of firms in developing economies is sometimes described as having a 'missing middle', although as Figure 4 shows, it might be better described as a 'missing top'. Smaller businesses account for the largest *number* of firms at all stages of development (Figure 4a), but larger firms are much more common in richer countries. Looking at the share of employment (Figure 4b), the lack of more mid-sized firms (in this sample, those with 20-90 employees) is also apparent.

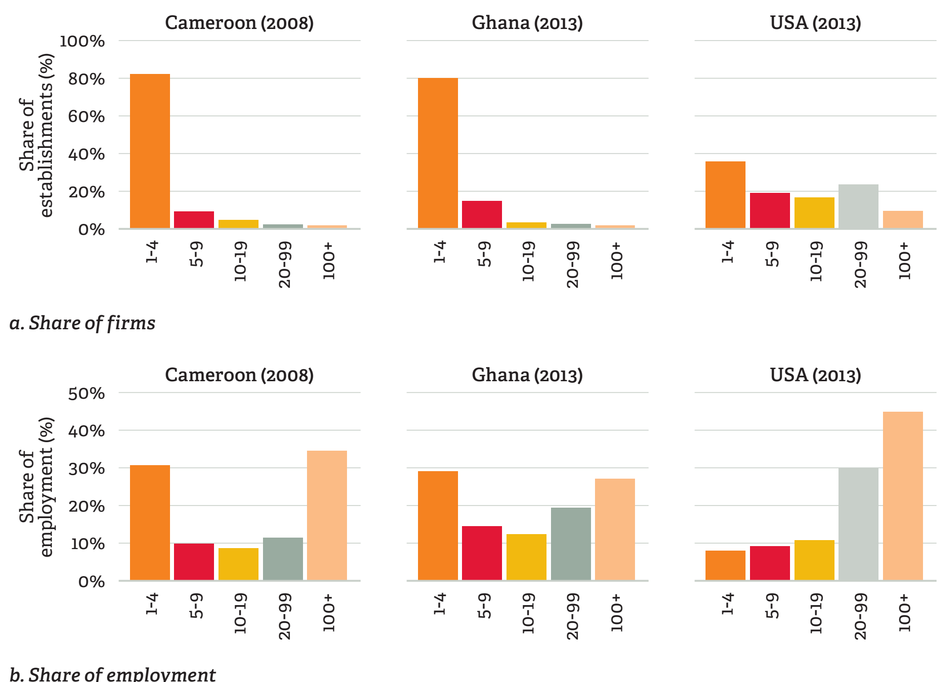


Figure 4: Distribution of firm size by share of total number of firms and share of total employment
Source: Abreha et al. (2022)

19 Page and Soderbom (2015) examine the wages and job quality of small firms in Africa in detail.

The important questions are about the causes and consequences of this preponderance of unproductive small firms in poor countries. Academics have proposed various 'frictions' and 'distortions' that prevent more productive firms from growing large (see Buera, et al., (2023) for a survey). Some of these frictions are financial. Thioune (2023) studies 12 sub-Saharan African countries and shows that financial constraints prevent firms from growing to their optimal size, and that this negative effect is greater the smaller the firm. This brings us back the idea that inadequate finance is a constraint on SME growth.

3.2 What constrains SME growth?

If the objective is to remove constraints on SME growth, it is important to bear in mind that constraints come in many shapes and forms, and will differ across different countries. In Burundi, the most significant obstacle cited by firms (of all sizes) is tax rates (cited by 30 per cent of firms), in Indonesia, it is competition from the informal sector (cited by 37 per cent of firms).[20] But access to finance is the greatest obstacle most cited in developing countries as a group.

While World Bank Enterprise Surveys place access to finance at the top of its rankings of constraints for roughly a quarter of all firms by country, this share increases to 42 per cent for sub-Saharan African countries. Small firms are more than twice as likely to report access to finance as their biggest obstacle than large firms in Malawi, Rwanda and Tanzania, and more than three times as likely in Ghana, Côte d'Ivoire and South Africa.[21] Figure 5 shows that across sub-Saharan Africa, SMEs are more likely to report access to finance as the biggest obstacle than large firms. This does not mean that DFIs should put all their eggs in the financial services basket: in Bangladesh, Democratic Republic of the Congo (DRC), Uganda and more, electricity is a bigger challenge. But the point remains: while SME finance is not the only constraint to growth, it is often the most significant.

Small firms are more than twice as likely to report access to finance as their biggest obstacle than large firms in Malawi, Rwanda and Tanzania, and more than three times as likely in Ghana, Côte d'Ivoire and South Africa.

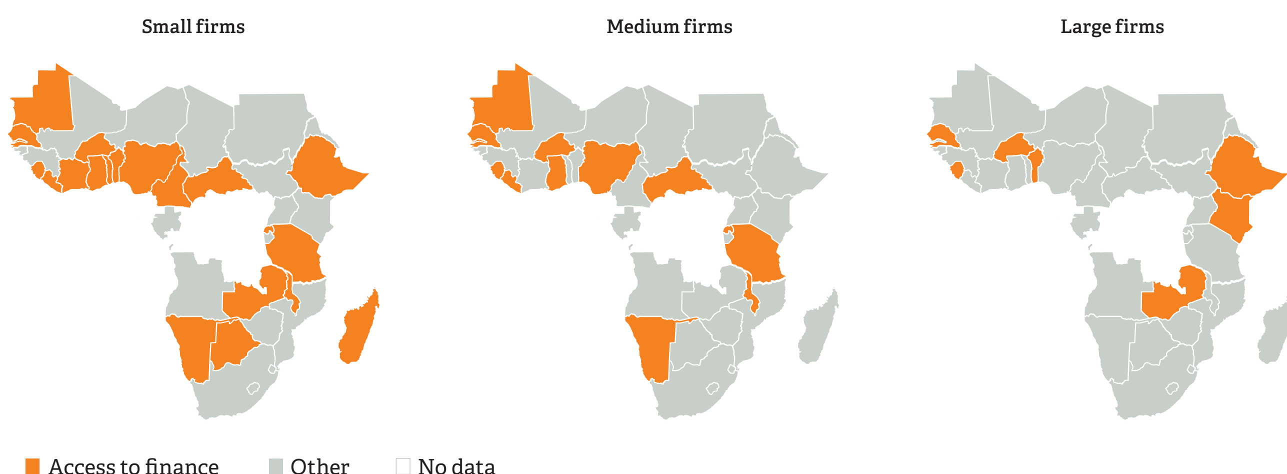


Figure 5: Biggest obstacle to business operations by firm size, Sub-Saharan Africa
Source: World Bank Enterprise Surveys

20 Informal sector practices' refers to the fact that informal firms are able to engage in behaviours that can give an unfair advantage over formal firms that must comply with the prevailing rules and regulations.

21 World Bank Enterprise Surveys data, accessed 24 September 2023.

When a firm is credit-constrained, improving its access to finance will affect its behaviour, including decisions relating to growth. When a firm is not credit-constrained, and can already obtain the credit it wants from the market, increasing the supply of finance for SMEs does not change its circumstances and so typically will not affect its behaviour.[22] If a DFI intervenes to increase the supply of credit to SMEs – perhaps by helping a bank expand its lending – some of those borrowers will have been credit-constrained, and some of them will not have been. The impact of that intervention on development outcomes will depend on the proportion of new borrowers that were credit-constrained.

The concept of credit constraints is closely related to the concept of financial additionality in development finance, which can be seen as the requirement for DFIs to only invest in firms that are facing a financing constraint – they cannot obtain what they need from the market.[23] Ultimately, we want to see financing flow to those businesses where credit constraints are the greatest, as it this financing that will make the most difference.

Because SMEs are more often credit-constrained than large firms, it is natural to think that an intervention to increase supply of SME finance is more likely to have an impact on firm behaviour. But when it comes to comparing the likely additionality of SME financing against the additionality of financing large firms, the answer depends on how lending decisions are taken. Finance to SMEs is usually provided by intermediaries such as banks. When a bank is making decisions on which businesses it should or should not lend to, it is concerned with being repaid and does not ask whether the business is credit-constrained. However, when a DFI considers direct investment in a large firm, it can interrogate the need for its finance and incorporate additionality (financing constraints) into investment decisions.

3.3 SMEs and growth

In low- and middle-income countries, of all firms that enter with fewer than 20 employees, nearly nine out of ten are still small after five years. Only one in ten grows to medium size, and one in 100 becomes large.

Some of the excitement surrounding SMEs in recent years relates to the prospect of being able to identify 'gazelles' or 'camels'. Gazelles are rapidly growing firms that are known for being among the best job creators (Henrekson & Johansson, 2010), whereas camels typically grow more slowly but also have the resilience to survive in emerging markets where funding is scarce and economic shocks are frequent.[24] However, while animal kingdom analogies abound (see also 'zebras' and 'unicorns'), the reality is that attempting to pick winners is unlikely to be a reliable strategy because standard approaches to allocating credit are poor predictors of business success (Bryan, et al., 2021).[25]

Most SMEs will not grow large. In low- and middle-income countries, of all firms that enter with fewer than 20 employees, nearly nine out of ten are still small after five years. Only one in ten grows to medium size, and one in 100 becomes large (Ciani, et al., 2020). Realistic expectations about growth rates matter, because development interventions can be judged failures and stopped if they do not live up to expectations. Efforts to generate growth by improving access to finance should not fall into the trap of assuming that lending is a seed to be planted in an SME that will usually result in growth. Growth is a minority activity (see Section 4.2).

22 In reality, the situation is not so binary. For example, even firms that do not report that finance is a constraint may respond to improvements in the terms on which finance is offered. Banerjee & Duflo (2014) examine how mid-sized firms in India respond to a directed lending programme and conclude that many of them were credit-constrained. While there are many academic papers on credit constraints, only recently is research into equity constraints being undertaken.

23 BII *Our approach to investor contribution: 2022–26 Strategy Period*.

24 Haas, et al., (2022) identify five distinct start-up types, which they label basic, large, capital-intensive, cash-intensive, and high-leverage, which they show predict future productivity and employment generation and exit rates. In advanced economies, firm dynamism has declined in recent years and there are fewer gazelles – see Sterk, et al., (2021).

25 The ability to predict high growth is also more relevant to equity investing, where investors capture the upside, than it is to credit, when loan repayments are the same whether the borrower is moderately or highly successful. The ability to predict growth could affect the volume and terms of loans, however.

Many large firms are "born large" (Ciani, et al., 2020). Those that start operations at scale are more likely to be foreign-owned, often the result of a large-scale, greenfield investment in a new market, or spin-offs from existing firms. One such example is Hela Clothing, a Sri-Lankan garment producer invested in manufacturing in Ethiopia in 2017. Within six months of commencing operations, it had 800 workers, 70,000 production hours logged, and was the most efficient factory in Ethiopia.[26]

But the fact most SMEs will not grow large does not imply they are unimportant for growth. Take Kenya, where IFC data estimates there were over 122,000 SMEs in 2016 employing around 23 people on average. If one in 100 of those SMEs grew large, reaching the top end of the IFC definition of SME (300 workers), that would imply around 340,000 new jobs. Or, put another way, there were an estimated 178 large firms in Kenya in 2022. If one in 100 of Kenyan small firms grew to be large, the number of large firms would quintuple.[27] Due to the proliferation of SMEs, improving access to finance so that the proportion of small firms that grow large increases from one in 100 to two in 100 would dramatically change the dynamism of an economy.

Firm growth, like SMEs themselves, is something that comes in different shapes and sizes. Helping firms grow from small and medium to large enterprises is not the only objective. A retailer that uses a working capital loan to increase the variety of goods it stocks and increase its sales is still growing, even if it remains a single shop and does not hire more workers. Seen in isolation, the provision of growth capital for an SME to invest in ambitious expansion has more impact than a loan to an SME that is used to manage its finances more efficiently with a more modest effect on growth. But the provision of quality finance that meets firms' needs at scale, to achieve modest growth and productivity improvements across many SMEs, can add up to something important on aggregate. It can result in higher incomes for proprietors and employees, and lower prices for customers and, ultimately, lower levels of poverty.

3.4 SMEs and jobs

Labour is most people's main source of income. Creating jobs and increasing incomes is the most important single contributor to improving the lives of the poor. In many countries that have experienced substantial declines in poverty in recent years (for example, Bangladesh), over half of the reduction came from increasing the earnings for the work done by the poor.[28] The question of how to create more and better jobs is therefore at the heart of development.

Jobs are created by new firms and growing firms, so removing financial constraints on SME entry and growth is a natural response to the problem.[29] But the share of employment accounted for by SMEs usually falls as countries grow. That is partially achieved by some SMEs becoming large, and partially by employment growth in firms that are already large.

26 Ethiopian Investment Commission (2018).

27 Author's calculations based on IFC MSME Economic Indicators, ILO World Employment and Social Outlook Data Finder, and S&P Capital IQ (2022). Assuming no existing large firms were destroyed as a result. We may infer that the number of small firms that grow large in Kenya is less than the one in 100 estimated in Ciani, et al., (2020) for all LLMICs, or that different definitions of SME were used.

28 Azevedo, et al., (2013).

29 Because workers can often earn the revenues needed to pay their wages, the role of financing constraints on employment in established firms might be more minimal. But Benmelech, et al., (2021) use three quasi-experiments to show that financing conditions have a major effect on firm-level employment decisions, as well as aggregate unemployment outcomes.

But job destruction is also part of this story. Many SMEs will cease trading and be replaced by larger competitors as economies develop (La Porta and Shleifer, 2014). And for those SMEs that survive, even if they do not each grow employment by much, the nature of jobs within those firms will often change. This is the third of the three labour market transformations that Bandiera, et al., (2022) observe as countries grow and poverty falls: "First, the marketisation of work; second, the emergence of firms as the main organising unit of work pulling workers out of self-employed work; and third, increasing specialisation and creation of 'new' jobs within firms."[30]

SMEs are often described as the engine of job creation, but what this really means is that the segment is characterised by high levels of 'churn', where firms enter and exit at high rates. It is typically the birth of new, small firms that drives a large share of gross employment creation, not the growth of older small firms (Ayyagari, Kunt, & Maksimovic, 2015). But while SMEs create a lot of jobs, they also destroy a lot too.[31] They are more likely to be ousted by more productive competitors, fail due to lower resilience to shocks, or simply be wound up by owners moving onto better opportunities or retiring, with the jobs they created disappearing with them.

This is not necessarily a bad thing. Joseph Schumpeter famously said: "Economic progress, in capitalist society, means turmoil." Disruptive entrepreneurs play an important role in economic development. At the same time, excessive churn – perhaps caused by firms having to fire workers because they lack the access to finance to manage volatility – prevents the accumulation of job-specific skills in addition to causing distress to those involved. In Ethiopia, for example, Shiferaw & Soderbom (2023) find very high levels of churn, with two out of every five workers gaining or losing a job within a six-month period.

Figure 6 shows the contribution of SMEs and large businesses across sub-Saharan Africa as they expand and contract (it does not include jobs created and destroyed on entry and exit).

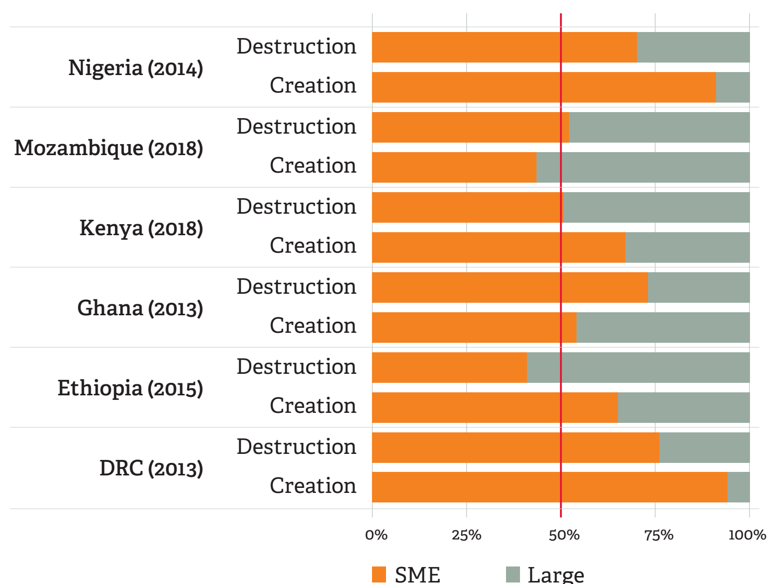


Figure 6: Share of job expansion and contraction
Source: World Bank Enterprise Surveys: Employment indicators

30 The marketisation of work occurs when people start paying for services that would have previously been performed by family members or within family businesses. Growth and poverty reduction is associated with structural transformation, as workers move out of agriculture and into manufacturing and services. Canudo, et al.,(2021) describe how the task content of jobs within sectors also changes.

31 Firm age has been shown to be a better predictor of growth than firm size, though it is also true that younger firms are also smaller (see Haltiwanger, et al., 2013).

In many economies, SMEs play a bigger role in both job expansion and contraction than large businesses.[32] For example, in Nigeria, SMEs account for 91 per cent of jobs created by firm expansion between 2012 and 2014, and 70 per cent of jobs destroyed by firm contraction. There are some exceptions, although these may relate to the nature of those economies. For example, Mozambique largely relies on extractives-based growth, so the sector which exhibits the most dynamism generates few jobs, while the sector which employs the most people lacks dynamism (World Bank, 2018).

Despite high youth unemployment, the main problem in most lower income countries is not that people lack an occupation, it is that their occupations are precarious and unrewarding. Job destruction can be a good thing because **we want to see *bad* jobs replaced with *better* ones**. Hence gross job creation by SMEs can contribute to development without growth in net employment. This idea was explored in a previous BII Insight paper.[33] From an individual worker's perspective, net job creation is less relevant, as the relevant transition is usually not moving from unemployment to employment (+1 net jobs), but from a low-quality job into a better one (0 change in total employment).

But this optimistic picture does not always hold – job churn can involve replacing bad jobs with equally bad jobs. Recent research suggests that high job-to-job flows in developing countries are not necessarily a sign that people are moving 'up the job ladder' into better jobs (Fields, et al., 2023). Donovan, et al., (2023) show that labour market turbulence is much greater in poorer countries: job-finding rates are modestly higher, employment-exit rates are two to three times higher, and job-to-job and occupational switching rates are five times higher. These higher labour market flows largely represent workers moving on and off the bottom rungs of the job ladder, between self-employment and low wage employment, rather than movements up the job ladder. They find workers in the poorest countries are between 36 and 39 percentage points more likely to fall down or off the job ladder than those in the richest countries. We may hope that improving access to finance will help more SMEs create better jobs and increase the likelihood of movements up the job ladder.

3.5 The evidence

At BII, we periodically conduct evidence reviews to ensure our investment strategies are informed by the latest research. A recent report we commissioned from the International Growth Centre – 'Why do SMEs matter?' – examines key assumptions held by development practititioners about SMEs, and assesses the extent to which they are supported by robust empirical evidence. There are many examples of SME lending programmes resulting in gains for the borrowing firms, such as revenue and employment growth. The IFC used Enterprise Survey data to estimate that for every $1 million loaned by banks and other financial service providers, borrowing firms added 16.3 jobs on average over a two-year period, compared to those who did not access finance.[34] That is not an estimate of the impact of an intervention – it describes how firms put credit to use, whether they previously had any difficulties accessing finance or not. The EIB offers intermediaries (banks) financing on preferential terms to on-lend to SMEs. Their evaluation finds borrowers experience significantly higher employment growth, increased their investment, productivity, and innovation activities. Benefits are greater for smaller firms and those in less-developed regions (EIB, 2023).

Ayyagari, et al., (2021) use the introduction of credit bureaus in developing countries to uncover the effects of *changing* firms' access to finance. They find a consistently stronger impact of improved access on employment growth for SMEs than for large firms. SMEs in countries that benefit from better coverage by credit bureaus grow employment 2.5 percentage points faster, on average (the baseline employment growth rate is 9 per cent).

32 These figures reflect change in employment in continuing enterprises and do not capture entry and exit.

33 Carter & Sedlacek (2019) How job creation fits into the broader development challenge

34 IFC (2021).

Brixovia, et al., (2020) also use impact-evaluation methodologies to show that not only do firms with better access to finance create more jobs, as expected, larger loans as well as loans with smaller collateral size and longer maturities are associated with a stronger and more significant impact on employment.

A recurring theme in development economics is the importance of expanding into new, typically rural, areas by lenders. This is both because expansion allows researchers to identify the effects of improved credit supply on the local economy, and because multiple historical accounts of inclusive growth emphasize the importance of lending and firm investment in rural areas and other regions that are distant from the main centres of economic activity. Kendall (2012) shows how the regional presence of banks affects firm growth in India; Fafchamps & Schundeln, (2013) show how local banks resulted in faster firm growth in Morocco; Ji, et al., (2022) show how local bank branch expansion had a very large effect on regional GDP in Thailand; Chakraborty, et al., (2022) uses branch expansion in India to show how liquidity propagates through production networks, increasing sales and employment; Bruhn & Love (2014) show how the opening of local bank branches raised the income of lower income individuals in Mexico.

Evaluations often focus on the impact of borrowing on the borrowers, and there is less evidence about the overall economic impact of increasing the supply of credit to SMEs that incorporates the indirect effects on other firms (non-borrowers). Cai & Szeidl, (2022) show that the introduction of a new loan programme for SMEs in China had a large positive direct effect on the profits and employment of borrowing firms, but a similar-sized negative indirect effect on the performance of their competitors. However, access to finance improved business practices and service quality, and reduced prices, so the main beneficiaries were consumers (although the researchers could not uncover the overall effect on the level of real wages paid by SMEs). Bazzi, et al., (2023) find that an initiative of the Brazilian national development bank to increase the supply of credit to SME caused new firms to enter at an increasing rate, and for those entrants to be larger, to have better survival rates, and to grow faster. The programme involved the supply of longer-term credit, which the authors believe made productive entrepreneurs more willing to make capital investments.[35] However, the positive impact on job growth at borrowing firms was offset by a higher rate of exit by other firms, so there was no overall effect on the total level of formal sector employment in municipalities that benefited from the programme (the researchers were also unable to study the impact on real wages).

In contrast, Gutierrez, et al., (2023) find that the supply of credit does affect the overall level of employment by formal small and medium firms at the market level in Mexico. They find that during credit supply expansions, the share of credit received by family firms, younger firms, and firms with no previous bank relationships, also increases, as one might expect changes in supply to have more bearing on types of firms more likely to be credit constrained. However, they find that in their sample the changes in employment were larger in the upper half of the wage distribution, reminding us of the importance of asking who benefits from SME lending. The authors interpret this result as small formal firms facing important credit constraints that prevent them from acquiring inputs that are complements of high-skilled labour.

The question of how gains from improved access to finance are shared between proprietors, workers and customers matters to us, but suffers from a lack of empirical evidence from research. We know that finance is sometimes used to invest in physical and intangible capital, and not labour. Although job creation is a natural motivation for SME financing, we do not presume that is where the primary impact lies, and our impact assessments also consider the characteristics of the proprietors and customers of borrowing firms. There is some evidence to suggest SMEs play a vital role in providing basic goods and services to the poor (see Altenburg & Eckhardt, 2006; United Nations Commission on the Private Sector and Development; 2004; World Bank, 2002).

35 The study did not cover prices or other benefits to SME customers from these new more productive firms.

4

Why is it so hard for SMEs to access finance?

In 1929, the UK Government set up the Macmillan Committee to determine the root causes of the depressed domestic economy. The Committee's report, largely authored by John Maynard Keynes, highlighted that "great difficulty is experienced by the smaller and medium-sized businesses in raising the capital which they may from time to time require" (the so-called 'Macmillan Gap').[36] While the depression-era UK economy might seem distant from the realities of contemporary SMEs in developing economies, some of the challenges are remarkably similar:

- The principal problem in accessing finance was that SMEs often could not provide an established profit record.
- Expansion often involved high levels of perceived risk due to unproven products and markets.
- Potential patient investors were neither capable of assessing the prospects of small firms, nor interested in investing what they considered to be small amounts.

Banks throughout the world play a vital function for society. They transform deposits into loans that are extended to businesses (and consumers, homeowners, etc.), helping them to grow and hire more people and pay more taxes, for example.[37] They are also the mainstay of lending to businesses in developing countries. The ratio of domestic private sector credit coming from banks versus total private sector credit is 0.96 in low- and lower middle-income countries, 0.74 in sub-Saharan Africa, and just 0.49 in high income countries, where non-bank financing (including bond markets) are more important.[38] African banks also overwhelmingly report SME lending as a business priority (EIB, 2020). Why is there an SME financing problem?

36 Report of the Macmillan Committee on finance and Industry

37 How banks convert the resources of risk averse depositors into risky loans in a way that would not happen without their intermediation has been referred to as a 'socially beneficial trick' (see Matt Levine at Bloomberg).

38 World Bank DataBank (see here and here).

Various structural reasons hamper the flow of finance between banks (and NBFIs) and SMEs (see Section 4.1 below). The outcome is that **banks in Africa and elsewhere may report *wanting* to lend to SMEs, but they see it as too difficult in practice**.

Despite often citing access to finance as their most pressing problem, for most SME owners and managers it is not a case of 'finance at any cost', but finance on terms that suit them and their businesses. Borrowing ultimately means putting their livelihoods and assets on the line, and many SME owners do not want to take the risk. For many entrepreneurs in low- and middle-income countries, an enterprise is a way of making a living and growth is not necessarily always their primary motivation (Schoar, 2010). Businesses at the smaller end of the SME spectrum in particular are more likely to be run by 'cautious entrepreneurs' who prioritise stability over growth, are averse to debt, and see formal providers of finance as disinterested or hostile (Sawhney, et al., 2023). The Small Firms Diaries research programme finds that this common distinction between "gung-ho" growth-focused entrepreneurs and "reluctant" or "survivor" entrepreneurs misses the largest group of SMEs: those with aspirations to grow but also in need of stability. They call these "Stability Entrepreneurs". These firms want to grow, but do not want to take on the additional risks necessary for rapid growth. They want step-by-step growth that helps reduce volatility and risk.

But access to finance matters for *all* SMEs, not just those looking to grow by investing in new capital. In Kenya, a survey found that 43 per cent of small businesses wanted loans to help them expand stock, and 26 per cent for buying inputs in advance.[39] Most firms need working capital – only a few are trying to finance investment for rapid growth. While firms likely prefer to use lower-risk options such as internal cashflows (retained earnings) or informal arrangements (for example, with friends and family), external sources of working capital are often necessary. Yet the average share of working capital provided by banks among small firms in Kenya is just 11 per cent.[40]

Most loans to SMEs take the form of a lump sum with a fixed repayment schedule of between one and three years. These loans may be taken to finance working capital, but they are not ideal. A firm's need to build up inventories, and the cash later generated, is periodic. Many firms would prefer something more like an agreed overdraft facility, that can be drawn down as needed, and repaid when cashflows allow, with interest paid on the outstanding balance. But banks find the risks of such working capital facilities difficult to manage. The arrangement may appear to be working well, but then occasionally something unseen by the bank will occur, and the SME will borrow the maximum available amount, and then go bust. Liquidity is also much harder for banks to manage with unscheduled withdrawals and repayments. Therefore, few SMEs have access to these sorts of working capital products.

From a development perspective, the greatest impact comes from ensuring that firms with opportunities to grow have the financing they need to exploit those opportunities. Growth often requires investment in fixed or intangible capital, and the ability to pay wages and suppliers while experiencing early-stage operating losses. But firms also need working capital financing to grow, and to operate efficiently after having done so. Working capital financing is therefore still an important piece of the SME financing puzzle.[41]

39 Small Firm Diaries, Kenya Country Data Overview

40 World Bank Enterprise Survey Database, accessed 12 December 2023.

41 See our 2022 investment in Kinara Capital for an example of how we support SMEs through working capital loans.

We ran a series of focus groups with SMEs in Ghana to get to the bottom of the financing features SMEs look for in that market. The following hypothetical example is a composite of the real complaints of SME owners we heard from in focus groups held in Ghana.

Albert lives in a regional city where he started working at his local market as a teenager trading t-shirts and footwear, sourcing his inventory in the capital. Over time, he realised that the costs involved with producing garments locally would be lower. He saved and borrowed money from friends and family, eventually buying several sewing machines which he and family members operated from home to produce shirts and other items. Demand for Albert's products grew. He expanded the business to employ workers in sales and production, moving into a small workshop which was financed by business earnings and loans from community members.

After five years, Albert's business had grown to 50 staff and $500,000 annual revenue, but he hit a problem. He could no longer keep up with the growth in demand and the only way to keep his prices low was to take advantage of economies of scale. This would require building a factory. Albert approached several banks for a loan, but the process was onerous, and he did not have any inside contacts at any of the banks to support his application. Several of them rejected him outright due to his inability to provide appropriate financial records. One bank eventually offered him a high-interest loan, with the full amount repayable within a year. However, his factory would take at least 18 months to come online. Later, the bank withdrew the offer as, despite offering all his properties and fixed assets as collateral to the value of 120 per cent of the loan, they later decided it was not enough.

Not all SMEs face exactly the same problems – for some it may be even harder than for Albert. A manufacturing business can potentially offer property and machinery as collateral. An information technology (IT) services company with a leased office and few tangible assets might be less appealing to lenders. The nature of Albert's business also meant that he could produce and earn revenue year-round, while a company with a chain of low-cost schools might struggle to make steady loan repayments that are not tailored to its seasonal cash flows.

While no two SMEs face identical problems, the purpose of this section is to set out common themes on why it is so difficult for SMEs to access finance and why it is not a straightforward problem to fix. The financing gap outlined in Section 2 is not just a supply issue. Therefore, we will address the problem through the lens of both supply and demand.

It is also critical to keep in mind that the SME financing gap is not experienced equally across society. SMEs run by women, ethnic minorities, and other marginalised groups all experience additional hurdles (see Box 2). The barriers discussed are worse for some relative to others. It is vital that all who are interested in SME financing should apply the lessons below through the lens' of these groups.

Box 2. Inequalities in the SME financing gap

Women-owned and led MSMEs (WMSMEs) account for a disproportionately large share of the financing gap. Globally one-third of SMEs are owned by women – yet 70 per cent report having no or insufficient access to financing.[42] Women entrepreneurs face barriers to accessing loans despite their advantages as clients – non-performing loans (NPLs) among female borrowers are 53 per cent lower than among males (Liaplina & Sierra-Escalante, 2022). In raising equity, only 7 per cent of private equity and venture capital is invested in female-led businesses in emerging markets (IFC, 2019). This points to a multi-billion dollar funding gap that financial institutions have yet to tap into.

This gap is attributed to structural inequalities and deeply embedded cultural attitudes that vary across the world. In many countries, women are not legally able to own land or inherit assets, and sometimes may require permission from a male family member to open a bank account and access financial services. Basic capabilities like being able to travel to a branch or provide proper documentation is difficult where travel is risky, and cultural or legal norms prevent women from having their own ID. In countries where regulation is more inclusive, women still face prejudice when engaging with financial service providers, which often assume women are riskier to lend to, have less experience and knowledge in managing finances, and are ultimately not profitable to lend to. BII-commissioned research in South Asia found that fewer than 10 per cent of WMSMEs (including micro) felt that their financial needs are being met, highlighting vast opportunities.[43]

Reports from IFC also indicate that Lesbian, Gay, Bisexual, Transgender, and Intersex (LGBTI) people frequently face restrictions on eligibility for financial products and services including business loans, and that physical and digital access to financial services is also limited for persons with disabilities (IFC 2022a; IFC 2022b).

Efforts to close the SME financing gap should take these, and other, factors into account. It is not just about addressing inequalities in access to financing between SMEs and large firms, but *within* the SME group.

4.1 The supply side

Traditionally, a growing SME wanting access to longer-term finance would likely explore two main options. They could borrow from friends, family, or other informal sources, or they might approach a bank for a loan. Other options, such as equity financing, are likely to be inaccessible for most SMEs in developing countries.[44] The focus of this section is on the supply-side constraints associated with an SME financing ecosystem reliant on traditional commercial banks.

42 World Bank Press Release (2017) New World Bank Group Facility to Enable more than $1 billion for Women Entrepreneurship

43 BII (2023) *How can Digital Financial Services act as a catalyst for Women MSMEs in South Asia?* BII: London.

44 For example, see Olomi & Mori, (2015) for a description of some of the challenges of financing SMEs via equity in Tanzania.

Banks are good at certain things like short-term lending to firms with established track records and collateral. But SME lending can be a risky business (see following section), which often limits how much banks are willing to lend to SMEs and on what terms. We have made successful investments in banks where one of our major motivations was to increase the total volume of credit available to SMEs. However, we have been less successful in growing SMEs as a *share* of the total loan book. In other words, it was easier to help banks grow overall than to shape their operations to be more SME-focused. A 2020 evaluation of our financial institutions portfolio looked at a sub-set of five direct investments in banks that specifically focused on supporting banks to become more 'SME-centric' (Sunderji, et al., 2020). While absolute SME lending grew, it found that only one of the five saw a substantial increase in the share of the banks SME loan portfolio (see Figure 7).

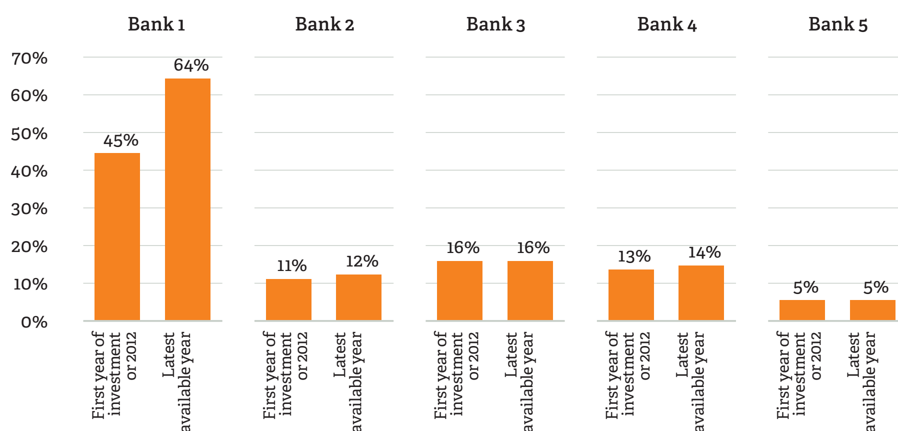


Figure 7: Share of SME lending to total lending across five BII investments in banks
Source: Sunderji et al. (2020)

Increasing overall lending without becoming more 'SME-centric' can still be impactful when it is accompanied by regional expansion and heightened competition. An important part of the impact story is where the businesses receiving loans are situated and whether banks are expanding into rural areas and provincial towns (see Section 3.5). Increased competition – more banks operating in each market – can reduce discriminatory practices in informal credit and increase the flow of finance to marginalised groups, with greater impacts on consumption and poverty than for non-marginalised groups (Bhukta, et al., 2023).

Working with and through banks therefore remains a key element of our toolkit – applying lessons we have learned (see Section 5) – but it is not the only one. Understanding how to shape financial systems that better serve SMEs, through banks and other channels, requires understanding the reasons why bank lending has its limitations.

Banks and risk aversion

In assessing whether to lend to the SME, and on what terms, the bank needs to assess the risks involved. A bank loan officer's job is to lend to households and businesses that will repay the debt with interest. Banks are highly leveraged institutions, meaning they are financed by a high level of debt relative to equity.[45] As a result, relatively small losses on lending can leave them insolvent (with assets that do not cover their liabilities) so banks are intrinsically risk-averse in their lending. Leverage may reduce risk appetite, but it also increases the amount of money available to the bank to lend. There is no guarantee that having less-levered banks would result in higher volumes of lending to SMEs.

45 African banks tend to have lower loan-to-deposit ratios than banks and advanced economies. They also tend to be more profitable (as measured by return on equity) because of higher interest rates and less competition.

A European Investment Bank (EIB) survey of 33 African banks found an average non-performing loan (NPL) ratio of 11 per cent compared with 2 per cent in advanced economies (EIB, 2023). The survey finds that 32% of African banks have SME NPLs of 10 per cent or more, which the EIB considers "significant", and a few report SME NPLs between 20 per cent and 50 per cent.[46] In stress testing the UK financial system, the Bank of England considers a "severe scenario" that banks must be capable of surviving to be an asset impairment rate of 4.7 per cent.[47] Impairment rates are not directly comparable to NPL ratios, but the more that borrowers have trouble repaying (such as when the loan becomes non-performing), the higher the chance of a bank losing money on its overall SME loan book (resulting in an impairment). From these high SME NPL ratios, it is easy to see why African banks may regard expansion into SME lending as raising the likelihood that the bank will come under severe stress. SME lenders that want to take a less conservative approach to lending than banks will need to manage even more elevated risks.

Banks must also manage liquidity and be able to honour depositor demands to withdraw cash. A bank may be solvent, but if too many of its assets are illiquid (such as long-term loans to SMEs) it is vulnerable to a bank run.[48] Banking regulations are designed to limit solvency and liquidity risks.

Risk and information asymmetries

An essential part of access to finance for SMEs in any country is therefore the ability of financiers to assess risk and separate the 'good' borrowers from the 'bad'. This requires information. How financially sound is the business? What are its assets suitable for collateral? How competent are its managers? How resilient is it to shocks?

But accurate answers to these questions can be difficult for a bank to obtain. Borrowers know more about themselves than lenders – this is called 'information asymmetry'. As a result, borrowers may struggle to convince a lender they are 'good' because they may be suspected of concealing information if they are 'bad'. Information problems partly explain why banks and other intermediaries exist – they specialise in acquiring information and what to do in its absence (Blinder and Stiglitz, 1983; Diamond, 1984). But because uncertainty remains, interest rates are higher and the volume of lending is lower than it would be if a borrower's probability of repayment was knowable.[49]

"I should have been suspicious they were exaggerating their company's earnings."

46 Here, NPLs are those where scheduled repayments have not been made for 180 days or more.

47 The Bank of England's 2022/23 stress testing involves modelling a "severe" credit impairment rate on UK bank loan books.

48 See Shin (2009) for an accessible account of the run on Northern Rock, a UK mortgage lender.

49 Such information asymmetries, where one party possesses greater material information than the other, have been shown to result in inefficiently low credit provision and even market breakdown (see Akerlof, 1970; Jaffee and Russell, 1976; Stiglitz and Weiss, 1981).

This is a global problem, but in developing economies it is more acute, largely because it is often difficult for borrowers to demonstrate creditworthiness due to poor accounting practices and record keeping and lack of third-party data (Cook & Nixson, 2000; Binks, Ennew, & Reed, 1992).

How do banks overcome these information asymmetries? One approach is to build the risk associated with uncertainty into the terms of the loan by demanding a higher interest rate (a 'risk premium'). The problem is that higher rates increase the risk the loan will not be repaid, as the burden of repayment is higher. Higher rates may also attract exactly the wrong types of borrowers (those with traits of a gambler rather than prudence) – known as 'adverse selection'. To avoid adverse selection, banks protect their profits by rationing the supply of credit (Stiglitz and Weiss, 1981). That means there are some firms that want to borrow at prevailing rates, and would (probably) repay, but cannot find loans.

Although interest rates are an imperfect response to risk, lenders do charge higher rates to borrowers they perceive as higher risk, to an extent. There is evidence the interest rate charged by lenders for similar loans can vary greatly within the same economy (see Banerjee, 2003; Banerjee & Duflo, 2010), and that these dispersions in financing costs particularly affect smaller businesses. In Brazil, a firm with 300 employees faces interest rates of approximately three percentage points less than a firm with 30 employees, and 5.5 percentage points less than a firm with three employees (Cavalcanti, 2021). Loan pricing dispersion that does not reflect underlying risks would have negative macroeconomic consequences in terms of lower productivity and wages.

Risk and collateral

If a lender can seize sufficiently valuable assets in the event of a loan not being repaid, then the risk of non-payment is unimportant. But how much money will be recovered from collateral also suffers from information problems, leading to an *overreliance* by banks on collateral (Collier, 1994; Mambula, 2002). On average, the value of collateral required is 207 per cent and 233 per cent of the loan amount in sub-Saharan Africa and South Asia, respectively.[50] This disadvantages SMEs that often lack tangible assets. By the IFC definition, a small business might have as little as $100,000 in total assets, much of which might not be appropriate or considered of sufficient quality to meet the bank's collateral requirements.

On average, the value of collateral required is 207 per cent and 233 per cent of the loan amount in sub-Saharan Africa and South Asia, respectively.

"Your assets speak for themselves. They say 'no'."

50 World Bank Enterprise Surveys data, accessed 24 May 2023.

Movable assets are the main type of collateral that SMEs can offer, but inadequate legal and institutional protections mean that banks are often reluctant to accept them (World Bank, 2018).[51] This can help explain why SMEs in service industries are disadvantaged – they have fewer fixed assets like a plot of land or building than industrial firms and are therefore more credit-constrained (see Guercio, et al., 2020; Moritz, et al., 2016; Kira & He, 2012). Collateral registries – publicly available databases of interests in or ownership of assets – can improve access to finance, but they are not widely available in Africa (Love, et al., 2016).

SMEs also face legal barriers in developing economies in terms of what they can offer as collateral. Legal frameworks dictate how a security interest is created, who may create it, how it is sold, who has priority in receiving the proceeds from sale of the collateral, etc. The challenge is that the types of assets held by SMEs – such as equipment, inventory, accounts receivable, livestock, etc. cannot be used to secure loan contracts. In this sense, these assets become "dead capital" (Fleisig, 2006).

Risk and 'relationship lending'

One approach to overcoming information asymmetries is so-called 'relationship lending', whereby the lender can gather information on the creditworthiness of the borrower through repeated personal interactions. This can sometimes take the form of preferential treatment for borrowers that share cultural ties with the lender (Fisman, et al., 2017). While there is evidence to suggest such relationships can partially overcome information problems (see Sette & Gobbi, 2015; Bolton, et al., 2016), it creates 'insiders' and 'outsiders', with some businesses, particularly SMEs, excluded because they lack these relationships that take time to develop (see Box 4). In addition, a tendency towards bank consolidation, often driven by regulatory changes, can have unintended consequences as smaller banks with SME relationships are rolled-up into larger banks.[52] These larger banks are more likely to focus on efficiency and lower transaction costs, and may remove loan officer discretion from lending decisions. Beck, et al., (2003) show that in markets with fewer and larger banks, firms of all sizes face higher financing obstacles, though it is smaller firms that fare the worst.

With the banks… if you don't know someone at the top who's going to hold your project and take it with them, you would sweat.

Participant in SME owners/managers focus group in Ghana

Risk and regulations

Regulations designed to keep banks safe can also constrain SME lending. Following the financial crisis of 2007-09, the international regulatory framework for banks (Basel III) introduced new requirements for bank capital adequacy and liquidity. Implementation is ongoing, particularly in developing economies, but 85 per cent of African banks are compliant or working towards compliance (EIB, 2020). A review of the effects of Basel III on SMEs found that the regulations slowed the pace of SME lending at some banks (Financial Stability Board, 2019). Fišera, et al., (2019) also find a short-term, negative effect, as intensified regulations make SME financing more complex and expensive. The evidence suggests efforts to reduce risk in the global banking system may have reduced the flow of credit to SMEs.

51 Firms may invest in more fungible (and less productive) assets like vehicles that can be easily monetised, particularly if there is a high level of uncertainty about the future (Gebrewolde & Rockey, 2023).

52 Oxford Business Group.

Regulatory requirements have also been used to push banks *towards* SME lending. For example, Pakistan has introduced regulations to increase SME financing, including the need for banks and DFIs to prepare a comprehensive SME Specific Credit Policy.[53] In India, banks have a priority sector lending mandate from the Reserve Bank of India which includes SMEs. And in 2021, the Central Bank of Egypt raised the regulatory floor in the share of MSME financing from 20 per cent to 25 per cent of banks' credit facilities portfolio.[54]

The rise of less regulated NBFIs, which typically do not take deposits from retail investors and therefore require less regulatory protection, is partially a response to banks retreating from riskier lending after regulatory tightening. NBFIs can be helpful as lenders, financed by more sophisticated investors who take responsibility for their own risk-taking, can be more flexible. Such flexibility can, in turn, improve business outcomes without deteriorating repayment rates (Barboni & Agarwal, 2021). But a lending boom by non-banks, largely in the real estate sector, played a big role in the recent Indian financial crisis (Subramanian & Felman, 2019). There are many different varieties of non-bank lending, including high interest 'leveraged loans' to large firms that are not relevant to SME lending. But some specialist SME lenders are non-banks and operate under a different regulatory regime.

Availability of long tenor capital

Financing growth typically requires longer-term capital because investment in productive assets, like Albert's factory, often takes time to generate earnings to repay debts.

Banks across the world use demand deposits to finance longer-term loans. This is known as 'maturity transformation', which creates the risk of liquidity crises – see Bologna (2018). However, banks in developing economies often face a dominance of particularly short-term liabilities – over 45 per cent of African banks have short-term deposits of less than a year accounting for between 90 and 100 per cent of total deposits (AfDB, 2015).

Volatile deposits and dysfunctional interbank markets, which banks in more developed markets rely on for liquidity management, mean that banks in Africa face severe liquidity risks. This further limits that ability to provide long-term loans. A shift in liabilities towards longer durations has a measurable impact on long-term lending, meaning banks are better able to deliver a crucial service for the real economy (Choudhary & Limidio, 2022). DFIs have an important role to play here (see Sections 5 and 6).

Profitability relative to alternatives

If banks in many places are failing to lend to SMEs, what are they doing with their capital? One important choice faced by banks is between investing in government debt versus lending to households and firms. By financing government debt, investors can help governments spend on services like education and healthcare, which are vital for social and economic welfare.[55] But in Africa, where the private sector is highly reliant on bank financing, a preference for sovereign debt among banks can inhibit the flow of credit to firms (or 'crowd it out'), to the detriment of economic development.

53 State Bank of Pakistan (2022): Prudential Regulations for Small & Medium Enterprises Financing

54 Egypt Today (2021). *Egypt's central bank obliges banks to increase financing directed to SMEs to 25%.*

55 Government-issued securities also serve other functions in financial systems, for example they play an important role as a low-risk, highly liquid asset that can serve as collateral.

There is evidence that African banks are increasingly opting for government debt as a preferred asset, and the greater the share of sovereign securities in total assets, the lower the credit growth to the private sector (Bouis, 2019). In Southern Africa, two-thirds of banks report increased lending to government as a major or severe constraint for lending to SMEs (EIB, 2023). Bank exposure to sovereign debt in emerging markets is relatively high and rising (IMF, 2022). The median exposure of African banks to public sector debt increased from 9 per cent of total assets to 17 per cent in the last decade, while over the same period private sector lending fell from 45 per cent to 34 per cent (Figure 8a). In some African economies like Ghana, banks' public sector exposure has overtaken private sector lending as a shared of assets (Figure 8b). This not only chokes the flow of capital to businesses, but also creates risks: banking systems in sub-Saharan Africa are relatively more vulnerable to sovereign distress (IMF, 2022).

There are some underlying structural reasons of this preference for sovereign securities – financial markets are inefficient, undiversified, and domestic savings are low – all of which limits banks' options.[56]

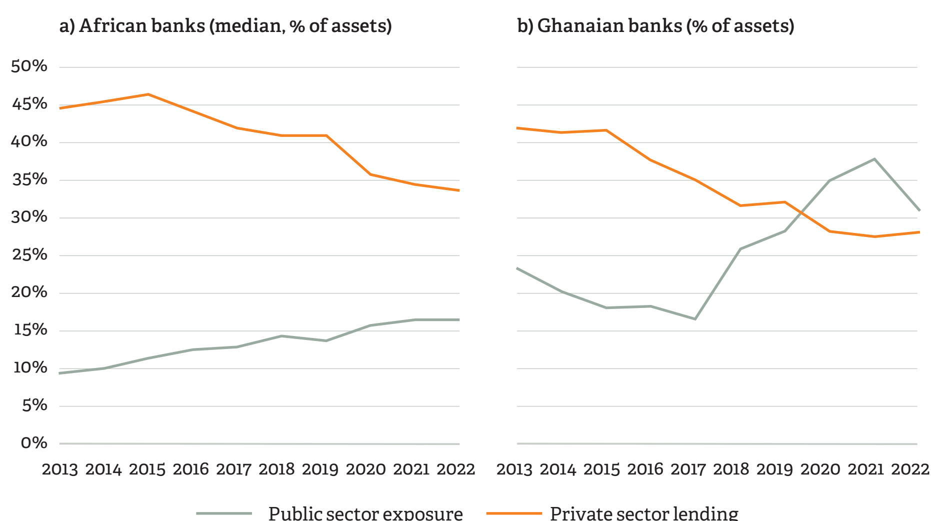


Figure 8: Banks' Domestic Sovereign Debt Exposure, 2005–21
Source: EIB (2023)

But at the level of an individual bank's decision-making, there are several factors that incentivise investment in government assets and not SMEs:

- **Low risks and competitive yields:** According to the EIB, sovereign bonds are typically viewed as the closest thing to a 'risk-free' investment in Africa. They also offer competitive returns, particularly in sub-Saharan Africa. The difference in yields between sovereign bonds issues by sub-Saharan African governments and those with the highest credit ratings (such as Germany) were three times the emerging market average in early 2023 (IMF, 2023). In December 2022, the interest rate on bonds issues by the Government of Ghana stood at 29.85 per cent.[57]
- **Lower administrative costs:** It is relatively quick and easy to assess the creditworthiness of sovereigns compared with the due diligence associated with lending to firms. This is also true of large private firms relative to SMEs.
- **Liquidity:** Government bonds are typically liquid and easily convertible into cash.

56 Low savings rates and underdeveloped financial markets mean less capital for both government and the private sector, but governments are often in a better position to compete through offering better risk-adjusted returns.

57 IMF International Financial Statistics, accessed 19 October 2023.

- **Low risk asset weighting:** Regulatory requirements often lead to a preference for sovereign bonds as they have a low risk weighting. The use of government policies such as interest rate caps – so-called 'financial repression' – may exacerbate this effect. An interest rate cap limits banks' ability to charge adequately for risk, so they are more likely to invest in 'safe' government bonds rather than risky loans to SMEs, stifling economic growth (Javarov, et al., 2019).

The problem for SMEs – and others in the private sector seeking funding – is that to attract funding they are required to outperform sovereign securities (and other financial assets) to be attractive for banks. This is particularly challenging in the less competitive financial sectors of developing countries. If a bank can make money through safer means, why would it take the perceived risky option of lending to SMEs?

4.2 The demand side

Successfully increasing the supply of finance to SMEs requires thinking about how to serve different types of SME with different needs.

Based on findings from India, Kenya and Peru, Sawhney, et al., (2022) put the owners of small (and micro) enterprises into one of two camps: "cautious entrepreneurs" or "determined aspirants". The focus of the former is on stability and the latter on growth.

When it comes to SME financing, risk is typically considered from the creditor's side. But borrowers are also putting their livelihoods on the line. SMEs operate from a position of vulnerability, which affects their appetite for the risks involved in taking on external finance. It is always safer not to borrow when you do not have to. Over half of African banks report lack of demand as a constraint to SME lending (EIB, 2023).

Globally, and for firms of all sizes, the most common way to finance investment is using internal resources (such as retained earnings) and informal sources such as friends and families and local savings groups. While there are benefits to formal financing, such as greater privacy in their financial dealings, smaller businesses typically report a preference for informal sources. This is partially attributed to a "trust deficit" with formal financial institutions that are also considered too inflexible (Sawhney et al., 2022). Figure 9 (left panel) shows that around 73 per cent of investment is financed internally, compared with 14 per cent by banks. This lends credence to the 'pecking order' hypothesis (Myers, 1984), for a hierarchy of preferences that firm owners have for different sources of financing, with internal sources at the top (see Section 4.1).[58] This preference is stronger in developing countries, where asymmetries are greater and make external finance relatively more expensive (see Holmes & Kent, (1991); Boateng & Abdulrahman, (2013); Abor & Biekpe, (2007). The right panel of Figure 9 shows that SMEs in many sub-Saharan African countries are more likely to self-finance than large companies.

58 If internal resources are insufficient, firms typically prefer debt, followed by hybrid securities, and finally equity (see Myers (1984)).

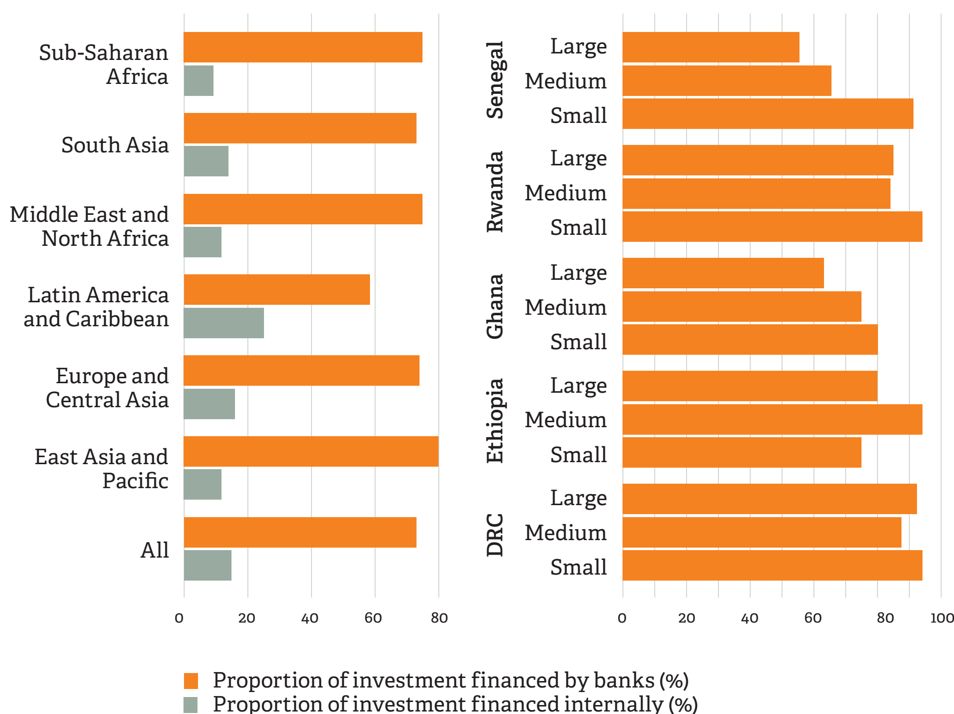


Figure 9: Share of investment financed by banks/internally by region (left panel) and country and firm size (right panel)
Source: World Bank Enterprise Survey Database, accessed 28 June 2023

Yet even for the most cautious and risk-averse business owners, the right type of external finance can be put to good use. The purveyor of a small, local shop who has little ambition to open new outlets will still need finance to purchase inventory, grow sales and increase earnings using existing capacities, perhaps without hiring new workers or investing in new capital.

Other forms of financing, such as supply chain financing (advancing payments from customers), vendor financing (purchasing equipment on credit from suppliers) and leasing, can be more useful than a bank loan to some SMEs. Sometimes finance providers with a 'vertical' (industry) speciality will have the edge over generalist lenders. A seller of farming machinery might be better placed than a bank to know which farmers to extend credit to, and would also know whether to offer a loan to purchase that same item and be more ready to accept the machinery itself as collateral.[59]

For those SMEs with growth ambitions, if they prefer not to use external capital then why are we in the business of SME financing? A clear answer to this came from one SME owner in Ghana:

"We do most of the things from our pocket… but you can't grow from your pocket".[60]

The ability to rely on internal and informal financing for growth is limited by the quantity available. Those SMEs that have ambitions to expand often have no choice but to turn to external sources to get finance in the amount required. But it is not just about the right amount: it is the right amount on the right terms.[61]

The implication of applying this demand lens is that the SME-financing market (not necessarily any one lender) should supply a suite of products to meet the varied needs of different SMEs.

59 Refer to chapter 3 here for more on asset based financing: https://www.oecd.org/cfe/smes/New-Approaches-SME-full-report.pdf.

60 SME Focus Group Participant, December 2021.

61 These SME-relevant considerations are captured in BII's approach to investor contribution. We typically find three types of cases where financial additionality can arise: 1) where capital is not offered at all; 2) where capital is not offered in sufficient quantity; and 3) where capital is not offered on suitable terms.

What kind of finance do SMEs want?

"Attractive financing means financing on terms that meet the needs of my business".

This was the key message voiced in a series of focus groups held in Ghana as part of BII-commissioned research. But as discussed in Section 3, SME needs vary. Some, typically larger, firms in our focus groups, were "very excited" by equity-type financing options, others were equity-averse. So what exactly do SMEs want?

Repayment structure: flexibility, tailored to cash flows

"I would put first on my priority flexible repayment, tailored to my cash flow."

"The payment should be structured such that the times that I'm having a lot of money, you can take a lot, and the times I'm not having, you can slow it down. Because, remember, I still need to keep my staff members."

The most highly-sought-after feature is repayment terms that suit the nature of the business. SMEs can often have irregular cash flows and struggle to make repayments in 'off-season'. One business providing childcare services highlighted the seasonal nature of cash flows, yet typical loan terms fail to recognise this, creating a major financing challenge. An agro-processing firm also noted that both production and demand are seasonal which creates a similar problem. A range of types of businesses value flexibility in the structuring of repayments. As noted in Section 4.1, research suggests that more flexible lending terms can contribute to better firm performance. However, it is also important to note that flexible terms are likely to be associated with increased costs, because lenders find them harder to manage.

Tenor: needs vary between short term (working capital) and longer term (capital expenditure), but it is the latter that is in short supply

"We are trying to get in some equipment… and also getting some lands… For me, financing means trying to get some time, some space, to make some profits before we actually start paying the interest on the loans."

Of the SMEs in our sample, 74 per cent reported loan tenors of less than three years. A key message voiced by the managers and owners we spoke to is that you cannot expand a business without financing with an adequate time horizon. A small agricultural producer felt that a reasonable moratorium for her business to grow would be five years, with an extended payment period after that. Yet only 8 per cent of SMEs reported accessing finance with a tenor of six years or more. The time aspects of the loan agreement matter greatly, both in terms of when the first repayment is due and when full repayment is due.

Price: the interest rate matters, but some firms (though not all) are also willing to pay higher rates for other attractive features.

"Financial institutions with high interest rates we are not able to pay back… We normally don't use them because they are too expensive for us."

Interest rates are a key concern. However, there is not necessarily a fixed view on what is an acceptable interest rate. Some firms indicated that they will accept a higher rate in return for attractive features like lower/no collateral requirements and quicker processing times. Around 40 per cent of SMEs we surveyed would pay a 1 per cent interest rate premium if collateral were set at a lower level of 50-70 per cent of the loan value.

Collateral: requirements in both the amount and type of collateral frustrates businesses, and is widely seen as slowing down the process of securing finance

"My financiers ask for a collateral. All the properties that I had, lay it down, and it's still not enough."

"They see that the project is viable but at the same time, as I said, the collateral issue also comes in terms of the amount that you need."

"A lot of the production we are doing manually. So how do I get the collateral?"

Collateral can serve an important function. A bank loan with standard conditions and good collateral implies lower transaction costs and higher security for the lender, enabling them to price a loan at a lower rate than they could with a more bespoke and unsecured loan.

However, SMEs feel that collateral is used so bluntly that it blocks out even the 'good' borrowers. They see it as a crude tool that blocks the formation of financing relationship whilst also slowing down the processing of loan applications. SMEs find high collateral requirements extremely burdensome, and the type of collateral required is typically landed property which many businesses lack.

Timely financing: getting the funding as and when it is needed

"By the time they give the money to the business person, the money is not useful."

"The decision making takes a long time, and more often than not, they come back because they don't understand what you're doing [which] lengthens the process."

Evidence show that the length of time it takes to access finance is an important consideration for SMEs (Sawhney, 2022). In our Ghana research, lengthy processing times was cited by a third of medium-sized businesses as a reason for not using a bank loan. Banks typically have a tiered approach in the credit approval process, with multiple layers according to the size of the loan. As the application progresses up the layers, decision-makers are further removed from direct engagement with the business and its owners, limiting understanding which can contribute to delays and rejections

Business support services: strong interest in non-financial support to drive business growth

"If you are an entrepreneur in this country, you need all the help you can."

"If the bank had given me that [business support] service, my business would have improved because it took me years to know what I needed to."

Another important theme emerging from our research centred the need for non-financial support. African SMEs typically operate in complex and dynamic business environments characterised by shocks and changes, and they therefore need to engage in practices that can enhance their ability to react and adapt.

Over three quarters of SMEs we surveyed indicated moderate to high levels of interest in business support services, with greatest interest in business development support (85 per cent), followed by financial management (82 per cent), environmental and social (79 per cent), and governance (74 per cent). Close to a third of respondents indicated they would pay a one percentage point premium on their interest rate to secure such business support.

5

What is the history and what have we learned?

The challenges associated with SME finance go back a long way.[62] And, as noted in Section 4.1, these problems, and the solutions needed to address them, are not isolated to developing economies.[63] This implies two things:

1) the persistence of SME financing gaps across continents and time suggests these are major, common structural issues; and

2) that there has been no single, silver bullet solution to 'fix' them.

But substantial progress has been made and lessons learned. As a learning organisation with first-hand experience, the following section seeks to distil the key principles that should underpin approaches to SME financing and the lessons we have picked up on our journey (see Figure 10).[64]

62 In Ancient Rome, capital markets reportedly depended heavily on personal ties between borrower and creditor, collateral requirements for longer term, secured loans were often difficult to meet, and loan terms onerous (Harris, 2006).

63 For example, see the 2018 report on SME Finance in the UK by the House of Commons Treasury Committee, or the strategic focus on financing in the European Commission's current SME strategy.

64 Given that SME finance challenges are global in nature, we have also included reflections on the experience of UK-focused institutions.

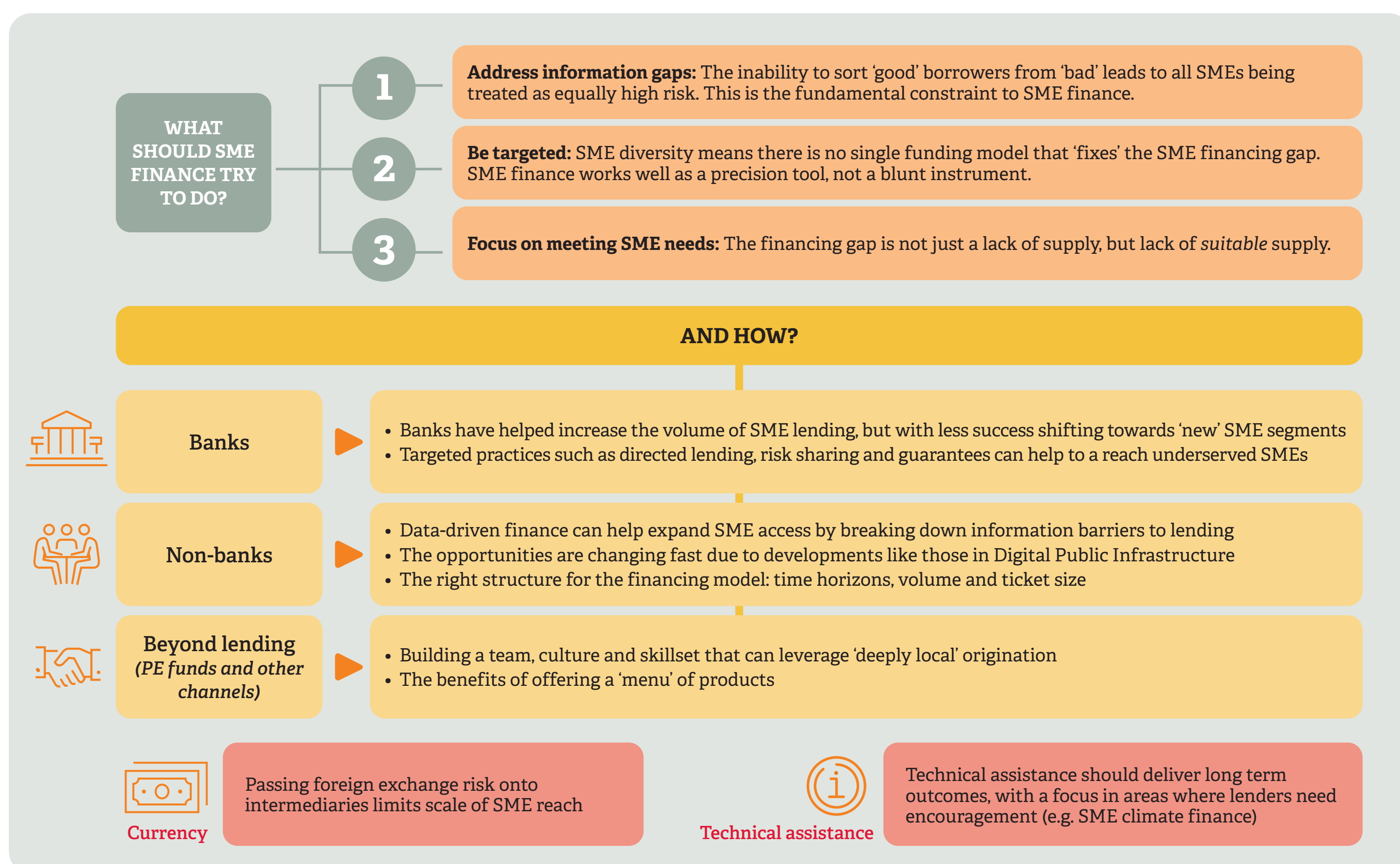


Figure 10: The 'what' and 'how' of SME financing: BII's lessons learned

5.1 What should SME finance try to do?

The discussion above shows that theory, evidence and experience reveal certain facts about barriers to SME financing that suggest a few principles on which efforts to boost SME financing should be based.

1) Address information gaps: The ability of lenders to sift 'good' from 'bad' SME borrowers – and the transaction costs involved in doing so – is arguably the most fundamental issue in SME finance. SME financing gaps are thus underpinned by information gaps. For a DFI like BII, there are two main ways to bridge these:

a) work with established lenders to get them comfortable with the uncertainty and risk associated with SMEs; and

b) work with new types of financial institutions and investment vehicles that are introducing and promoting innovative ways to accurately assess SME pre-investment prospects and effectively monitor the performance of their loan books.

2) Be targeted: Diversity of SMEs – in terms of size, sector, location, etc. – means diversity of needs. Within lenders, different products are likely to be needed to serve a ten-employee furniture maker in Nairobi and a 300-employee poultry farm in rural Nigeria. Looking across lenders, our end goal is to create a market that offers a suite of products, not for each lender to individually try to do everything. SME finance should be approached as a precision tool, not a blunt instrument, with DFIs supporting the tools that can successfully reach the most underserved SMEs.

3) Focus on meeting SME needs: Estimates of SME financing gaps are based on the difference between supply and demand, but they do not necessarily imply excess 'actual demand'. Lenders cannot take demand for granted – there can still be a mismatch between what is offered and what is needed. Understanding the needs of the targeted SMEs – which are likely to differ across businesses of different sizes, in different sectors and geographies – is prerequisite for success.

5.2 And how should it be done?

These principles can tell us much about what we should be trying to do to boost SME finance, but little about how to deliver it. Our experience across a range of approaches to has taught us a number of important lessons to apply to future SME finance approaches.

5.2.1 Lessons in financing from banks

Banks have helped us to increase the scale of SME lending, but there has been less success in shifting their lending into new SME segments.

Banks offer distinct advantages for investors who want to get capital into the hands of SMEs – particularly regarding their reach. As the penetration of banks to people and business in underserved regions has grown, so have the opportunities. In Lagos, 97 per cent of small firms have a bank account.[65] Reaching SMEs via banks can have real impact. A study looking at the SME effects of one of our bank investments in India found average annual growth in: income (10 per cent), assets (7 per cent), and productivity (6 per cent), with growth in employment disproportionately favoured towards women.[66]

As discussed in Section 4.1, banks are integral to financial systems in developing countries. As the banks grow bigger and stronger, they become capable of lending more to firms on better terms. Strengthening the capital base of a large bank can thus be an important tool in increasing the scale and terms of overall lending. However, it does not necessarily lead to a rebalancing of the bank's total loan book towards a greater proportionate focus on SMEs.

SME lending is relatively high-touch, so it is expensive to acquire new customers. Some SMEs may be able to access financing through the bank's 'standard' lending model, but the typically smaller and more credit-constrained SMEs that fall outside of this segment require bespoke structures that are expensive to administer. Underwriting becomes more labour intensive for smaller firms and needs to recur more frequently as the loans are also with shorter terms (so capital needs to be turned over more frequently). Moreover, operational requirements to monitor the loan book successfully – often involving frequent contact with borrowers to ensure that they identify problems early – are also costly. In an environment where uniform, scaleable products are more profitable (such as residential mortgages, credit cards, personal loans), a pivot to SME lending may not appear to make commercial sense to banks.

Working through banks, as with all SME tools, can help meet specific SME financing objectives, but it cannot do it all. In thinking about whether banks are the most appropriate channel, it can be helpful to frame the financing gap in terms of the following situations (which may be found in combination):

1) **Countercyclical financing:** When adverse macroeconomic conditions strike, banks can take risk 'off the table'. This affects the supply of credit to businesses of all sizes, but it most dramatically impacts those with the greatest perceived risk, such as SMEs. Our investments at such moments can help counteract the withdrawal of credit.
2) **Increasing scale:** A bank may already be lending to SMEs, but at a low volume. In such instances, closing the financing gap might mean doing more of the same but at a greater scale.

65 Small Firm Diaries, Nigeria Country Data Overview

66 CDC and IFC (2017) SME finance and growth: evidence from RBL Bank

3) **New geographies:** In other cases, SMEs in parts of a country may be underserved, so investment can support a bank out of its geographical comfort zone and help it expand its existing lending into new areas.

4) **New types of SME customers:** As outlined in Section 4.2, SMEs are often just outside the risk appetite of the bank, and this may apply to certain businesses – based on sector, size, or other characteristics – more than others. Expanding finance into new sectors may demand support for different approaches from banks, or looking beyond banks altogether. Innovative approaches to lending decisions can make a difference. Alibhai, et al., (2022) show that using psychometric credit scoring as a substitute for collateral positively impacts women's access to credit and can help to predict likelihood of non-repayment. Argidius and Women's World Banking have shown, in partnership with KCB Bank Group in Kenya, that a shift from traditional, collateral reliant credit assessment to a methodology based on cash flows and embedded in a relationship-based banking model helped boost lending, particularly for women-led SMEs and those in the services sector. Alongside other interventions, such as non-financial business support services, this contributed to NPLs of just 1.5 per cent, compared with 15 per cent for the rest of the SME portfolio. As a consequence, the bank's new product is its second-most profitable.[67]

Based on these situations, banks may or may not be the appropriate tool. However, the following are some examples of SME-focused bank investments that have helped illustrate some of these lessons.

In 2014, we made an initial $28 million equity investment in **RBL Bank**, a major Indian bank.[68] Central to the impact thesis was expanding the scale of RBL's SME lending, as well as its scope by reaching into underserved states. At that time, the bank worked in 13 states, but by 2019 this had increased to 28, including new operations in some of the poorest areas where SME finance gaps are widest. Between 2014 and 2018, the volume of SME lending by RBL increased more than four-fold from INR 13.2 billion to INR 56.8 billion.

In 2018, we invested in a $25 million syndicated debt facility to **Access Bank Plc** in Nigeria. The tier-2 capital provided by the syndication aimed to strengthen the bank's capital base by providing long-term capital (ten-year tenor) that it could not raise on the market, with the end goal of supporting growth in its loan book, especially for credit-starved Nigerian SMEs. In 2018, the bank had 1,393 outstanding SME loans amounting to around NGN 47 billion. By 2020, that had increased to 3,837 loans worth NGN 150 billion. Growth in outstanding loans related to gender finance increased disproportionately in terms of both value (37-fold increase) and number (20-fold increase).

Targeted practices such as directed lending, risk sharing and guarantees can help to a reach underserved SMEs

Where a financing gap is identified among new types of SME customers that banks consider outside their risk appetite, an injection of core capital is unlikely to close it. We started using more targeted approaches in such cases. Directed Lending Facilities (DLF) and Risk-Sharing Facilities (RSF) are two tools in our SME lending approach that have shown real promise in enhancing lending to underserved SME segments.

67 Argidius, (2023) $2 billion for women-led small and medium sized enterprises. See here and here for NPL figures.

68 We have since made several follow-on investments – see here for details.

Directed Lending Facilities (DLFs)

DLFs involve the extension of term financing with a defined use of proceeds. In providing capital via a DLF, investors can take advantage of the scale and reach offered by banks, while also building-in commitments that the capital reaches certain groups or uses. In the context of this discussion, that means on-lending to SMEs.[69]

In Nigeria, our $100 million finance facility with **FirstBank** directs funding towards SMEs as well as women-owned and led businesses. FirstBank has a strong commitment to SME lending, with over 2,000 dedicated SME relationship managers and ambitious targets to double the number of SME clients. However, it has limited ability to raise the type of long-term financing necessary to achieve this goal.

Countercyclical directed lending can also be important in mitigating the severe impacts that economic crises can have on SMEs and the people who depend on them. Our 2021 investment in **Commercial Bank of Ceylon** included a $25 million credit line to support SME lending, and was partially motivated by the challenging macroeconomic environment which has seen the Sri Lankan economy contract by 9 per cent between 2018 and 2022.[70] The bank's SME loan portfolio grew by 3 per cent between June 2021 and June 2022, despite a deterioration in macroeconomic conditions.

There are few rigorous evaluations of DLFs, but recent evidence from an EBRD facility in Türkiye shows that participating banks durably increased lending to women – both in absolute terms and relative to male entrepreneurs. Banks expanded credit to existing borrowers, poached clients from competitors, and crowded in first-time borrowers, while beneficiary firms grew their sales and profits, diversified suppliers, and exited less.[71]

However, there is also some evidence to suggest that DLFs alone do not necessarily provide enough incentive for any bank to refocus towards new, perceived high-risk businesses.[72] For DLFs to successfully achieve the intended development impact, the details of their design are critical. The bank should demonstrate a culture and track record consistent with a focus on achieving challenging SME-lending objectives. A well-designed approach to directed lending should also have a clear path to achieving sustainability, whereby the bank continues financing to the target group on fully commercial terms. This often involves the use of technical assistance to build or improve capacities to serve SMEs for the long term.[73]

Risk-sharing Facilities (RSFs) and guarantees

What can investors do where banks have such a finite risk allocation for SME lending? They can share the credit risk in the sub-loan portfolio via an RSF, meaning that the investor will assume a proportion of any losses from loans associated with targeted SMEs. In doing so, RSFs can enable banks to deploy greater volumes of credit (and other financial services) to SMEs.

69 Other objectives – such as lending to women-led businesses and/or business that contribute to environmental goals – can also be integrated.

70 World Bank DataBank, accessed 27 August 2023.

71 Aydin, Bircan and De Haas (2023).

72 World Bank Independent Evaluation Group (2020). The International Finance Corporation's Blended Finance Operations Findings from a Cluster of Project Performance Assessment Reports.

73 For more information on directed lending, see Tahir, et al., (2021) Directed Lending: Current practices and challenges

In 2022, we made a $75 million commitment to the **African Guarantee Fund (AGF)**, an established provider of SME portfolio guarantee products across Africa. AGF enters into risk-sharing agreements (50:50) with partner banks on portfolios of new lending to SMEs, with the underlying loans originated and managed by the banks. This helps to foster growth in the banks' SME loan books, with a strong focus on 'Alpha' countries and to the gender-lending and 'green' elements of the guarantees portfolio.[74] This innovative approach is relatively new to our portfolio, but it will enable us to continue our institutional learning journey about how best to support the development of inclusive financial systems for SMEs.

How targeted RSFs and guarantees are depends on their design. In SME terms, they can be relatively broad (namely, more lending to SMEs of all kinds), or can narrow in on particular markets or types of business (as per our commitment to AGF).

5.2.2 Lessons in financing from non-bank financial institutions

While the reach of banks is an advantage for in getting capital to SMEs at scale, our experience shows that reaching certain types of businesses in the SME segment can best be done by more specialist models. The following lessons focus on the emerging opportunities created by specialist SME lenders.

Data-driven finance can help expand SME access by breaking down information barriers to lending

As highlighted above and earlier in Section 4.2, the fundamental challenge to SME financing is information asymmetry. However, technology-enabled solutions are helping to turn the tide on this problem.

One area in which technology is helping to break down information-linked barriers to SME lending is exemplified by **Indifi**. Indifi is a leading digital MSME lender in India that uses the latest technology to provide unsecured lending to SMEs. Unsecured lending to SMEs is particularly hard to do successfully. As previously discussed, the typical response of banks to information asymmetries is to demand high levels of collateral. This means that secured lending is the norm, and most SMEs without (sufficient, good quality) collateral cannot get a loan.

Indifi is able to offer unsecured loans thanks largely to the use of its technology-enabled credit decision model, harnessing both traditional and non-traditional data, such as financial transaction history from mobile apps, to assess the creditworthiness of potential borrowers in a quick, low-cost way. Using technology to broaden access to credit delivers real development impact. In a survey of a sample of its customers, over half reported an improvement in their quality of life due to Indifi.

In January 2024, we announced a senior loan of €14 million to **COFINA Côte d'Ivoire**, a leading financing business for SMEs in Central and West Africa. COFINA helps entrepreneurs and SMEs to obtain medium-term or long-term financing not available to them via traditional banks or microfinance institutions. It uses a diligent credit scoring system with built-in flexibility to provide loans where other banks cannot, with a focus on women-led businesses.

This loan helped me in restocking my inventory and helped increase sales. It definitely helped improve my life.

Indifi Customer, Male, 40

If I hadn't gotten the loan, my shop would have closed, so my life has improved in the sense that I was able to save my shop.

Indifi Customer, Female, 31

74 As part of our Impact Score, we rank all the countries we invest in from 'Alpha' to 'Delta' according to their GDP per capita, fragility measures and poverty gap. Alpha countries are those most in need.

Investing via specialist fund managers has also become an increasingly important part of our approach to supporting innovation in SME finance. We made an initial investment in **Moniepoint** through Novastar Ventures Africa Fund II, a venture capital fund dedicated to supporting innovative business models that widen access, improve quality, and lower the cost of basic goods and services.[75] Moniepoint provides financial services to underserved businesses in Nigeria and plans to leverage its easy-to-use, reliable, and affordable online payment network to develop into a 'one-stop-shop' for SME financial solutions. This includes a focus on low-income women operating micro-businesses and underbanked borrowers in rural and semi-rural areas.

Both the quantity and nature of information being collected via new technologies and the opportunities to harvest it to assess business' credit risk are opening new doors for SME finance. One high-profile area of public policy that promises to create future opportunities in this space is the enhanced focus on digital public infrastructure.[76]

The opportunities for specialist SME financing vehicles are changing fast due to developments like those in Digital Public Infrastructure (DPI)

DPI relates to digital networks that, like physical infrastructure such as roads or rail networks, can be harnessed for the delivery of both public and private services. DPI has the potential to transform financial inclusion, making it easier faster and cheaper for SMEs to access finance.

Digital payment systems (DPS) that make use of DPI can help SMEs to build a credit history. They can generate rich data on cash flows and business performance of active SMEs, which can then be used by credit providers to assess their creditworthiness. The digitisation of collateral registries and other credit infrastructure can increase efficiencies, while DPS can also leverage alternative sources of data such as utility and bill payments.

In India, the trade receivables discounting system (TReDS) offers a platform through which SMEs can obtain financing without any recourse against their invoices issued to registered buyers. The General Sales Tax Information Network also allows for prospective lenders to access data on a company's tax payments, closing information gaps by making it easier to assess credit risk.

DPI is thus creating space for new SME financing business models, and new players – like digital banks, fintechs and platforms – are taking advantage of these opportunities and shaping how financial market structures are evolving. This is creating significant opportunities for both investors and SMEs.

Digital banks – fully licensed banks that use technology to target specific segments – are one of these new frontiers. **Tyme Bank** is a digital banking platform that caters to the underbanked and underserved segments of retail and SME customers. Tyme offers MSME financing through its subsidiary Retail Capital. Its core product is a merchant cash advance, repaid as a fixed percentage of card transaction values. This pricing has the benefit that if the merchant's business is booming and card transactions are increasing, this loan is repaid quicker (or can be upsized to fund new growth). Conversely, if the merchant suffers from some external shock and card transactions decline massively, the repayment is fixed on a smaller volume (thereby not leaving the merchant with a significant debt overhang). These loans can be extended to any merchant that has a point-of-sale terminal or digital track record of its trading history, for which DPI is critical. Our $24 million equity investment in Tyme will help it continue to scale in South Africa, lowering costs relative to traditional banks and ensuring savings are passed onto customers in the form of better interest rates. Our contribution aims to help it to expand internationally into underserved markets over time, while also supporting the improvement of its credit offering and sustainability.

75 Since our initial investment via Novastar, we have since invested equity directly in a subsequent round.

76 Under India's Presidency, G20 Digital Economy Ministers reached new consensus on how to effectively shape DPI as an accelerator of the Sustainable Development Goals (SDGs).

Technical assistance (TA) can help businesses to grow, and lenders to reach them, but there needs to be a focus on sustainability and adding value where it is most needed (e.g. SME climate finance)

TA can be provided to both lenders and borrowers to facilitate the flow of SME finance, but it is also relevant at the level of the broader business support ecosystem. For lenders, TA can be used to help them develop new capacities to deliver impact. For example, for a bank building a 'green' finance offer, it can be used to support staff training to accurately identify and support green asset creation, or in developing marketing materials to build client understanding of the business case for climate risk mitigation (as per our recent investment in **Pubali Bank** in Bangladesh). TA helps lenders to adapt their business models to serve high-impact SME segments in a commercially viable way.

For borrowers, it can help to address specific business issues inhibiting a particular SME's growth, such as developing marketing plans or improving management information systems. As a small business grows, the capabilities of its owners and managers to implement sound approaches to governance and financial management do not necessarily grow with it. This in turn creates problems for lenders, as these structures and processes are central to risk management. TA can therefore be used to help make high potential SMEs more investable.

Working with borrowers and lenders is key to the work of FSG Plus – part of our wider TA programme, BII Plus. But TA also has limits in terms of the number of actors it can reach. This is why, in scaling impact, we want to see wider development of an ecosystem of quality business support services – such as management consulting, finance and accounting, legal, and ESG expert firms – that can sustainably help to address SME capacity challenges.

SMEs value business support services. They recognise the value to their growth and also indicate willingness to pay for them (see Section 2.3), and the evidence reinforces this business case. A study on SME fund performance supported by Shell Foundation found that funds that offer TA achieved 44 per cent greater SME revenue growth and a higher average internal rate of return (IRR).[77] SME participation in non-financial services provided by banks is associated with lower rates of NPLs. Analysis of ACBA Bank in Armenia found that the value of this and other benefits of its non-financial services programme were 6.5 times the costs (IFC, 2020).

But the challenge is that business services providers in some markets – such as management consulting, finance and accounting, legal, and ESG expert firms – are of variable quality. Donor-backed facilities often focus on start-up and early-stage companies with little or no offering for established, high-potential SMEs. They also do not always focus on the major barriers to attracting capital and offerings can be misaligned with investor requirements.

Approaches to technical assistance that build the business support ecosystem – captured in one pillar of our Ghana Investment Support Programme – can therefore deliver more widespread and sustainable impact.[78]

77 Shell Foundation (2019) Insights on SME Fund Performance

78 See Ghana Investment Support Programme

5.2.3 Beyond high-volume lenders: Lessons from fund managers and small NBFIs

While the focus of this paper has been on debt instruments, our overall strategy towards SME financing spans both debt and equity. We have experience with fund structures, or fund-like structures, that offer equity, debt, and 'mezzanine' finance that has characteristics of both.

Many of the lessons we have learned about SME finance are about delivery via funds, or similar smaller stand-alone vehicles, as opposed to banks, fintechs and other high-volume lenders.

The design of our new SME finance platform GIP drew on lessons that we have learned from private equity funds that have tried to target SMEs, as well as what we have learned from investing in SME lenders to identify success factors. The flexible products that GIP offers can be seen as a hybrid of debt and equity.

The right structure for the financing model: time horizons, volume and ticket size

BII has supported specialist SME fund managers such as **Grofin** and **BPI Kenya**.[79] These were set up to provide loans that bridge a significant gap in the market: businesses that were too large for microfinance providers, too risky for banks, and too small for traditional equity providers.

Naturally, SMEs require smaller amounts of financing than large businesses. But if a financier is offering small amounts of capital but incurring the same transaction costs (such as for due diligence), as for larger loans, it becomes much more difficult to turn a profit. Experience from these types of funds has shown that the right balance between transaction costs, volume and ticket size is pivotal in SME financing vehicles is needed to make the model work.

Both BPI and Grofin found that SME funds have a relatively long gestation period to become self-sustaining – whereby interest payments received from loans can sustain the operational cost of running the portfolio and principal income can be reinvested. Rather than a limited life fund, permanent capital vehicles may therefore be a better way of structuring for such specialist SME funds in certain circumstances.

Although this report largely covers investments since 2012, some of our formative attempts to support attempts to create new types of specialise SME lender pre-date then (and were allowable under the 'fund of funds' strategy CDC Group had at the time). Between 2007 and 2008, we invested $16 million in **Access Holdings** and $14 million in **Advans**. Both of which were platforms for establishing greenfield commercial lending institutions, primarily in Africa, to support the growth of micro and small enterprises (MSEs). Both platforms delivered development impact: they successfully provided financial services to smaller/riskier borrowers in tough markets, including the DRC, Nigeria, Madagascar, and more. However, the mixed financial performance of some of their subsidiaries meant that the ability to deliver these outcomes in a commercially scalable and sustainable way was challenging. For Advans, it was projected that, with technical assistance, the underlying lenders would become profitable within four to five years of being established. However, they took longer than expected to break even, largely due to operational hurdles faced in launching new institutions in challenging areas, including delays in license approvals, staff hiring and training, and low initial branch productivity. Access Holdings also took longer than expected to reach and maintain profitability, driven by challenging macroeconomic environments.

79 Business Partners International (BPI) Kenya was set up in 2007 to provide financing, technical assistance (TA) and mentorship to SMEs. The GroFin Africa Fund, similar to BPI, provided both financing and business support to small enterprises whose financing needs fall above the limits of microfinance but below those of private equity and who generally have less collateral or a shorter track record than commercial banks require.

Private credit funds are another option. An independent evaluation of our financial institutions portfolio in 2018 identified private credit as a promising avenue for SME finance. But experience has shown that private credit funds are, on the most part, better suited to larger ticket investing.

Some specialist funds like **African Rivers Fund (ARF)** target SMEs in markets considered 'challenging' by most international investors. With its local presence, its fund manager (XSML) has increased its deployment capacity and honed its underwriting approach, matching its products to the financing needs of the local entrepreneurs. XSML has developed a 'hands on' approach to its clients, offering advice alongside its credit. As it builds its track record, it continues to raise larger funds and has also increased its average loan sizes, improving the cost efficiency of its business model. ARF's first fund (capital raised $19.1 million) had an average ticket size of $500,000; by the third fund (capital raised $85 million) the average ticket size was $2 million.

More recently, fund managers have been developing private credit as an asset class for institutional investors. Anchored by ourselves and other DFIs, fund managers like **BluePeak** and **Vantage** have developed pan-African investment strategies. Their aim is to demonstrate the commercial viability of the African private credit market. We have been supporting fund managers such as these as they develop the proven track record needed to mobilise commercial capital into this segment of the market. The provision of capital to mid-market businesses underserved by banks that have retrenched lending ($10-$30 million tickets) is at the higher end of the SME range, and is part of our strategy to improve the access to credit for productive businesses of all sizes, with the intention of improving the livelihoods of their employees and customers through improved access to employment and goods and services, respectively.

Building a team, culture and skillset that can leverage 'deeply local' origination

Experience taught us that the success of specialist SME financiers relies heavily on the quality and execution capability of the investment vehicle's management team. This may seem an obvious statement for any financial services provider, but the challenges of SME financing outlined in Section 4.2 add an extra layer of difficulty that calls for a combination of skills and experience to overcome.

SME finance is deeply local. A commonly-cited problem in SME investing in the least developed economies, where credit is least supplied, is that markets are not sufficiently deep and there simply are not enough deals. This may seem at odds with the idea of a financing gap, but the severity of a problem (the lack of finance) is not the same thing as the size of a market. Small economies can have big problems. This is also an issue of minimum ticket sizes – the deals that are more plentiful in low-income economies may be too small for most types of financiers.

Local presence, knowledge, and networks are key for origination in such an environment. It can still be possible to originate enough suitable transactions, even in relatively thin markets, provided the depth of engagement with local companies, communities, and regulators, is strong enough. Going deep requires sufficient in-country presence, but also means leveraging local advisers and community knowledge for origination and due diligence. Our experience with one fund manager revealed their country and regional funds performed better than their pan-African fund, which we attributed to loan teams comprising experienced operators who were recruited locally and brought their in-depth knowledge of local business and a well-established network.

The benefits of offering a 'menu' of products

An 'industrialised' approach can cut costs and save time, but there is no single packaged solution to every corporate capital requirement. Herein lies a trade-off. We have learned the right balance can be sometime be struck by offering a limited menu of products. Hybrid debt/equity products are particularly relevant to the African SME context, as they offer flexibility to the capital requirements of each company. They are more complicated than standard loan offerings, but this can be mitigated by simplifying the menu so that it does not offer too many or too complicated choices. It is also important to ensure that the vehicle's investment committee has a mix of requisite skills that reflect the product portfolio range to ensure high quality investment decisions (equity, mezzanine, debt, etc.).

On the demand side, it can be necessary to invest in building trust and educating SMEs about the benefits of products beyond those they are familiar with from banks. This applies to equity financing and particularly hybrid equity-debt products. As discussed above, the demand for patient capital is important. Our research in Ghana, and the experiences of other fund managers, shows that business owners do not always understand the implications – positive and negative – of equity financing. It helps to present possible choices in a way that is easy to understand, such as in a limited menu of options.

Passing foreign exchange risk onto intermediaries limits scale of SME reach

SMEs typically operate in local currency and therefore require local currency financing. There is no shortage of local currency financing, in the sense that it is widely available from local banks, but banks do not meet the needs of all SMEs and so other lenders must supply local currency loans too. Here we consider the options that DFIs and other investors have for supplying finance to SME lenders. The fundamental problem is that hard currency debt is cheap but creates currency risk, whereas local currency debt is expensive.

If a financial intermediary were to lend in local currency but raise finance in foreign currency, this creates a mismatch between its assets (loans to SMEs) and its liabilities (borrowing to finance its lending). Large lenders like banks are capable of managing a mix of liabilities, of different tenors and currencies, and often want lower interest, longer tenor dollar financing from DFIs. But for small specialist non-bank SME lenders, the currency mismatch is starker. The risk associated with volatile currencies has to sit somewhere; exactly where it sits will affect loan pricing and hence the supply of – and demand for – credit to SMEs.

Option one is to lend in hard currency to an intermediary, which in turn offers hard currency loans to borrowers. This might be attractive for certain borrowers, such as exporters or larger firms that can manage currency risk. Our recent investment in Dashen Bank in Ethiopia is targeted at on-lending to agricultural exporters who need hard currency to import equipment and will earn hard currency.[80] But this option is not the right one, in most cases.

Option two is to lend in hard currency to an intermediary, which in turn offers local currency loans to SMEs. In so doing, the intermediary takes the currency risk. If the local currency devalues, it is in trouble. This may work well for larger intermediaries that are able to manage hard currency liabilities, and they may even want to borrow in dollars if rates are lower and foreign exchange markets are thin. But this extra risk can also constrain the supply of finance, as intermediaries may tighten credit standards over and above the already tight approach to lending to a segment already perceived as risky. It can also dampen demand as the intermediary must price-in currency risk, raising interest rates for the SME.

80 BII press release (2023) BII and FMO unveil $40 million commitment to Dashen Bank, supporting Ethiopia's financial sector

The third option is to assume currency risk by lending to the intermediary in local currency. This option may also dampen demand as currency risk is again passed through to interest rates, but it represents the least amount of risk for the intermediary and may help to generate the greatest scale of reach. But, of course, it leaves the DFI bearing the currency risk. That needs to be considered within the context of overall portfolio construction and currency risk limits. At BII, we have developed a local currency envelope which gives us some capacity to provide local currency funding where we think there is high impact potential. But even DFIs – whose mandate typically includes accepting higher risk and lower returns than commercial investors – can only take so much currency risk onto their balance sheets.

Each of these options has its costs and benefits, and the combination that creates the best overall package – and ultimately the best terms for SME borrowers – must be considered carefully in context. The ability for DFIs to take currency risk onto their own balance sheet can be important. Sometimes currency hedging or other similar methods of offloading currency risk onto specialist third-parties may be available at prices that make them the better solution.

6

A new approach: Growth Investment Partners

Growth Investment Partners (GIP) takes the lessons learned from our experience and applies them to a new approach, initially in Ghana, but with the ambition to replicate it in other countries. The specific problem GIP is trying to address is that not enough SMEs are able to access long-term growth capital in the range of $500,000 to $5million. The traditional private credit and equity fund models struggle to work at this level, preferring larger investments sizes, leaving other institutions (such NGOs that offer seed funding) to address the lower end of the market. While bank debt is more readily available in these amounts, there tends to be a strong bias toward shorter term working capital and overdraft facilities. Bank risk appetite for longer-dated loans is limited and typically accompanied by collateral requirements that are prohibitive to the vast majority of SMEs. The result is an underserved financial no-man's-land for firms needing long-term growth capital in the middle to upper end of the SME segment.

The design features of GIP are directly linked to the critical elements outlined in the discussion above – we have tried to combine these to create a new solution for an old challenge. This section will explain how our approach to GIP – building on our experience and listening to the needs of SMEs – can establish an effective, profitable, and, most importantly, replicable and scalable model that can increase the flow of capital to African SMEs.

What is GIP?

GIP will be a **permanent capital vehicle** providing innovative and differentiated growth capital via mezzanine debt and self-liquidating quasi-equity products for SMEs.[81] These products are not readily available from the Ghanian financial sector and can be **tailored to the needs of borrowers to participate in the risk-reward** alongside business owners. GIP will stand alone as a new platform to provide **flexible capital** over **long horizons**, based on long-term cash flow generation potential, not short-term track record and collateral.[82] It will also push beyond a purely financial offering through **business support services** to enhance business growth prospects and de-risk GIP's portfolio.

Why Ghana?

First, there is a clear development need in Ghana. The prevalence of extreme poverty fell significantly from the late 1980s, from 58 per cent in 1987 to 26 per cent in 2012. However, progress since then has largely stagnated, which has coincided with weak advancement on structural transformation and economic development (Diao, et al., 2019).

Ghana also has the characteristics of the **right enabling environment**. It is a predominantly SME market made up of around 23,000 SMEs with an estimated combined turnover of at least $57 billion.[83] This compares with a mere 130 large businesses.[84] With 72 per cent of Ghanaian SMEs at least partly financially constrained, this represents a huge volume of opportunities, and the potential **demand for finance is estimated at around three times the volume offered**.[85] Figure 11 shows estimates of the number of Ghanaian companies securing financing of $1-$10 million via debt and equity in 2018, suggesting a limited capital offering, particularly on the equity end of the spectrum.

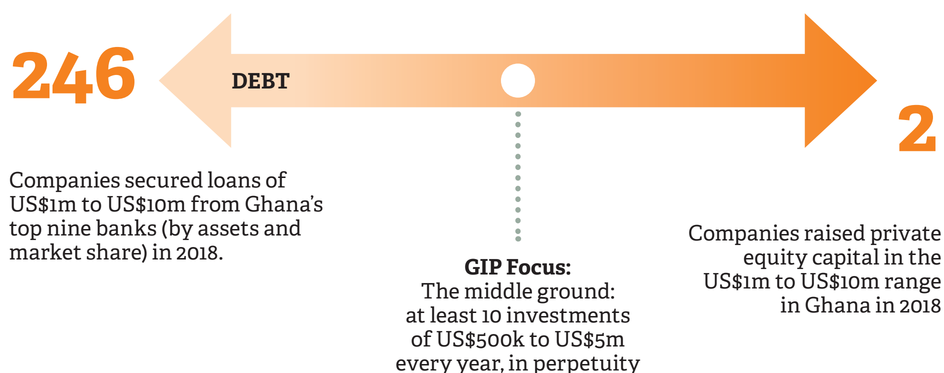


Figure 11: The limited capital offering in Ghana
Source: Debt data from primary research with banks commissioned by BII. Equity data validated by BII's internal database and Preqin for PE deals of $1 million-$10 million.

Yet, as highlighted in the previous section, a financing gap is a necessary but not sufficient condition to justify a new financing mechanism – it also needs to target the right area within that gap. There are SME private equity funds with a Ghana exposure (Synergy II, Verod III), as well as private credit funds (Vantage, Bluepeak), but these typically operate at the very upper end of the SME bracket with deals of at least $5 million in hard currency.

81 For the purpose of GIP's target market in Ghana, SMEs refer to businesses with 10-300 employees and $100,00-$15 million of turnover or assets. GIP will invest very selectively in small businesses, with less than 20 employees or where turnover is less than $500,000, with a focus on larger SMEs.

82 The tenor of GIP investments is three to ten years, with the average expected to settle around five to six years – substantially longer than the financing typically available to SMEs from traditional sources. Average collateral cover is expected to be c. 70 per cent across the portfolio, with flexibility to lower this on a case-by-case basis (compared to the 120-150 per cent that banks typically require).

83 Estimate based on BII research using market exchange rates at the time (Dec 2021) using the IFC definition of SMEs. Other research puts the estimated contribution of SMEs to Ghana's GDP around 70 per cent (e.g., see ITC, 2016), though the Government of Ghana definition of SMEs differs to that of IFC.

84 S&P Capital IQ (2022).

85 MSME Finance Gap Database, accessed 14 September 2023.

Specialist SME vehicles like Grofin tailor to the other end of the spectrum, providing local currency financing with deal sizes of between $100k and $1.5 million. There is, therefore, a **market gap** in the space between these groups of existing financing vehicles that GIP will target.

Apart from ticket size, the type of capital matters. Delivering a 'step change' in the growth of an SME typically requires external funding to invest in long-term productive assets. The type of funding needs to match. However, long-term patient capital is in scare supply and difficult to access. Equally, financiers need to be compensated for this additional risk with higher return. It is this **gap in the risk-reward spectrum** (between debt and equity) where GIP aims to bring a differentiated and flexible product offering that provides SMEs the patient growth capital they need – with mezzanine debt and self-liquidating quasi-equity products that share in the upside and offer some of the risk capital characteristics of equity.

Ghana's economy is also one of the most well diversified in Africa, allowing GIP to build a balanced portfolio and lowering concentration risk in any single sector. The banking sector and capital markets, including the local bond market, are also relatively well developed, allowing for easier **mobilisation of local capital** (in time, when GIP wishes to raise new funds).

The enabling environment is not without its challenges. Ghana has been facing a severe economic and financial crisis, largely centred on an unstainable sovereign debt burden, and in May 2023 the IMF approved a $3 billion 36-month Extended Credit Facility (ECF) arrangement for Ghana. However, with a deployment approach that carefully considers and seeks to mitigate exposure to macroeconomic risks, we believe GIP can be successful while playing an important counter-cyclical role, providing funding to SMEs at a time when bank risk appetite (and lending into the real economy) wanes.[86]

The structure

Unlike a conventional private equity or private credit fund, GIP's permanent capital structure means it will not need to wind-up and return capital to its investors after a fixed number of years, therefore better aligning with a **patient focus on long-term growth**.

Being backed initially entirely by equity investors means that GIP **does not face the liquidity risks that discourage banks from long-term lending**. GIP will target at least ten transactions per year, building a relatively large portfolio (by number of borrowers) compared to a traditional fund, but it will be more targeted and bespoke than a bank or other lenders – making it the best of both worlds. Every aspect of the model is designed to achieve scale and maximise reach and impact.

The products

GIP will employ a **menu of innovative financial products**, providing the equivalent of $500,000 to $5 million in local currency, a central feature given that financing options of an appropriate size in Ghanaian Cedi are highly limited for the GIP target segment. SMEs should not be forced to assume all the risks of borrowing in US dollars, and those businesses earning hard currency revenues are too few to sustain a dedicated new lender. Increasing local currency options for patient capital is critical for fuelling the growth of SMEs and scale, and hence, to Ghana's economic success.

GIP's products will feature **flexible repayments** linked to revenue generation, further insulating borrowers from risk in return for higher payments when business performance is strong. This affords both risk protection to the borrower – they repay less if the business does less well – as well as some upside for GIP – receiving higher returns if the business thrives. We believe this **partnership** approach creates better alignment with owners and opportunities to add value beyond capital.

86 The Ghanaian economy is expected to recover to its annual GDP growth potential of around 5 per cent by 2025 (IMF, World Economic Outlook Database, April 2023).

The investment process

GIP will employ a range of origination channels to ensure it is achieving scale, while reaching SMEs whose growth is stalled by lack of access to the type of finance offered by GIP. It will establish formal relationships with banks, identify businesses in the value chains of large companies, draw on advisory and management team networks, and work with SME service providers such as accounting and legal firms.[87] These channels will provide a 'first filter', ensuring potential investees meet the basic GIP criteria in terms of financing need, proposed use of capital (for growth), etc.

The next layer of selection comes down to the credibility of business' growth plans. For GIP, long-term growth potential is shaped by business models that are well-suited to market dynamics, with a strong competitive position and capable management team. These are the factors that will generate cash flows and determine the commercial and impact success of GIP and the SMEs it finances.

Determining an SME's potential in this regard requires taking the time to properly understand the business. While GIP will streamline due diligence where appropriate to enable efficiencies and scale – for example, using standardised legal templates – it will not be a box-ticking exercise. The scope of due diligence will be determined by the businesses' needs, with on-site visits and in-person engagement with management leading to tailored plans (drawing on external expertise where appropriate) on how to add value in supporting businesses development.

The entire investment process will be underpinned by GIP's mandate as a long-term business partner. Portfolio management will be a key element to maintaining these partnerships, ensuring financial forecasts are delivered, and issues identified early.

Adding value beyond capital

GIP will establish itself with SMEs not just as a lender but also as a long-term partner. It will take the time to understand businesses and share in their financial risk/reward, but also look to **add value beyond capital** by providing business support services.

These services will be targeted at improving governance and financial management – functions most often responsible for SME failure – and environmental and social standards.

Not only is this better for people and the planet, but the business case is clear. Better run, more environmentally and socially responsible companies will be more competitive and able to access new markets, identify cost savings, improve productivity, attract and retain staff and build human capital, and enhance their reputation and brand.

The GIP management team has also committed to building a diverse team that is representative of women, including targets at the Board of Directors, Investment Committee and employee level, in addition to incentivising investments in women-led businesses. This will be complemented by the Ghana Investment Support Programme, BII's new technical assistance facility, as well as UK Government initiatives that aim to increase investment flows to underserved SMEs more broadly across the market.

87 When looking for growth capital, SMEs typically approach banks. Being able to offer a complementary product to the debt products of banks is expected to be beneficial to both the banks and their clients.

The institution and its investors

Our goal is to establish GIP as an enduring institution, supported by Ghanian investors. That means it must offer a commercially attractive financial return.

The gap in the market GIP is designed to fill, the products it offers, and the expertise of its management team will deliver an attractive risk-return profile and offer much-needed diversification to local institutional investors. This is particularly important given the minimum allocation to “Variable Instruments” – which includes alternative assets such as GIP – introduced under the 2021 regulatory guidelines for Ghanaian pension fund managers.

While the high cost of long-term borrowing in Ghana will make it difficult to leverage GIP’s returns by using some debt to finance its lending, we expect GIP’s unlevered returns will compare well against alternative investment options when adjusting for risk. GIP may not offer the returns on equity that a highly-leveraged bank can deliver, but it will also not run the risk of periodic solvency crises wherein equity is wiped out. Moreover, unlike with private equity (PE) funds, GIP will also offer investor returns in the form of potential capital appreciation *and* a steady yield. Further investments of local currency equity capital into GIP, and its ability to recycle this capital on an ongoing basis, will fuel GIP to greater scale, profitability, and impact over time.

GIP aims to establish itself as a favourable alternative financial investment for long-term institutional investors, fuelling its growth and replication elsewhere in Africa and beyond.

7

Conclusions

SMEs are vast in number, diverse in needs, and opaque in information. The result is that SME financing is an inherently challenging business, despite the commercial opportunity for lenders and capital providers, and the impact opportunity to unlock growth, create jobs and improve the supply of goods and services. Coming up with new and better ways for getting capital to SMEs is critical to closing the financing gap, but trying new things entails risk. This is where DFIs like ours have an important role to play. Our willingness to take risk for the sake of impact means we can support unproven innovation and push lenders in more impactful directions that have been shown to work.

We are convinced that increasing the supply of suitable finance for SMEs is an important contribution to poverty reduction and sustainable development more broadly, and we have learnt this is a battle that must be fought on many fronts. It means we must continue to strengthen banks to help them expand and sustain lending during downturns, but we also want to push them in more impactful directions and help them experiment with new ways of lending. We must grasp the opportunity of new technologies to extend the reach of financial services, and to find efficiencies that make credit available more quickly at lower costs. We also want to build an ecosystem of specialist lenders and SME fund managers that service market segments that others neglect.

This is what we are aiming to deliver through our new approach to SME financing – Growth Investment Partners. By creating a new institution that harnesses decades worth of lessons learned and directs them to a significant problem in a targeted way, we hope to deliver a scalable, replicable model that can serve as a new weapon in the battle for SME financing. Of course, GIP will not single-handedly close the SME financing gap in Ghana. But by trialling new approaches, we can add to the existing arsenal of SME financing and shrink that gap. In so doing, we create new opportunities for capital providers and most importantly, we can deliver development impact where it is needed.

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