

The Development Bank of Southern Africa (DBSA) is one of the biggest donors to the private sector in Africa. Although it is more specialized in infrastructure financing, The DBSA also supports SMEs and has extensive experience of Southern African economies. In this article, its Executive Vice-President, Admassu Tadesse, stresses the importance of SMEs in Africa's socio-economic landscape and puts forward solutions to improve conditions for their access to financing.

# A Perspective on SME Financing in Africa

*SMEs may account for the bulk of firms and employment in SSA, yet they contribute very little to GDP. This is partly due to the financing constraints they meet. However, these firms have considerable socio-economic impacts and it is therefore essential to support their development. In order to do so, bankers and other donors must call on the support of intermediaries that have extensive knowledge of this segment and they must also provide technical assistance in addition to their financing.*

**By Admassu Tadesse, Executive Vice-President of the Development Bank of Southern Africa**

Development of South countries is a challenging pursuit in the 21st century, not simply because we are currently in the grip of a profound global economic crisis, or because Africa - and to a large extent most of Latin America - spent the last two decades of the 20th century locked in economic crises, but also because we are now more aware of the fact that development is as much about empowerment, participation and sustainability, as it is about generic increases in economic activity. In many parts of the world, economic development has, indeed, not managed to adequately create jobs, safeguard the environment or reduce economic inequalities, both between and within countries.

In this context, the role of SMEs has taken on even greater significance both in Africa and all over the world. In SSA, the SME sector accounts for over 90% of all enterprises of which 70 to 80% are micro and very small enterprises. They provide the main source of jobs and income for Africans after subsistence agriculture (see Table p.17). Significantly, African women entrepreneurs own more than half of African SMEs and up to 70% of Africa's vast rural population is active in formal and informal SME sectors. In spite of this, in most African countries SMEs contribute less than 20% to gross GDP whereas the figure can reach up to 60% in high-income countries.

## Rationale for supporting SMEs

It is now more deeply understood and widely acknowledged that SMEs play a key role in generating a pattern of economic growth that is generally labour-intensive, pro-entrepreneurship and competitive. This helps contribute to broad-based development and poverty reduction. The relatively

minimal capital needs of SMEs generally observed also foster an efficient use of capital, which is a scarce factor of production in developing countries. In addition to these highly desirable social and efficiency-enhancing attributes of an SME-friendly pattern of economic growth, SMEs tend to make use of available local resources, thus minimizing transport and engendering environmental sustainability.

The socio-economic rationale for SME financing, development and support is not difficult to understand. One factor is that SME profits are not dependent on long production runs and small firms can consequently produce smaller quantities to serve small local markets. The SME sector thus serves as a 'nursery' and a proven training ground for 'higher level' entrepreneurship and innovation. Their product ranges tend to reflect local technology and are often seen as more likely to satisfy the needs of the poor than large enterprises' products or foreign technology.

In addition, SMEs not only satisfy local needs by making differentiated varieties of products, by being spread all over the country they also help ensure some form of equitable distribution of income-earning opportunities. SMEs are also usually locally-owned and controlled: they can therefore strengthen the extended family as well as other social systems and cultural traditions.

For the economy as a whole, Brusco (1992) argues: "Small businesses are likely to be more resilient to depression and to offer a steadier level of employment than large ones; their activities and locations are diverse, they depend on a wide variety of sources and types of raw material, and their owners, ...

# 70%

of Africa's vast rural population is active in formal and informal SME sectors

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... if only for the want of any alternative, are likely to stay in business and maintain at least some activity and employment in conditions where foreign investors would have closed their factories”.

The fact that the vast majority of people in SSA live in rural areas and depend on agriculture and informal economic activities underpins the SME sector's importance to Africa. Indeed, most economic agents produce on a small-scale level, even if many market their commodities through cooperatives or agricultural marketing associations.

## Financing SMEs in SSA

Across the board, access to, and cost of, finance are a major development issue in Africa. In recent investment climate surveys of entrepreneurs it was identified as the leading constraint in private sector operations and growth. This is the case in both absolute and relative terms vis-à-vis the severity of finance as a private sector constraint in the rest of the developing world.

The financial sector of most African economies is characterized by very low levels of financial intermediation and weak capital markets which cannot effectively supply the financial resources and other products needed by the private sector, in particular the SME sector, which generally lacks the scale, collateral and relationships for formal financing. This is partly reflected in the ratio of liquid liabilities to GDP, which averages 32 percent in Africa, compared with 49 percent in East Asia and the Pacific and 100 percent in high-income countries. Similarly, the ratio of private credit to GDP averages 18 percent in Africa, compared with 30 percent in South Asia and 107 percent in high-income countries, whereas the ratio of private credit to GDP averages 11 percent in low-income countries in Africa but 21 percent in low-income countries outside Africa.

Existing financial intermediaries in Africa typically focus on a handful of large companies and government bonds. Lending to SMEs is hampered

by lack of knowledge of the sector, high transaction costs, limited staff capacity in financial institutions, poor credit culture among some target SMEs as well as underdeveloped tools to identify and mitigate risks associated with lending to SMEs. This results in a preference for large borrowers and the purchase of government bonds. SME markets in SSA are not only small and fragmented, they are severely complicated by lack of information. In general terms, SME financing gaps can be explained by three factors. The first is the merit-based explanation that many SMEs lack the requisite collateral and other risk protection in order to effectively access available loans at competitive prices. The second explanation is the lack of management and absorptive capacities on the part of African SMEs to profitably utilize available capital. The third is that there are extraneous factors that tend to discriminate against SMEs with certain attributes, the main factors being the gender of owners (women-owned enterprises are typically disadvantaged), the age of the firm (newer SMEs with no track record receive little or no financing), the location of firms (rural enterprises, for example, have restricted access to financing), and lack of political (patronage) connections.

The situation is even more challenging when considering risk capital as it is even more difficult to raise than debt capital. Unlike the rest of the world, start-up facilities, venture funds or angel investors are practically inexistent in the region. It has been observed that many venture funds in Africa behave more like private equity funds than real venture funds. Institutional weaknesses and complexities in many of the region's countries do not help improve appetite for SME risk. The informal and family nature of most SMEs in Africa also constitutes a stumbling block. Many potential investors find the lack of information and professionalism in SMEs to be a constraint in their dealings.

From a wholesale DFI perspective, the experience of supporting SME financing has thrown up some important lessons. Firstly, it is very ...

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## SME share in employment in Africa

South Africa	21%
Burundi	20%
Cameroon	19%
Ivory Coast	33%
Kenya	38%
Malawi	39%
Tanzania	32%
Zambia	37%
Zimbabwe	15%

Source: Ayyagari et alii, 2007

... important to identify appropriate intermediary partners with adequate commitment and capability to reach SMEs. Secondly, SMEs must be supported with more than just funds. Other non-financial support is needed and must be appropriately focused: industry-relevant advice, financial management tools and affordable business services, market networks, especially linkages with big business and export markets, on the job training... This additional support is crucial in enhancing management capacity, especially in financial and institutional areas, and access to markets.

### The way ahead

In spite of the significant contributions made by SMEs to GDP, employment and livelihoods, SSA's SMEs continue to face a plethora of challenges that inhibit their growth and development beyond mere survivalist modes of activity. Access to, and cost of, finance remain two leading constraints.

While there have been substantial and rapid recent improvements in financial sector development in the region, much still needs to be done, especially in the SME sector which is strategically very important as a driver of high quality socio-economic development.

The use of SME facilities, venture funds and targeted equity funds that enable non-specialist SME financiers to partake in SME financing through intermediaries can be an important mechanism for getting long-term development finance

into SME development. However, the quality of a SME fund not only lies in its ability to source a diverse group of financiers, it also depends on its knowledge of the sector, its client monitoring and its ability to provide a comprehensive package of finance and advice.

A 2007 report by the African Economic Research Consortium explored the question of the public sector's direct role in financing SME development. It reflected the complexity of the matter when it indicated that public sector initiatives to support the financing of small firms can be justified if market flaws result in access gaps and uncompetitive terms. However, it cautioned that in the absence of market failure, a direct role by the public sector could cause distortions if non-viable firms are subsidized at public expense. It rightly points out that where public sector sponsored interventions are undertaken, the financing gaps must be clear and, more importantly, it must be demonstrated that firms seeking special SME finance actually merit financing. ●

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