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Policy Brief

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Increasing access to finance for SMEs

How unlocking SME growth through increased access to finance could help to boost economic recovery in Zambia

Executive summary

A large proportion of employment in Zambia relies on the SME sector. The benefits of SMEs, if well-supported, can be significantly high, ranging from creating more decent jobs to meet the rising Zambian labour force to contributing to the sustainable economic growth and innovation. However, SMEs face disproportionately more barriers to scaling their businesses, chief among them being access to affordable capital. Moreover, COVID-19 has exacerbated these obstacles further dampening the appetite to lend by financial institutions due to uncertainty regarding quality of real sector assets.

SMEs will be essential to economic recovery in Zambia. To realise meaningful sustainable economic growth, impact investments should be leveraged to help boost SME growth. Deliberate efforts and support should be targeted at promoting innovative finance initiatives for early-stage finance, including:

- improving information sharing platforms for businesses to interact with relevant stakeholders;
- enhancing the capacity of local fund managers by ensuring that they are equipped with appropriate skills and experience to attract funds from DFIs and other institutional investors;
- promoting pension fund's participation in alternative assets including impact investments; and
- developing regulatory frameworks that support SMEs development including crowdfunding platforms and private equity.

Introduction

Small and Medium Enterprises (SMEs) play a critical role in contributing towards a country's employment and national income (GDP). SMEs account for 90 percent of all of businesses worldwide and half of all job creation[1]. These numbers are significantly higher when informal SMEs are included. In Africa, SMEs make up 90 percent of businesses and 80 percent of jobs, compared to 50 percent of jobs in the European Union and 60 percent in the United States[2].

[1]The World Bank. 2019, Small and Medium Enterprise (SMEs) Finance, 'Improving SMEs' access to finance and financing innovative solutions to unlock sources of capital'. Washington, DC: World Bank.

[2]Mckinsey and Company. 2020. Tackling COVID19 in Africa, an unfolding health and economic crisis that demands bold action.

In Zambia, SMEs employ 50 percent of the working population, similar to countries like Indonesia, Tanzania and Kenya and over 90 percent operate in the informal sector[3]. An estimated 770,000 jobs[4] will be needed by 2030 to absorb the growing national workforce, which makes SME development a high priority for the Zambian government considering the levels of employment creation that are required.

Yet, there are still major obstacles to starting-up and growing a business in Zambia. Access to finance is a key constraint to SME growth, it is the most cited obstacle facing SMEs to grow their businesses[5]. In addition, because of large proportion of the informal economy, there exist a large number of micro-enterprises that struggle to grow as they are financially excluded from the formal financial services.

SMEs are essential to realising the demographic dividend

Boosting SME growth will help increase economic growth, job creation, value addition and could contribute to both creativity and innovation. In Zambia, the potential benefits are particularly high, ranging from creating new jobs given the rising labour market, to contributing to achieving environmental sustainability as well as inclusive growth. If supported, SME development can also contribute to economic diversification and resilience. This is especially relevant for Zambia's copper and agriculture-based economy which is highly vulnerable to copper price fluctuations, and increasingly common climate change shocks (such as drought and flooding) in the agricultural sector. Moreover, SMEs are more likely to employ more people overtime than large firms. For instance, ILO report found that the number of employees within SMEs in the formal sector almost doubled in the 132 countries for which estimates were available, with SMEs' share of total employment rising from 31 to 35%[6].

With a growing number of young people entering the labour market and limited opportunities for job creation, unemployment and disengagement pose a great risk to sustainable development and social stability. Youth unemployment is one of the pressing social issues in Zambia. The age distribution of Zambia's labour force is significantly skewed towards the younger demographic, with over 50% of the labour force in the 15-35 age group[7]. Yet, youth unemployment rate (18%) is nearly twice the unemployment rate of the total working age population[8] - making it an issue of great concern.

The youth population in Zambia is a huge potential productive resource that could contribute significantly to economic growth and development, if the labour market can effectively absorb them over the next decade. When young people acquire the skills and economic opportunities to realize their potential, this demographic dividend can help stimulate youth-led job creation. But if viable businesses in the SME sector are not supported, the fallout could have significant negative social and economic consequences, and will disproportionately affect the most vulnerable.

What barriers to finance for SMEs in Zambia?

Key to boosting SME growth will be increasing access to finance for small businesses. A large proportion of SMEs experience limited access to capital to bridge business interruption (for example, during the pandemic or other economic shocks), or to support growth. Many SMEs rely on reinvesting their turnover in order to expand, which greatly inhibits growth and employment opportunities. This capital gap predates the current crisis, and it is particularly acute for youth and women-led businesses.

[3]Alfred Nuwagaba, Dr., 'Enterprise (SMEs) in Zambia', *International Journal of Economics, Finance and Management.* Vol 4, Issue No.4 (September 2015).

[4]ZIPAR. 2015. Flagship Project *'Better and More Jobs'*

[5]2010 Zambia Business survey

[6]ILO: \World Employment and Social Outlook 2017: Sustainable enterprises and jobs: Formal enterprises and decent work

[7]Labour Force Survey 2018

[8]Labour Force Survey 2018

The financial landscape in Zambia is largely dominated by commercial banks who have stringent enterprise lending requirements and mainly targeting established and larger businesses. There are 18 commercial banks, none of which lend to SMEs at scale and 40 non-bank financial institutions, of which only 5 are dedicated enterprise lenders – the rest being primarily 'payday lenders'[9]. SMEs are therefore less likely to be able to obtain bank loans than larger firms; instead, they rely on internal funds, or cash from friends and family, to launch and initially run their enterprises[10]. This drastically limits entrepreneurialism and the growth of the SME sector.

Moreover, the decline in lending and increased cost of finance has been influenced by many factors that have adversely impacted the amount of credit in the economy. Key among these from the supply-side include:

- COVID-19 induced risks in the real sector that have dampened the appetite to lend generally as banks focus on capital preservation to mitigate against the emerging unknown risk profile in the real sector thereby allocating their scarce capital to a small number of lower risk transactions such as government securities;
- Increased borrowing appetite from Government that is crowding out lending to the private sector. This has been a significant factor as uncertainty regarding quality of real sector assets elevates due to COVID-19; and
- The sovereign credit rating downgrades which have spiked provisional requirements, by banks in particular, adversely impacting available capital to support in general.

This leaves SMEs facing interest rates generally in excess of 40 percent. From the demand-side, the cost of finance to businesses is relatively high, particularly for SMEs due to a range of additional factors, including:

- high administration costs associated with assessing and lending to SMEs, due in part to significant information asymmetries resulting from poor record keeping, limited compliance with legal and tax obligations;
- high perception of risk by banks due to the high mortality rates of SMEs and their vulnerability to sudden policy and economic changes;
- lack of collateral or non-existent/weak collateral registration and enforcement;
- limited innovation in financial products for SMEs

According to a 2019 National Advisory Board for Impact Investment Zambia (NABII) study, there is also a mismatch in the ticket size of the financing products, with SMEs often requiring smaller investments and investors preferring larger ticket sizes[11]. More importantly, there is a limited number of "investment-ready" SMEs in Zambia that have the capacity to absorb the larger ticket sizes on offer. Trading history, scale and scalability of the business, quality of management, growth prospects and viability are among other key features which contribute to being investment ready.

In addition to commercial banks, there are some active international development finance institutions (DFIs) in Zambia, but they mainly invest in large scale projects. Local DFIs such as Development Bank of Zambia and Citizen Economic Empowerment Commission have limited exposure to SMEs due to limited funding from the Government.

Private equity and venture capital are emerging asset classes in Zambia. Between 2013-18, Zambia accounted for 8% of all private equity deals in Southern Africa (by value – and 12% by volume)[12]. This asset class is currently regulated by Securities and Exchange Commission (SEC) under non-banking services. In addition to capital, private equity investors bring knowledge and expertise to the companies in which they invest. Through active participation on the board of directors or in partnership with

[9]This is based on interviews with AMIZ and information gathered from individual non-bank financial institutions.

[10]Chera E. Deressa, MSMES for finance in Zambia. *Research journal of finance and accounting.* ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online) Vol.5, No.10, 2014

[11]National Advisory Board for Impact Investment Ecosystem (NABII): The Zambia Impact Investment Landscape (2019)

[12]African Venture Capital Association 2018

management, private equity investors can equip companies with critical improvements in governance, financial accounting, access to markets, technology, and other drivers of business success. Although there is an opportunity for private equity investors support to create, deepen, and expand growth of small and medium enterprises, in reality, the vast majority of private equity in Zambia targets larger or more established enterprises.

What are the options to increase access to finance for SMEs in Zambia?

Zambia needs to attract proactive investors to commit early-stage capital. To increase the capital flow for early-stage investments, the desired investor types are the venture capital subcategory of private equity, foundations, angel investors and crowdfunding platforms. These, combined with local suppliers of capital, can bridge the financing gap between businesses and investors. **Promoting impact investments, investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return[13] should also be targeted in order to increase SME's contribution towards sustainable growth**. Impact investing directly links investment opportunities to particular sustainability themes and Sustainable Development Goals (SDGs).

There are key risks associated with investing in Zambia that need to be addressed in order to increase these kinds of investment inflows. Several potential investors have highlighted exchange rate volatility and the macro economic environment in general as concerns which affect their appetite for increased investments in Zambia. Given the financial risks for foreign investors associated with doing financial transactions in Zambian kwacha instead of hard currency, there is a need to think innovatively about how to incentivise foreign investors in the current climate.

One solution would be for local pension funds to invest in local investment funds and provide co-investments to foreign capital. Unlocking the potential of Zambian pension funds to invest in alternative assets will involve addressing factors that influence their willingness to do so. These include the lack of awareness about asset classes; scarcity of investable assets and lack of appropriate vehicles through which to invest. Enabling actions must therefore address both supply and demand sides of pension funds investment.

Additionally, having a dedicated framework and policy guidelines for these asset classes would provide assurance to foreign investors. Bank of Zambia initiated this work a few years ago to put such a framework in place under the theme "Deepening of the Financial Sector Programme", but the framework is not yet operational.

Crowdfunding is also another option. It can provide a host of benefits that include (i) lowering cost and speed of deployment of capital to business and retail customers alike and at the same time offering smaller ticket sizes appropriate for early stage businesses ; (ii) potentially higher, risk-adjusted returns for investors than via mainstream banks; (iii) increased competition in finance and investment, traditionally dominated by few providers; and (iv) speed, customer service and convenience of providing capital in a more efficient manner. Again, implementing specific regulations at SEC for crowdfunding platforms, similar to what has been done in Kenya, would be key to encouraging investment in SMEs and attract diaspora remittances.

Finally, creating improved platforms for businesses to communicate their business innovations and impact stories to investors and showcase investment opportunities could help to improve information asymmetries. There is generally market unawareness of existing investment opportunities and platforms where businesses can access information on appropriate capital and understanding of priority areas when pitching for funding.

[13]Global Impact Investment Network (GIIN) Definition

Recommendations and conclusions

Initiatives to support the SME development requires increased collaboration between Government and ecosystem market players. The following are some of key initiatives the Government and the private sector should implement in order to expediate the flow of capital to SMEs:

1. Promoting innovative and novel financing mechanisms

More and more, SMEs are exploring innovative means of financing to overcome the challenges posed by traditional avenues of access to finance (commercial banks and microfinance institutions). There is need to promote impact investing and crowdfunding to improve access to finance for SMEs. The first step would be to ensure that appropriate regulatory frameworks that support impact investment including crowdfunding/p2p-lending are introduced. Government should take the lead in developing such regulatory frameworks to further encourage private sector participation and lending through such initiatives. Crowdfunding would serve two interlinked purposes: showcasing social enterprises to a broader audience of impact investors as well as assist with local capital mobilisation.

2. Supporting the capacities of local fund managers

Building and enhancing the capacities of local fund managers is key for better access to finance in combination with improved availability of other, non-financial, business development services. International investors are unwilling to invest in local funds because of lack of specialised skills due to lack of standardisation and lack of experience in complex deal structuring. The private sector, especially market builders, have significant role to play in promoting international linkages through fledgling local intermediaries with experienced players to help bridge this gap. The NABII, for instance, through its affiliation with the Global Steering Group for Impact Investment, is working with various local fund managers in ensuring appropriate linkages in form of trainings and skill transfer are established.

3. Promote business development services and match making platforms

Access to finance for SMEs should be combined with training and support services. Greater success rates are achieved when entrepreneurship activities provide access to finance in combination with advisory support. A small handful of market enablers are actively promoting impact investments by making businesses 'investment ready' and bridging the information asymmetry gap between supply and demand. Supporting accelerator programmes to provide businesses with mentorship and workshops, which can improve management quality and company processes is thus key to promoting SME development. The Government in collaboration with the private sector players can lead such programmes through pooling technical and financial resources together.

4. Accelerate local pension fund participation

Pension funds play a critical role in easing the role of local fund managers as it allows them not only to look for funding internationally, but also enables to have tangible options locally. Yet pension assets remain heavily invested in government securities and listed equities, despite regulatory reforms and Zambia's investment needs to support the real economy. In order to support SME development and improve local investments to the real economy, Government should enforce that the existing minimum 10% of pension funds be invested in alternative assets including impact investments. Further, Government should introduce local or international co-investment requirements in order to improve transparency, skills transfer and value addition from other experienced impact investors.

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