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Uganda | SME Services | 4 September 2017

SME banking
Alternatives to Debt Financing for SMEs

Introduction

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According to the Uganda Bureau of Statistics (UBoS), Micro Small and Midsize Enterprises (MSME) are categorised based on meeting any one of the criteria relating to the number of employees or total assets. The classification of MSMEs assesses all businesses irrespective of the legal form of the enterprise. Micro enterprises are businesses that employ less than five people and have total assets not exceeding Ugandan Shillings (UGX) 10m. Small enterprises employ between 5-49 people and have total assets between UGX 10m and 100m. Medium enterprises employ between 50-100 people and have total assets between UGX 100m and 360m.

MSMEs employ approximately 2.5m people and make up approximately 90% of private sector employment. They also contribute 20% of Gross Domestic Product (GDP) and produce 80% of Uganda's manufactured output.

Despite the significant contribution to GDP by the MSME component of the private sector, access to finance remains difficult. The World Bank's enterprise survey carried out in Uganda between January 2013 and July 2014 found that only 9.7% of MSMEs have a bank loan or line of credit. The survey also revealed that 58% of MSMEs require financing

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Challenges to SME financing

The primary reason for MSMEs taking loans in Uganda is for working capital with capital investment being a secondary driver. Most financing is provided only upon the provision of collateral, which the enterprise survey found the average value to be 161.8% of the loan amount. The reasons for MSMEs difficulty with respect to accessing financing relate to the high-risk perception of MSME lending by financial institutions, information asymmetry between lenders and borrowers, poor corporate governance and market linkages. Other factors that make financing MSMEs difficult include undercapitalization, inadequate technical and management skills, and lack of market access due to poor quality and non-standardized products.

The information asymmetry arises due to poor financial information, which demonstrates itself in unreliable accounting, and unrealistic business plans. The unreliable accounting may possibly be due to lack of knowledge or the deliberate understatement of sales for tax purposes. Unrealistic business plans are prone to overly optimistic outlooks and failure to include additional costs as sales or production increases. This makes it difficult for banks to access and ultimately lend to SMEs as they usually presented with incomplete, inadequate and inaccurate financial records. The problem can be partially offset by working with business advisors to improve the quality of financial information provided by MSMEs.

As a result of the possible misalignment between lenders and borrowers, lenders are forced to seek collateral and offer highly priced products. This is evident in the survey results, which indicated that 86.7% of loans issued require collateral. Additionally, at an average of 23.9% in 2016, lending rates in Uganda are the highest in East Africa.

Possible Solutions

Financial institutions are evolving to find alternative risk management techniques other than traditional collateral requirements. The use of leasing and invoice discounting are novel approaches to financing MSMEs. Leasing requires the leasing company to purchase equipment that MSMEs require and provide the MSME with the equipment for a fixed fee payable over the lease period, typically 3 years. The asset remains the property of the Lessor until the end of the Lease. This allows the Lessor to claim capital allowances and maintain their funds for working capital, while at the same time providing security to the lender. Invoice discounting occurs when a company provides a good or service on credit and sells the receivable to a third party at a discounted price. This provides the company with cash and the purchaser with a return on capital when payment is received. These forms of security are useful where traditional forms of security such as collateral may not be available. The flexible nature of the security makes it possible for more inclusive access to financing as the collateral is tailored to the business's needs.

MSME specific loans are available from development finance institutions (DFIs) like International Finance Corporation (IFC), CDC Group and African Development Bank (AfDB), and European Investment Bank (EIB) through commercial banks. The banks receive credit lines earmarked for onward lending to MSMEs'. EIB on 29 March 2017 provided a EUR 95m credit line for onward lending in East Africa to Equity Bank and Housing Finance. EUR 19m was earmarked for Ugandan SMEs through Equity Bank Uganda.

Peer-to-peer (P2P) financing, as a source of SME financing, is growing in the East African region. P2P lending is premised on the practice of providing funds (in form of grants, endowments, debt or equity) to businesses, mostly SMEs, through online services that match lenders with borrowers. This alternative avenue of financing seeks to circumvent traditional financial intermediaries such as commercial banks. Research on crowd funding and P2P financing showed that USD 7.5m was raised for investments in Uganda in 2016, representing an impressive growth rate of 312% from 2015. The success of P2P lending in the SME sector will be dictated by continued financial

innovation from the increased use of mobile phone technology, coupled with implementation and enforcement of a business-friendly regulatory framework.

DFIs offer credit guarantees to MSMEs that may lack sufficient assets to obtain financing. The DFIs guarantee to pay the bank a percentage of the principal in case of default. This provides MSMEs with the ability to receive loans at lower interest rates and longer tenors than they would have initially. For instance, SIDA and USAID jointly run a Health Program to encourage lending to companies in the health sector. The institutions guarantee loans provided by Ecobank and Centenary Bank to the health sector.

Lenders are more willing to finance companies that are well capitalised as they provide a buffer in cases where cash flow timings may be uncertain. There are however other avenues for MSMEs to receive non-debt financing through private investors who are willing to provide risk capital to businesses in the developmental stage.

Private equity is an available source of funding for larger firms as they target to invest amounts above USD 1m and require audited accounts as well as robust corporate governance structures.

Business development grants are also another option available to SMEs. The World Bank provides a matching grant facility as a component of the Competitiveness and Enterprise Development Project (CEDP). The grants provide businesses with the ability to acquire services that will increase their competitiveness such as management training, advisory services, business plan development and financial management.

Conclusion

Other forms of finance that may work with small businesses will not necessarily be possible with midsize businesses such as financing from microfinance institutions (MFIs). The financing provided by MFIs is usually short term and may be inadequate as they typically cater to small businesses. This leaves midsize companies in a precarious situation as larger companies can go to banks for their funding needs.

As the local financial sector develops, financing products for MSMEs will increase due to competition and new innovative business models. The use of technology and alternative financing vehicles will also be driving factors for the increase in MSME financing activity going forward. Technology will evolve services such as mobile banking and risk management, with techniques that rely on transaction and client data leading to alternative credit assessment methods.

MSME financing remains a challenge to the development of the sector. However, progress is changing the landscape with new financial products such as guarantees, P2P financing, leasing and invoice discounting. MSMEs can now access different products depending on their needs.

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