FINANCING SMEs

Engines of growth

African SMEs are still struggling to access the finance they need to grow – but private equity can help to fill the gap, writes AfricInvest's Ann Wyman

The case for investing in small and medium-sized enterprises (SMEs) as a key development pillar is well-supported – both in research and practice. Generally nimble and flexible in their structure and management practices, SMEs have become engines of growth and are important incubators of innovation. They help to stimulate job creation and provide incentives for entrepreneurship. Recent studies also suggest that support for SMEs can enhance systemic financial stability and integrity.

In addition to the macroeconomic and systemic benefits of promoting strong SMEs, many of these companies are highly profitable, providing substantial returns to their founders and investors. This is particularly true in the developed world, where support for, and investment in, SMEs has become increasingly institutionalised, helping to improve the business environment in which they operate while decreasing risks and financing costs.

In the emerging markets, SMEs have also proved profitable, though their access to financing has been much more constrained. This is especially true in Africa, where although SMEs contribute approximately 40 percent of GDP and almost half of the continent's employment, they remain underfinanced – both in absolute and comparative terms (a 2010 IFC/McKinsey report estimated that more than 60 percent of SMEs in Africa in need of access to either a bank loan or overdraft could not get one).

> **The provision of risk capital through PE structures is helping to provide solutions to many of the challenges faced by African SMEs**

A so-called "missing middle" has emerged, due to SMEs' challenges accessing risk capital versus both large corporations and small micro-enterprises. For those with comparative advantage understanding the risks, with expertise in SME management, and willing to provide financing, this presents an opportunity.

NOBODY SAID IT WAS EASY

A successful investment strategy for African SMEs starts with a recognition of the challenges faced by the sector. While there have been many positive changes in recent years, the business environments of many African countries still have room for improvement. Clearer and more transparent regulation, fewer bureaucratic impediments, more flexible labour conditions, and infrastructure upgrades are all underway, but more needs to be done.

At the corporate level, African SMEs are still in need of access to industry expertise and ways to benefit from others' experience. This is particularly true of start-ups. Business networks in Africa are also still in the early stages of development, and need considerable deepening. And more than most other places, SMEs in Africa need assistance (and incentives) to emerge from the informal economy in order to access new opportunities.

Wyman: *SMEs need support*

All of these factors contribute to the dearth of appropriately-structured and affordable financing for African SMEs. Indeed, a 2010 McKinsey report looking at the unmet financial needs of the sector estimated that sub-Saharan African SMEs would require an increase of 300-360 percent over their current outstanding credit to close the gap between their needs and what is currently offered. Multinational banks tend to provide larger loans to well-established companies with substantial collateral. Local banks often lack appropriate risk evaluation capacity, and many don't have any form of centralised credit bureau. As such, loan tenors can be too short and/or interest rates too high to allow for profitability.

LENDING A HAND, SHARING THE RISK

Into this gap has stepped private equity. The provision of risk capital through PE structures is helping to provide solutions to many of the challenges faced by African SMEs, while at the same time providing attractive returns to investors. PE firms can address the SME knowledge and experience gap by bringing their own in-house skills. With a focus on value creation from top-line growth and margin improvement, »

» successful African PE firms combine organic growth with buy-and-build strategies to take SMEs in directions they may not have pursued alone.

PE firms with pan-African strategies can also help enhance the networks of SMEs, not only within the borders of their own countries, but to their regional neighbors and beyond. In addition, PE firms are often more accustomed, and therefore more effective at approaching governments to make suggestions or lobby for changes to legislation or regulations that encumber the business environment.

Moreover, PE firms, in concert with development finance institutions (DFIs), can be even more powerful, bringing additional finance and know-how, as well as development experience from other areas of the world.

And PE financing solutions can be flexible, meeting the needs of the company, with investment horizons more suited to longer-term SME development. With PE investors on board, SMEs may also then gain access to other types of debt financing that may have previously been unavailable or too expensive. While exits in the private equity space can sometimes present a challenge, many more routes have been tested in recent years, including trade and secondary market sales, as well as IPOs and put options – all increasing the potential upside for investors. ■

ANSWERING THE CALL

AfricInvest has demonstrated that backing SMEs can be both profitable and socially useful, says co-founding partner Ziad Oueslati

As a successful pan-African investor for almost two decades, AfricInvest has proved the theory that SME investing can be profitable. The firm has provided more than 100 SMEs with alternative means of financing, offering strategic guidance and supporting the transformation of family businesses into institutional companies, and building regional champions. Companies in which the firm has invested have seen both sales and exports (where applicable) increase more than two times over the life of the investment, while delivering investors tier one returns.

AfricInvest's strong performance has primarily been derived from operational growth, and its results include downcycles weathered in the early and late 2000s. The firm has also pioneered and developed new exit routes, including a first-time listing of a non-state owned company on the Algerian stock exchange.

AfricInvest has also helped to create new jobs in the markets where it has invested, particularly for women. At the same time, it has increased the numbers and types of certifications of its investee companies, leading to sustainable firms that positively impact their local community.

AfricInvest's portfolio companies also contribute to the improvement of social conditions in the markets in which we operate. This can be through the support of key sectors like the pharmaceutical industry, which provides local populations with access to cheap generics drugs. AfricInvest is also involved in the provision of superior education, and efficient private hospitals that can increase patient access to adequate care in the face of more limited means and expertise at public hospitals. AfricInvest's agribusiness investments are also helping to provide inexpensive food to locals as an alternative to more expensive imported food.

MAKING A DIFFERENCE

AfricInvest blends expertise and market knowledge to provide its portfolio companies with valuable strategic, financial, technical and commercial guidance thanks to the in-depth knowledge of its partners in a number of sectors and their extensive network of commercial relationships.

The firm is neither an interventionist shareholder, nor a sleeping partner. It is a true business partner that uses its competence and network to create value through a close and active follow-up of its investments, especially at a local level, and by reinforcing the management of its portfolio companies when needed. SMEs particularly need assistance with building their capacity in human resources, and AfricInvest's network can help companies to do just that.

AfricInvest's independent shareholding and management structure, which is not tied to any bank or industrial group, offers unique safeguards against conflicts of interest. In particular, its neutrality vis-a-vis the banking sector allows it to tap all possible funding sources in order to negotiate the best possible conditions on behalf of its portfolio companies. Thanks to its network and foreign partners, AfricInvest is able to help its investee companies accelerate their access to international markets, as well as to capitalise on synergies. Through closely-knit relationships with the public and private sector, AfricInvest enables its investee companies to react promptly to changes in the economic, regulatory and financial environment.

"AfricInvest: Together we do better"


Together, we do better
We grow businesses, we create value,
for sustainable development
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