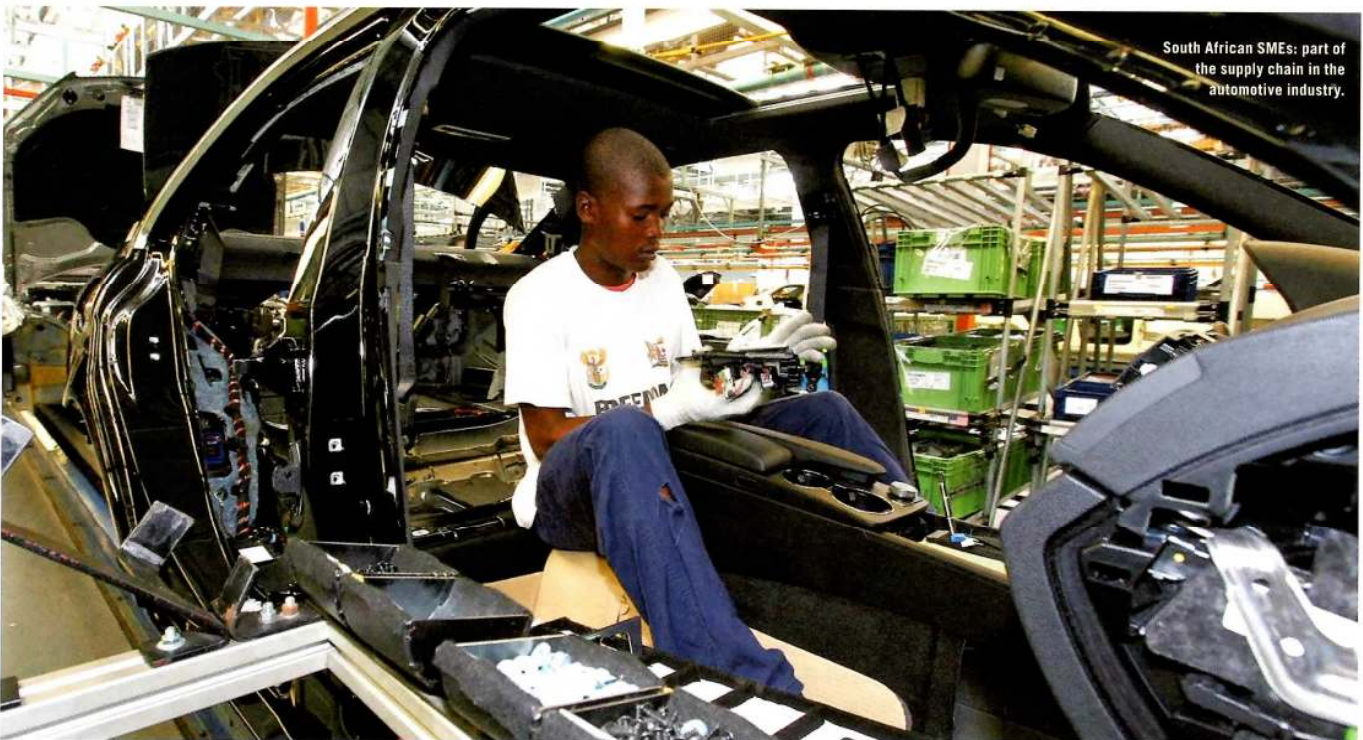


FINANCE

Vast profits await investors in Africa's 'missing middle'

Small and medium-sized enterprises (SMEs) form the backbone of the economies of developed countries, contributing over 50% of GDP and providing the bulk of jobs. This vital sector is still very underdeveloped in Africa – mainly through lack of finance. Yet the potential for banking profits is enormous. **Tom Minney** reports.



South African SMEs: part of the supply chain in the automotive industry.

Many investors trumpet the 'big picture' of fast economic growth in Africa, driven by rising population, growing middle classes and consumerism, and strong economic growth fuelled by commodities.

However, banks know that for long-term strategic advantage they need to do more than to ride the flood of current profitable markets – Africa's banks are already among the most profitable in the world.

Strategic leaders in finance are likely to be those that pick the next growth curve before the current one attracts too much competi-

tion or runs out of steam. Africa's small and medium enterprises (SMEs) offer huge scope.

These are businesses whose financial requirements are too large for microfinance, but too small to be served effectively by corporate banking models. The World Bank and others usually define SMEs as having 10-300 employees, sales of \$100,000-\$15m a year and needing loans of anything from \$10,000-\$1m.

They are a large and economically important sector in nearly every country worldwide, accounting for over half of national output in high-income and some middle-income countries. Opportunities for African finan-

cial institutions are good, and potentially even better for canny equity investors who can help financial firms and banks develop these markets.

According to *The SME Banking Knowledge Guide* published in 2009 by the International Finance Corporation (IFC) Advisory Services, the SME sector is important to national economies because it boosts employment and GDP.

It grows as economies develop away from the informal sectors that can be less efficient and productive because they may operate without books, paying tax or taking advantage



Equity Bank's Mwangi: innovative IT solutions.

of finance, performance measurement and other growth boosters.

The IFC guide notes that SMEs with fewer than 250 employees provide two thirds of formal jobs in 30 high-income countries of the OECD, but this is much less in lower-income economies, where the informal sector often dominates.

Banks that encourage businesses to grow and move away from the informal sector can help economic growth by making business more efficient. In return, as a country develops, the SME market usually increases.

SMEs remain one of the most undersupplied markets in the financial products and services critical to their growth. The World Bank's *Enterprise Surveys* and *Investment Climate Assessments* reports that SMEs rank the cost of finance as their greatest obstacle to growth, and access to finance as another key obstacle. They are also less able to grow without bank finance than larger firms, which can access capital markets, use their cash flows or find other ways to fund growth.

Many African banks already make good profits by sticking to wholesale investments such as government-issued debt, including treasury bills with little risk, or high-yielding large corporate accounts.

According to the World Bank's Financial Structure Database 2007, banks in sub-Saharan Africa had a return on assets of 2.4%, compared to 1.4% for banks in other emerging markets. Return on assets (ROA) leaders included Namibia (14.1%), followed by Malawi

(6.4%) and Uganda (3.9%). Return on equity was led by Malawi (41%), Botswana (40%) and Uganda (32%).

Why would bankers look further afield or take more risks, even if this is good for the economy? At the other end of the scale, charitable and microfinance organisations often target the lowest income earners, people who earn less than \$2 a day.

The opportunity for banks and others is what is termed a 'missing middle' market of both individuals and SMEs, where there are income levels to afford financial services, but a shortage of appropriate financial services.

Golden opportunities

The millions of potential customers in this sector and the unmet SME demand for financial services are opportunities for banks and other financial firms to expand market share and increase profit.

Peter Hinton, CEO of Summit Development Group, told *African Banker*: "The missing middle segment in Africa represents a tremendous untapped client base for financial services.

The best opportunity
for banks is in the
'missing middle' market

"The World Resources Institute estimates that the lower end of the market (those with incomes below \$3,000 in local purchasing power) is worth \$429bn in Africa (GDP in Africa is approximately \$1.6 trillion according to the McKinsey Global Institute) and represents the region's dominant consumer market, with 71% aggregate purchasing power and encompassing 95% of the population."

Summit is a private equity fund registered in Botswana and aiming to invest in and provide skills to firms and banks providing financial services for the 'missing middle' of lower- and middle-income groups in Africa, both individuals and SMEs.

It is currently raising \$125m in investments and heading towards its first \$40m close, backed by a \$25m equity investment from the African Development Bank (AfDB). It operates from offices in Johannesburg and London and has a pipeline of over \$300m of

potential investments across 37 deals in 16 priority countries. It is actively in discussion with financial institutions for seven deals for \$41m of investments and hopes to start finalising the first deals in the first half of 2011.

The AfDB says: "The project has tremendous economic potential benefits in employment creation, poverty alleviation and government tax revenue enhancement among other benefits.

"The Bank's involvement in the Fund will help to deepen the financial sector as well as bring much needed long-term capital to SMEs, a significant sector of Africa's economies and the unbanked. It will also help to improve sub-Saharan Africa's economic development."

The management have hands-on experience including running financial institutions in Africa, practical management of businesses in a wide range of sectors and successful private equity investing in emerging markets.

They claim it is a good time to invest into banks, since many banks need capital now due to changing regulations and increased minimum capital requirements, more management skills, declining asset prices and less competition as big South African and Nigerian banks concentrate on domestic markets.

The fund aims to bring technical assistance to build capacity and capital at financial institutions and SMEs, to reach some 5m Africans who do not have bank accounts, finance 190,000 SMEs through its investee institutions, and create 1,000 jobs in financial institutions and up to 1.4m jobs in SMEs by 2020.



Summit's CEO Hinton: SMEs are next frontier.

IFC guidelines

In the past, banks had seen the SME market as risky, costly and difficult to serve. But banks profitably serving the SME sector are finding effective solutions to challenges such as determining credit risk and cutting operating costs.

The IFC guide gives a detailed approach using the five stages of the banking value chain:

(1) understanding the SME market, (2) developing products and services, (3) acquiring and screening clients, (4) serving SME clients, and (5) managing information and knowledge.

Across all five lies the 'ongoing and critical task' of risk management which may not just mean avoiding risks by demanding full collateral but finding ways to handle risk, including offering higher-priced products which SMEs will still be happy to take because they have few alternatives.

Leading international banks such as Standard Chartered and HSBC as well as indigenous banks use IT and skills to develop SME banking in emerging markets.

For instance, StanChart uses a well-honed mixture of mass marketing and relationship management to acquire and service its SME clients.

The IFC *Knowledge Guide* points out that banking for SMEs is not just about giving loans. Other services include:

- Deposit and savings products as basic financial management tools for revenues and savings.
- Transactional products such as automatic payroll and payment collection, debit cards and currency exchange to cut the cost of doing business and streamline complicated processes.
- Advice, for instance to help produce reliable financial statements, develop business plans and select appropriate financing products, including making them better able to apply for credit.
- Short-term and working capital loans help SMEs grow, including helping finance when they take on more or larger contracts. Trade finance across borders, including letters of credit, can help SMEs get better payment terms.

Leading banks surveyed by the IFC say that 60% of their SME profits worldwide come from non-credit products and services. Leasing, payment solutions, mobile money and insurance are other financial services for which the missing middle, including SMEs, presents a huge opportunity.

Examples of African financial institutions that are successfully targeting the missing middle, including SMEs, as part of their operations, are Exim Bank in Tanzania, FMB in Malawi and Finance Bank in Zambia.

The IFC says that by 2009 it had \$6.1bn in

over 5.7m customers (57% of all bank accounts in Kenya) by refocusing its strategy to the missing middle and cutting minimum balances and eligibility requirements.

It built a reputation for being the 'people's bank' by providing mobile banking for customers in rural areas, in some cases with armoured trucks which served as mobile branches.

It is seeking to expand in Eastern Africa, including Southern Sudan, and is listed on the Nairobi Stock Exchange and the Uganda Securities Exchange.

According to the third quarter financial figures released in late October 2010, after-tax profit grew by 51% to KSh5.13bn (\$64m) and the asset base grew more than 40% to KShs136.5 bn (\$1.6bn), reflecting 50% growth in customer deposits to KShs98.8bn (\$1.2bn) compared to September 2009.

Equity Bank Group Chief Executive Officer Dr James Mwangi said the bank is adopting innovative customer-oriented IT solutions and growing its loan book by targeting micro, small and medium clients, including a partnership with China Development Bank for KShs4bn (\$48m) to support SMEs with loans at interest rates of between 7%–9% for periods of 3–7 years.

He said: "Our mission is to offer inclusive, customer-focused financial services that socially and economically

empower our clients and other stakeholders and that's a cardinal role that we shall continue playing in the medium and long term.

"As part of our vision to be the champion of the socioeconomic prosperity of the people of Africa, we shall continue to embrace ICT solutions and forge close links with like-minded partners in our quest to one day bank all of Africa's unbanked people."

Summit fund manager Hinton sees a huge future: "SME finance is the next frontier: it can build off the momentum of microfinance to create sustainable economic growth."

Serving Africa's SMEs is already proving profitable and rewarding for banks and their equity investors. It also promises giant development gains. ■



SMEs are the backbone of all economies.

a committed portfolio of investments into SME financial institutions worldwide, up 271% over the last five years. In 2006, it lent \$15m to Nigeria's Access Bank Plc to lend to women SME entrepreneurs and gave advisory services to help it become Nigeria's 'bank of choice for women'.

By June 2009, Access Bank had opened over 1,300 accounts and lent over \$33m in loans which averaged \$98,000. Over 650 women had been trained in business and management skills and the bank has won awards including, in 2007, the Most Innovative Bank at the *African Banker* awards. Its aims is to roll out the programme in other countries as it opens subsidiaries.

Equity Bank, initially formed in Kenya in 1984 as a building society, has evolved via being a microfinance institution to having