CIIP Competitive Industries and Innovation Program

Financed by ... in partnership with WORLD BANK GROUP

The Financing of Small and Medium-Sized Enterprises in Uganda

Preliminary findings and recommendations for further analysis

Introduction

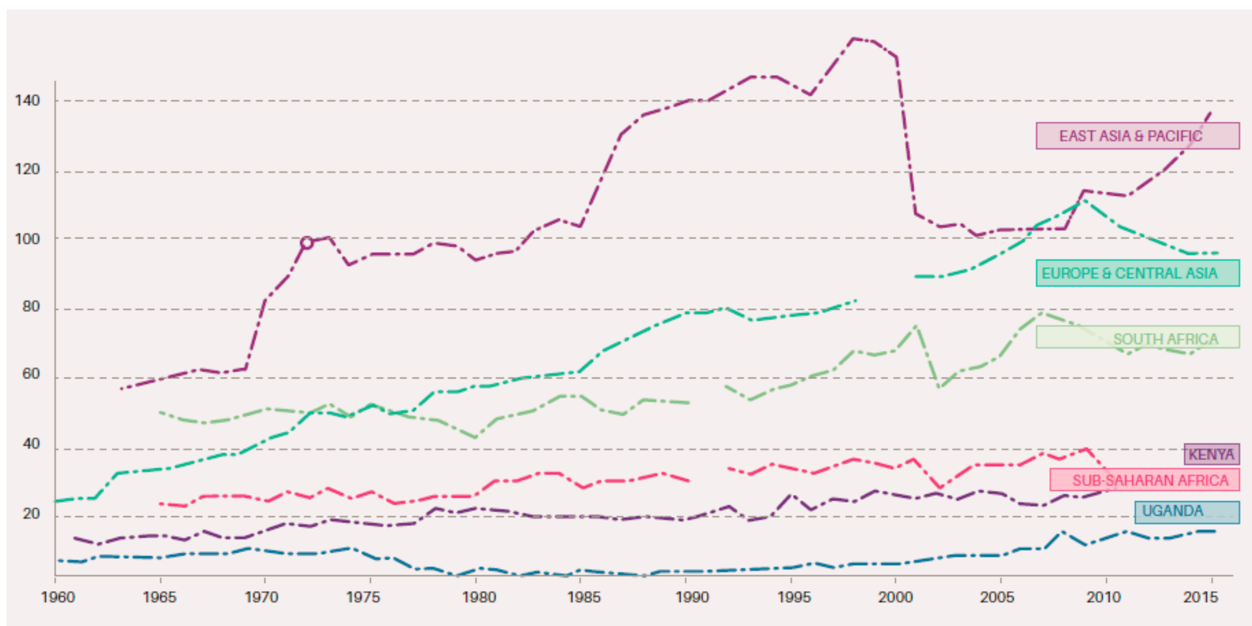
As in many countries in Sub-Saharan Africa, banks in Uganda have been reluctant to provide funding to SMEs. In part banks' reluctance to lend to smaller enterprises can be explained by the malfunction of the domestic credit market. In addition as regards newer enterprises with high growth potential, which are by nature only entering the formal market, banks argue that data about such enterprises is generally weak: they retain incomplete financial records, maybe with a view to understating their revenues so as to avoid tax, and the business plans they produce are insufficient.

This note seeks to set out the agenda as regards the dual challenges posed in: (a) enhancing the role of banks in servicing the financing needs of SMEs; and (b) establishing funding for newer small enterprises with high growth potential so lessen constraints to their growth.

1. Analysis of the market for bank credit

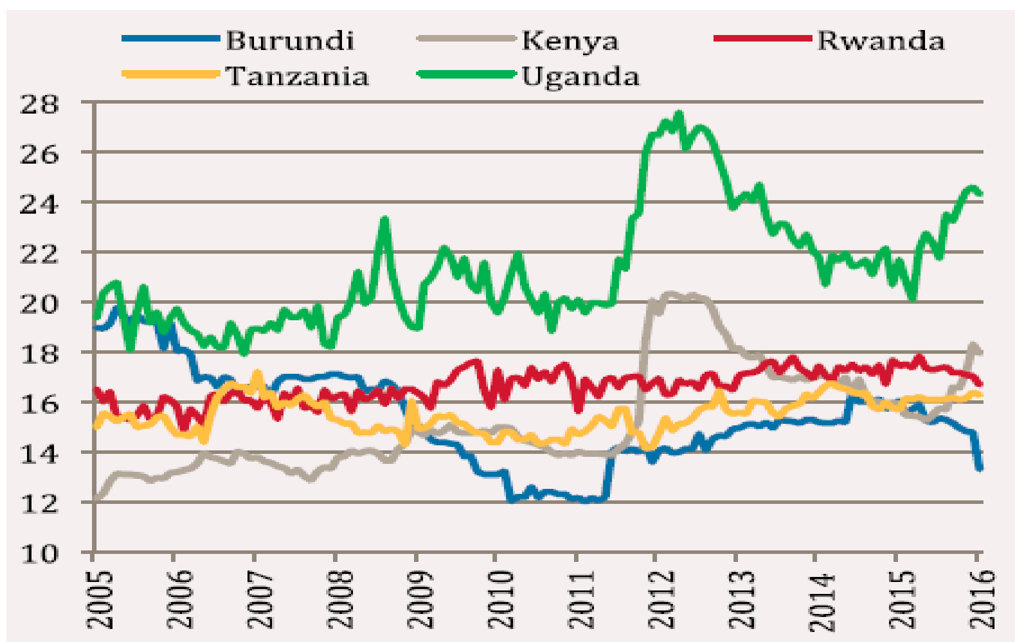
According to the latest Enterprise Survey (2013) access to credit is the most significant constraint to doing business in Uganda. Bank credit to the private sector (as measured as a proportion of GDP) has remained lower than in comparator countries over a protracted period (Figure 1), and interest rates have recently risen to levels above those in other countries in East Africa (Figure 2) giving rise to a marked decline in in the growth of bank credit (Figure 3).

Figure 1: *Private Credit as a percentage of GDP*



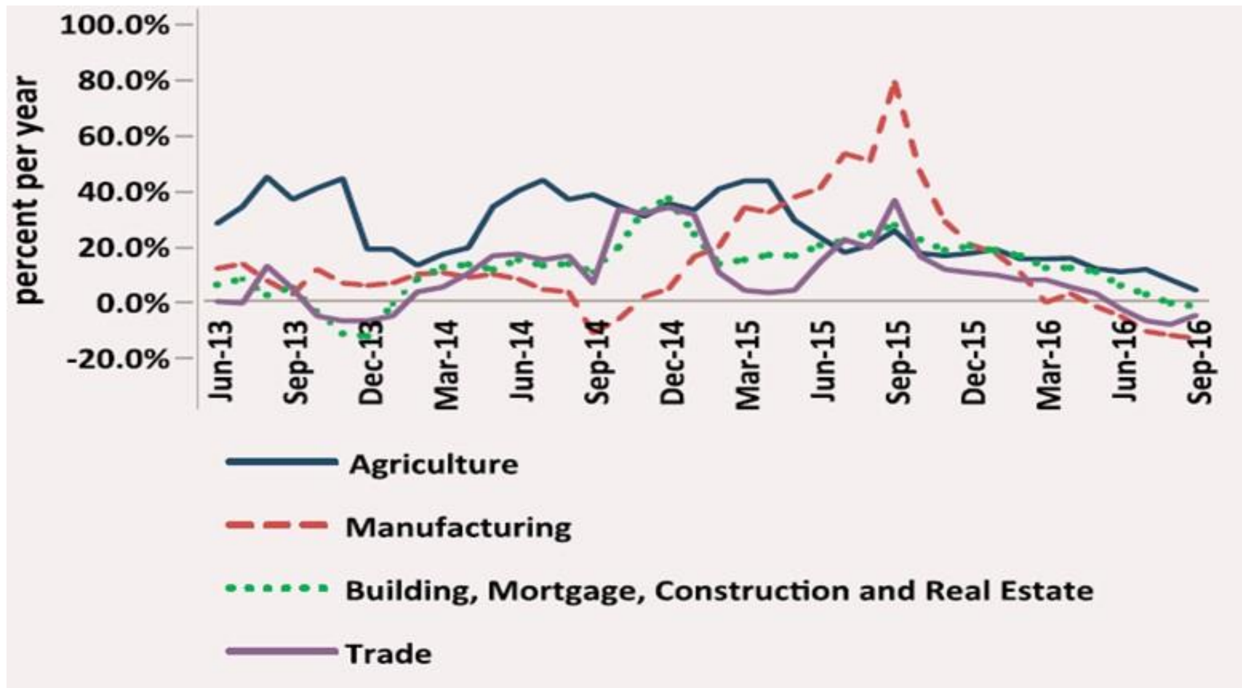
Source: Uganda Economic Update, November 2016.

Figure 2: *Development in lending interest rates in East Africa*



Source: IMF International Financial Statistics

Figure 3: *Deceleration of the growth of credit across sectors*



Source: Central Bank of Uganda

Of further concern is that banks are heavily dependent on credit lines and partial credit guarantees in making commitments to the finance of smaller enterprises. While providing funding on softer terms (e.g. longer maturities) than would otherwise be available and reducing banks' risk exposure, they also bring into question the sustainability of the banks' commitment to servicing this market segment. Tellingly one bank, which is among the largest providers of credit to SMEs in Uganda, relies on credit lines provided by donors to fund half of its exposures to SMEs.

This situation suggest that more in-depth understanding of the weakness of Ugandan credit markets is required both as regards in assessing the causes of the current market failure and the possible impact of alternative remedies. In particular it will be important to understand whether weakness of credit markets can be attributed to:

- Fiscal dominance: macroeconomic (mis)management giving rise to excessive government borrowing, thereby providing banks with 'risk-free' returns and discouraging private sector lending;

- Limited competition: the tendency of banks to preserve market-share rather than compete coupled with reluctance on the part of the authorities to address banking weaknesses leads to high spreads due to weak competitions and the accumulation of non-performing assets;

- Weak credit environment: malfunction of the credit infrastructure designed to curtail risks in lending as relates to factors such as collateral registries, property rights, credit bureaus, and foreclosure and insolvency regimes.

In exploring the impact of the above factors and building on the existing analytical work, such as the latest Uganda Economic Update, additional analysis is envisaged regarding the determinants of banking competition. Such competitiveness analysis will focus on factors such as market share, the breakdown of ownership, asset growth (by bank size and ownership categories), asset and liability structure, sectoral allocation of credit, interest rate developments and net interest rate margins. The analysis will include a bank-by-bank decomposition of the interest rate spreads charged by banks in their lending activities – identifying the extent to which factors such as the cost of loan-loss provisions, overhead costs, taxes, and required reserves, as well as bank profits contribute to bank-specific spreads. The analysis will also include undertaking international benchmarking of credit growth and asset concentration (assets of largest banks/system-wide assets). Finally, it will be important to analyze the degree to which lending is dependent on bilateral lines of credit and partial credit guarantees (such as the agriculture credit facility administered by the BoU).

2. Exploring opportunities for subordinated credit

While the analysis of factors impacting competition in the banking system will improve understanding of the formal credit market, it is also recommended to review possible interventions that could enhance credit provision from outside the banking system. This addresses a broader concern: even where the performance of credit markets is stronger than in Uganda, the ability of banks to address early-stage financing has proven to be disappointing.

The focus here will be into extending the market for traditional private equity (PE) to encompass smaller enterprises. Traditional PE is hampered in investing in SMEs by the tendency of PE

funds to gravitate towards funding larger enterprises. This occurs due to high search and monitoring costs associated with smaller firms; the high level of disclosure and transparency required by equity investors when committing funds to SMEs; the reluctance of SME owners to give up part of their equity, thereby reducing the potential upside associated with the enterprise they have created; and – seen from the perspective of investors – the high, but uncertain and delayed returns associated with exit using traditional PE funding mechanisms.

Therefore instead of using traditional PE, several advantages are associated with using a permanent capital vehicle that provides SMEs with subordinated debt instead of equity: the SME owner retains full ownership of the equity in her company; the subordinated debt structure ensures that investors receive a steady return – there is a known amortization schedule and the fund provides a regular income stream to investors; rather than relying on returns associated with exit, the fund is 'self-liquidating'; and while initially funded by impact investors, after establishing proof of concept it should be possible to attract resources from domestic institutional investors. Just as in traditional PE the success of subordinated debt finance depends on independent, commercial-motivated decision-making supported strong governance safeguards. The expertise of the general partner is crucial and attracting the required expertise depends on adequate financial incentives.

PE is altogether relatively new to Uganda. Until quite recently PE investments were largely conducted remotely from Nairobi, and only targeted larger enterprises. This has changed in recent years as more funds have established offices in Kampala. The table below summarizes the characteristics of three Ugandan PE funds with a view to gaining an initial understanding of the level of market development. All three funds are sponsored by impact investors – major sponsors of GroFin and XMSL being the Shell Foundation and IFC.

As illustrated by the data in the appended table, there is complementarity in the client-base served by Business Partners, GroFin and XSML in terms of the increasing size of their investment ranges.

Several other funds specializing in funding of SMEs in the agri-business sector are present in Kampala. Pearl Capital has been present in Kampala since 2005 (investing in 30 projects across East Africa, of which 9 were in Uganda). In 2016 Pearl closed on a fund specializing in agribusiness targeting investments in Uganda with €10m from the European Union (EU) through the International Fund for Agricultural Development (IFAD) and €2m committed by the National Social Security Fund Uganda (NSSF). So as to be able to benefit from investment by NSSF this fund was established as a domestic Ugandan corporate, thereby distinguishing Pearl Capital's Ugandan from other funds domiciled on Mauritius[1]. Pearl Capital Uganda makes investments in the range of €250,000 to €2 million and is supported by a €3 million Business Development Support (BDS) facility, provided by the EU as a grant to be implemented by IFAD. Other funds active in financing SMEs in East Africa with offices in Uganda include Mango Fund and Iungo Capital. With the growth of the number of Kampala-based funds a forum was recently established providing the basis for regular communication and exchange of views among PE funds with offices in Kampala.

Among the challenges faced by permanent capital vehicles are raising the standards of management information systems of investee companies – encompassing book-keeping, accounting and auditing. Many of these companies are startups or only partially formalized and face challenges in preparing accounts and professional business plans. Fund managers place reliance on credit, collateral and companies registries, although experience shows that credit

[1] Discussion with the EU confirmed that local domicile was difficult to arrange and is cumbersome to administer.

information is not always available for small enterprises, the collateral registry includes title errors and information in the companies' registry tends to be out of date and inaccurate, so an independent research effort is required. While each of the funds provides business development services, the extent and nature of the services provided differs both between the funds and also within the funds depending on the needs of the investee enterprises. For example, Business Partners relies to a large extent on a cadre of mentors with intimate knowledge of the local market, while GroFin and XMSL to a larger extent uses internal expertise in delivering technical support. Business Partners funds its technical assistance through interest-free loans while GroFin and XMSL provide technical assistance as grants.

It is recommended to explore further the desired structure of possible future engagement in the PE sector bearing in mind the nascent nature of the market. While impact investors may be willing to take bear more risk with a view to attracting a larger pool of potential investee enterprises using a first-loss facility, such interventions could distort the market for existing players and create moral hazard among the targeted investees (whose willingness to repay may be defrayed if receiving funds on soft terms).

Structural Characteristics of 3 Ugandan Permanent Capital Vehicles

	Business Partners	GroFin	XSML
Established in Uganda	2016	2007	2017
Fund size	US$ 10 million	US$ 21 million	US$ 50 million
Investment size range	$50,000 to $1 million	$100,000 to $1.5 million	$250,000 to $5 million with average of $1.5 million
Investments to date	US$ 2.5 million	Fully disbursed, excess deal-flow, seeking to establish new fund	US$ 17.5 million
Investment vehicle	5 year loans with 3 to 6 months grace period	3 to 7 year loans with up to one year grace period	5 year loans one year grace period
Interest rate	Prime (20%) plus 1	Base rate (21%) plus premium of up to 5%	US$ interest rate of between 11% to 16%
Royalty	0.5 to 3 % of revenues	Tried, but problematic with clients, so now no longer take royalty	Take revenue share of 0.5 to 3 % in about one third of investments
Equity stakes	Take equity participation in real estate	Do not take equity, as not preferred by clients	May take equity stakes, and always do so when funding start-ups. 90 % of funding is debt
Collateral	60 – 100 % range	60 – 70 % on average	0 – 150 % range
TA provision	Up to 30 % of loan amount as interest-free loans (for 60 months)	Financed by donors as grants and largely provided internally	Financed by grants and/or loans depending on financing capacity of clients
Sectors	Hotel, school, hospital, advertising firm	Education, health, small manufacturing & agri-business (32% of portfolio), water and sanitation, and energy	Coffee exporter, mobile network operator, pharmacy
Marketing	Through professionals: accountants, lawyers , valuators etc.	Through accountants, lawyers, incubators, existing clients	Through professionals