

Published On: November 5th, 2019.

Solving Africa's working capital problem



Africa's continued growth depends on innovations in access to finance.

As the global economy undergoes rapid technological change, leaders worldwide are deeply worried about the future of jobs. The use of Artificial Intelligence (AI), machine learning, and robotics will spur automation across industries and could undermine job creation at a mass scale. But African countries face a particularly daunting challenge: within the next two decades the continent will be home to nearly 1 billion working-age people entering the job market.

Unleashing private sector growth in African countries is critical to creating jobs at scale to employ the next wave of job seekers. While small business owners in countries with developed financial markets can choose from an array of financial service providers for loans, this is not the case in African countries. African markets face a chronic lack of working capital to catalyze private sector growth. The poor availability of working capital results from several factors: a low savings rate, lack of well-structured capital markets and a crowding out of the private sector due to high government borrowing.

To bridge the gap between banks and the real economy, impact investors and development finance institutions (DFIs) should invest in fintech startups and working capital exchanges. This would help unlock the flow of capital and jump start Africa's entrepreneurial ecosystem to grow and employ more people.

Traditional sources of working capital for small businesses such as asset financing are not common in African markets. When they are present, they are significantly more expensive compared to global benchmarks. High fees and interest spreads have led to interest rates across the continent which are nearly 20 percent higher than in other developing markets. Finance for small business is eye-wateringly expensive. Small and medium-sized enterprises are often referred to as the "missing middle" since these firms cannot provide the required collateral, such as equity, a mortgage, or equipment, for loans from African banks, but are too big to qualify for micro finance.

The headlines about the explosion of digital money in Africa should not be confused with the less covered issue of the lack of financing for small businesses. In Zambia, for example, while 95 percent of SMEs have bank accounts and use digital banking services, only 16 percent of those businesses have credit lines. In Nigeria, SMEs represent only 5 percent of total commercial lending. Given the importance of SMEs to economic growth and job creation, African businesses sorely need new and innovative ways to access capital.

Startups are working to bridge the gap between traditional financing and the needs of businesses. Africa is one of the last frontiers for banking services as 60 percent of its population is “unbanked.” To respond to this challenge, the fintech sector in sub-Saharan Africa alone has grown at a 24 percent annual rate over the past decade. Companies such as Lidya and Carbon integrate machine learning and advanced algorithms to develop credit scores for businesses that have never had them. Lidya connects business bank accounts to an online system that digitizes business activity to feed an algorithm that assesses creditworthiness. This system allows Lidya to approve and disburse loans to customers within 24 hours. Such innovative working capital solutions can help small businesses access capital to grow

In Kenya, where the financing gap for micro, small and medium enterprises is \$19 billion, companies like Pezesha, a Nairobi-based fintech, has taken a holistic approach and created a financial marketplace that offers financial lending, literacy courses, credit and debt counseling for the underserved SME market. Pezesha prevents SMEs from over borrowing and falling into indebtedness — a growing trend among Kenya consumers — by assessing applicants’ credit history through its subsidiary Patascore. To create an accurate credit score, Patascore tracks and analyses credit histories for individuals and businesses from more than 150 digital lenders. If an applicant’s loan request is rejected, Pezesha offers financial literacy courses and debt counseling to improve credit scoring. In addition, Pezesha provides value add innovative tools to SMEs to enhance long-term value and retention by helping them to efficiently track their inventory, sales and cash flows. Over time, Pezesha builds up transactional data that develops a strong credit score for SMEs and thus unlocks higher credit limits. More such innovative approaches are needed to help, not hinder, African SMEs in funding efforts.

Yet, fintechs have a limited impact on the market due to their small balance sheets. Africa’s working capital gap cannot be closed by small firms loaning tens of thousands of dollars at a time. Investors can have a systemic impact on the private sector in African markets by setting up working capital exchanges that can provide millions in working capital at the same pace as fintechs. Investors should look to innovative firms like the U.S. firm C2FO, for example, which allows buyers to turn invoices into cash flow by requesting early payment from their suppliers at an agreed-upon rate. This allows more capital to flow to and from businesses and quickly creates growth opportunities. An approach similar to C2FO could unlock capital in the consumer goods sector while a commodity-based exchange could serve the many natural resource companies that dominate African economies.

For example, AFEX, a Nigerian commodity exchange, is providing working capital to 105,000 smallholder farmers, while developing and structuring products that will allow processing companies to raise funds from the capital market to finance their operations. To drive these

innovative financing structures for Nigeria's agriculture sector, AFEX focuses on digitizing the sector — making it easier to see the flow of money in and out clearly — ensuring that risk is efficiently measured, managed and priced. This allows for finance to be drawn into the sector from varied sources, sponsoring impact that stretches from meaningful job creation to fulfilling Africa's food security potential. Creating working capital exchanges and systems in Africa that are open to DFIs and institutional investors would grow the number of financing mechanisms that businesses have access to and the amount of financing those mechanisms can provide.

Local entrepreneurs seeking to scale their businesses across the continent and the world will drive the jobs of the future in African countries. The capital they need to grow, however, will not come from traditional financial institutions. Impact investors and DFIs should step in and fund fintech firms creating solutions to this problem by taking equity or backing funds that invest in startups. DFIs can also provide easily accessible guarantees to these working capital exchanges. They will not be alone: African fintech firms raised a record \$132.8 million in 2018. Beyond fintech investments, there is still room for innovation in working capital exchanges to unlock millions more in financing for the African private sector. The continent's continued growth and future labor force depends on it.