



Supporting Small and Medium Enterprises in Sub-Saharan Africa through Blended Finance

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THE ISSUE

Small and medium enterprises (SMEs) are the backbone of the world economy, accounting for most businesses across nearly every region. In the developing world, SMEs make up **90 percent** of the private sector and create more than **50 percent** of jobs in their corresponding economies. In Africa, SMEs provide an estimated **80 percent** of jobs across the continent, representing an important driver of economic growth. Sub-Saharan Africa alone has **44 million** micro, small, and medium enterprises, almost all of which are micro. For these businesses to grow, create more jobs, and generate economic growth, they need access to capital. **Fifty-one percent** of these vital businesses, however, require more funding than they can currently access. Credit constraints are a serious challenge for SMEs. Without reliable sources of working capital, SMEs are unable to make investments needed for growth, leading to stagnation. Given the importance of SMEs as a source of employment, barriers to accessing financing become barriers to poverty reduction and economic growth. Blended finance can help firms fill this critical gap. Concessional debt and equity give SMEs the ability to expand without bankrupting themselves. Firms that would otherwise become stuck at the pilot stage because of the unavailability of working capital are thereby able to flourish. Technical assistance grants help firms expand their capabilities and improve their performance. Along the way, they gain the confidence of private finance and can eventually attract funding without the need for a blended approach.

INTRODUCTION

African SMEs face two significant financing challenges: accessibility and affordability. Accessibility refers to the ability of SMEs to access finance. SMEs in Africa are frequently informal—meaning they are not formally registered as businesses—and this makes it difficult for them to access financing. Moreover, even those that are formally registered still frequently suffer from a lack of accessibility. This is a significant issue because without sufficient working capital, firms are unable to invest and grow. Only **between a third and a fifth** of SMEs in sub-Saharan Africa have a bank loan or line of credit. An estimated **28.3 percent** of firms in the region are fully credit constrained.

Affordability refers to the cost of capital, or how much it costs for a firm to take out a loan or receive an investment. The total loan cost comprises not just the cost of the original loan but also the interest charged and transaction costs, like fees for lawyers to perfect collateral. This is a serious challenge in Africa because local interest rates from banks are often in the double digits, sometimes higher than 20–25 percent. Alternative finance providers, such as microfinance institutions or digital lenders (e.g., m-Shwari, Branch), can charge even higher rates, as much as 40–50 percent. High interest rates **often deter SMEs** from even trying to apply for financing. This lack of affordable financing seriously hinders SMEs in Africa.

Blended finance is one approach to providing SMEs with access to the capital needed to grow. Historically,

development finance institutions (DFIs) and bilateral donors have focused on direct funding for projects. But with official development assistance (ODA) representing a mere **6 percent** of the \$2.5 trillion Sustainable Development Goal (SDG) investment gap, their resources are insufficient. The **World Economic Forum** defines blended finance as “the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets.” Blended finance seeks to “de-risk” potential investments in such a way that private sector actors will feel comfortable investing alongside or on top. Blended finance is one of the primary ways that official finance can “crowd in” or catalyze private investment from institutions that have a lower risk tolerance or seek a higher rate of return.

To increase their ability to mobilize additional private finance, DFIs like the World Bank’s International Finance Corporation or the U.S. International Development Finance Corporation (DFC) are more carefully considering how they can use blended finance. Most blended finance continues to come from philanthropy and bilateral donors using their grant funding. This means that there is potential to expand blended finance programs through the significant resources available to DFIs, although many do not have concessional windows. Other development agencies, such as the U.S. African Development Foundation (USADF), are also looking at how they can use their grant resources in partnership with DFIs to create blended finance facilities. USADF and DFC are developing a joint blended finance program that will target entrepreneurs seeking loan and grant financing. The effort will be mutually beneficial for the agencies because it will allow USADF to apply more resources in supporting partners throughout Africa. It also gives USADF the opportunity to double down on its use of blended finance vehicles. The program supports DFC’s mandate to work in more low-income countries.

USADF and DFC will work together to provide loans of \$50,000–\$500,000 and grants of \$10,000–\$100,000 to African entrepreneurs in low-income countries and low-to-middle-income countries whose projects advance or deploy innovation or technology. It has the potential to be extremely beneficial in improving the work of both USADF and DFC. By bringing together USADF grants and DFC loan capabilities, SMEs are more likely to get off the ground. Ideally, this financing will help catalyze additional private capital by adopting a blended approach. This type of blended finance de-risks investing in these types of companies and leverages private capital into funds. The

opportunity with DFC allows USADF to both double down on this approach and encourage interagency collaboration.

To date, blended finance has mobilized approximately **\$152 billion** in private capital, roughly equivalent to annual ODA flows. Making true progress in addressing the needs of African SMEs requires a more widespread adoption of the philosophy of blended finance. To maximize the reach of blended finance to support SME growth, donors should consider the following recommendations: incorporate flexibility, map the investment ecosystem, develop methodology to identify areas of investment, work with local markets, and engage in investment facilitation.

THE IMPACT OF THE COVID-19 PANDEMIC ON SMES IN SUB-SAHARAN AFRICA

Affordable financing has become even more scarce because of the Covid-19 pandemic. The pandemic has caused immense economic suffering in sub-Saharan Africa with **\$115 billion** in output losses and an expected **3.3 percent** contraction of the GDP. SMEs have been hit **particularly hard** with simultaneous shocks to supply and demand. This means that they are in **desperate need of liquidity** at a time when financial institutions are especially hesitant to lend. If African SMEs do not receive financing support, the effects of the pandemic will be extended and exacerbated.

The Covid-19 pandemic has intensified gender inequality around the world. Women, and therefore women-owned SMEs, have been especially hard-hit by the pandemic. Around the world, with children home from school and sick parents also at home, women have increasingly had to take on traditional caregiver roles. Women are taking on **three times** more unpaid care-based work than men. This takes time away from growing their business or forces them to give up their business altogether. **One in ten women** around the world have had to quit their job for pandemic-related reasons. Half of them quit to take care of their children whose schools were closed. These issues compound on an investment environment that is already more challenging for women. Women’s formal ownership of SMEs throughout Africa makes up **a third** of all registered SMEs.

However, women-owned SMEs tend to be **smaller**, have fewer employees, and typically do not have as many sales or profits. This is in part because women often do not have access to land ownership rights, leaving them with fewer options to offer collateral damages for potential investments. Women also often lack credit history, which reduces their financial accessibility.

The types of blended finance tools to support SMEs in sub-Saharan Africa have not necessarily shifted since the start of the pandemic, but rather the focus has. For example, there has been an increase in demand by SMEs for technical assistance on leadership and adapting to change, as well as on digitalization of sales channels and business models.

BLENDING FINANCE ECOSYSTEM

Successful blended finance programs do not operate in a vacuum; rather, they require a robust ecosystem. The end goal of blended finance is to increase SMEs' ability to access private capital independently, without having to rely on grants or concessional terms. Local capital providers are essential partners because they have a deep understanding of the social investors and local knowledge of the market, helping ensure that funds go where they are needed. This familiarity can also address concerns about moral hazard and adverse selection problems confronting larger financial institutions. However, local capital providers experience their own challenges and also need support. There are gaps in knowledge and capabilities, and these local investors are often unfamiliar with innovative forms of finance. The University of Cape Town, for example, is the only institution in Africa with an innovative financing program. There certainly is room to increase the number of programs and institutions on the continent.

It is important to make connections among SMEs and between SMEs and potential investors. This will develop the necessary networks for future investment opportunities. Investing in the development of these local African institutions is essential for making any following efforts sustainable. Although the ecosystem must also be supported by effective and reliable systems of regulation, the initial investment and development approach must be nimble and flexible. Currently, many investors are stuck in more traditional mindsets. They do not realize the value of providing these institutions the tools to get their businesses off the ground or of providing access to

soft money. Blended finance is not sustainable without investing in and supporting African institutions.

BLENDING FINANCE TOOLS

Loans, equity, guarantees, grants, and technical assistance are five tools available to DFIs and development agencies to support SME growth. Whether using loans, equity, or some type of guarantee, the point with blended finance is that the provider is taking the riskiest parts of a capital stake and thereby de-risking the investment for others who want either lower risk or higher return. Blended finance is not just a set of tools; it is a strategy. When DFIs use loans, equity, grants, or guarantees, they do so in such a way as to adjust SMEs' risk profiles to make them more palatable for private investors.

Few SMEs in sub-Saharan Africa are immediately prepared to access loans on commercial terms. For firms at an early stage (pilot or seed), grant funding may be most appropriate in helping prove their business model. It comes without any obligations of ownership or repayment. Over time, though, all firms will want to access finance that helps demonstrate their attractiveness to the market. Technical assistance is particularly important in ensuring that these firms' employees develop the skills they need to grow. Depending on growth stage and need, SMEs may also look to grow by raising equity financing. Although accepting equity involves ownership reduction, its potential to generate returns makes it a more attractive proposition for DFIs and private investors alike. Concessional loans are another important tool for blended finance to support SME growth. With the need to make periodic payments, the loans require more development on the part of the firm. But as with equity, this burden means that the pool of available financing expands. The most mature SMEs can successfully obtain loans or equity on commercial terms or close to commercial terms. This is the goal of blended finance support. These firms can then entirely sustain their growth needs with private capital, without relying on DFIs.

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Financing tends to be inaccessible and unaffordable for African SMEs because they carry a **high degree of perceived risk** and because governments borrow a lot, which crowds capital out of the private sector. Development actors are much more **comfortable with risk** than institutions who have fiduciary duties. The de-risking instruments of blended finance adjust the risk-return calculus to attract private capital flows. First-loss coverage guarantees are **one of the most popular** de-risking mechanisms. They also make private investments as attractive as government debt offerings. Partnering with financial institutions, funds, and companies to provide first-loss guarantees lets partners take risks they might not be comfortable with otherwise. The partnerships allow development actors to assume responsibility for the riskiness of lending to SMEs. These guarantees are especially useful during the Covid-19 pandemic because they ensure that SMEs with existing loans can keep them. For foreign investors, de-risking currency fluctuations is also important, particularly in countries with macroeconomic instability.

LOANS AND EQUITY

Loans are offered on **concessional terms** or in local currency (which should become the primary form), to make them more accessible to SMEs. Doing so facilitates the goal of transitioning to commercial lending. The loans are good examples of blended finance if they are paired with other types of capital. Working capital is frequently provided as a loan because there is more flexibility in terms of how a firm can use it and tap a line of credit for additional capital if needed. For some new firms, concessional loans **exceed the capacity** of their balance sheets. That is why equity investments are critical instruments for development finance.

In exchange for a certain degree of ownership in the firm, equity investments provide an essential source of capital for struggling firms without burdening them with loan repayments. Non-debt alternatives, such as demand dividend notes, are also a viable option and consist of financing backed by revenue growth. DFIs are an important source of equity in developing countries, with some DFIs investing **as much as half** of their portfolios in equity. This often comes in the form of **junior equity**, which adds a concessional element to the investment with it low-priority status in the distribution of returns. However, once a firm does an equity series and burns through that round of money, it would need to do another round to access more capital.

The flexibility of loans makes them more attractive to some firms that are further along in their growth, while equity can assist firms in an earlier stage get to that point.

GUARANTEES

To create a greater pool of capital, additional instruments are often required to address SMEs' **high degree of perceived risk**. This is where guarantees come in. Rather than providing capital to SMEs directly, guarantees are contracts whereby development actors take responsibility for potential future liabilities that otherwise would have been suffered by commercial lenders. By adjusting the risk-return calculus, these guarantees help catalyze private capital flows. Guarantees were the blended finance tool responsible for mobilizing the most private finance in developing countries **between 2012 and 2018**. First-loss coverage is one of the most common forms of guarantees whereby development finance institutions promise to compensate private lenders if an SME defaults on their loans. These guarantees are especially important during the Covid-19 pandemic given the increased systemic risk. For external private investors, de-risking exchange rate fluctuations is also important, particularly in developing countries with macroeconomic instability.

GRANTS AND TECHNICAL ASSISTANCE

Grants are another essential element in the blended finance ecosystem and are most effective when combined with the tools above. Unlike loans or equity, they come with no strings attached, lacking repayment or ownership reduction. Given the **inherently distortionary effects** of grants, it is important that they are applied selectively to reduce the risk of crowding out private investment. For African SMEs, two of the most important uses for grants are technical assistance and soft money. However, once firms reach a certain stage in their growth, they no longer want grant financing because they would like to be perceived as legitimate. These types of firms use loans or equity to grow. Therefore, grants should be used selectively during the pilot stage of a firm and at later stages only for technical assistance.

There are many SMEs that only need a small amount of support before they are ready for commercial investment. Their **predicament** is that they are too large to qualify for microfinance programs and too small to appeal to financial institutions. Front-end grant funding provided by development actors helps fill this gap, giving SMEs the initial working capital they need to successfully grow to

the point that traditional debt becomes a viable source of financing.

Some SMEs require extended knowledge in addition to financial assistance. This is where technical assistance can be useful. **Technical assistance** (or technical cooperation) in the development field broadly refers to support for a specific project or country program including technical advice, research and data sharing, and skills training. In this context, it consists of providing advice to help SMEs mature current investments or prepare for future financial deals or development success. The goals of technical assistance are to strengthen countries' enabling environments, improve investment climates, and prepare investment opportunities.

Technical assistance is a key form of blended finance and a particularly important tool in high-risk markets with a weak enabling environment and few good deal opportunities. When opportunities do exist, they are often much smaller than necessary. **Effective technical assistance** meets businesses where they are and is grounded in a business's particular operational challenges and environment. African SMEs are not a monolith; their profiles and financing needs are widely varied. Solutions should be tailored to those varying needs, not just based on sector. Technical assistance must also be a true partnership with the SME, not just classroom instruction, since the latter is often ineffective. Finally, there is a significant gap for SMEs who require technical assistance but do not yet have the financing to pay consultants out of pocket. This is an area in which the international community can play a significant role.

WHEN TO INTERVENE?

Choosing which investors and SMEs to support should be viewed from both a supply and demand side, respectively. For lenders, the following supply-related questions should be considered:

1. Does the investor or lender have enough money to invest or lend?
2. Can they effectively evaluate risk and price their finance?
3. Can they renegotiate loans or deals that become too expensive?

SMEs should be viewed from a demand-side perspective and considered through the following three questions:

4. Is the SME working in an area that is likely to produce a sustainable return on interest?

5. Does the SME have both good business plans and administration so they can produce the information a potential lender would need to evaluate risk?
6. Can they manage the money well and effectively repay the lender?

Someone looking to provide technical assistance or support to either a lender or SME should ensure that the organization can already successfully complete at least one of the tasks laid out above, preferably two. An outside organization can only address one or two of these issues.

AREAS OF OPPORTUNITY

CLIMATE

Addressing climate change in Africa presents a **\$3 trillion** economic investment opportunity in the continent by 2030. The private sector in Africa is critical to adapting to, as well as mitigating, climate change. This is especially true of SMEs, given that they make up **a significant part of the continent's private sector**. It is critical that incentivization exists for SMEs to function in a sustainable manner and achieve **green growth**.

African SMEs' lack of access to financing unfortunately often forces them to **behave in ways that are not sustainable**. It is harder for SMEs focused on sustainability and **green business** to gain financial support because there are typically higher up-front costs and the markets are underdeveloped. **Green technology** is expensive because it is newer and comes with many up-front costs associated with installment. Green SMEs may also suffer from high interest rates as they begin to use and implement new technologies since they **lack collateral** and have a perceived higher risk as a business.

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By giving them the ability to access debt markets, blended finance allows SMEs to adapt their practices to meet climate risks. It is key to promoting green energy. One opportunity present in sustainable business development is "**leapfrogging**" the up-front costs for green businesses and SMEs. Certain areas in sub-Saharan Africa are not overcrowded by infrastructure and industry. As such,

they can build green business and technology from the ground up instead of having to transition already existing sectors and economies. There would be no need to transform entire industries, but the trade-off would be a high up-front capital cost. Green technology installation has the opportunity to be beneficial for SMEs, since it is associated with **lower operational costs** in the long run and because renewable energy generation can be done on a **small scale** for a low production costs. There is an opportunity to develop green SMEs, particularly in Africa, through initiatives such as the Green Climate Fund under the United Nations Framework Convention on Climate Change. The fund aims to support green development in developing countries and looks to raise \$100 billion annually for green business development. There is also USADF's **Off-Grid Energy Challenge**, which works to connect African SMEs with reliable solar energy.

AGRICULTURE

Agriculture represents a significant source of employment and economic growth across sub-Saharan Africa. Currently **over half** of all sub-Saharan African employment is in the agricultural sector, with **70–80 percent** of people in rural areas working on their personal farms. Agricultural SMEs are unfortunately also particularly troubled, especially with the Covid-19 pandemic **severely impacting** Africa's agricultural sector. These SMEs bring food from **farms to households** and seek to bring efficiency and effectiveness to a sector with greater potential. According to a **2018–2019 study**, lending to agricultural SMEs is twice as risky as lending to other sectors, but yields lower returns. Additionally, individual farmers often operate at a scale that is too small to be commercially investable. This highlights one of the greatest challenges for agricultural SMEs, known as the missing middle. The **missing middle** is the idea that many SMEs are too large to be assisted by microfinance, but do not have the ability to receive loans from commercial banks. As a result, agricultural SMEs receive less than **10 percent of commercial bank lending** in most countries.

There are significant opportunities for blended finance to support the agriculture sector. Because of this, the terminology has been updated to refer to the missing middle as the **hidden middle** instead, accurately conveying that sectors are present and willing to engage in the economy. **Changing conditions** have provided the opportunity for agricultural SMEs to grow. These conditions include increases in farm productivity, government investments in infrastructure, and dietary

changes (e.g., increased demand for processed food). As a result, there are rising investments by entrepreneurs. Additionally, large African businesses, such as supermarkets and large processors (**10–20 percent** of the agri-food economy), can help connect farmers to lines of credit or different markets, and can have a positive impact on employment rates and rural incomes. To grow this industry, governments and donors should focus on filling the gaps and providing supply chain services, including fostering and stimulating investments in the **middle of food supply chains**. There should also be a focus on ensuring **agri-food SMEs** are connecting markets and small-scale farmers. Nevertheless, climate change is adding more risks to agriculture, which is why finance needs to be combined with technical assistance to help agricultural SMEs manage the changing environment.

WOMEN-OWNED BUSINESSES

Female business owners in Africa continue to face gender-based discrimination and obstacles that affect their profits, community engagement, and ability to successfully maintain businesses. These include legal discrimination, social norms, risk of gender-based violence, education and skills gaps, confidence and risk preferences, access to networks and information, household allocation of productive resources, and time constraints and care. Because of these obstacles, women-owned businesses in Africa on average earn **34 percent less** per month than those owned by men. A mere **10 percent** of women-owned SMEs have access to the financing they need. With less access to land for collateral and a lack of credit histories, women are perceived as even more risky by private lenders. During the Covid-19 pandemic, women-owned SMEs have faced additional strains, as women are often asked to simultaneously maintain their **traditional caregiver roles** and run their businesses. These disadvantages have **increased their risk of closure** during the pandemic. Blended finance programs that specifically target women would yield significant development gains.

One of the biggest obstacles women-owned SMEs face is accessing capital and finances, so it is vital to eliminate credit barriers and **expand financial packages**. Other avenues to support women-owned SMEs include increasing financial literacy, providing entrepreneurial training, and expanding business networks. These goals can all be accomplished through targeted technical assistance. As far as **accessing capital**, women can also be supported through access to property rights and eliminating the need for collateral in obtaining

grants. Women-owned businesses tend to **employ more women**, so supporting women-owned businesses has a greater influence on gender equity across the continent. Finally, while women-owned SMEs create employment opportunities, they also **enhance the broader economy** of the African continent and can enhance larger regional and global markets.

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RECOMMENDATIONS

As the United States and other international stakeholders look to recalibrate their blended finance engagement with African SMEs, there are several recommendations and practices that can be integrated into future strategies. The planned joint USADF-DFC partnership will provide a critical platform to enhance synergy between USADF and DFC. By combining the benefits of USADF's grant allocations and established regional presence with DFC's lending capabilities, there is an opportunity to strengthen the SME transaction pipeline and ensure the longer-term advancement of U.S. development and commercial objectives.

First, incorporating flexibility into public-sector lending strategies will allow DFIs and other development agencies to fill the initial SME financing gap left by risk-averse commercial lenders. In taking a nuanced and flexible approach to early SME engagement, development actors can improve the organizational and administrative capacities of seed enterprises, ensuring preparedness for future private capital integration. Organizations like USADF and DFIs have an important gap to fill in financing SMEs in sub-Saharan Africa. Of the various types of capital, the private sector is the most risk-averse and inflexible. No matter the context, country, or type of firm, private capital will always have the same requirements, many of which pilot SMEs do not meet. This is the area where blended finance from DFIs is really important in providing more flexibility to SMEs and applying more nuance to investment decisions. This capital stack outside of the private sector will look different depending on an SME's growth stage and surrounding investment environment. This flexibility at

the initial stages can be invaluable in preparing firms for further private-sector investment down the road.

Second, the long-term success of blended finance programs will require an expanded focus on localized and in-depth knowledge of investment ecosystems. Using flexibility to adapt to certain investment ecosystems requires an understanding of what blended finance looks like in different places. Through case studies and exploratory missions, development actors will be better able to tailor their lending strategies with consideration for operational and market limitations. Analyses could also be conducted on an industry-specific basis.

Third, a new methodology for lending and investment selection must be developed. Any effective strategy for blended finance implementation requires a firm determination of when and where it should be pursued. Going forward, DFIs and other development actors should establish a common framework that reflects their foremost role as development institutions—prioritizing early, higher-risk lending opportunities that can shape emerging markets and expand future access to private capital. They should establish a framework for understanding de-risking opportunities, weighing the financial and administrative capacities of a given SME with the potential for sustainable returns and greater market development.

Fourth, development actors should incorporate local market development in conjunction with blended finance activities. To ensure the sustainability of blended finance programs beyond the immediate term, the expansion of investment opportunities for SMEs will require adjacent development initiatives to address other local barriers to economic growth and prosperity. Using blended finance to grow investment opportunities for SMEs will only have long-term successful impacts if the local markets are being developed simultaneously. Organizations like USADF should look to partner with existing local markets to tap into their local knowledge, include some of their financing, and more importantly, develop existing market capabilities. There is a common misconception that intermediaries do not exist in a local context; however, in most cases they are just not developed yet. As part of this engagement with these institutions, it is important to offer local currency guarantees in order to unlock local institutional capital in pension funds and other institutional investors. Developing local soft money capital can be part of an official blended finance deal or be addressed in a parallel manner through official development assistance.

Finally, like local market development, ODA and grant allocations should be targeted toward investment facilitation and the strengthening of local advisory firms and intermediaries. It is important to combine technical assistance with other financing tools. In the longer term, an effective investment facilitation infrastructure will be critical to the development of a self-sustaining investment ecosystem and allow for continued engagement between African SMEs and commercial lenders at large. In fragile markets, there tends to be an absence of investment intermediaries capable of assisting in deal-sourcing and the long-term facilitation of private investment. Targeting local advisory firms and other intermediaries through grants and ODA allocations will be an essential step in overcoming this challenge. Expanding attention toward investment facilitation will also be critical for the sustainable success and impact of blended finance initiatives, helping drive SME markets toward a self-sustaining investment ecosystem. ■

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