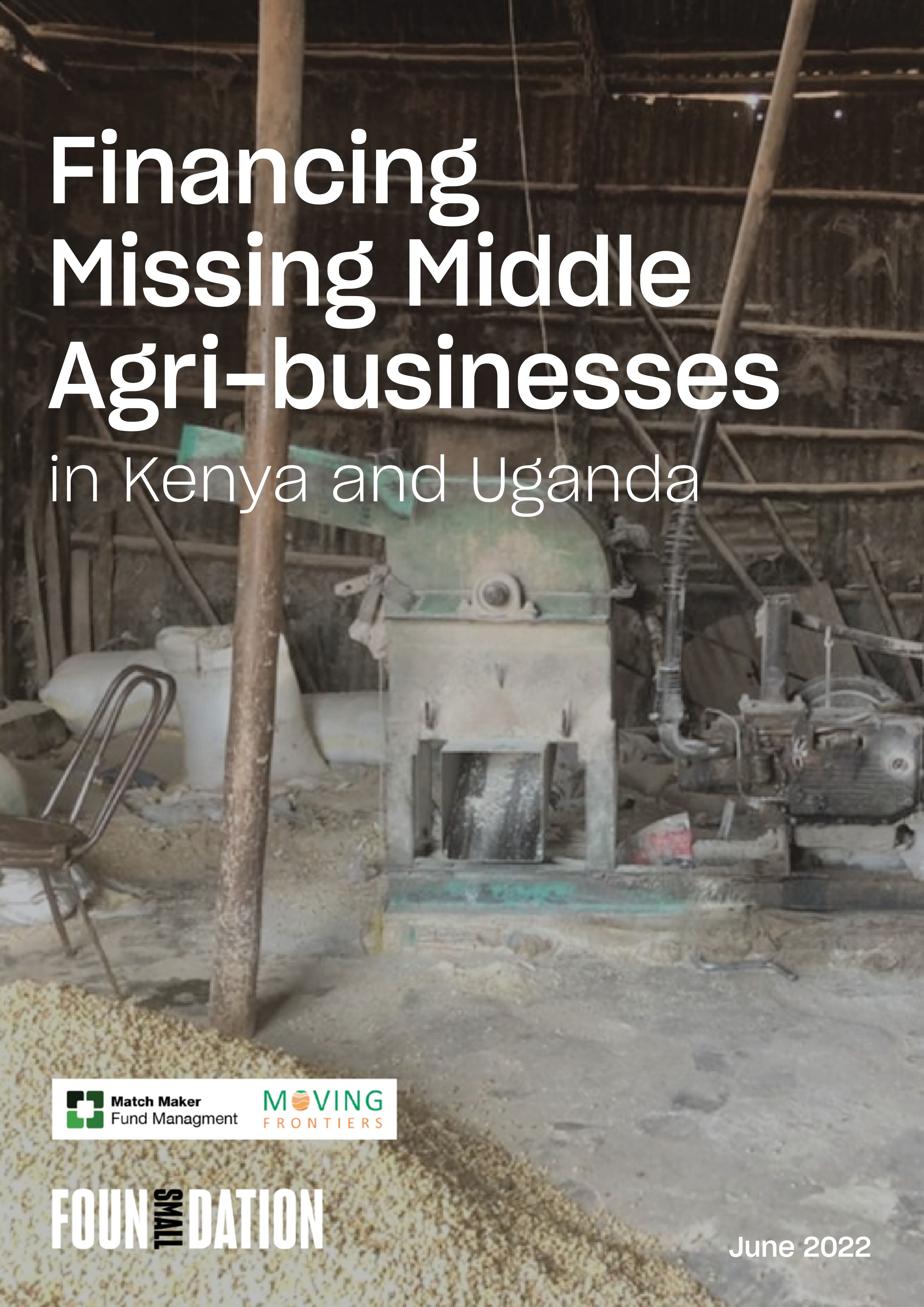

Financing Missing Middle Agri-businesses

in Kenya and Uganda

Match Maker Fund Managment

MOVING FRONTIERS

FOUN SMALL DATION

June 2022

Contents

Acronyms

AFC	Agricultural Finance Corporation
BDS	Business Development Services
BP	Business Partners
CBK	Central Bank of Kenya
COF	Cost of Funds
DFI	Development Finance Institution
EFRIS	Electronic Fiscal Receipting and Invoicing System
ESG	Environmental, Social, and Governance
FCY	Foreign currency
FI	Financial Institution (aka FSP)
FINCO	Finance Company (aka NBFI)
FSP	Financial Service Provider (aka FI)
FX	Foreign Exchange
IFRS	International Financial Reporting Standards
LAH	Lend-a-Hand
LCY	Local currency
LSE	Livelihood Sustaining Enterprises
MFI	Micro Finance Institution
MME	Missing Middle Enterprise
MMFM	Match Maker Fund Management

MSEA	Micro and Small Enterprises Authority
MSME	Micro, Small and Medium sized enterprises
MTL	Medium Term Loan
NBFI	Non-Bank Financial Institution (aka FinCo)
NPL	Non Performing Loan
PE	Private Equity
SACCO	Savings and Credit Co-operative
SCF	Supply Chain Finance
SGB	Small and Growing Business
SHF	Smallholder Farmers
SIF	SME Impact Fund
TA	Technical Assistance
TAT	Turn Around Time
UGX	Uganda Shilling
URA	Uganda Revenue Authority
USP	Unique Selling Proposition
VC	Value Chain
W/C	Working Capital

Glossary

Agri-SMEs
Businesses that are responsible for much of the sale of inputs, food production, collection, distribution, processing and retailing of food products.

Blended Finance[1]
A structuring approach that allows organizations with different objectives to invest alongside each other while achieving their own objectives (whether financial return, social impact, or a blend of both).

Cost of funds [COF]
Refers to the interest rate paid by financial institutions for the funds that they deploy in their business.

Emerging Entrepreneurs
Early-stage SMEs, many of which will be classified as informal enterprises.

Financial Service Providers [FSP]
Also referred to as Financial Institutions or Lenders. Any provider of financial products or services regardless of the organization's corporate form and primary business lines, whether it is prudentially licensed, or whether it is run for private gain or for charitable purposes, including public and private Banks, SACCOs, MFIs, NBFIs, DFIs, crowd-funders and Private Equity Funds.

Informal enterprise
Business entities that are not registered with relevant authorities and are not paying taxes - or show material deficiencies in those areas.

IFRS
International Financial Reporting Standards (IFRS) are a set of accounting rules for the financial statements of public companies that are intended to make them consistent, transparent, and easily comparable around the world.

IFRS-9
IFRS 9 specifies how an entity should classify and measure financial assets, financial liabilities, and certain contracts to buy or sell non-financial items. The implication for banks is that they may have to take a "forward-looking provision" for the portion of the loan that is likely to default, as soon as it is originated.

Lenders
In this study, the term Lenders is broadly used to refer to all FSPs that provide capital, loans or other forms of financing to agri-SMEs.

Livelihood Sustaining Enterprises [LSE]
A term used by the Collaborative for Frontier Finance to describe small, often family-run enterprises in traditional sectors, offering moderate growth prospects.

Missing Middle
In the context of this study, the segment of agri-SMEs that forms the core of SIF's client base. Missing Middle enterprises are usually described as being too large for MFI-type financing, and too small to be attractive for commercial banks.

MMFM
Match Maker Fund Management is the entity that manages the SME Impact Fund. MMFM has commissioned this Feasibility Study.

Moving Frontiers
A Nairobi-based agri-finance advisory firm sub-contracted by MMFM to assist in conducting this Feasibility Study.

Non-Bank Financial Institution [NBFI]
Non-Bank Financial Institutions that do not have a full banking license and cannot accept deposits from the public. NBFIs are a source of credit (along with licensed banks) and often specialize in sectors or groups.

SME Impact Fund [SIF]
A Tanzania based NBFI that focuses on financing rural agri-businesses that could be classified as Missing Middle enterprises. SIF is investigating the feasibility of expanding operations to Kenya and/or Uganda.

Small Foundation
Small Foundation is a philanthropic foundation based in Ireland that is working to catalyse income generating opportunities for extremely poor people in rural sub-Saharan Africa.

Technical Assistance [TA]
Also known as Capacity Building. In this context, the process of developing and strengthening the skills, abilities, processes and resources that an agri-SME needs to develop, adapt, and/or grow its core business.

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Small Foundation

Small Foundation’s vision is a thriving Africa free from extreme poverty. Small Foundation’s mission is to act with urgency and ambition to catalyze and scale income-generating opportunities for people living in extreme poverty in rural sub-Saharan Africa. Small Foundation’s goal is to collaborate with those creating the environment for micro, small and medium enterprises (MSMEs) to succeed and deliver opportunity at scale. In particular, work with intermediaries that increase availability of the finance, social and human capital, knowledge, technology and markets required by a thriving, commercially viable MSME ecosystem.

Introduction

About SME Impact Fund

Established in 2013, the mission of the SME Impact Fund (SIF) has been to create sustainable impact in food commodity value chains in Tanzania by enabling growth of agri-SMEs through finance and access to technical assistance.

SIF is addressing an underserved segment of agricultural SMEs that struggle to access finance and offers working capital loans between USD 50,000 - 150,000.

It is in this range where most of the missing middle agri-SMEs operate; SMEs too big for microfinance, but difficult to service and too risky for traditional banks and impact funds. These enterprises form the backbone of a thriving rural economy and play a vital role in creating jobs and lifting income to all players along the value chain, ranging from smallholder farmers to employees and the communities they are part of.

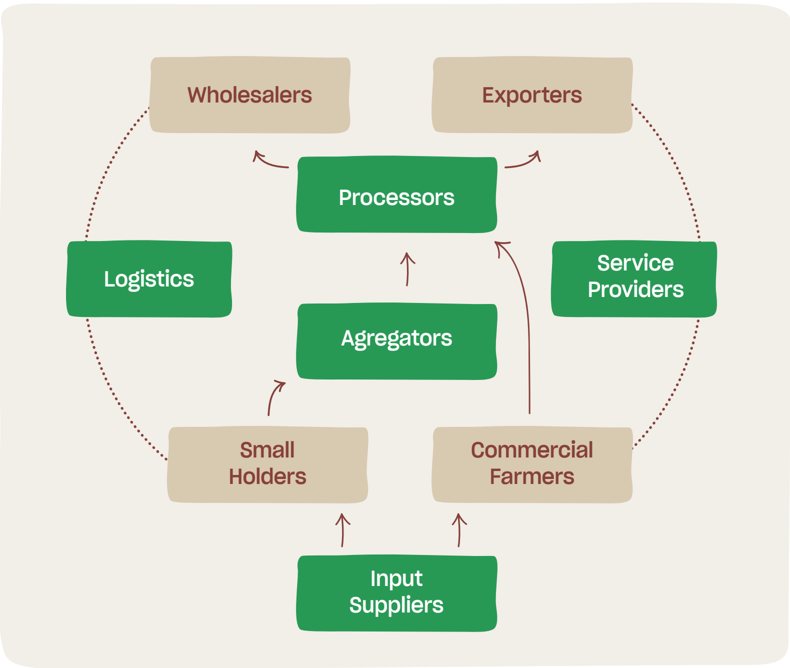
Based in Arusha, SIF has successfully provided 160 loans to more than 70 agricultural SMEs, altogether disbursing almost USD 15 million in small ticket, local currency loans to rural SMEs. By doing so SIF has enabled a total of 3,000 jobs in agri-businesses and impacted the lives of 20,000 smallholder farmers, delivering best in class cost-effective impact.

Now, after successfully gaining extensive experience in financing and growing agri-SMEs in food commodities in Tanzania, SIF is well-positioned to triple its fund size. It will scale up its operations and outreach by expanding to other East African countries i.e., Kenya and Uganda while still serving the same SME-segment.

Ph. 1: Agri-processor in Tanzania.
Med Foods Arusha Limited

SIF focuses on Agri-SMEs

Fig. 1: Agri-SMEs as potential SIF clients



SIF targets agri-SMEs across different value chains, and as such does not finance primary production by entities, farmers groups (SHF) or commercial farmers.

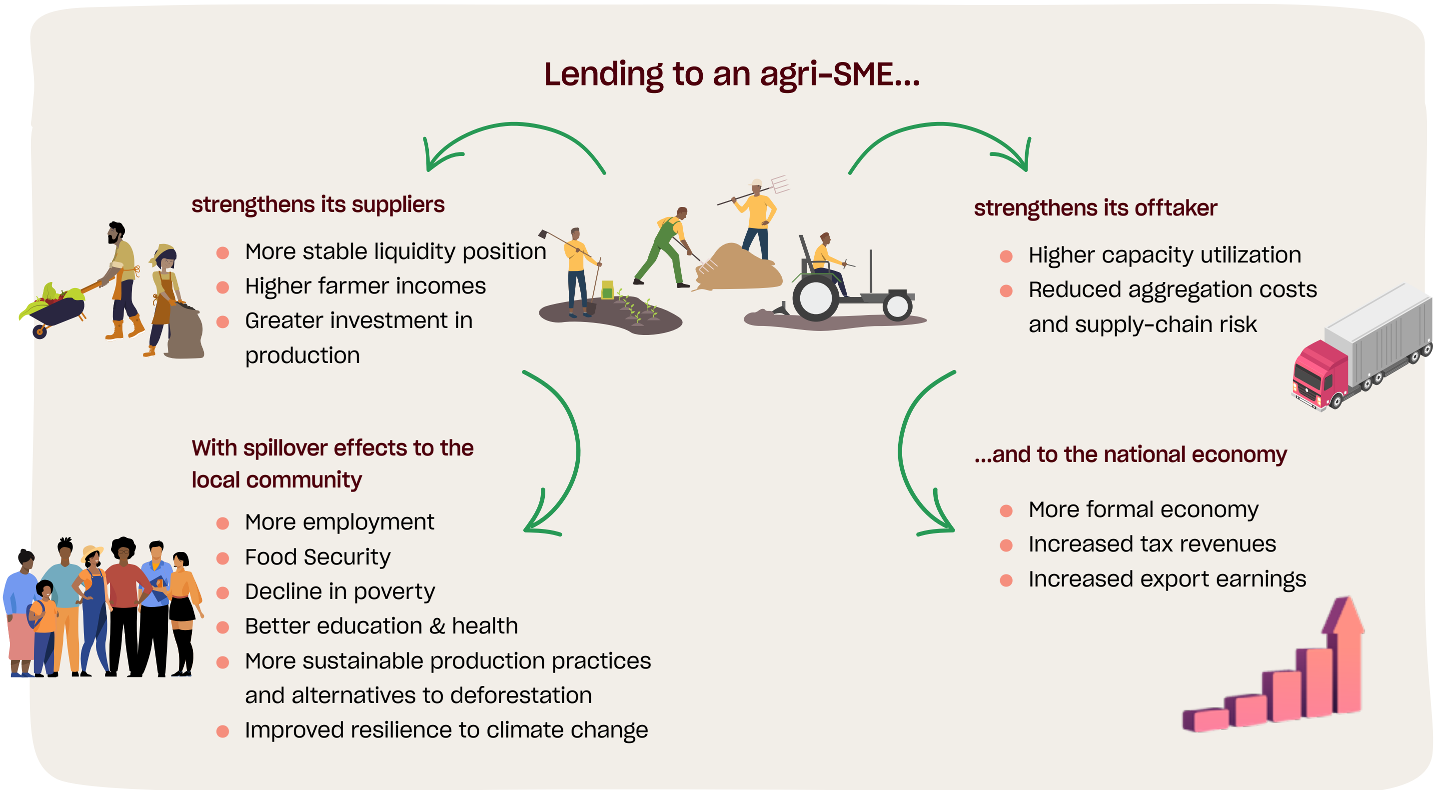
The SIF client base consists predominantly of small processors with a high degree of informality.

Credit is provided mostly in the form of revolving one year installment loans to be used for working capital purposes.

Grant-based capacity building forms part of the offering to clients but due to financial constraints, SIF has been limited in its ability to provide TA over the past few years.

A financing approach that creates impact

Fig. 2: Impact created by lending to agri-SMEs



Measuring impact in the reality of rural Africa requires adaptation and deep understanding of the business context of agri-SMEs. SIF communicates impact results to its investors using a combination of an impact dashboard, infographics and storytelling from their borrowers. It is essential that SME owners are motivated to achieve or surpass the agreed impact benchmarks. The active involvement by investees is based on their belief that the targeted impact adds value to their business.

In 2021, 60 Decibels undertook an impact survey funded by ACELI among SIF clients, particularly their employees, and their suppliers being mostly Small Holder Farmers. The results of the independent study confirms the catalysing effect of Agri-SMEs on income generation and rural development. The main findings are very encouraging.

Fig. 3: Survey findings from 60 Decibels survey (2021)

Of the smallholder suppliers interviewed (87), 74% report that they are accessing services like those provided by SIF-supported SMEs for the first time. Farmers also spoke about improvements along a variety of farm and household outcomes because of their engagement with SMEs, reinforcing our confidence in the choice of these SMEs as well as providing a baseline to measure progress against once the loan is disbursed:

- 95% report an increase in household income;
- 90% report an increase in monthly savings;
- Suppliers note they feel less stressed about providing for their families; 69% of farmers interviewed are able to afford household goods and bills;
- Farmers also shared some complaints: 13% identified limited financing on the part of SMEs as a constraint ("They do not have enough money to give credits anymore. They charge higher prices for services") and smaller numbers (under 5%) complained about long lines to sell their crop at harvest.

Employees largely reported favorable working conditions and improvements in their livelihoods while some also noted areas where the SMEs can improve:

- 56% of the 43 workers interviewed report that their job with the SMEs is their first formal employment;
- 65% state their quality of life "very much improved" since being hired by the SME;
- 95% report an increase in income relative to their previous source of income;
- 23% offered suggestions for improvement with the most common critique focusing on poor equipment and inadequate safety measures (7% of total respondents concentrated in one SME) and one noting periodic delays in salary payments ("We are treated well and our salaries are fair… there are times when we do not get paid on time…")

Feasibility to replicate the SIF model

Based on years of experience in the financing and supporting of agri-SMEs in Tanzania, SIF - together with its fund manager MMFM - has formulated an ambition to triple its fund-size and scale its model to other East African markets. To develop a convincing case for expansion, and to gather inputs for a business model, it commissioned a feasibility study that assessed both the supply and demand side of small(er) ticket agri-finance in Kenya and Uganda.

This summary report provides insight in the issues and challenges posed by SIF's target segment of small (often informal) SMEs and benchmarks the SIF commercial model to other lenders active in agri-finance. Based on lessons learned, a number of recommendations are made.

Executive Summary

SIF is a FinCo that provides working capital finance to Agri-SMEs that would qualify as Missing Middle Enterprises.

Based in Arusha, Tanzania, the client base of SIF consists mostly of agri-processors with working capital requirements in the USD 50,000 - 150,000 range; loans are provided in local currency.

Many of SIF's clients would be characterized as informal enterprises, and lack in registration, certification and administrative controls. Through combining credit with technical assistance, SIF helps its clients grow and move towards professionalization. A feasibility study has been conducted to evaluate the possibility of SIF expanding its business model to the adjacent markets of Kenya and/or Uganda. The competitive position of SIF was mapped versus other Agri-finance providers, and a survey was conducted amongst agri-businesses in both markets to assess their financing needs and bankability status.

Findings

The study found that there is no FSP in either Kenya or Uganda that provides credit to the agricultural sector in the same way that SIF does. In theory, SIF would face competition from a number of commercial banks, but they will be restricted from working with informal enterprises that cannot meet their regulatory KYC requirements. In both markets, FinCos exist that finance agri-businesses, but some will only offer foreign currency loans, whilst others provide much lower (or larger) ticket sizes or focus on entirely different financial products.

The study also highlighted profound differences in the state of SMEs and entrepreneurial acumen in Kenya as compared to Uganda. Kenyan SMEs tend to be larger, have been more exposed to BDS provision and many appear to be ahead of their Ugandan counterparts in marketing and internal administrative controls. This is not a surprising outcome, given that Kenya has been exposed to more private sector support programmes over the past decade than Uganda, and also enjoys a larger and more diverse financial sector.

SIF's model is difficult (but possible)

SIF has demonstrated that maintaining a sustainable business model is difficult but possible. With certain adaptions, its model can be replicated in other countries. The challenges in addressing SIF's Missing Middle clientele are mainly related to cost and risk. Origination costs are high - rural enterprises are spread over large distances and reaching them is expensive. Credit processing requires more work; especially for informal enterprises, on-site assistance is required to put together a coherent data set needed to successfully pursue a loan application. Likewise, loan monitoring in this inexperienced entrepreneurial segment is critical and SIF needs to be highly alert on picking up early warning signals. But the biggest adverse cost driver is the relatively low size of loans - noting the axiom in banking that providing a large loan is as much work as a small loan ... but the associated revenues are very different. Finally, what also affects the SIF model are its dependencies on agricultural crop cycles. For example, processors draw down working capital at the beginning of the harvesting season - but as loans are getting repaid in monthly installments, SIF may find it difficult to redeploy incoming funds towards new loans outside agricultural cycles.

How SIF makes its model work

The SIF model has a number of features that have supported sustainability whilst offering clients an annual interest rate in the 18-20% range.

- Concentration and focus on a main product of working capital loans of up to one year, repayable in monthly installments.
- An origination model that relies on introductions from other SME clients.
- Combining the loans with technical assistance to help SMEs to grow their businesses while assisting SIF to keep NPL rates low.
- Keeping wholesale funding costs down by accessing a funder class that accepts capital preservation as opposed to maximizing returns.

The report concludes by suggesting that successful businesses will need to be able to innovate in more than one area to succeed: provide similar services to an incumbent's customers cheaper, provide new services to an incumbent's customers, develop new customers by mitigating previous risks, or develop new customers by lowering the cost of serving them. Companies that can build a strong advantage in one of these areas are well-placed to bolt-on other capabilities, either through partnerships or acquisitions.

Recommendations

During the study, the question was often asked whether the SIF model allows for scale, for example not serving 50+ clients but 500+ clients. No conclusive answer exists as this has never been done before.

However, key drivers behind servicing a much larger client base would include:

- standardization of products and services;
- resolute application of technology to reduce internal operating costs;
- a hybrid service model combining very small client-facing teams in strategic locations combined with centralized processing;
- TAT as a key performance indicator (especially for agricultural loans);
- effective pipeline generation through thorough market mapping;
- increasing average loan sizes by bringing CAPEX requirements and W/C loans under one collateral arrangement;
- creating sustainability in providing technical assistance to SMEs through capacity building that is funded by (slightly) increasing the loan that is provided and/or by private/public funding and
- access blended finance schemes that will contribute to keep the client rate competitive.

Agri-SMEs as Livelihood Sustaining Enterprises

In terms of loan size and business maturity, SIF's target segment of smaller Agri-SMEs is part of the Missing Middle. Characteristics of missing middle enterprises have been extensively described in business literature as ".. those smaller and medium-sized enterprises (SMEs) that tend to be too large to be served by microfinance institutions and yet too small and high-risk to be attractive to the formal banking sector..".

To understand the clientele that SIF is serving, further segmentation is required.

Ph. 2: Banana field. Match Maker Associates

Four types of Missing Middle Enterprises

In its 2017 study[2], the Collaborative for Frontier Finance (CFF) sorted the universe of SGBs with financing needs between USD 20,000 and USD 2 million into four distinct segments - which they call "families."

Each family has unique financing needs and faces different gaps or mismatches in the market between available investment options and the solutions that are best suited to enterprise needs. SIF's clients are rural agro-SMEs (often processors) and many would be classified as type 4 entrepreneurs. These LSEs are small businesses selling traditional products and services.

More often than not, LSEs are driven by opportunity, employ a small number of people, and many would be classified as 'informal'. They tend to operate on a small scale, with low growth potential, and serve local markets or value chains.

An archetype of this enterprise profile is a small lifestyle enterprise that is growing and has "graduated" from traditional microfinance, and now seeks a larger sum of capital to support operations. LSEs are particularly important for sustaining livelihoods for rural and vulnerable populations. Their needs for external finance are relatively small in scale.

Fig. 4: Four types of Missing Middle Enterprises (CCF, 2018)

01	High-growth Ventures	• Disruptive business models and targeting large addressable markets • High growth and scale potential, and are typically led by ambitious entrepreneurs with significant risk tolerance
02	Niche Ventures	• Create innovative products and services that target niche markets or customer segments • Entrepreneurs who seek to grow, but often prioritize goals other than scale
03	Dynamic Enterprises	• Operate in established "bread and butter" industries - e.g., trading, manufacturing, retail, and services • Deploy existing products / proven business models; seek to grow through market extension / incremental innovations • Moderate growth and scale potential
04	Livelihood Sustaining Enterprises	• Opportunity-driven, family-run businesses that are on the path to incremental growth • May be formal or informal, and operate on a small scale to mantain a source of income for an individual family • Replicative business models, serving high local markets or value chains

What these small and/or early-stage businesses segments have in common is a financing gap that is fundamentally hard to serve. Lenders often have difficulty assessing the risk-return profile of enterprises due to the companies' lack of track record, their inconsistent or weak financial performance, and a general lack of information about their operations and management.

Even when risks are well understood, costs relative to investment return (e.g. high transaction costs and small ticket sizes) may prevent traditional financiers from seeing a strong business case for serving these segments of the market.

Livelihood Sustaining Enterprises

Livelihood Sustaining Enterprises (LSEs) have basic financial needs centered on short-term working capital. The primary challenge for this enterprise class is ensuring that they can continue operating at full capacity during their cash conversion cycles, as the enterprise may have "lumpy" cash flows or might want a safeguard against any unplanned events (e.g., customer default or late payment) that could affect its processes.

Ph. 2: Local market.
Match Maker Associates

Fig. 5: Characteristics of Livelihood Sustaining Enterprises (CCF, 2018)

		Product vs Market	Growth Curve	Management Behaviour	Segmentation Driver	Enterprise sub-segments
4 LIVELIHOOD SUSTAINING ENTERPRISES	Small, often family run in low-growth traditional business	Small scale potential and traditional business	Low but steady growth above local rates of inflation	"Treadmiller" – keeping small business afloat	Collateral availability & financial performance	Fully credit constrained small enterprise Partially credit constrained small enterprise

LSEs are sub-segmented based on their level of financial performance. Partially credit-constrained businesses are characterized by a demonstrable track record of performance and profitability, the presence of some moveable or non-moveable assets to collateralize, and a threshold level of internal financial controls. But fully credit-constrained businesses are far riskier due to the lack of track record of financial performance, absence of moveable or non-moveable assets to collateralize, and low level of financial management capabilities.

Such enterprises are among the most difficult to finance and require the highest levels of technical assistance.

Critical constraints to financing Livelihood Sustaining Enterprises relate to **transaction costs**, the **perceived risks of serving this segment**, and the challenges of **cost effectively obtaining assessment data** to be able to efficiently underwrite small-ticket-size loans.

Towards registration and formality

The Missing Middle will continue to exist in Kenya and Uganda for the foreseeable future. Issues like risk and bankability cannot easily be solved in a systematic manner and require bespoke solutions. However, there are trends emerging that may have a positive impact on access to finance for MMEs and address basic information gathering that Lenders require.

With effect of January 1, 2021, all Ugandan businesses are required to use EFRIS (the Electronic Fiscal Receipting and Invoicing System) to report electronic invoices and sales receipts to the Ugandan tax authority (URA)[3]. EFRIS is aimed at tackling tax evasion and the fraudulent practice of fabricating invoices. While full implementation may take time, eventually a 360-degree view will emerge at SMEs (formal or informal) that helps in understanding, tracking and measuring sales and revenues.

Meanwhile in Kenya, the Micro and Small Enterprises Authority (MSEA) announced in November 2021 that it will embark on a registration exercise as it seeks to register at least 15 million MSMEs across the country[4]. According to MSEA, only 7.1 million MSMEs are on record against the estimated 14.1 million operating in the country - implying they operate under the radar of the government's fiscal planning. In partnership with UNDP, MSEA has created an online platform that will allow small businesses in the informal sector to register, which will be overseen by the authority.

How SIF is financing LSEs

SIF focuses on financing Agri-SMEs and the largest part of its client base would qualify as LSE. Given the difficulties of financing this segment, the following are the most important characteristics of the SIF business model.

ORIGINATION
Finding prospective clients in a rural setting is difficult and costly. Ideally, new clients are introduced by existing SIF relationships that are active in the same value chain. Trust building is undertaken by SIF credit officers while undertaking origination missions;

LOAN APPLICATION
Where administrative systems are lacking, SIF will assist the SME in constructing a financial performance overview based on receipts, invoices, payment records etc. The overview forms the basis of calculating the working capital requirement, and the cash flow planning to repay the loan;

WORKING CAPITAL
Credit comes as a working capital loan with fixed monthly repayments (and an initial 2-3-month grace period); tenure not exceeding one year. Based on good performance, repeat loans may increase in size and CAPEX loans may be offered. The monthly repayment structure also serves as an early warning system;

COLLATERAL
The concept of "skin in the game" Is very important. SIF will take whatever reasonable collateral is available which - if so required - can be provided by friends and family;

PRICING
Loans are priced commercially with interest in the range of 18-20% (on a declining balance).

Technical Assistance
Where possible, SIF will provide grant-based capacity building to its clients but is dependent on donors or investors to provide the funding for doing so.

Market Differences Kenya vs Uganda

Surveying Agri-SMEs

As part of the study, a survey was conducted amongst Agri-SMEs in both Kenya (56) and Uganda (53). The SMEs were selected randomly and represented different value chains, geographic locations and company sizes (annual revenue). Based on this long list of SMEs, follow-up visits were conducted with 32 companies, split evenly over Kenya and Uganda.

Fig. 6: SMEs find it difficult to compare credit offers

Generic Findings

- Considerable differences exist between SMEs with a presence in Nairobi or Kampala, versus those SMEs that maintain their office and operations upcountry. There are various reasons for this:

  1. Most financial institutions have a large(r) footprint in the capital and hence, city-based SMEs are likely to have been targeted by one or more financial institutions;
  2. Donor and development organisations that facilitate access to finance also are dominantly present in the capitals. Direct support includes seed capital, refundable grants, match making grants. Indirect support can come in the form of guarantees, linkages to financial institutions, match-making initiatives etc. As a result, many city-based SMEs have benefitted from some type of concessional finance, and finance on commercial terms is deemed unattractive;
  3. SMEs in the capitals tend to be larger, both in turnover and credit requirements;

- Due to their informality, Livelihood Sustaining Enterprises (LSE) are not easily visible; not surprisingly, they constitute a category of enterprises that is underserved by financial institutions;

- Most of the SMEs that were visited found it difficult to compare terms and conditions of financial products offered by the financial institutions.

  1. Many of them do not fully understand the difference and its effect on interest repayments between a flat rate and on a declining balance.
  2. They seem to be misinformed about the upfront costs like application fees and other pre-disbursement conditions and costs, like life and theft/fire insurances;
  3. There is lack of understanding regarding the effect of the term of the loan on the sum of the interest to be paid;
  4. Most SMEs find it difficult to compare interest of a foreign currency loan versus a local currency loan;

As a result, quite a number of SMEs felt they were misled by financial institutions, especially commercial banks, and the sum they had to pay (upfront, principal & interest) was much higher than they anticipated.

Uganda specific findings

Among the 16 SMEs interviewed in Uganda, 3 would likely qualify for SIF finance, and an additional 4 SMEs could meet its eligibility criteria provided certain conditions were met.

- The Ugandan rural context appears similar to Tanzania, with an emphasis on loosely organized agribusinesses - many of which are still at a cottage/backyard stage.
- Also, comparable with the situation in Tanzania, many LSEs were involved with multiple business lines, with the intent of spreading risk, resulting in their limited resources being spread too thin. For example, a car mechanic who will engage in rice milling at harvest time.
- The breadth and width of BDS provision in Uganda cannot be compared to Kenya. Incubation and acceleration centres exist, as do individual consultants that focus on SME support - but the number of entities engaged in professional BDS support is relatively small.

Ph. 4: SMEs in Uganda
Diners Group Ltd

Kenya specific findings

The Kenyan market appears to have a much greater potential for SIF, both in terms of loan amounts and number of investment ready SMEs with demand for SIF's credit products. Among the 16 SMEs interviewed in Kenya, there are 5 companies that would meet the SIF client profile, and an additional 3 that would need further analysis.

Ph. 5: SMEs in Kenya
Smart Logistics

- An interesting market trend is that an increasing number of agri-processors are targeting 'bottom of the pyramid' consumers by producing micro-packages at very affordable prices (affordability) and marketing these via local vendors located close to the consumers (accessibility). Their business model is commodity-based, i.e. combining high volume and low margins.
- Specific for Kenya is that the geography where agri-producing and processing is undertaken is rather concentrated (not spread out over the whole country like Tanzania) and roughly confined to an area starting 150km east of Nairobi and then 200km north, bending west all the way to Lake Victoria. In all, some 12,000km^2 or 20 - 25% of the country.

Differences in entrepreneurial attitudes

The Kenyan entrepreneurship landscape differs substantially from Tanzania and to some extent Uganda.

- SMEs that were visited are much more ‘aware’; generally, they showed a good understanding of what is going on in their industry and beyond Kenya;
- most of them have better technical and managerial knowledge and skills, including adequate (financial) systems, compared to their peers in Tanzania;
- many entrepreneurs expressed a clear ambition and focus, instead of pursuing multiple business lines like in Tanzania and Uganda;
- many have a higher appreciation of BDS services than in Uganda and Tanzania - also because many were effectively linked to finance by advisors (see next point);
- Kenyan SMEs are more outward looking, helped by the fact that nearly all of them master English and hence can easily communicate and connect with others.

Kenya provides easier opportunity to expand

In terms of market maturity, Uganda resembles SIF’s home market in Tanzania. Kenya is different, but in both countries an LSE segment exists that struggles to access adequate finance.

Nevertheless, there are three reasons why SIF would find it easier to expand to Kenya first:

- SIF provides working capital loans in the range USD 50,000 - 150,000. Based on interviews with SMEs and stakeholders, the findings are that average loan sizes in Uganda will be on the smaller side (USD 50k) while those in Kenya would be USD 100k+. It is difficult for SIF to make a sustainable commercial return on smaller loans; this dilemma contributing to the Missing Middle gap applies to SIF as well;
- the Kenya segment of bankable SMEs is larger than in Uganda; pipeline building would be easier;
- there are big differences in the scale and scope of BDS provision to SMEs; Kenya has gone through numerous donor driven SME support programmes, and whereas some entrepreneurs may have developed grant-dependency attitudes, they have also come to realize the value of technical assistance and how this can help to build their businesses.

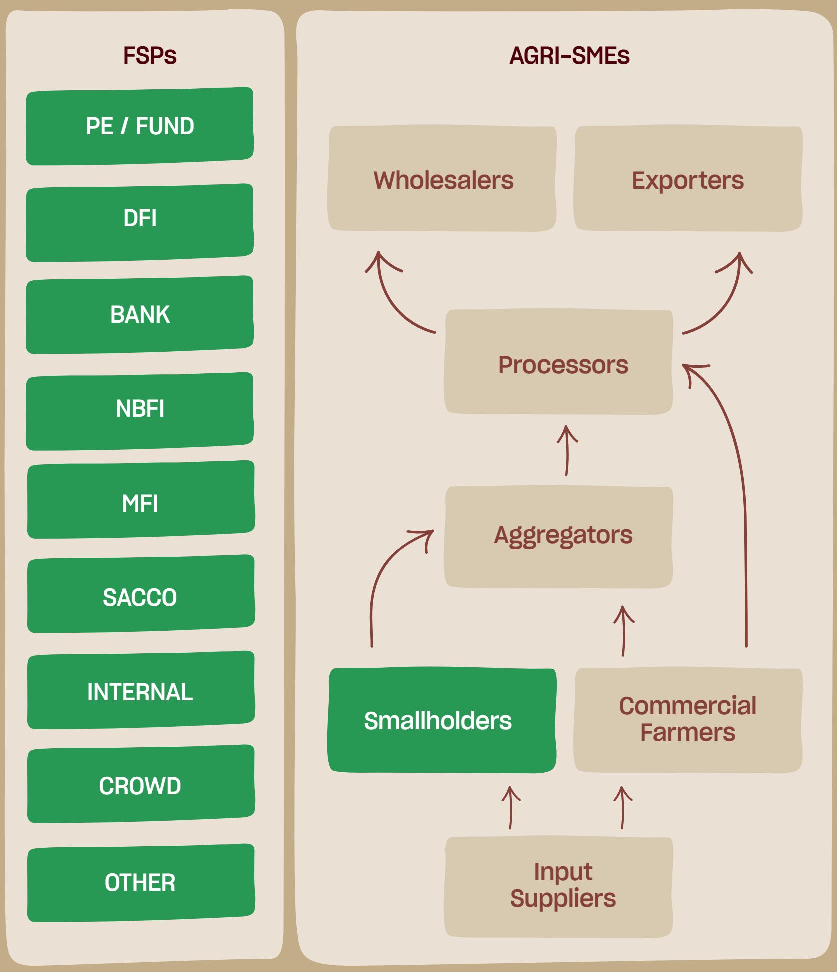
What is similar in both Kenya and Uganda is that in either market, SIF would face very limited competition in smaller ticket agri-SME lending.

Agri-finance providers

Addressing the agricultural finance gap

To assess SIF's competitive landscape, desk research was carried out to identify Financial Service Providers (FSPs) that provide credit to SMEs active in Food & Agriculture value chains.

Fig. 7: FSPs active in agricultural Value Chains



PE /Fund
Private Equity (Impact) Funds
Example: ABC Fund, DOB

DFI
Development Finance Institutions
Example: IFC, FMO

Bank
Commercial Banks (Tier 1-2-3)
Example: KCB (KE), Centenary (UG)

NBFI
Non-Bank Financial Institutions
Example: CSAF members

MFI
Micro Finance Institutions
Example: Musoni (KE), Pride (UG)

SACCO
Member based; Local or Regional

Internal
Supply Chain Financing
by VC actors

Crowd
Example: Lend-a-Hand

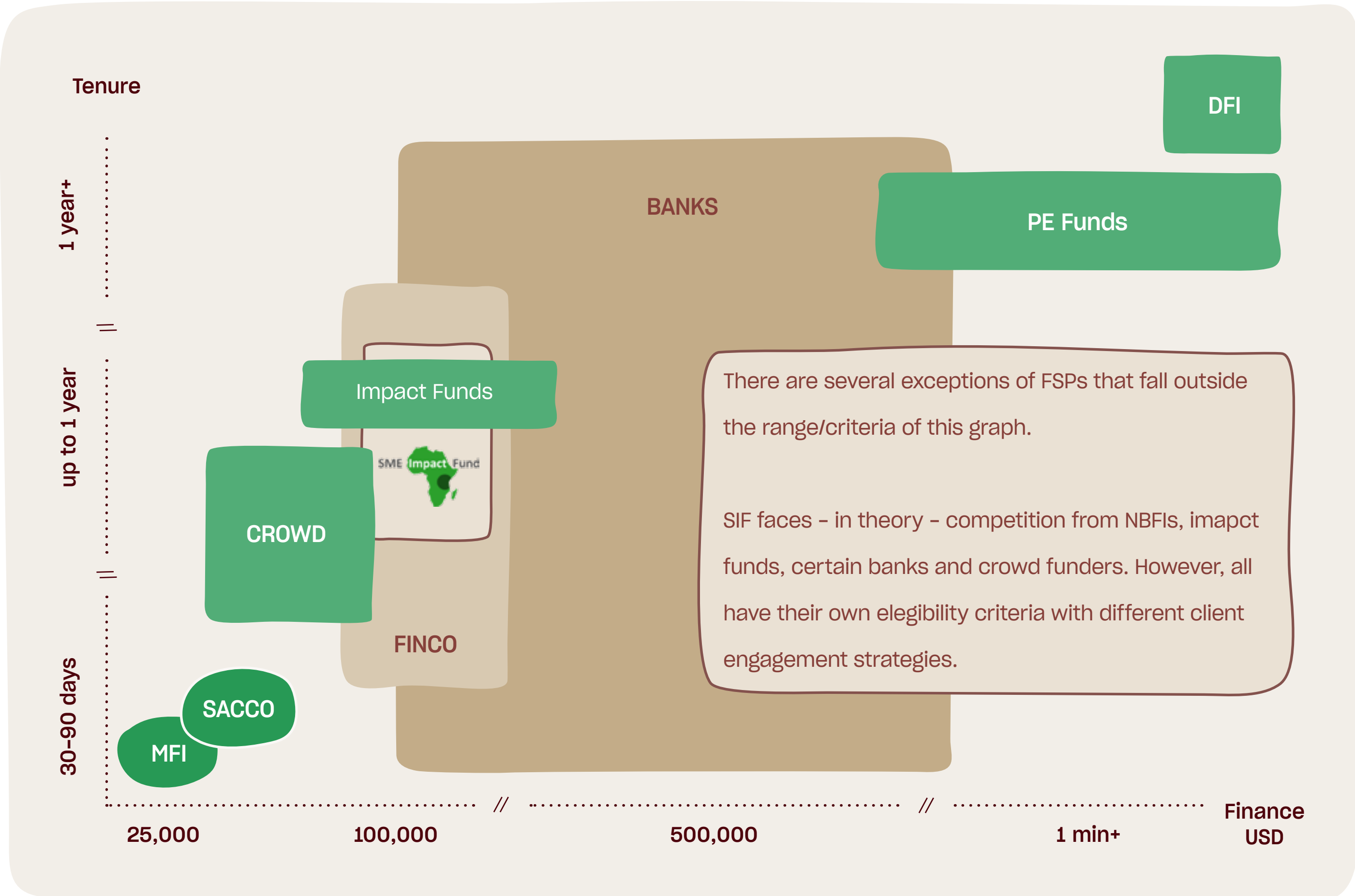
Other
Includes Challenge programmes
Example: AECF, AgriFi, M-Sawa

The competitive position of SIF

SIF mostly provides working capital to Missing Middle agri-SMEs and provides them with local currency working capital financing in the range of USD 50,000 - 150,000 (equivalent LCY). The tenure of its loan offering is up to 1 year. To get an initial understanding of where SIF is positioned vis-a-vis other FSPs, various types of agri-lenders were plotted according to ticket size and tenure.

The chart shows that SIF would - in theory - face competition from commercial banks with an interest in financing agriculture, as well as certain NBFIs, Impact Funds or Crowd. MFIs and SACCOs were deemed to service a different market segment in terms of client type and/or ticket size.

Fig. 8: SIF vis-a-vis other FSPs



Findings from the SME survey

As part of the feasibility study, a survey was conducted amongst 106 agri-SMEs in Kenya and Uganda with questions on finance, business model and strategy. Amongst others, companies were asked to list all sources of credit that they were utilizing.

What came out in Kenya is that almost 60% of SMEs did not have access to commercial bank finance, and only 44% mentioned funding from alternative FSPs (SACCO, MFI, NBFI or Crowd). Other sources of finance mentioned were Family & Friends (25), Angels (4) and Private Equity (7).

Kenya SMEs

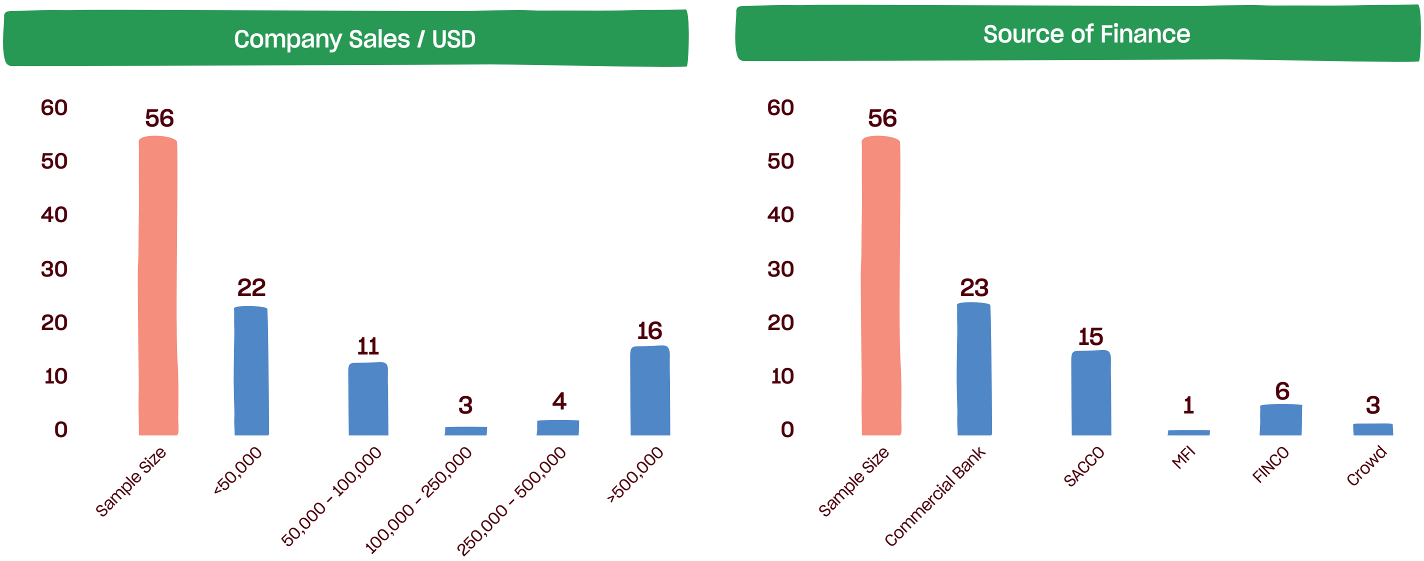


Fig. 9: Agri-SME Survey results, Kenya

Uganda SMEs

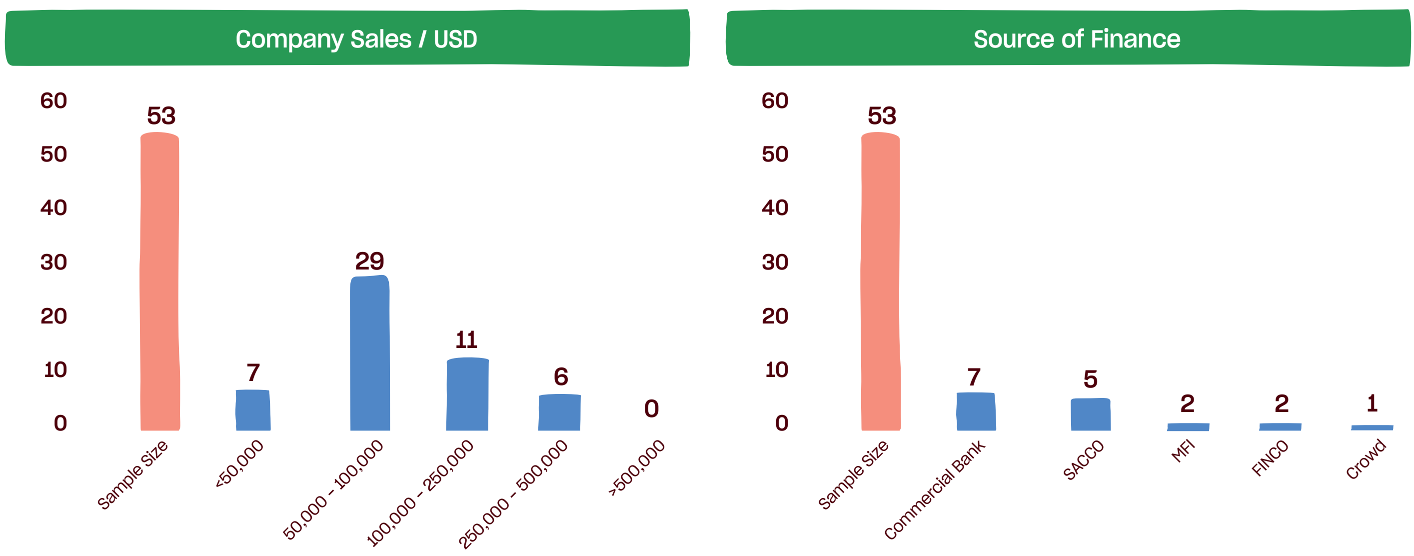


Fig. 10: Agri-SME Survey results, Uganda

In Uganda the numbers were different and showed how difficult it is for smaller agri-SMEs to attract external finance. Over 70% of respondents did not have access to bank financing, and the number of other external financiers that was mentioned was very low. Other sources were Family & Friends (18); in addition 17 respondents mentioned "own savings" as the only source of finance whereas in Kenya not one SME mentioned this as the only option.

More research would be required to develop a deeper understanding of how SMEs are financed. For example, no insight exists into the level and sufficiency of credit provided vis-à-vis the size and bankability of the SMEs. However, the survey did confirm that there are few lenders that focus on the same clientele as SIF.

The SIF Peer Group

SIF's target client base consists predominantly of SMEs that could be classified as LSEs many of which can be considered as 'informal entities'. To establish a peer group for SIF, fifteen FSPs were selected that were viewed as potential competitors. Smaller commercial banks in Kenya were chosen over more general banks such as KCB, Equity Bank or Cooperative Bank - all of whom also deal with agri-SMEs and were deemed to have comparable client strategies.

The 15 FSPs were approached to provide additional detail on product offering, client eligibility criteria and overall focus.
A map was construed to bring out similarities and differences with SIF and the lender attributes that were considered with special interest included

- product;
- currency (of loans);
- dedicated focus (on Agri-SMEs);
- client proximity;
- turn-around-time and
- non-financial services (i.e. supporting clients with TA).

Table 1: Heatmap ranking of 15 FSPs

	FSP	Country	Type	Segment	Informality	Ticket	CUR	Product	Agri Prod	Proximity	TAT	TA
0	SIF	Tanzania	Fund	LSE	Yes	$75k - 150K	LC	WC(1yr)	yes	in-country	<2m	bespoke
1	AFC	K	DFI	🔴	🟡	🔴	🔴	🔴	🔴	🔴	🟡	🟢
2	Apollo	K	NBFI	🟢	🔴	🟢	🔴	🔴	🔴	🔴	🔴	🟢
3	Family Bank	K	Bank	🟡	🟢	🔴	🔴	🔴	🔴	🔴	🟡	🟢
4	Credit Bank	K	Bank	🟡	🟢	🔴	🔴	🔴	🟢	🔴	🟡	🟢
5	Mango Fund	U	Funf	🟡	🟢	🟢	🔴	🔴	🟢	🟡	🔴	🔴
6	Yield Fund	U	Fund	🟢	🟢	🟢	🟢	🔴	🟢	🟡	🔴	🔴
7	Centenary	U	Bank	🔴	🟡	🔴	🔴	🔴	🔴	🔴	🟡	🟢
8	Opportunity	U	Bank	🔴	🟢	🔴	🔴	🔴	🔴	🔴	🟡	🟢
9	Iungo	K+U	NBFI	🟡	🟢	🔴	🟢	🟢	🟢	🟡	🟢	🔴
10	Truvalu	K(+U)	NBFI	🟡	🟢	🔴	🟢	🔴	🔴	🟢	🟢	🔴
11	LAH	K(+U)	Crowd	🟡	🟡	🔴	🔴	🔴	🟢	🟢	🟢	🟢
12	BID	K+U	NBFI	🟢	🟢	🟢	🔴	🟢	🟢	🟢	🟢	🔴
13	FACTS	K+U	NBFI	🟡	🟢	🔴	🔴	🟢	🟢	🟢	🔴	🟢
14	BO	K+U	NBFI	🟡	🟢	🟡	🔴	🟢	🟢	🟢	🟡	🟢
15	Rabo Rural	K+U	Fund	🟢	🟢	🟡	🔴	🔴	🔴	🟢	🟢	🟢

🔴 most similar to SIF 🟢 least similar to SIF 🟡 somewhat similar to SIF

The conclusion is that no FSP resembles SIF in terms of strategy or product. Off-shore agri-lenders such as Truvalu or LAH lend in foreign currency, Apollo Finance in Kenya focuses on farmers, the Mango Fund in Uganda is sector agnostic and finances smaller ticket sizes. Iungo capital finances SMEs across different sectors and provides only foreign currency loans.

In theory, SIF might face competition from the AFC in Kenya, although SMEs raised questions on flexibility and TAT, and no company that was visited had an active financing relationship with them.

In Uganda the situation is a little different. Although the SME survey showed how SMEs struggle in accessing finance, there is little doubt that Centenary Bank is a formidable agri-financier and they claim to service the entire value chain. Opportunity Bank is investing in skills and expertise to finance agri-SMEs and may become a competitor over the next 2-3 years.

A comparison with six other Agri-lenders

	Kenya				Uganda		
	SIF	AFC	Family Bank	Truvalu	Centenary	Opportunity	Iungo capital[1]
sector	agriculture	agriculture	diverse	agriculture	diverse	diverse	diverse
FSP type	NBFI	DFI	Bank	NBFI	Bank	Bank	NBFI
client type	LSE / SME	LSE / SME	SME > Corp	SME	Micro > Corp	Micro > SME	SME
product	WC	diverse	diverse	WC / TF / CAPEX	diverse	diverse	diverse
loan size (USD)	$50K – $500,000	$2000 – 1min+	$50K – 1min+	$100K – $500,000		$30 – $500,000	$50K – $500,000
*currency	LCY	LCY	LCY/FCY	FCY	LCY/FCY	LCY/FCY	FCY
tenure	max. 1 year	> 1 year	> 1 year	1-6 year	> 1 year	max. 5 years	max. 3 years
loan type	installment	diverse	diverse	diverse	diverse	diverse	diverse
interest (p.a)	18 – 20%	5 – 10%	13%	10 – 12%		12-24%	see note
client status	informality	registration	registration	registration		informality	registration
NFS (TA)	bespoke	training	training	bespoke	training	training	bespoke

NFS= non-financial services, WC = working capital, TF=Trade Finance

Table 2: SIF compared to six other lenders

It is not easy to make a precise comparison between SIF and its peers in either Kenya or Uganda. Products that are offered can differ substantially, and so do terms and conditions or eligibility criteria.

Currency

Truvalu and Iungo Capital offer FCY-based loans only, whereas SIF lends in local currency. As such they offer a different commercial proposition than SIF.

Registration

Only Opportunity Bank will accept clients that are not formally registered (like SIF does in Tanzania); this can be explained by Opportunity's focus on microfinance as a historical business segment.

Interest Rates

The table shows a wide variation in interest rates. However, rates are tied to different product types that may not be available to all clients. In Kenya, commercial banks have so far been adhering to the old rate capping regime, but commercial banks are

Iungo capital is active in both Uganda and Kenya. In subsequent financing rounds, credit amounts may be higher than USD 500 k (up to 1 mln) with a longer tenure and more focus on CAPEX based loans. Pricing is not expressed as an interest rate but as an internal IRR target.

now moving towards risk-based pricing which is being approved by CBK on an individual basis and will increase pricing for clients with a lower risk rating. Moreover, FSPs charge a variety of additional fees (processing, monitoring etc.) which were left outside consideration as it would mean allowing for a large range of different fee types, exceptions, circumstances, repeat loans, etc.

In SME surveys, loan pricing is never seen as a top consideration by prospective borrowers. Access to credit, i.e. being eligible for financing, collateral types, turn-around-time and lender transparency are invariably rated as more important issues for entrepreneurs[5].

Turnaround time (TAT)

Turnaround time is a debatable issue. FSPs like Truvalu and Iungo Capital state a TAT of 2-4 months, but most other FSPs would communicate much faster credit application times. However, in reality a loan processing/disbursement trajectory can be a very lengthy process with lenders and clients carrying joint responsibility for ensuring that required documentation is readily available for efficient loan processing. Nevertheless, quick and efficient TAT will be seen as a very positive feature by borrowers.

Non-financial services

Only Truvalu and Iungo Capital offer hands-on technical assistance (bespoke training), whereas the other FSPs resort to group-based training. Offering tailor made capacity building would be an important differentiator for SIF.

Cost of Credit

Cost-of-credit is invariably mentioned in surveys as a concern by borrowers. The following table is based on SIF estimates and provides a breakdown of different components that together make up the cost-of-credit for borrowers.

Table 3: Cost drivers for FSPs (SIF estimation)

	Costs	Est.	Description	Key Driver(s)
a	**COF**	**10%**	Cost of Funds	Blended finance could bring down the cost SIF pays to wholesale lenders
b	**Direct Cost**	**7%**	Origination & processing costs	High(er) for 1st time loan; thereafter can be lowered by some 2-3%
c	**Overhead**	**3%**	Contribution to general office overhead	Beware not to double count with Direct Costs.
d	**FX Risk**	**3%**	In case of Funding vs Lending currency mismatch	Can be hedged at portfolio level; but will be usually priced into cost of loan
e	**NPL**	**5%**	Credit write-off percentage over the entire portfolio	May be as high as 7-10% for many SME lenders
	= cost of loan	**28%**	**this is SIF's cost-price of providing a loan**	
f	**SIF Profit Margin**	**3%**	To absorb adverse conditions; means by which SIF grows capital	Calculated as Return of Assets (RoA)
	= cost to SME	**31%**	**what the borrower would pay**	

For SIF, the options to bring down costs are the following:

a. Cost of Funds

Lower wholesale funding rates would have the most significant impact on the cost of credit. SIF can potentially achieve this sustainably would be through blended-finance schemes.

b. Direct Costs

The costs of origination (identifying, vetting and processing) of rural SMEs are comparatively high. Prospective clients are geographically dispersed, and particularly LSEs need more work in due diligence and credit write-ups. For example, a 5% processing fee over a USD 50,000 loan would hardly cover the actual costs. For installment loans, the processing fee can be built into the nominal loan amount, which means the client does not need to pay the amount in one up-front lump sum.

c. **Overhead**

The traditional axiom in banking is that a USD 50,000 loan is as much work as a USD 500,000 loan. For SIF, increasing its average loan size from USD 75,000 to USD 125,000 could likely be achieved with only a modest increase in costs. This would imply shaving off several percentage points from the combined “Direct Cost + Overhead” mark-up, which could result in a lower cost to the SME by some 2-3%.

The downside to SIF increasing its average loan size is an adverse effect on narrowing the Missing Middle gap for the loan segment of USD 50,000 - 100,000.

d. **FX risk**

SIF is exposed to a currency mismatch, combining (off-shore) funding lines in FCY, with loans extended to its clients in local currency. The risk of currency depreciation should be priced into its overall cost-model. This is not a cost factor that is easy to influence, unless SIF would [also] provide foreign currency loans to processors that are pursuing an export strategy.

e. **NPL rates**

Providing BDS services will strengthen (and grow) LSEs and over time should help them to access other forms of finance over time. In the short run, BDS should be designed to help LSEs manage cash flow planning and avoid running into loan repayment problems.

BDS services cannot be indefinitely grant-funded. It would be interesting to explore if lenders could build a business improvement element into the nominal loan amount. For example, an SME applies for a $100,000 working capital credit, but receives a loan of $110,000 with $10,000 going into a “BDS” escrow account to fund technical assistance.

f. **SIF profit margin**

Is kept as low as possible and does not offer real scope to reduce further to lower the cost of credit to end-borrowers.

Two other factors that have a major bearing on costs are:

- the rate at which available funding lines can be fully deployed, i.e. the availability of investment-ready SMEs that could become borrowing clients;
- SIF draws down under wholesale funding lines for on-lending to its clients. But as SMEs repay their monthly installments, SIF cannot easily redeploy incoming liquidity as demand for credit is driven by agricultural crop cycles. Excess liquidity that does not earn any yield is very expensive - and it requires very careful planning and cash flow simulation for lenders to minimize this cost.

Recommendations

SIF as a lender to LSEs

From conducting the Feasibility Study, a number of conclusions were reached. The most important are:

- **High demand**
  The market of agri-MMEs is certainly there; the demand study provided insights in demand side dynamics and anecdotical evidence regarding market demand for financial products as offered by SIF. However, based on the similarities with Tanzania, it would take considerable time to develop a solid pipeline in Uganda. The conclusion is that Kenya offers more immediate client prospects. This is mainly driven by a combination of client maturity (even at lower SME segments) combined with a higher average loan sizes making any financing proposition commercially more feasible.

- **Limited competition**
  SIF's value proposition and USPs differentiate it from other providers of agri-finance. Very few FSPs address the Missing Middle, and even fewer focus on agri-SMEs. SIF will face very limited competition in Uganda. In Kenya, SIF's positioning as a dedicated agri-lender to smaller SMEs also stands out, but if it moves upmarket and starts to provide larger loans, SIF might encounter more competition.

- **East African markets are not the same**
  Tanzania, Uganda and Kenya all have their unique market characteristics. Lenders should adapt their products to cater for local differences. For example, informality is widespread in Uganda and many stakeholders have advised on smaller loan sizes (up to USD 50,000). At the same time, the BDS sector that could handle capacity building at LSE level is more underdeveloped in Uganda than in Kenya.

- **Combine MME financing with Technical Assistance**
  SIF operates in a high-risk segment, both in terms of sector (agriculture) as well as entrepreneurial experience and maturity. Stakeholder interviews confirm that years of on-the-floor TA is imperative to coach MMEs on their growth path and will act as one of the most effective risk-mitigation measures when it comes to keeping loan losses in check. Some TA can be done in-house (simple accounting services), but other forms of TA would likely be outsourced to specialist consultants.

- **Location**
  In Tanzania, SIF operates from its Arusha home-base. In other words, the company is not based in the urban capital but works much closer to where its clients are based. This is a differentiating factor that could be replicated in Kenya and/or Uganda. Client proximity becomes very important when a client faces repayment problems and arrears start to occur.

What it would take to reach scale

The SME survey(s) confirmed the Missing Middle challenge: some 60-70% of agri-SMEs did not have access to commercial bank financing, and other types of FSPs (SACCO, MFI, NBFI, Crowd) are only providing a limited role in extending credit to smaller agri-SMEs. In conversations with stakeholders the question of scale regularly came up. Banks lack the motivation or conducive regulatory environment to move down-market[6], and alternative financiers maintain relatively small client portfolios. We asked the question what it would take for a lender to finance 1,000 SMEs in the Missing Middle segment. The following points came out:

1. **Dedication**

   Creating an agri-portfolio at scale means skills and excellence in several dimensions: an understanding of agricultural value chains and appreciating LSE development challenges. It will be very difficult to combine these skills whilst simultaneously pursuing other unrelated business lines.

   Successful agri-lending with a focus on LSE finance requires dedication and complete organizational alignment.

2. **Flexibility**

   IFRS-9 accounting standards offer lenders very limited flexibility in restructuring loans, and in the LSE segment not everything will go according to plan (especially for first-time borrowers). Insufficient detail is available to assess if and how different types of FSPs apply IFRS-9 reporting standards, and how this affects their SME lending practices.

3. **Standardization**

   Handling very large portfolios will demand a relentless focus on cost control and standardization of internal processes. This implies (almost) total automation of work-flow, and a high degree of rule-based credit scoring. Standardization will have a bearing on both technology and product design (next points).

4. **Technology**

   Technology to be applied in all aspects of internal processes, but equally so in client-facing operations such as payments. Scale means handling much larger volumes at a reduced unit-cost.

5. **Technical Assistance**

   Capacity building will be an important factor to help LSEs grow (and eventually qualify for other forms of finance) and to properly plan for meeting scheduled loan repayments. Iungo Capital has a model where it appoints its own accountant at the client to oversee financial management. But BDS provision cannot be indefinitely grant based.

6. **Product**

   Rethink financial products for LSEs that would offer the best risk/impact outcome. For example:

   a. Working capital

   All SMEs struggle with W/C stress, invariably caused by late payment from off-takers, aggravated by the inability to obtain credit terms from suppliers. Focus on self-liquidating products, such SCF solutions which will mitigate some of the repayment risk to entities higher up in the value chain;

   b. Combine OPEX and CAPEX

   Processors will need both working capital (OPEX) and investment in machinery to grow. CAPEX can be financed through form of asset-backed lending; investigate to what extent W/C and CAPEX can be brought under one umbrella collateral arrangement;

   c. BDS as part of the loan

   Increase nominal loan amounts by 10% with excess amount going into escrow to pay for BDS provision.

7. **Proximity**
   A fully digital banking model may not work in the LSE segment. TA provision is part of the lending package and where it concerns bespoke capacity building, direct client contract is important. Equally so, when loan arrears start to develop, immediate action taken by the lender offers the best chance of successful restructuring. To service 1,000 SME clients with 20 local mini-units each consisting of 3-4 staff could create a workable hybrid organization (centralize processing, decentralize client-facing roles);

8. **Funding**
   Leverage on climate-smart funding initiatives that will increasingly be offered by wholesale lenders. To bring down the cost-of-credit, pursue blended finance transactions.

9. **ESG**
   Put ESG central in every lending relationship. Help SMEs to transition towards formality (registration, certification) by making tax-compliancy an eligibility criterion - if not for the first loan, then for any subsequent repeat loan. Many of SIF's peers are already doing this (incl. Mango Fund, Iungo Capital, Truvalu, LAH).

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