FINANCING SME GROWTH IN KENYA

By Dinah Bennett

INTRODUCTION

It is well recognised that a vibrant, robust and growing small and medium enterprise (SME) sector is a vital component of Kenya’s economy. Although there is consensus about the crucial role played by SMEs in Kenya’s growth, there is still a fundamental lack of knowledge as to why some firms manage to grow, while others remain stuck at small-scale and low productivity levels.

To help contribute to a better understanding of the relationships between finance, entrepreneurship and growth in the SME segment in Kenya, FSD Kenya has undertaken an in depth qualitative case-study based research, with a group of Nairobi based SMEs.

A separate research report describing the research and its findings in detail has been published. This briefing note presents a profile of the entrepreneurs and their businesses; provides some insight into how they have financed their business growth; and what they feel banks need to take on board if they are to deliver effective financial solutions for enterprise.

THE ENTREPRENEURS

A group of 27 entrepreneurs were initially interviewed for the research and out of these a total of 18 who matched the core criteria were selected i.e. those that had been trading for between 3 and 15 years; employed as a minimum between 10 and 50 people and had demonstrated growth since start up.

Abstract

This briefing note presents a profile of Kenyan SME entrepreneurs and their businesses; provides insight into their key drivers for growth and how they have financed this growth. The note also provides the entrepreneurs’ recommendations for how financial institutions can deliver more effective solutions for growing businesses.

About GrowthCap

Over the past few years FSD Kenya has been at the forefront of SME banking development through conducting market assessments and studies in areas such as trade finance and SME equity funds, as well as supporting development of the credit reference bureau. Through its partnerships with its Action Research Partners (ARPs), FSDK’s GrowthCap initiative is supporting adoption of SME best practices by individual financial service providers.

This paper is part of a series of resources that FSD Kenya has developed around transforming finance for enterprise. These resources provide detailed information about best practice and are intended for use by financial service providers and those supporting such institutions which are entering the SME market.

About the author

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The main objective of the research was to understand the characters and drivers of entrepreneurship that lay behind the SME growth stories:

- **Extrovert personalities** and strong communicators tended to predominate amongst the entrepreneurs consulted — your stereotypical outgoing ‘larger than life’ entrepreneur; however there were also others that were more reserved, almost introvert.

- The **way in which the businesses are run** tend to reflect the personality of the entrepreneur, and the image of the entrepreneur is an integral part of the business brand.

- It’s not surprising but worth remembering that **entrepreneurs start their businesses for very different reasons** and these reasons can shape how they do business. Many of the 18, had started their businesses at a very difficult period in their personal life (loss of loved one, loss of family breadwinner, deterioration of economic circumstances); others experienced frustration in their current profession or employment; some identified specific opportunities in the market and were driven enough to pursue these; while others were entrepreneurs ‘by vocation’, in the sense that they were simply determined to set up their own business.

- **Whilst drivers and personalities might differ**, the research identified **a set of core characteristics among all of the business owners** interviewed. All of the group were entrepreneurial, resilient, innovative and actively engaging in measured risk taking. All had great capacity to network and build relationships; having a sound understanding of their market and were not afraid of the competition. They valued honesty and were all highly committed to customer service as well as their staff.

- The 18 businesses were a mix of those who had grown a single business (11%) and the majority who had pursued several businesses, either sequentially or simultaneously.

### THEIR BUSINESSES

The entrepreneurs had been trading for more than 3 years with the oldest operating since 2001. The businesses ranged in size from the smallest, with 12 employees, to the largest with 250 people. It should be said that some entrepreneurs employed many hundreds of people when all of their enterprises were taken in account. Six themes emerged during discussions about how the entrepreneurs managed their businesses:

- The **role of family involvement in the business.** Although the businesses studied were not described as family businesses as such; nonetheless family members were seen to be important in playing roles as shareholders, providers of finance, ‘trusted caretakers’ of businesses on behalf of the owner, and as a source of labour.
**People first.** All of the entrepreneurs showed a strong commitment to taking care of those working in their businesses. Some did this through training and development opportunities for staff and some had put in place structures to reward performance and contribution. Several entrepreneurs said it was not always easy to retain staff despite taking care of them.

**Prioritised excellent customer service.** Successful entrepreneurs know their customers, understand customer needs and respond with a strong customer focus in their businesses. Their insight had enabled a number of the entrepreneurs to diversify their offering for a particular customer target group and/or develop new businesses.

**Not afraid of competition.** Most, if not all of the businesses, demonstrated a sound understanding of their market and did not appear to be afraid of competition. If anything, they were positive about competition because they felt it drove them to innovate.

**The concept of ‘growth’ means very different things to individual entrepreneurs.** Some see the concept of growth firmly in terms of the growth of their business or businesses. For others, growth was more personal, expressed as generating employment opportunities for family and friends. This latter point was especially clear, when talking with those who were ‘serial’ or ‘portfolio’ entrepreneurs.

**Responding to crisis.** Responding to these types of shocks was stressful for the entrepreneurs but they saw them as learning opportunities. One owner interviewed almost lost his business, but believes he was able to survive this incident by not having credit terms with his international suppliers and little outstanding debt.

**Use of social capital.** All of the entrepreneurs were extremely well networked and used their support networks extensively, to grow their business.

There was a significant use of informal sources of funding for establishing the initial businesses, ranging from using credit terms from suppliers through to moneylenders to chamas. From friends and family to the entrepreneurs own funds.

**FINANCING GROWTH**

All of the 18 entrepreneurs had faced critical incidents or points in growing their business when they had recourse to additional funds for survival and /or growth. Typically, these incidents included:

- Growth spurts that required additional general working capital to keep pace with a sudden and often unexpected increase in demand;
- The need to invest in the business, in order to finance a planned expansion or a diversification strategy;
- Very short term needs for funds to bridge the gap between spending cash and receiving funds – troughs in the business’s cash flow;
- Sudden shocks to the business, generally caused by factors external to the entrepreneur. These included: changes in environmental circumstances; the need for quick investment in order to react to moves made by competitors; or occasioned by the behaviour of a partner, client or supplier.

The 18 entrepreneurs used a wide variety of instruments and sources to cover their need for funds.

**Finance**

- There was a significant use of informal sources of funding for establishing the initial businesses, ranging from using credit terms from suppliers through to moneylenders to chamas, from friends and family to the entrepreneurs own funds.
- In many cases the researchers discerned a form of bootstrapping, where the entrepreneurs remained in employment in order to have a steady source of income while they built the business, often relying on others for the day-to-day management of the business. One business owner had set up three unrelated businesses,

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2 A Chama is an informal cooperative society that is normally used to pool and invest savings by people in East Africa, and is particularly prevalent in Kenya. Chamas were popular among some of the cohort interviewed during this study. Some of the interviewees indicated they were networks based on family or friends. A similar type of informal group is the Investment Club, where entrepreneurs pool money in order to seek investment opportunities.
starting in 2001, and had only resigned from his fulltime employment in 2013.

- Moneylenders were used by businesses at all stages of growth, as ‘lender of last resort’, and were generally seen as a necessary evil. They were predominantly used as bridging loans for short-term needs;
- Some serial entrepreneurs practiced cross financing through their multiple businesses. Some used earlier businesses to generate funds for more ambitious ventures as well as the practice of reinvesting profits generated in the business.

Banking finance

- Most of the entrepreneurs had a very good understanding of the banking system and were capable of managing multiple relationships with banks, choosing among them and selecting the best provider depending on their requirements.
- The practice of multi-banking was prevalent among all of the business owners, with some working with up to eight banks. That said, often one or two banks were used as core institutions with the others playing a more peripheral role.
- For many, an important criterion of banking choice was the speed of response to their requests. This often appeared to be directly related to the relationship between the entrepreneur and a given individual at the bank. When that contact moved, often the level of service also changed, and the entrepreneur switched banks.
- Many cash based businesses spoke of the benefit of being with a bank that had a wide branch network. This was for security reasons, as well as cutting down travelling time incurred by frequent bank visits.

Shareholding /Equity Investment

- Generally speaking, formal equity financing played a minor role for the 18 entrepreneurs.
- Shareholders, where they existed, often involved family members, although in many cases the family members were shareholders in name only and did not have an active role in the business. Some of the businesses were jointly owned with friends and former colleagues.
- Several entrepreneurs had been approached by private equity investors and had declined their offers for a number of reasons. Two of those interviewed were actively considering equity investment at the time of the research.
- SME owners as a group tend to have a poor understanding of capital markets and most of those interviewed were unaware of the ways the ways in which these could be used to raise funds.
- The research found no examples of an entrepreneur who was explicitly building their business in order to ‘exit’ from it at a given point in time (cashing out by selling the business).
LESSONS FOR BANKS

The nature of the research means that it is not possible to generalise from the evidence of 18 entrepreneurs to the entire population of SMEs in Kenya. Nevertheless, the study has provided insight into the issues that entrepreneurs face in growing their businesses and their perceptions of banks and financial institutions as stakeholders in the business growth journey. These reflections are presented below in terms of what the entrepreneurs want see from their banks and what they feel needs to change if banks are to build more effective partnerships for SME growth in Kenya. Entrepreneurs feel that banks need:

- **More effective ongoing relationship management practice.** Although a number of banks do focus on small businesses and relationship management, in practice, the entrepreneurs felt they were not well understood by or appropriately catered for by the banks. Their ‘relationship’ with banks is so often exclusively with the front office; any developed relationship is not taken into consideration by other departments, when funds are sought and staff are always changing necessitating new relationships be built. The success of a funding request was often seen as being heavily dependent on a personal relationship, which breaks down when that banking professional moves on.

- **To appreciate the reality of small business owner.** A number of the entrepreneurs felt that many banking professionals do not understand the reality or ‘life-world’ of the entrepreneur, often making unwarranted assumptions about the entrepreneur and his/her business (usually negative assumptions).

- **To segment their SME customers to better serve their needs.** Some of those interviewed felt that it was difficult to get their bank manager to understand the nature of their business. As one entrepreneur noted: “One size approach or facility does not fit all — banks often have no understanding of the nuances of different industry sectors and the needs of businesses within each segment.”

- **To understand how small businesses grow.** The stop-start nature of growth is a feature of many small businesses in their early years and yet many bankers did not seem to appreciate this.

- **To go beyond their current safe lending practices.** The entrepreneurs were generally frustrated that they are seen as no more than a balance sheet and profit and loss account by the banks. Furthermore, they perceive that banks are only interested in physical assets as collateral and do not take into account reputation, the relationship history and other intangible assets of the business. This appeared particularly important for the service businesses and technology-based SMEs. As the digital age takes hold, the typical configuration of a business’s assets has changed, and the entrepreneurs feel the banks have not been able to respond to this.

- **Faster reaction times and swift and appropriate feedback.** From the research it is evident that one of the strengths of the entrepreneurs has been their ability to react to changes in the environment, to latch on to opportunities as soon as they spot them, and to respond to them swiftly. If banking decisions and transactions cannot be completed quickly, then opportunities are lost. Small businesses are not able to rely on their bank to respond quickly to the need for finance and this can cause significant problems.

- **To better understand the practice of multi-banking and address this.** Many SMEs multi-bank to better manage their business risk and cash flow, as well as generally seeking to get best deal they can from a bank at any given time. This multi-banking, whilst bringing benefits to the entrepreneur, may be contributing also, to undermining the relationship between an entrepreneur and his/her bank. At the very least, multi-banking means that the bank has only limited financial information about the entrepreneur and his/her business. As a result each bank cannot be effective in identifying needs and providing solutions for the business/es in its/their entirety.
IN CONCLUSION

The focus of this note has been on discussing the findings and lessons from a research study with SME owners. It provides some insights as to how banks can better understand and serve their small business customers.

The research has shown also, that there are lessons for the entrepreneur and how they can help improve understanding between banks and their SME customers.

Entrepreneurs have an obligation to educate their bank and help their relationship manager to understand the operating environment of the business. In turn, banks must move away from sitting in judgment of their small business customers, take up a more advisory role by developing a genuine partnership that will be of mutual benefit, facilitate risk appraisal and maximise the benefits to both parties.

In this way the onus is on both parties to improve the effectiveness of the communication between them. In this light, banks might also consider how they might help entrepreneurs to:

- Know how to approach banks more effectively, so that they are able to explain the nature of their businesses, describe their plans and communicate their funding needs more clearly.
- Build the skills and knowledge that will help entrepreneurs better understand the financial dynamics of their businesses so that they are able to carry out financial planning, better appreciate the financial consequences of their actions and be able to articulate their development needs more clearly.

Acknowledgements: This briefing note is based on research undertaken by a team of researchers guided by Dinah Bennett together with Edoardo Totolo, a research economist at FSD Kenya. The key researchers were: Isha Kasule of Moesh Consult Ltd; Dr Wanjiru Kibe of Finesse Consulting; Chris Odongo of Wylde International and Grace Mungai a former associate of FSD Kenya.

The note was prepared by Dr. Pat Richardson, an international adviser to GrowthCap, taken from a full report written by Dinah Bennett.