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Financing Small and Medium-Scale Enterprises (SMEs): Uganda's Experience

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By

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Abstract

This paper investigates the economic rationale for intervention in support of Small and Medium Scale Enterprises (SMEs) on both theoretical and empirical grounds. It argues that the inherent weaknesses of SMEs in Uganda deny them access to financial services. It further argues that the justification for their support lies in market and institutional failures rather than any inherent economic benefits. Specifically, the reasons given for supporting SMEs are basically to increase their access to financial markets and other services; and to reduce policy induced bias against them. The Uganda government and other institutions have made significant strides to accelerate the development of markets for financial and non-financial services suited to SMEs by promoting innovation in products and delivery mechanism and by building institutional capacity. However, even with this support, the SMEs have to so more, themselves, to overcome some of the challenges they face.

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of BOU or BOU policy. Working Papers describe research in progress by the author(s) and are disseminated to elicit comments and to further debate.

Key words: Financial services, Market failures, Institutional support, Macroeconomic stability

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1. INTRODUCTION

SMEs are widely defined in terms of their characteristics, which include the size of capital investment, the number of employees, the turnover, the management style, the location, and the market share. Country context plays a major role in determining the nature of these characteristics, especially, the size of investment in capital accumulation and the number of employees. For developing countries, small-scale enterprises would generally mean enterprises with less than 50 workers and medium-size enterprises would usually mean those that have 50-99 workers. In Uganda, a small-scale enterprise is an enterprise or a firm employing less than 5 but with a maximum of 50 employees, with the value of assets, excluding land, building and working capital of less than Ug.shs 50 million (US$ 30,000), and the annual income turnover of between Ugshs.10-50 million (US$6,000-30,000). A Medium sized enterprise is considered a firm, which employs between 50-100 workers. Other characteristics have not been fully developed.

The main argument for favouring SMEs in developing countries is that they are increasingly playing a strategic role in economic growth and development through their contribution in the creation of wealth, employment, and income generation. In more developed economies, the dynamic arguments for the existence of SMEs have been stressed in terms of their being more innovative and constituting a seedbed for the development of new firms.

In Uganda, SMEs are increasingly taking the role of the primary vehicles for the creation of employment and income generation through self-employment, and therefore, have been tools for poverty alleviation. SMEs also provide the economy with a continuous supply of ideas, skills and innovation necessary to promote competition and the efficient allocation of scarce resources.

In addition, strong SMEs such as Capital Radio, Kabira International School, Masaba Cotton Co. Ltd and Africa Basic Foods (U) were formed through joint venture arrangements with foreign partners from Britain and the USA. These and other SMEs have provided domestic linkages such as the link between agriculture and large-scale industries, creating expanding opportunities for employment and income generation both in rural and urban areas at relatively low cost, ensuring a more equitable income distribution. This has, in turn, mitigated some of the problems that unplanned urbanisation tends to create, offering an efficient and progressive decentralisation of the economy. Thus, SMEs play a crucial role in creating opportunities that make the attainment of equitable and sustainable growth and development possible. It is estimated that there are 800,000 SMEs in Uganda, providing employment and income generation opportunities to low income sectors of the economy.

Due to their characteristics, however, SMEs in Uganda suffer from constraints that lower their resilience to risk and prevent them from growing and attaining economies of scale. The challenges are not only in the areas of financing investment and working capital, but also in human resource development, market access, and access to modern technology and information. Access to financial resources is constrained by both internal and external factors. Internally, most SMEs lack creditworthiness and management capacity, so they have trouble securing funds for their business activities such as procuring raw materials and products, and investing in plant and equipment. From the external perspective, SMEs are regarded as insecure and costly businesses to deal with because they lack required collateral and have the capacity to absorb only small amount of funds from financial institutions. So they are rationed out in their access to credit because of high intermediation costs, including the cost of monitoring and enforcement of loan contracts.

To overcome some of the constraints, the government and other players such as the Bank of Uganda (BOU), have designed programmes and policies that are market-driven and market non-distorting to support SMEs. Government has, for example, created stable macroeconomic conditions, liberalised the economy, and encouraged the growth of micro-financing business. A law is being enacted to guide the development and sustainability of micro-finance institutions while at the same time allowing them to collect deposits. Nevertheless, the challenge to SMEs in accessing financial services will also depend on how they themselves increase their creditworthiness.

This paper examines, in Section 2, the characteristics of SMEs and factors constraining them in accessing financial resources, and highlights the role of finance in SMEs development in Section 3. In Section 4, the programmes to support SMEs in accessing financing are discussed, while the challenges for SMEs in improving their creditworthiness are examined in Section 5. Section 6 gives the conclusion.

2. CHARACTERISTICS OF SMEs AND FACTORS CONSTRAINING THEIR ACCESS TO FINANCIAL RESOURCES

In Uganda, strong SMEs tend to be located in urban and peri-urban centres and are usually registered. However, they face a number of constraints, which include the difficulty in employing competent people with techniques in financial management because of the salaries such people would demand, financial problems arising from late payments by debtors, and inability to raise own finance and access financial services from formal sources. This category of SMEs usually looks to the banking sector and other financial intermediaries for instruments to finance working capital and to provide credit for short-term liquidity management. They, however, often fail to access the financial resources in the required amounts because banks evaluate them on the basis of a checklist, including:

- Audited financial statements for the last three years including management accounts;
- Project proposal highlighting the strengths, weaknesses, opportunities and threats;

- Financial projections;
- Monitoring costs;
- Credit or default risk because of the problem of information asymmetry;
- Enforcement costs.

Financial and accounting records are rarely in place, and where they are available, their accuracy is usually doubted. In instances where bank financing is provided, it is in most cases in amounts that are insufficient and at a high cost in relation to the term to maturity of loans and the real expected return on investment. In Uganda, loans are of a short duration, normally less than 5 years, and the average interest rate is way above the inflation rate. In the circumstances, it may be difficult for borrowers to realise a high enough real returns to finance repayments. A study by Mugume, A. and Obwona, M. (2001) also shows that Ugandan-owned firms appear less likely to obtain credit than foreign-owned firms do because most banks in Uganda are foreign-owned. This is because there is an element of social interaction between foreign-owned firms and foreign-owned banks that supplement physical collateral.

Weak SMEs on the other hand, employ less than 5 people, mostly family members, are usually not legally registered, apply simple and relatively backward technology in production and, therefore, the quality of their products are likely to be poor. They may suffer from limited market access and fierce competition from many rival producers. This category of SMEs usually does not have proper physical structures such as premises from which to operate business, and accessible roads and utilities, which are major impediments to accessing formal sector credit. In addition, there is a general lack of professionalism within this category of SMEs in terms of strategic planning procedures, decision-making processes and business planning, and management in general.

Generally, the smaller the enterprise, the less likelihood its management will understand the need for financial management and the poorer the understanding of financial management. Likewise, the size and the distance from major cities/urban centres are negatively related to the level of awareness of financial instruments. That is, the smaller the size of the enterprise and the farther away from the city/urban centre the enterprise is, the less aware the firm is of the financial instruments available. This makes them vulnerable to shocks to revenue or costs and, therefore, are unlikely to expand beyond the rate allowed by investment of earnings. This explains why the turnover of a typical SME in Uganda is estimated at only Ushs.10 million (US$6000) a year. Thus, poor returns, lack of good financial records, and lack of collateral make them not creditworthy. It is no wonder then that their demise is considerable. Nevertheless, MFIs are increasingly filling the gap by providing finance to this category of SMEs, albeit at higher interest rates than those offered by the traditional banks.

3. ROLE OF FINANCE IN ENTERPRISE DEVELOPMENT IN UGANDA

The foregoing Section has discussed the characteristics and inherent weaknesses of SMEs that deny them access to financial services. In this section, we focus on the role of Uganda's financial sector in financing SMEs.

3.1 Available Financing for SMEs in Uganda

d) Banking Sector Financing

Unfortunately for Uganda, the financial system is small and with minimal linkage to the real economy. Uganda's saving/GDP ratio is about 12%, including both private and public sector savings compared to the continental average of 17.7%. The ratio of money supply to GDP is only12%. There is only one bank branch per 180,000 people in Uganda, compared to an average of 7,000 per bank branch in the Common Market for East and Southern Africa (COMESA) countries. Moreover, bank branches are concentrated in the urban centres. Out of 123 branches, 64 are found in the 4 largest urban areas. In the year 2000, total assets of the banking sector, as a ratio of GDP, stood only at 26% compared to 50% in neighbouring Kenya. Total loan portfolio, as a percentage of GDP, is only 6%. These statistics reveal that the domestic banking system plays a sub-optimal role in facilitating development in the sense that it is not financing much real economic activity. Worst still, the Table below shows that distribution of credit is lopsided against agriculture and in favour of trade financing and manufacturing. Yet agriculture is the main stay of the economy. But even the little credit that flows into agriculture is concentrated on marketing as opposed to production. Although this is not surprising[1], the Table shows that the share of agricultural credit to total credit has been declining steadily over the last five years.

Commercial Banks' Loans to the private Sector by Sectors, 1996-2000, in % of total private Sector Loans.

	1996	1997	1998	1999	2000
Agriculture	19.49	19.21	16.24	10.32	7.12
Agriculture: Production	*1.17*	*1.29*	*2.86*	*2.15*	*1.82*
Agriculture: Crop Finance	*18.32*	*17.92*	*13.38*	*8.17*	*5.37*
Manufacturing	26.74	21.73	26.19	32.43	33.00
Trade	45.55	50.52	47.92	45.63	50.18
Transport, Electricity & Water	3.02	3.12	4.51	6.48	5.30
Building and Construction	5.14	5.34	5.08	5.13	4.39
Mining and Quarrying	0.06	0.07	0.06	0.01	0.01
Annual Growth %	**32.2**	**2.2**	**29.4**	**1.4**	**8.0**

Source: Bank of Uganda

[1] This is because trade and manufacturing require more credit than agriculture as a large share of their inputs have to be purchased with cash.

Several factors account for this low level of financial intermediation in Uganda:

First is the limited dispersion of the banking branch network, as most banks prefer to concentrate their activities in the urban areas where they enjoy economies of scale. In addition, there are a few large-scale and viable investment opportunities in the rural areas. Of recent, however, the resulting vacuum in financial services delivery, especially, in rural areas has been partially covered by micro-finance specialised institutions in the form of Savings and Credit Organisations (SACCOS), Financial Service Associations (FSAs), and NGOs;

Secondly, there have been persistently high non-performing assets that have pervaded the banking system for a prolonged period of time. This situation was partly a result of low culture of loan repayment compounded by economic decline suffered in 1970s and 1980s.

Thirdly, while there is a low level of monetisation in the overall Uganda economy, the formal banking sector is liquid and has played a significant role in facilitating private transfers, recorded at US$80.5 million in 1990/91 and US$539 million in 1997/98. However, the lending activities of the banking system tend to concentrate on less risky and higher-yield short-term lending especially for trade and working capital. Their risk-aversion tendency is based on the experience of poor loan repayments (particularly on agricultural loans) over many years. This has led to exceptionally high real lending rates and interest rate spreads. Since 1994 interest rate spreads have remained at between 15-20%, while lending rates have fluctuated between 10-25% since 1996. It should be noted that these high rates also constrain private sector demand for credit.

Fourthly, the vast majority deposits in the financial sector tend to be short term (up to 6 months) and are hardly appropriate for funding long-term lending on a large scale because of maturity mismatches.

Fifthly, the financial institutions themselves have suffered from governance and management weaknesses that have resulted into weak internal controls, inability to accurately assess lending risks, monitor loans and recover loans. In some situations, there have been shortages of skills and strong social pressures on loan officers to favour certain borrowers, especially those who are politically connected. The failure to correctly assess the creditworthiness of borrowers arises because of information asymmetry and the resultant adverse selection problem. To circumvent this problem, banks have generally required firms to pledge more collateral than the value of the credit they receive and/or limited their services to prime borrowers whose reputation, collateral and other types of guarantees reduce default risk to a minimum. As shown above, prime borrowers are mainly foreign firms that enjoy the trust of foreign owned banks, dominating the banking sector.

Equally significant, is the inability of the justice system to enforce commercial contracts. The experience of financial institutions is that courts take a relatively long time to dispose of cases involving breaches of contracts. This increases enforcement costs, which has discouraged bank lending to successful SMEs. However, efforts are underway to strengthen the commercial justice system by upgrading the capacity of commercial courts and revising commercial legislation.

e) **Micro-financing**

This industry has proved to be a reliable delivery vehicle for financial services to SMEs. They consist of licensed institutions, NGOs co-operatives as well as a large collection of associations ranging from women and youth clubs to loosely organised bodies. They offer savings, payments and insurance services to their clients.

The strength of MFIs is that they serve the rural areas at low costs. Their service delivery is flexible, which makes it easy for weak SMEs to access financial services from them. Their weaknesses, though, lie in their weak operational and management information systems, poor internal controls, limited access to technical assistance, and dependence on donor funding. A centre has been set up at the Uganda Institute of Bankers to address the issue of capacity building of these MFIs.

f) **Lease Financing**

Leasing has been an alternative means of financing capital investment of SMEs with minimum initial outlay. In Uganda, the industry is still too small and young comprising only one leasing company.

g) **Venture Capital Financing**

Venture capital has become an established investment vehicle in developed economies and is becoming increasingly popular in developing economies. Venture capital involves the provision of investment finance to SMEs in the form of equity or quasi-equity instruments not traded on a recognised stock exchange. It is a long-term risk finance whose primary return to the investor are capital gains rather than income. Venture capital investors actively get involved in the management of the companies that they invest in to ensure the success of the venture. Successful cases are sited above.

h) **Equity financing**

Uganda's capital market became fully fledged with the inception of the Uganda Stock Exchange (USE) in 1998. However, most SMEs cannot take advantage of the Exchange because of listing rules regarding disclosure requirements, which require companies to provide credible information to investors.

The banking sector has offered equity financing to a few successful SMEs. For example, SMEs such as UGACHICK LTD and COMMERCIAL MICROFINANCE LTD have receive equity financing from Messrs Development Finance Company of Uganda (DFCU), East African Development Bank (EADB) and the European Investment Bank (EIB).

i) Financing through Mergers and acquisitions

Not data suggests that Mergers and acquisitions are practised among the SMEs.

j) Credit Purchase Financing

Although there is no official data on the magnitude of the credit purchase, this has been a very popular way in which SMEs have raised raw materials for processing. Those in retail business have benefited having to pay for stocks only after sales have taken place. This type of financing has depended largely on the trust and the reputation of the SMEs with their suppliers.

4. PROGRAMMES TO SUPPORT SMEs IN ACCESSING FINANCING

In view of the important role SMEs play in economic development, the government and other institutions, including BOU, are creating a positive environment and support programmes for SMEs. The objective is to eliminate institutional barriers and provide access to formal credit and banking services to creditworthy SMEs.

This Section discusses the macroeconomic environment and support programmes that have benefited SMEs in terms of access to financial resources.

a) Macroeconomic Stability

The Government of Uganda launched an Economic Recovery Programme (ERP) in May 1987, followed by a series of rehabilitation and development plans. Initial efforts were aimed at rehabilitating the production sectors and infrastructure, especially transportation on which the economy depended. Inflation was tackled by imposing strict controls on budget spending and by curbing monetary expansion. Problems in the balance of payments were addressed by liberalising the exchange rate, encouraging exports and seeking donor support. The trade regime has been fully liberalised, and there are no restrictions on both the current and capital accounts.

In addition, the government pursued, with vigour, a policy of privatising parastatals, with the result that more than a half of them have been divested. An investment law was introduced in 1991 to allow repatriation of profits by foreign investors and this was immediately followed with the establishment of Uganda Investment Authority as a one-stop-centre for investors. A capital market was also established in 1998 though its activities are still low.

Monetary policy changed from use of direct controls to use of indirect instruments. The main thrust of monetary policy is to maintain stable and low inflation, and ensure the stability of the exchange rate and the financial sector.

In response to these efforts and incentives, the domestic economy has registered an average growth rate of 7 percent per annum over the past 10 years. Macroeconomic stability has also been restored. The inflation rate, which was on average 108.4% p.a. in 1986 – 1992, has declined sharply, posting a negative inflation of 0.2 in 1999. This has created an enabling environment for savers and investors. Gross domestic investment has averaged 14.3 % per year since 1988 and 15.3 percent since 1990. Financial savings as a percentage of GDP, has increased from 1.4 to over 12.7% between 1990/91 and 2000/2001. However, Uganda's small open economy has

meant that SMEs are now more than ever, facing pressures of trade liberalisation as domestic markets are no longer the preserve of domestic SMEs.

b) Government Support policies and Programmes

Government has produced comprehensive plans to act as a framework for the development of the economy. One of these plans is the revised Poverty Eradication Action Plan (PEAP), which has become the national planning framework. Derived from the PEAP is the Plan for Modernisation of Agriculture (PMA). The PMA aims at modernising agriculture by commercialising it and supporting information dissemination especially in the field of new technology and techniques of production. The third and equally important policy framework emanating from revised PEAP is the Medium-Term Competitiveness Strategy (MTCS) for the private sector. This framework aims at providing an enabling environment for the private sector to:

- Make profits;
- Have a higher capacity to create more jobs;
- Operate in a free and fair environment;
- Attract private sector investment; and
- Have a strong export base.

In order to operationalise the policy frameworks, the government is committed to the provision of infrastructure in terms of industrial estates and marketing services, including extension services and training. With donor assistance, the government is also implementing focused programmes such as Rural Financial Services, which aims at expanding outreach of sustainable micro-finance, School Leavers and Youth Enterprises Schemes, and Business Uganda Development Services (BUDS).

In addition, a Micro- and Small-Scale Enterprises Policy Unit has been established in the Ministry of Finance, Planning and Economic Development to specifically fine-tune SMEs policies, and Commercial Division of the High Court has been established to expedite disposal of commercial cases. It is hoped that operationalisation of these policy initiatives will result in rapid development of SMEs.

Measures to enhance the capacity of commercial banks to carry out better risk analysis of borrowers and reduce the impact of non-performing assets include the effort to establish a credit reference bureau at the Institute of Bankers.

(i) Performance of Government support policies and programmes

The authors have not come across any study that has assessed the effectiveness of these programmes. However, a recent household survey suggests that poverty reduction levels in the city have reduced but it may not be possible to link this outcome to the performances of SMEs.

c) BOU Financial Support Schemes

The Bank of Uganda operates a number of credit schemes and support programmes on behalf of itself, the government and the donors. The credit schemes provide loans to small and medium size enterprises in the private sector through licensed banks while the support programmes are for building the capacity of financial institutions, including MFIs.

The credit schemes include:

- Apex Private Sector Loan Scheme (Apex), which was designed to support small and medium scale private sector enterprises in manufacturing, agro-processing, and services, including tourism;
- Export Refinance Fund (ERF), which was designed to provide working capital in support of export of non-traditional exports;
- Distressed Flower Project Fund (DFPF), which was established to rescue flower firms recently found to be facing some distress, especially, with regard to working capital and replacement of green houses;
- Export Promotion Fund (EPF), which is part of the Apex credit line, was established to assist exporters to promote their exports and identify new markets;
- Development Finance Fund (DFF), which was established mainly to support production in agricultural sector. It is however, being phased out because of its poor performance.

Other credit schemes administered in the past include:

- Investment Term Credit Refinance Fund (ITCRF);
- Cotton Sub-Sector Development Project (CSDP; and
- Rehabilitation of Public Enterprises (RPE) project.

The Support Programmes include the following schemes:

- Export Credit Guarantee Scheme launched in December, 2000 to support the export of non-traditional products originating from Uganda with 35% Ugandan content;
- African Rural and Agricultural Credit Association (AFRACA);
- DANIDA funded Rural Financial Services Component (RFSC); and
- Capacity Building Programme (CBP), which wound up in December 2000, was established purposely to build the capacity of micro-finance institutions in rural areas to enhance their capacity to deliver rural financial services.

i) ***Performance of the BOU support Schemes***

The analysis of the impact of the BOU support programmes for SMEs is continuing. Preliminary evidence indicates that most companies that received loans under these schemes are doing well in terms of the expansion of activities and the jobs that they have created. There is also some evidence that some export companies have increased their export capacity and are now having access to financial services directly from commercial banks. The most remarkable achievement is that the default rate on the loans is low.

d) Other Support institutions include:

i) Private Sector Foundation which administers the BUDS
ii) Uganda Manufactures Association (UMA)
iii) Uganda Investment Authority (UIA)
iv) Uganda National Chamber of Commerce and Industry (UNCCI)
v) Export Promotion Board (EPB)
vi) Uganda Small Scale Industries Association (USSIA)

e) Micro-finance

Recognising both the role of the financial sector in economic development and the weaknesses in Uganda's financial sector in the delivery of the desired financial services, the Government of Uganda, together with BOU as a major stakeholder, has designed a policy framework for MFIs, which has been adopted by Cabinet. In addition, a MFI law has been drafted. When enacted, it will allow BOU to licence and supervise only the deposit taking micro-finance institutions to safe guard deposits. An Apex institution will superintend some credit only MFIs, while the rest of them will operate as member-based institutions.

5. CHALLENGES FOR SMEs IN IMPROVING THEIR CREDITWORTHINESS

Even with the support from Government and other agencies, there are challenges SMEs in Uganda have to face to improve their creditworthiness:

a) SMEs have to improve their management systems and adopt modern management techniques if they are to benefit from the opportunities offered by the formal sector.

b) They need to improve their financial records and accounting systems. Proper records need to be kept and maintained and the books of accounts have to be clear and should reflect a realistic picture of their operations and financial conditions. A good system and books of accounts are not only helpful to the banks; they are also crucial in managing and monitoring business as well as guiding tax authorities.

c) SMEs have to network and build linkages with other entrepreneurs to acquire raw materials or equipment that they need. The linkage can be an important market outlet. This feature can increase their credit worthiness in the eyes of banks.

d) SMEs have to improve their operating efficiencies and capabilities as these impact on production costs and profits. Material wastage is a major source of high costs in small businesses. To increase their capacities and minimise wastage, SMEs need to invest in skills development and infrastructure to be able to benefit from e-finance.

6.0 CONCLUSION

Finance plays a central role in enterprise development but this is only possible if it is accessible and reasonably priced. While SMEs are increasingly seen as playing a strategic role in economic growth and development, they suffer from liquidity problems arising from late payments by debtors. Furthermore, they usually experience difficulties in accessing loans from the banking sector and other financial intermediaries to finance working capital and to provide credit for a smooth transition through liquidity cycles. Some of the reasons why SMEs find difficulties in accessing finance are internal to SMEs and they include limited management and technical skills, lack of collateral, poor technology, and lack of credible financial accounts. Reasons that are external to SMEs include poor physical infrastructure, limited market, and the distance from SMES to financial institutions in rural areas. Where SMEs succeed in accessing financial resources, the cost of funds (interest rates) is high, sometimes leading to non-performing loans.

Therefore, while finance, would play a crucial role to enhance enterprise development, both the countries within which SMEs are located and SMEs themselves need to overcome constraints that would impede their access to financial resources. Countries such as Uganda, therefore, should create the necessary policy, legal, and regulatory environment. This should be supported by the establishment of effective information dissemination systems such as credit reference bureaux to provide information on the credit history of borrowers.

SMEs on the other hand should over come internal constraints such as lack of skills, lack of financial records and accounting systems, and poor loan repayment culture.

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