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Transforming Africa's Trade

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Factoring as a game changer: Empowering SMEs in the AfCFTA Context

Key Messages

- In the currently volatile and polarised geo-political context, the successful implementation of the African Continental Free Trade Area (AfCFTA) Agreement has become even more urgent as a stimulus for trade and economic integration.
- The urgency relates to the continent's limited participation in global value chains, its fragmented trade policy landscape, and high levels of informal cross-border trade.
- SMEs will be important strategic partners in the successful rolling out of the AfCFTA, but singularly and collectively must overcome structural deficits in their financing models and credit operations, with particular reference to the “missing middle” category of SMEs.
- The “missing middle” has to carry a dual burden: they are too big to be eligible for forms of microfinancing and too small to qualify for blended forms of finance from equity and impact investors, commercial banks, and development finance institutions.
- Factoring could be the game changer by providing financing solutions for the “missing middle” that are accessible and affordable.

Introduction

The passage of the African Continental Free Trade Area (AfCFTA) Agreement moves the continent inexorably into an era of structural transformation at rapid pace: its adoption in March 2018 was followed by its coming into force in May 2019, and then came its operationalisation in January 2021. By August 2023, 47 state parties had ratified the agreement as a measure of their commitment to what it portends for continental trade and economic integration. The inherent opportunities embedded in the anatomy of the AfCFTA to expand trade across national frontiers have great advantages for lifting SME growth and development across the entire continent, especially given the productivity enhancements that could be generated through factoring (ACBF-Afreximbank 2021).

The passage of the AfCFTA and the prospects it inaugurates for Africa's trade integration must, however, be located in a fast-changing, volatile, and mercurial global context of geo-political fragmentation, disruptive trade and commercial relations, environmental degradation caused by climate change, and neo-mercantilist and protectionist tendencies in the West. Amid these imponderables, the continent will increasingly have to shape its own destiny and agency; and hence the successful implementation of the AfCFTA takes on added urgency, especially given the continent's limited integration into global value chains which reflects its fragmented trade policy landscape, and high levels of informality in cross-border trade (IMF 2023).

The AfCFTA could, therefore, provide the impetus for diversifying intra-regional trade, promoting greater consumer welfare, and generating increased productivity gains (Diallo 2022). Consequently, there is the potential for significant gains for SMEs through regional value chains, and a unifying trade policy landscape. However, much will depend on ensuring the AfCFTA's prudential and judicious implementation, together with strengthening the institutional capacity of the AfCFTA to empower SMEs through new technologies, more accessible financing instruments, and greater digital literacy.

This Policy Brief is concerned with imposing analytical order on how factoring could be understood as a driver for achieving two objectives: one is to contribute to a financing environment in Africa that would allow SMEs to secure operating liquidity and funding security with greater immediacy than traditional forms of finance such as bank loans; and the other is to support the development of intra-regional trade in terms of the operational and implementation phases of the AfCFTA, of which SMEs could form a bridgehead. However, if factoring is to be a gamechanger in empowering SMEs in the context of the AfCFTA, it is important to understand the problematic terrain in which they have to operate in Africa, especially the “missing middle” category and how its different constitutive elements and operational dynamics can be understood; and the obverse of this, is the difference that factoring could make as a financing instrument.

Assessing the nature and scope of SME challenges

It is axiomatic that SMEs will prove to be a key ingredient in the strategic alchemy that shapes the successful rolling-out of the AfCFTA. It is now also a truism that SMEs suffer and have to labour under serious shortfalls and deficiencies in financing, with the current funding gap estimated at US\$421 billion (IFC: World Bank 2021). The widespread funding dilemma that afflicts the vast majority in the SME ecosystem is a significant inhibitor of SMEs reaching their full potential, especially those which occupy the “missing middle” (see below and Figure 1). This condition persists paradoxically in an economic and commercial milieu of great opportunity and good prospects where, with appropriate regimens of support and guidance to draw on, SMEs could grow and develop to reach levels of maturity that approximate “blue chip” corporate varieties (KEPSA 2023).

It is, therefore, worth revisiting some of the structural impediments which constrain and inhibit SME access to finance in the context of how factoring could play an ameliorative role as a sustainable financing intervention. The cyclical lack of funding for SMEs raises first order questions about the efficiency and effectiveness of domestic capital markets in terms of serving business needs, especially in driving innovation, expansion, and job creation (Quartey, Turkson, Abor and Iddrisu 2017). This problem is compounded by information asymmetries such that there are serious shortcomings in knowledge and awareness about financing options which are sensitive to SME needs and this *a fortiori* is the case with factoring as a financing instrument.

There is a logic that explains this situation: Africa is still a marginal player in the global factoring market, accounting for 1.14 per cent and where only six countries represent the most important players (FCI 2023). A major impediment and drawback to making factoring more attractive in Africa has been that it remains the preserve of banks and related banking institutions with onerous lending conditions and eligibility criteria, while autonomous factoring entities are few and far between (ACBF-Afreximbank 2021).



Financing options and related issues

Typically, the standard options range from microfinance and angel investing to private equity and venture capital as well as recourse to possible listing of potential growth segments in local stock exchanges. The net result is that local equity markets suffer from inertia and stagnation and thus, remain underdeveloped for purposes of supporting SME growth and development. This is a major contributing factor to the lack of depth and liquidity in domestic capital markets which, in turn, has knock-on effects on the pipeline of initial public offerings in local exchanges (Quartey, Turkson, Abor and Iddrisu 2017).

The tradition of SME's reliance on short-term debt to raise working capital accounts for their dependence on the banking sector, bank loans, and other methods of high-yield debt. These financing avenues, particularly bank loans, are regressive for SMEs since they have to bear the difficult burden of loan repayments or face the spectre of default and even being “blacklisted” by credit bureaus. Furthermore, banks require collateral (which can be prohibitively high) as a means of offsetting the unquantifiable credit risk that come with lending to SMEs (LSEG 2022).

There are other related challenges that SMEs must confront. These include poor access to the necessary expertise for improving their management structures and practices, especially with regard to digital literacy; an absence of financial information that assists lenders and potential investors with decision-making about worthy enterprises to support; and then there is the social capital dimension of unattractive working conditions, an absence of social safety nets, and poor retention of talented individuals. That said, there has been an improvement in business and SME support services in several countries such as Kenya, Mauritius, Rwanda, Tunisia, and South Africa. This includes legal and regulatory advice, financial management and administration, credit guarantee schemes, and incubation and acceleration programmes (LSEG 2022).

Nevertheless, much more will be required to strengthen SME business models and the financing fabric to enable more robust and effective participation in AfCFTA platforms and protocols such as trade in goods and services. This becomes especially significant for ensuring investment and operational readiness and promoting a more functionally effective entrepreneurial culture such as exists in many Asian countries whose economies have grown on the backs of SME inventiveness (Fofack 2020).



The problem of the “missing middle”

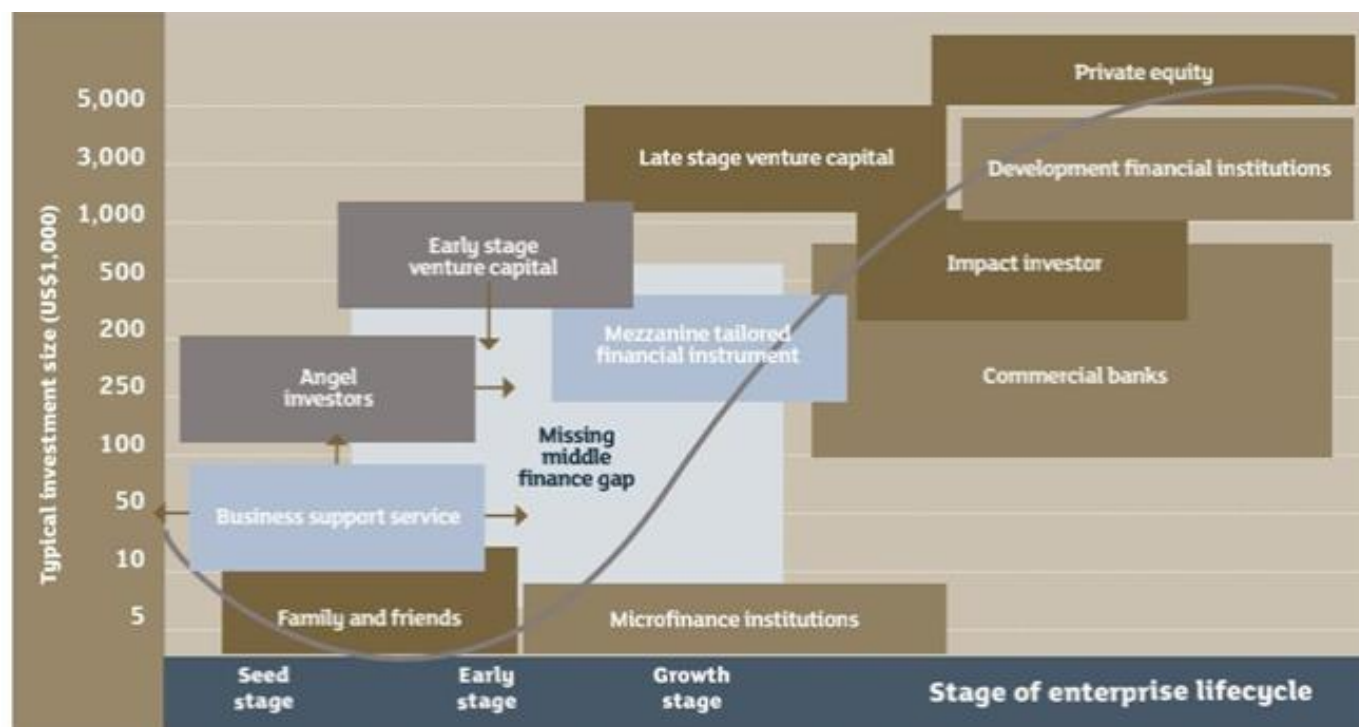
Taken together, the financing challenges highlight the plight of the “missing middle” in the SME landscape which is a sizeable demographic where there are serious financing deficits, exacerbated by a lack of visibility to investors. The “missing middle” are characteristically African SMEs and business entities with 5 to 250 employees and with capital requirements of between US\$20 000 and US\$2 million.

As is evident from Figure 1, those SMEs in the “missing middle” category have passed the seed stage of establishment and have graduated to the early stage of business operations and transactions with progress being registered towards steady growth. Depending on their size, there are a variety of financing instruments and services available to assist them during this phase, including family and friends, angel investors, basic forms of venture capital, and microfinance.

However, it is at this point of their life cycle where they struggle to negotiate the development curve which requires larger injections of capital from banks, impact investors, private equity firms, and development finance institutions. The main reason is that “missing middle” SMEs tend to be too large to obtain funds from microfinance institutions, but are too small or prone to risk to acquire adequate growth capital from conventional debt and equity investors, commercial banks, and development finance institutions (Alibhai, Bell, and Conner 2017).

This financial struggle is a pervasive problem and challenge for SMEs, and will be more so as they attempt to enter what will be competitive market conditions in the unfolding AfCFTA context (UNDP/ECOWAS 2021).

Figure 1: The SME “missing middle” financing gap in Africa



Source: LSEG Africa Advisory Group (2022)

Notwithstanding this pervasiveness, there have been positive trends in the increase of angel investor groups, networks, and initiatives across the continent. However, this does not suffice for either meeting the scarcity of available capital for SMEs; or addressing the structural and persistent financing problems of the “missing middle”, what with the credibility and trust deficits that they have to endure under difficult operating conditions (Runde, Savoy, and Staguhn 2021).

There is thus an overwhelming imperative for state parties to the AfCFTA, regional and continental bodies, and other stakeholders in the financing industries to create an enabling environment of credit and financing opportunities for SMEs so that they are better integrated into relevant policy matrices and operational platforms. This relates especially to the relevant provisions of Article 3 of the AfCFTA such as making it easier for SMEs to trade; removing non-tariff barriers; building expertise in intellectual property, investment, competition, and e-commerce; and lowering taxes and tariffs between state parties.

The provisions of Article 3 can usefully be tested in the crucible of an important study by the International Trade Centre, a joint agency of the WTO and the UN. The study examined 94 value chains in 23 sectors as potential drivers for boosting intra-Africa trade and where SMEs could play a pivotal and impactful role (ITC 2022).

What can factoring do?

Factoring is typically viewed through the lenses of providing solutions to cash flow problems. However, it does offer other benefits that extend beyond facilitating immediate access to capital, even though this remains its essential *raison-d'être*.

Immediate finance solutions

Barriers to accessing finance also throw up barriers to poverty reduction and economic growth. In this regard, factoring could be a gamechanger in two respects: accessibility and affordability of finance. Factoring enables better access to finance for SMEs; and it makes the cost of capital affordable. In this sense, factoring provides immediate solutions to the problems encountered by SMEs in the “missing middle” since as a transaction involving a financial business and as a debtor finance arrangement, its main function is to enable a business to sell its accounts receivable to a factor at a discount (Korankye-Sakyi and Oluyeju 2022).

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In constrained and difficult credit market environments such as those that exist in many African countries and sub-regions, factoring interventions provide immediate solutions to meeting pressing financial needs so as to enable a business not only to survive in competitive and demanding conditions but also to grow and prosper. Factoring also includes other significant trade-related services from which SMEs in the “missing middle” stand to benefit such as collecting the receivables, managing the receivables ledger on behalf of the creditor, and protecting the creditor against bad debts or debt default.

Factoring techniques

There are two strategic techniques of factoring which are advantageous for “missing middle SMEs. The first is its recourse or non-recourse nature. In recourse factoring, the factoring entity has a claim (in other words, recourse) against the debtor for any default in payment; that is, there is no credit protection for the seller. In non-recourse factoring, by contrast, the factor not only takes on responsibility for the invoices, but also most of the default risks since the factor does not have recourse against the supplier in the event of default; that is there is credit protection for the seller. The latter is especially suited to assisting Africa's SMEs in a developing country context and is an important underpinning of blended finance practices in making capital more accessible and affordable (Runde, Savoy, and Staguhn 2021).

A recent innovation which could have a significant bearing on SME participation in intra-regional and cross-border trade under the AfCFTA has been in supply chain finance, known as reverse factoring. This form of factoring makes working capital available by allowing the business to extend its terms of payment to suppliers with an option for early payment based on approved invoices. In other words, the factoring company buys the accounts payable without recourse from buyers with established and credit worthy credentials, thereby limiting the credit risk to more manageable proportions.

Supply chain finance is another tool of blended finance which could open new vistas for SMEs in export factoring which involves cross-border and international trade. Besides the client and export factor in the same area, it involves an import factor located in the customer's area in another country. The import factor helps to determine creditworthiness, collects the money on the due date, and sends this to the export factor.

Even though an integral component, factoring can be distinguished from other tools of blended finance such as conventional loans, equity, grants, or technical assistance. Its game changing attribute pertains to a financing model for domestic and international transactions that is more efficient, effective, flexible, and reliable. It has proven its pedigree as a short-term financing facility the world over (FCI 2022). Moreover, and especially for the “missing middle” demographic of SMEs, factoring generates a virtuous circle by:

- providing a credit management service that enables greater space for business growth and expansion;
- assisting with the expeditious collection of debt which greatly improves cash flow;
- reducing the risk of bad debts; and
- providing credit protection which eliminates the risk of bad debts (Irungu, Kibuine and Muhoho 2019; ACBF-Afreximbank 2021).

Policy Considerations

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These reflections elicit three dimensions that have implications for policy:

- **The information dimension:** It is a safe assumption that most SMEs do not have sufficient knowledge and information about the technical, substantive, legal, and regulatory requirements to benefit from the AfCFTA as a single continental market for goods and services. Using the UNDP/ECOWAS guide as an instructive medium, the ACBF with the support of the AfCFTA secretariat, and relevant agencies of UNECA, the AUC, and the AfDB should develop and distribute such manuals for SMEs across all RECs but in all languages of the AU. To ensure broader understanding, this should be accompanied by regional workshops which target the widest and broadest participation of SMEs.
- **The ‘missing middle’ dimension:** The Afreximbank's Factoring Unit with the assistance of the ACBF, the secretariats AfCFTA and the AfDB's Making Finance Work in Africa should conduct a comprehensive survey to get a better empirical handle on the quantitative representation of the “missing middle”. The methodology should include an assessment of their sectoral interests, national and geographic spread, and management ability to qualify for financing modalities that will assist them to engage in regional value chains, cross-border trade networks, and intra-regional markets. The ITC study (2022) forms a useful conceptual and empirical basis for components of the survey.

- **The factoring and financing dimension:** As an integral part of the blended finance toolkit with a global value of US\$152 billion, factoring must be made more attractive to SMEs, especially those caught in the uncompromising and nether world of the “missing middle”. This presents an opportunity for the Afreximbank's Factoring Unit, the AfCFTA secretariat, and FCI in partnership with the ACBF to shape a new discourse on factoring as a *sine qua non* of accessible and affordable finance. This exercise can be complemented and supported by relevant and potential networks which could contribute to developing a base of accessible and affordable factoring as well as putting in place appropriate support systems for SMEs. These include the AfDB, UNECA, the AUC, and the Africa Finance Corporation, identified private equity and venture capital actors in domestic capital markets, development finance institutions, donor agencies, and international financial institutions. They could come together in a collaborative endeavour to create an enduring factoring and finance product that best empowers SMEs to participate and benefit from the letter and spirit of the AfCFTA.

Conclusion

This Policy Brief has attempted to cast the spotlight on how factoring could be a game changer in spurring the consequential participation of SMEs in the AfCFTA ecosystem. While challenges remain and are material to the future success of the AfCFTA in knitting together a continent that is united in its diversity, factoring paves the way for a radical overhaul of the financing and credit deficiencies and defects that have undermined the progressive role of SMEs in poverty reduction and economic growth.

Finally, if properly managed, particularly as regards crowding in the “missing middle”, factoring could provide not only much-needed trade financing but could also be a major stimulus for improved market integration and increased intra-African trade.

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