INNOVATIVE FINANCE FOR

PRIVATE SECTOR DEVELOPMENT IN AFRICA

HIGHLIGHTS FOR BUSINESS

ECONOMIC REPORT ON AFRICA 2020

United Nations
Economic Commission for Africa

CHAPTER 1: RECENT ECONOMIC AND SOCIAL DEVELOPMENTS IN AFRICA

RECENT NUMBERS:

- Africa is the second fastest growing region in the world, estimated to have grown 3.4% in 2019.
- COVID-19 pandemic will impact growth to decelerate to between 1.8% and -4.1% in 2020.
- Growth in Africa is projected to rebound to 5% in 2021, supported by the effective implementation of COVID-19 response measures and global economic recovery.
- Refer to Figure 1.1 for data on Global Economic Growth.

ENGINE OF GROWTH: **The private sector, as the engine of growth,** will **catalyse investment in infrastructure and industrialization** and so contribute crucially to implementing the The African Continental Free Trade Area (AfCFTA). **The private sector can generate productivity** and **enhance the participation of households and business** firms in economic activity, driving economic growth and prosperity. (p.10)

AVIATION INDUSTRY: Air travel **restrictions and the reduction of air travel routes has affected major African carriers.** The International Air Transport Authority (IATA) projects **a $4 billion drop in revenue for African airlines.** The effect is aggravated for airlines that were weak before the pandemic and will likely end up filing for bankruptcy or seeking bailouts (p.4).

FINANCING: **Bank financing to the private sector remains low,** and usually **does not fit the needs** of the private sector since about **60% is short-term** (with a tenor of less than one year), (p.14).

DIGITAL REVOLUTION AND ALTERNATIVE FINANCING: The digital revolution under way in Africa, mainly based on mobile phone networks, presents **opportunities for sustainably developing finance.** The infrastructure is suitable for developing prepayment systems, and **if telecommunications companies and banks collaborated, prepayment systems could be replaced by bank account transfers** (p.20).

ALTERNATIVE FINANCE, especially crowdfunding, is another **fast-growing market in Africa. Crowdfunding** presents some difficulties, since entrepreneurs must spend time building a base of contacts that will contribute capital and promote the campaign, but it **can have non-monetary benefits**, such as increased credibility and market awareness (p.21).

Check out the case study “DIGITAL SOLUTION AND LENDING: TWO EXAMPLES FROM KENYA” on p. 21.

CHAPTER 2: THE PRIVATE SECTOR IN AFRICA

A robust and vibrant private sector is vital for inclusive and sustained economic growth. Indeed, the private sector is the engine of economic growth. (p.28)

The **infrastructure gap** in Africa not only challenges private sector development but also offers Africa's **private sector an opportunity to invest**. (p.28)

GROWTH: More than **700 private businesses** in Africa are large enough to **generate more than $500 million** a year in revenue. **Large companies** (with 100 or more employees) **generate between $1 billion and $1.4 trillion a year** in profits. (p.29)

Agriculture: the current **financing needs of Africa's 48 million** smallholder farmers are estimated at about $450 billion. (...) Innovative financing mechanisms are needed, such as cooperative groups; value chain frameworks or out grower schemes binding farmers to supply products to a particular firm, which can be linked to public-private partnerships (PPPs); and mobile money for the private sector (...). (p.30)

CHALLENGES TO PRIVATE SECTOR DEVELOPMENT: **Easy, affordable and reliable access to infrastructure** (particularly energy) and finance are **the two most cited obstacles** affecting the operation of businesses in Africa. **Access to electricity** is cited by **20.7%** of firms in Africa as the main obstacle, and **finance by 19.6%** (p.38). See figure 2.4 "Main obstacles to businesses in Africa" on p.39, and figure 2.5 "Main obstacles to the operation of businesses in Africa, by company size" on p.42.

ENERGY: **Some 79% of firms in Africa experienced electricity outages** between 2007 and 2018, and the average effective cost of electricity for manufacturing enterprises in Africa is close **to 20 cents per kilowatt-hour**, **about four times higher than industrial rates elsewhere in the world** (p.38). (...) The gap between demand and supply is a chance for the private sector to invest in the energy sector, to power industrialization and to stimulate growth, employment and trade, especially given the prospective benefits of the AfCFTA. (p.39)

COVID-19 PANDEMIC: African businesses expect **a slow recovery** from the crisis and a **drop in revenues by an average of 30–40%**, with small companies expecting to be affected worse. *Read more about the Potential impacts of COVID-19 on African businesses on p. 43 and 44.*

THE AFRICAN CONTINENTAL FREE TRADE AREA (AfCFTA): African firms need to industrially upgrade through participating in global value chains. AfCFTA provides an opportunity **AfCFTA provides an opportunity** for African countries to learn by doing how to **develop competitive regional value chain**s, a much needed step towards participating in global value chains. (p.35) Under the AfCFTA, it is assumed that tariff and non-tariff barriers to trade will be reduced and so reduce the cost of business operations. (p.50)

CHAPTER 3: ACCESSING FINANCING FROM THE CORPORATE BANKING SECTOR IN AFRICA

Most financing mechanisms in Africa are bank-based, and banks are a major source of innovative financing in Africa.

Financing: the banking sector is the main source of finance for the private sector in Africa, yet the ratio of bank credit to GDP is very low, less than 30% in 2019, compared with 47% in Latin America and the Caribbean and 94% in Europe and Central Asia. (p.61)

GROWTH: Though still small, **the African banking sector is one of the fastest growing and most profitable in the world** (FIGURE 3.2), making it one of the key sectors propelling economic growth on the continent. (p.61)

EXPANSION: The low levels of financial inclusion in Africa mean that there is **massive potential for growth** if the banking sector can bring financial services to underserved and unserved populations. **Expanding inclusion will lead to rising deposits and to financing** that can increase capacity for businesses. (p.62)

COMPETITION: Deregulation has relaxed entry barriers, paving the way for competition in the banking sector. (...) **If domestic banks are not structured properly** to enable them to compete on pricing, they are **likely to face tough competition from new pan-African entrants.** (p.65)

AfCFTA: With the establishment of the African Continental Free Trade Area (AfCFTA), and liberalization of financial services as one of the priority service sectors, **African banks will have the opportunity to tap into a continental market of over 1.2 billion consumers.** (p.65)

EXTRACTION: **As mining firms continue to grow, traditional banks in Africa may have to forgo financing** for some of these projects because of perceived high risk and limitations imposed by international regulations. Similar dynamics are also observed in oil and gas firms. (p.68)

SMES: As small and medium enterprises (SMEs) scale up production to enter other markets in Africa and engage in cross-border activity, **they will need trade finance and other types of credit to ramp up their business.** (p.69)

CHAPTER 4: TAPPING INTO THE POTENTIAL OF AFRICAN MARKETS

In other parts of the world, financial markets complement bank finance as another source of financing to the private sector, but in Africa they are small and undeveloped, largely dominated by commercial banks.

CAPITAL MARKETS: they provide not only an alternative for additional private sector fund raising, but also an **alternative to regular bank deposits for investors to save and to gain returns**. (p.74)

EQUITY MARKETS: they serve as a **fundraising platform for businesses** that require large amounts of capital to expand and as a sales vehicle to let entrepreneurs lower their stake in the business. Participating in equity markets **provides African investors and businesses** higher **name recognition, access to the public debt markets** and other varieties of **financing instruments, raise funds and diversify their savings.** (p.75)

LISTING REQUIREMENTS: stock exchanges often require that businesses meet **certain thresholds** before being listed. Businesses must also **align their accounting practices with the regulations** set forth by the stock exchange or regulatory authority. **Read more on p.77.** In recent years, African stock exchanges have started setting up secondary boards to offer **not-yet-profitable smaller companies** and **start-ups an opportunity to access equity markets** for fund raising (p.78).

INITIAL PUBLIC OFFERING (IPO): With more than 1,200 public offerings completed in 2019, the African IPO market represented **1.4% of the $1.2 trillion worldwide value of IPOs** (p.79). Refer to Figure 4.2: Initial public offerings by selected African exchanges, 2014-2019, p.78.

PRIVATE INVESTMENT MARKETS: In 2019, $106 billion in private capital was raised worldwide, but only $1.1 billion in Africa. **The number of deals in Africa increased** from 158 in 2014 to match its 2013 historic high – **186 deals in 2018.** (p.86). Check out Figure 4.6 "Share of African private investment deals by region, 2013-18" on p. 87.

OPPORTUNITIES: **Africa's growing population, emerging middle class**, rising food prices and increasing **value of the food market** (projected to reach $1 trillion by 2030) **present investment opportunities** for the private sector in both farmland and agribusiness. (p.89)

CHAPTER 5: LONG-TERM FINANCING FOR SUSTAINABLE DEVELOPMENT IN AFRICA

The cost to achieve the SDGs by 2030 in Africa is estimated at about $1.3 trillion a year, according to the United Nations. That could increase to $19.5 trillion as a result of population growth– projected to be 43% over 2015–2030.

SUSTAINABILITY BONDS: The **integration of environmental, social and governance** (ESG) considerations and sustainability increasingly **attracts environmentally and socially responsible investors**. It also offers Africa a **unique opportunity to mobilize private capital** for financing infrastructure development and large-scale economic activities. (p.99)

THE GREEN BOND MARKET: **The investment opportunity** to address climate change in emerging market cities is estimated at **$29 trillion by 2030**. The **key sectors** of such an investment opportunity include **green buildings, electric vehicles, public transport infrastructure, climate-smart water, renewable energy and municipal solid waste management.** (p.100)

FUNDING: In Africa as in many other developing countries**, the infrastructure sector does not attract much private investment and funding**. Private financing accounted for only 11% of infrastructure funding in Africa in 2018 (p.107). Check out "figure 5.3 - Infrastructure investment by international lenders and donors, national governments and the private sector in Africa" on p.108.

INFRASTRUCTURE INVESTMENT: due to considerable risks, demand must be great enough to cover capital and operating costs, creating risk for those investing large amounts of money in hope of future demand. So, **private investors willing to take the risk will demand a large risk premium for their investment**, or else guarantees, for example, of traffic. (p.110)

DEVELOPMENT BANKS: **they can provide funds to the private sector** through loans or equity; with a diversified portfolio integrating riskier and less risky projects, they can fund their operations through revenues and through funds levied on the market. (p.111)

CHAPTER 6: LEVERAGING GLOBAL INNOVATIONS IN FINANCIAL TECHNOLOGY IN AFRICA

The global fintech revolution is expected to triple access to financial services in Africa, creating a new market of 350 million customers. In Africa, fintech is reducing costs and risks, as well as extending service to unbanked populations.

ALTERNATIVE SOURCES: Africa's financing gap has provided a **unique opportunity for fintech development** to furnish alternative finance sources and investment mechanisms, particularly for start-ups and micro, small and medium enterprises. Two key fintech activities, **crowdfunding and crowdinvesting**, grew over 2017-2019 and **are projected to keep growing** during 2020-2023 (p.121).

CROWDFUNDING: It is currently **more prominent than crowdinvesting in Africa**, though Statista forecasts that crowdinvesting will surpass crowdfunding in 2022. (p.121) Refer to Table 6.1, "Alternative financing in Africa, 2017-2023" on p. 122.

MOBILE MONEY: Among fintech innovations, **mobile money** and **digital payments** are areas where Africa has made significant inroads. Almost **half of total global mobile money accounts are in Africa**, which had 396 million registered users and 1.4 million agents serving them in 2018. (p.125)

DIGITAL PAYMENT SYSTEMS: It is **growing fast in Africa**, along with e-commerce. Major e-commerce platforms offer multiple payment methods on their websites and apps, Table 6.4. (...) while **most e-commerce firms operating in Africa are local,** a **substantial portion of payments processed** on these platforms happen on **foreign-owned card and payment schemes** (p.126). Refer to "Box 6.1 - Regional developments in e-commerce", on p.128.

FUNDING: The emergence of fintech across Africa has opened new avenues of funding for businesses and has led to the emergence of new financial service providers, new financial instruments such as **crowdfunding** and **mobile money services**, **new currencies** such as cryptocurrencies and even new ways of conducting conventional banking such as **online banking** and **electronic payment systems** (p.130).

SMES: Fintech has the **potential to overcome some of the financial constraints** faced by Small and Medium Enterprises (SMEs) as a consequence of the complexity of SME financing. (...) **Fintech,** including data analytics, **is closing the financing gap in the SME sector** through innovation in credit appraisal, underwriting, origination and servicing (p.131).

CHAPTER 7: REGULATIONS TO SUPPORT FINANCING IN AFRICA

Africa needs to rethink its financial services regulation so that innovation is fully functional, the environment enables innovation, transparency is enhanced, and financing for private sector development is delivered.

CONFIDENCE FOR BUSINESSES: **Appropriate, effective and enabling regulatory frameworks** for all financial intermediaries operating in Africa **will give confidence to** a new breed of **fit and proper entrepreneurs**. The **frameworks will introduce new financial service platforms and innovative products**, whose competitive arena will become more transparent and will open up to new players. (p.137)

MOBILE PAYMENT: The **use of mobile payment systems is growing**, helping to fill the vacuum in the **unbanked segment of communities across Africa**. Domestic transfers through mobile payment platforms pay for a wide range of services, from school fees and rent to utility bills and wages. **The importance and extent of the financial services** provided through mobile platforms **should not be underestimated.** (p.143)

RISKS: Many African economies are dominated by a small number of sectors, normally the **producers of cash crops or natural resources**, such as oil and gas. **Bank lending tends to concentrate on firms and households in those sectors**, so great macroeconomic risks are associated with lending portfolios vulnerable to commodity risk. (p.146)

SMES LENDING: **Lending to small and medium enterprises (SMEs)** has been **considerably affected by regulations**. Read more on the Impact of regulations on small and medium enterprise funding on p.145.

CHAPTER 8: CONCLUSIONS AND POLICY RECOMMENDATIONS

This chapter summarizes the key aspects of innovative financing for the development of the private sector in Africa. Five messages are key (refer to Figure 8.1)

1 - **Financing innovations can arise from multiple sources simultaneously.** Businesses need to consider leveraging different sources according to their financing needs (banks, fintech, financial markets, capital markets, development banks)

2- **A transparent and effective regulatory institution** is mandatory to minimize risk and oversee the financial operations of firms and peer institutions.

3- The **absence of a sound eco-system can impede firms** even when financing is readily available. This affects firms of all sizes, depending on their stage in the growth cycle.

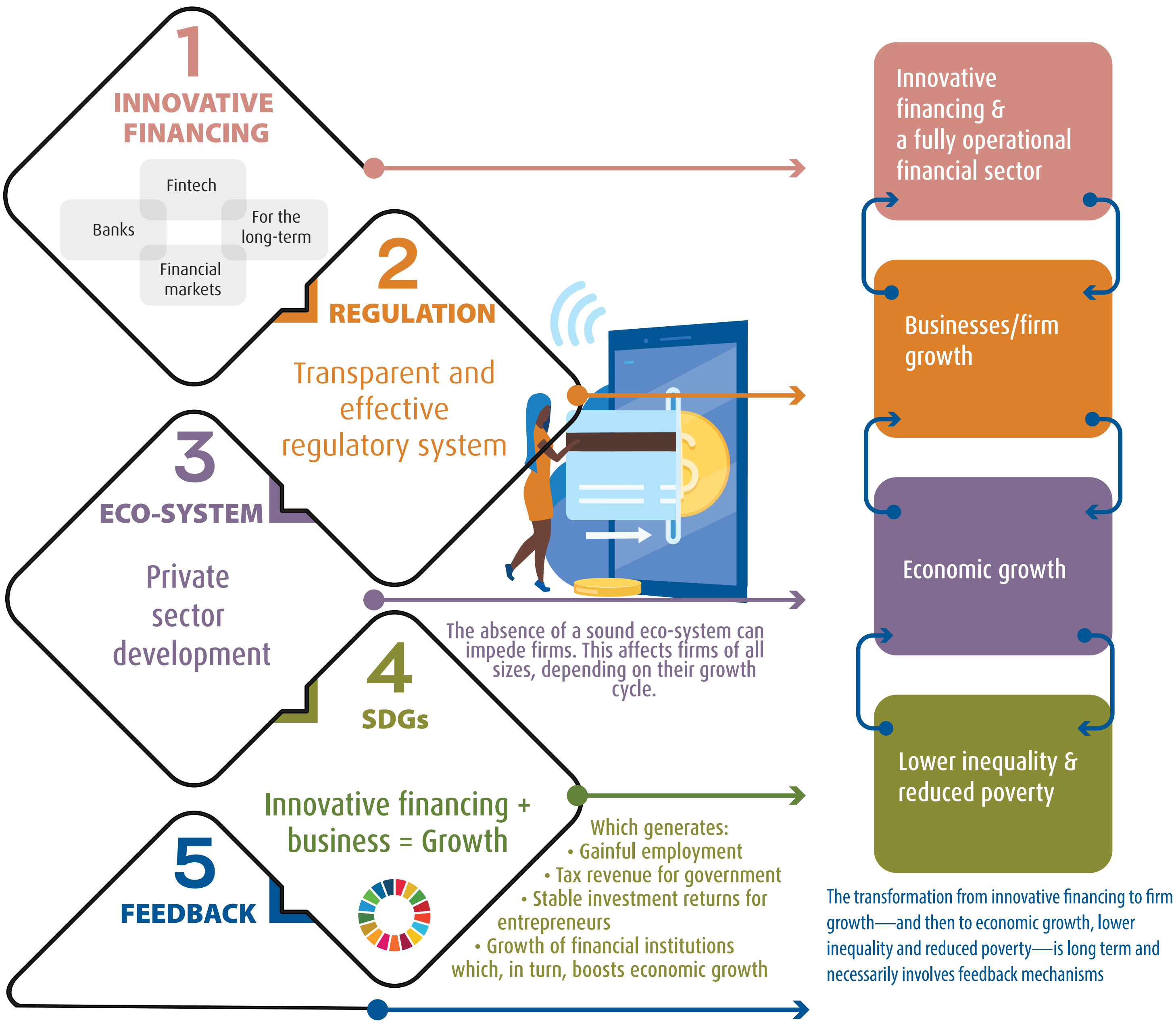
4- **Innovative financing** of the private sector and business growth **generates**: firm value added, gainful employment, tax revenue for government, stable investment returns for entrepreneurs, growth of financial institutions.

5- The **transformation** from innovative financing and from a fully operational financial sector to economic growth, lower inequality and reduced poverty is long term and **necessarily involves feedback mechanisms**.

FINANCING CHALLENGE: Over 2020–2030, **the private sector in Africa** is expected to play **an important role in enabling economic recovery** from the COVID-19 pandemic, increasing economic prosperity and achieving the SDGs. (...) However, **financing is one of the major impediments** to private sector development in Africa. The recent outbreak of COVID-19 is a threat and aggravates the already major challenge in finding financing. (p.159). Financial markets might be expected to complement bank finance as another source of financing to the private sector (p.161).

AFRICAN CONTINENTAL FREE TRADE AREA (AfCFTA): creates **opportunities for internationalization** by supporting the **development of regional** and **global value chains** in which manufacturers that rely on embedded and embodied service inputs can source such inputs locally in the continental market, **creating jobs, adding value and expanding their share of the global market**. (p.158)

PRIVATE SECTOR DEVELOPMENT AND SDGS



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