INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
OF UGANDA

ALTERNATIVE FINANCE MECHANISMS FOR SMEs

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ABOUT ICPAU

The Institute of Certified Public Accountants of Uganda (ICPAU) was established in 1992 by an Act of Parliament now the Accountants Act, 2013. The functions of the Institute, as prescribed by the Act, are:

i. To regulate and maintain the standard of accountancy in Uganda.
ii. To prescribe and regulate the conduct of accountants and practicing accountants in Uganda.

Vision

To be a world-class professional accountancy institute.

Mission

To develop, promote and regulate the accountancy profession in Uganda and beyond.

Core Values

Professional Excellence
Accountability
Integrity
Innovation

International Affiliations

The Institute is a member of the International Federation of Accountants (IFAC), the Pan African Federation of Accountants (PAFA) and the Association of Education Assessment in Africa (AEAA).

ABOUT THE FINANCIAL SERVICES WORKING GROUP

The Financial Services Working Group (FSWG) was established by the Council of ICPAU to foster dialogue, collaboration and knowledge-sharing among experts and policymakers in the financial services sector in Uganda. The output of FSWG are technical tools and policy recommendations made to relevant stakeholders to develop and strengthen the stability of the financial services sector in Uganda.

To achieve its objective, the FSWG represents a broad range of market participants from the following sectors:

- Regulatory Bodies including Bank of Uganda (BoU), the Insurance Regulatory Authority of Uganda (IRA), the Uganda Retirement Benefits Regulatory Authority (URBRA), Uganda Microfinance Regulatory Authority (UMRA) and the Capital Markets Authority (CMA).
- Investment fund Management;
- Banking Services;
- Security Broker/Dealers
- Pension funds;
- Insurance companies and insurance brokers;
- Infrastructure firms, particularly support firms within technology advancements;
- Trade associations representing relevant sectors and markets.
- Auditors and other accounting professionals.

1.0 INTRODUCTION

1.1 In the year 2020, as communities across the globe struggled to contain the spread of COVID-19 and manage the health and human costs of the pandemic, governments were hard at work introducing large and unprecedented emergency support measures to mitigate the worst immediate impacts of the pandemic. These measures encompassed lockdowns and economic incentives that included direct cash support for households and firms, monetary policies that reduced interest rates and eased lending conditions for financial institutions, and financial sector policies such as debt repayment suspensions for households and firms, as well as credit guarantee schemes. Uganda was no exception to many of such measures.

1.2 While these crisis policies helped limit the worst economic outcomes of the pandemic in the short run, they revealed and worsened a number of economic fragilities that could threaten a sustainable and equitable economic recovery. This is a real concern considering that the economic effects of the pandemic are proving to be more persistent and severe for low- and middle-income countries like Uganda.

1.3 Notably, Uganda has an extensive MSME sector that accounts for approximately 90 per cent of the private sector, over 80 per cent of manufactured output and contributes about 75 per cent to the GDP. The sector employs over 3.0 million people, which makes it one of the largest employers in the country, according to the Uganda Bureau of Statistics (UBOS)[1]. However, about 70 per cent of MSMEs close before celebrating their second birthday. One of the major difficulties SMEs come across is the issue of access to finance. SMEs, suffer from lack of access to appropriate (term and cost) funds from both the money and capital markets. This is due in part to the perception of higher risks resulting in high mortality rate of the business, information asymmetry, poorly prepared project proposals, inadequate collateral, absence of, or unverifiable history of past credit(s) obtained and lack of adequate historical records of the company's transaction and inadequate governance structures. These underlying issues within the SMEs operational structures were worsened by the emergence of the COVID-19 pandemic.

1.4 Uganda fully opened its economy for business after nearly two years of pandemic-related lockdown and other restrictions. Nonetheless, Ugandan MSMEs continue to face operational challenges because of limited capital. Over the period 2020-2021, many businesses lost operating capital and faced liquidity challenges because of

[1] The role of Uganda Development Bank in accelerating post lockdown recovery of MSMEs in Uganda (available at https://www.udbl.co.ug/the-role-of-uganda-development-bank-in-accelerating-post-lockdown-recovery-of-msmes-in-uganda/)

the increase in operational costs, and the significant losses incurred during the two lockdowns. The situation was exacerbated by the pre-existing limited access to affordable and patient finance especially for MSMEs. In 2022, the World Bank[2] acknowledged that finance plays a central role in the economic recovery from the pandemic for vulnerable groups as well as micro, small and medium-sized (MSME) businesses.

2.0 SITUATION ANALYSIS – SMEs/MSMEs FUNDING

2.1 The Africa Competitiveness report (2017) notes that access to capital ranks among the top five most problematic factors for doing business in Uganda. To understand this financial distress paradigm, it is important to assess the possible financing options available to SMEs and the ease with which the same can be utilised by SMEs.

2.2 Since banking credit is a scale economy, it is typically more expensive on a unit cost basis to lend to SMEs compared to larger organizations. As a result, commercial banks are generally biased toward large corporate borrowers, who usually provide better prepared business plans, have credit ratings, more reliable financial information, better chances of success and higher profitability for the banks. When banks do lend to SMEs, they tend to charge them a commission for assuming risk and apply tougher screening measures, which drives up costs on all sides. Banks also tend to regard SMEs as unprofitable because of the high transaction costs involved in providing many small-sized loans as opposed to fewer large loans, thereby not making SME financing a profitable business. SME borrowers are typically required to demonstrate that they have sufficient equity to contribute to their businesses, which many small business owners usually lack. Entrepreneurs of SMEs also tend to lack traditional collateral (such as land) and the credit history needed to qualify for meaningful loans. Even when SME owners are able to access bank financing, the maturities of commercial bank loans are often too short to pay off any substantial investment.

2.3 Capital markets are still evolving in respect to SMEs. While the capital markets can be sub-divided into public markets and private markets; our main focus will be on the private markets which usually cater for the small companies. Private debt placements and private equity financing form a greater part of private capital markets. In the past decade there have also arisen alternative stock exchanges or growth markets in the public markets aimed at catering for the long-term financing needs small companies with proven track record but with a high growth potential.

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[2] World Development Report 2022: Finance for an Equitable Recovery (available at https://www.worldbank.org/en/publication/wdr2022#downloads)

Therefore, when discussing about SMEs and capital markets we are looking at how SMEs can access long-term finance through the private capital markets and the alternative stock exchanges. Sadly, the Alternative Investment Market Segment (AIMS) at the Uganda Securities exchange (USE) which targets SMEs has not registered any Companies thereon.

2.4 Development Financial Institutions (DFI) worldwide play a key role in closing the funding gap faced by MSMEs. Uganda Development Bank (UDB) is the national DFI that is mandated to accelerate socio-economic development in Uganda through sustainable financial interventions. Currently, UDB has set out to enhance MSMEs access to affordable and patient credit through several initiatives. For instance, on in 2021, UDB launched Special programs to implement and manage interventions in the categories of SMEs, Women, Youth, and Business Advisory Services from start-ups to existing businesses with appropriate financial and non-financial solutions. While the government of Uganda has been recapitalised the Uganda Development Bank (UDB) over the years to enable SMEs access funding, only 5% of these funds have been accessed by SMEs. This points to an accessibility problem regarding these funds.

2.5 Other conventional providers of finance have no confidence in the credit worthiness of the SMEs. Non-bank financial intermediaries, such as micro credit institutions, could play a greater role in lending money to the smaller SMEs but do not have the resources to monitor their SME customers when they expand.

2.6 Financial literacy levels among SME entrepreneurs, in respect to available financial products and services and their management is equally wanting. This exacerbates the constant strategic and operational hurdles faced by SMEs thereby resulting into:

- Non-compliance with government legislations.
- Low uptake of advances in technology
- Poor marketing and customer acquisition strategies
- Poor quality of products/services.
- Low productivity, low returns and eventually perennial capital constraints.

2.7 Therefore, the main source of capital for SMEs are their retained earnings and informal savings and loan associations, which are unpredictable, not very secure and have little scope for risk sharing because of their regional or sectoral focus. Financing of SMEs using internal funds or retained earnings significantly limits the business's ability to take advantage of new market opportunities, access new technology, and capitalize on the improved internal capacity and external reputation it may have earned (Gibson 2008).[3] This means that not only do SMEs have difficulty accessing finance, they also have to deal with the higher cost of finance relative to the charges that larger enterprises face. This provides a strong rationale for the exploration of alternative sources of funding for SMEs entrepreneurs.

3.0 JUSTIFICATION FOR SME/MSMEs FUNDING

SMEs are vital for economic growth and development in both industrialised and developing countries, by playing a key role in creating new jobs. SMEs need adequate financing to meet needs at each stage of their life cycle, from creation through operation, development, restructuring, recovery and beyond. Financing is necessary to help them re- set up and expand their operations, develop new products, and invest in new staff or production facilities adopt better technologies, among others. With the impact that the pandemic had on SMEs, and the fact that unlike their counter parts, the large enterprises, the SMEs find it much harder to obtain financing from banks, capital markets or other suppliers of credit, hence a need to consider alternative options of funding if SMEs are to yield any meaningful contribution to economic development.

4.0 THE ALTERNATIVE SOURCES OF FUNDING

Financing needs of SMEs vary in size, frequency and maturity, depending on their level of growth including the relative importance of fixed and working capital (Nissanke 2001, PWC 2008, and Manuel Albaladejo 2002). The sources of finance also vary from one stage to another stage of development (Nissanke 2001, PWC 2008). With the post pandemic era, the ultimate goal of any enitity is to stay afloat. As such the funding modalities of SMEs should seek to ensure that the entities survive at least to a foreseeable future when the circumstances change to warrant sustainable growth agenda. With hurdles associated with the modes of financing discussed above, the FSWG proposes the following alternative sources of funding for MSMEs/SMEs sustainability:

(i) Government funding through Grants and other support schemes such as Business Incubators & Accelerators' recovery packages. This can be achieved with set criteria particularly focusing on the evaluation of an entity's decline in turnover over time. This could be by way of assessing the viability before the COVID-19 crisis and ensuring that beneficiary companies had a decline in turnover caused solely by the pandemic. The extent of decline can be assessed by an agreed-upon percentage for an agreed-upon period.

[3] Gibson Thomas (2008). Alternative Risk Capital Strategies for Africa's SMEs. A Paper presented at the High-Level Seminar on African Finance for the 21st Century, Tunis, Tunisia

(ii) Non-collateralized debt instruments – These debt schemes, supported by the government, may be extended to SMEs/MSMEs through commercial banks or development banks. They should specifically target viable firms (with prospects to grow), and companies owned by vulnerable groups. SMEs Kazi loan products of the Uganda Development Bank (UDB) fall under this category but there may be a need to re-think the criteria considered to access these loans.

(iii) Asset-based lending – To suit the operations of SMEs, asset-based lending can be provided against a wider pool of assets such as stock, property, plant, machinery, and sometimes intangibles such as forward income streams. This maximizes the cash available to the business to support plans.

(iv) Venture capital - Equity finance such as venture capital and business angel finance, can offer mentoring, business advice, and access to networks, which can improve the success rate of SMEs. In addition, it can provide entrepreneurs with useful resources to better adapt to new business conditions and consumer behavior changes as a result of the pandemic.

(v) Leasing - In the case of leasing, SME owners can acquire liquidity by providing the right to use an asset they own in exchange for payments for a specified period. In the recovery, while the economy and consumer demand get back on track, leasing can enable businesses to have liquidity while they return to the pre-pandemic levels of operations.

(vi) Hire Purchase Finance – Consumer demand is expected to reduce in the post-covid era. To guard against tying up capital in unsold inventory, MSMEs can enter into hire purchase financing arrangements with their clients. Under such arrangements, goods are sold and payment is made by the client in multiple instalments over an agreed period. To compensate the vendor, each instalment consists of a finance charge (interest) and the principal amount. This arrangement also guarantees the availability of liquidity and cash flows for the SME to meet its day-to-day financial obligations. The reverse of hire purchase financing between the SMEs and their suppliers is relevant and will ensure proper liquidity management at least in the short to medium term.

(vii) Debt factoring – SMEs that sell their products on credit can access finance by selling unpaid customer invoices to a debt factoring provider, also known as a factor. After the sale, the factor owns the debt and follows up on payment from the customers. At the onset of the sale, the factor advances the majority of the value of customer invoices while the balance is made available once invoices are paid, minus charges. Debt factoring improves cash flow by assuring invoice payment much sooner. This method combines the provision of finance with a service element, helping SMEs with effective credit control.

(viii) Invoice financing – This is similar to debt factoring, as it also involves SMEs using unpaid invoices as collateral to secure funding. However, this type of financing allows SMEs to access funds based on the creditworthiness of the debtor, before the SME but also the SME creditworthiness before the finance provider.

(ix) Bank overdraft – This is a flexible form of financing that allows SMEs to borrow money up to an agreed limit. Interest is charged only on the amount borrowed and for the period the overdraft facility is used. Bank overdrafts can be a useful tool for managing cash flows and short-term expenses.

(x) Equity capital – Equity, and in particular quasi-equity tools in recovery packages seek to fund SMEs in ways that are adapted to their needs. These can take any of the following forms:

- Participative loans: Where remuneration is linked to the firm's performance. It can be linked to a firm's sales, turnover or profits, and both interest rate and capital repayment can be contingent to the firm's results.
- Subordinated binds: These refer to unsecured bonds and offer the investor periodical interest payments and full redemption at maturity.
- Debt for equity swaps: This is an instrument used by companies and shareholders to exchange debt for shares to resize debt and improve the capital position of the borrower. When the swap is made, debt is written off (reducing a company's leverage) and in return, the lender will have a share that once the business recovers is sold or floated.

5.0 RECOMMENDATIONS

(i) Equity markets provide fewer opportunities for SMEs than for large firms. This trend suggests a concentration in large firms and high barriers to entry for SMEs, given the high costs associated with going public. As part of the recovery strategy, there is a need to change regulatory frameworks to facilitate equity investment for SMEs. One of the reforms should be an approval aimed at easing the process of issuing capital by SMEs and making it easier for investors to access SME information.

(ii) Discipline in loan management – SMEs can improve their creditworthiness by applying improved loan management strategies such as:

- Drawing up clear budgets to ascertain the monthly cash flows. This allows the SME to better understand how much it can afford to pay towards borrowings/loans.
- Assessing plausible sources of loans and avoiding spontaneous borrowing.
- Prioritizing loan re-payments which have the highest interest rates and severe consequences for missed payments.
- Considering automatic payments, such as standing orders, to avoid surcharges on missed obligations.
- Avoiding unnecessary spending.

(iii) Financial literacy - There is need to improve knowledge, skills and work ethics of SME entrepreneurs through trainings on financial management, governance and legal and economic environments that affect SME businesses among others.

(iv) Loan Refinancing – An SME that has multiple loans with high-interest rates can manage its portfolio of loans by negotiating loan terms. This should effectively seek to result into favourable changes to the interest rates, payment schedules or other terms.