Why SMEs default in sub-Saharan Africa: the example of ARIZ
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Using the example of ARIZ, the final report on the study as to why small and medium-sized enterprises in sub-Saharan Africa default to identify the problems faced by African SMEs, determine the reasons for payment defaults on bank loans taken on by SMEs, and distinguish perception from reality on the ground.

In sub-Saharan Africa, as in the rest of the world, national economies include a large number of very small, small and medium-sized enterprises (MSMEs), which represent the largest creator of jobs. Yet the increasing economic growth experienced by a number of sub-Saharan African countries over the last decade has not been reflected in job creation nor in more equitable wealth distribution. As a result, African governments are currently rethinking ways to stimulate inclusive economic growth, as well as respond to the needs of rapidly urbanizing communities and the rising youth numbers. The quantity and growth of SMEs is a major priority among these concerns, given their fundamental role in the economy. Notwithstanding, growth in new and existing SMEs in Africa remains extremely limited, largely due to a lack of financing options.

REMOVING OBSTACLES TO FINANCING

In fact, lack of access to financing is the biggest impediment to the growth of small businesses in sub-Saharan Africa, even more so than governance problems, a lack of infrastructure or heavy tax burdens. SMEs are often cut off from access to much-needed capital in order to grow and develop. The availability of financial capital (debt, equity capital) is thus inadequate, and SMEs are often perceived negatively by financial actors. An SMEs’ legal status makes little difference to the banks, which are reluctant to make loans given the risks entailed. Many businesses’ ability to access financing is closely linked to the interest rates they are charged.

Over the last 15 years, the Agence Française de Développement (AFD), the French development agency, has been working to help SMEs in developing countries secure access to financing through a risk-sharing mechanism called ARIZ. With access to extensive data on almost 7,400 guaranteed credit lines in the region, the AFD set its sights on producing an unprecedented analysis of the reasons behind defaults among sub-Saharan African SMEs. Several conclusions were drawn from the study, which was published in 2019.
MAIN CONCLUSIONS

- Firstly, SMEs are sensitive to problems related to delays in customer payments (including from the State) and suffer from structuring and management skills deficits, which leads to poor management decisions (such as, too much diversification) or poor financial decisions (for example, taking on too much debt, or taking on debt that is too expensive).

- The SMEs are also sensitive to local infrastructure-related problems (acute or chronic failures in roads and energy), but also to political crises. Currently, environmental crises are rarely cited, except in Madagascar.

- To a lesser degree, the client’s knowledge of the ARIZ guarantee and the level of risk taken on by the bank are recurring factors in defaults.

- Policies that support SMEs (from expediting registration procedures to setting up warranty registries) are critical to helping SMEs’ business function yet were found to be lacking in the countries studied. Communication from governments to SMEs about efforts undertaken to support them is often inadequate.

- A number of factors have no effect on the businesses’ risk of defaulting: the amount of the loan in euros, the nature of the loan, the interest rate, the percentage of the loan guaranteed, the kind of investment, the business’ age or revenues.

- Looking at all loans combined, businesses’ first missed payments occurred around the 40% mark of the total loan period.

One study, multiple results

The first result is that in half of the cases default is provoked by a single cause, and in the other half of cases by a combination of factors (with anywhere from 2 to 10 factors cited). The ten most frequently cited reasons for loan defaults (those cited in at least 10% of cases) include:

1. Problems linked to the business’ suppliers, subcontractors or customers (36% of cases);
2. Poor managerial choices that impacted the business’ management, organization, efficiency and profits (29% of cases);
3. Changes in market features over the project’s realization—shifts in market opportunities: competition, consumers, demand shocks, decreased sales, etc. (23% of cases);
4. Financial choices and financing systems (18% of cases);
5. The financial environment;
6. Management skill deficits in the business;
7. Problems linked to local infrastructure or to challenges functioning in the local environment;
8. The final beneficiary’s awareness of the guarantee scheme;
9. The level of risk taken on by the bank;
10. Political and social environment.
• The percentage guaranteed is not significant, nor is the proportion between the amount of collateral and the loan amount.

• The risk is much higher for businesses that have not previously been clients of the bank: in such cases, the risk rises to 64%. At the same time, the risk decreases considerably when the loan period is limited to anywhere between 12 and 24 months.

• When a business is an existing a client of the lending bank, the business’ size is significant in calculating risk: business with fewer than 5 employees (9% of the total sample) have a higher rate of defaulting (27%) than those with more than 5 employees (88% of the total sample, with 5% default rate).

• «Smaller» loans (under €300K, often part of a portfolio guarantee) and «larger» loans (over €300K, often on a single-deal guarantee basis) are affected in very different ways. Larger loans are more sensitive to changes in the market.

• Interestingly, a divergence was observed between our interlocutors’ assumptions and the results of the statistical study: if the total population of businesses covered by the ARIZ guarantee is considered, there is statistically no higher risk of default by sector in the four countries studied.
Causes for defaults cited

Problems linked to the business' suppliers, subcontractors, or customers | 36%
Poor managerial choices impacting the business' management, organization, effectiveness and profits | 29%
Changes in market features over the project's realization | 23%
Financial choices and financing systems | 18%
Financial environment | 16%
Lack of management skills | 16%
Changes in market features over the project's realization | 15%
The final beneficiary's awareness of the guarantee scheme | 13%
Level of risk taken on by the bank | 12%
Political and social environment | 5%
Loan diverted from its original purpose | 5%
Legal and fiscal environment | 3%
Growth crisis | 2%
Technical and technological factors | 2%
Macroeconomic environment | 2%
Geographic, climate and epidemiological environment | 1%
Education and skills-development issues | 1%
Human capital | 1%
Culture | 1%
Work force | 1%

The main causes of loan defaults

In half of cases, default results from a single cause, while in the other half it results from a number of factors (from 2 to 10) combined. The most commonly cited factors in defaults are:

- Problems linked to the business' suppliers, subcontractors, or customers: 36% of cases
- Poor managerial choices impacting the business' management, organization, effectiveness and profits: 29% of cases
- Changes in market features over the project's realization: 23% of cases
- Financial choices and financing systems: 18% of cases

Relationship between loan period and time before first missed payment

A linear relationship between the loan period and the time before the first missed payment is plausible. As a result, the moment of the first missed payment would be a function of the length of the loan. On average, the first missed payment occurs 40% of the way through the loan period, or 40% of the way through the first period beginning with the first due date and ending with the last due date. The ratio between the length of the loan and the time before the first missed payment is 19% for the first quartile, 36% for the midpoint and 58% for the third quartile.
This brochure, in the form of an executive summary, presents the final results on a study as to why small- and medium-sized businesses default in sub-Saharan Africa, using the example of ARIZ. The goal was to identify the difficulties faced by SMEs face and to determine the causes for default on the SMEs’ bank loans. Commissioned by the Agence Française de Développement (AFD), the French development agency, this study is the first to undertake an in-depth analysis into the reasons behind SME loan defaults through concrete case studies, and to draw statistical analyses from them. It also reveals the drivers of success that contribute to supporting SME financing.

With the ARIZ guarantee scheme, we are now able to better understand the relationship between the challenges and mechanisms behind African MSMEs loan defaults and the sources of financing, in order to distinguish perceptions from reality on the ground.