THE AFRICAN CAPACITY BUILDING FOUNDATION | FONDATION POUR LE RENFORCEMENT DES CAPACITES EN AFRIQUE

Securing Africa's future through capacity development

Assurer l'avenir de l'Afrique en renforçant les capacités

AFREXIMBANK

Transforming Africa's Trade

African Export-Import Bank
Banque Africaine d'Import-Export

Policy Brief No. 1
2024

From Vision to Reality:
Boosting SMEs through Factoring in the AfCFTA Era

Key Messages

- There has been significant progress with the AfCFTA's implementation programme which includes establishing the Guided Trade Initiative, the Adjustment Fund, and the SME Financing Facility.
- Across Africa, there are 44 million SMEs which account for 80 per cent of all employment.
- Given these densities, the AfCFTA and its various implementing platforms open new opportunities for generating scale economies for factoring as an innovative, alternate, and affordable source of financing for SME growth and development.
- Factoring could become a critical financing instrument for crowding in "second generation' SMEs participation in regional markets and value chains, thereby contributing to expanding the qualitative nature and quantitative volumes of intra-regional trade.
- The trade and finance infrastructure of the AfCFTA lends itself to enhanced and transaction-driven participation of the private equity and venture capital industry in Africa in terms of supporting SME financing through factoring.

Introduction

The African Continental Free Trade Area (AfCFTA) Agreement is a major achievement in its scope, promise, and ambition. Its inception in March 2018 represented a bold step in creating a conceptual, legal, and political edifice for accelerating trade and economic integration of the continent. It is precisely in creating a single market for goods, services, investment, and other production factors where, on the one hand, Small and Medium Enterprises (SMEs) stand to benefit significantly; and on the other how factoring as a modality for addressing their capital and liquidity constraints can play a formative role as a continuous source of alternate and affordable financing.

Since it came into operation in January 2021, the AfCFTA is not only the largest free trade area in terms of geographical coverage, but it brings together a market of 1.3 billion people and a combined GDP of US$3.4 billion. As of August 2023, 47 of the 54 country signatories (87 per cent) have deposited their instruments of AfCFTA ratification (AU 2023). Crucially, from its current level of 15 per cent, the AfCFTA is expected to increase intra-continental trade to 25 per cent by 2040 (UNECA 2021).

It is at the intra-African trade interface where SMEs and factoring provide a virtuous circle for stimulating economic growth and social development through regional value chains which are capable of knitting together disparate and often fragmented domestic markets. Thus, the importance of SMEs to the transformative and integrative goals of the AfCFTA cannot be stressed enough: in 2020, across the continent there were 44 million SMEs which provided 80 per cent of all employment (Borerwe 2021).

An audit of AfCFTA progress

Indicative of its resolve and determination to bring the vision to reality, the African Union has declared 2023 to be the "Year of the AfCFTA" with a sub-theme of "Acceleration of the AfCFTA Implementation". Intra-Africa trade features high on the implementation and policy reform agendas. As such, there are 43 AU member states (or 78 per cent) which have now made commitments and submitted offers to incrementally eliminate tariffs on 97 percent of all tariff lines, with the remaining 3 per cent belonging to an exclusion category of no tariff reductions (AUDA-NEPAD 2022b). Equally important is reducing barriers to trade in services with the intention of increasing Africa's income by US$450 billion by 2035 (AU 2023). It is noteworthy that the Trade in Services Protocol has received special attention because of its transformative potential to lock in the participation of SMEs, which play a prominent role across the continent's services landscape and in this regard, going forward, will be to ensure the inclusivity of women and youth in SME entrepreneurial activities.

Consequently, the AfCFTA's Guided Trade Initiative (GTI) will be a key driver for enlarging the scope of SME participation beyond national borders and across the five regions whose state parties have met the minimum requirements for trading under the Agreement. In addition, the AfCFTA Adjustment Fund (AF) is meant to support both member states and the private sector not only to effectively participate in the new trading ecosystem, but also to deal with near-term disruptions such as tariff revenue losses. The Adjustment Fund has three components, namely, a Base Fund, a General Fund, and a Credit Fund. The Base Fund is made up of voluntary contributions from state parties, as well as grants and technical assistance to offset tariff revenue losses. The General Fund will mobilise concessional funding and the Credit Fund will focus on attracting commercial funding to assist both the public and private sectors to benefit from opportunities that arise from the AfCFTA (AU 2023). Crucially, a special AfCFTA SME Financing Facility (SFF) will be an important vehicle for improving access to finance which has been the Achilles heel of their operational stability and functional integrity (AUDA-NEPAD 2022a).

For SME purposes and taken together, the GTI, the AF and its components, and the SFF plan to develop and finance trans-regional business networks and value chains through matchmaking for productive opportunities; and hence, identify baskets of goods and services that complement and support trade among the state and private parties involved. In giving life and substance to the GTI, there is an emphasis on services trade in five priority areas which also invite robust SME participation, namely, tourism, transport, business services, communication services, and financial services (UNECA 2021).

However, there is a recognition that for the AfCFTA to successfully navigate its passage from vision to reality, certain inter-linkages embodied in some of the flagship projects of the AU's Agenda 2063 must be taken into account, all of which have a direct impact on private sector activity in general but are particularly insidious for SME growth and development. These include silencing the guns to create a better environment for peace and security; addressing the increased costs of trade that arise from non-tariff barriers and challenges relating to inefficient and weak logistics infrastructure; as well as cumbersome regulatory procedures and customs processes. To this, the free movement of people can be added; and enhanced health security in the wake of the COVID-19 pandemic (AU 2023).

SMEs and the importance of factoring

The above operational background and the potential gains for SMEs that ensue from its implementation underscore the imperative of financial inclusion as a driver for ensuring that the gains from the AfCFTA are dynamic, lasting, and sustainable. Also, access to financial services is an important multiplier of creating employment opportunities and improving the participation of women and youth in otherwise anaemic labour markets.

In this regard, factoring provides a critical financing mechanism for sustaining SME "second generation" growth and development in regional markets and value chains, especially in terms of the strategic AfCFTA implementation vectors discussed above. Factoring can become an essential mechanism in the collective lives of Africa's SMEs when it comes to maintaining a healthy cash flow, meeting their financial obligations, and investing in new opportunities. For example, factoring could greatly complement the efficacy of the AfCFTA's Adjustment Fund and its SME Financing Facility.

In this new incarnation phase of the AfCFTA and in the context of the continent's economic recovery challenges in the wake of the COVID-19 pandemic, liquidity and a reliable cash flow will be the lifeblood of SME's future in Africa. Through factoring and by selling their accounts receivable to third parties, SMEs will be able to focus on growth dynamics under the AfCFTA, they will be more able to cover their operational costs, invest in new equipment and technologies, employ additional staff, improve their marketing outreach across national borders, and importantly expand into new regional markets (ACBF-Afreximbank 2021). Factoring also comes with ancillary and supportive value-added services which underpin the viability and profitability of SMEs while enhancing their profile such as better credit control and checking the credit worthiness of SME customers. This eliminates the burdens of credit investigation, bad debts, delayed payments, and credit risk (United Capital 2023).

In addition, given the anticipated embryonic exigencies and incubating contingencies of the Guided Trade Initiative, Adjustment Fund, and the SME Facility, factoring will allow SMEs the financial flexibility to adapt, innovate, and expand under the AfCFTA's new trading regime. This undoubtedly will not be easy and will require patience, skill, determination, and maturity of purpose in what will be a highly competitive intra-regional market landscape (MFW4A 2022).

While factoring is still at a nascent stage of development in Africa, it has proven its pedigree and effectiveness as a method of business financing and credit management (MFW4A 2022). While obviously not a panacea, its advantages are well established in international best practice (FCI 2023) since, for example, bank loans have stringent and onerous eligibility criteria which *ipso facto* exclude the majority of Africa's SMEs. They are typically labour intensive and have an inherent need for working capital not only to survive, but to grow and prosper. As such, SMEs constantly have to confront the structural problems of access to credit and lack of collateral in a general African business environment of widespread informality and risk aversion. These problems are compounded by non-financial constraints such as low revenue collection, poor management and administrative skills, and hardly any social protection from economic vagaries as these arise (Brixiová, Kangoye, and Urbain 2020).

Moreover, there is an astonishing mortality rate among Africa's SMEs which the influx of working capital through factoring could help to arrest. It is estimated that five out of seven SMEs fails in their first year. In Uganda, one-third of new start-ups do not survive in the first year of operation; while in South Africa the failure rate ranges from 50 to 95 per cent, depending on the sector or industry (AUDA-NEPAD 2022). There is a sad irony here since SMEs historically have been the conveyor belts of invention, innovation, new ideas, the creative use of technology, employment, and new forms of wealth creation, but have had to bear the brunt of existing deficiencies in operating support systems (Albaladejo and Schmitz 2000).

The changed and changing trading landscape under the AfCFTA further opens up an opportunity for digitally connecting SMEs and trade financiers who might be amenable to growing the factoring landscape in Africa. In this regard, it is worth examining the private equity and venture capital environment in Africa. It represents an area of investment resilience that could be encouraged to integrate factoring into its investment models under the AfCFTA's implementing instruments.

Africa's private equity and venture capital environment

Before the COVID-19 pandemic, Africa was the one of the fastest growing regions, with an average of 4.6 per cent annual GDP growth from 2000 to 2019. In turn, this robust growth was a key driver in the private equity (PE) and venture capital (VC) industry. The AfCFTA thus presents a unique opportunity for PE and VC firms to take advantage of the continent's post-pandemic investment appetite, especially in those goods and service sectors that have a high internal rate of return. These include financial services, information technology, healthcare, food production, logistics and transportation, agriculture and agribusiness, energy, fintech, construction, leisure and tourism, and education.

Because of its agility, the PE and VC industry has the potential to be a catalyst along two continuums: firstly, in assisting SME growth and development through innovation, entrepreneurship, and investment; and secondly, mobilising non-bank capital for factoring purposes, thereby increasing the number of operating entities that can focus on factoring as a profitable and mutually beneficial financing method. Furthermore, factoring could be an important ingredient in blended finance which is becoming more prominent in fund-raising. As a matter of fact, and prior to the pandemic, PE fund-raising in Africa reached US$3.8 billion in 2019 (Barry and Odoh 2021).

Factoring opens a vast opportunity landscape of capitalisation, business collateralisation, liquidity enhancement, and financial planning for SMEs such that it offers advantages as a permanent capital vehicle for investing in sectors that benefit both SMEs and AfCFTA activity streams. The AfCFTA's Pan-African Payment and Settlement System (PAPSS) is particularly salutary for the PE and VC industries' involvement in broadening the parameters of factoring for SMEs. PAPSS is a centralised financial market infrastructure that promotes and enables the efficient and secure flows of currency across national borders (AU 2023).

In conjunction with central banks, PAPSS will provide a low-cost, low-risk payment and settlement service, thereby expanding the ambit of financial inclusion to cover the continent's large population of SMEs which operate in the informal sector. Very importantly, since there are 42 currencies across the continent, PAPSS will greatly reduce the costs of currency convertibility which translates into a US$5 billion annual saving (AU 2023)

However, improving business and private sector environments is critical for realising the vast ambitions of the AfCFTA and the potential benefits that can flow from the SME and factoring nexus. This takes on added significance in terms of three risks that exercise the collective minds of PE and VC industry in the context of market dysfunctions (Eyraud, Pattillo, and Selassie 2021):

- **Project risk:** the AfCFTA has unlocked a wealth of business opportunities for large and small companies but especially for SMEs. However, the pipeline of projects and sectoral streams that are "investment ready" must be significantly expanded. Mitigating risk at this interface requires healthy support systems to assess feasibility, improve project design, and create an ecosystem of preparatory activities which develop and expand the quantum of projects, particularly those that have a trans-border and intra-regional growth appeal.
- **Currency risk:** the concern here is the ratio of return to simultaneous currency depreciation which has a direct impact on the profitability of investment. It is not surprising, therefore, that currency risk ranks high in the concerns of the PE and VC industry. To reduce volatility, state parties to the AfCFTA and continental stakeholders must promote prudent macro-economic policies underpinned by sound exchange reserve management.
- **Exit risk:** investors from PE and VC industry will hesitate to participate in the AfCFTA financing landscape if they do not have the assurance that they can leave by selling their stakes and recouping their gains. The institutional infrastructure of the AfCFTA must address the problem of narrow and undeveloped financial markets by improving legal and regulatory frameworks, especially when it comes to greater certainty on capital controls which can either slow down or increase the cost of exiting.

These risks notwithstanding, the continent remains an attractive PE and VC investment destination, with significant growth potential under the implementation programme and strategic agenda of the AfCFTA. There are over 400 PE and VC as well as asset management firms which are active in Africa; and there are another 200 such firms around the world which have a strong Africa focus in their portfolios (Withagen 2021). China is the leading Asian market for investors with its state-owned enterprises and banks making significant investments within the purview of its Belt and Road Initiative, to which 46 African countries have currently signed on (Xinlan 2023).

South Africa hosts 174 PE and VC firms and also serves as a location for their headquarters or regional offices; while other major PE and VC hubs are in Nigeria (63), Kenya (48), Mauritius (24), and Egypt (20). When it comes to the symbiotic and development potential that factoring as a business can generate for SME's working capital and liquidity, 25 per cent of the PE and VC industry players show a preference for deals of between US$1 to US$5 million; and 20 per cent each in the range of US$5 to US$10 million and US$10 to US$25 million (Withagen 2021).

Policy Considerations

This Policy Brief invites the consideration of four dimensions that arise from its overall analytical thrust:

- ***The regulatory dimension:*** factoring has emerged as a flexible financing mechanism for ensuring working capital efficacy and efficiency for SMEs. International experience shows that the factoring industry becomes more robust and SMEs benefit more in economic environments with functional and effective legal, regulatory, and institutional frameworks that protect all stakeholders. However, regulatory governance of the factoring industry and associated business entities still largely concentrated in domestic domains and the challenge in the African context is to better connect, harmonise, and coordinate various domestic elements into a practical continental endeavour. In this regard the ACBF, Afreximbank's Factoring Unit, with the assistance of the AfCFTA Secretariat and FCI should examine how Afreximbank's Model Law on Factoring could provide the basis for developing a prudential regulatory model that benefits SMEs by facilitating easy and inclusive access to credit and related services. This must conform to global best regulatory practices and should include authorisation and supervisory rules for factoring activities, mandatory licensing requirements for factoring companies, benchmarks for capital adequacy standards, fitness and propriety measures, and anti-money laundering and cybercrime protections.
- ***The capacity-building dimension:*** located in the Afreximbank Factoring Unit and in conjunction and with the support of the ACBF, the challenge is to create a "factoring/SME sociology" of support systems that promote an enabling environment for sharing knowledge, expertise, lessons, and legal and regulatory information about the benefits of factoring for SMEs. This sociology can be enriched by the involvement of and drawing on the resources of other stakeholders such as the AfCFTA Secretariat, the AUC and UNECA Secretariats, and the Education Director and Regional Manager for Africa of Factors Chain International to which 43 African countries belong.
- ***The financing dimension:*** with the AFCFTA's SME Financing Facility as its locus and in conjunction with the Afreximbank Factoring Unit, the AfDB's Secretariat for Making Finance Work for Africa, and the Africa Finance Corporation a road-map of financing vehicles should be developed as comprehensively as possible. This should include a dedicated and concerted outreach to PE and VC firms which must be encouraged to create and put in place special purpose vehicles for factoring and whose financing terms and conditions must accessible at concessional rates to the largest population of SMEs regardless of their formal or informal status.

The data-base dimension: state parties which have ratified the AfCFTA, in conjunction with technical assistance from REC secretariats and relevant desk expertise within the AUC, UNECA, and AfDB should conduct surveys to establish a data-base of SMEs. The methodology should be hierarchical with a focus on the short-, medium-, and long-term preparedness to participate in AfCFTA trading and finance platforms. As such, it must be sensitive to the qualities and attributes of those SMEs which have the operational readiness to take advantage of two elements: their sectoral interests and invoice receivables should be amenable to integrating factoring into their business models through appropriate guidance and support systems; and they should demonstrate the management and administrative potential to participate in cross-border and regional value chains.

Conclusion

In letter and spirit, the AfCFTA is a game changer as a trading configuration and great strides have been made with its implementation. It covers the entire continent with a legitimate social purpose of deepening integration and improving the welfare of 1.3 billion continental citizens. In advancing this legitimate social purpose, SMEs have a special role to play in a normative and substantive sense. They, however, need to overcome the binding constraint of financial instability and here, there is an opportunity for factoring to make a profound existential difference in the growth and development of SMEs in a manner that is truly transformative for the future of the continent.

Acknowledgements

The African Capacity Building Foundation (ACBF) would like to thank the Afreximbank Factoring Working Group and members of the ACBF Strategic Studies Group for their suggestions and insights which helped in fine-tuning the Research Paper. This Policy Brief was produced by Garth le Pere. Opinions stated in this brief and the paper it draws from, are those of authors and do not necessarily reflect the views of the ACBF and Afreximbank.

References

ACBF-Afreximbank (2023), "Factoring as a Catalyst for Small and Medium Enterprises Development and Intra-African Trade." Harare, Zimbabwe: ACBF.

Albaladejo, M and H Schmitz (2000), "Helping African SMEs to compete in regional and global markets: A strategic framework." UNECA: Addis Ababa. Enhancing SMEs Competitiveness in Global and Regional Markets: The Role of Support Services. Proceedings of a Workshop, 27 November -1 December.

Barry K and O Adoh (2021), "Private equity in Africa: Trends and opportunities 2021." Insight 5 April. At https://www.whitecase.com/insight-our-thinking/private-equity-africa-trends-and-opportunities-2021/ (accessed 28 November 2023).

Eyraud, L, C Pattillo, and AA Selassie (2021), "How to Attract Private Finance to Africa's Development." IMF Blog: Washington DC, 14 June. At https://www.img.org/enBlogs/Articles/2021/06/14/blog-how-to-attract-private-finance-to-africa-s-development/ (accessed 28 November 2023).

AU (2023), "AU Summit 2023: Powering trade through AfCFTA." Africa Renewal, 17 February. At https://www.un.org/africarenewal/magazine/february-2023/au-summit-2023-powering-trade-through-afcta/ (accessed 24 November 2023).

AUDA-NEPAD (2022a), "Unlocking the potential of Africa's SME's Using Emerging technologies in Africa" African Union Development Agency, 1 August Blog. At https://www.nepad.org/blog/unlocking-potential-of-africas-smes-using-emerging-technologies-africa/ (accessed 27 November 2023).

AUDA-NEPAD (2022b), *Second Continental Report on the Implementation of Agenda 2063.* African Union Development Agency, February. At https://au.int/sites/default/files/documents/41480-doc2nd_Continental_Progress_Report_on_Agenda_2063_English.pdf (accessed 22 January 2024).

Borerwe, M (2021), "Africa: Expanding access to trade finance is necessary for SMEs." The Africa Report, 29 November. At www.theafricareport.com/151540/africa-expanding-access-to-trade-finanfe-is-necessary-for-smes/?galid=CjwkcAiA9o/ (accessed 25 November 2023).

Brixiová Z, T Kangoye, and T Urbanin (2020), "Access to Finance among Small and Medium-Sized Enterprises and Job Creation in Africa." Discussion Paper 665, Global Labor Organization: Essen, Germany. At www.econstpr.eu (accessed 27 November 2023).

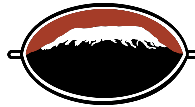
MFW4A (2022), "Unleashing the potential of factoring in Africa." AfDB: Making Finance Work for Africa: Abidjan, Côte d'Ivoire, March. at www.mf4a.org/sites/default/files/resources/factoring-profile_final.pdf/ (accessed 27 November 2023).

UNECA (2021), *Governing the African Continental Free Trade Area—Regional Economic Communities Interface.* Addis Ababa: UNECA.

United Capital (2023), "Factoring Advantages & Disadvantages: The Essential Guide." United Capital: Lagos, Nigeria. At https://www.unitedcapitalsource.com/blog/factoring-advantages-disadvantages/ (accessed 25 November 2023).

Withagen, R (2021), "What does Africa's private equity landscape look like in 2021?" The Africa Report, 8 July. At www.theafricareport.com/105738/what-does-africas-private-equity-landscape-look-like-in-2021/ (accessed 28 November 2023).

Xinlan, L (2023), "The Belt and Road Initiative: A Valuable Collaboration Platform." ChinaAfrica Magazine, 15, October.



THE AFRICAN CAPACITY BUILDING FOUNDATION | FONDATION POUR LE RENFORCEMENT DES CAPACITES EN AFRIQUE

Securing Africa's future through capacity development

Assurer l'avenir de l'Afrique en renforçant les capacités

THE AFRICAN CAPACITY BUILDING FOUNDATION (ACBF HEAD OFFICE)

2 Fairbairn Drive, Mount Pleasant, Harare, Zimbabwe
Tel: (+263-242) 304663, 332002
Cell: +263 772 185 308 - 10
E-mail: root@acbf-pact.org

ACBF REGIONAL OFFICE, WEST & CENTRAL AFRICA

3rd Floor, The Rhombus, Plot 24 Tumu Street, Kanda Estates, Accra,Ghana
Tel : +233 540122013
E-mail : accra@acbf-pact.org

ACBF REGIONAL OFFICE, EAST & SOUTHERN AFRICA

ACK Garden House, 2nd Floor, 1st Ngong Ave, Nairobi, Kenya
Tel: +254 (20) 5160052
Cell: +254 727 116 276
E-mail: nairobi@acbf-pact.org