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MSMEs AND ACCESS TO FINANCE IN RWANDA
Challenges and way forward

A case study on the stone and clay value chains

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This study was carried out by Azimut within the framework of the UEDi urbanisation programme led by the Government of Rwanda with the support of the Belgian cooperation ENABEL.

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1 Context and methodology

1.1 Context

Access to finance remains a major challenge for most MSMEs in Rwanda for a number of reasons, including: high collateral and documentation requirements, unsuitable financial products, risk aversion from financial institutions and lengthy procedures.

This study was conducted by Azimut within the framework of the UEDi urbanisation programme led by the Government of Rwanda with the support of the Belgian cooperation ENABEL.

The UEDi programme has a component aimed at increasing the production of *Made In Rwanda* building materials, in the stone and clay sectors, to meet the growing demand in the housing and economic infrastructure sectors.

The present study, commissioned by ENABEL, consisted of an assessment of the needs and constraints of working capital financing for Rwandan companies operating in this sector.

The objective was to identify the need to put in place new mechanisms to facilitate the financing of the cash flow of enterprises and, where appropriate, to propose recommendations for suitable mechanisms, based on a review of existing national mechanisms in this area.

1.2 Methodology

To carry out this study, Azimut conducted surveys and interviews with 55 companies and 13 support organizations operating in the stone and clay sectors. The setup was as follows :

- **Survey of MSMEs in the clay and stone sectors; visits and interviews with companies**

  In order to characterize the financing needs of MSMEs in the stone and clay sectors and their relationship with the financial sector, we conducted an internet survey of 114 enterprises. The aim of this survey was to evaluate the proportion of enterprises that had recourse to credit, to characterize the loans requested, to have a typology of enterprises and to identify the constraints encountered in the demand for financial products. 27 companies responded to the survey (15 in the stone sector and 12 in the clay sector).

  In addition, we visited and interviewed a sample of 5 companies, in order to illustrate and clarify the answers given, to better understand the conditions and financial constraints surrounding the production processes.

- **Meeting with technical and financial institutions involved in supporting the small-scale construction sector in the stone and clay industries.**

  We met with 8 banks and microfinance institutions involved in financing the productive sector in Rwanda. We assessed their level of investment within the two value chains, collected portfolio data and financial products' conditions when available, and questioned them about the constraints they face in supporting the MSME sector of the clay and stone industries.

  We also met with 5 technical and institutional organizations involved at different levels in supporting the MSME sector. The aim was to question them on the needs and constraints of access to finance for MSMEs in the clay and stone sectors, to identify the existing facilitation mechanisms and programmes and to gather their feedback.

- **Portfolio analysis of financial institutions**

We consulted the loan portfolio of the Financial Institutions (FIs) in the MSMEs of the clay and stone sectors. The aim of this consultation was to be able to size the financial investment in the sector, to identify the most invested FIs, and to characterize the typology of the loans requests (equipment, working capital...). 25 financing files were consulted in detail.

	MSMEs Survey	Interview with FIs	Interview with technical institutions
Who?	55 companies : 27 surveys, 5 field visits, 25 loan files consulted	5 banks, 3 MFIs	5 institutions : AFR ; SKAT ; BPN ; NIRDA ; Sustain Consortium
What?	- Study business model - Working capital financing model - Loan record and demand - Barriers in accessing finance	- Assess lending porfolio - Funding conditions - Opinion on performance-based grant mechanism - Barriers and leverages to access to finance	- Assess support to MSMEs - Barriers and leverages to MSMEs access to finance - Other existing programs and funds

Study setup

2 Main results and recommendations

- **Growing demand**. The market for building materials in the clay and stone sectors (mainly bricks and gravel) is growing, given urban and population growth. This generates opportunities and financing needs for local companies operating in these sectors.
- **MSMEs well connected with Fis.** Donors/programmes wishing to set up incentive mechanisms ought to work with financial intermediaries (banks/MFIs), which offer a broad and sustainable channel of support to MSMEs, given their geographical coverage and the sector's high banking rates.
- **Heterogeneous financing needs**. These companies need incentive mechanisms to facilitate their access to equipment and working capital finance. There is no demand for "pure" working capital loans in the clay sector, which benefits from advance payments from customers. In contrast, in the stone sector, the need for credit is greater, as MSMEs in this sector work with corporate clients, with payments made on delivery, which generates cash flow pressures.
- **Inadequate product offer** – in general, the financial products offered do not correspond to the needs of the operators: the documents required and the administrative procedures are lengthy, particularly at the level of the banks (which leads some operators to borrow from MFIs, which disburse more quickly but at less attractive rates) and the FIs focus mainly on the value of the collateral to determine the amount of the loans to be granted.
- **High collateral requirements and need for efficient partial loan guarantee mechanisms**. According to the institutions and enterprises met, the lack of sufficient guarantees represents the main constraint to the adequate coverage of the financing needs of the MSMEs in the stone and clay sectors. This is why the incentive financing mechanism favoured by the FIs is a portfolio guarantee fund with flexible and incentive intervention modalities. Existing national mechanisms are considered little attractive by most FIs.
- **Capacity building needs.** In addition to incentive financing mechanisms (risk coverage and possible reduction of the cost of credit), it is recommended to strengthen the financial management capacities of enterprises, which are insufficient and constitute an obstacle to their access to formal credit. At the same time, it is important to develop the culture of economic analysis within FI teams, which focus too much on the analysis of the collateral of enterprises, thus hindering their development potential.
- **Support greater synergies between FIs and BDS providers** - FIs and support organizations offering BDS services would benefit from strong partnerships to improve the financial inclusion of entrepreneurs. Indeed, these organizations, working closely with operators in both value chains, can help reduce the risk of information asymmetry, thus enabling FIs to make better decisions.

3 Full study

3.1 Financing needs of MSMEs in the stone and clay sectors: analyses from surveys and interviews with operating companies

3.1.1 Financing needs of MSMEs in the stone and clay sectors

The first element that emerges from the survey is that **the stone and clay sectors must be considered separately**. Companies in these sectors do not have the same characteristics nore the same financing needs.

- The clay sector contains a large number of **small enterprises** that manufacture mud or fired bricks in the traditional way and without equipment, in the dry season. These enterprises do not need cash loans or equipment to operate. **Medium-sized enterprises**, which represent about 5% of the sector, have infrastructure to operate (modern kilns, drying sheds, machinery) and produce bricks all year round, although their production capacity is reduced in the rainy season. These enterprises need **medium to long-term loans** to invest in land (clay quarry), infrastructure (drying sheds and kilns) and equipment (semi-automatic machines). Their cash flow is in theory relatively well financed, as these companies sell their production mainly to private customers and request them to pay in advance (43% of the companies receive cash advances from their customers). The fact remains that the national demand for bricks is growing and that production companies do not have the capacity to follow this demand. As a result, companies visited by Azimut are found to work on a just-in-time basis, with no safety stock. This situation leads them to lose markets from time to time, due to excessive delivery times.

  This analysis is confirmed by the study of a small sample of companies financed by an FI: all companies borrowed to finance land or equipment acquisition ; they used about 20% of their loan amount to finance their working capital (essentially 2 to 3 months of labour cost).

  In conclusion, we find that companies in this sector **do not have a significant need for a cash flow loan.** Some companies could, however, use a cash flow loan to complement the acquisition of infrastructure/equipment generating an increase in their production capacity; or on an ad hoc basis to respond to a public order characterized by a payment in fine (notably school construction).

- As for the companies in the stone sector, they mainly produce aggregates which they sell to construction companies or concrete manufacturers (cast or in bricks). Working with this type of clientele leads to longer payment delays (60 or 90 days after delivery), and therefore difficulties in financing production cash flow. Only 25% of surveyed companies in the stone sector receive payment advances from their customers. We visited a company that was unable to fulfill a significant purchase order due to a lack of production financing capacity. In this sector, companies produce larger orders for a smaller number of customers than in the clay sector.

  These companies therefore need to **build up more working capital** (several months) and have an interest in borrowing (credit line or overdraft) to finance their cash flow.

  The demand for crushed stone has declined with the covid, due to a slowdown in some construction sites. However, the Rwandan market, whether for infrastructure or building construction, will soon pick up again. Some major projects such as the construction of the new airport will also create a shortage of aggregates.

  These companies also have **financing needs for equipment**, which is on the whole expensive (at least RwF 5m for crusher machines and several tens of millions of RwF for excavators used to extract stone from quarries).

  The analysis of the types of credit taken by the 9 enterprises surveyed showed that 80% of the enterprises borrowed to finance machinery and used part of the loan to finance their working capital; 20% of the enterprises took a sheer working capital loan.

3.1.2 Relations of MSMEs in the stone and clay sectors with the financial sector and their recourse to credit

The enterprises in these sectors are well connected to the formal financial sector, notably with a significant use of credit. 40% of the enterprises surveyed have already borrowed a formal loan. This is partly due to the fact that the Rwandan banking sector is well positioned for the MSME sector, with a range of small credit products, in contrast to what is practiced in many African countries.

If we look at the two sectors in detail, the use of credit is more important for companies in the stone sector, which represent 74% of the companies surveyed having already taken out a loan. In this sector, 53% of the enterprises surveyed had already taken a loan from a formal institution, compared to 25% for enterprises in the clay sector.

The average loan received by enterprises is RwF 22 million. The amounts borrowed by stone enterprises are higher than in the clay sector: 26M RwF against 11M RwF. The average loan is therefore twice and a half as high for the stone companies[1]. This is explained by the larger size of these companies: they have an average turnover of 129M RwF, compared to 46M RwF for the clay sector, and even 196M RwF compared to 52M RwF if we only consider companies that have already taken loans.

Firms have used banks more than MFIs for their loans and the average amounts lent are higher (44M RwF vs. 11M RwF). However, MFIs appear to have a substantial portfolio of business loans. These data suggest that it is as useful to work with banks as it is to work with MFIs when designing mechanisms to facilitate access to formal finance.

	Stone manufacturing MSMEs	Clay manufacturing MSMEs
Market	Long-term growing ; Aggregates shortages (airport project) ; covid -> slowdown	Growing
Clients	Construction companies with payment delays (60-90d), 25% companies get cash advances -> difficult to finance working C. ; just-in-time production	Private individuals, 43% companies get cash advances -> no pb to finance the WC, but no stock (just-in-time production)
Turnover	Average ~129M RWF and 196M RWF for companies with loans	Average ~46M RWF and 52M RWF for companies with loans
Loan record	53% have a credit history	25% have a credit history
Average loan value	26M RWF. 10% loans >100M RWF	11M RWF. No big loan
Loan use	Equipment (80%) ; WC (20%)	Equipment (80%) + WC (20%), no loan request just for WC

Results of the company survey: two sectors with distinct financing needs

3.2 Coverage of the financing needs of MSMEs in the stone and clay sectors by financial institutions: existing mechanisms and constraints expressed by financial sector actors

[1] *However, there is a significant dispersion: the stone sector contains some large companies with greater financing needs. If we calculate in "median" and not in average, the median loan gap between the two sectors is only 22%.*

3.2.1 Constraints of the financial sector to finance MSMEs in the stone and clay sectors

We interviewed 4 commercial banks and 3 Microfinance Institutions (MFIs) about their loan portfolio to MSMEs in the stone and clay sectors.

For the financial institutions, the main constraint to increasing their lending to MSMEs is credit risk coverage: it is difficult for FIs to cover their financing risk with adequate guarantees.

All banks and MFIs are required by the National Bank of Rwanda (BNR: Central Bank) to cover credit risk with 150% collateral. This is true regardless of the economic sector concerned, but the clay sector makes FIs particularly cautious because of the risks associated with the seasonality of the activity.

However, **companies lack collateral**, which limits their access to borrowing. According to the FIs, most entrepreneurs have taken out personal loans over several years and have mobilized for this purpose land and house collateral that they own. This makes it difficult for them to mobilize other collateral to borrow for their business.

Pledging equipment as collateral is little practised by FIs, because of its non-fixed nature. The rules set by the BNR also require a 70% discount to be applied to the value of the pledged equipment. Therefore, the guarantees taken by FIs are mainly of a mortgage nature (land + house), which is facilitated by the existence of a comprehensive national land register, allowing FIs to register mortgages, foreclose and sell land and houses. However, FIs apply a discount of 30% to 50% on mortgaged properties and favour properties located in Kigali. This means that in practice, in order to obtain a formal loan, entrepreneurs have to mobilize collateral for a market value of up to **300% of the value of the loan** applied for.

The value of the assets owned by the entrepreneurs is therefore a clear limit to their borrowing capacity.

In addition, the determination of the value of land collateral and its registration by certified valuers is time-consuming, which is a clear problem for cash loan applications based on purchase orders.

This process is also costly to clients (> 100,000F, that is 5% of a 2MF loan).

All FIs, and several entrepreneurs, mentioned **the constraint of guarantees as a barrier to accessing loans of amounts adapted** to the needs of the enterprises. This constraint is increased for cooperatives and for less well-off entrepreneurs.

3.2.2 Feedback on MSME financing facilities in Rwanda

We interviewed organizations that have been involved in the implementation of MSME finance facilities to identify good and bad practices.

3.2.2.1 Guarantee funds

All FIs interviewed by Azimut work with the Business Development Fund (BDF), which offers individual guarantees covering 50% to 70% of the loan amount to entrepreneurs with little or no collateral. However, the feedback from working with BDF is mixed. According to the interviewees: the processing time of the guarantee applications is long (>3 months), leading to the inadequacy of the loan and client dissatisfaction, and guarantee calls are difficult. BDF carries out systematic site visits and asks the FI to seize the land guarantees (a procedure that takes 3 to 6 months) before calling on BDF's financial guarantee, if still necessary. As a result, the BDF guarantee does not really allow FIs to reduce the provisions that they must legally build up to cover their defaulted portfolio. The BDF guarantee mechanism therefore does not seem to provide an incentive for FIs.

KCB is also working with the FAGACE guarantee fund; we do not have clear feedback on this fund, but according to KCB, it also has constraints, in particular its individual nature and cost.

BRD works with a Kenyan portfolio guarantee fund but has reached the commitment limit and therefore cannot include new loans.

AFR also cited a guarantee scheme it has set up with KCB to facilitate loans to maize storage/purchase cooperatives. AFR placed a deposit on a KCB account, which covered 75% to 25% of the loans, with the remainder being covered by a guarantee on the crop stock (warrantage mechanism). This mechanism would have allowed for a significant increase in the volume of financing to cooperatives in the sector. The resources released by the deposit would have been sufficient to cover the defaults observed during the project; the consumption of the line therefore remained almost nil.

The drawback of such a guarantee mechanism is that 1/ it only allows to work with one financial institution; 2/ there is a risk that the deposit funds will be used by the bank to generate profit, while the banks are already over-liquid; 3/ the bank reduces its recovery action, since it is in a position to seize the deposit to compensate for unpaid loans.

Finally, we discussed with SKAT and BK the guarantee fund financed by the Swiss Cooperation to support the brick manufacturing sector. This USD 200,000 fund was set up in 2014, is managed by BDF, but its use is limited. The reasons given by the organizations interviewed relate to the fact that the terms and conditions offered by BDF are not incentive for FIs. The RwF 10 million cap on individual guarantees was also reported to be a constraint. That seems true given the average loan size in the clay sector (RwF 11 million) and the rules on collateral coverage mentioned before.

3.2.2.2 Credit lines to FIs

Several institutions referred to the export credit facility set up by KfW under the EXPORT GROFIN project, the use of which has been very limited. This is because the interest rate applicable was capped at a level that made this credit line unprofitable for the beneficiary bank. The Bank therefore preferred to grant credits from its own resources, outside the scheme.

3.2.2.3 Performance-based subsidised loans to SMEs

Performance-based grant schemes are considered attractive by FIs as they allow them to attract new clients, and benefit both the financial institution, by encouraging good repayment, and the client, who receives a subsidy when he effectively repays well. For this type of scheme, the BRD proposes as an eligibility criterion the absence of more than three months' delay during the repayment period.

However, one bank pointed out that this type of mechanism also has disadvantages: its duration is limited in time, due to the high consumption of funds by the subsidization of loan repayments; unclear communication with the client if he/she resumes a successive loan on the bank's traditional terms when the project is completed.

There is also the risk of misuse of the loan if a client keeps 50% of his loan in cash to make an early repayment and thus benefit abusively from the subsidy of the scheme.

3.3 Recommendations for incentive mechanisms to promote access to finance for SMEs in the stone and clay sectors

3.3.1 Establish incentive mechanisms for equipment and working capital

To reach a significant volume of beneficiaries, we recommend that incentive mechanisms target both equipment and working capital.

Incentive mechanisms (in the form of guarantees, interest rate subsidies or repayment subsidies) covering only working capital would probably attract only a few firms, as the study of FI loan portfolios and the survey of a sample of firms revealed little demand for working capital loans.

On the other hand, if the facility is for mixed equipment + working capital loans, the demand for loans could be higher.

It is important though that incentive mechanisms supporting the acquisition of equipment also facilitate the financing of working capital needs. This is because when a productive asset is acquired, production capacity is increased and requires more working capital, which is difficult for companies to pre-finance, especially those in the stone sector that face payment delays. Furthermore, if the asset is financed by debt, its repayment also weakens the cash flow of companies and thus their ability to finance their production costs.

Both FIs (notably BRD) and technical support operators consider that the financing of working capital is an issue for enterprises that access new productive equipment.

3.3.2 Work with commercial banks and MFIs

A programme aimed at facilitating access to finance for MSMEs in the stone and clay sectors would benefit from relying on banks and commercial microfinance institutions, rather than acting directly with enterprises. Indeed, given the high rate of banking among MSMEs and the geographical coverage of FIs in Rwanda, financial sector actors are good intermediaries to identify and support enterprises in the sector. In addition, the establishment of incentive, risk hedging, or credit cost reduction mechanisms based on FIs leads to increased sustainability, given the medium-term relationship FIs have with enterprises.

It is possible for a scheme to operate through calls for proposals to co-finance the acquisition of productive assets. On the other hand, in terms of financing working capital, this will not be relevant because the mobilization of this type of credit must be done at specific times depending on the order book of the companies.

3.3.3 Establish a portfolio guarantee fund

The access of enterprises to appropriate loans depends on their ability to mobilize sufficient land guarantees, a constraint that generates inequalities. The banking and MFI sector does not seem to make use of other types of guarantees that are more adapted to businesses, such as factoring for example. Thus, the growth of businesses is penalized by a lack of financial support.

Securing credit risk through the use of appropriate financial guarantees is an important lever for increasing the supply of credit from the banking/MFI sector to businesses.

All FIs consider that the main lever for facilitating access to finance would be access to a **portfolio guarantee fund** with flexible intervention modalities. The fund should be placed in an account managed by a third party organization. These guarantees could cover overdraft - a flexible credit instrument that an entrepreneur can call on when needed without planning, for example in the event of unexpected payment delays by a customer, as well as repayable lines of credit.

Guarantee agreements should be made on the basis of validation of the files by the banks, without duplication by the body hosting the guarantee fund, in order to ensure a rapid loan granting process. This is particularly important for cash loan requests, which correspond to excess customer orders.

The expected coverage rate is 50-70%.

The guarantee calls should result in the payment of an advance on first call from the banks for all borrowers in PAR90, a threshold which corresponds to a significant increase in the level of credits provisioning that the banks have to make.

At the same time, the bank must initiate the process of foreclosing the land collateral. The balance is determined at loan closing and is subject to a top-up payment from the fund or a repayment by the bank.

The size of the guarantee fund should be approximately 10-15% of the targeted loan amount outstanding. This percentage is a slightly increased estimate of the default rate currently observed in the sector, the indicator used for this being the PAR30.

Finally, if the operating cost of the guarantee mechanism is borne by a lender, it will allow additional reductions in the cost of credit: it could replace BDF or FAGACE, which charge the beneficiary bank a cost of 1 to 2% of the loan, passed on to the borrower, and also replace some of the land guarantees, whose constitution and registration formalities also represent a cost for the borrower.

3.3.4 Subsidize equipment loans to businesses

From our point of view, subsidizing a loan does not really make economic sense for a cash flow loan. Indeed, these are short-term loans whose amount is directly aligned with the borrower's turnover; the borrower is therefore theoretically able to repay the principal of the loan, as long as his activity is profitable.

In contrast, equipment loans are repaid out of the profit generated by the business. Subsidizing part of an equipment loan (in principal and possibly in interest) allows the company to retain a larger share of its profit, while reducing the risk taken by the financial institution. The establishment of such a facility by a lender would therefore be advantageous for both the productive and financial sectors. Moreover, it would make it possible to negotiate a lower interest rate with the financial institution.

Performance-based grant mechanisms, based on repayment, have the advantage of providing an additional incentive for the success of the project for which the loan is granted, but the disadvantage of unnecessarily increasing the amount of the initial loan, and therefore the cost of financing. Of course, they are. Also, access to borrowing remains constrained by the availability of guarantees. While generally well received by FIs, the disadvantage of such a scheme would therefore be that it would only benefit companies that are already in a position to access a loan, as they have sufficient guarantees.

3.3.5 Subsidize the interest rate on business loans?

Subsidizing the interest rate is an interesting mechanism, as it allows the company to increase its net profit margin, by reducing the cost of the loan, without reducing the profitability of the loan for the bank.

However, interest rate levels were not mentioned as a constraint by the majority of enterprises and FIs. It should also be noted that interest rate subsidies imply a form of market distortion.

The interest rate is in fact an indicator correlated to the cost of funds and the credit risk incurred by the lender. If loans were de-risked by an appropriate guarantee mechanism, the FIs surveyed would be willing to reduce their interest rate by 1 to 2 percentage points. This is preferable to direct interest rate subsidies, as the resources of the guarantee fund are only consumed by defaulting borrowers and can therefore generate leverage and have greater sustainability (this is also true in relation to the performance-based grant mechanism).

3.3.6 Establish a subsidized credit line for the commercial FI sector

This need does not seem relevant for banks: their high levels of liquidity allow them to finance loans from their own resources.

In contrast, MFIs seem to have more difficulties in accessing cheap resources. Financing their loan fund through grants or low credit lines is therefore a useful mechanism to put in place. It is important not to interfere with FIs' lending policies, including interest rates, as this may impact on their willingness to develop financing operations for the scheme's target sector.

3.3.7 Provide training and support to entrepreneurs in financial management

During our field visits, we noted a lack of accounting monitoring on the part of entrepreneurs, and insufficient knowledge of working capital and reserve management, even on the part of medium-sized enterprises. The absence of convincing accounting and cash flow data, the elaboration of unsuitable business plans, are obstacles to a good evaluation of their financial needs and their repayment capacities by credit officers. However, the growth of the construction market offers opportunities that companies could seize if they had the appropriate skills and financing.

Coaching and training could help them to strengthen their financial management, inventory management, accounting, and cash flow monitoring capacities, and make better use of financial products such as overdrafts and repayable lines of credit.

This action should go hand in hand with increased awareness among FIs of the importance of carrying out thorough economic analyses of loan applications, as Rwandan FIs tend to focus excessively on collateral assessment in credit risk analysis, to the detriment of project profitability analyses.

3.3.8 Strengthen synergies between FIs and support organizations (BDS)

FIs and support organizations offering BDS services would benefit from strong partnerships to improve the financial inclusion of entrepreneurs. Indeed, these organizations, working closely with operators in both value chains, can help reduce the risk of information asymmetry, thus enabling FIs to make better decisions.

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