The case for using Blended Finance to build resilience and accelerate growth of MSMEs in Rwanda

MARKET INTELLIGENCE AFRICA

Rwanda's attractiveness as an investment destination

Rwanda is an attractive investment destination, and the country's rapid growth over the last ten years is evidence of this. Up until the Covid-19 global pandemic in 2020, Rwanda had been experiencing exponential growth in GDP, recording the highest growth in GDP in Africa in 2019, according to World Bank data. In the last ten years, Rwanda's GDP has grown at an average (CAGR) of 5.1% compared to just 2.4% in Sub Saharan Africa.

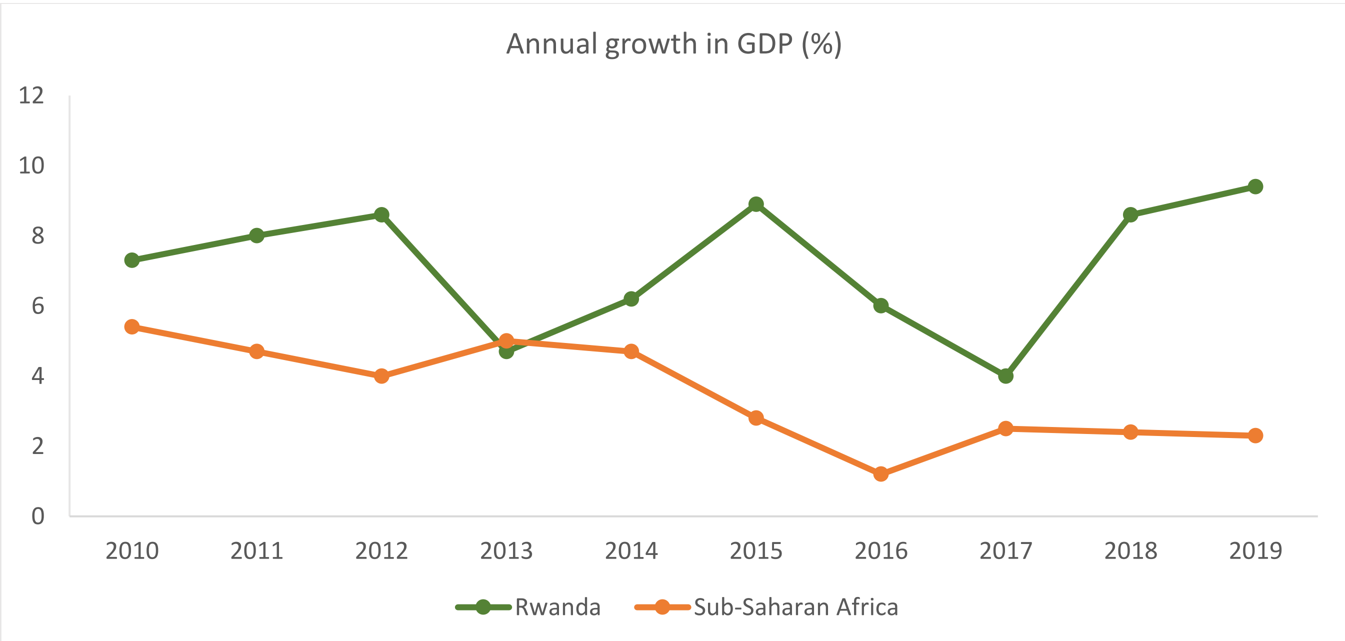
According to EY's Africa Attractiveness Survey (2019), Rwanda is ranked as one of the most attractive investment destinations in Africa, from both a macroeconomic and ease-of-doing-business point of view. This is evidence of the Government's deliberate and intentional strategy of creating an enabling business environment through the adoption of business-friendly approaches and easing bureaucratic processes.

Whilst the country's investment attraction strategy has been successful in putting Rwanda on the map and in attracting Foreign Direct Investment, the impact on Micro, Small and Medium Enterprises (MSMEs) is yet to be fully realised. The level of private sector investment activity is still relatively low in MSMEs in Rwanda as compared to its peers in the East Africa region and in Sub-Saharan Africa in general.

Vision 2050

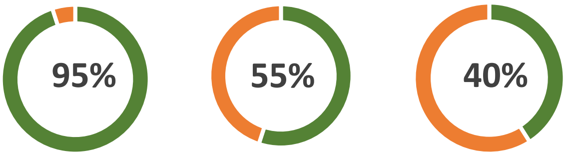
For Rwanda to achieve its vision to be a middle-income country by 2035, and a high-income country by 2050, it will need to aggressively grow the value of investments it attracts, particularly into MSMEs, who form the backbone for employment creation and economic development in the country.

Blended Finance will be a critical mechanism to achieve this aggressive growth, and one of the primary means to get investment participation by international institutional investors and developmental financiers into a market that is perceived to have small and risky investment opportunities in the private sector.



Micro, Small & Medium Enterprises (MSMEs) in Rwanda

Rwanda's MSMEs are the backbone of the country's commercial activity and make a significant contribution to the country's economic development. The growth of MSMEs is therefore critical to the overall economic growth of the country and the creation of employment.



More than 95% of businesses in Rwanda are MSMEs

MSMEs contribute more than 55% of Rwanda's GDP

MSMEs contribute more than 40% of employment in Rwanda

Challenges faced by MSMEs

The myriad of challenges faced by MSMEs in Rwanda, and that hinder the growth of the sector, can largely be grouped into two:

i. Limited access to formal financing
ii. Limited access to technical assistance

MSMEs face difficulties in accessing long-term financing on reasonable terms. The cost of local debt is generally high and the requirements too onerous to meet. MSMEs are typically expected to meet high collateral requirements even for short-term debt, leaving the business without any collateral to fund long-term financing requirements. From an equity point of view, there is limited demand from regional and international venture capital and private equity funds, and a general mismatch of expectations between MSMEs and such equity investors with respect to risk, required rates of return, investment horizons and exit options.

MSMEs also lack adequate technical assistance in several areas including business advisory, corporate governance, access to regional and international markets and access to new technologies.

The two broad challenges above are interlinked – the lack of technical assistance inevitably make the MSMEs riskier, and the riskier they are the less likely they are to attract financing from private commercial sources.

Why are private investors not rushing in to invest in Rwandan MSMEs?

Given these challenges, the general perception amongst private commercial investors is that the MSMEs are too small and too risky to invest in, even if the country is an attractive investment destination from a macro point of view. In other words, investors like the country's high growth potential and stable business environment, but in general they struggle to identify individual MSMEs with the right risk-return profile in which to invest.

Ranging from US$10k to US$2m, investment ticket sizes in Rwanda are generally small relative to other markets in East Africa and Sub-Saharan Africa. Whilst smaller-sized projects can have a high transformative impact on local communities, they need much more technical assistance as well as financing to fulfil their potential, and may yield less returns, therefore making them less attractive to private commercial investors.

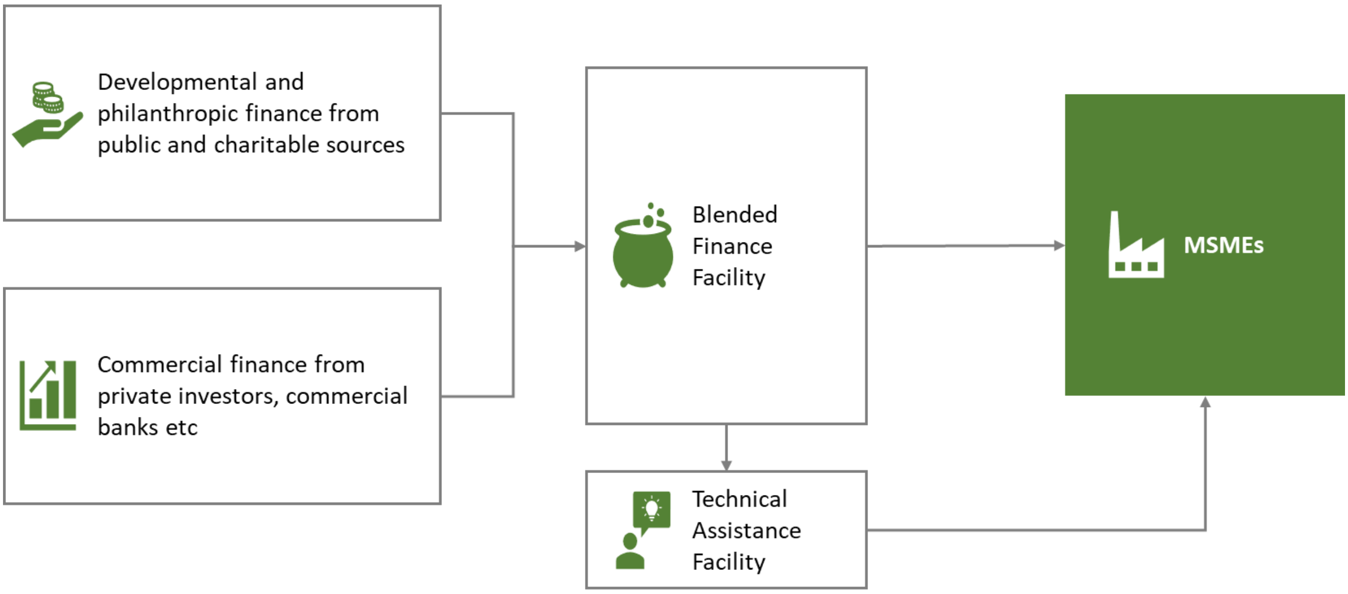
There is therefore a clear need for private commercial investors to be enticed to invest into Rwandan MSMEs via other mechanisms such as through Blended Finance facilities with capital injection from international developmental financial institutions.

Introducing Blended Finance

In its simplest form, Blended Finance is the use of developmental or philanthropic finance to mobilise and unlock private capital flows into developing countries. Its purpose is to attract private commercial investors into emerging markets by reducing investment risk and potentially improving investment returns in those markets.

Blended Finance is widely viewed as one of the most effective ways that emerging markets are going to be able to attract increased investments flows, ultimately facilitating the sustainable development goals (SDGs) and moving investments from billions into trillions, particularly in Africa.

A simplified structure of a Blended Finance facility



The existence of developmental and/or philanthropical capital in a Blended Finance facility essentially serves to achieve two main things:

1. Reduce the risk profile of potential investments through the provision of de-risking instruments such as grants, loan guarantees and interest rate subsidies. Such instruments also reduce the overall cost of investment capital.
2. Potentially increase profitability of the MSMEs through the provision of a standalone Technical Assistance Facility which can be used to support the MSMEs both at the pre-and post-funding stages. Technical assistance could include putting in place effective corporate governance structures, helping with sales and marketing support, access to regional and international markets and other technical know-how which is specific to the respective MSMEs' industry segment.

The availability of such a risk sharing facility and technical assistance facility would serve to attract additional investments from private commercial investors into the MSME segment, especially in sectors that are considered of higher risk.

The case for Blended Finance to support investments in MSMEs in Rwanda

The Blended Finance Gap

There is an obvious funding gap in the MSME sector, with businesses and potential financiers having differing views. Typically, MSMEs in Rwanda are looking to raise amounts ranging from US$10k to US$2m, which can be considered too small for private commercial investors. The due diligence process required by investors is the same regardless of the amount funded, therefore private capital providers are more likely to target those MSMEs looking for larger amounts.

Whilst local microfinance institutions (MFIs) play a considerable role in bridging this funding gap, the demand for financing by MSMEs is just too large to be adequately serviced by local MFIs alone, and would not be the ideal source of long-term financing for MSMEs. Blended Finance can therefore play a critical role in enticing private capital into the sector.

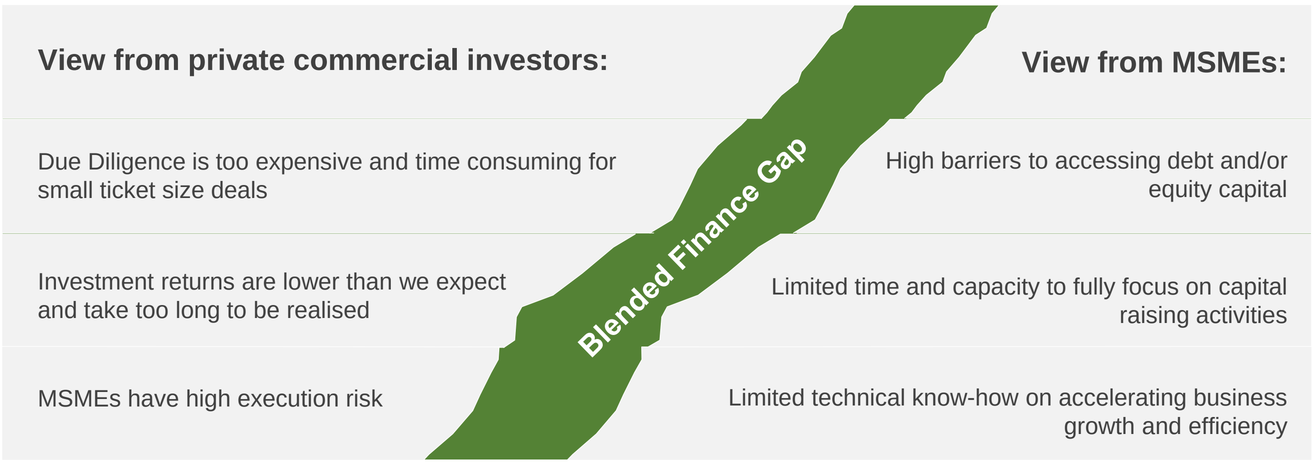
According to data from Convergence, Kenya, Uganda and Tanzania have been the largest recipients of Blended Finance in Africa, and in our view, Rwanda is well positioned to take advantage of this trend.

Opportunities for co-financing for local commercial banks and MFIs

Blended Finance programmes rely heavily on the local commercial banks and/or MFIs who have a good understanding of the local market and who have strong relationships with MSMEs. The presence and endorsement by development finance providers can also have a risk mitigating effect for the local financial institutions. Local banks and MFIs in Rwanda should therefore be actively looking for Blended Finance partners.

Blended Finance in the context of Covid-19

A Blended Finance facility would also be an effective way of cushioning the impact of external shocks such as the Covid-19 pandemic on the MSME sector. This can be in the form of the provision of concessional funding or guarantee programmes which support local banks to continue to provide loans to MSMEs which have been adversely impacted by the pandemic. For example, in Dec 2020 IFC announced a US$10m loan to I&M Bank to help the bank increase lending to MSMEs in Rwanda which are facing Covid-19-related liquidity challenges.



Long term benefits of using Blended Finance for investment in Rwandan MSMEs:

1

Accelerated growth and development of MSMEs

Blended Finance vehicles present an opportunity to accelerate the growth and sophistication of the MSME sector in Rwanda through:

- Access to affordable and patient capital by MSMEs.
- Access to Technical Assistance Facilities (TAFs) and other non-financial mechanisms which improve business and technical practises by MSMEs.
- Examples of the impact of technical assistance include enhanced corporate governance and management practices, enhanced sector linkages, technology risk management and improved approaches for de-risking value chains.

2

Targeted growth in specific priority sectors

Blended Finance can be used to strategically target specific priority sectors which require the most financial and technical investment:

- Whilst the agricultural sector makes up the bulk of MSMEs in Rwanda, Blended Finance can be used to develop depth and sophistication in other sectors such as manufacturing, renewable energy, technology, healthcare and financial services.
- For example, priority can be given to innovation and high-risk segments, such as new technologies, healthcare and education, where private capital might not otherwise flow to.

3

Larger ticket sizes in the long term

Blended finance vehicles in Rwanda would in the medium-to-long-term open a new market for private investors:

- The use of Blended Finance will lead to growth of MSMEs as it will serve not only as a de-risking instrument but also as a mechanism to grow businesses and consequently create larger ticket size investment opportunities, thereby attracting more private investors.

About Market Intelligence Africa

Market Intelligence Africa is a boutique commercial due diligence and advisory firm focused solely on Africa. Our aim is to assist investors make informed investment decisions in Africa.

We are working on a number of opportunities in the Rwandan MSME sector, and we would welcome the opportunity to discuss these with you. Please do get in touch.

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Publication date: **January 2021**