Leveraging Capital Markets for Small and Medium Enterprise Financing in Rwanda
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Leveraging Capital Markets for Small and Medium Enterprise Financing - RWANDA

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**Foreword**

The overarching goal of Rwanda’s Vision 2020 is to transform the country into a middle income economy by improving its competitiveness while ensuring unity and inclusive growth. The private sector employs the majority of the workforce which makes private sector led growth a core pillar of this vision. Small and Medium Enterprises are the bedrock of Rwanda’s private sector but most of these enterprises are informal and are yet to realize their full potential in terms of job creation and contribution to output and public revenues. High transport and energy costs, limited access to finance and deficiencies in core business competencies such as business planning and management are some of the major impediments.

The Government’s response to addressing these challenges has given rise to several initiatives. In the area of access to finance, the Financial Sector Development Program has spearheaded reforms to restructure and modernize the financial sector and to improve the regulatory and legislative framework. These reforms have catalysed renewed interest in the financial sector. For instance, Initial Public Offerings for Bralirwa Brewery and Bank of Kigali were both over-subscribed by over 250%.

This study seeks to complement Government efforts aimed at increasing access to long term capital particularly for SMEs. This study serves a number of purposes. First, it identifies the major constraints to access to long term capital for SMEs with particular focus on the capital market and related forms of financing. Second, it presents an action plan for addressing these constraints, distinguishing between the short- and longer-term measures. Third, it is a tool for stimulating dialogue on reform measures for improving SMEs’ access to long-term financing.

A key outcome of this study is that capital markets and related instruments have the potential to increase access to financing for SMEs and can also indirectly contribute to their growth. In addition to facilitating risk sharing and diversification, the increased publicity and scrutiny associated with equity investments also contributes to improved corporate governance and consequently business growth.

We believe that the findings of this study will be used to guide the design and implementation of the required reforms for increasing access to long term financing for SMEs in particular and the private sector more generally.

The Bank looks forward to continued dialogue and collaboration with various stakeholders, in order to develop bold and innovative approaches to SME and private sector financing in Rwanda.

**Vice President,**  
Country and Regional Operations and Policy  
African Development Bank
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EXECUTIVE SUMMARY

A. INTRODUCTION
1. The development of an efficient private sector spearheaded by competitiveness and entrepreneurship is an important pillar in Rwanda’s Vision 2020. Small and Medium Enterprises (SMEs) comprise over 90 percent of private sector establishments and employ the majority of the population, indicating that expansion in the sector is of strategic importance in achieving inclusive growth, and reducing the Balance of Payments and fiscal deficits.

2. Several interventions have been implemented during the past decade to support private sector development including SME development. However, significant challenges remain, ranging from capacity constraints in core business competencies for entrepreneurs to limited access to finance. This study endeavors to make a contribution in addressing the latter challenge by examining options for SME access to finance through capital markets and related financial instruments.

3. The study reviews and examines: the current legal and regulatory framework to establish the extent to which it facilitates private sector access to capital markets in Rwanda; available literature and data on private sector access to capital markets in Rwanda; and available evidence on what has worked in other countries in Africa and globally including in Asia, Brazil and Israel to provide lessons for Rwanda. To complement the 2011 Establishment Census, primary data were collected from a sample of 200 unlisted/unquoted private sector firms.

B. SITUATION ANALYSIS
4. In 2010, the Government of Rwanda (GoR) adopted the SME Policy aimed at guiding the implementation of a coherent and coordinated policy framework to create an enabling environment for the growth of the SME sector. It is envisaged that the growth of the SME sector will increase non-farm employment, develop business and technical skills in the Rwandan workforce, support targeted value-added clusters, grow the tax base, and spur industrial growth.

5. Most micro and small enterprises employ up to four people and 93 percent of private sector establishments are SMEs with an average capital employed of Rwf 16.3 million (US$26,080). About 60 percent of the SMEs have a turnover of less than Rwf 50 million (US$ 80,000). A significant number of SMEs are engaged in wholesale and retail trade, accommodation and food processing services.
6. About 11.2 percent of SMEs are registered with Rwanda Revenue Authority (RRA) and 4.8 percent with Rwanda Development Board (RDB). However, 87 percent are registered at the local government level. Some enterprises are also registered with the Rwanda Social Security Board (RSSB) and Private Sector Federation (PSF). The majority of the SMEs are not incorporated. According to the laws governing capital markets in Rwanda, one of the basic requirements for an enterprise to list on the capital markets is incorporation.

7. About half the total establishments started operations in 2010 and are therefore relatively young. Most of the firms are family-owned or sole proprietorships (91 percent), which raises the issue of corporate governance, a key prerequisite for participating in capital markets.

8. Key requirements for accessing most formal sources of finance include preparing a business plan, monthly cash-flow projections, audited books of accounts, and a track record of the firm's banking transactions. Only 30 percent of the SMEs have a business plan and less than 30 percent project cash-flows. About 40 percent of SMEs use retained earnings to finance their operations. Thirty percent of SMEs use trade credit and 25 percent indicated that they use bank loans. A negligible percentage of SMEs reported use of debt securities or equity financing.

9. The Capital Markets Authority (CMA) in Rwanda was established in 2011 to spearhead the development of the capital market. The Rwanda Stock Exchange (RSE) Limited was incorporated in 2005 but launched in 2008 with the objective of carrying out stock market operations. Stock market operations are conducted in both the primary and secondary markets. The RSE listing rules and regulations provide a framework for facilitating trade in a fair and efficient securities market.

10. Currently, the RSE has two domestic stocks - Bank of Kigali and Bralirwa Ltd; two cross-listings - Nation Media Group and Kenya Commercial Bank; five Treasury bonds and one corporate bond by the Commercial Bank of Rwanda. Clearly, the capital market is still nascent.

11. The Central Bank of Rwanda has implemented an Integrated Payment and Processing System that includes the Real Time Gross Settlement, the Automated Clearing House, the Automated Transfer System and the Central Securities Depository aimed at improving efficiency of the payment system. This has resulted in the adoption of a T+2 settlement cycle for all securities traded, with
the associated benefit of improving liquidity in the market, making it attractive to domestic and foreign investors.

12. Most of the SMEs are informal and not incorporated indicating that they cannot sue and cannot be sued. This constrains access to finance particularly from the formal sources. The range of products accessed is also limited with most of the SMEs surveyed indicating heavy reliance on term loans. This is both an indication of limited diversification of financial products but also the fact that SMEs lack the necessary requirements to access other financial instruments.

13. Given the low value of SME loans, the per-unit transaction costs of processing and tracking the performance of such loans are high. SMEs also tend to experience a more variable rate of return on their investments and higher rates of failure. These factors increase the risks associated with SME loans. Moreover, access to and affordability of business development services (BDS) remains low. This suggests that measures to increase access to finance should be coupled with interventions to expand access to business development services to ensure a holistic approach to SME growth and development.

14. The listing requirements currently do not distinguish between SMEs and large firms. These comprise a minimum capital requirement of US$813,008; a well-formulated business plan; audited financial records; and a generally accepted corporate governance structure. Most SMEs do not meet these requirements.

15. The absence of a robust SME information collection and sharing system compounds the information asymmetry associated with the SME sub-sector and thus contributes to the limited access to financing. For equity and debt markets to be developed for SMEs, relevant and complete information about these enterprises has to be readily accessible.

C. REGIONAL AND INTERNATIONAL EXPERIENCE OF SME ACCESS TO CAPITAL MARKETS

16. There are initiatives being undertaken within the region and beyond to enable SMEs to access financing from various sources including through the capital markets. These initiatives include private equity (PE) and venture capital (VC); fund of funds; and establishment of alternative investment market segments in the capital markets for SMEs.
### 17. Lessons from Private Equity/Venture Capital:

<table>
<thead>
<tr>
<th>Kenya</th>
<th>Tunisia</th>
<th>Brazil</th>
</tr>
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<tbody>
<tr>
<td>Measures to support the establishment of equity funds should be coupled with broader measures to support enterprise development including the provision of business development services. This will ensure a steady supply of clientele for the equity fund managers.</td>
<td>While other financial institutions such as development banks could also contribute to the mobilization of risk capital, a framework to ensure complementarity of these banks with rather than substitution for venture capital funds is critical for the success of venture capital funds.</td>
<td>PE/VC initiative can be a private-public initiative.</td>
</tr>
<tr>
<td>PE/VC managers can act as catalysts for growth of companies before these companies list on the stock markets; PE/VC provides more than finances. For instance, it may require a share in the company it is investing in, provide strategic advice and access to the PE/VC’s valuable business network; PE/VC exercises rigorous selection of firms to invest in, monitoring and governance that mitigate uncertainty and risks; Through an agreement, PE/VC exits take place in the stock exchange, which promotes listing of SMEs on the stock markets; and The success of PE/VC is also dependent on economic and institutional environment, including suitable legal and fiscal system and an efficient bureaucracy.</td>
<td></td>
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</table>

### 18. Lessons from Fund of Funds:

<table>
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<tr>
<th>Israel Fund of Funds</th>
<th>Korea Fund of Funds</th>
<th>Ghana Venture Capital Fund</th>
</tr>
</thead>
</table>
| • Government initiatives can act as triggers especially when coupled with a program design with in-built incentive structures in terms of options to buy out government shares over a given period of time; | • Government support ensures that a stable stream of PE/VC funding including during economic downturns and recessions;  
  • An institutional framework that enshrines the fund manager’s role in evaluating, selecting, and allocating capital to the most profitable uses assures professional independence and efficiency of the fund; and  
  • The public (government funding)-private (management from a professional and independent fund manager) sector collaboration ensures sustainability and profitability of the fund which enhances its contribution to enterprise development. | • Government initiative and partnership with the private sector is instrumental in particular by mitigating risks associated with financing SMEs; |
| • Existence of an investor base and enterprises with growth potential is critical for successful PE/VC funding interventions; and A dynamic capital market provides several complementary benefits to PE/VC financing mechanisms including an exit option via Initial Public Offerings (IPOs). | | • Coupling PE/VC financing with technical assistance to develop the core business competencies ensures enterprise growth and thus secures the PE/VC investment; |
| • Government initiative and partnership with the private sector is instrumental in particular by mitigating risks associated with financing SMEs; | | • Structured decision-making ensures that investment choices and decisions accommodate the interests of all stakeholders. For instance, fund managers are responsible for deal sourcing, selection, monitoring and exit of fund investments but final investment decisions are made by the Investment Committees comprising representatives of the fund’s investors and independent professionals appointed by the fund’s Board of Directors. |
19. **Lessons from Alternative Investment Market Segments:** Simplified or less stringent listing requirements in Uganda, Tanzania and Kenya have not resulted in the listing of SMEs. For Kenya and Tanzania, it can be argued that it is still too early to infer the impact of simplified requirements for SME listings because effectively the implementation has not started for Tanzania, and the initiative was only launched in January 2013 in Kenya. However, for Uganda, this suggests that simplifying the listing requirements is not a panacea. A holistic approach to addressing the constraints facing SMEs needs to be designed as is the case in South Africa, where relaxation of the listing requirements has been augmented by other business support services to the SMEs. For example, in addition to simplifying the listing requirements, programmes to support the development of core business competencies and awareness campaigns to demonstrate the benefits of capital markets to SMEs are also necessary. Complementing capital markets with alternative financing options such as venture capital and/or asset-backed securities should also be considered.

20. **Lessons from Asset-Backed Securities**

<table>
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<tr>
<th>South Africa</th>
<th>South Korea</th>
<th>Spain</th>
<th>European Investment Fund</th>
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<tr>
<td>• Presence of legal and accounting systems to support off-balance sheet transactions is necessary to mitigate the risk associated with asset-backed securities;</td>
<td>• Government initiative to establish a mortgage securitization body (KOMOCO) to issue mortgage-backed securities collateralized by mortgage loans acquired from the country’s National Housing Fund was key in fostering the securitization market;</td>
<td>• Securitization legislation explicitly permitting the creation of special purpose investment companies and the establishment of a government-supported guarantee programme for SME securitizations was key in developing the securitization market in general and SME securitizations in particular.</td>
<td>• Credit guarantees/ enhancements have a positive impact on securitization, including for the SMEs, by facilitating asset-backed security rating upgrades, mitigation of associated market risks, which consequently increases these asset’s market value and uptake by investors.</td>
</tr>
<tr>
<td>• Moreover, legal framework for securitization, in particular providing for the establishment of special-purpose vehicles as limited liability companies to manage securitization transactions, can catalyze the market.</td>
<td>• Ratification of Asset Backed Securitization legislation has dual benefits. First, it provides a legal framework for guiding securitizations and, second, it recognizes the activities of special-purpose vehicles as limited liability companies to manage the securitized assets.</td>
<td>• The Business Development Fund in Rwanda which currently provides credit guarantees for commercial bank loans could consider, with the ratification of supporting legislation, providing credit enhancement for SME securitization.</td>
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**D. CONCLUSION AND POLICY RECOMMENDATIONS**

21. SMEs play a significant role in economic development, including in Rwanda. However, in spite of several initiatives undertaken by the Government of Rwanda to address constraints facing SMEs, some bottlenecks persist. This study makes a case for the need to explore options for using capital markets to finance SMEs due to various benefits including the possibility of access to more affordable funds for business growth and expansion, risk sharing and diversification via a public offering; and increased publicity and scrutiny of SMEs’ operations which
comes with equity investments. Drawing on regional and international experiences, this study identifies several key recommendations with the potential to catalyze SME financing through capital markets and other sources. These recommendations include:

22. **Enact Supporting Regulatory and Legal Reforms**: While the regulatory and legal framework for the development of financial markets, including capital markets, is in place, the authorities should consider revising the listing requirements targeting the SME sector. The existing ones do not position SMEs to benefit from the equity and debt markets because the establishments are predominantly micro and small-scale enterprises, mainly sole proprietorships and family-owned. However, the authorities should not stop at relaxing the listing requirements. As the case of the AltX in South Africa has demonstrated, the Government of Rwanda will need to partner with the RSE, SME representatives and development partners to address the other SME-specific challenges such as poor financial management and reporting, issues of incorporation, corporate governance.

23. **Improve Information Collection and Sharing**: The government, CMA, financial institutions and SMEs should consider developing an information gathering and sharing system on key indicators such as performance, profitability, market niche, among others. The proposed system could be modeled around the credit reference bureau although the scope of information collected, managed and shared will extend beyond credit. Supporting legislation will be necessary for the operationalization of such an information sharing system. The information required from a company should at least cover the key financial indicators captured when companies are trading on stock exchanges. A similar database has been developed by the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN).

24. **Encourage and Promote the Establishment of Private Equity and Venture Capital (PE/VC)**: Rwanda can benefit from existing venture capital funds within the East African region which particularly target SMEs. Most of these funds are based in Nairobi but with a regional focus as discussed in Section C. The SMEs based in Rwanda can initially benefit from these funds if information is availed to them regarding the requirements for accessing these funds. In addition, an effort could be made to market some of Rwanda’s SMEs to the fund managers in the region. Developing a prospectus containing information on productivity, financial, and growth potential of these SMEs would be useful in this regard.
25. **Establish a Rwanda Fund of Funds (RFF):** This study recommends that the Government initiates the establishment of the Rwanda Fund of Funds by contributing the seed capital and inviting potential partners to contribute to the fund. By setting up the Rwanda Fund of Funds, the Government will not only be promoting access to financing by SMEs, it will also ensure the venture capital market has access to a steady supply of funding even during economic slowdowns.

26. **Setting-up Asset-Backed Securities:** Asset-backed securities should also be explored by the Capital Markets Authority for the benefit of SMEs. However, this would require various enablers including supporting legislation, credit enhancement, and a more vibrant securities exchange market, among other things. Moreover, appropriate mitigating measures would be necessary to alleviate the risks associated with asset-backed securities.

27. **Review the Current Approach to Providing Business Development Services:** While the privatization of the provision of Business Development Services (BDSs) is aimed at ensuring their sustainability, measures should be taken to ensure their wider access and affordability to the private sector including SMEs. For instance, measures to develop the capacity of the private providers of these BDSs and support to mobilize funding including from development partners should be fast-tracked. Cost-sharing between the Government and SMEs could also be considered in the short term.

28. **Maintain the Current Fiscal Incentive Structure:** Government interventions in the form of tax breaks, grants and other subsidies have the potential to support the growth of capital markets, especially during the formative stages. Given that capital markets have been operating for only a few years in Rwanda, there is limited empirical evidence to inform conclusions on the impact of the current tax regime on the growth of the capital markets, and whether any major reform is required in this regard. An assessment of the current fiscal incentive structure could be undertaken in say 2015 to inform any improvements in the targeting of incentives in line with the country’s development priorities. This study therefore recommends that Capital Market investment incentives contained in the special official gazette published on 28th May, 2010, should be maintained in the short-term.
A. INTRODUCTION

A.1 Background

Rwanda’s Vision2020 identifies six priority pillars and three cross-cutting areas, the development of which is crucial for making the necessary long-term transformations in the Rwandan society. One of the pillars is the development of an efficient private sector spearheaded by competitiveness and entrepreneurship. The Establishment Census 2011 in Rwanda reports that the country had over 123,000 business establishments in 2011 compared to an estimated 73,000 in 2008, a growth of nearly 70% over a three-year period. As Table 1 shows, of the 123,526 establishments, 96.5% were in the private sector, employing 91% of Rwanda’s workforce, mostly in agriculture. SMEs comprise 98% of all the establishments; micro-sized establishments - those employing between 1 and 3 people - account for 92.6% of all establishments while enterprises with only one worker account for 72% of all establishments. This indicates that growth in the SME sector could be of strategic importance in addressing the challenge of unemployment in general and youth unemployment in particular.

Growth of the SME sector also has the potential to lower Rwanda’s trade deficit, estimated at US$1,376 million in 2012, owing to the low export potential mainly driven by traditional crops (coffee and tea) and minerals. Rwanda’s vision is to address this trade imbalance by increasing export earnings through value addition. In addition, the Government of Rwanda (GoR) envisages reducing its dependence on external grants and loans, which contributed over 50 percent of the budget in FY 2011/12. Reducing the fiscal deficit could be achieved by tapping into SMEs as a source of tax revenues. Out of the 123,526 SMEs, only 25,000 (20%) were registered, of which 24% pay taxes regularly. Registration of more SMEs and drawing them into the tax net can therefore contribute to the expansion of the tax base and tax revenues.

Several initiatives to support SME development have been undertaken by various actors including the government, development partners, and development finance institutions. The initiatives include the establishment of the Centre d’Appui aux Petites et Moyennes Enterprises (CAPMER) whose major mandate was to provide training, advice and technical support to SMEs; the Financial Sector Development Program recently instituted within the Ministry of Finance and Economic Planning; and licensing of 416 Umurenge (village level) Savings and Credit Cooperatives (SACCOs) to grant loans of up to 40% of their deposits. Other initiatives include tailoring of a significant proportion of the Rwanda Development Bank (BRD)’s lending activities to SMEs and cooperatives; establishment of a Rwanda SME Fund with an estimated US$8m in loanable funds (The Rwanda SME Fund is a private venture fund under Business Partners International funded by International Finance Corporation, Rwanda Enterprise Investment Company, and Stichting Doen); and preparation in 2011 of the SME Development Action Plan by the Ministry of Trade and Industry.

In spite of the initiatives undertaken to promote SMEs and enhance their potential benefits, there still remain both internal and external challenges to their growth. Most SMEs still depend on internally generated funds and borrowing from informal sources. About 22% of the SMEs employ less than 500,000 Rwandese Francs in the form of capital (US$1 = RwF625 as of 13th September, 2012). Only 11.2% of SMEs are registered with the Rwanda Revenue Authority although up to 87% were found to have registered at the local government level. The Establishment Census 2011 reports that 89% of the enterprises are informal. This is compounded...
by the limited capacity of SMEs to develop bankable projects, particularly owing to limited human capital and skills. In addition, financial institutions consider SMEs to be highly risky and the transaction costs of lending to them high.

Furthermore, the overall private sector policy environment, which in the past was oriented towards large companies, has been identified as an impediment to the growth of SMEs and the Government of Rwanda has responded by developing an SME policy. The growth of SMEs is also constrained by limited access to affordable and quality business development services which are specifically tailored to their needs. The rural SMEs are also constrained by the absence of supporting infrastructure such as road network, power supply, water for production, and telecommunication services required for their growth.

Several studies on SMEs rank lack of access to finance as one of the most critical constraints to the growth of SMEs (Establishments Census, 2011; The Global Competitiveness Report, 2009/10). A number of reasons have been advanced in support of the use of capital markets for financing SMEs. A primary one is raising funds for business growth and expansion (Friedman and Grose, 2006; Manas and Manoj, 2006; Boot, et al., 2003). Wagacha (2001) reports that some firms seek capital markets financing because it is cheaper than other forms of financing particularly bank finance. Other benefits that come with accessing capital markets financing include risk sharing and diversification to reduce exposure to risk by having more investors through a public offering and increased publicity and public scrutiny to improve their performance. It is also argued that capital markets facilitate mergers and acquisitions, thereby promoting efficiency, performance, and growth of firms.

The financing gap for SMEs, defined as the difference between their demand for and supply of financing, results from both supply and demand side factors. On the demand side, the financing needs vary depending on the size of the firm; its level of maturity; the level of growth, including the relative importance of fixed and working capital; and the nature of ownership, which, for most SMEs, especially micro- and small-scale, are family-owned. In Rwanda sole-proprietorship is the most common form of legal status, accounting for 91% of the establishments that existed in 2011 (Establishments Census, 2011). In addition, awareness about the operations of capital markets, the associated costs and the ability of the SMEs to absorb further debt or equity are contributing factors to the financing gap.

On the supply side, there are also factors contributing to the SME financing gap. First, there is a perception that SMEs are risky and associated with higher per unit transaction costs relative to the low value loans required. Second, the limited availability of innovative financing methods (other than banks) including venture capital, collateralized debt obligations and mutual funds among others is another impediment. Third, the capital markets in Rwanda are still nascent. Fourth, the legal and regulatory framework is inadequate in relation to the provision of long-term funds and its role in facilitating the development of capital markets in Rwanda. These obstacles to the use of capital markets by SMEs as a source of financing have been examined in this report and possible solutions suggested.

A.2 Objectives and Contribution of the Study

The primary objective of this study is to identify obstacles to SME use of capital markets for long-term financing and to identify policies for mitigating those challenges. Specifically, the study aims at:

- Identifying the major barriers to access to long-term capital for SMEs through the capital market and other forms of formal financing;
- Outlining a phased policy action plan for addressing

1 A Capacity Needs Assessment of SMEs conducted by the Private Sector Federation in 2008 reports that many SMEs suffer from lack of technical and business skills, technical and industrial knowledge and finance accounting and management.
these barriers explicitly indicating the short-, medium-, and longer-term measures; and

- Stimulating dialogue on reform opportunities for SMEs to access long-term capital financing.

The study's principal contribution includes identifying policy recommendations and other options for increasing SMEs' access to long-term financing through the capital markets and other sources, drawing on lessons from successful approaches in other countries in Africa and globally.

**A.3 Methodology and Scope**

The methodology employed comprises the following:

- Review of the current legal and regulatory framework to establish the extent to which it facilitates private sector access to capital markets in Rwanda;
- Review of the available literature and data on private sector access to capital markets in Rwanda;
- Examination of available evidence on what has worked in other countries in Africa and globally including in Asia, Brazil and Israel to provide lessons for Rwanda;
- Collection of primary data from a sample of 200 unlisted/unquoted private sector firms to complement the 2011 Establishment Census. The sample design used was stratified simple random sampling. The survey relied on the register of enterprises used by the National Institute of Statistics in Rwanda 2011 to conduct the Establishment Census; and
- Synthesis of the findings from the foregoing assessment to inform key recommendations and an action plan for increasing SME access to finance through the capital markets and other sources.

The fieldwork was done in May 2012 and covered Kigali, and in particular Gasabo, Kicuciro, and Nyarugenge districts. Data collected were primarily on access to long-term financing by the sampled SMEs that were not collected during the Establishment Census conducted in 2011. Financial institutions were also surveyed to identify the key supply-side impediments to access to long-term financing for SMEs.

The SME survey was cross-sectional and the unit of analysis is the sampled firms. Both descriptive and quantitative assessments have been used in the data analysis.

**A.4. Organization of the Report**

The report is structured in six main sections as follows:

Section A presents the introduction, objectives, methodology and scope of the study. Section B provides a situation analysis with specific focus on the overview of Rwanda’s economy, analysis of the SME sector, the capital markets and the initiatives being pursued in Rwanda to improve access by SMEs to financing. The situation analysis was done based on both the results of the Establishment Census 2011 and the study’s complementary survey of 200 firms. Section C draws lessons from regional and international experiences while Section D evaluates the potential for SME financing and listing in Rwanda’s capital markets. Section E concludes with policy recommendations and Section F presents the proposed action plan for implementing these recommendations.
Leveraging Capital Markets for SME Financing in Rwanda
B. SITUATION ANALYSIS

B.1 Overview of Rwanda’s Economy

Rwanda’s economy has improved tremendously with per-capita GDP (PPP) estimated at $1,284 in 2011, compared with $416 in 1994. The real GDP grew at an estimated 8.6% in 2011 up from 7.2% and 6.2% in 2010 and 2009 respectively. A combination of factors ranging from implementation of prudent and coordinated macroeconomic policies to strategic sector policies, programmes such as flagships, and plans have driven this impressive economic performance.

The agriculture sector remains a key engine of growth, comprising of an estimated 33.6 percent of GDP in 2011, but the sector is mostly subsistence with a large number of rural households’ farm plots too small to earn a decent living. The sector grew at an average of 5.3 percent over the last five years, contributing an average of about 35.1 percent to GDP. In addition, the sector employs 80-90 percent of the labor force and generates more than 45 percent of the country’s export revenues.

The services sector has been growing at an average of 10 percent over the past five years. Having suffered during the 2008/09 economic slowdown as banks reduced lending, the services sector rebounded in 2010 and contributed 45.6 percent to the country’s GDP. Key drivers of this growth include banking and finance, wholesale and retail trade, hotels and restaurants, transport, storage, communication and insurance as a result of life insurance awareness campaigns. Others include real estate, business services and public administration such as education and health. The growth in communication services was due to the increase in mobile-phone penetration. Tourism, one of the fastest-growing economic resources, became the country’s leading single foreign exchange earner in 2011 with receipts of US$252 million and higher than the US$202 million recorded in 2010.

The industrial sector is small, contributing 15.1 percent of GDP in 2011. However, Rwanda’s mining sub-sector is an important contributor to GDP and generated an estimated US$151 million in 2011 up from US$54.6 million and US$67.8 million in 2009 and 2010 respectively. The construction sector, which accounts for more than 50 percent of the industry sector’s output, recovered from a slump in 2009 and 2010 to grow at 23.6 percent in 2011. The private sector has also grown in tandem with the economy, with the Establishment Census 2011 reporting an increase of the establishments from 73,000 in 2008 to more than 123,000 in 2011, the majority of which are SMEs.

B.2 SME Sector in Rwanda

B.2.1 Policy, Legal and Regulatory Framework

Following on from its Vision 2020, in 2010, the Government of Rwanda (GoR) designed the Small and Medium Enterprise (SME) Policy framework aimed at guiding the implementation of a coherent and coordinated policy to create an enabling environment for the growth of the SME sector. It is envisaged that the growth of the SME sector will increase non-farm employment, develop business and technical skills in the Rwandan workforce, support targeted
value-added clusters, grow the tax base, and spur industrial growth.


The SME policy therefore, among others, attempts to bridge the gap between previous policies which are cross-cutting in nature and targeted to large companies, thereby filling the void of policies specifically targeted to SMEs with a particular focus on facilitating investment finance.

**B.2.2 SME Definition in Rwanda**

There are several definitions of SMEs across the globe. For the purposes of this study, the definition of SMEs is adopted from the SME Policy document of the Government of Rwanda and illustrated in Table 2. Note that the definition takes into account the following: (i) Two of the three conditions i.e. net capital investments, annual turnover, and number of employees should be met; (ii) Rwanda Revenue Authority (RRA) has a different definition of SMEs for tax purposes; and (iii) Informal companies are defined as those not registered in accordance with the Companies Act or other legislation related to SMEs and cooperatives.

RRA classifies SMEs as enterprises with annual turnover in the range of US$35,087 and US$350,877, while medium enterprise with annual turnover of US$350,877 and US$877,192 (East Africa Business Week, 15 July, 2011).

**B.2.3 Structure and Characteristics of SMEs**

To provide a more complete description of SMEs in Rwanda, we examined in more detail their structure and characteristics along the following dimensions: number of SMEs and employment, size of capital; sectoral composition and turnover; business registration; ownership, age, corporate governance; financial management and reporting; and sources of and demand for financing.

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**Table 2: The SME Definition in Rwanda**

<table>
<thead>
<tr>
<th>Size of enterprise</th>
<th>Net capital investments (millions of RWF)</th>
<th>Annual turnover (million RWF)</th>
<th>Number of Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro-enterprise</td>
<td>Less than 0.5</td>
<td>Less than 0.3</td>
<td>1 to 3</td>
</tr>
<tr>
<td>Small-enterprise</td>
<td>0.5 to 15</td>
<td>0.3 to 12</td>
<td>4 to 30</td>
</tr>
<tr>
<td>Medium-enterprise</td>
<td>15 to 75</td>
<td>12 to 50</td>
<td>31 to 100</td>
</tr>
<tr>
<td>Large enterprise</td>
<td>More than 75</td>
<td>More than 50</td>
<td>More than 100</td>
</tr>
</tbody>
</table>

Source: Ministry of Trade and Industry, 2010; US$ = RWF 625 as at 13th September 2012

**Table 3: Number of SMEs and Employment**

<table>
<thead>
<tr>
<th></th>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>114,329</td>
<td>8,548</td>
<td>513</td>
<td>106</td>
</tr>
<tr>
<td>% proportion</td>
<td>92.6</td>
<td>6.9</td>
<td>0.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Employment (%)</td>
<td>51.3</td>
<td>24</td>
<td>8.7</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: Ministry of Trade and Industry, 2011
I. Number of SMEs and Employment:
Findings from both the Establishment Census, 2011 and the survey conducted by this study (complementary survey) indicate that most micro and small enterprises employ up to four people, suggesting that growth in the sector could be of strategic importance, especially in addressing the challenge of youth unemployment. As indicated in the Table 3, micro-sized establishments - those employing between 1 and 3 people - account for 92.6% of all establishments with 89,219 (72%) having just one worker. In terms of employment, micro-enterprises employ 51.3% of the 281,946 persons employed in all the establishments, further underscoring the importance of the SMEs with respect to employment generation.

II. Capital Employed
The structure of establishments in Rwanda according to capital employed is pyramidal, with a large base of micro-sized and a small upper-level of large-sized establishments. A total of 90,388 (71%) enterprises are categorized as micro establishments compared to the 1,095 (less than 1%) that fall in the large category (Table 4). The average value of capital employed by an establishment in Rwanda is RWF 16.3 million (US$26,080), which is relatively small compared to US$35,087 lower end turnover of a small enterprise as defined by the RRA. Rwanda being a low income country, it is not surprising to find that more than 70% of the establishments are micro-enterprises because of the low level of capital required to set up a micro-enterprise and a large reliance on subsistence agriculture.

III. Sectoral Composition and Turnover
A significant number of SMEs are engaged in wholesale and retail trade, and accommodation and food processing services as indicated in Table 5.

Based on the 2012 complementary survey, 60% of the SMEs interviewed have a turnover of less than 50 million

Table 4: SMEs by Capital Employed

<table>
<thead>
<tr>
<th></th>
<th>Micro (&lt;Rwf 0.5m)</th>
<th>Small (Rwf 0.5m – 15m)</th>
<th>Medium (Rwf 15m – 75m)</th>
<th>Large (Rwf +Rwf 75m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>90,388</td>
<td>27,603</td>
<td>2,052</td>
<td>1,095</td>
</tr>
<tr>
<td>% proportion</td>
<td>71.2</td>
<td>22.3</td>
<td>1.7</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Source: Ministry of Trade and Industry, 2011

Table 5: SMEs by Economic Sector

<table>
<thead>
<tr>
<th>Economic Sector</th>
<th>Establishments by Size</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Micro</td>
</tr>
<tr>
<td>Agriculture, Forestry &amp; Fishing</td>
<td>411</td>
</tr>
<tr>
<td>Mining &amp; Quarrying</td>
<td>9</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>3,663</td>
</tr>
<tr>
<td>Utilities</td>
<td>298</td>
</tr>
<tr>
<td>Construction</td>
<td>36</td>
</tr>
<tr>
<td>Wholesale and Retail Trade</td>
<td>63,153</td>
</tr>
<tr>
<td>Accommodation and Food Processing Services</td>
<td>31,109</td>
</tr>
<tr>
<td>Information and Communication</td>
<td>484</td>
</tr>
<tr>
<td>Financial and Insurance</td>
<td>436</td>
</tr>
<tr>
<td>Professional Services</td>
<td>4,870</td>
</tr>
<tr>
<td>Health and Education</td>
<td>411</td>
</tr>
<tr>
<td>Other Services</td>
<td>9,449</td>
</tr>
</tbody>
</table>

Source: Ministry of Trade and Industry, 2011
Leveraging Capital Markets for SME Financing in Rwanda

Rwandese Francs (Figure 1). This is in line with findings from the Establishment Census which also indicate the majority of enterprises in Rwanda fall within the micro, small and medium enterprise category. Compared to the capital employed as per the definition of SMEs, a turnover of about 50 million Rwandese Francs is a substantial amount and is quite promising for the growth of the SME industry and the Rwandan economy.

### IV. Registration

Out of a total 123,526 establishments recorded in 2011 in Rwanda, only 11.2% are registered with Rwanda Revenue Authority (RRA) and 4.8% with the Rwanda Development Board (RDB). However, 107,413 establishments (87%) are registered at the sector level for instance by the Rwanda Cooperative Agency, and at the district level (see Table 6). Some enterprises are also registered with the Rwanda Social Security Board (RSSB) and Private Sector Federation (PSF). However, registering with these entities does not necessarily make the enterprises qualified to benefit from the capital markets. According to the laws governing capital markets in Rwanda, one of the basic requirements for an enterprise to list on the capital markets is incorporation (see section B3). This suggests that the SMEs should aim for incorporation as a first step towards tapping into long-term finance from the capital markets.

### V. Ownership, Corporate Governance and Age

The Establishment Census, 2011, reveals that a total of 60,202 --almost half of the total establishments recorded -- commenced operations in 2010. This compares with 43,287 establishments (35.9%) that started operations between 2005 and 2009, and 9,172 firms (7.4%) established during 2000-2005. In addition, most of the firms are family-owned or sole proprietorships (91%) – Figure 2. There are 2,520 (2%) establishments limited by shares, and 8,573 (7%) with other forms of legal status (e.g. non-profit associations, government). The above statistics suggest that the majority of the existing establishments are barely two years old, indicating that ensuring firm survival is critical and could both influence and be influenced by accessing financing from capital markets. The statistics also indicate that the majority of the enterprises are sole proprietorships, which

![Figure 1: Turnover of the Surveyed SMEs](source: Author's computation from the survey data)

### Table 6: Registration of SMEs by National Authorities

<table>
<thead>
<tr>
<th>RRA</th>
<th>RSSB</th>
<th>RDB</th>
<th>PSF</th>
<th>District</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>13,878</td>
<td>5,519</td>
<td>6,037</td>
<td>5,724</td>
<td>97,766</td>
</tr>
<tr>
<td>%</td>
<td>11.2</td>
<td>4.5</td>
<td>4.8</td>
<td>4.6</td>
<td>79</td>
</tr>
</tbody>
</table>

Source: Ministry of Trade and Industry, 2011

2 Corporate governance is a set of relationships between a company’s management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined (OECD, 2004: The Principles of Corporate Governance)—include in references.
raises the issue of corporate governance, another key prerequisite for participating in capital markets. This means that support to SMEs to prepare them to access financing from capital markets will, among other sources, need to focus on improving corporate governance.

VI. Financial Management and Reporting
Findings from the complementary survey established that the key requirements for accessing most formal sources of finance include preparing a business plan, monthly cashflow projections, audited books of accounts and a track record of the firm’s banking transactions. As shown in Figure 3, the survey results indicate that only 30 percent of the SMEs have a business plan. The number of companies that project cash flows is less than 30 percent. Absence of all or some of these requirements is often used as a basis for rejecting SME loan applications. However, despite the fact that most SMEs operate without the business plans or cash flow projections, 88 percent keep bank accounts and regular books of accounts.

VII. Sources of and Demand for Financing
The 2012 complementary survey also asked the enumerated SMEs to indicate their sources of financing. As Figure 4 shows, about 40 percent indicated that they have been using retained earnings to finance their operations. Thirty percent of SMEs used trade credit and 25 percent indicated that they used bank loans. A negligible percent of SMEs

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3 Financial management is the planning, directing, monitoring, organizing, and controlling of the monetary resources of an organization http://www.businessdictionary.com
reported use of debt securities or equity financing, which is not surprising given the status of ownership, governance, incorporation, and financial management and reporting of the SMEs discussed above. However the survey did not establish the circumstances under which unlisted companies were able to secure funding from the capital markets.

In Kenya, findings from a survey of firms established that SMEs obtained capital from a variety of sources, especially family and friends, but also co-operatives, banks, NGOs, and other financial institutions (Christopher et.al. 2002).

Some of the firms interviewed reported a need for external financing. For instance, 19 percent of the firms reported that they would require more financing in form of bank loans and 22 percent in the form of trade credit (Figure 5). Fixed investment, inventory and working capital as well as limited availability of internal funds were reported as the major drivers for external financing.

The surveyed SMEs were also asked whether they had applied for additional financing in the last six months. More than 30 percent of the SMEs surveyed had applied for funds in the form of bank loans, bank overdrafts and trade credit (Figure 6). On average about 40 percent of the SMEs indicated that there was no need for them to apply for external funds as own-sources of financing such as retaining earnings were considered to be adequate. About 14 percent of the firms interviewed indicated that they could not meet the
documentation requirements for the various loan facilities. In addition, 7 percent indicated that they were discouraged from applying for fear of rejection while 6 percent reported they did not have collateral to secure the loans.

On average, between 30 and 45 percent of firms which applied for loans received what they requested for while 17 to 33 percent of all firms surveyed revealed that they only received a fraction of the amount applied for (Figure 7). The number of firms whose applications were rejected is between 5 and 21 percent of all firms surveyed. This creates challenges for the firms to realize their intended borrowing objectives.

**VIII. Terms and Conditions of Financing SMEs**
The complementary survey also reveals that the terms and conditions for borrowing from formal sources have not changed substantially (Figure 8) over the past six months. About 30 percent of the firms surveyed reported an increase in interest rates charged while the number of firms reporting increased collateral requirements is 15 percent. Between 70 to 84 percent of the firms surveyed reported no change in the various terms and conditions of borrowing, an indication of financial sector stability. To the extent that these terms and conditions comprise impediments to credit access, this finding could also indicate that implementing any requisite improvements in the terms and borrowing conditions could potentially support increased access to credit.

**IX. Summary of Key Messages from the Structure and Characteristics of SMEs in Rwanda**
- The average capital employed by an establishment in Rwanda is RWF 16.3 million (US$26,080) compared to US$35,087 which is considered as the lower bound turnover of an SME by the RRA;
- A significant number of SMEs are engaged in wholesale and retail trade, accommodation and food processing services;

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**Source:** Author’s computation from the survey data

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Over 60% of the SMEs have a turnover of less than RWF 50 million (US$80,645);
• An estimated 11.2% of SMEs are registered with Rwanda Revenue Authority (RRA) and 4.8% with Rwanda Development Board (RDB). However, 87% of SMEs are registered at the sector/local government level. Some are registered with the Rwanda Social Security Board (RSSB) and Private Sector Federation (PSF);
• About half of the total establishments commenced operations in 2010. Most of the firms are family-owned or sole proprietorships. A small share (2%) of the establishments is limited by shares;
• While 30 percent of the SMEs have a business plan, the number of companies that project cash flows is less than 30 percent;
• About 40 percent of SMEs have been using retained earnings to finance their operations. Another 30% used trade credit and 25 percent used bank loans. A negligible percent of SMEs reported use of debt securities or equity financing; and
• Between 70 to 84 percent of the SMEs surveyed indicate that the various terms and conditions of borrowing have not changed, an indication of financial sector stability but also of the potential to increase access to finance by implementing any requisite improvements in these terms and conditions.

B.2.4. Constraints Faced by SMEs in Accessing Financing and Banks in Lending to SMEs

B.2.4.1 Constraints faced by SMEs
SMEs across the world face an array of constraints. The complementary survey asked firms to rank the most pressing problems that hinder their business operations and growth. The key challenges reported include (see Table 7): (i) difficulties in finding customers, (ii) high level of competition in the same goods market, (iii) limited access to finance with more than 38 percent of the firms surveyed indicating that this is their biggest challenge, and (iv) increasing cost of production arising mainly from rising wages.

B.2.4.2 Constraints Faced by Financial Institutions
A questionnaire tailored to banks was also administered by this study to identify some of the key factors that constrain banks in their efforts to extend credit to SMEs. Out of the 11 questionnaires distributed, 7 banks responded with a fully completed questionnaire4. The Banks interviewed included those which have existed since 1967 and also the recently established ones. The key findings from this survey are summarized below.

4 Rwanda has 10 commercial banks and 3 microfinance banking institutions.
i. All the banks interviewed indicated that they provide financing instruments tailored to SMEs, and indeed some have specialized SME departments. However, there are two major impediments to lending to SMEs. First, is the informality of SMEs, which means that the firms are not incorporated and therefore, cannot sue and cannot be sued. In a situation like this, banks are not sure how to deal with such firms, especially when it comes to signing contracts. This poses a challenge and therefore, is a problem to both the firms and the lending institutions. Second, is the lack of bankable projects. However, all banks were of the view that the documentation required from SMEs to support loan applications did not comprise a major bottleneck to accessing bank financing. Moreover, four of the seven banks interviewed did not consider the corporate governance of SMEs as a serious limitation to borrowing.

ii. All seven banks surveyed indicated that term loans are the most widely used financing product while only two banks indicated use of equity financing. Several financing options are made available to SMEs by banks including traditional loans, overdraft facilities, asset financing, equity financing and guarantees. This suggests that while the scope of financial services available to the SMEs is relatively large, the SMEs utilize only a few of these instruments. A key reason for this is the characteristics of SMEs, which limit the suitability of the majority of the available financing options. For the SMEs to fully benefit from the available financing options, the banks would need to further simplify their requirements which include business plans, cash flow projections, incorporation/registration, and strict corporate governance requirements, among other things. Banks will also need to educate SMEs on what they need to do to benefit from the available financing options. Introduction of additional financial instruments Banks could also consider introducing new products tailored to SMEs such as asset-backed securities, discussed in Section D. Expanding access to quality and affordable business development services would provide an effective platform for addressing some of the SME-specific challenges that impede their access to financing.

iii. Banks use various methods to target SMEs which include advertising, use of the existing clients’ base and referrals from existing customers. In addition, some banks have designed specialized products like the agriculture guarantee fund which are largely tailored towards SMEs. As a result, the average proportion of loans to SMEs to the total loan portfolio across the surveyed banks is about 36 percent on average. Data from the central bank indicates that the average lending rate is 16 percent. The bulk of the financing requested by SMEs is working capital with a maturity period of less than 2 years. These loans are backed by collateral such as land, movable assets and buildings. Microfinance institutions are addressing the issue of requiring traditional collateral such as land and buildings through group guarantee arrangements and requesting non-traditional collateral such as certificates of deposit and household assets.

iv. The surveyed banks concurred that the government should play a leading role in making financing available to SMEs. The existing guarantee scheme under the Business Development Fund (BDF), formerly

<table>
<thead>
<tr>
<th>Constraints faced by SMEs</th>
<th>Proportion of respondents (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Difficulties in finding customers</td>
<td>56</td>
</tr>
<tr>
<td>2 High level of competition</td>
<td>42</td>
</tr>
<tr>
<td>3 Limited access to finance</td>
<td>38</td>
</tr>
<tr>
<td>4 Increasing cost of production</td>
<td>43</td>
</tr>
</tbody>
</table>

Source: Author’s computation from survey data
under the Rwanda Development Bank, while appropriate has only benefited a few SMEs. This is partly because the biggest challenge of SMEs is to raise the equity required by the banks as an indication that the proprietors of the SMEs share the risks involved in the business. To address this problem banks indicated that the government should create specialized funds tailored to SMEs. Section D also proposes establishing equity and venture capital, fund of funds and asset-backed securities as options to address these challenges.

v. Generally, banks perceive SMEs as potential clients. This positive perception notwithstanding, all banks still consider the sector as risky with short survival lifespan. The default rate on SME loan portfolios for most of the surveyed banks ranges between 2-7 percent with only one of the surveyed banks reporting a default rate of 35 percent on its SME loan portfolio. In addition, given that the loans are small; this raises the transaction costs of processing and tracking the performance of such loans. Whereas SMEs have a high growth potential, they are also more vulnerable to sudden changes in the economic and competitive environment. SMEs also tend to experience a more variable rate of return and higher rates of failure.

B.2.4.3 Constraints Related to Business Advisory Services

Business Development Services (BDS) are currently provided through five centers which were privatized. The centers are based in four provinces and the city of Kigali. Despite the presence of these centers they are also faced with challenges including the limited capacity of the new operators of the BDS centers to provide the needed services to SMEs—suggesting a need for capacity development; absence of a defined client base of SMEs which has implications for the sustainability of these BDS centers and a lack of appreciation of BDS services by the SME clients. To address these challenges, RDB is currently working with the operators of the BDS centers to develop business plans after which funding will be mobilized from various partners to support the development of these centers and thus improve efficiency in the provision of advisory services. BDF and RDB have been making various efforts to make advisory services accessible to SMEs.

The key objective of the BDF is to support increased lending to both the private sector through the provision of guarantees to individuals and SMEs. BDF also provides advisory services to SMEs with the objective of improving their managerial capacity. However, coverage and affordability of these advisory services remains a challenge. Moreover, the benefits of the BDF guarantee fund are yet to be fully realized due to the fact that commercial banks still require SMEs to raise their own equity before loans are granted. Capital markets could be utilized as a vehicle for raising equity and thus complement initiatives such as the BDF guarantee fund.

B.3 Capital Market in Rwanda

Simply defined, a capital market is a place in which financial securities are traded by individuals and institutions/organizations. It can be a primary market where initial public offers (IPOs) take place or a secondary market where IPOs are traded subsequently. Players in capital markets can be divided into investors, issuers and intermediaries. The market intermediaries in Rwanda include the Rwanda Stock Exchange, licensed brokers, dealers, and sponsors. The regulator is the Capital Markets Authority.

Like all formal capital markets, Rwanda’s capital market has been established and is governed by legal and regulatory frameworks. Of particular interest in this study are the listing requirements for firms to raise investment funds from the public through capital markets.

Below is an overview of the existing legal and regulatory frameworks, the regulator and the stock exchange. The other market players have not been covered because they are still very few.

B.3.1 Capital Markets Authority (CMA)

The Capital Markets Authority (CMA) was established in
2011 under the Capital Market Act of 2011, to guide in the development of Rwanda’s capital market. Prior to the establishment of CMA, the Rwanda Capital Market Advisory Council had been established in 2007 to develop the Capital Market in Rwanda, facilitate the trading of debt and equity securities and enable securities transactions, as well as perform regulatory functions over the Rwanda Securities Exchange (RSE).

CMA is responsible for promoting and developing an orderly, fair and efficient capital market. Its mandate includes: implementing government policy on capital markets; preparing draft policies on capital markets; advising government on policy relating to capital markets; and promoting public awareness on the capital market and developing such a market. Other functions include regulating and supervising all capital market activities with a view to maintaining proper code of conduct and acceptable practices; issuing or withdrawing licenses related to capital markets and protecting citizens from unfair practices such as misinformation by the market players.

In addition to licensing and regulating the RSE, CMA regulates stockbrokers/dealers and any other persons dealing in securities within the national territory.

Listing Rules and Regulations

The RSE listing rules and regulations provide a framework for facilitating trade in a fair and efficient securities market. The listing rules for equity securities are provided in the Table 8.

In addition to the requirements indicated in Table 8, some other conditions that have to be fulfilled include: (i) accounts have to be drawn up and audited in accordance with standards regarded as “appropriate for companies of international standing and repute”; and (ii) evaluation of profit forecasts or the minimum number of shareholders by CMA. While these rules comply with international standards used by other stock exchanges, they are also tailored to suit large companies that are well established and tend to exclude SMEs which can hardly meet such stringent conditions.

B.3.2 Rwanda Securities Exchange (RSE)

Establishment and Role

The Rwanda Stock Exchange Limited was incorporated in 2005 but launched in 2008 with the objective of carrying out stock market operations. The Stock Exchange was demutualized (separation of ownership from trading rights) at the time of registration and is a company limited by shares. Its key roles include providing a platform for raising capital for business expan-

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Official list</td>
<td>Listed securities</td>
</tr>
<tr>
<td>Sponsorship</td>
<td>Every new applicant for listing must be sponsored by a participant who is on the approved list of sponsors</td>
</tr>
<tr>
<td>Nominated Advisor</td>
<td>Every issuer must appoint a nominated advisor</td>
</tr>
<tr>
<td>Incorporation</td>
<td>Duly incorporated or otherwise established in accordance with laws of Rwanda</td>
</tr>
<tr>
<td></td>
<td>Registered under companies Act to carry out business in Rwanda</td>
</tr>
<tr>
<td>Minimum Number of Shareholders</td>
<td>50 for equities at time of listing</td>
</tr>
<tr>
<td>Minimum Spread of Shares to the Public</td>
<td>25%</td>
</tr>
<tr>
<td>Minimum Paid-up Capital</td>
<td>RWF 500 million (US$ 813,008)</td>
</tr>
<tr>
<td>Minimum Funds to be Raised</td>
<td>New Applicant: RWF 500 million (US$ 813,008)</td>
</tr>
<tr>
<td>Net Assets</td>
<td>RWF 1 billion (US$ 1.6 million)</td>
</tr>
<tr>
<td>Track record</td>
<td>3 financial years but less if issue is underwritten</td>
</tr>
<tr>
<td>Application Procedures</td>
<td>Letter of application to list and application fee</td>
</tr>
<tr>
<td>Disclosure Documents</td>
<td>Must be lodged with CMA</td>
</tr>
</tbody>
</table>

Leveraging Capital Markets for SME Financing in Rwanda

sion, mobilization of savings for investment and improving management standards of the listed companies.

Operations
Rwanda’s capital market has both the primary and secondary markets. The Over-the-Counter (OTC) trading market has also been established and it is a dual trading process. First, members of the OTC trade securities directly with investors and among themselves. Second, open outcry trading sessions are conducted at the trading floor of the OTC market at the CMAC Secretariat every day from 9:00 a.m. to 12:00 p.m. During the designated trading floor sessions at the CMAC, all members must report their transactions conducted from the closure of the previous official trading session up to the time of the next trading session.

Clearing, Payment and Settlement Infrastructure
The Central Bank of Rwanda has implemented a payment and settlement system referred to as the Rwanda Integrated Payment and Processing System. This system has various components aimed at improving efficiency including the Real Time Gross Settlement, the Automated Clearing House, the Automated Transfer System and the Central Securities Depository.

The implementation of the payment and settlement system has resulted into adoption of a new settlement cycle referred to as the T+2 for all securities traded. This implies that for all securities traded, payment is effected two days after the transaction on the RSE. At the Nairobi Securities Exchange, the equity and debt securities settlement cycle moved from the previous T+4 settlement cycle as in effect in July 2011 to the current T+3 settlement cycle.

For both Uganda and Tanzania, the settlement cycle is currently T+5. A shorter settlement cycle has the benefit of improving liquidity in the market for listed securities, thus making the market more attractive to domestic and foreign investors.

B.3.3 Capital Market Diagnostics
Rwanda’s capital market is relatively young compared to the other markets in the region. For instance, the Nairobi Securities Exchange (NSE), Dar es Salaam Securities Exchange (DSE) and Uganda Stock Exchange (USE) were established in 1954, 1996, and 1997 respectively.

As of May 2012, there were 58 companies and 43 bonds listed on the NSE, 17 companies and 13 bonds listed on the DSE and 14 companies and 30 bonds listed on the USE. Rwanda’s Stock Exchange was launched in 2008. Currently, the RSE has two domestic stocks - Bank of Kigali and Braiiwa Ltd., and two cross-listings - Nation Media Group and Kenya Commercial Bank. This is in addition to five Treasury bonds and one corporate bond by the Commercial Bank of Rwanda.

While activity has steadily picked up on the equity market from February 2011, largely on the counters of the two domestic stocks, trading of fixed-income securities has been intermittent, slowing down and then picking up, with most of the trading done by commercial banks and a few corporate investors. Figure 9 depicts the volumes traded at the RSE. It shows that the trade in the stock exchange has been sporadic from 2009 to 2011. The market capitalization of the Rwanda Stock Exchange is estimated at US$1.6 billion.

The turnover of the RSE also has fluctuated, exhibiting peaks during IPOs. For instance, during the period September-November 2011, the turnover fluctuated between US$5 million to US$8 million owing to the increased activity after Bank of Kigali’s IPO. Similarly, the turnover has also exhibited the same pattern of increased activity following IPOs as shown in Figure 10.

B.3.4 Awareness and Consideration of SMEs to Use Capital Markets
To determine why some SMEs would resort to capital markets to finance their growth, a logit regression model was estimated. The choice of a logit model is motivated by the fact that opting to use capital markets as a source of financing can be formulated as a binary decision. In this case, the dependent variable takes on a value of one if the...
Figure 9: Volumes Traded (RWF)

Source: Capital Markets Authority and author computations

Figure 10: Turnover at the RSE (US$)

Source: Capital Markets Authority and author computations
A firm is considering listing on the capital markets and zero otherwise. The explanatory variables include the age of firm, need for external financing, familiarity with or awareness of capital markets, gender ownership of firm and whether the firm is involved in export trade.

An attempt was made to include other variables of importance in the model such as the awareness about the benefits of issuing shares to the public, level of compliance with corporate governance standards as enshrined in the Capital Markets Act and the impact of listing fees on a company’s decision to list. However, given the limited knowledge about capital markets amongst the surveyed firms, these variables were found to be of low explanatory power and are thus excluded from the estimation. The findings are presented in Table 9.

The variation of the models 1-3 is based on the gender ownership of the firm or whether the firm is exports its products. The analysis reveals that the need for external financing plays a role in determining whether the firm would consider using capital markets. This variable is statistically significant for all the models presented in Table 9. Awareness of capital markets and involvement in export trade influence the firms’ consideration to use capital markets. The age of a firm does not appear to have a statistically significant relationship with the decision to list on the stock market.

An increase in the firm’s awareness of capital market by 1 percent increases the probability of listing on the capital markets by between 32 and 35 percent and this relationship is statistically significant at 1 percent level (Table 10). Similarly, a firm’s participation in the export market increases its likelihood of considering using capital markets by up to 27 percent and this relationship is statistically significant at 1 percent level. As would be expected, an increase in need for external financing to complement internally generated funds or retained earnings increases the chances of the firm’s participation in the capital market by up to 40%, all else constant.

### B.3.5 Capital Markets-Related Constraints Facing SMEs

There are various capital market specific constraints limit-

<table>
<thead>
<tr>
<th>Table 9: Determinants of Consideration to Use Capital Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Independent Variables</strong></td>
</tr>
<tr>
<td>Firm Age</td>
</tr>
<tr>
<td>Need for external financing</td>
</tr>
<tr>
<td>Awareness of capital markets</td>
</tr>
<tr>
<td>Male firm ownership</td>
</tr>
<tr>
<td>Exporting firm</td>
</tr>
<tr>
<td>Number of observations</td>
</tr>
</tbody>
</table>

**, *** denote 5% and 1% levels of significance. P-values in parenthesis.
ing SMEs from accessing capital markets. These include the listing requirements, limited financial instruments, and limited access to information about SMEs.

(i) **Listing Requirements**: These include a minimum capital requirement of US$813,008; a well-formulated business plan; audited financial records; and a generally accepted corporate governance structure. Most SMEs do not meet these requirements, and this limits their chances to list on the stock markets and raise relatively more affordable and longer-term capital (see Section B.3.1).

(ii) **Absence of Relevant and Robust SME information and Information Sharing System**: For equity and debt markets to be developed for SMEs, relevant and complete information about these enterprises has to be accessible. This information could range from management to financials of the company. Currently, information about SMEs in Rwanda is scattered between the companies themselves and banks which finance their operations. The credibility of the information especially on SME financial activities is also questionable based on the interviews with the banks. This would therefore call for a concerted effort between the government, the Capital Markets Authority, financial institutions and SMEs to come up with an information gathering and sharing system. Suggestions for establishing this system are presented under policy recommendations. Access to credible and comprehensive information will contribute to reducing information asymmetry inherent in SMEs. Moreover, for some instruments like the Collateralized Loan or Debt Obligation (CLO) (See Sections C and D), banks may not fully disclose to the investors the risks associated with SMEs and in the process package a CLO instrument with some “bad lemon” SMEs.

(iii) **Limited Capital Market Instruments**. Rwanda’s capital market is still in its infancy and thus, instruments currently listed and traded comprise shares (equity) and bonds (debt). Venture capital which can partly address the scarcity of equity for SMEs through investment in unlisted companies, as is the case with the Private Equity and Venture Capital program in Brazil, is not widely available in Rwanda. Sections C and D provide detailed discussions and analysis of venture capital, as well as other options such as a fund of funds and fiscal incentives that can be established to increase SMEs’ access to financing.

(iv) **Higher Per-Unit Transaction Costs of Handling SME Financing**: The relatively smaller loan size and the high information costs increase the per unit transaction costs associated with credit to SMEs. For any financial institution the following costs are considered to be fixed: (i) administrative costs; (ii) legal fees; and (iii) costs related to the acquisition of information about the loan applicant. In the case of SMEs, these costs (per unit of finance requested) are relatively higher compared to the larger enterprises and thus act as an impediment to lending to SMEs.

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm Age</td>
<td>0.026 (0.577)</td>
<td>0.011 (0.815)</td>
<td>0.023 (0.663)</td>
</tr>
<tr>
<td>Need for external financing</td>
<td>0.378*** (0.000)</td>
<td>0.400*** (0.000)</td>
<td>0.385*** (0.000)</td>
</tr>
<tr>
<td>Awareness of Capital Markets</td>
<td>0.335*** (0.000)</td>
<td>0.310*** (0.000)</td>
<td>0.322*** (0.000)</td>
</tr>
<tr>
<td>Male firm ownership</td>
<td></td>
<td>0.121 (0.437)</td>
<td></td>
</tr>
<tr>
<td>Exporting firm</td>
<td>0.273** (0.015)</td>
<td>0.256** (0.035)</td>
<td></td>
</tr>
<tr>
<td>Number of Observations</td>
<td>119</td>
<td>118</td>
<td>110</td>
</tr>
</tbody>
</table>

**, *** denote 5% and 1% levels of significance

B.4 Integration of the EAC Capital Markets and Implications for Rwanda’s Capital Market Development

In 1997, following efforts to revive the East African Community (EAC), the Capital Markets Authorities of Kenya, Uganda and Tanzania established the East African Securities Regu-
lators Association (EASRA) as a framework for mutual cooperation in the area of capital markets development. After the accessions of Burundi and Rwanda to the EAC in 2007, the capital markets regulators in these countries also joined EASRA. The East African Securities Exchanges Association (EASEA) was formed in 2004 with a similar mission as that of EASRA.

The main benefits arising from the establishment of EASRA and EASEA are information sharing and facilitating collaboration in harmonization and standardization of regulatory provisions and guidelines, as well as market practices. Through EASRA and EASEA, the EAC capital markets regulators have promoted cross-listing of companies. Several other collaborative efforts are being considered including initiatives to harmonize: (i) listing requirements in accordance with international standards; (ii) capital markets infrastructure such as trading platforms, and payment, clearing and settlement systems; and (iii) investor protection guidelines among others. These measures are expected to improve the operations and development of capital markets in the region, thereby enhancing opportunities for access to financing from the capital markets.

Upon signing the Common Market Protocol in 2009, the EAC Secretariat in collaboration with the World Bank established the EAC Financial Sector Development and Regionalization Project that became effective in 2011. Among others, the project focuses on harmonization of financial laws and regulations; mutual recognition of supervisors; integration of financial market infrastructure and development of a regional bond market.

Regarding the harmonization of financial laws and regulations, both EASRA and EASEA under the auspices of the Capital Markets, Insurance and Pensions Committee (CMIPC) of the EAC have agreed to develop Council Directives to guide the development, integration and regionalization of the EAC securities markets. The proposed model of integration of the regional stock exchanges and the regional central securities depositories will comprise linking the national trading platforms and national central securities depositories. However, progress in implementation of these decisions has been hampered by lack of specific provisions in the EAC Treaty mandating the EAC Council of Ministers to issue directives that can be used as a basis for regulating the EAC securities market and allowing for integration of the capital markets infrastructure.

The integration of the payment and settlement systems is also pursued under the East African Monetary Union agenda. The IMF’s Fiscal Affairs Department is also designing a project to support establishment of an efficient and effective payment and settlement system within the EAC region. The African Development Bank in partnership with the EAC Secretariat is also designing a programme aimed at ensuring sound national and integrated regional wholesale and retail payment and settlement systems that will strengthen the efficiency of cross-border funds transfers within the five EAC countries. The programme, which is expected to commence implementation in 2013, will also strengthen the financial sector regulatory and legislative capacity in the EAC partner states.

While full integration of the EAC securities markets will take time to materialize, the current efforts are important for strengthening the markets and building investor confidence. They are also acting as catalysts for capital markets development in the various jurisdictions, and therefore are likely to have a positive impact on the widening and deepening of Rwanda’s capital markets. Access to a wider market and initiatives to simplify listing requirements for SMEs will create opportunities for increased access to financing.

**B.5 Initiatives to Address Constraints Facing SMEs**

A variety of initiatives to support SME development in Rwanda have been implemented by the government, Development Partners (DPs), financial and non-governmental organization (NGO) sectors. A selected number of these interventions are summarized below.
B.5.1 Enabling Policy Environment and Infrastructure

Before the adoption of SME Policy in 2010 (Box 1), the policy environment was oriented towards large companies. The Government has acted by developing an SME development policy under the Ministry of Trade and Industry and the 2011/12 SME Development Action Plan in addition to initiatives to improve the ICT infrastructure in the country. The vision of the policy is to create a critical mass of viable and dynamic SMEs, significantly contributing to the national economic development and the mission is to stimulate growth of sustainable SMEs through enhanced business support service provision, access to finance and the creation of a conducive legal and institutional framework. The objective is to foster job creation and an increase in the tax and export base through the promotion of competitive new and existing SMEs.

The Government has prioritized cluster development so as to spur value-addition sectors, increase Rwanda’s international competitiveness, create more employment and business opportunities, expand the supply of skilled people and technology, expand the local supplier base, increase efficiency and productivity and foster innovation. The SME policy in particular supports the development of SME clusters in a particular field especially where backward and forward linkages can be exploited for instance via improving productivity and efficiency, stimulating and enabling innovation, facilitating commercialization and new business formation. Improvements in competitiveness including by addressing binding infrastructure constraints in transport and energy also remain a core objective of the Government. For instance, in 2010, Cabinet approved the Strategic Investments Programme which comprises six key investment projects aimed at expediting the realization of the Vision 2020 and EDPRS objectives7.

Box 1: SME Policy

The vision of the policy is to create a critical mass of viable and dynamic SMEs significantly contributing to the national economic development. This will involve stimulating growth of sustainable SMEs through enhanced business support service provision, access to finance and the creation of an enabling legal and institutional framework.

The main objective of the policy is to foster job creation and an increase in the tax and export base through the promotion of competitive new and existing SMEs mainly in value-added sectors. In order to achieve this objective, the Rwanda SME policy outlines the following five policy objectives.

1. Promote a culture of entrepreneurship among Rwandans
2. Facilitate SME access to development services including:
   • Business development services
   • Access to local, regional and international markets and market information
   • Promote innovation and technological capacity of SMEs for competitiveness
3. Put in place mechanisms for SMEs to access appropriate business financing
4. Simplify the fiscal and regulatory framework for SME growth
5. Develop an appropriate institutional framework for SME development.

These projects, which prioritize investments in infrastructure including ICT, are expected to improve overall competitiveness, catalyze private sector and SME development, spur job creation, and facilitate export diversification thereby contributing to poverty reduction and inclusive growth.

B.5.2 Demand Side Initiatives

The most prominent initiative was the former Centre d’Appui aux Petites et Moyennes Enterprises (CAPMER) whose major mandate was to provide training, advice and technical support to SMEs. In 2009, CAPMER was integrated into the RDB with the objective of combining its mandate

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7 The SIP projects include: (i) energy access rollout to increase household grid connections from 9% (84 MW) at end-2010 to 70% (1000MW) by 2017; (ii) building core ICT infrastructure for high-speed broadband connectivity; and (iii) construction and rehabilitation of a regional railway linking Rwanda to Burundi and Tanzania; (iv) construction of the Kigali Convention Centre; (v) capitalization of RwandAir; and (vi) construction of the Bugesera International Airport.
with export and investment promotion and general private sector development services. The RDB was established to coordinate and combine all services and support for Rwandan private sector development including investment and export support, business registration, environmental and tax advice, free trade zone and IT development and cluster specific programs such as tourism development. Thus the RDB provides specific support to SMEs, including training programs, networking and moveable asset registration, in addition to working to improve the overall business environment in Rwanda.

Specific agencies have also been created to support the development of Rwandan cooperatives, whose business activities are similar to SMEs. The Rwanda Cooperative Agency (RCA) works to train and regulate cooperatives in tandem with the Rural Small/Micro Enterprises Promotion Project Phase II (PPPMER-II), a project in MINICOM, mandated to provide marketing and other support to cooperatives and SMEs in rural areas.

Supported by the GoR, though a private sector member based institution, the Private Sector Federation (PSF) was formed to represent the interests of the private sector vis-à-vis the GoR. It collects information from private sector actors, provides training and support to these actors and advocates for their needs. PSF also runs a network of BDS under a new model of independent BDS providers within the framework of private/private partnerships.

Development Partners (DPs) have contributed as well to the development of SMEs. For example, Deutsche Gesellschaft für Technische Zusammenarbeit (GIZ) and the World Bank have been involved in skills training and entrepreneurship development. The International Fund for Agricultural Development (IFAD) has also been involved through projects like PDRCIU, PDCRE and PPPMER, which have been operational over the last five years and have directly contributed to the development of agricultural and non-agricultural rural SMEs.

**B.5.3 Supply Side Initiatives**

In 2007, the Ministry of Finance and Economic Planning (MINECOFIN) set up a Financial Sector Development Program with the objective of supporting increased access to finance, capital markets development, regulation of non-bank financial institutions and the improvement of the payment systems. In order to expand access to financial services to the rural areas, the GoR licensed 416 Umurenge (village level) Savings and Credit Cooperatives (SACCOs) to grant loans of up to 40% of their deposits. Measures are being developed to improve the structure and framework for supervision of these SACCOs. In 2011, legislation regulating Capital Markets and establishing the Capital Markets Authority were gazetted. The CMA is contemplating amendments to its guidelines to allow SMEs to list on the RSE as a way of increasing their ability to mobilize long-term financing.

Similarly, the CMA has kicked off a countrywide campaign to draw Rwanda’s 416 Umurenge SACCOs to the capital market to help reduce over-reliance on bank deposits as investment channels and to boost activity on the Rwanda Stock Exchange (RSE). This initiative is also expected to attract investors at the RSE to participate in the secondary market, a segment that is yet to attract institutional investors, save the Rwanda Social Security Board.

Currently, SACCOs’ deposits are banked with commercial banks thus attracting minimal deposit interest rates. Investing these deposits in the capital market would provide them an opportunity to diversify their investment and also attract higher returns. Moreover, the capital market has a competitive edge as income/dividends through the RSE attract a lower withholding tax of five percent, while interest incomes on deposits in banks are subject to a 15 percent withholding tax.

Regarding development finance institutions and programmes, a significant proportion of Rwanda Development Bank’s (BRD) lending activities are tailored to SMEs and cooperatives. The products provided include direct financing to SMEs and...
cooperatives, refinancing to microfinance institutions, equity financing and equipment leasing through agricultural and other loan funds. Several development partners support various programmes aimed at increasing access to finance, skills and entrepreneurship. USAID has an SME guarantee fund managed by the Bank of Kigali.

The banking sector is currently composed of 10 commercial banks and three microfinance banks. The banking assets doubled from 2006 to 2010 to RWF 1.1 trillion (US$ 1.8 billion) and a decline in non-performing loans from 26 to 12 percent was registered. Bank branches and outlets increased from 259 in 2008/09 to 467 branches and outlets in 2012 with an estimated 229 ATMs. The banking system remains concentrated with three banks accounting for 60 percent of the assets, loans and deposits while both loans and deposits are concentrated among a few corporate clients. This banking sector is supported by 109 MFIs, 8 insurance companies and 40 pension funds.

The 2012 Finscope survey indicates that over 72 percent of the population has access to either formal or informal financial services, an indication that the government’s initiatives and support from development partners have had a positive impact on financial sector development. A Rwanda SME Fund with an estimated US$7.2m in loanable funds was launched in July 2011 by the Business Partners International Rwanda, and financed by the IFC, World Bank Group, the Rwanda Enterprise Investment Company (REIC), Dutch NGO Stichting DOEN, and Business Partners International. The objective of this initiative is to provide access to funding and technical assistance to SMEs, thereby increasing employment and fostering local entrepreneurship in Rwanda.
Leveraging Capital Markets for SME Financing in Rwanda
C. REGIONAL AND INTERNATIONAL EXPERIENCE OF SME ACCESS TO CAPITAL MARKETS

Section B presents and discusses, among others, the key constraints that SMEs face in accessing finance from the banking sector, the capital markets and other sources. There are several initiatives being undertaken within the region and beyond to enable SMEs to access financing from various sources, including active participation in the capital markets.

This is after a realization that bank financing alone, which tends to be more costly for SMEs, is not sufficient for the growth of this sector.

This section presents the experiences with private equity and venture capital in Brazil, Tunisia and Kenya, experiences with fund of funds in Israel, South Korea and Ghana, and the establishment of alternative investment market segments in the capital markets for SMEs in South Africa, Kenya, Uganda and Tanzania.

C.1 Experiences with Equity and Venture Capital

Venture capital (VC) originated in the United States during the 1950s as a response to the need for financing for SMEs. The risks inherent in financing entrepreneurs without an established track record or collateral in developing new products make them less preferred customers to the traditional commercial or investment banks.

Venture capitalists provide equity-type financing designed to allow them to participate in the investments with high growth potential with a view to supporting enterprise growth and also diversifying their own risk portfolios.

Venture capitalists also seek to participate actively in the enterprise, for example as members of the board of directors and/or by reserving the right to appoint and replace key executives.

Since their inception in the United States, equity and venture capital funds have been adopted in other countries to meet the specific needs for investment financing, but with limited success in some countries such as Kenya and Tunisia and success in countries such as Brazil.

C.1.1 Equity and Venture Capital in Kenya, Tunisia and Brazil

In Kenya, Equity Capital was established in 1986 to invest in the equity of unquoted companies. It was funded in part by soft loans from USAID and grants to support management costs. However, challenges in finding promising equity investments in either SMEs many of which were unwilling to accept outside shareholders, or larger firms which could easily obtain bank financing, led the managers to abandon VC in favor of providing fundraising services on a fee-earning basis.

Tunisia’s first VC institution, la Société de Participations ET de Promotion des Investments (SPPI), was established in 1990. However, during the same period, the major Tunisian development banks were effectively undermining the potential demand for non-bank risk capital. The development banks typically provided medium- and long-term loans of up to 70 percent of total financing requirements, even for start-up enterprises.

These banks also provided equity funding in the form of an interest-bearing redeemable security with a repurchase contract. While these initiatives by development banks resulted in entrepreneurs financing new business ventures with real risk capital as low as 10 percent, they undermined the sustainability of venture capital funds.

In Brazil, several SMEs have been supported under the Private Equity and Venture Capital (PE/CV) Program to list in the capital markets. Founded in 2000, the PE/VC in Brazil program is a joint initiative between the Brazilian Association of Private Equity and Venture Capital and the Brazilian Trade and Investment Promotion Agency to create a bridge between international investors and Brazilian fund managers and companies to promote and develop long-term investments in Brazil.

PE/VC firms are financial intermediaries that perform investment in equity or quasi-equity instruments of unlisted companies including SMEs.
C.1.2 Lessons for Rwanda

<table>
<thead>
<tr>
<th>Kenya</th>
<th>Tunisia</th>
<th>Brazil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measures to support the establishment of equity funds should be coupled with broader measures to support enterprise development including the provision of business development services. This will ensure a steady supply of clientele for the equity fund managers.</td>
<td>While other financial institutions such as development banks could also contribute to the mobilization of risk capital, a framework to ensure complementarity of these banks with rather than substitution for venture capital funds is critical for the success of venture capital funds.</td>
<td>• PE/VC initiative can be a private-public initiative.</td>
</tr>
<tr>
<td>• PE/VC managers act as catalysts for growth of companies before they enter stock markets. They exercise careful selection, monitoring and governance that mitigate the uncertainty and risks of investing in such companies.</td>
<td></td>
<td>• PE/VC managers can act as catalysts for growth of companies before these companies list on the stock markets;</td>
</tr>
<tr>
<td>• PE/VC firms provide more than money. After a careful screening process, they usually require a seat on the board of directors of the companies in which they invest. During the long-term relationship, PE/VC managers provide portfolio companies with strategic advice and access to their valuable business network.</td>
<td></td>
<td>• PE/VC provides more than finances. For instance, it may require a share in the company it is investing in, provide strategic advice and access to the PE/VC's valuable business network;</td>
</tr>
<tr>
<td>• PE/VC exercises rigorous selection of firms to invest in, monitoring and governance that mitigate uncertainty and risks;</td>
<td></td>
<td>• PE/VC exercises rigorous selection of firms to invest in, monitoring and governance that mitigate uncertainty and risks;</td>
</tr>
<tr>
<td>• Through an agreement, PE/VC exits take place in the stock exchange, which promotes listing of SMEs on the stock markets; and</td>
<td></td>
<td>• Through an agreement, PE/VC exits take place in the stock exchange, which promotes listing of SMEs on the stock markets; and</td>
</tr>
<tr>
<td>• The success of PE/VC is also dependent on economic and institutional environment, including suitable legal and fiscal system and an efficient bureaucracy.</td>
<td></td>
<td>• The success of PE/VC is also dependent on economic and institutional environment, including suitable legal and fiscal system and an efficient bureaucracy.</td>
</tr>
</tbody>
</table>

How Private Equity and Venture Capital works in Brazil

- PE/VC managers act as catalysts for growth of companies before they enter stock markets. They exercise careful selection, monitoring and governance that mitigate the uncertainty and risks of investing in such companies.

- PE/VC firms provide more than money. After a careful screening process, they usually require a seat on the board of directors of the companies in which they invest. During the long-term relationship, PE/VC managers provide portfolio companies with strategic advice and access to their valuable business network.

- PE/VC investments cover different stages of business development, from financing an idea or invention (seed capital), to the acquisition of significant stakes in existing corporations (buyout), to start-up and expansion financing for high-growth SMEs. Typically, investments in early stage companies (i.e. seed capital, start-up and expansion stages) are considered as the venture capital (VC) segment of the PE/VC industry.

- Due to the rigor of the PE/VC investment and monitoring processes, which include detailed due diligence and the adoption of corporate governance guidelines, PE/VC recipients obtain a seal of approval that reduces the risks perceived by their suppliers, customers, external finance providers and employees.

- PE/VC firms exit their investments by selling shares. Sometimes, through an agreement, exits take place in the stock exchange indicating that the invested company has successfully graduated to the stage of receiving investment from other institutional investors and individuals.

The PE/VC-backed companies represented close to half the amount raised by initial public offerings (IPOs) in the stock exchanges in Brazil between 2004 and 2006 (Ribeiro, 2007).

Despite its successes in Brazil, PE/VC is still very much restrained by the challenging local economic and institutional environment, including unsuitable legal and fiscal systems and bureaucratic procedures.
C.2 Experiences with Fund of Funds

C.2.1 The YOZMA Fund of Funds in Israel

Box 2: The YOZMA Fund of Funds Success Story

Since the 1990s, Israel has been the most vibrant high-technology cluster outside the United States. Several complementary factors have contributed to this economic success including: a highly adaptive and innovative entrepreneurial culture, significant spending on research and development and a highly skilled immigration wave from the former USSR. In addition, the government recognized the importance of the technology sector to the economic growth and welfare of the country.

As a result, in 1993, the government decided to establish a fund of funds program – Yozma – with seed capital of US$100 million. Using this seed capital and in partnership with leading VC investors, 10 venture capital funds were established, each with about US$25 million. The government contributed 40 percent and the foreign investors gave the remaining 60 percent, for total venture capital of US$250 million. The program was designed in such a way that foreign investors had an option to buy out government’s share within five years. A purchase of government shares signaled the program’s success.

From the Yozma initiative, 15 investments were made, 9 of which enjoyed successful exits through IPO or acquisition. In addition, several international venture capital investors like Advent, MVP, CMS, Walden, Daimler Benz, DEG, Oxton and Kyocera were attracted to the fund.

With the increased foreign interest, the private investors exercised their option and bought out the government’s share in 9 of the 10 funds.

C.2.2 Korean Fund of Funds

Korea’s venture industry started in 1974 and the Korean government sustained direct investments in venture funds. In 2004, the Korean government announced the “Fostering Venture Companies” Initiative to address several challenges that plagued the industry including diminishing venture capital investment, the dissolution of many venture funds in 2004, and the absence of a stable and unified source of venture investment. This announcement was followed by the establishment of the Korea Fund of Funds (KFoF) in 2005. The fund of funds (FoF) is fully government funded but its institutional framework allows the fund manager to evaluate, select, and allocate capital to a various funds with a significant level of professional independence.

Benefits of the KFoF Post-2005:

i) It meets public interest and operates more efficiently. As a result, the Fund is more profitable. However, the KFoF is not completely independent from government influence. For example, the KFoF fund manager can be asked to allocate a large portion of the fund’s assets to sub-funds to support a particular government policy as opposed to following conventional business benchmarks for selecting beneficiaries;

ii) Government support ensures the fund is still able to finance the venture capital market even when the economy is in recession. Therefore, it can play a role in revitalizing the market during times of economic contraction;

iii) The venture capital market is transparent because of high standards applied in the selection of projects invested in and prudent management of sub-funds; and

iv) The fund is a stable investment source to venture capital firms, especially during economic downturns when private investors tend to invest in safer securities like fixed income.

By 2007, the KFoF had invested a total of US$278 million (Table11). The KFoF has also encouraged institutional investors to participate in the venture capital industry.

Table 11: Investment in Korea Fund of Funds

<table>
<thead>
<tr>
<th>Year</th>
<th># of venture investment funds in which the KFoF invested</th>
<th>Volume of venture investment funds in which the KFoF invested (US $ million)</th>
<th>Investment of KFoF (US$ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>7</td>
<td>241</td>
<td>52</td>
</tr>
<tr>
<td>2005</td>
<td>17</td>
<td>360</td>
<td>110</td>
</tr>
<tr>
<td>2006</td>
<td>21</td>
<td>461</td>
<td>115</td>
</tr>
<tr>
<td>Total</td>
<td>45</td>
<td>1,063</td>
<td>278</td>
</tr>
</tbody>
</table>

Source: Jae-Ha Park, Byung-Chul Lim, Jung-Han Koo, 2008
C.2.3 Venture Capital Trust Fund of Ghana

The Venture Capital Trust Fund was established in 2004 by Government of Ghana to provide low-cost revolving financing to SMEs. The vision is to provide businesses with enough resources to create jobs, increase revenue (through taxes), and ultimately add to the pool of funds available for downstream business investments. The trust fund has partnered with the private sector to establish various Venture Capital Finance Companies (VCFCs) whose sole authorized business is to assist in the development of SMEs by making available for their use, equity, quasi-equity and credit financing. SMEs are also provided with technical assistance to boost management expertise and productive capabilities.

Applications for funding are made to any of the venture capital finance companies by any individual or business entity that is Ghanaian and needs working or start-up capital. Depending on the expertise available in the potential investee company, that company may be provided with management and or other technical assistance to boost its capacity to more effectively utilize the requested funds. The investment package administered to the beneficiary SME may vary depending on the ownership structure.

Currently the priority sectors targeted are ICT, agriculture & agro-processing, tourism and pharmaceuticals. These priority sectors have the potential to benefit from about 55 percent of the total funds available. Venture funds are not limited to only the priority sectors: all sectors of the economy except direct imports to sell can receive funding.

The basic requirements for accessing the fund include:

- A comprehensive three-year business plan;
- Incorporation papers for SMEs that are incorporated;
- Audited financials for past 3 years for existing business;
- Tax Clearance Certificate;
- A minimum of 51% equity contribution from the business owner (not necessarily cash);
- No collateral is required but a good viable project is; and
- Any other information that may be requested.

Businesses are encouraged to contact any of the VCFCs for advice on preparing the required documentation. In practice, the Trust Fund is a fund of funds and operates through institutional partnerships by means of joint venture arrangements with VCFCs. VCFCs are managed by fund managers and are licensed by the Securities and Exchange Commission (SEC). Fund managers are responsible for deal sourcing, selection, monitoring and exit of Fund investments.

However, final investment decisions rest with the Investment Committees (ICs) that are made up of representatives of investors and independent professionals appointed by the Fund’s Board of Directors. Each VCFC can obtain a minimum of US$25,000 from the trust fund and a maximum of 15 percent of its total capitalization.

Ghana’s venture capital trust fund boasts of several achievements including:

- Leveraged its seed funding of GH¢22.4 million (US$11.2 million) to create additional GH¢40.2 million (US$20.1 million) from the private sector in a Public Private Partnership, totaling to GH¢62.6 million (US$31.3 million);
- Trained and developed the capacity of three local indigenous Fund Management companies;
- Provided training and capacity-building support to the pool of VCTF Funds’ portfolio companies;
- As part of its capacity development and public awareness focus, provided education and public awareness on private equity and venture capital’s role in easing access to finance in Ghana;
- Financed 3,500 farmers directly in each year of three years running; and
- Created Two thousand Five Hundred (2,500) direct jobs and Four Thousand Five Hundred (4,500) indirect jobs across all sectors of the economy.
C.2.5 Enabling Factors for a Successful Venture Capital Industry

Successful VC operations have certain basic common features. These can be regarded as essential conditions that need to be fulfilled when setting up new VC institutions.

**Growth Sectors:** The success of VC depends on finding opportunities for investment with high growth potential within its target market in a country. Given the need for highly selective screening of business propositions to generate a well-balanced and diversified portfolio, the first essential condition for any new VC fund is the availability of a substantial “deal flow”. While for the case of Rwanda it may not necessarily be able to create or support high-technology enterprises that have been characteristic of VC financing in the United States, they can offer attractive market niches based on specific comparative advantages for instance in agribusiness, and mining among others or the application of new technologies or deregulation.

**Entrepreneurial Quality:** Entrepreneurs with business judgment and managerial skills are also essential to manage the transformation of the deal into a successful enterprise. The ability of the entrepreneur to focus on a single business opportunity, to think strategically about the issues critical to its success and to ensure the preparation of adequate financial information is very critical. The VC manager can assist and guide the entrepreneur but cannot substitute for him.

**Equity Culture:** Entrepreneurs need to understand and accept the basis of the business relationship with equity investors. This relationship needs to be based on the principles of common interest, transparency in the sharing of information, participation in major decisions and equity in the distribution of profits. Changing attitudes to achieve these virtues is a difficult and time consuming undertaking. Thus, a VC firm can have an important educational role in explaining and nurturing the development of constructive relationships between entrepreneurs and investors.

**Professional Skills:** Successful international VC managers typically have broad management experience, often including marketing, technical and financial expertise. However, such managers are scarce, especially for work in difficult environments, but they are invaluable. Institutional investors generally require that the managers of funds in which they invest can demonstrate a proven track record. A good venture capitalist will learn through experience, but this takes time and the poor performance of inexperienced managers will impact on the initial results of a VC institution.

<table>
<thead>
<tr>
<th>C.2.4 Lessons for Rwanda</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Israel Fund of Funds</strong></td>
</tr>
<tr>
<td>• Government initiatives can act as triggers especially when coupled with a program designed with in-built incentive structures in terms of options to buy out government shares over a given period of time;</td>
</tr>
<tr>
<td>• Existence of an investor base and the enterprises with growth potential is critical for successful private equity/venture capital funding interventions; and</td>
</tr>
<tr>
<td>• A dynamic capital market provides several complementary benefits to private equity/venture capital financing mechanisms including an exit option via IPOs.</td>
</tr>
</tbody>
</table>
**Local Knowledge:** VC managers also need to have close knowledge of the specific markets in which they operate. An up-to-date understanding of local conditions and a network of contacts with prospective investee businesses are critical to generating deal flow, and to assessing the specific factors that will determine growth potential and to identifying the right method and timing of exits.

**Efficient and Incentive-Based Remuneration:** To attract well-qualified managers and focus their attention on maximizing returns on invested funds, the remuneration of VC managers needs to be structured to include strong profit-related incentives based on widely-accepted industry standards. The cost of these remuneration packages also has a significant impact on determining the minimum economic size for a VC fund (generally regarded as a minimum of US$20 million). To accommodate this cost structure in Rwanda, the fund managers may operate on a regional basis with responsibilities spanning several operations in the region and/or a portion of the management costs may be supported by development partners.

**Business Environment:** It should be supportive of productive private sector investment and of equity financing. Apart from macroeconomic policies, the system should provide for: legal and regulatory frameworks designed to support the creation and operation of VC funds; the protection of minority shareholders’ rights; the transfer of share ownership and the speedy and equitable settlement of commercial disputes. A tax regime that ensures a transparent and equitable treatment of company profits, dividends and capital gains, and the tax-free pass-through of returns to a VC fund and its investors is necessary.

**Exit Mechanisms:** The ability to liquidate investments freely and with substantial capital gains is critical to the success of VC. Exits are clearly easier where there is an active stock market. The limited choice of “exit” options for divestiture in many developing countries makes it difficult to incentivize VC investors. While the stock market is now in place in Rwanda, achieving the required depth and liquidity to absorb flotation of new ventures is not expected in the immediate term.

**Service Providers and Financial Infrastructure:** VC operations also need the support of efficient service providers including accountants, lawyers and bankers as well as communications facilities. Institutions providing VC also need to be structured to ensure flexibility of operations while meeting the interests of the investors providing the funds. To achieve this, the following two factors are important. First, legal form and domicile: a VC institution should be established under a legal jurisdiction that allows efficient incorporation. Second is the flexibility in raising funds and discretion in defining investment policies and opportunities. Moreover, institutional investors often require that fund vehicles which deal in illiquid, unquoted investments are established with a finite life (7 to 10 years) at the end of which, all such investments should be liquidated and the funds returned to investors.

### C.3 Establishment of Alternative Investment Market Segments

As discussed in Section B, some of the listing requirements are tailored to large companies, which tends to lock SMEs out of capital markets. To address these concerns, a number of countries have opted to establish alternative investment markets for SMEs with less stringent regulations that mainly focus on listing rules. This sub-section examines experiences from South Africa, Kenya, Uganda and Tanzania to provide lessons for Rwanda.

#### C.3.1 AltX for SMEs in South Africa

AltX is an alternative market in Johannesburg Stock Exchange (JSE) established to cater for SMEs. Launched in 2003, AltX aims to provide a platform for SMEs to raise capital and list on the stock exchange so to liquidate debt and build cash reserves. In addition to AltX’s less stringent listing requirements (see Table 12), JSE in partnership with the Department of Trade and Industry and the National
African Federated Chamber of Commerce (NaFcoc) have drawn up a programme that continuously educates the SMEs on various aspects of the capital markets such as listing requirements and share ownership. This partnership also creates awareness about the JSE and provides other forms of support to SMEs such as training for their directors.

Since its launch in 2003 and listing of the first company in January 2004, the number of SMEs listed by 2009 was over 70 and several companies were in the pipeline for listing. As of 2009, six companies had been delisted as a result of mergers and graduation to the main market (http://www.jsenews.co.za retrieved on 8 September, 2012).

**C.3.2 Small and Medium Enterprises Exchange in Kenya**

The Small and Medium Enterprises Exchange (SMEX), a listing for SMEs on the Nairobi Stock Exchange is set to commence operations in 2012 with less stringent listing requirements than those at the Nairobi Stock Exchange (NSE). In June 2012, the establishment of SMEX received a major boost following the gazettement of the Capital Markets Regulations to pave way for the Growth Enterprise Market Segment (GEMS) at the Nairobi exchange.

The GEMS is a collaborative initiative between the Capital Markets Authority (CMA), the Central Depository and Settlement Corporation (CDSC) and the Nairobi Stock Exchange which will facilitate the listing of Small- and Medium-Sized Enterprises. To provide the legal framework for GEMS, two draft laws of the Nominated Advisors (NOMADS) Rules 2011 and the SME Public Offers Listings and Disclosure (POLD) Requirement Regulations 2002 have been revised. The NSE is also working with the CMA to publish the rules for NOMADS which are aimed at assisting SMEs to list on the GEMS and to comply with good corporate governance practices. In addition, a corporate governance course for directors of the SMEs will be provided by the NSE to transfer knowledge on corporate governance competencies and to assure potential investors that the SMEs are being managed professionally.

**C.3.3 Alternative Investment Market Segment in Uganda**

Raising capital by issuing securities to the public in Uganda’s capital markets requires either the company or the securities to be listed on the Uganda Securities Exchange (USE). Listing is governed by the Listing Rules of the Exchange, the provisions of the Capital Markets Authority Act, the Capital Markets (Prospectus Requirements) Regulations 1999 and the Companies Act, Cap 110 Laws of Uganda 2000.

To enhance SME access to capital markets in Uganda, USE in 2009 established an Alternative Investment Market Segment (AIMS) under the equity section (Table 13). The AIMS is a platform built on a simplified listing framework with less stringent requirements than the Main Investment Market Segment (MIMS).

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Table 12: Listing Requirements for AltX Market in South Africa

<table>
<thead>
<tr>
<th>Listing Requirements</th>
<th>Main Market</th>
<th>AltX for SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Share Capital</td>
<td>R25 million</td>
<td>R2 million</td>
</tr>
<tr>
<td>Profit History</td>
<td>3 years</td>
<td>None</td>
</tr>
<tr>
<td>Pre-tax Profit</td>
<td>R8 million</td>
<td>N/A</td>
</tr>
<tr>
<td>Number of shareholders</td>
<td>300</td>
<td>100</td>
</tr>
<tr>
<td>Sponsor/Designated Adviser</td>
<td>Sponsor</td>
<td>Designated Adviser</td>
</tr>
<tr>
<td>Publication in Press</td>
<td>Compulsory</td>
<td>Voluntary</td>
</tr>
<tr>
<td>Special Requirements</td>
<td>N/A</td>
<td>Appoint Financial Directors</td>
</tr>
<tr>
<td>Annual Listing Fee</td>
<td>0.04% of average market capitalization with a minimum of R26,334 and maximum of R121,700</td>
<td>R22,000</td>
</tr>
<tr>
<td>Education Requirements</td>
<td>N/A</td>
<td>All directors to attend Induction program</td>
</tr>
</tbody>
</table>

Source: http://www.jsenews.co.za retrieved on 8 September, 2012
Listing Requirements Specific to AIMS/SMEs:

- The company must be a public company limited by shares under the Companies Act, Cap 110.
- The minimum authorized, issued and fully paid-up capital of the Company must be at least UShs 200 million (US$80,000);
- The net assets of the company must be valued at a minimum of UShs 400 million (US$160,000) prior to raising capital;
- The company must submit a business plan with a clear indication of its prospects;
- Where a company opts to raise capital through equity, the minimum number of shareholders immediately following the closure of the initial public offering shall be one hundred;
- The Company should have published audited accounts for at least two years;
- The Company must have suitably qualified senior management for at least one year prior to the application to raise capital, none of whom has committed an offence considered inappropriate for the management of a company;
- No director of the Issuer should have in the preceding two years been adjudged bankrupt, had any winding up proceedings pending or threatened against it (in the case of a company), been convicted of a felony within 10 years prior to the application, or been temporarily or permanently prohibited by a lawful order from acting as director of a public company;
- The controlling shareholders should make an undertaking to the Exchange to hold their shares for a period of at least 24 months following approval of the application for listing;
- At least one-third of the board should consist of independent non-executive directors; and
- The company must comply with detailed disclosure requirements for the AIMS/SME segment as specified in the Listing Rules.

In addition, the USE has pledged to ensure that potential and listed SMEs access all the information and support required to make the right investment decisions including training to help in deciding whether to raise capital on the USE. USE also disseminates information on the benefits of listing and the pre-listing and post-listing obligations among other things.

C.3.4 Enterprise Growth Market in Tanzania

In 2012, Tanzania ratified amendments to two regulations to pave way for setting up the Enterprise Growth Market (EGM) targeting the SMEs’ participation in the capital markets. The ultimate objective is to create a market segment within the
Dar es Salaam Stock Exchange, with less stringent issuance and listing rules of the existing equities market segment. The equities market will thus become two-tiered: EGM being the less stringent, more easily accessible, and therefore, a more risky segment aimed at start-ups and SMEs; and MIMS as a more stringent and less risky market segment for larger and more established enterprises. The EGM is also expected to be the market segment for nurturing enterprises and organizations to maturity in readiness for MIMS listing.

The listing requirements under the EGM:

- Must be incorporated as a public company under the Companies Act;
- No minimum capital required;
- No minimum track record required;
- No minimum profitability track record required;
- If the company has no track record; the promoters will not be allowed to exit for three years from listing;
- The company must appoint a Nominated Advisor for the duration of its listing on EGM;
- Must have five-year business plan and an independent technical feasibility report prepared by the Nominated Advisor.

As summarized in the above table, simplified or less stringent listing requirements for Uganda, Tanzania and Kenya have not resulted into listing of SMEs. For Kenya and Tanzania, it can be argued that it is too early to make this conclusion. However, for Uganda, this suggests that simplifying the listing requirements is not a panacea. A holistic approach that includes measures to address constraints

<table>
<thead>
<tr>
<th>Listing Requirement</th>
<th>MIMS</th>
<th>Enterprise Growth Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Track record</td>
<td>3 years</td>
<td>Not required</td>
</tr>
<tr>
<td>Profitability Track Record</td>
<td>Profits after tax attributable to shareholders in at least two of the last three financial years</td>
<td>None</td>
</tr>
<tr>
<td>Issued and paid-up capital</td>
<td>At least TZS 500 million (US$ 316,556)</td>
<td>TZS 200 million (US$ 126,622)</td>
</tr>
<tr>
<td>Profits and growth potential</td>
<td>Positive profits after tax for at least 3 of last 5 years</td>
<td>Existence in same line of business for at least 2 years</td>
</tr>
<tr>
<td>Incorporation Status</td>
<td>Issuers must be incorporated in Tanzania as public companies</td>
<td>Issuers must be incorporated in Tanzania as public companies</td>
</tr>
<tr>
<td>Net Tangible Assets</td>
<td>At least TZS 500 million (US$ 316,556)</td>
<td>The company shall have at least 50% of its net assets situated within Tanzania.</td>
</tr>
<tr>
<td>Issuer Type</td>
<td>All companies from different economic sectors</td>
<td>Growth companies of all sizes</td>
</tr>
<tr>
<td>Public shareholding spread</td>
<td>At least 25% of the listed shares must be held by public. In this case public shareholders will own not more than 1% for individuals and not more than 5% for institutions</td>
<td>At least 20% of its shares must be held by public</td>
</tr>
<tr>
<td>Minimum number of shareholders upon listing</td>
<td>Not less than 1,000 shareholders excluding employees of the Issuer</td>
<td>At least 100 shareholders</td>
</tr>
</tbody>
</table>
C.3.5 Lessons for Rwanda

<table>
<thead>
<tr>
<th>South Africa</th>
<th>Kenya</th>
<th>Tanzania</th>
<th>Uganda</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less stringent listing requirements than those of main market (JSE) in conjunction with additional support such as training provided in partnership with industry associations and the government was a key factor in attracting SMEs to list on the stock exchange;</td>
<td>Small and Medium Enterprise Exchange (Growth Enterprise Market Segment) was launched in January 2013. However, it will be important to complement the simplified listing requirements with other services that support SME development.</td>
<td>The Economic Growth Market (EGM) is yet to list any SMEs. Support to SME development and increased economic diversification are among the key factors expected to catalyze SME listings on the EGM.</td>
<td>As in Tanzania’s case, simplifying the listing requirements is only an initial step. Measures to support enterprise development and economic growth and diversification are also critical.</td>
</tr>
</tbody>
</table>

A dynamic economy characterized by economic diversification is a key driver of demand for financing through the capital markets.

C.4 Experiences of Asset-Backed Securitization

Securitization is the conversion of receivables and cash flow generated from a collection (pool) of financial assets such as (mortgage loans, auto loans, credit card receivables and other assets) into securities that are backed by these assets. Asset securitization is the issuance of a debt instrument backed by a revenue-producing asset of the issuing company. Asset securitization involves producing bearer asset-backed securities, which can be freely traded and which are secured by a portfolio of receivables. In order to ensure marketability, the instrument must have general acceptability as a store of value. Hence, the security is generally either rated by credit rating agencies or is guaranteed by an independent guarantor. The sub-sections that follow examine the experiences with these securities in South Africa, South Korea, and in Europe with a view to drawing lessons for Rwanda.

C.4.1 Experience of Asset-Backed Securitization in South Africa

The history of securitization in South Africa dates back to 1989 when the first securitization, an R250 million mortgage-backed security, was issued by the Allied Building Society (United Bank of South Africa Limited). Securitization continues to play a role in South Africa as shown by the listing of the first securitization company (Sotta Securitization International) on the Johannesburg Stock Exchange in November 1998.

However, securitization in South Africa still faces major obstacles. First, investors still prefer to invest in listed companies with an established track record. Second, there are legislative and accounting challenges arising from the fact that asset-backed securities transactions are off-balance sheet, which are considered more risky than other instruments such as mortgages. Third, there is no separate legislation for securitization, and no special entity, other than banks that are allowed to issue debt paper to fund the
associated operations. Thus, the securitization process by a Special-Purpose Vehicle, for instance one with a focus on SMEs, must be routed through a bank. Fourth, several of the commercial banks are adequately capitalized and their primary objective is to expand their operations rather than sell off assets as would be the case with securitization.

C.4.2 Experience of Asset-Backed Securitization in South Korea

Prior to the 1997 Asian crisis, some securitization deals were negotiated in Korea, but the activity in the securitization market started picking up in 1999. One of the most high-profile transactions took place in December 1998 by Korean Exim Bank. The Exim Bank was engaged in financing overseas operations of Korean companies and had receivables in foreign exchange. The bank securitized US$265 million of receivables representing promissory notes drawn on its clients. The securities in that transaction were rated AAA.

In 1999, the Korean government set up a mortgage securitization body, similar to the United States mortgage lender Fannie Mae, called Korea Mortgage Corp. (KOMOCO) and a joint venture with International Financial Corporation (IFC) and some domestic banks. KOMOCO’s mandate was to issue Mortgage Backed Securities (MBS) collateralized by mortgage loans acquired from the country’s National Housing Fund.

One of the main impediments that reduced the activity in the securitization market was the absence of supporting legislation. The government responded by enacting the Asset-Backed Securitization law in 1998. This law was primarily intended to govern securitizations originated by financial institutions, including government-promoted financial institutions such as Korea Development Bank, Korean Exim Bank, Industrial Bank of Korea, licensed financial institutions, merchant banks, insurance companies, securities companies, and trust companies among others. The law recognizes the activities of the Special-Purpose Vehicles (SPV) as limited liability companies to manage the securitized assets. The securities to be issued by the SPV may be in the form of investment certificates, bonds, and trust certificates.

C.4.3 Spanish Securitization Structure and Related Government Guarantees

Since 1992, Spanish securitization laws explicitly permitted the creation of special purpose investment companies established to purchase mortgage loans. In May 1998, the scope of the assets permitted for investment was widened
to include, inter alia, SME loans. These laws have facilitated True Sale transactions in Spain, which is the model used for all of Spain’s SME securitizations. The most important initiative for SMEs followed in May 1999 when the government established a programme of Kingdom of Spain guarantees for SME securitizations.

The programme currently provides an annual allocation of guarantees on SME ABS which may be used to guarantee up to 80% of notes rated at least “AA” and 50% of notes rated at least “A”. The guarantees are available under the conditions that at least 80% of the portfolio must comprise SME loans and that 80% of the securitization proceeds must be invested in new SME assets within one year.

The government guarantees reduce the funding costs of the ABS (Fondos de Titulizacion de Pequenas Medianas Empresas) as investors are willing to invest in government-backed obligations at lower credit spreads than those required of private sector obligors. In a typical transaction, this could amount to a saving of 15-20 basis points per annum on the total financing costs.

C.4.4 Role of the European Investment Fund in SME Securitization

The European Investment Fund (EIF) has played a prominent role in SME securitization in Europe by providing credit guarantees. Typically, EIF provides a credit wrap (lower rated ABS tranches are elevated to a higher rating by virtue of a guarantee from the credit enhancer) on both super-senior, senior and lower rated tranches of SME securitizations. This has had two beneficial effects for investors. First, it provides an AAA rating for the ABS tranches and second, it also allows banks to invest and obtain regulatory capital saving. Through this approach, EIF facilitates the placement of the wrapped tranches with investors, thereby considerably aiding the SME securitization process. Less frequently, EIF has provided enhancements by way of credit protection contracts, assuming risk down to a floor of a BB rating.

C.4.5 Lessons for Rwanda on Asset-Backed Securities

<table>
<thead>
<tr>
<th>South Africa</th>
<th>South Korea</th>
<th>Spain</th>
<th>European Investment Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Presence of legal and accounting system to support off-balance sheet transactions is necessary to mitigate the risk associated with asset-backed securities;</td>
<td>• Government initiative to establish a mortgage securitization body (KOMOCO) to issue mortgage-backed securities collateralized by mortgage loans acquired from the country’s National Housing Fund was key in fostering the securitization market;</td>
<td>• Securitization legislation explicitly permitting the creation of special purpose investment companies and the establishment of a government-supported guarantee programme for SME securitizations was key in developing the securitization market in general and SME securitizations in particular.</td>
<td>• Credit guarantees/enhancements have a positive impact on securitization including for the SMEs, by facilitating asset-backed security rating upgrades, mitigation of associated market risks, which consequently increases these assets’ market value and uptake by investors.</td>
</tr>
<tr>
<td>• Moreover, legal framework for securitization, in particular providing for the establishment of special-purpose vehicles as limited liability companies to manage securitization transactions, can catalyze the securitization market.</td>
<td>• Ratification of Asset-Backed Securitization legislation has dual benefits. First, it provides a legal framework for guiding securitizations and second, it recognizes the activities of special-purpose vehicles as limited liability companies to manage the securitized assets.</td>
<td></td>
<td>• The Business Development Fund in Rwanda which currently provides credit guarantees for commercial bank loans could consider, with the ratification of supporting legislation, providing credit enhancement for SME securitization.</td>
</tr>
</tbody>
</table>

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8 True-Sale transactions provide investors with a legal claim/right on the receivables from the securitization transaction.
Leveraging Capital Markets for SME Financing in Rwanda
D. SCOPING THE POTENTIAL FOR SME FINANCING IN RWANDA

Section B provides the situation analysis of SMEs and Section C summarizes experiences with various instruments for increasing SMEs access to finance from selected countries. In Rwanda and several other developing countries, the primary source of funding for SMEs is either own financing, informal sources or from the banking sector. Drawing from the regional and international experiences, this section explores the possible approaches for improving SMEs’ access to financing including through the capital markets. Four key instruments or vehicles are discussed:

i) Private Equity and Venture Capital Programme;
ii) Fund of Funds (RFF), funded by the government and in partnership with the private sector and development partners;
iii) Alternative Investment Market Segment (AIMS); and
iv) Asset-backed securities.

D.1 Establishment of Private Equity and Venture Capital

Feedback from the commercial banks in Rwanda indicates that one of the key challenges for SMEs is inadequate equity, often concentrated in a few shareholders. The rationale for higher and diffused equity is that the risk of the business would be cushioned and/or spread between shareholders and other financing sources including banks. Venture capital is one avenue through which SMEs could raise equity. The challenge is that the venture capital market in Rwanda is still in its infancy. However, Rwanda can benefit from existing venture capital funds within the East African region which are particularly targeting SMEs. Most of these funds are based in Nairobi but with a regional focus including Africa Capital Partners, African Agricultural Capital, Fanisi Venture Capital Fund, Citadel Capital Private Equity Fund, and Savannah Fund among others. The SMEs based in Rwanda can initially benefit from these funds if information is availed to them regarding the requirements of these funds. In addition, an effort could be made to market some of Rwanda’s SMEs to the fund managers in the region. Developing prospectuses showcasing the productivity, financial status, and growth potential of these SMEs could be useful in this regard.

To attract and establish venture capital in Rwanda, several steps need to be considered. Venture investment consists of three stages: fundraising, investment, and exit.

At the fundraising stage, the promoter of the venture capital fund seeks investors. These investors could include angel investors, government, pension funds, banks and other institutional investors like insurance companies. Rwanda could also adopt South Korea’s experience where the government took a lead role in financing venture capital funds for SMEs (see Korea Fund of Funds in section C). In this case the government could be the leading promoter of the fund and solicit other investors like the pension funds to invest in this initiative.

Thus, there would be a need to identify companies in Rwanda that have failed to raise the required equity but with potential to make high returns for equity investors. The mechanism to identify such enterprises should be a collaborative effort between commercial banks, CMA Rwanda, venture capital funds and other agencies such as the Rwanda Development Bank (RDB). The RDB has over the past few years been collecting information on companies for the annual Business Excellence Awards and such information could be a starting point for the venture capital industry (Appendix 1).

The investment stage typically involves VC investing and the participation of the VC institution in the investee company. This is motivated both by the need to protect the venture capitalists’ investment against downside risks, particularly since a profitable offloading of its investment (at the exit stage) is contingent upon the profitability of the investee company. The VCs will thus aim to “add value” to the investee company by contributing experience and contacts to such areas as business strategy, management organization and processes, financial planning and control, and investor relations. The extent of this involvement varies considerably between VC institutions in different countries and sectors and ranges from a “hands-on” approach associated with a close and continuous relationship with the investee company’s management to a “hands-off” or
passive approach where the VC relies on periodic financial reporting to monitor its investments. Maintaining close contacts with investee companies often requires physical proximity between the VC and its clients and a relatively high staffing ratio to ensure that each VC executive only handles a limited number of investee companies for optimal supervision and surveillance.

The exit phase of the VC investment cycle is to manage the divestment or exit from the investee firm. Since realizing a substantial capital gain is essential to achieving high investment returns, determining and achieving the timing and conditions of the sale of investments are crucial elements of the VC process. Divestments are arrived at via one of three basic exit routes. The first is flotation of the investee company’s shares through an Initial Public Offering (IPO) on the stock exchange or over-the-counter market. This usually offers enhanced marketability and a higher exit valuation for the investment through the higher price-earnings multiples of quoted shares. However, a key constraint to this exit strategy is that the investee company may be unwilling to incur the transaction costs and disclosure requirements of listing. The second exit alternative is the secondary or “trade sale” of the VC investor’s shares to another investor or company. This is probably the most commonly used route, although in larger, developed economies the transaction is often initiated by the acquirer, a firm which has identified the investee company as having a good strategic fit with its own operations. The third exit strategy is the repurchase of the venture capitalist’s shares by the entrepreneur or the investee firm. The original contractual agreements between the investors and the entrepreneur may provide for this possibility and define the conditions for the buyback of shares. The feasibility of these three options depends importantly on the size and liquidity of the securities market in the country concerned and the attitude of the entrepreneur to accepting outside shareholders.

As shown in Figure 11, there are various ways of promoting venture capital funds for the SMEs’ benefit. First, the venture capital company may invest directly in their preferred SMEs. Second, an investment fund could be created where venture capital companies pool their resources to finance SMEs. The government and other institutional investors could also allocate resources directly to this investment fund. The challenge for Rwanda is that the private venture capital market is still nascent, which on the other hand, could be an opportunity that allows government to take a proactive role in designing programmes for capital market development with specific focus on improving access to finance for SMEs.

D.2 Establishment of a Rwanda Fund of Funds (RFF)

This proposal to establish a Rwanda Fund of Funds borrows heavily from the South Korean experience. It is proposed that Rwanda considers establishing a fund of funds. To do this, the following steps are recommended:

i) Government should take the initiative in the establishment of fund of funds by providing the seed capital (see for instance the experiences of Israel, South Korea, and Ghana);

ii) A resource mobilization campaign targeting the private sector and development partners will need to be launched to complement government’s seed capital;

iii) Clear guidelines should be developed to inform the selection of investors to partner with the government and the beneficiaries including SMEs as in the case of Israel, Korea and Ghana. Explicitly clarifying that the support to SMEs will be a loan and not a subsidy is important for the fund’s sustainability;

iv) The fund of funds programme should be designed with a clear exit strategy for both the government and other investors. This often provides added comfort to the investors that their investment/contributions to the fund are redeemable;

v) The governance and management structure of the fund should allow for greater independence be
guided by international best practices. This would enable the managers to make funding decisions based on the viability and potential contribution of the SMEs to the broader national development objectives. The Fund would also have to be regulated by the Capital Markets Authority to ensure that it meets the generally acceptable standards and practices of capital markets and does not crowd out private venture capital initiatives. As demonstrated by the experiences from Ghana and Brazil, SME investments from the fund of funds should also follow the management practices used in the private venture capital market. In particular, the venture capitalists would invest in individual SMEs and for agreed periods of, say, 5 to 10 years; and

vi) Recruitment of competent fund managers, provision of a commensurate compensation package and development of performance benchmarks are prerequisites for a successful fund of funds. The structure of the funds of funds would appear as shown in Figure 12. It should be noted from the figure below that the source of financing should not only be restricted to government. Once the government provides seed capital, the FoF should marketed to other potential investors including pension funds and development partners. The seed capital will depend on various factors including government’s budget and initial contributions from investors. Given that SMEs comprise more than 90% of all business in Rwanda and the subsequent contribution to the economy in terms of employment, initial seed capital of US$30-50 million is recommended.

The government and its co-investors would also have to decide how much to allocate to the various sub-funds. This decision could be informed by the government’s strategy to promote the development of various SME clusters as outlined in the MSME policy (2010) as well as due diligence assessments on the growth potential and economic impact of the different SME clusters. Once the seed capital has been mobilized, the FoF would
operate as a revolving and self-financing fund in the same way the Government of Ghana envisioned the establishment and operations of the Venture Capital Trust Fund in Ghana. The dividends earned from the various SMEs would be ploughed back into the fund for investment in other SME companies.

**D.3 Establishment of Alternative Investment Market Segment (AIMS)**

Rwanda’s economy largely depends on agriculture for employment and export earnings, with the majority of the agricultural population engaged in subsistence farming. The dominant size of the establishments is micro- and small-scale, measured both in terms of capital and employment. Governance, management and financial reporting of the SMEs are still undeveloped. The predominance of sole proprietorships and family-owned businesses also presents challenges to the development of equity-based businesses. Thus, the current listing requirements that primarily target large companies might need to be adjusted to allow SMEs to participate in the capital markets. However, and as the experiences from the region demonstrate, adopting alternative listing requirements should not be considered as a panacea but rather part of the set of strategies to support SMEs participation in the capital markets. The CMA in partnership with the government and other stakeholders should sustain reforms aimed at addressing both the demand- and supply-side constraints to accessing finance, including through the capital markets. For instance, programmes to educate SMEs on issues of ownership, registration, financial management and reporting and other business competencies need to be emphasized. Increasing the affordability and access to business development services with a model based on cost-sharing should also be explored.

The table below presents the proposed adjustments to the listing requirements, drawing on data from Establishments.
Census (2011), Complementary Survey (2012), and experiences from other countries.

D.4 Setting up Asset-Backed Securities

Experiences in South Africa, South Korea and Europe reveal several important enablers in the development of the securitization market. These key factors, which are summarized below, will be essential ingredients for the development the securitization market in Rwanda.

- Appropriate and supportive legal and institutional framework to guide the securitization market and facilitate the establishment and operation of SPVs as limited liability companies;
- Advances in information technology to facilitate the transactions and improvements in risk analysis techniques;
- Advanced disintermediation, whereby banks originate and distribute some or all of the resultant risk to investors;
- Growth of derivative products and techniques for hedging and risk transference;
- Relative stability of ABS as a risk class, with consistently lower levels of default compared with other rated asset classes;
- Existence of a credible rating agency to authenticate the various notes issued by the SPV; and
- Credit guarantees/ enhancement to mitigate the risks associated with SMEs and thus enhance their credit worthiness.

Moreover, the implementation of the ABS would involve several key players including:

- **Originator:** The party which originally extended the loans (or other claims) being securitized;
- **Servicer:** The party which administers the securitized portfolio of assets. Almost invariably, this party is also the Originator;
- **Arranger:** The party that structures the portfolio of assets and negotiates and advises on the transaction terms. This function is usually performed by an investment bank or the capital markets arm of a large banking group;
- **Underwriter:** The party that underwrites the sale of ABS created by securitization. This task is usually under-

### Table 15: Proposed Alternative Listing Requirements for SMEs

<table>
<thead>
<tr>
<th>Listing Requirement</th>
<th>RSE (MIMS)</th>
<th>Proposed AIMS</th>
<th>Motivation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Paid-up Capital</td>
<td>RWF 500 million</td>
<td>RWF 50 million</td>
<td>Based on average turnover of SMEs (See Establishments Census 2011)</td>
</tr>
<tr>
<td>Profit History</td>
<td>3 years</td>
<td>None</td>
<td>The Establishment’s Census and Complementary Survey reveal that the majority of SMEs in Rwanda are still in their infancy and thus might not have any profit history</td>
</tr>
<tr>
<td>Number of Shareholders at Listing</td>
<td>50</td>
<td>10</td>
<td>Most SMEs are family-owned with few or no shareholders at start-up</td>
</tr>
<tr>
<td>Sponsor/Designated Adviser</td>
<td>Sponsor</td>
<td>Designated Adviser</td>
<td>An Adviser will be necessary to guide SMEs through the listing process</td>
</tr>
<tr>
<td>Company Listed by Shares and Incorporated or Registered</td>
<td>Required</td>
<td>Required</td>
<td>SMEs should be legal entities that can sue and be sued so as to improve their credibility and appeal to potential investors</td>
</tr>
<tr>
<td>Special Requirements</td>
<td>N/A</td>
<td>Appoint Financial Directors</td>
<td>Financial directors will improve the corporate governance structures for SMEs and consequently enhance their credibility</td>
</tr>
<tr>
<td>Education Requirements</td>
<td>N/A</td>
<td>All directors to attend induction program</td>
<td>This will equip the directors with basic competencies necessary to thrive in a capital market and as demonstrated by the AltX market in Johannesburg, contribute to the success of the alternative securities market</td>
</tr>
<tr>
<td>Audited Accounts</td>
<td>Required</td>
<td>Not required</td>
<td>The Complementary Survey reveals that the majority of SMEs do not have audited accounts and thus, including audited accounts among the requirements for listing on the alternative securities market could prevent several prospective SMEs from participating. However, to mitigate the associated risks, SMEs that eventually list could be subjected to more routine financial scrutiny.</td>
</tr>
</tbody>
</table>
taken by the Arranger;

- **Special Purpose Vehicle (SPV):** The legal or beneficial owner of the portfolio sold by the Originator. This is usually a specially created company that is dedicated exclusively to its role in a single securitization;

- **Rating Agency:** The party providing the credit ratings for the ABS, without which the market could not operate. The analytical process, which leads to a decision to award a particular rating for each tranche in a securitization, is complex and involves, among many other things, multiple simulation analyses of default frequencies and loss severity in specific asset portfolios. Debt ratings are expressed in an alphabetical format, the highest (strongest) being “AAA”, the next highest “AA” etc.;

- **Investors:** These are buyers of the debt instruments and could include banking institutions, insurance companies, mutual funds and others; and

- **Facilitators:** Other parties with a specific role in securitization, including trustees for the ABS, tax advisers, legal advisers, auditors and market makers/traders.

### D.4.1 Setting Up Collateralized Loan Obligations and Pooling of SMEs to Reduce Risk

While this instrument is mostly used for large enterprises, it is also applicable to SMEs. Under this transaction, selected loans to SMEs are packaged into a pool and sold by the originator, for instance a financial institution, to a special-purpose vehicle (SPV), promoter or trustee as illustrated in Figure 13.

The SPV/promoter/trustee refinances the pool by issuing tradable commercial paper secured by the underlying assets. The promoter then allocates proceeds to a prioritized collection of securities issued to capital market investors in the form of tranches. The tradable securities are categorized into senior notes, mezzanine notes and lower notes with varying risks and thus, returns.

Pooling various SMEs to form a CLO has the benefit of spreading the credit risk associated with SMEs across debt market investors and can attract investors with various appetites for risk. The CLO also provides additional leverage to commercial banks to increase the amount of loans available to SMEs. Other benefits of the CLO include sharing of the credit risk associated with SMEs across debt market investors.

### D.4.2 Setting Up Collateralized Bond Obligations (CBOs)

SMEs are associated with high transaction costs and high credit risk due to among other things, the low borrowing volumes and low survival rates. One way to circumvent these two problems supporting SMEs is to issue bonds through the stock market which are subsequently collateralized (Figure 14).

![Figure 13: Collateralized Loan Obligation](image-url)
CBOs are not very different from CLOs as both are collateralized debt and asset-backed securities except that the former are backed by bonds while the latter are backed by debt. For CBOs, once the SMEs issuing the bonds are identified by the promoter or government, the pooled bonds are sold to the promoter of the transaction or trustee. The promoter then issues the CBO, which is backed by the corporate bonds as the underlying asset, to investors. However, credit enhancement in the form of a guarantee or insurance would be necessary since the CBO’s underlying assets would still be considered risky.

CBOs represent a medium-term objective for Rwanda because of various reasons. First, implementing CBOs requires the SMEs that would issue bonds to be listed on the stock market. Second, it would require a market benchmark in the form of a yield curve to price these bonds. Third, there should be a thriving market of high-yield bonds, which currently is not in place in Rwanda. In spite of these challenges, CBOs are still viable instruments which can be explored by the Capital Markets Authority in the medium term, especially as the stock market develops. The Business Development Fund (BDF) which currently provides guarantees for SME loans could be considered as a credit enhancer for ABS.

While both the CLO and CBO seem to be attractive instruments that could be explored by the capital markets authorities, the instruments should be investigated carefully prior to implementation. These two instruments are associated with various risks (see Box 3) inherent in the underlying assets that would require safeguards for investors.

**Box 3: Risks Associated with Asset-Backed Securities**

**Credit Risk:** Credit risk arises from a change in the credit quality of the borrower which consequently affects the market value of the underlying collateral position. Defaults, whereby a counterparty is unwilling or unable to fulfill its contractual obligations is the extreme case. Investors are also exposed to risks that the counterparty might be downgraded by a rating agency. With regards to CLOs and CBOs, credit risk emanates from the risk of default on the portfolio. The equity investors who do not receive the benefit of overcollateralization or subordination have more exposure to credit risk since this category of investors receives principle or interest from the proceeds only after all other investors have been paid.

**Interest Rate Risk:** This risk arises from various factors in CLOs or CBOs and depends on the complexity of the structure and nature of hedging involved. For most of these arbitrage cash flow CLOs or CBOs, the interest rate risk is included in the form of basis risk; that is, a mismatch between fixed and floating rate asset and liabilities. Basis risk is usually hedged with interest rate swaps, caps, and/or floors. However, CLO and CBO interest rate risk is difficult to hedge fully due to the active management of the assets (use of human element—managers—to manage the portfolio as opposed to relying on a market/industry index—indexing—to monitor the assets’ performance) and limited ability to buy or sell interest rate hedges.

**Liquidity Risk:** Liquidity risk for the CLOs and CBOs relates to the ease with which assets in the asset portfolio can be traded. This could particularly be a challenge for a portfolio whose underlying asset is debt owed by SMEs.

Other types of risks associated with these assets include: prepayment risk, reinvestment risk, asset manager risk, systemic risks due to downturn of an economy and currency risks if the portfolio has a foreign-exchange component.
Leveraging Capital Markets for SME Financing in Rwanda
E. CONCLUSION AND POLICY RECOMMENDATIONS

SMEs play a significant role in many aspects worldwide including in Rwanda. The Establishment Census 2011 reports that Rwanda had 123,526 establishments in 2011 compared to an estimated 73,000 in 2008. Of the 123,526 establishments, 96.5% were in the private sector, employing 91% of Rwanda’s workforce. The SMEs comprise 98% of all the establishments with micro-sized establishments accounting for 92.6% of all establishments while an estimated 89,219 establishments (72%) employ just one worker.

This indicates that growth in the SME sector could be of strategic importance, especially in supporting inclusive growth and youth employment. Growth of the SME sector also has the potential to lower Rwanda’s trade and fiscal deficits which are driven primarily by the limited export diversification and dependence on external grants and loans respectively. Interventions to support enterprise development will spur SME growth and consequently expand the tax base. The resulting increase in public revenue mobilization will all else being equal, contribute to a reduction in the fiscal deficit.

Several initiatives have been undertaken by the Government of Rwanda, development partners and development finance institutions to support SME development. However, several challenges remain. Most SMEs still depend on internally generated funds and borrowing from informal sources. Only 11.2% of SMEs are registered with the Rwanda Revenue Authority although up to 87% are registered at the local government level. Financial institutions consider SMEs to be highly risky due to the low survival rates among other things and their high per-unit transaction costs due to the relatively lower loan volumes. Moreover, there is widespread information asymmetry about the operations of SMEs, and where available, information is scattered across various financial institutions, credit programmes and other programmes supporting the SMEs.

Limited financial instruments; the nascent capital markets; and a capital market legal and regulatory framework that is tilted in favor of large companies are also key challenges. Furthermore, the overall policy environment was in the past identified as an impediment to the growth of SMEs. However, the government responded in 2010 by developing an SME policy to guide the development of this sector. This policy seeks to address the core binding constraints to SME development including limited access to quality business development services and complements other policies aimed at improving supporting infrastructure such as road networks, power supply, water for production, telecommunication services and access to finance.

This study makes a case for the need to explore options for using capital markets to finance SMEs due to various benefits including the possibility of access to more affordable funds for business growth and expansion, risk sharing and diversification via a public offering; and increased publicity and scrutiny of SMEs’ operations which comes with equity investments. The study, drawing on regional and international experiences identifies several key recommendations with the potential to catalyze financing SMEs through capital markets and other sources. These recommendations include:

E.1 Enact Supporting Regulatory and Legal Reforms

While the regulatory and legal framework for the development of financial markets including capital markets is in place, the authorities should consider revising the listing requirements targeting the SME sector as discussed in Section D. The existing requirements do not help SMEs to benefit from the equity and debt markets because the establishments are predominantly micro- and small-scale enterprises that are mainly sole proprietorships or family-owned. However, the authorities should not stop at only relaxing the listing requirements. As the case of the AltX in South Africa has demonstrated, the Government of Rwanda will need to partner with the RSE, a representative of the SMEs and development partners to address the other SME-specific challenges such as poor financial management and reporting, issues of incorporation, corporate governance and other bottlenecks.
E.2 Improve Information Collection and Sharing.

Authorities should embark on improving access to information on the operations and activities of SMEs. This could be achieved by facilitating disclosure of data and information by various agencies to facilitate the evaluation mechanism by private investors including venture capitalists or banking institutions.

The government, CMA, financial institutions and SMEs should consider developing an information gathering and sharing system on the performance, profitability, market niche and other data of SMEs. The proposed information sharing system could be modeled around the credit reference bureau although the scope of information collected, managed and shared will extend beyond credit. Supporting legislation will be necessary for the operationalization of such an information sharing system. The information required from a company should at least cover the key financial indicators captured when companies are trading on stock exchanges. A similar database has been developed by the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN).

E.3 Encourage and Promote Establishment of Private Equity and Venture Capital (PE/VC)

Rwanda can benefit from existing venture capital funds within the East African region which are particularly targeting SMEs. Most of these funds are based in Nairobi but with a regional focus as discussed in Section C. The SMEs based in Rwanda can initially benefit from these funds if information is availed to them regarding the requirements for accessing these funds.

In addition, an effort could be made to market some of Rwanda’s SMEs to the fund managers in the region. Developing a prospectus containing data on productivity, financial status and growth potential of these SMEs would be useful in this regard.

E.4 Establish a Rwanda Fund of Funds (RFF)

As explored in Section D, it is recommended that GoR initiates the establishment of the Rwanda Fund of Funds by contributing the seed capital and inviting potential partners to contribute to the fund. By setting up the Rwanda Fund of Funds, the government will not only be promoting access to financing by SMEs, it will also ensure that the venture capital market has access to a steady supply of funding even during economic slowdowns.

E.5 Setting Up Asset-Backed Securities

Asset-backed securities should also be explored by the Capital Markets Authority for the benefit of SMEs. However, as demonstrated in section D.4, this would require various enablers including supporting legislation, credit enhancement and a more vibrant securities exchange market among other things. Moreover, appropriate mitigating measures would be necessary to alleviate the risks associated with asset-backed securities.

E.6 Review the Current Approach to Providing Business Development Services

While the privatization of the provision of Business Development Services (BDSs) is aimed at ensuring sustainability of these services, measures should be taken to ensure wider access and affordability of them to the private sector including SMEs. For instance, measures to develop the capacity of the private providers of these BDSs and support to mobilize funding including from development partners should be fast-tracked. Cost-sharing between the government and SMEs could also be considered in the short term.

E.7 Maintain the Current Fiscal Incentive Structure

Government interventions in the form of tax breaks, grants and other subsidies have the potential to support the
growth of capital markets, especially during the formative stages. Given that capital markets have been operating for only a few years in Rwanda, there is limited empirical evidence to allow for conclusions on the impact of the current tax regime on the growth of the capital markets, and whether any major reform is required in this regard. An assessment of the current fiscal incentive structure could be undertaken in say 2015 to inform any improvements in the targeting of incentives in line with the country’s development priorities. This study therefore recommends that the following capital market investment incentives as contained in the special official gazette published on 28th May, 2010, should be maintained in the short-term:

i. Income Tax Exemption: Income accruing to registered collective investment schemes and employees’ shares scheme are exempted from income tax;
ii. Capital Gains Tax: Capital gains on secondary market transactions of listed securities shall be exempted from capital gains tax;
iii. Corporate Income Tax: newly listed companies on the capital market shall be taxed for a period of 5 years at the following rates (the standard corporate income tax rate is 30%):
   • 20% if those companies sell at least 40% of their shares to the public;
   • 25% if those companies sell at least 30% of their shares to the public;
   • 28% if those companies sell at least 20% of their shares to the public;
iv. Venture Capital: Venture capital companies registered with the Capital Markets Authority in Rwanda benefit from a corporate income tax of zero percent (0%) for a period of five (5) years from the date the decision to list is made;
v. Withholding Tax on Dividends and Interest: Withholding tax on dividends and interest income on securities listed on capital markets and interest arising from investments in listed bonds with a maturity of 3 years and above shall be reduced to 5 percent\(^9\) when the person to whom this income accrues is a resident taxpayer of Rwanda or the East African Community; and
vi. VAT: The transfer of shares and capital market transactions for listed securities are exempted from VAT.

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\(^9\) Unless otherwise exempted, a withholding tax of 15 percent is levied on dividends, interest income, royalties, service fees, gambling proceeds and other things.
Leveraging Capital Markets for SME Financing in Rwanda
F. ACTION/IMPLEMENTATION PLAN

This section summarizes the key actions required to implement the recommendations discussed in Section E. While some measures can be undertaken immediately, others would require time to materialize. The immediate or short-term measures would prepare the ground for the medium- and long-term actions. The short-term in this case refers to a period of up to a year; the medium term covers 1-3 years while longer-term actions will require more than 3 years to implement.

The indicative costs for implementing the action plan are based on several assumptions. For the information sharing system, we assume that this role can be undertaken within the Ministry of Trade and Industry which also has the mandate for SME development. We also assume that the rules and remuneration for the required additional personnel will be in line with the Pay and Retention Policy.

For the case of simplifying the listing requirements, the institutional structures are already in place under the CMA and it’s assumed that the related actions can be implemented without any additional cost. Identification of prospective SMEs will be drawn from the RDB Excellence Awards database and could be strengthened in collaboration with the CMA. The Ministry of Trade and Industry in partnership with RDB and the CMA would then market the identified companies to potential investors within the region, for instance through a publication such as an investment prospectus and other outreach programmes.

For the administrative costs of establishing the RFF, we assume that at its inception, the fund would require an experienced fund manager with a proven track record in managing similar funds. This fund manager could be recruited internationally and probably deputized by a national for on-the-job training and knowledge transfer. As such, an attractive remuneration package is proposed for the fund manager. The initial endowment of the fund is based on the experiences from other countries such as Israel and also accommodates other factors including the financing gap for SMEs and the potential impact of SME growth on economic growth and development.

The recommendations and corresponding actions for increasing SME access to finance through the capital markets and other instruments are summarized below.
### Action Plan for Increasing SME Access to Finance through the Capital Markets and Other Instruments

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Action</th>
<th>Time-line</th>
<th>Responsible Agency</th>
<th>Budget (US $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory, Legal and Institutional Reforms</td>
<td>Review the listing requirements and create an AltX.</td>
<td>12 months</td>
<td>CMA, RSE</td>
<td>--</td>
</tr>
<tr>
<td>Information Sharing</td>
<td>Establish a database on operation of SMEs that can be shared with investors. The information sharing system could be modeled after the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN)</td>
<td>12 months</td>
<td>CMA, RSE, NSI, RDB, Ministry of Trade and Industry</td>
<td>100,000</td>
</tr>
<tr>
<td>Encourage and Promote Unlisted Securities Market, OTC and Private Placements</td>
<td>Develop a prospectus containing productivity, financial, and growth potential of these SMEs. Organize forums where SMEs and potential venture capitalists can meet and exchange information</td>
<td>Continuous</td>
<td>CMA, RSE</td>
<td>100,000</td>
</tr>
<tr>
<td>Pooling Risk for SMEs</td>
<td>The CMA and RSE could also explore the possibility of introducing an indexed equity fund with a specific number of SMEs and varying risk return profiles. Such indexed funds have been successfully traded on advanced stock markets and can partly address the high risk burden associated with individual SME companies.</td>
<td>Long-term objective</td>
<td>CMA, RSE</td>
<td>--</td>
</tr>
<tr>
<td>Establish a Rwanda Fund of Funds (RFF)</td>
<td>The government should initiate the fund of funds programme by providing seed capital and also invite the private sector, both local and foreign, to participate in the establishment of this fund</td>
<td>12 months</td>
<td>Ministry of Finance and Economic Planning, CMA, Ministry of Trade and Industry</td>
<td>Seed capital of 30 – 50 million</td>
</tr>
<tr>
<td>Set Up Asset-Backed Securities</td>
<td>1. Enact appropriate laws for regulating ABS; 2. Establish credit enhancement programmes and/or increase the capitalization of existing credit guarantee schemes; 3. Support the establishment of credit rating agencies and/or establish twinning arrangements between CMA, RSE, the Private Sector Federation and regional/international credit rating agencies;</td>
<td>2 years</td>
<td>Ministry of Finance and Economic Planning, National Bank of Rwanda, Commercial Banks, CMA</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Review the current approach of provision of Business Development Services</td>
<td>1. Subsidize the cost of provision of BDS to SMEs. 2. Enhance the capacity of the providers of the BDS</td>
<td>1 year</td>
<td>Ministry of Trade and Industry, RDB, BDF</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>
References


## APPENDIX 1:

### Prospective Companies for Venture Capital/Capital Markets

<table>
<thead>
<tr>
<th>Tourism</th>
<th>Real Estate</th>
<th>Manufacturing</th>
<th>ICT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royal villas</td>
<td>Sky Hotel</td>
<td>Hotel Urumuli</td>
<td>A-Link Technologies</td>
</tr>
<tr>
<td>Gorilla Hotel</td>
<td>Kiyovu Motel</td>
<td>Belvedere Hotel</td>
<td>BCS Group</td>
</tr>
<tr>
<td>Aberdeen House</td>
<td>Bloom Hotel</td>
<td>Peace Hotel</td>
<td>Axis</td>
</tr>
<tr>
<td>Stipple Hotel</td>
<td>Garden centre</td>
<td>Lake View Apartments</td>
<td>Star Africa Media</td>
</tr>
<tr>
<td>Milie collines hotel</td>
<td>Sabinyo Silverback Lodge</td>
<td>Hotel Ubumwe</td>
<td>Pivot Access</td>
</tr>
<tr>
<td>Laico Umubano hotel</td>
<td>Gorilla Neste Lodge</td>
<td>Peace Guest House</td>
<td>Perspective Design</td>
</tr>
<tr>
<td>Top Tower Hotel</td>
<td>La Palme Hotel</td>
<td>Hotel Faucon</td>
<td>Rock Global Consulting</td>
</tr>
<tr>
<td>Hotel chez Lando</td>
<td>Isherna Hotel</td>
<td>Hotel Credo</td>
<td>TELE-10</td>
</tr>
<tr>
<td>ALPHA PALACE</td>
<td>Virunga Lodge</td>
<td>Barthos Hotel</td>
<td>Rwandatel</td>
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**Source:** Rwanda Development Board