Small and Growing Businesses in Ethiopia

Edited by ADA asbl and First Consult PLC
# List of Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>ACSI</td>
<td>Amhara Credit and Savings Institution</td>
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<tr>
<td>ADSCI</td>
<td>Addis Saving and Credit Institution</td>
</tr>
<tr>
<td>DBE</td>
<td>Development Bank of Ethiopia</td>
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<tr>
<td>DECSI</td>
<td>Dedebit Credit and Saving Institute</td>
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<tr>
<td>ETB</td>
<td>Ethiopian Birr</td>
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<tr>
<td>FDRE</td>
<td>Federal Democratic Republic of Ethiopia</td>
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<tr>
<td>FUJCFSA</td>
<td>Federal Urban Job Creation and Food Security Agency</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GTP</td>
<td>Growth and Transformation Plan</td>
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<td>MFI</td>
<td>Microfinance Institution</td>
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<tr>
<td>MIS</td>
<td>Management Information System</td>
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<tr>
<td>MSE</td>
<td>Micro and Small Enterprise</td>
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<tr>
<td>MSME</td>
<td>Micro, Small and Medium Enterprise</td>
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<tr>
<td>NBE</td>
<td>National Bank of Ethiopia</td>
</tr>
<tr>
<td>NBFI</td>
<td>Non-Bank Financial Institution</td>
</tr>
<tr>
<td>NGO</td>
<td>Non-governmental Organization</td>
</tr>
<tr>
<td>OCSSCO</td>
<td>Oromia Credit and Savings S.C</td>
</tr>
<tr>
<td>SGB</td>
<td>Small and Growing Business</td>
</tr>
<tr>
<td>OSS</td>
<td>One Stop Service</td>
</tr>
<tr>
<td>PASDEP</td>
<td>Plan for Accelerated and Sustained Development to End Poverty</td>
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<tr>
<td>SME</td>
<td>Small and Medium Enterprise</td>
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<tr>
<td>SMMIDA</td>
<td>Small and Medium Manufacturing Industry Development Agency</td>
</tr>
<tr>
<td>SNNPR</td>
<td>Southern Nations, Nationalities, and Peoples’ Region</td>
</tr>
<tr>
<td>TVET</td>
<td>Technical and Vocational Education and Training</td>
</tr>
<tr>
<td>VFE</td>
<td>Vision Fund Ethiopia</td>
</tr>
<tr>
<td>WBG</td>
<td>World Bank Group</td>
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<tr>
<td>WEDP</td>
<td>Women’s Entrepreneurship Development Project</td>
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Executive Summary

The MSME sector has been fully recognized by the government of Ethiopia as a driver for economic growth and job creation. To that end, the government has designed and implemented a National MSE Development Strategy which facilitates the growth of the sector. However, the sector continues to perform below expectations due to various challenges including limited access to finance, lack of appropriate working premises and low quality business development services (BDS).

Given these challenges, this study sets out to provide detailed information on the main factors that currently affect the growth of businesses which started out as micro and eventually grew into small and medium sized entities. More specifically, the study answers the following: Who are SME owners? In which sectors do they operate? What have their growth patterns been? What were the critical factors that affected their growth/failure? How have they used financial services to support their growth? What other (non-financial) factors exist that are of significance in shaping SME development? In line with the above, a methodology was developed whereby a total of 45 Small and Growing Businesses (SGBs) were selected from a population of 140 urban SMEs in the portfolio of 3 MFIs that expressed their willingness to upscale their credit provision to SMEs.

In-depth interviews were conducted to gather information on the SGB owners, their business histories and their use of financial and non-financial services.

The main findings of this study include the following:

- **Female SGB owners are older but have less prior business experience than their male counterparts.** This reflects the fact that women have had fewer employment opportunities and/or have been unable to commit the time required to run a business due to household obligations. However, women require less time to grow their businesses than men. This could suggest that women have the skills and commitment required to run a business (more) successfully if given the opportunity.

- **Age and education levels seem to be the key determinants of the speed of business growth.** Younger business owners were better able to grow their business than older business owners. Similarly, owners with higher levels of education required less time to grow their businesses, which suggests that the more educated owners are, the better able they are to manage their businesses professionally, analyse competition and understand market preferences.

- **Almost all SGBs are managed by their owners.** The main reason given for not having a professional manager was that the owners wanted to have full control over the day-to-day operations of their businesses since they were dependent on them for survival. Growth is slower for business owners that manage more than one business (33% of the sample) than for sole business owners due to their split commitments.

- **Loans from families, own savings and Iqqub** were the predominant sources of start-up capital. Excessive collateral requirements and restrictive MFI policies such as demanding clients

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1 For the purposes of this study, we refer to the selected businesses as Small and Growing Businesses. This distinguishes them from the overall MSME population since they have demonstrated the potential to grow their businesses from a micro level to a very small, small or medium level. This is broadly aligned with the definition proposed by the Aspen Network of Development Entrepreneurs (ANDE) - [http://www.whymsgbs.org/whataresgbs/](http://www.whymsgbs.org/whataresgbs/)

2 Iqqub is an informal association established by a small group of people in order to provide substantial rotating funding for members, who take loans on the basis of a drawing of lots.
save 15% to 20% of the loan amount over a 6 month period are significant obstacles to acquiring start-up capital from MFIs. Only 9% of the entrepreneurs studied started out with a loan from an MFI plus their own savings. MFIs do not appear to take credit history into account when determining the terms and conditions of subsequent loan requests. Further, since loan amounts are bounded by the collateral coverage capacity of the client, a loan size bottleneck is ultimately bound to be created. This in turn limits the growth potential of the SGBs.

- **MFIs appear to provide preferential loan terms to female SGB owners.** The study revealed that the average loan size and tenure of both the first and the last loans for female business owners were superior to those offered to male business owners. This is almost certainly a consequence of different initiatives including the WEDP (Women’s Entrepreneurship Development Project), which has been facilitating a cash-flow based loan appraisal methodology for MFIs targeting women entrepreneurs.

- **The benefits of formal registration seem to be well understood by SGB owners.** All respondents stated that they were formally registered either for reasons of having better access to clients and/or government support. In addition to provision of working spaces and sales centres, governmental procurement favours legally registered MSMEs. This opportunity has created huge market linkages for the MSMEs involved.

- **SGBs appear to use the entire loan amount exclusively for the purpose stated in the loan application.** Utilization of the loan amount as intended vastly diminishes the risk of default. This result indicates that SGB clients are more reliable and potentially less risky than micro level clients. More than two-thirds of the SGBs used the loans to finance working capital. This indicates that once the businesses are up and running, financing needs predominantly shift towards working capital.

- **All businesses interviewed seem to be growth-oriented.** None of the SGB owners had the intention of changing business, slowing down or stopping. However, access to finance and lack of adequate working premises were mentioned by owners as challenges that could potentially limit the volume and speed of growth. Other challenges, such as access to foreign currency, fixed assets, competition and BDS (Business Development Services) were mentioned as barriers to growth. Despite these challenges, most SGBs planned to hire more employees in the near future.

- **SGBs have one foot in the MFI and the other in the bank.** At the MFI level, there is a lack of MIS software solutions capable of providing non-credit financial services in real time. SGBs therefore rely on banks to facilitate transactions with their clients/suppliers and cash management. However, banks do not actively seek out SGBs for financing due to the high transaction costs and the high risks this would involve. In that sense, despite MIS weaknesses, MFIs are better positioned to scale-up their small and medium business support than banks would be.

- **Business support services provided through government structures are inadequate and have little impact on SGBs growth.** Since the government established One-Stop Shops (OSS) to serve MSMEs business support services have become available to virtually everyone without charge. However, due to a lack of incentives to innovate and enhance the level of support, service provision remains sluggish, bureaucratic, and of uneven quality. To this end, public private partnerships (PPP) should be tested to pave the way towards a vibrant, organised, vetted, quality-driven BDS provided by the private sector which responds to the needs of growth-oriented small businesses.
1. Introduction

Micro, Small and Medium Enterprises (MSMEs) have played and continue to play significant roles in the growth, development and industrialization of developing countries. Accordingly, most developing countries have formulated and implemented a wide variety of MSME development strategies in order to support the growth of the sector, thereby transforming economies and generating substantial employment opportunities.

In line with the above, the Ethiopian government has historically supported the growth of Micro, Small and Medium Enterprises (MSMEs), especially growth-oriented businesses\(^3\), through various policy interventions. For instance, the government formulated a national Micro and Small Enterprises Development and Promotion Strategy in 1997 (revised in 2011) to create an enabling environment for the sector. Furthermore, MSMEs were placed at the heart of the first industrial policy strategy in 2002. Similarly, within the framework of the government’s 5 year economic development plans, including PASDEP, GTP I and GTP II, the expansion and development of MSMEs has systematically been a key strategic priority.

Despite the importance of MSMEs to the national economy and increasing government support, many of them remain unable to fulfil their full potential due to limited access to finance. According to a report released by the World Bank (World Bank, 2015)\(^1\), small firms face greater challenges in obtaining formal financing than large firms; they are much more likely to be rejected for loans and are less likely to have external financing due to a lack of collateral and credit history.

Microfinance institutions predominantly provide micro credit to micro enterprises while banks service medium and large enterprises. Small and medium sized enterprises in Ethiopia are currently excluded from the banking sector credit due to their size (too small to be served by banks) and inability to meet excessive collateral requirements (>200% of the loan amount). MFIs, on the other hand, have only been able to meet a small proportion of the demand from small and medium sized enterprises for finance due to limited liquidity, restrictive loan ceilings and strict collateral requirements.

Given the challenges and constraints mentioned above, this study seeks to identify and analyze a particular group of SGBs within 3 MFI portfolios, namely Addis Credit and Saving Institution (AdCSI), Vision Fund MFI and Agar MFI. More specifically, the study has been designed to provide detailed information on SGBs that started out as micro and grew into very small, small or medium sized enterprises.

This study will help stakeholders understand the typical features of these emerging SGBs, their growth patterns, the mechanisms they depend on to finance their business as well as their future financing needs for continued growth.

For the purposes of this study, the term MSME refers to Micro, Small and Medium-sized Enterprises. According to the National MSE development Strategy and the Development Bank of Ethiopia (see table below), MSMEs are defined by number of employees and net worth. It is also important to note

\(^3\) The Government of Ethiopia identified growth-oriented MSMEs based on their potential for job creation, poverty reduction, local raw material utilization and ease of transformation to medium and large scale businesses in a short period of time. Accordingly, MSEs engaged in manufacturing (metal, leather, textile, wood work, agro processing), construction (contractors and construction material producers), urban agriculture (dairy, cattle fattening, poultry, beekeeping and animal food production), trade (wholesale and retail) and services (hotel, tourism, solid waste collection, etc.) are considered as growth-oriented MSMEs.

that MSMEs are defined differently depending on whether they operate in the service/trade sector or the industrial/manufacturing sector.

<table>
<thead>
<tr>
<th>Economic sector</th>
<th>Micro Enterprises</th>
<th>Small Enterprises</th>
<th>Medium Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Services</td>
<td>Industry</td>
<td>Services</td>
</tr>
<tr>
<td>Employees</td>
<td>≤ 5</td>
<td>≤ 5</td>
<td>6-30</td>
</tr>
<tr>
<td>Capital</td>
<td>&lt; 50,000 Or &lt; EUR 2,000</td>
<td>&lt; 100,000 Or &lt; EUR 4,000</td>
<td>50,001-500,000 Or EUR 2,001 - 20,000</td>
</tr>
</tbody>
</table>

Unfortunately, there is not yet a clear benchmark for the upper capital limit defining medium enterprises. However, the Development Bank of Ethiopia recently prescribed a definition of medium enterprises (for its lease financing operations) based on number of employees and total capital irrespective of the sector in which the enterprises operate. Accordingly, medium enterprises in both the industrial and service sectors are enterprises with 31-100 employees and/or with a paid up capital or total assets of ETB 500,001 (EUR 20,000) to ETB 7.5 million (EUR 60,000). The present study uses both the MSE Strategy and the DBE’s guidelines to select samples from the 3 participating MFIs and applies the same in its analysis.

The findings are based on a survey conducted with 45 SGBs selected from 3 participating MFIs that had expressed their willingness to upscale their credit operations. All 3 MFIs are licensed and supervised by the National Bank of Ethiopia and provide credit and saving services to a wide range of customers including MSMEs. The following table provides basic information on the MFIs.

<table>
<thead>
<tr>
<th>Year of Establishment</th>
<th>AdCSI</th>
<th>Agar</th>
<th>Vision Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Status</td>
<td>NBFI, established as share company and licensed by NBE</td>
<td>NBFI, established as share company and licensed by NBE</td>
<td>NBFI, established as share company and licensed by NBE</td>
</tr>
<tr>
<td>Mission Statement</td>
<td>“To promote micro and small enterprises to alleviate poverty and unemployment prevailing in Addis Ababa and surrounding through provision of sustainable financial and other related service with particular attention to women”</td>
<td>“To provide fast, affordable and demand driven financial services on a sustainable basis to the missing middle in order to improve their wellbeing and generate profit for shareholders by deploying qualified and motivated staff and high-tech services”</td>
<td>“Promoting development and expansion of economically viable and sustainable micro-enterprise through quality financial and non-financial services”</td>
</tr>
<tr>
<td>Number of Active clients</td>
<td>292,080</td>
<td>11,160</td>
<td>134,405</td>
</tr>
<tr>
<td>Outstanding loans (as of Dec 31, 2016)</td>
<td>ETB 2.38 billion [EUR 95.2 million]</td>
<td>ETB 203 million [EUR 8.1 million]</td>
<td>ETB 520 million [EUR 20.8 million]</td>
</tr>
</tbody>
</table>
As shown in the table above, there are significant differences between these MFIs in terms of outstanding loan size and number of active borrowers. This is particularly true of Agar, which has deliberately opted to deepen its support for the missing middle with larger ticket loans, whereas AdCSI focuses on a broader approach by supporting both micro and small enterprises with lower average loan sizes. Finally, VF Ethiopia primarily focuses on micro level enterprises with growth potential and therefore has the lowest average loan size of the three institutions.

The MFIs provided the study team with a list of 140 SME clients from their respective portfolios (AdCSI=50, Agar=50 and Vision Fund=40). These SMEs were then contacted by phone to ensure that they met the selection criteria (see Annex 1). They were asked four essential questions regarding their start-up capital, number of employees at start-up, current capital and current number of employees. This information was used to determine whether the SMEs started operations as micro and eventually grew into small and/or medium sized enterprises. 45 of the 150 SMEs fell within the sample criteria and agreed to the interviews. The interviews were conducted from April 04 to April 21, 2017 at the SGB work places. All the SGBs included in the study are urban enterprises located in Addis Ababa.

The rest of the report is structured as follows: Section 2 provides a country profile and a contextual description of the MSME sector; Section 3 describes the characteristics of growth-oriented small and medium sized businesses and their owners; Section 4 summarizes the conclusions arising from the study and puts forward recommendations for financial institutions, governments and other stakeholders that wish to support the growth of SGBs in Ethiopia.

2. Country Profile and Context

2.1 Country overview

Geography
Ethiopia is a land-locked country located in the Horn of Africa and bordered by six countries; Sudan and South Sudan in the west, Somalia and Djibouti in the east, Kenya in the south, and Eritrea in the northeast. The altitude ranges from 148 meters below sea level at the Dallol Depression to 4,620 meters above sea level at the Simien Mountains in the North West. Ethiopia covers a total land mass of approximately 1.14 million square kilometers, making it the 27th largest country in the world.

Climate
Ethiopia is in the tropical zone, lying between the Equator and the Northern Tropic (Tropic of Cancer). There are considerable variations in climate and rainfall patterns throughout the country. There are four seasons in Ethiopia; Tseday is the spring season, also known as the harvest season, which runs from September to November; Bega is the long dry season which runs from December to February; Belg is the autumn season which runs from March to May; Keremt is the main rainy season running from June to August. The average rainfall between June and August is 990 mm. The temperature varies with the topography, reaching as high as 47°C in the Afar Depression and as low as 10°C in the highlands.

Population
Ethiopia is second the most populous country in Africa after Nigeria and is ranked 13th in the world. Ethiopia’s population grew at an estimated rate of 2.9% between 2014 and 2016. According to the Central Statistics Agency, the current population of the country is estimated at over 91 million, with approximately 19.8% of the population believed to be living in urban areas.
Ethiopia has close to 83 ethnic groups speaking a variety of languages with 200 dialects of Cushitic, Nilo-Saharan, and Semitic language families. Oromo and Amharic are the most common spoken languages. 44.2% of the population is aged 0-14 followed and 19.95 is aged 15-24. The country’s median age for both sexes is 17.6 years, which highlights the growing youth bulge in the country. With regard to religion, approximately half of the country’s population is Christian and one-third is Muslim.

**Political context**

The official name of Ethiopia is the Federal Democratic Republic of Ethiopia (FDRE) and the current ruling party is the Ethiopian Peoples’ Revolutionary Democratic Front (EPRDF). The FDRE has a parliamentarian form of government with a bicameral legislature comprised of the House of Peoples’ Representatives (HPR) and the House of Federation (HoF). The House of Peoples’ Representatives is the highest authority of the Federal Government. Executive power is vested in the Prime Minister, elected from among the members of the HPR for a five year term. Hailemariam Desalegn is the current Prime Minister of the country.

Ethiopia is organized into nine autonomous regional states and two chartered cities. The regional states are Tigray, Afar, Amhara, Oromia, Somalia, Benishangul-Gumuz, Southern Nations, Nationalities and Peoples (SNNPR), Gambela and Harrari while the capital, Addis Ababa, and Dire Dawa are chartered cities.

**Economy**

For more than a decade, the Ethiopian economy grew at a rate between 8% and 11% per annum. This makes the country one of the fifth-fastest growing economies in the world. Ethiopia’s economy is predominantly based on agriculture, with coffee as the major export crop. Almost 80% of Ethiopia’s population is still employed in the agricultural sector but services have surpassed agriculture as the principal source of GDP.

In financial years 2015/16 Ethiopia’s economy grew by 8% (NBE, 2016). The service sector remained the dominant sector with a 47% contribution to GDP. The share of industry, which mainly comprises small and medium enterprises (SMEs), grew slightly from 15 to 16% while that of the agriculture sector declined from 39% to 37%.

Over the past ten years, Ethiopia has shown positive growth in its GDP per capita and has been growing at an average rate of 15%. Last year the GDP per capita increased by 9.5% to USD 794 (NBE 2016).

**Ease of Doing Business**

As shown in Table 1 below, the World Bank’s “Ease of Doing Business - 2017” report sheds light on how easy or difficult it is for a local entrepreneur to open and run a small to medium-size business in compliance with relevant regulations. According to this report Ethiopia is ranked 28th among 48 Sub-Saharan African countries and 159th among 190 countries in the world. It is ranked 170th on getting credit and 179th on starting business indicators. Ethiopia has a better ranking than the regional average in the following four indicators: Getting Electricity, Registering Property, Enforcing Contracts and Paying Taxes.

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Table: Ease of Doing Business in Ethiopia

<table>
<thead>
<tr>
<th></th>
<th>Global Rank (out of 190 countries)</th>
<th>Sub-Saharan African Rank (out of 48 countries)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Rank</td>
<td>159</td>
<td>28</td>
</tr>
<tr>
<td>Starting Business</td>
<td>179</td>
<td>41</td>
</tr>
<tr>
<td>Cons. Permit</td>
<td>176</td>
<td>40</td>
</tr>
<tr>
<td>Getting Electricity</td>
<td>127</td>
<td>12</td>
</tr>
<tr>
<td>Property Regs.</td>
<td>133</td>
<td>23</td>
</tr>
<tr>
<td>Getting Credit</td>
<td>170</td>
<td>42</td>
</tr>
<tr>
<td>Investor Protection</td>
<td>175</td>
<td>43</td>
</tr>
<tr>
<td>Paying Tax</td>
<td>90</td>
<td>20</td>
</tr>
<tr>
<td>Cross Border Trading</td>
<td>167</td>
<td>34</td>
</tr>
<tr>
<td>Contract Enforcement</td>
<td>80</td>
<td>6</td>
</tr>
<tr>
<td>Resolving Insolvency</td>
<td>120</td>
<td>23</td>
</tr>
</tbody>
</table>

2.2 The Financial Sector

The Ethiopian financial sector mainly consists of banks, insurance companies, microfinance institutions and, more recently, leasing companies. The financial sector is mainly dominated by the banking industry, which accounts for 76% of the total capital of the sector, followed by MFIs with 15%. The remaining 9% is held by insurance and leasing companies.

The banking sector consists of 1 development bank (Development Bank of Ethiopia), 1 state-owned commercial bank (Commercial Bank of Ethiopia) and 16 private commercial banks. As of June 2016, the private banks had 1,927 branches and total capital amounting to ETB 22 billion (EUR 831 million) compared to 1,260 branches and a total capital of ETB 21 billion (EUR 793 million) for public banks. The Commercial Bank of Ethiopia is still the main actor in the banking sector, accounting for 32% of total capital, 36% of the total branch network, 53% of outstanding credit and 66% of deposits mobilized by the banking sector.

There is a total of 35 microfinance institutions with a total capital of ETB 9 billion (EUR 340 million). MFIs currently serve over 11 million clients all over the country. As of June 2016, the total outstanding credit and total savings stood at ETB 25 billion (EUR 944 million) and ETB 18 billion (EUR 680 million) respectively. The five largest regional government affiliated MFIs (ACSI, DECSI, OCSSCO, ADCSI and OMO) dominate the market and account for 84% of total capital, 88% of total credit and 93% of total savings of the MFI sector.

The government of Ethiopia has recognized that access to credit is key to micro and small enterprise development. Given their significant financial resources and market shares, the 5 regional government affiliated MFIs are tasked with a leading role in the provision of credits to MSEs operating in their respective regions. These MFIs are also expected to develop and adapt their different loan products to micro and small enterprises at different growth stages (i.e. start-up, growth and maturity) in order

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6 World Bank (2017), Doing Business Report
7 National Bank of Ethiopia (2016), Annual Report 2015/16
8 Ibid.
better to meet their specific financial needs. In response to the collateral problem, the government has also established a regional credit guarantee fund with the 5 leading MFIs. The MFIs were able to provide credit to micro and small businesses against the government guarantee during the GTP I period.

Despite the promising growth of the sector, MFIs currently face a number of challenges, which include limited access to funding, high operational costs, weak or inadequate MIS, high employee turnover and limited management capacity/expertise.

2.3 The MSME Sector

The Micro, Small and Medium Enterprise (MSME) sector has emerged as a highly vibrant and dynamic sector of the Ethiopian economy over the last decade. MSMEs not only play a crucial role in providing employment opportunities but also contribute enormously to the socio-economic development of the country, notably in their role as catalysts for the transition to an industrial society. MSMEs are viewed as seedbeds for the development of medium and large enterprises. It is reported that there are approximately 800,000 SMEs across the country.9

In order to promote a broader, deeper engagement with MSMEs and help them fulfil their full economic potential, the government published its first National Micro and Small Enterprise Development Strategy in 1997. The main objectives of the strategy were to promote economic growth, create sustainable jobs, strengthen collaboration among MSMEs and provide a platform for transformation to medium and large enterprises.

Driven by the conviction that MSMEs are key to laying the foundations for industrial development, the Ethiopian government placed them at the heart of successive poverty reduction and economic development plans, including PASDEP, GTP I and GTP II.

Within the framework of PASDEP (Plan for Accelerated and Sustained Development to End Poverty), which ran from 2005-2010, MSMEs were seen as the most promising avenue for job creation and tackling pervasive youth unemployment. To achieve this objective, MSMEs received basic training (such as business management, entrepreneurship and production techniques), upgraded business development services and enhanced market linkages. By the end of the plan, a total of 167,835 MSEs had created approximately 1.46 million employment opportunities (MoUDC, 2011).

PASDEP’s successor, the first GTP (Growth and Transformation Plan), also prioritized MSME development and sought to scale up support. During GTP I (2010-2015), ETB 16.4 million (USD 689,000) was disbursed in loans to MSMEs and more than 7 million employment opportunities were created (MoFEC, 2016).

Finally, the second Growth and Transformation Plan (GTP II - 2016 to 2020) continues to prioritize MSMEs but places greater emphasis on manufacturing, increased productivity and competitiveness. GTP II aims to disburse ETB 21 billion (USD 904 million) in loans to MSMEs through MFIs and stimulate the creation of 8.4 million jobs.

In line with the targets and objectives set out in the first Growth and Transformation Plan (GTP I), the National Micro and Small Enterprises Development strategy was revised in 2011 with ambitious

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9 Addis Fortune newspaper (September 2016), Interview with Asfaw Abebe, Director of Small and Medium Manufacturing Industry Development Agency
targets on employment creation and transition to medium size enterprises. This strategy defined the different stages of enterprise growth and the type of government support required for each stage in the following manner:

- **Startup stage**: organization in a group\(^{10}\), finalizing of licensing (established as association or private company), development of business plan, receipt of working premises and launch operations.
- **Growth stage**: effective use of inputs, competitiveness (price, quality and supply), sustained profitability, increase in assets and manpower (larger than at start-up), use of book-keeping system, etc.
- **Maturity stage**: In addition to fulfilling the above conditions, enterprises make additional investment and meet the conditions for graduating to the next higher level.

In addition to creating a working environment conducive to the growth of the sector, the government of Ethiopia provides direct policy support to micro & small business operators through different implementing agencies. This support includes access to working space (sheds constructed by the government), access to markets (linkages), access to finance (guarantee provision), access to industrial extension (various business development services such as market linkages and technical support) and access to training & advanced technology.

**Key Stakeholders**

The Micro and Small Enterprises Development Strategy established an institutional framework whereby MSEs could interact with other stakeholders such as government agencies, MFIs and Technical Vocational Education and Training (TVET) centers. MSE development in Ethiopia is therefore promoted through the interaction of these various stakeholders.

As the main actor in the sector, the federal government formulates strategies and policies through the Ministry of Urban Development and Housing. The main role of the Ministry is to draft and enforce MSME related policies and regulations, but it is also mandated to provide services directly, including advisory services, information provision and training to other executing agencies, at both federal and regional level.

The other key national MSME stakeholders are:

- **The Federal Urban Job Creation and Food Security Agency (FUJCFSA)**, which is responsible for supporting, coordinating and building the capacity of regional institutions assisting micro enterprises;
- **The Small and Medium Manufacturing Industry Development Agency (SMMIDA)**, which is accountable to the Ministry of Industry and is responsible for supporting small and medium sized manufacturing industries;
- **The TVET Agency**, which is responsible for the provision of MSME training in the areas of job creation, innovation, KAIZEN\(^{11}\) management methods, quality control, design and maintenance;
- **Microfinance Institutions (MFIs)**, which are responsible for developing appropriate financial products to MSMEs based on their respective growth stages\(^{12}\). They are also mandated to promote

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\(^{10}\) The strategy requires that a minimum of 5 people organize as a group and form an enterprise. This would make them eligible for MFI credit facilities with less stringent collateral requirements.

\(^{11}\) KAIZEN is a Japanese management tool designed to continuously improve organizational activities and processes to achieve high levels of customer satisfaction through improved quality of products and services. The Ethiopian Ministry of Trade set up the KAIZEN Institute in 2011 with support from the Japanese International Cooperation Agency (JICA). Since then KAIZEN has been implemented across different industries and manufacturing sectors in the country.

\(^{12}\) The Strategy identified 3 types of MSE based on stage of growth: start-up, growth and maturity
a savings culture among MSMEs and ensure that MSMEs draw up financial reports in order to facilitate access to credit.

These stakeholders coordinate with each other to provide MSMEs with the necessary support packages. For instance, the former Federal Micro and Small Enterprise Development Agency (FEMSEDA) together with regional micro and small business development agencies and other key stakeholders established One-Stop Shop (OSS) centers in woredas¹³ throughout the country. OSS services are designed to provide the necessary business support at a single point of service. This includes business registration, credit and saving services, provision of work and commercial spaces and creation of market linkages. Although there are some differences in the implementation of OSS support across regions, the three following actors are frequently present in the OSS to provide MSMEs with support¹⁴:

- MFI loan officers to deal with saving and credit issues;
- Industrial extension experts from TVETs to respond to training needs;
- Regional MSME development officers to facilitate and coordinate support packages and to handle any problems that arise during the day-to-day operations of OSS.

Officers from these institutions combine their expertise to address MSME needs and are able to do so without any bureaucratic hurdles.

Even with the support packages mentioned above, lack of access to adequate finance remains the most critical constraining factor for MSME growth. Various studies show that the principal challenge of creditworthy MSMEs in accessing credit is lack of acceptable and/or sufficient collateral. Furthermore, most MSMEs do not have a credit history with banks and are not used to dealing with big financial institutions. Banks are therefore reluctant to provide loans to MSMEs. According to the World Bank Enterprise Surveys Report (World Bank, 2015), 40% of enterprises included in the survey identified access to credit as a major business constraint in Ethiopia. The survey also revealed that only 33% of respondents had a bank loan or line of credit¹⁵.

With a view to improving access to finance for small and medium sized enterprises, the government of Ethiopia introduced a lease financing mechanism through the Development Bank of Ethiopia in 2016. DBE restructured its operations in such a way that 70% of its resources are now allocated to providing lease financing to small and medium enterprises (with a total capital between ETB 550,000 and 7.5 million (EUR 21,000 to 281,000)) engaged in manufacturing, agro-processing, tourism, construction and mining.

The lease amount ranges between ETB 1 million and 30 million (EUR 38,000 to 1.1 million). DBE covers 100% of the cost of machinery while small and medium enterprises are required to cover the working capital (estimated at 20% of the cost of machinery). Lease terms are more favorable than loan terms for the following reasons:

- No collateral is required
- The interest rate is relatively lower at 9%

¹³ Districts or woreda are third-level administrative divisions (after regions and zones) and are further subdivided into wards (kebele) or neighborhood associations, which are the smallest level of local government in Ethiopia.
• Tenure: > 5 years
• Smaller down payment requirement = 20%

3. SGB Characteristics

3.1 Personal and Family Characteristics

The study consisted of individual interviews with 45 clients of 3 MFIs: AdCSI, Agar, and Vision Fund Ethiopia (VFE). The distribution of respondents among the 3 MFIs was as follows:

<table>
<thead>
<tr>
<th>MFI</th>
<th>No. Respondents (n=45)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AdCSI</td>
<td>16 (36%)</td>
</tr>
<tr>
<td>Agar</td>
<td>14 (31%)</td>
</tr>
<tr>
<td>VFE</td>
<td>15 (33%)</td>
</tr>
</tbody>
</table>

Age and gender distribution
The 45 SGBs included in the study were predominately owned by male entrepreneurs: 38 owners were male (84%) and 7 female (16%). Female business owners were on average 5 years older than their male counterparts (41 years old compared to 36 for men). The findings suggest that the age of SGB owners could influence the time needed to grow their businesses. Older entrepreneurs are more experienced and have experienced a wider variety of business challenges, but younger entrepreneurs appear to need less time to grow their businesses.

The average time required for younger entrepreneurs (those less than 37 years old) to “graduate” their business was 3.2 years compared to 4.5 years for entrepreneurs aged 37 and above. One potential explanation for the faster graduation time for younger business owners is that they have a greater appetite for risk and higher aspirations, and are more likely to commit to working longer hours than older entrepreneurs. The government of Ethiopia also encourages young people to organize themselves in groups and establish micro and small enterprises. The government may have contributed to the more rapid growth of MSMEs owned by younger entrepreneurs, notably through the provision of different types of support, including allocation of work spaces, increased access to finance and market linkages.

Education levels
Level of education seems to be the key determinant of the amount of time required to grow a business from a micro to a small or medium sized entity. The average growth time for university educated business owners was 2.5 years while it took 4 and 4.3 years for college and high school educated entrepreneurs respectively. This could be because entrepreneurs with higher education levels are able to manage their firms more professionally and have stronger communication skills than entrepreneurs with lower education levels. This confirms the findings of the research carried out by Tiruneh (2011) with 62 MSEs in Addis Ababa, which showed that MSEs owned by entrepreneurs with TVET education levels and above demonstrated stronger performance (in terms of capital increase from time of establishment) than businesses with less well educated owners (Tiruneh, 2011)16. Similarly, a study conducted by Wasihum and Paul (2010)17 in Addis Ababa reported that

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entrepreneurs with higher education levels were better able to make wise, rational business management decisions that positively impacted enterprise growth.

Overall, SGB owner education levels ranged from secondary school to university. One third of respondents were university educated and more than half (58%) did not graduate from college (i.e. they had primary, secondary or TVET schooling). This indicates that the MSME sector attracts individuals without college or university diplomas and that most of the owners achieved their current level of education before establishing their businesses.

Several SGB owners with tertiary education indicated that their education helped them to conduct market research in order to understand the market and adjust their products & services accordingly. They claimed that this enabled them to grow their businesses and generate more revenue.

Marital status, children, and dependents
Most SGB owners were married with an average of 2 children and 4 dependents. 69% of the respondents were married (66% for men, 86% for women) and in 62% of cases their spouse was not directly involved in the business and worked outside the home. The average of 2 children per household is in line with the decreasing trend in fertility rates observed in Ethiopia since the 1990’s and is also consistent with the estimated fertility rate of 1.7 in Addis Ababa (BBC, 2015)\(^{18}\). Therefore, the number of children/dependents does not appear to be a factor contributing to business success outside the fact that fewer dependents generally means that owners can spend more time on business activities.

Prior business experience
Most SGB owners started their business after gaining experience in similar fields. 39 respondents (87%) indicated that they had prior business experience either as employees in private and governmental organizations or in running their own micro businesses (other than the business they were currently operating). 24 respondents (62%) reported that they gained experience by working for companies engaged in economic activities similar to those offered by their current businesses.

The average prior business experience was 8 years although there is a significant discrepancy between men (7.6 years prior business experience on average) and women (3.3 years). This finding reflects the fact that women in Ethiopia tend to carry the burden of household obligations, which limits the amount of time they can allocate to economic and other productive activities. Women also have limited access to and control over resources. Although women have less business experience, they were able to grow their businesses faster than men\(^{19}\) which suggests that given the same opportunities, they may be better able to manage and grow a business.

3.2 Business Characteristics

Owner = manager?
The SGBs surveyed were managed by their owners. The interviewees indicated that they did not trust others enough to allow them to manage their business. They expressed a clear need to maintain complete control over business operations, including purchasing, marketing, sales and employee management. This feedback is common when interviewing businesses in Ethiopia as it is still rare to find an MSME that is managed by a salaried professional manager.


\(^{19}\) A little less than 3 years for women compared to a little more than 4 years for men
Managing multiple businesses
Owners of more than one business managed two businesses on average and took a full year longer to graduate their core business than single business owners (4 years vs 3 years). Because of this diversification and lack of delegation, multiple business owners cannot focus as much on their core business.

Sample distribution across economic sectors
The economic sectors of the businesses surveyed were distributed as follows:

<table>
<thead>
<tr>
<th>Economic sector</th>
<th>Percent respondents (n=45)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade</td>
<td>20%</td>
</tr>
<tr>
<td>Services</td>
<td>31%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>36%</td>
</tr>
<tr>
<td>Construction</td>
<td>13%</td>
</tr>
<tr>
<td>Service (23 SGBs)</td>
<td>51%</td>
</tr>
<tr>
<td>Industry (22 SBGs)</td>
<td>49%</td>
</tr>
</tbody>
</table>

As indicated in the table above, all of the SGBs interviewed were engaged in governmental priority sectors due to their huge potential for urban employment creation. The government believes that the 5 priority sectors (manufacturing, construction, urban agriculture, trade and service) play a crucial role in reducing poverty, promoting entrepreneurship and laying the foundation for industrial development. Enterprises organized through OSS and the MSE Development agency and engaged in priority sectors are entitled to receive multifaceted government support such as business registration, credit facilitation, work space provision, market linkages and industrial extension services.

Years of operation of current business
The overall average time for which businesses have been in operation is 7 years, with an average of 7 years for male respondents and 6.4 for female respondents.

From Maid to Made: At the beginning, she had nothing, not even hope…
Aynalem\(^\text{20}\) never believed that she could make a good life for herself working in her homeland. Instead, she decided to fulfill her dream of travelling to the Middle East to engage in domestic work and earn a better living. Aynalem worked in Beirut for 4 years as a maid for a rich family. However, since she did not have a valid visa, her employer refused to pay her the salary she had accumulated over 2 years and eventually reported her and had her arrested by the police. She was sentenced to 6 months in prison for working without proper documentation and deported to back to Ethiopia in 2015.

"At first, I thought I was going to change my life and that of my family. Unfortunately, I ended up in prison and came back home empty handed."

Unlike her employment history, her time in jail proved to be a fortunate turn of events. While she was in prison, she received vocational training in fashion design and sewing. She was smart enough to make use of the training as soon as she returned home. She started her business with ETB 15,000 (EUR 565) worth of savings by acquiring a sewing machine and the necessary raw materials. She began making t-shirts and tights for women in rented premises.

At that time, the government started an initiative to help returnees from Middle East by organizing them as MSEs and providing them with workplaces (sheds) and other support services (facilitating access to finance, business registration, training etc.). The idea seemed absurd compared to her dreams of earning a better salary in Beirut, but she steeled herself and pushed the business

\(^{20}\) The name of the SME owner has been changed to protect clients’ identities.
forwards with the support of the government and MFI.

To expand her business, she borrowed ETB 170,000 (6,400 EUR) from a close friend and invested in more sewing machines and raw materials. She subsequently recruited 30 female returnees and trained them in fashion design and clothes making and gave them the opportunity to work in her business. Her factory became a haven for returnees who were confused and did not have any idea what they were going to do next. To date, she has created job opportunities for 42 young people who returned empty handed from the Middle East.

Early on, she had difficulties selling her product in the local market due to branding. She used to label her products “Made in Ethiopia”. Due to customer perceptions about the quality of Ethiopian products, her product was not selling in large quantities. After recognising the problem, she changed the label from “Made in Ethiopia” to “EKO Fashion”. Thanks to the change in label and the high quality of her products, she gained acceptance from the market in a short period of time and sales shot upwards.

Aynalem borrowed for the first time in 2015 with a loan of ETB 400,000 (about EUR 15,000). She used the entire amount to purchase sewing machines and raw materials. Although the tenure of the loan was 36 months, she was able to pay it back within 4 months. She only borrowed twice. The last loan she took out was for ETB 700,000 (about EUR 26,000) and she utilized the entire amount to purchase raw materials. She claimed that the collateral requirement was the biggest bottleneck in accessing credit from MFIs.

Aynalem is now in her mid-thirties and is passionate about her job. She spends most of her time managing her business. She acts as manager, purchaser, trainer, machine operator and designer. Based on the graduation recognition system of the Regional SME Development Agency, it took her only 1 year and 9 months to graduate the business from a micro to a medium enterprise. She received advanced training from TVET in fashion design, machine operation, business management and KAIZEN. She has a Certificate of Competence (CoC) in garment and apparel from the Addis Ababa TVET Bureau.

Aynalem lives with her 2 children and mother in a condominium she bought a year ago. She used the condominium as collateral when she took out her last loan in 2016. She covers the living costs of her children, mother and 3 other family members.

Aynalem aspires to expand her business and hire up to 40 additional employees. To do that she would need a loan of ETB 1.5 million (EUR 56,500). However, she does not think that she will obtain the amount she needs from MFIs due to strict collateral requirements.

### Start-up financing

An overwhelming 91% of respondents started their business with either their personal savings or a combination of savings and family support. Only 4 respondents (9%) indicated they started out with a

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21 In terms of total capital/assets MSEs in the industry sector are required to have more than EUR 60,000 while MSEs in the service sector should have more than EUR 20,000 worth of capital.

22 Kaizen is the Japanese word for “continual improvement”. In business, kaizen refers to activities that continuously improve all functions and involve all employees from the CEO to assembly line workers.
loan from an MFI plus their savings. Some of the respondents disclosed that they borrowed from close friends or family free of interest. From the findings of the study, it can be concluded that loans from friends/families, personal savings, and lqqub (informal saving associations established by a small group of people in order to provide substantial rotating funding for members) are the major sources of finance for start-up businesses. Given that it is the policy of almost all MFIs only to serve businesses that have been in operation for at least six months and have saved 20% of the loan amount over a similar period, this finding is not unexpected. Start-up seed money must come from outside financial institutions. This supports the findings in Haftu et al\textsuperscript{23}, which looked at 1,000 micro and small enterprises in 6 regions of the country and found that personal savings (58%) and family support (15%) were the main sources of start-up capital.

**Domestic vs. international markets**

The vast majority of the SBGs interviewed sell their products exclusively to the domestic market. Only one SME, engaged in the production of finished leather, serves both domestic and international markets. This is also the only company which indicated that sales did not grow over the past 12 months. The respondents in the manufacturing sector were asked about the main constraints that prevent them from selling their products in the export market. Almost all declared that lack of export-related information and shortage of capital were the main entry barriers. This corroborates the findings of Yehualashet and Chiloane-Tsoka (2015), who find that lack of market information, logistics and more functional factors (i.e. lack of managerial capability and lack of financial resources) are the main obstacles to greater MSME involvement in exports.

**Main start-up challenges**

The main challenge faced by 89% of respondents in establishing their business was access to finance due to insufficient collateral. This barrier to entry explains why such a high percentage (91%) not only launched their business with their own savings, lqqub, and family support but almost certainly had to self-finance the entire start-up phase before they could access formal finance.

**Formal registration**

The SGB owners interviewed appreciated the benefits of formalization and registration. All the respondents stated that they were formally registered because registration improved access to suppliers, clients, and government support services; in certain cases it was due to a fear of penalties from the authorities.

The findings of this study accurately reflect the reality of the Ethiopian MSE sector. According to a study conducted by the Ethiopian Development Research Institute (EDRI, 2014), most MSMEs in Ethiopia are formally organized and properly licensed. As a result, informal firms are being organized and provided with working space and business development services. According to the 2011 Urban Employment survey conducted by the Central Statistics Agency (CSA 2011), MSE owners indicated that they were unable to exploit their full production capacity due to inadequate work and storage spaces. The government of Ethiopia formulated a strategy to alleviate these problems. This was achieved through the construction and provision of standard work and commercial premises (sheds) to a number of formally registered enterprises. The premises are located in close proximity to the industrial clusters where medium and large scale enterprises are located. This was done in order to facilitate market linkages between micro & small enterprises and medium and large enterprises. MSMEs are encouraged to participate in government procurements and benefit from exemptions in terms of payments for bid documents and in the provision of bid guarantees issued by banks. For these reasons, most Ethiopian MSMEs are formally registered and licensed.

\textsuperscript{23} Haftom and et al (2009), Financial Needs of Micro and Small Enterprises in Ethiopia, Occasional Paper No 24, AEMFI.
Length of time to graduate from one business size to another

The average time taken to graduate from a micro to a small or medium sized business was 3 years. 37 of the 45 respondents (82%) stated that the time to graduate was no longer than expected. For this group, the average time to graduation was 3 years. For the 8 SGBs who felt that it took them longer than expected, the average time to graduation was 7 years. For 75% of the respondents in this group, the main critical factors leading to graduation were non-financial factors (including character (hard work, resilience and trustworthiness), support from family and friends, and external government support (increased access to work spaces and market linkages)). The other 25% cited both financial and non-financial factors as critical for graduation.

Under the MSE Development Strategy, micro and small enterprises are supposed to graduate to medium size in 5 years as from start-up. Therefore, the maximum period for which enterprises are allowed to operate in the government-provided shed is 5 years. Those enterprises which are able to grow into medium-size enterprises will be provided with another working space in an industrial zone or will be provided with land at an affordable lease price on which they can build their own workshop. Those that do not grow into medium-size enterprises must leave the cluster, but other support services such as provision of finance, training, information, and market linkages continue for another 2 years. The regional MSE Development Agency is mandated to follow-up on the growth stage of MSEs and act in accordance with the directions stated in the strategy.
“Where there is a will, there is a way”*: Amazing transformation

Noises from different machines can be heard inside a big compound which contains a number of sheds constructed by the government for MSEs engaged in wood and metal work. One of the sheds is owned by the visionary entrepreneur, Dereje Gizaw, who started his wood and metal work business as a micro-sized enterprise 12 years ago.

Dereje24 is 41 years old. He was raised in a poor family whose entire lives were dependent on the income from his father’s job as a security guard in a private company. Dereje attended a nearby public school and continued his education until the age of 10. He dropped out of school at 17 to work as a taxi driver assistant and later as a taxi driver. It was the best he could do to financially support his family. He earned 20 to 50 birr per day (EUR 1 to 2) and used the whole amount to cover the cost of his family’s daily basic necessities.

Like many taxi drivers and their assistants, he started to consume khat and alcohol at a young age as a way to cope with boredom at work. Over time, he was drawn deeper into this habit and finally became addicted. He was no longer able to provide financial support to his family as the income he earned was not even enough to buy khat and alcohol for his daily consumption.

“I was a cigarette, khat and alcohol addict. For a long time, my addiction dominated my life and hurt myself and the people around me.”

His parents, frustrated by his addiction, made him quit his taxi driving job and asked a neighbour who had a furniture making business to hire Dereje as a driver. The neighbour agreed and hired Dereje as a driver and salesperson. While he was working there, he used to see how workers were making furniture and doing other woodwork. He acquired some skills and experience in furniture making, but the owner fired him after a year because of his addictions and poor performance at work.

After he lost his job, his father borrowed ETB 700 (EUR 26) from a close friend for Dereje to buy some basic carpentry tools and start making simple wood products for household use at his parents’ house. However, his addiction continued to consume him and he spent the advance payments received from customers to satisfy his needs for khat and cigarettes.

Despite these repeated failures, his family did not give up on him. They helped him to recover from his addictions. Once he understood that his addictions were causing great pain to his family, he decided to try and find himself. After a long, hard struggle, he finally succeeded in overcoming his dependence.

In 2005, he established his woodworking business with an initial capital of ETB 5,000 (EUR 190),

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24 The name of the SME owner has been changed to protect clients’ identities.
which he received in the form of a loan from a close family friend. After the registration of his business as a micro enterprise, the Wereda MSE Development office provided him with a work space. He produced different types of wood and metal products for households and cafeterias. He started out with 2 employees who had been trained in woodwork from TVET. The products were of high quality and were accepted by the market within a short period of time. In 2011, the total capital of the business reached over ETB 1.5 million (approx. EUR 56,000) and the business graduated from a micro to a medium-sized enterprise.

For his accomplishments in the business, Dereje was presented with a certificate of recognition from the hands of the late Prime Minister, Meles Zenawi. He was also given the opportunity to acquire the usage and construction rights on a 1,000 m² plot of land from the government at a price of ETB 280,000 (EUR 10,500) to build his own workshop. Currently, the total capital and annual turnover of the business stands at ETB 4 million (EUR 150,000) and ETB 2 million (EUR 75,000) respectively. The business now employs 16 people.

For his first loan, Dereje borrowed ETB 50,000 (EUR 1,900). The whole amount was used to acquire fixed assets and raw materials. Last year, Dereje borrowed ETB 500,000 (EUR 19,000) from the same MFI to buy additional machinery and lay down the foundations of a workshop that he is building on a 1,000 sq. meter plot of land he acquired from the government.

Today, Dereje is married with four children. His wife works in his company as an assistant accountant. She is studying accounting and will become head accountant of the company upon completion of her studies. Dereje received assistance from the Wereda OSS (One-Stop Shop) in the form of working space and training on business development, Kaizen, bookkeeping and entrepreneurship.

Dereje envisages borrowing ETB 2 million (EUR 75,000) to complete his expansion plans. He anticipates finishing the construction of the workshop within the next couple of years and wants to expand to manufacturing car bodies. However, he believes that it's unlikely that he'll be able to finish the workshop within the expected timeframe as the collateral available to him to pledge is insufficient to borrow the amount needed.

**Employment Creation**

The businesses surveyed were launched with an average of 3 employees and have multiplied their workforce by a factor of 6. Out of the 769 job opportunities created by these businesses, 44% were created in the service sector, 38% in manufacturing, 9% in construction and 8% in trade. Most importantly, 93% of the total number of jobs created are for non-family workers, indicating that these businesses have demonstrated the will and ability to manage employees and are also capable of handling the associated costs and risks. Finally, the majority of these jobs are occupied by unemployed youths whose wages are primarily determined by their level of experience.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Initial Start-up</th>
<th>Current</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total # of Empl.</td>
<td>Average # of Empl.</td>
<td>Total # of Empl.</td>
</tr>
<tr>
<td>Trade</td>
<td>14</td>
<td>2</td>
<td>65</td>
</tr>
<tr>
<td>Service</td>
<td>68</td>
<td>5</td>
<td>338</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>41</td>
<td>3</td>
<td>295</td>
</tr>
<tr>
<td>Construction</td>
<td>13</td>
<td>2</td>
<td>71</td>
</tr>
<tr>
<td>Total</td>
<td>136</td>
<td></td>
<td>769</td>
</tr>
</tbody>
</table>
29 respondents (65%) indicated that they considered only prior experience as a basis for determining employees’ wages, and 14 respondents (31%) stated that they used a combination of education level and experience. The remaining 2 respondents (4%) used neither experience nor education level nor a combination of both to determine salaries. These enterprises usually hire unemployed youths (whose ages range from 18 to 25) and determine wages based on personal judgement. The respondents indicated that permanent employees were part of a pension plan where employers contributed the equivalent of 11% of the gross wage and employees 7%. All employees are entitled to overtime payments. Respondents in the service sector also indicated that they paid commission to employees who brought in new clients. However, none of the respondents appeared to provide housing allowances and/or health insurance.

“When one door closes another opens” – A story of bouncing back from failure

When Helina25 discovered her career and business interest five years ago, she was an 11th grade student. She was born and raised in a poor family who struggled greatly to meet their daily basic needs. Helina is a visionary who was able to recognise her natural gifts so she did not hesitate to base her life on her dream. After high school, she enrolled at Addis Ababa University to study marketing management. However, she dropped out of university after 1 year to pursue her dream of establishing a successful “Enjera”26 making business.

“When my way back from school, I used to see people buying “Enjera” from local shops every day. I understood that “Enjera” is a daily need for 95% of Ethiopians. I developed a strong interest in entering the business. I remember how jealous I was of the people who were in the business. At the time, I was thinking that it would be me making the “Enjera”. I did not know that I would have to hire a professional “Enjera” maker; above all, I couldn’t imagine that gaining a client’s trust would be such a big challenge as long as I produced quality “Enjera.”

Helina contacted the Wereda MSE Development office to support her with work premises and financial support. The officials at the MSE Development office requested that she partner with other people and register as a formal (micro) business. She mobilised two partners who shared a similar ambition and they launched their first cafeteria in 2013 with a total capital of ETB 15,000 (EUR 566) (each partner contributed ETB 5,000 (EUR 189). At that time, Helina had ETB 2,000 (EUR 75) in her savings account and borrowed the remaining ETB 3,000 (EUR 112) from friends.

Upon submission of all the required documentation and proof of establishment, the MSE office allowed Helina and her partners to use the Wereda’s cafeteria along with the equipment and furniture. They began serving beverages and good quality food at fair prices. Although the original plan was to make and sell Enjera, Helina temporarily set aside her idea due to a lack of adequate finance and proper working premises. Therefore, the only option she had was to start the café business and save enough money for the Enjera business.

A few months later, Helina borrowed ETB 50,000 (EUR 1,900) for the first time from her MFI. The loan was used to acquire raw materials for the cafeteria. Although the loan tenure was 24 months, she was able to pay it back within a few months and took out a second loan of ETB 100,000 (EUR 3,800) from the same MFI.

“The loans we received from the MFI helped us to increase our service provision capacity but also accelerated our business growth as we became a small sized enterprise in less than a year.”

25 The name of the SME owner has been changed to protect clients’ identities
26 Enjera is Ethiopian flatbread made out of “Teff” flour. It is consumed daily in almost all households.
Before their business celebrated its first year, Helina and her friends were able to increase their total capital to ETB 500,000 (EUR 19,000). With this capital amount, their business graduated from a micro to a small-sized enterprise. Following this graduation, the Wereda MSE development office ordered them to hand over the Wereda’s cafeteria to other micro enterprises. This unexpected decision by the Wereda office put the business at risk of liquidation due to the fact that the capital they had at that time was insufficient to cover 6 months’ rent along with the necessary furniture and equipment expenses. Unfortunately, with no solution in sight, the business came to an end after operating successfully for 15 months.

Although the failure was a painful experience and knocked the wind out of her sails, it opened up new opportunities for her to start over and refocus on her dream. Helina was not discouraged by what happened. Instead, she immediately launched an “Enjera” making business in her family’s small kitchen using a single “Enjera” making stove. She hired 2 employees to help her in “Enjera” producing and distributing the Enjera to customers. The initial production capacity of the business was 300 “Enjera” per day.

Socio-cultural stereotypes towards young female business owners were the most difficult challenge that she faced at the initial stage of the business. Her family did not trust that she would be able to run the business, customers hesitated to buy from her, and friends advised her to go back to college instead of spending precious time on this “ridiculous” business idea.

Despite the negative feedback, Helina continued pushing her business forward. Her nephew was the only family member who always stood by her. Helina says that her strength lies in her capacity to face criticism and overcome challenges. As a result of her determination to live her dream, the total capital of the business reached over ETB 800,000 (EUR 30,000), with an annual turnover of ETB 500,000 (EUR 19,000).

Currently, she runs the business in rented premises and employs more than 20 previously unemployed youths including “Enjera” makers, drivers, sales staff, and an accountant. She supplies 4,000 “Enjera” daily to hotels and embassies. She supported her business with a loan from her MFI. Her last loan amounted to ETB 100,000 (EUR 3,800), which she utilized to purchase raw materials. The business is growing and now requires a larger work space and additional vehicles for product delivery. She currently requires ETB 1 million (EUR 38,000) in loans to acquire working space and additional “Enjera” making stoves. If she could obtain the amount she needs, she would hire an additional 20 employees. However, she does not think that she can secure the funding from MFIs as she does not have sufficient collateral to meet the requirements.

Helina, who is just 23 years old, is the bread-winner in the family. She lives with her parents and financially supports her brothers and sisters. Once she made sure that her business could stand on its own two feet, she returned to college to finish her studies. She will earn her degree in Marketing Management within the next 3 months.
### 3.3 Financial Service Use

#### Amount and tenure of first loan

The average amount for first time loans among all respondents was ETB 120,285 (EUR 4,810), with averages of ETB 142,500 (EUR 5,700) for the industry sector and 132,500 (EUR 5,300) for the service sector. The average loan term was 20 months. The table below summarizes the amounts and tenures of first loans per sector:

<table>
<thead>
<tr>
<th>Sector</th>
<th>Loan Amount</th>
<th>Tenure (in months)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Average</td>
<td>Max</td>
</tr>
<tr>
<td>Industry (Manuf. &amp; Const.)</td>
<td>142,500</td>
<td>500,000</td>
</tr>
<tr>
<td>n=22</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Service (trade &amp; service)</td>
<td>99,043</td>
<td>500,000</td>
</tr>
<tr>
<td>n=23</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>120,285</td>
<td>500,000</td>
</tr>
<tr>
<td>n=43</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The average loan amount for female-owned enterprises was ETB 178,286 (EUR 7,130), with a tenure of 24 months. The corresponding figures for male-owned enterprises were ETB 109,605 (EUR 4,380) and 19 months respectively. The higher average loan amount for women is almost certainly attributable to the WEDP\(^{27}\) project (Women Entrepreneurs Development Project), which has been facilitating a cash-flow based loan appraisal methodology for MFIs targeting women entrepreneurs.

In terms of loan size, more than half of the SGBs reported that the amount of their first loan was greater than ETB 50,000 (EUR 1,900). 86% of women stated that they accessed more than ETB 50,000 for their first loan while for men the figure was 50%.

<table>
<thead>
<tr>
<th>Amount of first loan</th>
<th>≤ ETB 50,000</th>
<th>&gt; ETB 50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>All SMEs</td>
<td>20 SGBs (44%)</td>
<td>25 SGBs (56%)</td>
</tr>
<tr>
<td>Female-owned SGBs (n=7)</td>
<td>n=1</td>
<td>n = 6</td>
</tr>
<tr>
<td></td>
<td>14%</td>
<td>86%</td>
</tr>
<tr>
<td>Average loan size for Female</td>
<td>ETB 30,000</td>
<td>ETB 203,000</td>
</tr>
<tr>
<td></td>
<td>EUR 1,200</td>
<td>EUR 8,120</td>
</tr>
<tr>
<td>Male-owned SGBs (n=38)</td>
<td>n=19</td>
<td>n = 19</td>
</tr>
<tr>
<td></td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Average loan size for Male</td>
<td>ETB 31,500</td>
<td>ETB 187,600</td>
</tr>
<tr>
<td></td>
<td>EUR 1,260</td>
<td>EUR 7,504</td>
</tr>
</tbody>
</table>

Ethiopian MFIs primarily determine loan size based on the value of collateral as opposed to the creditworthiness or cash flow potential of the client and project. One SGB owner reported that he was able to access ETB 500,000 (EUR 20,000) from AdCSI in his first loan application against collateral of a residential building and vehicle worth more than ETB 2 million (EUR 75,000). He claimed that the amount was well above the usual first loan amount provided by the MFIs because of the value of the collateral he had pledged.

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\(^{27}\) WEDP is a USD 50 million World Bank project scheduled over a 5 year period (2013 to 2017). The objective of the program is to increase the earnings and employment of Micro and Small Enterprises (MSEs) owned or partly (+50%) owned by women entrepreneurs. The World Bank provides concessional loans to the Development Bank of Ethiopia, which in turn provides wholesale loans to MFIs to finance women-owned MSMEs.
However, several projects (such as CapitaLink\textsuperscript{28} and WEDP) have provided comprehensive capacity building services (including tools and training) to MFIs for the implementation of cash-flow-based loan appraisal methodologies. This has led some MFIs to lower their collateral coverage levels, particularly for long-term clients, increase first-time loan amounts (prior to 2005 MFIs would only provide a maximum of ETB 10,000 (EUR 400) for a first loan), and maintain their portfolio quality (as measured by PAR).

**Number of loans taken**

Twenty-two respondents (49\%) indicated that they had borrowed 1 to 3 times while the remaining 23 respondents (51\%) had borrowed between 4 and 10 times. The average number of loans accessed by a single business was 4. Furthermore, the respondents all indicated that they intended to borrow again. Since these businesses are expanding and growing, continued access to finance is undoubtedly necessary. However, it would be worth studying at what growth stage, if any, a business either sporadically needs external finance or no longer needs it at all. More specifically, does this mean that MSME “drop-outs” (i.e. clients that either stop borrowing or cease to “chain-borrow”) are businesses that are in decline, or are they businesses that have reached a level of self-sustainability and are able to finance their growth needs internally? As the current economic growth ratio in Ethiopia remains in double-digits, the opportunity may be ripe to delve deeper into these questions.

**Loan purpose**

44 respondents (98\%) claimed that they used 100\% or at least more than 80\% of the loan amount for business purposes (i.e. working capital or fixed asset financing). Only a single respondent indicated that half of the loan was used to finance other family businesses. It is quite common for micro businesses to divert a large portion of a loan towards household consumption, but this study indicates that SGBs can basically be counted upon to use the entire loan amount for the purpose stated in the application. For a lending institution, knowing that their financing will be used as intended vastly diminishes the risk of default due to misuse or deviation of funds, further underlining that small and medium sized business clients are potentially more reliable and less risky than micro level clients.

Respondents were also asked about the purpose of the last loan that they had accessed from MFIs. A sizeable portion of the respondents (69\%) indicated that they borrowed to finance their working capital needs. Respondents also mentioned that savings (retained earnings) were the primary source of financing, followed by credit from MFIs and advance payments from customers.

**Amount of last loan**

The average amount of the last loan received by the 45 respondents was ETB 316,000 (EUR 11,900), with ETB 554,000 (EUR 21,000) for female-owned enterprises and ETB 276,000 (10,400 EUR) for male-owned enterprises. The average loan term for all respondents was 24 months. SGBs in the industry sector received an average of ETB 366,000 (EUR 13,800) while their counterparts in the service sector accessed an average of ETB 268,000 (EUR 10,000). The significant difference in the average loan sizes can be explained by the fact that SGBs in the industry sector invest more in capital-intensive activities such as acquisition of fixed assets (machinery and equipment) than service sector SGBs, which primarily need financing for working capital. The table below summarizes loan amount and tenure by sector and gender:

\textsuperscript{28} CapitaLink is a EUR 6 million microfinance refinancing guarantee facility funded by KfW and implemented by a consulting consortium comprised of First Consult and Enclude B.V. The project provided partial guarantees to banks to provide wholesale loans to MFIs to strengthen their lending to MSEs. The guarantee facility was augmented by a mandatory technical assistance to participating banks and MFIs.
<table>
<thead>
<tr>
<th>Sector/Gender</th>
<th>Tenure of Last Loan</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Average</td>
<td>Average</td>
</tr>
<tr>
<td><strong>Sector</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industry (n=22)</td>
<td>366,000</td>
<td>26</td>
</tr>
<tr>
<td>Service (n=23)</td>
<td>268,000</td>
<td>23</td>
</tr>
<tr>
<td><strong>Gender</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Female-owned (n=7)</td>
<td>554,000</td>
<td>29</td>
</tr>
<tr>
<td>Male-owned (n=38)</td>
<td>276,000</td>
<td>23</td>
</tr>
</tbody>
</table>

**Ease of Access to Loans**

18 respondents (40%) reported that they had been denied loans from MFIs due to a lack of adequate collateral and inability to meet the pre-loan saving requirements. Similarly, 23 respondents (51%) claimed that loan terms had become more restrictive over time, particularly in terms of loan size and collateral requirements.

When pressed further, the respondents clarified that the MFIs did not seem to take positive credit histories or business performance into account when determining the terms and conditions on subsequent loan requests. Despite good past repayment records, MFIs continued to require the equivalent collateral coverage levels and frequently approved and disbursed lower loan amounts than requested. MFIs justify this policy as a way of serving as many clients as possible with limited resources. Unfortunately, this approach creates a cat-and-mouse dynamic whereby the client ends up asking for more than is needed knowing that the MFI will approve a lower amount. Ultimately, perhaps things even out. However, since loan amounts are still bounded by the collateral coverage capacity of the client a loan size bottleneck is created, possibly limiting the growth potential of SGBs.

**Use of non-credit bank services**

All the respondents indicated that they used services provided by banks. 40 of the 45 SGBs (89%) have at least a savings account at banks, while 44 of the 45 SGBs (98%) have a current account, use transfer services, and have a debit card for access to ATMs. However, none of the respondents accessed credit from banks.

The main reasons given for using non-credit bank services included: (1) MFI not offering the services needed; (2) closer proximity of the bank branch; and (3) the relative higher quality of service provided by banks. Interestingly, even though all MFIs offer saving account services, SGBs prefer to save at banks due to ease of access and better service.

These findings are consistent with those of other global SGB studies which show that as businesses become larger and more sophisticated they tend to move away from cash-based transactions, both with suppliers and increasingly with clients. Another emerging trend is the shift from holding cash on the business premises to keeping it in current accounts – a service clearly not provided by MFIs. These non-loan business services, along with ease of access to funds via ATMs, are clearly essential to MSME operations and financial management.

**3.4 Business Support Services Use**

**Accounting records**

All the SGB owners surveyed appeared to keep accounting records for their businesses. With regard to whether accounting is kept in written or electronic format, 64% responded they used both formats, while 36% only had written records.
The vast majority (78%) use an outsourced, paid accountant. Out of the 35 SMEs that resort to a paid accountant, 29 (or 83%) keep their records in an electronic format, and they all use the services of an external accountant. If this finding is reflected over a broader scale, this is very promising news for financial institutions seeking to finance the SME sector since they will be able to access financial records.

**Use of One-Stop Shops (OSS)**

Only 9 of the 45 respondents (20%) claim to have used the services of the One-Stop Shops available to enterprises at all Kebele levels.

However, there appears to be a difference between OSS use and economic sector. None of the SGBs in the trade/service sectors have ever used the OSS facilities, whereas 9 of the 22 SGBs in the industry sector (41%) have used them. Furthermore, all 9 SMEs indicated that they planned to continue using the OSS services in the future. A likely reason for this difference between economic sectors and OSS use is that manufacturing SGBs commonly seek out government support for the use of subsidised working space and access to machinery available in “industrial sheds” or incubator parks.

Concerning business support services other than OSS, 11 of the respondents (24%) stated that they benefited from assistance, mostly in the form of technical training from professional private and governmental organisations. Furthermore, although 100% of the respondents indicated the need for increased access to finance, 58% also stated that they still needed support in other areas covering technical training/coaching, accessing or expanding premises and market linkages.

**3.5 Owner’s Vision on Growth and Prospects**

**Growth Plans**

Without exception, all 45 respondents expected their businesses to continue growing and none intended to change business, slow down or stop. Access to sufficient capital was perceived by all the respondents as the main challenge that could potentially limit the scale and speed of growth. Access to adequate business premises was also mentioned by 31% of the respondents. Other challenges, such as access to foreign currency, fixed assets, and competition (again, in addition to capital) were mentioned by 16% of the respondents.

Plans to hire more employees were expressed by 31 of the respondents (69%). All 14 respondents (31%) who stated that they did not plan to hire more employees in the future said that this was because they currently had sufficient personnel for their current operations. As shown in the table below, 58% of the SGBs planning to hire new staff operate in the industrial sector and 42% in the service sector. This confirms the more labour intensive nature of industrial activities and explains why the government prioritises sectors with greater employment potential such as manufacturing, agro-processing, and construction.

<table>
<thead>
<tr>
<th>No plans to hire in future</th>
<th>N=14 / 31%</th>
<th>Plans to hire in future</th>
<th>N=31 / 69%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service/Trade</td>
<td>Industry</td>
<td>Service/Trade</td>
<td>Industry</td>
</tr>
<tr>
<td>10 (22%, n=45)</td>
<td>4 (9%, n=45)</td>
<td>13 (29%, n=45)</td>
<td>18 (40%, n=45)</td>
</tr>
<tr>
<td>(71%, n=14)</td>
<td>(29%, n=14)</td>
<td>(42%, n=31)</td>
<td>(58%, n=31)</td>
</tr>
<tr>
<td>(43%, n=23)</td>
<td>(18%, n=22)</td>
<td>(57%, n=23)</td>
<td>(82%, n=22)</td>
</tr>
</tbody>
</table>
With regard to gender, 74% of the male-owned SGBs planned to hire more employees in the future compared to just 43% of the female-owned SMEs.

Although the data sample is small, the results suggest that SGBs in manufacturing and construction are more bullish on growth and expansion in the future, while SBGs in services and trade have a more prudent outlook.

**Growth factors**
The most frequent response (69%) to the question of what were the most critical factors needed to succeed and grow was personal effort and hard work. In most cases, however, this response had access to finance attached to it. Only 31% of the respondents attributed growth to a combination of other factors such as family support, government support, knowledge and experience. Nevertheless, even these respondents usually included access to finance as a component.

Overall, the results indicate that the prime success factors for the growth of an SME are 1) access to capital; 2) adequate premises; and 3) hard work.

### 4. Principal Observations, Conclusions and Potential Implications Going Forward

**Ease of doing business vs. entrepreneurial success**
Despite Ethiopia’s low ranking in the World Bank’s “Doing Business Report” and poor performance in the so-called “distance to frontier” score, none of the respondents indicated these factors as being top challenges during either start-up or growth. Out of the 11 indicators measured in the framework of regulatory efficiency and quality, only the “getting credit” indicator was mentioned as a challenge by the respondents. Without further probing it is impossible to determine whether regulatory issues are indeed challenges or whether the respondents simply take these inherent difficulties for granted as ‘normal’ and inevitable. Perhaps “ease of doing business” is overrated? Perhaps a certain amount of difficulty is a good way of “testing the mettle” of an entrepreneur? Is it a case of survival of the fittest where less resilient entrepreneurs will drop out or give up when faced with difficulties, leaving only dedicated “success-bound” entrepreneurs to build the economy and become employment generators?

Obviously, this study is not advocating less developed or even weak business environments or having things too easy, especially in an economy where the demand for credit is still far from being met (as is the case in Ethiopia), but perhaps a certain level of administrative and regulatory difficulty does not entirely put the “dampers” on success. The low ranking in the latest edition of the “Doing Business” Report clearly did not deter our 45 respondents from their pursuit of success and prosperity. Conversely, it could also be argued that a more favourable “doing business environment” might have enabled our 45 respondents to grow to a higher level of success and prosperity than they have achieved today. However, business growth is seemingly less dependent upon the ease of doing business: appetite for growth, management skills, market forces, and non-financial services (working premises, market linkages etc.) also play significant roles.

**One foot in the MFI and the other in the bank**
The universal use of non-credit services provided by banks by all 45 respondents has significant implications for MFIs. Today in Ethiopia, not a single MFI runs an MIS software solution capable of

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29 Relating to starting a business (also including the minimum capital requirement indicator), dealing with construction permits, getting credit, obtaining electricity, registering property, paying taxes, trading across borders, enforcing contracts, and resolving insolvency.
providing non-credit financial services in real time, or of connecting to mobile / network platforms and technologies. To be blunt, MFIs are lagging far behind in this regard. SMEs which are not ‘plugged in’ to their suppliers and customers will fall behind the competition. Therefore, access to connectivity technologies for transaction and cash management services is a matter of survival for contemporary SMEs. Consequently, SMEs have one foot in the MFI and the other in financial resources in the MFI and banking sectors are nor- orsers therefore, the MFIs nor banks are easy options. F and other in the bank – the MFI for credit and the bank for (electronic) business management services. To what extent then should MFIs be upscaling? Should they simply let businesses go to banks when they become too sophisticated to serve? Or should MFIs collaborate with banks so that they keep providing loans while outsourcing non-credit services to banks? In some countries and financial environments the answer could be a simple “yes”.

In Ethiopia the reality is that there is more demand for credit than can be met across the entire financial system. In other words, it is a seller’s market for finance. Banks are not actively or enthusiastically seeking out MSMEs to finance – there are so many of them and the ratio of transaction costs to potential loan amounts is not sufficiently attractive. Despite the lack of modern MIS solutions currently in use by MFIs, they are probably better positioned to scale-up their services to small and medium sized customers than banks are to scale-down to clients that they hardly know and pay little attention to. Furthermore, almost every MFI in Ethiopia is actively seeking to acquire core banking systems that will enable them to offer the same network-based services as banks. Even though many challenges remain, it is not inconceivable that in the next 3-8 years a large number of MFIs will be able to offer small and medium sized enterprises a more highly developed supply of non-credit services alongside credit products, including leasing.

The challenge of collateral
All of the respondents still need credit to grow and create jobs but the amounts that they require are all too often well above the value of the collateral they own. In light of this situation, neither MFIs nor banks are easy options. Financial resources in the MFI and banking sectors are already being stretched by current demand. A business without sufficient collateral is therefore not necessarily a priority for either MFIs or banks, no matter how viable the business or trustworthy the client. Certain MFIs have lowered their collateral coverage in recent years, mainly for long-serving, reliable customers. Nevertheless, the coverage is still capped at a minimum of 80% of the requested capital and with collateral valued at 50% of market value access to credit is still out of reach for many customers. On the other hand, banks do provide “clean” loans (loans without collateral) although such privileges are normally applied only to big-ticket customers and more often than not those which are involved in exporting (hence giving the bank access to highly-prized foreign currency).

In short, the access-to-credit environment is not conducive to businesses that are struggling for growth, require external finance, and are short of the collateral amount demanded by financial institutions. Ironically, it is precisely such businesses that have the greatest potential to create sustainable job opportunities and the capacity to contribute to priority sectors such as manufacturing and processing (i.e. import-substitution enterprises).

To date, MFI portfolios have been overwhelmingly comprised of micro enterprises (most of which have been served through the group-lending methodology) while banks have focused on lending to large enterprises, with medium enterprises serviced mainly if they are engaged in export activities. Moreover, the prevailing government policy leans towards the promotion of start-ups (especially those founded by recently graduated and/or unemployed young people) and micro businesses. There is, of course, nothing wrong with fostering an enabling environment conducive to start-ups and micro enterprises: on the contrary, start-ups are extremely crucial in bringing innovative and ground-breaking ideas into all value-adding sectors in an economy. However, when looking to stimulate job-creation in an economy as well as to increase growth and the importance of import-substitution enterprises,
bolstering the enabling environment to facilitate expansion of small and medium enterprises may have a greater overall impact in both areas. Perhaps the preferred option is to consider micro enterprises as part of a value chain (i.e. comprised of micro, small and medium enterprises) and establish value chain financing.

This could be achieved by extending lines of credit to small or medium enterprises large enough for them to accommodate micro enterprises within their value chains. This would very much depend upon supply chain dynamics (i.e. whether small or medium businesses can act as suppliers to or buyers of inputs from micro enterprises) but if done successfully it could reduce the risks and transaction costs associated with direct lending to micro enterprise borrowers.

It might be worthwhile for MFIs, banks, and even government policy-makers to recognise the potential power of the SME sector in sustainable job-creation and the strengthening of high potential sectors. However, it is both unlikely and imprudent to expect financial institutions to substantially lower or eliminate collateral requirements for SGBs, so a more practical solution to the collateral challenge could lie in the creation of a national guarantee facility. Such facilities are common in hundreds of countries around the world, and would enable financial institutions to cover the collateral gaps that exist among SGBs if (and only if) the viability of the SGBs and proposed projects are deemed creditworthy. Highlighting the potentially powerful contribution to the economy that SGBs can have, and providing financial institutions with appropriate approaches and tools to make servicing SGBs more efficient and effective, could help to foster positive change with regard to current MFI and bank attitudes and increase resource allocation to the sector.

**Homogeneity of the SME sample**

Readers of this study will undoubtedly note how all the SGBs in the sample are seemingly robust, successful and growing. Despite the randomness of the sample selection and the use of 3 different MFIs (1 with government support and 2 private), the homogeneity of the sample stands out and can be explained through several factors.

First of all, most MFIs in Ethiopia do not serve start-ups. A business client must be in operation for at least 6 months (WEDP loan) before lending can be considered. In addition, a client must be able to prove that it can save, usually by making regular monthly deposits into a savings account over 6 months prior to requesting a loan. The savings must be equivalent to 15-20% of the loan amount requested. This mandatory saving requirement continues until the client fully repays the loan. The savings are primarily used to guarantee part of the loan of the borrower. To a certain extent, these MFI policies create a sort of “natural selection” process by weeding out weaker or prone-to-fail businesses before the loan application stage. In this regard, start-ups have to make it under their own steam (own savings and/or financial assistance from friends/family) before they can apply for a loan; therefore it is not entirely surprising that the SGBs in the sample, which have all succeeded in becoming small or medium in size, are successful and growth-oriented.

Secondly, MFIs in Ethiopia, by contrast with numerous other countries, are regulated, inspected, and gaged against high portfolio quality and financial prudent norms by the National Bank of Ethiopia (NBE). As a result, MFIs cannot afford to experiment or cater to clients with weak business prospects or management capacities.

Finally, the economy in Ethiopia is, and has been, growing at double-digit rates. Any business that has managed to secure a market should be faring well and have growth potential. Since the first two factors mentioned tend to steer MFIs towards businesses that have already made it to a certain level of success through hard work and self-finance, it is logical for all the SGBs in the sample to share growth-oriented prospects.
Business support services and the impact of government
The reader will notice that the government plays a significant role in supporting MSMEs (through registration, provision of work spaces, directing MFIs towards funding, and non-financial support services), especially for start-ups and early-stage growth businesses organized and registered by Micro and Small Enterprises Development Offices. In the past, before any government intervention in this area, business development services (BDS) were only available on an ad-hoc basis from various international and national NGOs. When the government established One-Stop Shops (OSS) in all primary-level administrative districts (“Kebele” level), business support services became available to virtually everyone without charge.

Despite the general success of OSS services (as evidenced in this study by the SBGs that have used the services and plan to continue using them), the fact that they are provided by government employees through government structures does have its drawbacks. Notably, government officials have no structured incentive to develop or innovate the services that they provide to businesses. Services are all too often sluggish, bureaucratic, and of basic or even low quality. Furthermore, due to government policies stemming from the 5-year Growth and Transformation Plans, certain production sectors are promoted over others, creating potential service gaps for businesses outside the priority sectors.

The study indicates, however, that all the SGBs in the sample avail themselves of accounting services from private service providers (the OSS system does not provide business accounting services). Fiscal policy no doubt has a strong influence in making SBGs seek to keep viable accounting records, and so accounting services can really be considered more as business “equipment” than as an SBG demand-driven service. Apart from private accounting services, the study sample did not indicate use of any other non-government business support services. A focused study in this area would need to be launched to unveil the reasons, but it is known that private business support and consulting services in Ethiopia are rare, weak, unorganised, and vetted. Whether this is due to government provision of free BDS or lack of strong demand this study is not in a position to comment. However, the fact remains that private BDS is not developed in the country and so the options for businesses are severely limited in this area.

OSS services are generally used by micro and small sized businesses organized by MSE Development offices as cooperatives (government-backed). However, the services are also provided to independent businesses free of charge. According to a study conducted by MoUDH (2013), 67% of government-backed enterprises were found to benefit from OSS services. Assefa et.al (2014) conducted a qualitative study on enterprise support schemes in the 6 main cities. They found that independent or self-started businesses perceive government-backed enterprises as unfairly benefiting from OSS services, particularly in terms of better access to infrastructure and market linkages with massive government owned projects. Such support services are believed to have an impact on business growth, but this does not mean that all businesses which received the services were

30 There are two types of MSE in Ethiopia: government-backed and independent. Government-backed MSEs are usually cooperatives with at least 5 members and are organized and registered by Wereda MSE offices. They are entitled to receive BDS from OSS free of charge. Independent MSEs, by contrast, are established by entrepreneurs individually or as a group. They can receive services from OSS. However, most self-founded MSEs are not aware of the existence of such services.
productive and successful. According to a study conducted by Girum (2015) in 13 major cities in Ethiopia, government backed enterprises are neither more productive nor more technologically advanced than independent enterprises.

The study also revealed that there is a selection bias for OSS support services. The services target government backed enterprises, which have naturally have a smaller chance of being led by true entrepreneurs. As a result, they end up contracting in size after start-up.

Nevertheless, the fact that businesses do use OSS services indicates that such services are generally needed. Whether or not SGBs would be willing or able to pay for such services from the private sector is another issue, though the low quality and lack of innovation typical of OSS services cannot serve the market for too long. Testing a public-private partnership (PPP) based on responding to the exact BDS needs of SMEs may pave the way towards a more vibrant, organised, vetted, and quality-driven BDS private sector.

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Annexe

Annex 1: Methodology

Objective
The objective of the study is to assess SMEs that have graduated their business from micro level to small and medium level. The assessment focuses on understanding their growth patterns and identifying the critical factors that have influenced their successes and/or shortcomings. The study also seeks to identify and recommend key intervention areas that need to be addressed in order to promote greater financial inclusion for Ethiopian SMEs.

To meet the objective stated above, the study uses primary data collected directly from a sample of SMEs through semi-structured, face-to-face interviews. The data obtained from the SMEs is further supported by interviews held with loan officers at the 3 MFIs (i.e. AdCSI, Agar and Vision Fund) selected for the study.

Sampling Framework
The first step to collect qualitative data for the study was to secure a sampling framework that consisted of the population of emerging SMEs within the portfolio of the MFIs. The population for the study was selected from the databases based on the following criteria:

- Total number of employees = 6 to 50 (for those MFIs which do not hold such information in their database, a proxy criteria based on loan size was used)
- Started as micro and graduated to small/medium business
- Have been in business for at least 3-5 years (this enables us to follow a longitudinal approach in examining the growth and growth-critical factors of the enterprises over a period of time and capture the growth trajectory of the SMEs)

Sampling
Based on the above criteria a list of 140 SMEs with their contact details was collected from each MFI (50 from AdCSI, 50 from Agar and 40 from Vision Fund). The random sampling method was used to select the sample for the study in order to give every SME in the target population an equal chance of being selected. This approach ensures an adequate spread and representation of all SMEs working in the various sectors of the economy.

Once the pre-selection process was completed, each SME was contacted by telephone in order to confirm whether they fell within the sample criteria and whether they agreed to the interviews. Out of the 140 SMEs, 45 fulfilled the criteria and their managers/owners gave their consent to the interview. After the 45 SMEs for the study were selected, they were contacted again by phone to schedule the interviews. The interviews were conducted at their workplaces.

Data Collection
In-depth, face-to-face interviews were conducted with the selected SMEs to gain insight into their performance, their growth trajectory, and the challenges involved therein. The in-depth interview method was selected not only because it enabled us to explore the current situation in the SME sector in more detail but also to enable interviewees to express their opinions in their own words. Thus, the study has a wealth of information to draw upon for a meaningful understanding of the subject matter.

With a view to ensuring consistency between interviews and thus increasing the reliability of the findings, an interview guide that lists questions or issues to be explored during the interviews was developed. The interviews with the SMEs focused on the following aspects:

- Identify the characteristics of emerging SMEs and document the profile of their owners.
• Understand the growth trajectory of each SME and identify factors that determine success and failure.
• Understand their access to finance and the challenges that they are facing in the process.
• Identify the type of support services that they are currently using.
• Identify the type of support services (both financial and non-financial) that they require to expand and grow their businesses.

The interviews were conducted in the local language (i.e. Amharic) and the feedbacks were captured on an audio recorder. The audio-taped interviews were then transcribed into English.

Data Analysis
A data analysis tool was developed in Excel format. The interview transcriptions were then transferred to the Excel spreadsheet to conceptualize the responses and draw conclusions. In addition, pivot tables were applied to identify any correlations, characteristics, and profiles.