LAGOS BUSINESS SCHOOL
PAN-ATLANTIC UNIVERSITY

STR-C-01a-2-12
September 2020

Equity Bank:

Engaging the East African SME Market

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Dr. Nkemdilim Iheanachor and Professor Chris Ogbechie prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Equity Bank: Engaging the East African SME Space

Dr. James Mwangi, the Managing Director and CEO of Equity Bank (Equity or Equity Bank), Kenya's leading microfinance bank, sat behind his expansive and busy office table to review Equity Bank's 2012 second quarter financial performance ahead of a scheduled investors briefing. Equity Bank's performance in the East African microfinance space had been phenomenal with growth recorded across all identified key performance indicators – Revenues, Net Profit, Number of loans, Number of Customers etc. Equity was undoubtedly the market leader. Equity's consistency and support to its microfinance customers over the last ten years had resulted in the growth of the scale and scope of their businesses as a result of which conventional microfinance products and services had become inadequate to cater to their needs. Equity defined this market as the Small and Medium Enterprise (SME) Market. SMEs were firms whose financial requirements were too large for microfinance, but were too small to be effectively served by corporate banking models.[1] SME Growth was identified by various organizations as a key contributor to the sustainable development of any economy. SMEs drove job growth by the creation of more jobs than large firms and contributed greatly to overall job additions. Access to financial services was a driver of growth for SMEs and appropriate product/service combinations by Equity Bank largely contributed to the growth and development of its SME clients.

It became very clear to James that Equity Bank's current structure and operating model was insufficient to deliver on the bank's next phase of growth. Equity Bank had to develop the products, services, operating model and competence to serve the needs of this emerging space. James was not sure what the best approach to engage this SME Market was. An option was to outsource the responsibility to a consultant who would map out the strategy and move on to execution. The challenge this option had was that it could hurt the existing strong corporate culture of Equity that had values like inclusiveness and empathy, more importantly was how he was to go about ensuring that all the senior managers of Equity's various locations all around East Africa understood, contributed and had ownership of the plan. James was also very keen on ensuring that Equity retained its position as the East African leading bank even in the SME Space.

Equity Bank realised that the big East African banks already had relatively well developed and resourced SME Banking desks and had gradually began to serve the needs of these emerging SMEs that Equity had grown from the micro level. To be able to compete effectively, James was faced with the task of moving Equity Bank into the big league of SME Banks within the shortest possible time. A few questions came to his mind on how best to engage this market – How best should Equity define its SME segment? Equity currently defined the SME sector from a credit angle as customers borrowing from KSh 3 million to KSh 50 million. Could small and medium enterprises in Kenya be banked profitably? What was the size of this market opportunity in dollar terms? What was the potential number of SME clients and the number of sectors that were to constitute Equity's priority focus? What relevant product and service combinations were

[1] www.ifc.org

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most optimal in serving this market? What channels were most appropriate? Should Equity establish customized SME Banking desks or was a complete creation of specific SME branches that had the resources and capabilities for engaging this market more appropriate? How was Equity supposed to translate its sterling success in microfinance to this sector and what was a most appropriate timeline within which to launch remained critical questions. Could Equity employ a range of measures, such as risk-adjusted pricing, credit scoring models, and SME-tailored non-lending products to mitigate risks, lower costs, and increase their overall market share of the SME banking space?

Another critical question was whether the SME banking rollout should begin in Kenya or whether a simultaneous rollout across all Equity's locations in East Africa was better? More important was how to map the initial Kenya rollout – How was Equity going to establish the leading SME sectors in each country of operation and each geographical region in the country? The coast was clear and Equity had to rise up to the occasion.

Equity's History

Equity Bank started operations in 1984 as the Equity Building Society, originally established to provide mortgage financing for Kenyans who were classified as low income earners. The bank's logo was designed to communicate that Equity was an institution desirous of assisting them in building their own homes. The Kenyan government at the time significantly deregulated the economy in a bid to encourage private investment and ultimately economic development. The deregulation of the economy provided opportunities for proactive and discerning investors to start formal financial institutions. This led to an increase at the time of the number of financial institutions in Kenya.

At the time Equity commenced its business activities, competition in the financial services industry was fierce among the industry big players and the potentials were limited. In addition, the mortgage sector was not developed and well understood. This forced many of the smaller building societies to close shop. Equity, however, managed to survive the onslaught by mobilising customers and deposits through one-on-one marketing. The bank was at the time operated as a largely informal family business whose board members were largely friends of the founders. The absence of disciplined processes and controls led to a gradual deterioration of the bank's loan book quality. In the absence of strong board oversight, Equity's financial health became worse. At this same time there was a gradual decline of interest and involvement in the affairs of the building society by three of the five founding owners/directors and a subsequent withdrawal of two of them from the business. This period of apparent board inactivity (1984-1992) resulted in the stagnation and subsequent decline in the organisation's performance. Customer deposits grew by only KSh1 million between 1986 and 1991. In the same period, loans and advances grew by only KSh7 million from KSh2 million to KSh9 million. Accumulated losses also grew steadily from KSh5 million in 1986 to KSh22 million in 1991.

Indeed, the first eight years of operations were hard for Equity. No staff member received a salary increase. Twenty staff members worked long hours in order to retain clients. All around, many other institutions were closing as a result of high costs coupled with the continuous loss of customers and increasing levels of loan default.

By December 1993, the Central Bank of Kenya (CBK) declared that Equity was technically insolvent. Equity's non-performing loans made up 54%[2] of the total loan portfolio and its liquidity ratio stood at 5.4% which was well below the 20% required by law. The CBK noted that supervision by the board was very poor. Accumulated losses were KSh33 million on a capital base of KSh3 million[3]. Deposits were being used at this time to meet

[2] Equity's annual reports

[3] Equity's annual reports

operating expenses. However, limits to its powers meant the CBK could not request the closure of Equity. Only the Registrar of Building Societies, which licensed Equity for business, had the power to close the institution.

At the start of 1994, Equity was technically bankrupt, with only 17 staff who had extremely low morale, a loan portfolio of KSh12 million (54% of which were bad), and a deposit base of KSh25 million. Three main depositors accounted for 84% of total deposits: the Kenyan Ministry of Water (KSh12 million), James Mwangi (KSh7 million), and the National Health Insurance Fund (NHIF – KSh2 million). The board had not met between 1992 and 1994 and performed no oversight functions. The company was grinding to a halt with an average annual loss of KSh5-7 million. A court case was instituted by the Ministry of Water and NHIF seeking to liquidate Equity. James Mwangi, an accounting graduate from the University of Nairobi at the time was the financial controller of Trade Bank that was essentially targeted at the elite leaving the poor and economically disadvantaged Kenyans.

When it became clear to James that his life savings in Equity were threatened, he opted to rescue Equity by joining the team; he subsequently resigned his job at Trade Bank and accepted a salary of $300 in Equity as against his salary of $5,000 in Trade Bank. James' humble family background and desire to impact the low income population in Kenya made him look beyond the fact that he most recently got married at the time and his wife had just been delivered of their first baby. James career started after his graduation from the University of Nairobi at the top of his class at Price Waterhouse but after one month, he moved over to Ernst and Young. He worked with Ernst and Young for three years, and then joined Trade Bank where he rose to the position of group financial controller after three years.

James joined Equity Building Society as Finance and Operations Director and he, along with then Managing Director John Mwangi and the Chairman Peter Munga, constituted the board. Four independent directors were appointed from pre-eminent Kenyan organizations. James converted his KSh7 million deposit with the bank to ordinary shares, making him the majority shareholder, but John Mwangi remained as the CEO to allow for continuity and contact with the regulatory authorities.

Equity's Turnaround

James Mwangi also doubled as Equity's Chief Operating Officer at the time, and was saddled with the responsibility of saving the company in conjunction with the CEO. He tackled this task in steps, starting with trying to raise the morale of staff. He subsequently ensured the skill level of Equity's staff in the technical and managerial areas were significantly upgraded. He was also very open to effective delegation of responsibilities to his colleagues. His vision was of a better future that would be achieved by teamwork, hard work and aspiration. According to James, "We had to fight to save the bank or sink and lose all we had."

At the same time, James had to refocus Equity on microfinance since the existing mortgage market that constituted its primary business required more capital and skill. The mortgage market was also more competitive than microfinance. The process involved a radical transformation of Equity's DNA; it underwent a company-wide visioning process where the directional beacons were set. There was broad ownership among staff of what the organization would be about and how the audacious goals and objectives will be achieved. James believed that poor people did transactions like any other group of people; the difference was in the size of the transactions. He believed a business model that will deliver financial services to the Kenyan poor could be effectively executed. The training staff members received reinvigorated the Equity team by

educating them on the needs and peculiarities of this microfinance market and the enormous benefit their work will bring to Kenyans.

At the time in Kenya, the political environment changed with the introduction of a multi-party political system that led to more freedom for the people. In addition, the government relaxed its requirement that state employees bank only at government-controlled banks. This change resulted in a flood of new deposits at Equity and other industry players. The board realised that if it wanted to turn Equity around, it needed more resources (capital and non-capital) to bring in new thinking, train staff to meet the dynamic challenges of the environment, and also expand its marketing thrust.

Gradually, a culture of customer service, hard work, dedication and devotion was institutionalised. James saw his main role as that of trainer/coach. He was very firm in institutionalising this culture. At the initial stages, there were strict deadlines, uncompromising customer service, long working hours and other such measures. Later on, he intensified staff training, encouraged on-the-job training and coaching and a participative leadership style, all of which helped to galvanise the workforce.

By 1995, customer deposits grew to KSh124 million from KSh31 million in 1993, with profit rising to KSh9.7 million from a loss of KSh5 million within the same period. With the company showing signs of profitability, James successfully approached the International Finance Corporation (IFC) and European Investment Bank (EIB) in 1996 to invest in Equity through AfriCap (owned by both entities), and they were given a seat on the board. This international connection helped improve the image of the company and won customers' confidence. As the year 2000 approached, Equity Building Society's manual processes became untenable. The manual system could not handle the growing numbers of clients. The cost of serving the customers was high, the staff productivity low, fraud levels up and customer turnaround times compromised. Pressure to automate was mounting as the growth in customer numbers, deposits, and loan portfolio as well as over the counter transactions increased. Equity's proposal to UNDP's Microstart's call for proposals from microfinance institutions for capacity building for US$ 150,000 to procure Bank 2000 system. Another responsible factor for Equity's growth was its investment in superior IT systems and innovation as it had to leverage low cost delivery channels to reach a large customer base. This automation delivered some significant benefits which included - Lower turnaround times as a result of automated of the ledger system; Lower account opening cost as customers were no longer required to carry passport photos as data and image could be simultaneously captured at the account opening desk; Enhanced fraud security as all signatures were scanned alongside customer photos and account operation mandates for the signatories; Staff enjoyed more time with their families as filing and reconciliation work of ledger cards was eliminated; Higher productivity per cashiering and loan staff as they could handle more workload and Reduced error rates.

In 1997, with this new focus, the company set a target of a KShs1 billion deposit base by 2000 which was achieved as planned. This burst of performance saw the deposit base of Equity grow by 40-50% per year from 1995 till 2002. Profit margins also grew strongly. Equity had bounced back. Successes afforded access to international partners such as European Union funded MESP programme and UNDP-Microstart, followed by Swiss Contact and MicroSave, the British Department for International Development and Master Card.

A remarkable evidence of Equity's recovery was the rating it was issued by the Central Bank of Kenya (CBK). Shortly after 1993, its rating moved to marginal, then to fair, and by 2002 it was satisfactory. Capital adequacy was fair and asset quality was satisfactory, as were earnings and liquidity ratios. By 2002, Equity had become a highly profitable institution that operated through 12 branches and 18 mobile units, with 107,000 depositors whose total deposits was KSh1.6 billion, and a loan portfolio of 18,000

borrowers worth KSh1 billion. The activities of the microfinance institution had also become computerised. It had about 190 staff members, 7 directors, and 2,367 shareholders. By the end of 2005, Equity had become the biggest bank in Kenya in terms of customer base, 13th largest by capitalisation and 14th largest in terms of deposit base, and was rated among the top five banks in the country by the CBK. By 2010, Equity posted a profit before tax of KSh 9.04 billion which was a 71% increase from the previous year's level. Equity also massively grew its customer base by growing its customers from 4.4 million in December 2009 to 7.8 million as at June 2012. This made Equity home to 57% of all bank accounts in Kenya. Customer deposits also grew from KSh 69.8 billion in 2009 to KSh 104.4 billion in 2010.

The Kenyan macroeconomic environment

Financial Sector Reform

The Central Bank of Kenya (CBK) pursued deliberate policies that have achieved relatively stable and low underlying inflation, stable exchange rate even with some minor volatility, a strong balance of payments position, low and stable interest rates, and substantial inflows of both official capital and foreign direct investment. Kenyan growth also came with challenges ranging from payments, settlements, investors' returns to safety of investors' assets to the stock exchange, brokers, Capital Markets Authority. Despite these challenges there was a significant growth in the Fixed Income segment of the Nairobi Stock Exchange and vibrancy in the entire capital markets in general. This lengthened the maturity profile of the bond market.

The Financial sector was singled out as a key industry that would play a pivotal role in successful implementation of the Vision 2030 through mobilization of long term financial resources. This was expected to make Nairobi the financial hub of the East African region.

The Central Bank of Kenya in collaboration with the Treasury and other stakeholders carried out significant reforms to spearhead further growth and efficient functioning of the financial markets. Some of these reforms related to the introduction of an efficient trading platform and an introduction of Primary Dealership expected to further deepen the capital markets. The proposed reduction of the threshold for investment in Kenya Government Treasury bills was expected to pave way for wider public participation in government debt markets as the Government started implementing Vision 2030. Teams comprising of Central Bank of Kenya and the Nairobi Stock Exchange (NSE) worked to connect CBK's-CDS with the NSE's Automatic Trading System (ATS) to facilitate online trading of bonds in the secondary market. If this was successful, Delivery versus Payment arrangements would be greatly enhanced to the extent that Over-The-Counter (OTC) trading could effectively take place. The CBK and the Treasury were also working on a Benchmark Bonds programme to be rolled out in the near future.[4]

In order to facilitate provision of adequate housing to Kenya's growing population, the 2010 Finance Bill proposed to amend the Banking Act. The proposed amendment would allow mortgage finance companies to operate current accounts and banks to advance up to 40% of their total deposit liabilities for purchase, improvement or alterations of land. This proposal would result in an increase from the actual ratio of 25%.[5]

Exports

The Kenyan economy grew by 5.0% in 2010, compared with 2.6% in 2009, and 1.7% in 2008. Kenya's main exports consisted mainly of tea, coffee, horticultural products, hides

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[4] http://www.bis.org/review/r080409b.pdf

[5] http://www.africareit.co.ke/about-kenya/economic-development

and skins, pyrethrum, pineapples, beer, among others. 75% of all the 35 million inhabitants of Kenya were employed or involved in the agricultural sector, which represented 24 % of Gross Domestic Product (GDP). A third of Kenya's produce was exported[6]

Kenya was also the world's largest producer of black tea whose production was dependent on weather conditions. Kenya's earnings from horticulture exports rose by 18% in 2011, despite the drop in production. The exchange rate and strong prices for vegetables and fruits favoured the industry's earnings. According to USAID, Kenya Horticulture Competitiveness Project (KHCP), the country earned 91.6 billion shillings ($1.10 billion) from the sale of flower, fruit, vegetable and nut exports in 2011. Flowers, which made up the bulk of the earnings for the industry, fetched 44.51 billion shillings from 35.56 billion shillings in 2010. Europe was the largest importer of Kenyan flowers. The most popular destinations were Holland, Britain, Germany and France.

Coffee exports earned about 26 billion shillings ($313.9 million) in 2010/11, up from 16 billion shillings in the previous year.[7]

Industry

The Industrial sector was composed of two main components; manufacturing and construction which constituted about 16% of Kenya's GDP. The manufacturing industry had over 700 established multi sector manufacturing companies in Kenya. The country was home to over 200 Multinational companies whose businesses and transactions stretched to the East and Central African community via Nairobi. The Industrial sector was largely driven by construction. The construction Industry recorded an 8.1% growth in the first half of 2011 while manufacturing recorded a growth of 3.2%.

Construction growth was driven by a continued rise in public investments; infrastructure projects especially roads, energy and water which have supported the growth of this sector were the main growth drivers. Cement consumption increased by 8.7% from 782.9 million tons to 851.2 million tons.

The manufacturing sector was composed of medium and large-scale enterprises with major foreign multinational companies from Europe, United States of America, India, China and Asia. The year 2011 saw a large number of conglomerates make their way into the country to set up bases in Kenya. Majority of them were vehicle assembly plants such as TATA, Beiqi Foton Motors and Chevy Automobile. The manufacturing industry in Kenya dealt with production of agricultural products, oil refining, vehicle assembly, aluminium, steel, lead, cement and small scale consumer goods such as furniture, batteries, textile clothing, soap, cigarettes, flour among other things. The industry's production slowed down at a rate of 3% owing to the rise in inflation which in turn lowered the public's demand for products. Another reason was because of the high cost of production which was too high due to energy rationing following the low rainfall. The manufacturing industries therefore turned to energy sources such as thermal power which was quite costly. In next few years, the manufacturing sector was expected to benefit from the on-going integration of the East African Community as Kenyan firms are considered more competitive than their regional counterparts.[8]

The top most exported non-agricultural products in Kenya were mineral fuels, oils & products of their distilled product which included petroleum jelly; paraffin wax, micro-crystalline. These are exported to various destinations such as Europe, Uganda, Tanzania,

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[6] http://www.brandkenya.co.ke/index.php?option=com_content&view=article&id=67&Itemid=41
[7] World Bank Report
[8] http://www.africareit.co.ke/about-kenya/economic-development

Pakistan, Egypt, Rwanda, Sudan, India and USA. Africa was the greatest market for Kenya's manufactured goods.[9]

Service Sector

The service sector was a very wide sector comprised of the Information and Communications Technology sector, the financial services sector made up of the Banking and insurance sectors and the tourism sector. The service sector was the greatest contributor to the country's GDP constituting 62% of the country's GDP in 2011. The sector grew at a rate of 4.3% between 2010 and 2011, driven by financial intermediation – Contributing 8.2% of the growth , hotels and restaurants 6.4% of the growth, transport and communication 5.2% of the growth and tourist arrivals whose rate increased by 13.6% in the first half of 2011 compared to the same period in 2010.

The Information and Communications Technology industry developed at a very fast rate owing to the constant innovations in technology. The most recent developments in this sector were those in the mobile phone revolution which grew rapidly in the past year. In 2011, the number of subscribers rose to 25.3 million active mobile lines which was more than the number of adults in Kenya. In addition, the number of internet users increased by 60%, rising to 12.5 million users. This increase in numbers was attributed to the introduction and adaptation of new affordable tools such as smart phones, which bear social networking applications as well as internet. As a result many other mobile applications had been innovated in almost every other sector of the economy, among them M- Banking an application linked to personal bank. For example, M-Kesho was a mobile application used by Equity bank account members. M-Kesho allowed one to withdraw cash from their Equity bank account through the M-Pesa[10] account on their phones and deposit cash to their M-Kesho account via M-Pesa. The latest application was Karopay, which necessitated the payment of school fees via M-Pesa.[11]

The Kenyan SME Market

The Kenyan SME market was estimated to have grown at a 40% compound annual growth rate between 2006 and 2011 and Equity Bank's market share was estimated to be about 25% as at 2011. In Kenya, they are responsible for approximately 80% of employment and contribute approximately 20% to GDP[12]. The Gross Domestic Product (GDP) of the region representing Kenya, Rwanda, Tanzania and Uganda grew from 5.6% to 7.0% between 2010 and 2011 and was forecast to continue at that pace till 2016. Other indicators in the region also revealed that GDP per Capita, Average household income, Loans/GDP etc. would all continue to rise and result in a migration of customers from micro-customers to SMEs. Population for the region was also expected to rise from a modest 133 million in 2011 to about 153 million in 2016. This was going to provide a huge consumer market for several sectors in the SME Space.

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[9] World Bank Report

[10] **M-Pesa** (**M** for mobile, ***pesa*** is Swahili for money) is a mobile-phone based money transfer and microfinancing service for Safaricom and vodacom, the largest mobile network operators in Kenya and Tanzania. Currently the most developed mobile payment system in the developing world, M-Pesa allows users with a national ID card or passport to deposit, withdraw, and transfer money easily with a mobile device. *Culled from Wikipedia*

[11] World Bank Report

[12] http://fsdkenya.org/wp-content/uploads/2015/08/15-07-20_GrowthCap_Briefing_Note_2_State_of_practice_of_SME_banking.pdf

The Kenya Vision 2030, a national long-term development blue-print that aimed to transform Kenya into a newly industrialised, middle-income country that provided a high quality of life to all its citizens by 2030 in a clean and secure environment categorized SMEs as businesses with 11 to 100 employees and a turnover of between KSh 5 million and KSh 1 billion. It further categorized it into small businesses – 11 to 50 employees and a turnover of KSh 5 to 5 million and medium businesses 51 – 100 employees and a turnover of KSh 51 to 100 million. SMEs were adjudged to be responsible for 80 % of employment of Kenya and were hence identified as a powerful tool for the economic development of Kenya. Various banks in Kenya adopted various ways of classifying SMEs based on number of employees, turnover, profit level and working capital requirements. There was a general understanding that SMEs included businesses whose borrowing needs do not exceed KSh 50 million. The SME sector constituted 65% of Kenya's Gross Domestic Product accounting for a total contribution of US $ 23.45 billion in 2011. Analysis from Standard Investment Bank revealed that Agriculture, Manufacturing, Building and Construction, Mining were the sectors that had the highest growth in credits from the banking sector with year on year growths of 45.2%, 37.9%, 60.6% and 58% respectively. Gross loans to these four sectors in the year 2010 amounted to about KSh 203 billion while Non-performing loans ratios of these four sectors declined from 12% to 7% for Agriculture, 5.7% to 4.3% for Manufacturing, 6.1/% to 4.7% for Building and Construction and 0.6% to 0.4% for Mining between the third quarter of 2010 and the third quarter of 2011. The Trade, Real Estate and Personal/ Household sectors collectively accounted for KSh 511 billion from a total of KSh 879 billion. The International Finance Corporation (IFC) estimated that there were 2.3 million SMEs in Kenya whose combined financing needs were about KSh 10.52 billion ($135 million). The total SME lending portfolio in December 2013 was estimated at KSh332 billion, representing 23.4% of the banks' total loan portfolios. (The USD equivalent is USD 3.84 billion, based on the exchange rate on December 31, 2013.) Furthermore, in the context of general growth of the financial sector, SME financing represented a growing share of the commercial banks' lending portfolios: in 2009 and 2011 the total SME portfolio represented 19.5% and 20.9% of overall lending, respectively.13 IFC estimated that 24% of the SMEs were owned by women and 43% of all SMEs had no form of banking relationship. Mckinsey estimated that the size of the SME Market in Kenya was estimated at about $350 Billion in 2013.[14]

The specific challenges faced by Kenyan SMEs included – Inadequate education, inadequate business and management skills, insufficient working capital, access to credit with heightened difficulty caused by the 2008 – 2009 global financial crisis, difficult policy and regulatory environment, poor infrastructure like roads and electricity, scanty market information that make aggregate planning difficult and an increase in associated business risk. All these factors collectively made lending to the SME Space difficult with increased risk and likelihood of default. In spite of these challenges the SME market was considered the fastest growing sector in Kenya. Access to finance for SMEs was a significant problem for Kenyan SMEs based on an IFC Enterprise Survey. Anecdotal evidence also suggests that access to finance was considered one of the greatest problems among businesses in the region, but Kenya only ranked this factor third behind Practices of Competitors in the Informal Sector and Corruption among small businesses (the ranking of access to finance by medium-sized businesses was even lower). Internal finance was still the most important source of funding for Kenyan businesses (60%) but bank finance, at 24%, is a significant source (vs. 78% and 10% respectively for the region)10. Virtually all businesses in Kenya have either a current or savings account.[15]

[13] http://blogs.worldbank.org/psd/smes-are-good-business-kenya-s-growing-banking-sector
[14] http://mckinseyonsociety.com/downloads/reports/Economic-Development/MSME-Emerging-Market-Banking-report.pdf
[15] http://fsdkenya.org/wp-content/uploads/2015/08/15-07-20_GrowthCap_Briefing_Note_2_State_of_practice_of_SME_banking.pdf

The Kenyan Capital Markets Authority (CMA) announced plans to establish an exclusive stock market for SMEs with flexible listing rules to enhance the attractiveness of the SMEs and increase their access to finance. The new market was expected to open access to capital while raising savings and investments in SMEs through additional listings. Some proposals of the new stock market included lower listing and trading fees, with considerations to be made on how fees were to be reduced within the sector. A new process for listing and offering would also be factored in within the context of a new regulatory environment and a policy framework that would allow SMEs raise capital in an environment specifically designed for their needs. The CMA also had plans to attract both individual and institutional investors to the market to increase the diversity of the shareholding base.[16]

Few Kenyan Banks applied credit scoring methods in the assessment of risks attributable to lending to SMEs. Though credit scoring was adjudged a cost effective risk assessment approach some considerations prevented their adoption by Kenyan Banks. Firstly, there was a need for Government to make targeted consultations with Kenyan banks to establish their capacity for portfolio risk management and develop expert based scorecards. Secondly the volume of SME applications and accounts were not sufficient to allow most lenders develop their own scorecards. Thirdly, there were few licensed credit bureaus, mandatory reporting of positive and negative credit performance information, and a lack of standardized collections and calculation of key financial data, all of which impeded the development of a generic, pooled-data scoring model that could be used by all lenders. Lastly, the portfolio risk management that leveraged credit scoring required significant up-front and on-going investment in risk management skills and infrastructure, it was potentially not cost-effective for banks with a low base of SME clients.[17]

Approaches by existing banks serving SMEs

Kenyan banks with expertise and reach for the SME Market had the following approaches to the Kenyan SME Market. Banks typically had relationship managers (RMs) with skills in engaging and approaching the SME space. These RMs had expertise in customer service and customer engagement with extensive knowledge of the business needs of their clients. They also had the responsibility of escalating loan requests to the Bank's management and modifying the features and benefits of the deposit and loan products to meet the specific needs of their clients. The relationship managers were in most cases long term oriented and as such were interested in building long term partnerships between their clients and the banks. They were not desperate to get a transaction at the expense of the desired long term relationship with the client.

Existing banks also had a host of value added services they gave the SME Market like business clubs, business plan competitions, and business mentoring schemes where they hired industry experts to mentor their customers and assist them in solving specific business problems. They had special SME branches and/or SME desks where the relationship manager resident in the branch sat and managed the entire branch's SME relationships with his/her team. Banks also had a bouquet of products that gave the SME a feeling of importance and recognition like special accounts, customized cheque books and special cashiers to attend to their needs.

Some of these banks made their SME business a major strategic thrust and deployed senior management staff and well-resourced teams from top consulting firms and multilateral development organizations in the development and execution of their SME Banking strategies. Banks identified new channels for reaching out to SMEs like SME workshops, professional associations, physical contact at branches and electronic

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[16] http://allafrica.com/stories/201108241460.html

[17] http://www.fsdkenya.org/pdf_documents/08-11-24_Credit_Scoring_for_SME_lending.pdf

channels. Banks developed and launched several products for engaging SMEs like Late Banking (Banking for SMEs after the official closing time of 4pm), Early Banking (Banking for SMEs before the official business opening time of 8am), Unsecured loans, Import and Export credit support, International events like trade fairs, seminars and workshops for SMEs as well as Business Advisory services to SMEs.

Some major products offered to SMEs included Deposit/Savings products, Trade Finance, Import Finance, Access to Markets, Working Capital Solutions, Business Expansion Solutions, Business Protection Services, Cross Border Solutions and Yield Enhancement Services. The Working Capital Solutions assisted SMEs in managing their working capital more efficiently and ensuring there was adequate cash to meet short term financial obligations. The products aimed at assisting SMEs manage collections, credit terms with their customers and inventory.

The Business Expansion Solutions assisted SMEs in embarking on long term ambitious growth plans and in preparing internal proposals that informed the capital budgeting decisions that drove business growth. Business expansion required capital investments, which were medium to long-term investments financed by one or a combination of retention of business profits, injection of fresh capital by business owners and financing via bank loans that needed to be repaid based on projected future business cash flows. Banks provided a host of services and lending solutions to fund SME growth, and were ready to help them create and make the most of business expansion opportunities with a suite of short term, medium term and long term financing solutions to grow their businesses.

Some banks offered business protection needs that created innovative solutions that meet all the risk management and protection needs of SMEs. Some had dedicated teams of specialists that developed customized and cost-effective risk management solutions and protection alternatives through in-depth analysis across various types of lending models. Most of the solutions were tailored to meet the needs of the specific business plan and strategy. Some banks have been successful pursuing niche markets that have been mostly or fully neglected in the market, on the basis that the niche is large and can be profitable particularly if the bank has a “first strike” opportunity. Examples of market niches include sharia banking, agribusiness, women-owned businesses, youth, and recent start-ups.[18]

Business expansion required capital investments, which were medium to long-term investments financed by a careful assessment of the cash level required to meet SMEs business commitments and ensured their idle funds were invested to optimize the returns on their cash. Banks had solutions that assisted SMEs in the prudent management of their excess cash as it had significant impact on their ability to fund their own business expansions and improve their profitability. The Relationship managers were trained to assist the SMEs in deciding on how much to invest and in understanding where to invest. They helped SMEs realize opportunities that may lie in investing in their own business. Banks also positioned themselves as business partners to the SMEs providing them with access to investment expertise to secure higher yielding solutions based on their business needs and risk profile.

Some Banks with international reach and branches all over the world also had borderless banking products available to Kenyan SMEs such that as their businesses expanded, they took advantage of the bank’s international network and trade expertise in thousands of branches across the various continents of the world in reaching out to their customers and executing international transactions.

[18] http://fsdkenya.org/wp-content/uploads/2015/08/15-07-20_GrowthCap_Briefing_Note_2_State_of_practice_of_SME_banking.pdf)

Equity SME Bank today

James felt that SMEs constituted a significant opportunity for Equity if a model that developed the right products, services and operating environment was created. In 2011, SME's were responsible for 40% of Equity Bank's interest income, 90% of income from trade finance and 90% of income from foreign exchange transactions. An important motivator for Equity Bank to launch SME Banking was the award of Dr James Mwangi as the Ernst & Young World Entrepreneur of the Year Award in 2012 after a very competitive process in Monet Carlo from a list of over 50 Top Global Entrepreneurs for his role in democratizing access to banking in Africa. SME banking would be an avenue for Equity Bank to also mentor other SMEs to scale the heights19.

James put together to a team made up of selected senior management staff of Equity with functions ranging from strategy, financial control, risk and human capital management to conduct an assessment of Equity's current SME Bank with a view to developing a strategy and an action plan that would enable Equity conquer the East Africa SME market. The team realized after their work that existing customers of the Bank had businesses whose financing and business support needs had outgrown their lending capacity. Between 2009 and 2012 Loans to Deposits Ratio in Equity dropped from a high of 91% to 79%. Between January and December 2011 transaction count and transaction value in Equity did not grow as fast as historical figures. Transaction count and volume with the Agents contrarily had been on the increase. Equity's loan composition had also shown a declining proportion of loans granted to micro customers from a high of 40% of total loans in 2010 to low of 33% of total loans in March 2012 while loans to SMEs grew from 37% of total loans to 41% of total loans within a corresponding period. The Non-performing loans ratio between 2010 and 2011 also increased marginally.

The Team felt the reasons for this were lack of an in-depth appraisal of SME loan requests since Equity traditionally offered micro customers short tenured small loans. Another key factor in driving the shift to SME Banking was the need to recalibrate the loan portfolio mix to a more conservative portfolio with a loan book backed by collateral security. This necessitated rebalancing the loan book from heavy dependence on consumer loans to more dependence on SME loans.

SMEs required longer tenured loans with less processing time and a more responsive relationship management team. This required an upgrade of risk assessment and risk management capabilities in the bank. Equity's loan book however had 50% of its total loans to SMEs. From all indications and feedback from branches it was clear that many micro customers were becoming larger and the scope of their businesses were also getting more diverse. This had resulted in transactions increasing in volume across all the areas of their needs for financial services. Some SMEs had moved their businesses to competitor banks for the reason that Equity did not understand the needs of their new business scope and did not have a model, the products and infrastructure to cater to their needs. This made a poignant case for the establishment of an Equity SME Bank that would understand the needs of SMEs and evolve an appropriate model and framework to cater to SME needs.

Equity's SME customers also had the traditional problems SMEs had in several other parts of the world and required tailored products and services that extended to business advisory services and customized loan and deposit products to help them meet their business objectives. Equity also realized that small, medium and large enterprises do not receive as much advisory support, relationship management and tailored products as those received by micro and corporate clients. Equity also did not have a bank-wide definition of SMEs that would inform customer engagement and operating model

[19] http://www.ey.com/GL/en/Services/Strategic-Growth-Markets/Center-for-Entrepreneurship-and-Innovation---James-Mwangi---Entrepreneur-Of-The-Year

definition. Various branches classified SMEs in various ways with proxies like the company's annual turnover, number of employees and net assets level. The team also realized that client segmentation would assist Equity Bank in better customer relationship management and enhance the customization of banking and advisory services to specific clients. The team came up with a list of important pieces of information that would assist the bank in defining the SME Market – Annual revenue, Fixed assets, Sector, Number of employees, Management composition, Ownership Structure, Loan Size, Collateral offered etc.

They realized that most of the SMEs had no business plans, growth strategies or mapped out structure for the efficient use of their funds. Most of the SMEs had limited business training and professional development. Some of the companies were not legally incorporated and as such had limitations on what their businesses could go for. Some of the SMEs had no sound governance structures in place and as such it was difficult to ensure that loaned funds were not diverted to other personal uses. Boards were not in place and when in place lacked the diversity and independence required to add value to the business.

Most of the SMEs had a single bank account for business and personal uses of the CEO and as such had no way of separating personal transactions from business transactions and ensuring prudence in the use of the company funds. Most of the CEOs did not place themselves on salaries; they simply drew cash from the company's account whenever they needed to solve personal problems. There was also an absence of accurately kept record of financial transactions that showed the position of the company whenever it was required. They generally had no financial directors and in instances where a financial director existed they lacked the skill and power to effectively perform their duties.

Some SMEs did not leverage on advances in IT to improve efficiencies. They had no manuals or process maps that showed clear policies and procedures for their business processes. They had no process of periodically reviewing and auditing their processes. There was also an absence of market research and intelligence. SMEs did not sufficiently invest resources in understanding customer needs and developing product/service combinations as well as strategies to meet those needs as at when due.

Some SMEs had no employee development plans like organizational charts, career paths, mentoring and training plans. They carried out no performance reviews and had no independent professionals in senior positions, only family members regardless of qualifications were put in strategic positions. There was also no Human Resource policy manual that had standardized procedures for recruitment, performance appraisal, career management and discipline. Most employee career development decisions were based on the sentiments of the CEO and as such may not be in the best interest of the organization.

SME Banking Opportunities

The Team also conducted research on the kinds of products SMEs required and came out with a shopping list of the products– International/Local Trade Financing products through Letters of Credit, Bills for Collection etc.; Working capital loans, Trade liaison arrangements, Bank guarantees, Advance payment guarantees; Local Purchase Order Financing, Financing Leases; Credit and Debit Cards; Foreign Exchange Loans (Usance lines); Bills discounting; Over Draft, Temporary over Draft; Insurance services, Mortgage Loans; Cash Management (Managing Cash collections and payments).

To effectively serve SMEs some Value Added Service were proposed – Mentoring, Leadership Development, Capacity Building in various areas of business; Business Advisory Services; Awards and Competitions; Networking opportunities. The team proposed that the Value Added services were offered on a needs basis depending on the

stage of development at which the SME[20] was – Stillborn/problematic, Start-up, Growth and Established. Services that could be offered to any of them include – Market research and information, Business expansion and acceleration planning, Business promotions, Product packaging, Labeling & branding, Financial planning and review, Business matching, Problem solving, Business/product life cycle study, 5-year Business Plan.

The team also noted that Equity Bank needed to manage the risk associated with serving these SMEs by appropriately pricing the loan and deposit products that would be sold to the various market segments. They proposed that Equity Bank came up with an SME risk scoring approach that iincorporated credit scoring, development of a statistical application for behavioral scoring and psychometric testing.

Customer Segmentation

The team proposed a customer segmentation approach that identified profitable customers and those that destroyed value, evaluated their potentials, adjusted service level and commercial approach, developed better understanding of needs and opportunities in each of the segments. Some considerations that were expected to follow market segmentation included – Target market understanding, Product offering, Product/Pricing Model, Channels, Relationship Model, Operating Model and IT Platforms.

Looking Ahead

In line with Equity's aim to be the champion of the socio-economic prosperity of the people of Africa by offering inclusive, customer-focused financial services that socially and economically empower their clients and other stakeholders, James knew it was not only necessary but urgent to rollout Equity's SME Bank. Equity was undoubtedly a success story but the journey to full actualization of its vision and mission was still far. Equity had extended operations to other East African countries with fully owned subsidiaries in Tanzania, Rwanda, South Sudan and Uganda but had to also extend the bank's international scope from microfinance to SME banking all across board. Another challenge was the problem of having multiple brands under one roof given the anticipated confusion over a transition in the bank's business model from traditional microfinance to SME Banking. What effects this would have on the existing microfinance business were not clear. James did not want the new SME Bank to cannibalize or disturb the existing microfinance bank's operations. He also did not want the concept misunderstood by Equity Bank's managers as a discontinuation of their existing microfinance business model.

As he proceeded to convene a meeting of Equity Bank's Senior Management to discuss next steps in this process he pondered on how the various issues will play out when the execution of their SME strategy began.

[20] Start-ups are SMEs who have been in operation for not more than 3 years, SMEs in the Growth stage are those that have been operating for between 4 years and 10 years, Established SMEs have been operating for more than 10 years while Still-born/Problematic SMEs may have been operating for any number of years but are fraught with several problems.

Exhibit 1

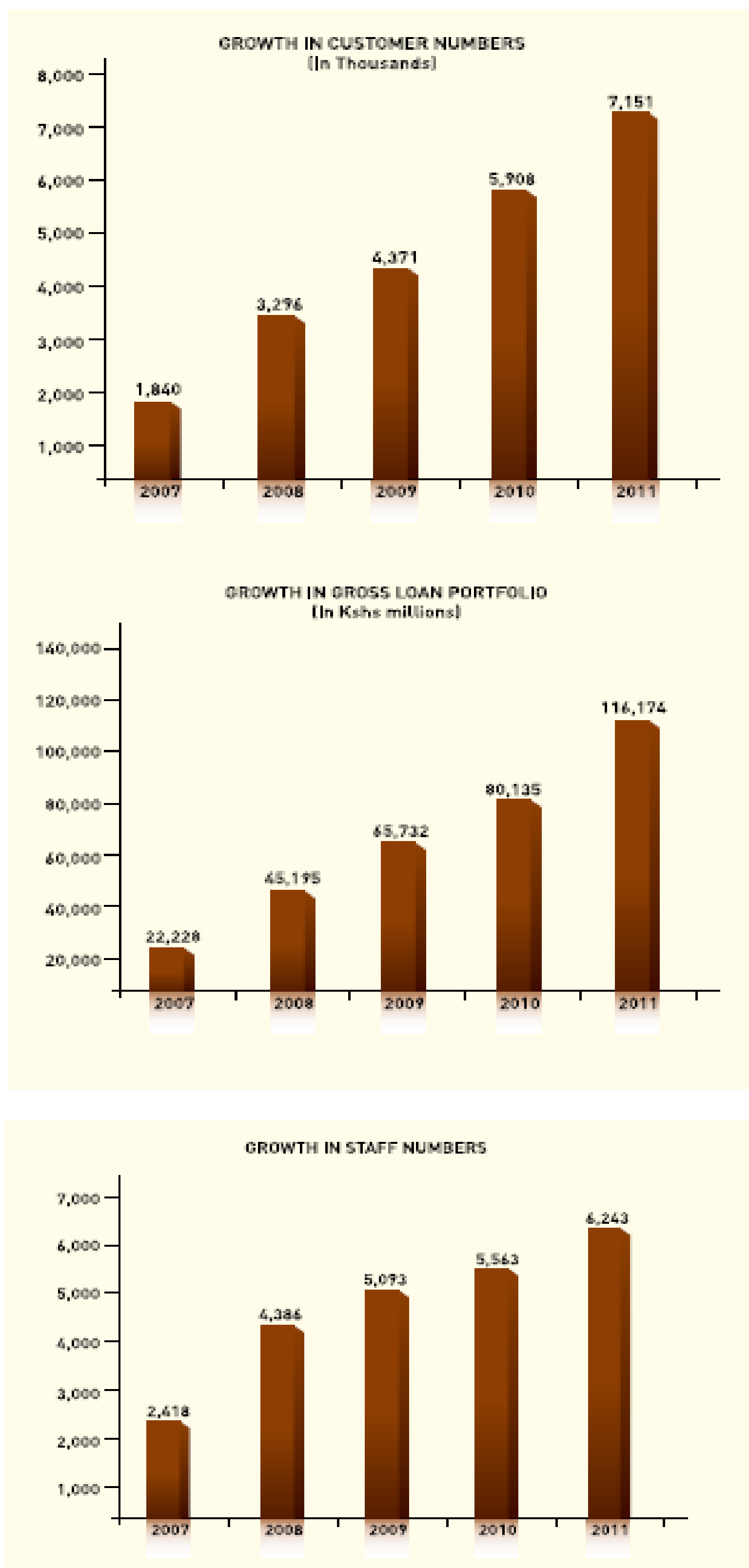


Exhibit 2

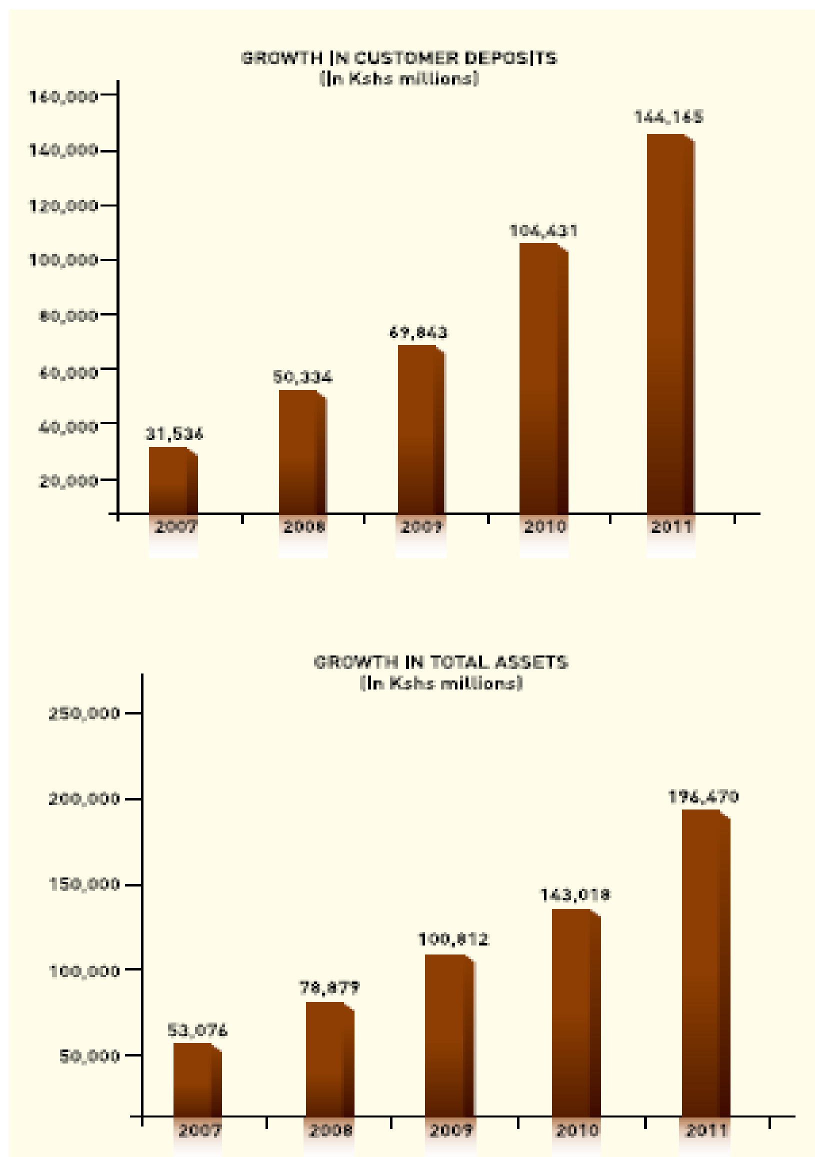
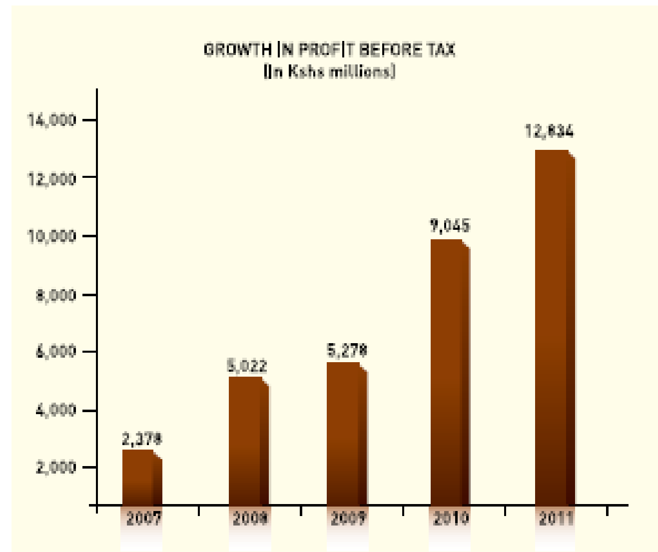


Exhibit 3



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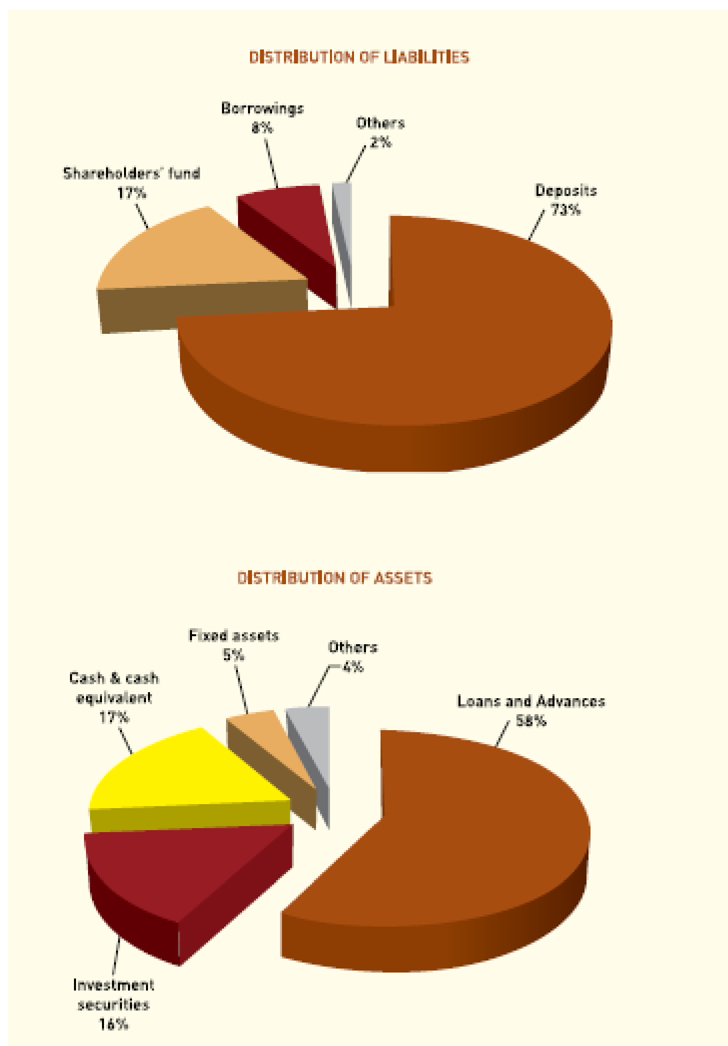


Exhibit 5

Equity Bank

Vision

"…To be the champion of the socio-economic prosperity of the people of Africa.…"

Mission

"…..We offer inclusive, customer-focused financial services that socially and economically empower our clients and other stakeholders….."

Positioning

The Listening, Caring Financial Partner.

Motto

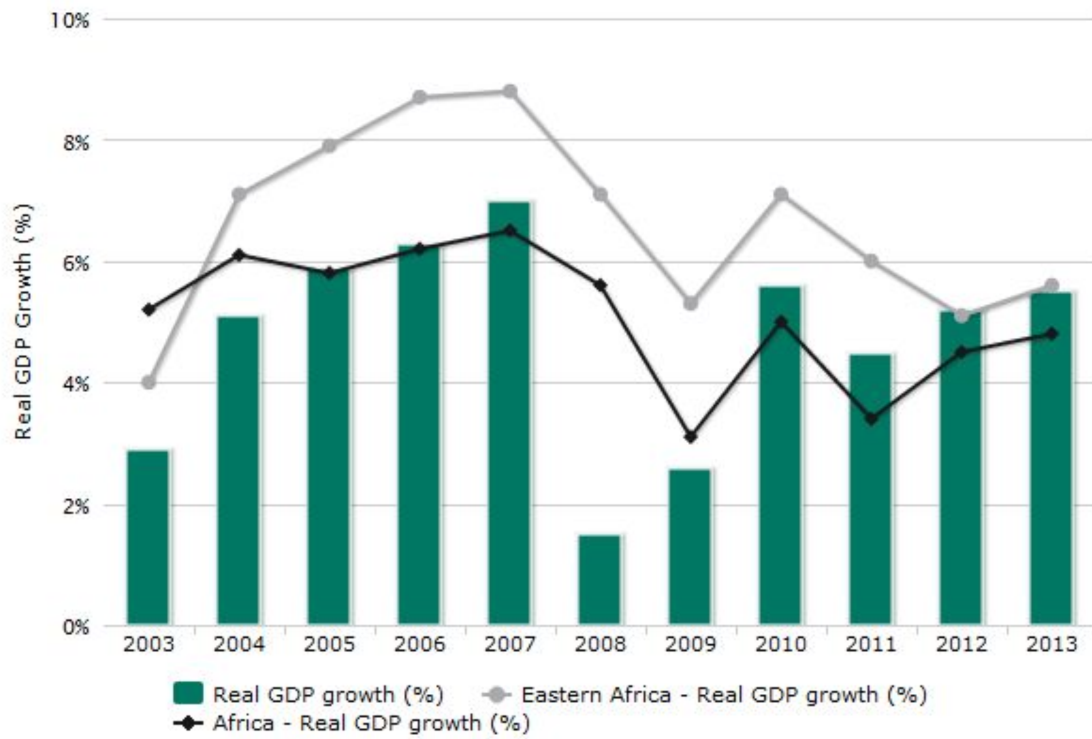
"… Growing together in trust…"

Core Values

- Professionalism
- Integrity
- Creativity and Innovation
- Teamwork
- Unity of Purpose
- Respect and dedication to customer care
- Effective Corporate Governance

Exhibit 6

Real GDP Growth East Africa and Africa



Figures for 2010 are estimates; for 2011 and later are projections.

Exhibit 7

Equity Bank Profit and Loss Account (for the year ended 31st December 2011)

	Note	Group		Bank	
In millions of Kenya Shillings		**2011**	2010	**2011**	2010
Interest income	8	19,339	13,775	18,376	12,885
Interest expense	8	(3,116)	(2,062)	(2,815)	(1,829)
Net interest income		**16,223**	**11,713**	**15,561**	**11,056**
Net fee and commission income	9(a)	2,349	1,644	2,034	1,528
Net fee and commission income		**2,349**	**1,644**	**2,034**	**1,528**
Net trading income	9(b)	2,423	2,925	1,274	2,437
Other operating income	10	7,675	5,871	6,598	5,172
Operating Income before impairment losses		**28,670**	**22,153**	**25,467**	**20,193**
Net impairment loss on financial assets	11	(1,630)	(1,905)	(1,533)	(1,558)
Operating income after Impairment losses		**27,040**	**20,248**	**23,934**	**18,635**
Personnel expenses	12	(6,009)	(5,266)	(5,185)	(4,455)
Operating lease expenses	13	(919)	(609)	(687)	(547)
Depreciation and amortisation	14, 15	(1,745)	(1,489)	(1,483)	(1,258)
Other expenses	16	(5,688)	(3,934)	(4,475)	(3,063)
Total Operating expenses		**(14,361)**	**(11,298)**	**(11,830)**	**(9,323)**
Profit before tax and equity income		12,679	8,950	12,104	9,312
Share of profit of associate	17(a)	155	95	-	95
Profit before income tax		12,834	9,045	12,104	9,407
Income tax expense	18	(2,509)	(1,913)	(2,330)	(1,852)
Profit for the year		**10,325**	**7,132**	**9,774**	**7,555**
Attributed to:					
Equity holders of the parent		**10,325**	**7,132**	**9,774**	**7,555**
Earnings per share(basic and diluted)	**29**	**2.79**	**1.93**	**2.64**	**2.04**

Exhibit 8

Equity Bank Balance Sheet (as at 31st December 2011)

	Note	Group		Bank	
In millions of Kenya Shillings		2011	2010	2011	2010
Assets					
Cash and cash equivalents	19(a)	35,282	18,503	19,130	11,747
Loans and advances to customers	20(b)	113,824	78,299	106,486	72,902
Finance lease receivable	20 (c)	1	3	-	-
Investment securities	21	30,502	31,988	30,199	31,911
Amounts due from related parties	22(g)	124	106	1,094	1,239
Other assets	23	5,038	3,784	4,707	3,235
Tax recoverable	18	53	86	-	-
Investments in associate	17(a)	1,366	1,260	1,260	1,260
Investments in subsidiary companies	17(b)	-	-	6,672	5,084
Property and equipment	14	7,592	6,970	6,044	5,693
Prepaid leases	14(c)	29	30	4	4
Intangible assets	15	1,352	1,041	1,076	754
Goodwill	17(c)	887	887	-	-
Deferred tax assets	24	244	61	239	61
Total assets		**196,294**	**143,018**	**176,911**	**133,890**
Liabilities					
Deposits from customers	25	144,165	104,431	125,492	95,204
Tax payable	18	487	701	417	657
Other liabilities	27	2,565	2,714	2,186	2,258
Borrowed funds	26	14,792	7,963	13,769	7,464
Deferred tax liabilities	24	-	5	-	-
Total liabilities		**162,009**	**115,814**	**141,864**	**105,583**
Equity					
Share capital	28(a)	1,851	1,851	1,851	1,851
Share premium	28(b)	12,161	12,161	12,161	12,161
Retained earnings		17,715	11,204	17,974	11,941
Available for sale reserve	28(c)	(1,062)	(990)	(1,062)	(990)
Loan loss reserve	28(d)	521	414	420	382
Foreign currency translation reserve	28(f)	(525)	(325)	-	-
Revaluation reserve		34	40	-	-
Other reserves	28(e)	(113)	(113)	-	-
Proposed dividends	28(g)	3,703	2,962	3,703	2,962
Total equity		**34,285**	**27,204**	**35,047**	**28,307**
Total liabilities and equity		**196,294**	**143,018**	**176,911**	**133,890**

Exhibit 9

Equity Bank Cash Flow Statement (as at 31st December 2011)

		Group		Bank	
In millions of Kenya Shillings	Note	**2011**	2010	**2011**	2010
Cash flows from operating activities					
Net profit before taxation		12,834	9,045	12,104	9,407
Adjustments for:					
Depreciation	14(a)	1,583	1,343	1,338	1,133
Amortisation of intangible assets	15(a)	162	146	145	125
Profit on disposal of fixed Assets		(7)	-	(3)	-
Provision for non-performing loans	11	1,630	1,905	1,533	1,558
Share of profit for associate	17a	(106)	(46)	-	(46)
Dividends received	17a	(49)	(49)	(49)	(49)
Interest on term borrowings	8	763	602	806	553
Operating profit before working capital changes		**16,810**	**12,946**	**15,874**	**12,681**
Loans and advances		(37,159)	(16,938)	(35,118)	(14,592)
Other assets		(1,254)	(1,071)	(1,472)	(101)
Finance lease Receivable		2	-	-	-
Customer deposits		39,734	34,588	30,289	29,379
Due from related parties		(16)	(96)	144	-
Other liabilities		(151)	1,160	(73)	1,042
Cash generated from operations		**17,966**	**30,589**	**9,644**	**28,409**
Income taxes paid	18	(2,875)	(1,294)	(2,747)	(1,270)
Net cash generated from operating activities		**15,091**	**29,295**	**6,897**	**27,139**
Cash flows to/from investing activities					
Purchase of property and equipment	14	(2,225)	(1,893)	(1, 689)	(1,633)
Purchase of intangible assets	15	(473)	(310)	(467)	(310)
Proceeds from sale of property, plant and equipment	14	25	22	4	-
Investment in subsidiary		-		(1,588)	(1,647)
Dividend received	17(a)	49	49	49	49
Purchase of investment securities	21	(22,546)	(31,534)	(22,248)	(31,532)
Proceeds from sale of investments securities	21	23,959	10,628	23,888	10,362
Restricted balances with Central bank		3,913	(1,820)	4,255	(1,392)
Net cash (used in) generated from investing activities		**2,702**	**(24,858)**	**2,204**	**(26,103)**
Cash flows used in financing activities					
Dividend paid	28(g)	(2,962)	(1,481)	(2,962)	(1,481)
Proceeds from long term borrowings		8,096	2,631	7,502	2,129
Repayment of long term borrowings		(1,267)	(1,154)	(1,197)	(780)
Interest paid on term borrowings	8	(763)	(602)	(806)	(553)
Net cash flow used in financing activities		**3,104**	**(606)**	**2,537**	**(685)**
Net increase/ (decrease) in cash and cash equivalents		20,897	3,831	11,638	351
Effect of foreign currency translation reserve		(205)	(143)	-	-
Cash and cash equivalents at the beginning of the year	19(b)	13,440	9,752	7,492	7,141
Cash and cash equivalents at the end of the year	**19(b)**	**34,132**	**13,440**	**19,130**	**7,492**

Exhibit 10

Loans and Advances to Customers (as at 31st December 2011)

	Group		Bank	
In millions of Kenya Shillings	**2011**	2010	**2011**	2010
Concentration by sector				
Consumer	40,298	33,401	37,563	31,970
Micro Credit	13,956	9,039	13,419	8,702
Agriculture	3,303	2,598	3,302	2,598
SME	27,211	20,692	22,983	17,083
Large SMEs	31,406	14,405	31,506	14,294
	116,174	**80,135**	**108,773**	**74,647**

Exhibit 11

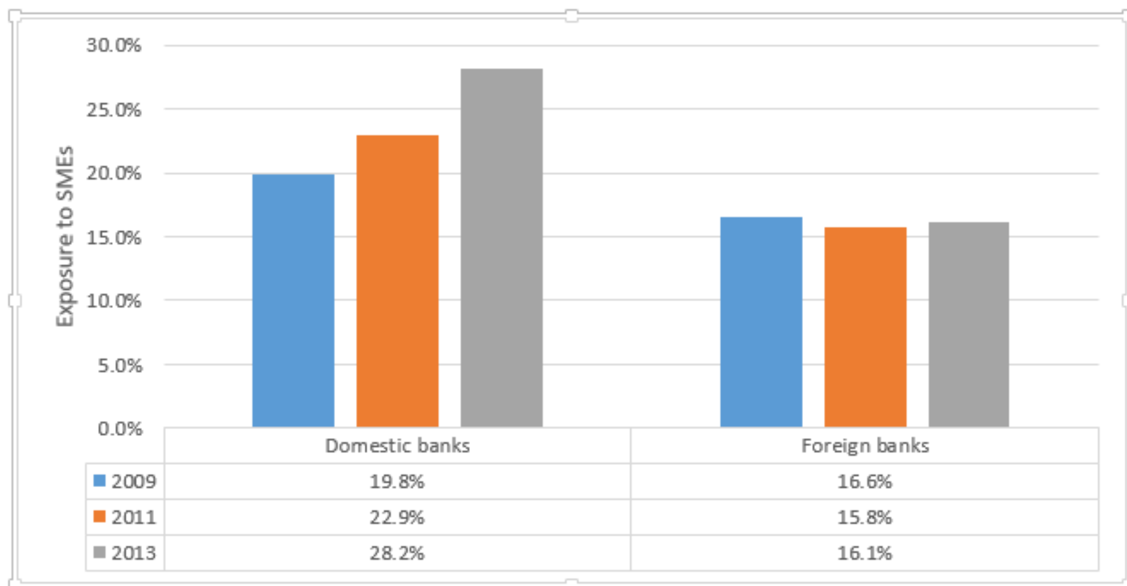


Figure – Exposure to SMEs in Kenya by Domestic and Foreign Banks

Source - https://blogs.worldbank.org/psd/smes-are-good-business-kenya-s-growing-banking-sector