



NO SMALL BUSINESS

A Segmented Approach to Better Finance for Micro and Small Enterprises

EXECUTIVE SUMMARY

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Micro and small enterprises, livelihoods of low-income populations, and the need for segmentation

Nearly half a billion micro and small enterprises (MSEs) in emerging markets provide livelihood opportunities for millions of low-income populations around the world (Dalberg 2019). Access to relevant, affordable, and responsible finance remains a persistent barrier, constraining stability and growth for these MSEs – especially the smallest firms and those in the informal sector. Estimated at a staggering \$4.9 trillion, the current unmet demand for finance reflects the limitations of traditional financial services providers (FSPs) in effectively serving MSEs (IFC 2017). However, recent advances in technology enable new digital business models that have the potential to overcome these limitations and provide MSEs with viable solutions for increased access to finance.

While the financial inclusion community has long focused on supporting MSEs, FSPs and funders tend to view the entire MSE sector as monolithic and do not consider the diversity of firms within that universe. The result has been one-size-fits-all solutions that deal with the

constraints felt by the entire sector. In reality, MSEs have a variety of motivations and journeys, differing financial and nonfinancial needs, and diverse experiences in accessing financial services. This Focus Note advocates the importance of a segmented approach to addressing MSE needs and focuses on MSEs with up to 20 employees.

This Focus Note is based on primary research conducted with 383 MSEs in India, Kenya, and Peru – three diverse emerging markets with a vibrant MSE finance ecosystem that includes strong incumbent providers like microfinance institutions, cooperatives, and banks, as well as innovative new providers like fintechs. The research profiled MSEs based on demographic and firm characteristics, explored their attitudes toward and experiences of accessing finance, and probed their unmet financial and nonfinancial needs. The respondents primarily came from the transport, manufacturing, and retail sectors, representing a significant majority of firms in the MSE universe. The differentiated insights from the research are important for FSPs to better serve their MSE clients. They are also relevant to the financial inclusion community as it endeavors to rebuild the MSE ecosystem in an inclusive and resilient manner in the wake of the ongoing COVID-19 pandemic.

Breaking down the MSE monolith

CGAP's research segmented MSEs into five dimensions:



I. SECTOR OF OPERATION

An MSE's choice of economic sector is shaped by its entrepreneur's gender, socioeconomic status, motivation, and ability to access productive assets. The sector dimension further influences growth prospects, as well as attitudes toward formalization, digitization, and financial services (see Figure 1).

FIGURE 1. Differences in MSEs by sector of operation

	Transport MSE	Retail MSE	Manufacturing MSE
Lifecycle capital needs	High upfront, tapers later	Low upfront, increases as MSE expands	<ul style="list-style-type: none"> High upfront (large scale, industrial production) Low throughout lifecycle (low scale, artisanal production)
Use of formal finance sources	At outset (vehicle serves as asset to collateralize)	Cautiously as MSE expands	<ul style="list-style-type: none"> At outset (large scale, industrial production) Cautiously (low scale, artisanal production)
Digital readiness	Low	High	High

II. ENTREPRENEURIAL MINDSET

CGAP's research suggests there are two types of entrepreneurial mindsets that determinately affect an MSE's business trajectory: **cautious entrepreneur** and **determined aspirant**.

While entrepreneurial mindset may be an effective way to predict preferences and behaviors, neither style is "better" than the other. Whether an individual is a cautious entrepreneur or a determined aspirant is often a reflection of socioeconomic factors and personal circumstances. Both entrepreneur types are critical in helping the MSE ecosystem to flourish (see Figure 2).

FIGURE 2. **Differences in MSEs by entrepreneurial mindset**

	Cautious entrepreneur	Determined aspirant
Entrepreneur's orientation	Enterprise stability	Enterprise growth
Entrepreneur's motivation	Alternative to low-wage labor to improve livelihoods	Build safety net, transition from wage job, fulfill entrepreneurial ambitions
Business decisions	Centered around focused and immediate livelihood goals (e.g., children's education, renovating a house)	Aligned with broader goals of advancing family's economic mobility, creating jobs, giving back to the local community, etc.
Attitude toward risk	Low-risk appetite manifests as reluctance to scale, formalize, or embrace new technologies	High-risk appetite manifests as constant hustle, plans to scale, seeking out new technologies to solve business needs
Attitude toward finance	Persistent preference for informal sources, hesitant to use credit products	Open to using formal sources over time, provided they are relevant and create value. Positive attitude toward and limited-but-judicious use of credit

III. MSE GROWTH STAGE

An MSE traverses at least three stages in its lifecycle: the **start-up stage**, the **stable operations stage**, and the **growth stage**. Not always a linear journey, the MSE often moves between stages multiple times.

MSEs typically start from a position of relative economic weakness and can afford to lose little, which lowers their risk threshold in the start-up stage. Even when an MSE enters the stable operations stage, its reliance on peers and informal channels is far greater than its reliance on formal providers. Awareness of financial and nonfinancial sources of support is shaped and improved by peer MSEs and social networks. Moreover, insufficient engagement with FSPs at the early and stable operations stages can leave an MSE in a poor position for the growth stage. With a lack of affordable entry points, it is left to self-finance, even though the privacy and leverage of working with formal providers is preferable.

IV. ENTREPRENEUR'S GENDER

A gender lens is essential to better understand the motivations and contexts that influence an MSE owner's journey and experience. It is not surprising that our research found sharp

differences between male and female entrepreneurs in access to resources, experience with FSPs, risk appetite, experience of social norms, and growth pathways.

Gender norms often push women to prioritize household responsibilities. These same norms, however, enable many women to choose operating a business over wage employment as it allows them to undertake an economic activity that includes flexibility around the use of their time, efforts, and work. On the other hand, a woman entrepreneur's choice of sector is often influenced by these norms and sometimes limits income opportunities. CGAP research suggests that while some women start businesses to support their families, many do so to achieve economic empowerment and independence. Thus, they are often motivated to seek funding from outside the family to preserve autonomy.

We found that women entrepreneurs seek stability in FSPs and demonstrate a preference for providers with female representation among their staff, client base, and marketing campaigns. More digitally savvy women entrepreneurs perceived greater safety when using digital solutions for commercial exchanges rather than face-to-face interactions with male counterparts. This finding suggests the potential for early adoption of digital financial services (DFS) by women entrepreneurs.

V. MSE SIZE

Most MSEs do not expand or grow into large businesses for multiple reasons, including a lack of access to finance, technology, markets, and human capital. CGAP's research suggests that an MSE's size is often associated with its owner's socioeconomic status, level of education, and social networks. MSEs that are larger at inception tend to be inherited family businesses or set up by entrepreneurs from advantaged socioeconomic backgrounds. Conversely, owner-run MSEs or those with few employees are often conceived on a small scale as an alternative to unstable employment. Additionally, growth in smaller MSEs is often via the creation of a portfolio of several small businesses rather than the growth of one business – led by the desire to diversify sources of income and manage the risk of putting all efforts and resources into a single enterprise.

Evidence also suggests that a business's size may be a good indicator of preference for formal vs informal finance, with smaller firms preferring the speed and lower collateral needs of informal finance. Conversely, larger MSEs tend to seek formal finance, particularly for growth. They have clear expectations on how providers should meet their needs.

Attitudes toward finance

PERSISTENT PREFERENCE FOR INFORMAL FINANCE

MSEs across segments reported a strong preference for informal over formal finance for several reasons. In their experience, formal FSPs demonstrate little or no trust and flexibility, while informal providers extend timely and affordable financing on flexible terms – with lower documentation and collateral requirements.

CGAP research suggests that MSEs, especially those in the stable and growth stages, are often loyal users of formal personal finance (e.g., savings accounts, term deposits, credit, debit cards). However, many enterprises find that loyalty does not result in increased or better access to finance due to excessive collateral requirements and the continued rejection of business loan applications.

Furthermore, while financial illiteracy is often cited as a reason MSEs cannot access finance, their exclusion is likely a result of the use of jargon and lackluster communication from FSPs that presents barriers to entry and excludes potentially responsible, growth-oriented customers.

DIGITAL FINANCE SKEPTICS

Most MSEs are unwilling early adopters of digital finance. The recent proliferation of the use of digital payments is more in response to COVID-19-related mobility restrictions and evolving customer and supplier preferences. MSEs remain reluctant adopters of many of the technologies their businesses rely on, especially if they lack agency and control over those technologies.

A deep-seated trust deficit in providers – especially DFS providers – continues to be a dominant barrier to increased uptake of formal finance by MSEs. Digital channels exacerbate the trust deficit due to the limited number of recourse mechanisms users have to enforce their rights. Lack of transparency on the use of customer data also remains a recurring concern.

Nevertheless, MSEs need formal financial services to accelerate growth and strengthen resilience. FSPs with a strategic inclination to serve MSEs can address these concerns by considering changes to their service approach for different MSE segments, including tailored services, greater trust built through increased transparency and clear communication, and strengthened recourse mechanisms with more human touchpoints.

Implications for the financial inclusion community

The devastating health and economic effects of the COVID-19 pandemic have disproportionately impacted MSEs, especially the smallest, women-owned, and informal-sector firms. However, one silver lining has emerged: the increased adoption of digital technologies by MSEs that were pushed to seek ways to keep commerce flowing during restrictions and lockdowns. Beyond operational efficiencies, MSEs that embrace digitization have the potential to access alternative forms of finance, streamline payments, and obtain new forms of insurance coverage. Digitization helps create small digital trails and alternative data that lenders can use to evaluate credit risk more effectively.

Rebuilding the livelihoods of millions of low-income populations and fostering resilience against future economic shocks requires both financial and nonfinancial support to the MSE ecosystem. But any support effort should begin by acknowledging the diversity within the MSE universe and embracing a segmented approach. It also requires the coordinated effort of several key stakeholders (see Figure 3).

FIGURE 3. **The role of stakeholders in rebuilding a resilient digital MSE finance ecosystem**

<p>Financial inclusion funders</p> <ul style="list-style-type: none"> • Provide patient capital to MSE-focused DFS providers • Support further research focused on segmentation of MSEs in other markets • Convene stakeholders to facilitate knowledge exchange 	<p>Development finance institutions (DFIs) and other investors</p> <ul style="list-style-type: none"> • Provide targeted financial support to DFS providers serving excluded MSEs in frontier markets • Deliver technical assistance to DFS providers to support customer segmentation 	<p>DFS providers</p> <ul style="list-style-type: none"> • Collaborate with the research community to identify barriers to access, especially those related to gender and social norms • Integrate segmentation with the organization's strategic priorities
<p>Sector support organizations</p> <ul style="list-style-type: none"> • Undertake advocacy and capacity building for MSE segmentation • Support communications campaigns and digital/financial literacy programs to increase MSE awareness of, trust in, and capacity to use DFS 	<p>Regulators</p> <ul style="list-style-type: none"> • Nurture an enabling regulatory environment that balances DFS innovation and customer protection • Create safeguards to protect new-to-digital customers from fraud and abuse • Conduct communications campaigns to increase MSE digital and financial literacy 	<p>Researchers</p> <ul style="list-style-type: none"> • Conduct further research on how best to profile MSEs and validate the need for a segmented approach • Undertake further impact research on MSEs and their owners on the benefits of tech-enabled finance • Clarify linkages and channels of impact – from enterprise to the improved livelihoods of low-income populations – and the role of finance

