FOCUS NOTE

CGAP

NO SMALL BUSINESS

A Segmented Approach to Better Finance for Micro and Small Enterprises

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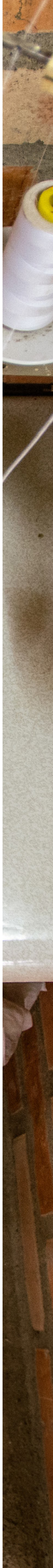

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EXECUTIVE SUMMARY

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:

Sector of Operation	Entrepreneur-ial Mindset	MSE Growth Stage	Entrepreneur's Gender	MSE Size

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	• 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	• 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**

Financial inclusion funders

- 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

Development finance institutions (DFIs) and other investors

- Provide targeted financial support to DFS providers serving excluded MSEs in frontier markets
- Deliver technical assistance to DFS providers to support customer segmentation

DFS providers

- 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

Sector support organizations

- 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

Regulators

- 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

Researchers

- 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

SECTION 1

INTRODUCTION

Gaps in Understanding Micro and Small Enterprises

Micro and small enterprises (MSEs) are important and valuable livelihood sources for low-income households in emerging markets. Through self-employment, MSEs create jobs for a large proportion of the world's poor population. CGAP and Dalberg research estimates that nearly 500 million MSEs exist in emerging markets, with Sub-Saharan Africa and South Asia accounting for half (Dalberg 2019). Eight-six percent of MSEs in emerging markets are micro enterprises with fewer than 10 employees. A vast majority have only one worker: the owner. A small number (approximately 86 million) employ up to 50 people. These MSEs are considered small enterprises.

Although usually quite small, MSEs play a disproportionately large role in the economies of developing countries, with firms of 5–19 employees contributing to as much as 50 percent of net job creation (Ayyagari et al. 2014). Although MSE owners generally create jobs for their household members rather than paid employment for outsiders, the sheer number of low-income populations in emerging markets positions the MSE sector as a critical driver for sustainable livelihoods. For many, it is often the only viable alternative to unemployment.

Given its significance for low-income populations and overall economic development, the international development community has long focused on the MSE sector. Yet much of what we know about MSEs remains theoretical; important knowledge gaps still exist. Despite decades of research, little is known about the unique characteristics of MSE owners, the trajectories of their businesses, and the role financial services play in supporting MSE owners and employees. Moreover, while research on microenterprises is extensive, it often relies on data such as the World Bank Country Indicators and Enterprise Surveys that exclude from their sample very small enterprises with fewer than five employees and informal enterprises, where much of the world's poor population is concentrated. Consequently, insights on how MSEs sustain and expand livelihoods are based on the experience of larger, more formal MSEs while small, informal, and the poorest MSEs often remain excluded.

Significant knowledge gaps persist with respect to the smallest MSEs. Some salient gaps relate to the productivity factors most relevant to them, the mindsets and strategies prevalent among owners and the motivations behind them, and, most importantly, the remaining unmet needs across different types of MSEs. Gaps mainly persist because information about larger firms is easier to access and the general belief that greater productivity – and therefore greater impact – lies with larger firms. Although the productivity and growth emerging through support to larger enterprises is important for overall economic development, an equally cogent argument can be made for focusing on sustainable livelihood generation and reduced levels of unemployment through smaller firms. Although often not growth-oriented, smaller firms provide low-income populations with stable employment and reliable livelihood support. They are a steppingstone toward reduced poverty – the ultimate focus of most economic development activity. It is imperative to take a balanced approach that also considers the needs of the smallest MSEs in the ecosystem.

A related and critical gap is the limited understanding of the details and nuances of segments that make up the larger universe of MSEs: firms with fewer than 20 employees. These firms are the focus of this paper. To better support these MSEs, it is important to understand how their journeys are impacted by the number of employees in the firm, gender and socioeconomic status of the firm's owner, entrepreneurial mindset (linked to gender and socioeconomic status), and business sector, among other attributes. Differentiating firms by these variables and taking a granular and segmented approach toward MSEs with fewer than 20 employees can provide valuable information for designing and implementing targeted support efforts. This is particularly significant at a time when the development community seeks solutions to rebuild the MSE ecosystem and promote greater economic resilience in the wake of the ongoing COVID- 19 pandemic.

Access to Finance for MSEs in the Digital Age

Access to finance is long recognized as an enabler of growth for MSEs globally. While results from studies on increased access to finance for MSEs are mixed and suggest potentially modest impact, it is strongly recognized that access to adequate and timely financial services goes a long way toward increasing resilience, stability, and growth opportunities for MSEs and, consequently, higher incomes and job security for low-income households (Kumaraswamy 2021).

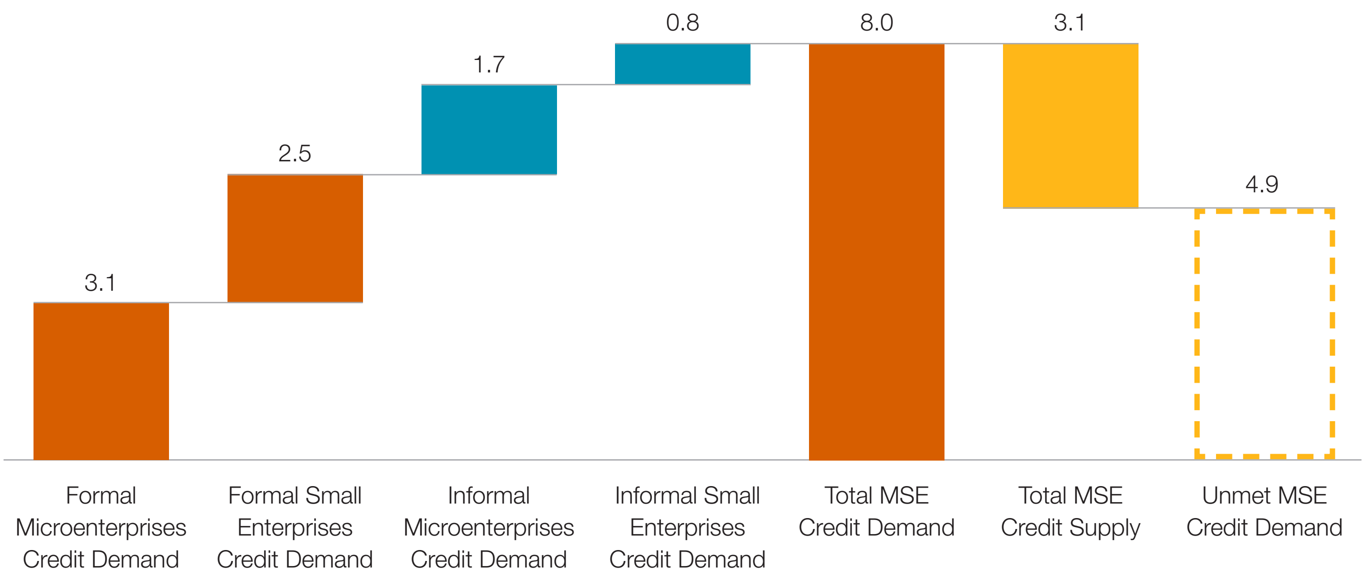
The International Finance Corporation (IFC) estimates the global demand for credit from MSEs in emerging markets at approximately $8 trillion, with 30 percent of demand coming from MSEs in the informal sector. At $3.94 trillion, credit demand is highest in East Asia, followed by $1.6 trillion in Latin America (IFC 2017).

Despite the enormous demand for credit, traditional finance mechanisms continue to underserve MSEs. The remaining $4.9 trillion finance gap constrains growth and employment for low-income households (see Figure 4).

The barriers to providing financial services to MSEs in emerging markets historically include:

- The high cost of customer acquisition and assessment
- Insufficient or inaccurate data to make accurate credit assessments
- Low lifetime customer value due to small loan sizes and short loan tenors
- Limited opportunities to cross-sell
- The high costs of distribution and servicing

FIGURE 4. **Estimated global MSE credit gap (in USD trillions)**



Source: Dalberg (2019) and IFC (2017)

Technology-enabled business models demonstrate significant potential to revolutionize MSE finance, particularly for firms with fewer than 20 employees that previously were too small, too costly, or too complex for traditional financial sector players to serve. The opportunity exists for incumbent financial institutions focused on providing productive finance to MSEs (e.g., microfinance institutions, financial cooperatives, credit unions, others) to adapt their existing business models to the emerging digital ecosystem. This allows those providers to serve new and existing customers more effectively. New entrants into the ecosystem, such as fintech start-ups, will also find the opportunity to create entirely new business models that help them serve a part of the market that is not served by others and is potentially difficult for incumbents to replicate. A deep understanding of several segments within the MSE universe is necessary and useful to either of these types of FSPs.

CGAP's Focus on MSEs

To better understand the characteristics and the financial/nonfinancial needs of MSEs – particularly those with fewer than 20 employees – CGAP conducted primary research with MSEs in India, Kenya, and Peru. The research methodology consisted of surveys, in-depth interviews, and focus group discussions designed to:

1. Understand the various factors affecting livelihood and income generation across different MSE segments
2. Examine the role of financial and nonfinancial services in supporting MSE livelihoods
3. Recommend ways in which FSPs, particularly DFS providers, can tailor their approach and offerings to better address the needs of MSEs

Details of the primary research methodology and sample structure can be found in the Annex.

This Focus Note presents a differentiated understanding of firms with fewer than 20 employees by first proposing key variables for effective segmentation, then describing how each MSE segment has different financial and nonfinancial needs, attitudes, preferences, and priorities. It also discusses how these differences impact the journey and growth trajectory of MSEs, and how this knowledge can be used to serve MSEs more effectively within the financial sector and improve access to finance for underserved and excluded MSEs.

Research Methodology

This Focus Note is based on primary research with 383 MSEs in India, Kenya, and Peru. The research methodology consisted of rapid online surveys, in-depth interviews (some conducted in-person, some remotely by video), and small group discussions. We adopted a convenience and snowball sampling approach, intentionally structuring the sample to cover MSEs of all sizes across three sectors, including women-owned MSEs. The sample consequently is not representative of the underlying population.

Insights presented in this paper are qualitative in nature and should be interpreted as such – and with caution. The goal is by no means to provide a definitive or comprehensive segmentation of MSEs in these markets. The purpose of the research and the paper is to demonstrate the diversity that exists within the MSE universe. It also underscores the importance of what we can learn by taking a segmented approach to a financially underserved and excluded population that is far too often perceived as a monolith by both providers and funders. Further research in this space is warranted and necessary.

A NOTE ON TERMINOLOGY

The terms *formal finance* and *informal finance* are often mentioned throughout this paper. Formal finance refers to sources of finance within the organized financial sector whose providers are regulated, such as banks, microfinance institutions, and DFS lenders. Informal finance refers to sources of finance outside the organized financial sector, including quasi-formal providers that are either less regulated or wholly unregulated. Examples include family, friends, neighborhood moneylenders, neighborhood savings groups, and rotating savings and credit associations.

Similarly, the term *digitization* (including but not limited to digital finance) is broadly used to refer to the use of digital tools and technologies to conduct business operations. It includes the use of e-commerce websites and social media like WhatsApp, Facebook, and Instagram for marketing and customer relationship management, and the use of computer software and mobile apps to maintain account and inventory books. It also refers to the use of DFS, such as digital payments, mobile money wallets, digital savings, and credit.

STRUCTURE OF THE PAPER

The remainder of the paper is structured as follows:

- **Section 2** highlights the importance of MSEs to the livelihoods and resilience strategies of low-income households in emerging markets, particularly as related to local communities and disadvantaged populations.
- **Section 3** breaks down the monolithic MSE sector to portray the great diversity within the universe of firms with fewer than 20 employees. It describes their unique characteristics and behaviors across demographic variables and firm characteristics.
- **Section 4** explores MSEs' attitudes toward finance: how they seek financing, which sources they prefer, their experience accessing formal finance, the extent to which they embrace digitization, and their unmet financial and nonfinancial needs.
- **Section 5** concludes with a discussion of implications for stakeholders in the MSE finance ecosystem.

A note on names and images: To protect the identities and privacy of resarch participants, all names used in the MSE profiles are fictional and the graphics illustrative.

SECTION 2

MSEs, JOB CREATION, AND LIVELIHOODS

Definition of MSEs

MSEs can be defined in various ways based on the number of people they employ, the value of their total assets, their revenue, and the amounts they borrow.

The IFC and OECD define micro enterprises as those with fewer than 10 employees, small enterprises as those with 10– 49 employees, and medium enterprises as those with 50–249 employees. Together they are considered micro, small, and medium enterprises

(MSMEs) and are defined as enterprises with fewer than 250 employees. Large enterprises employ 250 or more.[1]

While cognizant of these official definitions, CGAP's research focuses on the lowest end of the MSE spectrum, especially businesses with fewer than 20 employees. This subsegment represents the vast majority of enterprises in emerging markets that remain substantially financially excluded, despite being a significant livelihood source for low-income households. **Throughout this paper, MSE refers to micro and small enterprises that employ fewer than 20 people.**

MSEs and Livelihood

It is estimated that in developing economies, microenterprises with 5–19 employees create 50 percent or more of net employment, making them critical to building sustainable livelihoods (Ayyagari et al. 2014).

In emerging markets, most MSEs are very small, informal, and low productivity businesses operating in crowded markets with few barriers to entry (de Kok et al. 2013). Prevalent informality and limited opportunities for formal-sector wage employment make micro entrepreneurship the better, and often the only, source of sustainable livelihood for low-income households in emerging markets.

People start enterprises:

- Because they cannot find wage jobs that pay well
- To sustain and smooth incomes while they look for wage jobs
- To cope with health shocks that prevent them from seeking wage jobs
- To supplement income from and to finance agricultural activities

> **"I decided to create the job for myself. It's better even though I am making less money now. I have a greater peace of mind. I am my own boss. As much as the business has ups and downs, I have a chance to diversify. I can wake up tomorrow with another idea and get into it. The possibilities are endless."**
>
> — Male, leather and metal works manufacturing business owner, Kenya

MSEs can play an important role in generating livelihood and skills development within broader communities. They tend to be owner-operated, with many owners learning the trade from family members, former employers, peer MSE owners, or community members.

Few MSEs hire outside labor. In Sub-Saharan Africa, for example, 70 percent of MSEs have just one worker: the owner. Fewer than 20 percent engage family members, while only 10 percent hire outside

1 Further information about the taxonomies of micro, small, and medium enterprises are available at the IFC website: https://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/financial+institutions/priorities/ifcs+definitions+of+targeted+sectors and the OECD website: https://data.oecd.org/entrepreneur/enterprises-by-business-size.htm

labor and pay wages (Beegle and Christiaensen 2019). The sheer number of MSEs in emerging markets makes them important vehicles for income diversification and resilience, especially for low-income households, thereby helping to secure sustainable livelihoods and providing viable alternatives to unemployment. MSEs that employ outside labor tend to hire low- or semi-skilled workers, providing opportunities for skills development (OECD 2019). More educated MSE owners pass along skills to employees who otherwise may not have access to skills through education or training.

Proximity to their local communities makes MSEs responsive to community needs. They provide employment and opportunities for skills development across sectors and geographies, especially for low-skilled workers. Growth and productivity determines an MSE's ability to create employment and provide sustainable livelihoods. Since MSEs are mostly local and tend to hire low-skilled labor, they have the potential to provide opportunities that allow financially vulnerable, disadvantaged, or marginalized groups within their communities to participate in the economy. This includes young people, women, seniors, migrants, ethnic minorities, and disabled individuals.

"I also always wanted to create employment for other youth, the ones in my neighborhood, because in Kibera, you see young people on a bench and when I get back at night, I will see them on the same bench. So I thought maybe these are people who struggled just as I did, and I want to support them."

— Female, online women's fashion business owner, Kenya

CGAP research indicates that MSEs contribute to inclusion by serving low-income populations and frontier markets that are too small to scale and thus may not attract larger firms. The economic value add and employment opportunities they create are important channels for inclusive growth and poverty reduction, especially in emerging markets.

SECTION 3

SEGMENTING MSEs: BREAKING DOWN THE MONOLITH

Despite a large body of research about the MSE sector, many gaps in knowledge and understanding remain, particularly about MSEs in the informal sector. Existing research and data sources such as the World Bank Enterprise Surveys often exclude very small enterprises (those with fewer than five employees) and informal enterprises, both of which are central to understanding the world of MSEs.

Unlike large enterprises, most MSEs are not growth-oriented and remain small and less than optimally productive throughout their lifetime. Yet they have the potential to be an important – and often the only – source of livelihood for low-income populations in emerging markets. They can be a critical steppingstone in the journey out of poverty. Consequently, there is much to learn about how low-income populations take up enterprise to secure sustainable livelihoods for themselves and their employees, their entrepreneurial journeys and needs, and the role of financial services in enabling them to achieve desired outcomes.

Even less is known about the peculiarities and nuances of various segments within the MSE universe. MSEs are not homogenous; there are a great variety of sizes, growth prospects, ambitions, and business needs. Yet few efforts have been made to segment MSEs and build a differentiated understanding of their unique needs.

A segmented approach can be invaluable in helping FSPs better serve MSEs and strengthen the ways development funders support their improved financial inclusion. MSEs can be differentiated by:

Sector of Operation	Entrepreneur-ial Mindset	MSE Growth Stage	Entrepreneur's Gender	MSE Size

Sector of Operation

CGAP's research focused on MSEs from three economic sectors: transport, retail, and manufacturing. These sectors encompass a variety of firm characteristics, such as asset and technology intensity, seasonality, digital readiness, and level of formality. The sectors also illustrate diverse financial needs – from working capital and asset financing to growth capital – hence providing a strong demand-side representation of MSEs. Firms across the three sectors in the selected sample covered a spectrum of MSEs, including single-member enterprises, women-owned and headed enterprises, and multigenerational family-run enterprises.

An MSE owner's choice of sector is influenced by factors such as socioeconomic status, gender, access to assets, and entrepreneurial motivation.

SOCIOECONOMIC STATUS OF MSE OWNER AND AVAILABILITY OF ASSETS/CAPITAL FOR START-UP

Advantaged entrepreneurs with higher socioeconomic status (SES) have more flexibility in their choice of sector and are equally seen across transport, retail, and manufacturing. Their businesses are often inherited from family members rather than built from the ground up. Due to their ability to finance assets through loans from social networks or formal, low-cost asset financing sources, higher SES entrepreneurs are more prevalent in asset-intensive sectors such as transport and manufacturing. On the other hand, low SES entrepreneurs prefer retail MSEs because they are inexpensive, quick to start up, and require much lower asset investment. For the same reasons, retail is often more attractive to entrepreneurs looking to start a new line of business as an alternative income source.

MOTIVATION FOR START-UP

Despite the somewhat limited growth prospects, the retail sector's low barriers to entry attracts entrepreneurs seeking more stable income relative to wage jobs. Entrepreneurs seeking to increase wealth and build a bigger base for their families and communities are concentrated in the transport and manufacturing sectors (provided they're able to finance investments upfront). These sectors provide significantly better opportunities for growth and expansion.

ENTREPRENEUR'S GENDER

Women face barriers that may influence their choice of sector when starting MSEs. Since they are often expected to prioritize caregiving and domestic responsibilities, women are left with little time to take on economically productive activities. They also face constraints in mobility due to a lack of safe and reliable transport facilities, supporting infrastructure, fear for physical safety, and restrictive gender norms. Consequently, they tend to start home-based businesses in sectors considered "appropriate" for women. This may limit their ability to grow enterprises and incomes beyond a certain size.

Throughout the lifecycle, MSE capital needs vary substantially by sector: transport requires higher upfront investment, retail requires low start-up capital, and initial capital needs in the manufacturing sector depend on enterprise scale.

Transport sector MSEs require significant upfront investment, even on a small scale. However, capital needs do not significantly grow throughout the business lifecycle. They tend to remain at low and stable levels, unlike retail and manufacturing where investment for growth and expansion can substantially increase the need for capital.

Retail sector MSEs are not asset or labor intensive and are easier to set up with less upfront investment. Most retail MSEs are cash and carry businesses with low liquidity needs.[2] Those selling fast-moving consumer goods have a limited need to stock inventory, further decreasing the need for working capital. Adopting digital channels for sales, marketing, and logistics creates further opportunities for retail sector MSEs to decrease capital needs.

Manufacturing sector MSEs have capital needs that depend on the scale and complexity of the business. For example, capital needs can range from substantial asset financing for a manufacturing unit's machinery to a minimal amount of working capital to cover labor and overhead for a small, artisanal business.

Although all three sectors access finance through a combination of formal and informal sources, when they shift from informal to formal finance and the type of formal institutions they seek out differs by sector.

2 "Cash and carry" businesses sell or provide goods on the spot for cash. Transactions usually do not include delivery service.

Transport sector MSEs typically need financing to invest in a fleet at start-up and again during the expansion phase. MSEs, including low SES MSEs, typically purchase their first vehicle through asset financing products from banks and nonbank financial institutions (NBFIs). In most cases the seller or dealer arranges financing, or a down payment is financed through personal savings or informal loans from family and friends. Few transport MSEs report difficulty accessing formal asset finance. Despite the proliferation of digital payments, the transport sector is cash-based in many markets and cash receipts are settled daily or weekly. Consequently, business expenses require limited financing and are usually funded through business revenue or, in some cases, through overdraft facilities.

Transport MSEs have little trouble accessing asset financing from banks or seller-referred NBFIs. They feel better supported by FSPs compared to their peers in the retail and manufacturing sectors. They usually have good relationships with providers and look to them for financial and business guidance.

Retail sector MSEs require lower amounts of capital during start-up but need frequent short-term financing to cover operating expenses such as the cost of raw materials, labor, premises, and other overhead. The lack of affordable short-term financing drives these MSEs (especially smaller and low SES MSEs) to seek financing from family and friends, peer MSE owners in the community, local savings and credit groups, and others who are likely to be flexible when the MSE experiences a shock or delays repayment. The size and scale of the business doesn't lend itself to formal financial products such as purchase order or inventory financing, trade credit, or working capital loans. When retail MSEs use formal financial services, they normally access retail or personal credit rather than business credit. Larger, more advantaged MSEs can generally access bank overdraft facilities and get credit from suppliers to manage their liquidity needs.

As financing needs arise, retail MSEs expand or pursue growth opportunities through vertical integration or product diversification. But existing sources of finance often do not meet their growth needs. Loan requirements are larger than the amount typical microfinance institutions, DFS lenders, or savings groups can provide, and MSEs often lack the credit history or documentation banks need to finance growth capital. Many MSEs report that they have used digital credit apps or platforms but found costs too high, loan tenor too short, and loan size too small.

Retail MSEs in some markets operate digital wallets to meet specific customer requests and preferences. They see multiple digital wallets as a burden and prefer to maintain one provider at a time. In some cases, formal providers deny or partially address requests for finance and are therefore perceived as hostile or disinterested. However, some MSEs try multiple times and occasionally use retail savings or current accounts for emergency savings.

> **"In the construction field you can't just invest everything you have into equipment. You have to get financing. I was looking forward to, and still am, being financed to purchase equipment and machinery and trucks."**
> - Male, construction and logistics business owner, Kenya

Manufacturing sector MSEs have substantially higher financing needs than their retail or transport sector counterparts. They need long-term loans to cover the start-up costs of machinery and premises

and expansion costs down the road. They need short-term loans to cover costs of inputs, labor, storage, and shipping, and to finance receivables. Liquidity needs are more pronounced for MSEs that accept large orders or experience seasonal demand.

Larger and more advantaged MSEs access formal financing for their start-up and growth needs while smaller and low SES MSEs rely on personal savings and informal loans from friends and family. This has implications for size (cottage vs industrial), type of manufacturing setup (machine intensive vs artisanal), and how long it takes an entrepreneur to start up (immediate with financing vs having to wait and save up capital). Most manufacturing MSEs struggle to find affordable short-term financing for working capital while some larger MSEs manage with bank overdraft facilities. Smaller and low SES MSEs tap into personal savings but typically cope by not accepting large orders, foregoing expansion, or deliberately keeping their enterprise small.

MSEs across the three sectors often express skepticism about digital credit, even if they use digital payments. They have low trust in digital credit providers and share concerns over data privacy, aggressive repayment follow-up tactics, and high penalties for slightly delayed payments. While some MSEs had negative experiences, most based their opinions on the experiences of friends and family, or hearsay. They are comfortable with digital payments but feel they lack sufficient motivation (and value) to further digitize. They also see DFS payments as simple and remain cautiously open to new payments offers.

MSEs across sectors often use personal accounts as business accounts. This suggests the opportunity to increase awareness on how business financial services differ from retail finance, and to better design business accounts to meet MSE-specific needs.

Transport MSEs (particularly those run by more advantaged owners) usually meet their financing needs through formal credit products like asset finance. However, smaller and low SES MSEs need increased access to these solutions as well. Transport MSEs consistently express the need for affordable, easy-to-use technological solutions to digitize bookkeeping and facilitate greater control over revenue and expenses. In a cash-dominated sector like transport, greater use of nonfinancial digital solutions could substantially increase the future adoption of formal DFS as well.

Retail MSEs, with their higher rates of informality, reliance on personal finance, and absence of collateral, are poor candidates for the sizable, flexible, and affordable finance they need to scale. As a result, growth slows or stalls early on in their journey, forcing many to rely on personal savings for growth. Smaller retail MSEs lack the tools that enable them to track business performance beyond revenues and savings.

Manufacturing MSEs often work with informal enterprises. This poses a challenge in financing inventory or receivables. Manufacturers broadly need better awareness of and ease of access to affordable inventory and invoice financing. On the other hand, "factoring" may be too expensive for MSEs with tight margins.[3]

While digitization is recognized as critical for the future, it poses unique challenges for MSEs in each sector.

Transport MSEs see digitization as a way to secure revenue but the process can be challenging. It requires investment, adoption of new technology, and customer behavioral change. The global proliferation of digital payments creates opportunities to accelerate digitization among transport MSEs. **Retail sector MSE** digitization is often limited to adopting digital payments and using mobile communications apps like WhatsApp or Facebook Messenger to receive customer orders, manage delivery, maintain customer relationships, etc. Since use is spread across numerous providers and platforms, it is difficult to manage further digitization. MSEs need accessible, affordable tools to tame digital complexity and to reconcile accounts, digital wallets, cash, inventory flows, and receivables.

"In this business everyone pays in cash. People can buy tickets and get in and get out. So it's difficult to manage. You must have trust in the employees. It's not that I don't want to make it digital. Our business just happens in cash."
— Male, taxi fleet owner, India

Manufacturing MSEs need financial, inventory, and project management tools to manage stock, staff, and liquidity. Liquidity needs can be quite complex and must take into account raw materials procurement, production, sales, and settling receivables. Data generated through digital tools may present opportunities to further channel financial services to MSEs.

3 Factoring is a way in which businesses raise money by selling their accounts receivable to an intermediary known as a "factor" in exchange for cash and at a discounted price.

Meet Innocent and Fatouma, Kenyan entrepreneurs who operate a camping gear and bag manufacturing business and are actively seeking growth capital from formal providers

Innocent, 48, lives in Nairobi with his wife, Fatouma, and their three children. Inspired by his childhood love of camping, he owns a small business that manufactures and retails camping gear, shoes, and bags. Innocent and Fatouma invested their life savings of 500,000 Kenyan shillings (KSh) as start-up capital.

Due to the seasonal demand for camping gear, business income widely fluctuates. Innocent and Fatouma want to secure larger customer orders and diversify into manufacturing other goods. They'll need to buy more equipment and move to a larger premises.

They need 4–5 million KSh to fund the expansion. However, their business revenue has been severely affected by the COVID-19 pandemic and is not high enough for banks to consider giving them a loan. Banks also need audited account books before they decide to lend, and at 30,000 KSH, the cost of an audit is prohibitive.

Despite their familiarity with MFIs and DFS lenders, Innocent and Fatouma do not consider this an option due to their high interest rates and small loan sizes. The couple is currently focused on building back their business and developing a good relationship with their bank in the hopes of borrowing in the future.

"We're looking at a loan of around 4–5 million Kenyan shillings. It is best to borrow through a bank. With a bank, the rate of interest is around 9–12 percent, but others charge 18–25 percent. It is too high."

Entrepreneurial Mindset

Understanding the entrepreneurial mindset as part of MSE segment analysis is imperative for designing tailored support programs. However, it is important to avoid normative judgement about the cautious entrepreneur mindset vs the determined aspirant mindset and appreciate that both are equally valid. The factors that shape an MSE owner may be grounded in socioeconomic factors and social norms beyond their control. Both types of entrepreneurs play important roles in providing sustainable livelihoods for families and communities.

Along with socioeconomic factors, an MSE owner's mindset significantly influences their entrepreneurial journey, including decisions about business size, number of employees, economic sector, level of formalization, and growth aspirations.

Entrepreneurial mindset is a key factor in aspects of the MSE journey. CGAP research suggests that MSE owners primarily fall into one of two mindsets: cautious entrepreneur or determined aspirant. Although differences exist, both are extremely resourceful and driven.

- Cautious entrepreneurs tend to be tenacious and resourceful. They strongly value stability over growth and rarely grow their business beyond a certain level. When they do seek growth, it is through new business lines rather than expansion of existing businesses. They cautiously manage costs and overhead, demonstrating a preference to remain informal, including in their choice of finance provider.
- Determined aspirants are often optimistic and confident. They are strongly growth-oriented but value stability, and all their business actions are targeted toward growth. They are quite strategic in planning and formalizing systems early on, including for finances. They are inclined to be collaborative and willing to consider partnerships.

The mindset of an MSE owner has an important impact on business size at inception and growth trajectory (see Figure 5). Cautious entrepreneurs tend to start businesses as an alternative to low-wage labor and to improve their livelihoods. Determined aspirants are strongly driven by the need to build a safety net and transition away from decent (but somewhat unstable) employment.

FIGURE 5. **Differences in MSE characteristics and growth orientation by entrepreneur's mindset**

	Cautious entrepreneur	Determined aspirant
Business size	• Usually smaller, mostly retail MSEs • Most have fewer than five employees • Hire labor by the job rather than by increasing regular staff • Prioritize controlling overhead by minimizing employee count • In periods of shock or contraction, feel well-served by their smaller size; quickly adjust via cost controls and lowering overhead	• Mid-sized MSEs with 1–4 or 5–19 employees • The larger of these MSEs often have multiple owners in partnership, offering better networks and broader expertise to draw on for capital resources, business leads, labor pool, and management capacity
Attitude toward growth	• Prioritize resilience over growth, with a focus on sustainable livelihoods • Those that grow significantly often do so by starting new business lines rather than growing any single business • Turnover is too low to rapidly generate sizable lump sums, so growth is severely constrained	• While focused on growth, not necessarily "hurried" growers; just as focused on stability • Patient and often do not draw a salary from the MSE at start-up, preferring to wait until turnover is substantially higher with business growth • Actively seek growth opportunities; sometimes become too large for informal networks yet too small or unestablished for formal providers

While different types of business owners can be found in all sectors, cautious entrepreneurs tend to focus on retail and services while determined aspirants seem to prefer manufacturing and transport.

An MSE owner's choice of sector also provides insight into their entrepreneurial mindset.

Cautious entrepreneurs mostly focus on business in the less asset-intensive retail and services sectors. They often cannot afford or access financing for equipment, materials, or the staff required to run a manufacturing MSE – apart from simple products such as handicrafts, which may be inexpensive to start up but difficult to scale due to a lack of skilled labor. Although transport sees some engagement from cautious entrepreneurs, those who venture into the sector often previously performed platform work (e.g., driving a motorbike) and can expand solely through financing from friends and family.

Determined aspirants, while well-represented in all three sectors, have greater presence in sectors with higher growth potential – manufacturing and transport. Those in manufacturing typically engage in high-skill, value-added crafts or construction but rarely have the capital for scalable commodity production. Transport MSEs may have fleets of passenger vehicles or local transport buses but rarely the capital to acquire large fleets or to finance the bulk fuel supplies and commercial trucks required to regionally transport goods. Finally, retail and services owners are often able to scale to a second physical location for the same business or add a different product or service line.

Cautious entrepreneurs are reluctant to formalize and digitize. Determined aspirants informally start businesses with the intent to formalize as soon as possible, and welcome digitization throughout business processes (see Figure 6).

FIGURE 6. **Differences in MSE attitudes by entrepreneur's mindset**

	Cautious entrepreneur	Determined aspirant
Formalization	• Slow and reluctant to formalize due to concerns over costs of registration, reporting, and taxes • Most are content with the retail financial solutions they can informally access • Often do not feel their reluctance is a problem as they rarely have the opportunity to conduct business with larger, more formalized enterprises or governments that typically require formalization	• Often start informally, backed by personal and social sources of financing; intend to formalize from the outset • Believe that provider business services' know-your-customer (KYC) requirements require multiple years of registration so want to formalize well in advance of planned investments • Also formalize to position themselves for opportunities to transact with larger businesses and governments that require contractor registration
Digitization	• May consider digitization burdensome but understand it is essential to use social platforms and DFS payments • Digital interactions are frequently mediated on social platforms • Unlikely to have an independent e-commerce web presence but frequently use informal online commerce channels • Often feel compelled to adopt digital payments platforms to facilitate sales in response to customer demand • Guided by younger members of the family or community	• Consider digitization an opportunity but need advice and support to understand which products best reward efforts to adopt and maintain • Tend to begin digitizing to meet tax and reporting requirements, however, sophistication remains low for a while and the process is still highly manual • Significantly increased use of social commerce and e-commerce channels during the pandemic; particularly determined aspirants in the retail and services sectors

An MSE owner's attitude toward finance and growth is closely linked to mindset. Cautious entrepreneurs demonstrate a stronger preference for informal finance.

Cautious entrepreneurs tend to prefer informal finance. They distrust formal providers but are cautiously open to DFS. Most are uncomfortable with debt and fund additional investments through savings. Those who seek credit from formal providers are typically denied or offered financing that is a lower amount and more costly than expected. As a result, they tend to view formal providers as disinterested or hostile, harboring class prejudice. Expecting an adversarial dynamic, they are often reluctant to try for loans again and generally are skeptical of new providers or services. Despite this skepticism, they remain open to learning about new providers or services from social platform ads, friends, suppliers, and MSE peers.

"Peruvians want to grow their business. Unfortunately, people don't realize that they should use money to produce more money. When you take a loan, it would be useful to make sure that you are using funds in the best way possible to produce a gain on top of what you need to pay back."
— Male, tire manufacturing, Peru (Determined Aspirant)

Determined aspirants are strategic about financial services usage and prioritize adoption of basic accounts and services. They believe creditworthiness grows simply because they are an active account holder. While proactive in learning about and trying new products and services, they often struggle to navigate provider systems and services and feel that formal financial systems are biased. Moreover, longer-term engagement with financial services does not reflect a higher level of financial literacy. It is often merely a reflection of their comfort level with current usage. Determined aspirants ideally seek single providers that provide preferential access and rates for new or beneficial services that are tailored to their business in response to loyalty.

Meet Kishan, a cautious entrepreneur who moved from rural India to the city of New Delhi and built a transport business to support his family

"When customers pay using PayTM, the money takes time to get deposited in my bank. Sometimes the money gets 'stuck' in the phone. There's also a different feeling when you see what you have earned at the end of the day as cash."

Kishan, 38, migrated to New Delhi from his village in Uttarakhand in search of a better life for his family. Starting off as a bus conductor and mechanic, he taught himself how to drive, obtained a commercial driver's license, and now owns a small transport business with a fleet of three autorickshaws and a minibus.

Kishan financed his first autorickshaw with his savings, along with loans from friends and family. He obtained asset finance for additional vehicles from ICICI Bank, arranged through the autorickshaw dealer. Borrowing from banks is important to Kishan as he believes it will help him expand and formalize his business and, in turn, facilitate greater access to finance. He prefers private banks like ICICI over public-sector banks because of their professionalism and helpful, customer-friendly nature.

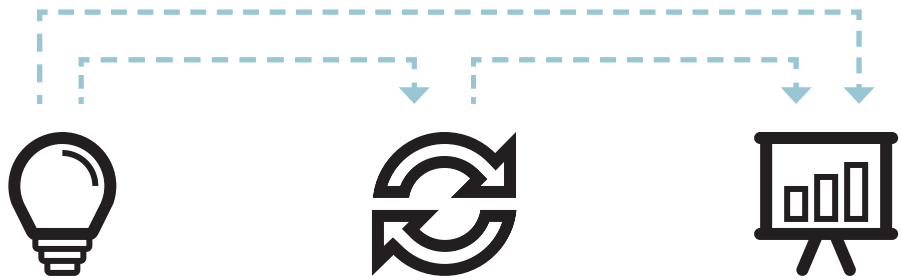
Based on his friends' experience, Kishan is skeptical of MFIs and DFS providers. He prefers to receive income in cash because digital wallets like PayTM sometime cause friction – like money not immediately reaching his bank account or data connectivity issues.

To cope with the economic setbacks of the COVID-19 pandemic, he cut employee pay in half, tightened his household budget, and dipped into his savings. Kishan also used the temporary debt repayment waiver his bank granted. While he wants to add cars to his fleet and solicit corporate clients, he is currently unable to plan this expansion as business continues to suffer due to the adverse impacts of the pandemic.

MSE Growth Stage

MSEs traverse multiple stages throughout their business journey, including the start-up and early stage, stable operations stage, and growth stage. While most traverse at least two stages in the course of the journey, the trajectory is not always linear and often does not follow a specific order (see Figure 7).

FIGURE 7. **Three stages of growth for MSEs**



Start-up and early stage
In this stage, MSEs launch and set up the business, arrange seed capital, establish market access, secure assets or inventory, start production, and identify the processes and services they'll rely on in the future.

Stable operations stage
MSEs in this stage have established the key processes, relationships, and services that keep the business operating. They are not significantly changing in size or commercial activity. They have identified critical business cycle patterns and how to manage them, as well as risks to mitigate and barriers to overcome.

Growth stage
Growth stage MSEs aim to increase headcount, improve sales, launch new product offerings or service lines, grow asset holdings, expand or upgrade locations, and augment commercial sectors and activities. They also seek to address the shocks and challenges that threaten the business, strategically respond to setbacks, and build resilience.

Start-up MSEs tend to function in risk-averse, unstable environments. At the early stages of their business, entrepreneurs often begin from a position of relative economic weakness and can afford to lose little. This lowers their risk threshold.

Early and start-up stage MSEs often lack the data, customer relationship management (CRM), and business insights tools to form a strategic understanding of their business – an understanding that can guide investment. Early-stage owners often learn the trade by working for other MSE owners. Others tap into family and the community for mutual support that otherwise may be difficult to access. Some MSEs use a family member's creditworthiness as a resource, registering a business and opening financial accounts in that person's name. In the start-up stage, they often use personal savings or subsidize the business with secondary employment, both especially viable strategies for small-scale retail MSEs.

> **“There are so many incentives I am able to get from a member of a SACCO vs from a bank. With the SACCO, they are flexible. Whenever something happens they can give me a refreeze. That cannot happen with a bank. The SACCO is also able to give me a dividend. The return also trickles down while a bank keeps all their profit.”**
> — Male, firewood delivery business owner, Kenya

While formal and informal financial channels each offer distinct value for MSEs, experience with low-cost, flexible terms and speed of access to informal sources sets up high expectations on how formal finance should work. Friends and family are often the only financing option at start-up. Even when formal options exist, they cannot compete with fast, free, flexible start-up capital from informal sources. By limiting the size of their loans from individual sources, MSEs increase the odds that informal and formal lenders will deem their request low-risk. Informal sources also provide valuable networking opportunities for MSEs to learn and improve their business. The use of informal finance also serves the important function of reinforcing social bonds and upholding community norms of reciprocity.

Even when an MSE enters the stable operations stage, reliance on peers and online communication channels is far greater than reliance on formal providers. The MSE’s awareness of financial and nonfinancial sources of support is influenced and improved by how savvy their peer MSEs and social networks tend to be.

MSE perceptions of formal FSPs are often based on their own experience and the experience of family, friends, and peers. Both good and bad experiences amplify throughout networks. These perceptions, once formed, are sticky. MSEs tend to represent and respond to peer experience as if it were their own.

Even when MSEs are aware of and have a positive opinion of formal financial services, they don’t find them to match the value of informal sources in terms of timeliness, affordability, and ease of obtaining finance.

MSEs in the stable operations stage tend to increase adoption of formal finance in response to advice from suppliers, customer needs, and personal outreach from FSPs. While they often receive low-cost, short-term financing directly from suppliers, these MSEs eventually hit order volumes their suppliers cannot finance. Suppliers frequently suggest other providers and/or products and MSEs generally take that advice, even when it carries switching costs from current providers.

Stable stage MSEs are likely to embrace formal financial services (e.g., digital payments) in response to customer needs and preferences. With the proliferation of mobile and digital payments, especially in markets like Kenya and India, MSEs – including low SES and low digital literacy MSEs – have rapidly adopted products like GooglePay, PayTM, and M-PESA.

Personal outreach by providers at MSE locations increases trust in formal finance and makes MSEs more open to new financial products and providers.

It is important to note that FSPs don't always support stable stage MSEs with relevant financial products. MSEs seek products that address several financial needs at once (e.g., savings and credit, payments and credit). They also value products that address combined financial and nonfinancial needs (e.g., a bookkeeping app with embedded credit options, a vehicle dealer that arranges financing and insurance).

Holistic, one-stop solutions carry greater value than à la carte products and can be more affordable when responsibly structured. An innovative product bundle or embedded financing can be a valuable way for an MSE to try new products. However, FSPs must restrain from cross-selling products that could be perceived as unneccesary or excessive to MSE business requirements, as this type of activity has the potential to damage long-term trust.

Lack of engagement with FSPs at the early and stable operations stages poorly positions an MSE for growth.

Even in DFS, MSEs prefer to use savings-backed credit products that address multiple financial needs (e.g., liquidity management, resilience). In Kenya, products such as Fuliza and M-Shwari are examples of financial tools MSEs viewed as complementary to credit products. They find that these services de-risk financing while building creditworthiness, similar to savings and credit with rotating savings and credit associations (ROSCAs) or savings and credit cooperative organizations (SACCOs).

"It would have required between $10–15k from the company. And do you know how long the process to release company funds would take? I don't know, I was speculating, they didn't give me the final time. The interest rate was 30-40 percent and obviously I did not want to borrow with such a high rate. That is why I prefer to withdraw funds from my pension because this business is going to become my pension of the future."
— Male, bicycle messenger business owner, Peru

For many growth stage MSEs, obtaining growth financing from formal providers can be an alienating, unforgiving, slow, and unclear process. These providers offer limited service and zero guidance to MSEs still working to establish and grow.

Without access to affordable entry points, MSEs may be forced to grow organically and achieve capital investment goals through savings and cash flows. The growth stage is an opportune time for FSPs to engage with MSEs since wariness of formal credit usage often reflects broader social norms around indebtedness.

Formal providers can help even MSEs building their enterprises with social or informal finance to taper off friends and family in the growth stage. Formal providers offer privacy and allow MSEs to access finance without the risk of social pressure to borrow smaller sums, to reciprocate by lending to social networks, or to consider unsolicited opinions and business advice, among other things.

When social norms frame debt as pure risk rather than an investment tool, the privacy of formal channels can insulate MSEs from social pressure. However, when formal providers deny MSEs credit access after years of patronage and with little explanation on why or how to address it, this rejection can trigger widespread frustration and distrust toward banks and all formal financial providers. Once disappointed, many MSEs, particularly those seeking growth capital,

Meet Maria, an entrepreneur who runs a stable upcycled handicrafts business that supports indigenous communities in Peru

Maria, a 29-year-old entrepreneur, lives with her parents in Lima, Peru. In 2019 she used her savings to start a small business – selling native handicrafts made by indigenous communities in the Peruvian Amazon.

Maria was hesitant to take a loan to grow her business and instead registered to access government grants and programs. She won a business support challenge award, which provided access to funds and mentoring support on cash-flow challenges, distribution, and growing a business. She employs her sister, two part-time staff members, and a designer (paid on commission). She keeps track of monthly costs in an Excel sheet that she shares with her team. Eighty percent of monthly revenue is reinvested in the business, and Maria keeps the remaining 20 percent in lieu of a salary. Her estimated profit margin is 30–40 percent.

Suppliers from the indigenous community are paid in cash but Maria is building a credit history by using her business account for all other transactions. She opened an Interbank business account to receive payments from institutional buyers and accepts digital payments from individual customers. Products are promoted through her website and she wants to explore existing e-commerce platforms but is hesitant, given the high fees. Her biggest challenges are managing cashflow for bulk expenses like packaging materials and growing her customer base. Maria has been offered loans by banks but is reluctant to apply, even though she contemplates growing her business.

"If you want to do something, you can't start with money that isn't yours because there's a lot of risk. On the internet, all banks can see your transactions and how much you're saving. They often call us to offer more credit but we don't need it."

are reluctant to try again with any formal provider.

Gender of Owner

An MSE owner's gender can be a crucial factor in understanding the motivations and context that guides the enterprise's journey. CGAP's research expectedly indicates sharp disparities in the experiences of male and female entrepreneurs with respect to access to resources, experience with all types of financial and nonfinancial services providers, freedom and willingness to grow businesses, and overall risk appetite. Gender norms play a critical role in the MSE growth journey.

Enterprise is often a viable alternative for women in emerging markets who are constrained from seeking wage employment due to restrictive gender norms.

Gender norms that push women to prioritize household work and childcare can be a barrier or a motivator for women who want to start a business. Starting and running an MSE can be a far more attractive economic opportunity for women than pursuing employment since it:

- Provides the flexibility to manage their care responsibilities
- Allows them to grow their business at a comfortable pace given competing household priorities
- Can be home-based or located close to home, thereby circumventing any mobility restrictions they may face as women

Women-owned MSEs are often household enterprises where other members, including spouses, play a role. Joint household ownership is less common with women from higher SES households. Men may be a gateway (providing initial capital or labor) or a gatekeeper (limiting a woman owner's financial decision-making).

Although business ownership may be preferable to having a job, women MSE owners often find that owning and running a business comes with challenges — many of which are rooted in gender norms.

For many women, balancing business ownership with household responsibilities is preferable to having a job. However, the start-up process and keeping a business going has its share of challenges. Even when women are able to work as MSE owners, often they still only have tenuous consent from gender-repressive household members. For instance, Indian women looking to start MSEs, especially those in multigenerational households, may find strong social opposition from household members – and not just men. Mothers-in-law may forbid daughters-in-law from seeking employment, stating that household responsibilities will suffer. In these cases the situation may be so intractable that women have no recourse but to wait for the opposing household member to leave or to pass away.

Given the persistent sexism women MSE owners face in many aspects of their business lives, they are regularly forced to clear business needs with husbands or fathers based on the belief that going through male household members is more efficient and more likely to meet with success. On many occasions men (particularly husbands) monopolize the resources available to women MSE owners – or split them with the woman in whose name funds were originally accessed.

MSEs in Kenya reported that the government and certain banks, cooperatives, and ROSCAs made funds available to women entrepreneurs at preferential rates and with little or no collateral or credit history required. Both female and male MSE owners reported that a male head of household instructed a woman in the household to secure funds and give (or share) them to a male household member. One male MSE owner raised financing this way because he could not otherwise get an affordable loan, likely due to his lack of collateral and low credit score.

Although some women start a business to support their family, many primarily do so to achieve independence.

"I guide young girls who want to quit. I tell them that they have continue fighting because they can be an example for their children. As a housewife, you don't have much contact with the world. You are no different to a washing machine or a dryer."
— Female, grocery store owner, Peru

Women are more likely than men to report that having their own business opened doors to livelihoods and economic empowerment. Women sometimes start and run businesses to earn income to support their family when they become the primary breadwinner because a male family member is unable to fulfill that role.

Owning a business augments family income and provides women with a way to increase economic opportunities and quality of life for their spouse, siblings, children, and other family members.

Business ownership can give women economic independence, as well as recognition and status. Being economically active allows many women to feel valued and recognized as more than just a homemaker.

Gender norms limit time available for productive work, sometimes limit income opportunities, and may influence choice of sector.

Gender norms shape opportunities and create specific barriers for women-owned MSEs. Two key challenges women business owners face are time poverty and mobility constraints. These issues are often reflected in their choice of MSE type and sector.

Time poverty is a constraint for many women's livelihoods. Women are expected to prioritize caregiving and domestic responsibilities, leaving limited time for economically productive activities. Globally, women are responsible for over 75 percent of unpaid care and domestic work (ILO 2018).

Women's mobility can be constrained due to a lack of safe and affordable transport,

inadequate supporting infrastructure such as electricity or restrooms, concerns over physical safety, and restrictive gender norms, among other factors.

"My husband allowed me to start my business only if I was able to commit to managing the home and the beauty parlor.... I started the first months alone but now there are 5–6 of us."
— Female, beauty parlor owner, India

Given time and mobility constraints, women tend to choose sectors that include "home-based businesses," which sometimes limits their ability to increase or grow their enterprise and income beyond a certain size.

Considerations for physical and reputational safety and security often mean that women stick to sectors considered "appropriate for women" and stay away from enterprise opportunities that require significant travel or interacting with men in certain settings.

Women-owned MSEs with access to household financial support often seek outside funding to preserve or regain autonomy.

Initial capital often comes from spouses or other family members, which in turn means spouses frequently continue to have joint financial decision-making authority over income and business priorities. Women are rarely willing to start a business by taking a loan but are likely to consider the option during growth stages. However, to meet collateral requirements, they need to consult with spouses and other household members, which may impact decision-making and control over loan use and associated business income.

Even when financing is available for women, women MSE owners don't always have full control over the use of funds. In India, many women running enterprises access initial capital by using the gold previously given to them by family members.

In Peru, women often prefer the independence of formal financing as a hedge against coercive or abusive male family members. Ensuring that business finance is not tied to an abuser makes it easier to escape and still support oneself and one's children. Overall, we found that formal finance provided greater autonomy and control.

Women seek stability in their FSPs and prefer providers with female representation.

Outside of family funding, women MSEs rely on informal chama micro-saving groups or SACCOs (in Kenya) and cooperatives/self-help groups (in India and Peru) that provide an opportunity to network with other women. These options often present lower barriers to entry (e.g., paperwork to join, initial deposit).

Women MSE owners looking for larger amounts to invest in their business are more likely to pick providers that feature women as clients in their advertising/marketing vehicles and those

> **"It was important for me that it was a women's SACCO and also the history they have. It started in 1999 or 2000. The testimonials of members and also the kind of management they have, I trusted them. Seeing women and old women in business. A lot of women in business."**
> — Female, mobile money agent and hairdresser, Kenya

that have women in staff and leadership positions. Women MSE owners prefer to engage with established and reputable financial institutions such as national banks (India) and commercial banks (Kenya and Peru).

In Kenya, digital credit providers are rarely perceived as a source of business capital since loan amounts are small and providers do not actively target women.

Digital solutions increase women's safety, trust, and transparency in commercial exchanges across the board.

Use of DFS and digital platforms such as WhatsApp allow women to feel less threatened when interacting with male clients. For this reason women are sometimes early adopters. These platforms create prompt, shared records of transactions and agreements and facilitate transactions without in-person contact (especially important during the pandemic). These features protect users who may be at risk of gender-based violence or discrimination.

Using DFS enables better record keeping (both paper-based and digital) which, in turn, allows women to access formal financial services in the future. Trust in providers along with peer referrals are key to using or trying DFS. Peer referrals may also help with initial onboarding or troubleshooting. When services are offered by a well-established brand (e.g., Google), trust further increases.

Meet Sonia, an entrepreneur who runs a beauty parlor and wants to expand her business to secure her children's future

Sonia lives in New Delhi, India, with her in-laws, husband, and children. She has run a beauty parlor for more than nine years. When she was younger, her parents encouraged her to train and start a small beauty business. When Sonia married, her in-laws did not allow her to work. Around ten years ago, her husband gave her permission to restart her beauty parlor on the condition that she would prioritize her responsibilities to her children and the home. He bought her a small space where she worked on her own. She has grown the business and now has six staff members. She also trains and certifies other girls and women in beauty services. Her beauty parlor gives her confidence and happiness, allowing her to live life on her own terms.

Within 18 months Sonia moved to a bigger space financed with personal funds. Her daily income can fluctuate up to ten times the normal amount, peaking during festivals and the wedding season. She has seen a significant shift from cash payments to the use of PayTM, PhonePe, and GooglePay. She has relationships with two banks and reinvests business profits into mutual funds and other investments in her children's names.

She aspires to secure her son's future by growing her business into a full-fledged beauty parlor and spa. She would like to finance the expansion with a bank loan, a gold loan, or loans from relatives at 2–15 percent interest. She does not trust DFS providers that offer women discounted loans. Sonia often engages with young girls in the community and advises them to start small-scale ventures to build their confidence. She would like to see banks like HDFC, ICICI, and Kotak develop low interest rate loans (1–2 percent), especially to help women start small ventures. Currently, all such options are expensive.

"You get confidence from running a business.... It helps you have the good life you want. You have money, savings, and your children's future in your hands. Sure, my husband takes care of the house and my in-laws offer me money, but I don't take money from them. In fact, I give them money. If my husband's business is running at a loss, he asks me to help him.... If my business does well in the festival season I make the girls I employ happy.... I want to move ahead. I don't want to just sit around."

MSE Size

An MSE's size is often a manifestation of the socioeconomic status of its entrepreneur/owner.

Socioeconomic status, education, and social networks significantly influence an MSE owner's ambition, journey, and growth prospects.

Companies that are larger at inception are usually headed by owners or entrepreneurs who are more privileged, educated, financially included, and well connected. Many businesses are inherited, and advantaged owners tend to have 20–30 staff members. Larger, well-established MSEs exist in all sectors and are strongly growth-oriented. The jobs they create provide sustainable livelihoods for entrepreneurs, their families, and other low-income people.

The number of assets an MSE owns often corresponds to its number of employees, particularly in the transport and manufacturing sectors. An MSE's attitude toward risk and growth is impacted by the availability of tangible assets, which are often linked to the owner's "advantaged" status. These businesses can benefit from significant intergenerational endowments, including direct cash advances or an asset inheritance from parents.

As an added advantage, larger MSEs whose owners come from a more privileged background often have multi-partner ownership. These partnerships offer better networks and broader expertise that can be draw upon for capital resources, business leads, labor pool, and management capacity. As a result, MSEs owned by advantaged entrepreneurs tend to be more stable and resilient.

Layered onto socioeconomic status, an entrepreneur's mindset impacts their choice of sector, their enterprise's size at inception, and business growth trajectory.

Cautious entrepreneurs tend to cluster in the retail and services sectors. Many have fewer than five employees and a business model structured around recruiting labor for specific jobs rather than increasing employee headcount. This system allows them to manage overhead and quickly downscale in the event of a shock.

Since these MSEs are more likely to have a low SES, they can seldom afford to purchase the assets required to build manufacturing MSEs – apart from businesses that produce simple products such as handicrafts. Businesses like these are not as expensive to start but are challenging to scale.

Determined aspirants, on the other hand, tend to have mid-sized MSEs with an employee count that ranges from 1–4 to 5–19. They veer more toward growth than stability. Owners are represented across all sectors but with greater prevalence in retail/services and transport, and, increasingly, in manufacturing.

While it is conventionally believed that a strong enabling environment and access to finance can be critical factors in helping MSEs grow, research indicates that smaller MSEs (1–5 employees), in particular, often do not transform into larger businesses. For smaller MSEs, growth usually comes from new business lines rather than any single business. This finding particularly applies to cautious entrepreneurs but is also the case with some determined aspirants planning for growth.

Business size can be a good indicator of preference for formal vs informal finance. Smaller firms have a stronger preference for informal finance.

The smallest MSEs – particularly those with fewer than five employees but even those with up to 10 employees – more frequently use informal sources to finance their business, leveraging friends, family, and social networks. These sources are quicker to access, cheaper, and often require limited or no collateral. Informal finance influences MSE perceptions of formal finance. Frequent users of informal finance and the benefits it offers (e.g., lower costs, flexible terms, timely access) find it difficult to switch to formal finance.

Since formal providers cannot compete with the fast, free, and flexible start-up capital MSEs are able to access via informal sources, smaller MSEs may not use formal financial services (especially credit) until the growth stage – if their business even gets there.

Larger MSEs and those in the growth stage veer toward formal finance since their needs are greater and cannot be met by informal sources. As MSEs grow, borrowing from friends and family can also result in greater interference in business decisions. As a result, many MSEs at this stage prefer formal finance, which allows them to retain control over business decisions and maintain greater privacy within their family and community.

"In my current business I've never needed credit outside of what I've mentioned here. If in the future I want to expand new stores, I will need a lot of money and speak to a government bank if they can give me good rates. I would choose the bank with the least paperwork."
— Male, stationery and toy store owner, India

Larger MSEs seeking formal finance look for ease in accessing services, timeliness, equitable pricing and bundled services, easy-to-use products and proactive advice, and provider support.

It is important to note that larger MSEs can also be denied credit from formal providers, even after years of engagement and with limited explanation. Rejection may lead to frustration and distrust toward all formal financial providers, often leaving MSEs unwilling to consider formal finance in the future.

Meet Ramesh, an entrepreneur who has expanded the transport business he inherited from his well-to-do family

"In my business, many customers are not tech-savvy and one-on-one interaction is key, so you have to meet in person. I want to hire people to help me digitize bookkeeping."

Ramesh, 40, lives in New Delhi, India, with his wife, two children, and parents. He runs a small transport business with a fleet of three cars and two minibuses. He inherited the business from his father seven years ago and has since expanded it.

Ramesh financed his fleet with vehicle loans from HDFC Bank, financing the down payment through his own savings and family support. He trusts the bank because his family members have been customers for a long time and he values the positive customer experience at his branch. While his business is cash-based, Ramesh sometimes uses digital wallets like PayTM and GooglePay, or credit cards.

During the pandemic, Ramesh's business revenue shrunk by nearly 50 percent and he laid off five employees. Competition from ride share services like Uber and Ola further stressed the business. Ramesh coped with the shock by relying on financial safety nets such as investments in his savings account, term deposits, and mutual funds. He maintains an overdraft facility with HDFC to meet liquidity needs and informally borrows small amounts from friends and family.

Ramesh wants to digitize bookkeeping and is looking for user-friendly mobile apps based on costs and data privacy considerations. He wants to add to his fleet and expand operations to other cities. He plans to borrow from HDFC again.

SECTION 4

MSE SEGMENTS AND FINANCE

As outlined in the prior section, a differentiated and segmented approach to MSEs is critical to understand MSEs better and for the design and delivery of effective financial inclusion interventions within the sector. Nuances that emerge across sector, size, owner's gender, business stage, and mindset play a significant role in determining an MSE's financial preferences and its attitude toward different types of financial and nonfinancial services and providers.

In addition to the segment-specific preferences previously discussed, CGAP's research indicates cross-cutting themes that consistently emerge across various MSE segments. Although some more strongly resonated in certain segments, many themes tended to be consistently raised across MSE segments. And although it was clearly recognized that products and services are distinct across providers, many themes also apply across different financial provider groups.

Insights on MSE Segments and Finance

With few exceptions, a strong preference for informal over formal finance remains across MSE segments.

A preference for informal finance is based on several factors, including:

- **Trust and flexibility.** MSEs are willing to seriously consider both formal and informal finance. However, they find informal providers understanding, flexible and collaborative, and trusting in their commitment to pay. On the other hand, formal FSPs engender little trust and show low levels of flexibility. Formal providers also constrain MSEs in ways that social and informal channels do not: through extensive documentation requirements, demands for high levels of collateral, and cumbersome administrative processes. All of these factors lower MSE access, trust, and comfort with formal providers.
- **Loyalty.** Determined aspirant MSEs are often loyal users of formal finance and understand the importance of concepts such as credit history. However, based on repeated loan rejections, continued ineligibility to access finance, and intimidating or alienating customer experiences when transacting with formal FSPs, many of these MSEs feel that loyalty does not earn increased access to finance or more tailored services.
- **Communication.** Contrary to popular belief, the challenge for MSEs is often not financial literacy. Rather, it is financial exclusion due to the jargon and lackluster communication used by formal FSPs, which filters out lesser educated MSE owners and those from lower SES who have the potential to be discerning, dedicated, responsible, stable, and growth-oriented customers. FSPs often fail to link an MSE's business needs with the financial services that could serve it. Without this type of support, even the most curious MSE owner often will not attempt to figure out financial services on their own.
- **Tailored products and services.** MSEs of all sizes and across all sectors do not want services that require heavy engagement or significant time to manage. MSEs are busy and it is risky to take on additional management demands. Financial services that are offered separately may also create complexity rather than flexibility. With the proliferation of providers and further unbundling, each new financial service carries with it an additional mental load and management burden.

MSEs are not willing early adopters – particularly of digital finance. Much of the recent increased use of digital finance (particularly payments) is solely in response to customer preferences.

In response to customer and supplier preferences, MSEs across the board recently have been forced to increase their use of DFS, particularly payments platforms. Despite high uptake and frequent use, many MSEs remain reluctant and unenthusiastic users, limiting their risk exposure by strictly managing frequency of use and reliance on DFS.

Even with the support of younger, more digitally savvy employees, MSE owners with low digital literacy (an often-older demographic) are likely to find the burden of using digital services outweighs the benefits.

Cautious entrepreneurs and smaller/start-up MSEs use the same few services across many digital payments providers, and although they are frequently compelled to add new providers at the request of their customers they are reluctant to do so and view diverse customer preferences as a drain.

Meanwhile, determined aspirants and mid-sized, well-established MSEs are more willing DFS users, often seeking providers that can deliver financial and nonfinancial value in exchange for MSE usage and data. However, they find it difficult to shift consumers toward payments systems that are easier for them to manage and those that deliver their ideal services.

More advantaged owners and owners of larger MSEs are more confident in their ability to push back on customer requests and control the number of DFS services used. They appear to have greater capacity and willingness to adopt new products that offer business value.

Despite an increase in digital finance options, MSEs remain wary of DFS providers because they do not trust their longevity and doubt their motives on how MSE data is used.

MSEs believe that DFS and other digital spaces are not as well-regulated as banks or other nondigital NBFIs. MSEs are aware that apps are dynamic and constantly changing. They believe DFS providers may disappear, abandoning valued products. A lack of control over the technology they rely on adds to their reluctance to adopt DFS for essential services.

"I would want to know what the app is going to cost me. And I should know how to use it. I don't know how a new app would work. How the data is stored. Could the data get erased? We don't know anything about these apps, the people, where they're from. HDFC Bank, I have their trust, such a very established company. If it's some hidden thing I've never heard of, maybe my account would be drained immediately. All your data is going into this app and it could be misused."
— Male, transport business owner, India

Further, MSEs frequently note a lack of DFS provider transparency on annualized interest rates, loan tenor, and other loan terms. The smallest of MSEs, especially those that have recently embraced digitization, share concerns about data privacy and a lack of transparency on how DFS providers use it.

Widespread concerns about DFS provider collection practices also exist, stemming from personal experience and experiences within an MSE's social network. There is the belief that some DFS providers scrape user data and track down personal contacts in the event of delayed repayments.

As a result of these types of incidents, MSEs are wary of nonpayment DFS products, particularly credit products, and providers that are not backed by banks. MSEs believe that the more a DFS provider knows about them, "the more they'll be able to rip me off, hunt me down, harass

> **"Those providers, they have access to your contact list. Once you delay your payment, they will start calling people from your contact list. Imagine them calling your mother-in-law and asking for money. The government has been trying to blacklist all those providers so I am trying to stay very far away from them. Apart from M-Shwari and M-PESA, I don't even want to learn more about any of them."**
> — Male, firewood delivery business, Kenya

me, or even ruin me with other providers" (manufacturing sector entrepreneur, Kenya, in conversation with research team). Multiple Kenyan participants cited stories or personal experiences of DFS credit platforms calling friends and close relatives about late payments during the pandemic, harassing borrowers by threatening their social standing. Meanwhile, Indian MSEs frequently cited fears of being a victim of scammers posing as DFS providers or of ill-intentioned providers themselves, having no way to tell the difference and believing that both exist.

Meet Ibrahim, a Kenyan *jua kali* artisanal metal worker whose business has suffered due to the pandemic

Ibrahim, 50, hoped to be a teacher. But since he couldn't afford higher education, he became a *jua kali* (Swahili for street entrepreneur who "gets things done"). He supports his family by manufacturing metallic gutters and boxes, selling them to construction projects and schools in Nairobi.

Ibrahim paid 20,000 KSh to become certified as a metal worker. He financed vocational training by selling his car and borrowing from chamas (informal savings groups). But as less expensive PVC pipes began to enter the market from China, demand for metallic gutters decreased and his business was affected.

The pandemic accelerated the decline. He let go of half of his 10 employees and is finding new ways to feed his family. He would like to expand his business to nearby towns but has no access to capital. He considered becoming an artisan in the construction business but cannot afford the training.

Ibrahim once took a loan from a DFS provider who threatened to report him to the credit bureau when his payments were delayed by a few days. That negative experience eroded his trust and he hasn't borrowed since. While Ibrahim relies on neighborhood chamas to meet his financial needs, he hopes the government will provide financing or vocational training so he can improve his livelihood.

> **"I borrowed 1,000 KSh from [a DFS lender]. I couldn't repay my loan due to COVID, but they said they wouldn't extend any lenience because the loan was made before COVID. They were threatening to put my name at CRB (credit bureau). I didn't argue with them because I owe them. I didn't try to borrow any money from any app since then. I was very embarrassed."**

What Can Providers Do to Reach Underserved and Excluded MSEs?

MSEs seek financial services that enable and accelerate growth, shore up resilience, and optimize business and financial practices. While financial products and services can vary by provider type (e.g., bank, cooperative, fintech), CGAP research finds that MSEs experience common challenges, pain points, and value expectations relevant to the complete spectrum of formal FSPs, including DFS providers.

This section outlines high-level guidance on designing products and services for consideration by all providers inclined to work with MSEs. Also see Figure 8.

1. **Tailor value propositions for the segmented needs of MSEs**
   FSPs in many markets do not differentiate when targeting small businesses. However, MSEs need products and services tailored to their business cycles, demographic profiles, and risk preferences. A tailored value proposition can be accomplished in four ways:
   - **Design products and services differentiated by use case and aligned with MSE business cycles.** As previously discussed, there exists a heterogeneity in MSE business cycles and strategies that is impacted by size, growth stage, and sector of operation, among other factors. **Providers need to design flexible, customized products that align with MSE use cases and sync to their business cycles.** For example, since transport MSEs in many markets are cash-based and have a lesser need for cash advances, they require financing to purchase vehicles. Dealer-arranged financing from FSPs like banks or asset finance companies is often beyond the reach of an MSE that lacks a credit history and documentation, and the ticket size is often larger than what digital credit providers usually extend. Therefore, an unmet need is created.
   - **Develop a suite of gender-specific products for women entrepreneurs. Providers must acknowledge differences in MSE owner profiles – particularly female owners.** For example, CGAP's research suggests that women-owned MSEs have a very different experience navigating formal finance. They often possess inadequate information about relevant financial services; hesitate to interact with FSPs because of male-dominated, intimidating, and sometimes hostile environments; and are subject to social norms that restrict their ability to obtain credit. Outreach to women-owned MSEs can be expanded by designing and delivering context-sensitive financial services, extending business hours, hiring additional female staff members and agents, and creating savings-linked credit products.
   - **Build product and service awareness and clearly articulate benefits for MSEs.** Many MSEs, especially highly informal and women-owned MSEs, prefer to borrow from informal sources. This can be explained by the perceived lack of relevant formal financial services to meet their specific needs. Explaining product benefits and linking them to an MSE's livelihood and growth strategy encourages adoption and use. In addition, given how profound an influence peers may have on an MSE's perception of finance providers, it is beneficial to build business cases that are specific to their contexts and networks.
   - **Providers may also consider embedding components of digital and financial literacy into product offerings** and developing communications campaigns specifically targeted to motivate MSEs.

2. **Build greater trust and confidence**
Low levels of trust in FSPs and a perceived lack of relevance and value likely lead to limited MSE use of formal finance and voluntary exclusion. MSEs may treat DFS providers, especially credit providers, as lenders of last resort for emergency use – but not for enterprise needs like liquidity, inventory, or capital investment. However, FSPs can reasonably address drivers such as low trust and lack of relevance in several ways:
   - **Simplify communication and increase transparency.** Many markets experience information asymmetry. MSEs report a lack of knowledge about different financial services, especially recent, tech-enabled DFS, as well as their eligibility to access those services. MSEs often meet repeated rejection when trying to access formal finance, frequently without an explanation as to why or how they can improve their application the next time. **Providers can improve communication by embracing simplicity, eliminating jargon, and designing user-friendly interfaces – especially for low literacy users, many of whom are women.** Transparency on costs and associated fees or penalties, terms and conditions, and consequences of default in intuitive terms (e.g., annualized percentages instead of daily or monthly interest rates, costs expressed in amount per hundred borrowed) can empower MSEs to make prudent financial decisions.
   - **Build trust through partnerships.** Despite best efforts, FSPs are limited by physical, psychological, and socioeconomic distance from poor, excluded, and underserved MSEs. We observe that MSEs learn about financial services and benefits from the social networks they trust and frequently transact with: family, peer MSEs, long-time suppliers, loyal customers, community elders, community- and trade-based organizations, etc. Women-owned MSEs also have distinct trusted social networks of women such as neighborhood savings groups, banking agents, and fellow entrepreneurs. **Forging partnerships with trusted actors and positioning partner resources to be presented to MSEs** as they transact can help providers engage with MSEs, listen to their concerns, tailor support, and build trust.
   - **Provide clarity on data usage and recourse mechanisms.** CGAP's research finds that concerns about data privacy are a severe deterrent to MSE adoption of DFS across markets and segments. Skepticism toward DFS, especially tech-enabled credit products, can be mitigated by **providers sharing more information on how and who will use MSE data and how providers will protect it.** Trust and confidence can be built by providing clear guidance around grievance recourse mechanisms for customers and explicitly articulating accessible consumer protection principles and best practices.

3. **Provide greater customer support**
   As MSEs make initial strides toward formal finance and interact with FSPs, they seek positive customer experience beyond the financial service itself, especially when using DFS. MSEs greatly value both online and offline customer support services geared toward awareness, literacy, trust, troubleshooting, and dispute resolution. Support can help them develop the confidence to become sophisticated users of finance over time in the following ways:
   - **Simplify and de-risk onboarding.** Low literacy MSEs often report signing up for products and services without understanding how they work or what they cost. They frequently have no way to discontinue use without incurring significant fines and penalties. **Providers can simplify and de-risk customer onboarding through transparent communication, making available human touchpoints to guide new users, and eliminating risk** by allowing trial use periods, setting transaction limits and cooling off periods, issuing targeted warnings, etc.
   - **Develop effective customer journeys.** As reluctant adopters of DFS, MSEs are easily overwhelmed by the number of products and digital channels required to engage with providers and customers. **Interoperability** and **data portability across providers and platforms** can decrease switching costs and reluctance to try new services. Providers can **encourage adoption by thoughtfully embedding new offerings** into currently used and more familiar products, both financial and nonfinancial. **Creating service pathways to support MSEs that failed to qualify in their first attempt** to access services provides feedback and guidance that strengthens subsequent applications, mitigating what could be an alienating experience. These simple steps can reinforce an MSE's loyalty and its relationships with FSPs.

FIGURE 8. **Differentiated approaches to serving MSEs across various stages of their growth**

Service providers need to consider which types of solutions are best suited and the best times to engage with MSEs to add maximum value.

1. START-UP STAGE

Target MSEs as retail customers. Identify current or future entrepreneurs among retail customers; position low-commitment business solutions.
MSEs can be loyal and committed to providers and often prefer to grow services with existing providers.

Provide nonfinancial business support. Bundle nonfinancial knowledge resources about business fundamentals with financial products; train customer-facing staff to provide support to MSE customers.
MSEs believe that FSPs know business as well as finance and greatly value providers that can extend support beyond financial products.

Develop products that are quick and affordable. Streamline credit processes and account for informal receivables and inventory expenses where feasible.
Timeliness and cost are key factors for MSEs; they tend to be more flexible on credit term and loan size.

2. STABLE OPERATIONS STAGE

Use simple, transparent language. Ensure communications vehicles are jargon-free and easy to understand.
MSEs often have no prior knowledge of financial services and business terminology. Language should be clear, describing what products and services mean for the MSE.

Ensure human engagement. Position quick, human multichannel support.
MSEs are often open to in-app channels and chatbots. However, they need the reassurance that they can speak to a live person for urgent needs. Access to support is key.

Communicate data protection policies. Be completely transparent about the use of customer data and customer rights over it.
Ensure confidence in data use by providing clear guidance on scenarios that could potentially compromise MSE data (e.g., forgotten password, lost ID, lost phone, delayed payment). Stress test the answers to those questions.

Consider sector dynamics when developing products. Reach retailers through their wholesalers, transport through vehicle vendors.
Retail MSEs seek collateral-free growth financing options and need help planning ahead. Transport financing needs are consistent and ticket sizes larger. Manufacturers are less likely to rely on financing for operations – except for sudden large orders.

Chart pathways for increased financial engagement. Together with the MSE, plot a pathway that incentivizes steadily increasing use of financial and nonfinancial services as their business grows.
MSEs need support from providers to understand which products and services exist and how to maximize use for their specific business. FSPs can help MSEs navigate financing options (e.g., shifting from personal loans to affordable inventory financing, lines of credit).

Use payments data to cross-sell products and services. Leverage payments activity to offer and prequalify MSEs for financial and nonfinancial solutions.
Since the pandemic, most MSEs first engage with DFS providers and broader digitization through payments and business solutions. These solutions potentially provide DFS providers with data and the opportunity to expand other services.

3. GROWTH STAGE

Develop credit options for changing business needs. Ensure that the suite of MSE options can adapt to their changing business needs.
Growing MSEs need financing. Mature businesses expect credit ticket size and tenor to go up and costs to go down. FSPs should ensure flexibility, especially for existing customers. If an MSE does not qualify, advise them about why and what they can do. Simplify the application process and clearly communicate credit terms.

Provide flexible term options. Offer finance terms that assure flexibility in payments structure and term length.
Growing MSEs need financing. Mature businesses expect credit ticket size and tenor to go up and costs to go down. FSPs should ensure flexibility, especially for existing customers. If an MSE does not qualify, advise them about why and what they can do. Simplify the application process and clearly communicate credit terms.

Provide solution bundles. Bundle financial and nonfinancial products based on the needs of MSEs at different business stages.
MSEs find separately selecting financial services to be administratively complex and confusing. Product bundles can be significantly enticing (e.g., insurance with asset financing, working capital loans with business and transaction digitization, business financial advisory services with larger unsecured loans).

SECTION 5

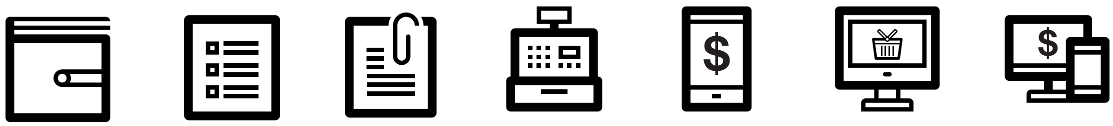
LOOKING AHEAD

The COVID-19 pandemic has impacted countless people around the world. The catastrophic global health crisis unleashed disastrous socioeconomic impacts that continue to put millions of firms across the globe out of business. MSEs are among the hardest hit; they remain the most vulnerable to demand and supply shocks that are enormous in scope and scale. Adequate and appropriate support is critical – particularly support to the smallest firms that many poor and vulnerable households depend on for their livelihoods – to ensure that millions more are not plunged back into poverty.

While the negative economic effects of the pandemic will be felt for a long time to come, one silver lining to emerge is the increased adoption of digital tools and technologies by MSEs. These firms were pushed to seek new ways to keep commerce flowing during pandemic-related restrictions and lockdowns. Digitization of the MSE sector (which was already underway) has accelerated, driven by the emergence of financial and nonfinancial services enabled by technological advances such as mobile connectivity, artificial intelligence (AI), and application programming interfaces (APIs). While MSEs traditionally digitize slowly or in stages, and many are only partially digitized for record keeping and business management, the COVID-19 crisis pushed many to take up DFS and other online platforms for the first time.

Digitization creates value for MSEs through lower costs, new customer acquisition channels, improved customer relationship management, better accounting and control, and improved revenues. It enables MSEs to access alternative forms of finance, streamline payments, and obtain new forms of business insurance coverage. By digitizing transactions and operations, MSEs create digital trails and alternative data that technology-enabled lenders can use to evaluate credit risk, offer tailored products, and increase access to finance for excluded and underserved firms.

Digital transactional tools used in the MSE ecosystem include:



Digital wallets | Digital invoices | Digital purchase orders | POS payments | Mobile money | E-Commerce sales | Payment gateways

Technology-enabled models can address supply- and demand-side barriers to MSE finance. However, MSEs need support on integrating digitized services into their long-term business plans and understanding how new services complement and interface with those they already use. MSEs need assurance that the digital services they adopt will not suddenly disappear or become obsolete.

There is an immense opportunity for a concerted and coordinated effort to support MSEs as they increase their use of DFS and, in turn, to advance access to responsible finance. To realize this opportunity, multiple stakeholders in the ecosystem can build upon CGAP's efforts to promote a segmented approach to understanding the MSE universe.

Implications for Financial Inclusion Donors

- **Fund country-level research to develop a granular and nuanced understanding of MSE subsegments.** The goal is to support effectively tailored products through continuously learning about and recalibrating financial services offerings in response to the needs and circumstances of MSEs.
- **Bring together stakeholders to facilitate knowledge exchange** and socialize key insights, knowledge gaps, perspectives, and experiences serving MSE clients.
- **Deploy capacity building programs** to help providers embrace the human-centered design approach to MSE market research and segmentation.

Implications for Investors

- **Make selective investments in DFS providers** (particularly DFIs) focused on serving MSEs, especially the smallest firms providing stable livelihoods and employment to excluded, vulnerable people in frontier markets.
- **Provide patient capital in the form of targeted credit lines and other innovative financial instruments to support DFS providers in developing new lending portfolios that deepen reach into microsegments.** Support can encourage DFS providers to embrace a segmented approach and design relevant and differentiated products, test innovative delivery mechanisms, and operate in frontier markets perceived as risky by more traditional providers.

Implications for DFS Providers

- **Strongly engage with the research community and sector support organizations** to better understand the barriers to access that MSE segments face, especially those related to gender and social norms, and to identify high-impact products and delivery mechanisms.
- **Integrate segmentation as a strategic priority** by allocating more resources for market research and developing MSE-specific growth strategies to ensure that a differentiated approach to serving MSE clients is embraced as a primary principle rather than an afterthought.
- **Invest in tailoring products** that deepen reach within the female-owned MSE segment and empower women entrepreneurs to sustainably grow their business.

Implications for Sector Support Organizations

- Support funders and DFS providers in **capacity building, knowledge sharing,** and **fostering dialogue between private and public sector actors** such as regulators and policymakers, and advocacy for a segmented approach to supporting MSEs.
- Allocate resources to research focused on **increased adoption of digital channels and strategies that can be implemented for MSE growth and sustainability,** nuanced (when possible) for segment-specific variations.
- **Increase awareness** and bridge information asymmetry among MSEs about the suite of digital financial solutions at their disposal through communications campaigns and financial and digital literacy programs.
- Work with DFS providers to find actionable solutions to **address the trust deficit** between MSEs and FSPs (particularly DFS).
- Develop programs and research aimed at finding shared solutions to **address repressive gender norms** that negatively impact the growth and success of women entrepreneurs.

Implications for Regulators

- **Foster an enabling regulatory environment** that supports DFS providers to innovate and adapt to serving low-income MSE clients. This may include open dialogue with DFS providers and private-sector stakeholders, adopting test-and-learn approaches (e.g., regulatory sandboxes), and enforcing regulations in a predictable, transparent manner.
- **Create safeguards to protect customers**, especially those new to DFS and susceptible to increased risk, fraud, and abuse. Regulators should ensure that laws, regulations, industry standards, and customer protection protocols exist to protect MSEs, their data, and their privacy during DFS transactions.
- **Increase financial and digital literacy** through communications campaigns, advocacy, and trainings to expand awareness of and trust in DFS providers (among MSEs).

Implications for Researchers

- **Clarify the links between MSEs and livelihoods** to better understand how low-income populations use MSEs to improve incomes and build resilience to shocks.
- **Undertake further research** to understand the great diversity of firms within the MSE universe and their unique characteristics, attitudes, and preferences, and to validate the need for segmentation.
- **Further study** the impact of technology-enabled MSE finance on the lives and livelihoods of low- income households, especially women MSE owners. Identify the dimensions of wellbeing that access to finance can improve, pathways of impact, and borrowers that will most benefit.

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ANNEX
DATA AND RESEARCH APPROACH

A. Research Approach

This Focus Note is developed from primary research with MSEs in transport, manufacturing, and retail trade and services sectors in India, Kenya, and Peru. The global sample size was 383 participating MSEs. The mixed methods approach included surveys, in-depth interviews, small group discussions, and ideation workshops – all online due to COVID-19-related restrictions.

Supplementary research was conducted with 25 additional MSEs in India using an ethnographic approach, including remote and in-person interviews, shadowing entrepreneurs, unstructured conversations, and interviews with MSE customers and employees.

CGAP's research focused on India, Kenya, and Peru since these markets represent geographic diversity, the presence of a variety of microfinance institutions and fintech services targeting MSEs, and a vast spectrum of experience in the overall delivery of services to MSEs.

MSE owners represented urban and peri-urban areas, largely in Tier 1 and Tier 2 cities, with the understanding that MSE ecosystems and livelihoods are shaped by the urbanization, migration, and mobility these environments surface.

The sample (see Figures 9 and 10) was recruited using vendors' professional networks, references from FSPs, and snowball sampling. Potential participants were provided a link to an online survey screener. While most interviews were conducted over Zoom or WhatsApp with the support and facilitation of local research partners and translators, some interviews were supported in-person by local research partners, particularly to assist low connectivity and low digital literacy MSE owners.

FIGURE 9. **Sample distribution by research methodology**

Research methodology (Number of participants)	India	Kenya	Peru	Total
Rapid online survey	95	94	169	358
In-depth interviews *(Recruited from survey sample)*	20	20	20	60
Small group discussions *(Three sessions per country, recruited from survey sample and interviews)*	9	12	12	33
Supplementary in-depth interviews	25	–	–	25

FIGURE 10. **Sample distribution by MSE size, gender of owner, and sector of operation across methodologies**

Rapid online survey sample [N=358]

Survey participants	India	Kenya	Peru
	(Percentage of sample by variable)		
MSE size			
1–4 employees	65%	81%	63%
5–19 employees	16%	18%	33%
20–30 employees	19%	1%	4%
Gender of owner			
Female	38%	28%	51%
Male	62%	72%	49%
MSE sector of operation			
Retail	51%	64%	40%
Manufacturing	28%	25%	43%
Transport	21%	11%	15%*

**Two percent of MSEs in Peru did not belong to any of the above sectors.*

In-depth interview survey sample [N=60]

Survey participants	India	Kenya	Peru
	(Percentage of sample by variable)		
MSE size			
1–4 employees	50%	55%	45%
5–19 employees	40%	45%	45%
20–30 employees	10%	-	10%
Gender of owner			
Female	30%	30%	55%
Male	70%	70%	45%
MSE sector of operation			
Retail	50%	50%	60%
Manufacturing	25%	25%	10%
Transport	25%	25%	30%

Supplementary interview survey (India) [N=25]

MSE size	
5–19 employees	100%
Gender of owner	
Female	16%
Male	64%
Jointly owned	20%
MSE sector of operation	
Retail	32%
Manufacturing	68%

B. Sample Selection Criteria

MSE SIZE

MSEs were sampled in three segments based on size as defined by number of employees (1–4, 5–19, and 20–30), with a core focus on businesses with 1–4 and 5–19 employees. This segmentation helped CGAP understand how circumstances and access to services differ and allowed us to look for tipping points where service expansion – particularly demand-driven – could take place. The COVID-19 pandemic had a significant impact on the accuracy of the size variable, with several respondent MSEs recently fluctuating in size due to the pandemic.

ECONOMIC SECTOR

The sample focused on three sectors: retail (including services), manufacturing, and transport. While these sectors are large, cross-tabulation with other selection criteria (e.g., size, formality) effectively narrowed the range of businesses represented. In the retail and services sector, a limited number of informal online commerce sellers were also included. Across all markets, it was challenging to find manufacturing businesses that would join for interviews.

FORMALITY AND DIGITIZATION

The sample included businesses along a spectrum of formality and digitization. These binary factors provided insight into how formalization and digitization might change an MSE's access to opportunities and services.

GENDER

Although the sample was not optimized to dive deep into gender dynamics, a gender lens was applied throughout the research. Women MSE owners were explicitly targeted, all data was gender disaggregated, and some interviews included limited time to probe the gender dynamics of MSE experiences. Although our screening process was intentionally structured to include nonbinary and LGBTQIA participants, we only received responses from participants who identified as male or female. As a result, we noted only those two genders in our research.

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