

EQUITY GROUP— FINANCING INNOVATION IN KENYA

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Equity Group Holdings is a Pan-African financial services group based in Nairobi, Kenya with Bank subsidiary operations in Kenya, Rwanda, Uganda, Tanzania, South Sudan, and the Democratic Republic of the Congo which now enjoys the position of the largest financial services and banking group in Eastern and Central Africa by market capitalization. The Group's operations include a fintech company, Finserve Africa; as well as a networked health care provider, Equity Afia. The Group's corporate foundation, Equity Group Foundation (EGF), has delivered humanitarian programs in Education and Leadership, Food and Agriculture, Social Protections and Safety Nets, Health, Clean Energy and the Environment, and Enterprise Development and Financial Inclusion to millions in the region.

Equity Group's Creating Shared Value (CSV), strategy provides triple bottom line socio-economic returns to society, the environment, and social development policies. Our programs and services are underpinned by technology, innovation, and synergy as a central means to launch, nurture, and scale up Africa's next generation of successful leaders and entrepreneurs delivered to all communities in which Equity has operations.

Equity Group finances innovation in Kenya directly and indirectly through debt financing, entrepreneurship education, retained earnings, and government financing. The African Guarantee Fund has noted that capital support is an integral part of actuating innovation in Kenya. Equity Group's vision for the future of innovation financing is to close the small and medium-sized enterprises (SME) financing gap in Africa, raise private and public gross domestic expenditure on research and development (GERD) as African economies shift from being primarily commodity-driven to innovation-driven economies, finance integration of African SMEs into global value chains to accelerate adoption of 4th Industrial Revolution technologies,

and catalyze the development of industry clusters. Kenya has a vibrant and diversified private sector driven economy that embraces a start-up entrepreneurship culture and innovations such as mobile money. Key challenges such as weak intellectual property rights (IPRs) are overshadowed by the immense opportunities of innovations to tap into Africa's large and youthful population, rising middle class, rapid urbanization, and rapid leapfrogging in the adoption of mobile and Internet technologies. Developing countries can learn from Kenya's mobile money innovation ecosystem, the financing of innovations through financial inclusion, and adoption of free market policies that enable SMES to thrive.

Equity Group's biggest challenges and solutions for financing innovation in Kenya

The financing of innovation faces the challenge of low financial and entrepreneurial literacy among micro, small, and medium-sized enterprises (MSMEs). This trickles down into higher business failure rates and loan defaults as well as hinders the breadth and depth of financial products and services that MSMEs consume. Likewise, the informal setup of most MSMEs hinders the use of financial statements and records to compute credit scores for their businesses. The informal sector in Kenya is the largest employer and also a key driver of the economy. Many entrepreneurs and innovators lack collateral to give as securities for their loans. In addition, Kenya also has weak protection of innovators' intellectual property rights such as patents and trademarks. This has led to a lack of legal guidance on the use of IPRs as collateral for loans, which could be a big hindrance to debt financing of innovations. Finally, in the critical sector of agriculture in Africa, the biggest risk to financing

agriculture innovations remains not credit but the unpredictable dangers of changes in weather.

Banking and financial services providers finance innovations through efficient capital allocation to businesses with the highest probability of 1) executing the most promising product, process, business model, and marketing innovations, 2) commercializing new technologies, and 3) shaping research and development by financing innovations.¹ To help address many of Africa's key challenges to innovation financing, Equity Group has launched a suite of products that support the innovation ecosystem.

Equity Group's primary conduit for financing innovation is debt financing to SMEs across all sectors of the economy. Deposits mobilized from households and firms are the key source of intermediate funds, with surpluses that amounted to US\$4.82 billion in December 2019. The financing of SME ideas and aspirations comprised 59% of Equity Group's US\$3.66 billion loan book, while large enterprises made up 13%. The Group maintains a deliberate strategy of aligning products for SMEs across the entire enterprise life cycle from micro start-ups to small, medium, and large enterprises—and eventually to multinationals. This has earned the Group a reputation as the leading incubator and funder of entrepreneurs in Kenya. Financing for SMEs who are integrated into the global value chains (GVCs) which drive export competitiveness in Kenya stood at 27% of the entire loan book being denominated in foreign currencies. This financing was mainly funded by foreign currency borrowings from development finance institutions (DFIs), such as the International Finance Corporation (IFC), European Investment Bank (EIB), KfW Group, and African Development Bank (AfDB), and stood at US\$567 million in December 2019, while remittances from Africans in the diaspora grossed US\$1.42 billion.

Entrepreneurs solve the most challenging socioeconomic problems of our times by offering creative and innovative solutions that can be piloted or scaled up. The United Nations Economic Commission for Europe has noted that innovative micro, small, and medium enterprises (MSMEs) profitably convert new ideas, technologies, inventions, and industry knowledge into new products, services, markets, processes, and organizations.² Low entrepreneurial skills have been linked to not only higher loan default risk and low innovation but also low survival rates of businesses. In 2018, the United States of America (U.S.) Small Business Administration (SBA) Office of Advocacy reported that only 50% of start-up businesses survive the five-year mark, and only 30% live to ten years.

Equity Group Foundation (EGF) nurtures entrepreneurs and innovators in Kenya to stimulate innovation and economic growth by training MSMEs on the entrepreneurship education curriculum provided by the International Labour Organization's (ILO) Start and Improve Your Business (SIYB) program. Since 2011, EGF has trained more than 52,000 MSMEs throughout the country, averaging over two new jobs created per trainee. EGF launched the Financial Knowledge for Africa (FIKA) program in partnership with MasterCard Foundation to deliver financial literacy training covering budgeting, savings, debt management,

and financial services to over 2 million women and youths. The Financial Literacy and Entrepreneurship Education comprised 13% (US\$53.5 Million) of Equity Group Foundation's US\$411.6 million in cumulative social investment programs as of December 2019.

In the key sector of agriculture, Equity Group also helps MSMEs access financing through collateral substitute innovations, such as group social cohesion guarantees, the use of stock of goods for sale or quantity of agricultural produce, and cash flow based lending. It assists farmers in circumventing weather risk by financing the adoption of irrigation agriculture technologies such as greenhouses, drip or sprinkler irrigation, and farm inputs like high-yielding, drought-resistant cash and food crop varieties. The bank leverages a value chain model for agricultural financing by roping in partners on both the input and output side. Equity Insurance Agency has also developed innovative products with insurers, such as crop weather insurance and index-linked livestock insurance, to help farmers manage climate-related shocks.

Vision for the future of innovation financing

Equity Group seeks to replicate the success of championing financial inclusion innovations and MSME financing for innovation by reaching 100 million individuals and enterprises in 15 sub-Saharan African countries by 2024.

Equity is itself a serial innovator and a role model for SMEs. In the 1990s, Equity developed a savings-led, low-margin, high-volume business model that democratized access to finance and financial services for the majority of Kenyans. This model won the 2007 Global Vision Award as "initiator of concepts of the future that will change the world economy". In 2010, the Computer Society of Kenya declared Equity the Best in Mobile Technology Application. In 2012, African Banker Magazine declared Equity the Most Innovative Bank in Africa. Equity has consistently won the Best Bank in Agency Banking, Mobile Banking, and Internet Banking awards by Think Business. In the 2018 Banker East Africa awards, Equity Bank was named the Best Digital Offering in East Africa and Most Innovative Bank in Kenya. Equity is the only bank in Kenya that owns a Mobile Virtual Network Operator, Equitel, to provide itself with holistic mobile money and telecom infrastructure services. It is a front runner in open banking since the launch of the Jenga API suite, which allows software developers and SMEs to integrate themselves into the Group's ecosystem through a sandbox. Equity is a market leader in diaspora remittance processing due to integrations with financial technology (fintech) companies such as Wave, World Remit, and PayPal. These innovations are funded through retained earnings as the Group's dividends policy demands retention of 60% of profits after tax. Retained earnings as of December 2019 stood at US\$897.15 million.

The role of governments in innovation financing is globally acknowledged. It includes supporting scientific research, formulating laws, building innovation institutes and public

universities, creating budgetary incentives, enabling technology transfers, and protecting intellectual property rights. The Government of Kenya funds research and innovation by public universities through entities such as the Universities Funding Board and the National Research Fund. In addition, they fund research institutes, such as the Kenya Medical Research Institute, the Kenya Agricultural Research Institute, and the Kenya Industrial Research and Development Institute, which provide fiscal incentives to innovators and SMEs. This works alongside funding regulators like the Kenya Industrial Property Institute. Equity Group is a responsible corporate citizen that supports government financing of innovations by augmenting the government's fiscal deficit to the tune of US\$1.72 billion in a treasury securities portfolio and corporate tax payments program that stood at US\$89 million as at December 2019.

Measurable impact of innovation financing

Since 1994, when Equity turned around from an insolvent building society, the Group has been experiencing tenfold growth across all its parameters for success every five years (Table 13.1). The number of customers grew from 12,000 in 1994 to 13.9 million in September 2019, principally due to innovations to democratize access to finance. Today, the Bank enjoys a market share of over 50% of bank accounts in Kenya. This contributed heavily towards driving Kenya from merely 4% of the adult population banking in 1994 to a financial inclusion penetration rate of 58.7% in 2006 and an 89% rate by 2019.³

The savings-led model innovatively created a savings culture among clients to grow the Bank's deposits from US\$1.15 million in 1994 to US\$4.82 billion in December 2019. As a result, the Bank's cost of funds is well below the industry average at an enviable 2.9% in December 2019, which is largely comprised

of checking and savings accounts. The loan book grew from US\$350,000 in 1994 to US\$3.66 billion in December 2019 with financing of MSMEs constituting 59% and large enterprises comprising 13%. Financing innovations of SMEs involved in international trade exports composed 36% of the loan book in foreign currency, amounting to US\$1.32 billion in December 2019. Equity was feted as Africa's SME Bank of the Year in both 2018 and 2019 by the SME Finance Forum of the G20 Global Partnership for Financial Inclusion (GPF).

Total assets grew from US\$1.22 million in 1994 to US\$6.73 billion in December 2019, representing 6.88% of Kenya's GDP of US\$98.37 billion. The GDP growth rate for Kenya stood at 2.63% in 1994 but averaged 5.45% between 2005 and 2019 with the highest growth rate recorded in the fourth quarter of 2010 at 11.6%.⁴ Shareholder funds grew from negative in 1994 to reach US\$1.08 billion. Equity Bank has the highest market capitalization in East and Central Africa and on the Nairobi Securities Exchange, with market capitalization reaching US\$2.04 billion in January 2020. Investors put a high premium on Equity Bank's value-driven innovations of about US\$300 million above the market capitalization of the second-ranked bank. Equity Group's global rating of B2 by Moody's is at the same level as the sovereign rating of Kenya.

The Bank was ranked globally by Banker Magazine at the 844th position on total assets size, 15th on return on total assets, 75th on soundness (capital assets ratio), and 32nd on profits on capital.

Equity Group's investments in mobile money innovations have led the Bank to acquire over 20% of Kenya's mobile money market share since the 2015 launch of Equitel MVNO (mobile virtual network operator)—a telecom and banking sector convergence solution. Digitization and innovation in the Bank have changed the concept of banking from "somewhere you

TABLE 13.1

Equity Bank performance trend analysis—10X growth every 5 years at peak

Value in US\$	1991	1996	2001	2006	2011	2016	2019
Funding	290K	3.02M	16M	163M	1.59B	3.37B	4.82B
Loans	86K	1.69M	8M	109M	1.13B	2.66B	3.66B
Total assets	240K	2.13M	19M	200M	1.96B	4.74B	6.73B
Profit before tax	(40K)	106K	550K	110M	128M	249M	315M
Shareholder funds	(180K)	225K	2.38M	22M	342M	820M	1.12B
Number of customers	9K	26K	105K	1.01M	7.15M	11.1M	14.14M

Source: Equity Group Holdings Plc Internal Records.
Note: K (thousands), M (millions), and B (billions).

go” to “something you do”, as customers have adopted banking as a lifestyle. In December 2019, 97% of Equity’s transactions occurred via mobile self-service channels, agency points, and merchant banking, as opposed to fixed cost branches and ATMs. The Bank’s innovations via artificial intelligence and machine-learning scoring technologies have enabled 93% of the loans to be disbursed efficiently via mobile channels (Figure 13.1). The Bank has more than 40,000 agents in Kenya serving as bridges to cash as the economy shifts towards a cashless society. Integrations with global card associations and innovations in mobile point-of-sale (mPOS), along with acquisitions of last mile retail merchants, has seen the Bank gain 60% of the merchant banking share in Kenya. Integrations with global fintech companies have seen the Bank become a market leader with almost 50% market share of Kenyan diaspora remittances, reaching US\$1.42 billion in December 2019 across Equity Group. The Financial Times and IFC declared Equity the most sustainable bank in Africa in 2009, and the Computer Society of Kenya honored Equity as the best in mobile technology in 2010. African Banker Magazine awarded Equity the most innovative bank in Africa in 2011 and the Banker declared Equity the most innovative bank and the best mobile banking service in 2016. Think Business has consistently ranked Equity as the best in agency banking every year, since 2015.

Lessons learned and policy recommendations

Across more than two decades of experience and expertise, Equity Bank knows that there is still very high unmet demand for financing innovation in developing countries such as Kenya. Deepening access to finance for MSMEs is thus critical if entrepreneurs and innovators are to lead in wealth and job creation. There is a need for capacity-building training for MSMEs and innovators to not only commercialize and monetize their innovations but also to better manage their businesses for longevity. The impartation of entrepreneurship skills and best of breed business practices can help many MSMEs live well beyond their fifth birthday.

Leveraging private sector GERD from retained earnings of companies is key to the adoption of new technologies. This is also key in companies building a culture of serial innovation, serial intrapreneurship, and serial mergers and acquisitions that underlie serial monopoly strategies of leading companies globally. The role of government in improving business conditions for MSMEs and deliberately investing in the global competitiveness of their countries is likewise important.

SME finance policies, modeled on the lines of the G20 Global Partnership for Financial Inclusion (GPII) guidelines, can help many countries create reforms geared towards the funding of SME innovations.⁵ The reforms needed comprise the regulation and supervision of SMEs’ access to financial products and competition—as well as financial infrastructure, such as credit reference bureaus, and government interventions, such as credit guarantees and government procurement. Kenya has three credit reference bureaus which have helped to lower overall over-indebtedness by reducing adverse selection and

information asymmetries, such as moral hazard. Credit risk guarantees help banks finance innovations by MSMEs in the high-risk informal sector or as climate shocks to agriculture. Government procurement provides access to markets for MSME innovations. Policies geared towards improving business conditions, as well as improving the global competitiveness of countries, are key to spurring a vibrant entrepreneurship and innovation ecosystem that banks can finance.

The adoption of National Entrepreneurship Policies and Strategies, as well as National Financial Education policies, are key to the provision of entrepreneurs’ and innovators’ capacity-building capabilities as a public good for emergence of an MSME ecosystem at the core of any “start-up nation”.⁶ Entrepreneurship policies normally cover regulations, entrepreneurship education, skills development, technology transfer, innovations, and access to finance by innovators through debt, venture capital, and government grants—in addition to promoting awareness and peer-to-peer networking. Financial literacy training is seen as a key life skill for individuals and MSME innovators to develop the financial capability to understand and consume financial products, thus driving financial inclusion.

Government use of tax or debt funding to finance GERD by universities and public research institutes—spurring development of industry clusters, regulating adoption of new technologies such as fifth-generation wireless technology (5G), protecting IPRs, financing innovative start-ups through early-stage venture capital, or providing a market by buying new technologies and innovations—is central to whether or not a country will emerge as a champion in the digital economy.

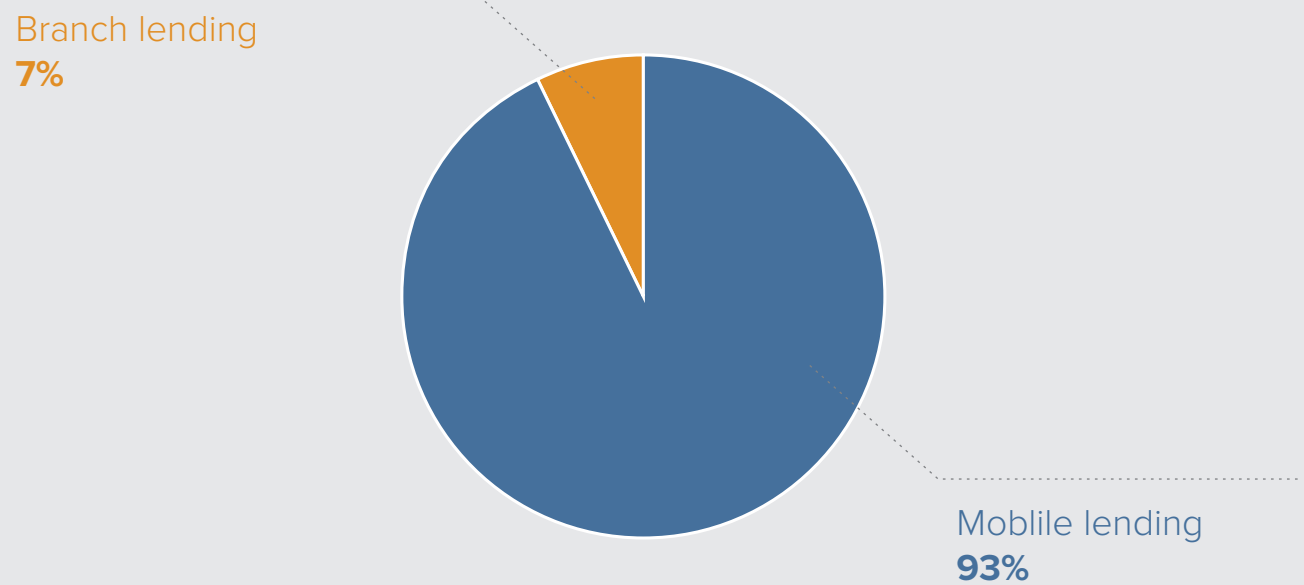
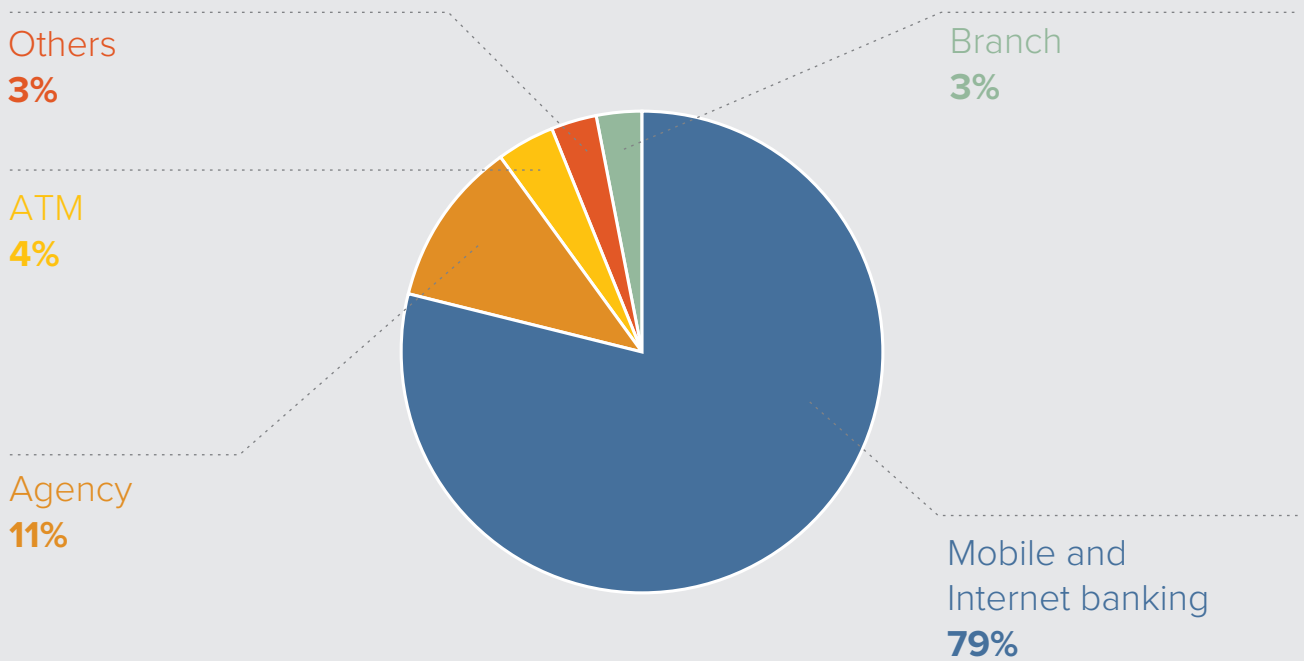
Finally, fiscal policies, such as targeted lower corporate income tax incentives, can help quicken the pace of adoption, experimentation, and consumption of innovative technologies if linked to the use of retained earnings to increase private sector GERD. For instance, in Germany, private sector GERD as a percentage of GDP stood at 2.1% with annual spend in 2015 reaching 62.4 billion euros.⁷

Opportunities for financing Africa’s innovative future

Kenya’s financing for innovation largely hinges on the vibrant and diversified private sector-driven economy, which is endowed with a well-educated and entrepreneurial workforce and a relatively high level of business and industry sophistication. Kenya has a start-up nation culture with over 7.41 million MSMEs in 2016 that Equity Bank targets to finance their innovative ideas, dreams, and aspirations.⁸ The bank envisages playing a key role in bridging the finance gap and providing access to SMEs. This can be achieved by increasing financing to enable Kenya’s GERD of 0.98% of GDP to catch up with world leaders, such as Israel at 4.8% or South Korea at 4.5%.⁹ Funding the agrarian revolution in Africa as a food and agricultural bank is also key, as agriculture employs 80% of Africa’s labor force.

FIGURE 13.1

Fintech innovation and digitization



Source: Equity Group Holdings investor presentation, full year 2019.

Likewise, Equity Bank is acutely aware of the need for Kenya and other African countries to shift from an overdependence on primary commodity exports growth to manufacturing efficiency, innovations, intellectual property, and business sophistication-led growth. It is thus also important to finance industrialists that can make Africa the manufacturing hub and “factory” of the world. The pursuit of exports and promotion leveraging gives Equity Bank the low wage competitive advantage and is key to the continent’s global competitiveness and employment of youths, who comprise over 60% of the population. Related, Equity Bank is also keen on ensuring that it plays a critical role in funding the gap within Kenya’s industry cluster development. In recent years, Kenya has excelled in information and communication technologies (ICT) business incubators with hubs like Nailab, iHub, and iLab cropping up to offer ICT innovators with a one-stop shop for facilities, mentorship, and funding for the whole innovation funnel cycle. This will only blossom exponentially with the full launch of the Konza Technopolis technology hub by the Kenyan government, dubbed “Silicon Savannah”, and the creation of new fintech companies through the Nairobi International Financial Centre.

To help achieve this transition, mobile and Internet computing technologies are also expected to revolutionize innovation in Kenya by enabling the leapfrogging of pathways to development. Kenya’s mobile phone subscriptions reached 49.5 million (96% of the population) in 2018, with many accessing the Internet through mobile channels. Equity Bank is a market elder in mobile money innovation and is also financing the whole innovation value chain for mobile money payments—both for its own ecosystem as well as those of telecommunication and fintech companies. Fourth Industrial Revolution (4IR) technologies, such as cloud and quantum computing, AI, machine learning, and the Internet of Things (IoT), are expected to herald a plethora of innovations that Equity Bank will be financing. Financing innovation towards the achievement of the UN Sustainable Development Goals (SDGs) is another gap that Equity Bank will be helping to bridge.

Finally, Equity Investment Bank is expected to grow as Kenya and other African economies shift from low-income to lower middle-, upper middle-, and, eventually, high-income economies. This will see the bank launch private equity and venture capital funds to offer equity investments for innovators and MSMEs. Financing and leveraging intellectual property as collateral is expected to significantly evolve as the economies become increasingly digital. The Group’s fintech arm, Finserve, is expected to set up a fintech fund to invest in innovative ICTs for the development start-up sector providing digital solutions to Africa’s most pressing problems.

To this end, Equity ultimately sees its role as financing the emergence of homegrown, African multinational corporations, innovators, and entrepreneurs. Equity seeks to mobilize a factor of production for wealth and job creation, as a cure to the African paradox of poverty amidst abundant resources, thus enabling Africa to finance its way to an innovative future.

Notes:

- 1 Kerr et al., 2015.
- 2 United Nations Economic Commission for Europe, 2009.
- 3 Central Bank of Kenya et al., 2019.
- 4 Trading Economics, 2010.
- 5 International Finance Corporation, 2011.
- 6 UNCTAD, 2012; OECD, 2015.
- 7 DAAD, 2017.
- 8 Kenya National Bureau of Statistics, 2017.
- 9 AUDA-NEPAD, 2019.

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