FIBR CASE STUDY

THE SWEET SPOT

Designing Credit Solutions for Small Merchants

Leveraging Suppliers to Deliver Working Capital to Shopkeepers

fibr mastercard foundation BFA

1 Executive Summary

Managing the finances of a small shop is challenging, especially since traditional credit offerings don't match the rhythms and constraints of small shops. Micro, small and medium enterprises (MSMEs) need working capital to smooth the ups and downs of their cash flows and to maintain adequate inventory.

Unfortunately, merchants struggle to access adequate inventory financing, whether through informal or formal means. While informal credit, sourced through social networks, can help with quick access to smaller amounts, it is not sufficiently regular or predictable to meet the needs of shopkeepers. In addition, commercial banks still struggle to reach small merchants with attractive credit and loan products despite claiming to see a business case and need in the MSME segment. Without clear records of purchases and sales, and credit histories, commercial banks will continue to view MSMEs as higher-risk and will limit MSMEs' access to the right kind of financing.

Inventory suppliers, which are already in the ecosystem and know merchants well, can facilitate access to smaller, recurring credits on their own balance sheet or through partnerships with banks. Access to these smaller amounts could contribute to the creation of credit histories, eventually enabling access to larger, periodic amounts from commercial banks. From the point of view of suppliers that are trying to grow their market share and outrun competitors, such financing is a competitive value-added service for attracting merchants.

Along with FIBR's partner Sokowatch, an e-commerce platform that supplies informal merchants in Africa, we recently researched the financial lives of 20 merchants to understand how merchants, banks, and suppliers could work together. We then designed and piloted a credit solution on a smartphone app to learn how suppliers could offer merchants credit lines. The merchants repaid the loans in full, with 98 percent of the funds repaid on time. Our results suggest that partnerships with suppliers can help financial service providers (FSPs) reach "downmarket" and that merchants value credit from suppliers. However, financial institutions need to provide a compelling value proposition to both suppliers and merchants to make the partnership work.

BFA's FIBR initiative, with the support of Mastercard Foundation, seeks to digitize small businesses and use the resulting data to help tech companies partner with financial institutions. Through these partnerships, we aim to expand access to credit, savings, and loans to MSMEs and low-income populations.

2 Financing Needs

In our research, we saw that most merchants are active borrowers. Eighty-five percent of them borrow for business purposes and half borrow on a regular basis. The main reason that small merchants take out recurring business loans is to keep up their inventory. This makes sense since, without a properly stocked store, sales and loyalty are lost -- customers are fickle and will head to nearby shops if they cannot find the products they want.[1]

That said, not all merchants want or need credit. Some merchants are weary of credit, especially those that have had bad experiences managing debt. Other merchants just do not need it since their businesses are stable or they have no plans to invest to increase their capacity. This is typical behavior of merchants who treat their business as a "**side-hustle**."[2]

Borrowing through formal institutions can be complex and slow so almost all the merchants we interviewed borrowed through informal and culturally-familiar means; through savings groups, from family and friends, or via M-Shwari.[3]

Merchants Need Smaller, Recurring Loans for Working Capital to Purchase Inventory

While informal mechanisms are quick and easy, they are not reliable for regular credit needs as family members and friend tend to have other, competing financial obligations and are not able to consistently provide the required amounts. Similarly, while a mobile product like M-Shwari offers acceptable rates, easy access from phone menus, and assumable loan sizes, it does not provide revolving credits.

In an ideal world, borrowing to purchase inventory would look like a flexible credit line whereby merchants could stock up when inventory is low and pay down as they make sales. Merchants want to borrow for two or three days, or from Friday to Monday, and in amounts ranging between US$50 and US$100 to replenish stock.

We found that these challenges around payment flexibility prevented merchants from purchasing supplies from Sokowatch. Eight out of 18 merchants left Sokowatch to buy from other suppliers where they get credit, such as deferred payments, to purchase inventory.

Even in a market such as Kenya, where there is a proliferation of loans from major banks, microfinance institutions, MSME-specific lenders, and new digital lenders such as Tala and Branch, the merchants we interviewed did not access them.
We interviewed eight financial institutions in Kenya and found that while some providers were more interested in reaching downmarket (some offer loan solutions already), most struggle to pursue micro-retailers as a segment. First, there is not enough reported data about merchants' transactions for providers to feel comfortable serving them. Second, providers also feel it is important to have an on-the-ground partner or agent network to manage the customer relationship and secure repayments.

Even newer, MSME-oriented providers, face challenges. Smartphones barriers such as quality of devices, connectivity and user readiness and in some cases, high-interest rates, limit adoption of digital loans among merchants.

3 Suppliers Facilitate Inventory Credit

Within this ecosystem, suppliers are uniquely placed to offer a credit line to merchants. Suppliers have what the merchants want, visit them regularly, and know them well. Many have begun to taken advantage of this position to offer financing. In Kibera, the largest informal settlement in Africa and the most competitive area for suppliers, all the merchants we interviewed received credit from at least one supplier.

As suppliers are increasingly facing stiff competition to gain market share; lines of credit to merchants - in addition to short delivery times, a good variety of products, lower prices, a sense of trust, and customer service - are good differentiators. Suppliers can offer credit options to increase retention and loyalty, and compete with other providers. In addition, merchants may also make larger purchases versus more frequent, smaller purchases if they had access to credit.

Among Sokowatch's competitors, local wholesalers already offer delivery services and competitive prices. To compete, suppliers typically offer three types of credit to Sokowatch merchants (none of which were offered by Sokowatch when we started working with them):

1 / Deferred payments - merchants pay the supplier a day to several days after they have recouped cash from daily sales.

2 / Staggered payments - merchants make a partial payment at the time of purchase or in installments to supplier.

3 / Revolving credit line - merchants can still purchase on credit as long as they repay a portion of the outstanding balance.

4 An App-based Credit Solution

Given the tough competition among suppliers, our goal was to help Sokowatch add a credit component to their mobile-based ordering tool for merchants. The credit was organized into a four-tier ladder, with previous transactions determining the credit limits (figure 4.1). Limits increased with good credit history (or decreased in the case of bad history). In addition to repaying the original loan, merchants paid a markup ("interest") depending on the credit bracket. Merchants had seven days or until their next order to settle their outstanding Sokowatch balance.

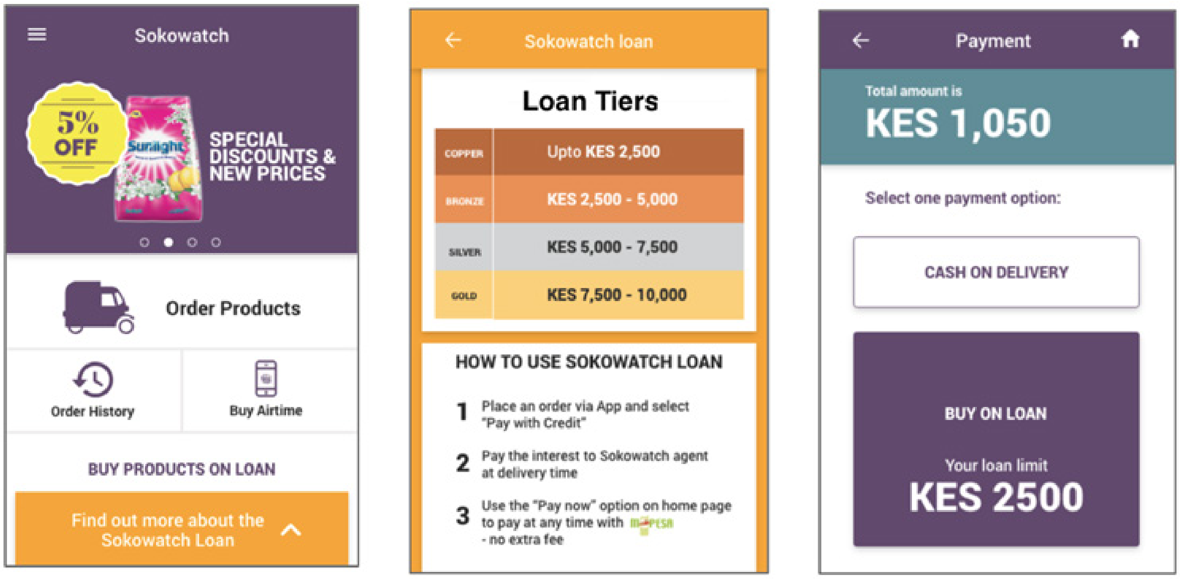

Figure 4.1. Screenshots of the Sokowatch App and the option to purchase on credit

5 Early Pilot Results: 100 Percent of Loans Repaid

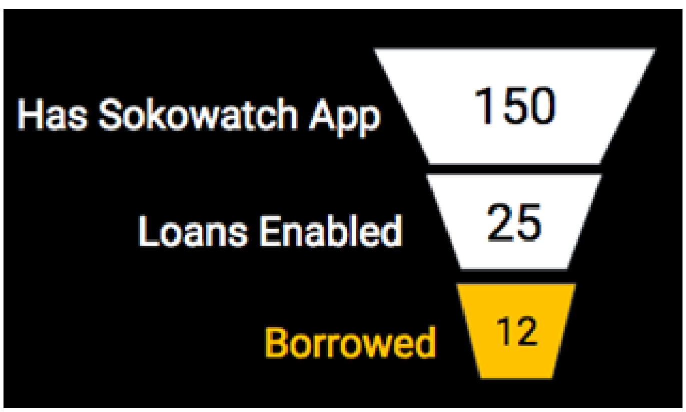

Figure 5.1. The credit pilot funnel showing how many merchants used the app for borrowing

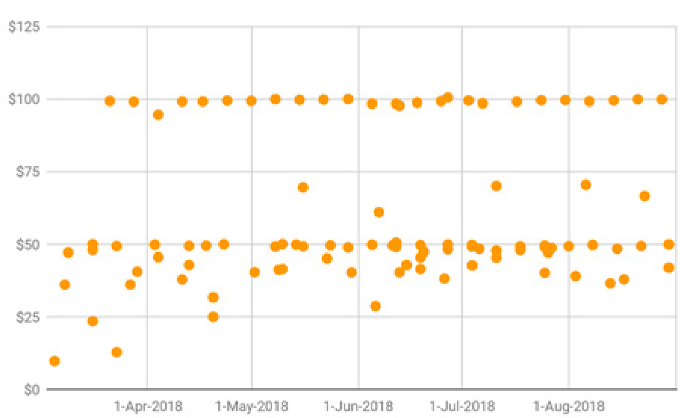

Figure 5.2. Purchases supplied by Sokowatch on credit.
Note: Merchants are regular borrowers. One customer used the credit feature 20 times, borrowing US$100 on a weekly basis

Sokowatch, with the support of FIBR, offered the credit option on a pilot basis to a small group, with plans to progressively scale up to a broad user base. Of all the Sokowatch merchants in Kenya, slightly more than half own smartphones but only 150 were already purchasing through the app, making them eligible to participate in the pilot (figure 5.1).

During the six months of the pilot, Sokowatch disbursed more than 100 loans totaling US$6,000 to 12 merchants. While this is a small number of merchants, the repayment behaviors we observed are promising: over 50 percent of the eligible merchants used the credit and all loans were repaid (two delinquent customers paid after the seven-day default period).

Credit amounts clustered around US$50 and US$100 (figure 5.2). The markup helped maximize utilization of the credit limit and proved to us that charging interest did not present a barrier to use despite initial protests from merchants. It was important to choose appropriate wording (i.e., "loan tariffs") to avoid confusion among the merchants, since "credit" can also refer to airtime.

We observed **three types** of merchant behavior:

Weekly borrowers (25 percent): customers that, for example, every Tuesday pay back the previous purchase and purchase again. The merchant buys on credit, makes a profit and then buys again.

Occasional borrowers (25 percent): customers that use cash more often than credit, although may make use of the credit on any given day.

Cash users (50 percent): customers that always transact in cash, even if they are aware of credit options offered to them.

6 Key Takeaways and Recommendations

Merchants Value Access to Credit

Merchants preferred the supplier credit option as either the method of payment or as a backup to manage the up and downs of their cash flows.[4] "Finally you give me the option!" one merchant exclaimed, "I have been asking to the agent for credit during months. We sometimes need that support from you." These are merchants who have reached the stabilization phase of their business, and struggle with cash flow while making small changes in their business to try to increase profitability. Providers likely find these merchants quite attractive; they need financing for cash flow, they are low-risk with consistent incomes, and may eventually digitize their business ledgers.

Opportunity for Financial Service Providers to Partner with Suppliers

Suppliers have established relationships with the merchants, which are fundamental for reaching customers, securing repayments and avoiding diversion of funds for the lender. Suppliers may not see the value of a financing partner especially if they can offer the credit themselves. Therefore, financial service providers need to structure partnerships that are aligned with the suppliers and that create value for both the supplier and for merchants to create win-win scenarios.

Providers

Providers need to monitor the performance of the loan portfolio at a high level

Providers should use the digital transaction records that suppliers have at hand - whether records of cash purchases or credit histories - as alternative sources of data to design their product and manage its risk.

Providers need to track usage, collections, and reconciliations, and put in place appropriate processes and monitoring tools so that different departments, from retail banking to credit risk, can keep track of the performance of the overall loan portfolio.

Suppliers

Suppliers need to be able to follow up on delinquent customers to guarantee repayments for providers

Suppliers need to provide agent-based onboarding, usually face-to-face, to complement digital versions to educate merchants about the app and credit features.[5] A standalone “how it works” guide in the app is not enough to get merchants to adopt the credit solution. Thus, it is essential to train field agents to onboard effectively and to find the best commission structure to align agent incentives.

Suppliers need to train agents to manage end-of-day reconciliations and to monitor delinquent customers to be able to follow-up on repayments.

Contact fibr@bfaglobal.com to better understand the kind of data sets we are capturing about merchants and learn how FIBR is using the data to foster partnerships between financial institutions and fintech providers.

Endnotes

[1] The level of inventory in a shop therefore is a measure of the health of the business. Well-stocked shelves mean that the business has enough working capital to stock up on inventory and sustain customer demand. Poorly-stocked shelves indicate that the business cannot invest in purchasing enough stock, which stunts the sales cycle and threatens business viability.

[2] In the MSME context, the shop side-hustle provides supplementary but not primary income for the family, even though the person (usually the wife) is at the shop is full-time and does not hold another steady job.

[3] M-Shwari is a banking product for M-PESA customers that allows customers to save, earn interest and take out affordable loans, including emergency loans, through mobile phones. Interestingly, merchants did not necessarily perceive M-Shwari as a formal service underwritten by a bank (in this case, the Commercial Bank of Africa), but rather a Unstructured Supplementary Service Data (USSD) feature embedded in their M-Pesa accounts.

[4] The impact on growth of the business is not yet clear and unobservable in the short duration of the pilot, especially for credit that only applies to small purchase sizes or a low share of the total inventory. Specialized suppliers or manufacturers, such Unilever, Nestle, and including Sokowatch, usually hold a small share of the shop inventory.

[5] The impact on growth of the business is not yet clear and unobservable in the short duration of the pilot, especially for credit that only applies to small purchase sizes or a low share of the total inventory. Specialized suppliers or manufacturers, such Unilever, Nestle, and

[6] When designing credit solutions where the FSP underwrites supplier credit lines to merchants, both partners need to be ready to work with customers that may have smartphones but who are not ready to use the full range of device features or who have hardware with limited capacity to run apps. To account for these specificities, Sokowatch reduced the app download size to 6 Mb, distributed the app via Google Play, Bluetooth, and WhatsApp, enabled local language (Swahili) functionality, and allowed the app to work without data connections via SMS orders.


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About FIBR

FIBR is an initiative of **BFA** in partnership with **Mastercard Foundation** to create new ways to connect low-income populations to financial services that meet their needs. Rapid uptake of smartphones in these markets means we can digitize data about how individuals otherwise informally, transact as employees, customers or suppliers in their communities and with local businesses. The digitization of these trusted business relationships allows for new data that a broader range of providers can use to offer tailored financial products and services to this demographic.

For more information and to sign up for our newsletter, please visit: www.fibrproject.org. Follow on Twitter @FIBR_BFA #inclusivefintech.

About Mastercard Foundation

The Mastercard Foundation works with visionary organizations to provide greater access to education, skills training and financial services for people living in poverty, primarily in Africa. As one of the largest private foundations, its work is guided by its mission to advance learning and promote financial inclusion to create an inclusive and equitable world. Based in Toronto, Canada, its independence was established by Mastercard International when the Foundation was created in 2006.

For more information and to sign up for the Foundation's newsletter, please visit www.mastercardfdn.org. Follow the Foundation at @MastercardFdn on Twitter.

About BFA

BFA is a global consulting firm specializing in using finance to create solutions for people on low incomes. Our approach is to seek out, create, and implement financial solutions to help people manage challenges and seize opportunities. We partner with cutting-edge organizations that touch the lives of low-income consumers such as financial institutions, fintech companies and information providers. In creating solutions, we integrate our deep expertise in customer insights, business strategy, new technology, and growth-enabling policy and regulation. Founded in 2006, BFA's clients include financial institutions, technology companies, donors, investors and policymakers. BFA has offices in Boston, Medellín, Nairobi, New Delhi, and New York.

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