



FEED THE FUTURE

The U.S. Government's Global Hunger & Food Security Initiative



CASE STUDY: FEED THE FUTURE KENYA USAID KUZA & THE IMPACT FOR NORTHERN KENYA FUND

JANUARY 2022



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DISCLAIMER

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ACRONYM LIST

FCDC	Frontier Counties Development Council
FCL	First Capital Limited
FI	Financial Institution
LPO	Loan Purchase Order
MFI	Microfinance Institution
MSME	Micro, Small and Medium-Sized Enterprise
PAYGO	Pay-As-You-Go
SACCO	Savings and Credit Cooperative Organization
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

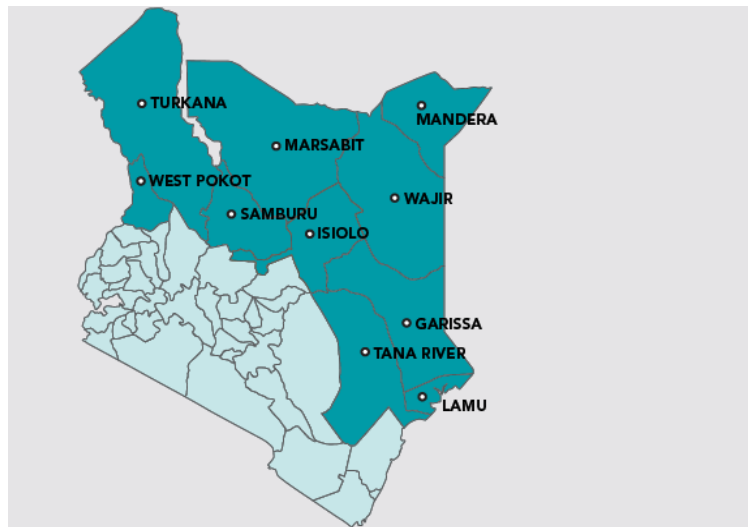
In October 2020, Feed the Future Kenya USAID Kuza launched the Impact for Northern Kenya Fund (“the Fund”), which mobilizes and leverages private capital to support institutions, enterprises, and individuals that foster economic and social impact in Northern Kenya. The Fund will provide financing to local financial institutions (FIs), who then match the amount and on-lend to growth-oriented micro, small and medium-sized enterprises (MSMEs) in the region. In parallel, USAID Kuza supports the strengthening of local FIs through direct technical assistance.

As capital is deployed through FIs, lessons learned will be shared widely with practitioners and partners to inform future programming. USAID Kuza will share supply-side innovations from the FI partners that foster impact. We will also share the impact of the Fund on the demand-side, highlighting borrower MSMEs, who catalyze market system impact and foster further growth of the region’s private sector. The expected impact of both FIs and their borrowers includes improving economic opportunities for vulnerable populations, creating jobs, improving gender and youth equality, having a positive impact on the environment, and making market systems improvements.

This information will be used by the counties and donors to design future investment policies, access to finance activities, and investment mechanisms. As a first step in this process, USAID Kuza is pleased to share a case study on the establishment and rollout of the Fund.

Activity Background

USAID Kuza works to develop and support economic opportunities in ten arid and semi-arid counties of Northern Kenya: Garissa, Isiolo, Lamu, Manderla, Marsabit, Samburu, Tana River, Turkana, Wajir, and West Pokot. This area, the Frontier Counties Development Council (FCDC) region, has historically been an area of recurring crisis, and thus viewed as a destination for humanitarian assistance, rather than investment activity. USAID Kuza is implemented by ACDI/VOCA in close collaboration with Frontier Counties Development Council (FCDC) and is supported by AV Ventures LLC and select FI clients. As an affiliate of ACDI/VOCA, AV Ventures is an impact investment company and serves as the Fund Manager.¹



USAID Kuza operates in all ten counties of the FCDC region.

USAID Local Orientation and Linkages:

USAID has been working in Kenya for 55 years, investing in areas of mutual interest, such as security, food security, health, and education, for both the United States and Kenya. Many USAID programs in Northern

¹ USAID and ACDI/VOCA jointly decided for AV Ventures to serve as the Fund Manager.

Kenya have been successful and laid the foundation for future work, including the establishment of the Fund. USAID Kuza supports USAID's Local Orientation Policy by building capacity of county governments and regional blocks to achieve sustainable results, mobilize public and private sector capital, and improve the enabling environment to support MSME-driven development.

INTRODUCTION

Background

Kenya is one of sub-Saharan Africa's fastest-growing economies; however, economic development has been unequal within the country and economic growth has failed to keep up with population growth. In Northern Kenya, development has lagged far behind the rest of the country. This area has long been challenged by limited accessibility, population challenges, regional conflict, inequality, and frequent environmental challenges. These complex challenges have exacerbated the vulnerability of Northern Kenya's pastoralist communities and threatened their livelihoods, driving food insecurity and poverty and weakening communities' ability to withstand shocks and adapt to a changing environment.

Key to driving the region's development is growth of its private sector, including its MSMEs. MSMEs play a vital role in the economic development of Kenya, contributing to approximately 40 percent to the GDP. MSMEs also employ 14.9 million people, of whom 12.1 million are employed in microenterprises.² MSMEs are the engine of the regional economy, and their success is a necessary step toward broader growth. MSMEs need support to grow, and it is important to facilitate the growth and development of organizations that support MSMEs, including a diverse set of FIs, to provide needed financing.

ACCESS TO FINANCE

Kenya has made significant progress in financial inclusion, tripling the percentage of its financially included population in 13 years. Kenya is now providing financial access to 83 percent of the population.³ However, as with economic development, access to financial services has been uneven. Per the 2019 FinAccess survey, only 70 percent of the country's poor are financially included, compared to 96 percent of the wealthy. Eighty percent of women are financially included, as opposed to 86 percent of men². There is also an urban and rural divide in access. The uneven progress in improving access to finance has led to several supply- and demand-side barriers in accessing finance that are hampering economic development.

Supply-side financing challenges:

- *Less economic appeal than other regions in the country because of a lack of infrastructure and existing financial access:* The opportunity cost for financial institutions created by the country's economic differences leads to many of the institutions operating largely in the south rather than the north. The FIs that are present tend to have higher ratios of non-performing loans, making it riskier to work with them. Further exacerbating the effects of the opportunity cost challenge, regional FIs face liquidity constraints that severely hamper their ability to offer products at an attractive market rate.
- *Limited local presence:* Most banks do not have physical branches in Northern Kenya due to the large and spread-out nature of the region as well as the opportunity cost mentioned above. Serving the region requires a shift for some FIs toward processing large volumes of small loans and increasing the

² http://www.microsave.net/2021/01/19/msmes-in-kenya-amid-covid-19-a-question-of-survival/#_ftn2

³ [http://www.centralbank.go.ke/uploads/financial_inclusion/1035460079_2019%20FinAcces%20Report%20\(web\).pdf](http://www.centralbank.go.ke/uploads/financial_inclusion/1035460079_2019%20FinAcces%20Report%20(web).pdf)

transaction costs. In addition, some FIs lack the ability to evaluate the applications of many small borrowers in sectors they are not familiar with. Private investors also mainly source opportunities from within Nairobi, limiting their investors' exposure to promising investment opportunities within the region.

- *Limited knowledge of regional livestock sector:* FIs often lack a general understanding of livestock sector and the Northern Kenya region, making it difficult for them to identify financing opportunities. Because of this, FIs are not tailoring financial products to meet the needs of livestock agribusinesses.
- *MSMEs are deemed too risky.* FIs have been reluctant to lend to MSMEs within Northern Kenya due to the perception that the agribusiness and livestock sector are un-bankable and too risky and profit margins too low. FIs often cite a shortage of capital and high opportunity costs of capital in lending to this sector.
- *Lack of knowledge about investment opportunities:* Investors and lenders are uninformed of Northern Kenya's promising landscape for agribusiness investment and lending opportunities. Though Kenya continues to be an attractive destination for investment, most investments by government and private investors have been in the financial services and energy sectors,⁴ leaving a gap in finance for small agribusinesses.
- *Larger ticket sizes are more attractive:* More than half of enterprises in Kenya are still in their early stage of growth.⁵ These enterprises require small ticket-size capital, whereas FIs prefer larger loans, leading to limited capital for early-stage companies.⁶ Pre-investment technical assistance and pipeline building have been limited, requiring investors to spent significant time and money on the due diligence of agribusinesses, limiting their ability to invest in smaller, early-stage growth companies.

Demand-side financing challenges:

- *Strict collateral requirements:* Due to the perceived risk of MSMEs and the region, collateral requirements are challenging. Residents in Northern Kenya do not have ample securities to secure their loans. Land in these counties is often communally owned or the owners of privately owned land have no title deeds, making it difficult for the banks to secure the loan.
- *Gender gaps:* Gender disparities in access to and control over assets that are required as collateral further complicate women's access to finance. Some of the region's cultural norms also limit access to finance for women-owned MSMEs.
- *High interest rates:* In addition to challenging collateral requirements, the interest rates offered on most credit products are perceived as high and create another barrier to access.
- *Challenging business environment:* Conflicts over resources in pastoral areas of Northern Kenya, including access to and ownership of land and livestock, impede access to markets and food and tend to inflate prices due to higher transaction costs and market failures.
- *Lack of access to Shariah-compliant products:* The region is predominately inhabited by Kenyans who practice Islam and would not be open to traditional interest-bearing products, requiring FIs to tailor their products or offer different lending models. Though there have been many efforts to expand access to Shariah-compliant finance, including among several USAID-funded projects, access across Northern Kenya remains limited.

⁴ <http://assets.kpmg/content/dam/kpmg/ke/pdf/deal/PE%20Survey%20Booklet%202019.pdf>

⁵ British Council Report, 2017

⁶ http://kenya.un.org/sites/default/files/2019-09/Kenya%20Impact%20Investment%20Report_GSGII_May%272019.pdf

THE MARKET OPPORTUNITY AND NEED FOR THE IMPACT FOR NORTHERN KENYA FUND

The divides in financial access play out in the form of unsuitable financial products and a lack of access to an investable pipeline of businesses, which hampers broader private sector development. Key to further supporting the region's development is tailored support to grow the financial sector and activities designed to close the supply- and demand-side gaps.

USAID Kuza established the Fund to provide much-needed financing to Kenya's underserved counties to improve access to finance and build the capacity of existing FIs in FCDC counties. The mechanism provides wholesale loans to FIs located in the counties, injecting liquidity into the areas and businesses that most need it. Per the Fund's requirements, FIs that receive loans must also provide matching capital. This, in turn, further expands access to finance in the counties and encourages more buy-in from partners. The partner institutions then offer flexible loan products tailored to best suit the needs and characteristics of the businesses in the counties. The Fund demonstrates the viability of lending in the north and justify the business case for targeting MSMEs as a viable sector for the FIs.

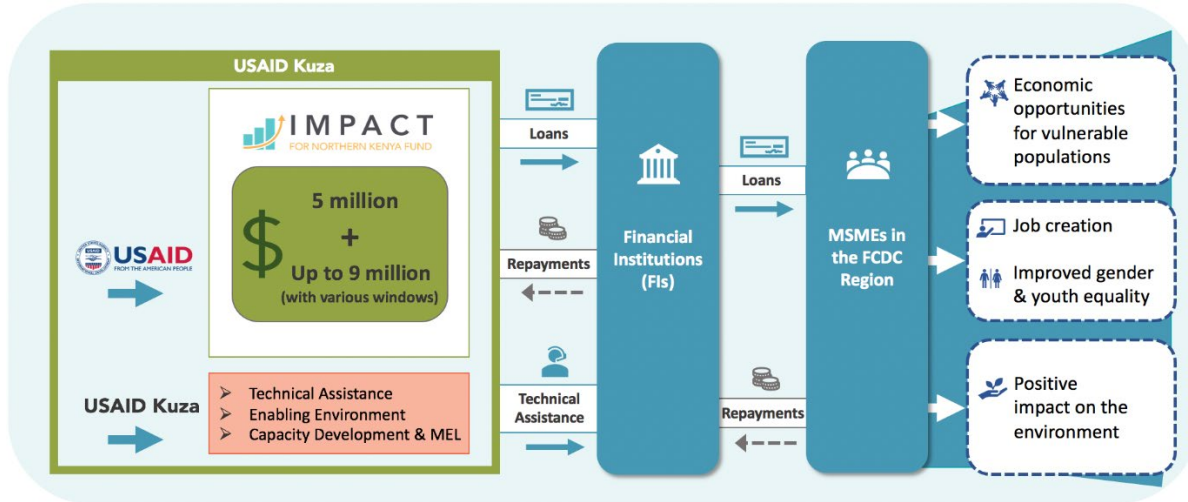
The Fund Design

The Fund structure was designed to ensure a rapid deployment of capital, provide a proof-of-concept of the "investability" of MSMEs in FCDC counties, and create a foundation that aligns with USAID Kuza's mission. The Fund is designed to jumpstart economic development by achieving the following:

- De-risking lending operations in Northern Kenya (largely related to security and immovable guarantees)
- Demonstrating commercial viability of lending in northern counties
- Attracting investment to achieve development
- Ensuring access to finance for marginalized groups
- Creating opportunity for income diversification among pastoralists

To determine the optimal products and structure for the Fund, USAID Kuza conducted over 25 co-creation sessions, meetings, and interviews with USAID, FCDC, county governments, financial institutions, investors, business advisory service providers, investment and legal advisors, and donor partners.

To serve as a catalyst for ongoing investment, the Fund began with five million dollars in anchor capital granted by USAID Kuza. As seen in the diagram below, USAID Kuza complements loans made from the Fund with capacity development of county government staff and monitoring and evaluation activities designed to capture successes of the Fund.



TARGETED INVESTMENTS AND SUPPORT

Loans are made to FIs, including banks, microfinance institutions (MFIs), savings and credit cooperative organizations (SACCOs), and pay-as-you-go (PAYGO) service providers, operating in Northern Kenya. These FI then on-lend capital to their customers. Relying on existing banking structures and customer relationships allows the relatively small fund to reach end customers efficiently. This method allows FIs with a stake in the local economy to determine where investments are made and ensures that benefits are enjoyed beyond the life of the project. Loans made from the Fund will benefit the citizens of Northern Kenya in a broad array of economic sectors, including value addition businesses, energy production, and more. Loan products have a tenor of three to five years to allow USAID Kuza to assess the market at the end of the project. If loans are largely repaid, future loans can have more flexible periods of performance.

In addition to the loans, the Fund will also rollout three windows to further support regional development. The windows, listed below, will be open to any interested FI and provide additional emphasis on building FI capacity and achieving social impact:

1. **Gender-Lens Investing and Youth-Lens Investing Window:** Provision of capital and technical assistance to FIs and MSMEs that support women and youth
2. **Bridge to Investability:** Pre-investment technical assistance and contingent loans for MFIs and SACCOs
3. **Impact Incentive Window:** Incentive payments to FIs and county funds that finance MSMEs with significant social or environmental impact

BALANCING IMPACT AND FINANCIAL CRITERIA

Because the Fund and USAID was capitalized with grant funding from the U.S. government's Feed the Future Initiative, impact objectives were determined along similar lines as USAID Kuza. All loans made from the Fund should contribute to expanding economic opportunities in FCDC counties of Northern Kenya in the following ways:

Economic	Increased financial returns to FIs and MSME end clients
	Increased market opportunities for FI and MSME end clients
	Increased employment opportunities for FIs and MSME end clients
Social & Environmental	FI and MSME end clients consider positive social and environmental impact beneficial to their business models.
	Economic linkages between businesses and consumers create social cohesion.

Governance	FI and MSME end clients conduct well-managed, transparent businesses that are well-poised for future investment. Consumers and business partners have an increased confidence and lower perception of risk with FIs and MSME end clients.
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FIs are selected according to their ability to contribute to a healthy private sector and develop MSMEs. So, FIs identify competitive companies with potential to grow that will enable marginalized populations to benefit from services. The Fund contributes to this trend through the assessment of FI's pre-investment due diligence and portfolio reports.

INCLUDING MULTIPLE TYPES OF FIS

As the Fund examines potential partnerships with various FIs, the goal is to construct an impactful, balanced, and diverse portfolio. This includes diversity of institution types (banks, MFIs, FinTechs, and PAYGO providers), types of impact (number of borrowers, depth of outreach, innovation in financial offering), and size (low or high absorption capacity). The size of partner FIs is important in balancing impact and financial criteria because the same amount of effort goes into evaluation and contracting, regardless of the size of the loan. MFIs, SACCOs, and non-traditional lenders, such as PAYGO, providers are all important to expanding access to investment because they reach a different group of businesses and individuals who are overlooked by larger FIs.

Access can also be expanded by non-FIs, such as mobile money providers or PAYGO providers whose innovative business models reach the unbanked or un-bankable. However, effort the Fund expends loaning money to smaller institutions does not yield the same results (in terms of the number of end borrowers and contribution to its sustainability) as it would if effort were expended on larger loans for larger institutions. The Fund is balancing achieving economies of scale while still being inclusive of smaller FIs that reach a different set of loan recipients.

In addition to providing catalytic financing, the Fund also supports partner and portfolio FIs to improve their capacity to serve FCDC counties and provide necessary financing. This includes providing tailored technical assistance to portfolio FIs to enable them to better serve Northern Kenya MSMEs and attract additional capital from international impact investors and development financial institutions. Technical assistance includes the development and improvement of agricultural, rural, and mobile financial products, business planning, improved corporate governance, marketing, and business analytics. This will be done via any of the windows listed above or via other partnership agreements.

COVID-19 RESPONSE

The COVID-19 pandemic is impacting the way that enterprises and individuals can repay FI loans. Because of how severely the pandemic has impacted businesses through forced closures, limited transportation and shipments, and other infection prevention measures, businesses are not creating income at the same level as before the pandemic and, thus, cannot meet loan deadlines. This directly impacts FIs.

The FIs have higher constraints because of the economic downturn and more non-performing loans, making it more difficult to find FIs that qualify to participate in the Fund. Because of the unprecedented nature of the pandemic, the Fund has decided to factor in FIs' pre-COVID-19 loan performance to evaluate FIs that qualify for the Fund.

LOOKING FORWARD

Pathway to Local Ownership

In line with USAID's Local Orientation Policy, USAID Kuza assessed and identified potential fundholders. Based on this evaluation, co-creation with USAID, and preliminary discussions with stakeholders, USAID Kuza selected a local institution as the Kenyan fundholder. USAID Kuza believes the local partner has requisite expertise and capacity to hold the Fund, ensure capital preservation, and stimulate county participation and fundraising.

Selection of the Kenyan fundholder was based on its following strengths:

- Full regional representation and county buy-in
- Strong creditability with donors and stakeholders
- Experience in managing donor relationships projects worth millions of United States dollars
- Alignment with USAID Kuza's goal of increasing investment activity and encouraging private enterprise as well as USAID's self-reliance agenda for both institutions and county governments
- Long-term goal of establishing a development finance institution for Northern Kenya

To facilitate effective service delivery, USAID Kuza will provide capacity strengthening to the local partner in the following areas:

- Technical assistance on fundholding and fundraising
- Designation of a non-voting seat in the investment committee on a rotational basis per county
- Establishment of monitoring and evaluation systems for performance tracking

The Fund's Sustainability

The Fund, in its current plan of implementation, aims to exist as an operationally sustained fund with the ability to make loans continuously over an extended period of time. Because the Fund is for-profit and receives a return on its investments, the Fund will work to maintain capital preservation to ensure long-term sustainability. As the Fund is the first entity of its kind to take this loan structure, the overall rate of return on the loans is unknown. The expectation is that the Fund will have capital preservation. As investments are disbursed and repayments are monitored, USAID Kuza and the Fund Manager will then be able to understand the rate of return and the level of performance.

BRIDGING CAPITAL AND TECHNICAL ASSISTANCE

USAID Kuza is unique in that, in partnership with allocating capital, it also provides technical assistance to FIs and county governments in the FCDC region. This support to local FIs fills in their assessed capacity gaps and improves their ability to qualify for the Fund via the relevant windows. So far the USAID Kuza has provided technical assistance to FIs to improve their monitoring, evaluation, and learning procedures and additional trainings are scheduled on Islamic Finance and Gender-Lens Investing.

In addition, USAID Kuza builds the capacity of county governments to develop guidelines and provide coaching and mentoring support on critical topics, such as taxes, compliance, business registration, gender lens investing, and dispute resolution. USAID Kuza also supports the counties in management of their local funds and supports them in developing investment prospectuses to attract private sector financing.

The Fund's Progress to Date

Thus far, the Fund has made two loans to FIs operating in select FCDC counties. Per the Fund's requirements, the FIs will provide matching capital to the region on a *pari passu* basis and use the capital for on-lending to MSMEs in the region.

\$1 MILLION TO FADHILI MICRO ENTERPRISES LIMITED

Fadhili Micro Enterprises Limited ("Fadhili") is a credit-only MFI. Fadhili will use the loan of \$1 million from the Fund to on-lend to MSME clients in the FCDC region, including an expansion into Isiolo, Garissa, Samburu, Turkana, Wajir, and West Pokot counties. The MFI is using the capital to finance 150,000 micro-entrepreneurs.

Fadhili was established in October 2011. Its model is primarily based on group lending with cross-guaranteeing of individual borrowers within the respective groups. Fadhili's portfolio consists of small loans with tenors averaging 24 months. Fadhili offers the following products: MSME loans, *kikundi* (group) loans, individual loans, *musharakah* (asset finance) loans, *FAFA* ("faster, faster") loans, emergency loans, Christmas and Ramadhan loans, and school fee loans.

It has maintained a consistently low non-performing loan ratio that is significantly lower than the national average. Fadhili has a total loan book of 856 million Kenyan shillings and approximately 40,000 clients, 80 percent of whom are women and women-led microenterprises.

\$850,000 TO FIRST CAPITAL LIMITED

First Capital Limited (FCL) is a credit-only FI operating since 2015. FCL is using the loan of \$850,000 from the Fund to on-lend to MSME clients in the FCDC region, including an expansion into Isiolo and Marsabit counties. FCL offers business loans, loan purchase order (LPO) financing, import financing, and guarantees.

FCL currently has two Sharia-compliant products: *sahib* leasing financing and *murabaha* LPO financing. It is exploring the feasibility of offering additional Sharia-compliant products, including *ijara* (rent), *mudharaba* (profit sharing), *musharakah* (asset finance), *salam* (supplier financing) and *istisna* (contract for the acquisition of goods) financing models, as a part of its expansion strategy.

FCL has a portfolio valued at approximately \$2.5 million. It offers loans valued between \$5,000 and \$65,000 to producers and MSMEs in and supporting the agribusiness and livestock sectors. FCL has reported high growth rates since inception, largely driven by growing customer numbers, branch expansion, and new product offerings.

\$1,250,000 TO AGRICULTURAL FINANCE CORPORATION (AFC)

The Impact for Northern Kenya Fund disbursed its third loan to Agricultural Finance Corporation (AFC). Per the Fund's requirements, AFC will provide matching capital on a *pari passu* basis and use the capital for on-lending to producers and micro, small, medium and microenterprises (MSMEs) in select Frontier Counties Development Council (FCDC) counties.



Mobile banking kiosk managed by the Fund's client, Fadhili Microenterprises Limited

AFC (www.agrifinance.org) was established as a subsidiary of the Lands and Agricultural Bank in 1963 to cater for African farmers in the post-independence Kenya. AFC's mandate is to support the development of agriculture and agricultural industries by making loans, and providing managerial and technical assistance to farmers, co-operative societies, incorporated group representatives, private companies, public bodies, local authorities, and other persons engaging in agriculture or agricultural industries. AFC is a leading agriculture-focused financial institution in Kenya, with coverage across 36 of 47 counties, including a presence (physical and/or branchless) in all ten FCDC counties.

The loan from the Fund will be used to improve access to agricultural financing to livestock and crop farmers in the Northern Kenyan region. The partnership is intended to increase financial inclusion and develop resilience to chronic shocks and stresses over the long term by creating sustainable pathways in northern Kenya, in line with the objectives of the USAID Kuza project. AFC will achieve this by customizing existing products to suit the financing needs of the people of the FCDC counties.

All investments are complemented by technical assistance to the financial institutions provided by USAID Kuza.