BUSINESS GENERATION AND JOB CREATION THROUGH MICROFINANCE

Final Report

Presented to:

USAID SOUTH AFRICA
PRETORIA

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I. INTRODUCTION

In June 2002, USAID South Africa initiated a program to support FINCA in its effort to deliver micro finance services to low-income entrepreneurs in Kwazulu-Natal.
This is the final report for this cooperative agreement and it summarizes FINCA's program over the two-year period from June 2002 to June 2004. This report provides updated information on project activities, achievements, and obstacles toward achieving the goals and objectives.

A. Goals

1. To increase the volume of business generated by low-income entrepreneurs, both in survivalist and more established micro enterprises.
2. To increase employment in survivalist and micro enterprises.
3. To increase profits and incomes earned in survivalist and micro enterprises.

B. Objectives (according to Modification of Assistance and budget revised by USAID as of June 6, 2003)

1. To disburse 30,957 loans, with a total value of $1,659,495.
2. To support a total of $8,537,002 in business activity by micro entrepreneurs.
3. To support the creation of 2,874 jobs in 5,748 enterprises. [1]
4. To support the generation of $2,134,251 in net income to micro enterprises[2].

As per Cooperative Agreement number 674-A-00-02-00022-00, at the end of the project period, property title will be vested with FINCA South Africa, the recipient of the award.

II. PROGRAM ACTIVITIES (STATISTICS)

	Target End of Grant	**Actual End of Grant**	**% on Target**
Number of Loans Disbursed (Cumulative through LOP)			
Group	29,407	12,095	41.2%
Individual	1,550	923	59.5%
Total	30,957	13,018	42.1%
Value of Loans Disbursed ($US, Cumulative through LOP)			
Group	1,459,021	1,001,497	68.6%
Individual	200,475	226,762	113.1%
Total	1,659,495	1,228,259	74.1%
Portfolio Outstanding ($US)			
Group	117,210	34,989	29.9%

[1] The number and value of loans disbursed, and the number of micro enterprises supported, are based on FINCA's projections of its activities, as shown in Annex C of the project proposal, "Portfolio Projections." The values of business generated and jobs created are based on calculations derived from recent surveys of clients, focusing on loan use, stock price and sales value, turnover, and employment, as described in the project proposal.
[2] Net income estimated at 25% of total business generated.

Individual	53,109	32,796	61.8%
Total	170,319	67,785	39.8%
Value of Loans Disbursed, Rands (Cumulative through LOP)			
Group	36,307,000	8,446,770	23.2%
Individual	5,349,000	2,553,670	47.7%
Total	41,656,000	11,000,440	26.4%
Portfolio Outstanding (Rands)			
Group	3,903,083	223,931	5.7%
Individual	1,768,538	209,894	11.9%
Total	5,671,621	433,825	7.6%

Note: Targets in Rand appear high due to the high exchange rate that was projected. Exchange rates were much lower than initially anticipated.

Challenges

A. External Challenges

There are widely divergent views within the microfinance industry about how to build successful operations in South Africa. There is, however, broad agreement that, in one expert's words, "South Africa is an expensive place to run a microfinance programme, no matter what the variety."[3] The uniquely difficult operating environment for microfinance in South Africa traces directly to the country's colonial and *apartheid* past which created a country that, on the one hand, has one of the world's most advanced and industrialized economies but where a majority of the population lives in poverty comparable to that of the poorest nations.

Market Characteristics. The very economy and culture of South Africa are, in some respects, unfavorable for the development of a sustainable microfinance sector. It has been observed that "unlike postcolonial societies elsewhere in Africa, in Asia, the Caribbean, and Latin America, South Africa's advanced manufacturing and retail distribution sectors severely constrain opportunities for small-scale manufacturing, the salvation of the poor in many countries." [4] The economy is dominated by large firms, with low unit costs, leaving very little margin for home industries and informal trade. At the same time, the survival strategies which are typical in other poor countries (home gardens, small scale production, etc.) are less viable in South Africa. This is evident in the relatively small participation of informal businesses in overall employment in South Africa.

In this environment, the dominant survival strategy is to secure state grants (basic income grants, pensions, etc.), rather than to strike out as an informal entrepreneur. As a result, FINCA has found that South Africa also suffers from a weak repayment culture. Many of South Africa's poorest people have grown accustomed to state grants or they view the failure to pay back loans as a legitimate form of social protest.

Given the geographic remoteness of South Africa's poorest citizens, the typical strategy would be to try to reach as many clients in each settlement as possible. But given the shortage of viable opportunities for microenterprises, microfinance institutions can often reach only a few households: by some estimates, no more than one out of five in very poor communities. [5]

[3] Baumann, Ted. "Microfinance and Poverty Alleviation in South Africa," August 2001, p. 17
[4] Ibid, p. 4.
[5] Baumann, Ted. "Doing Pro-Poor Microcredit in South Africa: Cost Efficiency and Productivity of South African Pro-Poor MFIs" (undated), page 11

Labour Force Issues. FINCA has found that attracting and retaining qualified, motivated staff is probably more difficult in South Africa than anywhere else in the world. A generally combative labour relations environment has created a situation wherein FINCA struggles to enforce the high performance standards which are necessary for its success.

In addition, South Africa's educational system does not produce a workforce with the skills to run microfinance operations. As Baumann points out, credit officers in South Africa "tend to be young, and many lack life skills and a mature work ethic, considering their MFI jobs neither as a career nor as particularly 'developmental.'"[6] FINCA has experienced very high staff turnover rates as it struggles to deal with this labour force. Such turnover has proven costly to FINCA.

Despite lacking hard technical skills, credit officers typically have at least some education, albeit usually unrelated to the job. As a result of this, and the high cost of living, salaries in South Africa are normally higher than in other countries, despite the low performance of staff. Thus, FINCA has encountered a paradox in South Africa. The costs of doing microfinance are very high, and clients are spread out over a wide area. At the same time, the revenues from lending are very low, owing to the small loan sizes that most clients can afford.

B. Internal Challenges

Due to both external challenges and internal issues, FINCA has failed to reach its targets for this USAID project. It's important to note, however, that FINCA's problems in South Africa mostly arose in the period that it attempted to achieve rapid gains in scale in order to reach sustainability. Most of the problems which arose internally were a result of an ineffective strategy for scaling-up the operation, taking into account the unique challenges in South Africa.

The implementation of the scaling-up strategy was poorly timed. A large push for expansion in the period from November through February 2003 resulted in the disbursement of many loans which went unpaid. (December and January are universally poor performing months for microfinance in South Africa.) Most clients who defaulted in the quarterly period ended March 31, 2003 had used loans taken out in December and January for consumption rather than productive investment, leaving them with no new income with which to repay. This client behavior is typical during the holidays and in January, when school fees come due. In response, FINCA is preparing to offer special educational loans to assist clients to cover this recurring expense.

FINCA South Africa also struggled to rapidly replicate the efficiencies of its solidarity-based group lending methodology in the "low trust" South African society and to attract new clients, who proved deeply suspicious of nonbank financial institutions given past bad experiences with pyramid schemes and predatory lending.

The large-scale expansion push proved to be very costly for FINCA, both in terms of staff salaries and transportation costs, but also in the deterioration of controls which occurred as responsibilities were delegated. As noted earlier, the typical South African credit officer is more expensive and less productive than in virtually any other microfinance market. FINCA South Africa's original strategy was to add staff quickly in order to scale up the operation, and provide on-the-job training and supervision from more qualified staff. Experience proved, however, that this structure actually contributed to the decline in performance by weakening accountability for results. The presence of auxiliary staff with specialization in collections, training, and marketing diluted the responsibility of

[6] Ibid., p. 11

the area supervisor and created a situation where nonperformers were able to avoid direct responsibility for their results. FINCA South Africa also experienced isolated incidents of fraud by unscrupulous credit officers which, while limited in scale and swiftly corrected, pointed to the urgent need for tighter management.

Finally, FINCA was challenged by the fact that USAID funds were depleted ahead of schedule, mainly due to the recovery in the Rand, which resulted in a lower-than-planned level of support in local currency.

Steps Taken / Lessons Learned

As a negative trend in some performance indicators became evident, management engaged in wide-ranging discussions and analysis, together with staff and clients, to identify the causes and remedies for these. FINCA thoroughly analyzed its operational systems and practices, and determined the likely causes and possible solutions for the problems experienced by the organization. As a result, FINCA developed a strategic recovery plan aimed to reorganize FINCA's organizational structure; set up a more stringent system of internal controls; reduce operational costs; and increase operational efficiency.

FINCA South Africa began to realize that its Credit Department had contributed to the decline in performance, most particularly by weakening its accountability for results. It found that auxiliary staff with narrow specialization in collections, training and promotion had diluted the responsibility and accountability of the area supervisor and created a situation wherein non-performers were able to avoid direct responsibility for their poor results. In addition, these extra positions made the program administration more expensive, which was unsustainable given the small size of the field operation. To improve the situation, in September 2003 FINCA restructured the Credit Department, Finance Department and Administrative Department to eliminate the "auxiliary" positions.

Management also reassessed its geographic operations and FINCA determined that the vast geographical areas that comprised each supervisor's district were so widespread that they weakened supervision of the field program. Given that public transportation is unreliable and that field staff depend on it for their daily visits to Village Banks, it was nearly impossible for each supervisor to establish a presence to oversee the activities of his or her subordinates. To address this problem, FINCA management decided to limit its geographical reach to Durban and its surrounding areas. This approach eliminated a significant portion of transportation costs, while strengthening and consolidating internal controls and management of field staff.

FINCA South Africa also changed its approach to the Individual Lending Program. In theory, individual lending should have been more profitable than group lending, given that it required less administrative overhead. Unfortunately, the quality of the individual portfolio became a problem throughout the first year of the program, which negatively affected the second year's results. As a result, delinquent loans did not generate the expect interest income that was needed to reach operational sustainability, and the new focus on loan recovery detracted from FINCA's efforts to grow its program according to plan. In response, FINCA revamped this program with the objective of reducing the risk of bad loans. FINCA has now successfully lowered its portfolio at risk for this product by only offering individual loans to select repeat individual and Village Bank loan clients. In other words, FINCA has stopped providing individual loans to new clients. Now, the graduation from Group Lending to Individual Lending serves as an added incentive for group clients with good repayment histories and well-managed growing businesses.

FINCA also developed new internal control procedures which successfully identified fraud among some Individual Lending staff, which took place in April 2003. In compliance with FINCA requirements, FINCA pressed charges against the perpetrators, and they have been taken to court. As a result, FINCA South Africa tightened its internal controls policies and procedures. One example of this is FINCA's new prohibition of cash collection directly from clients. In addition, staff responsibilities were reviewed and outlined in detail, and explained to all staff members. Once staff were fully trained in all new policies and procedures, FINCA then informed its clients of the new procedures regarding loan repayment. Since these new policies and procedures were implemented, FINCA's portfolio at risk (30+ days) has improved significantly.

The new plan also resulted in cost cutting measures. In September 2003 FINCA South Africa's Executive Committee reorganized the institution. To reduce administrative expenses, the Committee cut the following department manager positions: Finance Manager, Administrative Manager, Operations Manager, and Chief Accountant. While this elimination of top management positions reduced administrative costs, it also increased the pressure and the job responsibilities for the remaining staff members. These staff had to quickly learn additional job skills and assume new responsibilities. In effect, the simplification of the organizational structure helped to increase the efficiency and productivity of operations.

Also helping to lower operating costs, FINCA has started to rely on successful clients to promote its program. Satisfied clients have served as strong endorsers of the program by spreading the word throughout their communities of the strengths and benefits of the new and improved FINCA. To make the process of program promotion even more efficient and less costly, FINCA now offers its best clients a referral fee for spreading the good word about FINCA's micro-lending services and bringing new clients to the program. These "client–promoters" place FINCA advertising leaflets inside their business facilities and share information with potential clients regarding the financial support that small entrepreneurs can gain through FINCA loans. They also share their satisfaction with the quality of services provided by the new FINCA. This promotional system has worked well to appeal to clients in environments where current clients already operate.

As part of this plan, FINCA also developed and began implementing revised growth and loan recovery strategies. FINCA has refined its system of monthly incentive targets for Loan Officers. The new system, which places renewed emphasis on client growth with portfolio quality, has proven successful. All Loan Officers have been retrained on customer service, and this new operational strategy has increased the monthly growth of new clients, while incurring minimum costs for promotion.

Finally, FINCA has launched a fresh retraining campaign. A small team of six Loan Officers is receiving capacity building training, in which they are learning how to improve their time management skills; provide better financial services to customers; and access monthly bonuses. Each FINCA staff member is also being trained on how to learn from mistakes and how to resolve potential problems in the office and the field, with a view towards providing transparent microfinance services with excellent customer service. FINCA has also institutionalized an award to recognize the most committed and productive workers on a regular basis. FINCA hopes these activities will help strengthen teamwork and help create a supportive office network. In addition, FINCA is communicating best practices among staff, which highlights the value of each team member by allowing each person to contribute valuable experiential and theoretical information.

III. FINANCIAL AND ADMINISTRATIVE

The relevant 269 and SF 272 forms will be filed separately.

IV. TARGETS / RESULTS: DATA ON INDICATORS (USAID)

Section (I.) displays the statistics and results achieved in the fourth and final quarter in terms of the program activities. This section shows how these results have, in FINCA's estimation, resulted in progress toward the project objectives.

	Target to date	Actual to Date	Variance	Variance %
Loans Disbursed (#)	30,957	13,018	17,939	(57.9%)
Loans Disbursed ($)	1,659,495	1,228,259	431,236	(25.9%)
Business Activity Generated ($)	8,537,002	6,325,534	2,211,468	(25.9%)
Profit Generated (@ 25%) ($)	2,134,251	1,581383	552,868	25.9%

FINCA's Path to Sustainability

Although FINCA South Africa has not managed to meet its original targets, it has, after the recent period of consolidation, begun to demonstrate positive trends in clientele and portfolio growth, with a reduction in portfolio at risk. FINCA remains committed to building a successful program in South Africa, even if it requires slower, less ambitious growth. FINCA's experience in the last six months suggests that the new strategy of achieving sustainability through efficiency gains rather than massive scale-up can work.

By maintaining only one branch in Durban and limiting outreach to Durban and the surrounding areas, operating costs have been cut in half. Projections for FY05 and going forward will maintain these low operating costs while maintaining a steady growth in outreach and portfolio.

Over the past three months, FINCA South Africa has experienced a 28% increase in productivity levels due to the smaller outreach area as well as strengthened internal controls and the addition of incentives, which have all enabled management to monitor the performance of its credit officers more closely. These measures will continue into FY05, and, accordingly, projections show a 133% increase in the productivity of credit officers as the confidence in and among the staff continues to grow.

In the first year of projections (FY05), the Operating Cost Ratio is quite high at 271.7%; however, as FINCA South Africa maintains lower operating costs and continues to steadily increase its outreach and grow portfolio with quality, the ratio will decrease to 128.5% by the end of its second year, further decreasing to 39.3% by the end of Year Five.

FINCA South Africa has also seen a dramatic decrease in its Portfolio at Risk in recent months, from 26 percent in April 2004 to 12 percent as at end of July 2004, with a value of $9,000. This is due to the collection of previously written-off loans as well as the strengthened collection procedures described above. As noted above, PAR is projected to end at around 5.5 percent at the end of FY05. Client growth has also resumed, from 300 at the end of April to 600 at the end of August.

FINCA South Africa has conservatively projected an operational self-sufficiency (OSS) rate of 63 percent and financial self-sufficiency (FSS) of 57 percent at the end of FY05, allowing for slow but steady growth in outreach and high-quality portfolio. These projections assume funds from FINCA International to support FINCA South Africa as it rebuilds and re-fortifies its program in order to reach out to more poor South Africans. If these assumptions hold, FINCA South Africa is projected to reach 105 percent OSS by October 2005 and 103 percent FSS in December 2005. These projections also assume the infusion of external loan capital donations.

The organization's human resources strategy will continue to emphasize building the skills of its staff, and helping them pursue a career path within FINCA. Credit Officers have the opportunity and a stake in growing their loan portfolio, and will be given the chance to supervise an assistant when their portfolios have reached maximum levels. This strategy will open up career opportunities for staff and, at the same time, encourages them to develop their marketing and management skills.

FINCA is active in the microfinance practitioner networks in South Africa and has openly shared the lessons we have learned from the program's growing pains. We believe that the program's continued recovery and strengthening experience would provide value to the microfinance sector as a whole, especially in South Africa but in other especially difficult operating environments as well.

This new and improved FINCA South Africa team, together with the technical assistance of FINCA International, has successfully identified and corrected the errors of the past and started on a path towards client growth, while maintaining portfolio quality. It is understood that these steps will take time to yield tangible results in growth terms, but it is clear that FINCA's efforts have already started to yield positive results. FINCA International is committed to nurturing FINCA South Africa to enable it to reach its full potential and provide financial services to the country's poorest microentrepreneurs. With the lessons learned during this grant period, FINCA South Africa has developed and will continue to develop into a stronger organization, holding true to its mission to improve the standard of living of low-income families by providing financial services to poor self-employed women.