SMALL "B" BIASHARA:
SELF-EMPLOYMENT & ECONOMIC ADVANCEMENT IN FINANCIAL DIARIES HOUSEHOLDS

SEPTEMBER 2016

financial DIARIES

BFA Bankable Frontier Associates

FSD Kenya Financial Sector Deepening

Small "b" biashara:
Self-employment & economic advancement in Financial Diaries households

Author
Julie Zollmann

The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). In addition to the Government of Kenya, funders include the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA) and Agence Française de Développement (AFD).

Table of Contents

Figures

Abstract

Self-employment is a major source of income for low income Kenyans, and Financial Diaries respondents are no exception. When we talked to respondents in 2015, two years after the close of the original Diaries, those whose economic lives were improving pointed to business returns as one of the main drivers of their success. Business opportunities are more widespread than employment and offer the possibility of increasing income for the household beyond the base pay of a salary. The businesses of low income people are quite diverse, at the lowest level encompassing petty trade in enterprises that come and go with high levels of churn. Only a few become more permanent and specialized, and almost none graduate into the traditional SME space, hiring formal employees, expanding branch outlets, or introducing new improvements in productivity. In this paper, we take a close look at the businesses of respondents, the financial needs for different levels of business activity, and the limitations of these microbusinesses to join and contribute to Kenya's modern economy.

About the Diaries & the Diaries Update

The original Kenya Financial Diaries study in 2012-2013 was made possible by FSD Kenya and the Bill & Melinda Gates Foundation. FSD Kenya also sponsored the Diaries Update research that feeds into this report. Both rounds of research were led by Bankable Frontier Associates, with fieldwork conducted by a team of researchers at Digital Divide Data Kenya who also provided input and feedback on drafts of this report. Reports and datasets associated with the Kenya Financial Diaries research programme can be accessed on the FSD Kenya website, *www.fsdkenya.org.*

FSD Kenya Financial Sector Deepening

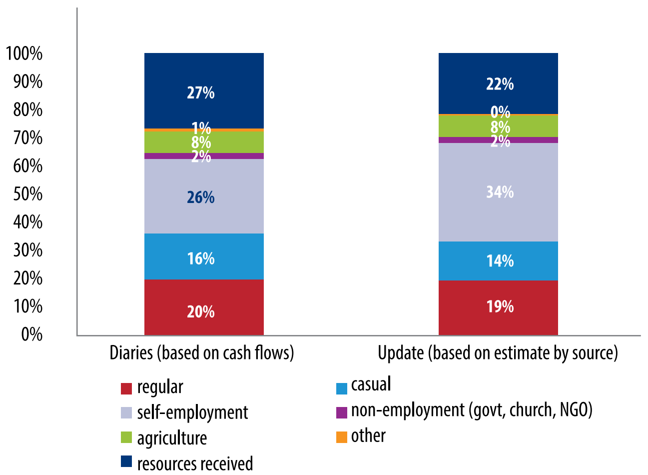
BFA Bankable Frontier Associates

INTRODUCTION

In many ways, business—of all kinds—is a way of life in Kenya. In fact, 61% of Diaries households engaged in some kind of business (which we also call throughout "self-employment") during the Diaries year. These are activities in which the individual or household invests some of their own funds in order to run an enterprise with the intention of making money.[1] Among those households, it typically accounted for about half (mean 48%; median 50%) of all household income. It was the most significant source of income for 26% of households in our study and for 18.4% of adults in the FinAccess survey of 2016.[2]

In Focus Note 1 in this series, we also point out that these self-employment activities accounted for a large number of instances in which Diaries households reported improvements in their living conditions between 2013-2015. While enterprise activities are both widespread and highly important in the lives of low-income Kenyans, how much is really understood about the nature of these businesses, their financial needs, and the role of such enterprises in an evolving economy?

Figure 1: Distribution in main income source by HH (%)



26% of households in the Diaries relied most heavily on self-employment for their incomes. In the Update, that figure went up to 34%. We suspect that increase is due in part to underestimation of the importance of resources received (remittances & other gifts).

In this note, we draw on data from the original Financial Diaries (2012/2013) and the Diaries Update (2015) to explore low income people's enterprises. More on the specific methodologies employed in both rounds of research can be found in Focus Note 1 of this series.

1 We classified those kinds of activities where only labour and not capital were involved separately. Agriculture—for consumption and profit—was also separately tracked.

2 2016 FinAccess Household Survey. FSD Kenya. February 2016. http://fsdkenya.org/publication/finaccess2016/ The-2016-FinAccess-household-survey-report4.pdf

UNDERSTANDING DIARIES RESPONDENT BUSINESSES

The great majority of the enterprises active in our households are nano sized, very few having turnovers that would even put them on the Small and Medium Enterprise (SME) map of financial service providers. These are businesses that exist—often temporarily—as a means of household survival in a context with very few formal (and informal) employment opportunities. They are often businesses that supplement a more regular income from a spouse and that hedge against economic risks, like unemployment. But, they are not always born out of desperation: many of the employed actually aspire to leave their jobs and start a business to sustain themselves. Businesses offer their owners confidence, the possibility of increased earning potential, and freedom. Business in Kenya is seen as one of the most important ways to get ahead and to move out of poverty. Let's take a closer look at some of the key features of these businesses before clustering them into a few specific segments in the next section.

Low investment, low revenue

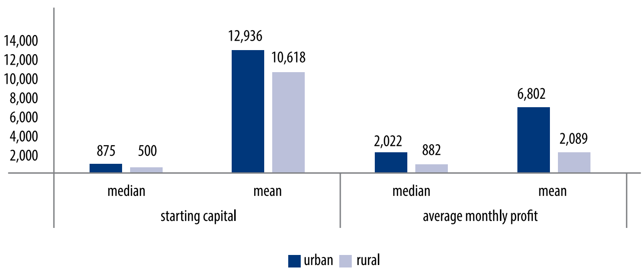
These businesses are small, probably much smaller than you think. Of the 369 businesses registered by Diaries households during the start of the main study, the median starting capital was just KSh 600. Twenty percent of the businesses—often service-based ones like hair salons—started with no capital at all. The mean start-up capital needed was significantly more, around KSh 11,500, reflecting the smaller number that begin with a much larger investment. Still 75% of the businesses were started with less than KSh 5000.

Only a few businesses generated enough income to sustain a family. Eleven percent of businesses active in the Diaries were loss-making on a cash flow basis during the Diaries. Often the situation was not as dire as it seemed: the family might have been eating from the stock, for example, making the business's economics look terrible, while still providing important benefits to the household. The median businesses earned only about KSh 1500 per month in profit during the months they were active during the Diaries. The mean rose to KSh 4,791, but only 11.5% of any of our registered businesses produced an average monthly profit of KSh 10,000 or more, the median amount that our respondents reported they would need to live comfortably. This reality of low profits was not intentional, but rather part of the reality of operating with very little capital in very demand-constrained markets. Still, even small profits are meaningful at this end of the income scale.

When we look at start-up costs and profitability across rural and urban areas, we see that the capital required to start an enterprise is roughly similar in both places, but that urban businesses tend to be more profitable. This comes as no surprise given that rural business owners have a smaller accessible market, both in the numbers of potential customers and their income levels, a point we will return to when we discuss business growth trajectories.

> *"Like I told you, the market is very small and the people from this side are just peasants, they go for small, small things, but if the market could be big, we could be making a lot of money. But anyway as we are going on, we are trusting God."* Paul, Vihiga

Figure 2: Urban and rural differences in startingcapital and monthly profits (KSh)



Rural and urban businesses require similar amounts of start-up capital, but show a significant gap in profitability.

Informal

Few small businesses are formally registered with any government body in Kenya generally, but many—especially those with physical premises or who operate in designated market areas—obtain operating permits or pay a daily fee to local government offices, like town councils. Among the businesses in our sample, though, only 13% had even that basic kind of operating permit.[3] If they operate in public spaces and choose not to pay permits or small informal payments to local officials, they often close when they see local officials approaching, losing out on some potential business.[4] Their unofficial status makes it difficult for some to borrow against their earnings or do things like collect electronic payments, where know your customer (KYC) regulations mandate business registration and tax identification numbers.

No records

Only about 24% of the businesses registered during the Diaries reported keeping any kind of written record of sales and expenses in their businesses, and we observed that even when this was done, it was rarely done consistently and accurately. For the very small businesses, like those selling mandazi (fried dough snacks), respondents could recall daily sales and stock purchases easily with mental calculations. Keeping a written record seemed pointless to them; their businesses were small and simple. By necessity, business and household expenditures were all mixed into one budget:

> *"We don't separate the money for business and for buying food. The most important thing is to make sure that the children are fed and they are well."* Leah, Nairobi

Larger businesses were more likely to keep books. There was more to keep track of and more opportunities for leakage where there might be an employee or attendant involved. On average, businesses with written records made KSh 7,805 (median KSh 3,131) in monthly profits versus KSh 2,847 (median KSh 998) for those that did not.

Temporary

Many of these businesses are not built to last. Respondents start them often in a moment of need and close them just as easily when business slows down, when capital needs to be diverted to pressing household needs, when a woman is dealing with a sick relative or new baby, or when the business operator has a chance for some other kind of temporary work. On occasion, businesses spring up to serve a particular, temporary need—like selling lunch at a construction site—and close when the need has passed. Forty-eight percent of the businesses that operated at some point during the Diaries were closed by the time of the Update interview two years later. The median age of businesses operating during the Diaries was just one year. Only the most established 25% of businesses had passed the five-year mark of at least intermittent operation.[5]

Our respondents told us about moving in and out of businesses, often depending on the availability of working capital:

> *"From there, I started selling roasted maize. I started with little money but this increased after three to four days. I did the job for the whole of 1989. In 1990 I started doing the work of 'mali mali' selling cups and many household things, but it didn't go well with me. My capital went low. You know, if you haven't been taught how to do or handle some things it is difficult to succeed because you have got no knowledge about it."* Patrick, Nairobi

3 This is likely an overestimation, since this question was asked for most businesses at the start of our study, when trust levels were low, and respondents may have feared reporting unregistered business activity.

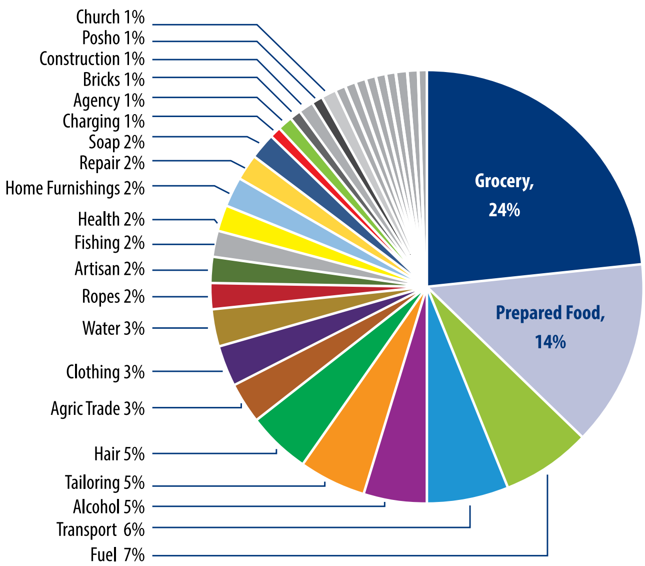
4 In a separate study in which BFA worked with FSD Kenya to create a census of businesses in two medium-sized Kenyan towns, we found 91% of businesses operating publicly—typically from a regular business location (though not always a permanent structure)—had a single business permit. Diaries respondent businesses were typically even smaller than this, a whole layer below what's visible in a typical town.

5 This is consistent with the Global Entrepreneurship Monitor, which finds that rates of business discontinuance are quite high in Africa and other "factor-driven" economies. High rates of entrepreneurial activity in a market are also correlated with high rates of discontinuance.
Kelley, D., Singer, S., and Herrington, M. 2015/16 Global Report. Global Entrepreneurship Monitor. http://www.gemconsortium.org/report/49480 /gem-2015-2016-global-report-110416-1460370041.pdf

Low technology; low productivity

The businesses run by our respondents tend to provide basic goods and services to local communities. Our respondents were by and large selling the same things that other respondents were buying. Many do very simple, low capital trading, most often of foodstuffs and cooking fuels like firewood and charcoal (see *Figure 3*). This is no surprise, since food consumed about half of our respondent households' budgets. Another big segment prepares and sells cooked foods, doing some very basic value addition. When it comes to services, the businesses in our sample mostly provide transportation (motorbike taxis and pushcarts), tailoring (the making and repairing of clothing, including school uniforms), and hair plaiting and cutting services. The top seven categories of businesses account for 66% of the businesses in our sample, showing just how little diversification there is in these kinds of low capital enterprises. Figure 4 contrasts this picture with the summary of firm types in the Kenya Enterprise Survey for 2013. In the formal private sector, we see different kinds of manufacturing emerge, which are much more capital intensive and absent in Diaries' respondent-level firms.

Figure 3: Distribution of Diaries household business types (%)



The distribution of business types in our sample highlights the concentration of business types in a few key areas of high demand in low income areas.

Figure 4: Distribution of firms in the 2013 Kenya enterprise survey, meant to be representative of the country's private sector.[6]

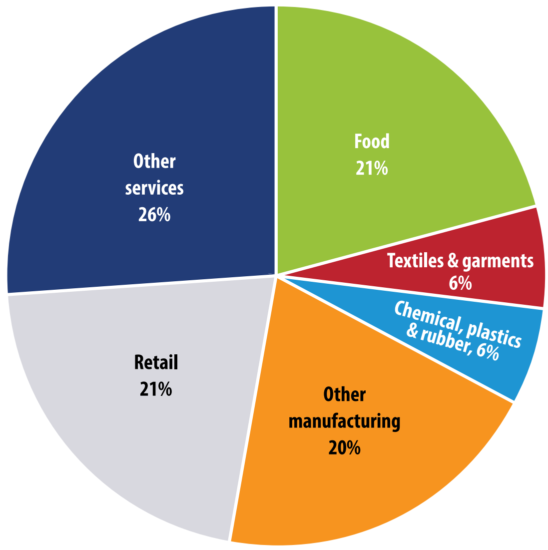


Figure 3 also shows that Diaries respondents' businesses are mostly based on quite simple trading. The capital needed to start and grow them is going towards stock rather than fixed capital/technology that increases productivity. The most common machine and equipment investments we saw were things like cooking pots and stoves (for those preparing food or brewing alcohol), motorbikes and carts (for transportation), and sewing machines (for tailoring). A few respondents had been able to make more substantial investments in bore holes (for selling water) and posho mills (for grinding maize) at some point in their lives. Those investments might enable long-term businesses, but did not come out of an organic growth trajectory for most, a topic we'll discuss later. Very, very few businesses run by Diaries respondents have grown or will ever grow large enough to make formality appealing or to even cross the threshold of hiring a single employee. Scale is often not the goal.

Born of necessity, not invention

In more advanced economies, the Global Entrepreneurship Monitor points out, more businesses are initiated around opportunity rather than necessity. Many entrepreneurs in those economies see a way to offer something new, better, or delivered more efficiently in a given market.[7] That is a world away from our respondents who start businesses out of the necessity of earning sufficient income in contexts where employment is scarce.

6 http://www.enterprisesurveys.org/data/exploreeconomies/2013/kenya
7 Kelley, D., Singer, S., and Herrington, M. 2015/16 Global Report. Global Entrepreneurship Monitor. http://www.gemconsortium.org/report/49480

> *"I gave birth in June 2000. We didn't have anything. There was no money; the little money we had was for food. We didn't have any capital to start that business, so after some time [my husband] got a menial job and with the money he got, we started a small business, and that is when life started changing a bit."* Florence, Nairobi

Our respondents told us that business is an important livelihood diversification strategy. It is also easier to start a business when the household already has one fairly stable source of income that gives them room to divert some money to the business. The employed have an easier time saving for a business or taking a loan that can be used to start a business that increases and stabilizes household earnings.

Businesses were particularly important for our female respondents. In addition to diversifying the household's overall earnings, it allowed them to fill gaps in the household budget, particularly in areas that were priorities for women, and also gave them some independence in financial decision making:

> *"My motivation came out on the nature of the work of my husband. Because he works in a company. So I thought, like, what if the work ends? What if he is stopped from work? What will we do? We won't have what to eat, and that's what motivated me. I wanted to be independent so that even if anything happens to him at work at least life will be okay. I had to think hard and at least have my own money from my vegetable business."* Maggie, Vihiga

> *"[My husband] was sending [money only] after several months, but since this child started going to school he does send for us monthly nowadays. Before the child started going to school he was never sending money consistently. We just used to do business to put something on the table."* Alice, Vihiga

> *"That time my husband was always going to Nairobi and would stay there without getting a job. I do not understand that up to today what was happening there. He could go to Nairobi and Mombasa. After some time he could come back and get me pregnant. Every time he comes and he leaves and goes back to Nairobi or Mombasa and he says he does not get any work. I did not understand what was happening to him. I got my own brains and thinking the way a woman can think faster and that time I came and realized, that's when I started doing the business. My first-born and the second-born did not go far with school; they just reached class six. Now when I got that thought of starting business I was able to educate these other children up to class eight."* Esther, Vihiga

Even those who are employed worry that their wages are not sufficient to meet their families' needs, that their jobs are unstable, that they have little opportunity for wage growth within their jobs, and that they will need some alternative income source after retirement.

> *"You know, when you tell your wife to just sit there and not do anything, you can go and be told there is no work anymore. When this happens, it is never easy getting work elsewhere. That's why I decided to start a business for her, because I wanted security."* Stephen, Nairobi

Business offers nearly everyone the possibility of earning just a little bit extra, not typically by doing something new or innovative but by offering the goods and services in demand from their own communities, hoping to capture some local market share.

Useful and fulfilling

While all of these features of respondent businesses may make it seem difficult to bring them into the formal economy, extend formal financial services, poise them for extensive growth, or make them a target for increased government tax revenues, it is precisely these features that make them such attractive and useful tools for Kenya's poor. A low income person can move in and out of business activities with ease, turning a meaningful profit, even if in nominal terms that profit is small. This allows for an important cushion in an otherwise vulnerable circumstance. If Kenya's economy was more formal and respondents faced even lower demand for their small scale trading enterprises, it's likely we would see signs of much greater hunger and vulnerability.

> *"Now I am at least better, because when I started I was staying in a grass thatched house, but when I started this business of brewing alcohol, I saved some money and built that house then later moved to this house and improved it. I then realized that my brothers had no place for sleeping and that land was theirs. I moved from that land to this one, which was for my grandparents. After coming here is when I started progressing and I will even build a better house than this one, now I am at least better unlike before."* Michael, Vihiga

Our respondents also told us that being able to start and manage a business, earning money for oneself, is rewarding and boosts a person's confidence. For many, it is a life goal, even when they are employed:

> *"You know, when you are just from school and you do your business or work it gives you self confidence in life. Currently, I don't see anything that is hard to do and I always advise people who have finished school that they can look for work to be able to get their own cash even if it's five hundred or two hundred. So it gave me self-confidence and again it showed me that there is*

no need choosing what kind of work to do. I have cousins who are strong but when you ask them to join construction work, they tell you to wait until next week, next month and time goes. So it teaches me that you should not wait for somebody or choose work to do." Samuel, Nairobi

"At the moment I cannot say I have achieved anything but in future I would like to start my own business here in Nairobi then maybe I will say that I have achieved something after setting up a business." Clement, Nairobi

NOT YOUR TYPICAL SME: A TYPOLOGY OF LOW-INCOME PEOPLE'S BUSINESSES

We see the businesses of our respondents clustering roughly into four separate segments, as outlined in Figure 5. While some growth between segments occasionally happens, there is no clear growth trajectory from the first segment to the fourth; instead, they tend to be different kinds of businesses, led by different kinds of people with different intentions from the start.

We distinguish them mostly by size. At the lowest end, you have the smallest of businesses. These account for the largest number of businesses in our sample, but they rarely constitute the entire earnings of a household. They are small and supplementary, consist mostly of small scale, very low investment trading. These businesses start and stop frequently, depending on household needs and the availability of working capital. These kinds of businesses are very helpful for the truly poor, providing small boosts to household income that help a family move away from hunger and desperation, at least for a time.

The next level consists of the livelihood businesses, where the monthly profits of the business are more substantial and begin to constitute a large share of household earnings. They typically require more substantial investments in working capital or even equipment, potentially helping the owner operator even begin to access commercial capital through microfinance institutions. Though these businesses tend to lack physical premises and do not have employees, they are more stable than the nano businesses, with households committed to pursuing the business nearly full time and over a number of years. Still, commitment and scale are not totally intertwined; these enterprises can remain small, and these entrepreneurs may not have an ambition for scale.

Those first two categories of businesses account for probably 80-90% of all the businesses in our sample. We have a few households operating larger, more sophisticated businesses, but we should also point out that those operating at the next two levels have been above the poverty line throughout the Diaries. There's a certain level of financial security that one must achieve before being able to start these higher-investment kinds of businesses.

Figure 5: Four business segments among Diaries households.

Type 1: Nano

Very low profit (<KSh 1000/mo)
Very low start-up investment (<KSh 500)
Owner moves in and out of business
Supplement to HH income

Example:
Natasha pieces together an income from multiple nano businesses that are always changing. Last time we saw her, she sold a few vegetables from her home and also irregularly provided childcare for neighbors in an informal settlement in Nairobi.

Type 2: Livelihood

Moderate investment required (KSh 1000-50,000)
Some commitment to the business as a livelihood
Moderate profit (KSh 500-10,000/month)
Still lacks dedicated physical space or employees

Example:
Christine in Mombasa prepares fried potatoes and mandazi daily, selling from the roadside. She's run this business for four years in a dedicated way, allowing her to take and repay multiple loans from Kenya Women to pay school fees.

Type 3: Specialising

Establishes physical location, may have part time, casual staff
Offering service/good requiring some skill/specialization
Some commitment to long-term operations of the business
Begins to earn sufficient revenue to support the family

Example:
With the help of her father, Janet purchased a chemist in rural Vihiga opposite the local health centre. She sells medications and does some basic diagnostics from her fixed shop. She recently started also offering printing and photocopying services.

Type 4: Established

Multiple physical locations and more than one employee
Some complexity in management
Significant capital investments (>KSh 50,000)
Tend to have some vision for growth

Example:
Evan and Gloria, a husband and wife pair, run three dreadlock salons in Nairobi. They regularly invest in renovations and have even connected one salon to the internet. Each location brings in about KSh 1000/day in revenue. They now have staff at all locations and have dreams of continuing to expand.

We call type 3 "specialized," reflecting that most of these businesses tend to be more focused and unique than the others in the bottom two tiers. Here, you can find specialized artisans, like Patrick who makes and sells ***jikos***, charcoal cooking stoves. Last time we visited him, he had even begun to brand his stoves with a sticker. We find salons and hotels with fixed premises and even casual employees. In the photo in Figure 5 for this category, we show a husband and wife duo who recently opened a bakery. They sell wholesale, distributing their ***kangumo*** (a kind of hard cake typically served with tea) to a number of area retailers. Type 3 businesses are usually capable of supporting their families' needs completely, even allowing for households to make bigger investments in things like better schools, secondary and university level school fees, purchases of land, and construction of permanent houses.

Only a small number of our respondents—and only in Nairobi—have established businesses in Type 4, where there are regular staff and multiple physical locations. These are growth-oriented businesses that required significant start-up and expansion capital. In two cases, they are specialized businesses—one a network of salons, another two locations of a branded bar. The few others are diversified business clusters offering a range of different services. For example, Jonah (see box) really started building his business empire with a popular men's barbershop. Later, he opened an M-PESA agency right next door to the barbershop, started a restaurant (operated by his wife), and founded a revenue-generating church. These businesses tend to have government registration, even if they are not fully tax compliant. They operate bank accounts and access commercial loans when needed. They operate with a significant cushion of savings and are able to weather most shocks that strike their businesses and households.

These segments are important for considering the financial service needs of each unique group and also as we imagine the impact potential of the diverse institutions we often call "small businesses." At the lowest end, type 1 businesses help their owners meet very basic needs, even if not always well or consistently. In type 2 they may enable some investments in the welfare of the family, including the education of children, helping the next generation be better poised to participate in what may become a more formal modern economy. Type 3 & 4 businesses start to offer wages to others typically lower on the income scale. In addition to funding the education and healthcare of their children, these business owners also often send regular remittances and help cover the cost of healthcare shocks within the extended family. Even then, though, they are not necessarily introducing significant innovation or productivity gains in the economy. Few are even contributing tax revenue to central government.

Patrick, the Jiko King

Patrick, an artisan who handcrafts jikos (charcoal cook stoves) from a workshop in Nairobi seems to have recognized that the only way to grow his business is to become specialized, pulling business from his many, undifferentiated competitors. When we visited him during the Update, he had introduced a new line of multi-function jikos (pictured above), which both cook with a pot on top and roast like a barbeque. He had even branded the new jikos with a sticker showing his phone number.

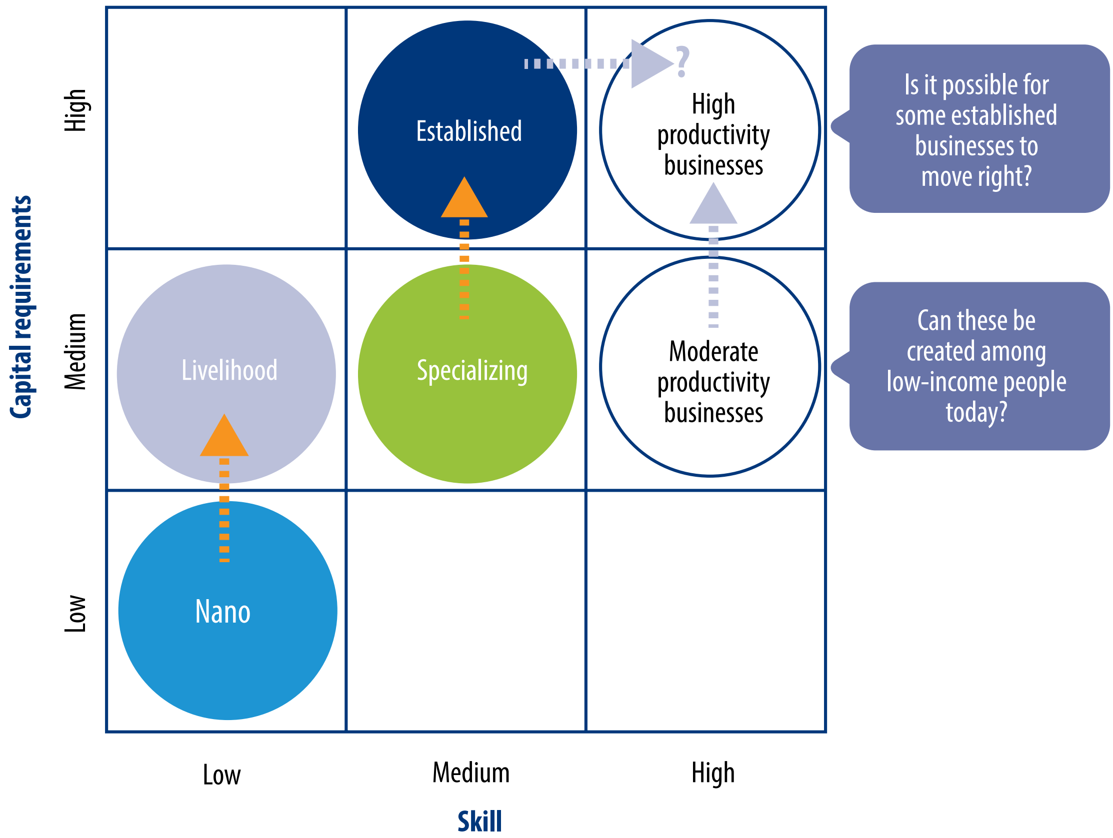
During our visit, Patrick explained more of his business philosophy as he vented frustrations with one of his sons. One son had recently finished high school. He wasn't a particularly good student, but Patrick hoped to send him at least to a technical college or trade school to have more opportunities in the long term. Instead, the son decided to start doing casual work on construction sites. The pull of having KSh 500 in his pocket every evening—and the independence it brings—seemed too strong to delay earning even a few more months.

Patrick was disappointed, but still hoped the boy would learn a few lessons from him, "If you want to work in construction, fine! But there are many people who work in construction. One day, when you have a wife and children, KSh 500/day won't be enough. So if you want to work in construction, choose something that people need, like being a mason. Then be the best mason in all of Nairobi, so that when there is a job, everyone calls you. You can't be picky in your jobs, but whatever you do, you have to become the very best, to build your reputation, or you will never survive."

If we take these business segments in our Diaries sample and plot them on a skills versus capital requirements matrix, it looks something like Figure 6. Income from the business typically increases as one moves diagonally up and to right across the grid. But if there's any movement between segments, we see that it's mostly vertical according to capital requirements rather than horizontal due to skills/productivity increases. We have no high-skilled businesses among Diaries respondents and few in the country as a whole. And the businesses we see today are unlikely to move into that space.

This doesn't necessarily inhibit livelihoods today. In fact, this could be good for livelihoods in some way, meaning there is plenty of space in the economy for many Kenyans to thrive in small, low-productivity businesses, achieving a "comfortable" life and putting their kids through school, possibly even university. However, if there's very little growth in high productivity businesses, where will those young people work when they graduate in 15 years? The strategies needed to support the creation and growth of high productivity businesses and those to enable vertical mobility in the survivalist businesses of today's low income adults are very, very different.

Figure 6: Capital requirements



If we were to plot these four businesses on a capital-skills matrix, they would probably look something like this. We tend to see some vertical movement from type 1 to 2 and from 3 to 4, but horizontal movement tends to happen only by the entrepreneur switching businesses. Income tends to increase with productivity as one moves up and to the right, but individual businesses are not as mobile in that direction as one might hope.

From Type 1 to 4: The unlikely empire that Jonah built

Jonah was raised by a single mother in Nairobi. She introduced him to business from a very young age:

> *"I was doing some businesses which my mother introduced me to while I was in class seven to class eight. My mother told me to put up a kiosk nearby where when we were out [of school] for holidays, she would bring some fruits worth one hundred for me to sell and keep the profit… After class eight, I couldn't continue with education, so from then onwards I started doing business: selling a few things like fruits, sweets, and cigarettes."*

Jonah got caught up with the wrong crowd when he was selling cigarettes. His friends would smoke marijuana and organize robberies. He didn't really see a way to disassociate himself until his mother encouraged him to change business lines and get into potatoes. That helped him accumulate some savings. While selling potatoes, he got his first big business blow when a lorry full of potatoes he bought was rotten. His mother's example made him stick with it:

> *"I had a big loss at that time. Still, I didn't get frustrated… In business one has to take risks and not be frustrated because losses and profit do vary. Sometimes it can be high or low, so you must still have that heart to continue. That foundation that was built in me by my mother was strong and I was not ready to give up on the business."*

Eventually it stabilized and he was able to save. He had enough money in his savings when an opportunity came along:

> *"I found somebody who was selling his barber shop for ten thousands shillings including all the equipment. It was very challenging because there was electricity rationing but I managed to go through until now."*

He bought the barbershop and first operated himself, using skills acquired over two weeks of training. In time, he added some additional people to work with him. This increased total income, but it reached a limit, since there was only so much time he could work and he also had to pay his employees. So he decided to diversify. During the Diaries, he started a church with another investor. After the Diaries, he added an M-PESA agency and bought a restaurant that his wife now runs for him. He added another location of his barbershop, too, but for him diversification is key. He tells us that a barbershop can only do really well if located in upmarket areas that are costly to break into. If he wants to grow his income, he feels he needs to run additional, higher margin businesses.

> *"I am also saved, I have been doing church work together with barber shop which has help me a lot to achieve more. I have a home and also I have bought some house equipment. I am also happy to be a pastor; a lot of my resources and concern are channeled towards that direction… So generally, I have done a lot of things with the blessing from God."*

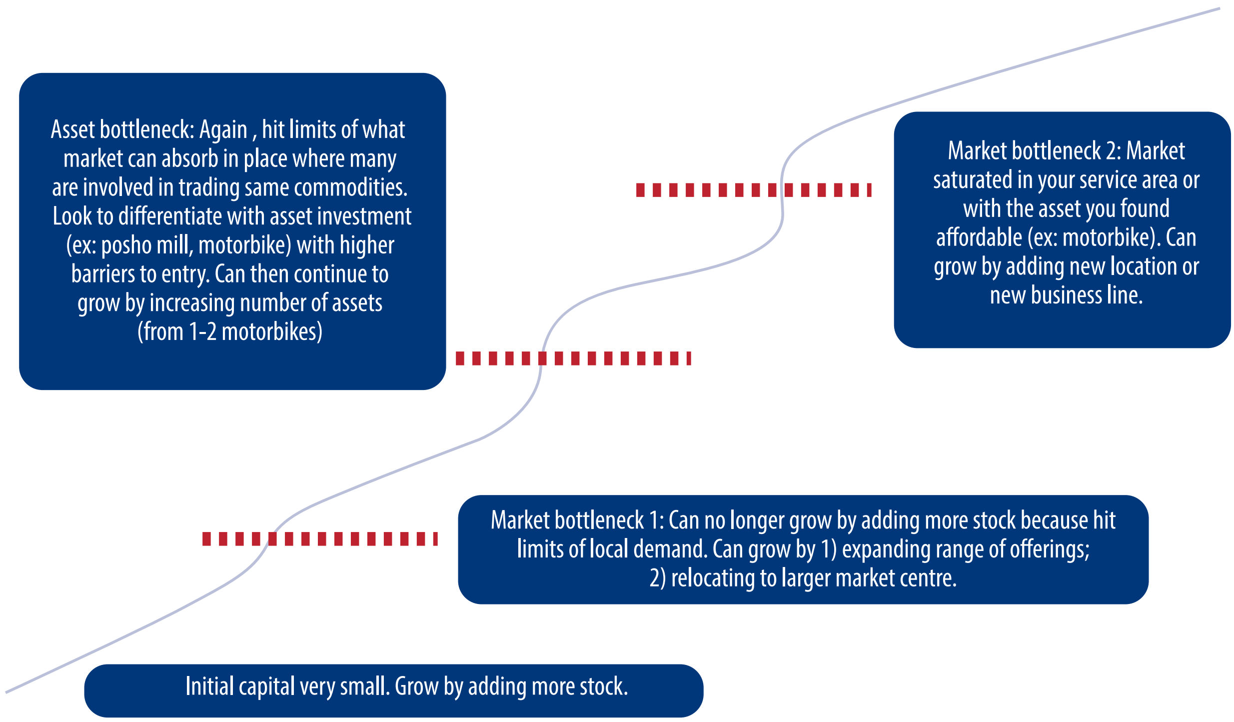
In the Diaries, Jonah's monthly income was around KSh 23,000 on average. Two years later, he estimated it had reached around KSh 100,000; truly transformative, but also rare.

BUSINESS GROWTH TRAJECTORIES

As we discussed in the previous section, business segments are distinct for lots of reasons that go beyond size. A type 1 business may be selling KSh 200 in bananas per day. But you are unlikely to find a type 4 business selling KSh 20,000 in bananas per day. Local markets cannot absorb that kind of scale in a single commodity.

Instead, we see that as an entrepreneur—rather than a single business—evolves, this leads to changes in both the scale and nature of the operation. Growth is not always the goal and certainly doesn't always happen. But, when it does, we see that it tends to follow a common pattern as depicted in Figure 7.

Figure 7: Stylized depiction of growth trajectories and bottlenecks of low-income people's businesses.



Most businesses start, as we have seen, with very little capital. Mostly, they involve very small-scale trade of a very limited range of commodities. Here, revenue can be ploughed back into stock leading to growth. A woman can quickly go from selling 30 to 100 mandazi per day, for example. But, before long, they hit the first growth bottleneck where additional growth cannot be achieved through expanding the size of the stock alone. They now have a market size problem. The woman could make 100 more mandazi per day but could not sell them. Now, if she wants to grow, she either needs to offer new products to the same customers or find more customers, usually by relocating the business to a busier area. Businesses in rural areas often hit this bottleneck earlier and have fewer options for growing by expanding their market access.

Christine, whose business is given as an example in Type 2 of Figure 5 above, was able to transition through this first bottleneck. She started small selling mandazi in the morning to schoolchildren walking along the road. She expanded her stock and grew for about a year. But then, she reached the point where adding more mandazi would just mean that they went unsold. She needed more income, though, so she then decided to sell fried potatoes in the afternoons, catching the children as they came home from school along the same road. By the time the Diaries were ending, she had reached the limits of her own time. She would wake at 4am to start cooking the mandazi, then go to sell. By mid-morning she was home preparing potatoes and would finish selling those in the evening. If she wanted to earn more, she would need another product line. To do that, she could hire someone, but that comes with only moderate returns, since that person must also be paid, increased risks of reduced income during sales slumps given what would likely be fixed daily labour costs, and, of course, the headaches of management. Her other options would be purchasing some equipment that would help her use her own time more efficiently, perhaps then freeing up some time mid-day to sell lunch to workers in the local godowns.

Christine hasn't crossed the asset bottleneck. But, Christopher did. He was running a successful spice business in the local market. When he reached his peak there, he expanded his market reach, traveling twice a week to markets in smaller towns where he would sell his goods while his wife tended their main stall. But, when that peaked, he realized he needed to add a new kind of business. He took a loan from the bank to buy a secondhand motorbike and hired a driver to run it as a motorbike taxi. The last time we saw him, he had added a second motorbike to his growing fleet while continuing to also run the spice business.

This general sense of the growth trajectory of respondent businesses helps us recognize that the nature, duration, and size of financing needs are quite different for businesses working at each stage, whether that is for cash flow management or growth past these shared bottlenecks. It also reminds us that the lack of business growth is not a purely financial problem. Market size is also an important constraint, as is the lack of diversification in lower end businesses, which makes it difficult for small entrepreneurs to cost effectively reach a larger market outside their own communities.

Is there a skills bottleneck?

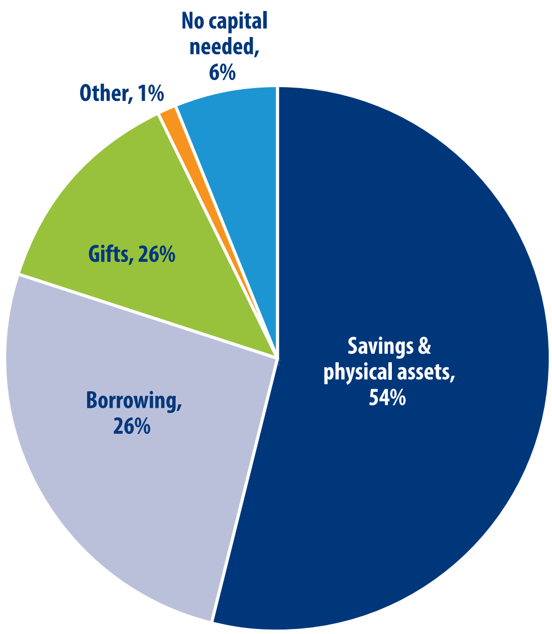
The role of skills in advancing our respondents' businesses is difficult to isolate. We see some eagerness to invest in applied, technical skills training when respondents are themselves young or their children are finishing secondary school. Driving, mechanic, and tailoring courses are particularly popular, though not always put to use. Very few do formal training before offering barbering or salon services, often learning from peers or on the job. Hands on skills rather than business training seem to be perceived as more valuable in building a successful business, but they are also seen as more accessible than the capital needed to run a business based on skill. It is much easier to learn to weld, for example, than to acquire the equipment needed to run a welding business. It is much easier to learn to drive a motorbike than to access the funds needed to buy a motorbike. So, when it comes to the businesses run by our respondents, skills may be a barrier to entry to some kinds of higher value businesses, but they are not viewed as a bottleneck in business growth.

FINANCIAL SERVICES & BUSINESS START-UP & GROWTH

How do these businesses make use of financial services today? Given how blended the businesses are with household finances, the owners tend to use financial services for savings and payments in very similar ways to the population at large. With the exception of occasional payments over M-PESA's normal "send money"[8] function, they don't accept electronic payments today. So in this section, we will focus on two financial needs specific to businesses: starting up and expanding.

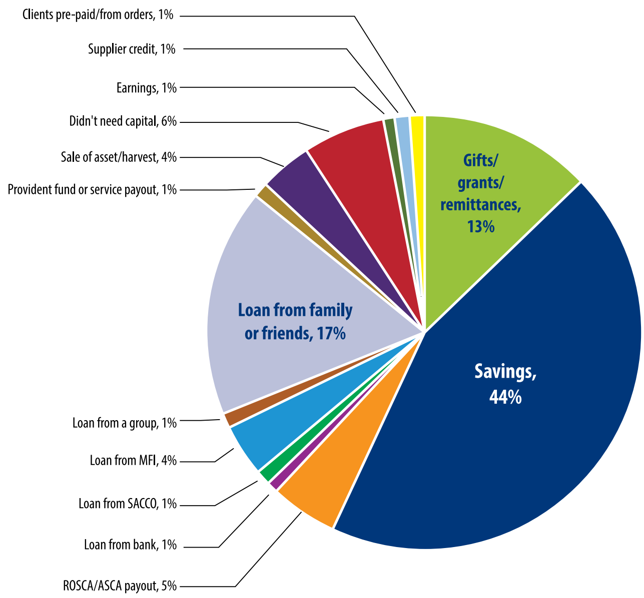
The majority of our respondents' businesses were started with savings, gifts or remittances, or no capital at all. In other words, use of debt to finance business start-up was relatively uncommon, accounting for only about 26% of Diaries businesses. Instead, respondents tended to initiate their low capital enterprises with these lower risk financing strategies *(Figure 8)*.

Figure 8: Where did the starting capital for your business come from? (%)



Credit is not the preferred means of financing the launch of a new business.

Where did the starting capital for your business come from? Detailed (%)



Gifts and remittances for starting a business are significant. We observe that those in the network who are relatively successful tend to help others—particularly family members—get ahead as well by helping with school fees and even regular payments for basic things like food. A gift to start a business is seen as particularly helpful, potentially helping the recipient become more independent and attain a lasting higher standard of living. Our respondents were both givers and receivers of this kind of help:

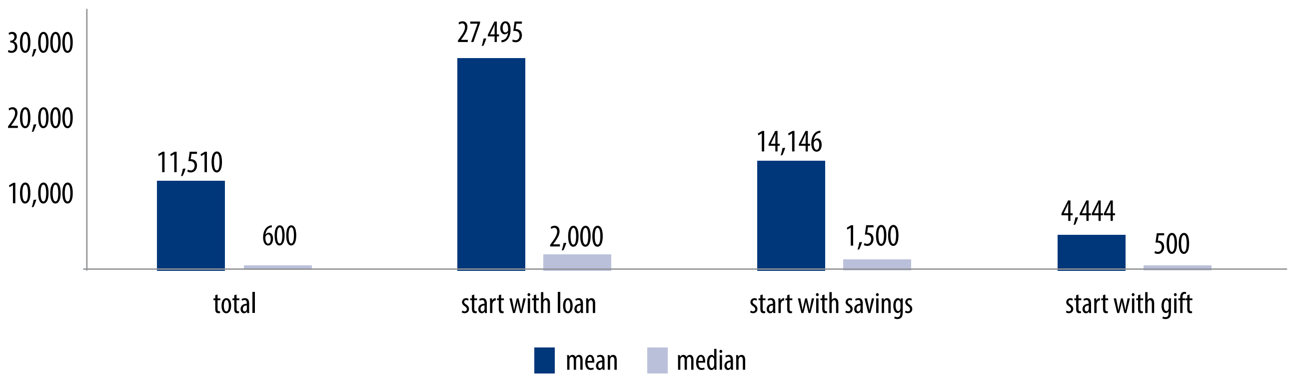
> *"My brother was in Nairobi then. We planned with him, so that I could come to Nairobi, because I was tired of taking care of cattle. I asked God to help me with something else to do. That was 1988 August. So I worked for some time, like six months, then I asked my brother for some money to start-up a business. He didn't refuse, he gave me the money. He was employed by G4S as a watchman".* Patrick, Nairobi

> *"You know even when he called me, he didn't tell me about the job. But, when I reached there I found the job and decided to try it because he called me last year and this year too. My aim was that if it could be a long-term job, I would help my mother. I can be able to start a business for her."* Kenneth, Vihiga

8 As opposed to "Lipa na M-PESA" specific to the acceptance of person to business payments.

But, we also see, as seen in Figure 9, that businesses financing start-up from gifts tend to start with even lower amounts of initial capital. The median start-up capital for businesses starting with financing from gifts and remittances is just KSh500. Start-up capital goes up to KSh2000 at the median for businesses financed through savings and borrowing—including both formal and informal borrowing. But, we do see some evidence in the high mean value of start-up capital for businesses funded by loans that being able to borrow may help some make larger initial investments in their enterprises.

Figure 9: Value of starting capital and financing strategy (KSh)



We see some evidence that loan capital can help enable larger start-up investments, but at the median, there is no difference between the values of start-up capital when the financing is from savings versus credit.

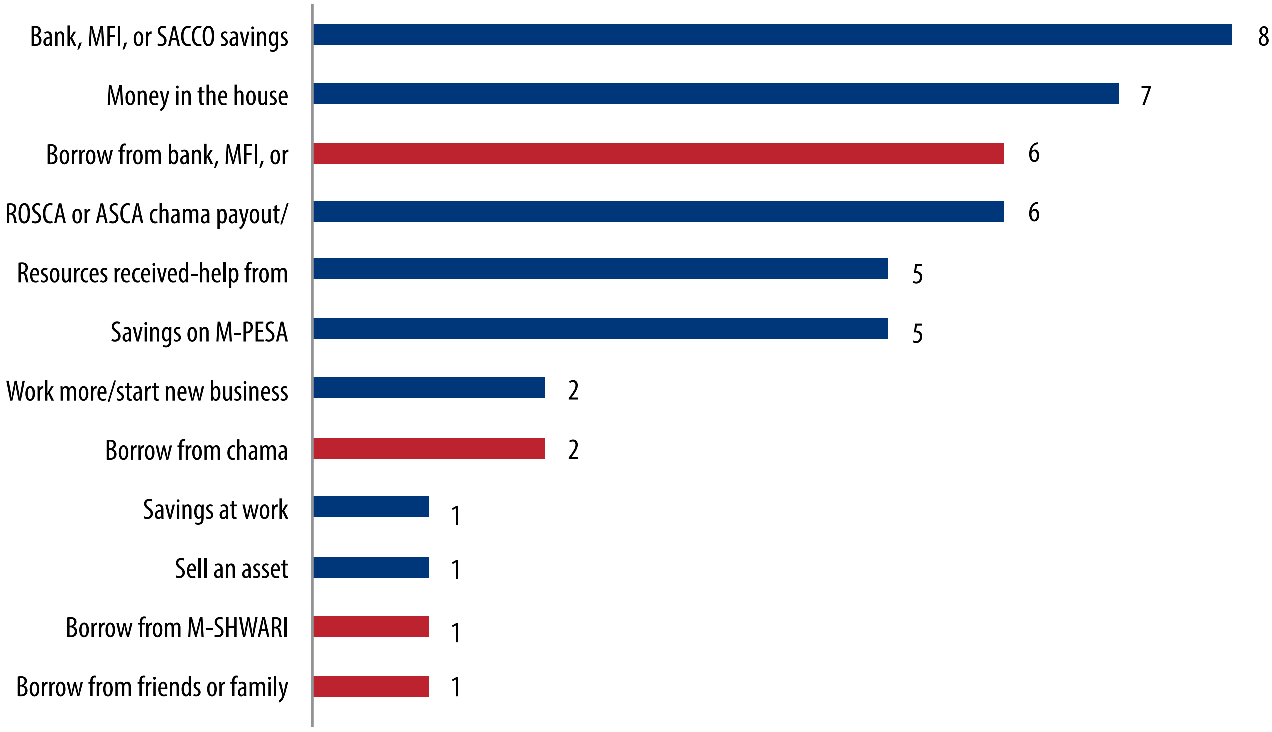
During the Diaries Update, we asked respondent households some details specifically about business expansion, rather than just start-up costs. Business expansion was one of the most commonly reported reasons given by respondents who felt that their economic situation had improved since the close of the previous study. We registered 37 business expansions in the two years between the two studies. Among these, the median expansion investment was KSh 10,000 (mean KSh 33,669). That size of investment is significantly larger than initial start-up investments. It's also a bit too large for an M-Shwari loan: the median loan limit for eligible M-Shwari borrowers in our sample was KSh 1500 (mean KSh 2963). And, it's too small for traditional bank loans, though within the range of some SACCOs and MFIs.

Borrowing isn't necessarily the preferred mechanism for business expansion, either. Respondents told us that loans work better for fast turnover businesses. Florence, who runs a business sewing curtains explained how a loan was useful for her husband who ran a matatu business, but not for her:

> *"Going to KWFT was not because of my own business, it was because of [my husband]'s business because by then I didn't have a business and if I wanted to put that loan in my business it wouldn't have helped me at all because the interest is so high and the loan repayment is per month."*

Instead, many turn to their own savings or to help from family and friends to help grow a business (*Figure 10*). This may be lower risk, but it's also more opportunistic. Investments only happen at the time when someone is able to divert those funds for this purpose, which is usually only after other key necessities have been paid for or can be pushed out into the future. Financing may still be a constraint to business growth; 92% of our respondents during the Update said they would start or expand businesses if they could access the right financing.

Figure 10: Resources for business expansion (n) more than one option allowed; liability financing in red.

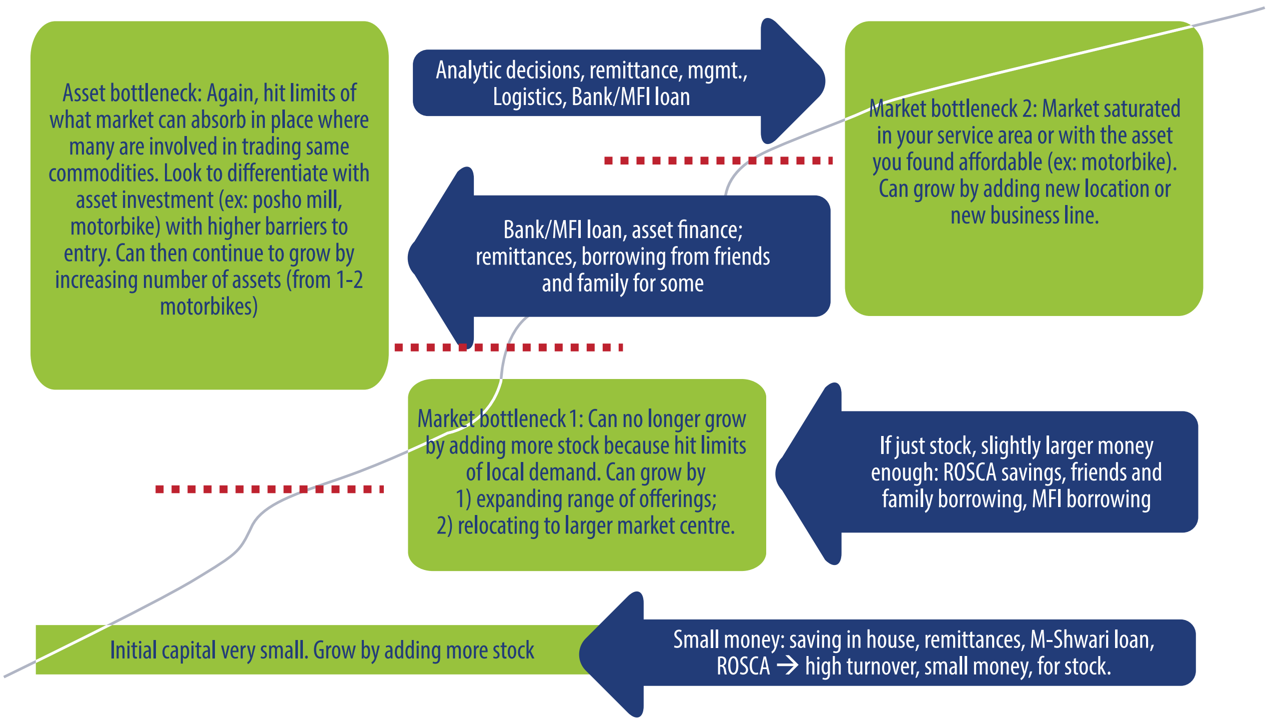


Business expansion was more often financed by savings and remittances than by borrowing.

THREE IMPLICATIONS FOR IMPACT

1. **Financial service providers are already on the right track for providing the kinds of finance that help businesses move through growth bottlenecks.** Filling the financing gap between KSh 1000-10,000 still needs to be done, but there's reason to believe that is on the way. This is more clearly seen in Figure 11 below, where we look more closely at the financing needs of businesses facing different bottlenecks and how those financing needs are met today. The kinds of capital these small entrepreneurs need that they can't access today is relatively small. It falls somewhere between traditional bank loans and M-Shwari limits today. While there is a gap, it's likely that gap will soon be closed by mobile-based lenders like M-Shwari, KCB M-PESA, and Equitel, who are refining their credit scoring methodologies to enable these kinds of loans to be more easily accessed by a larger number of Kenyans. This is all very encouraging. Of course, just having these loans available does not mean that the pricing and durations are suitable to support small business growth. Donors and support agencies should continue to monitor this evolving market to track how well the terms of the loans on offer are meeting the needs of small entrepreneurs.

Figure 11: Financing needs and practices at each market bottleneck.



2. **Finance is not the only bottleneck to small business growth.** These kinds of small businesses also face important hurdles in their lack of differentiation, which leads to high competition in the market of a small number of goods and services. They each serve relatively small markets with little potential to competitively grow their businesses to serve more people or meet unmet needs. In addition to pure financial solutions, companies that use new technologies to bring small business people into their supply chains or offer them access to a new, larger pool of clients (like Uber or other new innovations in logistics), have the potential to increase the earnings and sustainability of the small enterprise activities of low income families.

3. **The small businesses of the poor are unlikely to evolve into formal SMEs driving future productivity growth throughout Kenya.** Only a very small number of the businesses created by our respondents ever grow into something that specializes even to a small degree, hires employees, or creates new branches. The overwhelming majority of owner-operators do not even aspire to that kind of scale. They want to operate relatively low risk enterprises that ensure they can feed their families, build homes, and send their children to school, children they hope will go to college or university and take their place in the modern economy of the future. Perhaps that is and will continue to be the true impact of these kinds of enterprises on Kenya's economy: not what they produce directly, but for the opportunities they enable for the next generation of Kenyans.

4. **Donors and service providers should recognize that Type 1 and 2 businesses are different in character to Type 3 and 4 – and need different things.** Once we understand the nature and ambitions of these different kinds of businesses, we can think of tailoring services to better support them. For example, the temporary nature of many type 1 & 2 businesses makes them ill-suited for long term credit arrangements, while demand and ability to pay for short term kinds of cash flow management credit could be quite good. But, expecting that types 1 & 2 will and should "graduate" with more professional management and record keeping may be an unrealistic fantasy. Instead, some technologies that help with business tracking, payments, and personnel management could be quite helpful for types 3 & 4. In those spaces, it might be worth exploring whether entrepreneurs could benefit from more specialization rather than diversification and what kinds of financial and technological services could make that kind of growth possible. For example, our Jiko King respondent could potentially benefit substantially from support in branding and distribution.

5. **Entrepreneurs need financial services for more than just business growth.** Financial service firms would do well to think of entrepreneurs at this level as an important segment. They are economically active and likely to remain a large share of the Kenyan economy well into the future, but their needs—even apart from business—are shaped by the nature of their livelihood and cash flow patterns. While many flexible savings and credit schemes are already available and being widely used, attractive pension and insurance products are lagging behind. The Jiko King, for example, was very excited about the government's "Mbao Pension"[9] scheme when it was launched, but lost interest given issues around poor execution by providers involved. Especially from Type 3 & 4 entrepreneurs we see demand for these kinds of longer-term risk management services. But, making them work for this segment will require deviating from old service delivery models premised on payroll and debit order payments, enabling higher frequency, more flexible digital payments and much better transparency around balances and claims.

9 The Mbao Pension was a partnership between the government's Retirement Benefits Authority and Safaricom to offer a pension plan for self-employed Kenyans who would fund their account with the equivalent of KSh 20 per day. Our respondents were frustrated that they could not view their balances in the scheme. They were uncertain of how to claim their funds in retirement and lost faith that their savings was being adequately tracked and would be available when needed.

FSD Kenya
Financial Sector Deepening

info@fsdkenya.org • www.fsdkenya.org
FSD Kenya is an independent trust established to support the development of inclusive financial markets in Kenya
5th Floor KMA Centre • Junction of Chyulu Road and Mara Road, Upper Hill
P.O. Box 11353, 00100 Nairobi, Kenya,
T +254 (20) 292300 • **M**, +254 (735) 319706