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FinTech in Kenya:

Towards enhanced funding and investment

1. Introduction

As part of efforts to strengthen the UK and Kenya trading relationship, TheCityUK and the Nairobi International Financial Centre Authority (NIFCA) established a formal partnership in July 2021 that aims to establish a robust framework and supporting infrastructure to encourage the conditions that will lead to mutual and improved opportunities for the financial and related professional services industries. The first area of collaboration in the partnership between TheCityUK and NIFCA has been on FinTech, and in particular, to collaborate in three key areas:

a) Policy workstream – Reviewing policies and regulations to support FinTech growth;

b) Funding workstream – Providing advice on funding mechanisms; and

c) Scaling workstream – Helping FinTech to scale internationally.

This paper predominantly relates to the funding workstream. The key objective of this paper is to identify ways in which Kenyan FinTech firms access finance and investment allowing them to easily establish themselves and grow. The paper also covers some of the funding challenges faced by Kenyan FinTechs and outlines some potential mitigants to these challenges.

2. Background on startups and FinTech funding in Africa

Investment in startups in Africa has been growing over the past five years. The number of startups accessing funding grew by 42.1% and 27.7% in 2021 and 2020 respectively.[1] The year 2021 saw a threefold increase in the amount of funding over 2020 for capital raises worth over US$200,000. This explosion in funding was particularly notable in Nigeria, where FinTech providers attracted a major share of the capital raised.[2] In addition, more than 60% of the capital invested in African startups in 2021 went to the top 20% companies.[3]

In Kenya, FinTech was the third largest sector to attract funding, contributing 21.3% (equivalent to US$62m) of the total capital raised in 2021.[4] FinTech was the sector with by far the most funded startups in Kenya in 2021, with 27 ventures receiving backing, making up 31% of Kenya's funded companies.[5]

In general, Kenya has been on the rise over recent years, with the amount of funding raised in the country increasing further year-by-year. It is useful to understand the factors that led to this exponential growth in funding, and whether such growth is sustainable over a longer term. According to The African Tech Startups Funding Report, 2021, despite the positive trend witnessed over recent years, Kenya remains a market skewed towards the earlier stages of funding. Of the 48 rounds to name the stage of funding in 2021, 37.5% was at the pre-seed level, and a further 41.7% at seed stage.

The parameters of this paper focus on outlining the current capital funding landscape in Kenya, identifying the unique problems FinTech and tech-enabled start-ups face and proposing mitigating factors that are aligned to the funding obstacles. This discussion paper is aimed at fostering further conversations between relevant stakeholders on the funding options for Kenyan FinTech providers.

[1] The African Tech Startups Funding Report, 2021
[2] Partech – Africa Tech Venture Capital Report, 2021
[3] Briter Bridges – Africa Investment Report 2021
[4] The African Tech Startups Funding Report, 2021
[5] Ibid

3. The start-up lifecycle

The type of financing available to a start-up, FinTech or otherwise, is typically dependent upon the stage of the company in the "start-up lifecycle". The start-up lifecycle can be divided into three broad stages: early stage, growth stage and maturity stage. Each of these stages has different financing needs, with different risks to the investor, and offering different rates of return.

It should be noted that not all ventures will go through all of these funding rounds and the naming conventions may vary.

3.1. Early stage

The early stage of a venture consists of pre-seed and seed stages. At the pre-seed and seed stages, the product is still under development and has not been released to the broader market. Typically, pre-seed ventures tend to need founders to rely on their own savings and personal loans, or on friends and family for financing. At this stage of the venture, the founders try to get a proof of concept and will normally have minimal staffing. Externally sourced pre-seed financing is dominated by debt financing, with a small number of start-ups gaining access to equity investments.

At seed stage, ventures tend to have a proven concept, but the product is still a work in progress. It is at this stage that founders normally obtain their first major inflows of external investment. The founders are generally concerned with accessing funding to enable them to develop upon the initial idea to the point where it is ready to launch to the broader market. At seed stage, the founders might also seek equity investment. Potential investors available at this stage normally have a high-risk appetite and relatively patient capital. The financiers at this stage normally include angel investors, early-stage venture capital funds, incubators/ accelerators, friends and family.

3.2. Growth stage

The growth stage of a venture consists of different series of financing (primarily Series A and B funding). The growth stage is associated with a proven business with potential to scale. At this point of the start-up lifecycle, there is an increase in the capital required but generally at a lower risk level to investors than that of early-stage financing.

Growth stage financing is dominated by venture capital firms, corporate venture capital[6], investment banks and private equity funds. Each successive round of growth stage financing is associated with less risk to investors and therefore attracts more capital from risk averse financiers such as investment banks and private equity firms.

3.3. Maturity stage

The maturity stage of a venture is normally associated with a stable company that has operated in the market for some time. At this stage, founders and earlier stage investors will typically be looking at capital raising as either an investment exit strategy or a growth strategy to finance large transactions such as corporate acquisitions.

Companies in the maturity stage are trusted as a going concern and therefore they will more easily be able to raise funds from traditionally risk averse sources such as banks and retirement funds. Debt financing options are available, in theory, to companies in all stages of the start-up lifecycle. However, the ease of accessing debt financing increases as the company matures along the start-up lifecycle. It is also common for companies at this stage of maturity to raise funds from the general public through an Initial Public Offering (IPO).

4. Funding challenges to FinTech firms in Kenya

A number of the key funding challenges faced by FinTechs in Kenya are outlined in the section below.

4.1. Traction trap

Investors want to see proof of market traction before committing investment funds. However, FinTech firms, particularly those offering digital financial services solutions, need innovative and risk-tolerant working capital to demonstrate market traction.[7] Most startups typically struggle most to attract debt capital during two critical phases:

[6] A leading example of corporate venture capital in the Kenyan market is Safaricom's 'Spark Venture Fund' a US$1m fund that supports the successful development and growth of late-seed, early-growth stage, high potential mobile tech start-ups through a combination of investment, business development support and technical assistance leveraging on Safaricom's unique capabilities, assets and market positioning.

[7] Breaking the Pattern: Getting Digital Financial Services Entrepreneurs to Scale in India and East Africa', Village Capital

a) Pilot stage: It is difficult for companies to attract debt capital during initial piloting, refining, and validating of their products and services. Although there are some investors willing to partner and fund promising pilots, many FinTech companies struggle to find early investment partners. These companies then end up funding their pilots from existing equity capital, quickly burning through their cash.

b) Launch stage: After the initial pilot phase, companies must continue to find supporters who are willing to provide them with the capital necessary to launch and deliver their products and services. In the case of digital lenders for instance, investors, particularly financial institutions, evaluate the digital lenders debt assets on the balance sheet and assess their ability to collect repayments before committing further funding. Most digital lending FinTech firms, however, struggle to demonstrate a healthy lending balance sheet due to the lack of capital to lend.

4.2. Difficulty accessing investors

At the early stages of a FinTech start-up, it is difficult to get an audience with investors and secure a commitment to funding. A FinTech start-up might have an innovative product or service and a clear roadmap for scaling. However, their chances of procuring investments to develop and scale their products and services diminish if they do not have access to an angel network of investors, influencers or mentors.

4.3. The pattern-recognition problem

Investors often rely on patterns when making an investment decision. Traditional pattern indicators include attending a prestigious university or involvement in an accelerator program. However, FinTech firms do not always follow traditional patterns. This increases investors' perception of risk.[8] Due to the high cost of early-stage due diligence, most investors often fall back on pattern recognition to find companies and make investment decisions. This makes it difficult for unconventional FinTech firms to find investors who understand their market and who are still likely to invest without expected visible investment indicators.

4.4. Human capital trap

Often, investors assess the attractiveness of FinTech startups based on the strength of their teams. However, FinTech startups often cannot afford to hire talent with the right technical, operational and financial skills for growth without raising capital, such as talent from legacy institutions like banks and technology companies. Without the right team, FinTech firms cannot raise investment capital, and without capital they cannot attract the right team.[9]

4.5. Lack of contextual understanding

International investors typically lack in-depth knowledge and contextual understanding of the local market. Most of the decision makers are internationally based which makes it difficult for them to interpret risks on the ground. On the other hand, legacy lending institutions such as banks often cite a lack of adequate internal credit risk scoring metrics and frameworks to appropriately assess investments in FinTech startups. Consequently, a conservative approach is taken towards investments in FinTech firms by banking and investment institutions.

4.6. Financial jargon barrier (Telling the story effectively)

Investors communicate using a certain industry language within investment and financial market circles. They therefore look for financial metrics and investment terminologies in product pitches and messaging. Most founders on the other hand, are more focused on showcasing their products and services and the impact of their innovations. Some founders struggle to tell the 'Big Picture story' and may also struggle to articulate their fundraising messages using investment-speak due to the lack of a strong background in finance and investment. Stakeholders have also noted that some barriers to 'Big Picture' storytelling could be cultural, as exhibiting extreme confidence, as is necessary in a pitching environment, is frowned upon in many traditional Kenyan communities.

4.7. Fluctuation of foreign currencies

Local currencies in most of the East African countries have depreciated over the last five years making it difficult for businesses to repay foreign currency debt. According to East African Venture Capital Association and Intellecap's report 'Fintrek: Exploring new frontiers in FinTech investments in East Africa', the cost of raising foreign currency debt is sitting high at 18 – 20% due to fluctuation of forex. These high costs stifle the growth of local FinTech firms and increases the risk of default, making the region less attractive to foreign investors.

[8] 'Breaking the Pattern: Getting Digital Financial Services Entrepreneurs to Scale in India and East Africa', Village Capital
[9] Ibid.

4.8. Lack of investee readiness

Lack of internal structures within most early-stage businesses can make them unattractive to external investors for the following reasons:

a) Due diligence takes an unnecessarily long time because of a lack of proper documentation of agreements, for example, supplier contracts and employment contracts.

b) Commingling of company funds with the owners' funds.

c) Failure to keep proper financial records.

d) Issues with regulatory compliance.

4.9. Scaling challenges

In order to satisfy minimum investor requirements, FinTech providers often need to structure their companies in other jurisdictions. Different countries have different regulations, languages and cultural differences that impede scaling of FinTech startups in the region. Navigating new environments with no experience makes it difficult and burdensome for FinTech firms to operationalise plans made towards accessing investor funds.

5. Potential mitigants to the FinTech funding challenge in Kenya

This section highlights potential mitigating factors that directly respond to the funding challenges facing FinTech firms in Kenya and that could help broaden access to funding at the different stages of a FinTech start-up lifecycle. The mitigating factors are a combination of recommendations or suggestions from FinTech stakeholders in Kenya and available research on how to alleviate the funding challenges that startups face in Africa.

5.1 Development of a FinTech focused growth fund

FinTech companies find it difficult to access the growth capital necessary to transition and flourish due to the unique challenges discussed above. Given the important role FinTech plays in financial inclusion and development of the economy, opportunity exists for the government, working together with bodies such as the Nairobi International Financial Centre Authority (NIFCA), to utilise its influence and convening power to support the concept of a domestically funded growth capital investment vehicle focused on FinTech, following similar initiatives in other countries.

For example, in February 2022, the Kigali International Financial Centre (KIFC) announced the launch of the first FinTech-focused Africa Fund.[10] Backed by MyGrowthFund Venture Partners, the US$50m fund will focus on FinTech companies with proven technology, operating in Africa. The fund domiciled in KIFC will create proximity between investments and FinTech investment opportunities and will increase African investment in African FinTech. The fund's objective is to grow the capital to US$120m. As a result, several of the newly formed African unicorns, particularly those offering payment or banking solutions, have sought out Kigali as a base to consolidate their regional operations[11] [12].

The Kalifa Review of UK FinTech (Kalifa Report) in its recommendations, proposed a £1bn (approx. US$1.4bn) 'Fintech Growth Fund' to act as the catalyst in developing a world leading ecosystem in the UK. It would be funded by holders of domestic institutional capital and, where feasible, utilise existing regulatory concessions made applicable only to the fund, thus providing a vehicle to support growth from Series B to pre-IPO stage and the option to hold beyond. The fund would be modelled on the Business Growth Fund (BGF)[13], leveraging the concepts and principles which have made the BGF successful, such as using the large institutions to form the nucleus of the initiative, and the use of trade bodies to act as a coordinating function to enable successful implementation.[14]

To enhance the prospects of success of such a FinTech growth fund in Kenya, other innovative mechanisms could be employed such as structuring the FinTech growth fund as a tiered fund that is based on growth stages of FinTech startups so as to promote clustered level investment, structuring deals with first loss[15] or matching-grant guarantees, providing for matching grants to de-risk different levels of investments[16] and provision of subsidised capital for strategic human capital hires.

[10] Source: Kigali International Financial Centre (KIFC) website
[11] Ibid.
[12] Also see the Small Business Investment Company (SBIC) Program, administered by the U.S. Small Business Administration (SBA) at: https://www.sba.gov/document/support--sbic-program-overview
[13] BGF is the UK and Ireland's most active and dynamic investor of equity capital in growing companies, backing entrepreneurs and innovators.
[14] Kalifa (2021) Review of UK FinTech
[15] The first loss guarantee is a mechanism whereby a third party compensates lenders if the borrower defaults.
[16] 'Breaking the Pattern: Getting Digital Financial Services Entrepreneurs to Scale in India and East Africa' – Village Capital

5.2 Leveraging on public listing and local investment

A majority of Kenyans invest in low risk, long term investments such as real estate and fixed income securities. Stringent listing requirements, corporate governance and mandatory disclosures have historically discouraged companies from raising capital on the bourse. As a result, Initial Public Offerings (IPOs) on the Nairobi Securities Exchange (NSE) by mature startups tend to be a limited and underexploited channel for financing.

In 2021, the Kenya Capital Markets Authority (CMA) launched the revised Capital Market Master Plan (CMMP, 2014/2023) with the aim of mobilising savings and stimulating investments. Some of the key changes in the CMMP include clarification of the complementary roles of CMA and NIFCA in the promotion and regulation of capital markets, introduction of measures to catalyse activity in private equity and debt capital by making the asset class more accessible to asset managers, retirement schemes and the general investor base and leveraging Environment, Social and Governance (ESG) principles to attract green capital.[17] Other mechanisms bourses can employ include improving the listing environment through free float reduction[18] and dual class listing – as opposed to single share listing which forces founders floating their company to cede control.[19]

NIFCA can play an important role in collaborating with the CMA to educate startups on listing benefits, offerings and considerations. Information imparted could include advice on keeping good financial records and good corporate governance practices from the first year of operation, as well as details of less stringent alternative NSE listing products such the NSE Growth Enterprise Market Segment[20] and private placements. Networking opportunities with capital market and investment professionals will expose FinTech startups to the kind of support needed to achieve increased and successful listings.

Kenyans should concurrently be made more aware of the positive growth potential that exists in tech-enabled startups, more specifically, FinTech companies, which will in turn encourage more unicorns to join the bourse so as to meet the growing demand. According to the Kalifa Report, once enough FinTech companies have listed and formed a sub-sector, a bespoke FinTech index or segment could become a trendsetter for FinTech shares and cement a country's reputation as a listing destination.[21]

Beyond targeting ordinary Kenyans to invest in startups by increasing the ease in understanding how they can achieve returns, NIFCA could work with fund managers to encourage diversification of their portfolios to include startups that have technology as the backbone of their business.

The proliferation of global Fintech unicorns can be used as a catalyst for a national paradigm shift away from traditional investments like real estate.[22] It is likely that investment by locals in startups will increase should there be more start-up success stories that have Kenyans directly benefiting as investors.

5.3 Alternative funding models

Traditional sources of funding for growth stage startups include venture debt capital, which is often issued in hard currency at expensive rates, and bank overdrafts which are equally expensive and difficult to obtain without guarantees owing to the risk averse nature of investment and commercial banks.

There are a number of alternative finance options in the global market, ranging from peer-to-peer lending, invoice trading and crowdfunding. In Kenya, there has been a move by the CMA to regulate investment-based crowdfunding through the Draft Capital Markets (Investment Based Crowdfunding) Regulations, 2021. The finalisation of these regulations may serve to encourage young FinTech firms to rely on equity crowdfunding, more so during pre-seed and seed stages of funding, where a majority of African FinTech firms tend to receive their funding.[23]

For the traditional funding institutions, once they have developed the acceptable credit risk and regulatory analytical frameworks for the FinTech space, they should create innovative 'test and learn' based banking products. Such funding products could include cash collateral options to guarantee risk, interest rebate payments for successful ventures and flexibility in opening up additional funding as the venture grows.

Access to multiple alternative streams of finance would provide additional options to founders who may not be able to rely on traditional sources to provide seed funding. These alternative funding models can be a catalyst for early-stage growth.

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[17] Source: Capital Markets Authority website
[18] The free float is a measure of actual availability of stocks of a company in the market for public investment. The Issuer in the Growth Enterprise Market Segment of the NSE must ensure at least 15% of the issued shares are available for trade by the public. For the Alternative Investment Market Segment, following the public share offering or immediately prior to listing in the case of an introduction, at least 20% of the shares must be held by not less than one hundred shareholders.
[19] 'Breaking the Pattern: Getting Digital Financial Services Entrepreneurs to Scale in India and East Africa' – Village Capital
[20] NSE Growth Enterprise Market Segment (GEMS) see: https://www.nse.co.ke/growth-enterprise-market-segment/
[21] Kalifa (2021) Review of UK FinTech
[22] Between 2016 and 2021, 188 Fintech Unicorns raised US$106bn. The highest among all industries globally in that period. Figures from report by PwC US and PitchBook data, available in "Living in a world of Unicorns – Venture-backed giants are scaling up and transforming markets as varied as fintech, electric vehicles, and healthcare" by Vicki Huff Eckert - PwC US Global Leader, Ventures and Innovation. Report available here: https://www.pwc.com/gx/en/issues/reinventing-the-future/take-on-tomorrow/download/sbpwc-2022-01-17-World-of-unicorns.pdf
[23] The African Tech Startups Funding Report, 2021.

5.4 Policy and regulatory incentives for entrepreneurship

Government, fiscal and regulatory entrepreneurship incentives are an important tool that could help address some of the funding challenges that Kenyan startups including FinTech startups face.

In Kenya, a good example of utilisation of regulation to incentivise investment growth is the Start-up Bill, 2020.[24] The Start-up Bill proposes a legislative framework that will introduce subsidies and a credit guarantee scheme providing accessible financing for startups in Kenya. The Bill received conditional approval from the Kenyan Senate in 2021 and subsequently, has been referred to the Kenya National Assembly for legislation.

Similarly, the Ministry of Industrialization, Trade and Enterprise Development (the "Industrialization Ministry") has launched the 'Start-up Savanna'.[25] The Start-up Savanna is a World Bank funded initiative under the Kenya Industry and Entrepreneurship Project (KIEP) that brings together private entrepreneurship entities. Start-up Savanna connects the Kenyan ecosystem to international experts, investment, and support infrastructure, contributing to job creation, business growth, and sustainability.[26] KIEP is a significant step taken by the Kenyan government to support the investment and scaling of start-up firms in Kenya and the wider East African region. Registration for KIEP is available to startups in all stages of maturity through the Start-up Savannah website.

Lastly, foreign fiscal policy also forms an important part of the local investment landscape through grant funding. For example, the Federal Development Ministry of Germany (BMZ) has partnered with impact investment firm Seedstars to provide Kenyan startups with grant funding of up to €100,000 (approximately 13 Million KES).[27]

5.5 Deepen FinTech offerings, collaborations, tools and structures

A diverse service offering by Kenyan FinTech firms is likely to broaden their investor base. Various investors have multiple objectives for their investment portfolios. For instance, venture capitalists are interested in growth milestones, with the view of receiving a profit as their Return on Investment. As a result, they may rely on equity agreements with start-ups.[28] Inversely, Development Finance Institutions (DFI's) seek to provide grants or debt financing to FinTech firms with a 'social impact mandate', that is, FinTech firms with inclusivity as the primary focus of their business model. It is contingent on founders to articulate the objectives of their business in a clear and concise manner, to ensure that they address the priorities of investors.

Newer entrants in the start-up ecosystem can greatly benefit from mentorship opportunities with seasoned FinTech founders, large companies, accelerators and professional services firms which serve to prepare startups going through their programmes to be investor ready in the early stages of their lifecycle. Such interactions could also provide an avenue for secondment of experienced staff by FinTech corporate partners as part of collaborative efforts, thus improving the service delivery of FinTech startups and attracting wider sources of funding.

Other recommendations to boost skill enhancement include the development of an integrated talent management network and programs to connect world-class talent with FinTech providers. These could be deployed by NIFCA in collaboration with other FinTech stakeholders. Partnerships with local and international industry associations to develop such programs will further assist FinTech innovators become 'partnership ready'.[29]

To overcome pattern-recognition fallbacks, funders can employ independent diagnostic tools to help increase transparency and enable connection between investors and entrepreneurs.[30] Solutions that act as a primary matchmaking platform when used in tandem with traditional networks can serve to pair unconventional entrepreneurs to capital. Lastly, to ensure smooth exits, funders could structure their deals with the end in mind, for instance, through creating a viable investment vehicle or holding company in order to be lucrative to local and international buyers and investors at the point of exit.

[24] For the current status of the Startup Bill, 2020, please see the official Senate bill tracker available here http://www.parliament.go.ke/sites/default/files/2022-03/Bills%20tracker%20updated%20as%20at%2025th%20March%2C%202022.pdf
[25] Source: Startup Savanna Website
[26] Ibid.
[27] Source: Seedstars website
[28] Simple Agreement for Future Equity - SAFE agreements were cited as a common feature of initial engagements between startups and investors during the stakeholder interviews.
[29] 'Breaking the Pattern: Getting Digital Financial Services Entrepreneurs to Scale in India and East Africa', Village Capital
[30] Ibid

6. Conclusion

FinTech plays an important role in boosting financial inclusion and economic growth in Kenya and beyond. However, the nascent, inventive and often complex nature of the sector means FinTech innovators face unique challenges when trying to access resources required to grow and thrive. As a result, FinTech players can struggle to raise the capital desperately needed for growth and scaling. This has a trickle effect in limiting financial accessibility and affordability opportunities for the population. For the FinTech industry to continue to flourish, it is imperative that industry stakeholders create the right environment that will encourage the channelling of capital investment funds to FinTech startups. This will allow the country to seize the economic and societal opportunities afforded by a vibrant FinTech start-up ecosystem.

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