Private Sector Afghanistan

Private Sector Characteristics

- Afghanistan's economy has a complex mix of informal, formal, illicit and aid- sustained elements.
- The formal Afghan private sector contributes only 10–12 per cent to the country's official GDP.
- Although it has the potential to be, Afghan private sector is not the engine of economic growth or instrument of social inclusion.
- 90% Afghans are employed in establishments with less than five employees, a net majority of those establishments with a sole proprietor.
- Afghanistan's few large enterprises are relatively marginal to employment, they play an important role in generating government tax revenue, attracting foreign direct investment (FDI), providing certain critical services (such as telecommunication and construction), introducing technology and management standards and catalyzing the establishment of smaller enterprises.
- Foreign ownership outside of the services sector connected to the international presence is limited and mainly concentrated to technology-intensive industries, such as extraction and telecom.
- Large Afghan-owned enterprises typically have an ownership and management structure involving male members of the same family.
- The large corporate groups tend to be active in several sectors, foremost logistics, trade, finance, security and construction, as a means to support their main business, spread the risk or to reinvest profit.
- Many Afghan business groups, even when headquartered overseas, maintain a strong commercial base in their region of origin, where they often have ties to the ethno-political establishment. This model reinforces the existing configuration of interests and sidelines entrepreneurs, however, this represents also a way for these enterprises to reduce risk in the volatile and insecure environment, and maintain investment in the Afghan economy.
- 500 000 micro-enterprises largely in the informal, sector active across the country, they are a substantial source of employment and apprenticeship.
- As a war economy emerged formal institutions collapsed, the social fabric was torn, and illicit crops and criminal cross-border activities became ingrained in the country's economy.
- Weak fiscal regime limits the Government ability to collect tax revenue and provide essential public services and goods.

General Recommendations to tackle this situation

- Facilitating private sector environment for micro- enterprises is essential for overcoming poverty and employing the country's workforce, particularly for women and youth.
- The Afghan private sector could, in addition to leading economic growth, contribute to improving human and security conditions in the country.
- The Afghan Government will need to create a more facilitating environment for the private sector, particularly for the many disadvantaged players that form the bulk of the economy.
- In view of the weak state capacity as well as the miserable fiscal outlook new partnership modalities with the private sector are recommended.
- Facilitate the use of the Afghan private sector of country's economic potential.
- Urgent measures mast be implemented to fight unemployment levels that remain worryingly high and could continue to rise

- private sector has a role to play in providing a tax base, mitigating poverty, and granting the broader population, as well as the elites, an economic stake in the survival of the state.
- Reinforce the Government's administrative and technical capacity. In this regard, strategic Private Sector Development support from the international is required.
- The more contemporary organized private sector emerged through cooperation between Afghan businesses and the international community which shared a mutual interest in improving business conditions.
- Develop the legislations to an explicit legislative basis for investment protection of fixed assets and enforcement of contracts is a major impediment.

Access to finance

- Afghanistan is last among least developed countries (LDCs) in the low financing rate through banks. In fact, less than half of formal Afghan firms have a bank account and even the major banks only have offices in the largest urban centers.
- Relatively limited amounts of aid goes directly to private sector development .
- Fortunately, recent aid agenda has notably increased the focus on private sector development as the primary means for the country to achieve a self-sustained economy.
- Companies considere political instability to be the biggest business-environment issue because of the lack of trust in the future
- Much of the revenue generated through Afghanistan's macroeconomic growth over the past decade has been channeled abroad, typically to Dubai. Only narrow amounts remained available to segments of the private sector.
- SMEs are facing even more difficulties than large enterprises in obtaining loans, and women are further disadvantaged, with 81 per cent of female SME owners stating a lack of access to credit
- Only few per cent of companies employ bank loans to finance investment. Other forms of funding, especially through relatives and kin-based networks (informal Private Equity scheme).
- Trust in the formal banking system is low and has decreased considerably since the Kabul Bank scam.
- Prohibitive repayment conditions, including lending rates of at least 15 per cent, requiring a very high short-term profit margin. Collateral are still exorbitant and processing phase is too long and sophisticated.
- For large numbers of businesses, entrepreneurs, or producers, including in rural areas where access to finance can be decisive for vital livelihoods, bank credit will likely remain out of reach.

Recommendations to overcome the problem of accessing to Finance by Private Sector

The availability of capital for lending is not the root problem, officials from several leading Afghan banks explained that they would like to increase commercial lending to improve deposits to outstanding loans ratios. Bankers say that the main problem they face is with finding credible borrowers with bankable projects. A variety of donor-funded projects have been implemented over the years to address apparent market failures in Afghanistan's commercial finance market.

In brief, the fundamental obstacle to the growth of commercial finance in Afghanistan is the mismatch between the cumulatively high formal and informal costs of finance on the one hand, and the low risk-adjusted expected returns on investment on the other.

Afghanistan is currently caught in a "risk/return trap." But even in this situation, we can demonstrate that the access to finance problem can be overcome in the short-term with the right combination of circumstance and intervention. Despite initial concerns and uncertainties, Grantees have proved their ability to obtain commercial investment and working capital finance.

The right formula for private sector to access commercial finance is to incentivize its investment in innovative business models that would deliver wider development impact to drive inclusive growth.

Using Grants to reduce the cost of capital and encourage borrowing

(Grants can be also concessional loans with 0 interest or a loan with very favorable repayment terms)

To unlock this situation, we believe that Grants are an effective way to reduce the overall weighted average cost of capital in high risk environments. Grant finance does not necessarily crowd-out commercial finance if designed well. On the contrary, when used carefully, grants can be an incentive to secure and leverage additional commercial financing. As long as the cost of finance exceeds the returns that investment can generate, there is clearly no incentive to borrow. Grants can tip the balance and here is another argument of why we have recommended to partially use the grant funds as equity in the investment Projects.

The amount of the grant must be predicated on an estimated weighted average cost of capital (WACC) – a combination of the costs of debt and equity finance – in Afghanistan this is in the region of 25%. It is a truth universally acknowledged that no rational investor will invest if the cost of capital exceeds the expected return on investment.

The following steps are also recommended to access Commercial Finance

1. *Pre-investment due diligence*
   An extensive due diligence – examining both the credibility of the applicant and the viability of the investment and the business plan must be carried out. This process had two important outcomes. First, many applicants might scale back the size of their planned investment as they realize the working capital that would be required to finance their originally proposed expansion. Secondly, finance is granted according to the level of the confidence that these investments were realistic and able to be properly managed by the applicants.

2. *Securing Investment Guarantees*
   Once the due diligence work is done and we are convinced about the viability and feasibility of the projects, the second phase is to go to the Investment Guarantee Institutions such as MIGA, ICIEC etc. to ensure the foreign capital and loans invested in the Project. As match as the project is feasible and its risk is mitigated, the cost of the insurance premium and loan cost are low.

3. *Obtaining Grants for the project*
   As demonstrated above, Grants represent an important factor to reduce the cost and de-risk the Project.

4. *Talking to Commercial Banks*
   Once we have in hands the strong feasibility study, the well performed due diligence, the Investment Guarantee and the Grant approved, we can then start negotiating with Commercial Banks to obtain the most suitable loan conditions.

Recommendations to the Afghan Government

- Provide direction by developing a realistic private sector growth strategy with clear measurable milestones, division of labor between international and national actors, and implementation, monitoring and follow-up mechanisms;
- Increase the capacity of state economic institutions that support the productive potential of the private sector, including through continuous training of the civil service. Relevant public institutions must be given unambiguous mandates.
- Take immediate carefully tailored measures to curb corruption starting at the highest government echelons. Curb corruption in regulatory processes through increased use of digitalized processes.
- Improve the business climate in close coordination with the organized business community through realistic growth- promoting economic policy reforms and by prioritizing sustainable development of strategic industries. Instruments such as tax relief, state supply contracts and public-private partnerships (PPPs) should be considered.
- Evaluate and update the strategy for trade policy instruments that can enhance Afghan competitiveness and protect infant industries. Full digitalization of customs procedures could help to eliminate exiting gaps in regulation.

- Tackle the hurdles that limit access to economic resources, in particular land and capital. Access to resources should be combined with clearer and enforced property rights.
- Mobilize state landholdings for use by the private sector through favorable long-term lease agreements.
- Leverage the potential of existing and developing unbanked credit mechanisms. Sector-oriented banks that provide demand-led financial products.
- Invest in infrastructure critical to economic activity. In view of government financial limitations, rapidly move to pass and implement the new PPP law.
- Prioritize women's full and equal participation in the economy, leveraging women-to-women economic networks, while promoting male endorsement. Support policies should be mainstreamed within all economic plans.

Recommendations to the international community

- Support the Afghan Government with all the above-stated recommendations. Direct but careful market interventions can also be considered.
- Set up a formal cooperation and coordination mechanism for the development of the private sector in conjunction with the Government.
- Support full value-chain development projects in the agricultural sector, which have high labor intensity and job creation potential, including for women.
- Consider diversifying geographic focus: aid interventions should aim to target communities based on need rather than on political or security priorities.
- Incorporate consumer demand perspectives into Private Sector Development programming.

Recommendations to the private sector and other Afghan stakeholders

- Give greater weight to Strengthen the smaller- scale business actors, including informal and rural-based businesses capacity and boost transparency, and member representation of organized business.
- Strive to curb supply-side corruption. Leverage collective action, engage officials, utilize media, and engage organized civil society to promote clean business.

Afghanistan UNDP Country Office's Private Sector Funding Initiative

Establishment of a Revolving Fund to Support Women Owned Companies, Innovative Startups Companies and Export Companies.

The fund aims to leverage the available ODA and Grants to create a larger effect on the beneficiary companies and assure Sustainability, Growth, and Revolving structure to reinvest and invest in new ventures. The ultimate objective of this repetitive action is to establish an Impact Investment Fund capable to attract Governmental and Non-Governmental entities, International Investors, Local Investors and Credit and other Local and International Players

The fund Mechanism:

- Setting Funding Criteria, Disbursements and Reimbursements mechanisms.
- Screening of the Market and Shortlisting of Eligible Companies.
- Implementing of Capacity Building Programme to assure the ultimate use of the fund
- Putting together a Business Plan that clarifies: the short and medium terms targets, resources required, output and marketing, cash flow and funding to assure the targeted Profitability and Growth Rates of each venture.
- Implementing of Risk Mitigation Instruments to protect Investments.
- Exiting and Reinvesting.