



UNEP FI and WWF Workshop:

Innovative Financing for Sustainable Small & Medium Enterprises (SMEs) in Africa

International Environment House, Geneva, Switzerland
Wednesday 26th September 2007,
0900 – 1630 hrs

Background Reading

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*Africa Competitiveness Report 2007, Chapters 1 & 2*¹

by World Economic Forum, World Bank, and African Development Bank

*From Talk to Walk: Ideas to Optimize Development Impact*²

by Clinton Global Initiative

*Financing SMEs in Africa*³

by Celine Kaufmann

*Sustainable SMEs: Creating Value within Planetary Limits*⁴

by Jenni Inglis, Consultant WWF

*Blended Value Investing: Capital Opportunities for Social & Environmental Impact*⁵

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*On the Frontiers of Finance: Investing in Sustainable SMEs in Emerging Markets*⁶

by Belinda Hoff, Institute for Responsible Investment, and Mareike Hussels,
World Resources Institute

*Venture Capital for Development*⁷

by Alan J. Patricof, APAX Partners and Julie E. Sunderland

*Why doesn't Africa get more Equity investment?*⁸

by Todd Moss, Vijay Ramachandran, and Scott Standley; Center for Global
Development

*Risk Mitigation Mechanisms for Investment in Sustainable SMEs*⁹

by DeRisk Advisory Services

*Financing Sustainable SMEs in Africa: a hierarchy of development needs and
acknowledging the vital role of the Diaspora*¹⁰

by Dr. Kimberly Ochs, London School of Economics

¹ www.weforum.org/africa

² www.dalberg.com/pdfs/taskforce.pdf

³ “Financing SMEs in Africa” by Celine Kaufmann, OECD Policy Insights No. 7, available at
<https://www.oecd.org/dataoecd/57/59/34908457.pdf>

⁴ Research paper prepared for this workshop.

⁵ https://www.weforum.org/pdf/Initiatives/Blended_Value_Report_2006.pdf

⁶ Included with prior agreement from the authors of the paper.

⁷ Prepared for the Brookings Blum Roundtable: Private Sector in fight against global poverty, 2005

⁸ “Why Doesn't Africa Get More Equity? Frontier Stock Markets, Asset Allocation of Global Emerging
Market Funds”, by Working Paper 112, February 2007, Center for Global Development

⁹ DRAFT of the research paper prepared for this workshop, and to be concluded after capturing inputs from
the workshop delegates.

¹⁰ Winner of the Call-for-papers specifically conducted for this workshop.

Africa Competitiveness Report 2007

Chapters 1.1 & 1.2

By World Economic Forum, World Bank, Africa Development Bank

(Full report can be found at www.weforum.org/africa)

Assessing Africa's Competitiveness in a Global Context

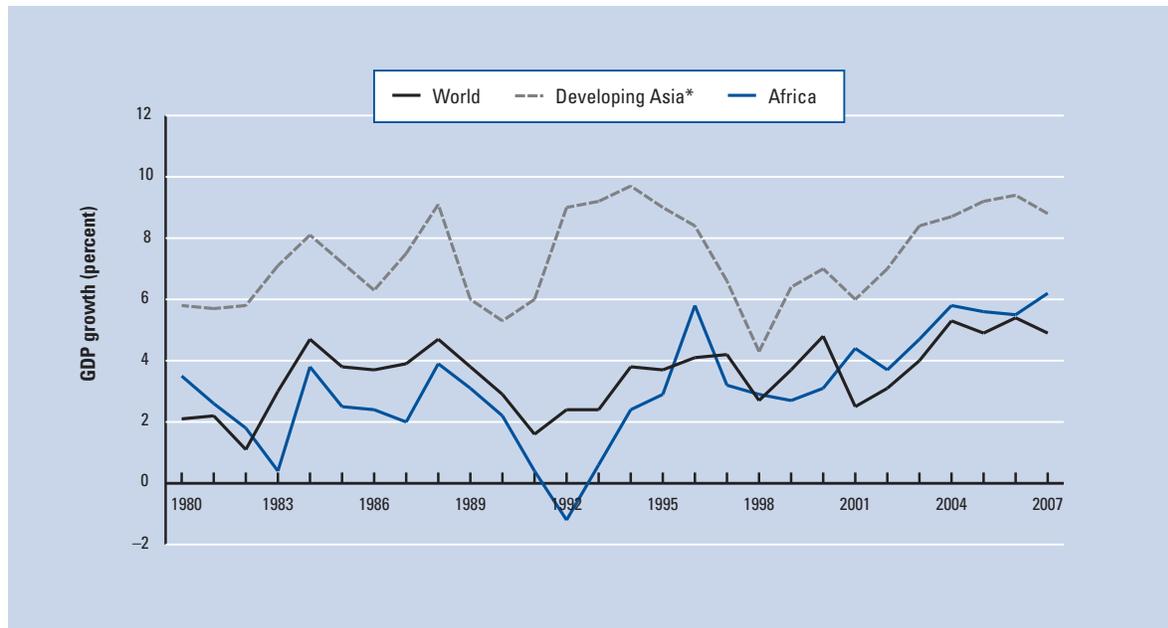
JENNIFER BLANKE, World Economic Forum

The World Economic Forum has analyzed the competitiveness of African countries since the early 1990s and has produced regional reports on the economic competitiveness of Africa for nearly a decade. The first *Africa Competitiveness Report* was published in 1998, followed by two further editions in 2000 and 2004. The goal of this series is to highlight the prospects for sustained growth in the region and, more importantly, the obstacles to competitiveness. This fourth *Report* comes amid renewed optimism against the background of a much more encouraging regional economic climate.

After many years of economic stagnation, and at times even decline, Africa is experiencing an economic resurgence. Between 2001 and 2006, growth in gross domestic product (GDP) on the continent averaged 4.9 percent annually, according to the International Monetary Fund (IMF). In 2006, Africa as a whole grew by an impressive 5.5 percent and sub-Saharan Africa in particular by 5.7 percent. In 2007 these rates are expected to increase even further—to 6.2 and 6.8 percent, respectively—the highest growth registered for decades. In parallel, foreign direct investment has been picking up, with increasing activity by booming emerging markets, drawn by the continent's rich natural resources. Accordingly, the overall outlook for the region's economic prospects is broadly optimistic.

Despite this new-found optimism, questions remain as to how sustainable this growth will be over the longer run. Even though the continent is experiencing its highest growth since the 1970s, and even though significant progress has been achieved in terms of stabilizing the macroeconomic environment in many African countries, most of the current growth has been fueled by a confluence of external circumstances and interventions, including high commodity prices, debt relief, and a favorable international economic environment. Genuinely sustainable growth, however, must be based on solid domestic foundations rather than on cyclical or exogenous circumstances. Moreover, high rates of growth over decades, like those observed in developing Asian countries, are desperately needed in Africa in order to significantly raise the living standards of its people. In this context, African countries must become more competitive.

To illustrate the importance of increasing the region's competitiveness, Figure 1 compares the growth rates of Africa with those of developing Asia and the world average since 1980. As the figure shows, throughout the 1980s and 1990s Africa's growth rates were mostly below the world average, and consistently below the developing Asia average. The figure also shows that since the beginning of this decade, African growth rates have finally exceeded those of the world average. At the same time, growth rates continue to be much lower than the group of developing countries from Asia, a region that has raised the living standards of its citizens significantly over recent decades. Indeed, these are the magnitudes of growth rates that must be achieved over a

Figure 1: Africa's comparative growth performance (1980–2007)

Source: IMF, 2007.

* Developing Asia comprises Bangladesh, Bhutan, Cambodia, China, Fiji, India, Indonesia, Kiribati, Lao People's Democratic Republic, Malaysia, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Tonga, Vanuatu, and Vietnam.

long period of time in Africa in order to lift many citizens rapidly out of poverty. Present growth rates in Africa, although high by historical standards, are still short of the estimated 7 percent annual growth that would be required to meet the Millennium Development Goal (MDG) of halving poverty rates in the region by 2015.¹ With a few exceptions, income levels across the continent remain very low, and African poverty rates are the highest in the world.

Recognizing the urgency of enhancing Africa's competitiveness to improve living standards, the continent has benefited from a renewed focus and increased attention from several institutions from within the region and beyond. Within the region, the effort that has probably received the most attention is the New Partnership for Africa's Development (NEPAD).² Such regional efforts are joined by the various institutions of the African Union (AU) and the African Development Bank (AfDB), as well as a number of regional economic communities that are pursuing, with varying degrees of success, the economic integration of the continent's major subregions. Beyond the continent, promoting development in Africa has been high on the Group of Eight (G8)'s agenda since the 2005 summit in Gleneagles.³

The World Economic Forum's work on competitiveness aims to complement these efforts by contributing to a better understanding of the key ingredients of economic growth and prosperity, and by placing individual country performances into an international context. We assess a number of factors that will determine whether

African countries will continue on a sustained growth path, or even accelerate that growth.

Why has Africa's overall economic performance been lagging behind other developing regions? Which are the areas requiring urgent policy attention in order to ensure sustained strong economic performance going into the future? This chapter will present a framework for addressing these questions. In order to prioritize those areas requiring urgent policy attention to improve competitiveness on the continent, the analysis will provide a bird's eye view of the competitive landscape in Africa. It will show how African countries are performing vis-à-vis each other, as well as where the region stands vis-à-vis international benchmarks, highlighting specific areas where countries in the region are lagging behind. By highlighting the strengths and weaknesses of the region and individual economies compared with other economies from around the world, policymakers, business leaders, and other stakeholders are offered an important tool for the formulation of improved economic policies, institutional reforms, and investment decisions.

The first section of this chapter describes in some detail the methodology used by the World Economic Forum in measuring national competitiveness to place the analysis in context. This is followed by a discussion of Africa's competitiveness from a global and regional perspective, comparing African countries' performances with other relevant developing countries and regions, and highlighting some differences between the geographical regions of North Africa and sub-Saharan

Africa. The next section includes a more detailed analysis of the best performers in the region across the various “pillars” of national competitiveness. This analysis shows that there are strong individual country performances in a number of areas and highlights the existence of best practices within the region. The final section provides details on the competitive performances of individual African countries, discussing both the competitive strengths and weaknesses in each, and pointing toward those areas most requiring policy attention.

Measuring competitiveness

In order to assess national competitiveness, the World Economic Forum has developed the Global Competitiveness Index (GCI).⁴ *Competitiveness* is defined as the set of institutions, policies, and factors that drive productivity and therefore set the sustainable current and medium-term levels of economic prosperity.⁵ In this sense competitiveness is not viewed as a zero-sum game, such as competition among companies vying for a larger portion of a given market share. Instead, by placing the focus on the drivers and the facilitators of productivity, improvements in one country’s competitiveness do not exclude similar improvements in other countries.

We have learned from our years of research that the measurement of competitiveness is a complex undertaking. The GCI, albeit simple in structure, provides a holistic overview of factors that are critical to driving productivity and competitiveness, and groups them into nine pillars: *institutions* (public and private), *infrastructure*, the *macroeconomy*, *health and primary education*, *higher education and training*, *market efficiency* (goods, labor, financial), *technological readiness*, *business sophistication*, and *innovation*. Each of these pillars plays a critical role in driving national competitiveness. The GCI is the most comprehensive competitiveness index to date, measuring the macro- and microeconomic drivers of competitiveness across a large number of countries.

The selection of these pillars, as well as the factors that enter each of them, is based on the latest theoretical and empirical research. It is important to note that none of these factors alone can ensure competitiveness. The value of increased spending in education will be undermined if rigidities in the labor market and other institutional weaknesses make it difficult for new graduates to gain access to suitable employment opportunities. Attempts to improve the macroeconomic environment—for example, bringing public finances under control—are more likely to be successful and receive public support in countries where there is reasonable transparency in the management of public resources, as opposed to widespread corruption and abuse. Innovation or the adoption of new technologies or upgrading management practices will most likely not receive broad-based support in the business community if protection of the domestic

market ensures that the returns to seeking rents are higher than those for new investments.

The most competitive economies in the world will therefore typically be those where concerted efforts have been made to frame policies in a comprehensive way—that is, those that recognize the importance of a broad array of factors, their interconnection, and the need to address the underlying weaknesses they reveal in a proactive way.

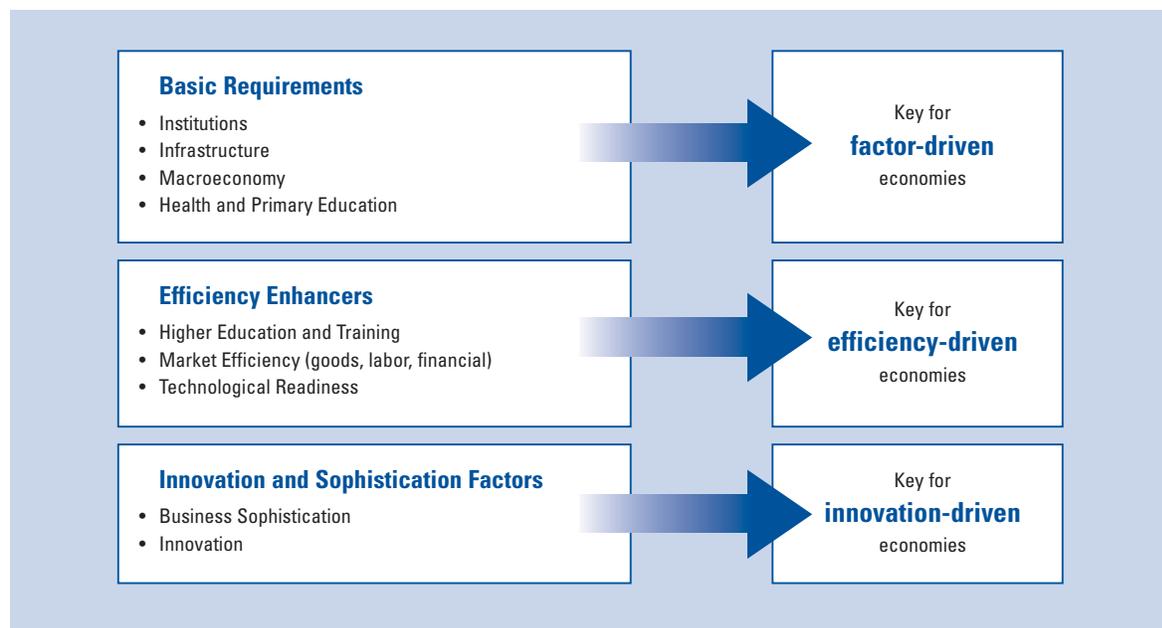
The nine pillars are measured using both “hard” data (such as inflation, Internet penetration, life expectancy, and school enrollment rates) from public sources and data from the World Economic Forum’s Executive Opinion Survey, conducted annually among top executives in all of the countries assessed. The Survey provides crucial data on a number of qualitative issues (for example, corruption, confidence in the public sector, quality of schools) for which no hard data exist.⁶

Our sample covers 128 economies at different stages of economic development, with GDP per capita in the wealthiest country surpassing that of the poorest country by a factor of 117, based on purchasing power parity. Clearly policy priorities must evolve as countries advance on the development path, since what it takes to achieve productivity improvements in a less-advanced economy—such as improving health, fighting illiteracy and corruption, or constructing basic infrastructure facilities such as roads and ports—will no longer be sufficient to increase productivity in a more sophisticated economic framework, where productivity gains from these policies have often already been exploited.

To take this process into account, the concept of stages of development has been introduced into the calculation of the Index. Specifically, countries are separated into three stages, based on the idea that as countries move along the development path, wages tend to increase, and that in order to sustain this higher income, productivity must improve. This concept is integrated into the Index by attributing higher relative weights to those pillars that are relatively more relevant for a country given its particular stage of development.

In the *factor-driven* stage countries compete based on their factor endowments, primarily unskilled labor and natural resources. Companies compete on the basis of prices and sell basic products or commodities, with their low productivity reflected in low wages. To maintain competitiveness at this stage of development, competitiveness hinges mainly on a stable macroeconomic framework (pillar 1), well-functioning public and private institutions (pillar 2), appropriate infrastructure (pillar 3), and a healthy, literate workforce (pillar 4).

As wages rise with advancing development, countries move into the *efficiency-driven* stage of development, when they must begin to develop more efficient production processes and increase product quality. At this point, competitiveness becomes increasingly driven by higher education and training (pillar 5), efficient markets (pillar

Figure 2: Composition of the three subindexes

6), and the ability to harness the benefits of existing technologies (pillar 7).

Finally, as countries move into the *innovation-driven* stage, they are able to sustain higher wages and the associated standard of living only if their businesses are able to compete with new and unique products. At this stage, companies must compete through innovation (pillar 9), producing new and different goods using the most sophisticated production processes (pillar 8). Thus, although all nine pillars matter to a certain extent for all countries, the importance of each one depends on a country's particular stage of development.

To account for this, the pillars are organized into three subindexes, each critical to a particular stage of development. The *basic requirements subindex* groups those pillars most critical for countries in the factor-driven stage. The *efficiency enhancers subindex* includes those pillars critical for countries in the efficiency-driven stage. And the *innovation and sophistication factors subindex* includes all pillars critical to countries in the innovation driven stage. The three subindexes are shown in Figure 2.

The GCI implements the concept of developmental stages by weighting each of the subindexes differently, depending on the stage of a given country, placing more weight on those pillars that are most important at a given stage of a country's development. The specific weights we attribute to each subindex in every stage of development are shown in Table 1.⁷

For the calculation of the Index, the countries are allocated to stages of development based on two criteria.

Table 1: Weights of the three main groups of pillars at each stage of development

Weights	Basic requirements (percent)	Efficiency enhancers (percent)	Innovation and sophistication factors (percent)
Factor-driven stage	50	40	10
Efficiency-driven stage	40	50	10
Innovation-driven stage	30	40	30

The first criterion is the level of current GDP per capita at market exchange rates. This widely available measure is used as a proxy for wages, because internationally comparable data for the latter are not available for all countries covered.⁸ In addition, we have updated our methodology to also take into account the extent to which each individual economy is factor-based, using the share of primary exports as a percentage of total exports (goods and services) to measure factor intensity.⁹

The GCI also takes into account that some countries are “in transition” between stages. For these countries, the weights change smoothly as a country develops, reflecting the smooth transition from one stage of development to another. By introducing this type of transition between stages into the model—that is, by placing increasingly more weight on those areas that are becoming more important for the country's competitiveness as the country develops—the Index can gradually “penalize” those countries that are not preparing for the next stage and “reward” those that are doing so. The classification

Table 2: List of selected countries in each stage of development

Stage 1	Transition from 1 to 2	Stage 2	Transition from 2 to 3	Stage 3
Angola	Algeria	Brazil	Barbados	Australia
Bangladesh	Bosnia and Herzegovina	Bulgaria	Czech Republic	Austria
Benin	Botswana	Chile	Estonia	Canada
Bolivia	Colombia	Costa Rica	Hungary	Cyprus
Burkina Faso	Ecuador	Croatia	Korea, Rep.	Denmark
Burundi	El Salvador	Kazakhstan	Malta	Finland
Cambodia	Jordan	Latvia	Trinidad and Tobago	France
Cameroon	Libya	Lithuania		Germany
Chad	Macedonia, FYR	Malaysia		Greece
China	Namibia	Mauritius		Hong Kong SAR
Egypt	Peru	Mexico		Ireland
Ethiopia	Thailand	Poland		Italy
Gambia	Tunisia	Romania		Japan
Georgia	Venezuela	Russian Federation		Netherlands
Guatemala		Slovak Republic		Norway
India		South Africa		Singapore
Indonesia		Turkey		Spain
Kenya		Uruguay		Sweden
Lesotho				Switzerland
Madagascar				United Arab Emirates
Malawi				United Kingdom
Mali				United States
Mauritania				
Moldova				
Mongolia				
Morocco				
Mozambique				
Nepal				
Nigeria				
Pakistan				
Philippines				
Sri Lanka				
Tanzania				
Uganda				
Ukraine				
Vietnam				
Zambia				
Zimbabwe				

of countries into stages of development is shown in Table 2. Appendix A describes the exact composition of the GCI, and Appendix B provides further technical details on its construction.

Table 2 shows the allocation of African countries into the different stages of development. The table shows that all of the 29 countries in Africa analyzed in this chapter, shown in bold, are categorized in or between the first two stages—none has yet reached the innovation stage. Specifically, 22 African countries are in stage 1, 5 are in transition between stages 1 and 2, and only 2 countries—Mauritius and South Africa—have reached stage 2.

The GCI calculations in this *Report* have been updated since the *Global Competitiveness Report 2006–2007*. Specifically, three Arab world countries have been added to the sample, including one African country, Libya, which appears in our work this year for the first time. Further, a number of the hard data vari-

ables included in the Index, particularly those related to technology, have been updated. All of the data included in the calculation are provided in the Competitiveness Profiles of Part 2 of this *Report*.

Measuring Africa's competitiveness: The international context

This section will assess the performance of individual African countries, as well as the overall competitiveness of Africa as a region, compared with international standards. Table 3 shows the rankings and scores of the 29 African countries covered in the 2007 GCI out of all 128 countries covered. The table also shows their rankings in 2005 for comparison. To put the analysis into a global context, we also include a number of comparator economies. These include the averages of two relevant developing regions—Latin America and Southeast Asia—as well as the ranks and scores of the four rapidly

Table 3: Global Competitiveness Index, 2007 and 2005 comparisons

Country/Region	GCI 2007		GCI 2005
	Rank*	Score	Rank**
Tunisia	29	4.72	37
India	42	4.47	45
South Africa	46	4.42	40
China	55	4.25	48
Southeast Asia average		4.25	
Mauritius	58	4.22	55
Russian Federation	61	4.13	53
Egypt	65	4.09	52
Brazil	67	4.08	57
Latin America & Caribbean average		4.07	
Morocco	72	4.02	76
Libya	73	4.00	—
Algeria	76	3.98	82
Botswana	83	3.83	72
Namibia	88	3.76	79
Kenya	97	3.61	93
Nigeria	102	3.49	83
Gambia	104	3.45	109
Benin	107	3.41	106
Tanzania	108	3.40	105
Cameroon	111	3.32	—
Madagascar	113	3.29	107
Lesotho	115	3.24	—
Uganda	116	3.21	103
Zambia	117	3.21	—
Mauritania	118	3.18	—
Burkina Faso	119	3.10	—
Malawi	120	3.09	114
Zimbabwe	121	3.07	110
Mali	122	3.04	115
Ethiopia	123	3.00	116
Mozambique	124	2.97	112
Chad	126	2.64	117
Burundi	127	2.62	—
Angola	128	2.50	—

*Out of 128 economies; ** Out of 117 economies
Note: All averages are weighted by population.

developing and large “BRIC” countries (Brazil, Russia, India, and China).

As the table shows, of all the countries covered Tunisia is the strongest performer, ranked among the top 30 of all countries included in the Index. Tunisia also outperforms all other comparator economies shown in the table. Within Africa, Tunisia is followed by South Africa and Mauritius, ranked 46th and 58th, respectively. A bit farther down in the rankings are the other North African countries, namely Egypt, Morocco, Libya, and Algeria, ranked 65th, 72nd, 73rd, and 76th, respectively. All other countries ranked below Algeria are from the sub-Saharan region, with Botswana, Namibia, and Kenya as the only three other countries within the top 100 countries ranked. All of the other 19 countries from sub-Saharan Africa rank among the 27 weakest performers occupying ranks of 102 or lower.

Tables 4 through 7 provide more details behind what is driving the overall ranks and scores shown in Table 3. North Africa and sub-Saharan Africa have radically different competitive performances, as shown by

the averages in Table 4. Specifically, North Africa outperforms the average of the other countries on the continent in all three subindexes measured by the Index, as well as all nine pillars. The largest gaps can be found in the areas of health and primary education, higher education and training, infrastructure, and the macroeconomic environment. The smallest gaps are in market efficiency, technological readiness, and innovation.

The gaps between the north and south of the continent are echoed in many of the comparisons with the other regions and selected countries shown in the tables. Sub-Saharan Africa is, on average, outperformed by all comparators in seven out of the nine pillars: namely, infrastructure, health and primary education, higher education and training, market efficiency, technological readiness, business sophistication, and innovation. Again, the largest performance gaps relative to the comparators are in infrastructure, health and primary education, and higher education and training. However, we note that, on average, sub-Saharan Africa outperforms a few countries in the remaining two pillars. This includes Russia, China, and, narrowly, Brazil with regard to the quality of the institutional environment, and Brazil with regard to macroeconomic stability. Yet overall, it is clear that sub-Saharan Africa's competitive performance trails well behind that of other developing countries and regions.

By contrast, Table 5 shows that North Africa on average matches up quite well to many of the comparators shown across a number of areas. For example, North Africa outperforms all comparators except for India in the area of institutions. Its infrastructure is assessed as more developed than all comparators except for Russia and China (with scores very close to the North African average). The region's macroeconomic environment is more stable than in all comparators except China, Russia, and the Southeast Asia average. With regard to health and primary education, North Africa scores higher than India, Russia, Latin America, and Southeast Asia, and is on a par with China. In other words, North Africa performs well compared with the other economies shown in the tables in the more basic areas measured by the Index.

The competitive landscape in North Africa and sub-Saharan Africa get closer to each other once we move beyond the basic factors. Tables 6 and 7 show their comparative performance in more complex factors, such as technological readiness, market efficiency, innovation, and so forth, where North Africa performs more modestly. In fact, for most of the five pillars captured under the efficiency enhancers, innovation, and sophistication factors subindexes, North Africa and sub-Saharan Africa alike receive the worst assessments of all countries and regions shown in the tables. This is true for market efficiency, technological readiness, business sophistication, and innovation. Only in the area of higher education and training does North Africa very slightly outperform another comparator—China—but by a negligible margin.

Table 4: The Global Competitiveness Index 2007: Africa and comparators

Country/Region	OVERALL INDEX		SUBINDEXES					
	Rank	Score	Basic requirements		Efficiency enhancers		Innovation factors	
			Rank	Score	Rank	Score	Rank	Score
NORTH AFRICA								
Algeria	76	3.98	44	4.91	92	3.30	92	3.22
Egypt	65	4.09	64	4.55	75	3.63	65	3.63
Libya	73	4.00	45	4.87	95	3.25	97	3.16
Morocco	72	4.02	70	4.45	77	3.60	73	3.54
Tunisia	29	4.72	33	5.27	40	4.34	28	4.42
North Africa average		4.09		4.67		3.58		3.56
SUB-SAHARAN AFRICA								
Angola	128	2.50	128	2.48	126	2.51	126	2.52
Benin	107	3.41	106	3.74	107	3.04	90	3.23
Botswana	83	3.83	82	4.30	80	3.54	98	3.15
Burkina Faso	119	3.10	124	3.17	112	2.96	86	3.27
Burundi	127	2.62	127	2.73	127	2.46	121	2.66
Cameroon	111	3.32	108	3.71	117	2.91	104	3.05
Chad	126	2.64	126	2.90	128	2.35	125	2.53
Ethiopia	123	3.00	118	3.31	123	2.69	119	2.72
Gambia	104	3.45	105	3.84	103	3.11	115	2.89
Kenya	97	3.61	109	3.70	83	3.47	59	3.73
Lesotho	115	3.24	107	3.72	122	2.81	123	2.59
Madagascar	113	3.29	114	3.60	116	2.92	91	3.23
Malawi	120	3.09	119	3.30	119	2.87	112	2.93
Mali	122	3.04	123	3.19	121	2.83	96	3.17
Mauritania	118	3.18	117	3.41	113	2.94	108	2.98
Mauritius	58	4.22	50	4.74	62	3.88	47	3.84
Mozambique	124	2.97	122	3.25	124	2.63	118	2.86
Namibia	88	3.76	72	4.44	93	3.29	88	3.25
Nigeria	102	3.49	113	3.60	90	3.33	69	3.60
South Africa	46	4.42	57	4.66	45	4.24	29	4.35
Tanzania	108	3.40	115	3.56	96	3.17	77	3.49
Uganda	116	3.21	121	3.27	100	3.12	83	3.30
Zambia	117	3.21	116	3.52	109	3.01	127	2.43
Zimbabwe	121	3.07	125	3.09	108	3.03	94	3.18
Sub-Saharan Africa average		3.29		3.55		3.05		3.12
BRICs								
Brazil	67	4.08	88	4.23	58	3.96	38	4.09
China	55	4.25	47	4.82	72	3.66	57	3.75
India	42	4.47	63	4.56	41	4.33	26	4.60
Russian Federation	61	4.13	68	4.49	59	3.96	72	3.55
Latin America and Caribbean average		4.07		4.41		3.83		3.75
Southeast Asia average		4.25		4.53		4.01		3.90

Note: All averages are weighted by population.

Although North Africa has made relative progress in some basic areas of competitiveness, much remains to be achieved in Africa as a whole in order to achieve higher rates of growth, create jobs, and boost income.

Of course, the aggregate analysis of this section masks a great deal of the diversity among individual country performances within the region in the various pillars. Table 8 shows the rankings of African countries in the nine pillars of the Index, highlighting the three best performers in each case. The table shows that Tunisia is one of the top three performers in all of the pillars, while South Africa is one of the top performers in six of them and Mauritius in five, mirroring these countries' positions at the top of the overall rankings.

The table also reveals notable comparative strengths in several other African countries in specific areas.

Tunisia, South Africa, and Botswana have strong institutional environments (ranked 26th, 31st, and 38th, respectively), on a par with countries such as Chile, Estonia, and Spain. These countries have common strengths such as independent judiciaries, efficient government spending, and relatively low levels of corruption, leading to public trust in politicians. Private institutions are also positively assessed, including corporate ethics and aspects of corporate governance. Other countries in the top half of the rankings are Mauritius (43rd), Namibia (49th), Egypt (50th), Zambia (56th), and Gambia (57th), with rankings similar to countries such

Table 5: The Global Competitiveness Index 2007: Basic requirements

Country/Region	Basic requirements		1. Institutions		2. Infrastructure		3. Macroeconomy		4. Health and primary education	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score
NORTH AFRICA										
Algeria	44	4.91	65	3.95	80	2.93	2	6.19	46	6.56
Egypt	64	4.55	50	4.21	56	3.74	111	3.75	51	6.51
Libya	45	4.87	75	3.81	100	2.46	1	6.95	81	6.26
Morocco	70	4.45	68	3.89	61	3.58	81	4.24	89	6.07
Tunisia	33	5.27	26	5.06	37	4.42	39	4.91	33	6.69
North Africa average		4.67		4.13		3.53		4.57		6.44
SUB-SAHARAN AFRICA										
Angola	128	2.48	123	3.02	116	2.07	126	2.40	128	2.45
Benin	106	3.74	87	3.57	117	2.06	95	4.04	104	5.29
Botswana	82	4.30	38	4.53	67	3.38	41	4.85	115	4.42
Burkina Faso	124	3.17	67	3.92	113	2.15	119	3.37	127	3.24
Burundi	127	2.73	115	3.20	126	1.71	125	2.51	123	3.50
Cameroon	108	3.71	120	3.11	124	1.93	42	4.83	107	4.96
Chad	126	2.90	128	2.66	128	1.43	110	3.76	122	3.74
Ethiopia	118	3.31	91	3.55	105	2.34	98	3.98	124	3.39
Gambia	105	3.84	57	4.11	97	2.62	108	3.77	110	4.85
Kenya	109	3.70	92	3.55	89	2.75	102	3.91	113	4.59
Lesotho	107	3.72	89	3.56	121	2.00	54	4.64	112	4.69
Madagascar	114	3.60	98	3.43	119	2.03	118	3.39	103	5.53
Malawi	119	3.30	66	3.94	118	2.06	127	2.31	109	4.89
Mali	123	3.19	71	3.84	115	2.09	116	3.48	125	3.34
Mauritania	117	3.41	72	3.83	114	2.10	123	2.82	108	4.91
Mauritius	50	4.74	43	4.40	42	4.21	107	3.79	44	6.58
Mozambique	122	3.25	112	3.25	102	2.41	115	3.50	120	3.85
Namibia	72	4.44	49	4.23	45	4.16	45	4.79	114	4.58
Nigeria	113	3.60	93	3.53	108	2.26	57	4.62	119	3.98
South Africa	57	4.66	31	4.79	50	4.04	48	4.74	106	5.07
Tanzania	115	3.56	64	3.95	96	2.65	103	3.88	121	3.76
Uganda	121	3.27	103	3.38	122	1.99	69	4.42	126	3.29
Zambia	116	3.52	56	4.11	90	2.75	122	3.07	118	4.17
Zimbabwe	125	3.09	101	3.39	101	2.44	128	2.20	116	4.32
Sub-Saharan Africa average		3.55		3.65		2.45		4.00		4.04
BRICs										
Brazil	88	4.23	85	3.63	72	3.32	117	3.42	48	6.54
China	47	4.82	96	3.51	60	3.62	8	5.72	56	6.44
India	63	4.56	33	4.71	63	3.51	91	4.12	96	5.90
Russian Federation	68	4.49	119	3.16	62	3.57	35	4.95	78	6.29
Latin America and Caribbean average		4.41		3.69		3.25		4.20		6.51
Southeast Asia average		4.53		4.08		3.12		4.61		6.30

Note: All averages are weighted by population.

as Costa Rica, Hungary, and Korea. Representing both North and sub-Saharan Africa, with relatively strong institutions by international standards, these countries provide examples for other countries in the region wishing to improve their institutional environments. This is particularly important given that, among the 29 countries shown in the table, 13 are in the bottom third of all countries covered, pointing to the regional improvements needed in this area.

With regard to infrastructure, Tunisia, Mauritius, and Namibia are the three best-performing countries, ranked 37th, 42nd, and 45th, respectively—they are better assessed than some European countries, including Italy and Poland. Particularly high ranked are the quality of

their ports, the quality of railroads (in Tunisia and Namibia), and the electricity supply (particularly in Tunisia and Mauritius). The main weakness in all three countries is the low telephone line penetration rate (a weakness of decreasing importance given the rapid rise of mobile phone penetration). Yet, despite these few relatively strong cases, the only other countries assessed within the top half of all 128 countries are South Africa, Egypt, and Morocco (ranked 50th, 56th, and 61st). All other countries are ranked 80th or lower, with more than half of the countries ranked below 100th place. This emphasizes the importance of upgrading infrastructure on the continent to improve competitiveness.

Table 6: The Global Competitiveness Index 2007: Efficiency enhancers

Country/Region	Efficiency enhancers		5. Higher education and training		6. Market efficiency		7. Technological readiness	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score
NORTH AFRICA								
Algeria	92	3.30	86	3.46	97	3.67	93	2.75
Egypt	75	3.63	77	3.73	66	4.15	80	3.01
Libya	95	3.25	73	3.88	121	3.39	115	2.48
Morocco	77	3.60	87	3.45	75	4.07	70	3.27
Tunisia	40	4.34	36	4.72	36	4.65	47	3.65
North Africa average		3.58		3.69		4.03		3.03
SUB-SAHARAN AFRICA								
Angola	126	2.51	128	1.92	123	3.37	124	2.25
Benin	107	3.04	104	2.96	96	3.68	114	2.48
Botswana	80	3.54	89	3.41	61	4.20	81	3.00
Burkina Faso	112	2.96	119	2.51	89	3.81	106	2.57
Burundi	127	2.46	126	2.16	126	3.28	128	1.96
Cameroon	117	2.91	106	2.85	117	3.45	116	2.43
Chad	128	2.35	127	1.99	127	3.07	127	1.99
Ethiopia	123	2.69	123	2.39	119	3.41	123	2.26
Gambia	103	3.11	109	2.81	88	3.82	94	2.70
Kenya	83	3.47	90	3.41	73	4.10	83	2.91
Lesotho	122	2.81	118	2.52	120	3.41	112	2.50
Madagascar	116	2.92	116	2.55	100	3.63	103	2.59
Malawi	119	2.87	122	2.46	91	3.77	121	2.38
Mali	121	2.83	121	2.48	104	3.62	119	2.40
Mauritania	113	2.94	124	2.33	103	3.62	85	2.88
Mauritius	62	3.88	69	3.94	70	4.11	54	3.58
Mozambique	124	2.63	125	2.30	125	3.32	122	2.28
Namibia	93	3.29	108	2.82	80	4.00	79	3.04
Nigeria	90	3.33	103	3.04	71	4.10	90	2.85
South Africa	45	4.24	56	4.17	34	4.68	44	3.87
Tanzania	96	3.17	115	2.56	76	4.07	87	2.87
Uganda	100	3.12	110	2.78	85	3.90	97	2.68
Zambia	109	3.01	120	2.48	86	3.87	96	2.68
Zimbabwe	108	3.03	99	3.10	115	3.48	110	2.51
Sub-Saharan Africa average		3.05		2.84		3.86		2.71
BRICs								
Brazil	58	3.96	61	4.10	59	4.21	53	3.58
China	72	3.66	79	3.68	55	4.23	78	3.08
India	41	4.33	49	4.35	20	5.09	56	3.56
Russian Federation	59	3.96	43	4.44	60	4.20	72	3.25
Latin America and Caribbean average		3.83		3.92		4.13		3.42
Southeast Asia average		4.01		4.09		4.64		3.30

Note: All averages are weighted by population.

The macroeconomic environment presents an interesting case, as Africa is home to both the strongest and weakest performances in this area. Table 8 shows that the two best-rated countries out of all countries in the region are Libya and Algeria—two countries that have benefited from windfall oil revenues that have significantly improved their public finances. These countries have high government budget surpluses, manageable debt, high national savings rates, and at the same time they have managed to keep inflation rates low. The third highest ranked country is Tunisia (39th), an oil importer, which has also managed to tame inflation and has reasonably balanced public finances. A number of other countries have satisfactory assessments in this area,

such as Botswana (41st), Cameroon (42nd), Namibia (45th), and South Africa (48th), all ranked among the top 50 countries. On the other hand, the macroeconomic environment of most countries is assessed as very weak, with 18 of the 29 African countries ranked among the bottom third. In particular we see that Zambia, Mauritania, Burundi, Angola, Malawi, and Zimbabwe round out the bottom of all countries assessed, joined only by Guyana from outside the region (124th). Box 1 looks at recent macroeconomic trends in Africa. Although much clearly remains to be done to foster a more stable economic environment in many countries of the region, the box describes how the overall picture has been improving in recent years.

Table 7: The Global Competitiveness Index 2007: Innovation and sophistication factors

Country/Region	Innovation factors		8. Business sophistication		9. Innovation	
	Rank	Score	Rank	Score	Rank	Score
NORTH AFRICA						
Algeria	92	3.22	106	3.36	77	3.09
Egypt	65	3.63	57	4.22	83	3.04
Libya	97	3.16	88	3.57	98	2.75
Morocco	73	3.54	80	3.82	61	3.26
Tunisia	28	4.42	31	4.80	27	4.05
North Africa average		3.56		3.97		3.15
SUB-SAHARAN AFRICA						
Angola	126	2.52	126	2.74	124	2.30
Benin	90	3.23	87	3.58	91	2.87
Botswana	98	3.15	98	3.43	92	2.87
Burkina Faso	86	3.27	101	3.40	70	3.14
Burundi	121	2.66	120	3.01	122	2.32
Cameroon	104	3.05	104	3.37	100	2.73
Chad	125	2.53	124	2.81	125	2.26
Ethiopia	119	2.72	123	2.94	117	2.50
Gambia	115	2.89	109	3.30	118	2.48
Kenya	59	3.73	68	4.04	48	3.42
Lesotho	123	2.59	125	2.80	120	2.37
Madagascar	91	3.23	102	3.39	78	3.07
Malawi	112	2.93	116	3.16	106	2.70
Mali	96	3.17	110	3.29	81	3.04
Mauritania	108	2.98	105	3.36	111	2.60
Mauritius	47	3.84	44	4.44	65	3.23
Mozambique	118	2.86	117	3.13	113	2.58
Namibia	88	3.25	85	3.60	89	2.91
Nigeria	69	3.60	75	3.87	52	3.33
South Africa	29	4.35	32	4.79	29	3.92
Tanzania	77	3.49	83	3.68	56	3.30
Uganda	83	3.30	93	3.49	73	3.11
Zambia	127	2.43	128	2.51	121	2.35
Zimbabwe	94	3.18	92	3.50	94	2.86
Sub-Saharan Africa average		3.12		3.57		3.05
BRICs						
Brazil	38	4.09	38	4.61	38	3.56
China	57	3.75	65	4.05	46	3.44
India	26	4.60	25	5.06	26	4.14
Russian Federation	72	3.55	79	3.83	59	3.28
Latin America/Caribbean average		3.75		4.26		3.25
Southeast Asia average		3.90		4.33		3.48

Note: All averages are weighted by population.

Given the importance of basic factors such as primary education and the health of the workforce, the results in this pillar for the countries of Africa are disconcerting. Table 8 shows that the three countries best assessed in this area are Tunisia (33rd), Mauritius (44th), and Algeria (46th). These countries have attained relatively high rates of primary enrollment and have health indicators that compare well with the rest of Africa, and are on a par with economies such as Estonia and Hong Kong. They are joined in the top half of the rankings by Egypt (51st). Only Libya out of the 25 remaining countries is ranked in the top two thirds. With weak health

indicators; high prevalence rates of diseases such as malaria, tuberculosis, and HIV/AIDS; and low primary enrollment rates by international standards, 22 of the 25 lowest-ranked countries are from sub-Saharan Africa, and countries from the region fill out all 11 lowest ranks. Further, many African countries have experienced a significant deterioration in this area on a comparative basis in recent decades, as described in Box 2. It is clear that improving these aspects of the human resources base requires urgent attention to bring the region up to higher levels of competitiveness.

Table 8: Top three African performers in each pillar of the GCI

	1. Institutions	2. Infrastructure	3. Macroeconomy	4. Health and primary education	5. Higher education and training	6. Market efficiency	7. Technological readiness	8. Business sophistication	9. Innovation
Country	Rank	Rank	Rank	Rank	Rank	Rank	Rank	Rank	Rank
Algeria	65	80	2	46	86	97	93	106	77
Angola	123	116	126	128	128	123	124	126	124
Benin	87	117	95	104	104	96	114	87	91
Botswana	38	67	41	115	89	61	81	98	92
Burkina Faso	67	113	119	127	119	89	106	101	70
Burundi	115	126	125	123	126	126	128	120	122
Cameroon	120	124	42	107	106	117	116	104	100
Chad	128	128	110	122	127	127	127	124	125
Egypt	50	56	111	51	77	66	80	57	83
Ethiopia	91	105	98	124	123	119	123	123	117
Gambia	57	97	108	110	109	88	94	109	118
Kenya	92	89	102	113	90	73	83	68	48
Lesotho	89	121	54	112	118	120	112	125	120
Libya	75	100	1	81	73	121	115	88	98
Madagascar	98	119	118	103	116	100	103	102	78
Malawi	66	118	127	109	122	91	121	116	106
Mali	71	115	116	125	121	104	119	110	81
Mauritania	72	114	123	108	124	103	85	105	111
Mauritius	43	42	107	44	69	70	54	44	65
Morocco	68	61	81	89	87	75	70	80	61
Mozambique	112	102	115	120	125	125	122	117	113
Namibia	49	45	45	114	108	80	79	85	89
Nigeria	93	108	57	119	103	71	90	75	52
South Africa	31	50	48	106	56	34	44	32	29
Tanzania	64	96	103	121	115	76	87	83	56
Tunisia	26	37	39	33	36	36	47	31	27
Uganda	103	122	69	126	110	85	97	93	73
Zambia	56	90	122	118	120	86	96	128	121
Zimbabwe	101	101	128	116	99	115	110	92	94
Global leader	Finland	Germany	Libya	Japan	Finland	Hong Kong	Sweden	Germany	Japan

The quantity and quality of higher education and training becomes increasingly important for countries aiming to improve the efficiency of their business environments. In Africa, with the exception of Tunisia (36th) and to a certain extent South Africa (56th), the assessment is quite bleak. The third best assessed country is Mauritius, at a low 69th rank overall. Except for a couple of North African countries (Egypt and Libya), all other countries are ranked in the bottom third of all 128 countries. Enrollment rates at the secondary and tertiary levels throughout the region remain low, educational systems suffer from poor quality, and in many countries companies are not providing on-the-job training to compensate for these weaknesses. Upgrading educational systems, ensuring higher enrollment levels, and inculcating a stronger culture of training will be important for Africa as it continues on its path of development.

The efficiency of markets for goods and services, labor, and financial interactions are also important for ensuring the proper allocation of resources across the economy. In Africa, two countries are evaluated as having efficient markets: South Africa (34th) and Tunisia (36th), comparing well with countries such as Belgium and Spain. South Africa is particularly well assessed for

the efficiency of its goods markets (17th) and financial markets (27th), despite significant stickiness in its labor markets. Tunisia, on the other hand, has quite efficient and flexible labor markets (30th) and well functioning goods markets (32nd), although its financial markets are less developed (45th). There are a number of additional success stories. For example, Zambia's labor markets are rated very positively (26th), ahead of all other countries in the region, and Mauritius' financial market sophistication is second only to South Africa's on the continent (38th). However, as indicated by the overall ranking shown in Table 8, market inefficiencies abound within most other countries in the region. The greatest weaknesses are in the areas of goods and financial market efficiency, where the large majority of African countries are ranked in the bottom third of all countries, with several all the way at the bottom.

Technology is an important productivity enhancer, especially for those countries aiming to move up the value chain. As Table 8 shows, Africa as a whole is not harnessing these tools sufficiently. The three best-ranked countries from Africa—South Africa, Tunisia, and Mauritius—all receive mediocre assessments in technological readiness (ranked 44th, 47th, and 54th respectively),

The competitiveness of African countries

As mentioned above, **Tunisia** is the top-ranked country in Africa, ranked 29th overall, a full 17 places ahead of the second-ranked country on the continent, South Africa (46th), and higher than all other comparators in the tables. Tunisia displays comparative strengths across many of the areas measured by the GCI. To begin, the country has public institutions that are assessed as efficient, with low levels of corruption (19th) rather well protected property rights (36th), and an independent judiciary (34th) as well as a strong security environment in the country (20th). In terms of private institutions, corporate ethics also get quite high marks (29th), on a par with countries such as Spain and Portugal.

Tunisia also has a healthy workforce and provides excellent access to primary schooling, particularly by regional standards, with the educational system also getting good marks. Goods markets in the country are characterized by relatively few distortions, with little time required to start a business (12th), and taxation that is not perceived as distortionary (19th), although competition is not as intense as in some other countries (43rd). Labor markets are quite flexible and efficient with relative ease for companies in hiring and firing in the country (32nd), quite strong cooperation in labor-employer relations (29th), and one of the best assessments of the participation of women in the workforce (5th). Given that Tunisia is presently in transition between stages 1 and 2, all of these strengths, measured in the basic requirements and efficiency enhancers subindexes, support the country's strong competitiveness.

Although innovation and business sophistication are not yet considered to be fundamental for Tunisia's competitiveness, the country also demonstrates some strength in this area. For example, Tunisian firms tend to produce products relatively high on the value chain rather than basic products (29th), and intellectual property is quite well protected (31st). However, actual patenting remains quite low (70th), suggesting that there is perhaps untapped innovative potential in the economy.

With regard to competitive weaknesses, although infrastructure as a whole receives a reasonable assessment (37th), there are some areas of concern, most particularly telephone lines (80th). The macroeconomic environment is characterized by deficit spending (-2.8 percent of GDP in 2005) that has led to a substantial buildup of national debt. The national savings rate also remains low, placing the country 50th on this indicator.

With regard to education, although as mentioned above primary enrollment is positively assessed, secondary and tertiary enrollment rates place the country 74th and 61st, respectively. Financial markets are also ranked only as average, particularly for their level of sophistication (60th), local equity market access (70th), and the perceived soundness of banks (66th).

Finally, Tunisia could be harnessing new technologies more effectively for productivity improvements—it is

ranked 47th in the area of technological readiness. In particular, laws relating to ICTs are not seen as supporting their proliferation, and in fact, penetration rates of new communication tools (mobile phones, Internet users, personal computers) remain low by international standards.

South Africa, ranked 46th overall, is the second highest ranked country in Africa. It remains the top performer in sub-Saharan Africa, ranking higher than all other comparators in Table 3 except for Tunisia and India. South Africa is sub-Saharan Africa's economic giant, accounting for a third of its GDP despite accounting for only 6 percent of its population.¹⁰ Its strong performance in the Index reflects this. Relative to its overall rank, the country does particularly well in a number of areas typically reserved for rich, innovation-driven economies. Its economic sophistication is reflected in high ranks for property rights (23rd), corporate ethics (30th), and goods (19th), as well as financial market efficiency (27th), business sophistication (32nd), and innovation (29th). South Africa's scientific research institutions are assessed as on a par with Hong Kong's, and the country has a higher rate of patenting than a number of European countries, including Greece, Portugal, and Russia. These combined strengths explain South Africa's position at the top of the regional ranking.

However, South Africa does face a number of obstacles to competitiveness. For example, the country ranks 126th in labor market flexibility, encompassing hiring and firing practices, flexibility of wage determination, and union-employer relations. Flexibility of wage determination in South Africa is also constrained by the short supply of skilled labor. This year's ranking for higher education and training shows a drop to 57th place from 47th last year. Tertiary enrollment of 15 percent places the country 88th overall. Therefore, the implementation of education and training programs that deliver the skills necessary for a modern economy are a key ingredient to boosting economic performance.

Infrastructure represents another challenge. South Africa experienced a drop in ranking for this pillar, from last year's 35th place to 50th place this year, with particular concerns about the quality of the electricity supply that has been increasingly plagued by interruptions (73rd) and the low penetration rate of telephone lines (85th). The government is aware of these challenges and there are a number of efforts underway to address them, with investments planned in the areas of utilities and infrastructure.

Finally, lack of security remains an obstacle to doing business in South Africa. The business costs of crime and violence (116th) and the unreliability of police services to protect from crime (92nd) are highlighted as particular concerns. These are areas that need to be tackled in order to improve the country's competitiveness outlook.

Mauritius is the third most competitive economy in Africa, ranked 58th overall. The country is character-

ized by strong public institutions, with well-protected property rights (29th), reasonable levels of judicial independence (43rd), and a security situation that is very good by regional standards (40th). Private institutions are rated as accountable, with strong auditing and accounting standards (34th) and corporate boards (37th), assessed similar to countries such as Japan, for example.

The country's infrastructure is quite well developed, especially for the region. In particular air transport (38th), ports (33rd), and the electricity supply (37th) are of good quality, and the country has relatively abundant telephone lines (43rd). Financial markets in Mauritius are also highly developed (38th) with relatively abundant capital for business development through a variety of channels such as bank loans (36th) from a sound banking system (38th), as well as by issuing shares on the stock market (36th).

Mauritius also has comparative strengths with regard to business sophistication (ranked 44th overall in this pillar), an area that will become increasingly important for the economy as it moves into the next, innovation-driven stage of development. This includes some control over the international distribution of its products (43rd) and producing products already quite high on the value chain (28th).

On the other hand, Mauritius faces some weaknesses in its macroeconomic environment, with a government budget deficit that places the country 110th out of 128, relatively high inflation, and high interest rates.

With regard to human resources, there are low secondary and tertiary enrollment rates (placing Mauritius 64th and 83rd, respectively), and the educational system does not get particularly good marks for quality (66th). On a positive note, however, firms provide significant on-the-job training to make up for this shortcoming (34th). Beyond the educational weaknesses, labor markets are extremely sticky and inefficient, with stringent hiring and firing laws (118th), wages that are not flexibly determined (122nd), and little relation between productivity and pay. Further, there are some health concerns with regard to the workforce—particularly the high incidence of tuberculosis—which places the country 82nd overall.

Egypt is the second-ranked country in North Africa, at 65th place. Egypt's main strengths can be found in aspects of market efficiency. With regard to goods market efficiency, the country benefits from low taxation, little time required to start a business, and the country's large market size, which allows for economies of scale. Egyptian businesses also have access to a relatively large number of local suppliers (35th) and maintain control over the international distribution of products produced in the economy (31st).

There are also some strengths in aspects of the country's labor markets, such as flexibility in wage determination (7th), a rather close relationship between pay and productivity (31st), and reasonable private-sector

employment of women (38th). However, the labor market is clearly fraught with some challenges, such as stringent hiring and firing laws (100th) and a lack of cooperation in relations between labor and employers (78th).

With regard to other weaknesses, Egypt's drop of 12 places is attributable in large part to an extremely sharp decline of 61 places in the macroeconomy pillar, as it struggled with deteriorating government finances (the government deficit amounted to 10.5 percent of GDP in 2005, the second-highest deficit of all countries covered) leading the country to build up debt of over 100 percent of GDP by that year. Inflation has also remained quite high in the country (11.4 percent in 2005), at a time when inflation is generally low around the world, thus placing it 112th.

Higher education and training is another area of weakness, with enrollment rates at all levels that could be improved, an educational system that gets poor marks for quality (106th), and a lack of on-the-job training in the country (84th). This is no doubt related to the lack of technological readiness in the country (80th), with low penetration rates of ICTs such as mobile phones (94th). Innovation in the country also gets quite poor marks (83rd), although this should be of secondary concern given its stage of development, since it can still benefit greatly from getting more of the basics right.

Morocco, ranked 72nd, moved up by four places this year. The assessment of the country's public institutions has improved, especially in the area of security (47th). There have also been some improvements in the quality of the country's infrastructure, although more must be done to bring it up to world standards.

The results also show that Morocco has made progress in improving technological readiness (see Chapter 1.5), with big gains in firm-level technology absorption and in technology transfer through FDI. The country has seen an increase in Internet users and improved innovation since the last competitiveness assessment, in particular through stronger university-industry research collaboration and better protection of intellectual property rights.

Despite the overall positive trend, a number of obstacles remain. Although public institutions have improved, private institutions receive poor marks in areas including corporate ethics (96th), the strength of auditing and accounting standards (88th), and the efficacy of corporate boards in the country (102nd).

Further, despite some improvements, health indicators remain worrisome, including infant mortality (placing the country 91st) and tuberculosis incidence (76th). Further, enrollment rates across all education levels (primary, secondary, and tertiary) remain very low. The human resources base is thus in need of an upgrading across a number of fronts.

There are also some weaknesses with regard to how the country's markets allocate resources. In particular, Morocco's goods markets are characterized by a lack of

local competition (71st) and a prevalence of trade barriers (93rd), although setting up a business seems relatively straightforward (with few procedures and little time required for starting a new business in the country).

Libya is included in the Index for the first time in this *Report*, and is ranked 73rd overall. Libya's strengths can be found in two areas: its security environment and macroeconomic stability in the country. With regard to security, Libya is characterized by low business costs of terrorism (19th), low crime and violence more generally (25th), and extremely low levels of organized crime (10th).

In terms of its macroeconomic climate, Libya comes in at an impressive first out of all the 128 countries in this pillar, due to windfall income from high oil prices in recent years. In 2005 the country had the second-highest government surplus in the world (just behind Kuwait), a negligible government debt ratio of just above 1 percent, low interest rates, and low inflation.

Beyond these two areas of strength, Libya faces a number of obstacles to its competitiveness throughout the other pillars measured by the Index. Most notably the country's infrastructure requires upgrading (100th), primary education enrollment is low (89th), and the educational system receives extremely poor marks for quality (123rd). Markets overall are not assessed as efficient (121st), particularly financial markets (120th) and labor markets (117th). Finally, the country is not harnessing new technologies for productivity improvements (ranked 115th in technological readiness), with little technology entering the country through FDI and low uptake of ICTs.

Algeria is the lowest-ranked country in North Africa, ranked 76th overall. Despite its trailing performance in the region, it is experiencing an encouraging trend. Since last year's assessment, the country has moved up six places as a result of a better assessment of the quality of its public institutions and continuing improvements in its macroeconomic environment. With regard to public institutions, there have been measurable improvements in perceptions of government efficiency (now ranked 46th) and evenhandedness of public officials in their dealings with the public (25th).

Algeria's economy is also characterized by a strong macroeconomic environment (where it is ranked 2nd, just behind Libya) with its increasing revenues from oil and gas sales boosting its performance relative to the government budget balance and debt, while still managing to bring inflation down to very low levels.

However, Algeria continues to face a number of obstacles to its competitiveness: for example, in the area of market efficiency (97th) as well as technological readiness (93rd), both of which are very important for productivity improvements given its stage of development. Furthermore, its low rank of 118 for the perceived business costs of terrorism suggests that security is still considered to be a major problem affecting the

business environment, imposing heavy costs that are not conducive to sustained productivity improvements and economic growth.

Botswana has been relatively successful, ranking 83rd—the third best performance in sub-Saharan Africa, after South Africa and Mauritius. The government has succeeded in using its wealth from key natural resources and diamonds to invest in factors setting it on a more sustainable growth path. Among the country's strengths are its reliable and legitimate institutions, ranking a high 19th worldwide for the efficiency of government spending, 27th for public trust of politicians, and 25th for judicial independence. Botswana is known to be one of the countries with the lowest levels of corruption in Africa. Corporate ethics also receive relatively high marks, ranked 41st overall.

The transparency and accountability of public institutions have contributed to a stable macroeconomic environment (41st), with a low government budget deficit and one of the highest national savings rates in the world (although inflation remains a bit high by international standards).

Financial markets are also assessed as developed by regional standards, with a sound banking sector (40th), some access to financing through venture capital (45th), and by issuing shares on the local equity market (59th).

With regard to weaknesses, attainment rates at all levels of the educational ladder remain low by international standards, and the quality of the educational system receives rather poor marks—an area clearly requiring attention. Yet it is clear that the biggest obstacle facing Botswana in its efforts to improve its competitiveness is the health situation in the country. Botswana has the highest HIV prevalence rate of all countries covered, as well as very high malaria and tuberculosis prevalence rates, which has led to one of the lowest life expectancies in the world (only 40 years in 2004). Improving the health and education levels of the workforce are clearly the main priorities for the government at this stage.

Namibia is ranked just behind Botswana, at 88th overall. Namibia also demonstrates a number of clear competitive strengths: for example, the quality of the institutional environment within the country is ranked 49th. Property rights in Namibia are well protected (32nd) and the judiciary is perceived as independent from undue influence (28th). With regard to private institutions, auditing and accounting standards are quite strong (39th) and firms are viewed as demonstrating relatively good ethical behavior (53rd).

The quality of the country's infrastructure is also good by regional standards. In particular, aspects of the transport infrastructure such as the quality of railroads (35th) and ports (30th) are highly rated, although telephone lines remain scarce (94th).

Financial markets are also sophisticated by regional standards (57th), with relatively easy access to loans (45th), a relatively sound banking sector (44th), and

some venture capital available (50th), although raising funds by issuing shares on the local stock market is deemed difficult (89th).

With regard to weaknesses, as in Botswana, health indicators are extremely worrisome, including infant mortality (94th), life expectancy (54 years, placing the country 108th), and high prevalence rates of malaria and tuberculosis, and high prevalence of HIV. Further, educational attainment rates are extremely low, with primary, secondary, and tertiary enrollment rates placing the country 106th, 98th, and 102nd, respectively. The quality of the educational system is assessed as being among the worst of all countries in the Index, ranked 122nd overall. On a positive note, companies are making up for this weakness by providing some on-the-job training to staff (65th).

Namibia's labor markets are not very flexible or efficient, with stringent hiring and firing practices (96th), friction in labor-employer relations (105th), and little relation between pay and productivity. On a positive note, the brain drain from the country (55th) does not seem to be as severe as in many other countries in the region. Goods markets suffer from a number of distortions, such as a long time required for starting a business (95 days, placing the country 113th) and high agricultural policy costs (97th).

Finally, the country could do more to harness new technologies to improve its productivity levels. Companies are not considered sufficiently aggressive in absorbing new technologies (92rd) and Namibia has low penetration rates of new technologies such as mobile phones and the Internet.

Kenya is ranked considerably lower at 97th, the last sub-Saharan African country within the top 100. Kenya is an interesting case because its strengths lie in those areas normally reserved for countries at higher stages of development. For example, Kenya's innovative capacity is ranked an impressive 48th, with good scientific research institutions (31st), high company spending on research and development (34th), relatively strong research collaboration between universities and industry (50th), and some availability of scientists and engineers within the country (57th). Further, in terms of innovative "output," after South Africa, Kenya has the highest rate of patenting in all of Africa.

Supporting this innovative potential is an educational system that—although educating a relatively small proportion of the population compared with most other countries (primary, secondary, and tertiary enrollment rates are ranked 108th, 102nd, and 107th, respectively)—is rated highly for quality (37th) for those who are fortunate enough to attend schools. The economy is also supported by financial markets that are sophisticated by international standards, with relatively easy access to loans (58th) and share issues on the local stock market (43rd).

However, there are a number of basic weaknesses that are eroding at Kenya's overall competitive potential. The country's public institutions are assessed as highly inefficient, plagued by undue influence (95th), general government inefficiency and red tape (104th), and with very high levels of corruption (115th). Similarly, corporate ethics are assessed as lacking among the country's firms (91st). The security situation Kenya is also extremely worrisome, particularly in crime and violence (118th).

As well as the low enrollment rates, workers are subject to a high incidence of illnesses, with weak health indicators and a high prevalence of diseases—particularly tuberculosis, which is the highest of all countries covered and contributes to the low life expectancy of 51 years. Beyond these fundamental institutional and human resource weaknesses, more could also be done to free up goods and labor markets and to harness new technologies.

All of the other countries from sub-Saharan Africa are ranked below 100. While there are of course some nuances to their performances, all of these countries face significant obstacles to improving their competitiveness and productivity levels. Rather than discussing the difficulties facing each of these economies, it is perhaps more useful to mention some of the key competitiveness issues facing some of the larger economies in the region.

Nigeria, Africa's most populous country, is ranked 102nd. It is plagued by weak and deteriorating institutions—including a serious security problem—poor assessments for its infrastructure and basic health and education, and a significant change for the worse in macroeconomic management, all of which have depressed the country's rank down from 83rd in 2005. More generally, weaknesses abound throughout all of the areas measured by the GCI. The rankings show that, despite the country's windfall revenues from record-high oil prices, the large majority of the population remains without access to basic health care and education, and the basis for sustainable growth is not being put into place.

Tanzania and **Uganda**, two of the region's larger economies, have not managed to significantly improve their competitiveness in recent years and are ranked 108th and 116th, respectively. Even relative to these low overall rankings, they do particularly poorly on health and primary education (121st and 126th, respectively) and on higher education and training (115th and 110th, respectively). Although they do better on some of the innovation factors, their failure to make a significant improvement in the basic requirements subindex is likely to continue to dent their economic prospects.

Zimbabwe, a country that showed so much promise until just a few years ago, is ranked among the least competitive economies included in the GCI, at 121st overall. The institutional environment is ranked among the worst of all countries, with a complete absence of

property rights (ranked a rock-bottom 128th), high levels of corruption (122nd), and a lack of even-handedness of the government in its dealings with the public (119th) as well as basic government inefficiency (124th). After a number of years of mismanagement of the public finances and monetary policy, Zimbabwe has sunk to the bottom of all countries covered with regard to macroeconomic stability (ranked 128th), with large deficit spending, a negative national savings rate, and raging hyperinflation that is unparalleled anywhere else in the world today. Zimbabwe's weaknesses abound across the other areas measured by the Index, with weak health indicators, low educational enrollment rates, and very inefficient markets (particularly goods and labor markets). It is clear that for Zimbabwe to get back on track, improved governance affecting all levels of the economy will be necessary to restore confidence in the economy and to rebuild what was once one of Africa's stars.

Conclusions

This chapter has explored the various factors and policies driving the competitiveness and economic performance of African countries, providing a framework for prioritizing areas requiring policy attention and enhanced investment. The discussion has included an analysis of Africa's competitiveness from a global and regional perspective, providing a sense of country-level performances compared with the overall group of 128 economies included in the Global Competitiveness Index (GCI).

Specific comparisons have been made with relevant developing countries and regions, including Latin America, economies of developing Asia, and the four emerging BRIC countries. By placing individual country performances into an international context in this way it has been possible to highlight those areas requiring urgent attention within African countries to increase competitiveness and to better ensure sustained strong economic performance going into the future.

On average, the analysis has shown that the competitiveness of most countries in Africa continues to lag behind the rest of the world and even behind other developing regions across all areas measured by the GCI. The results thus provide a sense of the magnitude of the efforts required in order to raise competitiveness levels.

Although the specific priority areas vary from country to country, there are some common areas of concern. For North African countries, which are already assessed as doing comparatively well in some of the more basic areas measured by the GCI, the focus should be on improving the factors measured in the pillars of the efficiency enhancers subindex: most particularly, technological readiness and improved market efficiency.

In sub-Saharan Africa, efforts are needed on all fronts within most countries. This includes upgrading infrastructure and improvements in the health and edu-

cation of the workforce, as well as tackling weaknesses in the areas of market efficiency and technological readiness. Indeed, as shown by the results of the GCI, several of the big economies in the region are receiving high scores in the innovation and business sophistication pillars relative to their overall ranking, while neglecting more basic requirements that would help them migrate into a higher stage of development and achieve more sustainable growth.

Although much remains to be achieved, the fact that there are a number of strong performers on the continent in specific areas provides reason for optimism. An analysis of the highest-ranked countries in Africa across the various pillars of national competitiveness has shown that there are strong individual country performances throughout the continent in areas as diverse as institutional quality, macroeconomic stability, business sophistication, and innovation. These countries can serve as benchmarks for other economies in the region, as points of reference in their efforts to improve their competitiveness.

The relatively positive economic outlook across much of Africa, coupled with the renewed focus and increased attention from several institutions from within the region and beyond, now provide a promising opportunity to make the institutional and structural changes needed to put countries in the region on a more sustainable growth path and to pave the way for a more prosperous African future.

Notes

- 1 IMF 2007.
- 2 NEPAD was set up in 2001 as a strategic framework to address "the escalating poverty levels, underdevelopment and the continued marginalisation of Africa" through improvements in the quality of governance and leadership, infrastructure, and regional integration. Specifically, NEPAD aims to find African solutions to the continent's economic woes, spearheaded by Africa's leaders. Key for improvements in Africa's competitiveness is the potential of the African Peer Review Mechanism (APRM), under which countries voluntarily "open their books" to teams of African experts in various spheres who assess and critique the countries' political governance, economic governance, corporate governance, and socio-economic development. See NEPAD in Brief, available online at <http://www.nepad.org/2005/files/inbrief.php>.
- 3 At Gleneagles, under the UK presidency, the G8 governments (Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States) made clear commitments to increase aid spending, ensure debt cancellation, and improve the trading environment for developing countries, as well as increase investments in education and health, among other things. Africa will continue to remain high on the G8 agenda under the German presidency, although the focus is likely to shift more toward issues surrounding the investment climate and economic integration, as well as infrastructure and HIV/AIDS.
- 4 The GCI was developed by Xavier Sala-i-Martin and Elsa Artadi for the World Economic Forum. For more details on the construction of the GCI, see Chapter 1.1 in *The Global Competitiveness Report 2006-2007*.
- 5 In other words, these are the factors and policies supporting higher levels of productivity and sustainable growth. Technically, the index aims to measure the determinants of "A" in the production function (or similarly, in classical growth equations).

- 6 Further information on the Executive Opinion Survey can be found in Chapter 3.1 of *The Global Competitiveness Report 2006–2007*, which is available from the World Economic Forum on request. Please send requests to gcp@weforum.org.
- 7 As explained by Sala-i-Martin and Artadi 2004, “The weights were chosen using a maximum likelihood method of an econometric model that had the growth rate of per capita GDP between 1960 and 2000 as the explanatory variable, and various proxies for basic requirements, efficiency enhancers and innovation factors as independent variables. The regression allowed countries in different stages to have different coefficients. The coefficients that maximized likelihood, then, were ‘rounded’ and became the weights for each stage.”
- 8 The factor-driven stage includes countries that have GDP per capita below US\$2,000. The efficiency-driven stage includes countries with per capita income between US\$2,000 and US\$9,000. The innovation-driven stage includes countries with GDP per capita higher than US\$17,000. Countries between the categories are considered to be in transition, as discussed in the text.
- 9 All countries that export more than 50 percent of primary exports are considered to be to some extent factor driven. The stage of development for these countries is adjusted downward smoothly depending on the exact primary export share. The higher the primary export share, the stronger the adjustment and the closer the country will move to stage 1. For example, a country that exports 95 percent of primary products and that would be in stage 3 based on the income criteria will be in transition between stage 1 and 2. The income and primary exports criteria are weighted identically. Stages of development are dictated uniquely by income for countries that export less than 50 percent primary products. Countries that export only primary products would automatically fall into the factor-driven stage (stage 1).
- 10 As measured by purchasing power parity (IMF 2006).

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From Benchmarking to Impact: Identifying Which Dimensions Matter

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Chapter 1.1 has laid out a methodology for benchmarking the competitiveness and business climate of African countries. In setting priorities for reform, benchmarking is an important place to begin—but it is not the last step. Priorities should be set by an issue's impact. Issues with the greatest impact are often ones characterized by the longest delays or highest regulatory costs, although this is not necessarily always the case. What also matters is how central the issue is to firm operations—to productivity and job creation—and what alternative coping mechanisms are available to the firm. Linking investment climate conditions to firm performance reinforces the importance of finance, skills, infrastructure, and the rule of law. However, such linking also underscores the idea that the impact of these conditions varies by who you are and where you are.

The investment climate's impact on job creation and productivity is substantial. Costs and delays in transportation, electricity, and crime alone can raise overall costs by 20 to 30 percent, undermining whatever advantage firms enjoyed by lower labor costs or greater productive efficiency.¹ In addition, weak property rights and unpredictable enforcement of regulations weakens incentive to invest and work hard. Improving the investment climate is recognized as one of the most important ways to increase growth and expand opportunities—particularly for poor people.² In tackling the agenda of economic growth, the challenge is to identify the priorities for reform.

To be able to address this challenge better, the World Bank's program of Enterprise Surveys has interviewed over 70,000 entrepreneurs and senior managers in 104 countries (see Appendix A for further information on these surveys). The focus for this chapter are the 11,600 interviews in 34 countries in Africa. The Enterprise Surveys program has four distinguishing features:

- First, the program can benchmark not only subjective rankings of investment constraints to business performance (for example, the extent to which electricity is rated as a problem), but also objective measures of these constraints (for example, the frequency and duration of outages, production lost from outages, and the use and cost of generators).
- Second, it covers a wide range of issues—from access to financial and infrastructure services, to crime, corruption, and government regulations—allowing a ranking of these issues.

- Third, the data can also go beyond benchmarking to test directly the impact of these objective conditions on the actual performance of the firm, for example, how the actual investment climate conditions affect the productivity and employment growth of respondents.
- Fourth, large, randomly selected samples of firms allow for results to be compared across types of firms, with particular attention paid here to firm size.

For many of the countries in the region, the Enterprise Surveys are the only source of detailed information on firm performance and disaggregated objective indicators of a wide variety of business environment indicators.

The next section demonstrates the range of productivity and employment growth outcomes across the region, including the results from Brazil, China, and India, for comparison. It then moves to identify key dimensions in the investment climate across countries in the region that can help account for these patterns. First, it examines the top constraints as reported by firms, links them to objective measures of these constraints, and looks at how these patterns vary across different groupings of countries. Second, it examines ways to prioritize constraints from among obstacles in a longer list and to identify which measures account for greater differences across groups of countries. Third, it links the objective measures of the investment climate directly to productivity and job creation across countries, illustrating the potential gains from reform. While most of the chapter analyzes the impact of the investment climate across countries, the last section disaggregates the effects of the various dimensions of the investment climate by types of firm, focusing on firm size, ownership, and export orientation. Access to finance, electricity, tax rates, regulatory uncertainty, and corruption emerge as key areas for reform—with specific priorities varying not just across countries, but within countries too.

Firm performance across Africa

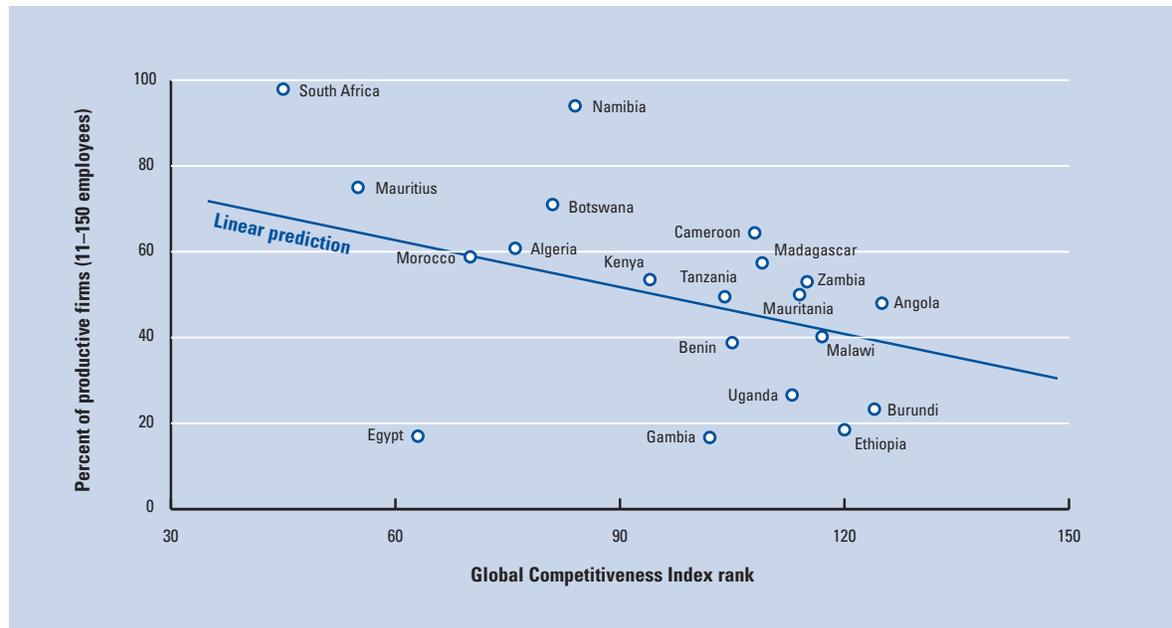
Growth rates in Africa have been rising in recent years as greater macroeconomic stability has been achieved in more countries and additional reforms have been undertaken. But the key to maintaining growth is not simply mobilizing more capital or labor. What is needed is greater productivity—being able to produce more with the same inputs.³ Productivity growth in Africa has been lower than in other regions. The average productivity growth from 1970 to 2000 was stagnant or even mildly negative.⁴ Returns to investment have also been relatively low. Investment rates are lower and the returns average about half those of other developing countries.⁵ What is encouraging is that the recent trends have been more

positive. Regional growth rates over the last five years have been higher than in Latin America and the Organisation of Economic Co-operation and Development (OECD) countries, with the average growth rate in Africa of just under 5 percent.

Within Africa, productivity varies tremendously—both across countries and within countries. Some of this is simply the result of differences of entrepreneurial talent across individuals. Some of the variation reflects differences in endowments or geography, but at least as much mirrors differences in investment climate conditions as illustrated in Figure 1 (see also Appendix B). Figure 1 shows how there are more productive firms in locations with better investment climates or business environments. The figure plots the share of firms in each country with labor productivity above a benchmark against the Global Competitiveness Index (GCI) discussed in Chapter 1.1.⁶ As the GCI captures many dimensions of the business environment, it is a suitable summary measure to correlate against firm performance. Figure 1 uses as its benchmark the median labor productivity of all the small and medium size firms (11–150 employees) combined into a regional sample.

The first thing to note is that *every* country has some firms that are above the regional median. Productive firms exist in every location. The very best firms do not operate only in the biggest economies or the countries with the highest standards of living. Firms can succeed even in poor investment climates. This is not to say that reforms are unnecessary. Clearly, more firms can achieve greater productivity when they operate in a stronger business environment. Based on these samples of firms, over three-quarters of firms in Mauritius and Namibia and two-thirds of firms in Algeria and Botswana operate above the regional median, while only 10–15 percent of the firms in Gambia or Burundi do so. Putting this into a broader international context, about 80 percent of firms in a comparable study in Brazil surpass the median African productivity level. In China this is about 60 percent and, in India, 55 percent. Thus, several countries in the region—including Algeria, Botswana, Cameroon, Mauritius, Morocco, Namibia, Senegal, Swaziland, and South Africa—have a higher share of productive firms than China has.⁷

The relationship between productivity and the GCI is not perfect. Egypt has a lower share of productive firms than would be expected given the quality of its business environment; Cameroon has a higher share.⁸ But correlations will almost never be perfect when using a composite index. The investment climate is not the only determinant of productivity—and an overall index can underemphasize a particular dimension that is constraining to a particular country. As the analysis here shows, elements of the GCI have relatively more or less impact for different groupings of firms and countries. Aggregate analysis is very useful at highlighting the

Figure 1: More-productive firms are in locations with better investment climates

Source: World Bank Enterprise Surveys, 2002–2006; World Economic Forum.

Note: Firms are categorized as ‘productive’ if their value added per worker is above the region’s median level for firms with 11 to 150 workers.

broad patterns, but it cannot explain all the variations at the micro level.

Turning to employment growth, there is a large amount of dynamism among incumbent firms (the Enterprise Surveys cannot capture the effects of entry and exit), with relatively high shares of firms that are expanding. Fully half of all the incumbent firms report having increased the number of workers they employ. Between 20 and 25 percent of firms reduced their number of workers, with the remaining 25 to 30 percent of firms maintaining the same number of workers. Within countries, beyond the smallest or micro firms (which are relatively more stable), employment growth is both more likely and at a higher rate for small and medium firms, while very large firms have the lowest rates of growth.⁹ The correlation, however, between employment growth and the GCI is less strong than with productivity.

The next section turns to the indicators of the business environment to investigate which dimensions make the most significant contributions to productivity and job growth.

How to identify priorities for reform

Ultimately, the aim in benchmarking and measuring all the dimensions of the investment climate is to identify areas where improvements can make a real difference. Benchmarking investment climate conditions, particularly of more objective measures, makes a significant contribution. But if one cares about assessing their impact,

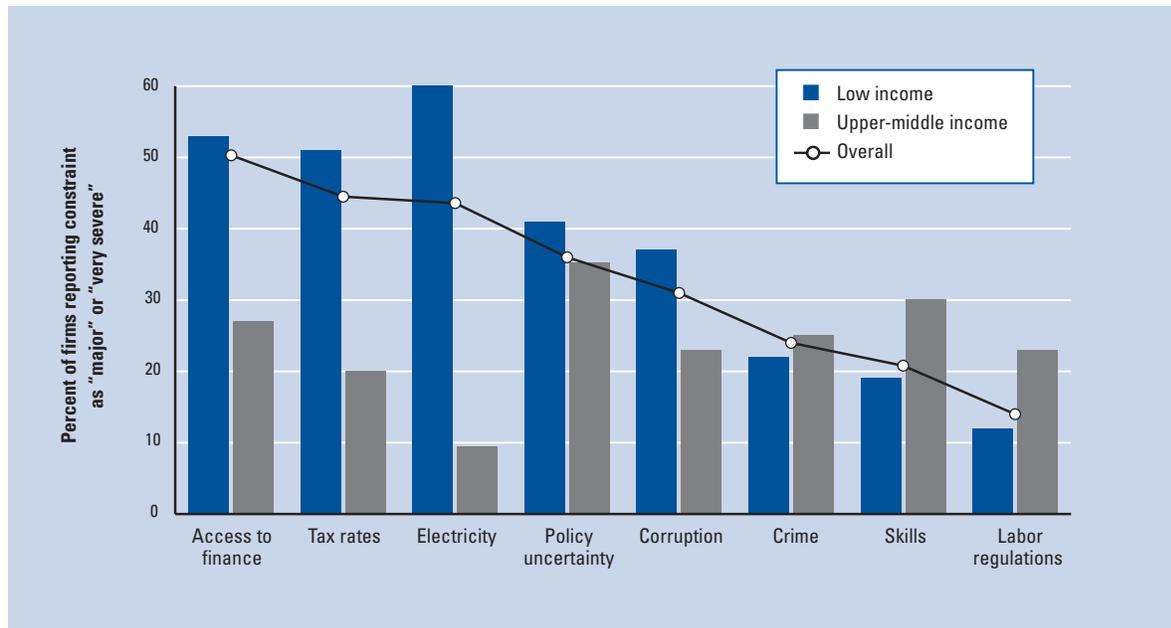
such benchmarking measures still need to be combined with additional information.

Going beyond simple costs or delays to capture the impact on performance

It is straightforward to use benchmarks on costs, delays, number of procedures, and so on to identify those areas where a country’s scores are weak—either across issue areas within a country or relative to neighboring or other comparator countries. Priority can then be given to improving those scores where a country is particularly weak. Targets for reform can then be very specific.

However, because certain costs or delays are high does not necessarily imply that these are areas of actual importance to firms or that they have a particularly onerous impact. This is particularly true if firms can easily adapt to or circumvent the problems, or if the costs or delays occur in areas of only marginal importance to firm operations. Thus, delays in getting a new telephone landline may be long but have minimal impact, particularly if mobile telephones are available. Likewise, outages from the public electricity grid can be disruptive. However, choosing technologies that are less energy intensive or using a generator can mitigate some of these costs.

There are three approaches that can shed light on the impact of investment climate conditions. The first is to compare the list of constraints as reported by firms. Implicitly, this ranking of constraints captures the impact of an issue; respondents are balancing their assessment of

Figure 2: Top constraints reported by firms: Variation across countries

Source: World Bank Enterprise Surveys in Africa (sub-Saharan Africa and North Africa), 2002–2006.

an issue with the perceived importance of that issue to their operations. Combining these rankings with more objective measures of the issue can corroborate the validity of these responses. A second approach is to use correlations amongst the variables themselves to determine the optimal grouping of variables and the relative weights assigned to them so as to account for the most information in the data. A third is to conduct econometric analysis of the impact of investment climate conditions on firm performance directly. This tests for the extent of impact of each variable directly. All approaches have the benefit of allowing for variations in impact across different types of firms or in different types of locations.

There is an important caveat to keep in mind when interpreting any of these three types of results from firm surveys.¹⁰ These approaches all focus on the benefits side of reforms. None of these methods takes into account the costs associated with reforms—either financial or political. Clearly policymakers would have to weigh possible benefits against the costs of reforms as well as the feasibility of securing the reform against the political capital spent in its attempt.

Measuring impact: Ranking constraints by firms

Respondents are asked in the Enterprise Survey to rank a list of issues based on how constraining they are to the “operations and growth of their business.” Access to finance, tax rates, and electricity are the constraints most likely to be reported as “major” or “very severe”—although the list varies substantially across different

countries (see Figure 2). Overall, half of respondents report “access to and cost of finance” as a top constraint, although the share is closer to one-quarter in upper-middle-income countries. The gap with electricity is even higher, with firms in low-income countries almost four times as likely to report it as a significant constraint. It is noticeable that in upper-income countries the overall levels of complaints are lower. However, for those countries the issues related to labor—available skills as well as labor regulations—raise more concern.

How well do these subjective rankings reflect objective measures? Within 16 issue areas, we tested whether the firms that report longer delays, greater costs, or lower-quality service are the same ones that report that issue as being more constraining. For all but one issue, the answer is “yes.” Firms with worse objective experiences are more likely to report the issue as representing a bigger constraint. Firms that pay higher bribes are more likely to report corruption as a problem; firms with more frequent outages are more likely to report electricity is an important constraint. The one exception is finance. In this case, firms with some access to finance already are the ones most likely to complain that access and costs of finance are problematic. However, restricting the sample to just those with some access, it is true that as the share of external finance rises, complaints decrease.

Table 1 provides a crude measure of the impact of improving the objective conditions (that is, monetary and time costs of interacting with officials and obtaining services). It reports the predicted change in the share of

Table 1: Level of firms' complaints: Impact of a one standard deviation change in objective conditions

Issue area	Objective investment climate indicator	Improvement in objective condition (one standard deviation)	Perception investment climate issue	Change in percentage of firms ranking issue as "major" or "very severe"
Infrastructure	Days of power outages (log).....	3.7	Electricity.....	13.8
	Losses due to lack of power (percent sales).....	12.6	Electricity.....	24.9
	Use of email with clients	No to Yes	Telecommunications	6.0
	Use of Web with clients.....	No to Yes	Telecommunications	7.0
	Days to obtain phone line (log).....	5.4	Telecommunications	18.3
	Losses in transportation (percent sales).....	5.2	Transportation.....	8.1
Corruption	Sales on bribes (percent)	6.7	Corruption.....	16.6
	Firms involved in bribes (percent).....	49	Corruption.....	22.3
	Gift at inspections	Yes to No	Corruption.....	15.6
	Government contracts in gifts (percent).....	7.6	Corruption.....	17.7
Regulations	Days obtaining licenses (log).....	3.6	Business licensing.....	15.7
	Days tax inspection (log)	2.6	Tax administration.....	11.3
	Gifts during tax inspection	Yes to No	Tax administration.....	19.6
	Days to obtain exports (log).....	2.5	Customs	7.7
	Days to obtain imports (log).....	3.1	Customs	11.8
Labor	Days labor inspections (log).....	2.5	Labor regulations.....	13.6
	Training employees.....	No to Yes	Skills shortage	4.1
	Time to hire skilled workers (weeks).....	7.3	Skills shortage.....	11.4
Crime	Cost security (percent sales).....	4.2	Crime	4.3
	Loss due to crime (percent sales).....	5.7	Crime	12.4
Finance	Overdraft facility.....	No to Yes	Finance access and cost.....	3.0
	Working capital externally financed (percent).....	21.2	Finance access and cost.....	5.6
	Investment externally financed (percent)	33.5	Finance access and cost.....	7.1

Source: World Bank Enterprise Surveys in Africa, 2002–2006.

firms reporting the issue as a “major” or “very severe” constraint if objective conditions underlying it were to improve. As the investment climate measures are all in different units, the size of the improvement is taken as one standard deviation to have the same relative magnitude change across the issue areas. Another benefit of this choice is that, as the extent of improvement is based on the range of conditions experienced in the region, it represents a level of change that has already been achieved by at least some countries in the region.

Looking at these results, the issues with the most robust relationship in the region are electricity, corruption, regulations, and crime. A one standard deviation increase in the days of outages is associated with an increase of 34 percent of electricity being reported as a “major” or “very severe” constraint.

For each category, a number of objective measures are collected, giving more detailed insights into which aspects of an issue are particularly problematic. For example, the constraint “tax administration” is more closely associated with “gifts during tax inspections” than to the time spent with tax authorities. “Skills availability” is constraining because of the increased time needed to hire skilled workers rather than the need to train workers.

All the results in Table 1 are highly statistically significant. Within an issue area, those firms experiencing greater costs or delays are more likely to rank that issue as constraining. However, when you compare across issue areas, those issues with the longest delays or highest costs are not necessarily identified as the top constraints. There are long delays associated with new access to landline telephone service, but this is not ranked as a top constraint. Managers can also spend a lot of time with government officials. This is time that might have been more productively spent—and often raises concerns that there may be higher demands for “gifts”—yet it is not usually reported as a top complaint.

The two areas where changes in objective conditions translate into smaller changes in subjective rankings are taxes and finance. As mentioned earlier, these are the two areas that almost all firms like to complain about. And although the link between actual access to finance and the level of complaint is less strong, the latter analysis does show that there is significant variation in the external finance available to different firms—and that this can have significant impact on firm performance.

Do constraints vary across groups of countries?

The physical geography and natural endowments of a country raise particular challenges to firms. Two geographically based features of economies receive particular attention. The first is whether a country is landlocked or not. Access to ports helps reduce transportation costs and gain access to additional markets; ports also facilitate importing capital goods that can help raise productivity and provide access to export markets. A second feature is the extent to which an economy is endowed with natural resources, particularly oil. These endowments have been called a “curse” in part because they generate such potential for concentrated wealth that governments’ incentives are distorted in their attempts to control the rents from these resources—as well as destabilizing the country in the form of fighting between groups to become the governing party. They can also suffer from “Dutch disease” whereby rising prices of the resource serves to appreciate the currency, making other goods less competitive internationally. With the focus on the resource sector, priorities for building up the manufacturing or services sectors may get little attention.

The results shown in this chapter show that these geographic and geological characteristics do have some impact on reported constraints—and on the impact that the underlying objective conditions have on productivity and growth at the firm level. But a firm’s prospects are not determined by these conditions. Among landlocked or resource-rich countries, locations with better investment climates are more likely to have productive firms. What constitutes a good investment climate, however, can vary somewhat by country grouping (see more below).

Infrastructure matters even more in landlocked countries than in countries with direct access to seaports. Firms in landlocked countries are up to 25 percent more likely to report transportation to be a major or significant constraint. This makes sense given the additional challenges of reaching markets. It is also no surprise that getting goods through customs is significantly more of a challenge for these firms.

Access to finance appears to matter more in resource-rich areas. Gaining access to finance can be a challenge anywhere. But it appears that in resource-rich countries, financial systems can be less developed or less oriented to helping finance manufacturing enterprises—which would be consistent with higher risks stemming from potential Dutch disease or less stable environments in which to operate. Interestingly, resource-rich countries report corruption to be less of an issue—except for expanding firms, which see corruption as more of an issue.

Another country grouping, which is not based on geography, geology, or income, is the distinction between countries that are more or less manufacturing intensive (defined as countries whose exports of manufactured goods are at least 10 percent of GDP).

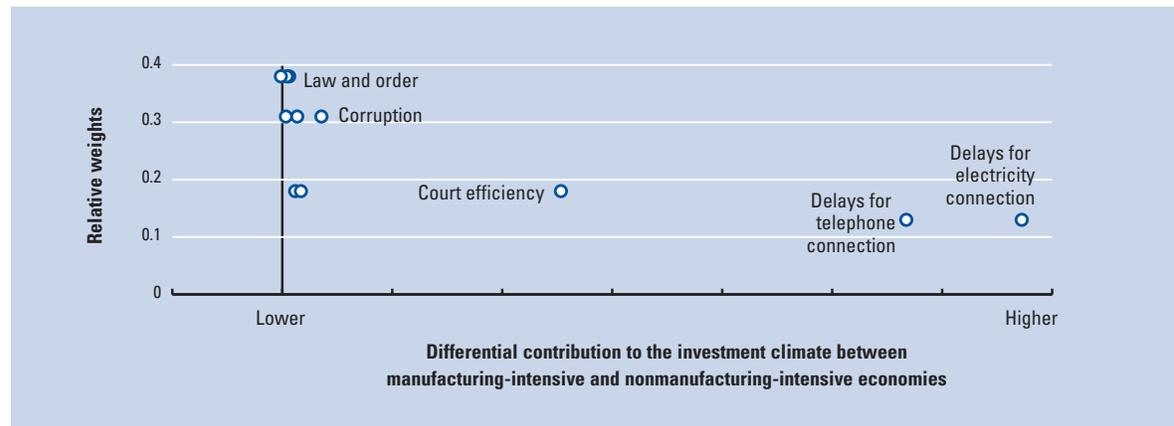
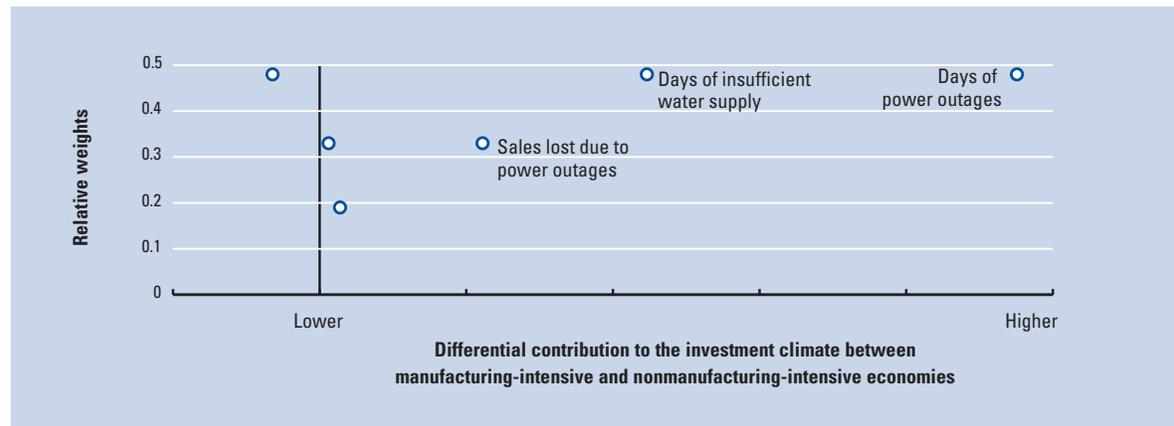
Comparing these groups can shed light on whether particular features of an economy help explain current manufacturing success. What is striking is that firms in countries that have already achieved a high level of manufacturing exports reported significantly fewer constraints than nonmanufacturing-intensive countries. The one exception is labor issues, where both labor regulations and access to skilled labor are reported as greater constraints in manufacturing-intensive countries.

Overall, the constraints reported by firms are significantly correlated with objective measures that try to capture the monetary or time costs of investment climate issues. They also vary by country groupings that show that priorities for reform will interact with broader country characteristics. These findings should bolster confidence in the use of reported constraints in identifying areas for reform.

However, critics of such data raise doubts about the reliability of comparisons of subjective assessments. It is true that there can be differences across individuals in their willingness to complain, and in what their threshold is for a “major” constraint. As a result, this work takes advantage of the fact that the list of issues is presented together in a comparable format so that it is possible to net out such individual effects and to rescale responses so that they reflect relative rankings. Thus, they measure “how much more” an individual firm complains about a particular issue than all the other issues. Furthermore, perceptions themselves can also be important in a firm’s decision of whether to undertake investments, hire workers, or expand production. Managers make these decisions with an eye to what they expect in the future, including their assessment of the investment climate. Perceptions can thus have real effects. On the other hand, it is important to keep in mind whose perceptions—and preferences—are being reported. Firms’ interests and society’s interests are not necessarily aligned; managers or entrepreneurs do not represent society as a whole. Almost all firms want lower taxes and interest rates—but this does not necessarily mean these should be priority goals for policymakers. There may be very good public policy reasons for some of the tax or regulatory policies in place that managers may not like. Part of the job of the government is precisely to balance competing views and to safeguard the public interest.

Measuring impact: Combining variables into thematic groups

Another approach to identifying which dimensions matter to a better business climate is to narrow the set of variables by aggregating them into thematic blocks and then examining which blocks account for differences across groups of countries. The aggregating tool we use is *principal components analysis*. This approach lets the correlation in the data determine the optimal groupings of variables (see Appendix C). This method also reports the share of the variation each grouping represents, which

Figure 3: Relative weightings of variables within themes**3a: Institutions variables****3b: Infrastructure variables**

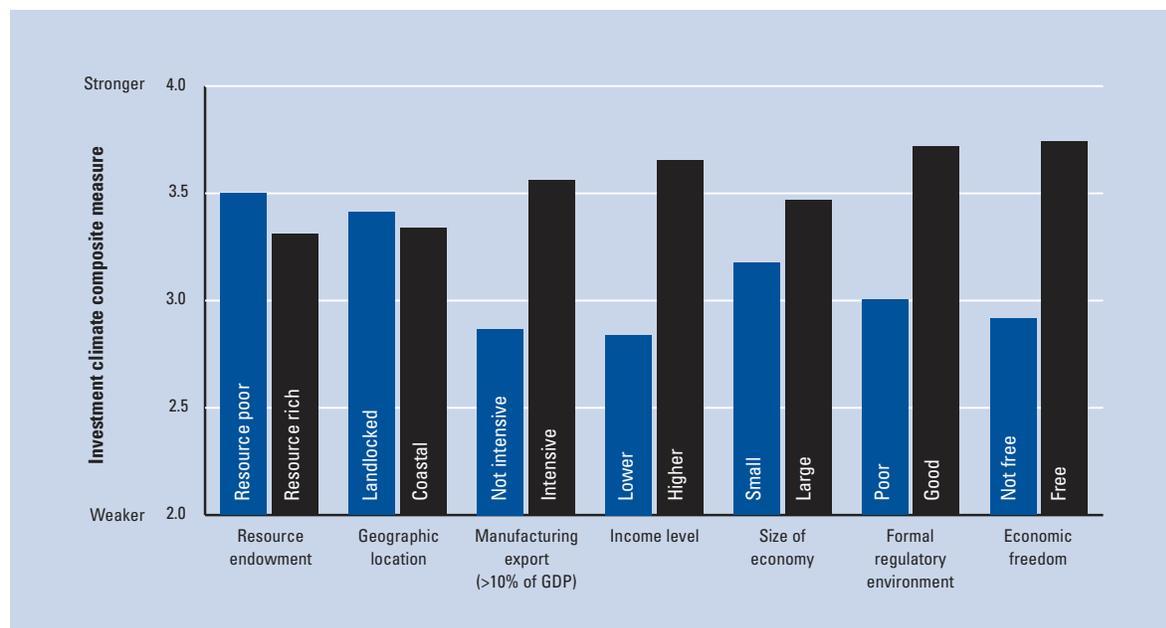
Source: World Bank Enterprise Surveys, 2002–2006.

we use as weights in aggregating the variables. Here, principal components analysis helps identify which variables are most associated with three important thematic areas—institutions, infrastructure, and inputs—and how they vary across countries in the region.

Using principal components, 11 objective variables were used to construct a composite measure of institutions. Among these variables, those that were most highly correlated and accounted for the greatest variation within the set of measures were those associated with a lack of security. As such, they receive the highest weighting in the aggregation procedure. The corruption-related variables received the second largest weighting. The efficiency of government services variables were given somewhat lower weightings. Within infrastructure, days of power outages and insufficient water supply and

days of inventories (a proxy for the quality of transportation) were most highly correlated and thus weighted. Within inputs, trade credit, proximity to customers, and share of firms adopting new technology were more strongly weighted.

Figures 3a and 3b plot the different groupings of variables as predicted by the principal components methodology against the relative difference in the average values of these variables across two sets of countries. The focus here is on countries that are manufacturing intensive and those that are not. For the “institutions” variables, Figure 3a, there is actually little difference between manufacturing-intensive and nonmanufacturing-intensive countries on the variables given the most weight, that is, security and corruption. Rather, the differences in the efficiency of government services in

Figure 4: Differences in overall investment climate measure by country groupings

Source: World Bank Enterprise Surveys, 2002–2006; *Doing Business*: World Bank, 2006; Economic freedom: Freedom House, available at www.freedomhouse.org/.

delivering infrastructure services are more pronounced, although overall these variables are less well correlated with the overall set of variables and so receive less weight in the principal components analysis. In contrast, Figure 3b illustrates the importance of differences in power outages within the infrastructure variables between manufacturing intensive countries. Similarly, trade credit stands out within the “input” variables.

The measures of institutions, inputs, and infrastructure can then be aggregated again into an overall composite measure of the investment climate.¹¹ Figure 4 illustrates how this composite measure varies across country groupings. The first interesting result is that geography and geology have little impact on the overall combined measure of the investment climate. Resource-endowed countries and countries with direct access to the sea have aggregate scores very similar to those of countries that are landlocked or resource poor. If anything, the less well endowed appear to have a slightly better investment climate.

Figure 4 also demonstrates the importance of policies. Countries with a higher level of economic freedom according to the Freedom House¹² and countries with a better formal regulatory environment (according to the World Bank’s *Doing Business 2007* report) show a significantly better investment climate composite measure. Similarly, more-developed countries, countries that are more manufacturing intensive, and larger economies also record a more friendly business climate. However, the effect of the size of the economy is not as significant

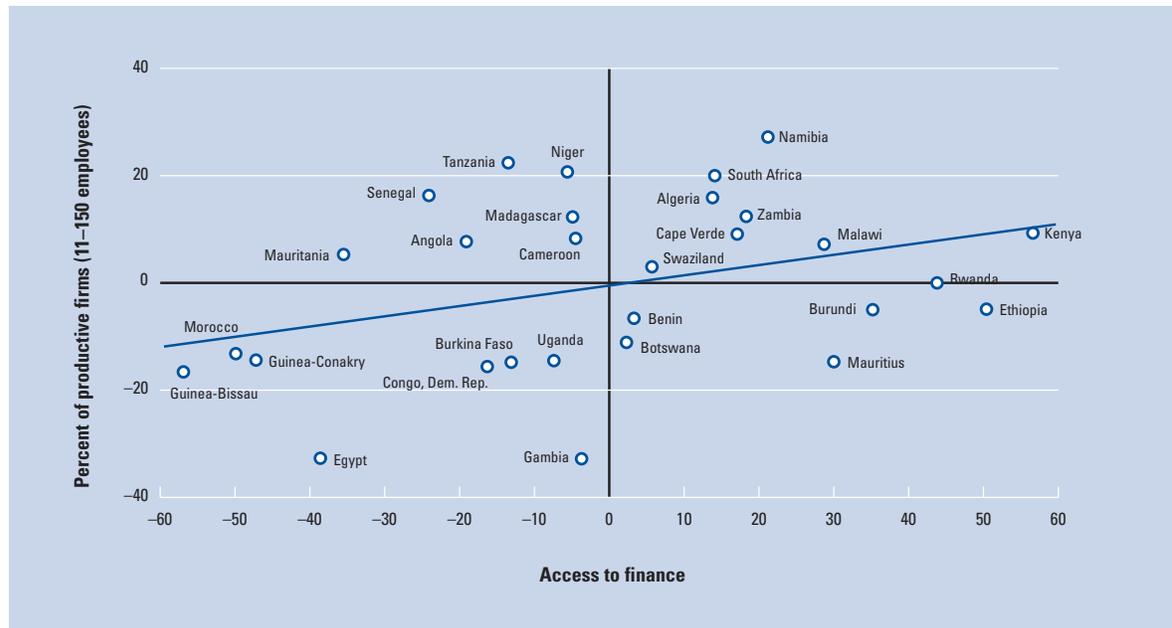
as earlier categories. Clearly the quality of the investment climate in Africa is associated with the quality of the policies adopted by the individual countries.

Looking more closely at manufacturing-intensive versus nonmanufacturing-intensive countries, the component categories that explain the most difference between them are inputs (finance and skills) and institutions (regulations, efficiency of government services, and governance). The same variables explain the differences between countries in weak versus strong formal regulatory environments (as defined by *Doing Business*). On the other hand, for countries with less income per capita, infrastructure (energy, transportation, and telecommunications) variables explain most of the difference between results for lower- and middle-income countries.

The discussion has focused on the constraints reported by firms, how they reflect real differences in underlying objective conditions, and how these objective measures vary across groupings of countries. Access to finance and infrastructure services and, to a lesser extent, corruption and consistent regulations have shown to be important issues. The next section turns to test directly the impact of these issues on job growth and firm productivity.

Measuring impact: What matters for firm productivity and job creation?

One of the real strengths of the Enterprise Survey is that it combines information on subjective rankings with objective rankings as well as with measures of firm

Figure 5: Across countries, more highly developed financial systems are associated with higher labor productivity

Source: World Bank Enterprise Surveys, 2002–2006.

Note: Regression controls for GDP per capita, age, export status and ownership. The figures display partial regression results, so the axes are expected values controlling for GDP per capita and firm characteristics. Firms are categorized as ‘productive’ if their value added per worker is above the region’s median level for firms with 11 to 150 workers.

performance. One can thus test whether there is a statistically significant relationship between the investment climate conditions and outcomes of concern to the private sector and policymakers. Such an analysis has the added benefit of indicating the extent of possible benefits that could be realized if conditions were improved.

However, this approach of relating objective measures to firm performance is considerably more analytically intensive. It also relies on econometric assumptions, the validity of which can be tested in most cases.¹³ There are two sources of variation that can be exploited, differences in the average performance across countries and differences based on deviations from the average within countries. Explanations for the variations between countries are presented graphically. The contributions of different factors in understanding variations within countries are presented as bar charts.

What matters in explaining differences in average performance across countries

Having more-developed financing services is strongly associated with higher productivity (see Figure 5) and employment growth. A one standard deviation improvement in access to finance is associated with an increase in productivity of 16 percent across countries. This confirms that access to finance is one of the key variables that can facilitate better performance.

The importance of access to financial services raises additional questions worth exploring in future work (see Box 1). A lack of access to finance could represent a

legitimate problem of a lack of supply of funds. But it is also possible that the lack of lending is a symptom of a deeper problem of insecure property rights. Banks are themselves a type of enterprise. And they may be unwilling to lend at higher volumes if they do not feel their investments will be protected. Alternatively, the outcome could be explained as a lack of sufficient demand on the part of firms. The cumulative impact of a weak investment climate, the higher indirect costs, and challenges of production and delivery may make the required rate of return too high to demand additional funds.

The results show that weak infrastructure (combining losses from power and transportation) is associated with lower productivity. In regressions controlling for firm characteristics and country and sector dummies, the effect of a one standard deviation deterioration in infrastructure is associated with a decline in productivity of more than 5 percent. The impact on employment growth is also strong; better infrastructure is associated with 7 percent more firms expanding their employment (see Figure 6).

Interactions with government have strong effects on both productivity and employment, underscoring the importance of consistency of regulations and their efficient enforcement. The time spent with officials in inspections is associated with lower productivity. The overall time management has to spend dealing with officials has an even larger effect on lowering employment growth. Figure 7 shows the effect of greater protection

Box 1: Making finance work for Africa

Firm competitiveness in Africa continues to be constrained by the high cost of finance and limited access to it. The financial sector is largely failing to meet the private sector’s needs. Financial markets on the continent are less developed than the worldwide average, even after taking into account average per capita income and inflation. Africans also have disproportionately high offshore deposits. Interest margins are high; international comparison pinpoints small scale, property rights institutions, and a lack of competition as being among the important causal factors. Most organized securities markets are small and inactive; institutional investors often concentrate on bank deposits and real estate instead. Microfinance has improved its outreach, though access rates in African countries remain behind those in other regions.

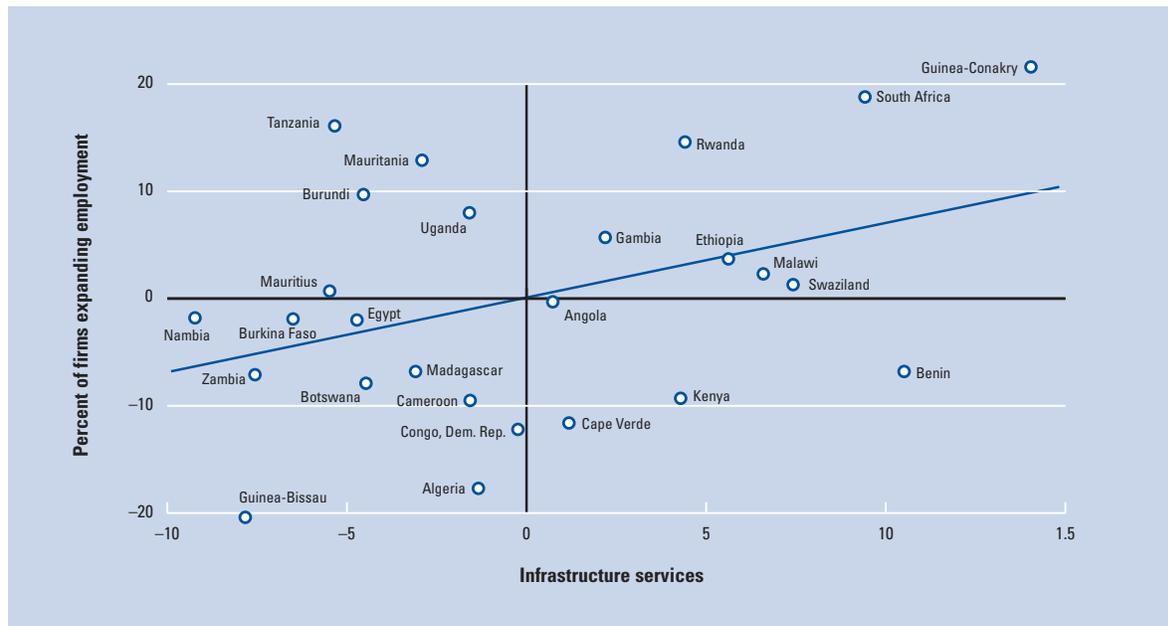
However, things are changing for the better in African finance. Credit growth is under way after a long pause. Solid new intermediaries are entering the marketplace, and the reach of microfinance is growing steadily. Strengthened by an extended wave of reforms over the past decade, financial systems in many African countries have begun to diversify their activities, deepen their lending, and increase their reach with new products and new technologies. Financial repression and the practice of

directed credit are both much diminished, and there has been extensive privatization of state-owned banks—often to foreign-owned banks, the re-entry of which represents only one aspect of a growing potential in internationalization and regionalization.

But there is still much left to do. The continued shallowness of finance, and the limited access by small firms and households to any formal financial services—especially in rural areas—means that these developments represent just a turning of the corner. The environment for financial firms remains difficult, and progress has not been as fast as had been hoped. With the entrance of mobile phones, satellite phones, portable computers, and smart cards into the African market, there is great potential for technology to help overcome remoteness and process-cost barriers to providing payments and making deposits, as well as other types of financial services. Many success stories are already in the making—the development challenge lies in identifying these success stories and scaling up their outreach to full potential.

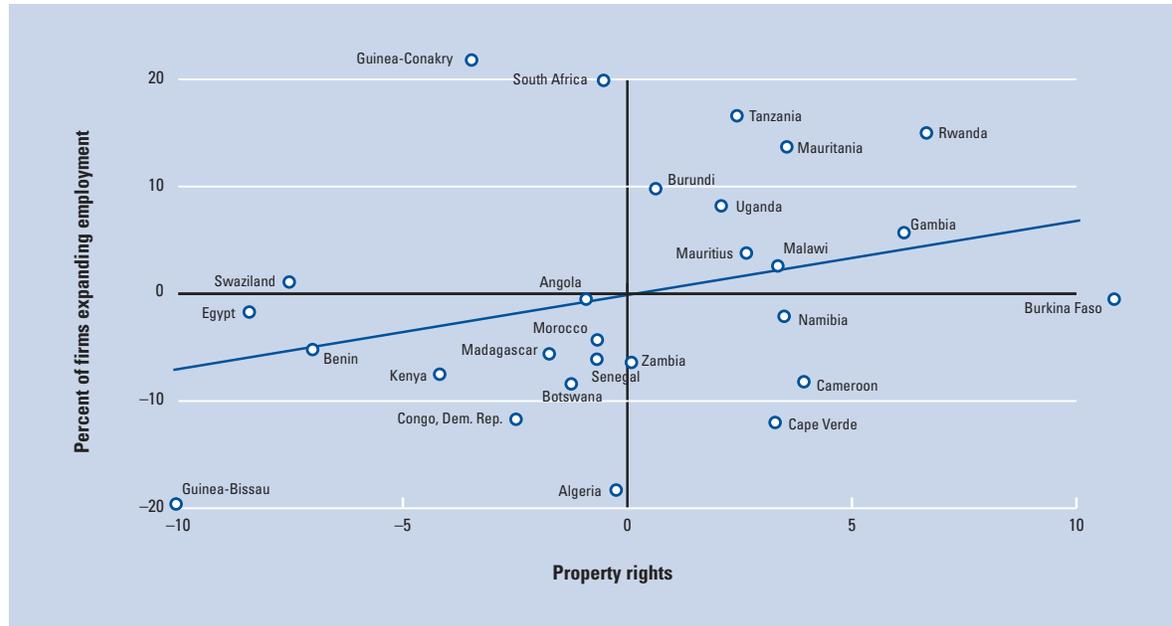
Source: Honohan and Beck, 2007.

Figure 6: Across countries, stronger infrastructure is associated with higher employment growth



Source: World Bank Enterprise Surveys, 2002–2006.

Note: Regression controls for GDP per capita and the share of firms in different sectors, size categories, export status, and ownership. The figures display partial regression results, so the axes are expected values controlling for GDP per capita and firm characteristics.

Figure 7: Across countries, stronger property rights are associated with more employment growth

Source: World Bank Enterprise Surveys, 2002–2006.

Note: Regression controls for GDP per capita and the share of firms in different sectors, size categories, export status, and ownership. The figures display partial regression results, so the axes are expected values controlling for GDP per capita and firm characteristics.

of property rights on employment growth. A similar picture emerges on measures of property rights regarding courts as well as crime.

Geographic groupings

These basic findings corroborate that infrastructure, finance, and institutions matter for firm performance. But is the impact of these variables themselves related to broader country characteristics? The impact can vary for two reasons. First, the average level of conditions can be worse in a location. Second, the impact of the same level of conditions has a bigger effect on firm performance. We have seen that landlocked countries report greater constraints with infrastructure and that access to transportation services (including ports) is less reliable. Is the impact on firm performance also greater in these countries? The answer is yes. Controlling for the various country characteristics, landlocked countries are up to 40 percent less productive, a disadvantage that is further exacerbated by weak infrastructure that can reduce productivity by a further 10 percent. This reinforces that tackling infrastructure issues is particularly pressing in landlocked countries.

Countries with greater manufacturing exports are significantly more productive, and to a lesser extent so are those with natural resources (all controlling for GDP per capita). Weak infrastructure and custom delays are also particularly damaging in more manufacturing intensive countries—both environments where access to markets are at a premium (see Box 2).

Having more-developed financing services is strongly associated with higher productivity, raising productivity by almost 15 percent. However, this potential benefit is reduced by a third in landlocked countries and in natural resource intensive countries. The effect is closer to 25 percent in middle-income countries.

What matters in explaining differences in average performance *within* countries

The large sample sizes and rich variation in conditions faced by firms in the same location make it possible to test for how investment climate conditions impact employment growth and productivity based on within-country variations. The results are based on including a wide set of objective indicators into regressions. They look at variations within countries, controlling for firm characteristics. Box 3 summarizes results from country-specific analyses of the impact of the investment climate on firms.

Figure 1 demonstrated variations in productivity across countries; there is also a large range of productivity levels within each country. In general, smaller firms tend to have lower labor productivity. The comparison is most dramatic in the case of South Africa; while large firms are among the most productive in the region, most small firms' labor productivity is close to the region's overall average. In Botswana, Mali, and Swaziland, productivity also rises dramatically with firm size. In countries with low overall value-added per worker, the absolute differences are smaller. But even

Box 2: Improving prospects for exports

Recently, there has been much concern about Africa's export performance. Africa's share of world exports has declined in recent decades, and most countries in Africa are still highly dependent upon a narrow range of primary commodities for their export earnings. The poor performance of manufacturing exports has been a particular concern—especially as exporting can help improve productivity.¹

There are a number of dimensions in which policies can help. Easing restrictive trade and customs regulations appears to encourage exporting. In recent years, many countries—including most of the countries in this study—have reduced tariff and nontariff barriers to trade. However, other problems remain. For example, customs administration is slow and prone to corruption in many African countries—enterprises in Tanzania reported that on average it takes about 12 days for exports and 19 days for imports to clear customs. In comparison, it takes only 2 and 3 days for exports and imports respectively to clear customs in the Philippines. Steps to improve customs administration could therefore be helpful. For example, reducing physical inspections of goods when appropriate and minimizing contacts between customs administration staff and importers and exporters could reduce both processing times and opportunities for corruption.² Programs

to encourage exports, such as duty-drawback schemes, are often poorly administered with long delays for payments and refunds.

Improving infrastructure is often highlighted as a way to improve exports. However, in an eight-country study in Africa, the empirical results provide only relatively weak support for the assertion that the quality of domestic transportation infrastructure affects export performance. Instead, improving communications facilities held greater promise. Enterprises with Internet connections are more likely to export than enterprises without. The Internet provides an important tool to contact suppliers and customers, to learn more about overseas markets, and to publicize a firm's products. In addition, increasing the use of information technology—and improving procedures so that it is used efficiently—can often accelerate customs processing. A recent program in Ghana reduced average processing times from weeks to only a few days.³

Source: Clarke, 2005.

1 See Bigsten et al., 2003; Mengistae and Pattillo, 2004.

2 See De Wulf, 2003; De Wulf and Finateu, 2002.

3 World Bank, 2004.

there, proportionately some of the differences are large. In Burundi and Uganda, median large firms are twice as productive as median small firms.

Which dimensions of the investment climate are associated with these differences in productivity within country? Figure 8 shows the relative contributions of the most significant variables, taking into account differences in capital intensity, firm age, firm ownership, and sector. The most significant impact is associated with the control of corruption. Reducing irregular payments and the discretionary interpretation of regulations by 10 percent is associated with a 2 percent rise in productivity. Regulations, particularly inefficient delivery of services, were also important. Improving the efficiency of services by 10 percent would be associated with a rise in productivity of 1 percent. The role of finance was, surprisingly, not always significant. If it was entered on its own, it did indeed have a large and significant impact on productivity. However, once all the other dimensions were included simultaneously, variables such as the share of financing from formal external sources only remained significant in certain country groupings (especially manufacturing-intensive, middle-income, and resource-rich countries).

Turning to employment growth, a somewhat different set of variables is important. In this area, improving

access to finance would have the largest impact. Increasing by 10 percent the extent to which firms have overdrafts or use formal external sources to finance investments would be associated with a 4 percent increase in employment growth. Improving the availability of skilled workers had the second biggest impact, followed by regulations (efficiency of government services), infrastructure (electricity and transportation), and property rights (see Figure 9).

It is striking that the objective measures associated with firms' reported top constraints are all statistically significantly associated with firm performance, whether that is higher productivity or higher employment growth. (The one exception is tax rates, for which the Enterprise Survey did not include objective indicators in all countries.) Access to finance, electricity, regulatory uncertainty (property rights and consistency of enforcement), and corruption are repeatedly identified as the key variables impacting performance outcomes.

Does "who you are" affect what matters to you?

The discussion so far has focused on comparisons at the national level. But the data reveal that there is a great deal of variation across different types of firms within countries too. More than export status or ownership, the size of the firm matters.

Box 3: Impact of investment climate issues at the country level (selected countries)

The specific investment climate issues for each country have been reported in the respective Investment Climate Assessments, published regularly by the World Bank Group. The Investment Climate Profiles, which draw on the same World Bank data, are available at the end of this *Report*. Here are some of the highlights for selected countries from different country groupings.

South Africa has the highest average firm productivity levels. Production tends to be capital intensive and shows high labor costs compared with China, Malaysia, and Poland. Labor costs are disproportionately high for managers. The main investment climate constraints are lack of skills, macroeconomic instability, labor regulations, and crime. Exporting firms complain specifically about the lack of macroeconomic instability, which is understandable given the extent of the fluctuations of the rand in recent years. Domestic firms report greater concerns about the lack of access to and cost of financing. Firms are often self-reliant, particularly with regard to financing and to training. The cost of crime is high. In contrast with many other countries in southern Africa, losses due to power outages are modest and the cost of power is low. Tax rates are also relatively low, but costs associated with crime are high. Employment growth for permanent workers is higher in some specific sectors, mostly in large firms. The construction sector is expanding significantly, an indication that there is optimism about South Africa's continued prospects.

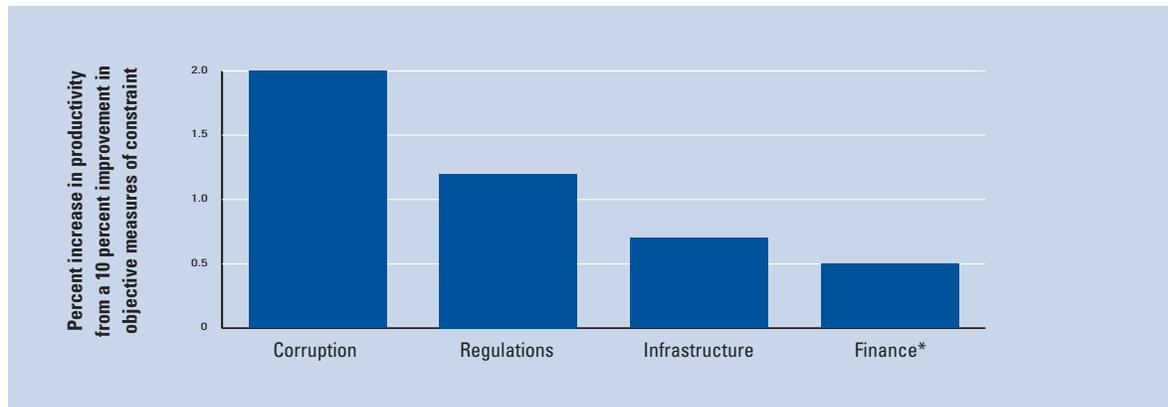
Kenya has a comparable share to that of China and higher than India of firms performing above the region's median level of value-added per worker. But its labor costs are higher than both of these countries. And China and India produce the same value-added per worker with lower levels of capital. Exports have grown in Kenya, but much of this has been driven by a few successful firms. It has a well-developed financial sector and a falling cost of capital. But its interest rate spreads remain high and there are high transaction costs of capital for smaller firms, both contributing to relatively low rates of investment. The main investment climate constraints are corruption, crime, and infrastructure.

Only 40 percent of **Zambia's** firms achieve a level of labor productivity above the region's median. It has relatively capital-intensive industries, about three times higher than its East African comparators. Nominal wages are low, but they are offset by low productivity, poorly educated workers, and costly labor regulation requirements. The main constraints of investment climate include four elements.

1. The high cost of capital depresses incentives for investment, especially for smaller firms with no access to microfinance. The average surveyed firm with a loan paid an annual interest rate of over 28 percent. It is not uncommon for collateral requirements to well exceed the value of the loan being sought.
2. Despite reform, taxation and tax administration continue to inhibit profitability. The tax burden in Zambia is high relative to that of comparator countries. Frequent and unpredictable changes in procedures and badly trained officials with wide discretionary powers invite corruption and arbitrary practices.
3. Of the firms in Zambia, 57 percent cite regulatory uncertainty as an important problem, compared with only 28 percent of Ugandan firms. Inconsistent policies—such as the recent change in immigration laws requiring all non-Zambians to renew unexpired permits at high costs—increase firms' perceived risk in investment.
4. Perceptions of weak law enforcement and fierce corruption hinder investment. Although 77 percent of Zambian firms claimed losses from theft or other crimes in the previous year, less than half of these cases were reported and only a quarter of these were solved.

Source: World Bank Investment Climate Assessments for the respective countries, 2002–2006.

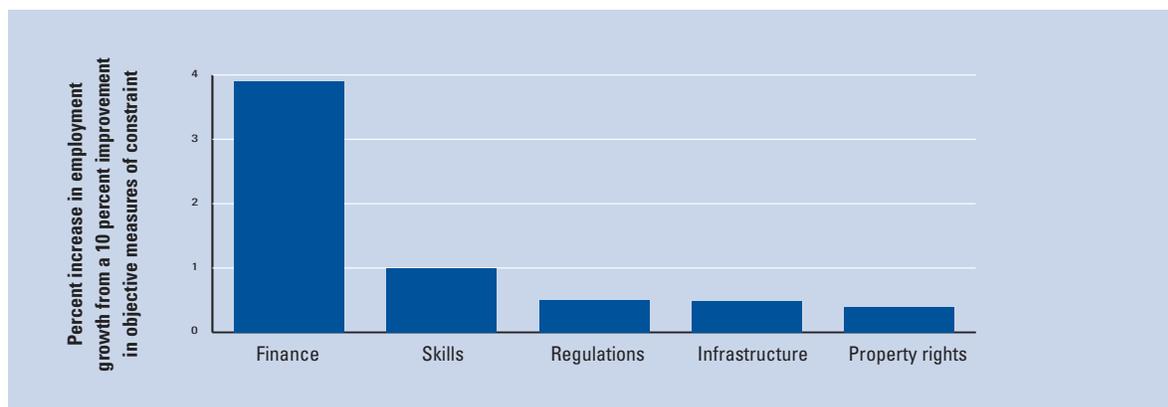
Note: For additional examples, please visit <http://www1.worldbank.org/rped/index.asp>.

Figure 8: The impact of constraints on firm productivity (variation within countries)

Source: World Bank Enterprise Surveys, 2002–2006.

Note: Based on regressions controlling for firm size, capital intensity, age, ownership, export status, sector and country, and controlling for possible endogeneity of investment climate measures. The bars represent the joint contribution of objective variables in each category, with all groups included simultaneously. All are significant at the 5 percent level except for finance.

*Finance is significant when included on its own; with other investment climate variables, it is significant for most country groupings.

Figure 9: The impact of constraints on employment growth (variation within countries)

Source: World Bank Enterprise Surveys, 2002–2006.

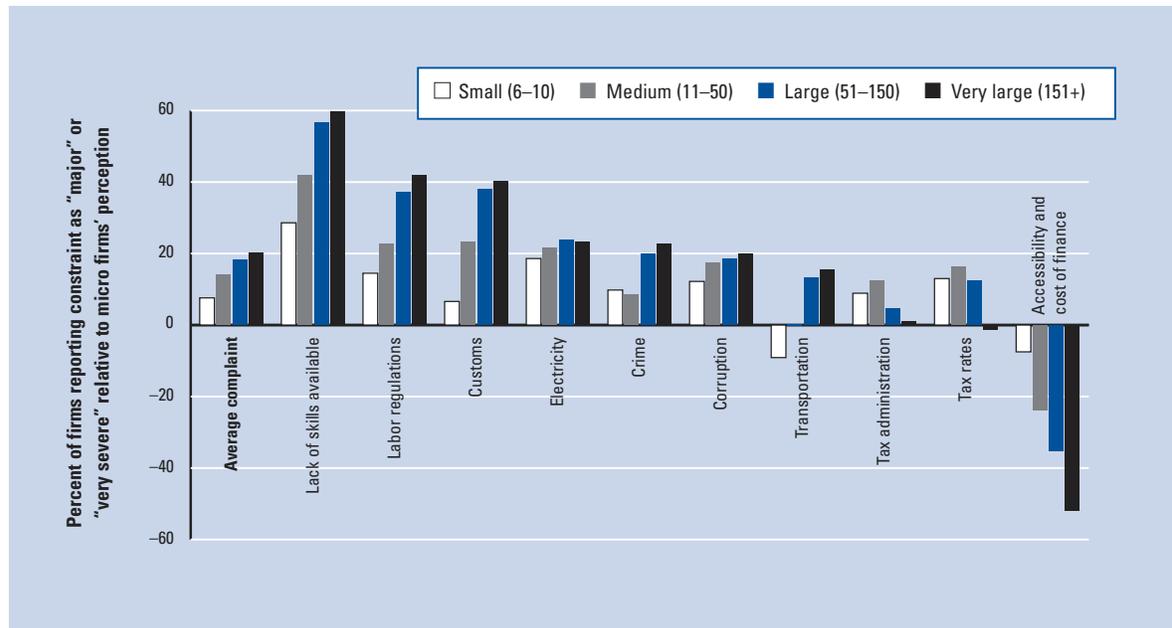
Note: Based on regressions controlling for firm size, age, ownership, export status, sectors, and country, and controlling for possible endogeneity of investment climate measures. The bars represent the joint contribution of objective variables in each category, with all groups included simultaneously. All are significant at the 5 percent level.

Size matters both in objective measures of investment climate conditions and in the actual impact of these conditions. Larger firms are significantly more likely to report more issues as constraining than micro or small firms, and there are differences in relative priorities. Figure 10 shows the differences in constraints across sizes of firms. It looks at the probability that small, medium, and large firms rate a constraint as “major” or “very severe” in comparison with the average rate at which micro firms rate the same constraints. The first column of bars shows the overall level of complaints. Compared with micro firms, the levels of complaints rise with firm size in almost all areas.

The areas with the strongest pattern by size are the availability of skills and labor regulations. Large firms are 60 percent more likely to report these as constraining. Since large firms have large workforces and face greater requirements regarding hiring and firing practices, this is not too surprising. Nor is it surprising that customs regulations are also seen as more important for large firms.

The one area where the smallest firms do register a greater level of complaint than larger firms is the lack of access to finance. Large firms are almost 60 percent less likely to see that as a top constraint. And, indeed, they are significantly more likely to have access to formal external financing.

Figure 10: Constraint perception and firm size (variation within countries)



Source: World Bank Enterprise Surveys, 2002–2006.

Note: Based on regressions controlling for firm characteristics, sector dummies, and country dummies. This is the variation within countries rather than across countries.

The objective numbers indicate that the smallest firms experience more frequent power outages. Yet micro firms are less likely to complain. It is the largest firms that complain the most—this despite the fact that the majority of these firms have generators. This is an example where firms are likely to have adapted their production process or way of doing business to the existing conditions. Precisely because it is hard to get reliable access to electricity and because the unit costs of generated electricity are so high for small amounts, most small firms have less automated processes—and thus don't see the issue as constraining.

What is somewhat surprising is that micro firms are only 10–15 percent less likely to be concerned with either taxes or tax administration than their larger counterparts. Particularly because many are informal firms—and so they do not comply with tax regulations—one might have expected a bigger jump with size. However, the data also show that compliance with the tax authorities is a matter of degree across the entire size spectrum. Many firms of all sizes report that “firms like theirs” do not report substantial shares of their income to tax authorities, and that they give “gifts” to inspectors. Corruption payments are higher for micro firms than for small firms.

Turning to a firm's export status, exporters share many of the same concerns as large firms. Controlling for firm size too, one area where exporting firms report significantly lower constraints is tax rates. This would be consistent with various programs that aim to promote

exporting, including several that provide tax breaks or rebates to exporters.

Foreign firms are relatively more concerned about telecommunications and customs than domestic firms. However, controlling for size and export status, the remaining significant result is that foreign-owned firms are less constrained by finance. Given that many can tap into funds of the parent firm or have greater access to international financial markets, this result is as expected.

A firm's performance itself can also affect what issues are most constraining, even after taking into account firm characteristics, the firm's objective experience, and country characteristics. Compared with firms that maintained stable levels of employment, both expanding and contracting firms report greater constraints—but they complain about different things.

Contracting firms report constraints that on average are 10 percent higher than stable firms, while expanding firms' complaints are 4 percent higher. Two issues stand out for contracting firms: corruption and labor regulations. Firms that are reducing their workforce are 21 percent more likely to report that corruption is a major or severe constraint, controlling for firm characteristics such as size, ownership, sector, country dummies, and objective measures of the issue. There are different explanations for why contracting firms see corruption as more problematic. The first is that they see competitors being able to get ahead by paying bribes or they see that vested interests have rigged the rules of the game in their favor. They are either not willing or unable to pay

to secure these benefits, and so they are not able to thrive in this environment—and identify the corrupt system as being in part to blame. Second, the potential benefits to a firm of paying bribes are not the ones of greatest importance to declining firms. If bribes are intended as speed money to obtain licenses or government services, these may be more beneficial to expanding than contracting firms. So corruption is more of a cost without a benefit. A third explanation is that officials may seek out declining firms for additional payments. These firms are likely to be less well positioned to seek recourse, and so may reinforce the firm's decline. Contracting firms are also 19.5 percent more likely to report labor regulations as a major or severe constraint. As many labor regulations aim to protect workers and often restrict a firm's ability to fire people, this is not surprising.

In contrast, firms that are expanding and hiring workers see the lack of finance and crime as key constraints. Expanding firms are 10 percent more likely to report finance as a major constraint, even though most of these firms do have access to some external finance. The fact that the issues that constrain expanding firms are not always the same that constrain contracting firms reinforces the message that priorities can vary by who you are.

Does the impact of objective measures also vary by “who you are”?

That subjective rankings of constraints can vary by who you are—for example, small or large firms—could be the result of differences in the objective conditions faced by different firms, or could be because the same condition has differential effects by type of firm. This section tests for the latter effects. There is some evidence for this differential effect in terms of corruption and property rights, although less so for finance and infrastructure. The results are more pronounced in their effect on employment growth than on productivity.

Lessening regulatory burdens, including the time spent with officials, are associated with higher growth, particularly for small firms. These interactions could be providing openings for bribes—and indeed the impact of corruption is greater on small firms. It could also be that officials are more likely to be providing beneficial services to larger firms. Consistent with this too is the importance of strengthening property rights. Such reforms would benefit all firms, but particularly the smallest firms.

Greater access to finance and reliable infrastructure helps all firms. Smaller firms report less access to reliable services. Looking at individual measures of infrastructure, the same improvement in electricity would have an additional impact on smaller firms, but the effect is only 1 percent of employment growth.

Within finance, the effects vary somewhat over sources of finance. For micro firms, access to an over-

draft accounts for much of its boost to employment growth. For larger firms, there is an additional boost of 3 percent to employment growth based on access to formal loans. Overall, smaller firms do complain more about access to finance as an obstacle to the growth of their firm. As they are significantly less likely to have access to external finance and finance is positively associated with employment growth, improving access to finance will benefit the smaller firms the most.

Conclusion

The factors that firms report as being constraining are indeed those that have the greatest impact on productivity and job growth. Access to finance is the top constraint overall. Across countries this variable is strongly associated with higher productivity, while the effect within country is stronger for employment growth. Infrastructure ranks as the second constraint. It is highly correlated with employment growth, across and within countries, and also affects productivity within countries. Property rights are also correlated with employment growth, particularly for smaller firms.

The results of the Enterprise Surveys also confirm that the prescriptions are not universal. Top constraints vary by country (see the Investment Climate Profiles in Part 2.2) and they vary within country by firm characteristics and by a firm's performance. Unreliable or costly infrastructure is particularly constraining in landlocked countries, where it hampers access to markets, and in countries with greater concentration of manufacturing exports, where timely delivery is increasingly important. A more-developed financial system and consistent regulations are associated with better outcomes, particularly in lower-income countries. And addressing skills and improving access to finance are most helpful to expanding firms, while labor regulations and corruption are most constraining to contracting firms.

Notes

- 1 Eifert et al. 2005.
- 2 World Bank 2004.
- 3 The chapter looks at two measures of productivity. *Labor productivity* is value-added per worker, while *total factor productivity* also controls for the capital intensity of production. The figures in the chapter that illustrate outcomes across country use the simpler labor productivity. However, the variations within country look at total factor productivity.
- 4 Bosworth and Collins 2003, p. 122.
- 5 Ndulu et al. 2007, p.50.
- 6 Labor productivity is measured as value-added per worker. As productivity can vary by firm size and the size distribution varies across country samples, this chart is restricted to small and medium sized firms between 10 and 150 employees. It does not weight country samples, but treats each observation equally. Figures are converted to 2005 US dollars. Note that the choice of base year can affect the results of countries with volatile exchange rates, such as South Africa.

- 7 The results are based on the survey samples. If census data were available, these proportions could be estimated more precisely.
- 8 Some of these differences can be the result of differences in sampling. The guidelines for sampling were the same for all countries. However, in some cases the available population frame had different size cutoffs (that is, firms had a minimum of 5, 10, or 20 employees), or the key sectors selected had slightly different size distribution of firms. How recently the sampling frame was constructed also had some impact, as smaller firms were more likely to move or close down. The figures in this chapter are restricted to firms in the 11–150 employee range to improve comparability.
- 9 For many small business owners, these microenterprises are not the start of an ambitious entrepreneurial endeavor, but rather represent the only opportunity available. And, because many of them would face increased costs of complying with regulations if they were to expand in size, it is natural that employment growth is lower among these firms.
- 10 On the technical side, the representativeness of the respondents is important. It should be noted that although firms were randomly selected, the size distribution of firms does vary slightly across countries because of differences in available sample frames. To ensure that the size distribution is not driving results, most of the cross-country comparisons use only small and medium firms.
- 11 A fourth dimension of aggregate indicators (for example, inflation, trade openness, and so on) was also added at this stage, but received the lowest weighting.
- 12 See www.freedomhouse.org/.
- 13 One potential concern is the extent of reverse causation: that it is the firm's performance that determines the investment climate condition. For many of the issues this is improbable, but for some it is a possibility. For example, measures of regulatory burden, corruption, and finance could all be affected by how well the firm is doing. More-productive firms should face an easier time accessing finance. The effect on corruption could actually go either way—officials could target better performing firms as they are on the radar screen and would have a greater ability to pay, but they could also have greater recourse against such officials.

To control for possible endogeneity, investment climate conditions are averaged by firm size-sector-location. This approach makes the indicator exogenous to the particular firm while representing the broader environment in which it operates. This is equivalent to using size-sector-location dummies as instruments. The test of over-identifying restrictions shows one cannot reject their validity as instruments.

Another potential concern is omitted variable bias. The results shown here control for all the investment climate variables simultaneously. The variables cover many dimensions of the broader investment climate, making it less likely that a significant variable is omitted. The variables are all jointly significant at the 1 percent level.

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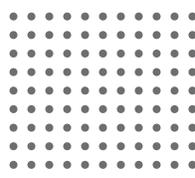
From Talk to Walk: Ideas to Optimize Development Impact

Report of the Task Force on Capacity for Program
Delivery: A Clinton Global Initiative Commitment

By Dalberg Development Advisors

Section 2.6 - Improving Delivery in Enterprise Financing

(Full report can be found at www.dalberg.com/pdfs/taskforce)



2.4 IMPROVING DELIVERY IN ENTERPRISE FINANCING: DRIVING GROWTH HOME

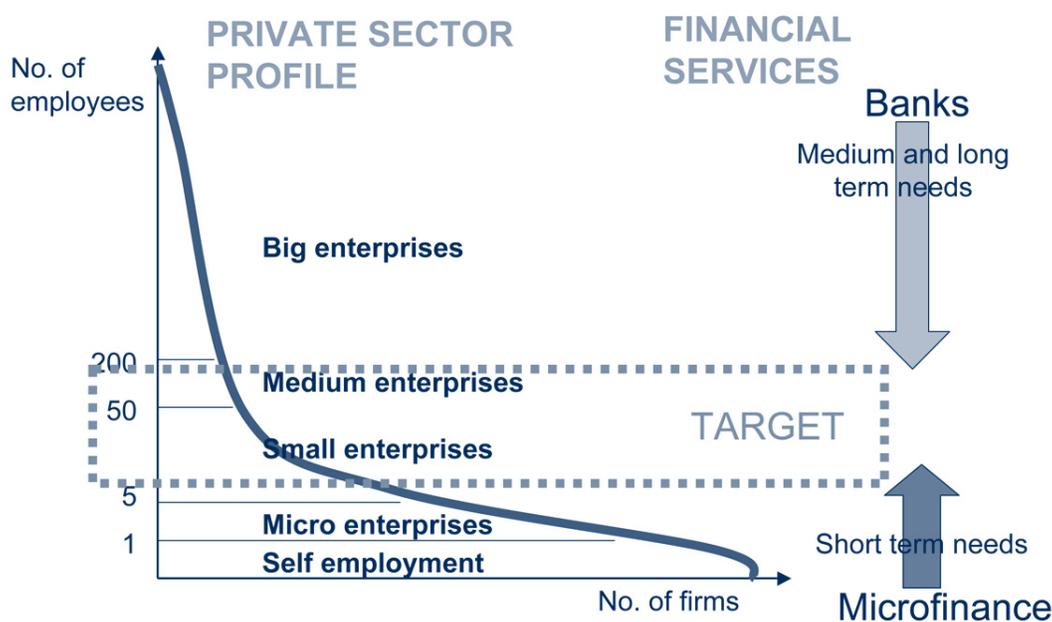
NEED AND RESPONSE

In looking at enterprise financing, the Task Force focused on the needs of microenterprises and SMEs. As highlighted in the recent 2005 World Development Report, many elements of the investment climate determine the success of micro, small, and medium enterprises. For SMEs, access to and cost of finance are rated as a severe or major obstacle by 40% of developing country firms, and is identified as a leading constraint along with policy uncertainty, macro instability, tax rate and corruption.¹⁵

90% of firms in industrialized economies are SMEs; however in the low-income countries, while the informal sector generates 30% of total employment, the SME sector generates only 18%. The SME sector generates only 16% of total GDP in low-income countries compared to 39% in the middle-income group and 52% in the high-income group countries.¹⁶

Significant resources and analysis have been devoted to tackling the SME issue. In 2004 the IFC spent roughly \$900 million on a range of activities supporting SMEs. Other elements of the World Bank Group put \$677 million into SME related programs in 2004

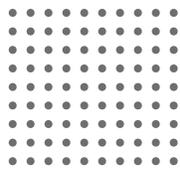
The enterprise financing gap



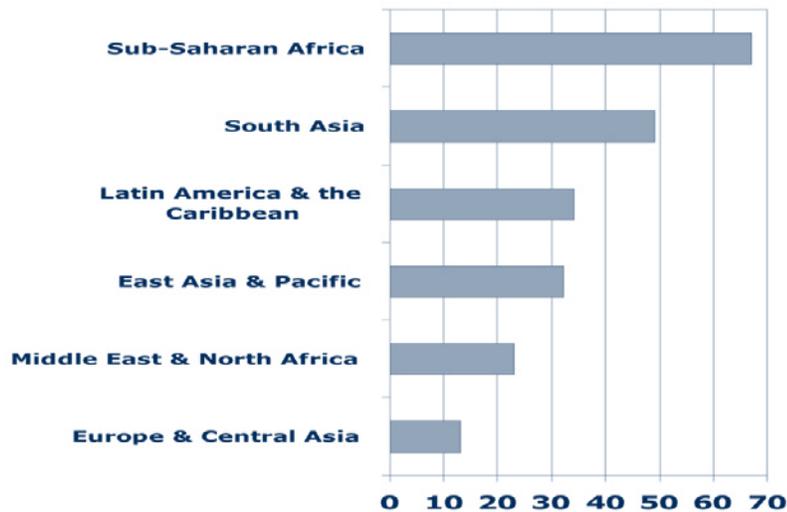
Source: World Bank Uganda, May 2006

¹⁵ World Development Report 2005: A Better Investment Climate for Everyone.

¹⁶ “Meghana Ayyagari, Thorsten Beck and Asli Demirgüç-Kunt; Small and Medium Enterprises across the Globe: A New Database.”



Inadequacies of finance in developing countries



Share of firms reporting access to finance as a major obstacle
Source: World Bank Investment Climate Surveys

(with some going to microenterprises). The U.S. government has transferred \$1.5 billion to enterprise funds. IADB invested \$165 million in 2004. In 2003, EBRD provided approximately \$150 million to SMEs and microenterprises.¹⁷ Japan's ODA budget to support SMEs in 2004 was \$1.8 billion.¹⁸ Several high profile efforts such as the recent 2005 World Development Report: "A Better Investment Climate for Everyone" have focused on addressing SME financing.¹⁹

THE DELIVERY CHALLENGE

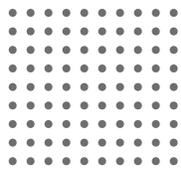
To a great extent, SME financing is a question of scaling-up the capacity of locally based financial institutions to deliver and of the domestic

financial markets to become more sophisticated. In the absence of well developed markets, a range of innovative private approaches have been used. These include for example, leveraging corporate supplier networks to establish the credit worthiness of SMEs, as ICICI Bank does in India, and which IFC has adopted as a model for some of its SME financing efforts. Nonetheless, public funds still play an important role, with well over \$5 billion in public funds deployed through equity funds, guarantees, and technical assistance to support SME development. Much of the support is designed to build local institutional capacity as well as provide direct financing.

¹⁷ Foreign Aid and Private Sector Development, Watson Institute for International Studies, Brown University.

¹⁸ Understanding the Japanese Budget 2004, Japan Ministry of Finance.

¹⁹ The Bologna Charter On SME Policies (2000); Incubating A Venture Capital Culture In Emerging Economies: Small Is Beautiful" (Monterey 2002); The Istanbul Ministerial Declaration on Fostering the Growth of Innovative and Internationally Competitive SMEs (2004); World Development Report: "A Better Investment Climate for Everyone"(2005).



A conservative estimate of the finance gap in Africa suggests that at least \$35 billion is needed simply to serve the needs of current SMEs. If SMEs constituted appropriate levels of their country's GDP, the finance gap becomes significantly larger. While local capacity and investment environment is the backbone of SME growth, international investment serves to further address the financing gap. The key issues associated with increasing access to SME finance are related to (i) slow disbursement of capital; (ii) high fund management and transaction costs; and (iii) limited/untapped local management and technical capacity.²⁰

THE OPPORTUNITY: THE POTENTIAL IMPACT OF ADDRESSING A POORLY FUNCTIONING SUPPLY CHAIN

While a development supply chain lens is not intended to address all elements of business climate, the approach of raising issues of cost, speed, and accountability highlights key opportunities to increase disbursement, reduce management costs, and develop capacity. The chart on the following page summarizes the nature and potential impact of the opportunity by supply chain phase.

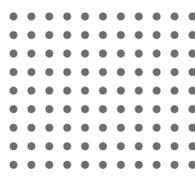
Our approach enabled us to both diagnose barriers to successfully delivering on the promise of poverty alleviation through development focused enterprise financing, and to identify practical and sustainable solutions to overcome these barriers.

Our analysis identified reducing fund management costs as a critical challenge, and thus we focused on opportunities to reduce the costs of serving SMEs which require investments between \$10,000 and \$1 million. Efforts such as the Shell Foundation supported GroFin in Africa seek to use an integrated model to deploy risk capital under \$1 million per company. By developing a core support team leveraged by strong local investment teams, GroFin seeks to reduce the management costs for under \$1 million investments, at the same time providing a skills base to local talent. Likewise, Small Enterprise Assistance Funds (SEAF) seeks to build the skills of local management talent by supporting educational programs. TechnoServe engages its resources to provide hands on support and mentorship to entrepreneurs in developing countries. Endeavor focuses on identifying and cultivating high impact entrepreneurs. E+Co, a non-profit with nine offices serving over thirty developing countries, has pioneered investing in over 120 clean energy enterprises by providing services and capital. Scaling efforts like these is the beginning of an approach to address key issues highlighted in the sector.

POTENTIAL SOLUTIONS

These recommendations are limited to those identified through the functional lens of the SME funding supply chain. A salient feature of this approach is the highlighting

²⁰ "Unleashing Entrepreneurship," UN Commission on the Private Sector & Development, 2004.



Nature and Potential Impact of Enterprise Financing Supply Chain Issues

	Issues	Financial Impact (efficiency / scalability)	Social Impact (effectiveness)
Secure and Manage Funds	<ul style="list-style-type: none"> • Reduce fundraising time • Increase size of funds raised • Reduce conflicting conditionality 		
Select Programs / Enterprises	<ul style="list-style-type: none"> • Increase sophistication of program / enterprise selection • Align fund objectives 		
Distribute / Invest Funds	<ul style="list-style-type: none"> • Factor in the development impact of invested funds and programs into expected returns • Increased financial management capability / sophistication of recipients and firms 		
Implement Programs / Manage Portfolio	<ul style="list-style-type: none"> • Increase management capacity in local economies • Use technology to reduce costs 		
Monitor and Evaluate Programs	<ul style="list-style-type: none"> • Increase relevance and quality of data captured • Use data for management decision-making • Leverage technology to monitor effectiveness 		

Legend

	None
	Medium
	Very High

Addressing supply chain issues can create:

Lower cost structures for delivering capital

More rapid scale up of financing mechanisms

of functions in the supply chain that benefit from bundling. A significant key to bridging the financing gap then lies in reducing capital costs by leveraging local resources, creating portfolios of products for investors of varying risk profiles, and incorporating development impact into the calculus behind providing access to finance (i.e., similar to how the U.S. government subsidizes SME

development through programs such as the Small Business Innovation Research program and SBA business loan programs). Intelligent subsidies that provide technical assistance at the early stage of the SME start-up and growth significantly reduce the risk of investment failure. The recommendations below aim to increase disbursement rates, reduce management costs and leverage local management talent to increase access to finance.



Policy Insights No. 7

Financing SMEs in Africa

by Céline Kauffmann

Policy Insights No. 7 is derived from the *African Economic Outlook 2004/2005*, a joint publication of the African Development Bank and the OECD Development Centre
www.oecd.org/dev/aeo

SMEs in Africa: the “Missing Middle”

The development of the private sector varies greatly throughout Africa. SMEs are flourishing in South Africa, Mauritius and North Africa, thanks to fairly modern financial systems and clear government policies in favour of private enterprise. Elsewhere the rise of a small-business class has been hindered by political instability or strong dependence on a few raw materials. In the Democratic Republic of Congo, for example, most SMEs went bankrupt in the 1990s – as a result of looting in 1993 and 1996 or during the civil war. In Congo, Equatorial Guinea, Gabon and Chad, the dominance of oil has slowed the emergence of non-oil businesses.

Between these two extremes, Senegal and Kenya have created conditions for private-sector growth but are still held back by an inadequate financial system. In Nigeria, SMEs (about 95 per cent of formal manufacturing activity) are key to the economy but insecurity, corruption and poor infrastructure prevent them being motors of growth.

Africa’s private sector consists of mostly informal micro-enterprises, operating alongside large firms. Most companies are small because the private sector is new and because of legal and financial obstacles to capital accumulation. Between these large and small firms, SMEs are very scarce and constitute a “missing middle.” Even in South Africa, with its robust private sector, micro and very small enterprises provided more than 55 per cent of all jobs and 22 per cent of GDP in 2003, while big firms accounted for 64 per cent of GDP.

SMEs are weak in Africa because of small local markets, undeveloped regional integration and very difficult business conditions, which include cumbersome official procedures, poor infrastructure, dubious legal systems, inadequate financial systems and unattractive tax regimes. Many firms stay small and informal and use simple technology that does not require great use of national infrastructure. Their smallness also protects them from legal proceedings (since they have few assets to seize on bankruptcy) so they can be more flexible in uncertain business conditions.

Large firms have the means to overcome legal and financial obstacles, since they have more negotiating power and often good contacts to help them get preferential treatment. They depend less on the local economy because they have access to foreign finance, technology and markets, especially if they are subsidiaries of bigger companies. They can also more easily make up for inadequate public services.

Restricted Access to Finance

Africa’s SMEs have little access to finance, which thus hampers their emergence and eventual growth. Their main sources of capital are their retained earnings and informal savings and loan associations (tontines), which are unpredictable, not very secure and have little scope for risk sharing because of their regional or sectoral focus. Access to formal finance is poor because of the high risk of default among SMEs and due to inadequate financial facilities.

Small business in Africa can rarely meet the conditions set by financial institutions, which see SMEs as a risk because of poor guarantees and lack of information about their ability to repay loans. The financial system in most of Africa is under-developed however and so provides few financial instruments. Capital markets are in their infancy, shareholding is rare and no long-term financing is available for SMEs. Non-bank financial intermediaries, such as micro-credit institutions, could be a big help in lending money to the smallest SMEs but they do not have the resources to follow up their customers when they expand.

Increasing SME Access to Finance: A Four Pronged Approach

Improving business conditions, boosting the capacity of SMEs, expanding the financial sector and strengthening links between firms will permanently increase SMEs' access to finance.

Improving business conditions

Proper information, a key to deciding whether to make a loan, would be helped by adopting clear accounting standards, setting up independent, competent and reputable accounting firms and creating more credit bureaux supplying data on the solvency of firms.

An impartial legal system that can help settle contract disputes, commercial law reform and drafting and clarifying land titles, as well as effective bankruptcy procedures, are vital for growth of the business sector.

A country's tax laws can either coax small businesses into the formal sector of the economy or keep them out of it. Governments should also make sure that they pay SMEs promptly, since public contracts are vital to the financial security of these firms.

Helping SMEs meet the requirements of formal financing

Apart from the need to boost SME capacities, some financial instruments can help provide missing information or reduce the risk stemming from some SMEs' lack of transparency. Franchising, which is very popular in Southern and East Africa with the encouragement of South Africa, allows use of a brand name or know-how that reduces the risk of failure. Warehouse-receipt financing (in South Africa, Kenya and Zambia) guarantees loans with agricultural stocks. Other financial instruments, such as leasing and factoring, can reduce risk effectively for credit institutions but are still little used in Africa.

Credit associations that reduce risk by sharing it are more common. They help financial institutions choose to whom to lend, by guaranteeing the technical viability of projects,

and sometimes providing guarantees. But growth of these bodies is limited by the lack of organisation among SMEs in Africa and by their focus on certain sectors and geographical areas.

Governments and donor sources have thus preferred creation of guarantee funds to ensure repayment in case of default. In several countries, especially in Central Africa, this has not worked since provision of a guarantee has meant less rigorous choice of investment projects and a lower rate of debt recovery. Elsewhere, notably in Mozambique, borrowers and financial institutions have worked together to maintain a good rate of recovery and to reduce interest rates.

Making the financial system more accessible to SMEs

Most African financial systems are fragmented. The "missing middle" in the pattern of size of firm is matched by one in the range of financing available. Lack of funding for SMEs has partly been made up for by micro-credit institutions, whose growth is due to the flexible loans they offer small businesses. In Angola, Novobanco provides loans free of bank charges, without a minimum deposit and with informal guarantees (property assets and a guarantor), as well as permanent contact with loan managers. Though adapted to local needs, however, micro-credit institutions remain fragile and modest-sized.

As well as lacking trained staff, micro-credit institutions face limited expansion because of their limited funds. Their mainly short-term finance means they cannot easily turn the savings they collect into medium or long-term loans. They are also up against the cost of refinancing through the formal banking sector and have no access to refinancing either by the central bank or by venture capital. Micro-credit institutions could be put on a firmer financial footing by developing and adapting long-term savings products that exist elsewhere, such as life insurance and home-saving plans, and encouraging the setting up of specialised refinance banks such as Mali's "solidarity bank" (Banque malienne de solidarité), or working more closely with the formal banking sector (Benin's SME support organisation PAPME and the local Bank of Africa).

Some countries (such as Kenya) have dealt with the lack of funding by supporting growth of smaller commercial banks or (in Ghana) of rural banks, so as to bring traditional banks and SMEs closer geographically and business-wise. South Africa passed two laws in early 2005 to expand the banking system to include savings and loan institutions (second-tier banks) and co-operative banks (third-tier banks) while easing banking regulations so the newcomers could still be flexible in providing loans. In many countries, commercial banks are also setting up their own micro-credit services.

Removing the obstacles to access for SMEs' to finance requires that commercial banks, micro-credit institutions, community groups and business development services

(BDS) work closely together. Pushing for agreements between financial bodies and BDS suppliers will help make up for lack of capacity and reduce costs by more efficient division of labour. The BDS supplier makes the initial choice of projects on a purely technical basis and the credit institution looks at financial viability.

Making loans to intermediaries (NGOs and federations of SMEs) with the job of allotting funds to members can also help cut administration costs. Solidarity between banks, especially setting up inter-bank financing to (as in Nigeria) pool money to be invested in SMEs, reduces the extra risk of lending to SMEs, as well. Working with banks boosts the financial viability of micro-credit institutions and can also help informal financial bodies to move towards the formal sector.

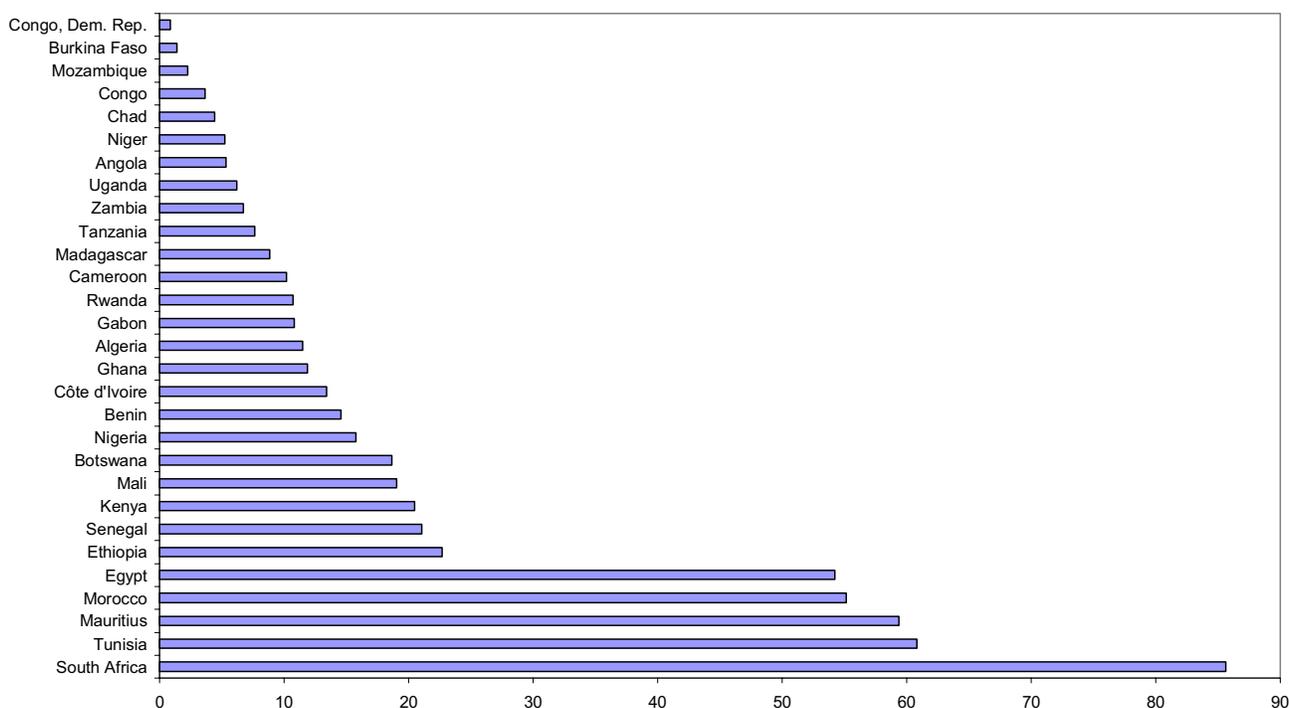
Expanding the supply of finance through the non-financial private sector

Financial institutions are not the only source of money for SMEs. Apart from remittances by nationals working abroad, which are a key boost to private-sector growth, the interdependence between SMEs, large firms and sectoral "clusters" is a major potential source of finance, as shown in Asia and Latin America.

Big firms can do a lot to help SMEs get finance more easily by transferring resources (money and factors of production) and guaranteeing SME solvency with financial institutions. Links with major companies can also help SMEs get export credits, which are especially important in countries with weak institutions, since commercial partners are better informed than other creditors (especially financial institutions) about the ability of their customers to repay debts. Export credits have been proved useful in Zambia's agro-food industry. Subcontracting is still uncommon in Africa, but has grown rapidly in South Africa since 1998, though there is increasing scepticism about it because it may confine SMEs to low-skill informal activities.

Clusters of SMEs, which are very active in Asia, enable member-firms to seek finance together, provide collective guarantees or even set up their own financial body. The threat of expulsion from the cluster ensures that promises are kept, which allows the network to overcome shortcomings in the legal system. Frequent interaction with financial authorities, as well as the role that reputation plays in the cluster, can greatly increase confidence between firms and financial institutions and thus make it easier to get loans and lower rates of interest. Working together also means firms can get supplier credits and can borrow from each other when necessary, which reduces general costs. Such clusters, however, are very little developed in Africa and are concentrated in South Africa, Kenya, Nigeria, Tanzania and Zimbabwe.

Figure 1. **Share of Credit to the Private Sector in 2003** (percentage of GDP)



Source: IMF, *International Financial Statistics*.

Facts about SMEs in Africa

Very few countries have working definitions of SMEs, except some members of UEMOA/WAEMU and Mauritius and Morocco. So data on this is hard to compare, though patterns can be seen and countries can be ranked by extent of SME activity:

- Nearly 80 per cent of firms in Congo have fewer than five workers. The country has 2 100 firms in the formal and 10 000 in the informal sector.
- A 1997 survey in Benin showed that of the 666 SMEs counted, half were in commerce and the rest were mostly in construction, or were pharmacies and restaurants. Only 17 per cent were in manufacturing.
- SMEs in Kenya employed some 3.2 million people in 2003 and accounted for 18 per cent of national GDP.
- SMEs in Senegal contribute about 20 per cent of national value-added.
- Nigerian SMEs account for some 95 per cent of formal manufacturing activity and 70 per cent of industrial jobs.
- In Morocco, 93 per cent of all industrial firms are SMEs and account for 38 per cent of production, 33 per cent of investment, 30 per cent of exports and 46 per cent of all jobs.
- Micro and very small businesses in South Africa provided more than 55 per cent of total employment and 22 per cent of GDP in 2003. Small firms accounted for 16 per cent of both jobs and production and medium and large firms 26 per cent of jobs and 62 per cent of production.

Source: African Development Bank and OECD Development Centre, *African Economic Outlook (2004-2005)*.

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Sustainable Small and Medium Enterprises

Creating value within planetary limits



Jennifer Inglis
September 2007



Foreword

WWF's Living Planet Report shows us that globally we are using the Earth's natural resources faster than they can be renewed. We are liquidating our planet's natural capital and threatening the potential for future generations to live in harmony with nature. Our challenge is to find new ways to improve standards of living and eradicate poverty while reducing impact on the natural world.

Small and Medium Enterprises (SMEs), as major employers in all economies, offer a unique opportunity to create possibilities for people, the environment, local and national economies and investors. These possibilities range from increasing labour, protecting natural resources, and securing long term return on investment. SMEs are well positioned to embrace particular sectors that are low in ecological impact but high in labour requirements. For example, solar electricity enables a society to learn and develop, requires skilled technicians, and delivers energy services without carbon emissions. Most importantly, SMEs have the potential to make a contribution to designing new systems that require less extraction and pollution than our existing models. SMEs are also of particular relevance to emerging economies where there is a great need for development opportunities. The solution to our global challenges will be through the simultaneously addressing these environmental and social concerns. Given their unique positioning in this context, sustainable SMEs are well poised to be supported as a catalyst for local and global change.

WWF presents this briefing document as a contribution to the investment communities who are considering investing in sustainable SMEs in Africa. It forms part of the background documentation to a 2007 workshop hosted jointly by UNEP-FI and WWF-UK. The workshop provides an opportunity for private, public and philanthropic investors interested in SME investments in Africa to gain new understanding of sustainable SME investing in Africa, to explore alternative financing models, and to create a network with like-minded individuals and organisations. The innovative SME investment and risk mitigation mechanisms necessary are explored in other discussion papers (De Risk, 2007) contributing to this workshop. The input of participants in the workshop is then sought to develop the agenda for further action.

About the author

Independent consultant Jennifer Inglis wrote this report for WWF. She works in a number of ways to create businesses and business practices that contribute to sustainable development – as an entrepreneur, employee, consultant and non-executive. She is active in the social enterprise movement in the UK and has expertise in many areas including policy around public sector procurement. She previously worked in capital investment in the food industry. She is a recent graduate of the MSc in Responsibility and Business Practice at the University of Bath.

Executive summary

The aim of this briefing paper is to provide an initial framework for considering the field of Sustainable Small and Medium Enterprises (SMEs) and, in particular, sustainable SMEs from the perspective of emerging economies in Africa. Sections one and two review the context of sustainable development and SMEs in Africa. Section three offers a system of categorisation for SMEs, and sections four and five consider the state of theory and practice within these categories of sustainable SMEs. Issues relevant to investors are also explored, such as financial return and the means of identifying investment opportunities.

KEY CONCLUSIONS

The principal conclusions from this paper are as follows:

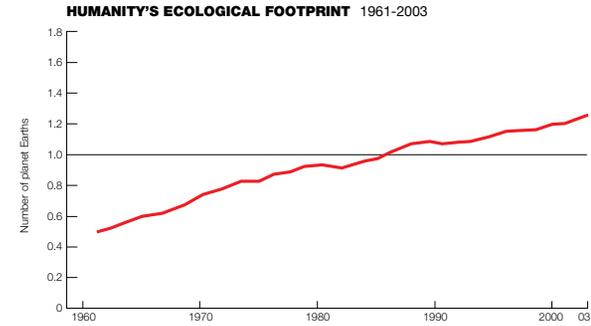
- 1** SMEs can contribute to development that is ecologically, socially and economically sustainable, and those that do so can be called sustainable SMEs. The development context determines the appropriate emphasis on these different elements; for most people in Africa social and economic development is crucial. There are serious dangers and future costs in simply pursuing social and economic development without reference to ecological limits, but the responsibility for enabling use of the most sustainable technology and systems in Africa must not rest with the poor.
- 2** Sustainable SMEs may be categorised as sustainably-designed or sustainable niche. The difference between these two categories is that sustainably-designed SMEs take responsibility for maximising the sustainability of their own operations, whereas sustainable niche SMEs happen to operate within market sectors and/or in ways that support sustainable development. Significantly increasing investment in these two categories is crucial to avoiding lock-in to unsustainable production and consumption systems in Africa.
- 3** Sustainably-designed SMEs offer benefits to system change beyond the financial, social and ecological returns they can deliver. The group warrants particular attention and must be provided with additional support to enhance and accelerate their establishment and growth and reduce the risk of failed investments.
- 4** Sustainable niche SMEs may be assessed in a similar way to any business: it is the investor that is in control of shaping the contribution to sustainable development in this case. A portfolio-based approach is suggested as the common basis for considering the full range of investments necessary to achieve genuine sustainable development, rather than simply incrementally reducing consumption or eco-efficiency.
- 5** There are considerable opportunities for translating the principles of sustainable development into investment programmes that support SMEs active in sustainable development priority areas. These include: increasing consumption among the very poor; social systems that future-proof the economy; putting natural capital into sustainable use; preserving biodiversity; reusing manufactured capital; supply chain leverage; and social and public services.

- 6** There are opportunities to maximise sustainability benefits from investments with higher rates of return by considering the model for taking products to market and for profit-sharing in these returns.

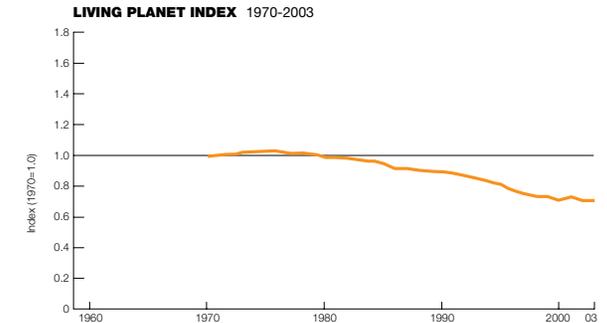
- 7** There is much scope to enhance and refine this field. The input of participants and the workshop is key to shaping this.

1 Sustainable Development

From a global perspective we have already exceeded the carrying capacity of the ecosystems that support us and the rest of life on Earth. The 2006 Living Planet Report (WWF, 2006) highlights the challenge based on two indicators.



The first, the Living Planet Index, is a measure of the state of the world's biodiversity. It has fallen by 30% over the last 33 years: natural habitat has been lost, and populations of many species have been affected. The second indicator, the Ecological Footprint, measures humanity's demand on the biosphere in 'global hectares' – the area of biologically productive land and sea required to provide our resources and absorb our waste. Demand exceeded supply by 25% in 2003 and a catastrophic loss of biocapacity is projected under the 'business as usual scenario'. The accumulated ecological debt would lead to irreversible and continuing depletion of ecosystems. Business as usual is therefore not an option.



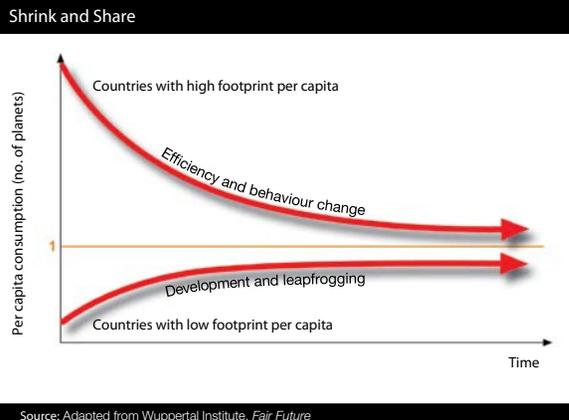
2 Small and Medium Enterprises offer big opportunities

Small and Medium Enterprises (SMEs) comprise a very large section of the worldwide economy and are stronger in developed than developing countries. Their contribution of formal employment to the many countries in Africa varies considerably: between 20% in Cameroon and Ivory Coast, and 82% in South Africa (World Bank, 2003). In low income countries the informal economy accounts for roughly 60% of total employment. For many people in developing countries an SME is the only realistic chance of formal employment.

The diagram below illustrates that while consumption in the developed world must fall, in most countries in Africa consumption of food, energy and housing must be allowed to increase to meet the basic needs of people. Nonetheless, countries that currently have low incomes now have an opportunity to encourage investment in creating different systems that meet these basic needs, while allowing for the flourishing of wellbeing within ecological limits.

High income countries, whose economic systems developed before ecological limits were understood, must take drastic action to change their existing systems. The Stern Review on the Economics of Climate Change removed any doubt on economic grounds that such action is desirable. The lesson from the developed world is stark: once systems of production and consumption are established – without factoring in the true costs of and limits on the use of fossil fuels – they are difficult and indeed expensive to undo.

The case of the developed world also exposes how limited the correlation between economic growth and wellbeing of people really is, with significant growth in GDP failing to correspond with an increase in broader measures of progress (e.g. NEF, 2004 and 2006). Moreover, where there is already sufficient consumption it is possible to achieve advances in human development without further increasing consumption. For example, Australia and the US both achieved a similar increase in the UN Development Programme's indicator of wellbeing – the Human Development Index – between 1975 and 2003. However, Australia did so with a small decrease in its ecological footprint per head of population, in contrast to the US's increase (WWF 2006).



The focus of the WWF/UNEP-FI workshop in September 2007 is to consider SMEs that employ between 10 and 100 people and that have financing needs anywhere from US\$50,000-500,000 for early stage, high potential, high growth sustainable enterprises. It is in this segment within the larger SME sector spectrum – where the financing gap is most acute – that interventions are difficult and therefore call for innovation. The case of micro-finance will be considered in a paper to follow the workshop and is therefore not dealt with here.

For the purposes of this briefing no strict definition of an SME is used, such as putting outer limits on turnover or number of employees. Instead, SMEs are considered because of their importance to the world's economies and populations and therefore their potential contribution or risk to sustainable development. SMEs can be thought of as 'not large enterprises', i.e. not having multinational operations, not being listed on a stock exchange, not established by foreign investors, and so on. The absence of these characteristics more commonly found in large businesses means SMEs are relatively invisible from an international perspective, and yet they provide employment for the majority of the population in nearly every country on the planet.

In many emerging markets, SMEs are one of the principal driving forces for economic growth and job creation. This presents both an opportunity and a risk.

The opportunities arise from:

- some general characteristics of SMEs that could be used to support sustainable development (e.g. support of public infrastructure through tax payment, connection to a community and therefore interest in reputation management, use of intensive labour, relatively equitable income distribution, diversity of activity and possibility of innovation);

- facilitating SME development in market sectors that support an improvement in quality of life (e.g. food production, education, rural solar energy) within environmental limits and offer a financial return; and
- the possibility of stimulating SMEs, for example those led by social entrepreneurs, whose very purpose is to pursue sustainable development and from whose practices we can learn.

The risks are:

- that simply investing in SMEs is considered as contributing to sustainable development per se (the positive characteristics listed above are relative to larger businesses and 'in general');
- many of the markets that are attractive to SMEs do not correspond with the development of sustainable systems of production and consumption (e.g. a water bottling company in Ghana would serve a niche market with a viable financial model but may not use water sustainably); and
- that SMEs are often forced to prioritise short-term survival over long-term strategic measures to address environmental impact, and are therefore unable to invest in cleaner technologies or even in some cases to comply with environmental regulations.

Appropriate investment is commonly cited as a barrier to the growth of SMEs, but such investment offers the chance to maximise opportunities and minimise risks. Investment can influence which SMEs have the chance to grow and in what ways. The rest of the report explores how SMEs that make a positive contribution can be understood and identified.

There are considerable opportunities for translating the principles of sustainable development into investment programmes that support SMEs active in sustainable development priority areas.



3 Positioning the bar for sustainable SMEs

There is no doubt that SMEs in general are important in the context of development (WBCSD, 2007), but does investing generally in SMEs promote sustainable development?

Sustainable development has been defined as a commitment to "improving the quality of human life while living within the carrying capacity of supporting ecosystems" (UCN et al., 1991) and thus includes social development.

There is no commonly accepted definition of a sustainable SME (or of a sustainable enterprise, or a sustainable business). Indeed the term 'sustainable SME' was used in a report on investment in emerging markets that noted:

"At present, the world of sustainable SME financing consists of disparate capital aggregators and other special purpose intermediaries that link capital to SMEs – these aggregators often have specific goals, such as poverty alleviation, biodiversity and land conservation, clean energy production, support for high-growth potential businesses, and so on. Development agencies, mission-based institutional investors, and philanthropists jointly fund many of these 'niche' projects, but to date there is no general place for sustainable SMEs in their investment portfolios." (IRI 2006.)

The report recommended a more coherent definition of and approach to the sustainable SME. As a starting point for a coherent definition of the field, two categories of sustainable SMEs may be identified:

- 1** SMEs that are internally led/driven to contribute to sustainable development to the maximum possible extent; and
- 2** SMEs that happen to support sustainable development in some way that is appropriate to the context within which they operate (including social and economic development, as will be explored later).

We can consider both of these to be sustainability-oriented SMEs, which for brevity will be referred to as sustainable SMEs, although it must be remembered that they are on a journey rather than at a destination. We could label the first category as sustainably-designed SMEs and the second as sustainable niche SMEs. The characteristics and principles behind these two categories will be explored further in sections four and five.

It is worth noting that these two categories do not by any means describe all SMEs. A further two categories of SMEs can be identified:

- 3** Those that don't make a particular contribution to sustainable development because they maintain and reinforce the status quo, but do not have practices that are socially or environmentally more negative than their industry norm. This category may include a significant proportion of existing SMEs. Supporting them to manage their environmental impact will be important. Possibilities for this support include investing in SMEs (in category one or two, above) that offer environmental management services to these businesses, and giving them access to cleaner technologies – for example, as part of a supply chain of a multinational.

- 4** Those that are deliberately, ignorantly or as a result of desperation causing disproportionate social or environmental problems. This could be an important group to intervene with in terms of impact on sustainable development. And while dealing with them directly would require regulations and enforcement, investment might be used to create alternatives for the desperate and ignorant.

In conclusion, while there are opportunities for investment to be used to address the environmental and social practices of a wider group of SMEs, the primary focus of this report is on positively screened investment in sustainable SMEs in the categories of 'sustainably designed' and 'sustainable niche' because the possibility of changing the system lies with this group.

4 Sustainably-designed SMEs

Conceptual and theoretical models

It is a challenge to put sustainable development into operation – to decide 'what to do today' – within the context of the system conditions necessary for sustainability. Several attempts have been made to address how an individual enterprise can go about this from a fundamental perspective. Three contributions to the field are:

- 1** Beyond the Business Case for Corporate Sustainability (Dylick and Hockerts, 2002), which proposes six criteria for assessing sustainable 'corporations' based on a business case, a natural case and a societal case for sustainability. These criteria appear as appropriate to small and medium-sized enterprises as they are to corporations. However, to expect any one enterprise to address all six criteria fully is highly ambitious. A possible solution is explored later in the report.

- 2** Designing the sustainable enterprise (Parrish, 2007), which stands out as an unusual contribution to the field because of its clarity on the first principles of a sustainable enterprise. It requires the enterprise to have designed itself to realise both survival (sustainability) and purpose (qualitative improvement). The survival conditions are (approximately) that stakeholders support the enterprise, that it maintains ecologically and socially sustaining functions, and that it allows primary stakeholders to meet their basic needs. This represents an even broader understanding of a sustainable enterprise than Beyond the Business Case proposes.

- 3** Sustainable business design based on The Natural Step Principles (Waage, 2003), which are:

- (i) nature is not subject to systematically increasing concentrations of substances extracted from the Earth's crust;
- (ii) nature is not subject to systematically increasing concentrations of substances produced by society;
- (iii) nature is not subject to systematically increasing degradation by physical means; and
- (iv) the ability of humans to meet their needs worldwide is not systematically undermined.

The best known example of a business in transition towards meeting these conditions is Interface, with its commitment to create the "prototypical company of the 21st century". This has been interpreted as 'zero waste', with only benign emissions, using only renewable energy, with closed loop recycling and having resource-efficient logistics. Clearly such a model is valid for industrial operations on a large scale, and indeed Interface has a whole research institution behind the effort. The Natural Step principles should also be applicable to SMEs, but they might need to work together to create the system transition necessary.

The common points from the above three models are that:

- they deal with the fact that nature's services cannot entirely be substituted with manufacturing and therefore expose the limits of the 'business case'-oriented approach to sustainable development often adopted by organisations that are not deliberately sustainably designed;

- it is clearly ambitious for a single enterprise to meet all true conditions for sustainability; and
- it is clearly an emerging field in which academia may be ahead of practice.

Practical developments in Sustainable Enterprise

Although examples of enterprises that have been designed fully in accordance with any theory of sustainable enterprise are few, there are many enterprises and entrepreneurs who push the boundaries of what is considered normal SME practice. The main ways this has been done are described in this section.

Emphasis on 'ecological' or 'social' enterprise only

In several developed economies there are efforts to promote the idea of ecologically or socially motivated enterprise. There are various interpretations of what this actually means in practice, and some disagreement over the roles and importance of profit and democracy in such enterprises. Generally speaking these enterprises tend to focus on a contribution either to living within ecological limits or improving social conditions or equity in some way. This split is perhaps testament to the difficulty of putting a completely sustainable enterprise into operation.

Sometimes social enterprise is used as a blanket term to cover ecologically and socially motivated enterprises – see www.socialenterprise.org.uk. There are various routes into social enterprise: the US route is primarily for 'non-profit organisations' to become enterprising through earned income – see www.se-alliance.org; the UK route is very mixed, but with more emphasis on alternative business practice.

Kenya 'Goodwoods'

WWF's Goodwoods project in Kenya is working to conserve critical forest habitats while enabling producers to reach new markets. This is done by enabling wood carvers to shift from traditionally preferred forest hardwoods such as ebony to farm-grown neem, providing sustainable livelihoods for carvers and tree owners. The supply chain comprises some 3,600 farmers, 5,000 carvers from Akamba Handicraft Cooperative Society, and a marketing company called the Centre for International Markets Access (CIMA), which was formed to help carvers meet quality standards, develop new designs and reach export markets. Forest Stewardship Council (FSC) certification was achieved in 2005 and successfully audited in 2006. Carvers now earn slightly more from FSC neem carvings than from ebony because neem logs are cheaper, easier to carve and less flawed. The final product is comparable to ebony in quality.

Cooperatives

Cooperatives are perhaps a special case of social enterprise – although they were around for more than 140 years before the term social enterprise appeared – where democratic control is required and equity between cooperators is particularly valued. One of the seven principles is “concern for the community”, which is interpreted on the ICA website www.ica.coop as a commitment to “work for the sustainable development of the community”. It is not always clear how this is interpreted by individual cooperatives.

In many places, including in some countries in Africa, they comprise a large section of the economy, and many will be large enterprises. For example, in Kenya, cooperatives put their contribution to GDP at 45%, with 31% of national savings and deposits. They have about 70% of the coffee, 76% of the dairy, 90% of pyrethrum (a biodegradable insecticide) and 95% of cotton markets (ICA, 2006). However, there are small and medium-size producer cooperatives, particularly in the agricultural sector. The interest of the cooperative movement in further embracing sustainable development by reinvesting its resources in small 'sustainably designed' cooperatives should be explored.

Emphasis on entrepreneurship rather than organisation form

In the context of entrepreneurship rather than enterprise there is also some polarisation – in this case into 'eco-preneurs' and 'social entrepreneurs'. Eco-preneur is usually a term for an entrepreneur concerned with profit-making green ventures – a double bottom line. On the other hand the various foundations that support social entrepreneurs tend to focus on social innovation as the important aspect (for example, Skoll's "pioneer of innovations that benefit humanity"), rather than how the innovation is delivered. So, while many social entrepreneurs do work within social enterprises, they are also found inside the public and private sector, and there are many whose projects require philanthropic support because they are a long way ahead of what a market will support.

Challenges for sustainably-designed ideas

On the whole, the more sustainable the behaviour of an enterprise, the more it is swimming against a tide (Barter, 2007), and the harder it is to sustain such an enterprise in the current market. After all, not many customers, investors, regulatory frameworks and other enabling factors for enterprise are aligned to valuing sustainable behaviour.

If there is no incentive, capacity or willingness in the market to value what the enterprise produces, then no matter how much contribution it could theoretically make to sustainable development it will be financially unsustainable. This is another way of saying that an SME cannot be sustainable in the context of an unsustainable system. A truly sustainably-designed enterprise will be constantly looking for ways to improve the sustainability of its behaviour by building a market that values this behaviour.

Opportunities arising from sustainably-designed SMEs

Applying any pure theory of sustainable enterprise would yield a small, although very important pool of potential investees. They are important because a sustainably-designed SME:

- challenges the accepted view of what an SME is capable of achieving, what can be valued in an (economic) system, and the necessary qualities of leadership;
- may deliver activities that would be considered 'public service' in the developed world but need to be undertaken privately, through charity or not at all in some emerging economies;
- is likely to create disproportionate value beyond the financial bottom line; and
- an create new business practice ahead of changes in norms and legislation.

Summary of characteristics of a sustainably-designed SME

A sustainably-designed SME is one that is inherently driven to find ways to maximise its positive contribution to sustainable development through its choice of business activity in relation to environmental challenges, its breadth and depth of service to society, and/or its degree of ecological and social return in comparison to economic value.

Return on investment in Sustainably designed SMEs

Since a sustainably-designed SME is deliberately trying to create value beyond financial value, it would seem that a method for assessing this value, centred on what it is trying to achieve, would be useful in deciding whether it is worthy of investment.

It has been noted that “whilst social ventures (i.e. a type of sustainably-designed SME) are typically credited with producing social value and financial ventures financial, they in fact both produce both to varying degrees” (Emerson, 2005). In recognition that the mainstream system does not fully value social and ecological impacts, Social Return on Investment (SROI) analysis was pioneered by Roberts Enterprise Development Fund (REDF) for considering philanthropic investment. The objective of SROI analysis is: “to more accurately capture the value generated or destroyed by organisations. As such, the concept at the heart of SROI analysis is valuation. Monetisation is a means to the end of valuation.” (Scholten, et al. 2006.)

SROI analysis may be used for investment selection. It may also be of particular interest as a tool for strategic planning and management within a sustainably-designed SME since it will offer some measure or value for what it is the organisation is designed to achieve.

Nurturing sustainably-designed SMEs

Sustainably-designed enterprise is in its infancy across the world, so it is necessary to have realistic expectations for Africa. Sustainably-designed enterprises might come from a charitable organisation or NGO, an established cooperative, or from the leadership of an ecologically or socially motivated entrepreneur. Their values may correspond with public service delivery, so public sector purchases and even aid-related purchases may be useful customer bases.

Given that the purpose of these enterprises is to deliver maximum sustainable development, the investment decision needs to focus on the quality of their design. To avoid concerns about creating dependency on philanthropy, their entrepreneurial capacity and intent should be assessed. As previously explored, these enterprises face a particularly difficult balancing act but produce value in terms of system change that warrants some calculated risk taking. Indeed their potential contribution to sustainable development punches such long way above their weight that there may be little justification for turning them away from investment and many good reasons for helping them to position their service to be marketable.

There are also some essential investments to be made in enabling conditions to allow SMEs to thrive. These include:

- supporting trade associations where sustainable business practice may be exchanged between practitioners, and lobbying may develop;
- supporting secondary marketing cooperatives to provide good access to customers;
- providing sector-specific (market and sustainable development) research; and
- standardising evaluation methodologies.

Patient and far-sighted investors are crucial to this group.

5 A portfolio approach to sustainable SMEs

A sustainable niche SME is one that can be judged by someone with an understanding of the system within which it is embedded to be making a positive contribution to that system on one or more criteria, and no negative contributions.

Since sustainable niche SMEs are not deliberately pursuing sustainable development, the crucial screening mechanism is not the motivation and value proposition of the enterprise but rather the sustainability priorities of a particular country and the priorities of the investors. However, once identified, some sustainability assessment of the individual SME needs to be made to ensure unsustainability is not inadvertently being reinforced. Aside from this investigation, a normal investment analysis would be undertaken.

Since system change beyond eco-efficiency is necessary, and given the challenges of finding any SME that is totally sustainable, a sustainability portfolio approach is recommended. In the same way as an ordinary investment portfolio might seek to spread risk and achieve an overall acceptable return, a sustainability portfolio would seek to invest in a range of SMEs so that sustainability priorities across a range of measures were supported.

One possible starting point for such a portfolio is to use a set of principles of sustainable enterprise and seek to achieve investment in a range of enterprises that score highly across different principles (and do not detract from any). The portfolio approach is ideally thought of as something that investors create together, although an individual investor's portfolio could also seek to spread across principles. This approach seeks to create a common concept of what range of sustainable SME-focused investments is necessary.

For an individual SME, the important thing in considering whether they are 'sustainable' is to ensure that they are making a contribution in at least one area and are guaranteeing no negative contributions. For the system, it is important that the portfolio is balanced across the different areas and that it works with the priorities for the country in consideration.

An illustration, based loosely on one of the earlier design concepts of a sustainable enterprise (Dyllick and Hockerts, 2002) is presented opposite.

Tailoring portfolios for African studies

Increasing consumption (socio-effectiveness)

WWF's work on ecological footprinting shows that in order to reduce the global consumption of natural resources, high impact sectors need to be addressed, including those of transport, food, energy and housing. This must be done in new ways that meet the needs of all people while working within the boundaries of ecological limits.

In the case of the vast majority of countries in Africa and other developing nations, it is not the current impact that is an issue, but rather the future impact that is likely if economic growth were to follow the same pattern as today's more developed countries. The task facing investors is therefore primarily how to avoid the mistakes of the developed world when investing in Africa. Sectors that are high impact in more developed countries, and that have long duration, require attention now to avoid a 'lock in' (WWF, 2006) to unsustainable technologies, infrastructure and behavioural patterns.

Therefore there is a need to leap ahead to the most sustainable technologies (eco-efficiency) and systems (eco-effectiveness) from the developed world to ensure that necessary increases in consumption do not create unsustainable systems in the long run. One type of sustainable niche SME would therefore radically shift sustainable technology to these time-critical sectors. Another example would be preventing economic migration and its social and environmental consequences through the development of labour-intensive sectors such as IT and knowledge-based enterprise.

In cases of poverty, a redistribution of consumption (i.e. reducing consumption in other places in the world or the system in order to allow for this basic human right of food, shelter or warmth) must take place if we are to live within the limits of the planet. However, from the point of view of social sustainability, consumption of essentials must simply be increased. It would be unreasonable to put the burden of 'shifting consumption' onto those currently without adequate ability to access products and services in the first place. The responsibility for ensuring that the production systems for meeting this need are sustainable must fall on the developed world.

An illustration, based loosely on one of the earlier design concepts of a sustainable enterprise (Dyllick and Hockerts, 2002) is presented below:

Criterion	Unsustainable	Neutral (minimum standard)	Sustainability contribution (includes at least one)	Major Sustainability Contribution
Eco-efficiency	Does minimum necessary to comply with the law	Industry average ecological impact	Minimum ecological impact possible given financial resources available	Invests progressively reducing ecological impact
Socio-efficiency	Does minimum necessary to comply with the law	Industry average negative and positive social impacts	Distributes wealth generated equitably amongst stakeholders	Invests progressively in enhancing positive social impact
Eco-effectiveness	Chooses a field that upholds existing eco-ineffective systems	Does not consider how to be eco-effective	Chooses a service-based business model	Chooses a field of business that makes a significant contribution to changing systems
Sufficiency	Sells unnecessary and ecologically impactful products	Sells only necessary products	Creates alternatives to consumption as a leisure activity	Sells a service that reduces consumption
Socio- Effectiveness	Only serves rich people	Meets industry norm in consideration of less lucrative markets	Takes products and services which meet basic needs to people who don't have them	Supports people who need basic products and services to create their own systems
Ecological Equity	Concentrates ecological assets further into the hands of the well-off	Maintains the status-quo of ecological asset distribution	Puts land/ sea into use to meet need in sustainable way	Re-distributes the balance ecological assets

Social systems that future-proof the economy

While sustainable technologies are available, unfortunately sustainable systems have largely been ignored by developed countries whose development occurred over a long period of time and before current awareness of the limits of the planet to sustain us. Creating villages at the size, scale and location appropriate to sustaining a system of exchange for all basic needs and trading a few specialised goods with populations at greater distance is a sustainable system.

More work needs to be done to develop completely new systems of exchange that allow people to meet their needs, to develop fulfilling lives and to live within ecological limits. This could be undertaken within a framework of investing in community enterprises or a simultaneous investment in a system of SMEs. The specialised goods and services developed should be diverse within a country and should target wealthier markets that are prepared to pay for ecologically- and socially-efficient solutions.

Zara Solar Ltd, Tanzania

Tanzania has one of the lowest rates of electrification in the world. Only 10% of the population have access to the electricity grid, and in rural areas only 2% have access, leaving people dependant on increasingly expensive kerosene for lighting. To date, Zara Solar and its sister company Mona-Mwanza Electrical & Electronics, have sold over 3,600 solar PV systems, directly benefiting over 18,000 people and this figure is expected to increase significantly over the coming year. In order to reach more remote areas, Zara Solar uses a network of trained local technicians that can service their own local customer base as well as providing customers with sufficient training to maintain the system properly once it is installed.

www.ashdenawards.org/media_summary07_zara http://www.ashdenawards.org/media_summary07_zara

Gone Rural, Swaziland supports over 650 women with an average of 8 dependents each through the production and direct sale of handcrafted products. It is committed to empowering rural Swazi women, alleviating poverty and supporting HIV/AIDS orphans by creating a regular income through working with traditional hand-skills to produce unique, beautiful products that are made in their homes using locally available and sustainable natural materials. Through ongoing design input, active marketing strategies, committed leadership, integrity, compassion and standards of excellence, the rural women are assisted in achieving their highest potential.

www.gonerural.za

Conserve, an NGO in India makes high added value products- handbags- from discarded plastic bags that otherwise cause a multitude of environmental problems. The handbags are sold in Europe. The business contributes to the livelihoods of more than 300 people. No dyes are added, the designs are all based on the original colours of the bags.

www.conserveindia.org

Wulff Capital assists African entrepreneurs in commercializing their health innovations. These innovative products can improve wellbeing and lower health costs on a global scale. Product commercialization can create new jobs and protect botanic diversity.

Source: www.wulffcapital.com

CIDA City Campus

CIDA City Campus, in South Africa, was founded in 1999 to provide disadvantaged youths a chance to earn a four-year business administration degree. At a cost of just US\$9,500 per student, CIDA has produced 1,800 graduates with potential lifetime earnings of US\$635,000 to US\$1.5 million, who teach and sponsor other students. CIDA plans to open new campuses, increase enrolment and create a franchise model called University-in-a-Box, entirely built and managed by students.

Source: www.skollfoundation.org

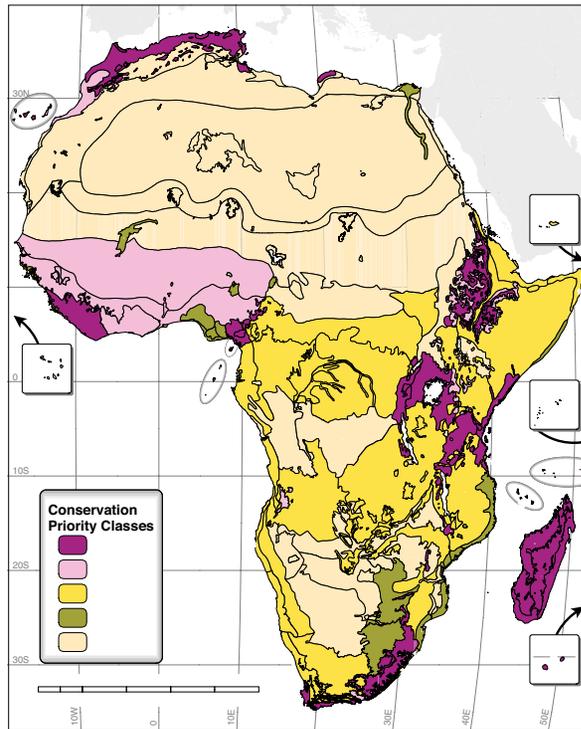
A further consideration is diverting the time of wealthier people away from following the Western/Northern pattern of non-essential consumption for leisure and status into more socially productive (and less ecologically impactful) leisure time and status-seeking activities. They would also include those that direct new consumption (as the economy grows) to services rather than products and to fair distribution.

Putting natural capital to sustainable use

While South Africa and Libya are the only African countries so far to have exceeded global fairshare of natural resources per person, consumption in several other African countries has exceeded the local biocapacity – the region's ability to support a certain population. This will require that they continue to use biocapacity from another country or that they increase their biocapacity, either by increasing the land used for production or the productivity of that land. None of these options are without implications. Sustainable niche SMEs can legitimately be involved in such an activity to cultivate land or increase land depending on the context of the country's consumption and available biocapacity.

Preserving biodiversity

There are also areas of land and sea within Africa with critical systems that must be protected in order to preserve biodiversity. One fundamental of an unsustainable SME would be harming such critical ecosystems. Conversely, sustainable-responding SMEs can play a part in protecting these ecosystems by providing a service of stewardship or by developing income streams based on the ecological asset with low ecological impact.



Burgess, N.D., D'Amico-Hiltes, J.A., Ricketts, T. and Driessen, E. (2008) Factoring species, non-species values and threats into biodiversity prioritisation across the ecoregions of Africa and its islands. *Biological Conservation* 127: 383-401.

Reuse of manufactured capital

In many places in Africa there are ecological problems caused by a lack of adequate waste treatment. Sustainable SMEs would include those that take manufactured capital out of waste streams and recycle or reuse it.

Supply chain leverage

SMEs that offer business to business services that assist other SMEs with their sustainability practices in some way (training, environmental management, leasing of sustainable technology) offer a good opportunity for sustainable SME investment. Likewise some SMEs that are or could be part of the supply chain of a multinational that takes sustainability seriously may offer good opportunities.

Social and public services not provided by the state

Enterprises that focus on improving quality of life – for example through healthcare, social care and education – are also within the spectrum of the sustainable niche SME.

For example, water is a massive area of need. A recent report found that “the number of people in sub-Saharan Africa with access to drinking water increased by 10 million per year over 1990-2004. However, population sizes have grown even faster, so the number of people without access has increased by about 60 million. The situation of sanitation is even more dramatic.” (OECD, 2007.)

Finally, enterprises that are led by women, educate women or improve women's options particularly support sustainable development. In addition to the obvious benefits to employment and education of women it also tends to reduce birth rates.

Design of sustainability portfolios

An understanding of what sustainable development means in the specific context of the country being invested in is clearly required. Such an understanding can be developed by partnering with NGOs that have a mission for sustainable development.

Many sustainably-designed SMEs will operate within sustainable niches targeted by a sustainable SME portfolio. However, it would be worth observing sustainably-designed SMEs to see if they target any other areas. This could inform the development of the portfolio.

Given the difficulty of operating a sustainable business within an unsustainable system, sustainable enterprises – both sustainably-designed and sustainable niche can be seen as being on a journey rather than at a destination. For sustainably-designed enterprises this journey is implicit in their purpose; for sustainable niche the types of enterprises that are attractive for sustainability investment will change over time, with improvements in understanding of how sustainable development can be put into operation.

Financial returns within the sustainability-responding portfolio

What are the places in the sustainable SME portfolio that a good financial return is likely to be achieved? While financial returns might tend to be more reliable in market segments that support continuing and increasing demand (business as usual) they might be higher in segments that anticipate an ethical trend. Financial returns should be possible across the full sustainable SME portfolio. But since spending power is by definition limited in emerging economies, those selling products or services that can be produced with positive (or little negative) environmental consequences to wealthier consumers – for example the developed world, wealthier customers in Africa, corporates and the public sector – may offer better financial returns.

This is a tricky aspect of investment with respect to sustainability because there is much scope for unsustainable behaviour in terms of the link to building unsustainable demand and also the use of profit. To maximise the financial return available both to the producer SMEs (which assists with socio-efficiency), some attention needs to be paid to the way in which the products reach markets in the developed world. This needs to be direct or at least fairly traded, and ideally through a secondary marketing cooperative in order to avoid investing in something from which the principal beneficiary is the Northern consumer. There is a growing consumer market for fairly traded goods, which could be taken advantage of with fair results all round.

6 Summary and next steps

It is possible to invest in SMEs in Africa in a way that supports sustainable development. Conversely if one fails to take account of the sustainability contribution and impact of investments there is a risk of undermining development and ecological needs. This has implications not only for the security of an investment but also for macroeconomic, social and environmental concerns.

To make investment in SMEs work for sustainable development, it would be necessary to:

- build consensus on making a coherent Africa-wide portfolio of investment decisions within a framework that can deal with the range of measures necessary for true sustainability, not just eco-efficiency;
- set up investment vehicles specifically focused on investing in sustainably-designed enterprises, and support their development by building knowledge and creating 'enabling' environments including a trade association;
- target investment in SMEs in Africa towards meeting basic needs and in leaping ahead to sustainable technologies and developing sustainable systems;
- invest in business to business services in environmental management services and physical infrastructure – for example, leasing environmentally efficient equipment; and
- protect the maximum sustainability return of financially attractive investments – for example, through fairtrade and secondary marketing cooperatives, and research into sustainable business.

Further work needs to be done to:

- explore more possibilities for designing thematic programmes within the portfolio approach: specific priorities for regions, countries or even sub-national level should be identified;
- test the practice of sustainable enterprise against sustainable enterprise design theories, and collect and share performance data where the burden of interpretation must fall on those with resources and perspective (such as universities);
- identify possible sources of sustainably-designed SMEs, including establishing the interest of the cooperative movement in further embracing sustainable development by reinvesting its resources in small sustainably-designed cooperatives; and
- establish consensus across different types of investment communities (public, private and philanthropic) on what constitutes sustainable SMEs, so that a consistent definition is used across the board, as a prerequisite to good collaboration.

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Blended Value Investing: Capital Opportunities for Social and Environmental Impact

By World Economic Forum

Selected Sections

(Full report can be found at:

https://www.weforum.org/pdf/Initiatives/Blended_Value_Report_2006.pdf*)*

Innovations in Private Equity Investing

Introduction

The universe of international blended value private equity investments is enormous, ranging from informal micro-capital investments by individuals all the way to professional private equity funds investing hundreds of millions of dollars in developing economies. Investment strategies range from social-value maximizing approaches to blended-value investment methodologies to strictly profit-maximizing investing. Given the broad range of investors, funds and deals in this realm, this section cannot be exhaustively comprehensive. Instead, it examines a range of methods deployed in the United States, followed by three very different international investment approaches, each deliberately adapting standard private equity practices to generate blended value returns.

The Crucial Role of Private Equity Investment in Developing Economies

Private equity investment is essential to building robust private sectors that create employment, improve living standards and produce tax revenues. Equity investors are usually more risk-tolerant than debt investors. They commit their capital for an uncertain term and have a residual claim on earnings only after all debt obligations have been satisfied. Equity investors face a host of other risks, several of which are explored below.

Equity investments are particularly suitable for early stage companies that will have unpredictable cash flows and accordingly are not suitable for debt investments. Unlike lenders, who maintain an arm's-length relationship with their borrowers in most circumstances, private equity investors can mitigate some of their risks by exercising a large measure of influence or control over the investments, and such investor engagement often encourages transfers of best practices and organizational capacity building. That involvement can help businesses build better, more efficient business processes, improve their corporate governance, forge partnerships with other businesses, and work more productively with other local institutions. The investors can also advocate for and/or support the entrepreneur's efforts to create, social and environmental value that, in turn, often builds enhanced economic value.

A Survey of Risks and Challenges

Private equity investors in developing economies face a variety of formidable risks that tend to be more severe than similar investments in developed economies. Savvy investors can deploy tactics to minimize some of these potential hazards, but many of them cannot be eliminated; all of them can challenge the likelihood of fully risk-adjusted market returns.

Corporate governance: Many cultures and economies lack a tradition and expectation of corporate governance that protects all stakeholders. Small enterprises particularly are often not subject to regulations that would encourage optimal governing practices. Remote investors not steeped in local culture may find it difficult to implement prudent governance.

Management competence: Frequently, entrepreneurs do not have the opportunities to work in well-run companies before starting their own businesses. Without widely available management training or relevant previous experience, enterprises in developing economies often lack well-trained managers.

Multiple ways of extracting value: Developed economies have established (and narrowly defined) means of extracting value from specific companies through interest, dividends or a sale of business. In many cultures, returns are generated in other ways. Examples include directing business to other companies controlled by a business's principals or hiring family and friends (in the developed world, such practices would be decried as self-dealing or cronyism). Such practices are by no means confined to developing economies, but in many cultures, these practices are considered legitimate ways of distributing value.

Corruption and graft: Certain countries and economic sectors face this obstacle more severely than others. Operating a business that does not engage in such practices can engender a very real competitive disadvantage when competing against business that do.³⁶

Bureaucracy: In many parts of the world, businesses face great bureaucratic regulatory hurdles when founding and operating businesses. Particularly when bureaucracy and corruption interact, the effect can dramatically chill a country's investment climate.³⁷

Innovations in Private Equity Investing

Rule of law and enforcement of contracts:

Many investors take a well-developed code of corporate law and a relatively functional judiciary for granted. Such conditions make contracts enforceable and give recourse to entities that have been wronged. Without them, an enterprise must carefully attempt to do business only with entities that will honour their contracts and obligations. In many emerging economies, the law and judiciary are not dependable, which increases transaction costs and risks.

Exits: Realizing a return either through a sale or public offering can be especially difficult when such strategies are rarely practiced or supported by a robust financial sector. Sales and ownership transfers depend not only on the presence of buyers and sellers (which may be relatively thin in emerging economic environments), but also require supporting professional services and infrastructure, including banking, accounting and legal services. Such support may also be in short supply in less developed economies.

Country risk - political and macroeconomic volatility:

With less political and economic stability in developing countries, private enterprises face a grave range of hazards from coups d'etat to currency devaluations. The duration of equity investments and the extraordinary difficulty in building currency hedges make currency exchange fluctuations a significant risk.

Variations on Traditional Venture Capital

As venture capital (VC) has generated spectacular financial value in the United States and other developed economies, many investors have sought to deploy risk capital with VC-like models that deliberately seek returns in multiple dimensions. In a number of locations in the United States, innovative blended value investors have sought to link community development investing to venture capital.³⁸ These investors make equity investments available to small enterprises that would create local employment opportunities and otherwise enhance the local communities. As many of these funds are dedicated to a specific geographic or municipal area, they significantly limit the number of companies in which they can invest. Furthermore, the nature of the returns they seek often renders their financial returns concessionary.

The Community Development Venture Capital Alliance, an investors' trade association, offers a variety of tools for exploring these investment strategies and the funds that deploy them.³⁹ *RISE Capital Market Report: The Double Bottom Line Private Equity Landscape in 2002/2003*, published by the Columbia Business School's Research Initiative on Social Entrepreneurship (RISE) in January 2004, remains an excellent starting point for further examination of blended value venture capital investing in the United States.⁴⁰

Pacific Community Ventures

Founded in 1999, Pacific Community Ventures (PCV) has become a leader in the area of community development venture capital. PCV enhances and invests in businesses that bring economic opportunities to low-income communities in California. PCV manages two venture capital funds, PCV Investment Partners I and II. The organization also offers "Business Advisory Services", capacity-building assistance for area businesses and social purpose enterprises that corroborate the organization's mission.

PCV invests in companies that operate in or near low-income communities and employ the residents of those communities. The investment screen assesses the quality of employment opportunities that the company offers, including the quality of benefits and potential for advancement. The funds measure multiple returns on a variety of parameters, which they then make available to the public.⁴¹ The fund makes US\$ 1 million to US\$ 5 million in equity investments in companies that realize annual revenues of at least US\$ 5 million

and have the potential to grow in ways that enrich their employees. The funds will invest alone, but often they invest in syndicates that include investors not using blended value investment frameworks.

PCV recently realized significant gains when portfolio company Timbuk2 was acquired by a private equity fund. The liquidity event triggered significant cash payouts to local, non-management employees, many of whom live in economically depressed areas, in some cases doubling annual salaries. While this sort of event is usually a very good thing for investors, it rarely touches employees.

Environmental and Clean Technology Funds

Another relevant class of venture capital funds directs investments at an industry or sector that will generate multiple returns. A significant number of such funds direct their capital to renewable energy or clean technology. Many of these funds do not make substantial changes to the standard venture model, and may be managed in a fashion all but indistinguishable from their peers on Sand Hill Road in Palo Alto, California—the difference, however, is their focus on leveraging environmental value through the application of market rate capital investments.

Expansion Capital Partners, LLC

Expansion Capital Partners (ECP) invests specifically in clean technology, which it defines as "[t]echnologies that offer dramatic improvements in resource productivity, creating more economic value with less energy, less materials and less waste. These technologies significantly lower cost and improve profitability, with short payback periods."⁴² Expansion offers a compelling investment thesis for focusing on this sector, noting that these markets are growing quickly, that companies in the space have been under-invested to date, and that venture investments in clean tech offer investors a measure of diversification beyond the typical venture capital industry foci. Expansion seeks equity investment opportunities in companies realizing US\$ 2 million to US\$ 20 million in revenues with the potential to grow considerably larger. Its target investments range in size from US\$ 500,000 to US\$ 2 million, and the fund aims to realize an IRR in excess of 25% (before subtracting fees and carried interest). Investors in ECP include an array of both individuals and private foundations.

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Solstice Capital

With offices in Boston, Massachusetts and Tucson, Arizona, Solstice Capital bills itself as an “early-stage, diversified, positive-impact venture fund” investing in alternative energy, environment, life sciences, education and information technology. The partners have committed to investing 50% of their two funds in socially responsible investments. Solstice notes that “socially responsive investments can generate superior venture capital returns and make a positive contribution to the natural and social environments.”⁴³

Solstice is affiliated with Village Ventures Partner Funds, a network of affiliated venture capital investors focused on investing in American geographic areas that have been typically overlooked by venture investors. Village Ventures centralizes many of its partners’ administrative and operational services, allowing the partners to focus on their core investment responsibilities. Affiliation with Village Ventures also improves Solstice’s deal flow exposure. Solstice’s two funds, formed in 1995 and 2001, manage a total of US\$ 85 million. Solstice’s early stage investments tend to range in size from US\$ 500,000 to US\$ 1 million, and the firm is committed to syndicating its investments and regularly co-invests with other firms.

Blended Value Angel Investing

Many businesses are not suited to venture capital, which, particularly in its established and widely practiced forms, only invests in a relatively narrow type of business. Most businesses take too long to mature before a liquidity event, are not likely to achieve the financial return hurdles that VCs require, or are in industries that garner little attention from venture capitalists.

Entrepreneurs not able to secure venture capital will turn to angel investors, individual private equity investors who commit their personal capital and assistance to private enterprises that do not meet venture capitalists’ investment profile. In the US, angel financing remains a loosely defined investment class that can be difficult to assess. Angel investors have a wide range of motivations and approaches to their investments, but most invest in ventures operating in the industries where they have had previous success, where their human capital can be as helpful as their financial capital.

In the United States, the angel investor capital market, such as it is, in many ways remains an inefficient and somewhat localized market; that is, investors and angel investors are often connected through interpersonal networks, not through any kind of market intermediary. Because an angel investor is accountable only to him or herself (and does not have a fiduciary duty to maximize financial profits for limited partners), an angel can invest in ventures as they suit him or her. Accordingly, one might expect that angels would be a fruitful source of capital for entrepreneurs deliberately generating blended returns—if they could find one another.

Investors’ Circle (IC) aims to help blended value private investors find ventures that will corroborate the blend of returns they seek. Though its members are both individual private equity investors and venture-style funds, Investors Circle describes itself as “a leading social venture capital intermediary whose mission is to support early-stage, private companies that drive the transition to a sustainable economy. Founded in 1992, IC has become one of the nation’s oldest and largest investor networks, and the only one devoted specifically to sustainability.”⁴⁴ A brief survey of the Investors’ Circle website will present the reader with an array of funds making blended-value private equity investments in the US.

First Case Study: ProFund⁴⁵

By the end of 2005, ProFund, the first commercial microfinance equity fund, had exited its investments, distributed the profits to its investors, and closed its doors—all according to plan.⁴⁶ Over the course of its ten-year life, ProFund demonstrated irrefutably that one could generate profits by investing in MFIs even through exceptionally challenging economic and political conditions. Whereas ProFund was the only investor of its kind when founded in 1995, by the time the fund distributed its gains ten years later, at least 20 other MFI equity funds had embarked on similar investment strategies.⁴⁷ In 2003, the proliferation of this investment strategy led to the creation of the Council of Microfinance Equity Funds, a membership organization aiming to advance the field of microfinance equity investing.⁴⁸

Not only is ProFund’s financial return, at the end of the day, an illustrative example, the fund’s administration and the sponsors’ public “post-mortem” examinations have revealed a variety of nuanced lessons.

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ProFund's Founding Premises

ProFund was predicated on a clear fundamental need: MFIs in Latin America needed more capital. The fund proposed to meet that need through equity investments. Between the need and ProFund's solution was the fundamental principle that a social mission and financial value creation are not only compatible, but they can be mutually reinforcing.

"ProFund does not perceive a conflict between poverty alleviation and profitability. In fact, it believes that financial viability is a necessity for the long-term success of poverty alleviation efforts in microfinance. Accordingly, while most of ProFund's shareholders are interested in the development of the microfinance industry, the fund seeks primarily to receive an adequate return on its investments, which it considers the most efficient way to entice commercial capital into the sector."⁴⁹

Sponsors ACCION International, Calmeadow, FUNDES, SIDI and Mr Fernando Romero invested in ProFund to generate social returns, to capture financial returns, and to demonstrate a model that had the potential to magnify the social and financial gains created by microfinance. Those sponsors contracted with Costa Rican fund manager and consulting firm Omtrix, SA to manage the fund, and Omtrix president Alex Silva became the CEO of ProFund. Silva's work has been central to the development of the ProFund approach and he is referenced throughout the balance of this discussion.

In founding ProFund, the sponsors articulated a preference for equity investments in MFIs for a variety of reasons. First, some MFI managers would prefer equity investments, with their longer-term investment horizon and lack of regular cash outflows. Nevertheless, the higher risk associated with equity investments made such capital scarcer than other sources. Second, financial institutions can only borrow up to a certain multiple of their equity investments (a requirement that varies by regulatory regime), so equity investments can facilitate follow-on debt investments. Third, the equity investment encouraged engagement and influence that could be exercised through membership on the investees' boards of directors, where ProFund's directors could introduce best practices where appropriate. Finally, in order to accept equity investments, MFIs had to acquire a certain level of sophistication. If an investee MFI was not already a private financial institution, it would either need to become one or would need to work with ProFund to craft a quasi-equity investment structure. Accordingly, the presence of ProFund encouraged MFIs to become more professionally managed.

The Mechanics of ProFund ⁵⁰

In founding the fund, the investors stipulated that ProFund would have a finite lifespan, ceasing operations in ten to twelve years after exiting all of its investments. The requirement forced the fund managers to deal with one of the most persistent barriers to private equity investment in microfinance and in developing economies in general: the lack of easy opportunities to liquidate investments. (ProFund's operational solutions to this challenge are elaborated later in this case study.) The founders also recognized that the fund would only spur similar investments if it could demonstrate realized returns for the whole portfolio, and stipulating the fund's ultimate liquidation guaranteed that ProFund would produce a conclusive, indisputable initial rate of return (IRR).

According to standard investment funds' practice, ProFund employed an investment committee that was ultimately responsible for investment decisions. The fund's professional staff uncovered and screened potential deals, negotiated and then monitored investments, identified exits, and served as a technical assistance resource to portfolio investments. Between the staff and investors, ProFund had extensive microfinance experience, and it could assist investees through the full range of their financing, strategy and operations challenges.

Though the professional staff had extensive responsibilities, the fund's charter ambitiously restricted administration to three percent of committed capital. At the fund's launch, this cap afforded ProFund only two full-time professional staff (plus an administrative employee and the input of paid consultants and other professional services service providers). Eventually, when the fund's size increased (reaching US\$ 22 million in 1998 with more than 15 shareholders), Omtrix was able to bring in an additional full-time staffer. Eventually, the fund reduced full-time staff size as it began to exit investments.

Quickly, Omtrix recognized that the initial premise of minimal investment engagement and relatively hands-off management was impractical. Many of the fund's initial investees were "NGO conversions", MFIs that were moving from not-for-profit models to independent financial institutions capable of handling equity investments. Over the fund's first three years, these conversions required significant attention from the staff. In later years, the investee profile evolved such that many investments were in

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newly created financial institutions, which also compelled highly engaged management. When macroeconomic turmoil began to sweep Latin America in the late 1990s, the staff found itself further stretched, making at least one deal that saved a healthy MFI from defaulting as a result of temporary macroeconomic shocks.⁵¹ ACCION and other sponsors readily acknowledge that the staff's extraordinary commitment and industry are largely responsible for the fund's positive results. Their experience reveals that close engagement is critical to such a fund's success, and, of course, high engagement requires a commitment of administrative costs.

Given the risk associated with equity investments, a soundly diversified portfolio was indispensable to ProFund's success. The resulting portfolio achieved diversification in countries, organizational forms (NGO-administered, existing financial institutions, and conversions from NGO to financial institution), market penetration and organizational maturity.⁵² To protect against undue investment concentration, the fund set a US\$ 4 million cap on any single investment. While the fund aimed to hold a substantial equity position in each investee (at least ten percent of its outstanding shares), ProFund opted not to take controlling positions; a 20-30% target became the norm.

ProFund's operations grappled with a profound, large-scale shift in the microfinance world, as the centre of gravity for MFIs' organizational forms shifted from NGOs to independent financial institutions. Not only did the fund develop expertise in effecting NGO conversions, it also learned to create near-equity investment structures in circumstances where the MFI could not accept equity investments due to its corporate form, by-laws or regulatory environment. Cataloguing the specific nature of those investment remains beyond the scope of this paper, but the resulting investments typically resembled subordinated debt or preferred equity. In some cases, they involved periodic cash flows, and many such investment vehicles included redemption clauses that provided investment exits on pre-arranged terms.

Once the fund finished liquidating its investments and distributing the proceeds to its shareholders, ProFund had realized a net IRR of 6.65%.

Key Lessons

Over the ten-year life of ProFund, its investors and staff learned numerous lessons about managing a microfinance equity fund. Silva explores many of those operations lessons in his essay, "Investing in Microfinance: ProFund's Story", and readers are encouraged to refer to that document for a more detailed exploration of those themes.⁵³

In its survey of microfinance, "The Hidden Wealth of the Poor", The Economist said of ProFund's returns (before the fund had exited the last of its investments):

At first sight, its returns look unexciting: just six percent annually, despite lots of risk. But on close examination this was a remarkable performance. All of ProFund's capital was contributed in dollars and then invested in local currency. In every country it operated in, its dollar returns were reduced by local currency depreciations, reflecting the economic chaos in Latin America during that decade. Two of the countries in which it had investments, Paraguay and Ecuador, suffered system-wide financial collapse. Haiti, Venezuela and Bolivia faced riots and revolutions.⁵⁴

In spite of significant currency losses, Silva indicates that "in most cases . . . the subsequent operational gains and intrinsic appreciation were more than enough to offset currency related losses and provide for the fund's positive overall yield."

Silva attributes the net gains to a number of critical factors. The first is the operational excellence of the investees' own management as measured by their ability to lend to more customers and do so with increasingly lower overhead costs. Silva has also acknowledged that ProFund's early entry into this market place enabled it to "cherry pick" the best investments at a lower investment cost, thanks to its lack of competition for deals. (Interestingly, Silva observes considerably more financing activity and, in turn, competition for deals in 2006. He has stated that he would not run ProFund II in the same geography because funding alternatives now exist, diminishing the likely success of a new fund—and further proving the success of ProFund as an inspiring demonstration of concept.)⁵⁵

Silva further identifies two other necessary conditions for profitable microfinance equity investing: the MFI must be located in a country that provides a sufficient "enabling environment", and the MFI's corporate governance must be sound and independent. In referring to the appropriate environment, he points to a country's regulatory

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and legal milieu. He cites an illustrative example: “[W]hen the Colombian government imposed tight interest ceilings and thus prevented [ProFund investee] Finamerica from recuperating the high operating costs associate with microfinance,” ProFund should have recognized the change in the investment environment and exited the investment.⁵⁶ (Unfortunately, ProFund did not act in time, and the fund eventually realized a loss on that investment.)

Successfully planning for exits at the time of the investments’ inception was another key success factor. Silva notes: “No investment was approved without some sort of negotiated exit possibility.”⁵⁷ With liquidity events remaining an elusive goal for most private equity in developing markets, ProFund’s example presents a variety of transferable operational lessons. The fund relied on several such exit strategies, many of which are suitable for liquidating minority positions, which can be especially difficult to sell when most buyers are seeking controlling interest.

- **Put Options:** These agreements gave ProFund the right to sell shares in the investment to a particular buyer, usually a larger co-investor, on a particular date at a price determined by the investment’s performance. The options typically provided a guaranteed exit opportunity of last resort that did not necessarily ensure a profit.
- **Controlling Block Shareholders’ Agreements:** Under such a contract, a number of minority investors agree to coordinate in selling their shares in unison so that a buyer can buy a controlling stake by aggregating several smaller shareholders’ stakes.
- **Management buy-outs:** ProFund also negotiated provisions by which an MFI’s management could purchase ProFund’s shares. Such arrangements may also involve seller financing, in which ProFund would arrange for the managers to borrow the funds that they would in turn use to buy out the investors. While this arrangement ensures that an interested party will purchase the shares, it also introduces the potential of moral hazard.⁵⁸
- **Redemption:** When ProFund relied on quasi-equity structures, it typically included a redemption feature that would coincide with ProFund’s closure and liquidation date.

Such provisions ensured that the fund would be able to liquidate investments, though the preferred exit remained selling the shares to a strategic buyer. Potentially offering greater exit multiples, such buyers also include “local financial institutions . . . and international socially responsible investors (including the equity funds).” Nevertheless, “[p]rivate individual or corporate sector buyers, while present, have not yet become a major force, and there is some reluctance to sell to such buyers unless they are convincingly socially motivated.”⁵⁹

Interpreting the Results and Looking to the Future

Particularly considering the macroeconomic environment in which ProFund operated, its results are remarkable—and they are made even more so given the “experimental” nature of the fund. Nevertheless, Silva observes that a similar fund, if launched in 2005 in the same geography, would be hard-pressed to replicate ProFund’s financial results. Silva points to the “downscaling” of many mainstream banks that have moved to microfinance products and otherwise serve previously un-banked poor people. He notes that downscaling may have a profound impact on how financial services are rendered to the poor.

He notes, “Coupled with lower cost of funds and underutilized infrastructure, the commercial banks are clearly more professional and know financial intermediation better than [most] MFIs. In many countries, downscaling is already as big as all MFIs combined.” Such developments help bring financial services to more poor people by creating increased competition for microentrepreneurial business. That increased competition might cramp the returns of MFI equity funds, but it might also introduce new exit opportunities for MFI equity investors as downscaling banks choose between building and buying microlending capabilities.

By 2005, a host of other microfinance equity funds were investing with similar models (though all at earlier stages in the funds’ lives). They will eventually contribute their data to the discussion of the asset class, and their experience will help establish the extent to which ProFund’s financial returns can be attributed to its being the first to market or to other factors, including the quality of the fund’s management and the overall nature of the investment strategy. These funds will also contribute to the body of best demonstrated practices, which will help investors and managers understand how to replicate and eventually improve upon ProFund’s results.

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Inescapably, ProFund's experience throws foreign exchange risk into sharp relief. Even when one invests anticipating returns on par with mainstream American private equity portfolios (in the realm of 30-40%), a major currency devaluation can quickly eliminate hard-won investment returns. Of course, developing markets and international blended value investors are quick to point out that foreign exchange rates can and do move in the other direction, and in many markets in the mid-2000s, they did just that. Nevertheless, the financial returns on investments in developing economies remain exceptionally sensitive to foreign exchange volatility, which as yet cannot satisfactorily be mitigated. Many well-informed would-be international blended value investors have avoided such investments (in equity and in debt) largely due to the uncontrollable and vaguely predictable foreign exchange risk. When financial services entrepreneurs and financial institutions develop a mechanism that manages some foreign exchange risk at a reasonable cost, it will likely open these investments to dramatic inflows of capital.

Concluding Thoughts

Equity investing in MFIs is a critical investment strategy, but it lacks single risk-reward profile. Equity investors, even more than debt investors, buy into the operations of the MFIs they support; the strong fundamentals of microlending alone will not generate MFI equity returns unless the financial institution is well managed. With the equity investors even further behind debt holders in their claim on an MFI's free cash flows, an equity investor must be that much more certain that sufficient cash flows will accumulate. The extraordinary range of corporate forms, lending models, and management strategies employed by MFIs makes equity investing a complex proposition. For example, the risk profile of an MFI converting from NGO to independent financial institution will differ significantly from an established financial institution that is extending its conventional models to new markets. Accordingly, perceptive, astute fund managers with deep microfinance and capital markets experience are absolutely essential to the success of equity funds.

ProFund has proven unambiguously that one can create social and financial value by investing in MFI equity, but investors have a long way to go before truly understanding the risk-reward profile of some of these investments. Fortunately, other blended value investors have engaged in this investment strategy and in due time will help reveal its nature.

Second Case Study: *Aavishkaar India Micro Venture Capital Fund* ⁶⁰

Founding Aavishkaar

Aavishkaar founder and CEO Vineet Rai discovered the need for micro-scale equity investments as the CEO of the Grassroots Innovation Augmentation Network (GIAN), an incubator for rural ventures in India. The entrepreneurs working with GIAN were caught between established financing mechanisms. Microfinance was not appropriate for these inventors; many had grown too large for microloans. Furthermore, these entrepreneurs were often creative inventors who had developed novel ways of addressing problems. Their inventions still required investment before they would generate predictable cash flows; accordingly, they were simply not suited to debt financing.

Rai's entrepreneurs faced financial institutions that were not equipped to help them grow. Many banks simply did not have programmes for working with small enterprises, especially those that were dispersed throughout rural areas. While India has a vital and growing venture capital market, most VCs are located in the cities (to be close to the clusters of innovation), and they operate almost exclusively at a scale that is an order of magnitude larger than GIAN's entrepreneurs. Rural India simply does not offer an angel network that could finance these enterprises.

Thus, Rai's entrepreneurs faced a grave funding gap between microfinance investment products (usually well below US\$ 1,000) and established venture capital fund investments (typically beyond US\$ 1,000,000). The rural entrepreneurs being incubated by GIAN needed flexible equity financing, patient capital that would help them build their enterprises' capacity and open further opportunities for growth.

After meeting with Indians living in Singapore, who themselves were contemplating more sustainable ways of supporting their motherland, Rai and his associates conceived of a new financing entity to address that gap, and Aavishkaar India Micro Venture Capital was born. In Hindi, Aavishkaar means innovation, and it invests in innovative rural enterprises that are "socially relevant, environmentally friendly, and commercially viable."⁶¹ Like traditional venture capital, Aavishkaar focuses on innovations that have the potential to benefit from economies of scale. Unlike the typical venture capital model, Aavishkaar invests only in small enterprises that could make a difference in the lives of rural Indians.

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Managing Regulatory Constraints

Beginning in 2002, Aavishkaar approached India's Securities and Exchange Board (SEBI) with the intention of formally incorporating as a venture capital fund. Formal incorporation posed a number of obstacles, including a minimum fund size that exceeded Aavishkaar's initial capacity to invest. The minimum fund size delayed Aavishkaar's initial venture investments while it worked to build a sufficiently large fund. The founders opened a Singaporean sister company, Aavishkaar International, to pool overseas investors' capital for investment in Aavishkaar as a single entity, an arrangement prompted by SEBI's regulations. The fund ultimately met its regulatory requirements and formally incorporated in May 2002.

Dr V. Anantha Nageswaran, a member of Aavishkaar's management board, indicates that Indian regulations do not encourage the flow of capital into non-traditional VC investments. He notes: "If banks could be allowed to contribute to . . . non-traditional venture capital funds, and if such contributions counted toward their obligations to the priority sector, then the flow of funds to the non-traditional venture capital industry would increase."⁶² Furthermore, some flexibility in the size and structure of the regulated venture fund would encourage further growth.

Fund and Deal Profile

Aavishkaar's investors are mostly individuals, and they have committed an average of about US\$ 16,000 to the fund. In late 2005, the fund totalled about US\$ 1.3 million, and it had placed six investments, with several others nearing completion.

Investments are scaled appropriately to the target companies that Aavishkaar aims to support, and the deals range in size from US\$ 10,000 to US\$ 100,000 with the average being about US\$ 30,000. Aavishkaar seeks an ownership stake of approximately 26%. While the investments are smaller than those of a typical VC, Aavishkaar targets VC-level returns for each investment, aiming for a 32% internal rate of return (IRR). Nevertheless, Rai anticipates a rate of enterprise failure that will likely exceed the typical VC's rate, and he anticipates the overall fund's IRR ultimately to be in the range of 5 to 10%.

He anticipates the duration of a typical investment will be as long as seven to nine years, which is considerably longer than the typical holding period of a standard VC. Accordingly, the fund has not yet

exited a deal. Nevertheless, those exits are likely ultimately to come in the form of a share buyback (in which the entrepreneur repurchases shares in his or her own company either with accumulated earnings or with commercially available debt), merger or sale of the enterprise, but Rai does not rule out the possibility that one of these enterprises will ultimately be sold on the public markets.

Investment Example

One of Aavishkaar's first investments was in Shri Kamdenu Electronics Private Ltd (SKEPL) in April 2003. The fund invested about US\$ 36,000 for a 26% stake in the company, which develops appropriate technology for dairy cooperatives. SKEPL's product portfolio includes automated milk collection and analysis systems that are suitable for use in India's tens of thousands of milk cooperatives. The product has the potential to make milk production safer and more efficient, thereby potentially improving the lots of the millions of milk co-op members.

Lessons Learned (or Lessons Learning)

Rai and everyone associated with Aavishkaar treat their fund as a carefully executed, high-stakes experiment. With a risk tolerance suitable to Silicon Valley, Rai declares that even if Aavishkaar fails, it will have been a success in that it will advance the state of the discourse about financing innovative rural entrepreneurs. He is confident that a private equity market will eventually grow up around these entrepreneurs, and Aavishkaar's approach may hasten the day it arrives. Nevertheless, he acknowledges that the market is miniscule, and a failure now could hobble the asset class for a long time.

In its several years of operation, Aavishkaar has seen its deal flow improve gradually but continuously, and the investment pipeline is now better suited to the size of the fund than it was in the early days. As Aavishkaar establishes a reputation, it sees more potential deals, including many that fall out of its focus area. Fund managers must resist the temptation to make larger investments that do not strictly fit the fund's investment focus. The temptation to move toward larger deals is great, as larger deals are, from a financial perspective, more efficient ways of deploying capital. Rai ultimately observes that Aavishkaar's small investment scale will limit its profitability, and it is difficult to imagine that the returns can be sufficiently large to overcome the costs associated with supporting the investments (e.g.: due diligence, investment monitoring and

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technical assistance). Without substantial returns, Rai raises concerns about retaining his capable and passionate staff. He needs employees with substantial professional financial experience and the opportunity costs for such professionals can be quite high.

In spite of these challenges, Aavishkaar has launched a viable fund in an investment space that has not yet had the benefit of competitors who can address the same challenges that Rai faces. The prospect of competition is very appealing to Rai, as other funds will help wring out inefficiencies, attract more capital to the sector, and ultimately make it more viable for rural entrepreneurs to take risks for the sake of building value. Though Aavishkaar still has no direct competitors, the fund has attracted the attention of other investors who are considering similar investment strategies, with one similar fund apparently close to launching.

Third Case Study: *ShoreCap International and ShoreCap Exchange*⁶³

ShoreCap International (SCI) is a private equity fund investing in MFIs and banking institutions that finance small- and medium-sized enterprises (SMEs) in Africa, Asia and Eastern Europe. SCI is not the only private equity fund investing in such institutions. This document refers to other MFI equity investors, but there is an increasing number of funds investing primarily in financial institutions serving SMEs in emerging economies. The Balkan Financial Sector Equity Fund (managed by Development Finance Equity Partners) would serve as one of several examples.

SCI adopts active roles in the companies in which it invests. Its work is corroborated and advanced by ShoreCap Exchange (SCE), an American not-for-profit organization that provides technical assistance to banks in SCI's portfolio and to other similar institutions. Both SCI and SCE were spun out of ShoreBank Corporation in the US, and their work draws considerably on ShoreBank's path-breaking and market-leading community development banking model in the US.

ShoreBank Corporation

ShoreBank began operating in Chicago, Illinois, USA in 1973, practicing what is now commonly called community development banking. The bank has become a diversified, full-service institution offering financial products and services designed to

enhance economic development in underserved American communities. The bank expanded outside of Chicago in 1986, and now it has locations in communities across the United States (including Detroit, Cleveland, Michigan's Upper Peninsula, Portland, Oregon, and Coastal Oregon and Washington). ShoreBank Advisory Services extends the bank's work to other financial institutions outside of the ShoreBank network. In 1994, the bank entered the field of environmental banking, bringing its investment practices to bear on conservation and environmental improvement.

The bank now manages over US\$ 1.7 billion in assets committed to community development, and its net income exceeds US\$ 7 million per year. Jan Piercy, a ShoreBank Executive Vice-President and former US Executive Director of the World Bank, notes that ShoreBank's original bank in Chicago now outperforms many of its peer banks that do not have a community development investment focus.

The bank began working internationally in 1983 with the Grameen Bank in Bangladesh. And in the 1990s, its work expanded to Poland, Pakistan, the former Soviet Union and elsewhere.

Introduction to ShoreCap International

Funding SCI

SCI was launched in July 2003 with US\$ 28.3 million in committed capital from 14 different institutions. The fund is structured as something of a hybrid between a permanent investment corporation and a limited-life investment fund. It has a mandate to invest funds for five years, concluding its investment activity in 2008. SCI does not have a terminal date or a requirement to liquidate its holdings by a particular deadline. Until 2008, the fund's directors can determine whether to re-invest any realized gains or to distribute them to investors. After 2008, investors themselves can determine whether they would like to have those gains paid out or reinvested. The fund managers aim to invest US\$ 23 million of the fund, reserving several million dollars to make follow-on investments and to support the fund's expenses (with very little current income, the fund must rely largely on its committed capital to fund expenses). SCI expects a seven percent IRR for the fund itself, which is concessionary to the risk-adjusted market rate.

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Investors

The fund's 14 investors committed an average of US\$ 2 million to SCI, and their investments range from US\$ 250,000 to US\$ 4 million. They include development finance institutions, socially responsible investment funds, foundations and one global commercial bank, ABN AMRO. The Netherlands-based bank's American subsidiary LaSalle Bank had worked with ShoreBank to meet its community investment obligations under the Community Reinvestment Act. Spurred in part by the investments made with ShoreBank's assistance, the LaSalle and ABN AMRO executives recognized that community development clients would be their future mainstream clients. Accordingly, ABN AMRO invested in SCI to learn more about its future mainstream clients in emerging economies.

Investment Parameters

SCI invests in financial institutions that provide financing and banking services to microentrepreneurs and small businesses that create economic opportunities for poor people. The fund invests in regulated banks, MFIs, and other financial institutions as long as at least 50% of the institution's assets are dedicated to financing small- and micro-sized enterprises that employ low-income people. Typically, it invests US\$ 500,000 to US\$ 2.5 million in equity with some convertible or subordinated debt, and its investments are made in local currencies. SCI's hurdle returns on equity are 12%, and it anticipates an average holding period of five to seven years. Though SCI does not take majority stakes in any of its investments, it does take board seats, often placing a top ShoreBank executive on the bank's board. The fund currently operates in Africa, Asia and non-EU Eastern European countries.

Deal Flow

Paul Christensen, president and COO of ShoreCap Management, the fund manager, indicates that it is much easier to identify microfinance deals, given the prominence of the sector and the fact that there are other investors seeking similar deals. Identifying investment prospects is more complicated for institutions that finance SMEs. ShoreBank's Advisory Services often sources such deals, and occasionally, existing SCI investments refer other potential investments. In some cases,

Christensen and his team prospect by travelling throughout Asia, Africa and Eastern Europe seeking financial institutions that might be investment prospects. SCI lists investment pipeline opportunities in Ghana, Uganda, Afghanistan and Azerbaijan, among other countries.

Measurement and Monitoring

SCI expected to have made eight investments BY late 2005, totalling US\$ 9.5 million, with several other likely investments pending. Through its regular monitoring and involvement of SCE, SCI remains in close contact with the banks in which it invests. Not only does it track the financial performance of its investments, SCI also works to assess its investments' social impacts. Christensen reports that tracking impact outputs for MFI investments is easier than doing so for SME-oriented investments. Some of SCI's MFI investments are already assessed by MFI rating organizations that track metrics like number and size of new loans and the gender mix of borrowers. In measuring the fund's SME investment impact, SCI has deployed many of the tools that community development banks use in the US. They attempt to measure the number of small businesses associated with the banks, along with the total number and quality of new jobs created. Nevertheless, the dispersed nature of the investments and the cost of measuring both make it difficult to compile accurate and complete data.

Introduction to ShoreCap Exchange

SCE is an independent American not-for-profit organization that operates internationally and is funded primarily by grants. SCE supports many of SCI's investments by offering technical assistance in the areas of organizational capacity-building, best practices transfer and "banker-to-banker peer exchange." While donors support SCE's work, client banks must make co-payments (determined on a sliding scale) for the services, ensuring that they are fully invested in the capacity building and knowledge transfer that SCE facilitates. SCE also sponsors a variety of exchange programmes that encourage knowledge transfer between bankers in developed economies with their colleagues operating in developing economies. SCE's involvement not only encourages positive development outcomes, but it helps to lower the risks associated with SCI's investments.

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SCI Looks to the Future

Nearly halfway through the investment process at the end of 2005, Christensen suggests that ShoreCap's future international private investment funds will likely have a sharper geographic focus. He notes that it can be a challenge to cover Africa, Asia and Eastern Europe with a staff appropriate for a US\$ 28 million fund. Beyond regional specialization, Christensen sees opportunities to expand this investment model to the low-income housing sectors of developing economies. He sees both viable potential business models and the opportunity to finance a substantial development impact, and he predicts that more capital will flow into low-cost housing finance in the next several years.

Fourth Case Study: *Actis*⁶⁴

Whereas Aavishkaar and ShoreCap were both founded as unorthodox approaches to private equity investment specifically intended to create blended value, Actis is a mainstream private equity fund with over US\$ 3 billion under management and generating market-rate financial returns. With a history stretching back to 1948, Actis's ingrained organizational values and investment strategies have driven the firm to generate multiple returns before it ever articulated a blended value investment strategy.

Actis's History and Investment Focus

Until its management buyout in 2004, Actis was a part of CDC Group PLC (formerly Commonwealth Development Corporation), which was wholly owned by the UK government. As the United Kingdom left its former colonies in the 1940s, it formed the CDC to begin establishing private sectors in the nations it departed. Initial investment vehicles were debt instruments with some private equity investments, but over 50 years the fund changed the balance of investments so that by 2005 its assets were almost exclusively private equity (consistent with a standard private equity fund's allocation).

Ultimately, CDC's management and the UK government pursued a privatization plan that would allow existing management and employees to buy out 60% of the company, thus converting it into a conventionally organized private equity fund. The management completed the buyout in 2004, when the management company was renamed Actis.

While the government still owns 40% of the management company, Actis now raises investment funds in accordance with typical private equity practice.

Actis has 16 offices, most of them located in the developing economies where the fund invests, including five offices in Africa, four in Central and South Asia and one in China. Staffed by over 90 investment professionals, the firm has developed a deep understanding of the markets in which it operates. Being geographically close to their markets, Actis's investment professionals maintain close engagement with their investments.

The deal sizes typically range from US\$ 10 million to US\$ 50 million, and the fund invests only in healthy, established enterprises with high growth potential. It selects sectors on a local basis, enabling it to choose those that offer the best potential for growth and benefit for the local economy, while avoiding those where corruption, environmental liabilities or other potential hazards make investments unappealing.

Between 2004 and 2005, Actis raised six regional funds and an umbrella fund investing in the regionally defined funds. If Actis meets its target fund sizes, the new pools of capital will represent over US\$ 450 million directed to investments in Africa, US\$ 225 million to China, US\$ 325 million to India, and US\$ 225 dedicated to South and Southeast Asia. Since 1998, it has exited over 50% of its South Asian investments, generating a gross IRR of 34%. In the same time period, it exited nearly half of its investments in Africa with a gross IRR of 23%. Though it has exited only two of eight investments in China, the realized gross IRR for that portfolio has been 54%.

Generating Multiple Returns

Actis's engagement in generating multiple returns begins at the investment screen, as it avoids companies that have poor reputations, will be placed at competitive disadvantage by upholding honest business practices, or will be potentially resistant to Actis's responsible engagement. Within the company, Actis aims to improve corporate governance, health and safety standards and/or environmental practices. In some of the changes it advocates, Actis resembles a progressive activist shareholder. It does so because such practices are ingrained in the firm's values and because they increase financial value.

Variations on Traditional Venture Capital

When it has the opportunity, Actis advocates for regulatory and legislative changes that will encourage a healthy, competitive and responsible private sector. The benefits of such advocacy accrue to Actis in that its investments can pursue their businesses with less friction. Furthermore, Actis-supported enterprises are prepared to compete successfully in competitive business sectors, and the fund is betting that its ventures can win on a level playing field. Naturally, the benefits of such work accrue to the communities and countries where Actis-supported ventures operate.

Social Fusion mapped Actis’s approach into frameworks presented in “Developing Value: The Business Case for Sustainability in Emerging Markets”, a white paper published by the IFC, Ethos Institute, and SustainAbility^{65, 66}. The “Developing Value” framework explains how “environmental risk reduction” and “socio-economic risk reduction” can be practiced such that they engender improved economic returns for shareholders as well as benefit other stakeholders. (See figure 7 for a concise representation of that framework.) The authors of the “Developing Value” study map a series of risk-reducing actions that generate medium- and long-term business results. The framework then establishes how these results confer benefits or returns on multiple stakeholders, including employees, investors and the community.

Social Fusion discovered that Actis’s investments consistently fit this framework. The firm’s investment professionals recognize the significant risks inherent in investing in emerging markets, and their systematic, thoughtful approach to mitigating those challenges translates into concrete actions that also create environmental and social value.

Improving Exit Multiples

Managing Partner Jonathan Bond observes that Actis regularly sells portfolio companies to large European and global firms, many of which recognize the risk engendered by environmental, social, and corporate-governance-related liabilities. Many companies will not even consider acquisitions that do not meet or approach their own standards for social and environmental practices. Accordingly, Actis aims to build companies that will appeal to such acquirers, and doing so engenders benefits for the portfolio companies’ employees, communities and economies.

Investment Example: *Celtel*

Bond reports that the firm sees a tremendous appetite for capital in Africa, where one of the highest-growth industries is wireless telecommunications. The growth rate in wireless services in Africa exceeds that of any other region in the world. Actis entered the sector with a

Figure 7: The Developing Value Framework

Risk Mitigation	Actions	Business Result	Stakeholder Benefit	
Governance	<ul style="list-style-type: none"> Culture of responsibility, accountability, teamwork and transparency Well-communicated guidelines for mission and operations Monitoring and review policies developed and strictly enforced 	<ul style="list-style-type: none"> Community goodwill Brand development and reputation Revenue growth and new market access Well-trained workforce Cost savings and increased productivity Greater access to capital Decreased healthcare costs Higher profits 	• Employees	<ul style="list-style-type: none"> Safe working conditions Increase in direct employment opportunities
			• Investors	<ul style="list-style-type: none"> Stable investment and development climate
			• Community	<ul style="list-style-type: none"> Community development and access to better services and facilities
Environmental Risk Reduction	<ul style="list-style-type: none"> Efficient use of natural resources Minimization of harmful products Highly efficient operations Reduction of waste streams 	<ul style="list-style-type: none"> Revenue growth and new market access Cost savings and increased productivity Brand development and reputation Greater access to capital Decreased healthcare costs Higher profits 	• Employees	<ul style="list-style-type: none"> Increase in direct and indirect employment opportunities Safe working conditions
			• Investors	<ul style="list-style-type: none"> Higher returns for investors Stable investment and development climate
			• Community	<ul style="list-style-type: none"> Community development and access to better services and facilities
Socioeconomic Risk Reduction	<ul style="list-style-type: none"> Workforce training Community activism – “first-in privilege” Access to healthcare 	<ul style="list-style-type: none"> Revenue growth and new market access Community goodwill Brand development and reputation 	• Employees	<ul style="list-style-type: none"> Increase in direct employment opportunities
			• Investors	<ul style="list-style-type: none"> Higher returns for investors Stable investment and development climate
			• Community	<ul style="list-style-type: none"> Community development and access to better services and facilities

Source: Social Fusion and Actis, adapted from “Developing Value: The Business Case for Sustainability in Emerging Markets”

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significant investment in Celtel, a pan-African wireless service provider, shortly after Celtel's founding in 1998. By the time of the company's sale in March 2005, Actis had invested a total of US\$ 77 million, representing 9.3% of the company's shares. Kuwaiti wireless concern MTC purchased Celtel for US\$ 3.4 billion, giving Actis a 77% gross IRR. Of the US\$ 3.4 billion purchase price, Bond reports that some US\$ 2 billion represented goodwill, value the acquirers ascribed to knowing that Celtel's contracts were all dependable, that the company had always operated to the highest ethical standards, and that it would not discover any fraud or hidden liabilities.

While it owned Celtel, Actis had many opportunities to advocate for multiple returns. The firm worked with government officials in the African countries where the company operated (particularly in those where it was among the largest taxpayers) to ensure that taxation and other business regulations were transparent and uniformly practiced. Celtel also instituted strong employee-development programmes and strict environmental protections. Furthermore, Celtel is active in many of the communities it serves, sponsoring various healthcare, education and other community initiatives.

Opportunities

In potential financial returns, Actis sees tremendous opportunities for investing in emerging markets. Especially in Africa, the firm is not wanting for investment opportunities. While the risks remain significant, the firm and other experienced private equity investors with personnel in-country are well positioned to reduce that risk, often in ways that engender positive returns in other dimensions of value.

Gillian Arthur is the head of Actis's Operations Group, which ensures that the firm's approach to health and safety, social and environmental issues is integrated throughout the investment lifecycle. She notes that Actis's most significant and immediate impact may be in the realm of employee health and safety, and Actis pushes its portfolio companies constantly to improve working conditions and opportunities for their employees. Actis will have ample opportunity to make such improvements as it invests recently raised funds in countries that have poor reputations for safeguarding employee health and safety.

Interest in blended value investing is building momentum. More and more capital is being guided not just by a conscience but by a proactive, sophisticated set of ethics. With the assistance of Social Fusion, Actis is currently exploring how investments in Actis can play a role in blended value investment strategies. To that end, Social Fusion has convened a series of "investor roundtable" events that have brought Actis partners together with potential blended investors in order to exchange ideas and discuss opportunities.⁶⁷ It should be noted clearly that Actis does not promote itself as a "socially responsible" investment manager, per se. Instead, it is transparently presenting its goals and practices to investors who can then determine how or whether an investment in Actis has a role in their portfolios.⁶⁸

In conclusion, as this modest slice of the developing private equity market universe demonstrates, private equity investment can be very flexible and can adapt to the variety of opportunities arising in developing economies. Making private investment work for international blended value creation will require additional time to build upon this initial track record to increase the experience of those structuring these funds and expand the capacity of both funds and supporting intermediaries working in this area of capital allocation. There are promising developments, such as the launch of VantagePoint,⁶⁹ a non-profit working regionally with investors to help expand venture capital options in emerging markets and the ongoing work of Endeavor,⁷⁰ providing support to entrepreneurs in emerging markets, both of which reflect the growing interest in and promising developments of venture capital expanding into these emerging markets.

A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

Of Opportunity and Risk

This paper has documented just some of the improving prospects for applying mainstream investing practices toward achieving social and environmental goals. Strategies such as microfinance and social enterprise, initially having been launched primarily with philanthropic support, are now approaching the status of “mainstream” investment opportunities for banks, foundations and high net worth individuals interested in doing well while doing good. For those who believe in the power of market forces and free enterprise—as well as the need to create a more just world—these are exciting times.

These transitions from philanthropic capital to financial investment capital are particularly unusual and even anomalous events in the history of capital markets. While investors may analyze and learn from the “non-profit to for-profit” transformation of hospitals as well as specific financing innovations such as the affordable housing tax credit, there are virtually no historical examples of wide-scale economic initiatives that began on a philanthropic (wealth *transferring*) platform and segued to a risk-oriented (wealth *creating*) platform capable of attracting private capital. In this nearly unprecedented situation, one must carefully re-evaluate the usual rules for gauging risk and return as they apply to this major capital markets transformation.

In the context of a blended value capital market, there is real risk and there is real return. However, to an outsider trying to determine whether or not to invest in or contribute to a microfinance entity or a for-profit social enterprise, the investment decision is quite simply not as straightforward as it would be for investors considering traditional investment opportunities. This complexity arises from capital markets that heretofore did not reflect the true nature of value; instead, they artificially broke value into components that over simplified the goals of creating value. Those capital markets corresponded to two very different sectors (one non-profit and the other for profit) that, of course, still exist today. Each has its own rules, regulations and relevant approaches to analysis. Nevertheless, value is a more complicated construct, and maximizing it with consistency will require that investors revise their rules for investing capital. They must be careful to combine the best aspects of philanthropic and financial investing, and they must be especially wary of combining the strategies in ways that obscure risks and jeopardize overall, long-term blended value creation.

Developments in financial instruments, portfolio theory, creative market-based problem solving, and their underlying conceptions of value are very encouraging. They should be supported, expanded and celebrated as being revolutions in thought and practice that create real value. At the same time, *it is critical to reflect on the risks present in any emerging market and to define what mechanisms should be in place to minimize those risks.* If efficient markets capable of attracting significant capital to blended value investments are ever going to emerge, would-be market participants must observe and address the characteristics that currently prevent the nascent blended value capital markets from functioning as efficiently as more established, efficient capital markets.

Many of the extraordinary projects documented in this paper—and so many other innovations not addressed herein—are, quite simply, in jeopardy. At this stage of development, blended value investing strategies are poised either to become victims of their own success or—with careful guidance—to emerge victorious as new waves of capital are prudently deployed in blended value investments. Should significant new blended value investments turn out to be founded on poor due diligence or faulty risk-management, those mistakes could sour the market for years to come. The collapse of any of the initial funds and investment instruments currently capitalizing the next stage of blended value investing would not only spell the end of that particular offering; it would make it extremely difficult for future offerings to find investors. The Chinese character for “change” is a combination of those for “risk” and “opportunity”, and such is the change in process.

Early financial failures would deal a significant set back to *all* those around the world who are attempting to bring new investment strategies to other emerging areas of economic development. Funds targeting small- and medium-sized enterprises in emerging economies, newly seeded renewable energy funds, community development venture capital funds, and many others have reason to be concerned and to ensure that early investment decisions are made wisely. This concern is not to say that mistakes cannot or should not be made. If the risk associated with these deals is appropriately priced and the markets are indeed efficient, some investors will lose money. These markets do not need to ensure that investors never lose money (doing so would distort the market in ways that would ultimately hurt value creation). Instead, the emerging market participants must ensure that every deal either succeeds or, in the

A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

words of Tom Peters, “fails forward”. Participants do not need to prevent all losses of money, but they must avert the catastrophic failure that arises from incompetence, hubris or malfeasance.

Looking to the Future of a Blended Value Capital Market

For years the focus of a great deal of work has been upon the challenge of how to build the microfinance capital market—and many have worked to address that challenge. At the same time, another, broader question remains:

How do we create investment strategies that are bankable and socially valuable, capable of providing capital to microfinance, social enterprise, small- to medium-sized enterprises, community development finance and more?

Microfinance and other blended value creation systems share challenges in gaining access to mainstream capital flows, though each programmatic area stands in a unique position—its own particular distance from that ultimate goal. Nevertheless, a series of approaches, principles and concrete steps will help participants respond to the common challenges shared by everyone interested in applying financial investment strategies for social and environmental gain.

Defining the “Push” Investing Past and the “Pull” Investing Future

Several decades ago, the hundreds of millions of dollars initially needed to launch and grow microfinance were provided with little or no expectation of financial return to the initial investors. One might characterize this investment as a “push strategy,” driven by the suppliers of capital:

- It was pushed by donors, philanthropic organizations (foundations) and governmental organizations, which in turn created the MFIs to deploy the funds.
- They pushed capital into microcredit because of its remarkable ability to create sustainable microenterprises started and owned by the poor.
- Philanthropic investors pushed it with little initial regard for whether the capital would be returned and, in many cases, limited understanding of whether it had been well deployed.

And it has been a successful strategy!

These early individual and institutional philanthropic investments demonstrated that poor people in developing countries could “help themselves” in a sustainable manner. These early philanthropic “investors” played the role of risk-tolerant angel investors as they helped capitalize a new industry. Nevertheless, they differed from traditional angel investors in that they had no expectation of an eventual liquidity event that would provide them with not only a return of capital invested, but a return *on* capital invested—a reward for their assumed risk.

Now, contrast this “push” flow of capital with the typical risk-seeking capital flow, wherein instead of being pushed, risk capital is “pulled” into a deal by the demand for capital:

- Entrepreneurs and investment opportunities pull early investors into investments with upside financial potential, and there is an expectation of future liquidity events. Typically, venture capitalists do not create the enterprises they fund; instead, entrepreneurs approach them with opportunities (and most venture capitalists reject more proposals than they fund).
- The early successes are tempered by early losses.
- If early success is sustained and scaled, this condition pulls even more capital, and mezzanine investors buy out early-stage investors as a new capital market is created.

Where this system works well—and there are numerous examples—great wealth is created, and revolutionary businesses are born. Along the way, the providers of capital come to learn about the risks and returns associated with the new businesses and investment strategies in part because they expect, accept and analyze failed investments. Furthermore, the investment opportunities become more standardized and the emerging markets form the necessary infrastructure to facilitate future flows of capital.

In the rush and enthusiasm for creating new capital markets that support blended value systems, investors must not forget this axiom of investing:

Mainstream capital is not brave. It does not like going places where the rules are unclear or subject to multiple interpretations. It does not like to go where the expected returns are not calculated clearly and plausibly and where the risk is not fully detailed and explained.

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Furthermore, mainstream capital does not flow to investments simply because it might have positive social impact. In fact, conventional wisdom suggests that pursuing financial return on investment (ROI) is agnostic at best and antithetical at worst to social return on investment (SROI). Blended value investing stipulates that investors *can* generate both types of value as an integrated, blended return, but it recognizes that investments must provide the reasonably predictable potential to generate financial ROI to attract (or pull) capital into deals in the first place. Without the potential for ROI that approaches the risk-adjusted market rate return, investments will be confined to philanthropic capital flows and will never have access to the much larger mainstream capital flows that have ROI as their highest priority. Importantly, such investments do not necessarily need to offer large ROIs; instead, it is crucial they have relatively predictable returns subject to well-understood risks. This mainstream capital currently is not flowing to blended value investments in large enough volumes, and the only way to pull it toward these investments is to structure them so that they can generate financial returns.

Blended value market participants must ensure that the present enthusiasm does not eclipse the tasks and disciplines required to build a functioning, efficient, liquid, self-correcting capital market that will provide ongoing, *sustainable* value for investors and entrepreneurs. The balance of this paper will present the core elements necessary for the creation of an effective, vibrant emerging market not simply for microfinance, but for the entire blended value arena made up of microfinance, social enterprise, for-profit social ventures and, indeed, any alternative financial offering that seeks to combine financial returns with social and/or environmental value creation.

Bringing such a global infrastructure into existence will not be easy. While this paper sets out a series of goals, the path to reach them is not clear, nor is achieving them at all assured. All practitioners need to assess what structures must be created and—perhaps more importantly—what business and investment principles must be maintained in order to achieve these goals. As explained later, these emerging markets require not only new and refined investment products and infrastructure, they also need participants to conduct their business with greater transparency, being more publicly thoughtful about failures and mistakes. A fundamental first step in building this infrastructure is for all potential investors in *any* investments that aim to generate both financial and social returns to vet each offering according to the degree to which the investment under consideration meets the relevant conditions described below.

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Creating an Emerging Capital Market Framework for Blended Value Investing

It is especially useful to examine the infrastructure of successful mainstream financial markets to evaluate the blended value capital markets' infrastructure. Mainstream financial markets work for both investors and those seeking new capital because they allow investors to evaluate potential investment risk/return objectively. Virtually any mature industry that has grown to scale and has attracted private capital has in place the following elements:

1. Common terminology
2. Transparency
3. Adherence to standard accounting practices
4. Regulation by third parties
5. Investment rating services
6. Fund comparison data
7. Insurance
8. Liquidity through secondary markets

Microfinance is the most well developed example of blended value investing. The industry has grown in 30+ years such that at this time is has millions of borrowers, thousands of lenders (MFIs), billions of dollars in loan portfolios, and countless donors and investors with a great deal of money looking for "investment" opportunities. Further, perhaps as many as 1,000 (an estimated ten percent of the total) MFIs are profitable in one way or another.

At first glance one might conclude that this industry represents a "breakout" – an industry delivering a true blended value return and doing so at scale. Upon closer examination, one must conclude that as good as it is, microfinance still has not developed the requisite infrastructure needed to attract mainstream capital.

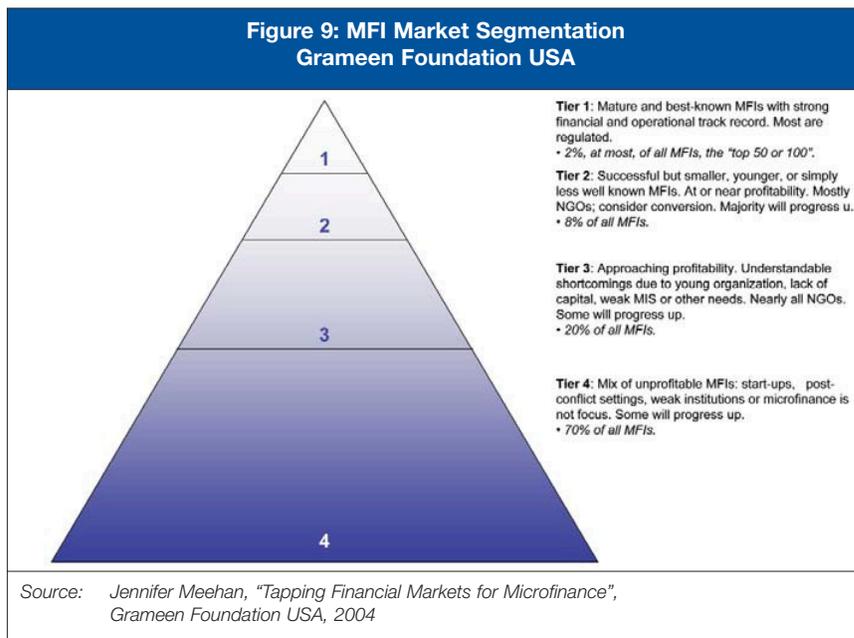
Tier-One MFIs and the Overall Market Critique

Microfinance experts segment the MFI market in a variety of ways, often referring to different "tiers" of MFIs, depending on their professionalism and financial health. (See figure 9 for one such segmentation.) Commonly, these experts distinguish about two percent of all MFIs as "tier-one", meaning that they have established track records, highly professional operations, healthy finances and,

often, many of the characteristics of commercial banks. Many are affiliated with ACCION, Grameen and other prominent MFI networks. Tier-one MFIs have developed significant scale and expertise in structuring capital to advance social and financial returns. Through both leveraging subsidies and loan guarantees effectively and by securing market rate capital, these groups and their peers have lead the overall field in its development and expansion; they pioneered and disseminated microfinance's best practices.

At the same time, there are many more organizations—98% of all other MFIs—that may be pursuing (but are still lacking) many of the characteristics one would expect to find in formal capital market participants. The MFIs not included in the tier-one designation vary dramatically from one another, and the diversity in their business models, scale and financial health cannot be understated. While the Tier One organizations have succeeded in building networks and leveraging capital, they are not even close to the entire microfinance market. A vast majority of organizations both make up this larger market and fall well short of the operating capacities of tier-one institutions.

While some enterprises in microfinance and across the blended value investing universe do successfully exhibit market-leading characteristics, the state of the overall market lags those leading investments.



A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

The following section assesses the broad state of play within the blended value investing arena by focusing on the particular silo of microfinance. The critique of the broad field should not take away from the work and quality organizations that have been created by many individuals, nor should it be taken to apply to every MFI. Rather, *this assessment raises concerns about the overall state of the market and its implications for achieving real sustainable scale capable of tapping into mainstream financial service sectors.*

Market Characteristics Explained

1. Common Terminology: Any industry must be able to describe its inner workings to outsiders wishing to evaluate performance. Microcredit has done an admirable job of developing terminology and metrics that facilitate description and analysis of MFIs. Numerous industry descriptive manuals and financial models are available. Unfortunately, many of these descriptions and associated metrics were developed to identify, describe and quantify the subsidies that are available to non-profit MFIs. Most MFIs are still operating as not-for-profit entities today and, as such, account for their operating results using not-for-profit terminology, this language can be confusing if not misleading to potential investors, especially those who typically invest only in for-profit entities. For an investor to understand and evaluate the operational performance of a given MFI, there must be a clear delineation of subsidies and the role they have played and will play in the future performance of the MFI.

Even the contemporary measures of financial performance tend to evince MFIs' non-profit origins. *The Economist's* recent survey of microfinance makes this point clearly:

"The foggiest place in the industry is 'on the ground' (another favourite microfinance term), where familiar words suddenly become oddly unintelligible. An item labelled 'profit' lets you keep mum about the losses transferred to a money-losing charity affiliate. An 'operationally sustainable' business is one that can pay for its running costs but not its capital, which is often the largest single expense for a financial firm. But the worst thing are the acronyms, which make learned analyses of microfinance next to unreadable. All this may sound trivial, but industry practitioners seem to care deeply."⁷⁶

No matter whether those terms and acronyms are defensible or not, they clearly befuddle mainstream financial actors as represented by the authors of the article, whose statements suggest that microfinance's vocabularies make the industry appear parochial and quaint.

A second and more problematic issue with terminology is that no consistent and objective measure of impact is promulgated. As the capital markets develop and capital is "pulled" to microfinance, there should be objective standards by which investors can judge the social impact of their investment. Unfortunately, what passes for impact measures today is usually a simple tabulation of microborrowers served and the average size of their loans. Many MFIs have established their own impact measurement regimes, but there appears to be little successful effort to pull those measurement schemes into a single unified approach.

Opportunities for improvement:

- Commercial financiers and regulated MFIs could continue to develop a common set of terminology that reflects the language and assumptions of mainstream international capital markets.
- After MFIs have standardized their language around inputs and financial performance, foundations and other NGOs might sponsor impact-assessment studies by independent third parties and academic research professionals.

2. Transparency: As not-for-profits operating in developing countries, many MFIs have few public reporting requirements. The transparency of the industry is driven primarily by two factors: the decision of individual MFIs who voluntarily make their results public and the mandatory reporting performed by the MFIs that are regulated and therefore obligated to report results. Even with this level of transparency, rigorous evaluation of MFIs is difficult. MFIs in many parts of the world now voluntarily report results to industry associations and these results are aggregated and benchmarked. For investors wanting to analyze an MFI and to compare results to other organizations by size, geography, product, etc., the transparency issue is problematic.

A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

Organizations like the Microfinance Exchange (MiX) are working to increase outsiders' access to the characteristics and performance of MFIs, but that information is voluntarily provided and in some cases may not be current. While many MFI investment funds and MFI networks have detailed information about the MFIs with which they work, that information is not necessarily being shared and aggregated in any one place so that the MFIs' initial transparency becomes opaque.

Opportunities for improvement:

- Market participants can encourage efforts like MiX and related efforts.
- Investors and MFI networks can combine due diligence and isolated market intelligence from various actors, making them available through clearinghouses like MiX.

3. Adherence to Standard Accounting

Practices: Many MFIs operate as not-for-profit organizations, and many control wholly owned subsidiaries engaged in related endeavours. Furthermore, most MFIs are not audited, and those that are tend to use small, country-based auditing firms. While many such firms utilize International Accounting Standards (IAS), application of these standards remains questionable. For investors, this condition poses a problem.

Opportunities for improvement:

- Market participants can form a reporting standards-setting board like the International Accounting Standards Board used to determine generally accepted international accounting standards. Such a board can focus on fitting international accounting standards to microfinance instead of creating a new set of microfinance-specific standards.
- Any emerging accounting standards must incorporate means of tracking subsidies as well as their intended outcome.
- Individual investors and funds can then demand financial statements prepared in accordance with those standards.
- Lobbying in appropriate legislatures can ensure that the international accounting standards will fit the emerging regulatory regimes for MFIs.

4. Regulation by Third Parties: In the developed world, financial services businesses are regulated by governmental agencies. Alas, it is not often the case with MFIs. In the developing world there is often, at best, a loose regulatory framework either in place or under development.

The net result is that MFIs *function* as banks but are not *regulated* as banks. Such mandated performance requirements such as capital adequacy, liquidity, reserves, reporting, etc. are often either non-existent or ignored. MFIs tend to be viewed by their host governments as NGOs (non-governmental organizations) and are relatively free to operate as they wish with virtually no oversight. For investors this condition poses obvious risks.

This condition varies dramatically depending on MFIs' corporate structures. In some countries, NGO MFIs can make the same loans as can regulated MFIs, while the latter will be bound by much more stringent regulations than the former. Countries that do regulate MFIs have regulations that vary from one another dramatically (allowing or not allowing MFIs to raise capital in certain ways, promulgating different capital adequacy requirements, etc.), which forces potential investors to become experts in a variety of regulatory regimes.

The question of regulation is complicated by a number of factors. First, many MFIs are NGOs and therefore not regulated as financial institutions—but some are indeed regulated under other frameworks. Second, regulations differ from one country to the next (coordinating them would be overwhelmingly daunting). Finally, on a case-by-case basis, some of those regulations might be cumbersome and burdensome. In general it should be acknowledged that this is a significant issue being addressed by a number of actors.

Opportunities for improvement:

- Investors like ProFund can help MFIs convert to regulated MFIs.
- Market participants can support the creation of third-party international recommendations or templates for MFI regulations.

5. Investment Rating Services: Within mainstream capital markets, most investors are unable or unwilling to conduct the type of comparative analysis that leads to sound investment decisions. Instead, they rely on third-party credit rating entities such as Moody's, Standard and Poor's and others. The microcredit industry has not developed in a way that has prompted the development of independent rating agencies, a problem that may remain in place until MFIs and their associated financing deals grow sufficiently large to warrant the cost and attention of mainstream ratings agencies.

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Early investors did not expect a “financial return” on their philanthropic investments so they had no need for ratings. Microfinance agencies do exist, but unlike the large rating agencies, these microcredit-specific rating agencies look only at microcredit. Accordingly, mainstream investors see such agencies as lacking credibility, sometimes reporting in terms that do not coincide with those used in mainstream investing. As microfinance and related industries begin to attract funds from risk-seeking investors, this lack of rating services will pose significant problems for achieving meaningful scale. Furthermore, standardized and reputable rating agencies will lower the cost of investments’ due diligence, which currently exceeds the typical costs associated with initiating similarly sized investments in more mainstream markets.

Opportunities for improvement:

- Ratings services such as Standard and Poor’s, Moody’s and others must have incentives to enter this realm
- Local branches of some of these agencies have rated some MFIs (see ACCION affiliates section); their experience would surely be valuable in expanding the practice.
- Here, a “smart subsidy” or creative blended value investment would advance the cause if it could creatively encourage the mainstream ratings agencies to develop microfinance rating methodologies and to overcome the hurdle of scale.
- MFIs need to see value in being rated, and so financiers and foundations alike can give them incentives—in the form of a lower cost of capital or a subsidy to purchase the rating services—to be rated by an appropriate agency.

6. Fund Comparison Data: While there is some public information to allow comparison between MFIs themselves, virtually nothing exists to allow investors to compare the operating results of the increasing number of funds investing in MFIs. For a variety of reasons, these funds are likely to be the vehicles of significant capital flowing into microfinance. There are between 50 and 100 of these funds in operation today around the world—with more on the way. Virtually all of them are private funds and publish little to no public data. A prospective microfinance investor has little if any means of finding a complete list of funds, comparing their investment terms, and understanding their investment results and non-financial impact.

The MFI fund world is relatively small, with relatively few actors. Accordingly, the information on past funds should not be difficult to aggregate. Nevertheless, the relatively early stage of many of these funds (which have not fully repaid principal lent or have not liquidated equity investments) makes some of them hesitant to share data. A recent report published by CGAP aggregates data (as of 2004) on many foreign funds (though the data are not rendered for side-by-side comparison).⁷⁷ The report indicates that many of those funds shared investors. Some funds have been focused on keeping their investors through emotional appeal (characteristic of not-for-profit investors) instead of through a clear statement of performance and a comparison to the investors’ other options.

Opportunities for improvement:

- MFI fund investors need to invest on the basis of expected performance and should demand performance and comparison data.
- An independent group should study existing funds and assemble the data in a way that makes comparison easy.
- The industry would also benefit from a definitive forum (a *Wall Street Journal*, of sorts) in which fund managers can announce and promote new funds and where existing funds can report performance data.

7. Insurance: Most investors, or the funds in which they invest, are able to obtain insurance to help manage risk. The microcredit industry has yet to develop the scale necessary to interest the insurance industry. Accordingly, such things as foreign exchange risk, errors and omissions risks, directors and officer’s risk, asset appropriation risk, political risk and others are generally uninsurable. While there is some ability to account for these risks through aggressive underwriting and risk sharing within funds, most investors would appear to have few options and relatively little appreciation of the true relative risk associated with an investment in microcredit or similar offerings.

Opportunities for improvement:

- The small scale of MFIs (relative to mainstream financial institutions) will remain a barrier to creating these insurance products, but mainstream insurers operating in MFIs’ home countries may have the means and experience to offer such products.

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- Early iterations may need to be subsidized by other (possibly philanthropic) actors who might provide assets to underwrite policies that would be administered by the mainstream insurers.
- Ultimately, as the insurers learned more about the associated risks, mainstream underwriting capital would enter the market.

8. Liquidity through secondary markets: At the risk of stating the painfully obvious, for a true capital market to exist there must, in fact, be a market. Clearly, there is a primary microfinance capital market where equity is placed or loans made. From that point on, virtually all of the equity and debt invested in microfinance is simply illiquid. It can not be traded or sold freely among willing investors. This simple fact makes it very difficult for the average investor to consider taking a position. At present there is not even discussion among those in the microcredit industry on how or when a secondary market might develop.

Opportunities for improvement:

- The conditions above suggest that there is not yet the demand to buy microfinance investments on a secondary market; instead investors seem interested in investing their capital in new issues, in part because those new issues directly help poor entrepreneurs, while transactions on a secondary market would not.
- Spurring a secondary market when there seem to be no buyers would be a dubious prospect, and creating such a market place before it is demanded would amount to a new “push” investment strategy that would likely not bear fruit.
- Pushing MFIs and investments to adhere to the conditions enumerated above would help make a secondary market more viable and likely.

Implications for the Creation of a Blended Value Capital Market

Moving the entire industry in the direction of the tier-one institutions (and even beyond them) will be very difficult. Traditional market forces will certainly push some institutions in the right direction (indeed, those forces are already doing so, and they are bringing mainstream commercial banks in to microlending in many parts of the world). Nevertheless, subsidies—some with very legitimate social-value creating outcomes, and some with counter-productive outcomes—will prevent the entire sector from looking like those tier-one institutions.

At a recent conference on microfinance, Bowman Cutter, Managing Partner of Wall Street investment firm Warburg Pincus and Chair of the Board of microfinance fund Microvest, shared his perspective on the state of the microcredit capital market. Cutter spoke at length about the effort, time and resources expended to bring Microvest into being.⁷⁸ He observed that he and his colleagues created from scratch virtually all of their work; they had no templates or standard procedures to use as models. He observed that if every step toward building a microfinance capital market turns out to be as hard as starting Microvest, maybe the industry should rethink its strategy.

Fortunately, Cutter also provided real hope. He noted that he started in the investment banking profession more than 30 years ago. At that time, the profession was effectively in a start-up mode and that everything they did then was a “one-off” creation. He noted that today investment banking is a robust and very successful industry attracting and successfully managing billions of dollars annually and that microcredit feels like investment banking did 30 years ago.

The success of investment banking was built on a firm's appetite for capital and an investor's desire to put capital at risk. That situation exists today in the broad range of BVI investment opportunities. The microfinance business needs many billions of dollars to fund loan portfolios so that hundreds of millions of people can begin to create income and wealth and ultimately raise themselves from poverty. Similar demand for capital exists in the BVI segments that would fund affordable housing and community development, environmental protection, health, education and related services for the poor in all countries. As was the case in microcredit

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there are many case studies that could have been added to those in this paper to make the point that there are successful, hard-won interventions already in the market.

However, there are a number of steps that precede the creation of this blended value capital market.

Silos Versus Value Chains

First, blended value market participants, both investors and investees, must collaborate across their relative areas of interest (for example community development finance and banking actors could work more directly with microfinance practitioners to address common challenges). All should work to “come out of their silos”.

Silos breed isolation and the need of every organization in a given field of endeavour to do everything in virtual isolation. When applied to industries such as microcredit or community development, it means the major players within their respective organizations are both vertically and horizontally integrated. They build their organizations and attendant support structures. Because the connecting tissue that ties entities together into value chains is not present, they go about doing everything for themselves. They develop no set of core competencies that when paired with others with different core competencies allow the formation of a true network of firms all aligned in their purpose and relying on each others' strengths to add value to the end customer.

These value chains or collaborative networks are how business is done in the for profit arena. One need only look as far as a Wal-Mart, Boeing or Cisco Systems to see business models based, at their very foundation, on the assumption that networks add value; going it alone does not.

What are the implications of this for those interested in building a blended value capital market? Leaders in the various BVI areas could construct value chains, ensuring their organizations develop core competencies and distribute common work. What is more, they should reach out to existing players operating outside their BVI area and enlist them in this effort.

This is exactly what the Calvert Foundation did by going to the Depository Trust Company (DTC) to handle the clearing and holding of community investment notes. The foundation knew this service was vital to its business model. It also knew mainstream investors require such a service. Rather

than build an alternative or survive without it, Calvert Foundation created with DTC a value chain that added value for the customer. In reflecting on how the case studies presented in this paper evolved, one is struck by how often the successful initiative was characterized by the sponsor reaching out to others and building value chains.

Value chains are resource-conserving by design. A successful value chain involves bringing together the best firms in a way that minimizes overlap or redundancy. Who, exactly, benefits when redundancies are eliminated and the very best players are joined along a line where each is there because of a core competency? Quite simply, everyone. Scarce resources are preserved, firms are there because they add value in their areas of strength and investors get the best return because the customers get the best good or service at the best price. The value chain should become the model of how every BVI initiative is organized.

The second and concluding thought is that this process will take time—a lot of time—and will require the building of systems that are, today, not in place. The time is necessary because, at its most basic, building successful BVI initiatives capable of attracting and rewarding large amounts of capital is about changing culture—the culture of traditional financial services groups, NGOs, foundations and other participating entities structured to address the needs of either for-profit or non-profit actors. Conceptually and technically, it really is not hard to imagine microcredit or affordable housing or community development being able to arrange themselves into competitive value chains. In most cases the leaders of the various BVI segments have a foot in each world, the economic and the social. Their employees, boards and stakeholders expect them to be mission-oriented yet financially successful. That is very hard to do and requires that culture change to accommodate the needed alteration in mission execution.

But if it will be hard for the operators of BV endeavours to change culture, imagine how hard it will be for investors. The dominant culture asserts that one cannot mix mission with money. Even the socially motivated investor merely winks at the notion that a very well-run microfinance institution can address poverty and earn a respectable return on investment. They hear the story and see the pictures but suffer a cognitive dissonance. This dissonance is, of course, what led the founders of the microcredit industry to initially approach philanthropists.

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A Progression of Investors

Many critiques of microfinance-backed assets address barriers to the widespread adoption of those securities by institutional and other mainstream investors. While emerging blended value capital market participants must not forget this investor segment is its long-term goal, it would be wise to pursue a systematic plan that will bring these investments ever closer to that mainstream investor pool by targeting other strategic investors who can help advance the cause.

Most institutional investors require a defined asset class (wherein the securities bear a certain uniformity of structure so that the securities' behaviour can be better understood if not predicted). Most mainstream market participants would assert that most blended value investment products can not yet be considered legitimate members of an asset class. In spite of the recent and effective productization of microfinance bonds, the issues remain too different, there remain too few of these securities, and they have existed for too little time for financial analysts to understand their aggregate behaviour.

Furthermore, institutional investors with fiduciary responsibilities will often not even invest in a new fund or investment product in the mainstream capital markets. Typically, professional investors will avoid fund managers and funds that do not have a demonstrated multi-year track record of managing that particular investment with that particular investment style. They do so because they need to build the expected performance of any given investment into sophisticated asset allocation and portfolio models. As long as such quantitative models are built on historical performance information, such investors will need to wait for years until blended value securities can reach sufficient scale and can generate several years of performance data. This condition is a factor of time and it cannot be accelerated.

Instead, market participants offering blended value investments can target other investors strategically (as indeed many already have). Currently, it is a rare blended value investor who can construct a reasonably diversified portfolio even of microfinance-backed investments. To do so, investors must have sufficient capital (in the tens if not hundreds of millions of dollars) to dedicate to such a portfolio, and they must have a dedicated staff that can research potential deals and can thoughtfully assemble it.

Thus far, many of these investors have been development banks and foundations that have both the scale of investment and staff to effect it. This condition leaves high net worth individuals—those with limited staffing resources and a desire to deploy capital in the hundreds of thousands to the low millions of dollars—limited options for blended value investing. As more and more such investors express interest, there may be a place for investment funds that can syndicate high net worth individuals' investments and then place those funds into a well-diversified portfolio of blended value investments. Such intermediaries could help these investments get “pulled” closer to mainstream investments by making them accessible to the next stage of investor (after the way has been blazed by development banks and foundations). If these financial intermediaries build properly diversified portfolios, they will be able to sustain the occasional inevitable losses on individual investments.

When high net worth individuals can buy blended value investments, they will eventually and increasingly ask their professional wealth advisers to incorporate such investments into their overall portfolios. Those advisers, in turn, will bring a new set of mainstream capital resources to bear on these emerging investments as they research and analyze these new investments.

Accordingly, blended value market participants should continue to focus on “socially responsible investors”, individuals who would purchase blended value investments first because of their expected SROI and second because of their expected ROI, because those investors can help these asset classes establish a track record and because they can bring additional resources to bear on the analysis of such assets. Nevertheless, in doing so, advisers and investors must diligently focus on the fundamentals and risks of such investments as though they were purchased purely for their expected ROI.

Failing Forward

In any market, particularly an emerging market that has few precedents, there will be occasional imbalances of supply and demand. At times prices will be too high, and at other times they will be too low. As the markets learn to price risk and digest market and non-market events, prices will likely swing; some people will make money, and some will lose. The blended value capital markets must anticipate this sort of volatility and must face it without avoiding it.

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Market participants should structure their investments so that market shocks engender market corrections, not market collapses. Keys to doing so are diversification (at least in terms of geography, financial instrument and fund managers) and conscious risk mitigation. As mentioned elsewhere in this study, foreign exchange risk remains largely unmitigated in many international blended value financing strategies. Drastic currency devaluations have the potential to destroy returns and collapse private-investor-supported markets for international lending unless market participants can develop facilities to understand and begin to manage foreign exchange risks.

Fortunately, a number of such initiatives are under development. Investment advisers such as Omtrix and others have been at the forefront of advancing such foreign exchange hedges where they have not existed in the past.

Furthermore, open communication about investment methodologies, pricing, failures and equity-holders' profits will be essential to pricing these blended value investments correctly. Keeping the data private introduces the chance that other funds will erroneously price risk. When substantial capital enters (or fails to enter) a market based on mispriced risk, that market is prone to dramatic failure. Markets cannot accurately price the risk associated with their securities unless they openly explore failures as well as successes.

Investors must also be exceedingly rigorous about entering and exiting investments. They must be especially careful to understand how the drive to create SROI can affect an inclination to enter ill-advised investments and their decisions to exit (or not exit) underperforming investments. Investors must have the fortitude to take losses and cut off investments that are not obviously salvageable.

The emerging blended value capital markets simply cannot afford for participants to be secretive about their data, ashamed of their failures, or fragmented in their terminology.

Conclusion

This paper explores various capital structures that have successfully been used to finance microfinance, community development and related areas. We suggest these blended value investing practices be extended to other value-generating projects or sectors. It must be stated that such a progression will not be easy, swift or painless. Microfinance has the benefit of over 30 years of refinement—a three-decade head start on other blended value investments. Furthermore, microlending itself has some very appealing characteristics that are not necessarily shared by other blended value strategies. The fundamental economics of microfinance are so strong because they are built on many loans to many people diversified across business sectors. Given that those microentrepreneurs are operating in predominantly cash-oriented economies, often times providing essential goods and services, they are somewhat insulated from macroeconomic fluctuations. Furthermore, those entrepreneurs can shift their businesses very quickly, exiting and entering new business areas as conditions dictate.

Other potential blended value investment vehicles may not possess such appealing risk-reward fundamentals. Accordingly, investors and intermediaries will need to structure and price investments such that they account for those unique risk characteristics. Microfinance's lessons cannot be applied wholesale and unthinkingly to other blended value investment systems. Nevertheless, the market participants aiming to bring new capital flows to low-cost housing, small scale irrigation, and so many other systems can and should learn from the laborious 30+ year journey that microfinance and its capital markets have undertaken. Undoubtedly, much can be learned from careful research into the major microfinance innovations that led it from a philanthropically supported enterprise to one supportable by mainstream capital. Building upon the great strides made by those within microfinance and community banking, sustainable financial innovations hold the promise of expanding into countless areas of both social need and market demand.



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On the Frontiers of Finance

Investing in Sustainable SMEs in Emerging Markets

A Discussion Paper for the Geneva Private Capital Symposium

September 24th-25th, 2007

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Research supported by:



Section 1

1.1 Introduction

Small and medium enterprises (SMEs)¹ are a critical component of vital economies. They play an important role in innovation, economic growth, employment creation, and the provision of goods and services to underserved communities, especially in rural areas. Sustainability oriented SMEs that work in environmental sectors or those that serve low-income communities generate additional benefits for society and the environment. Through its New Ventures Project, the World Resources Institute has promoted the creation and growth of such enterprises in emerging economies since 1999. With the sustainable enterprise sector gaining considerable momentum, we feel that it is timely to offer some scrutiny of our own experience from working with entrepreneurs and investors, as well as that of other practitioners in the sustainable SME finance sector. We teamed up with the Boston College Institute for Responsible Investment (IRI) to compile the information and provide it as a basis for discussion in this paper. With the support of the UN Foundation the IRI convened two working groups of Sustainable SME funds during 2006. The purpose of these dialogues was to promote greater understanding of the impact of these funds and to identify ideas to overcome the challenges they face in achieving scale.

New Ventures - A new way of doing business

WRI's New Ventures Project works with profitable SMEs that safeguard the environment and engage local communities. Our initiative serves as an accelerator for innovative business models that deliver triple-bottom-line benefits by tapping into new market trends from Brazilian fuel cells to rural WiFi access in Asia.

Working in Brazil, Mexico, China, India and Indonesia, **New Ventures** identifies outstanding entrepreneurs, helps them improve their business plans through training and one-on-one mentoring and connects them with investors. We have supported more than 150 SMEs that have attracted over \$43 million in investment, grown their revenues, supplied to large international business and become leaders in their sectors.

Much of this paper is informed by interviews we conducted with 20 fund managers that operate SME funds in emerging markets and developing countries, most of them focusing on sustainable SMEs. In addition we convened a group of these 17 fund managers at a workshop co-convened with the International Finance Corporation (IFC) in May 2007. An overview of the funds and their investment models is provided in section three and in a summary matrix in the annex.

The aim of this study is to provide an overview of the current landscape of sustainable SME finance, clarify key challenges, and inspire discussion among fund managers, investors, entrepreneurs, and the donor community. We see a clear demand for an action oriented dialogue on how the sustainable enterprise sector can best be supported to reach scale, attract additional finance and become more effective in meeting return expectations and development goals. We invite you to join this process and welcome your comments and feedback on this paper.

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¹ As a global orientation to define SMEs, the IFC established a metric in 2003 that defines a Small Enterprise between 5 and 49 employees, and a Medium Enterprise between 50 and 250 employees.

This paper is divided into five sections:

1. Our rationale for supporting sustainable SMEs;
2. A summary of the key issues in SME finance;
3. An overview of the VC funds and Capital Aggregators surveyed for this paper;
4. A discussion of these funds' major challenges and innovative financing models;
5. Suggestions for bringing the sustainable enterprise finance sector to scale.

1.2 Why focus on sustainable SMEs?

The focus of this paper is “sustainable SMEs”, in particular sustainable SME finance. We define sustainable SMEs as companies that capitalize on commercial opportunities while generating environmental and social benefits as part of their core business. For example, these companies could be operating in the renewable energy, healthcare, organic agriculture and housing sectors. Through a series of interviews with leading practitioners, we have identified the financial structures that are being used to direct capital to sustainable SMEs in developing countries and emerging markets and analyzed key elements of their business models.

We believe that targeted investment in emerging economy sustainable SMEs makes good sense for both business and sustainable development. While this view is not uncontested, there are many arguments for targeted support to these SMEs that corrects market failures and allows these companies to realize their full potential to contribute to dynamic, healthy economies and societies. In addition, sustainable SMEs can make tremendous contributions to environmental protection, poverty alleviation, improved quality of life and also provide the innovation and role models required to chart out more sustainable models of economic development. The benefits provided by sustainable enterprise can be divided into three categories:²

- Economic benefits: monetary benefits to target populations, such as increases in employment and wages; taxes paid; cost savings; enhancement of overall economic environment;
- Social benefits: improvements in the quality of life of the target populations;
- Environmental benefits: reduced energy and resources consumption; land and species conservation; improved air and water quality, among others.

Economic benefits

SMEs promote development and alleviate poverty by increasing competition and innovation and creating jobs. The development impact of jobs created by SMEs is noteworthy because they primarily employ local, low-skilled labor and make significant investments in training.³ SMEs also make important contributions to the formalization of

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² Kramer, Mark and Sarah Cooch, Foundation Strategy Group, Investing for Impact: Managing and Measuring Proactive Social Investments. January 2006.

³ Small Enterprise Assistance Funds, 2005. The Development Impact of Small and Medium Enterprises: Lessons Learned from SEAF Investments. Washington, DC.

the economy, by creating enterprises that pay taxes. Unlike microenterprises, which generally do not pay taxes, or some large firms, who have political power to avoid taxations, the tax contributions by SMEs can support the public sector as they generate private returns. In addition, the SME sector serves as a fundamental link in the supply chain between small-scale producers and urban, national, or export markets, and SMEs often operate in underdeveloped markets, especially in rural or impoverished urban areas that lack the infrastructure necessary to support larger scale public or business activity.

Those who question the effectiveness of SMEs as providers of economic benefits argue that larger firms exploit economies of scale and invest more in research and development. They further assert that SMEs are neither inherently more labor-intensive nor better at job creation, and thus do not provide additional poverty alleviation.⁴ However, our experience is that SMEs driven by local entrepreneurs can exploit market gaps and, given appropriate financing and business support, can become stable employers in the long term with the potential to grow into large enterprises and employers.⁵

Selected arguments for and against SME development contributions	
Arguments for SME contributions to growth and poverty reduction	Arguments against SME contributions to growth and poverty reduction
<ul style="list-style-type: none"> ○ Enhance competition and entrepreneurship, which increases the economy's efficiency, innovation, and productivity growth. ○ Generate disproportionate share of new jobs, many of which engage low-income groups. ○ Support the formal economy, contribute to tax revenues, and often serve underdeveloped markets. 	<ul style="list-style-type: none"> ○ Larger firms are better able to exploit economies of scale and invest in R&D, thus improving an economy's efficiency, innovation and productivity growth. ○ SMEs do not provide more jobs, neither do they provide more labor-intensive ones.

Social benefits

SMEs have a vested interest in contributing to the well-being of the communities they are a part of. They often invest in local education, health and infrastructure, and contribute to building social capital by supporting local initiatives and empowering women employees. In comparison to large firms, SMEs are also more likely to re-invest profits locally.

SMEs can turn their superior knowledge of local circumstances into a competitive advantage that benefits the community as well as the company. SMEs are in an advantageous position to understand market opportunities that address unmet needs in their communities, such as access to clean water, health services and housing. Similarly they are very suitable providers of products and services that empower poor people, such

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⁴ Beck et al.'s 2005 study of emerging economy SMEs fails to support the conclusion that SMEs exert a causal impact on long-run growth or poverty alleviation. However the study also falls short of showing any negative correlation. Beck, Thorstenl. 2005. "SMEs, Growth, and Poverty: Cross-Country Evidence" *Journal of Economic Growth*. 10(3), 199.

⁵ Biggs, T. 2006. *Is Small Beautiful and worth of Subsidy: A Literature Review*. (Available online: www.bidnetwork.org/artefact-39422-en.html), p. 3.

as microfinance or affordable telecommunications. Moreover, because of their understanding of local culture, SMEs are well positioned to engage low-income communities as producers, for instance through support for agricultural co-operatives.

Building opportunities for marginalized communities

Fideos Coronilla is a Bolivian-based company that offers organic, gluten-free snacks made from traditional Andean grain. The company purchases the grains for its products from local farmers' cooperatives, directly benefiting 6,800 farmers and their families. One of Coronilla's inputs, the rare Andean grain cañawa, is grown in remote and isolated areas of the country. The population of these isolated regions belongs to the poorest of the poor in Bolivia and the sales to Coronilla are helping greatly in raising their living standards.

The company is also an important source of employment, training and education for the community. Coronilla provides employment and benefits, such as healthcare, milk subsidies and formal education, to more than 30 workers a high-proportion of which are low-skilled and female. The company contributes to a local educational organization, coordinates educational meetings on health and hygiene and sponsors a student award. As a result Coronilla's employees are healthier than the average local worker and have increased the chances for their children to lead healthier and more productive lives.

Additionally, many SMEs engage in business that preserves and enhances local culture, such as arts and crafts, sustainable agriculture or forestry, and – if well managed – eco-tourism. The example of Fideos Coronilla highlights the difference a socially oriented company can make by engaging marginalized communities as employers, employing low skilled labor and providing critical benefits and support to the community.

Environmental benefits

SMEs that address environmental challenges primarily operate in the following sectors: clean technology, renewable energy and energy savings, organic agriculture, certified forestry, eco-tourism and green construction. The deterioration of ecosystems and their

Transforming coffee supply chains

Richard Trubey and the rest of the team behind Solar Trade Corporation (STC) have created an innovative coffee drying system powered by biomass and solar energy that cuts nearly 90 percent of electricity and eliminates the use of fire wood or diesel in coffee drying. STC is also offering hermetic storage systems that preserve the quality of dried coffee at origin and in transport. With its Café Solar® brand, STC aims to transform the coffee supply chain.

STC's comprehensive approach gives local farmers the independence to dry and store their own coffee while providing a 34 percent production cost savings. STC is also using its low-emission system to capitalize on emerging opportunities in carbon-trading markets. The enterprise is working with the government of Honduras to set a goal of transitioning 1/3 of the country's coffee production to solar power and design a carbon market for trading by producers. Farmers using the STC system will easily out-compete producers using conventional dryers that consume large amounts of increasingly expensive energy.

decreasing ability to provide natural resources and vital regulating services, such as the climate system and water cycles, is creating market opportunities for products and services that address these challenges. Some sectors such as renewable energy, and organic food products have already developed strong commercial potential in developed markets and are increasingly profitable in emerging economies. Sustainable SMEs tap into these opportunities, innovate locally oriented solutions to environmental challenges and drive the development of "green markets" that value environmental externalities.

Often, environmentally sound products are particularly relevant for developing country conditions. For example biomass, solar or wind energy can be well-suited to provide electricity in rural

and off-grid communities and in the process reduce the unhealthy and environmentally damaging use of firewood and charcoal.

Section 2: Overview financial actors

2.1 Types of SME finance and financial actors

In well functioning financial systems, SMEs are able to access a range of financing options as their business grows. For example, a typical SME in the US will start with a combination of personal savings, contributions from friends and family, debt from banks and potentially start up funds from angel or venture capital investors. As their needs change, SMEs can access additional sources of capital, including trade finance/supplier credit, factoring, leasing arrangements, commercial debt, private equity (venture capital) and ultimately aim for an initial public offering to obtain further financing.⁶ Each of these options brings firms into contact with different financial actors and the sources of capital that are best suited to different parts of the business cycle. The ability to graduate from one form of financing to the next is critical to the company's success.

SMEs in developing countries typically operate in a less supportive environment. Often SMEs are too small for commercial lenders, and too big for microfinance institutions. Reasons for this situation are varied and include an incomplete financial institutional infrastructure, a lack of competition among local banks, restrictions on capital allocations by local investors, or macroeconomic policies that emphasize government debt. The lack of familiarity of banks with business opportunities in the SME sector, perceived risk, high transaction costs and asymmetrical information pose additional difficulties, compounded by lack of credit scoring mechanisms and experience with relationship lending – lending based on a close, long-term bank-borrower relationship.⁷ For providers of risk capital, the historically poor market for exit and low shareholder protection mechanisms are impediments to investment in developing countries.

Partnering with local banks: Shorebank, Shared Interest and Rio Bravo

ShoreCap International (a subsidiary of ShoreBank Corporation) invests in local banking institutions in developing countries. A key part of ShoreCap's approach is to provide technical assistance to investee institutions through its affiliate ShoreCap Exchange. Such assistance can encompass a variety of institutional capacity building measures, including transfer of specialized micro and small business lending technologies, as well as more specific training on assessing the environmental risks associated with investments.

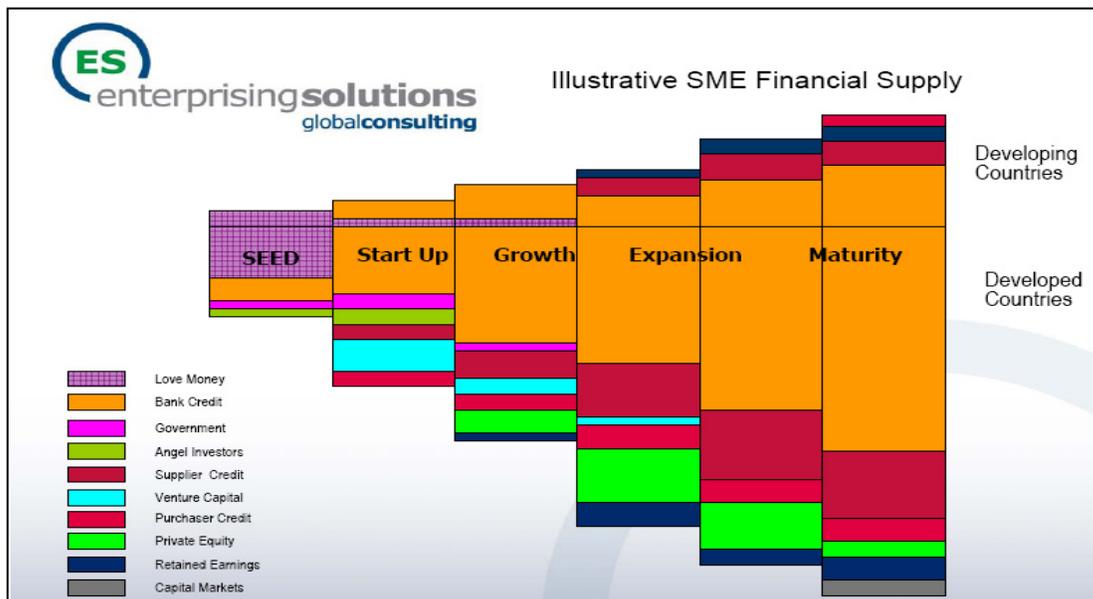
Shared Interest operates an open-ended, loan guarantee facility through a related entity in South Africa, Thembani International Guarantee Fund (Thembani). Guarantees are provided to businesses providing services to rural and underserved communities including micro-finance, low-cost housing, small manufacturing, retail businesses, and agriculture. Thembani works closely with local banks with a two-way referral service for clients. Thembani's guarantees allow these businesses to access loans that would otherwise be unavailable which, in turn, exposes local banks to the SME sector creating opportunities for them to gain a better understanding of these customers.

Rio Bravo, a Brazilian investment firm, is partnering with a large Brazilian bank for a \$125 million sustainability venture capital fund that is about to be launched for fundraising. The partnership will allow Rio Bravo access to the bank's extensive network of commercial relationships across the country and the bank in turn will gain experience in the field of sustainability driven business.

⁶ Hamilton, B. (1990). *How to Write a Business Plan*, contained in the US SBA publication *Financing for the Small Business* (FM-14). Online at: www.ussba.gov. OECD, *The SME Financing Gap*, Vol 1. p. 42.

⁷ Wendel, Charles B., and Matthew Harvey. 2006. "SME Credit Scoring: Key Initiatives, Opportunities, and Issues". *Access Finance*. (World Bank Group) No. 10, 1 and 6.

This combination of factors creates few incentives for banks and other financiers to expand their products and services targeted at SMEs. The situation is particularly difficult in rural areas and product sectors in which most sustainable SMEs operate because there are high sunk costs and unproven markets with which to contend. The following diagram provides an indication of the restrictions on the supply of financial capital in developing countries as compared to developed markets.⁸



2.2 The missing middle

The consequence of this market failure in the supply of capital to SMEs is a missing middle in the economic structures of developing countries, meaning that SME density drops below an efficient level and existing SMEs cannot realize their full potential to provide the attractive economic opportunities they could otherwise.⁹ The impact of this “missing middle” of SMEs is all the more acute when the relative contribution of SMEs to employment, innovation and as engines of economic growth are taken into account.

2.3 Growth of private equity in emerging markets

Although we have highlighted the restrictions on financing options for SMEs in developing countries, recent trends suggest that there is increasing interest among investors, both domestic and international, to place private equity investments in emerging markets. The foreign capital flows are driven by a number of factors, including the increasing allocations to alternative assets generally, greater understanding of the opportunities that emerging market firms present for investors, the existence of local co-investors which creates greater opportunities for exit or trade sale, and government

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⁸ Graphic prepared by Marc de Sousa Shields, based on his extensive consulting experience assisting developing market SMEs. The diagram is intended to be illustrative of the experience of his firm Entreprising Solutions Global Consulting (<http://esglobal.com/index.php>)

⁹ OECD. OECD Keynote for SME Financing Gap: Theory and Evidence. 2006.

policies that create improved financial stability.¹⁰ Attractive return prospects coupled with these improvements to the investment climate have led to substantial increases in flows of international capital to emerging market private equity funds. In 2006, private equity funds in emerging markets raised \$33.2 billion in capital commitments. This represents a 29 percent increase over the \$25.8 billion raised in 2005 and more than a 400 percent increase over the \$6.5 billion raised in 2004. Moreover, a 2007 EMPEA¹¹ survey of Limited Partner interest in emerging market private equity reveals promising trends. Just fewer than 80 percent of those interviewed expected to increase their commitments to emerging markets over the next three to five years.¹²

In addition to increased international flows, in many emerging markets, there is also a growing pool of local capital that is seeking out alternative asset classes, including private equity. With changes to macroeconomic policy making government bonds less attractive and growing pools of local savings through shifts to pension policies, local institutional investors are looking for ways to maintain returns and diversify their portfolios. There is also growing awareness of the virtuous cycle that is created for economic development through well-functioning financial markets and the need to harness local savings to contribute to facilitate market development.

Experience of the Small Enterprise Assistance Funds (SEAF) in Colombia and Peru

SEAF has a long history of investing in SMEs and proving the market for SME financing. To establish a fund in Colombia and Peru, SEAF, with the support of USAID, worked closely with the governments of both countries to amend regulations that restricted the investment choices available to public pension funds. These restrictions did not permit private equity investment limiting the funds' ability to diversify their portfolios.

SEAF tackled the problem with an integrated approach: The patient capital provided by USAID permitted SEAF to establish a fund administrator and build credibility in Colombia and Peru while it worked with the multiple regulators and the pension funds to identify the regulatory barriers, negotiate and draft the needed modifications and push the changes through the various levels of government. SEAF brought in experienced US venture capital and small business investors to make the case to the government and regulators, demonstrated its capacity to meet the transparency, valuation, fiscal control and reporting requirements for a regulated fund administrator and lined up a pipeline of potential investments. With a viable private equity investment vehicle and investment commitments from international development finance institutions such as SECO, BIO and USAID, the local governments had an incentive to approve the required regulatory amendments and the pension funds and insurance companies were ready to invest. The groundbreaking result was that, for the first time, pension funds and insurance companies were able to invest in private equity funds. As a result, SMEs in these countries were able to access regulated capital that had previously been off-limits. Opening the door to these new sources of capital is a critical piece of the development equation because it means that domestic resources can now be channeled toward helping the local economies grow.

¹⁰ The International Bank for Reconstruction and Development, "Global Development Finance 2007." The World Bank. Washington DC, 2007

¹¹ EMPEA is the Emerging Markets Private Equity Association founded in 2004, comprised primarily of private equity fund managers, but also includes institutional investors, service providers and others with an interest in the asset class.

¹² EMPEA, "Survey of Limited Partner Interest in Emerging Markets Private Equity." May, 2007

2.4 A view on sustainable enterprise finance in China

For Chinese entrepreneur Chen He, one would think that finding financiers for her Tianjin Lotus Biological Technology Company would not be a problem. After all, the firm, which produces non-toxic seed fertilizers that strengthen crop growth while reducing the use of chemical fertilizers, has been doubling its revenues for each of the last three years with annual sales now topping 675,000 RMB. However, Chen He has not been so fortunate. “I have not received any loans or any private investment. The banks and venture capitalists say my company is too small and that I have too little collateral to justify the risks,” explained Chen He. With the exception of a 70,000 RMB municipal government grant, she has invested over close to 3 million RMB of her own money into the company since its founding in 2003.

Chen He’s predicament reflects the continued financing challenges of China’s SMEs, which number over 4.3 million firms and account for 60 percent of China’s GDP. Despite the country’s booming economy and the massive surges in foreign investment, SMEs still find it difficult to raise the necessary capital to build up their businesses. This situation is particularly evident for smaller businesses and those in new sectors, such as the green industries that are being promoted by the government to counter China’s worsening ecological conditions. Of the \$420 million cleantech venture capital that was estimated by Clean Tech Venture Capital to be invested in China in 2006, very little made it into the hands of SME entrepreneurs, such as Chen Jing of the Jiangsu Ruikang Organic Food Corporation. With the help of some bank loans her small business has grown to a 10 million RMB gross revenue earning firm, but is still unable to attract venture capital investment. According to Chen Jing, the reason for her rejection is that the revenues are simply not big enough: “How can I grow without the investment? It’s like the old Chinese saying – having the horse run without feeding it grass!” When looking at potential firms, most venture capitalists use the benchmark of 50 million RMB in gross revenues, before taking a serious look at the growth potential of the business.

The reasons for SME’s financing struggle are not simply because of size. Stephen Guo is director of research at China Environment Fund (CEF), a fund that invests exclusively in Chinese green industries. According to Guo, venture capital investors are hesitant about the smaller companies because they often lack proven management and finance skills. “A lot of these businesses are run by people who are technical experts and not managers,” said Mr. Guo who meets as many as 80 firms a month.

To make matters even harder, China lacks a culture of angel investors, affluent individuals who are willing to front start-up costs during the difficult phase of setting up an enterprise. As a result, the remaining formal channels of capital for SMEs are the banks and government. But banks are reluctant about lending to the small businesses because of their little collateral and perceived inability to service their debt. Institutions that do loan require their borrowers to have their debt collateralized through credit guarantee centers, which can be extremely expensive. Ruikang Organic Food Corporation was only able to secure a 2 million RMB loan from the local bank after paying the credit guarantee center a fee of 500,000 RMB. Although this amount was later deducted from the principal borrowed, as a down payment it represents a prohibitive proportion of the capital requirements for many SMEs.

Liu Zheng, of the Shenyang SME Credit Guarantee Center noted that too many lenders inappropriately use the same measures of performance for smaller companies as they do for larger ones, and the risks are often overestimated. “For SMEs, non-financial factors are comparatively more important than the financial ones,” said Liu who uses the seven standards – character, ability, margin, purpose, amount, repayment, and insurance, when evaluating perspective clients. The center has provided guarantees for over 1,000 SME loans worth a total of 400 million RMB. Out of the total amount borrowed, bad debts accounted for less than .001 percent.

Fortunately, there is help. Organizations like the World Resources Institute’s New Ventures Program, which helps sustainable entrepreneurs improve their management and finance skills, while working with venture capitalists to invest in the more promising companies. The Chinese government is also trying to better the situation and reduce the bottlenecks of SME financing. Policies already implemented include a three-year business tax exemption for qualified SME credit guarantee centers. Another big boost has been the passage this year of a new property law, which should help SME collateralize their assets and secure bank financing.

What could be the biggest saving grace for sustainable SMEs is that China's deteriorating environmental problems have created enormous demand for new technologies and services. Deutsche Bank projects environmental investments in China to grow annually by 16 percent and reach a cumulative USD230 billion by 2010. With the ability to develop niche and cutting edge products, smaller firms are in prime position to capture the demand that could lead them to financial success. "China's environment needs all the help it can get. The more companies in the sector, the better it is for the environment," observed CEF's Guo. Indeed, the belief that they can make a positive contribution for China's development is driving many of China's small green entrepreneurs to overcome their struggles. "My product can really help farmers and protect the environment," said Chen He of the Tianjin Lotus Biological Technology Company. "I know the problems I am facing now are only temporary!"

Section 3. Overview of existing funds & Capital Aggregators

3.1 Information gathering

Recognizing the positive social and environmental impacts as well as the financial opportunities, that can be achieved through a vibrant sustainable SME sector, a number of innovative financial intermediaries are identifying ways to channel more capital to sustainable SMEs whether through direct investment or using other mechanisms to bridge the financing gap. Poor management is frequently cited as the principal reason for small business failure, with inadequate or ill-timed financing a close second.¹³ By providing access to the right sort of capital, at the right time, coupled with technical assistance and business development services, these funds are helping to create long-lasting businesses that have tangible environmental, social and economic impact.

In order to gain a better understanding of the ways that funds are overcoming the barriers to sustainable SME investment in emerging markets, we conducted 20 interviews with leading funds and convened 17 of them in a workshop with the IFC. The purpose of our interviews was to find out how the funds were structured and identify the challenges they are facing in bringing their operations to scale. In this section we provide a brief overview of the funds, while in the next we discuss their challenges.

WRI-IFC fund managers workshop

On May 8th, 2007, WRI and IFC hosted a workshop for fund managers that invest in clean technology, clean energy, and biodiversity in emerging markets. The event convened 17 fund managers from Latin America, Africa, Eastern Europe and Asia whose exchange of experience greatly helped to inform this paper. Discussion focused on fundraising, the project pipeline, technical assistance and monitoring and evaluation. From the workshop emerged a strong interest for additional networking opportunities, specifically for sustainability oriented fund managers from or operating in emerging markets and developing countries.

The interviewed funds are listed below and further details about size, sector focus, funding sources and investment mechanisms are provided in the annex.

- Acumen Fund
- Axial Par
- Asia West Environment Fund III, Asia West

¹³ United States Small Business Administration, "Finance Start-up", Available online: http://www.sba.gov/smallbusinessplanner/start/financestartup/SERV_FINANBASICS.html

- China Environment Fund, Tsing Capital
- E+Co
- Eenergy Clean Tech Fund, Eenergy
- Environmental Investment Partners (Continental Wind Partners, European Investments & Partners)
- Evolution One Fund, Inspired Evolution Investment Management
- Fondo EcoEmpresas, The Nature Conservancy
- Grofin
- Photovoltaic Market Transformation Initiative, Impax and IT Power UK & India
- Rio Bravo Sustainability I
- Root Capital (formerly Ecologic Finance)
- Shared Interest
- Shorebank
- Small Enterprise Assistance Funds (SEAF)
- Southern African Cleantech & Sustainability Fund, Inspire South Africa
- Stratus VC III, The Stratus Group
- Triodos Renewable Energy for Development Fund, IT Power India
- Verde Ventures, Conservation International

3.2 Characteristics of the funds examined

The funds interviewed are all focused on investing in sustainable SMEs in emerging markets and developing countries. Some funds are based in country, while others are internationally based with local offices and investment teams. The range of different business models they represent can best be captured by looking at the two ends of the spectrum that emerged:

- Locally based venture capital funds that are realizing opportunities for financial and sustainability returns by targeting growth sectors such as cleantech and renewable energy (**VC Funds**).
- The second group we describe as “capital aggregators” - internationally based funds with a primary focus on creating positive economic, social, and environmental impact by supporting sustainable SMEs and generating financial returns for investors (**Capital Aggregators**).

We found that the local VC Funds tend to have higher levels of risk while the Capital Aggregators use a blended capital approach, combining capital from fully risk adjusted sources to softer mission-focused funds from donors (elaborated in section 4.2).

VC Funds tend to make investments of between \$1million and \$5 million, putting them at the “medium” end of the SME spectrum. These funds are mostly structured as limited partnerships, and primarily target opportunities in growing environmental markets, such as renewable energy, energy efficiency, organic food products and new materials. In contrast, the Capital Aggregators tend make investments between \$20,000 to 1 million, using a variety of instruments from “standard” equity investments to straight debt, with a range of quasi-equity structures in between that permit the fund to participate in the upside of the portfolio company while being structured as a debt investment.

The returns generated also varies across funds, with the local VC Funds seeking market

rate equity returns and the Capital Aggregators' targets and performance ranging from preservation of the initial capital to market rate debt returns. For many funds, the local regulatory environment has a strong influence over the structure of their investments. In some cases creditors receive greater practical protections than shareholders, while in others it is the preference of the SME/entrepreneur to obtain debt rather than equity financing due to either cultural preferences or capacity to receive and manage an equity investment.

Some of the key features of these two groups are listed in the table below.

	VC Funds	Capital Aggregators
Date of creation (trend)	2002 – 2007	1998 – 2001
Size of fund (USD)	10-35 million (current fundraising up to 150m)	5-20 million per fund (NB some managers were operating multiple funds with up to \$100 million in total assets).
Av. investment size (USD)	1-5 million; mostly medium sized companies	20,000 – 1 million
Investment model	VC model, equity investments and some convertible debt; seeking risk adjusted rates of returns; fund managed locally	Mix of debt & equity; HQ often in US/EU; return expectations range from proving model to local interest rates
Funding model	Patient capital & commercial investment; Early investors mostly family offices and development finance institutions, now increasingly local institutional investors	Combination of risk capital and soft donor funded capital; instruments include debt; promissory notes; partnership structures; private investment vehicles limited to accredited investors; combination of separately raised equity and debt pools

The interviews and broader conversations also indicate significant growth in sustainable enterprise finance. Many of the VC Funds interviewed were either still in or had recently completed their fundraising phase. In Brazil alone, a new sustainability fund has just started investing and two more are being raised this year. Other players are emerging in Central America, two funds are raising capital in South Africa, and the pioneer in cleantech investment in China, the China Environment Fund (CEF), is raising its third fund, after completing two successful exits through IPO this year. CEF and Axial Par, the oldest VC Funds of those interviewed, were both capitalized by family offices while the more recent funds are targeting local institutional investors and international financial institutions, demonstrating the growing recognition of commercial opportunities in this space. And while the VC Funds have, to date, mostly focused on environmental companies, where the commercial opportunities are clearest, there are indications of a wave of commercial fund creation focusing on BOP business opportunities.

Similar growth is evident among the Capital Aggregators. While some of the older Capital Aggregators have been operating funds since the early 1990s, many raised their first rounds of capital between 1998 and 2001. Currently, we are seeing existing players growing in size or raising follow-on funds, as well as number of new funds recently created, such as Agora Partnerships and Care Enterprise Partners. All funds have, in some form, combined capital with technical assistance and business development services. Although this model raises costs, it also helps to mitigate the risk of business failure.

Further, almost all of the Capital Aggregators are engaged in some form of monitoring and evaluation of their economic, social and environmental impacts. These additional costs are both sources of challenges for the Capital Aggregators, and in some cases the VC Funds, which we outline in greater detail in the following section.

Section 4 – Challenges

4.1 Introductory comments

SME financing is a complicated business anywhere in the world, but the funds interviewed for this paper were up against an impressive range of challenges from a restrictive business environment, to the lack of a good project pipeline and supportive financial infrastructure to the trials of operating in sectors without a long track record. In the following section we will focus on three challenges cited as significant pieces of the sustainable SME fundraising puzzle by the fund managers interviewed: fundraising and coordination of blended capital; technical assistance to entrepreneurs; and monitoring and evaluation of economic, social and environmental benefits. In our view an analysis of these issues also provides a map for areas of intervention by mission driven investors and development institutions. Smart deployment of capital by investors and donors will go a long way in scaling sustainable SME finance and unlocking additional capital.

The Aspen Institute, Acumen Fund and Dalberg Global Development Advisors launched a “Private Sector in Development Initiative” in 2006 and have convened three meetings of key players in the sustainable SME sector in the US since then. The aim of the Initiative is to build a stronger “movement” around sustainable SME finance, mobilize additional capital and put the building blocks into place that will allow the sector to grow. The Initiative seeks to facilitate the right approaches, services and partnerships required to generate the deal flow, invest responsibly, measure effectively and ultimately build sustainable enterprises.¹⁴ WRI and IRI are part of this Initiative and will engage the other participants for further development of this research.

4.2 Fundraising challenges

Among the funds interviewed, there is a clear division between those funds seeking commercial risk capital and those coordinating and “blending” different types of capital spanning commercial capital to philanthropic grants. While some of the fundraising challenges identified are common to both groups, funds seeking blended capital had to overcome different, and some additional, obstacles in obtaining finance. More so than the VC Funds, they have to balance the tension between needing to prove the financial viability of the sustainable SME sector as an asset class and remaining focused on achieving positive non-financial (social, economic and environmental) impacts.

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¹⁴ The group’s development of shared metrics is outlined in section 4.3.

Increasing mainstream investor interest in sustainable SME financing

With private equity investment only recently starting to grow in many emerging markets, mainstream local investors are often not very familiar with this asset class. For example, in Brazil (one of the most vibrant equity markets of the regions included in the survey), only recently have investors needed to take on more risk and seek out alternative asset classes beyond government bonds in order to achieve high returns. In some cases, as shown with the example of SEAF in Colombia and Peru (see section 2.3), legislative intervention has been required to permit local investors to consider private equity as an investment opportunity and achieve greater portfolio diversity. Even in those regions where investors are becoming comfortable with private equity investment, there is a lack of familiarity with sustainable sectors. This creates an additional hurdle for funds focused on organic agriculture or renewable energy, for example, as some of these sectors demand a longer investment cycle than traditional venture capital and therefore require investors with longer time horizons and patient capital.

Perhaps the biggest challenge to fundraising identified by participants at the WRI-IFC workshop was proving that the sustainable SME sector can be profitable in the long term. Fund managers raised concerns about the difficulty in attracting international investors when they, themselves, had relatively short track records. This problem, shared with new entrants in developed markets, creates a dilemma for fund managers in that they need capital to create a pipeline and prove the viability of the sector, yet cannot raise the initial capital required to do so. In particular, upfront expenses to train local investment teams and to start creating a pipeline mean that without the support of patient capital - whether from individuals, foundations, or development finance institutions - it can be hard to achieve the scale needed to prove the model.

Challenges of blended capital

The core concept of blended capital is that it brings together investors seeking different rates of single, double or triple bottom line returns, from those seeking purely financial returns to those only interested in the social, environmental or economic impact. In essence, the softer capital operates as a “smart subsidy” for the Capital Aggregators and some VC Funds.¹⁵ These subsidies are justified as the interventions made by the funds help to rectify existing market failures and are made on a commercial basis at the SME level, helping to avoid moral hazard. Unsurprisingly, funds that use this approach feel a tension between maintaining a deal flow that generates attractive financial returns to some investors, while at the same time delivering the non-financial impacts sought by others.

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¹⁵ As set out in the UNCDF’s Blue Book on Inclusive Financial Sectors for Development, the four broad categories of “smart subsidies” are those that seek to overcome the financing gap for SMEs by:

- (1) improving risk mitigation opportunities;
- (2) fostering greater transparency among borrowers;
- (3) increasing efficiency and reducing costs thereby permitting scale; and
- (4) enhancing innovation among lenders.

UNCDF. 2006. *Building Inclusive Financial Sectors for Development: Executive Summary*. (Online at: www.uncdf.org/English/microfinance/pubs/bluebook/index.php). “The Blue Book”, 20.

Among the Capital Aggregators we interviewed, a number of different approaches are used in order to bring together different sources of capital.

- Offering investors different levels of risk exposure. For example, creating different tranches within the fund or combining a range of different instruments to raise capital are ways to achieve this.

Examples of risk apportioning structures: E+Co and Root Capital

E+Co, a small scale clean energy fund, blends public and private capital via a range of instruments to meet its capital requirements. The primary investment vehicle is a managed account with a coherent set of investment guidelines, transparent governance and multiple options for investors, lenders and grantmakers, allowing for a layering of financial, social and environmental returns. This is supplemented with loans (issued as promissory notes) and donations, which covers costs such as business development services and monitoring and evaluation costs. E+Co has also established a subsidiary fund management corporation, E+Capital Latin America, and special purpose partnerships that more closely resemble traditional fund structures. E+Co Capital Latin America manages an Inter-American Development Bank sponsored fund in Central America, CAREC.

Root Capital provides short term and long term loans to producers in rural, low-income communities in Latin America, Africa and Asia. Using funds from socially minded investors, Root Capital seeks to prove that these environmentally-sustainable SMEs – such as organic coffee cooperatives, lead-free ceramics producers and ecotourism enterprises – are in fact bankable. To mitigate portfolio risk, Root Capital uses a three-way “factoring” model whereby the loans are guaranteed with future purchase contracts that the SMEs hold with buyers. Contributors to Root Capital’s capital pool include agricultural product importers, international coffee roasters, high-net worth individuals, foundations, religious institutions, and socially responsible investment firms. Some supporters are investors seeking a financial return while others are donors providing grant funding. Root Capital issues promissory notes to investors with interest rates averaging 2.6 percent over a 1-5 year period. In case of a loan default, Root Capital takes the first loss position, followed by their investors who share risk equally. Additionally, for certain Root Capital loans placed under a USAID Development Credit Authority (DCA) Guarantee, the U.S. government provides 50 percent risk sharing on the loan in case of default.

- Raising funds explicitly for different purposes and maintaining capital in segregated funds for these purposes.

Segregated funds for blend capital: The Nature Conservancy and Grofin

The Nature Conservancy (**TNC**) established its Fondo EcoEmpresas as a separate entity, in which it co-invested alongside a group of partners including the Inter-American Development Bank (**IADB**)/Multilateral Investment Fund, Corporacion Andina de Fomento (Andean Regional Development Bank) and socially responsible investors. TNC purchased its shares with grant-based funds, which allowed a number of smaller donors to contribute to the venture, despite the minimum amount required for direct investment. The total committed risk capital of \$5.2 million is supplemented by a separate technical assistance facility, managed through TNC. The technical assistance pool was provided on a grant basis by donors including the IADB, IFC/GEF, foundations, and TNC donors. Interestingly, TNC found that because of the tax benefits afforded by charitable contributions, many individuals preferred to support the venture by allowing TNC to purchase shares with their donations or by contributing to the technical assistance facility than by direct investment in the fund.

While **Grofin**, an African SME fund, does not find securing capital to be a problem, close attention is paid to the composition of the investor base for its funds. This involves balancing

local and international investors as well as considering the non-financial benefits that some investors bring, for example multi-national companies who play a key role in pipeline development. Investors in Grofin’s funds include banks (50 percent), development finance institutions (18 percent), local currency investors (14 percent) and corporations (18 percent), who all participate on equal terms. In order to supplement these equity contributions, Grofin has special co-finance arrangements with local banks whereby a predetermined pool of capital is available to make loans to portfolio companies. Co-finance arrangements are done on the same risk-reward basis as fund capital and Grofin is responsible for administering the pool.

Communicating the nuances of these blended capital structures and maintaining them present significant challenges to the Capital Aggregators, with even the most flexible types of capital coming at a cost. The two issues we focus on here are:

- Difficulties in explaining the concept of blended capital and ensuring transparency around the use of “smart subsidies”.
- High transaction costs associated with coordinating different types of capital due to timeframes, the “fundraising treadmill” and priority areas for different organizations.

Explaining concept of blended capital and ensuring transparency

As the idea of blended capital and applying commercial solutions to development problems is still a relatively new innovation, many Capital Aggregators reported difficulty in communicating the benefits and nuances of their approaches to potential investors and donors. In particular, this related to justifying the use of “smart subsidy” in order to preserve returns for commercial parties.

We do not to suggest that the application of “smart subsidies” by these funds is inconsistent with best practice.¹⁶ Rather, we emphasize that a key feature of best practice that we identified among fund managers was transparency around their structure and the application of the smart subsidies. There must be understanding of the risks and costs associated with achieving scale in order for the existing funds to play their role of proving the model of sustainable SME finance and encouraging new entrants and investors.

High transaction costs associated with capital coordination

Many fund managers observed that considerable time is required in order to obtain different types of capital. Given the relatively small amounts that are being asked of different donors, a disproportionate amount of staff time and resources are required to bring funds to scale. Many funds noted that a more streamlined fundraising process would allow them to focus more time and resources on assisting entrepreneurs and making investments. The difference in the grant funding process (cyclical) and the investment process (ongoing) poses an additional coordination challenge. Funds also noted the need to tailor their pitch so that the social, environmental and economic impacts were both broadly defined to capture a wide audience, but still specific enough to attract

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¹⁶ UNCDF. 2006. Building Inclusive Financial Sectors for Development: Executive Summary. (Online at: www.uncdf.org/English/microfinance/pubs/bluebook/index.php). “The Blue Book”, 20.

those funders that would take the riskier positions in the funds on the basis of the high non-financial returns.

The complicated timing for philanthropic grants can affect the funds ability to provide ongoing technical assistance. For example, Capital Aggregators were concerned that the cycle for SME finance – the shortest of which is ten years – was far longer than the typical program cycles for grant-making institutions. As these grants often fund key components of the funds’ pipeline development, due diligence and risk management processes, they are a critical ingredient for financial success over the term of the fund.

Funds also reported a tension created by the additional costs associated with achieving the social, environmental and economic impact that are required to attract grants both in terms of pipeline development and ongoing technical assistance. In particular, maintaining a focus on those businesses most affected by the financing gap can increase the risk exposure of the fund without commensurate increases to potential financial returns. Thus it is important for funds to identify investors and donors that prioritize the non-financial returns, in order to maintain their focus on those sustainable SMEs most in need of financing.

4.3 Monitoring and evaluation

For most of the funds with an explicit focus on sustainable enterprise, the proof of positive environmental and social impacts is key to fulfilling their own mission as well as attracting capital from mission-driven investors. At the same time, monitoring and evaluation is a complex, costly and time-intensive undertaking for a fund. The following section provides a short discussion of the rationale for monitoring and evaluation, the challenges of implementation, examples of current practice, as well as opportunities to move forward with a sector-wide approach.

The key reasons to tackle the monitoring and evaluation challenge can be summarized as follows:

- Understanding, quantifying and monitoring social and/or environmental impacts of its investment activities is essential to fulfilling a sustainability fund’s mandate, and the information is critical for strategic planning and maximizing impact;
- Credible demonstration of positive development impacts helps attract capital from governments and foundations;¹⁷
- A methodology for capturing non-financial aspects of a company can reduce the cost of due diligence, contribute to risk management and to the strategic positioning of the portfolio company.

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¹⁷ Commercial investors seem less concerned with rigorous proof of non-financial benefits at this point, but this may change as the sustainable investment space becomes more competitive and the credible demonstration of sustainability impacts becomes a competitive advantage.

Environmental impact tracking paves the way for additional financing

E+Co, an investor in clean energy enterprises, has a comprehensive indicators matrix for monitoring both environmental and social goals and impacts and has dedicated staff for this in headquarters and field offices. The information E+Co is gathering with its monitoring and evaluation system was useful when the fund started facilitating the sale of carbon offsets for selected companies in its portfolio. E+Co estimates that 80 percent of the required information needed to monetize the carbon value of its investee companies is already collected through their ongoing monitoring and evaluation. This places E+Co in a unique opportunity to access international carbon markets for the benefit of companies in Africa, Asia and Latin America who might otherwise never see financial return from their carbon emission reductions.

Many of the funds interviewed are measuring and reporting on the social and environmental impacts of their investments. In particular, the Capital Aggregators note that the demand for monitoring and evaluation of social and environmental impact is driven by their investors, which is reflected in the more systematic approaches to monitoring and reporting of these funds as opposed to the VC Funds whose investors are generally less concerned with comprehensive proof of non-financial impacts.

Implementation challenges

While the benefits of monitoring and evaluation are compelling, the challenges of implementation are daunting. Starting with the selection of the right indicators to the entrepreneur's capacity to generate meaningful data and the costliness of such an undertaking, the barriers to developing and implementing monitoring systems are considerable. In a practical context, there is an inherent tension between credibility and feasibility of a monitoring and evaluation system. The right balance - comprehensive without being cost-prohibitive - is hard to strike. The question is what a monitoring and evaluation system could look like that is cost-effective, scaleable across different sectors and funding models, and still generates meaningful information.

What to measure?

Monitoring and evaluation starts with the question of what to measure. Taking economic, social and environmental impacts as the three main categories of non-financial performance, there is a need to recognize the different challenges for each of these categories. While socio-economic benefits can be relatively easy to measure, environmental and social impacts present greater challenges. Many environmental impacts are quantifiable and, in some cases, where accepted market values such as the trading price for carbon emissions credits exist, they can even be monetized. Others, such as ecosystem change, involve complex science and even in purely qualitative terms, are difficult to convey to a non-expert audience. Social benefits related to quality of life or changes in government policy are equally difficult to capture and are this point mostly reported upon qualitatively.

How to measure?

Precise measurements for impact evaluation, including control groups, and external assurance, is not a realistic expectation for SME monitoring. However, any assumptions used to arrive at conclusions about impact need to be transparent and plausible. The critical elements of the impact chain are outputs (results of activities, such the sale of x-number of biomass cookstoves), outcomes (the change achieved, such as saved fuelwood and improved health), and impacts (the change occurring as a result of the investment).

The difficulty of establishing causation has led most funds to track outputs as a proxy for quantitative measures of impact, and to complement this reporting with a narrative description of less tangible outcomes of an investment.¹⁸

Examples of Acumen Fund’s quantitative social impact measures:

- Over 3,500 squatters in safe, legal housing
- Over 12,000 new women clients borrowing for sustainable livelihoods
- A bednet that costs \$7 is protecting more than 6,000,000 Tanzanians from Malaria for five years.
- More than 100,000 rural villagers in India with access to safe, affordable water from community water systems
- Poor farmers with dramatically increased incomes from the more than 80,000 drip irrigation systems sold in India

Who is measuring?

Measurements can be made by entrepreneurs themselves, the fund managers who have invested in them, or third parties.¹⁹ The least costly approach is to have portfolio companies periodically provide data to the investor in preformatted templates. However, the capacity of many entrepreneurs to provide data that goes beyond simple indicators is limited. SMEs, especially in the start-up phase have a range of urgent priorities around financing and basic business operations that make it difficult to spend time on impact monitoring. Significant involvement of the fund manager or a third party in capacity building and additional investment into monitoring systems may be required to put the entrepreneur in a position to report reliable information independently. New Ventures is building capacity for self-reporting of sustainability impacts among a pilot group of ten entrepreneurs as described in the adjacent box.

Sustainability reporting for SMEs

New Ventures is piloting a sustainability reporting project with a group of ten sustainability focused SMEs in Brazil, Mexico, China, India and Indonesia. Consultants are working with each company to develop a small sustainability report based on the guidelines for SME reporting by the Global Reporting Initiative. Each report covers 6-8 economic, social and environmental indicators, as well as the company’s vision and policy regarding sustainability. The reports, as well as an analysis of the process will be published in early 2008. It is already apparent, though, that the process is a significant learning experience for the participating entrepreneurs. Despite many challenges, some of them still unresolved, we have already received feedback about the usefulness of this report for marketing, and for conversations with potential investors or buyers with environmental and social standards.

A more time-intensive and costly approach is to send fund representatives into the field to work with the entrepreneur to collect or certify the data and to improve the business’ record-keeping. These field representatives visit the portfolio companies, conduct interviews with employees and other stakeholders, and thus develop a more complete picture of outcomes and impacts. In practice, a mix of self-reporting and technical assistance from the fund manager is often required.

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¹⁸ Kramer, Mark and Sarah Cooch 2006. *Investing for Impact. Managing and Measuring Proactive Social Investments*. (Foundation Strategy Group, online: www.fsg-impact.org/app/content/ideas/item/287).

¹⁹ Kramer, Mark and Sarah Cooch. 2006. *Investing for Impact. Managing and Measuring Proactive Social Investments*. (Foundation Strategy Group, online: www.fsg-impact.org/app/content/ideas/item/287).

Finally, third-party research studies can be used to develop an in-depth analysis of the non-financial impacts of investment activities. Because of the high cost associated with such an approach, it tends to be used in situations where significant grant funding is available. The approach does not offer itself as an option for widespread monitoring and evaluation, though it may offer a path towards developing a coherent and partially replicable system of measurement.

Who pays?

Even without using comprehensive third party studies, many funds that systematically monitor impacts rely on grant funding to finance the additional cost. SEAF distinguished itself by conducting comprehensive impact assessments of 18 portfolio companies in two separate studies, with funding by three bilateral donors and one foundation as described in the box below.

The development impact of SMEs: Lessons learned from SEAF investments

SEAF's impact assessment used a case study approach to analyze the impacts of 18 investee companies from Eastern Europe, Latin America and Asia. Based on IFC methodology, the study measured the incremental effects of each investment over time on stakeholders, such as investors, employees, customers, suppliers, local communities and others. SEAF concluded that every dollar invested in these SMEs generates, on average, an additional 12 dollars in the local economy.

It took SEAF over a year to develop the impact assessment and two full-time staff to develop and implement it for the first ten companies. Another year was spent on the second phase study that added eight more companies and implemented a data survey of 30 additional companies. Some of the lessons learned include that training internal staff as well as the entrepreneurs is critical for success, but time consuming.

The results of the impact assessment are available on SEAF's website.²⁰ Beyond the direct analysis of the information, SEAF reports that entrepreneurs and in-country staff felt that completing the impact assessment allowed them to think about development issues as they related to their companies and that it was interesting information that could be used for other purposes, such as marketing. SEAF also believes that the impact assessment helped them in making the case for SME investment with new and existing investors as the non-financial benefits of SME investing can now be more clearly articulated and quantified alongside the projected financial return.

Among sustainability funds operated by commercial investment management firms, monitoring of extra-financial impacts is less common, though not entirely unusual. This is in part due to a different mandate with stronger emphasis on financial returns, and in part to stricter cost control at the fund level. While several funds have systems in place to monitor very basic environmental and social information, the Brazilian Fund Axial Par stands out for its comprehensive, self-financed monitoring.

Axial Par raises the bar for impact monitoring of venture capital investments

Axial Par, within its team of five, has a dedicated staff person who works with investees to monitor employment generated, biodiversity preservation, creation of industry clusters, development impacts, output/input ratios, product cycles and other indicators. Axial Par uses the Natural Step method for the establishment of benchmarks and the Global Reporting Initiative Guidelines to guide investee companies towards self-reporting on sustainability performance, as well as pursuing independent verification. To date, Axial Par has been able to provide this assistance without external funding.

²⁰ SEAF. 2007. <http://www.seafweb.org/impact.htm>

Moving forward

Currently, the majority of Capital Aggregators and many venture capital funds conduct some kind of impact monitoring and many of them have invested significant time and capital into systems development, staff training and technical assistance to entrepreneurs. Most funds have ambitions to further improve their systems, and new entrants, even in the commercial space, seem to have relatively ambitious goals for impact monitoring.

However, the current situation - where most funds are currently using a home-grown system with different methodologies and indicators - is creating significant inefficiencies. Entrepreneurs may have to comply with varying reporting requirements, and it is virtually impossible to make any meaningful comparison of impacts across different funds. At the same time, intermediaries themselves feel the lack of common standards as they often face a range of different demands from their investors regarding the type and detail of information required. See the box about International Financial Institutions' development indicators below for a description of a harmonization initiative among these institutions.

Despite the investments already made, many funds and investors agree on the need for standardization, or at least harmonization of what should be measured, who should measure it, and how to verify the information. Not only would it reduce transaction costs, it would also help the sector aggregate data in meaningful quantities and start establishing a basis for comparison of investments.²¹

Acumen Fund, the Aspen Institute and Dalberg Global Development Advisors have facilitated discussions to build consensus among key practitioners toward a common framework, a set of baseline metrics and comparable approach to financial and non-financial accounting. A common metrics platform would encompass capital providers, intermediaries, and enterprises. While no definite list of indicators has yet been established, there is convergence around metrics such as jobs created, wage growth, revenue growth, number of customers served, local suppliers supported, total "base of the pyramid" providers, and others. Additional metrics could include additional finance mobilized, quality of data, comparable charitable impact, and carbon offsets. Acumen Fund and Google.org are in the early stages of working together to make an on-line portfolio management data system available to other practitioners in the field to support this initiative.

²¹ Kramer and Cooch identified three key elements of a standardized approach: Financial return and socio-economic benchmarks by asset class; qualitative guides for social and environmental performance indicators; technology that streamlines and automates the collection, aggregation, and reporting processes. Kramer, Mark and Sarah Cooch. 2006. *Investing for Impact. Managing and Measuring Proactive Social Investments*. (Foundation Strategy Group, online: www.fsg-impact.org/app/content/ideas/item/287).

International Financial Institutions (IFIs) harmonize core development indicators

An IFI working group on Private Equity Funds has started to address monitoring inefficiencies by agreeing upon a set of development indicators with common definitions and consistent tracking methods. The four core indicators - internal rate of return, employment at investee companies, compliance with international environmental and social standards, and compliance with core labor standards – are complemented by 21 optional indicators that cover economic, social, environmental governance, capital markets and private enterprise metrics. The indicators and methodology will be published²² to support fund managers in tracking positive development effects of their investments, harmonize the IFI assessment of development effects of private equity financing, and create data-bases calculated according to a harmonized methodology.

Broad agreement on a set of basic, easily measurable indicators would certainly be a significant step forward. Further to these, sector specific indicators around environmental and social impacts could be developed collaboratively by specialized funds. This would eventually give rise to an evolving list of optional indicators. While every fund may only monitor and report on a small selection of indicators, the aim would be to achieve agreement among key players on what and how to measure for a specific sector.

4.4 Technical assistance

In most emerging markets and developing countries the number of investment-ready projects is very limited. SMEs in developed countries have a wealth of resources that assist them in steering their businesses on the most effective path. As these support services for entrepreneurs are lacking or insufficient in most developing countries, it is often the financiers that fill this gap with extensive support to the entrepreneur, ranging from accounting to marketing and business strategy. Often technical assistance is required from very early stages, including for the identification of potential projects, feasibility and technical studies and for making business ideas presentable and bankable.

Examples of areas covered by technical assistance

Financial literacy: After years of providing financial education and management training on an as-needed basis during the due diligence process, **Root Capital** launched Root Capacity, a formal financial education program, in 2006. The program, supported with grant funding from the MIF/IDB and private donors, aims to strengthen the loan applicant pool and prepare rural SMEs to obtain financing from mainstream banks.

Strengthening local providers and creating clusters: **Verde Ventures**, a fund focused on biodiversity conservation, obtained a grant to increase the local availability of technical assistance from third party providers, for example accountants or marketing consultants. Verde Ventures also works with other business development providers, such as Technoserve, which allows the fund to complement its own technical assistance, which includes building industries around SME value chains, for example supporting local jewelry and craft manufacturers in eco-tourism areas.

All funds interviewed provide some type of technical assistance and business development to their portfolio companies. In the case of the VC Funds this is primarily the involvement in strategic planning and management typical of VC investors, but often also includes working with companies prior to investment to get them to investment grade. For the Capital Aggregators, support before the investment is even more common. For many of them technical assistance is a key part of the due diligence process as this allows the fund manager to

²² The indicators library will be hosted at <http://www.empea.net/research-information/empea-research-surveys/>

assess the viability of the business and the entrepreneurs (E+Co, Grofin). Other Capital Aggregators focus on strengthening their investees' operations and facilitating access to international supply chains (eg Root Capital, Verde Ventures, EcoEmpresas). Especially the funds focused on clean energy provide assistance focused on technical knowledge and the specific market (E+Co, Econergy Cleantech Fund, Continental Wind Partners). The costs associated with these services in many cases impacts net returns to investors.

Covering costs

Technical assistance costs can take up 10-30 percent of the investment depending on the region and project size. Econergy's CleanTech Fund, which invests in small scale renewable energy projects and alternative technologies in Latin America, needed one to two years of ground work before starting to make its investments. The fund managers need to work with most projects to get them to the advanced stage of development, until they reached "investment grade" status and when they were able to invest. Without technical assistance, only one or two in 40 projects that apply for funding would be considered investment grade.

Many of the Capital Aggregators use grant money or soft capital, to cover technical assistance costs, while most funds operating with a venture capital approach cover this support with their management fee. Some felt, though, that it was critical that the SMEs themselves were required to contribute to the cost in order to ensure the services were valued. For example Grofin and SEAF charge for the tailor-made business development services they provide. This helps to recoup a part of the cost of providing these services and also ensures that the entrepreneur is invested in the process by attaching a value to the assistance received.

Sometimes the costs of technical assistance can be lowered by investing in an entrepreneur across different growth stages or bundling the assistance with paid-for business development services. Some funds are also beginning to look more intensively for co-investment opportunities, as this may allow them to leverage the experience and insights of different investors, including sharing of due diligence cost. Nonetheless, the fundraising for grants to cover the much-needed technical assistance means additional effort on the part of the fund manager and many cite the lack of technical assistance funds as a significant challenge. Although many in the development community talk about the need to integrate TA funding with investment capital, to date, it has not been the norm for the same international financial institutions to both invest in a fund and provide TA alongside. This has led to the inefficiencies that fund managers describe in the fundraising process.

Local fund management capacity challenges

In addition to the lack of entrepreneurial capacity, in many countries private equity/venture capital is a relatively young sector and there are few individuals with the training and experience required for professional fund management. Especially institutions with a large number of funds in different countries, such as Grofin in Africa and SEAF throughout Eastern Europe, South America, Africa and Asia, cite hiring, training and retaining local staff as one of their principal challenges. The Capital Aggregators agree that investors need to recognize the need to support internal capacity building at the fund level in order to bring the sector to scale.

5. Conclusions

Sustainable SMEs that offer economic, social and environmental benefits need to be part of any long-term sustainable development strategy for emerging economies and developing countries. These businesses provide employment, link rural communities to markets, stimulate entrepreneurship and innovation, and have the potential to contribute to poverty alleviation and environmental protection. However, for sustainable SMEs to realize their potential and provide positive societal impacts, they need to be able to access the right type of capital at the right time throughout the business cycle.

However, despite the increasing flows of foreign investment to developing countries, sustainable SMEs continue to fall into a financing gap – both because of their size and a lack of understanding of their specific financing needs. The availability of financial resources is not the main barrier, but rather it is the ineffective deployment of these that creates this financing gap.

Innovations in financial mechanisms and investment practices can address this issue while also providing attractive triple bottom line returns to investors. Several funds are already proving the viability of sustainable SME finance and the commercial markets for these companies are growing. However, as this paper has identified, a number of challenges still exist that prevent the sector from reaching scale at the pace needed to address urgent global issues. Prominent among these are: the existence of a ‘financing gap’; high transaction costs; and a lack of coordination and standardization among current investors.

In our view, the positive externalities of sustainable SME investments may justify the use of smart subsidies in these areas, whether as grants for technical assistance and business development services or below-market rate financial returns. We believe that this approach could significantly increase the financing options available to sustainable SMEs. Scaling up in sustainable SME finance could lead to a tipping point where relevant information becomes more widespread, due diligence costs are reduced, and co-investment opportunities help to mitigate risk, particularly for new players.

Moving forward, we believe that efforts should focus on:

Greater collaboration between aggregators, VC funds and local banks

Better coordination and networking between aggregators, local VC funds and banks would provide opportunities for co-investment and pipeline sharing. Feedback from the WRI-IFC workshop indicates that there is significant interest in collaboration, but limited opportunities to do so, particularly across different countries and regions. In addition some aggregators report that collaboration with local banks has been critical to the success of their model.

Improved coordination and effectiveness of blended capital

A better understanding of blended capital requirements is needed to fully tap into the potential of this fundraising approach. On the part of the intermediaries, particularly the aggregators, this requires transparency in blended capital accounting. Investors and donors, in turn, need to be educated about blended capital models and then called upon to help improve the coordination of different types of capital and reduce the related

transaction costs.

Clarity around the different components of blended capital would allow for more targeted allocation of capital. The participation of different players such as development banks, foundations, commercial investors, and national and international aid agencies needs to be orchestrated in a way that maximizes the effectiveness of the different types of capital they each can provide: grant funding for technical assistance and business development services; public or philanthropic patient and risk capital; and private sector risk capital.

Harmonization of monitoring and evaluation

The lack of standardization in monitoring and evaluation approaches is creating major inefficiencies across the sector. A common methodology and a library of shared metrics would greatly enhance transparency and comparability, reduce transaction cost, and allow for a better understanding of the positive social and environmental impacts of sustainable SMEs. Ultimately, VC funds should also be engaged in these efforts, so as to work towards an approach that can be adapted to a variety of financing models, including return driven funds. A commonly accepted approach may also allow fund managers to satisfy a broader number of investors and donors with one reporting template.

Today's world is the richest it has ever been. Global GDP (PPP) is up to \$66 trillion (2006 est.), yet 4 billion people are unable to benefit from this growing wealth and continue to struggle in a cycle of poverty. A financial system that prioritizes short term gains leads to overexploitation of natural resources and is undermining nature's regulating services that are vital for life on this planet.

Given the right support, sustainable SMEs can be critical actors in building more inclusive economies with a vibrant, innovative private sector that provides smart business solutions to environmental and poverty challenges.

This paper aims to stimulate a greater dialogue among stakeholders and private and public sector leaders. It will be reviewed by a group of stakeholders, revised and released in Spring 2008. We welcome all comments and questions. Please send yours to Mareike Hussels at mhussels@wri.org.



VENTURE CAPITAL FOR DEVELOPMENT

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The Private Sector in the Fight against Global Poverty***

***Session III: Does Size Matter? SME's, Microfinance & Large Nationals
August 4, 2005***

Introduction

The developing world, and Africa in particular, faces a dearth of risk capital that has and will continue to constrain growth. Donors need to face the reality that the young companies that can really move the needle on innovation, inspiration and employment need high-risk, reasonably-sized, equity investments to grow, not the limited doles of short-term, high interest debt currently provided.

In the developed world, the young growth companies critical to innovative capacity and employment generation are financed with long-term, permanent equity capital. When a company is growing rapidly, it cannot generate sufficient cash through its current operations to support the investment required to generate future growth, nor can it afford to pay current interest or amortize the principal associated with loans. Angel investors and venture capitalists provide the equity capital that enables young businesses to take risks, build plants, develop technology and implement their long-term strategies to compete on a global basis.

Yet, companies in the poorest countries of the world have almost no access to this type of capital. Entrepreneurs struggle to build businesses with meager personal assets that rarely allow them to achieve the scale of operations required to be competitive. When entrepreneurs can get a loan—the only form of financing available in the market—the requirement to service the capital on a current basis puts undue pressure on their balance sheet, their ability to re-invest in the growth of their business and their willingness to take risks.

This past year has seen a renewed call to action to address persistent poverty in the developing world, especially in Africa. The key message from most of the discussions has been a call for an increase in development aid. But just spending more money is not going to build the long-term functional economies that will create the employment and wealth creation to get Africa and other poor countries out of their poverty trap. We need to get money into the hands of entrepreneurs who can build the businesses to enhance Africa's global competitive advantage and produce goods and services affordable to the world's poor.

We propose a specific program, an equity investment initiative funded by donors, which can have a real impact on business formation in the developing world. In partnership with local governments and investors, the program would provide equity capital and technical assistance to the subset of young Small and Medium Enterprises (SMEs) in developing countries which are truly growth-oriented and which the capital markets are not adequately supporting. These suggestions are offered as a beginning not an end; any initiative must strive to create over time viable private capital markets that can provide appropriate commercial instruments with reasonable financial rewards.

Growth Matters More than Size

The current landscape of companies in Africa and other poor countries and their requirements for capital and assistance is most often described in terms of the size of companies. The "Micro" enterprise sector is typically defined as companies with less than 10 employees and generally includes small-scale traders, artisanal producers and farmers. Increasingly, these types of enterprises have been provided with capital and technical assistance by the burgeoning and successful microfinance industry. The "Large" enterprise sector is typically defined as anything with more than 100 employees and therefore includes multinationals and almost all established local companies such as privatized infrastructure providers and financial institutions. In most cases, local and international capital markets provide these types of companies with the necessary capital. The in-between, small and medium-enterprise ("SME") sector, however, remains both the life-blood of the economy and the most challenging for policy makers to understand and financiers—whether commercial or donor—to serve.¹

This one-size-fits-all categorization of companies with between 10 and 100 or more employees as SMEs hides variations in characteristics that are critical to their capital and assistance needs, and their potential development impact. Most of the companies in the SME-size category in developing countries are similar to micro-enterprises in that they provide basic employment and income generation for a family or farming cooperative group. Because these types of "necessity entrepreneurs"—traders, niche domestic service providers and agricultural producer groups—are oriented toward generating immediate income, they are unlikely to have or be able to re-invest capital in

¹ Size definitions vary by country and organization; "small businesses" or SMEs are typically defined as companies with less than 100, 250 or 500 employees. Micro-enterprises are typically defined as less than 10 employees.

their businesses and take risks to grow significantly. As a result, these types of enterprises are unlikely to reach an economic scale to become globally competitive. On the other hand, they can also usually generate enough cash flow to service some form of debt. Many access working capital or trade finance through informal networks and a number of specialized providers of debt financing for this type of company have recently emerged.

A smaller segment of companies in this SME-size category, including high potential start-ups, have the potential to grow and become modern, globally competitive enterprises. These types of companies are run by “opportunity entrepreneurs” committed to innovating, adding value to exports, applying technology, achieving scale in production and re-investing profit in their business. And like their U.S. counterparts, they can have a *multiplier effect* on employment and overall economic growth. If these companies are successful in growing and reinvesting capital in their business, they can continue to expand direct employment, increase indirect income generation through sourcing local inputs, and pay taxes. Perhaps as important, successful companies and entrepreneurs can have a powerful demonstration impact: seeding and stabilizing clusters of related firms, inspiring other entrepreneurs to grow their businesses and serving as role models for youth. Unlike their “necessity entrepreneur” brethren, the impact of the capital invested in growth-oriented SMEs run by “opportunity entrepreneurs” can continue to have a compounding development impact.

But unlike in the United States and other developed economies, in most developing countries these segments of growth-oriented SMEs are virtually absent. In high-income countries, the SME sector has been estimated to contribute more than 50% to gross GDP, not to mention being the engine of new job creation and a source of as much as half of the innovation in these economies. In low-income countries, however, the contribution of the SME sector to gross GDP has been estimated at 16% and, in most African countries the SME sector has been estimated at less than 10%.² This absent segment of companies that are undergoing the risky but creative process of growing from small to medium to large-scale could explain much of the weakness in the overall economic growth of developing countries.

There are three basic explanations for the underdevelopment of the SME sector in developing countries: a weak business environment, a lack of managerial or technical capacity, and a lack of access to capital. We will not attempt to explain all three factors but will focus on the access to capital for growth-oriented SMEs.³ It should be noted, however, that without progress by local governments in creating an investment climate and business environment that is supportive of entrepreneurship and growth-oriented businesses, any policies related to increasing access to capital for SMEs will have limited impact.

² Source: Meghana, Demigurc-Kunt, Beck, “Small and Medium Enterprises Across the Globe: A New Database,” World Bank Policy Research Working Paper No. 3127 (August 2003)

³ For a full discussion of all three factors see: Patricof and Sunderland, “Big Ideas: Small is Still Beautiful,” The Milken Institute Review (2nd Quarter 2005) pp. 90-94

Risk-Reward Imbalances

In developed country environments, young companies are financed by various types of risk capital providers through a number of rounds of investment: friends and family supplying very early capital; angel investors such as retired businessmen providing start-up capital; and formal venture capitalists providing early-stage and growth capital. Each of these types of investors has specialized skills and information to evaluate the risks and rewards of the business plan at each stage of investment and to help the entrepreneur build the business. By the time a successful young company has graduated out of this risk capital market, it should have the cash flow and/or track record to access more formal capital markets such as banks and public markets. These public markets and mergers and acquisitions activity provide the critical high potential exit for the early risk capital providers.

Almost all developing countries lack this early risk capital market. This does not reflect neglect from development experts at the development finance institutions (“DFIs”). Surveys of the SME sector in developing countries have consistently identified lack of access to capital as a key constraint to growth.⁴ In response, over the last two decades a range of schemes, from direct investments in the SME sector to venture capital programs and SME loan guarantee programs, have been attempted.

Most of these DFI-funded programs, however, have had limited success. Loan programs have often suffered from lack of utilization by the SME sector, high default rates and currency devaluations. Equity investments in SMEs through the nascent private equity and venture capital industry have generated mostly poor returns and many business failures. As evidenced in recently gathered data on the emerging market private equity industry, private equity funds in emerging markets (including a mix of both venture capital and larger private equity transactions) have globally only returned capital to investors, delivering a -0.3% IRR return over a 5 and 10 year horizon. Venture capital investments have been shown to be even more difficult to manage. Data from EBRD’s analysis of its funds in Eastern Europe shows that investments of less than \$2.5 million didn’t even return capital while investments greater than \$10 million delivered returns significantly above the emerging market private equity benchmark.⁵

⁴ There are numerous region and country-specific surveys of the dynamics of the SME sector and constraints to growth. For a most recent general evaluation of the SME sector in 54 countries see: Beck, Demirguc-Kunt, and Maksimovic, “Financial and Legal Constraints to Growth: Does Size Matter?” *Journal of Finance* (Volume 60 Issue 1 February 2005) p. 137

⁵ Statistical performance data from Cambridge Associates Emerging Market Venture Capital and Private Equity Index have only recently been made publicly available. See *Emerging Market Private Equity Newsletter* (Volume 1, Number 2, June 2005) for a summary of the data. The EBRD analysis of the performance of its investments funds between 1992 and 2002 was presented in detail at the IFC Global Annual Private Equity Conference May 2004. General performance data for the EBRD sponsored funds is available at www.ebrd.com/country/sector/fi/index.htm.

For investments of less than \$250,000 the challenges to delivering net returns to investors becomes even greater. Analyzing the portfolios of leading global SME funds shows that, without even taking into account transaction costs, the gross realizations and valuations on these investments barely return capital to the funds, compared to healthier multiples on larger investments. When even small transaction costs are incorporated into the returns calculations, the base capital on the small investments is quickly eroded.⁶

The result of these historical returns is that commercial investors in developing countries necessarily migrate toward larger deals. Even the leading global SME funds, reacting to pressure from their primarily DFI investor base to demonstrate commercial returns, have increasingly abandoned smaller SME equity investments and migrated toward minimum size investments from \$500,000 to \$1M, and most frequently to \$2M, with a large component of their investments structured as interest bearing securities.

With the renewed focus on private sector development and the importance placed on the SME sector, however, the development finance industry is desperately seeking a scalable solution for delivering capital to the SME sector. As evidenced in the returns data, the difficulty with such a model is that, in most cases, the challenges of building growth-oriented companies in these markets mean that equity investments cannot deliver returns that justify the risks on a commercial basis.

There are a number of reasons for this:

- *Early Stage of Investment.* In many of the most promising developing countries, a stabilized economy and adequately functioning business environments have only been a condition of the past decade. Unless a product of privatization, high growth potential companies will often be start-ups or early stage companies with unproven products and marketing strategies, and limited track records. Investing in start-ups is notoriously difficult and risky—even commercial venture capitalists in the sophisticated U.S. market like to have some proof of a business plan and as a result leave the earliest stages of investment to angel investors.
- *Weak Managerial Capacity.* Many developing countries have extraordinary raw entrepreneurial talent -- as evidenced in the traders who effectively move large flows of goods across borders. But building and managing a modern enterprise that can add value and compete in international markets requires significantly different business language, contacts, and technical skills to which few of these raw entrepreneurs have access. For example, the stringent needs for quality control and timely delivery on contracts can be challenging for a businessman accustomed to the chaotic African trading environment to understand.

⁶ The Authors have worked closely with leading SME funds, including evaluating the underlying portfolios of the funds and the key factors affecting returns. The Authors wish to acknowledge the support of these fund managers in contributing to the development of the ideas in this paper.

- *Business Environment Risks.* In addition to the usual risks of starting and growing a company, these entrepreneurs must battle the hurdles created by government regulation, infrastructure weaknesses and even cultural impediments. Studies have shown that weaknesses in the business environment disproportionately affect smaller businesses.⁷ What these studies do not adequately convey is the day-to-day drain on resources and morale of dealing with issues such as official corruption, power outages, lack of communication, and poor roads that destroy vehicles and increase delivery times.
- *Few Exit Opportunities.* While local capital markets have been established in many developing countries, they have thus far been open primarily to large and established companies. The M&A market in most of these markets also remains nascent. Therefore, with limited possibility for exits from equity investments, investors have focused on debt instruments that are appropriate only for cash flow generating companies.
- *High Transaction Costs and Limited Deal Flow.* For the investors themselves, investing in the SME sector presents difficult challenges. Investing in a small company takes many if not more resources than a larger transaction. Furthermore, the scale of most of these markets means that there just isn't, at this point in time, the potential to create that many high growth-oriented companies in any given country. As a result, the overhead costs involved in setting up an investment operation can be extremely high on a per deal basis.
- *Currency Risk.* For international investors, currency volatility can further erode returns. Many positive return investments produce negative or minimal returns when converted to U.S. dollars.

These factors make SME investing in growth-oriented companies in developing countries difficult, if not impossible, to justify in commercial terms. The companies themselves are most often early stage under any definition with unproven and inexperienced entrepreneurs. The markets in which they operate exacerbate the company risks. Even if the companies are successful, the rewards are difficult to achieve. The investor will have trouble getting liquidity from the investment and the transaction and overhead costs associated with investment management activity further erode the returns.

Without some form of balancing incentive, therefore, commercial investors who expect returns to justify their risks are not likely to invest in the SME sector in these countries in the near future. At the same time, to meet the financial objectives established by their shareholders, most of the DFI investors continue to demand commercial level returns from SME investing. Because their incentive structure often rewards large top-line

⁷ See Beck 2005 cited above. See also: Mead and Liedholm, "The Dynamics of Micro and Small Enterprises in Developing Countries," *World Development* (Vol. 26, No. 1 1998), pp. 61-74, for a discussion of the relationship between firm growth, failure rates and macro-economic conditions.

disbursements of capital, the DFI investors also rarely get excited by the volume of capital appropriate to the SME segment.

This does not mean that DFI investors should abandon the sector. Rather, it is time for the DFI investors to be realistic about what effective investing in this sector really takes, and adjust their thinking and benchmarks accordingly. We strongly believe if the DFI community wants to build young, growth-oriented SMEs in these markets, they will need to accept the risk-reward imbalance and begin to promote models for SME investing that take into account the high risks, high transaction costs, low volume, and below market rates of returns endemic to the sector.

A Balancing Act

This type of reorientation in approach sounds simple in concept but is difficult to execute in practice because it requires a careful balancing act between creating market-driven incentives that enforce commercial discipline at the investment and company level and achieving the development objective of building businesses. Distorting capital markets with too much cheap capital or creating uncompetitive companies is always a danger when providing below-market funding to the private sector. Therefore, any initiative must strive to create over time viable private capital markets that can provide appropriate commercial instruments with reasonable financial rewards.

We propose, therefore, a program to create a pool of capital to invest equity or equity-like instruments in growth-oriented SMEs. The funds would, as much as possible in a given market, seek to leverage and build the nascent commercial risk capital market.

- *Capitalization.* Capital for the funds would be sourced from DFI investors, from local governments, and, crucially, with some participation, however modest, from private local sources. The donor investors and governments should be willing to accept very modest rates of return and directly support operating and transaction costs, allowing local private investors to manage the investments and take a disproportionate amount of the returns.
- *Investment Activities.* Capital from these funds should be available in amounts ranging from \$100,000 to \$2 million to invest in SMEs with the demonstrated ability to absorb capital and a growth strategy that can have a multiplier effect on employment. Investments should be in the form of quasi-equity with no forced amortization or current servicing required. Investors will receive returns from appreciation in the value of equity ownership where possible but more often in the form of payments linked to participation in increased revenues and free cash flow as generated.
- *Linkages to Pure Commercial Markets.* In addition to being managed by local private investors, the funds should work closely with other local financial institutions to graduate their companies for later stage financing from purely commercial sources. This could be achieved through pre-financing of companies

referred by the banking sector, working closely with banks to get loan financing for existing portfolio companies, and co-investing at later stages of financing with commercial venture capital funds.

- *Technical Assistance.* Capital alone will not be enough to develop growth-oriented SMEs in these markets. These companies need management training, advice from experienced business people, technical knowledge of equipment and processes, market information and insights to build their businesses. A parallel component of the funds will be dedicated to grant funding for technical and managerial assistance to the portfolio companies through existing assistance programs. The technical and managerial assistance component of the program should be fully integrated into the investment activities.
- *Investment Skills.* If local investors have appropriate skills and knowledge, they are much more likely to understand the risks and rewards of the SME sector and will be better placed to manage them on a day-to-day basis. Pairing local investors with skilled international fund managers could transfer the necessary knowledge and skills. Involving experienced venture capitalists in the overall management of the program should also allow for transfer of knowledge and skills.
- *Linking with the Diaspora.* The flow of entrepreneurs from the Indian and Chinese diasporas has had a significant impact on the quality of the young companies in those economies. The African diaspora has also begun to generate both the capital and the entrepreneurs that could significantly boost the SME sector's potential. The program should provide incentives for investment by the diaspora communities, encourage diaspora entrepreneurs to develop new companies in their home countries and involve senior business people from the diaspora in the program.
- *Commitment of the Companies.* The companies themselves will also need to be active participants in the program; in exchange for capital, they would commit to produce audited statements, pay taxes and abide by the rules of corporate governance.

The program will need to be adapted to the on-the-ground characteristics of the SME sector, the human resources, and the financial markets in a given country or region. Equity capital is not a one size-fits-all solution for the SME sector. In fact, in smaller or less developed countries, it may only be appropriate for a few companies. Regional funds therefore may be appropriate for regions with fragmented local markets and limited deal flow. The risks associated with the investments will also vary by the characteristics of the macro-economy and the financial markets. Smaller investments with higher leverage rates may be needed in underdeveloped markets whereas larger investments with lower leverage rates may be acceptable in more developed markets.

Conclusion

In all of the discussion of aid and poverty, we sometimes lose sight of the fact that making the poor not poor requires employment, and preferably employment sustained by productive economic activity rather than capricious donor funding. Foreign direct investment can provide some of this employment and micro-enterprise activity can support basic income generation. But a vibrant indigenous private sector presents the best prospect for enduring progress in creating the employment and wealth creation that will pull Africa and other poor countries out of poverty. A “private sector”, however, does not spontaneously emerge from the pages of commission and consultant reports. Rather, young businesses must grow to become the larger, established institutions that can really move the needle on employment.

Apple Computer, Microsoft and Fedex did not start out with loans. If their founders had been required to finance their early growth with the short-term, collateralized, high interest loans currently available in developing countries, the businesses would not even have gotten off the ground. Instead, friends and family, angel investors, venture capitalists and even the U.S. Government’s Small Business Administration provided risk capital to build these successful U.S. companies.

In developing countries, we must similarly find a way to get equity capital into the hands of entrepreneurs who have the capacity to build young businesses. We believe our program provides a good place to start.

**Why Doesn't Africa Get More Equity Investment?
Frontier Stock Markets, Firm Size and
Asset Allocations of Global Emerging Market Funds**
By Todd Moss, Vijaya Ramachandran and Scott Standley

Abstract

This paper addresses the question of investment in sub-Saharan African listed securities by examining characteristics of the continent's 15 equity markets, the rise and fall of African regional funds, and the asset allocation trends for global emerging market (GEM) funds. The data shows that South Africa is now a leading destination of capital, but that few managers invest elsewhere on the continent. However, we find that African markets are not treated differently than other markets and present evidence that small market size and low levels of liquidity are a binding deterrent for foreign institutional investors. Thus, orthodox market variables rather than market failure appear to explain Africa's low absolute levels of inward equity flows. The paper then turns to new data from firm surveys to explore why African firms remain small. The implications of our findings are threefold: (a) efforts to encourage greater private investment in these markets should concentrate on domestic audiences and specialized regional funds, (b) the depth and success of the Johannesburg Stock Exchange can perhaps be better utilized to benefit other parts of the continent, and (c) any long-term strategy should concentrate on the underlying barriers to firm entry and growth.

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Why Doesn't Africa Get More Equity Investment?

Frontier Stock Markets, Firm Size, and Asset Allocations of Global Emerging Market Funds

Todd Moss, Vijaya Ramachandran, and Scott Standley¹

I. Introduction

The rapid integration of international financial markets has been one of the starkest examples of globalization. The impressive rise of private capital flows to emerging markets, from \$25 billion in 1990 to \$300 billion in 2005, has been a key feature of this trend. Part of this expansion in financial flows has been enabled by the growth of equity funds dedicated to investing in publicly-listed securities in developing countries.² The number of emerging market funds grew from just a handful at the beginning of the 1990s to over 100 by the end of that decade (Kaminsky, Lyons, and Schmukler 2001).³ Sub-Saharan Africa has also participated in this trend, with South Africa rising into the ranks of the leading destination emerging markets and a number of regional funds specifically targeting the continent. At the behest of local governments, and with some donor encouragement, Africa has also expanded the number of its domestic stock exchanges from five in the late 1980s to fifteen today. Despite this modest headway, Africa's "frontier markets"—those outside South Africa—still receive a tiny fraction of emerging markets investment and the widespread reaction in Africa has been of disappointment. Policymakers in both African and donor capitals have fretted about this lack of response by private investors and frequently ask: **why is Africa not receiving more equity investment?**

There are two schools of thought. The first "market failure" view is that Africa is somehow different and investors are not responding rationally to the continent's investment opportunities because of some hurdle: a lack of information, perceptions of excessive risk, or another, perhaps unknown, variable that systematically discourages investors from bringing their capital into Africa. A second "market works" view argues that there is nothing unusual or exotic about

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² This paper deals only with funds targeting listed securities publicly traded on local stock markets, and explicitly does not cover either private equity or foreign direct investment (FDI). The universe of private equity funds, venture capital, and other asset classes are areas of future research for CGD. FDI is also beyond this paper. Recent data suggests FDI grown considerably in recent years, and not only to mineral/oil exporters.

³ See also Lavelle 1999 on the role of the international financial institutions in helping to launch new closed-end funds.

Africa and that investors value African investments like any other. If they are avoiding the continent it is likely because of orthodox reasons such as liquidity or market size.

This paper seeks to answer this question by looking at the characteristics of African equity markets and the activities of the two primary groups of foreign institutional investors: regional funds (which, by definition, invest in companies listed on African stock markets) and global emerging market funds (which, by definition, invest in developing countries but not necessarily any particular geographic region). A scan of the 94 global emerging market funds for which we have data shows that they all invest in South Africa, but almost none invest elsewhere on the continent. But we also find that African markets are not fundamentally different from those in other regions given their relative size. After correlating market and country data with the asset allocation of these funds, we find that African markets are not treated differently than other markets, which suggests that a primary deterrent for foreign institutional investors is the small size and low levels of liquidity for available shares. That is, for the GEM asset class, the evidence points strongly in the direction of a “market works” view and that Africa’s market “problem” is mostly one of size.

The implication of our findings is that, at least in the near to medium term, African equity markets are likely to remain targeted primarily by highly-specialized niche funds with specific mandates to invest in the region. Those that seek to encourage greater private investment in these markets should focus their efforts on this handful of foreign players and, probably more importantly, domestic institutional and individual investors. A strategy for longer-term growth of these markets should concentrate on the underlying factors preventing market expansion, namely the barriers to firm entry and growth that would allow more and larger firms—which could potentially list on local exchanges and be exposed to a greater number of potential investors. Surely, Africa’s frontier equity markets can play a more prominent role in their host economies, but it is not yet clear that they are unusually underperforming given their environments. The current emphasis on fixing perceived market failures is not only attempting to tackle a problem that may in fact not exist, but is diverting policymakers’ attention away from the real economic constraints. Interventions to boost equity investments based on fixing the “market failure” are thus akin to attacking the symptoms rather than the cause.

Section 2 of this paper frames why these questions about equity investment are important for economic development, how they fit into current academic debates, and how they might affect the range of options facing policymakers seeking to encourage greater flows to the poorest regions. Section 3 looks specifically at Africa’s equity markets and some of the dominant characteristics, including how these markets compare with those in other regions. Section 4 documents the rise and fall (and perhaps rise again) of regional funds. Section 5 analyses the asset allocation of global emerging market funds, concluding that African firms and markets are too small to attract much attention from this particular asset class of investors. Section 6 looks at why African firms remain small using data from firm surveys on the barriers to firm growth in Africa. Section 7 concludes with implications for policymakers.

II. Why is equity investment relevant to development?

Questions about stock market characteristics and equity investment flows to Africa are directly relevant to the development community in at least three ways. At the broadest level, there are thought to be strong links between the financial sector and economic growth. Schumpeter (1934) was an early proponent of the idea that finance was important for economic development, claiming that the system for allocating capital has a substantial impact on economic growth. (Others, such as Robinson (1952), questioned the direction of causality, suggesting that perhaps capital chased growth rather than the other way around.) In the seminal works on finance in developing countries, McKinnon (1973) and Shaw (1973) interpreted evidence from a number of emerging economies as strongly suggesting that Schumpeter was largely correct and that financial systems facilitated economic growth. More recent empirical research by King and Levine (1993) suggests a strong correlation between financial development and economic growth, while Caprio and Demirguc-Kunt (1997) found that higher levels of long term finance were associated with higher productivity and growth. Research by Levine and Zervos (1996) suggests that stock markets themselves are correlated with improved economic performance.

There are multiple ways in which capital markets might be expected to have such an impact on development: to serve as a source of long-term capital for financing investment, to expand the menu of financial instruments available to savers (allowing risk diversification and encouraging resource mobilization), and to continuously monitor the corporate sector. In addition, deep financial systems facilitate the trading of risk, allocate capital, monitor managers, mobilize savings, and ease the exchange of goods, services, and financial contracts (Levine 1996). There is even some evidence that institutional investors in particular (as opposed to individuals or smallholders) have an especially positive impact on corporate governance (Samuel 1996). While foreign private capital flows are increasingly viewed as playing these roles in emerging markets—with private capital displacing official flows for many countries—this trend is just barely beginning in Africa’s frontier markets (Ndikumana 2001; Kenny and Moss 1998).

This paper also contributes to the ongoing debates about the factors behind capital flow trends. The literature on the determinants of capital flows to emerging markets frequently differentiates between the global (“push”) factors and the local (“pull”) factors. The most significant push factors tend to be interest rates in industrialized countries and investor diversification (Chuhan, Claessens and Mamingi, 1993; Fernandez-Arias and Montiel, 1996; Frankel and Okongwu, 1995; Fernandez-Arias, 1994). The major pull factors are related to the strength of an economy, the profitability of its firms, and a country’s perceived policy and risk environment (Offerdal, 1996; Bhattacharya, Montiel and Sharma, 1996). In general, the consensus view is that push factors help to influence the overall appetite for emerging markets among investors, but that pull factors are crucial in determining where precisely those flows are placed—a conclusion that is consistent with our findings.

Lastly, and more immediately, this paper aims to help inform policymakers both in African and in donor capitals as they consider, devise, and implement strategies to catalyze private investment. Substantial efforts are underway to try to encourage greater investment in sub-Saharan Africa: policy reforms, publicly-backed equity funds, subsidies for promotion activities, and technical assistance, among many such interventions thought to compensate for some failure in the marketplace. However, if the constraints to higher flows and the decision-making process

of fund managers are not well understood, then the various interventions may be mis-targeted. Resources and actions by African officials and donors therefore might attack the wrong (or non-existent) market failure and divert attention from the real constraints. The paper argues that, as regards global emerging market funds and their treatment of Africa, there is no apparent market failure. The best course of action may therefore lie outside the financial sector itself, within a set of policy reforms that improve the investment climate and increase the ability of private firms to survive and grow in a sustainable manner.

III. Profile of Africa's equity markets

Sub-Saharan Africa currently has 15 active stock exchanges (Table 1; see Moss 2003 for more background). South Africa's Johannesburg Stock Exchange (JSE) is the dominant market on the continent. At the end of 2005 the JSE was the 16th largest exchange in world and is considered a sophisticated international market on par with the other leading emerging markets, such as Brazil or Malaysia. With a market capitalization of \$566 billion, the JSE accounts for 94% of sub-Saharan Africa's total and is more than 14 times larger than the all of the other markets combined.

Table 1: African Stock Exchanges, end-2005

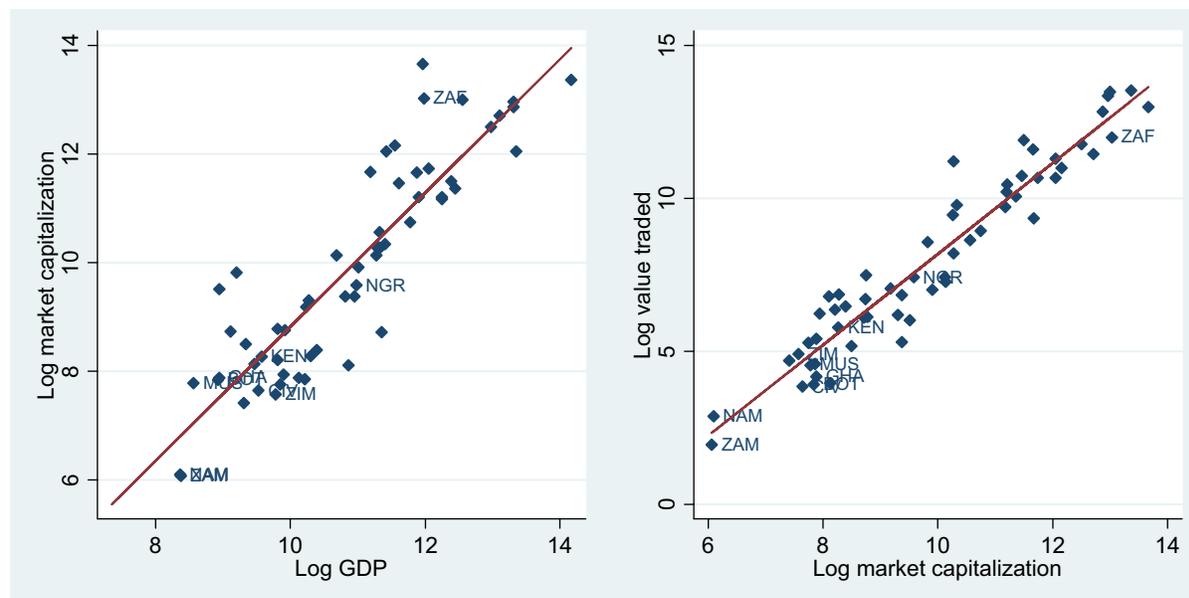
	Number of listings (incl. foreign)	Market capitalization (US\$ bn)	Value traded (US\$ m)	Return (local index; % in US\$ terms)
Botswana	28	2.4	47	-4.7
Cote d'Ivoire (BRVM)	39	2.6	47 ^a	26.0
Ghana	30	1.3	50	-30.5
Kenya	48	6.4	484	46.4
Malawi	10	0.2	8	42.2
Mauritius	38	2.6	155	4.5
Mozambique	2	0.3	na	na
Namibia	28	0.4	529	-3.6
Nigeria	214	19.4	1,917	2.3
South Africa	388	565.9	200,935	27.8
Swaziland	6	0.2	<1 ^a	-11.0
Tanzania	8	0.5	14	-12.2
Uganda	7	0.1	2	-9.2
Zambia	14	0.9	13	125.3
Zimbabwe ^b	79	1.9	385	14.1
Sub-Saharan Total	939	605.1	204,586	
ex South Africa	551	39.2	3,651	

^a2004 data for Cote d'Ivoire and Swaziland. ^bUses estimate of parallel FX rate of Z\$100,000:US\$1. Sources: Standard Bank; Databank; African Business Research Limited; Standard & Poor's (2005).

Table 1 shows that markets are not just small but also relatively illiquid. South Africa’s turnover ratio (traded value/market capitalization) is approximately 40 percent whereas for the smaller exchanges, the ratio is much smaller—Nigeria is about 10 percent, Kenya 8 percent and many of the others closer to 2 percent. This is reflected in the slope of the line in Figure 1 (the right graph)—log market capitalization of 6 corresponds to a traded value log of only 2.5 whereas log market capitalization of 14 corresponds to log traded value of almost 14.

While there are disparities among the other 14 “frontier markets,” they are all still relatively small and underdeveloped. Five of the exchanges list 10 or fewer companies and all but Nigeria and Zimbabwe list less than 50. Meanwhile, 12 out of the 14 frontier exchanges have total market capitalizations under \$3 billion. While these are extremely small in comparison to developed or even mid-sized emerging markets, they are not out of line with global norms given the size of their host economies. The left graph of Figure 1 shows market capitalization vs GDP (in logs) for 80 economies considered by Standard & Poor’s to be “emerging markets,” with the included African markets labeled.

Figure 1: Market Size of Emerging Stock Markets 2004



Note: Malawi and Mozambique are not included. GDP is 2003 data.

Sources: World Bank, World Development Indicators (2005) and Standard & Poor’s (2005)

The data on dollar value of equities traded on African exchanges tell a similar story. At first glance Africa seems far behind. As one active regional fund manager put it, “an entire year’s worth of trading in the frontier African markets is done before lunch on the New York Stock Exchange.”⁴ Indeed, global stock exchanges traded an average of \$150 billion *per day* in 2004, yet the combined trade for all 14 frontier markets in that *entire year* was just \$2.4 billion. South Africa traded \$201 billion and Nigeria \$1.9 billion in 2005, but nine African markets had \$50

⁴ Emerging Market Management’s John Niepold, quoted in Christy (1998).

million or less in trading activity for the entire year, and six had less than \$15 million. Even though these are very small absolute amounts—especially compared with the \$43 billion traded in Mexico or \$639 billion in South Korea that same year—they are consistent with global trends based on market size (Figure 1, right graph). Again, Africa’s frontier markets are undersized in absolute terms, but are not outliers given their relative size.

In addition to the market-wide annual trading data, we also have a unique window into trading in Africa’s frontier markets through information provided by Securities Africa, an advisory firm that works with nearly all the major institutional players in Africa. Because of low liquidity and a dearth of large blocks, these markets often act in practice more like private equity with advisors/brokers actively putting together most institutional-sized deals. Table 2 shows a snapshot of the available blocks on offer at a particular recent point in time. Consistent with the annual data showing low overall trading sizes, this table shows the very small number of large blocks available for trading: across all the frontier markets, there were only 3 bids and 2 offers for blocks greater than \$5 million, and only 14 bids and 8 offers greater than \$1 million. In addition, of the 85 total blocks (both bids and offers) available to the marketplace, more than half are less than \$500,000. As we will see below, this shortage of sizeable blocks of shares excludes *a priori* many funds which have minimum trade sizes that cannot be met by this kind of trading activity.

Table 2: Available blocks of African shares, October 2006

		<i>Total</i>	<i>>\$5,000,000</i>	<i>>\$1,000,000</i>	<i>>\$500,000</i>
Botswana					
	<i>Bid</i>	5	0	3	4
	<i>Offer</i>	2	0	0	1
Cote d'Ivoire					
	<i>Bid</i>	3	1	1	2
	<i>Offer</i>	5	0	0	0
Ghana					
	<i>Bid</i>	7	0	0	0
	<i>Offer</i>	6	0	0	0
Kenya					
	<i>Bid</i>	4	0	2	2
	<i>Offer</i>	3	0	1	2
Malawi					
	<i>Bid</i>	2	0	1	1
	<i>Offer</i>	4	0	0	1
Mauritius					
	<i>Bid</i>	0	0	0	0
	<i>Offer</i>	2	0	0	0
Namibia					
	<i>Bid</i>	4	0	0	0
	<i>Offer</i>	1	0	0	0
Nigeria					
	<i>Bid</i>	4	2	4	4
	<i>Offer</i>	4	1	3	3
Uganda					
	<i>Bid</i>	1	0	0	0
	<i>Offer</i>	0	0	0	0
Zambia					
	<i>Bid</i>	15	0	0	4
	<i>Offer</i>	7	1	3	3
Zimbabwe					
	<i>Bid</i>	4	0	3	3
	<i>Offer</i>	2	0	1	2

Note: All data is from October 9, 2006, using market price from Securities Africa, Africanfinancialmarkets.com or directly from individual bourses. Exchange rates are from FT.com

Source: Securities Africa

IV. Foreign institutional investors: Africa regional funds

In addition to their own domestic investors, emerging markets seeking to grow tend to have two natural investment fund types that they target: regional or country-specific funds and general emerging market funds.⁵

Africa's regional funds have been highly volatile. Prior to the mid-1990s, there was only the longstanding UBS Equity Fund South Africa. Around 1994-95, a result of renewed interest in South Africa after its first democratic elections and a general boom in emerging markets, more than a dozen new Africa-specific regional equity funds were launched, most with great enthusiasm and considerable press coverage. The funds were marketed as an efficient way to diversify since African markets tend to be less correlated with the major developed country exchanges and also as a chance to get in early while valuations were still low relative to other emerging markets (Siddiqi 1997). Reflecting the mood at the time and the hopes that Africa was at the beginning of its own investment boom, one manager of the Calvert New Africa Fund claimed that "Africa is approximately at the same stage where markets in Asia and Latin America were 15 years ago."⁶ At the launch of the Calvert Fund, the South African ambassador to the US predicted that the fund's name "will be written in the history of Africa" (Sisler 1995). (As we will see below, Calvert did gain notoriety, but not for the reasons the ambassador hoped.)

Though the Africa regional funds varied in size and specific geographic focus, most were small and fairly modest in scope by global standards (Table 3). The largest was the Morgan Stanley Africa Investment Fund, worth about \$260 million at its launch in 1994 and at its height had estimated assets over \$300 million. The Morgan Stanley fund had a pan-African focus with investments in at least 12 African countries. According to co-manager Michael Schwabe, "we have a mandate to provide pan-African exposure, and so we offer access to markets that are difficult to access any other way" (Emergingportfolio.com 1999). But Morgan Stanley was not representative of the typical African equity fund, most of which were considerably more modest. For example, Barings Simba Fund—also highly touted in the press—was only about \$30 million in total capitalization.

⁵ There are of course other fund types that might be interested in publicly-listed African securities, such as Middle East/Africa funds (e.g., Arisaig or Imara) or specific frontier funds (e.g., Terra Partners Worldwide Opportunity Fund, Ondine Frontier Market Select Fund) but these tend to be very small and difficult to track.

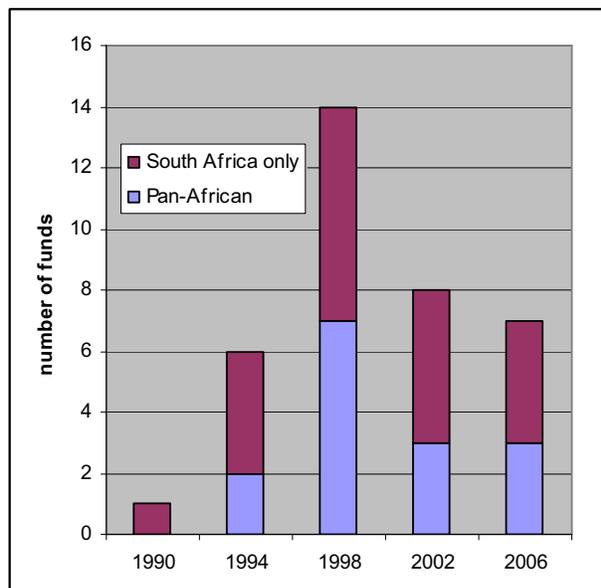
⁶ Justin Beckett of the Calvert New Africa Fund, quoted in Sisler (1995).

Table 3: Africa regional funds

<i>Fund name</i>	<i>Management Company</i>	<i>Fund status</i>	<i>Launch date</i>	<i>Geographic Focus</i>	<i>Size Estimates</i>
Africa Emerging Markets Fund	Emerging Markets Management	Active	1994	Pan-Africa	\$30m (launch)-\$724m (Oct 06)
Blakeney Investors Fund	Blakeney Management	Active	1995	Pan-Africa	\$25m (launch)
Calvert New Africa Fund	New Africa Advisors/Calvert Group	Closed (2001)	1995	Pan-Africa	\$6m-\$10m
EMIF South Africa Index	Sinopia/BBV/KBC	Active	2001	South Africa	\$7m
Flemings' New South Africa Fund (NSA)	Robert Fleming Holdings Limited	Closed (1998)	1994	South Africa	\$60m (launch)-\$85m
GT Africa Fund	GT Management	Closed (1999)	1995	Pan-Africa	\$75m (launch)
Investec Pan Africa Fund	Investec Asset Management	Active	Nov-05	Pan-Africa	\$25m (Oct 06)
Morgan Stanley Africa Investment Fund	Morgan Stanley	Closed (2003)	1994	Pan-Africa	\$ 263m (launch)-\$320m
Orbis Africa Equity (Rand) Fund	Orbis Investment Advisory	Active	1998	South Africa	\$252m
Regent Undervalued Assets Africa	Regent Fund Management	Closed (2000)	1996	Pan-Africa	\$10m
Save & Prosper Southern Africa Fund	Save & Prosper (Fleming's)	Closed	1994	South Africa	\$13m
Simba Fund	Baring Asset Management	Closed (2000)	1995	Pan-Africa	\$30m
South Africa Trust	Old Mutual	Active	1995	South Africa	\$145m
Southern Africa Investors Ltd	Mercury Asset Management/Sanlam (SA)	Closed (1998)	1995	South Africa	\$50 million
The Southern Africa Fund (SOA)	Alliance Capital	Closed (2004)	1994	South Africa	\$50m (launch)-\$120m
UBS (CH) Equity Fund South Africa	UBS Global Asset Management	Active	1948	South Africa	\$37m

Much of this initial enthusiasm for Africa funds was short-lived. The vast majority have since closed owing to poor returns, lack of investor interest, or, in at least one case, mismanagement. By 2006 only around seven of the funds remain active (Figure 2). Of these, only two are Pan-African survivors from the mid-1990s (the African Emerging Markets Fund and the Blakeney Investors Fund) and four invest only in South Africa. The remaining one, Investec's Pan Africa Fund, was launched only in November 2005 (see below).⁷

Figure 2: Africa regional funds



The first wave of Africa funds generally performed poorly and had difficulty attracting investors. Full details of why so many of these funds failed are not available, but press reports and some fund documentation can give the outlines of a few illustrative stories:

- The *Morgan Stanley Africa Fund* was a closed-end fund listed on the New York Stock Exchange and also began with a commitment to markets beyond South Africa, with initial plans to maintain South Africa's allocation at only 30-40% with the remainder of the portfolio spread throughout the continent, most heavily in Egypt, Ghana, and Mauritius. But the fund did not perform; by the beginning of 2002, when the decision was made to begin liquidation, it had lost an average of 6% per year over the previous five years. It was also unable to find enough investments in the frontier markets; by the time of liquidation, 84% of the fund was invested in South Africa (Morgan Stanley 2001).
- *The Calvert New Africa Fund* was launched in April 1995, hailed by its managers as the first mutual fund aimed at attracting American investors to African markets. Unlike most

⁷ There are several new funds reportedly just getting started (e.g. the Bermuda-based Finch Africa Fund) and others under consideration. In parallel to the rise and fall of funds has been niche media outlets. A number of newsletters and other services aimed at encouraging private investment in African equity markets arose in the mid 1990s, most of which quickly closed. However, there may be an uptick in these again as well; one example is investinginafrica.net which launched in early 2006.

of the other funds, Calvert targeted individual investors rather than institutions. The fund, split between New Africa Advisors (NAA) and Calvert, planned to initially invest 85% in South Africa but expected to expand into other markets including Ghana and Zimbabwe (Umoren 1995). The fund quickly ran into performance and management difficulties. After losing 19% in 1999 and 33% in 2000, the fund was also hit with a scandal at NAA.⁸ Calvert folded the remaining assets into a small South Africa Fund (EIU 2001). A year later—without publicity—this was merged into a larger International Equity Fund, citing “poor performance and problems attracting sufficient assets” (Murray 2002). The International Fund currently invests only around 2% in South Africa and none in the frontier markets.⁹

- The *Barings Simba Fund* generally underperformed since its launch and was never able to generate momentum. The final performance statement in 2000 claimed that net asset value per share fell 14% during the first six months of 2000 (Simba Fund Ltd. 2000) and the fund finally went into liquidation in September of that year.
- *Regent Undervalued Assets Africa* also failed. The fund was aggressively frontier-focused; its South African exposure was targeted at just 16% of the portfolio at launch (*Economist* 1997), but lost 31% in its first six months (*Africa Financing Review* 1998). In 2000 the fund was de-listed from its exchanges in Dublin, Nairobi, and Gaborone and eventually liquidated and dissolved.
- EMM’s *Africa Emerging Markets Fund* stands as the most notable exception to the trail of poor-performance, no doubt one reason it is one of the only originals from the mid-1990s left. According to Standard & Poor’s, the fund gained an average of 20.4% annually over the past ten years, and 61% per year during the last three years (S&P 2006). As a result, its assets have grown from \$30 million at launch in 1994 to \$724 million by October 2006 (ibid). EMM currently invests throughout the continent, with exposure in ten countries: Botswana, Cote d’Ivoire, Ghana, Kenya, Nigeria, Mauritius, Namibia, Zambia, Senegal and Mali (the last two presumably through listed shares in Abidjan and Accra, respectively, since they have no stock markets of their own).

Despite the generally disappointing track record of African regional equity funds, there are signs that interest in the region may be reviving, and that new regional equity funds may emerge. Investec, a major South African financial services group, announced in 2005 the start of two new Africa funds, one pan-Africa fund targeting foreign investors and the other targeting South African institutions looking to invest in the region. The former, the Investec Pan Africa Fund,

⁸ In November 2000 NAA’s fund manager Justin Beckett was accused of fraud and asked to resign from his position as head of another NAA-managed fund, the New Africa Opportunity Fund, a private equity fund launched in 1996 and backed by the Overseas Private Investment Corporation (OPIC), a US government agency. According to later court documents, Beckett was accused of ignoring fund guidelines, misappropriating, and falsifying documents. See Sloan Financial Group, Inc., et al. v. Justin F. Beckett 2003. The controversy also unsurprisingly led to the dismissal of NAA from its role as advisor to the Calvert New Africa Fund. See Serres 2001. Beckett is now CEO of Fluid Audio Networks, which runs the American Idol Underground website.

⁹ This type of merger is common with failing funds. In order “to avoid closing funds, companies often merge sagging funds into other funds within the same family.” See Justin Wisner, “Record 225 mutual funds close in 2000,” CBSMarketWatch.com, April 9, 2001.

has in its first year since launch raised \$25 million and invested in ten countries (Investec 2006). Only 34% of the portfolio is in South Africa, and it plans to limit its South African holdings to 50% or under (Cranston 2005).

Africa's regional funds have thus been both highly specialized and extremely volatile. Most of the funds that appeared in the heady emerging market days of the mid-1990s are now gone, but the very few that have shown positive returns have survived and grown. Whether Investec's new fund is an anomaly or the beginning of a trend of expanded interest, it is too early to say. Nevertheless, because of their specific geographic focus, regional funds are likely to be the dominant foreign fund players in the region. They thus hold potential for generating new inflows and for boosting trading volume in the frontier markets for the medium term.

V. Foreign institutional investors: Global emerging market funds

The other type of equity funds that might *a priori* be interested in African markets are global emerging market (GEM) funds, which have a mandate to invest their portfolios in across a range of emerging markets but do not have a specific geographic focus. If African markets are hoping to attract foreign capital, it might be expected that they would complement the small (and often quirky) boutique regional funds and begin to tap the very large pool of GEM money searching for undiscovered assets in developing countries.

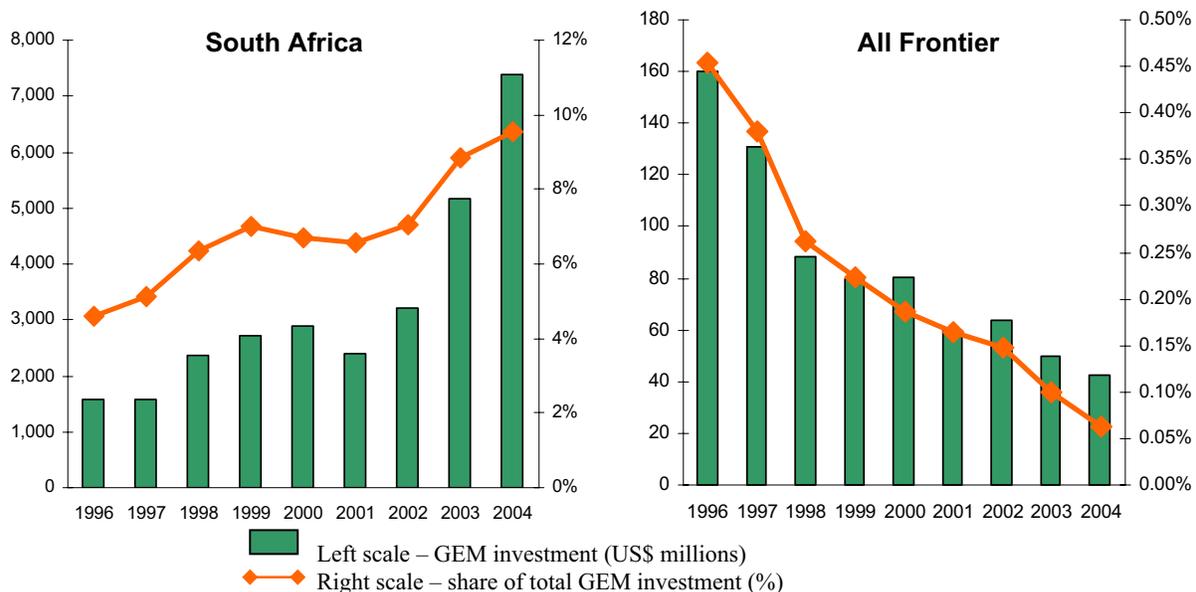
To investigate the activities of GEM funds, we use a dataset from EmergingPortfolio.com Fund Research (EPFR).¹⁰ The data includes end-year asset allocation by country for a large sample of GEM funds from 1995-2005, which, according to EPFR, covers 80-90% of the total GEM universe.¹¹ EPFR includes 11 African equity markets in its coverage: Botswana, Ghana, Cote d'Ivoire, Kenya, Malawi, Mauritius, Namibia, Nigeria, South Africa, Zambia and Zimbabwe. (While Uganda, Tanzania, Swaziland and Mozambique are not included in the EPFR dataset, these four markets are among Africa's smallest and their exclusion is unlikely to affect the results). For end-2005, the data include information on 94 funds with total assets under management of \$95 billion. Overall, the bulk of GEM holdings, 55% of the total, are in Asia, while holdings in sub-Saharan Africa are valued at \$9.4 billion, or 10% of the total (see Annex B; Table B1). But two striking facts immediately surface from this data: (a) every fund in the sample has at least one holding in South Africa and (b) a scant \$28 million is held in Africa's frontier markets.

Worldwide, South Africa is now the fourth largest destination of GEM investment, trailing only Korea, Taiwan, and Brazil, and ahead of Mexico, India, and China (Annex B; Table B2). Additionally, GEM investment to South Africa has also grown considerably over time, both in absolute terms and as a share of the global total (Figure 3 for moving 3-year averages). Since 1995, South Africa's share of worldwide GEM investment has more than doubled, while its absolute holdings have risen from under \$1.5 billion a decade ago to \$9.4 billion held in 2005.

¹⁰ Other studies that have used EPFR dataset include, among others, Gelos and Wei (2002), Borensztein and Gelos (2000), Gottschalk and Griffith-Jones (2003) and Gande and Parseley (2004).

¹¹ Given the volatility and fluidity of the funds in this asset class, the funds are not all the same over the panel. The sample includes 107 funds in 1995 and 94 funds in 2005.

Figure 3: GEM holdings in Africa 1996-2004
(3 year moving averages)



Source: EmergingPortfolio.com Fund Research

The story for frontier markets is almost a mirror opposite. The eleven other African markets attracted a combined 0.03% of the total assets. Zimbabwe was the largest single recipient with three funds holding \$9 million worth of assets. Mauritius was held by two funds for a total of \$3 million. Kenya (\$1 million), Ghana (\$4 million), Nigeria (\$5 million) and Botswana (\$5 million) were held by only a single fund each. No GEM fund held any assets in Cote d'Ivoire, Namibia, Malawi or Zambia at end-2005 (Annex B; Table B3).

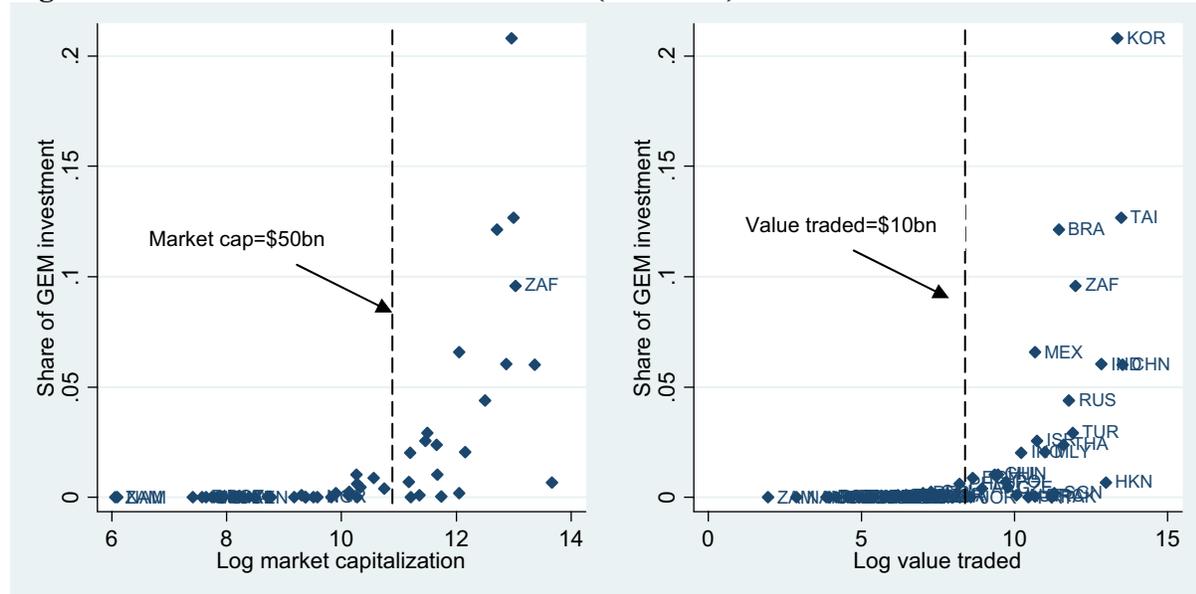
The trend is also not favorable, with frontier holding falling both in absolute and relative terms. From a high of \$238 million at end-1996, assets held in African frontier markers are now worth only \$28 million. As a share of the global total, investment to the rest of the continent has fallen from 0.56% to 0.03% (Figure 3 for moving 3-year averages). While extremely small sample size suggests caution about over-interpreting trends from these figures, they are nonetheless in stark contrast to the trends seen in the South African numbers.

The levels of GEM investment in sub-Saharan Africa may be extremely low, but, given the characteristics of these frontier markets, are they out of line with global trends? The data suggests a fairly emphatic 'no.' A series of simple correlations indicate that African markets receive the level of investment from GEM funds wholly consistent with their size and liquidity. To show this, we plot the share of total GEM investment against market capitalization, value traded, and GDP.¹² All tell much the same story. For example, GEM fund allocation to any

¹² See Annex A for pairwise correlations for these different indicators.

particular country appears to remain near zero until a market reaches a certain threshold followed by a sharp increase in the share of total investment. Figure 4 suggests that to get on the radar of GEM fund managers requires a minimum threshold of about \$50 billion in total market capitalization and/or total annual value traded of about \$10 billion.

Figure 4: Share of Total GEM investment (Dec 2005)



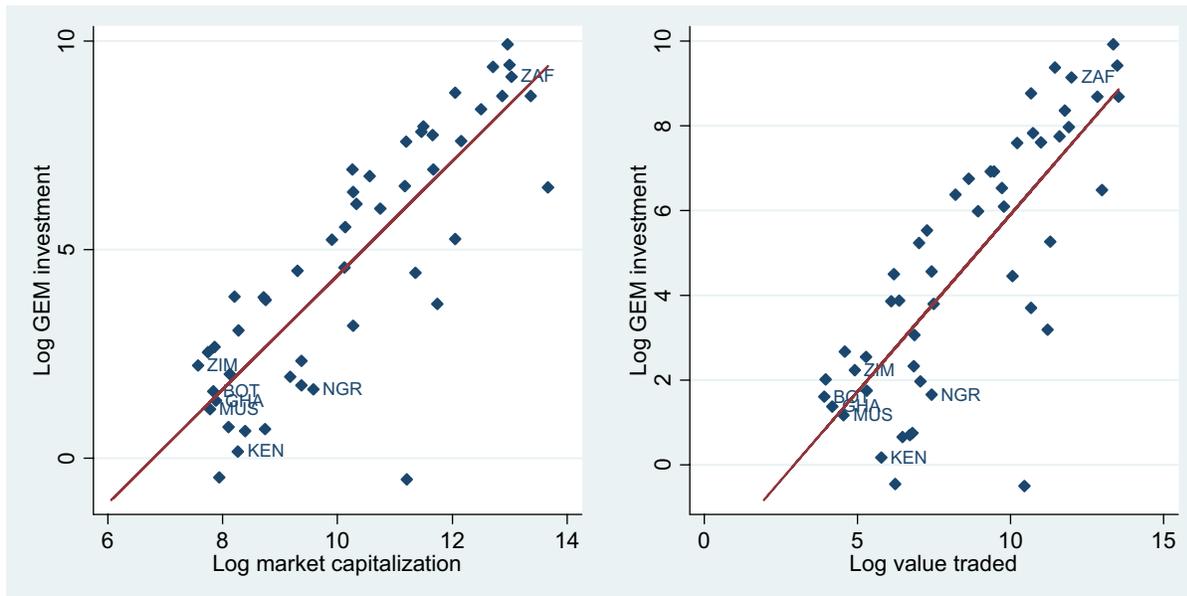
Sources: EmergingPortfolio.com Fund Research and Standard & Poor's (2005).

In the left graph of Figure 4, which plots the share of total GEM investment against market capitalization (African markets are labeled), the 20 countries with market capitalization above \$50 billion receive 96% of GEM investment. The other 39 countries below this level together receive just 4% and none individually receives more than 1% in 2005. The right graph is nearly identical, with a value traded threshold of about \$10 billion. All of the African markets, except for South Africa, are far below these thresholds—thus their exclusion from GEM attention is not necessarily a surprise, but perhaps is instead to be fully expected.

The conclusion remains the same if we use different measures of GEM fund investment. As market capitalization and value traded rise, so does GEM investment (Figure 5).¹³

¹³ Though not pictured, the linear relationship is similar for log GDP.

Figure 5: Value of GEM investment (Dec 2005)

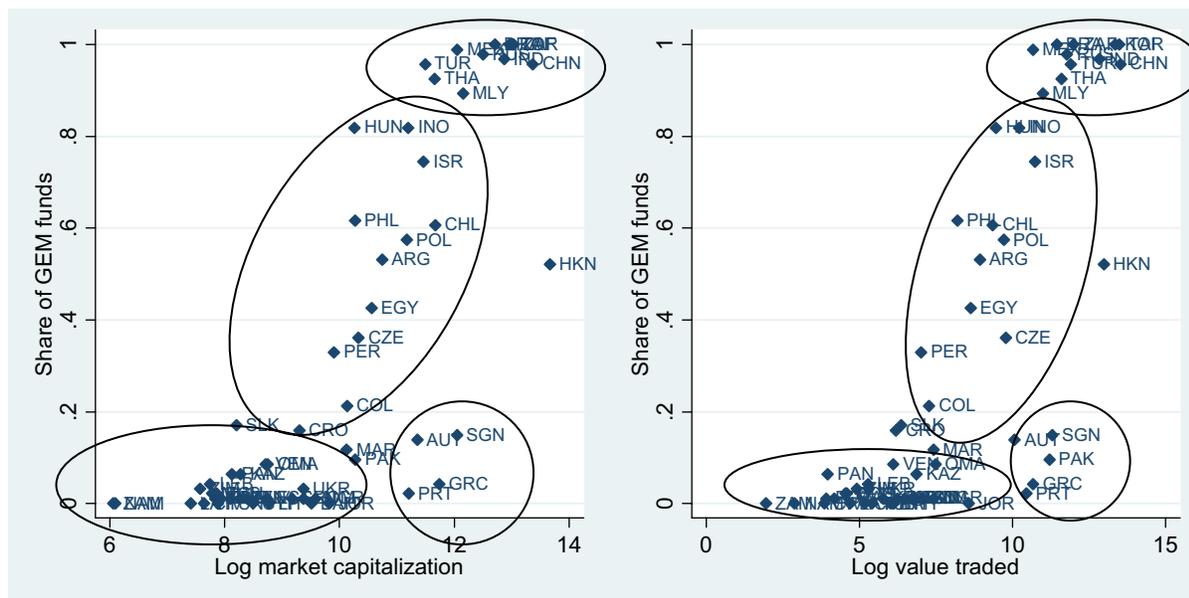


Sources: EmergingPortfolio.com Fund Research and Standard & Poor's (2005).

The story is also the same when we observe the relationship between market size and liquidity with the number of GEM funds investing in any particular market (Figure 6). The data appears to show fund managers lumping countries into one of three groups, highly correlated with market size: The first group is those with less than \$20 billion in market capitalization; fewer than one in ten funds in our sample invested at all in these countries. A second group of middle-sized markets (roughly \$20-150 billion cap) received more attention from a greater number of funds. A third group of mature emerging markets, countries with over \$150 billion in market capitalization receive investments by nearly every fund. (A fourth group, in the lower right corner, are countries such as Portugal or Greece which were once considered emerging markets, but have outgrown the asset class and are no longer typically considered emerging markets.) A similar picture is seen in the relationship between the number of funds investing in a market and the value traded on the relevant exchange. Markets cluster in groups, with thresholds at roughly \$1-2 billion traded per year to move out of the bottom group and \$75-100 billion to join the top group.¹⁴

¹⁴ We test to see if Africa is “off the trendline” by carrying out simple regressions of log (share of investment) regressed on log (value traded) and log (market capitalization) and an Africa dummy set to 1 if the country is in Africa. We ran several variations on this specification—in no case was the Africa dummy significant.

Figure 6: Share of GEM funds (Dec 2005)



Sources: EmergingPortfolio.com Fund Research and Standard & Poor's (2005).

Our conclusion from these figures is that African markets are not treated much differently from other countries, and that they may simply be too small to command much attention from GEM fund managers. Combining this cross country data with the information cited above about available blocks of African shares, and the general minimum trade sizes of many funds (which typically exceed the normally available blocks), the picture becomes clearer.¹⁵

The quantitative analysis described above is consistent with qualitative evidence provided by interviews with fund managers and market markers. Michael Schwabe, former manager of Morgan Stanley's Africa Fund, called the lack of liquidity the major deterrent to investors in the region (Emergingportfolio.com 1999). A *Financial Times* profile of the Ghana exchange noted that when the Simba Fund was trying liquidate its assets, it had trouble exiting the Ghana market because of a lack of buyers at any price (Kibazo 2000). Even where international fund managers may have an initial interest in a frontier market, the realities of limited market size and liquidity, keep them out.

¹⁵ Anecdotal evidence suggests that many funds target a minimum trade size of at least \$1 million, with some of the larger funds seeking \$5 million or greater sized blocks. A sample of the individual holdings of several funds (which is not available through the EPFR database) suggests that very few funds hold blocks smaller than \$500,000 and those above the average GEM size fund (about \$1 billion) tend not to have holdings smaller than \$1 million for any single share.

VI. Africa's small market size

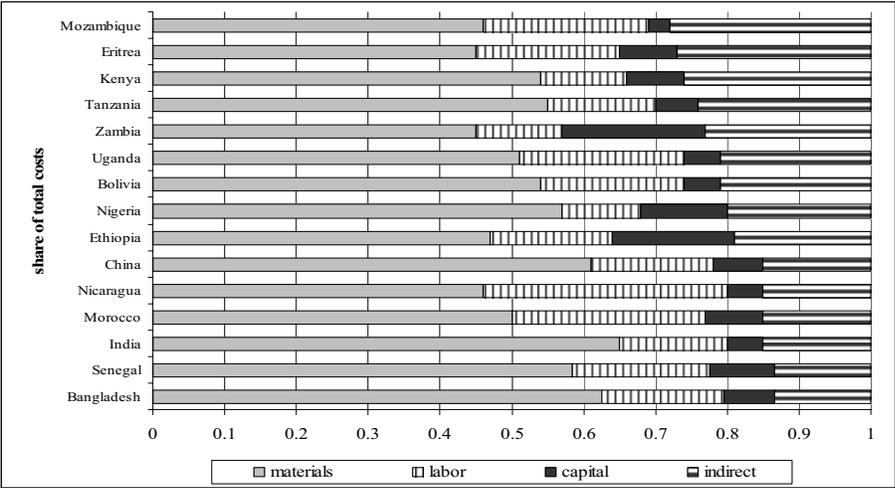
Our conclusion is that there is not an “Africa effect” per se but rather a set of problems combining size and level of GDP, which is hindering investment. Countries can rely on one or the other to cross the threshold—for example, India is relatively poor but its larger size generates enough enterprises that generate investor interest. There are also examples of relatively small countries which have become rich enough to generate enough firms to attract the kinds of investments we are discussing in this paper. But for Africa, level of GDP and size of market size are significant constraints, and this in turn may be determined by various underlying factors, including a poor investment climate.

There is a large literature on the constraints faced by the private sector which may help to explain the problem of small market size, including the combined obstacles of infrastructure and regulation and political economy factors that have prevented the rise of a sizeable black entrepreneurial class (Eifert, Gelb and Ramachandran, 2005; Ramachandran and Shah, 2007). Despite recent reforms, African firms still suffer from a harsh business climate; one that reduces their productivity to a significant extent when compared to firms in other parts of the world. Data from the World Bank's Investment Climate Surveys show that most firms in the formal private sector in sub-Saharan Africa are very small, of the order of 10-50 employees. They are also particularly disadvantaged when it comes to the supply of infrastructure.¹⁶ They suffer from burdensome regulations and in some cases, from high levels of corruption as well.

The investment climate survey data show that business losses due to investment climate constraints—power outages, transport failures, and logistics delays—are largely responsible for shortfalls in productivity observed in the data. African firms report substantially higher losses than their counterparts in higher-performing countries, which translates into a corresponding decline in measured productivity. In Kenya for example, losses from power failure amount to 6% of sales for the median firm, whereas in China, they are only 1% of sales. In total, “indirect costs” comprising of energy, transport, land, and telecom are less of a relative burden for higher-performing firms. Figure 7 provides a cross-country comparison of firms' cost structures, including labor (wages, benefits), capital (interest, finance charges, machine depreciation), raw materials, and other indirect costs. In strong performers such as China, India, Nicaragua, Bangladesh, Morocco, and Senegal, the combination of energy and indirect costs are 13 to 15 percent of total costs, and around half the level of labor costs. In contrast, this combination in most African countries accounts for 20 to 30 percent of total costs, often dwarfing labor costs.

¹⁶ For more detail about these datasets and how the data are collected, see www.enterprisesurveys.org.

Figure 7: Cost Structures, Firm-Level Average by Country



African firms also report substantially higher losses than their counterparts in higher-performing countries, which translate into a corresponding decline in measured productivity. A substantial portion of the variance in measured productivity between China and several African countries (especially Zambia, Ethiopia, Kenya, Nigeria, and Tanzania) can therefore be attributed to infrastructure and logistics-related losses rather than intrinsic capabilities.

How does all of this affect market size? The data suggest that African firms are faced with constraints that prevent them from increasing productivity and expanding their operations. A high cost business environment has reduced the competitiveness of African firms, thereby limiting their ability to grow. It has very likely hampered the entry of new firms and increased the exit of firms. We do not yet know if Africa’s investment climate is in line with its per capita GDP or whether it is exceptionally poor; this is an important subject for future work. To explore this question, we will need to look at the investment climate in comparably poor countries outside Africa.

VII. Conclusion

Africa has made significant progress in developing its domestic capital markets. Information on African markets is improving, regulatory and financial sector reforms have been implemented, and countries are beginning to adopt modern technologies such as automated trading and central depository systems. South Africa has successfully risen into the ranks of the leading emerging market destinations. However, the rest of the continent remains largely outside the expansion in global financial flows witnessed over the past two decades. Africa's "frontier markets" remain firmly off the radar of international portfolio fund managers, with the exception of a handful of Africa fund managers—and possibly Nigeria whose market capitalization has recently topped \$30bn. This paper suggests, however, that the overall level of GEM investment in African markets is consistent with global trends. Given the size and liquidity constraints that characterize these markets, the amount of attention from equity fund managers seems in line with global norms.

This analysis broadly supports the "market works" view of why Africa does not get more equity investment, but has some substantial implications for strategies to grow these markets and attract new investors. This conclusion suggests that many of the public policy interventions intended to increase equity investment in Africa are unlikely to have a significant impact in the short and medium terms. The implications for Africa and policymakers are threefold. First, for the foreseeable future, foreign fund investment in the frontier markets will be limited largely to those funds with regional specialties. Investment promotion efforts should therefore focus on increasing domestic institutional and individual investment and concentrate foreign efforts on raising the number of regional funds rather than attempting to lure general emerging market funds.

Second, the depth and success of the Johannesburg Stock Exchange need not remain constrained within South Africa's borders. Botswana, Namibia, and others have increased cross-listings—a trend that should continue to be encouraged. While wholesale regionalization of bourses faces significant barriers, there are other cooperative arrangements that would allow frontier markets to benefit more fully from the liquidity and exposure of the JSE (Irving 2005; Okeahalam 2005).

Finally, a long-term strategy for attracting equity investment should concentrate on increasing the supply of available securities—since demand will come naturally through the market. Increasing supply means tackling the barriers of small market and firm size to encourage the growth of more and larger firms on the continent. Solutions to increasing the size and scope of the African private sector must focus on improving the investment climate, reducing the level of risk and uncertainty, and providing greater means for small, indigenous firms to survive and grow without inducing large distortions. While these issues are far beyond the scope of this paper, it is worth emphasizing that addressing the problem of private sector growth—rather than attempting to fight imagined "market failures"—is a crucial component of any overall plan to increase equity investments in the region.

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Annex A

Measures of GEM fund investment have strong and positive relationships with individual market characteristics. Table A1 gives the simple pairwise correlations of three variables measuring GEM investment (log GEM investment, share of total GEM investment, and share of total funds investing in a market) and three measures of market size and liquidity (log market capitalization, log value traded, and log of host economy GDP).

Table A1: Pairwise correlations

	log_inv	share_~v	share_~s	log_cap	log_tr~d	log_gdp
log_inv	1					
share_inv	0.6715	1				
share_funds	0.9308	0.7173	1			
log_cap	0.8286	0.6027	0.8072	1		
log_traded	0.7861	0.6024	0.7962	0.9582	1	
log_gdp	0.7892	0.5775	0.7752	0.8908	0.8906	1

Annex B

Table B1: GEM Fund assets by region, end-2005

Region	GEM investment (US\$ mn)	Share of total
Asia	52,533	55%
Latin America/Caribbean	20,266	21%
Emerging Europe	9,571	10%
Sub-Saharan Africa	9,436	10%
<i>of which South Africa</i>	9,409	10%
Middle East/North Africa	3,528	4%
Total	95,334	100%

Source: EPFR

Table B2: Country allocation of GEM Funds, end-2005

Rank	Country	GEM investment (US\$ mn)	Share of total
1	Korea	20,410	21%
2	Taiwan	12,430	13%
3	Brazil	11,903	12%
4	South Africa	9,409	10%
5	Mexico	6,449	7%
6	India	5,918	6%
7	China	5,911	6%
8	Russia	4,297	4%
9	Turkey	2,871	3%
10	Israel	2,515	3%

Source: EPFR

Table B3. GEM holdings in SSA countries (December 2005)

Country	# of GEM funds with investments (out of 94 tracked)	Est. value of all GEM holdings (US\$ mn)	Share of total GEM investment (%)	Avg. share allocation -- all GEM funds (%)	Largest share allocation (%)
Botswana	1	5.0	0.01	0.01	0.80
Cote d'Ivoire	0	0.0	0.00	0.00	0.00
Ghana	1	4.0	0.00	0.01	0.64
Kenya	1	1.2	0.00	0.00	0.19
Malawi	0	0.0	0.00	0.00	0.00
Mauritius	2	3.2	0.00	0.01	0.52
Namibia	0	0.0	0.00	0.00	0.00
Nigeria	1	5.2	0.01	0.01	0.84
South Africa	94	9,408.5	9.58	9.36	14.34
Zambia	0	0.0	0.00	0.00	0.00
Zimbabwe	3	9.3	0.01	0.00	0.16

Total SSA	\$9,436	9.61%
SSA excl. South Africa	\$28	0.03%

Source: Author calculations based on EPFR

**DRAFT –
For delegate review and input only**

DRAFT

WWF/UNEP-FI workshop on Innovative Financing for
Sustainable Small and Medium Enterprises in Africa

Risk mitigation mechanisms and investment in sustainable SMEs

Geneva, 26 September 2007

- DRAFT

Version 18 September 2007

Prepared by DeRisk Advisory Services Ltd.

DRAFT

DeRisk Advisory Services Ltd. is a risk mitigation specialist for investors in businesses and projects in developing countries, providing unique access to a wide spectrum of risk coverage and services. We work with debt, equity, corporate, philanthropic, and other developing country investors, as they deploy capital beyond the security—and limitations—of more mature and liquid financial markets.

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1 Executive summary

In order for Africa to benefit from sustained and far-reaching growth, its small and medium size enterprise (SMEs) sector must continue to grow. And in order for this growth to be environmentally sustainable, “sustainable SMEs” – either SMEs whose business models are aimed at bettering the environment or SMEs that are run in an environmentally sustainable manner – should help drive it. An increasing number of SMEs require more access to outside capital in order to do so – capital whose price is commensurate with the actual investment risk and is easier to access.

There are a variety of reasons why more capital is not flowing to SMEs. Others at the *WWF/UNEP-FI workshop on Innovative Financing for Sustainable Small and Medium Enterprises in Africa* will address issues surrounding the supply of capital, the visibility of “investible” SMEs, restrictions on management know-how, among others. **This paper addresses the issue of risk – both real and perceived – as an SME investment hurdle by assessing the potential for specific risk mitigation mechanisms to reduce investment risk in a scalable and replicable manner. The result is a presentation of three mechanisms that could potentially be developed and/or more widely deployed in partnership with organizations like those participating in the WWF/UNEP-FI workshop.**

A wide variety of risk mitigation mechanisms are currently employed to eliminate or at least reduce the *business, market and country* risks related to SME investment in Africa. This paper provides concrete examples – or potential applications – in the following categories:

Table 1: Overview of SME Investment Risk Mitigation Mechanisms

Mechanism	Example	Risk impact
Diversification	<ul style="list-style-type: none"> GroFin Aspire funds in Africa 	<ul style="list-style-type: none"> All risks: stabilizes investment returns
Due Diligence / Assurance	<ul style="list-style-type: none"> Deloitte & Touche due diligence / assurance services 	<ul style="list-style-type: none"> Business risk: negative screening of bad risks
Fund Enhancement	<ul style="list-style-type: none"> [Anonymous] European relief agency “first loss” anchor investment in an East Africa SME fund 	<ul style="list-style-type: none"> Business risk: partial coverage against underlying business failure
Guarantee	<ul style="list-style-type: none"> Grameen Foundation “Growth Guarantee” network USAID – Development Credit Authority guarantees GARI Loan Guarantee Fund World Bank / IBRD partial credit “re-guarantees” 	<ul style="list-style-type: none"> Business risk: partial coverage against underlying business failure
Hedging	<ul style="list-style-type: none"> ING Bank commodity and currency derivatives Distributed Capital Group “DFT-Hedge” for currencies in developing markets FMO TCX Fund 	<ul style="list-style-type: none"> Market risk: minimizes volatility of business cash flows or investment returns related dependent on asset prices (e.g. currencies, commodities)
Private Sector Insurance	<ul style="list-style-type: none"> Hiscox (Lloyd’s syndicate) political risk insurance Atradius credit insurance Aureol Insurance Company (Sierra Leone) 	<ul style="list-style-type: none"> Business and/or country risks: insures against losses due to specific risk events
Public Sector Insurance	<ul style="list-style-type: none"> MIGA political risk insurance GIFF index insurance facility UEP Global Environment Facility 	<ul style="list-style-type: none"> Business and/or country risks: insures against losses due to specific risk events
Securitization	<ul style="list-style-type: none"> Blue Orchard/OPIC/DWM microfinance bond AWS profit-sharing bond 	<ul style="list-style-type: none"> All risks: stabilizes investment returns
Technical Assistance	<ul style="list-style-type: none"> Business Development Initiative - DfID-funded generic TA SME Sustainable Opportunities Initiative – IFC-funded sustainability-oriented TA 	<ul style="list-style-type: none"> Business risk: active management of risk

The paper uses a framework to assess and rank the above mechanisms in terms of deployment potential as defined by:

- Potential for impact on investment risk reduction
- Scalability and/or replicability potential
- Cost of adaptation/development and deployment
- Application to risk mitigation of sustainable SME investment
- Relevance to the organizational mandates of required supporting/partnering institutions

Three mechanisms emerge as having considerable risk mitigation potential for sustainable SME investment in Africa.

Table 2: High-potential Mechanisms

Mechanism	Summary	Impact	Input / resources required
Guarantee - Local Bank Unsecured Lending Facility	Theoretical mechanism with potential for development: A local bank unsecured lending facility would provide developing country lending institutions with partial credit guarantees, funded with their own risk capital, on lending portfolios.	<ul style="list-style-type: none"> ▪ Business risk mitigation: provides partial substitute for SME collateral for domestic financing ▪ Sustainability: possible promotion of sustainable SMEs 	<ul style="list-style-type: none"> ▪ Donor/DFI: Concept/facility development funding ▪ Local investors: facility co-investors ▪ Charity/NGO: sustainability criteria
Enhancement – Private Sector Investment Enhancement Fund	Theoretical mechanism with potential for development: A private sector investment enhancement fund would use its balance sheet to provide investment guarantees, credit enhancement to local and international investors in SMEs. Funded by private sector, "social" and / or philanthropic capital, it could also provide "first loss" or other direct investment enhancement to both equity and debt investors in – and from – any geographic region.	<ul style="list-style-type: none"> ▪ Business risk mitigation: broad, versatile coverage against business failure, collateral substitute for domestic and international investors ▪ Sustainability: likely promotion of sustainable SMEs given support of donor/philanthropic institutions 	<ul style="list-style-type: none"> ▪ Donor/DFI: Concept/facility development funding ▪ Auditors/TA providers: DD/Assurance/TA partnerships ▪ Charity/NGO: sustainability criteria marketing
Technical Assistance – Fund-linked technical assistance	Existing mechanism with potential for replication: A facility funded by UK Department for International Development called the Business Development Initiative (BDI) provides its sister organization, a Sierra Leone/West Africa-focused PE fund, with additional financial resources to identify, assess and develop potential SME investment opportunities.	<ul style="list-style-type: none"> ▪ Business risk mitigation: enables investors to potentially screen against – and later control – business risks leading to enterprise failure ▪ Sustainability: likely promotion of sustainable SMEs given support of donor/philanthropic institutions 	<ul style="list-style-type: none"> ▪ Donor/DFI: facility development and capitalization funds ▪ Charity/NGO: sustainability criteria, marketing

Next steps

1. Gain feedback from workshop delegates on the validity of this draft paper
 - Are there missing/other mechanisms that could be assessed?
 - Is the assessment framework appropriate?
 - What is the risk mitigation potential of selected mechanisms from your perspective?
 - Which, if any other mechanisms potentially more interesting to you?
 - Where are the data/analysis gaps from your perspective
2. Revise/complete assessment of highest potential mechanisms, and close data gaps
3. Identify partners to help develop/deploy one or more mechanisms

As this research paper is in working draft form, workshop delegate views on the analysis and conclusions presented is critical.

2 Introduction

This document is a draft of a research paper prepared by DeRisk Advisory Services for delegates in the WWF/UNEP-FI workshop on Innovative Financing for Sustainable Small and Medium Enterprises (SMEs) in Africa. The paper will provide data and background information for one of the workshop topics: “mitigating sustainable SME investment risk”.

DeRisk Advisory Services Ltd. is a risk mitigation specialist for investors in businesses and projects in developing countries, providing unique access to a wide spectrum of risk coverage and services. We work with debt, equity, corporate, philanthropic, and other developing country investors, as they deploy capital beyond the security—and limitations—of more mature and liquid financial markets.

2.1 Definitions

This paper will use definitions of “SMEs” and “sustainability” proposed in another workshop paper entitled “Sustainable Small and Medium Enterprises - Creating Value within Planetary Limits” (J. Englis 2007).

SME: businesses “...that employ between 10 and 100 people and with financing needs anywhere from USD 50,000 to 500,000 for early stage, high potential, high growth sustainable enterprises.”

The WWF/UNEP FI workshop will also distinguish between “sustainable” and “normal” SMEs.

Sustainable SME: “...two categories of Sustainable SMEs may be identified:

1. SMEs that are internally led / driven to contribute to sustainable development to the maximum possible and
2. SMEs that happen to support sustainable development in some way that is appropriate to the context within which they operate...”

For the sake of clarity, the paper’s definition of “sustainable development”:

Sustainable development: “...may be defined as a commitment to ‘improving the quality of human life while living within the carrying capacity of supporting ecosystems’ (IUCN et al., 1991) and thus includes social development.”

2.2 Objectives

The paper has the following objectives:

1. Present risk mitigation mechanisms are currently used, and which could potentially be developed, for SME investment – with a specific focus on Africa

The paper will provide a “long list” of risk mitigation mechanisms currently used and any new risk mitigation mechanisms that could be employed to reduce the risk of investing in sustainable SMEs. The purpose of this section is to give delegates to the meeting an overview of:

- Which mechanisms already exist in some fashion
- Which innovative mechanisms are potentially disposed to being adapted to make it less risky for investors, especially from the private financial sector, to invest in SMEs.

The paper will also elaborate and employ a framework for assessing the “long list” of mechanisms for their potential in reducing the risk of investing in sustainable SMEs. The framework will enable an assessment of:

- Which mechanisms are the most likely to reduce risks material to SME investors
- Potential for, and cost of, wider application and / or replication
- Which of these might most benefit from partnership with donor and philanthropic institutions

2. Present and assess in greater detail a small number of mechanisms with the greatest potential for impact on sustainable SME investing

Based on this assessment framework described above, the paper will present a “short list” of high-potential mechanisms for more detailed discussion. The purpose of this section is to provide delegates with:

- A framework for analysis and advancement of a number of concrete cases with potential for near-term development
- An overview of requirements, roles, responsibilities, rewards and risks for mechanism sponsors, developers, users, potential partners and stakeholders
- Any open issues to be resolved and / or further analysis still required

3. Gain input and feedback from Africa SME investment practitioners and stakeholders

As this research paper is in working draft form, workshop delegate views on the analysis and conclusions presented is critical.

2.3 Geographic focus - DRAFT -

The paper will present and assess potential risk mitigation mechanisms in the context of applicability to SME investment in Africa. While challenging investment conditions exist in other developing countries in regions like Latin America and Southeast Asia, sub-Saharan Africa is consistently at the bottom of human¹ and economic² development indices and warrants continued development efforts.

3 Risk as a hurdle to increased SME financing

All countries require a wide variety of building blocks to develop and grow sustainably – a healthy SME base being a fundamental one. SMEs themselves also have substantial requirements in order to develop and grow – straightforward and merit-based access to affordable finance being equally fundamental. Taking the perspective of a potential investor in SMEs, this paper assumes that investment risk is a major obstacle to such access to finance for sustainable SMEs in Africa.

Clearly, there are considerable obstacles to access to finance, which are not directly tied to investment risk. From the perspective of investors in general – and local investors specifically, hurdles include:

- Lack of SME investing know-how
- Effort intensity of SME investing vs. lucrative alternative investments (e.g. high-yield government debt) vs. SME investment
- High cost of local capital
- Lack of skilled resources to operate and work in SMEs in Africa

¹ UNDP

² CIA World Fact Book / IMF

- Lack of business information
- High investment monitoring costs

For international investors, additional hurdles apply:

- Low visibility of viable investment opportunities
- Small size of individual investments

But a considerable number of the reasons investors normally give as to why they don't finance SMEs are directly related to the risk – perceived and real – associated with investment. Put simply, investors fear that the money they've put into a business will be lost, diminished or not increased to the extent they require – or to the extent that it would have, had the investor placed that capital in an asset with surer returns. More effectively mitigating these risks should lead to an increase in finance available to SMEs.

Not all investment risks are equal, however. It is helpful for SME investors to recognize three levels of investment risk:

- **Business risk:** the risk that a business itself will fail – or fail to create adequate value
- **Market risk:** the risk that the surrounding business or financial market environment will cause a business to fail or reduce the value to the investor of the returns generated by a business
- **Country risk:** the risk that a sovereign or sub-sovereign entity will cause a business to fail or reduce the ability of the investor to extract capital from an investment

This categorization is a first step in assessing the potential for investment risk mitigation; a further classification is also useful: the controllability of the risk.

- **Controllable risks:** these are risks that investors and entrepreneurs can directly influence or mitigate – e.g. the risk of poor strategic decisions, of employee fraud, or low production quality.
- **Non-controllable risks:** these are risks, which as the title indicates, cannot be directly controlled by investors or SMEs. These fall into two subcategories.
 1. Non-controllable risks to which a discrete, pre-defined “risk event” cannot be prescribed. For example, an economic downturn may impact the viability of an investment, but no specific event, whose probability of occurrence can be estimated in advance, lends itself to straightforward risk mitigation.
 2. The second involves non-controllable risk events whose probability of occurrence can be, to some extent, estimated – be they “acts of God”, currency devaluation, civil war, etc.

The table below provides an overview of the main investment risks associated with SMEs in developing countries – ranked according to risk materiality, as indicated to DeRisk by well over 100 investors in the past year and a half.

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Table 3: Investor ranking of risk materiality

Risk type	Low	Medium	Top of Mind
Controllable Risks	<ul style="list-style-type: none"> Environmental Factors (B) 	<ul style="list-style-type: none"> Technology (B) Credit (B) Liquidity (B) Balance Sheet (B) Income Statement (B) Capital Adequacy (B) 	<ul style="list-style-type: none"> Business Strategy & Market (B) Mgmt. Systems and Operations (B)
Non-controllable Risks	<ul style="list-style-type: none"> Business Support (M) Financial System (M) Competition (M) Interest Rate (M) 	<ul style="list-style-type: none"> Global Impact Event (M) Policy Failure Event (C) Legal (M) Credit Worthiness (C) Natural Event (B) Civil Society Pressure (C/M) 	<ul style="list-style-type: none"> Political (C) War & Conflict (C) Policy Change (M/P) Currency (M) Infrastructure Service Failure (M) Business Disruption (B/M) Fraud & Corruption (B/C)

B: Business Risk, M: Market Risk, C: Country Risk

Source: Adapted from Gaines and Karius, "SIRIF Investment Risk Study" (2006)

The ability to mitigate these risks more effectively would allow investors to place more capital – and more cost effectively – in SMEs.

4 Investment risk mitigation mechanisms

4.1 Introduction

DeRisk, building on earlier work undertaken with Vantage has recently performed a market survey of risk mitigation mechanisms available on the global marketplace. There are nine main categories of risk mitigation mechanisms available to promoters of, and investors in sustainable SMEs. Using the two types of risk categories described above, the table below indicates – albeit simplistically – the categories of risks on which these mechanisms can have a significant impact.

Table 4: Mechanism definition and risk mitigation potential

Mechanism	Definition	Risks mitigated*		
1. Diversification	A risk-reduction strategy that involves spreading assets across a mix of companies, investments, industries, geographic areas, maturities, and/or investment categories.	B	M	C
		CR		NCR
2. Due Diligence / Assurance	The process through which a potential investor evaluates a target company or its assets for acquisition or investment. The relevant areas of concern may include intellectual property, real and personal property, insurance and liability coverage, debt instrument review, employee benefits and labor matters, immigration, and international transactions.	B	M	C
		CR		NCR
3. Fund Enhancement	Provision of "anchor" investments in equity or debt funds which act as a loss buffer to other investors in case of underlying business failure or asset loss	B	M	C
		CR		NCR
4. Guarantee	An agreement between a creditor and a guarantor which sets forth the terms and conditions under which the guarantor will pay the debts or obligations of another entity	B	M	C
		CR		NCR
5. Hedging	An investment that is taken out specifically to reduce or cancel out the risk in another investment. Hedging is a strategy designed to minimize exposure to an unwanted investment	B	M	C

Mechanism	Definition	Risks mitigated*		
	risk, while still allowing the investor to profit from an investment activity. An FX derivative is a financial contract whose value derives from the value of underlying currencies. The main types of hedge contracts involve futures, forwards, options and swaps.	CR	NCR	
6. Private Sector Insurance	A contract in which a commercial underwriter agrees to pay for another party's financial loss resulting from a specified, agreed event that can be anticipated, and whose probability of occurrence can be adequately estimated	B	M	C
		CR	NCR	
7. Public Sector Insurance	See "Private Sector Insurance", except: risks underwritten by a publicly-backed insurer	B	M	C
		CR	NCR	
8. Securitization	The process of gathering a group of debt obligations such as mortgages into a pool, and then dividing that pool into portions that can be sold as securities in the secondary market.	B	M	C
		CR	NCR	
9. Technical Assistance	A service provided to entrepreneurs and businesses encompassing: advice and tools required to develop robust business plans; training and assistance to entrepreneurs and their management teams; assistance in accessing finance from international, regional and local financial institutions; links for developing country enterprises to partner organizations in developed countries, who can act as suppliers, customers, mentors or investors.	B	M	C
		CR	NCR	

B: Business Risk, M: Market Risk, C: Country Risk, CR: Controllable Risk; NCR: Non-Controllable Risk

*Box shaded black indicates risk impact potential.

The analysis in the table above reflects the basic thrust of any investment risk mitigation strategy: the greater the number and kind of invested assets, the less risky it is – both "Diversification" and "Securitization" epitomize this strategy. The high potential for overall risk mitigation may, however, not necessarily be correlated with ease or low cost of deployment, etc. for sustainable SMEs, something the following section will address, as well as looking at concrete examples.

4.2 Mechanism evaluation framework

The purpose of the following evaluation framework is to determine whether or not there are available mechanisms – or those that can be developed or more effectively deployed – which have significant potential to promote sustainable SME investing in partnership with a various stakeholders seeking to support such investment.

This framework consists of the following criteria:

Table 5: Mechanism assessment framework criteria

Criterion*	Ranking
A. Potential for impact on investment risk reduction	All given a ranking between 1 (high) and 3 (low)
B. Scalability and/or replicability potential	
C. Cost of adaptation/development and deployment	
D. Application to risk mitigation of sustainable SME investment	See Annex 1 for ranking explanation
E. Relevance to the organizational mandates of required supporting/partnering institutions	

*The letter designation in the "criterion" category corresponds to the letter in the "Assessment" column in the table below

Using these criteria the paper provides a combined ranking, from 1 (high) to 24 (low) of the individual mechanisms according to risk mitigation potential with regards sustainable SME investment.

4.3 The mechanisms

The table below presents examples of all mechanism categories, in ascending order of risk mitigation potential (as defined by the framework above). NB: some mechanisms may have high risk mitigation potential in specific situations or on a limited scale, and could therefore be worth exploring in more detail. Complete information on each example can be found in the accompanying document (see Annex 2).

Table 6: Risk mitigation mechanisms

Mechanism	Current Application	Example	Assessment	Rank
Guarantee - Local Bank Unsecured Lending Facility	No current application. It is potentially applicable to lending by developing country financial institutions.	See Section 5.1	A: 1 - significant reduction of all categories of risk to investors B: 1 - high potential in any category or region C: 2 - potentially requires public subsidy; fundraising and development costs not insignificant D: 2 - could be aimed exclusively to sustainable SMEs E: 1 - likely central to the mandate of developers, investors, administrators	1
Guarantee - Private Sector Guarantee and Credit Enhancement Fund	No current application. It is potentially applicable all investments in developing country SMEs	See Section 5.2	A: 1 - significant reduction of all categories of risk to investors - except currency/political risk for international investors B: 1 - high potential in any category or region C: 2 - potentially requires public subsidy; fundraising and development costs not insignificant D: 2 - could be aimed exclusively to sustainable SMEs E: 1 - likely central to the mandate of developers, investors, administrators	(1)
Technical Assistance - Fund-Linked Technical Assistance (generic)	Equity investment in West Africa SMEs	See Section 5.3	A: 2 - selecting and monitoring SMEs has significant impact on some risk categories B: 1 - no material restrictions - potential funds in every country C: 3 - donor capital required - but potentially reimbursed from fund upside D: 1 - could be linked directly to funds investing in sustainable SMEs E: 1 - clear commercial interest	3
Due Diligence - Third Party Investment Due Diligence (DD) and Assurance	Equity and debt investments in developing countries	Deloitte South Africa assesses the commercial and financial aspects of a business to be acquired or sold, its strategic and market position and future plans. By means of an oral presentation and a written report, the investor receives an in-depth analysis of the target business and insightful evaluation on key points likely to affect the price and cause post-acquisition issues.	A: 2 – facilitates gathering of / provides additional information but only reduces up-front business risk B: 1 - no material restrictions - potential service providers in every country; some investors reluctant to “buy in” external C: 2 – little up-front capital required, network and contracting, sales and promotion required D: 2 - may be moderately less risky if assurance indicates sustainable SME, but little to do directly with business	(3)

Mechanism	Current Application	Example	Assessment	Rank
			failure risk E: 1 - clear commercial interest	
Fund Enhancement - Investment Fund Enhancement	Equity and debt funds targeting SMEs	A European relief agency is providing an “anchor” investment in a PE/VC fund focused on East Africa, in order to facilitate further fundraising for the fund. The investment will be subordinated to other investors, protecting co-investors in the fund against losses on principle due to investee business failure at fund liquidation.	A: 1 - partial but broad reduction of business failure risk; facilitates fundraising B: 3 - is by nature an ad hoc intervention C: 2 - low development cost - potentially high payout if risk not mitigated properly with good DD D: 1: - the fact that the SME is sustainable might induce such enhancement E: 2: - certain enhancers would see this as central to mandate	5
Guarantee - Loan Portfolio Guarantee Program	Private sector lending to developing countries (primarily by developing country financial institutions)	A USAID Loan Portfolio Guarantee (LPG) provides financial institutions with partial coverage on a portfolio of loans that they provide to their customers. In the case of the LPG, a guarantor agrees to share in the risk of a broadly defined category of bank loans with a view toward inducing local banks to extend credit toward an underserved sector. The individual borrowers under a LPG are not predetermined at the time the Guarantee Agreement is signed, but the borrowers must fall within a pre-agreed definition of “Eligible Borrowers,” such as borrowers that are small businesses operating in a specific geographic area.	A: 1 - partial but broad reduction of business failure risk; facilitates fundraising B: 2 - significant potential in any category or region – scalability hampered by DFI/donor subsidy requirement C: 2 – DFI/Donor balance sheet or guarantee required - includes public subsidy of guarantee costs D: 3 - minimal factor E: 1 - central to the mandate of guarantors	(5)
Guarantee - Guarantee Network	Debt finance provided by developing country financial institutions to MFIs	A network of wealthy individuals and institutions affiliated with the Grameen Foundation provide guarantees in the form of letters of credit to developing country financial institutions in order to encourage them to provide debt finance to Microfinance institutions	A: 1 - partial but broad reduction of business failure risk; facilitates fundraising B: 2 - significant potential in any category or region - but with restrictions that come with donor/guarantor support C: 3 - Donor/guarantor guarantee required - significant sales and development effort D: 2 - could be aimed exclusively to sustainable SMEs E: 1 - somewhat peripheral to respective mandates	(5)
Technical Assistance - Fund-Linked Technical Assistance (sustainability-oriented)	Equity investment in Africa businesses	The SME Sustainable Opportunities Initiative will channel funding from IFC and other donors to support various environmental, social, and health and safety upgrades in small and medium enterprises in which Aureos-managed private equity funds have invested. The initiative will allow a number of SMEs to reduce carbon emissions, improve energy and water efficiency, reduce effluents, and develop HIV/AIDS awareness programs.	1: 3 - selecting and monitoring SMEs has significant impact on some risk categories - but less than generic TA 2: 1 - no material restrictions - potential funds in every country 3: 3 - donor capital required - but potentially reimbursed from fund upside 4: 1 - is linked directly to funds investing in sustainable SMEs 5: 1 - clear commercial interest	(5)
Guarantee - Loan Guarantee Fund	Domestic and international lending (single)	GARI is an investment guarantee fund in Togo backed by the West African Development Bank. The fund provides	A: 1 - partial but broad reduction of business failure risk; facilitates fundraising	9

Mechanism	Current Application	Example	Assessment	Rank
	loans) to developing country companies and projects	credit guarantees to financial lending institutions in the area of and active in all countries of ECOWAS. Through this it aims to encourage banks and other financial intermediaries to grants medium- and long-term credits to companies in the region.	B: 3 - small individual transactions defeat scaling-up C: 2 - DFI balance sheet or guarantee required - includes public subsidy of guarantee costs D: 3 - minimal factor in mechanism E: 1 - central to the mandate of guarantors	
Guarantee – Public Sector Equity Guarantee	Equity investment in SMEs	A guarantee facility funded and backed by AWS (Austrian development bank) guarantees losses on individual equity investments by investors in Austrian SMEs. Equity includes: Covers loss of equity invested on: - "Additional cash" - Minority shareholdings - Quasi-equity (if subordinated, min. 10 year term, returns depend on the profit of the SME)	A: 1 - partial but broad reduction of business failure risk; facilitates fundraising B: 2 – model requires development to scale up impact; single country focus would have to be adapted C: 2 - DFI balance sheet or guarantee required - includes public subsidy of guarantee costs D: 3 - minimal factor in mechanism E: 2 – could require considerable “sales job” to convince donor community	(9)
Public Insurance - Political Risk Insurance (Public Sector)	Cross-border investment in developing countries projects	The World Bank’s Multilateral Investment Guarantee Agency (MIGA) provides insurance coverage for investments in developing countries against losses due to intervention by sovereign or subsovereign entities.	A: 2 - risk of internal business failure or market risk not addressed B: 2 - many individual transactions too small for insurers; agglomeration required C: 2 – high cost for minimal coverage D: 3 - sustainability not material E: 2 – further subsidy of insurance not covered by any current mandate	10
Diversification - Large-scale Investment Fund	1. Debt and equity finance in MFIs (Global, including Africa) 2. Debt and equity finance in SMEs (Global, including Africa)	GroFin’s Aspire funds invest USD 50k-1m per investment in SMEs in Kenya, Tanzania, Uganda, Nigeria and South Africa. The total assets under management exceed USD 100m. Finance facilities are structured using mainly medium-term loans (three to six years) and performance based incentive payments. Interest and/or capital moratoriums are applied depending on the projected cash flow of a particular business. GroFin will only consider an equity component in cases where a clear exit strategy is in place.	A: 2 - theoretically all risk categories impacted, but potentially higher rate of business failure than smaller, more “TA-intensive” funds B: 2 - access to potential SMEs is a significant issue for current scalability C: 3 – high development, target identification, assistance and monitoring costs D: 3 - little application - could increase risk, as SMEs concentrated in certain industries E: 1 – clear mandate to develop / extend / replicate such funds	11
Hedging - Commodity Derivative	Cash flows (e.g. sales or purchases) with exposure to the price risk of the following commodity categories: - Agricultural products - Metals - Energy products - Polymers	Cargill Risk Management sells a wide range of commodity derivatives to commodities producers and investors. Other examples include financial institutions selling derivatives for Assets or cash flows whose value is affected by: - Equities prices - Bonds prices - Other financial products prices - Macroeconomic trends	A: 2 - partial relation to SME business failure B: 3 - single transactions too small C: 2 - probable that significant direct or indirect subsidy required D: 2 - some relation, as bio-ethanol producers, e.g., could use derivative products E: 2 - some agricultural-related donors might be willing to subsidize	(11)
Hedging - Alternative Hedging	See Hedging – Foreign currency derivatives	Distributed Capital Group is a capital markets intermediary that will coordinate capital inflows to, and outflows from,	A: 2 – business failure not addressed B: 2 - debt investments only, but few restrictions there	(11)

Mechanism	Current Application	Example	Assessment	Rank
Product		developing countries to provide currency hedging products where it is currently not available or prohibitively expensive	C: 2 - support for identifying and harnessing one-way-flows required D: 3 - no relation E: 2 - potential to use own flows; some donors dedicated to harnessing financial markets	
Hedging - Local Currency Exchange Fund	Debt finance to MFIs and SMEs in developing countries - focus on sub-Saharan Africa	The Currency Exchange Fund is a local currency investment fund - a mixture of developing country currencies - backed by the Dutch development bank, FMO providing hedging products to fund investors (closed to a limited number of larger investors in development oriented companies and projects). This currency diversification aims to protect the fund from exchange related losses in any specific currency, and provides counterparties for transactions that investors engage in separately.	A: 2 - partial relation to SME business failure B: 2 - some SMEs could be funded by participants; limited sub-Saharan African currencies involved C: 3 - huge development cost D: 3 - no relation whatsoever E: 1 - clear mandate overlap to develop / extend / replicate such a fund	(11)
Private Sector Insurance - Political Risk Insurance (Private Sector)	Cross-border investment in any asset (physical or capital-based)	The Lloyd's Insurance Market provides insurance coverage for investments in developing countries against losses due to intervention by sovereign or subsovereign entities	A: 2 - risk of internal business failure or market risk not addressed B: 2 - many individual transactions too small for insurers; agglomeration required C: 2 - high cost for minimal coverage D: 3 - sustainability not material E: 2 - subsidy of insurance not covered by any current mandate	(11)
Public Sector Insurance - Renewable Energy Insurance Facility	Project finance and ongoing operation of renewable energy assets in Asia	A new UNEP-sponsored insurance facility could provide dedicated insurance capacity and specialist protection for renewables projects in Asia. The facility would distribute insurance policies through domestic insurance companies and provide an interface to re-insurance companies covering the renewables projects.	A: 2 - only some risks in some categories addressed B: 3 - insurance already available for SMEs; re-insurance capacity not an issue; SMEs not engaging in renewables projects C: 3 - some marketing to insurers required, significant effort and development costs associated with extension to Africa D: 1 - critical to risk mitigation mechanism E: 1 - central to mandate of DFIs/donors to replicate similar	(11)
Securitization - Profit-Sharing Bond	Debt finance in Austrian SMEs	AWS (Austrian development bank) underwrites a minimum 10-year bond offered on the Austrian stock exchange. The underlying assets are participation in the profits generated by participating SMEs.	A: 2 - theoretically all risk categories impacted, but potentially higher rate of business failure than smaller, more "TA-intensive" funds B: 2 - access to potential SMEs is a significant issue for current scalability C: 3 - high development, target identification, assistance and monitoring costs D: 3 - little application - could increase risk, as SMEs concentrated in certain industries E: 1 - clear mandate to develop / extend / replicate such funds	(11)

Mechanism	Current Application	Example	Assessment	Rank
Securitization - Microfinance Bond	Debt finance in MFIs	A securitization vehicle led by Blue Orchard, Developing World Markets and guaranteed by OPIC, securitized loans to microfinance institutions; senior tranches guaranteed by OPIC, junior and "equity" tranches taken on by sponsors	A: 2 - theoretically all risk categories impacted, but potentially higher rate of business failure than smaller, more "TA-intensive" funds B: 2 - access to potential SMEs is a significant issue for current scalability C: 3 – high development, target identification, assistance and monitoring costs D: 3 - little application - could increase risk, as SMEs concentrated in certain industries E: 1 – clear mandate to develop / extend / replicate such funds	(11)
Guarantee - Partial Credit "Re-Guarantee"	Developing country sovereign guarantees of domestic investments	The World Bank Guarantee Program covers creditors (not investors) for specified sovereign risks arising from a government's default on contractual obligations, or the occurrence of certain force major events of a political nature (maintenance of a regulatory framework, adhering to agreed formulas for determining or escalating tariffs, change of government, etc.)	A: 3 - no direct applicability to SME investors B: 3 - no potential C: 1 - low cost of guarantee D: 3 - minimal factor in mechanism E: 2 - moderately applicable to mandate	20
Private Sector Insurance - General Insurance	Assets (physical, human or capital-based)	Aureol Insurance Company (Sierra Leone) provides insurance coverage for the companies and projects operating in Sierra Leone against losses due to standard "Property and Casualty" or other risks (i.e. fire, flood, health and accident, workers compensation, business disruption, etc.)	A: 3 - many risks in all categories not addressed B: 3 - already widely available C: 1 - very low cost of deployment D: 3 - sustainability not material E: 2 - moderate incentive for local intermediaries	(20)
Private Sector Insurance - Credit insurance	Sales to domestic or international buyers of products and services	Atradius provides insurance coverage of losses due to insolvency of developing country buyers in their domestic or international markets	A: 3 - many risks in all categories not addressed B: 3 - already widely available C: 1 - very low cost of deployment D: 3 - sustainability not material E: 2 - moderate incentive for local intermediaries	(20)
Public Insurance - Index Insurance Facility	Sales from developing country agricultural production	The Global Index Insurance Facility is a publicly funded insurance facility providing insurance capacity to developing country insurers to cover agricultural producers risk of crop failure due to natural disasters, drought, etc.	A: 2 - availability would have moderate impact on investor sentiment in some categories of SMEs B: 3 - not replicable for most categories of SME investments C: 3 - huge effort and cost of deployment D: 3 - sustainability not material E: 2 - moderate incentive for stakeholders to make available for SMEs in Africa	24
Hedging – Foreign currency (FX) derivative	Loan repayments and other structured cash flows with exposure to currency exchange rate risk (e.g. import purchases, bond	ING Wholesale Banking sells a wide range of derivatives to investors starting from €2,500 in investment size	A: 2 - no relation to SME business failure B: 3 - transactions too small, often equity based C: 3 - significant subsidy required for most Africa investments D: 3 - no relation whatsoever E: 3 - no relation to mandate - if subsidy	25

Mechanism	Current Application	Example	Assessment	Rank
	payments, fixed dividends etc.)		is the strategy	
Hedging - DFI-Intermediated Hedge	The following IBRD loan types: - Fixed-Spread - Variable-Spread - Fixed-Rate Single Currency - Currency Pool - Single Currency Pool	The IBRD acts as a market intermediary to provide sovereign borrowers access to hedging products for IBRD loans. IBRD hedges comprise only those that are available on commercial markets.	A: 3 - too far removed B: 3 - no direct application for SME investors C: 3 - complete retrofit required D: 3 - no relation E: 3 – no mandate to lend to private sector institutions	26

5 High-potential risk mitigation mechanisms

Based on the assessment framework described above, the three highest ranked mechanisms were:

1. Local Bank Unsecured Lending Facility
2. Private Sector Guarantee and Credit Enhancement Fund
3. Fund-Linked Technical Assistance (generic)

The following section addresses these specific mechanisms in more detail.

5.1 Local Bank Unsecured Lending Facility

5.1.1 Summary

A local bank unsecured lending facility would provide developing country lending institutions with partial credit guarantees, funded with their own risk capital, on lending portfolios.

In the absence of sufficient collateral, domestic financial institutions avoid lending to otherwise viable SMEs. A third party guarantee against SME loan portfolio losses provides a valid substitute but generally requires direct subsidy from donors or multi-/bi-lateral development finance institutions (DFIs).

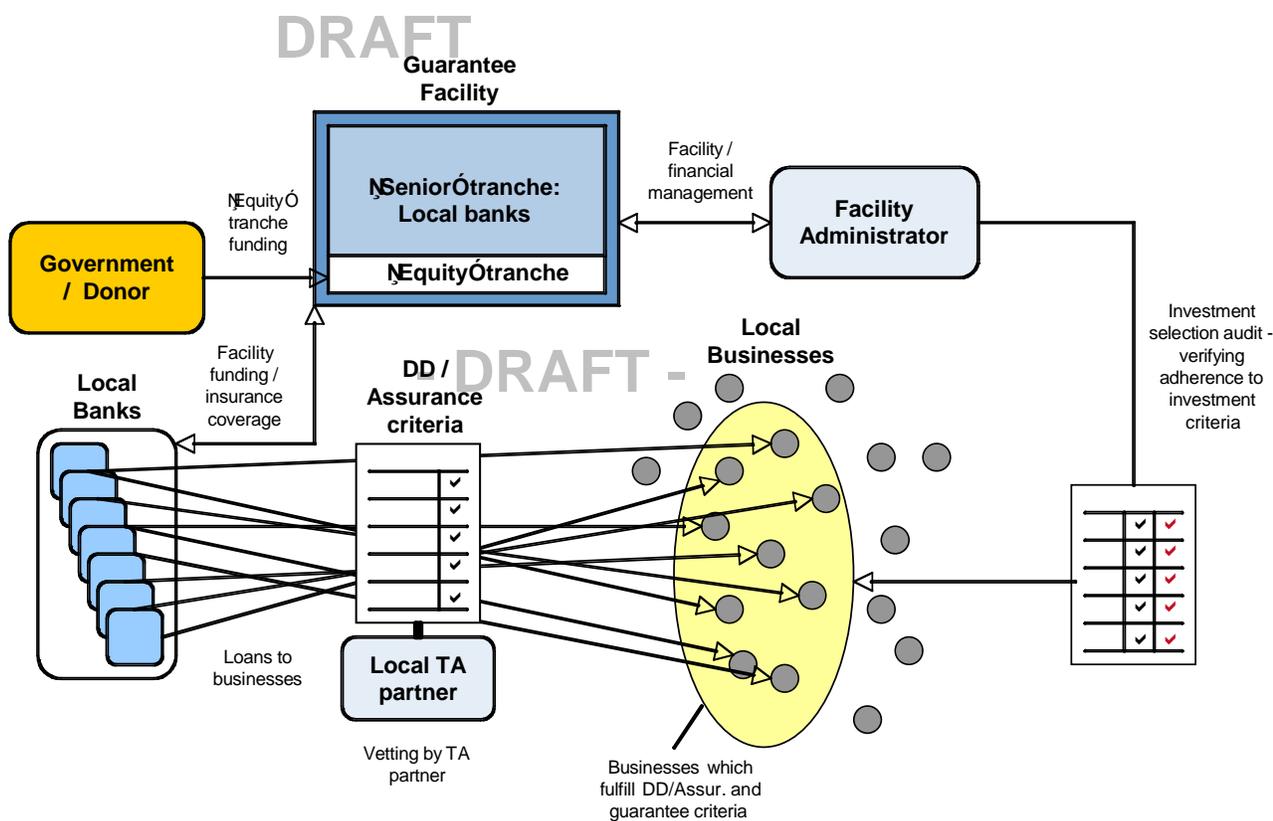
Pooling risk capital from developing country banks and investors in order to fund a market-based guarantee facility could solve this issue of scalability. It could also address the issues of additionality and moral hazard: given that guaranteed banks would “own” the losses (and positive returns) of such a facility, it would more readily attract banks wanting to engage in new lending, and motivate them to do so more responsibly.

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5.1.2 **How it works**

1. Local banks pool funds into a common facility, which will act as a partial credit risk insurer
2. Facility is run by non-bank 3rd party (e.g. an auditor)
3. Independent due diligence and assurance process developed for all applicable lending
4. "Equity" tranche (either first loss or "pari passu" coverage) of facility potentially provided by donor community / DFIs
5. Facility investment profits pay for administration fees, subsidize usage fees
6. Due diligence of financial institutions and individual investments provided by 3rd party audit and/or assurance partner

Local Bank Unsecured Lending Facility



5.1.3 **Assessment**

Risk mitigation impact

This mechanism provides broad coverage of business risk. More specifically, it partially covers banks against losses due to the failure of businesses in their lending portfolio. Mitigating the risk of unsecured creditor default – something experienced banks do with rigorous credit assessments and cash flow analysis – should have a significant impact on the willingness of banks to lend to SMES.

Depending on the terms and conditions of the guarantees, business failure due to political risks may or may not be covered.

Scalability

The mechanism is highly scalable to the extent that it is *replicable*. Given disparate market requirements, as well as the difficulty of coordinating users and funders in different countries, a multi-country facility could be less effective than one unique to a single country or a major financial center. Where there are well-capitalized banks and low penetration of SME lending, however, such a facility could be feasible.

Cost of development

The development, piloting and launching of a single-country facility would involve four categories of costs.

1. Mechanism concept development
2. Partnership development
3. Marketing
4. Piloting

As a cost benchmark for such a facility, the development costs of an insurance facility proposed by the broker Marsh for UNEP's Global Environment Facility is estimated at USD 800,000

Application to sustainable SMEs

The logical application of the facility would be for all SME lending deemed by participating banks to generate sufficient returns. Negative screening of unsustainable SMEs would enable mechanism to encourage funding of sustainable SMEs, but this might decrease the likelihood that banks will participate – given the oft-lamented dearth of SME investments in general, much less “sustainable” ones. Further subsidy by a sustainability-minded stakeholder of guarantee costs for lending to sustainable SMEs might help overcome this hurdle.

Other restrictions or limitations

- Does not address issue of pipeline of potential SME investments or loan monitoring skills / costs
- No application for equity investment (although less costly access to debt capital can have an indirect effect on the willingness of equity investors to invest alongside lenders)

5.1.4 **Required stakeholder analysis**

Despite its potential commercial viability, no single bank or other commercial entity is likely to develop and pilot such a facility, due to significant upfront costs. The skills and coordination required, and untested nature of the mechanism, would also make it too risky. Additional stakeholders are required.

The key stakeholders required to develop and launch the guarantee facility, and corresponding relevance the respective institutions, are as follows:

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Table 7: Local Bank Unsecured Lending Facility stakeholder analysis

Stakeholder	Role	Mandate relevance	Risks	Rewards	Resources required
Developing country banks	<ul style="list-style-type: none"> Investor in facility Lender to SMEs 	Yes; key to meeting growth requirements in increasingly competitive markets	<ul style="list-style-type: none"> Losses from other banks' lending portfolios 	<ul style="list-style-type: none"> New source of profitable lending growth Potential facility investment returns upside 	<ul style="list-style-type: none"> Unpaid participation in development process Investment in loan officers, monitoring staff
Developing country auditor	<ul style="list-style-type: none"> Due diligence and assurance provider 	Yes; key to meeting growth requirements in increasingly competitive markets	<ul style="list-style-type: none"> Wasted resources in case of short facility life 	<ul style="list-style-type: none"> DD/assurance fees from facility Future audit fees from SMEs 	<ul style="list-style-type: none"> Unpaid participation in development process
Sustainability NGO	<ul style="list-style-type: none"> Social / environmental DD and assurance methodology development 	Maybe; motivation is clear if facility focuses on sustainable SME investing	<ul style="list-style-type: none"> Reputation risk if facility underwrite unsustainable SME lending 	<ul style="list-style-type: none"> Fees for involvement PR for innovative facility 	<ul style="list-style-type: none"> Effort (compensated)
Technical assistance provider	<ul style="list-style-type: none"> Potential SME investment pipeline provider Investment monitoring 	Maybe; fees would need to be substantial enough to participate and provide additional services	<ul style="list-style-type: none"> Liability risk if SMEs fail 	<ul style="list-style-type: none"> Fees for services provided 	<ul style="list-style-type: none"> Unpaid participation in development process
Developing country government	<ul style="list-style-type: none"> Potential equity investor in facility Potential facility guarantor Concept development funder 	Yes; meets clear mandate to promote sustainable growth	<ul style="list-style-type: none"> Compensation of facility shareholders in case of large losses 	<ul style="list-style-type: none"> Resulting economic growth PR for innovative promotion of business growth 	<ul style="list-style-type: none"> Assets employed to provide facility guarantee
DFI/donor (multi- or bi-lateral)	<ul style="list-style-type: none"> Potential equity investor in facility Potential facility guarantor Concept development funder 	Yes; meets clear mandate to promote sustainable growth	<ul style="list-style-type: none"> Compensation of facility shareholders in case of large losses 	<ul style="list-style-type: none"> Resulting economic growth PR for innovative promotion of business growth 	<ul style="list-style-type: none"> Assets employed to provide facility guarantee
Philanthropic or social investor	<ul style="list-style-type: none"> Potential equity investor in facility Concept development funder 	Maybe; could apply to niche investor mandate	<ul style="list-style-type: none"> Loss of invested equity capital 	<ul style="list-style-type: none"> Positive development outcomes PR for innovative promotion of business growth 	<ul style="list-style-type: none"> Capital to invest in facility
TBD	<ul style="list-style-type: none"> Facility administrator (including fund management) 	TBD; possibly created to meet facility requirements	<ul style="list-style-type: none"> Closure in case of facility failure or insufficient interest 	<ul style="list-style-type: none"> Fees for facility administration 	<ul style="list-style-type: none"> TBD
TBD	<ul style="list-style-type: none"> Concept coordinator / developer 	TBD	<ul style="list-style-type: none"> Insufficient interest from banks "Still-birth" due to development complexity 	<ul style="list-style-type: none"> Fees for concept development and launching 	<ul style="list-style-type: none"> Effort (compensated)

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5.2 Private Sector Investment Enhancement Fund

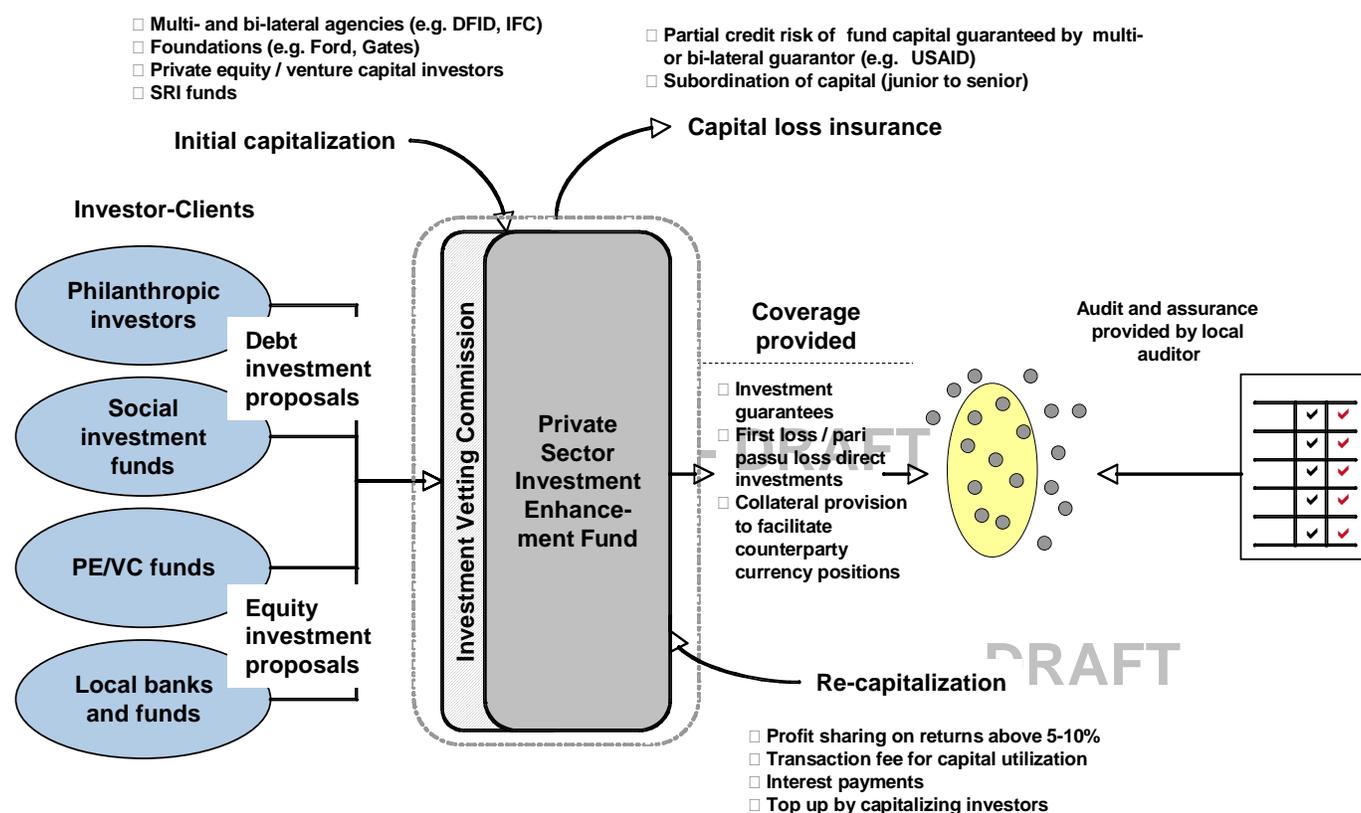
5.2.1 Summary

A private sector investment enhancement fund would use its balance sheet to provide investment guarantees, credit enhancement to local and international investors in SMEs. Funded by private sector, "social" and / or philanthropic capital, it could also provide "first loss" or other direct investment enhancement to both equity and debt investors in – and from – any geographic region.

5.2.2 How it works

1. Commercial, social and philanthropic investors invest in a fund enhancing equity and debt investments and related transactions (providing capital directly or via guarantee)
2. The fund establishes partnerships with due diligence and assurance providers in the regions of operation – vetting financial institutions and individual investments
3. Investors identify investment opportunities and apply for investment enhancement ("first loss investment", pari passu/proportional loss investment, equity or credit guarantee, financial collateral provision, etc.)
4. Fund partner performs due diligence on investor and investment opportunity
5. Investors pay market rates for investment enhancement
6. Fund pays out on losses to investors
7. Fund replenished with enhancement fees, investment returns and (in case of substantial loss) donor capital

Investment Enhancement Fund



5.2.3 **Assessment**

Risk mitigation impact

Similar to the local bank facility example above, the private sector investment enhancement fund This mechanism provides broad coverage of business risk, but is more versatile – covering a wider range of debt and equity investments. Beyond loss protection, it could have a significant impact the ability of private sector SME funds to raise commercial capital as well as more easily engage in financial transactions requiring collateral (e.g. currency hedging).

Currency risk and – depending on the terms and conditions of the enhancement – political risk would not be covered.

Scalability

If established in a developed country, a single enhancement fund could serve international SME investors on a large scale more easily than domestic investors, given the concentrated nature of the former and local network required to serve the latter.

A commercially viable business model for such a fund, however, would spawn similar initiatives in developed and developing countries.

Cost of development

A conservative estimate for development costs for a full facility would be in line with the local bank guarantee facility above (USD 800,000). Beyond this, fund equity and guarantees would need to be raised/secured.

There is the potential to test the concept with a single SME or SME fund transaction (similar to the Grameen Foundation Growth Guarantees cited in section 4.3) using funds or a guarantee provided by a social investor, donor or DFI.

Application to sustainable SMEs

The fund's enhancement tools would apply to sustainable and normal SMEs alike. Depending on the respective agendas of fund equity providers and guarantors with regards sustainable SME investing, the fund could focus solely on sustainable SME investment enhancement.

Other restrictions or limitations

- Does not address issue of pipeline of potential SME investments or loan monitoring skills / costs
- Ready application to developing country investors would require more extensive local networks

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5.2.4 Required stakeholder analysis

The key stakeholders required to develop and launch the guarantee facility, and corresponding relevance the respective institutions, are:

Table 8: Private Sector Investment Enhancement Fund stakeholder analysis

Stakeholder	Role	Mandate relevance	Risks	Rewards	Resources required
Social / philanthropic investors	<ul style="list-style-type: none"> Capitalize higher risk fund tranche Cover development costs Subsidize some guarantee fees 	Yes; would apply to niche investor mandate	<ul style="list-style-type: none"> Loss of invested equity capital 	<ul style="list-style-type: none"> Positive development outcomes PR for innovative promotion of business growth 	<ul style="list-style-type: none"> Capital to invest in facility
Private sector investors	<ul style="list-style-type: none"> Capitalize commercial tranche 	Yes; provides financial returns	<ul style="list-style-type: none"> Partial loss of capital if losses are large 	<ul style="list-style-type: none"> Financial returns 	<ul style="list-style-type: none"> Capital
Developing country auditor	<ul style="list-style-type: none"> Provide DD/Assurance on investment targets 	Yes; key to meeting growth requirements in increasingly competitive markets	<ul style="list-style-type: none"> Wasted resources if short facility life 	<ul style="list-style-type: none"> DD/assurance fees from facility Future audit fees from SMEs 	<ul style="list-style-type: none"> Unpaid participation in development process
SME-investor focused intermediary	<ul style="list-style-type: none"> Broker information, access and transactions 	Yes; new tool for risk mitigation intermediation	<ul style="list-style-type: none"> NA 	<ul style="list-style-type: none"> Transaction facilitation fees 	<ul style="list-style-type: none"> NA
Fund manager	<ul style="list-style-type: none"> Administer fund investment strategy / operations 	Yes; raison d'etre of a fund	<ul style="list-style-type: none"> Partial loss of capital if losses are large 	<ul style="list-style-type: none"> Fund management fees 	<ul style="list-style-type: none"> NA

5.3 Fund-Linked Technical Assistance

5.3.1 Summary

An existing example of small-scale fund-linked technical assistance is a facility funded by UK Department for International Development called the Business Development Initiative (BDI). BDI provides its sister organization, a Sierra Leone/West Africa-focused PE fund, with additional financial resources to identify, assess and develop potential SME investment opportunities. The result is that funds spend more time and employ more resources on these activities than they otherwise would.

5.3.2 How it works

1. A technical assistance fund is established and funded whose resources are available to (a) local investment fund(s) tied to the TA funding;
2. The fund managers raise capital aided by the premise that extra resources will be available to supplement the standard management fee
3. TA funders set criteria for SME investments eligible for facility assistance
4. The fund managers use the TA fund resources to select, assess and develop potential SME investment opportunities
5. TA funds are replenished (as necessary) by donors – and potentially supplemented by excess fund returns (funder re-imburement also possible)

Assessment

Risk mitigation impact

This instrument potentially addresses two key SME investment risks: selecting good investments and making sure they stay good investments. While not a guarantee against business and investment failure – nor does it address certain market risks (e.g. currency risk) or political risk - TA provides the best possible coverage of controllable business risks.

Scalability

Given the increasing number of funds operating in the SME space in Africa, the relative straightforward process for enabling this service (funds provide their own additional TA capacity), and the huge upside for such funds, replication in multiple markets should be assured. Additionally, a single TA fund could be tied to multiple SME funds fulfilling the investment criteria of the former.

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Cost of development

Development of a fund-linked TA facility would involve investment criteria development, eligible fund marketing and selection, TA facility fundraising and ongoing fund monitoring. A rough estimate for a pilot would be:

Capital required: USD 2m (for sustainable SME funds pilot)
 Development funds required: 3 FTEs x 6 months = USD 300,000
 Ongoing monitoring costs: 30 days/year x 3 years = USD 90,000
Total: USD 2.4m - DRAFT -

Application to sustainable SMEs

The facility funds would apply to sustainable and standard SME funds alike. In the event of donor interest in sustainable SMEs, the investment criteria could be adapted to fulfill sustainability criteria.

Other restrictions or limitations

- Requires at least partial direct subsidy – a significant initial outlay for any donor that may partially be recouped if the fund performs well

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5.3.4 Required stakeholder analysis

The key stakeholders required to develop and launch TA facility, and corresponding relevance the respective institutions, are:

Table 9: Fund-linked Technical Assistance stakeholder analysis

Stakeholder	Role	Mandate relevance	Risks	Rewards	Resources required
Donor / philanthropic institutions	<ul style="list-style-type: none"> Provide TA funding 	Yes; would apply to specific donor mandate	<ul style="list-style-type: none"> Market distortion with subsidy Abuse of funds by SME funds 	<ul style="list-style-type: none"> Positive development outcomes PR for innovative promotion of business growth 	<ul style="list-style-type: none"> Funds to capitalize the facility Facility development funds
Investment funds	<ul style="list-style-type: none"> TA funds recipient/employer 	Yes; clear incentive	<ul style="list-style-type: none"> Excessive effort required to obtain and justify funds 	<ul style="list-style-type: none"> Easier fundraising Surer investment returns 	<ul style="list-style-type: none"> Application effort
TA facility manager	<ul style="list-style-type: none"> Administer fund investment / drawdown 	Yes; likely created for purpose	<ul style="list-style-type: none"> Short-term function 	<ul style="list-style-type: none"> Administration fees 	<ul style="list-style-type: none"> NA
Developing country auditor	<ul style="list-style-type: none"> Audit correct funds usage 	Yes; new business for fees	<ul style="list-style-type: none"> Liability risk 	<ul style="list-style-type: none"> Facility audit fees Access to future audit clients 	<ul style="list-style-type: none"> NA

6 Preliminary open issues and next steps

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Final conclusions will be drawn, and next steps determined, after incorporating feedback from delegates at WWF/UNEP FI workshop.

6.1 Preliminary open issues

- Detailed costing of identified mechanisms
- Restrictions on respective classes of partnering organizations (e.g. mission-based funding of for-profit mechanisms)

6.2 Preliminary next steps

- Gain feedback from workshop delegates on the validity of this draft paper
 - Are there missing/other mechanisms that could be assessed?
 - Is the assessment framework appropriate?
 - What is the risk mitigation potential of selected mechanisms from your perspective?
 - Which, if any other mechanisms potentially more interesting to you?
 - Where are the data/analysis gaps from your perspective
- Revise/complete assessment of highest potential mechanisms, and close data gaps
- Identify partners to help develop/deploy one or more mechanisms

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7 Annexes

7.1 Annex 1: Mechanism evaluation criteria

Criterion	Ranking explanation
A. Potential for impact on investment risk reduction (taking into account restrictions, risks covered, current availability)	1: High impact on perceived / real risks causing investors not to invest 2: Medium impact on perceived / real risks causing investors not to invest 3: Low impact on perceived / real risks causing investors not to invest
B. Scalability / replicability potential for investments in African “sustainable” SMEs	1: High scalability / replicability – widespread potential in all categories of SMEs in any location 2: Medium scalability / replicability – moderate potential in some types of SMEs in many locations 3: Low scalability / replicability – minimal / one-off potential in few locations
C. Cost of development / deployment	1: Minimum effort, resources and adaptation required for full deployment 2: Moderate effort, resources and adaptation for full deployment 3: Extensive effort, resources and adaptation for full deployment
D. Application to risk mitigation of sustainable SME investment (vs. “normal” SMEs)	1: Sustainability factor highly likely to cause mechanism to have intended risk mitigation effect 2: Sustainability factor moderately likely to cause mechanism to have intended risk mitigation effect 3: Sustainability factor hardly/not at all likely to cause mechanism to have intended risk mitigation effect
E. Relevancy to the organizational mandates of the agencies required to scale up / create the mechanism	1: Central to the mandate of the organizations required 2: Moderately applicable to the mandate of the organizations required 3: Peripheral or non-aligned to the mandate of the organizations required

7.2 Annex 2: Detailed mechanism list

See document “Mechanism long list.pdf” accompanying information pack

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Risk Mitigation Mechanism Long List - Mechanism Detail

10	Large-scale Investment Fund	Diversification	GrFin	- Developing country organizations that identify high-potential SMEs - DDC/Assurance providers	Debt finance in MFIs and (to a limited extent) SMEs Other: new OPIC Africa SME fund	GrFin's Aspire funds invest USD 50k- 1m in SMEs in Kenya, Tanzania, Uganda, Nigeria and South Africa. The total assets under management exceed USD 100m	1. A fund is raised from international investors to invest in African SMEs 2. The fund develops local teams in country to originate and develop investments 3. The fund managers identify and select promising investment targets from various country offices 4. The fund builds a large portfolio of investments 5. The fund provides "business assistance" to potential and current investees (to be self-funded by the Small Fund itself)	All risks - NA	2-3% of assets under management	NA	www.responsibility.ch/en/de/summits/772446_6_0/
6	Alternative Hedging Product	Hedging	Distributed Capital Group	- In-bound one-way-flow sources (aid agencies, philanthropic organizations, transnational corporations) - Funders of flow research - Specialist SME-investor focused intermediaries (to broker information, access and sales) - Donor / philanthropic institutions (to subsidize cost)	See FX derivatives	A specialist capital markets intermediary coordinates capital inflows to, and outflows from, developing countries to provide cost-effective currency hedging capacity where it is currently not available or prohibitively expensive.	1. DCG identifies "one-way" capital inflows to developing countries from aid organizations, philanthropic organizations and transnational corporate 2. DCG provides transparency to the schedule of these inflows 3. DCG and partners identify concurrent capital outflows (e.g. loan repayments, purchases of imports, etc.) 4. DCG intermediates between in- and out-flows to match the schedule of payments 5. Parties whose payments are matched receive a hedge against currency exchange risk 6. Parties pay a premium for the "natural hedge" enabled by DCG	Market risk - up to 100% of single risk category	c. 2-5% of investment amount covered (higher if duration of coverage is longer)	- Availability of inbound capital inflows to harness with DCG's mechanism - Length of hedging contract depends on the length of time that capital inflows can be scheduled	Distributed Capital Group information
4	Commodity Derivative	Hedging	ING Bank	- Specialist SME-investor focused intermediaries (to broker information, access and sales) - Donor / philanthropic institutions (to subsidize cost)	See foreign currency derivatives	A commodity derivative is a financial contract whose value derives from the value of underlying commodities. - Agricultural products - Metals - Energy products - Polymers	1. A business (e.g. a rapeseed producer) will sell a certain amount of a commodity product on a given date on the global marketplace or to a specific buyer 2. The price at which rapeseed will sell on that date is determined by global commodity markets 3. The business selling the product (or the counterparty buying the product) buys a commodity derivative fixing the price in advance at which the commodity will be sold at a later date - hedging the sale against an increase (or decrease) in the actual price until the date of sale 4. The seller (or buyer) of the product pays a premium for this contract	Market risk - up to 100% of single risk category	<0.1% -> 10% of commodity value covered	- Limited availability to SMEs / small agricultural producers (problem of access) - A credit relationship with a provider of derivatives (investment banks) is generally required - or provision of collateral - Minimum transaction size: investment of c. USD 10,000 for standard products and c. USD 1,000,000 for exotic products - Prohibitive price or unavailability of long term contracts and exotic commodity derivatives	ING Bank: https://secure.trade.ing.com/portal/ipo/derivatives.jsp?tab=DerivativesFromItems-Derivatives&class=Selected&menu=usproducts&menu=smepanel Wikipedia
9	Local Currency Exchange Fund	Hedging	FMO - Dutch Development Bank	NA	TCX in the Netherlands - Debt finance to MFIs and SMEs in developing countries - focus on sub-Saharan Africa	A local currency investment fund - a mixture of developing country currencies - providing hedging products to fund investors (closed to a limited number of larger investors in development oriented companies and projects). This currency diversification aims to protect the fund from exchange related losses in any specific currency, and provides counterparties for transactions that investors engage in separately. TCX is backed by the Dutch development bank, FMO	1. Investors in the fund engage in investments in developing country businesses and projects with various currency exposures 2. The TCX fund provides standard hedging products for its investors in the currencies contained in the fund	Market risk - up to 100% of single risk category	<0.1% -> 10% of cash flow / asset value covered	- Closed investment fund; limited number of investors who purchase hedging products - Limited currencies in the investment fund - Untested in practice over the long term	FMO - http://www.mfnbuzza.nl/en/news/pressreleases/2007/0505_new_fund_provides_better_against_currency_risks.html
18	Political Risk Insurance (Private Sector)	Private Sector Insurance	Hiscox (Lloyd's syndicate)	- Specialist SME-investor focused intermediaries (to broker information, access and transactions) - Donor / philanthropic community (subsidize some insurance fees)	Cross-border investment in any asset (physical or capital based)	Provides insurance coverage for investments in developing countries against losses due to intervention by sovereign or subsovereign entities	1. An investor in a developing country purchases an insurance policy through a broker covering the investment against political risks 2. Risks covered include: expropriation, nationalization, currency non-transferability/inconvertibility, political violence, war/civil war among others 3. In the event that the investor incurs unrecoverable losses due to risk events covered by the policy, the insurance company reimburses the amount of investment covered	Country risk - up to 100%	Up to 2-3% of investment covered annually	- Domestic investors generally excluded	http://7a00b01a0a.com
23	Political Risk Insurance (Public Sector)	Public Sector Insurance	World Bank / MIGA	- Specialist SME-investor focused intermediaries (to broker information, access and transactions)	Cross-border investment in developing countries projects	Provides insurance coverage for investments in developing countries against losses due to intervention by sovereign or subsovereign entities. Due to a lack of domestic insurance coverage of risks associated with investment in and construction of renewable energy projects an insurance vehicle would be established to provide dedicated insurance capacity and specialist protection. The facility would distributed insurance policies through domestic insurance companies and provide an interface to re-insurance companies covering the renewables projects.	See Commercial Political Risk Insurance	Country risk - up to 90% (Event); 95% (Death)	0.3%-1.5% of guarantee	- Single, new investments only (with certain exceptions) - Some investors (e.g. from host country) not eligible - Lengthy application / transaction process (3-4 months) - Host country approval required - Minimum guarantee period - Applicable investments include: equity, shareholder loans, and shareholder loan guarantees, provided the loans have a minimum maturity of three years.	http://www.miga.org/site/ev/07/ev07_rfm345_1058
73	Global Environment Facility	Public Sector Insurance	UNEP	- African insurers - Africa-oriented DFIs	Project finance and ongoing operation of renewable energy assets in Asia	1. Local insurers market and distribute insurance coverage for renewable energy projects 2. Insurance vehicle provides technical and underwriting expertise and primary insurance capacity 3. Insurance vehicle liaises with re-insurance providers to arrange re-insurance 4. Re-insurers insure the insurance vehicle / specific projects	1. Bond originators source interested MFI assets 2. Originator evaluates and vets potential MFIs and provides prospectus, other roadshow / marketing activities 3. Originator structures bond assets into tranches of various risk levels 4. Investors participate in the bond offering various tranches 5. MFIs receive capital 6. MFIs conduct business and service debt obligations	Business risk (selected) - up to 100% Country risk - up to 100%	NA	- Coverage only available to renewable projects in China and India	UNEP
25	Microfinance Bond	Securitization	OPIC Gramen Foundation Blue Orchard Finance Developing World Markets	- Bi-lateral / multi-lateral development bank (guarantee bond) - Securitization specialist / intermediary (manage transaction) - Dev. Country audit firms (provide DD/Assurance on investment targets)	Debt finance in MFIs	Securitized loans to microfinance institutions, who lend to micro-entrepreneurs; senior tranches guaranteed by OPIC; junior and "equity" tranches taken on by sponsors	1. Bond originators source interested SME assets 2. AWS evaluates and vets potential SMEs and provides prospectus, other roadshow / marketing activities 3. Investors participate in the bond offering 4. SMEs receive capital 5. SMEs generate annual profits which are pooled and shared with bond investors (participation before taxes and reserves) 6. AWS guarantees a minimum annual return (c. 8%)	Business risk - up to 100%	Rough guide: 1-2%	NA - senior tranches have lower risk / return; vice versa for junior tranches - Limited number of underlying assets can be included in transaction	http://www.fewnews.com/ifa/40/inside_black_box/black_box.html
24	Profit-Sharing Bond	Securitization	AWS - Austrian Development Bank	- Bi-lateral / multi-lateral development bank (guarantee bond) - Securitization specialist / intermediary (manage transaction) - Dev. Country audit firms (provide DD/Assurance on investment targets)	Debt finance in Austrian SMEs	AWS underwrites a minimum 10-year bond offered on the Austrian stock exchange. The underlying assets are participation in the profits generated by participating SMEs.	1. Bond originators source interested SME assets 2. AWS evaluates and vets potential SMEs and provides prospectus, other roadshow / marketing activities 3. Investors participate in the bond offering 4. SMEs receive capital 5. SMEs generate annual profits which are pooled and shared with bond investors (participation before taxes and reserves) 6. AWS guarantees a minimum annual return (c. 8%)	Business risk - up to 100%	10% of principle amount - one-off	- Only Austrian SMEs can participate	http://www.ef.org/cms/htm/rev/ef.org/attachments/press_releases/map_conference_1_1.pdf
16	Partial Credit "Re-Guarantee"	Guarantee	World Bank / IRFD	NA	Developing country sovereign guarantees of domestic investments	Covers creditors (not investors) for specified sovereign risks arising from a government's default on contractual obligations, or the occurrence of certain force majeure events of a political nature (maintenance of a regulatory framework, adhering to agreed formulas for determining or escalating tariffs, change of government, etc.)	Similar to USAID Investment Guarantees, except: 1. Host government provides an investment guarantee to the institution 2. The financial institution applies for a secondary guarantee from the World Bank 3. If the government fails to honor its guarantee the World Bank will cover losses due to agreed risks	Business risk	c. 2-4% of investment guaranteed annually	- Requires an initial sovereign guarantee: only "re-guarantees" the guarantee given by the host government - Targeted at large-scale, long-term, higher-risk projects (infrastructure, etc.) "where the Bank's clout is needed"	http://web.worldbank.org/external/efas/efmain2menu.cfm?cid=44354500&openid=4435372&pv=44343352&ht=501&py=3985719
5	Other Derivatives	Hedging	Investment banks	- Specialist SME-investor focused intermediaries (to broker information, access and sales) - Donor / philanthropic institutions (to subsidize cost)	Assets or cash flows whose value is affected by: - Equities prices - Bonds prices - Other financial products prices - Macroeconomic trends - Inflation rates - Weather events - Creditor default	NA	See FX or Commodity derivatives	Market risk - up to 100% of single risk category Business risk - up to 100% of single risk category	<0.1% -> 10% of cash flow / asset value covered	See FX and Commodity Derivatives	Wikipedia

Risk Mitigation Mechanism Long List - Mechanism Detail

21	Credit Insurance	Private Sector Insurance	Atradius	NA	Sales to domestic or international buyers of products and services	Insurance coverage of losses due to insolvency of buyers in their domestic or international markets.	1. Local business establish contractual relationship with domestic or international buyers of their goods or services 2. The business purchases an insurance policy that covers the value of receivables which would be lost in the event of insolvency of the buyer	Business risk (selected) - up to 100%	Up to 2-3% of investment covered annually.		DeRisk own research
20	General Insurance	Private Sector Insurance	Local and international commercial insurers	NA	Assets (physical, human or capital-based)	Insurance coverage for the companies and projects operating in emerging markets against losses due to standard "Property and Casualty" or other risks (i.e. fire, flood, health and accident, workers compensation, business disruption, etc.)	1. Local business purchases standard insurance cover 2. In the event of loss covered by the insurance policy, the local business makes a claim	Business risk (selected) - up to 100%	Up to 2-3% of asset covered annually	- Certain key risks for African SMEs are often not coverable by insurance; international product liability (for exports to the US, for example)	DeRisk own research
1	Index Insurance Facility	Public Sector Insurance	GIIF, EU, Multilateral Development Banks	NA	- Sales from developing country agricultural production	A publicly funded insurance facility provides insurance capacity to developing country insurers to cover agricultural producers risk of crop failure due to natural disasters, drought, etc.	1. Donors and developing country governments pay a premium to GIIF to cover losses on participating agricultural producer output due to natural catastrophe (losses triggered by a breach of an agreed rainfall index, for example) 2. GIIF provides the insurance capacity and re-insures the risk in alternative capital markets and with re-insurers 3. If an "index event" occurs, GIIF pays out the the insured government	Business risk (selected) - up to 100%	NA	- Producers in participation countries only	http://www.giif.com/risk-portal/documents/meetings/inter-laken2005/giif2.pdf
3	Foreign currency (FX) derivative	Hedging	ING Bank	- Specialist SME-investor focused intermediaries (to broker information, access and sales) - Donor / philanthropic institutions (to subsidize cost)	Loan repayments and other structured cash flows with exposure to currency exchange rate risk (e.g. import purchases, bond payments, fixed dividends etc.)	An FX derivative is a financial contract whose value derives from the value of underlying currencies. Securities are purchased on both sides of a risk, so that any loss in one security is countered by gains in the other securities. The main types of derivatives are futures, forwards, options and swaps	1. Start with an institution on the receiving end of a regular stream of cash flows (e.g. loan repayment) in a given developing country currency (DCC) but who will exchange those cash flows for USD 2. If the DCC devalues against the USD, the cash flows are also worth less in USD 3. Either derivatives exchanges or investment banks will sell contracts that fix a given exchange rate in advance (or allows the institution to exchange at a given exchange rate if they so chose) throughout the life of the cash flow 4. The institution buys or enters into a contract with a derivatives provider (broker or investment bank)	Market risk - up to 100% of single risk category	<0.1% -> 10% of investment amount covered	- A credit relationship with a provider of derivatives (investment banks) is generally required - or provision of collateral - Minimum transaction size: investment of c. USD 10,000 for standard products and c. USD 1,000,000 for exotic products (source ING Bank) - Only a limited number of currencies are able to be hedged with derivatives - those in liquid foreign exchange markets. The essential characteristic of a liquid market is that there are ready and willing buyers and sellers at all times. For the following currencies, there is ready availability: Australian Dollar Canadian Dollar Danish Krone Euro GB Pound Hong Kong Dollar Japanese Yen Korean Won New Zealand Dollar Norwegian Krone Singapore Dollar South African Rand Swedish Krona Swiss Franc US Dollar. There is limited, and more expensive, hedging capacity some middle income developing country currencies - Prohibitive price or unavailability of long term contracts and exotic currency derivatives	http://pages.stern.nyu.edu/~igiddy/corshd.html http://www.schaefersesearch.com/streetside/market.html#hedge_calculator.aspx http://economist.com/research/Economics/alphabetic.cfm?letter=D#derivatives
8	DFI-Intermediated Hedge	Hedging	World Bank / IBRD	NA	Following IBRD loan types: - Fixed-Spread Loans - Variable-Spread Loans - Fixed-Rate Single Currency Loans - Currency Pool Loans - Single Currency Pool Loans	The IBRD acts as a market intermediary to provide sovereign borrowers access to hedging products for IBRD loans. IBRD hedges comprise only those that are available on commercial markets.	See FX or Commodity derivatives, except: 1. IBRD acts as an intermediary between the borrower and financial markets / counterparty, leveraging its AAA-rated balance sheet to obtain the best terms and conditions for available products 2. IBRD charges a transaction fee of <0.5% of the loan amount covered	Market risk - up to 100% of single risk category	- No "premium" per se on the actual hedge - cost is "embedded" in the potential foregone higher return associated with the domestic currency - IBRD charges a transaction fee of < 0.5% of cash flow / asset value covered	- Available only to IBRD loan recipients - Available on loans in the following hard currencies: in CHF, EUR, GBP, JPY, USD, and potentially other currencies supported by liquid derivatives markets, to be considered on a case-by-case basis	http://treasury.worldbank.org/web/odf/english_ho.pdf

Financing Sustainable Small and Medium Sized Enterprises in Africa: a hierarchy of developmental needs and acknowledging the vital role of the Diaspora

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Abstract:

According to the World Bank, the global flow of formal remittances in 2005 was US\$167 billion, or twice as much as global development aid. It is estimated that an additional 20-40% is channelled informally to the home country. Yet, in international development and financing strategies, the role of the Diaspora, and particularly the highly skilled, is not taken into account. This paper highlights the important role of the Diaspora to the development of small and medium enterprises (SMEs) in Africa. The first section reviews the significance of the Diaspora to economic development. This section also discusses research on the African Diaspora and their ambitions and plans for investment and new business generation in the region. The second section discusses the obstacles and challenges to SME development in Africa, as identified by the Diaspora community who are optimally positioned to contribute skills and local knowledge to the growth of SMEs. Herein lies a hierarchy of needs for the development of SMEs. The final section suggests initiatives to promote the financing of sustainable small and medium enterprises in Africa, which address the needs and a framework for 'hybrid' collaboration between government, business, the private sector, NGOs, and universities.

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According to the World Bank, the global flow of formal remittances in 2005 was US\$167 billion, or twice as much as global development aid. It is estimated that an additional 20-40% is channelled informally to the home country. Yet, in international development and financing strategies, the role of the Diaspora, and particularly the highly skilled, is not taken into account. This paper highlights the important role of the Diaspora to the development of small and medium enterprises (SMEs) in Africa. The first section reviews the significance of the Diaspora to economic development. This section also discusses research on the African Diaspora and their ambitions and plans for investment and new business generation in the region. The second section discusses the obstacles and challenges to SME development in Africa, as identified by the Diaspora community who are optimally positioned to contribute skills and local knowledge to the growth of SMEs. Herein lies a hierarchy of needs for the development of SMEs. The final section suggests initiatives to promote the financing of sustainable small and medium enterprises in Africa, which address the needs and a framework for 'hybrid' collaboration between government, business, the private sector, NGOs, and universities.

Migration central to development – role of the Diaspora

An estimated 5 million Africans are leaving Africa (Africa Recruit 2006). These migrants, referred to as the Diaspora, represent a hidden and often untapped resource with great potential to change the landscape of small and medium sized enterprises in their home countries. Many of these migrants are highly skilled. In 2000, 31.4% of African migrants in OECD countries were tertiary educated (compared to 23% in 1990), which includes IT specialists, scientists, and engineers (Commonwealth Secretariat, 2007, p.13). As of 2006, 28% of the total physicians trained in Sub-Saharan Africa were working abroad (*Ibid.*). These are international individuals, with indigenous knowledge of the region, significant skills and experience, and who are vested and active stakeholders in Africa's future. As Africa Recruit, a joint venture mobilisation programme of the New Partnership for Africa's Development (NEPAD) and the Commonwealth Business Council, reported:

Our research shows us that Africans want to increase investment in Africa. While African governments have put in place various policies to facilitate investment by large multinationals, little has been done to enable the inflow of investment from private individuals (Africa Recruit, 2006, p. 8).

An Africa Recruit survey of 1327 responses from Kenyans in the Diaspora from all professional categories, including accounting, information technology, banking, finance, education, health and law found that (Commonwealth Secretariat, 2007):

- 78% plan to go back to Kenya in the immediate future or at an earlier date.
- 70% of surveyed Diaspora responded plan to become self-employed immediately upon return to Kenya, with an additional 12% play to become self-employed after initially taking up a job.
- 60% left Africa for career and/or professional reasons
- 55% of those interviewed sent home more than \$300 per month to be used for investment. The top three areas of which were setting up and running a business, real estate, and capital market investment.
- 82% of the respondents remit for sustenance purposes

Another study of the African Diaspora (Africa Recruit 2006, p.8) from various countries (235 respondents) found that:

- 40% had a professional background in agriculture, with 31% having a Masters degree
- 35% of respondents had over 8 years of work experience

This data for the agricultural sector is particularly notable, given that agriculture accounts for almost 70-80% of the employment in Africa and almost 35-50% of GDP (Africa Recruit, 2006, 11). With this desire to engage in Africa's economy and business development comes the potential to transform brain drain into brain gain. The Diaspora are playing and will continue to play a significant role in financing development in Africa, and African countries are relying more on the stable foreign direct investment (FDI) flows and remittances from indigenous Africans living abroad (Africa Recruit, 2006). Sierra Leone is attracting post-war investment in social capital from its Diaspora community. Overseas Nigerians are investing in business given attractive capital markets in Nigeria. It is estimated that currently about US\$1 billion is remitted to Kenya annually from the Diaspora community of Kenyans living abroad (Kenya Diaspora Investment Forum, 2006, p.2).

Obstacles and challenges to the Diaspora's role in sustainable finance

This section discusses the challenges to creation and sustainability of SMEs in Africa, as conceived in a hierarchy of development needs, conceived by this author. What emerges from this discussion is also a framework for collaboration - among government, business, universities, NGOs, international organisations - to address each level to support the financing and integration of SME enterprises in Africa.

(1) Physiological needs

Africa is on target to miss all eight of the Millennium Development Goals by 2015, which potentially means continued poverty and hunger, lack of access to quality education, persistent gender inequality, continued health problems including high rates of child mortality, HIV/AIDS, tuberculosis. These are basic physiological needs for the development of African society and the African economy. How can sustainable SMEs exist if these needs are not met and investor confidence remains low? The promotion of the agricultural sector is paramount to mitigating risk and achieving the physiological needs of Africans. As reported by the Director of Food Security and Sustainable Development, Josué Dioné, the overall economy of most African countries, including their potential to achieve the MDGs, is dependent on the agricultural sector. Nearly one-third of Africans still suffer from chronic hunger, despite spending \$25 billion annually on food and agriculture imports and receiving \$2 billion in food aid (Dioné, 2007).

(2) Infrastructure

Physiological needs are closely tied to infrastructure – water, roads, energy sources – is also fundamental to the development and growth of SMEs, to support trade, distribution, and increase investor confidence. According to Dr. Wani Tombe Laco, a Sudanese economist, Africa uses only 4% of its water 'due to the inappropriate allocation of contracts to dubious firms, corruption and selfishness' (Laco, 2007). This also includes real estate, where in some countries the industry is unregulated and title deed fraud or illegal allocations of land are not uncommon.

(3) Security and safety

Crime, theft, and poor security are concerns for entrepreneurs and business people conducting trade through Africa. But lack of security, theft, fraud, and money laundering impact investor confidence. Part of the financing strategy has to address the needs to SMEs to provide a safe and fair marketplace.

(4) Policy initiatives and incentives

This could come from one of three groups, or through a partnership with includes one, two or all three: government, private sector, or third sector. Private sector partnership with government is very strong and policies have been developed that are conducive to business and investment. These might include national and/or international reforms, such as fiscal reforms for poverty reduction, or initiatives to achieve macro-economic stability or and improve governance.

(5) Human capital

Lack of access to technical expertise and capacity building resources are obvious barriers to the expansion of the sustainable SME sector, but given that many of the most highly qualified and skilled are working outside of Africa, the involvement of the Diaspora is key to the development of business and entrepreneurship in Africa. This also includes the regional migration of skilled talent within and across Africa.

(6) Social capital / knowledge networks

This includes formal and informal Diaspora networks, but across countries abroad and with the home country. The objective is to get a 'critical mass', and building a means to define and institutionalise commitments from the Diaspora to the home territory. A small group might serve as a springboard to launch projects, or to lobby together for favourable policy changes.

(7) Financial mechanisms

If an estimated 20-40% of monies are being remitted informally – perhaps tucked into the soles of shoes, or packages sent home – it suggests outrageous inefficiencies in current mechanisms of money transfer and ways to facilitate investment opportunities back home.

Addressing these needs from the Diaspora perspective

In conclusion, this paper summarises and puts forward several suggestions advocated by experts, policy makers, and researchers, which take into consideration the important role of the Diaspora in the development of creating sustainable SMEs on the African continent. They consider the specific needs of the Diaspora, to assume their key role in the development of SME enterprises and economic progress in Africa, but require cooperation from the diverse range of stakeholders.

In addressing the specific role of the Diaspora, the following recommendations are put forward:

(1) Physiological needs

Greater attention to the agricultural sector, and support for agricultural SMEs are both essential. Another challenge is turning "brain drain" into "brain circulation", so that doctors, nurses, teachers who have spent time working abroad are able to return home to opportunities to use their new skills and talents. Incentives for returning doctors to start their own clinics, or for teachers to return to take up posts or advance professionally are currently lacking (Commonwealth Secretariat, 2007).

(2) Infrastructure

One challenge remains in ways and means for the Diaspora community to invest directly in supporting infrastructure development. As an example, there might be the creation of infrastructure bonds or mutual funds that invest in government securities whose proceeds might be used for infrastructure development.

(3) *Security and safety* – Many African nations are still lacking the infrastructure for adequate legislative and judiciary systems to monitor and prosecute corruption and theft. Much of this responsibility lies within government, to improve law enforcement structures.

(4) *Policy incentives*

Liberalizing the agriculture export sector and be export market orientated, which requires governmental and inter-governmental trade initiatives as well as a committed private sector. There is also room to improve the processes to register companies, or to obtain permits and licenses to run businesses. Incentives, which might include tax exemptions or incentives to encourage investment from the Diaspora into their home countries, or special interest rates for the Diaspora, particularly during the business start-up phase when machinery and equipment might need to be imported from abroad. Greater participation in home government issues might also be facilitated with dual citizenship or right to representation in political affairs, enhancing trade and investment, and studying models from elsewhere – such as India, Israel, and China.

(5) *Human capital*

The creation of partnerships between African Universities and Universities in the UK or US have facilitated the sharing of knowledge, whilst keeping African talent in Africa. Partnerships between schools of engineering and business schools have helped African-based entrepreneurs develop skills that they will need to set up SMEs, receiving guidance from faculty and professors in industrialised countries. A further step in this process is building partnerships between the Diaspora business community and African business community to facilitate trade.

(6) *Social capital / knowledge networks*

There is room for greater communication between African-based companies and Diaspora networks. Additionally, this includes the sensitisation of the public and private sector stakeholders on Diaspora issues, to create a foundation for partnerships across Africa and between Africa and industrialised countries. Much is to be learned from the Indian Diaspora and their role in building partnerships and confidence in the US technology industry to create partnerships with companies based in India and Indians returning to their home after spending time in the US or Europe.

(7) *Financial incentives and mechanisms*

Financial institutions need to develop packages that suit the needs of the Diaspora. Further examples might include tax holidays for those who want to start-up businesses back home, or a relaxed import duty on machinery or capital equipment that needs to be imported. Banks abroad could also work closely with African banks to facilitate real estate purchases by non-resident nationals. This might also include greater access to e-banking. There is significant room for financial institutions to contribute, including services to facilitate the transmittance of remittances, facilities to make available foreign currency mortgages, and online banking.

Conclusion

The well-documented success stories and critics of microfinance both recognise that the careful consideration of context is essential to creating sustainable financing solutions. Promoting sustainable finance in Africa requires much more than the expansion of financial services. This paper sought out to propose a hierarchy of needs, which might be used for the coordinated planning to achieve sustainable financing solutions for African SMEs. Improving financial incentives and mechanisms are merely at the top of the pyramid.

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