



Transatlantic Innovations in Affordable Capital for Small- and Medium-Sized Enterprises

Prospects for Market-Based Development Finance

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TRANSATLANTIC INNOVATIONS IN AFFORDABLE CAPITAL FOR SMALL- AND MEDIUM-SIZED ENTERPRISES

Prospects for Market-Based Development Finance

A JOINT REPORT BY THE GERMAN MARSHALL FUND
OF THE UNITED STATES AND THE MILKEN INSTITUTE*

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1 INTRODUCTION

The fifth of June 2007 marked the 60th anniversary of George C. Marshall's speech at Harvard University that led to the launching of the Marshall Plan to rebuild post-war Europe. It was a significant departure from past foreign policy and sought to avoid mistakes of the interwar period. The Marshall Plan ranks among the most successful economic development projects and represents an innovative approach to trade, aid, and development. In addition to providing direct funding, the Marshall Plan ushered in the creation of new financial institutions, capacities, and mechanisms that were, for the time, innovations in generating affordable capital.

A portion of Marshall Plan funds ultimately went to small- and medium-sized enterprises (SMEs) to help with the reindustrialization of Europe. Unfortunately, replicating the Plan's success in the developing world has been difficult. After 50 years and \$2.3 trillion dollars of aid, donors and aid recipients are questioning the value and impact of the monies deployed through conventional foreign aid. SMEs in the developing world continue to face unique and enormous challenges: barriers to market entry, expensive and time-consuming regulatory requirements, burdensome tax and legal structures, labor market rigidities, and above all, limited access to affordable capital (traditional bank and risk capital). Angel investors, venture capitalists and early start-up specialized investors are hardly present in developing economies. Government and donor-directed subsidized credit programs in support of SMEs have had limited impact in the absence of wider systemic reforms and are fraught with moral hazard and adverse selection problems.¹

¹ Moral hazard emerges in development finance when the risk of a loan or investment contract induces behavior that amplifies the default risk. Adverse selection occurs because lenders, investors and borrowers are unable to accurately gauge the quality of investment opportunities or financial products, thereby creating a market of poor financial products. Foreign aid can create incentives that attract poorer-quality business opportunities because of adverse selection. Torsten Wezel, "Does Co-Financing by Multilateral Development Banks Increase "Risky" Direct Investment in Emerging Markets?" Discussion Paper Series 1: Economic Studies, Deutsche Bundesbank, Research Centre, 2004.

What makes affordable capital for SMEs so important? SMEs represent the dominant form of business organization worldwide, accounting for roughly 95 percent to 99 percent of enterprises depending on the country. They account for two-thirds of private sector employment and are the primary source of job creation in Organisation of Economic Co-operation and Development (OECD) countries. SMEs can have a multiplier effect on the economy by accelerating employment, raising incomes, spurring consumption, increasing locally-sourced inputs, and widening the tax base. They can lead to new products, services, and business models that fundamentally alter an industry and help launch a new one resulting in higher productivity. The agglomeration of SMEs helps to create new jobs, build supply chains, and forge dynamic business clusters linked to global markets through trade and investment.

The *mittelstand* of Germany, the sophisticated sub-contractors of Northern Italy and Japan, the venture-backed IT firms of Israel, and the Silicon Valley-like "start-ups" of the United States are a few examples. No doubt the SME landscape differs across countries. Many debate the differences between innovative versus redundant SMEs and the degree of entrepreneurial culture that exists in markets. Nevertheless, the organic growth of small enterprises remains a critical source of wealth creation.

Most of the developing world's industrial structure though suffers from a "missing middle" characterized by many small, static, and informal enterprises on one end of the spectrum and a few large firms on the other.² These small-scale enterprises, mostly traders, artisans, and farmers tend to be less productive, while large firms often face limited competition and may influence the regulatory, legal, and financial conditions to block new entrants. Banks in these markets typically focus services on the well-established, less-risky larger

² Some countries and regions in East Asia have benefited from the development of highly-skilled SME sectors, but this is not the case for much of the developing world.

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This democratization of capital helps bolster the development of a vibrant middle class which, in turn, can foster political stability.

firms. Despite microfinance investment approaching historical highs, SMEs remain underserved by financial markets in developing countries. Weak business climate conditions — especially an underdeveloped financial system — severely limit new firm entry and SME development. If young entrepreneurs are unable to raise capital to take advantage of new opportunities to design new products and services, add value to exports, employ new technologies, and achieve a cash flow sufficient to reinvest profits, then small firms are less likely to emerge and become bigger ones.

There are also political and institutional implications from generating affordable capital for SMEs and closing the “missing middle” gap. Demographic trends indicate that as most developed countries continue to gray, the world’s youth will increasingly be located in developing countries and this youth-bulge will be particularly acute in unstable parts of the world, such as the Middle East. In developing countries, without well-functioning financial systems, closed groups of incumbents typically oversee the allocation of capital. Better functioning financial sectors, with transparent systems and a range of products, generally allocate capital for productive investment on a reasonably objective basis, according to creditworthiness and potential returns. This democratization of capital helps bolster the development of a vibrant middle class which, in turn, can foster political stability.

The global aid architecture is evolving and there are growing concerns about the effectiveness of the traditional model of development finance. Foreign aid is becoming increasingly fragmented. New players, such as nongovernmental organizations (NGOs), foundations, and private sector entities are transforming the aid system. Some see this as exacerbating the problems of traditional aid — increasing the administrative burden on donor recipients, further draining local talent, and

undermining efforts to align aid with national plans.³ However, by operating outside the bureaucratic structures of donor agencies, some organizations are able to apply alternative and entrepreneurial strategies to SME development. At the same time, established aid organizations are exploring ways to try and improve aid performance by adopting the guidelines of the OECD Paris Declaration on Aid Effectiveness and partnering with NGOs, foundations, and the private sector to reduce duplication.

For instance, for-profit firms like U.S.-based Microfinance International Corporation are mobilizing remittance flows for capital investments in small enterprises. Organizations like Small Enterprise Assistance Funds (U.S.) have defined a niche in packing risk capital with specialized technical support for SMEs. Others are generating credit information or bureaus to help lower the risk premium associated with small businesses. The German bank ProCredit is training loan officers to work hands-on with small enterprises to manage credit risk and by achieving profits “crowding-in” traditional banks into the SME sector. The JSE Securities Exchange South Africa has created an alternative exchange for small enterprises that provides business training for SME executives. Public and private sector actors are exploring how they might underwrite international bonds for SMEs. Some are experimenting with new kinds of financial instruments (debt, equity, and quasi-equity) tailored to the credit/risk profile of SMEs — there is an interest in creative approaches to helping SMEs gain access to non-debt forms of finance that will free-up working capital to pursue business expansion.

³ It should be noted that NGOs are often subcontractors of donors. This may result in the classical principal-agency problem, limiting the ability of NGOs to function outside the donor community’s agenda.

To support this new impetus behind alternative approaches and increased focus on closing the “missing middle” finance gap, the German Marshall Fund of the United States (GMF) convened a roundtable of practitioners representing the public, private, and nonprofit sectors at the Affordable Capital for SMEs Conference held in Paris, France from June 11 to 12. The challenges and opportunities of generating affordable capital for SMEs were examined over the course of one and a half days. Many issues were raised, such as the notion that Africa does not lack capital, but good investment opportunities and an enabling environment for SMEs. Greater access to capital for SMEs must also be accompanied by, where necessary, capacity-building through management training, business and strategic planning, marketing, accounting, and technology upgrading. Creating incentives for local banks and financial intermediaries to develop SME products and services will also require new skills and management practices and a change in mindset. A variety of innovative approaches to “meso-finance” aimed at bridging the SME finance gap were considered at the conference and many of these are outlined below.

There was a consensus among conference participants that given the limits of past approaches and the dire need for unleashing finance for small enterprises in the developing world, alternatives must be explored — different aid paradigms and different platforms for delivering aid. Clearly, cross-sector learning and partnerships that include the United States, Europe, and the developing

world are needed. Collaboration can accelerate the development of innovative SME products, services, and delivery mechanisms that foster greater access to affordable capital and institutional capacity-building.

What are examples of such potential collaborations? Are there models for filling the financial service gap between microfinance and commercial finance? What are the barriers to generating affordable capital, and can they be surmounted to spur SME growth? How can product development and delivery be supported and monitored? How can we identify and assess SME deal flow? What investment capital structures will enable credit enhancement and flexibility for SMEs on a revolving basis? What would those hybrid capital structures for development investment look like if scaled? How can multilateral and bilateral agencies manage sources of risk for such longer-term investments? Can the combination of technical and management assistance, and capital investment by certain donors, NGOs, and private sector practitioners generate a standard platform for increasing affordable capital for SMEs? What is the role that developing world stock exchanges might play in intermediating capital for SMEs?

By examining these questions, providing case studies on U.S., European and developing world innovators working with SMEs, and identifying key challenges that lay ahead, this report aims to invigorate a thoughtful debate on how to leverage SME potential in support of economic development, entrepreneurship, and poverty alleviation.

Creating incentives for local banks and financial intermediaries to develop SME products and services will also require new skills and management practices and a change in mindset.

2 DEFINING THE “MISSING MIDDLE” IN SME FINANCE

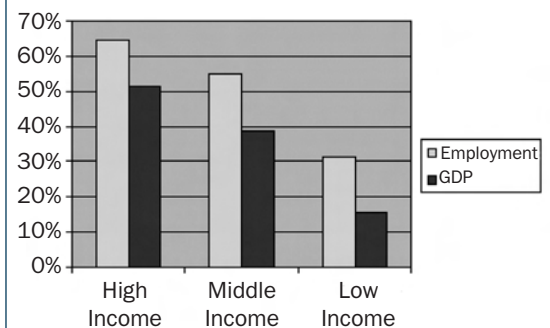
In recent years interest in SMEs has increased due to several trends: concerns about the ability of microfinance to create adequate numbers of jobs and help reduce poverty; the growing focus on private sector development, and linking with international value chains and global trade; the need to create employment in developing countries to address their rapidly growing young populations; and the increasing awareness that SMEs have a vital role in helping economic growth and political stability. To fully access the challenges of SME development though requires looking at the “missing middle” in SME finance.

A robust SME sector can contribute significantly to the growth and stabilization of developing economies. Expansion of this sector can generate strong returns for investors: the SME sector contributes to about two-thirds of employment and half of Gross Domestic Product (GDP) in high-income countries. However, among low-income countries, SME contributions — in terms of GDP and employment — are relatively smaller (Figure 1). SMEs account for less than 10 percent of GDP for African countries.⁴ High-income countries enjoy faster-growing and more numerous SMEs, while low-income countries see fewer, more static SMEs. Low-income economies suffer from weak SME development due to a lack of access to affordable capital and other major business climate barriers. This is important for understanding the skewed industrial structure that marks many developing countries.

It should be noted that in developing countries many SMEs simply operate in the informal economy. While data for informal firms is more problematic, some studies indicate that informal SMEs actually represent larger shares of employment and GDP in low-income countries.

⁴ A. Patricof and J. E. Sunderland, “Small is Beautiful,” *Milken Institute Review*, 2/2005: 90-94; A. Patricof and J.E. Sunderland, “Venture Capital for Development.” Discussion Paper. Prepared for the Brookings Blum Roundtable: The Private Sector in the Fight Against Global Property, August 4, 2005.

Figure 1: SME Sector's Contribution to Employment and GDP

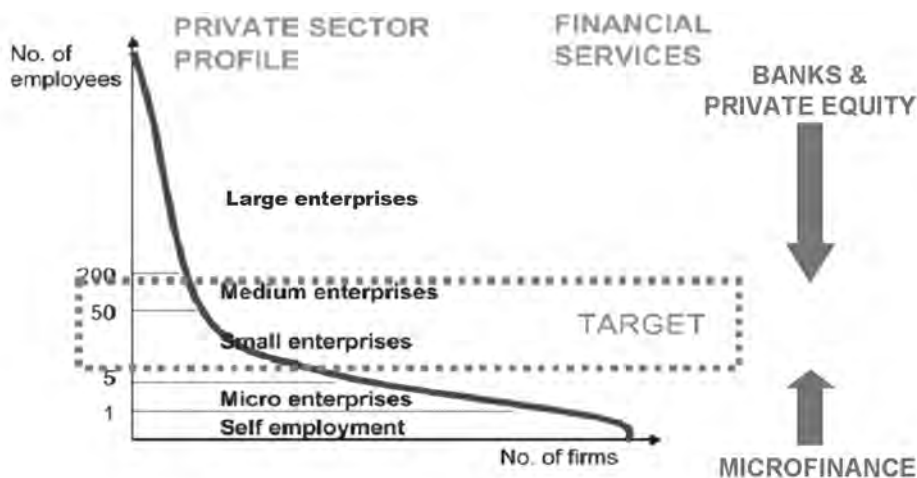


Source: Meghana Ayyagari, Thorsten Beck, Asli Demircug-Kunt, “Small- and Medium-Enterprises across the Globe: A New Database,” World Bank, August 2003.

Nevertheless, these informal SMEs are typically subsistence-driven enterprises with very low productivity. They have little incentive to build relationships with official sources of capital or develop more formalized transparent operating, disclosure or accounting practices. As countries move up the income scale, their share of informal SMEs decreases as the share of formal SMEs rises. SME informality is essentially a by product of the negative conditions facing SMEs in low-income countries, such as poor financial intermediation, weak human capital development, and high barriers to entry. Filling the “missing middle” means altering these conditions to move these firms into the formal economy.

Numerous research studies suggest that access to finance is among the top barriers facing SMEs. Large enterprises benefit from bank and non-bank credit, as well as private equity financing and microenterprises can access the rapidly expanding pool of microfinance funds. However, SMEs do not have a comparable source of capital in developing countries. This finance gap is mostly behind the bifurcated industrial structure seen in many developing countries where

Figure 2: Enterprise Financing Gap



Source: Dalberg Global Development Advisors, *From Talk to Walk: Ideas to Optimize Development Impact*, 2006.

In Cameroon, for example, the minimum deposit required for opening a checking account in a commercial bank is over \$700, an amount higher than that country's per capita GDP.

many small informal enterprises accompany a few large firms, which are either multinational companies or family-owned conglomerates.

While data may vary across countries, most identify SMEs as firms employing somewhere between 10 and 250 workers. Microenterprises consist of one or a handful of workers, while firms with 250 or more are considered large firms (in some cases firms with 100 employees could fall into this category). No doubt what represents the SME “missing middle” differs across countries since firm distribution, business climate factors, and financial sector development are not consistent in each case. It is generally accepted though that when looking at loan size and the kinds of capital available that firms in-between microenterprises and large firms are underserved (Figures 2 and 3).

Capital can be costly, constrained, or unavailable to SMEs for several reasons. The lack of competition in the banking sector reduces pressure to innovate

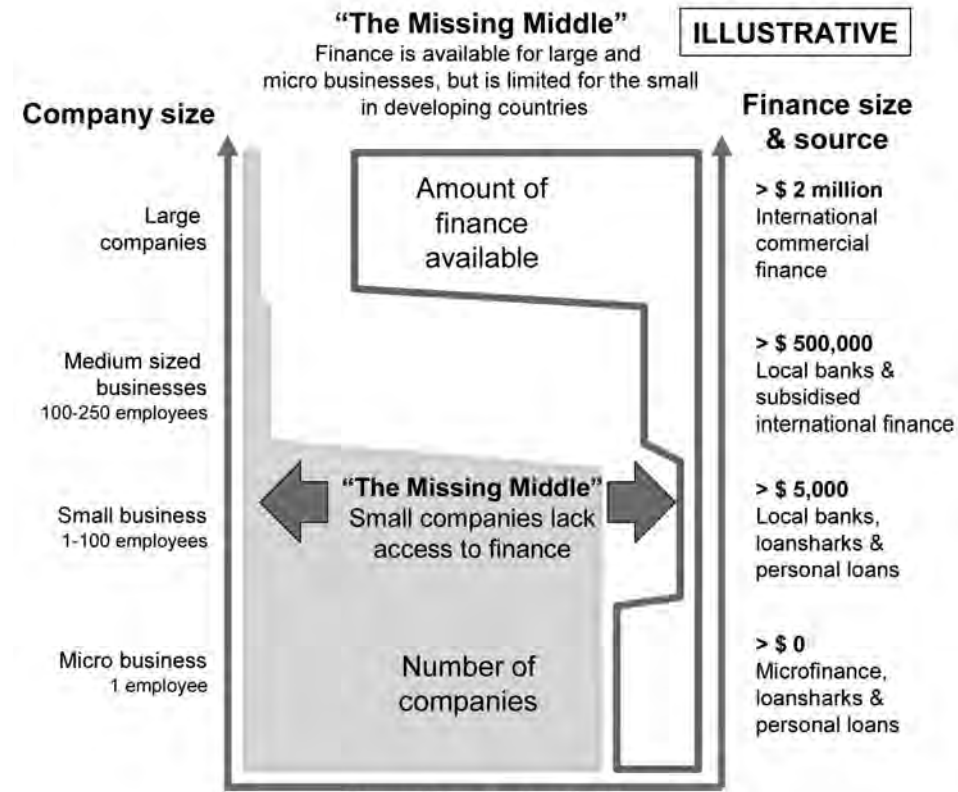
and develop products and services for smaller clients. In many developing economies, banks are owned-wholly or in part by the government or large private businesses and credit may be allocated to favored sectors or to affiliated companies representing entrenched management. Overly restrictive supervisory, capital adequacy, collateral, and deposit requirements often act as barriers to small enterprises. In Cameroon, for example, the minimum deposit required for opening a checking account in a commercial bank is over \$700, an amount higher than that country's per capita GDP.⁵ Financing is particularly problematic in rural areas, where services are fewer, less convenient, and more costly. Small firms focused more on domestic production and distribution often find it more difficult to access capital as well.

Access to private credit and the costs of starting a business most often determine the number of

⁵ World Bank, “Access to Finance: Measurement, Impact and Policy,” *Research Report*, November 2007 (forthcoming).

These business environment weaknesses have a disproportionately negative impact on smaller businesses and compound the problem of limited access to capital.

Figure 3: The Missing Middle



Source: Sanders and Wegener, 2006.

SMEs in an economy (Figures 4 and 6). Low-income countries tend to have limited access to private credit and low numbers of SMEs whereas the opposite is true for high-income countries (Figure 5). Other factors limiting SME development are the following: ill-defined property rights; burdensome, weak or non-existent regulation; ineffective contract enforcement; corrupt or monopoly markets; no clear legal structure for firm entry and exits; underdeveloped credit and risk appraisal skills and managerial experience; scarcity of credit information and registry systems; and high transaction costs associated with lending, equity, quasi-equity, and other forms of risk-capital. These business environment weaknesses have a

disproportionately negative impact on smaller businesses and compound the problem of limited access to capital. The capacity for SME business formation and achieving competitive growth rates requires addressing these barriers.⁶

Based on surveys of developing country SMEs conducted by the World Bank, among the leading constraints they face are the cost of and access to finance (Figure 7). Roughly a third of SMEs indicated that these factors act as major constraints to growth — along with tax rates, macroeconomic instability, economic policy uncertainty, and corruption.

⁶L. Klapper, L. Laeven, and R. Rajan. “Entry Regulation as a Barrier to Entrepreneurship.” *Journal of Financial Economics* 82 (3): 591-629. (2006).

Figure 4: Cost to Start a Business vs. Number of SMEs

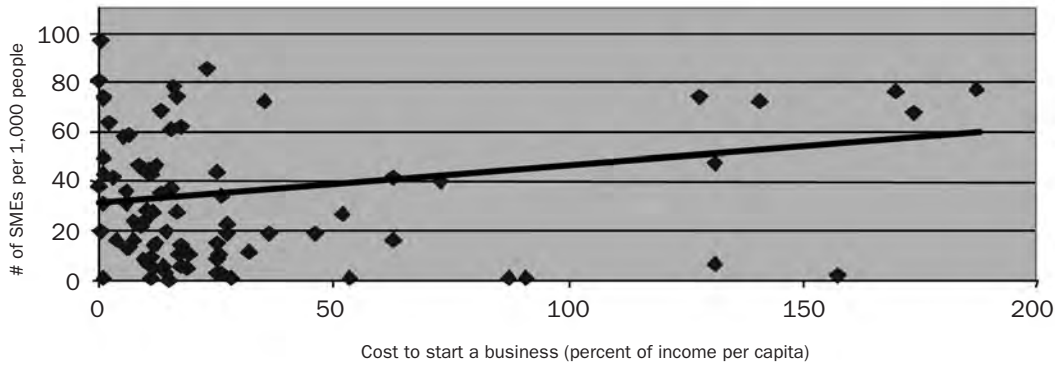


Figure 5: Private Credit vs. Number of SMEs

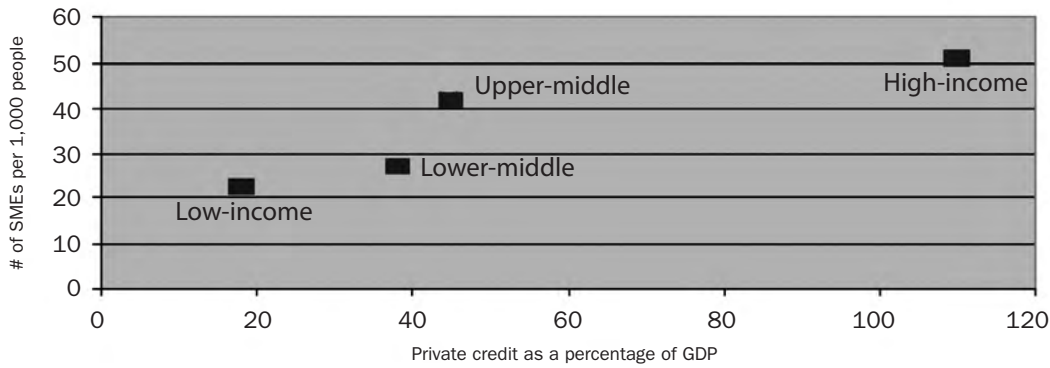
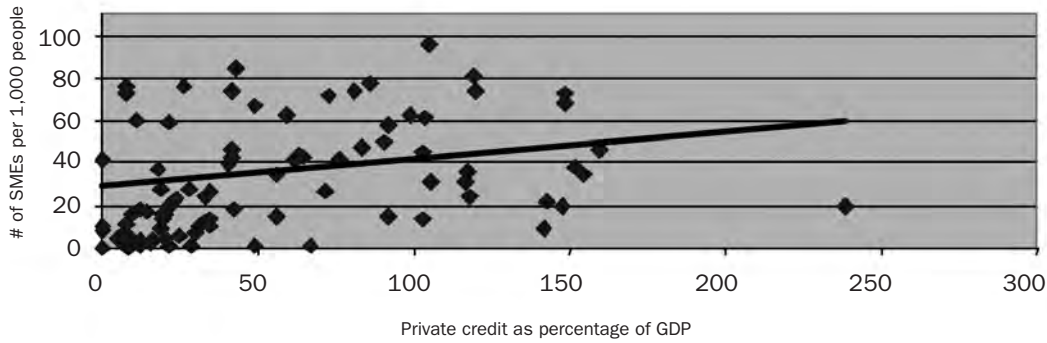
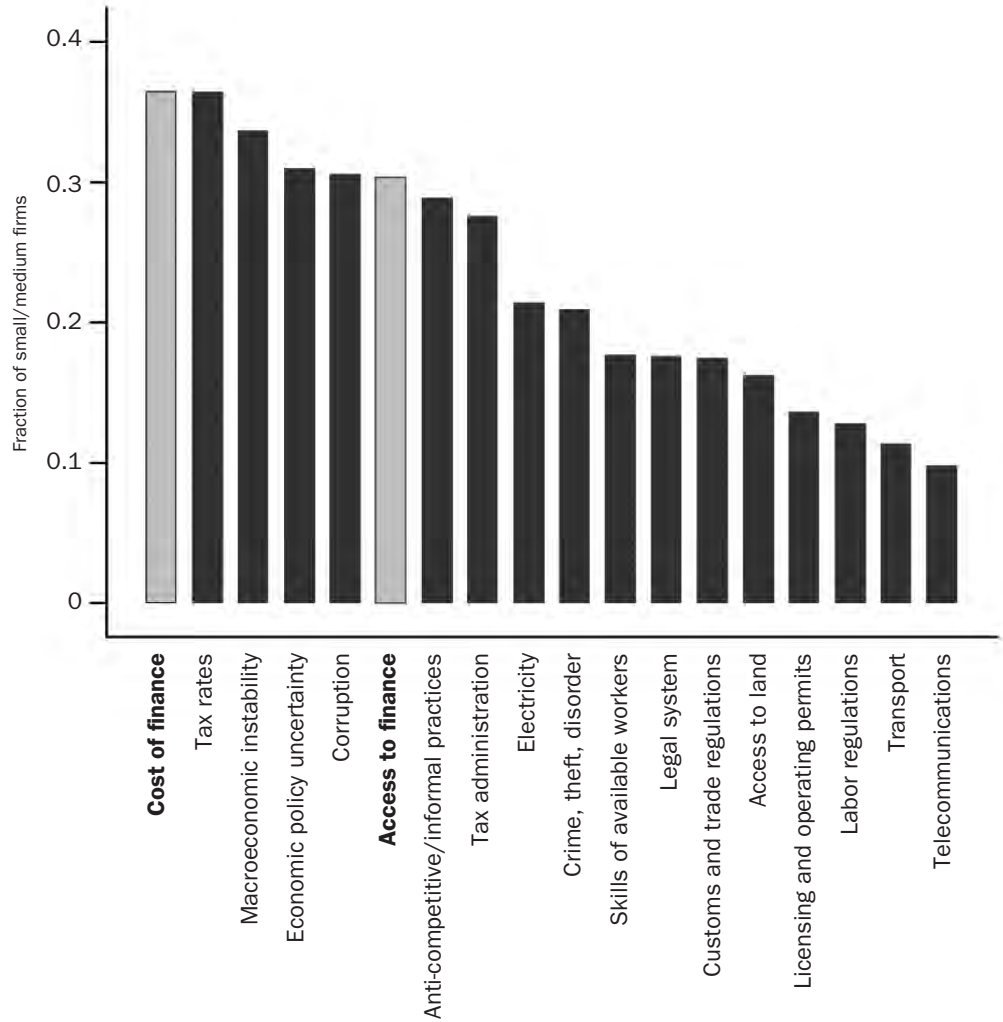


Figure 6: Private Credit vs Number of SMEs



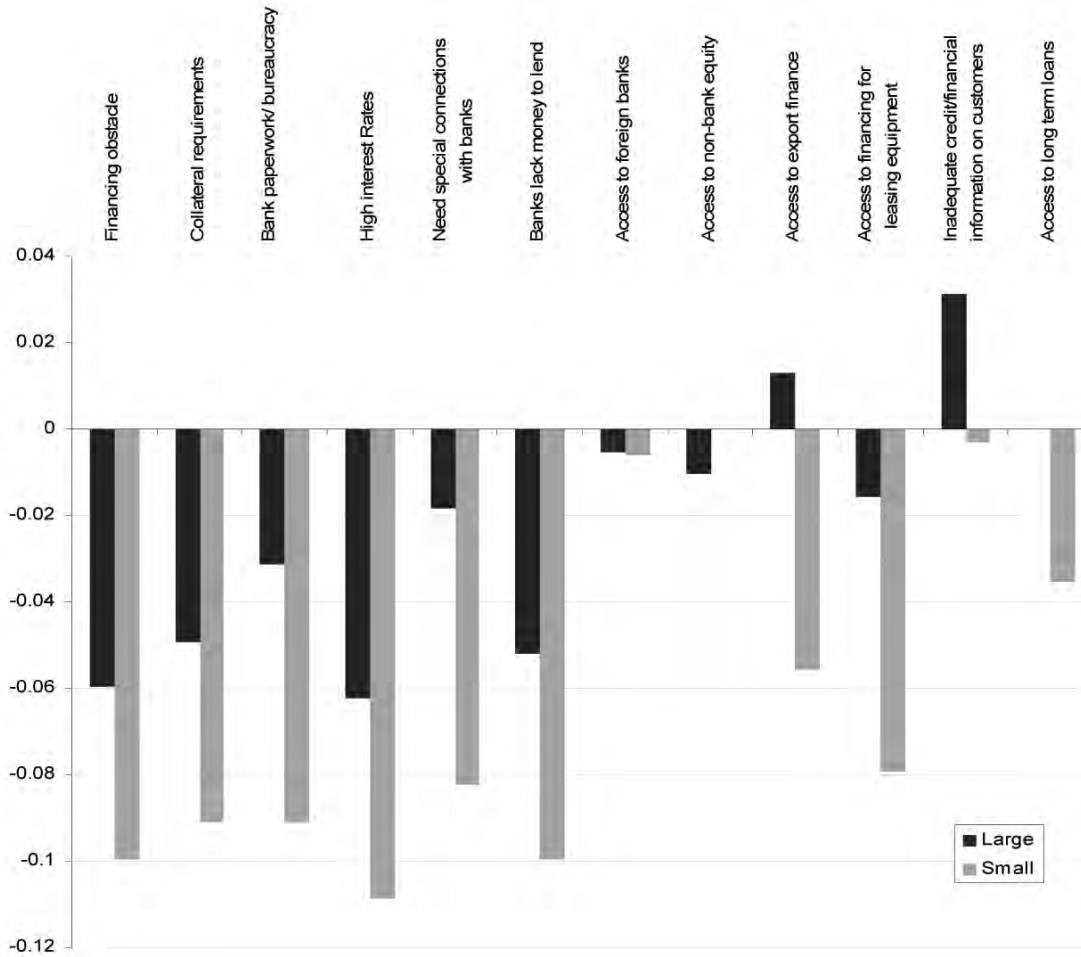
Source: IFC, *MSME: A Collection of Published Data*, 2006.

Figure 7: Growth Obstacles Reported by SMEs



Source: Thorsten Beck. "Financing Constraints of SMEs in Developing Countries: Evidence, Determinants, and Solutions." Working Paper. World Bank, April 2007.

Figure 8: Growth Effects of Financing Obstacles Across Firms of Different Sizes



Source: Thorsten Beck. "Financing Constraints of SMEs in Developing Countries: Evidence, Determinants, and Solutions." Working Paper. World Bank, April 2007.

A range of other business climate factors are also noted as obstacles by SMEs, like regulatory and legal systems, physical and IT infrastructures, access to skilled labor, and the social environment of the country.

A survey of SMEs and large firms reveals quite clearly an uneven playing field exists for finance in the developing world (Figure 8). There are much stronger negative responses from small firms relative to large firms across a wide array of

financing obstacles, such as collateral requirements, paperwork, higher interest rates, and special connections to the banks, among others. This bias against SMEs was evident for several forms of capital: export, leasing, and long-term finance are much scarcer for SME firms. This same report also showed that these financing obstacles have almost twice the negative effect on the growth of smaller firms compared to larger firms.

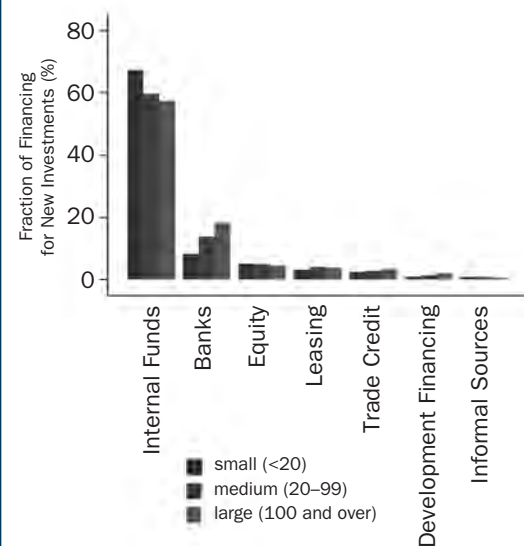
Without sufficient capital from banks, venture capitalists or angel investors to help unleash capital for business expansion, young entrepreneurs remain cash-strapped and risk averse.

When looking at the variety of sources for financing, most firms — large, medium, and small — rely heavily on internal funding compared to external forms of finance (Figure 9). However, small firms clearly are set apart as having to largely depend on internal sources of finance to drive their business growth and have much more limited access to bank credit. Large firms finance more than 20 percent of their investment needs using bank credit, while smaller firms finance less than 10 percent of their investment needs with bank credit. When they do gain bank credit — typically a loan — SMEs must pay the current interest and amortize the debt. Early start-up firms growing rapidly often are unable to generate enough cash to expand their business after the owners exhaust their internal resources and cover the costs of the debt. Without sufficient capital from banks, venture capitalists or angel investors to help unleash capital for business expansion, young entrepreneurs remain cash-strapped and risk averse.

Two key challenges to extending financial services to SMEs are the high costs and risk. SMEs typically require small financing amounts; somewhere in the \$5,000 to \$500,000 range (although some SME loans may be as much as \$3 to \$4 million as is the case with Aureos Capital). This means banks must process and manage many smaller loans in the SME sector. This translates into higher transaction and operating costs and reduces the attractiveness of such investments.⁷ Microfinance has led to some innovative approaches to reducing costs and lessons can be learned from those efforts. However, these techniques may not easily apply to SMEs, which present more complicated risk profiles. Credit, political, currency, regulatory, legal, and accounting risks discourage banks from catering to SMEs. Survey research shows that SMEs found local banks difficult to deal with because the banks' procedures

⁷D. Wood, "Convening Report: Toward a Coherent Investment Framework for Sustainability Investing in Small- and Medium-Sized Enterprises in the Developing World," Boston College, 2005.

Figure 9: Financing Patterns Across Firms of Different Sizes



Source: Thorsten Beck. "Financing Constraints of SMEs in Developing Countries: Evidence, Determinants, and Solutions." Working Paper. World Bank, April 2007.

were not always clear or consistent.⁸ Investors are unable to overcome information asymmetries due to lack of accounting records, business plans, and inputs for adequate credit and investment analysis. A lack of credit information and the means to manage complex SME risk limits both domestic and foreign sources of SME finance.

With larger firms dominating local capital markets and the bulk of merger and acquisition activity, SME equity is very limited and exit opportunities are few. International agreements and financial standards require regulatory agencies in the developing world to apply strict collateral and equity requirements that might not consider the undeveloped nature of these financial markets. This further stifles the growth of equity or equity-like assets. In general, capital market strategies have

⁸W. Smith, "World Development Report 2005: A Better Investment Climate for Everyone," World Bank, 2005.

not been applied to the SME sector as a means of managing local and cross-border risk and risk mitigation is an important piece of the solution to increasing investment to SMEs.⁹

Furthermore, emerging markets have yet to fully exploit the benefits of modern technology innovations that have occurred in mainstream finance. During the past 30 years, the corporate finance revolution helped eliminate advantages of size held by entrenched, large firms, bureaucracies, and management that stymied growth. The financial innovations that were unleashed returned activist investing and aligned interests in capital structure between owners and managers and between creditors and investors, to finance growth.¹⁰ Yet, these dramatic changes left development finance largely untouched. These technology-driven innovations have led to more sophisticated financial products and services, created new markets and efficiencies, and fundamentally transformed modern financial markets. Financial and information technology offer great potential for generating greater access to capital for SMEs at lower costs in the developing world.¹¹

Empirical research widely demonstrates that financial exclusion retards growth and increases poverty and inequality—the antithesis to the

putative objective of development finance.¹² The absence of financial depth and the availability of more flexible capital structures (including the spectrum of both actual and synthetic equity to debt products) hamper growth and disproportionately harm smaller firms, their employees and their communities. Direct intervention through taxes and subsidies in support of SMEs has not been uncontroversial. Some see these policies as undermining market discipline and distorting risk-taking. However, government has a critical role to play. Policies aimed at improving the overall business climate and institutional capacity can foster financial sector development. Macroeconomic stability, physical and IT infrastructure, credit and information systems, transparent and enforceable corporate and financial legislation, and balanced regulation offer ways to widen financial inclusion.

Recent experience suggests that financial practitioners are beginning to explore and develop mechanisms to overcome many of these identified problems. As policy makers consider ways to improve financial inclusion and create an enabling environment for SMEs, they should take note of these new efforts. Many of these pioneering practitioners are asking some important questions. How can we identify and assess SME deal flow? What investment structures will enable credit enhancement and flexibility for SMEs on a revolving basis? Can the combination of technical and management assistance and capital investment by certain donors, NGOs, and private sector practitioners generate a standard platform for increasing affordable capital for SMEs? The case studies below highlight several market-oriented interventions that have brought capital and capacity-building to emerging market SMEs.

⁹ O. Karius and A. Gaines, “SIRIF — A Study of Risk Mitigation of Development Investments,” The Global Exchange for Social Investment and VantagePoint Global: 21, 2006.

¹⁰ G. Yago and S. Trimboth, *Beyond Junk Bonds: Expanding High Yield Markets*, New York: Oxford University Press, 2005; J. Stern and D. Chew (eds.), *The Revolution in Corporate Finance*, London: Blackwell, 2003; Walter Russell Mead and Sherle Schweninger (eds.), *The Bridge to a Global Middle Class: Development, Trade, and International Finance*, Milken Institute Series on Financial Innovation and Economic Growth, Boston: Kluwer Academic Publishers, 2003.

¹¹ I. Oluwajoba Abereijo and A. Oluwagbenga Fayomi, “Innovative Approach to SME Financing in Nigeria: A Review of Small and Medium Industries Equity Investment Scheme,” *Journal of Social Sciences*, 2005.

¹² T. Beck, A. Demircuc-Kunt, and R. Levine, “SMEs, Growth and Poverty: Cross Country Evidence,” *Journal of Economic Growth*, 10(3), September 2005:199-229.

Table 1: Activities of Selected Organizations*

	Technical Assistance	Risk Mitigation Instruments (e.g. loan guarantees or hedging)	Remittances	Credit-Rating Instruments	Business Plan Competition	Direct Financing	Consulting Services
Root Capital	No	No	No	No	No	Yes	No
Business Partners	Yes	No	No	No	No	Yes	No
KfW	Yes	Yes	No	Yes	No	Yes	No
SEAF	Yes	No	No	No	No	Yes	No
Agora	Yes	No	No	No	No	Yes	No
Shared Interest	Yes	Yes	No	No	No	No	No
E+CO	Yes	No	No	No	No	Yes	No
DeRisk	No	Yes	No	No	No	No	No
MFIC	No	No	Yes	Yes	No	Yes	No
IntEnt	Yes	Yes	Yes	No	No	No	No
Techno Serve	Yes	No	No	No	Yes	No	Yes
GEXSI	Yes	Yes	No	No	No	Yes	Yes
Aureos	No	No	No	No	No	Yes	No
Microrate	No	No	No	Yes	No	No	Yes
Acumen	No	Yes	No	No	No	Yes	No
JSE	Yes	No	No	No	No	No	No
OPIC	No	Yes	No	No	No	Yes	No
IFC	Yes	Yes	Yes	No	Yes	Yes	No
Bid Network	Yes	No	No	No	Yes	No	No

* Note that Technical Assistance and Direct Financing are indicated for organizations that do this for SMEs and/or financial institutions. For instance, the IFC directly supports SMEs, but also banks that may lend to SMEs.

3 SURVEY OF SELECTED INNOVATORS

The organizations surveyed below belong to a heterogeneous group of development finance innovators. Some are nonprofit and some for-profit; some receive only philanthropic money; some are entirely funded by governments; some are funded by private investors and required to produce a financial return on their investments, while others depend upon foundation funds and must show a measurable social impact. Some are funded by a combination of private, foundation, and government funding. They can be loosely grouped in four categories (some organizations may occupy more than one category):

Direct investors

Several surveyed organizations manage funds that invest directly in small businesses in the developing world, but even within this group there are notable differences. *Agora Partnerships*, *Root Capital*, *KfW*, *IFC*, *GEXSI* and *E+Co* give direct loans and make small equity investments at the lower end of the SME spectrum. The average loan, equity or quasi-equity investment for *Aureos*, *Acumen*, *SEAF*, and *Business Partners of South Africa* is higher. Some of these organizations may offer a combination of direct capital as well as technical assistance to enterprises. A few offer support to financial intermediaries that in turn offer capital to SMEs.

Remittance facilitators

There is agreement in the financial community that remittances constitute a source of untapped resources that could be channeled into entrepreneurial activities in developing countries. *IntEnt* has an initiative to create collective savings accounts for immigrants residing in the Netherlands to be used to finance SMEs in their countries of origin. It also offers pre-packaged investment opportunities in developing countries for immigrants. *Microfinance International*

Corporation (MFIC) has created a financial service network for Latino immigrants residing in the United States to channel remittances at a low cost to individuals and small enterprises in Latin America and help them build credit histories.

Service providers

The absence of business services acts as a major impediment for small firms seeking capital in developing countries. Business development services for SMEs, such as labor and management training, strategic planning, marketing, technology upgrading, and fostering businesses linkages, can help improve SME competitiveness and enable greater access to affordable capital. The business plan competitions operated by *BiD Network* and *TechnoServe* increase the potential deal pipeline for other investors or banks willing to lend. In addition, they enhance the creditworthiness of potential loan recipients by offering strong consulting and technical assistance services and cash prizes. *Shared Interest* has a guarantee fund aimed at fostering bank lending by limiting downside risk. *DeRisk* is developing a risk mitigation product to insure investors against multiple risks such as financial, political, and currency risk. *OPIC* provides SME investors with a partial guarantee of their investments to lessen risk, and offers enhanced transparency by monitoring financial and development results in an open manner. *JSE Securities Exchange South Africa* provides SME executives business training and has created a separate SME-focused exchange to intermediate capital.

Information providers

One of the problems encountered by organizations devoted to bringing affordable capital to SMEs is the difficulty in raising money. This is partly due to a lack of reliable standardized metrics to evaluate fund performance, and the absence of credit scoring

The driving force in Root Capital's model is the consumer's growing interest in ethical trade and sustainable agriculture, and the rise of a new breed of socially responsible traders, importers, and retailers.

agencies to evaluate organizations' management and profitability. *MicroRate*, a credit-rating agency for microfinance institutions (MFIs), does not evaluate SME financing organizations, but offers a compelling reason for them to want to be rated. Its services have contributed to attracting commercial capital to microfinance organizations and increasing microlending (about 10 percent of the MFI portfolios that *MicroRate* evaluates represent small enterprises and many of these microfirms have grown and reached the next rung in the enterprise development ladder). *MFIC* addresses the crucial issue of credit scoring by collecting financial data (bill payments, remittance transfers, mortgage or rent payments, etc.) on individuals and small businesses.

Selected innovators: A review

Root capital (U.S.)

Root Capital (formerly EcoLogic Finance) supports sustainable agriculture, wild-harvested products, handcrafts, ecotourism, and fisheries in 22 countries by providing affordable credit and financial education to grassroots enterprises in the developing world. Targeting the rural poor, who are often too remote and atomized to be touched by traditional microfinance, Root Capital offers capital and capacity-building to rural businesses such as farmer and artisan cooperatives that are exporting sustainable natural products into the rapidly growing world market for "green" goods and services. Loans range in size from \$25,000 to \$750,000, carrying interest rates of 9 percent to 12 percent. Trade and export credit represents 80 percent of the portfolio, with loans averaging 8 to 10 months in duration. Fixed-asset financing and long-term working capital loans with terms up to five years comprise the remainder. Root Capital's core business is to provide pre-harvest and export credit against trade receivables to otherwise unbankable rural producer enterprises. With this cash flow-based model, wholesalers in consumer countries can pay farmers

up front for their crops before the product is sold in the world marketplace. Without such loans, growers are often forced to sell their future crops before the harvest to middlemen at a fraction of market prices.

The driving force in Root Capital's model is the consumer's growing interest in ethical trade and sustainable agriculture, and the rise of a new breed of socially responsible traders, importers, and retailers. Buyers facing consumer-side pressure for product traceability and ethical sourcing must find stable suppliers who can meet their social and environmental criteria as well as provide adequate quality and volume. Root Capital enables suppliers of products such as organic cocoa, Fair Trade cashews and natural fiber handcrafts to access the capital they need to grow their businesses, invest in productive infrastructure, and survive the cashless gap between planting and the harvest. By helping connect rural communities to consumer demand for high-quality, premium-priced specialty products, the organization opens up global markets to very remote communities, thus providing economic incentives to stay on the land (not migrate to overcrowded cities), encouraging sustainable farming and production practices, and preserving valuable environments and ecosystems.

Root Capital has forged partnerships with two major coffee buyers, Starbucks Coffee Company and Green Mountain Coffee Roasters, and works with over 50 importers of natural products in the United States and Europe. By providing a reliable flow of working capital and technical assistance to grassroots enterprises, and by helping them weather price fluctuations, Root Capital has indirectly aided buyers large and small by improving supply chain security. "Stability is key," says William Foote, president and founder of Root Capital. "We help create stability for producer enterprises, allowing them to consistently sell their product at a fair price; we provide stability for specialty buyers, who can rely on a steady supply of high-quality products."¹³

¹³ Interview with William Foote, April 26, 2007.

Root Capital currently has \$20 million in assets with 75 private investors contributing low-interest loans to its lending capital pool. Starbucks is Root Capital's biggest investor with a \$7 million investment; this investment shows up as an asset on the company's balance sheet, precisely because the lender helps ensure a reliable supply of its main import, coffee. These industry alliances were so successful in Latin America that Root Capital has replicated them with various buyers in Africa (Rwanda, Uganda, Ethiopia, Rwanda, Mozambique, Tanzania, Malawi, and Ivory Coast) and in Asia (Indonesia, East Timor and India). In addition to financing from its industry partners in the natural product space, Root Capital receives funding from Citigroup, Deutsche Bank, JP Morgan Chase, the Skoll Foundation, the David and Lucille Packard Foundation, Calvert Social Investment Foundation, the U.S. Agency for International Development (USAID), the Multilateral Investment Fund of the InterAmerican Development, dozens of religious institutions and high-net worth individuals, among others.

Root Capital's latest initiative, launched in February 2006, aims to provide financial management training to technical staff and grassroots leaders from 50 rural enterprises in six Northern Latin American countries. Through a joint venture with EARTH University, a Costa Rican agricultural college, the initiative focuses on making competitive rural businesses better suppliers to the world marketplace and, over time, attractive clients to local financial institutions.

Root Capital's strategy provides a range of benefits: first and foremost, it allows community-based businesses to tap into premium prices for their crops; simultaneously, the model catalyzes systemic change by building a credit history for its clients, strengthening their linkages to third-party certifiers (for social audits and green seals), and offering a working example to local banking networks of how to make finance work for the rural poor. There is no question that Root Capital's investments support job creation and consolidation. Case in point,

when coffee prices collapsed in 2001, and 600,000 people lost their jobs and/or land in Northern Latin America over the next four years, Root Capital's lending commitments helped thousands of farmers to stay in business.

According to Root Capital, its model provides opportunities for expanded partnerships on many levels:

- More cooperation among European and U.S. private buyers and social enterprises could increase scale and bring even more stability for local underdeveloped economies and buyers alike;
- Cooperation with technical assistance providers could scale Root Capital's efforts to increase business literacy among small enterprises; and
- More cooperation between donors and local financial institutions could facilitate increased bank lending to farmers (e.g., supported by loan guarantees or deposits from donors/partners).

KfW (Germany)

KfW (Kreditanstalt für Wiederaufbau) is a German development bank with a long experience in financing SMEs in Germany; 80 percent of its capital is owned by the German national and regional governments. It is one of the biggest providers of capital to MFIs and runs two key initiatives that indirectly help bring affordable capital to SMEs in the developing world. Through one of its divisions, the Entwicklungsbank (development bank), it finances infrastructure projects and lends to state-owned banks in developing countries; and through another division, Deutsche Investitions- und Entwicklungsgesellschaft (DEG), it directly provides capital to privately-owned SMEs.

The Entwicklungsbank's investments are generally dictated by political agreements between the

German government and a developing country. KfW lends on behalf of the German government directly to foreign governments or to state-owned institutions that then help SMEs grow. DEG's declared mission, on the other hand, is to directly help the development of the private sector. It achieves this goal in two ways: by lending to subsidiaries of German companies in the developing world and by investing in local banks that lend to SMEs. The investments are in the form of equity (up to 25 percent of the capital), mezzanine financing (subordinated debt with risk-oriented yield) or long-term loans (4 to 10 years duration, fixed or variable interest rate at project specific level). DEG also provides guarantees to local banks which lend to local SMEs.

DEG also offers technical assistance to the financial institutions in which it invests, leveraging its vast experience in providing capital to SMEs in Germany. DEG aims to improve corporate governance, introduces criteria to evaluate banking activity such as credit solvency ratings and invests in human capital. KfW uses a rigorous system to monitor and evaluate the success of its DEG's investments in terms of their impact on development. Its rating system is based on several items - e.g., number of SMEs financed, default rates, direct and indirect effects on employment, social and managerial impact, return on equity, etc. These indices prove useful in selecting and greenlighting future investments.

DEG is one of the 15 members of the association of European Development Finance Institutions (EDFI),¹⁴ a group of bilateral institutions providing long-term finance to small enterprises, mostly European companies with subsidiaries in developing countries. DEG often coordinates its efforts with other international organizations

¹⁴ The members of the European Development Finance Institutions represent the countries of Austria, Belgium, United Kingdom, Spain, Hungary, Germany, Finland, the Netherlands, Italy, Denmark, Norway, France, Sweden, and Switzerland.

institutions such as the IFC, the European Commission and the other members of EDFI to reduce costs, eliminate duplications and speed up projects. DEG also uses "delegated cooperation," when two or more co-financing partners delegate the administration of a project to one donor. This form of donor harmonization makes projects more efficient and less costly.

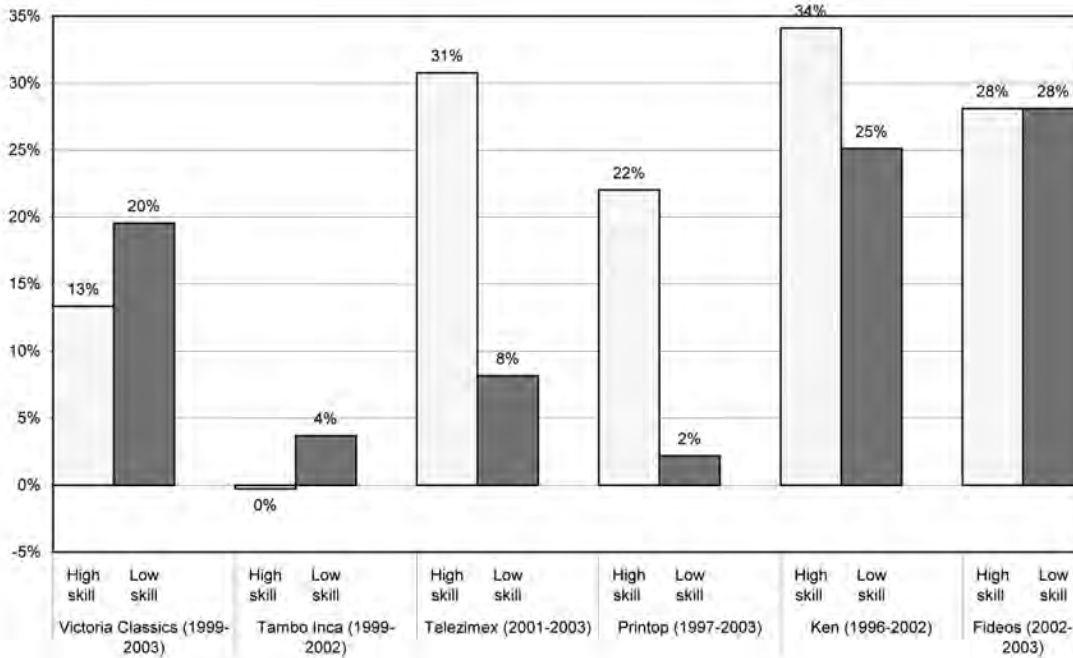
Small Enterprise Assistance Fund (U.S.)

Small Enterprise Assistance Fund (SEAF), a Washington-based organization in operation since 1989, helps very small enterprises grow in developing countries. SEAF provides technical assistance and financing to distributors, processing plants and other firms with more than \$2 million sales. The growth of these firms provides a stable supply chain for small farmers and artisans who are therefore able to reliably access national and global markets. Sometimes the bigger distributors and plants invest in their own suppliers. This supply chain approach is considered SEAF's "aggregator model." Sometimes SEAF works with microlenders who provide direct funding to the small enterprises.

SEAF is a nonprofit corporation funded by about 80 investors, a cross-section of international financial institutions (IFIs), nongovernment organizations (NGOs), local pension funds, insurance companies and banks. Its aim is to reduce poverty and spur economic growth in developing countries. It oversees the management of 19 for-profit funds invested in about 200 Latin American, Asian, and Eastern European companies. It has \$100 million in its portfolio. SEAF targets an acceptable, albeit below-market level, return on the investment. This is why, explains President and CEO Bert van der Vaart, "SEAF never provides loans smaller than \$50,000. For small enterprises, scale is not sufficient to cover costs."¹⁵

¹⁵ Interview with Bert van der Vaart, April 20, 2007.

Figure 10: Annual Real Wage Growth Since SEAF Investment (Six Funds)



Source: SEAF, *The Development Impact of Small- and Medium-Enterprises: Lessons Learned from SEAF Investments*, 2006.

SEAF investments, a mix of equity, quasi-equity and debt, range on average from a minimum of \$100,000 to \$5 million. While it does not invest directly, SEAF funds contribute to SME growth; their impact is substantial and measurable in terms of employment, especially for low-skilled workers (Figure 10).

Agora Partnerships (U.S.)

Agora Partnerships is a young, unique organization that combines a nonprofit consulting arm with a for-profit “double bottom line” venture fund. It aims to provide small entrepreneurs long-term capital, both equity and debt, to allow companies to grow in the initial phases, while offering a return and an exit to its investors. Since 2005, Agora has been active in Nicaragua, one of the poorest countries

in Latin America, and is currently preparing for an expansion into the region. It partners with local business organizations, foundations, and universities, technical assistance providers such as TechnoServe, and U.S. business schools such as Columbia, Duke, Georgetown, and the University of Virginia.

Agora’s approach is first to provide free educational and business programs to potential high growth entrepreneurs, with a focus on helping them analyze their constraints to growth. Each entrepreneur is matched with a team of students from a U.S. or Nicaraguan-based business school, who assists in solving a strategy or marketing problem identified by Agora staff as key to enabling growth. The teams often get school credit for the work.

“Entrepreneurs need investment and a trusted partner, not charity.”

Each year, Agora’s local staff selects about 20 potential entrepreneurs who typically run a small business with 5 to 10 employees. Selection criteria include the quality of the business plan, product viability, financial opportunity, social and environmental value, and management team. After being coached by student-consultants, the most promising ventures are able to access capital from the Agora Venture Fund, generally in the range of \$25,000 to \$250,000. Of the two deals green-lighted so far, one is a convertible loan that turns into a 50 percent equity stake; the other is a mix of equity/debt/royalties (50 percent equity investment, 50 percent debt/royalties). Two more are in the pipeline: one is an equity-debt-royalty mix and the other a straight equity investment.

The companies funded by the Venture Fund continue to receive leadership education and technical assistance at the operational level (legal, accounting and regulatory, back office support, export market development, strategy consulting, and cash flow management) and are closely monitored. “We want to fill the gap in a market segment with highly asymmetrical information,” said Ben Powell, managing partner for Agora. “Entrepreneurs with innovative ideas in a country like Nicaragua often don’t have information on global markets and, at the same time, investors in the developed world don’t have mechanisms to invest in businesses that can create sustainable social and economic value.”¹⁶

In addition to facing high transaction costs relative to deal size and an entrepreneurial class often lacking basic managerial skills, investing in Nicaragua is further complicated because of educational and psychological barriers. Some entrepreneurs with minimal knowledge of market mechanisms and basic financial instruments (e.g., equity investments and venture capital) have expected continuous subsidized funding,

¹⁶ Interview with Ben Powell, April 19, 2007.

or even grants. Agora is trying to bring financial education to these entrepreneurs and explain to them what it means to receive an equity investment. “Our mission is to give opportunity to great entrepreneurs to create change and generate employment,” said Powell. “Entrepreneurs need investment and a trusted partner, not charity.”

Agora puts a strong emphasis on both financial and social returns. Although aware that rates of return are likely to be below market levels given the small size and the risk, investors should encourage local entrepreneurs to follow market rules. “If no money is made,” said Powell. “Nobody pays attention.”¹⁷

Nicaragua’s experiment could be easily scaled to the rest of Latin America, but funding remains an issue. Agora’s Venture Fund is targeted to reach \$2 million, of which \$500,000 has been raised to date from private investors and the Dutch-based DOEN Foundation. Agora Partnerships and its local affiliate in Nicaragua have received funding from Argidius Foundation and USAID respectively, and from hundreds of individuals.

E+Co (U.S.)

E+Co is one of a few organizations that provide both business development services and capital to small enterprises that produce clean energy in developing countries. It operates in Africa, Asia and Latin America and offers its investors a triple bottom line: financial, social, and environmental returns. E+Co targets companies with less than \$1.5 million revenue and less than 25 employees. The size of financing is between \$25,000 and \$750,000, and most of it (about 85 percent) is in the form of debt. Debt is generally 5 to 8 years, with interest rates ranging from 8 percent to 13 percent, and requires collateral that is equal to the size of the loan.

A small percentage of financing comes in the form of equity (about 15 percent) with revenue-sharing

¹⁷ Ibid.

as an upside. The Central American Renewable Energy and Cleaner Production Facility, which is managed by E+Co, is specifically focused on mezzanine financing. Equity is rarely used since often there is no exit strategy. E+Co describes its financing as “venture debt;” they provide the type of management assistance given by venture capitalists, but expect just the return of the loan plus interest.

Since the mid-1990s, E+Co has funded about 140 companies. Its model is “enterprise-centered” and relies heavily on the combination of business development services and financing at the early stages of a company’s life. “The only effective way to reduce risk is to provide both enterprise development services and funds to small entrepreneurs,” said Christine Eibs-Singer, deputy executive director of E+Co.¹⁸ E+Co provides direct assistance for development of business plans, market assessment, risk identification and mitigation, legal and regulatory procedures, operational problem solving and planning, securing additional financing, and monitoring and evaluating results.

Eibs-Singer points out that one of the biggest challenges for an organization like E+Co is the general recognition of its triple bottom line return. E+Co supports the use of common metrics to measure social and environmental returns. The internal rate of return on its funds averages 8.2 percent, but its “net-net” return (deducting the subsidized cost of services) is close to 2 percent. Write-offs to date amounted to 10 percent of investments.

The organization covers the cost of technical assistance with the returns on its investments and with grant money. E+Co receives funds from a mix of private and philanthropic sources. It was initially funded by the German and Dutch governments,

both committed to the issues of energy access and climate change in the developing world. Other funders include IFIs, a small amount from U.S. foundations and some private money borrowed at a 3 percent to 5 percent interest rate.

Acumen Fund (U.S.)

Acumen Fund is a pioneering American venture philanthropy in operation since 2001. A portion of Acumen’s funds goes to grants and loan guarantees, with the rest invested directly, and evenly split between debt and equity. Acumen does not require collateral on loans and charges a 5 percent to 12 percent interest rate on loans with a five-year duration. Equity investments are sometimes in the form of preferred equity, most often straight equity, and are made principally in existing businesses, not in start-ups.

Although initially it targeted smaller enterprises in the health sector, Acumen now also invests in water purification, irrigation, and housing. In the future it plans to add clean energy. Noticeably, the average size of Acumen’s investments has increased and is currently in the range of \$500,000 to \$1.5 million. The average size of targeted companies is less than 20 employees. Currently, it has \$14.5 million invested in 21 companies in India, Pakistan, Tanzania, Kenya, and South Africa and loan guarantees in Uganda and grants in Egypt. The shift in investment size has occurred partly because the fund is targeting productive sectors with potential to grow and create jobs, and partly because the costs associated with smaller deals are too high. Acumen still devotes a small portion of its investments to deals in the \$50,000 to \$250,000 range, but regards them as “experiments” on which not much time is spent evaluating the business plan.

¹⁸ Interview with Christine Eibs-Singer, May 11, 2007.

Aureos firmly believes that a key to success for equity investors in emerging markets is having “on the ground” knowledge of the local market.

Acumen does not provide direct technical assistance, but occasionally contracts with third parties. It relies on a network of associates to help identify and select potential deals. Project selection criteria consists of having a cost-recovery model, serving the Bottom-of-the-Pyramid (BOP) (specifically those who make less than \$4 a day), and offering the potential to scale.

Acumen is setting benchmarks on the expected return of its investments in 2007: 10 percent to 14 percent in local currency on debt investments and 10 percent to 15 percent on equity investments. In 2006, these ranges were 6 percent to 11 percent on debt and 10 percent to 14 percent on equity. The fund employs a set of metrics to evaluate the economic and social returns.

Aureos Capital (UK)

Aureos Capital was created by a joint venture between the United Kingdom government-owned Community Development Corporation (CDC) and the Norwegian government-owned Norfund. It has raised \$570 million over the past six years and today manages 24 private equity funds. In July 2006, Aureos’s employees bought a 26.5 percent stake in the fund, while the Netherlands’s development finance institution, FMO, invested an additional \$2 million.

Aureos’s average investment in SMEs is significantly above the “missing middle” area of our focus. It also invests in companies at later stages of development and finances mostly management buyouts and consolidations. However, its experience is relevant to this discussion since Aureos is one of the few fully market-rate equity and quasi-equity funds invested in developing economies.

As noted above, Aureos received its early funding from government-owned development finance institutions. The fund basically “threw money at companies in emerging markets,” noted Noah

Beckwith, fund manager for Aureos.¹⁹ In the first five years of operation, its funds reported a -44 percent internal rate of return (IRR). With the new capital infusion, a change in ownership composition, and a new market-oriented investment strategy, IRRs are now positive. Since 2002, Aureos’s Regional Funds have invested \$92 million in 28 transactions and generated over \$19 million, 22 percent of total invested capital.²⁰

Aureos firmly believes that a key to success for equity investors in emerging markets is having “on the ground” knowledge of the local market. It also believes that it is necessary to have local investing partners. This strategy allows a foreign investor to tap into an information network familiar with the investment targets and to share the risk with local capital providers with more than a financial stake in the success of the investment.

BiD Network (Netherlands)

BiD Network (Business in Development Network) was born from a Dutch government initiative to engage private corporations and financial institutions in helping promote sustainable development and employment growth in developing countries. It has created a virtual community with the purpose of matching entrepreneurs in the developing world with investors, generally IFIs or NGOs. This process helps address the challenge of deal flow.

This online marketplace is organized around an annual business plan competition (the Bid Challenge) open to all businesses in developing countries. It targets start-ups or established companies with at least two employees seeking investments in the range of €5,000 to €500,000. To

¹⁹ “Investing in Emerging Market Small and Medium Enterprises”, *Milken Institute Financial Innovation Lab Series Working Paper*, February 2007.

²⁰ www.aureos.com/index.php?action=portfolio (Accessed on 06-07-2007).

enter the competition, a company must present a three-page detailed business plan that has a positive impact on its country in terms of environmental sustainability, employment growth, export growth, or improvement in health and education.

The competition is advertised through a network of partner organizations (IFIs, NGOs, cooperatives, etc.) and entrants post their business plans online. A committee of consultants in the Netherlands selects a group of finalists, who are then assigned coaches - usually lawyers, managers or accountants from Dutch private corporations, banks, accounting firms, universities or NGOs. The coaches help the entrepreneurs hone the business plans and provide online consulting services on a volunteer basis. Last year, 350 professionals volunteered their services and 95 percent of them volunteered again this year, a remarkable success according to Koen Wasmus, director for BiD Network.²¹ For the first time, this year, a team of local screeners, judges, and coaches assisted entrepreneurs in seven countries (Argentina, Peru, Columbia, Tanzania, Kenya, India, and Philippines) with consulting services in the local language.

In the first competition, launched in 2004, 10 winners received a total of €104,000 from a group of participating institutions (Rabobank, Oiko Credit, SNS Asset Management, GEXSI, Aqua for All, Women in Leadership, FMO, and the Dutch Ministry of Foreign Affairs, among others). An additional 15 businesses were started with money from third parties. Of the companies funded in connection with Bid Challenge, 50 percent have survived the first year and created 500 jobs. In the second competition, launched in early 2006, 73 finalists were selected in the first round with 25 making the second round; the 16 winners received prizes of €5,000 to €15,000 each. The third competition was launched in January 2007.

²¹ Interview with Koen Wasmus, April 17, 2007.

The investments are mostly in the form of loans and grants, but equity also. The terms of the agreement and the financial details are up to the individual investors. BiD Network does not provide any direct financing, but acts as broker between entrepreneurs and investors. It continues to provide technical assistance to the companies funded as a result of the competition, and closely monitors their progress.

BiD Network's most innovative feature is its online presence, which is both a strength and a weakness. On the one hand, the medium offers an opportunity to all businesses to participate in a fair and transparent competition; on the other hand, Internet access is limited in many developing countries. The model is scalable and BiD Network envisions closer cooperation with U.S. institutions. "American organizations could help expand our presence in Latin America thanks to geographical closeness," said Wasmus. "...Especially bring their expertise in equity and venture capital investments."²²

TechnoServe (U.S.)

TechnoServe has been a pioneer in delivering technical assistance and a variety of business consulting services to impoverished communities, mostly rural, in the developing world for over 40 years. The organization recently launched the Business Plan Competition and Entrepreneurship Development Program, an innovative initiative aimed at selecting promising entrepreneurs. The participants receive assistance in developing a business plan, the finalists receive additional training, and the winners receive a cash prize and a voucher for consulting services needed after the money is disbursed. The Business Plan Competition was launched in El Salvador, in 2002, and subsequently in 15 other Latin American countries. Based on the success of the Latin American competitions, TechnoServe has recently

²² Ibid.

MFIC helps build a credit history for individuals that would otherwise be shut out from the traditional financial system.

brought the initiative to East Africa, Ghana, Swaziland, South Africa, and Kenya.

Besides promoting and celebrating entrepreneurship, the competition serves the very important purpose of creating a pipeline of viable deals for commercial lenders; the cash prizes can be leveraged to obtain additional financing from local financial intermediaries. “The common complaint we hear from local banks in many developing countries is that there aren’t enough businesses worth being financed,” said Bruce McNamer, president and chief executive officer of TechnoServe. “We help build a pool of potential recipients.”²³

TechnoServe uses its support network to assist the entrepreneurs, half start-ups and half established small businesses, who participate in the competition. Over a period of about six months, it offers seminars covering a range of business topics and advisors and mentors help entrepreneurs acquire the knowledge and skills to refine their business plans. The winners each receive a \$10,000 cash prize and a \$10,000 voucher to purchase consulting services. The program is supported by corporate sponsors, such as Google, Lenovo and Databank.

This initiative has been very successful towards the goal of promoting economic growth, job creation, and the alleviation of poverty. The initial competition in El Salvador, for example, had 120 participants; after one year, 48 new or expanded businesses were running, had created 376 new jobs, and generated an additional \$3.12 million in sales. Last year’s competition in Ghana, a country where 80 percent of the population lives on \$2 a day, attracted 500 participants, resulting in 60 finalists and 10 winners.

²³ Interview with Bruce McNamer, May 15, 2007.

Microfinance International Corporation (U.S.)

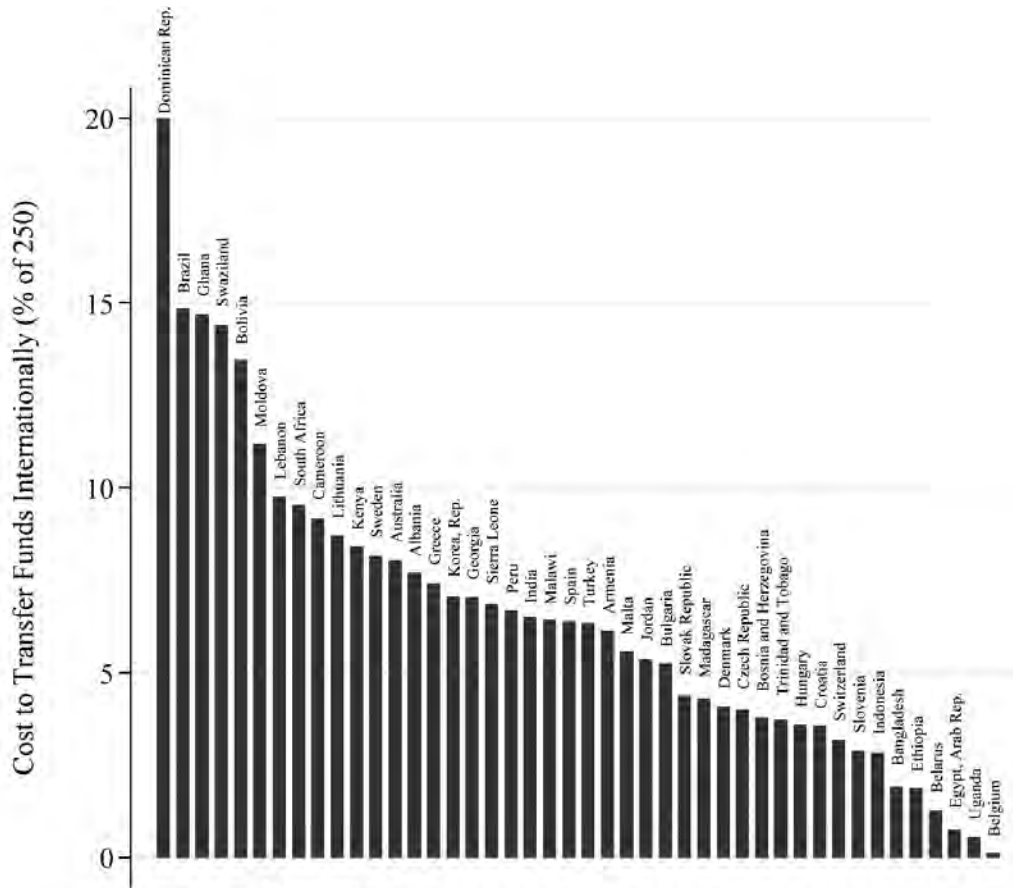
Microfinance International Corporation (MFIC) is a for-profit microfinance and remittance processing institution that has developed a variety of financial services and products to serve the Latino immigrant population residing in the United States. By delivering basic affordable services to 50,000 unbanked customers, MFIC helps build a credit history for individuals that would otherwise be shut out from the traditional financial system. In turn, this helps them obtain loans from MFIs in their country of origin, and move beyond the microfinance level to receive long-term capital.

MFIC owns a network of eight microfinance centers in the United States (Alante Financial) that provide loans in the range of \$400 to \$10,000 (with a median of \$1,600) to finance consumption and business activities. These centers, with operations in Washington, DC, Virginia, Maryland, and Delaware, also offer several financial services (e.g., check-cashing, mortgages, insurance products, remittance transfers, and bill payments) at rates well-below the prevailing level of traditional institutions. Alante partners with employers who want to offer their employees the opportunity to receive financial services at affordable prices.

MFIC has also developed a remittance transfer software platform (ARIAS) employed by about 70 banks, credit unions, and money transmitters across the world. ARIAS is a secure, easy and inexpensive money transfer system that enables recipients to receive cash and credit payments at MFIs and banks in most Latin American countries. This is a key benefit to immigrants in the United States given the generally high transfer cost of remittances (Figure 11).

MFIC contributes to bringing affordable capital to developing countries by offering several transnational products and services. It also allows

Figure 11: Cost to Transfer Funds Internationally



Source: Thorsten Beck, Asli Demircug-Kunt and M. Soledad Martinez Peria. "Banking Services for Everyone? Barriers to Bank Access and Use around the World." World Bank Policy Research Working Paper 4079, 2006.

its customers in the United States to obtain mortgages or loans to finance business activities, educational expenses or extraordinary expenses in their home countries. Thanks to the customer's credit history tracked by its network of financial service facilities, MFIC is in the position to provide a credit assessment of its customers to partner institutions (banks, cooperatives, MFIs, and other financial intermediaries) in Latin America. Finally, MFIC provides direct loans to small- and medium-sized MFIs to support their lending activities. The range of these loans is \$75,000 to \$500,000.

Shared Interest (U.S.)

Shared Interest helps SMEs in South Africa by providing guarantees to local banks that lend to enterprises in underserved communities. Their focus is on connecting entrepreneurs to local sources of credit, helping to create the pipeline of deals, providing risk coverage for local banks and greatly reducing the cost of capital for the entrepreneur. The target businesses are SMEs with five to 15 employees or cooperatives of under 200 members, mostly in farming and livestock, but also

in manufacturing. By linking local institutions with new borrowers, Shared Interest effectively provides technical assistance to the banks.

Shared Interest raises capital from U.S. investors (individuals and organizations) and invests in securities that comply with their stated socially responsible investment guidelines. These securities, deposited in a U.S. bank, are then used to secure letters of credit issued to those South African banks that lend to local community development financial institutions.

Shared Interest relies on its South African partner, Them bani International Guarantee Fund (TIGF), to select and monitor the local development financial institutions to which it provides guarantees. This would include MFIs, rural development projects or housing projects. TIGF helps with identifying potential partners and lenders, structuring loan applications, and negotiating the terms of a loan. TIGF also offers invaluable services to Shared Interest's investors by monitoring closely the disbursements of guaranteed loans and the repayment timeline and by writing risk assessment reports.

Currently Shared Interest's guarantee fund stands at \$8.6 million. In the past, these guarantees have had a 10:1 leverage: for every dollar of guarantee, banks offer a \$10 loan. "Since its inception in 1994 our organization has helped create 19,000 new businesses and 28,000 new jobs," said Donna Katzin, founding executive director of Shared Interest.²⁴

The Global Exchange for Social Investment (UK/Germany)

The Global Exchange for Social Investment (GEXSI) was founded in 2001 by a consortium of foundations with the purpose of bridging the gap between development aid and private investors on the one hand, and fund recipients on the other. GEXSI provides services to for-profit investors

as well as foundations and aid agencies willing to make mission-oriented investments. GEXSI helps them filter, monitor, and evaluate projects. It offers social investment opportunities in water and sanitation, carbon credit and biodiversity, low-cost housing, fair trade, agriculture and biofuels, renewable energy, and health care.

GEXSI selects projects according to each foundation's or investor's priorities, runs a pre-investment analysis, clearly defines the funder's expectations of the investment's outcome, and uses a set of metrics to evaluate the triple bottom line (financial, social, and environmental returns). In keeping with GEXSI's mission to blend market capital and charitable gifts for beneficiaries in the neediest places, for-profit investments in social benefit programs are segregated and held separately from charitable donations.

GEXSI's clients are mainly for-profit investors and foundations that want to make donations, but find it too costly to divvy-up their money among many small-scale initiatives and organizations that run many small projects and also find it too costly to monitor their progress. The monitoring and assessing work aims both to increase assurance and accountability and to create new incentives, services and instruments to increase the flow of capital to social investment.

Recently, GEXSI has also launched its own Bottom of the Pyramid fund to address directly the issue of the "missing middle" in SME finance. Although the fund is still very small (€10,000), last year the BOP fund started to make loans to environmental and socially responsible enterprises.

IntEnt (Netherlands)

IntEnt (Internationalization of Entrepreneurship) has been active for the last 11 years helping immigrants residing in the Netherlands start businesses in their countries of origin. IntEnt was

²⁴ Interview with Donna Katzin, May 9, 2007.

started by the Dutch Ministry of Foreign Affairs (NCDO) in collaboration with Hivos, one of the largest Dutch NGOs, to foster the growth of SMEs in seven targeted countries (Ghana, Ethiopia, Surinam, Morocco, Afghanistan, Curacao, and Turkey).

Recently, IntEnt launched two initiatives aimed at using remittances to finance entrepreneurial activities and enhance creditworthiness for small local enterprises. IntEnt is fostering the concept of circular migration, encouraging immigrants to reconnect with their home countries and contribute their savings to stimulate economic and employment growth. The organization provides a variety of technical assistance services, first in the Netherlands and later in the country where the business is established. Each entrepreneur is assigned a coach — generally a native of the same country — who assists with writing a business plan, conducting market research, accessing financial services, and navigating the legal and institutional environment. The entrepreneur initially pays a flat fee for these services, equivalent to 10 percent of its true cost, but after a year-and-a-half the rate rises. IntEnt also provides guarantees (through its Loan Guarantee Fund) to allow entrepreneurs obtain bank loans and helps them find other forms of subsidized funding.

Additionally, IntEnt has launched a training program for local banks in two countries (Ghana and Suriname) to encourage more local financing of SMEs. It supports the involvement of local governments, who may finance a portion of their country's program (in Curacao the government covers 100 percent). The average guaranteed investment is €42,000 for small companies that on average reach 4.5 employees within 1.5 years of operation.

There are two particularly interesting recent initiatives, both in their pilot stage, to channel remittances into income-generating activities. The

first, undertaken in cooperation with several Dutch banks, directs remittances into a collective savings account used to finance businesses in developing countries. IntEnt enhances these private funds with its Credit Guarantee Fund and encourages its network of local partners and banks to give additional financing. Simultaneously, IntEnt has launched a web site to help migrants compare transaction costs for remitted money. By 2008, this site could become a financial intermediary for remittances. In the future, IntEnt hopes to increase the site's scope to include all migrant groups residing in Europe.

The second initiative, Businessbox, offers three investment opportunities for Ethiopian migrants residing in the Netherlands. Migrants can choose to invest a portion of their remittances in one of these projects: one in bee keeping and honey production, one in manufacturing of construction blocks, and one in a network of mobile phone charging stations.

MicroRate (U.S.)

In 1996, MicroRate pioneered the idea of rating MFIs. It considers several rating criteria in addition to the likelihood of default: operations and portfolio quality, management and organization, governance and strategic position, and financial position. Although MicroRate's connection to SME financing is only tangential (some MFIs, as discussed below, are moving "upward" to finance SMEs), its work is extremely relevant to several issues dealt within this paper.

MicroRate's rating services have been important in enabling MFIs to move beyond donor funding and tap capital markets. In addition to providing information to potential commercial investors, MicroRate's ratings help MFIs better understand and improve their financial and operational health. They also increase the level of transparency and offer donors a measure

IntEnt is fostering the concept of circular migration, encouraging immigrants to reconnect with their home countries and contribute their savings to stimulate economic and employment growth.

Figure 12: SME Investment Risks



Source: Andrew Gaines (Gaines & Partners), 2006.

to assess the impact of their philanthropic efforts. “It is true that not all microfinance institutions are profitable,” said Damian von Stauffenberg, founder and principal of MicroRate. “But sometimes that’s because they might be badly managed.”²⁵

DeRisk Advisory Services Ltd. (UK)

DeRisk Advisory Services Ltd. (DeRisk) addresses some of the key barriers to capital flows to emerging market SMEs: the risks associated with political and regulatory instability, business uncertainty, and currency fluctuations (Figure 12).

While it is virtually impossible to cover all aspects of risk, Andrew Gaines, managing partner of DeRisk notes that SME financing needs to become “a bit more predictable.”²⁶ DeRisk is developing an insurance product for SME portfolios which, instead of trying to insure against every category of risk faced by investors, will cover only the most likely. This limited risk mitigation technique can reduce costs for investors who can design an insurance product with specialist brokers-underwriters that

²⁵ Interview with Damian von Stauffenberg, May 15, 2007.

²⁶ Interview with Andrew Gaines, April 10, 2007.

target the category of risk most applicable to their investments. Ideally, the portfolio manager could go to a single portal that offers coverage for all three types of risk: political risk insurance, currency hedging instruments, and credit enhancement or credit guarantees to cover credit risk.

DeRisk notes that credit enhancement schemes to mitigate business risk could greatly increase the amount of capital flowing to SMEs in emerging markets. Credit enhancement can come in the form of government contributions (for example loan portfolio or bond guarantees by USAID’s Development Credit Authority) or as loan-loss reserves, loan guarantees, over-collateralization or the purchase of subordinated debt at a concessionary rate of return by philanthropies or foundations.

International Finance Corporation (multilateral)

The International Finance Corporation (IFC), a member of the World Bank Group, fosters sustainable economic growth in developing countries by financing private sector investment, mobilizing capital in the international financial markets, and providing advisory services to businesses and governments. IFC’s vision is that

poor people have the opportunity to escape poverty and improve their lives. From its founding in 1956 through 2007, IFC has dedicated more than \$56 billion of its own funds and arranged \$25 billion in syndications for more than 3,500 companies in 140 developing countries. It aims to promote open and competitive markets in developing countries, support companies and other private sector partners, and generate productive jobs and deliver basic services.

IFC's Africa Micro, Small, and Medium Enterprises (MSME) program is a major institution-building initiative that seeks to raise the volume and quality of financial services to MSMEs in Sub-Saharan Africa. It acts as a platform to accelerate the transfer of knowledge to local financial intermediaries and develop long-term relationships with targeted banks in the region and leading MSME finance advisory firms. The program provides financial products and advisory services, leveraging IFC and consultant expertise and local banks' own resources. It rigorously and comprehensively monitors and evaluates client development of the MSME market and holds clients to their commitments.

The investment component typically involves senior corporate loans. The advisory services component is important in that it aims to facilitate knowledge transfer to local banks so that they may service SMEs along with microenterprises. This activity may involve streamlining loan policies and procedures; creating SME credit manuals, loan application materials, and specialized credit-scoring models; developing new products, marketing tools, and methodologies; training and mentoring relationship managers and credit analysts; assessing environmental risk factors; and performing due diligence. Under the program, development impact is measured across two dimensions: one at the bank level, portfolio growth, portfolio quality, service range, efficiency, and profitability are measured; and at the enterprise and community

level, income, employment, and other quality of life improvements are assessed.

As part of this program, IFC recently announced a commitment of \$200 million to an integrated investment and advisory services initiative targeting African MSMEs. The French firm Credit Agricole Consultants and the Egyptian firm Environmental Quality International are the first consultants to have joined the program. IFC is considering investing in 25 banks in 17 countries across Africa in the first phase of the program. These investments, combined with the technical support of IFC partners, intend to build the capacity of local banks and enable them to effectively downscale their operations to serve SMEs and microenterprises.

IFC's Grassroots Business Initiative was created in 2004 with the mandate of strengthening grassroots business organizations to provide economic access to the poor. These organizations are run on a commercial basis but have explicit social objectives, and as such they typically make conscious tradeoffs of profit against achievement of social mission. They can be either for-profit or nonprofit and either retail (that is, individual enterprise) or wholesale (that is, intermediaries providing support to a number of organizations or entrepreneurs). A special type of SME, grassroots business organizations often provide the only realistic means of expanding market access and business support to the poor in hard-to-reach regions and population segments.

For three years, the Grassroots Business Initiative has worked directly to strengthen the performance of grassroots businesses, improve their sustainability, scale them up, and feed this experience into wholesale initiatives that can help large numbers of such organizations. GBI's activities to date have generated solid results: over 40 projects affecting the lives of close to 2 million poor and disadvantaged. Overall 54,339 jobs have been created, and almost \$7 million disbursed

These investments, combined with the technical support of IFC partners, intend to build the capacity of local banks and enable them to effectively downscale their operations to serve SMEs and microenterprises.

in grants or investments in retail and wholesale projects, 85 percent of which are in low-income and high-risk countries.

To become more nimble and innovative, and achieve broader impact, the Grassroots Business Initiative will soon spin off from IFC into the Grassroots Business Fund. The fund will support grassroots businesses by providing direct funding in the form of grants, loans, quasi-equity, or equity investments, while also providing technical assistance through its own staff or partners.

The Grassroots Business Initiative not only works to scale-up its retail clients (to turn individual enterprises into intermediaries with greater impact), but also fosters initiatives and innovation that respond to the needs of small enterprises. Its strategy revolves around key areas identified as requiring special attention: *agribusiness and crafts* organizations and partnerships, primary sources of income for many of the world's poor; *youth and informal enterprise*, to stimulate local economies and create employment; collaboration and knowledge-sharing through a grassroots business *network*; and *access to finance* for micro and small entrepreneurs.

Despite the strong development of the microfinance field, many of the poor are still excluded from accessing finance on reasonable terms.

Microfinance access is still limited primarily to urban areas, provincial centers, and more advanced microenterprises. Most microfinance is also aimed at subsistence or personal finance, given its high interest rates and short maturities. In contrast, there is little financing available to grassroots businesses on affordable terms and with longer maturities and quasi-equity structures, which would be more suitable for asset expansion and the creation of long-term, sustainable enterprises. The Grassroots Business Fund aims to devise efficient ways to expand access to more suitable financing, coupling it with good quality capacity-building.

A special-purpose vehicle is being put in place to pilot a new financing mechanism that will direct resources cost-effectively to the poor, through partners who add value and business support to the final user (microproducers or entrepreneurs), thus offering more appropriately structured financing to grassroots businesses. Eventually, this pilot could be scaled-up and replicated in other social enterprise settings and also establish approaches and standards that could lead toward a world marketplace in social enterprise investment.

Overseas Private Investment Corporation (U.S.)

The Overseas Private Investment Corporation (OPIC) is a U.S. government agency that assists U.S. private investment in more than 150 emerging markets and developing countries through four principal activities: project finance, political risk insurance, private equity investment funds, and outreach activities. Over the agency's 31-year history, OPIC has supported \$138 billion invested in 3,000 developmental projects, generating more than \$10 billion in host-government revenues and nearly 668,000 host-country jobs.

OPIC approaches the challenge of SME finance from multiple angles. First, it seeks to help successful banks that serve SMEs — like ProCredit — further deepen their SME portfolio by supporting their efforts to tap international bond markets. This helps them move further upstream beyond just working with microfirms. Secondly, OPIC aims to help traditional big banks in parts of the developing world offer SME services through risk-sharing guarantees, allowing them to go downstream into the SME market. Thirdly, OPIC is supporting the development of new private equity funds for Africa that aim to engage investors interested in alternative risk/return profile investment opportunities. Lastly, it offers a service to investors by helping identify and retain talented fund managers and monitoring financial and development results openly and publicly, providing for greater transparency in the process.

Regarding the third point, OPIC recently launched an initiative to create one or more new and innovative private equity funds focused on Africa, with the goal of delivering financial as well as social and economic returns. The establishment of the Africa Social Development Fund offers a unique opportunity to engage socially-minded investors who share similar development objectives and are interested in providing equity to the fund designed to meet them. It will aim to encourage innovative financial structures and partnerships that would involve “patient capital” and/or grants from foundations or high-net-worth investors. The fund’s success will be evaluated according to its ability to make a significant contribution to improve employment opportunities and the social well-being of people in Africa while delivering positive financial returns for investors; this includes, but is not limited to, SME development, water and sanitation, health, education, agribusiness, and energy access.

Among the selected funds, OPIC will target enterprises of all sizes which advance social development or improve social infrastructure; enterprises, regardless of size, which provide valuable goods and services to underserved markets; and SMEs across all sectors. OPIC plans to provide 30 percent to 50 percent of each selected funds’ total capitalization or provide risk capital guarantees to eligible investors. The balance of the funds’ capital is expected to come from private investors and socially oriented institutions such as foundations, companies and high-net-worth individuals.²⁷

Business Partners of South Africa

Business Partners of South Africa (BP) is widely recognized as one of the most successful organizations in bringing affordable capital to SMEs in the developing world. Coupling on-the-

²⁷ OPIC Africa Social Development Fund Announcement, April 23, 2007.

ground technical assistance with a variety of equity and quasi-equity instruments, BP has become a model for similar organizations and has just started equity funds in Madagascar and Kenya with the financial support of the IFC, among others.

BP targets only companies in the formal economy, in all sectors with the exception of agriculture. Its investments range between \$50,000 and \$1 million. The most notable aspect of its model is the use of quasi-equity instruments to allow investors to reap the upside of their investments without the exit risk and allow borrowers to enjoy low initial payments on financing.

BP is an investor, not a lender. However, Jo Schwenke, managing director for BP, points out that many entrepreneurs will avoid equity financing if they can. “No smart entrepreneur in his right mind would want to give away a piece of its business,” said Schwenke.²⁸ BP has successfully employed debt and royalty schemes that allow lenient repayment terms on the debt for the first months of the loan, after which royalty-sharing kicks in. BP compares the internal rate of return that a prime loan would generate against the realistic ability of the business to pay; the difference is then covered with a revenue-sharing agreement lasting until the gap is filled. In a minority of cases, BP uses a debt/royalty/equity model, usually for more established businesses that have already received a first round of financing. The equity stake is in the 25 percent to 35 percent range.

BP is a strong advocate of technical assistance and support before and after financing is disbursed. In South Africa, it has a network of business support offices that are never more than a one-hour drive from any of the companies financed. Technical assistance is subsidized, but not free. “The provision of technical assistance and the inherent risk of financing small enterprises cannot guarantee

²⁸ Interview with Jo Schwenke, April 17, 2007.

AltX effectively helps bridge the “missing middle” in SME finance by offering small enterprises capital and management training to entities that are not yet able to list on the JSE main board.

a market rate of return,” says Schwenke. However, BP has been able to produce an 8 percent return on its South African funds.²⁹

Based on its success in South Africa, BP has launched two additional funds in Sub-Saharan Africa: a \$10 million fund in Madagascar that has received financing from international financial institutions (IFIs) such as the IFC, Norfund (Norwegian development fund), CDC (the British development fund), the European Investment Bank, the Dutch foundation DOEN, and Assurance Reassurance Omnibranche, a local insurance company. The \$14 million Kenyan fund has the same international investors, plus two local companies, Trans Century Ltd and the East African Development Bank. USAID is providing \$2 million in assistance funds to subsidize technical support. Although it is too early to assess the performance of the two new funds, entrepreneurs in these countries have accepted the debt-royalty mix of financing that has proven successful in South Africa. Eventually, BP International plans to start funds in other African countries like Mozambique and Nigeria where there are many potentially lucrative business opportunities and untapped financing sources.

JSE Securities Exchange South Africa

Established in 1887 and formerly known as the Johannesburg Stock Exchange (JSE), JSE is Africa’s leading financial hub offering modern electronic trading, clearing and settlement for a wide range of products — equities, financial and agriculture derivatives and other instruments — and information services. In 2003, in partnership with the South African government’s Department of Trade and Industry (DTI), JSE launched AltX — Africa’s first alternative exchange for small- and medium-sized growing companies. It seeks to provide young and fast-growing businesses, start-

ups, family-owned businesses, Black Economic Empowerment companies, and junior-mining companies access to capital, but also enhanced capacity. AltX effectively helps bridge the “missing middle” in SME finance by offering small enterprises capital and management training to entities that are not yet able to list on the JSE main board.

AltX runs parallel to the main exchange, but its requirements are tailored to SMEs. Companies have equal access to JSE services (share trading, market surveillance to eliminate irregularities, and electronic settlement), but face lower listing fees and are not required to have a profit history. A minimum share capital of R2 million is required and there is an emphasis on initial and on-going disclosure of company information. There is also a compulsory four-day directors introduction course at Wits Business School to help support these new business leaders gain skills in accounting, governance, and other business practices. DTI pays for the support and management capacity-building for AltX companies.

Through AltX SMEs gain access to long-term equity capital for the development of their business and a central-trading facility to support liquidity, realize value through an effective price discovery, and enhance corporate image among suppliers, customers, and other stakeholders. The aim of the alternative exchange is to target rising enterprises that offer growth opportunities and can eventually jump on the main board of JSE. The average market capitalization is over \$50 million with the smallest AltX firms averaging around \$3 to \$5 million.

²⁹ Ibid.

Table 2: Overview of Direct Investors in SMEs

	SME Size	Loan Range	Type of Financing	Target Industries	Geographical Focus
E+CO	>25 employees >\$1.5m turnover	\$25,000–\$750,000	Debt (5–8 yrs) 85% Quasi-equity 15%	Clean energy	Africa, Asia, Latin America
SEAF	< \$2 million turnover	\$100,000–\$5 million	Debt Equity Quasi-equity	All	Eastern Europe, Latin America, Asia
Root Capital	10–200 employees	\$25,000–\$75,000	Short term debt (8–10 months) 80% Long term debt (2–5 yrs) 20%	Coffee Nuts Beans Cacao	Mexico and Central America
Agora	5–10 employees	\$25,000–\$250,000	Equity 50% Debt + royalties 50%	Agriculture	Nicaragua
Acumen	Less than 20 employees	\$500,000–\$1.5 million	Debt 50% Equity 50%	All	India, Pakistan, Tanzania, Kenya, South Africa, Uganda and Egypt
Business Partners SA	N/A	\$50,000–\$1 million	Debt+royalty Debt+royalty +equity	All, except agriculture	South Africa and Mozambique
Aureos	N/A	Average \$3–4 million	Equity Quasi-equity	All	Central America, Africa, South East Asia
KFW	Less than 100 employees	€2,000–€500,000	Equity Debt Mezzanine financing	All	Asia, Africa, Latin America, Eastern and Central Europe
IFC (GBI)	N/A	\$50,000–\$350,000	Grants, debt, equity, quasi-equity and guarantees	All	Asia, Africa, Latin America, Eastern and Central Europe
GEXSI	N/A	€10,000–€500,000	Donations, loans and equity	Housing, sanitation, agriculture, biodiversity, renewable energy, and health care	Asia, Africa and Latin America

4 FUTURE CHALLENGES TO GENERATING AFFORDABLE CAPITAL

Although there is a strong correlation between the size of the SME sector and economic growth, whether SMEs “cause” growth or the conditions where SMEs thrive helps drive growth is debated.

Is direct SME financing an effective tool to alleviate poverty?

SME development is a priority for many organizations committed to the goal of alleviating poverty through financing SMEs. However, the premise on which this goal stands — that a greater percentage of SMEs is linked to higher economic growth rates and lower poverty levels — is not uncontroversial. Although there is a strong correlation between the size of the SME sector and economic growth, whether SMEs “cause” growth or the conditions where SMEs thrive helps drive growth is debated.³⁰ Policies that help SMEs likely help an overall better business climate. It could be worth considering an alternative view, namely that policies should be devoted to financing those firms with the highest potential for growth, independent of their size. Although compelling on the theoretical level, this approach cannot ignore that there is no level playing field for companies of different sizes in obtaining financing. Smaller companies, even if more innovative and promising, have more difficulty receiving funds.

A related question, however, has to do with the most effective way to encourage the development of small businesses. Which is more effective: direct financing of even very small SMEs — the approach of E+Co, Agora, Root Capital, and KfW, or indirect contribution to SME growth through the financing of aggregators or medium-sized companies — the approach of Business Partners, SEAF, Acumen, and Aureos? A meaningful assessment cannot be made without reliable and comparable data, but SEAF’s study³¹ offers a compelling case for the positive effects of its strategy (supporting aggregators) on small business development, job creation, and poverty alleviation. By creating a stable and reliable supply chain, SEAF’s

model has proven effective. Analogously, the supply chain links established by Root Capital with large coffee importers has worked effectively to build a stable export market for the cooperatives and small farmers to which the firm lends.

Can MFIs help with financing SMEs from the bottom up?

Bridging the “missing middle” has been treated so far as an issue of encouraging banks, equity funds and nonprofit investors to reach down to companies too small to access commercial sources of capital. Perhaps another promising way to reach the missing middle is from the bottom up, from MFIs moving up market. While there are limits to scaling-up microfinance to service SMEs, no doubt some lessons may be learned to better inform SME finance efforts.

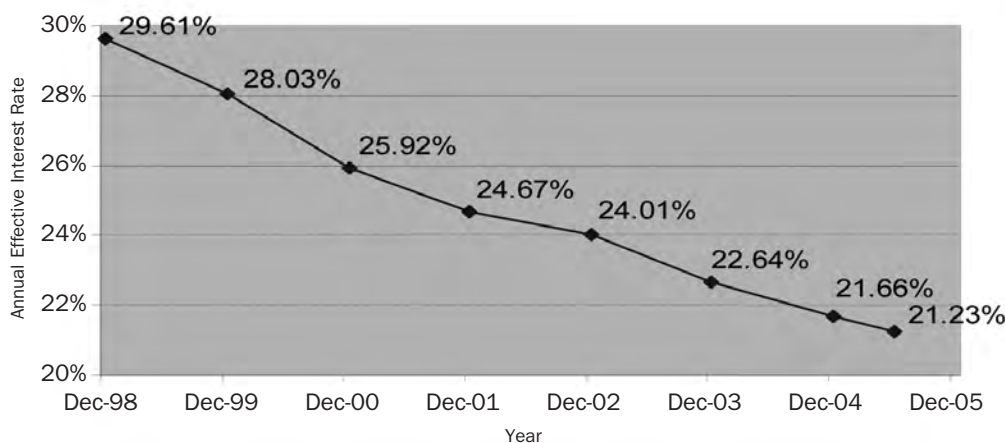
The outstanding growth of the microfinance industry has increased the level of competition and driven interest rates down, e.g. interest rates on microfinance loans in Bolivia decreased sharply over the period 1998 to 2004 (Figure 13), but made it more difficult for MFIs to find clients. Many of the most efficient and aggressive MFIs are able and willing to make bigger loans, in the \$10,000 to \$50,000 range, entering de facto into the SME arena. As examples, Procredito of Colombia, Findesa of Nicaragua, Mi Banco of Peru, and Banco Sol of Bolivia have recently moved towards larger loans. It is worth noting that these institutions are also offering a wider range of products and differentiating their pricing structure (as opposed to charging a standard interest rate, regardless of size or duration of loan). Figure 14 illustrates BancoSol’s product offerings.

Some commercial banks interested in entering into the profitable microfinance sector have started to make small business loans in the \$10,000 to \$50,000 range. Although this is a level above microfinance, this size amounts to a microloan from a large bank’s perspective. Examples of commercial banks

³⁰ T. Beck, A. Demircuc-Kunt and R. Levine, “SMEs, Growth and Poverty: Cross-Country Evidence”, *Journal of Economic Growth*, 10:3 (2005): 199-229.

³¹ SEAF, “The Development Impact of Small and Medium Enterprises: Lessons Learned from SEAF Investments”, February 2004.

Figure 13: Interest Rates on Microfinance Loans in Bolivia 1998–2004



Source: Elisabeth Rhyne and Maria Otero, "Microfinance Through the Next Decade: Visioning the Who, What, Where, When and How." Acción Internacional. Global Microcredit Summit, 2006.

"Microfinance has dispelled the myth that unsecured loans cannot be profitable."

moving downstream are Banco Credito of Peru, Banco Colombia, and Banorte of Mexico. Some major multinational financial institutions are also becoming more active as they either finance or buy MFIs. These include Citibank, Deutsche Bank, ABN Amro, and Scotia Bank of Canada.

This amounts to a major change in attitude of commercial banks and it must be attributed in great part to microfinance's success. "Microfinance has dispelled the myth that unsecured loans cannot be profitable," said Alex Silva, president and founder of Omtrix Corporation in Costa Rica. "And has stimulated the birth of alternative instruments to a collateralize loan, for example, through liens on inventory or on mortgages."³²

Microfinance's success coupled with new technologies has also contributed greatly to building credit scoring databanks for vast segments of the previously unbanked population. These databanks on basic financial transactions (microloan repayments, bill payments, cash transfers, etc.) are proving very useful

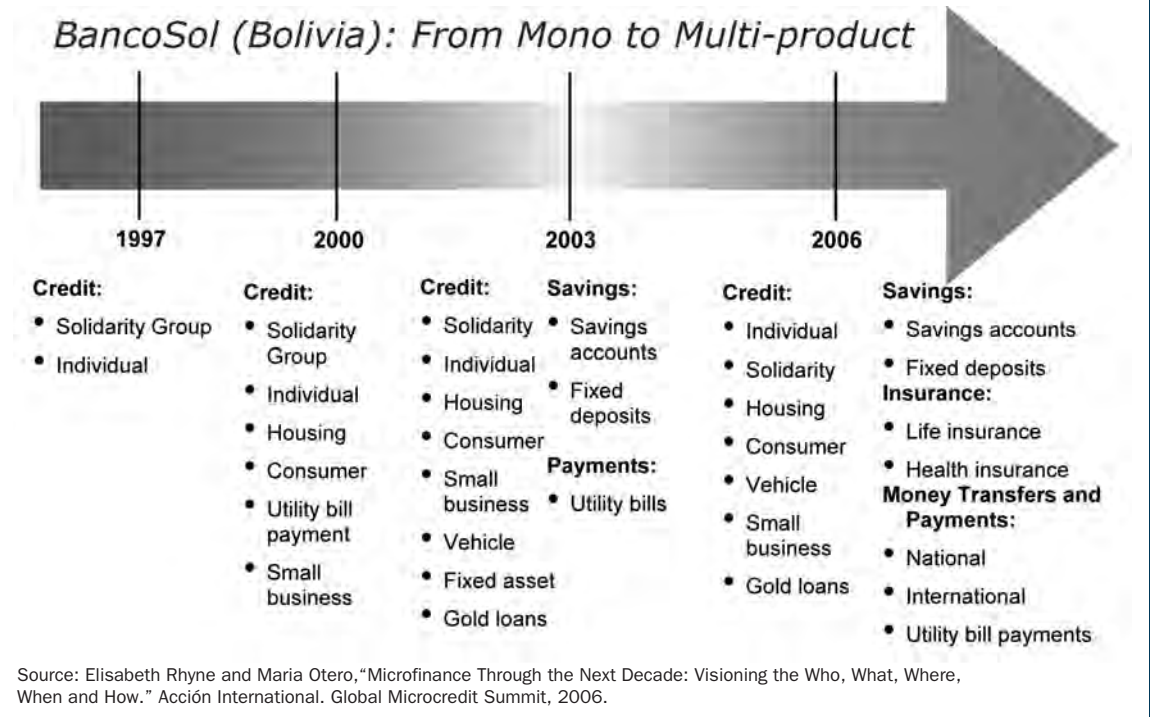
in assessing the creditworthiness of individuals commonly — and possibly erroneously — considered high credit risks. New technologies are also helping the collection of personal financial data.

Microfinance databanks might complement the databases compiled by commercial banks. Commercial banks can add this financial information to their back office capabilities, risk management techniques, information system management, collection schemes, and other financial data to better assess the credit worthiness of a much broader pool of customers. In this respect, joint ventures between MFIs and commercial banks could prove extremely beneficial. Although some MFIs financed by NGOs are reluctant to seek these kinds of joint ventures, others — like Accion International — are actively advocating these partnerships. (These could be similar to the bank/Community Development Financial Institution partnerships forged in the United States, in efforts to reach low-income borrowers.)³³

³² Interview with Alex Silva, May 21, 2007.

³³ G. Yago, B. Zeidman and B. Schmidt, "Creating Capital, Jobs and Wealth in Emerging Domestic Markets: Financial Technology Transfer to Low-Income Communities," Milken Institute, January 2003.

Figure 14: BancoSol Diversified Product Offerings (1997–2006)



Is technical assistance a key to success or a waste of resources?

Virtually all surveyed organizations stressed the key importance of technical assistance in helping small enterprises access capital. Technical assistance is deemed important to help potential entrepreneurs develop a business plan, understand and evaluate growth opportunities, overcome legal and regulatory issues, and present a financial plan to potential investors. It is also considered valuable after financing is disbursed, to assist and monitor the progress of the enterprise, and help secure additional funding.

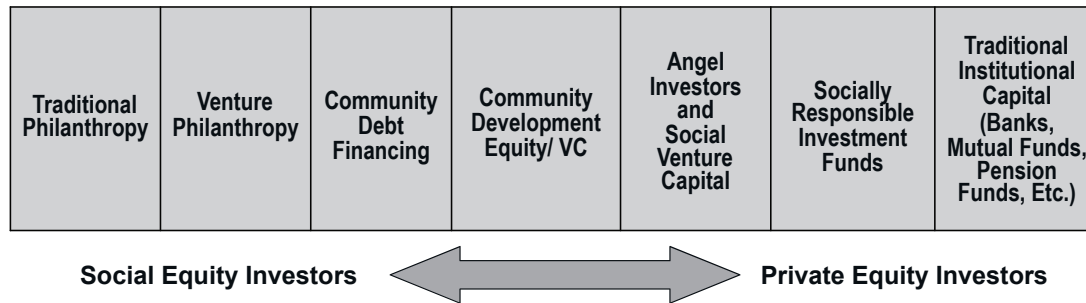
This claim was made both by younger organizations like Agora Partnerships, which targets the small end of enterprises in the extremely poor and undereducated country of Nicaragua, and by established and successful organizations, such

as Business Partners of South Africa. However, this view has been challenged in recent years. For example, Michael Klein, vice president of Financial and Private Sector Development jointly for the World Bank and the International Finance Corporation, states that there is no conclusive evidence in the existing literature that companies that receive subsidized technical assistance do better than those that don't. "Entrepreneurs are usually quick to learn and follow examples that have been successful," said Klein. "If the market works well, people learn on their own since the basics are not that difficult."³⁴ Subsidized technical assistance, he adds, might not be the best use of resources.

Damian von Stauffenberg of MicroRate, supports this view. His organization has been rating MFIs since the mid-1990s, providing investors a measure

³⁴ Ibid.

Figure 15: Spectrum of Investors



Source: Jed Emerson (Generation Investment Management) and Shari Berenbach (Calvert Foundation), 2006.

“The conclusion reached by many institutions was that technical assistance was not needed. If it were, clients would have been willing to pay for it.”

of their health and management quality. Although MFIs were providing some technical assistance to clients initially, he points out that this service has progressively disappeared. “The conclusion reached by many institutions was that technical assistance was not needed. If it were, clients would have been willing to pay for it,” said von Stauffenberg.³⁵ He states that some training may be useful, such as seminars to learn how to better access export markets, but generally, technical assistance should not be subsidized. Others may agree that technical assistance to enterprises may be irrelevant, but that assisting local banks and training loan officers to manage SME risk is critical if SME finance is ever to achieve scale.

How can the full capital spectrum be utilized?

Despite the challenges to investing in emerging market SMEs, funders — from purely philanthropic donors to market-rate investors — are exploring the area. The most successful projects will tap the full spectrum of capital providers (Figure 15).

The development finance toolbox includes a variety of products that should be linked and coordinated in development efforts. Each of these can affect SME targets in the developing world. They include:

- Grantmaking by government agencies (bilateral and multilateral) and foundations which include unrestricted gifts, restricted gifts and venture philanthropy;
- Debt instruments through program-related investments (PRIs),³⁶ loans, revolving credit lines, equity-participating debt instruments, bonds, and loan guarantees;
- Public equity investments through positive/negative screening, best-in-class screening, proxy voting, shareholder engagement, and published analyses that can affect portfolio flows;
- Alternative assets including targeted private equity, targeted real estate, commodities, direct investing, venture funds, funds-of-funds and buy-out funds.³⁷

In the debate on how to best provide affordable capital to SMEs, the choice of financial instruments utilized is important. A broader mix of debt and equity products also enables entrepreneurs to lower their overall cost of capital (Table 3). Bank lending in developing markets may be difficult to access for

³⁶ Program-related investments are those in which the primary purpose is to accomplish one or more of the foundation’s exempt purposes.

³⁷ Adapted from Diana Propper de Callejon, (Expansion Capital).

³⁵ Interview with Damian von Stauffenberg, May 15, 2007.

Table 3: The Capital Spectrum from Equity to Debt: Quasi-Equity Instruments

1. Convertible Subordinated Debt: A loan that carries standard interest payments as well as the option to convert the loan into a share at a predetermined price.
2. Royalty Financing: A loan against future sales. Typically the lender collects a part of the revenue at a determined interval up until a predetermined amount.
3. Long-Term Debt with Warrants: A long-term loan that carries a standard interest payment as well as the right to buy a share at a predetermined price after the loan is paid off.

a variety of reasons, as discussed above. Thus, equity or quasi-equity seems to be a valuable alternative both for entrepreneurs and investors, as it does not burden a company with high servicing costs in the initial stages of development, and it gives an upside to the investor. Moreover, it facilitates further senior lending through the banking system by providing collateral required by banking regulators.

However, the few equity funds investing in developing countries offer a mixed record to date: while there exists no systematic data on private equity investments in SMEs with regard to deal size, return or exits, some studies have shown that returns from venture capital investments in emerging countries tend to be far lower than in high-income countries for large companies.³⁸ Currency, regulatory and political risk, coupled with high transaction costs and few, if any, exit options explain these lower returns. An analysis of the SME funds managed by the European Bank for Reconstruction and Development (EBRD) in emerging markets in Eastern Europe shows that the capital wasn't even returned for investments under \$2.5 million.³⁹ Additionally, quasi-equity and

³⁸ J. Lerner and A. Schoar, "Private Equity in the Developing World: The Determinants of Transaction Structures", NBER Working Paper, 2005. See also the discussion of the importance of the small business sector in growth in post-conflict or transitioning economies such as Northern Ireland in *Economics in Peacemaking: Lessons from Northern Ireland*, The Portland Trust, May 2007.

³⁹ A. Patricof and J. Sunderland, "Venture Capital for Development," Discussion Paper, Prepared for the Brookings Blum Roundtable: The Private Sector in the Fight Against Global Poverty, August 4, 2005; A. Patricof and J. Sunderland, "Small is Beautiful," *Milken Institute Review*, 2/2005:90-94.

equity investments in the SME sector in emerging markets have produced many business failures.⁴⁰

The vast majority of existing SME equity funds in developing economies are supported by some form of donor money: by a governmental organization (e.g. Swedfund), by an international organization (e.g. the initial and unsuccessful model for Aureos Capital Limited), or a state bank (e.g. SIDBI Venture Capital Limited) or a combination thereof. These funds cover a broad range of SMEs in various industries and provide investments through equity or quasi-equity from \$20,000 (Aavishkaar India MicroVenture Capital Fund) to \$5 million at the upper end (Aureos Capital Limited). Most of the investments are made through quasi-equity, rather than standard equity, which includes royalty financing, subordinated debt, payment-in-kind, and similar instruments. Greater experimentation and innovation is clearly needed to help leverage the full capital spectrum.

Should commercial rates prevail?

The declared mission of most surveyed organizations is to achieve the first of the United Nations Millennium Development Goals (MDGs) to reduce by half the proportion of people living on less than \$1 dollar a day by 2015. Poverty alleviation is, therefore, a crucial tenet in the investment strategy of most development institutions committed to helping SMEs in developing countries. For this reason many investments are expected

⁴⁰ Ibid.

to deliver social and/or environmental returns in addition to financial return. This approach, however, might hide inherent inefficiencies in the underlying financial model. “It is easy to claim that high operating costs are justified by double bottom line returns and that low financial returns are compensated by marvelous development work,” said von Stauffenberg. “Often development funds never reach their final destination and are lost in high administrative expenses that subsidize white collar employees and not the poor.”⁴¹

The issue has been framed in more general terms by Michael Klein. Introducing market mechanisms is critical to better allocating resources, even in underdeveloped countries. Acceptable rates of return are the only true measure of a project’s viability; if it is heavily subsidized, Klein noted, an investment is neither scalable nor sustainable.⁴² Even without an expected rate of financial return, some philanthropic investors require that market mechanisms be implemented. The Dutch DOEN Foundation, for example, has the explicit goal of encouraging entrepreneurship, and requires operational and financial self-sustainability within three years for the businesses it funds.

Can commercial banks be wooed to go downstream?

According to Matthew Gamser, IFC’s SME program manager, the vast majority of small businesses around the world simply need plain bank lending.⁴³ Entrepreneurs in the developing world complain that banks are unwilling to lend except under constraints so stringent as to make capital unaffordable; and the main reasons why banking is prohibitively expensive in many developing economies are regulation and an uncompetitive

banking sector.⁴⁴ In Bangladesh, for example, the minimum amount required to obtain an SME loan is almost ten thousand percent of the local GDP per capita. Therefore, the critical question to answer is if, and how, IFIs, NGOs or other institutions committed to alleviate poverty can best encourage commercial banks to increase lending to SMEs.

There is no consensus on why banks are so reluctant to lend to SMEs. The most common explanation is the lack of collateral to secure a loan. Low levels of competition in the banking system, a large share of state-owned banks, the absence of credit bureaus or other credit-rating databanks, inefficient judiciary systems, low contract enforceability, burdensome banking regulations, and inefficient bureaucracies help create insurmountable barriers, which in turn tend to affect the smaller end of SMEs to a disproportionate degree.⁴⁵ The implementation of Basel II provisions for capital adequacy may also present potential problems associated with SME lending in developing countries.⁴⁶

According to Klein, the publication of the World Bank’s “Doing Business” report has proven successful at “shaming” some governments into passing institutional reforms to raise their standing on the international list.⁴⁷ The report ranks 175 countries based on a broad measure of the ease of doing business. It covers a range of business climate factors, such as the number of days needed to start a business, the degree of contract enforceability, the procedures, time and costs associated with business licenses and gaining access to credit, among others. The report is monitored regularly by heads of state

⁴⁴ T. Beck, A. Demirguc-Kunt and M. Soledad Martinez Peria “Banking Services for Everyone? Barriers to Bank Access and Use Around the World”, World Bank, Working Paper, December 2006.

⁴⁵ Ibid.

⁴⁶ Stephany Griffith-Jones & Stephen Spratt, 2003. “Basel II and Developing Countries: Diversification and Portfolio Effects,” London School of Economics, FMG Discussion Papers dp437, Financial Markets Group.

⁴⁷ Interview with Michael Klein, April 23, 2007.

⁴¹ Interview with Damian von Stauffenberg, May 15, 2007.

⁴² Interview with Michael Klein, April 23, 2007.

⁴³ Interview with Matthew Gamser, April 16, 2007.

According to Matthew Gamser, IFC’s SME program manager, the vast majority of small businesses around the world simply need plain bank lending.

“This is above all an institution building challenge: how to build the loan officer skills and the organizational structures to take decentralized risk-based credit decisions.”

and has worked successfully as an incentive for reform. According to Klein, NGOs could be most effective using their resources to press governments towards liberalization and reform.

Others argue that this is not a regulation or collateral problem, but a skills and corporate culture problem within the local banks. ProCredit Holding, for instance, has been profitable in SME banking and maintained low arrears through aggressive training programs, despite the lack of collateral and weaknesses in legal structures. “This is above all an institution building challenge: how to build the loan officer skills and the organizational structures to take decentralized risk-based credit decisions,” said Helen Alexander, managing director for ProCredit.⁴⁸ A whole array of services e.g. reliable source of credit (long term and short term overdraft facilities), documentary business (letters of credit and guarantees), savings and liquidity management facilities, payment facilities (for managing supplier and customer relationships), and payroll facilities (managing employee payroll and overdraft needs) could be extended to deepen ties between SMEs and commercial banks.

Can credit scoring improve the access to capital?

Rating agencies, private credit bureaus, and methods of credit scoring are all innovations that can overcome information asymmetries imposed by high levels of opacity in developing market economies. The emergence of these innovations can help with overcoming the weaknesses of ineffective state institutions. By demonstration, they can induce changes and reform in more formal economic systems. In developing markets, these private, often foundation-led, solutions have formalized rules and procedures and imposed sanctions for opacity and lack of information disclosure and

⁴⁸ Interview with Helen Alexander, March 28, 2007.

default.⁴⁹ The advantages of such innovations are that they reduce information costs by collecting and processing information, minimize agency costs by creating self-enforcing behavior, and generate an economic incentive (i.e., more investment) through participation. As these information-led systems achieve higher scale of operations, they can incrementally lower overall costs.⁵⁰

Credit rating is particularly difficult in developing countries where a large portion of the population is unbankable. However, some of the surveyed organizations are providing services aimed at building credit-scoring databanks. For example, MFIC’s financial service network for unbanked immigrants in the United States records transactions and creates a form of credit rating. The emergence of new technologies (e.g., mobile banking, Internet banking, PDA banking) also offers new opportunities for data collection and analysis.

Many point out that no credit scoring technique can replace the role of human capital in assessing the viability of a business and the quality of its management through relationship investing. This is an important point for discussion as partnerships with local intermediaries that have more extensive personal relationships and information on the local business climate can greatly contribute to the success of the investments.

⁴⁹ M. Bird, “Traveling Down the Other Path: Learning to See Extra-Legality as an Investment Opportunity,” *Business and Development: The Private Path to Prosperity*, International Finance Corporation and Financial Times Annual Essay Competition, 2006; A. Grief, “Commitment, Coercion and Markets: The Nature and Dynamics of Institutions Supporting Exchange,” in Claude Menard and Mary M. Shirley (eds.), *The Handbook for New Institutional Economics*, Norwell, Mass: Kluwer Academic, 2005.

⁵⁰ M. Fernando, “Innovation of a Global Local Currency Micro-finance Fund,” *Business and Development: The Private Path to Prosperity*, International Finance Corporation and Financial Times Annual Essay Competition, 2006.

5 CONCLUSION

Traditional state and donor-driven approaches to economic development in the SME sector have largely failed. Macroeconomic, institutional, and financial weaknesses prevail in many developing countries, hindering SME financial access and development. However, new market-based approaches to supporting SMEs are being tested by U.S. and European as well as developing country innovators who recognize that a vibrant SME sector often accompanies economic, social, and political development. Transatlantic knowledge exchanges and joint ventures can help lower costs, limit redundancy, and improve efficiency. North-South collaborations would equally serve that

purpose and help to build indigenous capacities in terms of better public policy and financial sector inclusion. Technical assistance, risk mitigation, use of remittances, rating services, IT systems, direct financing, and loan guarantee programs are being employed in alternative ways and in various combinations. Leveraging partnerships and sharing best-practices can help determine if these innovative models and financial instruments can be scaled to maximize impact. This study seeks to enable that process and advance a discussion across government, business, and nonprofit sectors working to accelerate capacity-building and capital for developing country SMEs.

APPENDIX

List of Interviewees

Helen Alexander
Managing Director
ProCredit

Clara Barby
Capital Markets Associate
Acumen

Siobhan Cleary
Senior Manager Strategy
JSE Securities Exchange South Africa

Christine Eibs-Singer
Deputy Executive Director
E+Co

William Foote
President
Root Capital

Andrew Gaines
Managing Partner
DeRisk

Matthew Gamsler
SME Program Manager
International Finance Corporation (IFC)

Paul Gossens
Manager SME-Fund
BIO

Susanne Grossmann
Managing Partner
BTS Investment Advisors Limited

Rob John
Fellow
Skoll Foundation

Donna Katzin
Founding Executive Director
Shared Interest

Michael Klein
Vice President for Financial
and Private Sector Development
IFC/World Bank

Asad Mahmood
General Manager
Deutsche Bank

Marc Manara
Portfolio Associate
Acumen Fund

Bruce McNamer
President and CEO
TechnoServe

Alan Patricof
Managing Director
Greycroft, LLC

Ben Powell
Managing Partner
Agora Partnerships

Preethi Rao
Team Facilitator, Small Enterprise Finance Centre
Institute for Financial Management and Research

Andreas Renner
Head, Development Investment Services
GEXSI

Kai Schmitz
Executive Vice President and COO
Microfinance International Corporation (MFIC)

Jo Schwenke
Managing Director
Business Partners South Africa

Krishnan Sharma
Economic Affairs Officer
United Nations

Alex Silva
President and Founder
OmtrixINC

Jasper Snoek
Finance Director
DOEN Foundation

Nienke Stam
Program Manager
IntEnt

Saskia van der Mast
Project Analyst
d.o.b. Foundation

Bert van der Vaart
President and CEO
SEAF

Damian von Stauffenberg
Founder and Principal
MicroRate

Koen Wasmus
Director
Business in Development Network/NCDO

Eva Witt
Division Chief Financial Sector
KfW



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