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CAPITAL MOBILISATION THAT REACHES SMALL BUSINESS IN EMERGING MARKETS – WHAT WILL IT TAKE?

Input Paper to the Impact Taskforce prepared by the Collaborative for Frontier Finance

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In emerging markets, most formal jobs are generated by SMEs, which create 7 out of 10 jobs.[1] Despite this outsized impact, micro, small and medium enterprises (MSMEs) in developing countries have an unmet financing need of $5.2 trillion every year.[2] There is nothing new in the scale of these numbers. Variations have been quoted since the first Addis Ababa gathering on the role of Private Sector Development. Not surprisingly, the economic and job impact of small businesses is similar across OECD countries as well.[3]

The gap in small business financing and therefore their ability to grow and create jobs does not shrink; rather, it continues to rise. Youth underemployment in sub-Sahara Africa is up 20+%; and the population of Africa is expected to grow to 2.5 billion from 1.3bn in 2019.[4] Again, these numbers and trends are well known to the development community.

At the Collaborative for Frontier Finance we are razor focused on the issue of access to capital for small businesses and the gap in appropriate financial resources.[5]

So why are we still here? Why has capital not been mobilized to reach small businesses in emerging markets?

We are left accepting there are well-established and systemic barriers – all of which are addressable:

- **Lack of common understanding regarding SME market segmentation – and therefore misaligned efforts**. Do we even agree on what constitutes an SME? Who are they, what are their needs? Where do they fit within the economies and business sector? And how best to fund their needs? In recent interviews with banks and microfinance institutions (MFIs) in Zambia, each bank had their own definition, despite there being standardized reporting requirements by the Central Bank. Two examples illustrate that the answer is that we lack a collective definition, and as such, lack a common view on how to address the problem. For the Collaborative we apply a twofold classification of MSMEs.[6]
    - Stage of business model and growth expectation. Staffing ranging from 5 – 100 employees. In our 2019 report, we further segmented small enterprises to those that intentionally are seeking to grow beyond basic livelihood businesses – *emphasizing the role that they play in driving jobs in their economies*.

[1] *World Bank SME Finance*
[2] *Ibid.*
[3] *OECD SME and Entrepreneurship Outlook 2023, OECD iLibrary.*
[4] UN DESA. *Africa's Fast-Growing Population: Tackling Youth Unemployment.*
[5] *The Collaborative for Frontier Finance.*
[6] CFF (2019). *The Missing Middles: Segmenting Enterprises to Better Understand Their Financial Needs.*

- o Size of financing needs. Often the first formal financing for an enterprise, depending on market, ranges from $50,000 - $500,000.

What is important is at this stage, there is a commonality of the needs and type of financing. While a large percentage of needs are for working capital, Africa's new generation of businesses are less capital intensive and often focus on services that require human capital, not infrastructure to meet their markets. This growth capital is difficult to come by, particularly in countries where small business finance is almost exclusively limited to collateral-based financing. These capital needs require different types of funding approaches than what has been available to date.

- **Reach and deal size**. Small businesses are by definition dispersed. Their needs are often highly contextual to their communities and economies. Funding them requires following a well-established axiom in small business finance – work through local intermediaries that know the local business value chains and market norms.
  - o CFF has been supporting a network of emerging such local capital providers (LCPs). They represent an emerging asset class of small business finance-oriented fund vehicles. These vehicles purposely target financing the "*transforming middle*"[7] with financing and investing amounts ranging from $50,000 - $2,000,000, with 80% of the needs ≥ $500,000. They offer a broad range of financing constructs; debt, equity and self-liquidating quasi-equity – aligning instruments and terms to the needs of their portfolio enterprises.
  - o To best meet the needs of their target market of small businesses, these LCPs themselves, purposely target fund vehicles sub $50 million, more often in the $25 million range. Cumulatively, they currently finance 1,200 small businesses across Africa. Should each of these local capital managers reach targeted AUM, they account for $1.5 billion in new capital for Africa's small businesses. We anticipate that **Africa alone needs 300+ of such LCPs** to meet the untapped market – what we refer to as 1,000 flowers blossom versus targeting a few large vehicles/funds.
  - o Fintech tools and tech-enhanced financing models will fill an important gap in working capital financing. Coupled with behavioral change at the organizational level, large regulated FIs can evolve into credible financiers for the daily financing needs. This has been illustrated by KCB, Kenya's largest bank. With grant funding from the Argidius Foundation, the bank redesigned all aspects of its small business finance. In just four years, its lending to small businesses and women entrepreneurs has become a $2 billion line of business, providing intraday inventory finance.[8]
- **Bias towards perspectives and capital models "imported" from the developed economies and markets**. To date, we have applied several basic assumptions derived from established practices in the OECD financial marketplace.
  - o 2/20 Private equity and venture capital closed-end fund models. These constructs have served well the large-scale capital flows in the US and European private equity and VC

[7] The Argidius Foundation (2022). *Annual Report 2022. A Message from the Executive Director.*
[8] The Argidius Foundation (2022). *$2 Billion for Women Led Small and Medium Sized Enterprises*.

marketplace. However, for small business finance in emerging markets, these models may not be as applicable. Large fund vehicles are not properly positioned to underwrite and manage smaller transactions. Rather smaller fund vehicles that bring deep understanding of their local markets and businesses, willing to apply innovative financing constructs to meet the needs of their portfolio are demonstrating a different path. Yet, DFIs are finding it difficult to underwrite and fund such well positioned local intermediaries.

- Regulated banks and MFIs are "the" path to reaching MSMEs. In emerging markets, local banks struggle to finance small businesses. As one local banker stated, "*…we lend based on the collateral, not an understanding of the business and its cashflows*". They focus on fixed assets, and in most markets, even chattel mortgage financing is still a novel approach (e.g. lending against movable tangible assets such as inventory or receivables). Small businesses, particularly women-owned, lack the hard assets that bankers require. Despite this limitation, the major development finance players have funneled hundreds of millions in lines of credit to regulated FIs for on-lending purposes. Yet, these monies are not reaching these growth-oriented enterprises.
- Prioritization of risk mitigation. In the goal to bring private capital into the impact investing arena, we have come to see "blended finance" as the steppingstone. Yet, blended finance as a concept has increasingly been narrowed down to philanthropic and grant capital used as a de-risking mechanism. There has been a focus on either concessionary monies to offset the interest rate or guarantees to offset risk. Both of these are effectively prioritizing a balancing of the perceived risk/reward imbalance in impact-oriented capital transactions.
- Failure to adapt and learn from local stakeholders. CFF's Annual Survey of Local Capital Providers illustrates that the use of catalytic capital is equally important for capacity support/investment readiness of small businesses, supporting the operational and staffing needs of local intermediaries and broader ecosystem applications.[9]

We need to move beyond just the de-risking orientation of blended capital and the finance models of the more developed markets by working with local capital managers to address the truly constraining factors in scaling access to finance for small businesses in emerging markets. In this note we highlight these systemic barriers that should be our collective priorities going forward.

- **Lack of coordinated, collective action**. While we focus on the issue of capital, CFF is fully aware that other barriers exist, including the investment readiness and the provision of business services, regulatory environment, and the quality human capital. Building further upon the learnings and programs developed by early-stage local capital providers will encourage collective approaches by catalytic capital providers, including foundations and other early stage LPs who can also band together to implement collective approaches.
- **Need for transparency and evidence**. These are two very critical means to achieving scaled impact.

[9] CFF (2023). *Annual Local Capital Provider 2023 Survey.*

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- o Informed learning. In 2017, as the MacArthur Foundation was first developing the concept of the Catalytic Capital Consortium (C3), [10] which it, the Omidyar Networks, and Rockefeller Foundation committed $150 million, a very relevant question arose. What has been the experience and track record of the DFIs, bilaterals and multilaterals, with regards to the topic of catalytic capital? The subsequent review uncovered a multitude of initiatives, from pilot to full scale programs. Yet, there was virtually no shared learnings as to what occurred with these programs. Lacking transparency regarding these experiences, there was no informed learning. The development sector would have to simply start anew, and unnecessarily spend monies that might be better allocated should the development agencies documented and disseminated what occurred.

  Based on this, C3 committed up to $10 million to share the learnings and further build the field's understanding of what their investment activities encountered and how it can inform future activities, including how to take these initiatives to scale.

- o Financial and transactional-level data. Little has been done on this front. The last effort was by Shell Foundation and Omidyar Network in 2019. Their report on SME fund performance was based on a longitudinal review of five institutional level funds and their combined portfolios. [11] However, as the authors noted, more detailed analytical work was needed. There is still little data on the underlying portfolio, sectors, financing needs, tenors, countries, etc. It is difficult to imagine building out an industry without transactional data. We need to build upon that initial work.

- **Sense of urgency to address operational constraints**. Markets like it simple and they like it fast. In the investment banking world, we learned that in bringing innovation to market and scale requires us to took look at all the complexity, break it down into its components and then to be able to design and deliver a straightforward and viable financing construct for the marketplace. Yet, the development field has built very heavy operational approaches and financing complexity, often with legal having outsized control.

  In his opening remarks at his first World Bank annual meetings, World Bank President Ajay Banga referenced that the average timeframe for the World Bank to disburse on a loan is 27 months.[12] Having spent several years at the Bank, that may actually be an optimistic view of the pace of World Bank loan programs disbursements. I managed a venture philanthropy program with a portfolio of highly impactful social-oriented enterprises. When I arrived, our grants of $120,000 took 18 - 24 months of internal processes to be disbursed. This was after a robust and time-consuming application and selection process, leading to a three-year disbursement timeframe from program initial design. This extended timeframe is a "valley of death" period for early stage social and environmental entrepreneurs. With the assistance of a wonderful operations individual, we broke the process down over two whiteboards. Using that mapping we revisited each stage, we engaged each of the World Bank teams responsible for these components. Within a week we had redesigned the process. Grants disbursement period was reduced to 90 days, while still achieving the requisite internal approvals.

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[10] MacArthur Foundation. *Catalytic Capital Consortium.*

[11] Shell Foundation, Omidyar Networks, and Deloitte (2019). *Insights on SME Fund Performance: Generating Learnings with the Potential to Catalyze Interest and Action in SME Investing.*

[12] Reuters. 2 November 2023. *World Bank Eyes Speeding Up Loan Approvals Amid Bold Overhaul*.

In 2020, as COVID-19 began to hit, it was clear that small businesses would be hit very hard. We approached all of the DFIs, none felt they had the strategic or operational alignment to implement a rapid response COVID-19 relief facility for small business finance. One of the most transparent DFIs, DFC, stated that given their backlog, it would be eighteen months before their legal team could initiate due diligence. Indeed, many businesses failed due to lack of liquidity.

At a gathering of DFIs, bilaterals and other ecosystem players we hosted two years later, one investment officer stated it clearly. She understood the opportunity that LCPs offered and her personal desire to provide the requisite capital. However, she said that regardless of the impact that such intermediaries could play, and the immediacy of their needs, her risk committee was not prioritizing small business finance transactions.

No one is asking these agencies, supported by taxpayers' monies, to undertake bad deals. However, there is indeed substantial room for better strategic alignment, and with that, more streamlined operations. So indeed, to President Banga's vision, timeframes should and can be materially reduced.

So how do we mobilize capital for small businesses in emerging markets?

✔ **Achieve clarity on who, what and how are we funding**. Across the spectrum of the development and traditional capital stakeholders, we need to align on the SME segmentation – the needs, capacity, and approaches to financing these entities. Local businesses require working capital and growth capital. It will take different providers, approaches, and instruments to finance these enterprises based on their stage of business, business sector, role in the value chain, the use of funds, and capacity to repay/return the capital provided.

In 2019 CFF oversaw an initial review on the segmentation of small businesses, defining them by their growth trajectory and capital requirements.[13] Our annual surveys have further highlighted the capital needs of small businesses. While our research has been informative, additional work is required to advance the understanding of how best to align capital with the needs of today's small enterprises that increasingly are based on intellectual capital, than those of earlier decades whose business were largely fixed asset intensive.[14]

✔ **Small business finance is all about local** – including the opportunities, challenges, solutions and resources. Small businesses are highly contextual, market and value chain specific. They are best understood by those in their markets. The development field needs to recognize that the best path to supporting small businesses is via local intermediaries, particularly those that bring innovative approaches to meeting the needs in their local markets. It will be critical for DFIs and institutional capital holders to familiarize themselves with this emerging asset class, embrace with openness the dynamic approach they apply to addressing the financing needs of small enterprises in their markets.

✔ **Address the scale disparity**. Without the monies of institutional capital holders, we do not achieve the scale needed to address the capital gap. Yet, such holders operate at minimum transaction levels which are often far greater than any one SME can absorb, and often their

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[13] CFF (2019). *The Missing Middles: Segmenting Enterprises to Better Understand Their Financial Needs.*
CFF (2023). *2023 Annual Local Capital Provider Survey.*
[14] J Haskel and S. Westlake (2022). Restarting the Future – How to Fix the Intangible Economy.

minimum transaction amounts are too big for even the local small business financing intermediaries. New fund-of-funds (FoF) platforms will be a critical pathway to bridging institutional capital holders and the local capital providers. There has been criticism on use of FoFs – doubling the intermediary fees and return requirements, with comments such as *"…we know how to finance these businesses, and therefore don't need another intermediary."* By applying a new mindset, there is great value in working via these aggregators of small business capital.

CFF is working with a network of some twenty-five small business FoFs platforms operating across Africa and MENA. These vehicles offer a pathway to mobilize institutional capital, including capital from DFIs, to local providers.

✔ **Reframe "blended capital"** to a more comprehensive approach in addressing the gaps in the capital that flows to small businesses. As an ecosystem, we have not been asking the fundamental question as to why the capital is not flowing where needed. We have defaulted to the belief that it is solely due to the perceived transaction risk.

In our work on behalf of the Central Bank of Zambia to design a credit risk guarantee scheme for small business finance, we have interviewed each of the regulated FIs. When asked "*what will you do when the guarantee program ends?"*, the universal answer is *"…we will stop lending to these businesses*". When further pursued as to what would change their behavior, they raise a host of other challenges. They are clear that risk guarantees alone will not change their underwriting standards. Risk guarantees do not address a number of other barriers that hold back the small business finance by local banks such as their operational cost structure, the regulation requirements regarding risk weighting and capital adequacy, and the business investment readiness of small businesses. De-risking blended capital structures have not sought to address these constraints. They need catalytic monies to address capital adequacy and to provide financing incentives to address such regulatory hurdles as the rules associated with IFRS 9.[15]

Similarly, the emerging class of local small business funds have other challenges that traditional blended capital approaches do not address. Their needs relate to the initial fund vehicle economics as they scale, ability to hire quality staff, the need to provide technical support to their portfolio, and the administrative and legal burden placed upon on small fund vehicles, the latter of which is often imposed by the very development agencies that should be facilitating their ability to reach such a critical sector as small businesses. They see portfolio risk assessment and management as their core skill, and hence to not see de-risking mechanisms as their fundamental need. Such fund vehicles need capital to address operational considerations, particularly as they scale.

✔ **Call for collective action that is "*catalytic*" and "*purposeful*"**. DFIs, bilaterals, multilaterals, and foundations have tended to work in silos. And equally, as noted above, we have tended to pursue de-risking mechanisms, when those are not the only needs. Seldom is there truly strategic alignment among the development players and private sector capital providers.

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[15] See *IFRS - IFRS 9 Financial Instruments.*

Individual institutions are starting to consider new approaches. Last month, the UK agency, BII announced an MOU to co-invest with ILX.[16] This is a very good precedent. We need similar such joint initiatives that target small business finance. During this year's GIIN, the US DFC presented analytic work reviewing their Portfolio for Impact and Innovation (PI^2).[17] They sought market input on how they best scale such initiative. Comments included not only the value of working with local intermediaries such as LCPs that know the needs of their local markets well, but that "catalytic" only happens with speed and in partnership with other capital and ecosystem building players.

Meanwhile, a group of foundations have begun testing the opportunity for a Growth Firm Alliance, an initiative that looks establish a continuum of capital and capacity building among charitable foundations and the large development agencies. Over the past decade, these foundations have made great progress in the areas of small business finance and enterprise development services for small business. They have built relationships with key local stakeholders, have addressed the human capital needs of small businesses and intermediaries, etc. What they need is "*purposeful*" partnerships with the large development agencies that share the sense of urgency and are able to take their efforts and innovations to scale.

In November 2023, CFF will bring together sixty local capital providers for small businesses (LCPs) and twenty-five institutional scale capital holders and field building organizations. These LCPs look to raise over $1.5 billion in impact capital for Africa's small businesses. They need support and funding from institutional capital and patient capital providers. Further, at the field building level, we need better coordination among those that support small business development services as well as those that prioritize the requisite regulatory changes in domestic markets. We look to use these discussions to seek actionable paths for joint action, commitments to move institutional monies to local managers and agreements on areas of joint knowledge sharing and ecosystem strengthening.

✔ **Intentional learnings and shared field building**. CFF has partnered with the FSDA Impact (FSDAi), a UK agency operating across Africa to drive capital into the impact investing sector.[18] We will work together to provide $10 million in catalytic funding to these emerging LCPs. Equally important, we will launch a learning lab. Through this lab, we will develop case studies on the LCPs, showcasing their capabilities, their needs, and how FSDA-i's funding addressed specific gaps in the LCPs ability to get to scale and meet the needs of their target portfolios of small businesses.

When structuring "*innovative*" financing, we tend to focus on the transaction structuring. We spend less time articulating what is the catalytic impact we are seeking, tracking what happened, and sharing those learnings with the broader marketplace. Like the C3 and the FSDAi programs, we need to be very purposeful about "*why*" we are using this capital, so that we can inform the

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[16] BII. 16 October 2023. *British International Investment Signs Memorandum of Understanding with ILX to Mobilise Impact Capital.*

[17] DFC. *Portfolio for Impact and Innovation.*

[18] See *FSDAi*.

large capital holders as to how their monies can be brought into the small business finance sector.

Similarly, we need to look at better informing mechanisms on what social, environmental and economic impact this financing is having. 60 Decibels, in work with Argidius Foundation, have begun testing how to assess these impact factors that are critical to the "why?" small business finance matters.[19] CFF is undertaking similar work with South Africa's Riscura, a global investment firm, to assist in applying appropriate financial valuation mechanisms.[20] Further work is needed to make such tools easily applied by small businesses (vs. the less appropriate and burdensome application of the traditional log frame M&E or PE valuation methodologies).

In summary, these small business capital reformers are just like entrepreneurs – both are fighting against the reality of accepted practices, trying to demonstrate their vision of how things can be done better. We need to facilitate these reformers, bring their respective approaches and skills to collectively mobilize the capital needed to address the long ignored gap in large scale capital flows into the small businesses that are critical to growth and employment in emerging economies.

A vision of the future - where can a refocused capital mobilization lead us in the next 3 – 5 years?

- **Mobilize capital at the global level.**
  - Grant makers and "catalytic" capital holders. Foundations, family offices, bilateral agencies and domestic development agents can provide subsidies to address the systemic barriers. As has been evidenced with most industries that drive economic opportunity, in the early days, we need subsidies. Not just in the form of de-risking mechanisms. Rather, more specific support for relevant and market appropriate technical and business support of both small enterprises, but also the financial intermediaries that specifically target small businesses in their markets. This system building capital needs to be re-positioned beyond "de-risking" capital (e.g., first loss constructs) to instead prioritize capacity support – technical skills/resources, human capital and "launch capital" for the local financial intermediaries. We need to mobilize and coordinate this catalytic, system building capital to inform on how best to address and scale small business finance.
  - Development Finance institutions. DFIs and MDBs have the opportunity to re-focus their "catalytic capital" application to patient and "risk tolerant" capital. By focusing their catalytic monies on local capital intermediaries, they can drive system change in small business finance. They would be well-positioned by building upon the learnings from programs initiated by such catalytic capital players as the Growth Firm Alliance. The opportunities include:
    - **Anchor SME Growth Funds.** Local Capital Providers (LCPs) are the innovators and "ground level" change makers. Provide the patient, junior ranking capital tranches of risk capital. This can be done directly, or for smaller ticket needs, via the new capital platforms that can distribute the funds among a portfolio of SME growth funds. There are a number of impactful models evolving over the past five plus years, including

[19] See 60 Decibels – Measuring Impact.

[20] See Riscura.

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women-led funds and funds targeting climate related investments. Working directly or indirectly with these SME growth funds would be the foundation of over $1.5 billion in impact capital to Africa and MENA's impact-oriented small businesses.

- **Hold local banks accountable**. Regulated banks have long been the focus of DFI funding, yet they have not made material changes as to the scale, impact, or sustainability in SME lending practices. By observing the innovations of local growth funds, adapting fintech tools, and applying cash flow-based lending practices, these institutions could be positioned to move large and flexible capital into the SME marketplace. The Argidius Foundation has demonstrated viability of such program with KCB in Kenya.[21] Development institutions should incentivize local FIs to use their support to re-invent their lending to small businesses.
- **Support the application of fintech providers and tools**. In particular, working capital finance for small businesses can be greatly enhanced through technology-enhanced client acquisition, risk management and portfolio management tools. The cost of financing small business can dramatically decline through the application of fintech tools and data-based lending methodologies.

Mobilize capital at the local, domestic Level. Such "in-market" capital mobilization can be driven by:

- Domestic pension funds. There exists an incredible opportunity regarding "additionality" by the DFIs. Local pension funds have historically limited their investments to local government bonds and real estate. As small business finance is a new sector for them, pension funds are looking for the leadership of the DFIs to extend capital to this emerging asset class. By anchoring investments into local small business funds, DFIs attract pension funds as co-investors. Over time, through the shared learnings with the DFIs, pension funds can be a major provider of capital to the small businesses in their communities, just as pension funds in the US became critical to growth of the PE and VC fund markets. By bringing local pension funds into the impact investing arena we are addressing several critical constraints (i) local currency, (ii) longer term capital, and (iii) developing local solutions that will have long term sustainability.
- Regional and Domestic Fund-of-Fund Platforms. There is an emergence of local/regional platforms that invest in small business funds. These platforms aggregate a portfolio of LCPs who in turn provide capital to small enterprises. These intermediary vehicles allow pension funds and other institutional capital managers to indirectly support small business financing. By working through such aggregator platforms, institutional capital holders can better manage their own cost structures and portfolio diversification requirements.
- Central Banks and Regulators. Local regulatory authorities have the capability to reassess the means of supporting small business finance. They can provide regulatory incentives for local financial institutions (FIs) to mobilize capital for small businesses. Improved segmentation of the SME sector by national authorities will allow for more targeted financing by local FIs. This, coupled with new capital weighting rules, can be key drivers of capital flows into the

[21] The Argidius Foundation (2022). *$2 billion for women-led small and medium sized enterprises.*

economically critical small business sector. In addition, LCPs would benefit from greater regulatory clarity and flexibility for non-bank finance in emerging markets.