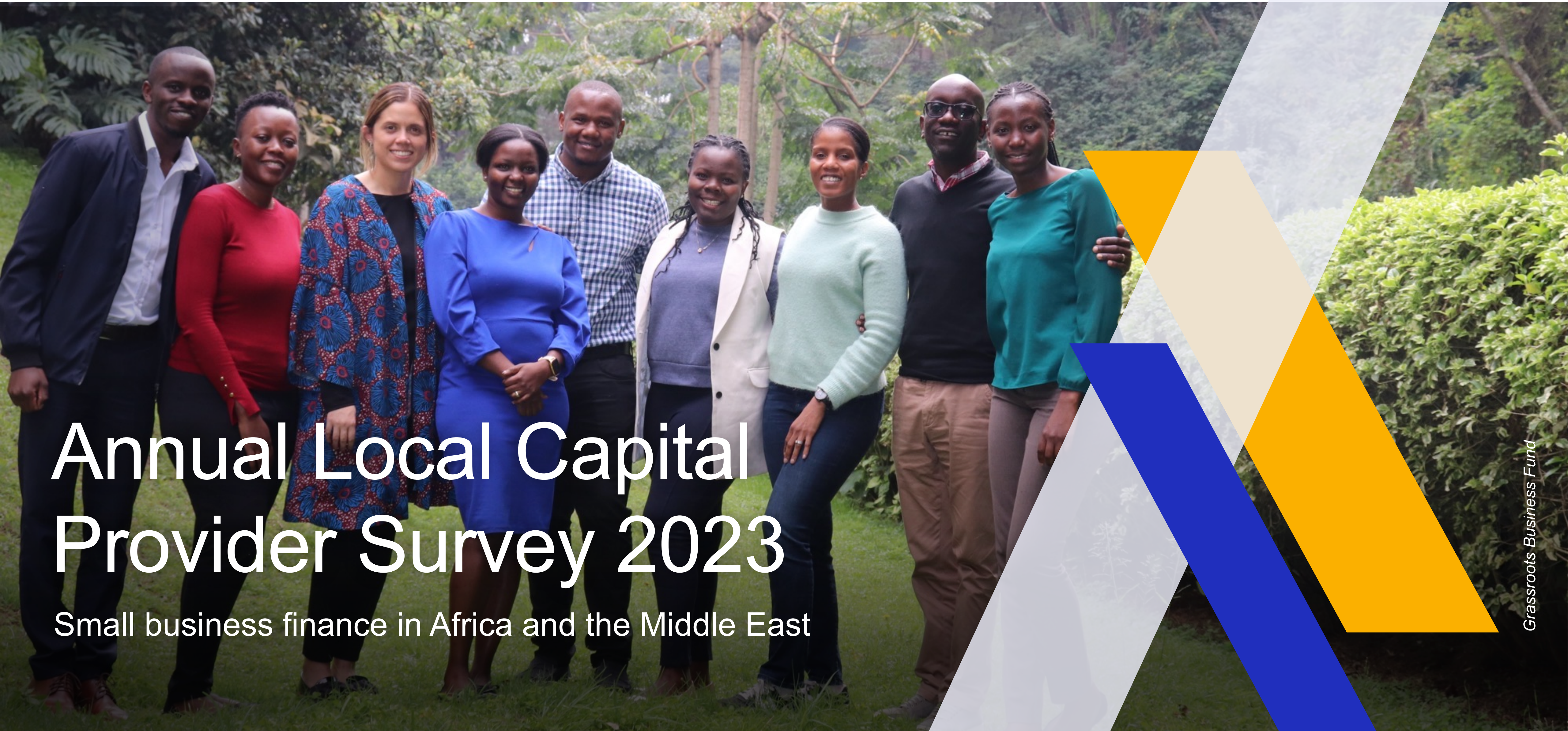
Annual Local Capital Provider Survey 2023

Small business finance in Africa and the Middle East



Grassroots Business Fund

Foreword

Small businesses in emerging markets play a significant role in promoting inclusive growth and building resilience in the face of macroeconomic shocks. Small businesses need investment capital, yet the traditional banking systems in emerging markets have struggled to meet their financing needs.

Meanwhile, an emerging asset class of nonbank financial players have stepped in. Local capital providers (LCPs) are part of the growing private fund landscape. They are fund vehicles based in market by providing smaller ticket, growth-oriented impact capital into small businesses across Africa and the Middle East. They are often the first formal investors in these businesses.

With a few notable exceptions, the global developmental institutions and local government agencies have traditionally backed programmes that focus on regulated banks, larger-scale private equity (PE) funds and tech-oriented venture capital (VC) funds. While noteworthy, these programmes have struggled to reach small and growing businesses in these economies. As such, these critical institutions currently observe the innovations and outcomes of LCPs from the side lines.

In this 3rd annual survey, we provide a state-of-play for these LCPs. We explore the characteristics that distinguish them from existing investment models, focussing on 60 LCPs who, collectively, are looking to provide $1.5bn in capital to small businesses and, to date, have financed 1 200 enterprises.

Having observed these fund managers for the last five years, we are witnessing traction on a number of fronts. As pioneers, they have developed multifaceted approaches and investment models to reach and fund finance small businesses. As field-builders, they have contributed to this report by providing insights and shared learnings. With their innovative approaches, they can inform the broader market on how small businesses finance can be done in the toughest markets.

That said, as this report will indicate, to reach scaled impact, these LCPs themselves need support and investment capital from the development community, institutional capital holders and national small business finance programs. Hopefully, this report can begin to address the information asymmetry that has limited the flow of institutional and patient catalytic capital that is requisite in order to ensure a more resilient small enterprise ecosystem across these regions.

Regards
CFF team

Authored by

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Acknowledgements

Thank you to the local capital providers (LCPs), particularly those in the growing Early-Stage Capital Provider Network, as well as those in CFF' sister networks of 2X Global, Women in Africa Investments and I&P.
The generosity and candidness of the fund managers are major accelerants of the growth of this asset class.

Thank you to our funders, Argidius Foundation and FSD Africa Investments whose ongoing support makes this type of systematic data collection possible.

Abbreviations

AUM	assets under management
BDS	business development support
bn	billion
CFF	Collaborative for Frontier Finance
DFI	development finance institution
FMCG	fast-moving consumer goods
FoF	fund of funds
FTE	full-time equivalent
FX	foreign exchange
GLI	gender lens investing
GP	general partner
HNWI	high net worth individual
k	thousand
LCP	local capital provider
LP	limited partner
m	million
MENA	Middle East and North Africa
mezz	mezzanine
PE	private equity
SAFE	simple agreement for future equity
SDG	sustainable development goals
SGB	small and growing business
SME	small and medium-sized enterprises
TA	technical assistance
USD	United States dollar
VC	venture capital

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Introduction

Purpose of survey

- Further elucidates the distinctive attributes of the SGB finance asset class
- Tracks specific trends and growth momentum of asset class
- Provides deep insights into how small business finance needs are being met by fund managers
- Explores how fund managers are innovating to raise capital, addressing their own track record and sustainability
- Illustrates the business and impact case for these intermediaries considering the early stage of fund lifecycle
- Builds value proposition for LP investors and market builders to engage

Audience

- Commercial and concessionary LP investors: To raise awareness of innovation and investment opportunity in asset class to increase quantum of capital into LCPs.
- Fund managers: To benchmark practice against peers in order to improve effectiveness, sustainability and scalability.
- Policymakers and market builders: To encourage development of mechanisms to leverage capital and continue to evidence business case in order to build sustainable market.

Framing of SGB finance market

- SGBs are crucial contributors to local socioeconomic development and employment in Africa and the Middle East, particularly in the face of macroeconomic shocks and the climate crisis.
- SGBs are chronically under-funded as well-established financial paradigms from banks/microfinanciers/PE/VC funds cannot adequately address their risk and size to be able to offer affordable finance. There has been insufficient recent progress to suggest these financial institutions are heading in this direction.
- LCPs are shaping a new funding paradigm from the ground up. They are using a variety of fund models, investment theses and value creation approaches to not only address specific SGB financing needs, but also address funding vehicle sustainability and scale.

Methodology

Context

This is the 3rd annual CFF Local Capital Provider Survey, following on from the 2020 and 2022 editions. It tracks the progress of an emerging class of fund managers addressing SGB finance in Africa and the Middle East. It is designed to better understand how fund managers are innovating in order to address challenges in this notoriously tricky market segment. Through the years it demonstrates how the market is evolving and SGB finance asset class is taking shape.

Circulation

49-question survey shared with CFF's Early-Stage Capital Provider network, partner networks, regional industry associations and market builders, and posted publicly on social media channels.

Respondents

60 Fund managers investing ticket sizes of between $20k and $2m into SGBs in Africa and the Middle East. All fund managers answered all of the questions.

Survey design

- Organisational Background and Team
- Vehicle's Legal Construct
- Investment Thesis
- Pipeline Sourcing and Portfolio Construction
- Portfolio Value Creation and Exits
- Performance-to-Date and Current Environment/Outlook
- Future Research

Taxonomy

This market segment is emerging along with more precise terminology. Below is some guidance on the choices CFF has made in this report.

Small and growing business (SGB)

SGBs are a subsegment of SMEs whose common characteristics include commercially viable businesses with opportunity for growth, five to 250 direct employees creating new jobs, demand driven business models in real economy, and typically seeking growth capital from $20k to $2m. CFF uses the term SGB as SME definitions are too broad and often context specific.

Fund manager, general partner (GP) and local capital provider (LCP)

These terms are used interchangeably to describe the respondents in this survey. They are a group of financial intermediaries that LPs would routinely refer to as fund mangers or GPs. CFF generally prefers the term 'local capital provider' because they are based in the market they are investing, using a wide variety of fund models, investment theses and operational practices.

SGB finance asset class

SGB finance behaves differently from more established asset classes such as PE, VC and private debt. It has a unique mix of characteristics, which are continuing to be defined through this research, for the purpose of informing LP risk, return, impact, liquidity and correlative preferences. See slide x to explore emerging distinguishing characteristics. Ongoing research will track financial and impact performance of SGBs and funds.

Self liquidating and equity investment models

For the purposes of a comparative analysis between self-liquidating and equity investment models, we have categorised secured/unsecured senior debt, mezz debt, shared revenue and convertibles as self-liquidating, and common/preferred equity and SAFEs as equity.

Commercial, catalytic and concessionary funding

Commercial investment seeks market-rate financial returns and is usually provided by traditional financial institutions. Concessionary funding offers more favourable terms than market rates either in terms of risk appetite, return expectation, length of tenor or a combination of these factors. Catalytic funding aims to drive positive social or economic impact and attract additional investment – it is return seeking but willing to take more risk than commercial funding.

Pioneer fund

For this report, a pioneer fund is ≥$10m in size, set up as first fund or proof of concept to test investment thesis and build track record.

Currency

Figures are quoted in USD and depicted as $(x).

Summary

Amam Ventures. Photographer Tariq Orani

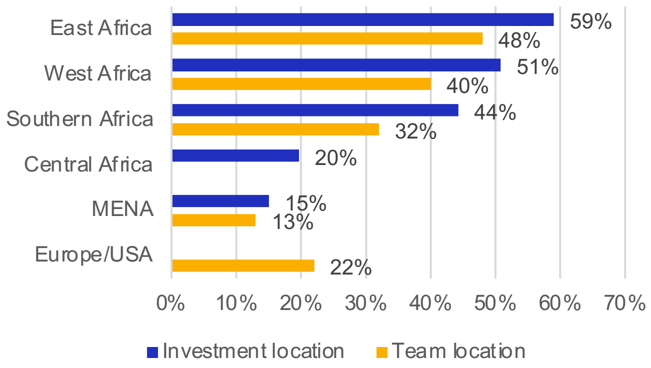
Small business finance as an emerging asset class

Despite operating in different markets with varying investment vehicles, these fund managers share many common features

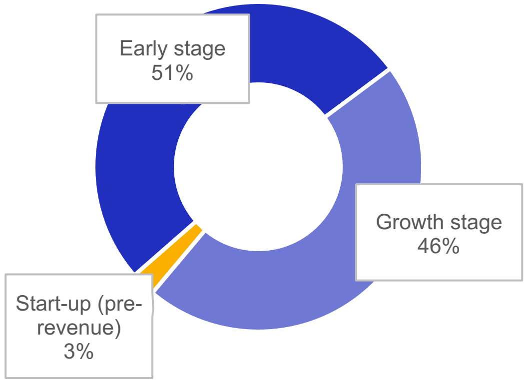
Observations

- **Finance the 'missing middle'**. Write cheques of $200k to $2m
- **SGB-oriented portfolios**. Funds tend to be sector agnostic and target small, growth-oriented enterprises that meet local market needs. While not usually VC type investments, most businesses are tech-enabled.
- **Leverage local business knowledge.** GP teams operating in market include seasoned business executives with extensive understanding of local markets, customer needs, supply chains etc.
- **Balancing fund economics and small business finance**. Emerging evidence suggests sustainability at smaller size than the traditional $30m.
- **Provide the funding *needed* by small businesses**. Working capital, as well as the 'soft' and intangible investments required for growth
- **Innovative approaches**. Cashflow-oriented, with minimal or alternative collateral-based protections.
- **Post-investment value-add**. Investment thesis calls for supporting their portfolios' business and growth requirements.
- **Impact-oriented.** Focusing on job creation and the SDGs.
- **Focus on diversity and inclusivity** among the team and their portfolio businesses, with a strong focus on gender and youth opportunities.

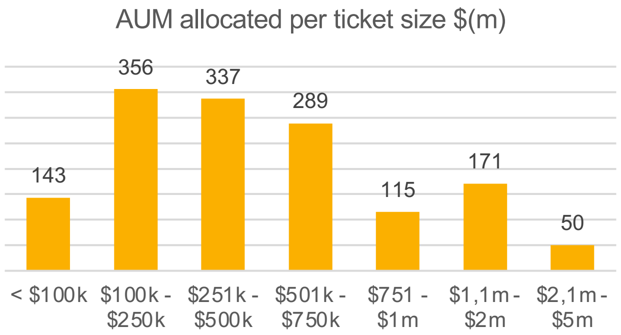
There is a trend towards localisation growing year-on-year



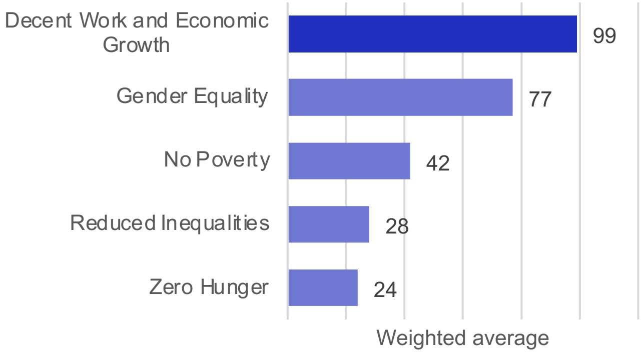
Investing in post revenue companies demonstrating growth potential



75% of fund managers report an average ticket size of <$500k. The majority of AUM overall is allocated to investments ≤$750k



Employment, inclusivity and food are most important SDGs



Visible traction of this growing asset class

See Section 1

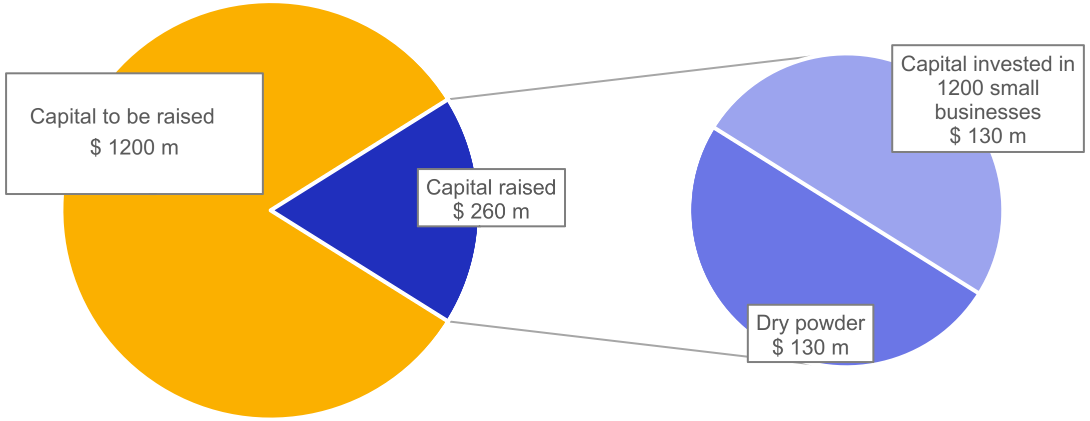
Observations

- **Emerging asset class.** This emerging asset class of small business finance fund managers has continued to grow. AUM is now $260m. Nine funds have reached first close over 2022/23 vs. three in the prior year with almost half now achieving formal first close.
- **Demand exceeding inflow of LP capital**. Learning curve for LP investors continues to lag demand for capital. Fund managers have reported closing at a smaller size than intended to meet the needs of their pipeline. 40% of funds have started investing despite not having reached first close.
- **Financial and impact performance**. 1 200 small businesses have been funded. We can now track performance as 90% were financed more than a year ago and 30% have a five-year track record.
- **Scaled potential is real**. We estimate that the 60 respondents approximate half of small business-oriented funds across the SSA/MENA regions. Cumulatively this group is targeting $1.46bn in AUM – implying a potential in the near term for the sector to achieve approximately $3bn AUM.

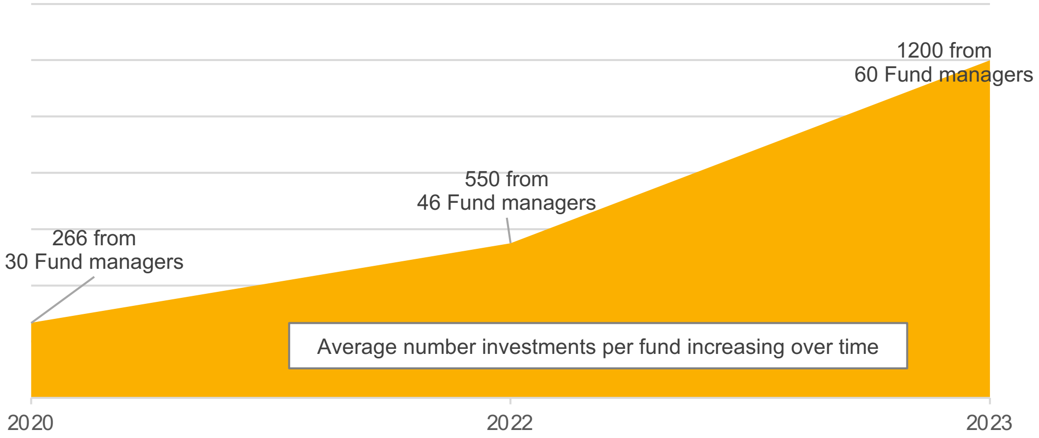
Considerations

- Demand continues to outstrip supply of capital for Africa and Middle East's SGBs. **Yet growth is happening.**
- **Improve understanding of the sector** by institutional and development agency LP's regarding the investment case to accelerate investment
- Begin **benchmarking financial and impact performance** of portfolio companies.

***$1.46b** target AUM representing half of asset class*



Number of investments into small businesses growing exponentially



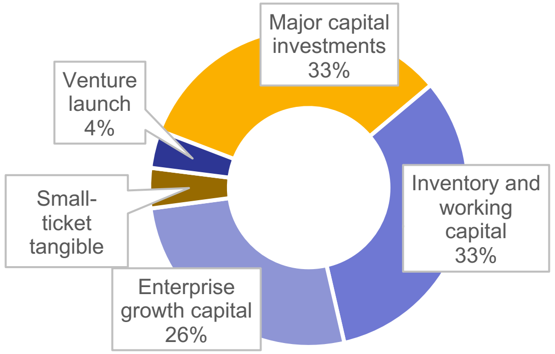
Investment thesis designed to address the needs of small business

See Section 3

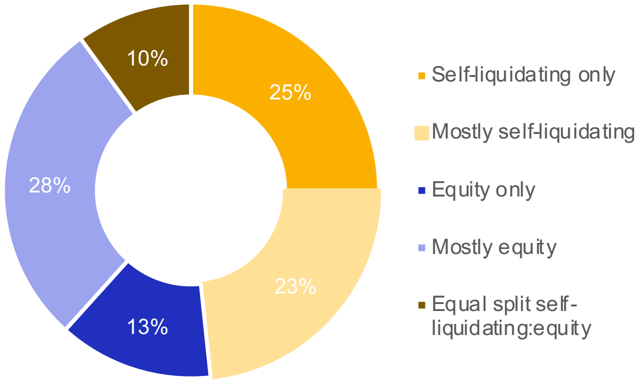
Observations

- **<u>Financing Needs</u>**. 80% of fund managers allocate growth capital for intangible investments – the type of finance small businesses find impossible to raise from banks.
- **<u>Diverse instruments and constructs.</u>** 60% of managers can use either debt or equity, flexibly managing business needs while better managing the risk/ reward balance.
- **<u>Minimise exit challenges of equity</u>**. 60% prioritise debt or self-liquidating instruments – allowing cash flows to cover capital funding needs. Self-liquidating instruments address cultural ownership preferences, allow businesses to prioritise growing their business and cash flow in the early part of financing lifecycle, providing higher degree of liquidity for the enterprises.
- **<u>Technical assistance (TA)</u>**. All funds provide or have intent to provide TA to portfolio companies. Most use a tailored as opposed to standardised approach. This is indicative of business need and is applied despite tight margins.

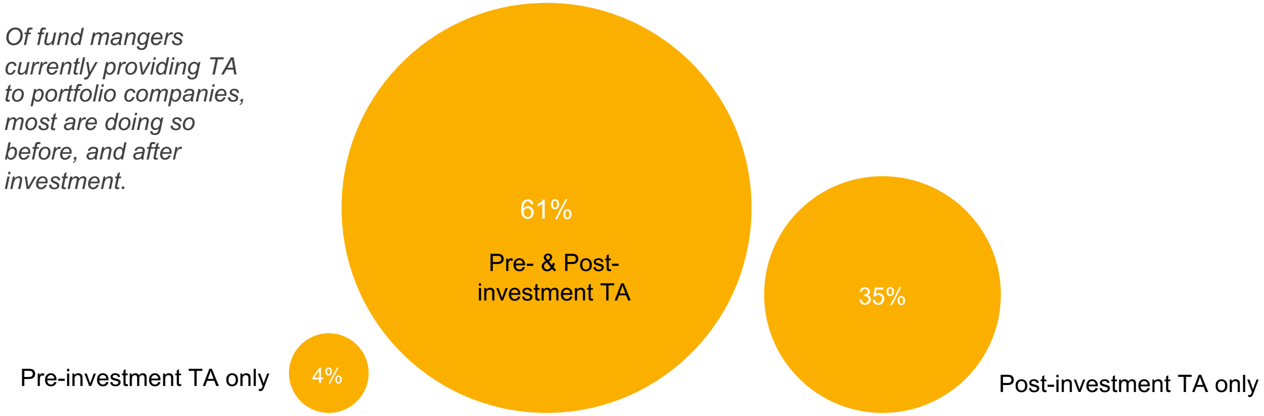
Use of proceeds mainly used to finance working capital, large asset investments and intangible growth investments



60% of fund managers are using a mix of self-liquidating and equity instruments in their portfolio



Of fund mangers currently providing TA to portfolio companies, most are doing so before, and after investment.



Considerations

- **<u>Fund Managers are innovating</u>** on the traditional investment and finance models – ensuring that they can provide the appropriate capital for small and growing businesses
- **<u>Segment and profile fund management models</u>** according to how they address small businesses finance.
- **<u>Provision of TA is a core offering</u>** to portfolio enterprises. Explore how best Institutional funders/donors can support manager's' ongoing capacity to provide these critical services.

Driving an impact thesis of job creation, business sustainability, and inclusivity – while driving financial performance

See Section 3 and 6

Observations

- **Driving employment**. 80% of fund managers are targeting job growth. 100% have achieved stable or positive employment growth in their portfolio companies in last year. Almost all consider the impact of women representation in the workforce.
- **Principal SDGs**. All target at least three SDGs.
- **Inclusiveness**. Women-led funds make up 60% of this asset class compared to 12% in PE and 5% in VC globally.[1] The principals in women-led funds have 2x more direct investment experience than in men-led funds both in terms of deal execution and documented exits.

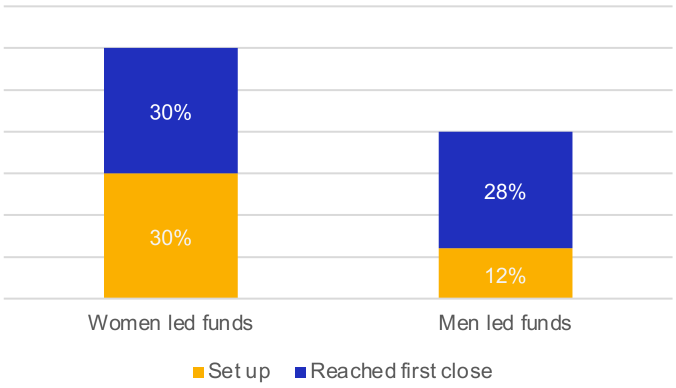
  Women bring other women into investment decision making structures. Women owned funds are 2x as likely to have majority women representation on boards and 1.5x more likely to have majority female management teams.
- **Financial Performance:** Although too early to determine return profiles most fund are reporting positive revenue and operating cashflow growth over the last 12 months.[2]

[1] The State Of Diversity In Global Private Markets: (McKinsey & Co, 2022)
[2] Small and growing businesses are the key to inclusive development. (von Glahn, 2023)

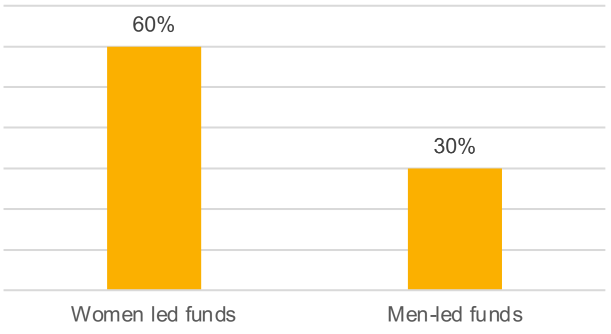
Considerations

- **Develop impact methodologies** that are cost efficient and timely.
- Develop appropriate methods for **portfolios valuation and tracking performance** of small businesses funds.
- Apply **disciplined portfolio valuation** methodologies.

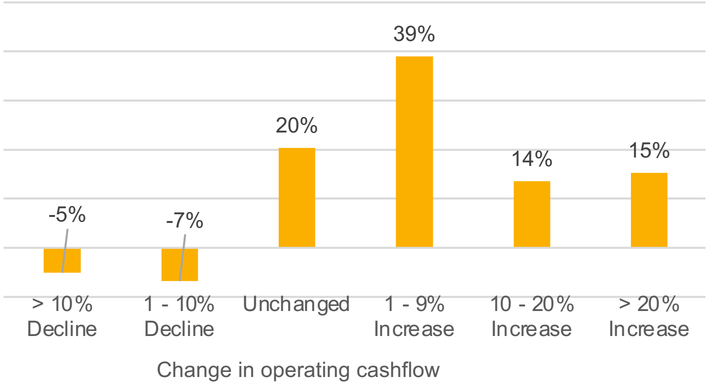
60% Funds are women-led and 100% of all funds are reporting against 2x criteria



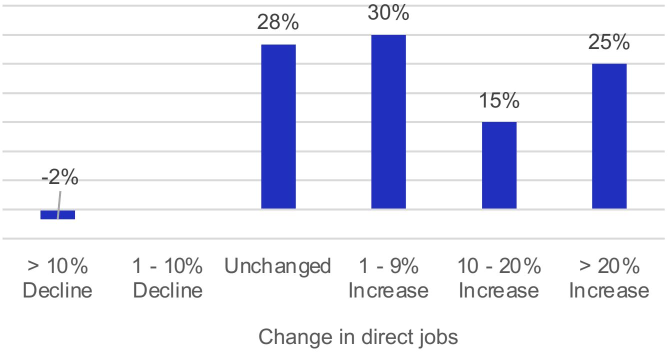
% funds with least two investment principals with well documented exits



70% fund managers are reporting positive change in operating cashflow in the last 12 months



70% fund managers are reporting positive job growth in the last 12 months despite tough macroeconomic conditions



Navigating the twin hurdles of track record due diligence norms and perceived risk of small business finance

See Section 2

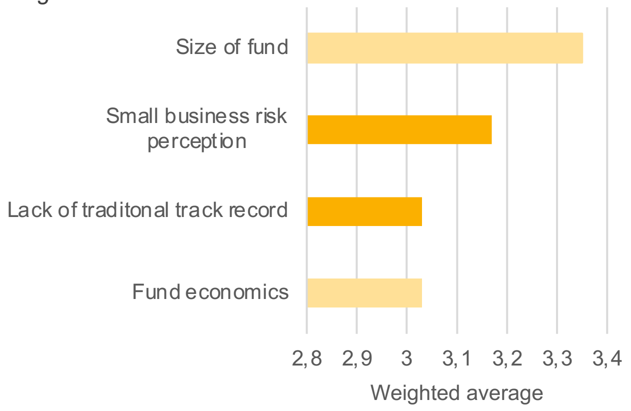
Observations

- **Team track record**. 90% of GPs have direct investment experience (although often as angel investor and not a fund) although only ~50% have documented exits.
- **LP biases**. LPs do not seem to 'value' the GPs' deep local knowledge and business experience
- **Enhanced portfolio selection and value creation**: 50% of funds have their own accelerators and many are integral to angel networks. This approach enhances pipeline quality and leverages market knowledge
- **Demonstration effect**. ~35% of funds are open ended, putting monies to work without delay; ~30% have set up pioneer funds of ≤$10m to test investment thesis; and 30% are investing before first close
- **Information asymmetry of small business finance.** The perceived risk associated with small businesses is considered a significant hurdle to attracting LP investments.
- **Avoid unproven business models**. Only 5% of funding goes towards higher risk, unproven venture type businesses.

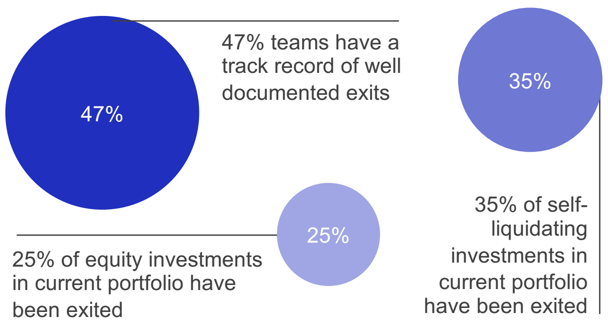
Considerations

- By any metric, this sector needs a **substantial boost in engagement** from development community and better alignment with national leaders
- Embed **appropriate GP incentive constructs** to align team interests and retain talent.
- Increase **availability of warehousing capital** to accelerate 'demonstration effect'.
- **Distinguish the lower risk profile of this asset class** compared to VC/PE investing models.

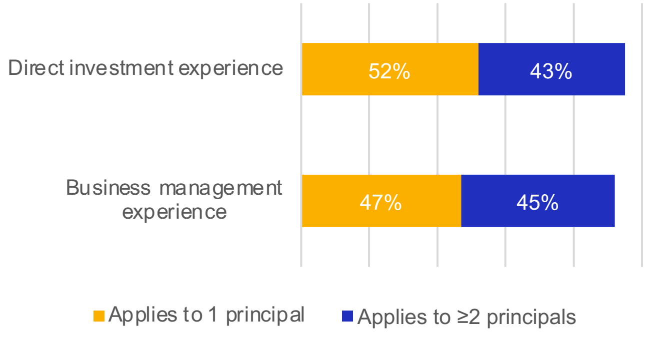
Track record and business risk some of top challenges to fund raising



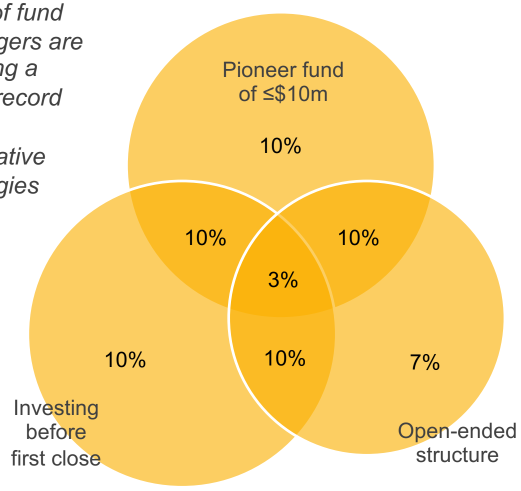
Historic and current portfolio exits



Fund managers have a relevant combination of experience to address small business risk



60% of fund managers are building a track record using alternative strategies



Heading towards making fund economics work …

See Section 1 and 4

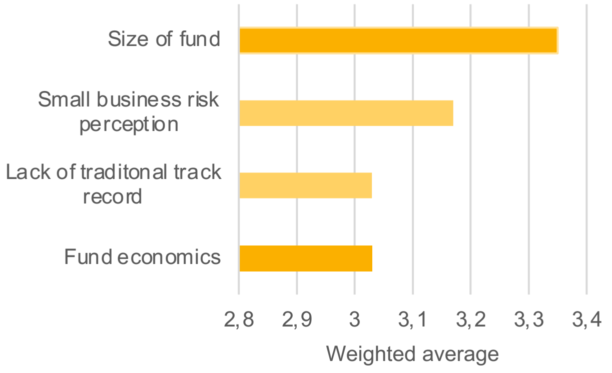
Observations

- **<u>Alternative fee models</u>**. ~ 60% funds use alternative fee structures. ~30% access concessionary funding to set up and cover part of running costs.
- **<u>Managing smaller funds</u>**. 60% of the funds are <$30m, requiring alternative approach to the traditional 2&20 fee model.
- **<u>Open-ended fund models</u>**. ~ 30% launch with open-ended constructs, allowing them to earn fees immediately.
- **<u>Self-liquidating & debt instruments</u>**. 85% of fund managers use at least some self-liquidating investment constructs, allowing for generation of cash flows throughout the investment period vs. waiting for exits. 60% of AUM is invested in self-liquidating instruments.
- **<u>'Value' of market knowledge</u>**. 90% of funds are comprised of highly experienced executives allowing for smaller teams and lower staffing costs.
- **<u>Efficient pipeline development</u>**. 50% have their own accelerator programme or other efficient models of assessing pipeline opportunities – lowering due diligence time and costs.

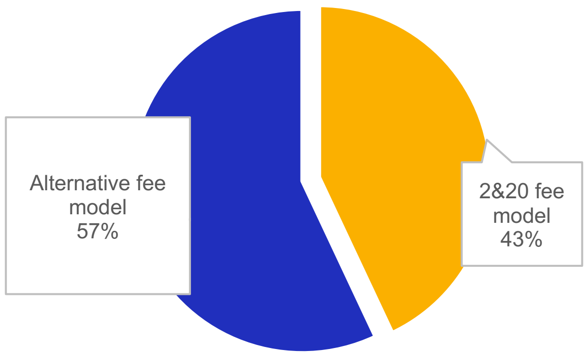
Considerations

- **<u>Shared services</u>** would allow GPs to lower operating costs.
- Sector would benefit from **<u>use of 'smart subsidies'</u>** to support fund managers in early stages of fund lifecycle.
- As ecosystem builders, **<u>DFIs may need to consider greater flexibility</u>** regarding management fees given the economic impact of a resilient small business financing sector.

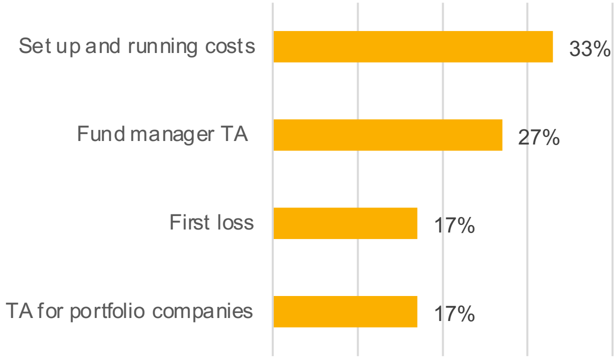
Perception of fund size & related economics are key constraints to fund raising



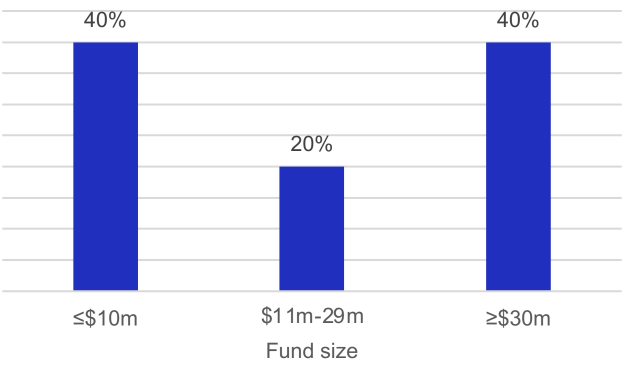
Many LPs appear willing to pay only the 'traditional' fund management fees.



60% of fund managers are accessing concessionary capital in one or other form



Emerging evidence to suggest sustainability at fund sizes <$30m



Where are the those that espouse private sector development?

See Section 4

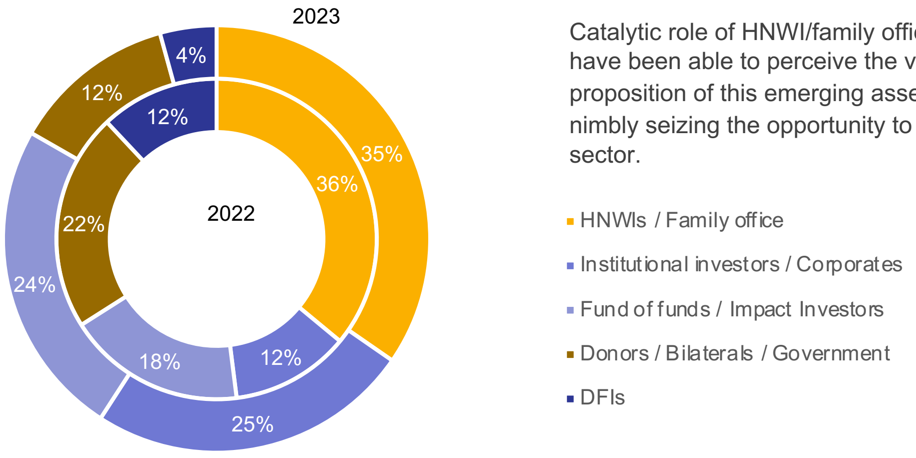
Observations

- **<u>Critical role of local HNWIs</u>**. For the last two years, fund managers have been highly dependent upon the funding support of local HNWIs/family offices.
- **<u>Material support of local institutional investors</u>**. 2023 saw a doubling in the percentage that have tapped these investors.
- **<u>Non-relevance of DFIs</u>**. Despite the development role that such funds play, DFIs have not been compelled to directly support this sector.
- **<u>Shift from donors to market-oriented Investor</u>**. As noted in this report, while concessionary funding can play an important role in launching these funds, managers are increasingly relying on more commercial type capital.
- **<u>Increasing role of fund-of-fund LPs</u>**. FoF are taking on a bigger role.

Considerations

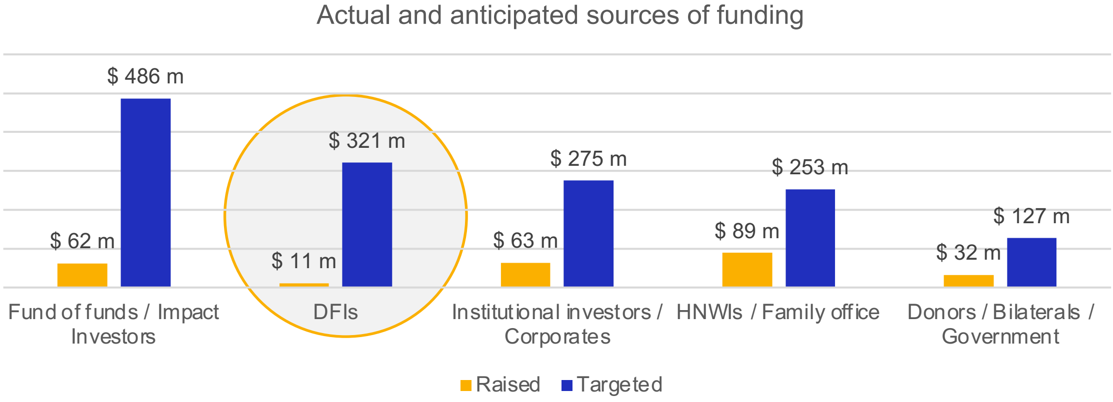
- DFIs played a critical role in the establishment of the microfinance sector. Similarly, **<u>DFIs should play catalytic role</u>** for this emerging asset class.
- Importantly, **<u>local institutional capital</u>** could provide local currency and longer-term funding (e.g., pension funds, asset managers and sovereign wealth funds).
- **<u>FoF vehicles</u>** offer DFIs/institutional investors opportunity to commit larger sums while diversifying across a spectrum of local funds.

Shift in existing sources of LP capital over the last two years



Catalytic role of HNWI/family offices as they have been able to perceive the value proposition of this emerging asset class, nimbly seizing the opportunity to kickstart the sector.

DFIs report large increases in funds invested in 2023. However, with regards to small business finance, they are not prioritising the role of local capital managers.



Concessionary capital key to unlocking an emerging asset class

See Section 5 and 6

Observations

The ‘smart’ use of concessionary capital is critical in the creation of new industries and asset classes. Principal application of concessionary funding has assisted these funds to launch and support initial operating capacity.

- **Set-up costs**. ~30% have received funding for set-up and initial operating overhead costs.
- **Fund TA Support**. A similar percentage have accessed funding for their own TA needs.

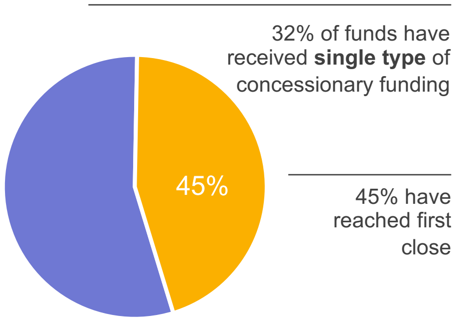
Other uses include:

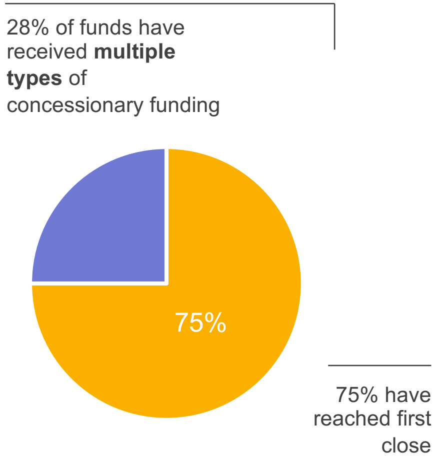
- **Portfolio company TA**. Fund managers provide critical post-investment support to accelerate the growth of their portfolio enterprises. 25% of the funds have received concessionary funding to cover this TA need.
- **Risk mitigation**. The ~20% of managers who have raised first loss have raised ~20% of targeted fund size, which is marginally more than the average of 17%.

Considerations

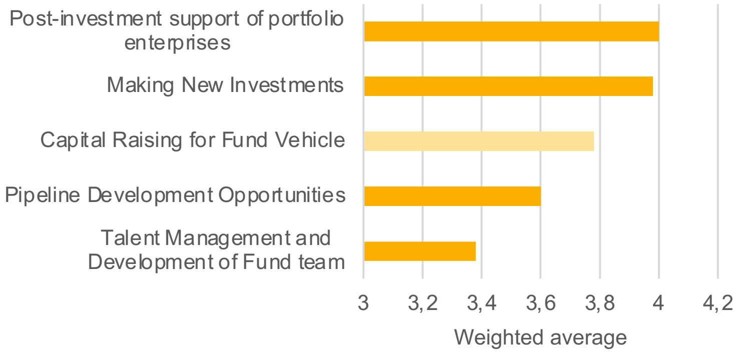
- **“Smart Subsidies”**. Development funders have overly focused on LP risk mitigation in financial intermediary sector, which, while relevant, is not the exclusive ‘smart’ use of subsidies and subsidised capital.
- Recognise the need for **‘catalytic and patient capital”** to build this ecosystem and asset class by developing a ‘suite of subsidies’ to meet the different needs and stages of funds.
- **Capture and disseminate learning** from capital facilities and FoFs that support early-stage funds and emerging managers to accelerate pipeline development.

Structured systematic concessionary funding support can be used to accelerate capital raising in early stage of market building

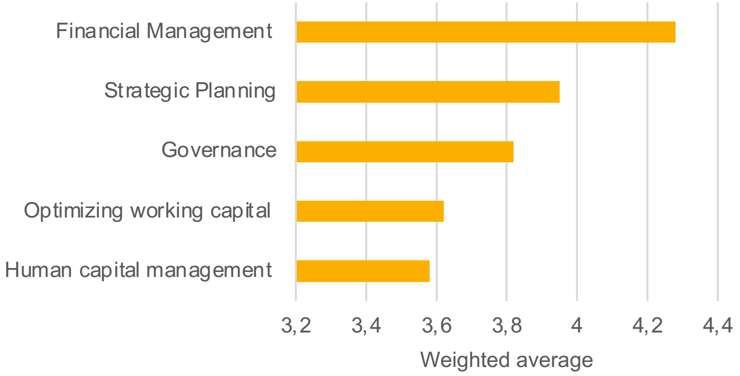




Fund team priorities in next 12 months – grant funding supports TA, capital raising and team retention



~40% of TA for portfolio companies is covered by donor funding supporting mainly finance, strategy and governance



Investors and ecosystem builders need to take a stewardship role in building the small business finance market

See Section 5

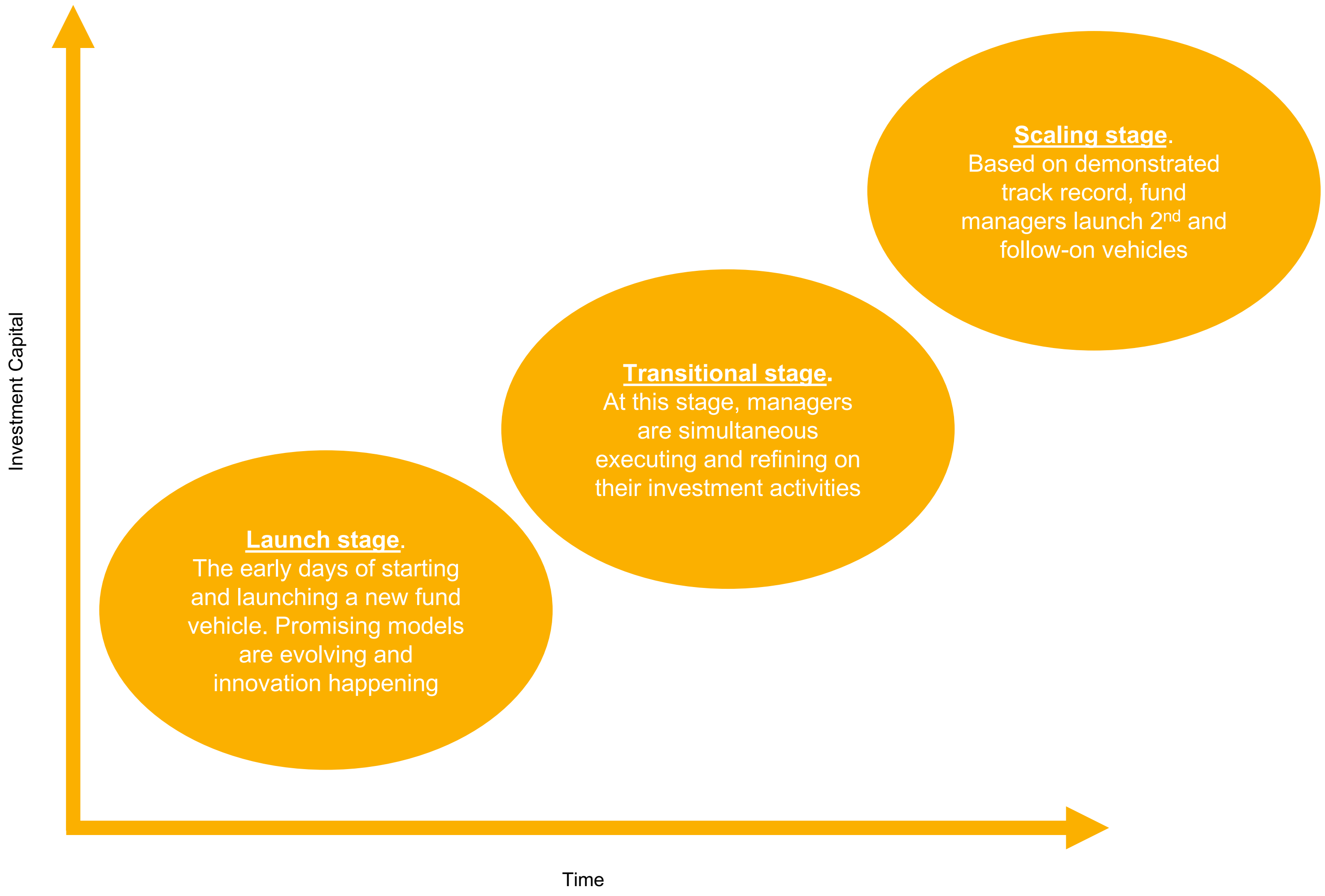
Observations

Three stages in fund development requiring different types of subsidised capital support.

- **Launch stage**. Promising models are evolving and innovation happening . However, this '*R&D*' phase requires ecosystem building capital that is the domain of bilaterals, local development agencies, donors and DFIs (out of TA or subsidised divestment pots).
- **Transitional stage**. Require disciplined capital to provide the monies, confidence and time to play out their investment thesis and capabilities. Fund managers benefit from 'anchor capital' commitments from ecosystem builders that leverage other LPs. Stakeholders include transitional FoF, impact investors and DFIs, local institutional, sovereign agencies, HNWIs and family offices.
- **Scaling stage**. Having demonstrated their investment thesis and capabilities, fund managers move onto achieving scale (e.g., follow-on funds and/or follow-on capital)– while attracting mainstream institutional LPs. At this stage, concessionary monies are highly beneficial to assist in developing impact metric methodologies, post-investment TA.

Considerations

- **Strategically allocate catalytic capital** to each stage of the development and scaling of this asset class



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