COLLABORATIVE
FOR FRONTIER FINANCE

Executive Summary

SGB Fund of Funds Vehicles

ROLE, OPPORTUNITY, AND DESIGN CONSIDERATIONS

Accelerating Access to Capital for Small and Growing Businesses **June 2022**

Fund of Funds Vehicles for Small and Growing Businesses (SGBs)

ROLE, OPPORTUNITY, AND DESIGN CONSIDERATIONS

Accelerating Access to Capital for SGBs

Developed in partnership with

- World Economic Forum Global Alliance for Social Entrepreneurship (Global Alliance)
- Collaborative for Frontier Finance (CFF)
- The Global Steering Group for Impact Investment (GSG)
- Impact Investing Ghana (IIGh)
- Sustainable Development Investment Partnership (SDIP)

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Amos Gachuiri (FSDAi)

1 Executive Summary

1.1 What did we set out to do and why?

Small and medium-sized enterprises (SMEs) are one of the key growth engines of emerging-market economies, absorbing up to 70% of the labour market, generating 40% of gross domestic product (GDP) and unlocking sustainable development. Access to finance is biggest constraint to growth, with a USD3.7 trillion funding gap (excluding micro-enterprises).

The biggest source of credit is working capital through local banking systems, with allocation limited by fixed-asset collateral requirements. Growth capital is available mostly through private funds, vehicles and platforms which are capitalised predominantly by international investors such as development finance institutions (DFIs) or multilateral development banks. But there are limitations on the market-building capabilities of international development capital: lack of proximity to market and preference for debt and direct deals.

In some emerging economies, development funding is being used to leverage local institutional capital to provide local-currency investment to entrepreneurs and businesses. And, indeed, to leverage additional international capital which complements the existing, deep knowledge of local investors with technical, sustainable and innovative finance skills.

It is with this in mind that a consortium of partners, initiated by the World Economic Forum Global Alliance for Social Entrepreneurship (WEF) and including the Collaborative for Frontier Finance (CFF), The Global Steering Group for Impact Investing (GSG) and the Sustainable Development Investment Partnership (SDIP), has been working with Impact Investing Ghana (IIGh) to accelerate the design and implementation of Ci Gaba Fund of Funds, an investment vehicle, that could address some of the key barriers to growth finance for small and growing businesses (SGBs)[2] in Ghana.

[2] *Commercially viable businesses with five to 250 employees that have significant potential and ambition for growth, typically seeking growth capital from USD20k to USD2m.*

1.2 The current situation in Ghana and other African markets

In 2021, 429 private capital investments totalling USD7.4 billion were reported on the continent, with 259 exits reported between 2016 and 2021. This record-level growth has been driven by large deals in infrastructure over the last year, although early-stage companies attracted 54% of the total amount invested.[3]

Ghana is consistently ranked as one of the top 10 private equity and venture capital (PE/VC) destinations on the continent and has attracted over 35% of PE/VC investment in West Africa over the last five years. Most of that capital (70%) is from international investors, mainly DFIs. The local capital that has been raised has been mainly through a government-funded fund of funds, the Venture Capital Trust Fund (VCTF), which has successfully provided first-loss capital to enable local venture funds to raise further financing. The VCTF has recently been recapitalised by the government of Ghana, through a World Bank facility, to invest in additional funds and implement an innovative emerging fund manager programme. This, as well as other FoF initiatives, will provide a critical mass of co-investors focused on local funds that could partner with a pension-funded fund of funds.

The potential of private pension-fund capital in Ghana into private-equity and debt funds has yet to be tapped. These funds control 66% of the more than USD5.5 billion pension-fund assets under management (AUM), growing at a rate of approximately 30% per year. Despite an investment limit of 15% in alternative assets, there is currently only a ±0.03% exposure.[4]

The opportunity for a private-sector-led vehicle to complement the existing initiatives, attracting capital from an alternative segment of investors and focusing on emerging private fund managers, is significant – on paper. Translating that potential into a compelling investable proposition has been the work of the last six months. This took the form of designing and structuring an FoF to unlock pension funding and forming a Pensions Industry Collaborative that brought the industry together to develop a broad action plan to unlock pension funding for alternative assets.

[3] *AVCA. (2020). Private Equity & Venture Capital in Africa Covid-19 Response Report. https://doi.org/10.1177/1403494812457731.*

[4] *Ghana National Pensions Regulatory Authority. (2020). Annual report.*

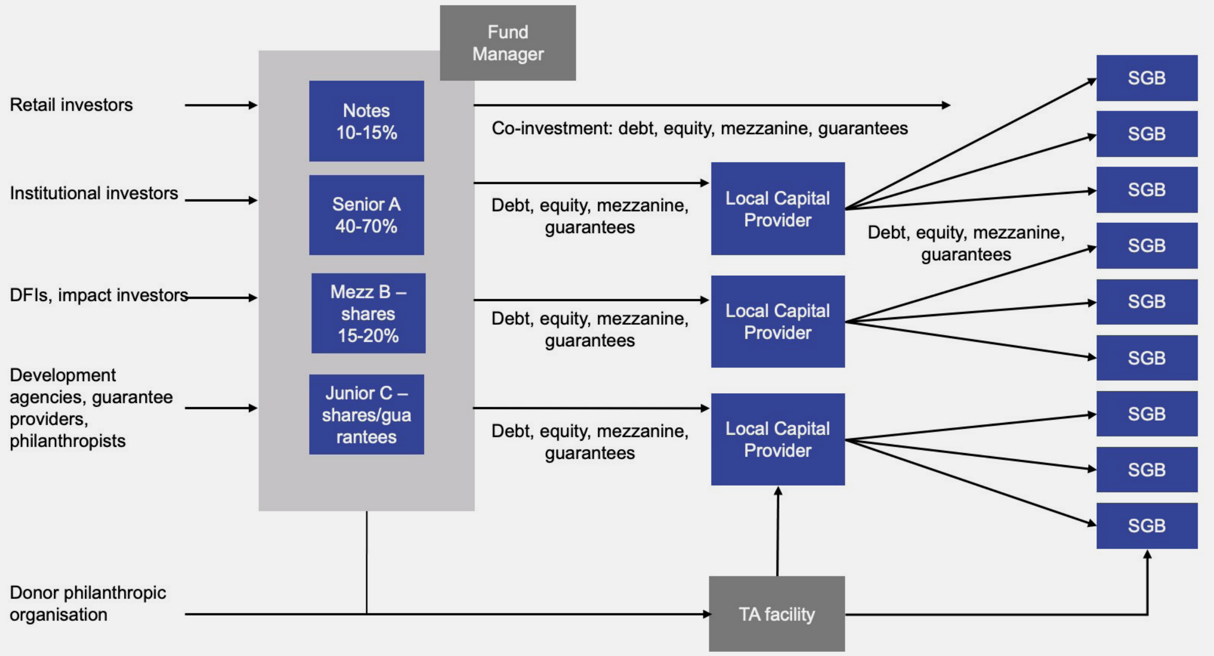
Lelemba Phiri (Africa Trust Group), Leila Charfi (Actawa Ventures) and Dmitry Fotiyev (Brightmore Capital)

1.3 The opportunity to build on and apply our learnings

This research and market review is intended to inform the broader ecosystem on the need for, value of and key construct considerations in the development of new intermediary vehicles to accelerate the flow of capital to SGBs in emerging markets. We have documented our learnings and look forward to working with the ecosystem builders to further both the adaptation of vehicles such as FoFs and an understanding of the role they can play in private-sector development.

We have termed these vehicles SGB FoFs, referring to the underlying asset, or transitional FoFs, referring to the vehicle's role in asset-class development.

Figure 1: Typical Fund of Funds structure[5]



1.4 System-level change: a catalytic opportunity

Fund of funds vehicles for SGB finance offer the potential to address certain market gaps, as described below.

1 Efficient capital mechanisms

These FoF vehicles allow institutional capital holders to "reach down" into the underserved missing-middle market segment, aligning institutional-scale capital with the financing needs of SGBs.

The International Finance Corporation (IFC) and others have long documented that emerging enterprises across Africa are starved for capital in the USD50,000 to USD500,000 range: the "missing middle".[6] To date, it has been a challenge for institutional capital, DFIs and multilateral development banks (MDBs) to addresses SGB finance consistently and at scale. As a result, we have seen a market phenomenon in which "SME" funds are generally between USD30 million and USD50 million in size, driving fund managers to target investment activities above the needs of the missing middle. By supporting a pool of smaller capital vehicles

[5] *Adapted from König, A.-N., Club, C., & Apampa, A. (2020). Innovative Development Finance Toolbox. October. https://www.kfw-entwicklungsbank.de/PDF/Download-Center/PDF-Dokumente-Broschüren/2020_Innovative_Development_Finance_Toolbox.pdf*

[6] *Dalberg & Collaborative for Frontier Finance. (2019). Closing the gaps: Finance pathways for serving the missing middles. Collaborative for Frontier Finance. https://www.frontierfinance.org/closingthegaps*

that meet the funding needs of the missing middle, FoFs address the mismatch in ticket size.

Further, FoFs address the economies-of-scale conundrum that institutional capital holders confront when considering supporting smaller local capital providers[7] that prioritise SGBs (i.e., local fund managers that operate vehicles below USD30 million). Such large institutional capital holders have found that the operational cost of assessing, underwriting and monitoring smaller capital vehicle is prohibitively expensive.

2 Standardisation and simplicity

Over the past two decades, institutional capital and DFIs flowing into local banks and microfinance institutions (MFIs) has benefited from the homogenous nature – and often regulated operating environment – of these intermediaries. Key terms and constructs can be adapted easily from one financial institution (FI) or MFI transaction to the next.

However, local funds or investment vehicles that serve the missing middle are a heterogeneous group. Their capital managers have developed investment models that benefit from the managers' unique skills and experience to meet the capital needs of the emerging enterprises in their markets.

By tapping an FoF, institutional capital and DFIs benefit from the FoF vehicle managers' ability to aggregate such diversified models. Applying standardised underwriting terms, FoFs are able to pool these heterogeneous models under one umbrella, simplifying the investment process for DFIs.

3 Risk diversification

Underwriting SGB missing-middle capital in emerging economies is inherently high-risk. A portfolio of local capital providers provides the requisite pooled diversification.

As demonstrated across all markets, experienced LCPs are in a position to best underwrite and manage local business finance. FoFs are able to pool together a portfolio of such LCPs. This allows for risk diversification, as FoF invests across multiple funds, fund structures and regions – and, thus, underlying small businesses.

4 Enabling market transition

Initial SGB-oriented FoF vehicles offer a pathway to scaled market capital.

We anticipate that these initial FoF models, while immediately achieving a level of scale and addressing market gaps, are a step towards increasing capital flow to the missing-middle sector. Learnings will drive further innovation, thereby enabling access to even larger pools of institutional capital.

In order for these FoF vehicles to play this informing and catalytic role, it will be necessary to obtain as much data as possible from their implementation. This includes information on the types of local funds (the "who"), instruments and investment approaches (the "how"), financial performance and Sustainable Development Goals (SDG) impact (the "why").

The term "transitional" is used in the context of the stage of market development. These "transitional" FoFs enable LCPs to develop a track record with a view to raising institutional monies in the future, providing a staging platform for capital to flow to LCPs through pooled vehicles in the short to medium term, and directly from institutional investors in the long term.

[7] *Investment intermediaries such as funds, vehicles, platforms, non-bank finance intermediaries, etc., investing between USD50k and USD500k into small and growing businesses, using diverse investment theses/tool/instruments having deep local knowledge*

5 Building local SGB financing ecosystems

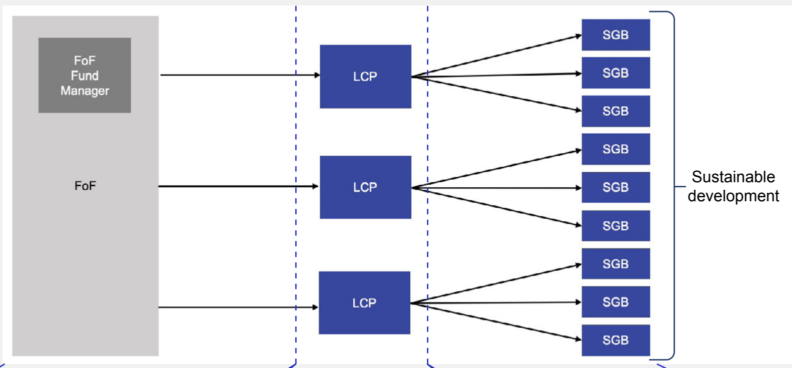
The FoF structure is required as a developmental step to building the market for private, local SGB-oriented fund vehicles.

In the past, it has been the orientation of DFIs, MDBs, bilateral agencies and other "ecosystem builders" to prioritise direct investments[8] into SMEs, "soonicorns*" and high-growth small business. However, in doing so, such development-oriented organisations are failing to support the LCPs that better understand the small-business operating environment. It is these local managers who can best underwrite and manage local business finance.

An FoF vehicle allows field-building organisations to support such local intermediaries and, in doing so, build local teams, skills and experience for establishing a more consistent and resilient SME-financing sector in emerging markets.

[8] CEM Benchmarking. (2015). Value added by large institutional investors between 1992-2013.
** Soonicorns" – "A recently launched business that has the potential to become a "unicorn" (valued at more than one billion dollars)*

Figure 2: Potential Theory of Change at the FoF, LCP and the SGB levels



Investor

Providing flexible or additional capital to LCP's

Leveraging additional commercial, local institutional or private capital

Sharing data to enable transparency on financial and non financial performance

Driving impact integrity by sharing data, frameworks and benchmarks

Advocating with policy makers for regulatory change

LCP

Building capacity

- Emerging and existing fund manager capacity development
- Impact measurement and management support
- Network activation
- Working capital facilities
- Negotiate and set up opportunity for Shared services

Providing anchor funding

- First time fund managers
- Minority or underserved fund managers
- Fund managers source funding from other investors as a result
- Warehouse facilities for fund managers

Replicating fund structures in alterative geographies, sectors or market segments

SGB

Investing on suitable and affordable terms

Providing technical assistance to SGBs

Achieving impact in the lives of entrepreneurs, employees and customers at SGB level

Developing sub-sectoral pipeline through advocacy, regulation or project development funding

Increasing capital supply to SGB sector by building investment case and reducing information asymmetry

Accelerating the implementation process - critical issues to be considered

This project has had the benefit of input and guidance from a number of experts across the ecosystem. Recognising the value proposition of FoFs for SGB finance, our goal was to lay out the key issues for accelerating the market's acceptance, design and implementation of such catalytic vehicles.

In this review, the following major considerations arose:

Establishing the purpose

1 Clarity of purpose is critical in establishing the investment thesis and operational model

FoFs offer the opportunity to develop a diverse portfolio of fund vehicles - and therefore, presumably, can address multiple market failures. However an overly broad investment and theory of change focus runs the risk of creating too much uncertainty or novelty for investors.

Considerations for establishing the investment approach and operating model

2 FoF economics is challenging

The economics of small - business finance in emerging markets is inherently difficult. The key to system - level change is demons trating that the FoF's portfolio of LCPs can indeed make market - based investments in SGBs. Although at this catalytic stage, it is not a necessity for the FoF itself to obtain market - based returns for all its LP capital investors. Rather, a "blended" return approach may most likely be required, in which a portion of its capital or funding is subsidised. Alternative approaches to remuneration can also be considered in the early stages of market development.

3 Desired flexibility does not necessarily equate to open - ended models

FoF form should reflect core investment objectives whilst meeting the often - complex objectives of LPs and addressing any perceived potential risk imbalances. While SGB FoFs are not automatically candidates for open - ended vehicles, the flexibility afforded by an open - capital vehicle implies that such vehicle is suitable for system informing FoF vehicles.

Accessing appropriate limited partners (LP) and institutional capital

4 Local LP capital

FoFs offer local institutional investors, particularly local pension funds (LPF), an interesting "play" in small - business finance by addressing need for diversification and long - dated assets. FoF vehicles and teams can and have addressed capacity, regulatory and risk - return constraints.

5 International development capital

DFI's consider themselves FoFs so are reluctant to invest into an additional intermediary layer, yet they rarely access the type of LCP highlighted in this report. Perhaps most convincing, is the role FoFs that can play in accessing local institutional capital but the authors consider it is also incumbent on development funders to innovate around risk/return/impact expectations and enhancing their respective contributions to better - informed market data in SGB finance.

6 Blended capital for transitional FoF vehicles.

There is an important role for concessionary capital at this time with regard to risk mitigation, management fees, technical support and data analytics. There is evidence to suggest that, once precedent for fund models is achieved Expanded critical insights.gdoc in a market, fundraising for similar structures becomes much easier with both the original investors and a wider group.

Risk management – unbundling and managing the risk profile is critical

7 Governance

A well - articulated governance framework is required for aligning with the value proposition of the investment vehicle.

8 Portfolio

The ability to diversify investment risk across a portfolio of local fund managers, different investment strategies, differing underlying SGB portfolios, and return and investment mechanisms will be key.

9 Team capabilities and experience

Even with emerging data and risk management tools, SGB finance requires a nuanced understanding of the local markets. The knowledge and experience of these LCPs is therefore critical. FoF teams may be augmented by tapping experienced FoF managers or IC members who may have operated outside the local markets.

Design process and implementation

10 Resources and mandate

The complexity and technical factors to be considered in the design of an FoF require material resources. The FoF design process is driven – and influenced – by several foundational factors, including development funding, anchor funding and vehicle mandates.

Roeland Donckers (Iungo Capital) and Wiem Abdeljaouad (Actawa Ventures)

1.5. Using the Ci Gaba Fund of Funds design process to anchor the learnings

The Ci Gaba Fund of Funds has been designed by a group of investment professionals associated with Impact Investing Ghana. The key terms are captured below, and the fund management team is in the process of capital-raising.

Of the remaining nine operational FoFs and wholesaler vehicles summarised in the table below:

- They hold a total of over USD875 million in AUM and all are currently deploying.
- All are focused on addressing constraints at a fund-manager level (mostly first-time or underserved fund managers).
- Four have either targeted or have managed to raise local institutional capital from pension funds.
- The single-funding-source wholesalers have created funds of ±USD150 million to USD200 million in size; the size of FoFs pooling investments tends to range from ±USD25million to USD100 million.
- Ticket sizes range from USD5 million to USD20 million.
- Fees range between 1-2% of AUM, with two offering performance-based incentives to FoF management teams.
- Only one FoF does not offer technical assistance to fund managers.

Lillian Mramba (Grassroots Business Fund)

Table 2: Fund of funds profiles (funds 1 – 5)

Fund	Ci Gaba	Nyala Venture	I&P IPDEV2	Seed capital and Business Development Facility	FMO Ventures
Geography	**Ghana and West Africa**	**Sub-Saharan Africa**	**Francophone Africa**	**Africa**	**Africa**
Goal	Designed to address lack of investment in early-stage funds providing equity investment in SGBs	Designed to promote investment readiness of funds seeking institutional capital	Designed to share methodology of equity investment and sponsor first-time fund managers addressing early-stage capital gap in SGBs in Africa	Designed to address lack of anchor investment in first-time fund managers	Designed to support business using technology to enable affordable access to goods and services
Construct	• USD85m • Senior tier for pension funds • 30% first loss • Ghana domicile • Open-capital vehicle	• GBP8m from FSD Africa • Kenya domicile • Limited liability company (LLC)	• EUR24m sponsor fund • Investors include DFIs and private foundations • EUR15m leveraged from mainly African investors thus far	• EUR 40m from Ministry of Foreign Affairs of Netherlands	• EUR200m from Dutch government • First-loss guarantee from European Commission
Portfolio	• 10 to 15 funds • 40% emerging funds • Flexible capital - debt or equity • 50:50 Ghana/regional • 20% co-investments	• 6 to 8 LCPs (funds) • Flexible capital – debt or equity (+ working capital loans) • USD25k - USD2m ticket size	• Targeting 10 first-time fund managers (invested in 5 so far) • Anchor investor up to 20% fund size	• Demonstration of sub-scale funds of ±EUR7m-15m in size • EUR1m – 1.5m ticket size • Loan, equity or mezz with results-based instrument linked to socio-economic outcomes	• 60% Africa • 50% indirect • 14 investments in VC funds • EUR515m ticket size
Management	• 1% AUM management fee • Investment team based in West Africa • Independent Investment Committee (IC)	• 4-person investment team based in Europe and Africa	• No data on IPDEV2 specifically • I&P 100-person team across 10 countries	• Managed by four-person team from Triple Jump	• Netherlands-based team
Value creation	• Target return on investment (ROI) of 20% per annum (local currency) • 5% technical assistance (TA) facility to support emerging fund managers	• USD300k TA facility • USD270K Learning Lab • Both manged by CFF	• EUR3.50m facility • Funds pre-close costs • GP TA • Supports TA fundraising • Access to I&P network	• Some shared capacity building for fund managers • Loan/grant for portfolio company TA distributed through GP	• Co-investment with qualified lead investor • Ventures programme TA facility focus on environmental, social and governance (ESG)/impact/ inclusive business

Table 3: Fund of funds profiles (funds 5 – 10)

Fund	Capria Fund 1	Black Business Growth Fund	SA SME Fund 1	Thuso Incubation Partners	Public Investment Corporation (PIC)
Geography	**Africa, Latin America, and Asia**	**South Africa**	**South Africa**	**South Africa**	**Africa**
Goal	Designed to address lack of early-stage and early-growth risk capital required to scale	Designed to invest in emerging black-owned and -managed private-equity funds	Designed to address lack of economic growth due to lack of capital into SMEs	Designed to support emerging black fund managers in low mid-cap funds	Designed to increase PIC exposure to alternative investments across Africa
Construct	• ±USD60m • Closed-ended 13(+2)-year fund	• USD80m • Senior tier includes local PFs • USD13m first loss from government • Closed-ended fund	Fund 1: • USD100m • Open capital vehicle Fund 2: • Target USD35m with 20% first loss • Closed-ended fund	• USD165m AUM • Instigated and anchored by Eskom Pension and Provident Fund	• USD200m • Part of 5% strategic asset allocation from Government Employees Pension Fund
Portfolio	• 50:50 between emerging and experienced fund managers • Fund size: USD20m – 100m • USD500k – 3m ticket size • Debt or equity	• 5 to 7 funds • Focus on growth capital investments rather than buyout	Fund 1: • 7VCs + 5 growth funds (private equity and debt) • 5 first-time fund managers	• 9 funds • Underlying investment in low mid-cap companies	• 10 Investments (1 FoF) • ±USD20m ticket size • 20% emerging; 50% developmental, 20% established
Management	• 10 people in investment team • 5 people in operations and finance	• 1% AUM management fee • Performance fee: 10% above 8% hurdle	Fund 1: • 2% AUM management fee • Performance bonuses in lieu of carry	• Fees % AUM in line with FoF precedent and no carry • Team of 2 FTEs; ±8 for ad hoc support	• 2% AUM management fee
Value creation	• Long-term GP partnering & CEO support • Access to Capria network	• Target return: CPI+10% net internal rate of return (IRR) in ZAR • Supported funds during COVID • Shared IMM system	• Fund manager support • TA to support pipeline development	• Shared services platform (compliance, audit, legal)	• Exits for direct investments require auction process • No TA offered

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